

The Russian Financial Crisis of 1998

How uncontrolled markets and a weak government led to the collapse of a nation

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The Russian financial crisis of 1998 marked a watershed moment in modern economic history. It was the first time since the chaos of the Great Depression that a major, western, industrial country faced the prospect of imminent economic collapse and a default on its sovereign debt. Scenes of speculative attacks, panicked investors, impotent Central Bank governors and bank runs used to be confined to the former colonized peoples of the world and were unthinkable for a developed state. Moreover, less than 10 years previously, the Soviet Union was one of the most powerful states in the world and represented a distinctly alternate form of economic organization which rivaled capitalism for 80 years. Thus, it is all the more shocking and significant that after straddling the globe since the end of the Second World War while threatening the West with its economically based ideology, Russia was faced with economic catastrophe and political humiliation in the aftermath of the 1998 financial disaster.

The immediate causes of the Russian financial crisis of 1998 can be attributed to the overvalued peg of the Russian ruble, the unsustainable debt accumulation of the government and the external economic shocks that occurred due to the Asian financial crisis of 1997/98. However, despite these immediate triggers, systemic weaknesses in the Russian political economy were major causal factors that directly led to the eventual crisis. The underlying weaknesses in the Russian banking system, the power of the 'Financial-Industrial Groups' and the systems of tax evasion, non-payments and arrears which all stemmed from the faulty and corrupt reform movement that characterized the break-up of the Soviet Union and the collapse of the command economy lie at the heart of the financial crisis and the endemic weaknesses in the Russian economy.

The fall of the Berlin Wall and the collapse of the Soviet empire were not merely political events that marked the end of the nuclear standoff and the arrival of democracy to the peoples of Eastern Europe. These were also economic phenomena which shaped the course of modern economic history as the communist system of production and distribution disintegrated with the arrival of private property and the triumph of capitalism. The former centrally planned economies of the East would have to be fundamentally restructured as the private sector and free market would have to be instituted, cultivated and shepherded through a period of transition as reform of the economy meant a reform of the basic structures of power, wealth and privilege

For Russia, this process began in the early 1990's as the Soviet Union disintegrated into its constituent parts and the Russian Federation emerged as the rump core of the empire. The revolution in Russia was a peculiar phenomenon as the dissolution of communism was an elite led project which involved the repudiation of an old order without the turnover of power to a new elite backed by a fresh ideological commitment. In Eastern Europe, the expulsion of Soviet troops provided a rallying point for the people and a new ideological consensus emerged which involved a removal of the old regime and the empowerment of a new class of citizens backed by the masses. The physical change of power and the rhetoric of liberation provided the political capital to the new elites to embark on wholesale reform measures which transformed the economic foundations of the state and engineered the creation of a new political-economic order based on Western principles of governance¹.

¹ Granville, Brigitte and Oppenheimer, Peter, *Russia's Post-Communist Economy*, New York: Oxford University Press, 2001, p.28

However, in Russia, these sweeping changes did not occur as quickly or as thoroughly in the immediate years following the end of Soviet rule. This is due to the complex political-ideological reality that existed in which the leaders of the revolution were the former communist leaders. There was no public or elite consensus on the evils of the past as those in the elite Soviet classes were the same elites still in power and the rhetoric of liberation was ill suited to a Russian population who were the main perpetrators of the original conquests. Therefore, the desire for reform and a radical overhaul of the system was problematized through the ambivalence of Russians towards their apparent revolution².

Accordingly, due to a lack of elite turnover or mass purging of the power structure, the Russian government was left adrift without a unifying ideological force. The mandate for change existed but the process of reform would prove problematic given the lack of institutionalized structures in place to guide the reform and a system of checks and balances to guard against corruption and the privileges of power. Thus, Russia embarked on a project which would fundamentally alter the economic system and restructure wealth creation without the necessary political system to ensure the freedom, fairness or justice of the revolution³.

With the ascendance of Boris Yeltsin to the Presidency of the newly created Russian Federation in 1991, the economic structures of the Soviet Union disintegrated. GDP began to fall dramatically as systems of distribution, supply, production and labour discontinued their relationships and pricing systems, transport links, systems of ownership and payment schedules would have to be invented anew. Inflation surged uncontrollably as wage and price controls were lifted as part of the process of dismantling the centrally planned economy. Savings were

² Granville, p.28

³ Granville, p.29

destroyed, shortages proliferated, factories lay idle and uncertainty gripped the landscape as the economic backbone of the country relied on firm political control from Moscow. Between 1990 and 1995, GDP shrank by 40% and inflation peaked at 800% in 1993⁴.

