

# Exchange Rate Policy After the Currency Crisis: Walking the Tightrope

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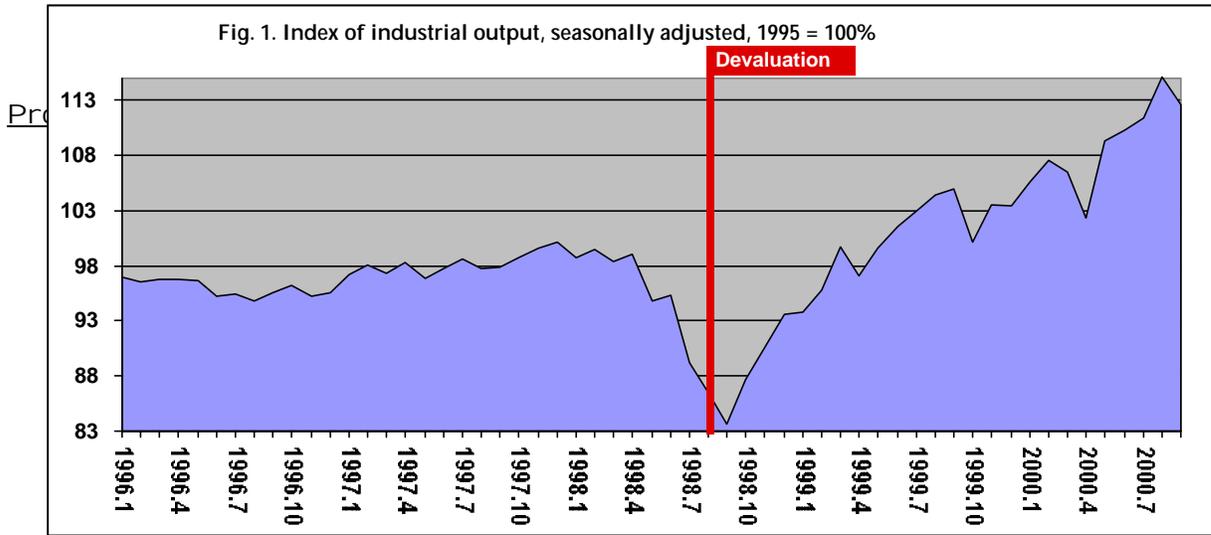
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## **After the 1998 Currency Crisis: From Recession to Growth**

Although the August 1998 currency crisis came as a surprise to at least some observers, the rapid recovery of the Russian economy after the crisis was even more unexpected. Unlike the experience of East Asian countries, Russia's economy enjoyed a boom after the currency crisis, not a recession. Output started to grow immediately after the crisis in October 1998, and continues to increase at a high rate for over two years now. In fact, gross domestic product (GDP) grew by 3.2% in 1999 and is expected to increase by an impressive 6 to 7% in 2000, whereas industrial output expanded by 8% in 1999 and will probably grow even faster in 2000 (fig. 1). This is the first period of solid economic growth after nearly a decade-long recession and stagnation (1989-98), and the period of fastest industrial growth since the 1950s.

