Russian Crisis Essay, Research Paper

The improper financial policies implemented by the Russian government during and previous to the economic crisis of November 1997 causing Russia’s economy to decline lead to a severe crisis in August of 1998 which my avoided been contained or avoided if the situation would have been handled differently.

Since May of 1998, Russia has been caught in the latest, and likely the most serious economic crisis. The crisis came to a head on August 17, 1998, when the government of then-Premier Sergei Kiriyenko abandoned its defense of a strong ruble exchange rate against the dollar by defaulted on government domestic debt forcing its restructuring, and placed a 90-day moratorium on commercial external debt payments. Those actions led to President Yeltsin’s dismissal of Kiriyenko on August 23, replaced, after a political standoff with the Duma, by a more leftward-leaning government led by 35 year former energy secretary Yevgennij Primakov. The August crisis also lowered Russians’ standard of living and set back Russia’s efforts toward establishing a market economy, perhaps for years to come.

The direct cause of crisis has been the Russian government’s failure to address fiscal imbalances. Less direct but more fundamental causes have been structural problems. The government has an inefficient tax regime that fails to generate sufficient revenues to meet fiscal obligations. More fundamentally, incomplete economic restructuring has left an economy, much of which is run on barter, that masks inefficient and even “value-subtracting” economic activities, and that makes attaining fiscal balances even more arduous. But Russia has faced difficult setbacks along the way, this current crisis being the most serious. The effects of this crisis and how Russian policymakers manage seems likely to determine the future of Russian economic reform, and, consequently, prospects for long-term Russian economic growth and development.

Crisis in October 1997 as a seed of crisis in August 1998

What the world financial crisis was, Russians knew basically from the books. It was so before October 23, 1997, when after unprecedented collapse of the world’s major stock exchanges it became clear that this could happen in Russia as well. Because Russian stock market became a part of the world financial system.

The major cause of the stock exchange collapse was common crisis of the exchange markets in South Asian countries, which were characterized by rapid economic growth and by extremely easy accessibility to the western credits. Financial market was developing correspondently. Cash inflow had been accompanied by skyrocketing growth of the securities rates.

However, by the end of the summer the external debt of some South Asian countries approached the critical point. At the same time the export, the basis of the financial pyramid, essentially reduced its growth, causing the trade balance deficit. As a result of this foreign exchanges crisis the capital forwarded to Hong-Kong stock exchange, which at the moment managed to hold its market positions.

On that day an unprecedented crush of the stock rates was recorded at Hong Kong stock exchange, the cumulative index dropped by 1600 points, or 14%. Panics embraced the market. The world’s largest investors urgently began to call back their funds not only from Hong-Kong exchange, but also from all South Asian stock markets. Then everything worked according to domino scheme – crisis jumped to all major exchanges.

On October 27, 1997 Dow Jones dropped by more than 550 points, which was the record fail in its whole history. It was deep night in Russia when it happened, and therefore the crisis came to them only on the following day.

In first minutes of the beginning of trades at Russian stock market brokers characterized the situation as “near to collapse”. Foreign investors, who played a major role on the Russian market, were intensively selling out quickly depreciating securities. Because of the quick decreasing of the stock rates in 5 minutes from the beginning, the trades on the Moscow Foreign Currency Exchange (MFCE) were paused. At the same time the rate of the stocks of RAO “Gasprom” (leading Russian stocks) at Moscow Stock Exchange dropped by 7,5%, and the trades were stopped. Second opening of the Russian Trading System practically didn’t change anything, because in 10 minutes after trades resuming “Gasprom” stocks dropped by additional 8%. One of the witnesses is telling how it was at stock exchange:

“From the beginning of trades has passed only an hour, but stock quotes dropped by that time by 10%. Somebody lost one more million of dollars. The market was crashing. It wasn’t decreasing or correction, but crush. I couldn’t follow after the numbers on the brokers’ monitors. “Mosenergy” – minus 5% from the moment of opening, “Lukoil” – minus 6%, “Rostelecom” minus 8%. Again “Mosenergy” – already minus 6.5%. In front of my eyes people were losing millions of dollars”

Comparatively abrupt jump was noticed at Russian foreign exchange market as well. On October 28 US dollar raised comparatively to Russian ruble by 54 points. However the Central Bank managed to handle the situation without dollar intervention. But Russian governmental bonds in foreign exchanges suffered essentially. The cause of the catastrophic dropping of the foreign exchange securities is very strong market internationalization. Major parts of the investors in Russian securities were situated abroad, where was pretty hot on those days and without Russian securities. Nobody could support these sectors – in scales of the world’s capital market, Russian market of foreign exchange obligations was hardly recognizable.

