GERMAN ECONOMIC TEAM IN BELARUS

76 Zakharova Str., 220088 Minsk, Belarus. Tel./fax: +375 (17) 294 1147, 294 4395
E-mail: bmer@ipm.by. Internet: http://research.by/

PP/17/04

Monetary and Exchange Rate Policy in Belarus: Analysis and Recommendations

Summary

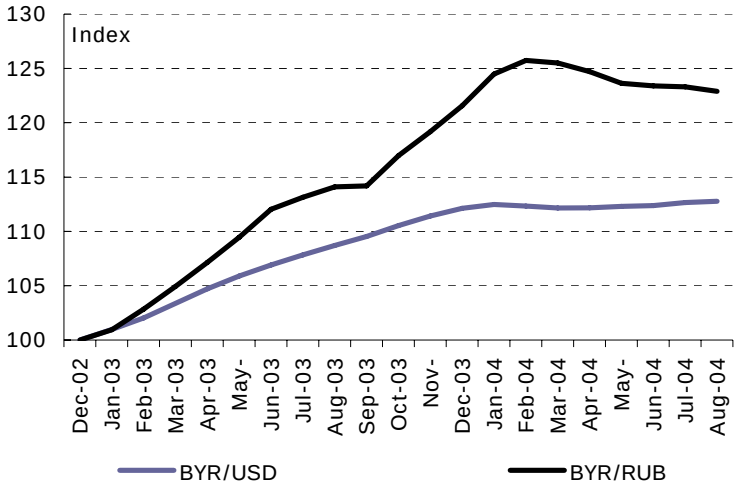
This paper describes and evaluates the current monetary and exchange rate policy of the National Bank of Belarus. After a short description (Part 1), an assessment of the National Bank's policy is provided by means of raising and answering three questions. *First*, we ask whether the current focus on external (i.e. exchange rate) rather than on internal (i.e. price) stability is appropriate (Part 2). Several arguments are presented in support of the existing focus on external stability. *Second*, the question on the right implementation of external stability is raised (Part 3). Instead of the current practice of targeting the US Dollar, we recommend to target a currency basket consisting of three currencies: Russian Ruble, US Dollar and Euro. Besides, we agree in principle with the usage of a crawling band, but the public should be informed more accurately about it. *Finally*, we examine whether the current level of the exchange rate is suitable (Part 4). Devaluation will only become necessary, if the government fails to improve the investment climate and to attract foreign capital as a source of current account deficit financing.

Contents

1. The current monetary and exchange rate policy in Belarus

According to article 25 of the Banking Code, the goal of the National Bank of Belarus (hereafter: NBB) is to ensure the stability of the Belarusian Ruble, including *both* its purchasing power and the exchange rate to other currencies. In the long term, i.e. periods of more than five years, these objectives can be considered as complementary.[1] However, a key insight from economic theory and practice is that it is usually not possible to simultaneously satisfy these objectives in the short term. The coexistence of multiple objectives may become a source of policy conflict, which has to be avoided by setting a clear hierarchy of priorities. Consequently, the NBB has to make the fundamental decision, whether its policy should be focused on reaching internal (i.e. price) *or* external (i.e. exchange rate) stability. The NBB chose for the time being to concentrate on external stability.

Chart 1. Exchange rate of the Belarusian Ruble to the US Dollar and the Russian Ruble



Source: National Bank of Belarus.
Note: December 2002 = 100.

The concrete *implementation* of this fundamental decision can be described using Chart 1. The development of the BYR/USD exchange rate is very smooth and especially much smoother than the BYR/RUB exchange rate. This clearly indicates that the Belarusian Ruble is *pegged to the US Dollar* (and not to the Russian Ruble). Furthermore, one can see that the BYR/USD rate is not constant over time. Thus, we are dealing with a *crawling peg* to the US Dollar. Besides, the rate of devaluation is not constant over time. While in 2003 the Belarusian Ruble depreciated at a monthly rate of 1% vis-à-vis the US Dollar, the exchange rate has practically remained unchanged since the start of 2004. Apparently, the devaluation rate can be adjusted on short notice, if the monetary authorities consider this to be justified. As is usual the case with crawling pegs, a *band* exists within which the exchange rate is allowed to fluctuate. This band seems to be rather tight. Since 2004 the observed fluctuations around the central parity did not surpass 1%. To sum up, a *crawling band* based on the US Dollar seems to be in place. But this crawling band seems to be rather flexible in the sense that the devaluation rate can be adjusted on short notice. Furthermore, the existence of this crawling band has not been communicated to the public in an explicit manner.[2]

1 This view is empirically supported by the fact that economies with a focus on internal stability, i.e. a low rate of inflation, normally exhibit also a high degree of external, i.e. exchange rate, stability in the long-term. Vice versa, countries with chronically high rates of inflation tend to have weak currencies.

