RUSSIA’S FINANCIAL MARKETS BOOM, CRISIS AND RECOVERY 1995–2001:

LESSONS FOR EMERGING MARKETS INVESTORS

by Ralph Süppel

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RUSSIA'S FINANCIAL MARKETS BOOM, CRISIS AND RECOVERY 1995–2001:

Lessons for Emerging Markets Investors[1]

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Abstract

From 1995 to 2001 Russia witnessed an asset market boom, a deep financial crisis, and a surprisingly forceful recovery. An event study of this episode provides important insights for Emerging Market investment and Russia's medium-term prospects.

The initial surge in bond and stock prices in 1995–97 owed to a highly ambitious monetary stabilization program, which compressed inflation much faster than other transition economies. Due to high dollarization, disinflation was based on the exchange rate. The program produced rapid real appreciation and a persistent need for capital inflows, while weak economic structures and lack of domestic political support prevented accompanying

[1] The paper has been written as a follow up to the author's assignment as senior economist for Emerging Europe at J.P.Morgan Chase and with support of the European Central Bank. It is not related to his current assignment at Merrill Lynch nor does it reflect the views of either of the aforementioned institutions.

fiscal consolidation and foreign direct investment. The gap between stabilization ambition and structural reality made the currency increasingly vulnerable. Also, the program did not provide a politically viable “emergency exit” from the exchange rate target corridor. Devaluation was postponed through heavy international support. The ultimate crisis escalation in August 1998 resulted in a partial government default and steep devaluation.

However, the economy responded from 1999 with relief to the real depreciation, entering a phase of sustained expansion. Also, the crisis escalation united the political spectrum around a new fundamental consensus on economic policy. Post-crisis governments prioritized fiscal consolidation over disinflation. The more stable political and economic environment spurred broader economic reform from 2000, particularly in the areas of public finances and investment conditions. Together with persistent commitment towards international integration this heralds a long-term convergence of Russia’s economic structures with those in Central and Western Europe.

TABLE OF CONTENTS

1 Introduction

Russia's financial markets underwent a spectacular boom, bust and recovery in the time span of just seven years from 1995 to 2001. The violent swings in the country's asset prices not only reminded investors of the inherent risk of investment in emerging countries. They also raised questions regarding the efficiency of global financial markets. Indeed, the published research of international banks and institutional investors broadly failed to predict both crisis and recovery. Also, verbal and financial support of Western governments and the IMF was negatively correlated with the imminent success of economic policy: official lending surged in the year prior to the crisis and declined when the country was pulling itself out of it. Also, financial flows apparently established perverse incentives for domestic policy. The large-scale foreign lending to Russia in 1995–1997 accommodated misuse of public funds and spurred the political ambition of the "party of power". By contrast, the crisis and financial isolation broadened political support for fiscal consolidation and fast reform.

Against this backdrop, this paper seeks to characterize the main causes of Russia's crisis and subsequent rapid recovery. This is done with two purposes. The first is Russia-specific and shows the country's thorough metamorphosis from a high-risk unstable emerging economy to a predictable converging economy that seeks international economic integration, particularly with Western Europe. The second purpose is to provide an event study that supports the broader search for risk indicators, which look beyond the standard set of economic data used in sovereign credit research. In this context, the paper looks particularly closely at the interaction of domestic politics, international investors and the International Monetary Fund. The analysis combines findings of academic research with an in-depth study of a broad range of economic data, official documents, investor research and contemporaneous research missions[2]. The findings support the following key propositions:

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[2] Unless indicated otherwise the economic data set used in this paper uses the JPMorgan Chase Bank economic data base on Russia, which has been developed by the author between 1998 and 2001 using data of Goskomstat, Central Bank of Russia, Institute for the Economy in Transition, IMF, IIF and various financial news providers. Research missions included regular visits and discussions with the Russian authorities from 1997 to 2001 in the context of the assignments of Russian economic coverage for JPMorgan Chase Bank and the London Club economic subcommittee.

a. **Russia's pre-crisis monetary stabilization program was excessively ambitious.** Inflation, money growth and currency depreciation were compressed much more rapidly than in the advanced Central European transition economies. However, Russia's preconditions for sustained monetary and fiscal tightening were much worse. The country had lagged Central Europe in the restructuring of the economy, the setup of a legal framework and the formation of a consensus for economic reform. The aggressive monetary tightening hampered rather than spurred reform, by antagonizing a large part of the political spectrum. It also created a (politically) critical mass of unviable enterprises, which in turn imposed an inefficient system of payment arrears and soft legal constraints upon the economy.

b. **Stabilization ambitions were pursued through a highly risky policy of massive capital imports and steep real appreciation.** Indeed, the exchange rate was the dominant if not effectively single anchor of stabilization. By contrast; government budget deficits increased and tax collection deteriorated. The focus on real appreciation was risky because the ruble regime was vulnerable to external shocks and its failure threatened to entail high political and economic costs. Vulnerability reflected that large capital inflows and high revenues from oil and natural gas exports were required on an ongoing basis, in order to offset capital flight. The expected political and economic costs of devaluation were high and growing because public and private external debt were on the rise.

c. **Despite these risks, the stabilization program did not provide for an "emergency exit".** When external shocks had eroded the sustainability of the foreign exchange regime, the government and the IMF were trapped between policy options that would all lead to severe economic and political repercussions. As a consequence, both the Russian government and the IMF raised the stakes in the stabilization program from late 1997 to August 1998, extending financing and verbal support to Russia. The measures were not self-sufficient, however, but rather bought time in hope that external conditions would turn for the better until a set of urgent structural reforms took effect. The support of official international creditors managed to ease the fears of financial investors that the ruble exchange rate regime was unsustainable. However, this policy ultimately aggravated the local and global impact of Russia's devaluation.

d. **The crisis united the political spectrum and spurred fiscal consolidation.** The precipitous devaluation and fears of social unrest forced the Yeltsin administration and its supporters into a de-facto coalition with the (hitherto unreformed) communists. This "grand coalition" quickly developed a broadly-based political consensus, which shaped economic policy across various governments from 1999 to 2001. The policy used tight regulation where the government lacked confidence in the functioning of markets. In particular external capital flows were restricted. However, it also put great emphasis on fiscal consolidation, boosted tax collection, forced domestic households to accept huge real income losses and achieved a restructuring of a large part of domestic and foreign government debt.

e. **Post-crisis stabilization policy lacked monetary ambition but was robust to shocks.** In fact, Russia's 1999–2001 stabilization policy was almost diametrically opposite to 1995–98. It set modest and flexible monetary objectives. Disinflation even stalled at times and the exchange rate was governed by an intransparent managed floating. However, the authorities were rigid in their commitment to fiscal consolidation and enjoyed broad political support. Together with the persistent stabilization of the political environment, risks to government solvency and exchange rate stability quickly faded. External shocks, particularly the drop in oil prices and the emerging markets crises in Turkey and Argentina in 2001 could not rattle the stabilization program and had little impact on Russia's asset prices.

f. **Since 2000 Russia is on an economic convergence course with Central Europe and the EU.** The political and monetary stabilization allowed economic policy to focus from 2000 on investment and growth. But the crisis had discredited the idea that old Soviet economic structures would simply adjust to a market economy by using foreign capital. Instead, the Russian government began to follow the successful example of Central Europe's transformation economies using a standard set of supply side reforms. The key measures of 2000–2001 included a drastic simplification of the tax system, a cut in marginal and statutory taxation, a reduction in bureaucratic obstacles for businesses, and a strengthening of property rights.

In light of these observations, the Russian case supports more general propositions on Emerging Markets risk management. Thus, it reminds investors to be wary of highly ambitious monetary stabilization programs. It also admonishes investors to give credit political commitment only to the extent that it is prudent and sustainable. Indicators of excessive ambition are an abrupt decline in price growth, lack of domestic political support, precedence of disinflation over fiscal consolidation and steep real appreciation. In addition, any monetary stabilization program warrants to be checked with respect to its robustness to swings in international capital flows and on the feasibility of a contingency plan.

2 Ambitious monetary stabilization and rising financial vulnerability: 1995 to 1997

2.1 Overview

The period 1995 to mid-1997 was boom time for Russia's financial markets. The value of the Russian bonds and stocks soared, with the participation of foreigners in these asset markets increasing rapidly. International investors' optimism about the country's future was lifted by stabilization policy that followed the advice of Western institutions and political victories of the pro-reform camp:

- An **IMF-sponsored stabilization program** managed to reduce the pace of ruble depreciation drastically from 141% in 1994 to 14% in 1997 and to lower headline consumer inflation from 194% at the end of 1994 to only 7.9% at the end of 1997. At the same time GDP rose by 0.9% in 1997, the first increase since the beginning of system transformation.

- The **struggle for political power**, which had reached its apogee during the 1991 and 1993 coup attempts, and persisted in conflicts between the president and a communist-dominated State Duma (Lower House of Parliament), failed to unseat the pro-reform administration. In particular, Boris Yeltsin's victory in the 1996 presidential elections barred communist and nationalist forces from power. The post-election administration featured an increased number of "young reformers" as ministers. Most importantly, the failure of left and right wing extremists to capitalize on the immense social hardship of the first five years of system transformation removed one of the biggest risks for Russia's economic and political development.

However, confidence in sustained economic expansion and stabilization missed an essential point: The very coincidence of fast-track monetary stabilization and political power struggles created a divergence between monetary ambitions and fiscal realities. Large capital imports were required to reconcile exchange rate stability with a growing public sector deficit. And the inertia of the economy's structural deficiencies raised doubts on whether foreign financing was just a short-term necessity. Thereby, Russia's public sector and external accounts became increasingly vulnerable to swings in global market prices and investor sentiment.

2.2 Motivation and flaws of the stabilization program

2.2.1 A simple plan

Commitment of the political leadership to a drastic stabilization program in 1995 reflected not only general concerns over inefficiencies created by high inflation. It was also motivated by the socially painful experiences of the 1991–92 hyperinflation and the more recent 20% collapse of the ruble against the US dollar on "Black Tuesday" in October 1994. The Yeltsin administration had reason to fear that another such incident would be a devastating blow to its political prospects ahead of the critical 1996 presidential elections. Meanwhile, international economists claimed that a reduction of inflation in Russia would greatly benefit efficiency and growth.

Thus a program was drafted in cooperation with international financial institutions that focused on rapidly reducing ruble devaluation and money growth, by using two key mechanisms:

- A change in the central bank law in April 1995 **barred the Central Bank of Russia (CBR) from direct lending to the government**. This was a crucial step, as in the early 1990s the lack of domestic savings and financial structure had fueled monetary financing of government deficits. Monetary financing had been the main source of inflation ever since.

- In July 1995, the CBR introduced an exchange rate target band. The regime was mutating during the following three years, featuring various corridor ranges, levels and crawls[3]. Also, from 1996 the CBR targeted an "inner band" with a small range and a short announcement horizon, in order to smooth the day-to-day fluctuations of the ruble. Yet the principal regime remained in place until August 1998. It slowed ruble depreciation to a 9.7% average during target regime which compares impressively to the 138% during the 2 years prior to it. Frequent and sometimes large interventions on behalf and against the ruble underscored the CBR's commitment to the exchange rate regime.

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[3] The CBR announced and sustained the following exchange rate target bands: 4.3-4.9 RUB /USD for the second half of 1995, 4.55-5.15 RUB /USD for the first half of 1996, a sliding band starting at 5.0-5.5 and ending at 5.6-6.1 RUB /USD in the second half of 1996, a sliding band going from 5.5-5.75 to 5.75-6.35 RUB /USD in 1997, 6.2 RUB /USD +/- 15% from January to August 14 1998, and 6.0-9.5 RUB /USD from August 17 to September 1 1998 (IMF, 1999).

Importantly, the program sought monetary stabilization first and accepted that fiscal consolidation and structural would take more time. Specifically, the inflation pressure exerted by fiscal deficits was to be stemmed before the deficits themselves were to be reduced. The order of priorities reflected hopes that monetary stability would foster economic activity and government revenue collection, launching a virtuous cycle of economic development. However, it was probably also a concession to political ambitions. Both the federal administration and the international community had an interest to speed up Russia's recovery, after the early of transition had precipitated a collapse in output and real income, and popular discontent strengthened the political influence of left and right-wing extremists. And, it was far more tedious and time consuming to reform the tax and treasury system than changing the operational principles of the CBR[4].

2.2.2 A worsening fiscal Achilles heel

On paper the stabilization program also contained a commitment to fiscal consolidation. It stipulated a reduction in the federal government deficit, an increase in cash revenues and selections and cuts in costly state activities. Yet the quantitative objectives were modest and the results even poorer, neither of which was surprising given the country's political pressures, the structural economic deficiencies and improving access to foreign finance:

- The **federal budget cash deficit increased** from 5.7% of GDP to 8.4% in the 1996 election year. Financial markets and IMF support accommodated higher borrowing requirements in 1996 and 1997 without apparent problems. Under pressure of the unfolding financial crisis it was reduced in 1998, but remained at 5.9%, above its level at the beginning of the stabilization program.

- Meanwhile, **the aggregate deficit of the enlarged government** (including regions, municipalities and four off-budget social funds) **widened even more from 6.1% in 1995 to 8% in 1998**. This reflected a deterioration of the budget gap of sub-federal territorial entities from 0.3% of GDP to 1.3%. Regional and local budgets increasingly suffered from the burden of "unfunded mandates". This means that in the wake of

[4] Fiscal reform was slowed not only by legislative but also pure technical constraints. Thus, it took the Ministry of Finance until 1998 to implement a treasury system that would control all non-defence spending of the federal government. Expenditures of the defence sector were being gradually integrated into this system from 2000.

devolution of state activity they became liable for an increasing share of social expenditures – including for child benefits, housing and education – without receiving an equivalent increase in their share in general government revenues. Also, by 1997 regions and municipalities began gaining access to foreign capital.

- **Cash revenues declined from already low levels.** On the federal level they fell from 12.9% of GDP in 1995 to just 10.7% in 1998. Enlarged government revenues declined from 33% to 31.7%. Tax collection problems were mostly structural and tedious to ease. Tax laws were complicated, inefficient and inconsistent. Marginal and statutory taxation was high, motivating evasion. Low public sector income and weak auditing capacities fostered corruption. And the lack of a workable bankruptcy law discouraged the enforcement of budget claims against companies. Also, the government accommodated the custom to use non-monetary fiscal operations. In particular in 1996 the government made extensive use of so-called "tax offsets", tax credits that were issued as payment for state purchases of goods and services, and "monetary offsets", ad-hoc arrangements for enterprises that were both creditor and obligor of the government (Government of the Russian Federation, 2000a). Tax offsets disappeared during 1996, but monetary offsets remained in use until 1997. In addition, Commander and Mumssen (1999) argue that authorities tolerated the accumulation of arrears and non-monetary transactions among companies as support and credit to loss-making companies, which would not show up in the public budget. Indeed, non-monetary transactions also proliferated between companies. The Russian Economic Barometer survey suggests that the share of barter in industrial sales soared during the stabilization program from below 20% in 1995 to roughly 50% in 1998.

- **Cash expenditures of the federal government soared** from 18.6% of GDP in 1995 to 20.9% in the 1996 election year. The government cut spending thereafter, particularly in 1998 in response to financing constraints down to 16.6% in that year. Most impressively, non-interest spending was compressed from 15.1% in 1995 to just 12.4% in 1998. However, the reduction in cash spending was not matched by a similar cut in spending commitments. Government arrears were rising, particularly in 1997 and 1998, and fueled the economy-wide non-payment problem.

With persistently high deficits and barred from monetary financing, the government's borrowing requirement was soaring. There were few domestic funds available however: Russian household savings were modest, and the domestic banking sector tiny by international standards. Thus federal government borrowing required capital imports. As a result, the inflow from gross foreign currency loan disbursements and non-residents' GKO purchases surged from below USD 8bn in 1995 to USD 21.7bn in 1997 and was still at USD 18.5bn in 1998. The sources of external funding were broadly based:

- **Official lending:** Russia's stabilization program enjoyed considerable official international support, in the form of words and funds. Gross foreign currency loan disbursements from bilateral and multilateral creditors (mostly IMF and World Bank) surged from an already sizeable USD 4bn in 1994 to an annual average of USD 7.4bn in 1995–98. The federal government's liabilities to IFIs jumped from USD 5.4bn in 1994 to USD 26.2bn just before the crisis escalation in July 1998.

