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in the European Transition Economies

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Introduction by Marek Dąbrowski

The series of currency crises which hit several developing countries in the 1990s did not leave the emerging market economies of Central and Eastern Europe unscathed. However, contrary to the experience of Mexico in 1995 and South East Asia in 1997–1998, the roots of the crises in our region were usually less sophisticated and easier to identify. Most crisis episodes in the former communist countries fit nicely with the "first generation" canonical model elaborated in 1979 by Paul Krugman and developed in 1980s by other economists. In this model, fiscal imbalances are the main factor leading to depleting international reserves of the central bank and speculative attacks against national currencies.

This was the main reason behind all currency crises in our region, very often closely related to serious microeconomic weaknesses and delays in structural and institutional reforms. The only minor exception was the Czech Republic where the devaluation crisis in May 1997 (of rather limited magnitude) was caused by over-borrowing of the enterprise sector, an unreformed financial sector, and political turmoil rather than by fiscal imbalances and an excessively expansionary monetary policy.

This volume, following another collection of similar monographs related to Latin American and Asian regions, presents five episodes of currency crises in Eastern Europe in the second half of 1990s. Four of them were related to post-communist economies and one (Turkey) to a developing economy aiming to integrate with the EU and suffering many macroeconomic and structural weaknesses similar to those of the transition group.

Bulgaria in 1996–1997 represents the first episode of a full-scale financial crisis, involving drastic currency devaluation and near-hyperinflation, a banking crisis and a near default on debt obligations. The roots of the crisis were fully domestic and, although severe, were restricted to Bulgaria.

Russia's financial crisis in August 1998, despite similar characteristics and domestic roots as in Bulgaria, had an important international dimension. On the one hand, the first speculative attacks against the ruble in the fall of 1997 were triggered by crisis events in Asia, particularly in Hong Kong and Korea. On the other hand, when the Russian crisis erupted, it provoked a huge contagion effect across all the countries of the former USSR. It also caused a big turmoil on all segments of the international financial market, bringing the danger of a recession in the US and other developed countries, and triggering a currency crisis in Brazil few months later.

The monographs on Ukraine and Moldova present two case studies of such a contagion effect. However, one should remember that these two economies (as well as most other FSU economies) experienced the same weaknesses and vulnerabilities as in Russia. Thus Russian events could only accelerate the crisis in these countries which was, in any event, hard to avoid.

Finally, we present the analysis of the recent financial market crisis in Turkey, which fortunately has been stopped by fast and substantial IMF and World Bank support and has not evolved into a full-scale currency crisis.

All the studies were prepared under the research project no. 0l44/H02/99/17 on "Analysis of Currency Crises in Countries of Asia, Latin America and Central and Eastern Europe: Lessons for Poland and Other Transition Countries", carried out by CASE and financed by the Committee for Scientific Research (KBN) in the years 1999–2001. They were the subjects of public presentation and discussion during the seminar in Warsaw organized by CASE on December 21, 2000 under the same research project.

Part I.
The Bulgarian Currency Crisis of 1996–1997
by Georgy Ganev [1]

1.1. The Facts of the Crisis

On January 2, 1995, the US dollar traded at 66.11 Bulgarian lev (BGL) [2], on the Bulgarian foreign exchange market, while on December 29, 1995 it traded at BGL 70.70. A 7 percent depreciation of the Bulgarian lev during a year when CPI inflation was 33 percent was a pretty decent performance. The Governor of the Bulgarian National Bank (BNB – the central bank) was appearing in the media, claiming that there was serious support for the lev, and that nothing major could happen to the exchange rate and to the stability of the currency.

At the same time, the country was governed by a government which enjoyed an absolute majority in Parliament, and had received a strong mandate for socially-friendly reforms in the December 1994 elections. With the exception of December, industrial production was increasing year-on-year in every month of 1995 – in 7 of these months by more than 10 percent in real terms. After recording its first annual increase in 1994, Bulgarian GDP registered its best growth since the beginning of transition (2.9 percent in 1995).

Given this picture it is no surprise that the Bulgarians did not expect the events of 1996, which crippled the economy and are considered today an internationally significant example of financial crisis.

The currency dimension of the crisis had several stages. One important aspect of the exchange rate regime in Bulgaria at that stage of its transition was that there was no fixing of the exchange rate. Institutionally, after the liberalization of the exchange rate on February 19, 1991, the Bulgarian lev was a freely floating currency – a decision explained at that time with the lack of sufficient reserves to support a peg. The only indication that a constant exchange rate was of any concern for policy makers was the Bulgarian National Bank (BNB) Act of 1991, whose article 2 stated that the maintenance of external stability of the Bulgarian lev was among the obligations of the BNB. This implied either an obligation for a zero, or very mild and controlled, depreciation. Indeed, the BNB had maintained such stability after the first stabilization of the exchange rate occurred in November 1991 (following the initial liberalization of the exchange rate in February 1991), with the exception of one exchange rate crisis in the last quarter of 1993 and the first quarter of 1994. Between the end of 1991 and the last quarter of 1993, and between the summer of 1994 and the beginning of 1996, BNB was, at least on the surface, successful in maintaining a stable exchange rate.

On April 19, 1996, all this proved to be illusory. The lev fell by 2 percent against the dollar, after having depreciated by 13.7 percent since the beginning of 1996. This was the beginning of a spectacular crash. Eleven working days later the exchange rate of the dollar reached 100 leva – a further depreciation of 22 percent. May 1996 saw another 47 percent drop of the lev against the dollar, and even after a relatively stable market situation in June, by the end of August the dollar exchange rate was over 200 leva.

A second futile attempt to stabilize the lev, relying heavily on a new agreement with the IMF, failed after the IMF refused to transfer the second installment of the stabilization loan, due to the lack of implementation of the loan conditions on the part of the Bulgarian government. The government lost all credibility and, as a result, the Bulgarian lev depreciated by 33 percent in November 1996, by 39 percent in December 1996, by 110 percent in January 1997, and by a further 187 percent in the first two weeks of February 1997. As a result, for approximately 300 days between April 19, 1996 and February 14 1997, the Bulgarian lev depreciated by 3500 percent against the dollar.

Needless to say, these developments occurred in an environment characterized by many other violent movements and by other processes, most of which were deeply rooted in the Bulgarian transition. The macroeconomic indicators of the economy registered extreme values and

[1] Center for Liberal Strategies – Sofia.

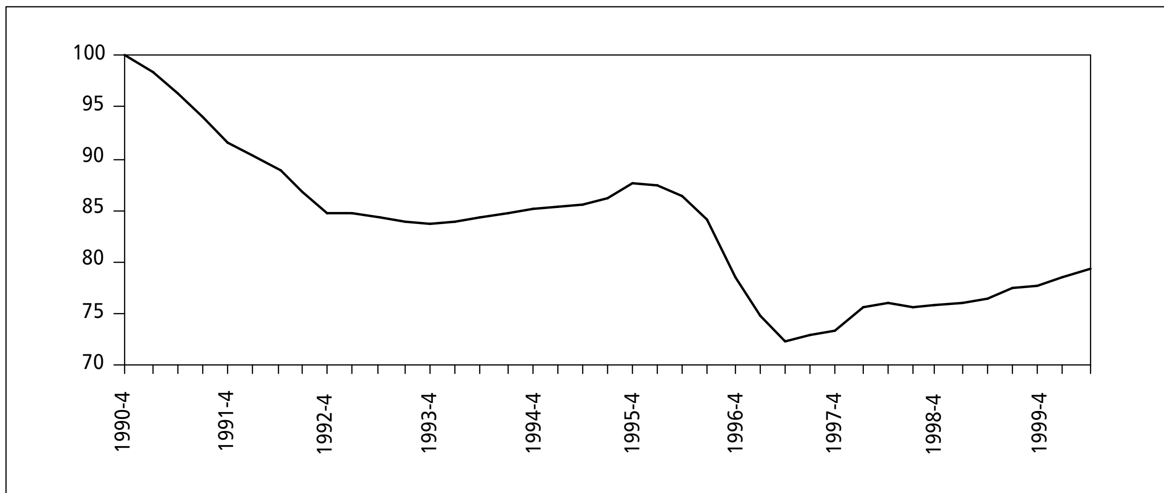
[2] The abbreviation BGL indicates the old Bulgarian lev, which was denominated on July 5, 1999, and replaced by the new Bulgarian lev, BGN, at the rate of 1 BGN = 1000 BGL. Since the period covered in this study is entirely before the denomination, only old Bulgarian lev (BGL) will be used.

changes during this period. Of course, these macroeconomic changes reflected the microeconomic behavior of Bulgarian economic agents, the dominant mode of doing business in Bulgaria, strategies and patterns of interaction within the business community (and between business and government) that precipitated the crash. Ultimately, this microeconomic behavior reflected the political reality in the country, the specific choice of transition made by the Bulgarian society, and the specific political way of implementing this choice. All these factors shed light on the Bulgarian currency crisis of 1996–1997, and need to be considered if one is to attempt to grasp the full depth of these events.

1.2. Macroeconomic Dynamics

The currency crisis in Bulgaria was accompanied by a sharp drop in output, which started in the same quarter as the crash of the exchange rate. Figure 1 shows the dynamic of quarterly GDP, which clearly illustrates the particular of Bulgarian GDP pattern during transition.

Figure 1-1. Bulgaria 1990–1999: 4 Quarters Real GDP Index, 1990=100



Source: NSI, own caluclations.
Note: Quarterly data for 1991, 1992, and 1993 are interpolations

After the initial recession in Bulgaria, which started as early as 1989, Bulgaria registered two years of low and unstable growth, but instead of continuing on the growth path as most other Central and Eastern European countries, it plunged into a steep depression, from which it is still far from recovering despite the growth during the period between the second quarter of 1997 and the second quarter of 2000.

Hence, the currency crisis of 1996–1997 was simultaneously accompanied by an overall crash of economic activity with long-term consequences for the productive potential of the Bulgarian economy.

1.2.1. Fiscal and Quasi-Fiscal Deficits

The crash was preceded by significant imbalances in various macroeconomic indicators. The lack of ability on the part of the government to maintain a sustainable fiscal position is clearly seen in the budget numbers, presented in Table 1-1.

Before the crisis of 1996–1997, the Bulgarian government registered high deficits, which proved to be unsustainable in an unreformed economy. Even more telling about the lack of discipline on the part of the political class (than the raw measures of the deficit) is the treatment of the State Budget Act and the number of times it was amended each year before 1997. In 1993, 1994, and 1995, the Budget Act was adopted on June 26, March 15, and May 19 of the respective year, despite the legal requirement for Parliament to adopt the Budget Act for a given year before the end of the previous year. Even after the late adoption, the Budget Act was amended at least once in the part concerning the expenditure side and the amount of the deficit in each of these years. In 1996, while the Budget Act was adopted as "early" as February 23, it ended up being amended 7 times before the year has come to an end.

The deficits were piling up in the first half of the 1990s, while the economy was not undergoing market reforms beyond the initial partial price liberalization, and by the end of this period interest payments amounted to a substantial proportion of GDP. This problem became more severe in 1993, when the accumulated internal public debt resulted in

Table 1-1: Bulgaria 1990-1999: Budget Deficits (in percent of GDP)

Year	Primary deficit	Deficit	Deficit (state budget)
1990		-7.0	
1991	2.7	-3.6	-4.3
1992	0.6	-5.8	-5.2
1993	-1.7	-11.0	-10.9
1994	7.0	-6.5	-5.5
1995	7.5	-3.8	-5.6
1996	8.7	-8.2	-10.5
1997	3.9	-1.5	-3.1
1998	5.4	1.5	1.1
1999	6.4	2.0	-1.0

Source: BNB, Bulgarian Ministry of Finance
Note: the state budget is a consolidation of the budgets of the government, the social security system, the judicial system, and the municipalities

interest payments surging to 10 percent of GDP. It turned into an insurmountable burden after 1994, when the country concluded a deal with the London Club on the restructuring of the Bulgarian foreign debt and regular service started in mid-year. In 1994–1996 interest payments amounted to the level of between 11.3 and 16.9 percent of GDP.

In the case of Bulgaria, however, the visible fiscal deficits presented a relatively small part of the actual government involvement into redistributing GDP. Quasi-fiscal deficits, resulting from losses of state owned enterprises as well as from unproductive domestic credit expansion in the private sector (ultimately financed by the BNB), presented a substantial burden on economic activity and considerably sped up and increased the magnitude of the crash.

Avramov and Guenov (1994), and Avramov and Sgard (1996) present a description of the way in which lack of fiscal discipline worked in Bulgaria during this period, and contain some data pointing the scale of the imbalances. In Avramov and Sgard's Table 7 (1996, p. 87), the total amount of predatory financing (interest, social security, wage and tax arrears) by enterprises amounted to between 6 and 12 percent of GDP in the period of 1992–1995.

At the same time, banks continued to expand their credit to the public and to the private sector. Bank lending was a major source of redistribution in the Bulgarian transition [3], and it was characterized by a constant increase in the number of bad loans, the losses from which were covered through generous refinancing by the BNB. The refinancing of commercial banks increased from close to BGL 16 billion in December 1993 to more than BGL 60 billion in June 1996 (BNB Bulletin).

The scale of this increase is hidden by a move of the Bulgarian government to alleviate the situation of the banks by issuing government papers in their favor in 1995 (exchanging old, low-income government paper with high-income, long term papers) and thus, in essence, assuming some of their obligations. Even more telling is the fact that the proportion of short-term non-collateralized loans from BNB to commercial banks in total refinancing grew from virtually 0 percent at the end of 1994 up to 90 percent in June 1996. These developments indicate both the precarious position of Bulgarian banks, and the scale of the quasi-fiscal deficits. Avramov and Sgard (1996, Table 11, p. 99) conclude that when the quasi-fiscal component is added to the official state budget deficit, the total losses of the public sector amount between 14.8 and 24.3 percent of GDP in the period of 1992–1995. Such a path of public deficits is clearly unsustainable.

1.2.2. Investment and Saving

The environment created by the government imbalances was unfavorable for Bulgarian businesses and households, and they responded by very low levels of investment and saving. Figure 2 exhibits the quarterly ratios of investment and saving to GDP between 1994 and 1998.

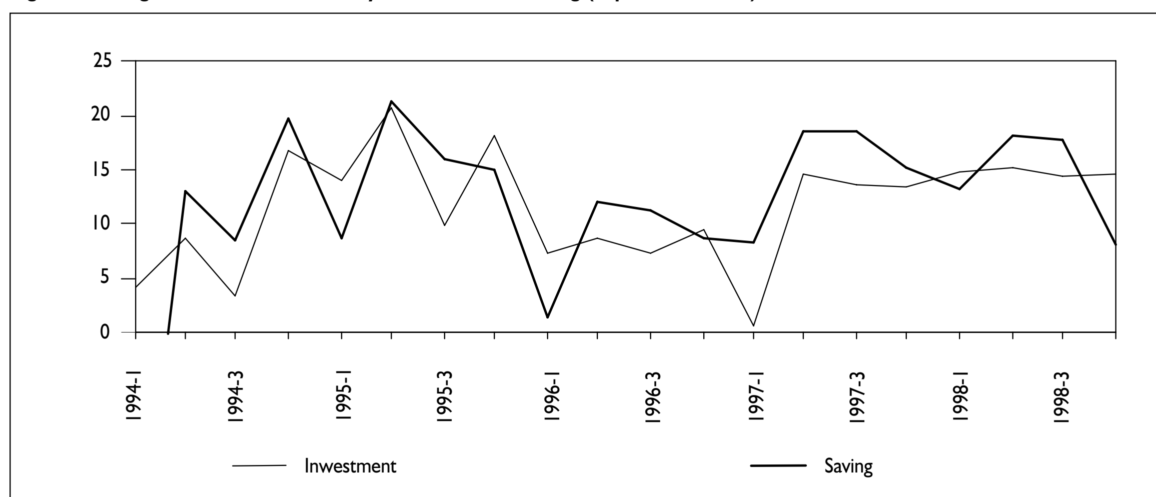
The overall levels of saving and investment in Bulgaria are very low compared to average international standards and to other transition countries. Figure 1-2 seems to suggest that it is more often that the level of investment is not enough to absorb the saving of households (this is the case in 8 of the 13 quarters before and during the crisis), which indicates that the supply barriers and the quality of the business environment and prospects may have been a more serious problem than the ability of households to finance investment projects. The level of investment was very low and insufficient to build up the productive capacity of the economy after the initial wave of price liberalization.

1.2.3. Debt

The public debt issue in Bulgaria had a relatively unusual history during the transition. At the end of March of 1990,

[3] This issue will be dwelt upon when the political context of the crisis is considered later.

Figure 1-2. Bulgaria 1994–1998: Quarterly Investment and Saving (in percent of GDP)



Source: NSI

the Bulgarian government unilaterally announced that it was stopping the service on the country's foreign debt. This default effectively closed the door to borrowing on the international capital markets for both the government and private economic agents. A sum of about USD 12 billion was kept in accounting terms as the foreign debt of Bulgaria, but service was minimal, and arrears were piling up, and by the end of 1993 the total sum was approaching USD 14 billion (BNB).

At the same time, the structural problems of the economy (due to half-hearted reforms, coupled with the unwillingness on the part of domestic economic agents to generate savings and to invest) meant that the economy was not creating productive capacity and was experiencing significant de-capitalization. In these circumstances it was vital for the country to get access to external capital. After more than year-long of negotiations, a deal with the London Club of private lenders was completed. Bulgaria's debt was transformed into a set of Brady bonds, and service started at the end of July, 1994.

Table 1-2. Bulgaria 1991–1999: Foreign and Domestic Debt (in percent of GDP)

Year	1991	1992	1993	1994	1995	1996	1997	1998	1999
Gross foreign debt, % of GDP	161.1%	160.5%	130.5%	118.1%	78.1%	102.9%	96.0%	83.7%	81.3%
Domestic public debt, % of GDP	7.2%	19.9%	37.2%	52.1%	39.2%	60.2%	25.8%	22.1%	22.7%

Source: BNB, Bulgarian Ministry of Finance, own calculations

On the one side, this deal meant that Bulgarian agents were now again capable of borrowing abroad. On the other side, this meant that the government had to face regular and significant (relative to the then normal levels of foreign reserves) payments in hard currency, which it could not afford to miss neither politically, nor financially. At the same time, private economic agents willing to borrow were considered as a non-prospective investment location, and were facing the according risk premium and rationing. The main reason was that Bulgaria was perceived as lagging too far behind other transition countries. The lack of genuine privatization further confirmed the view in the eyes of the international investors that Bulgaria was an uninteresting and volatile place. As a result, the Brady deal led to immediate costs for the government, while the expected benefits never materialized because of the failure to reform.

This situation forced the government to borrow on the domestic market, and the share of domestic public debt to GDP was increasing constantly until it reached more than 60 percent of GDP. Coupled with the foreign debt issue, this presented an insurmountable burden and quite rightly fed inflation and depreciation expectations. The public debt burden is illustrated in Table 1-2.

Until 1999, the share of private debt in gross foreign debt was negligible (less than 4 % of the total debt stock), so the numbers presented in Table 1-2 correspond quite closely to total public debt. The ability of non-government agents (state owned enterprises and private firms) to bor-

Figure 1-3. Bulgaria 1994–1998: Quarterly Growth Rates of Domestic Credits to Government, State and Private Enterprises (in per-

Source: BNB

row was limited only to the domestic credit market, and they used it, but had to face the constant competition of the government even there, which can clearly be seen on Figure 1-3, where the quarterly growth rates of domestic credit components in the five years surrounding the crisis are shown.

It can be seen that while net credits to private enterprises were constantly growing, sometimes at a very rapid pace, they were not far outpacing credits to the government and to state enterprises. All of them were increasing faster than inflation before the crisis, and only after it the government started actually returning its domestic debt and the crowding out effect disappeared.

The mounting level of indebtedness in the Bulgarian economy was a problem, but even worse was its quality. As Avramov and Sgard (1996), and Ganev (1999) suggest, the credit activity was aimed towards redistribution and abuse, rather than towards genuine investment goals. An the end, most of the debts were non-performing, and even despite government interventions and the fiscalization of some of the bad debts their proportion to GDP was 70.8 % in 1996 (Mantchev, 2000).

The overall inference that can be made from looking at the dynamics of debt in Bulgaria before the crisis is that the unsustainable government position, the lack of reforms and the domination of predatory rather than productive behavior among Bulgarian economic agents led to a significant increase in the stock of non-performing debt.

1.2.4. Monetary Policy

Monetary policy in Bulgaria during the period leading up to the crisis can be described as accommodating. The fiscal needs , as well as the actions of other economic agents, determined the actions of the monetary authority. Despite the fact that the BNB Act envisioned a high level of independence of the Bulgarian central bank, the practical level of independence of the BNB was very low (Christov, 1997).

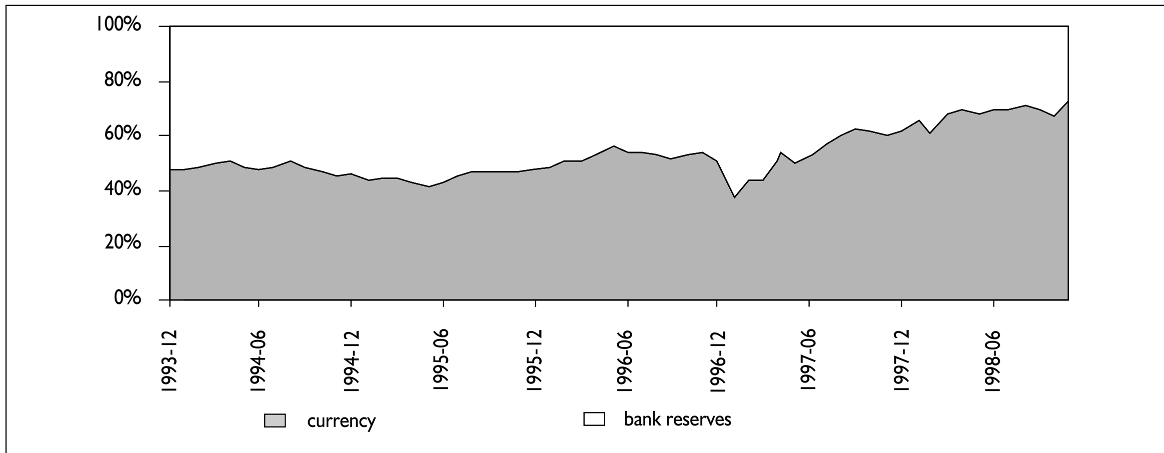
Even though all BNB annual reports indicate that the central bank was consciously trying to limit the growth of money relative to inflation, restrictions were never credible enough to curb inflationary expectations. So, it happened that, on the one hand, the BNB was trying to limit monetary growth while, on the other hand, it found itself in a position of accommodating the needs of the government (to fill the budget gap), and of the predatory private sector (to fill the bad credit gap).

The structure of the reserve money supply was relatively constant in Bulgaria in the period of 1994–1996. Currency in circulation and bank reserves grew constantly in the years before the crisis but were lagging behind the monetary aggregates, and behind inflation, leading to an increase in the money multiplier, and to a drop in the real reserve money supply.

As shown in Figure 4, in 1994–1995 there was a tendency towards an increase of the share of bank reserves in the total supply of reserve money, while in the year before the outbreak of the crisis, the structure of reserve money experienced a slight and gradual change, as the share of currency increased from around 41% in mid-1995 to around 54% in mid-1996.

The reason for these dynamics lies in the policy of the BNB. First, in 1994 it substituted the reserve money for credit ceilings as the main intermediate target of monetary policy (Balyozov, 1999, p. 6) and also increased the reserve requirement from 7 to 10 %, resulting in increased bank reserves. Also, refinancing of troubled banks continued, as a result of which these reserves increased further. This tendency continued until mid-1995, when a reversal of this

Figure 1-4. Bulgaria 1994-1998: Structure of Reserve Money Supply



Source: BNB

Figure 1-5. Bulgaria 1992–1998: Base Interest Rate and Interest Rates on Time Deposits and Short-Run Credits (in percent)

120
100
80
60
40
20
0
1992M1 1992M5 1992M9 1993M1 1993M5 1993M9 1994M1 1994M5 1994M9 1995M1 1995M5 1995M9 1996M1

base time deposits s-r credits

1200
1000
800
600
400
200
0
1996M1 1996M4 1996M7 1996M10 1997M1 1997M4 1997M7 1997M10 1998M1 1998M4 1998M7 1998M10 1999M1

base time deposits s-r credits

Source: BNB

trend occurred, and the share of currency in circulation began to increase. This was due to two facts. First, inflation in 1995 was lower, and the opportunity cost of holding cash decreased. Second, the problems of the banking system were beginning to be felt by the households and the firms, who chose to keep cash balances more and more.

At the same time, the attempts of the BNB to curb inflation led to a slower growth of the money supply than the growth of the price level, leading to falling real money supply and to high nominal interest rates. Interest rates were high throughout the period 1991–1996, and subsided only after the introduction of a currency board as a response to the crisis (Figure 1-5).

On several occasions, the BNB was trying to use the base interest rate [4] to counteract inflation, but never successfully – in no occasion was the base interest rate higher than the rate of inflation in any year, so real interest rates, especially on deposits, were permanently negative, with the only relatively long period of positive interest rates in the first months of 1995, when inflation reached its historic lows for the pre-currency board period.

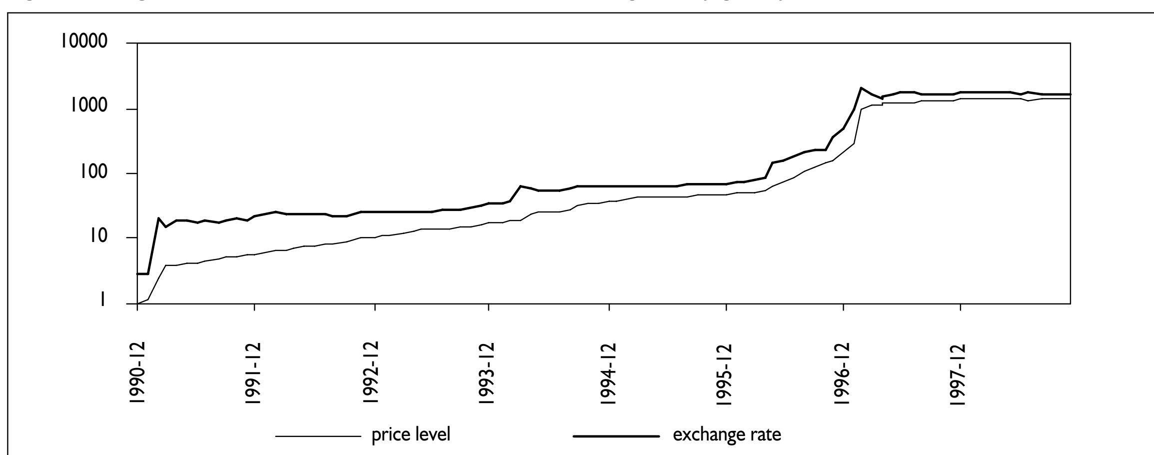
The increases in the base interest rate, while affecting the interest rates used by banks, were not capable of curbing credit expansion and inflationary pressures. A major reason for this again, was the increase in the refinancing of troubled banks and the deteriorating quality of the indebtedness in the economy.

"Refinancing" is the word, which best explains the behavior of the BNB in the period leading to the crisis of 1996–1997. The BNB Annual Reports for 1994 and 1995 stress extensively the reasons and amounts of this refinancing. The process of never-ending supply of cheap and mostly unrestricted credit to banks is explained with the attempts to restructure bank assets in order to cope with the situation of inherited bad debts from the socialist period. In any case, the BNB found itself dependent enough on the decisions and the desires of the political and the private sectors. As a result it accommodated their demands for fresh funds, and not only did not stop inflation, but contributed to the affirmation of a business and political culture of soft budget constraints.

This process was augmented by the lax policy of the BNB in licensing and supervision of new commercial banks (Balyozov, 1999, p. 7). Strict requirements existed on paper only, and the actual enforcement of rules and prudential standards were nonexistent.

The whole range of decisions made by the Bulgarian monetary authorities in the 1991–1996 period was dominated by the issue of bad debts. Internally, these were debts accumulated before, as well as after the beginning of transition. Externally, this was the foreign debt of the country, which was left without servicing between 1990 and 1994. Thus, monetary policy was secondary to other concerns and policies in the economy, and its subordinated position was reflected in the dynamics of the price level and of the nominal exchange rate (Figure 1-6).

Figure 1-6. Bulgaria 1991–1998: Price Level and Nominal Dollar exchange Rate (log scale)



Source: NSI, BNB

The price level was constantly growing after the initial jump due to the first liberalization of prices in February 1991. This cannot happen without accommodating monetary policy. The constant remarks in the BNB Annual Reports that its overall intention was to restrict money and

[4] The base interest rate in the period 1991–1997 was set by the BNB and served as a basis for the calculation of many other interest rates in the economy. After the introduction of a currency board in 1997, the base interest rate reflects the yield obtained at the auctions of 3 month treasury bills, and is not administratively related to other interest rates.

credit growth only served to show that the Bulgarian monetary authority constantly failed in its intentions. Not being able to stop monetary and credit expansion, it allowed for pressure to accumulate in the economy, and both the price level (less pronouncedly) and the exchange rate moved up in jumps as the pressures led to adjustments. This type of dynamics could be especially observed in the exchange rate trend, where (after the initial jump from administrated to market rates) there were clearly three periods of a relative stability, and two periods of rapid depreciation.

1.2.5. External Balances

The Bulgarian foreign trade data, presented in Table 1-3, show indirectly the significant inefficiency of the Bulgarian economy. On the import side, in the years before the crisis, the country depended, to a significant extent, on energy imports which constituted a significant burden for the economy. The energy dependence was not diversified and most of the imports came from the Russian monopolistic structures which increased the level of uncertainty of the Bulgarian business environment. The share of investment goods in total imports was low, reflecting the process of de-capitalization of the economy.

The Bulgarian exports exhibited a clear non-competitive structure with absolute dominance of raw materials. Bulgarian exporters, mostly large state-owned firms at that period, were not able to compete on the high value-added consumer and investment goods markets, and had to settle for low value-added exports of raw and intermediate materials, chemicals, etc. These exports depended on the conditions in the international markets, thus making the Bulgarian economy vulnerable to changing external conditions. At the same time, the trade deficits were not very large in 1995–1997, and represented no immediate danger to the economic system.

The situation with Bulgarian foreign trade, however, in combination with the inflationary and nominal exchange rate developments, resulted in near-constant real exchange rate appreciation, punctuated by the exchange rate crises. This dynamic of the real exchange rate vs. the US dollar is shown on Figure 1-7.

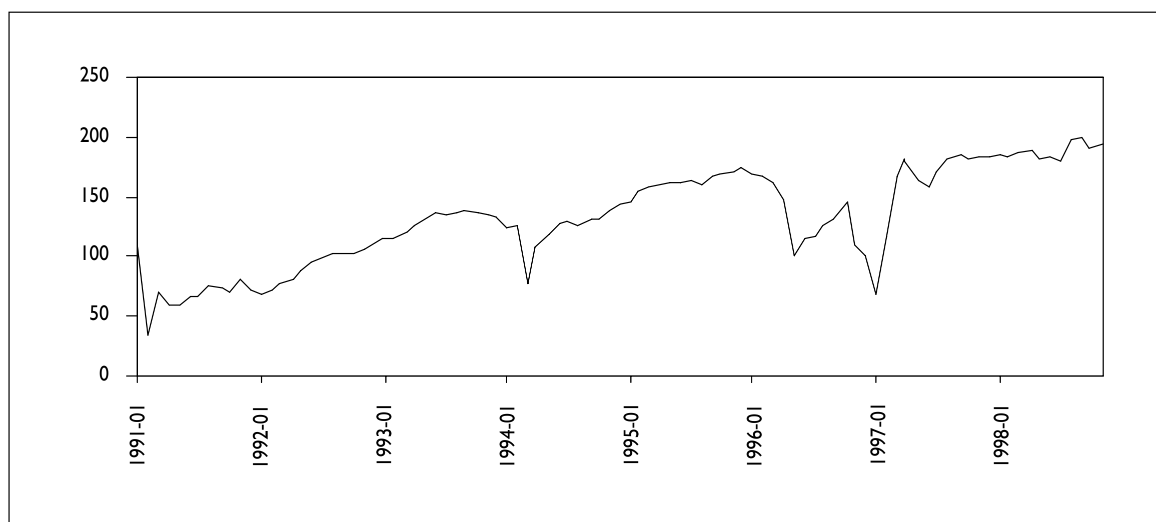
The two exchange rate crises, as well as their relative severity, are clearly visible on Figure 7. While the trend towards real appreciation was only temporarily broken with the 1994 adjustment and continued in 1995, the correction

Table 1-3. Bulgaria 1995–1998: Foreign Trade Structure and Volume

	Imports				total	Exports				total
	cons.	mat.	inv.	fuels	USD m.	cons.	mat.	inv.	fuels	USD m.
1995	11%	36%	19%	34%	5319	27%	52%	14%	7%	4967
1996	9%	37%	19%	35%	4927	30%	49%	15%	7%	4689
1997	10%	40%	17%	33%	4854	28%	49%	15%	8%	4809
1998	14%	41%	21%	24%	4957	31%	46%	16%	7%	4194
1999	17%	33%	27%	22%	5515	34%	42%	15%	9%	4006

Legend: cons. = consumer goods, mat. = raw materials, inv. = investment goods, fuels = fuels and energy
Source: NSI, BNB

Figure 1-7. Bulgaria 1991–1998: Real Exchange Rate BGL vs. USD, 1990-12 = 100



Source: BNB, NSI, US Bureau of Labor Statistics

Table 1-4. Bulgaria 1991–1998: Balance of Payments Items, in USD mln

	current account	financial account	foreign investment	change in reserves
1991	-77	-429	56	274
1992	-360	613	41	-270
1993	-1098	759	40	322
1994	-32	1	105	-41
1995	-141	360	90	-479
1996	-57	-699	109	724
1997	427	599	505	-1283
1998	-61	267	537	95

Note: positive values for "change in international reserves" indicate a decrease
Source: BNB

in 1996–1997 was more severe and led to a qualitative change in the trend (the real appreciation of the lev in 1998 was due more to the international weakness of the dollar than to domestic developments).

As opposed to other Central and East European economies, Bulgaria could not support a process of real appreciation of its currency for more than short periods of time, and this process regularly led to crises. The main reason for that was the inability of the country to balance the real appreciation effects on foreign trade and specifically on the non-competitive Bulgarian exports with developments in the other positions of the current account or in the financial account of its balance of payments. As Table 1-4 indicates, the most significant problem was the inability of the country to attract foreign investment.

The cumulative amount of foreign direct investment in Bulgaria in the years between the start of economic reforms and the crisis of 1996–1997 was less than USD 350 million. The inconsistent policies of the different governments, the half-heartedness of reforms, the great internal instability and unpredictability of the business environment made Bulgaria unattractive for foreign capitals.

As a result, the Bulgarian economy did not possess any degrees of flexibility when the external circumstances were unfavorable, and was not able to generate growth, relying on internal resources only. The hypothesis that this situation was caused mainly by internal developments was confirmed by the sharp change in the behavior of foreign investors after overcoming the 1996–1997 crisis. A qualitative change in the economic regime brought in foreign investments and they increased to annual levels of USD per capita comparable with other transition economies with similar stance as Bulgaria.

Thus, even though the balance of payments deficits were not chronic and were not even very large compared to what other transition economies had experienced, the deficits of 1993 and 1995 (second half)-1996 resulted in economy-wide turbulence and instability. As many other indicators already analyzed, the Bulgarian external balances exhibited the vulnerability of the country's economy and its incapacity to follow a stable path of reforms and growth.

1.2.6. Indicators for the Crisis

The literature on currency crisis indicators is growing [5], and there is a variety of candidate indicators. Many of the indicators mentioned by Kaminsky, Lizondo and Reinhart (1997) have already been analyzed and most of them pointed towards the fact that by late 1995 and early 1996 the exchange rate of the Bulgarian lev was under serious pressure. Another indicator, which seemed to perform quite well in the case of Bulgaria, was the ratio of the M2 monetary aggregate to international reserves. The dynamics of this ratio are exhibited in Figure 1-8.

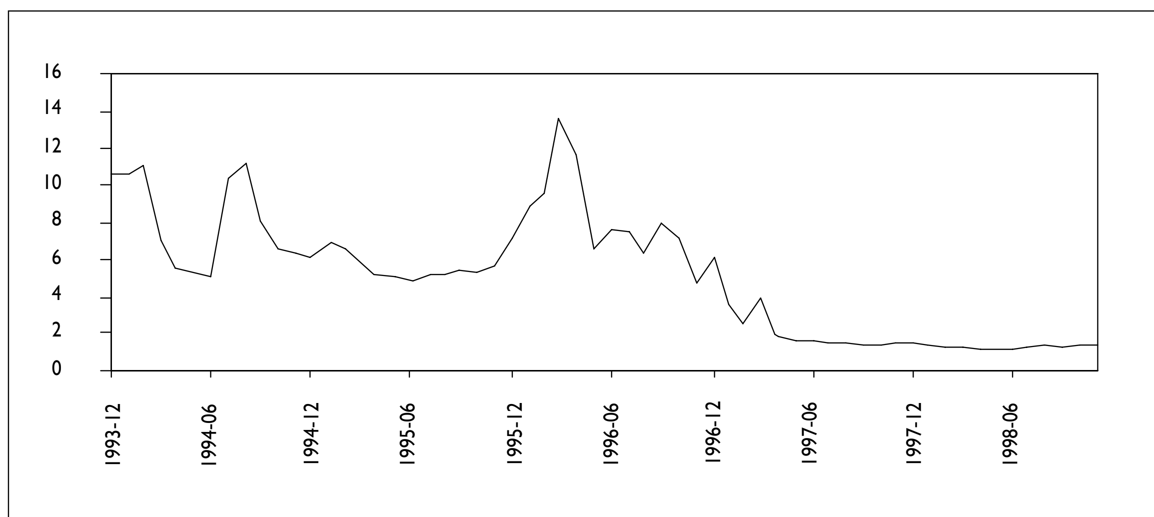
The ratio of M2 to international reserves clearly picked up as early as November 1995, when the situation in the banking sector became visibly unsustainable. The indicator reached its all-time peak in the initial month of the crisis, and dropped significantly after the resolution of the crisis and the introduction of a new and more credible monetary policy regime.

It is interesting to note that the ratio of M2 to international reserves indicator was high throughout three years preceding the crisis. This was also true for other indicators, based on the speculative attack index proposed by Eichengreen, Rose and Wyplosz (1996). Nenovsky, Hristov and Petrov (1999) calculated the speculative attack indices for Bulgaria based on the US dollar and on the Deutsche mark (pp. 22–23). They found that the indices were positive for most of the pre-crisis years, indicating mounting pressures, and that they reached higher than the critical levels – on two occasions in 1994, and in most of 1996.

Thus, one may conclude that the most severe currency crisis in Bulgaria started in April 1996, and finished in February 1997. This crisis was a natural consequence of mount-

[5] See a review in Tomczynska (2000).

Figure 1-8. Bulgaria 1994–1998: Ratio of M2 to International Reserves



Source: BNB

ing macroeconomic imbalances. The imbalances were caused mostly by the behavior of both government and private agents. The currency crisis was closely connected with other crises, such as a banking crisis, a real output decline, and, more fundamentally, a crisis in the Bulgarian model of transition.

1.3. Microeconomic Behavior

The micro behavior of the Bulgarian economic agents was shaped by the existing institutional setting. Its most pertinent characteristics were the soft budget constraints and the poor definition and protection of property rights. In this environment, as described and analyzed by Avramov and Guenov (1994) Avramov and Sgard (1996) V. Ganev (1999), the dominant elite project became the extraction from the state, and by 1996 this project was institutionalized and embedded in the structure of the Bulgarian economy. There were two channels in which predatory behavior affected the macroeconomic balances: through state-owned enterprises and through the banking sector.

1.3.1. The Banking Sector and its Crisis

Kovatchevska (2000) found that real exchange rate appreciation, domestic credit expansion, and the spread between lending and deposit interest rates, all variables whose unstable and divergent dynamics in Bulgaria were described above, predicted a banking crisis. The estimation was based on the model of Demirguc-Kunt and Detragiache (1997) and the results showed that Bulgaria was in a serious banking crisis in 1996. In reality, Mantchev (2000) demonstrated that according to most measures (ratio of problem credits to GDP, potential costs of the recapitalization of banks up to international standards for capital adequacy as a percentage of GDP, ratios of different monetary aggregates to GDP) used by Demirguc-Kunt and Detragiache (1997) Bulgaria's banking system was in a state of crisis ever since its emergence as a two-tier banking system after the fall of communism. It started recording permanent losses already in 1992 and in 1995 the losses recorded by the banking system amounted to 2.8% of GDP (Source: BNB). The ratio of problem credits and loans classified as loss to total credits was constantly increasing between 1992 and 1995 (BNB, Mantchev, 2000).

In November 1995, the first problem bank was "nationalized" when BNB acquired it for 1 lev. In February 1996, the second problem bank was nationalized in a similar manner. Then in March 1996, two banks were stripped of their licenses, and in May 1996 two major banks (one state-owned, and the biggest private bank) were put under receivership and later entered insolvency procedures. At the end of May 1996, Parliament passed emergency deposit guarantee legislation, confirming the expectation that the banking sector was going to face serious problems. The severity of the crisis became clearer on September 23, 1996, when BNB decided to put 9 more banks under receivership. Bank failures resulted from their insolvent positions built up during the period 1991–1995 and continued long after the crisis was resolved Many banks were closed, and some of the court proceedings were not completed as late as the end of 2000.

