

Toward Full Convertibility of the Ruble? Benefits, Pitfalls, and Prospects

PONARS Policy Memo 350

Mark Kramer
Harvard University
November 2004

In May 2003, Russian President Vladimir Putin announced that the Russian ruble would be made fully convertible by the end of the decade. Over the next year, he steadily moved up the target date for this goal. The law on capital controls that was adopted by the Russian parliament at Putin's behest in late 2003 set a date of 2007 for full ruble convertibility. In an interview on Russian television in February 2004, one of Putin's senior economic advisers, Aleksei Ulyukaev (who was then first deputy finance minister and is now first deputy head of the Russian Central Bank), said that the projected date for full convertibility might be moved up still further. In May 2004, Putin confirmed that he wanted the Finance Ministry and the Central Bank to prepare to make the ruble fully convertible by 2006, some four years earlier than originally planned.

If this ambitious goal is achieved, it will greatly improve the operating conditions for Russian businesses (especially energy companies) and will foster a more auspicious climate in Russia for foreign investors. But any such move will entail serious risks and will probably be infeasible, particularly if 2006 remains the target date. It is doubtful that the Russian banking system and capital markets are capable of sustaining such a rapid transition to full convertibility. If convertibility is established prematurely, it could lead to wild swings in capital flows, the collapse of Russia's fragile banking sector, and a severe financial crisis.

Background

During the Soviet era, the ruble was neither internally nor externally convertible. Internally, foreigners who were leaving the country could exchange small amounts of rubles for dollars or other foreign currencies, but the exchanges were transacted at artificial rates that bore no relation to actual purchasing power. Externally, the Soviet ruble could not be converted at all. In July 1992, after the Soviet Union had broken apart, the Russian government made the ruble internally convertible, allowing Russians and foreigners alike to exchange rubles within Russia for foreign currencies. Over the next few years, sharp changes in the nominal exchange rate – notably in October 1994, when the ruble was devalued by 27 percent in a single day – both reflected and contributed to the country's prolonged macroeconomic instability. In July 1995, the Russian government announced that it would maintain the ruble in a relatively narrow band

against the dollar. Within a few months the ruble not only had stabilized but had even appreciated slightly, and it remained stable thereafter. Flush with this apparent success, the Russian government established a “crawling band” exchange rate system in May 1996 that would permit the ruble to depreciate gradually to around 6,000 to the dollar (or 6 to the dollar in redenominated currency). This system lasted, more or less intact, until August 1998 when the onset of Russia’s financial crisis precipitated a sharp devaluation of the ruble.

In the wake of the financial crisis the Russian government imposed a highly restrictive foreign currency regime. Businesses had to seek permission for capital transfer operations on a case by case basis, and they had to sell 50 to 75 percent of their hard-currency proceeds from exports. (This latter requirement was introduced because many companies, after August 1998, were wont to hold export revenues in their corporate vaults.) These measures evoked strong complaints from business executives, who claimed that the rules gave arbitrary discretion to government officials and created lucrative opportunities for rent-seeking.

During the first several years after the financial crisis, the ruble’s nominal exchange rate continued to decline against both the dollar and the euro (falling to roughly 32 rubles to the dollar as of late 2002), but in early 2003 the Russian Central Bank changed its policy from one of promoting a gradual nominal depreciation to one of accepting some appreciation against the dollar. As a result, the ruble began to appreciate in nominal terms against the dollar (though not against the euro), and the appreciation continued in 2004. The rise would have been even sharper if the Russian Central Bank had not repeatedly intervened, a policy that stemmed mainly from political considerations (specifically from pressure exerted by influential domestic manufacturing and mining firms) and that had little if any economic justification, not least because it caused a further surge in base money growth and thereby kept inflation in double digits.

