

Russia in Crisis

A Roundtable Discussion held at the Harriman Institute, Columbia University

September 22, 1998

Participants: Professor of Economics Padma Desai, Professor of Economics Richard Ericson, Professor of Political Science Robert Legvold (foreign policy expert), Professor of Political Science Steven Solnick (domestic policy expert).

Professor Padma Desai: Why did the crisis arise? It arose because the budgetary management of Russia has been poor; expenditures were not controlled while taxes could not be properly collected. The government was forced to borrow at home and abroad at very high interest rates. The disparity between Russian and foreign rates was so high, that foreigners were enticed to buy GKO's (short-term government bills and bonds). Russian banks borrowed from abroad in foreign currencies at lower rates, which they then invested in government securities that offered higher rates. There was a pyramid of government GKO's that were financing the deficit. When the Asian crisis hit Russia, its export earnings from commodities such as oil and other industrial raw materials fell. The current account was turning negative and that weakened the ruble. Investors started selling off government GKO's denominated in rubles. On August 17, the government had to devalue the ruble by 35 percent, and announced a moratorium/default on \$20 billion government debt. Kiriyenko was removed and Primakov was confirmed as Prime Minister. Primakov is a savvy and pragmatic politician who has a lot of staying power. He began his political career as an advisor to Gorbachev and he is widely recognized and accepted in various political circles and by the public. However, it is to be seen if he can bring together a viable economic package. There is no clarity so far. First, the Cabinet is not in place. It is also unclear what direction will Primakov take: Will the Central Bank print more money? Will price controls be introduced? Will the remaining industrial enterprises be privatized or nationalized? Will the government impose quantitative restrictions on the trading system? It is clear to many that old, market-oriented programs aimed at monetary stability have failed. There are several reasons for the failures, firstly, an institutional background with a strong central bank, a Securities and Exchange Commission, a proper stock exchange and rule of law are all missing. Secondly, the political opposition in the Duma prevented expenditure cuts that contributed to the fiscal crisis. What needs to be done? Recent currency printing has caused the monthly inflation rate to shoot up to 45 percent or so. So the money that people might receive will be worth less both because of currency emission and devaluation which have dramatically increased the import prices. If the CB provides liquidity to the banks, will the payments reach the people and companies or will banks again divert the money abroad? I also disagree with the IMF insistence on capital account convertibility. It turns out that the whole capital movement was purely financial and speculative. I don't buy the argument that in order to attract strategic foreign investors you need capital account convertibility. China is an example that you can attract investors by allowing them to repatriate the profits and even the capital; giving them a legal framework, and thereby creating incentives to stay in the country. Price controls would also be a mistake: There is too much pressure on prices because of emission and rising import prices. Price controls will lead to black

markets, more corruption and inefficiencies. The government needs to allow prices to adjust freely, while offering income subsidies to poorest parts of the population. Increased prices would also stimulate entrepreneurial activities since it would be more profitable to produce at home because import prices have shot up. It would also be a mistake to re-privatize assets as that would lead to legal battles. It is difficult to say if Primakov and his deputy Maslukov could create a viable economic package. It is clear that they think differently about the economy than the market reformers. In a recent press conference, Maslukov said that Russia needs to subsidize industry and develop an industrial policy. He expressed his disbelief in the central notion of market economies that lower interest rates by themselves will stimulate the economy. So the current team believes that you need direct intervention to stimulate the economy. It is also unclear what role the Duma will play: Will it support Primakov or will it sabotage his actions? At the moment I feel rather pessimistic about the prospects in Russia.

