

# NAVAL POSTGRADUATE SCHOOL Monterey, California



## THESIS

**REFORMING A NATION: IMPLICATIONS OF IMF  
CONDITIONALITY ON RUSSIA**

by

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June 2003

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**REFORMING A NATION: IMPLICATIONS OF IMF CONDITIONALITY ON  
RUSSIA**

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Submitted in partial fulfillment of the  
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## **ABSTRACT**

Since the end of the cold war and the transition from a centrally-planned to market-oriented economic system, the Russian economy has undergone a staggering and incomplete economic transformation. International financial and technical assistance played a significant role in the evolution of the Russian economy. As the International Monetary Fund (IMF) took a central role in the Russian transition process through the provision of technical and, more importantly, financial assistance, it was able to attach significant conditions to the use of its funds. These conditions ranged from the reform of markets, government revenues and expenditures, to the role of the public sector in the emerging market economy. An unanswered and increasingly important question is whether IMF conditionality has promoted or hindered economic reform and more importantly economic performance. This thesis argues that IMF conditionality combined with mistakes by the Russian government created the 1998 financial crisis.

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Figure 1. IMF / Russia Cartoon.

“Boris Yeltsin calling. They’re having a telethon to keep Russia from returning to communism.”

-Boston, Thursday, June 25, 1998.

<http://www.csmonitor.com/durable/1998/06/25/fp11s3-csm.htm> (August 20, 2002).

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## I. INTRODUCTION

In 1991, the Russian Federation set out to transform its centrally planned economy to a market based economy. The transition, however, has not been a smooth or orderly process, with Russia experiencing significant declines in output, employment, and financial stability.<sup>1</sup> In August 1998, Russia experienced a major economic and financial crisis that cast doubt on the transition process and on the prospects of the Russian economy.<sup>2</sup> In this thesis we examine the period leading up to August 1998 to identify factors that may have contributed to the crisis. To answer the question of responsibility, we focus on the policies of the Russian government; the role and recommendations of the International Monetary Fund (IMF); and the impact of the combined policies on the Russian economy.

### A. RESEARCH SCOPE

In this thesis, we examine the Russian government and IMF economic policies preceding and during the crisis of 1998. We argue **a priori** that there is an important link between Russia's transitional economic policies and IMF conditionality and that these policies were unsuccessful in preventing the crisis. Research from leading economists, Russian reports on the crisis, and IMF documentation appear to support this argument. The combined economic policies of the Russian government and the IMF may have, in fact, caused the 1998 economic crisis.

Curiously, even though these policies may have contributed to the 1998 crisis, they were continued after the crisis event. The continuation of these policies further weakened Russia's economy leading to the hardships still experienced today. A by-product of these policies may be the increasing dependence of the Russian economy on the export of natural resources and the continued underdevelopment of the Russian industrial and service sector. This thesis provides an understanding of the players involved and the catalysts of the 1998 financial crisis in Russia.

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<sup>1</sup> Thomas E. Graham Jr., "Russia's Decline and Uncertain Recovery," Carnegie Endowment for International Peace (May 2002) [www.ciaonet.org/book/grt01.html](http://www.ciaonet.org/book/grt01.html) (November 3, 2002).

<sup>2</sup> Jorge Martinez-Vazquez and others, "IMF Conditionality and Objections: The Russian Case," International Studies Program Working Paper 00-3 (June 2000): 18.

If, as we argue in this thesis, domestic economic policies combined with IMF prescriptions to act as a catalyst for the 1998 crisis, the policy implications are stunning. The transition of the Russian economy may have been swifter and at a lower long-term cost by forgoing IMF financial aid and policy conditionality. One may argue against continued assistance and conditionality to other developing countries based on this finding. On the other hand, there is no explicit linkage between IMF aid and conditionality and the 1998 crisis, then the arguments against the role of the IMF in developing and transitional countries may be misplaced and warrant further evaluation.

## **B. ORGANIZATION OF THE STUDY**

The thesis is organized into five chapters. Chapter II briefly reviews the research on the Russian economy. This section also provides a brief historical background of Russian economic development efforts prior to 1998. Chapter III focuses on IMF programs and conditionality. Chapter IV examines the Russian government's economic and political policies and relationship between the two in the emergence of the 1998 economic crisis. Chapter VI concludes the examination of the economic crisis by revisiting the major arguments of culpability and final analysis of material presented.

## II. REVIEW OF LITERATURE

While the Soviet Union experienced a rapid rate of economic growth following World War II, the inefficiencies of the Soviet economic system began to slow economic growth in the 1970's. By 1980, rampant corruption, inefficiency, and inequality characterized the then stagnant Soviet economy. The collapse of the Soviet political system was soon followed by the dissolution of the Soviet Union and the collapse of the Russian economy. As the Russian government struggled to stem the economic collapse, the International Monetary Fund assumed the role of direct provider of financial aid and technical assistance.<sup>3</sup> From the start, relations between the Russian government and the IMF were nothing but contentious. The unanswered question is whether the policies of the IMF and the Russian government contributed in a significant manner to the 1998 financial crisis.

The objective of this chapter is to provide a review of the economic literature of the period preceding the Russian economic crisis of 1998. This thesis initially reviews the Russian economic development literature focusing on the economic environment of the 1980s and 1990s. We then present a brief background of the Russian economic situation prior to 1998 discussing the government's economic policies leading to the crisis, and the policies of the IMF. We conclude by providing the basis for the following chapters, which will discuss whether the conditions required by the IMF and agreed to by the Russian government played a significant role in the 1998 economic crisis.

The collapse of the Soviet Union caused economic and political turmoil around the world. Many researchers have argued that IMF financial and technical assistance created the 1998 financial crisis while others note the influences of the global economic environment and Russian policy. This section synthesizes the debate over International Monetary Fund assistance to the Russian Federation. This chapter provides the foundation for an in-depth look at the impact of IMF assistance and conditionality in subsequent chapters. In the following sections, I discuss the timeline of the crisis.

## A. TRANSITION PHASES

### 1. Pre-Transition

To understand the state of the Russian economy in 1998, I must first discuss the evolution of the Soviet economy over time. The legacy of the decisions made in the pre-transition period influenced the policy choices of the Russian Government prior to and during the 1998 crisis. In this section, I examine the history of the Russian government beginning with the Soviet Union in the 1920's; the economic policies of the Soviet Union up to the initial transition period in the late eighties; and the transition process through the pre-crisis period leading to the 1998 economic crisis.

The Soviet Union pursued several different development strategies over the course of its existence. At the time of the Revolution in 1917, the Soviet Union was largely an agricultural society with little technology and a large illiterate population. The Bolsheviks set out to modernize the state through large-scale industrialization under the guise of socialism. By 1961, with the launching of the first man into space, the Soviet Union had been largely transformed into a modern industrial state.

By the mid-1920's, the Soviet Union was growing, but debates began to arise on how to maintain the growth. Government officials believed a shift of economic policy was needed. Joseph Stalin proposed the first Five-Year Plan in 1928 to industrialize the U.S.S.R. in the shortest possible time while simultaneously making the USSR self-sufficient by emphasizing heavy industry at the expense of consumer goods. The plan set out to increase industrial production, and standards of living within five years.<sup>4</sup> Soon after implementation, a lack of funding needed to meet the goals of the five-year plan resulted in its failure.

In the 1930's, the government launched the second five-year plan, which expanded the first. This program was designed to overcome the deficiencies of the previous five-year plan, but replaced agriculture with an increased emphasis on industry and oil production. Before the plan was fully realized, a new government structure was

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<sup>3</sup> The IMF was, by no means, the only provider of technical and financial assistance to the Government of the Russian Federation. We argue, however, that the IMF had the greatest resources to offer and thus warranted a significant share of the attention that the Russian Government paid to these organizations.

<sup>4</sup> Eugene Zaleski, Planning for Economic Growth in the Soviet Union, 1918-1932 (Chapel Hill: University of North Carolina Press, 1971) 75.

to be implemented: Stalinism. Stalinism revolutionized the Soviet Union by using coercion to achieve the rapid industrialization lacking from the initial five-year plans. Throughout the forties and into the early fifties, the Soviet Union introduced three more economic plans. The fourth (1946–50) and the fifth (1951–55) five year plans had little impact on growth or productivity within the Soviet Union due largely to the lack of full implementation and social acceptance.

The death of Stalin in 1953 ushered in a new era in Soviet history. Soviet citizens began to gain a greater degree of personal freedom and civil security; and this helped boost the Soviet economy.<sup>5</sup> Again new economic plans were introduced to stimulate the economy. The sixth plan (1956–60) was discarded in 1957, primarily because it overcommitted available resources and could not be fulfilled. It was replaced by a Seven-Year Plan (1959–65), which was to increase agricultural production, but also failed. The Seven-Year Plan was considered the start of a longer period devoted to the establishment of the material and technical basis of a Communist society.<sup>6</sup>

During the 1970's, the Soviet Union saw an economic boom with the increased spending to support the Cold War.

From almost every point of view, economically and militarily, in absolute and in relative terms, the USSR under Brezhnev was much more powerful than it had been under Stalin.<sup>7</sup>

Brezhnev believed that eventually, the West would experience a revolution and would ask for assistance from the socialist government. Soviet military strength ranked as a top priority for Brezhnev and dominated the economy of the Soviet Union. During his leadership industrial production increased steadily but not as rapidly as Brezhnev would have desired. To make up for a growing deficiency of technology, a number of major contracts were signed with Western firms to build factories and stores in the Soviet Union. Following the initiation of outside investments, world oil prices rose dramatically

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5 Gur Ofer, Soviet Economic Growth: 1928-1985 (RAND/UCLA: Center for the Study of Soviet International Behavior, May 1998) 12-16, 40-43.

6 Gur Ofer, Soviet Economic Growth: 1928-1985 (RAND/UCLA Center for the Study of Soviet International Behavior, May 1998) 46-52.

7 Adam Bruno Ulam, Dangerous Relations: The Soviet Union in World Politics, 1970-1982 (New York: Oxford University Press, 1983) 39.

in 1973-1974 further assisting development of the Soviet economy. Unfortunately government corruption, inefficiency, and a rededication of funds towards military development, caused the economy to suffer.<sup>8</sup>

In 1985 when Mikhail Gorbachev came to power, the country was in a situation of severe stagnation, with deep economic and political problems. Recognizing this, Gorbachev introduced a two-tiered policy of reform under the thirteenth five-year plan. On one level, he initiated a policy of glasnost<sup>9</sup>, while on the other level; he began a program of economic reform known as perestroika.<sup>10</sup> With the plans of reform, he tried breathing new life into the stagnant Soviet system.<sup>11</sup> There were, however, not enough funds though for training, equipment, research and development, or to keep the government operating, or to keep the citizens happy. Gorbachev's vision was to see the Soviet Union enter into the world economy with a hard currency, a strong economic base, and a limited market economy. He sought to achieve these goals through his policies both at home and abroad. All of these policies however, can be summed up in Gorbachev's 'New Thinking', which spread its influence throughout the Soviet Union, Soviet satellites, and the rest of the world. This 'New Thinking' offered an entirely new attitude to Leninism-Marxism and all the policies upon which the Soviet Union had existed since the Revolution of 1917. Gorbachev introduced his new policies at the United Nations in December of 1988:

...Human interests take precedence over the interests of any particular class; the world is becoming increasingly interdependent.<sup>12</sup>

With his plan, he began the transition process of the Soviet Union. In his June 26, 1987 plenum report, Gorbachev stated:

...The radical reform of the system of economic management is not a single act but a process for whose completion a certain amount of time

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<sup>8</sup> Christopher D. Barth "The Decline and Death of the Soviet Union: 1970's Détente through the Present," Writings (December 1991) [www.articwind.com/writings/sovunion.shtml](http://www.articwind.com/writings/sovunion.shtml) (January 21, 2003).

<sup>9</sup> policy of open government.

<sup>10</sup> reform of the economic and political system.

<sup>11</sup> Robert L. Kellogg, "Modeling Soviet Modernization: An Economy in Transition," Soviet Economy 4, 1. (1988): 37.

<sup>12</sup> Mikhail Gorbachev Speech to United Nations. December 1988.

will be needed...we must enter the 13<sup>th</sup> five-year plan with a new economic mechanism, although its development will continue even in the following five-year plan.<sup>13</sup>

All of these changes required funding which was not available since growth had virtually ceased in the Soviet Union.<sup>14</sup> It soon became apparent that transforming the socialist economy would be a formidable task due to a slow transition and limited economic and industrial resources necessary for such a transition.

The government needed growth to quell the discontent of the Soviet population. The new economic and political openness created even greater economic inefficiency due to the double direction that these policies went. Some segments of the economy were freed; namely wages, while other segments of the economy were still being planned or regulated; namely prices.<sup>15</sup>

During the late 1980's, the Soviet Union began to implode due to a weak economy that could not produce enough food and consumer goods. Perestroika failed as a policy of economic restructuring and glasnost served to highlight this and other failures.

...The result of these incremental changes was to expose the vaunted stability of the communist regime for what it was; an artificial rigidity imposed from above and devoid of internal supports. What had been created by force could only be sustained by force; the price was national rigor mortis.<sup>16</sup>

The disintegration of the Soviet Union began in the non-Russian areas on the periphery. Mass, organized dissent first appeared in the Baltic region, where, in 1987, the government of Estonia demanded autonomy. Lithuania and Latvia, the other two Baltic republics soon followed with similar demands for autonomy. The nationalist movements in the Baltics constituted a strong challenge to Gorbachev's policy of glasnost.

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13 Pravda, second edition (June 26, 1987): 5-6.

14 Donald Filtzer, "Soviet Workers and the Collapse of Perestroika: The Soviet Labour Process and Gorbachev's Reforms, 1985-1991," Journal of European Studies (December 1995): 447-449.

15 Kent Osband, "Economic Crisis in a Shortage Economy," Journal of Political Economy Vol. 100, 4 (1992): 673 - 690.

16 Christopher D. Barth, "The Decline and Death of the Soviet Union: 1970's Détente through the Present," Writings (December 1991) [www.articwind.com/writings/sovunion.shtml](http://www.articwind.com/writings/sovunion.shtml). (January 21, 2003).

