Russia's Economic Woes -- A Pile of Ruble

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The world economy has yet another "submerging market" crisis on its hands, only this time in a country with 6,000 nuclear weapons. Thanks to a multitude of factors -- a major liquidity crisis among Russian banks, 200 percent interest rates, the failure of the weekly government debt auction, a debt downgrade by Moody's and Standard and Poor's, a gloomy forecast by George Soros, the Duma's postponement of a session on tax reform, and aftershocks from Asia, the Russia stock market hit its lowest point since the "Red election" scare of March 1996, 90 percent below its level a year earlier. One month after a hasty International Monetary Fund bailout, the government was broke again.

So, on Monday morning , August 17, Russia announced that the ruble was free to fall, sanction a devaluation of 34 percent. In addition, Russia in effect declared bankruptcy. Circumventing the IMF, it unilaterally suspended payment on short-term government debt. It also imposed a moratorium on debt payments by banks and corporations to foreign corporations. According to Western fund managers, the defaulted foreign obligations include as much as $100 billion in foreign contracts under which Russian banks obligated themselves to convert rubles into dollars at the previous exchange rate.

The financial stabilization, for the sake of which the real economy has been sacrificed, has turned out to be a mirage. The risk now is that the Russian people will stampede, pulling their deposits out of banks and converting their rubles to whatever dollars and other hard currency they can find. This would spell an unlimited fall of the exchange rate and very high inflation.

This is a country where $200 billion of private capital has already disappeared into offshore havens, and most other finance capital is invested in $100 bills or short-term securities. Furthermore, after seven years of western-designed reforms, Russia remains mired in economic stagnation, without the institutional base or competitive strategy required for a viable market economy. Indeed, bailouts have only postponed the pain while financing hundreds of billions in capital flight by Russia's immensely rich, virtually untaxed elite.

How did Russia -- one of the world's richest countries, in terms of natural resources, skills, and technology -- end up in such trouble? Before the July bailout, the overwhelming consensus among Russia experts was that there was nothing fundamentally wrong with the anti-inflation strategy that Yeltsin had pursued since 1992. This strategy has had three key elements -- cutting spending, increased tax collection, and privatization; maintaining the real exchange rate; and throwing the doors wide open to foreign trade and capital flows.

But, while the July crisis should have prompted a reassessment of these policies, most officials, bankers, and Wall Street professionals rushed to blame the crises on extenuating circumstances like falling oil prices, Asia's turmoil, or the Duma. They also persuaded themselves that yet another bailout was preferable to devaluation. After all, it was not their money, and, hey, maybe this time around Russia really would be serious about fixing tax collection, wage arrears, shareholder rights, and corruption. The U.S. Treasury's Lawrence Summers and David Lipton, and the State Department's Strobe Talbott, wholeheartedly agreed.

In hindsight we should have asked tougher questions before going along, recognizing that many of the so-called Russia "experts" who favored the deal had strong vested interests. Foreign bankers had $75 billion of Russian loans outstanding. Private investors like Soros had $60 billion in the T-bill market or investments in Russian banks that had issued piles of forward contacts to hedge rubles. And Russians naturally liked buying foreign imports and dollars at subsidized exchange rate -- while the party lasted.

This time around, more skeptical thinking has prevailed. Russia has not hit its targets for deficit reduction *once* in seven years of IMF programs; there has been no discernible progress in its collection of vast unpaid taxes. In May 1993, the IMF predicted the economy would shrink 3.5 percent in 1994; it fell 12.6 percent. In 1995 it projected two percent real growth for 1996; it fell 2.8 percent. In 1997 IMF Director Camdessus said Russia was on the verge of "a sustained recovery." In January 1998 the IMF said "Russian reform is entering a less dramatic phase." In early May, as Russian markets were cratering, Camdessus told us "This is not a crisis." Then, in July, to justify the last bailout, the IMF predicted that the deficit would be halved by 1999, relative to GDP, that the growth rate would double despite the current mess, and that Russia could borrow $20 billion more from domestic investors this year -- predictions that were as unrealistic as the others.

So, as of last week, policy makers really had no idea whether another bailout would be the last; all they knew what that Russia's crisis reflected much more than just exogenous forces. The "hold the ruble at any price" policy was the *cul-de-sac* of a long series of neoliberal policy experiments that Russia has run at the behest of Western advisors and the IMF. These experiments -- heavily subsidized by the West -- have played a key role in making Russia more prone to crisis by undermining its tax base, its manufacturing and technology sectors, as well as the incentives that Russians have to save and invest in real assets at home. The strategy has made Russia far too dependent on exports of natural resources, Western imports, and "flighty" short-term Western capital – while encouraging private capital to seek refuge outside the country or under the mattress, where it is unavailable for development.