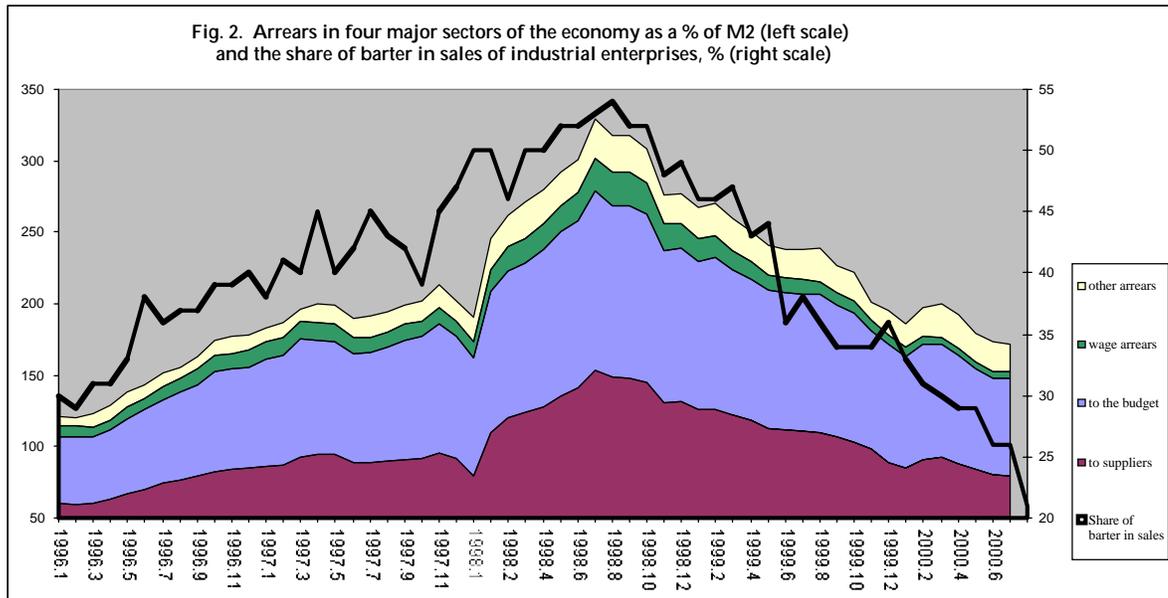
No less impressive is the fact that the non-monetary economy in Russia has steadily declined after the 1998 crisis. During the period of macroeconomic stabilization (1995-98), the Russian economy was overburdened by growing nonpayments, increasing barter transactions, and the proliferation of monetary substitutes (offsets and *wechsels*). After the crisis these unfavorable phenomena have subsided for the third consecutive year. Arrears of industrial enterprises as a percent of output fell from a peak of over 64% in August 1998 to below 30% by mid-2000; the share of barter transactions declined from 52% to 26% over the same period (fig. 2); and the ratio of broad money (M2 monetary aggregate) to GDP rose from 15% to nearly 20%.

Why did all these improvements *not* happen in 1995-98, during the seemingly successful macroeconomic stabilization, when the government was trying so hard to achieve growth and to fight barter and nonpayments? And why did they happen after the crisis almost by themselves, spontaneously, without any special policy actions?



### Basic Arguments

At the end of the day, the Russian crisis was a most trivial, straightforward, plain vanilla balance-of-payments crash. It resulted from the inconsistency of macroeconomic policy objectives, and it has occurred in many countries. It was caused by the attempts to sustain the unsustainable and overvalued exchange rate of the ruble. The crisis was complicated, but not generated, by the budget deficits and mounting government debts. It would have occurred even without Asian viruses, Russian fiscal imbalances, and oligarchs' prodigality. The root of the crisis was the overappreciation of the exchange rate: from early 1992 to late 1995 the real exchange rate of the ruble grew over 7 times (more than 600%: see fig. 3)--more than in other transition economies and more than enough to kill the growth of exports, to cause an unaffordable rise in imports, and to undermine the current account surplus, leading to the depletion of foreign exchange reserves.



The dramatic improvements in the performance of the Russian economy initially occurred not because of the right policy, but despite the lack of it. The exchange rate was overvalued and unsustainable, and attempts to maintain the rate were killing growth--and actually provoked a mini-recession in 1998 (fig. 1). So the economic recovery started only when the market corrected the mistakes of the government, i.e., after the devaluation.

