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Abstract

In the third quarter of 1998, Russia experienced what seemed a classical financial crisis, combining a currency crisis, a debt crisis and a banking crisis. The Russian crisis was also evidently connected with the earlier Asian crisis, and sent shock waves across global financial markets. Still, a closer look shows that the Russian crisis was mostly home made, typically caused by excessive public sector debt, and the mechanisms of crisis can not be understood without an understanding of the peculiarities of the Russian economic system, including demonetisation and insider ownership. Such factors also go a long way in explaining the emergence of Russia from the crisis.

Keywords: Russia – economic development and policies, financial crisis, global financial markets

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In August 1998, Russia experienced what fulfils the criteria of a classical financial crisis combining a currency crisis, a banking crisis and a debt crisis, as the rouble collapsed from about RUR 6 for USD 1 to 20-25 for one, the aggregate capital of the banking system shrunk very close to zero if not below and even the payment system temporarily ground almost completely to a halt, and the country declared a moratorium on much private foreign debt and defaulted on all rouble-denominated public debt. Since, Russia has defaulted on many currency debts, as well. The main macroeconomic achievements of Russia's stabilisation policies since 1995 – low inflation and a stable exchange rate – were gone. It was obvious that the perspective of economic growth, first visible in 1997, again had to be postponed. The 1997 stabilisation was seen not as the natural outcome of consistent policies, but as a windfall created by an exceptional net capital inflow of BUSD 15 to the federal government and BUSD 6.2 of foreign direct investment, BUSD 2.2 of portfolio investment and BUSD 7.4 of net loans to the private sector. It is estimated that 1997 was also a year of exceptionally large capital flight. Against that background, 1998 was also a return to normalcy. Russia's crisis, in spite of the marginal position of the country in the international trading system, sent shock waves through global financial markets, largely because of two reasons: the country had become a major borrower of short-term capital and a full-scale sovereign default was deemed possible. The debate on whether the Washington Consensus "lost Russia" fed into a general discussion on the future of the international financial system.

In retrospect, the peculiarities of the Russian crisis become more visible. The shift in economic policies widely expected in Autumn 1998 has been much less than forecast. The new left-wing government promised all kinds of things that they fortunately failed to fulfil, but paradoxically it did preside over a collapse in real wages of about a third. The Russian economic policy consensus proved more robust than most had expected as even politicians with populist and dirigiste vocabulary decided to respect the constraints. After the initial devaluation-triggered peak, inflation came down quite fast, and the exchange rate has been quite stable since March 1999. Industrial production declined steeply, but just to climb strongly back at least to the 1997 level. Curiously, there has until now been only a modest increase in export volumes, and the USD value of exports remains lower than last year in spite of the surge in oil price. Contrary to other recent experiences, Russia has failed to produce a V-shaped export recovery. Import substitution, on the other hand, has been strong. The banking system only functions as a payments system, but that has not hindered industrial recovery. Real incomes in rouble terms remain about a quarter lower than before the crisis, and there may have been a loss of one fifth of private consumption.

This paper is divided into three further sections. First, it characterises the peculiarities of the Russian economic system from the financial perspective. Second, it describes the 1998 crisis and policy responses. Third, it looks at the Russian financial situation a year later to detect what if any were the longer-lasting consequences of the August 1998 shock.

1 The Russian economic system

During the last ten years, Russia has changed almost beyond recognition. The country no longer has a one-party rule, censorship and an official ideology. Very few Russians long for such defining features of the old regime. Economically, the country no longer has formal central planning, a fixed-price system, full employment and small income differences. The

rouble is reasonably convertible, many prices are free and there is both entry and exit of companies. The share of foreign trade in GDP has leaped, and the country is dependent on foreign finance. It does not seem all too outrageous to call this a market economy.

But surely Russia is a very peculiar market economy, probably without a parallel outside the former Soviet Union. All countries are different, but Russia is more different than most others, as a look at the three dimensions of classical economic systems literature shows: property rights, the co-ordination mechanism and the decision making system.

