

THE RUSSIAN CRISIS

Paper prepared jointly by the secretariats of the United Nations Conference on Trade and Development and the United Nations Economic Commission for Europe

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A. Introduction

The underlying origins of the Russian crisis of 1998 are to be found in the country's economic structure, institutional environment and political processes. But the character of the crisis has much in common with others in the series of recent financial crises in emerging markets. Whilst the crisis must be seen in the context of policy failures and abortive reform efforts during the 1990s, its unfolding reflected mismanagement of the opening of the country's financial markets to foreign lenders and investors which left the country vulnerable to the risk that domestic financial difficulties (such as those of the management of the market for government debt instruments) could be transformed into a full-blown currency crisis. The crisis brings out the interaction of weaknesses in external and internal economic policy which have resulted in the hardships endured by the public at large during the Russian government's efforts to transform a centrally planned into a market economy.

B. The economic and institutional background

The process of economic transformation in Russia has been marked by a prolonged transitional depression and macroeconomic instability: seven years of continuing decline resulted in a cumulative drop of GDP by more than 40 per cent between 1989 and 1996; in that period there were also several outbursts of near-hyperinflation. The first radical effort to tackle inflation was the IMF-supported stabilization programme of 1995. It focussed on tight monetary control and nominal exchange rate targets; subsequently, direct central bank financing of the budget was discontinued and the exchange rate was placed under control. In the years that followed Russia made marked progress towards price and exchange rate stability (table 1) and this prompted

Table 1
RUSSIAN FEDERATION: SELECTED ECONOMIC INDICATORS, 1993-1998
(Average annual rates of change, per cent, unless otherwise indicated)

	1993	1994	1995	1996	1997	Jan.-Jun. 1998 ^a
Gross domestic product	-8.7	-12.7	-4.1	-3.5	0.8	-0.5
Gross industrial output	-14.1	-20.9	-3.3	-4.0	1.9	0.1
Gross agricultural output	-4.0	-12.0	-8.0	-5.0	0.1	0.6
Gross fixed capital formation ^b	-25.8	-26.0	-7.5	-18.5	-5.0	-6.0
Total employment	-1.7	-3.3	-3.0	-0.7	-0.8	-0.9 ^c
Employment in industry	-2.4	-10.7	-7.5	-4.7	-5.3	-3.9 ^c
Unemployment rate (<i>per cent of labour force, end period</i>)	5.5	7.5	8.8	10.0	11.3	11.5
Consumer prices (<i>annual average</i>)	875.0	309.0	197.4	47.8	14.7	8.4
Consumer prices (year-on-year) ^d	844.2	214.8	131.4	21.8	11.0	6.5 ^e
Industrial producer prices (year-on-year) ^d	902.6	235.1	175.3	25.5	7.4	1.8 ^e
Average gross wages and salaries in the economy (<i>real</i>)	0.4	-8.0	-25.1	1.9	4.6	8.6
Dollar value of average gross wages and salaries	..	71.0	9.3	32.4	6.3	9.4
Money supply (M1) (<i>per cent of GDP</i>)	..	8.0	6.9	7.6	9.0	..
Money supply (broad money) (<i>per cent of GDP</i>)	..	14.5	13.5	14.4	16.0	..
Total credit to non-government sector (<i>per cent of GDP</i>)	..	13.7	10.9	10.0	10.6	..
Average yield on short-term (3-month) treasury bills	..	..	168.0	85.8	26.0	39.2
<i>(annual compound rate, per cent)</i>						
Average short-term lending interest rate of commercial banks	..	..	319.5	146.8	46.2	43.9
<i>(annual compound rate, per cent)</i>						
Average interest rate of commercial banks on time (1-month) deposits	..	..	102.0	55.1	16.4	7.4
<i>(annual compound rate, per cent)</i>						
Share of loss-making enterprises in industry (<i>average for the period, per cent</i>)	..	21.9	25.7	36.4	45.1	47.0
Consolidated budget surplus (- deficit) (<i>per cent of GDP</i>)						
Russian Ministry of Finance methodology ^f	-4.6	-10.7	-3.0	-4.2	-4.4	-4.8
<i>Alternative estimates</i>						
Institute of Economic Analysis (Moscow) ^g	-15.8	-9.6	-5.9	-8.7	-7.7	..
Russian Economic Trends ^h	..	..	-5.9	-8.9	-8.4	-5.9
OECD ⁱ	..	-10.1	-5.7	-8.8	..	..
Current account surplus (- deficit) (<i>per cent of GDP</i>)	3.4	3.3	3.0	3.3	0.6	..
Gross forex debt (<i>end period, billion dollars</i>)	112.8	121.6	120.5	125.0	130.8	..
Official forex reserves (excluding gold) (<i>end period, billion dollars</i>)	5.8	4.0	14.4	11.3	13.0	10.9
Merchandise exports, total (<i>billion dollars</i>)	59.6	68.1	81.3	89.1	87.4	36.0
Merchandise imports, total (<i>billion dollars</i>)	44.3	50.5	60.9	62.3	67.6	33.6
Trade balance (<i>million dollars</i>)	15.3	17.6	20.4	26.8	19.8	2.4
Exchange rate (R/\$, <i>period average</i>)	0.99	2.19	4.56	5.12	5.78	6.12