In the midst of the economic chaos, a political accord was being reached which saw Yeltsin remain President due to his popularity stemming from his role in aborting the coup in 1991 which threatened to revive the Soviet Union. Elections were held and a new constitution drafted to provide the necessary political backing to the proposed economic reforms that were shaking the Russian state to the core. The 1993 elections witnessed a broad spectrum of political interests taking shape as the majority of the people supported Yeltsin and empowered him with fresh authority under a new constitution which saw Presidential powers increased so as to afford the President with the authority to manage the crisis and to enforce his will on parliament. However, parliament also witnessed a surge in the number of seats going to communist and ultra-nationalist parties as the economic hardship led many to wish for a return to a paternalistic and stable state system. Ultimately, reforming interests carried the 1993 election as Yeltsin remained President and Victor Chernomyrdin, a representative of industrial interests, was elected Prime Minister⁵.

With political control now assured, the focus returned once again to economic reform and the transformation of Russia from communism to capitalism. The privatization of state owned industry was a top concern for the government as the state sought to create a private market in the formerly state controlled industries ranging from energy to telecommunications

⁴ Lokshin, Michael and Ravallion, Martin, "Welfare Impacts of the 1998 Financial Crisis in Russia and the Response of the Public Safety Net", *Economics of Transition*, Vol. 8 (2), p.270

⁵ Gould-Davies, Nigel and Woods, Ngaire, "Russia and the IMF", *International Affairs*, Vol.75, No.1, Jan.1999, p.9

to metals. Additionally, the government needed funds through its divestment campaign to balance the budget as the collapse of the economy following the Soviet breakup led to massive deficits that were previously being financed through inflation and monetary policy. Additionally, the government was perennially behind on its payments to state employees and government owned operations as arrears amounted to approximately 15% of GDP by 1994⁶. Thus, there was a perceived imperative to privatize these giant industrial organizations to alleviate the burden from government and to instill market incentives into the lackluster and underperforming Russian industries.

Despite the nominal commitment of the government to free markets and western economics, the actual process of privatization was deeply corrupted due to the lack of true political reform and public checks on the power of the reformed communist elites. The process of privatization was typified by the 'loans for shares' scandal of the mid-1990's. The process was supposed to be characterized by competitive bidding in an open and public manner wherein Russian nationals would compete for ownership of industrial operations. Additionally, the labour force of these industrial enterprises were to be given partial ownership so as to facilitate public participation in management and guarantee a return to the employees stemming from the privatization of the firm that was nominally owned by them, through the state. However, the process was incredibly corrupt as former communist party managers of these enterprises gained political support for the takeover and ownership of the new corporate entities. The bidding process was closed and removed from public scrutiny and the businesses were sold to private interests at fire-sale prices to ensure rapid privatization and a significant

⁶ Pinto, Brian and Drebensov, Vladimir and Morozov, Alexander, "Give Macroeconomic Stability in Russia a Chance", *Economics of Transition*, Vol.8, (2) 2000, p.300

discount for the desired purchasers. There was rampant collusion between the government and the proposed buyers so as to ensure a quick and quiet turnover of ownership of some of the country's most powerful and profitable enterprises at very low costs. In exchange, the state would win over powerful patrons who would loan the government large sums of money to finance the budget deficit as well as provide private donations to the political campaigns of their benefactors⁷.

These schemes were carried out in 1995/96 during a period of political uncertainty as a new round of elections was scheduled for late 1996. The unreformed Communist Party leader, Gennady Zyuganov, was leading in the polls and a desperate Yeltsin was searching for allies in the business world to bolster his career. Accordingly, a quid pro quo was reached with the leading Russians business interests in a tacit exchange of political support for industrial ownership. This corrupt deal saw billions in dollars worth of Russian industry fall into the hands of a small cluster of individuals who became known as 'oligarchs' in exchange for their financial contributions and influence peddling in favour of Yeltsin in the upcoming Presidential elections. The lucrative exchange was successful as the privatization programs sold state assets to a group of loyal and wealthy supporters of the President who ensured his re-election in the 1996 campaign⁸.

