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IT'S NOT JUST RUSSIA: CURRENCY CRISES IN THE COMMONWEALTH OF INDEPENDENT STATES

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Highlights

- The currency crisis that started in Russia and Ukraine during 2014 has spread to neighbouring countries in the Commonwealth of Independent States (CIS). The collapse of the Russian ruble, expected recession in Russia, the stronger US dollar and lower commodity prices have negatively affected the entire region, with the consequence that the European Union's entire eastern neighbourhood faces serious economic, social and political challenges because of weaker currencies, higher inflation, decreasing export revenues and labour remittances, net capital outflows and stagnating or declining GDP.
- The crisis requires a proper policy response from CIS governments, the International Monetary Fund and the EU. The Russian-Ukrainian conflict in Donbass requires rapid resolution, as the first step to return Russia to the mainstream of global economic and political cooperation. Beyond that, both Russia and Ukraine need deep structural and institutional reforms. The EU should deepen economic ties with those CIS countries that are interested in a closer relationship with Europe. The IMF should provide additional assistance to those CIS countries that have become victims of a new regional contagion, while preparing for the possibility of more emerging-market crises arising from slower growth, the stronger dollar and lower commodity prices.

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IT'S NOT JUST RUSSIA: CURRENCY CRISES IN THE CIS

MAREK DABROWSKI, FEBRUARY 2015

THE PERIOD OF FAST ECONOMIC GROWTH and relative macroeconomic stability in the countries of the former Soviet Union seems to be over. The collapse of the Russian ruble, expected recession in Russia, the stronger US dollar and lower commodity prices have negatively affected the entire region through trade, labour remittance and financial-market channels, resulting in negative expectations and leading to either substantial depreciation of national currencies, or decline in countries international reserves, or both. This means that the European Union's entire eastern neighbourhood faces serious economic, social and political challenges coming from weaker currencies, higher inflation, decreasing export revenues and labour remittances, net capital outflows and stagnating or declining GDP.

The currency crisis started in Russia and Ukraine during 2014 as a result of the combination of global, regional and country-specific factors. Among the latter, the ongoing conflict between the two countries and the associated US/EU sanctions against Russia have played the most prominent role. At the end of 2014 and in early 2015, the currency crisis spread to Russia and Ukraine's neighbours.

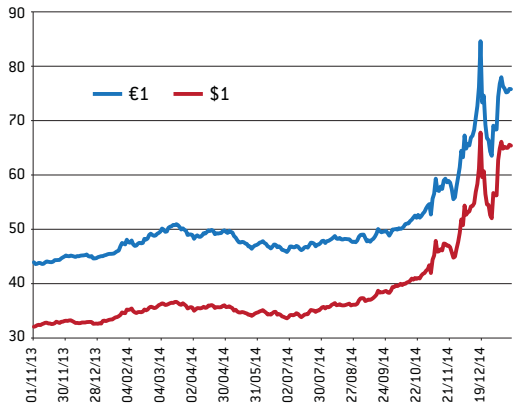
This Policy Contribution analyses the dynamics of currency crises in Russia (section 1) and Ukraine (section 2) and their regional contagion (section 3), with attention to changes in nominal exchange rates, international reserves and official reactions to the development of crisis, such as changes to central bank interest rates, changes to monetary and exchange-rate regimes and resorting to foreign exchange restrictions. A number of factors have helped create this situation: the impact of US monetary policy tightening and the stronger US dollar, and lower commodity prices (section 4), the Russian-Ukrainian conflict (section 5) and the poor business climate in the region (section 6). But there have also been mistakes in crisis management which, in some instances, reinforced negative market reactions (section 7). All the crisis-affected countries face legacies from their past macroeconomic and financial instability, such as high inflation and hyperinflation, sharp devaluations, government defaults and banking crises, and this substantially narrows the menu of available policy responses and calls for serious measures to rebuilt credibility and confidence (section 8). National governments in the region, the European Union and International Monetary Fund all have a part to play, and section 9 recommends steps they should take.

1 ANATOMY OF THE CRISIS: RUSSIA

The gradual depreciation of the ruble against both the euro and US dollar started in November 2013, before the Russian-Ukraine conflict emerged and when oil prices were high. The depreciation intensified in March and April 2014, after Russia's annexation of Crimea and the first round of US and EU sanctions against Russia. Between May and July 2014, the ruble partly regained its previous value.

However, the depreciation trend returned in the second half of July 2014. Its pace increased in

Figure 1: Ruble exchange rate against the euro and dollar, 2013-15



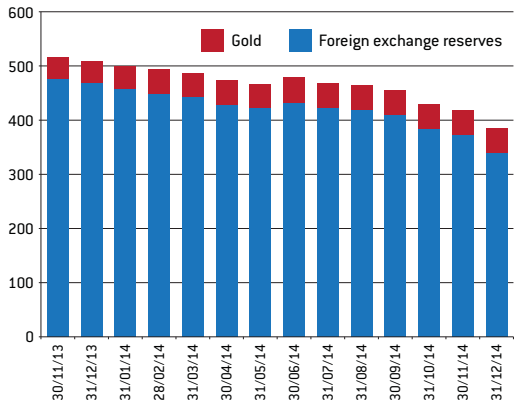
Source: Central Bank of Russia, http://www.cbr.ru/eng/currency_base/dynamics.aspx

October with a culmination in mid-December 2014 (Figure 1). After a massive intervention on the foreign exchange market and the adoption by Russia of other anti-crisis measures (see section 6) the situation stabilised for a while. However, depreciation started again in January 2015, boosted by Moody's and Standard & Poor's downgrading of Russia's credit rating, and the subsequent escalation of the Donbass conflict in the Ukraine.

