

Dilemmas and Tradeoffs in Russian Exchange Rate Policy

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Russia is at a crossroads in dealing with one of its greatest dilemmas: how to set the ruble's exchange rate. The August 1998 financial crisis led to a very sharp and sustained drop in the ruble's exchange rate against the dollar. By the end of the year the ruble had lost 70% of its pre-crisis dollar value. Over the first nine months of 1999 the ruble lost an additional 17% of its dollar value. The exchange rate reached 25 to 1, as compared to 6.29 to 1 before the crisis.

The massive devaluation of the ruble did have some positive effects for the economy. With their rubles worth so many fewer dollars, Russians were no longer able to afford imported goods. They began to look for domestically produced alternatives, and many Russian businesses responded with alacrity. Russian exporters also benefited, because their costs for wages and other domestic inputs fell greatly in dollar terms, making them more competitive on world markets. These beneficiaries of devaluation also were able to pay many more rubles in taxes, easing Russia's fiscal crisis.

It is widely feared, however, that the positive effects of devaluation will be short-lived. Opportunities to replace imports have largely already been realized. Meanwhile, inflation is starting to outstrip the continuing decline in the exchange rate. As a result, Russian prices are going up in dollar terms, eroding earlier competitiveness gains. By late summer 1999, for instance, automobile manufacturers were already finding themselves with substantial stocks of unsold vehicles.

Thus, Russia now needs to make important decisions regarding its exchange rate policy. Should policy aim to preserve the competitiveness gains associated with the ruble's devaluation by making sure the exchange rate drops in line with inflation? Or is the calming effect of a stable exchange rate on consumers and investors more important, even when Russian producers begin to find it harder to compete against their foreign rivals? In other words, is it better to have a "soft" ruble, or a "hard" one? Economists have differently assessed the tradeoff between competitiveness and predictability. But such an analysis should not be done in isolation from the political effects of opting for a soft or hard ruble on trade policy in general. Russian experience shows that businesses hurt by the chosen exchange rate regime, if they are not able to change it, will seek and win other kinds of government relief. This relief comes in the form of policies designed to affect the cost of importing and exporting goods. Exchange rate policy cannot be evaluated without evaluating these associated trade policies. The first section of this

memo explains how exchange rates affect trade policy in light of the Soviet economic legacy. The second section argues that Russia would be well-advised to choose a strong exchange rate but protect its industry through tariff barriers.

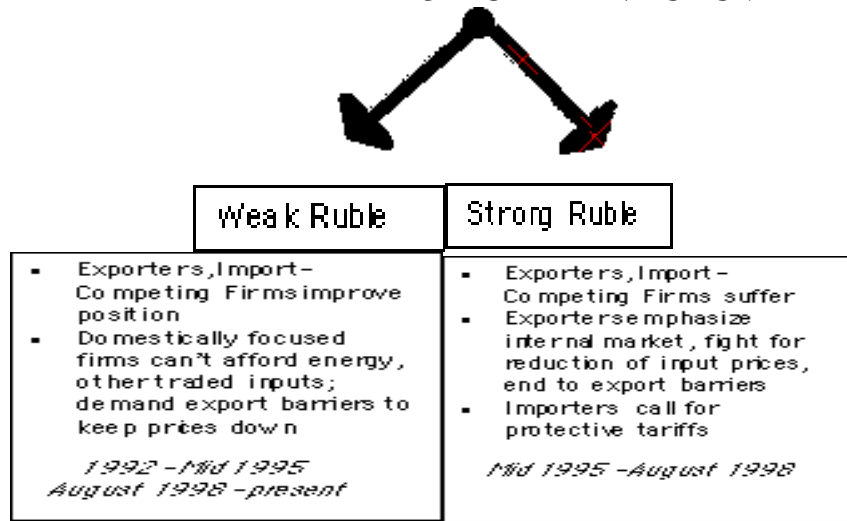
Exchange Rates and Trade Policies: The Pendulum Effect

The key political effects of exchange rate policy stem from the legacy of Soviet policies on oil and natural gas. During the Soviet era, both these industries received major investments, and a huge pipeline infrastructure was built for delivering energy resources to domestic and foreign consumers. However, in Soviet times domestic consumers--power stations and industrial enterprises--were not encouraged to conserve these resources, and made far, far more intensive use of them than their foreign counterparts.

