

Pondering the Past

(to the tenth anniversary of the 1998 crisis in Russia)

By Andrei Vavilov

The 1998 financial crisis in Russia has emerged as an important economic lesson, highlighting the first phase of the market reforms in the country. The decision makers and the witness are reflecting on the events that lead to the crisis on the occasion of the anniversary. Many are still trying to answer the question of who is responsible - the Ministry of Finance, the Central Bank, the populist State Duma, IMF, etc. They name specific individuals who on the 15th of August, 1998 unexpectedly and astonishingly decided to simultaneously devalue ruble, default short term obligations and announce a moratorium on payments by the Russian banks. Even after ten years the debate often boils down to settling of personal accounts, accusations and excuses. But whoever was to blame, it is necessary to understand the causes of the crisis and analyze the weak points in the Russian financial system highlighted by the crisis.

The roots of the crisis were in the macroeconomic and political developments in Russia between 1995 and 1997. Specifically the budget deficit, the anti-inflationary monetary policy, with the consequent expansion of the state debt, the protracted and overexploited fixed exchange rate policy, the opening of the short term obligations market to non-residents, with the Bank of Russia guaranteeing against currency risks, the mixed role of the IMF, the domestic political upheavals in the spring-summer of 1998, and of course, the external shocks - the decline in commodity prices and the Asian financial crisis that erupted in the summer of 1997.

A decade later the current macroeconomic situation appears radically different. Nevertheless the fears of a new financial crisis in Russia are justified and growing. Going back to the events of 1998 we would like to discuss the financial system vulnerabilities that have not changed significantly after ten years. Firstly this still includes the secondary role of the financial markets, which lack tools and diversity of participants (in this respect there are some setbacks since the second half of the 90s). The crisis of 1998 was exacerbated by the fact that the banking system was "the weak link" of the financial system but had the greatest influence on the policies of the monetary authorities. Central Bank has done everything possible to save domestic banks, delaying devaluation of the ruble and signaling to the banks about the inevitable defaults. Many banks took advantage of this time and sold short term obligations but the banks were still left with bad currency risks because of the forward contracts with non-residents and collateral agreements with foreign creditors. The Russian banking system assumed virtually all foreign exchange risks to attract "hot money" in 1996 - 1997. So it's not surprising that the decision on external payments moratorium was made to save the Russian banks. There were major infusions of ruble into the banking system in the fall of 1998. Many of the banks went bankrupt but managed to move their assets into "bridge-banks" leaving their depositors out in the cold.

Not much changed over the past ten years. Still not very reliable banking system dominates other institutions and markets. Although proportion of banks lending to fixed assets investments is extremely low, just 9.4%, many of them are involved in potentially risky operations with financial assets in Russia and abroad. Self financing by enterprises still dominates, while the banking system has not become a conduit between the savings and the investment sector. However, as ten years ago, it is still the key link to the external financial risks; this relationship is much more dangerous now than ten years ago. In just the last two years the external debt of Russian banks increased 5.5 times, from \$31 billion in early 2006 to \$171 billion at the end of the first quarter of 2008.

The risk management is difficult due to the lack of financial instruments and for the moment few are interested in it. At the backdrop of the favorable external factors and muted potential threats there is no demand for hedging instruments. Just like until the autumn of 1997 for most players the problem of bad risks did not exist because of the fixed rate of the ruble and guaranteed high return of the short term obligations. When the situation changed drastically it became clear that the Russian banks had to hedge themselves instead of non-residents. However, the bulk of such emergency transactions were conducted within the banking system, which further exacerbated its crisis. Unfortunately outside of the banks and the stock market the derivatives trading remains in its infancy.

