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Introduction

Great social revolutions are inspired by big ideas, implemented by enthusiasts of these ideas, fostered by big finance, and may be spontaneously affected by unforeseen eventualities. To some extent this is true with regard to the Russian capitalist revolution that began in 1991 and continued throughout the final decade of the twentieth century. It was a materialization of the basic idea to transform radically the decaying communist system into a modern market economy that would be able to survive and develop in the post-industrial world. The idea was not new at that time because the unprecedented economic transformations had already been occurring in Eastern European and some developing countries and had proved to be pretty successful in many cases.

The processes of economic liberalization began around the world in the 1980s and led to tectonic changes that would have certainly affected the former Soviet Union. Fortunately, the last Soviet leaders, headed by Mikhail Gorbachev, were prudent enough to reject any new radical communist experiments and even tried to modernize, albeit unsuccessfully, the communist system. The author of this book is part of a generation of young economists brought up under the intellectual influence of the liberal ideas of that epoch. Twenty years ago all of us were very enthusiastic about the beginning of radical market reforms in Russia. Some got a lucky and rare chance to implement these big ideas in practice when the new post-communist Russia was born as a sovereign state in 1991.

This book presents a participant's observations and thoughts in hindsight about the revolutionary events that occurred during the last decade of the past century. The book presents a history of Russian finances that played a very important role in the Russia's transition from communism to capitalism. Usually financial issues remain in the shadow of historical

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events or personalities. They are typically neglected by historians who are reluctant to pay much attention to the dull matters of debts and credits. But in the case of Russia these issues were paramount because the attempts at economic transformation were very closely interrelated with the resolution of a cornerstone problem of public debt.

This problem arose in the late 1980s and mirrored the serious economic troubles of the Soviet Union that were hidden for many years by official statistics. The excess and rapid build up of external debt obligations by the USSR alongside ineffective attempts to introduce semi-market reforms eventually caused the Soviet debt crisis and led to the insolvency of the state. There is no coincidence in the fact that the bankruptcy of the Soviet Union in December of 1991 occurred simultaneously with its disintegration. The history of the Soviet debt crisis and default is a story of the agony and death of the Soviet Empire. The subsequent history of new Russian debt origination, accumulation, and a new crisis, which is the principal subject of this book, is essentially a more intriguing story of the successes and failures behind Russia's transition to markets.

Market reforms started in Russia in the aftermath of the Soviet bankruptcy and in a political situation of considerable complexity. The new Russian government headed by Yegor Gaidar was formed by the first Russian president, Boris Yeltsin, at the peak of his charisma, as a team to conduct some radical economic reforms. Being widely perceived as a team of 'whipping boys', it had to fulfill three concrete tasks. First, the government of reformers had to undertake urgent measures to pull the country out of a deep economic crisis and to prevent a widespread social catastrophe. Second, it had to launch the great capitalist revolution in Russia, something that the previous liberal reformers in tsarist Russia (the predecessor of the USSR), such as Peter Stolypin, had failed to accomplish eighty years earlier. Third, the government of post-Soviet young reformers had to solve the Soviet debt problem in a civilized manner.

These three tasks were mutually interrelated. The economic crisis could be resolved only on the basis of a market that was yet to be created. In introducing its reforms the Russian government needed political support from the governments of developed countries that were official creditors of the Soviet Union. At the same time the success of reforms was the only way for the Russian government to become eventually solvent so that it could pay back Soviet debts. The solution of the debt problem was, thus, a necessary condition for overcoming the economic crisis under which the Russian Federation was born as a new political entity.

