AT THE CROSSROADS AGAIN

(Leonid Grigoriev, Chapter 1 of "Survey on economic policy in Russia in 1998", Moscow, BEA, 1999, ISBN 5-8243-0055-0)

1. End of Hopes for Fast Transformation

In the beginning of 1999, Russia is only starting to realize how deep and protracted will be the consequences of August 17, 1998, events. The financial meltdown has in many respects defined the country's future for the next generation. The crisis was inevitable, as the economic policies of the recent years aimed at reaching important goals of macroeconomic stabilization, but did not contain safety measures to prevent or mitigate crises of this type. "August 17" is a symbol of everything that appeared impossible to do during the 1990's and of the failure of Russia's hopes of the transition over a short historical period from a "medium–developed planned economy" to a more efficient "medium–developed market economy" that would hold a worthy place in the modern global economic system. The pattern of transition selected in early 1990's failed in completing the transformation of the economic basis of the society over a short time. The latter could not have been easy, as it was not easy in other post-socialist countries, though transition crises differ significantly in their depth and duration. In Central and East Europe the transition goes notably more successfully. In Russia and many other CIS countries the transition crisis has appeared especially painful. Reasons for this being so were rooted in the lack of adequate preparedness of the society for such a transformation, huge disproportions in prices, structure and deployment of productive assets and human capital. An essential role in the coming and development of the crisis was also played by political struggle, unevenness of reforms, the lagging behind of structural adjustments and, especially, of the creation of institutional framework for the market economy.

Добавлено примечание ([br1]): Year !!!

A year ago the purpose of the state policy in Russia was formulated as the search of paths to economic growth. In the beginning of 1999, topical is already the search of ways out of the heavy crisis. The President noted in his message that it is not the market economy that should be blamed for the difficulties that the country faces, but "the existing ugly transitional system, which has stuck halfway in between the planned economy and the market economy."[1] This is justly said, as the process of transition from the planned to market economy in Russia during the 1990's has remained substantially incomplete. Probably, adding the missing stages (elements) for the creation of the basis of a normal market economy should make up the contents of further transformation.

The decline in the GDP and industrial output in Russia in 1998 was caused mainly by internal reasons. However, the sharp aggravation of the international market conditions due to the structural specificity of this country's economy played an important role too, which is the

[1] See: *Rossiya na rubezhe vekov* /Russia at the turn of the century/. The Message of the President of the Russian Federation to the Federal Assembly. Moscow, 1999, p. 12.

reason for dependence on the raw material prices and imported capital. An essential drop of the export revenues and a rise of the cost of capital, large caution of foreign investors began to show back in the Fall of 1997. Already at that time (i.e. in the second and third quarters of 1997), when the Russian economy demonstrated the signs of revival, the inflation was suppressed and the interest rates declined, it was, perhaps, necessary to transfer to a more cautious borrowing policy, at least, at the federal level, and a lower ruble exchange rate, as well as make no haste with liberalizing the domestic GKO market, etc.[2]

Unfortunately, even if the level of risk for the country had been realized by the economists at the time, a radical policy change was hardly politically feasible. It would have implied consciously giving up a chance for economic growth for the sake of playing safe in case of probable, but apparently not yet inevitable "troubles" and a basically different pattern of relations between the analysts and the decision making system. It was exactly in 1997 when Russian commercial banks were actively opening foreign credit lines, working with forward contracts on a growing scale and, like the regions, entered the eurobond market to attract capital. The Ministry of Finance was also interested in attracting inexpensive capital from abroad to the GKOs and reducing the total cost of servicing of the internal debt. The conduct of foreign investors was still quite rational, as they expected a steady ruble to dollar exchange rate within a long-term corridor backed both by the official policy of the Government and the Central Bank and the IMF support. It is doubtful that any rational force could have reversed all these factors to switch over to a policy of "defense" (against the future crisis). Besides, the chances for the regulators (monetary authorities) to take measures aiming at direct curtailment of revenues of the key and most politically influential segments in the economy are generally extremely low in any developing country that has a strong system of oligarchic clans. In the middle of 1997 the debt trap was completely set, in which the national economy found itself caught one year later.

The trap, probably, banged shut early in 1998, when the probability of a heavy crisis began to grow after a number of investors left, the foreign exchange reserves went down and there was a first attack on the ruble. From that moment on, the Central Bank had to defend the ruble, as its significant devaluation would have resulted in losses for the foreign GKO holders and would have put Russian banks and the Ministry of Finance in a very serious situation. During that period the financial authorities still hoped for a "soft landing". By May, however, the chances for this were rather minor and political difficulties in the country prevented from making a clear analysis of threats and scale of potential losses. The "August 17" may be recorded in the history as the largest financial catastrophe in Russia outside of the times of war or revolution. As a result, Russia faces an unpleasant perspective of meeting the new millennium as "a sick man" of the world.

Historians will be arguing for long about the logic behind and technique of the implementation of the set of measures set forth in the August 17 Statement. But one thing is

[2] The Review contains detailed information or a special section dealing with the majority of the issues discussed in this chapter.

clear in the perspective of a long-term economic policy: the threat of such a crisis was not seriously analyzed in the core of the state power, and its drawing near did not stimulate the development of radical anti-crisis measures. In the summer of 1998, foreign investors were trying to withdraw their profits and capitals, domestic investors were increasingly taking their capitals out of the country while the circumstances allowed to do so. The program of budget measures that was not implemented in the summer, to all appearances, could not produce immediate results or prevent the crisis, but would have only delayed it. Accordingly, it was also impossible to count on having smoothly and rationally implemented the three far from ordinary measures at once: the default on the state internal debt per se, a radical change in the exchange rate policy, and a 90-day moratorium on the repayment of private debts due to non-residents. One has to get thoroughly prepared for such undertakings in a strictly confidential manner, which would take quite a time. The expectation of the IMF's approval acting as a surety against external troubles has never come true: the IMF is influential but not omniscient or omnipotent.[3] As a result, the heavy financial crisis ripened to come in as an explosion. A discussion of possibilities for limiting its scale by taking preliminary measures is of an academic character and generally, the chances to avoid it was, to all appearances, extremely low.

Perception of Russia's economic policy has undergone a striking transformation from a euphoria over historical achievements of the transition from the planned economy to what was thought then to be the market economy to the current heavy situation of a general debt crisis. The unceasing expectations of the resumption of economic growth reflect better than anything else the unrealized forecasts of the macroeconomic dynamics (see *Table 1*). But exactly at the time when internal conditions for growth in Russia looked relatively favorable (during the summer and fall of 1997), the external conditions turned against her.

By early 1999, which is "celebrated" in the West as the 10th anniversary of the beginning of a transition in the former countries of the "socialist camp", Russia has never recovered from a deep industrial crisis, the country is encumbered with debts at all levels of administration, is barely able to maintain an inefficient social safety net and can only provide minimum funding for complex and expensive technological and military systems created in the former USSR that had become the attributes of a great power. The standards of living have significantly declined, social inequality has dangerously increased, structural reforms are not accomplished, the institutional basis is inadequate, and the ownership pattern makes one feel an unfeasible, though understandable desire "to start all over again".

[3] Cf., e.g.: Aleksashenko S. *Bitva za rubl'.* /The Battle of the Ruble/ Moscow, 1999, pp. 184-185, 199, 224.

Table 1.

Macroeconomic Indicators: Dynamics and Forecasts
(Incremental Growth Rates, in real terms, %)

Indicator	1995	1996	1997	1998	1999	2000	2001
GDP							
Actual	-4,2	-4,9	0,8	-4,6			
Forecast A, May 1995.	-7,0	0,0	2,5				
Forecast B, May 1995.	-9,0	-3,0	0,0				
Forecast, December 1995.		-2,0					
Forecast, December 1996.			1,0				
Forecast, January 1998.				1,5	3,5	5,0	
Forecast, March 1999.					-3,0	1,0	3,0
Industrial Output							
Actual	-3,3	-4,0	2,0	-5,2			
Forecast A, May 1995.	-6,0	0,0	2,0				
Forecast B, May 1995.	-10,0	-3,0	0,0				
Forecast, December 1995.		-3,5					
Forecast, December 1996.			1,0				
Forecast, January 1998.				3,0	4,0	5,0	
Forecast, March 1999.					-1,0	2,0	4,0
Investments							
Actual	-10,0	-18,0	-5,0	-6,7			
Forecast A, May 1995.	-13,0	1,0	7,5				
Forecast B, May 1995.	-17,5	-2,0	2,5				
Forecast, December 1995.		-7,0					
Forecast, December 1996.			0,5				
Forecast, January 1998.				0,0	5,0	6,5	
Forecast, March 1999.					0,0	2,0	5,0

Sources: The Russian Federation State Committee for Statistics (Goskomstat); Programs for the respective years of the Government of the Russian Federation.

For all that, the collapse of a significant part of the system of public and private finance, debt relations, banks and oligarchic control in the economy does not put an end to the history of reforms. As the global economic growth rates are declining and export prices of raw materials and semi-finished products are low, with two elections to take place in 1999 and 2000, Russia should find the way to continue the transformation from the centralized planning to the market economy, find a path to economic growth and survive the consequences of the default on the government obligations on the domestic market.

After seven years of endeavors of carrying out a fast transformation, the emerging new pattern of reforms seems to be predicated on a greater than earlier declared interference of the state in the regulation of economic processes, which was natural to expect to happen in the USSR a decade ago. Liberal intentions remained characteristic only of the initial stage of reforms. Before the two elections are over, it is difficult to predict what kind of reforms we shall see in the future, radical or gradual, ideology–driven or pragmatic. There are some signs indicating that Russia's populace have lived through the financial catastrophe a little easier than expected, though will have to pay for the "broken financial pots" for long. The economists and politicians start to reconcile themselves with impossibility of fast, "inexpensive" solutions and are searching for acceptable approaches in the national post-crisis policies given the current global reality.

The crisis has put an end to the previously emerged model of transition and has caused the search for pragmatic solutions both to the problems of the national economy and the paths of transformation. The time has come to think of the character of transformation of the Russian society and economy at the turn of the millenium. Early in 1999, Russia finds herself at the crossroads again and needs an economic policy that will be adequate to this serious situation.

2. Crisis Dynamics

Analyzing the crisis development in Russia in 1997-1998 is extremely difficult, as objective events and sudden political zigzags interlaced in quite a complex and unpredictable pattern. All participants to the process acted rationally in their own ways, but their purposes and principles underlying their decision making sharply differed. Though at each particular point in time the dynamics of the key economic indicators did not coincide and the economic agents demonstrated not necessarily similar conduct, on the whole the year before the crisis allows reasonable periodization.