In addition to the privatization of industry, the banking and finance centres of the economy were privatized. In theory, the privatization of credit allocation would be critical to the proper functioning of the free market as the banking sector would adequately reward successful and profitable companies with plentiful, cheap credit while forcing the inefficient

⁷ Granville, p.32

⁸ Gould-Davies, p.14

enterprises out of business in the process of creative destruction that would herald the birth of an indigenous, modern Russian business class. Despite the lofty aims of the program for the democratization of credit, the privatization of state banks was thoroughly corrupted in a similar manner as the industrial enterprises. The concentration of wealth in the hands of the politically connected led to the creation of organizations known as 'Financial-Industrial Groups' (FIG'S). These consisted of huge conglomerate enterprises that often combined a large bank, a manufacturing firm and an element connected to an extractive industry such as mining. These groups became self financing through reaping huge profits from the reformed Soviet industrial structure and due to the possession of a banking/financial enterprise. The markets for goods, services and credit became far from free and were in fact controlled by very few firms which acted as oligopolies in their respective fields⁹.

This not only stifled the creation of competitive industry and the process of creative destruction that is necessary for the proper functioning of a capitalist system but led to a system of pervasively corrupt politics as the oligarchs wielded a form of autonomous power that was intrinsically tied to government based patronage networks. Moreover, many existing industrial operations were underperforming and unprofitable as the burden of Soviet employment policies left a legacy of waste and inefficiency. These practices were insulated from reform due to political pressures which lobbied against layoffs and painful restructuring as the associated unemployment and fall in output were politically unacceptable. These losses were financed through the profitable arms of the FIG's and attributed to the costs of business

⁹ Gould-Davies, p.12

in a society where political connections were essential for business operations¹⁰. The collusion between government and business interests led to many of the systematic perversions of the marketplace that would directly undermine the economic system and left it vulnerable to the shocks which led to the 1998 crisis.

Government actions thereafter always combined an element of collusion between the interests of the oligarchs and the interests of the state. This was notable during the stabilization plans created in the mid-1990's to stem the growth of inflation and stabilize the Russian economy in the hopes of fostering a return to positive GDP growth following years of economic decline. The stabilization plan entailed a curtailment of the money supply and a dramatic increase in interest rates in an effort to lower inflation from its triple digit peaks to manageable levels of under 10%. Additionally, the ruble was to be pegged to the US dollar in an effort to instill financial discipline and consistency to Russian finances as well as provide a signaling mechanism to foreign investors as to the suitability of Russia as a source of investment¹¹.

The mechanisms by which these policies were implemented consisted of a deep reliance on the Russian financial sector under control of the FIG's and a dependence on foreign capital to aid in the financing of government debt and to maintain a positive capital account balance to support the currency. The Russian Central Bank could unilaterally increase interest rates to achieve its goals however it utilized a core group of private banks as the tools through which it would sell government bonds and regulate secondary market transactions in a sophisticated

¹⁰ Estrin, Saul, "The Russian Default", *Business Strategy Review*, Vol. 9, Issue 3, 1998, p.4

¹¹ Buchs, Thierry, "Financial Crisis in the Russian Federation", *Economics of Transition*, Vol. 7 (3), 1999, p.689

effort at the manipulation of monetary policy¹². The profits that this special group of banks received were disproportionately large as they not only underwrote the majority of government bond issues but benefited from holding these bonds directly due to their high interest rates (often over 30%)¹³.

Additionally, the majority of government bonds were short term issues (GKO'S) as the shorter time span allowed for savings in the form of lower interest rates. However, this precipitated a constant need to rollover debt and reissue new bonds to finance government operations. As well, the government came to rely on foreign investors to purchase government bonds as both a means of financing the deficit, due to the inherent limits of the domestic securities market, and to support the currency as the inflow of wealth helped prop up the ruble peg. In 1996, the Central Bank released restrictions on capital movements which led to a large influx of foreign investment in government debt, due to the highly attractive yields¹⁴. As a result of the relationship between the state, the FIG's and the banking sector, Russian financial interests were almost completely divorced from the larger economy and derived the majority of their profits from the securities market. The highly profitable nature of banking operations focused on government securities trading left no incentive for Russian banks to engage in the declining and difficult terrain of domestic private enterprise. For example, the lone state owned bank, Sberbank, had over 78% of household deposits due to the lack of interest from the private sector in attracting average Russian savings and a government guarantee of deposit

¹² Medvedev, Alexei, "International Investors, Contagion and the Russia Crisis", *Institute For Economies in Transition: Bank of Finland: Discussion Papers*, 2001, p.9

¹³ Medvedev, p.16

¹⁴ *ibid*, p.6

insurance¹⁵. Thus, the banking sector did not only fail to become an engine for promoting economic reform and growth in the real economy but instead became a parasitic enterprise which derived revenue from speculation and trade in government securities exclusively¹⁶.