Another problem from the decade ago is still relevant – the inefficient management of the financial assets and obligations of the State. Negotiations with Paris and London Clubs of creditors successfully concluded in November of 1996. Russia received a good sovereign ratings and it became possible to attract financial resources from abroad. It was necessary at the time to continue active work with debt, with an emphasis on transformation from the short term domestic debt into the long term foreign currency commitments. It was quite possible during 1997, though it required more expensive services (in case of moderate devaluation of ruble). It was the best option as a means of protection against default and to mitigate the crisis. Unfortunately the right moment to optimize the debt structure has been missed. The authorities have tried to address this issue too late in the mode of *force majeure*. The exchange of the short term obligations into Eurobonds (\$6 bil.) occurred a month before the August default without any impact (as was the useless release into the foreign exchange markets of \$4.8 billion *tranche* of the IMF in July of 1998).

Unfortunately even today managing of the States assets and liabilities leaves much to be desired. The state got rid of the external debt but billions of dollars are lost every year because of the inflation and exchange rate depreciation of the huge financial assets. No one considered protection against credit risks of the "prime" borrowers such as mortgage giants Fannie Mae and Freddie Mac. The increasing corporate debt, including the debt of the biggest Russian companies (\$21.5 billion in 2000 to \$295 billion, on the basis of the first quarter of 2008, nearly 14 times) led to the partial transformation of external risks of commodity sectors and the financial risks of the State, exacerbating the problem of the low economic diversification. Financial policies are still determined by budgetary expenditures as evidenced by their clear cyclical nature. During the economic

overheating the state stepped up spending spurring the inflationary processes. The cooling economy would require cuts in expenditures and that could further undermine the economic growth now dependant on domestic consumption. Incidentally the authorities are unlikely to be ready to take tough and unpopular measures.

The events of 1998 showed how dangerous is the illusion of security by the leaderships of the financial institutions. Late in 1996 such illusions arisen because of success of Boris Yeltsin in the elections and the influx of "hot money" into the country. Partly for this reason the authorities remained complacent, concentrating on the internal politics instead. As a result, before 1997, the opportunity for structural reforms and preventive measures to protect the financial markets was missed. The monetary corridor was not canceled and no action was taken to break the fiscal crisis. At the time such measures lost relevance. Russia's entry into the external financial markets and admission of non-residents to domestic markets appeared to guarantee stable sources able to cover the budget deficit. The mood of complacency by the monetary authorities was vividly illustrated when the Bank of Russia in the summer of 1997 ceremoniously announced changes in the ruble denominations. The decision to get rid of three zeros on the currency notes have not changed anything on the merits but had to demonstrate victory over inflation and continued stability of ruble (incidentally this step became one of the political obstacles to timely devaluation).

In the current situation the illusions of security are somewhat similar. It would seem that nothing can threaten the accumulated huge foreign exchange reserves and the macroeconomic stability. At least there is no sense of worry about the collapse or devaluation of the ruble. With nearly \$600 billion in reserves it is possible to keep the desired dual currency course for a few years and mitigate the currency exchange risks. But the question is how Russia's financial system is protected from the other systemic risks, perhaps much more dangerous for the economy?

The following mental experiment could illustrate the vulnerability of the Russian economy to the external price shocks now and ten years ago. The price of oil has fallen in 1998, from \$17 a barrel 1997 to \$11 in 1998. What if the price had not fallen but rose to at least reasonable at the time \$20-25 (not to mention the current \$ 110+ a barrel)? With great confidence it can be argued that Russia would have been spared the financial crisis, at least to the extent orchestrated by the monetary authorities. The devaluation of the ruble would have to happen for objective reasons (at the beginning of 1998 the ruble was overvalued) but only by 20-30%, rather than 4-5 times. It would have been possible to restructure the domestic debt in Eurobonds eliminating the risks associated with refinancing of the short term debt. Of course the medium-term debt would have increased the pressure on the budget but "hindsight" we are well aware that the price of oil has increased many times over. The Russian government could have easily coped with debt in any reasonable form of restructuring. Short Term Federal Term Bond would not have tarnished its reputation in a predatory default. Stabilization Fund would have probably plunged below \$50-60 billion but I do not see this as a great disaster. Thus the \$10-15 difference in the price of oil ten years ago could have lead to a very different scenario. We could have been speaking about a "soft landing" for the Russian economy.

