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Michael P. Barry
Office of Economics
U.S. International Trade Commission

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address correspondence to:
Office of Economics
U.S. International Trade Commission
Washington, DC 20436 USA

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Michael P. Barry, Ph.D.
Country and Regional Analysis Division
Office of Economics
United States International Trade Commission
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500 E Street SW
Washington DC 20436, USA
Phone: (202) 205-3246
Email: mbarry@usitc.gov

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The Russian Financial Crisis: A Look Back

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With a quickly dwindling stock of international reserves and despite a sharp hike in interest rates meant to support the ruble, on August 17, 1998 the Central Bank of Russia and the Ministry of Finance announced a series of emergency measures, including an effective devaluation of the ruble, a unilateral restructuring of government debt, and a moratorium on private sector payments on external liabilities. The devaluation and introduction of default on sovereign debt as a policy tool shook markets around the world. Just as the drop in Russian GDP seemed to have bottomed out for the first time since the fall of the Soviet Union, a new crisis highlighted Russia's dubious position as one of the worst performers among transition economies. The following article examines what went wrong in the months leading up to August 1998, and outlines some of the consequences on international finance and trade.

Before the Crisis: The Russian Economy and Some Trouble Signs

Though it would have been difficult to predict the timing of any crisis, several signs pointed to instability in Russian economics. Investors became unwilling to lend to Russia at any price, and savers lost confidence in the banking system. Well-studied in hindsight, the ominous list of problems to be discussed include:

1. Deficit Spending: Large government expenditures and weak tax collection
2. Debt Management Problems
3. Drop in World Oil Prices
4. A Weak Banking Sector
5. The Asian Financial Crisis
6. Problems in Structural Reforms
7. Political Turbulence

Deficit Spending

Continued inflation after the 1992 price liberalization in Russia was fueled by large government budget deficits and loose monetary policy to pay for them. In a centrally planned economy, the government is in charge of all sectors of production, all output levels and all prices. Often, this involves enormous government subsidies of inefficient firms. After the massive privatization program and the freeing of prices, firms themselves garnered more and more independence from government control. But the separation of firms and the state was not complete: subsidies remained for firms. The new policymakers inherited the socialist levels of expenditure in subsidies, defense, education, transportation, health, social spending and more.

It can be argued that the Soviet Union had budget deficits even before reforms started. Russian prices were fixed low, translating into much of the same for government revenues. On the other hand, state expenditures were dominated by wages. Stalin's program of wage bonuses increased nominal wages. Ideally, such increases should be matched by equal increases in productivity–meaning more goods for consumers to buy and more revenues for the government. Unfortunately in Russia, the over-emphasis on non-consumer goods (industrial development and defense) meant workers got their bonuses, but there were no extra goods to buy. This process fed implicit inflation in Russia and stunted government revenue.

Up until 1992, the deficit was fed directly by three main sources. First, many former republics remained in the rouble-zone, and hedged on their reforms by borrowing from the Russian central bank. When these roubles returned to Russia, money supply increased, inflation increased, and the budget deficit increased. A second source were the huge subsidies to state firms and privatized firms with sympathetic listeners in the Ministry of Finance. Large benefactors of subsidies included the defense sector, the coal industry, agriculture, and energy. The remainder of the deficit was due to general structural overspending by a government with limited revenues.

Prime Minister Yegor Gaidar's administration decided in 1992 to cut military spending by 90 percent. By the end of 1993, Russia had stopped payments to other members of the CIS, and privatization had sold a large proportion of state enterprises. In January 1995, the government passed a law prohibiting the financing of debts by printing money. Subsidies and overspending remained, however, in the face of an inability to increase government revenues.

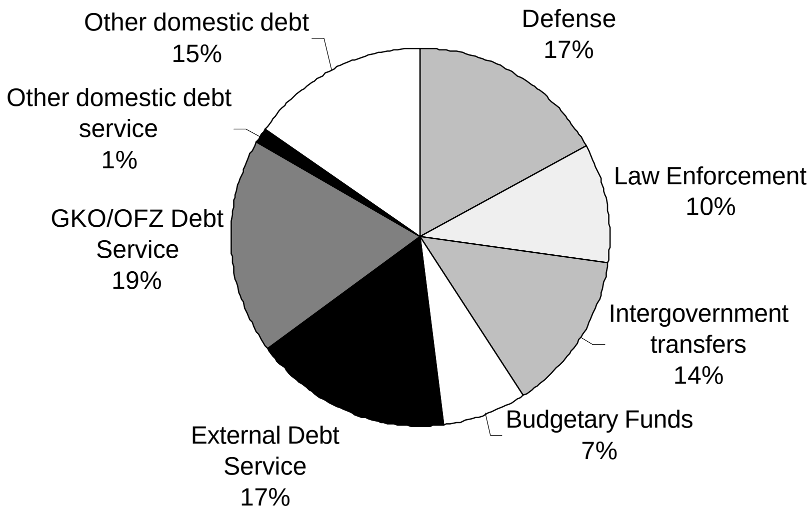
In first years of reform, Russia operated with no budget. With the participation of the Yeltsin administration, the Duma, and pushing by the IMF, more realistic budget bills were adopted, though actual budget execution has regularly lagged behind IMF targets. Table 1 shows the actual execution of the federal budget, in percent of GDP. In 1994, expenditures accounted for over 23 percent of Russian GDP, with revenues below 12 percent. With the dis-inflation policies of the mid-1990's, cuts in defense expenditures, and a decrease in subsidies, federal expenditures were down to 17.7 percent of GDP just before the August 1999 crisis. But revenues had remained weak, even falling, to 10.7 percent of GDP. In their own version of Graham-Rudman policy, the Russians did succeed in pushing the primary budget balance down from a 9.4 percent deficit in 1994 to a 1.4 percent deficit in the quarter before the crisis. But with weakening world oil prices, a weakened current account, and extremely high interest rates aimed at protecting the domestic currency, servicing the existing debt was becoming a greater burden. With interest payments on domestic government debt approaching 6 percent of GDP, the overall budget balance (primary plus interest payments) remained above 7 percent of GDP on the eve of the August panic.

Table 1: Russian Federation: Federal Government Budget Execution, 1994-1999

	1994	**1995**	**1996**	**1997**	**1998**				**1998**	**1999**
					Q1	**Q2**	**Q3**	**Q4**		**Q1**
Revenue	11.8	12.9	12.5	12.0	10.8	10.7	7.7	13.2	10.7	10.3
Expenditure	23.2	18.6	20.9	19.0	16.7	17.7	15.1	17.1	16.6	18.1
Interest	2.0	3.6	5.9	4.6	5.1	5.7	4.6	3.4	4.6	6.7
Non-interest	21.2	15.1	15.0	14.4	11.6	12.1	10.6	13.6	12.1	11.4
Primary	-9.4	-2.2	-2.5	-2.4	-0.8	-1.4	-2.9	-0.4	-1.3	-1.1
Overall	-11.4	-5.7	-8.4	-7.0	-5.8	-7.1	-7.4	-3.8	-5.9	-7.8

Source: Ministry of Finance and IMF

1998 Government Expenditures



The burden of government deficits is arguably even larger than official statistics show. A distinction can be drawn between *shadow*, and *legal* economic activity. The Russian state committee on statistics (GOSKOMSTAT) calculates official Russian GDP as the sum of the two. But some argue that the shadow economy should not be included when calculating the burden of taxes and deficits that the Russian government faces.

