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Russia From Crisis to Crisis

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RUSSIA FROM CRISIS TO CRISIS

Balance of Payments and Monetary Policy Review
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The period of more than a year that has passed since the latest devaluation of the ruble makes it possible to analyse unemotionally the causes of the monetary and financial crisis of 1998 and evaluate their impact on the country's balance of payments.

(The period between the last two devaluations—from September 1994 to September 1998—is reviewed.)

A great deal has been written about Black Tuesday, so the analysis of the developments that led to 1994 crisis is not the purpose of this paper. It should only be noted that the ruble devaluation of September 11, 1994, which occurred when the exchange rate was allowed to float while the inflation ran at 215 percent, did not change the dynamics of the real exchange rate, which even grew slightly, and had no impact on foreign trade, which continued to expand quickly (over the year the foreign trade turnover increased by almost 18 percent).

1995

The sweeping administrative measures undertaken by the Russian authorities in the second half of 1994 and early 1995 to liberalise foreign trade (Russia lifted quantitative restrictions, abolished the institute of special exporters, shortened the list of export commodities requiring licensing and cancelled some export tariffs) had, metaphorically speaking, a pushing effect on the country's balance of payments, causing it to move like a pendulum.

At the beginning, the large-scale liberalisation of foreign economic activity led to an unprecedented growth in exports, which in the 1st quarter of the year expanded by 40 percent as compared with the same period of the previous year. At the same time, the current account surplus soared to an all-time record of $8.3 billion, strengthening the ruble significantly in real terms.

As the dollar became cheaper against the ruble, the imports started growing at a landslide speed (in the 2nd quarter the imports of goods and services rose by 27 percent as compared with the 1st quarter), while exports remained unchanged and in July–December period the current account posted a small deficit.

The first and the most spectacular phase (in the 2nd quarter for the first time ever the ruble began to grow stronger even in nominal terms) provoked revaluation expectations and economic agents started to flee from the dollar to the ruble. That year was the only one in the analysed period when no growth in foreign currency holdings was registered in the non-banking sector.

The second stage, which, as it was noted above, resulted in a current account deficit, did not weaken the ruble in real terms because foreign capital had already begun to flow into the country. At that time significant expansion of financial support for the Russian reform by the IMF sent an unambiguous encouraging signal: in 1995 the loans extended to Russia ($5.5 billion) exceeded by 38 percent the loans rendered to this country during the preceding three years of its membership in that organisation.

The success in monetary and foreign exchange spheres even made the residents reconsider their investment priorities, encouraging them to repatriate the funds they had taken out of Russia in the previous years. The 1995 was the only year in the entire period under observation when the economy’s foreign assets (except reserve assets) decreased. Moreover, they declined by a whopping $4 billion (net amount).

Taking advantage of the favourable situation in the 1st quarter and significant growth in the international reserves (in January–June they expanded by more than $6 billion), the monetary authorities made a turnaround in their foreign-exchange policy, which was intended to keep the exchange rate within the established band for the six months to come (the so-called “horizontal exchange-rate band”). It was justly believed that the exchange-rate band set and declared in advance and backed up by the market mechanisms would have a stabilising effect on the country’s financial system, reduce inflationary expectations and, combined with the budget deficit-cutting measures, give an impetus to recovery in the real sectors of the economy.

On the whole, the 1995 developments confirmed the soundness of the tactics persued: the inflation rate slowed down from 215 percent to 131 percent, the GDP decline slowed down from 13 percent in 1994 to 4 percent, the budget deficit decreased from the previous year’s 10.7 percent to 4 percent of the GDP and the international reserves grew by $10.4 billion.

1996

The favourable trends in foreign trade continued from the previous year and 1996 became the best year for the balance of payments.

Bearing in mind the current account problems of the second half of 1995, the monetary authorities modified the exchange-rate policy and on July 1 introduced the so-called slanting exchange-rate band regime. Its slope corresponded to anticipated and forecasted inflation rate. In other words, the exchange-rate movement within that band ensured its zero change in real terms and neutrality in regard to the profitability dynamics of foreign economic transactions.

