

The Crisis: What Is the Damage? What Are the Options?

The economic crisis continues to take its toll on Russia's welfare. Putting an end to it and minimising its damage to the population remains the issue of foremost importance for the Russian government. This report lists the main effects of the crisis to this date, and reviews two anti-crisis programs which were among those submitted for the government's consideration.

What is the damage?

Consumers suffered in several major ways. The rouble devaluation and subsequent inflation significantly diminished the purchasing power of the Russian population, most of which is earning incomes fixed in nominal roubles. The rouble fell from R6.3 per dollar before the crisis to R20.8 on September 8, then bouncing back to around R16 per dollar. This reduces the average wage to just \$70 per month. The fall in the local currency made imported goods significantly more expensive. Households started to buy up goods and to stock up on food ahead of price increases and due to the fear of things disappearing from the stores. As a result, prices for domestically produced goods also began to rise. While before the crisis in July overall prices grew only 0.2% month-on-month, in August monthly inflation rose to 15.3%, escalating further to 38% in September (according to preliminary Goskomstat figures), the highest monthly rate since February 1992.

Russia's fragile banking system crumbled following the August depreciation of the rouble, with many Russians losing access to their savings held in bank deposits, adding to the impoverishment of the population. The collapse of the financial system encouraged further flight into dollars and contributed to rouble weakness. Many people lost their source of incomes in the wave of lay-offs as local banks and firms became insolvent.

Russian *producers* also became seriously affected by the crisis. While exporters may have welcomed the fall of the rouble, its depreciation badly hit Russian importers, forcing a sharp decline in the volume of goods purchased from abroad. Technical difficulties which resulted from government's decision to close the foreign exchange market for several days in August and then in September have also disrupted the flow of foreign goods into Russia. According to preliminary figures of the Trade Ministry, imports fell 65% in September compared to the previous month. Coupled with the dismal harvest this year (in August agricultural production was down 23% year-on-year), this will lead to a very rough winter for the population. Russian firms are suffering from the breakdown of the payments system which accompanied the banking crisis. Larger enterprises started to switch to cash only as the basis for their operations. Many companies, not being able to collect customer receipts, are likely to have gone into default on many of their obligations and possibly had to close down their operations.

The most serious implication of the crisis for the Russian *government* is the fact that it now was unable to borrow from either domestic or international capital markets. The state is left with no sources of funding for either budget deficit, wage arrears to state employees, or compensation which it promised to the depositors who lost their savings as a result of the banking crisis, other than printing money. The arrears, for the federal government alone could be estimated approximately as at least R 30.5 bn, including R 7.5 bn of wage arrears, R 3 bn to the pension fund and around R 20 bn of the government consumption arrears, not including delayed foreign debt payments. Adding to this arrears to the military sector should more than double this number. The federal government would need to divert more than three months of average revenues to finance these overdue obligations alone. And these estimates do not include various arrears of the local and regional budgets.

What are the options?

It is a very complex task to develop an anti-crisis plan which would be realistic and credible on the one hand and would both minimise the immediate pain of the Russian population and create the appropriate foundations for future stabilisation and growth of the Russian economy, on the other. For the rub of the problem is that the government is effectively bankrupt. It is facing a severe shortages of funds at the same time as increased spending pressures.

Here we analyse two of the plans proposed for the government's consideration and were published on October 1 in Kommersant Daily (Plan 1) and Segodnia (Plan 2). The comparative summary of the two plans can be found in the appendix attached. These two plans can be described as being close to the two extremes of the variety of opinions which exist among government advisors.

Both plans argue that the stabilisation of the rouble's exchange rate is the initial task of paramount importance for the government. This indeed is critical for the welfare of the Russian citizens who are suffering from the deteriorating purchasing power of their incomes. Plan 1 argues for the introduction of tougher administrative controls over foreign exchange transactions in order to restore the value of the rouble. However, the experiences of many countries have demonstrated that such measures are likely to result in even further flight into dollars and encourage the development of black markets for foreign exchange. Banning pre-payments for imports, which is a part of Plan 1 proposal, would reduce flows of foreign goods into the country even further, which may exacerbate any food shortages in the coming winter.

Only those measures that increase the Russian population's trust in the rouble will result in a more stable exchange rate. In order to make people more willing to hold rouble, the government has to undertake a credible commitment to low inflation. To this effect, Plan 2 proposes that the government commits itself to not printing money, and to make this promise credible, the plan suggests that rouble money base is tied to the CBR's dollar reserves at a constant exchange rate in a currency board type arrangement.

