

What Went Wrong

Russia's financial crisis has turned into a full-blown economic crisis. The crisis has shaken and will shake Russia's fragile market institutions to their roots. The stabilisation of the rouble and gross domestic product has come to a crashing end. The collapse of that stabilisation throws into doubt the very attempt to build a liberal market economy in Russia. Why did this happen? What steps can be taken to improve the dire situation?

Market economies are ones in which freely acting parties choose to trade and invest. Savers and investors need to have enough confidence in the government or company they are investing in or loaning to. Market participants need to trust that the market they operate in will not suddenly change the rules of the game. It is the government that is the guarantor of the system. It is the government in whom investors, savers, and market participants must have faith.

What triggered the final collapse was investors' lack of confidence in the government – their unwillingness to lend to Russia at any price and savers' lack of faith in the banking system. Specifically it was the blow-up of the government rouble debt market (the GKO market) that forced the authorities to carry out a forced restructuring of the debt – in effect to default on that debt. Any country (company or individual) that becomes unable to rollover its bonds or loans, is in huge trouble. In effect it is declared technically bankrupt by the investing public.

Finances

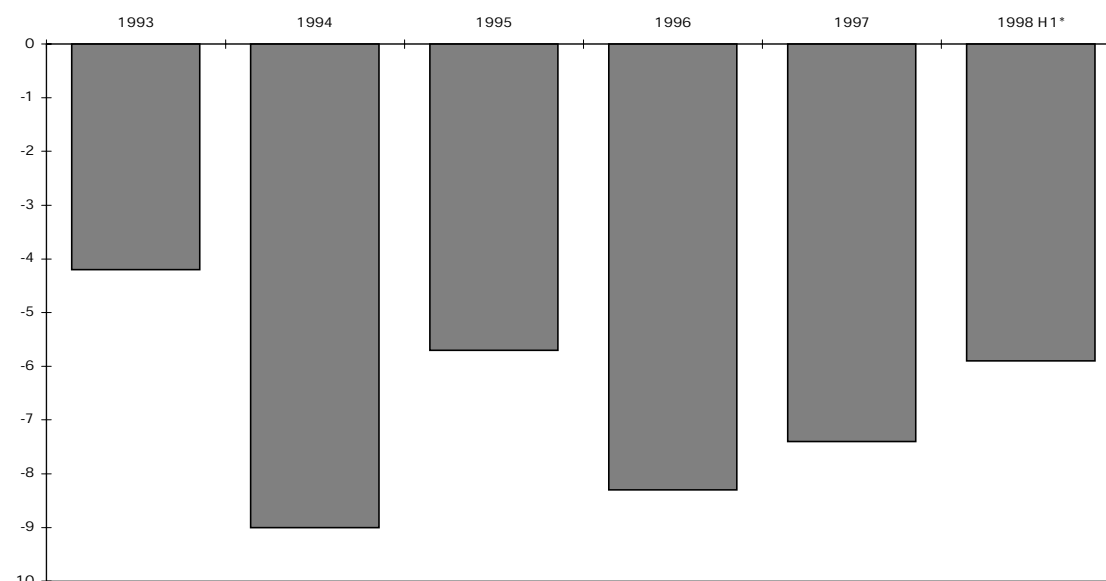
Large budget deficits – a profligate government

Total government spending (including all extra-budgetary funds etc.) made up 41% of GDP in 1997. These expenditures can be financed in one of three ways: tax and other revenues, borrowing, or printing money. Taxation must cover most of government expenditure; borrowing is justifiable only as a way of financing government investment, and of smoothing over cyclical shortfalls in revenue. But the benefits of spending should be carefully weighed against the costs imposed on the private sector by taxes and government borrowing. The third option - printing money – should always be avoided. Unfortunately, this is the policy now most likely to be enacted.

Russia managed to bring down the high inflation of the early 1990s through a feat of financial engineering: by changing the way the government financed its budget deficits. The shift from direct monetary financing by the Central Bank to private sector loans in the form of government short-term obligations (GKO's), eurobonds and other interest-bearing financial instruments led to a steady disinflation and bought the government time to rectify its fiscal imbalances. At the same time, however, it exposed the government to the ruthless judgement of the domestic, and later international, financial markets. As long as investors believed that the government would be able to service its debt, investors were willing to roll over these loans.

But when those investors began to doubt that the government would be able to bring down the deficit rapidly enough to prevent the debt from growing out of control, the government had to face the cumulative burden of its deferred decisions. That point was reached this summer, though the ratio of government debt to GDP was still not high by international standards. There are three reasons: the poor state of the banking system, the government's debt management strategy, and political uncertainty.

