

Analysis

Memories about the Future: The Second Edition of the 1998 Crisis

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Abstract

By not devaluing its currency, Russia is repeating the mistakes it made in 1998, thereby deepening and lengthening the current economic crisis. Today the Central Bank and the government are supporting the ruble even though it is driving down domestic production. A wiser policy would be to devalue the ruble as soon as possible to stimulate output.

A New Cycle of Crisis

“Hegel once noted that history repeats itself twice. He forgot to add – the first time in the form of tragedy, and the next time as a farce...” Karl Marx, Eighteenth Brumaire of Louis Bonaparte

We forget everything and learn nothing. The Central Bank has done it again. For a second time, Russia is stepping on the same rake. Just as in 1998, the government is first pushing the economy into a recession, taking a hit in the form of a drop in production, and only then, “forced by circumstances,” will it devalue the ruble sufficiently to restore growth.

Crisis, As Was Predicted

Russia has already entered an economic crisis – it reached maximum industrial production in June and production has dropped consistently since then (see Figure 1). The reason is not so much the global economic crisis or even the drop in energy prices, but the government’s and central bank’s stubborn refusal to devalue the ruble.

From June 2008 to the end of January 2009, the ruble fell in relation to the dollar from 23 rubles/dollar to 35 and from 37 rubles/euro to 45, setting new records – the ruble has never before been so cheap. But even this partial devaluation was not sufficient to stop the contraction in reserves and money supply, the growth of interest rates and the drop in production.

The ruble exchange rate was greatly inflated even during the era of high oil and gas prices, which lasted until August. Many economists then understood that the economy was sick with the “Dutch Disease.” They knew that Russia could not support such a strong ruble if energy prices simply stopped increasing, to say nothing of what would happen if they fell. The nominal exchange rate from the end of 1998, although it fluctuated, ultimately changed insignificantly, at the same time that Russian prices from 1999 to 2008 grew annually on average almost 16 percent and increased by the end

of 2008 more than four times, while prices in the US and the euro zone increased only 2–3 percent annually. Thus the real ruble exchange rate, namely the ratio of Russian domestic prices translated into dollars or euros by the official exchange rate to American or European prices, increased almost three times (see Figure 2).

Obviously, in such conditions, domestically produced goods were no longer competitive and imports grew rapidly. The value of overall exports rose extremely quickly (thanks to the high and growing price for oil and gas), more quickly than the value of overall imports, but the growth of the overall physical volume of exports was much smaller than the growth of the volume of imports, which expanded between 1999 and 2007 more than five times (see Figure 3).

To repeat, even if the prices for oil and gas remained at a very high level, but simply stopped growing (after all, they can’t keep going up forever), it would be impossible to maintain the ruble exchange rate in long-term perspective. Russian inflation is higher than in the West, and therefore simply to maintain the competitiveness of Russian goods, Russia must constantly devalue the ruble – on average, by the amount that Russian inflation exceeds Western inflation. If this is not done, trouble will ensue – the trade balance, and subsequently the balance of capital flows, will run a deficit, and after a more or less quick exhaustion of hard currency reserves, Russia will still have to devalue the ruble.

With the drop in prices of Russia’s chief exports – oil and gas – and the massive outflow of capital, devaluation understandably should happen even more quickly. The sooner, the better because the drop in hard currency reserves causes panic, which leads to an even greater contraction of the reserves. For the last six months – from the beginning of August 2008 to January 23, 2009 – the reserves have dropped by more than a third, from \$598 billion to \$386.5 billion. At the current rate of withdrawals, they should last approximately one year, but most likely, they will not even last that long because, in expectation of a devaluation, people are increasing-

ly quickly transferring all of their ruble holdings into hard currencies.

Supporting the ruble at any price, even though it exerts downward pressure on production, seems to be the main goal of the Central Bank and the government. Even though the economy is already in crisis, monetary policy in recent months became even more tight in order to stem the outflow of capital and support the ruble exchange rate: the tempo of growth for the money supply not only slowed, but went negative (see Figure 4), and interest rates grew for this reason (see Figure 5). In other words, precisely because of the limited growth of the money supply and the increased interest rates, the economy entered crisis beginning in July 2008. Producers found themselves between a rock and a hard place: on one hand they faced the pressure of competition from foreign goods thanks to the strong ruble, on the other, pressing monetary restrictions and the growth of interest rates. In the second half of 2008, Russia was one of just a few countries in the world where the money supply shrunk and interest rates grew. Supporting the ruble exchange rate turned out to be more important than supporting production.

The Same Thing Happened in Argentina, and More Recently, in Russia

How similar this all is to the Russian crisis of 1998! Then the government and Central Bank with great doggedness supported the ruble from devaluation through monetarist restrictions: the amount of money in circulation stopped growing from the end of 1997 and the returns on GKO's (short-term government bonds) jumped to over 100 percent.

Then in 1998, thanks to the monetary restrictions and the strong ruble, production began to drop without a world crisis or a drop in oil prices. In effect, the tight monetary policy designed to save the ruble and stem the outflow of capital manufactured recession. Ultimately, the Central Bank did not succeed in supporting the ruble, even at the cost of a 15 percent decline in production from December 1997 through September 1998 (see Figure 1). Was it worth it to try?

