The Russian Financial Crisis:

Causes and Effects on ENI Countries

Robert M. Birkenes, USAID/PPC/CDIE/DIO/ESDS
John A. Pennell, USAID/PPC/CDIE/DIO/RRS

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Introduction: Scope and Purpose of Paper

On 17 August 1998, the Russian government defaulted on its GKO Treasury Bonds, imposed a 90-day moratorium on foreign debt payments, and abandoned the ruble exchange rate corridor. Within the next couple of weeks, the Russian Central Bank announced that it would stop selling U.S. dollars, suspend trading of the ruble on main exchanges, abandon the exchange rate band, and allow the ruble to float. These events led Russia's international reserves to fall by $13.5 billion and to the dissolution of the Kiriyenko government. One month later, Standard and Poor's downgraded its rating of the Russian ruble to "CCC," the lowest possible Standard and Poor's rating, for its long-term outlook and "C" for short-term outlook. These events signaled the onset of the Russian financial crisis, which had its roots in the fundamental problems in the Russian economy but was triggered in part by the continuing financial crises in emerging markets in Asia and around the world.

What were the causes of this crisis and near financial collapse? What are the so-called "experts" saying about the crisis and its spillover effects on other ENI countries? What are the possible courses of action that could minimize the adverse effects of the crisis and reduce the likelihood of future occurrences?

The purpose of this paper is to summarize the divergent viewpoints expressed by leading scholars and practitioners in the field of international development and finance. By surveying the literature, it is apparent that the Russian crisis, and to some extent the Asian crisis that preceded it, was caused by a combination of internal structural problems in the domestic economy (especially in the banking and fiscal systems) and growing problems with the international financial system that permits excessively rapid outflows of capital. However, there is significant divergence of opinion among scholars and practitioners as to which set of factors, those related to the Russian economy or those related to the international financial system, are the cause of the crisis. In addition to the differences of opinion as to the causes of the crisis, disagreement exists as to the remedies to the crisis. As a result, each group has recommended its own set of policy prescriptions.

The first section of this paper discusses the divergent opinions on the causes of the crisis. The second section highlights the economic, social, and political effects of the crisis. The third section provides a list of the proposed remedies offered by the divergent camps. The final section summarizes the main findings and includes a timeline of the Asian and Russian crises.

Divergent Opinions: Causes of the Russian and Global Financial Crises

The divergent views regarding the causes and cures of the Russian and Asian financial crises can be broken down into two camps: (1) those that believe that the crises derived primarily from problems in the international financial system and (2) those that place blame primarily on the structural problems within the countries themselves which left them vulnerable to capital flight and other problems arising from external financial instabilities. Members of the first group tend to be critical of the IMF and other international financial institutions, saying that these institutions played a role in creating and exacerbating the financial crises rather than helping to reduce the negative impact, although the "fix the system" critics do agree that each of the crisis countries did suffer from internal structural problems as well. The second group of analysts—the "fix the countries" group—believes that the international financial system and the approach of the IMF in assisting these countries are more or less working, and that the current crises derived from a lack of sufficient regulatory and fiscal reforms in Russia and Asia.

"Fix the Global Financial System" Critics

Jeffrey Sachs. According to Sachs, "the Treasury and the IMF have driven a large part of the developing world into recession…And the Brazil case makes absolutely clear that the first step is not to defend overvalued currencies. The punishing cost of this is overwhelmingly high. This is a lesson that the IMF and the Treasury have continued to ignore" (Uchitelle 1999). In his view, the IMF exacerbated the crisis by demanding tight fiscal and monetary policies. He claims that perceiving the crisis to be one of balance of payments, rather than a financial panic, the IMF chose an approach similar to the mistaken policies implemented by the United States in the early stages of the Great Depression of the 1930s (Radelet and Sachs 1999). Furthermore, Sachs insists that since high interest rates and austerity measures are bringing disaster to many emerging markets, interest rates should be kept down to encourage economic activity and allow exchange rates to find their own equilibrium level.

He does not attribute the devaluation of exchange rates as a cause of the crisis in Russia, nor does he believe that a currency board arrangement would have saved the country. He states that "when pegged rates become overvalued, [this] forces countries to deplete their foreign exchange reserves, in a vain defense of the currency peg." In his view, it was the combination of broken promises (i.e., the ruble will not be devalued) and depleted reserves that left the country vulnerable to panic (Radelet and Sachs 1999). He believes that a growing economy is more likely to restore investor confidence than a recessionary one burdened by high interest rates (Uchitelle 1999).

An additional contributing factor to the crisis, according to Sachs, was "moral hazard." Investors clearly had doubts about Russia's medium-term stability, and talked openly about the risk of collapse and about the safety net that they expected the IMF and G-7 to provide to Russia. Knowing that these international lenders would rescue Russia and guarantee investments in the event of a financial meltdown in Russia, international investors tended to underestimate the risks—and hence tended to over-invest in Russia. Russia was viewed as "too big to fail," and this led to an inflow of capital that was larger than appropriate for the actual level of risk (Radelet and Sachs 1999).

George Soros. As one of the world's most successful international investors, an important philanthropist with millions of dollars invested in democracy projects throughout the ENI region, and a public intellectual who has proposed that sweeping changes be made to the international financial system, George Soros is a key figure in the Russian and Asian financial crises. His disparate roles often create a conflict, as Soros-the-intellectual appears to many an advocate of the regulation of international capital flows to prevent potential damages from speculations by people like himself (Frankel 1999).

