THE NEW IMF ORTHODOXY FOR RUSSIA IS THE OLD PROTECTIONISM FOR AFRICA

By Michael S. Bernstam and Alvin Rabushka

The IMF released its mid-year report on the Russian Federation in July 2001. It is an important, indeed historic, document. In it, the IMF discards its traditional policy triad of stabilization, liberalization and privatization (or SLiP) as the correct prescription for Russia (and other post-Communist economies). Instead, it recommends a new protectionism modeled on the lines of the old (failed) African policy of import substitution that was prevalent in the 1960s and 1970s. The new protectionism, which consists of encouraging domestic production at the expense of imports, is camouflaged in the language of preventing real appreciation of the ruble (RAR). The new IMF stance is that RAR will, by reducing the cost competitiveness of domestically-produced goods and encouraging imports, retard growth in Russia.

We find it fascinating that the same issue of *The Economist* (July 21-27, 2001), which contained "A Survey of Russia" written by Moscow corresponded Edward Lucas, also included an advertisement for Director of the African Department of the IMF (page 15). It may be coincidental but it is ironic and symbolic.

SLiP, based on decades of IMF experience with developing countries, was supposed to produce growth in Russia and other post-Communist economies. But the opposite happened. As successive groups of young reformers applied SLiP between 1992 and 1998, the Russian economy contracted by almost half and ended up in the Great Default of August 1998. The IMF has been at a loss to explain this Great Contraction in the context of its traditional orthodoxy. Nor has it been able to explain China's remarkable growth since 1978, inasmuch as China did not follow SLiP. (See Chapters 1 and 2 in *From Predation to Prosperity*.)

August 17, 1998, was a watershed event in modern Russia. The Russian government defaulted on its domestic debt and devalued the ruble. Russia's immediate economic prospects looked bleak.

The economy rebounded in 2000. Growth was 8.3% in 2000, and 5.3% during the first half of 2001. The IMF seeks to explain this growth, but cannot do so using SLiP. Instead, it explains Russia's recent growth, after seven years of contraction, stemming from two developments: (1) depreciation of the ruble, which gave a boost to domestic Russian industry and (2) higher world prices for oil and gas, Russia's two main exports, which increased net exports, corporate profitability, and tax receipts.

As the IMF argues, the first, a weaker ruble in the wake of the August 17, 1998, devaluation, made imports relatively more expensive and domestic goods relatively more attractive to Russian consumers. This cost advantage stimulated an increase in domestic industrial output. The second, higher net exports, is self-explanatory. However, both arguments are false on accounting grounds. Import substitution substitutes domestic production between sectors—it does not add to GDP. (This substitution effect is discussed in detail in "Can More Liberal Subsidies Spur Growth and Reduce Inflation?") Higher world prices improve the terms of grade, but do not, by themselves, increase real output unless production increases on the supply side. (On the actual causes of growth, see "The Secret of Russian Economic Growth: Testing An Old Hypothesis with New Data.")

The main worry of the IMF is that RAR poses a risk to expanding domestic industrial output. The IMF claims that real appreciation of the exchange rate contributed to a slowdown in growth in 2001. Double-digit Russian inflation, resulting in RAR, threatens to stall growth. To preserve the current cost competitiveness of Russian producers, it is essential to halt RAR. This is protectionism, plain and simple.

What is the source of RAR? The IMF, international investment bankers, and many Russian government officials attribute RAR to a combination of high international energy prices and the Central Bank's mandatory repatriation and conversion of a portion of those foreign currency earnings into rubles. (The Central Bank's requirement that 75% of foreign currency earnings be repatriated and sold for rubles was reduced to 50% by an act of the Duma in July 2001.) A large current account balance coupled with mandatory repatriation has increased domestic base money in Russia. This increase exerts inflationary pressure, causing RAR.

The IMF encourages the Russian government and the Central Bank to take aggressive steps to sterilize the increase in rubles through fiscal surpluses and domestic bond issues, and also liberalize capital outflow to take pressure off the domestic currency. This latter recommendation traps the IMF in a contradiction.

The IMF has been complaining about capital flight from Russia for a decade. The IMF maintains that sound economic conditions in Russia, namely, a stable macroeconomic environment, would attract foreign investment and repatriation of Russian capital for investment. This capital inflow is good. However, the IMF fears the repatriation of oil and gas earnings and their conversion into rubles. This is bad. Insofar as their impact on inflation in the short-run is concerned, the IMF cannot explain why one set of inflows is desirable and the other is not. At least some Russian policy makers are consistent on this position. They oppose both forced CBR repatriation and foreign investment.

The IMF reports that for 2000 as a whole, more than half of the current account surplus was offset through net private capital outflows. This is bad because money that could be invested in new plant and equipment or used to restructure existing industry is fleeing the economy. But capital flight is good because it prevents further RAR, which thwarts the growth of domestic industry. Which is it?

We have posted numerous articles on this site explaining that RAR is a canard. (See "Appreciating Ruble Appreciation," "Can More Liberal Subsidies Spur Growth and Reduce Inflation?" "Capital Flight?" "Is Financial Liberalization Good for Russia?" and "Too Many Dollars?") Russia does not have to be concerned about the external competitiveness of its manufactured exports. About 80% of Russian exports consist of oil, gas, and other natural resources. RAR may reduce the profits of natural resource exporters by raising domestic costs, but has no effect on external demand and export volume. RAR could only affect export volumes in Russia if the price of oil simultaneously collapses and energy production becomes value subtracting.

It must be recognized—there is not a single word on this subject in the IMF report—that most domestic manufactured goods subtract value. Russia would be better off if these factories were shut down. The IMF's emphasis on sustaining the current increase in domestic industrial output means that value subtraction in the Russian economy remains intact. It means that restructuring value-subtracting production into value-added production is further delayed.

Insofar as RAR is perceived to be a problem, there are ready solutions. One is to use the dollar as a second legal currency. (See "It's the Dollar.") Another is for the Central Bank to sell dollars on the market for rubles, which will reduce both reserves and inflation, or stop purchasing dollars for reserves. Real appreciation would give way only to nominal appreciation. Another solution is to increase imports, which will benefit consumers, force domestic producers to become more competitive, thereby diminish value subtraction in industry. The problem with an increase in imports is that it would be seen by the new protectionists in the IMF and the Russian government to undermine domestic producers. If protecting domestic producers is seen as the key to sustained growth, then the most effective protectionism is the abolition of free trade.

As a side comment, footnote 4 on page 7 of the report acknowledges that the IMF knows the Russian government cheated in reporting the level of reserves in the past by counting the CBR's dollar loan to the government as part of its foreign reserves, even though that money had been spent. The IMF states that the CBR now agrees not to cheat in ways already exposed and that it will provide the IMF with more accurate balance sheet data. (See "How Big Are Russia's Foreign Exchange Reserves?")