

The crisis of 1998 in Russia: political intervention and its implications

E. Fakhrutdinova¹, O. Severyanov¹, A. Shigabutdinov², and R. Fakhrutdinov³

¹Kazan (Volga region) Federal University, Kremlyovskaya Street 18, 420008, Kazan, Republic of Tatarstan, Russian Federation

²Kazan State University of Architecture and Engineering, Green Street 1, 420043, Kazan, Republic of Tatarstan, Russian Federation

³Saint-Petersburg State University of Economic, Sadovaya Street 21, 191023, St. Petersburg, Russian Federation

Abstract. In this paper the role of the Russian government in overcoming the crisis of 1998 is considered. The changes adopted by Russian authorities after the whole government, including the head of the Central Bank and the head of Russian government, was changed had a vital role on the recovery of the economy after the crash. Further, the most important shifts, which were undertaken in order to improve the situation, including the transition to the free exchange rate of ruble, the change of monetary control, changes made in the budget policy and the commencement of price control will be analyzed. However, the work will not be limited just to the analyses of the responses of the Russian government to the crisis, but will also cover their premises and long-term effect.

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Introduction

After the price liberalization took place and the ruble began to be traded in the beginning of 1992, inflation became to be one of the most important problems for Russia [1, 2, 3]. By the end of 1992 prices rose 25 times. On the following graph, the reader can see the consumer price index. The prices were changing so fast that salesmen had to change price-lists every day. Of course, together with delays in payments of salaries, which lasted up to six months, it was a complete disaster for the population of Russia [1]. In 1994 inflation had fallen, but it was still around 250%. To prevent large-scale starvation and contain violent inflation, the Russian government adopted a policy of maintaining the dollar-ruble's high exchange rate. The huge interventions of the Central Bank helped to achieve the desired result.

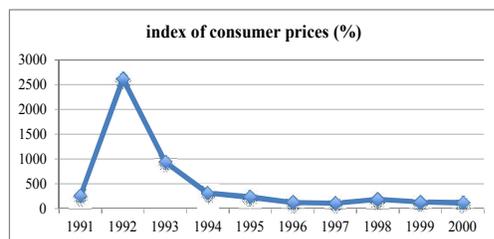


Fig. 1. Index of consumer prices (December of previous year is 100%) [4]

In July of 1995 the corridor system was introduced. It allowed the ruble to fluctuate only within a certain range, which was defined and updated

by the Russian government. However, the ruble's exchange rate was held at an unreasonably high level. First Deputy Premier Anatoliy Chubays, who was in charge of economic policy, said, "The main purpose we want to achieve by the corridor system is the predictability and stability that are necessary for all people."

As a result, the high exchange rate drove foreign goods to be purchased at a relatively low price. While prices for Russian products rose on average 25 times, foreign products increased only 4,2 times in the same year. Of course, inexpensive foreign products helped to make life easier for the people to certain a extent, because wage and other income grew slower than prices did [5].

However, this kind of policy also had its downsides. Russian production was dying. It could not compete with cheap foreign goods. On the next graph you can observe the decline of Russian industry in the beginning of 90s. Closure of many productions led to the rise of unemployment, illegal activities, misallocation of resources and the outflow of labor abroad. In addition, the high exchange rate had a negative impact on the investment [6, 7]. The high exchange rate was maintained artificially by the interventions of Central Bank. This led to the rise of concerns about the possible fall of the exchange rate, because it cannot resist market forces forever, and which in turn was a reason for the outflow of investments.

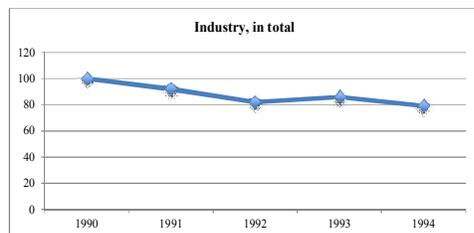


Fig. 2: Dynamics of the volume of industrial production (Previous year is 100%) [4]

