

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is centered in the narrow neck of the hourglass. The text is overlaid on the hourglass.

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February 2, 2009

Congressional Research Service

Report RL30161

*RUSSIA: PRIMAKOV'S ECONOMIC POLICY DILEMMA  
AND U.S. INTERESTS*

John P. Hardt, Foreign Affairs, Defense, and Trade Division

Updated May 3, 1999

**Abstract.** This report focuses on two divergent scenarios faced by Russia in the wake of its financial crisis of August 1998. Prime Minister Yevgenii Primakov expected either a vicious cycle of decline and possible collapse in government or an economic management scenario following outlines of an agreed action program that makes imperative fundamental changes in the Russian financial system. The success or failure of Russia in dealing with this crisis may have more effect on the pursuit of peace and prosperity by the United States than any other foreign policy crisis.

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## Russia: Primakov's Economic Policy Dilemma and U.S. Interests

May 3, 1999

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## ABSTRACT

This report focuses on two divergent scenarios faced by Russia in the wake of its financial crisis of August 1998. Prime Minister Yevgenii Primakov expected either a vicious cycle of decline and possible collapse in government or an economic management scenario following outlines of an agreed action program that makes imperative fundamental changes in the Russian financial system. The success or failure of Russia in dealing with this crisis may have more effect on the pursuit of peace and prosperity by the United States than any other foreign policy crisis. This report draws on a number of CRS reports that summarize actions relevant to United States relations with Russia, including CRS Report 98-578 E, *The Russian Financial Crisis: An Analysis of Trends, Causes and Implications*; CRS Issue Brief 92089, *Russia*; CRS Report 98-299 F, *Russian Missile Technology and Nuclear Reactor Transfers to Iran*. This report builds upon CRS Report 97-977 E, *Russia's Opportunity to Enter a New Stage of Transition*. This report may be updated or superseded by a new report, depending on action in the 106<sup>th</sup> Congress on these issues or events.

# Russia: Primakov's Economic Policy Dilemma and U.S. Interests

## Summary

Russia's devaluation of the ruble and default on its debts in August 1998 put it in its most serious crisis to date. If trends that created the crisis continue, Russia is faced with a vicious downward cycle toward dire economic straits--hyperinflation, steep reduction in output and income, default on debts precluding the ability to borrow; political weakness--disintegration of central government power with increased corruption and instability, and growing military dissent inviting a political implosion resulting in a threatened collapse of Russia's ability to govern. The Russian government, foreign donors and investors agree that this is the likely outcome without radical change. The Primakov government and the donors (International Monetary Fund, the major industrial economies--the G-7, led by the United States) are negotiating on an Action Program that might, if effectively implemented, provide a basis for managing economic revival. Effectively dealing with debt management, bank restructuring and reform, budget balancing, and investment generation might keep the major donors and some investors engaged with the Russians and justify domestic support of reform. Adjusting now, before the parliamentary and presidential elections of December 1999 and June 2000, might open the option of proceeding toward comprehensive reform in the manner of Poland and other successfully reforming states.

The choices between the vicious cycle and managed economy are stark and understandable to Russians and donors alike. However, the shortfalls in reform that created the crisis also established the wealth and power of the financial industrial groups, the oligarchs, who must change from "rent seekers" living off politically determined allocations from the State budget and monopoly profits, to "profit seeking" competitive groups able to contribute to economic growth, reduction of poverty, and payment of taxes. This change is crucial to the success of a managed economy scenario.

The United States has different policy options if either the vicious cycle or managed economy scenario develops. Without concrete, fundamental measures by the Russians, the United States and all major donors are committed to limiting support to humanitarian aid and some military reduction programs. The United States may in this negative scenario face a hostile Russia still armed with nuclear weapons that is viewed by our defense authorities as the number one threat to our security. With a successful Russian economic adjustment strategy, the United States may play a major role in responding to Russian concrete reform actions leading all donors to provide targeted assistance keyed to Russian actions and therefore likely to stimulate foreign direct investment from the United States and elsewhere, especially in the energy sector. If successful over time, Russia might then move toward becoming a political ally in peacekeeping and a partner in development of some of the most promising natural resources and technologically advanced assets in the world.

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# Russia: Primakov's Economic Policy Dilemma and U.S. Interests

## Russia's Historic Turning Point

Resolution of post-Soviet Russia's most serious economic crisis is of singular importance to the United States. The danger to the United States of a failed Russian Federation is great through possible deployment and use of nuclear and conventional weaponry; increased destabilization of its Eurasian neighbors, possible return of authoritarian governance of a weakened federation, and further aggravation of the global economic crisis. On the other hand the opportunities opened by Russia's actively managing its crisis and keeping open the prospects of return to a democratic market trend would provide positive benefits; a cooperative Russia moving toward a democratic market system might become an important political ally and business partner. Congressional interest has been expressed on monitoring the measures promised by the Primakov government, which are intended to meet the challenges of its financial crises and respond to the requirements of donors and investors. This criticality of Russian-United States relations is illustrated by the importance attached to its government's bilateral economic discussions with U.S. leaders and the relevance of the Kosovo crisis and ratification of the Start II agreement to these exchanges.

