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Rainer Lenz*

Convertibility of the Rouble – Monetary Integration of the Russian Federation

Russia has so far failed to achieve its goal of monetary integration into the international capital markets. Due to the deep financial and currency crisis which began in 1998, the current situation is a far more difficult one than in 1991, at the start of the transformation process. The following article examines the reasons why this situation arose and formulates alternatives to the reform approaches to date.

Russia should have experienced an upswing in 1998. After years of economic decline, it was able to post real economic growth in 1997 for the first time since the Soviet Union broke up. With an inflation rate of just 11% at the end of the 1997, the stability policy showed presentable successes. Assuming that Russia has now finally overcome the economic problems involved with transforming the system, portfolio investments in Russian shares and bonds have become a profitable speculative object for western investment funds and banks. As the Russian capital markets have only been able to absorb the inflow of foreign capital with difficulty, rouble assets are showing extraordinarily high price increases.

Despite all the positive signs, 1998 was a year of crisis for Russia. International investors downgraded Russia's credit rating as the reassessment of credit risks on international capital markets in the wake of the Asian crisis revealed the blatant deficits in Russian government financing and with regard to stabilisation. Foreign portfolio investments were repatriated just as erratically as foreign capital had flown into Russia previously. Russia was thrown into a deep currency and financial crisis by this extreme switch from major capital inflows to major capital outflows within the space of a year.

The fact that the Russian Federation is not an individual case with respect to the catastrophic effects of introducing capital account convertibility too early can be seen from the past experience of Latin American countries in the mid-1980s and

beginning of the 1990s ('Mexico Crisis') and most recently that of the Asian 'Tiger' states. In essence, the characteristic problem for developing countries in opening up foreign trade and payments is invariably the ambivalence of two convertibility targets, namely the fixing of the exchange rate as an instrument for stabilising the internal value and the greater transfer of resources from abroad in order to reconstruct the capital stock. The success of opening the capital account therefore depends on the efficiency of the domestic financial sector, otherwise the high volatility of portfolio investments could become a high risk to the country's macroeconomic stability.

The aim of this article is to investigate the problems associated with monetary integration into the international capital markets in more detail taking the example of the reform process in Russia. First, the term convertibility and the two central goals of introducing convertibility will be explained and presented with respect to their specific requirements. Then the goals of convertibility for the reform process in Russia will be evaluated. The contribution of the convertibility of the rouble to stabilisation and the transfer of foreign capital resources to Russia is discussed and evaluated. The deduction of the economic consequences of the Russian Federation's reform process forms the conclusion from the theoretical objectives and the failure of Russian monetary integration documented in the empirical part. Taking into account the current currency and financial crisis in Russia, alternatives to the reform approaches to date are formulated. The recommended reform measures are brought together in a model of the sequence of the reform process so that the time dimension of the future monetary integration of Russia into the international capital markets becomes clear.

* DG Bank, Frankfurt am Main, Germany. The following article is based on the author's dissertation which will be published shortly by Transfer-Verlag, Regensburg, under the title "Konvertibilität des Rubels – Monetäre Integration der Russischen Föderation".

Convertibility: Definition and Impact

The term convertibility simply means the possibility of exchanging the domestic currency for foreign currency. According to definition, there is full convertibility if each economic subject (domestic and foreign currency holder) can freely exchange funds in this currency for every other currency regardless of whether for pure capital transactions, for settling foreign trade transactions or for travel purposes.¹ But the macroeconomic implications of currency exchange are far more complex. The extent of the convertibility rights determines the monetary and economic integration of a state into the international goods and capital markets. There are a number of possible variations between the two extremes, the inconvertibility of the currency, which corresponds to a state's efforts at full monetary autonomy, and the irrevocable fixing of the exchange rate for national currencies, which corresponds to the efforts of a state or group of states at complete integration. The selection of the extent of monetary integration is the result of the respective state's consideration of costs and benefits.

The advantages of the monetary integration of a strong economy with major economic efficiency and monetary stability will be different from those of a weak, unstable national economy. An economy which is not very efficient and characterised by high inflation rates and a decline in overall production essentially has two basic goals in mind if it is pursuing greater monetary integration: firstly, the import of monetary stability through the fixing of the exchange rate and secondly, the inflow of foreign resources for rebuilding the domestic capital stock.

Stabilisation via a Currency Anchor

The focus of the currency anchor is to stabilise domestic inflation and the internal value of the currency, with respect to its stable external value.² The exchange rate becomes an instrument of stabilisation policy. The central bank does not pursue an independent monetary policy for controlling the internal value. Rather, this is determined passively by

exchange-rate stability and the balance of payments situation. The clearly defined, transparent aim of exchange-rate stability replaces the domestic objectives of monetary policy which are difficult to assess in the transformation process. With the linking of the exchange rate, stability policy is imported from abroad. The argument for a currency anchor is hence based on two factors: firstly, the domestic currency being firmly linked to a stable foreign currency unit should force the central bank to pursue a stability-oriented domestic monetary policy. Secondly, the government's public announcement of sustaining a fixed exchange-rate parity over a certain period should increase the credibility of the reform process. The exchange-rate target should serve to bind the government to a stability-oriented monetary and fiscal policy which replaces the central bank's lacking reputation and has a positive influence on the inflationary expectations of economic individuals.³

International Capital Allocation

In the case of the eastern European states, which after decades of planned economy are faced with the task of system transformation, the capital requirements for the renewal of the existing capital stock are extraordinarily high. System transformation implies the revaluation of the capital stock on the basis of the change in relative prices, the reorientation of demand structures and technological competition with western standards. The consequence of this 'new accounting' is the extraordinarily rapid depreciation of further parts of the capital goods inherited from the planned economy. The European Bank for Reconstruction and Development describes this depreciation process as the result of various exogenous shocks, 'The inherited capital stock was exposed to several "shocks": shifts in relative prices and allocations, a radically different structure of demand, changes in the environmental and other regulations, and exposure to superior technologies. None of these shocks is "exclusive" to the transition. However, their suddenness, magnitude and pervasiveness during the transition are unusual.'⁴

Convertibility has an important function because it creates the basis for mobilising and allocating foreign capital. The right of economic subjects to the free exchange of currency brings about a direct link not

¹ Cf. F. A. Lutz: Das Problem der Konvertibilität europäischer Währungen, in: ORDO – Jahrbuch für die Ordnung von Wirtschaft und Gesellschaft, 1954, Vol. 6, p. 79.

² Lipton and Sachs write in their reform model for Poland: 'The best chance for stability is to recognize that the nominal exchange rate is the fundamental "anchor" to the price level in an open economy the size of Poland. The prices should therefore adjust to the exchange rate, rather than vice versa.' D. Lipton, J. Sachs: Creating a Market Economy in Eastern Europe: The Case of Poland, in: Brookings Papers on Economic Activity, 1990, No. 1, p. 127.