While a currency board is an arrangement that can be used to restore the confidence of the people in the rouble, it must be started at a time when the government's commitment to it is credible. A government that amongst other things does not pay its current wages and has a large backlog of unpaid ones is not credible. Until these overhanging government liabilities are cleared such a stringent policy cannot be reasonably adhered to.

Plan 2 plan gets to the heart of the problem: the government has far smaller revenues than it has expenditure plans. The government is extremely poor just at a time when there are increased expenditure needs. For this reason the government is talking about monetary emissions to finance the shortfall. But as is clearly understood all that printing money achieves is increases in the general price level - viz. inflation. It makes the existing roubles worth less, and so increases individuals demands for dollars. To limit this effect the government must commit to credibly limiting its expenditure.

And so it is crucial for any government plan that spending is prioritised, and that the source of financing be made explicit. As a result of an earlier default on the GKO debt and collapse of the domestic banking system, the government has found itself cut off from the markets for private loanable funds, both externally and domestically. Furthermore there is unlikely to be more financing from the IMF as long as the government's plan includes sizeable emissions and is not fully based on market principles.

So the government faces a simple choice - fund the gap between its revenues and its spending plan by printing money or limit its spending to what its revenues plus possible IMF loans entail. The first course means hyper inflation and a crashing rouble (unless it is fixed

by administrative means that simply mean a crashing rouble on the black market) leading to great economic dislocation, but at least most of its obligations being paid in (debased) roubles. The second course is tough and painful and likely to initially entail simply the payment of wages and some crucial benefits, but will mean gradually stabilising prices and rouble. The first course means that the government does make good on at least a majority of its obligations (though likely bar that of servicing foreign debt). The second course means that the government will have to delay, restructure or default on some of its obligations. The first course is that represented by Plan 1, the second by Plan 2 below.

It is worth noting too that if the first course is chosen then the government will have to prioritise its spending anyway if it wants to avoid a hyper-inflation. If it does follow this course then every spending limit (implying reduced emissions) is crucial. For example the plans to fund industrial development at a time of severe fiscal crisis is ludicrous.

Finally it is worth looking forward a bit too. The former plan (implying large rouble emissions) is at best a short term solution. To carry on printing roubles will lead to continued and accelerating inflation, a worsening environment for investment and a withering of the state as real tax revenues fall. To avoid this course the government would have to switch to the second course, the sooner the better. The painful course of reducing government expenditure will have to be pursued at some point. The sooner that decision is made and that painful medicine taken the sooner real economic activity can commence.

Appendix: Main points of the two of the proposed programs

<i>PLAN 1: Proposal attributed to left wing members of the government (published in 'Kommersant-Daily' on October 1)</i>	<i>PLAN 2: Proposal signed by Egor Gaidar, et al (published in 'Segodnia' on October 1)</i>
<i>Stabilisation of rouble exchange rate, including</i>	
<ul style="list-style-type: none"> • An exchange rate fix against a basket of foreign currencies, based on current account balance, the amount of reserves and inflation • Stricter administrative controls over foreign currency flows, including conduct of all foreign currency transactions of Russian banks via specially designated accounts at the Central Bank • Enforcement of more stringent rules requiring exporters to convert their hard currency revenues into roubles • 100% advance payment rule for all exports • A rule allowing importers to pay for purchased goods only when they arrive at the customs 	<ul style="list-style-type: none"> • A commitment to not conducting money emissions, which would help restore the rouble's credibility • Adoption of currency board type policy under which rouble money base is fully covered by gross international reserves of the CBR (this would imply the rate of R 16-18 per \$1) • Co-operation with the IMF with the aim of obtaining credits to boost international reserves of the CBR
<i>Adoption of new budget policy, including</i>	
<ul style="list-style-type: none"> • Adoption of emergency federal budget for the fourth quarter of 1998, which would ensure financing of articles of foremost importance, including federal wage, social payment and pension arrears in the amount of at least R 15 bn. • Commitment to unconditional financing of at least 1/15 of annual federal budget expenditure targets every month 	<ul style="list-style-type: none"> • Consistent implementation of balanced budget fiscal policy, including primary surplus in 1999 • Adoption of a credible budget plan for 1999, where the amount of spending is determined by a realistic estimate of tax revenues • Immediate consolidation of off-budget