Cumulatively, between the end of November 2013 and end of 2014, Russia lost in the region of $130 billion of its international reserves (Figure 2), which resulted from a large-scale capital outflow estimated to exceed $150 billion in 2014 (see section 6). Nevertheless, Russia continues to have a sizeable current account surplus. In the first half of January 2015, the reserves decreased further by about $7 billion[1].

At first glance, Russia's international reserves remained at a comfortable level of about $380 billion as of mid-January 2015. However, this aggregate figure includes gold, Russia's reserve position in the International Monetary Fund (IMF) and financial assets of two sovereign wealth funds – the National Wealth Fund and the Reserve Fund. Their total assets amounted to $88 billion each on 1 January 2015)[2], but part of these amounts is not held in Central Bank of Russia accounts and is not included in its international reserves statistics. Deducting these items from the total reserves leaves about $150-160 billion of liquid reserves, which can be used by the CBR for intervention in the foreign exchange market[3].

Figure 2: Russia's international reserves in $ billions, 2013-14



Source: Central Bank of Russia, http://www.cbr.ru/eng/hd_base/default.aspx?Prtid=mrrf_m

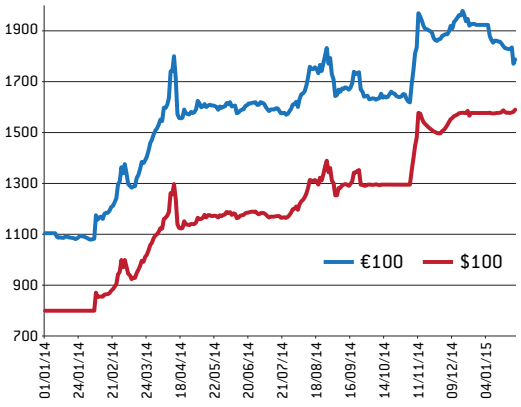
This amount should be considered in relation to foreign exchange liabilities of $110 billion to be paid back in 2015 and $37 billion of on-demand liabilities (according to information available on 1 October 2014[4]). Liabilities of commercial banks and non-banking corporations represent the dominant share of these amounts. Their market rollover looks problematic, especially in the case of state-owned companies, because of the EU/US sanctions and increasing uncertainty about the Russian economy's prospects. However, part of the liabilities is probably attributable to foreign subsidiaries of Russian companies and other offshore affiliated organisations.

The mid-December speculative attack spread beyond the foreign exchange market. Households started to withdraw their rubles and change them into foreign currency or durable consumer goods. The dramatic increase in the CBR rate for repo operations (with maturities of between one-day and one-week) from 10.5 percent to 17.0 percent on 16 December 2014 fuelled further market panic. Only a massive intervention on the foreign exchange market managed to tame it, at least temporarily. In two days, 15-16 December 2014, the CBR sold more than $4.3 billion followed by government foreign currency sales at the end of December 2014 and January 2015[5].

2 ANATOMY OF THE CRISIS: UKRAINE

In parallel with the decline of the ruble, a similar process was observed in neighbouring Ukraine. The hryvna, which was previously fixed quite

Figure 3: Hryvna exchange rate against the euro and dollar, 2014-15



Source: National Bank of Ukraine, http://www.bank.gov.ua/control/en/curmetal/currency/

1. See http://www.cbr.ru/Eng/hd_base/?PrtId=mrrf_7d

2. See http://old.minfin.ru/en/nationalwealthfund/statistics/amount/index.php?id_4=5830, http://old.minfin.ru/en/reservefund/statistics/amount/index.php?id_4=5817

3. Aslund (2014a) estimated liquid CBR reserves at $190 billion as of 31 October 2014.

4. See http://www.cbr.ru/statistics/credit_statistics/print.aspx?file=schedule_debt.htm.

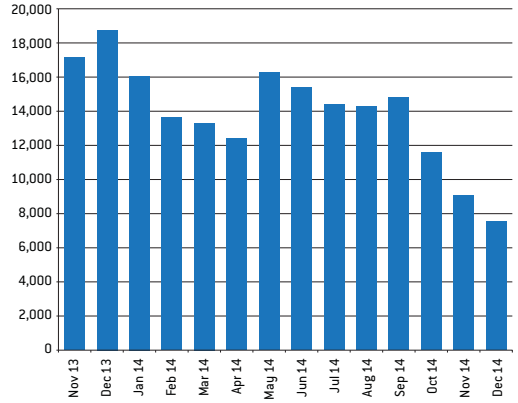
5. See http://www.cbr.ru/eng/hd_base/default.aspx?prtid=valint_day&pid=idkp_br&sid=ITM_20811.

tightly at the level of about eight to the dollar, started to depreciate rapidly in February 2014 as result of Ukraine's domestic political crisis (the dramatic events of the Euro-Maidan and the collapse of the Yanukovych regime) and the subsequent Russian annexation of Crimea and intervention in Donbass.

