

The Luck Ran Out

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Russian Crisis Redux

At times, it seems that Russia specializes in the production of crises. This has been a particularly good year, with both political and economic crises in multiple episodes. Beginning in the spring, the long-serving (if only modestly effective) government of Viktor Chernomyrdin was removed by President Boris Yeltsin; in its place, Mr. Yeltsin nominated a government led by a reformist political newcomer, Sergei Kiriyenko. Mr. Kiriyenko put together a cabinet heavy with reformers, but not long after its stormy parliamentary confirmation his government was confronted with the beginnings of a financial crisis that would stretch throughout the summer. Finally, on 17 August, the Russian authorities announced both a devaluation and a unilateral debt restructuring in an attempt to stop the hemorrhage of foreign currency reserves and give the government some breathing room to meet its obligations. Six days later, Mr. Kiriyenko was out, and Mr. Yeltsin called upon Mr. Chernomyrdin once again to put out the domestic political fires and cope with the crisis. But Russia's financial

difficulties stem from a combination of international and domestic problems that will not yield easily to any solutions, especially not

those which might be palatable to any large portion of Russia's political spectrum.

Path dependence

The stage for the financial crisis was set in the early years of Russian independence. In an effort to battle the hyperinflation then ravaging the country, the Russian government shifted away from printing rubles as a way of financing the central budget deficit to issuing government debt instead. Because prices were still rising rapidly, and the economy was extremely shaky, investors were only willing to accept bonds with very short maturities. Halting the uncontrolled money emissions was a critical step, but the government's heavy dependence on ruble-denominated debt with maturities of less than one year forced it to constantly refinance

that debt—so the burden of debt service could balloon rapidly. (The Russian government also issued dollar-denominated bonds with longer maturities, but they represented a smaller proportion of the total debt.) Interest payments equaled 5.7% of GDP in 1996, 4.5% in 1997, and 5% in the first quarter of 1998; but the debt burden continued to grow since the government budget continued in deficit even excluding interest payments—by 2.2% of GDP in 1996 and 2.5% in 1997 (and this with accumulating payments arrears).

Also important to our story is the fact that as much as one third of the short term debt (mostly bonds known by the acronym GKO) was held by foreign investors interested in the attractive interest rates and short-term commitments. Most of the rest was held by Russian private banks, whose assets were largely tied up in GKO and currency trading operations. In contrast to banks in the west, the major Russian private banks performed little retail banking and instead served mostly as financial intermediaries for the “financial industrial groups” (and the business tycoons) which owned them. Not only were most of these banks' assets tied up in GKO and currency contracts, they often used the bonds as collateral to obtain foreign loans.

Finally, by the time the reformist Kiriyenko cabinet was named, the world economy had already felt the major shocks of the 1997 Asian economic crisis and investors were nervous. World prices for oil, Russia's principal hard currency export, were in a major slump and near 10-year lows. Moreover, the brinkmanship Mr. Yeltsin needed to use to get his nominee through the Duma (lower house of parliament) left major questions about the ability of the new government to tackle the country's serious problems, despite the reformist credentials of key ministers [see *E/W Letter*, Mar/Apr 98, p.1 for more on the Kiriyenko cabinet and the confirmation battle].

Crisis of confidence

Within days of the completion of Mr. Kiriyenko's cabinet in early May, the new government faced its first tests. Coal miners staged widespread strikes to protest unpaid wages, reflecting a growing anger with wage arrears throughout the economy. At the same time, investors in Russian financial markets got in-

