The Heritage Foundation
Backgrounder
Executive Summary

No. 1296 June 18, 1999

# WHAT RUSSIA MUST DO TO RECOVER FROM ITS ECONOMIC CRISIS

*ARIEL COHEN, PH.D.*

When President Bill Clinton meets Russian President Boris Yeltsin on June 20 at the summit of the world's seven leading industrialized countries (the G–7) in Cologne, Germany, the discussion likely will focus on the current economic crisis in Russia. The reforms attempted by Moscow between 1992 and 1998 were poorly planned and executed, and riddled with corruption. They were unable to stop Russia's economic decline. A recent agreement with the International Monetary Fund (IMF) for $4.5 billion in new credits is not likely to reverse this trend. What Russia must do to recover from its economic implosion is to put in place a new economic team with leaders who understand the principles and policies of market economics and will undertake a new round of comprehensive reforms.

Unfortunately, the war in Kosovo and a protracted political crisis in Moscow have distracted Russia's power elite from attending to the deteriorating economy. The communist-dominated Duma tried but was unable to impeach President Yeltsin, who then fired Prime Minister Evgeny Primakov (thought by many to be Yeltsin's successor) and installed a relatively centrist government under new Prime Minister Sergei Stepashin, a senior security official. The new economic team under Stepashin should be an improvement over the Primakov cabinet, which was dominated by Soviet-era stalwarts who tried to implement policies favoring rust-belt industries and the state sector. Unless the new economic team undertakes a significant new reform plan, however, it is doubtful that these officials will be any more able to pull Russia out of its economic morass than their predecessors were.

Russia is suffering from the effects of an unprecedented ten-year slump. According to Moscow's Institute of Economy in Transition, the 1999 inflation rate may reach 50 percent. Unemployment is approaching 18 percent. In the six months between July 1998 and January 1999, the consumer price index rose over 90 percent and average monthly wages dropped from $177 to $57. Domestic and foreign investment dropped to 20 percent of 1990 levels. Overall, Russia's

Produced by
The Kathryn
and Shelby Cullom Davis
International Studies Center

Published by
The Heritage Foundation
214 Massachusetts Ave., N.E.
Washington, D.C.
20002–4999
(202) 546-4400
*http://www.heritage.org*

economic prospects appear to be worse than they were 100 years ago, when the market-based economy was growing at 5 percent to 7 percent a year.

This systemic economic crisis is the result of many distinct problems:

1. An obsolete industrial base that manufactures non-competitive goods—a byproduct of the economy that formed around the gigantic Soviet-era military-industrial complex;
2. A barter-based domestic economy, subsidized by the state through artificially cheap raw materials and energy;
3. A large budget deficit, which accrued as the result of the punitive and poorly administered tax system;
4. Sharply declining oil and commodity prices in 1997 and 1998, which caused foreign currency revenues to decline;
5. The devaluation of the ruble in August 1998;
6. A shrinking federal budget; and
7. An inability to service foreign debt, a decline in domestic and foreign investment, and capital flight since 1987 amounting to more than $150 billion.

Clearly, misdirected economic policies and adverse market conditions have combined to create the most prolonged economic depression in Russian history. Instead of working to resolve these problems, however, the Russian government chose to deal with the crisis by replacing market reforms with foreign borrowing. Today, Russia owes more than $150 billion to the West, including over $90 billion from its Soviet-era debt to Western governments (the "Paris Club"), and $51 billion of post-1992 Russian Federation debt. This "new" debt involves $19 billion to the IMF; $18 billion to Western commercial banks (the "London Club"), Eurobonds, and bilateral foreign government loans; and $14 billion in ruble-denominated short-term treasury bills (GKOs) and short-term bonds (OFZs) held by foreigners.

To reverse Russia's economic free-fall, the new Russian government under Stepashin must undertake a comprehensive program of reforms as quickly as possible. Specifically, it should:

- **Reduce** crime and corruption;
- **Strengthen** the rule of law by reforming the judicial system;
- **Secure** current and future foreign loans with collateral, such as oil fields and gold mines;
- **Improve** debt management and concentrate it within a high-level government agency;
- **Reform** the tax system;
- **Eliminate** the barter system in non-competitive goods and services, and abolish the use of barter to pay local and federal tax arrears;
- **Stop** the disruption of interstate commerce by regional governors;
- **Pass** a land code to encourage the development of construction, private farming, and agribusiness; and
- **Consider** the benefits of a currency board.

President Clinton will soon have an opportunity to convey to President Yeltsin the importance America places on Russia's economic recovery. Jump starting the economy, facilitating entrepreneurship, and attracting domestic and foreign investment, however, will require a new economic reform package that goes beyond the failed quasi-socialist policies of the former Primakov cabinet. Moscow needs modern market institutions to develop quickly, but this effort will not succeed unless the rule of law is firmly in place.

*—Ariel Cohen, Ph.D., is Senior Policy Analyst in Russian and Eurasian Studies in the Kathryn and Shelby Cullom Davis International Studies Center at The Heritage Foundation.*

The Heritage Foundation
Backgrounder
214 Massachusetts Avenue, N.E. Washington, D.C. 20002-4999 • (202) 546-4400 • http://www.heritage.org

No. 1296 June 18, 1999

# WHAT RUSSIA MUST DO TO RECOVER FROM ITS ECONOMIC CRISIS

*ARIEL COHEN, PH.D.*[1]

When President Bill Clinton meets Russian President Boris Yeltsin on June 20 at the summit of the world's industrialized countries (the G–7) in Cologne, Germany, the current economic crisis in Russia should occupy much of their discussion. The economic reforms attempted under Yeltsin between 1992 and 1998 were poorly planned, ineptly executed, and plagued with corruption. They did little to stop the decline. The foundations of a real free-market economy, with complex market institutions and the rule of law, failed to take root.

The result is a situation that undermines the faith of ordinary Russians in free market systems and participatory government and discourages foreign investment.[2] Russia is defaulting on loans from foreign creditors, and a recent agreement with the International Monetary Fund (IMF) for $4.5 billion in new credits will not reverse its problems. What Russia needs is new economic leaders who have experience with markets and solid plans to restructure the economy.

