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EXCHANGE RATE POLICY BEFORE AND AFTER CRISIS [1]

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At the *G-20* meeting in November 2011, its participants re-emphasized the need to accelerate transition to the market principles of exchange rate setting, which will allow us to avoid ongoing exchange rate discrepancies, competitive devaluation and, at the same time, will reflect the fundamental processes in the economies[2].

In Russia the monetary policy for 2012 also stipulates conditions for "flexible exchange-rate regime". The Central Bank will present at the currency market in order to mitigate excessive fluctuations of rouble "but will not obstruct the development of market-based rouble exchange rate trends formed by fundamental factors"[3].

Trade balance surplus and the growing gold and foreign currency reserves demonstrate that, in order to prevent the national currency rate from becoming over-strengthened, regulators have to be constantly present in the currency market, to withdraw currency liquidity surplus and to prevent otherwise inevitable cheapening of the U.S. dollar. According to some experts, the Russian ruble appreciation against foreign currencies, seen in certain periods, reflects objective market trends. Others, on the contrary, believe that strengthening has reached the level where it is beginning to affect adversely the economic development[4].

The advocates and opponents of the "cheap" rouble have been debating for many years. Although, historically, specific decisions on exchange rate changes have always had some reasons aimed at objectives of the current economic policy, the divergence of views are founded on deeper, conceptual differences in approaches determining the general trend of economic development.

Apparently, the supporters of high importance of exports and external sphere as the main source of growth are interested in the depreciating currency. However if domestic factors, domestic solvent demand, are considered as the main sources of

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[1] This article reflects the personal opinion of the author. www.ershovm.ru

[2] Final Declaration, November 4, 2011, p. 2.

[3] "Guidelines for the Single State Monetary Policy for 2012 and for 2013 and 2014", CBR, draft, October 2011, p. 3.

[4] Vedomosti, 06.10.2011; Moscovskie Novosti, 19.09.2011.

growth, in this case it is particularly important to transform the rouble into the full-fledged national currency for savings and investments, creation of a more stable exchange rate which reflects objectively the economic situation and is determined to a considerable extent under the influence of market trends.

A few words about approaches in other countries

In a normal non-crisis situation, a well-balanced exchange policy is an important factor ensuring sustained internal development[5].

Leading countries, primarily the United States, underline their commitment to a strong dollar. According to the head of the U.S. Federal Reserve, "strong and stable dollar is both in American interest and in the interest of the global economy"[6].

In global environment a number of countries continuously maintain approaches when their currency is maintained overvalued against the US dollar (based on purchasing power parity, PPP) (Table 1).

Table 1

Levels of Over- (+) or Undervaluation (-) of Some Currencies Against USD (%)

<table>
<tr><th></th><th>1990</th><th>2000</th><th>2005</th><th>2009</th><th>2010</th></tr>
<tr><td>Canada</td><td>10.5</td><td>-22.4</td><td>0.2</td><td>4.3</td><td>17.9</td></tr>
<tr><td>Japan</td><td>25.9</td><td>31.3</td><td>17.7</td><td>22.8</td><td>28.4</td></tr>
<tr><td>Denmark</td><td>34.1</td><td>6.0</td><td>43.3</td><td>52.5</td><td>29.6</td></tr>
<tr><td>France*</td><td>-17.7</td><td>-8.9</td><td rowspan="3">6.9</td><td rowspan="3">11.9</td><td rowspan="3">7.6</td></tr>
<tr><td>Germany*</td><td>22.6</td><td>-9.7</td></tr>
<tr><td>Italy*</td><td>15.7</td><td>-31.9</td></tr>
<tr><td>Switzerland</td><td>36.8</td><td>15.5</td><td>39.9</td><td>40.9</td><td>38.0</td></tr>
</table>

* Since 2005, calculations have been for the euro.
Source: calculated based on data from OECD and US Fed.

Meanwhile, the currency exchange rate in developing countries is, as a rule, considerably lower than the purchasing power parity level (with regard to USD). This fact is usually brought forward by currency depreciation supporters as an argument that this is the 'reality' of developing countries. They, however, often discard the fact that many such

[5] For details, see: M. V. Ershov. Currencies in World Trade. M.: Nauka, 1992; M. V. Ershov. Financial and Monetary Mechanisms in the Modern World (Crisis Experience of the Late of '90s). M.: Ekonomika, 2000; M. V. Ershov. Economic Sovereignty of Russia in the Global Economy. M.: Ekonomika, 2005.

[6] Chairman Bernanke's Press Conference. April 27. 2011. P. 8.

countries are small-size economies that are extremely exposed to exports[7] and the low exchange rate of their national currency is their only means to ensure foreign currency inflow to solve their domestic growth problems (Table 2).

Table 2

Levels of Over- (+) or Undervaluation (-) of Some Currencies Against USD (%)

	2001	2005	2009	2010
Poland	-57.2	-42.2	-40.8	-59.4
Hungary	-61.4	-35.4	-36.5	-57.4
Turkey	-64.9	-38.2	-40.0	-56.9
Mexico	-32.4	-34.6	-42.8	-55.8

Source: Estimated according to data of OECD, central banks.