Soros was Russia's biggest individual investor prior to the crisis in August 1998. He held a $1 billion stake in Svyazinvest, a telecommunications concern, and millions in stocks, bonds, and rubles. In mid-August 1998 Soros sprang into action to try to stop the crisis. He contacted the U.S. Treasury department, influential former members of Yeltsin's administration, and published a letter in *The Financial Times* saying that the meltdown in Russian financial markets "had reached the terminal phase" (O'Brien 1998).

In his letter, Soros called for immediate action—a devaluation of the ruble and institution of a currency board—that would have eliminated the Russian central bank's discretion over monetary policy. Not realizing that a letter from Soros would be perceived as coming from Soros-the-investor instead of Soros-the-intellectual, his letter helped to prompt a panic in Russian markets, where investors believed Soros was shorting the ruble. Soros' funds ultimately lost $2 billion in Russia as a result of the financial crisis there.

According to his testimony to the Congressional Committee on Banking and Financial Services on 15 September 1998, Soros pointed out that "the Russia meltdown has revealed certain flaws in the international banking system which had previously been disregarded" (Soros 1998a). These flaws can be summarized as follows:

(1) Banks engage in swaps, forward transactions, and derivative trades among each other—in addition to their exposure on their own balance sheets—but these additional transactions do not show up in the banks' balance sheets. So when Russian banks defaulted on their obligations to western banks, the western banks continued to owe their own clients. As these transactions form a daisy chain with many intermediaries, and each intermediary has an obligation to his/her counterparty, no simple way could be found to offset the obligations of one bank against another. As a result, many hedge and speculative funds sustained large losses, and had to be liquidated. This systemic failure led most market participants to reduce their exposure to emerging markets all around, and this caused bank stocks to plummet and global credit market to enter a crunch phase.

(2) As individual countries attempt to prevent the exodus of capital from their economy by raising interest rates and placing limits on foreign withdrawal of capital (as in Malaysia), this "beggar-thy-neighbor" policy tends to hurt the other countries that are trying to keep their capital markets open.

(3) Another "major factor working for the disintegration of the global capitalist system is the evident inability of the international monetary authorities to hold it together… The response of the G7 governments to the Russian crisis was woefully inadequate, and the loss of control was kind of scary. Financial markets are rather peculiar in this respect: they resent any kind of government interference but they hold a belief deep down that if conditions get really rough the authorities will step in. This belief has now been shaken" (Soros 1998a). He also adds that "…financial markets are inherently unstable. The global capitalist system is based on the belief that financial markets, left to their own devices, tend toward equilibrium…This belief is false" (Soros 1998a).

His proposed cure is to reconsider the mission and methods of the IMF as well as replenish its capital base. Additionally, he'd like to see the establishment of an International Credit Insurance Corporation to help create sound banking systems, which would be subject to close supervision by the international credit agency, in developing countries (Soros 1998b). His last recommendation is to reconsider the functioning of debt-swap and derivative markets (Soros 1998b).

Academia and Other Nongovernmental Organizations. Initially, Paul Krugman, an economist at MIT, argued that problems with the Asian economies, combined with corruption and moral hazard, led to wild over-investment and a boom-bust cycle. More recently, however, Krugman explains that such weaknesses cannot explain the depth and severity of the crisis, nor the fact that it occurred in so many countries simultaneously, and instead he places the blame on financial panic and overly liberalized international and domestic financial systems (Radelet and Sachs 1999).

According to Krugman, "all short-term debt constitutes potential capital flight." The need to fix structural problems in individual countries should not stand in the way of broader macro-economic measures, in particular those designed to stimulate growth in hard times. He states that "it is hard to avoid concluding that sooner or later we will have to turn the clock at least part of the way back. To limit capital flows for countries that are unsuitable for either currency unions or free floating; to regulate financial markets to some extent; and to seek low, but not too low, inflation rather than price stability. We must heed the lessons of Depression economics, lest we be forced to relearn them the hard way" (Uchitelle 1999). In other words, the global financial system is largely to blame for the recent crises.

<u>"Fix the Countries" Analysts</u>

IMF. According to the IMF, Russia's financial crisis was brought on by a combination of (1) weak economic fundamentals, especially in the fiscal area; (2) unfavorable developments in the external environment, including contagion effects from the Asian financial crisis and falling prices for key export commodities such as oil; and (3) its "vulnerability to changes in market sentiment arising from the financing of balance of payments through short-term treasury bills and bonds placed on international markets" (IMF December 1998).

The IMF had pointed out in May 1998 that Russia had made insufficient progress in improving budget procedures and tax systems, establishing competent agencies to collect taxes and control expenditures, clarifying intergovernmental fiscal relations, and ensuring transparency at all levels of government operations. By August 1998, investor confidence in the ability of Russian authorities to bring the fiscal system under control began to decline, immediately leading to the financial crisis, after the Duma failed to approve fiscal measures planned under the augmented Extended Fund Facility (EFF). These measures were aimed at reducing the fiscal deficit, implementing new structural reforms addressing the problem of arrears, promoting private sector development, and reducing the vulnerability of the government's debt position, including a voluntary restructuring of treasury bills.

