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Russia's "Black Tuesday": The Economic and Political Ramifications

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The dramatic fall of the rouble seems to spell the end of Russia's economic growth based on high oil and gas revenues. The central bank's decision to hike interest rates inhibits economic development and will deepen the recession in 2015. The currency crisis may also have political spillover, intensifying conflicts among the ruling elites and reactivating systemic opposition. In the coming year, the Kremlin is likely to focus on power preservation rather than addressing Russia's structural economic problems.

Economic Aspects of the Rouble Crash. Despite a rise in interest rates, which the Russian central bank adopted on Monday night, the fall of the rouble has not been halted. The price for one dollar reached a historic high on 16 December of more than 80 roubles, and for each euro, 100 roubles. The currency's crash can probably be regarded as a turning point: it marks the symbolic end of the economic model Russia developed after the infamous currency crisis of 1998. This model based growth mainly on the rising prices of oil and gas, allowing Russians to enjoy a higher standard of living and elites to amass fabulous fortunes. Behind the facade of relative prosperity, however, lay gigantic levels of corruption, inefficient government, and the inability to develop new technologies. The stabilisation of oil prices in 2013 was the silently start of the crisis. Its most acute phase began with the imposition of sanctions and the steep decline in oil prices. At this point, Putin's bubble burst.

For now, the absolute priority for the Russian authorities is to master the chaos on the financial markets. Unfortunately, the tools available do not guarantee success. In addition, each of them has risky side effects. The central bank can, and has increased interest rates. With the weak effects of this latest jump from 10.5% to 17%, a next attempt would be a spectacular demonstration of the bank's determination. If it does, it likely would be over 20%. The price for such extreme monetary measures is high. It can stifle economic activity and deepen a recession. With such expensive access to capital there is little to no chance for a quick replacement of imports by increasing domestic production because manufacturers need long-term financing at low interest rates to expand capacity.

Another tool the central bank and the ministry of finance can apply to the crisis is currency intervention. However, the official level of reserves ($350-400 billion) hardly translates into intervention capacity, since not all of the assets are fully liquid. The real firepower could be much lower, even below $100 billion, so there is no guarantee that Russia will be able to defend the rouble for a long period of time. In addition to that, the financial markets have little confidence in the ability of the Russian central bank to manage the crisis after it confused investors with a vague stance on possible interventions. Another reason for the uncertainty is found in the interest of short-term investors: after "Black Tuesday", they probably see the rouble as easy prey. This is why the Russian authorities may try another, less sensitive option of pumping money directly into companies and banks in trouble. The decision on 17 December to adopt new bookkeeping rules for banks that help them hide losses plays into this direction. Politically, this is a comfortable option, though on the other hand it makes the state directly involved in the business sector.

A third tool Russia may use is to impose controls on the movement of capital, primarily by suspending the convertibility of the rouble. However, such a step would result in an even faster erosion of trust in Russia's economy and cut off its companies from international markets, which will hurt many Russian companies, which must carry service on their foreign debt into 2015 (about $150 billion). It also would make President Putin's initiative to offer amnesty on the return of capital futile as no one would be willing to repatriate capital back to a country with a falling currency and controls on the movement of capital. In addition, such a move would create an informal currency market, but one extremely difficult to control by the authorities.

Political Fallout of the Crisis. There are several immediate consequences of the emerging currency crisis on Russia's domestic politics. The first is that the Russian authorities no longer can deny that the country faces grave economic problems. The economic challenges Russia is confronting simply cannot be swept under the carpet. Russian officials' public and private comments, the latter leaked to the press after the rouble's recent severe fall, point to growing alarm among the country's economic elites regarding the scale of the troubles and the potential social impact. As confirmation of the seriousness of the situation, Prime Minister Dmitry Medvedev, one day after publishing an opinion on Ukraine's economic problems, had to chair an emergency meeting on the financial and economic situation in Russia and pledge to enact complex measures to stabilise the situation.