Source: Secretariat of the United Nations Economic Commission for Europe. For sources of the alternative estimates of the fiscal deficit see notes.

a Preliminary.

b The data for 1997 and 1998 refer to total investment outlays.

c January-June 1998 over January-June 1997.

d December over December.

e June over June.

f As reported by Goskomstat. Deficit in 1994 includes additional forex credit operations and deferred central bank transfers.

g Institute for Economic Analysis, "Ekonomicheskoe razvitiye Rossii v 1997 godu", *Voprosy Ekonomiki* (Moscow), No.3, 1998, pp. 141-142.

h Working Centre for Economic Reform/Russian European Centre for Economic Policy, *Russian Economic Trends*, Monthly Update (Moscow), September 1998.

i OECD, *Economic Surveys Russia 1997-1998*.

positive expectations in the West and a widespread - but in the event deceptive - perception that the country was pursuing the right course of reforms.

It is important to point out that the 1995 stabilization effort was not underpinned by deep structural and institutional reforms. Russia inherited from the past an overindustrialized economy, dominated by highly inefficient heavy industry (including the military-industrial complex). The liberalization of prices and the discontinuation of subsidies resulted *de facto* in the destruction of a large share of the existing capital stock. Restructuring these industries is a daunting policy task: simply closing down the large number of non-viable or inefficient enterprises would not be socially and politically tolerable, while their active restructuring would require - if it is possible at all - new investment of a magnitude which, when compared with Russia's absorptive capacity, was simply implausible even in the medium run.

In these circumstances the Russian authorities opted for a speedy, give-away mass privatization programme which was carried out during 1992-1994. However, this resulted in most cases in the concentration of effective property rights in the hands of insiders (company managers) who had neither the incentives nor the capital to perform the necessary deep restructuring of the enterprises. The newly emerging system of private ownership was not conducive to effective corporate governance and was in fact another obstacle to the process of enterprise restructuring. Moreover, the loopholes in regulation and perverse incentives seem to have incited a continued stripping of the assets of the privatized enterprises rather than their market-oriented restructuring.

The progress in institutional and legislative reforms in Russia in the 1990s has thus been modest and the emerging market infrastructure in the country is extremely feeble. This is especially so in the areas of commercial and corporate law and, indeed, in the establishment of the rule of law in general. Contractual agreements are among the basic foundations of market relations but they have never been supported by an adequate legal framework in Russia: their execution most often relies on the good will of the parties, while contract enforcement is often impossible by legal means.

Very little was done to reform the functioning of Russian public administration whose lack of transparency and irregular practices are well known. This omission gave birth to widespread rent seeking which even in the early phases of the reform process (when the country's assets, including the control of mineral resources, were being privatized) resulted in the *de facto* concentration of wealth in a relatively small group. The latter in turn used its newly acquired economic power to pressure the legislative and regulatory bodies for new concessions. This distorted the socio-political and institutional environment, and the presence of a deliberately malfunctioning public administration has created a vicious circle which is a major obstacle to reforms and to social justice.

One frequent characteristic of the Russian *nouveaux-riches* is the apparent deficiency of entrepreneurial spirit combined with a high propensity to consume. The wealth of numerous members of the new class was not acquired as a result of entrepreneurial success; it was simply "easy money", obtained in some cases from illegal or semi-legal activity. Huge amounts of capital left Russia and were spent on luxury goods and investment in real estate or just placed in safe havens instead of being put to productive use within the country. The unprecedentedly rapid stratification of society and the public perception of a lack of social justice in the process of policy development eroded initial public support for the reforms and strengthened the revival of a conservative opposition to the reform process.