³ Cf. W. M. Corden: Exchange Rate Policy in Developing Countries, in: J. d. Melo, A. Sapir (eds.): Trade Theory and Economic Reform: North, South, and East, Essays in Honor of Bela Balassa, Cambridge 1991, p. 224 f.

⁴ Ibid.

only between the commodities markets, but also between the domestic and foreign capital markets. Free international capital movements according to individual economic calculations lead – in the same way as the arbitrage process in respect of the liberalisation of the transportation of goods – to the balancing out of the national differences in the marginal productivity of capital, the time preference of consumption and the liquidity preference. From the point of view of the optimal allocation of scarce resources, a shift in savings from markets with less of a capital shortage to places with a greater shortage is to be expected from the liberalisation of capital movements.⁵

The inflow of foreign capital protects the expansion of investment volume beyond the limits of domestic savings. External savings supplement in this respect internal savings and improve the overall efficiency of the economy using the capital for investments. The net inflow of resources is reflected in the capital account balance as a surplus while the non-monetary corollary, the current account balance, shows a deficit. This relationship between the financial gap in the domestic economy and the balance of payments can be deduced formally from national accounting.

A current account deficit for a developing economy is acceptable as long as the capital inflows are used for investment purposes. If the foreign loans are used to finance consumption expenditure, no additional profit is generated in the following periods to guarantee the interest and redemption payments which arise. The use of the capital imports for investment is different: the domestic investments financed by foreign loans generate a return on investment in the following periods which – via current account surpluses – guarantees the interest and redemption payments abroad. This gives rise to additional profit as the domestic return on investment is higher than the foreign loan interest. Foreign trade and international capital movements allow the shifting of consumption and investments according to the time preferences of the economic subjects to differing periods so that intertemporal clearing of the balance of payments account is possible. According to Siebert, 'a current account deficit which is accompanied by capital imports is a normal phenomenon. It marks the first stage of the development in which eastern European countries incur debts in order to build up their capital stock. In a second stage, the

debt is paid off.'⁶ To this effect, it is decisive for the assessment of a current account deficit whether a national economy will be in the position in future to make the expected debt service payments for the foreign loans.

Complementary or Contrary Goals?

Until now the two goals of monetary integration, stabilisation and the transfer of resources, have been examined independently of each other. The interdependency of the goals will be analysed below. Under the premise that both goals of monetary integration, stabilisation and the transfer of resources, are pursued at the same time, there is a natural conflict of aims which manifests itself in the following problem areas:

□ *Expansion of the money supply and sterilisation of capital inflows.*

In the foreign exchange market, the inflows of foreign capital oblige the national central bank – given a fixed exchange-rate – to buy. A rise in currency reserves leads, *ceteris paribus*, to the expansion of the money supply which brings about an inflationary effect on the prices of untraded goods.⁷

This impact of capital inflows on the development of prices in the commodities market bears a diametric relation to the goal of stability: stabilisation via a nominal currency anchor is based on the contraction of the money supply as soon as the inflation differences compared to abroad lead to a current account deficit. In the stabilisation concept, the convertibility rights are limited to current account transactions. Foreign capital flows – with the fixing of the exchange-rate – would have an expansionary effect on the money supply counteracting monetary stabilisation. On the other hand, in the intertemporal approach of the transfer of resources, the convertibility rights are extended by capital movement transactions. While there is real devaluation at the end of the stabilisation process – triggered by a decline in prices for domestic goods – capital imports result in the direct or indirect appreciation of the real exchange rate. With a fixed exchange rate, capital inflows lead to a rise in currency reserves so that – *ceteris paribus* – the monetary base and the money supply are expanded.

⁵ C. P. Kindleberger: The Pros and Cons of an International Capital Market, in: Zeitschrift für die Gesamte Staatswissenschaft, 1967, Vol. 123, p. 603.

⁶ H. Siebert: Die Integration Osteuropas in die Weltwirtschaft, in: E. Kantzenbach (ed.): Die wirtschaftliche Neuordnung Europas – Erfahrungen und Perspektiven, Schriften des Vereins für Socialpolitik, No. 218, Berlin 1991, p. 66.

⁷ Assuming a 'small economy', there is no direct influence on the development of world market prices or prices of tradable goods.

Basically, high capital flows, in particular sharp increases in inflows from portfolio investments, are difficult to reconcile with the stabilisation concept of a nominal currency anchor. Discretionary measures on the part of the central bank to sterilise the effects of capital inflows on money supply can only develop their effectiveness in the short term. In the intermediate term, the capital inflows exceed the central bank's sterilisation capacities.

□ *The risk of a speculative attack on the exchange rate.*

In addition to the effect of money supply expansion from capital inflows, there is a risk on the foreign exchange markets of a speculative attack by foreign institutional investors on the fixing of the exchange rate. In this case, the investors speculate by means of short selling on the devaluation of the currency. With a fixed exchange rate, the central bank is obliged to finance the growing currency demand caused by outflows of capital via the sale of currency reserves. Lasting currency demand which exceeds the central bank's currency reserves compels, in the end, the discontinuation of the exchange-rate peg. If the currency is devalued, the speculators make a profit from the difference between the sale price at point t_0 and the purchase price at point t_1 (where $t_1 > t_0$). The loss from the currency transactions is borne by the central bank. The setting up of a short position is – disregarding the interest effects – almost risk-free as the appreciation of the currency instead of its devaluation is extremely unlikely in the situation described. With this asymmetrical distribution of the market risks, there is a permanent incentive for currency speculation over the central bank's limited currency reserves and the currency anchor.

□ *Volatility of price movements on domestic capital markets.*

The extensive inflow of portfolio investments generates above-average price increases in domestic securities in the domestic money and capital markets. With a lack of market capitalisation, short-term inflows of foreign capital result in securities prices overshooting, without fundamental reason being able to justify such price increases. The formation of speculative bubbles in the domestic capital markets often marks the introduction of convertibility for capital transactions.⁸ In the event of such speculative bubbles, an abrupt outflow of foreign portfolio investments can lead to an extreme price drop in the domestic securities markets which amounts to an asset deflation. Looking at it purely from the accounting mechanism of national accounting, the

nominal depreciation of the assets is not offset by a depreciation of liabilities. As a result, the profits side of the claims is reduced while the interest and repayment obligations from liabilities remain unchanged.

