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# The Russian Financial Crisis of 1998: An Analysis of Trends, Causes, and Implications

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# The Russian Financial Crisis of 1998: An Analysis of Trends, Causes, and Implications


## Summary

Since May of 1998, Russia has been caught in the latest, and likely the most serious, in a series of economic crises. 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, defaulted on government domestic debt forcing its restructuring, and placed a 90-day moratorium on commercial external debt payments. Those actions led to Yeltsin's dismissal of Kiriyenko on August 23, replaced, after a political standoff with the Duma, by a more leftward-leaning government led by Premier Yevgennij Primakov. The August crisis also lowered Russians' standard of living and has seriously 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.

The crisis (and Russian policymakers' efforts to manage it) has already had an immediate economic impact on Russia and will have longer term implications for the Russian economy and Russia's efforts to become a market economy. As the crisis continues, the impact on the Russian economy will become more severe. The Russian economy requires new investment, both foreign and domestic, to replace outdated and worn-out capital assets and to build new infrastructure. But the crisis has undermined investor confidence, setting back prospects for economic growth.

Russia remains a focal point of U.S. national interests. It is formidable country whose political and economic stability are critical for the rest of the former Soviet Union, Eastern and Central Europe and the areas these regions border. Russia is a nuclear superpower, has large supplies of some of the world's most important natural resources, including oil, natural gas, and strategic metals.

The report will be not be updated but will remain available to meet congressional needs.

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# The Russian Economic Crisis of 1998: An Analysis of Trends, Causes, and Implications

Since May of 1998, Russia has been caught in the latest, and likely the most serious, in a series of economic crises. 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, defaulted on government domestic debt forcing its restructuring, and placed a 90-day moratorium on commercial external debt payments. Those actions led to Yeltsin's dismissal of Kiriyenko on August 23, replaced, after a political standoff with the Duma, by a more leftward-leaning government led by Premier 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 United States and the other major industrialized economies have been encouraging Russia to develop democracy and a market-driven economy during the last seven years. Russia had made great strides toward becoming a market economy. It abandoned central planning and integrated itself with much of the rest of the global economy.

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.

Russia remains a formidable country and a focal point of U.S. national interest. Its political and economic stability are critical for the rest of the former Soviet Union, Eastern and Central Europe and the areas these regions border. Russia is a nuclear superpower, has large supplies of some of the world's most important natural resources, including oil, natural gas, and strategic metals, and possesses a large skilled labor force and scientific community.

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.[1]

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[1] For more information see CRS Report RL30012, *Global Financial Turmoil: Contagion, Effects, and Policy Responses*, by (name redacted).

This report examines the basic indicators or symptoms of the crisis, the probable causes, the responses from Russian policymakers and the international financial community. It also examines the impact of the crisis on the Russian economy and economic reform and their likely prospects. The report will be not be updated but will remain available to meet congressional needs.

# Russia's Crisis: The Symptoms

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 current crisis is 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.

## Domestic Economic 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.

**Falling 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. Russian GDP is projected to drop even further in 1999.[2] A contracting economy, especially over a long period, leads to a deterioration in living standards.

**High Inflation.** 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.[3] High inflation rates (as high as 2,500% 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.[4] High inflation

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[2] 1998 figure reported by Bloomberg. February 4, 1999. 1991-1997 figures reported in PlanEcon. Inc. *Review and Outlook for the Former Soviet Republics*. September 1997, p. 21 and March 1998, p. 21.

[3] The Russian Central Bank. [http://www.cbr.ru]

[4] It should be kept in mind that while Russia had ostensibly reined in inflation, actual inflation may have been masked by the use of barter and other nonmonetary means of (continued...)

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.

**Rising Unemployment.** 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.[5] While the current crisis cannot be blamed entirely for the unemployment problem, the decline in economic growth has set back attempts to reduce it.

**High Interest Rates.** 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.

## External Economic Indicators

In addition to (and related to) the deterioration in Russia's domestic economic conditions has been a worsening in a number of Russia's external economic indicators: exchange rates; foreign reserves; and trade. These trends help to define the crisis.

