PONARS Eurasia
NEW APPROACHES TO RESEARCH AND SECURITY IN EURASIA

Lessons (Half) Learned

Comparing the 1998 and 2014 Ruble Crises

PONARS Eurasia Policy Memo No. 370
July 2015

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"Reforms begin when the money runs out."
- Sberbank president German Gref, May 2015

In December 2014, Russia experienced the most significant drop in the ruble's value since the financial crisis of August 1998—an event that proved devastating to then-president Boris Yeltsin's government and its "oligarch" financiers. The December crisis encouraged pundits and scholars to make comparisons with 1998 and to wonder whether dire consequences might be in store for Vladimir Putin's government as well. Yet despite certain similarities between the two crises, the Putin government has weathered the storm far better than did Yeltsin's. This is because of three key lessons that Putin and his team learned from 1998 and successfully applied in subsequent years. An equally important lesson remains only half-learned, however, with significant future implications for the Putin regime and Russia's economic development trajectory.

Similarities between the Ruble Crises

Markets were bullish on Russia throughout 1997, and the Central Bank of Russia (CBR) felt so confident in the sustainability of its earlier stabilization efforts that it redenominated the ruble in January 1998, knocking three zeros off the end. The ruble seemed similarly under control in early 2014, so much so that the CBR began limiting its currency-market interventions to move toward an inflation-targeting regime. Even the March 2014 Crimean takeover and ensuing Western sanctions had little effect on the ruble—that is, until oil prices began falling last summer.

In both cases, Russia's status as a major energy exporter meant that a dramatic drop in world oil prices played a key role in fomenting crisis. Changes in the ruble's value closely track changes in oil prices over time. Prices fell by over 50 percent in 1998 before the August crisis and by over 40 percent in late 2014 (falling to below $56/barrel from a summer price peak of $107). Ironically, in both cases events surrounding the state-

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owned oil company Rosneft were a crisis trigger. The government's failed attempt to sell Rosneft in July 1998 brought its solvency into question. In December 2014, Rosneft's need to find $14 billion to pay foreign currency debts that could not be refinanced internationally due to sanctions spooked ruble markets.

These pressures contributed to sudden drops in the ruble's value in August 1998 and December 2014, followed by re-stabilization a few months later. Both crises stoked inflation, encouraged capital flight, discouraged investment, and prompted the government to provide emergency funds to bail out leading banks and companies. Inflation hit 27.6 percent in 1998 and 85.7 percent in 1999; while not as severe, 2015 headline inflation is running near 17 percent, with food price inflation higher. Capital flight in 1998 was $25 billion—significant for the Russian economy at the time, far exceeding international reserve levels—with another $15 billion following in 1999. Capital flight in 2014 hit an all-time high of $151.5 billion and is projected to reach $110 billion in 2015. The crises affected Russian economic growth rates as well. GDP fell by 4.9 percent in 1998 and then rebounded by 6.9 percent in 1999, supported by a recovery in oil prices and a boost in exports from the ruble depreciation. Current predictions are that Russia's GDP will fall by 3-5 percent in 2015 and return to growth in 2016, for largely the same reasons.

Yet the political consequences of the two crises for Russia could hardly be more different. In 1998, the crisis led to a full-scale government shakeup, including replacement of both the prime minister and central bank governor. Yeltsin's already low popularity nose-dived after August and bottomed out in the single digits in late 1998; in 1999, the largest party in the Russian parliament, the Communists, began proceedings to impeach him. In contrast, the 2014 crisis seemingly had few political consequences for Putin or his government. No high-level officials were fired, social unrest has been minimal, and Putin's popularity has actually risen, reaching an astonishing 89 percent in June 2015. In fact, Putin's approval rating from late 2014 through early 2015 moved in opposition to the exchange rate—as the exchange rate fell, his popularity increased. The 1998 crisis represented the beginning of the end for the Yeltsin era, while the Putin government has remained in control and on message. The financial crises had such different political effects because the Putin government learned and applied three key lessons from 1998.