The domestic commercial banks are directly affected by asset deflation in the event of an abrupt decline in prices on the securities markets as they carry out both lending and deposit business in their function as intermediaries. Many factors are absent as a rule for hedging against price risk: firstly, there are no significant futures and options markets, or they are only very rudimentary, for hedging price risks. Secondly, there is a lack of suitable information technology for recording the price risks as well as of experience and know-how on the part of the banking staff. Furthermore, there are still loopholes in the statutory framework in respect of risk control in the domestic banking sector. Without the possibility of, and the (statutory) necessity for, price hedging, short-term fluctuations on the capital markets will be fully reflected in the business success of the activities of domestic banks. Hence, the major volatility of the price movements has a destabilising effect on the domestic financial sector.

□ *Short-term nature of liabilities and claims.*

At the beginning of the reforms, the differentiation between the money and capital markets is scarcely of relevance in terms of economic policy as market activities are concentrated in the money market segment. With a view to the lack of stability of prices and the general uncertainty over the success of the reform process, market participants give preference to liabilities and claims with a maturity of up to one year. With bank lending, fixed interest periods of more than one year are rarely agreed. In the same way, the government issues primarily bonds in the one-year maturity segment according to demand. This concentration of the lending business and the bond market on money market transactions results in direct and immediate transmission of monetary impetus to the real economy. Changes in refinancing rates have direct effects on the level of loan interest and on the market interest rate for government bonds. Interest-rate policy measures by the central bank are quickly reflected in interest rate movements in the same

⁸ Calvo et al. establish this effect of overshooting domestic capital markets in their investigation of the capital flows of Latin American countries at the end of the 1980s; cf. G. A. Calvo et al., *Capital Inflows and Real Exchange Appreciation in Latin America, The Role of External Factors*, in: IMF Staff Papers, 1999, Vol. 40, No. 1, pp. 108-151, here pp. 118ff.

direction in other segments of the money market on account of its 'interest rate leadership'.

It is to be generally established that the short fixed-interest period as well as the short maturity of the bonds subject the debtor to an extremely high risk of market changes and guarantee only little planning certainty when calculating financing costs. Given this tight interlocking of monetary policy, lending business and bond market, the inflow of volatile portfolio capital can have a heavily destabilising effect on the real economy, on fiscal policy and also on monetary policy.

Foreign Exchange and Exchange-rate Policy

After the disintegration of the Soviet Union at the end of 1991, the Russian Federation was faced with the challenge of replacing the centrally planned system with a market system. In view of the complete breakdown of economic stability and an incomplete mixture of rudimentary elements of a planned economy, the transition of the economic system was a task which could hardly be accomplished using only internal resources, let alone in the short term. The monetary integration of the Russian Federation took on a key role in the transformation process because there was the opportunity, with the introduction of the convertibility of the rouble, to link two reform targets to each other. The import of stability through the introduction of a currency anchor and the transfer of resources through the inflow of foreign capital.

The aim of the investigation below is to evaluate the goals of convertibility presented above for the reform process in Russia. The contribution of the rouble to stabilisation and to the transfer of resources of foreign capital to Russia is discussed and evaluated.

Up to 1995, foreign trade in the Soviet Union was a state monopoly. The scope and structure of the international transactions were predetermined by the central national economic plan. The Union's entire foreign trade was organised by around 100 centrally managed foreign trade organisations which reported directly to the foreign trade ministry. International payment transactions were settled by the state foreign trade bank (Vneshekonombank) alone, a legally independent subsidiary of the state bank (Gosbank).⁹ The rouble was a purely domestic currency the ownership of which only guaranteed

⁹ Cf. Osteuropa Consulting Center (ed.): Die Entwicklung der Unternehmensstrukturen im Transformationsprozeß der Russischen Föderation, Research report drawn up on behalf of the Federal Ministry for Economic Affairs, Berlin 1997, pp. 358f.

economic subjects a theoretical claim on domestic production, but which entailed no freedom to exchange the currency. The exchange as well as the possession of currency was subject to the state's 'currency monopoly' and was in this respect reserved for the foreign trade organisation of the Vneshekonombank.

The policy of Perestroika was documented in foreign trade with the partial discontinuation of the strict division between the domestic economy and foreign trade. With the independence of the Russian Federation as a state of its own (1991) there was also a change in the organisation of foreign trade towards the free-market decentralisation of external transactions. The state's currency monopoly was replaced by the gradual extension of convertibility rights for companies and private persons at home and abroad. Within a period of six years (Jan. 92 – Jan. 98), the full convertibility of the rouble was introduced with the result that it very quickly became universally usable as a means of payment for all domestic and foreign transactions after originally having extremely limited functionality as a purely domestic currency.

A rouble-dollar exchange-rate target was announced for the first time in exchange-rate policy within the scope of a stability programme in mid-1995

Table 1
Reform Steps of Russian Foreign-exchange and Exchange-rate Policy, 1992-1998

	Convertibility	Exchange rate
Jan. 1992	Abolition of state's foreign trade monopoly, (limited) internal convertibility of the rouble	Multiple exchange rates
July 1992		Introduction of a single flexible exchange rate
July 1993	Convertibility of the rouble for foreigners for current account transactions and portfolio investments in shares	
July 1995		Exchange-rate target with a fixed range for 6 months
Jan. 1996	Convertibility of foreign portfolio investments in government bonds with conditions	Exchange-rate target with a fixed range for a further 6 months
July 1996	Declaration of current account convertibility according to IMF Art. 8	Exchange-rate target with a crawling peg for 6 months
Jan. 1997		Exchange-rate target with a crawling peg for 1 year
Jan. 1998	Convertibility for portfolio investments in bonds without conditions	Fixed exchange rate with a range of +/-15%

after the rouble had steadily been devalued in the years before (see Table 1). After this, an exchange-rate corridor was fixed for the rouble rate for a period of six months. The Russian central bank committed itself to unlimited intervention in the event of the corridor's being exceeded. In the following year, the central bank modified the exchange-rate policy by introducing a crawling peg, also for a period of six months. On the basis of the agreed corridor for the rouble rate's having been easily kept to hitherto, the period of validity of the exchange-rate target was extended from six months to one year in 1997 with the announcement of a new crawling peg. At the same time as the realisation of the full convertibility of the rouble, the Russian central bank announced at the beginning of 1998 that it wanted to keep to a new rouble-dollar parity, to be reset once a year up to 2000, with a fluctuation range of $\pm 15\%$. In August 1998, a deep financial and currency crisis in Russia forced it to give up the currency anchor with the result that the rouble fluctuated freely against the dollar from this point on.

