CHAPTER 8

1998: YEARS OF BAD ADVICE CULMINATE IN RUSSIA'S TOTAL ECONOMIC COLLAPSE

AP Photo/Misha Japaridze

SEARCHING FOR FOOD: Following the complete collapse of the Russian economy in 1998, the number of people living below the official poverty line—in Russia, a measure of truly desperate conditions—rose to nearly 40%. Seniors in urban areas—with no access to jobs or land—were the hardest hit. Unlike those in rural areas, who could subsist on homegrown food, they had nowhere to turn. As in Soviet times, Russians were waiting in lines, hunting for scarce goods, and hoarding what they could find. The devastation of Russian life was by all measurements worse than America's Crash of 1929. U.S. unemployment at the end of 1929 reached 1.5 million, representing 1.2% of the total population, but more than 11.3 million Russians were jobless at the end of 1998—7.7% of the nation's total population. In the 1929 crash, stock prices fell 17% by year-end—and 90% by the depth of the Great Depression, four years later. By contrast, the Russian stock market lost 90% of its value in 1998 alone. Millions of ordinary men and women who had deposited their money in Russian banks lost everything. Here, an elderly Russian woman takes fruit from a trash bin in Moscow, August 28, 1998.

I try, but they are hungry all the time.

Potatoes, potatoes, most of all they eat potatoes. It is potatoes all the time. I am just trying to feed them.

Tatyana Shurmanova, a mother of six children in Kungur, Russia, as quoted in *Newsday*, April 4, 1999

On March 23, 1998, five months before the Russian government's default on its international and domestic debts led to the nation's complete economic collapse, Viktor Chernomyrdin was fired as Prime Minister. The allegations of corruption against him had only reinforced the public impression that the policy of a handful of powerful Russian officials was not the construction of a free enterprise system, but rather the subversion of the public good through crony capitalism.

The unexpected firing of Chernomyrdin, Vice President Gore's partner in the highly visible Gore-Chernomyrdin Commission, unnerved Clinton administration officials. They were just as unprepared for the appointment of the little-known Sergei Kirienko to replace Chernomyrdin. Lawrence Summers, then Deputy Secretary of the Treasury, had inauspiciously dubbed the outgoing Prime Minister's deputies, Boris Nemtsov and Anatoly Chubais, "the Dream Team."[1] Summers' characterization epitomized the wishful thinking of the administration, and its willful blindness to the worsening reality in Russia.

As late as the summer of 1998, the Clinton administration still failed to grasp the fundamental error of its policy of funneling enormous amounts of money into a corrupt central government. Despite widespread rumors that Kirienko, too, would soon be fired, the administration proposed nothing more than pouring still more loans from the International Monetary Fund (IMF) into Russia's central government. Vice President Gore, Treasury Secretary Robert Rubin, and Summers set to work on an additional $18 billion U.S. commitment to the IMF chiefly intended to support new lending to Russia.

"We have a significant opportunity to use the leverage of IMF financing to help the Russian government," Rubin wrote to then-House Speaker Newt Gingrich on July 28, 1998. "The basics are all in the right direction," Stanley Fischer, the IMF's Deputy Managing Director, said the same day.[2] The administration successfully forced the $18 billion through Congress.

The reality of the situation, however, was that the Russian economy had already begun to collapse. The stock market was plunging. The day before Rubin's letter to the Speaker of the House and the IMF's blindly upbeat assessment, the market had suffered a 9% drop. "It's looking ugly," said one Western economist on July 27. Said another Western investment strategist: "We're sitting and watching this in shock and horror."[3]

Over the next two weeks, the deterioration continued. Finally, on August 17—one month after the latest bailout—the roof caved in.

The Russian government announced that it would no longer be able to pay its official debts. The ruble was devalued at the same time. The default, coupled with the devaluation of the ruble after years of promises that this would not occur, led to Russia's total economic collapse—a cataclysm by all measurements worse than America's Crash of 1929.

The end of Soviet Communism had afforded the United States its greatest foreign policy opportunity since the Allied victory in World War II. Barely six years later Russia's economy lay in ruins—an opportunity lost.