The fall of 1997 before the external impact on the Russian markets occurred (on October 28th) was a period of hopes for the growth to begin. The IFIs were quite content with the Russian monetary policy and urged further liberalization of the financial markets. The tax–related problems were serious, but not critical yet. The change in the fundamental conditions and risk perception on the global financial markets went unnoticed in Russia. The Government, private companies and banks mechanically borrowed at relatively low interest rates as much as they were lent. The rest of the world was preoccupied with the acute crisis in South East Asia. Capital outflow from Russia broke record in a relatively safe year of 1997.

Then the crisis went on through several stages, which differed in the political situation, objective status of the Russian economy and conduct of the main players on the financial markets and the character of decisions made. Therefore, it is worthwhile to track down the conduct of the main participants at various stages of their way to the "August 17". One can identify at least three main groups of participants in the economic process inside the country: commercial banks, export–oriented industries, and the government in the broad sense of the word (for we cannot here separate the Ministry of Finance from the Central Bank). Outside of the country, active participants in the drama included international financial institutions and investors, which had invested nearly $30 billion in the GKOs and also opened significant credit lines to Russian banks.

The initial stage of the Russian crisis comprised two waves of crisis that took place on the financial markets from late October (see *Table 2*) to late March of 1998. During this period the economy moved from rise to stagnation. The general anti-inflationary trend of the macroeconomic policy conducted by the V.Chernomyrdin Government was maintained. The price for supporting the ruble and the GKO market in November was rather high: the reduced foreign exchange reserves of the Central Bank were not to return to the October 1997 level any more over the next eighteen months. The fact that investors from several countries left the GKO market in November was disquieting but it looked as though it was part of events of the outside world. At that time it was decided to continue liberalization of the GKO market and to remove limitations on withdrawal of non-residents' funds from the GKO market as from January 1, 1998.[4] Investors were expected to come back again in 1998 after their fixing profits for 1997, but only some of them did so.

Attempts to raise a matter of introducing a floating exchange rate of the ruble, according to the memoirs, were not successful. It seemed at the time that a rapid growth was already waiting "behind the corner", so that it was necessary to hold out just a little longer. The new arrangements with the IMF regarding the 1998 program seemed to guarantee continuation of the reforms and a financial crisis of the scale that other countries had already developed was, generally speaking, not perceived as something likely to happen in Russia. During that period, the Central Bank did not hedge exchange risks taken by commercial banks any more.

Beginning from January 1998, bad economic news considerably subdued the hope of a rise even with the optimists. In a country so heavily dependent on raw material exports, the economic growth is still possible even at low prices of petroleum and metals. But it is hardly so if the prices drop so sharply as was the case since early 1998 under the impact of the crisis elsewhere. The industrial output began to decline in the new year and the stock of non-payments grew faster and faster. The second wave of the financial crisis of January–February was attributed to the speculators, both domestic and foreign. The second wave did not cost as much as the first one, still leaving hope that the Central Bank was able to protect the ruble.

4 Even the supporters of wide liberalization recognize now that the measure was hasty. Cf.: *Rossiyskaya ekonomika v 1998 godu. Tendentsii i perspektivy* /The Russian economy in 1998. Trends and prospects/. Moscow: IEPP /Institute for Economy in Transition/, 1999, p. 10.

Table 2.

1997-1998 Financial Crisis Indicators

Indicator	**RTS Index**		**Average Weighted Return on GKO**		**Exchange Rate**	
	(Sept. 1, 1995=100)		**(%) ****		**(Ruble/USD)**	
	First Wave					
Beginning End Variation	22.10.97 02.12.97	550,4 320,4 -41,8 %	24.10.97 02.12.97	18,2 46,0 27,8	22.10.97 02.12.97	5878 5921 0,7 %
	Second Wave					
Beginning End Variation	05.01.98 29.01.98	411,6 265,9 -35,4 %	09.01.98 30.01.98	29,0 45,6 16,6	05.01.98 30.01.98	5,960 6,025 1,1 %
	Third Wave					
Beginning End Change	05.05.98 01.06.98	315,2 171,7 -45,5 %	05.05.98 28.05.98	31,2 68,6 37,4	05.05.98 28.05.98	6,134 6,162 0,5 %
	Fourth Wave					
Beginning End Variation	20.07.98 30.09.98	193,0 44,0 -77,2 %	31.07.98 14.08.98	58,7 162,5 103,8	22.07.98 09.09.98	6,226 20,825 234,5 %

The Government was engaged in a routine struggle with the State Duma over the 1998 budget and the Tax Code throughout the winter — political factors did not play an independent role in financial destabilization yet. This also helped create an illusion of stability. The Government continued to view the crisis events abroad as a remote trouble that only marginally concerned the Russian economy. An important new factor emerged and that was formation of what we would conventionally call “a party of exporters”, who were openly interested in the devaluation.

The latent crisis of April–June. This stage of the crisis featured both the falling down of the petroleum prices and faster and faster reduction of domestic production, whereas the Government and the Duma were preoccupied fighting each other. The S.Kirienko Government attempted to address the corporate finance problems but failed with arranging a fast series of decisions, as there had been no new set of ideas prepared. The third wave of the decline of the share prices in May, the rise of the refinancing rate, growing amounts of borrowing from abroad at a growing cost — all these can well define the economy as being actively drawn into the crisis. During this period Russian banks were gradually leaving the GKO market while already facing liquidity problems. By the summer, many of them raised the deposit rates up to a level of 45-50%, an obvious symptom of difficulties, and turned into a trap set for the “new rentiers”. By mid-June it was not the Ministry of Finance but the

Central Bank alone that redeemed the GKOs, the return on which quickly grew. And already it was impossible to place the new issues at acceptable prices. Capital flight and sale of the ruble were occurring faster and faster.

The Government reacted mainly with an attempt to work out a new economic program to receive about ten billion dollars more from the IFIs. The logic, however, remained the same: a strict monetary policy conducted at the time when the real size of the money supply (M2) was quickly declining as the economy entered the crisis mode of operation already since June.

The open phase (July–August 1998) represented a crisis development process, in which objective and subjective factors and group interests were intermixed. No one in Russia had been experienced in surviving a large–scale financial crisis of the market economy, and there had been no alternative, off-the-shelf emergency options. Low prices of petroleum and a meltdown of the GDP and the industrial output that occurred in July left no hopes for the crisis to resolve by itself.

First signs of the search for some new, extraordinary solutions were seen in mid-July. The practical steps included the GKO for eurobonds swaps, the reaching of a new agreement with the IMF, and new loans from the IFIs. At the same time, the Duma, for political reasons, denied support to the new Government's program. It should be noted here that there was no talk in the open about preventing a collapse of the type similar to what had happened in South East Asia. The measures included in the new program were supposed not only to pass through the Duma, but their implementation required quite some time and huge efforts, too. It is doubtful that those measures could have prevented the crisis and it was simply not too rational any more to buy a delay with new borrowings. But there were little chances of preventing the collapse given the CBR continuously maintaining the ruble exchange rate within the narrow corridor as the investors were abandoning the GKO market with immediately converting their proceeds into hard currency. Anyway, in the circumstances of the summer of 1998 it was naïve to expect a sudden, large inflow to Russia of private capital or a large–scale international aid.

Actually, the crisis burst out not so much because foreign institutional investors left the GKO market — many stayed until the end — but because domestic investors withdrew their confidence in the ruble. By early August the banking system was quickly losing ability to effect payments, in particular and most importantly, tax payments, having left the Ministry of Finance without cash revenues. The drop of Russian security prices cornered banks that borrowed from the West against bonds. Banks started to sell securities to replenish their collaterals under credit lines. Early in August the Ministry of Finance was quickly losing ability to provide even the current budget expenditures. On Friday, August 14th, it became clear that some major banks could not execute forward contracts for foreign exchange delivery. In two days' time the "August 17" solution was found that covered the monetary policy, default on the GKO, and a moratorium on private debts, which brought the crisis to its final stage.

Confusion over when the GKO restructuring plan is to be declared, lack of clarity about the plan itself inside the Government, debates over legality of the moratorium put off the period of uncertainty even further. A spontaneous devaluation to one-third of the previous rate in just a few weeks as the payment system is in the state of paralysis — this was exactly the nightmare that threatened stability of the entire economy. In August and September the nation probably went through more serious threats than it actually realized.

3. The Russian Crisis: A Global Context

Historians will yet be trying to find out the reasons for politicians and financiers to be so blind as to overlook in the end of the 20th century the new threats to the global economic and political stability. The 1997-1998 financial crisis put the global economy on the edge of recession and its scale in the developing and transition economies and the mechanism of its contagion were not anticipated. Just a few more years ago it seemed that the heaviest shocks of this century that is nearing its end are left behind, humankind became wiser, politicians reconciled themselves with impossibility of creating an ideal world "of their own", and the inhabitants of the Earth can look forward for less poverty or inequality. Now suddenly again half of the world sees recession and there are financial troubles and political shocks in Russia and some other countries. Though it looks like the direct threat of a global depression is past after all, fanfares are silent as the 20th century is ending.

A historic analogy that naturally comes to mind — the 1929 collapse on the financial markets in the USA and Europe and the Great Depression — is comparable with the crisis of transformation in the former USSR, especially Russia, in terms of its depth but not duration. Devaluations and trade wars played a role then in delaying the crises for later times. Analogies from the recent history of developing countries, where debt crises, stock exchange collapses, or sharp fluctuations of the export prices caused most serious financial and economic shocks — for example, in Mexico in 1984 and 1994 — were of local nature.

The current financial crisis started in the spring of 1997 (the Czech Republic and Thailand) to reach South East Asia in 1997-1998 and Latin America in 1998-1999. Its distinguishing feature is that it interrupted the growth phase in many countries, having reduced possibilities for capital inflow and growth in the developing and transition economies for a few years. The attempted measures to protect the exchange rate of the national currencies, massive panicky withdrawal of short-term capitals and disorder in the national banking systems served to spread the crisis. It had a hard impact both on countries with a record of fast and, at the first glance, well–balanced growth ("the Asian tigers") and Latin American states with a hard record of alternating inflation and macrostabilization. The inflow of private long-term capital to the developing countries dropped from about $75 billion per quarter in the second half of 1997 down to $33 billion in the third quarter of 1998.