Most of Russia's industry, services and agriculture is founded on insider ownership. The role of new private activities is at best modest, mostly because the grabbing hand of the state (Shleifer and Vishny, 1999) continues to hinder entrepreneurship. But there is a large second economy. In industry, the mass privatisation of 1992-1994, covering some two thirds of industry, resulted in about two thirds of cases where about two thirds of stock were owned by company insiders. Employees were quite often the majority or at least major owners, but managers have been the active owners (Blasi, 1997). As the shares were transferable, the reformers hoped that over time the position of the insiders would be diluted (Boycko, 1995), but that at most has happened to a very small extent. The second phase of Russian privatisation, in particular the loans-for-shares arrangement of 1995, did create an outside investor group of some strength, the so-called oligarchs, but the 1998 crisis not only frightened potential foreign investors but very much weakened the oligarchs and thus left insider ownership without a clear alternative in the foreseeable future.

Lacking earlier experience and a well-developed theoretical framework, speculation on the impact of predominant insider ownership is uncertain, but it seems clear that (a) insiders often see their ownership role more as a matter of implicit employment guarantee or power than as a matter of asset management, (b) insiders typically lack other investment finance than cash flow, (c) they often take a negative attitude both towards outside equity holding and dependence on credit (some evidence is discussed in Filatotchev et al, 1999). Therefore, one would expect an insider owned economy to have small financial and equity markets and relatively little investment and structural change. Indeed, the stock of bank credit to the private sector never reached ten per cent of GDP in Russia (with total bank assets even in early 1998 less than 40 per cent of GDP and only 21 per cent in 1999), the stock exchange capitalisation was at peak only 25 per cent of GDP (and now about five per cent) and the market was dominated by a relatively small number of energy, telecommunications and infrastructure companies, and – as has been shown by the post-devaluation export performance – the competitiveness problem of the Russian industry is a real, not a price one.

Second, Russia is a demonetised and/or a multi-currency economy. The markets are not primarily co-ordinated via roubles. The ratio of rouble M2 to GDP has in recent years fluctuated around 15 per cent. Dollars are much used, with the value of the dollar stock even before devaluation probably greater than the value of the rouble stock. One Russian peculiarity is the wide use of barter in business-to-business transactions. According to the Russian Economic Barometer survey time-series, the share of barter in industrial output has risen almost monotonously from about five per cent in early 1992 to about 46 per cent in early 1998 and peaked at about 53 per cent in late 1998, to come back to 43 per cent in April 1999. In addition, a large share of public-to-private sector transactions are based on the use of offsets. At times as much as one half of fiscal revenue has consisted of offsets. Finally, there are various quasi-monies – usually issued by enterprises and banks – in circulation.

The reasons for such phenomena have been discussed but are not well understood. But some of the consequences are quite self-evident: (a) non-monetary exchange will tend to emphasise the role of personal ties and trust, but also of paternalism and arbitrariness, as

against the anonymity and trust in institutions more typical of monetary-based markets; (b) the (usually multilateral) exchange chains created will always be less efficient than a money-based economy; (c) the true costs and productivity of the economy will be difficult to judge; (d) tax collection will be extremely difficult; (e) and as a large part of revenue collected will not be in cash, the effectiveness of fiscal policy is lower than in a money-based economy; (f) that is also true of monetary policy, as money demand may be unstable and anyway only connects with a fraction of the economy; and (g) most importantly, an economy based on non-monetary cash is not well suited to generate savings and investment. On the other hand, (h) such an economy will be robust in face of a financial crisis: if money and financial institutions are little used, their collapse will not bring the whole economy down. This was also shown in 1998.

One defining feature and a central goal of Soviet socialism was the fusion of economic and political decision making. Though the Central Committee is gone, the fusion still continues, not only on the very visible federal level, but to an even greater extent on the less-closely monitored regional and local levels.. This contributes to a short-termism where decisions are much more dependent on the ever-changing correlation of elite interests than on any perceptions about the long-term national interest. Policies are thus captured by interest groups drawing great benefit from the state. Peculiarly, though the public sector continues to consume a very large part of resources, the state is a weak one: it is unable even to supply the fundamental public goods like law and order, public health and institution-building in a satisfactory way. Corruption is rife, ownership and creditor rights weakly protected, and the legal environment incomplete, contradictory and sometimes arbitrarily implemented. For a financial crisis, the existence of politically well-connected financial-industrial groupings is important. The Russian FIG's are however different from – say – Korean chaebols: their major goal was not excessive investment with borrowed money, but reliance on the state for finance and privilege.