In exchange for FIG cooperation in the financing and maintenance of government debt, the state allowed for special provisions which steadily reduced the tax obligations of the major businesses to the Russian state. The oligarchs pressed for these tax exemptions as they did not need credit or any other form of financial support from the state. The revenues derived from business operations combined with the lucrative banking sector revenues stemming from profits in the bond market made the FIG's self reliant and financially autonomous.

Consequently, the only demand on the state was to be left alone in the form of reduced tax burdens. The oligarchs could extract these concessions from the government due to their immense clout within the economy and the dependence of political interests on contributions from the business community¹⁷.

Due to the declining economy, the lack of revenues stemming from endemic tax evasion by the public and tax exemptions from the few profitable sectors controlled by the oligarchs, the government was in perennial deficit which intensified its reliance on short term bond issues to finance operations. Moreover, the state was often delinquent in its payments to domestic partners, such as state employees and indigenous business relationships, which led to arrears, non-payment and a partial barter economy to flourish as the inconsistency and unreliability of

¹⁵ Buchs, p.708

¹⁶ Buchs, p.701

¹⁷ Pinto, p.313

the government fostered similar practices throughout the economy¹⁸. The annual budget deficit averaged 7-8% through 1996/97 and the government often resorted to unsound accounting practices such as moving cash from off-budget accounts, such as pensions, to finance deficit spending¹⁹.

The lack of consistent, reliable and sizeable sources of government revenue was a major complicating factor in the creation of a modern system of governance. Following the collapse of the Soviet penal system and the chaos of early 1990's, tax evasion became akin to a national sport as the wealthy used political connections to evade payment and the lower classes simply used any means necessary to ensure their meager incomes were protected. A basic level of trust was lacking due to the tumultuous nature of post-Soviet Russian society and violent outbreaks were not uncommon. In 1996 alone, the State Tax Service reported that 25 tax inspectors were killed, 74 were injured, 6 kidnapped, 164 violent threats were made against state employees and there were 18 bomb or shooting attacks on tax collection offices²⁰. It was estimated that 50% of Russian businesses paid taxes only "occasionally" and 35% did not pay taxes at all. These problems of non-payment and reactionary attacks were only exacerbated at the larger and more powerful companies. For example, the World Bank has estimated that if Gazprom (the main energy company) had paid its share of taxes, the tax revenues from Gazprom alone would cover 1/3 of the entire budget deficit²¹.

Thus, without proper sources of revenue, the government became increasingly beholden to the interests of the oligarchs and foreign capital. The oligarchs helped finance

¹⁸ Pinto, p.299

¹⁹ Desai, Padma, "Why Did the Ruble Collapse in August 1998?", *The American Economic Review*, Vol. 90, No.2, May 2000, p.48

²⁰ Buchs, p.704

²¹ Gould-Davies, p.14

politicians private political careers through political donations (legal and illegal) and helped support the state through providing employment in the loss making enterprises of the FIG's and by purchasing government debt through the banking sector. In addition, the constant inflows of foreign capital became critical to government financing and solvency as the perennial deficits could not be financed through domestic markets exclusively and inflation was discredited and perceived to be dangerous due to the experiences of the early 1990's. Moreover, the fixed exchange rate regime depended on a positive capital account balance as the overvalued ruble could not be sustained without external support. Thus, governance in Russia became intimately tied with the interests of a small elite consisting of the oligarchs and international capital. Broader society would be left to its own devices as the short term demands of financial and political survival outweighed long term considerations of sustainability and democratic rule.