2 De jure (as stated in the Monetary Policy Guidelines for 2004), the NBB targets the Russian ruble according to a smooth path of devaluation with a fluctuation band of 4–5%. The chart makes clear that this guideline has not been followed in 2004, as the Belarusian Ruble has revalued vis-à-vis the Russian Ruble.

After this short description of the current monetary and exchange rate policy, we move on to evaluate the policy of the NBB on the basis of the following three key questions:

Question 1: Is the NBB right to focus on external (i.e. exchange rate) stability or should it consider a strategic shift towards internal (i.e. price) stability? Part 2 addresses the fundamental choice between internal and external stability.

Question 2: Is the current implementation (definition) of the external stability appropriate? In Part 3 we discuss alternative exchange rate policies.

Question 3: Does the NBB target the proper level of the exchange rate? Part 4 examines whether a depreciation of the national currency is necessary to achieve an external equilibrium.

2. Should the focus be on internal or external stability?

As described above, the NBB faces the fundamental choice between the objectives of internal and external stability. For Belarus, we recommend that *external* stability should be the predominant objective of the NBB, which is in line with its actual policy. It follows then that the internal stability objective has to be subordinated to this objective. Our recommendation is based on two arguments in favor of external stability (2.1) as well as on two arguments against internal stability (2.2) as the predominant objective.

2.1. Arguments in favor of external stability as the predominant objective

Fixed exchange rates and disinflation

Many emerging markets that have suffered chronically from very high or even hyperinflation have adopted a fixed exchange regime in the hope of rapidly reducing their rate of inflation. General arguments in favor of pursuing fast disinflation are better allocative efficiency and signaling effect of prices.

Fixing the value of the own currency to that of a more stable currency, which is exactly what an exchange-rate peg involves, provides a stable and credible nominal anchor for the economy that has several important benefits. First, the exchange-rate peg fixes the inflation rate for internationally traded goods, and thus directly contributes to keeping inflation under control. Second, a credible exchange rate peg will also reduce domestic inflation expectations to the inflation rate in the anchor country. The lower inflation expectations will then bring the domestic inflation rate in line with that of the stable anchor country relatively quickly. Finally, an exchange rate peg may be more transparent than an internal policy target (e.g. monetary and credit aggregates or the inflation rate). The simplicity and clarity of a peg that is easily understood by the public enhances the credibility of such a policy target.

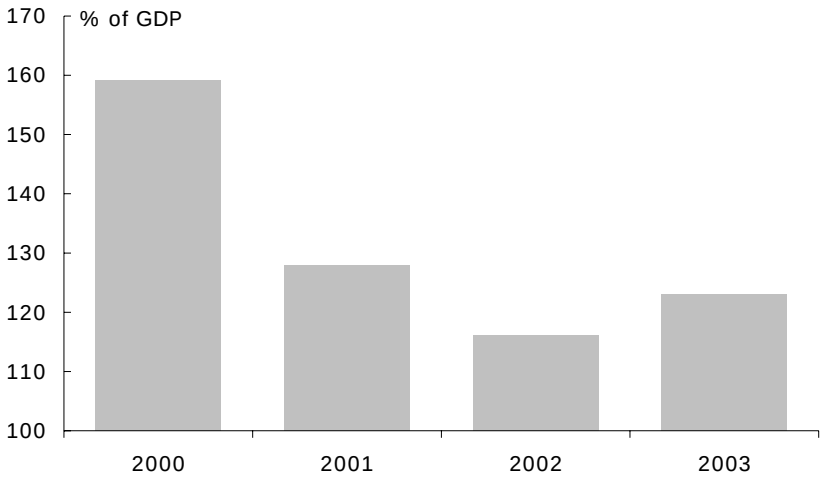
However, an exchange-rate peg has certain implications for domestic policymakers. The regime is inherently fragile, because an attack on a pegged exchange rate can force the abandonment of the peg by stripping away the country's foreign reserves. Policymakers must therefore be able to convince the public that they are willing and able to defend the fixed exchange rate. The commitment to a pegged exchange rate is implicitly a commitment to monetary and fiscal stability, without which a fixed exchange rate cannot be sustained.