- **Eurobonds:** The Russian federation issued its first Eurobond with a face value of around USD 1bn to the markets in 1996. In 1997 the government raised a further USD 3.6bn through three new issuances. And in 1998 proceeds from Eurobonds soared to USD 9.6bn, albeit this number was inflated by the USD 4.4bn Eurobond-for-GKO swap in July 1998, which had no impact on budget financing.

- **GKO/OFZs[5]:** In 1996 and 1997 the local (ruble-denominated) government bond market flourished and became the key channel of capital imports. Non-residents were permitted to participate in the local market from early 1996. Trading and repatriation was initially heavily restricted, but liberalization progressed fast[6]. In combination with the high USD returns under the exchange rate target regime this led to a rapid increase in international investors' bond purchases[7]. Thus the stock of outstanding

[5] GKO denotes a ruble-denominated short-term bond promising to pay a pre-determined face value at a specific date. They were first issued in 1993. OFZ-PK is a variable-rate ruble denominated coupon bond with a maturity of more than a year. They came to the market in 1995. Finally, OFZ-PD denotes a fixed-rate ruble-denominated coupon bond. These were issued in 1996 to amortize debt accumulated to the CBR in 1992-94.

[6] From January to July 1996 foreigners could only buy GKOs and OFZs in primary auctions and were obliged to hold the paper until maturity. Repatriation of the proceeds was only possible through foreign exchange forward contract with the CBR. From August 1996, non-residents were admitted to the secondary market, but proceeds of transactions had to be deposited in special "S-accounts" with local banks. Repatriation of these funds required a notice to the central bank as well as purchase and holding to maturity of 3-6 months foreign exchange forward contracts. Counterpart of the contracts was the CBR, which set the forward exchange rates such that the USD yield on GKOs and OFZs was at a targeted level. The share of non-resident funds subject to forward transactions was gradually lowered from 100% in the first quarter of 1996 to 25% in mid-1997 (Vavilov et al., 1999). From January 1998 restrictions on repatriation were removed.

[7] The average GKO yield in 1996/97 in USD terms was 34.7% annualized.

> GKOs and OFZs soared from RUB 67.6bn (USD 14.9bn) at the end of 1995 to RUB 380.2bn (USD 64.3bn) at the end of 1997. The government estimates that non-residents' purchases went from zero to USD 5.9bn in 1996 and a staggering USD 10.9bn in 1997.

A substantial share of external funding was used for the amortization of old foreign debt. Yet despite redemption payments and some debt restructuring total outstanding external debt of the government rose from USD 127.5bn at the end of 1994 to USD 176.4bn in July 1998. Also, the official balance of payment data show net foreign lending to either the federal government or the CBR of a total USD 12.7bn in 1996 and USD 21bn in 1997, which was worth some 3% and 4.7% of GDP respectively. Such generous external funding benefited stabilization not only through termination of monetary financing. It was also a precondition for sustaining the exchange rate regime after the surge in the real exchange rate of the ruble in 1995.

Table 1: Russia's external debt 1994–1998

USD billion, end of period	**1994**	**1995**	**1996**	**1997**	**Jul-98**	**Dec-98**
Federal government						
Soviet-era debt	108.6	103.0	100.8	91.4	91.8	93.6
New Russian debt	11.3	17.4	24.2	32.1	51.2	51.4
of which: IMF	5.4	11.4	15.3	18.7	26.2	26.0
Eurobonds	0.0	0.0	1.0	4.5	15.8	16.0
MinFins (1)	7.6	7.6	11.1	11.1	11.1	11.1
GKO-OFZ (2)	0.0	0.0	7.2	17.7	20.1	5.8
Subfederal entities	0.0	0.0	0.0	1.3	2.2	2.4
Total government	127.5	128.0	143.3	153.6	176.4	164.3
as % of GDP (3)	74.1	37.5	36.2	35.7	42.5	126.4
Private	4.9	6.3	11.3	50.9	57.3	43.4
as % of GDP (3)	2.8	1.8	2.9	11.8	13.8	33.4

Source: Bureau of Economic Analysis, Moscow
(1) Domestic foreign-currency bonds issued by the Finance Ministry
(2) Domestic debt (GKOs and OFZs) held by non-residents
(3) Previous four quarters nominal GDP measured at current exchange rate

2.3 Signs of excessive ambition

The authorities' inability to reduce fiscal deficits was one indication that stabilization ambitions were not in sync with structural economic and political realities. The point is reinforced by a comparison of Russia's 1995–98 stabilization with similar efforts in Central Europe, which reveals the former as far more rapid, while political support for government policy was weaker and conditions for investment (and thus sustained capital imports and real appreciation) were much poorer.

a. A rush for disinflation

An important fact should be stated first: inflation was not out of control at the outset of the stabilization program in 1995. Indeed, Russia was well past the initial price liberalization shock which had sent prices soaring across transition in the late 1980s or early 1990s. Also, the country had clearly overcome its hyperinflation phase. Headline annual consumer price growth had settled just above 200% by late 1994 down markedly from 1126% on average in 1992 and 971% in 1993. True, inflation failed to drift lower during the first half of 1995, reflecting ongoing monetary financing and recurring bouts of exchange rate weakness. However, in that respect, Russia's position was similar to that of advanced Central European countries, Poland, Hungary and the Czech Republic (CE3) in 1991, and, after some setbacks, in 1993–95. The Russian authorities, like their counterparts in the CE3, faced the task of reducing inflation on a sustained basis by reining in fiscal deficits, curbing money growth and raising confidence in the local currency. The difference was that Russia's monetary and fiscal structures were much weaker and that inflation had to be reduced from a much higher level.

Table 2: Central- and Eastern Europe disinflation periods in the 1990s

% over a year ago

Country	Start date (1)	CPI inflation at beginning	after 1 year	after 2 years	after 3 years	Disinflation sustained? (2)
Poland	91Q1	99.1	47.1	41.4	32.2	yes
Poland	95Q1	33.0	27.6	17.2	13.9	yes
Hungary	91Q2	39.0	21.1	21.9	18.3	no
Hungary	95Q2	30.4	23.9	18.3	15.3	yes
Czechoslovakia	91Q2	67.6	7.7	–	–	no
Czech Republic	93Q2	21.8	9.3	10.1	8.4	yes
Russia	95Q3	213.6	43.7	14.7	7.2	no

Sources: GUS, KSH, CSO and Goskomstat

(1) starting points are either end quarter of hyperinflation or end quarter of periods of rising or stable inflation

(2) "yes" if disinflation was followed by further decline or stable inflation or just slight temporay inflation rebound (<5%-points and <1year).

Against this backdrop it is remarkable that the Russian stabilization program sought to reduce headline consumer inflation much faster than this happened in any CE3 country during the 1990s. Within two years of the launch of the program the country had slashed its annual consumer price growth from 213.6% to just 14.7%. That was a reduction of 189.9 percentage points to a ratio of 0.069 of the initial rate. For comparison, disinflation periods in the CE3 on average reduced annual inflation by 22.9 percentage points within two years or to a ratio of 0.513 of its original rate (Table 2). As a consequence, Russia's consumer inflation had fallen below the lowest rate of the CE3 by early 1998.

The rush for stabilization was documented by other indicators as well. In particular, the slowdown in wages and monetary aggregates was more abrupt than in the CE3. Average monthly wages decelerated from 127.1% annual growth at the outset of the stabilization program to 18.5% two years after. M2 slowed from 154.9% to 32.6% over the same period and even contracted ahead of the 1998 crisis escalation. Among the CE3 only Poland had to lower money growth from such dizzying heights. In the Polish case M2 decelerated from 160% in the last quarter of 1990 to 45.6% two years later. However, that slowdown occurred in the context of preceding hyperinflation. Poland's broad monetary aggregate decelerated far more gradually thereafter. At the end of 1997 Russia's money growth rate had slowed below Poland's.

Table 3: Money growth and currency depreciation in disinflation periods

growth denotes % over a year ago, ratio is normed to 1 for the first quarter of disinflation

Country	Start (1)	M2 growth initially	M2 growth after 2 years	M2/CPI ratio after 2 years	NX growth initially	NX growth after 2 years	NX/CPI ratio after 2 years
Poland	91Q1	90.6	49.9	1.01	147.3	9.6	0.67
Poland	95Q1	36.3	28.4	1.27	22.9	7.4	0.81
Hungary	91Q2	25.8	27.0	1.12	13.4	7.2	0.78
Hungary	95Q2	12.7	17.9	1.13	36.3	8.3	0.85
Czech Republic	93Q2	2.1	16.3	1.22	-4.3	2.5	0.83
Russia	95Q3	154.9	32.6	1.32	134.6	-2.5	0.68

Sources: GUS, KSH, CSO and Goskomstat
NX is the nominal exchange rate defined as the ruble value of a trade-weighted basket of foreign currencies
This is based on nominal trade-weighted exchange rates computed by JPMorgan Chase Bank
(1) starting points are either end quarter of hyperinflation or end quarter of periods of rising or stable inflation

Most importantly, the Russian authorities employed exchange rate policy for disinflation far more aggressively than any of the CE3 countries. This was indicated by the rapid stabilization of the nominal exchange rate, both relative to other countries and Russia's own consumer price disinflation, and the surge of the real exchange rate:

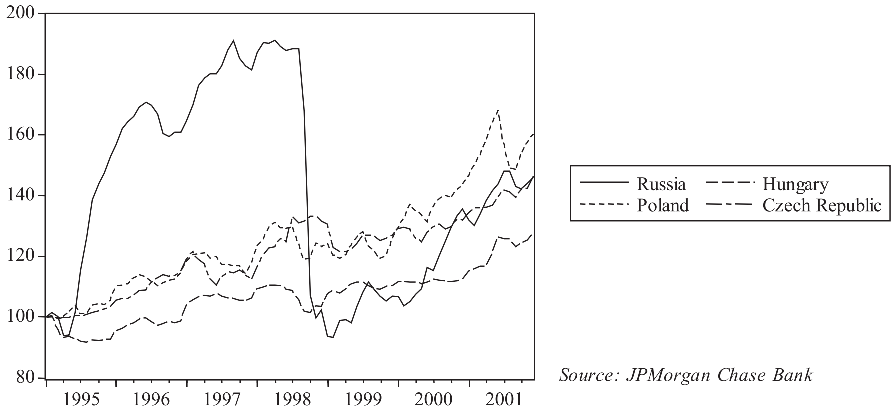
- **The swing in the exchange rate dynamics was outstandingly drastic:** At the beginning of the stabilization program in 1995 the ruble price of a trade-weighted basket of currencies posted 134.6% annual growth, more than four times the pace of the highest "foreign currency inflation rate" in the CE3 (Hungary at 31.2%). Only two years after the launch of the stabilization program the ruble had actually begun to appreciate in nominal trade-weighted terms (and against the Central European currencies). No CE3 country posted a similar impressive swing, except towards the end of hyperinflation phases.

- **Disinflation relied narrowly on this exchange rate swing:** The deceleration in currency devaluation outpaced consumer price disinflation. By itself this would not be remarkable, as all disinflation periods in the CE3 and Russia relied on foreign exchange rate stabilization. What is remarkable though is how aggressively and narrowly Russia relied on this mechanism. The point is illustrated in Table 3. The final column NX/CPI ratio represents the price of a unit of the foreign currency basket two years after the start of disinflation relative to a unit of the CPI basket and as ratio to the relative price at the start date. All ratios are below unity, indicating that foreign currency became cheaper relative to domestic goods or – equivalently – that external stabilization progressed generally faster than internal disinflation. However, the ratios are outstandingly low for Poland 1991–93 and Russia 1995–97. Meanwhile, a similar ratio computed for the relative dynamics of M2 and CPI (third column) shows that in all cases money has grown faster than the CPI in disinflation periods, reflecting the de-dollarization and fast development of the financial sector in transition economies. However, the pace of excess growth of money was vastly different across cases. In particular, Poland in 1991–93 combined the drastic slowdown in zloty depreciation with almost stagnating real money balances. By contrast Russia in 1995–97 posted the highest excess growth of money, underscoring that the program relied much more heavily than others on the foreign exchange rate.

- **The resulting real appreciation was many times as fast as in the CE3:** According to JPMorgan's real trade-weighted exchange rates (CPI-deflated) real appreciation of the ruble from the mid-1995 to mid-1997 was 77.8%. This came on top of a 238.2% real appreciation over the previous three years, which had however been less worrisome, however, as it was largely a result of large-scale price liberalization. Indeed, the largest post-liberalization real appreciation that any CE3 economy achieved over two years was 32.9% in Poland from mid-1999 to mid-2001, a spurt that was not sustainable and gave way to an 11.3% real depreciation in just 2 months thereafter.

Real trade-weighted exchange rates

index, January 1995=100



Source: JPMorgan Chase Bank

b. Russia lacked broadly based political consensus for reform

Prior to the 1998 crisis escalation, political support for economic transition in Russia was weaker than in the advanced Central European countries. This not only reflected the organizational strength and long tradition of the orthodox communist party. Also, in contrast to Central Europe, Russia could not refer to experience with a market economy prior to World War II or during the era of Soviet dominance. Moreover, its politicians were not united by prospects of fast EU accession and common fear of Russian hegemony in the region. In Russia system transformation coincided with the breakup of the Soviet Union and a downgrade from the status of a global superpower. In addition, economic transition in Russia was particularly painful, as the long era of central planning had endowed the country with a large self-sufficient defense industry and huge manufacturing compounds in geographically remote regions. Social consequences of large-scale plant closures were severe, as many regions depended on a small number of companies, if not a single factory. Labor migration was hampered by geographic distances, relocation costs and the dependence of workers on benefits of locally dominant enterprises (Friebel and Guriev, 2000).

The lack of broad-based support for reform translated into wide rifts and bitter political infighting among the various sections of the political spectrum. Climaxes of that confrontation were the putsch attempts in August 1991 and October 1993. Furthermore, communist and nationalist parties were strong in many regions and the State Dumas elected in 1992 and 1996, turning the parliament into a bottleneck for stabilization and reform legislation.

However, the lack of basic political consensus and fears of a communist comeback did not only block law projects and budget measures. It also weakened the government's position with respect to the enforcement of policy tightening and the fight for law and order. Specifically, the fragile political situation forced president Yeltsin into alliances with so-called business "oligarchs", in Moscow as well as in the regions. To be sure, there was an obvious strong case to sponsor a post-communist economic elite, which owed its wealth and influence to reform and possessed a natural aversion to central planning and an authoritarian political system. However, the business oligarchs had mainly economic interests and as such were expensive allies. The post-communist administrations earned themselves a reputation for putting a blind eye to the plundering of state assets by the new "entrepreneurs" and the ongoing operation of obviously bankrupt companies.

These occurrences not only undermined public confidence in president and government. They also indicated that the stabilization process was compromised by soft legal constraints for companies and the proliferation of payment problems (Perotti, 2001, Pinto et al. 2000, Schleifer and Treisman 1998). The important consequence was that policy tightening from 1995 did not lead to mass closures and restructuring of unviable firms, but rather boosted payment arrears and non-cash transactions. In such an environment prices rarely reflected true cash payments for goods and services. The resulting misallocation of resources and distortion of statistics was often referred to as a "virtual economy" (Gaddy and Ickes, 1998).

c. Russia's business conditions were poor

The ambition of rapid stabilization looked particularly presumptuous in light of the existing business conditions in the mid-1990. As section a. above pointed out, Russia's stabilization program relied on rapid real appreciation. Such a strategy obviously required two necessary conditions. First, the country needed to attract sufficient foreign capital to push up the real exchange rate over the full length of the disinflation program (and sustain it at an elevated level later). Second, productivity growth in the economy had to be fast enough to prevent a large-scale crowding out of domestic producers as consequence of the strengthening currency. These two conditions ultimately required attractive investment opportunities. Put more specifically, foreign funding – channeled through the local financial system, the government or direct investment – ultimately had to translate into fixed investment with high returns on capital.

