Juliet Johnson and David Woodruff

Currency crises in post-Soviet Russia

Article (Accepted version)
(Refereed)

Original citation:
Johnson, Juliet and Woodruff, David. (2017) *Currency crises in post-Soviet Russia.* Russian Review 76, (4) pp. 612-634 ISSN 1467-9434

DOI: 10.1111/russ.12150

Currency Crises in Post-Soviet Russia

Juliet Johnson
McGill University

David Woodruff
London School of Economics

This is a preprint of an article accepted for publication in *Russian Review* (forthcoming October 2017).

Abstract: Currency crises have been a recurrent feature of Russia's post-Soviet experience. This paper examines three episodes of sudden and sharp ruble depreciation in 1998, 2008, and 2014-16. We examine these crises and their political consequences as iterative episodes in the Russian government's ongoing efforts to deal with its structural dependence on energy revenues and international capital flows. We argue that the 1998 crisis and the Russian government's response to it proved effective in transforming policies and institutions that had contributed to the ruble's collapse, but also paradoxically reinforced the central role of resource revenues and international capital flows in Russia's political economy. Policy decisions after 2008 then represented variations on a theme, leaving the Russian government better able to manage future currency crises while simultaneously maintaining and deepening the state's underlying structural vulnerabilities as well as its patronage-based political-economic system. The crisis of 2014-16 may, however, ultimately bring greater shifts in policy as Russia adapts to fundamentally changed international circumstances.

Currency crises have been a recurrent feature of Russia's post-Soviet experience. This paper examines three episodes of sudden and sharp ruble depreciation in 1998, 2008, and 2014-16. While the causes of the crises did vary to a certain extent, the more profound and consequential variation was in their effects. Many of the most significant features of Russia's 21st-century politics and economics have their origins in the immediate aftermath of the August 1998 collapse of the ruble. By contrast, the crisis of 2008 had quite limited effects on domestic governance and the character of Russia's insertion into the international economy while the outcome of the 2014-16 crisis remains uncertain.

We examine these crises and their political consequences as iterative episodes in the Russian government's ongoing efforts to deal with its structural dependence on energy revenues and international capital flows through adjustments to monetary and fiscal policy, with particular emphasis on the exchange-rate regime. This dependence manifests itself in the direct effect of international commodity prices on Russia's state budget, in the significant weight of the oil/gas industry in influencing cross-border capital movements, and in the importance of international capital to the everyday operation of the Russian economy.

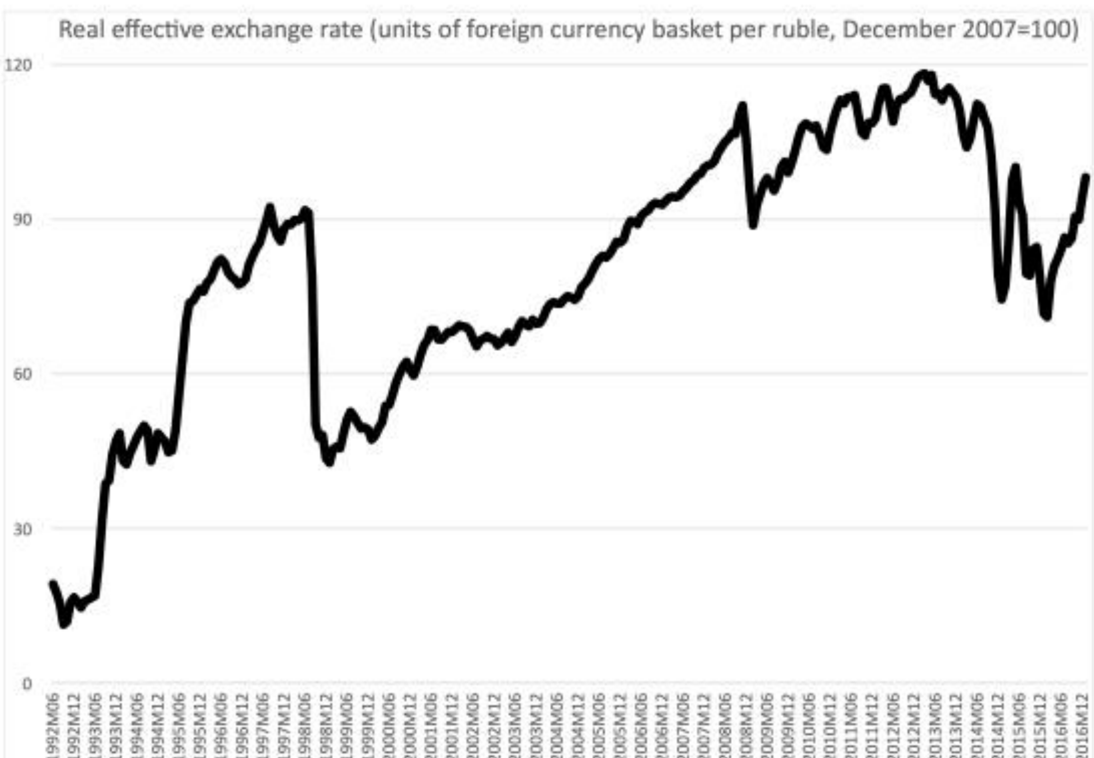
We argue that the 1998 crisis and the Russian government's response to it proved effective in transforming policies and institutions that had contributed to the ruble's collapse at the time, but also paradoxically reinforced the central role of resource revenues and international capital flows in Russia's political economy. Policy decisions after 2008 then represented variations on a theme, leaving the Russian government better able to manage future currency crises while simultaneously maintaining and deepening the state's underlying structural vulnerabilities as well as its patronage-based political-economic system. The crisis of 2014-16 may, however, ultimately bring greater shifts in policy as Russia adapts to fundamentally changed international circumstances.

Currency Crises and the Challenges of Russia's Exchange-Rate Policy

A currency crisis occurs when a country experiences a sharp and sudden depreciation in the value of its currency, typically as measured against the US dollar or a basket of leading international currencies.[1] As Paul Krugman notes, "There is no generally accepted formal definition of a currency crisis, but we know them when we see them. The key element is a sort of circular logic, in which investors flee a currency because they fear that it might be devalued, and in which much (though not necessarily all) of the pressure for such a devaluation comes precisely from that capital flight."[2] Currency crises are a common phenomenon historically and can snowball quickly across countries during times of general international financial turmoil such as the Asian Crisis of 1997 or the Global Financial Crisis of 2007-08.

Russia experienced three major currency crises after its initial 1992-95 post-Soviet economic transformation and apparent macroeconomic stabilization: in 1998, 2008, and 2014-16. In all three cases the ruble suffered significant drops in its nominal as well as real exchange rates vis-à-vis both the US dollar and a broader currency basket (e.g., Figure 1).

Figure 1: Real Effective Exchange Rate of the Russian Ruble, 1992-2017



[1] Economists often identify a currency crisis as involving at least a 30 percent nominal depreciation as well as a 10 percent increase in the rate of depreciation as compared to the year before. See Luc Laeven and Fabián Valencia, "Systemic Banking Crises: A New Database," *IMF Working Papers* 8/224 (2008).

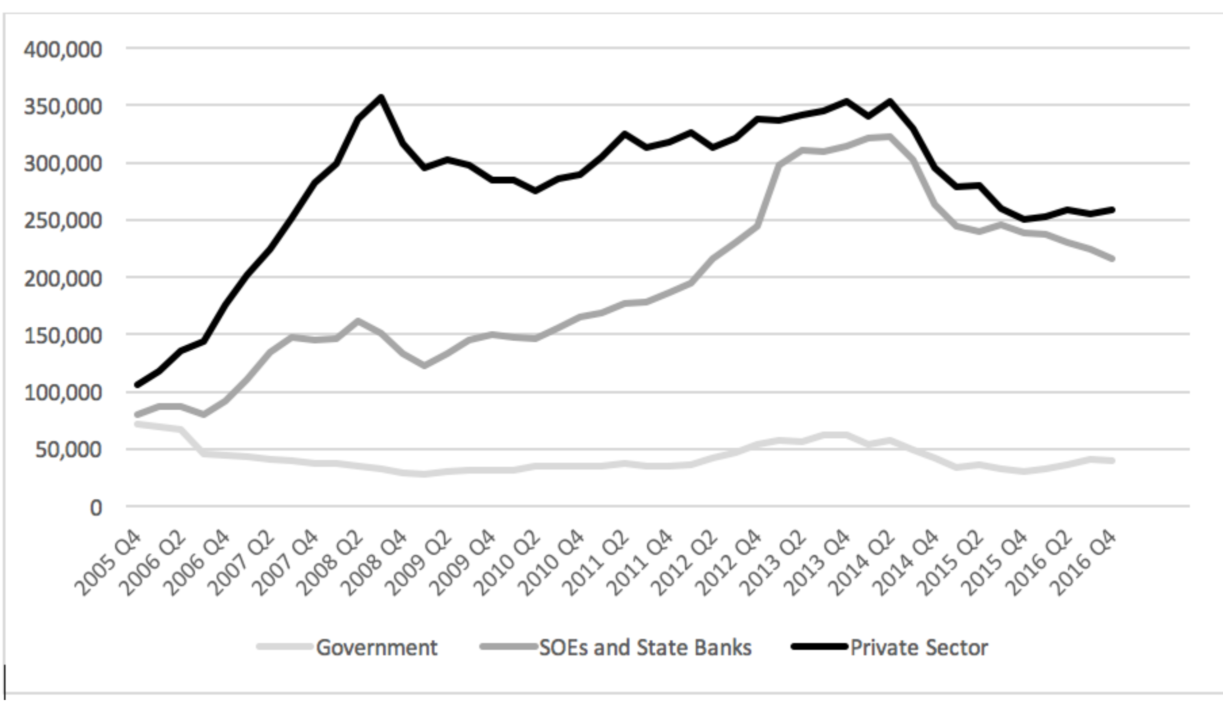
[2] Paul Krugman, ed., *Currency Crises* (University of Chicago Press 2000), p. 1.

