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Monetary Policy of Quantitative Easing at the Central Bank's High Interest Rates.

Abstract

This paper investigates the possibility of conducting an unconventional monetary policy of Quantitative easing (QE) at high interest rates using the example and experience of Russia. The Central Bank of the Russian Federation has raised the key interest rate on six occasions during the 12 months of 2014 from 5.5% to 17%. The Central Bank has been coming in for criticism for such an increase. However, this criticism is unfair, as sometimes interest rate reduction or failure to raise interest rate result in adverse consequences. Luckily, interest rate is not the only and often far from being the most efficient tool of successful monetary policy. During the hardest phase of the most recent crisis, the central banks worldwide, for example, U.S. Federal Reserve System, resorted to another tool, i.e. Quantitative easing (QE), rather interest rates (which, by that time, had been virtually dropped down to zero). Some experts recognize those to be an important innovation devised by Ben Bernanke, Head of the U.S. Fed during 2006 - 2014. The Central Bank of Russia now has an opportunity of employing a still more innovative policy, i.e. to have "quantitative easing" at high interest rates rather than at zero rates. The experience of the «Golden Decade» (the decade of robust economic growth in Russia between September 1998 and September 2008) proves the efficiency of such monetary policy. The criterion for «sufficiency» of quantitative easing must be the growth rate of the real money supply. In June 2014, the real money supply decreased. That has happened for the first time since December 2009. It shows that there is a need for urgent action on the part of the Central Bank. To bring about steady economic growth, it is required that such quantitative easing be put in place as would make real money supply grow at a pace no slower than the target growth rate for GDP. According to preliminary estimate, the volume of necessary easing would be in the range between RUR 0.5 and 1.7 trillion. Such a program may make itself felt as soon as 3-4 months after its launch.

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Key words: Monetary Policy, Central Banking, Interest Rates, Quantitative Easing (QE), Economic Growth, Money Supply;

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Interest Rates Are Rising in Russia

The Central Bank of the Russian Federation has already raised the key interest rate three times during 2014. It increased from 5.5% at the beginning of the year to 10.5% at the time of writing (December 2014). The Central Bank came in for criticism for such an increase in the key interest rate during the time when the economy is on the brink of recession (some people believe that the economy has passed this borderline and recession has already set in). This decision was criticized outright both by the current members of the Government ([as «Kommersant» writes, «the decision of the Board of Directors of the Central Bank of July 25-th, which raised the key interest rate before September 12-th by 50 basis points, aroused official protest by the Economy Ministry](#)), and the former ones ([«Klepach criticized tooth and nail the increase in the key interest rate by the Central Bank»](#)). Sergey Glasyev, advisor to President Putin, habitually criticized this decision which did not come as a surprise.

In his previous publications, the author of these lines also touched upon the subject of interest rates (see, for example, Blinov, 2014a, [«Money, Dollar and the Russian Recession»](#)), pointing out that high interest rates had a negative impact on money supply. It would be logical to assume that this article would further criticize the decision by the Central Bank to increase the key interest rate. However, we shall now talk about something else. Making a point that the interest rate of the Central Bank is not the criterion for adequacy of monetary policy at all. And also that even at high interest rates the monetary and credit policy of the Central Bank may be very effective.

Myth About the Interest Rate

Interest rate of the Central Bank has been regarded as an effective tool of economic policy since times immemorial. It is a long time ago that people noticed that low interest rates led to economic boom while high interest rates were responsible for the cooling-down of the economy. Historically, to heat up the economy or to fight a crisis, the Central Bank had lowered interest rates. And vice versa, in order to avoid blowing up the so called «bubbles» in financial markets, interest rates used to be increased. This was done to avoid crises which happened after a sudden collapse of such bubbles.

All this may seem to be elementary. You would think that you only needed to determine desired rate of economic growth. And if it has been determined at, say, the level of 5% per annum, then the role of the Central Bank in managing it looks simple enough: if the growth rate is lower than 5% per year – it lowers interest rates until the GDP growth rate reaches 5%; if the growth rate is more than 5% per year – it raises interest rates to avoid the «overheating» of the economy and growth of financial «bubbles». It appears to be so simple that one would think any housewife could manage it. Almost as Vladimir Mayakovski (a Soviet poet) has it: «We will teach each of the kitchen staff to run the country».

However, it is not so easy as that. First, while having a positive effect on economic growth, interest rate, at the same time, may influence other important indicators adversely, for example, accelerate inflation. Secondly, sometimes *interest rate just does not work at all*. Let us now take a closer look at both such cases.

Negative Consequences of Low Interest Rates

Interest rate does not affect only economic growth, it affects other macroeconomic indicators, such as exchange rate of the national currency (previously, with gold standard in place, gold content of the currency would play the role of exchange rate), inflation and some others. And while low interest rates may help the economy, at the same time they can also hurt the exchange rate of the national currency

or accelerate inflation. Therefore, economic growth has, on many occasions, been sacrificed for the sake of currency stability or for the sake of fighting against inflation.

Example One: «Gold Standard» Is Protected By High Interest Rates. During the times of the so called «gold standard», almost all the key currencies, in this or that way, were pegged to gold, and would be exchanged for gold at a fixed rate at the first request of the currency holder. Interest rates would affect the situation in such a way that there would be an outflow of gold taking place from the countries which were sticking to low interest rates, into the countries with higher interest rates. In order to understand it, just imagine that you own gold and decide where you are going to place it: at high interest rates in one country or at low interest rates in another country? In the countries with low interest rates, gold would run dry, and there would happen problems. Gold was scarce and not enough to give it to all those who wanted the country's currency to be exchanged for gold. In other words, the so called «attack» on the currency began. For the purpose of protecting their national currencies from such «attacks», the Central Banks would often be forced to raise interest rates, even if no «cooling-down» of the economy was required.

One of such episodes happened in the USA during the Great Depression in September and October 1931. The Great Depression was in full swing. At this time the dollar came under the «attack». It consisted in many holders of dollars beginning to put them up for exchange for gold (in keeping with the then operating «gold standard»). « Fed decided to focus on stopping the loss of gold reserves to protect the dollar. To stabilize the dollar, the Fed ... raised interest rates sharply, on the view that currency speculators would be less willing to liquidate dollar assets if they could earn a higher rate of return on them. The Fed's strategy worked, in that the attack on the dollar subsided and the U.S. commitment to the gold standard was successfully defended, at least for the moment» ([B. Bernanke, «Money, Gold and the Great Depression»](#)). But on the economy which was in the state of depression, the increase in interest rate had a negative effect.

