On Possibility of Artificial Currency Devaluation Within the Customs Union*

Introduction

After Japan’s currency interventions in September 2010, the overall view was that a “devaluation race” had begun, i.e. a situation where countries strive to weaken their currencies so that their economies can gain a competitive advantage. However, the IMF head promptly responded to these statements, saying he sees no threat of a global currency war.

The recent currency interventions by a number of countries can be viewed as a form of protectionism. After World War I, some governments adopted such a policy in order to preserve jobs and protect domestic industry. However, these governments refrained from making more decisive steps towards economic restructuring such as wage cuts or reforms aimed at enhancing labour productivity. Nowadays, currency interventions are largely a means of preventing currencies from rapid strengthening rather than artificial devaluation.

Artificial devaluation entails an increase in exchange reserves and a soft monetary policy. The latter may in turn result in non-optimum distribution of capital and pave the way for bubbles in the housing and other asset markets. Efforts to weaken a national currency at all costs are counterproductive, especially where several currencies are being devalued simultaneously. In such a situation, the price of gold and other precious metals and raw materials will increase, and all participants in a devaluation race will eventually lose, as will all third parties, due to stricter protectionist policies, shrinking international economic cooperation and potential setbacks in the global financial system. Any benefits of devaluation for each individual country will be wiped out by similar actions by neighbouring countries.

At the summit in November 2010 in Seoul, the heads of the G20 agreed that any “war” in this sphere, or any artificial devaluation of national currencies, is inadmissible. Although no direct measures against low exchange rate policies were promulgated, the parties agreed to control swift or chaotic...

* “This paper has been written in November 2010, and only focuses on a possibility of competitive devaluation within the Customs Union. Nevertheless, a Belarusian currency crisis that ended up with a 56% devaluation in May 2011 to some extent confirms our proposition that none of the CU members would have an interest in artificial devaluation of national currency.”
exchange rate fluctuations, to move towards currency systems that would reflect market fundamentals, and to give up competitive devaluation of their currencies. This further indicates their understanding of the harm such protectionist policies may bring about. It is therefore premature to talk about the start of a devaluation race.

In December 2010 the heads of the three Customs Union countries (Russia, Kazakhstan and Belarus) signed the fundamental documents to form the Common Economic Space (CES). With the inception of the Customs Union, the issue of unilateral currency devaluation by any one member becomes even more pressing. What are the prospects for such behaviour, and what consequences would artificial devaluation have in Customs Union states? In this paper we attempt to answer these questions. The next section discusses recent trends in the formation of national currency exchange rates in these three countries. Section III discusses the probability of competitive devaluation. Section IV provides an insight into the effects of real devaluation on trade flows. The last section summarises our analysis.

**The foreign exchange policy in the Customs Union**

Should a country have to fix its national currency exchange rate or, quite the opposite, allow it to float freely? Maybe the Customs Union members should form a monetary union with the neighbouring countries and adopt a common currency, as did the European Union? All these forms of currency regime have already been tested. The ability of a monetary union to stand up to currency wars depends on the situation in each individual country or union.

A monetary union is the most definite form of fixing currency exchange rates. Its most obvious advantage is the stability of the exchange rate. Unlike under a volatile floating exchange rate scenario, the stability of a common currency works to reduce exporters’ risks. Another important advantage is that union members are unable to interfere with the currency market to promote the artificial devaluation of their currencies against those of their partners. A monetary union also has a number of drawbacks. The most notable is the loss of independence in macroeconomic policy making. No central bank in a union can raise or reduce its official rate without consulting its counterparts. If business cycles in union countries are fully synchronised, this process is easy. But where countries need different monetary policies, as is the case with Greece in the European Union, this can pose major problems.

From the perspective of the macroeconomic synchronisation of the Customs Union states, calculations using the System of Indicators of Eurasian Integration (SIEI) (EDB, 2009) in Figures 7.1 and 7.2, suggest that there is no trend towards the macroeconomic convergence of post-Soviet states. The leaders in terms of convergence are small groups, first of all EurAsEC-3 (the Customs Union). The second decade since the disintegration of the Soviet
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Figure 7.1. Macroeconomic convergence
Note: An increase in the index corresponds to lowering of the convergence level

Figure 7.2. Monetary convergence
Note: An increase in the index corresponds to lowering of the convergence level

Union saw the convergence process in all the five post-Soviet country groups. This convergence was driven by similarities in the monetary and credit policies of all countries in the region and, to some extent, trends in the global currency market.

