TOO MANY DOLLARS?

By Michael S. Bernstam and Alvin Rabushka

Russia' foreign currency and gold reserves have recently hit a new post-Soviet high, officially stated at $29.5 billion as of February 2, 2001. The increase stems from the Central Bank of Russia purchasing dollars on the local market earned by oil firms, which have been benefitting from high world prices.

The IMF and other experts regard the rise in international reserves as positive in that it helps to maintain Russia's positive external balances and enables the Central Bank to defend the foreign-exchange value of the ruble at the rate of R28.5 to US$1.

As pointed out in our recent article, **The 100% Repatriation Rule: An Option for Russia**, the Central Bank requires exporters to sell 75% of their foreign currency export revenues on the local market. These sales have resulted in a corresponding increase in rubles. A rise in the domestic money supply has led some analysts to express concern that excess rouble liquidity may trigger inflation, which, in turn, could threaten both the internal and external competitiveness of Russia's non-natural resource producers.

Domestic inflation was 2.8% in January 2001, which exceeds the 2.3% level of January 2000. Inflation was 0.8% during the first week of February. Estimates of 5% for the first two months of 2001 are leading some analysts to forecast 20% for all of 2001, well above the government's official 12% target. These analysts are concerned that 20% inflation will result in too rapid appreciation of the ruble.

Fears about inflation and ruble appreciation have put the issue of capital market liberalization on the front burner; in particular, relaxing the 75% repatriation and conversion rule to bleed off excess dollars and rubles is increasingly becoming a policy issue.

Analysis

It is important to separate fact from fiction. To begin with, Russia's exports to non-C.I.S. countries consist overwhelmingly of natural resources. Higher domestic ruble inflation does not affect world prices of natural resources. In this regard, Russian exporters are price takers, not price makers. Higher domestic ruble production costs might reduce domestic profitability, and perhaps take marginal producers off line. However, there is enormous unused production capacity among Russia's natural resource producers. With the proper incentives, e.g., lifting price controls on domestic production, Russian energy producers can readily increase output and foreign sales.

Ruble appreciation, in principle, can reduce the competitiveness of Russian manufactured exports. But Russian firms export little in the way of manufactured goods to non-C.I.S. countries. In this regard, ruble appreciation is a canard.

This canard is being cited as a reason to relax capital controls, the official mantra of the International

Monetary Fund. But it is precisely capital controls which have eased the payment jam, reduced payroll and other arrears, and increased tax remittance, resulting in the favorable budgetary balance aggressively endorsed by the IMF. A positive effect of higher oil prices is that Russia ran a budget surplus in January 2001. Foreigners cite this healthy fiscal condition to insist that Russia pay its foreign debt on time.

So long as additional rubles are backed with foreign exchange reserves, and given that Russia's natural resource export earnings are a function of world prices instead of ruble costs, there is no need to be concerned about excess ruble liquidity and ruble appreciation. As we pointed out in **It's the Dollar,** making the dollar legal tender would eliminate the need for concern about excess ruble liquidity and ruble appreciation.