...The political crisis has two principal aspects; a vertical conflict within the Communist Party between conservative and democratic elements and a horizontal conflict between the central government and the governments of the union's 15 constituent republics.<sup>17</sup>

Gorbachev did not want to crack down too severely on the participants in these movements; yet at the same time, it became increasingly evident that allowing them to run their course would spell disaster for the Soviet Union. It was feared that tolerating these demands would lead to the collapse of the Soviet Union, as other periphery republics would follow the Baltics in demanding autonomy.<sup>18</sup>

As the economy continued to decline, greater political discontent and fractionalization within and outside of the Soviet government occurred. The discontent induced an even more dichotomous policy: trying to free the economy more and at the same time controlling it more. The Soviet economy continued to suffer from the command system. Finally the sinking economy produced enough discontent that the political system broke down.<sup>19</sup>

Gorbachev's primary miscalculation was his quick transformation of the centralized economy. The transformation began without having the market system to replace it. In mid 1989 politicians claimed they could bring the benefits of reform to the people faster and thereby gained great support among the people, signaling the downfall of the central government. The individual republics then no longer had any need to follow directives and orders from the central government in Moscow.<sup>20</sup>

The economy in the Soviet Union, hobbled by corruption, inefficiency, and the lack of free markets, finally collapsed June 1990. With the collapse of both the political and economic systems, the Soviet Union merely ceased to be and in its place arose Russia

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17 Christopher D. Barth, "The Decline and Death of the Soviet Union: 1970's Détente through the Present," *Writings* (December 1991) [www.articwind.com/writings/sovunion.shtml](http://www.articwind.com/writings/sovunion.shtml) (January 21, 2003).

18 [www.bartleby.com/65/un/UnionSov.html](http://www.bartleby.com/65/un/UnionSov.html) (May 2, 2003).

19 Brigitte Granville and Peter Oppenheimer, *Russia's Post-Communist Economy* (New York, NY: Oxford University Press, 2001) 25-34.

20 Alan Smith, *Challenges for Russian Economic Reform*. (The Royal Institute of International Affairs. Washington, D.C., Brookings Institution, 1995) 33-37.

and the other newly independent states. Massive demonstrations in Moscow in August 1991 over an attempted coup by hardliners were witness to the demise of the Soviet Union.<sup>21</sup>

On December 25, 1991, Mikhail Gorbachev resigned and was succeeded by Boris Yeltsin. Replacing the former Soviet Union was the “Commonwealth of Independent Republics,” and was composed of most of the independent countries of the former Soviet Union. While the member countries had complete political independence, they were linked to other Commonwealth countries by economic, and, in some cases, military ties. Mikhail Gorbachev, instead of invigorating the Soviet Union, by removing the rigid controls that had kept the system together for decades, brought about its dissolution. His actions led to the end of the cold war between East and West, the sudden decline of the Soviet empire, and the virtual elimination of communism as a dominant influence in world affairs.

When the Soviet Union, with its centralized political and economic system, ceased to exist, the fifteen newly formed independent countries, which emerged in the aftermath were faced with overwhelming tasks. They had to develop economies, and reorganize their political systems to ensure stability and success as independent states. Despite its many problems, Russia took bold steps were being taken toward democratization, reorganization, and rebuilding.

What Gorbachev conceived as a social revolution to democratize socialism, empower the Soviet public, and improve the overall quality of life for Soviet citizens became instead a capitalist revolution, orchestrated by party-state officials to enrich themselves as a new elite under the ideals of a free market<sup>22</sup>. Kellogg claims that while Gorbachev intended the reforms to strengthen the base of public support for a rejuvenated Soviet Union, but party-state officials promoted the demise of the Soviet Union as an immediate priority to realize their own personal and material goals.<sup>23</sup>

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21 Nigel Gould-Davies and Ngaire Woods, “Russia and IMF,” *International Affairs* 75,I, 1999: 4.

22 Brigitte Granville and Peter Oppenheimer, *Russia’s Post-Communist Economy* (New York, NY: Oxford University Press, 2001) 28-35.

23 Robert L. Kellogg, “Modeling Soviet: An Economy in Transition,” *Market Economy* 4, 1, 1998: 55.

The problem with the Russian economy was stagnation. The economy had not been made sufficient progress toward the market system. While some parts were close to being market based, others were centrally controlled; a mixture that merely created chaos. Russian companies, especially those in the core manufacturing sectors, tried to protect their investments against the failing economy by transferring capital out of the country.<sup>24</sup> What resulted was a new type of economic system with its own rules of behavior and criteria for success and failure.<sup>25</sup>

## 2. Initial Transition

Following the Gorbachev era, Boris Yeltsin came to office promising economic reform. In a speech to the Fifth Congress of Russian Soviet Federal Socialist Republic (RSFSR) People's Deputies on October 28, 1991 he stated that economic reform would now begin for real by taking on the crucial aspect of price liberalization: "economic reform proposals which leave out price liberalization are so much empty talk."<sup>26</sup> Yeltsin planned to shake up Russia. The painful reform policies he proposed aimed at rebuilding the economy starting with the basic standards of living and working up.

In order to accomplish this, the first step was to rewrite the Soviet Constitution, which was drafted in 1977 under Brezhnev and based on the ideals of "all power to the Soviets." With a new constitution, Yeltsin could establish new rules and laws to support the recovery and strengthening of Russia.<sup>27</sup> The Fourth Congress, however, denied the revisions to the constitution forcing Yeltsin to request special decree powers in March 1993 for one year to jump start economic reform.<sup>28</sup> Again the congress denied his request. The congressional chairman Ruslan Khasbolatov, who declared that the people must be protected from mistaken reforms, led the coalition against the reforms. Yeltsin's

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<sup>24</sup> A. Abalkin and J. Whalley, ed., "The Problem of Capital Flight from Russia," Centre for the Study of International Economic Relations (Oxford: Blackwell Publishers, 1999).

<sup>25</sup> Brigitte Granville and Peter Oppenheimer, Russia's Post-Communist Economy (New York, NY: Oxford University Press, 2001) 63-75.

<sup>26</sup> Boris Yeltsin speech to the Fifth Congress of Russian Soviet Federal Socialist Republic (RSFSR) People's Deputies on October 28, 1991.

<sup>27</sup> Brigitte Granville and Peter Oppenheimer, Russia's Post-Communist Economy (New York, NY: Oxford University Press, 2001) 25-29.

<sup>28</sup> [www.departments.bucknell.edu/russian/chrono4.html](http://www.departments.bucknell.edu/russian/chrono4.html) (December 21, 2002).

response was to use the new freedom of the people to incite change stating: “let the people decide” the course to take. This step led to a semi-democratic congress being elected.<sup>29</sup>

With the new congress came a new constitution in 1993.<sup>30</sup> While Yeltsin had gained the victory in the passing of a new constitution, it would take several years to gain acceptance. The new constitution laid the groundwork for the recovery of the Russian

### **3. Transition**

In 1991, with the dissolution of the Soviet Union, Russia embarked on a program of drastic reforms to transform its economy to a market system. With the end of communism, the Russian government followed the International Monetary Fund directed policy of “shock therapy”, that is, the liberalization of prices, trade, currency and capital controls.<sup>31</sup> It was believed by the IMF that shock therapy would work for countries transforming to a market economy; the stronger the dose, the more quickly the change to be affected.<sup>32</sup> Faced with economic turmoil, the Russian government requested financial and technical assistance from the International Monetary Fund.<sup>33</sup> In accordance with established IMF policy, the provision of financial aid was tied to a series of policy conditions.

Since 1991, a very small part of the Russian people have benefited from the move to capitalism. Widespread poverty was common due to the partial transformation. Russia became according to Joel C. Moses a “presidential autocracy,”<sup>34</sup> hardly different from the Soviet Communist era. Power was concentrated in the hands of a privileged

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<sup>29</sup> Brigitte Granville and Peter Oppenheimer, Russia’s Post-Communist Economy (New York, NY: Oxford University Press, 2001) 28.

<sup>30</sup> Brigitte Granville and Peter Oppenheimer, Russia’s Post-Communist Economy (New York, NY: Oxford University Press, 2001) 51.

<sup>31</sup> Alexei Izyumov, “IMF in Russia: Who Else Will Crack the Whip?,” Christian Science Monitor Online August 10, 1998: <http://csmweb2.emcweb.com/durable/1998/08/10/p11s1.htm> (March 21, 2003).

<sup>32</sup> Nigel Gould-Davies and Ngaire Woods, “Russia and IMF,” International Affairs 75, I, 1999.

<sup>33</sup> Sergey M Rogoy, “The Russian Crash of 1998,” Center for Naval Analyses 1998: 9

<sup>34</sup> Journal of Economic Literature, vol XXXVI.

elite. The concentration of economic wealth and political power in the hands of a very small number of oligarchs directly resulted from this capitalist revolution.<sup>35</sup>

One of the major steps in the transformation was Boris Yeltsin's privatization law promulgated in July 1992.<sup>36</sup> Under the law, seventy percent of the state controlled enterprises would be privatized within three years. The privatization of state-owned enterprises was riddled with problems. A few elites were able to buy all the industries at a low cost and made huge profit.<sup>37</sup> Joseph Stiglitz, former Vice President of the World Bank describes it as "...the rapid privatization imposed on Moscow by the IMF and the U.S. Treasury had allowed a small group of oligarchs to take control of the country's assets."<sup>38</sup> Joel Hellman of the European Bank better describes the policy for Reconstruction and Development, as "winner takes all."<sup>39</sup>

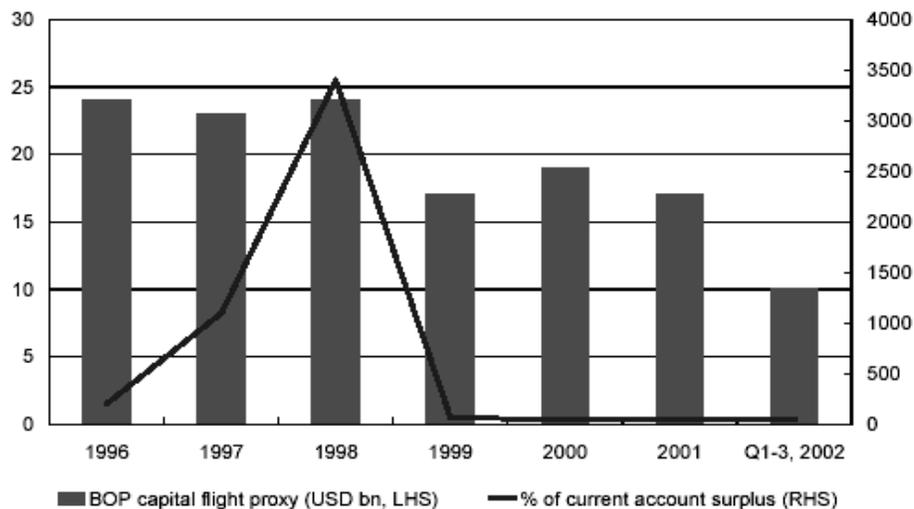


Figure 2. Capital Flight  
 From: Schroder Salomon Smith Barney  
[www.iet.ru/guest/Sundstrom/RussiaCapFlows.pdf](http://www.iet.ru/guest/Sundstrom/RussiaCapFlows.pdf) (May 13, 2003).

35 David M. Kotz and Fred Weir, "Revolution from Above: The Demise of the Soviet System," *Nationalities Papers* Vol. 28, Issue 2 (June 2000): 374.

36 Charles Jr. Wolf, *Economic Transformation and the Changing International Economic Environment* (The Rand Graduate School: Santa Monica, CA, 1993) 41-46.

37 Charles H. Fairbanks Jr., "The Nature of the Beast," *The National Interest* Spring 1993, Number 31: 54.

38 Joseph Stiglitz, "What I Learned at the World Economic Crisis," *The Insider* April, 6, 2000.

39 J. Hellman, "Winners Take All: The Politics of Partial Reform in Post-communist Nations," *World Politics* vol. 50, No.2: 203-234.

The profits in turn were transferred out of the country leaving the economy and state with nothing. This exodus of capital further weakened the already struggling economy.<sup>40</sup> Additionally the gap between classes increased, resulting in a small elite and majority poor with almost no middle class.<sup>41</sup> Widely acknowledged as an abysmal failure, Russia's privatization increased corruption, crime, and inequality. "...Russia suffers not from too free a market, but from corruption...Russia's tragedy is that reformers never had enough power to overrule these avaricious interests."<sup>42</sup>

Even with these problems, by 1996, the structure of Russian economy had shifted to the point that it more closely resembled that of a market economy than the previous socialist economy of the former Soviet Union. With the decline in demand for defense goods, industry shifted its resources from heavy industry to consumer goods.

Clifford S. Poirot, Jr. suggests the reforms that were implemented were largely cosmetic and were often undermined by "the proliferation of new financial institutions and instruments."<sup>43</sup> This was proved by the low quality of much of the goods manufactured in Russia. Counter to Poirot's argument, Aslund states the Russian government made attempts to slow the financial decline. The Russian government implemented price and exchange rate liberalization instituted a central bank and held democratic elections. While these were positive steps, problems within the government led to implementation of improper financial policies prior to and during to the economic crisis of August of 1998. It is possible the crisis may have been contained or avoided if the situation had been handled differently.<sup>44</sup>

Anders Aslund offers another cause to Russia's crisis. His argument is counter to the "shock therapy" theory and instead offers the explanation that reforms were too slow

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40 Terry Sicular, "Capital Flight and Foreign Investment: Two Tales from China and Russia," Blackwell Publishers, 1998.

41 Shahrukh Rafi Khan, *Do World Bank and IMF Policies Work?* (Palgrave Publishers, New York, NY: 1999) 24.

42 Anders Aslund, "Russia's Collapse," *Foreign Affairs* September/October 1999.

43 Clifford S. Poirot Jr., "Financial integration under conditions of chaotic hysteresis: The Russian financial crisis of 1998," *Journal of Post Keynesian Economics* Vol 23, issue 3, (Spring 2002): 7.

44 Anders Aslund. "Russia's Collapse," *Foreign Affairs* September/October 1999.

and incomplete. He does agree though that there was a problem with corruption in the government, which contributed to the slow, incomplete transition and eventually the economic crisis of 1998.<sup>45</sup>

#### 4. Pre-Crisis

Several authors and economists offer explanations to the causes of the 1998 economic crisis. One of the causes of the crisis was the Russian government's failure to address the state's fiscal imbalances. Due to a weak, inefficient, and corrupt tax service, the Russian government was unable to generate sufficient revenue to meet expenditure demands. The continuing process of economic transformation also hindered economic and financial stability. The inevitable result of IMF conditionalities was a dramatic drop in Russia's standard of living and rising unemployment resulting in a weak governmental institution unable to meet the conditions imposed by the IMF.<sup>46</sup>

On February 20, 1997, the Russian government considered a new tax code for the first time. The idea behind the new code was to restore order to the tax system, which was overrun by corruption and tax evasion. The restructuring would simplify the system by reducing the number of taxes from 200 to 30 while simultaneously eliminating loopholes plaguing the system. The estimated loss of revenue from the ineffective tax system was estimated at 160 trillion rubles a year.<sup>47</sup> Granville and Oppenheimer suggest the problems with the Russian tax structure and policies of the government were a result of the government frequently changing regulations and a burdensome system of compliance. More importantly, the existing tax administration was notoriously inefficient; it was significantly larger than the U.S. Internal Revenue Service for a fraction of revenue collected.<sup>48</sup>

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<sup>45</sup> Anders Aslund, "Russia's Collapse," Foreign Affairs September/October 1999.