The depreciation trend was stopped and even partly reversed on two occasions: between the end of April and July 2014 by the first tranche of the IMF Stand-by loan, and in October 2014 following the ceasefire in Donbass. In November 2014, the rapid depreciation trend resumed, leading to an almost doubling of the hryvna /dollar exchange rate between February 2014 and January 2015 (Figure 3). The hryvna /euro exchange rate increased by 62 percent during the same period (the difference is explained by a substantial strengthening of the dollar against the euro – see section 4). Throughout 2014 there were several waves of market panics, taking the form of a massive withdrawal of hryvna deposits from Ukrainian banks and their conversion into foreign currency.

As Figure 4 shows, the National Bank of Ukraine lost more than half of its gross international reserves in 2014. The end-of-year level of $7.5 billion must be considered as critically low if one takes into consideration Ukraine's import financing needs and foreign liabilities to be paid back in the near future (see Aslund, 2014b).

Figure 4: Ukraine's international reserves in $ billions, 2013-14



Source: National Bank of Ukraine, http://www.bank.gov.ua/doccatalog/document?id=46950

3 CONTAGION EFFECT: THE SPREADING OF THE CRISIS TO NEIGHBOURS

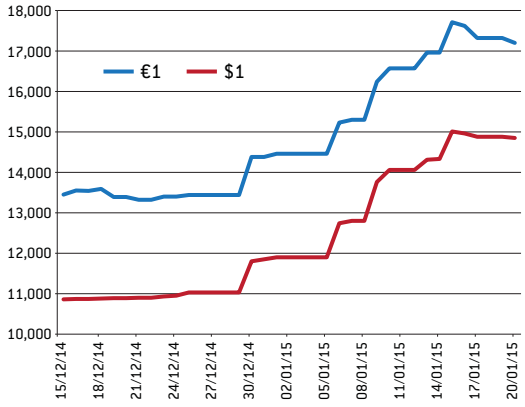
Since November 2014, the crisis has spread to number of former Soviet Union countries, especially Belarus, Armenia, Kyrgyzstan and Moldova. It also affected, to a lesser extent, some countries in central and eastern Europe. The crisis-contagion mechanisms worked through several channels: decreasing trade and deteriorating terms of trade with Russia, decreasing remittances from migrants working in Russia and, most importantly, the devaluation expectations of households and financial market players. Those former Soviet Union countries, for which Russia is an important trade partner, could not sustain continuation of the nominal appreciation of their currencies in relation to the ruble.

3.1 Belarus

In mid-December 2014, following similar developments in Russia, Belarussian households started to withdraw their savings from Belarussian banks, convert Belarussian rubles into foreign currency and massively purchase durable goods. As result, on 19 December 2014, the National Bank of the Republic of Belarus introduced a 30 percent commission on any form of purchase of foreign currency by physical persons, and increased its interest rate for overnight credit to 50 percent.

During the next three weeks, the commission fee was gradually eliminated and the overnight inter-

Figure 5: Belarussian ruble exchange rate against the euro and dollar, 2014-15



Source: National Bank of the Republic of Belarus, http://www.nbrb.by/engl/statistics/Rates/RatesDaily.asp

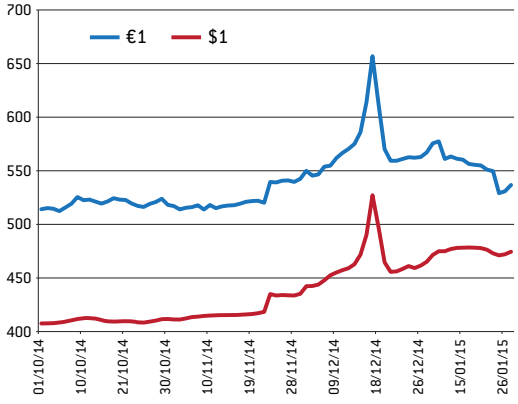
est rate reduced to 40 percent. However, the Belarussian ruble (which was largely stable in 2014) has been allowed to depreciate against the dollar by approximately 36 percent (see Figure 5)[6]. In addition, Belarus's total international reserves decreased from $6,023.9 million on 1 November 2014 to $5,059.1 million in January 2015 – a drop of approximately 16 percent[7].

Interestingly, Belarus is neither directly involved in the Russian-Ukrainian conflict, nor the subject of the EU/US sanctions against Russia. A few weeks before the crisis, there were even anecdotal stories of how Belarus benefited from circumventing those sanctions and Russian counter-sanctions against the EU, the US and other advanced economies. Nevertheless, Belarus's close trade and financial relations with Russia, within the Belarus-Kazakhstan-Russia Customs Union (CU) and the Eurasian Economic Union (EAEU), along with fresh memories of previous currency crises (the last one in 2011) and pure contagion effects, contributed to the market panic.

3.2 Armenia

Armenia is very much dependent on the remittances of migrants working in Russia, and was persuaded to join the Belarus-Kazakhstan-Russia CU and EAEC on 1 January 2015 (in 2013, it concluded negotiations on an Association Agreement, including a Deep and Comprehensive Free Trade Agreement, with the EU, but abandoned these under Russian pressure).

Figure 6: Armenian dram exchange rate against the euro and dollar, 2014-15



Source: Central Bank of Armenia, http://api.cba.am/ExchangeRatesToExcel.ashx?DateFrom=2014-10-01&DateTo=2015-01-27&ISOCodes=EUR,USD

Some pressure on the foreign exchange market already started in the third quarter of 2014 but intensified in mid to late November. The speculative attack came on 16-17 December 2014, following developments on Russia's foreign exchange market. On 17 December, the Armenian dram (AMD) reached its lowest level in 2014 – 525 to the dollar and 657 to the euro. In the next couple of weeks, it partly recovered (Figure 6).