The above indicates that in 1996 Bulgaria became a classic example for a "twin crisis" (Kaminsky and Reinhart, 1996) when banking sector meltdown was closely associated with severe problems in the external balances reflected in a currency crisis. The facts also led Kovatchevska (2000) to claim that the currency crisis was caused by an expansionary monetary policy reflecting an attempt of the monetary authority to deal with the banking crisis.

However, looking at the longer time trends, presented in the previous section, another interpretation may be justified. There was a constant banking crisis in Bulgaria, which was causing expansionary policies. But these expansionary policies did not result in constant depreciation of the currency because the exchange rate policy of the central bank tried to preserve exchange rate stability as long as possible. Sharp depreciations did occur only when further defense became impossible [6].

This is clearly visible on Figure 1-6, where the rapidly increasing price level, reflecting in part the constant monetary expansion due to refinancing of banks, was juxtaposed to the punctuated upward dynamics of the nominal exchange rate, reflecting the efforts to keep the exchange rate constant, which led to short periods of sharp depreciation. So, in Bulgaria the banking crisis and the currency depreciation had a common third cause, which was the lack of market reforms coupled with the dominance of predatory economic behavior.

The reasons for the banking crisis were complex and interwoven in a complicated web. All of the major types of cau-ses for bank unsoundness, pointed by Kovatchevska (2000, p. 9–11) were in place in Bulgaria – problematic macroeconomic development with two years of unsound and unreasonable expansion, poor and fraudulent bank management, high degree of government control over the banking system.

All of these causes, however, were rooted in one fundamental process: the dominant rent seeking behavior, described in V. Ganev (1999). Under this behavior, the resources of the state were drained and "privatized" through two main channels – the budget and the banking system. While the first channel was simpler and more obvious, the second was larger and more significant. Its operation required soft budget constraints and poor and unequal protection of property rights, and led to the domination of an entrepreneurial culture based on non-cooperation and appropriation of already existing value mainly through and from the state, rather than on cooperation and creation of new value.

This behavior and its dominance was the fundamental cause for the rampant self-lending, looting, insecure crediting and poor discipline in Bulgarian banks before the crisis – it was the way in which business was done. The same behavior was the cause for the constant failure of macroeconomic balances and for the resulting high inflation and rate of currency depreciation.

1.3.2. The Enterprise Sector: the Willing Accomplice

For the rent extracting behavior to be successful, the economy needed to have a certain structure. It required the existence and the access to soft credits of large, state-owned enterprises in a largely monopolistic economy with underdeveloped markets. In this way extraction from the state was easily achievable, and monopolistic rents could be realized. The mechanisms were concentrated on privatizing profits, shifting losses, and covering the resulting financial problems of the enterprises with government funds or with soft credits by state owned or private banks, which then obtained refinancing.

The behavior of private enterprises engaged in rent extraction was not qualitatively different. They operated nominally, reporting losses to avoid taxes, and used their owners' connections with banks to receive soft non-collateralized loans, which were never serviced, and additional refinancing covered the banks' losses.

In this environment non-predatory behavior had low survival chances, investment in new value-creating capacity had a very low individual expected rates of return, and the economy was experiencing constant de-capitalization. The lack of cooperation strategies and the resulting extremely low level of trust between economic agents exacerbated the informational problems of financial exchange and prevented the establishment of sound and operative financial markets [7].

1.4. Politics of the Crisis

The behavior of politicians throughout the period preceding the crisis was highly conducive to its development and severity. The newly established political democracy in Bulgaria after the fall of communism had not experienced major crises, and the initial pain of reforms was not consi-

[6] This behavior of BNB was in harmony with the desires of the predatory private sector, especially with some banks, which made large temporary profits by knowing exactly when depreciations would be allowed to happen by the BNB.

[7] A very indicative observation showed that the most actively traded shares on the fledgling Bulgarian stock market in the early 1990s were those of companies, which subsequently turned out to be financial pyramids.

dered by the public as a fault of politicians, and they were accordingly not sanctioned severely.

A defining feature of the political system was the influence of the elites implementing the dominant elite project over all major political parties and players of that period. The interests of these interest groups were corresponding to the short term agendas of all ruling coalitions between 1990 and 1997. Given the extreme shortage of "authentic" (a term coined by Avramov and Guenov, 1994) market behavior in the historic experience of Bulgaria, the Bulgarian public exhibited a strong preference for gradual and socially friendly reforms in their transition from a centralized administrative economy towards a market democracy. Actions of politicians believed to decrease the pain of reforms, even when this meant postponing them, were generally welcome. So, accommodation and acceptance of soft budget constraints was a winning strategy for many governments.

At the same time, the governments were often dependent on voters such as pensioners and poorly qualified workers in doomed old unproductive plants, who stood to lose from authentic reforms. Their interests were added to the interests of the elites involved in rent seeking. These coalitions of interests were strong enough to impede many measures which were aimed at the introduction of market institutions and competition in the economy.

In 1993 and 1994, Bulgaria was ruled by a government which was supported in Parliament by a majority, including representatives and defectors from all major parliamentary parties. The fragile balance of power forced the government to make concessions to different interests, and as a result it did nothing to stop the spreading and the success of predatory behavior. On the contrary, this government was the first to clearly choose the option of slowing down reforms in the face of public uneasiness, and later fathered most of the actions and procedures, which completed the informal institutional framework of the process of extraction from the state. There was no political price to be paid for this policy, because, first, the public largely agreed with what was being done, and, second, the assignment of political responsibility to one or even several parties was impossible in this eclectic coalition.

In early 1995, the Bulgarian Socialist Party, the heir to the Bulgarian Communist Party, came to power after winning a full majority in Parliament in a landslide victory in December 1994. The main message in its political program was the implementation of socially-friendly reforms, which among other things included the slowing down of many measures, return to some controls of the government over the economy, and avoidance of the "painful" Washington consensus conditionality by breaking relations with the international financial institutions. Whether intentional or not, all these actions played into the hands of the dominant elites. Possibly the starkest example of this coincidence of interests was the statement, made by the Socialist Minister of Industry in early 1995, in which he explicitly encouraged state-owned enterprises NOT to worry about servicing their debts to banks and to concentrate on production. Naturally, these policies and processes were unsustainable and the only question was when they were going to lead to a crash.

Thus, the events of 1996–1997 were a simple realization of the inevitable. They also marked a political turnaround even though this was not a necessity as the ruling party enjoyed an absolute majority in Parliament and could have changed the policy course if it had reacted in time. As events unfolded, the government proved to be too dependent on the support of entrenched predatory interests, and was not able to cope with the situation, which demanded a radical change in the mode of economic behavior at least on the part of the government and the public sector.

At the same time, the ruling party was quickly losing popularity. Interestingly, the first wave of public disappointment was not related to the developments in the banking sector or to the unsustainable fiscal position of the government but to a grain crisis in the spring of 1996. This crisis was caused by uncontrolled grain exports under the conditions of cheap, government controlled domestic grain price allowing to realize an easy profit. To this initial disappointment, the 1996 developments quickly added a sharply depreciating domestic currency, bank nationalization and closures, rampant inflation.

This change in public attitudes was used by the center-right opposition, which forged a broad coalition and managed to defeat the ruling party's candidate in the presidential elections in late 1996 by a very large margin. The fall in the ruling party's ratings continued, and by January 1997 the government had resigned and the attempts of the old parliamentary majority to form a new government of the same party were being met with mass protests, demonstrations and strikes. The door for early elections and for a new ruling majority finally opened.

1.5. Dynamics and Solution of the Crisis

When in March 1996 there appeared a sharp shortage of bread, in April 1996 the currency started to rapidly depreciate, and then in May 1996 one large state owned bank and the largest private bank were put under receivership, it became obvious that the country was not on the right track.

[8] The most striking example of this policy was the fact that while in 1993 the share of administrated and controlled prices in the consumer basket was 26%, by the end of 1996 it was 52.1%. Source: EBRD.

The level of unreasonable and unsustainable monetization proved to be too high, the public and private debts – mostly non-perfoming and too excessive, the productive capacity of the economy – too low, and the ability to attract flows from outside – nonexistent. Initially, the response of the government to the new situation was of the "more of the same" type. By the end of June 1996, the government had opened two credit lines for up to BGL 10 billion with the BNB, and had received more than BGL 10 billion in two other loans directly from the BNB. It was trying to solve the problems caused by too much refinancing with more refinancing. The only result was inflation, which by then was in the double digits monthly.

As a result of the lack of success of these measures, the Socialist government decided to address one of the real deficiencies of the economy and to attract money from abroad. It gave up its hard posture with respect to the international financial institutions, and asked the IMF for a loan. After intensive negotiations, the loan was granted in September 1996, but it came accompanied with hard conditions. Fulfilling these conditions proved to be impossible for the government because it would have meant directly contradicting the interests of the entrenched elites, on which its mandate depended. The conditions were not fulfilled, and the loan disbursement was promptly stopped. The access to international money did not materialize, while the situation continued to deteriorate.

Having lost the IMF money, the government continued borrowing from the BNB (three loans in September and October 1996 for a total of BGL 17.5 billion) and from the financial and non-financial public (increased emissions of treasury bills with constantly dropping maturity and rising nominal interest rates, accompanied with two changes in the budget act introducing sharp increases in the deficit). Given the dominant behavior in the country, this led to acceleration of inflation without changing the major real trends.

At this juncture, after having stopped the financing of the government, the IMF introduced the idea of establishing a currency board arrangement in Bulgaria. It was then perceived as an adequate response to the actual situation in the country. The currency board is a simple reputation mechanism, which brings financial stability and credibility of economic policies through a highly institutionalized and obliging exchange rate peg. Its major consequence is a sharp increase in financial transparency and in financial discipline. Thus a currency board was an adequate measure addressing the fundamental problems of the Bulgarian economy.

By then, even though the government generally agreed with the idea of introducing a currency board, it was not believed by the public to be a player capable of enforcing the arrangement. From that moment on, the solution of the crisis lay outside of the Socialist government. While it continued with its previous policy of borrowing more and more internally, it was not capable of doing anything to address the fundamental problem of financial discipline. Thus, in the last days of 1996, Parliament voted the last change in the Budget Act, which ordered the BNB to provide a loan for the staggering BGL 115 billion (6.6% of the 1996 GDP) to the government. The stage for hyperinflation was set [9], and the government resigned.

In the very beginning of 1997, there were two major developments. While hyperinflation was cleaning the bad internal debts, the Socialist majority in Parliament was trying to form a new government with a new credit of trust from the public. At the same time, the public was demonstrating, at moments even violently, that it could offer no credit of trust to this majority. The new president, a member of the opposition, was trying to find a solution to this situation [10].

On February 12, 1997 the president called the early elections for mid-April, and approved a caretaker government formed mostly by representatives of the opposition. On February 12–14, 1997, the highest ever central (announced by the BNB) exchange rate of the US dollar to the Bulgarian lev was recorded at BGL 2, 936.7 for USD 1, and in some exchange bureaus the rate was significantly above BGL 3,000 per 1 USD. By the end of February 1997, the exchange rate of the dollar had dropped by one third to BGL 2,045.5 per USD 1.

In March 1997, the caretaker government concluded negotiations and signed a one-year agreement with the IMF [11]. The agreement included the obligation of the Bulgarian government to introduce a currency board arrangement, for which the IMF was to provide and secure support. The dollar continued dropping to below BGL 1,500 per USD 1, the international reserves started rising quickly, and the government, on its own initiative, started behaving as if the currency board rules were already in place.

On April 19, 1997, the early Parliamentary elections gave a new absolute majority of the center-right Union of Democratic Forces, whose program included completion of market reforms and strict financial discipline guaranteed by a currency board. International support for the change continued, and Bulgaria experienced an unprecedented capital inflow. In May 1997, the new government was sworn in, and

[9] The rate of inflation in January and February 1997 was a cumulative 392 %.

[10] Under the Constitution of the Republic of Bulgaria, the president is a mostly representative institution and has only limited powers, mostly in limiting other branches of power rather than in pushing his or her own agenda.

[11] It constituted a precedent for the IMF to sign an agreement with a caretaker government.

in June 1997 all the necessary legislation for the currency board was passed.

The currency board in Bulgaria was officially introduced on July 1, 1997, with BGL 1000 equal to DM 1. In the case of Bulgaria stabilization happened quickly and without high social cost – most of the pain was experienced during the crisis and public support for the change was very strong. The exchange rate of the US dollar converged to the rate corresponding to the international USD/DM exchange rate as early as May 1997. Inflation converged to sustainable levels in less than half a year, interest rates dropped immediately to levels very close to the ones in Germany. GDP recorded growth as early as the last two quarters of 1997, and growth has been positive in the following 3 years.

1.6. Conclusion

In 1996–1997, Bulgaria experienced a sharp and severe crisis. The crisis was complex, involving drops in output and a financial crash, including a banking crisis and a currency crisis.

The indicators, describing the road to the crash, include unsustainable fiscal deficits, low savings and investment, accumulation of bad debts (both public and private), and accommodating monetary policy.

The fundamental cause of the crisis was the behavior of the Bulgarian economic agents. Their dominant behavior was to extract rents from the state, and the institutionalization of this behavior created the conditions for macroeconomic imbalances. In the Bulgarian conditions, this way of doing business succeeded and resulted in predatory economic behavior based on non-cooperation, short-term actions, and escape from responsibility. Influential elites were interested in preserving the culture of soft budget constraints, of half-hearted reforms, and of insecure property rights. However, their actions led to the accumulation of unsustainable imbalances in the economy.

The crisis led to a change in public attitudes and to the institutionalization of a different economic culture of greater financial discipline and more decisive market reforms, manifested most strongly in a currency board arrangement. Since this solution addressed the fundamental causes of the crisis, stabilization occurred quickly and led to a visible turnaround in the major economic indicators. In the four years after the peak of the crisis, the economy has not exhibited unsustainable imbalances, and has achieved steady (albeit relatively low) GDP growth.

Appendix: Chronology of the Bulgarian Crisis

Date	Event	Result
March, 1990	Unilateral default of Bulgaria on its official foreign debt.	Bulgarian government and private agents could not borrow internationally
February, 1991	Beginning of partial reforms in Bulgaria: liberalization of some prices, interest and exchange rates.	Initial drop in output, beginning of rent seeking through soft budget constraints due to lack of financial discipline and property rights enforcement.
July 28, 1994	First payment to the London Club according to the renegotiated foreign debt service agreement.	Bulgaria started facing serious payments every six months. No way around this first occasion of a hard budget constraint.
November 30, 1995	Acquisition of Agrobusinessbank by the BNB for BGN 1.	Beginning of explicit banking crisis, to be followed by many other liquidations of banks.
March, 1996	Grain and bread crisis.	Caused by rent seeking operations preying on state controlled prices, the crisis led to loud public outcry and exacerbated the political position of the government.
April 19, 1996	The Bulgarian lev lost 2 percent of its value against the dollar in one day.	**The beginning of the currency crisis**, during which the Bulgarian lev depreciated by 3500 percent in approximately 300 days.
May 17, 1996	The BNB put Mineralbank, a large state owned bank, and First Private Bank, the largest private bank, under receivership.	The banking crises entered its trough. Trust in the system was shaken, flight from the Bulgarian lev began.
August, 1996	First tranche from a new agreement with IMF received	Temporary slowdown in exchange rate depreciation and a pick up in privatization, predominantly of separate parts rather than of whole enterprises.
September 23, 1996	The BNB put another 9 banks under receivership and adopted a set of measures for recovering the financial stability.	The set of measures announced by the BNB did not remove the fundamental factors for the crisis and had no impact on economic agents' behavior and on macroeconomic turbulence.
October 26 – November 2, 1996	Two rounds of presidential elections. The opposition candidate won by a large margin.	The ruling party was losing political support and capacity to govern.
November 6, 1996	An IMF mission poses the issue of introduction of a Currency Board Arrangement (CBA) as a was out of the crisis.	A heated public debate in which the government claims it had capacity to implement a CBA, while the opposition denied the existence such capacity and political will.
December 22, 1996	Resignation of the government of the Bulgarian Socialist Party.	Beginning of a political crisis, in which the Socialist Party was trying to form a government and the opposition and the public demanded early elections.
December 27-28, 1996	The Parliament voted to provide three BNB loans for a total of BGL 115 bln., 6 % of 1996 GDP, to the Ministry of Finance.	The stage was set for hyperinflation during the first six weeks of 1997.
February 4, 1997	After a month of public protests and strikes, the Socialist party gives up its attempts to form a new government.	The newly elected President obtained the opportunity to appoint a caretaker government and to set a date for early elections.
February 12, 1997	Caretaker government appointed, new elections scheduled.	Beginning of a recovery program enjoying high public confidence and international support.
February 14, 1997	Peak of the BGN/USD exchange rate.	**End of the currency crisis.** The dollar starts falling.
May 21, 1997	A new center-right government, enjoying an absolute Parliamentary majority, was sworn in.	Beginning of implementation of a massive reform package, starting with the legislation setting up a CBA.
July 1, 1997	Official start of the Currency Board in Bulgaria.	The fundamental causes for the crisis are essentially tackled, financial discipline introduced, and reforms enabled.

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Part II.
The Russian Crisis of 1998
by Rafał Antczak

Introduction

There are three questions to be answered in this paper. What was the fundamental nature of the Russian crisis in 1998? How effective were implemented measures to manage the crisis? What are the consequences of the crisis for the Russian economy?

To understand developments in Russia leading to the crisis of August 1998, one has to go to the roots of the economic problems following the collapse of the Soviet Union. Part 1 describes the growing fiscal deficit financed by expansionary monetary policy and suppressed inflation that led to the economic and political collapse of the Soviet Union. Persistency of economic wrong-doings during 1990–1991 in Russia was followed by the unsuccessful stabilization efforts during 1992–1994. The balance of these first stabilization attempts in Russia is developed in Part 2. The next part is devoted to the period of 1995–1998 when illusive stabilization was reached. A description of the crisis and its management is analyzed in Part 4, together with the most current developments in the Russian economy. Additionally, Appendix 1 presents a chronological description of the main events leading to the August 1998 crisis.

2.1. The Break-up of the Soviet Union and Collapse of the Ruble Zone

The collapse of the communist regime resulted in a gradual erosion of central planning and worsening of economic situation in USSR since eighties. The broad attempts of systemic changes, begun in 1987 with Mikhail Gorbachev's reforms, only accelerated the downfall as the traditional discipline of central planning began to fail due to partial economic and political liberalization under *perestroika*. The expansionist monetary policy was a response to a growing budget deficit that, according to IMF estimates, was 2.4 percent of GDP in 1985, 6.2 percent in 1986, 8.4 percent in 1987, 9.2 percent in 1988, and 8.5 percent in 1989. The broad money supply increased at the rate of 8.5 percent in 1986, 14.7 percent in 1987, 14.1 percent in 1988, and 14.8 percent in 1989 [1]. During the perestroika period, economic growth completely ground to a halt. Russia's net material product (NMP) increased by only 2.4 percent in 1986, 0.7 percent in 1987, 4.5 percent in 1988, and 1.9 percent in 1989. What is more, partial economic liberalization gave enterprises more maneuvering room in using their funds, thus speeding up money velocity and compounding inflation. Hidden inflation grew throughout the years of *perestroika* as prices of basic goods were regulated by the state.

The 1990–1991 period marked a further dramatic decline in production and uncontrolled increase of money supply. From the beginning of 1990s, the Russian NMP decreased by 3.6 percent in 1990 and 11 percent in 1991. The main cause behind NMP decline included the crisis of central planning, disruption of discipline in state enterprises, the collapse of trade in Central Europe following the liquidation of Comecon, and gradual collapse of commercial links among Soviet republics. Estimates by the IMF suggest that the Russian Federation's budget deficit reached over 30 percent of GDP in 1991, as Russia became responsible for the entire budget of the Soviet Union. The growing deficit financed solely by credits from the State Bank of the USSR (Gosbank) and, to lesser extent, central banks of individual republics, became the main factor leading to hyperinflation. Additionally, credits were channeled to enterprises by republican banks that perhaps as early as in 1990 ceased to abide by the Gosbank's directives regarding limits on the credit issue.

In the spring of 1990 the new Supreme Soviet [2] of the Russian Federation elected Boris Yeltsin as its speaker – at that time also the formal head of the Russian Federation. The declaration of sovereignty of the Russian Federation from June 12, 1990 was the first step towards the disintegration of the USSR taken by the new Russian parliament. And the Law on the Central Bank of Russian Federation and

[1] IMF et al. 1990.

[2] Mikhail Gorbachev decided to organize in March 1990 democratic elections to republican supreme soviets, council on *the oblast'*, *raion*, and city levels.

Law on Banks and Banking Activity from December 1990 were the first concrete steps on this path. The newly created CBR with Georgii Matyukhin as governor began to take over the personal and administrative control over all regional branches of the Gosbank on the Russian territory. The CBR did not respect the Gosbank recommendations and decisions in relation to credit emission, interest rate policy, or reserve requirements. It started to finance the republican budget deficit and Russian enterprises through fully autonomous credit emission. The monetary and banking war was followed by a war in fiscal policy. The Russian government started to consolidate control over all-union enterprises offering them lower tax rates. Collected taxes were transferred to the republican budget but not to the Union budget. This practice was followed later by some other republics. At the same time, the Soviet government of Prime Minister Valentin Pavlov tried desperately to improve the macroeconomic equilibrium by non-equivalent exchange of 50- and 100-ruble banknotes on January 1, 1991 and administrative change of prices, with some elements of liberalization, especially in the area of production supplies [3].

In the second half of 1991, the Union budget was left without revenues and with fixed expenditures, like military and security forces, central administration, some subsidies and investments, which forced Gosbank to uncontrolled monetary expansion financing huge deficit. The political events gained momentum. In June 1991, presidential elections in the Russian Federation were won by Boris Yeltsin that led to the August 1991 *coup d'etat* [4]. The failure of the August coup accelerated the process of political and economic disintegration of the USSR. During the next several months, Gosbank definitely lost control over monetary policy in Russia and the Baltic states, price controls gradually weakened due to political collapse of the regime, and inflation become took on an open form. In the second half of 1991, relaxed financial discipline fueled a fast growth of nominal wages and inflation. Between December 1990 and December 1991, CPI prices grew by 144 percent and 93 percent on average (see, Table 2.1).

From the beginning of 1992, all of the fifteen former Soviet republics became independent states having their own central banks but using the old Soviet rubles and functioning in monetary union. Although Russia became a monopolist in the emission of ruble cash, some republics began to introduce parallel cash currency (coupons), and most of the central banks were behaving like "free riders" trying to outbid each other in the emission of money in the form of credit (e.g., Ukraine, Belarus, Lithuania, Azerbaijan) [5]. The traditional structural imbalance in inter-republican trade in favor of Russia (energy resources and capital goods versus consumer goods) and vastly expansive monetary policy in several republics caused an enormous import of money in credit form by Russia in 1992 and the first half of 1993.

The end of June and the beginning of July 1992 marked the first alternative for former republics. At the end of June, Estonia decided to exit from the ruble area and introduced a national currency. Latvia, Lithuania, Ukraine followed suit in July, October, and November 1992, and Kyrgyzstan in May 1993. At the beginning of July 1992, the CBR introduced requirements of daily clearing of settlements between Russia and other post-Soviet republics still using rubles. Payments made by these states to Russia were realized only in the amount in the corresponding account of a given central bank with the CBR on a given day and were not allowed to finance trade with any third state – they were strictly bilateral. This step meant an end of the ruble as a uniform currency in non-cash settlements and the creation of national non-cash rubles. In cash turnover, the ruble remained a common currency although the use of monetary substitutes (coupons) expanded due to Russia's rationing of cash ruble deliveries. The demand for cash rubles increased as payments for imports from Russia were realized in cash, given the existing limits on credit. However, this monetary arrangement has been softened until spring 1993 by a supply of the so-called technical credits for the ten former republics from the CBR and the Russian government [6]. The sum of technical credits and cash deliveries amounted respectively, to 1,258 million and 412 million rubles in 1992 and 932 million and 1,260 million rubles during the first half 1993. These constituted respectively, 11.2 percent of the Russian GDP in 1992 and 7.1 percent in the first half of 1993 [7].

Exchange of banknotes by the CBR on the Russian territory at the end of July 1993 meant the final collapse of the ruble area. After several months of political bargaining over the idea of creating a so-called new style ruble area, all remaining post-Soviet states during the period from September to November 1993 (except Tajikistan until May 1995) introduced their own currencies. The further attempts to preserve or reanimate the ruble area included numerous agreements signed at summits of the Commonwealth of Independent States (CIS) but in general they were not very concrete and lacked in any effective implementation mechanism. Thus, all the monetary and banking agreements were never implemented and had no longer an impact on monetary and fiscal stance of Russia.

[3] Dąbrowski and Antczak (1998).

[4] The attempt taken by the communist party hardliners included the Vice-President of USRR Yanaev, Prime Minister Pavlov, Minister of Defense Yazov, KGB Chief Kryuchkov, and Supreme Soviet Speaker Lukiyanov.

[5] Dąbrowski (1995).

[6] With exception of the Baltic countries and Georgia, which opposed to any forms of closer cooperation with Russia.

[7] Granville and Lushin (1993).

Until mid-1993, the macroeconomic stabilization under the ruble area was not possible. The Russian Federation continued to import inflation and devoted limited resources to finance the rest of CIS states. The Russian politicians, not without a support of international financial institutions and foreign experts postponed decisive political actions to halt further financing of the ruble area and overestimated negative economic consequences of collapse of the monetary union. Prolonging this process significantly raised costs as Russia botched two macroeconomic stabilization programs in 1992 and in 1993.

2.2. Attempts to Reform Russia During 1992–1994. The First Currency Crisis in October 1994

At the beginning of November 1991, President Boris Yeltsin appointed the new government of the Russian Federation working under his own direct leadership. A team of economists under Deputy Prime Minister Yegor Gaidar drew up a program that contained certain elements of a radical approach, such as liberalization of domestic prices, forced program of corporatization and privatization of state enterprises, as well as gradualist approach towards demonopolization or foreign trade liberalization. The weakest element was macroeconomic stabilization and ambiguous attitude towards inflation. The political handicap of the first stabilization program became apparent with dissolution of the USSR in December 1991. The Russian Federation declared itself the political (and economical) successor of the Soviet Union. In practice, it also meant taking responsibility for the all-union budget obligations and debts of the former Soviet Union. The continuation of the ruble zone (see, the previous section) resulted in a very sizable financial support (technical credits and cash deliveries) to the CIS countries.

The reforms in Russia did not start without a support of the international financial institutions. The Russian Federation formally re-joined the Bretton Woods institutions in June 1992, and the Russian authorities' first agreement with the International Monetary Fund – the first credit tranche of stand-by arrangement (SBA) was approved on August 5, 1992 (to expire on January 4, 1993). The SBA was equivalent to 16.7 percent of Russia's quota at the IMF and Russia drew the full amount of SDR 719 million available under the arrangement. The IMF has not decided to put rigorous conditions on the SBA in 1992 and the Yeltsin-Gaidar reform program concerned mainly with liberalization, privatization, institutional reforms, and not at all with rigid stabilization policies. One of the distinctive features of this stabilization plan was that neither the wage nor the exchange rate would serve as a nominal anchor. The inflation objective was below 5 percent per month, which was not very ambitious. The political weakness of Yeltsin-Gaidar government became apparent with nomination of Victor Gerashchenko as the acting chairman of the Central Bank of Russia, who represented interests of lobbies (industrialists, regions, FSU countries, etc.) demanding credits from the authorities. During 1990–1992, the general government budget deficit of over 20 percent of GDP became persistent. Monetization of almost 20 percent of GDP deficit of enlarged government and credit lines to the FSU countries led to development of CPI inflation exceeding 20 percent monthly in the fourth quarter of 1992. Obviously, all the IMF targets were exceeded at the very beginning of the program in September-October 1992 [8].

On the Seventh Congress of People's Deputies President Boris Yeltsin distanced himself from directly running the government and agreed to personnel changes in the government's composition. Acting Prime Minister Yegor Gaidar was replaced by Victor Chernomyrdin as the Prime Minister confirmed by the Congress (on December 14, 1992). Victor Chernomyrdin was a moderate representative of the managerial lobby and was preferred by the majority of deputies. The government organized two weeks later included Boris Fedorov as deputy prime minister for financial policy. Many of the former deputy prime ministers and ministers remained in the government. In January 1993, Boris Fedorov started to prepare a stabilization program to lay the groundwork for the next round of negotiations with the IMF.

The first Article IV consultation was concluded on April 21, 1993 [9]. On June 30, 1993, the Executive Board approved an economic program to be supported by two-tranche purchase under the Systemic Transformation Facility (STF). Russia purchased the first tranche of SDR 1,078.3 million (equivalent to 25 percent of quota) from the IMF on July 6, 1993 [10]. The STF, as a new facility window allowed the IMF crediting the Russian government irrespective of failure of the previous program. Also, there

[8] Usually, the key quantitative benchmarks include cumulative limits for: a change in net credit (of the monetary authorities or/and the banking system), a deficit of the general government, a change in the net domestic assets, and a change in net international reserves.

[9] According to Article IV, Section 3 of the IMF Articles of Agreement, the IMF has the mandate to oversee the compliance of each member with its obligations, and each member should provide the IMF with necessary information.

[10] In April 1993, the IMF created the STF as a special facility for countries confronting problems with transition to market economies (mostly post-communist countries). The new facility was designed to members experiencing severe disruption in trade and payments arrangements, due to a shift from significant reliance on trading at non-market prices to multilateral, market-based trade. Access to STF was limited to 50 percent of the IMF quota and could be in addition to any other IMF facilities. Repurchases were to be made in the period of 4,5 to 10 years.

were many new features of the program. Firstly, the STF specified that the purchase from the IMF would not have to be added to the stock of Russia's official international reserves but would be available to provide additional credit to the economy (and to the budget). Therefore, the IMF drifted from its primary goal of providing financial assistance to countries that run into temporary balance of payments problems. Instead it entered the field of activity usually occupied by the World Bank and its agencies financing government projects or better to say budgetary expenditures.

The conditions of the STF program remained broadly the same as those of the SBA but requested more rigorous targets, especially on lowering budget deficit and its inflationary financing. They envisaged:

1. Upward pressure on interest rates and the CBR refinance rate was to move within seven percentage points of the interbank rate.

2. A decline in the rate of growth of money and credit. During the program the CBR credit to the government was projected at the level of 7.3 percent of GDP but it was not a direct target. Direct subsidized credits, whether by the government or the CBR, were to be limited and consistent with the program and direct central banks credits were to be phased out completely. The CBR was to increase the portion of credit extended to commercial banks through credit auction and other market-related mechanisms.

3. Expansion of access of nonresidents to foreign exchange market and establishment of mechanism to monitor foreign disbursements.

4. Firstly increase of export quotas by 20 percent for non-energy products and 10 percent for energy products, secondly elimination of all quotas in end-1993 except for oil, gas, and oil products.

5. Budget expenditure cuts amounting to 4.2 trillion rubles through reductions in subsidies to the coal sector of 1 trillion rubles, to grain producers by 0.5 trillion rubles, and 40 percent cuts in the average rate of import subsidy.

6. Budget revenue measures to increase collection from excise taxes on natural gas and oil of 0.6 trillion rubles and avoid new tax exemptions.

It the course of the program it was expected that the deficit of the enlarged government would fall from 11 percent of GDP in the second quarter of 1993 to 8.5 percent of GDP in the fourth quarter, which would have allowed inflation to drop from a monthly average of 17 percent in the second quarter to 8 percent in the fourth quarter (still over 150 percent on annual basis). The CBR was to maintain a floating exchange rate of ruble and abandon interventions on the foreign exchange market. Net international reserves were to halve during the program but maintain at the minimum level of $2.4 billion in December 1993. A decline in net reserves was to be supported by a rise in gross reserves from $5.8 billion in June 1993 to $6.8 billion in December 1993 as a consequence of successive STF disbursements.

The program went on a good start, but already in the third and the fourth quarters of 1993 targets were exceeded by wide margins. The reason was that tight monetary policy was not accompanied by fiscal adjustment. The attempt of parliament to continue 20-percent budget deficit in 1993 resulted in President Yeltsin veto and became one of the reasons of dissolving the Supreme Soviet in September 1993 (what led to a serious constitutional crisis and brought country on the verge of the civil war in the beginning of October 1993). In the end of 1993, Minister of Finance Boris Fedorov made a last attempt to limit expenditures and refused to pay some government obligations. The result of sequestration was a buildup of government arrears, some of which would have to be repaid. What concerns the role of the CBR, during the first half of 1993, the central bank provided credit lines to the FSU countries and during the second half of the year it kept monetizing budget deficit. The performance criteria agreed with the IMF such as credit limits or increases in interest rates were missed. The CBR exceeded limits of net domestic assets increase by wide margins or circumvented other IMF conditions distributing central banks credits below the market rate. As a result of permanent softening of policies in the second half of fiscal year, inflation was gaining momentum in the last quarter of the year exceeding 15 percent monthly in the fourth quarter of 1993.

The liberalization of exchange rate market in 1992, soon resulted in interventions by the CBR to maintain the exchange rate of around 1000 ruble per U.S. dollar. Real appreciation of ruble led to increase in imports, decline of reserves, and finally depreciation of ruble by 20 percent in September-October 1993 [11].

The second tranche of STF was to be disbursed in September 1993 after reviewing the program, however, the failures of the second program and political developments in Russia resulted in signing a new agreement with the IMF. On April 20, 1994, the IMF Executive Board approved the next program of the new Russian government [12] supported by a second credit of SDR 1,078.3 million under the STF. The major goal of the program was to safeguard the fragile achievements of the Russian reforms, especially in the areas of price and exchange market liberalization, and foster structural reforms, extending the privatization process, liberalizing external trade, increasing competi-

[11] In the same period, but a year earlier similar depreciation of the ruble took place.

[12] Victor Chernomyrdin remained Prime Minister and Sergiei Dubinin was nominated as Minister of Finance.

tion, and boosting transparency. Gradualism was officially the key operating concept both for Prime Minister Victor Chernomyrdin and the IMF. Again, conditions of the second STF program were similar to the first STF.

The year 1994 witnessed the repetition of the previous stabilization efforts. Until the second quarter of 1994, the government program followed by the second STF agreement had been implemented and limits on credit growth and budget deficit financing by the CBR were hold. The monthly inflation rate fell to 6 percent in June 1994 and even fell to 4.5 percent in August 1994. However, the government managed to keep its borrowing from the central bank within the program target only because it relied on aggressive sequestration of expenditures. In the third quarter of 1994, credits from the central bank surged as revenues lowered in relation to GDP and subsidies to agricultural sector, the Northern Territories, and other customary recipients of budget financing rose sharply. Government's ability to use sequestration diminished and Duma [13] rejected most of the revenue measures specified in the budget.

After international reserves dropped by almost $4 billion in the third quarter of 1994, foreign exchange market participants started to speculate against the ruble. They were fully aware of inconsistencies in expansionary fiscal policy, and quasi-tightening of monetary policy limiting credits to banks but expanding deficit financing. On October 11, 1994, the ruble tumbled in the Moscow interbank market by over 20 percent against the U.S. dollar. "Black Tuesday" became the first currency crisis in post-communist Russia.

In the fourth quarter of 1994, the central bank limited credit expansion to banks and the government, and Ministry of Finance restricted expenditures but also started issuing government securities (KOs) to finance enterprises well below the market rate. Tightening of credits led to rise in interest rates but inflation continued to increase reaching a monthly rate of 16 percent in December 1994. Altogether, the exchange rate depreciated by 45 percent during the second half of 1994. The first currency crisis in 1994 was a warning indicator. However, it was broadly misinterpreted by the Russian authorities as wrongdoing of speculators.

The macroeconomic stabilization during 1992–1994 was characterized by the lack of authorities' ability or will to sustain adjustment efforts. Fiscal policy remained too expansionary and monetary policy monetized fiscal and quasi-fiscal deficits. None of the IMF (and government) stabilization programs were successfully carried through, as there was a systematic tendency to relax economic policies in the second half of each year. A decline in CPI inflation from over 2,320 percent in 1992 to 215 percent in 1994 was a minor success. Doubtful progress in reforms damaged the credibility of the authorities and liberal approach to the transition process undermining the pace of reforms during next years.

There were few successes in the structural area and their picture was very mixed. The prices were liberalized on a federal level. Mass privatization process began and capital privatization of smaller enterprises picked up with cash auctions but came to a halt by end-1994 as result of political pressures. Lack of well-defined ownership structure and property rights slowed enterprise restructuring. Agricultural reform was very slow. Foreign trade became more liberal as import subsidies and most export duties on non-energy products were eliminated or reduced. However, the scheme under which only special traders were allowed to export "strategic" commodities was left intact, and the export licensing system was replaced by a restrictive export contract registration system. Also, export duties remained higher than envisioned and import duty exemptions were not abolished. Therefore, foreign trade regime remained non-transparent and subject to rent seeking. Contrary to trade liberalization, financial markets' liberalization was deep and comprehensive. Exchange rate was unified and most exchange rate restrictions on current and capital account were phased out. The institutional and legislative framework was strengthened (exchange rate market, Treasury bill market, and the foreign investment code) as well as the independence of the central bank. However, this last function was understood opaquely during the whole period of 1992–1994.

2.3. Further Stabilization Efforts in 1995–1997 – Stagnation and Decline

The exchange rate crisis on October 11, 1994 led to the next reshuffle in the Russian Cabinet of Ministers. Finance Minister Sergei Dubinin and the CBR governor Victor Gerashchenko were fired. Anatolyi Chubais was appointed the First Deputy Prime Minister in charge of economic policy, Yevgeni Yasin became the Minister of Economy, and Tatiana Paramonova acting governor of the central bank. Negotiations with the IMF resumed on a program that could be supported by a Stand-by credit of up to SDR 4,313 million.

As in previous years, at the beginning of 1995 a major tightening of monetary and fiscal policies took place. During January, the stock of credit to the government was frozen, the CBR increased reserve requirements and as international reserves kept declining, the base money dropped by

[13] The lower house of the Russian Parliament elected first time in December 1993.

9 percent. Inflation slowed to 10-11 percent in February-March. On March 10, 1995, President Boris Yeltsin, in a letter to Michael Camdessus, Managing Director of IMF, expressed his wide support for the new arrangement. On April 11, 1995, the IMF Executive Board approved the Stand-by arrangement supported by a credit of SDR 4,313.1 million for a period of 12 months. Additionally, the IMF waived Article V, Section 3(b)(iii) that provided for an increase of up to 200 percent of the member country's (Russia's) quota. In the official statements, the SBA was aimed at decisive progress in stabilization and structural reform during 1995 and it envisaged the same old measures as in the previous programs. In the course of the stand-by program, quantitative targets were all met, however, the most vulnerable remained the situation in fiscal sector, because of substantial revenue shortfalls. At the end of 1995, the Russian authorities probably used "window dressing" to achieve the quarterly targets. Structural reform targets were considered as relatively sluggish, especially bank restructuring and the pace and scale of privatization have fallen behind expectations. To sum up, from 1995 the Russian authorities apparently managed to stick to some macroeconomic targets while they were forced, under the pressure of different lobbies, to slow down the structural reforms.

The relative success of the 1995 Stand-by arrangement, compared to the previous programs, allowed the Russian authorities to request IMF support for the medium-term program of macroeconomic stabilization and structural reforms. In a letter dated of March 6, 1996, the Russian government requested three-year arrangement under the EFF in the amount of SDR 6,901 million or 160 percent of quota. The ongoing stand-by program would then be cancelled as of the date of approval of the extended arrangement. Such trade off gave positive results as early as March 26, 1996 when the IMF Board approved the program (and again waived Article V).

The proposed strategy for 1996–1998 aimed at setting the basis for sustained growth by: lowering inflation toward a single-digit annual rate, implementing key structural reforms, and achieving medium-term viability of the balance of payments. The 1996 program was based on quite optimistic assessments, such as a high rate of GDP growth (6 percent since 1997), 1 percent inflation monthly from the end-year, recovery in money demand, repatriation of flight capital, increase in foreign direct investments, and a comprehensive restructuring of debt obligations ($7 billion). The debt service burden was especially large for the federal budget as maturities and arrears began to accumulate during the next few years, and this perception seemed to be apparent already in 1996.

However, the critical element of the medium-term strategy was a further reduction in the overall fiscal deficit of the enlarged government from around 6 percent of GDP in 1995 to 4 percent of GDP in 1996 and 2 percent of GDP in 1998. Local governments and extrabudgetary funds were to remain balanced and deficits financed from non-inflationary sources (without credits from the CBR). The fiscal performance envisaged a net increase in revenues close to 5 percentage points of GDP over the medium term (increase in tax rates, broadening the tax base through elimination of tax exemptions and preferential treatment, especially energy resource producers). The monetary framework targeted the same parameters as previous programs, limiting the pace of credit expansion and monetization of budget deficit.

2.3.1. Real Sector

Slow progress in creating favorable micro- and macroeconomic environment contributed to the further decline of the Russian economy during 1995–1998, after a dramatic output fall in years 1991–1994 (Table 2.1 and Table 2.2). The cumulative GDP decline in the latter period reached over 35 percent, and during 1995–1998 an additional 11 percent. During 1991–1994, a sharp decline was registered across all branches of the Russian economy. In the years 1995–1996, industrial output decreased by 3–4 percent annually. In extraction industries, producing 6 percent of GDP, this decline was even smaller (1–2 percent annually) while processing industries giving around 23 percent of GDP recorded a decline of 4–5 percent annually. Agricultural output remained in decline, as higher crops were more than compensated by a strong decline in animal production. The year 1997 indicated slow recovery, both in industrial and agricultural output and in line with trends of 1995–1996. The growth was registered in industry and crop output, and GDP rose by 0.9 percent in 1997 (Figure 2.1).