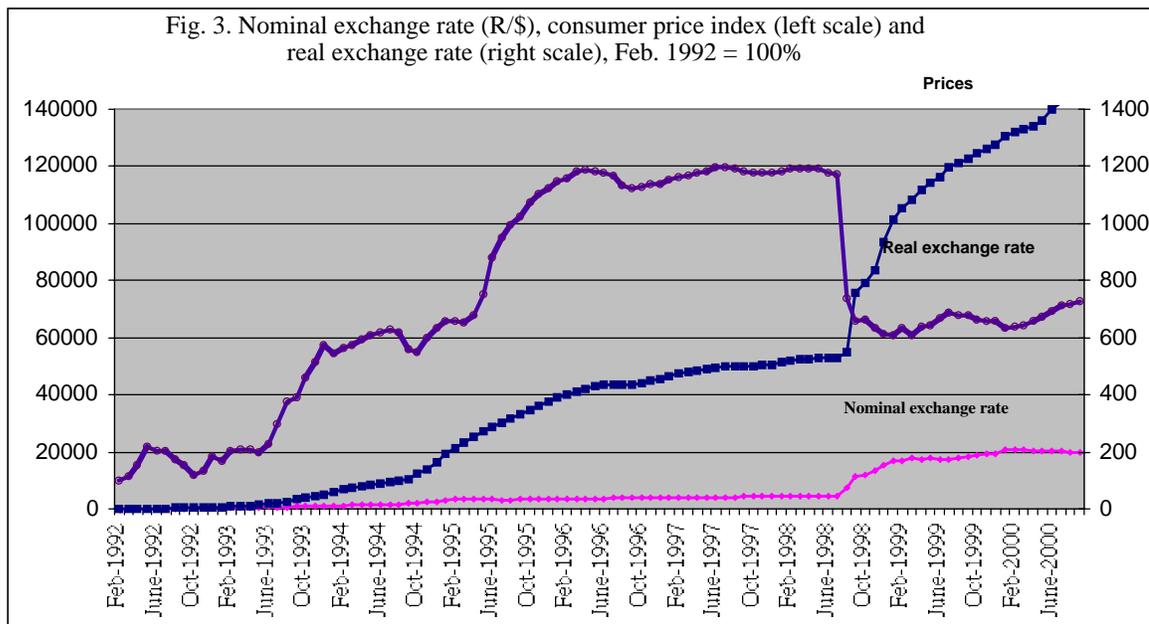
After the crisis, however, the macroeconomic policy of the government and the Central Bank of Russia (CBR)--whether by chance or by design--was quite prudent and succeeded in creating favorable conditions for recovery. Even though the economic boom of 1998-2000 did not start because of the government, Moscow should be credited for not undermining this growth, as it had done in 1998.

Such prudent macroeconomic policy is quite an achievement, since the room for maneuver is very limited. A lower exchange rate leads to the buildup of inflationary pressure; a higher exchange rate threatens to undermine exports and growth, and can lead to another rise of nonpayments and barter.

### Origins of the 1998 Currency Crisis

Unlike the currency crises in East Asia and the preceding currency crises in Latin America, recent currency crises in Russia and in other transition economies were caused not by excessive debt (private or government) accumulation, but by the mere appreciation of the exchange rate, undermining the competitiveness of the export sector, leading to the deterioration of the current account, and finally causing the outflow of capital in anticipation of devaluation. Theories that were offered to explain the trend towards the real exchange rate appreciation in transition economies proved to be of limited

applicability. In the end--in transition economies as well as in other countries--the appreciation of the real exchange rate cannot be infinite, and if it goes too far, leads to a crisis.



Currency crises in post-Communist countries can be best explained by “the first generation” currency crisis models, i.e., by straightforward macroeconomic mismanagement through overvaluation of the exchange rates before the crises. In Russia the crisis was aggravated by the decision to default on short-term and later long-term debt, which was by no means necessary. In other words, the debt crisis was manufactured by the government. On the contrary, in Southeast Asia currencies were not overvalued, macroeconomic policy was prudent and fundamentals were sound; the collapse of currencies was a side effect of the private sector debt crisis--overextension of credit by banks and companies financed by foreign borrowing.