The current account surplus reached its maximum level at $12 billion, and this was not the result of any administrative measures to liberalise exports (the effect of such measures had already been significantly exhausted by that time), but reflected a substantial rise in the world prices of fuel and energy, the major items of Russian exports. In the 4th quarter the price of crude oil reached its maximum level, averaging $23 per barrel in October–December.

Net capital inflow from abroad almost quadrupled (to $26 billion against $7 billion in 1995). This development was significant since for the first time considerable funds were invested in production: over the year the non-financial enterprises attracted over $6 billion - $2.4 billion in foreign direct investments, $2.2 in portfolio investments and $2.5 billion in foreign loans.

For the first time ever Russia appeared on the European credit market, placing a $1 billion worth of federal eurobonds, while the loans from foreign governments and international financial organisations to the Russian government sector exceeded $9 billion.

However, the macroeconomic stabilisation that commenced in 1995 could not be maintained mainly due to chronic budget problems. The federal budget deficit in 1996 rose to 3.3 percent of the GDP, while the price of domestic government borrowings became exorbitant.

These developments and the fact that resident investors evaluated the political situation in Russia during the 1996 presidential elections more sceptically and nervously than the non-residents led to the resumption of massive capital outflow. The commercial banks augmented their foreign assets by $3 billion, non-financial enterprises and households increased their foreign-exchange holdings by $9 billion and illegal capital outflow intensified significantly.

Keeping the exchange-rate dynamics within the pre-set limits, the Bank of Russia had to conduct massive currency interventions in the domestic foreign-exchange market, reducing Russia’s international reserves by $2,8 billion.

To cope with the budget deficit financing problems and in order to cut the yields on the government borrowing instruments (GKO-OFZ) the monetary authorities made the difficult decision to allow non-residents to have a wide access to the government securities market. The move was deemed as a temporary measure, giving the government some breathing space needed to develop and implement an effective fiscal policy and improve tax collection.

Nonresident capital did the job: GKO yield fell by more than two times and reached 32.6 percent at the end of the year.

The budget problems piled up, however, and the government had to borrow more and more in order to cope with them. The Russian market for ruble-denominated government securities could no longer survive without non-resident capital.

Over the year non-residents’ net investment in the ruble-denominated government securities amounted to nearly $6 billion and by the end of the period under the review these financial instruments in their portfolio accounted for about 17 percent of the total face value of the issued securities.

Thus the budget became heavily dependent on foreign capital injections, the internal sources of financing the budget deficit were gradually replaced by external ones and that perpetuated the backwardness and weakness of the Russian fiscal infrastructure.

1997

In 1997 Russia's balance of payments was determined by the following three major factors:

- a fall in the world energy prices (the price of crude oil dropped by 5.5 percent);
- the crisis that hit South East Asian capital and currency markets in the second half of the year;
- the mounting federal budget deficit (3.6 percent of the GDP).

As before, the exchange rate was kept up at roughly the same level in real terms within the limits of the "slanting currency band".

The first factor along with the increased burden of servicing the foreign debt led to a threefold decrease in the current account surplus and as a result of the second factor, the massive capital inflow in the January–June period gave way to the significant capital outflow in July–December and enhanced capital export by the residents.

Therefore, the increase in foreign exchange holdings in the non-banking sphere rose to an unprecedented $13.4 billion.

The third factor naturally required a wider use of external sources of financing the budget deficit, whose share in all sources of the budget deficit financing expanded from 45 percent in 1996 to 57 percent. At the same time, the inflow of nonresident funds to the GKO-OFZ market amounted to $10.9 billion and by the end of the period the non-residents held 27.5 percent of all such securities traded in the market.