These events are similar to Argentina's crisis in 1999–2002. The Argentines also supported their currency (1 peso=1 dollar) in the framework of a currency board regime and faced an outflow of capital. This should have reduced reserves and the money supply and should have led to lower prices in order to increase exports, reduce imports, and correct the balance of payments. They waited for this automatic mechanism to kick in: the outflow of capital – reduced reserves – re-

duced money supply – increased interest rates and lower domestic prices – improved trade balance and an inflow of capital. They waited three years with clenched teeth and suffered through a drop in production of 20 percent (see Figure 6). Ultimately, however, they did not get what they had hoped for since the mechanism did not work: inflation dropped to zero, but this was not enough to restore the competitiveness of Argentine goods; interest rates grew, but not enough to stop the outflow of capital. They could have waited longer, but the reduction of the money supply led not only to lower prices, but to a 20 percent decrease in production – waiting while prices dropped low enough to level the balance of payments during a continuing drop in output was not possible, so the government collapsed along with the currency board and exchange rate.

In contrast to Russia and Argentina, where the drop in production (until September 1998 in Russia and until the beginning of 2002 in Argentina) basically preceded devaluation, in East Asia, the drop in production took place after the devaluation of the national currency, which confirms the argument here. The problem in the Russian and Argentine crises was the strong national currency and the symptom was the reduced rate of growth in exports and production while imports were growing and the trade balance was worsening, leading to the cure of devaluation, after which production started to grow. The problem in the Asian crises of 1997 was the excessive expansion of private debt without a strengthening of the exchange rate of the local currencies: while credits and debts expanded, production grew, but the crash of the credit system hurt production more than the on-going devaluation of the currency stimulated it.

Those events are similar to what is happening today in Latvia, Lithuania, Estonia, Bulgaria, and Bosnia which have currency boards instead of the central bank (currency boards are not allowed to purchase government bonds, so the money supply is always equal to the amount of foreign exchange reserves) and support a fixed exchange rate in relation to the euro. Latvia, which formally does not maintain a currency board, but supports a fixed exchange rate of the lat to the special drawing rights (SDR) since 1994 and to the euro since 2004, has already experienced the greatest drop in production: from GDP growth rates of 11–12 percent in 2006–7 to a drop of 4 percent in the third quarter of 2008. And all because Latvia, with a deficit balance in its current accounts of more than 20 percent of GDP in 2006–7 did not want to devalue its national currency when it confronted an outflow of capital in 2008.

The country's reserves shrunk from \$6.6 billion in May 2008 to \$3.4 billion in November, and the amount of money in circulation fell 10 percent.

Paul Krugman, the winner of the 2008 Nobel Prize in economics, compared Latvia and Argentina in a December 23 *New York Times* blog entry: "This looks like events repeating themselves, the first time as tragedy, the second time as another tragedy."

The consequences of the various reactions of the east European countries to the outflow of capital in 1998–9 after the East Asian currency crises are also extremely instructive. The countries that devalued their currencies in order to restore an equilibrium of the balance of payments experienced a smaller drop in the rate of growth than the countries that supported a strong domestic currency (the Baltic republics, Slovakia, and the Czech Republic). The general reason is that prices of goods and services are not as flexible as the exchange rate: it is easier to restore lost competitiveness by reducing the exchange rate than by reducing prices (or slowing their rate of growth). Theoretically, the automatic mechanism described above should work (outflow of capital – reduced reserves – reduced money supply – increased interest rates and reduced domestic prices – improved balance of trade and an inflow of capital), however in practice, it works slowly and a side effect is a significant reduction in production.

Between Bad and Worse

There are no good policy choices today, so decision makers must pick between bad and worse. Russia's policy makers let slip the opportunity to make good policy at the beginning of the current decade, when it was still possible not to allow the strengthening of the ruble, either by more quickly accumulating hard currency reserves or by purposefully stimulating imports of equipment to restructure the existing economy. Today it will not be possible to avoid losses.

The best option is to devalue the ruble as quickly as possible. This step will lead to a reduction of real incomes and consumption (like the August 1998 devaluation) but at least will make it possible to stop the drop in production. It will be necessary to help the banks

and the non-financial companies which have accumulated large foreign debts, since devaluation will increase their costs in servicing this debt. While Russia's reserves are still significant, it is possible to help the hard currency debtors.

It will be worse if the devaluation is postponed. Domestic production will fall, as in 1998, imports will be high, the trade balance will drop into deficit, capital will flow out, which will deplete in several months the hard currency reserves built up during the last ten years. The end result will again be devaluation. Consumption will likewise then drop, not immediately, but only after the drop in production.

The Central Bank from August to December 2008 reduced the exchange rate by one ruble a month, and since the middle of December quickened the pace to one ruble a week. But even this partial devaluation was not sufficient, since the money supply continues to fall and interest rates keep rising. The result is that Russia will be artificially deepening and lengthening the crisis, as in 1998, and then some time in the middle of 2009, will end up with an exchange rate which will reduce real incomes and consumption and bankrupt hard currency debtors anyway.

Only a sharp rise in hydrocarbon prices can change the outlined scenario. Every analyst has a strong opinion about where oil prices will be next year, in five years, and in ten years. However, as past experience has demonstrated, no one has figured out how to accurately predict oil prices. We only know that in the last 140 years, this price on average was slightly more than \$20 a barrel (in constant 2006 prices) and only in fewer than 30 years of the last 140 (1869–1876, 1973–1985, and 1999–2008) did the price rise above the average level. In any case, betting on "luck" in state policy is not prudent.

It is already clear that even the seemingly large hard currency reserves are insufficient to survive one more year of low prices for oil and gas. Accordingly, it is necessary to pick between the bad and the worse. Either devaluation without a recession (thereby curtailing consumption, but avoiding a drop in production), or first a recession and then devaluation.

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