The war in Kosovo and a protracted political crisis in Moscow have distracted the attention of Russia's power elite from attending to the serious economic situation. The communist-dominated Duma tried but failed to impeach President Boris Yeltsin. Former Prime Minister Evgeny Primakov—thought by many observers to be Yeltsin's successor—was fired, and a relatively centrist government was installed under a

Produced by
The Kathryn
and Shelby Cullom Davis
International Studies Center

Published by
The Heritage Foundation
214 Massachusetts Ave., N.E.
Washington, D.C.
20002–4999
(202) 546-4400
*http://www.heritage.org*

1. The author thanks Gerald O'Driscoll, Senior Fellow in Economic Policy at The Heritage Foundation, and Roger W. Robinson, William Casey Chair at the Center for Security Policy, for their comments on this paper, and Heritage interns Isabelle Congras and Vasili Gurchumelidze for their research assistance.
2. "Russia Economy: Investor Survey; Attitudes to the Market," *ISI Emerging Markets*, from Economist Intelligence Unit, April 23, 1999, at *http://www.securities.com/sgi-bin*. Note that 60 percent of Western companies operating in Russia put new investment plans on hold and 30 percent have cancelled investments.

new Prime Minister, Sergei Stepashin, a former senior security official.

This political instability makes policy consensus on basic principles of post-communist reform difficult. Yeltsin appointed Nikolay Aksenenko, a former national railway executive and close family friend, as First Deputy Prime Minister with wide economic powers instead of nominating a strong reform economist. New Prime Minister Stepashin backed the nomination of Victor Khristenko, a politically weak bureaucrat, as another First Deputy Prime Minister. These appointments should be an improvement over the individuals in Primakov's cabinet, but appointing new people by itself will not solve Russia's problems. Without a strong pro-reform team with experience in the market, it is doubtful that Stepashin and his team will be able to pull Russia out of its economic morass.

Russia's economy is in an unprecedented ten-year slump. Foreign debt stands at about $150 billion, and Russia has little chance of meeting its repayment schedules. Moscow has defaulted on much of its foreign obligations. Domestic and foreign investments stand at 20 percent of their 1990 rates. Estimates of capital flight since 1987 run between $150 billion and $300 billion.[3]

Overall, Russia's economic prospects look much worse than they did 100 years ago, when the market-based economy was growing at an average rate of 5 percent to 7 percent a year.[4] Its protracted political and economic problems have resulted in widespread investor pessimism.[5] Clearly, misdirected economic policies and adverse market conditions have combined to create the most prolonged economic depression in Russian history.

To reverse this decline, Russia's new government must implement a comprehensive program of reforms as quickly as possible. Such a program should include:

- **Reducing** crime and corruption;
- **Reforming** the judicial system to strengthen the rule of law;
- **Securing** foreign loans with natural resources as collateral;
- **Concentrating** debt management in a high-level government agency;
- **Reforming** the tax system;
- **Eliminating** the use of the barter system rather than cash in non-competitive goods and services and payment of tax arrears;
- **Stopping** the disruption of interstate commerce by regional governors;
- **Passing** a land code to encourage the development of construction, private farming, and agribusiness; and
- **Considering** the possible benefits of a currency board.

These steps would help the new government to jump-start the economy, facilitate entrepreneurship, and attract domestic and foreign investment.

In addition, any new and comprehensive Russian economic reform package must go beyond the failed quasi-socialist policies of the former Primakov cabinet and build modern market institutions that are buttressed by the rule of law.

## THE ROOTS OF RUSSIA'S ECONOMIC FREE-FALL

Today, eight years after President Boris Yeltsin began to introduce market reforms into the economy, Russia continues to suffer. According to

3. See *Russian Economy: Trends and Perspectives*, Institute for the Economy in Transition, Moscow, December 1998, at *http://mac.www.online.ru/*, and Fritz Ermarth, former senior Central Intelligence Agency official, in presentation at Jamestown Foundation conference, Washington, D.C., June 9, 1999.
4. "Russia Economy: Stagnation to Continue," *ISI Emerging Markets*, from *The Economist*, April 28, 1999, at *http://www.securities.com/sgi-bin/*.
5. "Russia Economy: Investor Survey; Attitudes to the Market."

Moscow's Institute of Economy in Transition, the inflation rate in 1999 is projected to reach 50 percent. Russia's unemployment rate is close to 18 percent.[6] The consumer price index increased 91 percent between July 1998 and January 1999, while average monthly wages dropped over 300 percent from $177 in July 1998 to $57 in January 1999.[7] (See Table 1.)

At the root of this economic free-fall are serious problems:

- **The costly military–industrial complex inherited from the former Soviet Union still dominates the national economy.** Central planning and the lack of market mechanisms to provide supply and demand signals have denied Russia an economic base that could compete in the post-industrial world of high technology, computers, and telecommunications.
- **Over two-thirds of the economy operates on a barter system instead of cash transactions.**[8] To preserve jobs and help the rust-belt industries avoid bankruptcy while producing products that do not compete globally, the state maintains artificially low prices for oil, electricity, and other commodities. These heavy industries engage in complicated barter arrangements to keep afloat and avoid taxation (the state cannot tax a transaction that has no declared monetary value), and the state barters with these enterprises for goods in exchange for forgiving their tax liabilities. Even the Russian government's Inter-Agency Balance Sheet Commission criticized this institutional reliance on barter in December 1997:

  > An economy is emerging where prices are charged which no one pays in cash; where no one pays anything on time…where wages are declared and not paid.… This creates illusory, or virtual earnings, which in turn lead to unpaid, or virtual fiscal obligations (with business conducted at non-market, or virtual prices).[9]

  Former Minister of the Economy Evgeny Yasin observed that all Russian industry, except the energy sector, is "value subtracting"—the value of inputs is higher than the value of the finished goods.[10] Clifford Gaddy of the Brookings Institution and Pennsylvania State University economist Barry Ickes call it a "virtual economy."[11]
- **Declining tax collections triggered a budget and finance crisis, and a run on the banks and low reserves augmented the banking crisis.** Russia's commercial banks (which collapsed in August 1998) owe Western creditors more than $10 billion.[12] They are being restructured by a special government agency amid accusations of corruption and favoritism. Not only do the banks' foreign liabilities exceed their assets, but the amount of short-term ruble-denominated treasury bills and bonds held by non-residents exceeds total foreign currency reserves, creating a significant payment crunch.[13] (See Chart 1.)