Foreign capital inflow in the 1st quarter of the year allowed the monetary authorities to increase significantly the foreign exchange reserves (by $9.3 billion), but during the remaining part of the period under the review the Bank of Russia, being commited to its foreign-exchange policy, had to conduct massive interventions which assumed proportions of billions of dollars. The situation required an adequate reaction—change of foreign-exchange policy and transition from the rigid "currency band" policy to a floating exchange rate regime. Unfortunately, that wasn't done.

1998

The beginning of 1998 was not very promising for the balance of payments. The fall in world energy prices accelerated, while the burden of servicing the foreign debt accumulated by all sectors of the economy continued to grow fast. The investment income account deficit reached an exorbitant amount of more than $11 billion.

It should be noted that the latter became possible because the quality of foreign assets accumulated by the economy was much lower as compared with liabilities to non-residents. It is sufficient to recall that multibillion claims on non-residents have the form of non-interest bearing-assets, such as foreign exchange holdings.

As a result, the current account deficit began to grow fast: in the first half of the year it amounted to $5 billion.

Instead of introducing a floating exchange rate, the authorities announced a new wider exchange-rate band, this time a horizontal one, for three years rather than for six months as before, that is, until the next presidential election. That move changed little in substance because the authorities intended, as before, to keep the exchange-rate dynamics in line with the inflation rate (and they did). In other words, there was no intention to modify the exchange rate in accordance with new realities. Their decision was hardly dictated by economic considerations: to remain within the band, the Bank of Russia in July and August sold several billion dollars at the average rate of 6.2 rubles and 7.1 rubles per dollar respectively.

In May non-residents began to withdraw their funds from ruble-denominated instruments, convert them into hard currency and repatriate.

The main sectors of the financial market were destabilised and the government could no longer refinance domestic debt by incurring new liabilities. As a result, the federal budget deficit in 1998 was entirely financed out of external sources and the budget's dependence on external financing went beyond all reasonable proportions.