Professor Richard Ericson: The fundamental problem in Russia is the failure to understand and respect real economic constraints, specifically spending constraints. This coupled with the failure to marketize brought on the current crisis. The government had to cover for its commitments with credit emission and debt emissions, specifically from abroad. These emissions were supposed to be paid back through taxation on output, which was not there in a real sense. All of that was coupled with a collapse in the banking system. The banking failure occurred because Russian banks are not financial intermediaries but a failure of marketization. Rather than being intermediaries, Russian banks serve as control centers for cash flow rights of insecurely held assets. They are conduits for central credit and management of central debt and a mechanism of rent extraction for banking bosses. Underneath the insolvent government and sick banking system, one has a nonviable production structure. There is an illusion of capacity. The production structure cannot create a sufficient surplus to pay labor, suppliers, capital providers or governments. Continuing operation produces uncoverable arrears. The system survives by reproducing on shrinking scales the cycles of production and exchange inherited from the command economy. A barter system has emerged which avoids market accountability and equivalence of value. Consequently, you have millions of different prices for the same products between different pairs of agents. In effect you have a barter system with inflated prices for heavy machinery, especially for the energy sector, and overpriced food products for workers, etc. How to resolve this problem? The only way out is massive restructuring of the real economy and massive real bankruptcy. This involves the transfer of debt into equity control, something never recognized in Russian bankruptcy law. We have a good example in the investment firm that went belly up several days ago. There we have a private reorganization where all control has been handed down to providers of funds - debt holders. Something like that has to happen to most of the Russian industry. This, of course, requires those missing institutions and especially strong property rights, which don't give special consideration to important people. For this restructuring to succeed, Russia will need to distinguish financially viable enterprises, and to provide an environment where viable enterprises will thrive while nonviable operations will be cut out. This is unlikely to happen under this or any other government. What does the current government recommend? Monetary emission, which will lead to hyperinflation, was the first step undertaken by the current government. We should realize that the problem is not the lack of money. The low ratio of M2 to GDP reflects the fact that people are unwilling to hold rubles, not the fact that there is not enough liquidity. Pumping more rubles will just lead to hyperinflation. Controlled emission will lead to increased prices; however, it will be truly damaging if it is used to support

Russian industry as it is now. State and financial injections in the industry can be useful only if massive restructuring takes place simultaneously. Russia needs wide scale bankruptcies, substantial reorganization of ownership and control, new technologies, new production organizations, new configurations of capital and skills, etc. It is not clear that any Russian organization or industry can accomplish that. My view of Russia's current prospects is very pessimistic. It might be possible to stabilize the current situation without undertaking massive reorganization and restructuring. But that, if indeed possible, will generate a future collapse that would be more serious than the current crisis.

Professor Steven Solnick: I will talk about domestic politics, and my view will probably be bleaker still. People think that Russia has still a chance to avoid going over the cliff if the right government and policies are implemented. I think Russia is beyond the cliff, but still doesn't know about it. I want to discuss whether Russia can survive as a federal state. Our previous speakers noted that the crisis will not begin to abate until the government gets to collect taxes, lives within its means, and creates property rights in order to attract foreign investors. The political question, which I want to pose, is whether those forces which profited under the current extortionist system, will find it in their interest to finance the federal government and save Russia as a united state. Will they decide that it is in their interest to finance the government and prevent final disintegration? I tend to agree with Paul Krugman who says that they are looters, not kleptocrats. They are not attempting to establish a kleptocracy in which they will continue to steal from the state; rather they are stashing away billions of dollars, which they will be able to live off of -- with or without Russia. I doubt that bankers think it is in their interest to finance the federal government and save Russia. However, I doubt whether the bankers are the key group in anyway. I think the critical actors are the 89 governors of the Russian regions. They have extensive powers, most specifically de facto control over operations of tax officers, central banking and treasury officials. Kiriyenko tried to re-centralize those officers but that was abandoned. The governors control the regional media and they even got control over some federally owned properties in the regions. They are accepting equity positions instead of taxes, thus consolidating their control over the local enterprises. This is a first step toward re-nationalization. In many regions, it is the governors who are housing and feeding the army, and that might erode the loyalty of the army to the center. It is clear that the ability of the federal government to survive runs counter to the interests and the power of the regions. You need to re-centralize the tax, the central bank and the treasury systems, you need to reassert shareholder rights in the enterprises where they have been abused by the regions, and you need to reestablish revenues from the enterprises controlled by the regions. So far Primakov has been continuing Chernomyrdin's policies of appeasement toward the regions. He even invited some key governors to join the Cabinet as deputies. If that goes through, they will serve in three branches of the government: Regional executive, upper house of legislature and federal executive Cabinet. They will have a veto block almost impossible to break. In the past, every open conflict between the federal government and the regions resulted in a defeat of the center. For example, Sakha blackmailed Yeltsin into allowing them to market a share of their diamonds independently. Tatarstan failed to accept the Constitution, and ended up signing a bilateral treaty with the center. Luzhkov has been given a free hand in Moscow region. I won't even mention Chechnya. Sooner or later the center will need to reassert its power if reforms are to succeed. In that case, the governors might force the center to accept a confederacy. Regional army officers will probably fail to respond to the center's efforts to centralize. There are a dozen or so governors who can

force the creation of a confederation. Historically, confederations do badly in collecting taxes and living up to international commitments. Because of these prospects, I am extremely pessimistic about Russia.

