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Real Effective Exchange Rate and Economic Development: Outlook for Russia

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I A weak real effective exchange rate: a necessity for Russia.

Under-valuation of the exchange rate and inflation

Management of the rouble exchange rate has taken on a paradoxical urgency in recent months. After using a lot of energy over a number of years to avoid accelerated devaluation of its currency, Russia is now faced with the opposite situation. Due to huge trade ($60.9 bn, or 25% of GDP, in 2000!) and current account surpluses ($40 bn), the country is receiving very large hard currency inflows in both absolute and relative terms. The Central Bank has to intervene massively on the foreign exchange market to avoid a resulting rise in the nominal exchange rate of the rouble. This has allowed the CB to rebuild a comfortable level of foreign exchange reserves ($25 bn at the end of 2000, up by $16bn from 1999), but the acquisition of foreign money has been mirrored by an equivalent emission of roubles. In a context of weak demand for cash money and absence of a genuine system of financial intermediation, rapid growth of the money base (by 65% y-o-y in January 2001) generates excessive liquidity, which explains a tendency to more rapid inflation in recent months despite a substantial public finance surplus (the federal government showed a primary surplus equal to 5% of GDP in 2000 and a nominal surplus of 2.5%).

A recent IMF mission suggested allowing the rouble to find its own nominal equilibrium in order to avoid a scenario where the monetary counterpart of foreign currency purchases leads to very strong inflation.[1] The immediate effect would be to weigh down the balance of trade, mainly due to a resurgence of imports, since exports are largely raw materials and non-elastic to exchange rate fluctuations.

[1] IMF, Public Information Notice No. 00/883, November 9, 2000, 'IMF concludes article IV consultation with the Russian Federation', p.2: 'Given the massive external current account surplus, most directors believed that real appreciation would be both

The IMF argument makes sense to those who remember the impact of foreign currency purchases on the internal money aggregates of a country like Brazil in 1993, where there was monthly inflation of nearly 50% in the absence of any operational public deficit.[2] The more so since Russia is probably still under-utilising its production capacities in numerous sectors (imperfection in measuring tools makes it hard to be categorical about this), limiting pressure on prices until now. It can even be argued that rebuilding of working capital of companies, which followed the August 1998 crisis, has allowed these companies to lower their average costs by taking advantage of certain 'fixed' factors of production, such as excess employment, which they had previously failed to axe. Russia would thus have begun its industrial production recovery in exceptional circumstances of 'free' growth, which, in combination with strict budget management, would explain the initial absence of a genuine vicious circle of devaluation and inflation.

There is a risk that the situation will be considerably harder to manage in coming months. Although nobody really knows the capacity utilisation rate in Russia, the point must be rapidly approaching at which companies will tend to respond to demand, which they cannot fully satisfy, by accelerating their price increases. This risk is made greater by the fact that the country cannot rapidly develop its production capacity due to continuing low levels of investment. Although gross capital formation increased by 18% in 2000, it is still 41.9% lower than in 1994, and the old capital stock is therefore permanently on the edge of breakdown.[3]

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desirable and unavoidable, and that it would be preferable for this to take place through a nominal appreciation rather than through inflation.'

[2] On the impact of exchange rate under-valuation on inflation, cf. Christophe Cordonnier, 'L'Amerique latine au-dela de la crise de la dette: les trois cercles de la transformation structurelle' ('Latin America beyond the debt crisis: the three circles of structural transformation'), Problemes d'Amerique latine, No. 21, April-June 1996, pp.69-98.

[3] Cf. Jacques Sapir, 'Le financement de la croissance en Russie: Problemes, contraintes, options', p.3, Actes du colloque EHESS-CEMI-IPAN, Saint Petersburg, December 2000

In this context, it is not far-fetched to think that Russia could once again face an inflation fever much more serious than the recent monthly levels of approximately 2.5%. The corollary would doubtless be the return of a stabilisation strategy relying on nominal exchange rate peg, the devastating results of which were seen in 1995-98. The increase in the real effective exchange rate would then happen due to pressure of events and not due to a well-considered decision by the authorities. The effect would be to undermine the credibility of the authorities.

Risks associated with an over-rapid increase in the real exchange rate

Although we agree with the diagnosis of IMF experts on the risk of a new upsurge of inflation, the therapy, which the Fund proposes, does not seem to us to be the optimal one. There are four reasons for this.

First, the correlation between present levels of current account surplus and the real effective exchange rate is somewhat incidental. The last few months have seen a strong increase in imports (21% y-o-y in Q4 2000), probably partly encouraged by the gradual return of international banking institutions to Russia, which has made it easier to open letters of credit for purchase of foreign goods. Moreover, Russia's exports over the last two years have reaped the full benefit of increasing hydrocarbon prices, and of higher prices for other raw materials and intermediary products (steel, non-ferrous metals, etc.). Following the recent sharp slowdown of the American economy, it seems that this windfall effect cannot last for long. Oil prices have already declined far below their levels in 2000.