Looking at the components of the global demand, the movements in GDP were dominated by households' demand that represented 49 percent of GDP in 1995–1996 and increase up to 56 percent of GDP in 1998 (Figure 2.2). General government consumption represented roughly 20 percent of GDP. Generally, during 1992–1996, the decline in real consumption of households and government was lower than GDP, and during 1997–1998 growth in consumption outstripped GDP growth by 2 percentage points. It was fuelled by rising real wages and income and the lack of public sector adjustment. Changes in net export were relatively less important representing 3–4 percent of GDP in 1996–1997. In 1998, the share of net export increased to 8 percent of GDP as domestic demand collapsed.

The sharp decline in output over the transition period has been accompanied by even sharper declines in investment. The decline could have had a positive influence if it reduced inefficient areas of investment. However, the fail-

ure to impose hard budget constraints has allowed many non-viable enterprises to survive and widespread corporate governance problems have prevented viable enterprises from improving efficiency and boosting growth.

2.3.2. Structural Reforms

The early years of transition were marked by liberalization of prices and internal trade, but the process of privatization was impeded by implementation problems (unregulated financial markets), complicated ownership structure (federal vs. local authorities), and political bargaining related to control over the biggest enterprises.

The decision to choose mass privatization as the main vehicle of ownership changes in Russia was based on the expected pace of this process comparing to case-by-case privatization and broad participation of citizens. Between 1992 and 1994, over 15,000 medium- and large-size enterprises employing over 80 percent of the industrial workforce were privatized.

However, the lack of an adequate legal and institutional framework to support ownership changes that suffered from poorly defined property rights, weak corporate governance, lack of bankruptcy discipline, and consequent competition policy undermined privatization. Accounting and auditing standards diverged widely from international ones and were not reliable for investors. The loans-for-shares scheme of 1995 made the privatization process even less transparent [14]. Only in mid-1997 case-by-case privatization was supported by the passage of a new Privatization Law. However, eight large-scale privatization tenders carried out in 1997 and 1998 contributed less that 1 percent of GDP and caused political tension domestically and abroad [15].

The poor financial situation of enterprises in Russia also resulted from low labor productivity (or high costs, including social ones) and inflexibility of labor market that hindered restructuring processes (see, Figure 2.3). The Russian Labor Code was inherited from the Soviet era and has been subject to piecemeal amendments. It constrains the right of management to lay off workers (without a consent of trade union and an offer of alternative employment). Excessive social safety net brings additional constraints on labor mobility. Housing and other social benefits have been traditionally provided by the biggest industrial employers what has increased costs of labor and limits workers' willingness to resign from job. These social factors have been particularly important in one-company towns, which have lacked alternative sources of employment.

Despite significant reallocations of labor from industry to the service sector (of roughly 7 percent of total employment in 1991–1997), the pace of labor shedding lagged behind the output decline. Formal employment declined by over 12 percent during 1991–1997 while GDP decline exceeded 40 percent. Except legal barriers, enterprises have continued to hoard labor also due to potential bargaining vis-a-vis regional or federal authorities. In practice, managers have resorted to hidden unemployment – putting workers on administrative leave or part-time schedules and increase wage arrears. Workers have often tolerated wage arrears, as non-wage social benefits provided by firms have been more important and opportunities of alternative legal employment have been non-existent.

Registered employment increased from 0.8 percent to only 2.8 percent of the labor force in 1992–1997. Using the ILO definition, unemployment increased from 4.8 percent to 11.1 percent in this period. Regional variations in unemployment rate remain very high (e.g. in 1997, 3–4 percent unemployment rate in Moscow region and 58 percent in the Republic of Ingushetia what reflects very limited labor mobility).

After the adoption of the exchange-rate based stabilization program in 1995, inflation began to decrease (see, below) and average real monthly wages showed some increases in 1995–1997 but still have been lower than in 1992–1994 period (Figure 2.3). More relevant from the point of view of competitiveness, wages in U.S. dollar terms have increased significantly, reflecting the real appreciation of the ruble. Labor productivity calculated as the ratio of output to employment declined the most in light industry, electric power generation, and metallurgy from 60 to 40 percent, comparing to 1991 level. The lowest decline was in machinery and forestry sectors by 10 percent. The cross-sector decline in labor productivity from one side and appreciation of the ruble from another side worsened microeconomic fundamentals during 1995–1997. Accumulation of wage arrears that had been growing since 1992 might have been perceived as an attempt to lower costs by enterprises but their macroeconomic and microeconomic effects were very negative.

Privatization of small- and medium-size enterprises after the initial surge also continued at a slow pace. The list of "strategic" enterprises that could not be privatized was

[14] Due to the lack of financial resources to finance budget deficit (and implicitly to support presidential campaign of Boris Yeltsin), the Russian government drew funds from the market (private financial and non-financial institutions) with shares of the most valuable state enterprises as collateral. Obviously after elections the government was not able to pay the loans back.

[15] During the famous "Svyazinvest" tender, the Russian "oligarchs" Gusinskii and Berezovskii fighted together against Potanin who had a foreigner George Soros as a minor partner. Potanin and Soros were attacked in the most furious way both by the NTV and ORT (the television networks controlled by the competing "oligarchs").

reduced only in July 1998 from 3,000 to 700 (as one from many steps to please the IMF under negotiations of a new arrangement). As of end-1998, over 130,000 enterprises had been privatized since the start of the transition and some 90,000 enterprises remained public-owned (mostly by regional and municipal authorities).

Conditions for the new firm entry have continued to be very difficult. Numbers of small new enterprises increased insignificantly from 841,000 in 1996 to 868,000 in 1998. According to the World Bank, several factors have contributed to such poor development compared to other transition economies. These have included widespread and discretionary licensing and regulatory requirements, a complex and burdensome tax system, absence of bank credit, weak enforcement of property rights, discriminatory access to business premises and urban land, and corruption and organized crime. The average new business applicant must deal with 20–30 registration and licensing agencies and a tax system consisting of over 25 different taxes and fees. It is hard to expect that such business conditions could generate a vibrant and growing economy.

The major infrastructure firms such as gas giant Gazprom, Transneft – the oil transport company, RAO UES – the national electricity holding, and the state rail holding play a central role in the Russian economy. Tariffs usually do not reflect economic costs, numerous exemptions and rebates are granted inside Russia and for some FSU countries (e.g., Belarus) on social and political ground. As a result, cash collection ratio was around 15 percent for energy supply and below 50 percent for rail freight. Financial losses of infrastructure monopolists have had also quasi-fiscal consequences as they have been passed to the government via in-kind payments and reduced return on the authorities' ownership stake.

Uneven progress in structural reforms was one of the main reasons of weak economic performance of enterprises and persistent fiscal problems. The lack of financial discipline on a macroeconomic level was reflected by huge budget deficits in the Russian Federation practically until 1998 (Table 2.4). Monetization of deficits in 1990–1993 by the CBR was later replaced by borrowing on the treasury bills market and introduction of non-monetary settlements, such as promissory notes, tax-expenditure offsets, barter transactions, and accumulation of arrears. Lack of financial discipline at the federal level tempted public and private enterprises to draw resources from the budgetary sector and from each other's adding to the non-payment problem of the Russian economy.

The tax arrears, usually related to contributions to extra-budgetary funds, entailed a fiscal subsidy to enterprise. During 1995–1996, the yearly increase in tax arrears of 4–6 percent of GDP was equivalent to roughly two-thirds of the general government deficit. The level of wage arrears of 2–3 percent of GDP was less significant. Irrespective of the fact that the federal authorities were responsible for only one-fifth of them, their political importance before every election in Russia increased and led to the depletion of financial resources from the budget. Enterprises often used in-kind payments and quasi money to pay wages, and workers were forced to accept barter transactions.

However, inter-enterprise arrears posed a more serious problem. Total payables were growing at a slower rate than total receivables, resulting in growth of net arrears of the enterprise sector to over 15 percent of GDP in 1998. The pattern of non-monetary payments usually was the following, the enterprises from manufacturing and agricultural sectors as well as households were subsidized by the energy and transportation sectors. The federal authorities subsidized the latter (and the former) by accepting the tax arrears and barter operations. The data indicated 40–50 percent share of barter in total sales in 1998 [16].

Promissory notes (*veksels*) were issued by banks and enterprises, and their beginning originated from the government notes (see, next part). The denomination of *veksels* into cash as legally binding was often restricted by issuers, which required redemption in their products or through a specified agency or chain. The estimations of the total value of veksels in the Russian economy varied from 20 to 120 percent of broad money [17].

The broad use of non-monetary settlements had serious negative consequences for the Russian economy. The broad use of non-monetary transactions resulted in non-payment crisis. The authorities, under the pressure of enterprises endangered by a loss of financial liquidity, involved themselves in clearing operations. The injection of liquidity in the form of credits to the economy always led to increases in inflation that hindered the credibility of stabilization efforts. Soft budget constraints on micro- and macro level reduces incentives for enterprise restructuring when nonviable enterprises exist on expense of viable ones that need to bore additional costs and lose their efficiency. Non-monetary payments allow redistribution of property by non-market forces with involvement of insiders (managers) and at the expense of owners (authorities or shareholders). The financially non-transparent settlements may also favor tax evasion and corruption. All of the above factors had negative consequences for fiscal policy in Russia.

2.3.3. Fiscal Policy

Since 1995, Russia did not achieve its main fiscal policy objectives, which were a reduction in the unsustainable

[16] The World Bank – Russian Academy of Science, EBRD data.

[17] OECD data, Renaissance Capital Group (1997).

high deficit, a reversal of decline in budget revenues, and a reduction of expenditures. The general government primary deficit rose from 2.6 percent of GDP in 1995 to 3.1 percent of GDP in 1997, and overall deficit increased from 6.1 percent to 7.7 percent of GDP in the same period. At the same time, revenues of the general government increased only from 33.5 percent of GDP in 1995 to 35.5 percent of GDP in 1997, while expenditures increased from 39.6 percent to 43.2 percent of GDP in the same period. Although federal non-interest spending declined insignificantly from 15.1 percent of GDP in 1995 to 14.4 percent of GDP in 1997, there was a notable shift in government expenditure from the federal level to local and regional governments (by 1.6 percentage point of GDP during the same period).

Interest expenditures increased by 1 percentage point of GDP from 1995 to 1997. The increase would have been even higher, as GKO/OFZ interest expenditures almost doubled (to 3.3 percent of GDP) during this period but an agreement reached with Paris and London Club creditors (respectively, in April 1996 and October 1997) eased the tension in debt servicing.

After positive outcomes of stabilization program in 1995, the government program for 1996 envisaged a consolidation of the fiscal position, but fell short of expectations. In 1996, federal government revenues, after an increase in 1995, began to decline. This reflected a number of fundamental factors, but perhaps the most important among them was a continued recourse to non-monetary fiscal operations and tax offset schemes.

The use of non-monetary operations began in the fourth quarter of 1994 when the authorities attempted to close the fiscal year and clear mutual tax and spending arrears with *kaznacheskie obyazatel'stva* (KOs). The instruments carried below-market interest rates and holders were aware from the very beginning that at KOs' maturity it would allowed to convert them into *kaznacheskie nalogovye obyazatel'stva* (KNOs) and settle tax obligations. In 1995 from 1.4 percent of GDP of maturing KOs, 1 percent of GDP were used to convert them into KNOs. Until September 1996, the government issued KNOs at the amount of 2 percent of GDP.

In October 1996, the government conducted a clearing of arrears injecting liquidity to the banking sector. Commercial banks refinanced by the CBR were lending money to a tax debtor to pay tax arrears into a Treasury through the same bank. The same money would have then to be used to pay the budget recipient to clear inter-enterprise arrears and finally to make repayment of the bank loan. In the fourth quarter of the year clearing operations amounted to 1.2 percent of GDP.

In 1997, despite signs of recovery in the real economy (see, above), revenues continued to decrease. The clearing scheme was continued for the eight months of the year, then was supplemented by so-called reverse monetary offsets (RMOs). It differed from the previous scheme with respect to the first payment, which was initiated by the budget and not by tax debtor. From the end of 1997 to January 1998, 2.2 percent of GDP in the form of RMOs was conducted.

The clearing operations, except hikes in inflation, gave other undesired results. Arrears kept growing just after the clearing was over. The government cash collection and budget revenues declined both in 1996 and 1997 (indirect taxes increased but less then decrease in direct taxes).

Other factors that have contributed to poor fiscal performance included the weak tax administration in Russia. Large taxpayers, including energy resource companies routinely negotiated their tax payments. Complex and contradictory tax laws, high marginal tax rates, non-payments in the economy, and corruption among both taxpayers and tax collectors, have also eroded taxpayers' compliance. A number of tax reforms have been attempted, including large taxpayer inspection unit, limits on tax deferrals, elimination of tax privileges or attempts to change the tax laws according to requirements of the IMF. However, all these measures were ineffective as Parliament periodically rejected changes in tax law that would effectively increase tax compliance or implemented measures were inadequate. Therefore, improvements in tax policy did not gain political support, irrespective of an international conditionality.

On the expenditure side, increases in interest rates became the main factor of growth in federal government spending while non-interest expenditures remained broadly constant during 1995–1997. Attempts to reduce arrears and control expenditures on commitment basis were ineffective, as usually the preliminary successes in first half of the fiscal year were neutralized by growth in arrears in the second-half.

The fiscal position of the regional and local budgets has slowly deteriorated since 1995. Their balance moved from surplus of 0.5 percent of GDP into a deficit of 1 percent of GDP in 1997/1998. The deficits were financed by issuance of promissory notes (veksles) domestically, borrowing abroad (Eurobonds), and transfers from the federal budget on the average of 2 percent of GDP in 1995–1998. With constraints to access foreign markets in 1997, regions faced financial problems and the federal government made a loan of 0.8 percent of GDP to clear local wage arrears. In the course of 1998, the decline in federal transfers resulted in an increase of arrears to 3 percent of GDP.

The four main social extrabudgetary funds (Pension Fund, Social Insurance Fund, Employment Fund, and Federal Medical Insurance Fund) have also deteriorated since 1995. Expenditures increased from 8 percent in 1995 to 9.6 percent of GDP in 1997, following smaller increase in revenues from 7.5 percent to 8.8 percent in the same period,

and federal transfers doubled to 0.9 percent of GDP in 1997. Final result of a faster growth in expenditures than in revenues was a growth in primary deficit of general government from 2.6 percent of GDP in 1995 to 3.5 percent of GDP in 1998.

The interest payments increased to 4.2 percent of GDP in 1996 compared with less than 2 percent in 1995. In October 1997, the Russian budget began to suffer from increase in interest rates after the Asian crisis. The fast growing costs of debt service resulted from replacing monetization of the budget deficit in 1992–1994 with non-inflationary financing during 1995–1998 (ie, domestic and foreign borrowing). However, the financial pyramid was fragile as the maturity of domestic debt was getting shorter and remained vulnerable to interest rate changes. Therefore, the viability of debt pyramid required stable premiums on liquidity, maturity, and, most of all, on exchange rate. A real appreciation of the ruble additionally attracted foreigners to buy the Russian government papers, however, reversal in market confidence could end up in debt default.

2.3.4. Exchange Rate Regimes and Monetary Policy

At the beginning of 1995, the CBR tightened monetary policy and CPI inflation declined to a single digit level since March (to 8.9 percent monthly comparing with 17.8 percent in January 1995). In April 1995, the new law on Central Bank of Russia was passed, which prohibited direct lending to the government and provided independence in formulating monetary policy to the CBR. These developments laid the groundwork for an exchange rate-based stabilization policy.

In July 1995, the CBR introduced an exchange rate band ranging from Rub 4,300 to 4,900 per 1 U.S. dollar until the end-1995. Successful experience with the band resulted in a set up of new band of Rub 4,550–5,150 per U.S. dollar for the period January 1 – July 1, 1996. In July 1996, a crawling band with monthly depreciation of 1.5 percent was introduced, which started at Rub 5000–5600 and ended at Rub 5500–6100 per U.S. dollar at end-December 1996. Within the band, the CBR announced a narrower daily band at which market participants made transactions. For 1997, the CBR announced a crawling band beginning at Rub 5500–6100 and ending at Rub 5750–6350 per U.S. dollar, implying a depreciation of 4 percent for the center of the band, and actually the ruble depreciated by 6.7 percent over the year.

In November 1997, the authorities announced a new regime for 1998–2000. The exchange rate was centered at 6.2 re-denominated rubles per U.S. dollar, with a margin of +/-15 percent. At the same time, a narrower daily intervention band would remain in effect around an official mid-point rate for the day. In practice, the daily intervention band varied and had began with +/- 0.5 percent around the mid-point rate in January then it narrowed to +/- 0.3 percent in April, expanded to +/- 0.7 percent in the second half of 1997 and narrowed again to +/-0.3 percent by August 1998 (Figure 2.5). Effectively, exchange rate regime was heading towards the horizontal peg. The yearly rate of devaluation was at roughly half the level of yearly CPI inflation since 1995.

The CBR actively managed the exchange rate, heavily intervening in the foreign exchange market and using the interest rate policy to defend the ruble. During periods when demand for ruble assets was increasing, market interest rates were allowed to fall and the CBR reserves were increasing. But during periods when confidence towards ruble was endangered, market rates soared and the CBR sold reserves. Nevertheless, the impact of large external capital inflows on base money growth was offset by sales of foreign exchange by the CBR and capital outflow.

Money-based stabilization programs in the previous years (and floating exchange rate regime) failed because base money supply grew at the rate exceeding 40 percent quarterly, during 1992–1993. In 1994, this rate was lowered to 20–40 percent. Obviously, the main component of growth was credit to the government that financed budget deficit. Since 1995, the extension of credit by the CBR was restrained, but it was still possible to credit government out of the IMF loans provided to the CBR, i.e. through the sale of gross international reserves. This operation was similar to sterilization of capital outflow and did not affect base money. However, the CBR could continue purchasing the Treasury bills in the secondary market. Base money growth was lowered to below 10 percent quarterly in 1996. Exceptional were periods when organized offsets of arrears took place pushing base money growth to 10–20 percent quarterly. Nevertheless, some re-monetization of the economy occurred as broad money velocity declined from 15 times in 1995 to 12 times in 1996, and below 10 times in 1997.

The decline in central bank financing of the government budget deficit resulted from a rapid growth of the Treasury bill market. The stock of outstanding bills increased from about 1.2 percent of GDP at end-1994 to over 12 percent of GDP at end-1997. Nominal yields on bills fell during 1995–1997 (despite considerable volatility) as inflation rate declined. However, yields adjusted for inflation and depreciation of the ruble remained high, what reflected risk premiums on lending to the Russian government. The primary instrument of the CBR interest rate policy was the open market purchases and sale of T-bills. In addition to open market operations and foreign exchange market interventions, the CBR used some instruments to regulate liquidity of the banking system (lombard facility, repurchase agreements, or overnight settlement facility). The lombard rate was lowered in 1996 with a decline in inflation, from 160

percent in January to 48 percent annually in December, 1996. In October 1997, central bank and market interest rates reached their lowest levels: lombard rate – 21 percent and three-month Treasury bills – 18.3 percent.

Reduced inflation and high real interest rates had a positive impact on ruble demand. Broad money increased by over 20 percent in real terms from 1994 to mid-1998. Ruble deposits increased by 27 percent in real terms and currency in circulation by 16 percent during the same period. Dollarization also declined, as the ratio of foreign currency deposits to broad money declined from over 53 percent in 1997 to 43 percent in mid-1998 (Table 2.4).

Despite some progress in remonetization, commercial banks did not play active role in the Russian economy. Money multiplier remained almost constant at 2.2 since 1995, and real stock of credit to the economy in 1997 declined comparing to end-1994. Commercial bank deposit and lending rates fell steadily from January 1995 to end-1997, although effective real rates remained very high and interest rate spread lowered from over 40 percentage points in end-1996 to "only" 15–20 percentage points in 1997. The persistence of a large spreads could be attributed to a lack of competition, high costs of bank operations, including high portfolio of bad debts, and attractive yield offered by investment in government debt instruments (Figure 2.6).

From 1994 until 1997, credit to government from commercial banks crowded out credit to the economy. The real value of government securities in banks' portfolio increased by over twenty times from 1994 till mid-1998. The liquidity crisis during the first half of 1998 with rising interest rates and falling prices of government debt turned into a system-wide insolvency problem. Concentration of government securities in large Moscow-based banks that actively participated in foreign forward contracts to hedge foreign investors made them exposed to exchange rate and interest rate risks.

In mid-1998, commercial banks' short-term liabilities to nonresidents denominated in foreign currency amounted to $11.8 billion while foreign currency assets amounted to only $5.9 billion [18]. Total balance sheet liabilities denominated in foreign currencies exceeded total foreign assets in 1998 and the quality of the latter was doubtful. Also close to 30 percent of foreign-currency liabilities had maturities shorter than one month. Altogether, gross assets and liabilities of banks denominated in foreign currency exceeded $40 billion. The off- balance sheet different sort of forward foreign currency claims exceeded $90 billion and obligations over $80 billion in mid-1998. The foreign currency contracts were of short-term nature as they hedged short-term government securities.

Non-residents gained access to the GKO market in early 1996. They were allowed to participate in primary auctions and hold securities to maturity. Preliminary, foreign investors received a predetermined dollar yield of 25 percent through an effective CBR foreign forward contract, which in April 1996 was reduced to 19 percent. Since August 1996, all non-residents were allowed to participate in primary and secondary markets similarly to residents. They could keep all the ruble proceeds, however, their repatriation could not take place until the investor had purchased and held until maturity a three- to six-month forward foreign exchange contract. These contracts were provided by commercial banks, which were required to enter into contracts with the CBR for 90 percent of the amount to be repatriated.

The CBR was earning provision and was informed as for the calendar of potential outflow of foreign currency. What was more, it could gain on forward contracts intervening in the foreign exchange market and selling T-bills above the market rate (in ruble terms) as they still yielded to investors 19 percent per year. This yield was reduced to 9 percent in September 1997 and proportion of the forward contract provided by the CBR had been reduced to 25 percent. By the end of 1997, all restrictions on capital accounts had been removed and, in the beginning of 1998, the CBR withdrew from forward contracts. However, non-residents hedged their exposure through contracts with Russian commercial banks which, in turn, hedged with other domestic banks.

Until the crisis in mid-1998, Treasury bills, spot and forward foreign exchange contracts, and commodities were traded on numerous exchanges in Russia. Interbank markets were active and the debt market – including Treasury bills, floating rate federal savings bonds, and medium-term foreign-currency bonds (MinFin bonds) – was highly liquid. Short-term debt instruments, including promissory notes issued by banks, companies, and local governments were widely issued and traded. The number of stock exchanges was increasing in line with a lack of proper supervision and massive speculation.

The equity market in Russia belonged to the best emerging market performers in 1997. The performance of financial markets in Russia resulted from favorable treatment of investors by the Russian authorities. During 1995–1997, sequencing of capital account liberalization was based on short-term financial needs and was more progressive than current account liberalization where many obstacles to trade still existed.

Pegging the exchange rate of the ruble to the U.S. dollar with some tightening of monetary policy and stopping the monetary financing the fiscal deficit helped to lower inflation. Monthly CPI changes kept lowering from 6 percent in mid-1995 to less than 1 percent in the third quarter of 1996.

[18] Data may not be accurate as most of the Russian commercial banks did not report according to the IAS.

Monetary expansion, including netting-out operations, pushed monthly inflation to 2 percent in end-1996 – beginning 1997. However, high real interest rates attracted the inflow of foreign capital, which together with development of financial market instruments put an appreciation pressure on the ruble and provided sources of non-monetary deficit financing, bringing monthly inflation below 1 percent in 1997. This trend continued until mid-1998 when CPI monthly inflation rate reached a record low of 0.1 percent.

Such favorable conditions of a strengthening ruble was based on a new currency regime adopted in mid-1995. However, appreciation of the ruble was not based on microeconomic fundamentals (labor productivity) but on macroeconomic ones – inflow of capital, as interest rate differentials were high. Domestic demand increased followed by demand on import of consumption goods leading to balance of payments deterioration.

2.3.5. Balance of Payments Performance

Beginning in 1994 and through mid-1998, Russia's current account position deteriorated substantially, driven by a growth in imports and stabilizing exports (see, Table 2.5). This trend coincided with the continuing real appreciation of the ruble. After the shift in the destination of exports towards non-CIS countries in 1992–1994, which was driven by the partial dismantling of the former inter-republican trade relations and limiting trade imbalances between Russia and other FSU countries and removal of many trade barriers towards the rest of the world, there was little change during 1994–1998. The ratio of total exports going to non-CIS countries stabilized at 78–80 percent, of which 55 percent directed to Europe. Russian exports became increasingly dominated by primary commodities, where fuel products, ferrous and non-ferrous metals, precious stones, and forest products constituted from over 70 percent to 77 percent of total export in 1995 and 1997, respectively.

Imports revealed similar pattern with the share of non-CIS countries of 71–73 percent during 1995–1997. Despite a sharp decline in GDP, import was dominated by consumption goods, with 26 percent share of foodstuffs and 33–38 percent of machines (including cars). Much of the import growth was attributed to shuttle trade that amounted to over a third of total import in 1995–1997. The Russia's traditional deficit in services owed to interest payments increased by half to $15 billion in 1998 (4 percent of GDP) as interest payments on debt kept growing.

The balance of payments performance has been heavily influenced by capital and financial accounts and developments in international capital markets. Capital account balance moved from a deficit of $27.1 billion in 1994 to a surplus of $6.3 billion in 1997, and than to a deficit of $9.7 billion in 1998. There were two items dominating movements of capital. The federal government-related capital net inflows moved from a deficit of $11.2 billion in 1994 to a surplus of $15.1 billion in 1997. The disbursements of credits to the Russian government increased from $2.7 in 1994 to $8.8 billion in 1997 and net purchases of government securities went up from zero level in 1995 to almost $11 billion, while amortization declined from $14 billion to less than $4.6 billion in the same time. Such a surge in short-term inflow was mostly concentrated during 1997. The medium- and long-term investments also increased fourteen-fold comparing 1994 with 1997 but up to only $5.8 billion. Another dominating flow was related to net errors and omissions, which revealed a permanent outflow of roughly $8 billion in 1995–1997 and surprisingly the same size after the crisis in 1998 (see, below).

The relaxation of restrictions on nonresidents' holding of domestic papers decided in late 1996 together with interest rate differentials and "stable" macroeconomic conditions improved investors' perspective, making the Russian market attractive for short-term sovereign debt investments during 1997. The easy access to international capital markets also encouraged private entities and local governments to borrow abroad. The non-sovereign debt capital account deficit declined from $19 billion in 1996 to $13.5 billion in 1997. The overall improvement in debt indicators in 1996–1997 resulted from agreements reached on debt rescheduling. The agreements were reached with Paris and London Clubs in April 1996 and October 1997, respectively, and envisioned reduced debt service and lengthening the maturity structure of the debt. Another agreement with uninsured debtors was reached in December 1996.

Russia's growing indebtedness was not a concern to either authority, nor to international creditors, until the second wave of the Asian crisis hit in end-1997. At end-1997, Russia's total foreign currency debt stood at $169 billion, where sovereign foreign currency debt at $135 and non-sovereign debt at $34 billion. Two thirds of sovereign debt was inherited from the Soviet era (under the zero-option plan Russia accepted all liabilities of the former Soviet Union – including FSU countries' ones – but also took over all the Soviet assets). In the Russian era (i.e. after 1991) the sovereign foreign currency debt increased from $11.3 billion to $35.6 billion in 1994–1997 but nearly all of it had a medium- and long-term character. The data on residency of creditors are weak but estimations on debt to nonresidents stood at $152 billion in 1998.

The biggest obligations in non-sovereign debt were accumulated by banks, from $2.6 billion in 1994 to $19.2 billion in 1997, of which majority was short-term. Additionally, banks had large off-balance sheet obligations to non-residents coming from the forward foreign currency contracts. The sovereign foreign currency debt-GDP ratio showed a decline from 46 percent in 1994 to 30 percent of GDP in 1997 and a surge after the ruble devaluation to 50 percent

of GDP in 1998, and total external debt reached over 80 percent of GDP in 1998.

An interesting perspective on the effectiveness of international financial assistance (disbursement and debt rescheduling) can be provided by an assessment of capital outflows from Russia. The assistance should create favorable conditions (stability of the currency, reliable banking system, liberal foreign exchange, trade, and investment regime, and enforcement of private contracts) for attracting private financing, and the Russian record has been very poor until nowadays. The Russian authorities estimated annual capital flight at averaging roughly $11 billion in 1994–1997. There has been a considerable debate over the size of capital flight in Russia. Estimates for 1990–1995 differ from $35 billion (Russian government) to astonishing $400 billion (Russian Security Ministry). The CBR estimated capital flight (defined as the sum of nonreceipt of export earnings, underdeemed import advances, nonequivalent barter trade, and half of errors and emissions) on $54.2 billion in 1994–1998, less than $11 billion per year.

Therefore, a stable trend of residents' capital outflow stood in sharp contrast with improvements in macroeconomic indicators in 1997 and foreign investors' perception. Domestic investors did not seem to be convinced in favorable conditions to keep and invest money in their own country and foreign ones preferred short-term debt instruments hedged against foreign exchange risk.

2.4. Crisis of August 1998

Volatility of financial markets started with the outburst of the crisis in Asia. Devaluation of Thai baht on July 2, 1997 resulted in growing investor concern about spillover and contagion effects across the region. From July 1997 to February 1998 (preliminary agreements with the IMF), Asian countries experienced abrupt devaluation of their currencies towards the U.S. dollar. The Thai baht devalued by over 87 percent, Indonesian rupiah by 231 percent, Malaysian ringgit by 55 percent, Philippine peso by 51 percent, and Korean won by 83 percent. When the Asian crisis reached Korea, regional developments posed a threat to the global economy, as Korean economy was rated eleventh largest in the world and had close trade and financial relations with Japan, the second biggest world economy.

Currency crises caused a crash on Asian financial markets, foreign and domestic capital outflow, which resulted in decline of foreign reserves within the countries' banking systems. Investors that accepted poorly supervised and audited financial institutions in emerging markets during long lasting lending boom, finally began to be afraid of the collapse of the whole financial system. This threat was additionally augmented by the massive financial support to bankrupt financial institutions from central banks and budgetary resources. The Russian economy presented much grimmer picture than the Asian ones.

The year 1997 was the apogee of positive expectations towards Russia. The economy halted its decline, inflation was lowered to single-digit levels, the ruble exchange rate was practically fixed, and patronage of international financial institutions and G-7 governments, irrespective of non-fulfillment of their conditions, allowed for some optimism at financial markets. From end-1996 to September 1997, the RTS index increased by 245 percent in dollar terms, yield on government papers oscillated from 18 to 39 percent on annual basis. The beginning of the crisis in Korea in October 1997, worsened Russia's perspectives. Foreign investors – in possession of 30 percent of GKO/OFZ market – started to withdraw their assets, which in turn forced the CBR to increase interest rates to end-1996 levels. The period of declining interest rates in Russia was over. The pressure on foreign exchange market forced the CBR to widen the band from +/-5 percent to +/-15 percent on November 11, 1997. Central parity of the ruble at 6.2 per U.S. dollar was introduced for the years 1998–2000, instead of crawling band regime. The CBR had to intervene heavily in order to defend the declared exchange rate band. In the fourth quarter of 1997, the central bank reserves declined by $5.9 billion and net inflow of foreign capital was null.

Reaching the preliminary agreements with the IMF by the Asian countries in February-April 1998 improved market sentiment in Russia and the CBR decreased refinance rate from a peak of 42 percent on February 2 to 30 percent in mid-March. Similarly, investors' expectations of the stock market and Treasury securities market perspectives improved a bit. However, most of investors acquired shorter term T-bills than before.

In May 1998, there was a next stock market crash triggered by the "patriotic" attempts of the Russian parliamentarians to limit the foreign stake in "strategic" enterprises of the energy sector. The trade on the Russian stock markets, including the biggest RTS-1 one where over one hundred companies were quoted, was concentrated mostly on big enterprises, many of them from energy sector. The RTS index in dollar terms dropped by 40 percent in May and by additional 21 percent in June.

In mid-1998, the stock of government papers in foreign hands reached half of the market (roughly $38 billion). In mid-1998, Russia's total public debt-to-GDP ratio was 50 percent, of which domestic debt-to-GDP ratio amounted to 16 percent. Although the latter level could not be considered as particularly high, the maturity of most of the debt instruments was less than one year and payments accumulated in the second half of 1998. Weekly rollover of GKO/OFZ in that time reached 8 billion rubles ($1.3 billion). In addition to that, the budget recorded a growing deficit.

In May 1998, there was another stock market crash triggered by the "patriotic" attempts of the Russian parliamentarians to limit the foreign stake in "strategic" enterprises of the energy sector. The trade on the Russian stock markets, including the biggest RTS-1 one where over one hundred companies were quoted, was concentrated mostly on big enterprises, many of them from energy sector. The RTS index in dollar terms dropped by 40 percent in May and by additional 21 percent in June.

The Russian economic outlook started to worsen as a result of a growing current account deficit in mid-1998. There were two reasons of current account worsening: growing imports of consumer goods and very low prices of oil and gas prices. The decline of price of the barrel of oil by $1 costs the Russian exporters $1.2 billion losses in revenues per year, and oil price had dropped by 30 percent from 1997 till mid-1998. Since 1993, the high current account surplus safeguarded permanently high budget deficit and allowed for accumulation of the CBR reserves (and stability of the ruble exchange rate since 1995). The danger of twin deficits shifted investors' expectations.

At end-June 1998, foreign investors started the third round of withdrawal from Russia. The CBR net reserves dropped from to $16.2 billion (from $24.5 billion in mid-1997). The real level of liquid reserves could have been much lower and amounted to few billions of U.S. dollars only. For example, $5 billion of gold was valued at $300 per ounce when the world price was $280 per ounce and a good practice in other central banks was to undervalue the gold reserves (at $140–169 per ounce).

The Russian commercial banks also played a part in putting pressure on the ruble exchange rate. Profitability of government papers crowded out other banking operations and the Russian banks were heavily indebted abroad with their assets full of T-bills. They have also actively hedged foreigners buying domestic papers together with forward contracts on the ruble exchange rate. The collapse in Treasury bills market undermined liquidity of banks what forced them to close position in ruble assets and buy foreign exchange to realize forward contracts and foreign debt payments. At the beginning of July 1998, interest rate on T-bills went up to 130 percent and the market stalled.

In mid-1998, there were numerous symptoms of an imminent financial crisis in Russia. The speculative bubble on financial markets broke down. Export revenues were in decline, imports soared, and the current account went into deficit. The ruble has been appreciating since 1995 in real terms, and the maturity structure of capital inflow shortened.

On July 1, 1998, the Russian authorities sent a package of reform measures to the parliament and on July 16, 1998 signed an agreement with the IMF. The proposed package of Prime Minister Sergiei Kiriyenko was the most complex and radical from the beginning of transition in Russia (see, Appendix). It contained three main elements: a radical tightening of the federal budget with a deep reform of tax policy, bolstering international reserves of the CBR with a substantial foreign financing, and lengthening of debt maturity with a conversion of the ruble-denominated instruments into the dollar-denominated ones. The perspective of massive financing after signing Memorandum of the Government of the Russian Federation and the Central Bank of the Russian Federation on Economic and Financial Stabilization Policies with the IMF, on July 16 improved the Russian outlook. However, the improvement was only temporary because the Duma rejected the proposed changes in tax policy (widening the base of personal income taxation and transfer of its higher share to federal budget, increase in land tax, and balancing the Pension Fund). The Russian government had to supplement the memorandum to the IMF on July 20. The fiscal reforms also faced strong opposition from powerful lobbies of oligarchs, enterprises, and regions and the package was under massive critique in (controlled by oligarchs) mass media. The chances for radical fiscal reform and elimination of budget deficit disappeared.

On August 11, 1998, the Japanese Agency of Economic Planning published a report talking of a 'crisis' in Japan, instead of repeatedly using the word "stagnation". Yen-dollar exchange rate reached 147.64, the lowest level for yen in eight years. On the New York Stock Exchange, the Dow Jones Industrial Index lost 300 points, in anticipation of a decline in profits of U.S. companies in the third quarter of 1998 (and after a decline in the second quarter). The very next day, the Moscow Stock Exchange had to halt its quoting after a decline of its index by 10 percent. On August 13, George Soros published an article in "Financial Times" criticizing the IMF program and proposing 20–25 percent devaluation of the ruble and introduction of currency board in Russia [19].

The band wagon effect caused a mass withdrawal of investors from the Russian market. On August 17, 1998, the Russian government and the CBR announced: (i) widening of exchange rate band from Rub 5.3 – 7.1 to 6.0 – 9.5 per U.S. dollar and elimination of daily narrow band, (ii) obligatory conversion of GKO/OFZ with maturity of up to December 31, 1998, into non-specified government securities, suspension of government papers market, and restrictions on access to foreign exchange for both domestic and foreign investors. Also, the 90-days moratorium on all foreign debt payments was announced and foreigners were prohibited investments in ruble assets with maturity lower than one year.

[19] The Financial Times, August 13, 1998.

2.4.1. Crisis Management

Just after the announcement, financial turmoil intensified and the ruble depreciated sharply, despite central bank interventions. President Boris Yeltsin shook investor confidence on August 23, 1998 by firing the Kiriyenko government. On August 26, foreign exchange trading was brought to a halt when the CBR terminated the fixing of the exchange rate within a corridor of Rub 6.0–9.5 per U.S. dollar. The exchange rate band was abandoned on September 2 and the ruble reached 10.9 per U.S. dollar. Within a week, the exchange rate jumped to over Rub 20 per U.S. dollar and later declined to Rub 15–16 per U.S. dollar until November 1998. Driven by depreciation of the ruble, the monthly inflation increased to 38.4 percent in September 1998.

Following the August crisis, financial markets ceased operations and the payment system came to a virtual halt due to a breakdown of trust between banks, while run on bank deposits ensued. The response of the authorities was to inject liquidity into the banking system, including freeing-up banks' mandatory reserves. Firstly, the exchange rate of the ruble used for calculation of reserve requirements on foreign currency deposits (44 percent of all deposits in mid-1998) was frozen. Secondly, requirements were uniformly reduced by 1 percentage point on August 24, 1998. Thirdly, requirements were reduced for selected banks (depending on their portfolio of Treasury bills) to 5–7.5 percent on September 1. It was also the beginning of fast ruble depreciation as it caused a flight to quality by banks acquiring foreign exchange that ultimately weakened the ruble (Figure 2.7). Finally, reserves were further reduced during September-November 1998, depending on individual bank's obligations towards clients. The required reserve ratio varied considerably among different banks, with the biggest banks having, on average, the lowest requirements.

On December 31, 1998, the CBR unified reserve requirements on ruble and foreign exchange deposits at the rate of 5 percent and required market exchange rate to be used for calculating requirements on foreign currency deposits. The net claims on deposit money banks increased by 344 percent in the fourth quarter of 1998. The base money increase in the same period was moderate (26 percent), because a decline in the CBR reserves was substantial enough to sterilize the domestic credit increase. The CBR also created a special facility to provide rehabilitation loans to commercial banks of up to one year maturity and at 20 percent interest rate (annualized inflation exceeded 100 percent in 1998/1999) in return for 75 percent plus one share of the bank as collateral. The loans were then extended on a case-by-case basis and detailed terms were not transparent.

The crisis was a fatal blow for the Russian banking system, particularly the biggest banks. It is worth noting that neither prudential regulations, nor contract enforcement in Russia was strong. Devaluation of the ruble led to an increase in foreign currency exposure of the Russian banks that, in turn, led to a default on off-balance sheet foreign exchange forward contracts and foreign credit liabilities. The chain of defaults on contracts spread across the banking sector as many smaller banks credited bigger ones, operating in the financial markets. Additionally, many commercial banks possessed substantial amount of government papers in their portfolios, which became a subject of compulsory restructuring at a fraction of face value.

The authorities decided to transfer households' savings into the State Saving Bank (Sberbank) providing guarantees in order to avoid run on banks. Rehabilitation credits from the CBR allowed banks to function but there were reports on asset stripping, shifting assets to shell entities domestically and abroad. As a result, the bulk of banking sector became insolvent and lost its reputation.

The announcement by the Russian authorities of compulsory restructuring of all the GKOs/OFZs holding shocked foreign creditors, which held 83 billion rubles out of 190 billion rubles being subject of restructuring. In addition, foreign investors faced default on forward contracts. The agreement reached with resident and non-resident investors in March 1999 assumed a payment in the form of rather non-transparent package of cash, GKOs, and OFZs. For example, the cash payments in rubles received by non-residents must be deposited in special accounts (S-account) and could be used for purchases of permitted corporate bonds and equities. Conversion and repatriation of rubles were allowed after depositing the funds in non-interest bearing account for a period of one year. The complexity and non-transparency of the package does not allow for estimations of losses incurred by investors [20].

The announced moratorium on private external debt repayment suspended payments by residents to non-residents of principal on loans with maturity exceeding 180 days, margin payments on loans collateralized with securities, and foreign currency forward contracts. The moratorium did not cover payments on debts of the Russian government, the CBR, or the local governments. Therefore, the announced debt default was theoretically selective. However, as mentioned above, non-residents faced repatriation problems. According to the official data, a moratorium affected $3.1 billion payments to non-residents, of which $2.7 billion were liabilities of commercial banks (excluding forward contracts).