The Crash of 1998

The disaster that began on August 17, 1998, spread immediately throughout Russia. In just 24 hours, some retailers raised prices by more than 30%.[4] The free-falling ruble forced shopkeepers to raise prices daily, even hourly. "People are in a state of

AP Photo/Maxim Marmur

RUN ON CASH: A security officer tries to prevent a photographer from taking pictures as a man withdraws cash from an automatic teller machine in Moscow on Friday, Aug. 14, 1998. Customers said the bank only allowed them to withdraw money in rubles, even from accounts established in U.S. dollars. Individual deposits in Russia—which before August 17 had totaled some $27 billion—fell in value to less than $12 billion. Shortly afterward, virtually all ATMs in Russia ceased to function.

shock," one Russian woman told the *New York Times*.[5] Prices in the first week of September alone rose by 36%.[6]

Millions of ordinary men and women who had deposited their money in Russian banks lost everything. Savings accounts throughout the country were frozen.[7] ATM and debit cards ceased to work.[8] Dozens of banks became insolvent and disappeared. Angry depositors besieged Russian banks, only to learn they had been wiped out. Within days, individual deposits in Russia—which before August 17 had totaled some $27 billion—fell in value to less than $12 billion.[9]

Still more millions of senior citizens, whose meager pension income had been delayed for months, were cut off completely. Pensioners who kept some money at home rather than in banks found their purchasing power greatly diminished as the value of the ruble plummeted.

At the end of 1929, following America's disastrous stock market crash, unemployment in the United States reached 1.5 million, representing 1.2% of the total population.[10] But the 1998 collapse of the Russian economy was far worse. Over 11.3 million Russians were jobless at the end of 1998—7.7% of the nation's total population.[11]

Those who kept their jobs frequently found their wages suspended.[12] When wage payments were finally made, the average Russian saw his or her wages drop by two-thirds, from $160 to $55 per month.[13] The number of people living below the official poverty line—in Russia, a measure of truly desperate conditions—rose to nearly 40%.[14] The standard of living for the average Russian, already low by international measures, plummeted by 30%.[15]

In urban areas, Russian families with children and seniors—with no access to jobs or land—were the hardest hit. Unlike those in rural areas, who could subsist on homegrown food, they had nowhere to turn. As in Soviet times, Russians were waiting in lines, hunting for scarce goods, and hoarding what they could find. Such staples as flour, butter, rice and sugar were purchased as soon as they appeared on shelves. Retailers found it difficult to restock inventories.[16]

The devastation of Russia's economy wreaked the kind of human misery that America experienced in the Great Depression. By 1932, the U.S. gross national product had been cut by almost one-third. But within just six months of the 1998 crash, Russia's economy, measured in dollars, had fallen by more than two-thirds. From $422 billion in 1997, Russia's gross domestic product fell to only $132 billion by the end of 1998.[17]

In the crash of 1929, stock prices fell 17% by year-end—and 90% by the depth of the Great Depression, four years later. By contrast, the Russian stock market lost 90% of its value in 1998 alone.[18]

Foreign investment in Russia plummeted by 60%. Amid a wave of panic among investors, foreign direct investment fell from $4 billion in 1997 to $1.7 billion in 1998.[19] "The financial markets are dead," said Sergei Markov, an analyst at the Institute of Political Studies. "And, most fundamentally, it is a crisis of the real economy—Russia doesn't work."[20]

By the first week of September, the ruble had lost 60% of its value.[21] When the dust finally settled in March 1999, the ruble—and with it, every Russian's life savings—had lost fully 75% of its value.

The most immediate and dramatic result of the Crash of 1998 was the virtual collapse of Russian banking. The government imposed a two-month freeze on withdrawals from the country's six largest private banks. With the ruble dropping precipitously in value every day, ordinary Russians were forced to watch in horror as the money in their bank accounts lost its value. The experience of 66-year-old Yevgeny Ushakov, who had spread his life savings of $4,000 among three different banks to diversify his risk, was illustrative. "I didn't think all three would fail," he said.[22]

With prices rising uncontrollably, retail stores were forced to close repeatedly throughout the day, just to figure out how much to charge.[23] Even those Russians who had become accustomed to the occasional Western product were forced to do without, as the price of imports soared beyond their reach.

The collapse of international trade not only curtailed the supply of foreign goods, but also created scarcities and high prices for Russian-made goods with foreign components. Foreign providers refused to let Russian firms buy on credit, because of fear of non-payment. Wary of the declining ruble, foreign suppliers also demanded payment in hard currency, which most importers did not have. Such indignities added to the growing anti-Western sentiment.

The lack of a reliable currency reduced much of Russia to a barter economy. Many citizens were paid with whatever goods were currently available, regardless of the goods' practical value. Teachers in Voronezh, for example, received cemetery headstones in lieu of cash payments.[24] A textile machinery plant in Kostroma tendered 6,000 pairs of socks to the local police in payment of its tax bill.[25]

Farmers were devastated by the 1998 economic collapse. Grain harvests fell 30% below 1997 levels. The sudden impact of the ruble devaluation was especially harmful because existing levels of farm production were already depressed, having fallen for years. In Kaluga, for example, local production had fallen by 22% in the four years prior to the crash.[26] Shortages of meat and cooking oil were so severe that humanitarian food aid from the West, which had not been necessary since the collapse of Communism, was resumed on an emergency basis.[27]

The fallout from the economic collapse greatly exacerbated many of the problems that plagued Russia. In addition to the unemployment, lost wages and pensions, and financial hardship, there has been an attendant social crisis.