6. *Russian Economy: Trends and Perspectives*, December 1998.
7. *Ibid*.
8. "Russia Economy: Stagnation to Continue."
9. "Report of the Inter-Agency Balance Sheet Commission (Moscow)," December 1997, quoted in Clifford G. Gaddy and Barry W. Ickes, "Beyond a Bailout: Time to Face Reality About Russia's 'Virtual Economy'," Brookings Institution, July 1998, at *http://www.brook.edu/fp/articles/gaddy/gaddick1.htm*.
10. Personal interview with author, Moscow, June 1994.
11. Gaddy and Ickes, "Beyond a Bailout."
12. See "The Crisis in Emerging Markets and Other Issues in the Current Conjuncture," in *World Economic Outlook: Financial Turbulence and the World Economy* (Washington, D.C.: International Monetary Fund, December 1998), p. 56, at *http://www.imf.org/external/pubs/ft/weo/weo/1998pdf/1998*.

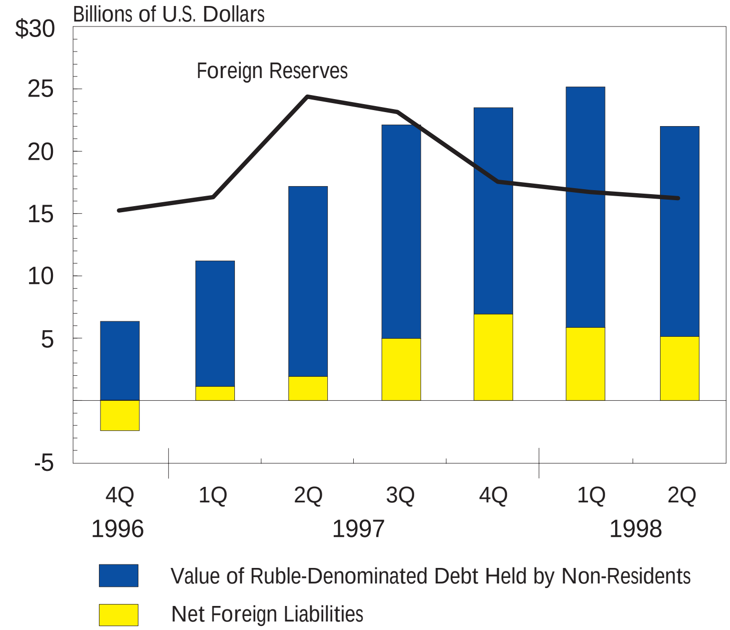
- **A 30 percent drop in oil prices from 1997 to 1998 caused foreign currency revenues to decline.** Oil and gas exports account for 75 percent of Russia's foreign exchange revenue. Due to a decline in international oil prices, the price of Russian oil from 1997 to 1998 dropped an average of 33 percent, from $18 to $12 per barrel. Oil production declined by more than 1.0 percent in 1998, and oil refining declined by more than 8 percent.[14] Oil and gas exports will not be able to subsidize Russia's failing economy much longer.

- **The sharp devaluation of the ruble in August 1998 and plummeting foreign exchange reserves precipitated a monetary crisis.** The ruble fell from 6.1 rubles to the U.S. dollar to 21 rubles to the dollar, and reached 25 rubles to the dollar in mid-June. (See Chart 2.) The sharp depreciation of the ruble damaged Russia's foreign debt and risk profiles and magnified the effects of the crisis. The cost of Russia's debt portfolio in rubles almost quadrupled, and Russia's ability to access international markets to refinance its maturing debt declined acutely. Today, Russian debt instruments trade between 5 cents and 30 cents on the dollar.[15]

- **The federal budget fell from $80 billion to $20 billion (in U.S. dollars) after the precipitous devaluation of the ruble.** This decline significantly undercut the government's ability to provide even basic services and to pay pensions and state-sector salaries,

Chart 1 B1296

**Net Foreign Liabilities of Russian Banks, Non-Resident Participation in the Sort–Term Bond Market and Foreign Reserves of the Russian Federation**




Source: WEFA, 1999.

Table 1 B1296

**Key Russian Economic Indicators, 1998**

| | |
|---|---|
| Nominal GDP (billions of U.S.$) | $149.5 |
| Population (millions) | 146.8 |
| Nominal GDP per Capita (U.S. $) | $1,018.3 |
| Change in Real GDP | -5.0% |
| Change in Consumer Prices | +73.2% |
| Unemployment Rate | 11.5% |
| External Debt (billions of U.S.$) | $145.0 |

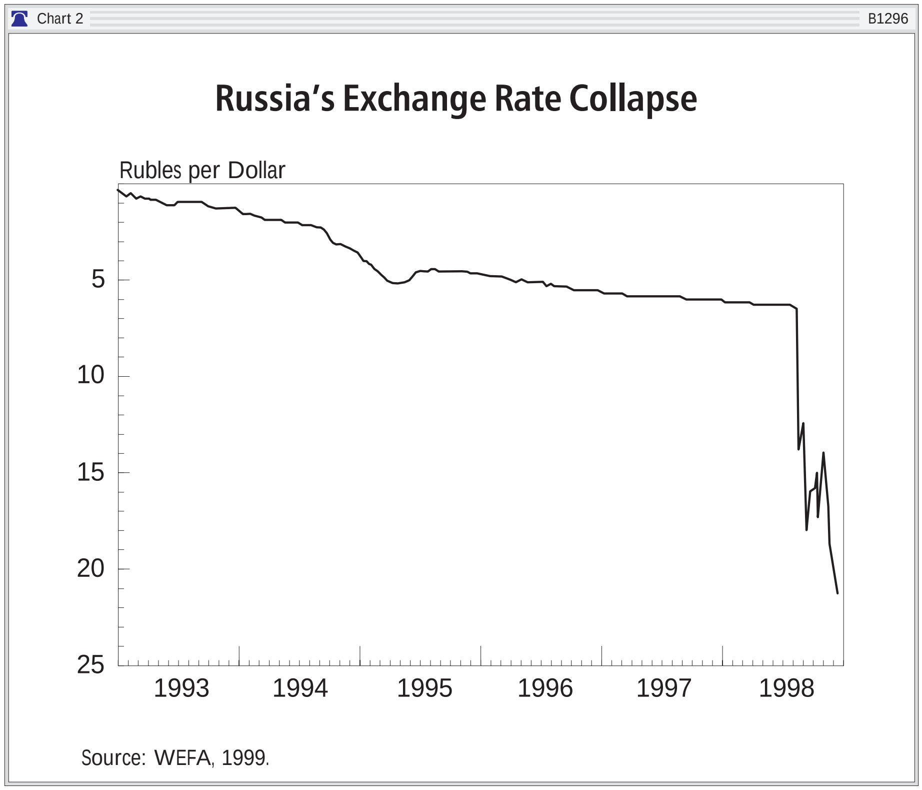
Note: Figures are estimates.
Source: WEFA, 1999.