**Fall in Value of the Ruble and Decline in Foreign Reserves.** The value of the ruble on foreign exchange markets plummeted. At the end of July 1998, the exchange rate was $1=R6.235. By the end of August 1998 it had declined to $1=R7.905, a 21% depreciation. But by the end of September the ruble had declined to $1= R16.064, a 61% depreciation in a two month period[6]. By early February 1999, the ruble stood at around $1=23R.

Commensurate with the sharp depreciation of the ruble has been the decline in Russian government holdings of foreign reserves, including foreign currencies. Until August 1998, the Russian government tried to maintain a stable exchange rate for the ruble. But to do so required the Russian Central Bank to sell foreign exchange for rubles when the ruble was facing downward pressure. At the end of May 1998, the level of foreign reserves stood at around $11 billion.[7] The foreign reserves were augmented in July by a $4.8 billion loan from the International Monetary Fund (IMF)

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[4] (...continued)
exchange discussed later.

[5] Russian Central Bank.

[6] Ibid.

[7] International Monetary Fund. *International Financial Statistics*. July 1998. p. 597.

but have dropped since then. On August 26, the RCB announced that it expended $8.8 billion over the last two months, $1.9 billion alone from August 7 to August 14, in foreign reserves to defend the ruble.[8] By the end of November 1998, Russian foreign reserves were at $8.2 billion.[9]

**Fall in Oil Prices and Burgeoning Pressures on the Current Account.** World prices for oil and other raw materials have been declining, largely because of the Asian crisis. Russia is heavily dependent on exports of these products for its foreign reserves. In 1998, fuel, that is, crude oil and petroleum products plus natural gas, accounted for 43% of Russian exports.[10] On January 22, 1999, the price of Russian crude oil (Urals grade-32) was $11.20/barrel, down from $15.79/barrel on January 1, 1998, and down from $22.85/barrel on January 1, 1997.[11] Due to the inefficiency in Russian energy production and transmission, the current oil prices may be less than the average production costs for Russian oil which underscore Russia's need for foreign technology and investment to boost productivity in the energy sector. The fall in oil prices has decreased Russian export revenues causing the Russian current account to go from a $3.9 billion surplus in 1997 to an estimated $4.5 billion deficit in 1998.[12]

### Domestic Turmoil

Signs of financial crisis have been showing up and contributing to domestic insecurity. For example, payments to coal miners and other workers in state-run companies have been delayed by many months creating discontent and insecurity. Miners have staged strikes blocking the operation of the Trans-Siberian railway, effectively dividing the country in half and cutting the country's main transportation system. Miners and others have staged protests in front of the Russian White House demanding payments. Furthermore, the non-payment of wages to Russian soldiers has contributed to morale problems in the Russian military.

## Causes of the Crisis

In dissecting the current 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. The less direct but deeper causes concern the incomplete restructuring of the Russian economy that has left a large part of the economy non-monetized and run by barter, thus making it difficult to resolve the imbalances.

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[8] Reuters. August 26, 1998.

[9] International Monetary Fund. *International Financial Statistics.* January 1999. p.607.

[10] Economist Intelligence Unit. *Russia: Country Report*. 3rd Quarter 1998. p. 42.

[11] Energy Information Administration. *Weekly Petroleum Status Report.* January 22, 1999. p. 22.

[12] Economist Intelligence Unit. *Russia: Country Report.* 4th Quarter 1998. p. 20.

## Immediate Cause: Government Fiscal Imbalances

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.

On the downside, 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.[13] (In comparison, the U.S. federal government carries a debt service burden equal to 15% of the U.S. federal budget.)[14] 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.[15]

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.[16]

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

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[13] Economist Intelligence Unit. 4th Quarter 1998. p.34.

[14] Office of Management and Budget. *Budget of the United States. Analytical Perspectives.* Fiscal Year 1999. p. 245.

[15] Russian Central Bank.

[16] Stevenson.

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.

