MONETARY SOVEREIGNTY IN RUSSIAN CONTEXT
(WORKSHOP DISCUSSION PAPER)

1. INTRODUCTION

The experience of failed systemic transformation from central economic planning to market economy in post-Soviet Russia and the resulting severe demonetisation of the Russian economy have made the strive for monetary sovereignty an important part of the Russian political and academic debate throughout the post-Soviet period. The recent global financial crisis and the financial sanctions have revealed the full extent of the Russian dependency on foreign currencies and the global financial markets, and led to a new round of discussions on the remonetisation of the economy and thus ensuring Russia's monetary sovereignty. In this context, monetary sovereignty is understood as one of the main components of economic sovereignty with close links to democracy, equality, accountability, legitimacy as well as economic and social development.

As a legal concept monetary sovereignty is a relatively simple idea. It is generally understood to include the following three essential authorities of a sovereign State:

- Authority to issue its own currency as a legal tender within its territory;
- Authority to regulate the use and determine the value of its own currency; and
- Authority to regulate the use of any other currency within its territory.

The legal concept of monetary sovereignty is based on the concept of general state sovereignty and emphasises the power of the State to exercise absolute authority within its boundaries. This understanding expresses the normative ideal of the state monopoly in creating money and regulating its own monetary affairs. In the contemporary Russian context, where the limitations on the exercise of monetary sovereignty that arise from international law (most notably Articles IV[1] and VIII[2] of the Agreement of the International Monetary Fund) constitutes only a minor constraint on the modern State, monetary sovereignty is essentially a domestic legal concept. Moreover, from the purely legal point of view the Russian state retains all the sovereign powers to regulate its monetary affairs.

In contrast to the normative ideal and the legalistic interpretation of monetary sovereignty, however, it is well recognised that the Russian state is seriously constrained in the exercise of its monetary sovereignty. The analysis of factual constraints constitutes the positive interpretation of monetary sovereignty which evaluates the actual capacity of the State to determine its monetary policy and affect economic outcomes with a particular focus on the consequences of international economic integration. As a result, the contemporary understanding of monetary sovereignty combines normative and positive interpretations which complement each other in the dialectical search for a harmonious role of the State in monetary affairs by providing a value-based regulatory guidance and an analytical framework for evaluating factual constraints on monetary sovereignty.

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1 Art. IV(1) of the contains a code of conduct for the IMF members. Most notably, Art.IV(1)(iii) obliges IMF members to avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.

2 Art. VIII sets out various general obligations of IMF members. In particular, according to Art. VIII(2)(a), no IMF member shall impose restrictions on the making of payments and transfers for current international transactions without approval of the Fund.

In the Russian context, the normative ideal of monetary sovereignty is clearly expressed in the political will of the contemporary Russian authorities and in the works of nationalist economists. The extensive currency substitution of the rouble by the US dollar combined with the lessons from the recent financial crisis, the opposition to financial sanctions and the longstanding anti-American socialist tradition makes the search for monetary sovereignty ever more important in Russia. Although the debate on monetary sovereignty too often treats the State as a single set of preferences and ignores the workings of opposing interests entangled in an intricate web of modern economies, the current debate on monetary sovereignty in Russia is likely to gain support from a wide spectrum of various fractions of the Russian economic and political elite.

While the will for reasserting Russia's monetary sovereignty is evident, there exists little consensus on the most effective ways to achieve it. The debate on the monetary sovereignty, therefore, almost exclusively focuses on its positive interpretation, i.e. the study of the factual constraints on its exercise and the ways to remonetise the domestic economy. The debate is necessarily complex by its nature and touches upon a wide variety of domestic and international aspects of monetary affairs and their connection to the economy. In this context, this paper provides an overview of the most critical aspects of the debate on monetary sovereignty in Russia by looking at the history of the development of the Russian financial system and the key obstacles to remonetising the Russian economy.

2. TRANSITION TO TWO-TIER BANKING

2.1 Soviet monetary system

Until 1987, the Soviet economy was based on central planning, with the state exercising direct control over 90 percent of production and distribution. The system of central planning consisted of a series of national production and distribution plans developed by central authorities and implemented throughout the Soviet Union by establishing detailed output production targets and determining the end-use of most of the output products.

