Russia Since August 1998: A Political-Economic Balance Sheet

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The most dire predictions about the Russian economy after the August 1998 financial crisis have not come true. Devaluation, for example, has led to import substitution and created growth in some sectors of the economy. Hyperinflation has been avoided, and a strong recovery in oil prices has boosted tax receipts. A Paris Club rescheduling of Soviet-era debt has given Russia some debt relief, while renewed funding from the IMF and World Bank have brought an infusion of funds to pay debt and help advance development projects. However, Russia's economy remains in recession, with GDP contracting by 5% in 1998. A new war in Dagestan, terrorist bombings in Moscow and elsewhere, financial scandals, electoral uncertainties, and hamstrung structural reforms are only some of the factors that make political stability and economic growth highly unlikely in the near term. This memo is a snapshot of Russia's economic and political environment in the second half of 1999, and articulates two broad policy guidelines.

THE ECONOMY

Assets	**Liabilities**
New IMF and World Bank Funding Paris Club Debt Rescheduling Trade and Current Account Surplus Privatization	Recession Capital Flight, Decreased Investment Fiscal Deficit Large External Debt Unreformed Banking Sector Unemployment and Poverty Exchange Rate and Inflation

Economic Assets

New IMF and World Bank Funding. In June 1999 the IMF resumed funding to Russia with a $4.5 billion loan over 18 months. The loan allowed Russia to roll over its debt to the IMF, thereby avoiding default. It also unlocked another $3 billion in funding from the World Bank and Japan, and facilitated Russian debt rescheduling with the Paris Club. Although the Fund reports Russian overperformance on goals set in the IMF agreement, other actions by Russian authorities seem to violate the spirit of the agreement. For example, the government has decreed quotas for crude oil output that must be kept within the country before any exports are allowed. This erodes market discipline and signals a lack of deeper commitment to effective economic restructuring. Investigations of alleged money laundering also risk delays in further IMF disbursements.

Paris Club Rescheduling. The Paris Club of official creditors has agreed to reschedule billions of Soviet-era debt payment. Specifically, Russian payments on nearly $40 billion of debt have been postponed until the end of 2000. Then, the Russian government will pay only $600 million instead of the $8.1 billion originally scheduled. Negotiations on debt rescheduling with the London Club of commercial creditors are also ongoing. Debt rescheduling, along with the new IMF loan, eases the pressure for money emission and diminishes the risk of runaway inflation.

Trade and Current Account Surplus. Russia's August 1998 devaluation led to a collapse of imports in the fourth quarter and created a small current account surplus of $2.4 billion. According to preliminary numbers from the Russian Ministry of Finance, in the first six months of 1999 Russia had a trade surplus of $13.2 billion (with exports at $32.6 billion and imports at $19.4 billion), compared to only $300 million in the first five months of 1998. Higher commodity prices in 1999 will likely lead to a total year-end trade surplus of about $27 billion and a current account surplus of $10 billion. In 2000, a similar surplus is likely, although imports may inch up as Russia's recession levels out.

Privatization. In July 1999 the Russian government announced that it would privatize 25% of Rosneft, 19% of Slavneft, and the remaining 40% of Tyumen Oil controlled by the state. These companies are significant assets still in state hands. Rosneft, in particular, is the last vertically-integrated Russian oil company owned by the state, and privatizing it will complete the transfer of the oil sector to private owners. These transactions, along with 1999 sales of minority shares in Gazprom, Sviazinvest, and Lukoil will bring the government an estimated $650 million in revenues. But this amount is minuscule compared to what the government could raise if it were willing to sell bigger stakes in its most lucrative properties to foreign investors. Limiting the participation of outsiders diminishes privatization receipts and impedes the effective restructuring of privatized enterprises.

Economic Liabilities

Recession. The devaluation of August 1998 stimulated import substitution and led to output growth in industry, agriculture, and other sectors. In March 1999, Russia recorded year-on-year growth of 4.2% in industrial production, 5.1% in freight transportation turnover, 1.8 % in agriculture, and 1% in retail trade. These figures, reflecting market and quasi-market mechanisms at work, are encouraging. However, a 12% drop in exports also occurred in the first half of 1999, while Russian GDP as a whole contracted by 5% in 1998 and 3% in the first quarter of 1999. Except for minuscule growth in 1997, the Russian economy continues to shrink. The current impetus provided by import substitution will not last, and only a weak recovery is expected in 2000. Sustainable future growth will depend on restructuring of industries, more efficient production, increased investment, structural reform, effective governance, and political stability--all of which are highly uncertain.