## Fundamental Problem: The Tax Regime and the "Virtual Economy"

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.[17]

Some experts suggest that even if Russia manages to reform its tax regime, fundamental problems with the structure of the economy will prevent the government from attaining fiscal balance. In a recent study, two experts, Clifford Gaddy and Barry Ickes, describe and analyze what they call Russia's "virtual economy." This economy is one in which barter, bills of exchange, and other nonmonetary means of exchange have largely replaced currency. According to the article, more than 50% of payments among all industrial enterprises in Russia are conducted by barter. In 1997, the Russian federal government received 40% of its tax revenues in the form of nonmonetary forms of payment. Such a payments system is inherently inefficient and, as the authors point out, has led to masking of the true value of output which tends to be substantially below what prices indicate. In terms of public finance, the

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[17] OECD, *OECD Economic Surveys: Russian Federation--1997.* Paris. p. 57-60

"virtual economy" makes tax collection difficult and leads to unrealistic government projections of revenue and expenditures.[18]

Other structural problems include the administrative relationship between the federal government in Moscow and the regional and local governments. Confusion and conflict arise among them over control of assets and tax authority. The problems also include how to deal with the so-called oligarches, the group of individuals that have amassed a great deal of wealth and who control the major banks and enterprises.

## Response of the Russian Government and the International Finance Community

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, forced a restructuring of government domestic debt, and placed a 90-day moratorium on commercial external debt payments, essentially placing the Russian government in default. Those actions put President Yeltsin in a precarious position politically: He had announced just three days earlier that the government would maintain the value of the ruble.

On August 23, 1998, Yeltsin dismissed Kiriyenko and his government. A political dispute ensued between Yeltsin and the Duma as the latter twice rejected Yeltsin's initial candidate, former Prime Minister Chernomyrdin, placing the country on the brink of a constitutional crisis. Eventually, on September 10, 1998, Yeltsin nominated then-Foreign Minister Yevgennij Primakov to be prime minister, who was approved for the post by the Duma on September 11. Primakov chose for his government individuals largely considered to be less inclined to pursue economic reforms than had the previous governments.

In the meantime, the Russian government appealed to the international financial community for assistance. After significant deliberations the IMF on July 13 announced agreement on a new package of $17 billion in new credits. The package included new loans totaling $11.6 billion from the IMF, $4.0 billion from the World Bank, and $1.5 billion from Japan. The credits were scheduled to be distributed through 1999. Combined with committed but undistributed IMF credits of $5.6 billion, the package was to provide Russia with $22.6 billion. The IMF subsequently turned over to Russia $4.8 billion as the first tranche from the package.[19] But the IMF has ceased making further payments (the second tranche was scheduled to be delivered on September 15) because of the Russian government's failure to meet the conditions of the loans.

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[18] Gaddy, Clifford and Ickes, Barry W. Russia's Virtual Economy. *Foreign Affairs.* September-October 1998. p. 53-67.

[19] The IMF withheld $800 million of the tranche because of the failure of the Duma to pass crucial reform measures. *International Trade Reporter*. July 29, 1998. p. 1328.

The Primakov government adopted an "anti-crisis plan" in late October to stabilize the economy. Among other things, the plan calls for subsidies for the production of food, medicines, and other goods considered critical to the population; more strictly controlling the activities of the so-called natural monopolies— natural gas, electricity, and rail; imposing controls on using and holding foreign currencies; restructuring the banking sector and the tax system; and reducing the volume of wage and pension arrears.[20]

The objectives of the "anti-crisis" plan underlie the budget proposal for 1999 that the Primakov government submitted. The Duma approved the budget on February 5, 1999. The upper legislative chamber, the Federation Council, must approve it before it can be implemented. Many analysts and the IMF have criticized the budget as based on unrealistic assumptions: an annual inflation rate of 30%; an exchange rate of 20R/$1; cooperation in getting foreign debt rescheduled (the budget includes only $9.5 billion for debt servicing out of $17.5 billion that is due). Perhaps most critically, the IMF continues to withhold funding because it views the Russian government's plan and budget unworkable.[21]

## Potential Impact on Russian Economy and Russian Economic Reform

The crisis (and how Russian policymakers choose to manage it) has already had an immediate economic impact on Russia and will have longer term implications for the Russian economy and Russia's efforts to become a market economy. Ruble depreciation has caused prices of Russian imports, including some consumer goods, to rise, feeding inflation and greater economic instability. It has caused buyers and bank depositors to panic and buy up goods in stores and withdraw deposits from banks as the currency loses it value. On the other hand, prices for some Russian exports in other markets should decline, aiding their price competitiveness.