13. S. Arkhipov and S. Dobryshevsky, "External Component of the Banking Crisis," *Russian Economy: Trends and Perspectives*, Institute for the Economy in Transition, Moscow, November 1998.

14. Yu. Bobylev, "Situation in Oil and Gas Sector," *Russian Economy: Trends and Perspectives*, December 1998.

15. "Money Can't Buy Me Love," *The Economist*, February 6, 1999, pp. 23–25.

including to its military and security forces, on time.




- **Russia cannot service its foreign debt obligations; capital flight since 1987 is estimated to run between $150 billion and $300 billion.**[16] Foreign borrowing replaced reform as Moscow's way of dealing with its crisis. (See Chart 3 for the structure of Russia's foreign debt.) Consequently, Russia now owes more than $150 billion to the West, including over $90 billion from its Soviet-era debt to the Western governments (the "Paris Club"), and $51 billion of post-1992 Russian Federation debt. This "new" debt involves $19 billion to the IMF; $18 billion to Western commercial banks (the "London Club"), Eurobonds, and bilateral foreign government loans; and $14 billion in ruble-denominated short-term treasury bills (GKOs) and short-term bonds (OFZs) held by foreigners.[17]

In December 1998, Russia defaulted on a critical portion of its foreign debt to the London Club by failing to make a $360 million cash payment. It offered to pay 2.5 cents on the dollar in new state-issued paper.[18] Only the Deutsche Bank and Chase Manhattan Bank accepted the offer. Russia also offered 1 cent on the dollar for overdue GKO bonds.[19] After this move, an international credit rating agency downgraded Russia's post-Soviet Eurobonds, giving them the lowest rating possible, and declared the pre-1992 Soviet debt in default.[20]

Then, on April 21, 1999, Russia defaulted on $1.3 billion in Soviet-era Ministry of the Treasury bonds called *Minfins*, increasing losses for Western investors and exacerbating the crisis in investor confidence. In May 1999, it announced it would default on another $560 million in Soviet-era certificates of principal called PRINs.

Russia's pervasive capital flight of more than $150 billion may surpass its amount of foreign debt, and is greater than the total amount of Western assistance during the past ten years. The experience of Argentina, Brazil, and other

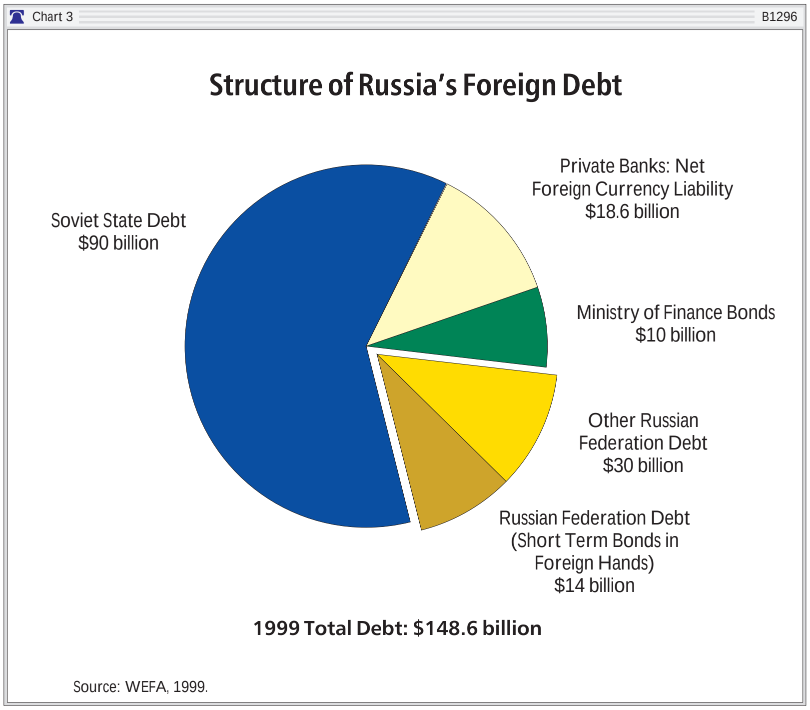
16. Ermarth, presentation at Jamestown Foundation conference, June 9, 1999.

17. See Martin J. Kohn, "Russia," WEFA, December 23, 1998, p. 3.10. WEFA, a nationally recognized econometrics forecasting firm in Philadelphia, ranks Russia's economic risks, including price stability, growth, interest rates, domestic financial stability, external debt, and business confidence, as 2 out of 10 (10 is the highest).

18. Alexander Goreyev, "Russia's Foreign Debt Hits Default," *The Moscow Times*, December 30, 1998, p. 1.

19. Kohn, "Russia."

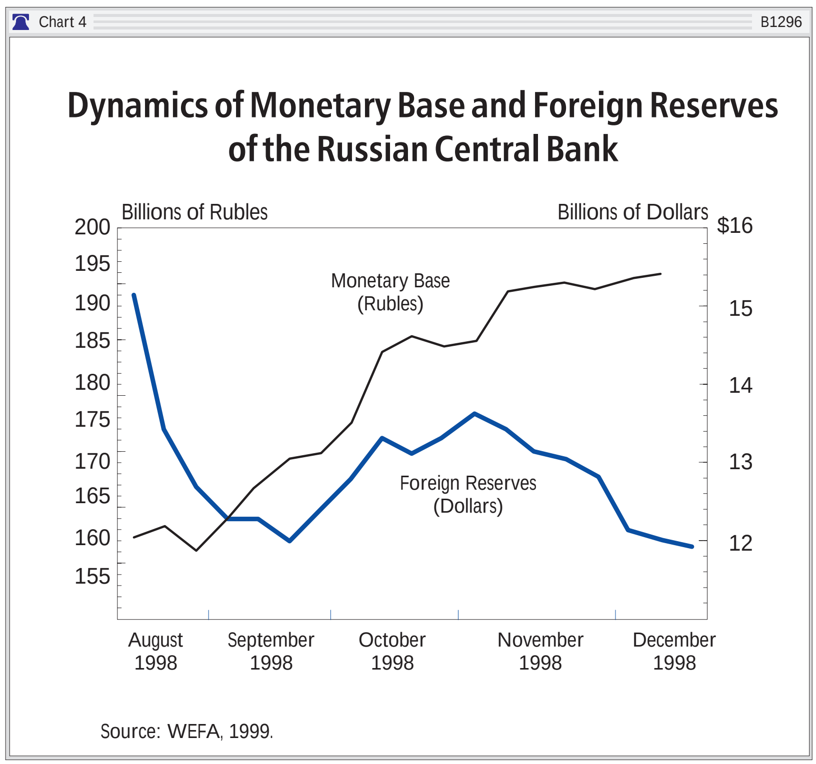
20. John Thornhill, "Fitch IBCA Warns on Russian Debt," *The Financial Times*, January 14, 1999, p. 42.




