Russian question hangs over international markets

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How far are the effects of the Russian crisis going to spread? To other so-called 'emerging markets', to Latin America, into Europe or even to the United States? These are some of the issues hanging over international financial markets following Monday's dramatic rouble devaluation.

Barely one month after the International Monetary Fund organised a $22.6 billion Russian bailout, drawing on emergency funds, the entire operation has collapsed.

The crisis came to a head last week when trading on the Russian stock market was twice suspended, amid growing fears of debt default, devaluation of the rouble, banking collapses, or a combination of all three. Then on Monday morning Prime Minister Sergei Kiriyenko and the Russian Central Bank jointly announced a devaluation of the rouble, the suspension of trading in government bonds known as GKOs and a 90-day moratorium on the repayment of rouble-denominated foreign debt.

The figures on the debt and currency balances left the authorities with little choice. The short-term debt falling due by the end of the year is $20 billion, with $6.5 billion of this owed to foreigners. Foreign reserves total $17.5 billion, but in the past three weeks they have been running down at the rate of $1 billion a week.

The decision represented an abrupt reversal of President Boris Yeltsin's policy. As late as Friday he declared there would be no devaluation. Under the plan the rouble will decline from the official rate of 6.3 to the dollar to about 9.5 by the end of the year, a devaluation of some 30 percent.

The decision had immediate international ramifications. The German DAX stock market index fell more than 2 percent and the deutschemark slid against the US dollar. Germany is the major Western lender to Russia, with an exposure of about $30 billion.

The decision is expected to result in the collapse of a number of Russian banks within weeks. The crisis erupted last week with the news that Russian banks were in trouble and unable to repay debts to Western lenders and other Russian banks.

Many of the 1,600 banks operating in Russia have been buying up Russian government securities, which pay high interest rates, and then using these securities as collateral to borrow more money to purchase more securities. However, with the deepening crisis in Asia and falling oil prices, Russia has become an increasingly risky operation in the eyes of international lenders, and the value of securities has declined. Consequently lenders demanded that Russian banks begin to make some payments on their debts. But some of the banks did not have sufficient cash, and were forced to sell stocks, leading to the market plunge.

Last Thursday international financier George Soros wrote to the *Financial Times* in London warning of a collapse.

'The meltdown in Russian financial markets,' Soros stated, 'has reached terminal phase. Bankers and brokers who had borrowed against securities could not meet margin calls and forced selling swamped both the stock and bond markets.'

At the height of the financial storm, interest rates on government securities, GKOs, went over 200 percent, shares plunged, and banks refused to lend to each other for fear of a rouble devaluation or a default. In the words of one financial analyst, the market, to all intents and purposes had 'ceased to exist.'

In his letter Soros called for devaluation of the Russian currency by between 15 and 25 percent, with the provision of an additional $15 billion from the G-7 countries. In the absence of further aid from this quarter, the government had to carry out a bigger devaluation and impose a debt moratorium.

But there are considerable doubts as to whether the measures will bring even short-term stability. As the *Financial Times* warned in an editorial comment on Soros' proposals, devaluation would be 'extremely risky'. 'With markets as turbulent as Russia's,' it declared, 'there can be no such thing as a 'controlled' devaluation. Such a move would most likely spark a panic reaction, sending the rouble into a tailspin.'

Both major US credit rating agencies, Moody's Investor Services and Standard and Poors, have downgraded their ratings on Russian financial paper. Moody's cited 'concerns about the potential systemic effects of the financial crisis' while Standard and Poors said the liquidity problems were 'compounded by the banking crisis and the likelihood that further sharp declines in output and living standards will weaken domestic support for the Yeltsin administration's economic reform program.'

But what exactly is the program? Under the terms of agreement with the IMF, Yeltsin agreed to cut back spending and increase tax collections. As Soros pointed out in his letter, this could exacerbate the crisis.

'The trouble is that the action that is necessary to deal with a banking crisis is diametrically opposed to the action that has been agree with the International Monetary Fund to deal with the budget crisis. The IMF program imposes tight monetary and fiscal policy; the banking crisis requires the injection of liquidity. The two requirements cannot be reconciled without further international assistance.'

Similar criticisms were voiced following the devaluation, amid fears that IMF policies themselves were contributing to the crisis.

According to Allen Sinai, the global economist with the forecasting firm Pridmark Decision Economics, the IMF is 'part of the problem.' 'The IMF is calling for fiscal austerity and tight monetary policy. That's the wrong prescription for an economy which is in recession, or perhaps depression.'

IMF managing director Michel Camdessus literally confessed failure. He said the Russian government had been satisfactorily implementing measures in line with the IMF plan. 'Despite this, confidence in financial markets has not been re-established and a result Russia has continued to lose reserves and asset prices have fallen sharply,' he said.

However, despite its obvious failure, Camdessus insisted the Russian government had to continue with the IMF plan. It was 'especially important' for Russian authorities to take all necessary measures to strengthen the fiscal position. 'Prompt passage' of the necessary measures in the forthcoming session of the Duma would 'be essential to this end.'

The IMF is demanding that the Russian government step up tax collections. That prescription may be all very well on paper, but in the face of a worsening global economic environment, implementing it is another question.

Since the start of the year Russian government finances have come under increasing strain because of the failure to raise sufficient tax revenues, a consequence, among other things, of falling world commodity prices, particularly oil.

Since the onset of the Asian crisis oil prices have fallen in real terms to below their levels prior to the OPEC price increases of 1973. And oil is not the only commodity in decline. According to the Commodity Research Bureau index, world commodity prices are at their lowest levels for five years. Since the Asian crisis began a year ago, the CRB index has dropped more than 20 percent. Market analysts are becoming increasingly fearful that the decline is not so much the result of a change in the immediate economic weather--a downturn in the business cycle--but flows from a deflationary shift in the international economic climate.

Falling commodity prices and declining profits are not the only problem for the collection of tax revenues in Russia. There is the more general problem of the economic devastation produced by the imposition of the so-called 'market economy' following the collapse of the Soviet Union.

Russia's economic output has fallen since the beginning of the 1990s, except for last year when official figures showed a marginal increase.

Whole areas of the economy have been thrown back to a barter-like existence. This was graphically portrayed on a recent BBC television report on a farm machinery factory exporting equipment to Bulgaria. Instead of receiving money, the company was paid in jars of pickled gherkins, which were then distributed to workers in place of wages. As the incredulous reporter was forced to comment: How is it possible to levy taxes on this?

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