It was in this economic and institutional environment that the Russian government launched the 1995 stabilization programme. Despite the progress in disinflation, the climate for productive investment in Russia remained hostile, mostly due to the negative impact of this environment. Owing to the persistent lack of investor confidence which changed little after 1995, the dramatic fall of investment in productive assets continued, leading to further decapitalization of the economy and undermining the sources of future growth. In real terms, gross fixed investment in 1997 was a mere quarter of its 1991 level. Hence the long awaited recovery failed to materialize and the modest economic upturn in 1997 turned out to be short-lived.

In the absence of a coherent and consistent policy mix, the considerable tightening of monetary policy after 1995 had a marked negative impact on economic activity. The combined

effect of tight monetary policy and the large public-sector borrowing requirement was exceptionally high interest rates (table 1). But, as discussed below, the Russian financial markets were dominated by lucrative speculative operations, and the banks had no incentive to engage in normal lending. As a result, after 1994, total credit to the non-government sector declined as a share of GDP and stayed at a very low level (table 1), and the corporate sector's access to bank finance was extremely limited.

The prolonged financial squeeze on enterprises provoked an acute credit crunch and the emergence of various monetary surrogates (acting as payment substitutes) and widespread barter (closely related to the diffusion of loss-making activity) which eroded further the tax base. Wage arrears kept mounting not only in the public domain but also in the corporate sector: in 1996-1997 the latter was responsible, on average, for about 85 per cent of outstanding wage arrears.

After a short-lived and meagre recovery in 1997 the economic situation started to deteriorate in early 1998. Russia depends heavily on exports of energy resources and other primary commodities which make up 80 per cent of merchandise exports, and the weakening of global demand and the unprecedented fall in their prices in the aftermath of the Asian crisis had a significant negative impact on its economy. There was a sharp fall in export earnings (by some 11 per cent year-on-year in the first half of 1998) and this had a major impact on Russia's external and fiscal balances. The tightening of fiscal policy squeezed the economy further and as early as the second quarter of 1998 economic decline resumed.

C. The fiscal problem

There is wide agreement that mismanagement of a major fiscal imbalance and of the market for government debt was the proximate cause of the present Russian financial crisis. But it is more accurate to say that the persistent Russian fiscal crisis is itself just the expression of the overall crisis of the Russian transformation. Fundamental institutional reform of both taxation and expenditure, an immense challenge in any event, has been repeatedly set back by political conflicts and centrifugal forces. As alternative estimates of the budget deficit suggest (table 1),

none of the fiscal campaigns to address the imbalance have ever succeeded in reducing deficits to sustainable proportions. The principal change has been simply in the method of financing the gap, the major shift from the inflation tax to bond and bill financing occurring in 1995. In view of the high real interest rates necessary to place domestic debt, a sustainable level of the fiscal deficit in relation to GDP could have been attained only if there had been more successful efforts to increase government revenue and economic growth than those actually made.

For the first half of 1998, the consolidated budget deficit (federal, regional and local, but excluding “off-budget” funds) stood at 4.8 per cent of GDP, according to the lowest (Russian State Statistical Committee, Goskomstat) figures.¹ The overall position was considerably worse than this, particularly because the major extra-budgetary fund, the Pension Fund, is reportedly also running an exceptionally large deficit. These figures must also be seen in the context of mounting payments and wage arrears throughout all sectors of the economy.

Recent acute fiscal distress occurred despite a remarkable primary federal budget *surplus* for the first five months of 1998 so that the overall deficit was increasingly showing the impact of the harsh arithmetic of a debt spiral: debt service was fully one-third of federal spending in the first quarter of 1998. This visible strain was in itself another factor undermining confidence in the ability of the government to correct the situation and thus led to increasing difficulty in placing new debt. In July the government-owned Sberbank declined to roll over its holdings of maturing short-term treasury bills (GKO), a remarkable indicator of the fragility of the situation.