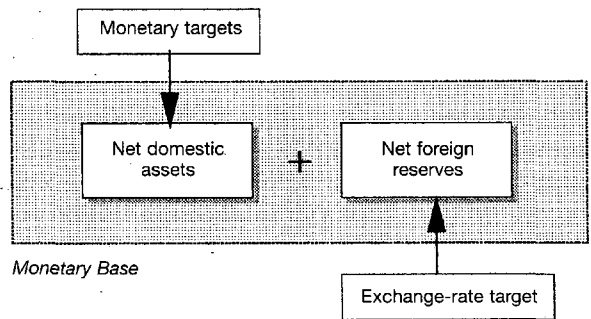
The Russian Route to Monetary Stabilisation

The Russian route to stabilisation can be broken down according to the conceptional orientation of monetary policy into two phases, a regulative phase and a stabilisation phase.

The *regulatory phase* from 1992-1994 was characterised by the institutional restructuring of monetary and fiscal policy. The continuation of the old link in the planned economy between the state, banks and companies led in the first years of reform to the uncontrolled expansion of state and corporate debt through the granting of central bank loans. Driven by high growth rates for net domestic loans, this resulted in an expansionary trend in the money supply which hindered every serious effort at stabilisation made by the central bank. Despite a decline, the inflation rate remained at a high level until the end of 1994.

During the *stabilisation phase* from 1995-1998, the Russian central bank's monetary policy was firmly anchored by the two components of the stability programme. With the fixing of the rouble within the agreed range, the external components of the monetary base were determined via the balance of payments account. As an additional safeguard, agreed quarterly targets for the most important components of the monetary base limited money supply growth. Based on the negative experience in previous years, the central bank and the government

Figure 1
The Russian Stabilisation Programme



agreed to keep to certain upper limits for the portfolio of net domestic loans as well as for the portfolio of net loans to public authorities per quarter in future. In view of the protection of the fixed exchange rate by central bank intervention, it was regarded as important that currency reserves did not fall below a certain limit. This lower limit for net foreign loans was agreed explicitly for the quarterly development of net currency reserves and also for that of gross currency reserves (see Figure 1).¹⁰ To summarise, the Russian stabilisation concept can also be described as a type of 'double strategy' where a money-supply target for the domestic components and an exchange-rate target for the foreign components of the monetary base should force the Russian central bank to pursue a stability-oriented monetary policy.

The stability programme was passed in 1995 in cooperation with the IMF, which made the observation of the formulated money supply targets a basis for decisions on the further granting of IMF loans to the Russian Federation.

The stability concept, nominal currency anchor plus quarterly targets, lastingly reduced the growth rates for the monetary base and M2 money supply with the result that the inflation rate fell steadily from 1995. The decline in net currency reserves in the period from mid-1995 to the beginning of 1997 made an important contribution to stability by limiting the expansion of the money supply. Under the premise of an exchange-rate target, the net currency reserves served to finance a balance of payments deficit which could be put down in turn to a capital account deficit, the extent of which far exceeded the natural contra item

¹⁰ Cf. The Central Bank of the Russian Federation, op. cit., pp. 34f.

for accounting purposes resulting from a current account surplus. The trade balance showed an almost unchanged credit balance despite the significant real appreciation of the rouble to begin with.

The extension of convertibility rights to pure capital account transactions in mid-1996 brought volatile inflows and outflows of foreign portfolio investments in its train in 1997 which in turn triggered erratic fluctuations in net currency reserves. Despite the Russian central bank's sterilisation efforts, the high rates of change in net currency reserves were reflected in the development of the monetary base and of M2 money supply. In conjunction with the crisis on the Asian capital markets, the strong withdrawal of foreign capital led to a balance of payments crisis at the end of 1997. With the growing deficit in the balance of payments, net currency reserves fell considerably over the course of the first half of 1998. The Russian central bank reacted to the increasing outflows of foreign portfolio investments with drastic interest rate increases in order to ward off the devaluation of the rouble and the abandonment of the nominal currency anchor.

Contribution to Monetary Stabilisation

Taking the exchange-rate target for the rouble as a basis, the stabilisation effect was negatively influenced by two factors: firstly, the exchange-rate target announced for six months (and later for the full year) of a corridor within which fluctuations of the rouble against the dollar were allowed and secondly, the invariable nominal devaluation of the rouble with the periodic resetting of the exchange-rate target. With these two factors, the permitted rouble fluctuation range and nominal devaluation, part of the potential balance of payments deficit is already compensated for by the price mechanism. As a result, the financing requirements of the actual balance of payments deficit are reduced via the change in net currency reserves (volume effect).¹¹ With the parameter of a fixed parity for the rouble without a rate corridor and without nominal devaluation, the Russian central bank would have had to use a far higher currency amount to stabilise the exchange rate. The contractionary effect on the money supply, triggered

by the decline in net currency reserves, would consequently have been greater.

The same applies to the effect of the real appreciation of the rouble: with the nominal devaluation of the rouble through the periodic resetting of the exchange-rate target, the appreciation of the real exchange rate was reduced. After a significant real appreciation of the rouble in the first year after the introduction of an exchange-rate target, the real exchange rate showed a stable trend from mid-1996 on.

The real devaluation of the rouble having been too weak may have contributed to the fact that the inflation differential between home and abroad was not enough to bring about a deficit in the Russian trade and current account. However, in view of Russian exports being heavily dependent on commodities, it can be assumed in any case that the trade balance is not very price sensitive. The Russian trade account showed no reaction to begin with to the strong real appreciation of the rouble. The Russian trade balance also invariably showed a surplus in the years before, between 1992 and 1994, in which the real appreciation of the rouble was far stronger. Consequently, the basic assumption of the concept of the currency anchor of an elastic reaction by the current account to the real appreciation of the rouble was not fulfilled in Russia's case.

The Russian balance of payments deficit was not – as was envisaged by the stability concept of the currency anchor – due to a negative current account balance in the period of observation from 1995-1997 despite Russia's diminished ability to compete internationally. The balance of payments deficit was brought about rather by major capital flight and by a high capital account deficit. The fact that a balance of payments deficit came about at all can obviously be put down exclusively to the introduction of a currency anchor.

When analysing the financing structure of the Russian balance of payments deficit, a further weak point in the anchor concept becomes evident: with special financing and the use of IMF loans, the circle 'balance of payments deficit ⇔ decline in net currency reserves ⇔ monetary contraction' was weakened and temporarily suspended. Special financing enabled the opposite development of the Russian central bank's net currency reserves and the balance of payments account in 1995 for example.