Example Two: Paul Volcker, the Inflation Fighter. During the 1970-s, a huge problem for the US economy was inflation, which, all of a sudden, started to exceed the level of 10%, unheard-of hitherto for the time of peace. The special feature of this inflation was the fact it was observed against the background of stagnation in the economy. It was exactly at this time that the term «stagflation» was coined signifying a combination of stagnation and inflation. And Paul Volckner, appointed to the office of the Head of the Federal Reserve System in 1979, declared a war on inflation. Interest rates were raised which immediately resulted in the most severe recession in the USA. Unemployment reached the levels unseen since the time of the Great Depression.

Inflation was defeated but economy suffered a fierce negative shock. In this situation the policy of 'quantitative easing at high interest rates' described below would have been effective.

In Russia, as has already been mentioned above, since early 2014, the key interest rate of the Central Bank has been increased six times and from 5.5% it has reached 17% at the present time (these lines are being written in December 2014). And the rationale behind the action taken by the management of the Central Bank of Russia is exactly the same as in the above two examples. Just as in the first example, the raising of interest rates is supposed to help fight off the «attack» on the Ruble (the role of gold «is being played» by the USDollar and EURO). And just as in the second example, the rise in interest rates, as conceived by the management of the Central Bank, is designed to restrain inflation which is above the target levels designated by the Central Bank. Everything looks like the Central Bank having many good reasons to put up interest rates.

So, we have seen that in certain cases, the lowering of interest rates (and even keeping them at current levels, i.e. avoidance of interest rate increase) is or, at least, is considered to be highly undesirable, even if interest rate reduction is required for economic growth.

Sometimes Interest Rates Don't Work

But sometimes use of interest rates as a tool of monetary policy makes one be faced with another problem which is that low interest rates do not produce the sought-after economic growth. One of the causes of «non-working» low interest rates may be deflation (or descending inflation).

Example Three: Great Depression in the USA (1929-1933). Above we mentioned the episode in the history of the Great Depression, where the Federal Reserve System of the USA was compelled to raise interest rates to avoid an attack on the national currency (the dollar) on the part of international financial speculators. But that was just an episode. Throughout most of the Great Depression, interest rates had remained at record low levels. «many observers pointed to the fact that nominal interest rates were close to zero during much of the Depression, concluding that monetary policy had been about as easy as possible yet had produced no tangible benefits to the economy... (FRS) officials, noting among other indicators the very low level of nominal interest rates, concluded that monetary policy was in fact already quite easy and that no more should be done. These policymakers did not appear to appreciate that, even though nominal interest rates were very low, the ongoing deflation meant that the real cost of borrowing was very high because any loans would have to be repaid in dollars of much greater value » ([Bernanke, 2004](#)).

Example Four: «Lost Decade» in Japan. Prior to 1989, economic growth in Japan had been phenomenal. That was a true «Japanese miracle». But in 1989, there happened a collapse of stock in Japanese companies in the stock exchange, which triggered a debt crisis, resulting in a crisis in the banking sector. And that was only the beginning. Awaiting Japan was the so-called «Lost Decade», initially that was how the years 1990-2000 had been labeled. But now this term is often used in application to the 2000-2010 decade. During most of this problem period, interest rates of the Bank of Japan had been at record low level of nearly 0% (since September 1995, it had been no higher than 0.5%, from 2008 up to the present time it has been 0.1%). But despite all this, no recovery of high growth rates of the economy occurred.

Hence, there are cases where reduction in interest rates simply cannot be used. In the above mentioned examples, this happened due to the fact that interest rates had been dropped down to virtually zero. But as we shall see below, there may also be other reasons why it is impossible to use reduction in interest rates as a tool of the monetary and credit policy.

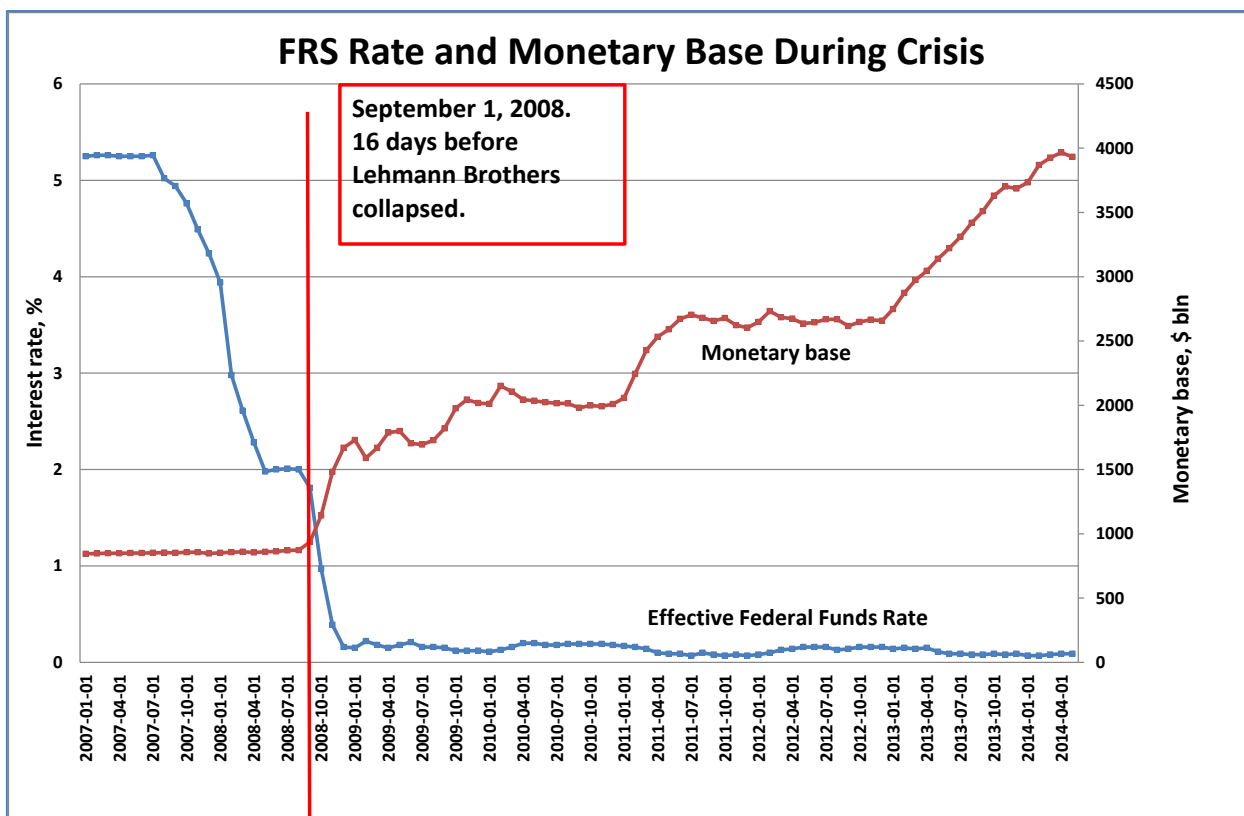
Bernanke, the Innovator

Ben Bernanke, during his tenure as the Chief of the US FRS from 2006 through 2014, ran into a serious crisis in the financial sector of the USA. And his approach to solving the problems, in the opinion of many experts, can be described as innovative. This is, for example, the opinion of Robert Kahn, leading economic adviser of the International Relations Council, senior economist of the Board of Governors of the Federal Reserve from 1984 through 1992. «Ben Bernanke's policy was innovative in the following respect. Even with zero interest rates ... additional loosening of credit and monetary policy was needed. But Bernanke did not have a tool for that: he was unable to reduce interest rates down to negative levels. What did he do then? He looked at the experience of Japan and other countries which had also reached zero interest rates but which had still been suffering from low growth rates... Having studied

this experience, he understood the need for new innovative measures. He started to promote the idea of what we now know as the program of quantitative easing» (Kahn, 2014).

