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Russia: From Rebirth to Crisis to Recovery

NOT A SINGLE REFORM EFFORT IN RUSSIA HAS EVER BEEN COMPLETED.

Boris Yeltsin
President of the Russian Federation
1994

On August 19, 1991, hard-line communist forces in the Soviet Union launched a military coup against President Mikhail Gorbachev in reaction to his efforts to give greater autonomy to the Soviet republics. In Moscow, with Gorbachev under house arrest in Crimea 1,200 kilometers to the south, Russian President Boris Yeltsin climbed atop a tank outside the parliament building to call for a general strike and for the armed forces to oppose the coup. The resulting popular fervor and military support crushed the conspiracy and restored order within two days. Although Gorbachev quickly returned to the Kremlin, Yeltsin now held the reins as the union collapsed and the Russian Federation emerged as the successor state and dominant regional power. Almost exactly seven years later, on August 16, 1998, a physically ill but still politically powerful Yeltsin faced a financial crisis that threatened to undo all the economic and perhaps even the political reforms he had brought to Russia. The Russian ruble, the strength of which was the most visible symbol of his success, verged on toppling, and Yeltsin had no choice but to agree to a default on a substantial part of his government's debt.

The path that Yeltsin and Russia took from the political crisis of 1991 to the financial crisis of 1998 was one of steep slow climbs and precipitous crevasses. The promised rewards at the end were a strong, healthy economy; a free and democratic political system; and a welcome to a seat in global councils. The potential cost of failure would be an impoverished country of nearly 150 million people; a return to communist or ultranationalist dictatorship; and political isolation from a world community fearful of Russia's massive arsenal of nuclear weapons. Helping Russia's leaders succeed, whatever their faults might be, was the most important task and the biggest challenge facing every world leader and every international institution—none more than the IMF. At the end of the decade, Yeltsin's pessimistic observation (quoted above) remained true, with the push for democracy and economic reform still meeting resistance. Even so, economic progress was palpable, and the worst risks seemed to have been conquered.

First Steps

Once the baton of leadership passed to Yeltsin, he did not hesitate to run with it. On January 3, 1992, less than a week after becoming the undisputed sovereign head of the Russian Federation, he wrote to the Fund's Managing Director, Michel Camdessus, applying for IMF membership.[1] Standing behind Yeltsin and spearheading this move was First Deputy Prime Minister Yegor Gaidar. Gaidar had been picked to oversee the economy of one of the world's great powers, but he understood full well that the economy was virtually bankrupt.[2] At the moment that Russia emerged as the successor to the Soviet Union, it inherited responsibility for a rising stock of some $66 billion in external debt, and it possessed only a declining stock of not much more than $2 billion in net gold and foreign exchange reserves.[3] Consumer goods were extremely scarce because the Soviet production and marketing systems had effectively ceased to function. Without full cooperation from creditor countries, Russia could neither service its debts nor escape from its rapid descent into widespread deprivation and poverty. Securing that cooperation, as the Group of Seven (G7) industrial countries made clear, would require the IMF to take on a central role as policy advisor, lender, and coordinator of western assistance.

[1]"Russian Federation: Application for Membership," EBD/92/4 (January 7, 1992). Yeltsin was elected president of Russia on June 12, 1991, and shared power with Gorbachev until the dissolution of the Soviet Union.

[2]Yegor Timurovich Gaidar was one of the leading advocates of economic and political reform in Russia throughout the first two decades of the transition. Although he was in the government only intermittently in the 1990s, as described throughout this chapter, he continued to influence the reform process as a politician, as the founder and director of the Moscow-based Institute for the Economy in Transition, and as a prolific writer who authored several best-selling books. Gaidar was one of the most frequent and helpful contacts for senior IMF officials throughout the 1990s. He died in 2009, just 53 years old.

[3]Even though the Soviet Union was one of the world's largest miners of gold, its official holdings at the end of 1991 were reported at just 290 tons (then worth approximately $3.2 billion), and a substantial portion of that stock was pledged as collateral for various foreign obligations. As of end-March 1992, Russia reported its net international reserves to the Fund as $2.25 billion; see "Russian Federation—Use of Fund Resources—Request for First Credit Tranche Stand-By Arrangement" (EBS/92/119, Suppl. 3, July 24, 1992), Table 6; and Letter of Intent (EBS/92/119, July 10, 1992), p. 16.

The link between G7 assistance and Russia's cooperation with the IMF had started with the joint study of the Soviet economy in 1990 (IMF and others, 1990), had been reinforced by the Special Association agreement in July 1991, and had been cemented in a G7 accord on Soviet external debt in November.[4] Although it would take several months to complete the process of bringing Russia formally into IMF membership, these earlier agreements paved the way for the Fund staff to open discussions immediately on an economic reform program.

A Preliminary Economic Reform Program

For the Fund to negotiate and agree to monitor a program for a nonmember country was unprecedented, but so were the circumstances. The Special Association agreement provided a mandate and a framework, and the Fund eagerly seized the opportunity and the responsibility thrust upon it. The more ominous aspect of the arrangement, as would become increasingly clear in the ensuing years, was the G7's controlling role over the ostensibly independent activities and decisions of the IMF in its relations with Russia.

Gaidar's reform campaign began with a bang when the government ended controls on all but a few prices on January 2, 1992. Because most prices had been kept artificially low and because little competitive pressure acted to hold market prices down, this liberalization quickly led to a 10-fold increase in the overall price level, but it also quickly succeeded in bringing consumer goods back into shops where shelves had long been almost bare.[5] Preventing this initial and necessary adjustment from turning into ongoing and destructive inflation posed the next challenge. The Central Bank of Russia absorbed and replaced the old Gosbank, but it was still far from being a real central bank with the means, mandate, and will to stabilize the price level by limiting the banking system's access to liquidity. Two separate IMF mission teams spent most of January in Moscow trying to assess the situation, but they had to spend the greater part of their time just collecting basic data from officials who were still reluctant to release it.[6]

Russia attached the highest priority at this point to reaching an agreement with the Fund on stabilizing the economy, because that would unlock access to possibly large-scale financial assistance from the G7 and other donors. That goal was achieved fairly easily because Gaidar and John Odling-Smee (Director, European II Department, or EU2), largely saw eye-to-eye on the major policy issues. After some

[4]Relations with the Soviet Union in 1990 and 1991 are covered in Chapter 2. The settlement of Soviet debt is discussed in Chapter 8.

[5]The economic effects of the price liberalization are analyzed in Koen and Phillips (1993).

[6]Memorandum from Ernesto Hernandez-Catá to the Managing Director, "Russia—Back-to-Office Report" (January 29, 1992); and memorandum from Tobias Asser, Joseph Lang, and Orlando Roncesvalles to the Managing Director, "Russian Membership" (January 31, 1992); IMF archives, OMD-AD, "Russia 1992 – (1) Country Files," Box 22043, Accession 1996-0187-0006.

haggling over the targeted inflation rate, the staff and the Russian authorities agreed on the text of a Memorandum on Economic Policies (MEP; similar to a Letter of Intent for a conventional Fund-supported policy program) before the end of February. Camdessus understood that political support for the reforms was limited in Russia, as was the government's administrative capacity to carry out its intended policies,[7] but he had no choice other than to gamble on the authorities' ability to get the job done.

Russia's Quota

Before the Fund could lend to Russia, the Executive Board had to decide on the terms on which Russia could become a member of the Fund. Politically, Russia was sufficiently important to have a quota large enough that it could elect its own Executive Director—but not so large as to put it in the top five members with the right to appoint their Directors, nor so large as to encroach upon the G7.[8] Those considerations implied that the quota should be in the range of 2.5 percent (just above China) to 3 percent (just below Italy) of total quotas. Illustrative calculations by the staff, using the standard quota formulas but relying on data that were known to be of poor quality, suggested a similar range.[9] Within that range, the prevailing view among the sitting Directors gravitated toward setting the quota closer to the lower end to avoid upsetting the balance of power any more than necessary.[10] When this proposal was put to the Russian negotiator, Konstantin Kagalovsky, he rejected it as categorically unacceptable.[11]

In the absence of reliable data, political considerations guided the quota discussions. In the view of the Russian government, the Fund's quota calculations reflected the temporarily depressed state of its economy, not its real potential and certainly not its geopolitical importance. After all, at Bretton Woods in 1944,

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[7]Statement by the Managing Director to the Executive Board, BUFF/92/36 (February 27, 1992).

[8]The Articles of Agreement specify that the five countries with the largest quotas are to appoint their own Directors. In addition, if any other member is one of the top two creditors of the Fund, it also may appoint a Director. All others participate in a biennial election of Directors. In 1992, two members—China and Saudi Arabia—had chosen to elect Directors using only their own votes, rather than forming or joining a multicountry constituency.

[9]See "Quota Calculations for the Republics of the Former Soviet Union—Methodological Issues," EB/CW/QMethodology/92/1, February 28, 1992; and "Republics of the Former Soviet Union—Qualitative Factors and the Ratio of Actual to Calculated Quotas," EB/CW/QMethodology/92/2, March 19, 1992.

[10]See the minutes of the Committee of the Whole on Membership for the Republics of the Former U.S.S.R., EB/CWM/Former USSR/MTG/92/1 through EB/CWM/Former USSR/MTG/92/6, March 16–30, 1992.

[11]The following account is based primarily on interviews with participants in the discussions. For an external perspective, see Momani (2007).

the Soviet Union had been assigned the third largest quota (13.6 percent of the total), behind only the United States and the United Kingdom. Updating that original quota at the average rate of increase for all members and then allocating Russia its current portion of the Soviet-area economy would produce a quota share of about 6 percent (second only to the United States and slightly above Germany and Japan). The British Executive Director, David Peretz, who was looking after Russian interests in the Fund discussions, managed to convince the Russians that a quota of that magnitude was out of the question. The most they could realistically hope to get was 3 percent, the top end produced by the quota formulas.

In the first round of informal discussions among Executive Directors from the G7 countries, Peretz dutifully argued for a 4 percent share, while some others—notably Hiroo Fukui (Japan)—tried to put politics aside and offer a share below 3 percent. When Kagalovsky found that he could not even get to the 3 percent level in talks at the Fund, he took his case to the bosses of the G7 Executive Directors, the finance deputies. He met with the U.S. deputy, David C. Mulford, in Washington; traveled to London, Paris, Bonn, and Rome to talk to the European deputies; and reached the Canadian and Japanese deputies by telephone. Meanwhile, and far more important, Yeltsin took the quota case directly to U.S. President George H.W. Bush. With the White House now behind him, Kagalovsky easily lined up enough support to pressure the Fund to raise the quota offer to 3 percent. That still put Russia in ninth place, but now just below the smallest quota for a G7 country (Italy).[12]

With that dispute effectively settled, the Executive Board met on March 30 to give its informal blessing to the Russian program, as set out in the MEP. ("Directors commended the Russian authorities for having launched a bold and comprehensive economic reform program, which until a few months ago would have appeared almost inconceivable.")[13] Camdessus chaired the meeting, calling it "a most historic occasion." Kagalovsky addressed the Board in the same spirit, stressing the importance of Fund membership and of the program for the future of Russia. "Now we begin a radical economic reform," he concluded, "the target of which is to build a normal market economy and democratic society. We do not want to find unique ways for our approach. Rather, we want to use the traditional economic approach of stabilization and liberalization of the economy."[14] The reality, of course, was far more complex, but whatever foreboding those sitting in the Board room may have felt was overshadowed for the moment by the excitement of finally fulfilling the vision of the founders at Bretton Woods of the IMF as a universal institution.

[12]The eight largest quotas were held by the G7 countries plus Saudi Arabia.

[13]Minutes of EBM/92/39 (March 30, 1992), p. 76.

[14]Minutes of EBM/92/39 (March 30, 1992), p. 6.

G7 Support

The IMF's approval of the Russian program put the ball back in the G7's court. Two days later, on April 1, 1992, President Bush and German Chancellor Helmut Kohl announced that the G7 had approved a one-year financial support package for Russia totaling $24 billion. That figure, however, was just a headline number that disguised how little money was actually being offered directly by the G7 countries. Of the total, $6 billion was earmarked for a ruble stabilization fund, modeled on the fund established for Poland two years earlier, to be administered by the IMF upon satisfaction of the as-yet unspecified preconditions.[15] Another $4.5 billion was the estimated potential value of loans that might be extended by the IMF and the World Bank. A debt rescheduling approved by Paris Club creditors in January constituted another $2.5 billion.[16] The remaining $11 billion was to be offered in the form of bilateral assistance from the G7 countries, but much of that was not yet budgeted or specifically committed, and all of it depended on Russia and the IMF agreeing on a program of economic reforms.[17] In fact, the ruble stabilization fund never materialized, multilateral assistance fell well short of projections because Russia failed to meet the program conditions, and bilateral assistance took longer than expected to be disbursed.[18] The Grand Bargain envisaged in 1991—large-scale financial assistance from the west to support fundamental economic reforms in Russia (see Chapter 2)—was far from being realized.

Without any doubt, Russia desperately needed financial support. The Russian reform program was exacerbating the country's economic decline—the MEP projected an astonishing 50 percent drop in output over three years, starting from an already depressed level, before an anticipated recovery in the second half of the 1990s. The Fund staff estimated that preventing an even worse short-run decline would require external financing of some $17 billion in 1992, not including the proposed currency stabilization fund. Failure to implement the reforms would also make matters worse. In other words, Russia needed all the money in the G7's advertised package, and it needed to fully implement the policies outlined in the MEP, neither of which could be considered likely.

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[15]The idea of a ruble stabilization fund was first broached by Gaidar, reportedly with support from the IMF, in December 1991 (Braithwaite, 2002, p. 308).

[16]Although the G7 announcement treated these sums as part of their package, the financing was envisaged as coming from a broader group of creditor countries. The currency stabilization fund would have been financed by activating the General Arrangements to Borrow, in which 11 countries participated. The funds for IMF and World Bank lending would have come from the 40 or so creditor countries in the membership. The debt rescheduling involved 17 official creditor members of the Paris Club.

[17]This link was made explicitly by the G7 finance ministers a few weeks later. After meeting with Gaidar in Washington on April 26, the group issued a statement to the press noting that the financing was to be provided "in the context of an agreed IMF program."

[18]For details, see Christensen (1994), Table 5 and Appendix IV; and Brau (1995).

"AIR DROP"—A 1993 Herblock Cartoon, copyright by the Herb Block Foundation

By mid-April, when the Executive Board next met to discuss Russia's requirements, the government verged on collapse owing to parliamentary[19] displeasure with liberalization generally and with Gaidar's program in particular. From a financial perspective, lending to Russia under these circumstances was very risky. From a political perspective, failing to support the government was even riskier. Peretz (United Kingdom) put the dilemma starkly: "We have no alternative but to proceed on the assumption that a reform program of some kind will survive in Russia, and we must always fervently hope that it does, because it is extremely important."[20]

[19]Throughout this chapter, the term "parliament" is used to refer to the Russian legislature. Until September 1993, legislative power was held by the Congress of People's Deputies and the Supreme Soviet. Yeltsin dissolved those bodies in September 1993. Under the new constitution ratified by referendum in December 1993, the State Duma (Russian for "assembly," previously applied to a parliamentary body created by Czar Nicholas II, 1905–17) was established as the lower house of parliament and the principal body for enacting legislation.

[20]Minutes of EBM/92/54 (April 13, 1992), p. 13. As noted, at this time Peretz was responsible for Russia's interests in the Fund as well as those of the United Kingdom, pending the election of a Russian Executive Director later in the year.

Russia's transformation was only beginning, but at least a start had been made. On June 1, 1992, the Russian Federation became the one hundred sixty-fifth member country of the IMF, with a quota of SDR 2,876 million (approximately $4 billion and 3 percent of total Fund quotas).

The Initial Transition: Support from the IMF

The Fund set out immediately to provide three types of assistance to Russia: financial support, policy advice, and technical assistance. Because of the breadth and magnitude of the structural changes under way in Russia, the least glamorous of these—technical assistance—took on unusual importance in the early stages.

Technical Assistance and Policy Advice

Technical assistance on economic and financial institutions was especially important in Russia, as in other transition economies, because the availability of even basic textbook economic analysis had been suppressed for decades under the Soviet system. Exceptionally, Yegor Gaidar reportedly had obtained a copy of Paul Samuelson's economics textbook, which he studied carefully and then shared secretly with fellow would-be reformers. Andrei Illarionov, a senior economic advisor to the Russian government, recalled in an interview for this History that as a university student in Leningrad in the 1980s, he had had no access to textbooks or other material explaining the workings of market economies. The university library did, however, subscribe to the IMF's monthly global statistical digest, *International Financial Statistics* (IFS). For several years, Illarionov quietly pored over the numbers and the explanations of their derivation and the relationship between one and another, until at last he believed he understood the structure of a market economy and the ways in which it differed from the one where he lived. Other than these "young Turk" reformers, however, most officials were picking up the study of western economics at square one.

The differences between a market economy and the economic system of Soviet Russia were enormous and pervasive. Output had been measured as "material product," not by GDP or GNP. Statistical systems had been constructed around the requirements for detailed input-output tables, which in turn were required for implementing a series of national production and distribution plans. Domestic goods prices had been set for social reasons rather than to clear markets, and international trade among the member countries of the Soviet-run Council on Mutual Economic Assistance (CMEA) had also been based on arbitrary prices and exchange rates. Moreover, the major economic agencies and institutions, including the finance ministry and the central bank, had been designed to further national political and social goals and not to promote macroeconomic stability. For Russia to become a full participant in the global economy, virtually all of its technocratic infrastructure would have to be redesigned and rebuilt from the ground up.[21]

An army of multilateral agencies—notably the European Bank for Reconstruction and Development (EBRD), the European Union (EU), the IMF, the Organization for Economic Cooperation and Development (OECD), the United Nations (UN), and the World Bank—was prepared to help Russia reform its institutions, and many governments of countries with advanced market economies were eager to provide bilateral assistance and advice. Plenty of help was forthcoming; the challenge was to organize and coordinate it. For example, throughout the 1990s, the EBRD and the EU worked together to promote the establishment and development of private enterprises in Russia. The OECD provided extensive advice in areas such as competition policy and corporate governance. The World Bank helped Russia set up and run its privatization programs, and it provided assistance in efforts to strengthen health care, education, environmental protection, and other social and structural policies.

The IMF's role was more limited but no less important to Russia. In October 1990, Teresa Ter-Minassian (head of the interagency task force on the Soviet economy) set out the priorities for IMF technical assistance to the Soviet Union.[22] That blueprint served as a guide for the work that would intensify greatly once Russia became a member of the Fund. It set out five key areas of assistance:

- converting the Gosbank into a true central bank, with the ability to stabilize the supply of money and credit through indirect controls such as open market operations and reserve requirements;
- putting foreign exchange operations on an efficient and market-determined basis;
- strengthening administration of tax collections, reforming tax policy to make it more efficient, and modernizing the customs office;
- developing a system of statistics consistent with international standards; and
- improving economic forecasts, particularly with respect to the data required for financial programming.