Most countries do not include the shadow economy in official GDP statistics, but Russia does. This includes economic activity that is not recorded and is not subject to taxation. Including the shadow economy in GDP means the deficit to GDP ratio appears smaller than otherwise would be, thus understating the burden put on the taxpaying economy. According to one study, the share of shadow economic activity in total GDP was 25.7 percent in 1996, 27.1 percent in 1997, and 28.6 percent in the first half of 1998.[1] If GDP includes only the legal portion, the budget deficit to GDP ratio is substantially higher: 13.1 percent in 1996, 10.9 percent in 1997, and 7.6 percent in the first half of 1998.

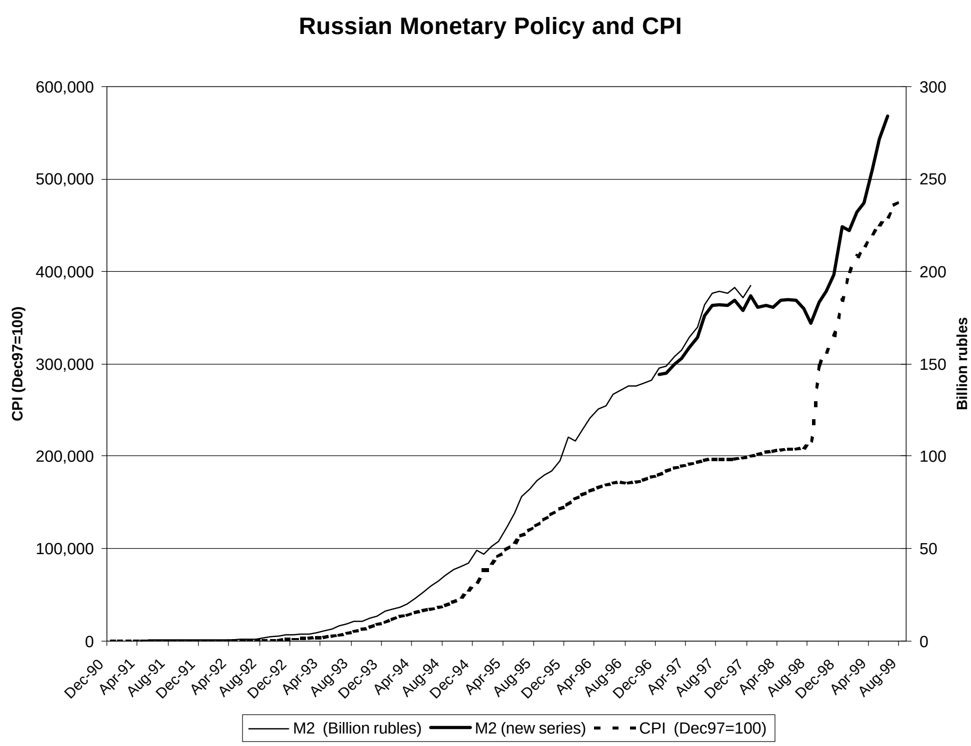
Getting rid of the total deficit has proven difficult for the transition period in Russia. The choices include raising tax rates, expanding the tax base, improving tax collection, and cutbacks in expenditures. But this is in a country where tax evasion has become a national sport. No matter what the government budget plans for in revenues, there is a shortfall. In 1997 alone, only 65 percent of planned revenues were actually collected). In most developped countries, the main tax burden on the population is throught the income tax. In Russia, however, income taxes accounted for 0.8 percent of revenues in 1997, and 0.1 percent of revenues in the 6 months prior to the August crisis. Instead, Russia gets its taxes from indirect sales taxes,

[1] Illarionov, Andrei. "Kak Bil Organizovan Russki Financovyi Krizis," Voprosy Ekonomiki," ("How the Russian Financial Crisis was Organized," Economic Questions, 1998.)

value-added taxes (VAT), and business profit taxes. Privatization revenues have been dissappointing; Russia met only 12.2 percent of its privatization revenue goals. Due to a bad economic climate, the government held back the bidding of Rosneft (oil) and Sviazinvest (communications). A interesting illustration has been the story of the energy giant, Gazprom, which was once run by former Prime Minister Viktor Chernomyrdan. The World Bank once estimated that if Gazprom were to pay all of its taxes and give up its special priveledges and tax breaks, the revenue for the government would amount to 2-3 percent of Russian GDP.

Debt Management Problems

Three ways to finance these continued budget deficits include borrowing domestically, borrowing from abroad, or printing money. In the initial reform period, Russia resorted to emissions, and the resulting inflation is evident. (See figure 1). Price liberalization produced rapid price jumps in April 1991 and January 1992, while loose monetary policy fueled continued inflation over that year of over 2,500 percent. The government adopted a broad anti-inflation program in 1995, prohibiting direct central bank financing of the government, establishing a currency corridor for the ruble/dollar exchange rate, and some efforts to slow the primary budget deficit. The results are one of the few great success stories in Russian transition economics. End-of-period inflation went from 839.1 percent in 1993 down to 71.9 percent in 1995, 48.4 percent in 1996, and 22.5 percent in 1996.



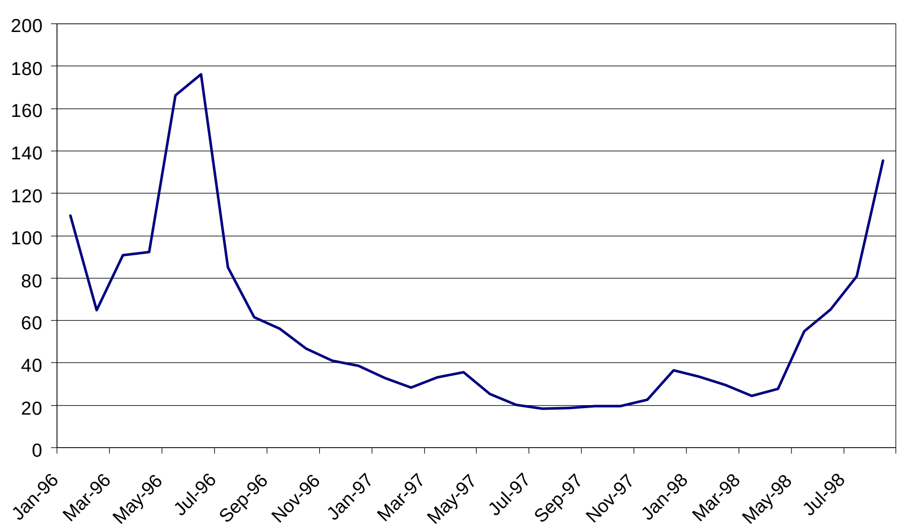
The change was significant to deficit financing because it removed the option of monetary emissions to pay government bills. Financing would have to shift to borrowing at home and borrowing abroad. Domestic borrowing was soon dominated by the sale of short-term treasury bonds (GKO bonds[2]) to private banks. Sources of foreign borrowing came from multilateral creditors like the International Monetary Fund and World Bank, bilateral credits, and the sale of newly developed Russian Eurobonds issued in Europe.

