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SNAPSHOT

Revenge of the Ruble

What the Crisis Means for Putin

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The ruble has already lost almost half its value against the U.S. dollar this year, and its potential collapse has pushed Russian President Vladimir Putin into an increasingly tight corner. In Ukraine, where hostilities have brought sanctions and alienated investors, Putin has only bad options to choose from: He can either make a deal now—one he won't like, since he holds few cards—or compromise later, once his negotiating position has deteriorated further. No matter what happens, he will end up badly wounded. The question is whether he will drag his country down with him, turning Russia into a full-fledged pariah state.

When Putin first moved on Ukraine, Western leaders confidently predicted that the economic consequences would force him to retreat. But things didn't play out that way. After Russia annexed Crimea, the ruble actually strengthened, thanks in part to Moscow's huge foreign exchange reserves (equivalent, on paper, to half a trillion dollars at the end of last year). Putin seemed to be winning, and it looked as if the potential consequences—capital flight, a currency collapse, a replay of the financial crisis of the late-1990s—would never materialize.

But that supposed victory was always an illusion. To believe it was real, one would have had to believe that Putin's adventure in Ukraine would be quick and easy. Many did, especially in the Kremlin. But it should have been clear to Putin and his advisers that if the war lasted much longer than a few months, some exogenous event, such as a European recession or another 2008-style financial panic, would eventually make it impossible to defend the ruble. A drop in oil prices ended up doing just that.

The price of crude has been sliding ever since the U.S. Federal Reserve ended its bond-purchasing program last summer, and prices now stand at a little more than half what they were a year ago. The price of Brent oil, a key benchmark for global prices, has dropped from $90 a barrel at the beginning of October to well under $60 today.

Two-thirds of Russia's export revenues come from petroleum, so at today's prices, it's hard to see how Moscow can keep its once-formidable trade surplus positive. The economy, meanwhile, is forecast to shrink at least four percent next year, although that estimate now seems conservative. And inflation now exceeds eight percent, and will only get worse. It's hard to ignore a sense of déjà vu: Russia experienced crippling hyperinflation in the early 1990s, and those in power today are more or less the same crowd who were responsible for that fiasco.

Seeing all this, investors have concluded that the Russian central bank's defense of the ruble was a temporary solution to a permanent problem. Capital flight has accelerated as a result, and Russia's reserves now total less than $400 billion. That still sounds like a lot of money, but most of it is illiquid—the bank has at most $1[illegible]0 billion of usable reserves left. In October, the last month for which figures are available, at least $10 billion dollars fled the country. The price of oil is a lot lower now, so the outflow could only have worsened since then.

When there's no light at the end of the tunnel, people try to jump off the train as fast as they can. Another ruble crisis became inevitable once the price of oil started to slide. Involving the country in an unwinnable war just as oil was about to take a dive was a terrible blunder. For as long as the conflict continues, Putin won't be able to persuade Western investors to come back and get the economy going again.

No matter what Putin does at this point, the ruble remains in serious trouble, simply because at this oil price, Russia's foreign exchange reserves, which are already seriously depleted, will continue to shrink rapidly over time. It might be possible to avoid another 1998-style ruble crash if he were to mend ties with the West tomorrow. But that would require him to make politically costly concessions.

With nothing to lose, the Kremlin could act even more aggressively, exercising the sort of freedom the North Koreans and Iranians enjoy. But it won't be easy to survive the inevitable political blowback. Russians aren't ready for a permanent return to the darkest days of the 1990s. To persist in his present course and maintain power, Putin will have to abandon all pretense of regular government or the rule of law and construct a comprehensive, Soviet-style police state.

If Putin thought he could defeat the West in a proxy war, he may actually believe himself capable of this task, too. But the cost of the Soviet system wasn't just the brutality required for its maintenance—it was also the bloodshed required to set it up in the first place. Paying that price is what Putin will be committing himself to if he doesn't back down before the ruble crashes completely.

Once Putin starts down such a path, it will become much harder for him to relent. The United States must therefore do what it can to persuade him to step back from the ledge, even if that means allowing him to save face. If Washington wants to end the Ukraine crisis swiftly, now is the time.

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[1] http://cup.columbia.edu/book/the-domestication-of-language/9[illegible]802[illegible]116[illegible]92[illegible]