



AROUND INFLATION

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Absrtract

Few years before the fall of 2007 inflation in Kyrgyzstan was low relatively to the neighboring states. Unfortunately this achievement was not supported by high levels of economic growth. In our article we consider these phenomena, analyze their interrelation and try to find ways for more rapid growth of Kyrgyz economy. We assume that economic growth should be the main goal of the National Bank as well as the government, while maintaining an acceptable level of inflation should be an instrument to achieve this goal.

Key Words: inflation, economic growth, investment.

К ВОПРОСУ ОБ ИНФЛЯЦИИ

Аннотация

2007 жылдын күзүнүн алдында, бир нече жыл бою Кыргызстанда инфляция коңшу мамлекеттерге караганда төмөн болгон. Бирок, тилекке каршы, бул жетишкендик экономикалык өсүүнүн жогорку деңгээли менен коштолгон эмес. Биздин макалада бул феномен көрсөтүлгөн жана инфляция менен экономикалык өсүштүн байланышы анализденген. Ошондой эле экономикалык өсүшкө алып бара турган жолдор талкууланган. Биздин оюбуз боюнча экономикалык өсүш өкмөттүн гана эмес Улуттук Банктын да негизги максаты болушу керек. Ал эми инфляцияны башкаруу ошол максатка жетишке багытталышы керек.

Ачкыч сөздөр: инфляция, экономикалык өсүш, инвестициялар.

According to the CIS Interstate Statistical Committee, for the first four months of 2007, inflation in Kyrgyzstan was the lowest.

Can we assert based on this fact that the situation in the economy of Kyrgyzstan is good? Perhaps, not.

According to Andrei Illarionov, a former economic adviser to V.V. Putin, Kazakhstan's GDP growth from 1998 to 2004 amounted to 10.4% per year. At the same time, inflation in Kazakhstan was slightly higher than in Kyrgyzstan. Now the question: Whose Economy, Kazakhstan's or Kyrgyzstan's, in recent years has developed better?

Next question: How do you feel about the fact that retention of inflation at a low level is the main task of the National Bank of the Kyrgyz Republic?

Low rates of inflation mean only that the National Bank of the Kyrgyz Republic within the limits of possible meets an objective, which is declared in the National Bank Act - keep inflation low, and is not responsible for the economic growth. As a result, it turns out that in Kyrgyzstan to promote the economic growth only the tools of fiscal policy are used.

The flaw of this approach reflected in the September-October 2007, when commenting on the upsurge in food prices, representatives of the National Bank of Kyrgyzstan were forced to acknowledge that fighting inflation using only monetary means is impossible.

Of course, you can try to "save face" and continue to argue, as the official sources, that everything is controlled, but the reality shows another.

Most of the people of our country used to assess personal well-being and economic situation in genera, not on the figures, which are published in newspapers, on radio and echoed in the form of graphs on television screens. Much more than the general economic performance we are interested in the price lists in markets and shops, where we buy food and other essential things that make up our "consumer basket". Comparison of its value to official figures provided interesting results. It turns out that the prices of essential commodities are increasing much faster than inflation recognized by the government.

Perhaps it comes as no surprise that these words express the essence of the problems faced by Kyrgyzstan appear in the article by Oksana Pokrovskaya "Russians get poorer faster than it seems", written in the electronic newspaper utro.ru on June 6, 2007. Post-Soviet countries together with a common history have common problems.

To complete the picture, you can refer to the article "Kyrgyzstan returned to bread cards?", published in the newspaper Komsomolskaya Pravda on September 28, 2007, which states that the price of products in the country rose by 100%, while, according to official sources, the inflation rate does not exceed 10%. Here comes a little theory.

Equation of quantitative theory of money

$$MV = PY \tag{1}$$

where

M - the amount of money in the economy,

V - the velocity of money,

P - price level (GDP deflator)

Y - real GDP,

is major in macroeconomics.