AP Photo

DEJÁ VU: Irate and bewildered customers at the closed doors of the Bank of United States, in New York City, Dec. 11, 1930. After the collapse in Russia, banks hired guards who let customers in one at a time to determine the fate of their savings, much of which was wiped out in the August 1998 collapse.

Those who were sick or under a doctor's care were badly hurt by the crash. Russia's health care system, in poor shape even before August 1998, suffered a run on medicine that quickly reduced supplies in hospitals and pharmacies to Soviet-era levels. The collapse of the ruble's value, the widespread unemployment, and the freeze on savings, wages, and pensions left millions of patients unable to pay for medical services.[28]

Hospitals suffered from shortages like every other Russian business. Drugs, always in short supply, became even more difficult to come by—particularly those that had to be imported. Nurses and doctors were forced to ration drugs to patients. In Novosibirsk the main hospital was reduced to a five-day supply of food. The central hospital serving a community of 1.4 million citizens had no milk for patients, and drugs sufficient to handle only 20 cases of severe injury.[29]

The 1998 economic crisis also helped worsen Russia's demographic crisis. According to the Russian Statistics Agency, Russia's population has fallen every year since 1992.[30] Deaths outnumbered births by 784,000 in 1999, the year following the crash.[31] Russia's birth rate of 1.3 children per woman falls well below the 2.1 needed to maintain the current population. Over the next 16 years, if current trends continue, the Russian population will drop to between 130 and 138 million, compared to 146 million today. Murray

Feshbach, the leading Western expert on Russian demographics, projects a population of just 80 million by 2050 if Russia does not arrest its social problems.[32] The population decline is expected to continue because of lower standards of living and mounting divorce, which in turn contribute to Russia's depressed birthrate.

The economic hardship of raising a child is a significant factor in Russia's sky-high abortion rates: for every birth in Russia, there are now two abortions.[33] As women in poor health give birth to less healthy children, the rate of infant mortality, too, is expected to grow. The CIA estimates Russia's infant mortality rate at 23 deaths per 1,000 live births.[34]

Drug use and addiction in Russia have skyrocketed, fueled by growth in organized crime and widespread economic depression. More than 3 million Russians are habitual drug users, according to the Ministry of Interior.[35]

Alcoholism, a chronic problem in Russia, has grown worse as economic conditions have deteriorated: according to a January 2000 report, the number of deaths resulting from alcohol poisoning is 35,000 per year, compared to 300 a year in the United States.[36]

Russia's widespread joblessness, poverty, and drug use have led to an increase in crime, homelessness, unemployment, and school dropout rates.

The jump in drug use has also led to an increase in HIV infections. According to Russian and World Health Organization officials, drug addicts account for 90% of all HIV-infected people in Russia. The collapse of the Russian economy in 1998 coincided with a doubling of the number of people living with HIV: Russia's HIV population literally doubled between 1997 and 1999—the fastest growth rate in the world.[37] According to Russia's leading epidemiologist, Dr. Vadim Pokrovsky, 10% of Russia's population will have the HIV virus by 2005.[38] Tuberculosis, which has increased by 57% from 1994 to 1998, has reached near epidemic proportions in parts of the country.[39]

Causes of Russia's Economic Collapse

Russia received its first loan from the IMF in April 1992, for $1 billion. In 1993, the Russian government took out another loan, this time for $1.5 billion. A year later the IMF provided still another $1.5 billion. By December 31, 1995, the Russian central government had borrowed over $10 billion through the IMF. When on March 26, 1996, the IMF and Russian central government reached final agreement on a new loan of $10.2 billion—the second-largest loan ever made to any borrower by the IMF—many outside observers were dumbfounded.

In a single commitment, the IMF was preparing to flood the Kremlin with more money than it had disbursed in the more than four years since the end of the Soviet Union. The extension of such significant new credit was surprising because there was little in the way of basic free market reform legislation in place to justify it. There was still no market in banking services, no reliable protection for private property rights, no mortgage lending, and no honest system of commercial dispute resolution.