[20] Some press estimations indicate that under this restructuring, returns to investors would amount to 5 cents on the one dollar invested.

Commercial banks, despite restrictions, decided to settle $1.8 billion of their obligations (excluding forward contracts) by utilizing their assets held abroad. The Russian authorities encouraged non-residents to seek bilateral agreements on claims on Russian banks. However, the ability of non-residents to sue the Russian banks in the Russian courts were very limited as legal status of forward contracts under Russian law was ambiguous, not to mention low effectiveness of court procedures. Some Russian banks decided to meet their obligations towards foreigners, other took advantage of moratorium and stripped assets, while others were suited abroad by foreign banks. To sum up, not only the domestic but also the foreign reputation of Russian financial institutions was undermined, and a moratorium was a costly undertaking.

2.4.2. Post-crisis Recovery

Following the crisis, the initial economic policy was passive. The worst possible crisis scenarios, however, have failed to materialize. The expansionary monetary policy and devaluation of the ruble in 1998 had limited influence on inflation. Monthly inflation, after picking up to 11.6 percent in December 1998, fell to below 2 percent in mid-1999. There were a few reasons for this. The banking system collapsed which had a deflationary impact on credit emissions, the foreign exchange market was closed, and households experienced a dramatic decline in real incomes. Also, monetary policy was tighter than expected which came as a surprise under the "new-old" Chairman of the CBR Victor Gerashenko. The base money increased by 49 percent in 1999 (until November) triggered by credits to banks (rise of 179 percent). Credits to the government from the CBR remained at the same nominal level through 1999.

Real GDP has recovered from the crisis and experienced a growth of 3.2 percent in 1999 and 7.5 percent in 2000. The output recovery was driven by two factors: large real depreciation of the ruble and increase in oil prices in the world markets. Output recovery began in the end of 1998 when large import substitution offset contraction in domestic consumption, which declined by 3.5 percent and household consumption went down by 5.3 percent of GDP in 1999 (Figure 2.1 and Figure 2.2). Domestic demand was not hampered as investments were growing over 9 percent of GDP, especially due to a growth in industrial output (by 8 percent of GDP).

Strong growth in GDP was not accompanied by a rise in employment. Unemployment remained on the pre-crisis level of 11 percent in 1999. It may suggest some improvements in productivity. However, the progress in structural reforms has been mixed reflecting the significant delays in accounting changes, privatization, debt management, and labor law reform comparing to structural benchmarks agreed under the Stand-by program reached with the IMF in July 1999.

The process of bank restructuring initiated by the CBR has faced many obstacles: the strong groups of vested interests in the sector have delayed the process. After the crisis, due diligence reviews of 18 large banks was conducted, of which six lost their licenses. However, four of them, after challenging the CBR decision in the courts, had their licenses reinstated, while the other two negotiated restructuring of their debts with creditors.

In July 1999, pressure from the international financial institutions finally resulted in the auditing of Sberbank. Sberbank accounted for roughly 85 percent of household deposits, had explicit guarantees by the state and, after the crisis, deposits from a number of insolvent institutions were transferred to the bank in order to provide reassurance. This would represent the first ever audit of Sberbank and will lay the groundwork for similar developments in the whole financial system in Russia.

The fiscal position improved significantly. The primary balance of federal government reached 1.6 percent surplus in 1999 after a deficit of around 2.5 percent of GDP in 1995–1997, and federal government deficit lowered to 4.7 percent of GDP from around 6–8 percent of GDP in the same period. The improved position of the federal government reflects an improvement in revenue collection due to several factors such as the growth in the tax base as a result of the recovery (rise in profitability and energy prices), tax changes (higher export taxes and shift in tax collection from local to federal level), improved tax compliance of large taxpayers, including Gazprom and oil companies. Although the higher budget revenues were accompanied by higher expenditures but the latter increased at slower pace than the former. The similar tendency was expected to continue in year 2000.

The overall balance of extrabudgetary funds and local governments improved by 1 percent of GDP in 1999, with the former being balanced and the later registering a surplus of 0.9 percent of GDP comparing with a deficit in the same size a year earlier. Whereas much of the adjustment at the federal level took place on the revenue side, the adjustments at the extrabudgetary funds and local governments took place on the expenditure side. The overall deficit of general government improved from 8 percent in 1998 to 3.8 percent in 1999, with expected strong improvements to reach a surplus of 3 percent in 2000.

The decline in imports from $72 billion in 1997 to $58 billion in 1998 and $40 billion in 1999, and in export from $89 billion in 1997 to $75 billion in 1999 resulted in current account surplus of $21 billion in 1999 or 11.3 percent of GDP compared with less than 1 percent of GDP in 1996–1998. Two-thirds from the increase in current account surplus was absorbed by capital outflows from Russia and the rest by increases in the CBR reserves. The capi-

tal outflows continued – albeit at a slower pace. In 1999, the capital account deficit increased to $16.6 billion from $7 billion. Meanwhile, position errors and emissions reveal an outflow of $7 billion but halved from almost $14 billion in 1997. As all payments on the Soviet-era debt remained suspended together with default on domestic sovereign debt and private sector debt, exceptional financing increased to over $8 billion. Altogether, net international reserves showed an increase of $5.4 billion in 1999 compared with a decrease of $10 billion in 1998, and net reserves of the CBR increased to over $21 billion in mid-2000.

The increase in the current account surplus and the CBR reserves did not influence the Russian authorities' decision to settle debts (see, Table 6). The expected debt repayments increased from $13.8 billion in 2001 to $18.7 billion in 2003 and can pose problems again. The Russian authorities prefer to delay the final settlement and continue the practice of selective defaults as Eurobond obligations are paid on time.

Political developments strongly influenced the economic stance. Vladimir Putin's overwhelming victory in the presidential elections strengthened the role of the federal government towards the regions and initiated the process of centralization. Enforced tax discipline towards the largest companies resulted in higher tax compliance and restrained fiscal expenditures resulted in significant improving the fiscal position. Vladimir Putin initiated reforms which may lay the groundwork for sustained growth. However, the repetition of 1995, when short-term macroeconomic stabilization was not accompanied by structural reforms cannot be excluded neither.

2.4.3. Conclusions

The macroeconomic stabilization during 1992–1994 was characterized by the lack of authorities' ability or will to sustain adjustment efforts. Fiscal policy remained expansionary and monetary policy monetized fiscal and quasi-fiscal deficits. None of the IMF (and authorities') stabilization programs were successfully carried through. Stabilization was not reached, as there was a systematic tendency to relax economic policies in the second half of each year in face of political pressure, leading to acceleration of inflation. Inconsistencies in policy-mix resulted in "Black Tuesday" on October 11, 1994 when the ruble collapsed on the Moscow interbank market by over 20 percent against the U.S. dollar. The first currency crisis in Russia was a warning indicator.

Between 1995 and 1998, Russia did not achieve a reduction in the unsustainably high deficit, a reversal of the decline in budget revenues, or a reduction of expenditures. The overall deficit increased from 6.1 percent of GDP in 1995 to 7.7 percent of GDP in 1997. The use of non-monetary fiscal operations that began in the fourth quarter of 1994 continued until the beginning of 1998. On the expenditure side, increases in interest payments became the main factor of growth in government spending.

Accumulation of macro- and microeconomic problems coincided with cumulating maturity of debt payments in the third quarter of 1998 that amounted to one third of budget revenues and with current account deficit resulted from a decline in world prices of energy resources. The Asian crisis in 1997–1998 increased financial markets volatility and investor pessimism about the performance of the Russian economy. However, the contagion effect was weak as it only speeded up what was unavoidable – the deep correction of the exchange rate due to accumulated macroeconomic imbalances.

The Russian crisis of 1998 represents a typical case of the "first generation" model. The balance of payments crisis led to the currency crisis with sovereign debt default and, as a result of weak supervision of financial institutions and poor management in the aftermath of ruble devaluation, resulted in a full-fledged financial crisis with debt default and bank closures. The Russian economy registered a decline in 1998–1999. However, economic recovery came sooner than expected due to the growth in prices of energy resources and consequences of devaluation of the ruble. But the quality of the authorities' crisis management could be judged on the situation in the banking sector and financial markets which remained fragmented and lost credibility domestically and abroad.

The open question remains as to whether positive influence of high prices of energy resources will coincide with outcomes of reforms launched in 2000 and will not be undermined by the next debt default. The experiences of the first-generation crises show that, without deep macroeconomic reforms and restructuring of the economy, any improvements are only temporary.

Appendix: Chronology of the Russian Crisis

Date	Event	Result
July 2, 1997	Devaluation of Thai baht.	The beginning of Asian crisis.
July 1997 – February 1998	Containment of the Asian crises, contagion and spillover effects.	Devaluation or depreciation of currencies in Indonesia, Malaysia, Philippines, South Korea.
October 1997	Withdrawal of investors from Russia.	Dropping indices at stock markets, increase in the CBR and market interest rates.
November 11, 1997	Pressure on foreign exchange market.	Widening the band of ruble-dollar exchange rate fluctuation from +/-5 to +/-15 percent and introduction of central parity of ruble based on three-year average at the level of 6.2 ruble per U.S. dollar. Heavy interventions of the CBR on the foreign exchange market leading to decline in official reserves of $5.9 billion in the fourth quarter of 1997.
February – April, 1998	Preliminary arrangements reached among IMF and the Asian countries, a new inflow of foreign capital to Russia.	Lessening pressure on the Russian markets. Decline in interest rates starting from mid-March 1998, increase in market indices. Foreigners in possession of approximately half of GKO/OFZ markets.
May – June, 1998	Stock market crash in Moscow.	RTS index in dollar terms dropped by 40 and 21 percent in May and June, respectively.
End-June 1998	Massive outflow of foreign capital from Russia.	A decline in CBR reserves by over $8 billion, increase in GKO/OFZ yields to 130 percent.
July 16, 1998	Signing a memorandum between the Russian government and the IMF, which implied an introduction of radical stabilization package under Prime Minister Sergei Kiriyenko.	Slight improvements in market moods in Russia.
August 11, 1998	Publication of report by the Japanese Agency of Planning warning on the danger of crisis in Japan.	Yen reached the lowest level of 147,64 Y per U.S. dollar and Dow Jones Industrial Index dropped by 300 points.
August 13, 1998	George Soros publishes in the "Financial Times" a critical letter to the Russian government on the IMF program suggesting devaluation of the ruble by 15-25 percent, introduction of currency board, and warning about the possibility of crisis.	Band wagon effect of withdrawal investors from Russia.
August 17, 1998	Devaluation of exchange rate band by over 33 percent, announcement of 90-day moratorium on private external obligations and compulsory restructuring of the domestic public debt.	Trading of GKO/OFZ has been suspended, the ruble started to depreciate – **the beginning of currency crisis**.
August 23, 1998	The government of Prime Minister Sergei Kiriyenko was fired.	Increased volatility in the markets.
September 2, 1998	Abandoning of the exchange rate band.	Depreciation of the ruble by 20 percent to 12.8 per U.S. dollar on September 3.
September, 1998	Banking panic, bankruptcies of banks and financial institutions.	**Beginning of full-fledged financial crisis**.
end-October, 1998	Industrial production down by 15 percent, import halved in terms of dollar value, ruble depreciated by 150 percent (from August), increase in CPI inflation to 7 percent monthly,	

Tables

Table 2.1. Basic macroeconomic indicators, 1991–1994

	1991	**1992**	**1993**	**1994**
	Percentage change during the period			
Real GDP	-5.0	-14.5	-8.7	-12.6
Consumer price index (CPI)				
Average	93	1,353	875	308
Within-period	144	2,322	840	215
Average monthly wage[1]	0.522	6	59	220
Registered unemployment[2]	0.1	0.8	1.1	2.1
Base money		1,070	442	170
Net international reserves		538	300	1
Net domestic assets of the MA		531	347	185
Net credit to banks		442	100	-9
	In percent of GDP			
Federal government deficit	-16.0	-11.1	-6.9	-11.1
General government deficit		-18.9	-7.6	-10.1
Current account balance		-5.2	1.6	3.1
	In billions of U.S. dollars			
Current account balance	3.2[3]	-4.2	2.6	8.4
Trade balance	8.7[3]	5.9	14.1	19.3
Exports	53.2[3]	52.1	58.3	67.8
Imports	44.5[3]	46.5	44.2	48.5
Average exchange rate (rubles/US$)		222	1,034	2,262
End-period exchange rate (rubles/US$)		415	1,247	3,550

Source: data for 1991–1992 IMF Country Reports, 1993–1994 IMF IFS.
[1] Level, in new rubles
[2] End-period level, in percent of labor force
[3] Excluding FSU countries

Table 2.2. Basic macroeconomic indicators, 1995-2000

	1995	1996	1997	1998	1999	2000F
	Percentage change during the period					
Real GDP	-4.1	-3.6	0.9	-4.9	3.2	7.0
Consumer price index (CPI)						
Average	198	47.7	14.7	27.7	85.9	18.6
Within-period	131	21.8	10.9	84.5	36.7	16.0
Average monthly wage[1]	472	790	950	1,051	1,582	
Registered unemployment[2]	3.2	3.4	2.8	2.6	1.7	
Base money	107.8	27.3	27.6	25.3	66.8	
Net international reserves	261.3	-21.6	14.4	-39.5	8.4	
Net domestic assets of the MA	70.0	78.5	17.1	191.7	-3.3	
Net credit to banks	-420.0	-256.3	-87.7	-11.2	-92.9	
	In percent of GDP					
Federal government deficit	-5.7	-8.4	-7.0	-5.9	-4.7	1.5
General government deficit	-6.1	-8.9	-7.7	-8	-3.8	3.1
Current account balance	1.4	0.9	0.6	0.3	11.3	
	In billions of U.S. dollars					
Current account balance	4.8	3.9	2.8	1.0	20.8	
Trade balance	18.7	17.8	17.4	17.1	35.8	
Exports	82.7	90.6	89.0	74.9	75.3	
Imports	64.0	72.8	71.6	57.8	39.5	
Average exchange rate (rubles/US$)	4.6	5.5	5.9	20.0	26.8	
End-period exchange rate (rubles/US$)	4.6	5.6	6.0	20.7	27.0	

Source: IMF IFS, Goskomstat, IMF country reports
[1] Level, in rubles
[2] End-period level, in percent of labor force

Table 2-3. Fiscal data on federal budget, summary of 1992–2000

	1992	1993	1994	1995	1996	1997	1998	1999	2000[1]
Revenue	16.6	13.7	11.8	12.9	12.5	12.0	10.7	13.4	16.3
VAT	8.3	4.5	5.1	5.1	5.4	4.6	3.9	4.8	5.9
Other taxes on goods and services	0.9	0.7	0.7	1.1	2.4	2.1	2.0	2.0	2.0
Profit taxes	3.6	3.4	2.8	2.7	1.6	1.3	1.3	1.7	2.7[2]
Personal income taxes			0.02	0.2	0.2	0.1	0.0	0.4	
Natural resources taxes	0.6	0.3	0.2	0.2	0.2	0.3	0.1	0.2	
Taxes on trade	2.5	3.3	1.6	1.9	1.3	1.2	1.5	1.9	3.3
Budgetary funds			0.5	1.0	1.1	1.5	0.9	1.2	
Other	0.5	1.5	0.9	0.6	0.3	1.1	1.0	1.1	2.3
Expenditure	27.7	20.6	23.2	18.6	20.9	19.0	16.6	18.1	13.8
Non-interest expenditure	27	18.5	21.2	15.1	15.0	14.4	12.1	11.8	10.8
Government administration	0.4	0.5	2.4	0.3	0.3	0.4	0.4	0.3	
Defense	4.7	4.4	4.6	3.1	3.0	3.1	2.1	2.6	
Law enforcement	1.3	1.5	1.8	1.2	1.3	1.7	1.3	1.3	
Education	1.3	0.8	0.9	0.6	0.5	0.6	0.5	0.5	
Health	0.3	0.3	0.4	0.4	0.4	0.6	0.4	0.4	
Social policy	0.8	0.2	0.2	0.2	0.5	0.9	1.4	1.1	
Intergovernmental transfers	1.8	2.7	4.1	1.9	2.4	1.9	1.7	1.6	2.7[3]
Other	5.9	3.1	0.9	0.9	1.9	1.1	1.9	0.8	5.8
Interest payments	0.8	2.1	2.0	3.6	5.9	4.6	4.6	6.3	3.0
External debt	0.1	1.6	0.5	1.1	1.1	0.9	2.1	2.0	
Treasury bills (GKO/OFZ)		0.1	0.2	1.9	4.2	3.3	2.3	2.7	[4]
Other domestic debt	0.7	0.4	1.2	0.6	0.7	0.3	0.2	1.6	

Table 2-3. Fiscal data on federal budget, summary of 1992–2000 (continued)

	1992	1993	1994	1995	1996	1997	1998	1999	2000[1]
Federal government overall balance	-11.1	-6.9	-11.4	-5.7	-8.4	-7	-5.9	-4.7	1.5
Federal government primary balance	-10.3	-4.8	-9.4	-2.2	-2.5	-2.4	-1.3	1.6	6.1
Revenue	16.6	13.7	11.8	12.9	12.5	12	10.7	13.4	16.3
Expenditure	27.7	20.6	23.2	18.6	20.9	19	16.6	18.1	13.8
Local government overall balance	1.5	0.6	0.5	-0.3	-0.4	-0.8	-1.2	0	0.7
Revenue (including transfers)	13.5	16.7	18	15	15.2	16.6	14.6	15.8	15.8
Revenue (excluding transfers)	11.9	14.1	13.9	13.2	12.8	14.7	12.9	14	14.2
Expenditure	12	16.1	17.5	15.4	15.6	17.5	15.8	15.9	15.1
Extrabudgetary funds balance	2.5	0.6	0.5	0	-0.1	0.1	-0.9	0.9	0.9
Revenue (including transfers)	10.9	8.6	9	8	8.1	9.7	8.4	8.6	9.1
Revenue (excluding transfers)	10.9	8.4	8.9	7.5	7.7	8.8	8	8.2	8.7
Expenditure	8.4	8	8.6	8	8.2	9.6	9.3	7.7	8.2
General government overall balance	-18.4	-7.4	-10.4	-6.1	-8.9	-7.7	-8	-3.8	3.1
General government primary balance	-17.7	-5.4	-8.4	-2.6	-3	-3.1	-3.5	2.5	7.7
Revenue	39.3	36.2	34.6	33.5	33	35.5	31.7	35.6	39.1
Expenditure	57.7	43.6	45	39.6	41.9	43.2	39.7	39.4	36

Source: Goskomstat

[1] The Russian authorities and the IMF projection

[2] Together profit and personal income taxes

[3] Together intergovernmental transfers and budgetary funds

[4] Debt moratorium

Table 2-4. Monetary data, summary of 1994–1999 (billion of rubles)

	1994	1995	1996	1997	1998	1999
Monetary authorities						
Net international reserves	8	35.7	9.5	22.4	-204.1	-76.5
(in billions of U.S. dollars)	3.5	7.7	1.7	3.7	-8.4	-2.8
Net domestic assets	40	68	121.4	142.1	414.5	400.7
Net credit to general government	66	111.2	162.1	191.8	276.2	309.2
Net credit to federal government	72	115.4	166.4	199.9	283.4	333.1
Net credit to commercial banks	1	-3.2	-11.4	-21.4	-23.8	-45.9
Other items net	-31	-39.9	-29.3	-28.3	162.1	137.4
Reserve money	48	103.7	130.9	164.5	210.4	324.3
Currency	38	83.4	108.6	137	197.9	288.6
Monetary survey						
Net foreign assets	40	51.9	23.5	-19	-184.8	71.4
Net domestic assets	96	224	341	474.3	856.7	923.5
Net claims on general government	70	164.1	300.8	365.4	487.3	550.8
Net claims on federal government	80	174.4	306.7	370.4	482.2	574.9
Claims on rest of economy	120	196.8	227	290.2	423.7	557.6
Other items net	-95	-136.8	-186.8	-181.3	-54.3	-208.9
Broad money	136	275.9	364.5	455.3	671.9	994.9
Ruble broad money	97	220.7	295.1	370.3	448.4	704.7

Source: IMF country reports

Table 2-5. Balance of payments, summary of 1994–1999 (billion of U.S. dollars)

	1994	1995	1996	1997	1998	1999
Current account	8.4	4.8	3.9	2.8	1.0	20.8
Trade balance	19.3	18.7	17.8	17.4	17.1	35.8
Exports	67.8	82.7	90.6	89.0	74.9	75.3
Natural gas	10.6	12.1	14.7	16.4	13.3	11.4
Imports	48.5	64	72.8	71.6	57.8	39.5
Services and incomes, net	-10.6	-13.9	-14	-14.3	-15.8	-15.7
Current transfers, net	-0.3	0.1	0.1	-0.3	-0.4	0.6
Capital account	-27.1	-4.2	-10.9	6.3	-7.1	-16.6
Capital flows related to federal government	-11.2	-9.7	1.7	15.1	7.7	-1.9
Purchases of gov. securities	0.0	0.0	5.9	10.9	2.8	-0.3
Medium- and long-term capital	0.4	1.6	3.8	5.8	2.8	0.2
Foreign direct investments	0.5	1.7	1.7	3.6	1.7	0.8
Other, incl. short-term capital	-16.4	3.9	-16.4	-14.5	-17.6	-14.9
Errors and omissions	-0.3	-7.9	-8.6	-13.6	-9.2	-7.0
Overall balance	-19.1	-7.3	-15.6	-4.5	-15.3	-2.9
Financing	19.1	7.3	15.6	4.5	15.3	2.9
Net international reserves	3.9	-5.4	4.6	-1.4	10.2	-5.4
Exceptional financing	15.2	12.8	11.0	5.9	5.1	8.4

Source: IMF country reports

Table 2-6. External debt in 1994–1999 (in billions of U.S. dollars)

	1994	1995	1996	1997	1998	1999
Total external debt	127.5	128	136.1	168.5	189.9	185.7
Total sovereign	127.5	128.0	136.1	134.6	158.2	154.6
to nonresidents					152.4	147.6
Russian-era (post 1/1/92)	11.3	17.4	27.7	35.6	55.4	51.1
Total long-term debt					55.4	51.1
Multilateral	5.4	11.4	15.3	18.7	26.0	
Bilateral	5.9	6.0	7.9	7.6	9.7	9.5
Eurobonds	0	0.0	1.0	4.5	16	15.6
Minfin bonds	0	0.0	0.0	1.3	0.2	0.1
Soviet-era (pre 1/1/92)	116.2	110.6	108.4	99	102.8	103.5
Nonsovereign debt				33.9	31.7	31.1
Local governments				1.1	2.2	2.1
Banks		5.2	9.2	19.2	9.9	
Nonbank corporations				13.6	19.6	20.2

Source: IMF country reports, BIS

Table 2-7. Summary of disbursements and repayments of the Russian Federation (in thousand of SDRs) to the IMF

Year	General Resources Account (GRA)	
	Disbursements	Repurchases
1992	719,000	0
1993	1,078,275	0
1994	1,078,275	0
1995	3,594,250	0
1996	2,587,861	359,500
1997	1,467,253	359,500
1998	4,600,000	673,922
1999	471,429	3,101,139
2000	0	1,771,666
Total	**15,596,343**	**6,265,726**

Source: IMF, Treasurer's Department, Accounts and Financial Reports Division

Table 2-8. The Russian Federation: position in the Fund as of September 30, 2000

Financial Arrangements					
Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)	Amount Outstanding (SDR Million)
Stand-by	07/28/1999	12/27/2000	3,300.00	471.43	471.43
EFF[1]	03/26/1996	03/26/1999	13,206.57	5,779.71	5,085.23
Stand-by	04/11/1995	03/26/1996	4,313.10	4,313.10	359.43
STF II	04/20/1994		1,078.27	1,078.27	0
STF I	06/30/1993		1,078.27	1,078.27	0
Stand-by	08/05/1992	01/04/1993	719.00	719.00	0
Total			**21,538.67**	**11,283.24**	**5,916.08**

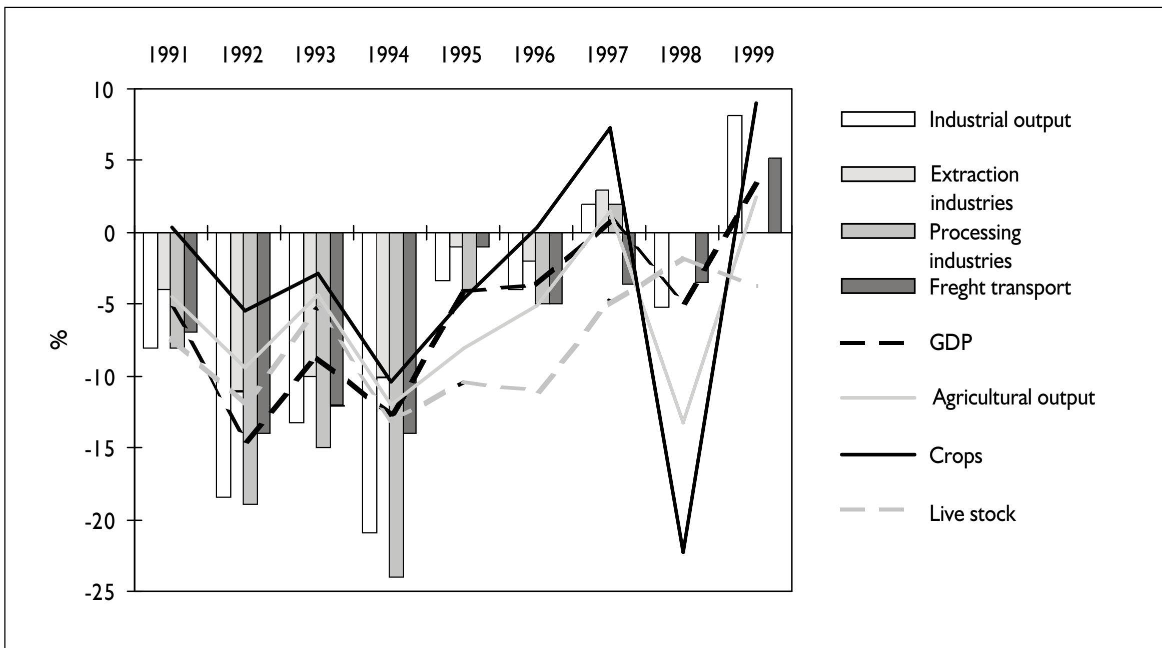
Projected Obligations to Fund (SDR Million; based on existing use of resources and present holdings of SDRs):				
	2000	**2001**	**2002**	**2003**
Principal	417.8	1,111.0	2,136.0	2,254.6
Charges[2]/ Interest	132.2	481.1	393.0	263.0
Total	**550.0**	**1,592.1**	**2,529.0**	**2,517.6**

Source: IMF, Treasurer's Department

[1] The EFF programs in 1996 consisted of three EFFs; ordinary, GAB - non-SRF, and SRF through GAB.

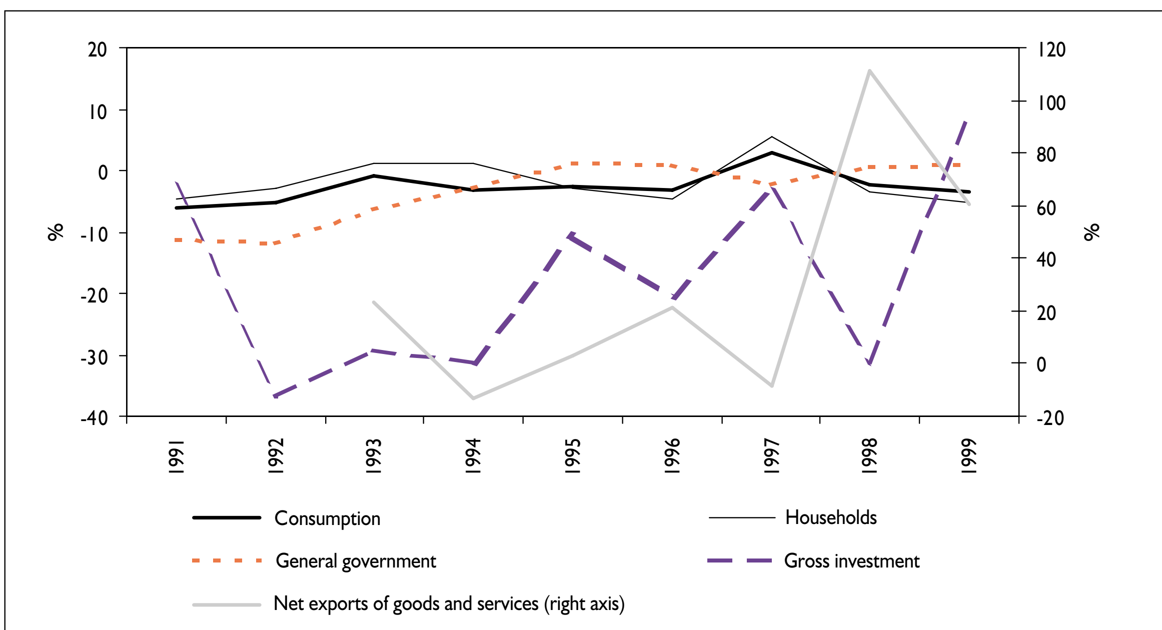
[2] The estimates of amounts of charges and their due dates are estimates and subject to change.

Figure 2-1. GDP by sectors (annual percentage change), 1991-1999



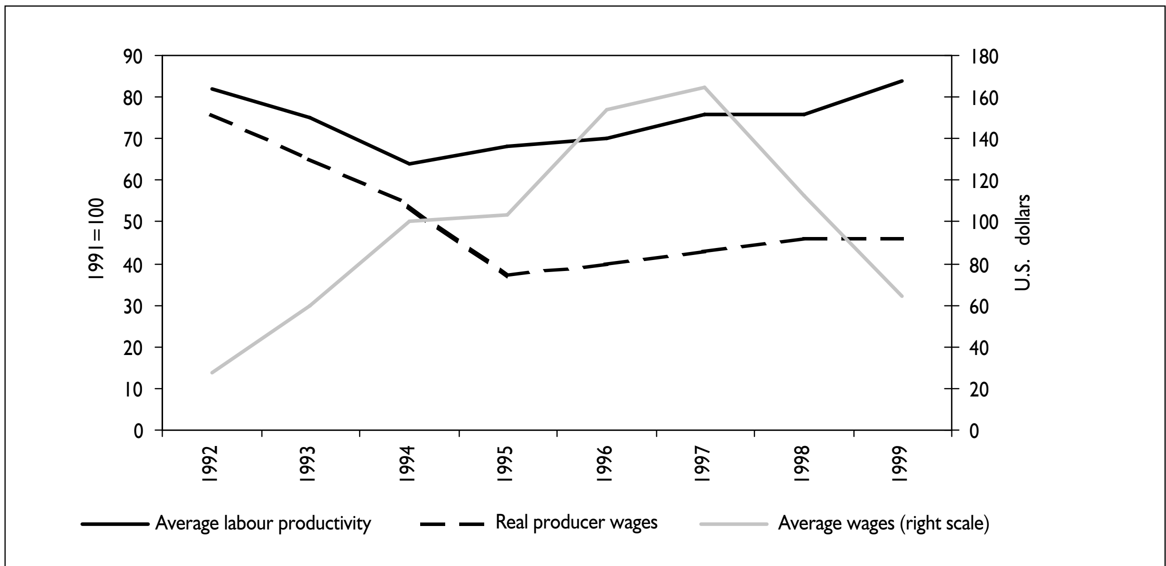
Source: Goskomstat

Figure 2-2. GDP by expenditure (annual percentage change), 1991-1999



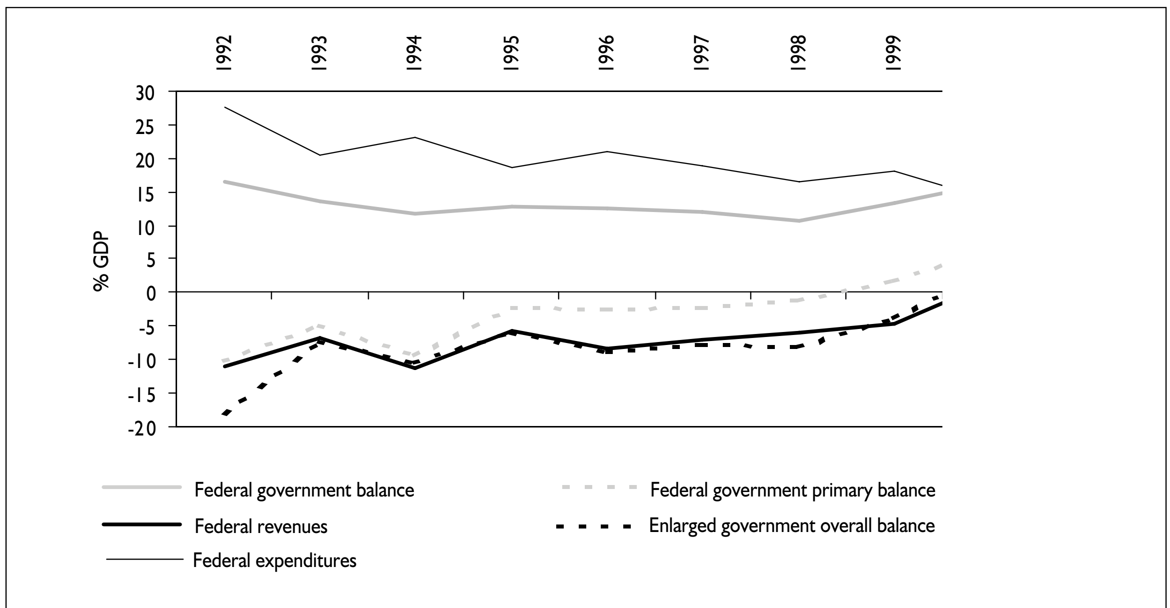
Source: Goskomstat

Figure 2-3. Labor productivity and wages, 1992-1999



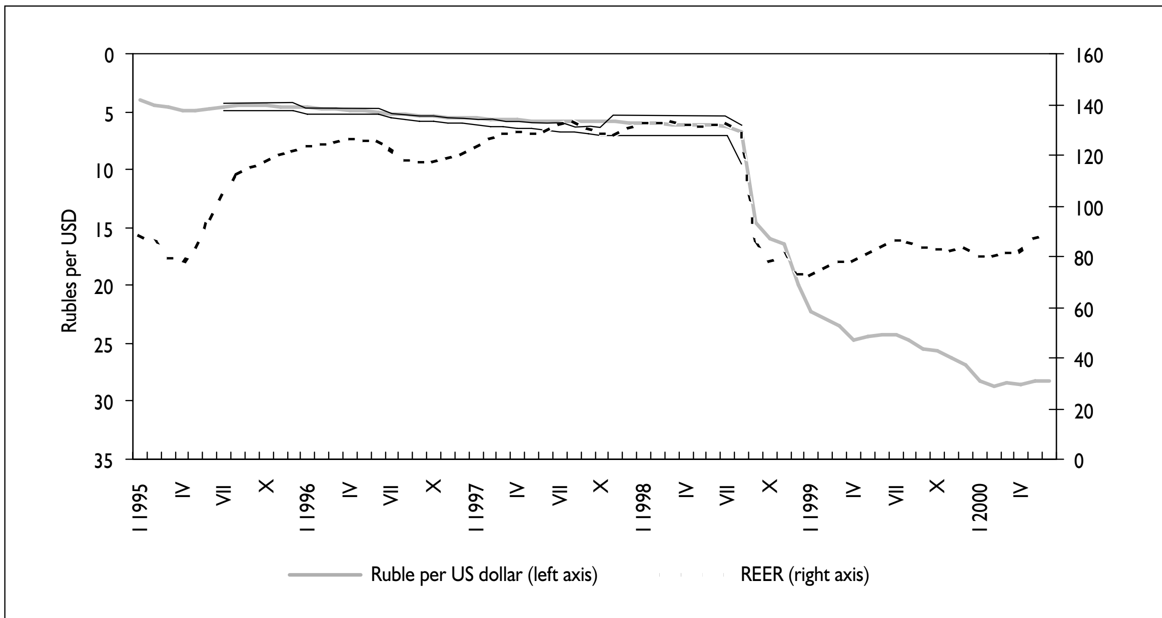
Source: Goskomstat, IMF data, own calculations
Labor productivity measured as the ratio of production to workforce
Real wages measured as nominal wages deflated by CPI

Figure 2-4. Fiscal indicators, 1992-2000



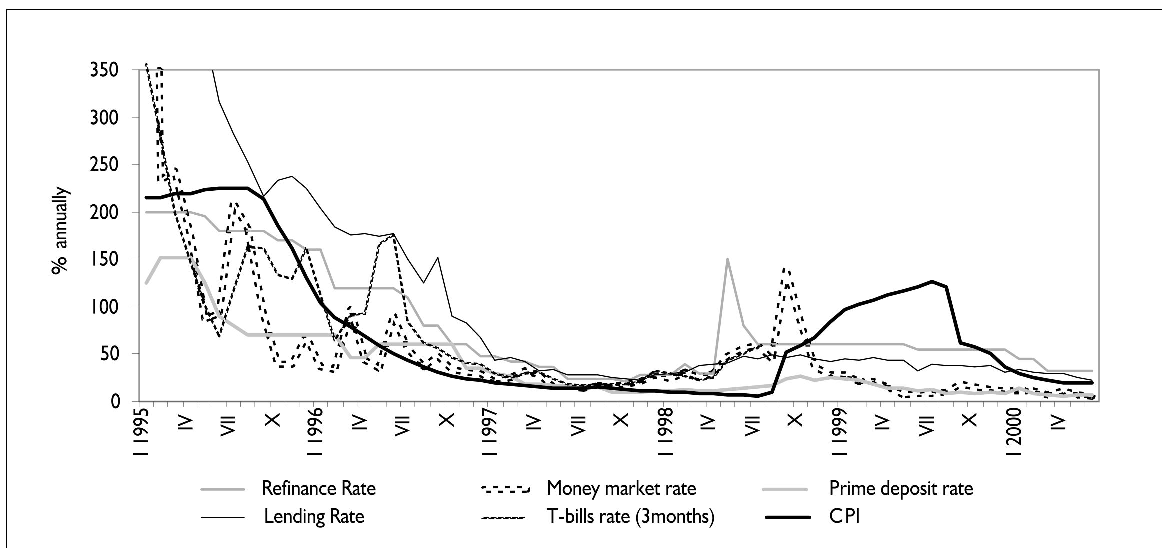
Source: Goskomstat

Figure 2-5. Ruble exchange rate, exchange rate regime, and real effective exchange rate (1995-2000)



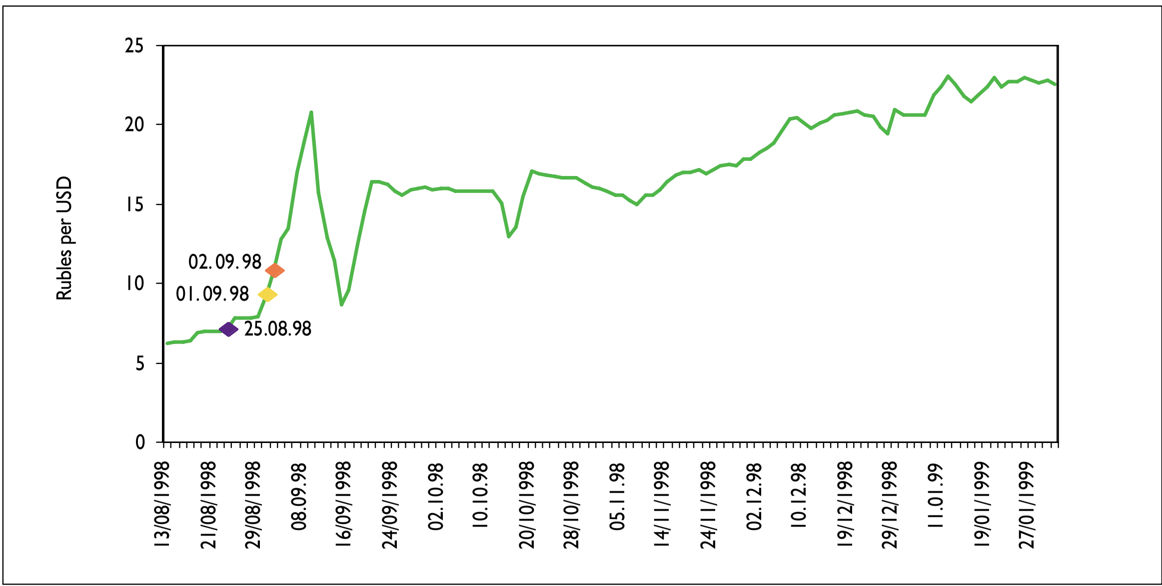
Source: Central Bank of Russia, IMF IFS

Figure 2-6. Monetary policy instruments and inflation, 1995-2000



Source: Central Bank of Russia, IMF IFS

Figure 2-7. Daily ruble exchange rate, August 1998 - January 1999



Source: IMF IFS

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Part III. The Ukrainian Crisis of 1998 by Małgorzata Markiewicz

The financial crisis in Ukraine (August 1998) can be explained on the grounds of the first generation model. Sources of Ukrainian financial crisis were mostly internal. The crisis in Russia, the main trading partner, merely accelerated some processes, rather than causing them. The contagion effect of the Russian crisis was generated because of a common systemic linkage between these two countries inherited from the past. This paper illustrates how the economic problems accumulated, eventually leading to the crisis.