Many Russian specialists in and outside Russia believe Russia is doomed to a downward trend before the parliamentary and presidential elections in the months ahead. Michael Marrese of Chase Manhattan Bank, London, reflects this widely held view by projecting a "vicious cycle," a deepening crisis of hyperinflation, increased capital flight and debt default as the most likely scenario for Russia.<sup>1</sup> The vicious

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<sup>1</sup>Michael Marrese, *Russia: Balanced Payments Deterioration and Capital Flight Equals Debt Servicing Blues*, Chase Manhattan International Fixed Income Research, December 11, 1998. For detailed assessment of capital flight to date by Canadian and Russian economic specialists, see *The Problem of Capital Flight from Russia*, A final report from a joint project on capital flight from Russia undertaken by the Institute of Economics, Moscow, and The Center for the Study of International Economic Relations, University of Western Ontario, Canada, October, 1998; 37 pages. Philip Hanson, *The Russian Economic Crisis and the Future of Russian Economic Reform*, draft paper for a meeting at SAIS, Johns Hopkins, February 12, 1998; William Cooper, *The Russian Financial Crisis: An Analysis of Trends, Causes and Implications*, CRS Report 98-578 E, February 18, 1999; Andrei Illarionov, "Financial Crisis in Russia," *Institute of Economic Analysis*, Moscow, September 1998; Susan Gold, editor, "The Russian Economy in Crisis," *Harriman Review*, December 1998, 31 pages; James Duran, *The Russian Federation: Political and Economic Update*, Atlantic Council Bulletin, December 8, 1998; Keith Bush, "The Russian Economy in December 1998," *Center for Strategic and International Studies (CSIS)*, Washington, DC, August 1998.

(continued...)

cycle assessment is basically a projection of past trends that gave rise to the current financial crisis.

When Yevgeni Primakov took the reins of government in September 1998, he found Russia in its most serious economic crisis in its seven-year existence. With the default on debts and devaluation of the ruble by the previous government on August 17, 1998, Primakov stated that his government needed to take urgent measures to avoid defaulting on sovereign debt.

International donors and some investors adopted a policy of continued engagement with Russia under which concrete measures must be taken by Russia to receive further assistance--measures such as debt settlement, setting up a workable monetary system, adopting and implementing a sound budget, and, most importantly, establishing a rule of law for businesses to encourage investment.<sup>2</sup> The new approach of requiring both Russian commitments and concrete measures as preconditions for assistance resulted from donor perceptions that previous reform-oriented Russian governments consistently made commitments that were not honored by performance. Thus successful negotiations between the Primakov government and the donors are premised on implementation of urgent, concrete measures that would redress the critical problems that caused the financial crisis and keep open the option for future transition to comprehensive reform after parliamentary elections in December 1999 or the presidential elections in June 2000.

The Russian reform record from September 1998 through March 1999 did not change the views of many Primakov skeptics because concrete radical reform measures were not implemented. Still, Primakov's government has repeatedly reaffirmed his assessment of the seriousness of its crisis and need for urgent measures that seem to conform to conventional wisdom on the minimum requirements of an incremental policy as judged by the global market, donors, and investors. The IMF Managing Director Michel Camdessus and the Russian authorities agreed on key elements of an economic program required to receive continued support from all donors for 1999 and beyond.<sup>3</sup>

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<sup>1</sup>(...continued)

1998; Michael Ellman and Robert Sharrenborg, "The Russian Financial Crisis and the IMF," *Problems of Post-Communism*, September-October 1998, pp. 17-25.

<sup>2</sup>Lawrence Summers, Under Secretary of Treasury, testimony to Senate Foreign Relations Committee, January 27, 1999 following similar comments at Davos World Economic meetings in December, 1998.

<sup>3</sup> Camdessus and Russian Leaders Agreed on Key Elements of Economic Program, April 29, 1999. "The program includes many measures in the fiscal, banking, and structural areas that the authorities have undertaken to implement, including through enacting the necessary legislation, as quickly as possible. The authorities have also agreed to provide me with a full explanation of the management of reserves by the CBR [Central Bank of Russia] and the use of disbursements from the IMF over the last few years." [IMF Website]

## A Primakov Action Program

The Russian government needs to implement measures that Primakov has indicated would lead to promised improvements in output, reduced social tensions, manageable inflation, a stronger central government, and effective debt service management. These actions are needed to elicit foreign support. Successful reform may also enhance Primakov's chances to stay in office and later ascend to the presidency.

- *Preconditions for Successful Action Program.* A two-step approach would seem warranted for Primakov's action program to be successful, judging by actions and successful reforms elsewhere.

1) *A Broad Activated Political Consensus Favoring His Economic Action Program.* A broadly based Russian program is necessary for success, including support of some industrial magnates or oligarchs who favor globalization, market system institutionalization, and a rule-driven society; and some regional governors who would benefit from radical change and economic improvement; and some more of the electorate who favor reform as a means to ensure a fairer, more efficient system with prospects of improved performance. The Duma, Primakov's original parliamentary sponsor, might be influenced by all of the above. President Yeltsin is certainly a wild card in developing and implementing a consensus-based policy.