Despite the qualification that the decline in net currency reserves was not based on the non-

¹¹ The difference between the so-called potential and the actual balance of payments deficit is made on the basis of Meade's balance of payments concept. However, the analytically meaningful differentiation into potential and actual deficit does not prove to be very operational in respect of the measurement of the balance of payments defined in this way. Cf. J. E. Meade: *The Theory of International Economic Policy*, Vol. I: *The Balance of Payments*, London 1995, p. 15.

monetary reaction of the current account, it nevertheless had a stabilising effect on the development of the monetary base up to 1997. This means that the introduction of an exchange-rate target made a contribution to the stabilisation of the internal value of the rouble. The fact that this contractionary effect on the money supply was in the end the result of the greater flight of capital does not speak for success, however, in respect of the credibility of an exchange-rate target. With currency holdings accounting for a growing share of the savings of private households (85% in 1997), the aim of the currency anchor of having a positive influence on the expectations of private financial asset owners and introducing the de-dollarisation of the economy has not been achieved.

The introduction of capital account convertibility in mid-1996 proved to be a high risk for the success of the Russian stability programme. The major volatility of foreign portfolio investments led to strong fluctuations in net currency reserves in 1997. The Russian central bank made efforts to sterilise the effects on the money supply of the change in net currency reserves as a result of the contrary development of net domestic lending. However, the growth rates in respect of M2 money supply and the monetary base reflect the volatile trend in net currency reserves in 1997, which means that the central bank's sterilisation policy had no lasting success. The central bank's sterilisation efforts reveal the inconsistency of the objectives of the Russian stability concept: the contractionary effect on the money supply of the decline in net currency reserves in the second half of 1997 could only be compensated for by the corresponding expansion of net domestic lending. But the increase in net domestic lending conflicted with the quarterly upper limits agreed in the stability programme. The conflict between money-supply target and exchange-rate target was also documented in the central bank's drastic interest-rate increases which could not be justified by domestic factors, but which supported only the maintenance of the exchange-rate target. In the end both measures, sterilisation via net domestic lending and the interest-rate increases, made nonsense of the original concept of the currency anchor, as the monetary effect of a change in net currency reserves itself unsettles domestic stabilisation, while the domestic factors serve as a correction factor. According to the concept of the nominal currency anchor, the cause and effect relationship should be exactly the other way round: uncontrolled growth in net domestic lending should be countered by a correction factor via the fixed exchange rate.

The costs of the nominal currency anchor can be calculated using the extent of the balance of payments deficit and changes to net currency reserves. Russia's balance of payments deficit to be financed each year amounted to \$ 36.5 billion in the period from 1995 to the third quarter of 1997. Adding the financing costs for setting up adequate currency reserves, the resources to be provided for establishing an exchange-rate target amount to around \$ 50 billion in the period under review. This currency amount for squaring the balance of payments deficit was raised primarily through IMF loans as well as forms of special financing, in particular through rescheduling with private and public-sector creditors in western industrial nations. However, the major transfer of resources did not serve to finance surplus currency demand, brought about by Russia's current account deficit, but only to satisfy the currency demand resulting from the flight of capital from Russian companies and private households. The private sector's growing net foreign assets were thus financed by the borrowing on the part of the Russian government without profits being generated by the transfer of resources which enable the government to make interest and redemption payments in future. As a result, the concept of the nominal currency anchor required a large transfer of resources to cover the balance of payments deficit, the economic usefulness of which is to be seen exclusively as the contribution of the rouble exchange-rate target to Russia's monetary stability. But this stability contribution is to be assessed as extremely low in Russia's case and hence does not justify the capital imports required.

Transfer of Resources to Russia

Instead of the net transfer of resources from abroad as presumed, Russia was a constant exporter of scarce resources from 1994 (according to the official statistics). The high Russian foreign trade surplus achieved over years implied continual capital exports which led to a deficit in the Russian Federation's capital account. This implies that domestic aggregated savings have to finance not only domestic investment and the state's budget deficit, but additionally the huge amount of flight capital and the foreign trade surplus.

The government sector and the corporate sector were identified as the primary sources of capital exports while the Russian banks have shown a surplus in their external capital account since 1995 (see Table 2).

Net Transfer of Resources by the Government

As regards the Russian government, the increase in the inflow of portfolio investments in domestic government bonds since 1996 with the introduction of capital account convertibility was not enough to compensate for the outflows from the annual servicing of foreign debt. Although the government benefited from Russia's increasing monetary integration in the form of capital imports, there was still a slight deficit in the government's external capital account of \$ 1 to 2 billion in 1996 and 1997. The primary cause of this was that the Russian Federation agreed to take over all foreign liabilities of the former Soviet Union and hence started off the reform process with foreign debts amounting to more than \$ 100 billion in 1992. Although Russia's new borrowing rose from \$ 3 billion to \$ 32 billion in the period from 1992 to the end of 1997, this transfer of resources from abroad did not cover the interest and redemption payments due on the Soviet Union's accrued existing debts – despite the debt rescheduling agreement with the creditors of the London and Paris Clubs.

While the financing structure of the government's foreign debts is geared towards the long term, the financing of the government's domestic debts is based on government bonds with an average maturity of less than one year. Owing to the extremely short-term financing structure of domestic government debts, a rise in interest rates is reflected directly in the government's refinancing costs and the extent of debt

servicing. With an average government bond maturity of less than one year, the entire inventory of domestic debts has to be refinanced annually. The greater inflow of foreign portfolio investments with the opening up of the domestic government bond market led on the one hand to a drastic decline in GKO (Russian T-bills) interest rates from 176% in June 1996 to 18% in August 1997. On the other hand, there was a withdrawal of foreign capital at the end of 1997 as a result of the Asian crisis so that interest rates rose just as rapidly as they had previously fallen. GKO interest rates reached a level of 65% in June 1998. A rise in interest rates from 18% in August 1997 to 65% in June 1998 implies that the Russian Federation has to make annual debt service payments given an outstanding volume of GKO and OFZs (obligations of the Finance Ministry) of RUR385 billion – calculated roughly – of RUR250 billion instead of RUR70 billion. The additional expenditure from the increase in debt servicing absorbs a far higher share of overall production. Assuming an average GKO interest rate of 25% in 1997, annual debt already amounted to 4.0% of GDP. But assuming a GKO interest rate of 65% for the whole of 1998, the share of GDP accounted for by the annual debt service payments would increase to 10.5%. In addition to the interest and redemption payments for domestic debts, annual debt servicing for the Russian Federation's foreign liabilities amounting to 3% of GDP is still to be taken into account. Caught up in the debt spiral, the Russian government needed to increase capital imports in mid-1998 to finance the growing budget deficit. Although the rise in interest rates increased the required risk premium for portfolio investments in emerging market bonds, the proliferation of government debt put pressure on the Russian Federation's creditworthiness. It also made the devaluation of the rouble more likely with the withdrawal of foreign portfolio investments. The international rating agencies took account of the higher credit risks in May 1998 by downgrading the rating for Russian government bonds in foreign currency.¹²

Net Transfers by Russian Companies

The external capital account of the companies invariably showed a deficit in the period of observation and saw annual currency outflows abroad of between \$ 8.1 billion and \$ 22.4 billion. The transfer of resources between Russian companies and abroad

Table 2
Net Transfer of Resources in Russia, 1994-97
(in \$bn¹)

	1994	1995	1996	1997
Russia overall ²	-15.1	-0.2	-15.6	-19.1
Government	2	-5	-1	-2
Portfolio investments in Russian state bonds	0	1.4	3.5	12.5
Companies	-13.8	-8.1	-22.1	-22.4
Portfolio investments in Russian Stocks	0	0	2.0	2.5
Banks	-0.6	7.2	1.9	9.8
Other Flows of resources	-2.6	5.9	5.4	4.9

¹ Figures at the end of the period in each case.