2 The background of the crisis

By late 1994 a near consensus had arisen in Russian politics that the high and variable inflation of 1991-1995 – with ten-to-thirty per cent monthly price increases – was probably the major source of many of the ills plaguing the economy: declining production, collapsing investment, increasing income differentials and the emergence of a major open poverty problem. The disinflation programme was anchored since July 1995 to nominal exchange rate, which strengthened the real exchange rate steeply in 1994-1997. After that, the real exchange rate was kept quite stable, with average monthly wages at about USD 160-180. The central bank was able to defend the exchange rate in spite of having lost a third of reserves in November 1997, the time of the first Asian crisis. There was some debate of a change in exchange rate policy, but the time never seemed to be the right one (Alexashenko, 1999). That has been much deplored afterwards.

The exchange rate anchoring was accompanied by tighter monetary policies. Real interest rates, still strongly negative in 1995, rose hugely in 1996 and only converged towards normalcy during the second half of 1997, to rise again as uncertainty increased. There was some remonetisation of the economy as the rouble broad money velocity declined. The ratio of foreign currency deposits to rouble deposits also declined. Inflation was down to the one per cent monthly – the target set.

While monetary policies were tight, fiscal policies maintained a major deficit. Since 1993, the enlarged government deficit has fluctuated between 5-10 per cent of GDP, without any clear declining trend. Until 1995, the deficit was largely financed directly by the central bank, but this was forbidden in the April 1995 Central bank law. After that, the deficit was financed primarily by issuing government securities.

The market for government securities (GKO/OFZ) was established in 1993 and became vital since 1995. By early 1998 the stock of securities equalled or was higher than the rouble money stock. Non-residents were officially allowed to the market in early 1996, and by Summer 1998 they directly held thirty per cent of outstanding GKO debt, equivalent to about BUSD 70. Moscow analysts assume that the actual share held by non-residents may have been as high as one half (Malleret et al, 1999). Thus, non-residents held some BUSD 25-35 worth of GKO debt in a country with the official reserves of BUSD 16 at the end of July. This was a fragile situation, made worse by privately-held short-term foreign debt. By early 1998, no limitations on outward capital flight were in place. Therefore, Russia was very vulnerable to a sudden turnaround in investor confidence. The rouble debt stock was very short-term, with 45 per cent with a maturity of six months or less. The GKO/OFZ debt stock rose from zero per cent of GDP to about 14 per cent in June 1998. Still the need to keep pace with maturing issues and meet interest payments surging in 1998 meant that net financing (after debt-service costs), which had been 85 per cent of new issuance in 1993, dropped to less than ten per cent in 1997 and to zero since the beginning of 1998. The cost of debt-service surged. During the first half of 1998 fifty per cent of federal tax revenue was needed for servicing the debt, and just before the crisis all federal tax revenue was so used. To appreciate the precariousness of the situation, two comparisons need to be repeated. By 1998, the stock of short-term government debt was roughly equal to the rouble money stock; debt owned by non-residents may have equalled twice the official reserves.

In addition to non-residents, Russian banks were another important buyer of rouble denominated government securities. In 1997 thirty per cent of the banking sector revenue was derived from government securities, though by 1998 the share was down to about 15 per cent (Dmitriyev and Surkov, 1999). The larger Moscow-based banks dominated the market. Some two thirds of the total number of banks had less than two per cent of their assets in GKO's (Dmitriyev et al, 1998). Especially important was the role of the central bank majority owned Sberbank, the savings bank, which alone accounted for about a quarter of all bank assets. At times, it owned up to forty per cent of the GKO stock. Three quarters of household rouble savings went into the Sberbank. These saving were not channelled into investment; they were used for financing the public sector deficit. The Central Bank of Russia also financed the deficit through the secondary markets.