Capital Flight, Decreased Investment. Despite the current account surplus, capital flight will create external financing pressures and Russia may be unable to sustain service of its post-Soviet debt. Ratings agency Fitch IBCA estimates that up to $136 billion in capital has fled Russia from 1993-1998, while other sources report that capital flight in 1999 continues at around $1 billion/month (with a high of $2.5-3 billion/month in July-August 1999, according to the Institute of International Finance). With political uncertainty rising due to elections in 1999-2000, it is likely that more capital will flee the economy. External financing pressure will also increase because of lower net foreign direct investment. Russia received net foreign investment of $1.2 billion in 1998 (as opposed to $3.6 billion in 1997), and is expected to receive only $1 billion in 1999.

Fiscal Deficit. Capital flight, weak tax revenues, a large gray economy (estimated at 25-40% of GDP), and undisciplined spending have led to an average yearly budget deficit equivalent to 7% of GDP from 1992-1998. During the same period, Russia was unable to maintain a primary budget surplus for an entire year. It is doubtful that Moscow can achieve the 2% primary budget surplus stipulated in the latest IMF agreement. The deficit in 1998 ran at 5% of GDP, and is expected to be approximately 4.3% of GDP in 1999. In ruble terms, in the first six months of 1999 Russia's deficit stood at R66.4 billion, even though tax collection was 109% of the tax target set by the 1999 Budget Law. The high tax collection was due largely to "one-off" sources, including 1) receipts from the energy sector, where companies were benefiting from an 18-month high in oil prices; 2) the raiding of revenues from regional budgets to the federal budget; and 3) exchange rate depreciation. Deficit reduction will require the government to control spending, sustain higher tax collection, and make the tax burden more equitable. Moody's Investors Service reports that the top 20% of Russia's population paid only 23% of taxes they owed, and the top 10% paid only 16.7% of their tax bills. In contrast, the bottom half of the population paid more than 90% of what they owed. If the richest 20% paid their tax bills fully, Russia's fiscal deficit would be almost eradicated. Unfortunately, in an election year, it is doubtful that effective steps will be taken to address Russia's fiscal problems.

Large External Debt. The International Institute of Finance estimates Russia's total external debt at $168 billion in 1999, equivalent to over 200% of exports and nearly 100% of GDP (as opposed to only 37% of GDP in 1997). The bulk of external debt is Soviet-era debt, on which the federal government has already defaulted. However, federal authorities have continued to service fully and punctually Eurobond obligations incurred between 1996-1998 ($15.9 billion par value). Although the recent Paris Club restructuring gives Russia some debt service relief, it is not a long-term solution to the country's indebtedness. Moscow officials are seeking up to 75% debt forgiveness for Soviet-era obligations (totaling about $100 billion), but the extent to which this strategy will work is doubtful. Russia's selective default on external debt and ongoing pressures in external financing will mean greater difficulty for the government to raise any financing in the future.

Unreformed Banking Sector. The government's default on domestic debt in August 1998 and the ruble's devaluation devastated many Russian banks, making them insolvent and illiquid. With foreign exchange-denominated liabilities soaring after devaluation and with the termination of lucrative yields on government bonds, Russian banks ended 1998 with a negative net worth of about $10-15 billion (about twice the system's capital). Instead of genuine restructuring, however, cronyism, weak political will, and lack of financing have led instead to widespread fraud and asset stripping. Several large banks did close operations, including Inkombank, Menatep, Tokobank, and Unikombank. The Central Bank also withdrew as many as 64 banking licenses and, in July 1999, further voided the licenses of four prominent banks and launched bankruptcy filings against them (i.e., Uneximbank, Promstroibank, Mosbiznesbank, and Mezhkombank). But these steps fall far short of strategic restructuring, are uncoordinated, and are likely to be politically motivated. Further, none of Russia's large bankers have been taken to account for irresponsible and fraudulent practices. ARCO, the agency set up by the government to deal with bank restructuring, is severely under-funded, does not have full support from the Central Bank, and is unlikely to midwife the birth of a healthy banking system.