High level of foreign trade

The Belarusian economy shows a high degree of openness to foreign trade (Chart 2). In this context, the generally cited advantages of fixed exchange rates are the elimination of exchange rate risk that should stimulate increased trade and investment. Fixed exchange rate regimes provide greater certainty for exporters and importers and can exert a strong discipline on domestic firms and employees to keep their pro-

duction costs under control in order to remain competitive in international goods markets. This argument is especially important for an open economy such as Belarus.

Chart 2. Openness of the Belarusian economy (merchandise trade turnover in % of GDP)



Source: calculations based on data of the NBB and the Ministry of Statistics and Analysis.

Another potential benefit of a fixed exchange rate regime is that by providing a stable foreign value of the currency, this might lower risk for international investors and thus encourage capital inflows, which could stimulate growth. Thus, to the extent that a pegged exchange rate reduces the profit uncertainty associated with exchange rate volatility, it encourages investment and growth.

2.2. Arguments against internal stability as the predominant objective

Problems with the indicator of internal stability

A strategy based on the achievement of internal stability presupposes the selection of a relevant indicator as the measure of internal stability. Usually the inflation rate, as measured by a consumer price index (CPI), serves as an indicator of internal stability. Having transition countries like Belarus in mind, two caveats have to be added here. First, inflation data, and in particular consumer price inflation data, may be subject to measurement errors and may exhibit an upward bias. Due to a dramatic increase in the number of new products and the improving quality of existing products this bias can be substantial in transition countries. Second, an important factor affecting the controllability of inflation that is especially relevant in a transition country context is the high share of government-administered prices (mainly public utility and fuel prices) in the index, especially when some of these prices have some form of backward looking indexation. This constraint restricts the share of “free prices” which monetary policy can influence while adding significant persistence to the inflation rate. Both arguments given above imply that the inflation rate as an indicator of internal stability is both unreliable and less than perfect to control. This supports the focus on external stability further.

Lack of prerequisites for domestic strategies (inflation/monetary targeting)

Apart from the discussion of the availability of an appropriate indicator of internal stability, there can be other reasons why targeting the internal stability of the currency might possibly fail. The two most prominent strategies that use domestic nominal anchors are monetary targeting and inflation targeting.

Monetary targeting is aimed at controlling an established intermediate target, a monetary aggregate, in order to achieve the final goal of low and stable inflation. The preconditions for the successful introduction of monetary targeting are empirically stable

relationships between money and inflation (i.e. a stable demand for money that results in a stable or at least predictable development of its velocity) and the ability to control the broad money supply by the central bank (i.e. a stable money multiplier). When money demand is subject to large random shocks and velocity is unstable, or when shocks to the money multiplier weaken the control of the money supply by the central bank, the effectiveness of monetary targeting is considerably reduced. Indeed, in transition countries such as Belarus, there is often a lack of such stable relationships, or the shortage of historical data makes it impossible to identify reliable ones, therefore this strategy is rarely applied.

The other variant of a domestic monetary policy strategy is *inflation targeting*. Here, the central bank targets the final objective of monetary policy, a low rate of inflation, directly without the use of intermediate targets. This strategy gained importance in a number of industrialized countries, and recently also in several emerging markets. In the context of Belarus, direct inflation targeting is fraught with the difficulty of measuring, forecasting, and controlling inflation, and a lack of knowledge about the relationship between the instruments (e.g. policy rates) and the final objective. Moreover, as in the case of monetary targeting, when monetary policy is forced to respond to domestic economic shocks this strategy carries the risk of large swings in the exchange rate, at least in the short term. Thus, neither monetary nor inflation targeting look attractive to Belarus for the time being.

Conclusion 1: Given Belarus' current stage in the transformation process, the main focus of its monetary and exchange rate policy should be external (i.e. exchange rate) rather than internal (i.e. price) stability. We consequently support the NBB's decision to concentrate on external stability.