According to the first generation model, the crisis corresponds to a situation when weak economic fundamentals result in a persistent loss of foreign exchange reserves, which does not allow the maintenance of a fixed exchange rate regime. The following range of factors is expected to influence the risk of crisis: persistent loss of international reserves, expansionary fiscal policy, expansionary monetary policy, real appreciation of currency and unbalanced current account deficit.

This paper provides an analysis of the financial crisis in Ukraine in 1998, focusing on the underlying role of weak fundamentals and macroeconomic policies. First, it describes the sequence of events leading to the crisis. Second, the analysis of macro, micro, and political factors are provided. Third, it addresses issues of crisis management. The last section provides a conclusion.

3.1. A Sequence of the Crisis

The macroeconomic situation at the end of 1996 turned out to be promising. In September 1996, monetary reform was implemented and a new currency (hryvna) introduced. Limited credit expansion, together with slow remonetization of the economy, contributed to the relatively low rate of inflation, which decreased from 181.6% in 1995 to 39.7% in 1996. The demand for hryvna increased among foreign investors buying Ukrainian treasury securities (OVDP). The second group of investors on T-bills market included commercial banks constrained by limited possibilities to issue credits due to the small amount of credible investment projects and low number of profitable enterprises. The inflow of portfolio investments led to an increase in the central bank foreign exchange reserves and allowed financing the budget borrowing requirements. The improvement of macroeconomic performance was rooted in the growing credibility of the government. Under the leadership of Deputy Prime Minister Victor Pynzenyk, a complex program of economic reforms had been prepared. How-ever, this program was rejected by Parliament and became one of the examples of reform attempts which failed due to the lack of political support.

As a result, in the middle of 1997 foreign investors, comparing political declarations with limited results of government activity, reassessed the level of investment risk in Ukraine and started to withdraw their money from domestic treasuries. The outflow of portfolio investments was accelerated by financial crisis in South East Asia. As a result, the foreign exchange reserves of the National Bank of Ukraine (NBU) decreased and the exchange rate of hryvna began sliding. Along with the drop in foreign exchange reserves the central bank was increasing credit to government. In autumn 1997, the central bank started to buy T-bills on the primary market, replacing outflow of foreign portfolio capital. The monetary policy was asymmetric. While inflows of foreign short-term capital led to an increase in reserve money, its outflow was not reflected in the fall of reserve money. As a consequence, the central bank assets structure deteriorated as the drop in foreign assets was balanced by increases in credits to the government. The ratio of foreign assets to reserve money had fallen which limited the potential room for maneuver of the monetary and exchange rate policies. The gross foreign exchange reserves amounted to USD 2,854 million in August 1997 and went down to the level of USD 2,374 million at the end of the year. The Central bank's policy allowed the exchange rate to remain stable: at the beginning of 1997 it amounted to UAH/USD 1.893 and in the end it was equal 1.899. A disinflation policy continued and CPI increased in 1997 only by 10.1%.

Over this period no significant structural reforms were implemented. Moreover, the public sector unbalances increased. The general government deficit (including Pension Fund) grew from 3.4% of GDP in 1996 to 6.1% of GDP in 1997. With limited monetization possibilities, growing bud-

getary imbalances caused an increase in the burden of public debt and interest payments.

At the end of 1997, when the possibility of a crash on the T-bills market was high, the central bank increased its interest rate from 16% to 35%. However, it did not stop the outflow of portfolio capital. Furthermore, the central bank was involved in the process of hedging the external credits provided for financing fiscal deficit. In the case of devaluation, it created additional pressures on foreign exchange reserves.

In order to maintain its liquidity, the government continued to borrow while not paying much attention to the price of new credits. Using the opportunity to raise money on international financial markets, Ukraine, with a low credit rating, issued Eurobonds with enormous coupon equal to 16%, eventually resulting in a debt trap. However, this could have been avoided. If Ukraine had accelerated structural and fiscal reforms it would have allowed arresting debt growth and would have created the basis for economic growth. Meanwhile, on the eve of parliamentary elections, budgetary expenditures were increased. The budget deficit in the first quarter 1998 was equal to 7% GDP. Due to the lack of progress in reforms and missing the performance criteria, in March 1998 the IMF stopped further tranches of the stand-by credits.

Capital outflows accelerated, leading to growing pressure on reserves and the exchange rate. As a consequence of the capital outflow, debt repayments in foreign currencies and the central bank interventions on the forex market, the gross foreign exchange reserves dropped from USD 2,374 million at the beginning 1998 to USD 1,490 million in the end of July 1998. At the same time hryvna depreciated from UAH/USD 1.899 to 2.1349. The deteriorating macroeconomic situation was not properly recognized as there was economic growth of 0.2% in the first half of the year and inflation for the same period was equal to 3% only. Almost nothing was done in the field of fiscal and structural reforms at that time. The general approach was to roll over the existing debt and finance the new deficit. Ukraine wanted to issue new securities on the international financial markets. EFF credit from the IMF in the amount of USD 2.2 billion has been negotiated and expected to be approved in August 1998. However, in August Russia entered the financial crisis and spillover effects were observed in Ukraine almost immediately.

3.2. Macroeconomics

3.2.1. Fiscal Policy

In order to capture the complexity of fiscal performance we will focus on the following aspects: measurement, budgetary planning, tax policy, diversification in the financing sources, and interrelationship between the government and the central bank.

Ukraine has made considerable progress in fiscal reforms, which have led to significant decreases in cash budget deficit (Table 3-1). However, the overall fiscal stance cannot be evaluated on the basis of the cash deficit only. Fiscal adjustment has been achieved mostly due to sequestration of expenditures and an increase in budgetary arrears as the necessary reforms of the tax system, fiscal management, social policy, etc. are still delayed, and privatization, restructuring, and deregulation processes are going very slowly.

The decrease in the budget deficit on a cash basis was accompanied by a drop in the transparency of public finances, growth in budgetary and tax arrears, and widespread use of netting out operations. The government was involved in various quasi-fiscal operations, which were not reflected in the budget record. Thus, the deficit calculated on the accrual basis would be higher than the cash deficit. Moreover, the privatization receipts were included into budget revenues. According to international accounting standards, this item should be one of the sources of budget deficit financing. Additionally, in 1998 tax payments in kind were accepted and amounted to 2.3% of general government revenue. This practice also contradicts international standards [IMF, 1986]. Therefore, budget deficit calculations according to the IMF methodology would be even higher.

The second observation focuses on budgetary planning. During the period 1991–1999, the budget approved by Parliament was never executed. There were systematic errors in planning budgetary revenues, as the basis for the plan was plan for the previous year, not the data concerning execution. The actual revenues were always lower than the plan, so the revenues projection assumed in the budget were always overestimated. Initially, it was the result of a shortage of skilled personnel at the Ministry of Finance then there was a lack of political will to create realistic budget.

Consequently, consolidated budget expenditures have been constantly unfunded and not executed as provided by law. Funded expenditures ranged between 84% to 96.5% of approved appropriations during 1995–1999 [Tomczyńska, 2000]. As a result, expenditures were sequestrated. However, sequestration did not protect efficiently from the growth of budgetary liabilities, which could not be paid off, as the budgetary institutions made expenditures according to the assignations in the budget. Budgetary arrears along with lack of structural reforms in the economy stimulated growth in tax arrears. Consequently, the government allowed clearing operations and started to issue bills of exchange which were used as a money surrogate and as a medium of exchange to repay obligations to the budget. The final results were growth in tax and budgetary arrears and in mutual settlement operations (Table 3-1).

One of the reasons for an unrealistic budget were the budgetary rules themselves. The role of the Ministry of Finan-

ce in the budgetary process was more limited than in other countries. Parliament, while approving budget, could change the level of revenues, expenditures and the deficit. While the project prepared by Ministry of Finance reflected some macroeconomic constraints, the same could not be said about the budget approved by Parliament reflecting wishful thinking and populist approach. Additionally, taking out tax policy issues from the Ministry of Finance to the State Tax Administration (from 1996 till 1999) weakened further the position of the Ministry of Finance.

One of the components of the system of public finances are extrabudgetary funds, many of them were not incorporated into the budget. The budget for 2000 again included the task of incorporating extra-budgetary funds into the budget. It is essential to note that neither Statistical Committee, nor the central bank has a full record of operations undertaken by these funds. There is still enormous work to be done concerning the transparency of fiscal operations.

The need for substantial restructuring of the tax policy has not been addressed yet despite some attempts. At the end of 1996, Deputy Prime Minister Victor Pynzenyk initiated a complex tax reform (as the part of *Economic growth 1997* program containing also measures in the field of deregulation, privatization, land reform, pension reform, etc.). The proposed changes in the tax system were generally aimed at lowering tax rates (particularly of the payroll taxes) in exchange for broadening the tax base and eliminating most of the existing exemptions. Unfortunately, most of this package was not supported enough by the Prime Minister and the rest of government, and blocked by the Parliament. Only two laws (on VAT and on profit tax) were adopted in 1997. However, the final version of these laws differed from the proposed drafts and most of the existing exemptions remained. Both President and Parliament continued to grant the new tax exemptions, particularly in the eve of parliamentary election in March 1998.

A further attempt to reform the budget and tax policy was undertaken at the beginning of 1998. Some of the proposed measures were taken from the above mentioned program of economic growth, however these steps were lacking in consistency. The President signed the decree decreasing the level of budget expenditures. On the President's initiative, some decrees concerning taxes were adopted [Dąbrowski et.al., 1999c]. However, most of them were rejected by the Parliament.

Since the beginning of 1999, the adopted changes in tax policy were subordinated to the purposes of presidential election campaign. The Parliament and President approved mostly populist, anti-reform measures. For example, the President signed the decree canceling the outstanding debt (including tax arrears) in the agriculture sector and exempting agriculture from VAT. On the other hand, Parliament readopted zero VAT and excise tax rates for the goods named "critical import", and decreased the excise tax rates for petrol and alcohol. The Cabinet of Ministries joined these actions, exempting some enterprises from taxation.

In the period under discussion, some tax and other revenues were collected in the form of mutual settlements, i.e. netting out the existing budgetary arrears and enterprises' tax obligations [World Bank, 1999]. In 1997, 74% of state budget revenues and 66% of local budget revenues were collected in cash, the rest came in the form of netting out operations. In 1998, these numbers were equal to 88% and 68% for state and local budgets respectively.

The increased level of tax arrears matches the shrinking level of tax receipts. The volume of tax arrears increased from UAH 1.3 billion in 1996 to UAH 2.3 billion in 1997 and amounted to UAH 10.3 billion at the end of 1998. The policy of repeated restructuring or cancellation of these arrears (aimed at eliminating them) has resulted in decreasing tax discipline and increased moral hazard.

Among the most important drawbacks of the tax policy, we could indicate the wide range and volume of tax exemptions and unstable tax system. For example, in the period between 1997 and 1998, almost 200 amendments were made to the VAT law [World Bank, 1999]. At the same time the tax burden on entities and individuals that are paying taxes increased. The tax system became the object of permanent political struggle and lobbying both in the Parliament and the Government. Enlarging the list of tax exemptions and permanent manipulation of tax rates decreased significantly the efficiency of tax collection.

The permanent decline in real revenues from the enterprise profit tax reflected the economic situation of enterprises. The bankruptcy procedures were almost not working, GDP continued to fall, and the share of unprofitable enterprises in the national economy had increased from 22.2% in 1995 to 53% in May 1999. This reflected the slow pace of structural and institutional reforms including privatization and soft budget constraints.

The tax system failed to satisfy the state's need in revenues, and did not fulfill its regulatory and stimulating functions. The existing tax system distorted efficient allocation of resources, did not foster savings and investment and, successively, economic growth. In addition, it was not fair, not stable, not simple, not neutral, and could be characterized by low transparency and high compliance and administrative cost. The existing tax system led to the creation of the structure of budgetary revenues that differed from those observed in the other transition economies with direct taxation exceeding indirect taxes and high share of non-tax revenues.

Inefficient tax regulations and excessive public sector expenditures could be maintained due to the existence of budget deficit financing sources. Until 1995, budget deficit was financed mostly by direct credits from the central bank and by foreign loans from the so-called official sources (international financial organizations and bilateral aid). In 1995, the treasury securities market had been launched. Its develop-

ment allowed rising money for the deficit financing. In 1998, as a result of crisis, T-bills payments were restructured, which led to drop in demand for them. The central bank replaced private capital and became almost the only investor at the T-bills market.

Fiscal tightening observed in 1995–1996 was followed by relaxation of the fiscal policy in 1997. It was possible due to ample demand of foreign investors for T-bills. This source of budget deficit financing was limited in the fall 1997. In 1998, the outflow of both foreign and domestic investors from the T-bills market continued, leading to devaluation crisis in August and the necessity of urgent restructuring of government obligations in September and October 1998. However, the fiscal adjustment took place only in the second half of the year, when the demand for government securities dropped almost to zero. Access of the government to the T-bills market became, in fact, completely closed and other sources of deficit financing (foreign loans, NBU credit) were limited.

Starting from the inception of T-bills market, the government built the debt pyramid. Lacking in liquidity, the government issued new securities to repay those, which matured. Following this scheme, UAH 304.1 million was borrowed in 1995, UAH 3145.1 million in 1996, UAH 8051 million in 1997, UAH 7341 million in 1998. In the first half of 1999, UAH 2117.4 million was raised from T-bills. Starting from October 1997 the net volume of T-bills transactions became negative.

In the fall of 1997, the Government increased T-bills yields from about 20% in August 1997 to nearly 50% (this implied 40% real profit), which only in part prevented outflow of foreign capital. This operation saved public debt market only temporally. At the same time, the attempts to obtain financing from the official creditors failed. As a result, the T-bills market turned out to be the only source of credit to the government. In order to avoid collapse of this market and supply the budget with financial resources, the NBU started to participate in the primary market of government securities replacing gradually foreign and domestic investors. In August 1998, the NBU announced that its share in the T-bills market had raised to 63% of all outstanding debt. Foreigners' share in the market has dropped to 28% in August 1998 from above 50% in the middle of 1997.

In the middle of 1998, the economic situation in Ukraine further deteriorated. Inability to get foreign loans ruined the Ministry of Finance's (MF) plans to finance T-bill redemption with foreign funds, which led to growth in interest rates and increasing involvement of the NBU. The banks' involvement shrunk, as the MF refused to float short-term securities. MF reduced the number of weekly auctions from four to two. Default on the government debt in Russia and near-default in Ukraine ("voluntary" debt conversion under the risk of official default) froze the T-bills market. The NBU became the only buyer.

In February 1999, the MF conducted mandatory conversion of T-bills from the commercial banks portfolio what completely destroyed the government credibility, increasing default premium. However, the MF was not going to pay this premium, as long as the NBU was buying long-term government securities with yield not reflecting market preferences. In May 1999, the new *Law on the NBU* was adopted. One of its sections regulates the relationship between the NBU and government, banning the central bank to extend a direct credit to government [1]. However, the central bank continued to be an active participant of OVDP auctions, breaking not only the concept of central bank independence but also the law.

One important topic concerns the relationships between the NBU and MF in the context of NBU's profit transfer to the budget. The central bank, as a public institution, should be obliged to transfer its profit to the budget. With the NBU participation at the OVDP primary market, this obligation is even more obvious [2]. However, actual NBU profit transfers did not reflect the central bank revenues coming from purchase of the OVDP. The NBU profit and loss account statement reveals that in 1995 allocation to the budget was equal to 2.1% of overall profits, in 1996 this share was equal to 7.5%. It means that seigniorage remained mostly in the bank and was not transferred to the budget. The bank allocated these resources for financing construction projects and "social protection of employees". This raises the question of transparency of the NBU operations and its accountability.

The development of the T-bills market has not been supported by fiscal reform and other structural reforms. Continuing GDP decline has additionally contributed to the fast accumulation of public debt to the level exceeding 60% of GDP in 1999. Taking seriously into account some other legal promises done by the Parliament such as inflationary revalorization of saving accounts in the Savings Bank, the ratio of public debt to GDP would exceed 200% of GDP [Brudzynski and Kovalev, 1999]. The mandatory conversion of the OVDP reduced country's creditworthiness and the interest rates became a heavy burden for the budget. In the light of such developments, a hope for revival of T-bills market in a short perspective is not realistic.

[1] Direct central bank lending to the government can have form of the overdraft on the Treasury accounts in the NBU, fixed-term loans, cash advance, or direct purchase of government securities [Mackenzie, Stella, 1996].

[2] According to the budget for 1997, the NBU had to transfer 200 million UAH as the profit to the budget. The realized amount was equal to 92,5 million UAH. At the budget for 1998, the amount of 200 million UAH was approved. According to the State Treasury, in the first half of this year the NBU transferred UAH 135 million in current profit to the budget. Amendments to the 1998 budget provide for increasing the NBU profit slated for the budget in 1998 from UAH 200 million to UAH 400 million. However, the NBU transferred about UAH 180 million of its profit only to the state budget.

3.2.2. Public Debt

One of the factors undermining progress in budget deficit reduction was the accumulation of public debt. There is no law on public debt in Ukraine, therefore the method applied for measurement may strongly influence the results. According to the MF data, in the middle of 1999 public debt was equal to 57% GDP. The figure reported by the Accounting Chamber was equal to 174% GDP in the same period [Brudzynski, Kovalev, 1999]. The difference between these figures originates from the fact the Accounting Chamber includes debt on pensions and other social payments, debt of government with the NBU and restructured physical persons' savings.

The main component of foreign public debt comprises obligations before international organizations, i.e. IMF, World Bank, EBRD and EU. The second item is credit from foreign governments with the majority of liabilities towards Russia. As concerns domestic public debt, the NBU is the largest creditor.

Most of the public debt represents a short-term maturity structure and high yields, reflecting the lack of credibility in the government. A significant part of the liabilities towards NBU was restructured and converted into long term debt, however coupon payments will need to be paid during next few years. In the beginning of 2000, the government proposed exchanging external bonds with a total value of USD 2.6 billion (or 21.6% of total external debt) [HIID, 2000]. A significant part of this conversion concerned Ukrainian Eurobonds, which were held by several thousand investors. According to the restructuring plan, commitments maturing in 2000–2001 were converted into Eurobonds maturing in March 2007 and denominated in either USD or EUR.

This debt restructuring exercise can be considered as a success, as over 85% of Ukraine's creditors accepted government conditions. Conversion of foreign liabilities undertaken in 2000 allowed delaying repayment, yet closed Ukraine's access to the international financial markets. The attractiveness of the Ukrainian debt instruments was destroyed for the next few years.

As of July 1, 2000, total foreign debt stood at roughly $10.6 billion, which is 15% lower than year before. Domestic debt increased from UAH 15 billion ($2.7 billion) to UAH 23.2 billion ($4.2 billion), mainly due to the restructuring of the government debt to the National Bank of Ukraine in the first half of this year [PricewaterhouseCoopers, 2000a]

3.2.3. Monetary and Exchange Rate Policy

The effectiveness of monetary policy measured by price stability was surprisingly high. However, the dynamics of monetary aggregates give little clue as to the sources of instability, demonstrated by the August 1998 crisis. A growth in monetary base and broad money does not conform to a pattern that could explain the low volatility of inflation and the exchange rate before the crisis.

In 1996–1997, the inflow of portfolio investment on T-bills market put pressure on the hryvna, which led to significant net purchases of the foreign exchange by the NBU in order to prevent a serious appreciation. The inflow was partly sterilized, but in general the reserve money was allowed to grow in line with growth of foreign assets. These years witnessed a low correlation between the money growth and prices, which signified the gradual increase in money demand. The increase in money demand was predominantly transaction-based and related mainly to currency in circulation [Markiewicz et.al., 1999].

In the second half of 1997, the outflow of foreign short-term capital exercised pressure on foreign exchange reserves of the NBU and on the exchange rate of hryvna. The NBU did not allow reserve money to fall in line with foreign assets.

The fall in foreign assets was substituted with NBU credit to government. On autumn 1997 the central bank started to participate in the OVDP's primary market. From then on, the share of T-bills bought by NBU consistently increased. The lower was the share of short-term foreign capital, the higher was the T-bills market's share of the NBU. As of August 21, 1998, the volume of OVDPs owned by the NBU was equal to 63% of all issued bills. Raising the NBU purchases of T-bills to offset nonresident withdrawals sustained strong real growth in domestic credit after August 1997, even despite cuts in refinancing to commercial banks.

Trying to prevent a collapse of T-bills market, the NBU raised the refinance rate from 16% in October 1997 to 35% in November 1997. These steps only partly prevented an outflow of foreign capital. Interest rates on T-bills market gradually rose, reflecting shrinking demand for government securities with almost sticky supply.

Monetization of the Ukrainian economy rose from 10.4% in September 1997 to 12.3% in August 1998. In the second half of 1997, the increase in money demand was predominantly because of growing demand for hryvna denominated savings instruments. In the beginning of 1998, the foreign exchange denominated deposits had started to growth faster then hryvna ones. The positive tendencies in banking sector deposits growth became less intensive.

As a result of a deterioration of fiscal position and foreign capital outflow, depreciation accelerated causing depletion of foreign exchange reserves. Conditions on international financial markets deteriorated considerably in the middle of 1998. Among other things, investors' demand for securities in developing markets dropped significantly. The government experienced a shortage of funds to repay its domestic and external obligations. In the third quarter of 1998, the NBU has remarkably extended credit to government. Ukraine had started to negotiate a new credit EFF from the IMF. Then the Russian crisis hit.

The common view was the perception of Ukrainian monetary policy being too tight. However, the fact was that

monetary policy was subordinated to fiscal policy and the central bank in many ways supported the government [Markiewicz, 1998]. Firstly, in autumn 1997, the central bank started to take part in the T-bills primary market, which was a form of direct financing of the budget deficit. The central bank's participation at the primary OVDPs auctions changed its role from passive agent of the Ministry of Finance into active participant of the T-bills market. Second, the central bank was involved in the process of hedging the external credits to government in foreign currency. Third, T-bills were used to meet reserve requirements of the commercial banks according to the decision of the central bank. Finally, the scale of fiduciary operations revealed by the reports of PricewaterhouseCoopers (2000b) indicated significant NBU assistance for the budget [3]. All these activities of the central bank contradicted the widespread opinion about restrictive monetary policy.

The growth of budgetary liabilities against the central bank has not caused direct inflationary consequences due to sterilization policy carried out by NBU. The central bank was extending credit to government (by the purchases of new bills) and simultaneously made the conversion for that part of securities withdrawn by non-residents from the market, decreasing the level of foreign exchange reserves and curbing in this way the growth in reserve money. This could be considered as a shortsighted policy that created only new threats for macroeconomic stability. First, the monetary policy supportive for the budget hampered necessary fiscal adjustments. Second, the policy of sterilization caused the additional pressure on the foreign currency reserves, and created a new threat to exchange rate stability. Third, the central bank conducted the sterilization policy inconsistently.

Another topic was the exchange rate policy. Since the introduction of hryvnia, the managed float persisted until May 1997. Then a narrow band was introduced (Table 3-2). The band was changed several times with a tendency to extend its range. The introduction of a corridor was stimulated by a willingness to have a nominal anchor in furthering the stabilization process [Markiewicz et.al., 1999]. The foreign capital outflow forced monetary authorities to change the exchange rate corridor few times. All the corridors (except the first one) failed before the announced deadline of existence. The peg exchange rate policy (within a band) not supported by sufficient reserves of foreign exchange, in case of capital outflow created the threat of speculative attack on domestic currency. Moreover, the central bank was obliged to defend the exchange rate, leading to a drop in foreign exchange reserves. When the Russian crisis had started, the central bank intervened on the interbank market, being the only participant selling foreign currencies. About USD 377 million was spent to defend the exchange rate before it was announced a failure.

3.2.4. Foreign Trade and Balance of Payments

The Ukrainian economy is relatively closed and the share of foreign trade with other countries permanently decreases. During the period 1994–1999, the share of exports to GDP decreased from 44% to 42% and imports from 47% to 44% [Kuz'myn, 2000]. It should be noted that real GDP for this period was shrinking.

During the last few years, a change in the direction of trade, along with diversification of exports, has taken place. However, Ukraine remained strongly dependent on import from Russia, with its share making up almost 50% of overall import volume (mostly energy resources). Some scaling up is taking place in overall foreign trade with EU countries, however, there are number of factors, which hinder further developments. First, the low competitiveness of goods on international markets should be admitted. Most of the exports consist of ferrous metals, chemical industry products, machinery, equipment and electrical appliances and mineral products. The problem stems from slow restructuring of industries and, in general, the slow pace of structural reforms establishing conditions for long-term growth and exports. Secondly, the government imposes different trade restrictions, particularly tariff and non-tariff barriers and customs regulations. Thirdly, Ukraine with a "non-market economy country" status is vulnerable to anti-dumping investigations against the goods originating from this country. Ukraine is involved in negotiations on the membership in WTO, however, the progress in this field is extremely slow.

Since the crisis, a decrease was observed in foreign trade as a consequence of real appreciation of currency against the Russian ruble [4] and administrative regulations imposed on trade which led to drop in exports and an even greater fall in imports. As a result, the trade balance turned out to be positive starting in Q2 1999 (for the first time since 1994). Export started to revive in the beginning of 2000, mostly due to favorable conditions on the international markets of metal products.

Both the current account and the overall balance of payments followed similar patterns. Starting from the beginning of 1998, the overall balance of payments deteriorated significantly, due to an increase in short-term foreign capital outflows and the financial crisis in Russia. As a result, there was a substantial loss of reserves. The situation started to improve in Q2 1999.

As far as the financial account is concerned, the balance of payment data shows that Ukraine still has problems in attracting new foreign capital into the country. Inflows of FDI into Ukraine are among the lowest in the region on a nominal and per capita basis. Investments in Ukraine, since the country's

[3] The NBU had overstated its reserves and engaged in numerous instances of misreporting in order to obtain next tranches of IMF stand-by credits.

[4] At the end of October 1999, UAH devalued in real terms from 10% to 50% comparing to January 1997 against currencies of Italy, Germany, Turkey and USA and appreciated by 12% against RUB [Kuz'myn, 2000].

independence in 1991, have reached only ca. $3.5 billion, as of April 1, 2000. There are plenty of fundamental problems related to limited inflows of foreign investment. However, resistance to big privatization among leading political forces, administrative barriers and corruption should be stressed as the most important.

With regard to portfolio investments, conversion of debt carried out in 1998 and in 2000 destroyed confidence in the Ukrainian market for a long time. Moreover, the "net error and omissions" item, which was negative from 1997 gave indication of capital flight. Due to a current account surplus, the NBU foreign currency reserves started to increase in the Q2 1999, following the enormous drop in 1998.

3.3. Microeconomics

One of the biggest problems concerning microeconomics is the lack of political support for restructuring the economy, which would entail privatization and bankruptcy proceedings. The bankruptcy law remains ineffective. The following phenomena are strongly interconnected: lack of bankruptcy processes, remarkable ratio of loss-making enterprises, arrears, barter and clearing operations. As long as there is no political will to restructure the economy, these problems will not be solved. There is no doubt that all these problems are reflected in the state budget, therefore, a realistic budget would be a good starting point. As it was pointed above, none of the approved budgets was executed.

The worst situation relates to the agricultural sector where over 90% of enterprises have made losses and Parliament passed the bill with the ban for their bankruptcy for the next few years.

The size of non-payments in Ukraine was growing geometrically. Payables of enterprises (in percent of GDP) have grown almost continuously since early 1995 and in the end of 1999 stood at 154% GDP. Another group of arrears comprised tax arrears to all levels of the budget equal to 9.6% GDP at the end of 1999 [Markiewicz, 2000]. The budgetary arrears were equal to 6.2% GDP at the end of 1999 (this figure did not include arrears of budgetary organizations). Moreover, barter operations were equal to 32.7% of the total volume of operations conducted in the industrial sector in 1999 (however, this ratio has been falling).

According to the State Statistics Committee, at the beginning of 2000 about 40% of all enterprises were unprofitable. The clearing operations were systematically undertaken by all entities involved in the arrears accumulation process. These operations allowed for canceling debts and they indirectly subsidized enterprises, which produced goods that there was no demand for.

The condition of the banking sector has been as weak as the whole economy. The NBU tried to increase capitalization of the banking sector, however, this requirement was not fulfilled by most of the banks [5].

The microeconomic conditions could not be directly blamed for the financial crisis in 1998. However, they clearly increased the vulnerability of the economy.

3.4. Political Factors

When analyzing the pace of reforms in Ukraine some comments need to be made on political factors. During last ten years, there was never any political consensus concerning market reforms. The Parliament was in opposition to the President and government (appointed by President). A process of transition can not be pursued without some agreement on need to create realistic budget and accelerate structural measures. A system whereby the President appoints the government undermines parliamentary accountability. All economic decisions are highly politicized and every election is correlated with growth in budgetary expenditures. The rule of law does not exist and even the government does not fulfil its obligations. The current political regime in Ukraine involves considerable instability. Frequent amendments to the core economic legislation and slow processes of adoption of consistent legislative package push economic agents to move to the underground economy [Dąbrowski et.al., 1999a]. The need for substantial restructuring will not been addressed as long as there is no political consensus.

However, it must be admitted that during the crisis period in September 1998 there was some coordination of actions between all political actors, which allowed avoiding the worst possible scenario. Unfortunately, this cooperation lasted for a limited period of time only.

3.5. Crisis Management

On August 17, 1998, the Russian authorities decided to give up the ruble exchange rate, default on T-bills market and introduce a moratorium on the repayment of private external debt. These decisions strongly influenced Ukraine,

[5] From January 1, 1997 all banks were required to have at least ECU 0.5 million of capital, from July 1, 1997, ECU 0.75 million, and from January 1, 1998, ECU 1 million. The new deadlines were announced, however, till the end of 1999 many banks did not fulfil the minimum capital requirement.

as Russia remained its main trade partner (34,4% of trade turnover in the first half of 1998) and both countries suffered from the same fundamental weaknesses of their transition processes.

During the first week of crisis the central bank devalued the hryvna below the level indicated by the interbank market and publicly announced that the further devaluation would be possible if the situation in Russia continued to deteriorate. This fed devaluationary expectations. On August 28, 1998, the hryvna reached the upper band of the corridor, which was supposed to last until the end of the year (2.25 UAH/USD). The exchange bureaus' and interbank exchange rates became higher than the rates officially fixed and announced by the central bank. The central bank did not succeed in balancing the market and stopped intervening in the currency exchange market when the level of foreign exchange reserves dropped below USD 800 million [Dąbrowski et.al., 1999b].

On September 5, 1998, the government and the NBU decided to reexamine the parameters of the exchange rate corridor, changing its range to 2.5–3.5 UAH/USD [6]. The new parameters were established for an unlimited period of time. Furthermore, on September 4, 1998, the International Monetary Fund's Executive Board approved a three-year Extended Fund Facility loan of USD 2.2 billion for Ukraine.

The Cabinet of Ministers and the NBU approved anti-crisis measures aimed at stabilizing the country's finances, primarily in the field of foreign currency control [Financial News]. At first, the NBU banned hard currency operations on the interbank currency market and concentrated currency trading on the *Ukrainian Interbank Currency Exchange* controlled by the NBU. Banks were prohibited from having open currency positions in freely convertible currencies and from concluding futures contracts in foreign currency. The NBU also introduced control over the operation of foreign currency exchange points throughout Ukraine. A permissible deviation from official currency exchange rate was fixed at 5% level.

Banks were required to sell 75% of their resident clients' hard-currency proceeds from exports (The Cabinet of Ministers lowered this proportion to 50% within a few days). Residents were barred from making advance payments on import contracts. The NBU tightened the procedures for buying foreign currency in a bid to lower demand for the dollar at a time when its currency reserves were very low. Adopted measures allowed the NBU to fully control the foreign exchange market. Thus, the NBU tried to balance the market, using administrative and non-transparent measures. Anti-crisis measures in the field of foreign trade, budget revenues and expenditures, and social policy were implemented.

In September 1998, the government unilaterally restructured OVDP debt held by resident banks, but a decision on mandatory conversion was rescinded after bilateral negotiations. Only 16 Ukrainian banks participated in the voluntary conversion and converted 35% of the total bonds held in their portfolio. The converted bonds fall due in 2001–2004.

In October 1998, debt held by nonresidents was restructured. The conversion included about 99% of the total volume of securities that were subject to conversion. As concerns those, which were redeemed, the NBU refused to convert the money into dollars and government proposed their reinvestment in Ukraine. Standard & Poor's qualified these actions as a default, though officially default was not announced. Securities held by nonresidents were converted into coupon bonds in foreign currencies due in 2000 [7]. As a result of conversion, demand for treasury securities disappeared and the central bank became the only buyer of them.

The first tranche of the IMF credit, combined with the introduction of administrative control on the currency market and restructuring of the public debt, allowed the authorities to curb the rapid depletion of foreign exchange reserves. However, these were only the short-term measures to control the state's liquidity. Structural measures were badly needed, as well as a realistic budget.

The IMF disbursed two tranches of EFF loan program in the overall amount of USD 336 million and suspended financing in November 1998 until the new budget will be adopted [8]. The IMF decision was followed by other international financial institutions, i.e. the World Bank and the EU. The main conditions for resumption of the IMF and World Bank loans were approval of a realistic 1999 state budget that would ensure financial stability and introduction of structural reforms which were already behind a schedule. In order to obtain the next tranche of EFF loan, the government needed to improve tax collection and cancel mutual settlements.

On December 31, 1998, Parliament approved a budget for the next year. The budget was considered unrealistic by most experts, especially in the part related to revenue plan and financing sources. Most of the restrictions on the forex market were canceled within one year [9]. Up until then, the parallel foreign exchange black market had existed.

[6] The previous exchange rate corridor of 1,8–2,25 UAH/USD was announced on January 21, 1998, for the entire 1998. At the same time the monetary authorities abandoned the exchange rate corridor of 1,75–1,95 that was established on October 31, 1997 for the first half of the 1998.

[7] These bonds were converted again in the beginning of 2000.

[8] In 1999, the IMF financing was resumed and Ukraine received 625 million under the loan program during 1999. The amount available under the EFF loan program was increased by USD 365 million in May 1999. The National Bank of Ukraine received the last tranche (USD 180 million) of the IMF's EFF loan in mid-September of 1999. Then the financing was suspended and was resumed in December 2000 only.

[9] Only in July 2000 restriction on making advance payments on import contracts was suspended.

3.6. Consequences of the Crisis and Post-Crisis Recovery

The course of financial crisis in Ukraine was less dramatic than in Russia. There was no banking crisis, as Ukrainian banks had not been involved in foreign borrowing and off-balance sheet transactions on derivatives. Then there was no political crisis. Some outflow of private and enterprise deposits was observed but it did not undermine banking sector's liquidity. In the end of 1998, the value of banking deposits started to grow, but one should bear in mind that the deposits base of the banking sector was relatively small and amounted only to about 8% GDP. With the annual devaluation of hryvna equal to 80% in 1998, CPI index grew by 20% and PPI by 35.4% only. The sharp devaluation of the domestic currency turned the current account balance into surplus. With a lag of one and half a year, exports started to grow, improving the CA balance and leading to a replenishment of foreign exchange reserves of the central bank.

At the end of 1998, foreign exchange reserves were equal to about USD 1 billion (whereas only half of them were liquid) and foreign liabilities due in 1999 were equal to USD 1.7 billion. Unsurprisingly, the only way to avoid default was to restructure debt (carried out in the end of 1998 and in the beginning of 2000).

The financial crisis implied a sharp devaluation of the hryvna and brought a new wave of inflation. The credibility of exchange rate system had been destroyed and a floating exchange rate regime was introduced in February 2000. The real value of income and savings had dropped, undermining credibility of domestic currency and slowing down remonetization. As a result of debt conversion access to private financial markets was closed for next few years. One of the most costly consequences of the crisis was a decrease in the central bank independence. As there were no other financing sources, the central bank again became the main creditor of government.

After symptoms of moderate economic recovery in the first half of 1998, the real GDP started declining in the period of crisis. Only in the third quarter of 1999 did real GDP start to grow again and in 2000 the growth rate was positive for the first time since independence. One of the driving forces of economic growth was exports which have grown due to the real devaluation of the exchange rate but mainly due to growth in Asian countries and growth of external demand for Ukrainian export.

In order to decrease vulnerability of the economy and create a basis for long-term growth, structural measures need to be taken and public finances improved. However, this does not seem to be the case. So far, the government was not able to carry out the large scale restructuring and privatization of state owned enterprises. In 1999 and 2000, budget revenues from privatization were lower than planned. Moreover, the budget accepted for 2001 was not based on realistic assumptions [Tomczyńska, 2000]. In the absence of external financing, adjustment would require additional compression of domestic demand as well as cuts in budgetary expenditures.

3.7. Conclusions

This paper presents some issues related to the Ukrainian currency crisis in August 1998. The primary reasons for the crisis were bad policies and weak fundamentals. Budgetary policy was particularly responsible for the vulnerability of the economy to changes in portfolio investors' sentiments. A process of debt accumulation caused by excessive government borrowing led to the building of a debt pyramid. When investors decided to leave the Ukrainian T-bills market, the NBU started to spend foreign exchange reserves to defend the exchange rate. The beginning of Russian crisis accelerated these processes.

Two years after the crisis, the economy started to grow – but fundamentals remained as weak as before the crisis. The process of debt restructuring delayed repayment of debt for next several years. If the current policies continue, Ukraine will not be able to repay these debts in the future.

The currency crisis may have some positive consequences if it leads to the mobilization of efforts and acceleration of necessary painful adjustments. This seems not to be the case in Ukraine. A sharp devaluation did not restore macroeconomic equilibrium. Economic policy is unlikely to achieve a sustainable fiscal consolidation and accelerate structural reforms. As the government does not seem to be ready for the implementation of a consistent program of economic reforms, the next wave of crisis is still possible.

Appendix: Chronology of the Ukrainian crisis

Before the crisis

The middle of 1997 – the beginning of foreign portfolio capital outflows

Fall 1997 – the NBU started to participate in primary market of government securities

Depletion of foreign exchange reserves of the NBU from USD 2,854 million in August 1997 to USD 2,374 million in the end of 1997 and USD 900 million in the end of August 1998

October 1997 and January 1998 – change in the parameters of the exchange rate corridors (before the announced deadline of its existence)

Increase in general government deficit from 3.4% of GDP in 1996 to 6.1% of GDP in 1997 and 7% in the first quarter of 1998.

November 1997 – the NBU increased discount rate from 16% to 23.4%, then to 25%, and finally to 35%

March 1998 – IMF stopped disbursement of the Stand-by credit due to the lack of progress in reforms and missing the performance criteria

Crisis

August 17, 1998 – the beginning of the financial crisis in Russia

August 28, 1998 – hryvna exchange rate reached upper band of the corridor, which was supposed to last until the end of the year

September 4, 1998 – IMF approved three-year Extended Fund Facility for Ukraine of USD 2.2 billion

September 5, 1998 – the parameters of the exchange rate corridor were reexamined

Fall 1998 – government and the NBU approved anti-crisis measures, restructuring of government debt took place

On December 31, 1998 – Parliament approved a budget for the next year

Recovery

Q4 1999 – real GDP growth

July 2000 – the last restrictions on the foreign exchange market were abolished. Since then the exchange rate is established on the market.

Tables

Table 3-1. Summary macroeconomic indicators

	1995	1996	1997	1998	1999
Real GDP (% change to the previous year)	-12,2	-10,0	-3,0	-1,9	-0,4
Nominal GDP (bln UAH)	54,5	81,5	93,4	102,6	127,1
CPI (annual %)	181,6	39,7	10,1	20,4	19,2
General government deficit (% GDP)	6,8	4,8	6,7	2,0	1,5
Tax arrears (cumulative) UAH mn	545,0	1365,0	2342,0	10301,7	12154,4
Budgetary arrears (cumulative) UAH mn	581,0	3299,8	5634,4	9673,0	7900,2
Mutual settlements and promissory notes UAH mn	870,0	6086,8	8339,0	4984,5	5274,4
Money base (mn UAH eop)	3538	4882	7058	8604	11988
M2 including deposits in foreign currency (mn UAH eop)	6846	9024	12447	15432	21714
Exchange rate eop UAH/USD	1,794	1,889	1,899	3,427	5,216
External debt (mn USD) eop	8217	8839	9555	11483	12438

Source:IFS, Ukrainian Economic Outlook, Ukrainian Economic Trends, Brudzynski and Kovalev 1999, IMF (1999), Ministry of Finance, Tax Administration

Table 3-2. Exchange rate corridors

Date of announcement	Range (UAH/USD)	Announced date of ending	% devaluation	Maintenance
May 1997	1.7 – 1.9	End of 1997	12	Maintained
October 31, 1997	1.75 – 1.95	First half of 1998	11	Till January 19, 1998
January 19, 1998	1.8 – 2.25	End of 1998	25	Till September 3, 1998
September 5, 1998	2.5 – 3.5	Not announced	40	Till February 8, 1999
February 9, 1999	3.4 – 4.6	End of 1999	35	Maintained*

*Maintained, although the exchange rate in the end of the year was above the upper band
Source: Markiewicz et.al., 1999

Table 3-3. Balance of payments 1996-1999, million USD

	1995	1996	1997	1998	1999
Current account	-1152	-1184	-1335	-1296	834
Trade balance	-2702	-4296	-4205	-2584	-482
Capital account	6	5		-3	-10
Financial account	-726	317	1413	-1340	-55
Net errors and omissions	248	259	-781	-818	-953
Overall balance	-1624	-603	-703	-3457	-184
Reserves and related items	1624	603	703	3457	184
Reserve assets	-469	-894	-385	1328	-281
Use of Fund Credit and Loans	1221	776	283	279	75
Exceptional Financing	871	721	805	1850	390

Source: IFS

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Part IV.
The Moldavan Currency Crisis, 1998
by Artur Radziwiłł

Introduction

Moldova underwent a major financial crisis that came on the heels of the Russian crisis in August 1998 [1]. The crisis led to the rapid depreciation of the domestic currency and dramatic changes in the structure of balance of payments. The capital flight brought the country to the verge of default. The Russian crisis affected the real economic activity in Moldova over a longer time period through the sudden loss of access to major CIS export markets. While the real sector suffered severely, the banking sector survived the crisis relatively intact.