The national production and distribution plans were expressed first in units of production (material planning) and then in money (financial planning). Although the financial planning was an integral part of the central planning process, the allocation of financial resources was largely determined by the central plan for material goods and implemented through the so called cash and credit plans under the administration of the State Bank. For the most part credit plans were the financial counterparts of the quantitative material planning, whereas cash plans determined the supply of liquidity to the household sector. In these circumstances, the macro- and microeconomic planning by centralised administrative methods minimized the role of banks in financial intermediation and risk assessment.

The State Bank performed the functions of a central bank and most of the functions of a commercial bank. As a central bank the State Bank emitted cash, operated a payments system and held responsibility for the overall provision of liquidity and credit resources in the economy through the implementation of cash and credit plans. As a commercial bank the State Bank financed certain deviations for plan targets, such as short-term falls of profits, and provided a limited amount of credit. In addition to the State Bank prior to 1987 the Soviet banking system included three specialized banks: the Savings Bank, the Construction Bank and the Bank for Foreign Trade. The Savings Bank acted as a deposit taking institution and provided long-term government bonds as an alternative financial asset for the household sector. The Construction Bank provided long-term investment credits to enterprises in the implementation of the long-term credit plan and the Bank for Foreign Trade conducted all foreign exchange operations, managed the international reserves and extended credit to enterprises responsible for foreign trade.

2.2 1987-1988 banking reform

The Soviet planned economy began to be reformed in 1987 with the aim to make it more efficient through limited liberalisation and decentralisation. The reforms aimed to dramatically increase the banks' role in the Soviet economy by raising enterprises' autonomy and liberalising flow of credits in the economy. The reform reorganised the system of specialised banks by separating commercial banking activities from the State Bank and concentrating them in a set of newly created specialised banks. As a result of the reform three new state banks were established: the Industrial and Construction Bank, which became the successor of the former Construction Bank, Agricultural Bank and Social Investment Bank. These banks took over all the commercial banking functions of the State Bank, including taking deposits from, and granting credits to enterprises.

In 1988 the reform of the banking sector was also accompanied by the introduction of the Law on Cooperatives, which authorised the establishment of cooperative enterprises and cooperative banks. These banks significantly deferred from the specialised banks as their customers were not limited to a particular sector of the economy. They were free to service both households and enterprises across all sectors of the economy by granting short- and long-term credits, accepting deposits and engaging in foreign exchange operations.

The 1987-1988 banking reform became a first step in the subsequent transition to two-tier banking system in Russian Federation. In the reformed system the State Bank retained the power to determine the volume of credit formation in the economy and all the other banks could issue a loan only by drawing on deposits or by borrowing from the State Bank. Although under this more decentralised system specialised banks were allowed to attract deposits, the State Bank placed ceilings on the aggregate credit granted by each bank and their lending activities were almost exclusively financed by the State Bank credits. The State Bank prescribed the amount of credits directed to each specialised bank according to the centralised sectoral allocation and the refinance rate for those credits.

In line with the increasing realisation of the rigidity of central planning at the time, it was well recognised that the demand for money could not be measured with absolute precision by centralised administrative methods and decisions to issue loans could not be concentrated entirely in a single centre in principle. It was argued that the absence of competition in the banking sector and the rigidly of centralised procedure for setting interest rates seriously hampered the effectiveness of the financial system[3].

2.3 Debate on two-tier banking

The 1987 banking reform did not go as far as to establish a two-tier banking system. Leading economists maintained that "there must be strict centralized control over the overall volume of credit investments and the magnitude of the money mass" [4]. The solution to the contradiction between the centralised control of the money creation and the recognised need for decentralised credit allocation and decentralised process for discovery of equilibrium interest rates was seen in the establishment by the State Bank of credit limits, the terms of which would allow the distribution of credit in accordance with the resulting economic effect whilst ensuring the accomplishment of the state plan at the same time.

The Soviet economic literature did not rule out the possible transition to a two-tier banking system completely, but cautioned that under the two-tier banking system the

3 S.M.Ignatyev, "The Banking System: Paths to Reform", Problems of Economics, May 1989. Translated from the Russian text in Ekonomika i organizatsia promyshlennogo proizvodstva, 1988, no.8, pp 21-34.