For the Russian market, it is important that with all the variety of objectives in place its foreign exchange policy should be aimed at strengthening the foundation of the “rouble economy”. It must be focused on the rouble as the national currency, the national bank should use in full its core functions as the lender-of- last-resort, issuing centre, and principal money regulator.

Some history of the Russian currency market

The current exchange rate policy considers exports and the external sphere in general as the main factor of economic growth.

In the course of creation of the exchange market back in the end of 1980s and early in 1990s, the rouble/dollar exchange rate reflected the price relations of only a limited group of then prestigious consumer import goods. As a result, the rouble exchange rate was **significantly undervalued,** when considering not the indicators characterising limited market segments only, and reflecting its "marginal economic efficiency" (as some economists do sometimes), but rather take into account complex and balanced economic assessments (such as price ratios for a wide GDP basket).

This would, obviously, imply the most favored treatment of exporters and, actually, a hidden form of export subsidies (and simultaneously import duties) supporting export to the detriment of the remaining economy.

We would remind of inaccurate market estimates of the exchange rate that was set at first currency auctions that were first launched in November 1989. The rouble exchange rate that existed at that auctions (Rub 15 – 20 per USD in average) only

[7] They are sometimes ‘monocultural’ exporters.

reflected a narrow basket of the prestigious consumer imports: jeans, cosmetics, etc. (We remember that a pair of jeans then cost up to 200 roubles in the Russian black market, while their price in the US could be about 20 dollars in average). However, a whole range of other products and services were many times cheaper in the Russian market. The metro fare was 5 kopecks, while the New York subway fare cost about 1 US dollar; bread cost about 20 kopecks in Russia against 1 or 2 dollars in the US. Comparable level housing and utility fees are many times lower even today. Back in the 1980s, with the average amount of housing fees of about 15 to 20 roubles per month in Russia, this value was **hundreds of times (!)** lower than prices for similar housing in Western capitals.

We also need to take into account the share of the respective product in expenses. While we typically buy a pair of jeans once every six months or once every year, and they accounted for less than 10% of annual income at that time (in case of Russian consumers), the utility fees are paid on a monthly basis and reach at least 20 to 30% of monthly costs in case of Western economies. In other words, the 'weight' factor of this component plays an important role.

Even more important, the cost of our industrial assets was also many times lower.

As a result, the course towards the economic 'openness' and liberalisation of capital operations in such context gave rise to a risk that foreign investors would get control of our real assets at highly underestimated prices.

Table 3

RUB to USD Undervaluation Level (Number of Times) *

	1990	1991	1992	1995	1998	2006	2008	2009	2010
Exchange rate/PPP ratio	38,2	50,2	13,0	1,8	2,9	2,0	1,8	1,8	1,7

* Subject to the GDP basket (according to internal use parameters).
Estimated according to materials of the MICEX, State Statistics Committee, and IMEMO for the relevant periods.

Note that even now we are talking about the fundamental undervaluation of the Russian currency by as much as 70% (!) [8]

Clearly, such enormous undervaluation from the very beginning was a great stimulus to strengthen the profile of the Russian economy as an export-oriented one,

[8] In other words, considering the PPP-based exchange rate, if it depreciates by 80%, we obtain the current level of the nominal market rouble/dollar exchange rate (about 30 roubles).

making exports exceedingly efficient. Obviously, given such exchange rate distortions, export operations were becoming much more attractive than domestic ones (particularly bearing in mind the lower level of domestic prices for a significant part of manufactured products). It is also clear that fuel and energy products were becoming the most "competitive" goods in such situation, as they generally met the requirements of the world market. Taking into account that fuel and energy products have always accounted for a significant part of the national exports, the opportunities to perform superefficient export operations, which opened up as a result of the large-scale undervaluation of the rouble exchange rate, have determined the primary export orientation of the Russian economy for a long time and inhibited progressive structural transformations. Prominent experts fairly note that the “undervalued ruble exchange rate, being beneficial to raw material exporters and the budget, is in direct conflict with the modernization goals”[9].

In turn, the money supply mechanisms strengthen the "translation" of such domination on the domestic economy where even non-primary non-export industries started focusing to a greater extent on servicing for the fuel and energy industries[10].

It is also clear that for many years the undervaluation of the Russian currency created perfect conditions for dollarization, when the rouble and all rouble-denominated assets appeared to be fundamentally undervalued for holders of dollars. Naturally, such enormous "efficiency" made the dollar extremely attractive.

The exchange rate established thereby was used as the basis to determine the official rouble exchange rate.

The subsequent accession to Article VIII of the Charter of the IMF obliged Russia to introduce a “unified” rouble exchange rate, which applied to current account as well as capital transactions (investments etc.), which meant a notable drop in the efficiency of investments and relative depreciation of sold assets.

The environment for structural transformations in the economy became even more complicated due to the fact that, given the big differences in the world and domestic prices for certain goods and commodity groups, the system of differentiated foreign currency coefficients - actually, the system of "multiple exchange rates", which were developed to eliminate such distortions, was abolished. In essence, this measure meant "shock therapy" in foreign trade.