2) *Institutional Changes to Make the State Market Friendly.* Establishment of a legal and regulatory system through fiscal, monetary and military reform would be required to create the necessary institutional infrastructure. This would especially require a change in the power and mindset of key Russian entrepreneurs, the financial industrial groups, and the oligarchs, who must change from "rent seekers" living off politically determined allocations from the State budget and monopoly profits, to "profit seeking" competitive groups able to contribute to economic growth, reduction of poverty, and payment of taxes. As Primakov is aware, a broad political consensus supporting reform and establishing an institutional infrastructure conducive to the implementation of his action program is necessary for successful reform and support by donors.<sup>4</sup> The recent weakening of recalcitrant oligarchs such as Boris Berezovsky may indicate that this change is taking place.

- *Implementation of an Action Program.*

1) *Debt rescheduling.* Discussion on restructuring and renegotiating the debt inherited by Russia from the Soviet Union is under way for commercial debt (London Club) and sovereign debt (Paris Club). Russians would like the London Club and Paris Club debt to be generously restructured and rescheduled, using the precedents of the Polish debt rescheduling of 1990-92. It may be essential for all debts, not just sovereign debts, to be restructured with substantial long-term forgiveness and front-loaded relief on servicing. Other concrete measures toward comprehensive Russian

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<sup>4</sup>Nicholas Stern, *The Transition in Eastern Europe and the Former Soviet Union: The Strategic Lessons from the Experience of 25 Countries over Six Years*, Working Paper No. 18, European Bank for Reconstruction and Development, 1997.

reform would be critical to creditors' acceptance of deep debt restructuring. The initial problem for the Russian government is to meet the \$17.5 billion debt servicing required for 1999 with only half that amount available from their own budget. With revenue projected this year at \$22 billion, Russia would have to use 80 percent of its budget for debt servicing. Therefore assurance that as much as \$9 billion would be covered by successful negotiations is critical. Moreover the first debtor in the queue is the IMF, with some \$4.6 billion due. IMF agreement to begin releasing funds to Russia in May, 1999 is a critical first step. Successful negotiations on debt reduction and repayment schedules acceptable to both sides will be necessary to avoid default. Primakov has frequently reassured creditors that all debts would be repaid, albeit after restructuring.

2) *Commercial and Central Bank Restructuring.* The restructuring and recapitalization of the paralyzed banking system, funded by state finances, would result in many banks going bankrupt. Recapitalized banks would need to be guided by sound banking practices in order to begin to generate more savings and investment. Russian and Western financial interests would have to accept substantial losses and recapitalized banks would need to be covered by new monetary regulations and legal requirements.<sup>5</sup> The Central Bank of Russia would need to become more transparent and accountable for reserves and play an effective regulatory role for commercial banks. Bank restructuring is projected to be completed by summer 1999 under a program set up by the Primakov government. An effective banking reform process might then result in foreign banks accepting Primakov's invitation to operate in Russia. Another critical indicator of trust in banking reform would be the willingness of the oligarchs to pull their still substantial financial assets back from abroad for deposit in their own banks, and Russian citizens' willingness to take some \$40 billion in assets out of their mattresses, and to deposit them in Russian banks.

3) *Budget Balancing.* State and regional budgets need to make progress toward supporting necessary expenditures from central, state, and regional revenues without incurring an additional debt burden. Under the agreed guidelines of the Primakov IMF agreement March 29, 1999, a new, fairer, and more efficient tax code might be passed into law and implemented with a new budget, e.g., reducing the burden on legal enterprises and increasing the yield from the value added tax. Institutional reforms, including military and administrative reforms would be necessary to cut excessive expenditures and eliminate the carryover *nomenklatura* state administrators.<sup>6</sup> Moving toward budget balancing illustrates the complementary or synergistic character of the action program: the debt service burden on the state budget would be reduced by debt renegotiation; banking reform might reduce the budget subsidies for failing banks; and increased foreign investment and related joint ventures may lead to increases in tax revenue and other financial flows to the state treasury.

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<sup>5</sup>European Bank for Reconstruction and Development (EBRD), *Financial Sector in Transition*, November 1998. John P. Hardt, *Russian Banking System: Facilitation or Barrier to Investment-Based Growth*, CRS Memorandum to Russia Watchers December 17, 1997. 10 pages.

<sup>6</sup>Hardt, CRS Report 97-977 E, *op. cit.*

4) *Foreign Direct Investment Generation.* Market-friendly laws, including an implemented civil code, would encourage foreign direct investment. Full and viable production-sharing agreements for joint energy ventures would have immediate utility if they begin to meet the need for assured foreign investor return on investment. While passage of new production-sharing laws is necessary, their implementation with approval for opening some of the more profitable fields to joint ventures would be necessary to lead to the often-predicted double-digit, billion-dollar U.S. investment in Russian energy resources. Primakov has complained that U.S. and other foreign investors have favored other Central Eastern European countries in placing their investments. Russian Foreign Direct Investment (FDI) was one-tenth of per-capita financial flows to Hungary in 1997 and only 0.8 percent of Russian Gross Domestic Product (GDP). Increased FDI is critical to coping with the financial crisis. In addition to financial flows, FDI would provide advanced technology and managerial and a corporate governance culture of market economies to Russian enterprises. FDI is also a non-debt-creating source of current account finance. A steady flow of FDI is an important sign of confidence since the world's major credit rating agencies include it among their indicators of international creditworthiness: thus, a rising inflow of FDI can help to create a "virtuous circle" in which improved creditworthiness leads to more FDI.

