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Ruble-Based Modernization

Weak national currency fosters dependence of the Russian economy on raw materials

A year ago, the most discussed question was: "Has the (global, Russian) economy hit rock bottom?" Each quarter of percent of production increment was viewed as a meaningful sign of early rebound. Today's discussion seems to be more optimistic: "Has sustainable growth already begun or statistical data still fluctuates around zero?" Obviously, indicators support various viewpoints. Importantly, in both cases (a year ago and today) participants in such discussions propose academic perception of events. In Russia it is most evident, reflecting virtually passive approach to a set of practical steps rotating around hydrocarbon price forecasts.

It seems more pragmatic to consider alternative long-term active economic policies. Naturally, they will be affected by external factors (updated situation around investment banks in U.S.A, budget crisis in Europe, the situation in agriculture and social sector of China, oil disaster in the Gulf of Mexico and unexpected shale gas situation). However, national economic path should be influenced rather than predetermined.

Consideration should be given to the growth of global liquidity and associated risks of "hot" money, turbulence and future new bubbles. If these threats are ignored and mitigation mechanisms are not created, stable future plans are questionable. "Unexpected" events may then happen all the time.

Our suggestion is that we begin with the issue of relationships between the real and financial sectors (primarily banking) of the economy. Their relationships remain difficult. Banks, on the one hand, are full of liquidity and, on the other hand, expand lending symbolically: rates are reduced, the quantity of extended loans grows (+1.1% in April, net of Sberbank's loans), yet arrears increased by 1.9%, exceeding 15% for some major banks and tend to grow.

However, it appears that analysis in such system of coordinates takes us away from the essence of the matter, which the crisis clearly highlighted, i.e. underdeveloped structure of the Russian economy. If we go down to lower-level real processes, we will find out that the above-mentioned figures are poor consolation from any viewpoint as they are neutralized by the following numbers: since the beginning of this year, the price of iron ore raw materials has grown by 40%; accordingly, the largest metal suppliers notified leading mechanical engineering enterprises of their intention to raise prices by 30% from July 1. In 2010, state-regulated tariffs for natural monopoly services will grow by 9-15% (heat, electricity and railway transportation) to 26% for gas. Clearly, the budget will not help any more ("Greece" should play a sobering role here). Structural changes in the manufacturing came too late. More so, they simply could not occur in the context of 30-percent ruble devaluation in the early stage of the crisis. The real sector is characterized by the strengthening of raw materials component, with increase of assets in manufacturing. This starts resembling the situation of 2008.

The interim summary is that the financial sector has already accumulated excess liquidity. In the crisis year of 2009, it grew by 15-20% in Europe and North America. Although global cross-border investments of traditional financial donors went down by almost 40%, their permanent recipient (China) raised foreign investments by 6.5%. Potential for investments already exists. The question is where they will go. To the restructured real sector (but where does restructuring take place?), to cover European budget deficits (ECB adopted a decision to purchase sovereign bonds) or shape a new financial bubble?

In this situation, we cannot delay a decision concerning the corner stone of national post-crisis policy: which ruble do we view as beneficial to our economy – strong or weak? The answer to this question affects whether our ultimate development will be based on domestic demand and accompanied by the diversification of our economy or external, global demand will be the key driving force and the role of raw material sector will only grow. As a result, will the Russian economy in general be attractive to direct foreign and domestic investors into manufacturing or it will be of interest only to extracting industries and speculations in the stock market?

In the broad sense, higher price of national currency should reflect positive changes in the economy, making it more reliable and attractive to investors. Yet current interests often have the upper hand and currency becomes a tool to protect them.

Typically, currency devaluation policy is justified by the need to stimulate national export and increase the inflow of foreign currency revenue into the country. That being said, we should take into account that in our situation undervalued ruble as such does not actually lead to an increase in export currency revenue. Raw materials account for 90% of Russian exports, therefore the real possibilities to increase physical export volumes in order to stimulate external demand are limited by the capacity of our pipelines and ports. It is hard to maneuver the prices of raw materials to stimulate demand due to their low price elasticity.

In this regard, how does ruble undervaluation fit into the plans for attracting foreign investment? In this case, we are interested in more expensive ruble. However, it is difficult to diversify economy without attracting foreign investment in the manufacturing. Moreover, this should be accompanied by careful monitoring (and regulation, when needed) of the nature of inflows with regard to how long the stay in the economy, what are repatriation rules, etc. This money should work for the economy, not for speculators. The more expensive the ruble is, the more expensive domestic assets and the richer the population will be.

There is a wide range of additional implications of unreasonable ruble devaluation which adversely affect the country. For example, ruble undervaluation results in higher external (state and corporate) debt service costs and inflation growth. Devaluing ruble reduces household income too, thus limiting actual (payable) demand, and this important component of economic growth remains unused. Furthermore, general confidence in national currency (as a depreciating asset) weakens, contributing to the transfer of funds into more stable and appreciating currencies (assets) and leads to "dollarization." Formal data indicates strong correlation of the currency structure of bank deposits: as soon as the ruble grew in value, its share in deposits went up (against the currency), and vice versa.

Quite obviously, economic policy is at the crossroads under the existing circumstances: will we put up with the role of raw materials supplier or rather focus on attracting direct investment in the manufacturing, which requires strong ruble? Indeed, more expensive ruble increases competition with imported goods. Yet this is a natural impetus raising the competitiveness of domestic producers from non-processing sector, a precondition for building a diversified and long-standing national economy. Furthermore, if necessary, both exporters and domestic manufacturers may (and sometimes should) be supported, yet different tools should be used.

It is absolutely clear that neither financial market manipulations nor budget restructuring will allow us to avoid the main issue, i.e. deep structural changes in the real sector in favor of the processing sectors. This solves two crucial tasks in parallel. It encourages natural growth of innovations and also creates a stable partner for the banking sector. There is no painless recipe to accomplish this task. However, delaying the adoption of proposed amendments to the economic policy will be more costly for the budget, the real and financial sectors and the society in general in the future.

European events point at the possibility of the second wave of crisis: the weakest budgets have been breached. There is little doubt that the third wave will reveal socio-technological foundations of the current crisis. It will become absolutely clear that sustainable way out of the crisis necessitates changes in the interaction “private sector efficiency — social obligations of the state.” The sooner we realize it and agree with the necessity to adjust our financial system to the necessary structure of the real sector of the national economy, the higher our chances to “outplay” the crisis will be.

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