The extent to which the Russian crisis is attributable to contagion effects from the Asian crisis instead of to internal problems stemming from insufficient reforms in fiscal management is difficult to determine. According to the IMF's May 1998 assessment of spillover effects from the Asian crisis, Russia's stock market was seriously hit by the crisis and by early spring 1998, stock prices in Russia had indeed not yet fully recovered from the lows reached in fall 1997. The Russian ruble had also been hit hard and the central bank had to intervene heavily in the foreign exchange market just to keep the currency within the new exchange rate band.

As international capital fled from the risky Asian economies in the fall and winter of 1997, investors who were similarly wary of risky investments in the transition economies began to reduce their exposure to Russian and other ENI markets. Nevertheless, emerging market investors quickly began to differentiate between high- and low-risk countries. By first quarter 1998 the Czech Republic and Poland had become relatively attractive to investors, receiving considerable short-term capital inflows and by January 1998 Standard and Poor's credit rating for Hungary had greatly improved. Russia and Ukraine, on the other hand, continued to suffer from structurally weak financial sectors and an over-dependence on short-term borrowing. To attract investment back into Russia, the Russian government had to raise interest rates in order to offer yields well above pre-crisis levels to cover for the increased perception of risk. As a result, foreign investment had started to flow back into Russia by early 1998.

According to the IMF, differences in the severity of interest rate and equity price movements among the transition countries illustrate the importance of appropriate domestic macroeconomic and structural policies to limit vulnerability to international financial crises. In Russia and Ukraine, financial sector weaknesses and a high dependence on government borrowing, in addition to chronic revenue problems, especially in Russia's case, explain why these two countries were more affected by the Asian crisis than the Central and East European countries. In other words, the Asian crisis exposed Russia's underlying structural problems and made the need to address them more apparent.

The IMF continues to assert that the financial crisis in Russia was a crisis of the state. Nearly a year and a half ago, Michel Camdessus, Managing Director of the IMF, claimed that the Russian state "interferes in the economy where it shouldn't; while where it should, it does nothing." Camdessus pointed out that the Russian state needs to make progress in promoting an efficient market economy through transparent and effective regulatory, legal, and tax systems. At present, the IMF still supports these recommendations (IMF November 1998).

Existence of a "Virtual Economy." Clifford Gaddy of the Brookings Institution and Barry Ickes of Penn State University argue that although the immediate causes of Russia's financial crisis are the large budget deficit, resulting from insufficient revenue collection, and an inability to service the debt, especially short-term dollar liabilities, there are more fundamental problems with Russia's economy. These problems stem from "illusions" regarding prices, wages, taxes, and budgets that permeate the Russian economy to such a great extent that the economy has become "virtual" rather than actual. This virtual economy is derived from a public pretense that the economy is bigger and output more valuable than they really are. According to Gaddy and Ickes, the virtual economy primarily originated from the unreformed industrial sector inherited from the Soviet era, in which enterprises produced output that was sold via barter at prices that were higher than they would be if sold for cash.

In general, these enterprises operate without paying their bills, as wages that should be paid to employees (but are not paid) become wage arrears, and required payments for inputs (which are also not paid) emerge as interenterprise arrears and payments through barter. In fact, Gaddy and Ickes assert, people make an effort to avoid cash transactions because they would expose the pretense of the virtual economy. They go on to state that although the virtual economy acts as a safety net for Russian society, it has serious economic repercussions since it negatively affects enterprise restructuring, economic performance measuring, and public sector reform (Gaddy and Ickes 1998).

At this point, they argue that the West has two choices on how to help Russia. First, the West can concentrate on keeping Russia stable in the short term by bailing out the virtual economy, which will lead to further consolidation of a backward, noncompetitive economy and will guarantee the need for future emergency bailouts. The second option would be to refuse the bailout. The consequences of this option would be drastic—the ruble will lose its value, foreign capital will flee—but on the positive side, the Russian economic policy that is so addicted to borrowing would have to kick the habit as it found its supply of international credit cut off. They state that "denying Russia a bailout is not without risks. But bailing out the virtual economy is sure to increase those risks for the future" (Gaddy and Ickes 1998).

U.S. Government. The U.S. Treasury Department points out that despite the many important reforms that have been carried out in Russia—including extensive privatization, price liberalization, and reduction of government spending—reforms in a few critical sectors have lagged behind, leading to the financial crisis. According to David Lipton, the principal problems include the failure to control the budget deficit and extensive government borrowing. The budget problems are a manifestation of the political struggle over the country's economic direction and as long as these disputes over the proper role of government remain unresolved, he believes that budget difficulties and unnecessary government borrowing will continue unabated. He also argues that Russia's high fiscal deficits have led to the country's high interest rates since "Russia's macroeconomic problem is fundamentally fiscal; interest rates are more properly viewed as a symptom of that problem, not a cause" (Lipton 1998). Lastly, he argues that the failure to build a favorable investment climate and adhere to the rule of law also helped to sow the seeds of the financial crisis (Lipton 1998).

The Treasury Department also points to external factors that led to the crisis. According to Deputy Secretary Lawrence Summers, the Russian crisis was not inevitable. He avers that if the Asian crisis had not reduced confidence among emerging markets investors, and had the prices of export commodities (e.g., oil) not fallen so dramatically—the August 1998 crisis might not have taken place (Summers 1999). Nevertheless, the crisis did occur because the Russian government attempted to pursue an enormously risky course of simultaneously devaluing the ruble, imposing a debt moratorium, and restructuring government bonds in response to the external pressures (Lipton 1998).