Domestic Borrowing

The start of the GKO market meant a new source of financing and alleviated inflationary pressures, but the increase in domestic and then foreign borrowing would make Russia more and more exposed to the volatile global financial markets. As long as investors felt confident the government would be able to pay them back, the Ministry of Finance gained time to focus on its fiscal overspending. Investors' doubts in the summer of 1998 would be the problem for the government. In 1996, the debt accounted for 4.8 percent of Russian GDP. By 1998, serving the debt would reach 25.6 percent of total budget expenditures, one of the largest line items in the Russian budget.

Something bound to play a central role in the August 1998 turmoil was the short-term nature of government borrowing. The maturities of government bonds averaged between 60 and 90 days in 1995, up to 150 days in 1996, 250 days in 1997, and about 330 days in the months before the crisis. With such short maturities, the government faced an enormous debt rollover every month. In the first half of 1998, monthly payoffs of previously issued bonds accounted for 10 to 15 percent of monthly GDP.[3]

GKO Interest Rate: Secondary Market



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[2] Gosudarstvenie Kreditnie Obligatsii (Government Credit Obligations)

[3] And this doesn't include coupon payments on 2- and 3-year coupon bonds or federal loan bonds)

High nominal interest rates hurt Russia in many ways. In the immediate term, the government faced enormous interest payments, with annual rates reaching as high as 200 percent in late 1994, and over 325 percent in December 1995. Even as rates fell with the anti-inflation program, it wasn't until June 1997 that they dropped below 100 percent annually. In July 1998, a month before the crisis, the interest rate was approaching 80 percent, very high according to western standards. The other cost of such interest rates were an extreme case of investment "crowding out." Not only was investment weak in face of government deficits, but the banks and financial institutions themselves were the ones financing the deficit by buying the governments bonds themselves. This prevented savings from being routed to capital investment, and also meant banks were not in the business of banking–they were not developing the credit skills and loan expertise they should to be able to connect savers an investors efficiently. This meant even less productive investment, less productivity increase, and slower growth for the country.

Further, with the great interest rate differential between Russia and other countries, Russian commercial banks were able to borrow dollars from abroad for the sole purpose of investing in high yield Russian government bonds. Any future default on government debt would mean the collateral on these commercial bank dollar debts would be worthless. This mechanism would prove itself in August 1998.

A solution Russia tried to avoid was monetization, to start printing currency. But some debt simulation models have shown that the high interest rates and size of the debt meant the Russian government might not even have been able to print its way out of the debt crisis it eventually faced.[4] Because bond maturities were so short, increasing the money supply and pushing up prices very quickly translated into even higher nominal interest rates. So the possibility was that interest payments would rise just as fast as the central bank could try to monetize.

Foreign Borrowing

Low Russian private savings was soon seen as a limit on domestic borrowing. The alternative was to turn to the outside world. One step was to allow non-residents into the domestic GKO market. This meant a new source of funds, but also served lower interest rates on outstanding debt. By April 1998, up to 28 percent of the GKO market was held by non-residents. This helped government finances, but also meant Russia would become more exposed to the competitive conditions and volatility of world markets.

Foreign debt in Russia can be split in two parts: debt inherited from the former Soviet Union, and new debt taken on by the Russian Federation itself. Before August 1998, Russia honored both debts. But with the devaluation, a difficult decision was made to interrupt principal and interest payments on Soviet debt while continuing to honor all Russian Federation debt. Today, total external debt is approximately $134 billion.

Soviet debt accumulated with weaknesses in the centrally planned economy. Foreign borrowing from 1985 to 1989 was mainly used for capital investment and development, but in 1990 and 1991 external borrowing was used increasingly to maintain household consumption of imported goods. As of January 1, 1992, Soviet debt had reached $107.7 billion.

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[4] The U.S. Treasury and Russian Ministry of Finance developed such models in a one year joint project in Moscow under Vice Minister of Finance, Oleg Vyugin. The modelers we Michael Keran, Michael Barry, and Julia Tseplaieva.

Russian External Debt, May 31, 1999 ($billion)	
Total External Debt	$134.0
Soviet Debt	$87.1
Paris Club	$39.4
Other Bilateral Creditors	$21.3
London Club	$26.4
Russian Federation Debt	$47.1
Multilateral (IMF and World Bank)	$23.3
Bilateral Creditors	$7.9
Eurobonds	$15.9
Source: Russian Economic Trends	

With the breakup of the Soviet Union, the initial agreement was to spread the debt burden over all former Soviet republics. But in 1993, Russia agreed to assume all external assets and liabilities of the former Soviet Union. (Approximately 97.4 percent). The two biggest parts of the Soviet debt are with the Paris Club ($39.4 billion in May 1999) and the London Club ($26.4 billion). In April 1996, the Paris Club of creditors restructured its portion so as to spread repayment over 25 years. But in August 1998, Russia defaulted on debts to Germany, and has now halted further payments. The London Club restructured $22 billion of its Soviet portfolio in late 1997, but Russia breached the terms in December 1998, and has continued to delay payments.

The second part of external debt is that taken on by Russia after the collapse of the Soviet Union. From 1992 to 1995 Russia did not have access to international financial markets. Presently, of the $47.1 billion in Russian Federation debt, roughly half belongs to multilateral creditors, including the International Monetary Fund and the World Bank. The IMF usually provides only balance of payments support, but with Russia it took the unusual step of financing the fiscal deficits of the Russian federal government. The last batch came in August 1998. The cabinet reshuffle under Prime Minister Primakov put the endorsement of another program on hold. An important policy choice to note is that with future hopes for economic assistance, Russia has always made its payments to the IMF and World Bank on time.