Figure 1 shows very clearly the sequence of actions taken by the Federal Reserve System headed by Bernanke during the crisis. At first the monetary base remained unchanged and the main tool of monetary and credit policy used was interest rate. But when interest rate dropped down below 1% (as of October 1-st 2008), and the crisis was in full swing, the main tool of impact exercised on the situation became increase in the monetary base (quantitative easing).

Fig.1. Interest rate was used only at the initial stage of the crisis, after that «quantitative easing» was applied.



Source: Federal Reserve Economic Data.

Can Nabiullina Become More Innovative Than Bernanke?

Elvira Nabiullina, Head of the Central Bank of Russia, stands every chance to beat Ben Bernanke in terms of innovations. What is needed for that? All she needs to do is implement «quantitative easing» without using lower interest rate at all, or even increase the rate, if necessary.

Ben Bernanke proceeded to practice quantitative easing (building up the monetary base) only after he had used up the potential of reducing interest rates virtually down to zero level. And following this well beaten path, the Central Bank of the Russian Federation appears to need to drop down interest rates and only after that, should the situation fail to straighten out, to go ahead with quantitative easing. However, you can frame the «rule» for the central bank's actions somewhat differently: **«If you can't use lower interest rates – use quantitative easing»**.

Bernanke's actions snugly fit this formula, since he could not have used interest rates due to them having reached zero level. However actions by the Central Bank of the Russian Federation would fit this formula just as snugly, if it went ahead with quantitative easing at the current high level of interest rates. And here, in accordance with the formula, «you can't use lower interest rates, either», for a different reason, though: protecting the Ruble from outside attacks and fighting inflation require that interest rates should not be lowered or even possibly be raised.

Quantitative easing at high interest rates will be innovative only as part of purposeful, fully bought-in policy. Because intuitively without proper commitment, as part of aspiration to achieve other goals, such policy happened to have been practiced already, and this, by the way, happened in Russia.

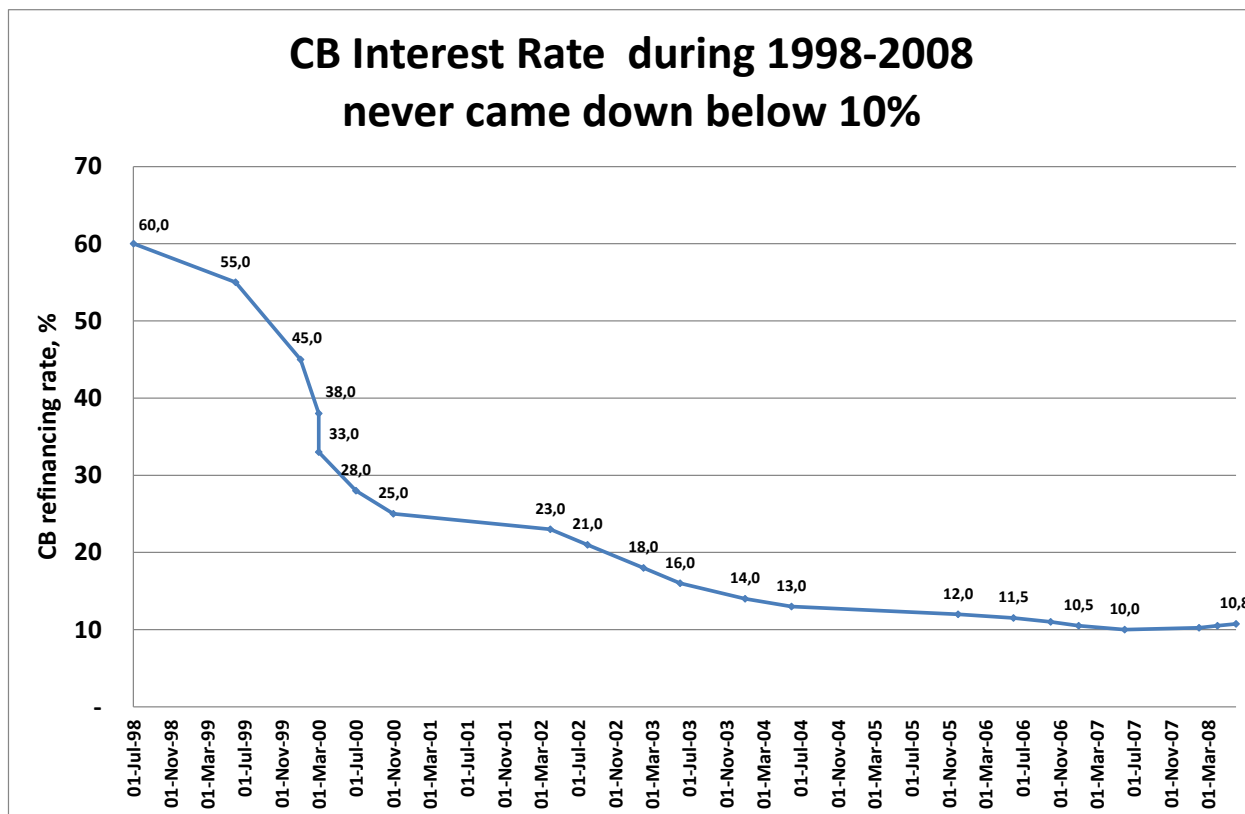
Russia's Golden Decade, A Historic Precedent

If we cast a look into Russia's recent economic history, we will see that interest rate is far from being a quick fix and Russia intuitively or inadvertently did use the above mentioned **technique of quantitative easing at high interest rates**.

Here we are referring to the Russian **«golden decade»**. This is what can be called the period of steady sustainable economic growth in Russia between September 1998 and September 2008. That growth was impressive indeed. GDP grew, people's quality of life became better. Growth rates struck one's imagination: the most «unfortunate» was the year 2002, when GDP grew by «a mere» 4.7%. Economic growth had deep political, military and cultural consequences for Russia.