<sup>46</sup> Henry Kissinger "The IMF: Throwing More Fuel on the World Economic Bonfire," The Washington Post, October 6, 1998: 2 [www.globalpolicy.org/soecon/bwi-wto/kissin.htm](http://www.globalpolicy.org/soecon/bwi-wto/kissin.htm) (April 20, 2003).

<sup>47</sup> Vitaly V. Shlykov. "The Crisis in the Russian Economy," Strategic Studies Institute U.S. Army War College, (1997): 9.

<sup>48</sup> Brigitte Granville and Peter Oppenheimer, Russia's Post-Communist Economy (Oxford University Press, 2001) 149.

Despite the problems that existed during the transition, several economists hoped that Russia would prevail and would make the transition successful. According to the New York Times, 1997 was the best in the whole decade for the Russian economy. For the first time in several years, economic decline ceased and small growth actually occurred.<sup>49</sup> With economic growth, Russia also experienced a decrease in the inflation rate, supporting the hopes for recovery.<sup>50</sup>

## 5. Russian Crisis

The Russian government historically throughout the twentieth century followed a state-controlled economic policy giving market-oriented private enterprise a major role in economic development with limited government intervention. Following the start of the transformation from communism to capitalism, the Russian government began to privatize key industries. While it initially appeared that the government was fully committed to the transition process; it soon became apparent that some in the Russian government wished to retain tight control over the economy. Regulatory and price controls combined with inefficient tax system, limited the extent to which the economy could develop over time by limiting growth and undermining the transformation to capitalism.<sup>51</sup>

The transformation would end in 1998 when Russia found herself facing economic hardship.<sup>52</sup> The most immediate and direct causes were the government's financial imbalances and Russian fiscal policies that made Russia vulnerable to the vagaries of the global financial markets.<sup>53</sup> In May 1998, Russia found itself in the midst of an economic crisis, which came to a head on August 17, 1998. Investor confidence

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<sup>49</sup> Michael R. Gordon. "Oil Price Drop Threatens to Squelch Russia's Economic Rebound," The New York Times March 20, 1998: A5.

<sup>50</sup> Sergey M. Rogoy, "The Russian Crash of 1998," Center for Naval Analyses (1998): 5-10.

<sup>51</sup> Shahrukh Rafi Khan, Do World Bank and IMF Policies Work? (Palgrave Publishers, New York, NY: 1999) 66.

<sup>52</sup> Sergey M. Rogoy, "The Russian Crash of 1998," Center for Naval Analyses (1998): 5-10.

<sup>53</sup> John H.Makin, "Interference with Free Markets Causes Global Crisis," Economic Outlook October 1998.

rapidly declined leading to deterioration in overall economic conditions.<sup>54</sup> The Russian crisis was a result of the Asian financial crisis of 1997/1998. Following on the coattails of Asia, the rest of the world found itself in a global financial crisis created by unease in world financial markets and raising questions about the strength of the international financial system.<sup>55</sup> The crisis hit especially hard in Russia due to its already weak and troubled economy created by the transition throughout much of the 1990's.

## **B. ROLE OF IMF IN THE CRISIS**

While the Russian government's miscalculations and corruption contributed to the economic crisis, the IMF's role in the crisis cannot be discounted. As noted previously in this chapter, the IMF played a central role in the transition before 1998. The IMF provided not only \$11.2 billion in financial assistance but also numerous technical assistance missions and projects in support of the transformation of the Russian government and economy. While there is significant disagreement on whether IMF assistance was beneficial to Russia, there is wide consensus that the IMF played a central role in the Russian economy prior to 1998. One problem was that the IMF had no more experience than any other organization in guiding states from communism to capitalism. Sanders wrote that the conditions in Russia are similar to those in Mexico, Indonesia, Korea, and Thailand.<sup>56</sup>

Bernard Sanders describes the policies imposed on Russia by the IMF as “shock therapy,” essentially a Russian translation of the devastating “structural adjustment.”<sup>57</sup> The IMF mandated Russia cut government spending, sell off public assets, and raise interest rates to attract foreign investment. The IMF policies were overly restrictive in the wrong areas and emphasized rigid fiscal and monetary targets.<sup>58</sup> The IMF did not take

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<sup>54</sup> Sergey M. Rogoy, “The Russian Crash of 1998,” Center for Naval Analyses (1998): 7-10.

<sup>55</sup> Thomas L. Friedman, The Lexus and the Olive Tree (First Anchor Books, April 2000) xii.

<sup>56</sup> Ariel Cohen and Brett D. Schaefer, “The IMF’s \$22.6 Billion Failure in Russia,” The Heritage Foundation. (24 August 1998).

<sup>57</sup> Rep. Bernard Sanders (I) of Vermont is an expert on the subject and has regularly dealt with IMF reform issues in the House.

<sup>58</sup> Clifford S. Poirot Jr., “Financial integration under conditions of chaotic hysteresis: The Russian financial crisis of 1998,” Journal of Post Keynesian Economics, Vol 23; issue 3 (Spring 2002): 7.

into account domestic conditions prior to imposing conditions. These policies had proven to be ineffective in other IMF interventions but were still imposed on Russia leading to disaster.

Illarionov states “The largest financial assistance package in the IMF history has failed in less than a month, international and domestic investors have borne multibillion losses, while Russia has fallen into one of the sharpest and deepest financial, economic and political crisis in history.”<sup>59</sup>



Figure 3. Real GDP 1995-2001

From: <http://www.bof.fi/bofit/fin/6dp/abs/pdf/dp0302.pdf> (May 2, 2003)

Following the transition, Russia's GDP fell 42 percent and industrial production fell 46 percent between 1992 and 1995 having a catastrophic effect on the Russian people and future stability. According to Russian officials, real income plummeted 40 percent since the Soviet Union collapsed in 1991.<sup>60</sup> A quarter of all Russians are living below the subsistence level and nearly one-third live below the poverty level. Three-quarters barely survive on an average income of \$100 per month. The Red Cross calls conditions in Russia “a silent disaster,” reporting “We saw babies who were being fed powdered animal fodder because of lack of baby food.” The average life expectancy for men has declined by seven years, to 59, since 1990. One-quarter of Russia's labor force receives its wages late, in kind, or not at all.<sup>61</sup>

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<sup>59</sup> Andrei Illarionov, “The Roots of the Economic Crisis,” *Journal of Democracy*, Vol. 10, Issue 2, Baltimore (April 1999): 23.

<sup>60</sup> Nigel Gould-Davies and Ngaire Woods, “Russia and the IMF,” *International Affairs* Vol. 75. (1999): 12-13.

<sup>61</sup> Nigel Gould-Davies and Ngaire Woods, “Russia and the IMF,” *International Affairs* Vol. 75. (1999): 11-14.

There is no evidence that IMF intervention does anything to prevent economic crisis in the long run. Instead, as Jeffrey Sachs points out, the IMF's track record indicates that it has become a veritable “Typhoid Mary,” spreading economic austerity and collapse to one country after another. According to Bernard Sanders “if the threat of a spreading global economic collapse is real - and I fear that it is - the evidence of the past year (1997-1998) indicates that current IMF policies are only helping spread the collapse.”<sup>62</sup>

On July 13, 1998 the Managing Director of the International Monetary fund (IMF), Michael Camdessus said, “The IMF team currently in Moscow has reached an agreement with the Government of Russia on a major strengthening of Russian economic programs.”<sup>63</sup> In the agreement between the two, Russia was to receive a 22.6 billion-dollar bailout package to help it deal with its economic crisis. The Russian Government was to submit an economic plan to cope with the crisis, and show that it is being implemented. After four weeks, however, the ruble was devalued and reforms are not likely to be implemented. The Russian Government has failed to comply with the guidelines set by the IMF to receive full disbursement of the 22.6 billion dollars. The first installment of 4.8 billion dollars to Russia did nothing to bail out the mismanaged banking system, nor was it able to prevent the devaluation of the ruble.

Joseph Stiglitz criticizes the IMF stating that it uses the same “cookie cutter” approach with all nations under a four-step program:

- Step One is privatization. Stiglitz said that rather than objecting to the sell-offs of state industries, politicians - use the World Bank's demands to silence local critics.
- After privatization, Step Two is capital market liberalization. In theory this allows investment capital to flow in and out. As in Russia prior to 1998, capital flowed out instead of into the country. Stiglitz calls this the “hot money” cycle. Cash comes in for speculation in real estate and currency, and then flees at the first whiff of trouble. And when that happens, to seduce speculators into returning a nation's own capital funds, the IMF demands these nations raise interest rates to 30 percent, 50 percent and 80

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<sup>62</sup> Bernard Sanders, “More Money to IMF will only make world economic situations worse,” Statement to United States Congress, October 14, 1998. [www.house.gov/bernie/statements/1998-10-14-imf.html](http://www.house.gov/bernie/statements/1998-10-14-imf.html) (December 21, 2002).

<sup>63</sup> “IMF Board to Consider Strengthened Reform Program for Russia,” News Brief No. 98/24, International Monetary Fund (13 July, 1998).

percent. “The result was predictable,” said Stiglitz. Higher interest rates demolish property values, savage industrial production and drain national treasuries.<sup>64</sup>

- Step Three: market-based pricing. This leads, to what Joseph Stiglitz calls “the IMF riot”. The IMF riot is “When a nation is, down and out, [the IMF] squeezes the last drop of blood out of them. They turn up the heat until; finally, the whole cauldron blows up.” According to Bernard Sanders “The IMF riots cause new flights of capital and government bankruptcies this economic arson has its bright side - for foreigners, who can then pick off remaining assets at fire sale prices.”<sup>65</sup>
- Step Four: free trade. This is free trade with conditions. Joseph Stiglitz has two concerns about the IMF. First, he says, because the plans are devised in secrecy and driven by an absolutist ideology, never open for discourse or dissent, they “undermine democracy”. Second, they don't work.

Under the guiding hand of IMF structural assistance, Africa's income dropped by 23 percent. Did any nation avoid this fate? Yes, said Joseph Stiglitz, Botswana. “They told the IMF to go packing.” Hallinan criticizes the IMF and their assistance by stating, “...no one should be surprised by any of this. The IMF’s track record is one of unalloyed disaster. It was the IMF that helped bankrupt Russia.”<sup>66</sup>

The IMF has been giving money and advice to Russia for over ten years and they have yet to make any progress in creating a stable economy. In most cases there is evidence that seems to indicate that much of the IMF aid has gone to bail out corrupt government officials, bureaucrats, and connected businessmen, while average Russians lost much of their bank deposits. Several Russian Government officials have been quoted as saying that they “swindled” the IMF into giving them more money and stalling on making economic reforms. This leads us to believe that the Russian Government has lied to the IMF and in doing so, hurt the Russian people. Reducing corruption is typically

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<sup>64</sup> Stiglitz, Joseph. “What I Learned at the World Economic Crisis,” The New Republic (April 2000) <http://www.thenewrepublic.com/041700/stiglitz041700.html> (March 10, 2003).

<sup>65</sup> Sanders, Bernard. “More Money to IMF will only make world economic situations worse,” Statement to United States Congress, October 14, 1998, [www.house.gov/bernie/statements/1998-10-14-imf.html](http://www.house.gov/bernie/statements/1998-10-14-imf.html) (December 21, 2002).

<sup>66</sup> Conn Hallinan, “The Global Goodfellas at the IMF,” San Francisco Examiner January 11, 2002: 2.

considered a key element in accelerating economic reform but when the leaders of the government are the ones stealing from the poor and paying the rich, a serious overhaul is needed.<sup>67</sup>

### C. CONCLUSION

Davies and Woods propose three possible positions as to the cause of the crisis: The first position suggested is one of “we lost Russia” or that the West was responsible for the failure of Russia due to lack of assistance. The second view, and probably one of the most accepted outside the IMF, is that outside pressures forced the Russian government to adopt measures ill-suited to the conditions of the country. The last position is that Russia brought about its own demise and that outside intervention did not help and could not have prevented the crisis.<sup>68</sup> These positions will be examined throughout this thesis.

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<sup>67</sup> Betsy McKay, “Small Gains Likely in Russian Debt Plan,” The Wall Street Journal September 1998: A25.

<sup>68</sup> Nigel Gould-Davies and Ngaire Woods, “Russia and the IMF,” International Affairs Vol 75 (1999): 3.

### **III. IMF PERSPECTIVE**

#### **A. INTRODUCTION**

The International Monetary Fund (IMF) was established in 1944 by 44 countries with the primary purpose of promoting international monetary cooperation, exchange rate stability, and the expansion of international trade by acting as a lender of last resort when countries faced economic crisis.<sup>69</sup> The IMF performs an important function in the global economy by attempting to make world trade less strenuous by providing support to nations in all stages of economic progress. In recent years the IMF has been the center of debate regarding its programs, advice and failure to help developing nations. This chapter is divided into two parts. The first section will discuss the role of the IMF, its funding requirements (conditionalities), and the impact they have on developing nations. The second section will examine IMF assistance specifically to Russia and evaluate the crash from the IMF perspective.

The debate over the role of IMF programs in recent economic crises including East Asia, Argentina and Russia have demonstrated the impact of IMF involvement in developing nations. These countries turn to the IMF for financial assistance in times of crisis. In return for the assistance, they must conform to the IMF articles of agreement, which require nations to undertake economic reforms proposed by the IMF.<sup>70</sup> The reforms are designed to ensure quick economic recovery leading to stability and prosperity of the nation.

#### **B. ROLE OF THE IMF**

The international financial system has been radically altered since the 1920's. This change is due in large part to the inception of the International Monetary Fund. This section looks at the creation of the fund and its responsibilities as created by the founders.

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<sup>69</sup> Payer, The Debt Trap – The IMF and the Third World (Monthly Review Press: New York, NY, 1974) 12-14.