Starting in early 2004, the Russian government hinted that it might begin shifting away from dollars (which currently represent more than two-thirds of Russia’s hard-currency reserves) toward euros to protect itself against the continued weakness of the dollar on international exchanges. A shift of this sort would be a sea change for Russia, which during the 1990s was the world’s single largest importer of dollars. In November 2004, Aleksei Ulyukaev (in his new capacity as deputy head of the Central Bank) publicly declared that an effort to reduce the country’s dollar holdings and increase its euro reserves was under consideration. It remains to be seen, however, whether such a change will prove feasible in light of Russia’s heavy dependence on commodity exporters for its hard-currency revenues. (Russian oil and natural gas exports account for nearly 57 percent of Russia’s hard-currency export revenues, and exports of other dollar-denominated commodities account for an additional 12 to 13 percent.)

The brisk economic growth during Putin’s tenure, the huge increase in Russia’s foreign currency reserves since 1998 (amassed mainly through cuts in imports and high taxes on oil companies, which face levies of 90 percent or more on oil priced over \$25/barrel), and the Central Bank’s desire to mitigate the costs of its interventions on the foreign exchange market (interventions designed to forestall a further nominal appreciation of the ruble) have provoked the recent high-level interest in making the

ruble fully convertible. Ulyukaev acknowledged in his interview on Russian television that “there will be some risks” in pushing ahead with full convertibility, but he said he was “hopeful” that “we will be able to cope with the problems that might arise.”

Benefits and Costs of Full Convertibility

Almost all observers of the Russian economic scene agree that the capital restrictions imposed after the August 1998 crisis quickly outlived their utility. The government over the past two years has eased some of those requirements, but it retains extensive control over capital transfers abroad (including cross-border investments and international lending) and still requires exporters to deposit 25 to 30 percent of their repatriated hard-currency earnings in ruble accounts with the Central Bank for up to six months. The elimination of these restrictions would greatly reduce the operating costs for Russian businesses, especially energy companies, which have been among the strongest supporters of full convertibility. The elimination of capital controls would also make Russia far more attractive for foreign investors, many of whom are currently unwilling to put up with the risks posed by the Russian market and to endure the wealth-destroying effects of capital restrictions. Capital liberalization would have the further benefits of giving small borrowers access to capital markets, encouraging competition in Russia’s sclerotic financial sector, and facilitating the integration of Russia into the world economy.

Despite these potential benefits, there are serious doubts about whether Russia can and should move toward full convertibility as rapidly as Putin suggests. For one thing, the extent of the government’s commitment to capital liberalization is far from clear. The new law on capital controls has done away with the permit and control system, but, in other respects, the Central Bank’s powers to interfere in capital transfers have actually increased, at least on paper. To forestall speculative investments, the Bank can now impound short-term loans for as long as two months and can require almost the entire amount of long-term loans to be set aside for as long as two years. These provisions have sparked a good deal of cynical commentary in the Russian financial press about Putin’s proclaimed goal of full convertibility. Although the Central Bank has not exercised its full powers under the law, it did begin imposing unremunerated deposit requirements on both inflows and outflows of capital as of August 2004.

Even if the government’s support for full convertibility were not in doubt, the weakness of Russia’s banking sector and capital markets militates against the rapid elimination of capital controls. Under full convertibility, large inflows of capital might quickly be followed by large outflows if macroeconomic policies were too lax or if some other external shock caused investors to lose confidence in the Russian currency. For the foreseeable future, Russia’s banking sector is simply incapable of managing such large capital flows and liquidity shocks. The International Monetary Fund’s latest status report on the Russian economy, issued in September 2004, makes clear that banking reform in Russia has made almost no headway since 1998. If anything, parts of the banking sector are even weaker than they were six years ago. The sector is dominated by two state-owned banks – Sberbank and Vneshtorgbank – which, along with the state-owned Vnesheksporthbank, account for roughly two-thirds of household deposits and nearly 55

percent of total bank assets. The extent of the undercapitalization of Russian commercial banks can be seen by the fact that not a single one controls assets over a billion dollars (an amount that, by Western standards, is paltry). Moreover, even if the banks were better capitalized, the Central Bank's regulatory supervision of the sector, as the IMF notes, has been inadequate, and the law on bank bankruptcy has not been enforced.