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Negotiations around the Soviet debt restructuring, hence, became the key strategic issue for the Russian authorities. The recognition and restructuring of this debt made possible a civilized solution of the sovereign debt problem, for the first time since the Bolshevik revolution and Russia's sovereign debt default in 1917. Russia assumed responsibility for the Soviet Union' foreign debt in full, although this implied a very high additional financial burden for the newly created state. But, on the other hand, the debt assumption opened new options for Russia to enter the global capital markets several years later. Another strategic reason for the Soviet debt assumption was maintaining the status of a nuclear superpower (infirm but still alive) that Russia inherited from the USSR as its legal successor. Of course, leaving these strategic considerations aside, a more rational choice might have been instead to issue new debt at the beginning of the transition to facilitate this process and to smooth out household consumption. Successful reforms would, after all, lead to higher future incomes, so it would be sensible to finance some of the painful reforms from richer future generations. But as the successor to the bankrupted Soviet Union, the Russian Federation could not borrow any more before the resolution of the Soviet debt problem. This vicious circle made the whole situation relating to the external financing of Russian reforms very difficult.

Another problem was that the Russian economy proved to be heavily exposed to fluctuations in the price of oil. 'Her majesty, the oil price' dictated the course of the most important events in Russia's history of the last four decades, since the large Siberian stocks of oil were opened for exploitation. Figure I.1 depicts the dynamic of the real oil price for the thirty-year period 1979–2008. The price jump at the beginning of the 1980s ensured large export revenues but weakened the Soviet rulers' incentives to make reforms. The first attempts to modernize the socialist system were initiated by Mikhail Gorbachev after the dramatic drop in the oil price in 1986 which turned out to be strong enough to cause the Soviet economy to fall first into crisis and then to collapse. The attempt to introduce semi-market reforms was in fact a 'false start', but the Soviet Union received huge volumes of foreign credits, as a seemingly upward price reversal manifested in 1989–90 (as seen in Figure I.1). But when the true market reforms started in 1992, the oil price began to fall again. A period of radical market transformations in the period 1992–99 thus coincided with a period of very low oil prices. Its drop fostered the initiation of radical reforms in Russia but at the same time made it very difficult to implement these reforms. As seen from Figure I.1, the minimal level of the oil price was reached in 1998,

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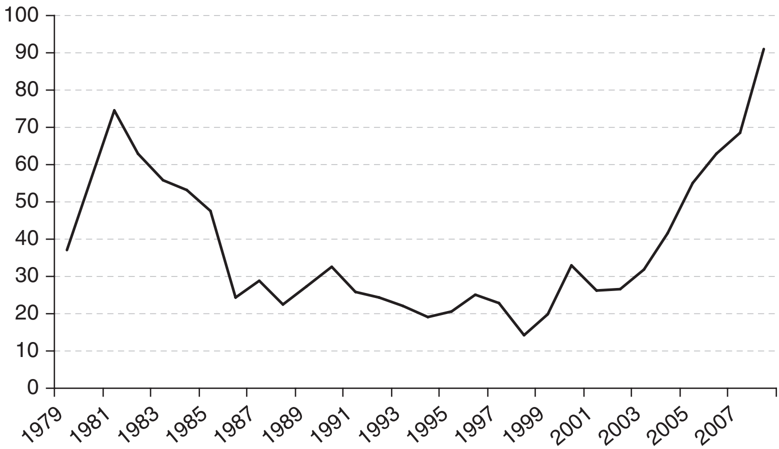

Figure I.1 The real oil price, 1979–2008 ($/barrel)
Source: The Federal Reserve System, the International Energy Agency.

a year of the Russian financial collapse that had a shocking effect on the global financial system.

Although the Russian government agreed to assume the debt obligations of the Soviet Union in 1992, it was able to reduce the debt burden temporarily as a result of its negotiations with the clubs of foreign creditors and G7 governments. Russia received a seven-year breathing space to bring about its capitalist revolution. This book contains a participant's personal view, with hindsight, of the political and economic processes in Russia that, being coupled with very unfavourable oil price movements during that period, led this revolution to the financial crisis and a new debt default in 1998.