The second reason for caution regarding the exchange rate increase has to do with the capital account. A chilly relationship with the international financial community, particularly due to the thorny question of Paris Club debt, inherited

from the USSR,[4] means that Russia cannot count on external help in case of need. For want of precautionary credit lines enjoyed by countries such as Mexico ($26.6bn), Russia has to maintain a level of reserves, which is high relative to its GDP and external trade volume. The precaution of high reserves is all the more necessary since capital flight levels remain very substantial[5] and there is nothing to suggest they would not accelerate brutally in case of a turnaround in the confidence of Russians in the future of their country, particularly since commercial banks have a significant amount of idle liquidity (on correspondent accounts at the Central Bank, where R80 bn had been accumulated by the end of November 2000), which they could easily bring into the circuit, putting immediate pressure on dollar demand.

There is a third more fundamental factor in favour of a weak exchange rate. In the present state of the Russian production system, which is marked by strong economic and political power of 'Ricardian-rent' raw material producers, the optimal exchange rate certainly is not the exchange rate, which would enable near equilibrium of the current account, as is the case in most other economies. Export rent translates into a classic phenomenon of Dutch disease, which had already attracted the attention of Montesquieu in the 'Esprit des Lois'[6] long before contemporary works on Holland, Norway and certain developing countries (Algeria, Venezuela, Nigeria, etc.). According to David Ricardo's own definition, export rent is the residue left to producers after 'normal' payment for labour and capital factors, and can be conceptually assimilated to an exogenous flow of financial resources without any internal productive counterpart.[7] This flow has the structural effect of engendering upward pressure

[4] After trying to obtain a partial debt write-off from the Paris Club for ex-Soviet debt, similar to that obtained form commercial banks, Russia is still trying without success to obtain rescheduling of $3 bn falling due this year and an equivalent amount falling due next year.
[5] According to the International Finance Institute, capital flight reached $23 bn in 2000 despite reinforcement of currency controls.
[6] Cf. Montequieu, 'Des richesses que l'Espagne tira de l'Amerique', in Esprits des Lois, book XXI, chap. XXII.
[7] David Ricardo, 'De la rente de la terre', chap. 2, Des principes de l'economie politique et de l'impot.

on the real effective national exchange rate, exactly like the pressure due to massive capital inflows. In such a context there is a steady dwindling of sectors that produce non-rent, exchangeable goods, since these goods cannot remain competitive with imports at an exchange rate, which is higher than their productivity justifies. The economy thus tends towards bipolarisation of a rent sector, on one hand, and a sector producing goods and services that are not subject to international competition, on the other hand. The latter sector benefits from improvement of internal terms of trade vis-a-vis producers of exchangeable goods when the real exchange rate increases.

Similar causes have similar effects, and it is to be feared that, without a strategy for combating the effects of Dutch disease, Russia could become, or return to be, a society structured around a raw material and semi-product producing pole, based on rent, and a jumble of service activities with little social utility, be they commercial services, a bloated bureaucracy, or military functions.

Such evolution would be regrettable, firstly because it would prevent emergence of a civil society of small independent producers, which is the sociological base of any democracy, and which plays a decisive role in creating demand for institutions and respect for the rule of law. Worse, it would condemn a large part of the Russian technical elite, who represents the country's real comparative advantage in the long run, to abandon genuinely productive functions and devote themselves to service activities, where their know-how would be under-used. Finally, such evolution would place Russia in the unenviable situation of low income rent economies, such as Venezuela, Algeria, Nigeria or Iran. Russia's natural resource potential, although considerable, cannot be compared *per capita* with that of major rent economies such as the Persian Gulf states, since its exploitation supposes gigantic investments, which current lack of confidence makes it hard to imagine, and since the means of production are in an advanced state of decrepitude. As in

the recent past, Russian growth and the country's political and social stability would be largely and dangerously dependent on unpredictable international prices for raw materials.

To avoid this trap, which could be fatal for stability in Russia, it is important to place the exchange rate at an effective real level, which allows development of non-rent productive activities and progressively marginalises rent-based production sectors in the country's economy, following the example realised so successfully over the last two decades by a country like Mexico.[8] This implies a present exchange far below that, which provides equilibrium of the current account.

