

**Fifteenth Meeting of the
IMF Committee on Balance of Payments Statistics
Canberra, Australia, October 21–25, 2002**

**Use of Balance of Payments Statistics in Foreign Exchange Policy Formulation:
Russia's Experience**

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Use of Balance of Payments Statistics
in Foreign Exchange Policy Formulation: Russia's Experience

Regulation of the use of BOP statistics for foreign exchange policy formulation presents a number of problems.

General recommendations, when applied to a certain country, are either ineffective or unfeasible.

Apparently, everything depends on the structure of the external sector of the country's economy and the extent of its involvement in the international exchange. It is essential to determine the key factors, the core of the external economic relations, from the outset.

The main factors that cause disequilibrium in Russia's BOP today and make it difficult for this country to maintain a prudent and transparent foreign exchange policy, are as follows:

- significant fluctuations in world prices for crude oil, oil products and natural gas, i. e., commodities which usually account for over a half of Russian exports;
- heavy burden of official foreign debt;
- considerable private capital outflow.

There are reasons to believe that it may be interesting for experts in international economic relations and balance of payments compilers to get an insight into some theoretical and analytical approaches applied in Russia for foreign exchange policy formulation.

The analysis employs the following definitions:

Foreign exchange policy - an established system of government restrictions on the purchase, accumulation and amortisation of foreign assets and liabilities by residents, which is designed to achieve balance of payments sustainability;

Balance of payments sustainability - the state of balance of payments that does not require exceptional financing (IMF loans, government foreign debt service arrears, reduction in foreign exchange reserves);

Hypothetical balance of payments - a balance of payments net of any considerable short-term anomalies in external conditions, which are not accounted for by any fundamental underlying reasons;

Equilibrium balance of payments - a hypothetical balance of payments that does not require exceptional financing and is characterised by zero change in international reserves;

Equilibrium exchange rate - an exchange rate that makes it possible to maintain an equilibrium balance of payments.

The starting point of the analysis is the simple and obvious fact that in general, the international exchange of economic values in an ideal market environment is conducted on the equivalent basis, i. e. on the basis of equality of the labour inputs in the items exchanged. Such arms-length exchange between owners does not require any additional financing by the government.

In BOP terms, this means that the “exceptional financing” indicator, including changes in foreign exchange reserves, should be equal to zero.

Consequently, in ideal market conditions the exchange rate is set based on the ratio of unrestricted supply to demand for foreign exchange, and moves only with changes in the efficiency of production.

In actual fact, the government is heavily involved in foreign economic operations, distorting the market environment, and it is well known that not only fundamental economic factors, but also psychological factors have a role to play in affecting changes in exchange rate correlations.

In the end, government involvement inevitably leads to “exceptional financing” of residents’ international operations, and the psychological factor contributes to unreasonably high exchange rate fluctuations.

In the case of Russia, government financing of foreign trade operations resulted in the accumulation of large official foreign debt that requires huge service and amortisation payments, while the psychological factor lead to undervaluation of the ruble.

As a result, the Russian authorities now have to manage resident foreign trade activities and domestic foreign currency relations in such a way that the mobilised

foreign assets should be sufficient not only to meet the needs of the private sector (current operations and export of capital), but also to effect foreign debt payments. Given this, the focus is to provide incentives to the private sector to transfer foreign assets to the government through the domestic foreign exchange market mechanism. The above approach calls for a set of measures—designed to regulate residents’ external operations and domestic currency arrangements—which constitute the essence of the foreign exchange policy.

In order to assess the efficiency of these measures, a special presentation of the BOP report—where intersectoral flows of foreign assets are clearly identified— is developed and analysed on a regular basis. This presentation is referred to as “The Sectoral BOP.”

Table 1
Intersectoral Flows of Foreign Assets*
(source: Russian balance of payments data)

billion US dollars

	Private sector	Public sector	Bank of Russia
1994	2.3	-0.2	-2.1
1995	-5.9	-4.1	9.9
1996	10.0	-6.5	-3.5
1997	12.6	-13.9	1.3
1998	13.4	-7.5	-5.9
1999	-9.6	8.2	1.4
2000	-26.9	11.8	15.1
2001	-21.5	16.6	4.9
2002 (projection)	-18.9	10.3	8.6

*) + signifies an inflow of foreign assets from other sectors of the economy;

- signifies an outflow of foreign assets to other sectors of the economy.