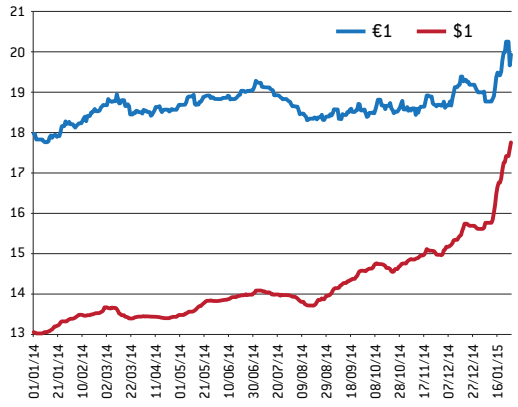
On 23 December 2014 the Central Bank of Armenia (CBA) increased its refinancing rate from 6.75 percent to 8.5 percent, and again, on 22 January 2015 to 9.5 percent. The Lombard repo rate increased from 8.25 percent to 10.25 percent on 24 November 2014, to 21 percent on 3 December 2014, and then decreased to 20 percent on 23 December 2014 and 17 percent on 22 January 2015. The CBA deposit rate increased from 5.25 percent to 7.0 percent on 23 December 2014 and to 8.0 percent on 22 January 2015[8].

Between July and November 2014, the CBA's official reserve assets decreased by 20 percent (data for December 2014 was not available at time of writing)[9]. The market situation remains strained and devaluation expectations did not fade.

3.3 Moldova

Between January 2014 and January 2015 the exchange rate of the Moldovan leu (MDL) to the dollar increased by about 36 percent, while the MDL-to-euro rate increased by about 14 percent. Depreciation accelerated after August 2014 with

Figure 7: Moldovan leu exchange rate against the euro and dollar, 2014-15



Source: National Bank of Moldova (NBM), https://www.bnm.md/en/rates_evolution

6. See http://www.nbrb.by/Press/?nId=89&l=en.

7. See http://www.nbrb.by/engl/statistics/sdds/report.asp.

8. See https://www.cba.am/en/SitePages/fmompiinterestrates.aspx.

9. See https://www.cba.am/Storage/EN/stat_data_eng/reserve.xls.

the peak recorded in January 2015 (Figure 7). The official reserve assets of the National Bank of Moldova (NBM) decreased from $2,763 million on 30 June 2014 to $2,069 million on 17 January 2015[10], a drop of 25 percent. Most of these losses were incurred between November 2014 and January 2015.

In December 2014, in response to mounting foreign exchange market pressures, the NBM started to increase its interest rates. On 12 December 2014 it increased its overnight credit rate from 6.5 percent to 7.5 percent, the basic rate from 3.5 percent to 4.5 percent, and the overnight deposit rate from 0.5 percent to 1.5 percent. On 29 December 2014, all rates were hiked again, to 9.5 percent, 6.5 percent and 3.5 percent, respectively[11].

3.4 Kyrgyzstan and other CIS countries

Kyrgyzstan, with its deep dependence on trade and remittance inflows from Russia, has been also affected, though to a lesser extent. Its currency, the som (KGS), fell by 20 percent against the dollar between January 2014 and January 2015 (with acceleration of the fall from October 2014)[12]. At the same time, the National Bank of the Kyrgyz Republic (NBKR) spent more than $500 million on foreign exchange market interventions. Most of these were at the end of 2014. As result, the NBKR's gross international reserves fell by $280 million in 2014, ie by 12.5 percent[13]. The NBKR discount rate was systematically increased from 6 percent in June 2014 to 11 percent on 26 January 2015[14].

Foreign exchange market pressures were also felt in Tajikistan and Azerbaijan, especially in December 2014 and January 2015. On 1 January 2015, the Central Bank of Turkmenistan devalued its currency, the manat, from 2.85 to 3.5 to the dollar, ie a 23 percent devaluation[15].

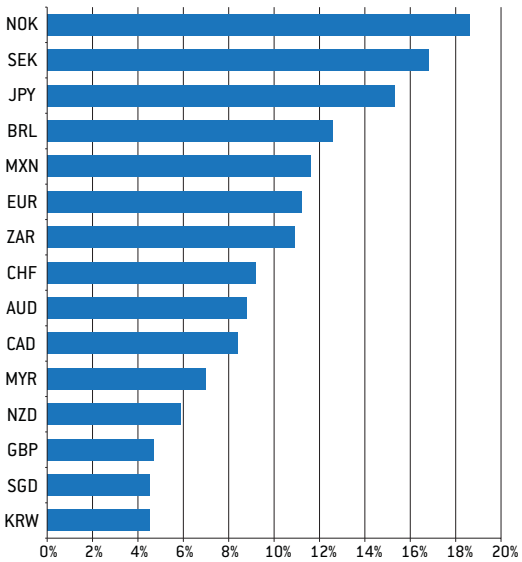
3.5 Impact on central Europe

Finally, during the December 2014 phase of the CIS currency crisis a degree of contagion effect was visible on foreign exchange markets in central Europe, where currencies with flexible exchange rates depreciated against both the dollar and the euro. This affected the Hungarian forint (HUF), Serbian dinar (RSD), Polish zloty (PLN), Romanian leu (RON) and Turkish lira (TRY). However, because of the limited trade and financial links between these countries and Russia and Ukraine, investors' negative reactions to these currencies were rather short-lived.