Unfortunately, Russia was not at all an attractive place for fixed investment at the time. While the country's long-term potential looked promising, current business conditions in the mid-1990s were among the poorest in Europe, judging from enterprise surveys and a very low fixed investment ratio. With some benefit of hindsight, the 1999 country staff report of IMF claimed that "...in 1995 Russia did not possess an adequate legal and institutional framework to support a market economy." The weakness in institutional and legal conditions for investment in the country's production sector is well documented in the literature as well as investor advisory and press reports at the time. The most prominent deficiencies are summarized below:

- **Property rights were poorly defined and protected.** Federal law had not even established the principle of private land ownership. Fears of re-nationalization of privatized companies were widespread. Most importantly, legal uncertainty and arbitrary state interference in business affairs undermined the security of property and required firms to pay regular bribes to officials. A study by Johnson, McMillan and Woodruff (1999), which polled private manufacturing firms in the second quarter of 1997 revealed that more than 91% of the surveyed managers made extra-legal payments to government authorities. This compared with just 20% in Poland at the time.

- **Corporate governance was marred by abuse.** Russian firms were dominated by insiders – managers and workers – as a consequence of the 1992–94 mass privatizations[8]. Poor legal protection of shareholder rights further enhanced the leverage of managers over company affairs. Also, the joint power of managers and large shareholders sometimes marginalized the influence of minority shareholders (Sprenger 2002). As a result, insiders were often violating shareholder and creditor rights. There were

[8] A 1995 Russian Economic Barometer survey on 136 companies found that managers and workers owned on average 55% of firms' equity capital (Kapelyushnikov, 2000). And a 1999 EBRD and World Bank survey states that the ratio of large and medium-size companies in Russia that was dominated by insiders was still 40%, compared to 10% in Poland, 11% in Hungary and 3% in the Czech Republic (Hellman et al., 2000).

abundant press reports with allegations of asset stripping, transfer pricing, share dilutions and delayed dividend payments.

Bankruptcy mechanisms worked poorly, a principal cause of soft budget constraints. Inefficient companies could persist operating even if they failed payments or lost their equity capital. This hampered the development of new more efficient enterprises and placed a burden on the public sector budget.

A study by McKinsey (1999) concluded that government policy was favoring large unproductive companies through preferential tax treatment and subsidized energy prices. The study suggests that the resulting distortions to competitiveness were a major discouragement for investment and hampered productivity growth.

Poor legal conditions were only one deterrent for investment. Furthermore, capital spending was inhibited by lingering political instability, an inefficient tax system and a banking sector that was tiny even by the standards of transition economies. True, the stabilization program drafted in 1995 contained many promises for structural reform. However, in the judgment of the IMF the Russian authorities rarely met their objectives (IMF, 1999). And even with rapid legal reforms the program would have implied a lag between real appreciation and better investment conditions. In the event, the slump in investment actually worsened:

- **Real fixed investment contracted during the stabilization program** by a cumulative 34.5% (full year 1998 compared to full year 1995), while it was growing rapidly in the CE3 during that time. The ratio of fixed investment to GDP fell in Russia from 21% in 1995 to 17% in 1998, well below the roughly 35% in Poland, and 30% in Hungary and the Czech Republic.

- **Foreign direct investment remained tiny by the standard of transition economies.** FDI (as measured in the balance of payments) as ratio of GDP averaged 0.4% from 1995–1998, compared to 2.1% in Poland, 3.7% in Hungary and 3.6% in the Czech Republic. Private consultancy and World Bank/EBRD surveys showed that the business climate for foreign investors continued to be worse than in Central Europe (Hellman et al., 2000).

- **Business surveys showed low and declining confidence of local businesses** in economic policy over the length of the stabilization program. The IMEMO survey showed that from 1996 to 1998 the share of business managers that approved government policy was consistently less than 5%, much worse than the 25–30% approval ratings during the early phase of economic transition[9].

Without high investment and a rejuvenation of the capital stock, productivity growth had to remain modest and production was strangled by real appreciation. Indeed, as is mentioned in section 2.4.1, Russian imports were growing rapidly, both in volume and value terms, eroding the current account surplus by the end of 1997. The manufacturing sector continued to contract throughout the stabilization program, which was a remarkable contrast to Central Europe and which prevented a broadly based convincing recovery of the economy until 1999.

2.4 Growing risks for macroeconomic stability

2.4.1 The vulnerability of the foreign-exchange regime

The single most vulnerable point of the stabilization program was its dependence on capital inflows. High and growing capital import was in two ways essential for the country's fast-track monetary stabilization. First, it allowed the government to finance its budget deficit without printing money, and thus precipitated a collapse in money growth. Second, capital inflows boosted the real exchange rate and supported sustained deceleration in currency devaluation below the pace of money growth and inflation.

However, while the influx of foreign funds propelled monetary stabilization almost mechanically, it was of course no such quick and simple remedy for the fiscal and structural malaises. The breakthrough on the monetary side was not matched by similar successes in fiscal consolidation and productivity growth. By contrast, the government's easy access to foreign capital diminished the pressure to reduce fiscal deficits. Also, real appreciation hurt the competitiveness of Russian manufacturers, discouraged fixed investment and eroded the current account deficit. As a consequence, public finances and external accounts became dependent on sizeable net capital imports for a sustained period, presumably until structural progress would catch up with stabilization. In light of the poor start position of the country, as described in section (2.3.), this was likely to take many years.

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[9] *Source:* IMEMO (Institute for World Economy and International Relations, www.imemo.ru).

Table 4: Russia: Key positions of the balance of payments 1994–1998

USD billion	**1994**	**1995**	**1996**	**1997**	**98H1**	**98H2**
Current account	8.4	7.5	11.8	2.1	-5.7	6.4
Merchandise and services trade	10.5	10.7	17.1	11.1	-0.5	13.3
Factor income	-1.8	-3.4	-5.4	-8.7	-5.0	-6.8
Current transfers	-0.2	0.2	0.1	-0.4	-0.3	-0.1
Capital and financial account	-9.0	9.8	-8.2	4.7	9.3	-6.2
Capital transfers	2.4	-0.3	-0.5	-0.8	-0.3	-0.1
Net direct investment	0.4	1.5	1.7	1.7	0.3	1.2
Net portfolio investment (1)	0.0	-2.4	4.4	18.5	8.1	0.5
Net other investment (1)	-11.8	11.1	-13.8	-14.6	1.2	-7.7
Memo: Federal government capital imports	n.a.	2.5	11.4	19.7	12.2	0.4
Errors and omissions	0.4	-8.0	-4.9	-4.9	-5.3	-3.8
Net international reserves (2)	0.1	-9.3	1.4	-2.0	1.7	3.6

Source: CBR, IMF
(1) adjusted for USD27 billion Paris Club restructuring in 1997Q4
(2) includes position "adjustment to currency reserves", negative sign denotes increase

The acute and persistent need for large capital inflows was well documented by the balance of payments at the time. In the early years of the program, 1995 and 1996, private sector capital outflows and government debt amortization payments were well in excess of the current account surplus. On average federal government amortization payments and capital flight exceeded USD 23bn[10] per annum, while the current account surplus averaged just USD 9.6bn. In order to offset that drain the government restructured its Soviet-era debt stock and borrowed new funds under the trademark "Russian Federation" from official financial institutions and the financial markets. Inflows related to the federal government soared from a modest USD 2.5bn in 1995 to USD 11.4bn in 1996. Yet, the "private sector drain" on foreign exchange was worsening rather than improving during the period:

- **The current account surplus disappeared:** As a consequence of rapid real appreciation merchandise imports into Russia soared, while export volumes stagnated. The merchandise trade balance excluding oil and natural gas went into a deep deficit. Meanwhile, the growing short-term lending of the government boosted the country's interest bill to foreigners

[10] The IMF estimates due amortization payments in 1995 at USD 12.6bn and in 1996 at USD 10.9bn (IMF, 1999). Capital flight is taken from the CBR estimates in Table 5.

and the factor income deficit. Altogether, the current account surplus was gone by th's e second half of 1997.

- **Capital flight worsened:** The official estimates of the CBR failed to show a trend decline in capital flight during the stabilization program from 1995 to 1998 (Central Bank of Russia, 1999). Instead, capital flight appeared to have peaked at above USD 15bn in 1997 and declined to just below USD 12bn 1998, due to increasing capital controls after the August 17 crisis escalation[11].

Table 5: Russia: CBR estimate of capital flight development during the stabilization program

USD billion	**1994**	**1995**	**1996**	**1997**	**1998**
Non-repatriated export earnings	3.9	4.9	4.2	3.7	4.6
Unredeemed import advances	0.0	0.0	4.3	6.9	4.3
Non-equivalent barter	0.0	0.0	1.3	0.8	0.4
50% of BoP errors and ommissions	0.2	4.0	4.5	4.1	4.5
Total	4.1	8.9	14.3	15.5	13.8
as % of foreign exchange reserves	50.4	86.3	90.8	79.0	86.4

Source: CBR, IMF

The private sector foreign currency outflows further fueled the government's appetite for foreign financing. The balance of payments show annualized inflows related to the federal government jumping to USD 19.7bn in 1997 and persisting at around that pace (annualized) through the first half of 1998.

The dependence on government capital imports, and the proliferation of eurobond and GKO/OFZ issuance for that purpose, made the exchange rate regime (and thus the overall stabilization program) vulnerable to swings in global investor sentiment. Ultimately this exposed the country to both global market and domestic policy shocks. The probability that over a 3–5 year period either of these shocks would, at least temporarily, spoil foreign investors' appetite for Russia assets was high. As a matter of fact, over the period analyzed in this paper (1995–2001) the emerging markets segment of financial assets was rocked by no less than eight crises in major developing

[11] A study by Loungani and Mauro (2000) shows similar results for various "hot money" and "broad money" measures of capital flight from Russia. All show an increase in outflows during the stabilization program compared to 1994, albeit some measures here show the peak in 1996 rather than 1997.

economies[12]. Meanwhile, Russia itself saw no less than seven government reshuffles, which included a change in prime minister and were often accompanied by tumultuous disputes between parliament and president and phases of uncertainty about policy.

Moreover, the structure of foreign investment allowed a rapid turnaround in flows. The vast majority of capital inflows into Russia were classified as portfolio investment in short-term government bonds and equity. Just before the first wave of crisis in October 1997 more than 80% of the domestic government bond market consisted of GKOs with maturity of less than one year. The outstanding stock of short-term government bonds was thus in excess of USD 50bn or more than two and a half time the amount of foreign exchange reserves at the CBR. It was also no advantage that non-residents held a large stake of this paper (some 41% of domestic bonds were held by foreign investors in October 1997). Medvedev and Kolodyazhny (2001) argue that non-resident investors rather destabilized the GKO/OFZ market in the subsequent period of turbulences from November 1997 to August 1998. In an empirical analysis based on daily trading data the authors claim that non-residents responded disproportionately strongly to both good and bad news on market "fundamentals", presumably reflecting their access to abundant alternative investments.

It is important to understand that a reversal of capital flows was not even necessary to sink stabilization program. A mere reduction would have sufficed. Thus, only a 50% decline in portfolio inflows would have been worth more than USD 9bn p.a. or 50% of foreign exchange reserves in 1997. This underlined the risk that even a modest initial loss of confidence, which would leave the portfolio investment balance positive, could undermined the sustainability of the ruble regime, raise doubts among investors and might, thus, escalate. And an outright halt or reversal of capital imports was a surefire road to devaluation and rebound in inflation.

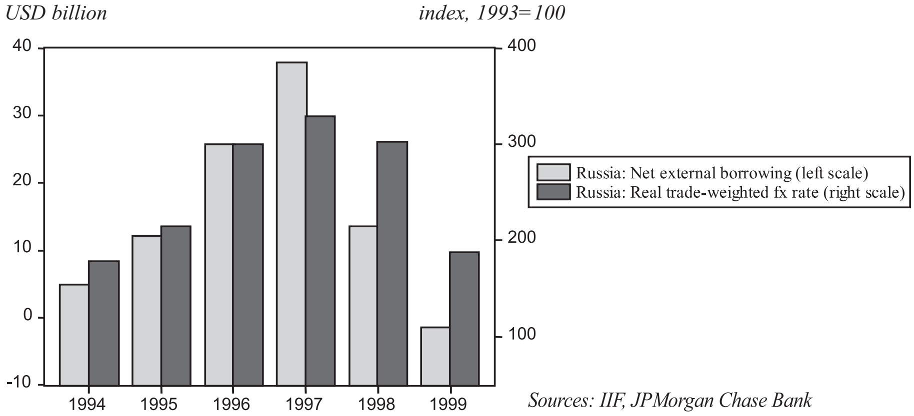
2.4.2 Inconsistency of monetary and fiscal objectives

Russia's strategy of rapid stabilization through capital imports not only "decoupled" monetary and fiscal stabilization. It made the two plainly inconsistent. That is because in the 1990s Russia had few private sector

[12] As such one can categorize country crises that had a major impact on the EMBI+ emerging markets sovereign debt index of JPMorgan, which included Mexico (1994/95), Indonesia (1997), Korea (1997), Thailand (1997), Russia (1998), Brazil (1998), Turkey (2001) and Argentina (2001).

borrowers that possessed sufficient credit quality to attract foreign investors. Corporates of international standing mostly belonged to the state or had only limited borrowing potential. As a result, the federal government was the only eligible obligor for large-scale foreign lending. And it would have been politically and legally difficult for the government of the Russian federation to borrow without the need to cover fiscal spending and deficits. In other words, the budget deficit was a prerequisite for large-scale capital imports, rapid real appreciation and fast-track stabilization.

Russia: Government net external borrowing and real exchange rate



Sources: IIF, JPMorgan Chase Bank

2.4.3 Rising stakes in the foreign-exchange regime

The mounting vulnerability of the foreign exchange regime coincided with a growing potential negative impact of its failure. In particular, ruble devaluation looked increasingly devastating for the financial positions of the government and banking system:

- **Government solvency was at risk.** The borrowing requirement of the federation was sizeable, and amounted to RUB 180bn (USD 31.6bn) in 1997. Ruble devaluation was likely to lead to a plunge in local debt market prices and spoil non-residents' appetite for new GKO/OFZ purchases. In addition, a steep fall of the currency would make it hard to issue new Eurobonds, as devaluation would almost certainly erode the tax base relative to the sizeable external debt stock.

- **Bank's solvency was threatened by devaluation directly and a potential government default.** The banking sector's dependence on the ruble stability at the eve of the crisis was not due to formal open currency positions. Rather it reflected a mismatch of maturities and high devaluation-linked default risks of obligors. Specifically, the banking statistics of mid-1998 show the following[13]:

- *The gross exposure of the banking sector was huge, with both assets and liabilities denominated in foreign currency exceeding USD 40bn.* This amount was larger than the aggregate equity capital of all Russian banks, registered officially with USD 36bn for that month at that time. To this came huge additional off-balance positions through trading in foreign exchange derivatives. Foreign-currency claims of banks through forward contracts added up to a staggering USD 93bn, while liabilities stood around USD 83bn.

- *Banks' foreign (on-balance sheet) liabilities with maturity of less than one year amounted to USD 11.8bn, while assets in the same maturity interval were less than USD 6bn.*

- *Banks' foreign currency claims looked risky, given that a large share of foreign currency loans had been made to clients without foreign currency earnings.* Also, there was a risk of a chain reaction of defaults on foreign exchange derivative contracts if some less solid credit institutions would not meet their obligations.

- *A government default would have further aggravated the situation of banks.* During the course of the stabilization program domestic credit institutions focused their lending activity heavily on the public sector. This not only reflected the government's appetite for capital, but also the dearth of sound companies and investor protection. The latter was a consequence of the legal uncertainties related to creditor rights and bankruptcies. Indeed, outstanding claims of the banking sector to the government at the end of 1997 accounted for 58% of all domestic bank lending.