The International Monetary Fund

The IMF has been involved in Russian economic reforms since the breakup of the former Soviet Union. Financial arrangements between the IMF and the Russian Federation since 1995 have included the following:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR)**	**Amount Drawn (SDR)**

Stand-by	April 4, 1995	March 26, 1996	4.3 Billion	4.3 Billion
EFF	March 26, 1996	March 26, 1999	13.2 Billion	5.8 Billion
Stand-by	July 28, 1999	December 27, 2000	3.3 Billion	0.5 Billion
Source: IMF				

On an annual basis, disbursements to Russia reached 3.6 billion SDR in 1995 before falling back to 1.5 SDR in 1997. Disbursements equaled 4.6 billion SDR in 1998 and 0.5 billion in 1999.

	IMF Disbursements to Russia (SDR)	**Russian Repayments to IMF (SDR)**
1992	719,000,000	0
1993	1,078,275,000	0
1994	1,078,275,000	0
1995	3,594,250,000	0
1996	2,587,861,200	359,500,000
1997	1,467,252,800	359,500,000
1998	4,600,000,000	673,921,875
1999	673,921,875	2,628,844,375
Source: IMF		

The IMF loans to Russia are disbursed in tranches, conditional upon the fulfilment of certain reform targets in monetary and fiscal policy. In the case of the $4.5 billion program approved on July 28, 1999, the IMF stipulated that all IMF money disbursed to Russia will be held in an account at the IMF. This account will be used only for Russia's debt service to the IMF. Over the period of the program, Russia's payments to the IMF of interest and principal will exceed new disbursements.[5]

Two developments have put the most recent tranche on hold in Russia–the second tranche totals $640 million and has been held since September. The IMF has been dealing with accusations of money laundering schemes through the Bank of New York and other organizations. IMF directors expressed strong disapproval of their finding that the channeling by the Central Bank of Russia of domestic transactions through FIMACO meant that the balance sheet of the CBR in 1996 had given a misleading impression of the true state of international reserves and monetary and exchange rate policies. Further, the second coming of the war in Chechnya and Russia's role have been under scrutiny by the IMF, and has had economists questioning the IMF's claim of being non-political.

[5] "Facts About IMF Lending to Russia," IMF, September 13, 1999.

IMF comments on Russia claim the main cause of the crisis was a failure of authorities to take seriously the severity of long-standing fiscal problems, and their failure to implement significant structural reforms. An intermediate cause of the crisis was the external environment and the Asian crisis, according to the IMF.[6]

The IMF recommends several measures for future stability in Russian markets:

1. Fiscal Consolidation: Target for a 2 percent primary surplus in 2000
2. No reduction in tax rates
3. Reform of Large Firms' Tax Arrears and Ability to avoid asset siezures
4. Resist Preferential Central Bank Credits to Ailing Banks
5. Structural Reforms: Bank Restructuring and barter/non-payment issues
6. Negotiate With Paris and London Clubs

The present choice confronting the IMF is whether to continue its next tranche payment to Russia. If the IMF pays, Russia can make its debt service payments. The next tranch is worth $640 million. But Russia owed the IMF $640 million by the end of the year. On November 27, IMF Managing Director[7] Michael Camdessus cautioned Russia that the war in Chechnya would endanger continued payments of the $4.5 billion loan. On November 30, the Russian Duma passed a draft of its 2000 budget, one that does not meet the IMF's austerity program.

With the IMF approved monetary stabilization program, new agreements with The Paris and London Clubs, and some success in reducing primary deficits, Russia gained a new creditworthiness on world financial markets. As a result, at the end of 1996, Russia issued its first Eurobond. From 1996 through 1998, there would be total of 9 Eurobond issues, totaling over $15.9 billion. Such financing was extremely attractive to the government: most everyone expected a stable exchange rate, so foreign bond issues allowed the government to switch from ruble borrowing at very high interest rates, to foreign currency borrowing at much lower interest rates. Initially successful, Eurobonds would become exceedingly costly once the ruble was finally devalued. With future external borrowing in mind, however, Russia ranked Eurobonds almost as high as IMF and World Bank debts, continuing all payments on time and in full. It was the old Soviet debt policymakers would choose to be late on.

Oil Prices, Exports, and the Dutch Disease

The drop in world oil prices pushed the Russian current account to deficit after sustained surpluses, and meant a great drop in revenues for the federal government. Up until this point, evidence pointed toward a Russian version of the "Dutch Disease," a phenomenon that often in occurs in economies with export earnings dominated by oil, natural gas, or other natural resources and raw materials. When oil and natural gas was discovered off the coast of the Netherlands, the resulting export sales pushed up the exchange value of the Dutch Franc. Such an appreciation severely hurt the competitiveness of other Dutch export industries, especially manufacturing. In Russia, crude oil, oil products, and natural gas made up over 37

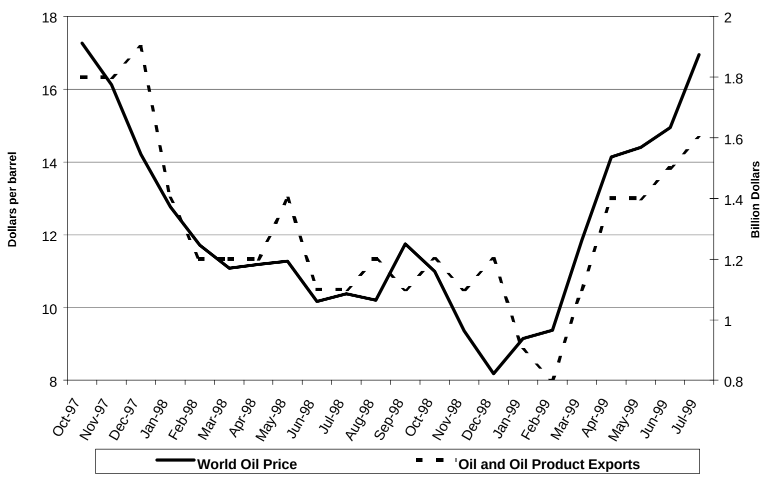
[6] "IMF Concludes Article IV Consultation with Russia," August 2, 1999.

[7] Camdessus has since reigned from the IMF.

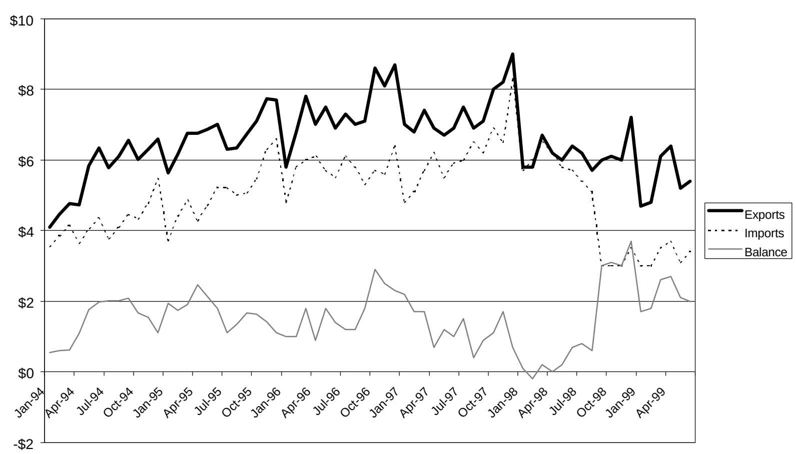
percent of total Russian exports in the first five months of 1999. Such strong natural resource exports earnings would arguably mean a higher ruble exchange value than would otherwise be the case, again translating into decreased global competitiveness of Russian manufacturing.