4 See Ignat'ev, supra note 3, p.99.

central authorities will find it difficult to monitor the amount of money supply. Sergei Ignatyev, the later chairman of the Bank of Russia in 2002 – 2013, wrote at the time:

> "In a two-tiered banking system, the central bank directly determines only the so-called "monetary base", i.e. the sum of the funds of independent banks in central bank accounts and cash in circulation. The size of the money mass depends not only on the "monetary base" but also on other circumstances, in particular on the proportion in which the population divides its accumulated money into cash and deposits. This shortcoming of the two-tiered banking system can be manifested with particular sharpness in a period of major institutional transformations, when changes in the behaviour of economic agents can result in difficult-to-predict changes in the money mass. Therefore, if the transition to the two-tiered banking system is to be accomplished, then it should come only in the concluding stage of restructuring of the economic mechanism." [5]

At the time the exogenous/endogenous nature of money creation and the mechanism for the transition of monetary policy under the two-tier banking system was hardly discussed in economic literature. It seems that the reactive nature of the two-tier monetary system, i.e. the fact that it responds to the development of existing markets, rather than actively assists in their development, was insufficiently discussed. The following introduction of the two-tier banking system in the USSR took place well before the development of market economy and resulted in disastrous consequences for the economic development of the country, and a significant loss of economic independence and monetary sovereignty.

2.4 Introduction of two-tier banking

Despite the precautionary analysis against early introduction of the two-tier banking system, soon after the Russian Soviet Federative Socialist Republic ("**RSFSR**") declared its state sovereignty on 12 June 1990 the Supreme Soviet of RSFSR proclaimed the introduction of the two-tier banking system in RSFSR. On 2 December 1990 the RSFSR adopted the Law on the Central Bank of the RSFSR and the Law on Banks and Banking in the RSFSR, which marked the beginning of Russia's modern two-tier banking system. The new legislation constituted the Central Bank of the RSFSR as an independent central bank under the new name of the Bank of Russia. The law provided the Bank of Russia with the means to supervise and regulate newly created commercial banks and to conduct monetary and credit policy under the modern system of two-tier fractional reserve banking.

The new law defined the Bank of Russia as the authority for monetary and credit regulation of the economy and obliged it to regulate the volume and the structure of money mass in circulation[6]. In line the basic principles of two-tier banking, it also pronounced that the issue of non-cash money was undertaken in the process of deposit and lending operations[7]. To this end the law provided that the necessary means of conducting monetary policy and loan regulation included the determination by the Bank of Russia of the size of mandatory reserves and loan interest rates, the prescription of economic rates for banks and effecting transactions with securities. The new system of banking regulation prescribed certain financial norms which had to be fulfilled by every commercial bank. These norms included: (1) a minimum statutory capital requirements; (2) a maximum equity ratio with due assessment of risks; (3) liquidity rates; (4) a minimum amount of statutory reserves to

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5 See Ignatyev, supra note 3, p.103.
6 Art. 13 of the Law on the Central Bank of the RSFSR.
7 Art. 11 of the Law on the Central Bank of the RSFSR.

be deposited with the Bank of Russia; (5) maximum risks allowable for one borrower; (6) limitations of hard currency and exchange rate risks; and (7) restrictions on the use of borrowed deposits for the purchase of shares belonging to legal persons[8].

After a short standoff with the State Bank of the USSR and the dissolution of the USSR the Bank of Russia became the only body of state monetary and foreign exchange regulation in Russia. On 20 December 1991 the State Bank of the USSR was disbanded and all its assets, liabilities and property in the RSFSR were transferred to the Bank of Russia. The transition to the modern two-tier banking in Russia was thus complete.

2.5 Consequences of the introduction of two-tier banking system

The introduction of two-tier banking system and the dissolution of the Soviet Union in late 1991 were soon followed by a set of comprehensive economic reforms led by Yegor Gaidar, a young economist, who was appointed the Deputy Prime Minister for economic reform in the Boris Yeltsin's Government. The reforms began with the abolition of all but a few price controls and the introduction of large scale privatisation program in 1992. The reform was largely unsuccessful as it quickly led to hyperinflation, devaluation of savings denominated in roubles and severe demonetisation of the economy.