<ul style="list-style-type: none"> • Mutual off-sets of debts of various government levels • Arrangements for the federal budget to acquire goods and services from companies which owe taxes to the federal government • Revision of ear-marked funds for targeted programs 	<p>plans within <i>federal</i> budget, freezing spending on most of the 'ear-marked' projects</p> <ul style="list-style-type: none"> • A 50% cut in administrative spending, foreign activity and subsidies, reducing the number of regions which receive federal assistance 2-3 times
<p><i>Reform of the tax system, including</i></p>	
<ul style="list-style-type: none"> • Introduction of a uniform VAT rate of 15% • Introduction of a uniform profit tax rate of 30% • Allowance for profits which are invested into production to be exempt from tax • Introduction of 15, 20 and 30% income tax brackets. Increase in tax exempted minimum income and increase in maximum income taxable at 30% rate. • New calculation of property tax base, which will now be lowered by the amount that overdue accounts payable exceed overdue accounts receivable and by other overdue liabilities • Introduction of maximum personal property tax rate at 1% and of tax exempt minimum • Introduction of single state register of tax payers 	<ul style="list-style-type: none"> • Simplification of tax system and abolishing small and poorly enforced taxes • Abolishing tax privileges • Introduction of a uniform VAT rate of 20% and abolishing sales tax • Introduction of a uniform income tax rate of 20%, with tax exempt income fixed at 50% of average earnings • Lowering of import tariffs, including those on food and food components, and equipment
<p><i>Domestic debt restructuring, including</i></p>	
<ul style="list-style-type: none"> • Resumption of secondary trading of GKO's • CBR emission to redeem maturing GKO's • Early redemption of foreign currency denominated government securities • Allowing companies to pay their tax debt with government securities • Compensation of losses incurred by companies, which had been required to invest into government paper • A special approach towards foreign investors which had invested at least \$ 50 mn into Russian economy 	<ul style="list-style-type: none"> • Adoption of a new GKO restructuring plan, which should both help recapitalize the banking system and provide guarantees of their investment to foreign investors. The plan should include two options to investors a) 20% repayment of nominal value on maturity with remainder restructured over 4 years and b) conversion of GKO's into foreign currency bonds maturing in 5-7 years and yielding 6%
<p><i>Protection of population from crisis and social security, including</i></p>	
<ul style="list-style-type: none"> • Indexation of minimum wage, pensions and transfers • Ensuring wage payments to all budget employees • Departure from tying certain payments (e.g. state sector wages) to minimum wage • Deposit insurance scheme (see below) • Tax forgiveness for persons who had failed to make full tax payments previously • Tax exemptions in the amount of foreign 	<ul style="list-style-type: none"> • Limited indexation of fixed incomes of the low income groups or introduction of a one-off compensating increase in pensions, transfers, stipends and state sector wages • Deposit insurance scheme (see below) • Introduction of new labour code developed in 1997 • Strict targeting of social security benefits • Provision of benefits only for the most needy