A quarter of a century has passed after the energy shocks in the developed countries, and their economic independence from import price fluctuations has become factual. Economic maturity of the developed countries, stability of their economic policies within the framework of generally accepted standards – control over budget deficit and inflation and well–developed competition — have created an illusion of global stability in the mid-1990's. The rest of the world obviously did not "catch up" with them in its internal transformation, and, as internal strain accumulated, showed signs of cracking. With a certain degree of convention, the end of prosperity in South East Asia, crises in Latin America and the CIS can be viewed as a crisis of the unevenly emerging, medium–developed capitalism that proved to be somewhat "small" for the operations that the financial Hullivers undertake. It is impossible to make up for the weakness of ownership relations, immature competition and low internal accumulation of capital through budget and issue control alone. In view of fluctuations of global prices of raw materials, the developing world is currently experiencing crises that were characteristic of European and North American capitalism of the period before World War II.

The developed countries have also suffered from the current crisis, as contraction of markets and losses on the financial markets of the developing countries limit the opportunities for economic growth (see *Fig. 1*). One of main reasons for this is that the existing system of international financial regulation has achieved significant progress with regard to the developed market economies but could not provide a coverage of the same quality for the emerging or weaker market economies. Resources and reserves that the international financial institutions have available are fit to cope with one or two large–scale crises but not to handle the situation in 5-7 large countries that find themselves simultaneously in a heavy financial state and require aid: South Korea, Indonesia, Thailand, Malaysia, Russia, Argentina, Brazil. Besides, Japan is experiencing its first recession in a quarter of the century and its financial sector needs serious adjustment. China, too, faces certain financial difficulties, especially in the banking and financial system, and a decline in the growth rate.

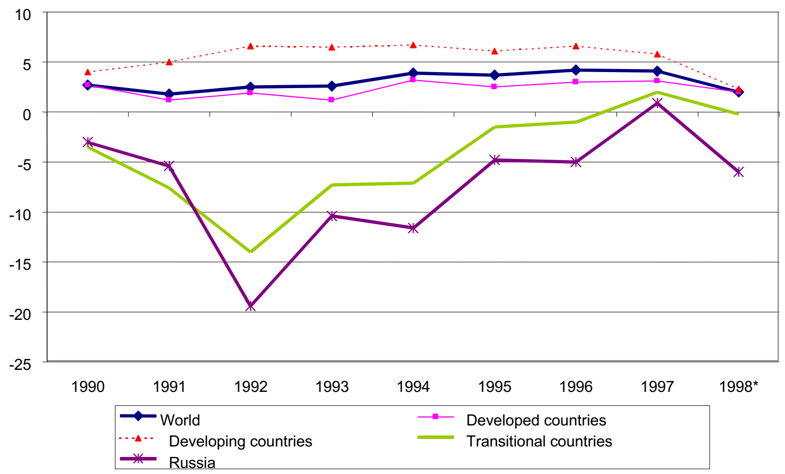

Fig. 1. Incremental Real GDP Growth Rate: A Global View (%)

Economic growth has been retained in Western Europe, as well as in the USA, where the "panicky flight" of capitals from all over the world directed driving the rates down and creating more favorable conditions for investments. The developed part of the world is not moving, as was the apprehension at a certain time, toward a new depression; however, in 1998-1999 the annual global increment of the real GDP will be less than 2% and that of trade, less than 6%. Devaluation of certain currencies has provided conditions for exporting from the developing countries but its effect will only show itself with time.

More frequent financial shocks are one of the features of the current globalization of the financial markets. Short-term financial capital influx may be a blessing one day and a misfortune on the next day. Speculative booms on the financial markets, resources that the banking system has available and stability of currencies (especially when protecting the fixed exchange rates) appeared to be linked to the flows of the international short-term capital. Against this background, the panicky ("gregarious") conduct of international investors who operate with capitals comparable in size with certain national budgets and exceeding the amount of liquidity in certain national banking systems, created instability, which was bound to blow up in crises.

Nevertheless, in-depth reasons of financial collapses in the countries with emerging markets are found inside those countries. For example, creation in the countries of South East Asia of a number of industries and services, integration of national economies into the global economy in what pertains to the movement of goods, information and workforce created conditions for a general economic growth in the region in the 1980-1990's. However, the growth of the per capita GDP does not make a country developed and stable, or protected from external impacts. Uneven economic development, weak national financial sector, budget deficit are peculiar to the majority of those countries, Russia being no exception here. Booming investments in real estate or prestigious projects without developing an adequate national base for long-term savings are characteristic of nearly all of them. In Russia, a speculative boom of this kind was to a large extent "substituted for" with capital flight of the size of several percent of the GDP annually: this is a value close to the amount of uncollected taxes and the gap of resources needed to cover social expenditures and government investments in the infrastructure.

International investment bankers follow a uniform inherent logic of business, which demands that an equilibrium be reached between risks and return. As the financial crisis was evolving globally, analysts at large international investment banks made similar decisions. They cannot be blamed for callousness, for such are the capital flow rules accepted in the world of developed financial markets. Developing and transition countries can either accept the same rules of the game, or abstain from borrowing. Graduates of the same universities, who were based on similar theories and used identical computers and (rather limited) information were analyzing risks (probably, wrong risks) of investing on the emerging markets. It is no wonder that they were coming to similar investment decisions as they reviewed their portfolios. However, the real riskiness of Russian instruments was not clear to external investors until the last minute.

Internal weaknesses of the developing economies cause disastrous changes in the direction of international capital flows. The necessity of reforming the global financial architecture becomes more and more obvious. International financial institutions that exist to date are not capable of resolving the problem of prevention of large–scale systemic crises. Some kind of adjustment of the international financial system (and its architecture) to the new “level of the lack of confidence” of investors in the emerging markets and also in the ability of the IFIs to effectively resolve economic problems is inevitable. It is not without reason that the discussion has resumed in the West about when it is rational to liberalize capital accounts, especially in countries with a weak national banking system, so as not to subject it to the risk of a sudden capital outflow.

The Russian crisis can and should be viewed in a global perspective. Inevitable integration of the national economy into the global economic system has made such a progress that it resulted in there being now a host of channels of external influence on the development of the Russian economy. At the same time, the development (and especially, the crises) of the Russian economy began to have a significant influence on the rest of the world. As the financial crisis was evolving in Russia in late 1997, regularities peculiar to the emerging markets were obvious, which manifest themselves in close interrelation among the processes occurring on such markets. The crisis in Asia has sharply reduced the investors’ preparedness to undertake whatever risky investments, on the one hand, and has drawn their attention to the risks that are inherent in the investments made in the emerging markets, on the other hand.

The liquidity problem that investors face as a result of the crisis on any market forces them to sell a part of their assets. Thus, open mutual funds have to make payments to their investors who prefer to leave. Many such funds were created with the only purpose of making investments on the emerging markets or markets in a certain region and, accordingly, they have only this kind of assets to sell to provide necessary payments. Investors who concluded a REPO transaction or a futures contract on securities or foreign exchange are obliged to pay the insurance premium if the prices fall down. First of all, the above described mechanisms result in the acceleration of the price drop on the market that experiences a crisis, since this is where the significant part of forced sales are effected. In case of a failure to pay the premium on the contractual date, the investor’s position will be liquidated. However, low liquidity of the market during the crisis and unwillingness of investors to fix their losses prompt them to effect part of the sales on neighboring markets.

Even if the investors that incurred losses as a result of a crisis on any market do not have an acute shortage of money, the risk management system, which is mandatory for use by the Western investment or commercial banks, implies that possible reduction of profitability should be made up for with a smaller risk associated with the respective assets. Investments in the emerging markets fall under the high risk category, and so their limit size will be automatically reduced. The desire to reduce the riskiness of the portfolio can also be caused by the expectation of future instability in the global financial system brought about by the crisis in this or that country.

It is difficult to precisely evaluate the losses incurred by foreign investors and banks in Russia in 1998. This amount might well be different from dozens of billions of dollars reported by the mass media, but nevertheless significant and tangible enough to be remembered for long (see *Table 3*). Investment funds were also among those that incurred considerable losses. Most appreciable losses were incurred by the investment funds whose specialty was investing in Russia and the CIS. *Table 4* gives some information on the largest of them. Several funds, including The Templeton Russia Fund, a veteran of the Russian market, ceased their operations with investors in 1998.

The crisis in Russia played a role in the bankruptcy of five hedge funds, which heavily relied on the borrowed capital (High Risk Opportunities Fund LTD, High Risk Opportunities Fund LP, McGinnis Partners Focus Fund, McGinnis Global Fund, and Russia Value Fund)[5]. Besides, the events in Russia played not an unimportant role in the actual bankruptcy of one of the largest hedge funds, Long Term Capital Management, a company founded by the Nobel prize winners R.Merton and M.Shols. The USA authorities perceived this as a threat to the entire national financial system and so effectively agreed to a bail-out.[6] In April 1999, legislative proposals were made public in the USA on introducing stricter regulation for hedge funds.

Names ???

Table 3

Estimated Losses Incurred by Western Banks that Dealt with Russia in 1998

Bank of America	$220 million losses in July–August 1998, mainly in Russia
Bankers Trust	$260 million investment losses incurred in Russia in July–August 1998
Chase Manhattan	The $200 million investment losses incurred in Russia reduced the net investment income in July–August down to $160 million
Citicorp	The net income for the 3rd quarter reduced by $200 million due to investment losses in Russia
CS First Boston	$250 million losses from investments in Russian debt obligations, total losses over $800 million
JP Morgan	Total assets in Russia $ 160 million, losses not reported
Morgan Stanley	$110 million losses in July–August 1998 from investments in the emerging markets, including Russia
Nomura Securities	$350 million losses from investments in Russia in January–August 1998
Republic, New York	The $110 million losses in July–August 1998 from investments in Russia reduced to zero the net income for the 3rd quarter.
Salomon Smith Barney	$360 million investment losses in Russia as from the beginnings of the year, including $150 million net losses in July–August

Source: "Russia turmoil hits banks", CNN financial network, September 3, 1998.

5 «Hedge Funds Win and Lose», CNN Financial Network, September 16, 1998.

6 «World Economic Outlook», IMF, October 1998, p. 136.

Banks and funds will write off their losses in Russia, but the level of Russia–related risks will remain an important factor for the next generation of students and investment bankers. A crisis that occurs in a given country allows the investors to draw inferences regarding the stability of other countries with similar macroeconomic and structural indicators and investment risks. Thus, the fall of the Thailand baht demonstrated the hazards of short-term loans denominated in a foreign currency and the weakness of the banking system. Events that occur during a crisis, especially any unusual actions taken by the national government, may be perceived as an important precedent that boosts the probability that similar events would take place elsewhere.