[13] Source IMF 1999 and CBR monetary overview for 1998 (www.cbr.ru).

3 External shocks and lack of flexibility lead to crisis: October 1997 to July 1998

3.1 Overview

A set of external shocks, including higher global investor risk aversion and a fall in oil prices put the ruble under downward pressure. Owing to Russia's heavy dependence on capital inflows the shocks eroded the sustainability of the stabilization program almost instantaneously. However, there was no way to exit the exchange rate regime without the risk of government delinquency and a banking crisis Thus, the authorities defended the ruble by tightening liquidity and letting short-term interest rates surge. This in turn boosted borrowing costs and undermined fiscal sustainability. After a turbulent change in government, the new administration tried to save the stabilization program through drastic fiscal tightening and new official foreign borrowing. However, with doubts about both the currency and the budget lingering, such efforts looked increasingly desperate and financial markets became highly unstable and volatile.

3.2 The ruble under pressure: Triggers and consequences

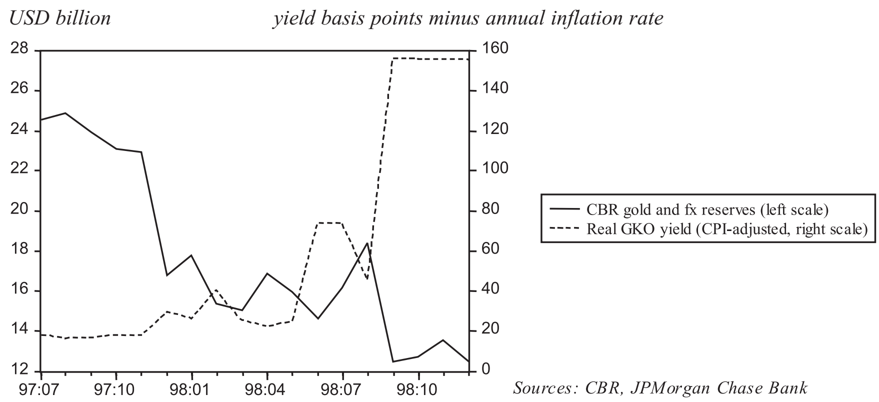
Several external shocks hit Russia's exchange rate regime from late 1997. First, on October 27 the Dow Jones Industrial Average dropped a record 554 points, raising the risk aversion of international investors. Then, the worsening Asian crisis around the turn of the year 1997/98 further fueled investors' fears and created specific misgivings against Emerging Market currencies and debt. The stripped spreads of Russian external bonds over treasuries soared from 540 basis points in the third quarter of 1997 to 690 basis points in the first quarter 1998. Finally, world oil prices collapsed by 35% in just three months, reducing the price for Urals oil from USD 19.10 per barrel in December 1997 to USD 12.40 in March 1998.

This combination of shocks meant that Russia's current account surplus was shrinking further, while foreign investors attached increased risk premia to Russian assets. Coincidentally, the CBR lifted all restrictions on the repatriation of GKO proceeds at the beginning of 1998, as the conclusion of a multiyear liberalization program, boosting the volume of short-term capital flows. Altogether, a look at the external balances in early 1998 revealed that the exchange rate regime would not be sustainable anymore if global conditions failed to improve.

- **The external balances revealed a drastic deterioration.** The worsening was mostly a reflection of real appreciation and was recorded before the oil price drop. Russia's current account posted a deficit of USD 1bn in the second half of 1997, which was a sharp deterioration compared to a USD 8.5bn surplus in the second half of 1996. In the first half of 1998 the deficit widened to USD 5.7bn in the wake of the collapse in oil prices. On aggregate the swing in the current account balance since the beginning of the stabilization program was USD 14.2bn or 3% of the 1997 GDP.

- **As the ruble came under downward pressure, interest rates had to surge to sustain capital inflows.** Indeed, the CBR initially responded to devaluation pressure on the ruble with sterilized interventions. However, with that policy the CBR lost no less than USD 7.4bn or 38% of its international reserves during the fourth quarter 1997 alone. With reserves depleting at such a torrid pace, the CBR and the government had no choice but to accept rising (nominal and real) interest rates. The Moscow inter-bank offered rate surged from 20.6% in the fourth quarter 1997 to 37.6% in the first quarter and 79.6% in the second quarter of 1998.

Russia: Indicators of crisis escalation



Sources: CBR, JPMorgan Chase Bank

- **Surging debt service costs and monetary tightening undermined the fiscal position.** Rising interest rates boosted domestic debt servicing, while the implied monetary tightening drained liquidity and cash revenues. The average GKO-OFZ yield jumped from 22% in the fourth quarter 1997 to 30.7% in the first and 40.4% in the second quarter of 1998. By contrast, headline consumer inflation declined from 12.8% in the fourth quarter 1997 to 8.0% in the second quarter of the following year, suggesting that the effective real interest rate soared even more than nominal rates. Also external funding became more expensive, albeit there was no immediate budget impact of higher Russian Eurobond spreads.

- **The economic expansion was aborted:** As funding of fiscal deficits became prohibitively expensive and interest payments soared the federal government scrambled to tighten fiscal policy. The resulting cut in expenditures, partly in form of sequestration of budgeted spending, contributed to the abortion of the economic recovery and an increasingly serious recession during 1998.

3.3 Lack of policy options and exit strategy

However, not only had the monetary and fiscal regime of the period 1995–97 become unsustainable by early 1998. Also, there was no credible policy option through which the government could have saved the foreign exchange regime by its own efforts, even if it had been ready to take drastic measures:

- **Monetary tightening** in the form of liquidity absorption in the money market and higher short-term interest rates was capable of lessening private capital outflow. However, a policy of tight money would boost funding costs for the budget and further increase doubts about the sustainability of the fiscal situation. Also, the banking system, which depended on short-term borrowing and held the bulk of outstanding GKOs and OFZs would incur heavy losses.

- **Additional fiscal tightening** was capable of reducing the delinquency risk of the federal government and supporting the current account. However, the aggressive tightening that would have been required to save the day in 1998 would also have strangled the economy, worsen the non-payments problem and increased social instability and political uncertainty.

- Finally, **structural public sector reforms** were certainly a commendable option at any time. However, the urgently required fundamental changes at the time related to the tax code and investor rights protection. Changes in these laws were not effective crisis containment measures, simply because they required time for drafting, a full-scale parliamentary approval and technical preparation for implementation. The lead of such law projects versus economic payoff was realistically longer than a year, even with swift approval of legislation by the State Duma. In fact, the government neither had much time nor a strong support base in parliament.

However, while the administration lacked the means to credibly defend the currency regime, it did not want to abandon it. Indeed, the stabilization program had never provided for an “emergency exit” through which one could depart the dollar peg in an orderly fashion. The stakes in the exchange rate were high for most Russians and foreign investors, making it politically unattractive, if not suicidal, for any politician to terminate it. The potential losers, and thus presumably opponents, of devaluation included the following:

- **President Yeltsin and his entourage of family and advisors** had thrown their full prestige behind the stabilization program. The program’s potential failure was a considerable threat for the president’s support base. Moreover, devaluation was likely to disrupt the GKO market and bring the government to the brink of delinquency, with all related the problems for orderly operation of the government and another humiliation of Russian national pride. (In the event, Boris Yeltsin’s public approval ratings collapsed below 5% after the crisis escalation[14])

- **Russian households** dreaded devaluation, for good reason. Thus, many employees had outstanding ruble claims against companies and the government through wage arrears. Also, ruble cash and deposit holdings had increased markedly since 1995. Most importantly, neither wage contracts nor social law stipulated an automatic indexation of payments to consumer inflation.

- **The international financial community** had a huge stake in Russia’s stabilization. This did not only include the trading positions in local market and external debt. Also, leading international investment banks had acted as underwriter for Russian eurobonds and recommended Russian securities (as well as GKO-OFZs) to their global client base. In addition, by 1998 many international financial institutions had built up their own offices or even full-fledged banks in Russia, predicated on the expectation of a sustained expansion of the domestic financial markets. The IMF had particularly much to lose, considering the surge in lending to Russia since 1995 and its support for and heavy involvement in the stabilization program.

[14] Source: Public Opinion Foundation (www.fom.ru).

- **The local banking system** looked fragile even without the devaluation threat, reflecting poor balance sheet management[15]. The nature of foreign currency positions (described in 2.4.3) threatened to unleash a systematic banking crisis.

3.4 Desperate measures to ward off devaluation

In the absence of effective remedies or a viable exit option, the government and the International Monetary Fund in 1998 focused on buying time. The ruble exchange rate target was defended through foreign exchange interventions, new official external financing and the introduction of fiscal and structural reform measures that meant to create confidence in the long-term sustainability of the regime. The main policy actions until the summer of 1998 included[16]:

- In March President Yeltsin replaced incumbent Prime Minister Victor Chernomyrdin with the little known Sergey Kirienko, emphasizing that "young reformers" and technocrats would from now be in charge, with a mandate for rapid structural reform and fiscal adjustment. The confirmation of the new Prime Minister through the Duma proved difficult, however, and increased financial market uncertainty.

- After its confirmation, the Kirienko administration put forward a fiscal emergency plan in mid-May, which emphasized commitment to the foreign exchange rate regime, proposed measures for fiscal tightening and announced accelerated structural reform. At the end of May negotiations started in Washington on a new IMF package of financial assistance.

- For the defense of the currency the CBR relied on unsterilized interventions and liquidity tightening. This sent short-term interest rate skyrocketing and made short-term financing of the government in the local market prohibitively expensive. After short-term nominal and real interest rates had surged above 50% by the summer with wild daily fluctuations, domestic debt servicing looked increasingly unsustainable. The administration arranged a debt swap of USD 4.4bn GKOs into eurobonds.

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[15] Cherkasov and Dobryshevskiy (2001) claim that the liquidity crisis and devaluation in the summer of 1998 to a large extend only exposed the deficiencies of bank management in the past. Beyond the problems with foreign currency positions described above, these deficiencies included a maturity mismatch of assets and liabilities, high default risk of credits and lack of precautions against the rising delinquency risk of the sovereign.

[16] A good summary of this period is provided by Arkhipov et al. (1999).

Financing at the time hinged only on external issuance and official credits and the government vowed never to issue short-term paper any more.

- In mid-July the government and the IMF finalized the agreement on a package of fiscal and structural reforms, which should pave the way for a disbursement schedule of new official loans worth around USD 17bn (including World Bank loans and co-financing through the Japanese Export-Import Bank).

All these measures helped to gain time and – at the margin – improved prospects for stabilization and reform. However, for the sustainability of the foreign exchange target band in the near term they were rather necessary than sufficient conditions. Hopes to rescue the exchange rate regime were pinned on a turnaround in global conditions. Also, unfortunately, time was bought at the expense of further raising the risk for the government and local banks' financial position:

1. **The exposure of the government's financial position to the ruble increased.** That was because government debt cumulated further and its structure worsened. Domestic government borrowing in the GKO market focused increasingly on the short-term (up to 3 months) maturities and increased by RUB 56bn or 15% from the beginning of the year until July. External debt surged a stunning USD 22.8bn during that period due to IMF and World Bank lending, the issuance of Eurobonds and a conversion of domestic into USD-denominated debt.

2. **Exposure of the banking system to the ruble increased.** The increasing risk aversion of foreign investors in the GKO market led them to hedge their currency exposure through forward contracts with local banks. Local banks, however, already had dangerous currency positions on their balance sheet as described in section 2.4.3. Devaluation thus became an ever bigger menace for liquidity and equity capital of the Russian financial sector.

3. **Exposure of the banking system to government finances remained high.** Lending to the government was the main activity of the banking sector since 1995, because the legal framework and the state of the economy were not suitable for large-scale household and corporate lending. The surge in government bond interest rates in 1998 crowded out the remaining non-government lending activity. Moreover, with CBR interventions draining more and more liquidity from the market, inter-bank relations and the payment system became more closely linked to government solvency.

4 Devaluation and crisis escalation: August – October 1998

4.1 Overview

Global conditions failed to turn for the better. By contrast, another plunge in the oil price in the summer of 1998 dealt a final blow to the foreign exchange rate target. However, even thereafter the Russian government clung to the regime, encouraged by a domestic debt conversion and a new agreement with the IMF. Yet, by August continued central bank interventions on behalf of the ruble had dried up liquidity in the interbank market to the point where the financial and payments systems began to sputter. This signaled that the CBR would not be much longer able to defend the currency.

As a consequence, the government announced a final emergency package which froze the local government market and most foreign transactions of banks. The authorities tried to defend a revised foreign exchange rate target, but ultimately had to accept a drastic devaluation and floating of the ruble. The immediate consequences were severe and painful. Government finances plunged into disarray, households faced a collapse in real income and partial freeze of bank deposits, and foreign investors saw most of the market value of their Russian portfolios wiped out. A new turbulent change in government added political uncertainty. Yet, once the new administration was in place it quickly took effective measures to prevent hyperinflation, social unrest and generalized government default.

4.2 The final emergency package: Devaluation and local markets freeze

On August 17 the government announced after consultation with the IMF a set of measures that essentially recognized the failure of the stabilization program and sought to retain at last some control over Russia's financial situation:

- **The ruble was devalued**. Initially the government just shifted and widened the exchange rate target corridor and eliminated the narrow daily trading band. The ceiling of the new corridor was set at 9.5 RUB /USD up from 7.13, allowing an additional 33% depreciation. However, despite heavy interventions the CBR also had to abandon this new target range and ultimately let the currency float on September 2. The ruble plunged to a low of 20 to the USD during September, but recovered to an average of 15.1 in October.

- **The government announced a forthcoming restructuring of domestic debt** with maturity until year end (IMF, 1999). The total value of paper concerned was RUB 190bn, out of which some RUB 83bn were held by non-residents. A final agreement between the government and investors was not reached until March 1999. Under the terms of this scheme restructured GKO/OFZ were exchanged into: a) OFZs with maturities ranging between 4–5 years and paying below-market interest rates of 10–30% p.a. (70% share), b) cash-value OFZs without coupon that could be used to pay tax obligations that were in arrears as of July 1, 1998 (30%) and c) 3 to 6-months GKOs and cash payments (10%). Importantly, interest rates were well below market levels and all funds that were received through the novation had to be deposited in restricted ruble S-accounts and could be (legally) repatriated only in small tranches through currency auctions. Institutional domestic investors that had been required by law to hold GKO-OFZ enjoyed somewhat better terms.

- **The administration imposed a 90-day moratorium on private sector external debt payments** from August 17 to November 14, 1998. The move was supposed to stem capital outflows and give domestic banks time to negotiate a rescheduling of their external debt obligations with foreign creditors. Importantly, the moratorium suspended payments to non-residents of loan principals with maturity of more than 180 days, margin payments on loans collateralized with securities and foreign currency forward contracts. The implication of the latter was that non-residents were not able to transfer funds from their S-accounts as this would have required a forward transaction of three days. The Russian authorities claim that payments of some USD 3.1bn were suspended directly through the moratorium[17].

4.3 Consequences of the crisis escalation

Devaluation and financial market disruptions entailed severe immediate consequences for the domestic economy and foreign investors:

[17] However, Russian commercial banks settled some USD 1.8bn in external payments during that period by either using foreign assets outside Russia or making deposits with subsidiaries of foreign banks in Russia (IMF, 1999).

- **The interbank payment system was paralyzed:** Trading in the interbank money market had sputtered already before the crisis escalation. By September relations deteriorated to the point of a paralysis in the payment system. Financial institutions distrusted each others' solvency since it was well known that devaluation and GKO market freeze had eroded the equity capital and drained the liquidity of many banks. What made the situation worse was that the CBR kept liquidity tight throughout August, in order to defend the new exchange rate corridor. Indeed, almost half of the country's top 20 banks missed payments or had to close down their operations already in September/October 1998[18]. The central bank withdrew in total the licenses of some 77 banks in the second half of 1998. By the end of 2000 no less than 207 credit institutions had been shut down. The CBR was able to revive interbank payments during the fourth quarter, but only through its direct involvement and the organization of centralized clearing operations.