3. How should the goal of external stability be implemented?

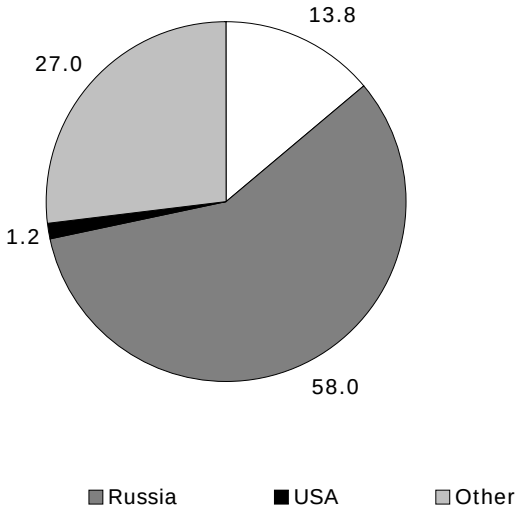
For the practical conduct of monetary policy, the goal of external stability must be implemented. In particular, the NBB has to decide on the anchor currency (3.1), the development of the central parity over time and the allowed fluctuations around it (3.2), and the communication with the public (3.3).

3.1. Choice of anchor currency

A useful starting point regarding the choice of an appropriate anchor currency is the inspection of Belarus' bilateral trade with selected trading partners. Chart 3 presents evidence of the strong economic ties between Belarus and Russia. As measured by trade flows, both economies are highly integrated and the *Russian Ruble* is therefore a likely candidate as an anchor currency. However, there are two major objections why the adoption of a ruble-peg might not be recommendable for Belarus. First, it is not clear to what extent Belarus and Russia form an optimal currency area. This term refers to the likely impact of macroeconomic shocks on the economies involved. An optimal currency area exhibits a symmetric response to shocks, or there are other mechanisms at work (i.e. factor mobility) that help to cushion any asymmetric impacts. In such cases, the exchange rate can be fixed since it is redundant as a policy instrument. Having this in mind, if we look at the external sectors of Belarus and Russia, it becomes obvious that both economies exhibit a very different energy position. External shocks such as higher energy (oil and gas) prices will affect both countries asymmetrically, and ask for different exchange rate reactions. In case of an energy price increase, this will improve the external position of Russia, and induce an appreciation of the Russian Ruble. Conversely, Belarus as a major energy importer will face a worsening of its external position that requires a depreciation of its currency in order to restore external equilibrium. In such a situation, a fixed exchange rate arrangement is clearly inferior to a flexible one, because the latter can play an insulating role in the presence of external shocks. Second, there are doubts whether the Russian

Ruble exhibits the important feature of a credible anchor currency, at least at the moment. As stated in Part 2, a major benefit of an exchange rate peg is the adoption of the low rate of inflation in the anchor country. Here, doubts are justified whether Russia can play this stabilizing role, keeping in mind its more recent history of high inflation and a current rate of inflation that is still high by international standards.

Chart 3. Shares of bilateral trade with Russia, USA, and the EU in total trade (2003)



Source: Ministry of Statistics and Analysis.

A further candidate as an anchor currency is the *US Dollar*, which is the predominant international reserve currency and undoubtedly fulfills the goal of a credible anchor currency. This is in the context of Belarus visible in its widespread use in informal transactions and as a store of value (i.e. a high degree of dollarization) in the economy. However, as chart 3 shows, the level of trade with the United States is extremely low, even though the amount of US dollar-denominated trade is much larger than shown, as main import goods (i.e. oil and gas) are quoted in US Dollar. Hence, we do not advocate a peg to the US Dollar, as the level of trade denominated in this currency is insufficient.

A third candidate as an anchor currency is the *Euro*, which shares several features with the US Dollar with respect to its use as a possible nominal anchor and means of payment in international trade. This currency can also be characterized as a credible anchor currency (as witnessed by the low and stable inflation rate in the countries of the Euro-zone) whose importance as an international reserve currency is slowly increasing. However, as in the case of the US Dollar, this positive feature is not backed by a sufficient trade volume with the Euro-zone, as can be seen in chart 3. Therefore, we do not recommend a Euro-peg at the moment. This situation might change, however, with the enlargement of the European Monetary Union and the introduction of the Euro to the 10 new member states. In the future, we expect Belarus' trade structure to be more heavily weighted towards the Euro than it is right now.

To sum up, the above analysis shows no clear preference for either of the currencies Russian Ruble, US Dollar, and Euro as an anchor currency. In this situation, we recommend the adoption of a peg to a basket of currencies, rather than to a single currency. When the exchange rate peg is to a single currency, fluctuations in the anchor currency against other major currencies imply fluctuations in the exchange rate of the Belarusian Ruble against those major currencies. By pegging to a currency basket instead, Belarus can reduce the vulnerability of its economy to fluctuations in the values of the currencies in the basket, i.e. is less affected by individual shocks to bilateral ex-

change rates. A fact that further supports the adoption of a currency basket is the relatively minor importance of capital account transaction for Belarus, and the associated low level of external debt. In situations where international capital flows are large, and a significant portion of the country's debt is denominated in a foreign currency, this might influence the choice towards a peg to a single currency.