Figure 1: Russia's general budget deficit (% GDP)



* This number is that of the federal and regional governments, it excludes the extra-budgetary funds.
Source: Ministry of Finance

Poor debt management - a large build up in short term debt

The federal government financed its large deficits mostly by borrowing in short-term rouble treasury bills (GKO's). Short-term debt instruments are usually regarded as less risky by investors (who get their pay-off sooner). As a result, they carry lower interest rates and hence are less expensive for the budget. The downside of short-term borrowing, however, is that debt has to be refinanced more frequently. This exposes the government to fluctuations in investor sentiment. At times of crisis, finding a buyer can be difficult. By August of this year, the Russian government was simply unable to rollover its stock of maturing debt. Instead, the government should have issued longer-term debt, giving it more time to resolve its tax and deficit problems. Investors would not have bought long-term rouble-denominated bonds because of the risk of devaluation, so this meant issuing more long dated foreign-currency Eurobonds. In the summer of 1997, the Russian government was raising long term finance at an interest rate of just 9.5% annually.

A weak banking sector – a history of government subsidies and bail-outs

Banks are supposed to act as intermediaries between households, which entrust them with their savings, enterprises, which borrow to finance investment projects, and the government, which borrows to finance its deficits. In Russia, however, the banking system failed in this function. Households did not trust the banks to keep their savings safe. Instead many preferred either to spend their savings on consumer durables, or to keep their savings in “mattress dollars” and foreign bank accounts. On the one hand, the inflation of the early 1990s made people reluctant to hold their savings in roubles. On the other, the Russian banks themselves provided poor quality of service and the bankers themselves were seen as less than trustworthy. This meant that very little financing of the budget deficit or investment was performed by depositors at banks.

The collapse of the banking system in August 1998 highlighted another failure of government policy during the 1990s: economic nationalism. Russian policymakers convinced themselves that a domestic, Russian-owned banking system was needed to create Russian capitalism. To this end, the Central Bank nurtured an inefficient, undercapitalised banking system with cheap credits. Later, the government paid the banks huge returns on high-yielding GKO's and accepted negative real interest rates on deposits held in private banks (rather than creating an effective treasury system). Over the years from 1994 onwards the amount of primary deficit financing performed by GKO's was about \$15 bln. By the end of July that market was worth \$70 bln in nominal terms. That difference of \$55 bln was simply interest to investors, most of which went to the banking sector.

Foreigners were kept out of the GKO market in the early days, although foreign money would have brought down interest rates and reduced the burden of debt service payments. During this period, the GKO market expanded from 0 to \$40 bln. The excessive interest rates on this debt amounted to a transfer from future taxpayers (or, as it has turned out, from investors who were defaulted on) to the banks and bankers.

Now the banking sector has collapsed. The money spent capitalising the banks has been wasted, and yet the CBR is spending good money after bad. In the first three weeks of August alone, the CBR issued at least R33 bln (\$5 bln) in credits, a large portion of it to the banking system. This looks like the beginning of the third period of bank bailouts or subsidies since 1992.

Real economy

Lack of the rule of law – corruption

A key failure of market reform in Russia was the inability or unwillingness of politicians at all levels to establish stable, transparent rules enforced in an impartial way. In the years of reform, corruption has flourished throughout the government bureaucracy. Underfunded law courts have struggled to interpret gaping holes in commercial legislation, but often fallen prey to political pressure or bribes. Even when appropriate decisions are adopted, they often fail to be implemented. Businesses have come to understand that the most important currency in the Russian marketplace is government connections. Companies that do not play along are subjected to excessive taxes, meddlesome inspections, arbitrary fines, and absurd regulations.

Table 1: Rates of growth of industrial production by industry (seasonally adjusted indices, %)

Industries	Local peak	Rates of growth		
		Jul-98/Peak	Jun-98/Peak	Jul-98/Jun-98
Fuels	Oct-97	-4.6	-5.0	0.4
Electricity	Nov-97	-8.0	-6.4	-1.6
Food processing	May-98	-8.0	-3.5	-4.5
Wood & paper	Jun-98	-9.8	0.0	-9.8
Building materials	Apr-98	-10.4	-3.7	-6.7
Total	Dec-97	-10.9	-4.6	-6.3
Ferrous metals	Oct-97	-13.5	-12.7	-0.8
Chemistry	Nov-97	-15.7	-5.2	-10.5
Machinery	Jan-98	-20.2	-4.6	-15.6
Non-ferrous metals	Jan-98	-23.3	-26.9	3.6
Textiles & footwear	Jan-98	-24.9	-16.0	-8.9

Source: Goskomstat

Lack of supply side reforms – state in the way of building infrastructure of a market economy

Governments are supposed to alleviate market failures and create an infrastructure in which markets can function efficiently. In Russia, however, state intervention has often reduced market competition and obstructed growth, while failing to provide fair rules of the game to which all market players would adhere. The most conspicuous example is the tax system. For several years, there has been broad agreement that the tax system is extremely burdensome, distortionary, and filled with ambiguities that have left much room for tax inspectors to act arbitrarily and corruptly. This gave incentives for companies to conceal their

profits, driving them into the shadow economy. It also favoured existing firms and discouraged the entry of competitors.

The issue of land ownership in Russia also remains unresolved. The president and Duma have yet to agree on a land code, so transactions with land are regulated by government decrees. Farmland still cannot be privately owned, which causes inefficiencies in allocation of land and leaves much room for corruption among government officials, creating significant disincentives for agricultural entrepreneurs.