A weak exchange rate strategy also seems to us to be necessary for a fourth reason, which happens to be a *sine qua non* of any strategy that seeks to escape the rent trap. The reason why non-rent sectors presently have a very low productivity level, and are therefore unable to tolerate even a small rise in the exchange rate, is not some cruel fate denying them any long-term development,[9] but the destructive impact on such sectors of a certain number of major shocks. In addition to the brutal change in relative pricing after switch from an all-inclusive plan economy to a market economy, Russia has been affected by a multitude of macro-economic and micro-economic uncertainties in the last 10 years. Before the 1998 crisis these factors, combined with a clearly inappropriate strong exchange rate policy, suppressed the internal financing capacities of enterprises exposed to international competition. Enterprises had no chance to invest in order to adapt themselves to the new relative-price context, and were led to such non-cooperative behaviour patterns as non-

[8] Cf. Christophe Cordonnier, Javier Santiso, 'Mexique, croissance ou developpement', Problemes d'Amerique latine, March 2001.

[9] The recent study by McKinsey, devoted to the structure of Russian productive potential (Unlocking economic growth in Russia, October 19, 1999) clearly shows the scale of potential productivity gains in Russian industry, given a minimum investment input and better corporate governance. Works by the Kondratieff Circle devoted to agriculture have come to the same conclusions, Russian firms having already

payment and barter. *A contrario*, the return to profit by many firms after rouble devaluation in 1998 allowed an increase in the investment rate and reintegration to the properly ordered economy of many enterprises that had been actively involved in the virtual economy, described by Gaddy and Ickes in their famous study a little time before.[10]

Because Russia has no real financial intermediation capacity that would allow transfer of funds for investment to the tradable goods sector from household savings or from savings of enterprises with low capital intensity, which make up most of the part of the economy that is not subject to international competition, it is vital for the country to foster accumulation of funds inside enterprises in the sector which is subject to competition. Different means can be used to achieve this, including an appropriate fiscal system or a relatively high level of protective tariffs. But the best means, following the example of countries, which have found the path of development after major crises in their financial sectors (Chile after 1982, Mexico after 1995, and several Asian countries, including Korea, after 1997), is to play the card of a weak real effective exchange rate. This card is particularly suitable, because it can have a rapid effect. Based on the real qualitative progress observed in the automobile and food sectors, it is reasonable to expect that recovery of investment due to adequate internal financing capacities at enterprises would lead to both considerable gains in productivity and a major reduction of micro-economic and social uncertainties in a short period of time. This would then permit a slow but sure increase in the real effective exchange rate, in line with the theoretical principles set out in the1960s by Bela Balassa.[11]

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demonstrated genuine capacity for adaptation in a context that has long remained extremely difficult.

[10] Clifford G. Gaddy, Barry W. Ickes, 'A simple four-sector model of Russia's virtual economy', The Brookings Institution, May 1998.

[11] Cf, on this subject, Bela Balassa, 'The purchasing power parity doctrine: a reappraisal', Journal of Political Economy, December 1964, pp. 584-596; Francois Benaroya, Didier Janci, 'La sous-evaluation des monnaies asiatiques', Economie internationale, 1996, No.66.

II How to keep the real exchange rate under-valued

Role of exogenous factors

It is not easy to guide the real effective exchange rate, even in a country that is partially disconnected from international financial markets by a regulatory arsenal of exchange and capital flow controls. It can even be argued that such guiding is an impossible task in the long term and that a real exchange rate will always ultimately reflect the level of development and competitiveness of a country or, in the case of a common currency such as the euro, of a group of countries. For that reason, on a short-medium term horizon, significant divergences can be observed compared with the equilibrium of the Balassa-Samuelson reference model based on an international equivalence of production costs in the tradable sector, and which takes account differences in prices and productivity.

These divergences are today linked to the impact of financial market expectations on currencies. Excessive optimism about a country leads to massive inflows of capital, usually volatile, and pushes up the exchange rate, often far beyond its long-term equilibrium level. This is true for emerging countries from Mexico to Thailand, which have suffered the bitter consequences too often in the last 10 years. But the rule is also applicable to developed countries, as can be seen from the American dollar, which until recently was on a path of uninterrupted appreciation against the euro even as the American external deficit took on the dimensions of an abyss in absolute terms ($120 bn for the third quarter of 2000 alone) and relative terms (the deficit is equal to over 40% of US exports!).

Conversely, pessimism on financial markets or simply their fear of uncertainty can cause the exchange rate to plunge to a level way below the long-term equilibrium. Turnarounds in expectations are greatly accelerated by leverage

effects, which have become common on markets since margin finance to players such as hedge funds gained acceptance. Hence the succession of giddy falls through the 1990s, of which the rouble collapse was undoubtedly the most spectacular.

