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RUSSIA'S PATHWAY THROUGH FINANCIAL CRISIS

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Introduction

In 1998 Russia suffered a financial crisis, which followed from mounting internal debt, a flawed current policy, a decline in commodity prices, a dramatic deterioration in the country's terms of trade, and ripples from the Asian financial crisis of 1997. More profoundly and directly contributing to the crisis, Russia's political system was in a state of flux. President Yeltsin's political position had declined, privatization of the government by oligarchic groups, growing dysfunctionality of state institutions in the background of fears in and outside of Russia of a communist revanche and roll-back of reforms.

The role of the IMF in the years prior to the crisis was mixed. IMF loans in 1992-1998 failed to act as viable external constraints on the Russian government because of the Kremlin's unique ability to call on the IMF's top shareholders. The US government in particular consistently exerted pressure on the IMF to provide funds for Russia regardless of Moscow's failures to observe the Fund's conditions. While aiding the Yeltsin regime reduced the risk of a major political setback, the IMF loans served to empower the oligarchic groups around the Kremlin and ultimately contributed to the structural causes of the crisis.

This articles traces three key groups of decisions made by the government, which assist in assessing the impact of external actors on the events in Russia. First there were decisions made during the run-up to the June 1996 presidential elections. Second, the government failed decisively to reduce the budget deficit and instead decided to liberalize the capital account in 1997. Third, the decision to implement simultaneous default and devaluation on 17 August 1998.

The presidential campaign consolidated the political foundation for oligarchic capitalism, leaving the state with fewer means to raise budget revenue. The government missed its last window of opportunity for structural reforms in 1997 and engaged in a borrowing spree that quickly became unsustainable. Finally, crisis management also reflected Russia's specific political set-up: the decision to simultaneously devalue and default on domestic debt was not accompanied by coordinated government policy. Crisis management was carried out in the background of concessions to the communists to ensure Yeltsin's political survival, including the appointment of a communist-backed Prime Minister Yevgeniy Primakov.

The Crisis

By late 1997, Russia was in economic difficulty. The government was failing to collect tax, indeed the World Bank would later estimate that had Gazprom (formerly headed by Victor Chernomyrdin) been required to pay all of its tax obligations in 1995, these would have gone some way towards shrinking Russia's budget deficit by contributing somewhere between 2 and 3% of GDP.[1] Instead of collecting tax the government resorted to the policy mix of high fiscal deficits reconciled by an exchange rate anchor (the rouble was pegged to the dollar through a currency band since 1994) and

heavy government borrowing. The positive expectations – fuelled by relative political stabilization, an apparent halt of economic decline (manifested by modest growth in Russia in 1997 for the first time since the break-up of the USSR) and declining inflation – created considerable appetite for Russian government securities on the part of both domestic and international investors. Between November 1996 and December 1997 the Russian government issued about $4.5bn in Eurobonds, while also ramping up rouble-denominated borrowing through short-term government bonds, GKOs. Net rouble issues in 1997 amounted to 4.2% of GDP. By the end of the year, foreign investors owned a third of outstanding rouble debt. In the meantime, the stock market was propelled to new highs, doubling in dollar terms in the first nine months of 1997.

The contagion effect from the Asian financial crisis forced the government to raise interest rates sharply in order to roll over the maturing GKOs. Falling global commodity prices led to a rapid deterioration in Russia's terms of trade. Emergency measures brought about by the government in early 1998 to improve tax collection and cut public expenditure proved insufficient to redress the budget imbalance, while the financing crisis proved impossible to contain by rising interests rates. The banking system in Russia was also coming under serious strain, as many large banks became excessively reliant on GKOs and other high-yield securities. As the prices of these securities declined in 1998, many banks were exposed to margin calls, forcing them to sell assets and put pressure on the balance sheets.

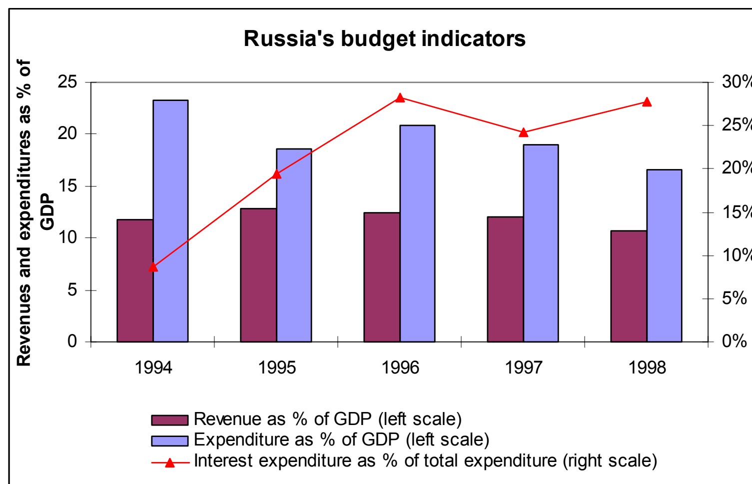
The government attempted to restore confidence in the adequacy of its reserves by agreeing a $17bn assistance package with the IMF and using its first tranche to support the exchange rate band. All these measures proved insufficient to avert the climax of the crisis, which came on 17 August 1998 with the government's decision to devalue the rouble and freeze private sector payments on external liabilities.