Source: Calculated from http://bruegel.org/publications/datasets/real-effective-exchange-rates-for-178-countries-a-new-database/

Although there is much debate over what makes some countries more vulnerable to currency crises than others, resource dependence and a related reliance on international capital flows have played key roles in Russia. Russia is one of the world's leading producers and exporters of oil, gas, and petroleum products, and such exports have been crucial to supporting the Russian budget and to Russian economic growth. Given that gas contracts are traditionally set in direct reference to oil prices, the importance of both oil and gas to Russia's economy leaves Russia especially vulnerable to price swings, making it difficult for the government to plan its budget and to conduct monetary policy. Rapid declines in international oil prices preceded all three Russian currency crises. Russia's dependence on natural resource revenues continued to rise after the 1998 and 2008 crises, with energy sales accounting for over three-quarters of Russian exports by January 2012.

Likewise, by the mid-1990s the Russian government, large corporations, and leading banks all began to rely heavily on international capital flows to build and maintain their operations. While the government itself began to eschew foreign debt after the 1998 crisis (discussed below), in the context of rising and volatile resource prices as well as an underdeveloped domestic banking sector, companies and banks increased their dependence on foreign-currency operations, loans, and investment (Figure 2). As such, it is no surprise that in addition to falling commodity prices, all three currency crises occurred at moments in which Russia experienced a contraction in access to international capital. In 1998 and 2008 this contraction occurred in the context of the Asian and global financial crises, while in 2014-16 US and EU financial-sector sanctions limited Russian companies' abilities to tap international financial markets.

Figure 2: External Debt of the Russian Federation, 2005-16 (in million USD)



Source: Calculated from Central Bank of Russia, https://www.cbr.ru/Eng/statistics/?PrtId=svs

The Russian government has over time employed a range of monetary and fiscal policies to attempt to mitigate these vulnerabilities. Central to this approach has been the evolution of Russia's exchange-rate management strategies. Exchange-rate management the world over involves not just the clash of particularistic economic interests, but also choices between incompatible policy priorities. Three trade-offs are of particular significance.[3] The first trade-off balances competitiveness against purchasing power. While a relatively weak currency makes exporters and import-competing firms more competitive, it also reduces the purchasing power of domestic consumers compared to international ones.

The second trade-off involves the choice between more rigid and more flexible means of setting the nominal exchange rate. A more rigid exchange rate can serve as a 'nominal anchor', encouraging individuals and businesses to hold and use a domestic currency despite fears of inflation or even hyperinflation. It may also create the sort of predictability that allows businesses to make effective use of cross-currency balance sheets. For instance, a firm may borrow at a lower interest rate in foreign currency, confident that domestic-currency receipts, converted at an exchange rate set by central bank policy, will allow repayment. Business models that rely on use of imported goods, or of imported inputs processed for sale to domestic consumers, can also be built around pre-announced exchange rates. However, limited flexibility in exchange rates can also have dangerous consequences. If the exchange rate does not adjust when domestic inflation rates outstrip foreign ones, the domestic currency undergoes a 'real appreciation', damaging competitiveness. Moreover, an exchange-rate commitment found to have been ill-considered may be difficult to change, as a drop in the domestic currency's value may dramatically threaten the balance sheets of those businesses that relied on the previous commitment.[4]

A final trade-off bearing significantly on exchange-rate policy regards whether to adopt a permissive or restrictive stance towards international capital flows. A permissive stance is often advocated as a means of attracting foreign investment, which can contribute to economic growth and development. However, the potential capital flight enabled by such a stance constrains the choices available regarding macroeconomic policies and the flexibility of exchange rates.[5]

The ways in which each of these three trade-offs confront Russian policymakers derive from the country's structural circumstances. Pressure for a liberal stance on capital flows arises from a banking system that has remained highly underdeveloped throughout the post-Soviet era. As a result, Russia's state-owned and private firms, as well as securities markets, are highly dependent on capital inflows and foreign-currency loans. In this context, limiting nominal exchange rate flexibility seems to offer crucial advantages. Capital inflows depend on prospects for a stable or strengthening ruble, while existing obligations incurred according to this pattern have made

---

[3] Lawrence J. Broz and Jeffry A. Frieden, "The Political Economy of International Monetary Relations." *Annual Review of Political Science* 4 (January 2001): 317-343.

[4] David M. Woodruff, "Boom, Gloom, Doom: Balance Sheets, Monetary Fragmentation, and the Politics of Financial Crisis in Russia and Argentina." *Politics & Society* 33 (March 2005): 1-44.

5 See, eg., Jeffry A Frieden, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance." *International Organization* 45, no. 4 (1991): 425-451.

downward adjustment of the ruble's value very costly. Another motivation for exchange rate stability is Russians' wariness about holding savings in domestic currency, rooted in the extremely high inflation of the immediate post-Soviet period and also a long Soviet history of confiscatory currency reform.[6] Even in relatively calm times, the potential for mass flight into foreign currency savings remains a constant backdrop. This has intensified reluctance to allow drops in the ruble's nominal value, for fear they may touch off panic.

Structural circumstances have likewise complicated Russia's task in managing the trade-off between competitiveness and purchasing power. Russia is, of course, a major hydrocarbon exporter--but as a cold country with much energy-intensive industry, and a growing fleet of passenger automobiles as well, it is also a major hydrocarbon consumer. This ensures that the relationship between domestic and international energy prices is a regular source of political tension because of how the exchange rate affects the opportunity cost of supplying hydrocarbons to the domestic market. For instance, if the ruble appreciates more slowly than world oil prices are rising, or depreciates more quickly than oil prices are falling, then the domestic oil sales become less attractive unless ruble prices for them are permitted to rise. Such price rises, however, are unpopular with domestic consumers. Mismatches between the strength of the ruble and world oil prices have led to intense political conflict on several occasions over the last two decades. In general, Russia's domestic energy needs make it hard to pursue an exchange-rate policy favorable to the competitiveness of Russian-produced goods. The resulting bias towards a stronger ruble promotes patterns of growth dependent on a domestic market that is large in international terms. In this context, a weaker ruble, whether the product of policy intent or international volatility, creates the possibility of substantial political upheaval, which could arise from stunted growth prospects, from increased conflict within the elite over energy policy, from popular discontent over the high price of energy as well as crucial imported goods, or from all at once.

Although the enduring tensions of exchange-rate policy choices have played into all three of Russia's post-Soviet currency crises, they have done so in different ways. The 1998 crisis was a consequence of an ill-judged attempt to radically limit exchange-rate flexibility as a weapon against inflation, which soon led to a devastating overvaluation of the ruble and vulnerability to whipsawing international commodity prices and capital flows. After the crisis, government policy sought to allow the ruble to strengthen only gradually, and despite a subsequent rapid and large rise in oil prices, the real exchange rate exceeded its pre-crisis peak only late in 2006. Institutional capacities acquired in the aftermath of the 1998 crisis were crucial to this policy of slowing the ruble's real appreciation, but the extent to which it was nonetheless permitted illustrated the force of structural pressures for a strong ruble. Meanwhile, Russia accumulated substantial international currency reserves. When in 2008 oil prices began what became a 70% drop and net international capital inflows imploded in the aftermath of the Lehman Brothers collapse, Russia relied on its reserves to allow only a 20% decline in the ruble's real value and to shore up the shaky international finances of large firms. The ruble's real value had recovered by 2013.

[6] Juliet Johnson, "Forbidden Fruit: Russia's Uneasy Relationship with the Dollar," *Review of International Political Economy* 15:3 (2008): 377-396.

The 2014-16 crisis proved somewhat more challenging. Structural pressures to limit the ruble's depreciation persisted, and reserves and informal capital controls were used to fight a slide in the ruble's value that culminated in a panicked popular flight into hard currency late in 2014. From mid-2015, however, the Central Bank ceased using reserves to support the ruble, and the drop in its real value was allowed to reach as much as 35%. Then 2016 saw a substantial (though still partial) recovery in oil prices, and, late in the year, election of a new US President less committed to the sanctions regime. By early 2017 capital outflows had halted. The ruble had appreciated by about one-third against its post-crisis low, and some government officials were complaining of its overvaluation, touching off new conflicts over exchange rate policy.