The Fund began offering technical assistance even before the formal breakup of the Soviet Union, when two unusually large teams arrived in Moscow on November 11, 1991. One team of 17 people, organized by the Fund's Central Banking Department (CBD), was led by a former governor of the National Bank of Belgium, Baron Jean Godeaux. That team also included experts from four other national

[21]For an introduction to the Soviet economic system, see Nove (1986, 1989).

[22]Memorandum from L. Alan Whittome to relevant department heads, "USSR—Technical Assistance" (October 11, 1990), with attachment by Ter-Minassian; IMF archives, Accession 91/118, OMD files, "USSR Mission and Reports by Mr. Whittome," Box 4. For Whittome's and Ter-Minassian's roles in the Fund's initial analysis of the Soviet economy, see Chapter 2, pp. 59–60.

central banks, the Bank for International Settlements, the OECD, and the World Bank. The other team of 14 people, headed by John McLenaghan (Director, Statistics Department, or STA), included statistical experts from the OECD, the EU (Eurostat), the UN Statistical Office, the International Labor Organization, and the World Bank.

After the breakup, the effort to provide technical support to Russia began early in 1992, with assistance from CBD and various national central banks to the newly independent Central Bank of Russia, from the Fiscal Affairs Department to the ministry of finance and various spending agencies, and from STA to the national statistical office.

In addition to this specific technical assistance, Fund staff provided macroeconomic and related policy advice. At the outset, much of the discussion centered on how and when to initiate structural reforms such as price liberalization, and on how to get the government's fiscal accounts under control as a way of stabilizing the economy. Although most prices were freed in January 1992, the Russian government wanted to delay raising energy prices as long as possible to cushion the impact both on industry and on the poor and the elderly. The Fund was concerned about the effect on the fiscal deficit of subsidizing energy and advised Russia to free up energy prices and provide targeted subsidies as a social safety net. Prices quickly adjusted to market levels, but the government was less successful at protecting pensioners from the effects of the price increase.

Extensive discussions were held on currency reform in 1992. That work focused first on managing the issuance and use of rubles in what was expected to be a multicountry currency union involving Russia and most of the other newly established countries, and later on how to unwind the currency union as the other countries established their own currencies.[23] More generally, the Fund tried to advise Russia on managing its exchange rate to maintain stability without endangering international competitiveness. As will be seen below, devising a sustainable exchange rate policy proved to be an elusive goal until the end of the decade.

As the new central bank gradually gained experience and control over monetary policy, the Fund shifted its own role from technical assistance to policy advice on using interest rates and other indirect policy tools to stabilize the price level. By the mid-1990s, the Fund's advice to Russia also encompassed a second generation of structural reforms, particularly privatization and other building blocks of a market economy. In that sphere, the Fund kept its advice on a general level and left the details to the World Bank and others with appropriate expertise. Throughout the decade, the overriding concern and the greatest continuing challenge was always fiscal policy: controlling spending and strengthening the central government's ability to collect taxes from a population that had no tradition of paying them.

[23]Fund advice regarding the ruble area is discussed in more detail in Chapter 8.

Financial Support

With the collapse of the Grand Bargain and the refusal of most creditor countries to provide large-scale grants or loans bilaterally (despite the G7 announcement), the IMF became both the gatekeeper and the lender of first resort to Russia.

The First Stand-By Arrangement

Three days after Russia became a member of the IMF in June 1992, Odling-Smee and a small team of economists traveled to Moscow to try to negotiate a program that the Fund could support with a stand-by arrangement. On the surface, it was a typical IMF encounter. Policies had not been implemented in accordance with the MEP agreed to four months earlier—both monetary growth and the fiscal deficit were higher than promised. The Russian authorities argued that to do more would weaken the economy, while the Fund staff argued that without greater effort inflation would spiral and undermine the economy even more. Bridging the gap between the two positions by the end of this two-week mission was impossible, even though preparatory discussions had helped pave the way. If this had not been Russia at its moment of rebirth, a series of follow-up missions over the next few months might have brought the two sides gradually to a compromise. But this was not an occasion for business as usual.

On June 15, while Odling-Smee and his team were still at work in Moscow, Yeltsin elevated Gaidar to the post of acting prime minister and took him along on a state visit to Washington. Yeltsin was welcomed in the U.S. capital with the enthusiasm usually reserved for rock music stars (and for his charismatic predecessor, Gorbachev) as he got out of his armored limousine, waved a small American flag, and mingled jocularly with the crowd lining the avenues. Yeltsin's popularity and the nearness of the next G7 summit intensified the desire of U.S. officials from President Bush on down to see an agreement soon. Meanwhile, Gaidar headed down the street a few blocks to the IMF, where he met with Camdessus to make the case for more flexibility on the part of the Fund. At the conclusion of that meeting, the prime minister and the Managing Director issued a joint news release, stating that "both sides were confident that the continuing negotiations [in Moscow] would lead to an early agreement on a program that could be supported by the financial resources of the Fund."[24]

Alarmed by the pressure from these developments, Odling-Smee faxed a memorandum to the Managing Director from Moscow, outlining the outstanding issues blocking an agreement and asking him not to push for an agreement before the G7 summit meeting. This plea initially had the desired effect—Camdessus informed

[24]See "Joint Statement of Mr. Yegor Gaidar, Prime Minister of the Russian Federation, and Michel Camdessus, Managing Director of the IMF," NB/92/15 (June 18, 1992). Also see Odling-Smee and Pastor (2002), p. 20; and Gaidar (2002), p. 35n.

the Executive Board later in the day that the effort to negotiate a program was being postponed. When public pressure from the U.S. government continued, Camdessus issued another press release a week later, saying that "agreeing on an inadequate policy package just for the sake of having an agreement before the economic summit would be a disservice to Russia, to our membership, and to the world."[25]

Odling-Smee came back to headquarters on June 18 but returned to Moscow before the month ended. For a few days, negotiations plodded along with no real movement. The Russian negotiating team put a compromise proposal on the table, but Gaidar—urged on by a team of foreign advisors led by Harvard Professor Jeffrey Sachs and including a former IMF economist, David Lipton—undercut his own team by subsequently rejecting their compromise and retreating to his previous position. Gaidar then decided to bypass the IMF staff as well and take the matter to a higher level by calling a few G7 finance ministers to get their support. In response, the German deputy finance minister, Horst Köhler, telephoned Camdessus to urge him to go to Moscow and meet with Yeltsin to break the impasse. Camdessus replied cautiously, saying that he could not go without an invitation from the Russian government. Köhler then escalated it further by getting Chancellor Kohl to ask Yeltsin to invite Camdessus. Yeltsin phoned Camdessus, who agreed, despite the obvious risk of undermining his own staff's authority.

Arriving in Moscow on July 3, Camdessus told Gaidar straight away that he would have to devise a stronger program to get an agreement from the Fund. That induced Yeltsin to call a press conference on July 4 in which he accused the IMF of trying to "force us to our knees" by imposing harsh conditions including a demand that Russia fully liberalize energy prices.

At that moment, the whole process seemed to be unraveling. A private meeting between Yeltsin and Camdessus the same day, however, was more agreeable and productive. The next day, the Russian side offered to tighten fiscal policy, and the Fund took that package as an acceptable compromise (without the increase in energy prices that the staff had been demanding). Gaidar and Camdessus exchanged letters to that effect, and the Managing Director flew to Munich with an agreement on July 6—the opening day of the G7 summit.[26]

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[25]For Odling-Smee's plea from Moscow, see his memorandum to the Managing Director, "Meeting with Mr. Gaidar, June 18" (June 18, 1992); IMF archives, C/Russian Federation/1760, "Stand-by Arrangement 1992." Camdessus's statement to the Executive Board was issued as "Statement by the Managing Director on the Russian Federation," BUFF/92/103 (June 18, 1992). The two press releases were NB/92/15 (June 18, 1992) and NB/92/17 (June 25, 1992).

[26]For an overview of these developments, see memorandum from Odling-Smee to the Managing Director, "Russian Federation—Back-To-Office Report" (July 8, 1992); IMF archives, Accession 1996-0187-0006, OMD-AD, Box 9110, "Russia (3) 1992." Odling-Smee (2006, p. 164) later acknowledged that the compromise agreement essentially reflected the authorities' preferences, forced upon the Fund by the G7's demand for a presummit agreement. Also see the lead editorial in the *New York Times* for July 7, 1992, praising the Bush administration for pressuring the IMF to "take a prudent chance on the Yeltsin government."

The summit communiqué implicitly acknowledged the weakness of the economic policies the G7 had pressured the IMF to accept:

> We support the phased strategy of cooperation between the Russian Government and the IMF. This will allow the IMF to disburse a first credit tranche in support of the most urgent stabilisation measures within the next few weeks while continuing to negotiate a comprehensive reform programme with Russia. This will pave the way for the full utilisation of the $24 billion support package announced in April. Out of this, $6 billion earmarked for a rouble stabilisation fund will be released when the necessary macroeconomic conditions are in place.[27]

One month later, on August 5, 1992, the Fund approved its first lending to Russia (and the first to any country of the former Soviet Union). The amount of the stand-by arrangement was small in relation to Russia's needs: approximately $1 billion (SDR 719 million), or 25 percent of Russia's quota in the Fund. It was thus a "first-tranche" arrangement, which, under the Fund's rules, does not involve any phasing (the money is available immediately to the borrower) or performance criteria (formal policy conditions). In this case, however, it was necessary to restrict the use of the funds, given the real risk that the authorities would be frustrated in their attempts to carry out even the small reforms they had promised. The staff appraisal, while recommending approval, fell back on the linguistic and syntactical fog occasionally employed in the Fund to obscure a lack of confidence: "The delays and slippages of the past few months show how difficult it will be in practice to implement the program in full. However, if it is fully implemented, the program would represent a marked tightening of financial policies which deserves the support of the Fund."[28]

The stand-by arrangement therefore required Russia to maintain a floor on its international reserve assets so high that it effectively prevented the authorities from spending any of the proceeds. This restriction angered some in the G7. Peretz complained during the Board meeting that the do-not-spend rule was too restrictive, and in October—when no funds had yet been drawn by Russia—32 U.S. senators wrote to Camdessus complaining of "excessive conditionality" in the face of a Russian economic depression comparable to that experienced in the west in the 1930s. In response, Camdessus insisted that if Russia failed to reform its economy, the outcome would be far worse.[29]

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[27]"Economic Declaration: Working Together for Growth and a Safer World," paragraph 40; accessed at http://www.g8.utoronto.ca/summit/1992munich/communique/.

[28]"Russian Federation—Use of Fund Resources—Request for First Credit Tranche Stand-By Arrangement," EBS/92/119, Suppl. 3 (July 24, 1992), p. 37.

[29]For Peretz's complaint, see minutes of EBM/92/101 (August 5, 1992), p. 6. For the exchange with the senators, see letter from Claiborne Pell and others to Camdessus (October 5, 1992) and letter of reply from Camdessus (October 19); IMF archives, C/Russian Federation/1760, "Stand-by Arrangement 1992."

The Russian government had little incentive to draw on the Fund's money under these conditions because the interest charges it would have to pay would wipe out any income it would earn by investing the proceeds. Only in October did Gaidar and Viktor Gerashchenko (acting head of the central bank) begin inquiring about procedures for making a drawing, and by that time the reform program was already hopelessly off track. First the staff and then Camdessus tried to discourage the authorities from drawing on the arrangement, fearing that the hidden intention was to spend rather than to invest the proceeds.[30] Russia, however, ignored the warnings and borrowed the full amount in two installments, in November and December.[31]

As 1992 drew to a close, economic conditions in Russia continued to deteriorate, and Yeltsin felt his own political support being dragged down as a result. Although he had not lost faith in the reform process, he sensed that he had to change direction to regain momentum for it. He abruptly fired Gaidar as prime minister and replaced him with Viktor Chernomyrdin, a deputy prime minister (in charge of fuel and energy) and the former head of the natural gas monopoly Gazprom. Chernomyrdin had little experience with macroeconomics and was free of any association with market reforms. His appointment bought Yeltsin some time to try to get a recovery started without the political pressure that Gaidar attracted like a lightning rod (see Yeltsin, 1994, pp. 197–201).

The external political climate was also shifting, with Bill Clinton succeeding George Bush as U.S. president in January 1993. Less than a week after his inauguration, Clinton delivered a foreign policy address at American University in Washington in which he called for large-scale financial assistance to Russia, akin to the Marshall Plan sponsored by the U.S. government after the Second World War. Privately, he told his aides that they needed "to think bigger and do more" for Russia (Talbott, 2002, p. 53; and Clinton, 2004, p. 505). With Clinton's support, when G7 finance and foreign ministers met in Tokyo that April, they were able to announce an increase in the size of their nominal financial support for Russia from the previous $24 billion to $43.4 billion. No less than before, however, this headline figure included a mix of previously delivered aid, multilateral lending that depended on Russia meeting certain conditions, and bilateral aid from G7 and other countries not yet in national budgets. The main immediate effect was simply to express the G7's "determination to support the reform process in ways which complement the efforts of Russia."[32]

[30]See, for example, letter from Camdessus to Gaidar (November 19, 1992); IMF archives, EU2 files, R-130, "Use of Fund Resources."

[31]By the end of 1992, Russia complied technically with the requirement to increase its gross and net international reserves by the amount of the drawings, but it did so by violating another commitment, which was not to increase its arrears to other creditors; see "Russian Federation—Staff Report for the 1993 Article IV Consultation," SM/93/66, Suppl. 1 (April 16, 1993), p. 8.

[32]See "G7 Chairmen's Statement on Support for Russian Reform," April 15, 1993; accessed at http://www.G8.utoronto.ca/adhoc/g7chair93.htm.

The First STF Loan

The next year, 1993, turned out to be another make-or-break year for Yeltsin and for economic and political reform in Russia. Outside the country, supporters of the reform effort showed increasing frustration. In early February, Camdessus told a reporter from *Izvestia* that the central bank had not kept its promises under the stand-by arrangement and had let the money supply expand much too rapidly in the second half of 1992.[33] A few weeks later, Canadian Minister of Finance Don Mazankowski told reporters just before a G7 ministerial meeting that the main obstacle to their providing further financial help was Russia's failure to meet the IMF's policy conditions (Ortiz, 1993). Meanwhile, inside the country, an anti-Yeltsin parliamentary majority was working to further undermine the reform effort and restore the stability that many still believed had been the hallmark of the Soviet system. Yeltsin survived an impeachment attempt in March, and in April he won a referendum supporting presidential power over the parliament.

Once again, the stakes were high when a large new IMF staff team—led by Ernesto Hernandez-Catá (Deputy Director, EU2), and comprising 11 professional staff (more than double the usual complement)—went to Moscow in May 1993 to negotiate terms for a second IMF arrangement. By this time the Fund had established a new lending window, the Systemic Transformation Facility or STF (see Chapter 5), so that it could lend quickly to countries in transition, in support of nascent rather than fully developed and rigorous policy reforms. Judged by this relaxed standard, Russia seemed to be making decent economic progress. A privatization program was under way, the government was cutting subsidies to state enterprises, and the central bank was raising interest rates in an effort to reduce the inflation rate—but this glass was only half full. Many of the new private firms were no more efficient than the old ones run by the state, and both the budget and the price level were still out of control, but the scent of progress was detectable and encouraging.

Hernandez-Catá reached an acceptable agreement after just two weeks of negotiations, and on May 22, 1993, Chernomyrdin sent Camdessus a statement setting out the economic policy program to be supported by an STF loan. This time the IMF would be offering more money than in 1992 (equivalent to $1.5 billion), available immediately and without the restrictions preventing the government from using the proceeds to help finance the budget.[34] The Executive Board approved the arrangement at the end of June and even permitted itself a little

[33]"Russia's Hyperinflation Must Be Prevented, Says Camdessus," *IMF Survey*, Vol. 23 (February 22, 1993), pp. 49–53.

[34]As with all IMF credits, the arrangement was denominated in SDRs. The total loan amount, SDR 1,087.275 million, was disbursed partly in SDRs and partly in currencies (U.S. dollars, deutsche marks, French and Swiss francs, Japanese yen, and Dutch guilders); see "Russian Federation—Purchase Transaction—Systemic Transformation Facility (STF)," EBS/93/91, Suppl. 2 (June 29, 1993). Also see Hernandez-Catá (1994), pp. 15–16.

optimism. Although Hiroo Fukui (Japan) observed with some sarcasm that parliamentary support for reform in Russia "remains uncertain, to put it positively," Thomas C. Dawson II (United States) declared himself to be "extremely encouraged" by the promises of fiscal tightening.[35]

The odds against success, however, remained high, and not only because of the ongoing domestic battle between Yeltsin and the parliament. The numbers added up, but only because the staff had to assume that Russia would receive $610 million in loans from the World Bank and $10.2 billion in assistance from G7 and other donor countries in 1993. Realization of the latter amount required that all the money being talked about by the G7 would materialize. The following week, the annual G7 summit in Tokyo concluded with a promise of only $3 billion to establish a privatization fund.[36]

The finance minister, Boris Fyodorov, and his principal deputy, Andrei Vavilov, struggled through the rest of the year to contain the budget deficit and meet the Fund's conditions.[37] The rest of the government provided less support. When Chernomyrdin went to Washington in September for meetings with U.S. Vice President Al Gore, both Camdessus and Lawrence Summers (under secretary of the U.S. Treasury) separately visited him at Blair House (the official U.S. residence for visiting dignitaries) to impress upon him the importance of meeting the Fund's conditions. Russia's economic policies, both visitors insisted, had to be adjusted to be consistent with the real discipline imposed by market economics.[38] With little progress in view, the size of the next staff mission to Moscow was scaled down and given instructions not to open discussions on additional financing until the government showed more seriousness of purpose in carrying out the existing program.[39]

In the middle of these economic discussions, the political disarray in Russia suddenly turned brutal. The parliament tried to depose Yeltsin, who responded by

[35]Minutes of EBM/93/92 (June 30, 1993), pp. 6 (Dawson) and 15 (Fukui).

[36]"Economic Declaration: A Strengthened Commitment to Jobs and Growth," paragraph 10, Tokyo, July 9, 1993; accessed at http://www.g8.utoronto.ca/summit/1993tokyo/communique/index.html. The assumption that donors and official creditors would deliver on their promises was an unavoidable standard practice in the Fund.

[37]Transliteration of Russian names into English is sometimes capricious. At the time, IMF documents spelled the finance minister's name Federov. The alternative Fyodorov later became more commonly used.