Imagine what would happen with the economy in Russia now, if the price of oil would drop from the current \$110 a barrel to quite acceptable ten years ago \$ 25 (or even to \$11 for the purity of our mental experiment)? The 4-5 times drop in the oil prices is not impossible. For example its level in 1986 was in real terms three times lower than in 1981 (\$12 to \$32 or nominally \$24 to \$74 a barrel in 2008). Certainly even \$25 a barrel could now become a catastrophe for the Russian economy worse than in 1998. Other possible triggers of the potential crisis: budget deficit in a few percentage points of GDP, capital flight, devaluation and trade inflation, stock markets collapse, unavoidable credit and banking crises, recession and unemployment. The default on T-bills is not a threat, but default of corporate debts is a high probability (the fall in price of oil will lead to the fall of gas and the rest of commodities). The crisis will be exacerbated by the credit expansion and stocks bubbles inflated for the five consecutive years, primarily in the real estate market. Economic history teaches us that such a flammable mixture almost always ends up in crisis.

I doubt that given the parameters of the price shock, the authorities would be able to prevent the pessimistic scenario. The vast financial reserves of the State are unlikely to stop the development of the systemic crisis. The Reserve Fund can cover debts of Gazprom or Rosneft but no amount is enough to stimulate the aggregate demand or support the banking system. Any attempt to tap foreign exchange reserves to the rescue will result in the three figure rate of the annual inflation. In addition the handling of the crisis by the previous cabinets and monetary authorities is not a cause for optimism. One can only hope that they do not worsen the situation as drastically as in August 1998. The citizens, once again, will have to take the fall. Now that they are used to the model of consumer society, will they agree to this role?

I open myself to argument that such an extreme version of the events is unlikely. But the crisis of 1998 was also the most extreme scenario, which no one could imagine a year before August the 17th. The lessons of a decade ago are important in order to envision the most unbelievable but yet possible events.

Andrei Vavilov: “It will happen this summer, likely in August”

By Nikolai Gonchar, Deputy of State Duma

At the end of 1997 I read an article by Andrei Vavilov, published in the Money (Деньги) magazine with the sensational title "I know there will be a crisis". The article analyzed forecasts for the next year balance of payments and justified the thesis of an inevitable devaluation of the ruble. It suggested urgent renouncing of the prevailing exchange rate regime, after a modest devaluation within the limits of 30%, in order to prevent the devastating financial crisis.

However the Bank of Russia executives categorically rejected such a possibility. Since January 1, 1998 ruble was denominated and the exchange corridor was expanded. Despite this the Central Bank was forced to intervene to maintain the exchange rate, wasting scarce foreign exchange reserves. In December of 1997 the negotiations with the IMF failed because of the Russia's reluctance to implement tough fiscal measures. In February of 1998 the negotiations resumed and only then the issue of granting Russia an emergency assistance was formally introduced. It created an impression of uncertainty and inconsistency in the actions of the authorities, the lack of a clear protection strategy for the threat of a crisis. Russian financial markets from the beginning of 1998 behaved very nervously, confirming the doubts about the ability of management to correct the situation.

There calming sentiment was everywhere; it proclaimed that everything will be normal, the threat is not so serious, etc. At some point it became apparent that this was not just a demonstration of tranquility and assurances for the benefit of the public. The authorities really believed that Russia is not vulnerable to the crisis. Andrei Vavilov's views expressed in this article contrasted sharply with this attitude. I phoned him directly and asked when and how could there be a financial crisis in Russia. He replied that “certainly it will happen in the summer, most likely in August, when everybody will be on vacation. The situation in the financial markets may dramatically worsen at the time when nobody would be minding the ship. In haste they will take most foolish decisions possible...”

Unfortunately Andrei Vavilov was right!