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International capital markets and exchange rate stabilization in the CIS

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In this paper, we examine the rationale for dollar and euro pegging in Russia and the CIS. We consider macroeconomic stabilization and transaction costs for international trade as rationales for pegging to the euro. Dollarization of international assets and liabilities are examined as determinants of exchange rate stabilization against the dollar. The impact of network externalities from a common anchor for all CIS countries is explored. Tests on de facto exchange rate stabilization reveal that dollar pegging has been pervasive in the CIS. *Journal of Comparative Economics* 33 (3) (2005) 425–440. Department of Economics and Business Administration, Tübingen University, Nauklerstrasse 47, 72074 Tübingen, Germany.

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1. Introduction

The rising US twin deficit and the sustained fall of the US dollar have triggered significant increases of foreign reserves and the money supply in countries pegging their

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exchange rates to the dollar. Reflecting the dynamics of increasing international imbalances involving the US currency, the Central Bank of Russia announced plans to give a higher weight to the euro in its daily exchange rate operations in early 2005. The chances of the euro becoming an anchor currency for the Russian ruble seem realistic from the perspective of macroeconomic stabilization and transactions costs for international trade. Since the euro has evolved into an international currency, it may qualify as a credible anchor for Russian monetary policy. Because the EU25 is Russia's most important trading partner, transaction costs for Russian trade would decline.

However, exchange rate stabilization against the dollar has persisted in Russia up to late 2004. Several papers elaborate the rationale for dollar or euro pegging in Russia and the CIS. [Rautava \(2004\)](#) examines the role of oil prices and the real exchange rate in Russia's economy using a vector autoregression framework and finds that Russian economic performance is influenced strongly by both factors. From this perspective large inflows of petro dollars may explain dollar pegging. [Keller and Richardson \(2003\)](#) identify the dollarization of Russia's international and domestic assets and liabilities as the motivation for stabilizing exchange rates against the dollar. If the CIS economies remain highly dollarized, reducing exchange rate volatility against the dollar is equivalent to enhancing financial stability.

Taking the increasing importance of international capital flows for exchange rate stabilization into account, we test for de facto exchange rate stability of the CIS currencies against the dollar and euro. The remainder of the paper is organized as follows. Section 2 provides the rationale for exchange rate stabilization in the CIS countries and identifies the euro as a candidate for the nominal anchor. Although exchange rate policy in these countries has followed dollar pegging for most of the period, de-dollarization pressures are identified. Section 3 considers the network externalities of using an informal common anchor for the CIS countries. Section 4 establishes the de facto exchange rate stability of the currencies in these countries before and after the Russian crisis. Section 5 concludes with some observations about the possibility of shifting from a dollar peg to a euro-based anchor.

2. Determinants of exchange rate stabilization in the CIS

[McKinnon and Schnabl \(2004a, 2004b\)](#) provide the rationale for applying the fear of floating argument of [Calvo and Reinhart \(2002\)](#) to developing and emerging market countries. They argue that exchange rate regimes are not chosen exogenously based on specific targets of economic policy making, e.g., reducing the risk of a speculative crisis. Rather, the regime choice is endogenously determined by several inherent and interdependent factors, e.g., macroeconomic stabilization, dollar or euro invoicing of international trade, and dollar or euro denomination of international capital flows.

The euro qualifies as an anchor currency for the CIS for two reasons. First, the Euro Area constitutes a large closed economy having a large volume of international trade. Inflation is low and government debt in the Euro Area, which may be taken as a proxy for future inflation, is moderate on average. Since capital markets are highly developed, the

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