

## Country Case Study: Russia and The Financial Collapse of 1998

This is the same paper as the Russia paper already posted, but this was re-submitted after the team realized their Money graph was missing.

By:

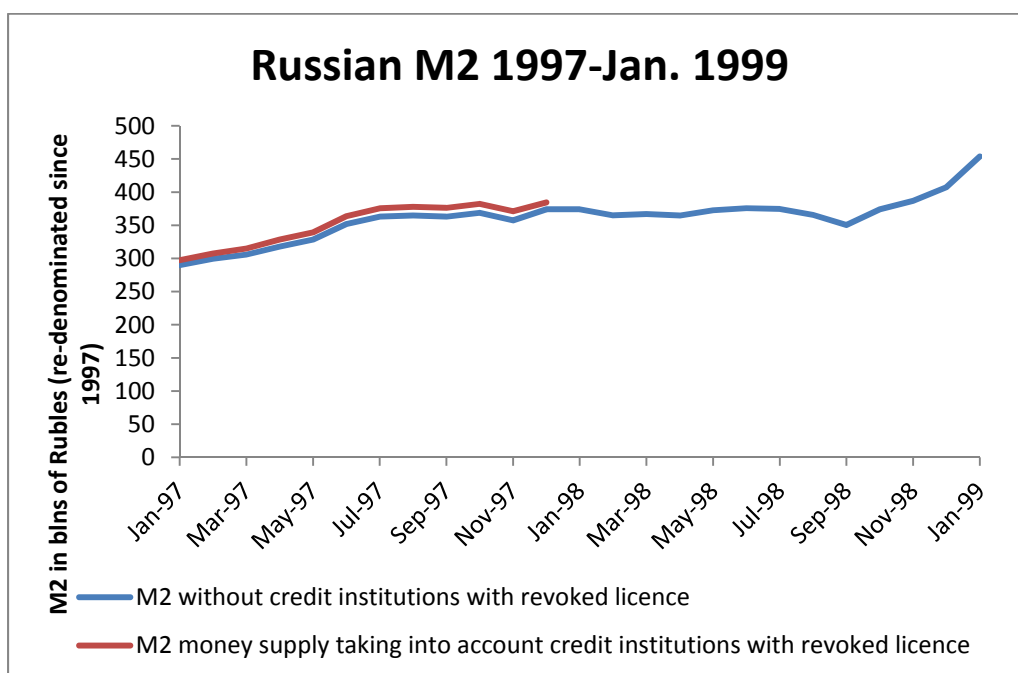
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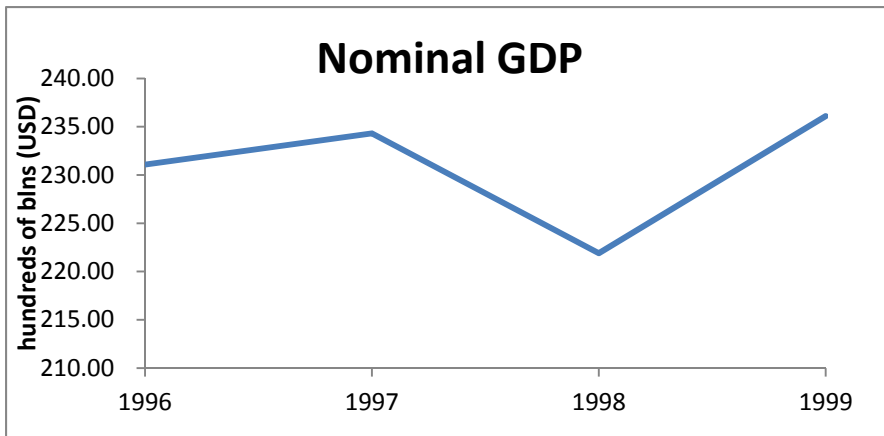
During the 1990's, Russia experienced a sea change in its economic system. The fall of the Soviet Union in 1991 offered its legal successor state, the Russian Federation, the opportunity to forge its society anew. Such provided an opening for both the Russian people, who desired personal liberties and greater economic mobility, and for foreign investors, who saw the country's vast smorgasbord of natural resources and its behemoth size as an economic bonanza.