[38]"Over a small dinner at Blair House, Larry [Summers] walked Chernomyrdin through the logic of conditionality. Chernomyrdin bristled. . . . Larry persisted. The rules that governed IMF lending . . . were a reflection of the immutable principles of economics" (Talbott, 2002, p. 85). Also see Camdessus's report to the Executive Board, minutes of EBM/93/123 (September 3, 1993), pp. 3–4.

[39]See memorandums from Odling-Smee to the Deputy Managing Director, "Russian Federation—Modification to the Mission Schedule" (September 2, 1993), and to the Managing Director, "Russian Federation—Staff Visit" (September 29, 1993); IMF archives, OMD-AD, "Russia 1993 – (3) Country Files," Box 22069, Accession 1997-0067-0008.

dissolving the parliament and calling for new elections to take place in December. Street battles erupted in Moscow between supporters and opponents of Yeltsin. This constitutional crisis climaxed on October 4 with the military shelling the parliament under Yeltsin's orders. That eventually brought a nervous calm to the capital but no victory to either side. In the December 12 elections, extreme nationalists gained parliamentary strength, but Yeltsin also won approval for a new constitution bolstering the powers of the presidency. Although contemporary reports worried mostly about the ascent of the ultranationalists, the shift to a powerful presidency would prove to be one of Yeltsin's most enduring legacies.

Despite all this political turmoil, most G7 officials—including those in the U.S. Treasury—continued to stand behind the IMF's ongoing efforts to convince the Russians to strengthen their economic policies, especially by cutting the budget deficit. A faction in the Clinton administration, however, perhaps panicked by the opposition ascendancy in Moscow, started publicly blaming the IMF for being too harsh. Vice President Gore led the attack (saying with typical turgidity that the IMF had been "slow to recognize some of the hardships that are caused by some of the conditions that have been overly insisted upon in the past"), joined by Deputy Secretary of State Strobe Talbott (saying famously and more succinctly that what Russia needed now was "less shock and more therapy").[40] At the end of 1993, the prospects for economic growth and stability in Russia were scarcely clearer or more favorable than they had been at the beginning of the year.

The Second Stage: Fiscal Reform and the Strong Ruble

For a time in the early months of 1994, the Russian economy continued to deteriorate while the political pressure persisted on both the Fund and the Russian reformers. Stung by the growing chorus from Gore and others criticizing the conditions on multilateral assistance, the IMF and the World Bank issued a joint public statement in defense of their approach. Unconditional financial assistance, the note argued, could actually harm the Russian economy "by financing the retention of the status quo, increasing capital flight, and prolonging the period of reduced living standards. . . . The [IMF and World Bank] have been insisting on policy conditionality, which Russia's reformers generally welcome."[41] In mid-January, however, Yeltsin suddenly decided to reshuffle his cabinet, including by forcing out the two leading economic reformers, Gaidar and Fyodorov. That move

[40]Both quotations—from separate remarks to journalists by Gore and Talbott in September 1993—are from Talbott (2002), p. 106.

[41]"Economic Reform in Russia: Lessons from Experience," EBD/94/3 (January 5, 1994), p. 5. The note was circulated internally for the information of Executive Directors with the unusual cover note that it had been "prepared at the initiative of the World Bank and Fund management and staff."

signaled a further weakening of official commitment to reform and provided further evidence that Gore's and Talbott's remarks had resonated in the Kremlin. Fyodorov responded with a blistering attack, calling the shift "an economic coup d'état" by "Red managers" and warning: "If the International Monetary Fund bends the rules, if some people continue 'rethinking policy,' Russia is in for major trouble that will inevitably affect the whole world" (Fyodorov, 1994).

The Second STF Loan

Despite the danger signs, the IMF proceeded to negotiate a second $1.5 billion STF loan. A February mission led by Hernandez-Catá failed to reach agreement despite three weeks of talks in Moscow, after which the G7 finance ministers and central bank governors met with their Russian counterparts in Kronberg, Germany. At the conclusion of that meeting, U.S. Treasury Secretary Lloyd Bentsen told reporters that the G7 planned to get "more involved" in the effort to get Russia and the IMF to agree on terms for the STF loan.[42]

More necessary, though, was for Camdessus to increase his personal involvement in persuading the highest-level Russian officials of the need for adopting the reforms advocated by the IMF. He had already met Chernomyrdin during the prime minister's visit to Washington in September 1993. Their relationship deepened in 1994 through the intermediation of Peter Castenfelt, a Swedish businessman with close ties to Yeltsin, Chernomyrdin, and other senior Russian officials. Camdessus met privately with Castenfelt in Frankfurt before the G7 meeting in Kronberg and again a few days later in Washington, after which Castenfelt set out to smooth relations between Russian officials and the Managing Director.[43] Hernandez-Catá then returned with his staff team to Moscow. Camdessus joined them a few days later. The Managing Director arrived in time to spend the weekend hunting with Chernomyrdin, after which they traveled to Sergiev Posad, where they visited the historic monastery and met with church leaders. This bonding experience, coupled with Camdessus's infectious optimism and empathy with the Russian culture,[44] helped to force a compromise, and Camdessus and Chernomyrdin were able to announce an agreement on the main policy issues on

[42]"IMF Mission to Return to Moscow in about a Week," Reuters News, February 27, 1994; accessed at http://global.factiva.com/. The G7 did not issue a formal communiqué for this meeting.

[43]The meeting between Castenfelt and Camdessus was arranged with the assistance of Jacques de Groote (Executive Director from Belgium). News of the unusual meeting soon leaked to the press, who characterized it as a back channel in the negotiations (Miller, 1994). Castenfelt, who knew Camdessus from his days as an investment banker, later became famous for helping to broker a 1999 peace agreement in Kosovo (Lloyd, 1999).

[44]Declaring himself an optimist in a speech before the Moscow Finance Academy on March 21, Camdessus enthused, "A country with such human and natural resources as yours will overcome its temporary problems."

March 22.[45] A month later, after the government had completed several required prior actions relating primarily to raising fiscal revenues, the Fund formally approved the loan, increasing Russia's indebtedness to the IMF to approximately $4 billion.[46]

Economic policies in Russia continued to be lax and unconstrained by the agreement that supposedly underpinned the STF loan. Despite major efforts by the finance ministry and other senior officials, Russia still had little cash support from the G7 or other external creditors, no significant domestic bond market, and a parliament demanding higher levels of government spending than could be paid for under the country's weakly enforced tax system. The Russian authorities thus had little choice but to run a large fiscal deficit and finance it with money creation by the central bank. For the second half of 1994, both the fiscal deficit and central bank lending to the government were about half again as large as had been targeted in the program.[47]

As a result of this fiscal weakening, consumer price inflation accelerated sharply at the beginning of the fourth quarter of 1994. That increase brought a loss of confidence in the overall reform effort, culminating in a panic in the foreign exchange market. On a single day that became known as "Black Tuesday" in Russia (October 11, 1994), the value of the ruble dropped by 21 percent against the U.S. dollar. This financial shock, though it seemed a disaster at the time,[48] turned out to be the jolt that finally convinced Yeltsin he could not avoid pressing ahead with the reform effort. As before, his first reaction was to fire and replace his economic team, but this time the shake-up was aimed at strengthening the reformers. Notably, he elevated one of the most well-known advocates of free market economics, Anatoly Chubais, from the post of deputy prime minister in charge of privatization to first deputy prime minister in charge of the economy. He also fired Gerashchenko as head of the central bank and elevated Tatiana Paramanova from deputy to acting governor.

The Second Stand-By Arrangement

The next IMF staff mission, arriving in Moscow a week after Black Tuesday, was able to make a fresh start with a new team on the other side of the table. Moreover,

[45]For a different perspective on Camdessus's diplomacy at this time, see Stone (2002), pp. 128–31. Stone reports (based on interviews) that Hernandez-Catá wanted to delay approval of the STF loan until Russia had successfully carried out a staff-monitored reform program, but he was overruled by Camdessus.

[46]The STF loan for SDR 1,078.28 million was approved on April 20, 1994. After drawing this amount, Russia's obligations to the IMF totaled SDR 2,875.56, equivalent to 166.67 percent of Russia's quota. On the prior actions, see Camdessus's statement to the Executive Board, BUFF/94/36 (March 24, 1994).

[47]"Russian Federation—Request for a Stand-by Arrangement," EBS/95/46, Suppl. 1 (March 29, 1995), Table 1.

[48]The drop in the rate was quickly reversed, but the loss of confidence that had brought it about continued to generate volatility and uncertainty in financial markets for some time.

Stanley Fischer—who had studied the Russian economy extensively, first as chief economist for the World Bank at the time of the 1990 joint study and then as part of a U.S. team of academic advisors to Yavlinsky in 1991—had recently joined the IMF as Camdessus's principal deputy and was actively engaged in devising a new policy approach. The mission took the opportunity to put two new and controversial ideas on the table as a possible basis for what would be Russia's first full-scale stand-by arrangement.

New Program Design

First, Hernandez-Catá proposed a set of specific measures to raise taxes rather than relying primarily on spending cuts to temper fiscal imbalances. Russians were still not comfortable with the idea of paying taxes, and the whole tax system was widely known to be inefficient and corrupt. Until the government could solve this problem, it would not be able to find the revenues to pay for essential public goods and services. Nonetheless, any tax reform was bound to meet with formidable resistance, and whether Chernomyrdin's government had either the will or the means to push it through the parliament was far from clear.

Second, Hernandez-Catá suggested that Russia should abandon the floating exchange rate and peg the ruble at a new devalued rate. The authorities, unconvinced that they could or should fulfill a commitment to stabilize the value of the ruble before the economy and the state of the government's finances were stronger, resisted this idea as well.[49]

The October 1994 mission did not produce an agreement, but it did get a serious negotiation process started, and it ushered in a period unprecedented in the intensity of relations between the IMF and a borrowing country. For the next few years, the IMF sent staff missions to Moscow almost every month, often involving two or three times the standard number of economists on such trips (without even counting the sizeable number of staff resident in Moscow, who also participated in the missions). For a time, two distinct teams of economists took turns, in an effort to minimize fatigue and burnout. The mission chief throughout most of this period, Yusuke Horiguchi (Deputy Director, EU2), who joined the IMF's Russia team with the October mission, made 31 trips from Washington to Moscow in as many months.

The first task of these monthly missions was just to get an agreement on an economic program the Fund could support. That task took a total of six missions in six months, with both Fischer (in December) and Camdessus (in March 1995) traveling to Moscow to help spur the process.

Legislative resistance to tax reform posed a substantial obstacle, one that would reverberate for years to come. The Fund staff and management believed strongly

[49]Back-to-office report from Hernandez-Catá to the Managing Director (November 2, 1994); IMF archives, C/Russia/1720.

that the only way to get the fiscal deficit permanently under control was to build an effective system for levying and collecting taxes to cover the country's spending demands.[50] Chubais, however, argued that the government could not possibly get strong tax legislation approved by the parliament, and the only practical way to control the deficit was simply to sequester a large part of the spending that the parliament approved. Neither Chernomyrdin nor Yeltsin was prepared to invest considerable political capital to force a showdown with the parliament, and were content to let Chubais take the heat for imposing deep spending cuts administratively. In the end—amid fears that Russia stood on the brink of a financial, economic, and political crisis[51]—the Fund had no real choice but to go along, though with serious misgivings.

Meanwhile, the G7 was sending strong signals to Russia that the government could not expect further financial help from them until they reached agreement with the IMF. Concluding a meeting in Toronto in early February, the finance ministers of the G7 issued a statement saying that additional "debt rescheduling for Russia will depend on the introduction of a comprehensive reform program that will merit IMF support."[52] With the pressure on, Camdessus and Chernomyrdin met in Paris on March 3 and agreed that if the Fund approved the program, Russia would allow the Fund to monitor compliance monthly rather than quarterly, as was usual. Tight monitoring offended Russian pride, but the Fund viewed it as essential because the program depended so heavily on the government's continuing ability to hold spending below what the parliament was likely to approve. In addition, Chernomyrdin agreed to complete a number of actions the Fund required before formally approving the stand-by arrangement, including keeping money creation within strict limits through the end of March and rescheduling $2.5 billion in debts owed by Ukraine.[53]

From Paris, Camdessus flew to Moscow to secure Yeltsin's personal backing for the agreement. On March 10, in a Kremlin ceremony, Yeltsin signed a letter to Camdessus promising his support for the program and his commitment "to use

[50]The first major fighting in Chechnya was under way at this time, adding further to the spending requirements.

[51]On February 9, Odling-Smee warned management that "a crisis could unfold fairly quickly" in Russia, owing to the Chechnya conflict, doubts about the breadth of commitment to reform in the government, and the possibility that Russian banks could switch quickly out of rubles into dollars. Memorandum from Odling-Smee to the Surveillance Committee, February 9, 1995; IMF archives, Accession 1998-0106-0008, OMD/AD (Fischer), "Russia 1995."

[52]"Excerpts from the G7 Finance Ministers and Central Bank Governors Statement from the meeting in Toronto on February 3–4, 1995"; accessed at http://www.g8.utoronto.ca/finance/g7torfin.htm.

[53]The rescheduling agreement between Russia and Ukraine was a prerequisite for the Paris Club of official creditors to reschedule their own claims against Ukraine; see back-to-office report from Horiguchi to the Managing Director (March 14, 1995); IMF archives, Accession 1998-0106-0008, OMD/AD (Fischer), "Russia 1995."

every means available to me to ensure its success." Chernomyrdin and Paramanova then signed the agreed-on Letter of Intent, to which was attached a detailed statement of economic policies. Chernomyrdin and Camdessus signed a joint communiqué stating that the Managing Director was "prepared to recommend" approval by the Fund "after the initial elements of the program are in place" (meaning the completion of the prior actions agreed to in Paris).[54]

Successful Implementation at Last

For once the process worked—or seemed to work. The Executive Board met on April 11, 1995, six months to the day after Black Tuesday, and approved a stand-by arrangement for $6.8 billion (SDR 4,313.1 million, or 100 percent of quota). Many on the Board expressed doubts that Russia would carry out its promises, and many indicated they were supporting the Managing Director's recommendation only because the costs to Russia and to the world of not doing so would be so great. As Autheman (France) put it, "We know that Russian programs go back on track in the winter, that we reach agreement in spring, that we congratulate each other in the end of June, and that everything falls apart in summer." Without "a summer and a fall of success, . . . the conclusion of this agreement will not raise confidence in private markets."[55] Nonetheless, no one objected, and the stand-by arrangement was approved unanimously.

With only minimal delays, Russia met all the conditions in the arrangement, and drew down the entire amount in nine installments from April 1995 through February 1996. Although that brought Russia's outstanding debt to the Fund to $10.5 billion (SDR 7.2 billion), the highest of any member country except Mexico, this successful implementation enabled discussions to proceed relatively smoothly toward even larger and longer-term financing from the Fund (Figure 7.1).

The program supported by the 1995 stand-by arrangement was both strong and apparently well implemented. It soon succeeded in restoring a measure of international confidence in the economy and the Yeltsin government, and the resulting foreign investment more than reversed the weakness that had plagued the value of the ruble since the beginning of the reform era in 1992. This success, however, disguised two lurking problems that would have major adverse consequences in the next few years.

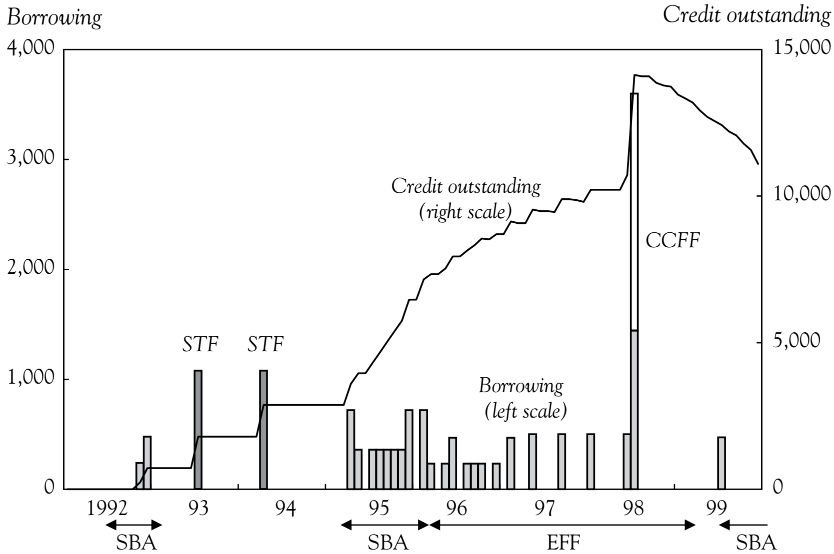
First Problem: A Flawed Privatization Scheme

The first problem, which was just emerging when the Fund approved the 1995 stand-by arrangement, was the way the government chose to privatize its major state-owned enterprises. Chubais had overseen a scheme for the first wave of

[54]These various documents are in IMF archives, Accession 1998-0106-0008, OMD/AD (Fischer), "Russia 1995."

[55]Minutes of EBM/95/38 (April 11, 1995), p. 37.

Figure 7.1. Russia: Use of Fund Credit, 1992–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: CCFF = Compensatory and Contingency Financing Facility; EFF = Extended Fund Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

privatizations in 1992–94, in which the government had sold vouchers for a nominal fee to Russian citizens. The vouchers could be used to buy shares in companies or could be sold for cash in a secondary market. That scheme had privatized some 14,000 enterprises and turned 40 million Russians into capitalists (see Chubais and Vishnevskaya, 1995; Stent and Shevtsova, 1996; and Schleifer and Treisman, 2000, Chapter 2). Unfortunately, many of these companies turned out to be no better managed than they had been under communism. Though some companies were managed successfully and well, by the time the voucher scheme ended in mid-1994, it had failed to generate much popular support. When Chubais undertook the second wave, in which some of the largest state monopolies would be sold off, he was presented with a more centralized process, which he carried out with disastrous results.