countries that underwent comprehensive economic reforms shows that capital repatriation will occur only when economic conditions are conducive to investment. Faced with inadequate property rights protection, the lack of a competent legal and court system, the prevalence of corruption and crime, and an avaricious bureaucracy, wealthy Russians will be in no hurry to repatriate their money invested in overseas accounts.

Because of these problems, Russia's economic crisis is systemic.[21] It is more severe than the Asian and Latin American crises of the early 1980s and the Mexican peso crisis of 1994. Both Russia and Mexico experienced a steep drop in commodity prices leading up to their currency crises, but this was not the sole source of their troubles. Both countries relied heavily on short-term expensive credit rather than on tax revenues, which were limited by insufficient economic growth and lax budgetary discipline.

In Russia, a low rate of domestic savings, a commitment to exchange rate stability from 1996 to 1998, and a high proportion of official financing denominated in U.S. dollars also contributed to the problems.[22] And the effects of the barter system, sustained by hidden subsidies through artificially cheap energy prices, are pervasive. Russia's output has declined by 50 percent since 1990; capital formation has declined to a low of 17 percent of its 1990 rate; and almost one-half of Russia's industrial enterprises report losing money.[23]




21. See "Financial Crises: Characteristics and Indicators of Vulnerability," in *World Economic Outlook: Financial Turbulence and the World Economy,* p. 74, at *http://www.imf.org/external/pubs/*.

22. Marcel Cassard and David Folkerts-Landau, "Sovereign Debt: Managing the Risk," *Finance and Development* (Washington, D.C.: World Bank, December 1997), pp. 1–2.

23. Gaddy and Ickes, "Beyond a Bailout."

## MOSCOW'S SOLUTION: A "VIRTUAL" BUDGET

So that it would appear to be correcting many of the problems that prevented the economy from turning around, the Russian government issued a new budget in January 1999 which it hailed as "austere" and "realistic."[24] IMF and Western experts did not agree. IMF First Deputy Managing Director Stanley Fischer observed in January 1999, for example, that the budget was "neither sufficiently ambitious nor realistic," and would cause "a continuation of the cycle of large deficits and ever-growing interest payments that led to the current crisis."[25]

Russia's 1999 budget was based on the following projections:

- An exchange rate of 21.5 rubles to the U.S. dollar. As of June 8, 1999, $1 equaled 24.45 rubles.[26]
- A 2 percent increase in gross domestic product (GDP) for 1999. However, the World Bank projects a decline of 4 percent to 6 percent.[27]
- An inflation rate of no more than 30 percent. Today, inflation is projected to reach 50 percent.[28]
- An increase in central government tax receipts. In reality, federal tax collections are dropping and currently amount to around 9 percent to 10 percent of GDP.
- Repayment of $9 billion of the $17.5 billion Russia owes in interest and principal on its debt this year. Russia projected it would be able to borrow an additional $5 billion to $7 billion abroad.

Russia's monetary base is increasing to 195 billion rubles, while foreign exchange reserves are decreasing to $12 billion—a negative sign of a low base-to-reserves ratio. (See Chart 4.) With exports falling and oil prices at a historic low, foreign exchange revenues will continue to decline. The foundations for a healthy exchange policy currently rest on quicksand.

**Reform Rhetoric.** Curiously, the IMF's Stanley Fischer had predicted in January 1998 that Russia would see "a low budget deficit, sustainable public debt position, low rate of inflation, an improved rate of investment," and a 6 percent annual growth in the economy.[29] In July 1998, he also predicted that the IMF bailout package approved on July 20, 1998, would boost investor confidence in Russia and lend support for the ruble.[30] Unfortunately, he was wrong. By June 1998, the State Duma and Central Bank admitted that the Russian economy needed fundamental restructuring and announced a wide-ranging structural agenda with

> reforms of public utility and transport monopolies, legislative and institutional changes…[for] furthering the transition to a market economy…fostering private investment and growth…continued liberalization of the trade and exchange system, consolidation of the banking system, and strengthening of the supervisory and monetary policy functions of the Central Bank…to improve revenue collection…and explicit expenditure cuts….[31]

24. Peter Graff, "Russia Vows to Pay Debts, but IMF Unlikely to Help," Reuters Newswire, at *http://cgi.pathfinder.com/time/daily/latest/RB/1999Jan16/183.html*.

25. *Ibid*.

26. *Yahoo!Finance*, available at *http://quote.yahoo.com/*.

27. "Regional Economic Prospects," in *GEP: Beyond Financial Crisis 1998–1999* (Washington, D.C.: World Bank), at *http://www.worldbank.org/prospects/gep98-99/apx1/eca.htm*.

28. Kohn, "Russia," pp. 3.7–3.8.

29. Stanley Fischer, "The Russian Economy at the Start of 1998, at *http://www.imf.org/external/np/speeches/1998/010998.htm*.

30. Stanley Fischer, in speech given during panel discussion at The Heritage Foundation, July 23, 1998.

This program, designed to encourage Western investment and IMF loans, remains unrealized. The government failed to implement timely payments to foreign creditors or to ensure transparency in such state-run monopolies as the natural gas company (Gazprom), the national electric company, the railways, or the oil pipeline company. Moscow shelved privatization of land and a number of government-owned assets.[32] It failed to reform capital markets or bankruptcy law, or to introduce internationally recognized accounting and auditing standards.

The Duma, which for the past six years has been dominated by communists and anti-Western nationalists, did not approve the ambitious IMF-inspired reform package required in the 1998 loan agreement. Nevertheless, based on a promise of reform, a $22.6 billion IMF loan package was negotiated and a $4.8 billion tranche released to Russia in July 1998.[33] This year, the IMF and the Clinton Administration are demanding some conditionality with the IMF loans, but the IMF is likely to release the credits regardless of Russia's performance. A major default by a large IMF debtor country would set an unwelcome precedent and reflect negatively on the decisionmaking abilities of the IMF board.