To take advantage of the opportunity, Russian President Boris N. Yeltsin employed the consultancy of foreign academics and financiers to spawn a formula for sustainable growth. To meet this end, the Yeltsin Administration implemented what would later become known as "shock therapy": a method by which most previously state owned and administered enterprises and entities would be privatized in a swift manner. However, Russia maintained the previous currency, the Soviet Ruble, albeit renamed as the "Russian Ruble," and attempted to initiate a common-currency zone in the former Soviet Republics (Russia, Ukraine, Belarus, Moldova, Lithuania, Latvia, Estonia, Armenia, Azerbaijan, Georgia, Kazakhstan, Uzbekistan, Turkmenistan, Kyrgyzstan, Tajikistan), at the suggestion of the International Monetary Fund. The attempt lasted for a mere two years, when the former Soviet Republics began issuing their own currencies. Nonetheless, foreign investment continued to pump into the country, although unemployment rose sharply during the early 1990s and GDP fell. Following the failed attempt to create a Ruble zone, 1993's annual inflation rate hovered near 1000%, which despite being lower than 1992's inflation, occurred because state expenditures had been delayed from the last quarter of 1993 to the first quarter of 1994. Russia's problems were further compounded with the onset of the First Chechen War in late 1994, which was an armed conflict between state military and Islamist separatists in Russia's southwestern region. The development coincided with a 27%

plunge in the Ruble's interbank exchange rate and Yeltsin's dismissal of central bank chief Viktor Gerashchenko. Western observers and the IMF did not look positively on the move heading into 1995. Nonetheless, Gerashchenko's replacement, Tatyana Paramonova implemented a tighter monetary policy which sought to restrain interest rates. Russia's attempt to stabilize the fiscal situation was further characterized by the Duma's enactment of restrictions regarding the use of monetary policy to finance the state's debt. Perhaps most pivotally, the Ministry of Finance started issuing government bonds at market rates to finance the country's growing deficits.

The attempt to rectify Russia's monetary policy presented the new country's leaders the challenge of satisfying international expectations with its domestic obligations to state workers. Throughout 1995, the government struggled to pay state workers, which put pressure on Duma members and Yeltsin, who were seeking re-election in 1996, to satisfy their constituents and allow the money supply to follow suit.





1996 saw an upward moving trend for the Russian economy. In April of 1996, Russian officials began a process of negotiations with the Paris

and London Clubs to reschedule the payment of foreign debt that was originally inherited by the former Soviet Union. 1997 seemed to be a turning point towards overall economic stability with the fact that balance of trade was beginning to reach a balance between exports and imports, a narrow exchange rate was set in place to keep the exchange rate between five and six rubles to the dollar. Crude oil was selling at \$23 per barrel, which was a high rate during the time period.

The government's measures to keep inflation in check appeared to be successful. The year over year change had fallen from 131 percent in 1995 to 22 percent in 1996, and eventually 11 percent in 1997. Russia's seemingly bright path continued in September of 1997, when the Paris Club granted the Russian Federation admission after rescheduling the payment of over \$60 billion in old Soviet Union debt to foreign governments. Russia also came to an agreement with the London Club, and signed a 23-year debt repayment plan of \$33 billion the following month. The aforementioned developments led analysts to predict that Russia's credit ratings would finally improve, allowing the country to borrow less expensively and reflect less risk in its sovereign debt.

However despite the positive plans set in place, problems still remained. On average, real wages were less than half of what they were in 1991 and less than 40 percent of the work force was actually being paid in full and on time. Another flaw in the economy was low tax