As the crisis continues, the impact on the Russian economy will only become greater. The Russian economy badly needs new investment, both foreign and domestic, to replace outdated and worn-out capital assets and to build new infrastructure. But the crisis has undermined investor confidence setting back prospects for economic growth.

The Primakov government confronts several immediate challenges. One is the problem of wage and pension arrears. The government has announced its intention

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[20] *On Measures of the Government of the Russian Federation and the Central Bank of the Russian Federation to Stabilize the Socioeconomic Situation within Russia." ITAR-TASS. November 15, 1998*. See also Economist Intelligence Unit. *Country Report: Russia.* 4th Quarter 1998. p. 30-33.

[21] Killen, Brian. *Russia Sinks in Debt.* Reuters. February 8, 1999.

to clear the backlog of unpaid wages, estimated at 30 billion rubles (around $1.7 billion), by the end of 1998 and on pensions by the end of 1999.[22]

Russia has to deal with outstanding debt obligations to both domestic and foreign investors. Part of the debt is short-term bills and bonds which the government froze on August 17, valued at around $40 billion at that time. About $17 billion is held by foreign investors. The Russian central bank announced a plan to reimburse foreign and domestic investors with a combination of cash, short-term zero-coupon bonds, and four-five year coupon bonds paying interest at variable rates beginning around 30% in the first year.[23] While the foreign banks were not happy with the situation, it is not clear that the Russian government's financial straits allowed either side much choice.

The Russian government also faces payments of $17.5 billion due in 1999 on its debt to foreign government and commercial creditors including payments due on Russian- issued Eurobonds and repayments to the IMF on previously issued credits. It also includes payments due on debt Russia inherited from the Soviet Union and which had already been rescheduled. While foreign government creditors (Paris Club) and commercial creditors (London Club) may eventually agree to reschedule some loan repayments, Russia's financial situation both in terms of its domestic and foreign debt makes it unlikely that it will be able to secure new credits in the foreseeable future. Absent debt rescheduling, Russia will be in default on sovereign debt, which could intensify and prolong the credit squeeze, deepening Russia's general downward spiral.

Related to the problem of servicing debts, the government must immediately address the difficult issue of establishing spending priorities within the constraints of revenues. The government faces pressures, on the one hand, from the international financial community, led by the IMF, to constrain spending, and, on the other hand, from legislators and others who demand that the government provide more subsidies to industries and defense and alleviate the financial burdens on the elderly and impoverished. Changing government expenditure priorities and increasing revenues will not be easy. To reduce expenditures, the government must grapple with some politically difficult issues: cutting subsidies to agriculture, to the norther regions of the country, and other favored sectors; rationalizing already reduced military expenditures; and establishing an economically regional social safety net for those unable to make it in the transition to a market economy.

The Russian government must also deal with fundamental reform of the tax regime. These reforms would have to be passed by the Duma which has resisted reforms.

A viable banking system is critical to an economy. It ensures the proper flow of financing from savers to borrowers, the lifeblood of an economy. The Russian banking sector was inefficient and was heavily struck by the financial crisis. The

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[22] Reuters. November 30, 1998. Government to Boost Army Wages, Pay Public Sector.

[23] Reuters. November 30, 1998. Banks Meet Amid Frustration Over Debt.

government must also deal with restructuring if the economy is to realize sustainable economic growth.

A key indicator of the Russian government's progress the will be if and when the IMF delivers the next tranche of the $22.6 billion assistance package that was announced in July 1998. The Primakov government considers the IMF funding vital to relieving its immediate financial crisis. Failure to receive the tranche would also send a negative signal to investors on the economic outlook for Russia. IMF officials continue to discuss the matter with Russian officials.

But the analysis in this report suggests that even measures that address revenue and expenditures problems and the banking sector will in the long run not be sufficient. The Russian economy has structural problems that will make it difficult to resolve the macroeconomic problems.

U.S. policy has deemed a stable, market-driven Russian economy to be in U.S. interests ever since Russia first embarked on reform in late 1991. Indeed, Russia had made strides toward that end. It removed price controls and many other elements of central planning. But a consensus has emerged that the current crisis has stalled, if not set back, Russia’s economic reforms.