The continued weakness of the Russian banking sector was underscored in mid-2004 by the crisis that swept through it. In the spring of 2004, efforts to tighten the enforcement of prudential standards in the banking sector caused many depositors to worry that their savings might suddenly be wiped out, as in August 1998. A sizable number of commercial banks experienced runs on their deposits in May, June, and early July, and several had to close down or restrict their payments. The Central Bank responded by injecting liquidity throughout the sector (in the form of a 50 percent reduction of reserve requirements) and by providing deposit insurance to all banks, regardless of their status. The Central Bank also facilitated Vneshtorgbank's takeover of Guta Bank, a commercial bank that had been forced to suspend its operations in early July. These measures stemmed the immediate crisis, but only at considerable cost, including the moral hazard posed by the extension of deposit insurance to banks that do not meet the criteria of prudential eligibility.

In addition to the obstacles posed by the weakness of Russian banks, the underdevelopment of Russia's capital markets raises serious doubts about the feasibility of capital liberalization. If Russian banks are to be strengthened, they will need access to a deep, high-quality market in fixed-income securities so that they can offset their liabilities. But the longest maturity of Russian bonds is currently 15 years. Until Russia's capital markets have progressed enough to offer longer-term (30 year) bonds that would pay higher rates, it is difficult to see how the commercial banking sector could strengthen itself enough to meet the challenges of full ruble convertibility.

Beyond these structural problems, questions of practicality immediately arise. Unless foreigners are willing to hold and trade rubles, the currency will not be truly convertible. Since late 2003 many Russians have been gradually converting some of their dollar savings into rubles to insulate themselves against a further decline in the dollar. (Most estimates suggest that Russians hold more than \$50 billion under mattresses, in foreign bank accounts, and in other off-book locations – the largest store of U.S. dollars outside the United States.) This sell-off within Russia has helped burnish the ruble's domestic reputation and encouraged some foreign companies in Russia to begin setting their prices in rubles rather than "conditional units" (which usually are adjusted to the exchange rate with the dollar). Nonetheless, in the absence of far-reaching structural reform of the Russian economy (a process that has not yet begun), it is doubtful that foreign investors will have enough faith in the Russian economy to use the ruble as a reserve currency. Because trading volumes would likely be small, full convertibility of the ruble would probably leave it undervalued.

Under the best of scenarios, Russia's economy for some time to come will remain heavily dependent on commodity exports, leaving it vulnerable to fluctuations in commodity prices as well as other external shocks. Capital liberalization in the absence of structural reform would increase this vulnerability. Capital flows into Russia in recent

years have been heavily swayed by oil prices, and it is therefore likely that unrestricted short-term capital flows would prove highly volatile. Moreover, even if oil prices remain high, that itself could spark a worldwide economic slowdown, which in turn would reduce the demand for Russian energy exports. Whether a fully convertible ruble could withstand that kind of shock is doubtful.

Prospects

Putin's decision to set 2006 as the target date for full ruble convertibility has created a dilemma for the Russian government. On the one hand, Putin has often sought to push ahead with economic initiatives that seem to have a political payoff. The fact that he mentioned full ruble convertibility in two consecutive state of the nation addresses and that he accelerated the projected date suggests that, as one observer commented, the president "sees [full convertibility] as one of the prerequisites for Russia to move toward a more developed economy."

On the other hand, the likely pitfalls and severe obstacles to capital liberalization provide ample grounds for skepticism about the desirability and practicality of Putin's goal. The constraints he would have to overcome by 2006 to establish "the necessary conditions for the ruble's full convertibility" are so formidable that it is hard to see how he can succeed. To the extent that his proposal is motivated mainly by political considerations (presumably to assist Gazprom with the reshaping of the energy sector in the wake of the YUKOS affair) rather than economic logic, it raises troubling questions about the nature of his economic program. Vladimir Tikhomirov, a senior economist at UralSib, told the Moscow Times in June 2004 that full ruble convertibility was merely "a political slogan" to bolster "national prestige." Tikhomirov added: "I'd rather we built a strong economy before we start making political statements." Whether Putin will heed that advice remains to be seen.