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The russian economic crisis - World Economic History Part 6

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In the mid 1990s, Russia was coming out of post-Soviet period to a market economy. There was massive social dislocation, fall in living standards, inflation in excess of 300 percent. Many Russians did not have savings for basic necessities of life. Barter was prevalent in several parts of the economy and the concept of debt repayment or legal enforcement was yet to be established. The source of inflation lay in a lack of fiscal discipline – Government ran huge budget deficits financed by the Central Bank of Russia. There was large scale tax evasion and huge capital flight. Fiscal discipline in the run-up to the 1996 election was not forthcoming and the Government did not show any resolve to tackle the budget deficits. The Government lacked the enforcement power to collect taxes from the major industrial and energy sector tax-payers.

Feeble attempts to cut the budget deficits were made in 1995. The Government sought to control the money growth by keeping the exchange rate of the ruble vis-a-vis the US dollar within a preannounced band. Thus money growth was controlled to maintaining the exchange rate. Russia had effectively surrendered large parts of monetary independence in deciding to use the exchange rate as nominal anchor for monetary policy. The tightening of monetary policy supported by the exchange rate anchor produced an impressive reduction of inflation in the short term and an improvement in the confidence of the ruble. Inflation was lowered to less than 50 percent by 1996 and to under 15 percent by the onset of the Asian crisis. Russia accessed international capital markets and foreigners acquired government issued paper. The strong external current account, rising international reserves and an appreciation in exchange rate, covered up the challenges of high debt servicing costs, short term structure of maturities and impact that a sudden depreciation of exchange rate could have on the Nation.

The weakening of the oil prices coupled with the onset of the East Asian crisis in 1997, resulted in a sharp and sudden deterioration in Russia's terms of trade. There was a 25 percent fall in the total exports and there were lower inflows from international capital markets with rising cost of access to international capital. Between 1997-98, faced with a deteriorating balance of payments situation, Russia faced international debt repayments of US $ 20 billion. The Central Bank of Russia intervened in the market, selling foreign exchange reserves to defend the exchange rate. Market sentiment had deteriorated rapidly and despite borrowings from International Financial Institutions, there was a rapid decline in the reserves position. It was clear that Russia could have avoided the massive disruption it faced if the Government had maintained fiscal discipline. There was a lack of coherence between institutions as the Duma rejected the key elements of the fiscal program recommended by the IMF. There was no credible macroeconomic policy response in the first 6 months of the Russian crisis. By February 1999, the Ruble had lost 70 percent of its value against the dollar and inflation had reached 90 percent. There was no banking crisis as banks largely served as the payments system and impact of the crisis on balance sheets of enterprises was modest.

Russia declared across the board suspension of debt-service payments including ruble denominated debt and suspension of private sector external payments. The authorities adopted a free floating exchange rate by abandoning the exchange rate anchor and preserved the remaining foreign exchange reserves. The policy focused on keeping the payments system operational. The political impasse between the President and the Duma made budgetary revisions impossible in 1998. Government adopted strict cash management and cut non-essential expenditures. By 1999, a credible economic stabilization program was put in place, with a prudent budget which was passed by the Duma.

The specter of seemingly unmanageable external debt and threat of an uncontrollable hyper-inflation instilled a sense of fiscal discipline into the 1999 Russian Budget. There was an improvement in the oil prices by the third quarter of 1999 enabling Russia to build reserves quickly. Russia recovered quicker than other crisis hit countries in the same period largely due to increase in oil and gas prices. The positive effects of the high oil prices on the Russian economy coupled with fiscally prudent budgets continued up to 2003. These policy corrections enabled Russia to cover the burden of debt service repayments. Fiscal restraint in the face of burgeoning oil revenues enabled the government to rebuild international reserves while slowing the appreciation of the ruble. As the confidence in the ruble and the banking system increased, gradual reduction in inflation was also achieved. Russia adopted wide ranging structural reforms in taxation and legal enforcement. The Soviet era labor and land codes were dismantled. The number of licensed activities were brought down, pension reforms, bankruptcy laws, agricultural land laws were passed. Russia recovered quicker than what any of the observers had predicted.

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