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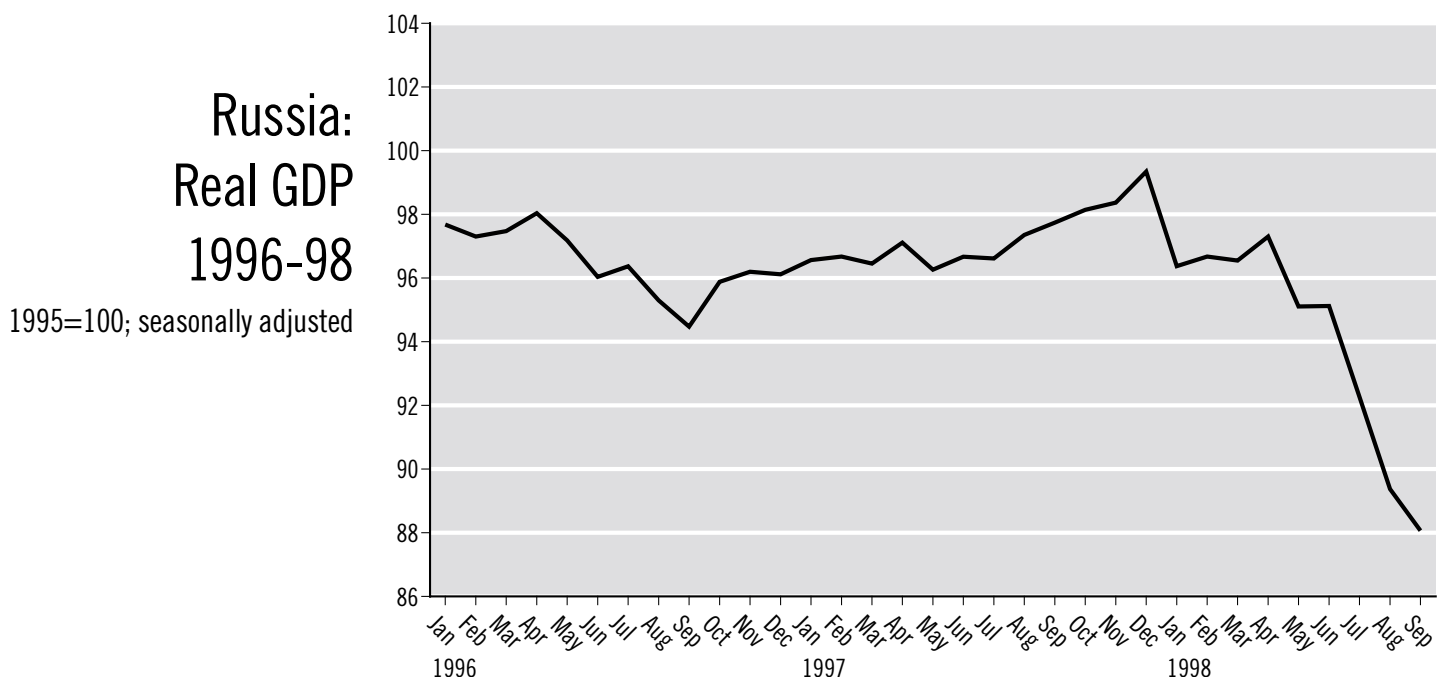
creasingly nervous as news about the Asian economies failed to improve and even Japan was in a slump. A great deal of the financial pressure on the Russian authorities stemmed from the growing unwillingness of international investors to stay in any emerging market, not just Russia. There were fewer and fewer takers for the government's bonds. An austerity package signed by Mr. Yeltsin on 26 May was intended to restore confidence in Russian markets, but the authorities were swimming against the tide. Promises of spending cuts amounting to \$10 billion and revenue increases had little effect. Instead, the failure of the government to attract any bids for a 75% stake in Rosneft, the last major state-owned oil company, fueled worries about budget revenue projections. On 27 May, the central bank trebled key interest rates, to 150%, after government bond and share prices fell precipitously.