But throughout this decade there were no low interest rates. **Figure 2** shows that throughout this entire period interest rate of the Central Bank never fell below 10%.

Fig. 2. GDP growth during 1999-2008 was proceeding at high interest rates of the Central Bank of Russia.



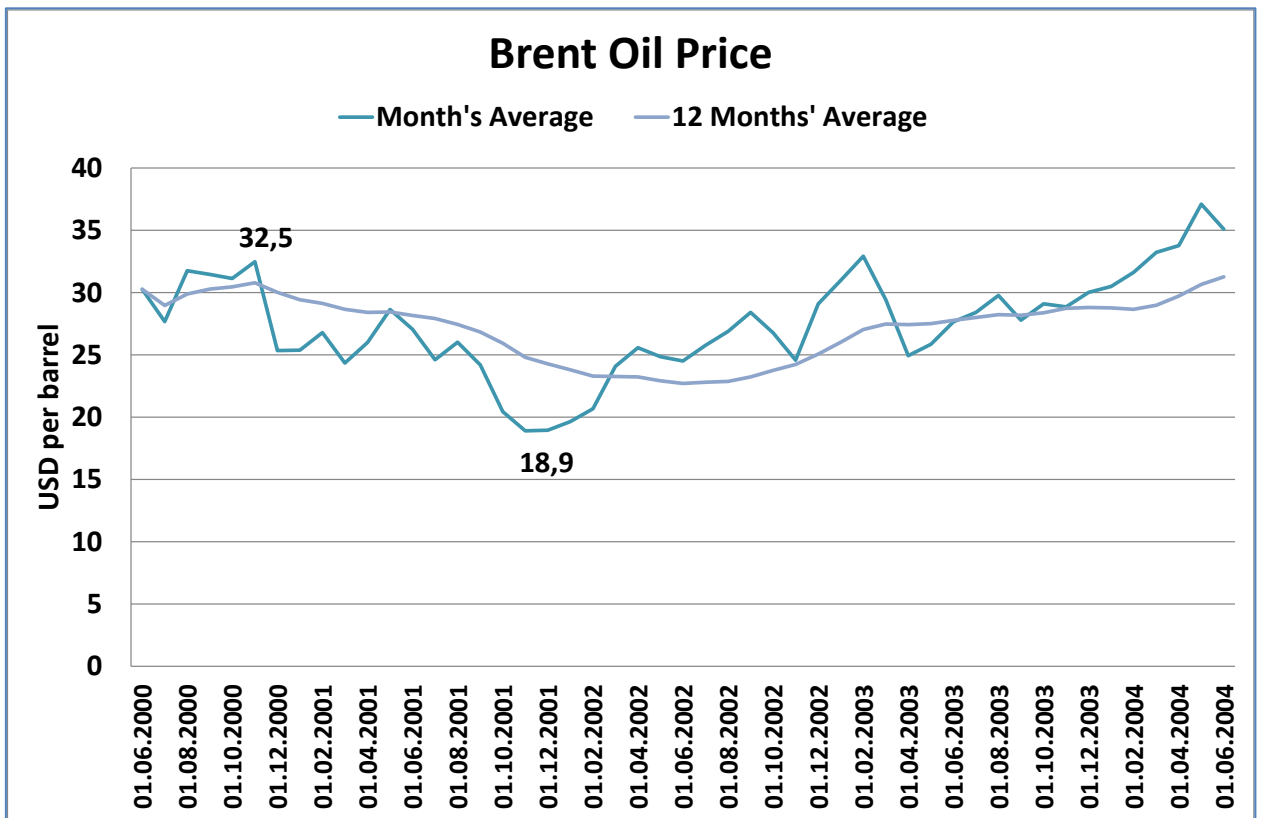
Source: Central Bank (CB) of the Russian Federation, refinancing rate data.

Those who criticize the Central Bank for the «high» interest rate have to explain at least why, despite high interest rates, during the «golden decade», one could observe vibrant economic growth?

Not a single conventional rationale for this growth can stand up to any criticism. **Oil prices** do not account for the GDP growth. For example, the oil price had been sliding down since the end of 2000, it was not until 2003 that the prices recovered (see **Fig.3**), while GDP grew by 5.1% during 2001, by 4.7% in 2002, by 7.3% in 2003. Another example: during 2006-2007 GDP grew 8.2% and 8.3% respectively, whereas oil prices had been sliding down since July 2006 for 6 months, and it was not until a year later that the prices recovered (see **Fig.4**).

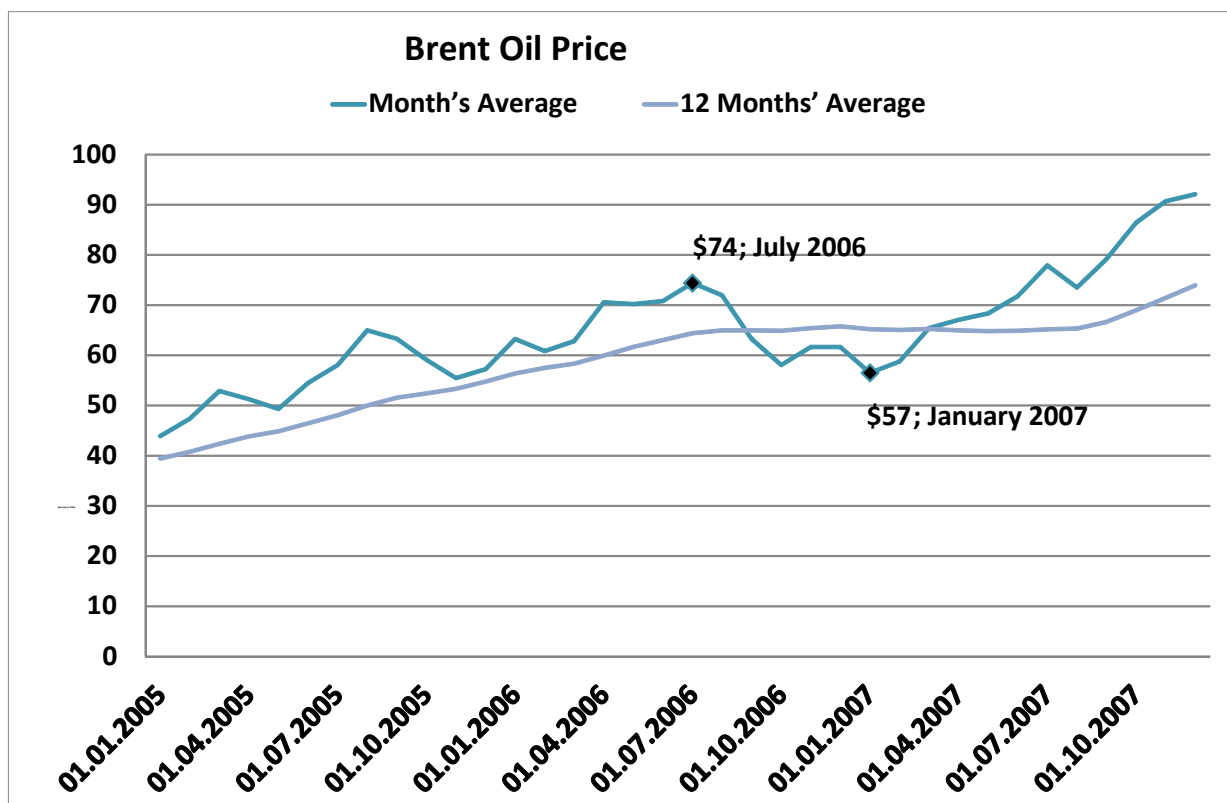
And vice versa, the oil prices do not account for the current stagnation of the Russian economy against the background of high oil prices. Neither do they account for a sharp drop in the GDP during 1994-1996 against the backdrop of rising oil prices (between March 1994 and January 1997, the oil prices rose by 70% from USD 14 to USD 24 a barrel).

