

Nicola Melloni

Market Without Economy

The 1998 Russian Financial Crisis

With a foreword by Eiji Furukawa

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To my father, for his encouragement

To Hyewon, for her love

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Foreword

Eight o'clock in the evening and a couple of hundred guests, all dolled up in black tie and evening dresses, are gathering at the Manezh Exhibition hall adjacent to Red Square. The hall is filled with the usual sounds of a champagne reception – lively chatter and the odd burst of laughter. It is a party for the introduction of yet another luxury foreign automobile into the Russia market. As seen from above, the director of the company smiles contentedly, the smile of a man sure of success. In advance of the official debut he has received orders for more than 300 cars, each of which is priced at eighty thousand dollars plus.

This has become a pretty common event in Moscow lately. The city is booming. As oil money floods in, huge neon signs advertising all manner of luxury goods light up the capital's streets, and foreign companies are rushing in, frightened of missing out on the rich pickings to be had from this growing market. New buildings are popping up like mushrooms, changing the face of the capital, once the center of the communist regime. The post-Soviet crisis seems a distant memory.

This book, however, reminds its readers of that time of crisis of the 1990s. In his perspective of Russia's 1998 financial crisis, Nicola Melloni delves into the economic policies taken up by Russian and, to some extent, international authorities. Over the years the crisis that provoked the Russian government's declaration of default and the devaluation of the rouble has been seen as the climax of the global financial crash that started in Thailand, and spread to Indonesia and South Korea. This view most commonly locates the root of the problem in the failure of policies adopted by the major industrial nations and the International Monetary Fund (IMF). Melloni, however, defines the crisis as the end result of years of mismanagement in the transitional economic policies of Russia after the collapse of the Soviet Union.

Long before the crisis began to spread from Asia, Russia, under IMF directives, had sought to stabilize its economy mostly by containing inflation, while pursuing massive privatization programs. The book's in-depth analysis reveals the contradiction of the core measures of austerity policies mixed with

loopholes in fiscal tightening. The peculiarities of Russian privatization led to the domination of business groupings, linked to the inner circles of the Kremlin and to the widely-spread but unofficial practices of these groups as a de facto loosening of fiscal policy.

Russia has made a bit of a comeback since then. Thanks to high energy prices, the federal budget has gone back into the black, accumulating a large sum of foreign reserves and funds. The highlight of this return to form came with the G8 Summit meeting, proudly chaired by President Vladimir Putin in his newly renovated hometown, St. Petersburg. This event marked Russia's comeback as a major power, with the early payment of a two hundred and twenty billion dollar debt inherited from the Soviet Union and owing to the west.

Yet many issues the book has referred to are still relevant today. Economic growth depends to a great extent upon energy exports, while much weaker financial sectors show little progress. Following on from Putin's call for the state control of strategic industries, cash-making enterprises are one after another falling into the hands of a small number of business groups connected to the Kremlin elite. Corruption is as rampant as ever. Despite capital liquidity, social welfare reform has lagged behind, so increasing the ever widening income gaps among Russians and in the regions. As history shows, it is worthwhile to review now what went wrong in the 1990s.

Eiji Furukawa
Nikkei Moscow Bureau
October 2006

Introduction

“History repeats itself, first as tragedy, second as farce.”

K. Marx

The aim of this book is to investigate the causes of the financial crisis that hit Russia in August 1998. Since then, much time has passed and much literature has been written on the topic both in Russia and in the West. Nevertheless I feel there is still something that can be added. My book will show that Russia experienced a real economic crisis and not just a financial one. Although I agree with most commentators that it has been a first generation crisis, a crisis generated by the inconsistency of macroeconomic policies, I think that the final collapse was just the climax of a series of wrong decisions since the beginning of the transition period. In particular, the privatisation process that gave control to insiders weakened the Russian real economy. The sequence of reforms also played a role: Privatisation was completed before achieving macroeconomic stabilisation and this initially left the newly privatised sector in the waves of hyperinflation and then in the midst of a stabilisation plan.

It is impossible to investigate the whole transition period in this book. I have decided to start my analysis in 1995, the beginning of the stabilisation process. The contradictions between fiscal and monetary policy began at this time.

Russia was forced to deal with external constraints imposed by the IMF in order to achieve stabilisation quickly. The “Washington Consensus” was based on the assumption that no growth is possible in the presence of high inflation. There are, indeed, few doubts that growth’s possibilities are affected by inflation rates above 40-50%, as suggested in a famous study by Bruno and Easterly.¹ The importance of inflation control in transition economies was explained in a well-known paper by Fischer (then chief economist of the IMF),

¹ M. Bruno, W. Easterly, “Inflation Crises and Long Run Growth”, *NBER WP* 5209 (1995).

Sahay and Vegh in 1996.² This paper concludes that monetary policies oriented toward stabilisation of the economy and development of the financial markets should have been the Russian priority instead of support for the real economy. In order to achieve these objectives, a tight monetary policy with high interest rates was run together with the adoption of an external nominal anchor, pegging the rouble to the dollar. In this study, I will evaluate the effects of these decisions on the Russian economy.

In addition, there was also a domestic constraint dictated by the firms sector. The Russian government could not leave industry to its destiny for several reasons. First, bankruptcy and closure of many firms would have had serious social consequences. Second, the firms' managers were the "electors" of Yeltsin's administration. Their support was vital for a government supported by only a minority of Russians. A loose fiscal policy was conducted in order to help industry. Direct credit and subsidy were, however, impossible because of the Stabilisation plan. Therefore, the Russian government used a system of hidden subsidies, like tax-arrears and non-payments of electric bills. The insufficient fiscal revenues led to a fiscal deficit that was financed through the emission of treasury bonds. Concurrently, interest rates were pushed upwards by a loose fiscal policy, in order to compensate the investors for their risks.

In this book, I will follow trends of the macroeconomic fundamentals, and analyse the results of the Russian reforms in political economy terms. I will illustrate how the above-mentioned double constraints led the Russian economy to a deep financial crisis. In addition, I will evaluate other factors that may have influenced the evolution of the economy, among them, oil price changes, the Asian crisis and capital outflow from Russia.

The book is organised as follows: The first chapter covers the years from 1995 to 1997, the period of the Stabilisation programme and "currency corridor". I will evaluate the macro-, and, partially, microeconomic consequences of the plan, showing the path to the crisis. In the second chapter, I will introduce some elements of financial crisis theory, in order to understand the nature of the Russian crisis. Then, I will present a literature review of the princi-

² S. Fischer, R. Sahay and C.A. Vegh, "Stabilisation and Growth in Transition Economies: The Early Experience", *Journal of Economic Perspectives* 10:2 (1996).

pal articles written about the rouble collapse, including some from Russian journals. Finally, getting to the core of the analysis, I will focus on 1998 and give my interpretation of the crisis. The third and last chapter will be dedicated to the immediate aftermath of the crisis, the period between the second half of 1998 and the first half of 2000. In particular I will show how some of the results of the crisis support my hypothesis. In the appendix, I provide a short chronology of the events that culminated with the crisis.

The data that illustrates, and comments on, the analysis comes from different data sets. Most of the data is from Russian statistical publications, namely *Goskomstat*³ (the Russian statistical agency), and the Russian Central Bank. In some cases, these figures diverge from the ones provided by international organisations, such as the IMF and the Central Bank, or by economic papers written about the crisis. The reason is that this data is constantly renewed. The publications of *Goskomstat* offer different figures in different issues. Wherever possible, the data presented in this book are the most recent ones.

³

Gosudarstvennyi komitet po statistike (Государственный комитет по статистике) – State Agency for Statistics.