In this regard, the exchange rate was given the central role in the regulation

[9] Ya. Dubenetsky. Modernization of the Economy: Lines, Resources, Mechanisms // Forecasting Issues. 2011. # 4. P. 8.

[10] M. V. Ershov. Economic Sovereignty of Russia in Global Economy. M.: Ekonomika, 2005. Pp. 198-222.

of **all types** of foreign economic operations (notwithstanding the diversified nature of its effects and the differences in the domestic and foreign prices for certain commodity groups). At the same time, the role of other instruments (duties, tariffs, export bonuses, etc.) that could alleviate the price distortions was, on the opposite, continuously declining.

At the same time, the rouble exchange rate was firmly tied with the dollar, which in essence merely reflected the monetary policy of the FRS.

Currently, such tie has slightly weakened: the currency basket used in the determination of the exchange rate now includes both - the dollar and euro - and the rouble exchange rate dynamics can a little better reflect the situation in the Russian exchange market.

All the aforementioned characteristics have laid basis of the present foreign exchange market.

Both - at the early stage and in the later years - systemic rouble undervaluation was also accompanied with the gradual depreciation of its nominal level (and, as a rule, without any links with the interest rate differential for the relevant pair of currencies), which even more impaired operations with roubles (as a depreciating asset).

Pros and cons

The supporters of reliance on a weak rouble and its depreciation at a higher rate than the price rise refer to a number of advantages of such approach.

The policy of currency depreciation is usually substantiated by the need to promote the national exports and inflow of currency earnings into the country. At the same time, it should be kept in mind that in our situation the undervaluation of the rouble by itself actually will not result in increasing export earnings in foreign currency. The opportunities to increase the physical volume of exports to promote external demand are limited by the throughput capacity of our pipelines and ports. Manoeuvring the prices for primary goods to promote demand is difficult due to their low price elasticity, and a reduction of prices for finished goods can be (and is) impossible by reason of tough antidumping restrictions in other countries (and the very fact of antidumping lawsuits means the recognition of the undervalued level of the rouble exchange rate).

The undervaluation of the national currency is only contributing to a rise in the rouble earnings of exporters after the sale of foreign currency earnings (which can also be achieved using exclusively internal mechanisms of the economic policy to support exporters). At the same time, the efficiency of borrowing in foreign currency is decreasing and, owing to the exchange rate dynamics, the shares of Russian exporters have become relatively cheaper for foreign investors (and more shares are required to be pledged to secure the loans).

How, in this connection, the undervaluation of the rouble meets the plans of attracting foreign investments? A "dearer" rouble perhaps would be in our interests in that case?

In general, a cheaper rouble in a broader sense means a declining foreign currency evaluation of our national wealth, GDP and other indicators characterising the level of development of the country.

From the geoeconomic point of view, the ruble sphere is shaped and managed by national monetary authorities and national economic entities. The weight and stability of the ruble environment in the international financial system affect the weight and position of the country (and, accordingly, its companies and banks) in the world.

There exist a number of additional adverse consequences of undervaluation of the rouble for the country. For instance, the cost of service of the external debt is growing due to the depreciation of the rouble.

Moreover, the depreciating rouble impairs the incomes of the households, thereby restricting the solvent demand, and such important component of the economic growth remains inactive.

When someone tries to convince us that a weak ruble is good for us it is just as absurd as saying that the smaller the salary we get and cheaper the rubles we have in deposits or in our wallets and the less we can buy with them, the more beneficial it is for us. Lack of logic in this phrase is obvious.

From the perspective of consumer sector this issue has another aspect of a geoeconomic nature. It shows how the results of our work (rouble salary, income in general) are evaluated by world markets; what quantity of goods we can buy there with the money we get for our day's (week's, month's, year's) work. In other words, what demand can we offer to world markets in return for the results of our work efforts? Will we be able (for example, at the end of a work day or week) to purchase some significant consumer goods abroad. Or if the rubles are exchanged based on ‘depreciating coefficient’ the maximum we can acquire will be – food (to regain energy after work) and minimal pleasures ("cinema and ice cream"). Considering the problem more seriously, we shall emphasize that the more groundless is the cheapening of the ruble, the more unequal our exchange with the rest of the world will be. (It will be similar to the principles used in the past in relations between a parent-state and developing territories.)

It is certainly necessary to apply mechanisms for domestic market protection and export encouragement. But who said that they shall be confined to the exchange rate only (especially since it is a **'counter-directional'** (i.e. acts in opposite directions) tool, which encourages some things while constraining the other? There is large number of economic policy tools that allow to reduce this 'counter-effect'?

On the other hand, a weak rouble means a higher estimated rouble equivalent of foreign currency earnings, hence increased tax revenues.