Despite many of the systemic weaknesses apparent in the economy, the stabilization package and the successful collusion between government and the oligarchs had led Russia to the appearance of economic recovery. By late 1996, inflation had settled at a manageable rate of 15% and GDP had ceased its decline and posted a small, 0.4% rate of growth by 1997²². Additionally, Russia experienced a boom in its foreign trade which pushed the balance of payments into a surplus of over \$5.9 billion dollars in the first quarter of 1997²³. This was largely due to the increase in international prices for energy and metals, which were Russia's main exports. For example, the price of oil had increased by 25% in 1996 which lifted the

²² Lokshin, p.270

²³ Medvedev, p.24

economy and provided foreign exchange to support the fixed exchange rate²⁴. Thus, with inflation stabilized, the economy posting positive returns and a pro-business government in place, Russia seemed poised to emerge from the Soviet collapse a stronger, more dynamic and capitalist friendly country.

The buoyancy of the economy provided a new sense of optimism and confidence in the Russian state not seen since the heydays of the 1960's. Russia felt so confident as to launch its first Eurobond offering in November 1996 as a signal to the global financial community of Russian ascendance. This would not only provide a new source of capital to the government but mark a significant turning point as Russia turned to foreign investors and began to denominate debt in US dollars²⁵. This was coupled with a complete opening of capital account restrictions and a deregulation drive to remove all capital controls from both foreign and domestic flows. Parliament enacted a series of laws which allowed for the full repatriation of profits on securities market transactions and the convertibility of the ruble to the US dollar at a fixed rate, which were designed to encourage investment and build a climate of confidence in Russian finances²⁶. This led to large inflows of foreign investment and an appreciation that led to the pegging of the ruble at an overvalued rate. The sale of metals and energy coupled with inflows of foreign wealth helped support the peg but damaged the manufacturing base of the economy as the ability to export and compete in global markets was hampered by the balance of payments surplus which supported the exchange rate²⁷.

²⁴ Kharas, Homi and Pinto, Brian and Ulatov, Sergei, "An Analysis of Russia's 1998 Meltdown: Fundamentals and Market Signals", *Brookings Papers on Economic Activity*, Vol. 2001, No.1, 2001, p.20

²⁵ Buchs, p.689

²⁶ Desai, p.50

²⁷ Kharas, p.20

Thus, the Russian economy appeared to be stable and growing by 1997. The strength of the ruble on the back of surging energy exports lulled financial markets into complacency as the fixed exchange rate of 6.29 rubles to the US dollar seemed justified. GDP growth had finally returned after a 6 year decline and the FIG's, which represented the heart of Russian industry, appeared to be profitable. The government felt increasingly confident in its deficits as there was no shortage of buyers for government bonds, ranging from American hedge funds to Russian pensioners²⁸. However, the Asian Financial Crisis was to act as the trigger which unraveled the façade of Russian prosperity and revealed the hollow core of Russia's post-Soviet political economy.

The Asian Crisis began in 1997 and saw the beginnings of the end of a major source of world economic growth. As the economies of East Asia began to slow, world commodity prices began to fall as the expected demand melted away and losses began to mount in the real economy. For Russia, significant declines in the world market prices for its base exports, energy and nonferrous metals, heralded a major cause for concern as the economy came to rely on these extractive industries as a major source of growth. Moreover, with a decline in exports, the fixed exchange rate looked less sustainable as the rate of foreign exchange accumulation dramatically fell due to losses in both the volume and prices of exports²⁹. In addition, losses derived from investments in East Asian markets caused an initial withdrawal of funds from Russian markets as developing state investors sold Russian government bonds to cover losses in their domestic markets. This was especially notable in the cases of Korean and Brazilian

²⁸ Kharas, p.1

²⁹ Deasi, p.50

investors as the prospects of contagion sowed fears into the speculative markets most directly affected³⁰.

These initial withdrawals led the Central Bank to increase interest rates from 21 to 28% and expend billions of dollars of foreign exchange to defend the exchange rate lest a lack of effective signaling breed suspicion and a lack of confidence from the markets³¹. As the Asian crisis evolved and fear spread of problems in developing country markets, international investors began to withdraw funding from all developing countries and speculative attacks began on currencies thought of as susceptible. With the crisis reaching Indonesia by 1998, the beginnings of market panic set in and bond yields in Russia were increased to 44% by January 1998 in an effort to attract foreign investment to address the constant need for debt financing by the government in addition to supporting the value of the ruble³². With rates stretching higher and a gap in secondary markets developing, the government pressured domestic Russian banks into purchasing vast quantities of government bonds to help smooth liquidity and provide a purchasing backstop so as to prevent a surge in yields. The interdependence of the government and the FIG's became increasingly apparent as it was in the interests of neither to witness a revival of the volatility and chaos that followed economic uncertainty after the Soviet collapse. In addition, the banks had become almost entirely dependent on government securities for their income so that a decline in the value of the existing bonds would entail large

³⁰ Kharas, p.7

³¹ Buchs, p.690

³² Medvedev, p.16

losses for the entire FIG, which would potentially imperil the foundational economic structure of the country³³.