² Balance of factor income, free transfers, the capital account and special financing.

Sources: IMF: International Financial Statistics, July 1998; IMF: Balance of Payments Statistics Yearbook 1997; Ministry of Finance/Vnesheconombank: The Russian Federation, Moscow, March 1998, p. 80; Russian Economic Trends, Web-Site, July 1998; The Central Bank of the Russian Federation, Web-Site, July 1998; author's calculations.

¹² Cf. Bank of Finland: Russian Economy, The Month in Review, No. 6, Helsinki 1998, p. 3.

is based on three sources: direct investments, portfolio investments and those transactions which are clearly to be allocated to the corporate sector under the balance of payments account 'other claims and liabilities', namely the extension of trade credits, non-repatriated export revenue and overdue payments. While direct investments and portfolio investments made a positive contribution to the transfer of resources to Russia between 1994 and 1997, capital exports from the many forms of capital flight were greater.

The fact that the comparatively low volume of foreign portfolio inflows was adequate to have a decisive influence on the development of prices on the Russian stock market documents the low market capitalisation and the lack of liquidity in daily trading volumes. The Moscow Times Index, which reflects the development of the prices of the 50 most traded Russian stocks, rose from 123.7 in March 1996 to 1061.2 in August, or by 850%. But in the second half of 1997, at the same time as the withdrawal of foreign investors from the foreign market, the value of the share index fell to 745.4 at the end of 1997. The Moscow Times Index showed an index level of 283 points in June 1998. As with the development of GKO interest rates, major concurrence with the monthly change in the central bank's net currency reserves can also be established for the development of Russian share prices.

Net Transfers by Russian Commercial Banks

Over the course of the reform process, the balance of the Russian banking sector's external capital account has gone from a deficit in the first years of the reform to a steady surplus since 1995: from 1992 to 1994, the Russian banks transferred greater amounts of capital abroad in order to escape the steady devaluation of the rouble due to the high domestic inflation rate. With growing foreign lending in relation to the small growth in foreign liabilities, the commercial banks benefited to a greater extent from the nominal devaluation of the rouble in the period under review.

The greater inflow of foreign capital from 1995 was channelled through the domestic banking system where it was reflected in an increase in foreign debt. Despite the gradual liberalisation of capital movements in 1996, foreign investors were obliged to carry out their transactions via special accounts held with authorised Russian commercial banks. Growing capital imports hence brought about more than proportionate growth in foreign liabilities and a rapid

decline in net foreign assets in the balance sheets of the commercial banks. The open foreign currency position changed in 1997 from a long currency position to a short currency position although the extent of the open position was reduced relative to total assets. A short dollar position is attractive from the point of view of the Russian banks as far lower refinancing interest is to be paid for raising capital on the international capital market than the interest generated by investing the capital in rouble-denominated securities. The Russian commercial banks obviously assess the risk of the devaluation of the rouble as low. For in the case of rouble devaluation, there would be major currency losses from a short currency position which by far exceed the interest differential between home and abroad produced previously as a rule. The exchange-rate risk involved in a short currency position is to be assessed as all the higher the more short-term the financing of the liabilities. According to the Russian central bank, short-term liabilities account for the largest share of foreign liabilities of 87.5%.

The Contribution made by Convertibility

Only the expansion of the convertibility rights of foreign investors to capital transactions, from mid-1996, induced a greater inflow of portfolio investments to Russia. Before then, in the period from 1992 to 1996, the transfer of resources consisted of the inflow of foreign direct investments alone, the contribution of which to the financing of domestic investments can be ignored on account of its low volume. The Russian balance of payments invariably showed a major deficit in the capital account up to 1996, which marked Russia's position as an exporter of capital abroad. The inflow of portfolio investments unleashed by the liberalisation of capital movements brought about a marked reduction in the capital account deficit and in the current account surplus, for the first time in the 1997 balance of payments. Even though the overall contribution of the inflow of capital from portfolio investments was not enough to compensate for the outflows from the flight of capital from the private sector and from the government's interest and redemption payments, there has been a recognisable trend towards net capital importer since the introduction of capital account convertibility.

The fact that the economic usefulness of the transfer of resources is nevertheless to be assessed as relatively low is due among other things to the missing preconditions for the realisation of full convertibility. The unequal distribution of the flows of resources between the government and the corporate

sector has led to doubt as to whether capital imports do justice to the requirements of the intertemporal approach. According to this intertemporal approach, the domestic investments financed with foreign loans should generate a return on investment in the following periods which guarantees the future interest and redemption payments abroad. While this criterion is assumed to be fulfilled a priori in respect of investments in Russian privately organised companies, the financing of the public deficit shows no investment considerations which directly fulfil the transfer criterion. But the Russian government above all has benefited most so far from Russia's increasing monetary integration in the international capital markets with around \$ 22 billion, while only a small part (around \$ 6 billion) of the capital flows has gone to the corporate sector.

Not only the unequal distribution of the flows of resources between the non-monetary sector and the government sector, but also the low fixed-interest period of government securities can be regarded as an indication of the lack of use of the funds for investment purposes. The extremely short-term financing structure of Russia's domestic public debt documents that the Russian bond market, when it was opened up to foreign investors, was not in a position to carry out the maturity transformation necessary for the financing of long-term non-monetary investments. The average maturity of Russian government bonds of less than one year subjects the Russian government as debtor to a market risk which is hardly justifiable and guarantees in this respect no planning certainty for calculating

financing costs. Short-term portfolio investments in Russian GKO's have hence made no contribution to the long-term financing of the government's domestic investments. The expansion of government consumption since 1995 can be regarded as an additional indication of foreign portfolio inflows being used for consumption purposes.