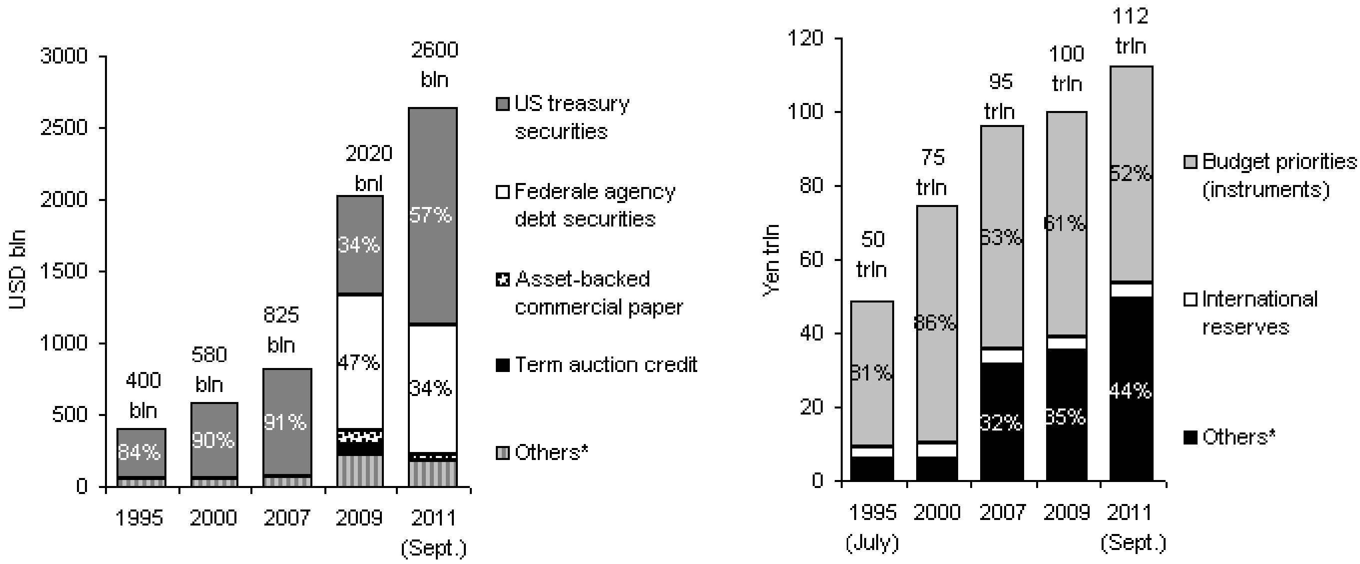
This aspect is important, **if the growth strategy is primarily based on foreign demand.** However, any large diversified (and, hence usually self-sufficient) economy must rely in the first place **on domestic demand as the main source of growth**. And the strong non-depreciating rouble is important for domestic demand.

The relative "shortfall" that arises can be compensated for through mechanisms of national monetary authorities, e.g. the use of deficient financing that is widely used in developed economies.

It's noteworthy that the two most developed global economies practice identical approaches, in which national monetary authorities are the shapers of monetary resources in the economy whereas budget priorities underlie the above-mentioned approaches[11] (Fig. 1).

[11] For details, see *M. Ershov.* World Financial Crisis. What's Next?. M.: Ekonomika, 2011. P. 156-164.

Monetary Base of USD **Monetary Base of JPY**



* Incl. swaps, gold, other loans, etc.

* Incl. funds supplying operations against collateral, asset purchase program, etc.

Fig. 1. Structure of the Monetary Base of USD and JPY

Source: calc. based on data of US Fed and Bank of Japan

Moreover, in general, the confidence in the national currency (as a depreciating asset) will be falling, contributing to the transfer of funds into more stable and appreciating currencies, which results in "dollarization".

It is also obvious that the current anti-inflationary policy is hardly in line with the use of such mechanisms (currency depreciation and undervaluation) that represent a direct stimulus for inflation. It is particularly important, taking into account that the share of imports in the final consumption is more than 10%, so any depreciation of the rouble exchange rate results in appreciation of imports and directly results in increasing domestic prices. The same occurs with other imports (half-finished products, spare parts, etc.), which also results in rising costs and appreciation of final products.

How could we arrange a more active participation in international globalization processes in such situation? Shall we suffice with the role of a raw material supplier or make more emphasis on the capital, investment component, where a stable rouble, the level of which is determined by the market, is an important tool both - to attract capital and for our systemic presence in the world economic domain?

Indeed, due to a dearer rouble, competition with imported goods increases. However, it is an incentive to increase the competitiveness of our manufacturers. In case where domestic manufacturers are unable to be in competition with foreign suppliers (and consumer prefers imported goods to those of national manufacturers), it would be expedient to engage trading policy mechanisms that will ensure the protection of the relevant industries (through tax and other mechanisms).

At the same time, cheaper imports have positive effects by making cheaper the import component for domestic production, thereby reducing the costs. Again, in accordance with the priorities of the economic and structural policy, a selective approach is possible by ensuring a low level of prices for imported goods of particular importance for domestic manufacturers and, on the opposite, introducing protective measures in respect of goods that must be produced domestically in the first place.

Post-crisis “hot” money risks

Similar approaches should also be applied to capital movements, all the more so that the strengthening of the rouble in general results in higher efficiency of attraction of foreign investments; however, new risks arise, connected with their speculative flows (especially if such appreciation is expected and continues on an on-going basis). Indeed, the immense resources available on international financial markets open up a lot of opportunities to finance the economic growth. At the same time, such resources are subject to the volatility of the world environment, as well as political factors, and can be withdrawn from the country within a short period of time. As a result, a crisis situation can arise on the currency and financial markets, which may endanger the stability of the national economy in general and halt the economic growth for long.