But such preliminary reflections on the role of the financial sphere in a globalised world should not condemn public authorities to powerlessness or passivity. The authorities retain a certain room for manoeuvre in management of exchange rates, which, supported by a strategy of efficient coordination between agents (central banks, treasuries, etc.), can give tangible results, particularly in countries where the regulatory arsenal makes it possible to conduct heterodox policies. For example Chile owes a large part of its post-1982 economic miracle to exemplary management of its real exchange rate, which it was able to keep consistently undervalued, helped by unhesitating recourse to such mechanisms as targeted obstacles to capital inflows.

In Russia's case the first factor favouring a lower increase in the real effective exchange rate than has been seen recently (there has been appreciation of 30% from the low point of January 1999 to the end of 2000) is purely exogenous. Despite the fact that most Russian foreign trade outside the CIS is with the euro zone, the rouble is currently effectively pegged to the dollar, against which it is declining very slowly. In this context the decline of the dollar against the euro, which has been observed recently and will probably continue in the medium term, carries a positive impact for the competitiveness of Russian producers. This process could accelerate if the Central Bank of Russia rebalanced the structure of its foreign reserves in favour of the euro, for example by giving the euro a relative weight equivalent to the EU share in Russia's foreign trade. It is thinkable that the Russian example would be followed by central banks of other emerging countries, which often have significant foreign exchange reserves compared to those at central bank institutions in developed countries.

The need for a real effective exchange rate strategy

However, it is evident that Russia must count on its own resources in the first place and not on unpredictable exogenous elements in managing its exchange rate more efficiently than in the past. The concept of efficiency is worth defining. The main point is not to return too quickly to an excessively high exchange rate, i.e. a rate which once again condemns key parts of the Russian economy such as agriculture or engineering. But it is also important to act with a reasonable degree of predictability in order to reinforce the credibility of the monetary authorities.

The experience of recent years shows that firms, whether national or foreign, are making more and more use of the idea of real effective exchange rates in their investment projections. This is perfectly logical since what is at issue is no more or less than their competitiveness.[12] It is also in Russia's interest to set

[12] In our analysis the real effective exchange rate is always calculated on the basis of consumption prices. This approach seems to us the most legitimate for several reasons. On one hand, in an open world, reference to a wholesale price index does not have much sense because it mainly reflects a basket of internationally tradable goods, which tends to adapt upwards or downwards to world prices depending on variations in nominal exchange rate and the international price of the goods concerned. This is why quasi-stability of wholesale prices is generally observed during a process of stabilisation by nominal peg, while prices for non-tradable goods, which weigh heavily in the consumer price index, may continue to rise at a sustained rate. Reference to unit labour costs in industry is also unsatisfactory. In the first place, they do not usually weigh more than a quarter of total value of goods produced by manufacturing industry (cf. Deutsche Bundesbank, 'Real exchange rates as an indicator of international competitiveness', Monthly Report, May 1994). Also, like wholesale prices, they can be forcible adjusted when firms with the highest costs are eliminated from the economic, and therefore statistical, circle during a phase of loss of competitiveness by the exchange rate. We will therefore adhere to the reference to consumption prices, which should be coupled with a careful analysis of the respective dynamic of each price index. Thus, devaluation is normally followed by a more rapid increase of the wholesale price index, while a stabilisation by nominal peg gives rise to an opposite phenomenon, since any evolution in the real exchange rate is ultimately analysable as a modification of internal terms of trade between producers of tradable goods and producers of non-tradable goods. If this dynamic of relative prices has been less clear in Russia than in Latin American or in Asia, this is undoubtedly largely because the notion of price had less relevance in Russia due to weak monetisation of exchanges and massive presence of barter. If the wholesale price index was corrected by a monetisation index for industrial or agricultural exchanges, one would arrive at the same conclusion as everywhere else, namely

itself a medium-term target for evolution of its real effective exchange rate, which would be a genuine point of anchorage for the monetary authorities. The target of stabilisation at the current real exchange rate is probably too ambitious and somewhat useless, since enterprises will in any case resist upward pressure on the exchange rate as they experience gains in productivity. It would be better to foresee an annual increase of 5%, which is much below the increases of the last two years and roughly comparable to what Chile achieved over the last two decades using a wide interventionist palette.

If the target is to be consistently adhered to, the means for attaining it must remain sufficiently subtle to discourage financial markets from massive short-term arbitrage, based on substantial differences in interest rates combined with absence of exchange rate fluctuations.[13] As shown by recent experience, an appropriate means for this purpose is to position the national currency relative to a basket of currencies. This seriously complicates the speculators' task. By contrast, if the basket closely reflects the structure of the country's foreign trade, such positioning facilitates the task of the monetary authorities, which have set themselves the objective of stability or slow appreciation of the real exchange rate. Speculative arbitrage can also be discouraged by gentle fluctuation of the currency (within a limit of more or less 10%) around the pivotal rate corresponding to the real exchange rate target, which needs not be precisely divulgated.