4 GLOBAL FACTORS: US MONETARY POLICY AND COMMODITY PRICES

Among the global factors that contributed to the CIS currency crisis, US monetary policy seems to have played an important role. Since mid-2013, the expectation of the phasing down of Quantitative Easing 3, which eventually happened in October 2014, and more recently, expectations of an increase in the US Federal Fund Rate in 2015, have led to tighter global liquidity conditions[16]. This could not be fully compensated for by simultaneous monetary policy easing in the euro area and Japan because of the much smaller size of financial markets in euro and yen. As result, net capital inflows into emerging-market economies decreased, growth in the latter decelerated and commodity prices started to fall (see Feldstein, 2014, and Frankel, 2014, on the effects of US monetary tightening on oil and commodity prices). During 2014, especially in the fourth quarter, the dollar appreciated against most currencies with flexible exchange rates (Figure 8).

Figure 8: Depreciation against the dollar, in %, Dec 2013 to Dec 2014, selected currencies



Source: US Federal Reserve Board, http://www.federalreserve.gov/releases/g5/current/default.htm

10. See https://www.bnm.md/en/fm_reserv_actives.

11. See https://www.bnm.md/files/index_30237.pdf.

12. See http://www.nbkr.kg/EXCEL/dailyrus.xls.

13. See http://www.nbkr.kg/DOC/12012015/000000000031956.xls.

14. See http://www.nbkr.kg/DOC/27012015/000000000032420.xls.

15. See http://www.bloomberg.com/news/articles/2015-01-02/turkmenistan-devalues-currency-19-amid-oil-plunge-ruble-crisis.

16. Actually, US monetary policy remained lax in 2013-14 (see Darvas, 2014) but expectation that it would change mattered a lot for tightening global monetary conditions.

The sharp decline in the oil price in the second half of 2014 and early 2015 (by more than half) was caused by a combination of several factors: the systematic increase in production capacities in previous years, the declining market power of the OPEC cartel, slower global economic growth, especially in emerging-market economies and tighter global monetary conditions. These factors accelerated decline of the ruble.

Interestingly, the lower oil price is a relatively new phenomenon, and its impact on Russia's real economy, balance of payments and budget is so far not so severe. The country has considerable fiscal buffers (the two sovereign wealth funds mentioned in section 1) and international reserves (even if adjusted for their illiquid components – see section 1). Even in an environment of lower oil prices, Russia should be able to continue to run trade and current account surpluses. By comparison, Azerbaijan and Kazakhstan, two other major CIS oil producers, have not so far been so seriously affected by lower oil prices. In Russia's case, expectations about the prospects of its economy and its financial sustainability deteriorated to a point at which massive panic behaviour on the part of economic agents was triggered.

In Ukraine, the decline in metal prices in 2014 (the main export commodity) negatively influenced its GDP and balance of payments. However, Ukraine as the net importer of oil should benefit from lower oil prices in the medium term. Similar factors apply to other CIS net oil importers effected by the crisis, especially Armenia, Kyrgyzstan and Moldova (Belarus benefits from processing and trading Russian oil on preferential terms, so lower oil prices reduce its oil-related rent). However, most CIS countries will lose out from lower prices for metals and agricultural raw commodities.

Looking ahead, further tightening of US monetary policy and dollar appreciation expected in 2015 might trigger more emerging-market crises, as happened in the early 1980s and mid-1990s.

5 CONSEQUENCES OF WAR AND SANCTIONS

Clearly, the impact of global economic developments do not fully explain the depth of the ruble and hyrvna depreciation against the dollar and other currencies. Other factors, including those of a political, security and geopolitical character, must be taken into consideration.

The Ukrainian economy has been heavily hit by the consequences of its domestic political developments (the Euro-Maidan, the collapse of Yanukovych's regime and uncertainty around two election campaigns in 2014), Russia's annexation of Crimea and military intervention in Donbass, and Russian trade restrictions against Ukrainian exports. On the macroeconomic front, these factors have been translated into heavy GDP, export and tax-revenue losses, additional military expenditure, war damage (including human losses), costs of dealing with internally displaced persons and humanitarian aid, further deterioration in the business and investment climate, and falling confidence in Ukrainian banks and currency. In particular, the war and partial occupation of Donbass, which contributed 16 percent of Ukraine's GDP and 25 percent of its exports (Havlik, 2014) put a heavy toll on the country's fiscal accounts and balance of payments.

For Russia, what was expected to be a painless and triumphal campaign (in the case of Crimea) or a local short-term proxy conflict (in the case of Donbass) has become a serious geopolitical confrontation with the US and the EU, and a bloody stalemate in eastern Ukraine, without a clear prospect of a resolution, at least of one that would be politically cost-free for the country's leaders.

While an estimation of the additional fiscal burden for Russia arising from the conflict itself and the annexation of Crimea and intervention in Donbass is not known publicly, it is likely to be substantial and likely to increase rapidly in a near future (for example, because of the costs of infrastructure projects required to integrate the Crimean penin-

'Looking ahead, further tightening of US monetary policy and dollar appreciation expected in 2015 might trigger more emerging-market crises, as happened in the early 1980s and mid-1990s.'

sula with mainland Russia, or of support to Donbass separatists). The increasing geopolitical confrontation with the west (as it is perceived, not always correctly, by the Russian leadership), will likely lead to further military spending increases.