Fundamental macroeconomic imbalances convincingly explain the occurrence of the financial crisis in Moldova. The lack of structural reforms and loose fiscal policy resulted in unsustainable internal and external positions at the end of 1997. Unless rapid policy adjustments were introduced, this situation was bound to lead to a financial crisis. The turmoil in financial markets that followed the 1988 Russian crisis was therefore a trigger that brought the inevitable collapse of the fragile monetary stabilization. Only a more disciplined continuation of structural reforms and close cooperation with international financial institutions can provide a basis for financial stability of the country in the future.

4.1. Crisis Sequencing

The immediate cause of the financial crisis in Moldova was the rapid deterioration in the balance of payments after the outbreak of the Russian crisis in August 1998. While the current account imbalances between 1995 and 1997 were coupled with surging capital inflows that increased twofold over the period, both current account and capital account were negatively affected in the second half of 1998. Major improvements in the balance of payments were also the most visible signs of adjustments in the year following the crisis.

As a result of the crisis in Russia and neighboring countries, Moldovan exports to CIS countries declined by 29% in 1998 and registered a further fall of 40% in 1999. Export prices also fell abruptly. At the same time, the Russian providers started to demand more strict payments for supply of energy. For the first time since early 1996, Moldova reported a negative trade balance with Russia. The impact on the trade balance was alleviated in the second half of 1998 by the decreasing imports from non-CIS countries. However, the overall trade performance was very unfavorable in 1998, when the trade deficit reached 24% of GDP (in comparison to 15% in 1997). After the deterioration in economic situation in Russia private remittance, important item in the Moldovan current account shrank significantly, so the net factor income in 1998 decreased by 50% in comparison to 1997. Although this change was offset by the surge in net current transfers, the current account deficit increased to 20% of GDP in 1998 in comparison to 16% in 1997.

As a consequence of the Russian crisis, Moldova, like other countries in the region, experienced a dramatic outflow of private financing with rising interest spreads on treasury bills. In response to the crisis, foreign investors in Moldova withdrew their funds, converted them into dollars and left the local financial market. Domestic entrepreneurs and commercial banks also became involved in speculations against national currency. The situation was very difficult due to the negative financing from international financial institutions. Inflows of FDI remained more stable, but insubstantial. Following the Russian crisis, the capital account shifted into a large deficit, while positive balance in 1997 covered 120% of current account deficit.

The balance of payments crisis exerted strong pressure on the national currency. Initially, the NBM tried to maintain the exchange rate through substantial interventions on the foreign exchange market. In the few months between August and November 1998, the NBM reserves were

[1]This paper draws on Radziwill et. al. (1999).

depleted to the 1994 level while depreciation pressures did not subside. The NBM was making attempts to stabilize the situation by changing the reserve requirement on commercial banks deposits from 8% to 25% at the peak. This effort also proved to be unsuccessful.

Finally, in November 1998, the NBM stopped interventions and allowed commercial banks to freely determine the exchange rate. Since that moment, the official exchange rate has been set as a weighted average of rates in interbank transactions. Until the end of November 1998 the exchange rate depreciated from 4.5 to 9.5 leu per 1 dollar. Later on, situation in the foreign exchange market stabilized and exchange rate in the end of 1998 was 8.3. In 1999 the nominal exchange rate was constantly depreciating to reach 11.6 leu per dollar at the end of the year.

Depreciation of the currency put strong pressure on prices, restrained only by higher supply of consumer goods to domestic markets due to abrupt loss in export possibilities in CIS markets. From the monetary point of view, two phases can be identified: first the cash in circulation shrank by about 25% in first three quarters of 1998 due to massive NBM withdrawals of lei in exchange of hard currency. Later on, the NBM extended a direct credit to government. The growth in money supply brought a surge in inflation in the fourth quarter of 1998 and at the beginning of 1999. Declining demand for real money balances was the obvious result of the loss of confidence in the national currency. Therefore, falling monetization of the economy (increasing velocity of money) was another cause for increasing inflation.

Capital flight had major consequences for fiscal policy. The unfavorable situation on international financial markets, which preceded the Russian crisis, made the debt financing of the deficit impossible, while the first nine months of 1998 brought a very unsatisfactory level of revenues. Consequently, the government introduced throughout 1998 a series of ad hoc expenditure cuts. The problem of servicing the internal debt was still not solved. While the volume of securities issued by the state was increasing continuously until 1998, after the crisis the proceeds from newly issued bills and bonds could not cover the amount needed for securities redemption. The returns on T-bills started to be immediately converted into US dollars, foreign investors refused to roll-ever state securities even at very high interest rates. In order to alleviate the crisis of confidence, the government started to issue T-bills with seven and fourteen days maturity, which managed to attract some interest. Commercial banks were also forced to hold a part of their reserves in T-bills. Still the government could not redeem all T-Bills. In this situation, the NBM was forced to direct a credit to the Ministry of Finance, with obvious impact on monetary aggregates.

Partly as a result of the crisis, Moldova was, in practice, unable to service its external debt without strong support from international organizations. In the case of Moldova, where the depreciation was not fully reflected in domestic prices, all external interest and amortization payments that the government needed to make required more domestic resources. Therefore, Moldova found itself in a debt trap, not much different than that in Latin America in the decade of eighties. The accumulated stock of external debt reached US$ 1.5 billion in 1999, which represented almost 130% of country's GDP. The share of debt service to exports raised from 17% in 1997 to almost 30% in 1998, and remained at the same level in 1999.

The crisis had a major impact on the real economy. The bad harvest in agriculture, combined with the crisis that hit the economy in the second half of the year, led to a decline of real GDP by 8.6% in 1998 and 4.4% in 1999. After the outbreak of the crisis, the decrease in industrial production was expressed in two-digit figures. Virtually all industrial sectors were damaged, including the leading agro-industrial complex. Real wages of Moldovan workers were not initially negatively affected as a result of the currency depreciation. The wage hike in the last quarter of 1998 (of seasonal character) more than offset the inflation effect and put further upward pressure on prices. Wages, however, fell both in nominal and real terms in the first months of 1999 what significantly reduced the purchasing power of the population. Wages expressed in dollar terms were falling since the outbreak of the crisis. Declining wages contributed significantly to the fall in inflation and imports in 1999.

Commercial banks emerged from the crisis relatively intact because there was no substantial currency forward exposure and the short-term debt denominated in foreign currency. There were no cases of bank runs as deposits were rather converted into dollars and into sight deposits but not withdrawn from the banks. Interest rates increased, however, significantly which impeded bank lending to the private sector and discouraged investments in fixed assets. In case of Moldova impact of financial instability on the real economy will be, however, limited because of the underdeveloped role of bank credit and the low leverage of the corporate sector. Moreover, a large share of transactions is conducted on a non-cash basis.

In 1999, major steps were taken in order to remove fundamental causes of the crisis: privatization gained momentum and a tighter budget bill was adopted. Depreciation of the domestic currency allowed curbing domestic consumption and therefore imports. As a result, the current account improved significantly. However, the chance for achieving financial stabilization was missed as cooperation with IMF was suspended again in the second half of 1999 and reforms slowed down. Lack of adequate structural reforms will therefore impede economic development in the country and the foreign debt will cast the shadow over the macroeconomic situation.

4.2. Fundamental Roots of the Crisis

4.2.1. Macroeconomics

The financial crisis in Moldova was caused by a fundamental weakness of the macroeconomic situation in the country. The first requirement of an efficient policy mix is that both fiscal and monetary policies are each on a sustainable path. This was not the case in Moldova: macroeconomic developments in Moldova in last years exhibited striking contrast between consequent tight monetary policy and loose, arguably unsustainable fiscal policy. The latter led to high absorption in the economy that was not met by the supply side response due to the impeded restructuring process. It fuelled imports and the trade balance steadily deteriorated. At the same time, capital inflows necessary to finance the budget deficit, combined with domestic restrictive monetary policy, prevented the depreciation of the currency. The ultimate result of the policy mix was the rapid accumulation of external debt and expenditure arrears. The unsustainability of both internal and external position of the state led to the inevitable financial crisis.

Unsustainable Fiscal Policy

The fiscal policy of successive Moldavian governments was driven on the expenditure side by the inertia of spending commitments and on the revenue side by the inability to actually collect taxes. Like many other CIS countries, Moldova suffered a significant drop in tax revenues in the years following the independence. This negative development was the result of both steady declines in GDP and the disruption of the tax collection system. The general decline of production and profitability of Moldovan large enterprises, the emergence of more difficult to tax private businesses contributed to a lower level of tax revenues. Low and decreasing tax revenues had also deep institutional roots: weak and rotten state structures, lack of effective law enforcement, corruption, absence of well-defined territorial borders of the country. Poor performance of revenues from income taxes stems primarily from the widespread reluctance to report properly income and earnings, even though the tax burden in Moldova was relatively small. The share of shadow economy is quite frequently evaluated at above 40% or even 60% of the formal sector.

On the other hand, expenditures were not reduced accordingly. No serious efforts were done in order to eliminate support for inefficient sectors of the economy. There was not a political group that would try to gather the general support for explicit social spending constraints. Such adjustments were indeed very needed. The last stages of existence of centrally planned economies were characterized by the build-up of extensive social expenditure programs. As the Moldovan economy shrank by 65% between 1991 and 1998, these programs became extremely expensive. As a result, the social spending bill was very high when compared to the standard levels in transition economies or middle income countries. The inability to openly reduce expenditure commitments remained the major weakness of Moldovan policy-makers. The social expenditures became the rigid part of the subsequent budget bills, although some of them were not executed later due to the scarcity of revenues. Since creditors were reluctant to finance unexpected increases in government imbalances, the budget was forced to withhold its due expenditures. During the budgeting process it became a common practice to increase planned revenues to meet the expenditure commitments. On the contrary, there was hardly any other effort to adjust expenditure commitments ex ante in line with forecasted revenues. As long as policy-makers tended to neglect realistic tax revenue forecasting, the chances for sustainable and efficient fiscal policy were very low.

Moreover, the structure of budgetary spending was characteristic for a centrally planned rather than market oriented economy. Specifically, the social assistance was not focused on the most vulnerable groups but rather to a wide spectrum of population through numerous privileges, subsidies and compensations. Those were especially concentrated in the energy sector, which led to huge overconsumption of imported energy and contributed significantly to trade deficit and related debt accumulation. Apart from that, the decline of productive sector led initially to the pressure on higher subsidies (both direct and indirect) for enterprises. Only in 1998 were more serious attempts to limit direct budget subsidies to enterprises made.

All these policy deficiencies had an impact on the size of the budget deficit. After the explosion of state budget deficit, shortly following the Moldova's independence in 1991, the consolidated budget deficit (on cash basis) peaked to 25% of GDP in 1992. Sharp adjustments, mainly on the expenditure side, reduced the gap to a less frightening level of 9% of GDP in 1993. This reduction could have been the promising prelude to the further fiscal consolidation that should have been a part of the stabilization program. However, no further significant cuts in the deficit were introduced after 1993. The extent of the fiscal problem was reflected in the high commitment deficit that exceeded 8% of GDP in each year between 1993 and 1996.

Only in 1997 was the committed deficit reduced sharply. This was mainly the result of a decision to allow the netting out operations in tax settlements and the one-off proceedings from the sales of military equipment, while the freeze of wages at 1996 level and a slight recovery of the economic activity also contributed to the improvement. In 1998, the year of eco-

Table 4-1. Consolidated budget deficit (% GDP)

	1993	1994	1995	1996	1997	1998	1999
Budget Deficit (Cash)	7.5	5.9	5.8	9.7	7.5	3.4	3.0
Budget Deficit (Commitment)	8.9	8.2	8.0	14.3	4.2	9.0	3.1

Source: IMF (1998b), Ministry of Finance, own calculations

nomic crisis, the deterioration of tax revenues re-emerged together with an overall deficit of 9.0% of GDP (Table 4-1).

The economic consequence of fiscal deficits depends not only on their size but also on the way of financing those deficits. According to Laurens and de la Piedra (1998), the fiscal deficit should be limited to the level at which:

a) its financing through domestic capital market does not distort the allocation of resources,

b) does not require direct credits from the central bank for financing it,

c) does not lead to excessive external borrowings.

Accordingly, there are three basic alternatives of financing the deficit calculated on the commitment basis and with privatization receipts incorporated into the budget revenues:

– direct credit form central bank (with resulting change in monetary base),

– domestic borrowing from commercial banks and private agents,

– external borrowings.

There is also a heterodox solution for deficit financing:

– accumulation of expenditure arrears

These four alternatives have various impacts on price stability, on the amount of credits available for private investments, as well as on the external balance. Moreover, the availability of these instruments depends on the independence of central bank, the development of domestic financial sector, the external openness of the economy and the ability to induce involuntary private savings (arrears). If the access to external markers is limited and domestic financial markets undeveloped, while the government cannot run up arrears, there is a direct conflict of goals between fiscal and monetary policy. This is due to the fact that only three elements in the above equation can be determined independently.

In Moldova, debt creation and arrears were the main source of financing for the budget deficit. As the base for domestic financing was very low in the past years, external portfolio investments gained significant importance. While such financing of the deficit allowed for short-lived monetary stabilization, accumulation of debt led to insolvency crisis. Additionally, substantial expenditure arrears contributed to the deformation of economic life in Moldova and undermined the credibility of government, making the economic agents more reluctant to meet their tax obligations.

Saving-Investment Imbalances

As can be seen from Table 4-2, the share of final consumption in GDP was steadily growing and increased from 84% of GDP in 1995 up to 100.5% of GDP in 1998 [2]. The rapid growth of private consumption between 1995 and 1998 can be explained by the massive drop in savings, and declining ability of state to collect taxes. Crucially important were the soft budget constraints in some sectors of the economy, especially in the energy sector, in which non-payment led to wide over-consumption. While savings were falling (from 18.6% in 1995 to 6.2% in 1998), the share of investment in the economy did not fall significantly and fluctuated around 25% of GDP throughout the period. This was possible only through substantial external borrowings that offset domestic saving-investment imbalance.

Inflows of capital for financing private and public consumption was preventing the depreciation of the currency. Real appreciation of 25% between 1995 and first half of 1998 led to excessive purchasing power of Moldovan consumers. Clearly, throughout this period Moldova was significantly credited by its trading partners, which was reflected by the increasing current account deficit (6.6% in 1995, versus the startling level of 19.6% in 1998). Such imbalances induced an extreme risk to the external position of Moldova and made it very vulnerable to changes in the pattern of capital flows.

Table 4-2. National accounts as % of GDP

	1995	1996	1997	1998	1999
Gross National Disposable Income	102.6	107.5	108.0	106.8	112.6
Consumption	84.0	94.8	98.8	100.5	91.3
Savings (S)	18.6	12.7	9.2	6.2	21.3
Investments (I)	25.2	24.4	24.0	25.8	23.0
Current Account Balance (S-I)	-6.6	-11.7	-14.8	-19.6	-1.6

Source: Jarocinski (2000)

[2] For detailed discussion see: Jarociński (2000).

Table 4-3. Foreign and domestic debt (% GDP)

	1993	1994	1995	1996	1997	1998	1999
Foreign debt	21	55	58	63	66	82	129
Domestic debt	6	6	7	9	11	17	16

Source: MET, own calculations

The crisis brought the inevitable adjustment in macroeconomic aggregates. The current transfers from abroad increased national disposable income as the percent of GDP, partly because of growth of their dollar value but mainly due to the depreciation of the domestic currency. More importantly, consumption was reduced dramatically, mainly due to the currency depreciation and decrease in crediting from abroad. As a result, the current account deficit was restrained to a sustainable level.

Indebtedness Crisis

The budget and current account deficits led to the accumulation of internal and external debt. Starting in 1995, the budget deficit was covered mainly by issuance of government securities (Treasury bills and bonds) and later, increasingly by external borrowings. Thus, the required budgetary funds were attracted from the financial market. This avoided further money emission by the NBM, but only at the price of increasing indebtedness.

Since Russia took over the historic debt of the former Soviet Union, Moldova started its transition with a debt close to zero. The foreign indebtedness raised later from 21% of GDP at the end of 1993 up to 82% at the end of 1998 and 129% of GDP in 1999. Although the indebtedness was not surprisingly high for the world standards, it should be noted that among all former Soviet countries only Tajikistan and Kyrgyzstan recorded comparable level of indebtedness as Moldova. However, the most important sign of the unsustainability of macroeconomic policy was the speed of debt accumulation. While the rapid increase of indebtedness in 1999 was the direct result of currency depreciation, more generally it was the result of shortsighted policies regarding external indebtedness.

As can be seen from Table 4-4, Moldova was confronted not only with an increasing debt, but also with an unfavorable structure of the debt. Since Moldova repeatedly failed to achieve the conditionality criteria, the IMF halted disbursements in mid-1997. The World Bank then suspended its Structural Adjustment Loan II. In this situation the part of debt that was increasing the fastest since 1996 was the short-term commercial debt. The proceedings from private placement in 1996 and issuance of Eurobonds in 1997 were used only to cover the budget deficit. How-

Table 4-4. External debt (million US $)

	1993	1994	1995	1996	1997	1998
Total (IMF included)	173.6	505.9	665.2	800.3	1029.9	1002.1
Total (IMF excluded)	86.3	343.0	434.8	552.5	795.9	825.7
Direct public debt	86.3	343.0	416.9	506.0	710.1	719.0
Multilateral creditors	59.3	158.4	203.5	221.1	257.0	293.4
IBRD and IDA	28.6	95.7	145.8	145.8	185.7	216.9
EBRD	0.0	0.0	0.0	0.3	5.2	6.1
EU	30.7	62.7	57.6	75.0	66.2	70.4
Bilateral creditors	19.8	162.7	177.3	173.9	155.7	160.2
Japan		29.7	37.8	33.4	30.0	33.7
Russia		93.4	90.3	78.8	64.0	62.0
USA	19.8	39.6	49.2	61.7	61.7	61.7
Commercial creditors	0.0	0.0	15.0	90.7	277.3	245.2
Commercial banks	0.0	0.0	15.0	60.7	32.3	30.2
Eurobonds	0.0	0.0	0.0	30.0	105.0	75.0
Gazprom					140.0	140.0
Commodity loans	7.3	21.9	21.2	20.3	20.1	20.3
Publicy guaranteed debt			17.8	46.5	85.8	106.7
Multirateral creditors		0.0	8.4	33.1	45.7	53.4
EBRD		0.0	8.4	33.1	45.7	53.4
Commercial creditors		0.0	9.4	13.5	40.1	53.3
IMF	87.4	162.9	230.4	247.8	234.1	176.4

Source: MET

ever, the most important and least controllable source of debt accumulation was the energy sector debt. Lack of restructuring in this sector resulted in a large debt towards Gazprom (140 million in 1997 and US$ 90 million in 1998).

Also foreign participation on the T-bill market was very high (close to 40% by the end of 1997). Obviously, this resulted in pressure on the exchange rate, leading either to currency appreciation or increased money supply (when central bank purchased currency in the forex market). The volume of issued state securities had a continuous and fast increase until 1998 when the Government realized that this "pyramidal" practice could not be continued any longer. The budget deficit was not reduced and, moreover, the proceeds from newly issued bills and bonds did not even cover the amounts needed for securities redemption.

The dependence on external financing causes a greater threat to macroeconomic stability than domestic financial obligations, as it makes the economy increasingly vulnerable to changes in perceived creditworthiness. Namely, the external debt payment stream is subject to:

– the risk of currency depreciation, which increases the debt burden;

– the risk of a shift in market sentiment, which determines the lenders to require higher interest rates to extend new credit for rolling over the existing debt (e.g. several treasury bills spikes across CIS reflecting the failing confidence preceding the Russian crisis);

– the risk of a negative impact of external financial crisis.

The risk of devaluation is extremely high when the external debt is high. As a result, the financial costs of adjustments were increasing with rising external indebtedness. The assessment of the volume of external borrowing was even more negative if its utilization in terms of future income generation was considered. The growth potential of Moldovan economy was not enhanced, as the funds were not directed to productive investments, but to the inefficient state sector. Borrowed funds were not spent on structural reforms that would have limited the primary deficit of the budget. Instead, the overwhelming majority of external financing was used to suspend the restructuring in the energy sector and fiscal adjustment. Possibility of external financing of government consumption undermined the incentives for reform implementation.

Such a policy led to increasing difficulties of debt servicing. The cost of servicing the debt increased from 4.2% of GDP in 1997 to 4.8% of GDP in 1998. Indeed, if Moldova did not manage to reschedule part of external debt service, payments would have consumed 7.5% of GDP in 1997 and 8.7% of GDP in 1998. Due to the depreciation of the currency, debt service reached 9.4% of GDP in 1999.

Serious problems with servicing the external debt already appeared at the end of 1997 and the beginning of 1998. While social expenditures proved to be rigid, the increase of debt servicing costs led to the collapse of the budget and financial stability. Moldova had to reschedule two credits from Russia (US$ 30 million) at the end of 1997, but in the course of 1998 it failed again to meet its obligations on this debt. The government also failed to honor some external guarantees.

Payment arrears on energy supplies were developing particularly quickly and there was always the possibility that they would be converted into state debt under the pressure of energy suppliers. It was expected that repayments in future years would be so substantial that external financing would remain negative. As an indicator of the country's external exposure, the spread on Moldovan Eurobonds increased from 380 basic points to 800 at the end of 1997. In fact, the external exposure of Moldova was already unsustainable in the first half of 1998, as the country found itself in a debt trap and liquidity crisis.

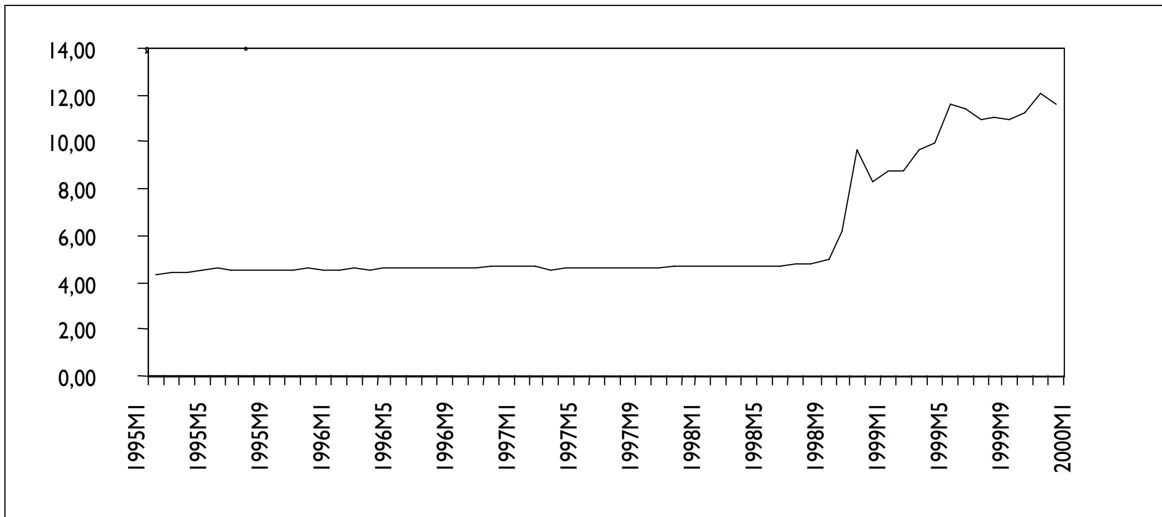
Depreciation of the currency during the crisis made a burden of external debt service unbearable without support from international financial organizations. As cooperation with IMF was suspended in the second half of 1999, the indebtedness problem of the country still poses a threat to the stabilization and the issue is still not resolved even two years after the outbreak of the crisis.

Short Term Monetary Stabilization

Until 1998, as a result of unfavorable conditions on the world financial markets, a non-inflationary financing of the fiscal deficit was possible and a successful disinflation occurred between 1995 and 1997. With the establishment of the independent NBM a relatively tight monetary policy was implemented which proved to be one of the most successful (along with the one of the Baltic States) in the FSU. Moldova introduced its national currency, the Moldovan leu, on November 29, 1993. The initial exchange rate of the leu was set at 3.85 lei per 1 US dollar. A managed floating exchange rate regime was formally adopted but in practice the exchange rate served as an informal stabilization anchor. Indeed, the leu showed a remarkable stability, and the yearly nominal depreciation rates were 14.8% in 1994, 5.1% in 1995, 3.2% in 1996 and 0.2% in 1997. Due to inflation, the Moldovan leu started to appreciate in real terms against the Russian ruble, Ukrainian karbovanets, US dollar and other currencies. Thus, the real exchange rate index appreciated against US dollar by about 74% in 1994, by 17.5% in 1995, 11.4% in 1996 and 10.9% in 1997 [3]. Black currency market phenomena have been practically wiped out.

[3] However, it needs to be bear in mind that initially, after hyperinflation, the leu-to-dollar exchange rate was arguably undervalued.

Figure 4-1. Nominal exchange rate (n.c. units per USD)



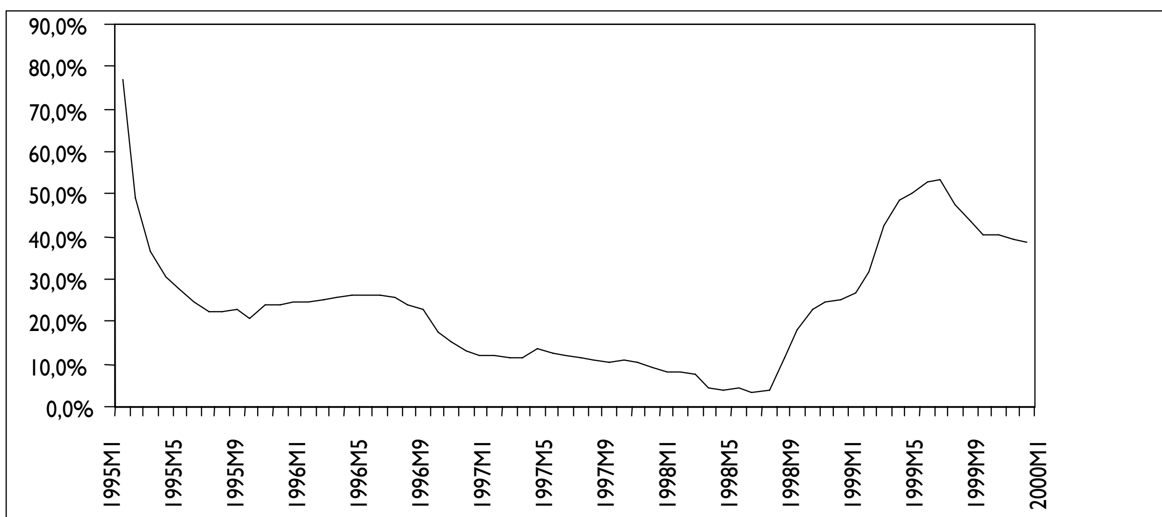
Source: IFS

As proof of the leu's stability, the hard currency surrender requirement was cancelled in the end of 1994. After acceptance by the NBM (June 30, 1995) of the Article VIII of the IMF Articles of Agreement, the Moldovan leu became de jure convertible for current account operations, and for some capital account operations. Gross foreign exchange reserves of the NBM were increasing continuously: from almost zero at end-1992, they reached $366m at end-1997 (covering 3.1 months of imports of goods and services). Volume of deposits in the banking system was increasing continuously (the biggest share being of those in leu), clearly showing the increase in confidence in the leu (supported by the stable exchange rate and the rapid decline in inflation).

As the most important sign of stabilization, the rate of inflation was constantly decreasing. While in 1993 annual inflation was higher than 2000%, it came down to 105% at the end of 1994, 23.8% in 1995, 15.1% in 1996, and 11.2% in 1997. Also the increase in the level of monetization until the end of 1997 was indicating monetary stabilization, as later reversal of the trend served as the early warning of possible crisis.

Beginning in January 1994, the refinancing rate became positive in real terms and the annual refinancing

Figure 4-2. Annual inflation rate



Source: IFS

Table 4-5. NBM direct credit to government

	1993	1994	1995	1996	1997	1998	1999
as % of:							
reserve money	60	58	55	43	46	126	110
broad money	40	42	35	26	27	76	66
as % of growth of:							
reserve money	NA	56	49	-85	53	-1342	68
broad money	NA	43	23	-32	29	-498	40

Source: IMF(1998b), MET,IFS, own calculations

rate established at credit auctions decreased from 377% in February 1994 to 16% by end-1997. High borrowing requirements of the government combined with low supply of domestic savings led to the high interest rates equilibrating the financial market. The international savings could be also attracted at the high interest rate, which included a significant country risk premium. High interest rates on T-bills caused an increase in the opportunity cost of lending, thus crowding out credit investments to the private sector and leading to a situation when a portfolio of major part of banks consisted mainly of profitable and relatively risk-free government securities.

Moldovan authorities managed, therefore, to achieve monetary stabilization because monetary policy was becoming increasingly independent from the fiscal one in the years preceding the crisis. However, the containment of direct credits to the government and consequent monetary stabilization was not based on a sustainable fiscal policy but rather on the capital markets' propensity to credit Moldovan government. This could not last forever.

In the first stage of transition, the central bank's credit it was apparently the only available source of financing the budget deficit. The volume of this credit amounted to 6 % of GDP in 1993. In next two years it decreased to 2.3% and 1.7% of GDP, respectively. Until the end of 1995, credit to government contributed to more than half of the growth of reserve money. Direct credit to government in 1996 became negative when the government started to repay its debt to NBM. In 1996, the stock of money increased without contribution of the NBM credit to government. However, in 1997 the recourse to this source of deficit financing reappeared (1.6% of GDP), with significant consequences in money growth. In 1998, the Budget Law explicitly forbid such a practice.

However, the crisis of 1998 brought the end of fragile stabilization. In September-October 1998, the NBM was forced to credit directly government in order to avoid its default on treasury securities market. The ratio of direct credit to the government increased to 9.3% of GDP. Although plunging foreign assets of the Central Bank offset an important part of increase in the NBM credit to the government and restraint its inflationary effect, monetary stabilization was destroyed. The NBM was also forced to credit government in 1999 what contributed to almost 70% of growth of reserve money in that year.

Although the role of the NBM as an independent and relatively conservative central bank should not be underestimated, the independence of the central bank and its refusal to issue a direct credit to the government in years preceding the crisis failed to impose the corresponding adjustment of fiscal policy. The tightness of NBM policy was facilitated by the availability of cheap international financing, as the domestic saving base was quickly saturated. Non-inflationary sources of budget deficit financing were no substitute for real fiscal adjustment. When fiscal policy is unsustainable in the longer run, only the short-term monetary stabilization can be achieved. Inflation and exchange rate pressures, combined with high interest rates accumulated slowly, with the adverse influence not only on the price stabilization but also on the economic growth in the medium term. Two years after the outbreak of the crisis inflation remains at the high rate and the NBM still needs to credit directly the government. However, the NBM (also because of its long, although unsuccessful defending of the exchange rate) retained some credibility as conservative central bank and may use this reputation to rebuild monetary stabilization. It should be noted that it might be possible only if the tight monetary policy is supported by the restrictive fiscal policy.

Unsustainable Balance of Payment

Developments in Moldovan foreign trade reflected major savings-investment imbalances. High absorption fuelled by budget deficits and excessive consumption led to high dynamics of imports. Inefficiencies in the energy sector also fuelled consumption imports. Real appreciation of the currency due to mix of loose fiscal and tight monetary policy reinforced this effect. Imports increased therefore from 44% of GDP in 1993 to 60% in 1998. At the same time, unrestructured enterprises did have neither incentives, nor abilities for penetration of new export markets, and exports increased in the same period from 33% to 37% of GDP only. Trade balance and, consequently, current account deteriorated sharply, and in 1997 both reached 15% of GDP and in 1998 above 20%. Such situation could not be sustained. After 70%

Table 4-6. Current account

		1993	1994	1995	1996	1997	1998	1999
Exports	USD mln	395	565	746	795	874	632	471
	as % of GDP	33%	49%	52%	47%	45%	37%	41%
Imports	USD mln	530	669	841	1072	1171	1033	568
	as % of GDP	44%	58%	58%	63%	60%	61%	50%
Trade Balance	USD mln	-135	-104	-95	-277	-297	-401	-97
	as % of GDP	-11%	-9%	-7%	-16%	-15%	-24%	-9%
Current Account	USD mln	-155	-97	-95	-198	-284	-347	-21
	as % of GDP	-13%	-8%	-7%	-12%	-15%	-21%	-2%

Source: MET

Table 4-7. Directions of trade (in percent of total)

		1995	1996	1997	1998	1999
Exports	CIS	63%	68%	70%	69%	54%
	Non-CIS	37%	32%	30%	31%	46%
Imports	CIS	68%	62%	52%	43%	39%
	Non-CIS	32%	38%	48%	57%	61%

Source: MET

depreciation of the exchange rate in last quarter of 1998, the current account deficit was reduced by 18 percentage points to estimated 1.6% of GDP.

The structure of trade prevailing before the crisis was also unfavorable. A single trade partner, Russia, intensified its domination over Moldovan foreign trade. In 1997, the exports to Russia accounted for more than 60% of total Moldovan exports, compared with only 35% at the beginning of the decade. The energy sector was strongly dependent on imports from Russia. Excessive dependence on a single trade partner was dangerous, especially since Moldova is a small open economy that is very sensitive to changes in international terms of trade. Therefore, reorientation of the Moldovan foreign trade that took place after the crisis was at the expense of contraction in trade and worsening terms of trade [4]. In 1999, comparing with the previous year, exports to the FSU went down by 61 percent and imports by 51 percent. The reasons behind a diminishing value of exports were both reduced prices and volumes. The weighted average of export prices went down by 28 percent and export volumes of most products declined from 30 percent to 70 percent of the pre-crisis level and increased in case of few products only.

Between 1995 and 1997, the current account imbalances were coupled with surging capital inflows which increased twofold over the period. Since consumption was the driving force in this process, the share of FDI in capital inflow was insignificant. Also portfolio-equity investments remained negligible. The balance of payments was therefore dependent on short-term debt creating capital inflows and the willingness of energy suppliers to tolerate non-payments.

The change in market sentiment following the Asian crisis, combined with the growing concern about economic developments in CIS countries, reversed this trend. As a consequence of the Russian crisis, all countries in the region experienced dramatic outflows of private financing with rising interest spreads on treasury bills. Private capital available to European emerging markets (especially CIS countries) shrank significantly, what led to the depreciation of the currency. The high costs of servicing external debt, especially without a support from international financial organizations became the largest problem after the crisis.

4.2.2. Microeconomics

The fiscal problems of Moldova reflected the weakness of state structures, the political climate favorable for populism and rent seeking, the slow pace of privatization and restructuring and delayed reform in the social sphere. The opposition of strong vested interests put pressures on Moldovan fragmented policy-making. The link between structural changes and the fiscal system was, however, mutual. Fiscal policy should provide the right incentives to economic agents. Unfortunately, the latter were exposed to many explicit and implicit subsidies, tax exemptions granted at the discretion of government officials, which create incentives for intensive rent-

[4] For detailed discussion see: Antczak (1999)

seeking and not for market adjustment. Orientation on the Russian market prevented quality adjustments and acquiring new marketing and managerial skills. Netting out operations led to the emergence of a non-payment culture. All these factors put constraints on the production and export capacities of the economy.

Slow Progress of Privatization and Restructuring

Progress in privatization and restructuring has been very slow before the crisis of 1998. In its survey, the EBRD gave both reforms a 3 and 2 rating respectively, on a 1-5 scale. It is widely accepted now that voucher privatization was a mistake because of the lack of transparency in the voucher privatization process resulted in the postponement of formation of effective owners and absence of microeconomic restructuring [5]. The introduction of market mechanisms required labor shedding or, alternatively, a decline in real wages. Moldovan enterprises failed to fully undertake this task, mainly due to "the soft budget" conditions created by the government. In place of cost-reduction and restructuring, enterprises adopted the strategy of state aid seeking. The state aid was not only expected in the form of explicit and implicit subsidies, but also through favorable netting out operations.

Enterprises were ready to assume the huge liabilities (including wage and tax arrears) in anticipation of government intervention and did not try to take very unpopular decisions of job reduction or wage cuts. The shrinkage of industrial employment was not sufficient to result in labor productivity gains [6]. However, due to social pressures and self-serving management, real wages increased rapidly. Therefore, profitability of industrial enterprises worsened rapidly. Unless enterprises face real hard budget constraint, there will be no scope for serious restructuring. Therefore providing such constraint is the most important role for the government's industrial policy – apart from privatization. Unfortunately, even after the crisis the government tends to provide in various forms "soft financing" to enterprises. It was, however, accepted by the authorities that cash privatization is better way to improve the corporate governance of enterprises concerned rather than the voucher or insider privatization or direct government intervention in enterprise operations.

Inefficiencies in the state-controlled energy sector also had profound negative implications for the economic situation before the crisis. Uncontrolled consumption of energy, coupled with growing arrears, led to the internal and external imbalances and high indebtedness. Only after 1998 did the process of privatizing the energy sector start. It is expected to bring strict payment discipline and rationalization of energy consumption.

Developments in the agricultural sector were also a source of concern before the crisis. Legally speaking, agriculture was private but the state farms continued to exist in the form of joint stock companies. This nasty combination of collectivist and individual farming had a negative impact on the overall situation in Moldova, taking into consideration a great share of agriculture in country's GDP and export. Moldova also lacked an agricultural commodity exchanges, which further hampered the growth of the most promising export branches. Only in last three years the program of real land privatization started to gain momentum.

The excessive dependence on Russia as a dominant trade partner (see above) had an additional negative influence on the restructuring efforts of Moldovan enterprises. Traditionally, Moldovan producers have from a privileged access to relatively low competitive Russian markets. However, this situation impeded the development of marketing skills of Moldovan enterprises, as well as the quality adjustment of goods. On the other hand, the export to Russia was politically promoted, in order to cover the import of energy from this country. Barter operations had a large share in total transactions with Russia, which induced further negative consequences (see below). As a result, the dependence of the economy has been raising, which allowed Russia to enhance its terms of trade against Moldova, and significant part of negative shocks faced by Russian enterprises during the transition was transferred to Moldovan firms. Consequently, the 1998 crisis was caused not only by a fall of exports to Russia, but also by lower prices paid by Russian importers for Moldovan products. Rapidly entering the international markets was unlikely as Moldova faced difficulties with compliance with international standards of quality (ISOs).

Emergence of Non-payment Culture

Netting out and barter operations, and in-kind payments, proved to be a persistent and harmful element of economic life in Moldova. These instruments contradicted principles of the hard-budget constraint and profit-orientation. The non-payment culture emerged as the government first allowed to run up the tax arrears and budget expenditure arrears, and then decided to offset these two non-payment flows. It further reduced the compliance rate and increased the difficulties of tax collection. Non-cash tax revenues could not be efficiently

[5] For detailed discussion see: Mihalyi (1999).

[6] For detailed discussion see: Jarocińska (2000).

distributed according to spending priorities. In addition, non-cash transactions encouraged enterprises to avoid placing their financial means within the banking system, where they can be seized against tax liabilities. Immediately, the intermediation role of banks was reduced with a negative impact on savings and investments.

Due to netting-out operations, enterprises could avoid adjusting their production profile and potential to the effective market demand. Instead, the production activities were driven by inertia. The low real market value of produced goods forced enterprises to trade them on a non-market basis - for tax liabilities, or to transfer them to workers as a substitute for wages. Barter and in-kind operations preserved, therefore, the inadequate production profile and impede restructuring, while adjustment to the market demand was the very first requirement for the economic recovery. The quality of products remained generally very low which made the expansion to western markets very difficult. Barter transactions hampered price adjustment between demanded and non-demanded products and, therefore, they effectively transferred money from good enterprises to bad ones and could be considered as the implicit subsidy to inefficient enterprises.

Proliferation of arrears was another phenomenon at the roots of the crisis. Arrears undermined the credibility of the state, making the economic agents more reluctant to meet their tax obligations towards budget. They destroyed the link between consumption of goods and services and their payments, and, as a consequence, led to the irrationalities in consumption, as in the case of the energy sector.

Banking Sector

Starting from 1992, the NBM put in place prudential regulations for all banks, subsequently revised in March 1995. These set the standards for the Moldovan banking system compatible with Basle provisions. Generally speaking, the situation in banking system of Moldova was stable and did not undergo any major shock. However, from the financial prospective, the banking system was weak and undercapitalized. As of April 1999, out of the existing 23 commercial banks, 5 originated from the reorganization of the former state specialized banks, and 18 were the new banks, including branches of some foreign banks.

Privatization of the banking sector has been completed - with the exception of the troubled Saving Bank taken over in late 1998 by the government due to serious mismanagement in the past. Western bankers are unwilling to invest their capital in Moldova, but this is related to the general economic and political conditions in the country and not as a result of the weaknesses of the banking system itself. The commercial banking system has faced a number of difficulties, such as: insufficiency of qualified personnel, lack of experienced local bankers as well as weak technical and material base. The areas, which suffered most from these shortcomings, are those of credit allocation, loan supervision and legal settlement of issues related to debt reimbursement. However, significant efforts have been made by most banks to overcome these constraints.