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that devaluation always favours producers of tradable goods at the cost of other economic agents, which is ultimately a platitude.

[13] Experience of recent crises has emphasised the harmful character of massive short-term capital entries in emerging countries. In most cases, such entries do not engender an increase in the internal investment rate but a fall in the internal savings rate. This explains why there is no proven correlation between external saving and growth. (Cf. Christophe Cordonnier, 'Flux finananciers internationaux et developpement, le cas de l'Amerique latine', in Colloque Caisse des Depots et Consignations, Lisbon, 1994). By contrast inflows of foreign direct investment have a very positive effect, largely because they are accompanied by know-how and technology transfers, and dynamic integration into the exchange of goods. In this regard, their current dominant role in external financing of emerging countries is a very favorable factor for their future development.

Mechanisms for sterilising the external surplus

Of course it is infinitely more easy to state all these considerations than to put them into practice. A central bank faced with a massive influx of foreign currency, either from a current account surplus or in the form of foreign capital inflows, has only two choices. The first choice is to opt for a floating exchange rate and not intervene on the exchange market. Demand for the local currency cannot then be fully satisfied. The equilibrium point is at a higher level of nominal parity, which immediately translates into a rise in the real effective exchange rate. Prices for tradable goods are forced to adjust downwards in the local currency. The second choice, largely followed by the CBR in 2000, is based on significant intervention to stabilise the nominal exchange rate. This has the consequence of local currency emission, an increase in demand, a rise in prices of non-tradable goods (tradable goods have very little scope for variation because they are constrained by external competition in the context of a stable exchange rate), and hence an increase in the real effective exchange rate provoked by higher inflation than in partner countries.

It can be seen, then, that the strategy followed by the CBR in the recent past at best postpones the problem, since the rise in the real effective exchange rate is less immediate in a situation of nominal quasi-stability than in a floating exchange rate system. It is important to complete this strategy without delay through a full arsenal of measures for effectively sterilising the internal monetary consequence of foreign currency purchases.

In 2000 Russia partly succeeded in sterilising growth of CBR monetary aggregates thanks to a substantial public surplus. As shown by the Chilean example after 1982, this is unarguably an excellent approach, since the Keynesian multiplier effect of the external surplus is partly offset by contraction of internal demand engendered by tough budget policy. Nevertheless, it is not possible to go too far in this direction, particularly in Russia where it will

probably be necessary to raise spending in sectors such as health and education, and suffer erosion of revenues due to lowering of tax rates decided in 2000. The best approach would undoubtedly be to target a long-run quasi-equilibrium of the budget along with creation of an extra-budgetary stabilisation fund, inspired, for example, by that recently put in place by Mexico. Excess revenues would be channelled to this fund, particularly excess revenues due to favourable market conditions for the raw materials exported by Russia and subject to export duties.

In this context it would definitely be necessary to absorb excess liquidity by issue of bonds. But such an open-market policy would need to be conducted with great prudence to avoid a new public debt crisis similar to the GKO crisis. In addition, the initial stages of such a policy would run up against the reticence of investors, who are not always inclined to buy the bonds of a country, which defaulted on its internal and external debt less than three years ago, and which is still in difficult negotiations on the question of ex-USSR debt to the Paris Club.

There are a palette of solutions to this first obstacle, allowing simultaneous elimination of the main credit risk and macro-economic risk (violent swings in the rate of inflation and exchange rate) for investors.

Russia could address the first risk by establishing a core of bonds with zero default risk, which would make it possible to rebuild an interbank repo market. This could be done by encouraging international financial institutions operating in Russia (the World Bank, EBRD) to issue rouble securities. For these major banks, which lend to or make investments in projects producing financial flows in roubles and not foreign currency, such instruments would be an effective way of limiting their own or their clients' exchange risk. The know-how of these institutions is currently much more important to Russia than their money, since the country has significant idle liquidity in its commercial banks and a heap of

totally sterile savings in the form of foreign currency, which its citizens keep under the mattress at home or on accounts in foreign banks.

As regards bond issue by the federal government, one possibility would be to create a layer of senior debt. Such bonds could be issued with a fairly long maturity (at least five years) and their conversion at par value could be permitted in the framework of future privatisations.