Lack of bankruptcies - the politicisation of the economy

"Politics is the most profitable business in Russia today"

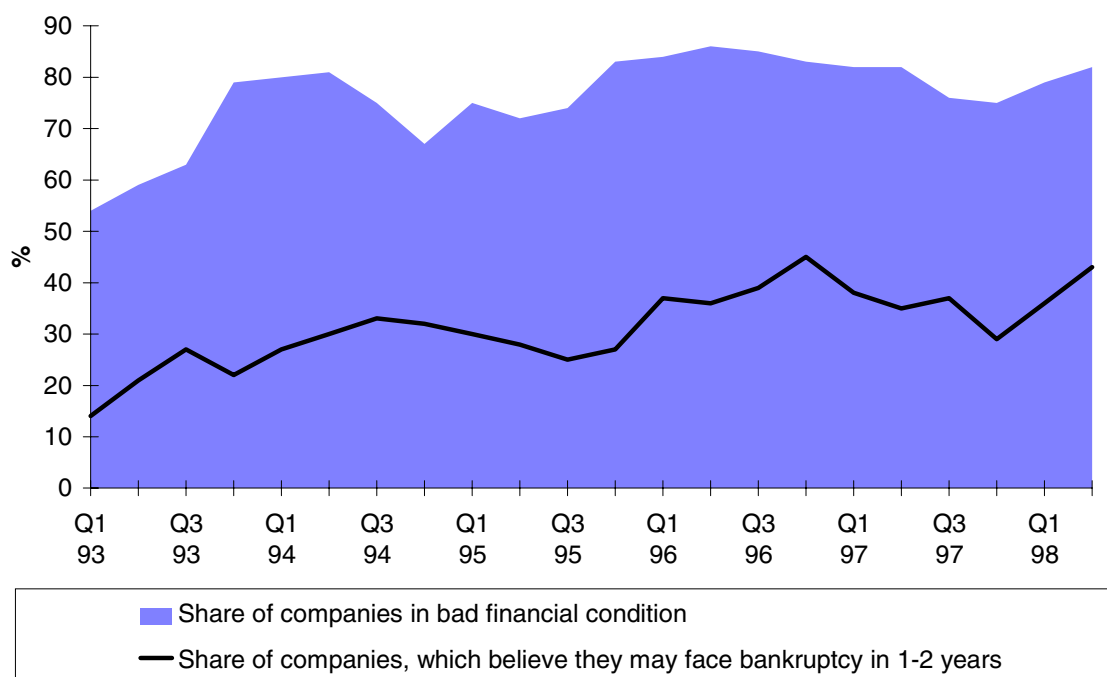
Mikhail Khodorkobsky,
Head of Menatep/Yukos

Privatisation of Russian enterprises did not create the intended distance between the state and the private sector. Many managers and owners retain ties to the government, and state policies towards enterprises are still political. Favouritism has evolved from explicit subsidies and cheap credits for politically important firms to selective tolerance of tax arrears. In all its forms, this favouritism worsened the fiscal situation.

The government postponed tough decisions on restructuring the corporate sector. It did not force insolvent companies into bankruptcy, even when the government itself was the largest creditor. The number of bankruptcy cases in Russia is still very low by international standards, and governments, particularly at the regional level, often interfere in bankruptcy proceedings to protect their political allies and prevent job-losses. The lack of a credible threat of bankruptcy has meant that managers have little incentive to avoid insolvency or pay their suppliers on time. One result is a huge accumulation of unpaid debts among companies.

In addition, the weak system of bankruptcy translates into poor contract enforcement in Russia. Creditors cannot feel confident that the system will help them recover their funds if a firm defaults; as a result, banks and foreign companies have been unwilling to lend to the real sector. Small shareholder rights are also often neglected discouraging strategic investments in Russian companies and delaying formation of proper corporate governance in the country.

Figure 2: How credible is the threat of bankruptcy for insolvent enterprises?