IMF Managing Director Michel Camdessus asserted that the enormous new lending was in furtherance of a program of "free market reforms," but in fact the commitment had a political aura. At a time when the Russian government was spending exorbitant amounts on the 14-month-old war in Chechnya and on extravagant election campaign promises, there were virtually no strings attached, no effective legal commitments as to how the proceeds should be spent, and no effective monitoring and accounting controls to track where the billions of dollars were going. Camdessus described it as a gesture of support for Russia: "We have a program, we have a country which needs support. It is our duty and moral obligation to support this country."[40]

Yeltsin was more forthright about the political nature of the IMF commitment. "We had to involve Clinton, Chirac, Kohl, and Major," he said.[41] In fact, Clinton had endorsed the loan a month before the details of the commitment were even agreed upon. Because of the heavy U.S. influence on the IMF, his endorsement left little doubt that the loans would be made. The United States is the only country in the world with veto power over IMF actions. Using this influence, the Clinton administration turned the IMF into an agent of U.S. policy in Russia.

From the administration's standpoint, the disbursal of the IMF moneys would help pave the way for Clinton's planned visit to Moscow in April of that year and shore up the team chosen by the administration to carry out Western aid policy.

On the merits, there was little economic justification for extending the IMF package in March 1996. The loans-for-shares ersatz "privatization" of major Russian industries into the hands of a few insiders was already notorious. The poor state of Russia's official budget and finances made it implausible to assume that the government would ever repay the latest IMF loan. Worst of all, the loan did not effectively stipulate economic conditionality: in the first year alone, the IMF granted three waivers for "nonobservance of performance criteria."[42] The Clinton administration's decision to extend yet another IMF loan was purely political.

Many in the West and in Russia argued against burdening Russia with more IMF debt. Boris Fyodorov, a former Russian Finance Minister, immediately criticized the decision. "This money corrupts the system," he said the day the deal was announced. "The moment you get a billion dollars, you delay the necessary reforms."[43]

The sheer size of the loan caused concern among many other observers.[44] Prior to March 1996, the largest amount of money given to Russia from the IMF was $6.8 billion in April 1995. The 1995 loan had been more than a six-fold increase from the first loan to Russia in 1992. With this 1996 loan, the Russian central government had borrowed close to $15 billion from the IMF alone. Moreover, the IMF's sister institution, the World Bank, had provided billions more in loans to the central government since 1992. A further $30 billion in direct bilateral assistance had been given to the Russian central government by Germany, the United States, and other countries.

Moreover, to the extent that the Clinton administration did hector for "reform," it repeatedly prescribed bad medicine.

During America's Great Depression, the infamous Smoot-Hawley tariff and President Hoover's 1932 income tax increases were widely credited with shrinking the U.S. economy in an attempt to increase tax revenues. Likewise, the Clinton administration saw the root of Russia's problems as the decline in government revenues—as if Russia's mistake had been failing to impose sufficient government levies on the struggling Russian economy.[45]

AP Photo/Oleg Nikishin

DESPERATE FOR MEDICINE: A pharmacy clerk looks for insulin on a shelf, while a Russian woman waits in Moscow, Dec. 11, 1998. Russia's 2.2 million diabetics rely on imported insulin, but imports dried up when the government devalued the ruble.

While Russia's revenue stream was indeed declining, it was declining due to the contraction of the economy itself. The Clinton administration's insistence on raising taxes was in part responsible for the worsening crisis, as Russia sought to squeeze more taxes from the economy.

In place of concrete steps to establish the building blocks of a free enterprise economy, the Clinton administration used the loans to attempt to induce Russia to reduce its budget deficit to stipulated targets: 4% of GDP in 1996, 3% in 1997, and 2% in 1998. These goals were never reached.[46] To the contrary, as the Russian government continued to borrow, the rising costs of debt service added to the strain on the budget.

In March 1997, when Nizhny Novgorod Governor Boris Nemtsov was appointed Deputy Prime Minister, then-Deputy Treasury Secretary Lawrence Summers dubbed the new Russian economic team of Nemtsov and Chubais the "Dream Team"—a typical example of the administration's tendency to support individuals rather than actual policies. The "dream," however, soon turned into a nightmare for 146 million Russians.

The Stock Market Bubble Bursts

Vice President Gore, Treasury Secretary Rubin, and Deputy Treasury Secretary Summers were not the only people taken in by the Chubais "Dream Team." In mid-1997, the Russian stock market—hyped up on billions from IMF, World Bank, and bilateral aid that initially permitted the Russian Central Bank to accumulate reserves at a pace of $1.5 billion a month—became the world's leading developing country stock market, as speculators chased stratospheric investment returns.[47]

The economic momentum, however, was exceptionally short-lived; it would not even last the year. By the fall of 1997, the trends were again all negative.

The onset of the economic crisis in Asia had reminded investors in emerging markets to pay attention to fundamentals, which for the Russian economy were not encouraging. Continued low gas and oil prices worldwide reduced the value of Russia's energy exports, and the lack of productivity improvement in the private sector was quickly erasing the justification for high stock prices.