After the reform the newly created banking system was supposed to play a crucial role in the monetisation of the fledgling economy and the allocation of risks between a wide range of economic agents. In reality, however, due to the combination of the lack of banking capital, the inexperience of both banks and enterprises, the lack of sound market infrastructure and macroeconomic instability, the nascent banking sector was unable to effectively assess the adequacy of their potential borrowers and profitably lend to the productive sectors of the economy. As a result the banking sector failed to monetise the economy. In these circumstances, high inflation co-existed with severe demonetisation.

The inability of banks to satisfy the demand for money led to persistent shortage of currency and severe demonetisation of the economy. Shortage of money resulted in the wide-spread use of foreign currency and monetary substitutes, such bills of exchange, promissory notes, barter or payment in kind in exchanges between producers and customers, employers and labour, taxpayer and the state. Demonetisation of the productive sector made the economic activity more opaque and prone to corruption by reinforcing the importance of the relationships developed under the central planning. The use of monetary substitutes also meant that public budgets ran persistent deficits and were forced to constantly cut expenditure, putting additional pressure on the aggregate demand in the economy. In its turn the growth in the public debt market also increased the demonetisation of the economy by diverting scarce financial resources to treasury bills instead of using it to invest in real economy and helped create the oligarchic strand of the Russian economy.

As a result of early introduction of the two-tier banking system, the banking sector was unable to provide the necessary means for planning the allocation of financial resources and successfully managing them in the interests of the economy due to inexperience, lack of sound institutional structure, insufficiency of capital and macroeconomic instability.

3. MONETARY POLICY

3.1 Indirect monetary instruments and structural imbalances

The transition to the two-tier reserve banking system meant that the monetisation of the economy was supposed to happen as a result of allocating bank credit in response to the market demand for money. The old system of direct monetary instruments, such as directed

8 Art. 24 of the Law on the Central Bank of the RSFSR.

credit to the government and enterprises, had to be replaced with market-based instruments of indirect control over bank lending. In contrast to the direct instruments, which provided for a straightforward link between the monetary target and the monetary policy objective, the indirect instruments had to rely on intermediary money markets, which had to have a predictable relationship with the ultimate objectives of monetary policy.

The indirect and quantitative nature of the newly created monetary instruments meant that their effectiveness depended on the level of development of financial markets and, in particular, the extent to which they represented the economy as a whole. With the development of financial markets and, in particular, the interbank market the range of indirect instruments available to the Bank of Russia significantly evolved to include a wide range of open market and liquidity provision instruments. Throughout the post-Soviet period, however, the Russian financial markets remained unbalanced and the monetary policy had to vacillate between providing necessary liquidity, and thus further monetising the economy, and exacerbating structural imbalances. In particular, the Russian financial markets often tended to skew toward speculative markets in foreign exchange and government bonds to the detriment of lending to the productive sectors of the economy. As a result the banking sector favoured financing arbitrage and currency speculation rather than extending loans to industry and the productive sectors of the economy experienced severe demonetisation and large scale inter-enterprise arrears.

A good example of the problems caused by the structural imbalances is provided by the rapid development of government bonds market in the 1990s. The falling profitability of productive enterprises and low predictability of the return on investments in the circumstances of macroeconomic instability led to the contraction of bank lending to the productive sectors of the economy. In response the Russian government attempted to stimulate the real economy through public spending and introduced short-term government bonds with extremely high "non-inflationary" yields. In the words of Sergey Glazyev, one of the leading Russian economists:

> "[t]he country's economic expanse effectively split into two poorly connected spheres as a result. The first sphere – financial speculation – was characterised by exceedingly high returns and monetary speculation, and relatively low risk. Characteristic of the second sphere – production – was low profitability and monetary circulation and high risk, owing to the uncertainty of ownership, reduced demand, escalating defaults on payments, and generally unfavourable competitive market conditions." [9]

The extensive acquisition of short-term government bonds further distracted bank lending from the productive sectors of the economy. Just as it happened with the excessive growth in investments in real estate markets in the USA, the UK, Ireland and Spain before the global financial crisis, excessive investment in government bonds in Russia must have been at the expense of more socially valuable projects which remained unfinanced. In 1998, however, the excessive growth in budget deficit led to the default on the government bonds and the 1998 financial crisis.