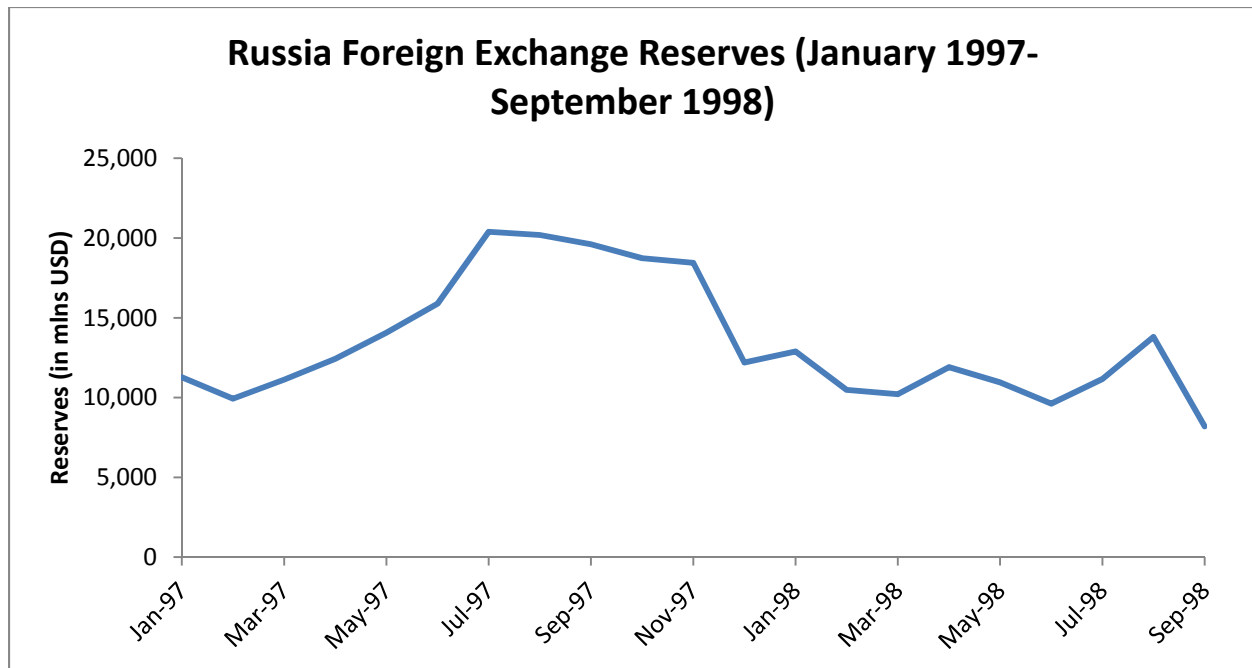
collection, which caused the public sector deficit to remain high. Therefore, the majority of tax revenues came from taxes that were shared between the regional and federal governments, promoting competition among different levels of government. Tax sharing in this manner can cause conflicting incentives for regional governments and help firms mask part of their taxable profit from the federal government in order to reduce total tax payments and therefore more profit.

Observers viewed the Paris Club's acknowledgment of Russia for several reasons. More than 25 percent of the assets belonging to Russia were in the form of debt belonging to Soviet-era allies such as Cuba and Vietnam. Recognition by the Paris Club was based upon the old official Soviet exchange rate of roughly 0.6 rubles per US dollar, as opposed to the rate of five to six rubles of the dollar that it was at the time prior to 1998's crisis. Despite the issues, restrictions were lifted and Russian banks began to borrow more from foreign markets, increasing their foreign liabilities from seven percent of their assets in 1994 to 17 percent in 1997. In October 1997, Russian government forecasted roughly 2 percent economic growth in 1998 to compensate for the overall debt growth. Unfortunately, events began to unfold that would hurt Russia's economy even more as real GDP declined in 1998 by 4.9 percent.

