BY ROBER J. BARRO

WHAT MIGHT SAVE RUSSIA: TYING THE RUBLE TO THE DOLLAR

JAY REED

STABILITY
A currency board would exchange the ruble at a fixed rate, eliminating volatility and hyperinflation as threats to the economy

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On a recent trip to Russia, I got an up-close look at some of its economic and political problems. The risks in the situation were evident, but it also seemed that the political turmoil might create opportunities for basic institutional changes. At times like these, drastic new policies sometimes become politically feasible, and it is therefore worth considering reforms that might otherwise be unthinkable.

One attractive proposal is a currency board, whereby the central bank would limit its activity to exchanging the ruble for foreign currency at a fixed rate. Since large quantities of U.S. $100 bills are already circulating and since many domestic transactions are viewed effectively in dollar terms, the natural unit would be a new ruble that equaled one U. S. dollar. But the system could also work in terms of the German mark, euro, or another currency.

The central idea of a currency board is to eliminate exchange-rate volatility and hyperinflation as threats to the economy. The experiences in Argentina and elsewhere have shown that this system can work effectively. However, it is crucial to recognize that a currency board is not a cure-all. It must be combined with an effective economic team and with a broader program that includes fiscal discipline, legal reforms, and improvements in the banking system.

MIXED BLESSING. A currency board is guaranteed to succeed at fixing the exchange rate if the central bank begins with international reserves at least equal to its liabilities-mainly currency and bank deposits-and if these reserves are dedicated to conversions between the domestic and foreign currency at a specified rate. The setup does rule out an independent monetary policy. Some economists view this as a shortcoming, although an independent monetary policy is, at best, a mixed blessing. In fact, a strong point of a currency board is that it prevents the central bank from financing the government (directly or by purchasing public debt), bailing out banks, providing credit to favored industries, propping up stocks, and so on.

The Russian government would foster the idea that the ruble was as good as the dollar by not restricting the uses of foreign currency as media of exchange or stores of value. Since tax collections and other items would remain ruble-denominated, the domestic currency could eventually emerge as the preferred means of payment for most transactions. In this happy state, people would choose to exchange their U.S. currency for ruble-denominated assets.

The currency-board period has to be preceded by a period of floating rates in which the value of the ruble is determined by the market. This market value would depend on expectations about future policies, notably on whether Russia was thought to be moving toward a period of uncontrolled money creation and hyperinflation. The unfortunate fact is that some interval of money creation-to clear the decks by paying wage and pension arrears and to cover some bank deposits-is inevitable. Roughly speaking, the monetary base has to rise by 50% to finance these items. This amount looks large but is actually small in relation to the rises in the ruble-dollar exchange rate and the price level that have already happened.

USEFUL OPTION The key matter is whether the impending money creation is temporary-a drunkard's last drink that precedes the implementation of lasting reform-or a permanent policy that goes along with hyperinilation and the return to a statist economic regime. The reform choice is by no means assured, but its probability would be raised by the presentation of a coherent economic plan, which includes a currency board. Also central is a budget program that involves improved tax collections, reductions in tax rates in areas where collections are minimal, and cuts in public outlays at the federal and regional levels. Another good idea would be the conversion of the domestic and foreign public debts-practically in default now-into long-term, dollar-denominated bonds.

The implementation of a currency board also provides the International Monetary Fund with a useful lending option. Instead of providing funds to Russia that basically disappear and are used as excuses not to carry out budget reforms, the IMF could lend only for the purpose of strengthening the currency board's reserves. To begin, something like $5 billion to $10 billion would be needed to raise international reserves from $12 billion to $13 billion to the required level, which I estimate at around $20 billion. With this policy, the IMF would not only be doing something economically useful but also be raising the probability that its old loans would be repaid.