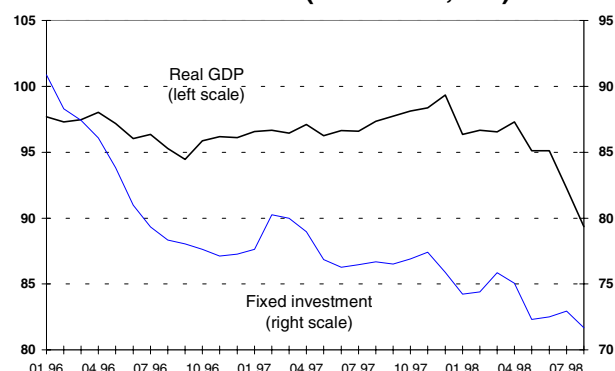
<p>currency savings deposited into banks within 2 months after publication of this program</p> <ul style="list-style-type: none"> • Introduction of measures regulating prices of food and other necessities, housing and transport • Targeting of social security benefits towards the most needy 	
<i>Banking sector policy, including</i>	
<ul style="list-style-type: none"> • Creation of a committee (reporting to the President) which would co-ordinate activity of the CBR, Ministry of Finance, Ministry of the Economy, Federal Securities Commission, Sberbank and Vneshtorgbank in the area of monetary policy • Central Bank credits to commercial banks on the collateral of foreign assets at the rate not exceeding the rate fixed by the Committee • Introduction of strict control by the Committee over commercial banks' fulfilment of their obligations. Imposition of fines and withdrawal of licences for repeated failure to meet obligations • 100% transfer of CBR profits to the federal budget. Financing of the CBR expenditures through the federal budget • Creation of state owned Bank for Reconstruction and Development with assets of nationalised commercial banks • Introduce a state guarantee on bank deposits of the population. The financing would come from the obligatory reserve fund of the CBR. • Cancellation of the 90 day moratorium on payments to non-residents by Russian entities introduced on August 17 	<ul style="list-style-type: none"> • Provision of access of foreign financial institutions to Russia's market for banking services • Nationalisation of major banks with following privatisation to strategic investors for a symbolic price with a condition of accepting bank's retail deposit obligations • Liquidation of insolvent banks • Recapitalization of most promising banks accompanied by an increase in Central Bank supervision over activities of these banks • Increase in transparency of the banking sector, including CBR and Sberbank • Introduction of state guarantee on bank deposits of the population (with a limit of \$ 5000). The financing would come from an increase in obligatory reserves of banks and from funds provided by the IMF and other international organisations • Cancellation of the 90 day moratorium on payments to non-residents by Russian entities introduced on August 17
<i>Industrial policy, including</i>	
<ul style="list-style-type: none"> • Restructure debts of enterprises to the state over 10 years • Off-sets of tax debts of enterprises by the amount of their expenditure on housing, which should have been transferred to the local government • Off-sets between tax liability of the military sector and the amount federal government owes to it for goods and services • State support for sectors of foremost importance • Securing financing for 1999 development budget 	<ul style="list-style-type: none"> • Encouragement of competition • Simplification of enterprise registration procedures • Abolishing restrictions on entry and exit of goods which exist in some regions • Limiting and controlling commercial activity of municipal governments • Legalising the sale of land

ECONOMIC UPDATE

Aggregate demand

Real GDP continued its rapid slide down, following the trend of previous months. In August seasonally adjusted GDP fell by 3% (the same drop was observed in July) and was 10% lower than in December 1997. Real expenditures on new construction and equipment (proxy for the gross fixed investment) also continued to decline. In August real expenditures on new construction and equipment were almost 11% lower than in December 1997.

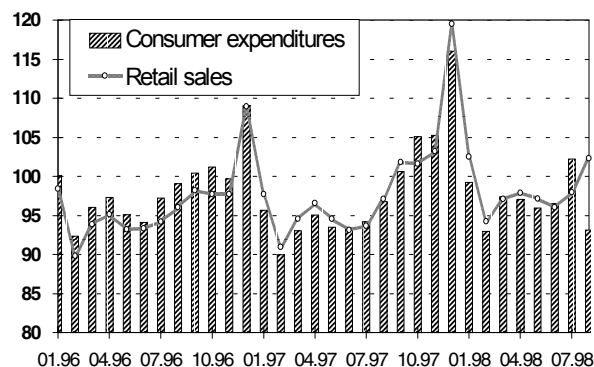
GDP and investment (1995=100, SA)



Source: Goskomstat

Acceleration of inflation caused by the financial crisis led to a deterioration in real personal income to the lowest level since 1992. Real value and liquidity of personal financial assets also dropped drastically. In the second half of August, people tried to withdraw money from their bank accounts and to spend as much as possible on goods and hard currency. As a result in August, real retail sales increased 5.4% compared to the same period in 1997. At the same time consumer expenditures, deflated by CPI, dropped by 3.7% reflecting the shift in consumption towards cheaper domestically produced basic goods (salt, soap, matches, etc.).

Consumer expenditures

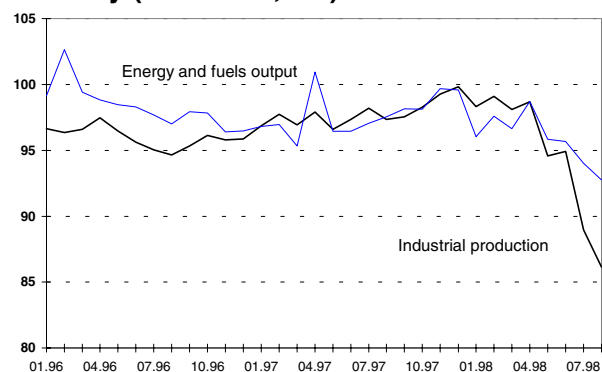


Source: Goskomstat

Output

Development of the situation in the real sector in August was strongly disturbing. All major indicators continued to decline very rapidly. As a result, in August seasonally adjusted industrial production was almost 14% lower than in December 1997. Agricultural output remained unchanged from previous month but was 23% less than in August 1997. The fall of industrial and agricultural output is reflected in the amount of freight carried by rail. In August seasonally adjusted volume of freight carried by rail was about 11% lower than in December 1997.