The growing burden of interest payments was built into the measures taken in 1995: while Russian official figures continue to record the 1995 budget deficit at 3.0 per cent of GDP, interest payments on the growing stock of GKO were actually adding nearly the same amount to the financing needs in that year. To avoid a debt spiral, any programme adopted then would have had to assume all of the following: a return to economic growth in Russia - indeed, to rapid growth of 4 per cent or more; a stable exchange rate; rising world commodity prices; a

¹ The substantial difference before 1998 between the Russian official figure and all the other estimates, including those of the IMF, is due overwhelmingly to the insistence of the Ministry of Finance that interest payments on (zero-coupon) GKO (treasury bills) should not be counted as expenditure.

government able to manage progress towards a primary budget surplus by means of a major fiscal reform; and the willingness of initial bond holders to roll over and increase their holdings. Not surprisingly, these conditions turned out for the most part to be mutually inconsistent or unattainable. A rise in world oil prices in 1995 and 1996 initially masked this impossibility.

The first issues of GKO were available only to residents, and offered very high interest rates. In 1996, and in part as a result of IMF insistence, the market was opened to non-residents. This did eventually succeed in lowering the interest rates (although the fears that drove up rates before the presidential election of July 1996 locked in subsequent high payments for the debt incurred at that time), but it also clearly meant that the dangerous accumulation of debt could be continued. Until the first major crisis of confidence in November 1997 this is what, in fact, occurred.

D. The financial crisis of summer 1998

The Russian financial crisis of the summer of 1998 shared many features of other financial crises in recent years. Each of these crises can be partly explained in terms of problems specific to the country affected, in Russia's case the shortcomings of its fiscal system described above being particularly important. But recent episodes of financial crisis - and Russia's was no exception - typically involve the attraction of capital inflows associated with an interest rate differential, generally resulting from tight monetary policy introduced for macroeconomic balance, and a currency regime designed to stabilize the exchange rate. The inflows are facilitated by relatively liberal rules for capital-account transactions and deregulation of the financial sector, which leave banks free to borrow abroad, thus benefiting from international interest rate arbitrage but building up foreign exchange exposure. The resulting dependence on foreign capital flows leaves the economy vulnerable to their reversal which can be triggered by unfavourable changes in domestic or external conditions (or both). The outflow of capital following the reversal is likely to cause a devaluation which leads to capital losses on the balance sheets of banks and other firms carrying unhedged currency exposures. The subsequent surge in the demand for foreign

exchange generated by attempts to cover these losses can create a free fall in the country's currency and a hike in interest rates, producing widespread bankruptcies.

As part of its efforts to achieve macroeconomic stabilization, as explained above, the federal government had made increasing use of the issuance of GKO's. As can be seen from table 1, of the government deficit (excluding off-budget funds) as much as 50 per cent was due to interest payments, and under the new policy the resulting obligations were financed in Ponzi fashion by sales of new government paper.² Much of this paper was bought by Russian banks which financed their purchases by borrowing from foreign banks through repo contracts,³ in the process exposing themselves to substantial currency risk. But an important part of the debt was also purchased directly by foreign investors, non-resident holdings of GKO's being estimated at about 30 per cent of the total in mid-1998. Currency risks associated with their investment were offset through the purchase of forward contracts from Russian banks (payments under which, as explained below, have been frozen under a 90-day moratorium on selected external obligations).⁴

As Russia's current account deteriorated from a position of surplus in 1997 (table 1) to a deficit now forecast at 1.5-2 per cent of GDP for 1998 as a whole, the rouble came under pressure and monetary policy was tightened with the result that the interest rates on GKO's reached levels of more than 100 per cent (more than 40 per cent above those on dollar-denominated instruments with similar maturities). The consequent decline in the value of government securities led to calls by the foreign creditors of Russian banks for additional collateral for their repo loans. Russian banks thus came under pressure to raise additional funds

² Ponzi financing denotes the use of additional borrowing to meet interest obligations (which are thus capitalised as part of a borrowers' liabilities).

³ A repo or repurchase agreement is a contract between a seller and a buyer of securities (usually those issued by a government) under which the former repurchases them from the latter at a higher price some time in the future. These contracts are used in many financial markets as a vehicle for short-term financing of inventories of securities, where the securities being financed serve as collateral for the loans.