<sup>70</sup> Adam Przeworski, and James Raymond Vreeland, "The Effect of IMF Programs on Economic Growth," Journal of Development Economics Volume 62 (2000): 386.

The IMF was conceived during the Great Depression in the 1930's.<sup>71</sup> It was however, another decade before action was taken to officially develop the IMF. In July 1944 at Bretton Woods the IMF was established and began operations in Washington D.C. in May 1946. Under the Bretton Woods agreement, the United States Dollar was tied to gold. This created a universally fixed currency around the world. The IMF was to ensure that the gold exchange standard was being followed as well as being the lender of temporary funds. In order for this system to function properly three things had to happen. First, each nation had to define its currency to gold. Second, each nation must then maintain a fixed relationship to its supply of money and its amount of actual gold. Third, the on-hand gold must be allowed to be exchanged freely between any nations throughout the world. With this in place, the exchange rates would be fixed to the gold standard and ultimately to each other.<sup>72</sup>

During the initial years the IMF contributed little to world economic performance. "Initially its quotas were small and interpreted conditionally very friendly. It also refused to make loans for reconstruction, which were seen as the providence of World Bank. As a result there was little borrowing."<sup>73</sup> As the fund grew its determination to foster monetary cooperation led to the introduction of rules of behavior for countries. The IMF established a primitive form of conditionality with rules regarding how much to lend and when it was to be repaid based on needs and ability of the country receiving the funds.

From 1948 through the next decade, several new and significant features surfaced in the international system. During this period saw the development of new institutions for economic cooperation, dramatic growth in Europe, and U.S. foreign aid to the Third World. These new programs helped to generate stability and prosperity in global markets.

In 1971 as the International Monetary Fund had positioned itself as a world entity when United States President Richard Nixon announced a new policy suspending the link of gold to dollars. This was the keystone of the international monetary system and the

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<sup>71</sup> <http://www.imf.org/external/np/exr/chron/chron.asp> (December 10, 2002).

<sup>72</sup> <http://www.imf.org/external/np/exr/chron/chron.asp> (December 10, 2002).

<sup>73</sup> A. Winters, *International Economics*, 4<sup>th</sup> ed: 416.

basis of IMF. This announcement and the move to a floating international exchange rate for the U.S. Dollar forced the IMF to abandon its role of enforcing the gold standard and move towards its current role of providing advice, information and funding.

In 1982 the IMF was thrust into the spotlight when it took on the role of assisting Latin America, Africa, Asia, and Central European states restructure their economies following the 1982 debt crisis. While this was not the intended purpose of the IMF, the members sought to expand the role and influence of the Fund. Following 1982 the IMF sought more ambitious role as an international lender to nations of the world. The fund lent money during times of financial crisis in an attempt to return the world economy to equilibrium. Since this shift in focus, the IMF has been under constant criticism.

The IMF plays an important role in the world economy. It has inherited a wide range of responsibilities including technical counseling and economic assistance to nations experiencing economic trouble, world economic stabilization and maintaining the health of the world economy. According to Auty, the IMF rests upon three central premises: rapid stabilization and tight inflation control; stabilization, which requires prompt realignment of internal and external prices with low fiscal deficits; and the pace of economic recovery is linked to the comprehensiveness of reform rather than to a recovery in the level of investment.<sup>74</sup> Richard Auty concludes such price reform requires privatization and improved financial regulation. The programs implemented by the IMF are aimed at accomplishing all these tasks as discussed in the following section.

## **1. Programs**

The IMF over the years has established several programs to assist nations experiencing economic problems. Evaluating the extent to which International Monetary Fund guided programs actually help countries they set out to assist tells us a great deal about the influence that international institutions have over markets, and whether an IMF endorsement is credible. IMF resources are dispersed in response to problems and are to lead to a solution to the problem.

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<sup>74</sup> Auty, Richard M. Auty, "IMF Model and Resource Abundant Transition Economies," Working Papers No. 169 (November 1999): 3.

One justification that the IMF employs is that its programs serve as a signal of borrower credibility. By signing a letter of intent and agreeing to implement it, the borrowing state sends a message to the outside world that it is about to adopt responsible economic policies. This claim has been used by the IMF as a rationale for conditionality and for making commitments more generally.<sup>75</sup> Unfortunately, evidence in support of this 'catalytic' effect has been scant.<sup>76</sup> The success or failure of Fund programs to generate catalytic effects has been alleged to be a source of noncompliance. Fund programs break down frequently because a state fails to keep its promises in the letter of intent. If we accept that signing a Fund agreement produces costs as well as benefits, and everything we know about reform supports this claim, then it could well be that politicians breach Fund commitments because the reforms promise results (in the form of foreign investment, aid, and additional private loans) that never materialize.

In response to the Russian collapse, the IMF assembled a mammoth financial package—\$17 billion for Thailand, \$43 billion for Indonesia, and \$57 billion for Korea—whose disbursements were linked to the countries' meeting a range of conditions that seem to go well beyond the fund's mandate, and whose objectives reflect a troubling lack of institutional self-restraint.

As Schadler notes, securing external financing to support adjustment programs is part of the Fund's strategy for addressing macroeconomic imbalances.<sup>77</sup> Fund programs are designed with specific assumptions about how economic variables will behave months in advance. If an adjustment program operates with the assumption that additional external loans or foreign investment will come in as a result of the program, and these fail to materialize, then it makes meeting the other benchmarks of the program more difficult. As a recent review of Fund conditionality noted external flows failed to materialize as projected in a number of countries.<sup>78</sup> If a country fails to secure additional

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<sup>75</sup> Pierre D'haeseleer, "Conditionality as an Instrument of Borrower Credibility," IMF Paper on Policy Analysis and Assessment PPAA 97/2 (February 1997).

<sup>76</sup> John Williamson, IMF Conditionality (MIT Press/ Cambridge: Washington, D.C., 1983) 27-28.

<sup>77</sup> Susan Schadler, "How Successful are IMF Supported Adjustment Programs?," Finance and Development 33:2 (June 1996): 14-17.

<sup>78</sup> Susan Schadler, "How Successful are IMF Supported Adjustment Programs?," Finance and Development 33:2 (June 1996): 15.

financing as needed to support IMF mandated programs, will cause problems including the inability to reduce deficits and reform thus necessitating further adjustment.

Program involvement—the decision to sign a Fund letter of intent—is undertaken for very specific reasons. Because states seek Fund assistance only under certain conditions, this has important consequences for the study of conditionality. The proposal that an economic crisis may precede the decision to obtain assistance from the Fund may have independent effects on whether investors and lenders choose to lend to a country that signs a letter of intent. A second problem is that many studies of the catalytic effect assume that the program is fully implemented. This, unfortunately, is rarely the case. In making this assumption, these works overestimate the degree to which a state is actually “under” an IMF program.<sup>79</sup> This measurement error attenuates the magnitude of the regression coefficients, making it appear like the program produces weak economic effects.<sup>80</sup> Thus, for these two reasons, it is perhaps not surprising that the results of previous tests have been so limited.

By approaching the IMF, a member country facing a financial crisis has access to the fund’s resources and advice. As a country’s loans become larger relative to its quotas, it must meet more exacting standards or “conditionalities”, which typically mean significant changes in economic policies to ensure that the country’s domestic and external deficits are drastically lowered or even eliminated.<sup>81</sup> Failure to meet those conditions results in suspension, renegotiation, or even cancellation of the program.<sup>82</sup>

So why are there so many conditionalities on funding? The reason may lie in the sources of funding. IMF funding is obtained through dues of member countries and returns on loans granted. Today there are 182 IMF members who are eligible to take out loans from the Fund. Membership requires a contribution to the Fund. The size of the contribution is dependent upon the size of the member’s economy. A member country

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<sup>79</sup> Miles Kahler, “External Influence, Conditionality, and the Politics of Adjustment,” *The Politics of Economic Adjustment* (Princeton: Princeton University Press, 1992) 94-96.

<sup>80</sup> Gary King, Robert O. Keohane, and Sidney Verba, *Designing Social Inquiry: Scientific Interference in Qualitative Research* (Princeton University Press: Princeton, N.J. 1994) 156,167-168.

<sup>81</sup> John Williamson, *IMF Conditionality* (MIT Press/ Cambridge: Washington, D.C., 1983).

<sup>82</sup> Polak, *Changing Nature of IMF Conditionality* *Essays in International Finance* No. 184 (September 1991) 13-15.

can draw up to twenty-five percent of its quota to address balance of payment deficits. To draw more than twenty-five percent requires a special agreement with the Fund.<sup>83</sup>

## 2. Conditionality

Before we can proceed in understanding the effects of the IMF, we must look at the conditions imposed on assistance and funding by the International Monetary Fund. The IMF has panoply of lending programs designed to address the imbalance of a state's balance of payments, and overall financial stability. Studies of the conditions under which these arrangements are entered into demonstrate a consistent number of factors: low monetary reserves, high debt with large budget deficits, and high rates of inflation. Many countries try to counter these problems by producing more currency, which creates a rapid growth of the money supply and further inflation.<sup>84</sup>

The conventional justification for Fund conditionality is that states lack credibility, and need to make a commitment to an external agent to bolster their resolve. Adam Przeworski argues: "Policy conditionality can be interpreted as a ...penalty, as seen from the viewpoint of the borrower countries policy makers. In this view governments accept conditions only when they need the IMF loans."<sup>85</sup> From the standpoint of a potential lender, this is not hard to understand.<sup>86</sup> Reform produces costs as well as benefits, and because implementing it often involves alienating the constituencies that leaders depend on for support, committing to reform can prove difficult. Foreign observers know this: leaders can promise all the reform they want, but a lender's return is directly related to a leader's ability to implement reform.<sup>87</sup>

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<sup>83</sup> L. Taylor, The Rocky Road to Reform: Adjustment, Income Distribution, and Growth in the Developing World (The MIT Press: Cambridge, 1993) 41-42.

<sup>84</sup> Sergey M. Rogoy, "Russia: The Difficult Road to a Market Economy," Center For Naval Analyses, (December 1996).

<sup>85</sup> Adam Przeworski and James Raymond Vreeland, "The Effect of IMF Programs on Economic Growth," Journal of Development Economics Vol 62 (2000): 390.

<sup>86</sup> Peter Kenen, Financing, Adjustment, and the International Monetary Fund Brookings Institution: (Washington D.C., 1986) 42-44.

<sup>87</sup> Peter Kenen, Financing, Adjustment, and the International Monetary Fund Brookings Institution: (Washington D.C., 1986) 47-56.

When a country requests assistance, an assessment is taken as to the needs of the country usually followed by the introduction of fiscal and monetary restructuring resulting in financial hardship for the country. This is because the Fund frames balance of payments problems resulting largely from domestic profligacy.<sup>88</sup> To counter the economic hardship, country leaders produce more currency without advising the IMF. This action creates high inflation, which given the constraints of a fixed exchange rate imposed by the IMF, puts pressure on the national currency. To counter this problem, the IMF aims to alleviate the balance of payments constraint by providing monetary reserves in exchange for the state undertaking policies designed to reduce their deficit with fiscal and monetary restraints designed to devalue currency to improve exchange rates.<sup>89</sup>

...to attain over the medium term, a viable payments position in a context of reasonable price and exchange rate stability, a sustainable level and growth rate of economic activity, and a liberal system of multilateral payments.<sup>90</sup>

In addition to devaluation and fiscal reform, the IMF requires privatization of industry and the removal of export price supports and subsidies. These steps, which have come to be known as “structural reforms” are implemented to strengthen the competitiveness and dependability of the economy.<sup>91</sup>

Increasingly, the IMF seems to be targeting structural adjustment criteria rather than stabilization criteria. This seemed to be the case in Indonesia, for example, where the IMF program appeared to target the corrupt dealings of the Suharto regime by advocating increased transparency in government contracting. Yet experts in this field tend to agree that establishing a Western-style rule of law in Indonesia could take a generation or more. How then, could these structural adjustments have been considered effective for an economic stabilization program?

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<sup>88</sup> John Williamson, IMF Conditionality (MIT Press, Cambridge: Washington, D.C., 1983).

<sup>89</sup> Polak, Changing Nature of IMF Conditionality Essays in International Finance No. 184 (September 1991) 11-13.

<sup>90</sup> Manuel Gutian, “Fund Conditionality: Evolution of principles and Practices,” Pamphlet Series No. 38 (Washington, D.C., IMF 1981): 3.

<sup>91</sup>G. Bird, “Myths and Realities of IMF Lending,” World Economy 15 (1994): 770-774.

Unfortunately this is not what happens in most cases. In fact the opposite is true in most circumstances. The main reason for this is successful reform is never guaranteed causing reservations by potential investors. The implementation of IMF “structural reforms” can often prove politically costly by upsetting the populous for which politicians depend on for support during the transition.<sup>92</sup> It is this counter effect, which complicates the reform process. It cannot be viewed as a simple matter of developing a game plan and then implementing it.<sup>93</sup>

Due to this lack of investor and states confidence in the reform process, it is not surprising that IMF programs fail. In fact, according to an IMF study of 59 programs signed between 1988 and 1991, IMF assistance was suspended in 35 cases, as the borrowing state failed to implement the policies outlined in the letter of intent.<sup>94</sup> Numerous authors have noted economic reform is politically problematic, and politicians have incentives to renege on their commitments.<sup>95</sup>

The existence of uncertainty about whether reform can be sustained can serve to deter political leaders, investors and ultimately the IMF to offer additional loans.<sup>96</sup> This creates a “double edge sword” in that uncertainty limits investment, which restricts fiscal policy, which ultimately causes in more uncertainty. Ultimately the cycle leads to instability in the state causing the program and transition process to fail. This is important because potential lenders and investors are concerned about rates of return, and if they think that reform backtracking will reduce their returns, they will not invest in these markets. Because Fund programs are often signed to tip the scales and use international leverage to bolster domestic reform, it is not always a given that the program will be successfully implemented. Thus, what might matter is not merely a

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<sup>92</sup> Dani Rodrik, “Why is There Multilateral Lending?,” NBER Working Paper W5160, June 1995.

<sup>93</sup> Stephan Haggard and Robert Kauffman. “Institutions and Economic Adjustment,” in Haggard and Kaufman, eds., The Politics of Economic Adjustment (Princeton: Princeton University Press, 1992): 3-37.

<sup>94</sup> Susan Schadler, “IMF Conditionality: Experiences Under Stand-By and Extended Arrangements: Background Papers,” Occasional Paper 129, Washington: International Monetary Fund, 1995.

