Essay

Russia's Financial Collapse

by Vladimir Popov

The words, "currency crisis" tend to be associated with Southeast Asia, at least over the past year, but transition economies are also experiencing turmoil with their currencies. The Russian currency crisis of August 1998 was perhaps the most spectacular example, but it was preceded by similar crises in Bulgaria and Romania in 1996 and in Ukraine and Belarus in 1997-98. In late 1998, currency crises in Kyrgyzstan and Georgia erupted. Were these crises the result of a financial "contagion" spreading throughout the global economy? Or were they primarily induced domestically, but caused by reasons similar to those in Southeast Asia? I believe that neither hypothesis holds true. A third alternative explanation--that the currency crises in transition economies resulted mostly from domestic policy mistakes, but of different nature than those in Southeast Asia--makes the most sense.

Currency crises in post-Communist countries may be best explained by "first generation" currency crisis models, or straightforward macroeconomic mismanagement: overvaluation of the exchange rates before the crises. In Russia the crisis was aggravated by the decision to default on its short-term--and later long-term--debt. That decision was completely unnecessary--the debt crisis was artificially manufactured by the government. In contrast, Southeast Asian currencies were not overvalued; macroeconomic policy was prudent, and fundamentals were sound. Their collapse became a side-effect of the private-sector debt crisis, which was spurred by the overextension of credit by banks and companies financed by foreign borrowing.

The Crisis, Up-Close

Within a few days after August 17, 1998, the Russian ruble--which had been stable during the preceding three years--lost more than 60 percent of its value vis- • Evis the dollar; prices increased by 50 percent within just two months of the crisis, as compared to less than 1 percent monthly inflation before the crisis; and real output fell by about 6 percent in 1998 after registering a small increase (for the first time since 1989) of 0.6 percent in 1997. It is expected to fall by a similar amount in 1999.

What is worse, the financial collapse in Russia marked the failure of the government program of macroeconomic stabilization that was pursued for more than three years with considerable success. After experiencing spiraling inflation of several hundred percent a year during the period immediately following the deregulation of prices on January 2, 1992, Russia finally opted for an exchange-rate based-stabilization program. In mid-1995, the Central Bank of Russia (CBR)--after accumulating foreign exchange reserves and managing to maintain currency stability for the first half of 1995--introduced the "crawling peg" system: an exchange rate corridor with boundaries that were, at least initially, very narrow.

The program was based on the determination of both the government and the CBR to put the brakes on the growth of the money supply, and thus to curb inflation. The key to the program was to contain within reasonable limits the government budget deficit, and to find financing methods that were non-inflationary. For three long years, the government backed its promises on both fronts. It managed not to increase the budget deficit, even though this required drastic cuts in spending, since budget revenues--despite laudable and persistent efforts to improve tax collection--continued to fall. The government also managed to finance the deficit mostly by borrowing. This was achieved in part by selling short-term, ruble-denominated Treasury Bills (which were also purchased by foreign investors), and partly by borrowing abroad in hard currency from international financial institutions, and from Western governments, banks, and the Eurobond market. Under these conditions, the CBR ensured the slowing of the growth of the money supply and brought inflation under control.

Thus, macroeconomic stabilization became a reality. Inflation right before the crisis was running at only 6 percent a year (July 1998 to July 1997), the reduction of output stopped, and the country was looking forward to economic growth. Russia's macroeconomic stabilization, however, was based on a weak foundation: the overvalued ruble since late 1995, and the subsequent policy of the CBR to keep the real exchange rate intact (that is, to proceed with the devaluation of the nominal rate in line with the ongoing inflation).

As a result, the "Dutch disease" developed in Russia after 1995. Domestic prices were typically about 70 percent of international prices, and stayed at this level until the crisis. The previously high export growth rates slowed down substantially. In 1997 total exports fell for the first time since 1992. Needless to say, it was Russia's already weak export of manufactured goods that was most affected by the appreciation of the real exchange rate. From 1996 to 1998, among economies in transition, Russia and Ukraine (together with Slovenia, which was by far the richest country in the former Soviet bloc, and which had experienced recovery since 1993) had the smallest gap between domestic and international prices.

The decrease in oil prices in world markets in 1997-98 added insult to injury: exports fell even further in the first half of 1998, while imports continued to increase, so that the entire trade surplus was nearly wiped out (in better times, in 1996, the surplus amounted to $20 billion). The current account balance turned negative in the first half of 1998. Given the need to service the debt and the continuation of capital flight, a negative current account was a surefire recipe for disaster.

Under the circumstances, the exchange rate became increasingly unsustainable; a new vulnerability of the ruble with respect to short-term capital flows had developed. From February 1998, the total amount of T-bills held by the nonresidents started to exceed the value of the country's foreign exchange reserves--just like in Mexico in June 1994, the value of dollar-denominated Tesobonos exceeded total reserves. Foreign investors also started to withdraw from the Russian stock market. From October 1997 until mid 1998--a very short nine months or so--the stock market in dollar terms fell by more than 90 percent--to its lowest level since 1994.