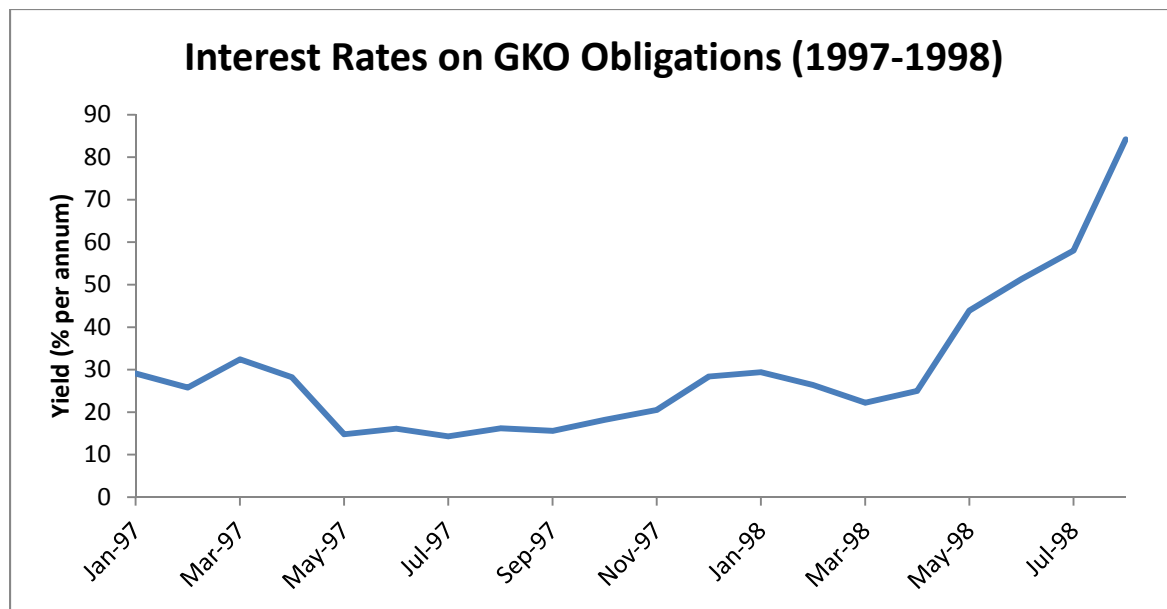
With all of the uncertainties, investors began to focus on Russian default risk. In order to revive their economy, the Russian government submitted a new tax code to the Duma with improvements in fewer and more efficient taxes in February of 1998. While the new tax code was approved, there were crucial parts that were meant to increase federal revenue, yet simply went unenforced. Officials in Russia also sought funds from the International Monetary Fund, but could never reach an agreement. On March 23, President Yeltsin assertively fired his entire

government including Prime Minister Viktor Chernomyrdin. He then appointed 35-year old Sergei Kiriyenko as the new Prime Minister, who at the time had been in government for less than a year. In early May of 1998, CBR chair Sergei Dubinin warned government ministers of a debt crisis to take place within the next three years. However, reporters made up part of the audience and reported that the Bank was considering a devaluation of the ruble due to the heightened sensitivity to currency stability due to contagion from the then-recent Asian financial crisis. In another misunderstanding, Kiriyenko stated that tax revenue was 26 percent below target, emphasizing a poor government. In reality, the government was planning to cut government spending and accelerate revenue but never took place since it was conveyed differently to the public. In the eyes of the public, people began to expect a devaluation of the ruble. Other incidents involving miscommunications with Kiriyenko as well as the IMF failing to reach an agreement with Russia on a 1998 austerity plan led to big investors beginning to sell government bond portfolios and Russian securities.

By May 18, government bond yields rose to 47 percent with an inflation rate of approximately ten percent. While Russian banks would normally have accepted these figures, lack of confidence in Russia's ability to repay the bonds and restricted liquidity did not allow this. This led to depositors and investors becoming increasingly cautious of the risk that banks and firms now had less cash to keep them afloat; the federal government's plan to collect more taxes ultimately lowered banks' and firms' liquidity. In turn, household ruble deposits increased by only 1.3 billion in 1998 compared to an increase of 29.8 billion in 1997.



The CBR responded by increasing the lending rate to banks in Russia from 30 to 50 percent. In a matter of two days, \$1 billion of Russia's reserves were used to defend the ruble. However by May 27, the overall demand for bonds had plummeted to the point where yields were more than 50 percent and the government failed to sell bonds. Oil had dropped to \$11 dollars per barrel, less than half their level the year before. Oil oligarchs were supporting the devaluation of the ruble, as it would increase the ruble value of their exports. The CBR then increased the lending rate a second time to 150 percent. Despite government efforts to form an anti-crisis plan by requesting assistance from the West and even begin the bankruptcy process against three large companies with large debts due to taxes, the CBR defended the ruble losing \$5 billion in reserves.