Thus, it was evident by the beginning of 1998 that the debt situation could only be regarded sustainable under unrealistically optimistic assumptions (Korhonen, 1998). There was an added dimension. The profitability of non-resident investment in rouble securities had originally been regulated through a central bank exchange forward contract. Gradually, the central bank withdrew from the market, but non-resident investors continued to hedge the exchange rate risk with contracts with Russian banks. The commercial banks' net off-balance sheet forward foreign currency claims on residents and non-residents in 1998 seem to have amounted to BUSD 6. Half of that was held by the ten largest banks. For many major banks, forward contracts stood at more than 100 per cent of total assets. For some, the ratio was in thousands of per cent (Perotti, 1999). It is unclear if the central bank knew the situation well enough.

Russia also had foreign currency denominated debt. Net inflows to the federal government were BUSD 2 in 1996, BUSD 15 in 1997 and finally BUSD 7.7. in 1998. In addition, local governments, banks and companies were able to access the international markets so that in late 1998 non-sovereign debt amounted to BUSD 31.7. Corporations often financed their domestic activities with USD denominated liabilities. Banks more usually both borrowed and lent in foreign currencies, but the quality of domestic currency loans was very low, as bank clients were weak and often had a currency mismatch. There was also a maturity mismatch, as foreign borrowing was often short-term, domestic lending longer-term.

3 What Was Wrong?

The reasons of any crisis can often be divided into bad luck, bad policies and bad institutions. Russia is no exception.

Bad luck came via two major routes. Commodities account for the bulk of Russia's merchandise trade. By the first half of 1998, the share was 77 per cent. Russia's terms of trade had improved by 16.5 per cent from October 1995 to January 1997. Then the terms of trade declined by 37 per cent by December 1998. Oil price peaked at about USD 24 per barrel (North Sea Brent) at the turn of 1996-1997 but then declined, as demand lagged due to the Asian crisis, to USD 12 and even 10 in 1998. Other raw material prices followed slightly later. At the same time, imports continued to grow rapidly in spite of the GDP decline. This hit Russia's trade balance, even turning the current account position negative in the second quarter of 1998, for the first time since the beginning of reforms. Concerns about the stability of the rouble increased, in particular as the Moscow stock exchange started to decline since October 1997. Almost half of the market capitalisation is accounted for by energy companies. As low commodity prices cut into export profits, tax revenue deteriorated. And because a number of major banks had acquired shares in commodity producers, the position of the banks also deteriorated.

The other aspect of bad luck, obviously, is the impact of the Asian crisis via investor confidence. Risk aversion increased, triggering a flight to quality and a withdrawal from emerging markets. Some analysts argue that without these two pieces of exogenous bad luck Russia would have been saved from the August crisis (Slay, 1999). This tends to neglect the fact that basically the crisis was made in Russia.

Many of Russia's policies have been accused of having been bad. It is now almost routinely argued that the rouble exchange rate had become overvalued, as the real exchange rate had strengthened seven-fold from 1991 to 1997/8. This is quite extreme, but then the starting point was exceptionally depressed. Even after huge real appreciation the average monthly dollar wage remained low in comparison with the non former Soviet Union transition economies.

Though there were loud Russian voices arguing for devaluation in 1997-1998 (repeated, inter alia, in Montes and Popov, 1999), the analytical view at the time was that rouble overvaluation was at least not self-evident (Halpern and Wyplosz, 1996, 1998). Opponents of a devaluation pointed out the usual arguments of instability, inflation and the impact of debt servicing, while also arguing that in Russia's case both exports and imports were inelastic. Exports, because the volume of energy exports was limited by capacity, imports, because there were few domestic substitutes available (Alexashenko, 1999).

The second, more important and quite self-evidently true aspect of bad Russian policies was the fiscal disequilibrium. This, as discussed above, is the basic reason for the Russian crisis of 1998. The short-lived Kirienko government presented in mid-1998 a fiscal package that might have helped, but the government had almost no political support in the Duma.