### **Past Reform Shortfalls: Remediation Essential for the Current Crisis**

In spite of some success in stabilization, liberalization, and privatization in the 1992-1998 period, critical shortfalls in reform policy set the economy on a course toward financial crisis.<sup>7</sup> Past failures reduced effectiveness of reform efforts from 1992-1998:

by continued subsidization of unproductive security forces and bureaucracy;

by permitting wealth creation that was channeled abroad and for consumption of newly wealthy elite rather than into productive investment and tax revenues;

by privatization without restructuring that would have created competitive enterprises generating economic growth and state revenues;

and, by imprudent short-term financing by sales of government securities that inflated the debt-servicing burden in the budget and led to the default in August, 1998.

Addressing these past failures and reform shortfalls is critical in the implementation of the Primakov Action program for dealing with the current crisis.

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<sup>7</sup>Anders Aslund, "Social Problems and Policy in Postcommunist Russia," in Ethan B. Kapstein and Michael Mandelbaum, eds., *Sustaining the Transition: The Social Safety Net in Postcommunist Europe*, Council on Foreign Relations, New York: 1997, pp. 124-146; Anders Aslund and Mikhail Dmitriev, "Economic Reform: Reform versus Rent-Seeking," in *Russia After Communism*, Anders Aslund and Martha Olcott, eds., Washington, DC: Carnegie, Chapter four (forthcoming, 1999).

- *Retention and Expansion of Security Forces and Bureaucracy* operating under old inefficient rules of the game. The failure to downsize and restructure Russia's security forces and administrative bureaucracy puts a heavy burden on the state budget and has been an incentive to inefficiency and corruption.

The heritage and continued burden of the Soviet militarized system contributed to the current crisis. The precipitous decline and erratic financing of military forces led, by 1995, to an escalating crisis in the formerly preferred military forces and the military-industrial complex. In 1997 Yegor Gaidar, chairman of the budgetary advisory committee to the last government, noted:

The chief national threat for the country is not the expansion of NATO to the east, but its own unreformed, hungry and disgruntled army and the economy can no longer withstand the financial load of maintaining an overstaffed and amorphous army. It hurts that military reform is starting too late. Much time has been lost. Better late than never.<sup>8</sup>

Military reform is to date considered "crisis management rather than managed restructuring," according to the International Institute of Strategic Studies (IISS). In spite of Russia's large and burdensome budget, the IISS estimates the true level of military spending at about 27 percent of federal budget or 7 percent of gross domestic product when the cost of paramilitary forces, arms control and subsidies to military regions and industries are included.<sup>9</sup>

The central administrative civilian bureaucracy has doubled since 1991 to 1.2 million, operating within much the same ministerial system as the old regime, despite the fact that the Russian Federation has half the population of the former Soviet Union.<sup>10</sup> Regional administrations have also retained much of the old system's structure and operating procedures. The present state system is not only inefficient but is acknowledged to breed corruption. In Russia an estimated 30-40 percent of the senior enterprise manager's time is estimated to be spent in dealing with the state officials, whereas in market economies the time averages only 8-12 percent. By international comparisons, Russia's state administration ranks with Nigeria, Bolivia, and Colombia as most prone to corruption.<sup>11</sup>

A good deal of the promise of the earlier reform teams was that they had taken over many of the leadership positions in the central government ministries and institutions, e.g., finance, economics, energy, privatization and the central bank, with

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<sup>8</sup>Yegor Gaidar, *RIA Novosti*, May 23, 1997; Clifford G. Gaddy, *The Price of the Past, Russia's Struggle with the Legacy of a Militarized Economy*, Brookings Institution, 1996; Stuart Goldman, CRS Report 97-820, *Russian Conventional Armed Forces: On the Verge of Collapse?* 54 pages.

<sup>9</sup>*The Military Balance 1997/98*, International Institute of Strategic Studies, London, October 1997.

<sup>10</sup>John P. Hardt, *op. cit.*, CRS Report 97-977 E.

<sup>11</sup>Paolo Mauro, "The Effects of Corruption on Growth, Investment and Government Expenditure: A Cross Country Analysis," in Kimberly Ann Elliott, ed., *Corruption and the Global Economy*, Washington, DC: Institute for International Economics, 1997.

their own reform-minded staff in key positions. The chief economist of the World Bank argues that a new state in transition from command to market systems needs to do more than to change top managers; it needs to be characterized by public-private partnerships that ensure that contracts are enforced and that expansion of markets into such areas as education, health, and pensions are both equitable and efficient.<sup>12</sup>