The emergency measures announced by the authorities on 17 August 1998 included a revision of the currency band, essentially amounting to devaluation, a unilateral restructuring of ruble-denominated debt falling due between 19 August 1998 and 31 December 1998 and a 90-day moratorium on private sector payments on external liabilities.

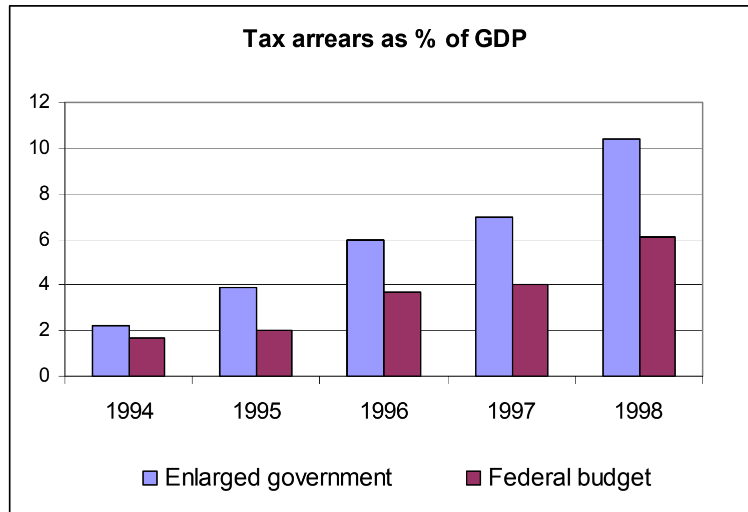
The simultaneous devaluation and default brought about a shock to the economic and political system. Several major banks went bankrupt and the entire banking system was close to a collapse. Disruption in transactions led to a severe contraction of output and trade, while inflation picked up dramatically. In the meantime, a political crisis in August and September 1998 resulted in the formation of a new cabinet under Yevgeniy Primakov, who was popular with the Duma and supported by the communist opposition.

Towards the end of 1998 and in early 1999, the economy stabilized, however. Aided by relatively tight fiscal policy, the exchange rate stabilized in March 1999, while output started to recover on the back of import substitution brought about by devaluation. Russia's external balance in the meantime was aided by the rebounding world commodity prices.

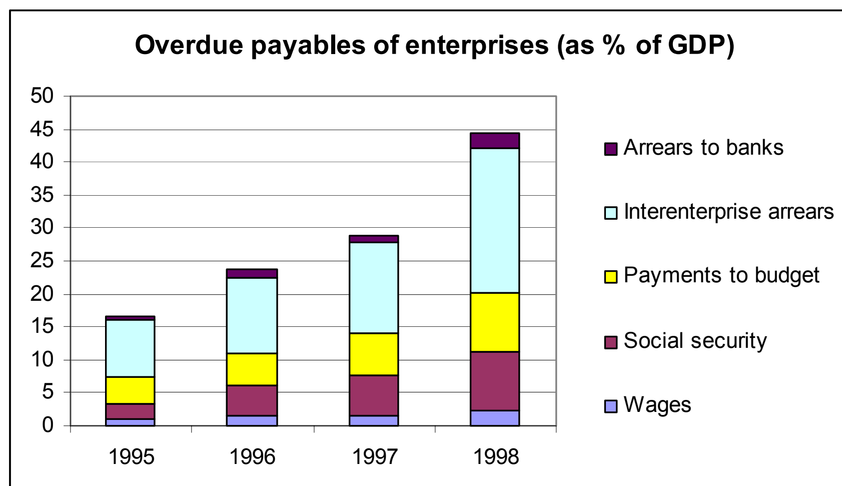
Although structural reforms stalled until April 1999, subsequent government policies sought to address the causes of the crisis. The government introduced several revenue-enhancing measures and demanded full compliance with tax obligations from oil companies. Important changes were brought about by the decisive policies pursued by Gazprom and RAO UES, the gas and electricity monopolies, which from 1999-2000 demanded full cash payment from their customers, credibly threatening to disconnect the services for non-payment. This conduct effectively broke the cycle of payment and tax arrears.[2] In June 1999, the government also attempted to reinvigorate the structural policy area: interbank currency markets were unified, bank-restructuring legislation was adopted and major insolvent banks were closed down.