While raising the interest rates might sharply increase the cost of government borrowing, the central bank's main priority was keeping the ruble exchange rate stable. The flood of funds out of Russian stock and debt markets and into dollars and other hard currencies threatened to force the ruble out of its official trading band in the absence of intervention. In addition to interest rate increases, the central bank was increasingly forced to dip into its hard currency reserves to prop up the currency. The government's determination to keep the ruble stable was grounded in several factors, among them: stability in the ruble exchange rate was one of the few economic policy

victories the Yeltsin administration could claim, and since even many everyday staples were imported, exchange rate stability was a major political issue. Moreover, as noted above, both private Russian banks and the government itself had considerable hard currency debts, and a fall in the value of the ruble would make those debts much harder to service. Given the shaky state of most Russian banks, stability of the ruble helped keep the system functioning.

Though pressure abated and interest rates fell back in early June after major tycoons pledged to support the administration and Mr. Yeltsin named hard-liner Boris Fyodorov to head the tax service, the relief did not last long. In mid-June, the International Monetary Fund delayed a \$670 million installment of its \$9 billion loan to Russia because of the government's problems in meeting fiscal conditions for the loan. Facing an increasing loss of confidence in Russian markets, the authorities asked for substantial new credits from the IMF and other western lenders, totaling \$10-15 billion. Another anti-crisis package of tax measures, announced late in the month, failed to impress investors but did move the IMF to release the delayed loan tranche.

July began with bad omens: coal miners resumed their strikes and blockades of key railroad links; the markets fell further because of growing political uncertainty. On 13 July, in response to worries about the solvency of the Russian government, the IMF agreed to lend a further \$17 billion over two years to restore calm to the Russian markets and keep the





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government afloat; accompanying loans brought the total to over \$22 billion. The IMF insisted on certain conditions, including a major cut in the budget deficit (to 2.8% of GDP from 5%), major tax increases and overhauls, and an overall shift in the tax burden from corporations to individuals (existing tax policy put nearly all the tax burden on companies, leading to low compliance). The tax changes included new sales and land taxes, increases in property taxes and import duties, and broadening the coverage of the VAT. The markets reacted very favorably to the IMF loan and the government's agreement to such stiff conditions, but the conservative Duma balked at most of the measures. While the government tried to enact some of the measures by decree, markets began sliding again as it appeared the government would not be able to push its program through.

Trickle to flood

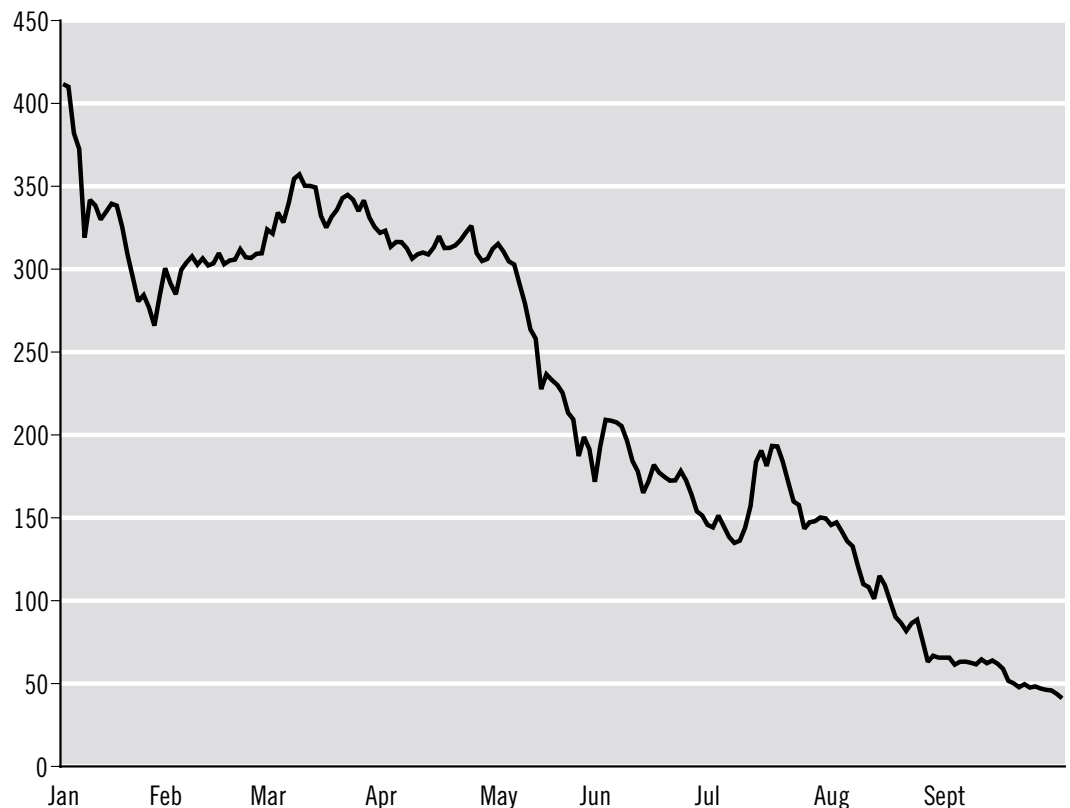
In August, worries began to grow about the impact of the rise in interest rates. On the one hand, the central bank would need to refinance a large chunk of government debt at much higher interest rates as a wave of bonds came due, significantly increasing pressure on the budget. On the other hand, increases in yields on existing treasury securities meant their market value had fallen substantially. Thus the many private banks which had used those bonds as collateral for loans, which they used to specu-

