

Russia's Financial Meltdown: Causes and Policy Responses

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We have to recognize that the Russian financial meltdown is a product of two factors: (A) a policy of accumulating debt to cover huge Russian fiscal deficits, which had been pursued since 1995, and was unsustainable in the long run, and (B) the increased volatility of global capital markets in the wake of the Asian crisis. Russian policymakers and international investors made bad bets, as is obvious in hindsight, but neither the timing nor the severity of the current crisis is attributable to "economic fundamentals." As long as the psychology of the market remained rosy, the Russian financial position was sustainable; as soon as it shifted, meltdown was unavoidable. This diagnosis leads to three main policy implications.

1) All of the policy responses currently being proposed in Moscow are incoherent, and international financial institutions should not support any of them.

- Before he fell from favor, Chernomyrdin proposed a temporary "economic dictatorship," which promised to reintroduce price and capital controls and reflate the economy by printing money. Chernomyrdin failed to recognize that after a few months Russia would face an even more dire economic crisis, and even more severe stabilization measures would be necessary to contain inflation.
- The currency board floated by Fyodorov is a good idea at a bad time. In normal times, a currency board sets a nominal anchor for macroeconomic policy because it establishes the exchange rate as a target that must be defended. During a panic sell-off, however, the currency peg is just a target for traders to shoot at. There is no "proper" level at which to peg the ruble in the short run; it could fall to 100 to the dollar next week, or go back up to six. Pegging the ruble low provides insurance to sellers, because its value won't rise above the peg, and pegging it high provides an incentive to bet against it.
- The crisis program promoted by the Economics Department of the Russian Academy of Sciences is a radical prescription for state intervention. It calls for partial suspension of convertibility, extensive capital controls, indexation of wages and entitlements, and mandatory monetary emissions to cover the budget deficit. If fully implemented, this program would aggravate the current crisis, effectively cut Russia off from international capital markets, and almost certainly lead to hyperinflation. This cannot be a prescription for domestic peace at the cost of rejecting sound policy. The evidence shows that the main victims of high inflation in post-Communist countries are the poor, and the consequence could only be to further undermine the legitimacy of democratic politics in Russia.

The Primakov government appears to be determined to learn the wrong lesson from the current crisis, so the IMF should withhold the next tranche of \$4.3 billion until the next swing of the political pendulum. Under the present circumstances, IMF aid cannot have any positive impact unless it is used as an inducement for the government to support a coherent, market-oriented crisis package. The ruble should be allowed to fall so that market forces can take over the job of punishing speculators from the Central Bank. The budget deficit requires urgent attention.

2) The West cannot bail Russia out, but that does not mean that we cannot do anything. It is no longer feasible for central banks or the IMF to intervene in currency markets decisively enough to stabilize currencies, so defending currencies has become a matter of tightening macroeconomic policy. What the United States can do to dramatically strengthen markets all around the world, however, is to lower interest rates. Alan Greenspan hinted that this was on the agenda when he said that it is no longer credible that the United States can remain an island of prosperity. Using interest rates for any other purpose than targeting domestic monetary aggregates cuts against the grain of professional opinion and the very successful experience of monetary management ever since Volcker. Unfortunately, it's necessary.

Another unconventional step would be to urge the Paris and London Clubs to forgive Soviet-era debt--all principal and accrued interest--in return for a renewed commitment to service Russian debt. There is a precedent for this: Poland received dramatic debt reductions from both clubs as a condition of its IMF stabilization plans in 1991 and 1993. Creating a firewall around Soviet-era debt would prevent the forgiveness of debt from further undermining Russian credibility, while substantially reducing Russia's obligations. Since this debt has already been restructured, this would not improve the Russian fiscal position very much, but it would have a significant psychological effect, because it would increase the probability that Russia would be able to meet its obligations in the long term. It would also be a dramatic gesture, and the West has not made many gestures that supported Russian democracy recently. The Europeans would complain that the burden fell unfairly on them, and there would be some cost to the world banking system, but these loans have all been written down to a small fraction of their nominal value by now.

3) We should not conclude from recent experience that international financial institutions are less necessary than we once believed, or that their advice is less sound. To the contrary, the volatility of global capital markets means that devices that coordinate market expectations are needed more than ever, and that unwise macroeconomic policies will be punished severely.

The function of the IMF is not to bail out unwise investors. It is to tip the balance of incentives in the short term in favor of policies of fiscal and monetary restraint. A credible IMF stabilization plan provides a focus for market expectations, which allows decentralized actors to coordinate their behavior. Coordinated markets provide strong incentives for governments to step back from the brink; uncoordinated markets offer them nothing. If Russia goes ahead with another disastrous round of monetary expansion and hyperinflation, it will be because its leaders have already written off the possibility that the market will do anything but punish them for the politically relevant future. The IMF can change the market's expectations--but only when it can extract policy improvements in return for support.

The IMF's advice to Russia has not been unwise. Quite correctly, the Fund and the Russian Government recognized last spring that their biggest problem was not economic fundamentals,

but market psychology. Devaluing the ruble would not have accomplished anything except spooking the market sooner, because the value of the ruble is not set by purchasing power parities, but by the decentralized decisions of millions of investors and currency traders. As late as July, it still made sense to think that the ruble could be defended--not by open market interventions, but by macroeconomic policy improvements. No one could possibly know when the market's mood would swing. Such things cannot be predicted, since the market's current value always takes account of the information that is currently known.

If the IMF is to be criticized, it should be criticized for being too soft on Russia. From the Fund's perspective, both the decision to release the June tranche of the EFF and to approve the rescue package in July were questionable, because Russia had already failed to meet its targets and did not commit itself to very much. When the Fund is lenient, it undermines its reputation, which in turn undermines the market impact of any agreement that it signs. The IMF does not have much credibility left in its dealings with Russia, since it has tolerated flagrant violations of conditionality for years. Unfortunately, US foreign policy has consistently undermined IMF bargaining leverage with Russia by pressuring the Fund to compromise.

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