RUSSIAN CENTRAL BANK LET THE RUBLE TO FREE FLOATING

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BRIEF SUMMARY OF THE ARTICLE

- Article suggest us the changes of the policy in activities of The Central Bank on the foreign exchange market:
  - Previously the economy operated as an open economy with raiding partners and fixed exchange rate but adjustable(by the operations of the central bank) however, with the change of the policy overall model of the economy has also transformed to the economy with a flexible exchange rate.
- Overall recession in the economy had an exacerbating factor with the change in domestic currency exchange rate
- The transition to inflation targeting
- As "The Central Bank has already spent on the maintenance of the course of more than 30 billion dollars from its reserves ." The economy also faces the decrease in the reserves of the foreign currency with the excess demand of the foreign currency on both forex and domestic markets

CRUCIAL ASSUMPTIONS

- Short run
- Open economy
- Fixed prices and wages
- Movement from fixed to flexible exchange rate
- Reduction of monetary and fiscal interventions

Facts

- Perfect capital mobility
- Overall recession in the economy

IDEA IN THE “GENERAL LANGUAGE”

- Discount rate is the interest rate charged to commercial banks for loans received from the Central Bank. With lower rate for which banks borrow money from CB they will reduce interest rates on loans. For private investors and consumers, this will mean an increase in the supply of cheaper money. As a result people will start to spend more on good and services, business will return to investmen in projects, restoring activity.

IDEA IN THE ECONOMICAL THEORY

- Decrease in the discount rate by the Central Bank leads to the growth of the monetary base in the form of increasing the excess reserves of commercial banks due to additional borrowing from the central bank . Loan potential of the banking system increases , the volume of loans issued by commercial banks increases and leads to multiplied expansion of deposits and growth in money supply.
  Money supply expansion, in its turn, leads to the liquidity growth, and, as a result, the LM curve will shift to the right, causing the decrease in the interest rate. The fall of the interest rate is the reason for the investments' growth, which is one of the components of the aggregate demand curve equation on the goods' market. In this situation, in the short-run the economy is in the short-run equilibrium, with higher prices, so the problem of inflation in the short-run exists. It is obvious, that in the short-run equilibrium, the increase in the price level has a positive effect on the labor market: the real wages will fall, which means the movement along the MPL-curve and the increase of the amount of labor used until the equilibrium on the labor market is reached. As a result, we can see that the government's policy will lead to the inflation in the short-run, however, it will stimulate the economy, so that the output will increase in the short-run, and intuitively in the long-run.

ALGEBRAIC EXPLANATION

Model Setup:

$$C(Y) = C_0 + c^p(1-t)\alpha Y + c_r(1-t)(1-\alpha)Y$$

$$I(r) = I_0 - I_1 r$$

$$G = G_0$$

$$NX = EX_0 - Im_0 - mY$$

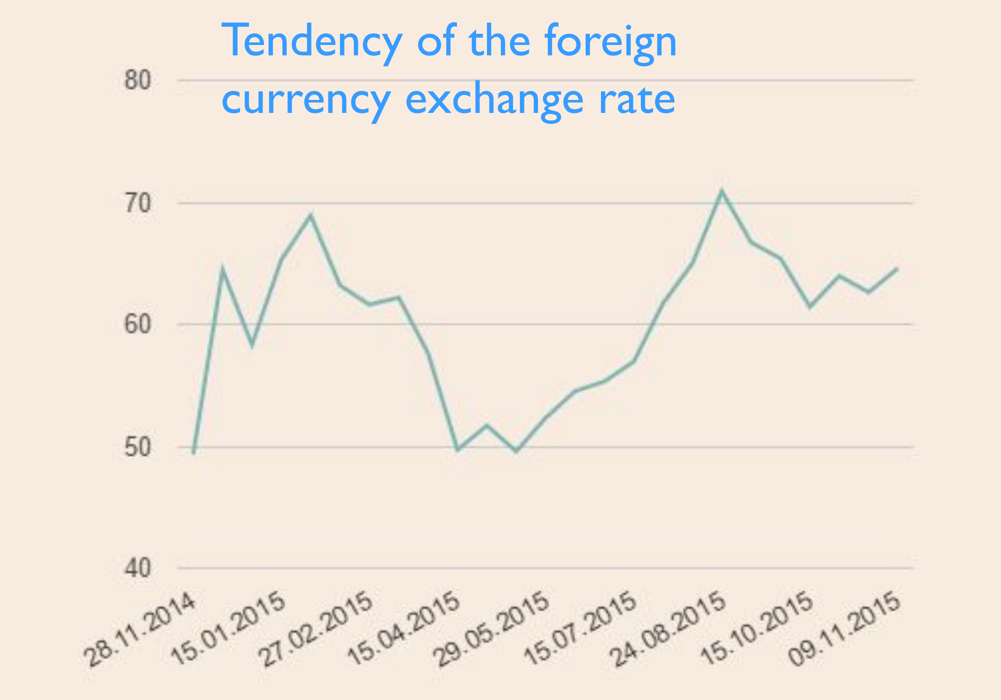
$$Y = C + I + G + NX$$

$$Y = C_0 + c^p(1-t)\alpha Y + c_r(1-t)(1-\alpha)Y + I_0 - I_1 r + G_0 + EX_0 - Im_0 - mY$$