late in the GKO market, found themselves vulnerable to margin calls—demands from their lenders to show they had enough collateral. The farther prices on government bonds fell, the larger the threat of default and collapse of the banks. Given all the uncertainty, capital flowed rapidly out of the country—both Russians of means and foreign investors were moving their money to more stable environs.

By mid-August, conditions had deteriorated enough that US financier George Soros suggested in a newspaper column that Russia consider a modest devaluation and the creation of a currency board (which would peg the ruble to the dollar or a basket of currencies and remove the swings of the market). Russian officials angrily rejected talk of a devaluation, but investors took these events as a signal to bolt, and Russian markets plunged on 13 August (and yields on 9-month treasury bills reached 200%). The markets stabilized somewhat after Mr. Yeltsin and Mr. Kiriyenko unequivocally ruled out devaluation, but good news was scarce. Banks were having trouble making payments to each other, and the central bank announced that its foreign exchange reserves fell by \$1.4 billion, to \$17 billion, in the first two weeks of August. Later, the central bank would admit that it spent the entire first installment of the new IMF support loan, \$4.8 billion, in a futile attempt to prop up the ruble

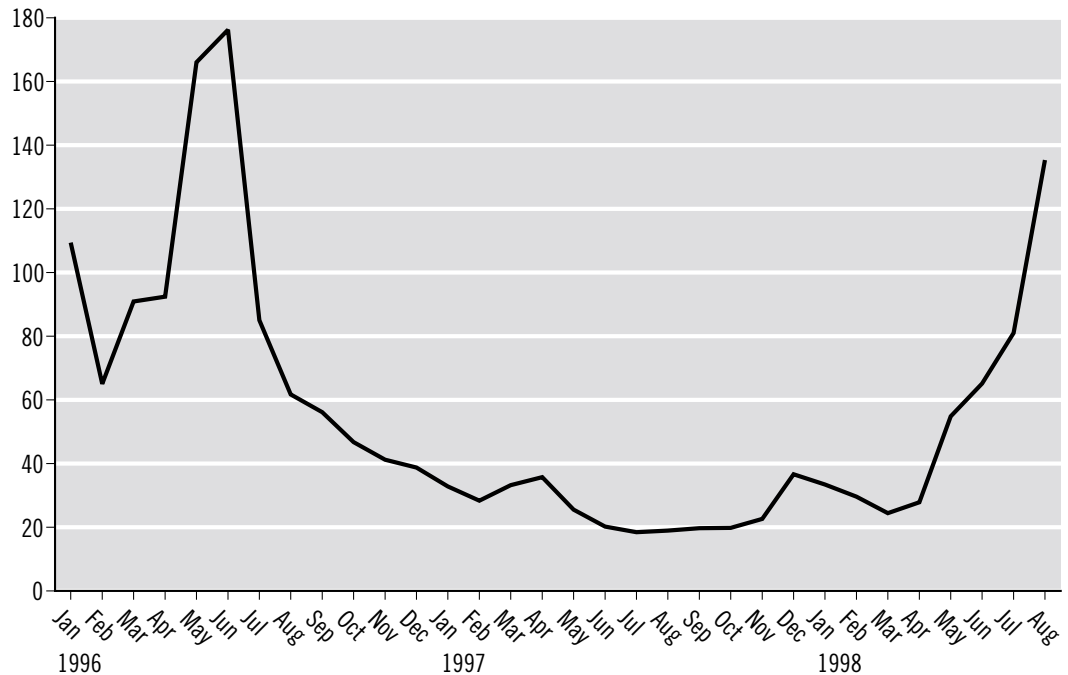
Russia:
Stock Market
Performance
1998

Russian Trading System (RTS)
index, daily close



Russia: Treasury Bond Yields, 1996-98

GKO secondary market yields,
avg. of all maturities



from 20 July until 17 August. Instead of restoring confidence in the ruble, these funds ended up in the hands of Russian and foreign investors who were able to move their money out of the country before 17 August.

No, repeat, yes

Russian authorities approached western governments and the IMF about further financial support in mid-August, but they found no takers. Faced with an uncontrolled drain on foreign exchange reserves, a collapse in the markets for government debt, and a banking system on the verge of implosion, the Russian government chose to change the rules of the game. Observers foreseeing drastic measures felt the government would choose from among devaluation, default, or currency controls; in the event, the government chose all three. On 17 August, the government announced that it was widening the trading band of the ruble, shifting the lower limit from 6.3 to the dollar to 9.5 to the dollar—potentially, a 34% devaluation. The authorities also announced a 90-day moratorium on certain kinds of foreign commercial debt payments (mostly those owed by banks) along with a freeze in the domestic government bond market, to be followed by a mandatory restructuring of short-term bonds into securities with longer maturities. Lastly, the government also announced some currency controls which would make it harder for foreign currency to leave the country (and make it harder for private entities to make good on hard currency debts).