Unemployment and Poverty. The International Labor Organization reported 12.4% unemployment in Russia in January 1999 (up from 11.8% a year earlier), while the Russian Statistical Agency reported 14.2% unemployment in April-June 1999. Unemployment and the ruble's crash have diminished real income and consumption. The Russian European Center for Economic Policy reports that in June 1999, as much as 35% of Russia's population lived below the subsistence level (defined as income of R950 or $38/month), up from 22.5% a year earlier and 21.0% in June 1997. At the same time, the official monthly minimum wage remained at R83.5 or $3.34/month, while the average monthly pension was R448.7 or $17.90/month. These figures correlate with severe deterioration in public health and increasing cases of AIDS and tuberculosis. The Russian population also declined by 0.3% in 1998--its biggest decline since the end of World War II. These figures have negative implications for the labor pool, labor productivity, and future economic growth.

Exchange Rate Policy and Inflation. Although sustained hyperinflation did not materialize in the wake of August 1998, nonetheless year-on-year inflation rose from 85% in December 1998 to 120% by August 1999. Monthly inflation was 8.5% in January 1999 but dropped to 1.2% in August 1999--totaling 29.5% for the year thus far. Inflation is expected to continue to rise for the remainder of the year, and is estimated at around 50% by year-end. The Russian ruble, having lost 75% of its value in the devaluation of 1998, has stayed at a relatively stable rate of R25/$ in the first half of 1999. But this rate has already fallen to R25.87/$ in September 1999, and the ruble is expected to depreciate in line with inflation for the rest of the year. Higher oil prices, exchange controls, renewed multilateral and bilateral assistance, and a disciplined monetary policy should stave off the threat of free fall in the ruble's value. Government monetary emission controls have held relatively well despite three changes in government between May and August 1999, but cannot be taken entirely for granted during an election year. If the ruble comes under renewed pressure, the Central Bank will be unable to intervene decisively, given low levels of foreign exchange reserves (only $8.2 billion at the end of the second quarter and expected to be at around $6 billion by year-end).

RUSSIAN POLITICS

Assets	**Liabilities**
Weakness of Extremism Renewed Cooperation with US	Ongoing Political Instability Crime and Corruption War in the Caucasus Weak Judicial System, Lack of Enforcement

Political Assets

Weakness of Extremism. Since the breakup of the Soviet Union in 1991, many have flagged the risk of "Weimar Russia"--i.e., a state that becomes steeped in extremist nationalist ideology and compensates for national humiliation by opting for authoritarian rule at home and military intervention abroad. But despite dire economic, political, and social indicators, the Weimar scenario remains remote. Extremist ideas and personalities since the early 1990s have proven weak at mobilizing the Russian population. Purveyors of extremism and fascism have failed to capture the public imagination or mobilize majority electoral support, and this trend does not appear to be changing in the current electoral season.

Renewed cooperation with the US after Kosovo. NATO bombing of Serbia over the Kosovo crisis in 1999 plunged Russian relations with the West, especially the United States, to a new low. Russian elites and the mass public alike expressed bitter recrimination at what they characterized as NATO's "aggression" against a historic Slavic and Orthodox ally. Various US-Russian and Russia-NATO cooperative programs were canceled. However, in the aftermath of the conflict, Russian relations with the West have improved slightly. The US supported the resumption of IMF assistance to Russia; Russian troops agreed to participate in KFOR, the NATO-led peacekeeping force in Kosovo; and arms control talks have resumed. Of particular importance are the Strategic Arms Reductions Talks (START III), which aim to reduce US and Russian nuclear weapons to approximately 2,000 for each side, and a new agreement to cooperate on a nuclear early warning center designed to avoid accidental nuclear launches due to Y2K glitches. Controversies regarding alleged Russian corruption and money laundering (including the Bank of New York case and others) could, however, dampen further cooperation.

