Russian-European Centre for Economic Policy (RECEP)
Российско-Европейский Центр Экономической Политики (РЕЦЭП)

Does Russia benefit from the US twin deficit?

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2005 Moscow | Москва 2005

This project
is funded by the EU

Этот проект
финансируется ЕС

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This project is implemented by the
Bureau of economic management
and legal studies
Этот проект реализует Бюро
экономического менеджмента и
правовых исследований

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Abstract

The paper discusses the effect of the long-term dollar depreciation on the ruble exchange rate vs. major currencies and Russia's balance of payment. The underlying idea is that insomuch as Russia's export proceeds are largely in dollars and imports are in euros, Russia is going to face deterioration of the terms of trade and the shrinkage of its trade balance.

This is quite an old argument, repeatedly quoted by many economists and policy advisors. In this article, I will provide a tentative evaluation of this effect. I will estimate the volume of trade transactions denominated in euros and in dollars and then provide a qualitative evaluation of the possible pass-through effect and the likely response of the relative prices of oil & non-energy goods. I will prove that today Russia's trade balance (goods + services) is characterised by a net outflow of euros and a net inflow of dollars.

In my opinion, Russia is to benefit from the long-term dollar depreciation: price competitiveness is improving, the inflationary pressure from the positive trade balance is being relieved, thus facilitating the transition from peg to float and to the capital controls abandonment. The liberalisation, in its turn, contributes to the long-term macroeconomic stability, mitigates the exchange rate and currency risks, and as such improves investment ratings and the capital account. The policy for weak dollar not only helps the US to overcome the twin deficit but also helps Russia to cure the Dutch disease.

The all time low US dollar depreciation attracted much attention from business analysts and policy advisors. The dollar has been slipping steadily during two years, then from the summer of 2003, it has been showing a year-long consolidation and then, in mid-October 2004, it relapsed into depreciation. Between mid-October and the end of November 2004 it lost 6 to 8% against all major currencies as well as the currencies of the countries considering the US to be their main trade partner. The dollar's global downward movement is not a correction but a long-term trend driven by fundamentals, particularly, the unsustainably large twin deficit of the US economy. George Bush's re-election became a clear signal to the market that the US will overcome this problem by allowing the dollar to slip rather than by applying domestic fiscal policies.

How deep is the dollar going to fall? From Russia analysis' perspective, we must be mostly keen on USD/EUR rate changes as Russia's exports, imports, transfers, and capital transactions are almost entirely denominated in these two currencies. According to HSBC, if no more oil shocks hit the world economy, EUR/USD is expected to reach 1.40 by Q1 2006 with the upper boundary of the confidence interval 1.67. UBS and Lehman Brothers, however, expect 1.40 already by the end of 2005 and 1.50 by the end of 2006.

What effect may this trend have on the Russian economy and, particularly, on the ruble exchange rate and the balance of payment?

At present, Russia has a de-facto hard peg regime – the Central Bank targets inflation and, indirectly, the real exchange rate meaning price competitiveness of the domestic producers. The latter target is set or "proposed" by the government.[1] With the relatively low investment ratings, low product quality and low productivity it would be quite difficult for Russian producers to market their products and to raise capital if the ruble exchange rate were higher than its actual value. This is why the government pushes the Central Bank to hold the ruble down. However, given the huge oil export revenues there is a need to constantly sterilize the excess liquidity. Thus, the ruble exchange rate is determined not so much by fundamental factors but by the economic policy objectives and political considerations as well.

In mid-November, "Novye Izvestia" quoted Natalia Orlova from Alfa-Bank as saying that even if a EUR/USD rate falls to the HSBC-suggested minimum of 1.67, the dollar-ruble rate under free float cannot go below 24-25. We, therefore, believe that ruble against euro may reach 40-42. Our guess is based on the fact that the relative price of the dollar and the euro on the Russian market is about the same as in the world market, deviating within an insignificant range. The relative price holds on thanks to the arbitrage opportunities and the transaction demand for both currencies. The relative price, therefore, should not be affected by any possible shocks.

What effect may this have on the Russia's balance of payment? A possible impact on the capital account and transfers must not be significant thanks to the liquid world financial markets and a sufficient flexibility of the financial instruments. The trade balance, however, may change dramatically. To evaluate the possible changes, it is necessary to analyze the structure of the foreign trade, particularly (a) the share of dollar-denominated transactions in exports and imports, (b) relative prices, (c) response of consumption and, accordingly, that of import prices and export demand to any changes in relative prices.

