LOOKING BACK AT THE RUSSIAN FINANCIAL CRISIS[1]

E.Gurvich

1. Causes of Russian financial crisis

The disputes on the nature and specifics of Russian crisis of 1998 have mainly passed, still fully convincing answers to many key questions are missing. We consider the same general factors as other authors [1-8], still the conclusions differ somewhat from the common views. One of our main points is to show that discussing Russian crisis one should make thorough difference between situation before and after commencement of crisis. Assertions on sustainability of macroeconomic policy which are often made without exact specification of timing an time horizon are rather misleading than explaining crisis causes.

Views on the origins of Russian crisis are lying in a broad range. Some analysts argue that Russia has experienced mainly debt crisis, which developed as a result of soft fiscal policy carried out by the government. It is often asserted that the GKO market was in fact a Ponzi scheme, and its collapse was initially inevitable, and was only slightly precipitated with the Asian crisis. According to this view, the debt crisis aroused the currency one, which otherwise would not occur, as the Central Bank (CBR) implemented tight monetary policy. The opposite view is that Russia experienced currency crisis, caused by strongly distorted targets of exchange rate policy (significantly overvalued ruble), while the debt crisis was not inevitable, and happened due to erroneous measures of the authorities. I suppose that both positions are disputable.

Before turning to analysis, let us look at economic developments on the eve of the crisis. The GKO/OFZ interest rates were rapidly falling in 1997. Yields for 6-month GKO's dropped from 45% in December 1996 down to 16-17% in July-October 1997. Ex-post real rates fell to only 8% in the Q3 1997. This decline was in a great extent explained with participation of non-resident investors. Dvorkovich, Gurvich (1999) estimate

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contribution of integration of the GKO market into international capital markets as 2/3 of the total observed decline.

Lower interest rates resulted in some slowing down of the debt stock: its growth amounted to 84% in 1997, as compared to 209% in 1996. Domestic debt of the Federal Government increased in 1997 by 3 percentage points of GDP, as compared to 5 percentage points in 1996. The scale of borrowing still remained quite substantial: total GKO/OFZ's placement was equivalent in 1997, as in 1996, to 20% of GDP. Duration of domestic debt was gradually growing, still remaining quite small, not exceeding 1 year. This fact determined enormous size of current debt redemption due: GKO/OFZ's redemption due in 1998 was over 1.5 times higher than the current revenues of the Federal budget, this being one of the key causes of debt crisis.

At the same time transformation recession ceased and production recovery began. Growth rate was rather high at this period, amounting in Q2-Q4 1997 to some 4% in annual terms.

Turning now to the issue of sustainability of debt policy, we should note that despite common view on the GKO market as a Ponzi scheme, opposite arguments also can be put forward. One simple pragmatic consideration is that participants at this market were not inexperienced people who invested to the notorious 'MMM', but the largest international banks, that undoubtedly evaluated future course of events, and hardly would invest billions of dollars to a security doomed for collapse.

From the theoretical point of view prospects of the market depend on trend of debt stock in % of GDP. The latter in turn depends on combination of real interest rates r, growth rate g, ratio of debt to GDP d, and primary fiscal balance bp.

$$\Delta d = d\,(r - g) - bp.$$

If we take actual figures as of pre-crisis period for the real interest rate (8%), growth rate (4%), and share of domestic debt in GDP (20%) we can see that if the government had primary surplus of 1% of GDP instead of primary deficit of 2% of GDP, it would stabilize debt ratio. This task does not look unfeasible. It is true, that fiscal situation was not improving before the crisis, but already in the Q2 1998, when export prices only