Taken together, the three episodes of currency crisis—which will now be dealt with in turn--demonstrate the enormous political and economic difficulties of managing Russia's insertion into the world economy. While each of these crises has prompted institutional and policy changes intended to make this task easier, they are still not fully adequate to the magnitude of the challenges.

The "Stable Ruble" and the 1998 Crisis

The 1998 currency crisis brought to a close a period of increasingly heavy-handed exchange-rate management, a policy which (however foolish it appeared in retrospect) had deep roots in economic and political circumstances. Russia had experienced hyperinflation in 1992 after the Yeltsin government's attempt to combine price liberalization with macroeconomic stabilization went predictably awry. Internationally, the Russian government had mistakenly attempted its liberalization and stabilization plan without taking into account the other post-Soviet states that still used the ruble as currency, most notably Ukraine. With Russian credit and cash restricted and prices raised, many post-Soviet central banks filled the gaps by issuing their own ruble-denominated credit to local enterprises and/or by issuing parallel currencies. These actions demonstrated that the Central Bank of Russia (CBR) did not control Russia's money supply. Only after the CBR cut the cross-border ruble credit link in November 1992 and carried out a unilateral currency reform invalidating all old ruble notes in July 1993 did it solve the problem of the ruble zone.[7]

Domestically, in the absence of state credits Russian companies ran up unpayable ruble debts to each other, entangling the entire economy in what became known as the inter-enterprise debt crisis. The CBR cut the Gordian knot in mid-1992 by clearing the inter-enterprise debts and increasing the money supply, again conceding its limited ability to control money creation; when it then removed the mechanism by which companies could amass these mutual debts through the formal financial system, companies turned to barter and informal IOUs (veksels) instead.[8] The CBR's interest and credit policies vacillated wildly over the next two years, culminating in Russia's October 1994 "Black Tuesday" currency crisis. The ruble's value dropped nearly 30%

---

[7] Juliet Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (Ithaca: Cornell University Press, 2000).

[8] David Woodruff, *Money Unmade: Barter and the Fate of Russian Capitalism* (Ithaca: Cornell University Press, 1999), 79-109.

against the dollar in one day, and CBR director Viktor Gerashchenko lost his job the next month.[9]

After the experiences of 1992-94, interests aligned across the Russian government, major banks, and Russia's IMF advisors to actively manage the ruble-dollar exchange rate and seek alternative means to finance the budget deficit in order to get inflation under control and strengthen the ruble. This led to three policy decisions that, while temporarily stabilizing the ruble, laid the groundwork for the 1998 crisis.[10] First, at the IMF's urging the CBR and Russian government introduced the "ruble corridor" in 1995, promising that the CBR would intervene in the currency markets whenever the ruble's value threatened to move above or below a predetermined exchange-rate band with the US dollar. Second, the Russian government and its international advisors developed the GKO market, short-term government bonds intended to help meet the government's financing needs through non-inflationary means. Finally, again with IMF encouragement, the Russian government liberalized the capital account in order to draw in foreign portfolio and direct investment.

The ruble corridor helped to bring inflation down, reassured the Russian public, encouraged capital to flow into Russia, and increased consumer purchasing power. But it came with enormous costs as well. Ensuring that the ruble remained within the announced band proved to require extraordinarily high real interest rates. Furthermore, while inflation shrank rapidly, it still far outpaced adjustments in the currency band, substantially worsening the competitiveness of Russian industry and agriculture. These circumstances contributed to an explosion in barter and veksel transactions, which facilitated alternative forms of lending and localized 'devaluations' by allowing ruble-denominated obligations to be paid off in lower-valued goods or monetary surrogates.[11] By 1998 perhaps as much as half of all exchange in industry relied on alternatives to the ruble.

The burgeoning of non-monetary exchange naturally created enormous fiscal difficulties for Russia's government, which either had to accept barter or monetary surrogates in taxes or squeeze businesses for their limited monetary income. A survey of the country's largest tax debtors in early 1998 found that only about a quarter of their receipts were in ruble form.[12] To cover fiscal shortfalls, the government relied on GKO funding, which was already covering 70% of the budget deficit by 1995. At first the GKO market was restricted to the politically influential domestic banking sector, which benefited from very high yields. Then, when domestic banks could no longer meet government financing needs, the government opened the GKO market to foreign investment.

---

[9] Johnson, *Fistful*, 134; Woodruff, *Money Unmade*, 99-101.

[10] Johnson, *Fistful*; Juliet Johnson, *Priests of Prosperity: How Central Bankers Transformed the Postcommunist World* (Ithaca: Cornell University Press, 2016).

[11] Woodruff, *Money Unmade*, 146-176. On the relationship between currency overvaluation and non-monetary exchange, and a critique of the idea that non-monetary exchange reflected a 'virtual economy', see David Woodruff, "It's Value That's Virtual: Bartles, Rubles, and the Place of Gazprom in the Russian Economy." *Post-Soviet Affairs* 15, no. 2 (1999): 130-148.

[12] Ibid., 189.

After Yeltsin's re-election as president in 1996, foreign capital flooded into the profitable GKO market, into Russian banks, and into the Russian stock exchange. High interest rates on ruble-denominated assets, when combined with the exchange rates promises of the ruble corridor, implied double-digit dollar returns that were irresistible to many foreign investors.[13] Many leading Russian banks also offered dollar-forward contracts to foreign investors wishing to hedge their currency risks in the GKO market; these banks were in essence betting on the stability of the ruble corridor. Markets were bullish on Russia throughout 1997, and the 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.

Immediately thereafter, Russia's dual dependence on resource revenues and capital inflows came back to bite hard. Foreign portfolio investors hit by the 1997 Asian crisis pulled their money out of the Russian stock and GKO markets.[14] At the same time, 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. Capital inflows became capital flight, the drop in oil prices blew an ever-widening hole in the budget, and the ruble corridor became an increasingly expensive luxury that the CBR nevertheless felt it could not abandon.

Indeed, Russia's own leading banks and companies helped drive it into crisis in 1998.[15] 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 far too long 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 corridor broke.[16] 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.

The Russian government, already running a significant budget deficit, took on over $18 billion in new sovereign debt in the first half of 1998.[17] It also 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 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

---

[13] Woodruff, "Boom, Gloom, Doom," 17.

[14] On contagion and the crisis, see F. Caramazza, L. Ricci, R. Salgado, "International financial contagion in currency crises," *Journal of International Money and Finance*, 23(1), February 2004.

[15] Pekka Sutela, "The financial crisis in Russia." *Global Financial Crises*. Springer US, 2000. 63-73.

[16] Johnson, *Fistful of Rubles*, 209-12; Woodruff, "Boom, Gloom, Doom," 30-32.

[17] On the toxic combination of fixed exchange rates and government debt/deficits in the Russian crisis, see A. J. Chiodo and M. T. Owyang, "A Case Study of a Currency Crisis," *Review*, Federal Reserve Bank of St. Louis, November/December 2002, and T. Komulainen, "Currency Crisis Theories - Some Explanations for the Russian Case," *HSE Economic Journal*, 3(1), 1999.

money to defend the ruble or pay its creditors, the Russian government defaulted in August 1998 and abandoned the ruble corridor.

The State Bounces Back

It would have been easy to see the August 1998 crisis as a symptom of a weak state, penetrated by particularistic interests, unable to collect taxes or even ensure the consistent use of the legal means of payment. But the rapid recovery of central state power after the crisis belied this picture. Eliminating the ruble's overvaluation and the extreme monetary restriction needed to sustain it removed the crucial underlying economic causes of demonetization, which rapidly waned, with corresponding gains in fiscal capacity and coherence.[18] At the same time, the crisis undermined - in many cases fatally - the parasitic banks of the so-called oligarchs, firmly tipping the balance of financial-sector power back towards the state.[19] The new Putin government concluded from Yeltsin's experiences that it needed greater influence over the "commanding heights" of the economy, the media, and the political system. During his first term as president 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.

The central episode in this restoration of state autonomy after the August crisis was a severe political conflict over resources between the government and oil companies, a conflict the government decisively won.[20] Its roots lay in two effects of the ruble's devaluation on oil company interests. First, given Russian consumers' decreased purchasing power, oil companies hoped to shift sales from domestic to foreign markets (see Figure 3). Second, the companies hoped to minimise any taxation of the windfall profits arising from the huge relative reduction in their domestic, ruble-denominated costs, a windfall later augmented by soaring world prices. Key figures in the Russian government, by contrast, had the opposite priorities, aiming to preserve energy supplies for domestic consumers while designing a tax regime that would direct oil profits to the state. Tariffs on exports of oil and oil products thus became a key bone of contention, as aside from the revenue implications, they also reduced the attractiveness of exports and thus helped to sustain supplies to domestic consumers.