According to international experts, risk of high exposure to international capital movements, especially short-term capital, is particularly high for countries conducting an inconsistent macroeconomic policy, as well as for insufficiently capitalised or inadequately regulated financial systems (which is especially important when monetization (the M2/GDP ratio) of the Russian economy is low).

In this connection, **not only the capital outflow, but also the capital inflow**, as well as the nature of attracted resources must be closely monitored.

In general, the policy of attraction of foreign investments (given all their importance) cannot be spontaneous, based on the principles "any investments will be good" or "the more will be the better". What also matters is the nature of raised resources, the duration of their stay in the economy, the purposes of use and repatriation principles.

Even IMF comes to more or less the same conclusion after the crisis of 2008/2009: “Capital controls may be useful in addressing both macroeconomic and financial-stability concerns in the face of inflow surges”[12].

We will point out that in the current situation, when there exists abundance global liquidity which is seeking where to go, a dearer rouble is a kind of barrier for the entry of such "hot" liquidity to the market, increasing the efficiency of such entry, because the price of entry increases and all rouble-denominated assets become more expensive for external speculators (and other investors).

In the situation of abundance of global liquidity arising from large-scale anti-crisis injections in the developed countries which seeks where to be invested, dear (but not unjustifiably appreciating)[13] rouble is a kind of buffer which neutralises undesirable inflows of hot speculative money, increasing the cost of rouble-denominated assets and, thereby, the cost of "entry" in general into the Russian economy. In this connection, it would be necessary to evaluate the possibility of a number of one-at-a-time appreciations, making the exchange rate closer to the level which to a larger extent reflects the general price level of the economy (with allowance for PPP) and solves the tasks of neutralizing the inflow of abundant and short-term global liquidity. The foreign trade consequences of such measures can be balanced by customs and tariff policy arrangements, as well as measures supporting exporters. The simultaneous or pre-emptive use of leverages which discourage destabilizing impact of speculative inflows and outflows should also be considered.

It is important to be ready to use **exchange control mechanisms**, contributing to longer-term resources and the mitigation of risks which can cause the emerging financial stability to be undermined by speculative transactions or fluctuations in the world economy. The risks of "bull speculations" must be reduced, when international speculators purchase roubles for a short term only, in order to use the appreciated rouble for the subsequent sale, to gain profits and withdraw from market, thereby undermining its stability.

Even countries with strong economic and financial systems (US, Japan) had to use a wide range of regulatory actions to maintain stability of their financial and exchange markets, and the real liberalisation in many of those countries did not start until the end of

[12] IMF. Staff Discussion Note “Managing Capital Inflows: What Tools to Use?”. April 5. 2011.

[13] The term "appreciated" rouble implies a static estimate of its absolute value, while "appreciating" in this case emphasises the dynamic component. Where such dynamics goes ahead of changes objectively determined by the market, it is an incentive for speculative currency operations, when foreign resources are invested into a given currency and then, following its appreciation, sold in order to gain profits. The lesser are the market grounds for such appreciation, the higher is the potential for speculative gains.

1980s (Western Europe, US) or the end of 1990s (Japan), when they attained firm positions in the world economy. Note that, for instance, in the case of Japan, the currency liberalisation and capital movement liberalisation occurred **more than 30 years (!) after** the liberalisation of current account transactions in the mid - 1960s.

As world experience shows, long- and short-term technical and regulatory tools that may reduce destabilizing effect in the financial market is wide: from tax rates depend on the duration of presence to reserve requirements to direct quantitative restrictions on investment of short funds.

Similarly, in order to prevent a destabilizing inflow of foreign currency, quotas on the volumes of exchange of foreign currency into the national currency could be used as well as more strict levels of the foreign exchange position for foreign banks. Where it was necessary to maintain the balance, the asset structure was regulated and quantitative parameters were used, prescribing the percentage ratios of investments in foreign and national currency for banks in the asset structure. The liability structure can also be regulated.

As the Russian economy has already been liberalised to a large extent, the main emphasis in this sphere of questions must be made on the development of anti-crisis mechanisms that could neutralize the impact of "external shocks".

In general, particularly in the after-crisis environment, the issues of capital outflow deserve no less attention than capital inflow.

It is also important to expand the potential of Russian business companies in terms of foreign market penetration since the assets in other countries will be less costly for a heavier-weight ruble used for purchase.

As a result, it will mean a gradual expansion of the presence of Russian business in foreign markets where it will play not so much the role as raw material suppliers (the latter is achieved via currency devaluation) but rather as systemic investors. Naturally, such presence will expand Russia's opportunities in terms of its influence on global development and in terms of support of its interests in the markets of other countries.

Generally, it seems quite strange that the stimulation through the rouble exchange rate is considered, as a rule, solely in terms of supporting our export supplies (as we remember, these consist mostly of oil and gas). Almost no one considers opportunities to stimulate our investments abroad. Understandably, for overseas markets we are important only as raw material suppliers or as a market for their products and no one is waiting for us there as buyers or shareholders of their companies (and a number of attempts of large Russian participants to acquire serious Western assets show the obstacles frequently faced). Moreover, a cheap rouble in general is a kind of protection of Western markets from our entry into their market of real assets.