<sup>95</sup> Stephan Haggard and Robert Kauffman. “Institutions and Economic Adjustment,” in Haggard and Kaufman, eds., The Politics of Economic Adjustment (Princeton: Princeton University Press, 1992): 3-37.

<sup>96</sup> Dani Rodrik, “Policy Uncertainty and Private Investment in Developing Countries,” Journal of Development Economics Vol. 36, 2 (October 1991): 233.

commitment to reform in terms of a signed letter of intent, but rather a good prior record of successful program implementation, which is difficult.

It is these concerns that have prompted world protests regarding IMF programs. Their main argument is the continued expansion of the IMF's power and mandate is bad for debtor nations, for the global financial system, and, ultimately, for the IMF itself. They look at the funds history of economic disasters in states they have guaranteed assistance for support of their argument.<sup>97</sup> The increasing scope of loan conditions implies that during a financial crisis, the fund should take over more and more of a country's decision-making process, without any commensurate increase in accountability. Moreover, the IMF's widening agenda has made it both less effective and more vulnerable to politicization, thus tarnishing the reputation that is essential to the credibility of the IMF.<sup>98</sup>

### **3. Performance Criteria**

With the programs, conditionality and funding there is the problem of measuring compliance of nations with IMF prescribed policies. The IMF uses performance criteria to monitor whether a members adjustment program is on track and if not, to encourage corrective actions be taken. Measuring performance is difficult for many reasons including nations willingness or ability to supply data, inaccurate measuring techniques and a standard as to what factors to measure.

...Every year, the IMF consults with each member country about its economic policies. It dispatches a team of what Joseph Stiglitz, former World Bank chief economist, famously scorned as "second rate economists from first rate universities" to measure performance...<sup>99</sup>

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<sup>97</sup> Patrick Conway, "IMF Lending Programs: Participation and Impact," Journal of Development Economics 45:2 (December 1994): 370-373.

<sup>98</sup> Patrick Conway, "IMF Lending Programs: Participation and Impact," Journal of Development Economics 45:2 (December 1994): 380.

<sup>99</sup> Robert Borosage, "IMF is Peddling Misery to the Poor," Dawn September 24, 2000.

Ultimately though it is the IMF, under undefined standards, that determines to what extent a country is in compliance.<sup>100</sup>

Over the years with increased conditions placed on nations for IMF assistance, created a negative impact. The additional requirements restrict nations from obtaining funds, or when they finally acquire assistance inevitably fail to meet all performance criteria as set by the IMF.<sup>101</sup>

...The tendency in the 1980's was to increase the number of performance criteria as adjustment programs had to be executed in an increasingly difficult policy environment. From an average of below six per arrangement in the years 1968 – 1977, the number rose to about seven from 1974 to 1984, and to more than nine and a half from 1984-1987.<sup>102</sup>

A major concern with performance criteria relates back to the IMF's "cookie cutter" approach of assistance to nations. If the IMF prescribes the same remedies for some or all nations, it must be assumed they are measuring success against the results of other nations.<sup>103</sup> The problem of course being that all nations are different and have different timelines of compliance due to capabilities and degree of willingness to comply with IMF conditionalities. According to Robert L. Borosage, Co-director of the Campaign for America's Future: "For indebted developing countries, the IMF's prescriptions are force-fed. When the fund prescribes austerity, health budgets are cut, children are forced to leave school, and workers are thrown out of work."<sup>104</sup>

Inevitably nations fail to comply with IMF conditions. With the nations failure, access to IMF funds are restricted leading to a decrease in standards of living, and public

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<sup>100</sup> Patrick Conway, "IMF Lending Programs: Participation and Impact," Journal of Development Economics 45:2 (December 1994).

<sup>101</sup> Polak, Changing Nature of IMF Conditionality Essays in International Finance No. 184 (September 1991): 40-42.

Polak, Changing Nature of IMF Conditionality Essays in International Finance No. 184 (September 1991): 14.

<sup>103</sup> Joseph Stiglitz, "What I learned at the World Economic Crisis," The Insider (April 6, 2000): 4.

<sup>104</sup> Robert Borosage, "IMF is Peddling Misery to the Poor," Dawn September 24, 2000.

support for the transformation and the government. The end result is a weakening of the political infrastructure, which is necessary to carry out the transition and carry out the IMF programs.<sup>105</sup>

#### **4. IMF Impact**

Critics including Bernard Sanders and Joseph Stiglitz have been insisting reforms proposed by the IMF hurt developing countries. Many view the IMF as an inferred loan guarantee but IMF programs may have the opposite effect: rather than act to attract foreign capital and investment, they deter it. The problem of whether this guarantee helps nations credibility or encourages capital investment is the core of the difficulties with the IMF. Another problem that shall be addressed is the assumption by the IMF that all programs are successfully completed. This section addresses these problems.

Why proposed reforms have negative effects is not hard to understand. Potential lenders and investors understand the effects of past Fund programs, limiting their desire to risk financing which, over the short run, reduce their returns rather than increase them. Because of this, investors rarely commit additional resources after a letter of intent is signed. This creates problems in achieving financing for developing/ transitional countries under IMF guidance. This problem is addressed in this section. Additionally we look at the impact of both signing and keeping commitments on investment and loan guarantees from the IMF.

Initially, an important question needs to be raised about the conditions under which international agreements are sought. States seek help from the Fund when they face balance of payments crises. Because of the crisis, agreements are usually signed when states have no other viable options.

Concerns over the effects of International Monetary Fund policies on developing countries have always been important. The primary concern is with the unintended consequences of Fund programs, more commonly referred to as moral hazard.<sup>106</sup> The

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<sup>105</sup> Henry Kissinger, "IMF Can't Tackle the Crisis," Dawn Karachi: Oct 6, 1998: 3.

<sup>106</sup> Charles W. Calomiris and Allen H. Meltzer, "Fixing the IMF." The National Interest 56, Summer (1998): 88-96.

debate over the Fund turns on the distributional consequences of Fund programs, namely, which bears the burden of adjustment, as well as the moral standing of conditional aid.<sup>107</sup>

Another problem with IMF prescribed programs that is usually not addressed is the assumption that IMF directed policies are fully implemented, which is rarely the case. This complicates the ability to assess whether programs produce desired effects or not. This lack of compliance may have adverse consequences. By assuming that all programs are fully completed, the IMF does not have the proper tools for further assistance. Without completion of initial programs and solution of problems, the IMF's policies on further funding are not sound.

...the IMF has utterly failed to grasp the political impact of its actions. In the name of free market orthodoxy, it usually attempts – in an almost academic manner – to remove all at once every weakness in the economic system of the afflicted country, regardless of whether these caused the crisis or not. In the process it too often weakens the political structure and with it the precondition of meaningful reform.<sup>108</sup>

The IMF acts as a somewhat “seal of approval” to foreign investors and lenders, particularly those with a positive track record. Once a country implements programs, often they need additional capital to maintain positive transition. The opposite happens though. Upon entering an agreement and receiving initial assistance, flows of investment capital and loans decrease substantially. This often leads to turbulence within a country, which compounds resulting in default of the agreement due to lack of funding. So instead of assisting a country until completion of transition, they “hap hazzardly” assist usually causing failure.<sup>109</sup>

One major problem though in determining the effectiveness of IMF programs is the misperceptions created by governments attempting to avoid responsibility. Governments conduct currency devaluation to encourage free markets while failing to restrict flows of capital across national borders. These may undermine IMF

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<sup>107</sup> G. Bird, “Myths and Realities of IMF Lending,” *World Economy* 15 (1994).

<sup>108</sup> Henry Kissinger, “The IMF: Throwing More Fuel on the World Economic Bonfire,” *The Washington Post* October 6, 1998, [www.globalpolicy.org/soecon/bwi-wto/kissin.htm](http://www.globalpolicy.org/soecon/bwi-wto/kissin.htm) (April 20, 2003).

<sup>109</sup> Adam Przeworski and James Raymond Vreeland, “The Effect of IMF Programs on Economic Growth,” *Journal of Development Economics* Vol. 62 (2000).

effectiveness. While there may be some degree of blame for governments, such blame is dangerous for two reasons. First, it leads to government actions that worsen the crisis. Second, it leaves in place false impressions that make more likely the reemergence of another tragedy in Russia.

The final conclusion is that by placing the responsibility of adjustment on debtor countries, the fund's actions relieve any pressure on creditor countries to change the status quo or the increasingly ineffective regulation of international finance.

Poverty is a critical factor in economic transformation that is too often overlooked to accomplish the bigger goals. Some of the major causes of poverty are IMF prescribed "structural adjustment" policies. The lending of money in exchange for cutting social expenditures decreases nations economic growth and development. According to Thomas Friedman: "many are tied to opening their economies and being primarily commodity exporters, which, for poorer nations leads to a spiraling race to the bottom as each nation must compete against others."<sup>110</sup>

### **C. REASONS FOR THE CRISIS: IMF PERSPECTIVE**

A major problem and cause of the Russian crisis may have been in the banking sector. The banking sector in Russia was consumed by corruption and inefficiency that led to trillions of Rubles in bad loans. Because of this no amount of fiscal stimulus or monetary stimulus would have been able to stem the rapid deterioration of the Russian economy. The policies of the Russian government, which were the exact opposite of the free market principles created an economic disaster in Russia.

Much of the problem according to the IMF is the false representation of the Russian economy by the government. The failure of full disclosure of economic conditions led to a collapse of private investment and confidence in Russia. So as a result, the attempts by Russia to restrict domestic demand and increase output requested by the IMF failed.

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<sup>110</sup> Thomas L. Friedman, *The Lexus and the Olive Tree* (First Anchor Books, April 2000) 8-9.

The crucial factor though according the IMF was the global economy. During the mid 1990's, world markets entered a downward spiral and with globalization, emerging economies could benefit only at the expense of other emerging economies. The most dramatic example was in August with the decision by Russia to devalue its currency and allow its debts to go into default. Today the loans to emerging markets are securitized and traded in open financial markets; a dramatic fall in their value must be reflected promptly in the balance sheets of banks, mutual funds, hedge funds, and other investors. The losses associated with the Russian default totaled \$100 billion.<sup>111</sup>

Admittedly, global financial problems have exacerbated Russia's problems. But the IMF suggestion to provide additional resources for the Brazilians to protect their currency against free market factors, which have judged that Brazil must devalue. Beyond that, many Brazilians are attempting to get funds out of the country in what amounts to a vote of no confidence in the government's expedient policies leading up to the October 4 election.

The IMF in 1992 rushed to assemble a \$22 billion package for Russia, supposedly conditional on the Russians suddenly discovering how to collect taxes to replace the \$5–6 billion per month that they had been borrowing from the global financial markets. When the initial \$5 billion loan from the IMF was dispensed to Russia after July 13, Russian oligarchs, anxious to convert rubles into hard currency, immediately consumed it. The Russians then expected to receive more funds from the IMF by threatening devaluation and default. Even the IMF saw that further funds would simply be consumed by the same clique moving funds out of Russia, and the Russians unilaterally devalued and defaulted.<sup>112</sup>

The Russian episode is hardly an example of free market operation and free and unfettered flows of capital. The IMF essentially expropriated resources provided by industrial countries and irresponsibly allocated those funds to a country that had absolutely no hope of meeting the conditions allegedly attached to the IMF program. Russian technocrats such as Anatoly Chubais openly chortled to the Russian press that

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<sup>111</sup> [www.ecaar-russia.org/nekipelov.htm](http://www.ecaar-russia.org/nekipelov.htm) (May 2, 2003).

<sup>112</sup> "Russia: IMF Approves Loan Package," [www.2facts.com/stories/index/1999144090.asp](http://www.2facts.com/stories/index/1999144090.asp) (December 15, 2002).

they had “conned” the IMF and its chief negotiator, Stanley Fischer. The Russian episode, not to mention the IMF performance in South Korea, Indonesia, and Thailand, reflects the actions of people who face no accountability for their performance. If the IMF managing director and deputy managing director had been managing funds in the private sector in the same way, they would have long ago been bankrupt and forced out of business.

Although less-developed countries such as those in Asia undoubtedly need to open up to the world’s capital markets, they would be well advised to do so at a pace commensurate with their capacity to develop sound regulatory and institutional structures. In particular, tighter limits on short-term foreign borrowing, especially by banks, may well be essential. The lesson that should have been learned from Indonesia should be that instruments must be matched to objectives, including the time frame envisioned for the objectives to be achieved. Unfortunately, IMF staff had not absorbed this lesson by the time the last IMF loan to Russia was approved last summer. The record of the Russian debacle is as follows.

In the first two weeks of August 1998 it was already clear that Russian central banking authorities could not prevent a collapse of the ruble. And this was just weeks into a \$4.8 billion IMF program, part of a \$22.6 billion package of loans whose main goal was to support the ruble, come what may. On August 17 the Russian government devalued the ruble and, in a potentially more damaging move, mandated a general default on Russian debt.<sup>113</sup>

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<sup>113</sup> “Russia: IMF Approves Loan Package.” [www.2facts.com/stories/index/1999144090.asp](http://www.2facts.com/stories/index/1999144090.asp) (December 15, 2002).

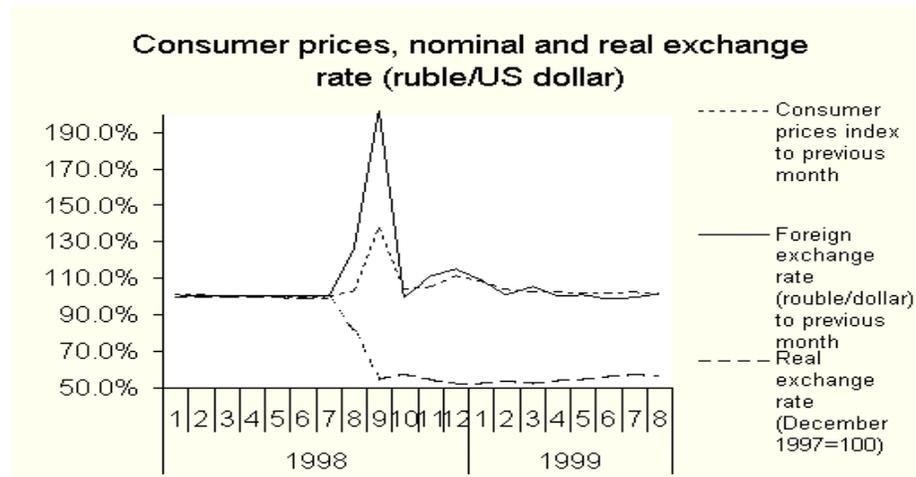


Figure 4. Consumer prices, nominal and real exchange rate from: International Financial Statistics. November 1999. <http://www.ecaar-russia.org/nekipelov.htm> (May 13, 2003).