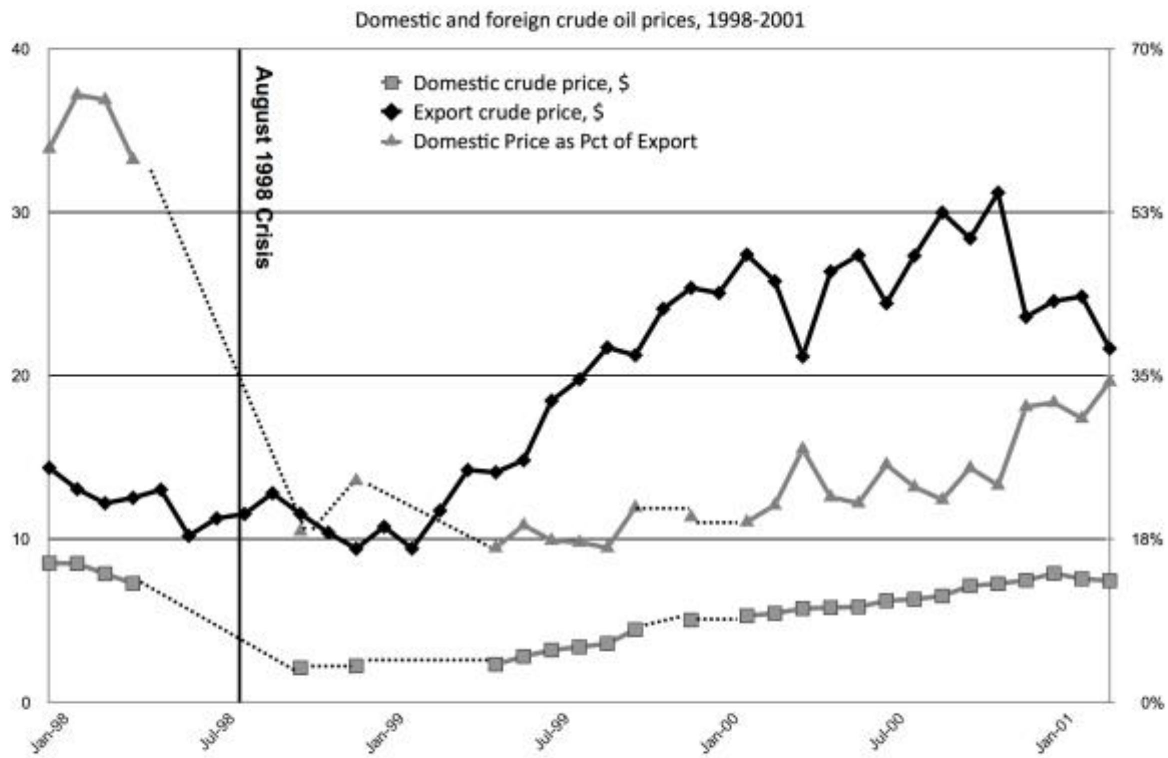
---

[18] Neil Robinson, "August 1998 and the development of Russia's postcommunist political economy," *Review of International Political Economy*, 16:3 (2009), 444; David M. Woodruff, "After neoliberal constitutionalism: Financial crisis and state resurgence in Russia and Argentina," in *Moments of Truth: The Politics of Financial Crises in Comparative Perspective*, eds. Francisco Panizza and George Philip (Routledge 2013), 53.

[19] Johnson, *Fistful of Rubles*, chapters 7-8.

[20] Hilary Appel, "Is it Putin or is it oil? Explaining Russia's fiscal recovery," *Post-Soviet Affairs* 24:4 (2008): 301-323. David Woodruff, "Shock to the Systems: The State and the Oil Sector After Russia's 1998 Financial Crisis." Paper Presented the APSA Annual Meeting, Chicago, IL, 2004.

Figure 3: Domestic and Foreign Crude Oil Prices after the 1998 Crisis



Source: Data courtesy of ESA, Incorporated.

While the tax regime generally tightened over the next several years, oil companies retained significant bargaining power in the resulting conflict through 2003. In July 2001, the Duma passed a comprehensive tax reform affecting the oil sector to take effect from 2002.[21] Assessment of taxes based on physical volumes of oil and world market prices greatly simplified tax administration. Export duties were linked to world prices. However, fiscal authorities were not able to achieve all of their taxation aims, and the government actually lost some autonomy in setting of export tariffs, especially after an additional May 2002 Duma law limiting taxation of exported oil products. Oil companies also retained the ability to channel revenues to regional tax havens within Russia. There is significant evidence that tension over energy-sector taxation was an important backdrop to the conflict over the Yukos oil company and the arrest of its leader Mikhail Khodorkovskii in October 2003. Curtailing of regional tax havens and restoration of flexibility in the setting of export tariffs on oil products were among the first actions of the new Duma that sat shortly thereafter.[22] In June 2004 the Duma approved a large hike in the oil export

[21] Galina Liapunova, "Skol'ko stoit novye nalogi," *Kommersant-Daily*, July 23, 2001, https://dlib.eastview.com/browse/doc/6719572

[22] Iurii Aleksandrov, "Gosudarstvo i neftianoi biznes: osennee nastuplenie. Pravila igry na rynke podvergaiutsia korrektsii," *Nezavisimaia gazeta*, December 26, 2003, http://dlib.eastview.com/browse/doc/5735686.

tariff, ensuring that 65% rather than 40% of price rises above a set level would pass directly to the state through this tax alone.[23]

The Yukos conflict also presaged passage of a significant share of ownership in the oil sector into state hands. Most Yukos assets wound up held by state-owned company Rosneft', which has been headed by close Putin allies. Control over state-owned Gazprom, which acquired the previously private Sibneft' oil producer was also tightened.[24] In this environment, tax enforcement and tax compliance both strengthened.

Once Russia's political leadership had decisively won the conflict with the oil sector touched off by the massive weakening of the ruble after August 1998, it was in a much better position to manage pressures for a stronger ruble brought on by the upswing in world oil prices that began not long after the August crisis and continued until reaching an all-time high in July 2008. Foreign currency inflows brought on by commodity exports tended to push the nominal exchange rate up. For the inflation-averse leadership of the CBR, a strong ruble represented a secondary issue, or even a welcome constraint on rising prices, but the Putin government asked the CBR to limit the pace of ruble appreciation in order to preserve some of the earlier competitiveness gains.[25] After targeting the ruble's exchange rate informally in 2002-2005, the CBR then adopted a more formal dual-currency basket (US dollar and euro) as a reference point to determine when to intervene to limit exchange-rate volatility; under continued pressure from rising oil prices, the CBR maintained ruble stability vis-a-vis the basket both through intervention and through gradually increasing the relative basket weight of the euro.[26] This policy involved buying up foreign currency, which the CBR did on a massive scale: the central bank's international reserves rose to nearly $600 billion at their height in mid-2008, from less than $13 billion a decade earlier.

However, as the rubles issued to carry out these purchases entered the economy, they could stoke inflation; in effect, the central bank could avoid nominal appreciation only at the cost of real appreciation. The fiscal gains deriving from remonetization and the taming of the oil companies offered opportunities to address this problem. First, Russia began to pay off its outstanding foreign debt ahead of schedule, creating hard-currency outflows that helped to restrain the ruble's rise. Second, spearheaded by Finance Minister Alexei Kudrin, Russia in 2004 created a sovereign wealth fund: the Stabilization Fund. The fund accumulated a large share of the tax receipts deriving from high oil prices and took them out of the economy, "sterilizing" some of the inflationary effect of hard-currency inflows. Without the increased budget receipts deriving from higher taxation on the oil sector, the fund's effectiveness would have been much less.

---

[23] Shinichiro Tabata, "Price differences, taxes, and the stabilization fund," in *Russia's Oil and Natural Gas: Bonanza or Curse?,* edited by Michael Ellman, 35-54 (London; New York: Anthem Press, 2006).

[24] For a meticulous and comprehensive account, see Andrew Yorke, "State-led coercive takeovers in Putin's Russia: Explaining the underlying motives and ownership outcomes" (Ph.D. diss, London School of Economics and Political Science, 2014). http://etheses.lse.ac.uk/962/

[25] Johnson, *Priests of Prosperity*, 195.

[26] Central Bank of the Russian Federation, "The history of the Bank of Russia's exchange rate policy," in *Market volatility and foreign exchange intervention in EMEs: What has changed?***,** BIS papers #73, February 2013, 294.

While sterilization was the Stabilization Fund's key purpose for market liberals, much of its broader support derived from the conclusion of Putin and many other leaders that 1998 demonstrated the need for a reserve buffer to protect the country from currency and budget crises sparked by oil price fluctuations. As the Fund reached a size sufficient to assuage these concerns, conflict over whether the Fund's resources might better be invested within Russia became intense.[27] In 2006 the Fund's assets were converted into foreign currency, in part as a device to blunt such calls to devote them to domestic growth. The Fund was also split into two, creating the Reserve Fund (linked to GDP and thus a way of ensuring some continued sterilization) and the National Wealth Fund (to guarantee pensions). These funds combined held $225 billion by December 2008.