**Primakov's Economic Legacy.** Under former Prime Minister Primakov, Russia reverted to some of the former socialist economic management approaches without fully resurrecting central planning. Primakov's economic team was headed by the former head of the Soviet Union's central planning agency, Yuri Maslyukov, and by Viktor Gerashchenko, a Soviet-era Central Bank official. Though Primakov enjoyed the overwhelming support of the State Duma, his cabinet failed to implement an effective economic reform program.[34]

Prime Minister Stepashin has yet to establish a new economic policy agenda, so Primakov's policies remain in place. Unfortunately, the Primakov plan is an unworkable amalgam of market-based economics and Soviet-style policy prescriptions.[35] The Primakov cabinet had promoted state-owned enterprises and worked to set up a state-run Russian Development Bank. Four large oil companies were approved to merge into one state-run entity with 75 percent state ownership. This giant company, which controls the world's largest explored oil reserves, is expected to produce 55 million tons of oil per year.

Under Primakov, the economic team had established an array of tax reductions and transportation tariff breaks for products defined by the bureaucracy as "socially significant" and "vital." Some industries qualify legitimately for these targeted tax credits; others do not. Only government officials would be able to define which goods and industries would be targeted, creating an opportunity for corruption in the issuing of permits and licenses. The program allows enterprises to cancel each other's debts through barter. It also includes harsher currency controls: Businesses are forced to exchange 75 percent of their hard currency revenues into rubles.

These policies—tariff breaks, subsidies, and the legalization of barter for tax payments—ensure that the Russian government will continue to face a revenue shortfall.

In 1998, most deputies in the State Duma seemed more concerned with their political

31. *Statement of the Government of the Russian Federation and the Central Bank of the Russian Federation on Economic and Structural Policies for 1998*, June 15, 1998, at *http://www.minfin.ru/off_inf/50.htm*, p. 1.

32. Except for 2.5 percent of Gazprom.

33. Ariel Cohen, "Russia's Meltdown: Anatomy of the IMF Failure," Heritage Foundation *Backgrounder* No. 1228, October 23, 1998.

34. T. Khokhlova, "Economic and Political Outlook, December 1998," in *Russian Economy: Trends and Perspectives*, December 1998.

35. "*O merakh Pravitel'stva Rossiiskoi Federatsii I Tsentral'nogo Banka Rossiiskoi Federatsii po stabilizatsii social'no-ekonomicheskogo polozheniia v strane*," National News Service, Moscow, 1998, at *http://www.nns.ru/chronicle/article/981115gov-program.html*.

survival in the upcoming December elections than with passing legislation to improve the economy or repay the foreign debt. Nevertheless, in a hopeful move, the Duma passed a Production Sharing Agreement in December 1998 to allow Western companies to invest in over 50 Russian oil fields, generating as much as $50 billion in foreign investment over the life of projects (25 or 30 years) covered by the legislation.[36] This amount, however, will not be enough to repay Russia's foreign debt or boost budget revenue.

Currently, the Federation Council (the upper house of Parliament) is focusing on increasing revenues for regional governments and boosting the political power of the governors. But economic mismanagement has plagued regional and central governments as well. For example, the Leningrad and Sverdlovsk regions (*oblasts*) have been cited as likely to default on their foreign loans.[37]

**The FIMACO Scandal.** On February 1, 1999, Russia's Prosecutor General Yury Skuratov revealed in a letter to Duma Chairman Gennady N. Seleznev that the Central Bank had placed about $50 billion in a previously unknown offshore asset management company called the Finance Investment Management Company (FIMACO).[38] The Paris-based Eurobank, which is owned by the Russian Central Bank, set up FIMACO in 1990 using $1,000 in start-up capital.

According to Skuratov, since 1993, FIMACO handled up to $37 billion in U.S. dollars and about $13 billion in other currencies.[39] Shortly after his announcement, Skuratov resigned his post for "health reasons" and checked into a Kremlin hospital for fatigue. He resumed his duties a few weeks later, although Yeltsin tried repeatedly to fire him.

Foreign governments usually manage their own reserves or use the services of major Wall Street or London investment firms. But the revelations of Central Bank chairman Gerashchenko and his predecessor, reformer Sergey Dubinin, were unusual. Gerashchenko acknowledged that FIMACO managed the Central Bank's funds,[40] justifying this by saying that the Central Bank did not have the capacity to handle foreign exchange reserves at the time. Dubinin went even further: He acknowledged that the purpose of FIMACO was to hide assets from foreign creditors and that its actions therefore were justified.[41] Dubinin indicated that part of the funds managed by FIMACO came from the World Bank and the IMF. He added that the matter involved state secrets and national security.

As the facts about FIMACO became known, the Central Bank's top officials refused to disclose the names of FIMACO's managers or reveal who was benefiting from commissions on the reportedly gigantic sums it managed. They would not disclose where the commissions were deposited or who had paid taxes on them. The Bank later admitted that FIMACO had private partners in Eurobank (FIMACO's owner), including Russia's leading oil and banking firms.

Former Finance Minister Boris Fedorov admitted that he knew about the offshore dealings of the Central Bank in 1993, but Gerashchenko had refused to disclose the specifics. "[A]s I understand, friends were given a chance to make some money," Fedorov observed.[42] Former First Deputy Prime Minister Alexander Shokhin disclosed that

36. Interview with the author, U.S.–Russia Business Council, April 15, 1999.

37. Julie Corwin, "Rash of Regions Heading for Default?" Radio Free Europe–Radio Liberty Newsline, February 22, 1999, at *http://www.rferl.org*.

38. Igor Semenenko, "$50 Billion in Reserves 'Managed' Offshore," *The Moscow Times*, February 5, 1999, p. 1.

39. *Ibid*.

40. Igor Semenenko, "Bank Chief: Reserves Managed Offshore," *The Moscow Times*, February 6, 1999, p. 1.

41. John Thornhill, "Russia 'Moved Reserves to Tax Haven'," *The Financial Times*, February 11, 1999, p. 1. One such creditor is Geneva-based billionaire Nissim Gaon, who attempted to attach the Russian government's assets in Europe after the Russian government defaulted on credits extended by Gaon's company, Noga.

in 1998, the Central Bank parked $1 billion in a zero-interest account in Eurobank—a highly suspicious practice.[43]

Finally, the bank's officials admitted that the Central Bank played the highly lucrative treasury bill (GKO) market—which yielded annual interest rates of up to 300 percent—even as it set the GKO interest rates. Between March and September 1996, FIMACO made $38.9 million on an investment of $143.3 million in GKOs.