The central bank Governor at the time, Sergei Dubinin, disclosed that from July 20 until the ruble’s collapse, the central bank had actually spent up to \$3.8 billion to defend the currency, while the Finance Ministry had used \$1 billion to redeem short-term government debt. The IMF loan was depleted immediately as the Russians tried to prop up the ruble by spending more than \$1 billion a week. But there’s more. Former Deputy Prime Minister Nemtsov alleged that during this period he tried to get the prime minister to consider devaluation, only to be told that this was impossible. Why? “Because the IMF opposed it,” said Kiryenko, according to Nemtsov, who revealed this, after President Yeltsin fired the entire government.<sup>114</sup>

Russia had achieved a false stability with its oil exports, in combination with the nonpayment of government wages and pensions, to compensate for its failure to collect taxes. But when the price of oil fell by half, its oil income dropped. When an unforeseen income shock like this occurs the response should be to reduce the price of one’s exports and increase the price of imports to regain stability. The way to do this is to let the currency depreciate, withstand the upward adjustment of import prices that will follow by standing fast against increased wage demands and pleas for more subsidies, and just ride it out.

<sup>114</sup> [www.bartleby.com/65/un/UnionSov.html](http://www.bartleby.com/65/un/UnionSov.html) (May 2, 2003).

IMF loans are supposed to help a country ride out the stabilization period by providing the foreign exchange it needs for essential imports until the depreciation causes exports to pick up. It is true that depreciation makes it harder for the country to repay its foreign loans until its exports have recovered. But that is also what IMF loans are supposed to help with, by providing short-term liquidity to finance the increased cost of servicing foreign debts until export revenues pick up.

Instead, somehow IMF staff was persuaded to tie short-term stabilization goals to commitments to implement medium-term structural adjustment measures. With oil and gas revenues having severely declined, and with the government having already borrowed well beyond its capacity, immediate reform of the tax system, including reform of the tax collection institutions, became a prerequisite for the success of the IMF-supported stabilization program.

Moral hazard or the propensity in both borrowing countries and their creditors to take excessive risks because of the implicit insurance offered by bailouts—applies to the IMF as well as to borrowers and creditors. The steady expansion of institutional objectives has occurred because borrowing countries bear a disproportionate share of the political, economic, and financial risks of IMF programs. There is little downside to these programs for the fund's major shareholders, its management, or its staff. The damage resulting from the IMF's mishandling of the Indonesian banking sector, for example, was borne entirely by Indonesia, not by the IMF or the board that signed onto these conditions.

#### **D. CONCLUSION**

The purpose of this chapter was to bring to light implications for the effects of Fund programs. First, the evidence demonstrates that Fund sanctions can be costly. This is somewhat surprising, since the conventional wisdom is that states can return to the Fund with their past sins of program noncompliance forgiven and receive fresh loans. In the Public Choice approach to international institutions, the Fund is a budget-maximizing bureaucracy that values lending over policy reform. To derive from this that

noncompliance is costless, however, is a misnomer, since as the conditional coefficient suggests, all types of flows drop off in the wake of a program suspension.<sup>115</sup>

This evidence stands in contrast to our conventional understanding of international institutions. The evidence here suggests that the opposite is the case; Fund sanctions are costly to the extent that they deter additional flows of loans and investments. While these countries made mistakes, their economies were undermined by the impact of the global market and capital flows that the IMF sought to set free.

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<sup>115</sup> Roland Vaubel, "The Political Economy of the International Monetary Fund: A Public Choice Analysis," in Roland Vaubel and Thomas D. Willett, eds., The Political Economy of International Organizations (Boulder: Westview Press) 1991.

## **IV. RUSSIAN PERSPECTIVE**

The Soviet Union since its inception has seen tremendous shifts in its economy. As discussed earlier, the leaders of the Soviet Union attempted to stem the economic turbulence through thirteen separate five-year plans.<sup>116</sup> This chapter will demonstrate the attempts by the Russian government to produce a strong, stable economy were superficial and failed to address the real issues resulting in economic hardship. The result was the 1998 Russian economic crisis. This chapter will look at the conditions that existed and the Russian view of IMF assistance to determine the cause of the 1998 crisis.

At the IMF's urging, Russia rapidly dismantled its pre-existing economic system by abolishing central planning, eliminating controls on imports and capital flight, and privatizing most state enterprises. A new and effective capitalist market system was supposed to appear rapidly through individual initiative. But in the modern world building a capitalist system requires an active state role and a considerable period of time. With its old economic system dismantled and no new one to take its place, the Russian economy descended into chaos.

### **A. THE GOVERNMENT'S ECONOMIC POLICIES**

The Russian government's economic policies significantly contributed to the 1998 Russian economic crisis. The policies were intended to transform the Russian economy from a socialist driven into an export-oriented, private-sector-driven economy. Initially the government was heavily dependent on oil sales to fund the transformation and support the policies mandated by the IMF. Unfortunately as the political competition began to increase after the 1991 coup, the government strayed from fully implementing their original reform program and instead pursued policies popular with the people, in an effort to quell the uproars. This move proved to be economically devastating. The

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<sup>116</sup>[www.departments.bucknell.edu/russian/chron4.html](http://www.departments.bucknell.edu/russian/chron4.html) (December 21, 2002).

Russian economy was already in bad condition with a high public deficit and inflation rates only to be worsened by the failures to address underlying causes of the problems.<sup>117</sup>

The IMF's insistence on reform further hurt any chances at recovery and restricted the implementation of any possible solutions the Russian government may have had. In this economic context, the government made significant policy changes regarding its debt financing methods during the second half of 1993, which, in return, triggered an outflow of capital into foreign exchanges and started an economic crisis.

## 1. Banking Sector

For more than 20 years, the IMF has provided loans to debt-plagued and cash-strapped poor countries. The funds came in exchange for their implementation of far-reaching policies designed to encourage foreign investment and rapid economic growth.<sup>118</sup> Following IMF insistence, Russia's economic output fell by half and its investment by three fourths.<sup>119</sup> As a result, money became so scarce that half of all transactions were conducted through barter creating a virtual economy.<sup>120</sup>

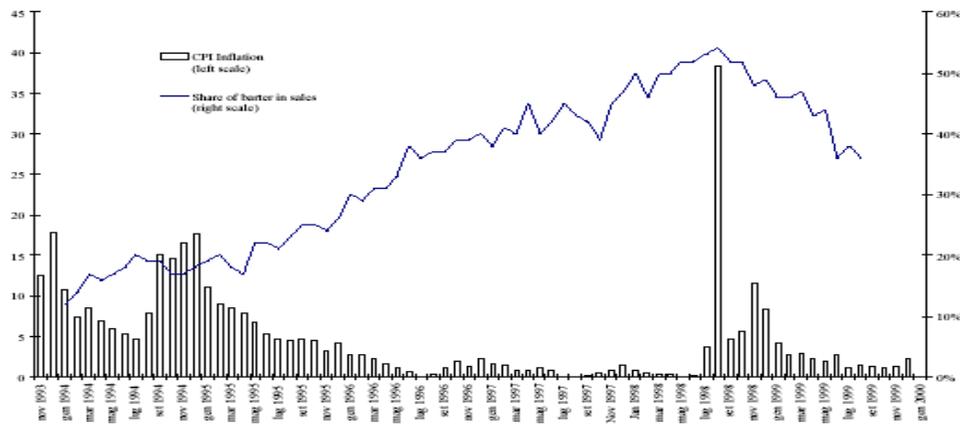


Figure 5. Barter Trade and Inflation

from: <http://www.st-andrews.ac.uk/~res2000/papers/pdf/Gara.pdf> (May 1, 2002)

<sup>117</sup> <http://www.departments.bucknell.edu/russian/chron4.html> (December 21, 2002).

<sup>118</sup> William Easterly, "The Effect of IMF and World Bank: Programs on Poverty," World Bank November 2000.

<sup>119</sup> Ariel Cohen and Brett D. Schaefer, "The IMF's \$22.6 Billion Failure in Russia," The Heritage Foundation (24 August 1998).

<sup>120</sup> Clifford G. Gaddy and Barry W. Ickes, "Russia's Virtual Economy," Foreign Affairs (September/October 1998).

On the back of this, Russian elites and government officials got richer as the stock market soared on oil. Western banks helped to finance the buying of government owned industries that drove up Russian stock prices, making it one to the world's best-performing stock markets.<sup>121</sup>

Among other policies, the IMF requires countries to reduce tariffs and other import barriers, increase exports, reduce government budgets and subsidies, privatize state enterprises, and provide tax and other incentives for foreign investment. According to Strobe Talbott, Russia experienced "too much shock and too little therapy" in its transformation.<sup>122</sup> The IMF insisted upon rapid privatization of government-controlled businesses, which allowed a small group of oligarchs to gain control of state assets. The IMF paid insufficient attention to the institutional infrastructure that would allow a market economy to flourish and by easing the flow of capital in and out of Russia; the IMF had laid the groundwork for the oligarchs' plundering. Due to this short sightedness, the Russian economy continued to fail throughout the 1990's resulting in falling output levels and population. Through the mid-90's the Russian economy continued to implode. Output plummeted by half. While only two percent of the population had lived in poverty at the end of the Soviet period, the IMF reform saw poverty rates increase to almost 50 percent.<sup>123</sup>

Programs are ultimately directed towards achieving the highest possible growth, which is not necessarily the same as achieving the highest possible poverty reduction.<sup>124</sup>

These policies tended to hurt the interests of the poorest and most vulnerable sectors of the borrowing countries, which was evident in Russia.<sup>125</sup>

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<sup>121</sup> David M. Kotz, "Capitalist Collapse: How Russia Can Recover," Dollars and Sense (November/December 1998): 10-12.

<sup>122</sup> then in charge of the noneconomic aspects of Russia policy.

<sup>123</sup> Joseph Stiglitz, "What I Learned at the World Economic Crisis," The Insider (April 6, 2000).

<sup>124</sup> Jim Lobe, "World Bank and IMF Anti-Poverty Schemes Still Rile Grassroots."

<sup>125</sup> Joseph Stiglitz, "What I Learned at the World Economic Crisis," The Insider (April 6, 2000).

## B. IMF ASSISTANCE

As discussed earlier, the Russian government made several attempts at creating a strong market economy. Many of these attempts failed or produced marginal improvements primarily due to a lack of understanding of the effects of free market principles. This is a key point in understanding the crisis of 1998. The volatility of the political environment in Russia had a crucial effect on the government's ability to implement stable economic policies. The government could not implement the necessary fiscal measures to decrease the public deficit and improve its fiscal situation. The government responded to these events by depleting foreign exchange reserves and by borrowing abroad instead of restraining expenditures and increasing revenues.

Towards the end of 1992, Russia experienced significant decreases in the manufacturing sector due to the inability of owners to adjust to capitalist ways. For years, the government controlled costs, production and to an extent employment. When the economy was thrust on to the global market, owners had no idea how to purchase raw materials or sell products competitively on world markets. This resulted in a decline in industrial production, exacerbating the recession. Following this, the government set out to obtain the confidence of international creditors, such as the World Bank and the IMF, in its determination to implement structural reforms to overcome its major economic problems with the stabilization program.<sup>126</sup> The government succeeded in this goal and signed an agreement with the IMF in April 1992 for 24 Billion Dollars.<sup>127</sup> Unfortunately however, political problems obstructed the implementation of the economic stabilization program and IMF stand-by agreement measures.

The IMF failed to recognize that Russia and Russians were a world unto themselves. Even more to the point, "perhaps the one view that the Russian privateers shared most strongly was that the Russian people, like the rest of the world, were economic men, who rationally responded to incentives."<sup>128</sup> Bernard Sanders seems to summarize the issue of Russia in his statement to Congress where he said:

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<sup>126</sup> Anders Aslund, "Russia's Collapse" *Foreign Affairs* Vol. 79, Issue 5 (Sept/Oct 1999): 64-77.

<sup>127</sup> <http://www.departments.bucknell.edu/russian/chron4.html> (December 21, 2002).

<sup>128</sup> Maxim Boycko, Andrei Shleifer, and Robert Vishny, *Privatizing Russia* (Cambridge: MIT Press, 1995) vii.

...And then the meltdown in Russia began. Poor Russia. It is incredible that a great country with such a tragic history has got to suffer again. When communism fell in 1991, the Russian government received the attention and the guidance of the IMF and all of their brilliant policy advisors, and tragically the Russian government listened to them and took their advice. It is fair to argue that never before in modern history has a major industrialized nation experienced the kind of decline in a seven – year period as Russia has under IMF guidance, and with \$20 billion of IMF loans.<sup>129</sup>

Stiglitz has criticized the west's best and brightest that ended up relying on what he calls simple textbook models or naïve ideology. It is not so much that Russians always react differently to incentives; but that the ill formed market infrastructure within which those incentives operate is all but guaranteed to produce differing results.

During this period, the wages of these socio-economic groups continuously decreased in real terms. Hence, maintaining political support from these groups and simultaneously implementing economic reforms became increasingly difficult for the government. In order to tackle this problem and prevail in political competition, the government began to stray from the proposed reform program by the IMF and began to pursue populist economic policies. The government sought to find new ways to build public support, therefore, started to shift its investments from manufacturing to infrastructure. On the other hand, with these populist economic policies, the government compromised fiscal discipline and failed to implement necessary economic measures to control and cut the fiscal deficit on a permanent basis.

### **C. ECONOMIC POLICIES**

This section covers the government's economic policies prior to the crisis. From the beginning of the transition to capitalism the Russian government designed its monetary, export, and import policies to improve Russia's foreign trade, but heavily relied on oil exports. The government initially aimed at increasing foreign exchange reserves by improving the profitability of the tradable goods sector, and hence

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<sup>129</sup> Bernard Sanders, "More Money to IMF will only make world economic situations worse," Statement to United States Congress, October 14, 1998, [www.house.gov/bernie/statements/1998-10-14-imf.html](http://www.house.gov/bernie/statements/1998-10-14-imf.html) (December 21, 2002): 2.

implemented trade policies accordingly. The government launched export promotion measures, such as export subsidies and exchange rate measures to promote exports and eliminate foreign exchange constraints on the tradable goods sector.

IMF should have weaned Russia of its dependence on oil. Equally important was the sharp drop in oil and other raw material prices during 1998. This caused the value of Russia's oil exports, its main source of foreign currency earnings, to fall by almost half in the first six months of 1998 compared to the same period of 1997.<sup>130</sup>



Figure 6. Russian Oil Prices 1995-2001

From: <http://www.resbank.co.za/economics/qbul1298/pdf/review.pdf> (May 13, 2003).