Source: Russian Economic Barometer

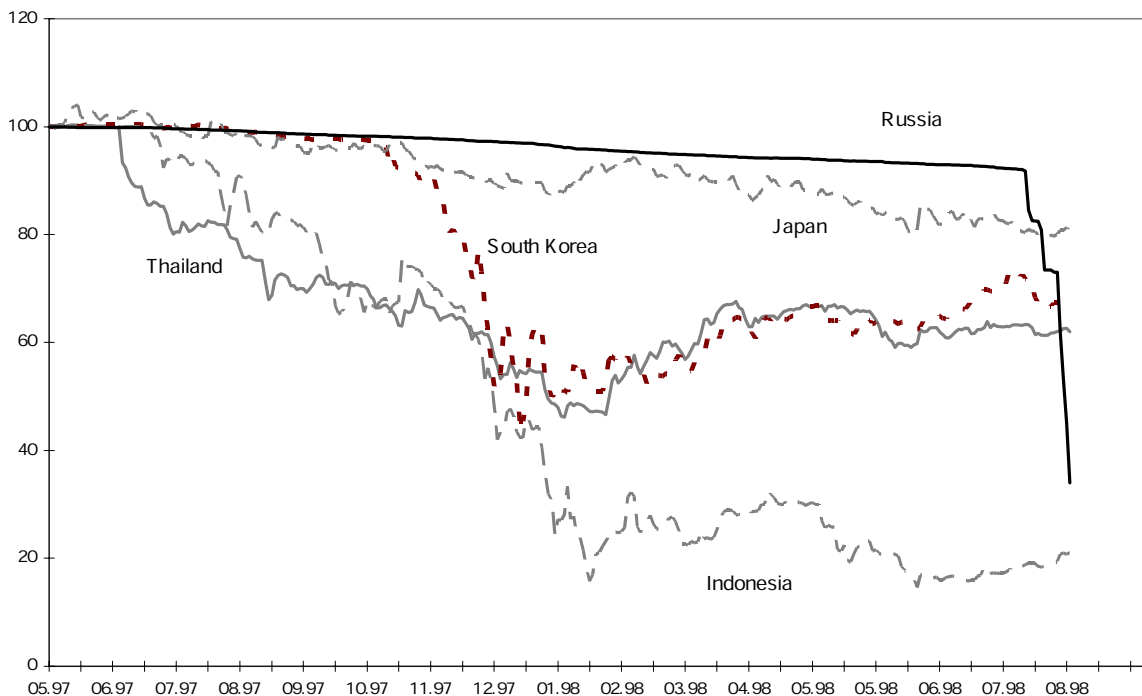
External causes

Most of the deep causes of Russia's collapse are domestic. But two changes in the World economy contributed to timing of the crisis: Asian contagion and declining commodity prices.

The Asian contagion – the collapse of emerging markets

Many emerging market economies have seen their currencies collapse since July 1997. Most countries tarred with the “emerging market” brush have been affected. And some “developed” economies - like Japan - have not escaped. Partly, this “contagion” is due to reappraisal of risk, as investors take a fresh and more sceptical look at the unaffected countries. In addition, it is due to liquidity problems in investment funds that have lost money on other emerging markets and are forced to sell assets across the board. Sales by these companies drive down prices and exacerbate the situation. And partly it is simply fear. Everything is sold and foreign investors return to their home waters. This is the aftermath of a boom - a bust. And with a bust as strong as this only the sturdiest economies and currencies can remain standing.

Figure 3: Asian Contagion: currency collapses



Source: Goldman Sachs, Moscow Times

The drop in the oil price

The fall of the Asian economies and the strength of the dollar has depressed all world commodity prices. Commodities make up about 80% of Russia's exports. The drop in these prices has hit exports badly. Exports fell by 10% in the first half of 1998 compared to the first half of 1997. Combined with the increased imports, this turned the current account round from a surplus of \$3.9 bln in the first quarter of 1997 to a deficit of \$1.5 bln in the first quarter of 1998.

Politics

Reform or not reform – need for political support and consensus

Painful economic reforms are difficult to adopt in any political system. In Russia, their fate depended entirely on the will – and whims – of a single individual: President Boris Yeltsin. The twice-elected president lent legitimacy to the reform effort, despite the relentless opposition of a succession of parliaments. Whenever Yeltsin has wavered in his support for reform, however, progress has faltered and the opposition has gained ground. The result has been spurts of rapid reform, followed by retrenchment as Yeltsin sought compromises with opposition groups.

In March, President Yeltsin sacked the government of Victor Chernomyrdin and appeared to throw his weight behind a group of young, radical reformers. This burst of energy proved short-lived, however, as it soon became clear that the president was unwilling or unable to back them in their toughest fights, against the opposition Duma and against entrenched corporate and financial interests. Large companies ignored demands to pay their tax arrears; the Duma rejected many of the points of the government's agreement with the IMF; and, in a final show of contempt for the state, allegedly, the banks managed to convince the president to sack the government, rather than allowing it to take radical measures to address their insolvency.

The Future

Russia is in a very deep hole. The banks are bankrupt. They have no money to pay their depositors. Most of the deposits carry a government guarantee since they are in Sberbank, and the rest have been, more or less, guaranteed too. The government has lots of debts, including to its employees. And revenues are and will be increasingly insufficient to finance current expenditure plans. This all means that the government has much larger expenditure commitments than it has tax and other revenues.

After the forced restructuring of the GKO market and the moratorium on commercial debt, there will be no new private sector finance to the government for a long time. There is little chance of any financing from the IMF or other international official creditors, except perhaps to cover debt service payments.

So the Russian government faces a choice. Either the government cuts expenditures drastically, allows banks to go bankrupt and lets depositors receive only a share of the liquidated bank assets – in essence, lives within its means. Or the Central Bank issues credits to cover any or all claims on the government. This is the path of hyperinflation. The first imposes pain on many of the powerful guilty parties in the current situation. The latter spreads the pain over all holders of roubles, hitting the poor hardest of all.