Among the reasons cited for the drop in oil prices, there was a decision in late 1997 by OPEC to increase oil production. The Japanese recession and growing Asian financial crisis that began in the late summer of 1997 meant lower global demand for oil. The El Nino weather pattern was even blamed for a warmer than usual winter and less world demand for heating oil. Whatever the case, the price of oil fell from over $21 per barrel in January 1997 to around $10 by the summer of 1998[8]. Oil prices have since rebounded to about $17 per barrel, but the glut of 1997-1998 came at a bad time for Russia.

Oil Price and Russian Oil Exports



Russian Foreign Trade
Billion Dollars



[8] As a proxy for "world" oil prices, data listed is the average f.o.b. cost of crude oil imports to the United States, taken from the Energy Information Administration/Petroleum Marketing Monthly, October 1999.

In response to the price drop, Russian oil and oil products export revenues fell from $23.1 billion in 1996 to $21.9 billion in 1997 and $14.5 billion in 1998. The Russian trade balance in the first quarter of 1997 was $6.0 billion with a current account balance of $4.0 billion. By the first quarter of 1998, the drop in exports had pushed the trade balance down to $0.9 billion and put the current account into a deficit of $1.5 billion. By the second quarter of 1998, the current account deficit was $3.6 billion.

Russian Balance of Payments
($ Billion)

	1997				1998				1999
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Goods: Exports	21.2	20.7	21.7	25.4	18.6	18.8	18.1	19.2	15.6
Goods: Imports	-15.1	-17.1	-18.3	-21.0	-17.7	-17.3	-13.3	-9.2	-9.1
Trade Balance	6.0	3.6	3.4	4.4	0.9	1.6	4.8	10.0	6.5
Services Balance	-1.0	-1.2	-1.5	-1.5	-1.1	-1.3	-0.7	-0.2	-0.4
Net Income	-1.0	-2.4	-2.7	-2.4	-1.2	-3.7	-3.3	-3.2	-1.0
Net Transfers	-0.1	-0.2	-0.2	-0.2	-0.1	-0.1	0.0	0.0	-0.1
Current Balance	4.0	0.0	-0.9	0.4	-1.5	-3.6	0.9	6.6	5.1
Capital Account	-0.1	-0.3	-0.2	-0.2	-0.1	-0.2	0.0	-0.1	-0.1
Net direct Investment	-0.1	1.0	1.4	1.4	0.3	0.2	0.3	0.4	0.3
Net Portfolio Investment	6.1	8.0	1.9	29.4	3.6	4.1	0.2	0.4	-0.5
Net Other Investment	-6.1	0.4	-2.5	-34.1	-0.5	0.9	-0.2	-4.4	-5.0
Change,International Reserves	-1.3	-8.0	1.6	5.8	0.9	0.8	2.6	1.1	1.0
Capital and Financial Account	-1.5	1.2	2.2	2.3	4.2	5.4	2.8	-6.8	-4.2
Net Errors	-2.5	-1.1	-1.3	-2.7	-2.7	-1.8	-3.7	0.2	-0.9

Source: Russian Central Bank

Weak Banking Sector

Banks and financial intermediaries play an extremely important role in economics, where scarce resources are to be most efficiently utilized to satisfy unlimited wants. Three agents are linked: households, enterprises, and the government. Households have savings. Private enterprises have prospective investment projects for which they wish to borrow. The banking sector uses the efficiency and power of markets to decide which investment projects are most beneficial to society, and where the scarce resources of a country should be used. The government sector is a third arm that can be either a saver or borrower, though most often it too uses financial sectors to find funds to pay for fiscal deficits. A market economy needs banks to help decide which investment ideas are good and which are bad.

Banks in Russia do not perform this important function. A description of the industry just before the August 1998 crisis would be a vast array of over 1,500 banks. More than half were extremely small and did no lending activities at all. The profits of banks were made in currency speculation, servicing state needs and the national payments system, and the purchase of high interest government bonds. Common practices included the "lingering of payments," where banks collected taxes but delayed passing the funds on to the government, and "running budget money," where banks delayed payments in the opposite direction. Many would receive government expenditure funds, but delay payments to their final destinations.

In August 1998, lending was just 12 percent of Russian GDP, not enough to effectively influence investment and consumption decisions. The 1995 introduction of a ruble foreign exchange band meant few profit opportunities in currency speculation, so an enormous amount of bank resources were used for the purchase of GKO's and other government securities. The result was a dismal rate of capital investment—9.6 percent of GDP in the first half of 1997 and 8.8 percent in the first 8 months of 1998.

The legal and economic environment was not friendly to banking and investment. This included unclear property rights, changing legislation, weak judiciary and dispute settlement process, no deposit insurance, and high government security interest rates. The result was capital flight through bank transfers and trade credits, high proportion of assets in GKO's, and a very short-term nature of financial instruments. Up to 85 percent of public deposits were demand deposits with maturities less than 6 months. Further, Russian policy-makers were quite nationalistic, preferring to retain a fully Russian-owned banking system. While keeping out foreign banks, Russia was left with undercapitalized domestic banks, close bank-government ties, cheap credits, cronyism, and poor investment choices. The government supported banks with the high GKO rates, and in return accepted negative real interest rates on bank deposits.

The Asian Financial Crisis

The Russian crisis came less than a year after the 1997 breakout of currency attacks across Asia, including Thailand, Malaysia, the Philippines, South Korea, Indonesia and others. Three channels of "contagion" allowed the currency crisis spread. First, when country A devalues, it hurts the competitiveness of country B. Further, country A can have investment holdings in country B and vice-versa. Finally, market perception is such that investors everywhere get nervous when any country fails. This final factor might have been the crucial one for Russia.

There are similarities and differences between Russia and the Asian economies. Several Asian economies followed pretty good policy decisions before the currency attacks. For some time, low inflation, moderate budget deficits, and strong capital inflow diverted to Asia after the Mexican crisis earlier. Unlike Mexico, where much foreign investment had been used for current consumption, Asia put capital inflows into investment. Problems, however, included a Russian-like tendency towards short-term financing and an overconfidence in stable exchange rates and lack of forward exchange market hedging.