Unfortunately, the mechanisms for the support of national exports, protection of the domestic market, structuring the inflow of investments, which can be determined and used domestically, without the creation of external risks, are still generally ignored when pursuing the economic policy (we are talking about tax, tariff, monetary, and other measures).

At the same time, the exchange rate must not be allowed to move upward excessively without a good reason. In addition to the speculative pressure on the exchange rate, which arises alongside with general macroeconomic consequences that emerge (when, in the absence of necessary measures supporting the economy, an unjustified growth of imports and hampering of exports can have a systemic nature), this trend also creates a higher potential for depreciation of the exchange rate (and, in the situation of underdeveloped anti-crisis stabilising mechanisms, such depreciation can be significant), which can increase the unjustified volatility in the market. In this connection, the appreciation must be carried out in conjunction with general economic indicators (growing productivity of labour, inflation and general price level, economic growth).

Exchange rate, currency preferences and quality of growth

Devaluation of the rouble in the end of 2008 – early in 2009 significantly influenced the currency breakdown of deposits of companies and households, and actually during several months brought back to were it was several **years** ago (Fig.2).

In my new book “World Financial Crisis. What’s Next?” the relationship of the exchange rate dynamic and ‘currency preferences’ are thoroughly considered (as the rouble appreciated, the deposits in roubles increased, and vice versa), which should be kept in mind in implementing the exchange rate policy.

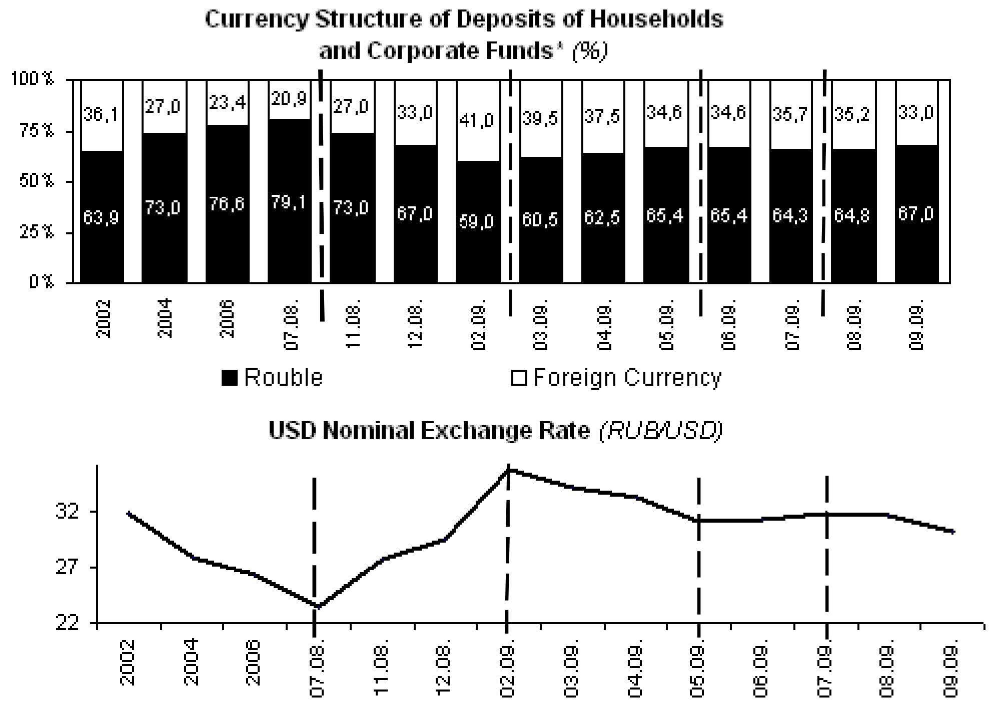


Fig. 2. Structure of deposits and exchange rate, Russia

* Funds of organisations include funds on deposits, settlement and other accounts.
Source: Central Bank of the Russian Federation; calc. based on CBR data.

Obviously, if the trend of non-depreciation will persist, then, in general, it will contribute to widening the domain of the rouble and substitution of the dollar, i.e. de-dollarization, which will also lead to the strengthening of the national currency, higher market confidence in it.

In fact, market trends accomplished what all previous efforts of various "decrees" and "decisions" of regulators were unable to do - de-dollarization of the economy.

We repeatedly mentioned that the use of dollars in the domestic circulation substantially limits the opportunities of expansion of funds via multiplier and in general undermines the positions of the rouble as the national currency. In addition to objective reasons connected with a sometimes obscure economic policy, the expectations of market participants about further nominal depreciation of the rouble contributed to the existence of such situation. Since they understood that such exchange policy was conducted for the purpose of promotion of exports and the increase in the foreign exchange reserves of the Central Bank actually shows that interventions are done to support the dollar and prevent a decline in its exchange rate.

These trends were quite predictable, especially given a high level of oil prices and strong interconnection between oil prices and foreign exchange rate (Fig. 3).