ECONOMIC UPDATE

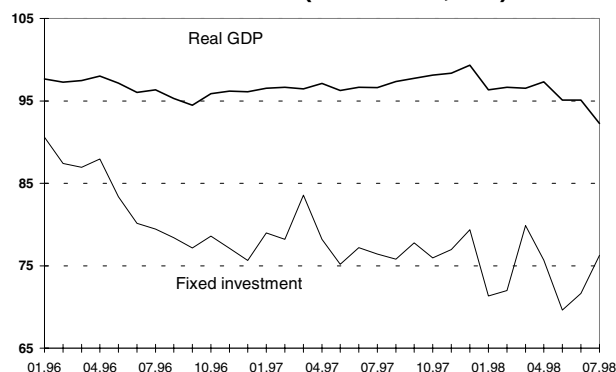
Output and aggregate demand

In July the majority of output indicators, such as real GDP, industrial production, agricultural output, and housing construction experienced a sharp drop. Seasonally adjusted real GDP decreased by 3% in a month and was 4.5% lower than in July 1997. Industrial production fell in June by 6.3% and was 9.4% lower than a year ago. This monthly drop was largely connected with a huge decline of machinery production (-15.6% in July), especially that of passenger cars. In July 38% less cars were produced than a year ago, reflecting a sharp fall in consumer demand.

Another indicator which is sensitive to the changes in final demand - the area of dwellings completed - also continued its rapid decline. In July area of dwellings completed on a seasonally adjusted basis was 21% lower than a year ago and 39% lower than at the beginning of 1998. In July a huge decline of agricultural output was observed. In a month seasonally adjusted agricultural production fell by 17.2% and was 16.7% lower than a year ago. This decline is connected with the poor harvest of potatoes and grain and will seriously decrease the domestic supply of food in the coming months.

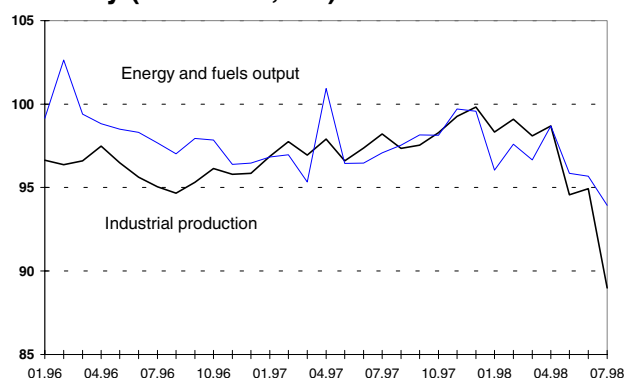
Peoples' concern with the economic situation in Russia manifested itself in continued growth in consumer expenditures despite the steady decline of real personal income started at the beginning of the year. In July nominal income was estimated at 4% below the level of a year ago implying a drop in real income of almost 8%. Retail trade, however, increased 4.5%. This growth was accompanied with a decrease of rouble cash holdings and an unprecedented drop of deposits in Sberbank. In June and July people also increased hard currency purchases. It looks like most of it was saved rather than spent on purchases of goods and services abroad.

GDP and investment (1995=100, SA)



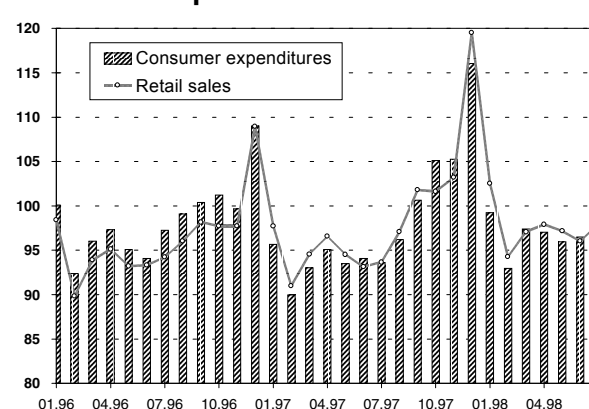
Source: Goskomstat

Industry (1995=100, SA)



Source: Goskomstat

Consumer expenditures



Source: Goskomstat

Wages

Seasonally adjusted real wages have stayed at a more or less the same level since the beginning of this year. But wage arrears continue to increase rapidly, meaning a continued reduction in the real wage bill. In May-June wage arrears were growing at 6.7% per month in nominal terms. By the end of July real wage arrears were 38.5% higher than in the end of December 1997. In nominal terms wage arrears reached R75.8 bn or 35.2% of monthly GDP compared to 20.4% of GDP in December 1997. The budget wage arrears are growing at a rate of 16-17% per month in nominal terms and their share in total arrears reached 19.6% in July, compared to 11.6% in January.