The essence of what became known as the loans-for-shares scheme was that a consortium of Russian banks would take control of a company from the state as collateral for a loan to the government. When the loan matured, and if the government chose not to repay it, the banks—which proposed this scheme to Yeltsin in March 1995—would auction the company to the highest bidder. If the government was dissatisfied with the outcome, it retained the right to buy the company back during the next year. The process turned out to be an open invitation to corruption. The banks manipulated the system by excluding all but one or a few bidders from the auctions so that favored clients could purchase companies at prices far below true market value. The cash-strapped government was in no position to intervene or to buy back the companies after the fact. In case after case, both the bankers and the new owners—"oligarchs," as they came to be called—became fabulously wealthy and thus politically powerful. When Yeltsin decided to run for reelection as president in 1996, the oligarchs largely financed his campaign and further strengthened their grip on economic power and political influence.[56]

When the staff negotiated terms for the 1995 stand-by arrangement, the government was still considering whether to accept the banks' proposal for the loans-for-shares scheme. The Letter of Intent Chernomyrdin and Paramanova signed in March included a commitment to resume privatization in a way that would "conform to internationally accepted standards," but the details were left to be specified later.[57] At the Board meeting on April 11, Karin Lissakers (United States) expressed concerns about press reports on the emerging proposal. Horiguchi reassured her. His understanding was that the government was "not interested in proceeding with the deal," and the staff "would continue to monitor the situation and report any developments."[58]

At the first review of the program barely a month later, Horiguchi questioned the authorities in Moscow about the proposed loans-for-shares scheme. In response to his concerns that it would cede control over public property without competitive bidding, would violate the principle of arms-length transactions between banks and their customers, and could worsen the monopolistic structure of the economy, the authorities agreed and insisted that they were "approaching the issue very carefully."[59] At Executive Board meetings for this and subsequent reviews through the summer of 1995, Stefan Schoenberg (Germany) repeatedly urged the staff to monitor the proposal. Although the staff agreed that the scheme was deeply flawed, they continued to accept the authorities' assurances that it was unlikely to be implemented. Following the August mission, Horiguchi concluded that the proposal seemed to have "lessened momentum," but even before the report was circulated to the Board, Yeltsin had signed a decree enacting the scheme.[60]

[56]For an overview of the scheme and its consequences, see Nagy (2000), pp. 88–96.

[57]"Russian Federation—Request for Stand-By Arrangement—Letter of Intent," EBS/95/46 (March 22, 1995), pp. 8–9.

[58]Minutes of EBM/95/38 (April 11, 1995), pp. 33 (Lissakers) and 50 (Horiguchi).

[59]"Russian Federation—First Monthly Review under the Stand-By Arrangement," EBS/95/84 (May 19, 1995), p. 8. Also see Odling-Smee (2006), pp. 168–69.

[60]"Russian Federation—Staff Report for the 1995 Article IV Consultation and First Quarterly Review Under the Stand-By Arrangement," EBS/95/149 (September 8, 1995), p. 14. Yeltsin signed the decree on September 1.

Even after the scheme was implemented, the staff paid little attention to it or to the corruption it was likely to feed. This acceptance resulted partly from the soothing reassurances from Moscow, and partly because the details of the way in which enterprises were privatized were considered to be the primary province of the World Bank, not the Fund. Some Executive Directors, however, continued to worry. In December, for example, Daniel Kaeser (Switzerland) noted the absence of any mention of the privatization scheme in the latest staff report. As a result, he had to rely on press reports, which had indicated that "powerful pressure groups" had secured a ban on foreign companies participating in the auctions, which was "contrary to the market-oriented philosophy of the program supported by the Fund." He asked for the Fund to impose conditionality on the process. Horiguchi expressed agreement with the general concern, but the staff did not regard it as an urgent issue for the Fund.[61]

Second Problem: An Unsustainable Exchange Rate

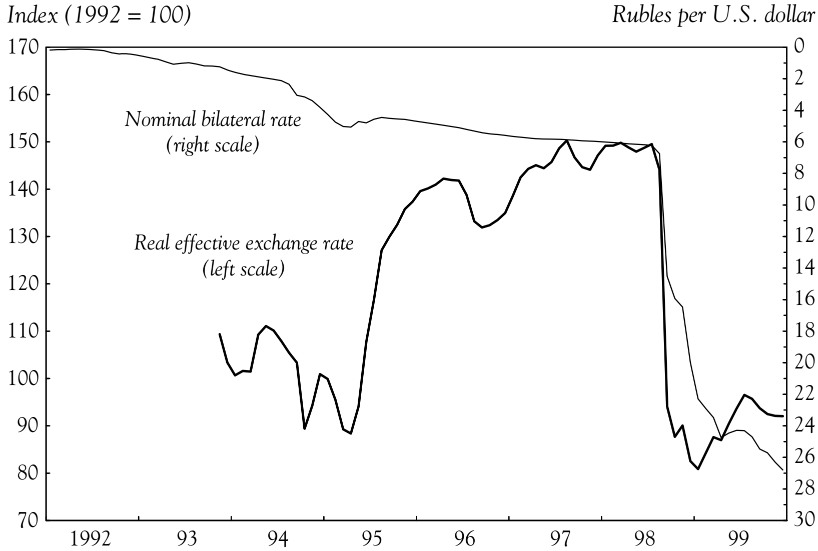
The second problem that arose in this period was that the strong ruble became an entrenched feature of Russian economic policy. As noted above, in late 1994 the authorities had rejected the staff's advice to peg the ruble on the grounds that they needed to stabilize the economy first. By June 1995, however, the roles were reversed. Chubais had decided the time to peg was right,[62] and he raised the idea with Horiguchi during the monthly mission as a proposal for solidifying the price stabilization already under way and preventing a return of inflationary pressures.[63] Horiguchi, after checking with Fischer, replied cautiously and did not encourage such a move. The exchange rate was appreciating strongly (by about 12 percent against the U.S. dollar from end-April to end-June, and by some 22 percent in real effective terms), raising the risks of both further volatility and overvaluation. The Fund was also newly wary of the dangers of trying to fix the rate, in the wake of the Mexican peso crisis that had erupted at the end of 1994 (see Chapter 10). Chubais flew to Washington with several advisors and took the case to Odling-Smee,

[61]Minutes of EBM/95/115 (December 6, 1995), pp. 90 (Kaeser) and 101 (Horiguchi); and additional information from interviews with participants. The authorities' Letter of Intent requesting the stand-by arrangement included two paragraphs describing plans for further privatization, but the arrangement did not include specific conditions related to the implementation of those plans; see "Russian Federation—Request for Stand-By Arrangement—Letter of Intent," EBS/95/46 (March 22, 1995), paragraphs 27 and 28.

[62]IMF staff were not the only advisors who had been encouraging Chubais to peg the ruble in 1994. Jeffrey Sachs, for example, had been offering this advice consistently since the beginning of reforms in 1992. At a 1994 conference attended by Chubais, Sachs argued that the failure to stabilize the exchange rate as an anchor "flew in the face of stabilization experience" in Eastern Europe and elsewhere (Sachs, 1995, p. 55).

[63]Memorandum from Fischer to Manuel Guitián and others, "Russia—Meeting on Exchange Rate Policy" (June 12, 1995); IMF archives, Accession 1998-0106-0008, Box 22082, OMD-AD (Fischer).

Figure 7.2. Russia: Exchange Rates, 1992–99



Source: International Financial Statistics.
Note: Nominal rate is normalized on the new ruble, introduced in January 1998 and equal to 1,000 old rubles.

who responded that the Fund would advise them to retain the floating rate for the time being but would go along if the authorities decided to peg the rate.[64]

The policy that emerged from these discussions and that was put in place in July 1995 was a horizontal band, or "corridor," for the exchange rate. That is, the central bank undertook to maintain a fixed dollar-ruble rate within a margin of ±6.5 percent. Despite the Fund's lack of enthusiasm about the policy shift, the staff worked closely with the authorities to help them design and prepare for it, and they soon acknowledged that the corridor had succeeded in calming the markets during a period of economic and political uncertainty.[65]

The difficulty with pegging the exchange rate did not become apparent until later. At first, the new exchange rate regime provided a stable anchor for price expectations, stimulated the government and parliament to get serious about controlling the fiscal deficit, and helped generate confidence in the ruble as the medium of exchange and value in Russia. Over time, however, as the fiscal imbalance proved more and more intractable, inflation continued to be higher than in the

[64]Memorandum from Odling-Smee to Fischer, "Russia—Exchange Rate Management and Stabilization Strategy," June 23, 1995; IMF archives, Accession 1998-0106-0008, OMD-AD (Fischer).

[65]"Russian Federation—Request for Extended Arrangement," EBS/96/31, Suppl. 3 (March 12, 1996), p. 9.

United States and western Europe, and the dollar appreciated against other major currencies, the real value of the ruble climbed steeply (Figure 7.2). Without a lasting solution to the fiscal shortages, preserving the peg was bound to become increasingly difficult and costly. The government and the Fund faced the challenge of finding a way to introduce more flexibility and realism into the exchange regime before a problem could escalate into a crisis.

The Extended Arrangement

THE REJECTION OF REFORM IS AN EASY SOLUTION, BUT IT HOLDS NO FUTURE.

Boris Yeltsin[66]
President of the Russian Federation
February 22, 1996

The successful expiration of the stand-by arrangement in February 1996 ushered in the next and more difficult stage in Russia's relationship with the IMF. After three and a half years of borrowing, the time had come for Russia to begin repaying the earliest drawings. The scheduled repayments were moderate—about $500 million, or 5 percent of outstanding debts, was due in the first year—but they were coming at a time when Russia needed *more* external financing and could not afford net outflows of hard currency. Output was estimated to have declined by more than 40 percent since 1991. Even allowing for the inherent exaggeration in such estimates, popular impatience with the length of the transition toward renewed economic growth was naturally becoming intense. The government accordingly requested a new arrangement, larger and longer term than its predecessors, to be financed under the IMF's Extended Fund Facility (EFF).

Negotiating in an Election Year

Planning for this multiyear EFF arrangement had begun earlier, in June 1995, with scarcely a pause after the start of the one-year stand-by arrangement. For eight months through February 1996, Horiguchi and two rotating teams of staff economists held almost continuous talks with Russian officials, mostly in Moscow but also in Washington, simultaneously reviewing compliance with the 1995 program and negotiating terms for the next one. As the talks progressed and the deadline for completion loomed, it became increasingly apparent to both sides that the successes of 1995 were already fading and would be difficult to repeat.

To meet the program targets each month in 1995, the ministry of finance had set up a special unit whose only job was to find ways to implement the program

[66]Letter from President Yeltsin to Michel Camdessus (February 22, 1996); in "Russian Federation—Request for Extended Arrangement—Supplementary Information," EBS/96/31, Suppl. 1 (February 27, 1996), p. 1.

and satisfy the Fund's conditions. In view of the continuing pressures on the budget, this task required ingenuity as well as perseverance, and by the end of the year the unit was nearly "out of breath."[67] The biggest difficulty was that the authorities were restraining the fiscal deficit largely by withholding or delaying essential government spending to keep it within sight of woefully inadequate tax revenues. Horiguchi now proposed to move beyond this ad hoc and transitory solution by insisting on broadening and rationalizing the tax base. The staff report supporting the authorities' request for the 1996 EFF arrangement stressed this point:

> At the heart of the revenue collection problem is the authorities' acquiescence to the perpetuation of a "culture of nonpayment." Greater exercise of political will to collect taxes due should be an integral part of a strategy directed at putting an end to this culture. . . . Significant strengthening in the technical design of the tax system and the procedures of tax administration is also required.[68]

Major political uncertainty, initiated by the growing strength of the Communist Party in parliamentary elections held in December 1995, added to these worries. Yeltsin was campaigning for reelection in July 1996, and it now appeared that his chief—and formidable—rival would be Gennady Zyuganov, the Communist Party leader. That prospect frightened not only those concerned primarily about the future of Russian democracy—G7 leaders as well as Yeltsin's supporters in Russia—but also those concerned primarily about the future of the Russian economy—notably the IMF. In an apparent panic, Yeltsin abruptly fired Chubais, the most prominent reformer in his cabinet, as first deputy prime minister in January 1996 and replaced him with Vladimir Kadannikov, known primarily as the former director of automobile manufacturing in the Soviet era. While this sop to the Communists might have enhanced Yeltsin's reelection prospects, it certainly did nothing to enhance the prospects for economic progress.

Pressure on the Fund from the G7 intensified as the anticipated expiration of the stand-by arrangement approached. U.S. President Clinton warmly received Chernomyrdin in the White House at the end of January and publicly stated his support for the proposed new IMF lending—even though negotiations were still under way.[69] Soon afterward, both German Chancellor Kohl and French President Jacques Chirac responded to personal appeals from Yeltsin by offering new bilateral

[67]The phrase is from a statement made by the Russian Executive Director, Dmitri V. Tulin, at EBM/96/27 (March 26, 1996), p. 6.

[68]"Russian Federation—Request for Extended Arrangement," EBS/96/31, Suppl. 3 (March 12, 1996), p. 12.

[69]In response to a reporter's question on January 30 about the proposed IMF loan, President Clinton replied, "As far as I know, they've worked out—they either have worked out or we are in the process of seeing worked out—the differences between them. So I believe that the loan will go through, and I believe that it should"; official transcript, U.S. Newswire (January 30, 1996). Also see Clinton (2004), p. 697. Additional information is from interviews. Also see Stone (2002), pp. 138–43.

aid and traveling to Moscow to meet with him. Within the IMF, several Executive Directors quietly conveyed their governments' desires for continuing IMF support for Russia.[70]

The effect this pressure might have had is difficult to judge. Both Camdessus and Fischer were already firmly committed to supporting Yeltsin and Russia if at all possible. Whatever weaknesses and faltering steps they might be seeing in the run-up to the presidential election were likely to be overcome once the election was over. But first Yeltsin had to win, and support from the IMF—as the embodiment of the international community—could help. Clearly, the Fund's support in these circumstances no longer depended primarily on the staff's technical assessments of economic policies and performance. As policy implementation weakened in January and February 1996, the staff saw its job as pushing as hard as possible for improvements while both sides knew that the Fund would approve whatever policies eventually emerged.

With Chubais out of office and the political atmosphere so highly charged, Horiguchi found it increasingly difficult to get the Russians to agree to any meaningful reforms. In a last-ditch effort to move the process along, Camdessus went once again to Moscow to take the case for reform directly to Yeltsin. When he insisted strongly on getting a tough program that the IMF could support on its merits, Yeltsin agreed. Following his meeting with the Managing Director, the Russian president issued a letter addressed to Camdessus, promising his support for "budgetary discipline . . . a tight credit policy . . . [and] strict compliance with the targeted plans to implement structural changes" to "permit the process of economic transformation to become truly irreversible."[71] A few days later, Chernomyrdin and Sergei Dubinin (governor of the central bank) signed off on a program that included, in addition to the usual program conditions, some 13 concrete measures to be taken prior to the start of the EFF arrangement and a long list of structural benchmarks that the Fund staff could monitor throughout the coming year.[72]

Approval of a Risky Program

Whether the government had either the will or the means to carry out this program—even if Yeltsin was reelected in July—was highly questionable.[73]

[70]In mid-February, France offered credits totaling about $800 million, and the prime minister, Alain Juppé, went to Moscow in a show of support. On March 6, the German government announced that it was providing guarantees for DM 4 billion ($2.7 billion) in loans to be provided by German banks. Chancellor Kohl traveled to Moscow in April.

[71]Letter from President Yeltsin to Michel Camdessus (February 22, 1996); in "Russian Federation—Request for Extended Arrangement—Supplementary Information," EBS/96/31, Suppl. 1 (February 27, 1996), p. 2.

[72]"Russian Federation—Request for Extended Arrangement," EBS/96/31 (February 27, 1996) and Suppl. 1 (same date).

[73]For a candid assessment of the risks, see "Russian Federation—Request for Extended Arrangement," EBS/96/31, Suppl. 3 (March 12, 1996), pp. 36–37.

Nonetheless, the combination of a strong political tailwind, a good record of implementation the previous year, and the prospect of monthly (and practically continuous) monitoring by the staff sufficed to induce the Executive Board to approve the program without dissent on March 26, 1996.[74]

The extended arrangement, designed to put Russia's external finances on a firm footing for at least the next several years, had some unique features. Even though Russia had a current account surplus and was expected to continue to maintain it, the Fund was offering a tremendous level of financial support. The arrangement would allow Russia to draw the equivalent of approximately $10 billion (SDR 6.9 billion, or 160 percent of quota) over three years. If fully drawn, and after allowing for scheduled repayments to the Fund, this new borrowing would raise Russia's indebtedness to the IMF to $15 billion (SDR 10.2 billion) by March 1999, equivalent to about a quarter of the Fund's total loan portfolio in 1996. Approving the arrangement was—along with the Mexico arrangement of the previous year—one of the riskiest financial decisions ever made by the IMF.

Economically, the most important innovation of the 1996 EFF arrangement was its requirement for an increase in tax revenues. In a departure from the previous reliance on sequestering expenditure, the arrangement included a floor that the federal government was required to maintain on tax revenue each quarter. Such a condition had not been used by the Fund before, but it was seen as appropriate for Russia's unique situation.[75] Paradoxically, however, the arrangement also required Russia to eliminate oil-export duties—a major source of revenue for the government—by mid-1996, as part of a general plan to liberalize foreign trade. New excise taxes on the *transportation* of oil ("pipeline" taxes) were supposed to compensate for the loss of revenue, but that assumption was simply unrealistic. As Autheman pointed out presciently, "in the complex world of Russian politics, . . . it is easier . . . to levy export duties than transportation fees."[76] More generally, because the parliament had to approve tax reform but was showing little inclination to do so, raising revenue was to a large extent beyond the control of Yeltsin's government. Desirable as this tax-floor condition might have seemed to the Fund staff at the time, it would eventually help undermine the program.

Once the program was approved, Yeltsin made a genuine effort to meet the Fund's fiscal targets, but he had to continue to rely on issuing decrees limiting

[74]In addition to continuing the practice of monthly monitoring, the EFF arrangement also included an unusually broad commitment from the Russian authorities to "consult with the Fund on the adoption of any measures that may be appropriate . . . whenever the Managing Director requests consultation . . . because [he] considers that consultation on the program is desirable"; "Russian Federation—Extended Arrangement," EBS/96/31, Suppl. 6 (April 2, 1996), p. 4.

[75]"Russian Federation—Extended Arrangement," EBS/96/31, Suppl. 6 (April 2, 1996) p. 25. As noted above (pp. 306–07), the Fund's major effort to persuade Russia to strengthen tax collections began in 1994.

[76]Statement by Marc-Antoine Autheman (France), at EBM/96/27 (March 26, 1996), p. 12.

spending rather than raising revenue. The Fund staff offered extensive technical assistance on strengthening tax collections, mainly through improvements to the value-added tax and cracking down on major tax avoiders, and on other related issues.[77] These efforts would take time to implement, and when the Executive Board met in early June to review the arrangement, the pledged improvements were still just vague promises. Yeltsin's decrees had, however, kept the deficit within the target, and the Board unanimously approved the next disbursement.[78]

The Fund's approval of the extended arrangement also cleared the path for further financial support from other creditors. At the end of April, the Paris Club of official creditors reached a historic agreement, rescheduling $40 billion of Russia's Soviet-era debts to be repaid over the next 25 years. The accord—the largest rescheduling agreement in the 40-year history of the Paris Club—was made contingent on Russia's "continued and full implementation of" the IMF arrangement.[79] Up to this time, the Paris Club had reached short-term agreements each year (1993–95) to reschedule payments coming due during the period covered by the annual series of IMF-supported programs. Under the rules of the Paris Club, a longer-term agreement required the country to have a multiyear arrangement with the IMF in support of a comprehensive adjustment program. In this case, however, the main catalyst for the adjustment was political rather than economic, driven by U.S. support for the Russian desire to put an early end to the need for continuing annual debt reschedulings.[80]

After the Elections: Weak Implementation

In the weeks leading up to the first round of the presidential election, Yeltsin's standing in the polls steadily improved. He placed first in the voting, just ahead of Zyuganov, and then handily defeated him in the runoff vote on July 3. In important respects, however, including for the Russian economy, it was a Pyrrhic victory.