The second is it will be harder to defend the line that the EU sanctions against the country and Russia's food embargo against the EU and others will stimulate domestic production and ultimately make Russia stronger economically. So far, life under the sanctions has proved just the opposite. Thus, for the Kremlin to shore up domestic support and externalise responsibility for the crisis it probably will have to rely more on a message that the West, via the sanctions, is pursuing regime change in Russia. Exploiting the fear of externally induced instability, the Kremlin will try to rally its population behind the Russian flag and buy time by promising minimal prosperity despite the economic turbulence.

The third effect is that the economic difficulties will intensify infighting among Russia's ruling elite, but with unpredictable consequences. The central bank's decision to drastically hike the interest rate was vehemently criticized by the spokesperson for Rosneft, the biggest state-owned oil company and run by Igor Sechin, a long-time associate of Putin. The attack on the increased rate came also from the presidential aide for Eurasian integration, Sergey Glazyev, who was rumoured to be in the cards in 2013 for a position with the central bank. However, Aleksei Kudrin, the former minister of finance, whom the Russian president still consults with occasionally on economic matters, defended the central bank's decision, throwing his weight behind the current head of the central bank, Elvira Nabiullina. President Putin might sacrifice Nabiullina if the crisis deepens, but this might be interpreted as a sign of weakness and could fuel a debate about whether the current prime minister should also keep his job. In a surprising declaration, a prominent representative of the extra-parliamentary party Yabloko, Grigory Yavlinsky, suggested the ministers responsible for the economic sector should be replaced and that Kudrin should be appointed prime minister. Shortly after that, Rosneft CEO Sechin denounced Kudrin as a provocateur. Even before the crisis, commentators in Russia wondered how long Putin would keep Medvedev, one of his loyal lieutenants, as head of government. As the crisis unfolds, Medvedev's status is again in question. The first public reactions show that Putin is unwilling to reshuffle the government now; however, surprises in the near future cannot be totally ruled out.

One last, but not the least, important political consequence of the crisis may be the reactivation, even if mainly theatrical, of a systemic opposition. While systemic parties usually play by the Kremlin's rules, if they sense blood in the water it might be the right time for them to score points as they are very opportunistic. Already, the Communists and Liberal Democrats have demanded parliamentary hearings in the Duma to question the prime minster, the head of the central bank and the Accounts Chamber, the country's financial controller. As the party in power, United Russia has deflected such initiatives in the parliament. In response, Communists have also called for special session of Russia's Security Council, while the Liberal Democrats blame Nabiullina for the fall of the national currency. From the Kremlin's vantage point, this may be useful to some extent as a systemic opposition helps to create the impression of political drama, even if controlled by the presidential administration. If the crisis deepens, however, and the Kremlin shows weakness, what looks useful today might easily spin out of control and thus turn into a threat to the current political stability.

Conclusions. The rouble's crash may be a prelude to a very difficult 2015. The coming year will be marked by both a recession (estimated to be 4.5%) and most likely double-digit inflation driven by the current level of devaluation. The government will face great difficulty in finding the right policy mix, since anti-inflationary instruments will stifle growth and pro-growth ones would accelerate inflation and the devaluation of the rouble. Another difficult choice for it is to point out who should suffer more under the unavoidable cuts in public spending. A contraction in social spending will undermine Putin's support in society and reducing subsidies for state companies will amplify the conflict among the economic elites. The coming months will be dominated by political friction among various interest groups and require adjustments in Putin's power-preservation strategy until, as the Kremlin hopes, oil prices will start to rise again. There probably will be the temptation to use aggressive foreign policy themes to distract society from Russia's economic problems. All these will leave limited space for what Russia needs immediately: reforms to eradicate corruption, a more efficient judiciary and improved governance, the development of small and medium-sized enterprises, and support for new non-oil or gas branches of the economy and new technologies.