Different patterns of the decline of output in Russia (before the currency crisis) and in East Asia (after the currency crisis) provide additional evidence of the different nature of the currency crashes. While in East Asia (where exchange rates were not overvalued) the devaluation led to an adverse supply shock coupled with the depressing effects of the collapse of previously overextended credit, in Russia devaluation of overvalued currency restored the previously lost competitiveness and led to an increase in capacity utilization rates.

In addition, the policy of keeping the exchange rate low through the accumulation of reserves seems to be not only prudent, but also conducive to economic growth. For transition economies facing the challenge of export-oriented restructuring, it is highly

desirable. The inflationary consequences of such a policy, as the example of East Asian countries shows, may be dealt with through sterilization operations.

### **The Art of Fighting Inflation Is to Know When to Stop**

Bringing inflation down to single digits in transition and other emerging market economies with many market imperfections and structural rigidities is by itself a questionable policy. It is true that in countries with a highly inflationary environment, it is quite likely that output growth will be weak or nonexistent. It has been shown, however, that inflation of 40% a year is a sort of threshold. While there is clear evidence that inflation of over 40% a year is bad for growth, the evidence on how inflation affects growth when it runs at 20 to 40% a year is inconclusive (with little evidence that it is harmful for growth). Finally, there is some evidence that pushing inflation below 20% a year may actually deter growth. One can also argue that the threshold for transition economies is actually higher than for other emerging markets because of the numerous structural rigidities. In most successful economic performers, inflation was by no means insignificant: it never fell below 20% a year in the first 5 years of transition in Poland, Hungary, and Uzbekistan--while in China, though it was low most of the time, there were outbursts of inflation in 1988-89 and in 1993-95, during which it increased to about 20%.

It seems that Russian authorities in this respect went from one extreme (very high inflation of 1992-94) to the other, trying to be "more Catholic than the Pope." Since its enactment in 1995, the exchange rate based stabilization program was pursued with greater diligence than elsewhere: right before the crisis, in July 1998, year-to-year inflation was brought to 6% (fig. 4)--the lowest level ever, and less than in most transition economies. Arguably this low level of inflation did impose unnecessary strains on the economy, causing the avalanche of nonpayments and leading to a reduction of output induced by lack of demand. In fact, after modest growth in 1997, output started to decline in the first half of 1998.

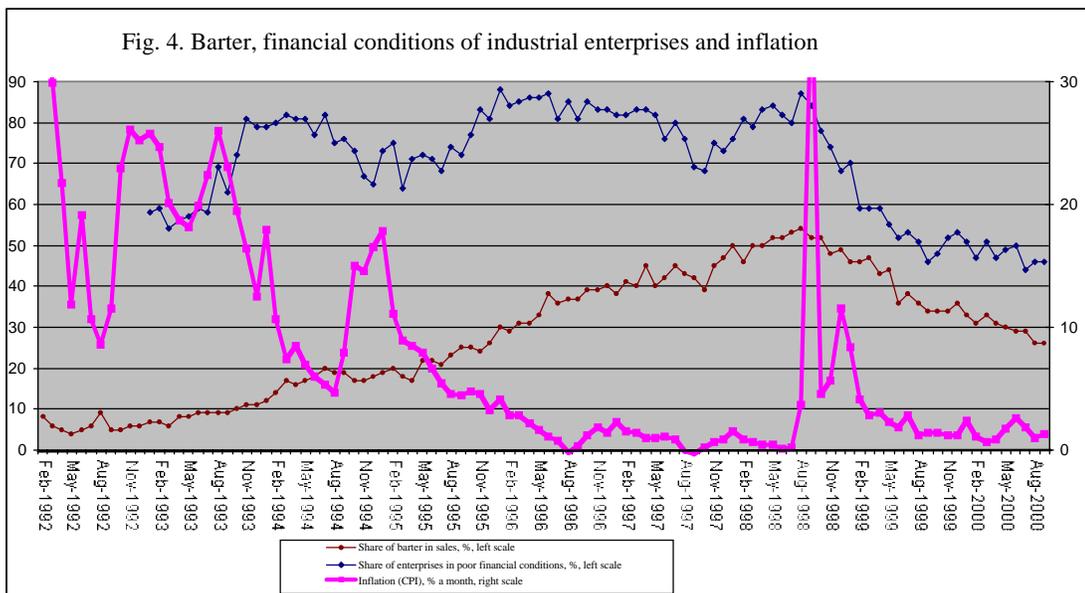
### **Inflation, Currency Crisis, Nonpayments and Recession: Policy on a Tightrope**