Source: Russian Ministry of Finance[3]



Source: Goskomstat[4]



Source: Goskomstat[5]

Key Elements of Russia's Trajectory

Four key elements defined Russia's trajectory towards and through its crisis. The first of these was the emergence of a strongly Presidential system which determined economic policy-making in Russia and shaped policies taken in the run-up to the 1996 election. The second is the relationships Russia had forged with the West, with the international financial institutions, and with capital markets. The second was the run-up to the June 1996 presidential elections and the policies undertaken by the government in that context. The third element was the government's failure decisively to reduce budget deficit and capital account liberalization in 1997. The final element was the simultaneous default and devaluation of 17 August 1998. Each of these is explored below so as to illuminate the political economy within Russia and how it was affected by relations with external actors.

The Emergence of a Strongly Presidential System in Russia

After a violent standoff between President Yeltsin and the Russian Congress in October 1993, Yeltsin forcibly dissolved the Congress and pushed through a new constitution, which concentrated political and economic decision-making in the hands of the President.[6] The Parliament was left with two levers over economic policy: approving the annual budget and confirming the appointment of the Prime Minister. By contrast, the President could appoint the cabinet, control the executive, rule by decree in economic matters, and veto laws adopted by the Duma. By 1995, Yeltsin's presidential administration included over 40 advisory bodies and policy-making and implementing agencies, all immune from legislative control.[7] The Duma needed a two-thirds majority to reverse a Presidential decree or veto. Although charged with producing economic legislation, it was unable to control implementation or enforcement.

Behind the Presidency emerged a group of powerful `oligarchs' entrepreneurs that took over major state-owned economic assets. Since these acquisitions were typically made through collusion with bureaucrats, the new owners needed constant political

support to retain their sources of wealth. Moreover, the oligarchs demanded preferential treatment from the government in the form of export quotas, tax breaks and access to state assets. The mutual dependence came center stage in 1996, when the oligarchs financed Yeltsin's reelection campaign and thereby amassed their political influence.[8] Once Yeltsin became debilitated by illness after November 1996, presidential functions devolved to his formal and informal entourage, called by some Yeltsin's "Family".

The resulting political mix consisted of an increasingly dysfunctional state with enormous constitutional powers of the president balanced by the powerful insider groups benefiting from access to state budget and assets. These groups were typically not interested in macroeconomic or budgetary stability, since it was a combination of instability and political access that provided them with information advantage crucial for arbitrage.

As the oligarchs' positions grew stronger following Yeltsin's reelection, tax collection failed to recover. Tax arrears grew dramatically as did the government's fiscal shortfall. The preponderance of tax revenue withheld was owed by a very small number of oligarch-owned companies who had not only become highly influential within the powerful executive but had gained control over most of the print and broadcast media outlets. Any move by the government, and by extension any pressure exerted on the government by the IMF, to challenge these interests would inevitably elicit direct resistance from the oligarchs and efforts to mobilize opinion in their favor.

Against this background, the government sought to resolve its high fiscal deficits by anchoring the exchange rate (the rouble was pegged to the dollar through a currency band since 1994) and borrowing heavily.

Relations with International Actors

Over the 1990s, Russia had developed a close relationship with the West, the IMF and World Bank, and with private markets. The first of these relations was that which President Yeltsin had cultivated with Western governments and most importantly with the US government. Throughout the 1990s, the US viewed Yeltsin as the only leader capable of retaining Russia on the path of reforms, steering it away from an anti-Western stance, and keeping the nuclear arsenal inherited from the Soviet Union under control. Russia's potential geostrategic threat was seen as a justification for the unwavering support for Yeltsin. Consequently a blind eye was turned to Yeltsin's questionable (or outright illegal) political actions: the anti-constitutional dissolution of the legislature in October 1993, the 1994-1996 war in Chechnya, and the controversial reelection in 1996 to name just a few. So long as Russia stayed clear of a communist restoration, Yeltsin would be "forgiven". Crucially for Russia's financial stability, its interactions with the IMF and the World Bank followed the same pattern. They were premised on Yeltsin's unique political "immunity" and his ability to call on the US for support when the Kremlin was unhappy with the IMF conditions.