Political Liabilities

Ongoing Political Instability. In August 1999 Yeltsin fired newly-appointed prime minister Sergei Stepashin and replaced him with Vladimir Putin, former head of the Federal Security Service (FSB), the successor to the KGB. Putin is Russia's fifth prime minister in 17 months. He is relatively unknown in international political circles, has never held elective office, and has no experience in economics. His appointment coincides with the escalating battle for political succession in Russia. Many analysts agree that Yeltsin and his closest circle (dubbed "The Family" in Russian media) have become fearful of a potential victory in the legislative and presidential polls of 1999-2000 by Moscow mayor Yurii Luzhkov, who has formed a popular coalition (Fatherland-All Russia) with former prime minister Yevgeny Primakov. Yeltsin and "The Family" are worried that their security--financial and otherwise--will be jeopardized by a Luzhkov presidency. The possibility is slight that Yeltsin will derail the democratic process; but if he does, polarization and open conflict could result. Recent deadly terrorist bombings in Moscow and elsewhere have also heightened feelings of insecurity among Russians; if such terrorism continues, support could increase for a state of emergency that would jeopardize democratic elections and a peaceful transfer of power.

Crime and Corruption. Crime and corruption are major blights on the Russian landscape. After declining in 1997-1998, contract killings are reported to be rising again. In the first half of 1999, 115,000 serious economic crimes were reported in Russia (i.e., crimes subject to mandatory investigation). These included money laundering, theft, bribery, abuse of power, fraud in banking and the stock market, smuggling, and counterfeiting. In July 1999, Pricewaterhouse Coopers released its much-awaited report on FIMACO, an offshore company that managed billions of Russian foreign exchange reserves and invested them in the Russian T-bill market in 1996. Former finance minister Mikhail Zadornov confessed that Russian authorities lied to the IMF about FIMACO's role and the amount of Central Bank reserves in 1996. Attempts by Russian and Swiss prosecutors to investigate allegations of financial crimes by highly-placed Russian figures--including those in the Kremlin--have led to Yeltsin's suspension of the Russian procurator. Allegations of billions of dollars of Russian money laundering via western banks and bribery of high Kremlin officials have highlighted anew the extent of corruption in Russia. Widespread discussion and recriminations in the western press (including hearings in the US House and Congress to investigate Russian corruption and US involvement) have elicited accusations in the Russian media of a new western conspiracy against Russia. In this atmosphere, the future of international financial assistance to Russia and US-Russian cooperation could be jeopardized. In the meantime, Transparency International, an international watchdog organization, ranks Russia among the top ten most corrupt countries in its 1998 Corruption Perceptions Index. Crime and corruption clearly will continue to raise the costs of investment in Russia and, if left uncorrected, will obstruct the flow of much-needed capital.

War in the Caucasus. In early August 1999 war broke out again in Russia's northern Caucasus region as Islamic fighters occupied villages in Dagestan, a Russian republic bordering Chechnya. These fighters, partly funded from outside, have proclaimed their goal as the creation of an independent Islamic state. Dagestan's two million population includes some 30 different ethnic groups, many of whom do not support the republic's separation from Russia. This makes this conflict different from--and perhaps less intractable than--the 1994-1996 Chechen secessionist war, which was supported by the bulk of Chechnya's ethnic population. Nonetheless, this conflict drains the government's meager resources, threatens to become a wider war as Moscow bombs targets in

Chechnya and prepares for what might be a ground assault, and highlights some fragile aspects of Russian statehood.

Weak Judicial System, Lack of Enforcement. Russia has undertaken legal reform and adopted many new laws since independence in 1991. However, the wording of many laws can be ambiguous, and laws often contradict each other. The weakness of law enforcement is a major problem. Recently, Russian Federal Securities Commission chief Dmitrii Vasilev has complained that private and public Russian entities have refused to follow a law passed in March 1999 to protect investors' rights. Courts and judges are also vulnerable to political and financial pressure. The Moscow Arbitration Court, for example, catering to domestic interest groups, ruled in May 1999 in favor of bankruptcy proceedings at oil company Sidanco. This was a blow to creditors and shareholders (including British oil major BP-Amoco) who had agreed to defer bankruptcy in favor of an amicable settlement of accounts with the company at a meeting scheduled in June. The weakness of the judicial system means that corporate governance will continue to be problematic in all spheres, including shareholder rights, contract enforcement, property rights, and others.

