THE DUTCH DISEASE: PETER THE GREAT'S REAL LEGACY?

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On June 29, 2001, the Russian government stated that it would soon introduce legislation to reduce the obligatory selling of foreign currency proceeds by exporters to the Central Bank from 75 to 50 percent. This measure, as we have discussed in detail with statistical evidence on this site ("The Secret of Russian Economic Growth: Testing an Old Hypothesis with New Data" and "Can More Liberal Subsidies Spur Growth and Reduce Inflation?"), threatens economic growth and fiscal solvency.

Nevertheless, Russia is abuzz with talk of the Dutch disease. The current conventional wisdom as summarized in a June 20, 2001, *Wall Street Journal* article entitled "Russia's Strong Ruble Damps Hopes for Extended Growth" is that high commodities prices are causing an economic slowdown, threatening Russia's recovery. This view holds that high oil prices, although the source of recent growth and strong profits in the oil sector, are causing inflation and real ruble appreciation that will strangle the growth of non-oil industries for years to come. There is a related, though somewhat contradictory, fear that profits in the oil sector (and equity prices) will decline if world prices fall while domestic production costs rise.

High oil prices are credited with Russia's strong 8.3% growth in 2000, the highest rate in more than 30 years. Every dollar rise in Russia's oil is said to contribute 0.4% to GDP. Energy and metals constitute 80% of exports and the bulk of the domestic equity market. The prevailing view in Russia is that devaluation of the ruble after August 1998 played an important role in recent growth by increasing domestic demand, as Russian consumers switched to cheaper domestic goods.

Subscribers to the Dutch disease argue that the conversion of large foreign currency earnings into rubles, which are sold to the Central Bank under its 75% repatriation rule, leads to increasing the monetary base, thereby inflation. Since Russia's inflation exceeds that of its trading partners, the ruble is appreciating in real terms, which reduces the competitiveness of non-commodities producers.

Real ruble appreciation is thus presumably causing a slowdown in growth (currently running at 5.4%) say those in the Dutch disease school of thought. With annual inflation running at 15-20% this year, the ruble will appreciate as much as 15% in real terms. This ruble appreciation must be curtailed to restore higher growth.

What's the policy answer to this conundrum?

On the above argument, the answer seems clear. If high oil prices are the cause of ruble appreciation, economic slowdown, and the Dutch disease, which crowds out the development of non-oil production, then lower oil prices are the cure. Less foreign earnings from oil exports would reduce the rise in the domestic money supply, slow inflation, ease or halt ruble appreciation, thus stimulating growth in non-oil industries. If so, the Russian government should simply instruct the country's oil exporters to sell oil at a lower price. Less foreign currency earnings would increase Russian growth. It would also curry favor with Western countries by reducing their oil import bills. Who knows? Perhaps Western Europe and the United States would buy manufactured Russian goods out of gratitude. Or write off some portion of Russian debt. Actually price-for-debt might be negotiated. There is probably no single gesture that would earn Putin more thanks in the West, and kudos from economists and bankers, than a decision to cut oil prices.

It would be a small price to pay if lower oil prices reduce profits and equity values of energy firms since the presumed benefit would be the promise of higher future economic growth. Sacrificing current growth from high oil earnings appears to be a price worth paying to encourage an increase in domestic non-oil output and the promise of higher future growth from a weaker ruble.

A second policy response is to relax or eliminate the Central Bank's 75% repatriation rule, allowing exporters to keep more of their earnings offshore and acquire foreign assets (e.g, foreign equities and bonds, foreign real estate). This would have the same effect as lower oil prices on easing ruble appreciation and forestalling the Dutch disease. The government is taking a first step in this direction.

This, too, is presumably a small price to pay, even if the current reduction in arrears in payrolls, taxes, and unpaid invoices between enterprises is reversed. As we have previously demonstrated, high oil prices in conjunction with the 75% rule have been responsible for the recent reduction of all arrears. Speeding up payments between enterprises has been the chief source of growth in the economy.

Apart from the profitable commodities sectors, much of Russian industry is value-subtracting, subsidized largely by the flow of funds generated from energy exports. Russia will not build a productive non-energy domestic economy until value-subtracting enterprises are shut down or transformed in value-adding enterprises. A weaker ruble does not by itself correct the problem of value subtraction. Indeed, a weaker ruble exacerbates the problem of value subtraction by keeping domestic producers in business as they are better able to sell their value-subtracting output to Russian consumers and other Russian enterprises.

The Dutch disease is not a problem for the Russian economy now or in the near future. It appears to be a problem, however, for policy advocates. Is this Peter the Great's legacy?