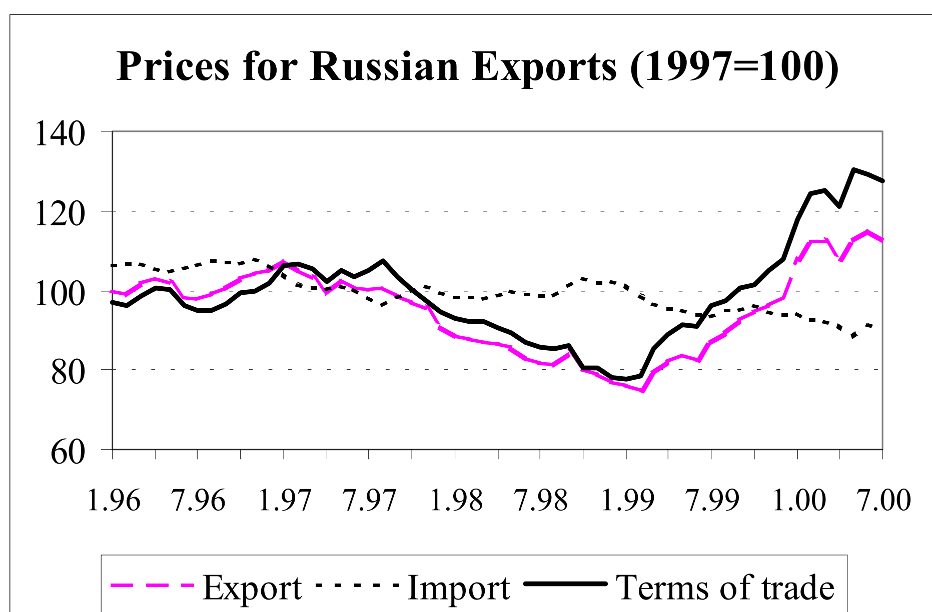
started to grow, still being quite low, primary surplus of 2.5% of GDP was recorded. In addition, even keeping the same size of deficit would increase debt to GDP ratio by 3 percentage points a year, i.e. it would take several years to bring debt to a dangerous level. In other words, in the absence of external shocks GKO market would most probable remain stable in a short term, and had reasonable chances to stabilize also in the medium run.

Let us turn now to the second question: was ruble overvalued? First of all, UN estimates of exchange rates to PPP ratios evidence that in 1996 this ratio for ruble (43%) was roughly equal to that for Czech (43%) and Slovak (40%) currencies, and was lower than for Hungarian (48%), and Polish (51%) currencies. Hence, according to these estimates ruble was not overvalued in comparison with other transition economies. The same conclusion can be obtained from comparison of wages in dollar terms in these economies. Finally, we can examine the main test of 'correct exchange rate': sustainability of balance of payments. On the one hand, Russian balance of payments was supported by large-scale inflow of short-term capital: in 1997 new investment to GKO's amounted to \$11 billion, external borrowing by the government made up another \$11 billion, inflows to the private sector turned to be \$24 billion, of which direct foreign investment accounted for only \$6 billion. The capital inflow totaled thus \$45 billion, with almost 2/3 falling on short-term investment, and we admit that such huge inflows were quite unsustainable. But, on the other hand, it should not be forgotten that capital outflow from Russia (in the most broad sense, as increase in foreign assets of the private sector) was almost as large, reaching in 1997 \$40 billion. Besides capital inflows and outflows if are not 'connected vessels', at least are highly correlated.

Analysis carried out by the Economic Expert Group found that sustainable in the medium term real exchange rate equals about 80% of its the pre-crisis level, that corresponds to \$7.5 ruble per dollar in the H1 1998. In other words, exchange rate was overvalued, but not so much: not by 100%, as it the H2 1998, but only by 25%. Surely, capital outflow cannot be reverted as fast as short-term investments, still this proves that in a medium term only minor modification of the exchange rate policy was required. We see also that again short-term judgements differ from the medium-term, but their relationship is opposite as compared to the debt situation. The debt policy was sustained (under no shocks) in a short run, but moderately not robust in longer run. As for the

exchange rate, we had, on the opposite, short-term vulnerability with sustainability (under minor corrections) in the long run.

This situation was broken abruptly with fall of the world commodity prices in the late 1997, as illustrated with the IMF data.



