

Too Much of a Good Thing? High Oil Prices and Russian Monetary Policy

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Strong Oil, Weak Ruble: A Contradictory Formula for Success

The gloom that followed the August 1998 financial crisis has given way, in some circles, to euphoria. In the first half of 2000, the Russian economy grew by 7.5% compared to the same period in 1999. This excellent economic performance, most agree, is based on two factors: high oil prices and a weak exchange rate. High oil prices have been a bonanza for Russian energy exporters, which have enjoyed tremendous sales growth. Taxes collected on burgeoning oil sales have also eased fiscal problems, improving the investment climate. Meanwhile, the ruble's weakening against the dollar has made Russian firms much more competitive against foreigners. Together, strong oil prices and the weak ruble have done much to contribute to the growth of the Russian economy. Most in the Russian government are eager to see this combination continue.

This formula, however, is contradictory, because oil export revenues tend to strengthen the ruble. As explained in the next section, the Russian government and Central Bank have sought to avoid letting oil revenues affect the exchange rate, but this turns out to be quite difficult. This memo explains why it is so difficult, and then turns briefly to contending political views on the issue.

Dollars Beget Rubles

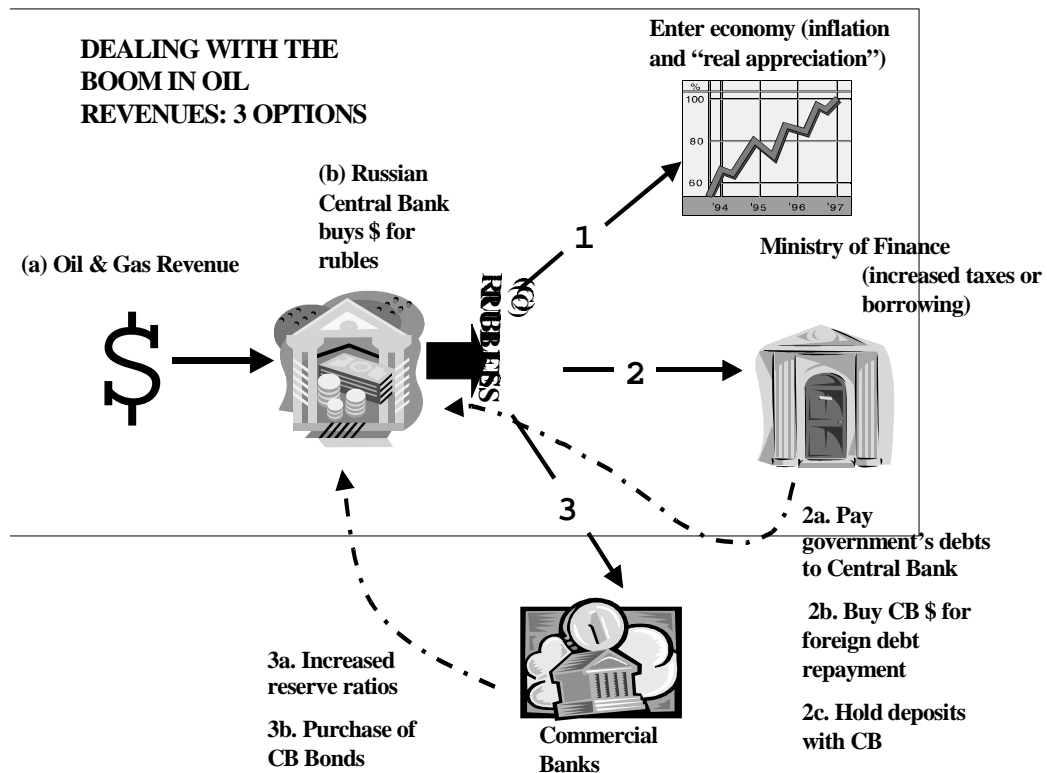
How oil revenues translate into monetary dilemmas is illustrated in the figure on the next page. Begin on the left-hand side, at (a). Oil exporters earn receipts in hard currency (mostly dollars). They then sell many of these dollars for rubles. Since these sales increase the supply of dollars, they tend to drive the price of the dollar in terms of the ruble down. In other words, the sale of dollar oil revenues ought to make the ruble stronger. However, through much of 2000, the Central Bank has kept the ruble price of the dollar from falling by buying dollars itself, pushing demand for the dollar, and thus its price, back up. This policy--shown in the figure at (b)--leads to an increase in the Central Bank's dollar reserves, which have more than doubled since the beginning of 2000. At the end of September, the gold and hard-currency reserves hit \$24.7 billion, the highest figure post-Soviet Russia has ever achieved.

When the Central Bank buys dollars to keep the ruble from strengthening, it does so by printing new rubles--shown in the figure at (c). It is what to do with these newly created rubles that is the main policy dilemma posed by high oil prices.

Where Should the Rubles Go?