Spreading ripples

The primary benefit of announcing the devaluation (or widening of the trading band) was to remove the tremendous pressure on the central bank's exchange reserves. Devaluations also normally benefit exporters by making their products cheaper, but in the case of Russia that means mostly oil and gas companies, which were not in a position to increase exports in any case. From the government's perspective, the move also cut the value in hard currency of the government's ruble-denominated debt.

However, the devaluation increased pressures on private companies and banks with large debts in hard currencies to default. The capital controls made it hard for even those firms which could make payments to do so. The effect on the population was potentially more serious: as much as half of all consumer goods and services in Russia are imported, and the devaluation would cause the ruble price of many staples to jump. (For example, even products one normally thinks of as being exclusively local, such as packaged milk, are often imported; agricultural production has collapsed so badly and supplies are so low that imports are often competitive with local products even after duties and taxes.)

The biggest political casualty of the measures is the loss of the image of stability: falling inflation and a stable ruble were the two main accomplishments of economic reform to which Mr. Yeltsin and his government could point. Wage arrears, rising unemployment, industrial collapse and growing poverty have left the



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government with few claims to success. Regardless of the real reasons, the crisis and devaluation it caused can be interpreted as the ultimate failure of Mr. Yeltsin's fitful economic reform program. It was partly in order to allay such critics that the president fired the Kiriyenko cabinet, implicitly signaling yet another change in direction.

Moreover, the government may find it even harder now to finance its budget: investors in government bonds are likely to be hesitant after what amounted to a default, and valuations of Russian firms are so low that the government will receive much lower prices for privatized state property. One observer noted that Russian total market capitalization had fallen so much that it was only three times that of the internet company Yahoo! and half that of do-it-yourself chain Home Depot.