Although advocates of the Fund's sterilization role had some success in defending it, the contentious status of this aim meant it was never expanded to the scale required for full sterilization of the inflationary effects of currency interventions. Thus, the CBR regularly missed the aspirational inflation targets it announced. The result was a relatively stable yet uncomfortably high inflation rate of 9-15 percent per year accompanied by a gradual nominal ruble appreciation vis-a-vis the US dollar, leading to substantial real ruble appreciation. Ruble appreciation in turn increased consumer purchasing power, leading to a situation in which, as Arend aptly put it, "Russian growth was increasingly *driven* by consumption [but] was largely *sustained* by rising oil exports."[28]

Between 2002 and 2008, the Russian economy grew at a rate of over 7% a year. In international currency terms, growth was even more impressive: in euros, for instance, Russia's growth was over 18% per annum in this same period. Russia's domestic banking system could not meet the desire to invest that this boom touched off, but international investors were more than willing to make up the gap. Even without a formal currency peg, the combination of inflation with the central bank's effort to keep the nominal exchange rate stable implied that ruble investments would appreciate rapidly in foreign-currency terms. High international liquidity made it easy for investors to act on this logic. The stock market also saw a huge run-up. Borrowing by state-owned enterprises (SOEs), private companies, and banks surged, facilitated by a progressive capital account liberalization completed in July 2006. By January 2009 the foreign debt of Russia's companies and banks had reached nearly 35% of GDP. Loans by Russia's nine largest banks to corporations and organizations amounted to only 92% of the money Russian firms had borrowed abroad (and banks themselves funded much of this lending by foreign borrowing).[29] While the Stabilization Fund offered at least a partial mechanism to contain the inflationary effects with hydrocarbon-related hard-currency inflows, Russia had no mechanism to sterilize capital inflows.

---

[27] Ewa Dabrowska and Joachim Zweynert, "Economic ideas and institutional change: The case of the Russian stabilisation fund," *New Political Economy* 20:4 (2014): 518-544.

[28] Rudiger Ahrend, "Can Russia Break the 'Resource Curse'?" *Eurasian Geography and Economics* 46.8 (2005): 584-609, p.587.

[29] "Russia can manage corporate debt risks," *Oxford Analytica Daily Brief*, January 19, 2012.

By 2008, then, despite some major political successes in limiting inflationary overheating of the economy and reserving a notable portion of the oil windfall for more difficult periods, the structural contours of Russia's insertion into the world economy had changed little from 1998. The currency was again arguably overvalued, and potential volatility in energy prices and capital flows remained major threats. High central bank reserves and the Stabilization Fund ensured a significantly improved ability to deal with a currency crisis if one occurred, but the elements that made Russia vulnerable to crisis in the first place remained.

Overcoming this vulnerability would have been an enormous challenge under any political circumstances. The government might have tried to organize a rapid expansion of the domestic financial sector either under state or private auspices, but insofar as its funding would have still ultimately derived from hydrocarbon rents the contribution to stability would have been limited. A more diversified economy would have offered more resilience in the face of price volatility, but at the prevailing exchange rates the sensible private investments were those focused on supplying Russian consumers. Sequestering even more of the hydrocarbons windfall could have limited real appreciation, but would have slowed improvements in living standards for a long-suffering population.

Whatever the prospects for these or other policies aimed at limiting Russia's structural economic vulnerabilities, in practice the Russian government did not make a serious effort to address dependence on energy and foreign capital. It concentrated its expenditures on supporting social programs and the patronage network that sustained Putin's "power vertical," a system that privileged a small group of loyal economic elites and informally institutionalized corruption to the detriment of medium/small business and foreign direct investors. Nevertheless, on the backdrop of high growth, Russian politicians and financial markets brimmed with confidence. Reacting to the same incentives that promoted foreign capital inflows, Russian citizens increasingly shifted their hard-currency savings into rubles. Russian leaders began discussing the ruble as a possible international reserve currency and declared Russia immune from global crises. These developments all served to legitimize the political-economic system that Putin and his team had built after 1998.

The 2008 Crisis

In 2007-8, the continuing vulnerability of Russia to changes in international conditions was dramatically highlighted. The international capital on which the Russian economy had come to depend started to dry up in late 2007 after the US subprime crisis hit and continued to flow outward as the global financial crisis advanced. Foreign investors were further spooked by Russia's unexpected invasion of Georgia in August 2008 and by a power struggle that year between the Russian and foreign owners of oil major TNK-BP. At the same time, oil prices spiked upward in early 2008 and then plummeted by over 70% in the second half of the year. Portfolio investors fled the stock market, Russia's stock exchanges repeatedly halted trading during fall 2008 in the face of collapsing share prices, and Russian companies and banks found it difficult to refinance their foreign-currency loans as capital flight hit $132.8 billion in 2008 and credit markets dried up.

Capital flight and falling hydrocarbon revenues put immediate downward pressure on the ruble. The CBR, which until recently had grappled with moderating the ruble's appreciation, now faced the prospect of a currency crisis. As Russian officials feared might happen, external pressures sparked a domestic flight from the ruble as wary Russians moved to cut their potential losses. As Olivier Blanchard et al. have argued, "the problems [in 2008-9] did not come so much from capital outflows by foreign investors as from a shift by domestic residents — households, firms, and banks — out of ruble and into dollar assets."[30] The ruble depreciated by about 30 percent from late 2008 through early 2009, and in 2009 Russia's GDP fell by 7.9%. The swing from nearly 8.5% GDP growth in 2007 to -7.9% in 2009 was among the largest in the world. The currency crisis, the broader economic reversal and the public protests that resulted led many to recall 1998 and to expect similarly significant, structural changes to the political-economic system. In the end, however, it did not create such an opening. Policy reforms carried out after 1998 had given the government better macroeconomic tools to contain the currency crisis, while the recovery in oil prices after 2009 and Putin's return to the presidency in 2012 short-circuited the tentative post-crisis efforts to open up and rebalance the political-economic system. Indeed, not only did the crisis not result in systemic change, but it reinforced the existing structure of the Russian political economy.

Copious reserves and budget solvency did not keep the ruble from coming under attack in 2008, but in contrast to 1998 they did give the government the ability to temper the pace and magnitude of ruble depreciation.[31] While the Russian government, like others around the world, carried out a massive fiscal expansion to recapitalize banks and stimulate the economy, the CBR countered with currency intervention to slow the ruble's slide in value. The CBR did so in order to support Russian consumers as well as Russian companies that held high levels of US dollar-denominated debt. Interventions from November 2008 to January 2009 cost Russia over one third of its reserve funds; by March 2009 reserves had bottomed out at $375 billion, down from their $598 billion peak in August 2008.[32] To put this in perspective, in order to cushion the ruble's fall, in less than six months the CBR spent about ten times the average *total* annual reserves that it had held during the 1990s. The ruble's real exchange rate sank by only a bit over 17% before recovering, compared to the 53% fall in 1998.The intervention combined with a moderate interest rate hike limited the inflationary impact of the crisis as well; inflation in 2008 only hit 13.3%, in contrast with 1998's 84.4%.[33]

As after the 1998 crisis, exchange rate shifts increased tension around domestic energy prices. However, the decision to limit the ruble's decline meant that the form of these tensions was

---

[30] Olivier Blanchard, Hamid Faruqee, Mitali Das, Kristin J. Forbes, and Linda L. Tesar. "The Initial Impact of the Crisis on Emerging Market Countries [with Comments and Discussion]." *Brookings papers on economic activity* (2010): 263-323.

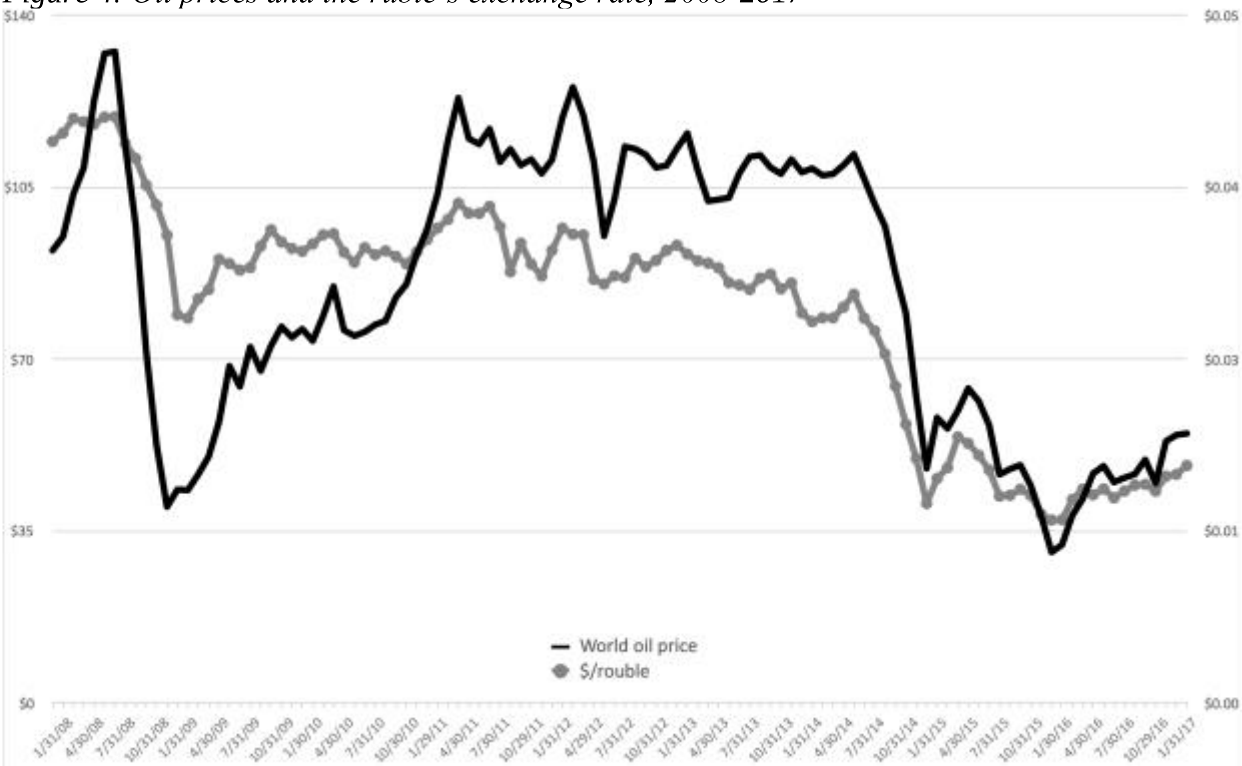
[31] Richard Ericson, "The Russian Economy in 2008: Testing the 'Market Economy,'" *Post-Soviet Affairs*, 25(3), 2009, pp. 185-207.