⁴ The most frequently quoted estimate of the value of forward contracts affected by the 90-day moratorium is about \$10 billion. According to an estimate of Fitch IBCA, the international credit rating agency, which is cited in J. Thornhill, J. Grant and T. Corrigan, "Stakes high in talks to restructure debt", *Financial Times*, 24 August 1998, the notional value of outstanding forward contracts sold by Russian banks is \$40-50 billion.

at just the time when the central bank was draining liquidity from the market as part of its attempt to defend the exchange rate. With the repo market in disarray owing to the falls in the value of government securities, banks' efforts to borrow were transferred to the interbank market which proved unable to sustain these extra demands for funding and eventually ceased to function. These difficulties signalled the liquidity squeeze on Russian banks to international lenders, and increased their fears of widespread insolvencies in the country's financial sector. At the same time the government faced increasing difficulties over borrowing to meet the interest obligations on its debt. The banks had no alternative to closing their repo positions by repaying their borrowing in dollars,⁵ and these repayments put further downward pressure on the exchange rate and international reserves, thus leading to additional monetary tightening and falls in the prices of government securities.

The package of international loans from the IMF, the World Bank and Japan arranged in July was to provide Russia with funding of \$17 billion during the remainder of 1998 and 1999 (which was in addition to financing from the IMF and the World Bank of more than \$5 billion during this period made available under earlier decisions). However, the attempt to defend the exchange rate which followed (and which cost approximately \$4 billion in a month) was eventually abandoned, and a wider band for the rouble/dollar exchange rate was introduced in the third week in August around a new central rate corresponding to a rouble depreciation of more than 25 per cent from the previous level of 6.1 roubles to the dollar. This decision was accompanied by other emergency measures including a 90-day moratorium on obligations on selected private foreign debts with a maturity of more than 180 days and on those due to margin calls⁶ and foreign exchange contracts, other capital controls such as a ban on purchases by non-residents of domestic bonds with a maturity of up to one year, and guarantees for private bank deposits. The government also announced a moratorium on its own debt which is to precede an eventual forced conversion of GKO's and other bonds maturing in 1999 into longer-term debt

⁵ Of the approximately \$19 billion of external liabilities at the largest Russian banks in mid-1998 about \$16 billion had a maturity of one year or less; see J.P. Morgan, *Global Data Watch*, 21 August 1998, p. 7.

⁶ Margin calls are the calls for additional monies from Russian banks due to unfavourable changes in various categories of their foreign-currency exposure owing to falls in asset prices (of which those for government securities used as collateral in repo loans mentioned above are an example).

instruments (a step which followed a largely unsuccessful attempt earlier in the year to persuade investors to exchange their holdings of GKO's for longer-term dollar-denominated debt).

The moratorium on government debt caused large losses to foreign banks as the value of the debt was written down, and additional losses resulted from the abortion of forward exchange contracts under the moratorium on selected external obligations. For Russian banks the losses associated with the crisis are estimated at 40 per cent of their assets.⁷ The events and the emergency policy response took place during a period when Russia was formally observing an IMF stabilization programme.

At the outbreak of the crisis the total exposure of non-residents to the Russian economy in the forms of debt and equity amounted probably to \$200-250 billion, though subsequent falls in asset prices are likely to mean that the figure is now lower.⁸ The exposure is unequally distributed, a high proportion being concentrated among West European lenders and investors. This figure constitutes a very small fraction of investors' and lenders' global external exposure: in the case of German banks, for example, whose lending to Russia amounts to more than 50 per cent of the total by international banks, their assets in Russia are less than 5 per cent of their total foreign assets.⁹

But despite the small scale of international exposure to Russia, the emergency measures taken by its government nevertheless were accompanied by significant declines in prices in international financial markets, substantial downward revisions in forecast levels of capital inflows to developing and transition economies, and unfavourable shifts in indicators of such economies'

⁷ See J. Thornhill, "Gerashchenko holds the key to market's long term future", *Financial Times*, 17 September 1998. Before the devaluation Russian banks' foreign exchange liabilities amounted to almost 70 per cent of their equity. Thus a 10-per-cent depreciation of the rouble reduced their equity by about 7 per cent; see J.P. Morgan, *Global Data Watch*, 2 October 1998, p. 14. In early September (after the abandonment by the central bank of the new band for the rouble/dollar exchange rate) the rouble lost half of its value against the dollar.

⁸ C. Harris and J. Grant, "World's exposure exceeds \$200 billion", *Financial Times*, 28 August 1998.