Extra shocks that hit Asia included scarce labor, rising wages, and real currency appreciation that hurt export competitiveness. Unlike Russia, Asia enjoyed huge savings, but the investment decisions were often poor over-investment in real estate and computer chips. Both real estate and computer chip prices would plummet. The recession in the richest country of the region, Japan, meant depressed exports for all Asian countries. Some Asian currencies were fixed to the US dollar, which was sharply appreciating against the Japanese Yen. Some also would point to the 1994 Chinese devaluation.

Current account deficits would affect both Asia and Russia, as well as central bank policies that maintained strong domestic currency. The 1997 crisis in Asia and the 1998 crisis in Russia highlighted the inefficiencies in the banking sector. Criticism in many affected countries would center on the relationship between the government and the financial sector. From the "chaebols" in Korea to the alleged "cronyism" in Russia, the allocation of investment funds was often less than optimal.

Reform Problems

Several other factors contributed to the poor performance, investor flight, and following financial crisis in Russia. Of growing importance to Russia was attracting and maintaining long-term relationships with foreign suppliers of capital. When investors looked at Russia they saw problems with the tax system, land ownership, privatization policies, weak bankruptcy laws, weak contract enforcement and dispute settlement, corruption, cronyism, bribery, lack of transparency, and even violence. Looking at the lack of foreign direct investment and the short maturities on financial assets, if investors wanted to abandon Russia, it wouldn't take very long.

Political Considerations

Measuring the impact of political change on the Russian economy, but several factors would argue politics and instability might play a large role in consumer and investor confidence in Russia. With little FDI in Russia, deficit financing was dependent on volotile short-term capital. The precarious economic fundamentals described above would certainly be on the minds of Russian investors. In additon, it doesn't require a long memory for Russians to recall the enormous inflation taxes of the early reform period, a history of monetary reforms and confiscations, battles between the government and the parliament, and the repetitive sacking of prime ministers in the Yeltsin cabinet.

There have been continuous reshuffles of the Russian cabinet and government. These and other events are analyzed in an event study on the Russian foreign exchange market.[9]

A short list of major events illustrates the political volatility Russian investors would remember well:

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[9] Michael Barry, U.S. International Trade Commission, "An Event Study of the Russian Foreign Exchange Market: January 1992 through November 1999," working paper.

June 1992	Yegor Gaidar appointed acting prime minister
December 1992	Viktor Chernomyrdin replaces Gaidar as P.M.
September 1993	President Yeltsin dissolves Congress
October 1994	Yeltsin sends tanks to shell House of Soviets
December 1993	First Federal Assembly Elections
December 1994	Communists Win Back Duma
September 1996	Yeltsin hands powers to Chernomyrdin, undergoes heart surgery
November 1997	Cabinet Shuffle; Finance Minister Chubais replaced
March 1998	Yeltsin fires entire government Stand-off between Yeltsin and Duma over new Prime Minister Kiriyenko replaces Chernomyrdin as Prime Minister
August-Sepember 1998	Yeltsin fires Kiriyenko, re-nominates Chernomyrdin Another Stand-off with Duma Yevgeniy Primakov named Prime Minister
May 1999	Yeltsin fires Primakov, Stepashin becomes Prime Minister
August 1999	Yeltsin fires Stepashin Yeltsin names Putin Prime Minister and successor
December 1999	Yeltsin resignes for New Years speech Names Putin Acting President
Source: NUPI, Centre for Russian Studies Database	

In addition, Russian consumers dont trust their savings to banks, possibly because of the great inflation of the early 1990's, and possibly because of a Soviet/Russian history of financial crisis, monetary reforms, and currency confiscations. An illustration of these would include:

January 1918	Default on State Debt (Tsarist and Provisional governments)
1918-1923	Hyperinlfation of Soviet Denominations
1926	Refusal of partial convertability of gold ruble
December 1947	Confiscatory monetary reform
1956	Refusal to pay state bonds for rebuilding of national economy
January 1961	Confiscatory monetary reform
January 1991	Confiscatory monetary reform (replacement of 50- and 100-ruble notes)

July 1993	Confiscatory monetary reform (replacement of Soviet rubles with Russian)
October 11, 1994	“Black Tuesday” (27 percent devaluation in a single day)
August 17, 1998	Devaluation of ruble, default
Source: Problems of Economic Transition, March 1999.	

Investor Confidence Crumbling

The Asian financial crisis began in the summer of 1997. On October 27, 1997, the Dow Jones industrial average fell over 550 points. It made a quick recovery, but a collapse in asset prices followed in several developing markets, including the Russian Federation. With investor confidence shaken, an enormous outflow of capital from Russia began. Between October 27 and November 2, 1997, the Russian stock market fell 18.5 percent. Over November, there was an additional 32 percent drop. The mean-weighted yield on state debt obligations increased from 22 percent to 28 percent in the first week after the Dow fell. Prices on Russian Eurobonds also experienced a significant decrease.

The response of the Central Bank of Russia would later be criticized for initially maintaining low interest rates through open market operations and bank purchases of GKO’s. The bank shifted its course two weeks later, choosing to raise interest rates to support the ruble and protect against a loss of international reserves. By then, however, the ruble flight had begun. Gold-currency reserves fell sharply from $22.9 billion in October to 16.8 billion in November. The government and central bank widened the ruble exchange “corridor,” and but it was months before any developed program was announced to reduce state spending and the budget deficit–something that might serve to calm investor anxiety. In early 1998, President Yeltsin had vowed to tighten the budget, and achieve “a primary surplus as early as 1998.” The “Twelve Major Steps of Socioeconomic Policy” were announced, and the IMF extended its 3-year lending program by another year. After the March 23, 1998 cabinet reshuffle that left young Kiriyenko as Prime Minister, there was some success in slowing expenditures and increasing tax receipts.

By May, however, investor confidence was dropping again. Interest rates rose sharply, the RTS-1 stock market lost 40 percent of its value, and reserves fell by 10 percent. In addition, the state Duma passed a law limiting to 25 percent the share of foreign ownership of the large United Energy System of Russia and other electric companies.[10] Such a move scared foreign investors in all industries. Later, CBR chairman Sergei Dubinin somberly announced the threat of a financial crisis and a crisis in state debt financing. Then the chairman of the Accounting Office Khachim Karmokov suggested a sequestration of budget spending–a move the national media interpreted as a coming freeze on payments and debt default. Slow progress with the IMF and an unsuccessful 5-year bond offering were followed by high-profile downgradings in Russia’s international credit-worthiness.

The Crisis Begins

[10] The Law on Specific Features of the Disposition of the Shares of the United Energy System of Russia Joint Stock Company (RAO EES Rossii) and Other Electric Companies.