The structural imbalances of the financial markets have always acted as a constraint on the effective exercise of monetary policy instruments. The whole panoply of the indirect monetary instruments is quantitative in nature and does not allow to address these

[9] S. Glazev, "The Central Bank Versus Russian Industry", Problems of Economic Transition, vol. 41, no.1, May 1998, p. 72. Translated from the Russian text "Voprosy ekonomiki", 1998, no.1, pp16-32. A publication of the Institute of Economics, Russian Academy of Sciences.

imbalances. If commercial banks tend to lend money into speculative high-yielding markets, the response of a central bank will be to tighten the monetary policy even though it may further exacerbate liquidity in the productive sector. Therefore, in response to the structural imbalances in the Russian financial markets the Bank of Russia generally tended to act on the side of caution by tightening the monetary policy. The resulting increase in the cost of bank borrowing accelerated demonetisation of the real economy and, therefore, exacerbated the loss of monetary sovereignty.

Due to the indirect nature of monetary policy instruments the Bank of Russia seeks to limit its interference in market pricing mechanisms and exerts direct influence only on the most short-term segments of the market. The main instruments to regulate liquidity in the banking sector are one-week operations to provide liquidity through repo auctions or to absorb liquidity through deposit auctions based on the analysis and forecast of banking sector liquidity. These instruments are accompanied by similar 1- to 6-day auction-based fine-tuning operations and overnight standing facilities. All these instruments are secured by collateral interests, such as bonds, shares, foreign currency, credit claims on non-financial organisations, guarantees or gold[10]. While this arrangement may be satisfactory for a well-developed market economy, by its very nature it is reactive to broader market conditions and does not allow to actively address structural imbalances.

While it is well established that the commercial bank lending is the primary source of remonetising the economy, there is little consensus on the actual mechanisms to achieve it. The interest rates for rouble loans continue to be prohibitively high for many enterprises and access to finance remains one the main impediments for economic development in Russia. Under the impact of the recent financial crisis and the financial sanctions the Russian banking sector is currently experiencing structural liquidity deficit. The liquidity deficit is bound to increase demand for refinancing beyond the existing volumes of security interests eligible as collateral for the Bank of Russia refinancing operations. In response to this, the Bank of Russia is determined to increase the volume of liquidity by adding other types of assets to its list of eligible security interests and expanding longer-term refinancing operations, which mainly include monthly loan auctions with 3 months' maturity period[11].

While the expansion of standard refinancing operations appears to be an adequate response to demonetisation of the economy and the increasing liquidity deficit, there is also a growing realisation that the use of standard monetary policy instruments is insufficient. It is argued that the indiscriminate and purely quantitative nature of monetary and credit policy does not allow to address structural imbalances and, in particular, to redress Russia's dependence on exports of natural resources. It is, for example, proposed to introduce a system of qualitative sectoral assessment and differentiate the refinancing requirements between various sectors of the economy according to their role in economic development[12].

In response to the recent arguments about insufficiency of the standard monetary policy instruments, in 2014 the Bank of Russia took a decision to use special refinancing programmes to stimulate certain segments of the loan market whose development has been held back by structural factors. To this end the Bank of Russia established a new

10 More on the use of monetary policy instruments can be found in "Guidelines for the Single State Monetary Policy in 2015 and for 2016 and 2017", the Central Bank of the Russian Federation, 2014, p. 28-31. Web address: http://www.cbr.ru/eng/publ/ondkp/on_15-eng.pdf

11 Guidelines for the Single State Monetary Policy in 2015 and for 2016 and 2017, supra note 10, p.29.

12 O.S. Suharev, "Monetary and credit policy of economy remonetisation", Efficiency of economic policy, 19 (205), 2014, p. 20.

refinancing mechanism[13] to provide loans at lowered interest rates for the implementation of investment projects selected by the Russian Government in accordance to Russian Government Resolutions No. 1016 of 14 December 2010[14] and No. 1044 of 11 October 2014[15]. These Government Resolutions provide for the selection of investment projects in priority sectors of Russia's economy by an intergovernmental committee.