Professor Robert Legvold: I was relatively optimistic about Russia's role in the international arena in 1997. However, I need to readjust my opinions in the view of the current crisis. This is another turning point in Russian history. The reason I was optimistic about Russian foreign policy stemmed from the way I saw the outcome in two critical dimensions. The most important dimension, the new states surrounding Russia, and the second dimension involving Russian relations with the West and the other great powers. Despite all the difficulties and the mistrust Russian elite feel toward the West, the most threatening issue of NATO expansion was managed. Meanwhile, Russia continued to play within the rules of great power cooperation on the Balkans and arms controls. With China, Russian relations were better than at any time in the past century. There was some movement toward improving relations with Japan as well. In the post-Soviet space, we also witnessed the normalization of relations with Ukraine and even some progress with the Baltic states. Also we witnessed a stabilization in some of the conflict spots in the post-Soviet space. The Russians have a role in the ethnic conflicts of the former republics of Karabakh, Trans-Dnester, and Abkhazia. There has been some progress toward solving those crises. However, the role of Russia, although important, is not viewed favorably by some, specifically in Tbilisi, Kishinev or Baku. Now the progress in the foreign policy front is being threatened by internal developments in Russia itself. Russian foreign policy will be affected by its internal crises. It will be much weaker and won't be able to affect the development in those regions. The situation is out of control politically and economically. Parallel developments in the international environment are also negatively affecting Russian foreign policy. As Professor Desai notes, the Russian position in the global economy has eroded because of falling commodity prices and decreased investor confidence in emerging markets. Even more important for Russia are the political developments in the post-Soviet space. Favorable changes in the post-Soviet space such as stabilization are deteriorating. For example, in Tajikistan the peace making and reconciliation processes are under enormous stress. In Karabakh, the prospects of achieving some kind of peace are also in question. The health of the relationships between Russia and other former republics is deteriorating. For example, Ukraine and Belarus, are seriously affected by the crisis in Russia. Their governments cannot really do anything about avoiding the spread of this crisis. Russia is so weak internally that it can't manage the spread of its crisis to other states. The CIS, which was always weak, is now utterly bankrupt in managing the effects of the Russian crisis. It will further fracture potentially constructive relations within the post-Soviet space. Russia's relations with the rest of the world are characterized by its weaknesses and the limitations of its policies. Now, in time of crisis, all the political instinct and inclinations are to move in the wrong direction. Russia views the global economy, international financial institutions and the major Western powers managing those institutions with increasing resentment. It is not clear if Russians will act rationally in the framework under which they have to operate. It is also unclear if they will do what is necessary to get the \$4.3 billion in loans from the IMF, although without it they will be in poor shape. Even post-Yeltsin politicians like Luzhkov sound like Communists when they speak about Russia's involvement in the global economy. Luzhkov, for example, on many issues involving post-Soviet space sounds like a nationalist politician, be it Russian minorities in the Baltic states, the Black Sea Fleet or Belarus. Some view him as a political opportunist, but I disagree as I see Russian politics moving in that

direction. On virtually all fronts, we have to be pessimistic about Russia's role in the international arena. On a positive note, Russia is going to be so weakened that it won't be able to act on its instincts either against the IMF or in its continuous opposition to Western actions in Kosovo. There has been very little progress on other security issues such strategic arms control or even managing the non-proliferation agenda. The real problem, however, is not Russian restlessness or its reorientation in foreign policy. The real problem is what Russia might become. Russians have a tradition of doing grandiose things, which are usually failures. The USSR was a superpower, and its absence is a super-problem.

Questions:

1. You emphasize the bleak prospects for economic restructuring. But do you think that there is any role for the international community in helping Russia in this restructuring process.

Can you also comment on the role of the military and interior forces in the event of a possible center-region conflict, and potential inter-ministry local conflict between the military and the interior ministry?

2. We saw in the example of Long Term Capital Management, how debt holders were given equity rights. Is there a way to do the same with Russian banks: Move from debt to equity basis control. If that happens in Russia, will we have the same actors in control as we do now, specifically FIGs (Financial Industrial Groups)? Regional governments own great chunk of enterprises. Do you think there is a conflict of interest between the national Financial Industrial Groups and the regional governments?