Together, these two developments led investors to begin removing their funds from Russia.

Russia suddenly began slipping into a classic debt trap. Although the government's deficit was running at only a moderately high rate of 5 percent of GDP, by early summer the growing flight of capital out of the country forced the government to pay rapidly escalating interest rates on the money it borrowed to finance the deficit.

<sup>130</sup> [www.eia.doe.gov/emeu/cabs/chron.html](http://www.eia.doe.gov/emeu/cabs/chron.html) (May 21, 2003), [www.gasandoil.com/goc/news/htm24663.htm](http://www.gasandoil.com/goc/news/htm24663.htm) (May 21, 2003)

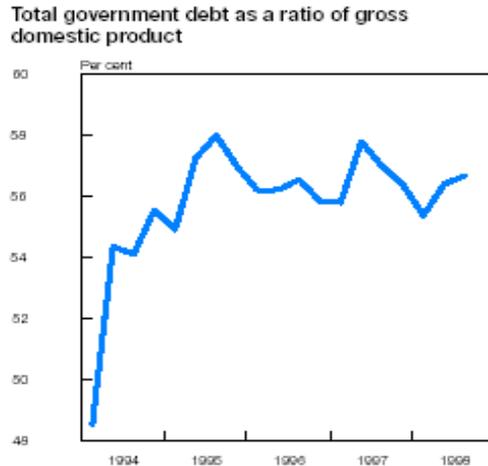


Figure 7. Total Russian Government Debt

From: <http://www.resbank.co.za/economics/qbul1298/pdf/review.pdf> (May 13, 2003).

To make matters worse, Russia mainly sold very short term bonds, some coming due in a matter of weeks after issue, which only deepened its repayment problem. By July, Russia's monthly interest payments exceeded its monthly tax revenues by 40 percent. Realizing this was unsustainable, investors began a stampede for the door despite the IMF's huge bailout loan.<sup>131</sup>

#### D. PRIVATIZATION

One of the major problems for the Russian government was implementing the IMF directed privatization of government owned industries. This was a major change for Russians. The IMF though, in their proposal failed to recognize the differences in culture, history, and previous economic and political evolution. The History and ways of the Russians conducted business were not compatible with free market principles and required more than just selling government assets to ensure success of privatization. The IMF assumed that because free market principles work in the United States or the United Kingdom that the same would hold true in Russia. This is a big assumption for a country that was subjected to forty-five or seventy years of communism. Given the differences, the results were bound to be very different. To be successful, the adoption of foreign experiments and legal codes must be designed so that those affected find it in their self-

<sup>131</sup> Clifford G. Gaddy and Barry W. Ickes, "Russia's Virtual Economy," *Foreign Affairs* (Sept/ Oct 1998).

interest to support such rules. In this way, the new owners become self-enforcers. It is rare that far-reaching measures of this sort become successful if the rules of the game are imposed only from the top down. The trick, then, is to design a system that will generate self-interest.<sup>132</sup>

To accomplish a successful privatization, Russia needed to take steps to build business and legal infrastructure by encouraging new business start-ups and the privatization of small state business entities. Only when a competitive infrastructure has been established should an effort be made to privatize larger state enterprises or monopolies, which went against IMF policies. The IMF failed to recognize that by privatizing state monopolies usually results with a private monopoly that operates little differently from its antecedent. This is due to the comfort factor. It is what the owners know and workers react to. Because of this, many of the privatized enterprises in Russia did not change but rather conducted business the same as they did in the Soviet era and disregard the operating customs necessary for a market economy to blossom. That is why it is so essential to concentrate on the creation of a competitive market infrastructure with a multitude of players who will support and maybe even enforce the rules of the game that are considered to be the hallmark of a market economy.

Another oversight of the IMF was the Russian peoples ingenuity. When the government began to privatize, many directors refused to buy the companies. Instead they waited until they went bankrupt or in default to and they could end up as the de facto owners of their factories and then proceed to strip the assets as they pleased. So the privatization process was side stepped and resulted in many of the businesses failing or operating inefficiently for the benefit of the directors.

Meanwhile, privatization has concentrated wealth in a few hands. According to Jeffrey D. Sachs, director of the Harvard Institute for International Development and a former adviser to the Russian government, the reason for such new loans is to “insure that the earlier loans are repaid and that the ruble keeps its value long enough for speculators to get their money out without large losses.”<sup>133</sup> Indeed, interest rates that recently reached

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<sup>132</sup> Anders Aslund “Russia’s Collapse,” *Foreign Affairs* (September/ October 1999): 68-70.

<sup>133</sup> <http://www.pbs.org/wgbh/pages/frontline/shows/crash/interviews/sachs.html> (December 16, 2002).

150 percent will almost certainly be paid out of funds currently earmarked for retired pensioners and unpaid workers.<sup>134</sup>

The IMF also insisted that, to combat inflation, Russia must pursue a tight fiscal and monetary policy - that is, make sharp cuts in public spending and keep money and credit scarce. This assured that plunging demand for goods and services would bring on a major depression. Eventually the Russian government found it could meet the mandatory IMF spending reduction targets only by increasing delays in paying workers and suppliers. Unpaid suppliers could not pay their own workers, spreading a chain of unpaid wages and taxes through the economy.

They could not agree on their privatization strategy. As a consequence, they delayed the privatization of most of their larger enterprises until about 1995. However, they wisely moved ahead with their plan to facilitate the start-up of new businesses, supplemented with the privatization of small state shops and services.

Factories must be not only privatized but also restructured so that they are better able to compete, not only in Poland but also externally. The public at large, not just the factory managers and workforce, should benefit from both the process of privatization and the subsequent and ongoing operation of these enterprises.

## **E. TAX POLICY**

Another reform necessary for successful transition was the restructuring of the tax system. Following the demise of the Soviet Union, the new Russian government under Yeltsin set out to reform the tax policies to overcome the increasing government deficit. In the past, when a new tax regulation loaded a new tax burden on a certain socio-economic group, depending on the extent of the reaction from this group, the government usually amended the tax law or somewhat alleviated the tax burden through exemptions, exceptions, and postponement of the tax payments. In this context, political conjuncture significantly affected the feasibility of the government's tax policies.

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<sup>134</sup> <http://www.pbs.org/wgbh/pages/frontline/shows/crash/interviews/sachs.html> (December 16, 2002).



Figure 8. Central Government Real Revenues 1995-2001  
 From: Rautava, Jouko. “The Role of Oil Prices and the Real Exchange Rate in Russia’s Economy” Bank of Finland: Institute for Economies in Transition (BOFIT). BOFIT Discussion Paper No. 3, 2002.  
<http://www.bof.fi/bofit/fin/6dp/abs/pdf/dp0302.pdf> (May 2, 2003).

The government’s tax revenues had been declining for several years prior to the demise of the Soviet Union. This was mainly a result of the government’s inappropriate tax policies. This became a significant issue with the attempts at economic transformation due to lack of funding to operate the new government. The inefficiencies and corruption mainly lay in the personal income tax, which constituted a major portion of the total tax revenues of the government’s consolidated budget.<sup>135</sup> The government collected the income tax according to the rates it determined for each income bracket; however, the government did not increase the nominal income bracket limit at the same rate as the inflation rate. As a result, lower income groups, particularly the government employees who paid payroll taxes, sustained high tax rates.<sup>136</sup>

A bigger problem was the lack of salaries being paid to employees, which meant there was nothing to tax. The majority of people in Russia including government and military went months without a paycheck. No paycheck, no taxes, which hindered tax reform. Other problems as discussed in earlier chapters including corruption and inefficiency also played crucial roles.

<sup>135</sup> L. Ebrill and O Havrylyshyn, “Tax Reform in the Baltics, Russia, and other Countries of the Former Soviet Union,” *IMF Occasional Paper* No. 182, Washington D.C.

<sup>136</sup> William Easterly, “The Effect of IMF and World Bank Programs on Poverty,” World Bank (November 2000).

The IMF mandated tax reform and collection criticizing the Russian government on its failure to collect taxes and correct corruption in the tax system.<sup>137</sup> But did Russia have the opportunity to do this under the tight restrictions of conditionality.<sup>138</sup> Specifically the IMF wanted cuts in government spending, higher taxes, and tighter credit. According to Stiglitz, for a country suffering from a 50 percent decline in production, this is absurd advice. The problem again came back to the fact that no was being paid so no taxes were being collected. The only way to help was through government spending to stimulate the economy, but this was against IMF policy.<sup>139</sup> Any economics textbook notes that such measures, by further reducing the demand for goods and services, will only make an already severe recession worse.

Take, for instance, the tax collection crackdown the IMF is urging. The Russian government, under pressure to increase the amount of cash in the budget, is demanding that enterprises settle their tax debts in cash, not in kind. One's gain is the other's loss. If taxes are paid, wages would not be.<sup>140</sup> That is what has happened at regular intervals in recent years. The government's efforts to raise taxes from industrial enterprises and individuals to pay public sector workers were only worsening the problem of private sector wage arrears.

Most urgently many enterprises must sell their products for cash in order to pay wages. This explains the ironic feature of the virtual economy that while it is itself a nonmarket system, it depends upon the market. In fact, many Russian exports lose money. But for participants in the virtual economy, the goal of exporting is not profit, but cash. The losses they incur are considered a necessary cost of staying in business. Finally, the minimal amount of cash in this system does not mean cash is irrelevant in Russia. On the contrary, in the land of the cashless, the man with pocket change is king, or at least an oligarch, as Russian capitalists and financiers are called. Some Russian capitalists

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<sup>137</sup>“ Russia Restores ties with IMF,” BBC News, June 19, 2001.

<sup>138</sup> “Russia Restores Ties with IMF,” BBC News, June 19, 2001.

<sup>139</sup> Joseph Stiglitz, “What I Learned at the World Economic Crisis,” The Insider (April 6, 2000).

<sup>140</sup> William Easterly, “The Effect of IMF and World Bank Programs on Poverty,” World Bank (November 2000).

certainly have more than pocket change, but in international terms they are not particularly wealthy.

In conclusion, the government's tax policies prior to 1998 were partially due to IMF constraints however the corruption and limitations of the Russian tax structure played a key role at not being able to establish an effective tax collection system nor increase the public revenue. The government gave up some of its tax revenues either to improve the financial sector or to support a certain economic activity. On the other hand, occasional remittances of the interests on tax debts and lack of supervision of the income earner's accounts, excluding the payroll taxpayers, degraded tax morality and obstructed the government's attempts to broaden the tax base.<sup>141</sup>

## **F. EFFECTS OF GOVERNMENT'S ECONOMIC POLICIES**

This section evaluates the relationship of the government's economic policies on the 1998 economic crisis and tries to demonstrate that the changes the government attempted prior to 1998 had significant influence on the crisis. As discussed in the previous sections, both the transformation of the Russian political arena, IMF policies and global economic problems created a suitable environment for an economic crisis. On the other hand neither the political factors nor the unfavorable economic situation caused an economic crisis. The events that ultimately started the crisis began with the government change in 1993 after the ratification of the new Russian Constitution.

Following the ratification, the new regime put all resources towards restoring the economy and basic standards of living. The government became heavily reliant on the central bank, foreign investment, and IMF for support. As this became more apparent, many investors began to lose faith in the strength of recovery and pulled out causing deterioration in the ability of the government to continue with economic reforms. The IMF rushed a relief package but was of little help.

The Russian's decided upon the IMF "shock therapy" type of program. But disregarding warnings from some veteran Sovietologists, the reformers, as noted earlier,

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<sup>141</sup> Schroder Solomon Smith Barney/ Citibank. "Russia: Capital Outflows Declining , Inflows Increasing and What About FDI?" Economic and Market Analysis, London: EC472, November 8, 2002.

refused to acknowledge that Russia was a special case. It was inconceivable to them that an economy could exist without an underlying market infrastructure. Just as when “shock therapy” reform was introduced in developing countries, the reformers in Russia assumed that all it would take would be a dose of fresh economic air to turn what was a dysfunctional economy in extension into a functioning one. With a freely functioning price system, prices would rise, queues would shrink, profits would rise, and output would increase. Almost immediately, new businesses would open their doors and a viable market infrastructure would take form. None of this happened, and actually the opposite took place.

Factory managers suddenly found themselves without a guide as to where to find inputs and how much to pay for them and, similarly, what to do with their outputs and how much to charge for them. At the same time, while government officials had been divested of their former responsibilities and obligations, they were as yet unfamiliar with the new powers normally operative in market economies. To make matters worse, Russia at the time was caught in a hyperinflationary environment, as evidenced by the twenty-six-fold price increase that occurred in 1992.<sup>142</sup> The result was people needed to find ways to supplement their income to survive, so many resorted to corruption and extortion.<sup>143</sup> The corruption seeped into all aspects of Russian life and politics including the tax system. The money otherwise destined for the government is diverted instead to the tax collectors' pockets as discussed earlier.<sup>144</sup> The corruption and lack of confidence had a huge impact on the transformation process and the ability to successfully operate under a market system. Due to a lack of good advice and guidance, Russia transformed into a hybrid of economic systems full of corruption and problems.

The IMF with assistance from the United States attempted to restructure the failing Russian economy but found that retrofitting is always more difficult than doing something properly the first time around. The biggest obstacles that were encountered by the IMF were the people, who lost faith in the government and its ability to successfully

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<sup>142</sup> Asad Alam and Mark Sundberg. “A Decade of Fiscal Transition,” September 20, 2001.

<sup>143</sup> Financial Times 1; Transactions 10, no. 5: October 1999.

<sup>144</sup> Manoucher Mokhtari and Irina Grafova, “The Russian Federation at Crossroads: Tax Collection, Transfers and Corruption,” University of Maryland (November 1999).

transition to a market system. Another difficulty was the few oligarchs who have benefited so enormously have acquired a vested interest in the status quo, whether it is good or bad for the country as a whole.

The reforms proposed in Russia would only be successful with public pressure and the business community, not only for a set of more equitable laws but also for the enforcement of those laws. This would be the only way of weakening the oligarchs and monopolists that were plaguing the Russian attempts at transformation. Moreover, a larger number of business men and women is likely to mean that there will be more effective lobbying groups, interested and determined to set restraints on the bureaucrats' ability to abuse the property rights of others.