Lesson #1: You can never have too many reserves or too little debt

The Russian government spent about $27 billion to defend the ruble in the six months before the 1998 crisis, exhausting its international reserves. Russia never held more than $25 billion in reserves at any time during the 1990s, and holdings dipped below $11 billion after the 1998 crisis. The government was running a significant budget deficit and took on over $18 billion in new sovereign debt in the first half of 1998. The IMF provided an emergency loan to help stabilize the ruble, but the funds disappeared into the currency markets and failed to forestall the crisis. Without enough money to defend the ruble or pay its creditors, the Russian government defaulted and let the ruble fall.

The new Putin government learned from 1998 that it needed a reserve buffer to protect the country from currency and budget crises sparked by oil price fluctuations. When oil prices started to rise again, the government used the opportunity to build up the Central Bank's reserves. Putin has been lucky to govern during a time of high oil prices, but he was also smart in using the windfall to stabilize the budget and amass reserves.

Russia paid off its outstanding foreign debt ahead of schedule and in 2004 created a sovereign wealth fund (the Stabilization Fund, later split into the Reserve Fund and the National Wealth Fund). From just over $12 billion on the eve of Yeltsin's resignation, Russia's international reserves rose to nearly $600 billion at their height in mid-2008. Reserves still stood at over $500 billion at the start of 2014, more than enough to give the government a healthy cushion to defend itself against shock, speculation, and sanctions. Indeed, before Russia's takeover of Crimea, Putin was reported to have asked his aides if Russia had sufficient reserves to buffer it from potential Western sanctions; when assured that it did, he proceeded with his plans.

What did this mean for the 2014 crisis? The Russian government could spend over $90 billion by mid-November 2014 and then billions more in December and the first quarter of 2015 to smooth the ruble's decline. Although reserves had fallen to $356 billion by May 2015, there was still enough left to cover Russia's import costs and the foreign exchange requirements of sanctions-hit companies needing to pay foreign-currency debts. The high reserves and low government debt forestalled any hint of government default, in sharp contrast to 1998. After a moment of panic in December, most Russians came to see the crisis as manageable, which in turn tempered its political fallout.

Lesson #2: Crisis management requires executive control and coordination

Russia's own leading banks and companies helped drive it into crisis in 1998. The Yeltsin government was dependent upon the so-called oligarchs, who owned the most profitable natural resource companies, controlled the media, and had banks that held major government accounts and domestic government debt. The CBR fought to support the ruble in 1998 in great part because of the extensive foreign-exchange debts and contracts of the oligarchs' banks, obligations that could (and in the end did) ruin many of them when the exchange-rate corridor broke. At the same time, Yeltsin's political opposition in the parliament prevented the government from adopting a more realistic budget that might have helped to fend off its own foreign creditors.

This same lack of control and coordination further undercut Yeltsin in the aftermath of the crisis. The CBR was forced to introduce formal capital controls in order to stabilize the currency, the media undermined confidence in the government's ability to revive the economy, and the Duma twice rejected Yeltsin's first post-crisis nominee for prime minister before later moving to consider Yeltsin's impeachment. This all fed the perception that the Yeltsin government and economic model had run their course, that Yeltsin's team had no answers for Russia's most pressing problems.

The new Putin government learned from Yeltsin's experiences that it needed to control and coordinate the "commanding heights" of the economy, the media, and the political system. The 1998 crisis facilitated this endeavor by bankrupting and otherwise undermining many of the oligarchs, giving Putin the opportunity to force them into submission once he came to power. Over the following years, Putin brought big business and finance increasingly under state control, put his own allies in the CBR, reasserted state domination over the media, and tamed parliament.

These efforts paid off during the December 2014 crisis. When it became clear that large export companies needing to make foreign currency loan payments had stoked demand for U.S. dollars in Russia, the government had no need to resort to formal capital controls. Instead, Putin and his team informally instructed Russian export companies to sell foreign currency; orchestrated an arrangement to provide them with foreign-currency loans and guarantee enough ruble liquidity to cover domestic obligations; opened up the National Wealth Fund; and "requested" that companies coordinate foreign exchange sales with each other and the CBR in the future. This coordinated intervention, one that would have been impossible in 1998, stabilized the currency markets. Then, with the help of the media and parliament, in order to deal with the aftermath of the crisis the government put into play the third lesson from 1998.