Industry (1995=100, SA)



Source: Goskomstat

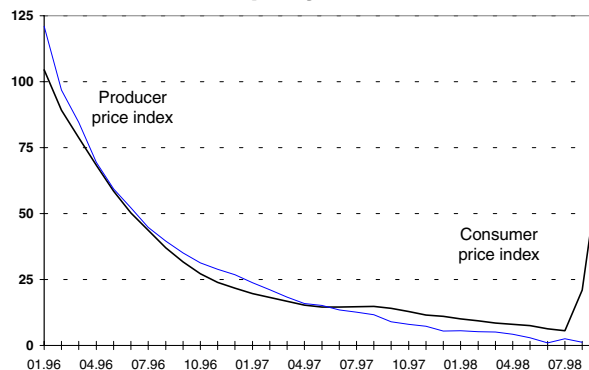
Prices

Consumer prices in the end-August and beginning of September experienced an extraordinary upsurge. In the last two weeks of August CPI grew by about 15%, and in the first two weeks of September - by another 43%. As a result in these four weeks CPI grew by about 65%. In Moscow and St. Petersburg the growth of prices was much more intensive because of the larger share of imported goods in personal consumption. Certainly, this jump is much smaller than the rise of CPI in January 1992 (245%), but is practically similar to the magnitude of another dramatic price increase -- in April 1991 (64%). In the third week of September the rate of growth of CPI declined to 1.5% per week, and in the fourth week prices actually declined. As a result, according to preliminary estimates, by the end of September CPI was 38% higher than in the end of August and about 60% higher than in the end of July. Producer prices in August didn't have enough time to react on financial crisis and even slightly declined, thus making the growth of CPI even more spectacular.

Wages

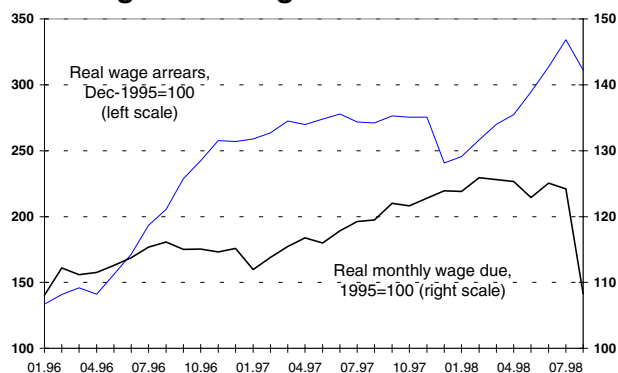
While nominal wages in August remained practically unchanged compared to July, real wages due followed the changes in CPI, thus fell by about 15%. Subsequently an even more pronounced drop in real wages can be expected in September, making indexation of wages (as well as other fixed payments, like pensions, stipends, etc.) almost inevitable in the nearest future. The rise of consumer prices also decreased the real value of wage arrears. While in nominal terms wage arrears continued to grow in August (by 7.7%, reaching 84 bn Rb by the month-end), real value of the stock of wage arrears decline by 8%.

Inflation rates, % per year



Source: Goskomstat.

Real wages and wage arrears



Source: Goskomstat.

Enterprise finances

In July, the stock of overdue payables in 9 sectors rose by 2.8% of GDP to R 1.2 trl or 46.4% of GDP. One of the reasons for this significant rise could be an increase in inflationary expectations as industrial and transport companies were postponing their payments to take advantage of the expected negative interest rate (they ran up far more arrears in July than did other sectors).

The Primakov cabinet decided to cancel the planned sale of 75% stake in Rosneft, citing adverse market conditions. The government announced that the starting price of 25%-2 shares in Svazinvest (to be sold on October 16), initially set at R 6.5 bn, will be revised upwards.

