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Why Putin is defending his currency

Paul Krugman

OPINION

It has now been more than 40 days since Vladimir Putin's forces reportedly thought they could capture Kyiv within 48 to 72 hours. Many news reports describe the Russian invasion as "stalled," but as I read the detailed analyses, that isn't quite right: Ukrainian forces are counterattacking, and in many places Russia appears to be losing ground.

One thing Russia has managed to defend quite effectively, however, is the value of its currency. The ruble plunged in the days after the Ukraine invasion, but it has since recovered almost all of its losses. How did that happen, and what does it mean?

Investigating the curious case of the recovering ruble.

One thing worth noting is that Russia's economic officials appear to be more competent than its generals. Elvira Nabiullina, the governor of Russia's central bank — a role equivalent to that of Jerome Powell at the Federal Reserve — is especially well regarded by her peers abroad. Nabiullina reportedly tried to resign after the invasion started, but Putin wouldn't let her leave.

Unwilling as she may have been to stay in her job, Nabiullina and her colleagues pulled out all the stops to defend the ruble. They raised the key interest rate — more or less equivalent to the federal funds rate in the United States — from 9.5 to 20 percent, to induce people to keep their funds in Russia. They also imposed extensive controls to prevent capital flight: Russians have faced restrictions on moving their money into their foreign bank accounts, and foreign investors have been prohibited from exiting Russian stocks, and more.

But there's a mystery here. No, it's not puzzling to see the ruble recover, given such drastic measures. The question is why Russia is willing to defend its currency at the expense of all other goals. After all, the draconian measures taken to stabilize the ruble will probably deepen what is already looking like a depression-level slump in Russia's real economy, brought on by surprisingly wide and effective sanctions imposed by the free world (I think we can resurrect that term, don't you?), in response to its military aggression.

Let's take a brief excursion into economic theory here. One of the classic

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Russia defends the ruble

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propositions in international economics is known as the "impossible trinity." The idea is that there are three things a country might want from its currency. It might want stability in the currency's value in terms of other currencies — for example, a stable value of the ruble in dollars or euros — to create greater certainty for businesses. It might want free movement of funds across its borders, again to facilitate business. And it might want to retain freedom of monetary action — the ability to cut interest rates to fight recessions or raise them to fight inflation.

The impossible trinity says that you can't have it all, that you have to choose two out of three. You can, like Britain, have open capital markets and independent monetary policy, but that means allowing the value of the pound to fluctuate. You can, like countries that have adopted the euro, have free movement of capital and currency stability, but only by giving up monetary independence. Or you can, like China, have a stable currency and your own monetary policy, but only by maintaining capital controls. (Those controls, by the way, are one main reason the renminbi isn't going to rival the dollar as a global currency for the foreseeable future.)

So what's puzzling about Russia? Normally a country can choose two out of three legs of the trinity; Russia has decided to take only one. It has imposed severe capital controls, but it has also sacrificed monetary independence, drastically raising interest rates in the face of a looming recession.

In effect, Russia is taking a belt-and-suspenders (not to be confused with Belt and Road) approach to defending the ruble, and this has seemingly taken priority over all other economic goals. Why? Let me offer a speculation, with the clear proviso that it's only a speculation, not based on any direct evidence. My guess is that the value of the ruble has become a crucial target not so much because it's all important but because it's so clearly visible.

Suppose that, as seems highly likely, Russia sees a huge surge in inflation and a plunge in gross domestic product in the months ahead. Will Putin's government admit that these bad things are happening? Quite possibly not. Authoritarian regimes often try to suppress unfavorable economic data. Recently, for example, Turkey's president, Recep Tayyip Erdogan, responded to reports of high inflation by sacking the head of his nation's statistical agency.

Some years ago researchers at M.I.T. created the Billion Prices Project using online price data to specifically track the consistent understatement of inflation by Argentina's government at the time. The same approach also turned out to be very useful in the United States for the opposite reason — as a way to refute claims by right-wing "inflation truthers" that the Obama administration was cooking the books (it wasn't).

If Russia's economy deteriorates as badly as most expect in the near future, it seems all too likely that the nation's muzzled media will simply deny that anything bad is happening. One thing they couldn't deny, however, would be a drastically depreciated ruble. So defending the ruble, never mind the real economy, makes sense as a propaganda strategy.

A further thought: Among the people who might not be aware of deteriorating Russian economic conditions, as long as the ruble holds its value, might be Vladimir Putin himself. U.S. intelligence claims that Putin's military advisers have been afraid to tell him how badly the war is going. Is there any reason to believe that his economic advisers will be any more courageous?

So Russia's defense of the ruble, while impressive, isn't a sign that the Putin regime is handling economic policy well. It reflects, instead, an odd choice of priorities, and may actually be a further sign of Russia's policy dysfunction.