- **Output and trade were disrupted:** The suspension of the exchange rate target created widespread confusion over the new ruble -dollar exchange rate. The official exchange and banks' market making functioned poorly through September and failed to provide a good orientation. In Russia's highly dollarized economy this led to considerable transaction problems. Russian households were uncertain at what rate to exchange dollar cash – a key means of private saving – into rubles for goods purchases. Producers and retailers were uncertain how to set post-devaluation (ruble) prices of their goods, leading to temporary closings of shops. This partly explained why industrial output collapsed 13.5% over a year earlier in September and October.

- **Household real incomes plummeted:** Most wages and social payments at the time of crisis escalation were set in rubles and contained no indexation mechanism. However, the CPI jumped some 59% between July and December, eroding drastically the purchasing power of these sources of income. Indeed, in the fourth quarter 1998 real income per capita was 23.4% lower than a year ago, led by real wages, which contracted by 34.4%. The ratio of people receiving official income below the subsistence

[18] The list of problem institutions included the country's second largest retail bank, SBS Agro, and many of the large Moscow-based banks, such as Menatep, Inkombank, UNEXIM, Rossiyskiy Kredit, Promstroibank, Mezhkombank and Unibest. Fortunately the largest financial institution, the CBR-owned Sberbank, remained solvent and ultimate took on a portion of failed banks' household deposits.

level increased to 29.3% from 21% a year earlier. Meanwhile, most bank deposits were frozen and the purchasing power of the ruble-denominated deposits and wage arrear claims was eroded. The Gini coefficient of income distribution increased from 0.370 at the end of 1997 to 0.379 at the end of 1998. Fortunately, the social crisis was not quite as bad as these official statistics suggested:

– *Standard deflators and the CPI overstated the increase in the cost of living.* These price indices contained a large share of imported goods, whose prices surged most[19]. Households, however, massively substituted foreign for Russian goods, as witnessed by the trade statistics. This is an indication that the prices of the latter increased less while their weight in the consumer basket expanded sharply. In particular, the composition of the shelves of Russian foodstores was changing drastically. This may explain why the VZIOM household survey posted much less of an increase in the (ruble denominated) subsistence level, than the official Goskomstat statistics (Arkhipov et al., 2000). Indeed Goskomstat showed the subsistence level roughly doubling from RUB 400 to RUB 800 per month between the middle and the end of 1998. By contrast, in the household's own assessment the rise was less than a quarter.

– *Russian households still held considerable dollar cash savings. The amount is estimated above USD 10bn*[20]. The purchasing power of these funds and the dollar deposits (USD 6.5bn) was up 75% over a year ago at the end of 1998, judging from the official CPI statistics.

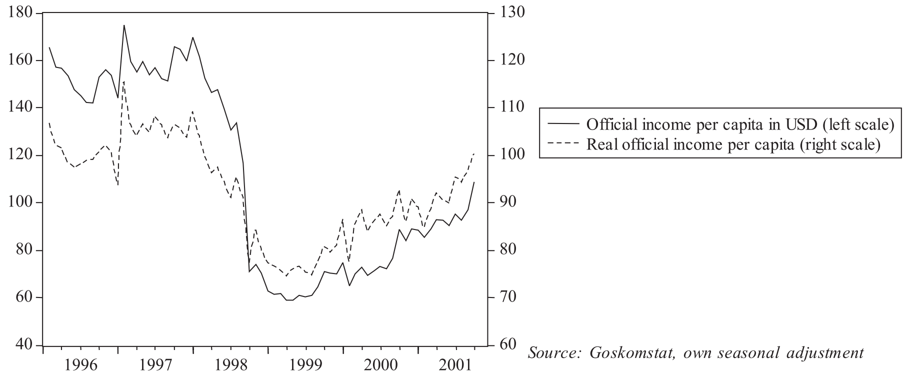
– *Devaluation jump-started the monetization of the economy.* This reflected both the easing of liquidity conditions in the interbank money market and the surge of sales revenues of Russian companies. As a consequence, the decline in official due real income was partly compensated for by more reliable payout of wages in cash.

[19] The conclusion is based on qualitative and methodological information provided by Goskomstat. Unfortunately Goskomstat does not publish the exact breakdown of its CPI basket.

[20] For a study on size and elasticity of currency substitution in Russia see Friedman and Verbetsky (2001).

Russian households' income shock

USD p.m., seasonally adjusted *index, 1995=100, seasonally adjusted*



Source: Goskomstat, own seasonal adjustment

- **Political uncertainty increased:** Shortly after the GKO market freeze president Yeltsin dismissed the Kirienko administration and re-appointed Viktor Chernomyrdin as prime minister. Yet, Chernomyrdin was deeply unpopular and his administration was viewed as responsible for the crisis. As a consequence chances for his approval through the State Duma were slim and the president ultimately had to look for a new candidate. Meanwhile, Boris Yeltsin's frail and deteriorating health received increasing attention after the crisis escalation, contributing to the impression that the country was drifting without leadership. Under pressure from parliament, Boris Yeltsin finally appointed Yevgeny Primakov, a former Soviet Union foreign minister, as prime minister. Primakov had a broad appeal across parties in parliament. Yet in the eyes of reformers and Western commentators he was tainted by his background as a leading politician of the USSR. The subsequent appointment of former USSR state bank governor Viktor Gerashchenko as new CBR head, and USSR state planning chief Yury Maslyukov as economic minister increased the impression of a return of the old communist guard to the helm of government. This naturally raised fears of a suspension if not reversal of economic reforms and, at least initially, dismayed investors.

- **Russia triggered a global financial crisis and turned into a pariah of the financial community:** The crisis escalation not only inflicted high direct losses upon international emerging markets investors. Also, as the event occurred less than a year after the latest shockwave of the Asian crisis, it discredited the emerging markets as an asset classed and raised concerns over the stability of the international financial system. In the wake of the Russian crisis, private and sovereign credit spreads surged globally and stock prices declined. The hedge fund, Long term Capital Management, LTCM, which had speculated on declining spreads came close to failure and had to be rescued. Banks incurred heavy losses and many analysts claimed that Brazil's crisis toward the end of 1998 was partly triggered by the events in Russia (Baig and Goldfajn, 2000).

Russia's administration plunged into the crisis with little preparation and room to maneuver. Also, there was a remarkable cacophony of opinions in the media on what would happen in response to the crisis and what should be done. However, with their backs against the wall the post-crisis governments had little appetite for dogmatic debate and economic experiments. In particular, the neo-communist administration showed remarkable pragmatism and circumspection, taking several critical decisions to avert hyperinflation and social unrest:

- **Expansion of the monetary base:** After September 2 the CBR was no longer committed to an exchange rate target. True, the currency was a key concern, but the administration used foreign exchange market restrictions as the main policy tool to stem devaluation from then[21]. This freed the CBR for the task of easing the domestic financial woes. Specifically, the central bank injected liquidity into the interbank market, by increasing credit to banks and lowering reserve requirements. Credit of the monetary authorities (CBR and Ministry of Finances) to commercial banks soared from RUB 10.5bn in mid-1998 to RUB 71.8bn by the end of the year and to RUB 190bn by the middle of 1999[22]. Also, the CBR returned to partial monetary financing of the federal government deficit. While this policy was heavily criticized in the international press, it was soon vindicated by recovery of the payments system, the stabilization of money demand and the decline in monthly inflation rates[23].

[21] The administration introduced restrictions on both current account and capital account transactions. Also, the foreign exchange transactions became subject to tighter regulation. The most prominent measures were the mandatory sale of 75% of export proceeds in foreign currency at the market or to the CBR, a deposit requirement on selected advance import payments, more extensive reporting requirements of banks with respect to their foreign exchange transactions and lingering constraints for the repatriation of non-residents' proceeds from the domestic government bond market.

[22] *Source:* CBR analytical accounts of credit organizations, 1999 and 2000.

[23] Broad money velocity computed as the ratio of nominal GDP to M2 rose from 6.6 in June 1998 to 7.3 in September. After the monetary expansion of the CBR it stabilized and ended the year at 7.4. Monthly consumer price inflation peaked at 38.4% in September but fell back to an average 5.1% in November/December (IMF, 1999).

- **Reduction of federal government borrowing:** The Primakov administration reined in both interest and non-interest spending in a supplementary budget for the fourth quarter 1998 (Süppel, 1998a). On the debt service side, it agreed with the London Club to reschedule some USD 360 million in Soviet-era debt. And in order to compress non-interest spending, the government refused to pay inflation compensation to households, a policy that would persist in 1999 and launch a phase of drastic and painful fiscal tightening (5.2.2.). In addition, the administration managed to sell a 2.5% stake in Gasprom to Germany's Ruhrgas in the fourth quarter for some USD 650 million. Altogether this allowed it to keep CBR financing of the federal budget below the targeted RUB 36.5bn (some 21% of the monetary base), a critical move to avert money supply-driven hyperinflation.

- **Integrating the communists into the government:** Actual and feared obstruction of anti-crisis measures by the State Duma was a critical liability of the Kirienko administration. The appointment of key communist politicians to the cabinet greatly increased the authority of the government in the State Duma. Indeed, the Primakov government was able to complete and implement a number of fiscal reforms that were launched by its predecessor. Also, the non-indexation policy for public wages and social payments would have been much harder without parliamentary support.

To be sure, stabilization also benefited from Russia's lack of financial development. Ruble monetization was low when compared with the advanced Central European countries. The ratio of M2 to GDP in Russia was only 25.3%, compared to 39.9% in Poland, 45.8% in Hungary and 69.7% in the Czech Republic[24]. Indeed, Russian households held large amounts of savings in USD cash rather than in deposits and roughly a quarter of household bank deposits were held in foreign currency. Also, 85% of all households' deposits were held at Sberbank (the former Soviet Union savings bank) and as such explicitly guaranteed by the government. Bank lending played a much smaller role for private sector economic development than in Central Europe, let alone Western Europe. Private bank credits as a ratio of GDP stood at 12.9% in Russia in 1998, compared to 19.3% in Poland, 24.2% Hungary and 58.5% in the Czech Republic.

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[24] *Source*: IIF database.

5 Stabilization and creation of new political consensus: November 1998 to mid-1999

5.1 Overview

Many commentators were disconcerted by the immediate post-crisis-changes in the government, which put a group of Soviet-era bureaucrats in control of economic policy. And indeed, both the federal administration and the CBR interfered heavily in the financial markets and introduced a set of new regulations. Superficially this looked like a step backward in economic policy. However, more interventionist policy was less an ideological shift than a response to dysfunctional markets in the wake of crisis escalation. Government policy turned out to be pragmatic, not dogmatic, both during the Primakov and the subsequent Stepashin administration. Commitment to fiscal consolidation and system transformation was not wavering. Thus, the most important result a few months after crisis escalation was that Russia's young democracy and its market reforms did not crack under crisis pressure. In addition, the political basis for stabilization and reform broadened. The communist party's involvement in the federal administration – the first since the dissolution of the Soviet Union – forced it to become more pragmatic, discharge ideological ballast and to accept loyalty to the post-Soviet economic and political order. The political improvement added to a surprisingly fast recovery of the economy and stabilization of monetary and fiscal conditions.

5.2 Post-crisis stabilization policy

5.2.1 Understanding the misunderstanding

Around the turn of the year 1998-99 Russia's international standing was marred by immense negative publicity. Many commentators feared for the social and political stability of the country. Financial markets expected the government to slip into generalized default. And most western economists were highly critical of the economic politics drafted and implemented by the "old socialist guard" that had taken over key positions in the federal government and the CBR.

Indeed, the mainstream view of Russia's economic policy at the time was blurred. It was biased to the negative side by the Western media's understandable dislike for the communist-led government in general and some of their economic measures in particular. In particular, the return to monetary financing and currency controls were heavily criticized. Moreover, news on Russia was dominated by the inevitable fallout of the crisis escalation, particularly increasing poverty and deep public discontent. Finally, financial investors were deeply frustrated over their losses caused by devaluation, unilateral domestic debt restructuring and asset stripping of private Russian obligors under the protection of the external debt moratorium.

In this emotionally and ideologically charged environment, many observers failed to fully appreciate the most critical facts. First, the new administration acted with only few policy options and took refuge in monetary financing and currency controls less for ideological reasons than for the restoration of basic government and financial services activities. Second, the new administration quickly grasped the importance of public finances consolidation and used the 1999 federal budget for aggressive fiscal tightening. And third, the economy gave signs of positive response very quickly after devaluation. The recovery of production already in the fourth quarter 1998 signaled that despite symptoms of a "virtual economy" in many areas, markets were not all dysfunctional and benefited greatly from the devaluation-related surge in domestic producers' competitiveness.

5.2.2 The government's secret but aggressive fiscal tightening

The rules for fiscal policy in Russia had changed drastically after August 7. The federal government was cut off from external and private internal financing. Also, as a result of devaluation, external debt servicing soared relative to the domestic tax base. Public deficit and amortization payments could only be financed through the CBR. However, monetary financing undermined the currency further, raising fears within the government of a politically fatal combination of hyperinflation and generalized foreign debt default. Thus, the administration had little choice but to employ its remaining two alternatives to monetary financing: fiscal tightening and debt restructuring (i.e. a cut in near term interest and amortization payments). Fiscal tightening indeed was more critical, because it was commonly viewed as a precondition for new restructuring agreements with external creditors.

More broadly, the difference between pre- and post-crisis fiscal policy was that from 1998 the budget constraint applied politically. The alternative to tightening was no longer bond issuance, but money printing, with immediate dire consequences for stability. Thus, it is no surprise that tax reform and fiscal tightening moved high up on the political agenda during 1998. In this respect the anti-crisis policies of the liberal Kirienko government, the leftist Primakov and the centrist Stepashin administrations were not all that different. The Kirienko policy brought the primary federal government budget into balance by the third quarter 1998. The Primakov government presented a 1999 budget with a projected primary surplus of 1.5–2% of GDP.

Fiscal tightening under the Primakov administration employed both a compression of non-interest spending and measures to raise tax collection[25]. For spending cuts, the key decision was not to adjust wages and social transfers for the jump in consumer prices after devaluation. The consequence was a sharp and enduring drop in real household income. The government initially eased the social impact of this measure by paying wages on time, against previous practice, and paying old arrears. However, over time this "pain relief" disappeared and the population had to bear the full brunt of fiscal restriction. Tax collection was boosted by a set of measures, which was mostly launched already by the Kirienko government. In addition tax collection benefited from increased (and united) political pressure on large tax payers and the normalization of the country's payment system.

5.2.3 Quick and positive response of the economy

Devaluation entailed drastic changes in the economy. Russian manufacturers' domestic costs collapsed compared to its international competitors[26]. Consumers faced not only abruptly different relative prices between domestically produced and imported goods, but also had to operate with much smaller budgets. The consequence was rapid and drastic import substitution and adjustment in the external trade balance. Within just two months from August to October 1998 the (annualized) merchandise trade surplus shifted upward from USD 9.7bn to USD 35.5bn and stayed around this level through 1999, a difference that was worth almost 10% of GDP.

Improved competitiveness and import substitution unleashed Russia's first wave of sustained economic recovery and broad macroeconomic improvement

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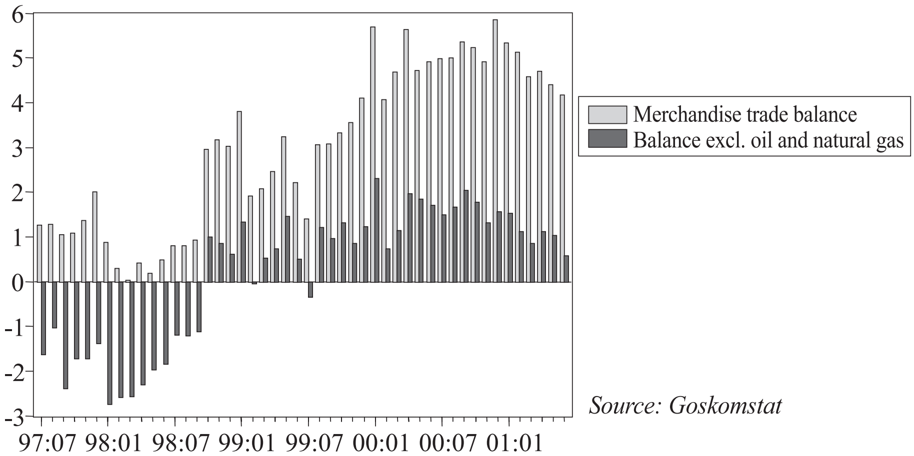
[25] For a more detailed description see Süppel 1998b.