Fig. 3. Oil prices do not account for GDP growth during 2000-2003, though partially this growth is accounted for by increase in physical export volumes.



Source: Finam, author's calculations.

Fig.4. Oil price decline did not preclude GDP in Russia from growing during 2006 and 2007.



Source: Finam, author's calculations.

Devaluation of the Ruble does not account for growth either. Growth was registered when the Ruble was falling (from August 1998 through December 2002 the exchange rate fell from 6 to 32 Rubles per dollar) and when it strengthened (from January 2003 through July 2008, the Ruble appreciated from 32 to 23 Rubles per dollar). Despite the conviction of those who believe that devaluation of the Ruble is beneficial for the Russian economy, beginning from 2003 through the present day the economy has been behaving «in exactly the opposite way», i.e. when the Ruble was devalued, it did not grow, it declined instead, and when the Ruble got stronger instead of economic downturn, we could register growth.

Russian «Quantitative Easing»

What are the reasons for such a steady growth of Russia's economy throughout the whole decade? The crux of the matter lies in the fact that despite high interest rates, the Central Bank of the Russian Federation was building up the money base. In other words, when it was impossible to use interest rate as a tool, the other tool was employed, i.e. «quantitative easing».

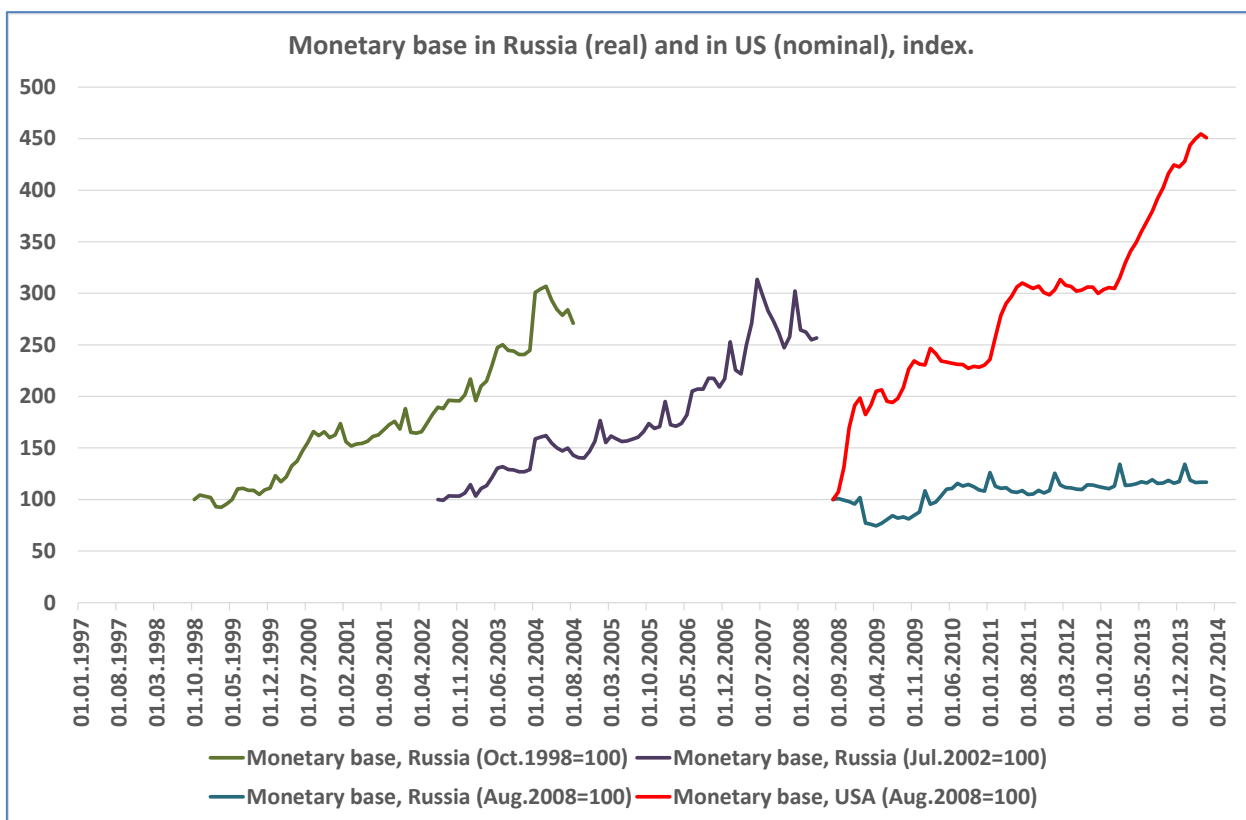
In order to understand the scale of quantitative easing in Russia during the «golden decade», let us compare the parameters of this easing in Russia and the USA.

In the USA, from August 2008 through May 2014, i.e. for 70 months, the monetary base grew from 843 bn. USdollars to 3932 bn. USdollars, having thus increased 4.66 times.

Let us choose, for comparison, a couple of periods of the same duration (70 months) during the «golden decade» and try to assess growth of the monetary base in Russia. Thus, during the first 70 months of the

golden decade», the monetary base from 184 bn. Rbls in September 1999 grew to 1870 bn. Rbls in June 2006 (having grown more than 10 times). During the last 70 months of the «golden decade», from July 2002 through April 2008, the monetary base grew from 1 trln. Rbls to 4.8 trln. Rbls (4.8 times). All [these data are available on the web-site of the Central Bank of Russia](#). And even when one factors in inflation (which «eats up» part of the growth), the scale of quantitative easing in Russia during the «golden decade» was just overwhelming. (Fig.5)

Fig.5. Monetary Base in Russia throughout three 70 months periods. Compared to quantitative easing in the USA



Source: Monetary base in Russia – Central Bank of the Russian Federation; inflation (consumer price index was used) – Rosstat; US monetary base – Federal Reserve Economic Data; author’s calculations.

