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Russia Muddling Through Uncharted Waters

By Martin Gilman

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Over the weekend, the world's financial leaders met in Washington for the International Monetary Fund's annual meeting. There were many pious speeches asserting that with the global economy exhibiting stagflationary features, cooperation was critical. Recent data underscore the fragility of the U.S. economic recovery. Europe could be facing even stronger headwinds. Meanwhile, commodity prices — and not just gold — reached new peaks last week. Oil posted a five-month high of $84, and financial markets are on a rip with bonds and equities flourishing. Only the dollar has dropped precipitously against most currencies, including the ruble.

There are two economic variables over which Russia has little control: the price of oil and the international value of the dollar. Nevertheless, Russia's economic performance, and that of other countries, is closely bound to those two key indicators. Hence, it is important to follow and indeed anticipate likely developments in the global markets for oil and the dollar.

Of course, I am stating the obvious. But the world economy is now wading into particularly treacherous waters, and the consequences for oil, the dollar and a number of other variables are far from clear. The fact is that a huge experiment, never tried before, is under way in the advanced economies. Depending upon how it goes, countries like Russia will bear the consequences.

The U.S. Federal Reserve is widely expected to revive emergency efforts to pump money into the U.S. economy through the process known as quantitative easing — in other words, buying Treasury bonds and other securities to stimulate bank lending. Already at the height of the financial crisis in December 2008, the Federal Reserve cut its lending rate almost to zero and turned to asset purchases to bring down long-term borrowing costs. It eventually bought $1.7 trillion in mortgage-backed securities, agency debt and Treasuries. The purchases ended last March, and the Federal Reserve began to plan an exit from its unprecedented intervention. But the weaker-than-expected U.S. employment data released Friday only reinforce speculation that the Federal Reserve will resume its asset purchase program at its regular scheduled November meeting to prevent sustained deflation and a feared double-dip recession.

Japan also surprised markets last week announcing its own variant of quantitative easing, and most other major central banks seem to be considering some form of easing as well. The Bank of England is next in line. The European Central Bank's focus is on providing specific countries and banking systems with funding while the central banks of Australia, Canada and New Zealand are among those now refraining from what would have been further interest-rate increases. By printing more money, central banks in advanced countries hope to stimulate economic recovery. What is not stated publicly is that this policy of printing money would have the expected side effect of weakening their currencies so that exports are enhanced.

The flip side of this putative quantitative easing is the continuing upward pressure on exchange rates in emerging economies. This is complicated by the fact that the use of unconventional monetary policy is being viewed as a deliberate attempt by advanced countries to weaken their currencies to boost exports, raising the prospect of competitive devaluations and protectionist responses. This was a major theme of the weekend IMF meetings, but all the Group of 20 countries could agree on was to mandate the IMF to study the issue. Korea, India, Thailand and Ukraine are among the countries considering steps to prevent more pressure for an appreciation of their respective currencies. They join Japan, Switzerland and Brazil, which have already intervened in markets to restrain their exchange rates. China has been the most aggressive in rejecting calls for an appreciation of the yuan.

Russia has so far been restrained, perhaps because the capital inflow surge has so far largely passed it by because of ongoing investor perceptions of high political risk in the country. Last week, in preparation for the IMF meeting, Deputy Finance Minister Dmitry Pankin explained that BRIC countries understood that exchange rates are a consequence of deeper processes, such as tendencies to save, to invest and of the investment climate. He also noted though that the BRICs would resist pressures from advanced countries to drop their defenses against currency inflows. Ironically, Russia is the only BRIC with a completely convertible currency and hence no controls.

The dilemma for the Federal Reserve and others is that their actions may not only do little to revive growth, but could actually make things worse.

First, there is the problem that we have no guarantee that a new round of quantitative easing will work. Even in economic theory, this is uncharted territory. If U.S. banks remain reluctant to extend credit, then the Federal Reserve is unlikely to prevent a prolonged period of stagnation or even another recession like the one Japan endured in the early 2000s. So if implemented, we will all be part of a vast experiment.

Second, and even more worrying, could be the unintended consequences of driving up the prices of oil and other commodities. Russia is highly vulnerable to excessive swings; we remember when the oil price peaked at more than $142 per barrel in July 2008 before plunging to $35 five months later. But real gross domestic product could actually decline in the very countries that print more money. Why such a perverse effect? Because rising oil and agricultural prices have the same effect on spending as a tax increase since they are the inputs into the goods and services we buy. If input prices rise at the same when enterprises have no power to raise their own prices to consumers in a stagnating economy, their profits drop, they produce less and GDP drops — clearly not what is intended. Purchasing power is drained from the consuming countries and passed on to the producer countries.

Joseph Stiglitz, a Nobel Prize laureate in economics, noted last week the irony of the Federal Reserve creating more liquidity that will do nothing for the U.S. economy except cause chaos for the rest of the world. And the irony for Russia, as it struggles to free itself of dependence on energy and commodities, is that macroeconomic management will be complicated and structural reform delayed further as oil prices surge.

High oil prices, sluggish growth in advanced economies and a falling dollar will challenge Russian policymakers. IMF head Dominique Strauss-Kahn is worried that many are talking about a currency war. Finance Minister Alexei Kudrin at least publicly tried to defuse this concern.

In the end, this situation is not sustainable, but how and when it ends is anybody's guess. With such an uncertain future, Russia will no doubt just try to muddle through.

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