

**The Memory of the Future:  
The Second Edition of the Drama of "The 1998 Crisis"**

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*"Hegel once said: history is repeating itself. He forgot to mention – the first time as a tragedy, and the second time – as a farce..." (C. Marx, The Eighteenth Brumaire of Louis Bonaparte*

We have forgotten everything and have learned no lessons. The Central Bank is doing this again. We are "stepping on the same rake" a second time. Just like in 1998, we have first pushed the economy into the economic crisis living through a recession, and only after that and under the pressure of the circumstances, are devaluating the ruble to the extent required for restoration of production growth.

**Crisis just like they warned us**

We have already plunged into economic crisis after the maximum industrial production was achieved last summer, in June, and since then, production has been steadily declining. The reason is not so much the crisis of the world economy, or the dropping energy prices, but the government's stubborn unwillingness to devalue the ruble.

Actually, as of July 2008 and until March 2009 the ruble kept sliding, from 23 to 36 rubles to the dollar, and the ruble/EUR exchange rate dropped from 37 to 46 rubles, while both currencies were setting new historical records; the ruble has never been that low against other currencies. But that was still not enough to stop the declining reserves, shrinking money supply, soaring interest rates and dropping industrial output.

The ruble exchange rate was too high, even when the oil and gas prices were too high and stayed at the high level until August of last year. Many experts realized that the economy was seriously sick with the "Dutch disease," and that such a high exchange rate could not be maintained, even if energy prices would cease to grow, not to mention their total collapse. As of late 1998, the nominal rate was fluctuating, but, in the long run there was only a slight change, whereas in 1999-2008 Russian prices were growing at the average annual rate of 16% and by the end of 2008 increased more than four-fold while prices in the U.S. and the Euro zone were growing at the annual rate of 2-3%. So, the actual ruble exchange rate, i.e. the ratio of our prices, converted in USD and EUR at the official exchange rate, grew three-fold, vs. the U.S. and European prices.

Given that ratio, competitiveness of Russia's domestic products was lost, while the import was dramatically expanded. The price of exported goods (owing to the growing energy prices) was quickly increasing, on a much faster rate than import prices, yet the growth of export volume was behind the growing import volume, which almost five-fold during 1999-2007!

Again, even if the prices of oil and gas stopped growing and stayed at a very high level (they just cannot keep growing forever), it would have been impossible to maintain the ruble exchange rate at the same level. Whether we like it or not, inflation in this country is higher than in Western countries, and, therefore, in order to maintain competitiveness of our products we need to keep devaluating the ruble, at the average rate that would match the gap in inflation dynamics in Russia and the West.

And, if prices of our main export items (oil and gas) collapse, along with the outflow of capital from the country, devaluation must be performed well before that. The earlier, the better, because the declining foreign exchange reserves cause panic and triggers fast depletion of reserves. Over the past seven months, between early August 2008 and late February 2009, national reserves shrunk almost three-fold, from USD 598 bln to USD 380 bln. At the current pace of their use, they may last for another year, but, in fact they may be completely used up even earlier than that, since due to the devaluation expectations, the process of conversion of rubles into other currencies is accelerating.

Maintaining the ruble at any price, even at the expense of suppression of production, seems to have become the principal task of the Central Bank and the government. Despite the fact that the economy has already entered the crisis, in recent months the monetary policy has become more stringent to stop the outflow of capital and support the ruble; the rate of growth of cash supply has not just slowed down, but has become negative, and for that reason the interest rates have increased. It was precisely due to the slowed down growth of cash supply and the increased interest rates that the economy entered the crisis in July 2008. The manufacturers found themselves in a tough situation: on the one hand, they are under constant competitive pressure caused by foreign-made goods and the overvaluated ruble, and, on the other hand, they had to cope with the monetary restrictions and the growing interest rates. In the second half of 2008, Russia was one of the few countries in the world where cash supply was declining and the interest rates were growing. It became more important to maintain the currency exchange rate than to maintain production output levels.

During the previous crisis, the government and the Central Bank were stubbornly holding the ruble back from devaluation through monetary restrictions: as of late 1997, the growth of cash supply virtually stopped, while state bond returns exceeded 100%.

Following that, in 1998, due to monetary restrictions and the overvaluated ruble, production was cut, although at that time there was no global crisis, nor the oil prices were dropping. The Russian crisis was actually triggered by the stricter monetary policy launched to rescue the ruble under the outflow of capital. All attempts to hold back the sliding ruble failed, including the 15-percent reduction of industrial output from December 1997 to September 1998. Were all those steps really worth the effort?

The situation was very much the same during the crisis in Argentina in 1999-2002. The currency exchange rate was also maintained at the level of 1 pecco = USD 1 by the Monetary regulation authority, and there was also the outflow of capital, which reduced reserves and cash supply, with the expectation of lower prices, higher export volume, lower import volume and improved balance of payments. In Argentine, they also hoped that the automatic mechanism would be activated, and all of the following phases would

be implemented (capital outflow – reduction of reserves - reduction of cash supply – higher interest rates and lower domestic prices - improved trade balance and capital inflow). They waited for three years and had to cope with all sorts of difficulties, and had to live through a 20% cut in production (Pic.7). Yet, nothing came out of it. The mechanism never brought the expected results: inflation dropped to zero level, but that was not sufficient to restore competitiveness of Argentine products; the interest rates were growing, but not at the rate required to stop the outflow of capital. They could wait longer, but the lack of cash supply failed to bring prices down, and there was a 20 per cent recession. It was not possible to wait until the prices drop to the level sufficient to maintain the payment balance under the continued recession, so the government collapsed together with the Monetary regulation authority.