As the crisis worsened, pressures mounted on the ruble. A collapse in the price of oil to \$12 per barrel by mid-1998 coupled with rampant withdrawals of foreign financing due to fears of systemic instability caused by the contagion from the Asian Financial Crisis forced the Central Bank to increase interest rates to 150% by May 1998 in an effort to defend the ruble and maintain the flow of foreign financing³⁴. The high interest rates not only led to a crippling of the domestic economy as companies could ill afford financing at exorbitant rates but the government budget was in peril. Due to the short term nature of the majority of government borrowing, the state was in a constant process of selling new securities to finance the existing deficit. High interest rates forced the government into increasing levels of debt and the financing of existing debt became ever more costly. Suspicions as to Russia's ability to afford its costly financing packages led to the downgrading of Russia's sovereign debt by most major organizations, which further raised costs for the government³⁵. By July of 1998, debt repayment was consuming approximately 40% of the federal budget³⁶. The short term nature of Russia's debt led to special concerns relating to its ability to rollover its debt stock and to meet the cash flow requirements necessary to avoid default³⁷. For example, the last seven months of 1998 saw \$32.7 billion dollars worth of short term debt maturing which would pose significant

³³ Kharas, p.33

³⁴ Buchs, p.690

³⁵ Buchs, p.690

³⁶ Gould-Davies, p.16

³⁷ Medvedev, p.25

problems for a government constantly short on cash and desperate to maintain the flow of foreign funds³⁸.

Compounding the cash crisis was the issue of the exchange rate and the denomination of large amounts of debt in US dollars due to the Eurobond issues of the previous few years. Not only did the yields on the domestic debt (GKO's) increase dramatically but the yield spread of the Eurodollar issues had jumped by over 900 basis points over the course of the crisis³⁹. This presented a unique dilemma for the government and Central Bank as the issue of currency convertibility and the defense of the ruble peg took centre stage. The fixed exchange rate regime had been a cornerstone of the stabilization program and any signs of abandoning the peg would signal a retreat from fiscal discipline and a return to the inflationary period of the early 1990's⁴⁰. As well, devaluation would dramatically increase the costs associated with financing the dollar denominated debt which would add a further burden to an already stretched budget. Additionally, many of the major Russian banks had speculated and invested heavily in foreign currencies and devaluation would result in huge losses for these enterprises. This was unacceptable to the oligarchs whose entire banking business was based on government securities and US dollar investments. A devaluation of the currency would have disastrous effects on the entire spectrum of the Russian banking and financial industry. However, the defense of the peg was costing the Central Bank billions of dollars in foreign exchange and the high interest rates were choking the lifeblood out of the real economy⁴¹.

³⁸ Kharas, p.24

³⁹ Kharas, p.25

⁴⁰ Summers, Lawrence and Williamson, John, "An Analysis of Russia's 1998 Meltdown: Fundamentals and Market Signals. Comments and Discussion", *Brookings Papers on Economic Activity*, Vol. 2001, No.1, 2001, p.58

⁴¹ Desai, p.51

Concurrent with the financial disaster befalling the financing of government debt, a political crisis emerged that weakened investor confidence in the ability of the government to act coherently and effectively in addressing the pressing issues at stake. President Yeltsin was often at loggerheads with parliament as he tried to force through legislation to deal with the crisis. In March of 1998, he replaced Prime Minister Chernomyrdin with Sergei Kirienko, who was less beholden to the oligarchs and had the reputation as a reformer. This was done in a bid to gain power and leverage over parliament and force through controversial legislation in a time of crisis and panic⁴². Prime Minister Kirienko was charged with stabilizing the budget and accordingly, he began his campaign with an attempt to crack down on tax evasion and increase taxes on the FIG's. This led the Yeltsin government into direct conflict with the oligarchs, who were his principal backers. The oligarchs orchestrated a parliamentary revolt which saw nearly all legislation challenged and curtailed as the pro-business interests aligned with the communists and ultra-nationalists in questioning the fitness of the regime. Allegations of Western espionage and a sell out to America were lobbed at the government as it sent its package of emergency reforms to be ratified by the Duma (parliament). The Duma rejected the emergency measures and the President began legislating by decree, which was technically an illegal act as his announcements held no formal sanction of law⁴³.