This book focuses on the problems and obstacles to the reform of the Russian economy with a special emphasis on state debt policy. This was the field of my personal activity as a member of the first and second cabinets that implemented radical reforms. When the state debt policy was designed initially, my colleagues and I shared the optimism that the debt burden would be eroded by economic growth that would be generated sooner or later by the market economy. We overemphasized the word 'sooner' and underestimated the difficulties that Russia would have faced in the transition to the market economy. One could not foresee the size of the forthcoming economic decline in the 1990s that was devastating for the Russian economy.[1]

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It was completely disorganized at the very beginning of market reforms, and, as I have mentioned, the main task of the reforming team was to prevent a catastrophe, rather than to transform deliberately the economy into a well-designed model. Of course, a programme of reforms had been prepared according to the standard logic of economic liberalizations and approved by international experts. But the programme could not envisage all the scenarios of transition and, in particular, it ignored a number of important features that were specific to the Russian economy. There was no theory of the transition to the market applicable to any country (since there was no reason to elaborate such a theory earlier). The experience of East European countries, on which the Russian reformers placed too much initial reliance, turned out to be not particularly useful. For reasons that I will discuss in this book, the economic transformation in Russia differed drastically from any earlier experience of other countries.

It had often happened in Russian history that policy measures designed initially as benevolent, turned out to have unforeseen consequences. The post-communist reforms were a good illustration of this regularity, and reformers in Russia faced an immense gap between desires and possibilities. They could not prevent, for example, huge budget deficits and persistent three-digit annual inflation, the widespread non-payment crisis, the chronic fiscal crisis, a huge polarization of incomes and horrifying poverty, and the rise of extremely sharp social problems. The market economy institutions developed slowly, while important structural reforms were incomplete and inconsistent or delayed indefinitely. The economy suffered from a lack of transparency in nearly every sphere, and this made it difficult to attract foreign investment in the production sector. The rule of law, respect for ownership rights, the creation of a good investment climate, and the building of a trustworthy reputation by the state, remained empty slogans that were used for political demagogy and manipulations.

One crucial difference is that Russia had experienced the planned economy for a much longer time and in greater depth than the East European post-communist countries. Three generations of Russians did not know about the market economy, while people familiar with capitalism were still alive in Poland, Hungary, the Czech Republic and other countries, where old traditions of individual activity and responsibility had not been forgotten completely. Even though the Russians were unaware of capitalism, many of them were enthusiastic about new opportunities for self-actualization and enrichment that appeared as

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the reforms began. Unfortunately, very soon these hopes turned out to be vain for the majority of people that could not find their place in the new environment and reach success. But their failure to adapt to emerging markets was not their fault because this environment was very chaotic.

In my opinion, the unintentional results of Russia's market transition were caused not by people's mentality, but rather by the burdensome legacy from the Soviet era. The Russian economy inherited a huge monetary overhang, implying that the economic liberalization had to begin from a tremendous inflation outburst. This was a shock for both domestic producers and households. The inherited economic structure was inefficient – due to arbitrary administrative decisions adopted previously in the command economy – and needed to be transformed dramatically. But the costs to the Russian economy of such structural adjustments were extremely high. On the one hand, the majority of domestic producers were used to the paternalism of the state and could not survive in the market – their cost structures were just not viable. On the other hand, the state could not permit the majority of enterprises be closed at one instant.[2] It would be hardly possible to build a new economy on ruins of the old one in the absence of new investment and knowledge. An acceptable strategy was therefore to search for compromises that were, of course, in conflict with the radical approach that the reformers had initially tried to implement.

Thus, the Russian government was trying to pursue conflicting goals and, at the same time, was faced by severe political constraints. The most serious problem was that the state had to maintain its social expenditures and obligations which were too high for an economy in deep distress. In relative terms these obligations were similar to those typical for the developed European economies. The state also continued to support inefficient production enterprises. The burdensome Soviet legacy, the unfavourable terms of trade, and the excess state obligations made inevitable huge budget deficits and emission of money or debt.

As is made clear by from the title of this book, the public debt policy of Russia in the 1990s is the main theme of our analysis. I try to understand the dualistic features of the debt in the Russian transition. Even though the external Soviet debt was a burden for the economy, its assumption furthered the integration of Russia into the global financial system. As a result of the resolution of the debt problem, Russia received sovereign ratings in 1996 and entered the Eurobond market. The external debt that Russia committed to service and pay back was a discipline

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device for economic policy making at home. The Russian financial system was dependent on external debt, but this circumstance deterred pro-inflationary political forces and compensated for the lack of political support to market reforms. In particular, the International Monetary Fund had some political influence on domestic financial policy and thereby contributed to the macroeconomic stabilization of 1995–96.