Though nobody would now doubt the crucial role the fiscal imbalance played, there is disagreement on the character of the problem. The everyday explanation is that the Russian state is unable to collect taxes. At first sight, facts actually do not support this argument. The enlarged government revenues as a share of GDP have declined, but only from about 42 per cent in 1992 to about 39 per cent in 1997 (and 35 per cent in 1998, when the crisis created additional, but temporary problems). This figure is still quite high for a market economy on Russia's income level, though not in comparison with other transition economies. Therefore, the problem really cannot be in an absolute lack of tax revenue. Recurrent attempts to maximise tax revenue, on the contrary, have clearly contributed to some of the worst anomalies of the Russian economy: tax evasion, capital flight, growth of the informal sector, squeezing of new private entities, corruption and demonetisation.

Still, there are several revenue problems. First, the share of regional tax revenue has grown at the cost of federal revenue without a consistent fiscal federalist solution. Second, the tax system is deeply flawed. Personal taxation is of little importance, corporate taxation has irrationalities and exemptions and other aspects of negotiated taxation are rife. Third, as pointed out above, not all tax revenue is in cash. Non-cash fiscal flows impede the efficiency of fiscal policy.

But overall, one must ask whether the expenditure commitments of the Russian state are not excessive, and a source of both fiscal imbalance and payment arrears. Many expenditures – like military procurement – have been cut severely so that the share of non-interest government expenditure in GDP has dropped very significantly. All the expenditure squeeze has happened without a proper review, while the weight of debt-servicing cost has surged.

There is a third aspect of bad policies as well. That concerns more narrowly financial market issues. There clearly was inadequate risk management at commercial banks with little attention to cash flows and liquidity. There was also poor monitoring by the central bank, and quite as evidently the market participants overestimated the central bank's ability to support the rouble.

This brings us to the third dimension of problems, bad institutions. Here, the list is a long one, but already quite familiar. In politics, a constitution giving huge powers to a president whose crucial decisions even in time of a ripening crisis are difficult to explain; an inability to avoid short-termism; chronically uneasy relations between the executive and the legislature; central bank and Ministry of Finance at loggerheads; corruption, cronyism and narrow furthering of group and personal interests; a media willing to spread any rumour thought to damage an opponent; a winner takes it all mentality; etc. In the economy, as already detailed, insider ownership; demonetisation; fusion of political and economic decision-making; an unwieldy, mismanaged and unreformed public sector etc. And so on. And on.

4 The August crisis a year after

The coming of the August crisis has been thoroughly described (Alexashenko, 1999; Malleret et al, 1999; Powell and Albats, 1999). In short, short-term capital started to leave the country, equity prices plunged, higher interest rates were unable to stop the outflow, tax revenue hardly

sufficed to cover absolutely necessary domestic expenditure and the government had to raise new debt at the central bank for debt servicing, neither the government, banks or companies could receive new private credit from abroad, official reserves were depleted in the defence of the exchange rate, and available additional support proved not sufficient. In short, this is a very typical story, even to the degree that foreigners were the ones who stayed in the GKO market, while many Russian banks, fully expecting a devaluation, were busy increasing their dollar assets and left the GKO market in scores. On 17 August, seemingly in somewhat chaotic circumstances, the decisions were finally made to widen the exchange rate corridor, in fact devaluing the rouble, to de facto default on the GKO's by unilaterally declaring a restructuring, and to declare a 90-day moratorium on repaying private foreign debt.

Clearly, there was no alternative to changing the exchange rate regime, as the attempts to defend the exchange rate were hopeless. Floating was the decision preferred by the central bank, while widening the band was the politically preferred, unsustainable original decision (Alexashenko, 1999, p.224). The default on rouble denominated government debt – regarded “completely unnecessary” by some analysts (Montes and Popov, 1999, p. 54) – did destroy any of the investor confidence that might have been left, but was regarded inevitable for fiscal reasons, and perhaps also preferable for reasons of burden sharing. The moratorium was a last-minute addition in reaction to lobbying by the “oligarchs”, who were afraid that almost all their banks would go under. The authorities, naturally, were interested in saving the core banking system.