After the brief euphoria, investment continued to decline in 1997; capital investment amounted to less than 24% of the Soviet-era level of 1990.[48] Capital flight at a rate of $2 billion to $3 billion per month (equivalent to between 4% and 10% of Russia's entire GDP)[49] was becoming a major drain on the Central Bank's foreign currency reserves.

For many Russian businesses, debts and liabilities significantly outweighed assets. Back wages rose to more than $4.4 billion by the end of 1997, and reached as high as $5.6 billion by July 1998.[50] At the start of 1998 business-to-business debt amounted to roughly $40 billion, while businesses' unpaid debt to the government totaled more than $35 billion.[51]

Russian firms, still suffering under the weight of Soviet-era laws and regulations, were unable to earn enough to pay taxes. The government's revenues were falling—at times as much as 50% below budgeted tax receipts. The decline in tax collections was exacerbated by the notoriously inefficient Russian tax system, as well as by corruption among tax authorities and sweetheart deals that granted tax leniency to select enterprises, such as the gas monopoly Gazprom.

The Clinton-Yeltsin and Gore-Chernomyrdin response to reduced tax collections—a symptom of the government's failure to building anything like a workable free enterprise system—was more government borrowing. IMF and World Bank debt would be used as a means of balancing the Russian central government's annual budgets, plugging the gap between the government's growing expenses and its rapidly declining revenues.

The heavy reliance on borrowing to finance budget shortfalls caused investors to demand an increasingly large premium to hold Russian debt. To attract investors, the government offered ever-higher interest rates—at times approaching 250%. The process was unsustainable.[52]

GKOs and the Russian Debt Pyramid

Russia's rapidly inflating short-term debt was an important factor in the August 1998 collapse. Facing budgetary pressures caused in part by already high debt service payments and expensive reelection campaign promises, the Russian government turned to short-term borrowing through ruble-denominated government bonds, known by their Russian acronym GKOs (Gosudarstvennykh Kratkosrochnykh Obligatsii, "State Short-Term Obligations"). Rather than solving Russia's debt problem, GKOs only delayed and intensified the final reckoning.

Russia's failure to develop a market economy and the concomitant poor investment climate meant the government had to pay investors a steep premium to sell them the GKO risk. Interest rates, which had averaged 26% in 1997, reached triple digits in July.[53] This ensured that the government could not meet its obligations when GKOs came due without issuing more GKOs: "The GKO pyramid was by then a full-blown Ponzi scheme, with new bonds being issued to pay the interest on old bonds."[54] GKO debt exploded during the spring and summer of 1998, and by then some 30% of Russian budgetary outlays was devoted to debt service.[55]

Russian and foreign investors earned enormous returns in the so-called "GKO casino." But investors were eager to convert their ruble profits into dollars and other stable currencies. Such conversions exerted more downward pressure on the already battered ruble, and raised the cost to the Russian Central Bank, which was trying to prop it up.

A considerable portion of the International Monetary Fund's $4.8 billion July 1998 rescue package was spent to prop up the ruble in the days before the collapse. Predictably, toward the end, only well-connected Russian and foreign investors were able to convert their rubles, a fact acknowledged by Treasury Secretary Rubin.[56]

The Clinton administration made consistent efforts to downplay the magnitude of Russia's economic crisis before the collapse. In late May 1998, for example, on the very day Russia's Central Bank tripled key refinancing rates to 150%, State Department spokesman James Rubin went out of his way to call the Russian government's economic team "fully capable," while then-Treasury Secretary Rubin blandly stated that "the Russian government is taking steps to deal with the situation."[57]

When asked what the administration knew about GKOs in the summer of 1998, Lawrence Summers, now Treasury Secretary, told the Speaker's Advisory Group on Russia that the administration was aware of the GKO market, knew the interest rates, and regarded them as symptomatic of an untenable fiscal situation.[58] Nonetheless, the Clinton administration viewed maintenance of the GKO Ponzi scheme as insufficient cause to turn off the cash spigot.

In light of the administration's previous enthusiasm for IMF lending to Russia, many investors may have believed that the Gore-Talbott-Summers troika would squeeze new loans out of the IMF to insure that Russia's economy did not fail and that their investments were protected. Ultimately, this perspective proved only partially correct: the IMF was persuaded to issue new credits, but the Russian economy would collapse nonetheless.

The Clinton Troika Pushes to Double IMF Lending to Russia

In mid-1998, just two months before Russia's economic collapse, IMF Managing Director Michel Camdessus insisted that investors should not worry about Russia: "Contrary to what markets and commentators are imagining, this is not a crisis," he said. John Odling-Smee, head of the IMF's Russia department, predicted that "large-scale additional financial resources … will fundamentally improve the financial situation of the Russian government."[59]

Similarly, the Clinton troika held the view that more IMF lending could fix whatever ailed Russia.