This stabilization was a hard-won victory because inflation was reduced at the cost of creating a whole set of new macroeconomic and financial risks. The monetization of budget deficits that had been the policy of 'choice' was replaced by domestic debt issues which were ruble-denominated, short-term, and high-yield. This kind of stabilization was a compromise solution justified by the absence of any other scheme to combat inflation, by the lack of credibility of state policy, and by the chronic fiscal crisis. There was also some optimism that somehow growth would accelerate enough so that the debt dynamics would not worsen (a sufficiently optimistic scenario always exists to justify any policy *ex ante*). The growth in domestic debt, however, created additional refinancing risks and increased the threat of a budget crisis in the near term as a result of the high costs of debt service. In contrast to the external debt which was managed in cooperation with the international financial organizations, the domestic debt was under the full discretion of national authorities and was therefore a source of many risks.

On the one hand, the opening up of the domestic debt market was a breakthrough in the organization of securities exchange in Russia. It contributed to the emergence and development of domestic financial markets on a modern basis. The Russian Ministry of Finance that took control of this process was the main generator of financial development during that period. On the other hand, an opportunity to cover budget deficits by borrowing in rubles had perverse effects on the incentives of policy makers. Domestic debt was viewed as an unlimited and easy source of funds for the state budget, and the problem of a sustained budget deficit seemed to be solved easily. This political myopia manifested itself sharply during the second presidential election campaign in 1996 when the domestic debt was used to finance additional large-scale expenditures of the state budget.

A comprehensive fiscal reform was delayed, although, in my view, it could hardly have been implemented during the 1990s. The obstacles to such reform were fundamental, and this was a deep-rooted problem which was also a consequence of the Soviet legacy. The government formally abolished subsidies to privatized production enterprises but continued to support them implicitly. As a result, the government

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was heavily involved in the economy-wide non-payment crisis, and a significant part of the state's financial flows relied increasingly on barter schemes and monetary surrogates. This was the most essential feature of the Russian fiscal crisis that the authorities could not deal with.

The risks of domestic debt proliferation were aggravated after the opening of the domestic debt market for non-residents in 1996. This was a good idea in principle, but its realization essentially neglected the fragility of the domestic financial system. Financial liberalization prompted hot money inflows that made it urgent to improve risk management by the state. On the contrary, the ruble exchange rate regime and the scheme of hedging of non-residents' ruble holdings introduced by the Russian Central Bank led to outrageous currency risk mismanagement. The extreme weakness of the Russian banking system was another fundamental factor of Russia's financial fragility. Domestic financial markets could not eliminate or diversify away the excess financial risks. Though the Russian government entered the Eurobond market in 1996, it did not manage to rationalize its public debt structure. The authorities misused the new opportunities opened by financial liberalization and only aggravated all kinds of financial risks. The financial crisis of 1998 with its sharp ruble devaluation and the default on domestic debt was the culminating point of this reckless policy.

A large part of this book is devoted to a description of the Russian financial crisis. I consider this to be a cornerstone event in recent Russian history which resulted from many previous mistakes and omissions and which has had a major impact on the subsequent economic and political development of the country. The genesis of this crisis is traced back to the previous Soviet debt default, and then through the period of market transformation in 1992–97. I pay special attention to the fundamental factors that the Russian authorities could have had very little impact on even if they had acted prudently in all circumstances. I also emphasize the key policy mistakes, first of all, the lack of risk management and debt management, and the failures of monetary policy.[3]

The Russian capitalist revolution began with the radical economic liberalization in January 1992 and was finished with the radical resolution of the financial crisis in August 1998. Was this attempt to build Russian capitalism in several years a failure? I think not. The Great French Revolution of 1789–94 was in my view not a failure, although it flooded France with blood and eventually brought Napoleon Bonaparte to power. Even more so, the Russian capitalist revolution was not a failure. Russia avoided a civil war and the blood that would be associated with

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it, as a possible scenario in the early 1990s. The government of reformers prevented famine and social cataclysms that were very well familiar to Russia in its previous history of the twentieth century.