There is a similar situation now in Estonia, Latvia, Lithuania, Bulgaria, Bosnia, which have initiated monetary regulation and are trying to maintain fixed EUR exchange rates to their currencies. Latvia (which officially performs no monetary regulation, while it has been maintained a fixed lat/SDR rate since 1994 and the lat/EUR rate since 2004) has already seen a dramatic decline in production - the GDP growth rate dropped from 11 to 12 per cent in 2006-07 to 10% in the fourth quarter of 2008. All that because of the fact that Latvia, with the current balance deficit of more than 20 percent, refused to devalue the national currency in 2006-07, after the capital outflow problem emerged there in 2008. Its reserves decreased from USD 6.6 bln in May 2008 to USD 3.4 bln in November 2008, and cash supply shrank 10%. In Estonia, the GDP growth rate also dropped from + 10% in 2006 to -10% in the fourth quarter of 2008.

The New York Times's Paul Krugman, a prominent contemporary economist and 2008 Nobel Prize winner, recently compared Latvia's and Argentina's experience. "It looks like history is repeating itself," he wrote, "the first time as a tragedy, and the second time...as yet another tragedy."

The effect of mixed reaction on the part of the East European countries to the outflow of capital in 1998-99r after the East Asian currency crises was also extremely indicative.

Those countries which devaluated their currencies to restore their payment balance experienced a less painful drop in their growth rates than the countries supporting their overvaluated currency rates (the Baltic Republics, Slovakia, and the Czech Republic). The common understanding is that the prices of goods and services are not as flexible as the exchange rate: it is easier to recover lost competitive positions by lowering the currency rate, rather than by slowing down the growing prices. Theoretically, the above-outlined automatic mechanism (capital outflow - reduction of reserves – reduction of cash supply – higher interest rates and lower domestic prices - improved trade balance and capital inflow) must work, but in practice it all works too slowly, with a significant reduction of output as a side effect.

### **Between the bad and the worst**

Today, there are no good policy options, so the only choice that remains is between what's bad and what's totally unacceptable. The good options were missed, and that did not happen yesterday, but, rather, the day before yesterday, in the beginning of the current ten-year period, when it was still possible not to allow the rapid growth of the ruble, either by an even more rapid accumulation of foreign exchange reserves, or through consistent efforts to stimulate import (for example, the import of machines and equipment required for structural modernization). Today, it will not be possible to avoid the high costs.

The best way is to devalue the ruble as quickly as possible. That will reduce consumption (just like it happened following the August 1998 devaluation), but that will at least suspend the process of shrinking cash supply, growing interest rates and dropping output. It will of course be necessary to help the banks and non-financial institutions that have accumulated significant external debt, since devaluation will increase their debt service costs. But today the reserves are still sufficient, and it's still not too late to help the companies with currency loan debt.

The consequences will be much worse if devaluation is delayed. Production will drop, just like in 1998, the import will be at a high level, just like the trade deficit, and the capital will continue to flow away, which over a few months will result in depletion of

reserves accumulated over the past ten years, and devaluation will still have to be carried out. Consumption will drop, maybe not right away, but only after a serious drop in production. All that will look like we are deliberately trying to deepen and extend the crisis, which was the case in 1998, and then, somewhere in mid-2009, we will still have to take up the course which will cause reduction of real incomes and consumption, and bankruptcy of the companies unable to repay their loan debt.

We will be saved from such a scenario if the oil prices soar again. Experts may differ in their forecasts regarding the prices of oil within the next year, five years or ten years, yet, unfortunately, as we all know from past experience; no one has ever succeeded in making accurate oil price forecasts. What everyone knows is that over the past 140 years those prices were, on average, at the level of a little more than USD 20/barrel (in 2006 prices) and only during some 30 years out of those 140 years (1869-1876, 1973-1985, 1999-2008), they were at a higher than average level. Whatever the goal is, it would not be appropriate to make unsafe government policy bets.

It is now quite clear that the seemingly large foreign currency reserves are not sufficient to survive another year of low-level oil and natural gas prices. So, we do need to choose between what's bad and what's totally unacceptable. We either go ahead and devalue the ruble (and reduce consumption) and thus escape another crisis (recession), or we plunge into a crisis first, and then carry out the devaluation project.

Meanwhile, the current recession threatens to be comparable in scale with the transition period's recession in the early 1990s. The monthly industrial output index declined 25% in January 2009, compared to the summer of 2008; by the summer of 2009, we may see a 50% drop, while in 2009 Russia's HDP may shrink 20% or more, compared to the level of 2008. Under these realistic prospects, monetary restrictions and maintaining a strong ruble run contrary to what you'll find in any book of economics. By the way, the country's financial policy leaves much to be desired. The package of incentives totaling 5% of the country's GDP, seems to be a miserly amount, compared to the U.S. package (12 per cent of GDP in 2009), while the U.S recession forecast is much more optimistic.

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