During these two overlapping periods of the «golden decade» the monetary base of Russia was increasing at rates which were comparable with those of the monetary base in the USA during the period of quantitative easing during 2008-2014. Just think: the USA was active in building up the base as an anti-crisis measure, whereas in Russia build-up of the monetary base went on in a «humdrum» atmosphere, without any «anti-crisis» rationale. It is my deep conviction that it was precisely this decade of «quantitative easing Russian style» that was the reason for fast economic growth during 1999-2008.

But if we are to look at the growth of the monetary base in Russia from August 2008 through May 2014 (dates are exactly the same as given for the USA in the example above), it grew «only» from 5.3 trln. Rbls to 9.4 trln. Rbls. 1.77 fold growth. If we take inflation into account, it grew 1.16 times (by 16%). Growth by several orders of magnitude degenerated to a paltry growth of only 16% for almost 6 years. This is exactly the reason for slow growth rates of the economy during this period.

The «quantitative easing Russian style» policy operated very effectively during the «golden decade», while the crisis and stagnation phenomena manifested themselves right after this policy started to be wound up.

Economic Growth As Side-Effect of Other Decisions Or «Thanks To Kudrin For This»

It has been shown above that the monetary base in Russia throughout the entire «golden decade» was growing fast. But was this «quantitative easing», underlying GDP growth, the intentional policy of the Government and the Central Bank? Unfortunately, it has to be admitted that it was not. Quantitative easing happened not because the economic authorities in the Government and the Central Bank were cognizant of its necessity. Easing occurred as a «side effect» of quite different decisions relating to budgetary and currency exchange policy. Let us now consider the mechanism of this process.

At the first stage, which began in September 1998, issue of money (which is quantitative easing) was designed, first of all, to finance the budget deficit. This is one of the most inflation-intensive methods. To all intents and purposes, this period can be considered to have ended in 2002. By December of this year, the Ruble weakening process had stopped, having begun in August 1998 (as mentioned above, from 6 Rubles per dollar in August 1998, the exchange rate reached up to 32 Rubles to the dollar in December 2002).

The second stage began in January 2003. The Ruble began to strengthen, and its appreciation continued up until July 2008. The exchange rate of 32 Rubles to the dollar in January 2003 reached 23 Rubles to the dollar in July 2008. And the main channel for supplying money to the economy was ... the Central Bank's campaign against still sharper strengthening of the Ruble exchange rate. Rubles were being issued not from the cognizance of the importance of growing quantity of Rubles for economic growth. Increasing the monetary base was not an end, but just a means to deter excessive strengthening of the Ruble. Since if the Central Bank had not increased the Ruble denominated monetary base (quantitative easing), the Ruble would have inevitably strengthened still more.

A positive role was played by the policy of accumulating the «safety cushion» in the form of the Stabilization Fund. As a result of this policy, with every 80 bn dollars saved in the Stabilization Fund, nearly 2 trln Rubles was fed to the Russian economy through the foreign exchange market. And this «inadvertent» flow of Rubles was conducive to fast economic growth.

One can thank Alexei Kudrin for consistently championing the idea of the Stabilization Fund (the idea came in for and is still coming in for, to this day, scathing criticism). One can be grateful to the management of the Central Bank during those years, who opted for a policy of crusading against excessive strengthening of the Ruble. This policy could have been even more successful (ref. for example, the article [«Long Money and the Policy of the Central Bank», Blinov, 2014b](#)).

But the harsh truth is that growing quantity of Rubles in the economy, this decisive source of vibrant growth throughout the whole decade, has always been «a bastard child», it was either ignored or looked upon as a potential threat to other performance indicators, such as inflation or exchange rate, for example. And the quantity of money grew not because the economic authorities understood its importance for economic growth, just as a «side» effect of the decisions from the area of budgetary (foreign exchange rate related, anti-inflationary) policy.

Nevertheless, while making our decisions today, we need to take into consideration *the successful experience of the «golden decade»: even at high interest rates, quantitative easing results in GDP growth*. Even if the people, implementing this quantitative easing «are not aware of what they are doing».

Another important finding is that both decline in 2008-2009 and current slow-down of the Russian economy are taking place because again nobody has looked and nobody is looking upon the growth rate of Ruble denominated money supply in the economy as an important criterion. The focal point of the monetary authorities is either the Ruble exchange rate (and in the process of interventions trillions of Rubles are withdrawn from the economy), or inflation, or something else, and as a result, the «bastard child» of money supply is falling down, pulling GDP down together with it.

Paul Volker's Mistake

We have satisfied ourselves, using as a specific example from Russia's economic history, that quantitative easing works very effectively even at a high interest rate of the Central Bank. That enables us to make a very interesting conclusion: Paul Volker's monetary policy could have been more successful. As mentioned above (see 'Example Two: Paul Volker, the Inflation Fighter'), to fight inflation the Federal Reserve, under his leadership, put up interest rates sharply. The goal was reached, inflation was beaten, but all that was done at the expense of recession and rising unemployment. Had Paul Volker used the policy of 'quantitative easing at high interest rates', the result for economic growth in the USA would have been much more positive.

Benchmark for the Monetary and Credit Policy

The Central Bank of Russia and those responsible for shaping economic policy in the Government will have to finally come round to appreciating the importance and capability of «quantitative easing» at the current and even still higher level of interest rates. However, the question comes up, what indicators one should orient oneself to in implementing this easing? How to assess its necessity and sufficiency?