On Monday, November 10, 1997 the Central Bank of Russia admitted that financial crisis was in the country. For that reason Central Bank announced increasing of the key interest rate from 21% to 28%. It had also been announced that beginning January 1998 1 US dollar at Russian market would be equal to 6200 rubles plus-minus 15%. Practically, it meant the end of the currency corridor, since by the rules of the MFCE dollar exchange rates couldn’t change by more than 10% in one trade day. Finally, the requirements for the reserve funds in foreign currencies were increased from 6% to 9% for banks.

These measures were necessary, because there were no other way to normalize the situation at financial market. Foreign investors possessed about 30% of the money, invested at that moment in government bonds, and not less than 70% invested in stocks. And they, following the market laws, quickly began to sell these assets. As a result of the massive selling of government bonds their prices began to drop and the yields to rise. Money, gotten from the selling of government bonds, were immediately forwarded by foreign investors to the foreign exchanges market, were they were converted into dollars, lowering ruble’s exchange rate. To support ruble’s rate, Central Bank was forced to spend large amounts of its foreign exchanges reserves. In such situation it is necessary to make money more expensive, which can be achieved by increasing the key interest rates and norms of minimal reserves. Since the reserves were to be formed in rubles, banks were rather to sell American currency, than buy it.

As history showed, these measures worked and market relatively normalized. However, since then Russia has been facing a decline in investors confidence which in turn has led to a deterioration in general economic conditions, causing next, by far more severe crisis of August 1998.

Crisis in August 1998

Causes:

1. External influence

The Russian crisis occurs as other regions of the world, such as East Asia and Latin America, are undergoing financial crises and problems. The global financial crisis as a whole has created unease in world financial markets and has raised questions about the strength of the international financial system. Since at least May 1998, Russia has been facing a rapid decline in investor confidence, which in turn has led to a deterioration in general economic conditions. The crisis has occurred against the backdrop of a weak Russian economy struggling to restructure and rebuild after the collapse of the Soviet system and, is in fact, an outgrowth of that struggle. The crisis was manifested in financial and other economic indicators, both domestic and external. Furthermore, the trends in most cases are worsening raising concerns about Russia’s prospects.

2. Worsening of all major macroeconomic indicators

Since May 1998 Russia has experienced declining gross domestic product (GDP), increasing inflation, increasing unemployment, and staggering interest rates. These trends connote a halt to, and possibly a reversal of, the progress, albeit limited, that Russia was finally making in establishing sustainable economic growth and macroeconomic stability. First the falling Russian GDP. Official Russian statistics estimate that the Russian real (adjusted for inflation) GDP contracted 4.6% in 1998. This contraction occurred after the Russian economy finally realized economic growth, although modest, of 0.8% in 1997, after having declined close to 40% since 1991. A contracting economy, especially over a long period, leads to a deterioration in living standards. Secondly the high inflation in the Russian economy. The Russian inflation rate in 1998, using the consumer price index, hit 84.4%. This figure appeared to be a significant setback for the Russian economy which had realized a manageable inflation rate of 11% in 1997. High inflation rates, which rose as much as 2500%in 1992, had been a major challenge to Russian economic policymakers ever since Russia embarked on economic reform in late 1991, but they seemed to have gotten it under control until recently. High inflation robs holders of rubles of potential purchasing power, contributing to a decline in the living standard. Inflation is especially debilitating financially to pensioners and others on fixed incomes. Unemployment in Russia has steadily increased in recent years. Economic contraction has led to growing unemployment in Russia. By the end of 1998, the Russian unemployment rate had reached close to 12% having increased from 7.0% in 1994. While the current crisis cannot be blamed entirely for the unemployment problem, the decline in economic growth has set back attempts to reduce it.