In terms of US and EU sanctions against Russia, limiting the access of Russian state-owned banks and large corporations to financial markets has proved the most efficient measure so far (see Aslund, 2014c; Rogov, 2014). This is hardly surprising, in the light of the 2008-09 global financial crisis, when exactly this segment of the Russian economy demonstrated the greatest vulnerability to external shocks. The high short-term refinancing needs, in combination with declining oil prices, made investors nervous about the prospects for Russia's external liquidity in the months ahead.

A general lesson from this experience is the high price of any conflict, even of supposedly local character, in the contemporary highly-interlinked global economy.

6 POOR BUSINESS CLIMATE AND CAPITAL FLIGHT

For years, Russia and Ukraine (as well as most other CIS economies) have suffered from numerous structural distortions, a poor business and investment climate, widespread corruption, weakness of the rule of law, organised crime and other factors. This is well illustrated in Tables 1 and 2, which present the results of two global rankings – the Transparency International Corruption Perception Index (TI CPI) and the Heritage Foundation Index of Economic Freedom (HF IEF).

With the exception of Georgia[17], which conducted far-going institutional reforms in 2004-07 and Armenia (only in the Heritage Foundation ranking), neither ranking rates any CIS country favourably. Russia and Ukraine have particularly low rankings: respectively 136th and 142nd out of 174 countries ranked by Transparency International, and 140th and 155th out of 185 countries ranked by the Heritage Foundation.

As long as the external economic environment for CIS countries remained favourable (before 2008), the problems highlighted by the rankings could be neglected without negative consequences for economic growth and macroeconomic equilibria. However, the shock associated with the global financial crisis of 2008-09 finished the 'golden' era of economic growth, which was based, to great extent, on high commodity prices and massive capital flows to emerging-market economies. The Ukrainian economy never really recovered after this shock (Dabrowski, 2014), while Russia enjoyed for a while the positive effects of high oil prices, but with a declining rate of economic growth from 2010-13.

The business environment in both countries has continued to deteriorate since the global crisis. In Russia, the re-nationalisation trend (an increasing share of state ownership) started with the crack-

Table 1: Transparency International Corruption Perception Index 2014, CIS region

Rank	Country	CPI 2014 score
50	Georgia	52
94	Armenia	37
103	Moldova	35
119	Belarus	31
126	Azerbaijan	29
126	Kazakhstan	29
136	Kyrgyzstan	27
136	Russia	27
142	Ukraine	26
152	Tajikistan	23
166	Uzbekistan	18
169	Turkmenistan	17

Source: http://files.transparency.org/content/download/1857/12438/file/CPI2014_DataBundle.zip

Table 2: Heritage Foundation Index of Economic Freedom 2014, CIS region

World rank	Country	2014 score
22	Georgia	72.6
41	Armenia	68.9
67	Kazakhstan	63.7
81	Azerbaijan	61.3
85	Kyrgyzstan	61.1
110	Moldova	57.3
139	Tajikistan	52.0
140	Russia	51.9
150	Belarus	50.1
155	Ukraine	49.3
163	Uzbekistan	46.5
171	Turkmenistan	42.2

Source: http://www.heritage.org/index/excel/2014/index2014_data.xls

17. Formally, Georgia terminated its membership in the CIS in 2009. However, for the sake of regional comparison, it continues to be considered as part of the CIS group of countries by most international organisations.

down on Yukos in 2003-05 and intensified in 2008-09 when several banks and companies required government bailouts. Re-nationalisation became particularly visible in the oil, gas and financial sectors. Russian domestic business has suffered from unstable property rights (the danger of politically motivated expropriation), increasing red tape and harassment by various law-enforcement agencies. Russia's policy towards foreign investors has become at least ambiguous if not openly unfriendly (as demonstrated by various legislative and administrative measures against foreign investors).

In Ukraine, the Yanukovych presidency (2010-13) was marked by increasing insecurity of property rights, extreme corruption and nepotism – the favouring of the business interests of the narrow group associated with the government and presidential family, at the cost of others.

It should not be surprising, therefore, that once their economies were hit by political instability and war (Ukraine) or prospects of western sanctions and further deterioration of the business climate (Russia), residents, especially large corporations, were the first to move their financial assets out of the country, on a massive scale. Similar reactions were observed in Latin American economies in periods of macroeconomic and political instability, especially in the 1980s and 1990s.

The rapid capital outflow from Russia and Ukraine has been facilitated by the dominant business model in both countries where most of the large companies remain in close ownership relationships with their foreign subsidiaries or parent companies (owned by expatriates), keep substantial part of their assets abroad and finance their domestic operations through foreign borrowing (see Rogov, 2014, and Table 3 in respect to Russia).

Table 3 shows the cumulative trends in private capital flows to and from Russia since 2005. Only in 2006-07 did Russia record net private capital inflows. Both 2008 (beginning of the global financial crisis) and 2014 (the current crisis) were marked by record-high net capital outflows.