- *Non-Productive Wealth Generation Limiting Productive Investment and Tax Revenue.* In 1992 over three-quarters of the Gross Domestic Product was channeled to wealth creation that did not contribute to investment or state revenue and instead weakened the value of the ruble and the balance of payments. Due to weakness in state regulation and politically controlled benefits, substantial fortunes were built up, e.g., by buying oil at very low domestic prices and selling at the world market price, by buying consumer goods including food at competitive foreign prices and selling at subsidized internal prices, and by obtaining “soft” bank loans for which repayment was not enforced. This exploitation diminished over successive years, but some such rent-seeking and monopoly profits continued up to the financial crisis.<sup>13</sup> The newly rich oligarchs channeled much of their wealth abroad, motivated by the classical reason for capital flight, fear of losing their assets. Capital flight has been estimated by an authoritative Canadian-Russian study to have been between \$125-\$140 billion in the years 1991-1997.<sup>14</sup> A Western banker estimates capital flight at \$20 billion in 1998 and projects \$17.1 billion for 1999 if trends continue.<sup>15</sup>
- *Privatization Without Restructuring of Enterprises.* In 1993 and early 1994 transfer of state assets by voucher privatization and in 1997 loans for shares at low cost to some politically influential rent seekers further reduced the effectiveness of reform by directing financial flows away from new capital assets for generating new output and shifting revenue away from the state budget. Those who benefitted from the wealth-generating opportunities of 1992 and others in politically advantageous positions were able to gain control of some of the most valuable industrial assets at low prices in the voucher privatization. The financial industrial groups, formed by those newly rich with ownership of key industries and banks, also gained control of key media sources--newspapers, TV and radio stations. When seeking reelection in 1997, President Yeltsin turned to them for financial and political support and offered shares in other key state enterprises as security for their financial support. Thus the “loans for shares” program extended the oligarchs’ control. Had

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<sup>12</sup> Joseph E. Stiglitz, *More Instruments and Broader Goals: Moving Toward a Post-Washington Consensus*, World Institute for Development Economic Research, Helsinki, January 1998.

<sup>13</sup> Anders Aslund, *Why Has Russia’s Economic Transformation Been So Arduous?* Paper prepared for the World Bank’s Annual Bank Conference on Development Economics, Washington, DC, April 28-30, 1999.

<sup>14</sup> Canadian-Russian Capital Flight Study, *op. cit.*

<sup>15</sup> Marrese, *op. cit.* Russian Central Bank Chairman Gerashchenko provided a \$40 billion figure for 1998 and a \$200 billion estimate for total capital flight.

privatization been undertaken through open auctions with foreign and domestic bidders, the state would have received much-needed cash, and the enterprises might have been restructured to make them competitive and profitable. This openness was the pattern followed in successful transitions and privatizations in Hungary and Poland.

The reform shortfall in voucher privatization and loans for shares programs was that Russian privatization did not lead to restructuring the capital assets and management of Russian enterprises. The new enterprise owners reinforced the power of the rent-seeking oligarchs, who benefitted from their influence on the state bureaucracy and access to the state budget. Restructuring the physical assets and management system of the enterprises in the most militarized economy in history has been a most formidable challenge not yet met by the reform program. Although some political gains may have accrued from reduction in state ownership, the privatization process that followed reinforced the rent-seeking rather than the profit-seeking criteria for success, and set back the monetization of the economy. The newly rich oligarchs were in a strong position to extract rents through political influence on the government and by operating outside the official economy. Many less politically powerful found that operating outside the official economy favored their survival. Over half of the transactions in Russia may have been in the barter or virtual economy rather than in the official economy.<sup>16</sup> The barter or virtual sector is a survival economy whose industrial enterprises do not contribute to economic growth and do not provide tax revenue to the state budget. Moreover, the banks privatized without state regulation do not perform their primary function of providing capital to restructured and new enterprises. Russian privatization, stabilization, and liberalization were necessary changes. They were not alone sufficient to ensure introduction of the profit motive and economic growth because the Russian economy lacked the necessary systemic infrastructure. Joseph E. Stiglitz, Chief Economist of the World Bank, aptly summarized the shortfalls in Russia's transition:

Russia achieved a huge increase in inequality, at the same time that it managed to shrink the economy, by up to a third according to some estimates. Living standards collapsed with GDP levels, as life spans became shorter and health worsened. All too late, it was recognized that without the right institutional infrastructure, the profit motive--combined with full capital market liberalization--could fail to provide incentives for wealth creation and could instead spark a drive to strip assets and ship wealth abroad.<sup>17</sup>

- *Imprudent Budget Deficit Management Burdening the State Budget and Leading to Default.* With the burden of rent-seeking subsidies on the state budget and slow growth in taxable income, expenditures and debt service continued to exceed state revenues. Taxable income was especially

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<sup>16</sup>EBRD, *Transition 1998*, *op. cit.*, p. 17. Clifford Gatty and Barry Ickes, *Foreign Affairs*, Fall 1998. The Russian statistical agency, Goskomstat, calculates the official economy to be as low as one-quarter of the official and unofficial economies combined.