The remarkable example of Mexico since the 1995 crisis shows that the key to stabilisation of public finances must indeed be sought through a balanced budget, but also, and most of all, through a means of financing, which is relatively immune to market fluctuations and which should therefore be based on a long-term financial resource. In Mexico, where public debt has dropped from 39% of GDP in 1995 to 25% in 1999, traumatic memories of a quasi-default situation in 1995 due to failure to roll over treasury bonds (mainly 28-day Cetes and minimum-one-year Tesobonos indexed to the dollar) persuaded the Ministry of Finance to seek a systematic lengthening of the domestic debt profile. Average maturity of the debt increased from 200 days in 1994 to 550 days in 1999. Three quarters of domestic public debt now consist of bonds with initial maturity of more than a year and with either floating rates (1-, 2-, 3- and 10-year bonds), or indexed to inflation (so-called Udibonos with maturities of 3, 5, 10 and even 30 years).[14]

The Mexican strategy offers numerous advantages. Local investors, primarily the recently launched Afores pension funds, can buy instruments with minimal macro-economic risk (no risk of a negative real interest rate). Financial markets themselves benefit because they have a pool of long and liquid bonds, which can offer multiple variants for progressive market reconstruction, for example for the issuance of long bonds with similar characteristics for the financing of development banks such as Nafinsa or of a new agricultural credit system,

[14] Cf. OECD., Economic surveys, Mexico, July 2000, p.57-58

which Mexico plans to create in the next few years. Finally, these instruments give the state a powerful tool for regulating the economy's internal liquidity without risking its own short-term solvency and without attracting massive, and profoundly destabilising, inflows of hot money.

The near total absence of non-residents on Mexican domestic public debt markets is remarkable to anyone who remembers the dominance of non-residents before the 1995 crisis. Foreign absence is clearly not explained by the economic and political situation in the country, which is very favourable and recently deserved an investment grade from Moody's rating agency. Rather it is explained by a strategy for issue of public debt, which prevents generalisation of simple market arbitrage, both because long-maturity bonds threaten speculators with a much larger capital loss than short maturities, and because arbitrages are mathematically much harder to calculate on bonds that are indexed to inflation and a floating currency.

If Mexico offers a model of what Russia could do, there are other cases, which offer models of what not to do as regards sterilisation of an external surplus. The Czech Republic before the 1997 crisis is an interesting example. The authorities found themselves in a vicious circle after issuing short bonds to soak up an excess of liquidity due to massive speculative inflows to what various speculators saw as the model of a 'velvet' transition. Issue of the paper kept domestic interest rates high and, in a context of stability and predictability of the currency and apparent abundance of external financing (money emission by the Central Bank reflected its foreign currency purchases and hence growing reserves), encouraged acceleration of speculative arbitrage mechanisms. This paradoxical situation, where rising interest rates engender massive capital entries and therefore, ultimately, growth of internal money supply, had already

been thoroughly defined by Brazilian experts at the time of that country's very high inflation as the result of passive monetary management.[15]

Such passive management is also very costly, since the return paid by the authorities on the open market bonds, which have drawn a massive influx of foreign currency, is naturally much larger than the slim interest rates, which the authorities obtain by placement of their foreign exchange reserves.

Selective obstacles to inflows of external capital

Sterilisation of excess internal liquidity by long bonds is not sufficient to stem inflows of speculative capital. Economic agents other than the pubic authorities may attract substantial volumes of volatile external capital. Such agents may be commercial banks or private companies in the non-financial sector. In recent years Mexico has been facing a perilous growth of commitments of its firms to non-residents (their debt grew from $26 bn in 1996 to $56 bn in 1999), which partly explains a current excessive rise in the country's real exchange rate.

Therefore a country like Russia, which wants to give itself the means for controlling evolution of its real exchange rate, will eventually need to install targeted obstacles to foreign capital inflows in addition to careful use of internal debt for sterilisation. Again, policies followed by various Chilean administrations since the crisis of the 1980s are rich in useful lessons. The Chileans have consistently tried to ensure that the capital flows, which come to them, are those they consider essential for their development, such as foreign direct investments or medium-term credits, which their banking system (totally destroyed after 1982) could not supply to local companies. Short-term credits, and speculative purchases of shares or public bonds have been systematically

[15] Cf. Conversation from July 1993 between Christophe Cordonnier and Affonso Celso Pastore, former Governor of the Central Bank of Brazil.

discouraged by a system that requires non-yielding deposits at the Central Bank equal to a part of the invested sums.[16]

Measures to stimulate domestic saving

If Russia followed Latin American examples and successfully used government bond issues to soak up excess domestic liquidity due to its external balance while keeping the exchange rate undervalued, there would naturally be a risk of interest rate increases, which are currently slightly negative for tradable goods producers (short-term nominal interest rates are inferior to wholesale price inflation). There would then be a risk of reappearance of arrears in payments to suppliers, employees and the tax authorities. Such mechanisms played a highly pernicious role before the 1998 crisis, when firms maximised their liquidity levels at the expense of third parties in order to place the money on the financial market. In the least bad case there would be classic phenomena of liquidity diversion away from private investment to government paper ('crowding out').