As a result export value has dropped by $15 billion, though its volume slightly increased. Sharp deterioration of the BOP made the then effective exchange rate no more sustainable even in a short run, and nobody could know how deep turns to be the recession and how long it would last. The monetary authorities had two options: to abandon the 'crawling peg' exchange regime and switch to floating exchange rate policy, or to defend ruble. The Central Bank and the Government chose the latter option.

It is clear that success in defending ruble depended critically on the duration of the crisis: the actual rate could be maintained only in a very short run. Hence the actual policy choice made implied **quite optimistic** expectations of rapid recovery of commodity prices. Throughout the crisis period authorities were arguing that prices would recover in some 3 or 4 months, and their actions were based on this presumption. The major measures included:

- replacing short-term domestic borrowing with long-term external borrowing,

- swap of the GKO/OFZ's falling due in 1998-99 (worth 27 RUR bn, or equivalent of around one month of redemption due) for long-term eurobonds (worth $5.9 bn),
- requesting an urgent IMF loan,
- cutting net domestic financing (it was negative since March 1998) and correspondingly cutting spending at the cost of building up arrears by the budget.

Fiscal Consolidation Program was elaborated, but faced difficulties in passing Duma, and as a result turned to be of no use.

Combination of all these circumstances resulted in development of two parallel, very fast and closely interrelated processes:

- Increased demand for hard currency,
- Falling demand for ruble-denominated government debt. Average GKO yields hiked to 37% in December 1997, 24% in March 1998, 55% in May 1998, and 81% in July 1998.

The underlying mechanism, as I see it, was the following.

- Expected depreciation raised GKO interest rates via 'interest parity ratio'. It is important to draw attention to the fact that while yields for 6-month GKO's hiked from 16-17% in Q3 1997 to 31-32% in H1 1998, yields for comparable MinFin bond increased relatively slightly: from 8-9% to 9-12%. It should be noted, that despite common view, the change in investors sentiments towards emerging markets had nothing to do with lower demand for GKO's, as share of non-residents in the GKO/OFZ market (as well as non-resident's holdings in dollar terms) was growing during the crisis.
- Borrowing at such rates evidently made fiscal policy unsustained, hence the Government made efforts to cut domestic financing as noted above. Domestic public debt has increased in the first half of 1998 by only 16%.
- The free money were directed then to the currency market, depleting Central Bank international reserves (the latter fell from $23 bn in the end of October 1997 to $15 bn in the end of March 1998),

• The Central Bank, trying to defend ruble from devaluation, used to raise money market interest rates,

• High interest rates in the money market relaxed pressure on ruble for a while, but, on the other hand, suppressed production. Say, industrial output has dropped in 9 months of crisis period (from October 1997 to July 1998) by 10% on a seasonally adjusted basis.

It is clear that such process could be sustained for only very short time, and the outcome depended on how long the period of low commodity prices may last. This was a gamble: monetary authorities bet that prices will start recovering before reserves are depleted. And if this would really occur a year earlier, than it happened in effect, the crisis could well be evaded in near term, and perhaps would make the government to modify its policy and thus evade the crisis in longer run as well.

Summarizing, we can conclude, that the macroeconomic policy pursued by the monetary authorities was not robust in a medium run, but, in the absence of external shocks it was far from crisis area, and required moderate, feasible modifications to be viable in a medium run. The impetus to the crisis was given by a sharp deterioration in the terms of trade. After this shock the previously pursued policy was no more sustainable in a short run, and required serious modification. First of all, switching to the floating exchange rate was urgently needed. The authorities underestimated the scale of the deterioration in the fundamentals, and failed to make adequate adjustments of the policy. They assumed that 'bad times' would finish not even in a short, but in a very short term. As optimistic expectations did not realize, the crisis became inevitable. The debt market was not the source of crisis, but was the weakest, most vulnerable element hit by the crisis. The fundamental cause of immense yields at the GKO market was expectation of devaluation, not distrust to Russian government debt or to emerging market securities in general.

After the crisis government had to make fundamental modifications in the macroeconomic policy, but this does not prove by itself that previous policy was doomed to fail. The course of events only confirmed necessity to react adequately to serious changes in fundamentals.

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