Answers:

Professor Richard Ericson: The possibility of offering restructuring help dissipated in the last 5-6 years. We offered a lot of general macroeconomic advice, instead of offering microeconomic advice. We should have helped in really restructuring the economy as we did under the Marshall Plan when European managers were brought to the US and taught superior production techniques. That allowed them to resume growth and to increase productivity.

The big problems are the banks and the FIGs themselves. They got control but they didn't get well-protected equity rights. You still have a moral hazard and adverse selection problems in relations with management. Management cared only about short-term cash flows since there was no long-term security of property rights. Now banks and FIGs have shown themselves to be bankrupt. They extracted resources, shipped them overseas but didn't do anything with them and then went into debt to various Western actors. There is room for allowing debt to be turned into equity. Give Citibank a chunk of Renaissance Capital or one of the big banks, and have them run it. You need a lot of experimentation and different sources of control. You don't want to put these banks into the same hands, which by now are in financial hole. We need to prevent government and the CB from forgiving these bankrupt actors and allowing them to return and revive the same discredited system.

Professor Padma Desai: I will address the role of international community in helping with the restructuring. The IMF has not been pressing Russia hard enough to work toward bringing strategic investors into the country. They also met resistance from the Duma and the oligarchs, who have their own ideas on how to continue reforms and develop industry. There is an implicit agreement between the left in the Duma and the oligarchs, who share the desire to keep foreign investors out. It is surprising that they do not want to invite strategic investors and develop their industry.

I also want to address the question of conversion of debt into equity. The Chubais privatization program allowed the insiders to keep control of the privatized enterprises. So even after privatization, the collectives have kept the majority control and they kept any restructuring from occurring. The way to restructure is to invite in foreign investors. However, the insider control combined with collusion with the banks is preventing the restructuring and the entry of outside investors. It is difficult to say how much time they have. How do people manage without being paid for 8-9 months? Well, information obtained from the people themselves indicates that about half of them have second jobs, and about half of them have garden plots which allow them to survive. It is almost a subsistence economy in which people are growing their own produce. This summer we interviewed construction workers in Novosibirsk, and almost all of them had their own plots. It is also interesting why Russia does not have movement like Solidarity in Poland. The Communists are a party of the past and they have no positive response to the reformers. They look back for inspiration and have not fulfilled their role as a party of the future and change. Most of the strikes, with the exception of the minors, have not been sustained long strikes. Also workers and managers collude against the central government. It is not like in the West, where strikes are against the managers. This, I think, is a product of insider control. So far there is no sustained, organized political movement coming out of the past.

Professor Steven Solnick: As a result of the debt to equity swaps, the government will give up some control the FIGS. Debt for equity swaps have been advocated for two main reasons. First, the international lenders are kept in the game because they don't lose their stake; at least they are given equity shares. Second, it brings in strategic foreign investors who will push for restructuring. Politically, however, it is beyond suicidal. Loans for shares scheme would be a gift to nationalist and communist forces in the Duma, just 18 months before elections. The plan wouldn't work for foreigners without some property rights guarantees from the federal government in any way. On the regional blocks against the center, there were titanic struggles between banking oligarchs and regional governments, even without foreign investors. Regions wanted to keep their voters employed in their enterprises, while banks, which had gotten controlling shares were pushing for restructuring of these enterprises. Norilsk Nickel is an example of that. You will see it in Gazprom or United Energy Systems. So I am not sure that regional government interests can coexist with oligarchs.

Regarding the role of military and interior ministry forces in the regions. I don't know whether the interior forces are in tighter hierarchical control than the military. I know that the appointment of interior officials is more coordinated with the regional governments. These troops are not captured by the regions to such a degree that they will go to war to gain independence for the regions. However, it is not clear whether these forces, for example, will

occupy the government offices in regions to support the center. Once it is clear that they won't actively support the center, the impotence of the federal government will be exposed.

Questions:

1. Western oil companies have been expending huge amounts of money on trying to start up various projects in Russia. However, they found themselves stuck, and their efforts sabotaged by both the regions and even the federal government. Do you think it would be better if the West helped its companies to build Russian infrastructure, rather than throwing money into the Russian "black hole"?

2. Primakov is now the head of the government. It is widely known that he is a supporter of Hussein and has a lot of affinities in the Middle East. At the same time there are great economic problems and a need for money. Taking these two factors together do you think Russia will be more prone to trade off nuclear technology for needed funds?