A second set of relations were those developed with the IMF and World Bank who were seen as capable of bringing a formidable range of technical capacities and knowledge as well as financial resources to assist Russia. Yet neither institution had strong leverage over Russian policy-makers. Both were under strong political pressure to lend on lenient terms. Already in 1993 President Clinton was publicly urging the IMF to increase its lending to Russia to $13.5 billion a year and to impose less rigorous conditionality.[9] Russia's Paris Club debt would later be rescheduled and a $28 billion package put together[10] and by April 1995, the IMF's Board approved a $6.8 billion Standby Arrangement, the largest ever loan to Russia. When Yeltsin looked vulnerable in the run-up to the 1996 election, both the Fund and Bank came under pressure to lend more to Russia to bolster Yeltsin's chances. The IMF waived its agreed targets on budget revenue and budget deficit and even turned a blind eye to the dubious accounting methods used by the Central Bank to cover up its failure to meet international reserves requirement.[11] Against a background of obvious non-compliance, the IMF offered Russia a new Extended Fund Facility (EFF) of around $10.1 billion which would be disbursed monthly over the period 26 March 1996-25 March 1999 and unlocked a comprehensive restructuring of Russia's $38.7 billion debt with the official creditors of the Paris Club in April.

A third set of relationships emerged in the mid-1990s between Russian business leaders and private Western capital. Although foreign direct investment in Russia was extremely low in the 1990s, portfolio investment increased dramatically in 1996-1997 aided by the Russian government's 1997 decision to remove capital controls. Emerging Russian banks played an intermediary role channeling Western funds into Russian government securities and also striking forward currency contracts with foreign counter-parties. As a result of the inflow of foreign capital, by May 1998 about one-third of all Russian domestic treasury securities (GKOs) were held by non-resident investors,[12] most of which were hedge funds.[13] There were two serious implications for Russia. First, as capital rushed into the government's coffers there was no hard budget constraint on policy-makers – efforts to rein in the deficit or increase tax revenue were bound to be wasted. Second, the rush of foreign capital would test – to the point of breaking – the country's fragile banking and financial system.

The Run-up to the June 1996 Presidential Elections

The 1996 presidential election campaign sealed the pact between Boris Yeltsin and leading oligarchs. In the months prior to the elections, the oligarchs agreed to pool their resources, including monetary contributions and media control, to support Yeltsin against the communist candidate Gennadiy Zyuganov. At the same time, Yeltsin deviated from the government's already feeble fiscal discipline by lavishly promising subsidies and other benefits to interest groups and the public across Russia's regions. Fearful of a communist revanche, Western governments encouraged the IMF to continue its loan disbursements to Russia despite evident deviation from key conditions by the Russian government.

In retrospect, Yeltsin's room for maneuver was extremely limited in 1995-1996. With his popularity at single digits in late 1995, Yeltsin needed to appease the electorate and ensure favorable coverage in the media. Increasing expenditure was unavoidable. Alliance with the oligarchs was not, however, but Yeltsin was desperately short of political supporters he could rely on. Crucially, in the early and mid-1996, Yeltsin drifted away from some his closest associates, such as his bodyguard and confidante Alexander Korzhakov, who pressed Yeltsin to cancel the elections and impose a state of emergency to stave off the seemingly inevitable defeat at the polls. Korzhakov and his sympathizers were finally sacked on 20 June 1996.[14] In this environment, the oligarchs, who commanded much of Russia's media and provided financial and human resources for the embattled president seemed appealing allies to Yeltsin. In the decision that perhaps best underscores his legacy, Yeltsin chose to stay within the broadly democratic parameters conceding significant political and economic resources to the big business that helped him stay in power.

These decisions had several implications. The system of oligarchic capitalism was incompatible with sound fiscal policy. Leading oligarchs acquired control over major privatized assets, especially in natural resource export-oriented industries at a fraction of the value that could have been realized in transparent conditions, thus depriving the government of significant potential benefit. The blind eye turned by the IMF on the Kremlin's deviation from loan conditions reduced the Fund's credibility in the Russian government and set a precedent for further softening of conditions.

Failure to decisively Reduce Budget Deficit and Capital Account Liberalization in 1997

Critical opportunities for fiscal stabilization were wasted in 1997. Following Yeltsin's reelection, the president and his circle had a reasonably high level of political capital (albeit constrained by the oligarchy). The external economic environment was improving. The completion of a rescheduling deal with Paris Club creditors alleviated concern about Russia's near-term foreign debt service burden. Investor perceptions of the emerging markets were improving after the retrenchment following the Mexico crisis of 1995. Domestic conditions were also favorable. A record grain harvest contributed to Russia's first economic growth in its recent history, while inflation fell to its lowest level since 1991.