Table 4

Assets of the Largest Funds Specializing in Investment in Shares in Russia and the CIS

Fund	**Total assets as of 01.01.99, million USD**	**Asset Variation in 1998, %**
The Hermitage	170,3	-88,6
Brunswick Russian Growth	126,1	-83,2
The Hermitage II	57,6	-88,6
Brunswick Russian Emg Equity Trust	26,6	-80,5
Rurik Investment	25,7	-77,2
Russian Prosperity	25,2	-86,1
Clariden Russia Equity	11,1	-84,2
Magnum Russia	9,0	-61,2

Source: Micropal.

Obviously, any national financial system or crisis has a specificity of its own, but it is important to note that the Russian crisis looks quite “normal” if seen as a link in the chain of development of the global financial crisis. The Russian economy was considerably affected by the crisis in South East Asia in 1997, when fundamental risk perceptions were revised. The “August 17”, in its turn, resulted in a new radical revision by investors of their perceptions of riskiness of financial instruments on the emerging markets. This caused a new wave of capital outflow from the respective countries. So, unexpectedly, Russia played the role of a mechanism to transmit the crisis from South East Asia to Latin America, in particular, Argentina and Brazil, countries that are quite important for the stability of both the continent and the US economy.[7] The fight against the financial “infection” in the fall of 1998 and during the first months of 1999 included attempts to find the way to stop the spreading of the

7 The share of US exports to Argentina, Brazil, and Mexico is approximately 13%, almost as much as the loans extended by American banks to these countries in 1997 in terms of percentage of their capital.

domino effect on Brazil by a combination of serious curtailment of government expenditure and revenue rise (a usual IMF recipe) with anticipatory introduction of the floating exchange rate (the lesson learned from Russia's "August 17").

The crises of the recent years have also shown the importance of democracy, restriction of corruption in the government, the danger of clans prevailing in the exercise of control over national political and financial institutions, which results in a serious conflict of interests between the state and the clans. The latter have played a distinctly negative role in the development and resolution of crises in many countries: being the first to receive information on the status of public finance and decisions planned to be made, the clans have automatically acted in their own interests. In most countries this was especially clearly manifested in the capital flight and the "running away" from the national currency, which destroyed confidence in the national markets of the country, but allowed to rescue a part of resources of a certain group. In terms of the capital flight, "national" financial and political elites have usually left behind even foreign investors who often learned from this that there was a collapse approaching.

The next global rise can possibly occur once the growth in Japan, South East Asia and Latin America is resumed. Only after this happens one can expect growth in the export prices of the raw materials and increased growth in the export of direct investments. Russia could not join the global rise of the mid-1990's. Our next hope is that Russia would be ready to join the economic rise some time in late 2000-2001. Provided that the external debts are successfully restructured, during that period investors may begin to return to Russia. Therefore, reforms should continue for the economic rise in Russia in the 21st century to proceed on a new basis of a normal market with healthy financial institutions.

4. What Has Not Turned Out Right?

In fact, by 1998 it became clear that the fabric of a normal market economy in Russia had not been woven. The purposes of the economic agents, their operational environment and real behavior were so remote from what the efficiency of the market economy, whatever its specificity or variation, is really based upon that there began a period of rethinking of both results and the sequence of stages of transformation.

Exaggerating a little, one can say that practically attained was the objective of price and domestic trade liberalization and, to a large extent, of the opening of the country, quick reduction of the share of the state–owned property and temporary macrostabilization. At the same time, over the years of transformation no success has been achieved in building the institutional framework for the market economy, providing compliance with the rules of the game by the economic agents, creating a multitude of legal and efficient owners as the prerequisites for the realization of the advantages of private property. Given the actual context, Russian citizens have largely lost (rather than become more certain) in their trust in the private financial system, which undermined the system of organized household savings. The tax system became one of the factors of stagnation of the legal economy.

In the conditions of uncertainty of control and ownership rights, back in the early days of reforms companies developed a short-term approach to purpose setting, which makes it rational to take capital out of the country and evade taxes, thus undermining accumulation. Certainly, this does not refer to companies as objects of a macroeconomic policy but to those managers and owners who came to be in control. Finding themselves in a situation of resource squeeze, the government bodies at all levels attempted to compensate that by borrowing and/or effectively non-fulfilling their obligations. The system of non-payments, especially regarding those by companies to the budget, the practice of making settlements abroad and other negative attributes of the current Russian economy have taken roots in the corporate world. The fiscal crisis, accordingly, is radically insolvable given the current system of economic relations at the corporate level.

We noted in the previous Review that the process of fast transformation in the area of structural and institutional reforms took place in 1992-1995. Adoption of the Civil Code in 1994 and a natural final chord of the mass–scale privatization, the 1995 “swaps”, are landmarks of its termination. From the political point of view, the period of fast (“early”) transformation was ended with 1995 Duma elections and the 1996 presidential election. The process of liberalization of economic activities took even less time, from 1992 to 1994, including transition of the Russian economy to the world prices and the end of direct financing of the budget by the Central Bank as of 1995. Political events of 1998 and the “August 17” have completed a significant stage in the history of transition, in particular, two or two and a half years of macroeconomic stabilization on the basis of economic relations on a microlevel and structural changes that were formed in 1992-1995.

The set of effective rules and laws observed both by the state and its bodies and the taxpayers provide effective operation of market mechanisms. This is precisely the reason for institutional reforms. The latter, by definition, cannot go before measures in the area of liberalization. But they should be an integral part of the transformation plan rather than a sort of last echelon of the reforms. In Russia this part of the transition, probably, appeared even more difficult than the other. Rules offered appeared so hard that compliance with them *appeared* disadvantageous to the participants of the market processes but favorable for the red tape and corruption.

Transition from the all-powerful role of a socialist state in a planned economy to a democracy that maintains its basic functions (law, rules of the game) lies not only through its reduction in size (which, in itself, is correct), but, first of all, through a change of the role of the state. Enthusiasm of curtailing the role of the state should not cloud an important constructive moment: during the market transition, the state should make a difficult “operation on itself”. The problems of the state in Russia at the stage of transition are characterized with widespread corruption, a large scale of economic crime, tax evasion, and capital flight.

The actual picture of the Russian post-reform economy was displaced relative to the objective purposes of transformation. The financial elite (“new Russians”) was formed earlier than and partly “instead of” the middle class that is most interested in the transition to a market economy and democracy. The country has remained in the state of an economic crisis, huge social inequality, poor tax system and weak administration. The sharp transition from a quasi–egalitarian society to the one of the Latin American type featuring huge inequality has caused weakness of the middle class and instability of the political process, widespread corruption and increase of general and economic crime, especially organized crime.

The people do not trust financial institutions and businessmen hold their liquid resources in the offshore zones beyond the Central Bank's monetary control. Savings and accumulation mechanisms have not formed in the new conditions: disinvestment continues even ten years after the beginning of the reforms. High–income brackets have concentrated the bulk of savings. That the interests of the new enterprise owners appeared to be confined in a very narrow horizon of immediate enrichment was caused precisely by the incompleteness of the processes of property privatization and organization of a control and management system. The crisis of non-payments, tax evasion and huge volumes of both legally and illegally taking the capital out of the country are not independent, isolated phenomena (with some "special" antidotes against each of them); these are rather a form of quite rational adaptation to the existing ownership relations and weak state. Hence the specificity of the painful and apparently endless process of the macroeconomic stabilization in Russia — a process that is not transformational in the full sense. Macrostabilization in various forms and on various scales is indispensable for most nations, and its sum and substance are the coordinated maintaining of internal and external balances, restriction of inflation, budget deficit and maintaining of currency stability, moderate interest rates and, on this basis, conditions for capital accumulation and reduction of unemployment.

Attaining these goals implies adequate behavior of enterprises and population. An actively resistant microenvironment makes the governmental macroeconomic policies inefficient, gives rise to tossing about, searching for a panacea, attracting external resources without long-term planning, etc. What the process of reforms in Russia in the 1990's created first was, paradoxical as it may sound, an economic structure that was as vulnerable to the financial crisis as that in the developing countries with a longer record of market development. The power of financial and political groupings and their small, if judged by international standards, banks was based on the weakness of industrial companies, low rates of savings and accumulation. Unresolved ownership issues — a key parameter of transformation — have not allowed an economic rise on the basis of new market principles. Capital flight, non-payments crisis, especially tax arrears, urged to use a non-issue coverage of the deficit through borrowing, which, to a certain extent, engendered an artificial speculative boom on the market for government short-term securities. Russia had not enough time to create a normal market economy represented with hundreds of thousands of industrial or commercial enterprises, but quite enough time to create exactly that financial segment, which in 1997-1998 appeared most vulnerable in the global economy.

The transformation has gone far enough, so even after the financial collapse the threat of counter-reform does not extend to include mass-scale nationalization. This is the achievement of the reformers of the 1990's. At the same time, an unavoidable question arises, what exactly was done “wrong”. Creation of a normal market economy and democracy are the natural goal of a country that is willing to provide prosperity of its citizens in the modern world. The ultimate goal of the transition is generally clear, but the strategy and tactics of transformation can vary in the same way as historical conditions of development of different countries resulted in there existing quite original societies and economic systems in the world, integrated in the global market economy.

To date, there are several points of view on the theory and history of the Russian transformation, although time, calmness and thorough analysis will be required to assess the alternatives. Those points of view, certainly, vary over a very wide range. The left wingers consider the transformation faulty in its design, purposes and implementation — anything else could hardly be expected. Another view is that the reforms were conducted too slowly, although it is hard to imagine how the totality of economic relations in the society and their institutional basis could have been transformed to the opposite quickly.

Traditional radicalism and uncompromisingness of Russian economists divert from quiet professional analysis. Nearly all participants in the recent years’ discussions of the transition from the planned to market economy in Russia have developed a black–and–white opinion of the selected path: some say, it was entirely correct (“how else?”), others say, it was entirely wrong. This black–and–white attitude prevails, surprisingly as it may sound, in regard of not only the key strategic decisions made during transition, but often even purely tactical steps. With time, architects of the key elements of the Russian reform are more and more difficult to identify. Both well–known Western economists and many Russian specialists distance themselves more and more not only from the results, but also from the concepts of certain steps taken in the recent past. Much could have been done differently, but there seems to have been no serious professional discussion of this matter over the years of reform.