<sup>17</sup>Joseph E. Stiglitz, "Development Based on Participation, A Strategy for Transforming Societies," *Transition*, newsletter of the World Bank and William Davidson Institute, December 1998, p. 2.

constrained by exemptions and offsets for politically powerful, profitable enterprises such as Gasprom, the world's largest gas company. Revenue from the sale of state assets in competitive auctions to foreign buyers failed to materialize to generate substantial income due to high risk perception in the global market. Flows from foreign direct investment fell far short of expectations. Capital flight increased to over \$20 billion a year and sizable profits were transferred abroad. The state temporized by sequestration or withholding of payments to workers, pensioners, military, and others not politically powerful. Loans from international agencies, intended for reform support, not budget balancing, brought much needed, but insufficient, financial inflows. In this constrained budget context a new major source for financing the budget deficit was found in the emerging markets for ruble-denominated treasury bills (GKO's) and bonds (OFZ's). The ruble had been stable and appreciating in 1996 and Russian international credit ratings reached investment-risk level in 1997-1998. Even though the GKO's had to be sold at high interest and short maturity, their sales became a major short-term means of balancing the budget. As a result, by 1998 servicing the debt had risen to about forty percent of the budget.<sup>18</sup> With the August 17 collapse of the ruble and *de facto* default, the GKO market collapse put Russia in a solvency trap: the Russian government could not sell more securities to service the debt it had increased to manage its budget deficit. GKO's thus emulated junk bonds of the United States with a similar requirement for resolving the solvency trap, including restructuring and recapitalizing its failing commercial banks with many seeking the protection of bankruptcy.

## Post-Crisis Scenarios and U.S. Policy Options

The policy options for the United States in relations with Russia would be significantly different depending on the development of either the vicious cycle or managed economy scenarios. The degree of effective engagement, the likelihood of influence on Russian developments beneficial to U.S. interests and the implications for future Russian developments would all be markedly different, depending on the course of Russian economic development prior to the parliamentary election in December, 1999 and the presidential election set for June, 2000. The election outcomes would likely be influenced by the alternative scenarios and, in turn, affect U.S. options in responding to the outcomes of parliamentary and presidential elections.

In an environment of failed governance some suggest that the Russian reformers might come back and reform might be renewed. This "worst is better" thinking is associated with the prospects of a Bulgarian or Argentine currency-board<sup>19</sup> model in

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<sup>18</sup>EBRD, *Transition 1998*, p. 17. Keith Bush, *Russian Economy in December 1998*. Center for Strategic and International Studies (CSIS), Washington, DC.

<sup>19</sup>Economists in the pre-crisis governments, such as Anatoly Chubais, reportedly favor the Bulgarian currency board. Anders Asland, Carnegie Foundation Report, September 1998. George Soros's *Financial Times* op. ed., August 15, 1998, prior to crisis favored a currency

(continued...)

which anti-reformers are discredited and true reformers make a political comeback with an austerity program featuring a foreign-controlled currency board. The Primakov government might be replaced before the December, 1999 parliamentary elections, but introduction of the Bulgarian-Argentine model seems less likely than the Belarus model in the successor government, because Belarus has an authoritarian, reactionary government that controls the populace by use of intimidation and force. Belarus might be the likely governance model of a vicious-cycle scenario. Under the vicious cycle, the United States' options for assisting Russia would be restricted; U.S. presence and engagement would likely be sharply cut back. Humanitarian aid in food and medicine may be even more needed and appropriate. Some cooperative security programs may continue as still deemed in mutual security interest.<sup>20</sup>

If the United States is to continue to be engaged with Russia, it may be because Primakov is able and willing to support reasonable efforts to manage its exit from financial crisis through performance on the agreed Action Programs. The strength of the Action Program and related negotiations for their coming to grips with the crisis may lie in its service to the basic interests of both the current Russian government and the donors and investors. Giving priority to an institutional restructuring strategy promises improved prospects for economic growth, improved economic security and closer ties with the global market. This strategy of the Action Program might encourage profit-seeking over rent-seeking, thus pressuring the rent-seeking, monopolistic oligarchs to shift the Russian economy toward a growth-promoting strategy.<sup>21</sup> The success of a strategy involving a cultural change in the Russian system is of interest to the United States and other donors. The predictability of the reform scenario is contingent on a basic change in the incentive character of the Russian system; a change in the way the elite is judged. Any benefit from reform is difficult to project as many potential supporters of change would seem to be acting against their interests.

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<sup>19</sup>(...continued)

board. Hanson, *op. cit.*; Steve H. Hanke and Kurt Schuler, "Keynes's Russian Currency Board," in S.H. Hanke and A.A. Walters, eds., *Capital Markets and Development*, San Francisco: Institute for Contemporary Studies Press, 1991; Steve H. Hanke and Kurt Schuler, *Currency Boards for Developing Countries*, San Francisco: International Center for Economic Growth, 1994.

<sup>20</sup>Russia and the U.S. are cooperating on issues of nuclear weapons and security. From 1991 through September 1997, the United States obligated \$857.2 million in Cooperative Threat Reduction program (or "Nunn-Lugar") funds in order to help Russia dismantle nuclear weapons and ensure the security of its nuclear weapons and weapons-grade nuclear material. During the September 1998 summit, both countries agreed to share information when either detects a ballistic missile launch anywhere in the world, and to reduce each country's stockpile of weapons-grade plutonium by fifty metric tons. President Clinton's State of the Union address (January 1999) included a proposal to increase U.S. funding for safeguarding nuclear weapons in Russia and the NIS by 68% over five years, from \$2.5 billion to \$4.2 billion. The Administration has proposed establishing a U.S.-Russian center to jointly monitor ballistic early warning systems during December 1999-January 2000, to address concerns about Y2K computer failures and strategic stability. (See CRS Report 98-299, *Russian Missile Technology and Nuclear Reactor Transfers to Iran*, December 14, 1998.)