In December 2010 the heads of the Customs Union states met in Moscow to discuss the formation of a Common Economic Space, which is expected to take place in 2012. To this end, a package of documents was signed on various aspects of economic cooperation between Russia, Belarus and Kazakhstan within the CES framework. These documents will become law after ratification by each member state. The most important among the 17 agreements are those pertaining to the coordination of macroeconomic and monetary policies. Macroeconomic coordination will include agreeing currency exchange rates and foreign debt, inflation and budgetary deficit levels; and monetary coordination will include agreeing currency interventions and mutual settlement in national currencies. The initial
version of this agreement provided for closer cooperation in monetary policy making, but then central banks voiced their concerns about losing independence in implementing these policies. The issue of a common currency has not been discussed so far.

**Is a currency war in the Customs Union possible?**

How instrumental can devaluation be in securing a competitive advantage for any of the Customs Union state? To answer this question we need to make a distinction between nominal and real devaluation (i.e. the slumping of a national currency exchange rate), artificial devaluation caused by central bank interference with the currency market, and natural devaluation resulting from a country’s macroeconomic situation.

Real bilateral exchange rates (RER) and real effective exchange rates (REER)\(^1\) reflect actual changes in the standing of a currency and competitiveness of a country. The dynamics of REER and RER in the Customs Union states, as shown in Figures 7.3. and 7.4., have several notable trends. In the period from 2001 to 2009, REER was increasing in Russia and Kazakhstan, which means a trend towards more expensive exports and poorer competitiveness. Belarus’ REER was declining steadily, making the country’s exports more competitive.

The mechanism of nominal artificial devaluation is as follows: a country replenishes its foreign exchange reserves by buying foreign currency on

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\(^1\) REER is calculated as average real exchange rate of the currency of country C against the currencies of all trade partners P:  
\[
\text{REER}_C = \frac{\sum B_{CP} P_{R_C} K_{R_P}}{\sum B_{CP} K_{R_P}} = \frac{\sum B_{CP} \times \text{RER}_{CP}}{\sum B_{CP} K_{R_P}},
\]

where \(B_{CP}\) is share of partner P in trade with country C; \(P_{R_C}\) – prices in country C; \(P_{R_P}\) – prices in partner country P; and \(K_{R_P}\) exchange rate.
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**Figure 7.4.**
RER (2001=100)

Sources: IFS, IMF and the central banks of Russia, Belarus and Kazakhstan.

Note: Upward movement indicates real currency strengthening.

The market, which enables it to issue more national currency and create conditions for nominal devaluation.

In the short term, artificial devaluation will make national exports cheaper compared to those of other countries and encourage growth in demand for the country’s products. These effects are much weaker in industries whose product cost structure is dominated by imported components. However, apart from these benefits for exporters, devaluation of this sort entails some negative consequences. Particularly, devaluation of the national currency renders loans denominated in foreign currency expensive for domestic borrowers. Countries with huge foreign debt may also face problems caused by significant devaluation (this is relevant to Belarus, since its foreign debt accounts for 52% of GDP and is growing rapidly). In countries with historically high inflation levels, artificial devaluation and an excessive supply of money may escalate inflation. On the whole, the real exchange rate of a currency does not change in the medium term. In other words, manipulating exchange rates does not bring about any improvements in competitiveness in the long and medium term, and the costs of artificial devaluation exceed the short-term benefits.

Let us look into the dynamics of five indices (compared to the same month of the previous year) for each country: central bank currency reserves, supply of money M2, exchange rate vs. the US dollar, consumer price index (CPI) and manufacturers’ price index (MPI).

As is shown in Figures 7.5 and 7.6, the monetary mass in Russia changes almost in parallel with currency reserves. Thus, in 2001-2010 monetary mass was growing by 35% per annum on average, resulting in growth in manufacturers’ prices. An insignificant change in the nominal exchange rate
Figure 7.5.
Changes in central bank currency reserves and monetary mass M2 (%)

Sources: IFS, IMF and the central banks of Russia, Kazakhstan and Belarus

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Figure 7.6.
Changes in the exchange rate, CPI and MPI (%)
Sources: IFS, IMF and the central banks of Russia, Kazakhstan and Belarus
caused gradual real strengthening of the rouble (i.e. an increase in REER) and deterioration of competitiveness.

The situation in Kazakhstan is largely identical, apart from volatility: currency reserves were growing by 37% per annum on average throughout the period under review. This resulted in a 40% growth in monetary mass and an 11% growth in manufacturers’ prices. The exchange rate of the Kazakh tenge strengthened somewhat in real terms, albeit to a lesser extent than that of the Russian rouble.

The Belarusian economy differs significantly in this respect from the Russian and Kazakh economies. From 2005 to mid-2008 the Belarusian rouble was fixed against the US dollar, and currency reserves were replenished largely by external borrowing. Therefore, the diagram does not reflect the correlation between changes in money supply and changes in currency reserves. Nevertheless, the expansive monetary and credit policy in 2001-2006 created conditions for an average 34% growth in manufacturers’ prices.

