Russia Financial Crisis of 1998

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Since the Great Depression to the recent economic recession that started in the United States of America, countries across the globe have had a share of unique economic and financial crisis. Selim (n.d) observes that in recent years financial crisis has plagued countries in such as Mexico in 1994, Korea, Thailand, Indonesia and Malaysia in 1997, Russia in 1998, Brazil in 1999, Turkey in 2000 and Argentina in 2001. For instance, On 17 August 1998, Russia was hit by a financial crisis that left its economic and financial system in ruins. According to Gerry & Li (2002, p2), the financial crisis in Russia started on 17th August 1997, the Russian government partially defaulted on its domestic, as a result, this sent shivers across the economic and financial system in Russia, with devastating economic and financial outcomes. Gerry and Li (2002, p.2) continue to observe that this led to the exchange rate to plummet by 300%, inflation to soar by 70%, the unemployment rate reached 13.7, real wages dropped by 30% and the economy shrank by 5% in that year. This economic turmoil ended two years of robust economic growth that Russia had enjoyed since 1995. The year 1997 was a year that the future of Russians looked bleak and economic fortunes uncertain. According to Gerry & Li (2002, p20), Russians living in urban areas were worst hit by the financial crisis that lasted for a short. This essay seeks to analyse critically the causes and consequences of the financial crisis that rocked Russia in 1998, and although it was short lived it left a trail of economic ruins in its wake, marking one of the worst financial crisis to have hit Russia post the fall of the United Soviet Socialist Republic.

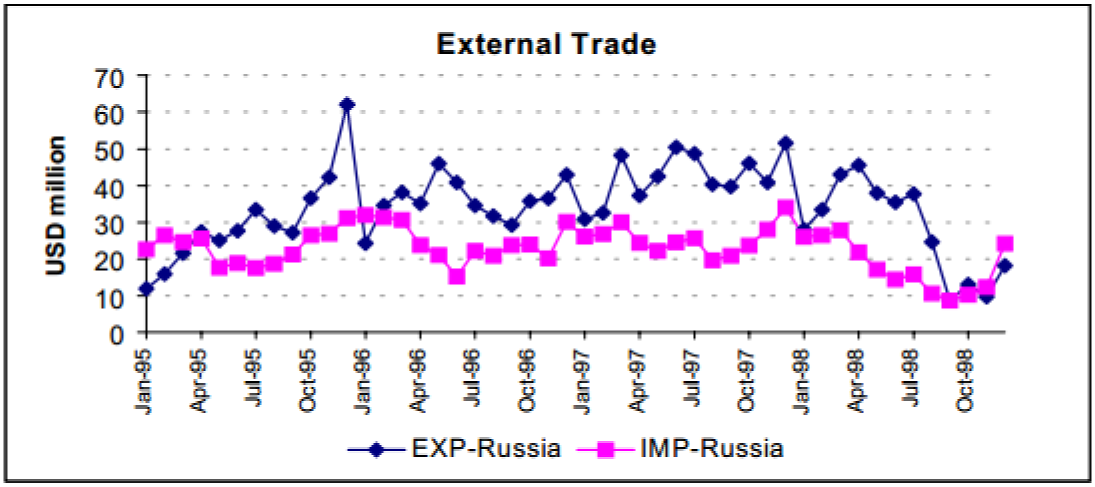
Causes of Russian Crisis of 1998

Kraussl (2003) argues that globalisation and uncontrolled speculation in the financial markets are the major reasons for the financial crisis that have rocked global economies, particularly developing economies. Increased speed and size of capital flows into international financial systems due to globalisation has caused devastating effects to economies, one argument purports.

One major characteristic of the recent financial crises that have rocked different countries is that, financial crises in different economies were caused by different reasons. Gerry & Li (2002, p2) point out that a specific financial crisis starts as a result of specific market failure in a given sector of the economy, the crisis then spreads to neighbouring countries through spill-over effects and contagion. A case in point is the Asian Financial Crisis that started in Thailand in 1997 and spread to other countries in the South-East Asia region and then to Russia through contagion spill-over effects. An observation made by Bocutoglu and Celik (2000, p.2) who states that, though, there is little literal evidence on the linkage between the Asian Crisis and Russian Crisis, the Asian Crisis is partly to blame for the financial and economic woes that rocked the Russian economy in 1998. This is because the Asian Crisis reduced the prices of Russia exports that included traditional raw materials; the crisis also adversely affected foreign investor confidence in the Russian market. These together with other factors coupled to cripple aggregate demand in Russia in 1998, consequently bringing Russia's economy to a halt in 1998.

