



RUBLE TROUBLE: THE POLITICS OF RUSSIA'S FINANCIAL CRISIS

By Chris Miller



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The Russian ruble's wild ride—starting the week at 58 to the dollar, spiking to nearly 80 on Tuesday, and settling back near 60 by Thursday—has left many questioning Russia's political and economic stability. Since the ruble's sharp fall on 'Black Tuesday,' a series of measures, from a 6.5 percentage point hike in the Central Bank's main lending rate, to promises of an extensive bailout of the banking sector, appear to have restored the ruble to its previous level, at least temporarily. Yet the crisis will have serious long term ramifications. The economic problems that sparked the crisis have only been swept under the rug, while aftershocks are still reverberating through Russia's political system. Why has the ruble been so volatile? And how will the crisis change Russia?

1. A Backdoor Bailout

Much of the ruble's decline over the past several months has closely tracked the falling price of oil, but the ruble's collapse earlier this week was not linked to the oil price. Instead, it was caused by a loss of faith in the country's mechanisms for governing the financial system. The Central Bank of Russia has long been seen as one of the best governed institutions in the Russian government and is broadly trusted by financial markets as a neutral arbiter.

That changed last week, as Rosneft, Russia's state-owned oil giant, received a \$10 billion bailout from the central bank that violated the implicit rules-of-the-game and marked a new, more explicit politicization of the central bank. Rosneft, which is prohibited by Western sanctions from raising funds in the West, owes \$7 billion in loan repayments that are due on Dec. 21, but it struggled to finance its debts. Rosneft hoped to receive funds from one of the government's long-term savings funds, but the process was dragging on, and Rosneft leadership apparently feared it would not come before debt payments were due.

Rosneft worked with state-owned banks and the central bank to issue 625 billion rubles of new securities at an interest rate that was even lower than the Russian government pays on debt. The central bank accepted these securities as collateral, allowing the banks that purchased Rosneft securities to offload them on the central bank, and receive newly-created rubles in return. In essence, the transaction amounted to paying for Rosneft's debt by printing rubles.

The Rosneft refinancing spooked markets for three reasons. First, it underscored the power of leading state-owned companies, which are evidently capable of hijacking central bank policymaking to refinance their debt. Second, it suggested that the central bank itself was losing control of monetary policy, and that the ruble was becoming an object of political conflict between interest groups. Finally, the Rosneft refinancing set a dangerous precedent. If other companies refinanced their debt in a similar fashion, it would devalue the ruble and spark even higher inflation.

Investors fled the ruble in response, and the currency's exchange rate with the euro and dollar fluctuated wildly. Sergey Shvetsov, an official at the central bank, said that "We couldn't imagine what's happening in our worst nightmare even a year

ago,” while Uralsib, a Moscow-based investment bank, predicted a “fully-blown crisis developing in Russia” and argued that a “bank run is on the cards.” Whether or not bank runs come to pass, it is clear that the Rosneft bailout has sparked an institutional crisis that calls into question the fundamentals of Russia’s financial system. The country’s political balance may shift rapidly as a result.

2. A Struggle for Resources

The plummeting ruble has placed immense stress on Russia’s political system, as it struggles to divide a shrinking pie. Bloomberg News calculated that Russia’s 15 richest men have lost a collective \$50 billion over the past year, as the falling ruble forced down asset prices. In the aftermath of the central bank’s Rosneft bailout, other oligarchs and interest groups have been jockeying to get their time at the trough. Oligarch Mikhail Prokhorov, for example, called on the central bank to auction off additional liquidity even if buyers lack credible collateral, which would function as a transfer of resources from the government to banks.

The apparent inability of the central bank to stem the crisis has emboldened those who believe its orthodox economic policies helped cause the crisis. Sergey Glazyev, a Putin aide who had been shortlisted to lead the central bank before Nabiullina was selected, as criticized the bank for cutting of credit to the real economy. Glazyev, who has long backed a policy of easier monetary policy, argued that the central bank’s decision to increase interest rates is starving the real economy of credit while emboldening “speculators.” Glazyev’s call for more industrial subsidies is backed by many others in the elite. Dmitry Rogozin, the deputy prime minister in charge of the military-industrial complex, has used the crisis to advocate import substitution and for higher subsidies for industry—policies that would benefit the interest groups he represents. As the crisis deepens, the struggle between oligarchic groups will only increase. Putin may struggle to maintain balance.

3. Retreat from Ukraine?

Media attention has focused on the collapse in the ruble’s value, but the past several days have seen surprising statements from Moscow, Kyiv, and from Western diplomats suggesting that Russia may be backing down from its aggressive posture in Eastern Ukraine. Diplomatic efforts have focused on reviving the Minsk ceasefire agreement, which Russia and Ukraine signed in September and which were promptly broken.

This week, however, Ukrainian President Petro Poroshenko reported that fighting along the line separating Ukrainian government forces from Russian-backed separatists had calmed considerably. Ukraine’s military said that shelling near Donetsk airport—previously at the center of the conflict—had declined by 80 to 90 percent. Poroshenko signaled that he was placing renewed emphasis on implementing the Minsk ceasefire.

Russia, too, appears newly willing to move toward a settlement with Kyiv, judging by recent statements from Russian Foreign Minister Sergey Lavrov. Such statements should be read with caution, both because Lavrov is not himself a key decision maker on questions of foreign policy, and because during the past year, there has often been a wide gap between the public statements of Russian leaders and their actions on the ground.