To avoid future crises, Summers points out that Russia needs a tax system that supports the government and legitimizes enterprises, which probably involves a new allocation of spending and revenues between central and regional governments. Summers, however, is also quick to point out that it is much easier to talk about what tax reforms need to be implemented than to discuss how the reforms can be accepted politically. He adds that bank restructuring is another area where reform is needed and that it should be done in a fair and transparent way within a legal framework that makes current owners take responsibility for their losses before scarce public funds are used (Summers 1999).

Russian Government and Nongovernmental Analysts. Yegor Gaidar, former prime minister of Russia, attributes the crisis to the combined continuation of soft budget constraints from the socialist period along with the weakening of previous administrative controls and government corruption, which led to the bankruptcy of state enterprises. The early years of transition in Russia were marred by inefficient macroeconomic policy, weak budgetary and monetary constraints, and inflation that eroded budget revenues. Although later macroeconomic policy was more efficient and succeeded in controlling inflation, efforts to improve revenue collection or cut expenditure obligations have failed, leading to unsustainable deficits. The lessons learned here are that budget deficits should be reduced as quickly as possible, as inflation is also controlled, and the vulnerability of exchange rate regimes to potential crises should be addressed immediately (IMF 1999; Gaidar 1999).

In terms of the current regime, Gaidar describes Primakov and his government as a "communist government in post-communist Russia," because Primakov and his cabinet come from the "traditional Soviet economics establishment" and his post-crisis approach relies on strengthening and centralizing government control. According to Gaidar, the Russian government faced two possible paths to solve the crisis: (1) return to the approach employed in 1992–94, with soft monetary and budget policies, or (2) maintain a tight monetary policy, stabilize the ruble, and carry out fundamental budget reforms to allow the government to balance revenues and expenditures.

The first path would lead to the return of high inflation rates, as the government relaxed its control over the money supply in an attempt to pay its debts, but the banks would benefit from the return of "cheap money" issued by the Central Bank. The second path would involve speeding up structural reforms, which would be good news for profitable enterprises but would mean painful consequences for unproductive enterprises—mostly firms in the industrial and financial sectors—as they would be allowed to go bankrupt if they could not compete in world markets. Both paths would be painful, Gaidar explains, but the first path of high inflation would also be inequitable, as the poorest layer of society tends to suffer most from increasing prices. Not surprisingly, Primakov chose to pursue a modified version of the inflationary approach, a sort of populist economics policy that had been implemented in many Latin American countries. The reason Primakov opted for this path, as Gaidar states, is because "in part, the lack of internal and external sources for financing after the dismissal of the Kiriyenko government pushed [the Primakov government] toward choosing the inflationary variant" (Institute for Economics in Transition 1999).

Andrei Illarionov, Director of the Institute for Economic Analysis in Moscow, while noting the IMF's successes with respect to Russia, criticized the IMF for being too willing to compromise on Russian conditionality. Not one of the IMF programs developed in Russia, Illarionov claims, has been executed in full, as a result of the softening and revision of conditions in original agreements. He states that "decisions to provide financing for Russia, motivated by political rather than economic considerations, have given rise to the problem of moral hazard." As a result, the Russian government became spoiled after being granted unearned financial assistance, and policy became even more irresponsible than before (Illarionov 1998).

Finally, Illarionov also criticizes the IMF for offering inappropriate policy recommendations to Russian authorities in two other areas: exchange rate and fiscal policies. The IMF program (mid-1998, pre-crisis) stipulated that the exchange rate policy should remain unchanged for the remainder of 1998, in order to preserve the low inflation rates, and prescribed that the Russian government should concentrate mainly on raising revenue rather than reducing expenditures. These IMF prescriptions, according to Illarionov, have not boded well for the Russian economy (Illarionov 1998).

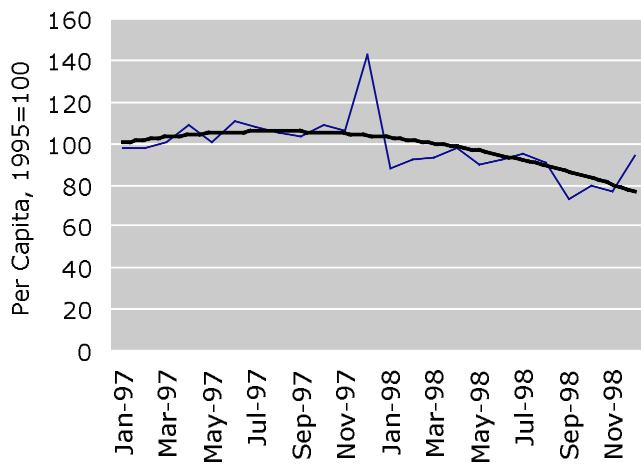
Effects of the Crisis on Russia and Other ENI Countries

<u>Russia</u>

Initial impact of crisis: Shocks to Foreign Exchange and Capital Markets

The rapid devaluation of the ruble made imports more expensive for Russians and exports less expensive in foreign markets. As a consequence, Russian consumers have shifted their consumption of food and other goods away from imported foreign products and toward cheaper, locally produced goods.

Real Personal Income in Russia



Source: RECEP, 03/1999.

A sharp loss of confidence among foreign and domestic investors led to a rapid outflow of capital from Russia. Foreign direct investment (FDI) fell by 60 percent in 1998, and the domestic stock market had collapsed by 70 percent within six months of the onset of the crisis. Capital flight from Russia, nearly six months after the crisis began, is estimated at nearly $1.5 billion per month.