The data above indicate that since 1999 the private sector has passed a part of mobilised foreign assets to the public sector and the Central Bank through the fiscal and domestic foreign exchange market mechanisms. This may be regarded as evidence of successful foreign exchange policy carried out by monetary authorities.

Foreign exchange policy recommendations for monetary authorities should help them to achieve a “hypothetically equilibrium balance of payments”, i. e. a balance of payments—net of short-term external anomalies, — requiring no exceptional financing, and therefore implying zero movement of foreign exchange reserves.

The process of elaboration of such recommendations includes the following stages:

- compile the BOP forecast, taking into account the indicators used in calculations for the draft federal budget for the next year, including indicators characterising the dynamics of domestic prices, the exchange rate of the ruble and forthcoming foreign-debt payments, and also the world economic and trade forecast;
- identify aberrations in the forecasts of foreign trade situation relevant for Russia;
- adjust the BOP forecast by means of statistical smoothing, i. e. compile a hypothetical BOP;
- in the event of a non-zero balance, conclude that there is an inconsistency between parameters accepted for draft budget calculations;
- select a new exchange rate path and propose an (equilibrium) exchange rate, which makes it possible to achieve an equilibrium BOP at the inflation rate assumed for budget calculations (in practice, a new value of imports is calculated, using the import elasticity index as per the real exchange rate);
- if the hypothetically equilibrium BOP implies a deficit in the projected balance, the latter should be financed from foreign exchange reserves, and if such reserves are insufficient, special foreign exchange regulation measures aimed at restraining private capital outflow should be proposed;
- if a hypothetically equilibrium balance implies a surplus in the projected balance, it should be evaluated from the viewpoint of its compatibility with the parameters of the monetary policy projected for the next year, and should it prove incompatible, measures are proposed for easing foreign exchange restrictions or sterilising excessive inflow of foreign exchange to government reserves.

In the case of Russia with its specific structure of exports, aberrations of foreign trade conditions are defined as significant deviations in world prices of oil, petroleum products and natural gas from their long-term averages or, as another alternative, from “fair” prices.

Table 2 shows the corresponding calculations. One can see from them that a value considered as an aberration in 2001 is \$11.7 billion. In other words, if there were no price aberrations, the balance of payments would be \$11.7 billion short of foreign assets and that, other things being equal, would have a corresponding affect on the dynamics

of foreign exchange reserves. Taking into consideration that actual growth in reserves in 2001 amounted to +8.2 billion dollars, in a hypothetical balance of payments that figure would be –3.5 billion dollars.

Hence the conclusion that the exchange rate dynamics in the period under review slightly differed from the equilibrium one, i. e. on average the exchange rate of ruble was higher than was required by economic realities.

Table 2
Deviation of Actual Value from Value Calculated at Weighted
Average Price for 10 Years (1993-2002)

US\$ million

	Crude oil	Natural gas	Oil products	Total
1993	-5,945.19	441.35	-802.64	6,306.48
1994	-3,462.01	-2,858.59	-1,429.11	-7,749.71
1995	-1,715.05	-2,091.73	-789.21	-4,595.98
1996	1,069.72	197.11	597.44	1,864.27
1997	-184.66	1,756.32	-179.07	1,392.59
1998	-5,910.44	-1,307.72	-2,278.01	-9,496.18
1999	-1,734.42	-3,632.62	-1,445.15	-6,812.18
2000	8,261.41	2,495.45	3,336.89	14,093.75
2001	5,467.58	4,568.16	1,706.33	11,742.07
2002: projection	4,153.07	432.27	1,282.52	5,867.86

As one can see from the above, methods used to formulate the foreign exchange policy and estimate its efficiency in Russia are based on a number of assumptions and simplifications. These are, above all, evaluation of the level of “significant short-term anomalies in foreign trade conditions” and calculation of the equilibrium exchange rate (specifically, this calculation does not take into account the effect of exchange rate movements on private capital outflow).

Moreover, it is assumed that the real exchange rate can be affected by currency interventions without provoking devaluation or inflation. However, this is only true in as much as the economy is capable to absorb additional liquidity in a non-inflationary manner (when there is growth in the demand for money). This assumption makes sense for Russia, given that Russian economy is currently on the rise, and there is a tendency towards a stable level of monetisation and velocity of circulation.