With the political stalemate and the economy in freefall, capital flight became rampant as foreign investors lost confidence in the government's ability to manage the crisis. The susceptibility of the Russian economy to capital flight was increased over the previous years as capital controls were lifted and the full convertibility of the currency was guaranteed. Thus,

⁴² Gould-Davies, p.16

⁴³ Granville, p.53

foreign investors abandoned the ruble in droves and many ordinary Russians closely followed as a type of herd mentality gained prominence which created its own economic-psychological logic. Panic and fear of developing country weaknesses stemming from the Asian financial crisis combined with the specific vulnerabilities of the Russian economy put immense pressure on the ruble as the Central Bank fought in vain to defend the fixed rate⁴⁴.

In a last ditch effort to prevent default, the Russian government, in coordination with the IMF, attempted a debt swap wherein short term ruble denominated debt holders would exchange their bonds for long term, US dollar denominated bonds. This was an attempt to alleviate the cash flow crisis by offering investors a potentially more secure investment. However, the debt swap was a failure as too few investors entered into the agreement as most preferred to sell and abandon the Russian debt market at almost any cost. Alternatively, some investors sought to keep their higher yielding ruble debt as they gambled on the moral hazard as they believed that the IMF and Western governments would bail out the Kremlin and prevent a full scale default at all costs. Less than 15% of Russian short term debt was traded for long term US denominated debt and the IMF backed swap was concluded in failure⁴⁵.

The severe strain was beginning to show in the real economy as one of Russia's largest banks (SBS-Agro) was officially bailed out by the government due to losses stemming from the economic crisis and capital flight, which depleted its reserves⁴⁶. Political upheaval remained a constant threat as the Prime Minister was sacked and Chernomyrdin was reappointed by President Yeltsin. However, parliament rejected Yeltsin's appointment and nominated their

⁴⁴ Medvedev, p.21

⁴⁵ Kharas, p.37

⁴⁶ Kharas, p.11

own candidate, Yevgeny Primakov (a former foreign minister). This marked a major defeat for the President as parliament had reasserted its authority and a fissure formed between the branches of government⁴⁷. The political crisis only worsened the economic emergency as capital flight accelerated and collapse seemed imminent.

Ultimately, the IMF attempted to rescue the Russian government, but to no avail. The funds offered were too few and the conditionality attached to the money in the form of true domestic reform was unacceptable to the oligarchs and their parliamentary backers. Consequently, Russia was left to its own devices and the decision was made to call for a moratorium on debt repayments, a suspension of the stock market and a suspension of bank withdrawals (to prevent a run on the banks)⁴⁸. Additionally, the ruble was allowed to float and devalue drastically. Moreover, a moratorium was declared on the debt and foreign liabilities of the major Russian banks as the oligarchs exerted their political strength to safeguard their remaining wealth⁴⁹.

As a result of the crisis and default, GDP shrank by 4.9% in 1998 and inflation resurged to 84%⁵⁰. The ruble lost over three times its original value and settled at 21 rubles to the US dollar. Short term debt holders lost between 75-85% of the value of their investments after the debt restructuring was complete and foreign investors announced losses of over \$33 billion US dollars⁵¹. The devastation laid bare the weaknesses in the Russian economy and shattered the illusions of growth which permeated the 'reform' period. However, a fundamental restructuring had taken place due to the default and the Russian economy quickly rebounded. The default

⁴⁷ Gould-Davies, p.18

⁴⁸ Buchs, p.694

⁴⁹ Kharas, p.34

⁵⁰ Kharas, p.2

⁵¹ Buchs, p.693

and restructuring reduced the overall debt load by over 50%⁵² and the devaluation allowed for a more competitive manufacturing sector which witnessed a 20% growth rate in the following years. The banking sector abandoned its dependence on securities speculation and began to engage with the real economy as a means of raising revenues and earning profits⁵³. 1999 saw GDP increase by 5.9% and inflation reduced by half to less than 40%⁵⁴. Global markets began their recovery in the following years and witnessed an increase in the price of oil, gas and metals, which remained the bedrock of Russian exports. Additionally, the crisis saw an end to the Yeltsin Presidency as by the end of 1999, Vladimir Putin had taken control of the Russian state.