In the summer of 1998, Russian banks began to default on their foreign debts; this problem accelerated out of control in August when the government defaulted on treasury bills (GKOs) and froze all foreign debt payments for 90 days. For many months following the crisis, banks had ceased providing credits to enterprises (Robinson 1999; EBRD 1999).

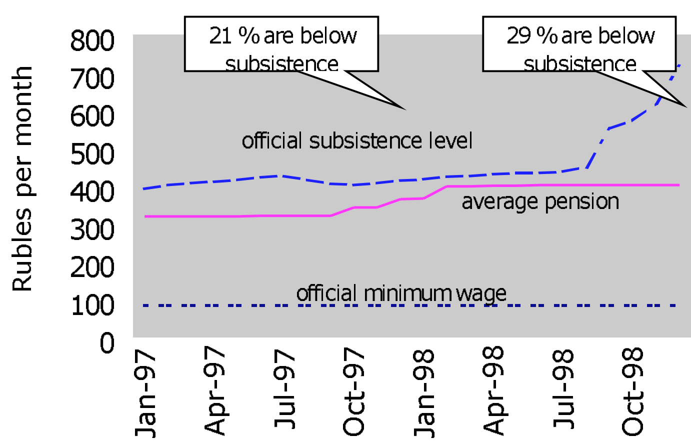
Economic Effects: Living Standards Decline

In Russia, the main microeconomic impact of the crisis has been a dramatic fall in real wages—average monthly wages in December 1998 were 39.9 percent lower than in December 1997. Losses in 1998 outweigh modest gains in real wages in 1997, resulting in a real wage level that is currently equal to about half of the 1990 level. The decline in real wages was partially offset by the increased repayment by the government and enterprises of some wage arrears. High inflation in the last few months of 1998—closing out the year at an annual rate of 97 percent—was the primary cause of the drop in real wages. (RECEP, 02/99)

The impact of the Russian crisis on employment has been moderate, according to official statistics, with only 11.8 percent unemployment (ILO definition) in December 1998, compared with 11.3 percent one year before. Some surveys reveal a significant loss of jobs in some sectors and areas of the country. According to one survey of 250 enterprise directors, 34 percent indicated that they had fired or laid off employees in an effort to cut expenditures after the crisis (RMRC 1998).

Dissatisfaction over the continuing problem of wage arrears led to an increase in strikes throughout the country toward the latter part of 1998; 1873 strikes were registered in December 1998, nearly 3.4 times the number during the previous December.

Wages, Pensions, and Subsistence in Russia



Source: RECEP, 02/1999.

One of the biggest questions about social impact concerns the effect on poverty and income distribution. The crisis affected nearly all people in Russia, but the more vulnerable groups—pensioners and public sector employees—were likely the hardest hit, as their real wages dropped due to the increase in prices. Clearly, the number of people living below the official subsistence level has increased over the past year as a result of the crisis, as wage and pension increases have not kept up with the increases in the cost of subsistence-level living.

According to some analysts, the crisis has led to a less equitable income distribution in Russia, although the evidence for this conclusion is not overwhelming. Although many poor people have become poorer, the impoverishing effects of the crisis have also hit other groups within Russian society. Workers involved in the business of selling imported goods have found that demand for their products has nearly evaporated as not only consumer incomes have fallen, but also ruble depreciation means higher prices on imports. As a result, many of these trade businesses have shed labor or closed.

One of the longer-term consequences of the economic crisis in Russia may be the strain on society, which is likely to weaken the Russian government's ability to continue to push for reforms. In some ENI countries, the crisis has given reform skeptics an excuse to abandon or reverse some reforms already implemented. The social pressure against further economic reforms, now seen by many as the cause rather than the cure for the economic crises, may become strong enough to counter-balance the pro-reform force. It may lead some ENI countries to get stuck in what Adrian Karatnycky describes as a "state of stasis" rather than of transition.

Stability Versus Democracy

Politically, the financial collapse has weakened Russia vis-a-vis the west, but its relative power in the region has in many ways increased. Not only has the crisis given Moscow an excuse to consolidate power over the regions throughout Russia, but it has also allowed many hard-liners within Russia to gain some ground in their push to reassert Russia's traditional sphere of influence. In addition, many neighboring regions have found themselves with large arrears on their payments to Russia for natural gas deliveries, and have had to strike deals with Russia to find ways to settle these debts through deliveries of food and other barter arrangements.

Following the onset of the crisis in August, the Russian government proposed many changes intended to promote economic stability at the cost of democracy. In February 1999, Prime Minister Primakov argued that Russia's governors should be appointed by the President, rather than elected by their constituents, so that Moscow can take back control over the regions and avoid a collapse of the country.

President of Belarus Alyaksandr Lukashenko rejoiced in the crumbling of IMF-backed reforms in Russia, considering the crisis to be a vindication of his position in favor of state planning and price controls. The old proposal regarding a possible political union of Belarus, Ukraine, and Russia has also resurfaced, as Russia and some neighboring countries have concluded that further integration will help solve their problems. In the words of Ivan Rybkin, President Yeltsin's envoy to the CIS, "the recent crisis taught us all that we must stand together in order to survive" (Rutland 1999).