3. High interest rates

Another cause was the high interest rates which Russia was experiencing. For a critical period in 1998, Russian interest rates increased sharply as a sign of loss of investor confidence. In May 1998, interest rates on GKOs, that is Russian treasury bills used to finance government budget deficits, roughly doubled from 27.8% the month before, to 54.8%. They continued to climb and peaked at 135.3% in August 1998. Other critical interest rates also climbed to very high levels. The Russian Central Banks’s refinancing rate spiked at 150% during the week of May 27 to June 4, 1998. While rates have decreased they nevertheless remain high. High interest rates cripple Russia’s ability to finance its government budget deficits and have stifled investment in the non-government sector as well.

Immediate causes

1. Fiscal policies

In dissecting crisis and trying to explain the reasons it developed two sets of related causes emerge. The most immediate and direct causes are the government’s financial imbalances and Russian fiscal policies that have made Russia very vulnerable to the vagaries of the global financial markets. Russia’s immediate financial problems center on its fiscal situation. The Russian government has run persistently high budget deficits. While general government expenditures (that is, expenditures of the federal and regional governments, plus extra-budget expenditures) have declined, some areas of public spending have not been adequately controlled. The government has not been able to cover its expenditures with revenues. From 1995 and until recently, the government had financed much of its budget deficit by borrowing in capital markets and issuing treasury bills, known by the Russian acronym GKOs, and bonds. On the upside, borrowing allowed the government to dramatically reduce inflation from a peak annual rate of 2,500% in 1992, to around 11% by the end of 1997. However, the low inflation rate may be superficial given that many state employees are not being paid and parts of the economy have increased bartering and have relied on other nonmonetary means of payment such as interenterprise debt.

2. Tax collection

The growth in government financial imbalances and borrowing practices largely explain the suddenness of the current financial crisis in Russia. But how Russia got to this point of vulnerability analysts explain by citing more fundamental problems with Russian economic policy and economic structure. One such problem has been the inability of the Russian government to collect revenues adequate to match expenditures. Many analysts and Russia’s Western creditors have pointed to Russia’s tax regime as being inefficient and a factor in the lack of sufficient tax revenues. The Russian system has consisted of some 200 different types of taxes at various levels of government (federal, regional and local) making administration of the regime unduly burdensome. The governments have frequently changed regulations on implementing the tax regime, making compliance even more burdensome. In addition, the governments have granted tax exemptions to favored sectors and enterprises reducing the potential revenue. Analysts have pointed out that the division of tax authority among the various levels of government has been unclear and conflicts have erupted making tax administration and compliance arduous. Importantly, the government has not had the resources, such as a sufficient number of tax inspectors, to administer tax collection.

3. High yields on treasury bills

The Russian government had to offer high yields on its treasury bills and bonds in order to attract the necessary capital. As a result, the borrowing added a new and heavy debt service burden to the Russian budget. Debt service expenditures have accounted for more than 30% of total Russian expenditures. In 1997 and the beginning of 1998, Russian treasury bill rates were averaging more than 25% per annum. Adjusting for inflation would make the real interest rate around 10%. During the late part of May and beginning of June 1998, the Russian government had to boost interest rates on bonds and bills even higher. Notably, most Russian domestic debt was short-term with an average maturity of around 11 months. That meant the debt had to be constantly rolled over, making the Russian government highly vulnerable to short-term fluctuations of capital markets. About 1/3 of the debt is held by foreign investors. The government also has not been able to rein in subsidies to agriculture, the residents of the far northern regions, and the oil and gas industries. It also has not adequately dealt with social payments to the aged, disabled, and others who require a financial safety net. The increasing burden of debt service made it difficult, if not impossible to address other budgetary priorities. Payments to workers, soldiers, pensioners, and contractors were deferred, building up arrears. Now Russia has not been able to pay banks and other investors who hold the government debt, which has created the current crisis.