The legacy of Soviet energy policy creates serious difficulties for either a hard ruble or a soft ruble policy. When the ruble's dollar value is low, Russian energy users cannot afford to pay world prices for oil and gas, or even a reasonable fraction of them. As a result, the government comes under pressure to intervene in the economy and hold down energy prices--often through limitation or discriminatory taxation of exports. When the ruble's dollar value is high, however, Russian firms cannot compete against foreign firms. The political result is new demands for protective tariffs against imports, and the dismantling of export barriers that compound the competitiveness problem. The resulting "pendulum" pattern of policy is illustrated on the next page.

The swing of the trade policy pendulum began to manifest itself very quickly after the August 1998 currency crisis. Oil producers immediately sought to restrict their domestic sales, since consumers could no longer afford to pay an acceptable share of world prices. In response, the government sought to make the right to export conditional on continued domestic deliveries. In the winter, power stations had trouble paying for fuel oil, leading national power network head Anatoly Chubais to call for restrictions on fuel oil exports, calls he renewed the following summer. In the spring, the government imposed new taxes on oil exports, and brokered a price-setting "cartel agreement" intended to keep domestic energy prices from rising to world levels. Although the spring's sharp rise in world oil prices clearly gave the policy pendulum an additional impulse, on the whole the policies adopted were quite reminiscent of those pursued in the earlier weak-ruble period from 1992 through the middle of 1995, policies that were dismantled once the ruble strengthened.

THE TRADE POLICY "PENDULUM"



Why Russia Should Choose a Strong Ruble

The choice that Russia now faces is whether to continue to combine a weak exchange rate with export restrictions, or whether to pursue a strong exchange rate that will make domestic energy sales attractive but damage the competitiveness of Russian industry. If it wants to create a political base for long-term growth and eventual world market competitiveness, Russia should choose a strong exchange rate. However, this policy must be coupled with far more sweeping protectionist measures than previously pursued. Such a policy has two key advantages.

- It makes energy producers into a constituency for growth.

In April of 1998, Russian consumers spent the equivalent of \$22 billion; in April 1999, their spending amounted to only \$8.4 billion. Thus, no plausible rate of economic growth will bring dollar spending back to its pre-crisis level within the next decade. With the domestic market so limited, energy producers will simply ignore it to the extent possible. A continued weak exchange rate would be particularly poignant for the powerful natural gas monopoly Gazprom, which is much less able to divert sales to foreign markets than oil companies and would be forced to regard miserable receipts on domestic sales as a cost of doing business. A stronger exchange rate, by contrast, would make the domestic market a realistic source of major sales, leading energy producers to invest in their customers in an effort to further expand the market. A weak exchange rate pits energy exporters against the government in a battle over whether the domestic market will be supplied at all; a strong exchange rate could unite the two forces in a battle for growth.

- It incorporates the lessons of the post-devaluation recovery.

The rise in industrial production after the devaluation of the ruble demonstrates something many had previously been inclined to dismiss: Russian enterprises do respond to market conditions. If they can benefit from the protection offered by the devaluation, they can benefit from tariff protection as well. This will clearly need to be more extensive than that introduced in the previous hard-ruble period. Internal competition--as well as

indirect competition from imported goods not produced by Russia but which consumers may choose to buy as imperfect substitutes for shoddy goods not worth owning--can help ensure that high tariffs do not become a recipe for permanent industrial mediocrity.

Whatever decision Russia makes about the future of exchange rate policy, the choice must be a considered one. More flexible international policy is needed. The IMF believes the export-restricting policies associated with the current swing of the policy pendulum distort market forces, and has sought their elimination as a condition for future loans. If this effort is successful, it will have the effect of pushing Russia to strengthen its exchange rate in order to maintain an acceptable level of energy supply for the domestic market. The associated loss of competitiveness, however, will lead to calls for restrictions on imports, which the IMF will find equally objectionable. Thus the IMF is taking the position that Russian industry can be protected from foreign competition, but only by making Russian consumers too poor to afford anything imported or exportable; alternatively, domestic energy needs can be met, but only if the internationally exposed sectors of the Russian economy are sacrificed. In short, when the trade policy pendulum reaches one end of its arc, the IMF gives it a hard shove back the other way. Violent oscillations driven by dogma accomplish nothing. The pendulum must be stopped at a position where it can point the way forward.

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