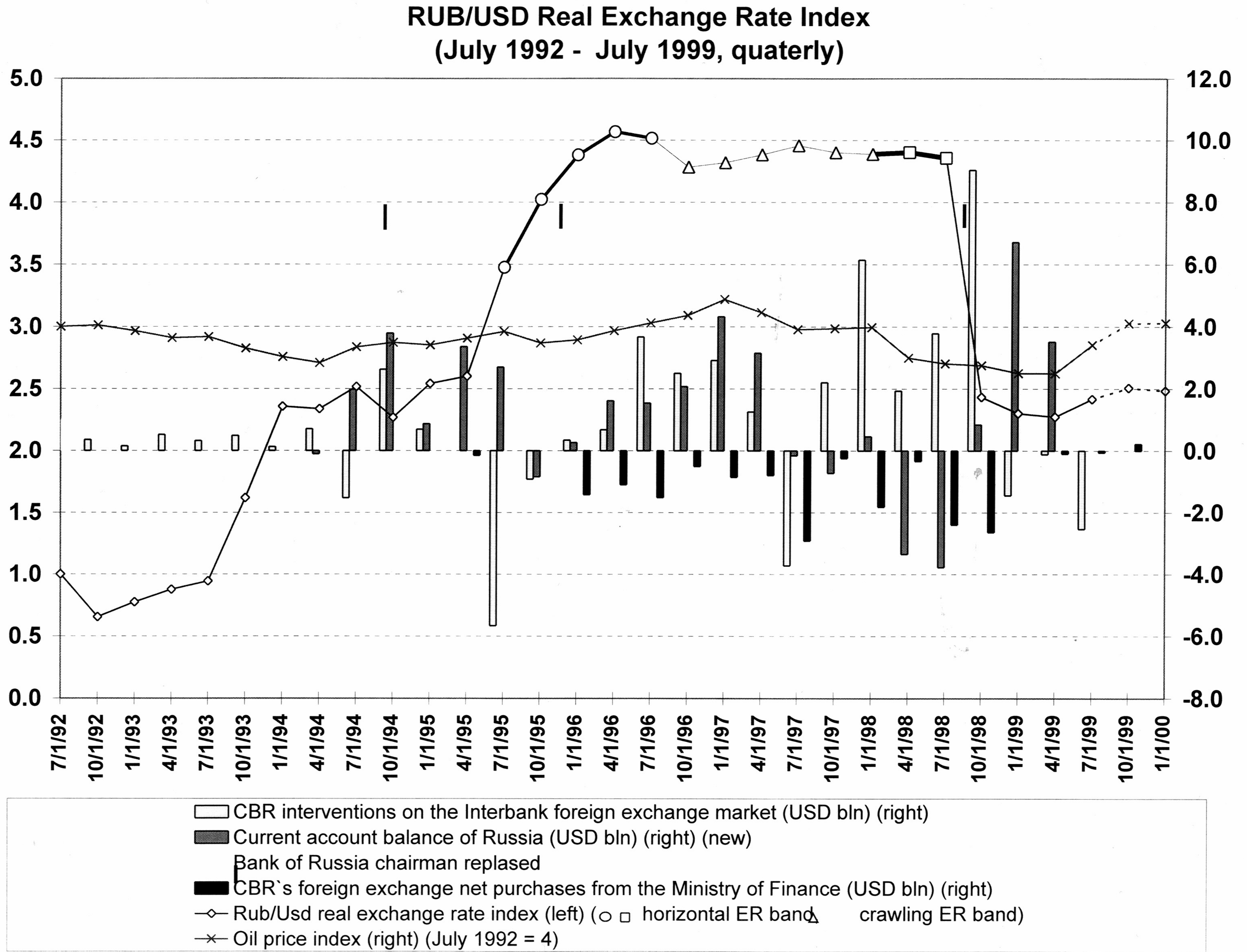
The attempts to stabilise the situation (partial conversion of ruble-denominated liabilities into long-dated foreign currency denominated ones and a moratorium on some transactions with non-residents), made in July-August, failed to produce the desired result. Capital outflow continued and on August 17 the government had to announce its decision to suspend the servicing of GKO-OFZ bonds due before the end of 1999 (the value of securities in question reached at that time about $13 billion in nominal terms).

By the beginning of September it became clear that it was no longer possible to contain the accumulated devaluation potential and maintain the new exchange-rate band announced on August 17 without reducing international reserves to a dangerously low level. In other words, their further depletion was not deemed to be permissible, so it was decided to change drastically the foreign exchange policy, to adopt a floating exchange rate regime and eventually to devalue the ruble.

The devaluation restored the economically significant exchange rate proportions, caused imports to decrease and straightened out the balance of payments on current transactions.

Speaking again of the causes of the 1998 crisis, one should, firstly, bear in mind the chronic budget problems that accumulated for years and eventually led to an exorbitant short-term foreign debt, which, as everyone knows, has a very unpleasant intrinsic feature to be repaid at short notice.

Secondly, it should be admitted that the foreign-exchange policy pursued from July 1997 to August 1998 was not responsive to the fast changing external and internal conditions. It failed to react effectively to the changed foreign conditions and the exacerbation of domestic problems and that led to conservation of the exchange rate of the ruble at an unreasonably high level in real terms.



RUB/USD Real Exchange Rate Index
(July 1992 - July 1999, quaterly)
5.0
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
-6.0
-8.0
7/1/92
10/1/92
1/1/93
4/1/93
7/1/93
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1/1/94
4/1/94
7/1/94
10/1/94
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1/1/00
CBR interventions on the Interbank foreign exchange market (USD bln) (right)
Current account balance of Russia (USD bln) (right) (new)
Bank of Russia chairman replased
CBR`s foreign exchange net purchases from the Ministry of Finance (USD bln) (right)
Rub/Usd real exchange rate index (left) (horizontal ER band crawling ER band)
Oil price index (right) (July 1992 = 4)