Instead of decisively moving in the direction of structural reforms, however, the government exploited the favorable environment and expanded borrowing via the Eurobond and GKO markets. The government's efforts to raise tax collection, evidenced in high-profile activity of the Temporary Emergency Commission on Strengthening Tax and Budget Discipline, were fiercely resisted by the oligarchs and ultimately failed to change the improve the budget balance significantly. In the meantime, borrowing could be justified by the relatively low interest rates available throughout most of 1997. However, the government did little to address the longer-term viability of the budget. Federal government revenue as percentage of GDP actually fell in 1997 and the deficit amounted to about 7% of GDP.

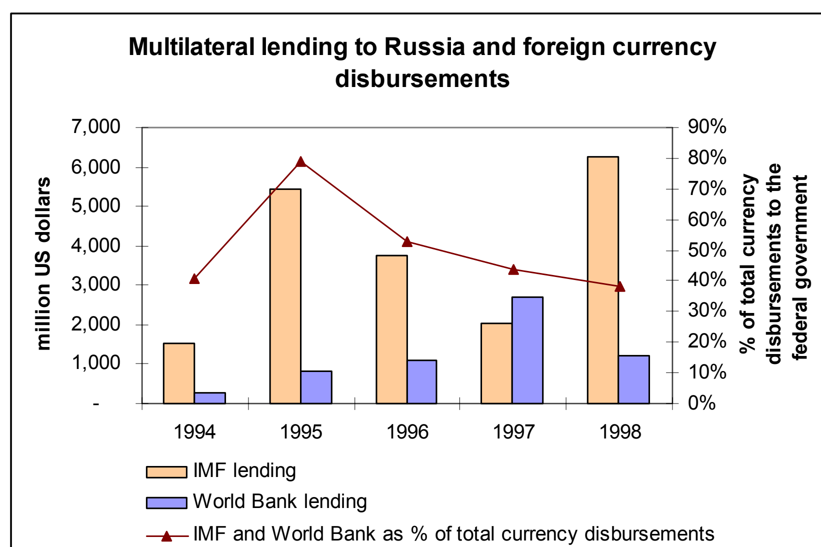
Another key development in 1997 was liberalization of the capital account, the decision taken by the Russian government with IMF encouragement. According to one Russian policy-maker, capital account liberalisation in 1997 was a straightforward quid pro quo. The IMF would be lax in enforcing targets on fiscal policy and restructuring, and in return Russia would liberalize its capital account. It was apparently easier for the government to dismantle capital controls than it was to take tough decisions on tax and spending.[15] In the battle among policy-makers this was the easiest and most likely area in which reform could be leveraged. This was particularly the case in a year when the Russian government could access resources from private capital markets, therefore obviating the need for too stringent a relationship with multilateral lenders. Capital account liberalization could appease the IMF and US at the same time as ease the government's financing difficulties.

By early 1998 Russia's capital controls had been abolished and access to foreign banks opened up. The Central Bank's capacity to limit the volatility of GKOs (rouble-denominated discount instruments) and OFZs (rouble-denominated coupon bonds) had been swept away. Russia was exposed to far greater volatility as a result. An inflow of foreign capital into government treasury bills in late 1996 to mid-1997 was quickly followed by the withdrawal of non-residents from the GKO market in late 1997, leaving the Finance Ministry in search of buyers to refinance its bonds. By late October 1997 the Central Bank was forced to intervene to support the bond market, depleting its reserves by about a third in a matter of days even though interest rates were increasing.[16] Further private foreign inflows were desperately sought. Indeed, by July 1998, accumulated foreign portfolio holdings were nearly 15% of Russia's GDP, with the loans from the Fund and Bank amounting to another 4.5% GDP. Russia had become heavily dependent on foreign capital flows.

Simultaneous Default and Devaluation on 17 August 1998

The decision to default on domestic debt denominated in local currency in addition to the devaluation of the rouble was taken by President Yeltsin and a circle of government insiders on the weekend of 15-16 August 1998. The decision-making process that led to this highly unusual solution is not quite clear. According to Sergei Dubinin, Chairman of the CBR at the time of the crisis, the default helped avert a much sharper devaluation of the rouble and far-reaching political consequences, such as an impeachment of President Yeltsin (which was then debated in the Duma) and the return to command economy methods.