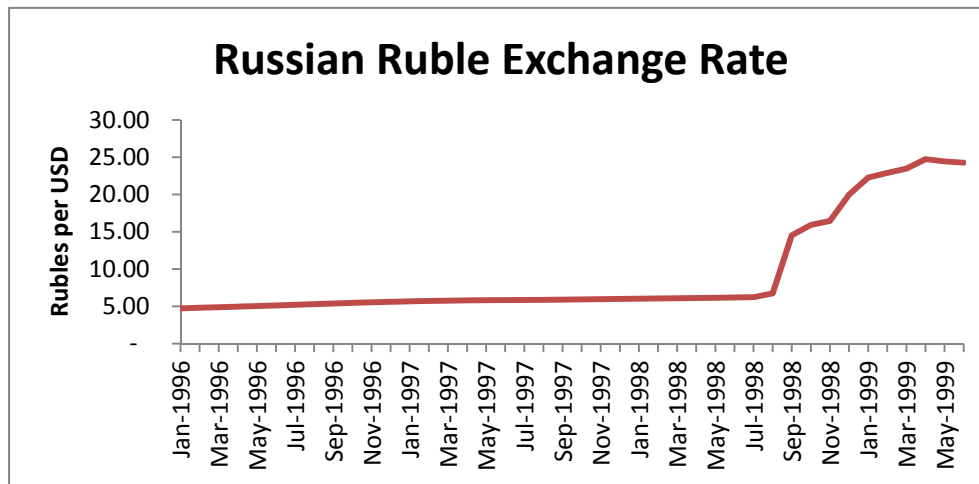


Despite government efforts being made, there was knowledge of \$2.5 to \$3 billion in loans from foreign investors to Russian corporations and banks that were come due by the end of September 1998. In July, the IMF approved additional assistance of \$11.2 billion of which \$4.8 billion was to be disbursed immediately. However, between May and August, Russia lost approximately \$4 billion in capital flight and an additional \$4 billion in revenue due to decreasing oil prices.

On August 13, 1998, the Russian stock, bond, and currency markets officially collapsed as a result of fear from investors that the government would devalue the ruble, default on domestic debt, or both. Annual yields on ruble-denominated bonds were more than 200 percent and the stock market had to be closed for more than 35 minutes as prices plunged. When the market closed, it was down 65 percent with little shares actually traded. Overall from January to August, the stock market had lost more than 75 percent of its value, with 39 percent coming in the month of May alone. On August 17, the government floated the exchange rate, devalued the ruble, halted payments on ruble-denominated debt, defaulted on domestic debt, and declared a 90-day moratorium on payment by commercial banks to foreign creditors.



Russia ended 1998 with a decrease in real output of 4.9 percent for the year as opposed to the small growth that was originally expected. The overall collapse of the ruble created an increase in Russia's exports while imports remained low. Some optimism still continues

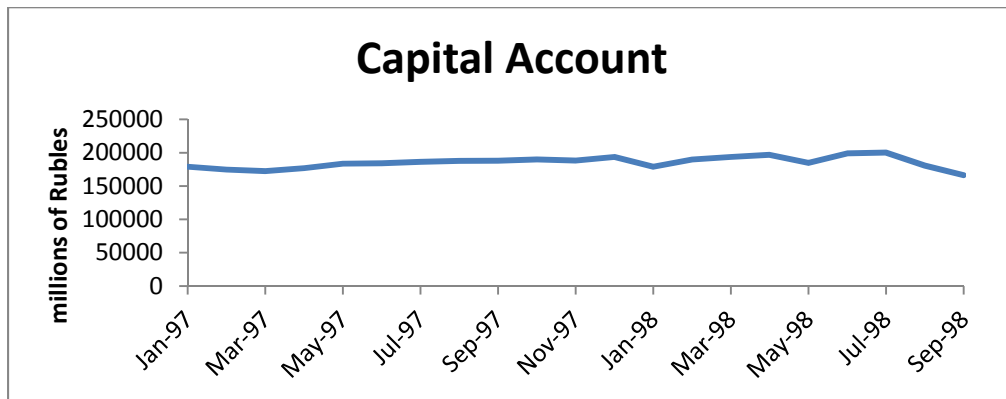


however. Real GDP growth in Russia grew 8.3 percent in 2000 and approximately 5 percent in 2001. The consumer

price index grew 20.9 percent and 21.6 percent in 2000 and 2001, respectively, compared with a 92.9 percent increase in 1999.