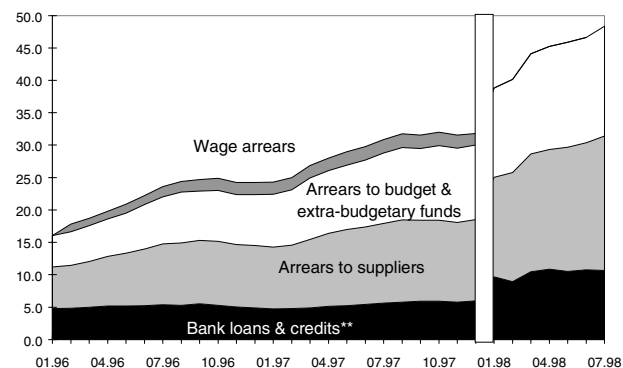
At long last, the rules of the game for commercial banks were finally defined when Duma passed the law on bankruptcy of credit organizations in mid September. The law gives the ultimate power to decide which banks should be bankrupted to the Central Bank. In addition, the law is said to be very debtor oriented, allowing the CBR to apply various 'soft' measures towards troubled banks which would help them avoid liquidation.

Foreign trade

In July Russia's trade balance rebounded into a surplus of \$400 mn after the June deficit. The reason being a drop in imports from \$6.7 bn in June to \$5.8 bn in July, mainly in non-CIS trade. In July exports to non-CIS countries were down \$400 mn on June and \$900 mn compared to July 1997, amounting to \$5.3 bn. Overall exports fell from \$6.4 bn to \$6.2 bn June to July. Compared to the same period in 1997 total exports were down from \$7 bn indicating the deterioration in Russia's terms of trade due to falling world commodity prices.

If the government goes ahead with plans to increase obligatory sale of export revenues under special conditions (currently exporters are obliged to sell 75% of revenues on the open market) exporters will try and find ways of keeping their earnings abroad, as this would act as an additional tax on their activities. Although no official figures have yet been published for August and September the first indications are that imports have fallen dramatically since the beginning of the crisis.

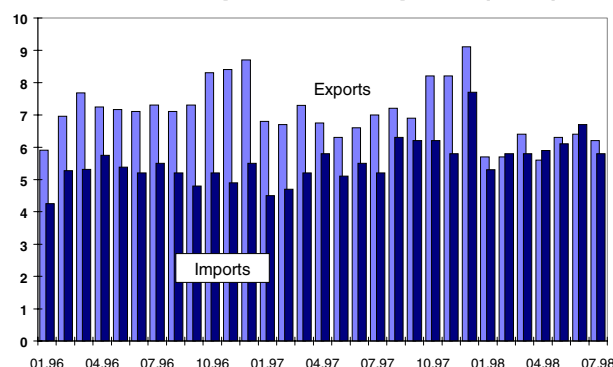
Arrears and bank credits & loans, % of GDP*



* 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

Merchandise exports and imports (\$ bn)



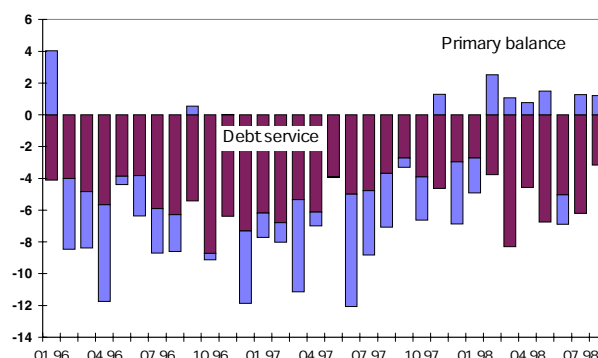
Source: Goskomstat

The budget

During the first 8 months of 1998 the federal government collected R165.3 bn of revenues. Taxes made up R139.2 bn of these, a share of 84.2%. The expenditures of the federal budget were R238.9 bn. This meant that the budget deficit, according to IMF definition was 4.5% of the GDP. The regional budgets ran a total deficit of 0.9% GDP, with expenditures of R233.6 bn and revenues of R219 bn.