In contrast to the standard monetary policy instruments, the special refinancing programmes for the first time provide for an instrument to address structural imbalances in the Russian financial markets. Moreover, many of the selected investment projects are in the infrastructure sector and are closely connected to territorial planning and development by being implemented on the basis of private-public partnership. This, in turn, may suggest a new principle for issuing money and remonetising the Russian economy, according to which money is not just lent into existence in response to developments in pre-existing markets as a result of profit-seeking activities of the banking sector, but include an assertion of the public interest in the very process of its creation. This may help to reassert money as an essential public good, which through its link to territorial planning and infrastructural development is created in the interests of the society as a whole. At the time, when many economist in Western Europe and the USA increasingly ask whether sectoral allocation of credit which emerges from the competition of profit maximising banks will be socially optimal, the above approach provides a solution for decreasing the potential for misallocation of credit to finance asset price speculation at the expense of new business projects which do not involve investment in easily marketable assets. This argument, therefore, while presenting a mechanism for reasserting monetary sovereignty in Russia, may also make an important contribution to the general debate on the possibility of sector specific macro-prudential tools and public policy interventions in the allocation of credit.

3.2 Inflation and inflation targeting

In the 1990s the simultaneous introduction of radical market and banking reforms led to unprecedented coexistence of hyperinflation and demonetization of the economy which under the established quantitative instruments of monetary policy required diametrically opposite responses to the macroeconomic instability. As a general rule of thumb, inflation is dealt with by tightening monetary policy, whereas demonetization is on the contrary reversed by increasing supply of money to the economy. The resolution of this controversy has always been of critical importance to monetary policy in Russia as quantitative nature of monetary policy does not always allow to qualitatively assess the structural needs of the economy and to address the structural imbalances in economic development.

The development of the appropriate response to the above controversy largely depended on the intellectual stance on monetary policy and in the absence of domestic tradition of central banking heavily relied on the examples of contemporary policies of central banking in the developed capitalist economies. Despite the significant opposition to economic reforms within the government in the 1990s, most of the opposition leaders did not wish to return to central planning and the experience of capitalist economies in designing their monetary policy was an obvious choice for them to study and emulate. At the time, the

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13 The information notice of the on the Implementation of new mechanism for credit institution refinancing can be found at: http://www.cbr.ru/eng/press/PR.aspx?file=25042014_1723113.htm

14 Russian Government Resolution No. 1016 of 14 December 2010, "On the Approval of the Rules to Select Investment Projects and Principals for the Provision of the Russian Federation Government Guarantees for Loans or Bonded Loans Attracted to Carry out Investment Projects".

15 Russian Government Resolution No. 1044 of 11 October 2014, "On the Approval of the Programme to Support Investment Projects Implemented on the Territory of the Russian Federation on the Basis of Project Financing".

underlying theory and policy of central banking was heavily influenced by the so called "New Monetary Consensus", a school of thought which became dominant among capitalist central banks in the 1980s and the beginning of the 1990s. This school of thought was grounded in the following three basic ideas: the ultimate goal of price stability, the independent central bank, which enforces a policy of low inflation by conducting independent monetary policy, and the focus on short-term interbank lending as the operating target[16]. These basic ideas were translated into the work of the International Monetary Fund and World Bank and subsequently became the basis of the intellectual and ideological framework for their policy advice to Russian Federation. In particular, in the early 1990s the International Monetary Fund was heavily involved in the designing of a consistent macroeconomic policy framework of monetary and fiscal measures.

In accordance with the leading monetarist thought represented by the works of Irving Fisher the International Monetary Fund and its supporters viewed inflation as an essentially monetary phenomenon and considered money creation as its ultimate cause[17]. In response to the high levels of inflation in Russia the International Monetary Fund emphasized the necessity of tight monetary and fiscal policies to contain inflation[18]. This contrasted with the alternative view, popular with many Russian economists, that inflation was largely caused by the structural defects of the Russian economy, the influence of prices on imported goods and the foreign exchange rate, the absence of competition, the increased cost of working capital and the urge of enterprises to pass along the growing costs of commercial credit. In the circumstances of severe demonetisation of the economy, which reached a disastrous level of 8.5 – 10 percent in the late 1990s[19] and still remains below 45%, the view on the nature of inflation has always been an important argument in the determination of monetary policy in Russia. Since the 1990s the controversy between the need to curb inflation and to ensure monetary sovereignty by ensuring the adequate level of monetisation of the economy has been a constant topic of policy and academic debate.