As regards the composition of the basket, due to the current and likely future importance of the three currencies discussed, we recommend a basket consisting of Russian Ruble, US Dollar, and Euro. The share of the individual currencies in the basket should mainly reflect the relative importance of the currency for Belarus (now and in the future). Given the predominant role of trade with Russia, the share of the Russian ruble should be at least as high as the share of the US Dollar and of the Euro. Furthermore, the shares of the US Dollar and Euro in the basket should be roughly the same. This can be justified by the continuing widespread circulation of the US Dollar in Belarus, and a possible increase in the amount of trade with members of the Euro-zone after the enlargement of European Monetary Union. As a result, the basket should have one the following two structures: 50% Russian Ruble, 25% US Dollar and 25% Euro; or alternatively 1/3 each.

Conclusion 2: We recommend to peg the Belarusian Ruble to a basket of currencies including the Russian Ruble, the US Dollar, and the Euro, instead of the current targeting of the US Dollar.

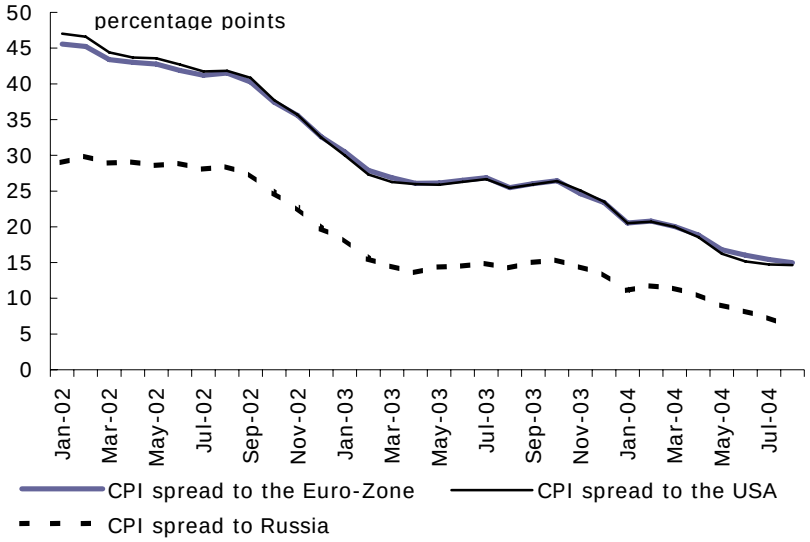
3.2. The fluctuation band and the development of the central parity

The flexibility and degree of monetary policy discretion of a fixed exchange rate system can be increased by placing a *fluctuation band* around the central parity rate, in which the exchange rate is allowed to be determined freely by market forces. Such a band may be necessary for dealing with short-term shocks, for example sudden changes in prices for exports and imports. In such cases, due to the band, the nominal exchange rate can absorb all or at least most of the pressure without loosing its anchoring role for the economy. Especially in view of the very low level of foreign exchange reserves in Belarus, this feature favors the introduction of a band rather than a simple peg, where the central bank is forced to intervene immediately upon deviation of the exchange rate from its parity. The extent to which the exchange rate is allowed to fluctuate within the band has also important implications on the perception of exchange rate risk from the side of the public.

The obvious question that arises in designing such a band system is how wide the band should be. Unfortunately, there are no economic studies that yield clear quantitative estimates of the desirable band width. Countries that have operated band systems have, with some exceptions, usually used widths in the range of up to ±10%.

A further crucial issue is, whether this central parity should be constant (horizontal band), or whether it should be adjusted (i.e. devalued) over time (crawling band). A horizontal band is not advisable for Belarus, since this would imply an ongoing real appreciation of the national currency, given the prevailing high inflation differentials to potential countries with anchor currencies (Chart 4). While there can be positive effects from a real appreciation (this keeps the price of imported goods such as oil and capital goods for the industry artificially low), there are also negative effects on external competitiveness and the export sector, leading to a deterioration of the trade balance.

Chart 4. CPI spreads between Belarus and selected countries



Source: calculations based on data of the IFS, the ECB and the Ministry of Statistics and Analysis.