<u>Effects on Neighboring Countries</u>

The drop in real wages in Russia—coupled with the devaluation of the ruble—has translated into dramatically reduced Russian imports. For the neighboring countries that depend on Russia as a market for their exports, the shrinking market in Russia has been disastrous for their local economies. As Russians are shifting consumption away from the relatively more expensive imported goods, the producers of these goods in neighboring countries are faced with a dramatic fall in demand for their products. This has translated into falling output and increased unemployment for the countries that are most closely tied to Russia through trade, especially Moldova (more than 50 percent of Moldovan exports go to Russia); Belarus, Ukraine, and Kazakhstan, (>33 percent of exports to Russia, as of early 1998); and Georgia (>30 percent of exports to Russia) (EC 1999).

The drop in remittances from nationals living in Russia has led to decreased incomes in neighboring countries with large numbers of *gastarbeiter* working in Russia. Armenia, Georgia, and Azerbaijan have been most severely hit by this decline in remittances. In some cases the pattern seems to have been reversed, with families in neighboring countries now supporting relatives living in Russia (EC 1999).

Finally, food prices have also increased in the neighboring countries of the NIS, as the cost of imports from outside Russia has risen as a consequence of the significant devaluation of local currencies. Some of the specific effects and impacts on other NIS and neighboring countries are summarized briefly below.

Armenia—Accumulation of public sector arrears is likely, as government is facing difficulties in financing of education, health care, and other expenditures. Remittances from Armenians in Russia have decreased, placing additional pressure on family support systems, and this could result in increased poverty.

Azerbaijan—Trade-related consequences in the short term are less than for other NIS countries, as the political instability in the North Caucasus region has already limited trade ties with Russia prior to the crisis. Government spending was cut in 1998, and further cuts in 1999 will affect key social sectors. As in other Caucasus countries, decreased remittances from Azerbaijani nationals residing in Russia has reduced family incomes in Azerbaijan.

Baltic Region—Estonia, Latvia, and Lithuania—The Russian crisis forced some Baltic banks to fail, and several others to reveal their under-reporting of exposure to Russia in their September 1998 quarterly reports. Better developed financial systems, a reorientation toward western markets, and general political stability have helped to limit the damage and contagion effects from the Russian crisis.

Belarus—One of the most affected countries in the NIS, Belarus was highly dependent on trade with Russia prior to the crisis. Exports to Russia plunged from $400 million/month in the first half of 1998 to just $170 million/month by September 1998. Shortages of basic foods forced the government to introduce rationing.

Georgia—The Russian market accounted for 30 percent of Georgia's exports prior to the crisis, and Georgian nationals living in Russia provided a significant amount of income to Georgian families through remittances. The trade deficit with Russia widened to 50 percent in October 1998, forcing the Georgian authorities to float the lari (which led to a sharp depreciation).

Kazakhstan—In the first half of 1998, half of Kazakhstan's exports went to Russia, and the impact of the crisis has been felt in Kazakhstan primarily through the reduction of exports to Russia. Kazakhstan introduced a temporary ban on the import of some Russian foodstuffs, in order to control the inflow of cheapened Russian goods following the depreciation of the ruble.

Kyrgyzstan—Nearly 60 percent of Kyrgyzstan's exports went to Russia, prior to the crisis, so this country was also one of the more vulnerable to negative shocks through the trade mechanism. In this most pro-reform of the Central Asian Republics, price liberalization of utilities and privatization may be threatened, as consumers are less able to pay the higher tariffs as a result of fallen incomes.

Moldova—Trade with Russia is important to Moldova, as 50 percent of Moldovan exports went to Russia prior to the crisis. Many farms and other agro-exporters have been unable to pay wages, as their export market has dried up in Russia. Here, too, the crisis has threatened the reform and liberalization process implemented by the government, as investors' interest in the Moldovan economy has diminished and a heavy withdrawal from commercial banks have signaled a lack of confidence in this country.

Tajikistan—Low commodity prices for cotton and gold had already damaged the Tajikistan economy before the Russian crisis, and the fragile peace held together in part with the support of the Russian military (serving as border guards) has certainly not gained strength from the crisis. Apparently, Tajikistan is not as dependent on trade with Russia as other NIS countries, and this has helped to insulate Tajikistan from the direct effects of the crisis.

Turkmenistan—Exposure of Turkmen banks to Russian markets has been limited, as the Turkmenistan economy is tightly controlled by the state. The Russian crisis therefore is not expected to have a strong direct impact on Turkmenistan.

Ukraine—Closely linked to Russia through trade and financial ties, Ukraine has suffered greatly as a result of the Russian crisis. The hryvnia lost half its value against the dollar following the crisis, and reserves have fallen (as of early 1999) to only one month of imports. Inflation surged to 12.8 percent in October 1998 alone, following a long period of relatively stable inflation before the onset of the crisis (2 percent inflation in first half of 1998).

Uzbekistan—As Uzbekistan has been gradually reorienting its international trade profile away from Russia over recent years, the country has apparently been less affected by the crisis than other NIS countries. Further, the underdeveloped banking system and financial markets in Uzbekistan may have helped to insulate that country from the shocks emanating from Russia in August 1998, as Uzbekistan had relatively little exposure to Russia's financial markets.

Proposed Remedies

As discussed throughout this paper, two camps have emerged in academic and policy circles that seek to explain the causes of and remedies for the Russian financial crisis. This section highlights some of the remedies proposed by each camp.