To limit this risk it is necessary to work on raising domestic rates of saving in addition to implementation of the sterilisation mechanisms set out above. This should be done using a variety of levers.

The first such lever is based on an evident point about public finances. A proper equilibrium of public finances based on long-term elements[17] has a doubly positive effect on encouragement of domestic saving. On the one hand, because the state itself acquires a significant saving capacity. And, on the other

[16] Cf. M.Agosin, R.Ffrench-Davis, 'Managing capital flows in Chile,' in S.Griffith-Jones ed., Short-term capital flows and economic crises, Oxford, 1999.

[17] In the equilibrium of public finances, it is important to avoid a reductive vision, which seeks to short-term maximisation of the budget surplus at any price. Thus pressure on investment spending in the public sector or on education or health are usually a false economy. Similarly, in order for a public sector to be efficient, it is essential that its functionaries should be decently paid, since this makes it possible to combat corrupt practices more easily.

hand, because credibility of public institutions is an essential factor for the confidence of citizens in their economic system and therefore for their propensity to choose deferred rather than immediate consumption. It should be added that a strong state is generally a good way of avoiding capital flight, which is mostly engendered by macro-economic and institutional instability.

In the case of Russia recent evolution shows that equilibrium of public finances and the obtaining of significant surpluses are not an unrealistic objective. Nevertheless the authorities' room for manoeuvre in the short term is not large. Overall fiscal pressure is heavy by the yardstick of the country's level of development and the coercive power of its administration (the federal state, subjects of the federation and extra-budgetary organisations demand around 40% of GDP in tax). It is also difficult to envisage an increase in the tax rate since the government of Mikhail Kasyanov has opted for reduction and simplification of tax rates in order to combat tax evasion more effectively. Spending is also severely constrained. In addition to the burden of internal and (more importantly) external debt, the Russian state suffers from a bloated bureaucracy, which it will only be able to reduce by setting up a genuine administrative elite, which involves raising the salaries of civil servants.

There is one last domain of illusion concerning Russian public finances. This is the perception of foreign analysts, who refuse to admit the necessity of a reduction in external debt to the Paris Club, arguing that it is possible to increase taxes on rent-based raw material producers, who are already subject to export taxes. It is certainly true that such producers have been the main beneficiaries of rouble devaluation, while the main loser has been the federal government, which has most of its debts in foreign currency and its receipts in roubles. It is also true that the raw materials companies have enjoyed high profit levels in recent years. But these profits have to be set beside redundant capita stock, largely written off from an accounting viewpoint. If they were

measured by the cost of replacing production infrastructure, profit levels would appear much lower and in some cases might be negative. Russia certainly has a rent, but it is probably undergoing slow contraction. This makes the rent all the more dangerous for the whole economic system because it is provoking the macro-economic distortions of Dutch disease in the present without any guarantee that it will continue to operate smoothly in the future.

The second lever for raising the savings level is quite simply related to the real effective exchange. As we have seen, internal financing capacities of firms in the competitive sector, which play a major role in nurturing domestic saving, are inversely correlated with the real exchange rate level. As has been seen in countries like Chile and Mexico, where savings rates nearly doubled after severe devaluations, the best way to boost the Russian savings rate is to stick with a weak exchange rate policy.

The third lever for strengthening national saving has less impact on the ratio of savings to GDP, and more impact on efficient structuring of the financial market in a situation where classical financial intermediaries (banks, insurance companies, etc.) have either disappeared or do not yet exist. This can be achieved via pension funds such as those set up in Chile after the 1982 crisis and subsequently copied in numerous Latin American countries (Peru, Uruguay, Argentina, and more recently Mexico). Under these systems, employees are forced to save part of their salaries (usually about 10%) by a forfeit scheme, while the cost of this saving effort is divided between the employees, their companies and to a lesser extent, the state.

The employees can entrust these sums to an approved management entity of their choice. The entity is usually private. The fund manager is subject to major regulatory and content limitations regarding his asset portfolio, and very strict control is imposed by a public regulatory body. The system is thus not really private or, more accurately, it orders the functions of the private managers very

strictly. The complementarity between the public sphere and private operators has a positive role in reinforcing the confidence of contributors in the future of their savings.

Recourse to such saving mechanisms could be useful for Russian in the very short term to allow absorption of a large part of the long indexed bonds used for sterilisation of the external surplus. In Mexico pension funds, which were set up very recently (1997), owns the major share of such stocks.