The decision to default and devalue was taken after several weeks of intense efforts by the multilateral institutions to help the Kiriyenko government. On 20 July the IMF approved $11.2 billion of new funds for Russian currency support and on 6 August 1998 the World Bank approved a $1.5 billion loan to Russia. IMF lending to Russia reached its highest absolute levels in 1998 (see chart below). This peak coincided with the overall decline in the utility of the lending. The first tranche of the IMF loan, amounting to $4.8bn had been used up in a failed attempt to support the ruble that served only to assist capital flight.



Source: IMF[17]

On the other hand, the decisions taken on 17 August 1998 were formed without announcement of supporting macroeconomic policies, resulting in rising uncertainly made even worse by the removal of Prime Minister Sergei Kiriyenko and Yeltsin's inability to persuade the Duma to support his preferred candidate for premier, Viktor Chernomyrdin. The decision to default carried significant risks, especially with regard to the banking system. The bankruptcy of several major banks and the resulting social tensions in instances where retail deposits were lost may have been averted if the government chose just to devalue. On the other hand, the longer term effect of the default on the government's budget position proved beneficial, especially as it appeared that the memory of international financial markets was short and foreign lending returned to Russia in less than two years after the crisis.

Who was Affected?

The immediate losers in the crisis were the institutional holders of Russian bonds, which ultimately lost most of their value. The total GKO/OFZ market before the crisis amounted to about $70bn. Approximately $20bn were held by foreign investors. Also at risk were Russian bank depositors, as the crisis led to the bankruptcy of several major banks. Typically, depositors were ultimately able to recover the nominal rouble amount of their deposits, which meant a loss of two-thirds of the deposits' real value.

Further, rapid devaluation and a surge in inflation, which rose to 84% in the aftermath of the crisis, hit the recipients of nominal rouble incomes, such as public sector employees and pensioners. As the table below demonstrates, the crisis was followed by a dramatic decline in real incomes and an increase in the poverty level.

Table: Income and welfare indicators

	1996	1997	1998	1999	2000
Real income as % over previous year	101	106	84	88	113
Individuals with income below official poverty line, % of total population	22.0	20.7	23.3	28.3	28.9

Source: Goskomstat 2003.[18]

The effect of the crisis on the oligarchic groups was mixed. The crisis resulted in a demise of several major groups that were based on banks heavily exposed to the GKO market. SBS-Agro and Incombank, whose principals Alexander Smolensky and Vladimir Vinogradov had been actively involved in the Kremlin politics, were wiped out by the crisis. Smolensky and Vinogradov consequently left the political and economic arena. Other oligarchs survived, although the crisis damaged some of them seriously. The seeds of a prominent media magnate Vladimir Gusinsky's demise, which took place in the form of the forced takeover by the state-owned gas monopoly of NTV television channel that he established, can be traced to the post-crisis bankruptcy of Gusinsky's Most Bank.

The misfortunes of individual oligarchs and the temporary resurgence of the communist opposition bolstered by the appointment of Yevgeniy Primakov as Prime Minister in September 1998 failed to decisively change Russia's political system, however. Key oligarchs not only retained their influence in the Yeltsin Family but also were able to mastermind and implement a succession from Yeltsin to Vladimir Putin, who was elected President of Russia in March 2000.

Although the social and economic costs of the crisis were high, economic recession precipitated by the crisis was short-lived. Devaluation sparked growth in both export-oriented and import-substituting industrial sectors. Industrial output was up already in the last quarter of 1998. By June 1999, it reached the 1997 levels.[19] Economic growth in Russia subsequently accelerated in large part due to the rebound on global commodity prices.

Conclusions

Russia's financial crisis in 1998 resulted in

- centralized executive authority
- could empower IFIs but did not because conditionality eroded by geostrategic concerns
- reforms were opportunistic on part of President and oligarchs

The August 1998 financial crisis resulted from the deep structural flaws in the Russian economy and the government's inability to establish a hard budget constraint. These factors in turn grew out the political weakness of the government, which after 1995 was challenged by powerful oligarchic groups. Oligarchic capitalism that was solidified after the 1996 presidential elections was based on the system of privileges for the emerging financial-industrial groups, which enabled them to benefit at the expense of the state. Russia's foreign lenders, which sought to aid the regime of President Yeltsin inadvertently strengthened the oligarchs and weakened the prospects of structural reforms. The government failed to use the window of opportunity presented in 1997, choosing the path of least resistance offered by relatively cheap borrowing. When external environment deteriorated due to declining world commodity prices and the Asian crisis, the debt became unsustainable.