According to Mete (2004), the Russian Financial Crisis of 1998 was as a result of coupling of economic and political factors. Mete (2004) further observes that the Russian Government, from after the fall of USSR to the late 1997, successfully sold GKOs and OFZs, which were Ruble denominated debt instruments and coupon bonds. However, on 1998, the Russian government started experiencing problems selling the Ruble denominated debt instruments due to declining commodity prices, domestic political developments and global economic events. The Russian Government converted the Ruble denominated debt instruments into US dollar denominated Eurobonds to mitigate risks. However, the government continued with its heavy borrowing, which raised concerns of its default exposure as foreign investors cut their exposure to Russia's debt, equity and commodity market due to falling investor confidence. Mete (2004) observes that during the time of heavy borrowing Russia's economy was pegged on the external developments and the wellbeing of the global economy due to over-reliance on capital flow from exports of raw materials. The dependence on the health of global economies made the Russian economy vulnerable to external shocks. Therefore, the Russian Financial Crisis is traced to external shocks that hit the country in 1997 and 1998. The shocks are the Asian Financial Crisis and a sharp decline in demand and price for traditional raw materials, which led to shrinkage of Russia's foreign exchange reserve. A view supported by Selim (n.d) who states that one of the causes of the Russian Financial Crisis in 1998 was a decline in commodity prices of crude oil and metals. Export of crude oil accounted for 50% of Russia exports, at that time, and representing 10% of global oil output. Hence, the Russian economy and foreign exchange reserve were propped by capital inflows from the export of raw materials and crude oil, so a decline in demand and prices of the exports had adverse effects on the fragile economy of Russia. The Economic Intelligence Unit (1998) notes that in the year 1998 the price of Russian barrel of oil declined from $22.85 per barrel on January 1997 to $11.20 per barrel, pushing causing the Russian current account to drop from a surplus of $3.9billion in 1997 to a deficit of $4.5 bullion in 1998. Consequently, a decline in capital flows due to a fall in demand and value of traditional raw materials, which were the main source of export for the county led to an adverse economic environment characterised by a fall in GDP per capita, increased unemployment rates and capital flight as investors liquidated the assets they held in Russia to avoid losses.

Figure 1. Comparison of exports and imports before 1998 and during the year of the financial crisis, 1998



Source. Radziwill, Scerbarchi and Zaman (1999).

During the 1990s, particularly in the year 1995, the Russian Government heavily borrowed to finance its development and recurrent expenditures, with most of the borrowing being through public debts such as GKOs, coupon bonds and treasury bills, which had an average maturity term of 11 months. The government was forced to offer its debt instruments at high interest rates to attract maximum uptake by investors, a situation that led the government to offer yields of 150% on GKO. Hiking of yields had two effects on Russia's economy, increasing levels of debt and escalating debt servicing expenditure. The Economic Intelligence Unit (1998) reports that in 1998, 30% of Russia's expenditure went to debt servicing because most of the debt was short term and constantly falling due. Gurvich (2001) reckons, therefore, that ballooning debt was a cause of Russian Financial Crisis of 1998 and was precipitated by the Asian Financial Crisis. Selim (n.d)   observes that in 1998 Russia had an outstanding debt of $180 billion of which a quarter were to mature at the end of 1999. The government was faced with a crisis because the debt levels by 1998 were roof high and payments were irregular, forcing the Russian government to default on $40billion in short term domestic treasury bills and bonds and to issue a moratorium on commercial external debt payment. Gurvich (2001) observes that analysts state that the debt crisis led to a currency crisis; however, the observation by these analysts is disputable because Russia's Central Bank in 1997 pursued a tight monetary policy aimed at curbing currency crisis.

Selim (n.d) argues that Russian Financial Crisis of 1998 was caused by a fall in the value of the Ruble, the depletion of foreign reserves and a weak Russian banking system. The Russian government through the Central Bank intervened in the foreign exchange market through pegging the Russian Ruble to the US dollar within a narrow band of a floor of 5.3 to a cap of 7.1 Russian Ruble to the US dollar. The Russian government would therefore spend its foreign reserves by buying Rubles in the market to prop the currency in case it breached the cap limit and would sell Ruble to the market if currency threatened to go below the floor limit. However, Kagarlitsky (1998) reports that the Russian Government abandoned the pegging system to let the Ruble float. This led to devaluation of the Ruble, which plummeted from 6 Russian Rubles per US dollar to 20-25 Russian Ruble per US dollar. Consequently, there was panic in the market, depletion of foreign reserves to one-month cover and increase by over 200% on yield on Ruble denominated debt instruments. According Selim (n.d) , the Russian Government reacted by declaring an intent to default on Ruble denominated debt and a moratorium on private foreign debt.