After devaluation of the national currency in 2009 the Central Bank of Belarus introduced a regulated floating rate, thus creating conditions for correlation between currency reserves and the monetary mass (see figure 7.5) and the emergence of inflation pressure in early 2010 (see Figure 7.6). As a result of considerable nominal devaluation of the Belarusian rouble against the currencies of trade partners (namely, Russia) Belarus’ REER gradually declined throughout 2001-2009.

During the 2009 crisis, nominal natural devaluation of the Russian rouble, Kazakh tenge and Belarusian rouble peaked at 47%, 25% and 36% respectively (see Figure 7.6); devaluation against the US dollar in that year averaged at 28%, 22% and 30% respectively.

A higher rate of this devaluation compared with other Customs Union states improved the competitiveness of Belarus’ exports in 2009 by 1.1% on average (Figure 7.4 shows a decline in real bilateral exchange rates of Belarus vs. Russia, and Belarus vs. Kazakhstan).

What are the prospects of artificial devaluation of the Belarusian rouble in the near future? Belarus will probably not need to resort to such a measure in order to maintain competitiveness on the markets of its partners in the Customs Union, as their “raw material” currencies will do this job for Belarus (the rouble and the tenge are likely to strengthen). An important factor that will fuel inflation in Belarus in the near future is the expansive monetary and credit policy; it has been pursued since May 2010 and was partially responsible for a 6% increase in GDP in the first nine months of 2010. This policy also resulted in a significant increase in foreign debt and the cost of labour, and is expected to dramatically reduce Belarus’ competitive advantage and devalue its currency even further.
Our analysis of data confirms that none of the Customs Union countries can artificially devalue its currency in order to improve competitiveness in the medium and long term, because any currency intervention results in an increase in the monetary mass and pressure on prices. Artificial manipulation of the exchange rate can only bring about short-lived growth in demand for exports, but then pressure on prices adjusts the real exchange rate of the national currency.

**What are the consequences of real devaluation?**

As we have mentioned in the previous section, a country cannot make its exports more competitive by means of artificial devaluation. A real exchange rate, which indicates a country’s competitiveness, is determined solely by macroeconomic policy and the changing situation on external markets.

Any change in competitiveness (e.g., real currency devaluation) must change (increase) demand for the country’s exports. Let us look into a connection between exports and real exchange rates in the Customs Union states. Table 7.1 shows the ratios of correlation between real bilateral exchange rates and export flows, by commodity group. Commodity groups that account for at least 10% of a country’s total exports to any importing country are marked bold. Grey cells contain net export commodity groups in 2001–2009. Since, in accordance with economic theory, real devaluation is beneficial for a country’s exports, the correlation ratio value must be negative. A higher ratio indicates closer correlation between exports and real exchange rate\(^2\).

For Russian exports, a positive correlation ratio means that real devaluation of the rouble is unlikely to further Russian exports considerably, as the Russian economy is heavily dependent on export of resources, which prices are dictated principally by the global situation. Real devaluation will not influence the competitiveness of Russian exports.

The situation is different in Belarus: correlation ratios are negative in all industries, however, just like in Russia and Kazakhstan. A positive trade balance in many commodity groups indicates Belarus’ strong competitive advantage over its partners in the Customs Union. If the competitive conditions of trade with Russia improve, Belarus’ food, textile, shoes and mechanical engineering will have an advantage. Belarus is a net exporter in trade with Kazakhstan and has a competitive advantage in practically all non-raw-material commodity groups.

Kazakhstan has a negative correlation value in trade with Russia and in some commodity groups exported to Belarus. Particularly, improved competitiveness in trade with Belarus will benefit textiles and shoes.

\(^2\) Notably, since ratios were computed based on the annual values of nine years (2001–2009), correlation ratios are statistically insignificant.
transport equipment, furniture and sports equipment. On the whole, these industries are of little significance for the economy.

Therefore, calculations of simple correlation ratios indicate that Belarusian exports have an advantage over the exports of Russia and Kazakhstan. Being a net exporter of food and electric and transport equipment to Russia and Kazakhstan, and having a competitive advantage in these commodity groups, as well as pursuing flexible monetary and credit policy, Belarus can secure long-term growth in exports within the framework of the Customs Union. The Russian and Kazakh economies depend principally on exports of raw materials and therefore are not sensitive to parity changes in the prices of export products.