7 CRISIS MANAGEMENT

To make things even worse, the authorities in both countries committed several mistakes and miscalculations in crisis management. In Russia, there was overestimation of the strength of the Russian economy, a belief in high oil prices continued forever, and an underestimation of the scale and potential impact of western sanctions. This led to nonchalance in reaction to the subsequent rounds of sanctions, including adoption of retaliatory measures against food imports from the EU and US in August 2014. This created additional one-off inflation pressure, deteriorated the quality of the domestic consumer market, caused trade tensions with the customs-union partners (Belarus and Kazakhstan), and strengthened market fears about policy unpredictability and

Table 3: Russia: net private flows, 2005-14

	Net private capital flows, total	Net capital flows from banks	Of which:		Net capital flows, other sectors	Of which:		
	(2+5)	(3+4)	Foreign assets	Foreign liabilities	(6+7+8)	Foreign assets	Foreign liabilities	Net errors & omissions
	1	2	3	4	5	6	7	8
2005	-0.3	5.9	-13.4	19.2	-6.2	-56.4	55.2	-5
2006	43.7	27.5	-23.5	51.1	16.1	-56.3	61.2	11.2
2007	87.8	45.8	-25.1	70.9	42	-93.6	145.4	-9.7
2008	-133.6	-55.2	-63.3	8.1	-78.3	-174.2	98.9	-3.1
2009	-57.5	-32.2	10	-42.1	-25.3	-53.3	34.3	-6.4
2010	-30.8	15.9	-1.7	17.6	-46.7	-62.9	25.4	-9.1
2011	-81.4	-23.9	-31.8	7.8	-57.4	-107.7	58.9	-8.7
2012	-53.9	18.5	-14.8	33.3	-72.4	-101.8	39.8	-10.4
2013	-61	-7.5	-27.9	20.4	-53.5	-138.3	95.6	-10.8
2014 (est)	-151.5	-49.8	-12.7	-37.1	-101.7	-106	0.9	3.4

Source: CBR, http://www.cbr.ru/eng/statistics/print.aspx?file=credit_statistics/capital_new_e.htm&pid=svs&sid=itm_49171

dominance of geopolitical considerations over economic rationale.

The Central Bank of Russia has changed its *de-facto* exchange rate regime several times, creating an impression that it takes decisions under market and political pressure not necessarily in accordance with macroeconomic priorities. First, it defended the ruble exchange rate (until October 2014), then it tried to minimise losses in international reserves. Finally, after 16 December 2014, it returned to intervention in the foreign exchange market. Its interest rate increases came too late and were not sufficient to change market sentiment. In addition, the Central Bank of Russia has been suspected of participating in non-transparent schemes to give financial support to large state-controlled corporations (see Guriev, 2014).

In Ukraine, successive governments have not been politically ready to take the most badly needed fiscal and macroeconomic adjustment measures, such as elimination of gas subsidies (Dabrowski, 2014), expecting that the major burden of the adjustment bill will be paid by external donors. The political rivalry within the victorious Euro-Maidan camp (especially between the president and prime minister) and subsequent election campaigns have not helped with policy consistency and clarity, or with the readiness to undertake comprehensive reform. This also concerns the coalition government of Arseniy Yatsenyuk formed in early December 2014, which issues contradictory messages about its reform plans.

The National Bank of Ukraine has changed several times its de-facto exchange rate regime, first accepting the principle of a floating exchange rate and then, on a few occasions, intervening heavily with the aim of stabilising the exchange rate. In addition, it resorted frequently to foreign exchange controls, including restrictions on current account transactions, which only served to fuel the nervous reactions of market agents to various shocks and uncertainties.

The International Monetary Fund, another important player on the Ukrainian scene, approved in April 2014 the Stand-by loan, which was based on over-optimistic macroeconomic assumptions from the outset and failed to close the financial gap (Mitov and Schneider, 2014; Schadler, 2014). Most market players realised this quickly.

8 GHOSTS OF THE PAST AND LESSONS FOR FUTURE

Finally, any discussion of the causes of the CIS currency crisis cannot overlook the legacies of the not-so-distant past, which have a powerful impact on the behaviour of domestic economic agents. These legacies include the hidden near-hyperinflation in the last years of the USSR (huge market shortages accompanied by substantial price increases which, however, were unable to close the demand-supply gap), open hyperinflation in Ukraine in 1993, 'Black Tuesday' – the deep devaluation of the ruble on 11 October 1994, the Russian financial crisis of August 1998 and its spread to Ukraine and other CIS economies, and the substantial depreciation of the hyrvna, ruble and other CIS currencies at the end of 2008 and beginning of 2009. In Belarus, there were even more such episodes, for example, the full-scale currency crisis in spring 2011.

As result, neither households nor enterprises trust domestic currencies and domestic financial systems. As long as there is no serious turbulence, the low level of trust might be enough to keep the currency stable, inflation low and banks afloat. However, even in good times, the level of spontaneous dollarisation remains high. In an adverse shock, whether of economic or political origin, external or domestic source, domestic money-holders are the first to run from the national currencies and domestic banks.

This experience should serve as an important input into discussions about the optimal exchange rate regime choice for the post-Soviet region. Since the 1997-99 series of emerging-

'The Central Bank of Russia has changed its de-facto exchange rate regime several times, creating an impression that it takes decisions under market and political pressure, and not necessarily in accordance with macroeconomic priorities.'

market crises, the IMF has advocated flexible exchange rates and an inflation-targeting regime, which has proved successful in several high- and medium-income economies. Nevertheless, in the CIS region its implementation never went beyond initial preparatory steps and general declarations of interest. There were several obstacles, such as insufficient central bank independence, underdeveloped financial markets and deficits in analytical and forecasting capacities in individual central banks. However, the 'fear of floating' has been the most important obstacle (see Dabrowski, 2013). In the light of recent experience described in this paper, the 'fear of floating' seems to be deeply rooted and cannot be easily dismissed.