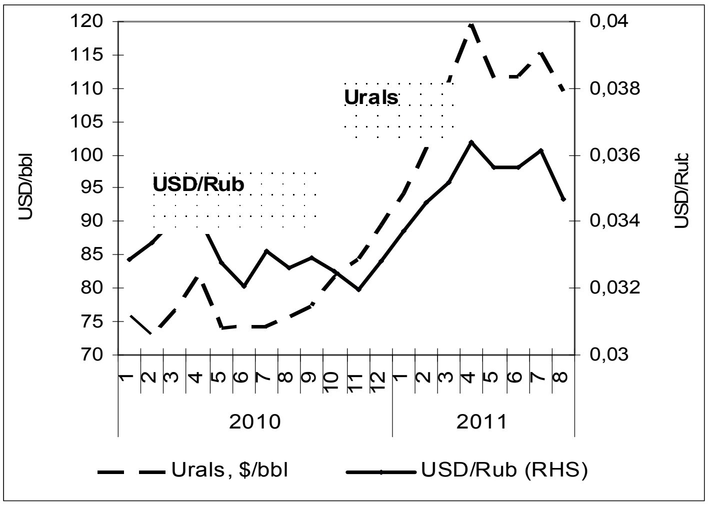


Fig. 3. Ruble Exchange Rate and Urals Price

Source: Ministry of Finance of the Russian Federation, Central Bank of the Russian Federation.

Adequate mechanisms for replacing external sources with domestic ones, necessary to lessen dependence on external environment, are very limited in use. In creating money and shaping monetary base (money supply), regulators again resort to external sources, when the ruble liquidity is based on the inflow of currency gains from export and foreign-currency-denominated loans raised from abroad. The practices of reliance on domestic factors in shaping the ruble base, which grew more important during the crisis, returned to the forefront.

As a result, the monetary segment of the Russian economy is becoming increasingly dependent on the world economic situation and all adverse effects it implies. These include, among other things, a higher share of raw materials industry in the economy, the aggravation of external risks, etc. As a consequence, system-wide, economic policy is forced to rely to a decisive extent on the fuel and energy sector branches.

If the balance of payments is still positive (which is highly likely if crude oil prices remain relatively high), the external monetization being important as it is should not be the dominant source of monetary resources in the national economy. If the objectives of improving the structure of economy and mitigating external risks remain relevant, it is necessary to assess thoroughly the possibility of a combined approach, which focuses on the task of supplying resources to the branches of "domestic" economy and simultaneously maintaining the optimal exchange rate level.

In such approach, foreign exchange gains, for example, can stay in the currency market instead of being purchased by the regulator in full (thus contributing, on the one hand, to the growth of the ruble rate, and, on the other hand, to partial money demand creation based on currency inflows). To neutralize these implications, lower-than-planned monetization can be offset by the replenishment of resources through domestic channels. To that end, a combination of **such mechanisms as refinancing, foreign exchange lending to banks, budget monetization channels, etc. can be used.**

Additional liquidity received through the above-mentioned channels can foster more even (equitable) allocation of resources among export and non-export industries and adjust the exchange rate dynamics (since this liquidity can partly return to the currency market, putting downward pressure on the strengthened ruble).

Another option is to use the currency instruments (with sufficient yield) of the Ministry of Finance or the Central Bank for accumulating a portion of currency revenue. It should also be assessed how feasible is subsequent direct sale of this currency by the Ministry of Finance (if purchased by using the instruments of the Ministry of Finance) to the Central Bank at the market rate as of the operation date. (Such transaction may, first, replenish the ruble liquidity in the market and, second, would not directly affect the exchange rate).

Such approaches to monetization, however, imply much more subtle management of financial flows, where mechanical "single-channel" approaches (which is the case in Russia) give way to a whole range of diverse, heterogeneous mechanisms of interaction between the financial economy and the real sector (as can be seen in countries with a far more mature level of financial development).

The strengthening of the economy and national currency is a serious incentive for market participants to make operations in roubles and it creates an additional basis for investment activities.

Moreover, before the crisis, as early as in 2005, changes were observed in the growth structure, when the growth rates in manufacturing notably exceeded the growth rates in mining operations.[14]

According to estimates of the World Bank, as early as in 2005, a fast growth in the domestic demand and steady growth in industries focused on the domestic market was seen. As a result, a conclusion was made that "the observed changes in the structure of industrial growth (especially manufacturing) suggest strong effects

[14] " Guidelines for the Single State Monetary Policy for 2006 ". Central Bank of the Russian Federation. P. 5.

from the real appreciation of the ruble"[15].

These trends persisted in general before the crisis, and although the World Bank's experts asked the question about how long the reversal of the trend in the manufacturing will continue, nonetheless, they stated that a number of branches of the manufacturing, focused on domestic demand, "may continue to thrive in Russia's booming domestic market"[16].

Hence, a trend took shape at that time to increasing growth quality and gradual (though slow) reorientation of the "growth drivers", firstly, from mining operations to manufacturing, and, secondly, from external demand to domestic demand. Already after the crisis – in 2010 – the conclusion was made again that drivers of economic growth in Russia are manufacturing industry and domestic demand[17].