Equation (1) through the relative increment can be rewritten as

$$\frac{\Delta M}{M} + \frac{\Delta V}{V} = \frac{\Delta P}{P} + \frac{\Delta Y}{Y}.$$

Assuming that the velocity of money is constant, and given that the inflation rate is

$$\pi = \frac{\Delta P}{P}, \text{ we get}$$

$$\pi = \frac{\Delta M}{M} - \frac{\Delta Y}{Y}. \quad (2)$$

Equation (2) states that the inflation rate is determined by the change of amount of money in the economy and has a negative correlation to changes in real GDP.

Primitive approach implies that the National Bank, reducing the supply of money ($\Delta M/M$) is likely to reduce the value of π . But the fact is that the reduction of money supply could lead to a reduction in growth of real GDP ($\Delta Y/Y$), which, according to the equation (2), negatively affects the level of inflation.

But the negative impact of inflation on the economy should not be exaggerated. Example of Kazakhstan, Russia and many other countries on the one hand and Kyrgyzstan on the other shows this.

On April 2, 2006, academician of the Russian Academy of Sciences V.M. Polterovich in a note to the government of the Russian Federation entitled "Reducing inflation should not be the primary objective of the economic policy of the government of Russia" wrote about this subject.

Here are a few passages from that work:

In late March 2006, the press reports that "the government has made the task of reducing inflation strategic" and plans to reduce inflation to 4 -5% by the year 2008 and up to 3-4% by 2009. It is not quite clear how it is going to achieve these results. However, with a high degree of certainty we can predict that if the decline in inflation was the main objective of the economic policy of the government, then the Russians have to forget about the rapid economic growth.

Rapid inflation is the typical disease in developing countries due to the irresponsible policies of governments. In seeking to reduce social tensions, to achieve the popularity they turn to a printing press to increase wages, pensions, allowances, and grants. This policy causes a rapid growth of prices and disruption of economy. That is why in popular articles and elementary textbooks economists prefer to emphasize the lethality of inflation. But already in the "advanced" training texts authors do not conceal that the issue of the impact of inflation on the welfare and growth is not fully investigated, and that in some cases, this effect can even be positive.

Massachusetts Institute of Technology Professor Stanley Fischer held the posts of Vice-President of the World Bank and the Deputy Director of the International Monetary Fund. In the textbook he co-authored we read: "As a flexible response to the supply shocks is needed, it is undesirable to have a maniacal inflation fighter at the head of the central bank" (Blanchard, Fisher (1992), p. 610).

And here is the view of Nobel laureate Joseph Stiglitz, not only a distinguished theorist, but also the largest specialist on economic policies: in 1993 he was appointed head of the Council of Economic Advisers under President Clinton, from 1997 to 2001 served as vice president and chief economist of the World Bank. In the book "Globalization and its discontents" (Stiglitz (2003), p.220), he writes: "While there is an agreement that no economy can function successfully in hyper-inflation, there is no consensus on the benefits as a result of lower inflation. There is no evidence that the increasing decline in inflation benefits comparable to the cost, and some economists even believe that the desire to make inflation too low leads to the negative consequences. "

It is clear that the National Bank of the country, can affect the rate of inflation by controlling the amount of money in the economy. And how can it contribute to the growth of GDP? One answer is very simple - improving the work of the banking sector of the Kyrgyz Republic's economy.

Gross domestic product, GDP, of the country is a value of all goods and services produced in the country during the year. Perhaps the change of its value best reflects the state of the economy. Not in vain Russia's President Vladimir Putin calls on the government to double the GDP, and Kazakhstan is rightfully proud of the fact that in the 21 century, the country's GDP grow annually by more than 10%.

Not surprisingly, the models that describe the change in GDP are very popular among economists. One such model is proposed to you.

Simple economic model assumes that GDP (Y) is the sum of investment (I) and consumption (C):

$$Y = I + C.$$

The consumption function C has a permanent part - consumption of essential goods (A). The remaining part of the GDP ($Y - C$) is allocated between investment ($I = b(Y - A)$) and the consumption of luxury goods ($(1 - b)(Y - A)$):

$$Y = A + B (Y-A) + (I-b) (Y-A). \quad (3)$$

Logically, the country's GDP is proportional to the amount of capital (production facilities, machinery, equipment, ...) in the country:

$$Y = aK. \quad (4)$$

And, as we know, investment is a change in capital capacity.