Eventually, these concerns came true. Due to the enormous ruble sell off on the market from the middle of August, the Russian Central Bank didn't have enough resources to keep the exchange rate stable and high. The last level the Russian government tried to hold was 9,5 rubles. On the 9th of September, the shift to the free floating exchange rate was officially announced. On the following graph one can observe how the ruble-dollar's exchange rate has fluctuated in September of 1998, just right after the default. In one week exchange rate had fallen from 9,5 to 21 rubles, then it rose again to 16 rubles. Later on, in April 1999, it fell again to 25 rubles and finally stabilized at the level of 28 rubles. As a result of low exchange rate, the foreign products became more expensive. The growth of import prices caused the growth of overall prices. So growth rate of prices shifted from 7,5% in 1997 to 23,2% in 1998 and in 1999 it already became 67,4%. Despite of the negative short-term effect, the low exchange rate had positive consequences on the Russian economy in the long-term effect. Russian production could breathe freely: Russian-made products became price-competitive and, in many fields, have replaced the foreign substitutes [8, 9]. Observing how Russian production develops and increases its market share, foreign capital flowed to Russia. Moreover, refusal to support artificially high exchange rate saved a lot of resources and allowed Russia to increase its foreign exchange reserves. So in December of 1998, Russian foreign exchange reserves totaled 12,3 billion of US dollars. In two just years, they increased by 227,65% and, by the end of 2001, became 28 billion of US dollars. The positive trend continued and Russian foreign exchange reserves became one of the largest in the world. It was important for the stability of economy and for the persuasion of people in the ability of the country to overcome all the negative circumstances.

In addition, exports had sharply risen. In 1999, Russia had a trade account surplus of 32,6 billion dollars, compared to 2,5 billion dollars in 1998.

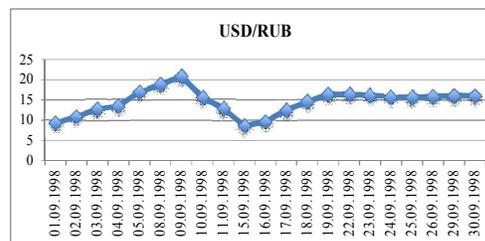


Fig. 3: Dynamics of USD/RUB exchange rate (September 1998) [10]

Of course, the main reason was the rise of oil prices. However, we should not underestimate the effect of the recovery of international competitiveness of Russian industries. All these had a positive effect on the growth of GDP and as a result, on the Russian economy in general. So, if the growth of GDP in 1998 was negative (-4,9%), in 1999 and later, it was positive and significant. In the following table, the reader may observe the dynamics of GDP in Russia from 1995 to 2001.

Table 1. Dynamics of GDP in Russia (previous year 100%) [4]

Year	1995	1996	1997	1998	1999	2000	2001
% Growth	95,9	96,6	100,9	95,1	105,4	108,3	105,1

All in all, the shift to free-floating exchange rate had a positive and important effect on the Russian economy, despite of some short-term obstacles.

Loosening of monetary control

From the beginning of 1990s delays in the payment of wages were used as a method to counter inflation. The Russian government did not raise enough funds by collecting taxes and from other receipts in the budget. At the same time it refused to increase the money supply to solve its financial problems, as it would increase inflation. As a result, the government could not fulfill its financial obligations in a timely manner [2, 3].

Together with a fall of purchasing power of wages due to the huge inflation, delays in the payment of wages had severe consequences on the Russian community and economy. By the end of 1995, the real wage accounted only 34% from the level of 1992, so it had dropped three times just in three years. A social survey from the sociological center RAGS (Russian Accounting Governmental Service) in April 1994 revealed that the most common answer to the question: "Are you afraid to lose your and your family's property and money due to some adverse changes or consequences?" was "No, we have nothing to lose". This answer in the best way describes the plight of common Russians at that time. By the end of

1998, the income of more than 23% of population was less than subsistence wage. It meant that almost 34,3 million people were earning less than 493,3 rubles per month, what accounted for 80 dollars before the fall of the exchange rate and 25 dollars after the fall of the exchange rate. All this led to the increase of social tension and sometimes even to the social unrest. During the year 1998, more than 320,000 people took part in protests. Mostly these were strikes on factories due to the nonpayment of salaries.

On the following graph the reader can see the dynamics of delays in the payments of wages from 1992 till 1996.