Indeed, in 2010 and 2011, manufacturing industry outpaced mining industry (Fig. 4).

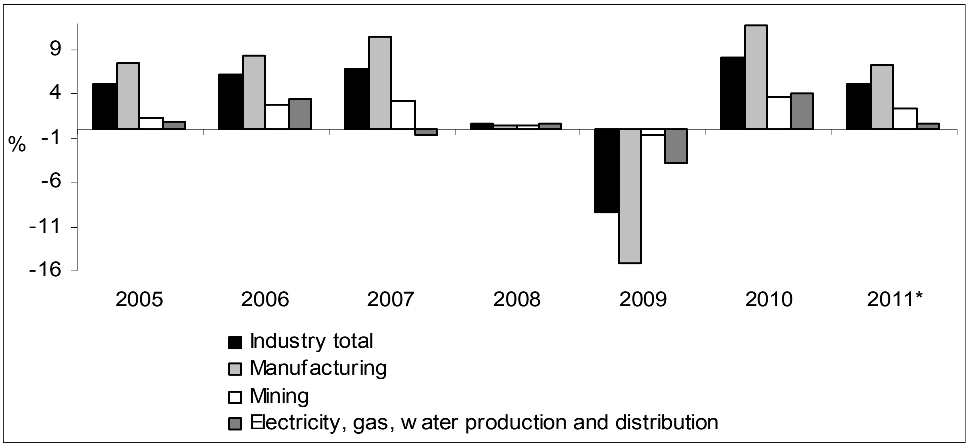


Fig. 4. Industry Growth Rates from 2005 to 2011 (% Year-on-Year)

[*] January to September 2011 / January to September 2010
Source: Federal State Statistics Service.

Furthermore, the "export" factor value goes down, whereas the values of domestic growth factors go up (Fig. 5, Table 4).

[15] The World Bank. Russian Economic Report, November 2005. No. 11, p. 6.
[16] The World Bank. Russian Economic Report, June 2007., No. 14, p. 5.
[17] The World Bank. Russian Economic Report, November 2010., No. 23, p. 5.

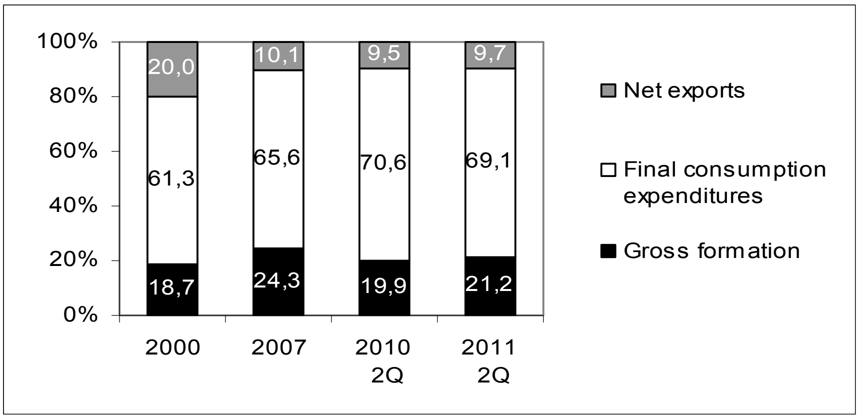


Fig. 5. GDP Breakdown by Use (%)

Calculated by the Strategic Analysis Center of Rosbank according to the Federal State Statistics Service.

Table 4

GDP Growth Rates by Principal Sector (Added Value Year-on-Year, %)

	2007	2009	2010	Q2 2011
GDP	8.5	-7.8	4.0	3.4
Traded sectors	3.6	-8.0	6.3	4.7
Non-traded sectors	12.4	-7.2	2.9	2.4

Source: Federal State Statistics Service, World Bank.

If such trends persist, they will need to be strengthened and supported with all economic policy tools available. It will allow the Russian economy to start gradually diversifying away from its commodity exports profile and start developing on a more advanced basis where manufacturing will play a higher role, thus increasing the quality of economic growth.

In the context of openness, currency policy is not only a mechanism of interaction between the world and Russian economies, but also a tool for solving critical domestic economic issues.

A sound currency policy must lead to the creation of a stable rouble environment required for a normal economic activity in the country and increasing investments. Measures must play an important role, stimulating the development of the internal financial market and making operations in it more attractive compared to foreign investments. Reserve requirements, balance sheet ratios, tax tools that will treat domestic rouble operations as more preferable compared to external foreign currency resources (the attraction of which in the situation of instability may be connected with a wide range of geoeconomic and political risks) must play an important role.

It is also necessary to establish a correct link between the currency policy and the main priorities of economy, fostering economic development (such as mortgage, small business, financial sector, etc.). This should strengthen the domestic position of national currency and contribute to its gradual integration into the world economy. This is important in terms of creating conditions for convertibility of ruble as well as making the ruble a full-scale financial instrument.

The currency policy itself must be closely integrated into monetary and budgetary mechanisms. It will give a positive effect in terms of strengthening the geoeconomic positions of the country and creating conditions for sustained economic development in the post-crisis world.