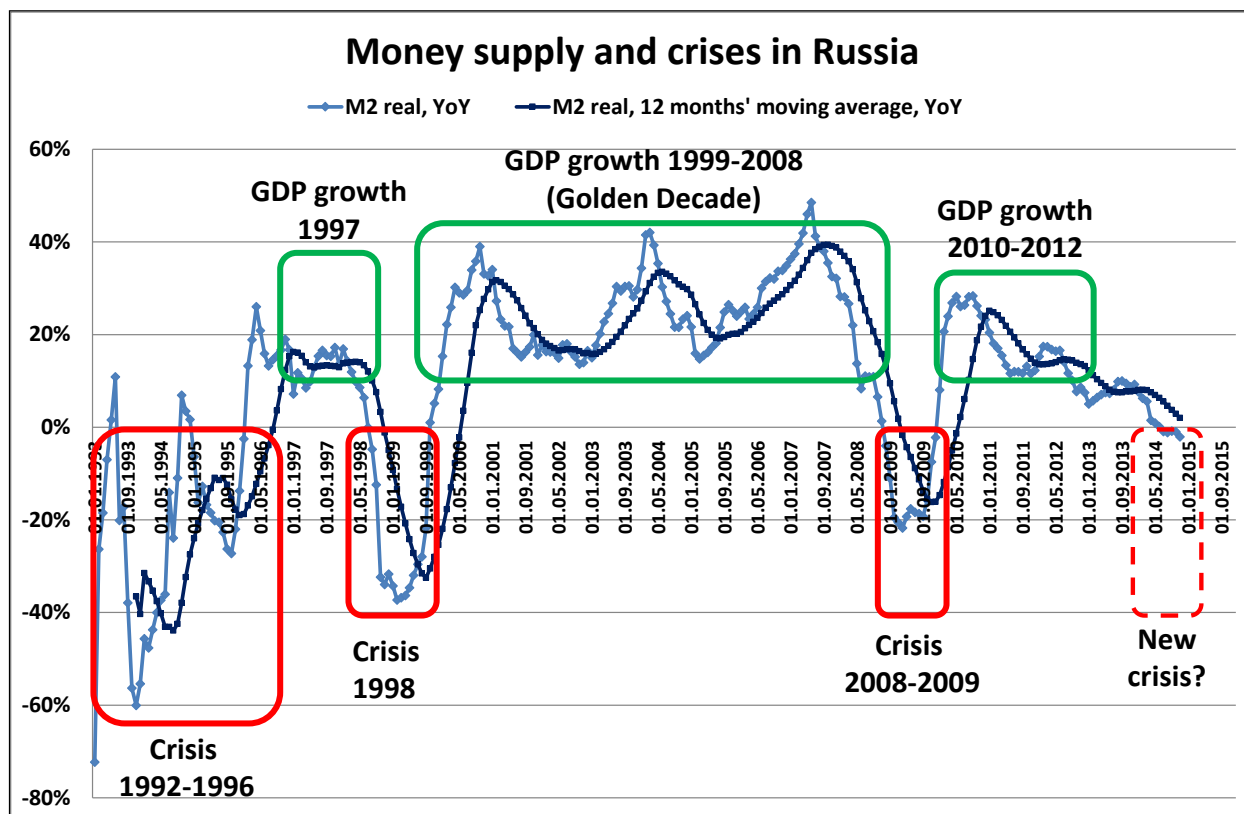
The Federal Reserve System, USA, orients itself in its policy to several indicators at once. One of such indicators is inflation. The difference, though, is that they are trying to raise it rather than lower, as this is the case with Russia. If the inflation indicator is below the target level of 2%, this is a sign of the FRS needing to continue with easing. Another important indicator is unemployment. The goal is to reduce unemployment.

For various reasons it is impossible for Russia to orient itself to such indicators. We want to reduce inflation rather than increase, while unemployment in this country is formally at very low levels, so reduction in unemployment as a goal is not suitable either. What shall we select as a benchmark? What should tell economic authorities that quantitative easing is necessary or, on the contrary, it should be disabled?

Fortunately, such a criterion does exist. These are growth rates of money supply (not to be confused with monetary base). At the same time, it is desirable that growth rates of real money supply be used. Throughout the entire post-Soviet history of modern Russia, it was exactly this indicator that has been a patent advance early warning indicator (i.e. precursor) of busts and booms. **Figure 6** illustrates in graph form growth rates of money supply in Russia since 1992. Color indicates the periods when the GDP in Russia was growing (green) or was falling down (red). As evidenced by this diagram, contraction of

money supply always resulted in decline of the GDP, while «quantitative easing» led to economic growth.

Fig. 6. Contraction of money supply results in crisis, «monetary easing» leads to GDP growth



Source: Money supply (M2) – Central Bank of the Russian Federation, inflation (consumer price index was used) – Rosstat, author’s calculations.

Between the green zones of boom and red «bust» areas, there lies, as it were, a «neutral territory». It corresponds to the situation of uncertainty, slow-down, stagnation (please, underline which of them applies). As the figure shows, during the previous past crises, the Russian economy would topple quite swiftly, within a few months or so. It has taken the economy a long journey to reach the 2014 crisis (more than two years), it has been a meandering path (sometimes, it looked like quantitative easing taking shape – the blue line pointed upwards), arriving, however, at negative growth rates of real money supply. This indicator turned negative beginning from June. It is very important to emphasize the fact that negative rates had not been observed since December 2009, i.e. since the time of the 2008-2009 crisis.

So, growth rate of real money supply quite qualifies for the role of the criterion signaling the need for quantitative easing. It is noteworthy that whatever indicators the Federal Reserve System of the USA may orient itself to, while carrying out quantitative easing, the outcome was exactly a restraint of money supply from declining and making sure it grows (ref. Blinov, 2014c, [«Central Bank is the Main Oil Company in This Country», Graph 1](#)). Therefore, orientation of the Central Bank of Russia to the indicator of growth rates of real money supply will be quite justified.

Is Easing Necessary Now, And If So, What Kind of It?

Easing is desperately needed. Departure of the money supply growth rates into the negative area in *Figure 6* (to put it simply – incipient contraction of money supply) beginning from June 2014, goes to show the need for urgent measures to be taken by monetary authorities. This is evidenced by depressing economic statistics, possible recession as early as this year, piling up problems in the economy (bankruptcy of tourist firms as an example of failing «weak links», dire straights even in the case of major banks and state run corporations and others), rising interest rates in the inter-bank market and corporate debt market. The conclusion is obvious: easing is indeed necessary.

Minimum amount of easing – inflation plus target growth rate of the GDP. In order to avoid a fall in real money supply, its growth must be no less than inflation. It is precisely the failure to follow this rule in the 1990-s that culminated in a disastrous decline in real money supply in the economy and a most severe economic downturn. Failure to live up to this rule in 2014 also caused real money supply to be reduced in June and July. Thus, for example, in October, money supply nominally grew by 6.0% (year on year). But inflation for the same period comprised 8.3%. Even at man-in-the street level it is clear to any person that if his or her salary or wages are going up, and the prices rise still faster, his or her real purchasing power is only deteriorating. Same applies to money supply. If its growth is below inflation, there occurs a reduction in real volume of money in the economy.

But it is not enough just to keep money supply at a stable level. If the target growth rate of the GDP is, say, 5%, this growth must be supported by a corresponding increase in money supply.

Other subtleties can be also considered. For example, if money in the country starts turning around more slowly (and this is exactly what is happening now in Russia), then per the well-known Fischer equation, it is required that the quantity of money be increased to support the GDP at the same level. Another feature of the situation in Russia is connected with one-off increase in the population by approximately 1.5% due to incorporation of the Crimea and Sebastopol. This requires that money supply be increased by the same 1.5%.