According to the "fix the countries" critics, such as the IMF and the U.S. Treasury Department, the Russian government must continue pushing for reforms in the public finance and banking sectors. According to Gaddy and Ickes, only two options exist for western creditors and international financial institutions: keep Russia stable in the short-term by bailing out the virtual economy or refusing a bailout. Denying Russia a bailout would have negative effects in the short-term by leading to the demise of large commercial banks and oligarchs, foreign capital flight, and currency devaluation. In the long run, however, Gaddy and Ickes prefer this option because they believe it will force Russia to adjust to economic life without a steady supply of credit available and adapt sound economic policies. They dislike the first option simply because they believe it will lead to the further development of a nonmarket-oriented economy that would require bailouts in the future. The Treasury Department adds that bank restructuring and reforms in tax administration and collection are necessary as well.

The "fix the global financial system" critics, such as Jeff Sachs and George Soros, urge that the international financial system be reformed so that short-term borrowing by banks and governments be limited so as to avoid potential investor panics. In addition, Sachs recommends that domestic banking regulations, in the form of enhanced capital adequacy standards and policies that encourage partial bank-sector ownership by foreign capital, be implemented in order to limit vulnerability of the domestic economy to foreign creditor panics, and that exchange rates be kept flexible instead of pegged.

In addition to these proposed remedies, others have gone further to propose mechanisms for recovering losses (Sexton 1998). According to Sexton, foreign creditors have at their disposal four mechanisms to recover losses to Russian firms:

1. *Convertible debt securities*: debtors could issue convertible bonds to creditors although Sexton argues that this probably won't work too well in Russia

2. *Treasury or redeemed shares*: company may exchange its own shares, that were bought back, or interests to extinguish outstanding indebtedness; there should be no tax consequences to debtor on repurchase of shares; on resale to foreign creditor, debtor should be taxed on any gain on shares or should be able to deduct any loss sustained

3. *Alternative debt refinancing structure*: swapping debt for convertible debt which creditor converts into equity; issue by debtor to creditor of convertible bonds as a means of refinancing outstanding debt; creditor should make sure conversion ratio covers value of outstanding debt over term of loan; disadvantage to this

strategy is that creditor is refinancing and likely to have twice the outstanding debt for some time

4. *Securitizing the debt*: convert debt into security which creditor then contributes to debtor's charter capital to pay for the shares (key issue facing creditors thinking of taking equity in a Russian debtor company in exchange for indebtedness is *how to value that equity*)

Summary

This paper has addressed the opposing views as to the causes of and remedies for the Russian financial crisis.

- Two central camps have emerged. One camp argues that the Russian economy has severe structural problems that were the primary cause of the crisis: fiscal deficit, banking sector problems. The other group points to the IMF and the problems with the international financial system, claiming that moral hazard problems led investors to underestimate the risk of investing in emerging markets such as Russia, and that unregulated short-term investment flows out of emerging markets can result from the panic.

- Each of these groups proposes different remedies for the crisis, based on their assessment of the roots of the crisis. The IMF and Treasury Department insist that the Russian government continue to push for reforms in public finance and the banking sector, claiming that weaknesses in these areas ultimately led to the onset of the Russian crisis. Jeffrey Sachs, George Soros, and others who are critical of the international financial systems and the role of the IMF in the recent financial crises, recommend that the short-term borrowing by governments and banks in emerging markets be limited and regulated, and that exchange rates are flexible rather than pegged.

Although the worst of the Russian crisis may have already passed, as the Russian and other ENI stock markets appear to have recovered and the dramatic fall in production has been reversed, the original causes of the crisis still need to be addressed. Continued progress in banking and fiscal reforms in Russia will be necessary to ensure that the country is less vulnerable to future external shocks and foreign creditor panics. Improvements in these sectors would help restore investor confidence in the Russian economy and reverse the current outflow of capital.

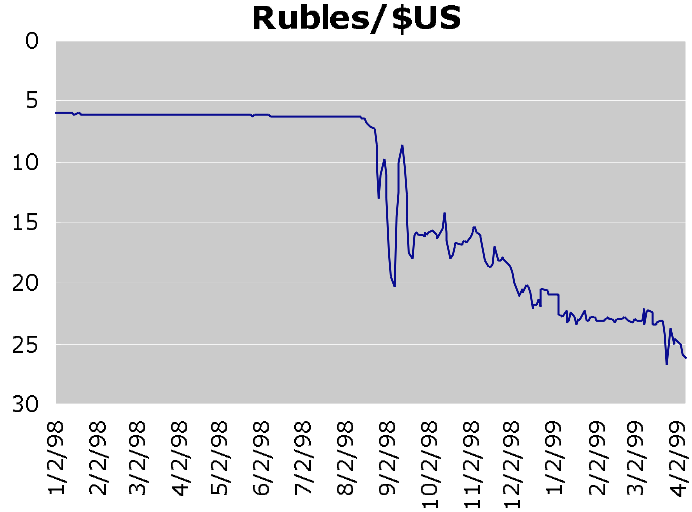
ANNEX: What Happened in Russia? A Brief Chronology of Events

Asian Crisis: Precursor to the Russian Crisis

- July 1997, Thailand—devaluation of Thai baht
- December 1997, Korea—devaluation of Korean won

After the devaluation of the Thai baht in July 1997, one Asian country after another had to raise interest rates sharply to avoid currency devaluation. But the combination of high interest rates and currency depreciation, which inflated the burden of foreign debt, provoked a financial crisis (Krugman 1999).