On May 2, 1992, Moscow's Mayor, Yuri Luzkov, undermined Boris Yeltsin's attempts at a successful transition by decreeing that anyone anywhere could sell whatever they wanted to.<sup>145</sup> This single act destroyed what might have been the best chance Russia had to build up the marketing infrastructure that it lacked. In that four-month period, Russians from across the country flocked to major intersections and metro stops to sell whatever they could assemble. Many were selling out of desperation,

Eliminating bureaucratic obstructions and corruption is one part of the process Russia needed to address. Once the doors were opened, attempts needed to be made to facilitate start-ups by offering readily available loans, something that Russian banks tended to avoid due to lack of funding or confidence. A study by the Russian Duma Committee on Privatization has reported that, from 1992 to 1996, the government collected only \$20 billion from the sale of about 70 percent of what had been the nation's state enterprises. According to their study, "too much was sold off, and often at the wrong time," under a set of laws that "covered only about 15 percent of the legal issues involved."<sup>145</sup>

Owners should be compensated or given the right of first refusal to make up the difference between the market value at the time and what they actually paid. Those

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<sup>145</sup> <http://www.usembassy.it/file9909/alia/99092421.htm> (February 10, 2003).

businesses acquired as part of the Loan for Shares program, in which valuable properties were sold at one-tenth their value to oligarch insiders in rigged auctions, should be made special targets.

## **G. CRISIS EVENT AND GOVERNMENT'S RESPONSE**

One of the Russian government's initial objectives after the fall of the Soviet Union was attempting to control the high rate of inflation through a series of economic stabilization programs. The programs included opening the economy to free markets, increasing interest rates and cutting money production. The disinflation programs of the 1990s, however, failed to achieve their objective of decreasing high inflation rates. The IMF identified the lack of structural reform as contributing to the continued fiscal pressures, which in turn, undermined attempts to achieve and maintain macroeconomic stability.<sup>146</sup> The World Bank and the IMF particularly emphasized the fiscal commitments to the SEEs, agricultural subsidies, social security obligations, and financial sector bailouts as the major causes of fiscal expansion, which undermined attempts to stabilize prices.

The goal of Russia's 1995 IMF backed stabilization program was aimed at resolving many of the problems the IMF felt were slowing Russia's economic transformation. This stabilization program aimed at improving Russia's fiscal balance and reducing the long- lasting price inflation. The main tenets of the program were tighter fiscal policy and structural reform.

Despite the stabilization programs by the IMF, the main problems of the Russian economy remained the same. The success of a stabilization program depends on the consistency of the overall package of the measures and perceived ability of the authorities to pursue these policies successfully.<sup>147</sup> During the period between 1991 and 1998, the Russian government failed to follow this consistency principle, mostly due to political factors. As the political competition in the Russian political environment increased after

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<sup>146</sup> William Easterly, "The Effect of IMF and World Bank Programs on Poverty," World Bank (November 2000).

<sup>147</sup> Asad Alam and Mark Sundberg, "A Decade of Fiscal Transition," (September 20, 200): 5.

the 1993 ratification of the new constitution, the government began to compromise with the 1995 stabilization program and pursued expansionist economic policies to increase its support for the new government and constitution.

This situation, however, significantly affected the government's ability to implement essential fiscal measures to stabilize the Russian economy. Consequently, although tight monetary and fiscal measures were supposed to be implemented after the 1993, the government failed to achieve neither of these successfully. The main problems of the Russian economy, such as the increasing public deficit and high inflation rate, remained unresolved and these problems finally led to the economic crisis in 1998.<sup>148</sup>

With these attempted improvements in the economy, the stabilization programs were short-lived and balances began to worsen towards the end of 1994 due to shifts in political power and global events including the war in Chechnya. The result was the crash of the ruble and the beginning of the road to the 1998 economic crisis. The reasons that contributed to the collapse of the stabilization program will be discussed in detail in the following section.

## **H. INITIAL CRISIS EVENT AND GOVERNMENT'S RESPONSE**

### **1. Immediate Impact of 1992 Ruble Devaluation**

The fall of the Soviet Union in 1991 significantly affected the Russian economy; in the aftermath of the crisis, the Russian economy recorded the highest decrease in output in the history of the Russian Republic. The economy contracted by approximately 6 percent. The Russian Ruble substantially depreciated against major foreign currencies between January and April 1992; the Russian Ruble depreciated by almost 70 percent against the United States Dollar and real prices skyrocketed.<sup>149</sup> The high depreciation ratio of the Russian Ruble significantly contributed to the output loss in the Russian economy by causing bankruptcies among businesses. Businesses that had foreign-currency denominated loans could not afford their payments and went bankrupt, causing

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<sup>148</sup> Asad Alam and Mark Sundberg, "A Decade of Fiscal Transition," (September 20, 2000): 4-8.

<sup>149</sup> <http://www.departments.bucknell.edu/russian/chron4.html> (December 21, 2002).

a drastic decrease in national output and increasing unemployment.<sup>150</sup> Rising prices resulted in a sharp decrease in both real wages and household income. Banks did not want to extend their lending in such an uncertain environment and increased their lending rates by approximately 400 percent between January and April 1994. The volatile economic situation, coupled with rising lending rates, significantly affected private consumption and investment, both of which declined during the crisis period.<sup>151</sup> The IMF's response, however, came quite late when considering that the crisis event began to unfold years earlier.

## **2. Government's Response to Conditionality**

Economic stabilization programs are usually implemented in developing countries facing high inflation, high external debt, unsustainable public-sector budget deficits, and balance of payments crisis. The fundamental objective of a stabilization program is to balance aggregate supply and demand in the economy. Timing is a crucial factor for achieving the projected goals of a stabilization program, regardless of which type of program is implemented. In the case of an economic crisis, the sooner the government launches a stabilization program, the more successful the stabilization program will be to alleviate the impacts of the economic crisis.<sup>152</sup>

When examining the economic crisis in Russia, the government was late in responding to the crisis with an effective stabilization program. The crisis' roots can be traced to 1992 as discussed earlier, but the government postponed any major stabilization effort until after local elections and the ratification of the constitution. The concern by many Russian leaders was that any stabilization effort before the local elections would endanger voter support for the coalition parties that formed the government. Immediately following the elections, the government under Boris Yeltsin announced the stabilization package. The government set out to decrease the high inflation rate, stabilize the Russian

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<sup>150</sup> William Easterly, "The Effect of IMF and World Bank Programs on Poverty," World Bank (November 2000).

<sup>151</sup> Dr. Philip Hanson, "Systemic Change and International Security in Russia and the New States of Eurasia," Presentation at The Johns Hopkins School of Advanced International Studies, February 23, 1999.

<sup>152</sup> Asad Alam and Mark Sundberg, "A Decade of Fiscal Transition," (September 20, 2001): 4-5.

Ruble, and attempted to restore economic stability in the short-run and implement structural reforms to maintain economic stability in the long run.

The government's failure to fully implement the stabilization programs, including privatization, tax reform and reduction of corruption greatly contributed to its failure. The government as a result was unable to raise the revenue it expected due to a lack of maintaining the tight fiscal policy it adopted in the initial stage of the stabilization program and relaxed its fiscal policy over time. As a result, despite the initial increase in the consolidated budget revenues and the decrease in the current expenditures, the government failed to keep the consolidated budget deficit within the IMF performance criteria with the deficit substantially increasing towards the end of 1994.<sup>153</sup>

In August 1998, the Asian financial crisis hit the Russian economy and aggravated the already adverse macroeconomic conditions in the Russian economy. In the aftermath of the Asian financial crisis, fiscal and current account deficits, the inflation rate, and unemployment rates significantly increased. These developments forced the government to sign a new stand-by agreement with the IMF in 1999. The government, however, could not effectively implement the measures of the IMF agreement and the Russian economy experienced the economic crisis.

The volatility in the financial markets stabilized temporarily after the IMF announced the availability \$10 billion financial assistance to the government. The IMF conditioned the financial assistance on the government's commitment to strengthen the financial sector, accelerate privatization, and to strengthen the budget to accommodate the fiscal costs of bank recapitalization.

Before the economic crises, the government delayed necessary structural reforms and executed inappropriate economic policies, which distorted the government's fiscal situation. In 1997, the government changed its debt financing methods and began to rely heavily on the Central Bank's resources to finance the public deficit. In addition, the government delayed implementing disciplinary fiscal measures until after the crisis happened. The government did not implement necessary banking regulations to

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<sup>153</sup> Maxim Boycko, Andrei Shliefer, and Robert Vishny, Privatizing Russia (Cambridge: MIT Press, 1995) vii.

restructure the banking system in order to establish a strong financial system. Russian banks remained highly vulnerable to shifts in the government's economic policy. Excessive foreign borrowing of the banks increased their vulnerability to unexpected increases in the interest rates. As a result, the inadequate risk management coupled with poor banking system regulation and moral hazard caused by government guarantees prevented the establishment of a strong financial system in Russia which, in turn, catalyzed the emergence of both 1992 ruble depreciation and 1998 economic crisis.<sup>154</sup>

## **I. CONCLUSION**

In conclusion, the government's economic policies significantly contributed to the 1998 economic crisis. This does not mean that deterioration in macroeconomic fundamentals did not contribute to the crisis. On the contrary, the deteriorating fiscal situation created a volatile economic environment prone to speculations. As a matter of fact, the government's economic policies in the second half of 1993, canceling domestic debt auctions and relying on the Central Bank's resources, were some of the main factors that started the crisis. In the absence of substantial stabilization measures, the government should have continued domestic debt financing despite its high cost, rather than relying on the Central Bank's resources. This would allow the government to maintain foreign exchange reserves, contain the inflation rate, and gain valuable time to design and implement radical stabilization measures to improve its fiscal situation.

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<sup>154</sup> Dr. Philip Hanson, "Systemic Change and International Security in Russia and the New States of Eurasia," Presentation at The Johns Hopkins School of Advanced International Studies, February 23, 1999.

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## V. THESIS CONCLUSION

Over the past decade, there have been extensive debates as to the effectiveness of IMF assistance in transitional economies. This thesis took this debate and focused it with respect to Russia and the IMF's impact on the 1998 Russian economic crisis.

The Russian economic crisis illustrated a combined misunderstanding by both the IMF and Russia as to the nature of the problem and the correct way to solve it. The result was the 1998 crisis. The crisis began long before the IMF and Russia began to collaborate on the transition of Russia. The blame can be placed on both sides but the burden lies more on the Russian side. The lack of addressing the corruption, inefficiencies, and the stagnant economy threatened the possibilities of a strong economy long before the IMF became involved. The legacy of the decisions made in the pre transition period influenced the policy choices of the Russian Government prior to and during the 1998 crisis.

Davies and Woods proposed three possible positions as to the cause of the crisis that were discussed in chapter III: The first position suggested is one of "we lost Russia" or that the West was responsible for the failure of Russia due to lack of assistance. The second view, and probably one of the most accepted outside the IMF, is that outside pressures forced the Russian government to adopt measures ill-suited to the conditions of the country. The last position is that Russia brought about its own demise and that outside intervention did not help and could not have prevented the crisis. The evidence presented in this demonstrates that Fund sanctions can be costly. This is somewhat surprising, since the conventional wisdom is that states can return to the Fund with their past sins of program noncompliance forgiven and receive fresh loans.

This evidence stands in contrast to our conventional understanding suggests that Fund sanctions are costly to the extent that they deter additional flows of loans and investments into a country. While these countries made mistakes, their economies were undermined by the impact of the global market and capital flows that the IMF sought to set free.

Chapter II showed the Russian government's policies were not the sole cause of the crisis. The IMF played a role by their failure to address the root causes of Russia's difficulties. Without an accurate understanding of Russian culture and a complete grasp of their problems, the IMF prescribed inappropriate measures to the Russian government. The IMF made two crucial mistakes in Russia. The first was their lack of understanding as to the true nature of Russia's problems. They assumed they could take a pre-existing model and apply it to Russia and instantly create a capitalist economy. This was a major oversight. The second mistake was the failure to ensure stabilization programs were actually being implemented. By not ensuring progress, the IMF permitted Russia to adopt destructive policies resulting in much of the debt, corruption and general distrust experienced. The arguments by Stiglitz, Sanders and others stated: the worst mistake Russia made was accepting IMF assistance.

As the economy continued to decline, greater political discontent and fractionalization within and outside of the Soviet government occurred. One of the biggest factors to the fall of the Russian economy came from within. Mikhail Gorbachev came into power with ideas of transforming Russia back into a great power. Gorbachev's primary miscalculation was his quick transformation of the centralized economy. The transformation began without having the market system to replace it.

After decades of communism, the people and the government were not prepared for the transition of their government and economy. Lack of knowledge as to the ways of capitalism and the need to adjust to new structure of government and living, greatly hindered the transition and success. The economy in the Soviet Union, hobbled by corruption, inefficiency, and the lack of free markets, finally collapsed June 1990. With the collapse of both the political and economic systems, the Soviet Union merely ceased to be and in its place arose Russia and the other newly independent states. Massive demonstrations in Moscow in August 1991 over an attempted coup by hardliners were witness to the demise of the Soviet Union.

The government's economic policies significantly contributed to the 1998 economic crisis. Upon completion of this thesis, several factors were brought to light in the wake of the crisis. On the Russian behalf, the contributing causes were a result of

attempts to transform their culture without a clear direction on how to complete the transition successfully. As a result, ad hoc transformation resulted in large deficits, corruption and failure. With the introduction of IMF assistance, the Russian government continued to pursue policies detrimental to successful transformation. The government failed to meet self-imposed or IMF mandated reform policies. As Russia continued to fall apart, the government continued to ignore the underlying problems causing the crisis. This does not mean that deterioration in the world economy or the IMF did not contribute to the crisis. On the contrary, in the absence of substantial stabilization measures, the government should have continued domestic debt financing despite its high cost, rather than relying on the Central Bank's resources. This would have allowed the government to maintain foreign exchange reserves, contain the inflation rate, and gain valuable time to design and implement radical stabilization measures to improve its fiscal situation.

This thesis found considerable problems with the Russian transition to a capitalist economy. The research in this thesis present many factors that played a role in creating the 1998 Russian economic crisis. In the end the blame for the crisis was not the economic or political liberalization of Russia, nor the world economic environment, or IMF policies, or lack of understanding; it was a combination of all these factors.

The combination of both Russia and the IMF's misunderstanding and lack of cooperation created an environment, which made the crisis inevitable. It is acknowledged, as addressed in this thesis, that world factors may have had a part, but these only worsened an already volatile situation. So in conclusion the cause of the 1998 Russian economic crisis is a result of mistakes by both the IMF and Russia.

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