Furthermore, the timing of IMF insistence on introducing the floating exchange rate and inflation targeting in Ukraine (this was the number-one condition of the April 2014 Stand-by loan) proved to be particularly controversial. The same must be said about the Central Bank of Russia's decision to move towards a flexible exchange rate in the last quarter of 2014. A period of major shocks, political instability and uncertainty, war and sanctions is not the best timing for such policy-regime changes, especially in countries where memories of past macroeconomic instability remain fresh and painful.

Looking ahead, large and medium-size economies such as Russia or Ukraine can think about introducing inflation targeting and free-floating exchange rate regimes, but in a much more stable macroeconomic and political environment, backed by necessary institutional reforms (genuine central bank independence) and increasing financial market depth and soundness. For the smaller CIS economies, another 'corner solution', such as a currency board, seems to be also a good option. It might offer several advantages, such as reducing transaction costs in small open economies, and importing credibility which is difficult to build internally (as demonstrated by continuous high dollarisation).

9 HOW TO FIGHT THE CRISIS?

The new round of currency crises in the CIS region requires a proper policy response from national authorities, the IMF and the European Union.

National authorities must rethink their policies, address their shortcomings and draw critical lessons about crisis management and about comprehensive economic and institutional reform. However, unlike previous regional crisis episodes (for example, in the early 1990s, 1998-99 or 2008-09) there is neither a single diagnosis nor a single prescription this time.

The Russian-Ukrainian conflict and war in Donbass, which have played a major role in triggering and deepening the current macroeconomic crisis in both countries and in the entire region, requires fast resolution based on respect for international law and the territorial integrity of each country. A peaceful and sustainable solution would offer a high economic pay-off to each side. The key to stopping atrocities and ending the conflict is definitely in the hands of Russian authorities and by doing so they can open the door to the phasing-out of sanctions and can return Russia to the mainstream of global economic and political cooperation, which the country badly needs. The role of the EU and US is to persuade Russia's authorities to return to full compliance with international treaties and norms using the available instruments of economic, political and diplomatic pressure.

Apart from deep correction of its foreign policy, Russia needs serious revision of its economic policy. It should embark on deep structural and institutional reforms to radically improve the business and investment climate and to reduce dependence on hydrocarbon prices. Even if it manages to end the Ukrainian conflict soon, the previous external macroeconomic and political environment will not quickly return. Most likely, oil prices will remain at a lower level than the previous decade, and rebuilding trust in international relations (including relations with major purchasers of Russian energy in Europe) will require both time and bold measures on the Russian side.

Discussing the details of the desirable reforms in Russia goes beyond the remit of this paper, but one can mention elimination of various forms of administrative red tape that discourage business activity and increase its costs, deep reform of law enforcement agencies (which harass businesses rather than provide public security), independ-

ence, impartiality and professional upgrade of the judiciary, privatisation of state-owned companies, genuine opening to foreign investment, market pricing of domestic energy supply, review of social entitlements (especially the early retirement age) which are unsustainable in the context of rapid population ageing, rationalisation of public investment projects and military expenditures, and fighting corruption.

The same type of structural and institutional reform is needed in Ukraine, regardless of how quickly the country is able to enjoy peace and its territorial integrity again. However, unlike a few years ago, a deep macroeconomic crisis requires rapid adjustment measures. Ukraine should focus on the elimination of gas subsidies, which, in turn, could help close fiscal and balance-of-payments gaps, the advancement of structural reforms, the fight against corruption and reduced energy dependence on Russia (see Dabrowski, 2014).

The radical reform and macroeconomic adjustment package if adopted by the new government of Ukraine should receive far-going support from the IMF, World Bank, EU, European Bank for Reconstruction and Development and bilateral donors. Apart from the financial aid package (to close the current financial gap), Ukraine needs well-tailored technical assistance and, most importantly, a roadmap for its further European and Euro-Atlantic integration. The experience of central and eastern Europe demonstrates that such external 'anchoring' against the domestic political cycle is crucial in sustaining and guiding deep structural and institutional reforms, which require time and continuity.

This means that the EU should be ready to go beyond the recently-signed association and deep and comprehensive free trade agreements with Georgia, Moldova and Ukraine, once implementation of their provisions is sufficiently advanced. The EU should offer these countries a roadmap towards their potential EU accession, even if the latter will take many years to materialise.

The IMF must be also ready to provide additional assistance to those CIS countries that have become victims of a new regional contagion (most of them have ongoing IMF programmes or have recently benefited from IMF lending). The governments and central banks of those countries face an uneasy choice between depreciation of their currencies against the dollar (and hence higher inflation) and appreciation against the ruble (resulting in competitiveness loss relative to Russia). These countries must also undertake the kind of reform that Russia and Ukraine need: improving the business climate and governance, and reducing excessive government expenditure, especially expenditure of social character.

The IMF should also prepare itself for the possibility of more emerging-market crises in the coming months and years as a result of slower growth, the stronger dollar and lower commodity prices.

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