[32] Central Bank of the Russian Federation, "The history of the Bank of Russia's exchange rate policy," 295; International Monetary Fund, *Russian Federation Article IV Consultation*, IMF Country Report No. 13/311 (2013).

[33] Bank of Finland Institute for Economies in Transition (BOFIT), http://www.suomenpankki.fi/bofit_en/seuranta/venajatilastot/Documents/BOFIT_RussiaStatistics_1990_2007.pdf

initially very different. From August to December 2008, world oil prices declined by about 70% but the ruble's value against the dollar sank by only about 20% (see figure 4). Thus, in dollar terms the price for Russia's consumers could afford to pay for hydrocarbons remained relatively high despite falling international prices. In 2009 and 2010, the government and anti-monopoly authorities directed ferocious criticism at oil companies for failing to pass international oil price declines on to Russian consumers, and created new mechanisms to regulate domestic gasoline prices.[34] By early 2011, however, oil was approaching pre-crisis highs on international markets, and the central bank was expanding its reserves, limiting the extent to which the ruble appreciated in parallel. Given government restrictions on domestic prices, the result was a declining attractiveness of domestic sales that led to highly disruptive nationwide gasoline shortages in April 2011. The 'gasoline crisis' touched off new efforts to use taxes and other regulatory mechanisms to assure supplies to the domestic market.[35]

Figure 4: Oil prices and the ruble's exchange rate, 2008-2017



Source: Oil prices (Brent monthly averages) from http://www.eia.gov/dnav/pet/pet_pri_spt_s1_m.htm, ruble exchange rate (end of month official rates) from http://cbr.ru

The Russian government's crisis bailouts and fiscal expansion led to further consolidation and state control over the energy and financial sectors, as well as to budget deficits as it funneled cash towards defense, agriculture, and social assistance. Strong domestic demand, rising oil prices, and the concomitant return of foreign capital allowed the Russian economy to return to

34 See, for instance, "Anatolii Golomolzin: Politika Neftianykh Monopolii Iavliaetsia Kolonial'noi," *Kommersant-Den'gi*, July 12, 2010.

35 See, for instance, Andrei Meshcherin, "Benzinovyi Populizm," *Neftegazovaia Vertikal'*, June 22, 2011.

growth in 2010. Rising oil in particular saved the day, because by restraining ruble depreciation the CBR had also limited the potential competitiveness gains in the non-energy sectors, gains which had been a key factor in the post-1998 recovery. By fall 2011, foreign exchange reserves had hit $545 billion - a near-complete recovery.

However, greater state control over energy and finance, the oil price recovery, and the political difficulties of unwinding the new state subsidies to favored sectors introduced during the crisis gave the government both the means and the interest to continue funnelling its hydrocarbon revenues to its traditional large-scale military, industrial, and agricultural supporters. The result was stagflation, an economy growing at an ever-slower rate with inflation consistently above 5%. Moreover, despite attempts to overhaul the financial sector, Russia's largest banks and companies were still heavily reliant on outside capital to support their everyday business activities.

The Modernization Mantra

Nothwithstanding the shifts just described, the relatively contained character of the 2008 crisis meant that its direct effects on institutional transformation were notably smaller than those of its predecessor a decade earlier. However, recognizing (yet again) the dangers inherent in running an economy so reliant on hydrocarbon revenues and foreign capital, after the global financial crisis Russian president Dmitrii Medvedev made modernization the centrepiece of his economic policy agenda. Most importantly, this meant diversifying the Russian economy to become less dependent on natural resource revenues.[36] Medvedev, like many other policy makers and scholars, argued that the financial crisis hit Russia especially hard because of Russia's dependence on oil and gas revenues and its failure to nurture high-technology export industries. Medvedev's famous "Go Russia!" speech in September 2009 condemned Russia's "economic backwardness," corruption, and paternalistic culture, and proposed an aggressive modernization campaign as the way forward.[37] The Skolkovo project on the outskirts of Moscow, initially projected to cost upwards of $4 billion and to feature a technopark, university, and start-up incubator, represented the showpiece of Medvedev's modernization plan.

Medvedev's campaign enjoyed substantial support among economic liberals. The high-profile Strategy 2020 proposal drafted in 2011 by leading Russian economic experts recommended pursuing diversification, promoting transparency and the rule of law, and maintaining macroeconomic stability.[38] While the Finance Ministry emphasized the need for fiscal restraint in this process, the Ministry of Economic Development advocating deficit spending in order to fulfill the entire wish list. In doing so, the latter Ministry posed a stark choice: Russia could either stagnate as an energy superpower (the conservative scenario) or grow by investing heavily

[36] For a critique of this call for diversification, see C. G. Gaddy, B. W. Ickes, "Russia after the Financial Global Crisis," *Eurasian Geography and Economics*, 51(3), 2010, 281-311.

[37] Dmitrii Medvedev, "Rossii, vpered!", September 10, 2009, http://www.gazeta.ru/comments/2009/09/10_a_3258568.shtml.

[38] For the full set of *Strategiia-2020* documents and projects as they have evolved over time, see http://2020strategy.ru/2020.

in diversified high-tech industries, health and education, and transportation infrastructure (the innovation scenario).

Whether a prolonged period of adverse external economic conditions would have deepened establishment support for Medvedev's modernization agenda is difficult to judge, but the quick recovery in oil prices certainly reduced its perceived urgency, and other political developments soon contributed to its marginalization. In September 2011, Putin announced his intention to return to the presidency. In the December 2011 parliamentary elections, establishment party United Russia captured just under half of the recorded vote, significantly less than in 2007. Charges of electoral falsification led to protests in Moscow, raising the profile of anti-corruption campaigner Alexei Navalnyi, who had made much of his reputation exploiting Medvedev's openness initiatives such as transparent public procurement and property registration to suggest official malfeasance.

As the presidential elections approached, Putin made extensive electoral spending promises, most incompatible with the modernization agenda, not to mention using budget restriction as a sterilization tool. He promised to raise both pensions and public sector pay, and promised massive new investment in the military-industrial complex. Putin himself estimated that the social spending commitments could cost 3% of GDP per year, while other estimates put the figure as high as 8% of GDP. This was on top of the military spending commitment of $870 billion through 2020. Given that Russia's GDP growth at the time hovered between 3-4% per year, fulfilling these commitments would not only leave few resources for modernization initiatives, but could undermine Russia's macroeconomic stability. The renewed Putin government was not in a position to invest heavily in new high-tech industries, to crack down on corruption, to reform the judicial system, or to strongly reduce the state's hold on the economy - that is, to do anything that would make serious modernization possible. Indeed, in the eyes of the establishment much of this agenda had become tainted by the use the opposition had made of it.

Economic and political circumstances thereby meant that in 2009-13 there was no substantial change in Russia's vulnerability to shifting international market conditions. Oil and gas accounted for approximately two-thirds of exports in 2013, just as they had in 2008 (as compared to only 26% in 1997).[39] By the middle of 2013, the ruble's real exchange rate was even stronger than it had been before the crisis, despite CBR efforts to refocus its policy on fighting inflation. After a substantial draw-down, total assets of the Reserve and National Welfare funds had returned to their pre-crisis level, although many of these assets appeared to be long-term investments in the Russian banking system incurred during the crisis, meaning they had no sterilization effects. Efforts to diversify capital inflows and to encourage Russian elites to hold their assets within Russia appeared to have little effect.

The 2014-16 Crisis

Nevertheless, at the beginning of 2014, as in 1997 and 2007, there were few signs that Russia would imminently experience another currency crisis. Although growth had slowed, the

[39] Kalman Kalotay, "The impact of the new ruble crisis on Russian FDI." *Baltic Rim Economies–Bimonthly Economic Review* 1 (2015): 31-32; Brenton Goldsworthy and Daria Zakharova, "Evaluation of the oil fiscal regime in Russia and proposals for reform," *IMF Working Papers* 10/33 (2010): 1-29.

exchange rate had stabilized and total reserves stood at over $500 billion. The CBR began limiting its currency-market interventions in a move toward the inflation-targeting regime it had long hoped to adopt and announced that it aimed to achieve 5% inflation in 2014. Steadily high oil prices kept money flowing into government coffers and Russian banks and companies continued to tap outside capital, with foreign debt reaching a peak of $732.8 billion in July 2014.