The authorities could just ignore the monetary side effects of their exchange rate policy. The result--option 1 on the figure--would be inflation, as the new rubles chased goods in the economy. Importantly, inflation undermines the goal of keeping the ruble weak. Inflation makes ruble prices higher. But since the exchange rate does not change, inflation makes dollar prices higher too, undermining the competitiveness of Russian firms. This scenario of rising ruble inflation combined with an unchanged ruble-dollar rate is known as a "real" appreciation of the ruble. (If dollars just got cheaper in terms of rubles, that would be a "nominal" appreciation.) In fact, since the beginning of the year the real appreciation of the ruble has been about 15%, a very substantial amount.

If inflation and real appreciation are to be avoided, then, rubles must be sucked back out of the economy. Such a policy is known as "sterilization." Arrows 2 and 3 on the figure illustrate the main options for sterilization under consideration.



Sterilization Through the Ministry of Finance

Some of the new rubles will wind up with the Ministry of Finance (Arrow 2), because of increased tax receipts. The Ministry can also borrow funds in rubles. By returning some of these rubles to the Central Bank, sterilization would be achieved. This return could happen in two ways. The Ministry could pay off accumulated debts to the Central Bank, which holds some of the largely defunct older bonds of the government (2a). Alternatively, the Ministry could use its rubles to buy dollars, and use these to pay off Russia's foreign debt (2b).

There is a downside for Russia in either of these policies, however. Paying off debts held by the Central Bank might anger some other creditors on the same bonds. Likewise, Russia is in ongoing discussions with the Paris Club of official creditors about reducing and rescheduling Soviet-era debt. High oil prices are already making the Paris Club less forgiving. But embracing a policy of using debt payments to sterilize dollar inflows would weaken Russia's bargaining position even further.

Finally, the Ministry can simply hold large deposits of its tax receipts with the Central Bank (2c), rather than spending them. It is this last policy that appears to have accounted for most sterilization this year. Rubles are taken out of the economy without converting them back to dollars, and without paying back any government debt. The major disadvantage of this system is that it bypasses parliamentary oversight of the use of tax receipts, which has led to bitter complaints by Duma deputies that the government is "hiding revenue."

Sterilization Through the Banking System

An alternative policy for sterilization is to rely on the Central Bank's control over commercial banks. For instance, banks can be required to hold more reserves against deposits, which reduces the supply of money that can drive prices upward (3a). Alternatively, the Central Bank can sell "bonds" of its own, paying banks interest to keep rubles out of the monetary system (3b).

The main disadvantage of such a policy is its effect on the institutional development of the banking sector. Russian banks still do far too little lending to business, and have not become a source of capital for growth. Restricting their lending via higher reserve ratios, or by encouraging them to buy risk-free bonds from the Central Bank, does little to push the banks toward learning to make domestic investments.

Politics

Political struggle over how to deal with the monetary side effects of increased oil revenues centers around two dimensions. First is the extent to which it should be pursued at all. Some politicians suggest that it is misguided to restrict the flow of funds to what

remains a backward economy marked by widespread poverty. (For a discussion of whether Russia should pursue a stronger ruble, see PONARS Policy Memo No. 90.) They suggest Russia should seize the moment to grow its internal market, before oil prices once again head downwards. Interests linked to financial services, and other goods and services not traded on the world market, are sympathetic to this view. Some episodes of reluctance on the part of Central Bank head Viktor Gerashchenko to fight appreciation of the ruble may also be related to his sense of the interests of the banking sector. Evidence also suggests that the leadership of the city of Moscow, which faces large payments on dollar-denominated debts, would like to see the ruble appreciate. Taking the opposite position are exporters, and others who fear that allowing the ruble to appreciate will threaten the competitiveness of Russian industry, and that any boom touched off by converting oil revenues into rubles will disastrously unravel if oil prices head downwards.

Russia's economic leadership, including Prime Minister Mikhail Kasyanov and Finance Minister Aleksei Kudrin, have repeatedly expressed their conviction that further real or nominal appreciation of the ruble should be avoided, and it is clear that the weak-ruble position has carried the day to this point. The main argument, therefore, is over methods of sterilization. The present method of holding government balances with the Central Bank exposes Russia's government to charges of nontransparency on all sides. It also conforms to Russia's unfortunate pattern of conducting "pro-reform" policies--here designed to rein in inflation--through channels that bypass democratic accountability. However, ongoing parliamentary debates over the budget for next year--which does include explicit provisions for paying off debts both to the Central Bank and to foreign creditors (though less than the latter would like)--may go some way to rectifying this problem.

Considerations for Paris Club Policy

Russia's situation may appear to present a happy coincidence between the need to fight inflation and a responsible attitude toward Russia's foreign obligations: policy 2b--using excess rubles to purchase dollars from the Central Bank and retire foreign debt--addresses both issues at once. But it should be recalled that much of that debt stemmed from an irresponsible, late-Soviet borrowing spree squandered on dealing only with short-term problems. Rich-country policy should focus not only on enforcing responsibility for the errors of the past, but also on promoting responsibility in planning for the future. Russian politicians and officials who seek some way to use the oil bonanza to build a more diversified and sustainable economy deserve at a minimum a respectful hearing.