The ruble was the weakest in April of 1999 when it reached 24.71. The change in reserves was the largest from 1996 to 1997 where it fell (\$201,000,000) in January to June, then fell (\$1,157,000,000) from July to December. This pattern continued for a while reserves would go up then fall dramatically which showed instability in the Russian Economy, the Financial Capital Account also witnessed a similar phenomenon where it fell from (\$685,000,000) in January to June but fell (\$3,985,000,000) in July to December. In 1997 the financial capital account rose again to 9,185,000,000 in January to June but then fell dramatically to (\$2,793,000,000) in July to December. The same pattern was also visible in 1998 when in January to June the FKA reserves rose to \$9,566,000,000 and then it fell to (\$6,694,000,000) crippling the Russian Economy. Most of the recovery can be credited to the import substitution

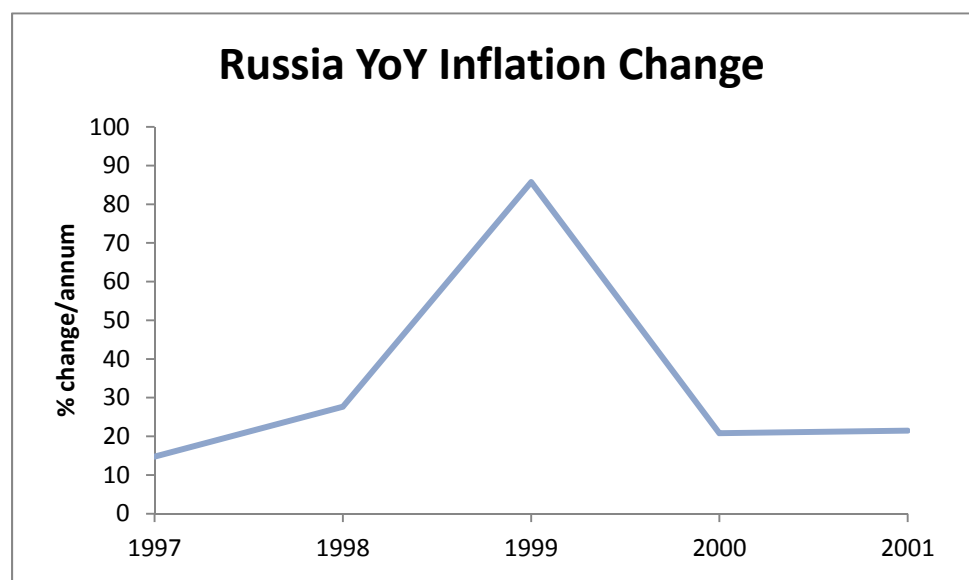
effect after the devaluation as well as the increase in world process for Russia's oil, gas, and commodity exports.



Despite its lengthy departure from the world stage, the Russian financial debacle of the late 1990's still sees

its effects felt today.

The crisis and a resurgent Chechen uprising took a toll on President Yeltsin's ability to govern,



which along with his ailing health, forced him from office in mid-1999. To fill the power vacuum which the development left, a former KGB spy named Vladimir Putin took the mantle of the Russian presidency. Putin, who had risen through the ranks of government during the 1990s, steered the fledgling state in a new direction. The new president reversed several of the democratic reforms which his predecessor implemented and vastly expanded the powers of the presidency. Overseas, the crisis took its toll, bringing down a New York-based hedge fund called Long Term Capital Management, which precipitated fears of contagion and required that large banks bail out the fund at a multi-billion dollar price tag. Perhaps most importantly, the Kremlin's newly-found muscle allowed for the state to provide direction to large industry and inspire confidence from foreign parties, which despite Yeltsin's most earnest efforts, was impossible through the 1990s.

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