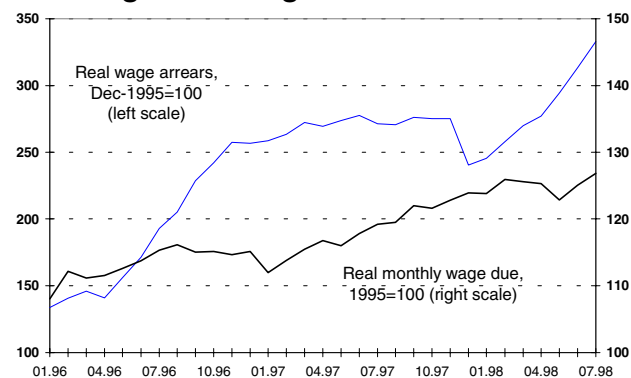
Enterprise finances

The current crisis is putting serious pressure on enterprises. The collapsing rouble has driven up costs of production of companies which rely heavily on imported materials, and will cause some enterprises to close down. The collapse of the banking system implies that companies which are net lenders to the system, are likely to lose some of their funds. At the same time, net debtors will benefit from the crisis as their loans shrink in real value with the negative real interest rates now likely. With banks going bankrupt, the payment system is falling apart, causing even financially stable companies to become temporarily insolvent. Arrears are bound to spike up in August and September, though if the printing presses really start to roll, many arrears will be paid off. In June, arrears to the budget fell slightly, mostly due to a reduction in taxes owed by the transport sector. Arrears to the off-budget funds and to suppliers continued to rise.

Prices

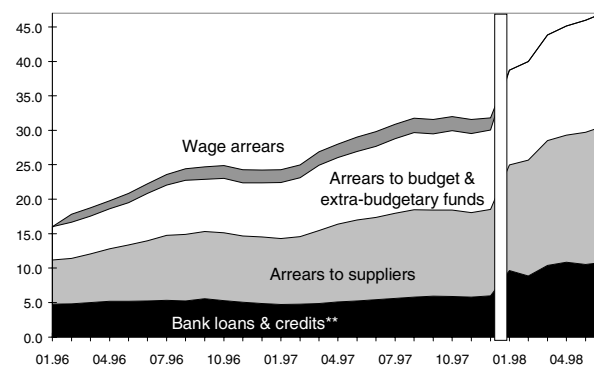
Consumer prices continued to fall in July – probably the last time for a while. The annual rate of growth of CPI equalled 5.6% in July its lowest level since prices were liberalised at the end of 1991. The composite producer price index began to grow in July - in a month it increased by 1.9% and its annual rate of growth was 2.7% compared to 1.1% in June. Growth of the composite PPI was connected with a sharp increase of tariffs for pipeline transportation, which in July were raised by 42.6%.

Real wages and wage arrears



Source: Goskomstat.

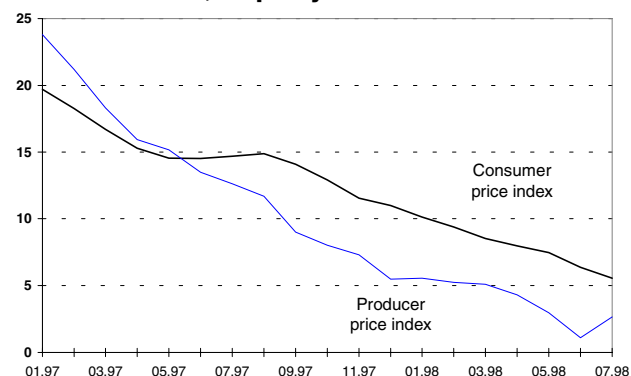
Arrears and bank credits & loans, % of GDP*



* Data is for 4 sectors of the economy (industry, agriculture, transport & construction) prior to January 1998 and for 9 sectors from January 1998. Data for wage arrears is not available for the same 9 sectors. See Table 7 statistical appendix for the list of 9 sectors.

Source: Goskomstat

Inflation rates, % per year



Source: Goskomstat

Foreign trade

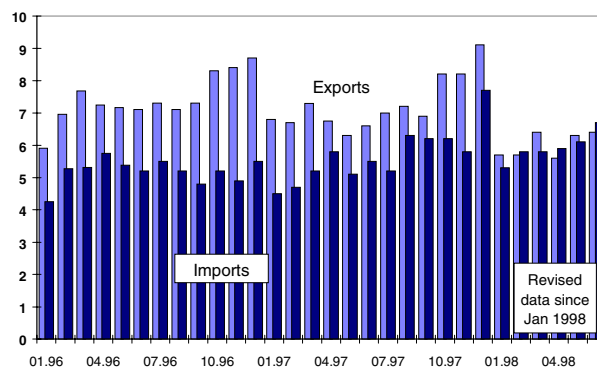
Imports have continued to increase, and in June imports were up compared to both the same period last year and the previous month, applying the new methodology introduced in May by Goskomstat. Exports in June stood at \$6.4 bn which was slightly up on the previous month but down compared to \$7.1 billion in June 1997, reflecting the fall in world commodity prices. Having experienced a surplus in May, in June the trade balance was again negative. The 3% rise in import duties, effective from August 15 in combination with the recent devaluation, mean that one can expect a fast decline in imports. As part of the current crisis, recent talks about introducing currency restrictions and possibly price controls would have additional negative effects on imports, delivering a severe blow to Russian consumers.