AP Photo/Pool

NOT A PRAYER: President Boris Yeltsin looks for help from above during a meeting with regional leaders on the 1998 financial crisis in the Kremlin in Moscow, June 5, 1998—just months before Russia's economic collapse. The Yeltsin-Clinton prescription for the crisis was for Russians to pay more taxes, ignoring the fundamental cause of Russia's increasingly poor fiscal condition: its failure to establish the basic elements of a free enterprise economy.

White House spokesman Mike McCurry bravely spun in July 1998 that the "program of Russian policy commitments and international financial support can provide a sound basis for increased stability and confidence."[60] According to the *New York Times*, Summers and Under Secretary of the Treasury for International Affairs David Lipton pressed the IMF to "double the amount of money it was willing to lend to Russia,"[61] even though this would dangerously deplete the IMF's resources.[62]

The *Times* reported that the Summers-Lipton diagnosis was that still more lending was required because Russia might "catch the Asian flu."[63] Such emphasis on external factors revealed the Clinton administration's inattention to the inherent problems in Russia's economy. By turning a blind eye to Russia's failure to put in place the building blocks of a free enterprise economy, and instead pressuring the IMF to put the Russian government still deeper into debt, the troika's policies exacerbated the depth of the coming crisis.

In Washington, over Memorial Day weekend, Summers, Lipton, and Talbott met with Chubais, who had been appointed as Special Emissary to the West after his dismissal from the Russian government. At backyard barbecues, they discussed terms and conditions. Afterward, they started pushing publicly for an agreement between the IMF and Moscow. A few days later, Clinton voiced support for the scheme and began lobbying Congress for an additional $18 billion U.S. contribution to the IMF so that the Fund would have enough money to cover the sizable new lending they had in mind.[64]

In fact, the economic situation in Russia was rapidly deteriorating. It was becoming clear that even a large-scale international financial package could not stave off the Russian free-fall. Angry miners began demonstrating in Moscow to protest wage arrears. The sale of the state-owned oil company Rosneft, projected to net the government $1.6 billion, was cancelled for the second time because of the probability of fire-sale bidding.[65] Interest rates on Russian debt were soaring. The Russian treasury market was showing signs of collapse: a Russian treasury bill auction failed to attract enough interested investors, despite sky-high interest rates. By July 1998, Russia's foreign currency reserves had fallen to $12 billion, down more than $3 billion from the month before. Though the handwriting was on the wall, the Clinton administration and the IMF chose to proceed with the loan.

The IMF Bails Out 'Insiders' Before the Ship Sinks

On July 16, 1998, the Russian government and the International Monetary Fund, joined by the World Bank and Japan, agreed on terms for the largest-ever infusion of cash into the central government of Russia: $17.1 billion. On top of this borrowing, Russia anticipated another $5.5 billion in international lending from prior agreements, for a grand total of $22.6 billion.

The 1998 IMF debt agreement was premised on commitments from the Russian government to implement a "comprehensive reform program," including a dramatic reduction of the budget deficit—this time to 2.8% of GDP from its then current 5.8%.[66] But the IMF funds were not conditioned on any legal commitment to the IMF, or even actual Russian performance.[67]

The IMF board approved the deal on July 20, 1998, even though the Duma balked at some of the reform measures that Chubais had promised. Disbursements began that day with a first installment of $4.8 billion—$800 million less than had been envisaged earlier, reflecting concern over the Duma's vote.[68]

The initial reaction to the IMF loan agreement was euphoric. The Russian stock market, after months of free fall, recorded a 17% rise.[69] This boost was short-lived, however. By the end of July, despite the infusion of billions of dollars in IMF funds, the market resumed its plunge.

On July 27, the market dropped 9% in one day.[70] Yields on the Russian government's short-term debt hovered around 60%.[71] In a desperate attempt to raise revenue, the Russian government prepared to sell a 5% interest in Gazprom, despite the unfavorable market conditions.[72]

This was precisely the reverse of what the Clinton administration and the IMF had hoped for. Instead of rewarding the Russian government for its temporarily cash-rich position, the market hammered it because it was now deeply mired in debt, with no discernable means of repayment.

The huge July 1998 IMF loan agreement did, however, succeed in one important respect. Because it was temporarily flush in IMF money, the Russian central bank was able to accommodate well-connected investors, foreign and domestic, who had discerned the handwriting on the wall and decided to convert their ruble holdings into hard currency. Thus, the IMF encouraged and paid for the capital flight that marked the final days before the August collapse.