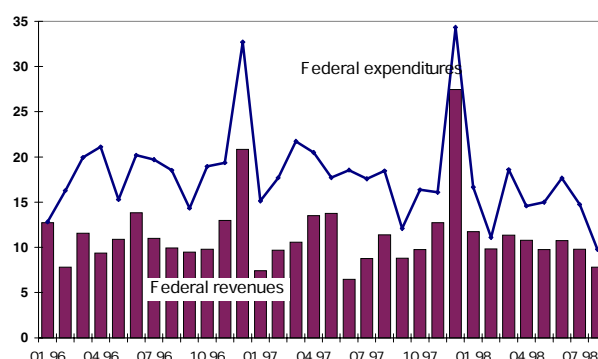
A new emergency budget is being proposed for the last quarter of 1998. It estimates that in October-December the federal government will collect R70 bn of revenues, and suggests expenditure in the period in the region of R168 bn. (For comparison the IMF targets for the fourth quarter were R85 bn and R125 bn.) The non-interest part of these expenditures amounts to R110 bn. This figure includes some provision for the payment of wage arrears. Even if the government made no debt service payments, following this programme it would still need to find money to finance a deficit of at least R40 bn.

Federal budget deficit, % GDP



Source: Ministry of Finance

Federal revenues and expenditures, % GDP



Source: Ministry of Finance

Financial markets

With the country, politics and economy in crisis, the financial markets slid into a worthless untraded morass. The value of all the major instruments has never been lower. Long dated dollar bonds are yielding close to 50% a year, implying that a couple of full coupon payments would mean a positive return. The Moscow Times dollar index is only 25% of its value when it was launched in 1994. Lay-offs in the financial services industry abound indicating the reality: that the financial markets are for the moment as good as dead in Russia.

Moscow Times \$ Index (The Russian bubble)



Source: Moscow Times

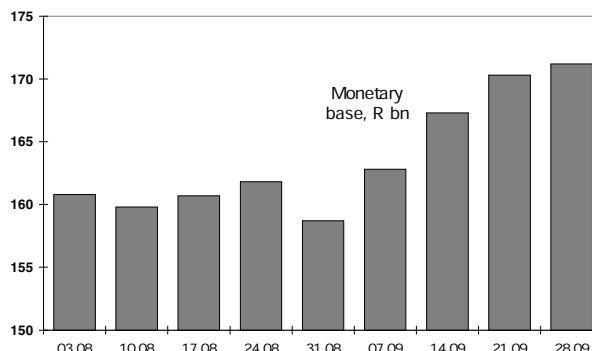
Money and the banking system

The government's discussion of what economic policy it will pursue in the face of the economic crisis centers on the size and priorities of government spending. Such spending implies greater or lesser degrees of money emissions since the government will be unable to borrow large sums domestically or abroad.

While they were talking the Central Bank slowly started acting itself, printing money at a moderate pace to help reactivate the payment system, get sufficient liquidity to Sberbank to calm the bank runs and fund some measure of government spending over and above that financed by the low tax receipts. In the first four weeks of September base money increased by R12.5 bn to R171.2 bn. In the same period, foreign exchange reserves at the Central Bank fell by a fraction to \$12.4 bn.

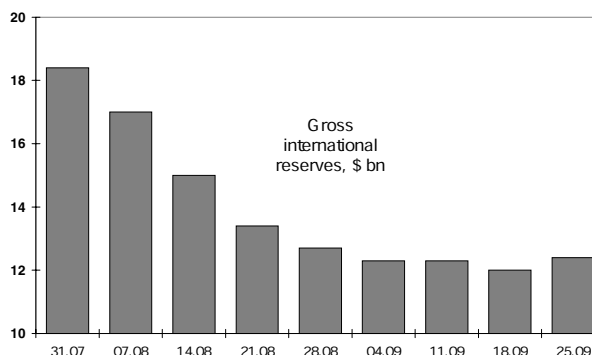
The new Chairman and board of the CBR have been concentrating on unclogging the payment system. Three clearing operations have been conducted, whereby the banks pay and get paid overdue payments with any net difference being drawn from their required reserves held at the Central Bank. Getting the payment system working is a crucial priority, but it does not solve the underlying problem of the insolvency of the banking system. Anecdotal evidence suggests that there will be many bank closures, while lots of accounts are being moved to the state owned banks: Sberbank, Vneshtorgbank and Vneshekonon bank.