The budget

The July figures for the federal budget was not available at the time of writing. For June the consolidated budget deficit (federal plus regional and local budgets) was 5.9% of GDP, down from May's deficit of 4.7% (according to IMF definition). This was due to an increase in both federal and local expenditures. Regional and local revenues in the second quarter of 1998 was 15.8% of GDP, slightly down compared to the same period of 1997, but up from 11.8% in the first quarter. On the expenditure side spendings of local and regional amounted to 17% of GDP in the second quarter, up from 12.6% in the previous quarter. Quarter on quarter expenditures were up from 14.9% in the second quarter of 1997. This increase was mainly associated with increased spending on the "national economy" item.

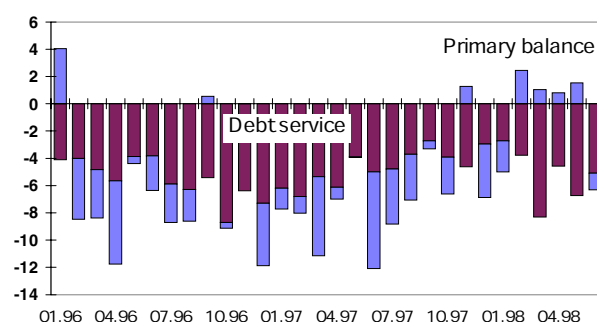
The current crisis, which culminated on August 17 with the devaluation of the rouble, has important fiscal implications. The default on GKO/OFZ and the subsequent restructuring plan, announced on August 28, reduces debt service costs. But the restructuring deal still implies 30% interest rates and it means that the government will have to find alternative methods to finance the deficit.

Merchandise exports and imports (\$ bn)



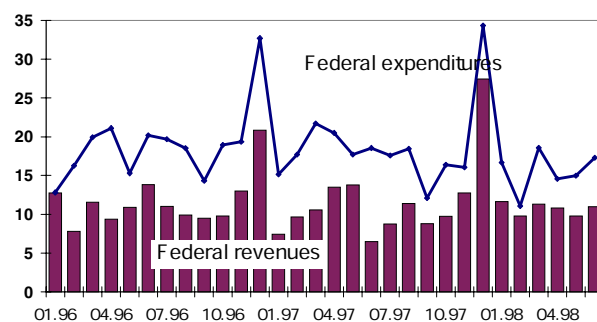
Source: Goskomstat

Federal budget deficit, % GDP



Source: Ministry of Finance

Federal revenues and expenditures, % GDP



Source: Ministry of Finance

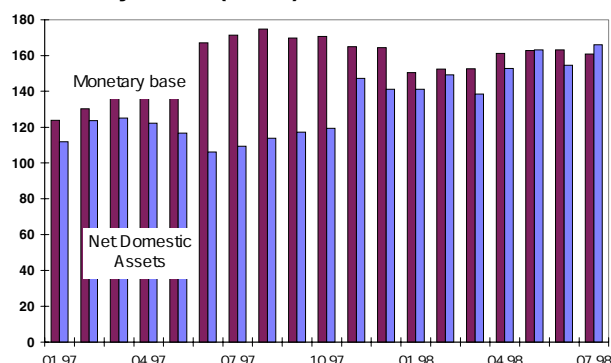
Money

In the first three weeks of August (the latest period for which we have data) the monetary authorities started issuing large amounts of credits. In a period when Gross International Reserves fell by \$5 bn, the monetary base increased by R1 bn. Assuming there was no borrowing by the Central Bank in this period (and there are rumours that in fact there was, with the Central Bank supposedly borrowing against the collateral of gold) this means that there were a net R33 bn of credits issued. We do not know where these credits went, but we can guess that they went to the banks who were facing liquidity and solvency problems. It is clear that these banks then bought foreign currency with the loaned funds. And it was the Central Bank who sold them this foreign currency. In other words the net effect was for the CBR to give dollars to these banks, in exchange for rouble obligations that given the subsequent collapse of the rouble are worth a lot less than they originally were. One of the banks reported to have received these loans is now in Central Bank administration, indicating that the CBR believes it insolvent. Such large credit issuance is highly inflationary. It also represents an effective bail out of the banks and/or bankers. On the possibility of the IMF granting their forthcoming credit, it is worth noting the figure for net credits to the enlarged government by the monetary authorities - one of the programme targets. In the programme agreed on July 16, 1998 the ceiling for this measure of money creation at the end of September was R227.6 bn. At the end of July the figure was R229.7 bn – already breaching the ceiling for two months later.