That the introduction of capital account convertibility hardly improved the financing conditions for Russian companies can be put down in particular to the lack of efficiency of the Russian stock market. The fungibility of Russian shares is extremely restricted on account of their legal form as 'registered securities' and the problem of re-registration involved in the event of a change of owner. In addition, there is no central securities settlements system or standard legal framework for the various Russian exchanges. The extremely high transaction costs as well as the Russian stock market's lack of transparency precluded an increase in investments by foreign investors in the Russian stock market and hence made the equity financing of domestic companies more difficult. The reverse, raising foreign capital directly on the international capital markets through the placement of stakes and ADRs, cannot adequately substitute for the lack of portfolio investments in Russian shares. The publicity requirements necessary for the acquisition of new capital on the international capital markets can only be fulfilled by the few internationally active Russian companies.

Although the inflow of foreign portfolio investments to the Russian capital market remained limited, the capital flows were still adequate in view of the low

Hans-Peter Schneider/Torsten Stein (Eds.)

The European Ban on Tobacco Advertising

Studies concerning its Compatibility with European Law

This collection of legal opinions on the legality under Community Law of the Directive 98/43/EC of the European Parliament and of the Council of 6 July 1998 in the approximation of the laws, regulations and administrative provisions of the Member States relating to the advertising and sponsorship of tobacco products, is a rather unique document. It is unique because of the striking conformity and unanimity of the results and conclusions found by well-respected professors of EU law and legal practitioners from almost all EU Member States. Notwithstanding their different national legal backgrounds, they all come to the conclusion that the adopted Ad-ban Directive would be ultra vires.

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market capitalisation to drive the prices of Russian shares and bonds strongly upwards in the first half of 1997. There was a strong correction in prices on the domestic capital markets with the withdrawal of foreign capital in the second half of the year. As standardised futures contracts to hedge price and interest rate risks are not actively traded on the Russian capital markets, the market participants are exposed to high risks when price movements become more volatile. This applies all the more to the Russian bond market as the debtors are confronted with refinancing costs which can scarcely be calculated as a result of the short term of the liabilities in certificate form.

The risk of asset price deflation became evident with the sharp falls in Russian share and bond prices at the end of 1997. The loans go into default as a result of the asset losses as the assets used to collateralise the loans are only valuable to a certain extent. Alongside the higher credit risks as a result of falling asset prices, there is the additional risk for the Russian banking system of the devaluation of the rouble on account of the high net foreign liabilities. Both risks are interdependent as rouble devaluation and also a fall in bond and share prices are brought about by the withdrawal of foreign portfolio investments. As a result, the short-term nature of the investments as well as the volatility have a destabilising effect on the Russian securities markets and on the domestic banking sector which can scarcely be neglected.

Failure of the Convertibility Strategy

The Russian Federation's balance of payments crisis, which already became evident in mid-1997 with the steady withdrawal of foreign portfolio investments, escalated in August 1998. The pegging of the rouble exchange rate to the dollar was abandoned, the unilateral deferral of Russian interest and redemption payments on foreign loans for a period of 90 days announced and at the same time trading in Russian government bonds suspended. The transition to the free floating of the exchange rate resulted in the drastic devaluation of the rouble. The fall in prices of nominal assets continued in the Russian stock market. A yield spread of 5,000 bp versus US government bonds in respect of outstanding Eurobonds issued by the Russian Federation signalled that the creditors regarded the repayment of the debts as unlikely. The devaluation of the rouble led – almost immediately – to a drastic rise in the inflation rate.¹³

The Russian central bank reacted to the crisis symptoms by increasing the refinancing rate for

overnight money to 140%. This restrictive monetary policy put pressure on the Russian government and banking sector which were already weakened by the devaluation of the rouble. The Russian government could no longer make its interest and redemption payments abroad owing to the fall in the currency. The Russian commercial banks were most heavily hit by the crisis: as net debtors abroad, the devaluation of the rouble directly increased the banks' debt burden. In view of the general uncertainty, private households attempted to withdraw their dollar credit balances from domestic banks. The banks were not able to meet the growing demand for dollars and had to cease business activities.

With the financial and currency crises, not only Russia's efforts at monetary integration into the international capital markets failed; after seven years of reform in respect of convertibility targets, stability and the transfer of resources, Russia has to start again. Neither of the goals of the convertibility policy were reached: the fall in the internal and external value of the currency, the government's inability to pay and the ruined financial sector indicate the Russian national economy's lack of stability. With the massive outflow of foreign portfolio investments and the greater flight of capital, scarce resources were taken away from Russia. This could have contributed to the financing of domestic investment with efficient capital markets and a financial sector which is capable of functioning.

Three Phases to Monetary Integration

The necessary reorientation of the Russian convertibility policy has to differ both in the selection of the reform elements and in the recommended sequence of the reform steps from the strategy applied by Russia before the currency and financial crises. The main elements of Russia's reformed stability policy are:

- The monetary stabilisation of the Russian economy is no longer a target of the convertibility policy, but is exclusively the task of monetary policy. In contrast to the policy of the currency anchor, the Russian central bank is now pursuing its own policy which is geared directly towards domestic targets without the help of a fixed exchange rate.
- The stabilisation concept is more global than the approach to date: alongside the core area of

¹³ Bank of Finland: Russian and Baltic Economies, The Week in Review, No. 36, Helsinki 1998.

monetary stabilisation, which also comprises the restructuring of the banking sector, the reform of fiscal policy will be a mainstay for the success of stabilisation.

□ Stabilisation and the transfer of resources will no longer be pursued at the same time, but the principle of domestic stabilisation before external liberalisation applied (for the purpose of the liberalisation of capital movements). Consequently, the convertibility of the rouble in the stabilisation phase remains limited to current account transactions with the exception of foreign direct investments.