Fallout

A growing chorus of critics, including ousted deputy premier and reformer Boris Nemtsov, insist that Mr. Kiriyenko was removed at the behest of the powerful "oligarchs" who dominate Russian business and who often have very close ties to the government. Mr. Kiriyenko was fired, the argument runs, because he and his government were refusing to bail out the failing private banks owned by those same oligarchs. (As noted above, most Russian private banks are business arms of the large industrial groups and hold few consumer deposits. Most Russians who have bank accounts keep them in the state-owned savings bank Sberbank, which was assured of government support in any case.) The central bank has since been funneling funds into the banking sector to stave off too many closures, leading analysts at CS First Boston to observe: "The current outcome is looking more and more as if the \$10 billion saved through

the debt restructuring is simply being plundered by the banking system and fleeing the country," according to the *Financial Times*.

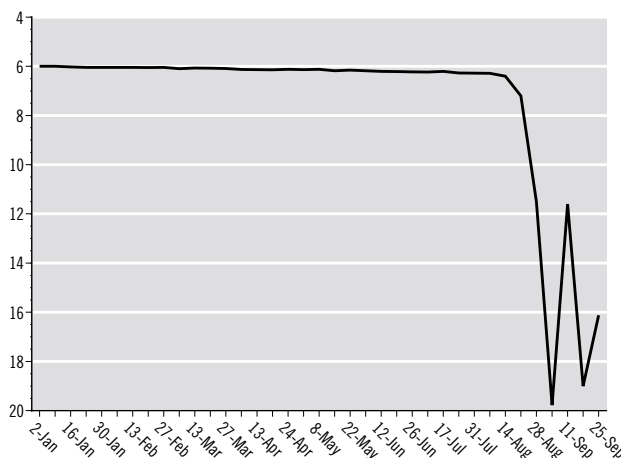
In fact, by early September, most observers were forecasting a new wave of inflation. Upward pressure on prices is inevitable, they say, because the central bank has no choice but to create credit to fund the government budget deficit—since further borrowing will be difficult after the default, and increased tax revenues are highly unlikely under the circumstances. There is considerable latent support for both increased liquidity and inflation: industrial firms would find that the size of the arrears owed them by the government would shrink with an injection of funds, and inflation would erode the value of their debts to the government and their employees. Banks desperately want increased credits in order to stay afloat. Finally, most citizens are now probably less worried about the specter of inflation than they are about the chronic shortage of funds to pay their wages, pensions, etc.

What have we learned?

The Asian crisis and the flight from emerging markets simply exposed how narrow the Russian "boom" really was. Granted, the sudden evaporation of foreign portfolio investment and record low prices for the key export commodity are serious burdens for any economy. But the focus on the financial churning in Moscow—the rising stock market, heavy demand for government securities with high yields, the influx of banking and financial firms—masked the extent to which the bulk of the Russian economy had not recovered from the production collapse and was not on the path toward restructuring. The plaudits for the government's ability to get inflation down and keep the ruble stable also ignored the problems that were constantly being put on the back burner. The government's inability to close its budget deficit for the foreseeable future, the failure to shape and enforce a tax structure that worked, the government's ineffectiveness at encouraging enterprise reform, and generally the failure to hammer out a politically acceptable economic program that could be enacted in the real world: all these issues were critical, yet the Russian state was unable to make much progress on any of them.