As figure 4 shows, the share of enterprises in poor financial conditions, as well as the share of barter, is largely an inverted image of inflation. When inflation falls briskly or is running below 1% a month, nonpayments and barter are usually on the rise. The relationship between barter/nonpayments and real interest rates (not shown here) is even stronger: when the real interest rate is rising rapidly or is above 0.3% a month, Russian enterprises respond by accumulating arrears and switching to non-monetary transactions.

This is not to say that tight monetary policy necessarily results in demonetization; in other countries monetary restrictions can cause the reduction of investment and output, but do not lead to the universal barterization and demonetization of the economy. However, in a Russian-type weak institutional and structural environment the economy develops a predisposition to nonpayments and barter, and such a predisposition becomes reality under tight monetary policy. In effect, it appears that without the devaluation and easing of monetary policy in August 1998, the Russian economy was heading towards a completely "moneyless" equilibrium (fig. 3 and 4), but the purity of the experiment was interrupted by the crisis. The monetized economy in Russia should thus be considered as

a case of unstable equilibrium--under very low inflation, money transactions are steadily replaced by barter, nonpayments, and money surrogates.

The Central Bank of Russia's goal of a stable nominal exchange rate (the budget projections for 2001 are based on a rate of 30 R/\$ as compared to 28R/\$ in October) is a recipe for new growth of nonpayments and arrears and perhaps even for the reduction of output, like that manufactured in 1998 (fig. 1). Stable nominal exchange rate policy can also result in another balance of payments crisis, no matter how improbable such a prospect looks today. Oil prices may fall as unexpectedly as they started to rise in 1999, whereas foreign exchange reserves, even after doubling in 1999-2000, are still lower than in Malaysia and will not be enough to weather the currency attack for as short a period as several weeks. The trend for the appreciation of the *real* exchange rate in 2000 (fig. 3) and the decrease in inflation (from the expected 18% in 2000 to the projected 12% in 2001) should be viewed as dangerous for both the balance of payments equilibrium and the favorable trend of the decline in barter and nonpayments experienced in the last two years. On the other hand, a rapid devaluation of the *real* exchange rate can lead to an inflationary spiral.



Given these constraints, it appears that macroeconomic policy in general and exchange rate policy in particular should follow a trial and error approach. The government and the CBR should constantly try to bring down inflation without allowing the appreciation of the *real* exchange rate of the ruble. In other words, their policy should be aimed at testing the limits of what is possible: how much inflation can be suppressed without causing the rise of nonpayments and a slowdown of growth. As soon as the signs of a new rise in barter and arrears appear, tight monetary policy should be reversed. In such circumstances the appropriate response would be gradual depreciation to improve the

competitiveness of domestic producers while allowing the money supply to expand (even at a cost of slightly higher inflation).

**Policy Recommendations**

This analysis lends itself to two recommendations for future macroeconomic policy: Do not bring inflation down too low (such that nonpayments and barter start to increase) and do not raise the exchange rate too much (such that the trade balance starts to deteriorate).

If nonpayments start to increase, it is better to devalue (rather than just ease monetary policy) in order to kill two birds with one stone--to improve competitiveness and the trade balance, and to allow the money supply to expand by not carrying out complete sterilization.

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