Monetary base (weekly data, R bn)



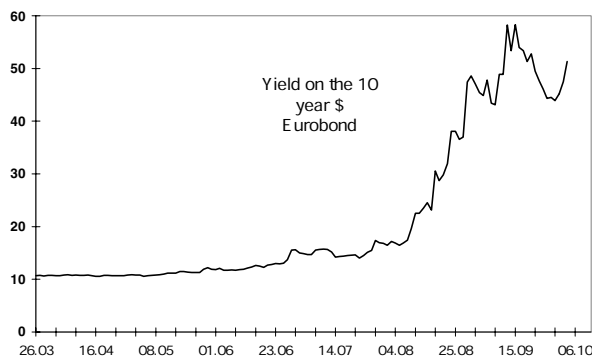
Source: CBR

Gross reserves (weekly data, \$ bn)



Source: CBR

Russian dollar debt interest rates, % per year

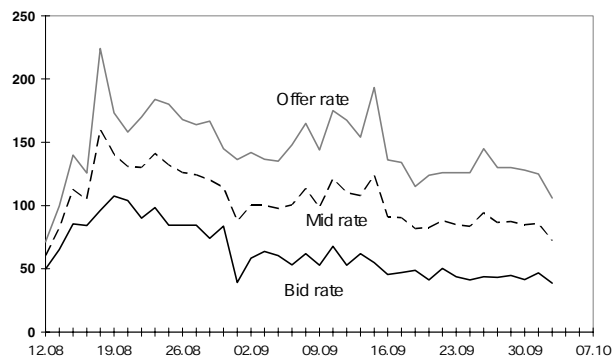


Source: Moscow Times

Interest rates

Given the capital controls, the breakdown of the capital markets, and the effective default on the government rouble debt, there are now two very separate interest rates worthy of note. One is that on foreign dollar debt of the Russian federation mentioned above. The other is the overnight interbank rate. Though there is a large spread between the bid and offer rates on the latter, indicating the illiquidity of the interbank market, this rate indicates conditions experienced by at least some banks in the banking sector. The graph opposite shows that the liquidity crisis is declining somewhat from its peak, illustrated by a slight contraction of the bid-offer spread, and the fall in the rates.

Overnight inter-bank rates, % per year



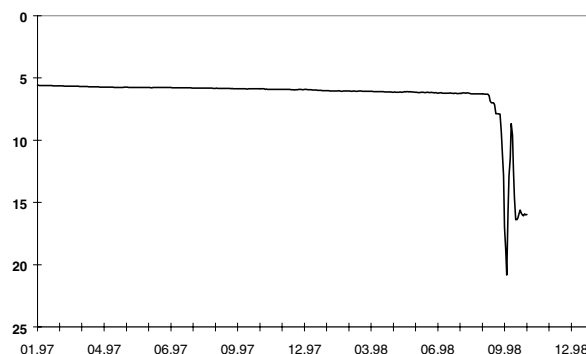
Source: Moscow Times

The exchange rate

In September the exchange rate was extremely volatile. At first it plummeted to a closing low of over R20 per \$, as banks and individuals exchanged all the roubles they could, fearing imminent money printing and ensuing inflation. But the CBR did not start the printing presses in earnest, and with the help of increased exchange controls, got it under control. Then there was the peculiar experience of the rouble appreciating markedly and quickly as the CBR and commercial banks engineered the rouble's appreciation to limit forward contract losses on those contracts maturing on September 15. Since then the rouble's volatility has fallen, with the exchange rate settling at a rate of around R16 per \$ representing a fall of a full 60%. Part of the reason behind the stabilisation of the rate is likely the governments' new decree forcing exporters to sell a further 25% of their foreign exchange earnings to the Central Bank. This is on top of the 50% that had to be already converted on a currency exchange.

The future course of the rouble is unclear and highly dependent on two crucial policy decisions that are currently being taken - how much money is going to be printed, and whether the rouble will be allowed to float cleanly. However the current correction already implies a marked depreciation in the real value of the rouble, which if and when the economy stabilises, means that Russian goods will be considerably more competitive on both domestic and international markets.

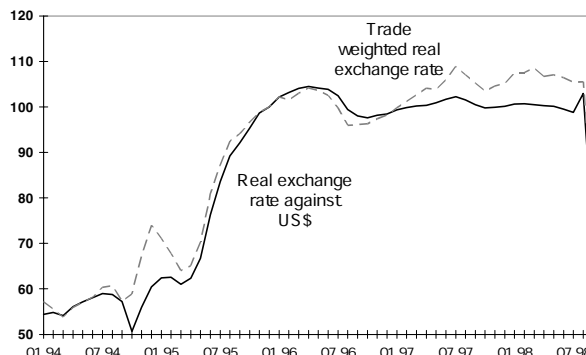
The rouble exchange rate (R/\$)*



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

Source: CBR

The real exchange rate



Source: Moscow Times, Goskomstat