APPRECIATING RUBLE APPRECIATION

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From time to time, it's useful to take stock of conventional wisdom on the problems and prospects of Russia's economy as reported in the main stream financial media. An article entitled "Russia's Strong Ruble Damps Hopes for Extended Growth," which appeared in the June 20, 2001, edition of *The Wall Street Journal*, affords such an opportunity.

First, some background. On August 17, 1998, the Russian government defaulted on its domestic debt and devalued the ruble. Several technical defaults on foreign debt followed soon thereafter. Private Western investors lost about $17 billion. The world's financial markets were thrown into a tizzy.

Now, several years later, it is conventional wisdom that the events of that date were a blessing for Russia's economy.

The author of the article summarized the view of foreign and Russian investment bankers, economic analysts, and advisers. This view holds that devaluation, by cheapening the ruble, sparked a resurgence of domestic Russian industry. Devaluation presumably improved Russia's export competitiveness by making its goods cheaper abroad. In addition, devaluation, by raising the price of imported goods, induced Russian consumers to switch to less expensive domestic substitutes. Evidence in support of this view is that industrial production grew 9% in 2000 (GDP overall grew 8.4% in 2000). For the period January-May 2001, industrial output increased 5.9%; GDP, 4.9%.

Now it is claimed that ruble appreciation is threatening to slow or halt the growth of industrial output and that to prevent this outcome, the government needs to take several possible steps to prevent further ruble appreciation.

Why is Russia suffering ruble appreciation? High world prices for commodities, especially oil, compared with several years ago, are generating large foreign currency earnings for exporters of Russia's natural resources. The Central Bank of Russia requires exporters to repatriate 75% of their foreign currency earnings, which are then sold for rubles on the domestic market. Foreign exchange reserves of the Central Bank have risen to a healthy $33.6 billion compared with about half that amount over a year ago. The conversion of billions of dollars into rubles has expanded the domestic supply of base money. More rubles in circulation mean higher inflation.

Inflation in Russia is currently running at 18-20%. Inflation in the U.S. is currently running at 3-4%. The ruble began 2001 at a rate of 28.1 to the dollar, and has since weakened to around 29.1 to the dollar, a decline of 3% after adjusting for inflation in both countries. On an annualized basis, taking into account the relative rates of inflation between the two currencies, the ruble has strengthened against the dollar by around 7% in 2001. Since the beginning of 1999, the ruble has appreciated against the dollar by about a third in real terms.

Investment bankers, analysts, and advisers want the government to pursue several policies to halt real ruble appreciation. They want the government to issue domestic bonds to soak up rubles, or run a budget surplus to tax rubles out of circulation, or pay foreign debts more quickly by cashing in rubles for dollars. Most of all, they want the Central Bank, or the government to order the Central Bank, to relax its 75% repatriation rule.

During this year, we have posted numerous articles on the issues of ruble appreciation (February 20, 2001; April 10, 2001) and the related issue of the Central Bank's 75% repatriation rule and why it has been largely responsible for Russia's current economic recovery (January 4, 2001; January 25, 2001; January 30, 2001; February 20, 2001; March 8, 2001, March 15, 2001; April 25, 2001; and, May 1, 2001). These articles show that the 75% repatriation rule has been instrumental in reducing the payment jam, thereby reducing inter-enterprise, payroll, and tax arrears. Speeding up payments in the economy fueled the growth of real output.

As we explained in Chapter 1 of *From Predation to Prosperity*, speeding up the payment of invoices increases output as cash flow turns over faster (until Russia runs out of spare productive capacity, which will not happen in the near future). The Central Bank rule has transformed budget deficits into budget surpluses as enterprises have a harder time to enforce tax non-remittance. The rule has increased foreign reserves, which enables the Central Bank to insure the ruble from a downfall. Most importantly, the rule has reduced excess invoices, which is the principal cause of growth in the past two years.

The concern about a strong ruble dampening hopes for extended growth is misplaced. Russia does not have to worry about the external competitiveness of its industrial products. It exports largely natural resources. As for manufacturing, most Russian industry is value-subtracting. It would be better if much of this industry were shut down. Russian goods do not compete in foreign markets, especially in Western markets, nor are they likely to do so any time soon. The main consequences from real ruble appreciation is lower profits for natural resource exporters, but this does not translate into reduced industrial output.