A *crawling band* is better suited to maintain the anchoring role for the nominal exchange rate, yet at the same time it limits adverse movements in the real exchange rate. A full specification of a crawling band regime requires the identification of the rate at which the band will crawl. Generally, the rate of crawl can be set in a regular backward-looking manner, in order to respond to past inflation differentials, or it can be set forward-looking, at a pre-announced rate that corresponds to expected inflation differentials. In both cases, the band then crawls each day in accordance with the specific formula chosen.

Conclusion 3: In order to avoid a harmful real appreciation of the Belarusian Ruble and to retain the necessary flexibility, the exchange rate system should be established as a *crawling band*, with the rate of crawl determined by the inflation differentials vis-à-vis the basket currencies and a fluctuation band around the central parity. We consequently approve, at least in principle, the current use of a crawling band by the NBB.

3.3. Announcement of the exchange rate policy

The communicative strategy of the central bank is a core element of its policy. While the preceding sections discussed the principle features of a suitable exchange rate regime for Belarus, the question remains how this policy should be announced to the public. From our point of view the main elements of the suggested crawling band system should be disclosed and properly communicated. Information about the current and future stance of monetary policy is a major advantage for the public as it removes unnecessary uncertainty. This is especially the case for a transition country such as Belarus in times of permanent structural change. A communication strategy, which can be relied on, is an important anchor for private sector behavior and a guidepost to the future course of the economy. Consequently, the core elements of the suggested crawling band system (such as the composition of the currency basket the Belarusian Ruble is pegged to, the fluctuation band and the rate of crawl) should be announced and published.

The proposed system still leaves the central bank the necessary *flexibility* to respond to short-run shocks to the economy, which is essential in times of structural change. In cases of negative shocks, the central bank has several opportunities to respond effectively to them within the framework of a crawling band system. A first line of defense might consist of a widening of the fluctuation band, which may smooth adjustment to the effects of the shock. Second, if the central parity or the rate of crawl is out of line with fundamentals, an appropriate modification of the rate of crawl, or a

one-time central parity change is advisable. Third, the composition of the currency basket could be altered if necessary.

Conclusion 4: A strategy of disclosing the main elements of the exchange rate policy will strengthen the credibility of the central bank and improve the conduct of monetary policy.

4. Should the Belarusian Ruble be devalued?

Current account deficits do not pose an economic problem for a country, as long as they are financed by regular and stable flows of foreign capital, preferably in the form of foreign direct investment (FDI). Belarus managed in the past to finance significant deficits (USD 527 m or 3% of GDP in 2003) through rather large, but somewhat sporadic capital inflows. But given the considerable worsening in the investment climate and the standstill in the privatization process, it is questionable whether Belarus will be able to further finance a large current account deficit in the near future. Consequently, Belarus is presently facing an external problem, which has to be solved.

The easiest and best way to solve this problem is to attract foreign capital and especially FDI. For this, the investment climate must be improved significantly and the discrimination of foreign enterprises in several sectors must be eliminated. Furthermore, the privatization process should be drastically speeded up. By pursuing such a policy, the government will crucially contribute in restoring external stability, and a devaluation of the Belarusian Ruble will not be necessary.

Should the government fail to improve the investment climate and to attract foreign investment, then the NBB has to consider other ways of how to restore external stability. The current account deficit could be financed by official reserves. But official reserves should only be used to finance temporary external problems, not structural ones. Besides, official reserves stood at a mere USD 660 m as of October 2004, which cover less than half a month of imports. This is significantly less than the recommended minimum of three months of import coverage. Thus, the only way to restore external stability would be to eliminate the current account deficit. For this, the NBB would be forced to devalue the national currency. Given the financial dollarization in Belarus, devaluation would weaken the banking sector. Besides, it would negatively affect inflation.

So, should the Belarusian Ruble be devalued? If the government manages to improve the investment climate and to attract foreign capital, then there is no need for devaluation. This would be by far the best way to restore external stability. But if the government fails to improve the situation, then the NBB will have to devalue the national currency. In such a case, the blame for the devaluation should not be put on the NBB, but on the government.

Conclusion 5: In order to restore external stability, the government should significantly improve the investment climate and attract foreign investment. A devaluation of the Belarusian Ruble will only be necessary and advisable, if the government fails to attract foreign capital as a source of current account deficit financing.

Authors: Ricardo Giucci, R.K., Christoph Trebesch, Alexander Chubrik (lector)

Berlin/Minsk, November 2004