The new exchange rate corridor only lasted for a few days, after which the rouble had to be floated and it sunk fast to fluctuate around 20 per dollar. The currency market remained very thin. By Spring 1999 the authorities had little difficulties in stabilising the exchange rate, with a little real appreciation, so that since late March the rate was around 25 roubles per dollar. A combination of administrative restrictions and market interference was used in a very thin market, and even though official reserves have remained low – during the first half of 1999 the central bank used 5.5 per cent of GDP worth of reserves to service government foreign debt – the low rouble rate has not been under severe pressure. Some of the administrative restrictions were lifted in June 1999. In real terms, the exchange rate has depreciated by 40 per cent since August 1998. The rouble became undervalued.

The devaluation soon produced a banking crisis, for several reasons. The currency and maturity mismatch and forward positions discussed above are among them. Also, the collapse of GKO market destroyed much of bank assets, especially among the politically influential larger Moscow banks, and also their vehicle for managing short-term liquidity needs. There was a solvency problem for the larger banks, but a more general liquidity problem. Further, the build-up of the crisis conditions had been enhanced by deficient prudential regulation and political favours given to the larger Moscow banks. There was much uncertainty on the policies that the authorities would adopt. In retrospect, the policy has been hesitant, under-funded and also subject to allegations of favouritism. Finally, in a non-transparent banking sector, the distribution of risks across banks was not only uneven, but also unknown. This further tended to destroy inter-bank markets.

Finally, the debt crisis. The default on GKO's froze the government securities market. It took until April 1999 before a restructuring was more or less finalised. In end-July 1999 Russia and the Paris club of sovereign creditors agreed upon a new restructuring of those payments of Soviet-era debt falling due before the end of 2000. Discussions on a final solution to Soviet-era debt should be held in Autumn 2000. Discussions are also held with the London club of private creditors, but they may last for years. The partial write-off of the old Soviet debt sounded out by the Primakov and Putin government will probably not be forthcoming.

Russian state has been able to honour its Eurobonds, but private borrowers and recently also regions have had great problems. Some of the outstanding forward contracts of Russian banks have been renegotiated, others have still not been settled. Many will probably remain unsettled. The Russian equity market has arisen from its lengthy slumber, but though the index has risen volumes are still low. In the March 1999 Euromoney survey, Russia was placed 161 among 180 as a country risk.

What, more than a year after the August 1998 crisis, is the state of the Russian economy? In brief, as follows:

1. The real incomes of the population are about a quarter below the pre-crisis level, and income differentials have further widened.
2. The banking system only works as a payment system. The large scale restructuring of the banking system is still ahead. Sufficient resources for a recapitalisation are not available, and the interest of foreign banks in the Russian market has been lukewarm at best. The share of foreign currency assets has increased, reflecting capital flight and lack of investment opportunities in Russia (Dmitriyev and Surkov, 1999).
3. Though the July IMF agreement opened a door for Russia to re-enter the international financial market, later allegations of major irregularities around Russian finance and banking have again darkened the skies. Russian credit rating is much worsened and a return of major investment flows still remains to be expected. Russia's image abroad has worsened radically.
4. On the other hand, the devaluation led to a halving of imports. The current account is again very strong. New export commodities are however not visible.
5. Industrial production has increased since September 1998 and is surpassing the 1997 level, though the growth rate seems to be slowing down. After a decline of 4.6 per cent in 1998, GDP may increase slightly in 1999. Managerial expectations, as shown in surveys, are higher than ever before. Still, investment may have continued to decline.
6. The financial position of the open sector has improved. This is reflected in lower share of barter and payment arrears. The better financial position is also reflected in higher tax revenue and a higher share of cash in the intake. Public sector wage and pension arrears have been slashed, and the government is able to finance the Chechenya campaign. The most pessimist expectations concerning the economy, economic policies and the society as a whole have so far been proven unfounded.
7. The sustainability of current industrial upturn in production is subject to disagreement. The most recent evidence is contradictory. A consensus however prevails that as long as the systemic fundamentals discussed above are in place, Russia will even in the best of cases grow only modestly during the next ten years.

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