[26] The real trade-weighted exchange rate deflated by unit labor costs collapsed some 70% in the second half of 1998 (IMF, 2000).

Russia: Post-crisis external trade adjustment
USD billion p.m.



Source: Goskomstat

since system transformation. Importantly, the economic data at the time reflected the turn for the better very quickly:

- **Output rebounded from the fourth quarter onward:** GDP increased some 1.4% in seasonally adjusted terms over the third quarter[27] and monthly industry data showed an even steeper increase in the course of the last 3 months of the year. Business sentiment improved, benefiting from devaluation and rapid import substitution, easing monetary conditions and some normalization in transactions after crisis-related frictions.

- **Inflation slowed:** In response to devaluation the CPI jumped a full 35.8% between September and October. However, monthly consumer inflation immediately fell back to an average 5.1% in November and December. This reflected the slowdown in ruble devaluation from 108% in October (versus the dollar) to an average 6.9% in the final two months of the year. Also, despite monetary financing of the budget M2 did not grow more than 4.9% per month during the fourth quarter.

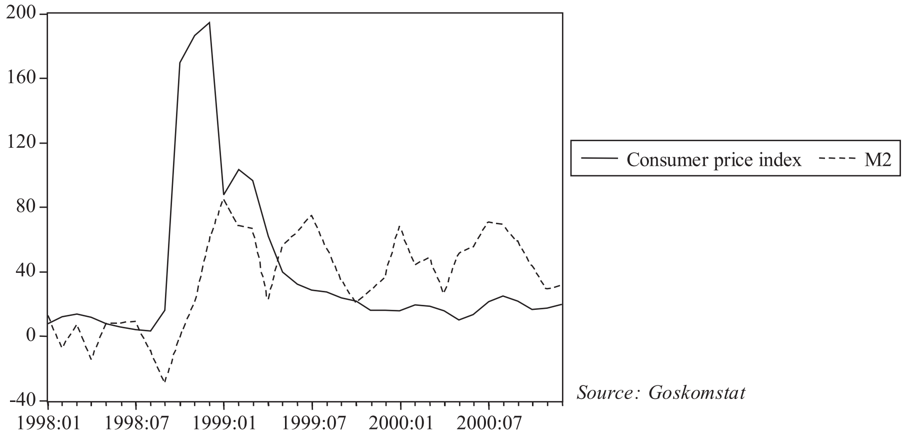
- **A run on the banking system was averted and interbank payments were restored** thanks to liquidity support to banks[28] and the transfer of household deposits to state-owned Sberbank. The banking payment

[27] *Source:* Goskomstat and own seasonal adjustment.

[28] This included a reduction in reserve requirements and CBR rehabilitation credits to banks with restructuring plans.

Russia: Post-crisis short-term inflation rates

% change over 3 months, annualized



Source: Goskomstat

system began to operate again and even cash transaction in the economy revived, reflecting the money injection from the CBR to financial sectors and a sharp decline in new government arrears.

- **Federal government revenue collection quickly rebounded from crisis levels.** They reached 10.3% of GDP in the first quarter of 1999, up from 8.4% in the fourth quarter and only slightly below the 10.8% a year ago.

This evidence was inconsistent with widespread fears of hyperinflation, prolonged recession and a deepening fiscal crisis. It contradicted the hypothesis that the economic policies of a neo-communist administration would precipitate a worsening economic situation. Rather they supported the assumption that Russia's economy had been strangled previously by excessively tight monetary policy.

5.3 Crisis as a catalyst for sustained policy change

Before 1998 policymakers and financial markets were much more concerned about Russia's political risks than about its economic shortcomings. Political worries had been fueled by the 1991 coup attempt and the 1993 armed conflict between president and parliament. They were kept alive beyond by the strong position of unreformed communists in parliament and the rise of nationalists in the polls. Meanwhile, economic concerns were eased by the positive experience with transformation in Central Europe and the conviction of most Western commentators that the application of market reform to Russia's impressive endowment with natural and human resources could ultimately produce only positive results.

Indeed, it took the 1998 crisis and the effective takeover of power by the left-wing opposition (the communists and their allies) to change the order of priorities in the domestic and global political agenda. With economic concerns taking center stage from 1998 a new realism characterized the position of domestic and global politicians and investors. Thus, the return of Soviet Union administrators to the helm of the government in late 1998 failed to produce a broad-based reversal of market reform and stabilization. Rather, communist support for anti-crisis measures in 1998 and 1999 reflected a broadening political consensus on a basic set of reform measures. Peaceful transition of (presidential) power and the election of a centrist parliament brought political stabilization to the next level.

As pointed out in Arkhipov et al. (2000) there was abundant evidence for the growing consensus among the political spectrum. With respect to economic policy the evidence included the following key points:

- **The policy of the neo-communist Primakov administration** turned out to be similar to its predecessors. If anything, the leftist government had to impose a more restrictive fiscal policy and tougher social policy. Most importantly, by preserving continuity the communists implicitly confirmed that there was no point in reversing the fundamental institutional reforms of the 1990s.

- **The economic programs for the 1999 State Duma elections** revealed a noticeable convergence, particularly when compared to the 1995–96 campaign. In 1999 all programs were based on the paradigm of a market economy. All major parties confirmed the principle of private ownership of capital. Challenges to the early-1990s privatization program were only based on irregularities in the sale procedures. In addition, all major parties underlined the importance of macroeconomic stabilization, non-inflationary monetary policy and a balanced budget.

- **The improved cooperation between government and parliament** in 1999 and the swift approval of economic reform measures in 2000 and 2001 confirmed that the differences among parties had lost their dogmatic character.

Importantly, the new consensus paved the way for a stronger government. There were increasing signs in 2000 and 2001 that the administration was disentangling itself from the business oligarchs, and even supported the prosecution of some of their most powerful figures. Likewise, the federal government was able to tighten its grip on the subjects of the federation, increasing federal powers through constitutional changes in 2000 and its leverage on regional elections[29]. A stronger central government in turn greatly improved the chances for rapid economic reform.

Meanwhile economic tasks were not only at the forefront of government policy but almost dictated it. After the crisis escalation administration and CBR had to take rapid and pragmatic steps to avert hyperinflation and generalized government default. And a tight schedule of vital fiscal and broader economic reforms kept the government and parliament busy from 1999 through 2001. Indeed, economic concerns were high on the agenda not only in Russia itself but globally. A further economic decay was seen as a threat to regional stability and the security of its arms technology. Also, international investors had learned in 1998 that a Russian economic crisis could not only destroy the value of the country portfolios but also rock global financial markets. Indeed, many financial markets analysts feared a generalized default of Russia in 1999 could deal another blow to global high-yield markets.

After the 1998 crisis escalation the influence of the IMF on Russian economic policy diminished. True, in May 1999 Russia and the fund again agreed on an economic program and a stand-by agreement. However, that agreement was mainly designed to pave the way for external debt restructuring agreements between Russian and the London and Paris Clubs. It did not entail any new lending and was not renewed in 2001, even though, the fund and the Russian government had broadly agreed on an appropriate economic program (Government of the Russian Federation, 2001).

5.4 The unexpected recovery

Even though most forecasts continued to see the country in recession and the ruble weakening rapidly, by the middle of 1999 the recovery of the Russian economy was increasingly hard to overlook:

[29] The political affiliations of regional governors were very diverse in mid-1999, favoring the Communists or the “Fatherland”, “All Russia” and “Voice of Russia” parties. By 2000 the overwhelming majority of governors had turned into supporters of President Vladimir Putin and his Unity party (Arkhipov et al., 2000).

- **Output expanding rapidly:** In the second quarter of 1999 seasonally-adjusted GDP already stood 7.7% above the “crisis” third quarter 1998, a sharp contrast with the 5–10% recession that was predicted by most economists (including the IMF, IIF and OECD) for the year as a whole. Industry was leading the way thanks to persistent merchandise import substitution. Business surveys confirmed this trend, with the IET index of manufacturing cash orders and the IMEMO index of industrial companies’ investment plans rising above their pre-crisis highs[30].

- **Exchange rate and currency reserves stabilized:** Thanks to the surge in the merchandise trade surplus and the suspension or restructuring of Soviet era debt payments the exchange rate stabilized. The average monthly rate of depreciation versus the USD was 1.2% during the first half of 1999, with the second quarter actually showing a slight ruble appreciation. Meanwhile, currency reserves began to stabilize. Gross foreign exchange reserves diminished by just USD 72 million in the first six months of 1999, despite government foreign debt payments of almost USD 2.8bn during that period.

- **Budget execution improved:** Government cash revenues as share of GDP had dropped to a crisis low of just 8.4% in the fourth quarter of 1998. However, in the first half of 1999 they bounced to 11.3% with a rising trend.

- **Popular support for politics increased:** There were broad signs of increased confidence in government policy. Thus, the approval rating of Prime Minister Primakov soared from around 30% in September 1998 to above 65% before his dismissal in May 1999[31]. The IMEMO survey of managers’ approval of government policy jumped from a very low level during the crisis escalation to the highest values since 1993.

Stabilization and growth obviously benefited from the surge in oil prices and the lagged impact of the 1998 devaluation[32]. And as convincing as data looked in mid-1999 they did not yet prove a sustained recovery. However, this does

[30] Source: Institute for the Economy in Transition (IET) and IMEMO research institute. The IET cash order index rose to a positive 10.3 (diffusion index) by the second quarter of 1999 compared to a pre-crisis (quarterly) high of negative 11.7 in the fourth quarter of 1997. The IMEMO investment plan index reached a positive 25.3 compared to a pre-crisis high of positive 24.7.

[31] VZIOM survey quoted in Arkhipov et al. (2000).

[32] For a detailed evaluation see IMF (2000).

not mean that Russia's recovery was the direct consequence of exogenous events. Importantly, the size of real depreciation and boost to competitiveness reflected tight fiscal and income policies, which prevented labor costs and non-tradeables' prices from following the price hikes in imported goods. Also, the rise in oil prices certainly opened a new window of opportunity for fiscal consolidation, monetization and economic reform. But it was not a sufficient condition for these improvements to occur. The important point was that subsequent administrations since 1999 have all seized these opportunities and strengthened Russia's structural position on the back of these "windfall gains".

6 Fiscal consolidation, economic recovery and rapid reform: Mid-1999 to 2001

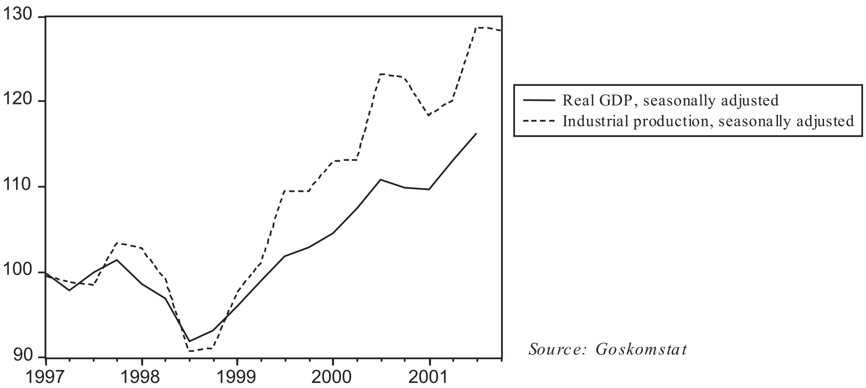
6.1 Overview

Doubts about the sustainability of Russia's recovery faded. The macroeconomic data and key policy events classify the period as one of stunning political and economic progress:

- **A sustained expansion of output:** GDP growth averaged more than 6% p.a. in 1999–2001. Industrial production led the recovery, growing more than 9% p.a. Importantly, the quality of Russia's economic recovery was changing over time. While the initial rebound of activity reflected the removal of crisis disruptions and a depreciation-related import substitution, during 1999 production was supported by rising domestic demand for machinery and equipment and growth in export volumes. Whether this reflected still mostly the devaluation and the surge in oil prices in 1999 or also structural improvement was initially hard to discern. Only after investment and export demand persisted in 2000–2001, when the exchange rate impact had tapered off and oil prices first stagnated and then declined, it became clear that the recovery also reflected more sustained factors.

Russia: Post-crisis output recovery

index, 1997=100



- **The external balances and real exchange rate strengthened:** Russia's current account surplus soared in two waves. First, in late 1998 and early 1999 real devaluation and income contraction pushed the current account balance excluding oil and natural gas from a deficit into a slight surplus. From the spring of 1999 also the rise in oil prices sent the external trade balance surging. Altogether the current account surplus soared from 0.2% of GDP in 1998 to an average 14.1% in 1999 to 2001. CBR gross currency reserves almost tripled from USD 12.5bn to USD 37.2bn during these three years. Nominal depreciation against the USD decelerated from 52% in 1999 to 6% in 2000 and 7% in 2001. The real trade-weighted exchange rate (CPI-deflated, JPMorgan measure) appreciated by a 13% p.a. during 1999–2001.

Table 6: Russia: Post-crisis change in external balances

	1998		1999		2000		2001	
	USD bn	% of GDP	USD bn	% of GDP	USD bn	% of GDP	USD bn	% of GDP
Current account	0.7	0.2	24.7	12.7	46.3	18.4	35.1	11.3
Merchandise and services	12.8	4.1	31.8	16.3	53.0	21.1	39.3	12.6
excl. oil and natural gas (1)	-16.2	-5.1	7.3	3.8	11.4	4.5	-4.9	-1.6
Factor income	-11.8	-3.7	-7.7	-4.0	-6.7	-2.7	-3.9	-1.2
Current transfers	-0.3	-0.1	0.6	0.3	0.1	0.0	-0.3	-0.1
Capital and financial account	3.1	1.0	-15.7	-8.1	-21.1	-8.4	-17.7	-5.7
Capital transfers	-0.4	-0.1	-0.3	-0.2	11.0	4.4	-9.4	-3.0
Net direct investment	1.5	0.5	1.1	0.6	-0.5	-0.2	-0.1	0.0
Net portfolio investment	8.6	2.7	-0.9	-0.5	-10.3	-4.1	-0.9	-0.3
Net other investment	-6.6	-2.1	-15.6	-8.0	-21.2	-8.4	-7.3	-2.3
Errors and omissions	-9.1	-2.9	-7.0	-3.6	-9.2	-3.7	-9.1	-2.9
Net international reserves (2)	5.3	1.7	-2.0	-1.0	-16.0	-6.4	-8.4	-2.7

Source: CBR

(1) own estimate based on customs trade data for crude oil, oil products and natural gas

(2) includes position "adjustment to currency reserves", negative sign denotes increase

- **Surging tax collection and budget surpluses:** Cash revenues and budget surpluses soared to the point where the government could buy back its own debt and accumulate a financial reserve (see section 6.2. below).

- **The political situation stabilized:** Russia's transition to a democracy and market economy was no longer challenged by any major political force. The 1999 Duma elections and 2000 presidential elections brought centrist forces to power. Cooperation between government and Duma greatly improved in 2000 and 2001.

- **Rapid economic reform:** Based on economic recovery and a stable political framework, economic reform quickly addressed the country's most urgent deficiencies. Thus, Russia drafted and executed one of the most drastic tax reforms in Europe and revamped the legal conditions for investment (see section 6.3. below).