[77]During the first 14 months the EFF arrangement was in effect, the Fund's Fiscal Affairs Department sent nine technical assistance missions to Moscow and maintained a resident advisor in the state tax service. Five of those missions dealt with tax administration, and the others covered tax policy, customs administration, and general budget issues. During the same period, the Monetary and Exchange Affairs Department sent ten missions, held three workshops, and maintained a resident advisor in the central bank. The Statistics Department sent five missions, held two seminars for central bank officials, and maintained a resident advisor in the state statistics office. The IMF Institute conducted two courses, for officials in the central bank and the ministry of finance. See "Russian Federation—Staff Report for the 1997Article IV Consultation, Review Under the Extended Arrangement, and the 1997 Macroeconomic and Structural Program," EBS/97/78 (May 2, 1997), pp. 44–45.

[78]See minutes of EBM/96/54 (June 5, 1996).

[79]For the press release, see http://www.clubdeparis.org/sections/communication/archives-anterieures/russie.

[80]For details on the agreement, see www.clubdeparis.org. Additional information is from interviews with participants.

In the course of the campaign, Yeltsin had suffered one or more heart attacks. He had managed to keep his weakened health secret by virtually dropping out of public sight, but the Kremlin now faced a power vacuum that would persist until well after Yeltsin could recover adequately to undergo heart surgery in November.[81] In the meantime, the implementation of economic policy slipped badly.

Despite the absence of real leadership, the government had to find a way to rationalize exchange rate policy as soon as the election was over. For a full year, the horizontal corridor had prevented the rate from depreciating in line with Russian inflation, and the extent of the overvaluation was beginning to bite. In April 1996, the IMF staff began discussing options for coping with a possible crisis in the run-up to the elections and for introducing more flexibility into the system once calm was restored. Both Odling-Smee and Fischer offered the Fund's services to the authorities to help them design a workable crawling peg arrangement, but the Russians decided to proceed on their own.[82] On May 15, Dubinin announced plans to replace the corridor with a managed crawl under which the central rate would depreciate against the U.S. dollar by 1.5 percent a month. Although the Fund staff feared the depreciation rate was too slow to prevent the overvaluation from continuing to worsen, they felt they had been presented with a *fait accompli* and had little choice but to keep their reservations quiet.

No one in the IMF knew it at the time, but the situation was worse than it appeared in the official data. As revealed by an external audit demanded by the Fund in 1999, the central bank was overstating the level of its unencumbered foreign exchange reserves by not reporting a number of obligations and guarantees, and it was understating its extension of credit to the government by misclassifying certain transactions. As a result, it appeared throughout the latter part of 1996 that Russia was in compliance with IMF conditions when in fact it was not.[83] When the external audit uncovered this deception, the Executive Director for Russia, Aleksei V. Mozhin, acknowledged that it had been a "shameful story" that had occurred in "a period of extreme madness and hysteria associated with the presidential elections." The Fund concluded that the episode constituted "a fundamental lack of cooperation on the part of the authorities and a serious violation of Russia's obligations to the Fund."[84]

[81]Yeltsin publicly acknowledged his heart problems only on September 5.

[82]See memorandums from Odling-Smee to Fischer, "Russia: Exchange Rate Issues" (April 22, 1996); and Odling-Smee to the Managing Director, "Russian Federation—New Exchange Rate Band" (May 15, 1996); IMF archives, "DMD's 1996 Country Files," Accession 1999-0275-0007.

[83]For the audit report and the staff analysis of it, see "Russian Federation—Staff Report for the 1999 Article IV Consultation and Request for Stand-By Arrangement," EBS/99/124, Suppl. 1 (July 20, 1999).

[84]Minutes of EBM/99/83 (July 28, 1999), pp. 28 (Mozhin) and 97 (Summing Up by the Acting Chairman). Because the discrepancies were not discovered until 1999, the IMF's usual remedies under its misreporting guidelines did not apply. For a more detailed account of the misreporting, see Stone (2002), pp. 142–45. Also see Chapter 16 in this volume.

In the summer and fall of 1996 it was already clear that Russia had progressed little in strengthening the collection of taxes. In July and again in November, the Fund, encouraged by at least some of the reformers in Moscow, temporarily withheld approval of monthly disbursements until the authorities showed modest new signs of progress. At one critical moment, Gaidar—who had left the Yeltsin government for good and had founded his own reform party—telephoned Fischer in late November to ask him to put more pressure on Chernomyrdin and Chubais to get fiscal policy under control. With Yeltsin about to retake the reins, the government had an opportunity to act decisively. If they did not, Gaidar warned, "everything will blow up in one-and-a-half years."[85]

That very evening in November Chernomyrdin and Camdessus were holding a long meeting in Paris that continued over dinner at the Jules Verne restaurant in the Eiffel Tower and went on until the middle of the night. Eventually the prime minister seems to have convinced the Managing Director that matters were about to improve. Camdessus issued a tentative and hedged but generally positive assessment to the press before finally retiring for the night.[86] He then agreed to recommend to the Executive Board that the Fund resume lending to Russia.

When the Board met on Friday, December 13, no one was happy to be asked to support such a weak reform effort. Thomas Bernes (Canada) expressed "deep concerns"; Autheman spoke of the need for "better standards" in dealing with Russia; and Lissakers described her "disappointment" in the authorities' weak performance in carrying out the program. Although the Board granted waivers for Russia's failures to meet the program's conditions (the fiscal deficit being too large, tax collections too weak, and foreign exchange reserves too low) and unanimously approved the drawing, the tone of the meeting conveyed a clear warning to management and staff that Directors expected better evidence of progress in the coming months.[87]

1997: A "Crisis of the State"

The next year, 1997, proved to be just as challenging as the last. With no prospect in sight for closing the gap between government spending and tax revenues or for making exchange rate policy consistent with the fiscal imbalances, the question that occupied the IMF was how the government could finance the fiscal deficit. The options were not attractive. Reluctantly, Horiguchi decided not to oppose a "tax offset" scheme whereby the ministry of defense was allowed to purchase goods from

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[85]See Fischer's notes on the conversation (November 27, 1996); IMF archives, "DMD's 1996 Country Files," Accession 1999-0275-0007.

[86]Report from Christian Brachet (Director, Office in Europe) to Shailendra Anjaria (Director, External Relations Department), November 29, 1996; IMF archives, "DMD's 1996 Country Files," Accession 1999-0275-0007.

[87]Minutes of EBM/96/111, pp. 66 (Bernes), 68 (Autheman), and 69–72 (Lissakers). Also see "Russian Federation—Third Quarterly Review Under the Extended Arrangement and Request for Waiver and Modification of Performance Criteria," EBS/99/189 (December 9, 1996).

suppliers and pay for them by canceling the companies' tax arrears.[88] That would help a little, but a more general and reliable source of financing had to be found.

Through 1996, foreign investors had purchased few Russian treasury bills, known by their Russian acronym GKOs, primarily discouraged by restrictions on repatriation of the proceeds.[89] By December 1996, both the Fund staff and the government became convinced that these restrictions had to be abandoned, partly because the restriction on repatriating interest income was incompatible with Russia's obligations under the IMF's Articles, but more important, because Russia needed foreign investment to finance the fiscal deficit. Eliminating the restriction on repatriating interest income (a current account restriction covered by Article VIII) would do little good without a corresponding elimination of the restriction on repatriating principal (a capital account restriction permitted under the Articles).[90] With the full concurrence of—and even encouragement from—the authorities, Horiguchi proposed, and Fischer approved, making a gradual liberalization of the GKO market a condition for continued disbursements under the EFF arrangement, beginning in January 1997.[91]

Meanwhile, the U.S. government was pushing for full acceptance of Russia as a major economic power. At a summit meeting with Yeltsin in Helsinki in March 1997, President Clinton promised to support Russian membership in the World Trade Organization, the OECD, and the Paris Club, and to reconstitute the annual G7 summits as the "Summit of the Eight" with full Russian participation. Accepting Russia as a Paris Club creditor made some sense given that Russia was an important creditor to a number of developing countries that had Fund-supported programs. The idea was nonetheless grating to some other creditors, who vividly recalled that it had been less than a year since they had agreed to reschedule Russia's obligations on its Soviet-era debt. Once again, the political imperative to

[88]Memorandum from Horiguchi to the Acting Managing Director (Fischer), "Russian Federation: Summary of Interdepartmental Meeting on Wednesday, December 4, 1996" (December 5, 1996); IMF archives, "DMD's 1996 Country Files," Accession 1999-0275-0007. For an analysis of these tax offsets in the broader context of the culture of "nonpayments" in Russia at that time, see Pinto, Drebentsov, and Morozov (2000).

[89]GKOs are short-term discount (zero-coupon) bills issued by the ministry of finance.

[90]For the different roles of current account and capital account restrictions in the IMF, see "Issues in Surveillance" in Chapter 4. Russia accepted the obligations of Article VIII in June 1996, and the IMF temporarily approved the continuation of the restriction on repatriation of interest in July. After the authorities agreed to remove the restrictions on both interest and principal gradually during 1997, the Executive Board extended its temporary approval through the end of 1997.

[91]Memorandums to the Acting Managing Director (Fischer) from Odling-Smee, "Russia: New Disbursement Schedule" (December 6, 1996); and from Horiguchi, "Russia: Back-to-Office Report" (December 30, 1996); IMF archives, "DMD's 1996 Country Files," Accession 1999-0275-0007. Also see "Russian Federation: Information Note on End-January Targets Under the Extended Arrangement," EBS/97/3 (January 13, 1997), p. 7. A mythology later took hold that the IMF had forced capital liberalization on a reluctant Russian government; see, for example, remarks by Dubinin, in Desai (2006), p. 235; Stiglitz (2002), p. 145; and Woods (2006), pp. 125–28.

draw Russia into closer economic relations with the west was running ahead of the country's economic realities.[92]

Camdessus, increasingly alarmed at Russia's inability or unwillingness to confront its tax-collection crisis, refused to be drawn into this political whirlwind. At the end of March, just 10 days after the Clinton-Yeltsin summit, he flew to Moscow for a series of meetings with Yeltsin, Chernomyrdin, and other senior officials. Toward the end of the trip, he delivered a speech at the Moscow Institute of International Affairs, publicly urging adoption of a comprehensive program of reforms. Despite an impressive list of achievements, he warned, Russia was "in a state of crisis . . . a crisis of the state."[93]

To resolve the crisis, Camdessus argued, Russia had to improve the legal, regulatory, and institutional environment for private investment. The nonpayment of taxes was close to becoming a "crisis of democracy," especially because it resulted in large part from "the exceedingly close relationship between the government and a number of large enterprises" (partly a reference to the oligarchs created by the loans-for-shares scheme, but also to companies such as Gazprom). More generally, Russia would have to root out corruption, which had become pervasive. Back in Washington a few weeks later, Camdessus went so far as to speak of "a major risk of anarchy" if the Russian government failed to stem the crisis.[94]

Yeltsin personally was receptive to this message, and sought new ways to overcome the parliamentary opposition to liberalization and reform. In mid-March he appointed or elevated several reformers in the government, notably by naming Chubais (who had been serving as his chief of staff since the July 1996 elections) to be a first deputy prime minister and minister of finance.[95]

These appointments created a dilemma for the IMF. For several months, the government had shown little resolve in implementing either fiscal policy or structural reforms, but the Fund had not cut off its financial support. Should it now continue disbursing large sums each month on the assumption that these new

[92]At that time, the Clinton administration was pressing ahead with plans to expand the North Atlantic Treaty Organization (NATO) by admitting three Visegrad countries—Poland, Hungary, and the Czech Republic—that were former members of the Warsaw Pact. Yeltsin objected strongly to this development, but he muted his opposition after Clinton cleared the path for Russia to join the G7, the Paris Club, and the WTO and to support moves toward Russian membership in the OECD. The G7 summit became the "Summit of the Eight" in June 1997, and Russia was accepted as a creditor member of the Paris Club in September. The three Visegrad countries became NATO members in March 1999. More than a decade later, negotiations continued for Russia to become a member of the OECD and the WTO.

[93]Untitled address (April 2, 1997); accessed at http://www.imf.org/external/np/speeches/1997/mds9705.htm.

[94]Transcript of a press conference (April 24, 1997); accessed at http://www.imf.org/external/np/tr/1997/tr970424.htm.

[95]At the same time, Boris Nemtsov was made first deputy prime minister alongside Chubais, and Aleksei Kudrin became Chubais's principal deputy in the ministry of finance.

appointments signaled an improved policy climate, or should it withhold its approval until the government could produce results, especially on tax collection? Having supported a weaker government for the past year, what message would the IMF be sending if it now turned its back on the reformers?

Those questions generated a fierce internal debate, with Jack Boorman (Director, Policy Development and Review Department, or PDR) leading the case for a "pause" in the arrangement and Michael Mussa (Director, Research Department) supporting Horiguchi in making the case for showing immediate support for the newly returned reformers. In the end, Camdessus sided with Boorman and insisted on a strengthening of tax revenues before releasing any more money under the EFF arrangement.[96] Negotiations continued, and no drawings were allowed in March or April.[97]

The dilemma did not ease with time. Chubais insisted that the Fund's proposed revenue floor was too ambitious economically and was unrealistic politically. In mid-April Fischer told Horiguchi—who was about to lead the last of his 31 staff missions to Moscow—to continue pushing for higher revenues but to be flexible if he failed to make progress.[98] That broke the impasse, and negotiations concluded with a federal government revenue floor equivalent to 8.3 percent of projected GDP, down from the 10.5 percent target that the staff had been demanding. In return, the authorities accepted a somewhat lower level of borrowing: SDR 500 million every three months, down from the previously scheduled SDR 593 million. On May 16, 1997, the Executive Board accepted this compromise, and drawings resumed.

For the next few months, the Russian economy seemed to be stabilizing. Inflation and interest rates were down, output and incomes were growing, the program conditions were satisfied, and the IMF was able to keep disbursing funds under the EFF arrangement. By the time of the IMF/World Bank Annual Meetings in Hong Kong SAR in September, Chubais was even speaking openly of a "friendly divorce" from the IMF. Although Camdessus was not optimistic about such a prospect, he did express his hope that they could succeed in reaching that point.[99]

The deeper picture was less glowing, and the talk of friendly divorce was soon revealed to have been premature speculation. When the next staff mission, now led by Jorge Márquez-Ruarte (Senior Advisor, EU2), went to Moscow in late

[96]Memorandum from Owen Evans (Assistant Director, Mr. Fischer's office) to Fischer (March 21, 1997); IMF archives, Accession 2000-0117-0009, DMD-AI, Box 22267, "Russia."

[97]Through April 1997, Russia had drawn approximately $3.4 billion (SDR 2,336 million) under the EFF arrangement, which was some $680 million less than had been envisaged under the original schedule. This was equivalent to 12 monthly drawings out of 14 scheduled.

[98]File memorandum by Owen Evans (April 17, 1997); IMF archives, Accession 2000-0117-0009, DMD-AI, Box 9, "Russia."

[99]Responding to a reporter's question in Hong Kong SAR, Camdessus noted that a "divorce" would mean "that we will continue, in one way or another, living together but I will no more pay for the expenses of the household. Our love will continue to be exuberant, and I believe the lady there will be even more charming." On that risqué note, his spokesman quickly called the press conference to a close. For the transcript, see http://www.imf.org/external/np/tr/1997/tr970925.htm.

October, it found that the budget imbalances were much worse and more entrenched than had been thought throughout the summer. Within days, even before the mission finished its work, the seeds of one of the most severe financial crises of the decade were beginning to sprout.

The Crisis of 1997–98

As promised, Russia had been gradually liberalizing its treasury bill market for foreign investors throughout 1997. By October, the remaining restrictions were largely ineffective, and nonresident purchases of GKOs were rising sharply.[100] Speculative investors were lured in by a combination of high nominal yields, the ability to engage in "carry trade" by borrowing cheaply in Japanese yen and other major currencies, a stable exchange rate, and the appearance of safety associated with IMF and other official international support. This inflow enabled the government to finance its fiscal deficit without tackling the deep-seated structural and social problems that made effective tax collection and expenditure control practically impossible. Even if the inflow of foreign capital had been steady and reliable, the longer-term consequences of these issues would have been worrisome. In reality, Russian fiscal policy was now constrained by the whims of international speculation as well as by the government's inability to control taxes or spending. The interaction of these two forces was about to drive the Russian financial system into a horrendous crisis.[101]

The First Wave: October 1997

The first break in expectations came on October 28, 1997, just five weeks after the ebullience of the meetings in Hong Kong SAR. On that one day, in an attack that apparently came as a complete surprise to Russian officials, the Russian stock market lost 20 percent of its value, interest rates on GKOs rose from 19 percent to 25 percent, and the exchange rate fell to the bottom of the central bank's daily intervention limit. The timing of the attack was unrelated to any particular news about Russia. For some weeks, investors had been getting increasingly nervous about financial developments in East Asia. The Taiwan dollar, which most investors had thought to be unassailable, had been devalued in mid-October, precipitating a general pullout from emerging stock markets beginning on October 20. Over the

[100]Throughout this period, until after the 1998 crisis, the IMF staff did not have access to data on the ownership of government debt by nonresidents. As it turned out, by mid-1998 about a third of the outstanding stock of GKOs was held by nonresidents; see IMF (1998), p. 18, and Santos (2003), p. 162.

[101]For an overview of the chronology of the crisis, and an analysis of how the inconsistency between loose fiscal policies and tight exchange rate policies made the crisis inevitable, see Kharas, Pinto, and Ulatov (2001).

next four days, the Hong Kong market fell by more than 23 percent. By the next Monday, October 27, equity markets were declining sharply throughout the Americas as well, from New York to Buenos Aires. Perhaps the real surprise would have been for Russia to remain unaffected, but the magnitude of the collapse was still a major shock.

Although these losses were partially reversed in the coming days, the IMF was now on the alert and ready to shift into crisis mode. Two problems had to be solved: fiscal policy had to be brought into balance without continued reliance on short-term money from abroad, and exchange rate policy had to be managed to prevent the outflows from depleting the central bank's reserves.