Throughout the brief period between the 1998 IMF loan and Russia's final economic collapse, the Russian government bravely insisted that the Ponzi scheme of financing its budget with ever higher-yielding notes would continue forever. On July 27, Nemtsov declared, "Devaluation will happen with other governments, not ours."[73] The Clinton administration was equally willing to mislead the investing public. On July 28, Treasury Secretary Rubin wrote to then-House Speaker Newt Gingrich that the Russian government could now be expected to "finally take the myriad steps needed to put its finances on a sustainable path."[74] That same day, Stanley Fischer, the IMF's Deputy Managing Director, sounded an equally optimistic note: "Don't underestimate what's happened," he said of the IMF action. "Interest rates are down … . The pressure is off the ruble."[75]

As they had for nearly five years, the small clique of Clinton administration officials had miscalculated the effects of their policies and closed their eyes to the consequences. Their tight circle excluded opposing points of view and became a self-reinforcing mechanism for pursuing failed strategies. Gore was too willing to believe Chernomyrdin and Kirienko; Rubin, Summers, and Talbott were too willing to believe Chubais. Convinced that the worst was over and a turnaround was in sight, despite mounting evidence to the contrary, the Clinton troika was among the last to realize that it would all come to a bitter end on August 17.

The Final Days

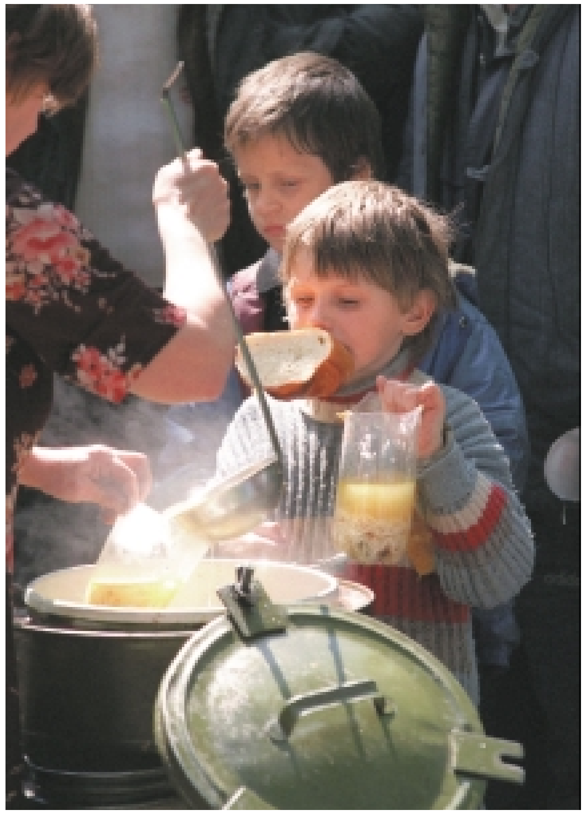
The Russian stock market continued its plunge in August 1998: on August 19 alone, trading was suspended twice because of drops of more than 10%.[76]

Demand for Russia's debt declined dramatically, even as yields soared above 200%.[77] Russian banks began calling on each other for loans—reflecting, in the words of Sergei Aleksashenko, First Deputy Chief of the Russian Central Bank, "the crisis of liquidity."[78] Some banks stopped allowing panicked Russians and foreigners to buy dollars with rubles.

In Washington, President Clinton was huddling with his advisers over what to do about his summit with Yeltsin, scheduled for September. On the one hand, the economic clouds were ominous; on the other hand, Yeltsin had reassured Clinton on August 14 that there would be no devaluation.[79]

Scrambling to avoid a meeting in the midst of a financial crisis, the White House dispatched Treasury's Lipton to Moscow "to ensure that the show stays on the road for the next three weeks at least," according to an administration source quoted in the *Economist*.[80] That would be just long enough to get through Clinton's visit and avoid embarrassment. Sidestepping Russia's underlying problems, it would seem, was the hallmark of administration policy in the final days before Russia's economic collapse.

Over the weekend of August 15-16, a small group of Russian government officials and their advisers met to consider the situation and their options. Another bailout from the IMF or the United States was deemed unlikely to win approval in Congress and, in any event, would arrive too late. Their options came down to seeking a rescheduling of the payment of billions in foreign government and private debts or a devaluation of the ruble. Either one would be tantamount to default, a declaration of Russian bankruptcy.



AP Photo/Mikhail Metzel

CHILDREN OF RUSSIA: Two children receive free soup from the Salvation Army at a Moscow railway terminal in 1998.