The strategy of transition from the planned economy to the market economy varied considerably from country to country over the last ten years. Hungary successfully avoided restructuring of its external debts, preferred to count on foreign capital and proven methods of privatization, is facing significant economic difficulties, but is an obvious leader as far as the depth of transformation *per se* and the degree of nearness to a usual market economy are concerned. The Czech Republic had no macrostabilization problems in the beginning of transition, has implemented a voucher privatization, but has gone through a banking and financial crisis in 1997. Poland relied on private farmers and private retail trade at the outset of the transformation, had prices liberalized back during the times of the last communist government, undertook a shock therapy, planned but never used a voucher privatization plan, achieved high commercialization of state–owned enterprises and high growth rates. China, actually, modified its previous political regime, commercialized the economic environment and demonstrates high growth rates. Since country strategies proved to be so diverse, the transition in Russia, perhaps, could have been constructed in a more elaborate way.

Economic debates that were held in Russia in the 1990’s were rather rigidly structured around several directions: macroeconomic stabilization, privatization, non-payments and tax crisis.

The achievements of the reform, such as liberalization of prices, trade and foreign economic activities served as a natural basis for those developments. No comprehensive study of the transformation strategy taking into account the objective differences in the speed of formation of the market economy among various areas and sectors has ever been undertaken. Institutional development and provision of legal support to the market economy, lengthy and effort–consuming as they are, were as though postponed till the second stage of the reforms, whereas measures toward liberalization were taken fast enough by command. To a certain extent, this was inevitable, but it required immediate, huge efforts to create the corpus proper of the market economy: new rules of the game, new laws — both to protect the freedom of business against the state and to regulate businesses in the best interests of the society. Institutional environment in which enterprises exist and operate have changed even more radically than the conditions of living of the population that relate to the reforms of the social safety net, wages and salaries, housing and communal services, etc.

In our view, historical processes of transformation have certain limitations on the speed of changes, mainly of institutional character. It should have been necessary to take into account not only the narrow "windows of political opportunities" for carrying out quick changes, but also real institutional and legal constraints relating to the intensity and comprehensiveness of changes. Sharp, wide–scope reforms without their preparation can only be justified by the extraordinary crisis circumstances, which was partly the case with the liberalization of early 1992.

After the August crisis there appeared an exotic point of view that the reforms were conducted radically and liberally enough only in the first half of 1992. This approach is predicated on the identity of the terms “quick” and “good” and on the refusal from the achievements of the transformation of the 1990’s for the sake of commitment to pure (uncompromising) radical reforms of the liberal type. Hence, it follows that the radical reforms in Russia came to their end exactly at the time when the IMF and the IBRD came to Russia with their ideas, technical assistance and loans. Huge changes were occurring during the whole of the 1990’s, but liberalization and the attempts at macrostabilization undertaken in the early years of the reforms look so impressive against the crash of the planned economy left behind from the Gorbachev era.

Unresolved key problems on the microlevel made futile the attempts to make the macrostabilization steady. The state failed to improve tax discipline and penalties accumulated over time created such a great “overhang” of overdue debts, penalties and fines that it was becoming less and less realistic to get out of the situation using simple means (strengthening of administrative authorities). The efficiency of monetary policy was sharply reduced because of Russian enterprises switching over to barter, making settlements in offshore centers, etc. On the whole, the state during the transition could not reduce its direct economic role and simultaneously create an adequate system of market economy regulation.

Without a solid microeconomic basis, the macroeconomic stabilization has not resulted in the general economic growth. The total level of accumulation across the country has fallen approximately four times since as recently as 1992 (see *Fig. 2*). Reduction of the total amount of consumption was less than that, but it was obviously “financed” by lower accumulation. And the change in the balance of trade in 1998 replicated the effect of a sharp growth of net exports in 1992.

It is quite correct that the structural reforms in the social sphere (and other areas, too) lagged behind, thus creating a huge pressure on the budget. At the same time, the democratic process of modification of the social legislation is extremely complicated all over the world. Reducing budget expenditures even further while boosting their efficiency “as you go” is, certainly, very difficult to do in the midst of a heavy economic crisis, decline of the real level of incomes and consumption of the majority of the population (electorate). Besides, at the first stage most structural adjustments involve additional costs while the saving will be achieved further down the road. The fiscal crisis became permanent and a threat to the stability of the financial markets. Its distinguishing feature was a lengthy and rather strict monetary policy and maintaining of a high exchange rate of the ruble while the state was unable to collect taxes.

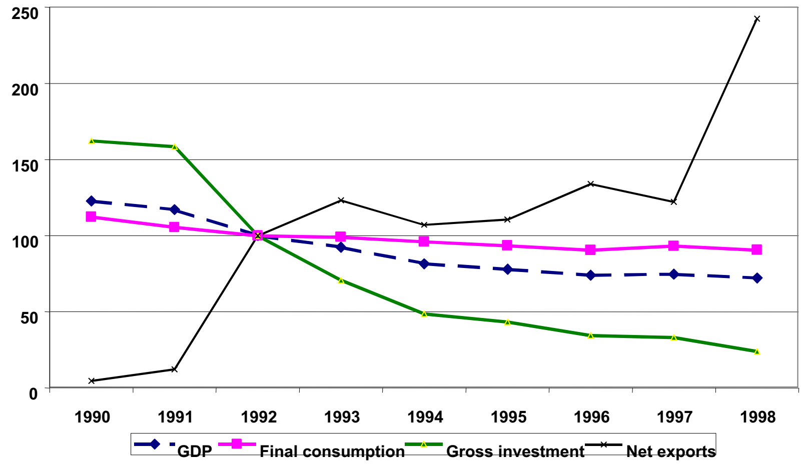

Fig. 2. Dynamics of the GDP and GDP Components (1992 = 100)

The high interest rate in Russia in these conditions has been traditionally treated as a result of the “raking out” of resources by the state. In our last year's Review we emphasized that nonequilibrium on the capital markets reflected not only a high government’s demand for deficit coverage in the form of sales of allegedly low–risk government securities. The above is in itself correct but not enough to explain the situation. It would be more exact to also take into consideration the extremely low supply of households’ savings at a saving rate of 5% in

1995-1997 (1.7% in 1998). The population maintained their private consumption rather than savings showing only limited trust to financial institutions, for which many were all the same hurt in August–September of 1998. Given huge volumes of both legal and illegal capital flight from the country, the capital market was extraordinary risky and expensive. No measures aiming at injecting resources in the economy that is actively taking capital out of the country can possibly produce steady results. Now in 1997, the amount of capital taken out of the country was of the same order of magnitude that the volume of sovereign borrowings (see hereinafter a chapter on the financial standing of enterprises).

In the circumstances like these, large, especially exporting enterprises, as well as many regions, attempted to make up for the apparent shortage of funds by means of borrowing. The federal Government did the same, gradually getting more and more into debt. An attempt to resolve budget problems through borrowing (external borrowing, in the first place) has resulted in huge distortions, "raking out" of the savings and has seriously limited accumulation. The total external and internal debts of all levels of administration and private businesses reached huge values without those funds being earlier used for development purposes.

Achievements and losses of the transformation serve as a basis for paying a more in-depth attention to the problems of protection of the ownership rights, corporate governance, protection of the investors' rights. Issues such as tax reform, barter and non-payments control, changes in the set of purposes of the corporate owners and managers are interrelated and should be addressed comprehensively. On the whole, this means that, to all appearances, the nation has approached a stage when comprehension of the specificity of its recent past is topical.

5. Debts

The problem of Russia's long-term dependence on the external debts has become central among the problems that encumber the national economy. This refers to the federal government, in the first place, which is willing to prevent a sovereign default that the nation barely escaped in early 1990's. Debts of the banking system, considerable mutual internal debts, a threat of growing regional debts have created a set of problems, which will have to be addressed for quite long. Another issue that one should be ready to face is that any improvement of the national economic situation in the 21st century will mean that greater amounts have to be paid to cover previous debts.

Relative political stability of 1996-1998, coverage of the budget deficit, a certain revival of the economy in 1997 were based on the inflow of large private portfolio capital to the GKO market and direct borrowings by the Government from the IFIs and the Euromarket. The policy that aimed at providing incentives for the inflow of external portfolio investments did not allow to concentrate on the creation of a normal investment climate and reduced attention paid to more important foreign direct investments. The investment process in the country squeezed in full conformity with the laws of market economy. The debt crisis did not take long to ripen, just a year or two.

The problem of public and private borrowing is considered in detail in the subsequent sections of this Review, so here we shall confine ourselves only to its most generic characteristics. Let us recall that the essence of borrowing, especially from abroad, is efficient utilization of credit resources. One can borrow at a high or low cost, but if the proceeds are used for current public or personal consumption rather than investment, then neither benefits, nor resources for repayment in the future are generated. Here lies the basic irrationality of the entire debt wave of the 1990's: the Russian state and many enterprises borrowed primarily to cover the current deficit rather than the deficit of capital resources.

It is necessary also to remind that the massive attraction of foreign capital to a country is efficient not only and not so much if it is inexpensive as compared with the domestic cost of capital, which logic underlay its attraction in 1996-1998. It is not enough to beat down the cost of capital inside the country to boost the rise: it is also necessary to provide capital inflow to the services, trade, and industrial sectors. Investment climates for the internal and external investments are not so different from each other. International experience is an evidence that it is almost impossible to have an inflow of foreign investments to a country where there is an investment crisis. The exception here is large infrastructure projects, large–scale investments, which are made all over the world with a certain support from the state. This country needs a "cultured capitalism", therefore, foreign direct investments. Whereas the actual policy conducted throughout the years of reform aimed at the inflow of portfolio capital, which came to use debt instruments of a relatively traditional form that proved to be too risky later on. Meanwhile, this country missed a huge boom of growth of direct capital exports from the developed countries to Central and East Europe and China.

The debt iceberg, into which the economy of Russia ran, was forming extremely rapidly. Having completed negotiations with the Paris Club in 1994, Russia assumed the entire USSR debt due to all the countries in exchange for assets located abroad. At the same time, Russia actually lost the chances for receiving a significant part of the debts due from most countries, to which the USSR had provided military and economic assistance — both for political reasons and because those countries were in a poor shape themselves. It is too early to make judgements about how wise the former strategy on the Soviet debts was or about perspectives of negotiations, all the more so that this is the domain of "high politics", in the first place, rather than pure rational economic logic. Let us only note that under the previous agreements the greatest burden of repayment of the Soviet debts was to be incurred after 2002, which date, probably, seemed very remote at the time.