Everyone who was involved at the IMF agreed that the fiscal problem was acute and a top priority. On exchange rate policy, views were less unified. At this time, the Russia team on the staff wanted the authorities to devalue the ruble immediately and then manage the crawling band with more flexibility than in the past year. Fischer discouraged that line of advice by arguing that the fiscal imbalance should be tackled first to avoid a serious loss of confidence. In the meantime, the authorities could let interest rates rise. If that approach failed to stem the pressure, then they could consider devaluation. [102]

The mission returned to Washington at the end of October without a resolution on how to strengthen policies. Fischer went to Moscow on November 9 to break the impasse. At the end of his three-day visit, he and the ministry of finance announced agreement on a package of tax and spending measures that became known formally as the Fiscal Action Plan and informally as the Kudrin-Fischer Plan.[103]

Now that the government had a strategy for controlling the budget, the question was whether it could implement the plan. Some elements, such as ending the practice of canceling tax arrears as a way of paying for government purchases, were implemented right away by getting Yeltsin to issue a presidential decree.[104] Others, such as raising domestic interest rates, could be implemented right away by the central bank. The longer-lasting elements, necessary for bringing taxes and spending into alignment and for reducing the incentives for corruption, were still impossible to implement because the government was deeply divided within itself and the measures were strongly opposed by the majority in parliament. Until some real

[102]Memorandums from Odling-Smee to the Managing Director, "Russia—Exchange Market Pressures" (November 5, 1997); and from Márquez-Ruarte to the Acting Managing Director (Fischer), "Russia: Emergency Assistance" (November 14, 1997); IMF archives, Accession 2000-0117-0009, DMD-AI, Box 9, "Russia III."

[103]For a summary of the plan, see "Russian Federation - Sixth Quarterly Review Under the Extended Arrangement," EBS/97/245 (December 24, 1997), p. 19.

[104]Yeltsin signed the decree ending the tax offsets on November 7. In recognition of the role the IMF had played in the background, Chernomyrdin signed a copy with a congratulatory note and gave it to Fischer, who proudly displayed it on his office wall for several years.

progress could be shown on that front, Fischer was not prepared to promise any more financial support from the IMF.[105]

While Fischer was still in Moscow, Dubinin announced that the central rate of the ruble would be devalued at the beginning of 1998 as part of a currency reform and that the market rate would be allowed to fluctuate within a wide horizontal band. In practice, this would allow the central bank to manage a gradual depreciation within the band. At the time, this tactic seemed sufficiently flexible, but it failed utterly to impress investors in the GKO market. By the end of November, the central bank was running dangerously low on foreign exchange reserves, the exchange rate was at the bottom end of the daily intervention band, and a further sharp increase in interest rates was not generating confidence.

For the next few weeks, the IMF tried to force specific reforms on a reluctant government while publicly dangling the prospect of renewed financial support. Camdessus, holding the toughest line, insisted that the government block access to Russia's oil-export pipelines for companies with major tax arrears. That requirement nearly backfired when Boris Berezovsky, owner of one of the delinquent companies and one of the country's most prominent oligarchs, obtained a copy of a letter to this effect from Camdessus to Chernomyrdin and promptly leaked it to parliamentary leaders. That, understandably, created the impression that the IMF was dictating economic policy to the government.[106] Nonetheless, the authorities proceeded to crack down on major tax cheaters, though the largest among them continued to avoid compliance. Despite the difficulties, Camdessus decided that the tax-collection effort was sufficiently strong to warrant resumption of lending. On January 8, 1998, the Executive Board met and approved a drawing of $672 million (SDR 500 million).

Despite this injection of cash and the vote of official confidence it represented, Russia's financial prospects continued to deteriorate. The February staff mission tried to take a tough line with the government by insisting on a high floor on federal tax collections (11 percent of GDP). The government eventually agreed to this demand, but it had no way to achieve it. The mission chief, Márquez-Ruarte, later admitted that the ambition had been unrealistic.[107]

[105]Memorandum from Fischer to the Managing Director, "Visit to Russia, November 9–11" (November 11, 1997); IMF archives, Accession 2000-0117-0009, DMD-AI, Box 9, "Russia III."

[106]Memorandum from Odling-Smee to the Managing Director, "Russian Federation: Report from the Mission" (December 9, 1997); IMF archives, Accession 2000-0117-0009, DMD-AI, Box 9, "Russia III."

[107]See memorandums of February 27 and May 26, 1998, from Márquez-Ruarte to the Managing Director, "Russia—Back-to-Office Report on Mission to Finalize 1998 Program Negotiations" (February 27, 1998) and "Russia—Back-to-Office Report for Follow-Up Staff Visit to Review Implementation of the 1998 EFF Program" (May 26, 1998); IMF archives, Accession 2001-0284, OMD-DMD [Fischer], Box 12, file "Russia (1)."

On February 17, Camdessus flew to Moscow from Seoul, where the Republic of Korea's own financial crisis was moderating but still worrisome after three months of effort (see Chapter 11). In meetings with Yeltsin and Chernomyrdin, he did his best to convince them that Russia faced many of the same preconditions for a crisis that Korea had a few months earlier. He warned that unless Russia decisively tackled its fiscal imbalances, made the oligarchs pay their taxes, and strengthened the banking system, it was heading for a disaster of similar dimensions as those that had hit countries across Asia. Camdessus also met with a group of the most powerful oligarchs—including well-known oil tycoons such as Platon Lebedev and Mikhail Khodorkovsky—and lectured them on the dangers they were foisting on the Russian economy and therefore on their own futures.[108] These warnings, however, had no discernible effect on either the government or the industrialists. Yeltsin, as he had several times before, reacted to the crisis conditions by firing the prime minister (Chernomyrdin) and his first deputy (Chubais).[109]

The change in government, predictably, made matters worse. The parliament twice rejected Yeltsin's chosen candidate for prime minister, Sergei Kiriyenko, before finally accepting him on April 24. Meanwhile, policy implementation slipped even more badly than it had previously. At the IMF, the challenge was to negotiate a realistic and viable economic program for the remainder of 1998 that would merit the continuation of Fund support through the EFF arrangement, at a time when no one—not even the U.S. officials who had long been pushing the IMF to lend in support of dubious programs—had any confidence that promises would lead to actions.[110]

The Second Wave: May 1998

Discussions between the staff and Russia's economic team continued through April with little progress. Then, on May 18, the second wave of the financial crisis began. The annualized yield on GKOs suddenly jumped from about 30 percent to more than 50 percent, and the central bank was forced to intervene heavily to

[108]On Camdessus's meetings in Moscow, see memorandums from Odling-Smee to the Managing Director, "Russia—Program for Your Visit" (February 10, 1998) and "Russia—Report to the Executive Board" (February 24); IMF archives, Accession 2001-0284, OMD-DMD [Fischer], Box 12, file "Russia (1)." Berezovsky also was on the list of participants, but he reportedly was injured and unable to attend (Blustein, 2001, p. 247). For Camdessus's views on the oligarchy and its similarities to "crony capitalism" in Asia, see his April 1998 speech to the U.S.-Russia Business Council in Washington; accessed at http://www.imf.org/external/np/speeches/1998/040198.htm. Berezovsky later went into exile to avoid prosecution, and Lebedev and Khodorkovsky were both convicted of and jailed for tax evasion and fraud.

[109]On the rationale for firing Chernomyrdin, see Yeltsin (2000), pp. 103–14.

[110]Treasury Under Secretary Summers went to Moscow in early May, and Vice President Gore in late July, to try to warn the Russians that they had to strengthen policies and meet the IMF's conditions if they wanted U.S. support.

prevent the ruble from collapsing. Although Gaidar had predicted 18 months earlier that "everything will blow up" in a year and a half (see above, p. 319), again developments in Asia more than those in Moscow dictated the timing of this wave. This time the catalyst was a political crisis in Indonesia, where rioting against the Suharto regime had left hundreds of people dead. The newly renamed "Group of Eight" summit meeting in Birmingham, England, had concluded on Sunday, May 17, with a call for "political reform" in Indonesia—widely understood to be a veiled call for President Suharto to resign. As investors began pulling money out of weak economies, Russia again was on the front lines.

By coincidence, Márquez-Ruarte and a team of IMF economists arrived in Moscow the next day to resume discussions on the 1998 program. (No drawings had been allowed since January while these talks continued.) Shortly afterward, the head of the IMF office in Moscow, Martin Gilman, told reporters that the Fund was not ready to approve Russia's policy program. That statement contributed to a further decline in financial markets, but the Fund and the government acted quickly. Camdessus publicly denied that the Russian economy was in a crisis and asserted that the financial panic was "not a major development" (Gordon and Sanger, 1998, p. A1). On Tuesday, May 26, Yeltsin announced a new package of fiscal measures. After Kiriyenko called Fischer to explain this new package, the Fund issued a news brief welcoming the progress and expressing the IMF's hope "to conclude its assessment of the 1998 program in the next few days."[111] Odling-Smee left immediately for Moscow, held further talks on the remaining fiscal shortcomings, and conducted a press conference intended to reassure financial markets.[112]

On May 28, Chubais flew to Washington, arriving at midnight, and spent all of the next day meeting with senior U.S. and international officials, including Secretary Robert E. Rubin and Summers at the Treasury and Fischer at the IMF. Though not even an official member of the Russian government at the time, Chubais (accompanied by Yeltsin's deputy chief of staff, Sergei Vasiliev) was not only pleading for an early release of the next installment of the EFF loan; he was also opening an appeal for large-scale additional financing through the Fund's new Supplemental Reserve Facility (SRF; see Chapter 5). The appeal succeeded quickly with the Americans, and two days later, President Clinton announced that he "endorses additional conditional financial support from the international financial

[111]See "IMF Management Welcomes Russian Fiscal Measures, Hopes to Conclude Program Assessment in Next Few Days," NB/98/14 (May 26, 1998); accessed at http://www.imf.org/external/np/sec/nb/1998/nb9814.htm.

[112]See "IMF Welcomes Russian Government's Statement on Fiscal Measures; Management to Recommend Completion of Review Under Russia's EFF Program," NB/98/15 (May 29, 1998); accessed at http://www.imf.org/external/np/sec/nb/1998/nb9815.htm.

institutions." Although IMF management and staff were initially skeptical, Clinton's announcement put strong pressure on them to consider the financing.[113]

Unfortunately, the latest policy announcements from Moscow impressed the financial markets even less than they had Fund officials. By June 1, GKO yields were approaching 95 percent, as the central bank tried desperately to preserve its policy of fixing the exchange rate of the ruble against the dollar. The IMF now had to sail a very narrow channel between the Scylla of financing weak policies and the Charybdis of contributing to a total collapse of the Russian economy.

Given the amount of pressure and the limited room and time for maneuver, it is perhaps not surprising that management of the crisis did not go smoothly. On June 11, the Fund announced that agreement had been reached on a program that qualified for financing via the next tranche of the EFF arrangement. "Provided that the actions to be taken in the next few days are implemented," the Board would meet on June 18 to complete the review and release the money.[114] This announcement was aimed at restoring a measure of investor confidence, but it risked backfiring if the authorities failed to complete the required actions, which included moving aggressively against tax cheaters and improving the transparency of industrial privatizations.

The backfire came on June 18, the day the Executive Board was scheduled to meet. Although most prior actions had been completed, little had been done to improve tax collections, and the Fund had to announce that the Board meeting was being postponed. As an additional misfortune, the announcement came just as the government was preparing to issue a new, long-term, dollar-denominated Eurobond. The postponement of the Board meeting confused and upset investors, and the government had to pay about 7.5 percentage points above comparable U.S. rates to sell the bond. Closing the financing gap was getting ever more out of reach.

Yeltsin then brought Chubais back into the government as his special representative to negotiate with the IMF and other official creditors. More important, both Yeltsin and Kiriyenko finally seemed to be convinced that they needed to act more decisively to fill the hole in the budget. On June 23, Yeltsin summoned legislators to a public meeting and threatened to rule by decree if they refused to pass his

[113]When news reports began circulating that IMF officials were skeptical, David Lipton, under secretary of the U.S. Treasury, telephoned the Fund's chief spokesman to insist that Clinton's expression of support not be undercut. That induced the Fund to change its official message slightly to say that additional support "was not being excluded"; see memorandum from Shailendra Anjaria to the Acting Managing Director (Fischer), "Russia—Call from Mr. David Lipton" (June 1, 1998); IMF archives, Accession 2001-0284, OMD-DMD (Fischer); Box 12, file "Russia (2)."

[114]See "Russian Authorities and IMF Reach Understandings on 1998 Economic Policy Statement," NB/98/20 (June 11, 1998); accessed at http://www.imf.org/external/np/sec/nb/1998/nb9820.htm.

proposed budget. At the same meeting, Kiriyenko stated unequivocally that the government had to assume responsibility for the crisis: "Today we are confronted with the result of our indecisiveness in carrying out reforms. . . . Russia's problems lie not in Asia, but in Russia itself" (Gordon, 1998b, p. A3).

The question at the IMF, as it had been all along, was whether brave words would be followed by convincing actions. Fischer had gone once again to Moscow on June 22 to persuade Kiriyenko and Chubais that they had to crack down much more forcefully on the largest tax evaders. By June 24, the authorities had taken actions against some offenders and had promised to act against the rest by July 1, when the next tax payments were due. That promise persuaded Fischer to schedule a Board meeting for the next day, even though neither he nor anyone else really believed the promise could be fully kept.[115]

When the Executive Board met on June 25, the atmosphere was heavy. At the outset, Fischer acknowledged that the Russians had not yet done all the Fund had asked. He recommended approval as a necessary step to prevent a total collapse of confidence, but he promised that "if the authorities do not proceed forcefully against the largest tax delinquents after July 1, that would affect the Board's consideration of any further financial support for the Russian Federation." Even though the U.S. government had been the leading advocate for going ahead with the program, Lissakers concurred with this cautious assessment. She poignantly compared the ongoing saga of apparently endless rescue attempts to the classic silent film serial, "The Perils of Pauline," in which the hapless heroine was repeatedly saved from impending death at the last possible moment. [116]

Several Directors were upset at being asked to approve a program for which both the track record and the prospects for implementation of promised reforms were so poor. Charles O'Loghlin (Alternate, Ireland) undoubtedly spoke for many of his colleagues on the Board in saying it was "with considerable reservations" that he was willing to "once again give the Russian authorities the benefit of the doubt." Yukio Yoshimura (Japan) complained that the Fund seemed to be supporting Russia only because it was, in a sense, too big to be allowed to fail. Concerns about "disruptive systemic implications for global financial stability," he warned, "should not compromise our attitude to program implementation."[117]

Despite these reservations, no one abstained or voted against completing the review. Russia drew close to $670 million (SDR 500 million), bringing the country's total indebtedness to the IMF to $14.3 billion.

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[115]See memorandum from Gérard Bélanger (Deputy Director, EU2) to the Acting Managing Director, "Russia—Decision to Hold Board Meeting Tomorrow" (June 24, 1998); IMF archives, Accession 2001-0284, OMD-DMD (Fischer); Box 12, file "Russia (2)." Also see "Russian Federation—The 1998 Program and Seventh Quarterly Review Under the Extended Arrangement," EBS/98/100, Suppl. 2 (June 24, 1998).

[116]Minutes of EBM/98/68 (June 25, 1998), pp. 21 (Fischer) and 13 (Lissakers).

[117]Minutes of EBM/98/68 (June 25, 1998), pp. 23 (O'Loghlin) and 25 (Yoshimura).

The Third Wave: July 1998

Even at this late stage, the Fund staff team remained convinced that Russia could and should avoid devaluing the ruble. The staff did, however, begin developing a more detailed fallback position in case market pressure on the currency and depletion of Russia's foreign exchange reserves should become unbearable. If the government could take exceptional steps to raise tax revenue, and if it could get even more large-scale financial assistance to close its financing gap until those revenues could be realized, then a devaluation of, say, 10 or 15 percent might stabilize the foreign exchange market.[118] In view of the amount of money involved, the six-year history of setbacks and false promises, and the importance of a stable Russia to the institution and to the world, this was almost as risky a prospect as anyone could have imagined. But with the expectation that Russia's continuing failures to act would lead to a complete collapse of the currency, destroy the Russian banking system, and ultimately bring down the government, the available alternatives appeared to be even worse. No one should have been under any illusion that the Russian government could get tax policy under control. On July 3, barely a week after the Fund had renewed its support, parliament rejected several of Yeltsin's proposals to raise federal revenues and thereby effectively undermined the program (see Schleifer and Treisman, 2000, p. 149).[119] In response, the U.S. government tried to shift its pressure from the Fund to the Russians, in what President Clinton privately called a "fulcrum moment" for U.S. policy toward Russia. The administration promptly dispatched David Lipton to Moscow to tell officials the United States would not support further disbursements from the IMF unless Russia carried out the agreed-on conditions. Yeltsin responded, as he often did, by phoning Clinton and insisting that he had to get a public promise of support from the IMF *before* he could get parliament to approve the tax reforms. If not, "it will mean the end of reform and basically the end of Russia" (Talbott, 2002, p. 275).[120] This telephone diplomacy severely circumscribed the ability of the staff and management of the IMF to influence the course of economic policy in Russia.

Meanwhile, Odling-Smee arrived in Moscow the same day as Lipton and spent an intense weekend negotiating a new program to be supported by additional and much larger IMF financing. Simultaneously, Márquez-Ruarte was helping Russia's finance officials complete an offer to private creditors to

[118]See memorandums from Fischer to the Managing Director, "Russia: What Now?" (June 28, 1998) and from Odling-Smee to Fischer, "Russian Federation—Alternative Adjustment Scenarios" (July 2, 1998); IMF archives, Accession 2001-0284, OMD-DMD (Fischer); Box 28269, "Russia (2)."

[119]Also see memorandum from Odling-Smee to the Managing Director, "Russian Federation—Outlook for Negotiations" (July 6, 1998); IMF archives, Accession 2001-0284, OMD-DMD (Fischer); Box 12, file "Russia (2)."

[120]Also see Blustein (2001), pp. 254–56; and Rubin and Weisberg (2003), p. 279.

convert holdings of GKOs into longer-term bonds denominated in U.S. dollars. In Washington, Camdessus was meeting with James D. Wolfensohn, President of the World Bank, to try to secure the Bank's help with the proposed financing package despite the Bank staff's reservations about the wisdom of trying to avoid devaluation.[121] In New York, the G7 finance deputies met privately and agreed to support massive new lending by the IMF once a new program was in effect.