One of the problems is the low availability and high cost of credit, partly resulting from insufficient development and limited competition in the commercial banking sector which continues to keep the real cost of credit at a high level. Because of big risks (economic instability and imperfection of collateral mechanisms), commercial banks refuse to make long term investments in a real sector.

During 1995–1997, interest rates on state securities gradually decreased following the reduction of inflation but they were often high enough to stimulate commercial banks to use available funds for buying T-bills and getting easy and guaranteed profits instead of crediting the economy. Again, only structural changes in real economy, coupled with fiscal contraction, can change the situation. Some steps in this direction were made in the first half of 1999. However the reforms were later slowed down.

4.2.3. Politics

The crisis forced the authorities to start thinking about solving the fundamental problems of the country, mainly related to the absence of structural reforms. A critical situation made the public more likely to accept the painful measures that are necessary to revert the negative tendencies accumulated in recent years. The fact that the state fails to deliver basic services is a credible reason for radical reforms; the population may indeed believe that the government has no other choice but to reform. The large external debt made the country fully dependent on the co-operation with international organizations, especially with the IMF.

Indeed, the new cabinet of young and liberal reformers formed in March 1999 initiated a more energetic program of reforms. Arguably, it was the first government in the office that tried to introduce real reforms. Energy sector privatization process has been started. Cash privatization was conducted dynamically. Completing the land privatization program might bring significant progress in agriculture. Similarly, the decline of exports to Russia forced Moldovan enterprises to search new export possibilities, many producers trying to enter non-traditional Western markets by struggling to enhance competitiveness and finding market niches. These developments were clearly positive. In the second half of the

year, however, the process slowed down again, partly because of the launch of 2000 presidential election campaign and the break-up of the ruling coalition.

4.3. Prospects for Future

The currency crisis in Moldova that took place in the second-half of 1998 is not over yet. After a sharp depreciation, the exchange rate fluctuates around its (gradually depreciating) equilibrium value. However, Moldova remains in the deep financial crisis as the production is still falling, inflation is high and debt trap poses constantly the danger of default. Only more disciplined continuation of structural reforms and close cooperation with international financial institutions can provide basis for long lasting financial stability of the country.

Appendix: Chronology of the Moldovan Crisis

January - August 1998 - macroeconomic situation in Moldova aggravated by declining GDP, interventions of National Bank of Moldova supporting exchange rate of leu, weak fiscal revenues and increasing interest rates on T-bills. Inflation is oscillating around zero.

August 1998 - Russian crisis results in capital flight from Moldova

August - October 1998 - National Bank of Moldova intervenes massively, selling USD 81 million out of the total initial stock of USD 224 million of its gross international reserves, exchange rate depreciates from 4.7 leu per dollar in the beginning of August to 5.0 in mid-October, in real terms leu appreciates strongly against devalued currencies of major trade partners (Russia and Ukraine).

September 1998 - monthly exports to Russia decreased by 80% in comparison to the same month of the previous year, industrial output in Moldova is down by 32.5%.

August - December 1998 - several ad hoc budget expenditures cuts are introduced.

September-October 1998 - dramatic fall in the demand for Treasury bonds, 7-14 day T-bills are introduced, still it is impossible to roll-over formerly issued T-bills, NBM provides liquidity to the government in order to prevent the default on treasury securities.

Second half of October 1998 - the reserve requirement ratio is raised from 8% to 25%, it is required that commercial bank invest 10% of their assets into treasury bills in order to support the treasury bill market. Until the end of October commercial banks fail to comply, leu continues to depreciate, approaching 6.0 lei per dollar by the end of October.

November 2, 1998 - National Bank of Moldova withdraws from selling hard currency at the Interbank Currency Exchange, the official exchange rate is being set as a weighted average of rates on banks' foreign exchange transactions.

November 1998 - exchange rate depreciates to 9.5 leu per and stabilizes. Until the end of 1998 it temporarily appreciates to 8.3 at the end of 1998.

November - December 1998 - monthly inflation rates averages 8%.

End of 1998 - beginning of 1999 - new reformist government is elected, memorandum of economic policies is signed with the IMF, and situation in the exchange rate and treasury markets stabilizes.

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Part V.
The Turkish 2000 Financial Market Crisis of Confidence by Marcin Sasin

5. I. Overview

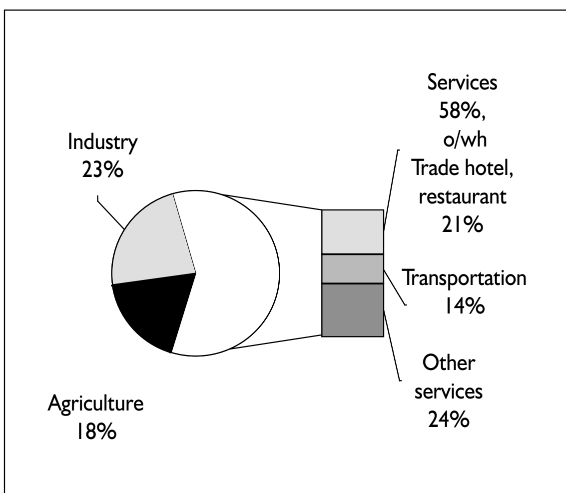
5.1.1. General Information About the Country and Its Economy

Turkey is a 65 mln-populated country located in Europe and Asia Minor. It is a member of NATO and has long lasting aspirations to become an EU member. In January 1996, it signed a custom union agreement with the EU, has recently gained EU candidate status, and negotiations are under way to set the conditions for integration.

The heritage of Kemal Ataturk, the army commander in the fight for independence and a founder of a modern, secular Turkish state is still vivid. The army overlooks the country's secular constitution and is ready to take over when the state security is threatened by Islamic fundamentalists or separatist "terrorists". Instability is one of main characteristics of the Turkish political scene. In November 1998, the Mesut Yilmaz government was forced to resign over corruption allegations. After the April 1999 elections, the three-party coalition – Democratic Left Party (led by Bulent Ecevit), Nationalist Action Party (led by Devlet Bahceli) and Motherland Party (led by Yilmaz) – formed the government under Ecevit's primeministership and stays in power up to now (December 2000).

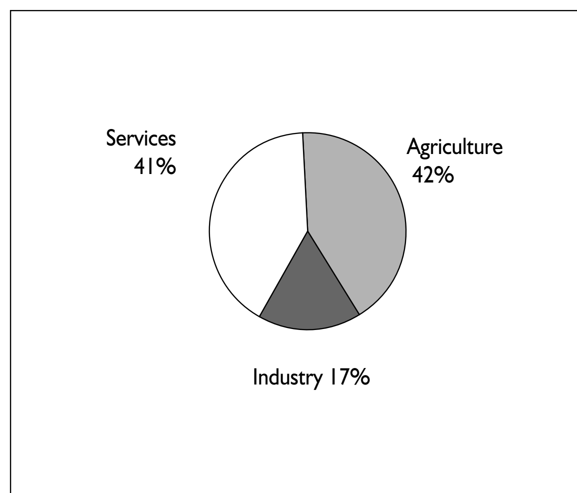
The Constitutional Court is soon going to deliberate on a long-running closure case against the Islamist Virtue Party which is accused by prosecutors of undermining the country's secular constitution. The only other opposition party in the Parliament, the True Path Party (led by Tansu Ciller), has been weakened and has not yet recovered after its infamous removal from office in 1997. The weakness of the parliamentary opposition and the implicit deal with powerful media tycoons who, in return for profitable business relations praise the government and protect its image, gave raise to hopes for some period of political stability. Indeed, the coalition and the government enjoy a comfortable majority in Parliament – sufficient to push forward some important reforms and embark on one of the most important stabilization plans ever implemented.

Figure 5-1. Turkey: GDP by sector in 1998



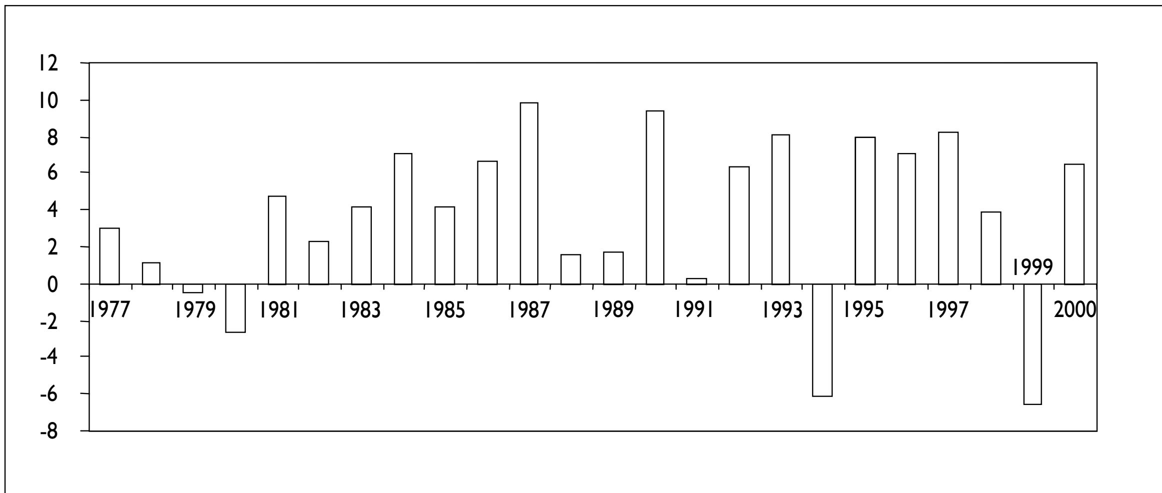
Source: IMF, State Statistical Office (SSO)

Figure 5-2. Turkey: employment by sector



Source: IMF

Figure 5-3. Turkey: GDP growth



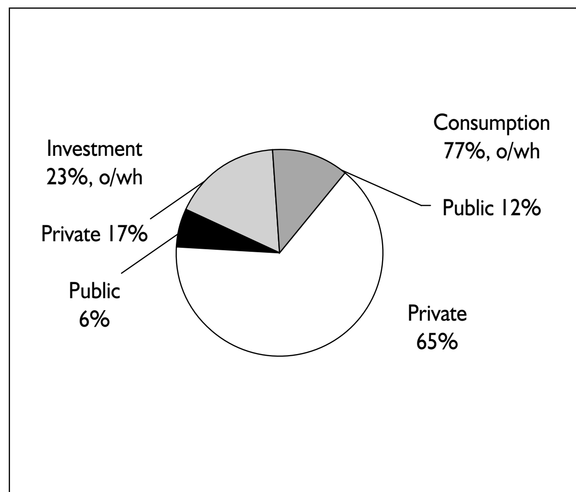
Source: IFS

Turkey is a dynamic economy and a mix of modern industry and commerce with traditional village agriculture and craft. It has a rapidly expanding private sector, dominated by the existence of the large family–owned conglomerates, usually enjoying tight and comfortable connections with politicians. However, the state still plays an important role in the industry, financial system, transportation, etc. The structure of the economy is typical for industrialized emerging markets. The total GDP amounts to 200 bln USD, which translates into a 3000 USD income per capita. Services are a leading sector of the economy with a 60% share in GDP, out of which tourism is a major component. Services are followed by industry with 18% share. The inefficient state-dominated agriculture sector is a burden for Turkish economy (accounting only for 18% of GDP it employs over 40% of the labor force, and is one of the main economic issues to be resolved). Agricultural products have been exempted from the customs union with the EU; the sector is heavily protected and subsidized. Total cost of agricultural support policies is estimated at 4%–7% of GDP, which constitutes a significant burden for the state budget.

Instability and volatility are good words to describe Turkish economic conditions, particularly during the 1990s. Erratic bouts of rapid short-term growth were separated by periodical recessions with negative or near zero growth rates. After a stagnation of 1988–1991, temporarily interrupted by a burst of 10% growth in 1990 there came two years of rapid growth effecting in overheating of the economy and the 1994-crisis. Then, again, the economy rebounded for three years just to come to a halt and another recession in 1999. Recently, the economy is again on a rebound, domestic demand surges, industrial production in 2000 rose by 10% and GDP growth is estimated to reach almost 7%.

During the 1990s, Turkey experienced several adverse developments. In 1994, a major balance of payments crisis struck the country's economy. The main cause was an unsustainable development in current account and a poor state of financial institutions. The exchange rate was devalued sharply by 150% [1] and the economy came through a sharp downward correction. Afterwards, having weathered the Asian crisis Turkish economy was in turn badly affected by the

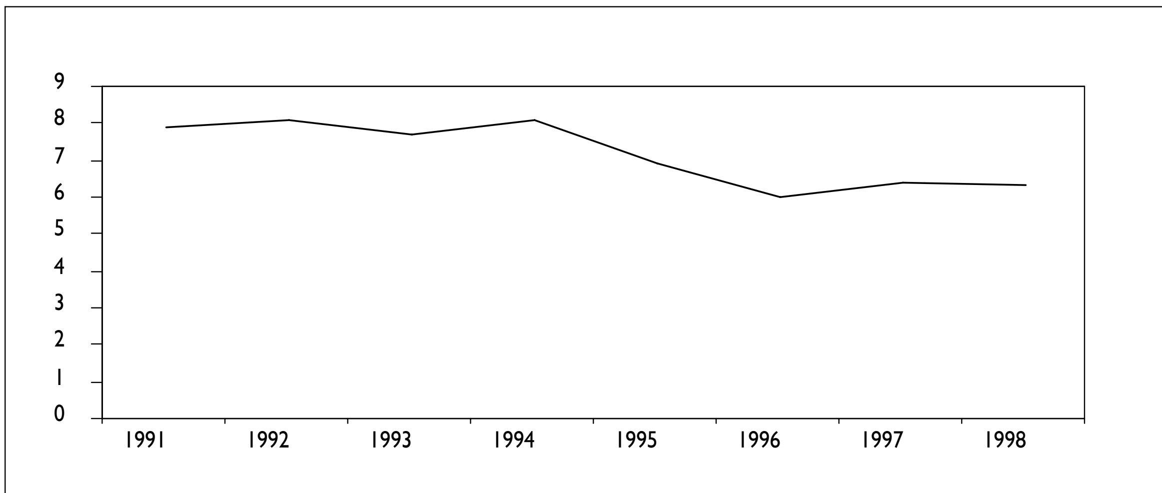
Figure 5-4. Turkey: Domestic Demand



Source: IMF, SSO

[1] That means it lost 60% of its value.

Figure 5-5. Turkey: Unemployment Rate in %



Source: SSO

Russian crisis in 1998. Not only did it almost completely loose one of its major export markets but also there was a sudden and massive outflow of foreign capital imposing severe liquidity shortage, which, through high interest rates, added its negative contribution to already slowing economy. On August 17, 1999, Turkey experienced a devastating earthquake that hit the heavily populated Marmara region and, apart from dramatic death toll, caused extensive damage to production facilities and capital stock – the demand and supply side of the economy contracted drastically.

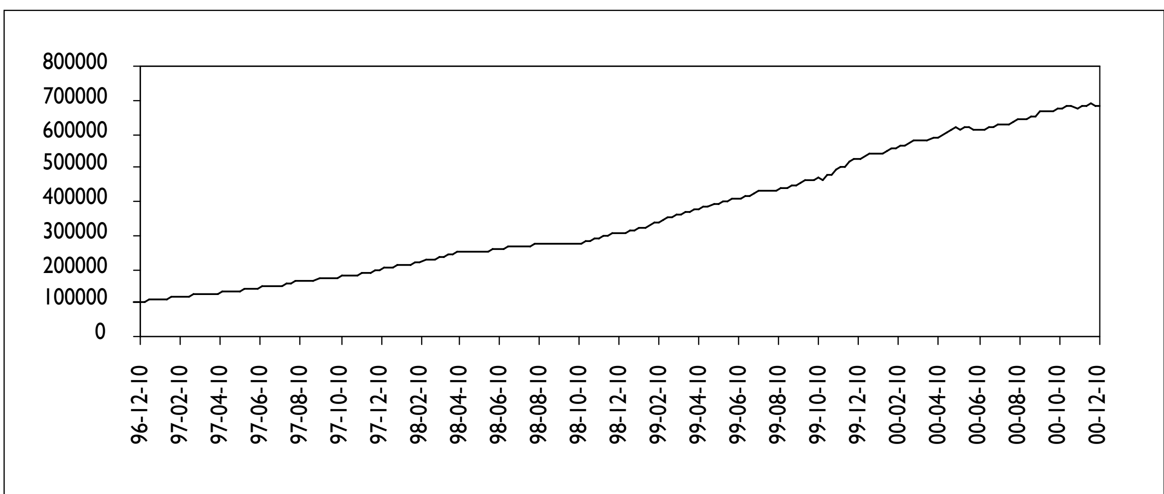
But the most characteristic, feature of the Turkish (macro)economy is its endemic and permanent high inflation. During the 1990s it was always double-digit, temporarily even exceeding 100% a year. Its source can be traced to excessive budget deficits and its monetization. Both points, inflation and fiscal stance, will be discussed separately.

Other issues worth mentioning include unemployment and social security system. The unemployment rate of around 6% in 1998 is relatively high, and is even higher among urban population – 10%, while in rural areas it oscillates around 3%.

5.1.2. The Monetary Policy

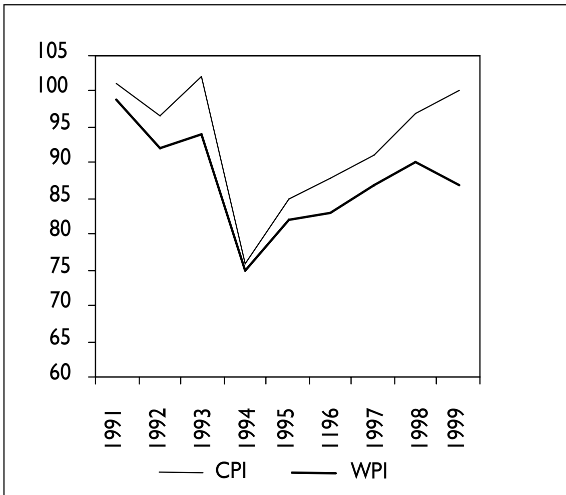
The Central Bank of Turkey (Turkiye Cumhuriyet Merkez Bankasi – TCMB) is responsible for conducting

Figure 5-6. Turkish lira exchange rate (TRL/USD)



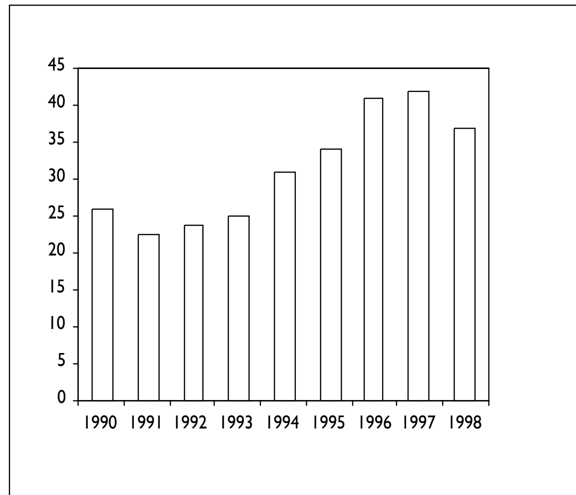
Source: Bloomberg

Figure 5-7. Turkey: real effective exchange rate



Source: IMF, TCMB

Figure 5-8. Turkey: the foreign trade as % of GNP



Source: IMF

monetary policy and issuing national currency, the lira (TRL). The main monetary and exchange rate policy tools of TCMB are foreign exchange market interventions, reserve requirement and liquidity ratios, as well as open market operations (most frequently used).

The conduct of monetary policy was always strongly determined and influenced by the government sector deficit. Until 1997, the government had a direct access to central bank credit and was consequently using this facility to monetize its deficit. In 1997, the government lost this source of financing and its accounts at the central bank were settled. Given the reluctance of the government to contain its chronic deficits, the policy of TCMB could be described as accommodative or passive. The TCMB wasn't actually fighting inflation (by surprising the market with lower money creation); on the contrary: the rate of money growth was in line with the expected inflation, in order to avoid the contraction of the economy. The foreign capital inflows (e.g. in the first half of 1998) and outflows (e.g. end of 1997, end 1998) were sterilized.

Equally passive was the exchange rate policy. Officially, authorities declared a free- float regime but in practice exchange rate was determined according to the variables such as short-term inflationary expectations, balance of payments and the government balance. The eventual goal was to stabilize the real effective exchange rate of the lira against the basket of 1 USD+0,77 euro.

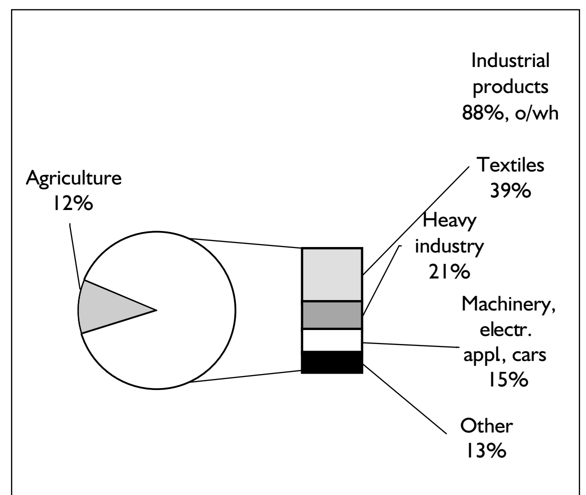
This policy was successful in assuring the overall competitive position of Turkish industry; usually the real exchange rate was below parity at around 85–95%. Assuring a smooth and predictable path of the lira depreciation the central bank was also protecting a banking system exposed to large net open foreign exchange positions, against foreign exchange risk.

In line with the 2000–2002 disinflation plan, the conduct of the monetary policy switched in January 2000 to the mix of currency peg and inflation targeting. The pace of depreciation slowed accordingly.

5.1.3. The External Situation

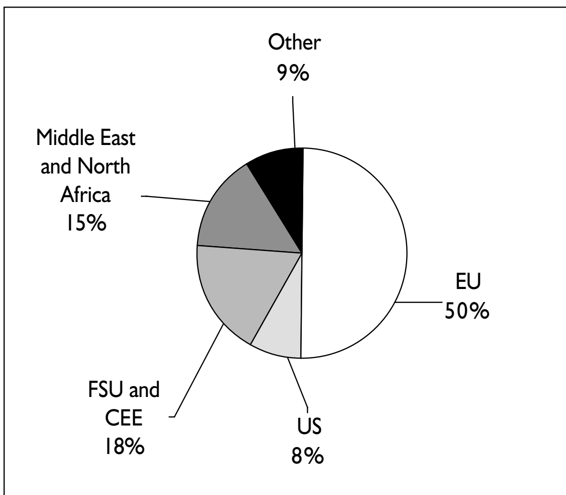
Turkish exports consist primarily of industrial products (88%), most importantly textiles (40%). Half of exports go to the EU. In 1990s, the Russian market steadily gained an importance for Turkish export becoming the fourth biggest,

Figure 5-9. Turkey: export by sector in 1998



Source: IMF, SSO

Figure 5-10. Turkey: destination of export, 1998



Source: IMF

but since the 1998 Russian crisis it collapsed almost completely. Foreign trade is equivalent to around 35–40% of GNP.

After trade liberalization in 1980 and liberalization of the capital movements in 1989, the integration process of the Turkish economy with the world capital and goods markets deepened. In January 1996, the custom union between the EU and Turkey came into force with all duties on imports of industrial goods from the EU reduced to zero (exports from Turkey to the EU has been tariff-free long before 1996).

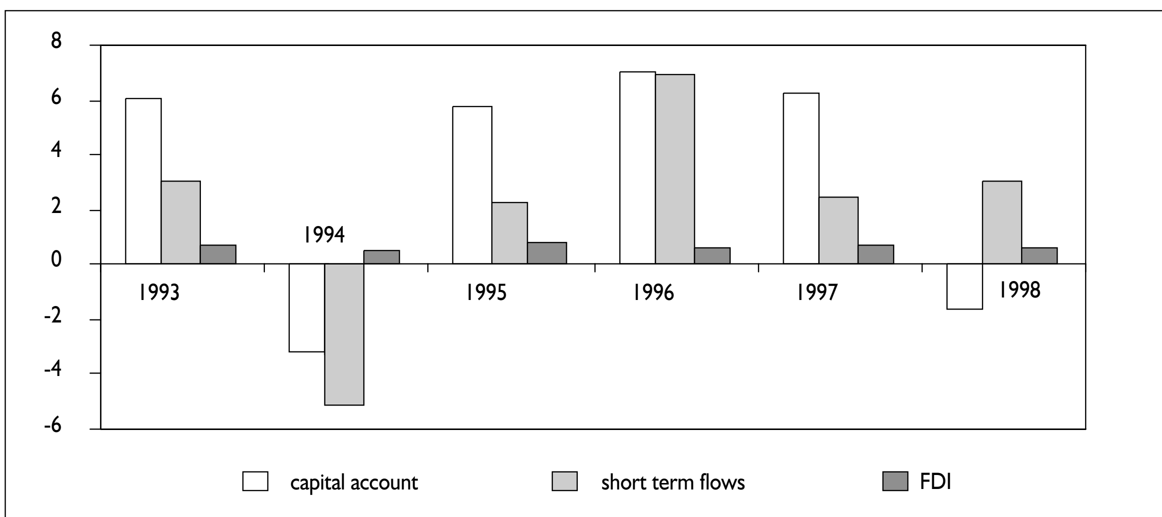
Turkey has a tradition of considerably high trade deficits, which are usually offset by the services' account; notably tourism receipts (5–7 bln USD per year). The "workers' remittance" item, i.e. transfers from Turkish people working abroad also brings significant improvement to the current account (3–5 bln USD a year). The existence of enormous (export) shuttle trade, in many cases very well organized and on a very large scale, obscures the statistics. Its estimates show magnitudes of 3.3 bln USD for 1994, 8.8 bln USD for 1996 and 3.7 bln USD surplus for 1998. The overall current account balance settlement was achieved mainly through the adjustment of the real exchange rate, overlooked by the central bank.

Capital flows into and out of Turkey exhibit huge volatility. The most striking feature is the low importance of foreign direct investments – because of the macroeconomic instability they remained as low as 500–700 mln USD/year.

Adverse external developments, especially a weak euro and increasing oil prices, combined with a surge in domestic demand, rapidly rebounding after 1999 recession and fueled by after-earthquake reconstruction needs, were responsible for recent drastic worsening of the current account. Import volume as well as its price rose – the trade deficit stands around 14 bln and the current account deficit for 2000 is likely to reach 10 bln USD (compared to 1.4 bln in 1999).

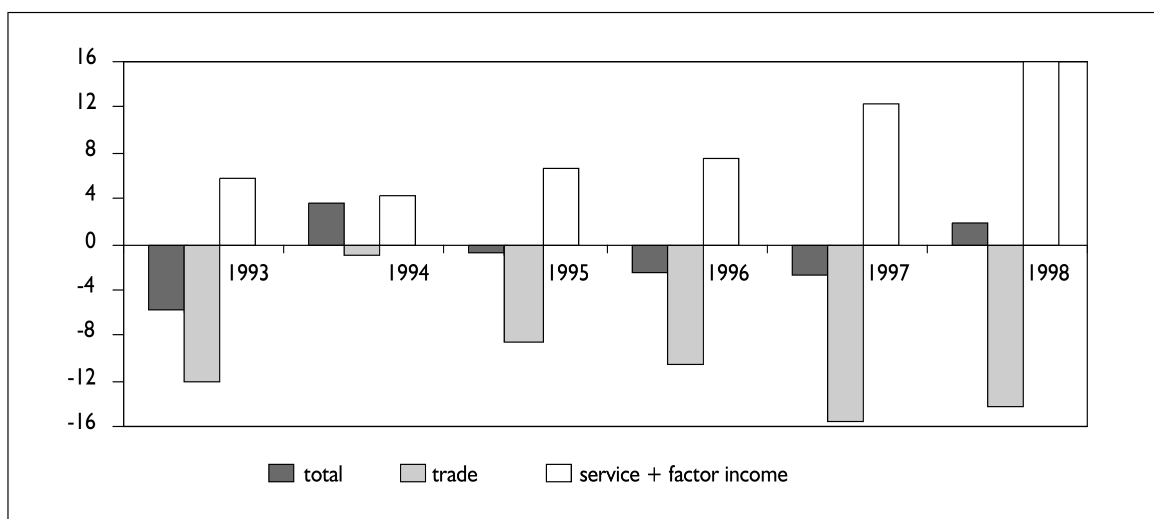
Total Turkish external debt stood at 100 bln USD in 1999 and there weren't any problems with its repayment. The share of short-term debt was reasonable, so did private sector external indebtness. However, banks had quite a considerable open foreign exchange position – some of them were borrowing in foreign currency to invest (speculatively) in Turkish government bonds. Total external debt service amounted to 16.3 bln USD in 1998.

Figure 5-11. Turkey: Capital flows in bln USD



Source: IMF

Figure 5-12. Turkey: current account in bln USD



Source: IMF

Table 5-1. Turkey's external debt in 1999, second quarter, in bln USD

<table>
<tr><td rowspan="6">Total outstanding</td><td rowspan="2">Short term</td><td colspan="2">Banks</td><td colspan="2">10,8</td><td rowspan="2">27,9</td><td rowspan="6">100,058</td></tr>
<tr><td colspan="2">Others</td><td colspan="2">17,1</td></tr>
<tr><td rowspan="4">Long term</td><td rowspan="2">Private</td><td>Financial sector</td><td>6</td><td rowspan="2">23,6</td><td rowspan="4">72,1</td></tr>
<tr><td>Non-financial sector</td><td>17,6</td></tr>
<tr><td colspan="2">Public</td><td colspan="2">38</td></tr>
<tr><td colspan="2">TCMB</td><td colspan="2">10,4</td></tr>
</table>

Source: IMF, TCMB

5.1.4. The Fiscal Stance

The Turkish public sector consists of the central government, a set of extra-budgetary funds, municipalities and local governments, three social security institutions, 49 state enterprises and the central bank.

The fiscal stance is shaped by traditionally unstable and populist ruling coalitions. Since the 1970s, the government used to run large deficits, which it preferred to monetize rather than finance by unpopular tax increases. This policy was facilitated by complete dependence of the central bank on the government and the government's direct access to central bank credits. As a result of money printing, inflation became a chronic feature of Turkish economy.

Later on, monetization of the deficit was stopped and replaced by domestic bond issues. This move prevented inflation, to some extent, from accelerating, but triggered an increase in domestic debt. Seignorage averaged 2,7% of GDP during 1987–1998; however, transfers from the central bank to the government were insignificant. The seignorage was transferred via the government debt cancellation, interest-free short-term advances and accepting interest rates below the market level on non-cash government securities held by the central bank.

The transparency of fiscal operations is very low. In the mid-1980s, the number of extra-budgetary funds over which the central government had little control increased significantly. This development contributed substantially to the weakening of fiscal discipline.

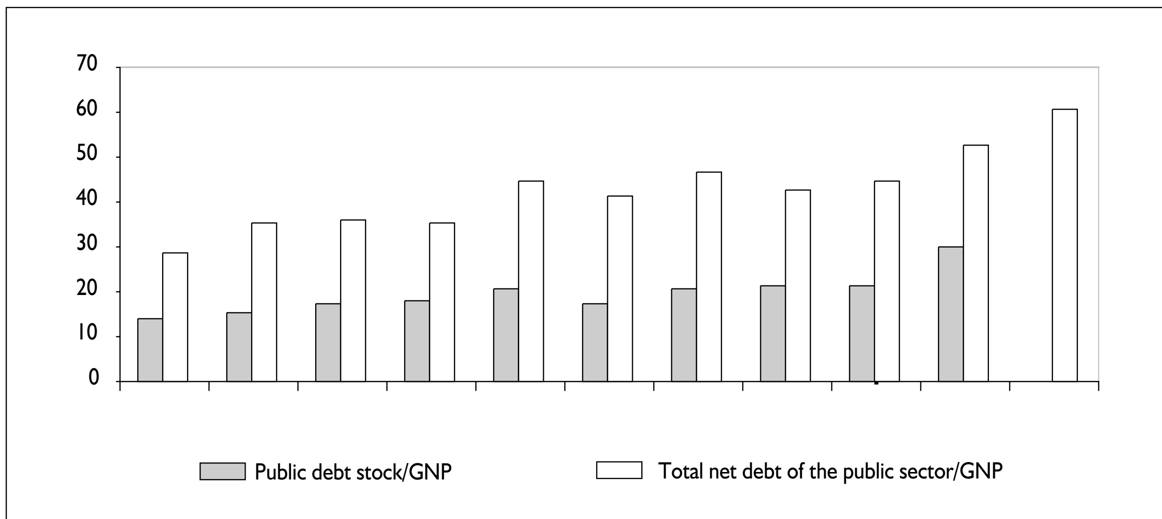
The government was able to hide part of its deficit in their balance sheets – in some years the deficit run by these funds, state enterprises and state banks was several times higher than that of the central government. To regain some

Table 5-2. Fiscal position of consolidated budget in % of GDP

	1994	1995	1996	1997	1998
Primary balance	3,7	3,3	1,7	0,1	4
Interest payment	7,7	7,3	10	7,7	11,5
Overall balance	-3,9	-4,1	-8,3	-7,7	-7,6

Source: IMF, TCMB

Figure 5-13. Turkey: Public debt stock



Source: IMF

Table 5-3. Budget revenues and expenditures, in1998, in % of GDP

<table>
<tr><td rowspan="3">total revenue</td><td rowspan="2">Tax</td><td>Direct</td><td>8</td><td rowspan="2">17,2</td><td rowspan="3">21,6</td><td rowspan="3">29,2</td><td rowspan="2">17,6</td><td>11,5</td><td>current</td><td rowspan="2">non-interest</td><td rowspan="3">total expenditures</td></tr>
<tr><td>Indirect</td><td>9,2</td><td>6,1</td><td>transfers</td></tr>
<tr><td colspan="2">Non-tax</td><td colspan="2">4,4</td><td colspan="2">11,5</td><td colspan="2">Interest</td></tr>
</table>

Source: IMF, TCMB

control over its expenditures the authorities incorporated in 1993 some 64 funds into the budget.

A substantial portion of quasi-fiscal operations are carried out via large state banks, namely Ziraat and Halk. The latter acts as government agency providing subsidized loans, collecting taxes and paying salaries to the public sector employees. The cost of credit subsidies is estimated to be around 1.5% of GDP in recent years. Since the financial liberalization, these banks started to lose market share and accumulate losses. The situation where Ziraat's cost of funds was 122%, while subsidized interest rate was 61% didn't prevent the bank to cease this kind of operations. In 1999, duty losses unpaid by the government to these banks amounted to almost 8% of GDP (flow), raising a stock of total duty losses to 12.5% of GDP. 49 state enterprises employ about 500.000 people (1999) – some of these institutions act as a vehicle to implement government policy in different sectors (e.g. agriculture).

An unsustainable social security system creates a further challenge. Despite a young and favorable demographic structure, the "pay as you go" system was generating deficits equivalent to 3% of GDP (1999) due to its excessive generosity. Until the 1999 pension reform there was no minimum retirement age. People who started working and contributing at age 18 could retire as early as 38(women)/43(men). The dependency ratio worsened from 2.8 in 1992 to 2.2 in 1999.

The course of fiscal developments has run out of control. Table 3 shows the typical Turkish budget. Despite positive primary balance, the public sector was actually overwhelmed by its debt (interest payments exceeding 11% of GDP).

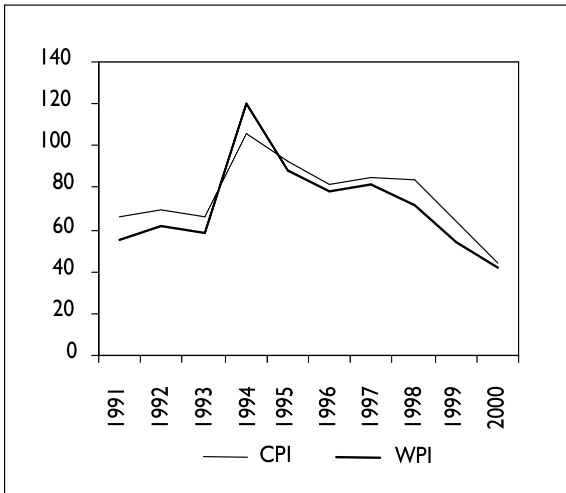
At the end of 1999, i.e. in the beginning of the recent fiscal consolidation and disinflation program, the fiscal situation demanded immediate emergency actions. The state banks accumulated 25 bln USD losses, interest payment were planned to account for 65% of budget revenues in 2000, public debt was expected to reach 61% of GDP and government borrowing requirements in 2000 were estimated to amount to 12% of GDP. In addition, in the run-up to the April-1999 elections the stance of fiscal policy was relaxed significantly.

Turkey is a good example of the crowding-out effect, sometimes called the "terror of government borrowing". The government always has priority in the capital market and no one can challenge the interest rate it offers. Therefore, huge government borrowing requirements limit the chances of the private sector to finance its investment.

5.1.5. Inflation

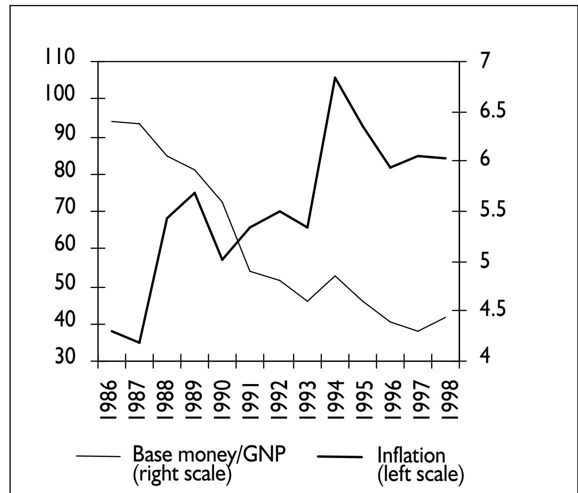
Turkey presents an astonishing exception to the disinflation trends observed worldwide since the 1970s. The primary cause of inflation has been, of course, persistent fiscal

Figure 5-14. Turkey: inflation



Source: SSO

Figure 5-15. Turkey: the erosion of base money



Source: IMF

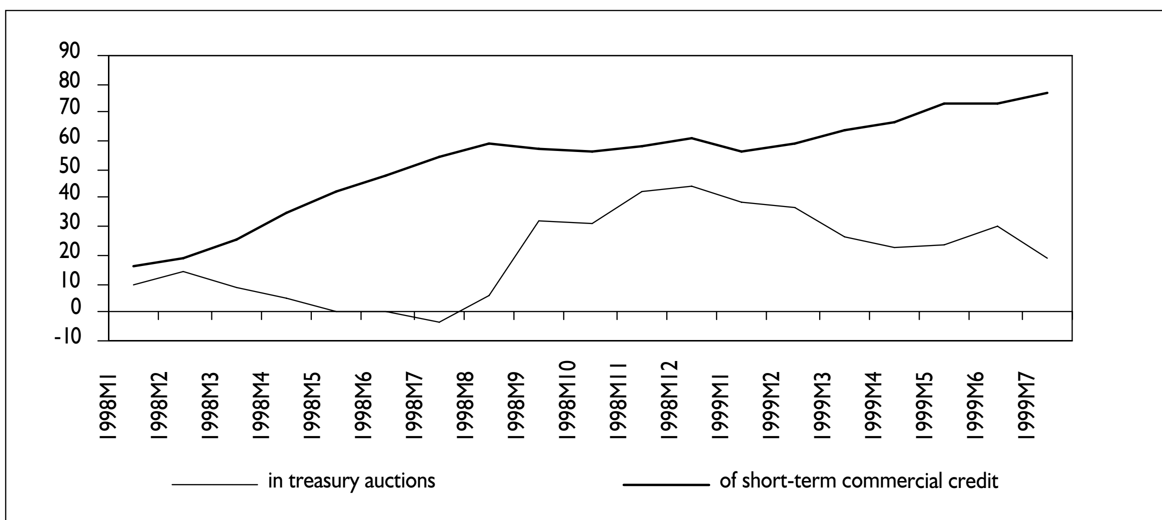
deficits, its consequent monetization and the accommodative monetary policy of the central bank. After many years of such developments inflationary expectations have become deeply entrenched in the behavior of economic agents (in a form of backward-looking indexation). Even when the government switched to non-inflationary deficit financing, the inflation has persisted, sustained by inflationary expectations. There has been inertia in the public sector wage and price setting, the central bank and populist governments have been reluctant to crack down on inflation, conducting policies ex-post validating inflationary expectations.

The inflation took advantage of every crisis or economy turmoil to accelerate. Between 1981 and 1987, it averaged to 40% annually. Later, following the 1988 crisis, it jumped to an average of 65%, and eventually after 1994 balance of payment crisis, it rose to 85%.

As a sort of "self-defense" of the economy against inflation, there was steady decrease of the economy's monetization – the proportion of base money (i.e. inflation tax base) to GNP went down from around 6.5% in 1986 to 4.5% in 2000. The slow pace of this erosion is, actually, the most common explanation, why, amazingly, years of high inflation have not ended with the hyperinflation.

The most visible effect of inflation and the uncertainty it brings is astonishing output volatility. Turkey is not following a stable growth path. Instead, the economy unexpectedly

Figure 5-16. Turkey: ex-ante real interest rates



Source: IMF

switches from periods of excessive growth to periods of deep recession.