<sup>21</sup>Anders Aslund, *op. cit.*

There are specific and general aspects of the financial, security programs, and humanitarian aid that merit particular attention and surveillance by the United States under an economic management scenario:

1) *Management of Debt Servicing.* The precedent of restructuring the post-World-War-II German and post-Communist Polish debt has been cited by Russians and Poles.<sup>22</sup> In each case the United States persuaded European sovereign and commercial debtors to accept substantial reductions in their claims through Paris and London clubs negotiations. Innovative debt restructuring approaches such as debt to equity and debt to nature may likewise again be explored. Debt to equity would involve transfer of ownership of industrial enterprises or mines to foreign creditors. Debt to nature would involve conversion of debt by the Russian government funding environmental programs in lieu of debt payment. Specific measures linking current debt settlements to improved climate for foreign direct investment and provisions for gaining transparency and repatriation of flight capital may also be in order.<sup>23</sup>

2) *Bank Restructuring Process.* Reconstructing the *de facto* bankrupt commercial banks might be keyed to making them reliable intermediaries for savings to investment in new capital stock. Primakov's proposal for foreign banks, including United States banks, to operate in Russia may be pursued if the preconditions for effective operation of American banks in Russia are fulfilled. Russian banking would be greatly improved by adding foreign-owned or joint venture banks to the Russian banking system. Hungarian experience with Citibank and other American banks could be instructive.

3) *Budget Balancing.* An improved budget for 1999 and adoption of critical aspects of the draft tax code by the Duma are necessary but not alone sufficient to proceed toward budget balancing. To effectively reduce redundant expenditures, all rent-seeking activities need to be addressed including military, administrative, as well as fiscal and monetary reforms. Without improved debt management and radical bank restructuring, the debt service burden on the budget might not be reduced sufficiently. Revenue from auctions of state assets may also add to state revenue if proper restructuring of assets for sale and necessary conditions for effective foreign management participation and transfer of corporate management are addressed. American participation in bankruptcy proceedings, especially akin to implementation of the Russian version of Chapter 11 of U.S. bankruptcy code, would be relevant.<sup>24</sup>

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<sup>22</sup>For U.S. role in Polish debt settlement see "The Congressional Role in United States Assistance Policy in Central-East European Economies in Transition," William E. Schuerch, *East-Central European Economies in Transition*, Joint Economic Committee, November 1994, pp. 343-344; cf. Patricia Wertman, *Rescheduling Russia's Debt: A Breakthrough?* CRS Report 96-506 E.

<sup>23</sup>Removal of the Russian-Cypriot double taxation agreement allowing 5,000 Russian offshore companies operating in Cyprus to transfer profits and avoid Russian taxes would be a good first step. Marrese, *op. cit.*

<sup>24</sup>Roswell B. Perkins, "Managing Out of the Financial Crisis: The Potential of Business (continued...)"

4) *Foreign Direct Investment Generation.* The legal and institutional environment for attracting foreign direct investment is a critical factor in coping with the financial crisis. FDI in turn may start its own virtuous cycle encouraging export-driven growth. Key engines for the development may be in the energy field: Russian participation in the Caspian Sea output and pipeline development; Gasprom alliance with Ruhrgas and American investors in further opening the European gas market to Russia.<sup>25</sup> Opening oil fields with good profit prospects for U.S. energy companies with new production-sharing laws might break the log jam in U.S. energy investment. Most-favored-nation trade status was extended in 1992, and permanent waiver of the Jackson-Vanik General System of Preferences (GSP) status was granted in 1993. A double taxation treaty entered into force in 1994, and a bilateral investment treaty in 1996, but tax and investment issues continue to vex bilateral commercial relations in 1999. The Export-Import Bank has approved over \$2 billion in loans for U.S. capital equipment exports under an Oil and Gas Framework Agreement. The Joint Commission for Economic and Technological Cooperation (headed by the U.S. Vice President and the Russian Prime Minister) is working to increase cooperation in science and technology, business development, space, energy policy, environmental protection, health, defense diversification and agriculture. The ninth meeting to have been chaired by Vice President Gore and Prime Minister Primakov, initially scheduled for March 23-25, 1999 in Washington, DC, is projected to be rescheduled.<sup>26</sup>

5) *Nuclear and Conventional Weaponry Downscaling.* The Nunn-Lugar funding for encouraging dismantling of nuclear weapons and sale of enriched uranium may enhance mutual security and benefit the Russian budget. (See CRS Report 97-1027 F.) Related security issues such as arms sales and transfer of military technology to China, India, and other states may be important to reducing a Russian balance of payment deficit but are unsettling to peace and stability in the U.S. view. Efforts of the Primakov government to bring these activities more under central control may be helpful if the peace-disturbing exports can be diminished or eliminated. The interrelationship of Russian security policy toward Iran and the multinational development of the Caspian Sea energy resources are issues of economic and security tangency that may continue to spark disputes both bilaterally and between the United States government and American business interests (see CRS Report 98-299, *op. cit.*).

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<sup>24</sup>(...continued)

Workouts in Russia," *Russia Business Watch*, Winter 1998-99, *op. cit.*

<sup>25</sup>David M. Woodruff, "It's Value That's Virtual: Bartles, Rubles and the Place of Gazprom in the Russian Economy," *Working Paper 11*, January 1999, Program on New Approaches to Russian Security, Davis Center Harvard, Cambridge, MA.