⁹ J.P. Morgan, *ibid.*, p. 42. Exposure in the form of official export credit insurance for the financing of Russian import was also relatively large for Germany but small in relation to the country's government budget; see J.P. Morgan, *Global Data Watch*, 4 September 1998, p. 40.

creditworthiness as the yield spreads¹⁰ on their external bonds in secondary markets. The pervasive declines in equity prices, which were particularly large in several emerging financial markets,¹¹ reflected partly investors' liquidation of positions elsewhere to make provision for their losses in Russia, but were also influenced by a reassessment of price levels in stock markets more generally associated with fears that financial disturbances might produce a global recession. Despite a continuation of relatively high yield spreads in secondary markets on the international bonds of most borrowers from developing and transition economies in the first half of 1998,¹² forecasts by various financial institutions for capital inflows remained relatively optimistic. However, since the outbreak of the Russian crisis these forecasts have been revised downwards, the changes being substantial, for example, in the case of Latin America.¹³ The reassessment of the creditworthiness of borrowers from developing and transition economies has also been reflected in a virtual standstill of their international issues of debt instruments and in increases in the already fairly high levels of the yield spreads on their international bonds in secondary markets just mentioned (chart 1).

¹⁰ For the definition of yield spreads see chart 1.

¹¹ Declines in equity prices were recorded in all 23 of a group of the main emerging financial markets during August 1998 by amounts which varied from 10 per cent or less in Hong Kong China, India, and Republic of Korea to more than 25 per cent in more than one-half of the sample.

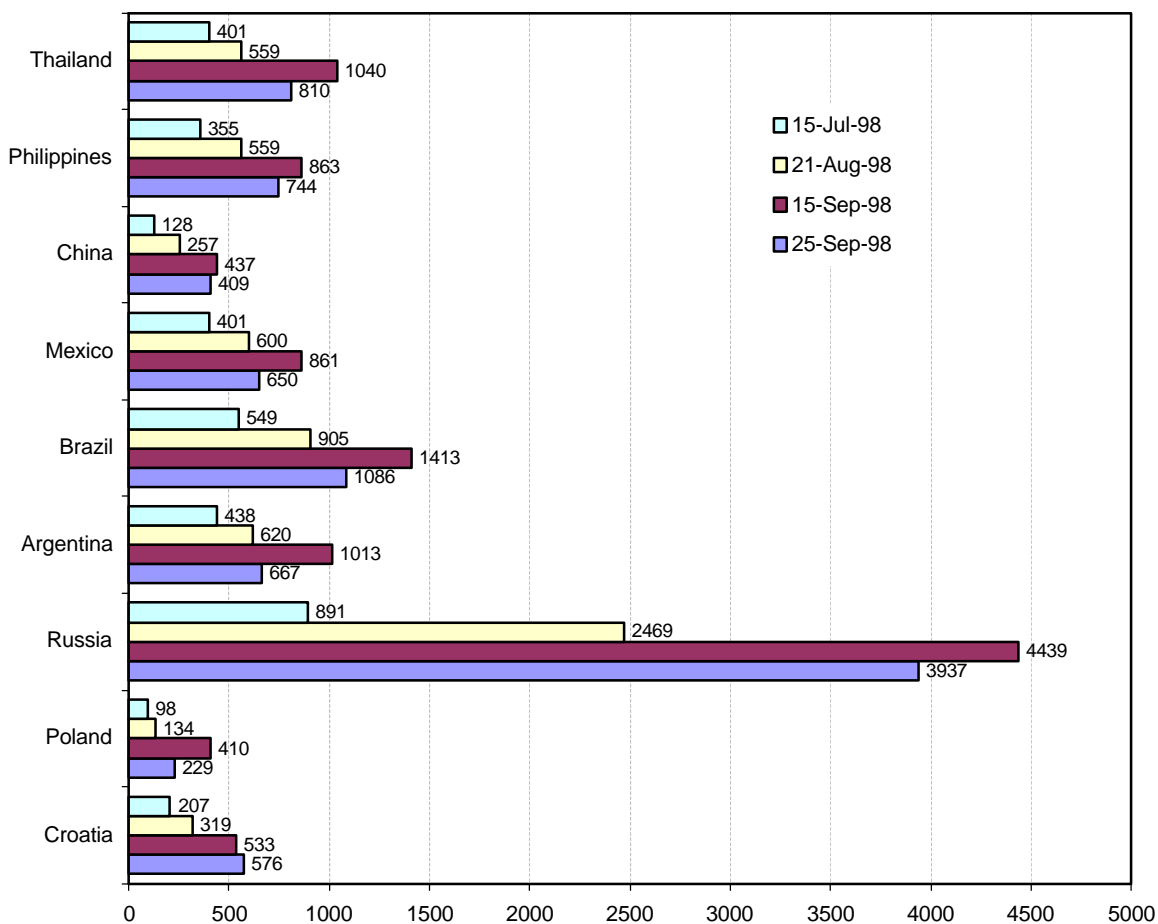
¹² See *Trade and Development Report, 1998*, Part One, chap. III, chart 2.