Then, two crucial developments struck directly at Russia's structural vulnerabilities: Western sanctions and an oil price collapse. In March 2014 the Russian government took advantage of political upheaval in Ukraine to repossess the Crimean peninsula, sparking outrage in the West and a progressive introduction and deepening of economic sanctions. While many of the initial sanctions on individuals and specific companies had symbolic rather than systemic effects, the sectoral sanctions introduced by the US and the EU in summer and fall 2014 cut off much of the Russian financial system and leading Russian companies - including in the oil and gas industries - from access to Western finance. All of a sudden, Russian enterprises that had relied on Western finance for their operational and investment needs found not only that they could not get newly sourced loans, but that they could not roll over old ones and would have to find and spend foreign exchange to pay them back as they came due. This led to a credit squeeze in the banking sector, to companies hoarding foreign exchange to preserve their ability to pay off upcoming debt, and to pressure on the ruble as foreign investors began to flee and companies sold rubles to acquire the foreign currency needed to meet their external obligations.

Second, and more importantly, oil prices plummeted (see Figure 4). Prices fell steadily from their high of $115/barrel in June to below $70 in December 2014 due both to weak international demand and continued strong production from both OPEC and non-OPEC members. Led by Saudi Arabia, OPEC chose to maintain production and draw on its deep well of foreign-exchange reserves in an attempt to protect its market share and drive more marginal producers out of business. While Saudi Arabia could afford such a policy, countries like Russia with fewer reserves and with budgets predicated on much higher prices were hit hard. As the price of oil fell, the ruble fell in lockstep with it.

The state's reaction to this new ruble crisis can be divided into two phases. In the first, the CBR and the government used reserves to attempt to moderate the pace and amount of the ruble's decline, albeit less aggressively than in 2008, spending over $90 billion by mid-November 2014. The CBR raised interest rates as well, from 5% at the start of the year to 10.5% by early December. However, the ongoing oil price freefall combined with sanctions and a broader atmosphere of political and economic uncertainty put steadily increasing pressure on the ruble. All that was lacking was a crisis trigger, which soon appeared when opaque CBR efforts to help Rosneft find $14 billion to pay foreign currency debts coming due in December spooked ruble markets.[40] On December 15 the ruble fell by nearly 20 percent in only 24 hours. The CBR responded by intervening heavily in the currency markets - spending over $15 billion in one week - and by raising interest rates from 10.5% to 17% overnight in an effort to "shock" the markets back to stability.

---

[40] Leonid Bershidsky, "Why the Ruble Fell as Oil Rose," *Bloomberg View*, December 15, 2014, https://www.bloombergview.com/articles/2014-12-15/why-the-ruble-fell-as-oil-rose.

Russian officials understood after 1998 that they could not maintain a fixed exchange rate in the face of rapidly falling oil prices, and that trying to do so would only burn through Russia's currency reserves. But they still did not fully appreciate the limitations of the CBR's interest-rate policy. In May 1998 the CBR had hiked rates to 150% to attempt to support the ruble. It then lowered rates to 60% to "restore confidence," only to raise them again to 80%. Nothing worked. The CBR used a similar strategy in 2014, raising rates throughout the year and then in December instituting the largest one-time hike since the 1998 crisis. As in 1998, these moves failed to calm the currency markets while guaranteeing that bank lending and economic growth would suffer.

What did finally check the ruble's collapse, along with the CBR's currency interventions, were informal capital controls. When it became clear that large export companies needing to make foreign currency loan payments had stoked demand for US dollars in Russia, 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, had calmed the currency markets by early 2015. As oil prices began to recover, the ruble even appreciated for a few months.

However, in May 2015 a second phase of the crisis began, as new oil price drops touched off another round of ruble weakening. This time, the CBR made good on its earlier commitments to focus on inflation and not to intervene to block the currency's slide. As the ruble steadily declined along with the price of oil to a record low of 86 rubles to the US dollar in January 2016, the CBR actually expanded its hard-currency reserves, arguing that it might again need them to preserve financial stability.[41] To fight inflation, which ran at 11.4% in 2014 and 12.9% in 2015, the CBR relied on increases in interest rates and reserve ratios, rather than directly propping up the ruble's value in order to reduce the price of imported goods. It also continued its unprecedented culling of weak commercial banks (it has revoked hundreds of licenses since 2013), tightened its macroprudential policies, and introduced incentives for banks to reduce their foreign currency assets.[42] Year-on-year inflation had slowed to 5.38% by end 2016 (due also in part to changes in Rosstat's methodology); a significant decrease, although not yet to the 4% that the CBR had targeted. The CBR's effort to refocus monetary policy on the domestic value of the currency was part of a broader push to decouple the domestic financial system from the international one. This policy appeared to reflect a judgment that international sanctions and low oil prices were likely to persist, and that Russia would need a financial system capable of operating more autarkically.[43]

---

[41] On CBR strategy in this period, see Ol'ga Kuvshinova, "My Ne Dobilis' Samogo Glavnogo," *Vedomosti*, June 22, 2015, https://www.vedomosti.ru/economics/characters/2015/06/23/597514-mi-ne-dobilis-samogo-vazhnogo.

[42] Central Bank of Russia, "Osnovnye Napravleniia edinoi gosudarstvennoi denezhno-kreditnoi politiki na 2017 god i period 2018 i 2019 godov," http://cbr.ru/publ/ondkp/on_2017(2018-2019).pdf, accessed April 28, 2017.

[43] See ibid. and Official Website of the President of Russia, "Meeting with Central Bank Governor Elvira Nabiullina," *President of Russia,* accessed April 27, 2017, http://en.kremlin.ru/events/president/news/54087.

A Slow Recovery

After the 1998 and 2008 crises, rapid oil price recoveries and the corresponding return of external capital enabled the Russian government to build and then maintain a political-economic system that used energy revenues to reward favored sectors and bolster domestic consumption without the need for deeper systemic reform. After the December 2014 currency crisis, however, neither condition obtained. Oil prices plumbed new depths, hitting $30/barrel in January 2016, while ongoing sanctions kept much foreign capital out. Russia's total foreign debt, nearly all of which was non-governmental, fell by over $215 billion between July 2014 and December 2015.[44] Oil prices did strengthen through 2016, but remained far below pre-crisis levels.

As a result, Russia found itself mired in a lengthy recession. Russia's GDP contracted by 3.7% in 2015 and remained slightly negative in 2016 (contracting by 0.2%), despite the small competitiveness bounce provided by ruble depreciation and import substitution. Capital investment in 2015 fell by 8.7%, real wages by 9.5%, and retail sales by 15%. Low oil prices also meant that the Russian government faced a budget deficit. The government initially proposed a 10% reduction in expenditures for 2016, but as Finance Minister Anton Siluanov warned at the time, more remained to be done and if not, "then it will be the same as it was during the Russian crisis of 1998-1999, when citizens paid with inflation for our failure to bring the budget into line with the new realities."[45] In October 2015 Prime Minister Medvedev had suggested raising oil taxes to bolster the budget, but this time the powerful oil companies lobbied heavily and defeated it. Instead the government ended up raising taxes on state-owned Gazprom, which subsequently recorded a loss in the last quarter of 2015. The Russian government ran budget deficits of 2.6% of GDP in 2015 and 3.5% of GDP in 2016, and under the current baseline scenario does not expect the budget to return to surplus until 2020. This meant that while the CBR retreated from exchange-rate management during the crisis, the fiscal authorities in effect did not. Russia drew down its Reserve Fund rapidly in 2014-2016 to cover budget deficits, which involved converting foreign currency to rubles. This helped support the ruble's value and cushion the impact of the Central Bank's expansion of its hard-currency reserves.[46]

The recession, the widespread expectation that oil prices would be "lower for longer" given the US shale boom, and the prospect of an extended period of sanctions reanimated the discussion about whether Russia could find an alternative growth model. In a reprise of the 2009 debate, calls for modernization and diversification that had been dampened earlier returned in full force. The liberal Russian delegation at Davos in January 2016 argued that crisis conditions would finally force the needed reforms,[47] while Russia's Security Council formally deemed Russia's

---

[44] "The volume of Russia's foreign debt decreases by $83.7 billion in 2015," *Russia Beyond the Headlines/Gazeta.ru*, January 25, 2016.

[45] Quoted in "Russia prepares stress test as oil slides below $30," *Russia Today*, January 13, 2016.

[46] "Minfin Rossii :: Reserve Fund," accessed April 27, 2017, http://old.minfin.ru/en/reservefund/index.php.