Among the worst examples of such experiments is the brutal shock therapy of 1992, designed by Harvard's Jeffrey Sachs, which triggered hyperinflation that cost the Russian people more than $130 billion of savings -- even as Russia was solemnly assuming $85 billion of the former Soviet Union's foreign debt. Then there was the weird voucher privatization and "loans for shares" schemes of 1992-95, designed by Chubais and Sachs' protege Maxim Boycko, and implemented with more than $300 million of US foreign aid. They resulted in the sale of 70 percent of state enterprises to the new elite for less than $12 billion. Even Hungary raised more from privatization. This fire-sale of valuable natural resources created a super elite, which promptly moved assets offshore.

Especially since 1995, the government has pursued a ruthless “forced lending” policy of not paying workers and pensioners on time. This was intended to satisfy the IMF's budget cut targets; it's easier to stiff workers and pensioners than to collect taxes from the wealthy and well-connected. By the end of 1997 a quarter of workers had not been paid in at least six months – the government had $10 billion of wage arrears and another $12 billion of back pensions, on top of $21 billion of uncollected taxes.

Together, these policies have decimated Russia's economy. Unlike East Asia, which experienced sustained growth before its recent troubles, Russia has been in a 1930s-style depression since 1991. While its "shadow economy" makes all such estimates uncertain, most observers agree that real GDP has fallen by 40 to 50 percent since 1990, and investment by eighty percent. From April 1997 to April 1998 – in just one year -- real cash incomes per capita fell 8.1 percent.

The strong ruble policy has also eroded the tax base by encouraging capital flight. As every private banker knows, nothing is better for the capital flight business than an overvalued exchange rate. The fact that the ruble has recently been overvalued has provided a strong stimulus for investors to buy artificially cheap dollars, speculating against a devaluation. Combined with political uncertainty, the opportunity to evade taxes and conceal illicit income, and the enrichment opportunities provided by Russia's privatizations, all this has made it the world's hottest "flight" market. The stock of Russian flight capital assets is now worth at least $200 billion, compared with Russia's foreign debt of $148 billion.

Most of this flight money has landed in havens like Cyprus, Lebanon, Switzerland, and the United Kingdom, with the laundering arrangements made by prominent German, Swiss, U.S. and U.K. banks. Unfortunately for the government's efforts to increase tax revenue, the earnings on such flight wealth are hard to tax. Russia has also become the world's largest non-US consumer of $100 bills, which many ordinary people hold as a kind of poor man's flight capital.

Russia's strongest growth sectors are speculative banking, money laundering, arms, raw materials, and energy. The oil and gas industry alone now accounts for more than fifty percent of legal exports. Science and technology have been gutted -- spending on R&D has dropped to a half a percent of national income. The domestic economy is starved for capital. But most foreign investment has been channeled into securities, not real assets_the sum total of all US direct investment in Russia today is less than in Hungary. Yes, world oil prices have dropped precipitously this year. But it is crucial to view Russia's vulnerability to this decline in this larger context_the country is now just another Third World raw material exporter.

Against this background it is easy to understand why Russia had to devalue. Adjusted for domestic inflation, in the last two years Russia's exchange rate had risen dramatically. Originally this policy had been pursued in the interests of grinding down inflation, after shock therapy sent it into orbit. Inflation is now below seven percent. Yet Russia's Central Bank had committed itself to a policy of holding the ruble virtually steady. This required exorbitant interest rates. One might have hoped that the Yeltsin government itself would have come to recognize that a policy of borrowing billions more just to just to achieve even lower inflation and provide still cheaper imports and capital flight did not serve Russia's long-term interests -- much less the interests of ordinary Russians. However, at the end of the day, it was the dictates of the market, not economic analysis, that forced Yeltsin's hand.

The devaluation is likely to make Russia's manufactured goods more competitive internationally. The lack of competitiveness has been a key factor stifling the domestic economy, and a recipe for industrial decline. Indeed, successful transition economies like Poland and China have generally maintained undervalued exchange rates. By taking a preemptive devaluation now, Russia may hope to join their ranks.

Inflation will rise in the short run, and the devaluation will be unpopular among the urban elites that consume most imports -- though those same elites also own most of the flight capital, which is now worth much more in rubles. Devaluation may also take a toll on Russia's 1600 or more banks, which have borrowed heavily in dollars or engaged in currency swaps that commit them to providing future dollars_which will now be much more expensive. But there are far too many "pseudo-banks" in Russia at this point anyway -- seventy-five percent of private deposits are with a state-owned institution called Sverbank, and most private banks are not really "banks" at all, in the sense of providing intermediation between savings and real investment. Rather, they are pure speculators, mainly involved (in Veblen's memorable phrase) in "clever chicanery or the thwarting thereof" in security markets.

It’s unlikely that Russia’s devaluation will help financial markets around the world. But Russia is hardly responsible for the fact that many of these same banks, investors, and international institutions have also made foolish moves in other developing countries. And there really is no alternative -- Western governments can't afford endless bailouts, and Russia is far too strapped to play such a lynchpin role anyway. It has faithfully followed neoliberal policy prescriptions for years, and they haven’t worked. The bankruptcy of Russia demonstrates the intellectual bankruptcy of the economic policy conducted over the last seven years. Hopefully, the devaluation will be the first step toward a real competitive strategy, reversal of capital flight, and an economic recovery.