The drivers of economic growth were shifting over time. In 1999 the recovery was still driven mainly by a reversal of crisis disruption and devaluation-related substitution of merchandise imports. From 2000 the beneficial impact of high global energy prices on Russian household incomes and corporate profits unfolded an increasingly powerful impact. And in 2001 the economy was supported by a "double fiscal stimulus". First, income tax reform drastically lowered statutory and marginal taxation. Second, the government began to increase spending noticeably from spring 2001, reducing its huge primary surplus. All this led to a surge in Russian asset prices, albeit mostly in response rather than in anticipation of improvement. The point is emphasized by the restructuring of London Club debt, which provided Russia very favorable condition in an agreement in early 2000, although Russia's recovery was already in full gear.

The 2000 parliamentary and presidential election underscored and completed the metamorphosis of Russia's political culture. The Duma elections in December 1999 replaced the leftist and nationalist majority with an overweight of centrist parties, most of which had strong links to the government. The resignation of Boris Yeltsin in January 2000 and the subsequent election of Vladimir Putin was the first democratic transition of power in Russia ever. A "technocratic" government under Prime Minister Kasyanov was appointed in January. It has been in place until now, focused on economic reform enjoying broadly based support in the State Duma.

6.2 Post-crisis fiscal policy: Prudence to the point of paranoia

Post crisis stabilization policy reversed the order of priorities of the 1995–98 stabilization program. It put fiscal consolidation first and disinflation second. Both fiscal and monetary stabilization took a defensive character. The main objective was to avert further crises rather than meeting performance criteria. Fiscal policy sought to recover a sustainable financial position for the government through a combination of very restrictive spending, reforms in the treasury and tax system and a restructuring of Soviet-era debt. The focus on fiscal consolidation had a thorough impact on public finances and overall macroeconomic stabilization:

- **Federal government cash tax revenues soared:** As share of GDP they almost doubled from 8.9% in 1998 to 17.6% in 2001. Importantly, the bulk of that increase seemed to reflect policy measures rather than exogenous factors. Thus, the IMF estimated that the first-wave improvement in federal government tax collection during 1999 was due mainly to the reintroduction of export taxes (adding tax collection of roughly 2% of GDP), and the centralization of VAT and income tax collection at the federal level (another 1% of GDP). The direct contribution of the ruble devaluation and the rise in crude oil and natural gas prices was estimated at less than 1%-points (IMF, 2000). Also, government policy was instrumental for the reduction of barter and non-monetary offsets, which hampered cash tax collection previously. Specifically, the federal governments after 1998 avoided the use of tax offsets and provided full funding of energy consumption at all budget levels, which had been the main source of arrears in the past.

Table 7: Russia's federal budget execution measured in cash flows

IMF definition, % of GDP	**1997**	**1998**	**1999**	**2000**	**2001**
Total revenues	10.2	8.9	12.6	15.5	17.6
Tax revenues	8.1	7.2	10.6	13.2	16.2
Other revenues	2.0	1.7	2.0	2.3	1.4
Total spending	17.0	13.7	13.9	14.3	14.5
Interest spending	4.7	3.9	3.4	3.5	2.6
Non-interest spending	12.3	9.8	10.5	10.8	11.9
Primary balance	-2.1	-0.9	2.0	4.7	5.7
Total balance	-6.8	-4.8	-1.4	1.2	3.1

* *Sources: Economic Expert Group at the Russian Ministry of Finances, IMF*

- **Pessimistic fiscal projections kept non-interest spending compressed:** The federal government's official projections of nominal GDP and tax revenues for the budgets 1999, 2000 and 2001 all underestimated the true values by a wide margin[33]. Thereby, the authorities understated the federal budget's spending capacity for the given financing constraints. Together with the fresh memory of the 1998 crisis escalation this helped in

[33] The 1999 budget foresaw total revenues of RUB 474bn versus an actual RUB 597bn. For 2000 the plan was RUB 797bn, way below the actual RUB 1132bn. And the 2001 budget projected revenues of RUB 1193bn, which compared to actual revenues of RUB 1591bn. For details see www.budgetrf.ru and www.eeg.ru.

persuading the Duma and the Federation Council to accept tight budget spending plans despite social hardship, an improving economy and the 1999 parliamentary election campaigns. Indeed federal government cash non-interest spending as share of GDP fell from 12.3% in 1997 to 9.8% in 1998 and remained compressed at 11.1% on average 1999–2001. The positive “surprises” of federal budget performance gave the government scope to build a financial reserve (foreign currency deposits at the CBR or commercial banks), buy back its tradable external debt in the secondary market and amortize external loans ahead of schedule[34].

- **The persistent surge in primary balances supported ruble strength and disinflation:** The evolution of the federal primary budget balance bears witness to more than four years of aggressive fiscal tightening. First, the balance posted a drastic swing from a 2.1% (of GDP) deficit in 1997 to a 2.0% surplus in 1999. The surplus jumped again to 4.7% in 2000 and peaked at 9.1% in the first quarter of 2001. Only during 2001 did this policy of persistent aggressive fiscal tightening give way to a more accommodative stance. The tightening hurt income and domestic spending growth. However, it boosted the current account surplus and helped to contain wage and money growth (see below).

- **Contingent fiscal spending protected funding limits:** In 2001 Russia’s fiscal policy was mutating. The surge in tax collection and the need to support economic growth in the face of rapid real appreciation called for an increase in government spending. Yet prudence was still high on the government’s agenda, spawning mechanisms that allowed higher fiscal spending only contingent of strong revenues. Both the 2001 and 2002 budgets distinguished between basic spending, which comprised all debt service and essential non interest expenditures, and supplementary spending[35]. Supplementary spending was contingent on excess revenues relative to a downward biased cautious revenue estimate. The funding

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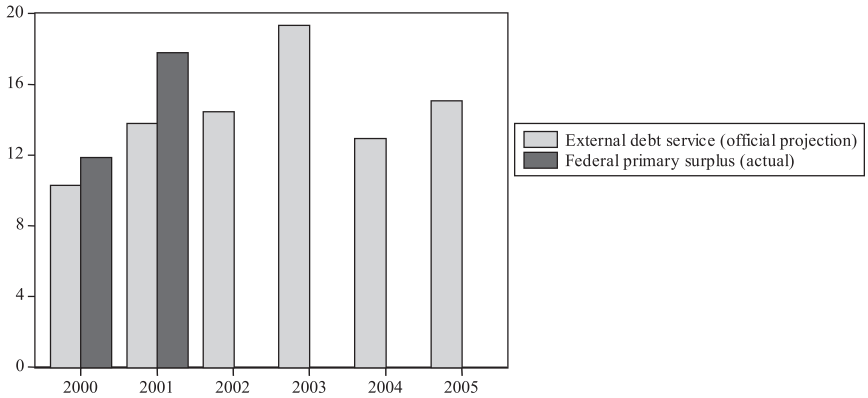
[34] Market makers in the Russian external debt market reported state-owned Russian banks purchasing the sovereign’s foreign currency bonds in both 2000 and 2001. Also, the federal government paid back prematurely some USD 2.8bn in IMF loans from September to November 2001.

[35] The official 2001 budget plan biased revenue estimates to the low side in a way that was obvious for the State Duma. As a consequence, the government had to agree with the Duma on a formula for distributing excess revenues, which stipulated that a first tranche (up to RUB 41.2bn) of excess receipts would go to debt service, a second tranche (RUB 41.2-165.2bn) would be used equally for debt service and non-interest spending and a third tranche (excess revenues of more than RUB 165.2bn) would again go fully to debt servicing (Ovanessian and Süppel, 2001a).

requirement of the federal government would thus not be affected by revenue shortfalls up to the pessimistic estimate.

Russia: Primary surplus rising above external debt payments

USD billion



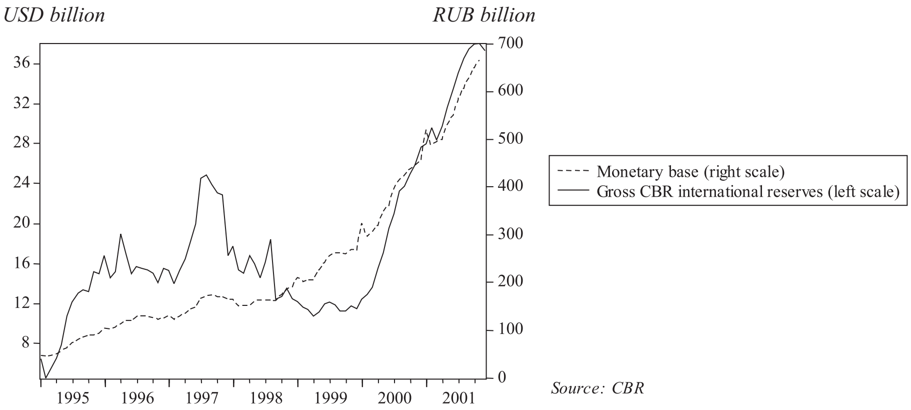
Source: Ministry of Finances, Economic Expert Group

- **Soviet-era debt restructuring restored fiscal sustainability:** After August 17 1998, the devaluation and lack of new foreign funding made full amortization and interest payments on external debt infeasible (Süppel, 1999). The government suspended most payments due on Soviet-era liabilities in late 1998 and 1999. It was widely accepted in the financial community that Russia needed another restructuring of the external debt stock to regain fiscal sustainability, which in that context denoted the ability to fund contractual debt payments and essential non-interest payments. The government used the negative publicity on the country's economic situation to gain an intermediated debt relief from the Paris Club for 1999 and 2000 and a far-reaching restructuring agreement with the London Club in early 2000 (Süppel). In combination with the primary surpluses this enabled the federal budget to post a headline surplus of 1.2% of GDP in 2000 and 3.1% in 2001, effectively terminating the debt crisis.

6.3 Unambitious monetary stabilization

Meanwhile, monetary policy sought to stabilize the ruble versus the dollar and thereby contain inflation. But official commitment was sparse and cautious. Despite heavy interventions in the foreign exchange market the ruble was officially floating and the CBR remained vague in statements about its intervention targets. Also, the central bank mostly intervened against ruble, propelling the growth rate of the monetary base to a 51% annual average from 1999 to 2001. Only part of these interventions was sterilized through increased government deposits with the CBR. Serious inflationary consequences were only averted due to the coincidence of rising budget surpluses and increasing monetization.

Russia: Post-crisis surge in currency reserves and base money



The rapid accumulation of currency reserves was an understandable precaution against external shocks. Thus, there were concerns that real appreciation occurred too fast, potentially strangling the recovery in output. And there were still two risks of a sudden destabilization of ruble: the country's dependence on oil exports and a surge in (post-restructuring) due external interest and amortization payments to an average USD 13.3bn in 2001/02 and USD 18.2bn in 2003.

Despite the lack of a formal exchange rate target, the bank did not move to formal inflation targeting either. A projection for year-end consumer inflation was published in the "fundamental directives of unified government money and credit policy" (f.ex. CBR 2001). These projections could be changed and were missed on the high side. Thus, at the end of 2001 consumer price inflation overshot its original projected value by a wide margin (18.6% versus 12-14%), while the underlying trend of price growth pointed upward. The CBR also provided annual official projections of money growth. However, in light of the minuscule underdeveloped financial sector monetary targets had to be taken with great caution and received little public attention.

The lack of an ambitious disinflation policy has left headline consumer inflation high and commitment to medium-term price stability subject to doubt. However, the country's financial and economic robustness benefited considerably from this lack of ambition and the pre-occupation with fiscal consolidation and external reserves buildup. Not only did fiscal surpluses and reserves surge. Also, the government began buying back outstanding external debt and began accumulating a so-called financial reserve, i.e. foreign-currency deposits with the CBR and commercial banks. In 2001 neither the ruble nor Russian Eurobond prices faltered, despite a series of external shocks that rivaled those of 1997/98: the Turkish devaluation in March, the descent of global growth to a 40-year low, and the plunge in the crude oil price by 41% during the year[36].

6.4 Accelerating economic reform

6.4.1 Rationale and strategy

The 1998 crisis escalation had effectively isolated the Russia from international capital markets. For the public budget this meant intense pressure to fully fund government activity through tax and other revenues. For the enterprise sector it meant that the urgently needed capital spending had to be financed mostly through profits and direct investment. It is no surprise that against this backdrop the Russian administration prioritized the reform of public finances and the improvement in investment conditions. These priorities became obvious in the reform strategy, formulated after the election of president Putin in May 2000. While the overall strategy was cast over a 10-year horizon and encompassed a wide selection of reform areas, the shorter 1-year action plan for 2000/2001 and a subsequent economic program for 2001 were heavily focused on reforms of the public sector and investment conditions (Government of the Russian Federation 2000b, 2001b).

Reforms in areas that the authorities considered less urgent advanced only gradually. Thus, the restructuring of the banking sector[37] and the state infrastructure monopolies (Gasprom, United Energy System and the State Railways) slipped behind the schedules set by the IMF stand-by agreement 1999–2000 and the third structural adjustment loan of the World Bank (IMF, 2001).

[36] Change in Urals price from end-2000 to end-2001, *Source:* Platts.

[37] A good overview of the post-crisis situation in the banking sector is provided by IMF (2002).

6.4.2 Reform focus 1: The tax system

Poor tax collection and related government spending arrears were major failings leading to the 1998 crisis escalation. Also, the complicated tax law and the high statutory and marginal taxation of activity were often quoted as a key obstacle to growth. This explains why the federal tax code was a natural early focus for post-crisis reform policy. Change started already during and right after the crisis escalation. Together with the 1999 budget the Primakov administration implemented a number of "emergency measures" that had been prepared by the Kirienko government during the heyday of the crisis. The key objective was to increase tax collection. The measures included the introduction of an "imputed tax" on small businesses[38], the introduction of a regional sales tax[39], and a rise in excise taxes[40] (Süppel, 1998). In July 1999 the Duma passed critical amendments to the "general" part of the Russian tax code, which were geared towards boosting revenues. Most importantly, the legal framework for the tax administration was strengthened by the coming into effect of Part 1 of the tax code at the beginning of 1999[41]. Other amendments included increased powers of the tax authorities, sanctions against tax agents that withhold payments and higher penalties for tax payers convicted of deferral and evasion of tax payments.

However, the first big leap forward occurred only in 2000, with a first deep cut in marginal taxation and a shift from direct to indirect taxes, in order to simplify tax collection. Key measures included the following[42]:

- **Personal income tax:** In a drastic move, the progressive tariff of 12%, 20% and 30% marginal tax rates was replaced by a single flat tax rate of

[38] The "imputed tax" was supposed to simplify taxation of small business. It is a lump sum tax replacing a large number of individual taxes by one payment. The tax payment is determined by the general characteristic of the firm rather than its actual profits and turnover. The coefficients for tax computation were to be determined by local authorities, but subject to the guidelines in the tax code. The tax payment was to be limited to 20% of imputed income. The tax had to be paid in monthly advances.

[39] Regional authorities were allowed to impose a new general sales tax of up to 5% of retail sales turnover, exempting certain categories of transaction, such as real estate and securities.

[40] The tax hikes took place already in the fourth quarter of 1998. Excise taxes on industrial goods other than mineral oil were lifted by 25%. Excise tax on tobacco and alcohol products was lifted by 40%.

[41] These were general provisions of the tax code regulating a) duties and relations of taxpayers and tax authorities, b) relations between federal and sub-federal tax authorities, c) restrictions on government additions to the tax code and d) definitions and rules for specific taxes (IMF, 2000).

[42] For a more detailed description of tax and other reform in 2000 see Ovanessian and Süppel (2000b).

13%. The income tax code was simplified in a way that was supposed to reduce by almost half the number of tax declarations.

- **Social security taxes:** Social taxes were unified and marginal rates reduced. The top aggregate tax rate was lowered to 35.6% from 39.6%. The tariff was changed from flat to regressive, with a top rate of just 2%. Together with the income tax changes the new regressive social tax greatly reduced marginal taxation of higher incomes and thereby discouraged capital flight and tax evasion. Thus, the cumulative marginal social and income tax rate of a person earning between RUB 300,000 and 600,000 (USD 10,600–21,200 at the time) per year fell from 69.6% to just 23%. Tax payers earning more than that would just pay a marginal 15%.