In sum, the Russian government survived financially, until recently, by accruing ever growing debt and government nonpayment of fiscal obligations to workers, soldiers, and others. These practices masked the weaknesses in the government’s ability to rein in subsidies and raise revenues. It managed to continue as long as investors were willing to renew short-term debt. But the Asian financial problems and other factors created uncertainty in emerging capital markets on the part of investors, and slumping oil prices made hard currency revenues scarcer, bringing the crisis to a head.

Russian “infection”, spreading the neighboring countries

As for Russia’s impact on the rest of eastern Europe, the fallout has been quickest to hit banks, notably in the Baltic states, and stock markets, with Hungary’s liquid bourse taking the worst pounding. But financial market contagion was not the real evil to the region; the genuine menace lied in the economic impact of ruble and Russian recession.

Take the little Caucasian republic of Armenia, for example. Although Armenia has made good progress in recent years in strengthening trade links with Iran, Russia remains Armenia’s dominant economic partner. That’s true of actual trade, and the supply of credits, and joint projects.

In addition, there are hundreds of thousands of Armenians now living in Russia working unofficially. They send back millions of rubles in wages to their families at home. It’s obvious then that Armenia had direct impact of catastrophe in Russia.

Looking further east, to Central Asia, we find similar ties between Kazakhstan and Russia. The Kazakh government has made efforts to re-align trade southwards and westwards, to Pakistan and Turkey. But Russia still supplies the bulk of the consumer and industrial market in Kazakhstan, and likewise takes Kazakh exports.

The results and suggestions

There are many underlying aspects to Russia’s crisis. The “Asian crisis” spooked fund managers into withdrawing from most “emerging markets.” World oil prices have fallen dramatically, seriously impacting Russia’s exports and balance of trade, Russian tax collections continued to disappoint and, in the few years since economic reform commenced, no significant, viable world class industries have yet emerged in Russia. The Russian Government couldn’t ease the Asian economic crisis or raise international oil prices, and development of competitive world-class businesses within Russia, if it is to happen, will take time.

What lessons should Russia’s leaders learn:

? If the socialist economy no longer functions, the government should try to disinflate as rapidly as possible. A delayed disinflation will be much more painful.

? If the government is confronted with delayed disinflation, it should cut budget deficits radically.

? The illusion of being able to finance the deficit out of a short-term portfolio should be abandoned.

? It should be understood that hardening the budget constraint is important not only for raising budget revenues but also for allowing market mechanisms to work and thus for increasing the efficiency of the economy.

So what is it that Russia can do to assure that it continues to progress towards its rightful place as a world economic power?

At the very least Russia’s political leaders must:

? Understand that the policy of seeking ever more cash from the West is not a policy that will develop Russia politically or economically.

? In short the Duma must accept responsibility for its crucial role in Russia’s future. Short-term political ambitions and partisan hopes that the failure of “Yeltsin’s reforms” will lead to greater political advantage for the opposition in the Duma must yield to the reality that international lenders will not keep lending to Russia forever.

? And most importantly, take immediate, positive steps to encourage long-term foreign direct investment (“FDI”) in Russia.

Why to focus on FDI?

Unlike portfolio investment in equities and debt, FDI directly creates jobs and cannot be withdrawn by a computer keystroke. The comparatively miniscule amount of FDI in Russia should be a source of acute embarrassment to the Duma and a stimulus to prompt, decisive action. Foreign investors do not expect guarantees of profit or protection from market forces. They do require some hope of tax stability and reasonable support, rather than interference, from the Government. To date Russia has attracted a meager amount of FDI even without offering such conditions.

Appendix

Exchange rate of Russian ruble comparatively to US dollar (the denomination in the 1998 is not considered)

Percentage of changing of Exchange rate of Russian ruble

comparatively to US dollar

S. Commander, C. Mumssen, Understanding Barter in Russia. (EBRD Working paper 37, 1998).

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Michel Camdessus ;Managing Director of the International Monetary Fund European-American Business Council New York, September 15, 1998

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