The value of investments in the period with the number n (I_n) is the difference between the amount of capital in the period n (K_n) and the amount of capital in the previous period (K_{n-1}):

$$I_n K_n = - K_n - I.$$

Then, using the term for investment in the decomposition (3), we get

$$I_n = b (Y_n - A) = K_n - K_{n-1}.$$

Therefore, from the ratio (4)

$$b(Y_n - A) = \frac{1}{a} (Y_n - Y_{n-1}).$$

Regrouping the items and reducing the expression to the standard linear differential equation of the 1st order:

$$abY_n - abA = Y_n - Y_{n-1};$$

$$(ab - 1)Y_n = - Y_{n-1} + abA;$$

$$Y_n = \frac{1}{1-ab} Y_{n-1} - \frac{abA}{1-ab}. \quad (5)$$

Solution of equation (5)

$$Y_n = \left(\frac{1}{1-ab}\right)^n Y_0 - \frac{abA}{1-ab} \frac{1 - \left(\frac{1}{1-ab}\right)^n}{1 - \left(\frac{1}{1-ab}\right)}$$

is easy to convert to

$$Y_n = \left(\frac{1}{1-ab}\right)^n Y_0 + A \left(1 - \left(\frac{1}{1-ab}\right)^n\right),$$

and

$$Y_n = A + \left(\frac{I}{I-ab} \right)^n (Y_0 - A).$$

The result is consistent with expectations: the higher the return on capital, expressed through the coefficient a , and the propensity to invest, expressed through the coefficient b , the greater the rate of GDP growth $\left(\frac{I}{I-ab} \right)$.

Moreover, the better starting conditions, in this case $(Y_0 - A)$ - a part of GDP not used for consumption of essential goods in the initial time, the greater the value of future GDP.

So, the GDP growth depends on the starting conditions, those are independent from us, on the return on capital – it is necessary to raise productivity of labor, and on the propensity to invest. According to the theory saving equals investment, so the propensity to invest is the propensity to save. That is, the greater the share of GDP, which is not used in current consumption, the greater the GDP in the future.

Unfortunately, in our country, not all savings are investments in the economy of the Kyrgyz Republic. Due to the unfavorable situation in the country, much of the funds are withdrawn from the country.

Moreover, according to the National Bank of the Kyrgyz Republic, the money in the hands of the population exceeds 13 billion soms - 350 million dollars are not working on the country's economy. This is a vivid indicator of the ineffectiveness of the banking sector.

In our view, there are two main reasons for inefficiency.

In the banking market in Kyrgyzstan there are low rates on deposits, and in the case of Demir Bank even negative rate (there is not only no interest on deposits, but even more, taking money for services). At the same time, the rates on loans, even in the face of availability of many monetary aggregates in banks, are very high. It is another vivid example of a high degree of monopolization (cartelization) of the banking services market. And this should be dealt by the National Bank.

Another reason is too stringent requirements of the National Bank procedures for granting loans to commercial banks, making the latter uncompetitive in servicing small and medium-sized businesses. Various micro-crediting organizations and the like use it, crediting entrepreneurs at the predatory conditions, the effective rate on some loans exceeds 50%.

Finally we cite another fact that speaks in favor of putting economic growth at the forefront.

Results of the research published in International Business Council's journal *Investment Now* (No. 11, Bishkek, spring 2007) show that the level of economic growth is one of the 10 key indicators taken into consideration in the planning of investment in the Kyrgyz Republic. At the same time investors, comparing Kyrgyzstan with other countries in the region, on a scale from minus 100 to plus 100, gave the Kyrgyz Republic minus 80 for economic growth – it is the most negative characteristic.

In sum, the main goal of the National Bank as well as the government should be economic growth in the country, while maintaining an acceptable level of inflation should be an instrument to achieve this goal.

Resources

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