The government securities market gave signals of the trouble ahead. Interest rates were rising, maturities were falling, and the government was finding it more and more difficult to find anyone interested in buying its debt instruments. To attract investors, the Ministry of Finance raised rates and shortened maturities. At first, investors refused to buy one-year securities, only those coming due within 6 months. By May, 6-month securities couldn't be placed, and the debt rollover turned to 3-month bonds. By July, the mean-weighted yield on domestic securities had reached 126 percent. On July 8, the MOF outright canceled two bond auctions for GKO's coming due on January 6 and January 7, 1999. It was later announced that GKO holders would be allowed to convert their assets to longer term, dollar-denominated bonds. On July 115, another GKO auction was canceled and the debt was serviced out of the budget. By July 20, the government gave up on GKO's and announced a one-year suspension on the issuance of state securities.

With the capital account dominated by short-term portfolio investment, a vicious cycle would develop in foreign exchange. As worried investors sold government bonds to turn their rubles into dollars, the central bank used its international reserves to support the exchange rate. With falling reserves, investors wondered if Russia would be able to finance its massive external debts. Pressure on the ruble increased, reserves fell even more, the risk of default increased, and the cycle continued. The question would be what would happen when reserves were gone?

At that time, possible outcomes could include a massive IMF bailout to increase reserves, restore confidence, and break the cycle. But with no such bailout, the CBR did run out of reserves and could no longer maintain the value of the Russian ruble. Running parallel with the foreign exchange market, banks faced insolvency. Factors included the drop in investor confidence, tight monetary policy in the first half of 1998 to support the rouble, and heavy bank investment in GKO's. Soaring interest rates and falling bond prices meant banks' assets were worth less and less. In addition, banks often used their GKO portfolios as collateral for credit from foreign banks. When the central bank increased the required reserve ratio to prepare for any bank panics, banks began selling off their GKO's and OFZ securities to meet the requirement. Some saw this as government cronyism, giving forewarning to private banks before the bond market collapsed.

Net International Reserves Billion $	
January 1998	0.9
February 1998	0.5
March 1998	2.4
April 1998	1.4
May 1998	0.0
June 1998	1.5
July 1998	-0.9
August 1998	-6.8
September 1998	-6.7

A controversial decision by the state Savings Bank (Sberbank) was made not to extend its large portfolio of treasury bonds. Sberbank was the largest single holder of Russian bonds, and is owned by the Russian Central Bank. Its decision forced the government to issue debt to other creditors at much higher interest rates, and further sent a signal to investors that the government's finances were in trouble. Further, it must be asked what the Sberbank did with the rubles it received from the Ministry of Finance. One of the few investment choices for liquid funds in Russia was hard currency. The IMF went so far as to wonder if the Sberbank itself served as a currency speculator, pulling down the ruble price and pushing money abroad.

August 17, 1998

A government plan was announced on August 17 that would include three directives:

1. Devaluation and widening of currency "corridor"
2. 3-month moratorium on the repayment of foreign debts by Russian banks
3. Compulsory restructuring of domestic GKO-OFZ debt. (De-facto default)

The ruble was initially supported in a newly widened band (between 6 and 8 rubles/dollar) by heavy central bank intervention. But on September 2 the support was abandoned altogether, and the ruble quickly fell to over 20 rubles/dollar before settling back to 16. With increased import costs and the renewal of central bank emissions, inflation jumped to 38 percent in September (on monthly basis). Banks collapsed, the payments system froze, imports fell, and GDP dropped again.

On a large scale, some major results of the crisis were the following:

1. **Decline of Domestic and Foreign Confidence**
   This meant the outflow of capital, slowed investment, and limits on future borrowing in Russia. Long-run growth prospects are less.

2. **Inflationary Debt Financing**
   With the borrowing channel closed off, printing currency remains the government's main option. The central bank resumes direct lending to the government, prices increase, and Russia returns to the inflation it left behind in the early 1990's.

3. **Import Replacement**
   Significantly benefitting from the devaluation was the domestic import-competing sector. Following periods when up to half of consumer spending went towards imported goods, the lower ruble value meant Russians would be more likely to buy goods produced at home.

4. **Stock-Market Decline**
   The huge drop in equity values hurt firms' ability to raise capital for investment. This, too, means slower productivity gains and less GDP growth.

5. **Banking Crisis**
   The collapse of the domestic securities market highlighted Russian banking inefficiencies and lack of lending activity. Several questions remain–most importantly maybe, whether or not Russians will even trust their savings to banks at all.

6. **Political Uncertainty**
   Boris Yeltsin has become famous for his dramatic cabinet re-shuffles. This crisis comes as voters start to think about the year 2000 presidential elections. The renewed economic

uncertainty only adds to the political uncertainty surrounding the replacement of Russia's first democratically elected leader.

U.S. Companies Trading and Investing in Russia

The U.S. Department of State did a survey of U.S. firms doing business in Russia, and asked how they were affected by the August events and their aftermath. Some of the most cited items included the following:

1. **Cash Flow Issues**
   Many firms reported problems meeting payrolls, collecting invoices, or paying for supplies. Banks closed, the national payments system shut down, and people across the country preferred to wait for news on where the ruble value would settle. The uncertainty brought much commerce to a stop. Other symptoms included the large financial sector layoffs, delays in any contract negotiations, slowdown in travel, and credit cards no longer being accepted.

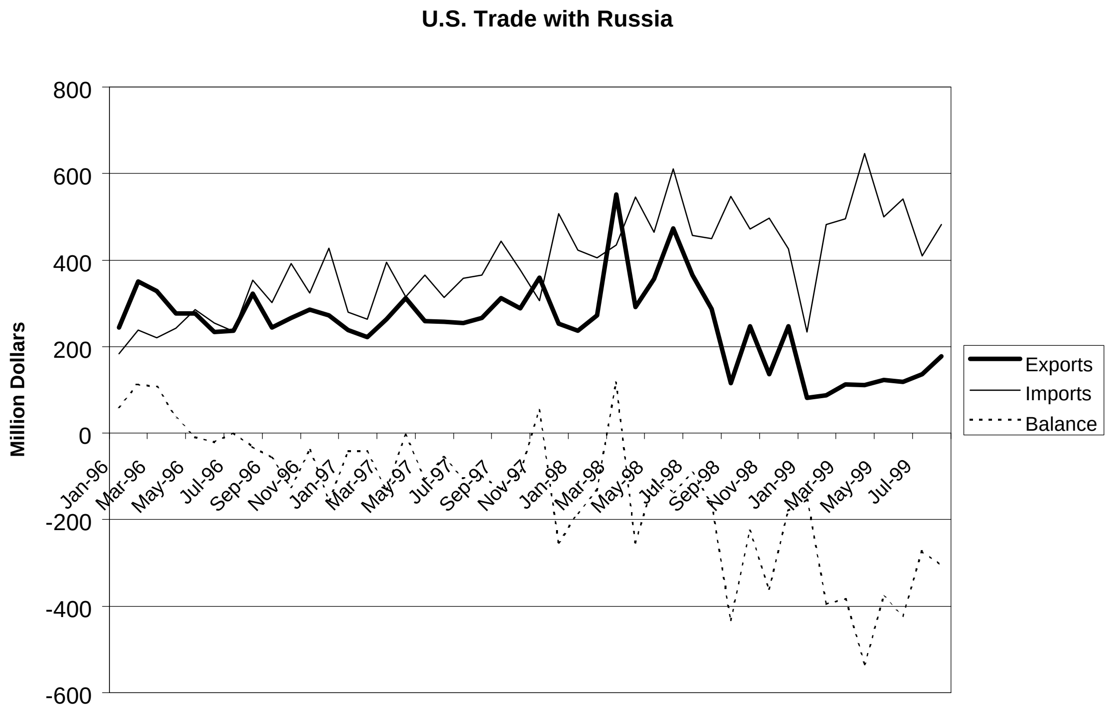
2. **Exchange Rate Losses on Receivables**
   Possibly because of overconfidence in the central bank pledge to support a stable ruble, many firms did not hedge in the forward markets. Some U.S. firms reported sending out ruble denominated invoices, especially those on consumer goods such as foodstuffs, cosmetics, and soft drinks. The ruble's initial plunge and partial recovery meant reduced dollar revenues for these firms.