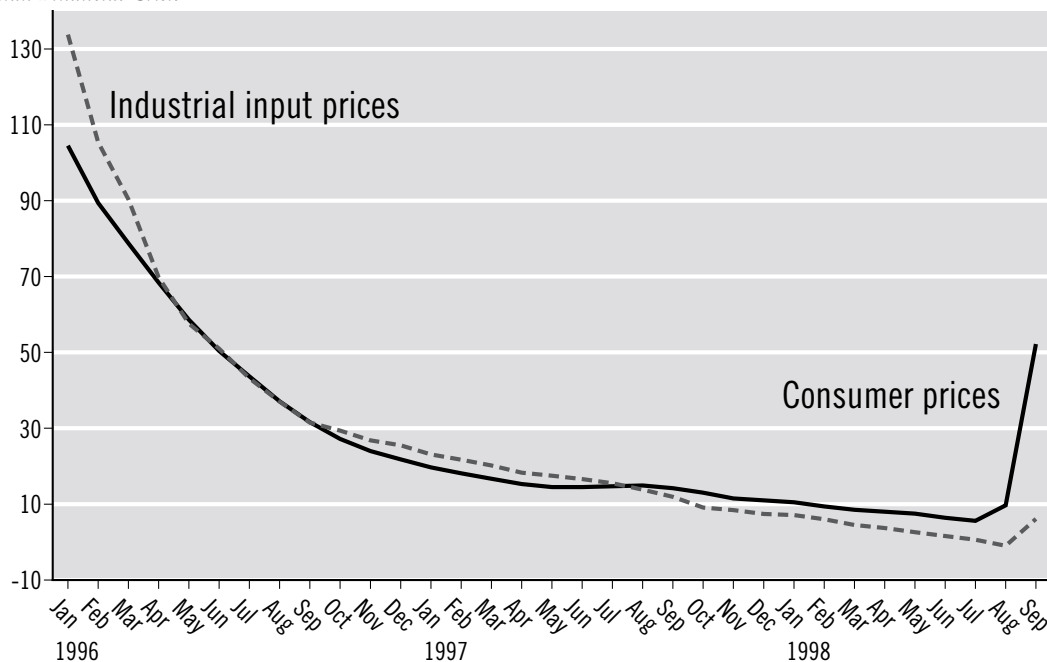
This lack of progress was in fact one of the key issues underlying the

Russia: Ruble exchange rate, 1998
Rubles per US Dollar,
Friday close



Russia: Inflation trends 1996-98

Consumer price index and industrial input prices, percent change on previous year



collapse: the Russian government had shown itself unable to implement most of the crucial measures it announced, in tax policy, overdue payments, fiscal policy, transparency, or a host of other issues. The state, it seemed, could only be effective when it served the interests of one of the well-connected business tycoons. Eventually, the Yeltsin government had lost all credibility with both investors and the public. As a result, even the enormous infusion of funds from the IMF in July was inadequate to restore confidence in the markets. The financial support simply allowed more people to get their money out before the roof fell in.

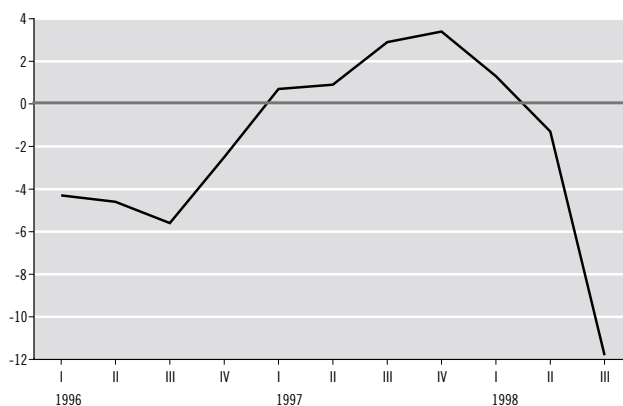
One of the government's greatest consistent failings was in an area over which, in theory, it should have had the most control: tax policy. The Russian tax system was poorly constructed and riddled with favoritism; enforcement was uneven, and rates were so high that non-compliance became a sport. The consistent failure of the authorities to collect the amount of taxes

they claimed were due exacerbated the budget deficit and increased the state's reliance on short-term debt, thus setting the stage for the crisis. But a number of commentators argue that those tax figures are simply fiction, and that there is much less (legal) economic activity in Russia than anyone wants to admit [see the discussion of the "virtual economy" in the accompanying article]. The fact that the federal government takes a large proportion of those taxes it does collect in kind hints at part of the problem; it is less politically painful to be chronically behind on tax collections than it is to admit that the size of the economy is much smaller than advertised and that budgeted expenditures (now simply in "arrears") simply cannot be supported. Russia's "bottom-up" method of collecting taxes, in which local and regional governments collect tax and pass the federal government's share upward, also guarantees conflicts within the system and revenue shortages at the federal level.