<sup>26</sup>See *Commercial Issue Briefs*, a private-sector guide to key issues affecting the business climate in Russia, prepared for the scheduled Gore-Primakov Commission meeting March 24-25, 1999 by the American Chamber of Commerce in Russia and the U.S.-Russian Business Council and presented to the U.S.-Russia Trade and Investment Forecast Conference held in Washington, DC at that time.

6) *Humanitarian Aid: Food.* Regional food shortages have been exacerbated by one of the poorest Russian harvests in years. U.S.-Russian governments agreed on a large food aid program of 1.5 million metric tons of wheat and 100,000 metric tons of other food under a grant; an additional 1.5 million metric tons of various grains were to be sold under a long-term, low-interest loan. The issue of central government control, effectiveness and responsibility was raised in American discussion by those concerned that the food would not go to the truly needy and this concern may influence decisions in Congress to increase assistance. Purported Russian food aid to Iraq and Serbia also cloud the aid programs. Some Russians argued the food need is exaggerated and the large U.S. agricultural surpluses had dictated the agreements (see CRS Issue Brief 92089, *Russia*, updated March 5, 1999).

## Broader U.S.-led Conditionality

Negotiations and conditionality currently undertaken by the International Monetary Fund appear to have been broadened to include concrete measures that may be responded to by the World Bank, European Bank for Reconstruction and Development (EBRD) and other bilateral and multilateral organizations in the G-7. The debate led by Joseph Stiglitz and Nicholas Stern on the need to forge a new transition strategy, a post-Washington consensus, focusing on building institutional infrastructures and emphasizing enterprise efficiency has apparently resulted in a broader U.S.-led reform assistance strategy and conditionality for Russia.

U.S. policy makers after August 1998 had seemed pessimistic in the short run but continued to have long-run optimism for democratic market reform in Russia. Deputy Secretary of State Talbott characterized the present crisis as a current Russian time of troubles (using the Russian terms *smutnye vremya*) in recent speeches; reference was also made to times of miracles (*chudyesnye vremya*) that may come in the new millennium.<sup>27</sup> However, by late Fall 1998, the U.S. and IMF policy began to stress continued U.S. commitment to an engagement policy with specific attention to “concrete measures” prepared to respond to short-term results in the months ahead.<sup>28</sup>

The broader conditionality in current negotiations on the Russian program may be appropriate not only because of the range of issues beyond the mission of specific international financial institutions, but also for the broader implications for change in Russia and in our bilateral relations. Moreover, the success of the reform policy seems increasingly tied to the broader issue of how Russia defines its identity and future. A change involving its incentive system and the institutional framework of Russian governance may be deemed necessary and required. Secretary Talbott, by framing the current financial crisis as a part of the identity crisis for Russia--a new time of troubles--suggests that necessary economic reform may affect not only Russian governance but Russian culture. For a favorable outcome Russia may need

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<sup>27</sup>Secretary Strobe Talbott, speech at Stanford University, September 17, 1998. John P. Hardt, Commentary on the IMF led Russian Assistance Program, Heritage Foundation, July 23, 1998 at a panel featuring Stanley Fischer and Alexei Mozhin of the IMF.

<sup>28</sup>IMF-Russian communique, *op. cit.* Laurence Summers, *op. cit.*

to address its broader cultural crisis in resolving its financial crisis in the short run-- then proceed, as other countries have, toward a democratic market system under a rule of law. This aspect of change makes adopting necessary changes seem to be a miracle, or as the Germans noted, a *wirtschaftswunder*. As Machiavelli earlier noted in the Renaissance period, this kind of radical change may be most difficult but crucial.

And it ought to be remembered that there is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things. Because the innovator has for enemies all those who have done well under the old conditions, and lukewarm defenders in those who may do well under the new. This coolness arises partly from fear of the opponents, who have the laws on their side, and partly from the incredulity of men, who do not readily believe in new things until they have had a long experience of them.

Thus it happens that whenever those who are hostile have the opportunity to attack they do it like partisans, whilst the others defend lukewarmly. . . .<sup>29</sup>

This broader political-cultural rationale for incrementally dealing with Russia's current crisis has been gaining more adherents among professional Russia watchers. While noting that the current government has survived the immediate crisis better in the short term than expected, some still view an incremental approach as too little, too late to hold sway with Russian voters later this year.<sup>30</sup> At the same time, others argue that furtherance at this time of the managed-economy reform plan, acceptable to foreign donors and investors, is necessary over a sustained period to decrease economic inefficiencies, revive economic growth, and enhance internal and international political support. What does appear clear is that Russia cannot continue to "muddle through" or just survive its economic crisis. Should he follow this path, Primakov risks losing both internal as well as international support. Primakov's dilemma may thus be that neither action nor inaction are riskless while continuing to push forward on his Action Plan.

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<sup>29</sup>Niccolo Machiavelli, *The Prince*, 1513.

<sup>30</sup>Michael Marrese, "Russia: Survival, Not Revival," *International Fixed Income Research*, Chase Securities Inc., London: April 16, 1999.