The implications of the Russian financial crisis for the Fund and Bank were far-reaching. Their leverage is based on their capacity to enforce terms and conditions, withholding further financing where necessary. In Russia it was clear that loan conditions were not being met, but the institutions were being told to lend. Their political masters had, in essence, redefined their mission as a political one, thereby dramatically reducing the bargaining power of either the Fund or the Bank.

The problem with the new political mission was that it was not a clear one. It was not to bring about political reforms. At most it was to support 'reformers' as a route to ensuring economic reform. Yet neither the Fund nor the Bank succeeded in developing a relationship with reformers that might later facilitate more reform through a persuasive influence – as they had done in Mexico. And the 'reformers' that the institutions supported became part and parcel of the Yeltsin regime that by the end of the decade was burdened by corruption and other social and political ills.

The experience of the IMF and the World Bank in Russia sheds important light on their nature as international institutions. Many expect international financial institutions to act as relatively autonomous agents undertaking technical tasks on behalf of government members who delegate such tasks to them. Yet in Russia, there was no clear-cut delegation. Although the mission in Russia was framed in technical terms befitting the goals and instruments of the institutions, there were overtly political aims that underpinned these goals. Although assistance was given according to strictly negotiated conditionalities, these were side-lined when major shareholding governments decided that political exigencies overrode technical qualifications, such as in 1993-1994 and in 1996 when the West saw it as critical to be seen to be supporting Yeltsin's government against communist and nationalist opposition which might be destabilizing. The result was to reduce the bargaining power of the IMF and World Bank, diminishing their capacity to enforce the terms they negotiated with the Russian government. Russia highlights the structural constraint within which the institutions work.

When it came to Russia a perception of 'systemic threat' overrode individual country qualifications or the lack thereof. The threat was not economic – Russia's trump card was geostrategic. As a nuclear-armed colossus bordering Europe with a capacity to

generate conflict and turmoil spreading right across the continent, Russia commanded attention and special treatment from the West, as illustrated by the vigorous debates undertaken in the US Congress in 1994 in the Committee on Banking, Housing, and Urban Affairs hearings on the IMF and World Bank policies towards Russia, and in the 1998 General Oversight and Investigations Subcommittee hearings on the IMF and Russia.

Conflicting political pressures and deviation from the institutions' mandates also provide at least a partial explanation for the policy mistakes committed by the Fund and the Bank and their support of actions that turned out to be wrong: support for the maintenance of the rouble zone in 1992, for the privatization in the mid-1990s, and for the exchange rate and capital accounts liberalization after 1995.

The IMF initially urged Russia to retain the ruble zone rather than creating national currencies for the Soviet successor states. This resulted in inflationary pressures, rendering financial stabilization virtually impossible.[20] The cost to Russia was immense, amounting to 9.3% of GDP in financing and 13.2% GDP in implicit trade subsidies in 1992.[21] Yet it was not until 1993 that the Fund took a clear stand against the rouble zone.

On privatization both the World Bank and the IMF seemed blind to the risks and negative scenarios emerging on the ground. In spite of considerable evidence about the risks of privatization it took a long time for the core Washington Consensus presumption in favor of any form of privatization to change. Already by the summer of 1993, in the first round of Russian privatization 'insiders had acquired majority shares in two-thirds of Russia's privatized and privatizing firms' and were demonstrating that privatization did not necessarily lead to restructuring and independence from state aid.[22] The loans-for-shares privatization of the mid-1990s had yet more dire consequences as discussed in the previous section. Yet it was not until the end of the 1990s that economists within the Fund and Bank began to examine the importance of sound institutional frameworks for successful privatization, and the costs of privatization in the absence of such institutions.

On exchange rates and capital account liberalization, the IMF's advice and prescriptions for Russia were ill-advised. Indeed, a later research paper by IMF senior economists would detail the issues and vulnerabilities arising from capital account liberalization.[23] In negotiations for the 1995 Standby Agreement, the IMF persuaded Russia to put in place a crawling band exchange rate.[24] Russia was then urged to open its capital account in negotiations for the 1996 EFF loan, thereby permitting foreign portfolio investment in government bonds and shares.[25] Both measures reflected Fund orthodoxy that was maintained until 1997.

The IMF prescribed the crawling band exchange rate to countries as an anchor against inflation. Capital account liberalization, high on the agenda of the United States, had become an article of faith within the organization. Indeed until 1997, moves were afoot led by the US to amend the Fund's Articles of Agreement to permit it greater jurisdiction in this area. Yet both parts of this orthodoxy proved risky and particularly in combination in the context of globalizing capital markets.