Financial markets

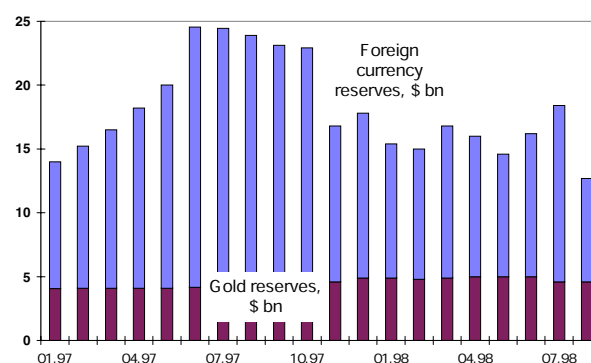
At present it is hard to claim that there are financial markets in Russia. Volumes on the equity market are minute and the indices are at their lowest level since 1995. The rouble debt market has in effect been disbanded. A moratorium has been imposed on the repayment of dollar principal on non-sovereign credits. And on many days recently there was no operative major currency market. The Russian government's dollar debt is traded off-shore with the probability of default priced in. What a change way from this time last year, when the equity indices were just off their highs, a full 750% above their current levels.

Monetary base (R bn)



Source: CBR

Gross reserves (\$ bn)



August reserves are for the 28th of the month.

Source: CBR

Moscow Times \$ Index



Source: Moscow Times

Interest rates

The GKO market was in effect disbanded on August 14. On that day yields on the benchmark 3 month issue were a large 166%. Now that these instruments have been restructured into long term notes and are presently not traded, the inter-bank market offers the only clue to short term rouble rates. Interestingly these numbers reveal that interest rates have been falling since the change of monetary regime was enacted. Given that the rouble is collapsing at a rapid pace (15% a day or so) this is surprising. What it suggests is that the Central Bank is issuing an increasing amount of rouble credits into the system. If true, rapid inflation is just round the corner.

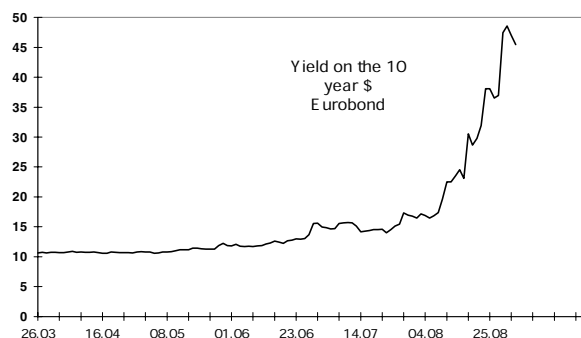
Meanwhile interest rates on Russian dollar debt have been climbing every higher. On September 2, interest rates on the ten year Eurobond were \$46% per year, and interest rates on a MinFin bond that matures in 1999 were a massive 290%. Both these numbers indicate that the market's estimate of the probability of default is greater than half.

The exchange rate

The pressure on the rouble had been building up for a number of months. In mid-August it finally snapped, and the rouble moved off its gradual, measured depreciation path. In the first couple of weeks after the policy sea change the Central Bank continued to intervene to shore up the rouble's value. Then last week it just abandoned trading. This week the phoney season ended. Now the exchange rate is collapsing. It has fallen to under 50% of its previous value against the dollar.

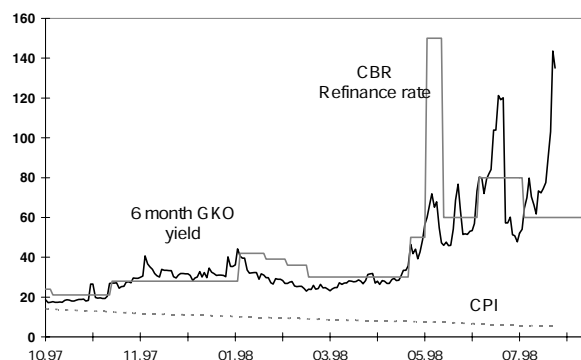
Such a large collapse is not warranted by the trade situation – indeed no fall was really warranted on those “fundamental” terms . It has fallen so far because everyone is expecting that the currency will be debased like it has been so many times in Russia's past. How much further it falls is dependent on the amount of credits issued by the Central Bank. In other words how much money is printed. The other possibility is that the rate will be made not to fall further by simply “fixing” it by administrative controls. Such measures would mean an end to internal

Interest rates, % per year



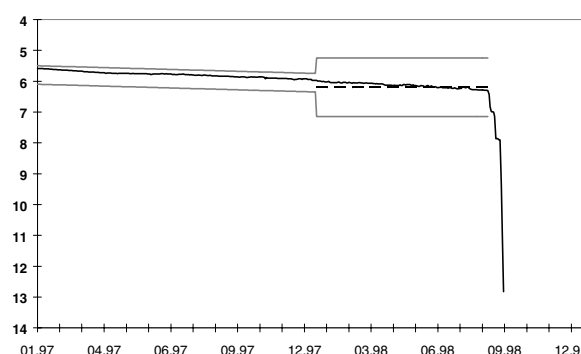
Source: *Moscow Times*

GKO rates and the refinance rate, % per year



Source: *Troika Dialog, CBR*

The rouble exchange rate and the corridor (R/\$)*



* MICEX exchange rate till 17th August. CBR rate from then on.

Source: *CBR*

convertibility of the rouble.