The central bank and the government, however, were sticking to the policy of a strong ruble up to the very last moment, maintaining scandalously high interest rates that eliminated all prospects for economic recovery and negotiating a stand-by package with the IMF. In a sense this was a policy designed to maintain consumption and imports, to avoid export-oriented restructuring and to continue to live beyond one's means. The central bank increased the refinancing rate to 150 percent in May 1998 to prevent capital from fleeing--about half a billion dollars was leaving every week--at a time when total foreign exchange reserves only amounted to about $15 billion. The IMF finally provided the first installment ($4 billion) of the $20 billion dollar package that went directly to the CBR to replenish vanishing foreign exchange reserves, but the money was gone in three weeks. As did many other economists, I strongly believed before the crisis broke out that the ruble was overvalued. I argued that if it did not get devalued "from above," it would certainly get devalued "from below" in the form of the currency crisis, with much greater costs (*Financial Times*, Dec. 11, 1997). In a sense, it was not so difficult to predict the crisis; more than a few scholars did so several months before it happened. Even Jeffrey Sachs, earlier a strong advocate of exchange-rate-based stabilization, in June 1998 spoke out publicly in favor of devaluation (*New York Times*, June 4, 1998).

What nobody was able to predict is the way the Russian government handled the devaluation: by declaring a default on domestic debt and a moratorium on part of the international debt held by banks and companies. This was completely unnecessary: unlike in Latin America in 1994-95, where the governments were excessively indebted, and unlike in East Asia in 1997-98, where the indebtedness of conglomerated banks and *chaebols* went beyond reasonable limits, no debt crisis existed in Russia. It only had a currency crisis, which was supposed to be handled only by means of devaluing the ruble.

True, government short-term obligations -GKOs, ruble denominated, but held by nonresidents, since early 1998, according to available estimates--exceeded total foreign exchange reserves. This was an obvious mismanagement and clearly contributed to the crisis. However, the absolute value of the outstanding short-term debt held by foreigners was by no means substantial: it was only $15-$20 billion. The problem was the rather the negligible amount of reserves ($15 billion), but even under these circumstances it was possible to continue to service the debt after, say, a 50 percent devaluation (which would immediately decrease debt service payments twice in dollar terms). This was a sharp contrast to the Mexican situation in the second half of 1994; Mexican Tesobonos were denominated in dollars, not in the national currency, so devaluation of the peso could not and did not decrease the dollar value of the debt.

The mistrust of investors in the first half of 1998 was associated first and foremost with the low credibility of the government course to defend the ruble, whereas the ability of the government to service its debt was not really put into question. The difference between the rates at which the Russian government borrowed abroad in hard currency (returns on Eurobonds were around 15%) and the rates offered to the prime borrowers (7%) was much lower than the gap between returns on ruble-denominated bonds (about 100% in real terms) and Eurobonds (15%). Because the first gap is an indicator of country risk (i.e. the risk associated with the default by the government of this particular country), whereas the second one reflects the currency risk (i.e. the risk associated with the devaluation), it is clear that the anticipation of the market at that time was that of devaluation, but not of default.

Where To From Here?

At the time of this writing (December 1998) Russia is left basically with two options for 1999. Both depend crucially on the ability of the government to contain the expansion of the growing budget deficit.

The favorable option--a soft landing--implies that the federal government budget deficit in 1999 would be limited to 1- 2 percent of GDP at most, and the expansion of the money supply, and hence inflation, would be limited to 20-40 percent. The other option is that the deficit would amount to 5-10 percent of GDP, which, in the absence of opportunities to borrow domestically and from abroad, is likely to produce inflation of several hundred percent. This latter option is certainly less favorable, but unfortunately more probable: unless the government initiates a draconian program of budget cuts, the odds of containing the deficit look very slim indeed.

The unexpected consequence of the crisis was the sharp reduction in government revenues. Businesses and regional governments responded to the financial turmoil and growing payment difficulties by withholding tax payments to the federal government. Federal budget revenues fell from 18 billion rubles in July 1998, (before the crisis) to 11.2 billion in August, to 9.3 billion in September and 13 billion in October. In November they recovered, rising to about 20 billion rubles, but in real terms were still nearly two times lower than before the crisis, since prices over the period from August to the end of the year nearly doubled. Government expenditure before the crisis normally stood at a level of 30 billion rubles per month, including about 10 billion devoted to servicing the short-term debt. Thus, in late 1998, the federal government faced the dilemma of either cutting expenditures to nearly half their previous level in real terms or to finance a deficit of nearly 10 percent of GDP by printing money (since, after the default, external sources of financing had disappeared). Once again, the government responded to the challenge in an unpredictable way: Instead of suggesting budget cuts, it offered a program of tax reduction (the value added tax was to be reduced from 20 to 15 percent, and profit taxes would be lowered from 35 to 30 percent), which reinforced the fears of a soon-to-come high inflation.

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