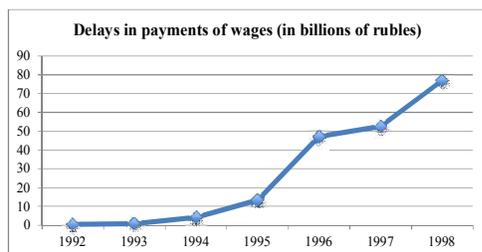


Fig. 4: Dynamics of delays in payment of wages (1992-1998) [4]

So by the time of crisis (1998) the amount of delays in the payment of wages was 77 billions of rubles. Moreover, the government did not fulfill its financial obligations to the budgetary organizations and to the contractors of state orders. As a result, many enterprises did not have money to pay wages and, instead of money, employees obtained goods their enterprise produced. At a later date, they had to exchange goods they received for what they needed for daily survival. Basically, Russia returned to barter system. More than 80% of industrial production was exchanged through the process of barter.

Another adverse effect of this policy was the rise of black economy. If people could not earn money officially, resourceful strategies were used which were not always legal. The peak of the “black market economy” was from 1997 through 1999, when, according to different estimates, the black economy ranged from 40% to 50% of GDP.

Finally, in the end of 1998, the tight monetary policy was found to be ineffective. Monetary regulation has become more flexible. The Russian government has completely stopped limiting the money supply by the delay or non-payment of wages, pensions, and other social security payments. By the middle of 2000, the amount of delays in payments of wages has decreased three times and became around 20 billions of rubles. This allowed not only to increase the social welfare but also enhanced the trust in

authorities and in the direction of current policy. In addition the government has almost completely abandoned the practice of non-compliance of financial obligations to the budgetary organizations and to the contractors of state orders. This approach allowed to normalize the financial situation in the public sector and to stimulate the economy. So loosening of monetary control improved both social and financial environments and raised the government’s authority.

Changes in the budget policy

Before 1998, tight monetary policy (control of inflation by refusing from the monetary financing of the state budget and by keeping overvalued exchange rate) was combined with extremely mild budget policy. It is not a secret, that this kind of controversial combination increases risks for stability of a financial system. However this policy was dictated by the political realities in Russia at that time.

The key role in budget forming plays parliament. It approves the budget proposal and then the president may or may not sign it. From the beginning of 90s parliament was under the strong influence and full control of communists and Boris Yeltsin, the president of Russia at that time, has approved all their proposals and decisions. As a result, the budget was formed in line with the populist policy they were implementing. Consequently, due to the pressure of the communist party, budget expenditures were enormous and were much larger than budget incomes. For many years the budget was closing with a deficit and government could not fulfill its obligations. For communists, however, it was a perfect political move: during the process of budget development, communists described themselves as defenders of people. They lobbied for the increase of social expenditures, raise of wage of public sector workers, support of agriculture and the military industrial complex and many other political causes. Nevertheless, at the stage of budget execution, or better, at the stage of inevitable failure, communists were severe critics of the government, which could not ensure all the commitments it had promised to the people.

As a result, the budget for many years was unbalanced and the ministry of finance had to engage the resources of the Central Bank in order to cover the deficit. These tactics could not last for a long time, resources of the Central Bank were also limited. Russian authorities tried to solve this problem by the increase of national debt (Pyramid of GKO-OFZ). In comparison with other countries, Russian internal debt was not so large. In 1996, it accounted for only 21% of GDP. In USA and Japan, for example, these figures were noticeably higher: 65,6% and 107,2% respectively. However, its volume was constantly growing. In 1995, the volume of issued GKO-OFZ

was 160 billion of rubles; in the year 1997, it was already 502 billion of rubles.

The necessary demand for GKO-OFZ was ensured by the increase of interest rates. In turn, high profitability of government securities pulled the financial resources from the real sector of economy to the financial sector. Moreover, the refinancing of government securities decreased the capacity of government to stimulate the economy, to fulfill its obligations and to support the social sphere. In addition, the growing debt led to the increase of fluctuations of the exchange rate and to the instability of the financial system as a whole. Unfortunately, the core problem was that Russia lived beyond her income and this had to be changed.

In the post-default years, budgetary discipline has significantly improved. In 2000, for the first time since the fall of the USSR, budget was in surplus of 1,9%. Of course, mainly it was due to the rise of oil and gas prices. In one year, from December 1998 until December 1999, oil prices have risen 2,6 times, from \$9,4 for a barrel to \$24 for a barrel. Moreover, the improvement of the taxation system, which was conducted in the beginning of 2000s, considerably increased the proportion of income from the export of natural resources, which was forwarded to the budget. Consequently, one of the main sources of income of the Russian budget, export of natural resources, had significantly risen.