In a letter made public by the State Duma, Yuri Ponomarev, a top Eurobank official, ordered FIMACO staff to trade through phone buy-and-sell orders and to use code words, leaving no paper trail—a highly unusual practice in managing Central Bank reserves. The Bank's former First Deputy, Chairman Oleg Khandruyev, noted that decisions about FIMACO were not made by the Bank's board; instead, they were "quiet decisions."[44]

Although Russian officials at first had denied that the IMF knew about FIMACO, on February 18, 1999, Deputy Central Bank Chairman Oleg Mozhaiskov reportedly admitted that the IMF did know of the arrangement.[45] On March 22, former Central Bank chairman Dubinin admitted that the IMF knew about FIMACO, but he insisted that Russia had done nothing wrong.[46] If officials at the IMF knew of this arrangement and did nothing, they allowed the fraudulent practices of the Russian Central Bank to remain hidden, and even to continue. If they did not know, they demonstrated enormous negligence in performing their responsibilities.

According to Russian polls, the people of Russia question their government officials' ability to manage Central Bank reserves, and many believe that these officials embezzle the funds Russia receives in financial assistance from the West.[47] Before the FIMACO scandal emerged, 60 percent of Russians polled said they believed IMF funds were being embezzled. Some 35 percent said their country did not benefit from the IMF assistance, compared with 31 percent who believe it did.[48] Such numbers highlight the aura of corruption and the lack of trust in Russia's government. The findings of an upcoming audit of the Russian Central Bank by PriceWaterhouseCoopers, which the Duma commissioned, may shed some light on this case; its findings should be fully disclosed.

## WHAT RUSSIA MUST DO

The Russian government's high level of corruption and official policies aimed at preserving the vestiges of the Soviet military–industrial complex are destroying the Russian economy. After seven years of borrowing from the International Monetary Fund, debt is escalating and the economy is deteriorating. Yet IMF officials try to justify their past lending policies, which focused on alleviating fiscal and budgetary inefficiencies and disregarded both Russia's structural weaknesses and the existence of a "virtual" economy so keenly dependent on the barter system.[49]

42. Andrew Jack, "Revelations Rock Russian Central Bank," *The Financial Times*, February 11, 1999, p. 2.
43. Igor Semenenko and Jeanne Whalen, "What Is FIMACO?" *The Moscow Times*, February 23, 1999, p. 4.
44. David Hoffman, "Central Bank Hid Investments of Russian Funds," *The Washington Post*, March 8, 1999, p. A1.
45. Reuters, "Central Bank Defends Offshore Scheme, Says IMF Knew," February 18, 1999, reported in *Russia Today*, at *http://www.russiatoday.com/rtoday/busin4ess/news/1999021801.htm*.
46. David Hoffman, "Russian IMF Loans Routed Through Offshore Company," *The Washington Post*, March 23, 1999, p. A11.
47. Sergey M. Rogov, "The Russian Crash of 1998," Center for Naval Analyses, Alexandria, Virginia, October 1998, p. 47.
48. *Ibid*.
49. See John Odling-Smee, "What Went Wrong in Russia," *Central European Economic Review*, November 18, 1998, at *www.imf.org./external/np/vc/1998/113098.htm*. Odling-Smee is IMF Director of the Europe II Department, which supervises dealings with Russia.

Russians, however, can no longer afford to ignore their economic problems. As Director of the USA–Canada Institute in Moscow Sergei Rogov wrote, "The Russian Federation has turned into a sort of 'financial drug addict,' becoming more and more dependent on foreign credits."[50] The decision to turn the Russian economy around can come only from within Russia's political class. Without a real transformation of the political climate in Russia, the prospects for stimulating domestic economic growth and attracting foreign investment will remain bleak.

Primakov's team was unwilling and unable to take the steps necessary to restore economic stability and bring about an enduring recovery. It is hoped that the new government recently installed by Boris Yeltsin will have a better chance of success.

To turn the economy around, Russia needs to take three important steps:

1. **Enforce a thorough and sustained crackdown on crime and corruption to restore popular support for market reforms and revive the confidence of Western investors in Russia's economy.** To encourage foreign investment, law enforcement officials and the judiciary need uniform and enforceable standards of investigation, prosecution, and punishment. As Under Secretary of the United Nations for Crime Prevention Pino Arlacci has stated, "Russia is the first large state completely overtaken by organized crime and corruption."[51]

   So far, anti-corruption measures have been used primarily as tools to settle political scores among the power elite. But corruption undermines the legitimacy of the current regime and increases the cost of doing business.[52] The government should conduct a full investigation and audit of FIMACO and all foreign assistance programs to determine how much Western assistance was channeled through FIMACO; how much in commissions and profits was generated and who benefited; whether these profits were repatriated to Russia and, if so, whether taxes were paid on them; what the IMF or other donors knew; and what, if anything, they did about it.

   Inadequate laws and the breakdown of the judiciary have led many Russians to invest abroad and have convinced foreigners not to invest in Russian companies. As long as the courts and arbitration tribunals are not the only venues of dispute resolution and contract enforcement, organized crime and corrupt officials will continue to determine how disputes are settled. Property rights must be expanded to protect investors and entrepreneurs and to encourage investment and the development of the real estate market and agriculture. The legal system also must recognize and protect creditor rights.

2. **Appoint an economic team that understands the principles of market economics.** This team must have practical experience with successful economic decision making in Russia to gain credibility. However, the new team headed by Aksenenko and Khristenko has many oligarch friends who have been accused repeatedly of abusing their political ties for personal enrichment.

3. **Undertake a comprehensive program of radical economic restructuring.** This program should be implemented with a new level of discipline and cooperation between the federal government in Moscow and regional governors. At this time, however, the Russian government has not released any new economic policy documents. In order to jump start economic recovery, the new economic team needs to take the following steps:

50. Rogov, "The Russian Crash of 1998," p. 54.

51. Pino Arlacci, presentation to National Strategy Information Center Working Group on Organized Crime, Washington, D.C., February 23, 1999.