So, according to the most conservative estimates, it turns out that growth of money supply (with inflation at the level of 8.3%) must equal 14.8% and more (8.3% is «indexing» for inflation; 5% is the target growth of the GDP; 1.5% is population growth; totaling up to 14.8%). Is it much or little? What amount of quantitative easing in Rubles is necessary in this case? Quantitative easing as a tool presupposes influence on money supply through a build-up of monetary base (mechanism of exercising such influence is described in the article [«The Central Bank is the Main Oil Company in the Country»](#), Blinov, 2014c) Let us make a simple calculation.

Minimum Scenario Calculation. As at November 1-st 2013, the monetary base amounted to 8.952 trln. Rubles. The necessary amount of the monetary base as at August 1-st 2014, according to our minimal calculations, should have been 14.8% more, i.e. it should have amounted to 10.3 trln. Rubles. The actual amount was 9.6 trln. Rubles, i.e. 0.6 trln. Rubles less than required. The necessary amount of «easing» according to this estimate is «only» 0.6 trln. Rubles or 600 bn. Rubles.

Optimal amount of easing – inflation plus 20%. If we are to revert to *Figure 6*, we will see that robust economic growth was observed with growth rates of real money supply at 20% and more. That means that apart from compensating for inflation, an additional 20% is necessary.

What may cause such a great need for money in the economy? One can put forward many theories and the first thing that comes to mind is the so-called «low monetization of the GDP» in Russia. Another

theory consists in the fact that money supply serves, as it were, as a «source» of establishing long money in the economy, and higher growth rates of money supply are needed to establish «long money» in the economy (officially long term deposits, for example, are not part of money supply M2). Those who are interested in this subject, I recommend reading the article [«Long Money and the Policy of the Central Bank»](#) (Blinov, 2014b)

Irrespective of what causes such a dependence, we can rely on more than 20-year historical experience and assume as empirical dependence the following formula **«Required growth rate of the money supply=inflation+20%»**. Based on this formula with inflation level of 8.3% the Central Bank with quantitative easing has to ensure that money supply grows by 28.3% or more (8.3% - «indexing» for inflation; 20% is real growth).

Calculation Based on Optimal Scenario. As at November 1-st 2013, the monetary base amounted to 8.952 trln. Rubles. The necessary amount of monetary base as at August 1-st 2014 has to be, based on the optimal scenario, 28.3% more, i.e. it has to amount to 11.5 trln. Rubles. Since actual value of the monetary base as at November 1-st, 2014 is 9.6 trln. Rubles, the necessary amount of «easing» according to this calculation is already 1.9 trln. Rubles.

What is the Central Bank of Russia to do?

So, above we have determined that the Central Bank can well use, basing itself on the experience of the «golden decade» of Russia, quantitative easing even at high interest rates. Also we have seen that the current situation in the economy and the indicator chosen by us (growth rates of real money supply in the economy) signal the need for urgent action. Based on the two calculation given above the volume of «quantitative easing» must amount to between 0.6 and 1.9 trln. Rubles. What can the Central Bank of Russia do in this situation?

Using the experience in carrying out similar «easing» by the Federal Reserve of the USA, we can suggest the following scheme.

1. The Central Bank is to announce the beginning of infinite duration program of quantitative easing for the purpose of not allowing the economy to slide into recession. The policy of interest rates is not to change at the same time (i.e. key interest rate is not reduced).
2. Monthly volume of operations aimed at easing is stated at the level of 300-500 bn. Rubles a month (equivalent to less than 10 bn. US dollars) with the possibility of reducing this volume as the situation improves.
3. During the process of carrying out the program, the Central Bank, itself or through authorized entities, is to buy out assets worth the amount stated above
 - a. In the public debt market
 - b. In the corporate debt market
 - c. In the foreign exchange market
 - d. In other accessible markets, buying out, for example, gold from Russian gold mining companies to replenish international reserves or shares of issuers quoted in Rubles while operating, for example, through VEB (Bank for Foreign Economic Activities).
4. Every month's results of the program operation are to be summed up, and on collegiate basis, a decision is taken regarding necessary adjustments of the amount of monthly transactions.

An important question comes up: can the foreign exchange market be used in the current situation to implement quantitative easing? Won't it lead to the weakening of the Ruble, as a consequence, to

inflation? As a minimum, there are two arguments, which speak in favor of the possibility of using quantitative easing. Firstly, the experience of 1998-2002, when, despite the drop of the Ruble exchange rate from 6 to 32 Rubles to the dollar, easing was carried out, speaks of such a policy being sufficiently effective.

Secondly, the foreign exchange market allows transactions of practically any volume to be carried out, whereas the debt obligations market and the stock market in Russia are rather limited in their size.

However use of foreign exchange market will only become possible after the Ruble exchange rate has stabilized or begun to strengthen.

Conclusion: How Quick Will the Result Be?

May I apologize to the reader for too down-to-earth an example from the history of the company for which I have been working for quite a while and developed quite a loyalty for. By August 1998, there had unfolded a very bad situation in the Russian economy. Many production facilities simply shut down. One of them was KAMAZ, truck producer from Naberezhnye Chelny. In the first 9 months of that crisis year only 1100 trucks were produced, on the average a symbolic volume of 120 units per month. In order to understand how little it is, one would need to know that during the best of years, KAMAZ used to produce 10 thousand trucks a month and more than 120 thousand trucks a year. Producing just 120 units a month was actually tantamount to the company's shutdown.

In August, default of the Government struck. On September 11-th, Evgeny M. Primakov was appointed Chairman of the Government. And practically at once the first Russian «quantitative easing» began. It can be easily traced based on the statistics of money supply on the web-site of the Central Bank of Russia. And the situation changed almost instantly. In the three remaining months of 1998, KAMAZ produced 2200 trucks (733 units a month on the average, which is equivalent to a six fold increase in average monthly production).

During the following year 1999, average monthly production equaled 1250 trucks already, while in 2000 it was 1950 units. During the subsequent years, growth continued.

So far as the Russia economy as a whole is concerned, as early as 1999, GDP growth rate made up 6.4% unseen since Soviet times. During the second quarter of 1999, the quarterly GDP showed growth and had not, a single time, gone into the negative area since then up until the 4-th quarter of 2008 when the Central Bank allowed a most serious monetary contraction to happen.

This example goes to show that in case the program kicks off immediately starting from September 2014, the first results of «quantitative easing» will be seen 3-4 months later. And in 6-8 months, all idle talk by travesty of experts about Russia facing a many-year period of “low economic growth” will simply be forgotten.

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