The debate on the nature of inflation necessarily touches upon the structural imbalances of the Russian economy and inherent costs of production and import. Monetary policy instruments, however, are quantitative by their nature and exercise only indirect influence on the existing financial markets. All monetary policy decisions rely on aggregate economic variables and do not differentiate between various sectors of the economy and sector specific costs. It is, therefore, very difficult to accommodate structural imbalances in a single monetary policy. Although this is true for many emerging market economies, the structural imbalances in the economy have been and still are particularly acute in Russia. In these circumstances the Bank of Russia tended to conduct a cautious tight policy.

The exercise of tight monetary policy in the circumstances of severe demonetisation of the economy has made the debate on the nature of the inflation and the critique of the Bank of Russia an important part of the modern Russian economic thought. As Sergey Glazyev mentioned in his article:

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16 The New Monetary Consensus itself was part of the wider neoliberal or market fundamentalist school of economic thought represented by the Washington Consensus. The basic tenant of this idea was the belief that liberalized financial markets could efficiently allocate resources and redistribute resources. Both the New Monetary Consensus and the Washington Consensus were the major reference theories for all structural and institutional changes in financial market over the 1990s.

17 Vincent Koen and Michael Marrese: "Stabilisation and structural change in Russia. 1992-1994", IMF Working Paper, WP/95/13, January 1995, p. 12.

18 The IMF and Russia in the 1990s. p.7

19 Vladislav Zhukovskii, "The Central Bank of the Russian Federation Continues to Block Modernization and Development of the National Economy", Problems of Economic Transition, vol. 56, no.9, January 2014. Translated from the Russian text in Rossiiskii ekonomicheskii zhurnal, 2012, no.5, pp 48-64.

> "[The Central Bank's] monetary policy was and is planned as if the country's economy were a "black box", with the money supply as the input and inflation as the output. Interest rates, the dynamics of investments and production volumes, and the payments situation are not taken into account. The defining significance of fighting inflation by tightening the money supply and the self-sufficiency of reducing inflation to restore economic growth are invoked therein" [20].

Currently the Bank of Russia is in transition to the inflation targeting regime. While it brings the Bank of Russia's strategy in line with the monetary policy strategies of other major central banks like the Federal Reserve System of the USA, the European Central Bank and the Bank of England, the Russian monetary system is very different from those of the USA and Western Europe. The Bank of Russia must simultaneously pursue a number of conflicting targets, such as development of the economy, stabilisation of the currency and the development of banking sector. It is obvious that in Russian context the achievement of the inflation target through interest rates is very difficult to achieve. While this article does not aim to provide details of the debate on inflation, it is important to note that the concern for inflation has always been the major constraint on the expansion of the Bank of Russia's monetary policy and remonetisation of the economy.

4. FOREIGN EXCHANGE POLICY

Throughout the Soviet period the state exercised monopoly on foreign trade and the ruble remained unconvertible. In 1987, however, the Soviet authorities introduced a combination of a foreign exchange retention scheme and a limited foreign exchange market, allowing enterprises to retain a certain percentage of their earnings in foreign currency and exchange it using a system differentiated foreign exchange coefficients, which applied different exchange rates to different types of transactions with the view to provide a flexible linkage between foreign and domestic prices for traded goods. Foreign trade liberalisation considerably increased in 1988 and 1989 and from November 1989, surplus foreign currency could be sold for rubles at regular foreign exchange auctions. From 1 November 1990 the system of differentiated foreign exchange coefficients was replaced by a commercial exchange rate and the Vneshekonombank, the monopolist on foreign currency deposits, started to conduct foreign exchange auctions as the first experiment in the discovery of market exchange rate of the ruble against foreign currencies in the USSR.

In 1991 the foreign exchange monopoly of the Vneshekonombank was abolished and licensed commercial banks were permitted to attract foreign currency deposits and deal in foreign exchange. In April 1991 the foreign exchange auctions were replaced by interbank foreign exchange market operated by the State Bank of the USSR. In 1992, however, the State Bank of the USSR ceased to exist and on 9 January 1992 the Bank of Russia and Russia's largest commercial banks established the Moscow Interbank Currency Exchange (MICEX). Since its establishment MICEX became the predominant player in the Russian foreign exchange market and soon after its opening the Bank of Russia started to intervene in its foreign exchange trading in order to stabilise the nominal exchange rate.