Ruble Exchange Rate: Rubles/$US

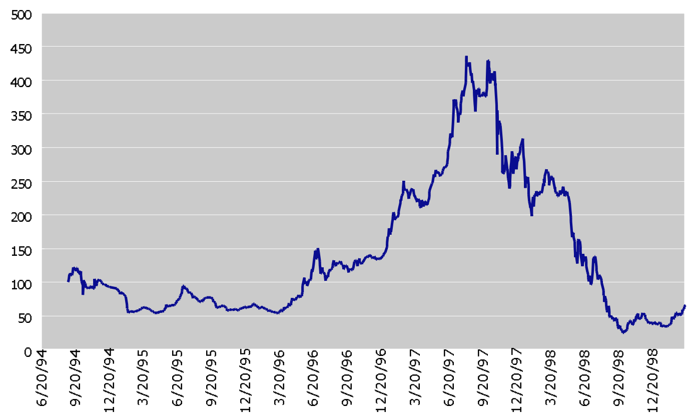


Source: PACIFIC Exchange Rate Service, April 1999.

Russian Crisis Timeline

- **late October 1997**—Pressure on ruble intensifies, as result of Asian crisis
- **December 1997**—Foreign exchange pressure temporarily recedes in Russia
- **19 December 1997**—Standard and Poor's Sovereign Ratings of Russian ruble: long-term—"BB-"; outlook—negative; short-term—"B"
- **January 1998**—Reemerging pressure on ruble forces Central Bank to raise interest rates, increase reserve requirements on foreign exchange deposits, and intervene on ruble and treasury bill market
- **March 1998**—Stock market prices in Russia have not yet recovered from lows reached in late fall 1997
- **May 1998**—Russia places major commercial bank under Central Bank administration; miners strike over wage arrears; Russia continues to intervene on foreign exchange markets to support ruble, but investors increasingly see this strategy as unsustainable
- **Late May 1998**—Interest rates in Russia increased to 150 percent; Russian government announces revisions to 1998 budget, including 20 percent cut in expenditures and new initiatives to boost revenues
- **Early June 1998**—Recent policy announcements temporarily ease tensions, allow partial reversal of earlier interest rate hikes
- **9 June 1998**—Standard and Poor's Sovereign Ratings of Russian ruble: long-term—"B+"; outlook—stable; short-term—"B"
- **Late June 1998**—Russian authorities unveil anti-crisis program, aimed at boosting tax revenues, cutting expenditures, and speeding up structural reforms

Russian Stock Exchange: Moscow Times Index



Source: Moscow Times, April 1999.

- **Mid-July 1998**—Russian authorities introduce additional policy package, in the context of an IMF agreement on an augmented Extended Fund Facility (EFF) arrangement
- **20 July 1998**—IMF releases first $4.8 billion tranche of $22.6 billion extra credit pledge, as policy package is approved by IMF
- **Late July 1998**—Initial effects of this package are positive, with equity prices rebounding 30 percent, treasury bill rates falling from 100 to 50 percent, and a lowering of the Central Bank refinancing rate from 80 to 60 percent
- **Early August 1998**—The Duma fails to approve new reform program; President forced to veto several Duma measures and introduce others by decree
- **13 August 1998**—Standard and Poor's Sovereign Ratings of Russian ruble: long-term—"B-"; outlook—negative; short-term—"C"
- **14 August 1998**—Average treasury bill rates are about 300 percent, international reserves down to only $15 billion, and Russian banks are unable to meet payment obligations... Russia on the verge of full-scale banking and currency crisis
- **15 August 1998**—Boris Yeltsin announces that there will be no devaluation of the ruble
- **17 August 1998**—Russian government defaults on GKO Treasury Bonds, imposes 90-day moratorium on foreign debt payments, abandons ruble exchange rate corridor
- **17 August 1998**—Standard and Poor's Sovereign Ratings of Russian ruble downgraded: long-term—"CCC"; outlook—negative; short-term—"C"
- **21 August 1998**—Russia's international reserves fall to $13.5 billion, after renewed heavy intervention in an effort to support the weakened ruble
- **26 August 1998**—Following heavy intervention, the Russian Central Bank announces that it will stop selling U.S. dollars, and suspends trading of ruble on main exchanges
- **Late August 1998**—Kiriyenko government is dissolved, financial crisis intensifies
- **1 September 1998**—Russia is the IMF's largest borrower, with a combined total of credits at this date equal to nearly $18.8 billion
- **2 September 1998**—Russian Central Bank abandons exchange rate band, lets the ruble float
- **16 September 1998**—Standard and Poor's Sovereign Ratings of Russian ruble: long-term—"CCC-" [lowest possible S and P rating]; outlook—negative; short-term—"C"
- **January 1999**—Moody's assesses financial strength ("E") and credit ratings ("Ca") of the Russian banks at the lowest possible levels; most banks are insolvent (or nearly so)

- **15 January 1999—**The Central Bank of Russia re-launches trading on the domestic debt market. The new securities are to be used in the restructuring of frozen GKO and other debt instruments
- **27 January 1999—**Standard and Poor's Sovereign Ratings of Russian ruble: Long-term—"Selective Default"; outlook—"Not Meaningful"; short-term—"Selective Default"
- **5 February 1999—**The 1999 budget was passed by the Duma in its fourth and final reading. The budget estimates a 2.5 percent budget deficit, and assumes that the government will receive $7 billion in external loans to help finance foreign debt service

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