In a way, a similar situation took place during the negotiations with the London Club completed in the fall of 1997. It seemed that payments (partly in cash, partly in bonds) under the commercial debts of the USSR would be made in rather moderate amounts of a few billion dollars per year. Against the background of an inflow of dozens of billions of dollars of portfolio resources and massive injections from the IFIs for the purposes of reforms, this size of payments looked quite moderate. Having resolved the issues of the old Soviet debt, the Government began to accumulate a new one (see *Table 5*). This was done in two phases: in 1996-1997 loans were raised for macrostabilization and reduction of inflation through non-issue financing of the budget deficit, and from November 1997 to August 1998 the federal borrowings went to rescue the macrostability.

Unreliability of financing of budget deficit using the eurobonds and foreign private investments in internal ruble–denominated securities is actually caused by the fact that the international movement of portfolio capitals is governed by laws other than those pertaining to national macrostabilization. The visible part of the Russian state debt proper consists mainly of the debts due to the international financial institutions (IFIs), eurobonds of the new 1997-1998 issue (including the GKO for bonds swaps of July 1998) and sums due under various bilateral agreements (see *Table 5*). Besides, the state debt includes state surety bonds on private loans, however, the total value of such sureties issued on behalf of the government remains unknown to us.

Borrowing from international financial institutions was an important component in the accumulation of the sovereign debts over the 1990's, as *Table 5* shows. Attention paid by the Russian mass media to the IFIs turns them into demonic forces that have an influence (positive or negative, depending on the writer's/speaker's political views) on the destiny of the Russian economy. A detailed analysis of the IFI activities in Russia is still pending. One thing, however, is important: the IFIs enthusiastically came to Russia in 1992 to conduct market reforms that they knew and believed to be helpful for Russia. But very much depended on our own decisions concerning when, how much and for what purposes to borrow. The position held by the IFIs was quite simple: according to a high-ranking IMF employee speaking early in 1999, the common opinion among the academic circles in the West in the early 1990's was that reformers should be given a lot of money; probably [he said], this was a mistake.

The injections of the IMF funds into the Russian federal budget aimed at promoting macrostabilization in Russia, especially after the legislative prohibition for the Central Bank to directly finance the budget as of 1995 in line with the agreement with the IMF. The debts due to the IMF grew quickly from approximately $4.2 billion in late 1994 up to $12.5 billion in late 1996. Over that period, tax collection remained low, as well as the level of savings, because during the elections it was difficult to considerably pressure businesses. The IMF funds were purely budget financing aimed at providing support to the reforms in the area of fiscal and monetary policies (it should be noted that, in accordance with the IMF methodology of budget formulation, IMF funds are considered as internal financing, certainly, with the exception of repayment, as in 1999). The next skyrocketing of the debt occurred already in 1998, when the loans were used in a desperate attempt to rescue stability of the ruble and the entire macroeconomy. Unfortunately, in 1998-1999 the three–year grace period under the previous loans from the IFIs expired, and, taking into account the interests accrued on the entire debt, Russia now has to pay about $5 billion in 1999, which is approximately equal to the last IMF tranche of July 1998.

Table 5

External Debt of Russia's Public and Private Sectors
(Principal Less Accrued Interest, Billion USD, as of Period-End)

Indicator	1992	1993	1994	1995	1996	1997	July 1998	1998
1	2	3	4	5	6	7	8	9
Public sector	**107.7**	**120.6**	**127.5**	**128.0**	**143.3**	**153.6**	**176.4**	**164.3**
Federal Debts								
FSU Debts	104.9	103.7	108.6	103.0	100.8	91.4	91.8	93.6
Paris Club[1]	n/a	n/a	n/a	n/a	n/a	37.6	37.6	38.4
London Club	n/a	n/a	n/a	n/a	n/a	28.2	28.7	29.7
Other debts	n/a	n/a	n/a	n/a	n/a	25.6	25.5	25.5
RF Debts[2]	2.8	9.0	11.3	17.4	24.2	32.1	51.2	51.4
Credits from the IFIs	1.0	3.5	5.4	11.4	15.3	18.7	26.2	26.0
Eurobonds	0.0	0.0	0.0	0.0	1.0	4.5	15.8	16.0
Other debts[3]	1.8	5.5	5.9	6.0	7.9	8.9	9.2	9.4
Other public debts								
Subjects of Federation and Local Governments[4]	0.0	0.0	0.0	0.0	0.0	1.3	2.2	2.4
Debts on non-residents' investments on the GKO and OFZ market[5]	0.0	0.0	0.0	0.0	7.2	17.7	20.1	5.8
Domestic Foreign Currency Bonds issued by the Ministry of Finance (OVVZ)[6]	0.0	7.9	7.6	7.6	11.1	11.1	11.1	11.1
Private sector[7]	**4.5**	**4.3**	**4.9**	**6.3**	**11.3**	**50.9**	**57.3**	**43.4**
Banking sector	n/a	n/a	n/a	n/a	n/a	37.2	34.58	20.29
Non-financial enterprises[4]	n/a	n/a	n/a	n/a	n/a	13.7	22.8	23.1
As % of the GDP at a Current Exchange Rate								
Public debt	235.0	87.7	74.1	37.5	36.2	35.7	42.5	126.4
Private debt	9.8	3.1	2.8	1.8	2.9	11.8	13.8	33.4
For information:								
GDP (in billion denominated rubles)	19.0	171.5	610.7	1585.0	2200.2	2562.6	2590.6[11]	2684.5
MICEX Rate (Ruble/USD).	0.4145	1.247	3.550	4.640	5.570	5.960	6.241	20.650

1 Including overdue interest payments.
2 Ignoring the sovereign sureties issued on private loans.
3 Bilateral agreements and commercial credits.
4 A certain part of the liabilities may be repeatedly accounted for in the Banking Sector section.
5 At the nominal, at the current exchange rate.
6 Data shown are the sizes of issue. Currently, non-residents own about 50% of the Domestic Foreign Currency Bonds.
7 Ignoring external liabilities of non-bank financial companies, which were estimated at \$0.35 billion as of end-1998.
8 As of period-end.
9 As of July 1, 1998.
10 As of October 1, 1998.
11 The total GDP for the 3rd and 4th quarters of 1997 and 1st and 2nd quarters of 1998.

As of 1.0.98

The World Bank and its institutions have played a more diverse role in Russia as compared with the IMF. Traditionally, the Bank follows the Fund in regard of the macroeconomic policy in the borrower country. However, the Bank is a world's leading institution that attempts to advance market reforms at the institutional level, as well as structural reforms over a broad range of sectors and industries. As of March 1, 1999, the Bank has extended (i.e., has approved by the Board of Executive Directors) to Russia a little less than $11 billion for carrying out structural reforms, of which amount a little over $6.5 billion has been actually received (disbursed), with about $2.0 billion being frozen pending the fulfillment by the Russian side of its reform plans that were revised and mainly agreed upon in January–April 1999. Under eight structural adjustment operations, Russia has received $4.4 billion, while the rest of the funds were extended to implement approximately 30 other projects in areas varying from a legal reform to procurement of medical equipment. The Bank's role in providing support of the ruble during the crisis was much less significant.

Proceeds of the investment loans from the World Bank continued to flow to Russia even after the crisis. It is essential to note that for Russia it is now one of the few sources of borrowing, especially for investment needs. With the guaranty agency MIGA and the International Finance Corporation on board, the World Bank Group plays a significant role in the long-term investment in the borrower countries, including Russia. The London–based European Bank of Reconstruction and Development plays a similar role, having extended to Russia under a host of specific projects a total of approximately 3.3 billion ECU with actual disbursement reaching 1.4 billion ECU. Of course, judging by the scale of this country, this amount is not too large but is still important, as those funds create elements of normal project financing and investment, often in cooperation with private Western investors. This is again the money that should be repaid, but one can hope that these costs will pay back.

As *Table 5* shows, active accumulation of "new" external debts apart from the IFIs credits also began in the end of 1996, when the finish of presidential election, a booming market for Russian shares and permission for foreign investors to enter the GKO market created generally favorable conditions for borrowing both by the state and by private businesses. Russia and Russian enterprises and banks began to receive the so-called "investment" ratings from international rating agencies. The general environment of a global rise made the Russian market attractive. Borrowers in this country did not take long to take advantage of it.

As for the size of the external debt, the total amount of the debt burden on the budget and the national economy (GDP) should be calculated in the national currency, as the debtors, in general, have to buy foreign currency to repay their debts. The fact that the debt problem became more acute for the budget and commercial banks in 1998 is directly linked to this: it is difficult for them to repay the foreign currency–denominated debts given a four-fold drop of the nominal rate of the ruble along with the fact that the level of nominal ruble–denominated incomes remained low due to the crisis and no more than twice as high inflation. The debt burden in terms of the accumulated debt size to the GDP ratio to a great extent also reflects the exchange rate. If seen at this angle, the low burden of 1995-1997 looks underestimated given the stable exchange rate of the ruble.

Actually, the burden should be calculated as a ratio of the current debt service flows and the revenues of the debtors (Federal Government, a bank, etc.). This is where complexity lies of the debt problems: the borrowing addresses immediate problems when money is lent today and the repayment date is not to come soon. However, a slightest shock and hazard make everything change quickly: it appears that one needs to repay tomorrow and in foreign currency, while refinancing the debt is impossible.

Regional authorities alone did not have time to borrow much directly from abroad. In late 1997, investment banks had quite a few new eurobond issues for the regions under “engineering”. However, difficulties of obtaining permission (a Presidential decree, at least) prevented massive borrowings by the regions which were bound to end in bankruptcy in a present situation. Yet, actually the regions borrowed from Russian banks, which, in their turn, attracted credit resources from abroad, therefore, a true size of the hidden regional debts is difficult to estimate precisely. A potential default on loans raised by the regional authorities poses a very serious threat. For example, refusal of the authorities of Minas Gerais State, Brazil, in early 1999 to repay their external liabilities nearly resulted in the Russian–style collapse of the national currency.

In this respect, independence of states or regions from the federal government as far as their debts are concerned is generally an illusion. Both regional and federal authorities in any country repay their debts using the tax revenues, the size and structure of which are established by the general legislation. Therefore, any debt crisis will immediately turn into a tax crisis: a government that comes to face a decline attempts to amend the tax laws (which is not an easy thing to do, to put it mildly), raise the tax rates and increase collection. If this is done at the regional level, then the regional government reduces the potential base for the federal tax service to use, which will get immediately known to the external and domestic investors whose portfolios include debt instruments issued by the federal government. Therefore, any debt–related difficulties at any level of administration will be immediately recorded and will have an influence on credit accessibility, credit cost, possibility of refinancing, etc. Investors’ perception of the risk of losing their capital is fed on precisely this kind of information: just one delinquent subject of federation makes the credit more expensive for the entire nation.