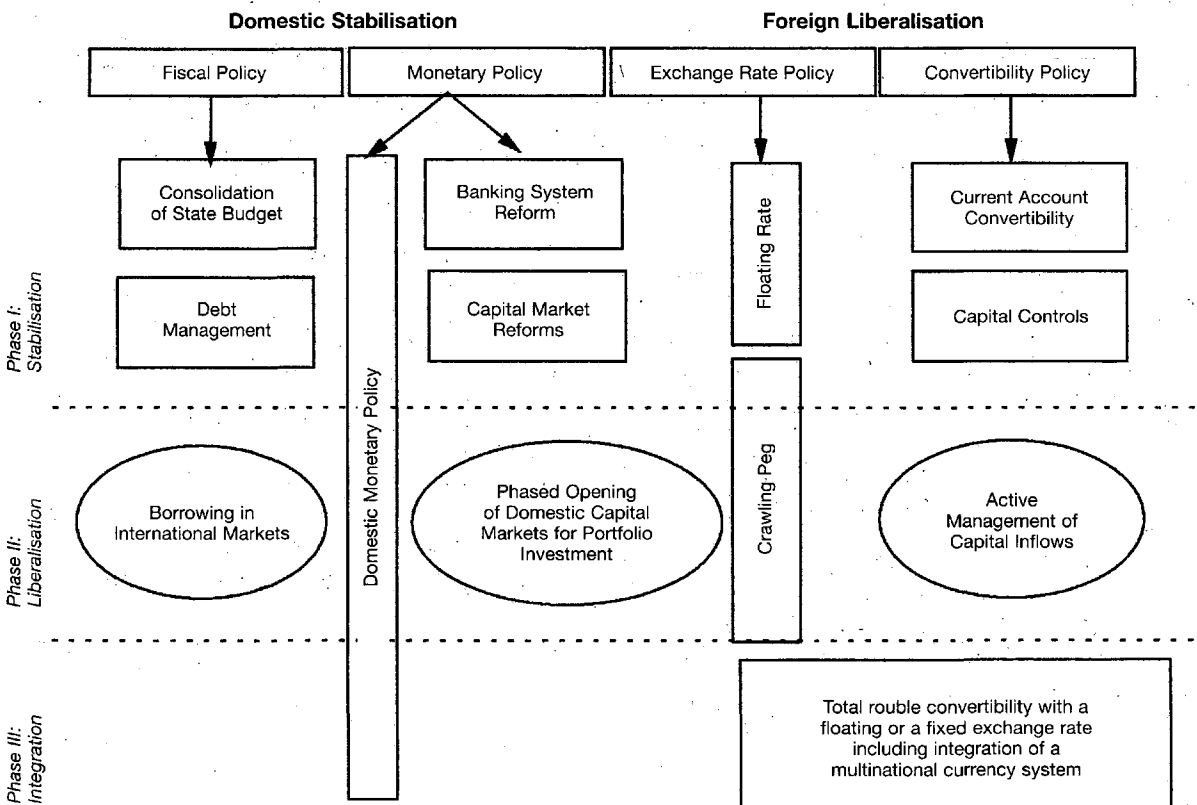
□ The introduction of the capital account convertibility of the rouble assumes that, alongside stabilisation, a basic reform of the Russian banking system and capital market has to take place. So that the economic usefulness of the inflow of portfolio investments is greater than the potential risk of destabilisation, the transformation of short-term oriented portfolio investments to long-term non-monetary investments has to be guaranteed at the time the capital account is opened up.

□ The extension of the convertibility rights to capital account transactions is carried out as a controlled process of the gradual liberalisation of the individual segments of the Russian capital market. The proximity to the corporate sector determines the priority within the chain of liberalisation. The convertibility policy is used here as an active instrument for controlling inflows of capital.

This new reform route in Russia out of the current financial crisis makes it clear that the goal of monetary integration into the international capital markets cannot be realised in the short to intermediate term. The measures proposed can be put into a three-phase scheme according to when they take place (see Figure 2): starting from the financial and currency crisis, the proposed reform route to monetary integration comprises the following phases: stabilisation, liberalisation and integration.

In *phase I*, emphasis is placed on the domestic reforms of stabilisation and the development of the capital markets. The aim of restricting convertibility to current account transactions is the external safe-

Figure 2
Sequence of the Reform Measures



guarding of the stabilisation process internally with the help of capital movement controls and the maintenance of a flexible exchange rate. In the stabilisation phase, the basic premises for the subsequent opening up of Russia's capital account are created.

In a study on private capital inflows into developing countries, the World Bank states, 'there is broad consensus – based on lessons from country experience and the considerable literature on the sequencing of reforms – that the most important prerequisites for successful financial integration are a sound macroeconomic policy framework, in particular a strong fiscal position, the absence of large domestic price distortions, a sound domestic banking system with an adequate supervisory and regulatory framework, and a well-functioning market infrastructure and regulatory framework for capital markets'.¹⁴

In *phase II*, the convertibility rights are extended step by step to capital market transactions. The inflow of foreign portfolio investments is supported by the transition to an exchange-rate policy of the controlled devaluation of the rouble already completed in the stabilisation phase. In order to reach the goal of the greater transfer of resources from abroad as quickly as possible, each capital market segment is initially opened for access by foreign investors who contribute directly to the financing of non-monetary investments. Top priority is given to the liberalisation of the stock market and the corporate bond segment, while the government bond market as well as the money market are only liberalised at a later date.

At the same time as macroeconomic stabilisation, Russia's international creditworthiness should improve gradually. This implies that along with the inflow of foreign portfolio investments to Russia, it would also be possible for Russian companies and the government to raise capital on the international capital market. With this form of transfer of resources, as well as with the opening up of the domestic financial markets for foreign capital, the capital account convertibility of the rouble is used as an active instrument for controlling capital inflows. Russian companies raising capital via share issues on the international capital markets therefore have priority. With outside capital financing via the placement of foreign bonds, the convertibility of the rouble is to be restricted to medium-term to long-term maturities.

Phase III characterises the aim of this reform package, Russia's monetary integration into the international capital markets. The process of gradual liberalisation of capital movements leads to the realisation of full convertibility for all rouble transactions between Russia and abroad. With monetary integration, there will be a basic change in Russia's position in international capital flows at the same time; while Russia has been a net exporter of capital so far, its integration into international capital markets will give it access to external savings with the result that the development of the domestic capital stock can be financed by greater capital imports. A current account deficit as a sign of the net inflow of resources to Russia should then be interpreted taking an intertemporal view of the balance of payments as an investment phase in which Russia incurs debts in order to achieve a return on investment in the following periods whose future surpluses will be available to meet the interest and redemption payments abroad.

The comparison of the final phase and the forecast result of this programme with Russia's current situation, characterised by a blatant financial and currency crisis, makes it clear that the goal of monetary integration can only be reached after a cost-intensive reform process over many years. It is to be taken into account here that the Russian Federation not only has to start again after the failure of the stabilisation programme, but also that the current situation is far more difficult compared to the start of the Russian transformation process in 1991. After a decade of steady declines in economic growth accompanied by a steady flight of capital, the resources which are to be generated domestically to cope with the necessary reform efforts appear to be extraordinarily limited. In addition, the failure of the earlier reform programme has destroyed the credibility of the policy and the social consensus over the necessity for drastic economic changes and for orientation towards free-market objectives. Russia cannot reckon with the greater inflow of resources from abroad on the part of private investors in the intermediate term. This is worsened by the Russian government's current inability to pay and hence by a lack of creditworthiness. Therefore, western industrial nations and supranational institutions are again required as lenders of last resort, as only with their help can Russia cope with the current financial and currency crisis. Otherwise, there is a direct risk that the Russian Federation will slip permanently into economic and political instability which would be detrimental to the global economic trend and in particular that in Europe.

¹⁴ The World Bank, op. cit., p. 5.