The following Monday, August 17, the Russian government announced a devaluation of the ruble *and* a 90-day moratorium on repayment of $40 billion in corporate and bank debt to foreign creditors—coupled with unilateral "restructuring" of domestic debt scheduled to mature in 1999.[81] The *Wall Street Journal* reported the next day, "Facing a choice between two economic evils to fight its financial woes, Russia chose both."[82]

The Clinton strategy of massive lending to the central government as a substitute for the construction of a free enterprise system in Russia had proved an error of historic proportions, and the administration immediately attempted to build a wall between their policy and its consequences. "It was the Russians' choice," said one administration official.[83]

Few in Russia accepted this version of events. Many Russians, not surprisingly, blamed the West, the IMF, and the United States for intentionally leading Russia down the path of ruin.[84] The heavy-handed involvement of Clinton administration officials in Russian economic policy had made America an easy scapegoat for millions of disgruntled Russians.

What made devaluation and default an especially bitter pill for the Russian people was the knowledge that many well-connected insiders had escaped its consequences by converting their rubles into hard currency and thereby avoided the consequences of devaluation. A number of the oligarchs, Duma deputies, and other officials had anticipated the devaluation or been tipped off to it and converted their ruble holdings into dollars before the foreign currency window was slammed shut, and then sent their money overseas before the August 17 devaluation. Given the scarcity of hard currency in Russia at the time, there is no question that the IMF loan proceeds were used to convert rubles to dollars, Deutschemarks, and pounds sterling in this way. Treasury Secretary Rubin, testifying before a House Appropriations Committee subcommittee in March 1999, acknowledged that much of the final $4.8 billion IMF loan distributed to Russia in the summer of 1998 "may have been siphoned off improperly."[85]

Following the devaluation, widespread speculation in Russia that IMF lending was being used to bail out insiders was fueled by the Russian Central Bank's decision to single out a dozen favored banks for government credits to reestablish their liquidity. The banks included those held by several powerful oligarchs. To all appearances, while the average Russian was left to fend for himself, the well-connected oligarch was being rescued by the Central Bank, by the IMF, and ultimately, by U.S. taxpayers.

Dmitri Vasiliev, former chairman of Russia's Federal Security Commission, confirmed that IMF loans were used to bail out insiders: "The [IMF] money is all spent," he told the *Los Angeles Times* a month after the devaluation. "It went to foreigners and Russian speculators, including the Central Bank. They got payments for their GKOs, converted the rubles into cheap dollars, and took the money out of the country."[86]

As Clinton was preparing for his September 1998 trip to Moscow, Prime Minister Kirienko and his team were fired. Not much earlier, one senior Clinton administration official had called the Kirienko government "the most cohesive and most united in its commitment to reform ... Russia has had in the last five years."[87] Kirienko's team lasted barely five months, and the Clinton administration was again without a policy and an interlocutor in Moscow.

AP Photo/Mikhail Metzel

THE CLINTON GENERATION: A Muscovite begs with his dogs next to a Pepsi advertisement, featuring Soviet leader Nikita Kruschev and President Nixon in 1959, in downtown Moscow, June 3, 2000, just before Clinton arrived in Moscow for a summit with President Putin. Clinton's reception, not surprisingly after the collapse of Russia's economy, was icy cold.

For a brief moment, Gore was heartened that his former partner, Viktor Chernomyrdin, might be making his way back. However, Chernomyrdin's comeback was to be short-lived: the Duma refused to confirm him. By the fall of 1998, the Clinton administration had no "strategic partners" in the Russian government, and its policy toward Russia had fallen into disarray.

The Continuing Fallout

The effects of the complete collapse of the Russian economy in August 1998 were profound. They are still being felt today.

Wage and pension arrears have declined significantly, but workers' real income is still only 77% of what it was before August 1998. The nominal increase in ruble-denominated wages has not kept pace with the increase in prices. Personal consumption, as a result, dropped 5% in 1999, while retail sales were down 8%. Those Russians living below the official poverty level still total more than 35% of the population. The official unemployment rate remains above 11%.[88]

Servicing Russia's foreign debt, now up to $150 billion, is draining resources from the economy.[89]

Russia's modest economic "turnaround," such as it is, is almost wholly a windfall result of higher world oil prices, and Russia remains unprepared to capitalize on this opportunity. Gazprom, the giant gas monopoly, reported in May 2000 that its output would be down this year because of a shortage of funds to invest in new fields.[90] More generally, the continued dependence of Russia's economy on basic Soviet-era industries such as the export of arms and natural resources—and one major export in particular, oil—underscores the failure to construct the basics of a free enterprise economy.

Nearly a decade after the end of Communism, the essential task still remains to be undertaken: building a free enterprise economy on the ashes of a centralized state-run system. But whereas in 1992 there was public support to see the job through, years of failed economic policy masquerading as "reform," a crushing burden of debt, and the discrediting of the United States in the eyes of the Russian people have made that task far more difficult than anyone could then have imagined.