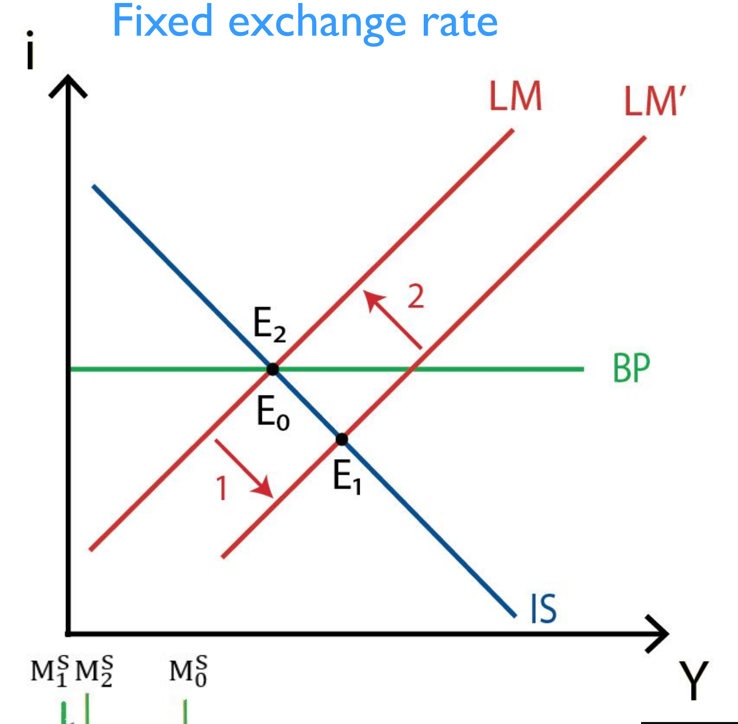
$$Y - c^p(1-t)\alpha Y - c_r(1-t)(1-\alpha)Y + mY = C_0 + I_0 - I_1 r + G_0 + EX_0 - Im_0$$

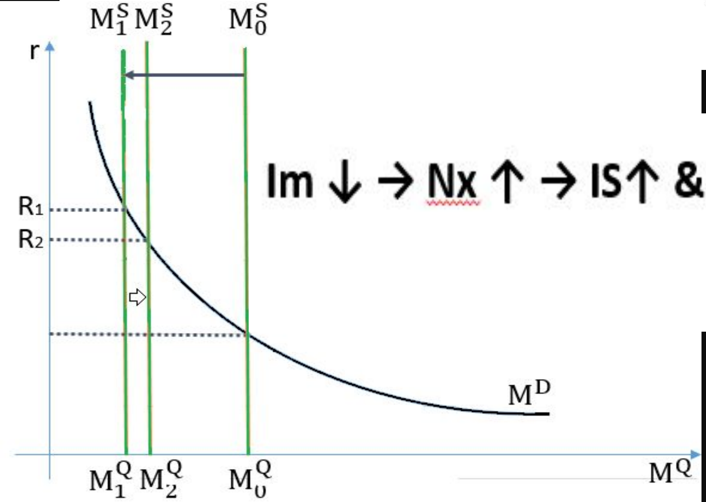
$$Y\left(1 - c^p(1-t)\alpha - c_r(1-t)(1-\alpha) + m\right) = C_0 + I_0 - I_1 r + G_0 + EX_0 - Im_0$$

$$Y = \underbrace{\frac{1}{1-[c^p(1-t)\alpha + c_r(1-t)(1-\alpha) - m]}}_{M} \cdot (C_0 + I_0 - I_1 r + G_0 + EX_0 - Im_0).$$



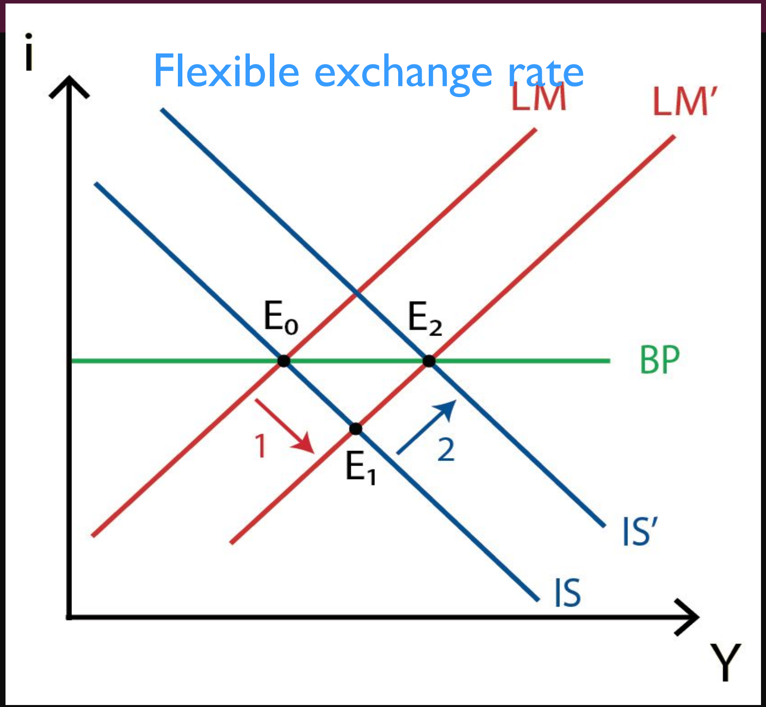
GRAPHICAL SUPPORT





Im ↓ → Nx ↑ → IS↑ & AD↑ → P↑ → $\frac{M}{P}$↓ → LM ↑

L↑



M^S↑ ⇒ r↓ ⇒ I↑ ⇒ IS shifts to the right.

CONCLUSIONS

- Basing on the economical model after the CB has canceled its operations toward the domestic currency rate the output should not change, while in the real situation we experience a drop in the output of the economy and enstrenght of recession.