The foreign exchange policy has always been an important part of the Bank of Russia monetary policy. In 1992-1994 the Bank of Russia regularly intervened in both the interbank market and in MICEX with the aim to prevent sharp fluctuations in the exchange rate. While this intervention succeeded in stabilising the exchange rate, it also resulted in

[20] S. Glazev, "The Central Bank Versus Russian Industry", Problems of Economic Transition, vol. 41, no.1, May 1998, p. 72. Translated from the Russian text "Voprosy ekonomiki", 1998, no.1, pp16-32. A publication of the Institute of Economics, Russian Academy of Sciences.

rapid uncontrolled growth in monetary aggregates and a wide discrepancy between acceleration in inflation and depreciation of the exchange rate. Given the tight monetary policy of the Bank of Russia the banking sector shifted from assets denominated in rubles to assets denominated in dollars. These developments led to an exchange rate crisis in October 1994, when the ruble tumbled by over 20 percent against the dollar. In response to the crisis authorities announced a 10 percent daily limit on exchange rate movements in MICEX, a 30 percent exposure limit for commercial banks and a 2 percent minimum reserve requirement on foreign currency deposits.

In 1995 the Bank of Russia introduced an exchange rate band, within which the market exchange rate was permitted to fluctuate. The Bank of Russia actively managed the exchange rate, heavily intervening in the foreign exchange market and using the exchange rate to stabilise the ruble against the dollar. In the circumstances of tight monetary policy and increased capital inflows and outflows the exchange rate became a nominal policy anchor and the whole monetary policy was essentially oriented towards foreign exchange. In particular, the exchange rate corridor was important for the maintenance of the market in government bonds, as by mid-1998 the amount of government bonds in foreign hands reached half of the market.

The 1998 government debt crisis forced the Bank of Russia to shift back to a system of managed floating exchange rate. While the Russian economy registered a decline in 1998-1990, in the 2000s the growth in prices of natural resources resulted in quick recovery from the crisis and high rates of economic growth. The good economic performance of export-oriented enterprises and the strong balance of payments flooded the Russian economy with foreign currency and debt. The foreign exchange market again came to play a significant role in monetising the economy. In these circumstances the purchase of foreign currency by the Bank of Russia became the sole channel for increasing money supply. During the same period the Bank of Russia did not expand its portfolio of government bonds and the refinancing of commercial banks was carried out only on an insignificant level.

Until 2005 the Bank of Russia conducted its foreign exchange policy only with the US dollar, but in 2005 it introduced a dual-currency basket, which included the US dollar and the euro as the operational indicator for its exchange rate policy. The Bank of Russia set the operational band for this indicator and intervened in MICEX and OTC markets to keep the rouble stable vis-à-vis other major currencies. With the growth of transactions denominated in the euro the weight of euro in the dual-currency basket was gradually increasing and in February 2007 reached 45%.

The global financial crisis sharply eroded Russia's current account balance and resulted in massive capital outflows. This led to significant downward pressure on the rouble and led the Bank of Russia to undertake large-scale interventions in the foreign exchange market in order to smooth the path of the rouble's depreciation. From November 2008 to January 2009, the level of Russia's foreign currency reserves fell by one third. At the same to the Bank of Russia gradually raised interest rates to prevent capital outflows and to slow the rouble's depreciation. Since 2009 the Bank of Russia gradually increased the width of the floating operational band to ensure shift to a more flexible exchange rate.

In October 2010 the Bank of Russia abandoned the fixed operational band of the dual-currency basket and announced the return to managed floating exchange rate regime. Since then the Bank of Russia emphasised the importance of greater flexibility on exchange rate and with a view to creating conditions for a transition to a freely floating exchange rate regime. Due to the financial sanctions, however, the Bank of Russia had to heavily intervene to the foreign exchange markets to prevent sharp depreciation of the rouble.

In general, the dependence of Russian economy on the US dollar and the euro represents the most profound loss of monetary sovereignty in Russian Federation. The combination of extensive external debt and substantial part of national income both denominated in the US dollars meant that throughout the post-Soviet period it was important to ensure stable foreign currency exchange rate as a main instrument for maintaining macroeconomic stability. In these circumstances the foreign currency exchange market became a dominant channel for increasing money supply in Russia. This in turn led to underdevelopment of the domestic banking sector and lending, and a substantial loss of monetary sovereignty.

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