

# Policy Lessons from the Russian Economic Crisis

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In August, the Russian government defaulted on approximately \$40 billion in ruble-denominated bonds, imposed a moratorium on debt payments by Russian banks to foreign creditors, and allowed the ruble to fall. Monthly inflation in September is estimated at 38%, and official GDP has contracted by 10%. Global capital markets were shaken, and the US stock market sustained record losses.

The Russian financial meltdown was a product of two factors: (1) 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 (2) 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 several policy implications.

(1) 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 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 of hyperinflation; uncoordinated markets offer them nothing. 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. The Fund has been widely criticized for encouraging Russia to defend the ruble exchange rate instead of engineering a preemptive devaluation last spring. The Fund was correct to recognize, however, that devaluing the ruble would not have accomplished anything except igniting a panic in the market. It would not have reduced pressure on the ruble, because the value of the ruble did not depend upon purchasing power parities; it depended upon the decentralized decisions of millions of investors and currency traders. On the other hand, the stable ruble had served as a faithful nominal anchor for monetary policy since 1995, and abandoning it would have been damaging. Until the crisis actually hit in August, 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 Extended Fund Facility (EFF) and to approve the rescue package in July were questionable, because Russia had already failed to meet its targets and refused to 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 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.

(2) The policy responses currently being proposed in Moscow are incoherent, and the West should not support them. Russia's fundamental problem is the widening shortfall in tax collection; it is impossible to address any other social or economic issue without solving this problem first. The Russian Ministry of Finance estimates a fourth-quarter deficit of 70 billion rubles, with 130 billion rubles of expenditure. Since its default in August, Russia has been cut off from all sources of budget financing, so the shortfall will have to be covered by printing money. This, in turn, will worsen the crisis by fueling inflation and increasing the downward pressure on the ruble.

Primakov's government appears to be determined to learn the wrong lesson from the crisis. Instead of cutting expenditures and raising taxes, the Masliukov-Gerashchenko plan for managing the crisis involves increasing spending in a number of areas, cutting taxes and creating new exceptions, and imposing draconian controls on prices and capital flows. The effect will be to prolong and deepen the crisis.

The crisis cannot be overcome without a renewed commitment to economic reform. Consequently, the IMF should withhold the next tranche of \$4.3 billion until a new government comes up with a coherent, market-oriented crisis package.

(3) The West cannot bail Russia out, but that does not mean that it 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. However, the United States Federal Reserve has taken a significant step to strengthen emerging markets--or to cast a lifeline to submerging markets--by lowering interest rates. The next step should be a coordinated effort by the G-7; unfortunately, such an effort failed at the Washington summit.

Another unconventional step would be to lead an effort by the Paris and London Clubs to forgive Soviet-era debt, including all principal and accrued interest. 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. However, 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 by now these loans have all been written down to a small fraction of their nominal value.

Any package of aid to Russia should be carefully constructed to maximize the leverage of IMF negotiators, since the longer Russia fails to come to grips with the economic law of gravity, the further it will fall. The consequences are threatening for the future of Russian democracy.

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