[47] Pavel Koshkin and Ksenia Zubacheva, "The worst of the economic crisis in Russia lies ahead," Russia Direct, January 22, 2016.

dependence on raw-materials exports to be a security threat.[48] Leading Russian economists such as Vladimir Mau and Sergei Guriev reinforced this message in the press, pointing out that Russia's oil dependence undermined prospects for sustainable economic growth.[49] The most liberal voices called for dealing with such structural challenges by controlling government debt and deficits, maintaining the CBR's conservative inflation targeting policy, property-rights reforms, a crackdown on corruption, redirecting state resources away from the military-industrial sector, working to reopen Western investment channels, and improving conditions for small and medium sized businesses to flourish. This viewpoint coalesced in early 2017 as the so-called Kudrin Plan, promoted by Alexei Kudrin's Center for Strategic Planning.[50] The contrasting point of view, advanced by Boris Titov's Stolypin Club, advocated an aggressive economic stimulus package focused on exchange-rate management accompanied by increased government borrowing and spending.[51]

However, construction of any fundamentally new growth model for Russia is unlikely to be successful absent some way to suppress appreciation of the ruble when oil prices are strong. As oil prices rose over the course of 2016, Russia's Ministry of Finance advocated using fiscal policy as a means to this end. In early 2017, it began to operate a "temporary budget rule," converting revenues from hydrocarbon taxes on prices higher than $40/barrel into hard currency held on special accounts at the CBR.[52] The budget rule raised significant issues of co-ordination between the government and the CBR. To the extent that the rule's operation would weaken the ruble, this could stoke inflation via its effect on import prices. If the CBR were to respond with higher interest rates, this could lead to capital inflows and appreciation pressures. The record of the first few months of 2017 demonstrated that this tension was much on the mind of CBR policymakers. Interest rate cuts in March and April 2017, although publicly justified by improving inflation indicators, might have been a sign that the CBR was deferring to the government's desire for a weaker ruble.[53]

---

[48] Interfax, "Russia identifies economic backwardness as national security threat," January 19, 2016.

[49] Vladimir Mau, "Mir vykhodit iz strukturnogo krizisa," *Vedomosti*, January 22, 2016, http://www.vedomosti.ru/opinion/articles/2016/01/22/625039-mir-strukturnogo-krizisa; Sergei Guriev, "Reasons for Russia's rouble rollercoaster ride: Moscow has to work at structural reform and a stronger rule of law," *Financial Times*, January 25, 2016.

[50] Aleksandr Prokopenko, "Kudrin ochertil programmu ekonomicheskogo rosta," *Vedomosti*, January 13, 2017, https://www.vedomosti.ru/economics/articles/2017/01/13/672888-kudrin-pokazal; Center for Strategic Planning, "Strategiia razvitiia strany 2018-2024," csr.ru.

[51] Aleksandr Prokopenko, "Stolypinskii klub napisal al'ternativu kontseptsii Kudrina," *Vedomosti*, March 1, 2017, http://www.vedomosti.ru/economics/articles/2017/03/01/679501-stolipinskii-klub

[52] Dmitrii Butrin and Vadim Visloguzov, "Ni Dnia Bez Bochki," *Kommersant*, January 25, 2017, http://kommersant.ru/doc/3201614; "Russian Economy: Ministry of Finance Moves to Hold down Rouble," *Economist Intelligence Unit - Views Wire*, February 8, 2017.

[53] "Zaiavlenie Predsedatelia Banka Rossii El'viry Nabiullinoi Po Itogam Zasedaniia Soveta Direktorov 24 Marta 2017 Goda," accessed April 28, 2017, http://cbr.ru/Press/print.aspx?file=press_centre/Nabiullina_24-03-2017.htm&pid=st&sid=ITM_10641. Vadim Visloguzov, "Bank Rossii Sinizil Stavku Do 9,25% Godovykh," *Kommersant*, April 28, 2017, http://kommersant.ru/doc/3286624.

A strategy reliant on decoupling the ruble's exchange rate from oil prices risks reanimating long-running tensions over energy prices. These tensions were illustrated yet again in late 2014, when Putin scored oil companies for failing to pass on price declines to domestic consumers, though in fact stable ruble prices for fuel meant these consumers were paying much less in dollar terms, effectively in line with changing world prices.[54] By early 2017 the situation echoed that of 2011, with government policy aimed at restricting ruble-price rises in fuel costs to the rate of inflation, while suppressing the ruble's appreciation. Grumblings among fuel retailers suggested a possible repeat of the 'gasoline crisis'.[55] Tax relief for the oil sector could be one response, but this would increase budget deficits.

More broadly, given the difficulty of dealing with these structural constraints under the existing political-economic system, the Putin government has so far attempted to square the circle by pursuing non-Western sources of finance and technology as well as by encouraging innovation through state investment in the military-industrial complex. Russia's patriotic militarization, pivot to Asia, promotion of the Eurasian Economic Union, promotion of 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 deal with its persistent structural dependence on hydrocarbon revenue and international capital without undertaking reforms that might challenge its hold on power.

Low Oil, Tight Money – What Future?

The three currency crises Russia has faced over the past two decades illustrate the huge structural challenges the country faces in managing its exchange rate policy. Each was preceded by a very substantial real exchange rate appreciation, though these happened at different speeds. Even the less-than-fully effective tools Russia initiated to restrain such appreciation during high oil price episodes during the early 2000s were politically controversial, and Russia did not make a serious effort to resist real exchange rate appreciation during the even more politically sensitive period in 2008-2013. Shifting capital flows, and parallel movements of consumer savings into and out of rubles, promoted competitiveness-damaging ruble appreciation during good times and terrifying plunges in the currency's value during bad ones. That international turbulence on the scale of 2008 did not lead to a worse catastrophe reflected Russia's ability to accumulate reserves over the prior decade, but by the same token the ability to manage this crisis, coupled with the rapid recovery of oil prices, reduced the urgency of a restructuring that would limit Russia's vulnerability to the shifting winds of the world economy. The turn of Russia's leadership toward a more nationalist stance and its vehement public rejection of undue foreign influence likewise worked against restructuring. Where the aftermath of the crisis of 1998 saw a thoroughgoing transformation of the place of the state in Russia's economy, the effects of 2008 did little to alter established patterns.

---

[54] Iurii Barsukov and Ol'ga Mordiushenko, "Benzin Doros Do Prezidenta," *Kommersant,* October 12, 2014, http://kommersant.ru/doc/2629777.

[55] "Roznichnyi Rynok topliva: 'Doktor, Mne vse Khuzhe i Khuzhe,'" *Informatsionnoe Agenstvo Ai92,* January 30, 2017.

On present evidence, the significance of the 2014-16 currency crisis may prove far greater. It is likely that an important shift has taken place in the structural features of Russia's integration into the international economy. Plummeting oil prices this time around, in the eyes of many observers, reflect not the latest swing of traders' fickle sentiments but sustainable increases in supply combined with limited prospects for demand growth, suggesting a long period of low prices. Meanwhile, sanctions and what looks likely to be a prolonged stand-off with the Western developed countries will continue to suppress capital inflows.

If these circumstances do prove enduring, Russia may face less currency volatility, though even a limited recovery in oil prices and capital inflows led to a notable currency appreciation in early 2017. Russia's leadership seemed committed to pushing back against this trend and maintaining a relatively weak ruble. However, the weak ruble comes with problems of its own, threatening a renewal of conflict over energy supplies to the domestic market and invalidating patterns of investment premised on the idea that Russian consumers can afford international prices. Optimism about "import substitution" is likely misplaced (the model usually makes sense for the individual business only if domestic consumers can afford to pay prices close to international ones), but any push to diversify exports relying on the weak ruble could face difficulties due to sanctions and the general global slowdown in growth. Moreover, despite the CBR's impressive recent efforts to improve the health of the financial sector, Russia is also very far from a domestic investment system capable of fueling growth. A state budget staggering under the impact of dwindling oil revenues and unable to replace them with borrowing cannot itself be a major source of investments.

It is sometimes suggested that low oil prices will have a positive effect on Russian economic policy. As Sberbank's German Gref put it, "the less money, the greater the pressure for reform."[56] However, there are at least two problems with this position. First, as the discussion over "secular stagnation" in the developed world highlights, good institutions do not by themselves generate investment: one also needs reasons to invest. Absent replacements for the demand stemming from hydrocarbon exports, potential investors may well conclude that given the now much diminished size of the Russian market in international terms it will be a long time before additional investments are required. Second, even if it were the case that reformed institutions would generate growth, these reforms may not be forthcoming. The relatively brief period of economic exigency after the 2008 crisis did not give the modernization agenda momentum, and there is so far little indication that the current period of economic difficulty will do so either. The fate of the Medvedev modernization agenda suggests that generating an establishment consensus even for basic transparency and relatively impartial courts is very difficult and that political considerations will play an overwhelming role in determining the final outcome of the 2014-16 crisis, particularly with the March 2018 presidential election on the horizon. And if oil prices do strengthen again, the record suggests that Russia will find itself hard pressed to resist falling back into the pattern of ruble overvaluation and capital inflows that set the stage for all three of its post-Soviet currency crises.

[56] German Gref, "U nas takogo za vsiu istoriiu ne sluchalos'," *Vedomosti*, May 27, 2015.