Policy Implications

Two general implications for US policy arise from the preceding snapshot of Russia. First, it is clear that Russia's economic and political liabilities currently outweigh its assets. To enhance the likelihood of future political stability and economic growth, Russia must have a new leadership with (hopefully) the mandate, will, and professionalism to tackle the country's many problems. In this context, US policymakers must unequivocally support the timely and peaceful conduct of Russian parliamentary and presidential elections in 1999-2000. A new leadership will not necessarily yield better and more effective policies, but it is clear that the current regime under Yeltsin has exhausted its potential and must allow a new political transition to take place. Second, US and other international assistance should continue--where honest and capable parties are found to work with--to emphasize institution-building throughout Russia. Technical assistance, training, and funding should be directed toward strengthening institutions that will underpin a more transparent and efficient market economy: banks; arbitration, bankruptcy and other courts; regulatory agencies for the securities market; small business administration; and others.

RUSSIAN ECONOMIC DATA SHEET*

Table I: Macroeconomic Indicators.

RUSSIA 1995 1996 1997 1998 1999 2000
Real GDP growth (%) -4.2 -3.5 0.8 -4.6 -1.0 -1.0
Nominal GDP (USD billions) 347.7 429.6 443 276.6 190.4 207.4
Population (millions) 148.1 147.7 147.1 146.5 146.1 145.7

GDP/capita ($) 2,347 2,908 3,011 1,888 1,303 1,423
Exchange Rate/USD, year-end 4.64 5.56 5.96 20.65 28.0 35.0
Urban Unemployment Rate (%) 8.8 9.9 11.2 13.3 14.0 13.6
CPI inflation (%) year-end 131.3 21.8 11.0 84.5 50.0 40.0
Central Bank Re-financing Rate 160 48 28 60 50 40
Money growth, M2 (%) 112.6 29.6 28.0 37.5 50.0 40.0
Government Spending as % of GDP 18.1 19.4 19.3 15.2 15.9 15.9
Fiscal Deficit/Surplus as % of GDP -5.4 -7.9 -7.1 -5.0 -4.3 -3.6

Table II: Balance of Payment Statistics.

RUSSIA 1995 1996 1997 1998 1999 2000
Current Account Balance as % of GDP 2.3 2.8 0.9 0.9 5.4 4.3
Current Account Balance ($bil) 8.0 12.0 4.05 2.4 10.3 8.8
Trade Balance ($bil) 20.8 23.1 17.4 17.3 26.6 24.6
Services & Income Balance ($bil) -12.9 -11.1 -13.1 -14.5 -16.0 -15.5
Unrequited Transfers ($bil) 0.6 0.4 -0.3 -0.4 -0.3 -0.3
Direct Investment ($bil) 1.7 1.7 3.6 1.2 1.0 2.5
Portfolio Investment ($bil) -1.4 6.3 7.6 -2.2 -0.2 0.4

Table III: Composition of Trade Balance.

RUSSIA 1995 1996 1997 1998 1999 2000
Merchandise Exports ($bil) 82.7 90.6 88.4 73.9 72.8 75.0
Merchandise Imports ($bil) 61.9 67.5 73.6 59.6 48.2 52.1
Major Exports, 1998 Fuels, Minerals, Metals 55.8%; Machinery 10.5%; Chemicals 7.6%
Major Export Markets, 1998 CIS 17.4%; Ukraine 8.3%; Germany 8.2%; USA 6.2%;
Major Imports, 1998 Machinery 35.4%; Foodstuff 25.0%; Chemicals 14.9%
Major Import Markets, 1998 Germany 35.4%; USA 25.0%; CIS 17.2%; Ukraine 14.9%

Table IV: Foreign Debt Statistics.

RUSSIA 1995 1996 1997 1998 1999 2000
Total External Debt ($bil) 116.3 136.8 163.0 171.0 167.6 175.9
Short Term Debt ($bil) 11.9 23.8 40.8 29.6 24.8 23.6
Commercially-held Debt ($bil) 48.9 62.7 88.7 85.6 81.1 83.2
External Debt/GDP (%) 32.6 31.0 36.7 64.2 90.7 95.6
Debt Service Ratio, due (%) 13.4 13.7 16.1 28.5 28.6 27.7
Reserves (excl. Gold) ($bil) 14.4 11.3 13.0 7.8 5.7 5.8
Months of Import Cover 2.5 1.9 1.9 1.3 1.1 1.1
Short Term Debt/Reserves (%) 82.6 210 314 379 435 407
S-T Debt + Debt Service/Reserves (%) 152 310 415 638 796 772
Current Bond Yields, basis points over US T-Bills 5-year Eurobond, trading at 2,479.8 bps (Maturity 7/05)