52. Kohn, "Russia," p. 3.10.

- **Secure** current and future loans with collateral. Russia's record of debt repayment in this century is poor. After the 1917 Bolshevik coup, Russia defaulted on the czarist debt. After World War II, Stalin refused payments to the United States under the lend-lease program that had contributed greatly to the Soviet victory in World War II. A Soviet debt of over $90 billion is outstanding, yet former top Soviet leaders remained in the highest offices in Moscow until May 12, 1999. If Russia continues to borrow, it should secure its previous and future loans with collateral, such as natural resources, oil fields, and property. This could generate a positive cash flow with long-term leases. An example would be leasing the Northern Territories (Kurile Islands) to Japan.

- **Improve** debt management. Debt management should be concentrated in a high-level government agency, possibly within the Finance Ministry, and headed by an official who has extensive experience in international finance and is supported by a highly trained staff. Portfolio managers must be experienced in risk-management techniques and given ample resources with which to do their work. Several developed debtor nations, including Austria, Belgium, Ireland, and New Zealand, as well as such emerging markets as Hungary and Colombia, have taken this path successfully.[53]

- **Reform** the tax system, improve tax collections, and revise the state budget. Russians have a saying: "The government is pretending to collect taxes, while we are pretending to pay." Large corporations and the super-rich in particular avoid paying taxes. Russia should implement a simple system of taxation and tax collection that will generate revenue from wealth-generating industries such as oil and gas and high net-worth individuals, and provide exemptions or very low tax rates for the majority of the population. Russia needs to stop the precipitous decline of GDP by cutting government expenditures, including subsidies to heavy industry and agriculture. Equally important are further cuts in the size of the military and significant nuclear arms reduction to reduce maintenance costs.

- **Eliminate** the barter system in non-competitive goods and arrangements to pay tax arrears. Up to 80 percent of all transactions, including local, regional, and federal taxation, are conducted by barter.[54] This occurs when enterprises cannot sell their products for "real" money because their products are not competitive, or when they arrange with local governors or federal tax officials to reduce their tax liabilities by bartering off goods—usually goods that are unmarketable and non-competitive. If bankruptcy procedures were working and the government refused to sustain money-losing industrial enterprises, the necessary restructuring of the industrial base in Russia already would be occurring. Only this kind of restructuring can guarantee long-term growth in GDP. The government, working with foreign economic experts, needs to design measures to monetize the barter system and to restructure the industrial base to reduce the importance of bartering in government operations.

- **Stop** the disruption of interstate commerce by regional governors. Unhampered interstate commerce guarantees optimal functioning of an economy, and disruptions in such commerce may lead to food shortages and declining outputs. After the August 1998 ruble crisis, a number of governors and autonomous republic administrations banned food exports from their regions. For example, the ultra-nationalist governor of

53. Cassard and Folkerts-Landau, "Sovereign Debt: Managing the Risk," pp. 4-5.

54. V. P. Makarov and G. B. Kleiner, *"Barter v rossiiskoi ekonomike: osobennosti I tendetsii perekhodnogo perioda,"* TsEMI, Moscow, at *http://www.cemi.rssi.ru/ruswin/publication/wp960006.htm*.

the Krasnodar region, Nikolai Kondratenko, restricted farmers from exporting grain, the area's main commodity. Other regions and republics licensed and regulated exports.[55] This practice should cease. Moscow must ensure the open flow of commerce within the Federation to prevent food shortages and encourage business to develop.

- **Draft and pass** a Land Code to allow the creation of a real estate and agricultural land market, including mortgaging, and to facilitate the development of privately owned farms and agribusiness. In the Duma, the communists and their allies in the Agrarian Party have blocked even the restrictive Land Code developed by the Yeltsin administration, claiming that it is against the national spirit of Russia to buy and sell land. Yet land was privately owned, traded, and developed in the late 19th and early 20th centuries in Russia. Today, such a Land Code would stimulate the economy and the development of a housing market, a registry of deeds, and the mortgage industry.

- **Consider** the benefits of a currency board. Currency boards have an impressive track record of bringing financial stability to such diverse countries as Argentina, Bulgaria, Estonia, Hong Kong SRA, Lithuania, Latvia, and Singapore. A currency board would stabilize the ruble and improve Russia's banking system. Support for such a board is widespread, ranging from analysts at the Cato Institute[56] to financier/philanthropist George Soros.[57] One of the critical concerns in implementing a currency board is the adequacy of foreign reserves. This concern highlights the need for the Russian Central Bank to implement a policy to stop the hemorrhaging of foreign reserves; otherwise, it will have no viable monetary policy options.

The new economic team must move quickly to implement these reforms to reverse Russia's economic decline and put the economy on a path that leads to greater prosperity for the Russian people.

## CONCLUSION

When President Clinton meets with President Yeltsin in Germany this month, he should convey the importance America places on Russia's economic recovery. Because the Russian economy is failing so desperately, the remedy will be bitter, but it must be of the "homegrown" variety and self-administered. International financial assistance will never take the place of solid economic policies based on market principles.

The new government installed recently by Yeltsin may represent Russia's last chance to step back from the edge of a socioeconomic abyss before popular discontent brings communists and nationalists to power or widespread anger scuttles the political system altogether. The reforms attempted by the Russian government since 1992 have been half-hearted, inept, and riddled with corruption. In large measure, they have failed. A real market economy, with complex institutions based on the rule of law, could not take root. The result is so flawed that it has backfired, undermining the faith of ordinary Russians in the principles of free markets and democratic government.

Russia today is like a rudderless ship; members of the crew, without maps, are fighting among themselves over whether to sail in one direction or the other. Whoever wins the power struggle in Moscow will need to jump start the economy, facilitate entrepreneurship, and attract investment. Moscow needs modern market institutions, but

55. Julie Corwin, "New Regional Food Restrictions Imposed," Radio Liberty–Radio Free Europe Newsline, December 21, 1998, at *www.rferl.org*.

56. Steve H. Hanke, "The Case for a Russian Currency Board System," Cato Institute *Foreign Policy Briefing* No. 14, October 14, 1998.

57. George Soros, letter to the editor, *The Financial Times*, August 13, 1998.

this effort will not succeed unless the rule of law is firmly established.

—*Ariel Cohen, Ph.D., is Senior Policy Analyst in Russian and Eurasian Studies in the Kathryn and Shelby Cullom Davis International Studies Center at The Heritage Foundation*