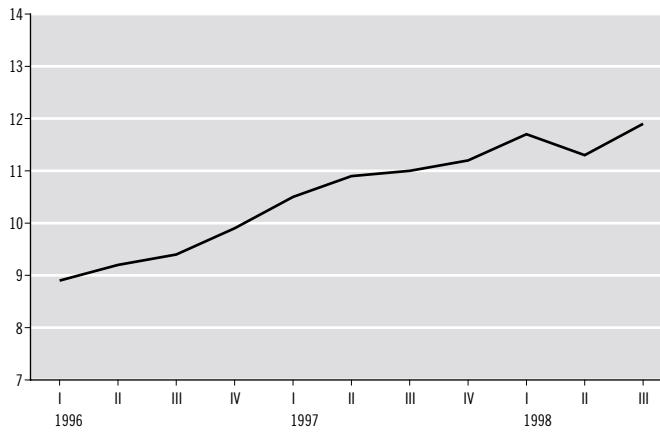
Finally, Russia's most serious problem also showed itself in this crisis: the emphasis on speculation over production, and on asset-stripping over restructuring. After recounting the CS First Boston analysis noted above, the *Financial Times* columnists concluded that "plunder is what the new Russian commercial elite understands." This is an over-generalization, perhaps; Russia has also seen its share of productive, entrepreneurial firms and former state enterprises trying to make a real go of it in the market. But the

Russia: Industrial production 1996-98

Percent real change on same period previous year; seasonally adjusted



**Russia:
Unemployment rate
1996-98**
Percent of labor force
(ILO definition)



point remains valid—much of the activity of the commercial elite is focused on financial speculation and snapping up valuable former state property at bargain prices. The fact that the new business “tycoons” were primarily engaged in removing value from the country was explicitly acknowledged by economic policy-makers; many of them viewed this as one of the prices to be paid for shifting assets to the private sector. When capital started flowing back into Russia from off-shore bank accounts a couple of years ago, some analysts saw in this evidence that the plunderers were beginning to act like investors (or proprietors). Nevertheless, observers might be forgiven for thinking that the Russian economy was currently structured to make it easy for the business elite to milk the country’s government and natural resources, while allowing life to remain largely unchanged for a wide range of lower level Soviet-era holdouts. When the good times seemed about to end, the flows of money reversed direction. The fact that so little of the economy has changed, and that the most dynamic actors in the economy are hardly engaged in productive activities, made Russia

that much more vulnerable to a financial crisis sparked by problems abroad.

Aside from the short- and medium-term economic consequences of the crisis, its most lasting impact may be political. A consensus may be forming, across a wide spectrum of political actors, that the time has come to abandon attempts at liberal economic policies and institute a more statist program. After all,

one could argue that reform’s natural constituents were the very ones shifting their assets abroad at great speed and exacerbating the crisis. Bankers, enterprise managers, opposition politicians, and much of the public see the solution not in more rigorous liberalization and restructuring but in far greater state control over the economy. The nationalist/left coalition hopes to rebuild what they see as the glory days of the Soviet system, and many local politicians and enterprise managers would feel much more comfortable with such a system. The Russian public would welcome more stability and less uncertainty; they would also like to have their wages and pensions paid. Finally, even the commercial elite would prefer a statist solution to one in which law and financial transparency reigned; it is much easier to make profitable use of political influence that way. With Russia stalled for so long in a quasi-reformed state, few remain to argue for the necessity of real reform. Whether all the parties in this new statist coalition will like what they have wrought, and whether voices for reform can make a comeback, remains to be seen. ◊

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