Nonetheless, Lavrov’s rhetoric over the past two days is notably different than before. He has lavished praise on Ukraine’s president Poroshenko, calling him “Ukraine’s best chance.” Lavrov also highlighted what he portrayed as a newly productive dialogue between the two countries. “I can’t say that there are any difficulties in contacts with the president of Ukraine,” Lavrov. “At the level of the leaders of the two countries there is a regular dialogue.”

Russian-Ukrainian dialogue has become more productive, it appears, because Moscow may be backing down from much if its earlier rhetoric that threatened Ukraine’s sovereignty over its eastern provinces of Donetsk and Lugansk, in the Donbass region. The Kremlin began building the insurgency in the Donbass while claiming that it was backing local calls for more autonomy from Kyiv. The rebels were not ‘separatists’, in Russia’s terminology, they were ‘supporters of federalization.’ Russia was widely believed to be backing federalization because such a policy would maintain the Kremlin’s influence in the Donbass and therefore in Ukraine more widely.

Now, though, Russia appears to be back peddling on its demands for federalization. On Dec. 16—as the ruble began its sharpest fall yet—Lavrov told a French TV station that “we aren’t suggesting federalization or autonomy [for the Donbass]...That is a question for Ukrainians.” Indeed, Lavrov claimed that the idea of federalization and autonomy came from European officials, rather than from Russia. This is false, but it provides additional evidence that Russia may be backing

away from its strongest demands in Ukraine. Lavrov also explicitly stated that, with the exception of Crimea, which Russia no longer recognizes as part of Ukraine, the Kremlin believes that Ukraine’s “territorial integrity should be supported in its [current] form”—that is, Donbass should stay part of Ukraine.

Moscow had never adopted a policy of recognizing the independence of the self-proclaimed republics in the East, but the past few weeks have seen fewer top officials discussing ‘Novorossia,’ a region that Russian nationalists believe encompasses much of southern and eastern Ukraine and which, they believe, should be independent from Kyiv or annexed to Russia. In a major speech in early December, Putin declined to use the word ‘Novorossia’ and focused entirely on Crimea, a territory he described as ‘sacred’ to Russians. This overblown rhetoric about Crimea is an attempt to refocus Russians’ attentions on the ‘success’ in Crimea—and to distract them from the fact that the Kremlin has gotten mired down in the Donbass. More than at any point since the war began, it looks as though the Kremlin is preparing to call a retreat.

Why? Russians themselves are unenthusiastic about the war—polls suggest that most Russians are unaware that the Kremlin deployed troops in the Donbass, and oppose such a move. At the same time, the economic costs of the war are beginning to hit home. For one thing, paying for the establishment of the new governing structures in the Donbass was turning into a more expensive proposition than the Kremlin appeared to have initially realized. Equally important is the rising cost of Western sanctions. While Russian officials long downplayed the effect of sanctions, now many Kremlin allies are openly blaming sanctions for the crisis. On December 17, for example, Alexey Pushkov, head of the Duma’s foreign affairs committee, complained on twitter that “The EU is not interested in the collapse of the Russian economy, [but] it will seriously hit Europe. The consequences are already being felt from Finland to Italy. Sanctions are dangerous.”

The effect of sanctions are felt across Europe, but they are only a real danger to Russia, which is why the Russian elite is pushing for policy shifts that would lead the West to lift sanctions. In recent days, Western diplomats have highlighted their willingness to remove sanctions if Russia changes its policy in the Donbass. “These sanctions could be lifted in a matter of weeks or days, depending on the choices that President Putin takes,” US Secretary of State John Kerry said this week. Kerry also underscored that “Russia has made constructive moves in the last days and there are some indications that whether it is the line of control negotiation or the calm that is, in fact, in place...the withdrawal of certain people, there are signs of constructive choices.” If Kerry is correct—if Lavrov’s new rhetoric is being coupled with serious action on the ground—a deal over the Donbass may be closer than many expect. If so, Moscow’s deepening financial crisis is a main reason why.

Conclusion: The Conflict between the TV and the Fridge

Historian Nikolai Svanidze has described current Russian policy as a conflict between the TV and the Fridge. Russian propaganda—the TV—has spun a narrative of Putin as a skilled and decisive leader. That story worked for a while, but reality is catching up. Higher prices for food and other basic goods—what Svanidze calls the Fridge—are beginning to illustrate the true costs of Putin’s policies, especially his war in Ukraine.

The West hopes that the economic crisis will force Putin to seek relief from sanctions by cutting a deal on Ukraine. Such an outcome is more likely, but it is still far from guaranteed. Putin has staked his credibility on the conflict, building up a nationalist movement in Russia that opposes any retreat. Having declared that the people of the Donbass face a “fascist” threat from the government in Kyiv, Putin will struggle to explain a policy of disengagement, even given his control of Russia’s media.

The currency crisis has heightened the economic stakes of Putin’s decisions. Russia’s leadership is skilled at blaming the West for domestic problems, but the Kremlin’s dilemma is that a deal over Ukraine, which is the only way the West will lift sanctions, would contradict the narrative that Russia is under siege. Even if the currency crisis leads to a deal over Ukraine and the lifting of sanctions, the results of this crisis will shape Russia’s domestic politics for years.