Arbitrage between domestic and external debt

In order to fully complete the reasoning on the strategy for managing exchange rates in a situation of real under-valuation, it is important to analyse what would be the best use for the funds raised by the state in the process of sterilisation by issue of public debt. It is clear that depositing these funds at the Central Bank or, if the bonds are issued by the Central Bank, leaving what is *in fine* the counterpart of these bonds at the Bank in the form of low-yield foreign exchange reserves, is not an optimal approach. As shown by Latin American examples in the recent past, the right strategy is for the authorities to carry out arbitrage between internal debt and external debt by buying the latter on the markets. Mexico bought more than $8bn of its Brady bonds in 2000. For Russia, the very large discount of its external debt makes such an arbitrage particularly justified.

Nevertheless, this poses two problems. The first is that it is difficult for a state to continue failing to meet all its financial obligations to the international financial community (in Russia's case to the Paris Club) at the same time as it is buying its own debt on the market. The only example of such practice on a large scale, to our knowledge, is that of Peru, which bought a large part of its debt to commercial banks via a Swiss bank before completion of its Brady plan. On the other hand, purchase of a country's debt on the secondary market can

engender corruption due to the difficulty of establishing transparent rules in the absence of auctions, which would tend to fuel prices.

For these two reasons the right strategy for Russia as regards arbitrage on its debt is probably to work through negotiations with its creditors. Regarding private creditors, it would be appropriate to draw a final line under restructuring of GKOs, funds from which are blocked on accounts with pointlessly complex rules of operation, by offering holders a way out in the form of cession with discount of the bonds issued by restructuring or conversion into long-term indexed bonds. Relations with the Paris Club, of which Russia is in fact a creditor member on the basis of inherited Soviet sovereign credits to third parties, badly need to be developed in a less fraught context, since the current dialogue by diktat is not in the interests of either side.

Vladimir Putin's Russia, which has largely been restored to favour in the chancelleries of the G7 countries, should be able to make a better case with public opinion in those countries by using a certain number of precise and powerful arguments. First, Russia needs to show that it is finally engaged in a process of political dialogue on the thorny question of Chechnya. This seems to be a necessary precondition for obtaining any debt remission. Further, the West should be reminded that, contrary to the received opinion about Russia as a black hole swallowing Western aid, the country has in fact received hardly any financial aid since the beginning of transition, the sum of assistance having been ridiculously low compared with the major historical juncture, which Russia's current evolution represents.[18] Finally, citizens of creditor countries, notably the Europeans, should be made aware of the necessity of being more generous towards the Russians by reference to the wretched pension benefits,

[18] On the question of international adi to Russia, see the founding article of the Kondratieff Circle ('La Russie peut aider l'Europe), published in Liberation, February 25, 1999. Arguments in that article are returned to by Anders Aslund in the Moscow Times, February 5, 2001 under the title 'We did too little'.

which most of them are currently receiving ($30 per month!), since nationalist radicalisation is partly the fruit of unbearable poverty.

But even supported by a public opinion campaign aimed at the G7 countries, it is probable that Russia will have difficulty persuading its creditors of the necessity for rescheduling, let alone debt forgiveness, in view of the size of its current surplus. The country should therefore move quickly to envisage an alternative scheme based on conversion of credits into investments, which would be the best way to simultaneously reduce the debt sum, stimulate an investment recovery and employ funds raised by the Treasury or the Central Bank from issue of rouble bonds.

The last suggestion would be realised by a debt conversion mechanism, under which the Russian state would commit to pay rouble cash against purchase of debt to international public or private creditors at debt auctions. The roubles would not be emitted by the Central Bank, which would further reinforce pressure on internal monetary aggregates, but would be raised on the market via bond issues. This would be the mechanism of internal-external debt arbitrage mentioned above, with genuine transparency and a very positive effect not only for reduction of external debt, but also for a sustainable relaunch of Russian industrial production.[19]

Conclusion:

The situation of under-valuation of the real exchange rate, inherited from the rouble crisis of 1998, has so far been more of an involuntary than an intentional experience for the Russian authorities. Nevertheless, the authorities have clearly understood the usefulness of the situation for restoration of company

[19] Cf, on the question of debt conversion, 'Debt Conversion: the Latin American experience', Kondratieff Circle.

profitability, and hence not only for improvement of the country's macro-economic variables, but also for micro-economic elements such as payment behaviour. The challenge today is to keep for a long as possible a highly competitive exchange rate, which firms need in order to continue boosting their investments in the consistent absence of a financial intermediation system. To achieve that, Russia could beneficially take inspiration from the example of other countries, particularly in Latin America, which have been able to maintain an under-valued exchange rate for many years without stimulating excessive inflation. The key to such a strategy is clearly in efficient coordination between interventions by the Central Bank and the Finance Ministry. It depends on carefully ordered implementation of a palette of technical instruments for soaking up excess liquidity from the external balance without creation of too much tension on interest rates and without attracting speculative foreign capital. Arbitrage between internal and external debt is what *in fine* can reinforce the dynamics and reduce the cost of such a strategy.

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