This flurry of activity succeeded well enough for Kiriyenko to sign a new Letter of Intent on Monday, July 13. In it, the prime minister acknowledged that the "root cause" of the financial pressures Russia faced was its "large government borrowing requirements and the uneven progress in structural reforms over the past several years." To address the problem, he promised a "radical tightening of the federal budget," to be supported by massive new financing from the IMF and voluntary restructuring of the government debt to lengthen its maturity. For its part, the IMF would augment the existing extended arrangement (approved in 1996 and scheduled to last until March 1999) by $8.5 billion (SDR 6.3 billion, or an additional 146 percent of Russia's quota). According to the press release issued in Camdessus's name on July 13, $5.6 billion would be disbursed immediately upon approval by the Executive Board, which was scheduled to take place just one week later, on July 20.[122] Of that $5.6 billion, half would be an initial drawing on the augmented EFF arrangement and half would be through the Compensatory and Contingency Financing Facility (CCFF) to help Russia cover a temporary shortfall in export receipts related to the depressed level of world oil prices.[123]

As was by then customary in dealing with capital market crises, the IMF folded its announcement of additional financing into a larger package that included pledges from other official creditors. The headline figure called for total financing of $22.6 billion for the remainder of 1998 and in 1999: $14.1 billion from the IMF,

[121]See file memorandum by Juan J. Fernandez-Ansola, "Russia: Debt Conversion" (July 10, 1998); memorandum from Odling-Smee to the Managing Director, "Breakfast with Mr. Wolfensohn" (July 7, 1998); and memorandum from Odling-Smee to Fischer, "Russian Federation—Recent Visit" (July 15, 1998); all in IMF archives, Accession 2001-0284, OMD-DMD (Fischer). The first two items are in Box 12, file "Russia (2)"; the third is in Box 28268, file "Russia (3)." Also see Gordon (1998a), p. A9.

[122]NB/98/24 (July 13, 1998); accessed at http://www.imf.org/external/np/sec/nb/1998/nb9824.htm. From March 1996 through June 1998, the IMF had disbursed the equivalent of $5.8 billion of the originally committed $9.2 billion under the EFF arrangement (both evaluated at the July 1998 SDR/$ exchange rate). By augmenting the total arrangement to $17.7 billion, the balance remaining to be drawn would be raised to $11.9 billion.

[123]Crude oil prices averaged $19.27 a barrel in 1997. In July 1998, the staff estimated that the price would average $13.86 in 1998 and then recover; see Appendix III of "Russian Federation—Use of Fund Resources—Request for Augmentation of Extended Arrangement and Request for Purchase Under the Compensatory and Contingency Financing Facility," EBS/98/120, Suppl. 1 (July 17, 1998).

$6 billion from the World Bank, and $1.5 billion from Japan. Aside from the $5.6 billion to be disbursed at once, the availability of these amounts depended both on further negotiations and on implementation of the agreed-on program.

These large proposed drawings strained the IMF's liquidity position, especially after the commitments the Fund had recently made to Indonesia, Korea, and other members in the past year. Many in the Fund thought it high time for major official creditors to get more publicly involved in backing the Fund's support for Russia. Consequently, after consulting with Executive Directors from creditor countries, Camdessus decided to borrow the money by activating the General Arrangements to Borrow (GAB) for the first time in 20 years (see Chapter 15). That is, the whole SDR 6.3 billion augmentation of the EFF arrangement would be lent to the IMF by the 11 countries participating in the GAB.[124]

Even before the Executive Board could meet to act on this request, the program began to unravel. The debt-conversion scheme activated on July 14 failed to slow either the continuing rise in GKO yields or the downward pressure on the value of the ruble.[125] Institutional investors were willing to buy long-term dollar-denominated Russian bonds only at high spreads over low-risk western government debt and only as long as they could be confident that the IMF and other official creditors would continue to provide large-scale financial support to the Russian government. Uncertainty about the IMF's intentions, especially after the obvious lack of enthusiasm for approving the June disbursement, seemed to be further driving up the required yields and driving down the ruble.[126]

Even worse, on July 16 parliament again refused to approve the tax increases at the heart of the economic program. To rescue the program long enough to keep the basis for IMF support alive—though just barely—Yeltsin once again issued presidential decrees to modify the tax laws. Under the Russian constitution, that gave parliament 10 days to decide whether to acquiesce to the decrees: 10 days

[124]GAB participants comprised the countries in the Group of 10 (G10). For a list of participants and the amount provided by each for this purpose, see "General Arrangements to Borrow—Proposal for Future Calls for Exchange Transactions Under an Augmentation of the Current Extended Arrangement for the Russian Federation," EBS/98/123 (July 17, 1998) and Suppl. 1 (July 20, 1998). President Clinton (2004) erred in claiming that the United States "contributed almost a third of the $23 billion IMF package in July" (p. 807). The correct figure was 25 percent of the GAB financing. Even applying that percentage to the potential financing of the IMF commitment would imply a contribution of about one-sixth of the total package.

[125]The text of the debt-conversion scheme was circulated in the Fund as FO/DIS/98/64, "Russian Federation—Road Show Documentation" (July 15, 1998). For background and analysis of the scheme, see Blustein (2001), pp. 260–65; and Kharas, Pinto, and Ulatov (2001), p. 2.

[126]At the June 25, 1998, meeting of the Executive Board, Willy Kiekens (Belgium) warned that the terms of the planned conversion were excessively expensive and that Russia was "now extremely vulnerable to changes in market sentiment, and that the continuation of her present policies was not sustainable"; minutes of EBM/98/68, pp. 18–19. Also see the above discussion of the overall tone of that Board meeting.

during which the Fund would have to decide whether to advance billions of dollars to the government.[127]

The staff report was brutally frank. "Clearly the Fund is undertaking exceptional risks in Russia. Past failures to implement agreed programs, the uncertain timing of a return of market confidence, and the uncertainty of a strengthening of the economy cast some doubt on Russia meeting its payments to the Fund on time."[128] Russia's Executive Director, Aleksei Mozhin, was no less honest, telling his colleagues that their approval would be "very risky" and would be justified only because the alternative would be "even more risky."[129]

Responding to these risks, and to quell a rebellion by Executive Directors threatening to oppose the augmentation of the arrangement, Camdessus decided to scale back the magnitude of the initial drawing from $5.6 billion to $4.8 billion. That infuriated Chubais, who had come to Washington in the days leading up to the Board meeting. Chubais went to the IMF to see Fischer and warned him that the financial markets were likely to view the reduced access as a signal that the Fund lacked confidence in Russia. If so, the hoped-for catalytic effect on investor confidence could be seriously undermined. Fischer disagreed, but in any case he could not overturn the decision.

When the Board met on July 20, several Directors from creditor countries wanted to delay approval until after the Russian parliament had approved the tax reforms, but Odling-Smee reassured them that "the staff believes the Duma will acquiesce to the Presidential decrees." In the end, no one abstained or voted against the proposal, but Fischer (who chaired the meeting) acknowledged that "most Directors agreed only reluctantly to the program."[130] The Fund promptly disbursed the equivalent of $4.8 billion, bringing Russia's outstanding debt to the

[127]The debt-conversion scheme discussed in the preceding paragraph, the rejected tax measures, and the plan to issue presidential decrees are described in EBS/98/120, Suppl. 1 (July 17, 1998), pp. 8, 10, and 16, respectively.

[128]"Russian Federation—Use of Fund Resources—Request for Augmentation of Extended Arrangement and Request for Purchase Under the Compensatory and Contingency Financing Facility," EBS/98/120, Suppl. 1 (July 17, 1998), p. 18.

[129]Minutes of EBM/98/79 (July 20, 1998), p. 29.

[130]Minutes of EBM/98/79 (July 20, 1998), pp. 29 (Mozhin), 51 (Odling-Smee), and 72 (Fischer). Those arguing for a delay were from Australia, Belgium, Canada, Italy, and Japan. Tellingly, the press release the Fund issued at the end of the day stated only that "the management of the IMF welcomes the decision of the Executive Board" and the policy actions taken by the Russian government, without stating that Executive Directors endorsed the program or the government's actions; "IMF Management Welcomes Executive Board Support for Russia," NB/98/26 (July 20, 1998); accessed at http://www.imf.org/external/np/sec/nb/1998/nb9826.htm. Later, Odling-Smee (2006) admitted the staff knew "the government was weak and could not deliver very much" on fiscal policy (pp. 170–71). Similarly, Rubin wrote in 2003 that he had believed at the time that the odds were less than even that the program would succeed, but "the risks to the United States from destabilization in Russia seemed so enormous . . . A small chance of success was worth a high risk of failure" (Rubin and Weisberg, 2003, pp. 276–77).

Fund to what would turn out to be its all-time peak of $16.2 billion (SDR 14.1 billion; see Figure 7.1).

The Russian parliament refused even to meet in August to consider Yeltsin's decrees. Kiriyenko, Boris Fyodorov (the former finance minister, now back in government in charge of tax collections), and other officials waged a public campaign to shame parliamentarians into returning from their holidays to pass measures deemed essential for restoring confidence and credibility, to no effect. With each passing day, interest rates on government debt rose, stock prices fell, and the central bank used more of its dwindling reserves to maintain the exchange rate. In just a few weeks, virtually all the $4.8 billion the IMF had lent Russia on July 20 had been spent, either directly by the treasury or to support the ruble.[131]

The Final Crisis: August 1998

Sensing that matters were worse than official pronouncements from Russia were suggesting, Fischer returned to Moscow at the end of July to try to "light a fire under" the Russians "before we hit a brick wall in September."[132] There he learned that the central bank was indeed hemorrhaging reserves and that tax collections were still weaker than expected. Drastic action would be required to save the economy, and drastic action was politically impossible. Chubais took a particularly bleak view and suggested that without new action on tax collections, the government would not only be forced to devalue, it also would have to default on at least some of its debt. If it devalued without defaulting, holders of GKOs would lose confidence and would stop rolling them over on maturity, which would then force a default. If they defaulted without devaluing, new capital inflows would dry up, and the central bank would no longer be able to maintain the exchange rate. After meeting with Chubais, Fischer tried to put a positive spin on the outlook, telling

[131]The original plan had been that the entire $4.8 billion would be added to the central bank's reserves. When Fischer went to Moscow at the end of July, Russian officials asked him to allow them to use $1 billion for budgetary support. After checking with Camdessus, he agreed; see memorandums from Odling-Smee to the Acting Managing Director [Fischer], "Russia—Latest Status of Conditions to Allow Use of $1 billion for the Budget" (August 4, 1998); and from Daniel A. Citrin (Assistant Director, EU2) to Odling-Smee and Thomas B.C. Leddy (Deputy Director, PDR), "Russian Federation: Information Note on Budgetary Financing and Recent Developments under the Extended Arrangement" (August 5, 1998); IMF archives, OMD-DMD, "Russia 1998 – (3) Country Files," Box 161971, Accession 2001-0284. The ministry of finance announced the shift publicly on August 12 in an effort to shore up public confidence; see Thornhill (1998), p. 2.

[132]Handwritten note, Fischer to Odling-Smee (July 29, 1998); IMF archives, Accession 2001-0284, Box 28268; OMD-DMD (Fischer), "Russia 1998 – (3) Country Files."

reporters in Moscow that the government had "a lot of hard work" to do to implement the program.[133]

Throughout the northern hemisphere, August is a time for holidays, and Russian legislators were not the only ones to close their offices while the economy was spinning out of control. In the second week of August, Camdessus was resting at his summer home in the south of France. Fischer was on the Aegean island of Mikonos. Rubin was fishing for salmon in Alaska, and almost all of the other senior G7 finance officials were similarly at leisure. Yeltsin, Chubais, and Dubinin were all out of Moscow. The IMF office in Moscow was open, but it was short of staff, and Gilman was distracted by the birth of his first child the week before. When the U.S. Treasury sent Lipton to Moscow to reinforce the message that Russia should not expect any more official financing, from the IMF or anyone else, he found that almost everyone of influence was gone.

On Thursday, August 13, with confidence in the Russian economy already at a nadir, the *Financial Times* published a letter from the financier George Soros lamenting that the "international financial authorities do not appreciate the urgency of the situation" in Russia. He called on the government "to introduce a currency board after a modest devaluation of 15 to 25%," and suggested that the "alternatives are default or hyper-inflation." Because Soros was famously remembered as the man who had successfully gambled billions of dollars against the British pound in 1992, financial markets—and some IMF officials—naturally assumed that Soros was similarly speculating against the ruble.[134] The only question now was whether the ruble could be devalued in an orderly manner without a default.

The financial chaos worsened dramatically the next day, as a run on Russian banks and a collapse in GKO prices forced the banks to start selling large quantities of securities they had purchased on margin. As the economist Nouriel Roubini later observed, by this time many Russian banks were acting more like hedge funds than commercial banks, with highly leveraged balance sheets, relatively little lending to real companies, and an unsustainable exposure to currency risk (Roubini and Setser, 2004, p. 60). In these circumstances, any attempt by the central bank to try to protect the payments system by serving as a lender of last resort to banks

[133]See memorandums from Fischer to the Managing Director, "Russian Options" and "Visit to Russia, July 31–August 1" (both dated August 2, 1998); IMF archives, OMD-DMD, "Russia 1998 – (3) Country Files," Box 28268, Accession 2001-0284. Also see Bohlen (1998a), p. 8. Additional information is from interviews with participants.

[134]Fischer later blamed Soros for triggering the crisis, along with the Russian authorities (for lacking policy discipline) and the G7 leaders (especially the German chancellor, Helmut Kohl) who had failed to provide enough aid as the crisis developed; see Kaps (1998), p. 17; and "IMF's Fischer Blames Kohl for Lack of G7 Russia Rescue," Dow Jones News Service, August 24, 1998; accessed at http://global.factiva.com/. At the end of August, U.S. President Clinton privately regretted to aides that his government had not provided the large-scale support that Russia needed; see Talbott (2002) pp. 283, 286.

was bound to fail. By Friday afternoon, only the weekend stood between the authorities and a complete financial meltdown.

That evening, Odling-Smee left Washington for Moscow to advise the Russians on what to expect from the Fund as the crisis unfolded. Unfortunately, his instructions were garbled. Camdessus had telephoned him that morning (Washington time) from the terrace of his vacation home in Bayonne, France. The Managing Director thought he was conveying the view—consistent with standard IMF policy—that the Fund could not accept a unilateral default, that instead the authorities should try to negotiate a debt restructuring with their external creditors. Odling-Smee, however, interpreted Camdessus as conveying a more neutral position on default. Separately, Fischer, who had rushed back to Washington from Greece to take charge of the Fund's response, sent a handwritten note to Odling-Smee by fax, stressing that the Russians should come up with their own solution to their problems; the Fund should not try to impose its views.[135] That message appeared to agree with the seeming agnosticism Odling-Smee had heard from the Managing Director. Accordingly, when Odling-Smee met with Chubais and Gaidar over dinner in Moscow on Saturday evening, he told them the IMF agreed they had no choice but to default and would support their decision. Regardless of the source of the miscommunication, it had no effect on Russia's decision to devalue, but it contributed to confusion about the broader policy package and to resentment regarding the Fund's role in the process.

On Sunday, Chubais accompanied Kiriyenko by helicopter to see Yeltsin at his country home to get his approval for a plan to default on GKOs and to allow the ruble to depreciate more rapidly while still using Russia's reserves to control the decline. The president quickly agreed that they had all "become hostages to the situation" and had no good options left (Yeltsin, 2000, p. 174). The die was now cast, and all that remained was for the government to announce the default on Monday.

Meanwhile, Camdessus rushed back to Washington over the weekend. Stopping briefly in Paris, he received phone calls from Summers and Rubin, who urged him to take a public stand in favor of default. Not knowing that Yeltsin had already decided on this course of action, Camdessus declined, saying the Fund could not be a party to a nonmarket solution. When Russia went ahead with the default on Monday, he issued a press release that was pointedly muted in its support. While noting that "it is important that the international community as a whole, both public and private sectors, show solidarity for Russia at this difficult time," the statement omitted any endorsement of the default. Instead, it suggested that

[135]Note from Fischer to Odling-Smee (August 15, 1998); IMF archives, OMD-DMD, "Russia 1998 – (3) Country Files," Box 161971, Accession 2001-0284. Also see Blustein (2001), pp. 268–69. The rest of this account is based primarily on interviews.

the Russian "authorities should . . . spare no effort to find a cooperative solution to their debt problems, in a close dialogue with Russia's creditors."[136]

The Russians immediately began negotiating with external creditors, but the two sides held widely divergent views about the sort of debt restructuring that would be feasible and appropriate. They faced an unprecedented situation in that Russia had defaulted on debts denominated in its own currency. Previous defaults on sovereign debts had always been limited to foreign-currency debt because the burden of domestic debt could more easily be reduced through inflationary policies. In this case, however, foreign financial institutions had bought large amounts of short-term, floating-rate, ruble-denominated debt, and the usual remedies would have been more costly. Negotiations dragged on for months, and a final settlement—imposing losses on creditors estimated at 50–70 percent of precrisis values (Sturzenegger and Zettelmeyer, 2005, pp. 9–18; 2008)—was not reached until March 1999.

Following the default, the IMF's dilemma was whether to continue lending to Russia. The situation the Fund faced was also unprecedented, in that the institution had lent as much as it possibly could to the country *before* the crisis hit. The usual response of lending to help the country resolve the crisis was, for the moment at least, off the table. The next drawing under the EFF arrangement was scheduled for mid-September, but the program would have to be completely renegotiated before the Fund could disburse any more money. Moreover, when Camdessus suggested that more lending might be needed, not just for Russia's sake but also for global financial stability, he met strong resistance. Finance officials from the G7 countries unanimously conveyed the message that they would provide no more loans to Russia, and would not support more IMF lending, at this time.[137]

Virtually everyone—Russian, IMF, and G7 officials alike—agreed that resolution of the crisis depended first and foremost on strengthening Russia's economic policies. Yeltsin, as always, began by firing his top officials, including the prime minister, Kiriyenko; the chief external negotiator, Chubais; and the governor of the central bank, Dubinin. To replace Dubinin, he brought Gerashchenko back in after a four-year hiatus. For prime minister, he nominated Chernomyrdin to return after a gap of less than six months. Chernomyrdin quickly interrupted his vacation and promised an antiliberalization government that parliament could support, with no "Chubaises, Gaidars, or Nemtsovs in the government" (Yeltsin, 2004, p. 181).[138]

[136]"Camdessus Comments on Russian Actions," NB/98/30 (August 17, 1998); accessed at http://www.imf.org/external/np/sec/nb/1998/nb9830.htm.

[137]The strength of opposition varied somewhat within the G7, with some U.S. officials—especially in the State Department—more sympathetic than others (Talbott, 2002, pp. 283–90).

[138]Boris Nemtsov (see footnote 95) was a first deputy prime minister from March 1997 until the dismissal of the Kiriyenko government in August 1998.