**Conclusions**

Artificial devaluation is not in the interests of the Custom Union members. Our analysis of data confirms that none of the Customs Union countries

<table>
<thead>
<tr>
<th>HS code</th>
<th>Commodity group</th>
<th>Russian exports to Kazakhstan</th>
<th>Kazakh exports to Russia</th>
<th>Belarusan exports to Kazakhstan</th>
<th>Kazakh exports to Belarus</th>
<th>Russian exports to Belarus</th>
<th>Belarusan exports to Russia</th>
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<tr>
<td>01–24</td>
<td>Food and farm produce</td>
<td>0.82</td>
<td>-0.61</td>
<td>-0.79</td>
<td>0.31</td>
<td>0.6</td>
<td>-0.94</td>
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<td>25–27</td>
<td>Minerals</td>
<td>0.83</td>
<td>-0.78</td>
<td>-0.59</td>
<td>0.76</td>
<td>0.98</td>
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<td>28–39</td>
<td>Chemicals</td>
<td>0.84</td>
<td>-0.82</td>
<td>-0.77</td>
<td>0.84</td>
<td>0.86</td>
<td>-0.92</td>
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<td>40–49</td>
<td>Rubber</td>
<td>0.85</td>
<td>-0.83</td>
<td>-0.68</td>
<td>0.28</td>
<td>0.52</td>
<td>-0.96</td>
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<td>44–49</td>
<td>Timber and paper</td>
<td>0.87</td>
<td>-0.58</td>
<td>-0.57</td>
<td>0.57</td>
<td>0.75</td>
<td>-0.76</td>
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<td>50–67</td>
<td>Textile and shoes</td>
<td>0.9</td>
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<td>-0.55</td>
<td>-0.34</td>
<td>0.75</td>
<td>-0.79</td>
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<tr>
<td>68–71</td>
<td>Cement, glass and precious metals</td>
<td>0.87</td>
<td>-0.59</td>
<td>-0.08</td>
<td>0.6</td>
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<td>-0.83</td>
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<td>72–83</td>
<td>Iron and steel</td>
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<td>-0.82</td>
<td>-0.64</td>
<td>0.81</td>
<td>0.81</td>
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<td>84–85</td>
<td>Electric machinery and equipment</td>
<td>0.82</td>
<td>-0.86</td>
<td>-0.54</td>
<td>0.54</td>
<td>0.67</td>
<td>-0.87</td>
</tr>
<tr>
<td>86–89</td>
<td>Cars and transport equipment</td>
<td>0.82</td>
<td>-0.55</td>
<td>-0.46</td>
<td>-0.33</td>
<td>0.73</td>
<td>-0.64</td>
</tr>
<tr>
<td>90–93</td>
<td>Instruments and optic equipment</td>
<td>0.86</td>
<td>-0.67</td>
<td>-0.68</td>
<td>0.43</td>
<td>0.56</td>
<td>-0.76</td>
</tr>
<tr>
<td>94–97</td>
<td>Furniture, toys and sport equipment</td>
<td>0.88</td>
<td>-0.52</td>
<td>-0.59</td>
<td>-0.44</td>
<td>0.52</td>
<td>-0.83</td>
</tr>
<tr>
<td>99</td>
<td>Others</td>
<td>-0.26</td>
<td>-0.33</td>
<td>-0.43</td>
<td>0.39</td>
<td>0.91</td>
<td>-0.93</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>0.85</td>
<td>-0.8</td>
<td>-0.62</td>
<td>0.73</td>
<td>0.95</td>
<td>-0.89</td>
</tr>
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Table 7.1. Ratios of correlation between exports and real bilateral exchange rates in the Customs Union (2001–2009)

*Source: computed based on IFS, IMF and TradeMap International Trade Centre statistics*
can artificially devalue its currency in order to improve competitiveness in the medium and long term because any currency intervention results in an increase in the monetary mass and pressure on prices. Artificial manipulation of the exchange rate can only bring about short-lived growth in demand for exports, but then pressure on prices adjusts the real exchange rate of the national currency.

The flexibility of export prices means that exports are inversely proportional to the real exchange rate, i.e. a comparative growth in prices must result in a decline in demand for exports. A simple correlation calculation based on nine years of annual data showed an inverse relationship between bilateral exports and real exchange rates of the Russian and Kazakh currencies, which reflects the raw material orientation of these economies. The most important commodity groups of Belarus have negative correlation ratios, which indicates that Belarus has good prospects for growth in exports; this country trades mainly in non-raw-material products with its Customs Union partners.

Of course, the Customs Union economies differ from each other in macroeconomic structure. Therefore, the formation of the Common Economic Space will require a well-balanced approach towards concerted macroeconomic and foreign trade policy making.

**Annex 7.1. Structure of foreign trade within the Customs Union (%)**

![Russian exports to Kazakhst](image)

![Kazakh exports to Russia](image)
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Russian exports to Belarus

Belarusian exports to Russia

Belarusian exports to Kazakhstan

Kazakh exports to Belarus

Source: TradeMap