¹³ The downward revisions in forecast capital inflows involve principally 1999, those for 1998 as a whole being affected to only a limited extent by recent developments. As of late August J.P. Morgan is forecasting a decline of about 35 per cent in capital inflows to developing and transition economies in 1999 (down from a decline of less than 5 per cent forecast at the beginning of July), a substantial part of this decline being accounted for by Latin America; see J.P. Morgan, *Global Data Watch*, 28 August, p. 2. The International Institute of Finance is at present forecasting little overall change in capital flows to 29 major emerging market economies but a decline of more than 10 per cent for Latin American members of the group; see International Institute of Finance, *Press Release*, 29 September 1998.

Chart 1

**SELECTED INTERNATIONALLY ISSUED EMERGING MARKETS BONDS:
YIELD SPREAD ^a OVER UNITED STATES TREASURY BONDS**

(Basis points ^b)



Source: *Financial Times*, various issues.

- a** Differential between the yield on bonds issued by the borrowing country and those of the same maturity issued by the government of the country in whose currency the borrower's bonds are denominated.
- b** 1/100th of one per cent.

E. Interpretation and conclusions

1. Structural weaknesses of Russia's fiscal management

Policy makers are now faced with the urgent tasks of restoring financial stability in Russia and drawing up a coherent programme of reform which will necessarily have to focus on building the institutional framework for market-based activity. But before the latter can be achieved, it is important to reach a more realistic understanding of what has gone wrong over the past several years. At present, the mainstream diagnosis seems to be that the short-termism of the Russian programme was part of a necessary gamble which did not pay off: Russian stabilization has failed, on this view, because the time gained was not used to implement necessary reforms, especially in the fiscal field. In particular, dismay has been expressed at the failure of the Duma in July to implement a full set of emergency measures, which would have included a shift towards individual income taxation.

The conventional wisdom on this question does recognise that further fiscal reform in Russia is a “tall order”, although at times it has been presented simplistically as a simple question of political will. There has yet to be a recognition, however, of more fundamental design flaws in the programme pursued from 1995. The core problem for fiscal policy is that owing to the limited resources and the restricted set of operational policy instruments available in a structurally unreformed Russia the programme was inherently unable to achieve a sustainable degree of economic stabilization. This runs counter to the view often expressed by the international financial institutions.¹⁴ On the contrary, the measures which were feasible to extract revenue and to cut spending propelled the economy further away from an orderly path to a market economy, and instead drove it towards increased reliance on barter, monetary surrogates and mutual “offsets”, and mounting arrears, public and private, of which wage arrears are only the most visible, journalistically interesting and potentially explosive manifestation.

¹⁴ Thus the First Deputy Managing Director of the IMF noted in January 1998: “In summary, Russian economic reform is entering a less dramatic phase than that of the last few years: the most important battles in securing macroeconomic stabilization and creating a market economy have been won, but much remains to be done to secure the future growth of the economy”, “The Russian economy at the start of 1998” (<http://www.imf.org/external/np/speeches/1998>).

Throughout recent years the fiscal problem has always demanded more than a marginal adjustment of expenditure to revenue. The Russian state, weak from its inception, has not been able to establish a budgetary process, oversight and audit, and a working system of fiscal federalism, which would allow genuine control over expenditure. On the other side of the balance sheet, the institutional deepening necessary to create a law-governed system of tax administration, to introduce a workable tax code, and thus to strengthen tax collection lagged behind the demands for revenue. In the context of a chaotic, opaque and arbitrary system, periodic campaign-style attempts to improve fiscal discipline to meet IMF targets generally succeeded in worsening fundamentals for the longer run.