The economic transformations that were very hard to implement in Russia and that were indeed several times on the brink of failure, ultimately bore fruit. It turned out that after the crisis of 1998 Russian people were living in a country that was quite different to the one it had been a decade earlier. The market economy has been created, and as a result of this Russia experienced spectacular economic growth in the period 2000–08. Of course, it was driven by even more spectacular oil price growth, but even this type of quasi-exogenous economic growth would have been impossible in the command economy. This was the first occasion, after many decades of dominating economic absurdity, that market forces had been in action and benefited the majority of the population. Most important is that Russia today has a perspective of further development which the communist system did not have in principle.

The civilized solution of the external debt problem in the 1990s stimulated the economic integration of Russia with the developed world. Many new developments occurred, including the creation of a legal basis for markets, the market economy infrastructure and institutions, the modern systems of learning for professional market participants. All of these building blocks of the modern market economy demonstrated the ability to work and develop after the crisis.

It is worth noting that in the 1990s economic policy making was a much harder task than it is today. The problems that policy makers faced in the 1990s were, in my view, much more difficult than those to be encountered today, even despite the global crisis that is seriously affecting the Russian economy. If, for example, the oil price was $25 per barrel in the first half of 1998 instead of $10 per barrel, Russia could, most likely, have avoided default. If, on the contrary, the oil price had fallen in 2008 to $25 per barrel, it would be a catastrophe for the Russian economy and financial system despite tremendous financial reserves accumulated by the state in the current decade.[4] Financial management in the low-oil-price regime required much greater effort, professionalism, smarts, and enthusiasm of policy makers than is required when oil prices are very high. The current generation of policy makers has been spoiled by such prices and firmly shielded from the bad surprises by the huge financial reserves of the state. I am not sure that under tougher circumstances this generation would be able to act as selflessly as our generation did.

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The book attempts to make this experience comprehensible, being based on both a description of recent Russian history and some personal reminiscences about the transition to the market. Nevertheless, it is neither a historical book, nor a political memoir; rather, it is an attempt to provide an assessment of economic policy in hindsight. I have tried to make such an assessment both from the view of an insider – a policy maker involved in making macroeconomic policy – and from the view of an outside observer of the course of events. During the historical period described in this book I occupied both roles. I was an insider during the 'breakthrough period' of the capitalist revolution 1992–97 and became an outsider a year before the financial crisis of 1998.

Needless to say, there is no shortage of studies of this crisis, so the question may be asked: why is another one needed? Many of these studies were completed just after the 1998 default and thus lack some historical perspective. Moreover, many of these studies are most focused on casting blame. This book, on the other hand, offers a more comprehensive picture with the advantage of perspective gained from the decade since the crisis. And rather than search for who to blame, this book focuses on the key aspect of debt management as the central theme to understanding the crisis. The grim decennial anniversary of 2008 provided another reason to write this book, as the deterioration of understanding of the real causes of Russian crisis demonstrated by both domestic and international public became apparent.

The book is structured as follows. Chapter 1 provides an account of external debt management in Russia in the 1990s which created a basis for integration into the world economy. Chapter 2 examines the interaction of the newly established financial markets and banking system, and also the link to the inflation-taming policy. Chapter 3 characterizes the specific concept of the virtual economy in the application to the problem of budget arrears and, more broadly, to the problem of the chronic fiscal crisis. Chapter 4 presents a road map to understand the development of public debt management in Russia. Chapter 5 contains a thorough account of the causes of the devastating Russian financial crisis of 1998. Next, Chapter 6 provides a description of how the crisis actually unfolded, and Chapter 7 explains how Russia recovered from the consequences of the crisis. Finally, Chapter 8 compares the situation and development in Russia during the current world crisis with the responses to the previous crisis.

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