In the presence of an open capital market high and volatile inflation produces a very high risk premium that, together with large domestic borrowing, results in very high real interest rates. This situation not only constrains the economy in its growth potential but also has a negative impact on the structure of the financial and corporate sectors. High interest rates make investment other than treasury bonds less attractive. Firms prefer to invest in government papers rather than put money into competitive service/production businesses. The country's top 500 companies earn more money from investing in treasury bonds that from manufacturing activities.

As another consequence of volatile inflation and high interest rates, economic agents have extremely short planning horizons. There isn't virtually any market for cheap long-term financing. This means that Turkish companies don't consider banking system as important source of funds and have to rely on shareholders' capital and internally generated funds to finance their investment. There were only one or two issues of corporate bonds and commercial paper between 1993 and 1997 and none since then. Few homes are mortgage-financed, despite high levels of homeownership. Moreover, output and inflation volatility together with overall political and economic instability discourages foreign direct investment in Turkey.

Permanent inflation has destroyed confidence in the lira as a store of value. The economy is, to large extent, dollarized – hard currency is used as an accounting unit, store of value, and in other important economic implementations. Half of the residents' deposits are denominated in foreign currencies.

High inflation also has its social consequences. It acts as an income redistribution mechanism where some segments of the economy, especially net lenders, i.e. banks and high-income households benefit on expense of other social groups.

The overall result is a quite severe distortion in the efficient allocation of economy's resources.

There have been many attempts by subsequent Turkish governments to bring inflation down. There were five disinflation programs launched during the 1990s alone. For example, the last but one program started in June 1998 and was backed by the IMF loan. The plan projected to bring inflation down to single-digit before end-2000 (50% by end-1998, 20% by end-1999 and single-digit level by end-2000) and to improve a governance transparency.

At the beginning, a forward-looking indexation was introduced in a public sector wage setting. However, this policy was not adopted with sufficient confidence and soon failed as a result of public employees' reluctance to observe their real wages eroding and politicians' inability to execute the legislation. The economic agents failed to believe the government, and, because of more-than-expected restrictive policy and Russian-crisis-induced capital outflows the real interest rates soared to over 50%. The economy started to slide into recession and, eventually, in the middle of 1999, government turmoil and general elections put an informal end to the program.

From 1961 to 1999, Turkey signed 16 agreements with the IMF concerning disinflation and fiscal consolidation – and broke every one of them. The failure of these programs was clearly caused by the lack of political commitment to the reforms. The task is much harder than it seems because there are quite powerful "pro-inflation" lobbies, consisting of representatives of social groups benefiting from high inflation environment.

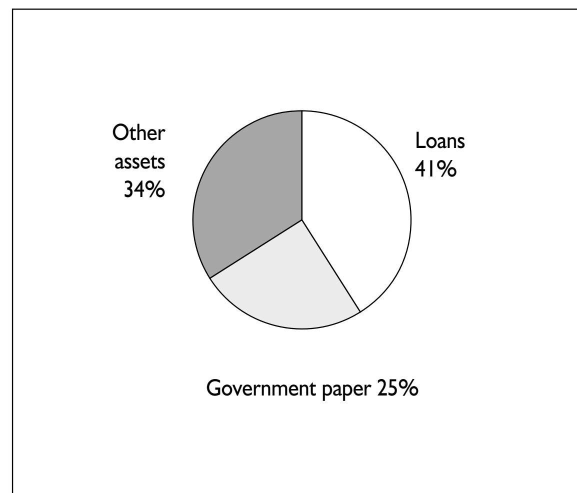
5.1.6. The Banking Sector

In November 2000, there were 81 banks in Turkey, out of which 19 were foreign, 20 had a development and investment profile and the rest were domestic commercial banks. The four biggest state-owned banks accounted for 40% of total assets. State banks often played a quasi-fiscal role and acted as government agencies, mainly for providing subsidized loans to sectors preferred by the government.

The four biggest private banks account for almost half of total private banks' asset. Most private banks are owned by the large conglomerates. This means that banks are quite dependent in their investment decisions (state banks on government officials and private banks on their owners – industrial conglomerates), so credit might not be directed to its most efficient use.

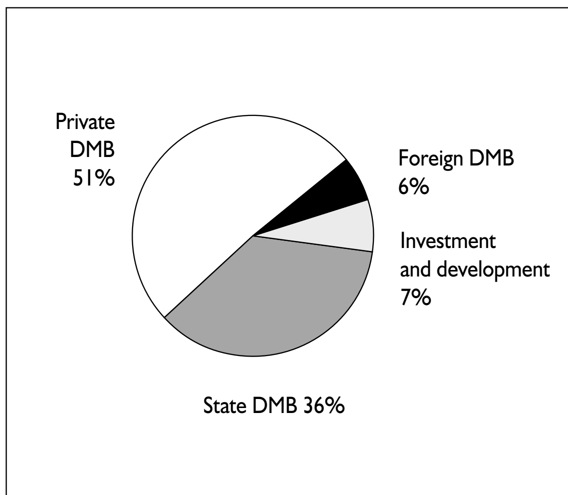
Private banks are, on average, more profitable (they

Figure 5-17. Turkish banks' assets



Source: IMF

Figure 5-18. Turkey: assets of the banking bystem



Source: IMF
DMB - Deposits money banks

account for 70% of total income and 65% of total profit). Their loans have a 40% share in the total banking system assets. Central government liabilities account for 25%, the remainder being interbank loans and deposits, fixed and other assets.

The Turkish banking sector significantly differs from its Western counterparts. It is shaped by the high inflation environment and, most importantly, by the large government borrowing and debt. Until very recently banks were the most lucrative form of enterprise. Much of their activities boiled down to collecting deposits and investing in highly profitable government paper. There was no risk, as all deposits had state guarantees [2]. Indeed, Turkish banks used to be highly profitable. Banks were also acting as intermediaries between the foreign sector and the government, they borrowed in foreign currencies and invested in government bonds. This speculation resulted in considerable net open foreign-exchange positions (in 1997 foreign exchange liabilities exceeded foreign exchange assets by 5 bln USD).

As a result, the most important bank activity – lending to private sector – is severely impaired by excessively high interest rates.

Inflation has also its effect on the structure of the banks' balance sheets. Lending to the private sector has a predominantly (80.4%) short-term character, average maturity of deposits is 3.7 months (June 1999), the ratio of short-term financing sources to other sources amounts to 300%. The low confidence in the lira means that the half of deposits is denominated in hard currency.

The overall size of the banking sector is very small – Turkish deposits to GDP ratio amounts to 28%, compared to an average 65% for emerging markets.

The Turkish stock market capitalization isn't large as well – it is equivalent to 31% of GDP (1997).

5.1.7. Corruption

Widespread corruption can be considered as one of the most fundamental problems of the Turkish economy, politics and social life. The interconnections between large industrial conglomerates and managers, politicians, bureaucrats, media owners, and financial institutions have grown into a virtually unbreakable system of mutual interests. Nobody believes that this problem can be effectively dealt by any Turkish government. As a symbol, the previous Yilmaz cabinet was brought down over banking corruption allegations and had to go under parliamentary investigation. Nevertheless, Yilmaz is now the Deputy Prime Minister in the cabinet, which, as one of its major goals, is pursuing anti-corruption campaign.

Corruption has had serious consequences for the economy. The government and financial sector have become highly interdependent. In many case politicians were issuing bank licenses to connected individuals in exchange for numerous favors. In best cases such banks were used for speculation with government paper, in worst they were badly mismanaged or looted. On the other hand, large private banks became a part of industrial group holdings and often served as a source of capital to doubtful and risky enterprises. The latter would not be able to finance these projects on the open and competitive capital market.

Turkish society has been fed up with corruption to such an extent that exploiting this frustration has become politically profitable. The ruling coalition failed to keep a veteran-politician, Suleyman Demirel, as the President, and the 1999 Presidential elections were won by Necdet Sezer, a man without a political or military background. About the same time, corruption became a major threat in the military national security doctrine. The senior army officials decided to intervene and put a pressure on the government to actively counteract this problem.

Table 5-4. Bank profitability in selected countries in %, averages for 1994–1996

Austria	Germany	UK	Czech	Hungary	Korea	Mexico	Poland	**Turkey**
0,9	1,0	1,4	1,8	0,8	1,7	2,6	3,7	**5,3**

Source: OECD, IMF

[2] This, of course, generated a moral hazard problem, one of the major reasons of the 1997 Asian and 1998 Russian crises.

As a result of above mentioned developments, the highly publicized anti-corruption campaign began in the end of summer of 2000, and left many people astonished not only by the scale of the phenomenon, but also by the apparently strong commitment of anti-corruption units.

5.2. The 2000–2002 Disinflation Program

5.2.1. Background

Finally, but not for the first time, the politicians came to the conclusion that inflation is too big a burden for the economy, and its short term appeal is not worth long term costs. They acknowledged that inflation leads to an unstable growth dynamic, impeding the efficient utilization of the resources. The inflation-driven uncertainty has negative effect on both domestic and foreign investments. Volatile and chronic inflation leads to painfully high real interest rates and high-risk premiums, which in turn reduce the investment demand and switches the capital away from the real sector to financial speculation. High interest rates further worsen the fiscal position. The vicious circle of budget deficits, high inflation, and high interest rates increases the total debt of the public sector rapidly, and dampens the prospects of long term fiscal sustainability. Inflation also creates social problems producing unfair wealth redistribution and wide income disparities.

It has to be clearly pointed out that monetary policy alone is not going to resolve inflationary problems. The central bank can, of course, cease to provide liquidity to the system but this would probably lead to a serious economic crisis and a severe recession. This is because inflation would persist for some time and the lira would become dangerously overvalued, Turkey would lose international competitiveness, the current account deficit would widen, and foreign investors, expecting problems (overvaluation, recession), might cut off their funds. As a consequence of a liquidity shortage (domestic borrowing requirements) a period of extremely high interest rates would devastate the economy – the ultimate crisis and devaluation of the lira would only validate the ex-ante expectations. This is a reason why the central bank, without help from the fiscal side, did not decide to stop its accommodative policy. The chronic fiscal deficits were responsible for Turkish inflation and, until this problem is resolved, no disinflation strategy can succeed. However, the strong and painful fiscal reforms need a political consensus.

Taking advantage of a majority in the Parliament and the backing of international institutions (IMF, World Bank), the Turkish authorities announced a three-year disinflation and fiscal consolidation plan on December 9, 1999. This plan can be qualified as an extension of the Staff Monitored Program signed with the IMF in July 1998 and is embodied in the Stand-by Agreement, with a credit line of almost 4 bln USD. Unlike previous reform programs, this program enjoys a strong political support, which, actually, is the most important factor for its successful implementation.

The fundamental goals of the agreement are:

– bringing down the consumer price inflation to 25% by the end of 2000, 12% by the end of 2001, and 7% by the end of 2002, via simultaneous implementation of consistent, credible, and persistent fiscal, income, monetary, and exchange rate policies, all supported by relevant structural reforms,

– reducing real interest rates to plausible levels,

– increasing the growth potential of the economy,

– providing a more effective and fair allocation of the resources in the economy.

The disinflation program operates on three main pillars:

– a tight fiscal policy that consists of increasing primary surpluses, implementation of structural reforms and speeding up the privatization,

– an income policy in line with the targeted inflation (i.e. the system of wage indexation),

– monetary and exchange rate policy.

On the fiscal side, the government planned to increase revenues by tax reforms and increases in tax rates and, at the same time, by tightening expenditures. It was expected that the total public sector primary surplus would be 2.2% of GNP in 2000. This implied that the primary surplus of the consolidated budget, including the earthquake expenditures would be 3.9% of GNP (when earthquake expenditures are excluded, the ratio was to be 5% of GNP).

The continuation of structural reforms in 2000 was to contribute to an improvement in public finances. The privatization proceeds for 2000 were planned to reach 7 bln USD. This budgetary improvement was considered sufficient for the first year of the program and it seemed plausible to stabilize the ratio of cash domestic debt to GNP at 27% and total debt stock to GNP at 61%. There were to be periodic announcements by the authorities on fiscal and income policies, the related targets and detailed explanations concerning these policies. Any revenues in excess of the budget projections were to be saved.

The authorities expected that, as a result of the program's implementation, nominal interest rates would go down, relieving much of domestic debt burden (up to 20 bln USD saved on the interest payments).

The most challenging issue was to break the endemic backward-looking behavior (i.e. the determination of wages and prices, and therefore the future inflation, by past inflation) and build up a framework for forward-looking indexation. The economists came to the conclusion that in Turkey's situation, a nominal anchor for expectations was essential to achieve this goal because backward-looking indexation was so deeply rooted in the economic behavior and

virtually impossible to wipe out any other way. The obvious candidate for a nominal anchor is the exchange rate thanks to its visibility and meaning (hard currency was in fact an accounting unit and a store of value).

Starting from January 2000 the central bank's policy was to be implemented according to the targeted inflation rate.

The exchange rate policy was to be conducted by the central bank via the exchange rate peg. The exchange rate, based on the (unchanged) basket of 1 USD+0.77 euro, was to be announced on a daily basis covering forthcoming one-year period. Such a preannouncement of exchange rate is a great support to the elimination of backward looking behavior.

The exchange rate policy was designed in two different exchange rate regimes and in two different periods. In the first 18 months, which is between January 2000 and June 2001, nominal value of the basket was to be increased strictly according to the targeted inflation rate, while in the following period the policy was to be carried out with respect to a progressively widening bands.

Between January 2000 and December 2000, the TCMB committed to the rate of devaluation equal to the targeted inflation. For each quarter monthly crawling peg rate amounted to 2.1%, 1.7%, 1.3% and 1%, respectively. Between January 2000 and June 2001, at the end of every quarter, the central bank is to announce the rate of devaluation compatible with the targeted inflation rate for the following quarter in the year ahead, while keeping the pre-announced rates for the previous 9 months unchanged. Accordingly, at the end of every quarter, the rate of the crawl for the following 12 months would be publicly known.

Every exchange rate peg has a deficiency that the authorities can get locked in the framework where every attempt to abandon the peg in favor of the floating regime carries the danger of financial upheaval, sharp devaluation or revaluation. To overcome this problem the authorities preannounced the exit strategy: in the period of July 2001-January 2002, a system of progressively widening symmetrical bands was to be introduced. Total width of the bands was to be increased gradually to 7.5% by end-2001, 15% by July 1, 2002, and 22.5% by end-2002. In this mechanism, the central bank would not intervene to the movements of exchange rate within the bands

The central bank's foreign reserves amounting to 22.6 bln USD at end-1999 (and expected to increase with the implementation of the program), together with the financial support of international institutions, were considered sufficient to back this policy.

The domestic monetary policy was designed by imposing a floor to net international reserves and a ceiling for the net domestic assets. The ceiling to the net domestic assets was fixed at -1200 trln lira for whole year 2000. The central bank announced its readiness to buy and sell all supplied foreign exchange at the predetermined exchange rate without any sterilization (no-sterilization principle) [3]. That meant injecting or removing liquidity only to the tune of capital flows. The volatility of net domestic assets was restricted to ±5% of previous end-quarter base money stock (that is roughly ±200 trln lira). Permitting some volatility is designed to avoid sudden and extreme fluctuations in interest rates.

The program stressed that the central bank would not provide credits to the public sector that could cause an increase in net domestic assets. The central bank decided also to reduce its presence in the interbank money market. To increase banks liquidity in the new environment, the statutory reserves, which were to remain at 8%, were divided into two parts: 6% was still to be keep in the blocked accounts in the central bank, while the remaining 2% was freely accessible with the requirement of preserving the weekly averages (of 8%). The net international reserve floors were set at 12 bln, 12,75 bln, 12,7 bln and 13,5 bln USD each end-quarter of the year 2000, respectively. Keeping net domestic assets unchanged means that base money will change only in return for the change in net foreign assets.

Table 5-5. The main points of Turkish stabilization program for 1999-2002, with further announcements (*)

	Targeted inflation	Exchange rate depreciation rate	Net international reserves floor, bln USD	Net domestic assets ceiling qdrln lira	cumulative primary surplus of consolid. budget in % GNP
2000 January-March	25%	2,1%	12	-1,2	
2000 April-June		1,7%	12,75	-1,2	2,25
2000 July-September		1,3%	12,7	-1,2	3,3
2000 October-December		1%	13,5	-1,2	3,9
2001 January-March	12%	0,9%*			
2001 April-June		0,85%*			
2001 December					3-5%*
2002 December	7%				

Source: TCMB

[3] Of course, for capital outflows, the sterilization was allowed up to the net domestic asset ceiling of -1,2 qdrln lira.

Reducing high inflation can be very costly in terms of lost output, especially if economic agents fail to believe the government policy and accept its targets. Hence, the authorities strongly warned that all must give up backward-looking indexation for price and wage determination, otherwise, the program would lead to the contraction of production and employment. For a public sector wage settlement, the salaries of civil servants were to be, in line with budget law, adjusted by the difference between inflation and 15% plus 2%. As the government has no authority over private sector wage and price process, it only warned the corporate sector about the negative consequences of failing to stick to the preannounced targets (danger of losing the competitiveness).

In addition to the above-mentioned policies, other reforms were expected to be introduced in the economy. Apart from accelerating privatization they included agricultural sector reform, social security reform and the implementation of a new banking law.

5.2.2. Program implementation up to December 2000

The program was backed by the IMF's 3.8 bln USD Standby credit line approved on December 22, 1999. Before beginning of December 2000, three tranches of 238 mln USD were already disbursed. On November 26, 2000 the IMF First Deputy Managing Director Stanley Fischer announced that the Turkish disinflation and fiscal consolidation program is on track, praised the government for its commitment and expressed the IMF's full support.

Inflation in 2000 is the lowest since mid-1980s. Market interest rates sharply declined in January 2000 and the rates has been steadily falling since then, the public indebtness in relation to GDP stabilized and is expected to decrease.

The fiscal performance has been strong – primary surplus floor has been met with a good margin (0.9% of GDP just after a first quarter). In the area of fiscal transparency, dozens of budgetary and several extra-budgetary funds have been closed, and the total number of extra-budgetary funds is going to be reduced to 6 at beginning-2001 (out of which the defense and social solidarity funds are the most prominent). Price and wage guidelines were published for private and public sectors. Civil servants' salaries in June 2000 were adjusted in line with the budget law. A breakthrough social security reform was implemented in mid-summer of 1999, including the introduction of a minimum retirement age of 58(women)/60(men), increase in the minimum contribution period, increase in the ceiling on contributions and other improvements. Some structural reforms have also been undertaken in the agricultural sector – the most important being the removal of state banks' credit subsidies. This has been amortized by a decline in interest rates.

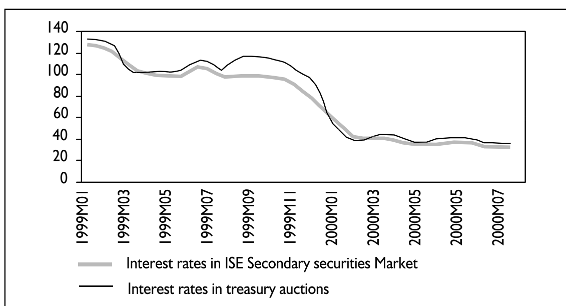
Fiscal consolidation was partly foreign financed. The share of external borrowing in total borrowing rose to 17% in mid-2000, from an average of 9% in 1999

Monetary and exchange rate policy was rigorously followed and the no-sterilization policy consistently implemented. Net domestic assets were kept strictly in the designed corridor [4].

What concerns the banking reform, the Bank Regulation and Supervision Agency started operations in September 2000 and commenced inquiries into the banking system. A new banking law was adopted and introduced. A consolidated capital adequacy ratio was included into the prudential regulation framework, reserve requirements regarding foreign exchange liabilities were raised to 100%, and security valuation regulations issued in May 2000.

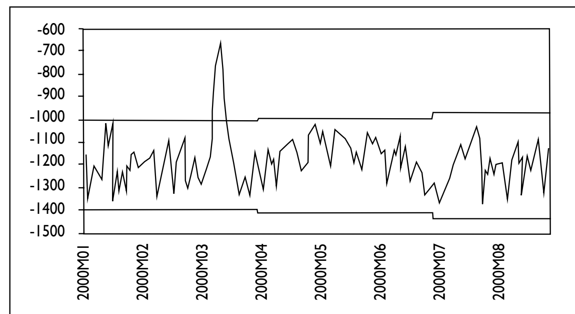
The reform package for 2001 includes a primary budget surplus of 3–5% of GDP, operational surplus of 2,75% of GDP and a further decrease in public debt/GNP ratio from 61% in 2000 to 56%. The government borrowing requirements are to be scaled down from 12% of GDP in 2000 to 3.5% in 2001.

Figure 5-19. Turkey: interest rates on government securities percentage



Source: TCMB

Figure 5-20. Turkey: net domestic assets (Trillion TL)



Source: TCMB

[4] Except for one period of major national holiday.

Despite the general success, not everything has been achieved. The pace of disinflation is slower than targeted (40% inflation instead of planned 25%). Adverse external developments – especially a weak euro and rising oil prices – have put a pressure on the program. The depreciation against the USD (the most visible nominal signal) is much larger than expected, while smaller against euro [5]. Reverse currency substitution expected by the central bank has not taken place. The slow pace of restructuring and privatization is subject to rising concern. As a result of political disagreement some privatization projects have failed [6], and the receipts are going to fall short of the target.

5.3. The "Crisis"

5.3.1. The Origins of Vulnerability

From a theoretical standpoint, the Turkish authorities made the economy vulnerable to a crisis in a very classic way. In presence of free capital flows it is impossible to support, at the same time, the financial system and the exchange rate. Supporting the financial system means injecting liquidity in the case of large capital outflows, while this, in turn, fuels further capital flight and exchange rate depreciation. Supporting the exchange rate means, in similar case, allowing the interest rates to go very high, which hurts the financial system (the Turkish banking sector is funded by short-term money and during crises short-term interest rates go very high). The authorities stated explicitly their commitment to defend the exchange rate, while the promise to support the financial sector was implicit and justified by its fragile condition. In such circumstances, only the confidence of foreign and domestic investors in the economic reforms prevents the policy framework from collapsing. The December 2000 turmoil was actually a crisis of confidence, so the adequate question should be why was Turkey vulnerable to such a market sentiment reversal.

Turkey has actually adopted quite a rigid monetary policy framework without the necessary preconditions – in particular a sound banking sector, easy access to foreign financing and strong balance of payments prospects. The declared exchange rate path and the net domestic assets target mechanism were based on the IMF agreement and central bank declarations only. Such an arrangement has not been credible enough for a long time.

Summing up, two issues are most important here: weak financial sector and unstable political situation. Having a weak financial sector, Turkey fell into an "impossible trinity" trap and provoked a crisis caused also by a worsening political situation.

At the beginning, the program was backed by a firm parliamentary majority but the first signs of rising disagreement became apparent in the summer-2000 political crisis over privatization issues. As a result, the government failed to go fast enough with the reforms. The privatization receipts were also smaller than expected, threatening the budget. The Turkish government tried to force the Parliament to vote on legislation preventing the Constitutional Court from banning the Virtue Party, fearing that the closure may trigger a by-election or even early general elections – a real catastrophe to the program. Other events such as energy shortages with dangers of immediate power cuts, and public employees' demonstrations also pose a threat to political stability. In addition, there also exists a " high inflation-high interest rates lobby" that is trying to undermine and obstruct the disinflation program.

The anti-corruption drive, which gained momentum in September/October 2000, became highly publicized. People saw previously influential and untouchable businessmen and bankers with wide ranging political connections – over 100 people -being arrested. A nephew of the former president is going to be tried on charges including siphoning off funds from one of the banks he owned, extension of fraudulent credit and a conspiracy to commit a crime. Shocking news about alleged banking fraud or even looting were daily occurrences. The confidence in the banking system declined dramatically. What is more important, the public, as well as foreign investors, started to worry about the safeness of their deposits in other banks, presumably also engaged in some, yet undisclosed, dubious activities.

In September/October 2000, the newly established Banking Regulation and Supervision Agency closed two banks. This decision brought the total number of banks taken into custody over the last two years to 10. It was discovered and publicly announced that the total losses of these banks amounted to more than 6 bln USD and the bill must be paid by a taxpayer, seriously undermining the budget.

Indeed, banking sector reform went very slowly, and its condition remained very fragile. Banks prospered very well during high inflation period [7] but the situation began to change. Net interest margin fell from usual average 12% to 7% in 2000, bringing the whole sector to the brink of profitability. Generally speaking, the Turkish economy started to exhibit considerable difficulties in adapting itself to a low

[5] The lira was depreciating against a basket of USD and euro, a change in USD/euro cross parity is responsible for this situation.

[6] The most spectacular was the unsuccessful attempt to sell 20% of shares of the Turk Telekom. Nobody submitted a bid because the state refused to cede management rights over the telecommunication operator.

[7] Bank profitability is on average twice higher in high inflation countries due to high interest rate margins.

inflation environment. The main sectors of the Turkish economy are not internationally competitive, especially the banking sector and agriculture. These problems were obscured by high inflationary environment, but as the situation started to change the structural weaknesses of theses sectors became increasingly apparent.

The recent deterioration of the current account only contributed to the concerns about the prospects of the program.

5.3.2. Crisis Development

Learning from the 1990s episodes of global financial crises (Mexico, Asia, Russia, etc) Turkish authorities were well aware about the dangers to which the program, and in general the whole economy, was exposed. Speaking about emerging markets financial crises and contagion the Governor of TCMB noted that:

"The reasons for the contagion can be divided into two groups:

1) Fundamental reasons: common reasons related to unsustainable macroeconomic policy orientation or global shocks such as major economic changes in industrial countries that can affect commodity prices, interest and exchange rates, trade links and financial links,

2) Investor's behavior, whether rational or irrational, may lead to shocks spilling from one country to another.

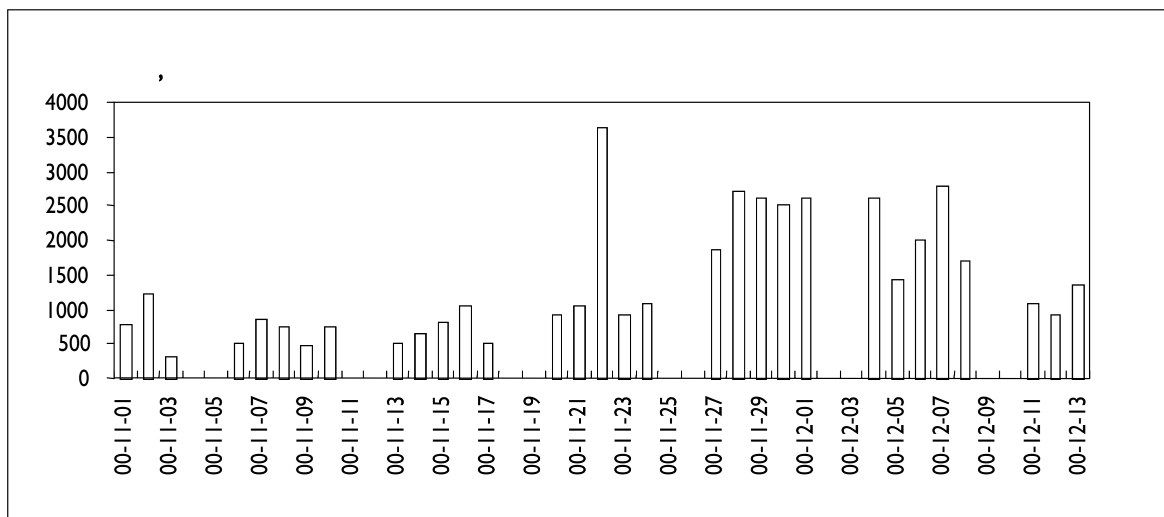
"In my view, the emerging markets should take actions in the five following areas in order to reduce their vulnerabilities to external contagion:

– external liability management
– exchange rate systems
– structural reforms in the financial system.
– transparency of the data
– credibility" [8].

The governor and senior government officials made numerous appearances explaining the reforms and policy in each of above-mentioned fields and stressing their commitment to the plan. They were fully backed by the IMF, not only by words but also by 4 bln USD credit line. Apparently it was not enough to sustain confidence for longer.

At the end of 2000, foreign investors were closing their books and reshuffling portfolios. The stock market was on a moderate decline since the beginning of November. Also in November, there were a series of media leaks about the investigation uncovering shocking revelations about alleged corruption, asset mismanagement, fraudulent and criminal activities in the banking sector. The capital market became very unnerved about the situation; prosecutors' inquiry into banks destroyed the confidence in the Turkish financial sector. More investigation was announced. Being afraid of "who will be the next to collapse?" the major Turkish banks cut-off credit to some of their small competitors as a kind of insurance against their possible closure. These banks were desperately seeking funds on the interbank market, causing the liquidity to dry up. The banks lost confidence in other banks and were very reluctant to extend credits to each other. Overnight interest rates rose sharply. This was the signal that something wrong was going on. With more bad news coming in, foreign investors started the sell-out Turkish assets. Interest rates were further rising.

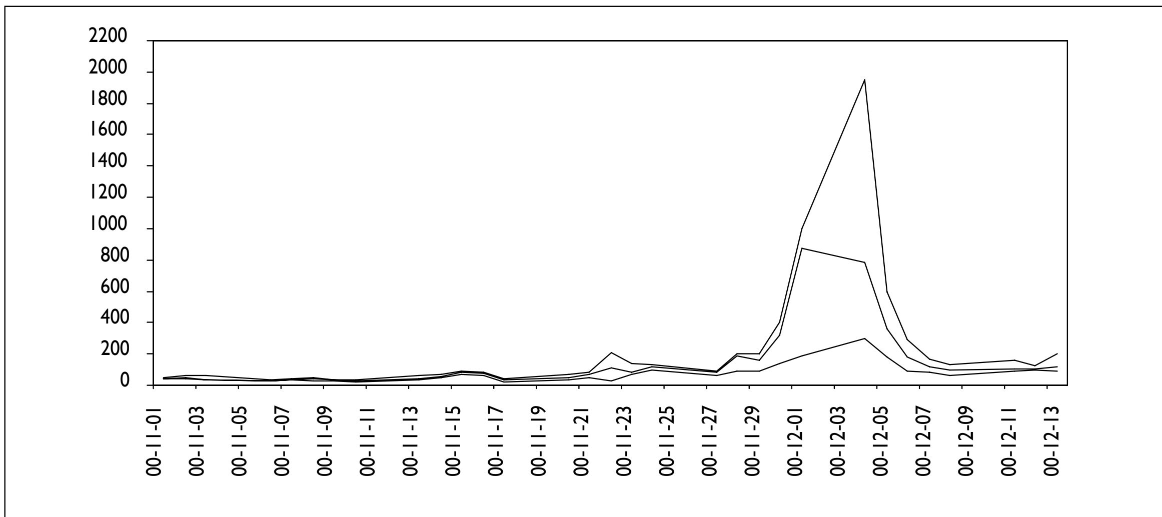
Figure 5-21. Turkey: interbank foreign exchange market, volume of transactions (mln USD)



Source: TCMB

[8] The TCMB Governor, Gazi Ercel's speech in Prague, September 24, 2000

Figure 5-22. Interbank money market interest rate (minimum, average, maximum)

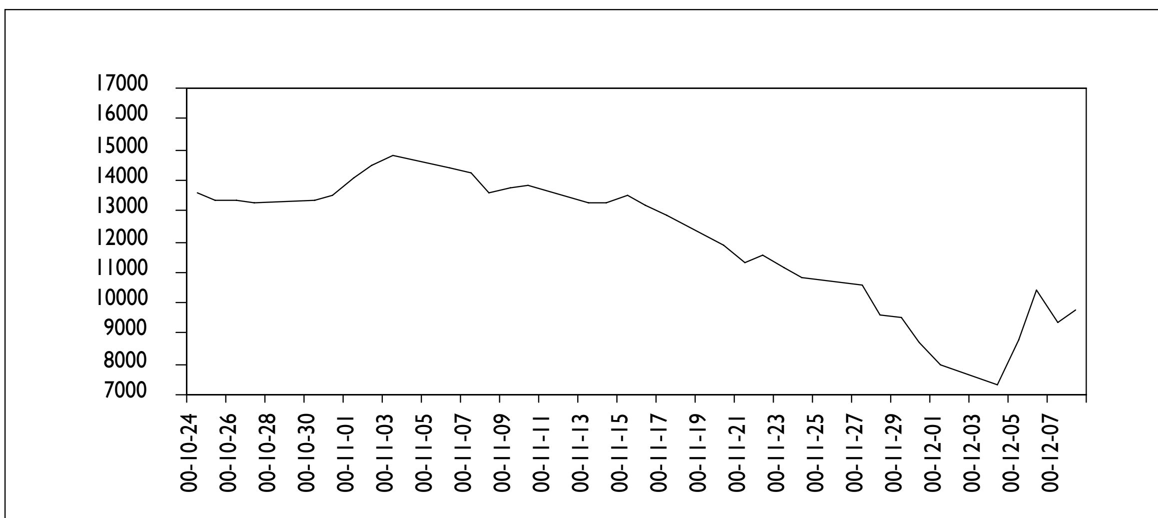


Source: TCMB

On November 17, 2000, the situation became so alarming that the central bank decided to break the rules of the program and engaged itself in large liquidity injections. During next three days the interest rates went down but soon they started to go up again. The response proved to be of no help and, in addition, liquidity support became so big that it soon violated the rules of the IMF's agreed program with respect to net domestic asset creation. Such a stream of liquidity threatened the sustainability of a peg and gave a signal to investors that TCMB would perhaps flood the market with the lira in an effort to bring the interest rates down. As soon as market realized that the panic erupted for good, investors started dumping Turkish assets. Capital outflow exploded to almost 1 bln USD a day at some point. By end-November, the liquidity injection broke the limits by more than 3 bln USD. The credibility of the authorities has been impaired. The TCMB realized soon that this policy is leading straight to a disaster and the exhaustion of foreign exchange reserves, so finally, on November 30, 2000, it announced a definite cut of emergency funding extended to the financial system. The interest rates skyrocketed reaching levels of 700% daily average (1950% at maximum).

The stock market took a plunge, and at its minimum lost over 50% value from its end-October peak. The panic that was triggered was well depicted by the incident where a desperate investor shot his banker.

Figure 5-23. Istambul Stock Exchange Index



Source: Bloomberg

The desperate move to cut-off liquidity injections and expose the financial system to more than 200% interest rates was aimed at rescuing the disinflation program, demonstrate the government commitment to reform and, crucially, restore confidence in the Turkish market and reverse severe capital outflows. On December 5, 2000, the authorities ordered a closure of Demirbank, the 9th largest private bank. As interest rates began to increase, Demirbank started to incur huge capital losses and couldn't finance its government bond portfolio any more.

If Turkey were to abandon its currency peg, the disinflation program together with its achievements would disappear and the credibility in economic reforms lost. A hope that the situation can ever improve would vanish. Realizing this, when the crisis erupted, senior officials were quick to reassure the markets about their commitment to the program. The government promised to speed up the privatization and especially to cede management rights to a new buyer of Turk Telekom. The central bank promised imminent statutory reserve requirements cuts, etc.

The government actions, however, failed to meet their goal – during the two-week period (by December 4) the capital outflow reached 7 bln USD. Yet on this day the analysts viewed devaluation as inevitable, arguing that three weeks of 200% or more interest rates would do much more harm than the devaluation.

In the meantime the Turkish authorities began emergency talks with the IMF.

On December 5, S&P rating agency revised downward its outlook on Turkey's sovereign debt from "positive" to "stable", justifying this step by the expected impact of the crisis during upcoming three years. Seven Turkish banks also were downgraded. This move was quite dangerous because it could only convince other investors to join the panic as well. On the other hand, Moody's said it had put Turkey's debt under review for a possible upgrade with a decision coming within few weeks. At the same time, it considered a downgrade of 14 Turkish banks. The Fitch agency maintained its rankings based on the belief that the crisis could be averted by cooperation with the IMF.

Because the central bank's foreign reserves were close to go below the 13,5 bln USD floor (one of the program's criterion) there was very little time to act. The deal had to be concluded quickly, before the relatively solid, major part of the banking system start to suffer and fall into insolvency. And, indeed, the agreement was reached and announced extremely quickly for IMF standards. The scale of the IMF's support, 7.5 bln USD [9] announced on December 6, 2000, came as a positive surprise to the market. Already on December 5, when it became known about its larger-than-expected magnitude the market rebounded and the interest rates eased.

5.4. Conclusions

5.4.1. Estimating the Impact

The crisis (in the form of high interest rates and a threat to exchange rate) is over. But certainly, it has left its traces in two areas – in the banking and corporate sector balance sheets (losses) and in the peoples' minds (uncertainty).

It is too early to say how badly the banking system has been affected by the crisis, and how many banks will have to be closed or merged. The IMF's officials confirmed that unspecified number of Turkish banks did not fulfil the statutory requirement of 8% capital adequacy ratio. Some of them were in a bad state already before the crisis, but some of them might cease to meet this requirement as a consequence of a recent interest rate hike. Fortunately, the limited exposure of the Turkish corporate sector to the banking lending mitigates the scale of potential bankruptcy chain reaction.

If the interest rates remain higher than expected the government can forget about expected capital gains from lower interest rates on its debt what in turn will threaten the budgetary targets for 2001 and undermine the whole stabilization program.

Taking all that into account it is reasonable to scale down next year estimates of Turkish GDP growth from 6% to around 4.5% [10].

It has been a relatively minor crisis of confidence, although experts hint that Turkey was "on the edge of an abyss".

5.4.2. Has the Situation Improved?

The root of the crisis can be seen in the loss of confidence caused by political disagreement on the course of reforms and by the bad state of the financial system.

Of course, not much has changed during three weeks of the crisis, except for:

– Political commitment seems to be improved by the shock that politicians incurred during the crisis – they might

[9] The money would not be available until the package is approved and until the government takes several steps to proceed with reforms, particularly with tenders on the privatization of 34% of the Turk Telekom and 51% of the Turkish Airlines. Prime Minister Ecevit expressed expectations that the Parliament would soon pass a law breaking a way for privatization of electricity sector.

[10] The news about the expected slowdown in the US economy gave grounds for further verification of that forecast – even to 2–2.5%.

have become more aware about the possible consequences of their behavior. The financial civil servants even warned the government officials to stick firmly to the program, otherwise, the crisis could happen again. Urged by a crisis, the government approved tax increase to enhance the credibility of tight 2001 budget.

– Banking sector certainly emerged in worse state than it was before the crisis, however, it seems to be a will to restructure and clean up this sector.

– The confidence has been boosted by the availability of 10 bln USD to counteract any "unjustified" capital outflow.

It must be stressed, however, that no amount of money is going to save Turkey from future troubles, unless it firmly embarks on the program of structural reform, i.e. until it cleans up its financial system and crack down on corruption.

Another issue is the trade deficit that reached a critical level. If the trend continues questions might be raised about the sufficiency of central bank's foreign reserves.

As everywhere, there are hopes that the crisis is going to finally convince politicians to proceed with unpopular reforms and economy-wide restructuring.

Appendix: The chronology of the crisis

2000

January 1, The beginning of the 3-year disinflation program

August, Disagreement among ruling coalition, mainly over privatization issues

September, The anti-corruption drive accelerates, 2 banks are taken over, total number of banks closed within 2 years reaches 10

October-November, More shocking revelations about alleged asset mismanagement in the banking sector.

November, The stock market begins to gradually decline

mid-November, Liquidity squeeze on the market, unnerved foreign investors start selling Turkish assets

November 17, The central bank decides to intervene on the interbank market, interest rates ease, but investors lose confidence, stock market collapse, panic begins

November 22, Panic reaches its peak, Turkish assets are dumped, capital outflows is counted in several hundreds million USD daily

November 29, The central bank has already pumped 3 bln USD more than it was allowed by the IMF agreement

November 30, The central bank decides to cut off liquidity support to save disinflation program, interest rates explode

December 2, Turkish government negotiates with the IMF

December 4, Interest rates reach unimaginable 1950%, while cumulative capital outflow exceed 7 bln USD

December 5, Rating agencies downgrade Turkey and Turkish banks, first news about the IMF agreement leak to the public

December 6, Larger than expected IMF aid package is announced. The aid amounts to 7.5 bln USD in addition to already available 2.9 bln

mid-December, Capital markets calm down and investors regain confidence, interest rates go down

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Notice
The Second Wave of the Crisis and a Collapse of the Exchange Rate

On Monday, February 16, 2001, before a monthly meeting of the National Security Council President Ahmet Necdet Sezer accused the Prime Minister Bulent Ecevit of challenging his decision further to investigate state-owned banks suspected of corruption. Outraged Prime Minister issued a statement that read: "The president had directed a serious allegation at me (…) Of course, this is a serious crisis (…)". Within minutes, the Istanbul stock exchange dropped 10%, and overnight interest rates jumped to from 40% to 100%. Turkish bankers immediately recognized that the political crisis would bring an end to the ambitious disinflation program. Having trusted the government and stayed in lira after the IMF bailout in December 2000, they hurried to buy dollars. Around 7.5 bln USD were withdrawn from Turkey in a single day.

Table 5-6. The second wave of Turkish financial crisis

Date	16.2.2001	19.2.2001	20.2.2001	21.2.2001	22.2.2001	23.2.2001	26.2.2001	27.2.2001
Exch. Rate	686 417	-	685 448	686 367	961 487	1 108 950	949 950	982 355
Interest rate	40.27	43.66	2057.74	4018.58	1195.28	568	102.09	100.2

Source: TCMB

The IMF warned that no new emergency loans would be granted for Turkey and advised devaluation but the government decided to continue defending the peg. Overnight interest rates reached 6000%. Another 3 billion USD left the country before, prompted by bankers' warnings against possible financial system collapse, the government finally decided to float the currency on Thursday, February 22. The lira devalued approximately 40%.