Lesson #3: Blame foreigners

Although internal political and economic conditions made Russia ripe for crisis in August 1998, external factors played an important role. Russia's 1998 crisis followed hot on the heels of the 1997 Asian financial crisis, as foreign portfolio investors hit by the downturn in Asia pulled their money out of the Russian stock and GKO (short-term government debt) markets. OPEC's decision to increase production just as the 1997 shocks were reducing demand in Asian markets led to an oil glut and price collapse that dealt a further blow to the Russian economy. Both the exchange-rate corridor that allowed the ruble to become dangerously overvalued and the GKO market that turned into a government pyramid scheme had been introduced with Western encouragement and assistance. Yet after the 1998 crisis, Yeltsin took the lion's share of the blame. In fact, much of the Russian media blamed Yeltsin for the external factors as well, arguing that his poor leadership had allowed foreign money and influence to weaken Russia.

External factors played a significant role in the December 2014 crisis as well. Falling world oil prices, wary foreign investors, and Western sanctions all contributed to the ruble's collapse. Nonetheless, like Yeltsin before him, Putin could have received much of the blame. His decision to reclaim Crimea and destabilize eastern Ukraine had triggered sanctions, spooked investors, and encouraged capital flight in the first place; his counter-embargo of EU agricultural products had boosted inflation; his military spending had begun to stretch the budget; and the CBR's repeated declarations that it would fight inflation rather than support the ruble put downward pressure on currency markets. But not only did Putin avoid taking the blame, he successfully used his control over the media and the political system to frame the crisis as a direct result of conflict with a hostile West. Unlike Yeltsin, the Putin government portrayed itself as a bulwark against Western threats. Enemies had tried and failed to bring Russia to its knees, but Russia under Putin was too strong, too wily, and too resilient to break. Blaming foreigners for Russia's perilous economic predicament so far seems to have made Russians more willing to excuse inflation and recession than they were in 1998.

One Lesson Half-Learned

The 1998 crisis provided another important lesson as well, one that remains only half-learned—that Russia needs to modernize and diversify its economy. Russian officials repeated this call with increasing urgency after the 2008 global financial crisis. But the Russian government has yet to learn that it cannot effectively modernize and diversify under its existing political system. The patronage system that sustains Putin's "power vertical" demands the redistribution of state resource rents to regime supporters and rests on informally institutionalized corruption. Russia's growth and investment rates had already slowed prior to 2014 as this system began to run out of economic steam, despite the government's avowed focus on modernization and diversification. Moreover, although currency crises raise awareness that diversification is needed, they also make it harder to carry out by increasing the relative competitiveness of natural resource export sectors and discouraging risky and expensive investment in alternative sectors. Ongoing sanctions further stifle modernization efforts by restricting Russian access to Western technologies and financing.

The Putin government has attempted to square the circle by pursuing non-Western sources of finance and technology as well as by encouraging development and diversification through state investment in the military-industrial complex. However, these efforts are unlikely to be effective. Over the past few years, the government has been spending more and more money with fewer economic results to show for it. Russia's patriotic militarization, pivot to Asia, troubled Eurasian Economic Union, call for import substitution, "de-offshorization" of the Russian elite, and overt challenges to the Western-dominated international financial system are all indications of an increasingly frustrated government attempting to retain power while escaping its current geopolitical and economic circumstances, with U.S. and EU sanctions pushing it further and faster along this reactionary path.

What will happen next? In the medium-term, sanctions and low oil prices will take a budgetary toll. The government cannot borrow on standard international markets. Its reserves will provide a buffer, but only temporarily unless oil prices recover. The CBR will also have a challenging time restraining inflation. There will be difficult choices for Russia to make over the next few years. Sberbank's German Gref may be correct that reforms begin when the money runs out, but as the history of financial crises in Russia illustrates, "reform" will not necessarily mean political or economic liberalization.

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