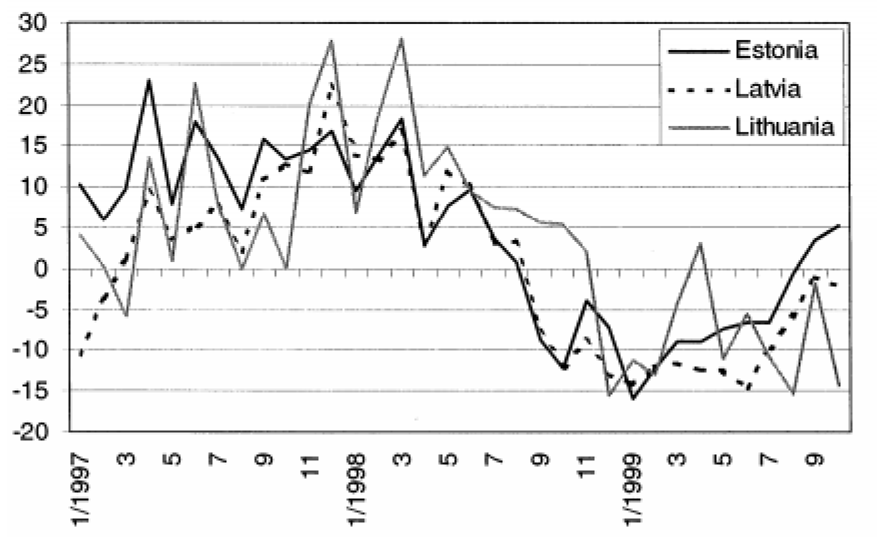
Consequences of the Russian Financial Crisis of 1998

The aftermath of the Russian Financial Crisis of 1998 had adverse effects on the domestic economy and the regional economies due to the spill over effects. Bocutoglu and Celik (2000), for example, state that the Russian Economic Crisis of 1998 had profound effects on the economies of Turkey, Moldova, Ukraine, Kazakhstan, Baltic States and Belarus as a result of the spillover effects. In Russia, inflation rose to double digit figures as the cost of imports, particularly consumer goods shot up due to a weak Russian Ruble. On the other hand, a weak Russian Ruble increased competitiveness of some export goods from Russia. Devaluation of the Russian Ruble caused investor panic, with most investors panic selling their Russian assets including currency, stocks and commodities, fearing further devaluation and an erosion of their asset values. According to Margolin (2000), valuations of equities in the stock market plummeted by about 90% in 1998. Selim (n.d) observes that in 1998 the Russian banking sector was near collapse with the aggregate capital of the banking system falling to negative levels and payment system being brought to the knees, which was fuelled by speculative trading of the Russian Ruble in 1998. Selim (n.d) opines that pre and during the crisis, Russian banks engaged in gambling on the Russian Ruble, they sold multi-billion worth of foreign exchange forward contracts speculating that Russian Ruble would not be devalued with government debt instruments acting as collateral.

Following the devaluation of the Russian Ruble, Russian banks were hit with devaluations on both assets and liabilities sides of their books. The foreign exchange forward contracts fell due increasing the value of liabilities, on one hand, and government debt instruments such as treasury bills and bonds, which acted as assets being reduced to worthless assets following default by the Russian Government. Consequently, most banks closed with most Russians loosing their savings. In addition to economic repercussion, the Russian Financial Crisis resulted in political fallouts, demonstrations and workers' strikes who were demanding for their pay. According to

Margolin (2000), in 1998, the Russian economy as measured by real GDP shrank by 4.6%, unemployment rate escalated sharply to 12% and inflation rose by 84.4%, all macro-economic indicators were depressed, consequently spreading to regional economies. According to Korhonen and Taro (1999, p183) the Russian Financial crisis worst hit the Baltic countries, particularly Estonia, Latvinia and Lithuania. The three countries sank into recession, a situation least expected. In the first quarter of 1999, Estonia's economy shrank by 5.6% due to reduced exports to Russia. The unemployment rate was not spared as it rose to hit 10% by 1999 from a modest figure of less than 5% in 1997. Similar to Estonian economy, the industrial output of Latvia shrank in the first eight months but 10.7% and the unemployment rate increased to 9.1%. Lithuania was the worst hit economy of the Baltic states of the Russian Financial Crisis, with GDP shrinking at an average rate of 5% in the three quarters of 1999.

Figure 2. Effect of Russian Financial Crisis of 1998 on industrial production in Baltic States



Source: Korhonen and Taro (1999).

Conclusion

Asian Financial Crisis took place in 1997, resulting in spillover effects in other countries such as Russia. The crisis subdued demand and prices of Russia's most valued exports, non-ferrous metals and crude. This resulted in the country running into deficits; as a result, the government opted to borrow from the public. However, due to a soft fiscal policy, weak economic fundamentals and external shocks, the Russian economy ran amok under huge debt and devalued currency, and as a result ushered an economic crisis. This resulted in loss of investor confidence to the Russian markets, increased unemployment levels, spiking inflation and a shrinking economy. The Russian Financial Crisis of 1998 was as a result of weak economic fundamentals, blunt fiscal and monetary policies and vulnerability to external shocks.

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