3. How will Russia respond to NATO expansion?

Answers:

Professor Richard Ericson: There is an unwillingness by the Russians to recognize the property rights of outsiders. This mindset is antithetical to proper functioning of the market. If you are an insider in Russia you don't have to worry about crises and various constraints, they will adjust to your needs. The unwillingness to allow outsiders to have control or piece of the action stands in the way of foreign investment, and that is reflected in the lack of legislation protecting markets and the lack of institutions facilitating proper functioning of the markets. Managers won't continue to do the same thing if they realize that they could lose everything as a result of their failure to make a profit. They need new economic environment and institutional framework to open the way for new people and force the old actors to adjust their behavior.

Professor Padma Desai: I agree that there is resistance to hand down the ownership of assets to foreigners. This resistance is primarily ideological, and it comes from both communists in the Duma and managers. Why has it been so easy in Azerbaijan for Western oil companies to assume ownership and control, while in Russia it has been so difficult? Western oil companies don't want to come to the Russian markets without production-sharing legislation. In Azerbaijan, however, Western companies have come in without any such legislation. The picture in Azerbaijan is very different: There is Aliiev and 6-8 key people around him. It is much simpler in Azerbaijan where there is a courtly atmosphere with no political opposition and no discussions in the press. In Russia the situation is too complex. There is opposition and confrontation between the executive and legislative branches and there are overlapping and conflicting interests between the center and the regions etc. These complications keep Western companies away from entering the market. I am surprised that Primakov does not sit down with the Japanese and sell those little islands for a hefty sum. I am sure they could get \$40-50 billion. However, there are too many complexities and conflicting forces in Russia to accomplish that.

Professor Robert Legvold: I don't think Primakov will affect the foreign policy significantly. If they do go ahead with some kind of arms transfers, it will be because they lost further control of their arms or they lost the incentive to cooperate with the West in the context of the crisis. But in no way, could it be characterized as the Primakov factor. Primakov has long believed that the West has the wrong perception of the Middle Eastern problems, both the Israeli-Arab and Islam component. Because of that he often disagreed with the West on substantive issues, but that never has led him to argue for rear-end operations that would go outside the policies of the West. Russia does have different stakes and interests in Iran, although Western policies are fragmented on that as well. They have common interests with Iran to stabilize the situation in Afghanistan. That might even lead to some kind of military cooperation. But Primakov has been more cooperative with the US on controlling missile technology transfers to Iran. Russia sanctioned three firms for illegal transfers of technology to Iran and Iraq. They agreed to set up six committees with the US to limit the transfers of the technology to the region. There also has been agreement to set up national monitoring facilities in Russia to keep the track of missile transfers to the South. That is also related to non-proliferation.

On NATO Expansion, there is no one in the West who wants to force the issue. There is even doubt that Slovenia will be invited to join NATO. There are surely none who want to raise the issue of the Baltic states or other former republics. However, in times of crisis Russian leaders like Luzhkov will draw the worst conclusions about NATO actions and intentions, be it exercises under Partnership for Peace, or non-NATO policies in the Caspian region, or critical relations with Ukraine. Russians interpret Western actions as a coherent strategy to gain influence in the post-Soviet space. NATO expansion brings all these feelings into focus, and convinces them that there really is a Western strategy to isolate Russia. In the long run, this is very damaging to Russian-Western relations. Russians will be disappointed in the new NATO image and the Founding Act. Most specifically, it will be revealed in Kosovo. Russia will view NATO actions as threatening and will be discouraged about the new NATO.

Question:

The question of debt versus equity and foreign investment has been debated for a long time in the Eastern Europe. When Hungary started addressing these questions, they found that their debt to the international community was equal to their real assets. Some people facetiously proposed selling the country to foreign investors, which would open up access to technology, managerial skills, and knowledge of markets. But maybe it is possible to bring foreign control and techniques without foreign ownership. Polish experiments attempted to do just that. Citizens received shares in the economy and invested those shares into investment funds. At this point foreigners could be brought in to manage those investment funds, and create real incentives for these foreign managers to allocate their capital among the companies.

Answer:

Professor Rick Ericson: Russia did go that way, and the real problem was that they had foreigners writing privatization statutes. There was experience with investment funds, but they turned out to be pyramid schemes. These have been largely discredited, and there could be no

debate about giving up the control for Western managerial expertise. Russians feel that they found their own way.