However, one should not underestimate the change in the approach to the budgetary process. Changed the entire attitude to the budget. Russia was learning to live on what it earned. The Budget was no longer considered only as the instrument for lobbying interest of particular political parties.

In the government the need to avoid a new default was on the agenda for a long period of time and this became one of the key internal standards of the effectiveness of economic policy. It allowed to dismiss the most irresponsible and risky decisions and this highly affected even communists and other left-wing populists. Also the dismissal of the head of the government and of the big part of parliamentarians had its effect on the change of political and economic vector. From the 1999, the influence of communists in the parliament was constantly falling and from the year 2003 the political party "United Russia" headed by Vladimir Putin has completely took over the influence in the parliament. So if in the years 1993 – 1999 communists had 157 places in the parliament and had the leading position, from 1999 till 2003 113 places, in the elections of 2003 they held only 52 places. At the same time "United Russia" obtained 223 places in the parliament.

In addition, it was decided to refuse from financing budgetary deficit by large loans, because on

the one hand this method doesn't have the desired anti-inflation effect and on the other hand undermines the stability of economy. So it was agreed not to recover the collapsed market of government obligations (GKO – OFZ pyramid). It led to the fall of profitability of government securities and, consequently, to the rise of attractiveness of the real sector of economy. As a result, a significant proportion of the released funds had been redirected into the real sector, which was one of the reasons for the revival of production growth and a base for the long-term economic growth. So the amount of investments in the fixed capital has risen from 408, 7 billion of rubles in 1998 to 1165 billion of rubles in the year 2000. The growth of 285% just in two years.

In the following table you can see the dynamics of the Russian budget: change of budget expenditures, of income and of deficit/surplus (1991-2000). Due to the fast change of purchasing power of money from 1991 till 2000 there is no point to observe nominal numbers. So all changes are indicated in relative index (as % of GDP).

Table 2. Dynamics of Russian budget (1991–2000) [4]

Year	1991	1992	1996	1997	1998	1999	2000
Budget expenditures (% of GDP)	56,3	45,7	32,5	35,8	32,0	26,1	26,8
Budget income (% of GDP)	24,3	31,5	27,8	30,4	26,1	25,2	28,7
Surplus/Deficit (% of GDP)	(32)	(14,2)	(4,7)	(5,4)	(5,9)	(0,9)	1,9

From the table you see, that for nine years the budget had a deficit. Of course such a long-term budget deficit has adverse impact on the economy. Deficit was especially huge in the first years after the fall of USSR. In 1991, it accounted 32% of GDP, so the deficit was bigger than the total income of the country. Later on it decreased, but still the budget had a deficit of 6,3% of GDP on average until the crisis of 1998th. Already in 1999 the situation was improved and the deficit became only 0,9% of GDP. From the year 2000, the budget has been consistently in surplus, that allowed to increase reserves and to create so called stabilization fund for adverse economic situations. In turn this led to increase of the stability of the financial system.

Price control

Before the crisis of 1998 inflation control and stabilization were one of the most essential policy directions of the Russian government and Central Bank. Efforts, which undertaken by the government in

1995, in order to tighten financial and credit policies, have contributed to a significant slowdown in the inflation. For example, monthly growth of prices of industrial production, which in January of 1995 was 21.5%, in February 16.9%, in March 10.7%, in April - 14.8% slowed down to 2.9% in November and to 1.8% in December.

However, this had a negative and significant effect on the industrial production by itself. The slowdown of growth of prices for material and technical resources, which were needed for production, was much slower than the slowdown of the growth of prices for the finished goods of industrial production. So while the prices for goods of industrial production improved 2,75 times from 1994 till 1995, the prices for the inputs increased 3,1 times. At the same time, consumer prices have risen only 2,3 times.

These circumstances led to the sharp deterioration of the financial situation of industrial enterprises. In the 1996 nominal earnings in the industry as a whole fell to 46%, relative to the 1995. Later on, they had increased but still their level was significantly lower than in 1995.

The overwhelming majority of industrial companies lost their internal sources for the working capital as a result of a sharp decline in inflationary profit and maintenance of high production costs. Significantly increased the share of barter and money surrogates in the mutual turnover of products between enterprises. Cash receipts from sales of goods and services in the industry declined by 30% in nominal terms in 1996th compared to 1995th.