Despite Chernomyrdin's stated antipathy to the reformers, he had developed a close personal relationship with Camdessus over the course of his previous five years as prime minister, and Camdessus viewed him as a man with whom he could work to rebuild the Russian economy. A week after the default, and two days after Yeltsin's nomination of Chernomyrdin, Camdessus flew to Paris and then traveled by Russian government plane to the Crimean peninsula in Ukraine. There, at the dacha where Gorbachev had been held under house arrest in 1991, Camdessus met tête-à-tête with Chernomyrdin. In yet another meeting that lasted well into the night, he urged the acting prime minister to press ahead with fiscal and structural reforms. He also suggested that a currency board arrangement might help to reestablish credibility for a stable exchange rate. Chernomyrdin was skeptical of the currency board idea, but he regarded the situation as "tragic but not hopeless" and was determined to press ahead with reforms.[139]

The Russian authorities, along with everyone else, had a hard time figuring out what to do next, especially with regard to trying to stabilize the currency. From August 17 (the date of default) to August 25 (when Camdessus and Chernomyrdin met in Crimea), the ruble depreciated by 19 percent, despite the central bank's continued intervention. At the IMF, even as the Managing Director was advising Russia to set up a currency board, the staff was advising the authorities to stop intervening and allow the exchange rate to float.[140] At the beginning of September, Russia shifted to a floating rate while Chernomyrdin and Fyodorov began advocating a currency board and Gerashchenko argued for imposing exchange controls. Meanwhile, although Clinton flew to Moscow on September 1 to meet with Yeltsin about the crisis, the prevailing U.S. view held that Russia had no economic leadership and no effective strategy. Until it developed both, no financial support could be expected from the United States, the G7, or the IMF.[141]

As the Russian economy continued to stagnate, parliament refused to confirm Chernomyrdin as prime minister. On September 10, Yeltsin withdrew the nomination and elevated the foreign minister, Yevgeny Primakov, instead. Primakov was quickly confirmed, and he signaled his intention to implement policies the IMF could support. After Odling-Smee met with Primakov in Moscow on September 15, he sent Márquez-Ruarte back to Moscow with a staff mission to try to negotiate a

[139]The phrase is from a press conference on August 28, 1998, in which Camdessus reported on his meetings in Crimea; see http://www.imf.org/external/np/tr/1998/tr980828.htm. Also see Camdessus's report to the Executive Board earlier that day; minutes of EBM/98/90 (p. 3). The details of the trip are from interviews with participants.

[140]See memorandum from Márquez-Ruarte to the Managing Director, "Russia—Exchange Rate Policy" (August 25, 1998); IMF archives, OMD-DMD, "Russia 1998 – (3) Country Files," Box 161971, Accession 2001-0284.

[141]On Clinton's trip and the U.S. reluctance to provide aid without more effective reforms, see Clinton (2004), p. 807; and Talbott (2002), pp. 278, 290. Also see remarks by Summers, in Erlanger (1998).

program for the coming year. That effort failed, largely as a result of the government's internal uncertainty about what policies to implement. After a week of negotiations, the main interlocutor on the Russian side, Deputy Prime Minister Aleksander Shokhin, publicly threatened to default on more of the country's debt if the IMF would not agree to accept Russia's policies as the basis for renewed support. IMF officials let it be known that they viewed this threat as unacceptable blackmail, and Shokhin resigned the next day. Once again, a leadership vacuum blocked progress.[142]

Even as these negotiations were breaking down, a new controversy erupted. On September 21, Venyamin Sokolov, the Russian government's chief auditor, accused the central bank of wasting billions of dollars defending the ruble, and he asserted that some unspecified portion of the money borrowed from the IMF had been stolen. At first, the IMF refused to take this story seriously, but when the rumor persisted the Fund insisted that the Russian central bank commission an external audit. That audit, completed by the firm PricewaterhouseCoopers in the summer of 1999, found no evidence of theft. The $4.8 billion the IMF lent to Russia in July 1998 was arguably wasted because it was used to try to defend an exchange rate that could not be defended, but it was used legitimately for that purpose.[143]

Negotiations between the IMF and Russia continued intermittently for several months, through missions in October and November 1998 and in April 1999, interspersed by visits to Moscow by Camdessus in December 1998 and in March and June 1999. The low point came at the end of the November mission, when negotiations broke down and Primakov complained that the IMF was trying to dictate policies to Russia.[144] The prime minister called Camdessus and asked him to come to Moscow to try to work out a new strategy. The Managing Director was in Madrid at the time, to deliver a speech in which he pledged that the IMF "will not abandon Russia. . . . But Russia must first be willing to help itself."[145] From there he

[142]See memorandum from Odling-Smee to the Managing Director, "Russian Federation—Visit to London and Moscow" (September 16, 1998); IMF archives, Accession 2001-0284, OMD-DMD (Fischer), "Russia 1998 – (3) Country Files," Box 28268. Also see report by Márquez-Ruarte, minutes of EBM/98/105 (September 30, 1998), pp. 13–16. On Shokhin's threat, see Bohlen (1998b).

[143]The PricewaterhouseCoopers audit of the 1998 transactions was one of two prepared in 1999, the other being the report on the 1996 misreporting episode (see above, p. 318). For both reports and a staff analysis, see "Russian Federation—Staff Report for the 1999 Article IV Consultation and Request for Stand-By Arrangement," EBS/99/124, Suppl. 1 (July 20, 1999).

[144]Memorandum from Márquez-Ruarte to the Managing Director, "Russia—Back-to-Office Report" (December 2, 1998); IMF archives, OMD-DMD, "Russia 1998 – (5) Country Files," Box 16197, Accession 2001-0284.

[145]"The Global Economy: Still in Crisis?" delivered at the International Financial Congress: Finantia '98, in Madrid, Spain (November 25, 1998); accessed at http://www.imf.org/external/np/speeches/1998/112598.htm.

flew to Moscow, where he and Primakov agreed on the outlines of a homegrown program for 1999 that Primakov believed would generate domestic "ownership" and that Camdessus agreed would be strong enough to justify both new financing from the IMF and debt relief from Paris Club (official) and London Club (commercial bank) creditors.[146] Adding to the urgency of these talks was a looming deadline for Russia to begin repaying the large loans that the IMF had advanced in 1996, when it first approved the EFF arrangement, on top of the ongoing repayments from earlier credits. In total, more than $4 billion would be due in 1999, including some $830 million in July alone. New lending would soften this blow by extending and smoothing out the repayment schedule, but as Camdessus had stressed in Madrid, Russia first had to prove it was serious about carrying out its promises, especially on tax collections. When, in March 1999, parliament again refused to approve revenue measures the government had agreed on with the Fund, the mission chief reported wryly that the rejection did "not suggest much ownership."[147] Throughout this brief period, the IMF's firm insistence on the strengthening of macroeconomic policies and on more-serious structural reforms for once had strong support from the U.S. government and other official creditors.[148]

By this time, Russia had received no external financing for eight months, and none was in sight. Could a new financial crisis still be avoided? Primakov was due to go to Washington the week after the failure of the March mission, and he and Camdessus made plans to meet there with the aim of quickly restarting talks on a new stand-by arrangement. That plan was abruptly shelved when a political crisis intervened. On March 24, North Atlantic Treaty Organization (NATO) airplanes began bombing Belgrade in an effort to stop Serbian atrocities in Kosovo. Primakov, who opposed NATO's military involvement in Yugoslavia, learned of the imminent campaign while en route to the United States, and he ordered his pilot to turn the plane around and return to Moscow. He then telephoned Camdessus and informed him of the situation. Not wanting to miss this opportunity, Camdessus offered on the spot to come to Russia instead. Primakov accepted, and Camdessus—along with

[146] See Camdessus's report to the Executive Board at an informal meeting on December 4, 1998; BUFF/98/111 (December 7, 1998). Also see memorandum for files by Gilman, "Managing Director's Discussions with Primakov" (December 3, 1998); IMF archives, OMD-DMD, "Russia 1998 – (5) Country Files," Box 161971, Accession 2001-0284.

[147] Memorandum from Gerard Bélanger (Deputy Director, EU2) to the Managing Director, "Russia—Back-to-Office" (March 22, 1999); IMF archives, DMD-AI, "Russia 1998 – (4) Country Files," Box 177888, Accession 2002-0149.

[148] On the U.S. position, see memorandum from Mark Sobel (Advisor to the U.S. Executive Director) to Odling-Smee and Citrin, "Russia—Economic Crisis" (November 19, 1998); memorandum from Fischer to the Managing Director, "Russia: Meeting between Prime Minister Primakov and Vice President Gore in Kuala Lumpur" (November 19, 1998); and memorandum from Odling-Smee to the Acting Managing Director, "Russia—Report from the Mission" (November 20, 1998); all in IMF archives, OMD-DMD, "Russia 1998 – (4) Country Files," Box 161971, Accession 2001-0284.

a documentary film crew from the French company ARTE that had been following his every move for several months—flew to Moscow the next day.

Camdessus's rush to Moscow came at some personal cost. After 12 years as the head of the IMF without missing a day of work to sickness, he developed severe back pain while flying to Europe, which turned out to be a case of shingles that would keep him confined to his bed and under medical care for much of the trip. He nonetheless managed to meet with Primakov, Finance Minister Mikhail Zadornov, and other officials—and to add considerable spice to the ARTE documentary film.[149]

Camdessus's trip closed much of the gap between Russia and the Fund on the requirements for raising tax revenue. That progress set the stage for a follow-up mission in April, which reached tentative agreement on an economic program, subject to several prior actions that would have to be completed before the Executive Board would consider it. Unfortunately, a domestic political crisis erupted. Yeltsin—facing yet another impeachment attempt in parliament—abruptly fired Primakov and asked the interior minister, Sergei Stepashin, to form a new government. The impeachment drive ultimately fell short, but the damage was done. No one believed Yeltsin and Stepashin had the political clout to carry out the economic program Primakov had started, but the IMF had little choice other than to approve at least enough new lending to offset the large repayment due in July. Failure to do so would threaten more than the stability of the Russian economy because Russia's debt to the Fund now accounted for more than 20 percent of the Fund's total credits outstanding.

On July 28, the Executive Board approved a new stand-by arrangement, committing $4.5 billion (SDR 3.3 billion, or 55 percent of quota) through the end of 2000. Directors did not disguise their reservations about approving what the U.S. Treasury regarded as a "virtual welfare payment" (Talbott, 2002, p. 291), but they all knew how much was at stake. Russia promptly made the initial drawing,[150] which would turn out to be the country's last drawing on the IMF (as of 2010).[151]

In August, Yeltsin sacked Stepashin and named Vladimir Putin to be prime minister and the heir apparent to the Russian presidency. Amid growing concerns about corruption, the renewal of hostilities in Chechnya, and continuing weaknesses in economic policies, political support from G7 leaders was waning, and the

[149]*Le Pouvoir FMI* (The Power of the IMF, 1999), directed by Pascal Vasselin, a coproduction of La Sept ARTE and Tétra Media.

[150]As an extra precaution to ensure that the money would not be misused, the arrangement specified that the drawing would be provided entirely in SDRs and would be held in Russia's account in the SDR Department of the IMF; see "Russian Federation—Staff Report for the 1999 Article IV Consultation and Request for Stand-By Arrangement," EBS/99/124, Suppl. 3 (July 26, 1999).

[151]Three days later, the Paris Club agreed to reschedule Russian debts one more time—the only time in the history of the group it had rescheduled the debts of a "creditor" member.

IMF was able to withhold further lending to Russia. A decade of close relationships, turbulence, and drama thus ended weakly. For the IMF and for the reformers within the Russian government, the satisfaction of seeing the country still on the road to integration with the world economy was mixed with disappointment that progress on that road was still slow and that success was far from assured.

This mixed and troubled story eventually had a happy ending. Thanks to a combination of factors—the structural reforms of the 1990s, the 1998 devaluation, later improvements in macroeconomic policies, and a resurgence of world oil prices that greatly boosted the value of Russia's exports—the Russian economy grew at an average annual rate of 6.75 percent from 1999 through 2004.[152] Throughout this period, the balance of payments was in substantial surplus, the exchange rate was stable, and the central bank steadily accumulated foreign exchange reserves. By the time the stand-by arrangement expired in December 2000, Russia had no further need for loans from the IMF or other official creditors. In January 2005, the government repaid all outstanding IMF obligations before they were due, and the IMF then added the Russian ruble to its list of currencies that are usable in lending operations. In a remarkable 14 years after emerging from the ashes of the Soviet Union as a heavily indebted country without a functioning economy, the Russian Federation had become a creditor country in the international community.

Lessons from History

Throughout the 1990s, the IMF confronted difficult choices on how best to help Russia, as did western governments and Russian officials. The country was undergoing a historic transformation—economically, politically, and socially, all at the same time—that made success a relative and elusive concept. To a degree, the transformation succeeded, and to some extent the IMF can justly take credit for having helped, as midwife and handmaiden as much as financier. In broad perspective, the IMF made two key decisions on Russia. First, it accepted responsibility for assisting with the transition from central planning to a market economy (especially in the extended arrangement approved in 1996), rather than focusing more narrowly on financial stability and the external payments balance. Second, it agreed to provide a large portion of Russia's external financing needs, rather than providing modest seed money and a seal of approval as a catalyst for large-scale financing from official creditors and private financial markets. Necessity drove both of these decisions because the Fund was the only institution that could coordinate and lead the more piecemeal assistance being provided from a large number of diverse sources. Together, these two paths of action kept the Russian economy

[152]For an overview of the postcrisis recovery, see Owen and Robinson (2003).

and the nascent move to democracy alive—on life support, perhaps, but alive. The mixed success of these decisions carried major consequences for Russia and the IMF.

More specifically, eight critical crossroads, from the beginning of the transition to the aftermath of the 1998 financial crisis, can be identified.

First, when Gorbachev asked the G7 in 1990 to engage in a dialogue on integrating the Soviet Union into the world economy, Camdessus took the initiative to prepare a detailed study of the Soviet economy. Although several other agencies participated in the project and brought much essential specific experience and knowledge to the table, the IMF became the lead agency on the project and ensured completion of the report in just a few months of intensive work. That effort positioned the Fund to continue to advise on a variety of policy issues with which it had limited expertise and experience, such as the sequencing of reforms and privatization of industry, as well as on those where it had a clearer advantage. Throughout the rest of the decade, the Fund staff struggled—not always successfully—to find the right balance between adhering to the institution's narrow mandate on financial and macroeconomic issues and meeting the broader challenges of helping Russia undertake a massive structural transformation.

Second, when the Soviet Union dissolved at the end of 1991, the Fund accelerated the handling of Russia's application for membership (completing the process within six months), granted Russia a quota a bit larger than that warranted by the staff's technical calculations, and began providing financial assistance immediately without the usual level of conditionality. Although understandable and even necessary in view of the magnitude of the issues and problems at hand, this rapid and positive response clearly reflected political pressure from the G7 and reinforced the image that the IMF was becoming deeply involved in Russia's transition.

Third, when the G7 countries decided in 1992 and later to provide very little bilateral cash assistance to Russia—the rejection of the Grand Bargain (Chapter 2) despite the announcement of large support "packages"—the IMF did not attempt to pressure or persuade them to provide large-scale support. The resulting situation not only required the IMF to shoulder a large portion of the financial burden, it also further reinforced the Fund's role as lead agency in the transition process. More important, because the Fund's own financial resources were limited, Russia was left strapped for cash in the early stages of the transition, magnifying the economic and social consequences of the country's fiscal imbalances. Whether pressure from the IMF on the G7 would have alleviated the shortfall is, however, far from obvious.

Fourth, when Russia's economic policies weakened in 1993 and 1994 and the prospects for implementing an agreed-on program were poor, the IMF continued to provide financial support rather than use its leverage to force an improvement. In addition to the Fund's usual leverage, Russia had a surplus in its current account throughout the 1990s. Thus, even though the government desperately needed budgetary support, it did not unambiguously qualify for balance of payments assistance. The IMF justified its lending to Russia on the grounds that the country had a shortage of foreign exchange reserves and that the external balance probably would have turned negative if the economy had grown rapidly enough to reach its estimated potential. That lending, though, enabled the government to meet its fiscal spending requirements without making the difficult political decisions to increase revenues from taxes. As Odling-Smee (1998) later wrote, "the ready availability of international financial support was only partly effective in encouraging the reform process in Russia. Regrettably, it also permitted the postponement of some of the tough measures necessary to plug fiscal gaps."

Fifth, in March 1996, during Yeltsin's tight race for reelection against communist and ultranationalist opponents, the Fund approved its largest and longest-term lending arrangement to Russia up to that time. Although the basis for the increased lending was an improvement in policy implementation in the previous year, undeniably, the political situation made approval practically irresistible. The timing did little to enhance the credibility of the Fund's support as a signal that the country was implementing good policies.

Sixth, the Fund tried to respond flexibly to changing circumstances in its advice to Russia on exchange rate policy. Rather than enhancing its effectiveness, that flexibility came across as inconsistency and uncertainty and thus had little effect on Russian policy. In 1992, the staff advised maintaining a currency union with at least some of the former Soviet republics in a "ruble area"; in 1993, it took a more neutral position on that issue. It advised pegging the ruble exchange rate in 1994, and reversed that position the following year. As the exchange rate became increasingly difficult to sustain in 1997 and 1998, the Fund officially stood behind the strong-ruble policy, despite occasional misgivings by the staff, until the ruble collapsed in the crisis of August 1998. Management and staff then gave conflicting advice on whether to let the ruble float or to try to stabilize it through a currency board arrangement. These shifting views reflected and responded to shifting conditions and were to some extent influenced by Russia's own independent policy decisions. If the Fund had held to a fixed position on exchange rate policy from beginning to end, it doubtless would have been subjected to even more criticism. In retrospect, it nonetheless seems that the Fund lacked a clear view and thus missed several opportunities to provide more helpful advice on a core policy issue.

Seventh, having provided substantial loans to Russia over a period of several years, the Fund began to appear reluctant in mid-1998, at the very moment when confidence among external investors was most in need of revival. A one-week delay in June 1998 and a 14 percent reduction in the size of the July disbursement may have seemed, to the Fund and to creditor-country officials, to be minor and necessary technical adjustments, but to many investors they seemed more like admissions that Russia was achieving too little to warrant full-hearted support.

Of course, at the time Russia *was* achieving too little, and investors may well have reached the same conclusion even if the Fund had put on a braver face.

Finally, after the default and devaluation of August 1998, the Fund was unable to provide the financial assistance Russia needed to manage and recover from the crisis. That constraint did not arise from an internal failing at the Fund. Rather, it resulted from a combination of political paralysis within the Russian government that prevented effective policy formation and from newly firmed-up resistance by creditor countries to bailing Russia out of a quagmire of its own making.

The controlling influence over the IMF's work on Russia throughout the 1990s was Russia's strategic importance. Preventing a communist backlash, preventing an ultranationalist electoral triumph driven by populist sentiment, and preventing a serious economic decline that might threaten the security of Russia's vast nuclear arsenal were the driving concerns of the world community and of every Executive Director and senior official at the IMF. Staff and management strove to give their best professional advice, and the depth and breadth of the Fund's technical assistance throughout the decade contributed greatly to the ultimate success of the transition. Viewing only the effect of the IMF's conditional lending on economic progress in Russia might lead to the conclusion that the Fund had failed. That narrow focus, however, was never the most relevant consideration, either at the time or afterward.

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