Accordingly, one can trace the origins of the 1998 crisis to the corrupt and botched transition of the Russian political economy from communist principles to capitalist ideology. Capitalism is not merely the existence of formal privatization, deregulation and free trade. The true bedrock of a successful capitalist economy lies with accountability, transparency, the rule of law, an effective judiciary, competitive markets and a corruption free political system⁵⁵. The corruption and collusion between the oligarchs and the government prevented the formulation of a marketplace that was accessible to the public as business became a privilege of an elite class supported by powerful political interests. There was a serious lack of countervailing power in the system as there were few checks and balances on the exercise of control and manipulative authority. Thus, the political system undermined the prospects for the creation of an effective economic system as political authoritarianism undermined the economic

⁵² Kharas, p.4

⁵³ Lokshin, p.271

⁵⁴ Kharas, p.4

⁵⁵ Gould-Davies, p.15

democratization that was expected following the collapse of the command economy. Crony capitalism emerged instead of liberal capitalism, which laid the foundations for a crisis prone political economy.

As a result of political corruption and a desire to undermine the democratic process, the oligarchs and the Financial-Industrial Groups were spawned to provide an advantage for the incumbent government. The lack of restructuring and/or break-up of the Soviet economic enterprises led to the maintenance of unsustainable and unprofitable business operations that were dependent on government largesse and speculative wealth. The failure to create a true competitive marketplace allowed for the dominance of a few enterprises to leach back into the political system. Moreover, dynamism and the process of creative destruction were stripped from the economy as oligopolies crushed any emerging competitors. This led to the system of arrears, non-payments and barter as both government and the FIG's were held unaccountable and traded in political favours as much as in cash. This undermined the trust and reputation of the government which fostered a national plague of tax evasion. The lack of revenues and reliable domestic funding drove the state to further rely on the oligarchs and deficit financing to maintain operations.

The need for constant and large amounts of borrowing drove a dependency on the securities market which led to the opening of Russia to foreign investment and a fixed exchange rate system which overvalued the ruble in an effort to instill discipline and signal to foreign markets the commitment of the government to combating inflation and the securing of their investments. The high interest rates and the overvalued currency eroded the foundations of the real domestic economy as manufacturing and small business suffered. The banking sector

became addicted to securities trading as the most lucrative source of profit due to the weaknesses in the real economy. Thus, the Asian Financial Crisis provided the necessary trigger which unraveled the system of corruption, deceit and misrepresentation as the one sided nature of the economy was laid bare.

As energy exports fell and foreign investors fled, the financial chicanery which gave the illusion of growth and prosperity was disturbed. The government's fiscal problems combined with the uncompetitive nature of Russian business drove investors to question the solvency of the government and the wisdom of the fixed exchange rate. The speculative flows that became the supporting infrastructure of Russia's recovery became its Achilles heel as consistent and enduring attacks on the ruble eventually forced the government into default and devaluation. While the crisis led to some positive elements of reorganization, including partial banking reform, tax reform and currency reform, the fundamentals of the political economy remain weak. The power of the oligarchs remains intact and the dependence of the state on energy and metal exports endures. An economy separated from political manipulation remains an illusion and there is still a lack of accountability and transparency in the dealings of both business and government. While certain reforms have helped Russia become stable once again, the security of the political-economic infrastructure remains questionable.

Ultimately, the question of fundamental reform takes the fore. Despite the corrupt and aborted revolution in the post-communist transition, there remains the potential for a second revolution to sweep the elites from power and install a truly democratizing government. While the prospects seem dim in the current environment of the Putin era, one must question as to whether a more destructive and perhaps violent crisis need emerge to agitate the elite and

masses into the overthrow of the existing order or whether reform movements may simply evolve indigenously without resort to chaos and disorder. The prospects for non-violent reform seem dim as the post-crisis reforms coupled with the reconsolidation of executive power under the Putin administration have solidified the base of political-economic control. The reassertion of state power, even at the expense of the oligarchs as seen by the attacks on the Yukos oil company and the imprisonment of Mikhail Khordorkovsky (a former oligarch), have sealed the power structure firmly in the hands of the ex-Soviet elite. The control and corruption of this elite lies at the heart of the post-Soviet Russian society and without a new revolution which firmly ejects them from the reins of power, there is little hope for a democratic, egalitarian or dynamic political economy.

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