Moreover, the formation of high-yield government securities market contributed to an outflow of financial resources from the real sector of economy, and high interest rates on credit made the financial resources virtually inaccessible for industry.

After the fall of the exchange rate in August of 1998, consumer prices rose sharply. At the same time, the fall of the ruble had virtually no impact on the dynamics of prices in the real sector of economy. The decline in prices or their stabilization were observed in almost all industrial sectors. From the beginning of 1998, the prices in industry had fallen on 1,5% on average. To the greatest extent, decrease was observed in the fuel-energy complex [11, 12]. The fall of industrial prices was largely due to the Asian crisis and the changed global market conditions. Consequently, the state of affairs in the industry had worsened again. Without the government support and stimulation, industry would have completely died.

With the significant slowdown in the price growth or even the fall of the prices, the sensitivity of production costs and profitability in the industry to fluctuations of the price indexes and tariffs on the

products of natural monopolies had sharply risen. In order to improve the situation and to save domestic production, the Government and the Central Bank of Russia determined the main direction of the state regulation of prices and tariffs of natural monopolies in November 1998 [13]. The adopted measures, which were excluding unreasonable increases in costs and prices (tariffs) for goods (services) of natural monopolies, managed to slow down their growth and to ensure their stability in some cases.

Thus, for example, the tariffs for railway freight in Russian domestic lines of communication and gas prices, which were virtually unchanged from 1997, remained stable during the first ten months of 1999, and only in November rose by 9.9% and 15%, respectively. The average monthly increase in electricity prices and tariffs for pipeline transport accounted for 1.0-1.1% in 1999th. Compared to the inflation of 36,6 % in 1998, the prices for goods and services of natural monopolies were quite stable.

From September 1998 till December 1999, the monthly growth rate of industrial producers' prices were higher than the growth rate of prices for certain types of products and services of natural monopolies. Together, with the relatively slow growth rate of nominal wages, the growth rate was reflected in the decrease of the relative costs of enterprises, which in turn significantly improved their competitiveness.

During the first nine months of 1999, there was a reduction of costs per one ruble of goods (services) over all elements of costs, compared to the same period in 1998. This contributed to a rapid improvement of financial situation in the industry. This, in turn, allowed the reduction of the amount of delays in the payment of salaries to the employees, the payment of arrears, the displacement of barter with monetary settlements, and access to financial resources [14].

On the following table, the changing volume of industrial output in Russia from the year 1998 till 2002 is demonstrated.

Table 3. Dynamics of industrial output in billions of rubles (1998 – 2002) [4]

Year	1998	1999	2000	2001	2002
Volume of industrial output (billions of rubles)	1707	3150	4763	5881	6868

After the crisis of 1998, the Russian industry had a rapid recovery. By the year 2000, the industrial output in billions of rubles has risen by 279%, compared to the 1998. It continued to increase.

However, the reduction of prices of natural monopolies for the industrial production had to be compensated somehow. These costs were imposed on

the population. For example, while the prices for electricity during 1999 had risen by 23,2% for the industrial enterprises, the general population had an increase of 43,7. This was a heavy burden for already poor population, but it helped to revive the Russian industry.

The stability of prices and tariffs of natural monopolies had been a major factor in lowering production costs and, consequently, in the reduction of losses for industrial production, and in the improvement of its profitability and in strengthening of its real solvency. One should understand that it was not only due to the stable prices of the natural monopolies, but also due to the general recovery of economy after the crisis. The net financial result (nominal) of industry as a whole in 1999 was 30 times greater than in 1998. Moreover, it helped to slowdown the dynamics of inflation. At the same time, fast growth rates of prices for paid services for the population restrained the growth of real income, of purchasing power of people and as a result hampered the economic development.

Conclusion

To sum up the paper it can be concluded, that the pertinent political interference helped Russian to overcome the crisis quickly enough and to build a solid base for the future stability and development. The free exchange rate, price control, changes in the budget policy, and loosening of monetary control not only helped to revive domestic industry and allowed to increase the state recourses tremendously, but also significantly improved social situation in the country. However, perhaps if the changes had taken place earlier, it could be possible to avoid many negative effects. Unfortunately, the government responses to the changing conditions were not preventive, but belated.

Corresponding Author:

Dr.Fakhrutdinova E.

Kazan (Volga region) Federal University
Kremlyovskaya Street 18, 420008, Kazan, Republic of Tatarstan, Russian Federation

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