- **Corporate taxes:** Two corporate turnover taxes, the road users' tax (2.5%) and the housing tax (1.5%), were to be scrapped fully by 2003[43]. To offset part of the losses a new local corporate tax (5% of taxable profits) was introduced that lifted the main total main corporate profit tax rate from 30% to 35%. On balance the statutory tax burden on corporate activity was lowered noticeably, however.

- **Indirect consumer taxes:** Taxes on tobacco and alcohol were hiked again. The excise on gasoline was also lifted, with revenues used to offset losses from the elimination of corporate turnover taxes.

The next important step followed in 2001, when marginal and statutory taxation of companies was reduced and the related tax laws were simplified[44]:

- **Corporate profit tax:** The profit tax rate was slashed to 24% from 35%. In addition, regional authorities were allowed to reduce the rate by another 4 percentage points. Most tax breaks were eliminated[45]. However, the reform introduced the deduction of legitimate business expenses, in line with practice in OECD economies.

- **Mining tax:** This new tax replaced three current types of levies in the (huge) area of natural resource extraction. The scrapped taxes were

[43] Most of the tax was abolished in 2001, but a remaining 1% road users tax is due for expiry at the beginning of 2001 subject to the approval.

[44] For more details see Anisimova et al. (2002).

[45] The most prominent victim was the "investment preference" tax break, which allowed companies to deduct up to 50% of their profits from the tax base, if the funds were used for reinvestment.

royalties, the mineral reproduction tax and oil and gas condensate excises. The single mining tax will ultimately be levied on the value of extracted resources[46].

Together the 2000 and 2001 tax reforms revamped Russia's tax system according to the standard rules of supply side friendly policies. The new tax code allowed few tax exemptions, permitted a simple tax base computation and stipulated one of the lowest sets of marginal tax rates in Central- and Eastern Europe. The reform allegedly also reduced the total statutory tax burden on the economy. However, its objective was not to lower the effective tax burden. This point was not only supported by the actual increase in tax collection, but also by the increasing power of the tax authorities and political pressure on large companies, particularly Gasprom and RAO UES, to make tax payments on time (OECD 2002).

6.4.3 Reform focus 2: Investment conditions

The improvement of business and investment conditions ranked at the top of stated policy objectives and motivated the majority of economic law projects in 2000 and 2001. The low level of investment was easily identified as the crucial obstacle to sustained satisfactory output growth (Government of the RF, 2000a, Astapovich et al., 2000). Indeed, the level of real fixed investment had dropped by 1999 to just 26.3% of the pre-transformation level in 1991. The ratio of fixed investment to GDP had fallen to a mere 13% by the end of that period, compared to ratios of 30% in the Czech Republic, 31% in Hungary, and 36% in Poland. Similarly, foreign direct investment stood at a meager 1.8% of GDP in 1999 in Russia, comparing with 9.6% in the Czech Republic, 4% in Hungary and 4.4% in Poland (Ovanessian and Süppel, 2000b). Moreover, the government considered high capital outflows through 2000 as an indication of poor investment conditions (Government of the RF, 2000a). International surveys confirmed Russia's reputation as a difficult place for investors (Hellman et al., 2000).

Reform legislation in 2000 and 2001 sought to boost investment by three simple means: easier and lower taxation (described in 6.2.3.), deregulation and "law and order". The legal changes made a serious effort to tackle excess bureaucracy, public sector corruption, rampant crime and difficult contract

[46] However, legal changes to avert tax-efficient transfer pricing need to be introduced first, in particular for oil extracting companies. Therefore, for the period 2002-2004 the tax rate for oil extracting is fixed in rubles per ton of extracted resources.

enforcement. By comparison, there was much less emphasis at the time on spurring competition and developing the miniscule commercial banking sector. The restructuring of the large infrastructure monopolies was launched but only as a gradual 5–10-year process. The main investment-related non-tax reform projects in 2000 and 2001 included the following:

- **The "de-bureaucratization package":** This reform aimed at facilitating business registration, licensing and supervision in order to encourage startups and take away opportunities for corruption. Thus it stipulated that an applicant for registration would have only to deal with a single federal authority (one window rule) rather than with a multitude. The maximum time lapse for registration of a company shortened to 5 days. Registration was permitted by mail and could not be rejected by the authorities if documentation was complete. Similar steps were taken for licensing: The number of licensed businesses was reduced and the licensing procedure simplified as well. Approval of (large) investment projects is likewise to be facilitated, with the number of approvals slashed from 40 to 12–15. The list of required documents was shortened and the evaluation time cut from 2 years to 3–5 months. Finally, the reform dealt with the problem of excessive inspections and related corruption: The ability of inspection authorities to exert control over enterprises, and the number and length of inspections were reduced by federal law.

- **A new land code:** Most importantly, the law finally established the general principle of private land ownership in Russia, ending a six year impasse in a conflict between State Duma and President. Land for personal use was allowed to be freely traded and transferred. The trade of land for agriculture was in principle possible as well, albeit restricted by a separate federal law. Importantly, the code established land ownership also for foreign citizens and foreign legal entities. The new norms diminished uncertainty related to fixed investment and reduced the influence of public authorities over private enterprises[47].

- **Protection against nationalization:** To counter investors' fears of expropriation, nationalization of companies was tied to very restrictive conditions. According to the new law, property could be nationalized only to meet government needs defined as "requirements of the Russian

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[47] Previously enterprises used land on the basis of rental agreements or agreements of unlimited usage. These required recurrent negotiations with local administrations who were local landlords.

Federation in terms of goods and services, which are indispensable to resolving tasks of citizens' vital interests, e.g. for the country's defense purposes and national security". Any nationalization would require a federal law and, thus, the approval of both Houses of Parliament and the president. The law stipulated full compensation for any expropriation at market prices. Only the government could initiate a nationalization process. The nationalization of bankrupt companies was generally banned.

- **Shareholder protection:** A new law on joint stock companies sought to strengthen corporate governance for minority and outsider shareholders. In particular, it inhibited the reorganization of companies and the issuance of new stock with the purpose of watering down the influence of the latter[48].

There were obvious limits to the government's will and ability to promote investment. Money was the most important of them. Expensive projects such as the rebuilding of the country's obsolete infrastructure, the dismantling of old industries and the restructuring of the banking sector were put off until 2004, when the country would be past the peak in external debt servicing. Also, some important law projects, such as the change in accounting standards in banking or the judicial reform simply will need considerable time for implementation, due to administrative adjustment costs.

6.5 International integration and convergence

Russia's integration in the world economy was a priority of economic policy after the breakup of the Soviet Union, reflected in the quick accession to key international organizations except WTO (Buchalova, 1998) and the opening of its domestic stock and bond markets. Integration was interrupted by the introduction of external trade and capital account constraints after the 1998 crisis[49]. However, these were emergency measures motivated by fear of escalating devaluation and inflation. Russia's underlying commitment to economic integration persisted, as reflected by its efforts to regain capital markets and the accelerated agenda for accession to the World Trade Organization.

[48] For a complete overview see Radygin (2002).

[49] These comprised the foreign exchange controls mentioned in footnote 20, the reintroduction of export tariffs on certain natural resources in 1999 and the introduction of non-tariff export limitations, which required oil produces to supply minimum quantities of oil and oil products to the domestic market prior to receiving access to export facilities (Government of the RF, 2000).

- **Debt restructuring and future markets access:** In the wake of the crisis escalation, the Russian authorities quickly proclaimed and pursued a two-pronged debt restructuring strategy. On the one hand, the authorities sought a comprehensive restructuring of external debt inherited from the Soviet era[50], which represented some two thirds of all external liabilities of the government. On the other hand, the authorities serviced in full the remaining third, which was debt contracted by the Russian Federation. The Soviet-era debt relief was designed to ease the fiscal burden of interest and amortization payments. The commitment to Russian Federation debt was a first step towards restoring the country's creditworthiness and kept a window open for Russia's return to Eurobond market. In line with these objectives the first 12–18 months after the crisis escalation witnessed a focus on the restructuring. From 2000, however, when government delinquency risks were fading, policy focused increasingly on the restoration of the country's reputation as an obligor. This even led to a divergent treatment of creditors: While the government reached a far-reaching restructuring agreement with the London Club of commercial creditors in early 2000, the government ultimately abandoned its pressure to obtain similar debt relief from the Paris Club. Rather, the government sought to regulate the debt obligations to creditors that were neglected previously, i.e. non Paris-Club official creditors (mostly former COMECON countries) and uninsured suppliers.

- **WTO accession:** Shortly after his election in 2000, President Putin declared Russia's accession to the WTO a priority of economic policies, a step that the advanced Central European economies had already completed by the mid-1990s (Michalopoulos, 1998). Since 2001 negotiations have picked up steam and it is possible that Russia will join the trade organization as early as 2003. This would require general agreements with the organization on tariffs and merchandise trade, on services trade and on the trade aspects of intellectual property. The rationale behind this quick accession is simple: Integration in the global goods markets will provide stimulus and guidance for the rebuilding of industry and some services branches. Moreover, WTO rules provide also for clearer protection of foreign investors, supporting the government's quest for stronger capital spending. And Russia's own exporters, which

[50] In an agreement with the Paris Club in 1994 Russia had accepted all USSR liabilities in exchange for the foreign assets of the Soviet Union. However, formally the obligor of this debt was not the Ministry of Finance but Vneshekonombank.

faced close to 100 dumping cases abroad at the end of the 1990s, stand to benefit from clearer trade rules as well (Friebel and Guriev, 2000).

Through reform and international integration, post-crisis Russia followed a familiar pattern of transition economies. Political stabilization has led to an acceleration of economic change and rapid supply-side improvements.

There is no reason to doubt that the coming steps in the development of Russia will resemble the course of the advanced Central European economies as well. That is because the ground has already been prepared for a higher investment ratio and a sustained period of strong output growth. Also for its future economic policy Russian politicians will find it difficult to ignore that Central Europe has provided a successful role model for economic transition. Moreover, as the Russian Federation's economic and institutional structures evolve towards Western standards it will be natural that Russia and the EU will enhance their integration. For Russia the union is already the most important trading partner. After the EU enlargement scheduled for 2004 and later this decade, Russia will also be the unions' most important neighbor, with strong cultural and economic links to Germany and Central Europe. It is therefore likely that the Russian Federation is about to leave the path of a traditional emerging economy and rather is about to be taking those of a converging economy that forms part of Europe's secular trend toward integration. For investors this means that the quality of risk involved in Russia is declining and changing its nature towards CE-3 standards.

However, some factors limit Russia's emulation of Western and Central Europe's structures. These include the country's vast natural resources, its geographic and ethnic diversity and its history as a nuclear superpower. Above all, Russia, unlike Central Europe, has not linked economic transition and reform with the objective of EU accession. Central Europe's quest for union membership, which begun already in 1991 with the European Association Agreements, has shaped its institutional reform, helped to attract EU financial and technical assistance, bolstered trade integration with the West and helped attracting FDI (Kaminski, 2001). While there is a strong case for a strategic partnership between Russia and European Union, EU membership looks like a far-fetched idea at this point in time. Thus, unlike for Central Europe, there is no immediate pressure for Russia to bring its institutional and legal structures in line with the EU *acquis communautaires.*

7 Conclusion

Russia's economic history from 1995–2001 was unique in many of its characteristics. Unlike other emerging markets crises during that period it marked the accelerated decay of a military superpower and the reshuffling of its political structures. However, there were also many parallels to financial crises in Emerging Asia and Latin America in the 1990s, such as the failure of an IMF-sponsored stabilization program, huge fluctuations in the real exchange rates and a blow to financial system stability. More specifically, the Russian crisis resembled problems in Latin America in the 1990s insofar as it occurred after an aggressive reduction in consumer price inflation, which had used huge capital inflows and rapid real appreciation (Hood, 2000). Russia's productivity growth, like Latin America's, disappointed and failed to compensate for the strong currency. Also, Russia shared with Emerging Asia the combination of rapidly increasing bank activity and liberalization of domestic financial markets in the absence of concomitant changes in supervisory capabilities and standards (Fernandez, 2000). Therefore, an investigation of Russia's pre-crisis boom, crisis escalation and subsequent quick recovery reveals important lessons for Emerging Markets investors. Above all, the experience 1995–1998 identifies key questions that should be asked to gauge the risks of an exchange rate-based disinflation program:

- **Is monetary stabilization excessively ambitious?** Investors should look for evidence whether monetary tightening and real appreciation hamper economic activity in a way or to a degree that is inconsistent with the country's political and economic objectives. In Russia's case monetary tightening aggravated an economy-wide non payment problem, which distorted competition, entailed social hardship and eroded tax collection of the government. Also, real appreciation in Russia strangled industrial production and fixed investment. In order to gauge risks of such excessive ambition, financial analysts should check financial statistics for signs of rising arrears or, alternatively, a commercial bank credit crunch. Also, the balance of payments should be monitored for signs of a rapid loss of competitiveness. A prolonged slump in economic growth should be taken as a warning signal as well.

- **Are the country's economic structures strong enough?** Real appreciation-based stabilization is only sustainable if net foreign investment and productivity growth can improve sufficiently to offset the currency's impact on the external balances. At the outset of a program analysts should thus look at conditions for investors and the ability of either the financial sector or the government to allocate funds efficiently in the economy. Once the program is underway, disinflation or accompanying structural reforms need to produce a growth dividend, which should be checked by the fixed investment ratio, foreign direct investment flows and productivity data. A most serious warning signal is the absence of improvement in these data combined with a focus of capital imports on the sovereign, as was the case in Russia 1996–1998.

- **Do the authorities have an exit option?** Not every stabilization program that fails leads to crisis. It is worth investigating whether in case of adverse external shocks an exchange-rate regime can be abandoned or modified. In practice one should look for the key factors that typically block the exit: a large external debt burden that would become unmanageable in case of real depreciation, large open foreign currency positions of banks or companies, or dependence of government financing on the stabilization program. In the Russian case all three applied. To be sure, governments' commitment to a stabilization program may be stronger without an exit option. However, if external shocks make it unviable there is no easy way out of the ensuing financial troubles. Also the authorities' public judgment on a program's chances of success cannot be trusted if a program cannot be abandoned without high economic and political costs.

However, also Russia's recovery from 1999 onward provides important lessons for investors. The most important applies to Russia itself. Motivated by the crisis, the country has greatly improved its political and financial stability. Its development today resembles more advanced Central- and Eastern European transition economies in the 1990s. The risks attached to Russian assets today are not comparable in size and quality with the mid-1990s. From a global Emerging Markets angle the Russian recovery suggests the following check list of analysts for post-crisis economies:

- **Does a crisis strengthen or erode commitment to stabilization?** Governments are often discredited by a financial crisis. Analysts need to assess whether stabilization or broader reform are discredited as well. In the Russian case it was clearly the former. Subsequent changes in administration did not alter the fundamental commitment to economic transition and disinflation. The crisis changed the means of stabilization – fiscal rather the monetary tightening – but not the ultimate objective. By contrast, the crisis experience strengthened the support for stabilization: It encouraged households to sacrifice real income to avert escalating inflation and united the political spectrum behind the goal of bringing the country back on track.

- **How does output respond?** Devaluation can be a boon or bane for growth. In countries with a large banking sector that depends on foreign capital, such as Turkey, a fall in the currency typically coincides with weakening activity. In a country with a small financial sector but large industrial sector such as Russia, bank credit matters little whilst the real exchange rate matters a lot. Thus, chances were always good that output would bounce on the back of the huge 1998 devaluation. A careful monitoring of manufacturing output trends and business surveys in the post-crisis month may quickly falsify or confirm such hypotheses.

- **Can the government regain fiscal sustainability?** Often crises are protracted because the government fails to bring its fiscal house in order. Of course a lingering risk of government delinquency undermines stabilization and weighs on the functioning of a market economy. Russia tightened fiscal policy drastically in response to the crisis and used its political and financial leverage to quickly restructure external debt. More generally, analysts should check whether fiscal measures taken restore a government's capacity to fund contractual debt payments as well as essential non-interest payments, even under dire external circumstances. In other words, one must verify a) whether post-crisis policy proceeds quickly to consolidate public finances, and, b) whether tightening and restructuring can keep the government current on vital spending even under pessimistic assumptions.

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