Why did the IMF seem to offer poor advice? The Fund was caught between powerful members on one side and scarce resources on the other. The United States pushed the IMF to lend at particular junctures such as in 1993 and 1996 to support Yeltsin - regardless of his economic policies – and to avoid turmoil in the markets when the financial crisis occurred in 1998. In these cases decisions to lend to Russia were being taken outside of the IMF and this left the institution with little negotiating or enforcement power in respect of conditionality. However, in other cases the IMF had more influence.

In respect of the 1993 and 1995 privatizations and the 1997 decision to liberalize Russia's capital account the IMF was more involved. Each of these decisions was driven by the Russian government's need to find a way to fund the government deficit. The IMF's advice on this matter was heavily constrained by its own lack of resources and alternatives. Other than exhorting tax reform and deficit reduction, the institution had neither the resources nor a ready set of ideas to propose or provide an alternative way for the Russian government to finance its deficit. It was unable to mobilize more resources. It was ideologically entrenched in the belt-tightening solution. Equally importantly, the institution was constrained by the interests and capabilities of Russian interlocutors. Whether or not policies were being proposed or pursued in a rational sequence, the incentive for the IMF was to seize any opportunity to implement policies that the institution and its major shareholders preferred. In so doing the institution could at least point to some success in implementing reform and change within Russia and thereby justify its ongoing lending.

Overall in Russia the IMF worked within a structural constraint imposed by its most powerful shareholders. Its actions were also shaped by institutional constraints imposed by its scarce resources and its entrenched contractionary approach to economic reform in a crisis. Finally, it was politically constrained by its dependence on Russian interlocutors to take-up and implement specific reforms. Working within these three sets of constraints, perhaps the most serious weakness in the IMF's approach lay in its sanguinity as to Russia's political, legal and economic institutions and the presumption that they would materialize and strengthen as an organic part of market reform. The World Bank was equally guilty of this.

In its sectoral work in Russia, the World Bank has been accused of 'pouring money into central government authorities of notoriously corrupt industries such as coal or agriculture'.[26] In total the World Bank has approved $1.525 billion of loans for coal sector adjustment in Russia since 1996 with the aim of making the coal sector more efficient and ensuring social protection for laid-off and disabled miners. Critics allege that the Bank's assistance to the coal sector has in part 'disappeared down a black hole' and that in 1997, 'instead of controlling how the money was spent, the bank handed over cash in exchange for Kremlin promises to reform the industry'.[27] The Bank's own staff admits of the constraints they have faced in lending in this area. These include 'the lack of stable top management in government' and 'the lack of fundamental reform in the banking sector, the lack of clarity in private sector development and the lack of clear government policy as regards oil, gas and coal are constraints'.[28]

One explanation for the lending in spite of inadequate reform was doubtless pressure from its most powerful shareholders. In 1994-5 and 1996 the institution came under intense pressure from Washington DC to increase its lending: in effect this was the structural constraint within which the Bank's work proceeded. But there were institutional driving forces as well. The World Bank exists to make loans. Its large staff earns their salaries by preparing loans, which meet the approval of the Board. IBRD loans are then repaid with interest, which pay for the working expenses of the Bank. In other words, there are powerful internal incentives within the organization that encourage staff to maximize lending. At the same time, there is a driving belief within the institution that it can learn from failures and improve its performance by refining conditionality and refining the modus operandi of the organization. Far from exercising a brake on the institution, failures spur new methods and new loans.

The Bank's failures in Russia have led to a constant rethinking of the Bank's mission and its prescriptions. In its coal sector loans to Russia, for example, the Bank has embarked on a more explicitly institutional approach to identifying necessary organizational mechanisms, processes and institutions through which to work. To quote a staff description, the task involved 'mapping the internal processes of each organization to identify the major bottlenecks or constraints' and changing the rules of the game so that 'stakeholders which no longer have institutional capability were bypassed'.[29] In effect, the Bank is attempting to overcome the political constraint both it and the IMF work within. Finding stakeholders who are both willing and able to use loans and to implement projects or conditionality is one aspect of that constraint but of course, such policy-makers will not always exist and the experience of both institutions is that they do not necessarily materialize in the face of external incentives and pressures.

	External constraints	**Internal constraints**
Economy	Dependence on world energy prices. Currency band.	Persistent deficiency of budget policy: inability to enforce tax collection and cut government expenditure.
Political system	"Post-imperial" contraction, break-up of traditional political and economic ties with the periphery.	Activity of major oligarchic groups that competed for access to state assets and budget and sought tax breaks.

Footnotes

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