3. **Debt Moratorium**
   There was confusion after the announcement of the moratorium on foreign debts repayments by Russian banks. The central bank tried to clarify the vague language of the announced law to say it didnt cover foreign trade activities, but firms worried about being able to pay suppliers. Many banks still claimed some trade payments to be foreign debt, and refused to pay.

4. **Ability to Raise Prices**
   A majority of the firms face very elastic demand in Russia. Compensating for the devaluation by raising ruble prices was thus difficult. In addition, new taxes were imposed: a 5 percent regional sales tax, and a 3 percent import surcharge.

U.S. Trade Balance With Russia

Before and after the financial crisis, U.S. trade with Russia is relatively small. U.S. exports to Russia had been stable and growing from $2.1 billion in 1992 to $3.6 billion in 1998. U.S. imports have also expanded, totaling $0.5 billion in 1992 and $5.7 billion in 1998. After U.S. trade surpluses in 1992 and 1993, the U.S. trade balance turned to a $0.7 deficit in 1994. By 1999, the trade deficit totaled $2.2 billion.

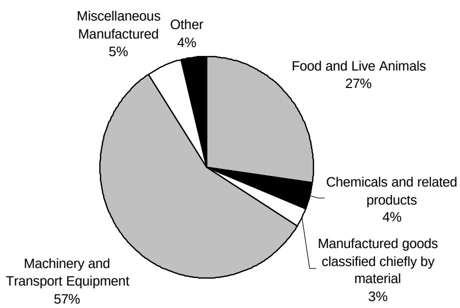


On a monthly basis, U.S. exports reached as high as $552 million in March 1998, while imports reached $610 million in June 1998. The August 1998 devaluation and crisis in Russia was immediately followed by a collapse in U.S. exports to Russia, as U.S. goods and services became prohibitively expensive to much of Russia. In June of 1998, U.S. exports totaled $474 million. By September they were $115 billion, and by January 1999, $80.1 million. In some ways, imports from Russia followed somewhat of a J-Cruve phenomenon. Imports held steady until January 1999 when they dramatically fell before recovering to even higher levels than before the crisis. Some of this is seasonality, but after the ruble devaluation, this delayed effect might also be explained by the slower adjustment of import quantities verses prices. The resulting U.S. trade deficit in Russia increased following the August events, mainly due to the weakening of exports.

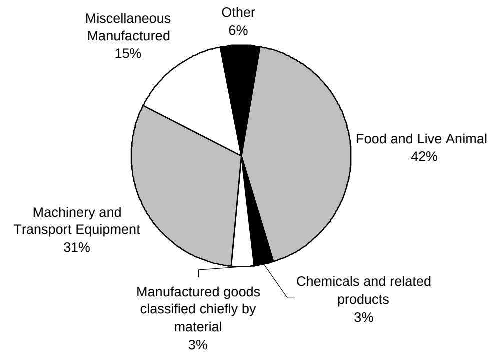
On a sectoral basis, the largest U.S. exports to Russia in July 1998 were machinery and transport equipment ($205.5 million) and food and live animals ($97.9 million). Almost a year after the devaluation, U.S. exports had declined from $365.6 million in July 1998 to $136.29 million in July 1999. U.S. exports of machinery and transport equipment fell by almost 80 percent to $41.9 million. Food and live animal exports fell 41.4 percent to $57.3 million, but took over the lead as the largest U.S. export to Russia.

U.S. imports from Russia are dominated by manufactured goods classified chiefly by material. Such imports totaled $341.8 million in July 1998 (75 percent of the total), and fell to $246.6 million by July 1999 (53 percent of the total). In the same period, other imports have increased, including machinery and transport equipment (267.5 percent increase), chemicals and related products (215.2 percent increase), and mineral fuels, lubricants, and related goods (122.6 percent increase).

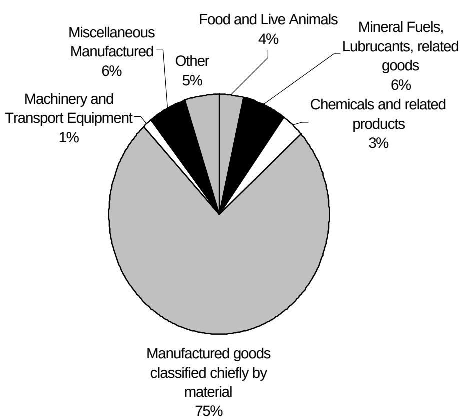
U.S. Exports to Russia, July, 1998



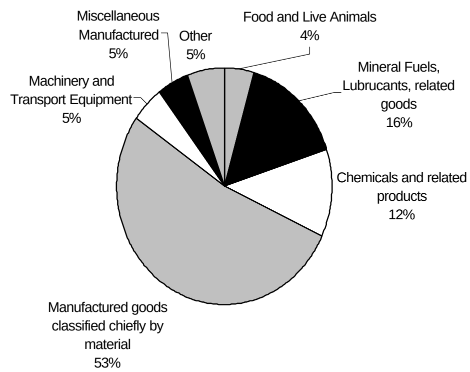
U.S. Exports to Russia, July 1999



U.S. Imports from Russia, July 1998



U.S. Imports from Russia, July 1999



Conclusion

Many factors contributed to the financial crisis in Russia, both internal and external. Much of the instability can be traced back to unsound fiscal policies and slow progress in economic reforms. The expected hyper-inflation after the crisis has been avoided, but the coming presidential elections, war in Chechnya, and a surge in the external debt service payments will make the year 2000 a challenging one for the country.