The mechanism by which the almost exclusive focus on the only clearly achievable goal, price stability, sowed the seeds of its own destruction, lay first of all in the development of a pernicious cycle in the fiscal process. The budget adopted annually consciously chose simply to paper over the gap between the revenue which could actually be collected and the expenditure being proposed. This meant, on the one hand, that revenues always had to be collected by “campaign methods”, and, on the other, that non-payment by the government of its own bills was endemic. Not only was there formal sequestration with revenue shortfalls, but also a welter of *ad hoc* non-payment and “offset” processes, the extensive development of monetary surrogates (especially at the regional level), and, necessarily, an increased toleration of tax arrears by those who, in turn, had not been paid sums due from the budget. This established, first of all, a culture of non-payment and an intricate web of arrears. The constant press of demands of tax collection, set in a legal framework famous for its inconsistency and room for “discretion”, consistently penalised those entities which attempted to live legally, and thus continued to narrow the tax base.

The issue of non-payment of taxes due from the important energy sector reveals the unusual character of the Russian fiscal dilemma. The popular perception in the West that arrogant oil and gas barons simply were unwilling to pay the taxes due needs some correction. In the complex tangle of non-payment, the Russian government also came to demand that energy be provided free of charge (that is, with no disconnection for non-payment) to a substantial

proportion of users. The demand for cash payments in addition to this effective “tax-in-kind” understandably appeared as a form of double taxation.

As this cycle developed, the economic system was effectively demonetised, with a particularly sharp impact on the payment of wages and pensions. Attempts to solve this problem also took on a campaign air: thus there were energetic efforts to pay off wage and pension arrears on several occasions. The systemic character of the arrears and barter problem, however, was increasingly revealed by the ultimately abortive nature of these efforts. This can be seen from one notable example: from 1 January 1998 the federal authorities (successfully) insisted on payment only in monetary form, but the outcome was a worsening in the fiscal position of the regional authorities and the off-budget funds, and a dramatic rise in wage arrears, which increased 38.5 per cent *in real terms* from the start of the year to the end of July.

The orientation towards stabilization through borrowing was further exacerbated by the setting of inflation targets which were inappropriately low for an economy undergoing major restructuring. To continue this course, very high rates of interest were often required. Although credit to the real sector has been low throughout this period, high rates of interest inevitably helped to reduce fixed investment, and thus almost certainly played a major role in choking off growth in 1998. This, in turn, had further negative implications for the fiscal position.

There are no institutional fiscal adjustments which could have dramatically improved the fiscal balance in an inexpensive way, through simple rationalization, given the conditions in which the reform process began in Russia. Restructuring is never inexpensive. The present financial crisis is thus the outcome of a series of decisions, domestic and foreign, which have persistently denied the sheer magnitude of the transformation required in Russia.

2. *The currency crisis, transparency and contagion*

The dangers inherent in the inadequacy of the efforts to achieve fiscal balance have been exacerbated by dependence on foreign financing both in the form of direct investment in government debt instruments and in that of lending to finance Russian banks’ purchases of these

instruments. This dependence increased the vulnerability of the Russian economy to a generalized debt run as part of a currency crisis whose consequences are much more extensive than those of a debt run by the creditors of domestic debtors.¹⁵

Lessons drawn concerning the external dimension of Russia's financial crisis should not be limited to the government's mismanagement of the opening of its financial markets to foreign investors and lenders or the vulnerabilities associated with reliance on capital inflows for financing fiscal deficits. This experience also highlights once more the irrational exuberance and herd behaviour of international lenders and investors in entering as well as exiting emerging markets.

Since the crisis in East Asia inadequacy of information and lack of transparency regarding structural weaknesses in emerging financial markets have been the subject of greatly enhanced attention as an explanation of build-up of external fragility and crisis. However, much of the increase in the external financial exposure to Russia took place during a period when information was widely available concerning the shortcomings of Russian macroeconomic policy, the weaknesses of the country's banks, and the underdeveloped state of the country's legal and regulatory framework and of its system of corporate governance. Moreover, as noted earlier, most of the recent capital inflows into Russia took place when the country was carrying out IMF stabilization programmes. The Russian experience thus raises serious questions as to the effectiveness of enhanced transparency in influencing the behaviour of international lenders and investors, and as to the relation between programmes of official external financial support and moral hazard.

The immediacy and scale of falls in asset prices and other unfavourable shifts in indicators of the creditworthiness of emerging financial markets in Asia and Latin America noted above are a stark reminder of the potency of contagion effects and of the vulnerability of recipients of capital flows to the so-called "flights to quality" of investors in today's global network of financial markets. The aftermath of the Russian crisis has once again emphasised the inadequacy of current arrangements for dealing with global financial instability.

¹⁵ See *Trade and Development Report, 1998*, Part One, chap. IV, sect. B.1.