Basically, this is also true for large, private companies whose borrowings essentially grew in the first half-year of 1998. Here, however, a change in the character of collateral provided for the loans extended was the most important factor in the perspective of long-term consequences for the Russian economy. Previously, guarantees issued by the federal government or local administration or shares of the borrower company itself were most preferable, whereas during the global crisis export deliveries of goods, mainly, petroleum, gas and metals, were used as a surety. Thus, in 1998 Russian non-financial private enterprises borrowed approximately $9 billion from foreign banks and financial institutions. Five fuel companies (Gazprom, LUKoil, YUKOS, Tatneft and Tyumen Oil Company) account for over $6 billion of this amount, with future deliveries of Russian gas and petroleum to Western Europe being used as a collateral for the loans.

Nearly all companies that have issued and placed eurobonds also belong to the fuel and energy complex.[8] In this case, too, investors traditionally prefer to acquire debt instruments of those companies in the developing countries that operate in the mineral industries and export their products. If the issuer fails to meet its obligations, the investor can recover exportable products of the debtor company as damages. Russian companies entered the international bond market in late 1997—early 1998, but the global financial crisis and complicated political situation inside Russia held up the development of this kind of borrowing. Nevertheless, as of the end of 1998, the aggregate debt on the eurobonds of Russian enterprises amounted to approximately $1.5 billion.

Getting back to the matter of the external federal debt, one can say that its increase over the seven months of 1998 was of an overtly crisis character. During this period, the federal sector borrowed a net of $5.6 billion from the IFIs and more than $11 billion from the Euromarket, while the GKO for foreign exchange bonds swaps of July were effected at very high rates and at the exchange rate of about 6 rubles per US dollar. According to experts evaluations, the total foreign assistance for the rescue of the ruble amounted up to $23 billion. These funds were mainly spent for foreign exchange sales in order to make up for the partial capital outflow.

Judging by the conduct of many Russian banks, private investors, wealthy population, the feeling of a forthcoming financial crisis of a vague form and scale was all in the air throughout the summer. In Russia during the summer many banks were seen to leave the GKO market for the US dollars. Incredibly high deposit rates in a number of banks (40-50% per annum in rubles at low inflation) in May–August certainly deceived many Russians, incorrigible pyramid fans. A crisis was expected to burst in the fall and many (recklessly) left for their vacations intending to take their money back from banks in September. But the collapse of the leading commercial banks, landslide devaluation and depreciation of the ruble deposits and the loss of the dollar deposits of the Russian middle class happened before businessmen returned from their vacations. The situation had a striking resemblance with that of early 1990's: borrowing from abroad "until the last minute", technical bankruptcy of the VneshEkonomBank (Bank for Foreign Trade), and the lack of a feasible plan for resolving the current crisis or long-term problems.

ВЭБ

The closing pages of the history of the GKO-OFZ (see *Fig. 3*) are described in detail in the subsequent sections of this Review. In particular, obviously unsuccessful was the decision to reduce the size of the internal debt by the GKO for eurobonds swaps, which did not rescue the internal obligations market but increased the dollar debt by approximately $6 billion just three weeks before the depreciation of the whole GKO bulk. Many investors viewed the GKO conversion program managed by the investment bank Goldman Sachs as the Government's statement of its inability to repay the current debts.

[8] Currently, bonds issued by six Russian companies — LUKoil, Tatneft, Sibneft, Mosenergo, Irkutskenergo, Moscow City Telephone Network — are traded on European stock exchanges.

Though the mass media had been reveling for long in the possible collapse of the GKO pyramid, politicians and investors, contrary to the financial logic, continued to be under the spell of a presumption that Russia was too big and "nuclear" to topple. Despite the fact that some foreign investors began to leave the GKO market in late 1997, the bulk of large institutional investors stayed till the end. They, probably, simply could not believe in a possible collapse of the Russian government securities, there being in place a macroeconomic policy supported by the IMF. In our view, however, an amazing thing is that most investors remained on the market for so long and not that some of them left.

The return was so high that it was certainly difficult to quit. According to some Western politicians, the investors knew what kind of risks they were running in Russia at the GKO return of about 100% on the secondary market and low inflation and hence they should bear themselves the responsibility for the consequences of their risky conduct. However, the investors were not ready for the Russian Government to take so sharp measures for getting out of the crisis. Many investors expected devaluation of the ruble by 30-40%, some of them supposed that the GKO restructuring or introduction of limitations on the capital flows were possible, but almost nobody expected to see simultaneously the devaluation, a moratorium on debt repayment by Russian banks, and a confiscatory GKO restructuring scheme. In the financial practice of the last decades there have practically been no precedents of default on the national currency denominated debts due to non-residents. Previous cases of debt restructuring included sovereign debts (the Brady Plan), or internal debt due to residents (the BOMEX-89 Plan in Argentina).

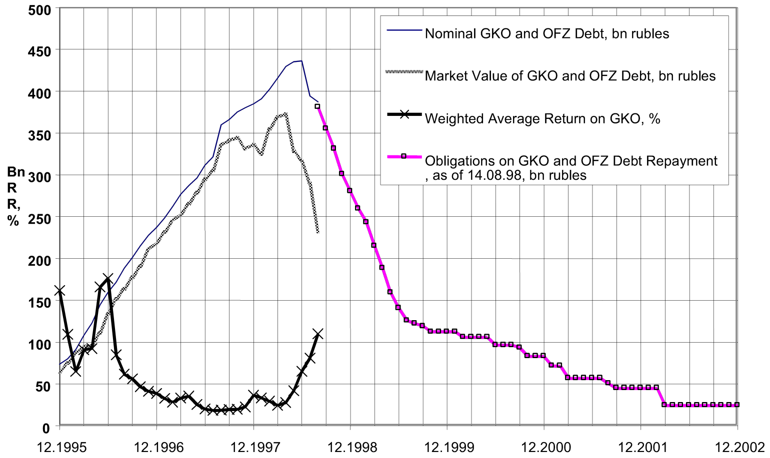

Fig. 3. Internal Debt Prior to the "August 17": Basic Characteristics

That external investors were taken aback with the Russian Government's actions on August 17 can be also explained by their underestimation of the chances that resolution of acute social problems would get a higher priority than the state's financial reputation. Certainly, the character of the decisions made also reflected the last minute attempt to help large banks to survive. On the other hand, the hope of the Government that foreign and domestic investors would quickly agree on dramatic reduction of the value of their GKO portfolios was obviously too optimistic. Negotiations are known to have been held until spring of 1999. Equally difficult is the progress at the negotiations on the private debt restructuring.

The total growth of debts during the period prior to August 17 immediately turned into a critical problem for the nation as soon as there was the devaluation. As shown in *Table 2*, the ruble–denominated size of the debts skyrocketed in proportion to the devaluation and sharply grew with respect to the national GDP. In regard of the GDP, it was more than just a growth of the total private debt that brought many Russian banks on the edge of bankruptcy on foreign credit lines and forward contracts. Importantly, a state debt of such a scale is beyond the real budget capacity to service it. Unfortunately, what the budget "saved" on the GKO default results in the dollar debts becoming much more expensive.

In fact, some kind of restructuring of Russia's external debts is an imperative. Russia is forced now to reopen negotiations on the "Soviet" debts — at present, this looks like the only possible strategy: an attempt to service the Russian debt and restructure the old debts. Hopefully, respective negotiations to be held in the summer of 1999 are a success. Refinancing of debts due to the IFIs is also needed in the short term, although this would be a temporary solution to the problem.

Most analysts agree that it is necessary to maintain the servicing of the eurobonds in order not to lose what remains of the private investors' confidence. There are signs indicating that the international community begins to be inclined to the opinion that the eurobonds should be considered as ordinary investment. However, for each particular country the possibility of returning to the capital market will depend on how that country treats a common investor during an acute crisis. As for private enterprises, many of them would repay credits due to Western banks, which were extended since 1997, although doing this would be rather difficult given the low exchange rate of the ruble. Nonetheless, one can expect that in the given circumstances foreign creditors would have to accept the debt restructuring for Russian private enterprises, too.

Before the crisis, the Government believed that Russia would reach sustainable rates of economic growth in the next century and would be paying about $15-17 billion annually in repayment of all federal debts. Problems that Russia faces with servicing the federal debts look rather complicated, especially in 1999 when basically the payments should amount to approximately $17 billion. This accounts for such a large share of the budget that these payments cannot be possibly effected, even if the ruble exchange rate was not to grow because of the intention to buy such an amount of foreign currency on the market.

Capital flight is still a problem. A positive balance of trade amounting to several billion dollars a month could reduce the dollar rate and facilitate debt servicing. However, no one has ever succeeded in resolving the issue of capital flight by administrative measures, while re-directing the capital flows by macroeconomic methods would take more time than is available for getting out of the present, most acute situation.

The matter of when and on what conditions foreign investors would be ready to return to the Russian market is far from unambiguous. Russia has demonstrated her readiness to ignore both the rules underlying the global financial system and her own legislation. The GKO restructuring, a failure to repay the liabilities to the London Club in December of 1998 and anticipated problems with repayment of the OVVZ debts will affect the rating of Russia as an international borrower for a long time. This effect would be considerably greater if Russia refused to fully discharge her obligations on the eurobonds.[9]

Political uncertainty caused by the forthcoming parliamentary and presidential elections makes it practically unlikely that Russia would return to the international financial market during the next year or two. Even if the Government confirms its commitment to the policy of reform, it is hard to imagine that a credit of confidence will be extended to it similar to what the investors demonstrated in 1997-1998. There exist a whole set of conditions the fulfilling of which alone will make possible the revival of the Russian market for portfolio investments. Apart from improved prospects of economic growth and political stability, more effective protection of the rights of investors, including minority shareholders, transparency of the reporting system, policy openness and predictability, more attentive treatment of the investors' interests are necessary. Besides, how high is the probability of investors' coming to the Russian market will in many respects depend on the overall situation on the emerging markets.

One can agree with those specialists who determine the real cost of servicing of the external debts at $3-4 billion a year for the foreseeable future until the general business situation changes on the microlevel and Russian capital proper actually reverses into this country. Until then, continuation of structural reforms, especially in the area of ownership relations, austere budgets with a primary surplus, and negotiations with creditors will, probably, remain the only way to prevent the sovereign bankruptcy. The latter, even in mild or limited (partial, etc.) forms, would hold Russia even farther away from recovering her normal position in the global economy, entering the capital market and resuming the growth.