A breakdown of exports and imports by countries and commodities as well as by currencies for Russia is not available. The share of the dollar-denominated transactions in exports and imports, however, can be estimated under the following assumptions: (1) euros can be used only in transactions with suppliers and recipients located in Europe[2], (2) exports and imports of services to/from European countries can be paid up only in euros, (3) all transactions with oil, natural gas, petroleum and petrochemicals, metals as well as sugar, cacao, and rubber are dollar-denominated, and (4) the volume of transactions in third currencies is insignificant and those can be pooled under the euro-denominated basket. With these four assumptions, the only two unknown variables are the dollar shares in exports and in imports of other goods. This group is largely composed

[1] Mixed policy targeting requires from the fiscal and monetary authorities to coordinate. In Russia, such coordination is facilitated by the State Monetary Policy Program.
[2] In Russian statistics, this is reported as transactions with European countries. The trade partner of a Russian company may be based outside Europe but if a good or a service has been delivered to/from the company or a branch located in Europe, this is deemed a transaction with a European country.

of timber, pulp, fertilizers, and machinery at exports end and "over-the-counter-traded food", consumer goods and, again, machinery in imports. In monetary terms, this group accounts for about 1/3 of the total export and 90-95% of imports. In its trade balance (goods and services), Russia, therefore, claims a net outflow of euros and net inflow of dollars. Accordingly, with the current volumes and the structure of Russia's trade, the depreciation of the US dollar against euro and other world currencies seriously deteriorates its terms of trade leads to shrinkage of its trade balance.

Let us take January-September 2004 as an example. This is the latest update from the Federal Custom Service.

Russia's exports, imports, and the balance of trade, January-September 2004, mln USD

	Europe (EU, Turkey and Eastern Europe excluded)	Rest of world including CIS
oil, natural gas, petroleum & petrochemicals, metals, sugar, cacao, and rubber	balance +82,507	
other goods	*Export 42,843* *Import -50,653*	
services	balance -3,535	balance -7,557

Source: author's calculation from the Federal Custom Service's data

The goods and services balance for this period was USD63.6bn (current account balance was USD74.4bn). Transactions in euros are highlighted in grey. The currency decomposition of 'other' goods is unknown but even if all these goods are imported for euros and exported for dollars, the balance 63.6bn must be a sum of a USD67.1bn inflow and EUR3.5bn outflow (in dollar terms at the average exchange rate for the respective period). Depending on the actual share of dollars in export and import of 'other' goods, the balance of dollar transactions can be between +67 and +75bn while the balance of euro transactions between -3 and -12, respectively. Remember, this is a rather tentative assessment, not proven econometrically.

Thanks to the dollar depreciation the US-made goods are getting cheaper (which is understandable). But a persistent, long-term depreciation is likely to change the relative prices for factors and final goods. What effect, if any, may this have on Russia?

Let us first examine the oil market, which is accountable for the biggest share of Russia's export revenues. The world's largest oil consumers are the USA and China (yuan is still fixed against the US dollar). Hence, no significant correction of the oil and petrochemicals prices in the dollar terms is expected. These products are, therefore, going to be relatively cheaper in the European market, bringing down PPIs and the costs of production. Since the demand for consumer and non-energy intermediate goods is inelastic with respect to the energy prices and because oil consumption increases insignificantly or does not rise at all, other goods tend to be relatively more expensive. (The counter-effect of the decrease of the relative prices of fuel and petrochemicals in the final consumption group is likely to be insignificant) Note, that 1.40/1.30 oil price decrease is simply incomparable with the today's oil price fluctuations. But anyway, the long-term dollar depreciation brings about more expensive imports, which is probably bad news for consumers but definitely exciting news for the domestic producers.

The problem is essentially in the currently undervalued ruble whose real exchange rate is believed to be 20 – 22 for one US dollar compared to RUR 28-29 for a dollar it is quoted now. Indeed, the Russian producers are very well protected. In 1998-99, the four-fold depreciation of the national currency permitted Russian companies to start selling their produce. This contributed to inward investments. But when the demand is inflating on the rent incomes from the raw materials export, the undervaluation causes inflation and puts restraints on market competition and economic growth. Moreover, a long-term macroeconomic stability is not feasible so long as the authorities keep the exchange rate away from equilibrium. To achieve the stability, exchange rate management needs to be confined to rare dynamic currency control initiatives and occasional interventions aimed at preventing speculative attacks and, under float, mitigating peaks. As such, the long-term dollar depreciation is more than good news for Russia as it relieves the inflationary pressure on the economy and improves its competitiveness.

This, in turn, helps authorities to let the ruble float freely and abandon discriminatory capital controls. It is a benefit from both political and economic perspective. The weak US dollar policy helps not only the US government to overcome twin deficit, it also helps Russia to cure the Dutch disease.

December 8, 2004