6. The Post-Crisis Period: A Minimum Program

In our opinion, during the period directly following August 17, 1998, there was a real danger of a sharp aggravation of the economic crisis due to the collapse of the national payment system, stoppage in foreign trade, panic among the population with a quite likely run on the

[9] We think it too early to review in detail the negotiations policy in regard of the restructuring of Russia's external debts.

Sberbank (Savings bank), separatist actions by the regions against the background of the political crisis. The Ye.Primakov Government entering the scene mitigated the acute political crisis and the Ministry of Finance and the Bank of Russia succeeded in preventing financial panic in August–September of 1998. Despite a sharp growth of (imported) inflation and decline of the standards of living, no large–scale social unrest took place, after all.

In September, the principal aims of the Government objectively included stabilization of the payment system, resumption of payment transactions by banks, prevention of galloping inflation due to the issue, so likely in the given circumstances. Another — but not second most important — aim was settlement of the problem of Government's GKO debts, as well as resolving of the problem of debt crisis at the banking system level. The resolving of these issues has not been completed by as late as April 1999, but nevertheless the threat of a sovereign default, massive seizure of bank assets abroad and other, quite material threats were not realized.

The Government succeeded in resolving some problems of the objectively needed minimum program in the fall of 1998 and early in 1999. The Ministry of Finance and the Bank of Russia managed to prevent uncontrolled issue and hyperinflation, restore a minimum capacity of the payment system, limit the bank panic, preserve confidence in the Sberbank. This set of aims, probably, exhausted the possibilities that the Government had in those circumstances.

The banking system certainly cannot provide credits for the development of the economy until it is restructured and recapitalized. The federal external debt will prevent for a long time from attracting new external credits both at the government level and at the private sector and regional levels. Negotiations on the reduction of the "Soviet" debt will go for long. A stimulating economic policy of the "Keynesian" type, as it is set forth in a number of governmental documents issued in the fall of 1998 through the winter of 1999, is difficult to implement due to necessity to have it cleared by the IMF and the IBRD. Loan arrangements proper achieved with the IMF in late April imply fulfillment of rather hard measures in the area of fiscal policy and even more, rather than less hard conditions relating to the implementation of the IBRD structural adjustment loans. Both institutions have kept their promises to support reforms in Russia rather than specific governments, but the loan conditionalities seem to have become somewhat stricter.

The Government was actively working out ideas in the area of economic policy, which resulted in adoption of a program of priority measures in November 1998. At the same time, over the period under review (until the spring of 1999) the policy was generally reduced to addressing most acute current problems. Significant discrepancies remained between the intentions declared by the Government from time to time (in particular, about boosting the economy, especially accumulation) and actual availability of funds and practical actions taken. The Government did not decide on a radical indexation of incomes in proportion with depreciation of the ruble on the domestic market — this was practically unrealistic because of budget limitations. A radical increase of the budget revenues during the crisis is certainly difficult to achieve, all the more so that this problem has remained one of the most difficult in the Russian economy for so long, and one can hardly expect the situation to change instantly. Feasibility of the 1999 budget remains doubtful for many, although moderate inflation leaves chances for growth of the nominal budget revenues.

As a matter of fact, the Ministry of Finance tried to use a respite on the GKOs for reducing the budget arrears of its direct obligations. By April 1999, appreciable reduction of the arrears to budgetary employees started to show itself and enterprises' arrears of wages began to go down. In general, despite some promises and an overall populist image, the Government objectively appeared to be rather hard. The volume of money printing was on the whole moderate, credits to banks significant but less than expected. At last, the Government did not index basic incomes until the spring of 1999 while prices has doubled since August 1998.

Adoption of the 1999 budget in as early as March with a linkage to the tax reform measures was an important event. The above mentioned tax reform has been ripe since long ago, though not all provisions of the Government's tax program enjoyed support of the analysts and could produce fast positive results as anticipated by the initiators. The problem of making stronger the administrative pressure on enterprises with a purpose of squeezing out taxes during the crisis remains a weak point of every government.

In March 1999, the total industrial output already reached the pre-crisis maximum of December 1997. But the growth of industrial output during the last months of 1998 and early in 1999 featured extreme sectoral unevenness (see *Fig. 4*) and was governed by short-term factors, in the first place, such as recovery of the output up to a minimal necessary level corresponding to the actual demand, as well as adaptation to the new structure of prices.

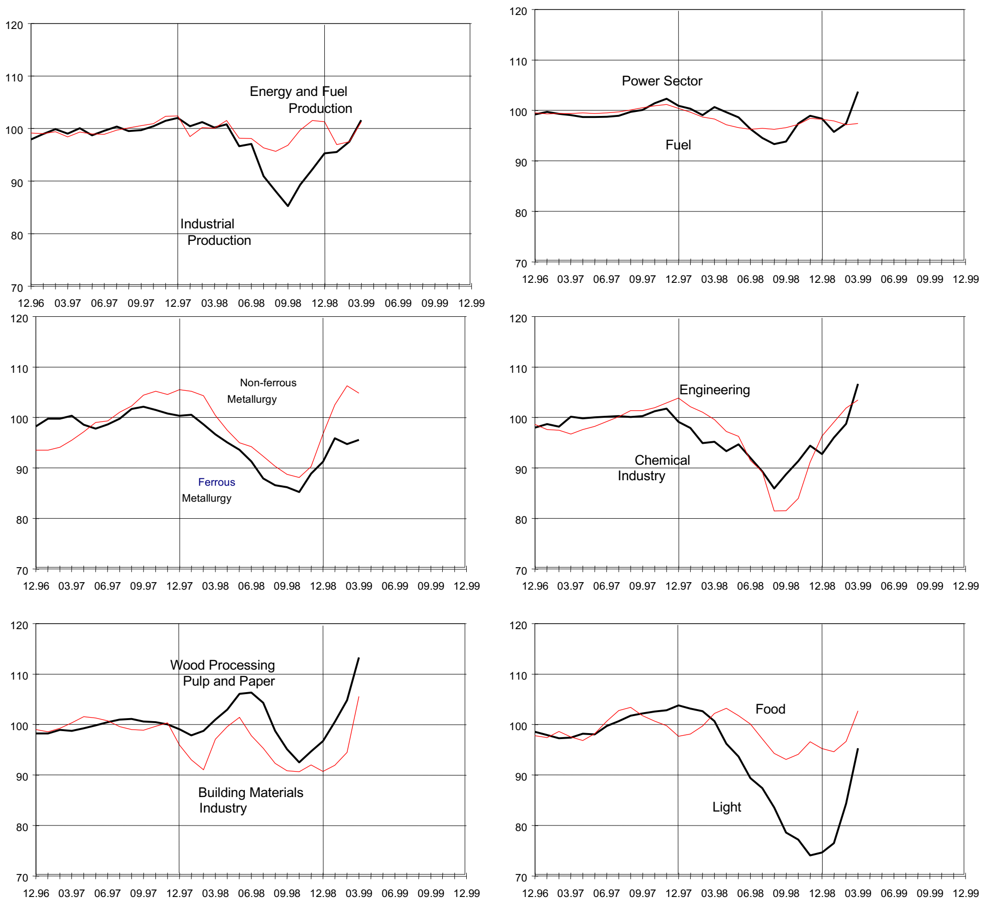

Fig. 4. Industrial Output Dynamics By the Sector (1997=100, seasonally smoothed indicators)

If the domestic demand grows little by little, then, given the two-fold drop of the actual exchange rate of the ruble after the “August 17”, the consumer goods industry will be gradually developing. But that would be far from the large–scale rise with high investment rates, demand for products of the Russian engineering industry, resources available to finance science, etc., which the Government was waiting for the last few years. Recovery of Russia’s real GDP up to the 1997 level will take at least two years. Changes in the structure of prices caused by devaluation of the ruble stimulated an intense growth of exportable goods output (with limitations imposed by the possibilities to expand sales on the global markets). Production output was quickly growing in individual sub-sectors of non-ferrous metallurgy, basic chemical industry (including production of fertilizers), pulp and paper industry. In the petroleum and gas industry, the demand for whose products on the global markets is rigidly limited, the output almost did not grow at all.

The rise of the ruble prices of the imported goods, in its turn, provided an incentive for increasing production of imports–replacing products, consumer goods in the first place (with limitations imposed by competitiveness driven by product quality). Consequently, among durable consumer goods there has been an intense growth of output of household appliances and cars. The output of perfume and cosmetics, certain kinds of food, and certain textile products quickly expanded. At the same time, the output of such goods as washing machines or household electronic apparatus that are to a much greater extent of inferior quality as compared with imported products grew slowly, if at all.

It is too early yet to talk about the rise, as the rate of imports replacement and the domestic demand are limited, while the external demand is shrunk by low prices of many goods that Russia exports. Even the rise of the petroleum prices in the spring of 1999 does not create conditions for growth. More important, perhaps, is a certain decline in the rate of inflation in early 1999, which means that in the crisis conditions the economy does not have too much of inherent inflationary trends and the effect of import inflation will weaken gradually as imports are replaced and competition is developed, provided the exchange rate is relatively stable. The growth of output after the low of September 1998 is certainly not the long-awaited rise, but it is an evidence that, on the whole, the economic system preserved the ability to adapt to operation under the payment system and banking crises.

Development of a new economic policy program for 1999 depends to a large extent on relations with the IFIs. Any government of Russia during the coming years will find itself in a situation of anti-crisis management, as the consequences of the GKO default of 1998 will show themselves for a long time. Elections will make up another constraint: the nation cannot afford any more to have as much resources drawn away for political struggle as was the case in 1995-1996. More or less clear are the minimum objectives that the economic policy faces in 1999 if the country wants to enter the phase of rise in the beginning of the next century. Provided that a positive resolution is achieved of problems, such as the sovereign debt, restructuring of the banking system, other external and internal debts, there will be a hope for a step-by-step recovery of the financial markets.

Two successive elections of 1999-2000 in Russia, judging by international experience, would be the time of populism, legislative stagnation and least of all the time of reforms, although the situation calls for explicit and active policies. The acuteness of economic reforms will be a trial for the national political and economic elite. Implementing active structural reforms, maintaining the macroeconomic balance will be an imperative for Russia to be able to accomplish the most difficult and complicated elements of the market transition. Tremendous concentration will be needed of the Government’s efforts on the structural reforms, taxation and regional finance reform, and strengthening of the ownership rights. Continuation of the transition to a normal market economy implies that the present Government and, most importantly, the Government that is in office by the fall of 2000 will create the fundamental premises for economic growth in Russia.