



The Russian Crisis of 1998: Was It a Result of a “Shock Therapy”?

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ABSTRACT

The “openness” promoted by the liberalisation process referred, ironically, to the openness to the financial crises in developing world in the 1990s. Russian case was the leading one among them, in which the “shock therapy” implemented by the neo-liberal perspective has been still under discussion. The paper analyzes and discusses such crisis in terms of the relevant models of crisis. The paper maintains that contrary to the general view shaped by neo-liberal perspective, the Russian Crisis has several compounds, which cannot be easily tackled in terms of either first or second generation models, rather points to the third generation models. Since the third generation models can be handled as a combination of theories such as financial market failures, highly volatile capital flows and contagion problems the paper finds out that those are the most appropriate ones for the Russian case contrary to the neoliberal perspective.

Keywords: International Financial Crises; the Russian Crisis of 1998; Crisis Literature; the Third Generation Models of Crises

JEL-classification: F39, G01, G15

1998 Rusya Krizi: Bir “Şok Terapi”nin Sonucu mıydı?

ÖZET

Liberalizasyon süreciyle teşvik edilen “açıklık”, ironik olarak, 1990’larda gelişmekte olan dünyadaki finansal krizlere açıklığı ifade etti. Rusya örneği bunlar içinde öncü olandı ki burada neoliberal bakış açısı tarafından uygulanan “şok terapi” hala daha tartışılmaktadır. Çalışma söz konusu krizi ilgili kriz modelleri açısından analiz etmekte ve tartışmaktadır. Çalışma, neoliberal bakış açısı tarafından şekillenen genel kanının aksine Rusya Krizinin birinci yada ikinci nesil modeller açısından kolaylıkla ele alınamayacak, daha çok üçüncü nesil modellere işaret eden pek çok bileşkesi olduğunu savunmaktadır. Üçüncü nesil kriz modelleri finansal piyasa başarısızlıkları, yüksek volatiliteli sermaye hareketleri ve yayılma problemleri gibi teorilerin bir kombinasyonu olarak ele alınabildiğinden çalışma, neoliberal görüşün aksine üçüncü nesil kriz modellerinin Rusya örneği için en uygun olanlar olduğu sonucuna varmıştır.



Anahtar Kelimeler: Uluslararası Finansal Krizler, 1998 Rusya Krizi, Kriz Literatürü, Üçüncü Nesil Kriz modelleri

1. Introduction

The restructuring of the world economy, which started in the 1980s through the policies of liberalisation and deregulation of financial markets continued increasingly and deeply into the 1990s, under the name of “globalisation”. This was by virtue of the significant developments in the Information and Communication Technologies and in the political arena through having entered a new unipolar world order after the collapse of the Soviet Union.

Although by virtue of liberalisation of capital in all over the world, enhancing the volume, speed and prevalence of capital, without any barrier, was aimed, this unrestricted movement of capital made the developing countries, especially the transition ones, unstable, crisis prone, crisis spreader and fragile economies by making them “open”, never been seen before in the world economy (Onis and Aysan, 2000: 321-333). In other words, the “openness” promoted by the liberalisation process did not mean only open to growth of output, welfare and international trade, but also referred, ironically, to the negative effects of these international transactions, of which the most important one is the international financial, particularly, currency crises, experienced severely in all around the world in the 1990s. This was especially severe for the ones in which the whole system was in change or transition. Russia with its crisis was the leading one among them, in which the “shock therapy” implemented by the neo-liberal perspective was heavily criticised and still under discussion, especially in terms of its contributions to the background of even today’s unstable and problematic conditions of the Russian Economy.

This paper handles the determinants of the Russian Crisis and aims to analyse this financial crisis in terms of the third generation models of crises. In this regard, after the introduction part the paper tackles the topic in three parts. In the first part, the paper briefly handles the third generation models of crises in terms of how they explain crises and which determinants of crises they focus on. In the second part, the paper concentrates on the case of Russian crisis in order to remember what happened. In the main part, the paper tries to explain the Russian case with the third generation models of crisis, namely, connect the third generation model of crisis with the Russian crisis.

2. The Third Generation Models of Financial (Currency) Crisis

When the first and second generation models were seen to be inadequate to explain the Mexican and Asian crises, the third generation models, which can be handled as a combination of a number of models, were developed (Copeland, 2005: 462).

Although there are some common points with the other two models, the significance of the third generation models is the fact that they put the real side effects of the crisis. Moreover, they stress the creator role of the capital movements in international financial crises among the other problems stemming from the financial sectors including the banking. They also highlight the contagion issue. Chang and Velasco (1999) put some real side effects of crisis as “Crises have real effects, in contrast with first- and second-generation models. Costly liquidation (or, more generally, projects that are left unfinished or not undertaken because of lack of funding) can cause illiquid banks to suffer real losses and become de facto insolvent” (Chang and Velasco, 1999: 28).



Like the first generation models, they handle the weak economic fundamentals behind the crises. However, in contrast to the first generation models they mostly focus on the microeconomic fundamentals of the crises rather than on the macroeconomic ones. Like the second generation models, they tackle the speculative attacks and self-fulfilling crisis and are typically multiple equilibria models. In this regard, Hamann et al. (2003) put this fact as follows: “These models acknowledged that second generation models captured some aspects of the Asian crisis (notably the existence of multiple equilibria) but noted that other factors were also at play—namely, corporate and financial weaknesses” (Hamann et al., 2003: 14).

However, in contrast to the second generation models, they do not explain the speculative attacks under governments’ policy trade-off situation. So, it is argued that although output gains can accompany the second generation models of crisis, due to the policy choice of government, under policy dilemma, the third generation models of crisis are experienced mostly with output losses. This is due to the existing problems in the balance sheets of corporations in which liabilities are mostly in foreign exchange and assets are in local currencies leading to distortions of the balance sheets in such crises. Hence this causes to the fall of their investment and output at the macro level.

Furman and Stiglitz (1998) maintain that second generation models stress the “transitory benefits of devaluation”. If the banks and corporations have foreign exchange exposure and especially if the banks have weak positions, pointing out the fragility of the whole system, such transitory benefits cannot be a policy choice for the government. They maintain that third generation models cannot include a policy dilemma of governments, even reducing the government’s debt cost. This is because devaluation would mean highly increased costs in foreign exchange exposure both in terms of government and corporations, which would collapse the whole system by reducing the credits and aggregate demand (Furman and Stiglitz, 1998: 31-33).

Hemming et al. (2003) argue that although the third generation models can be in various forms, they tend to underline the balance sheet problems. Moreover, they include both “self-fulfilling nonfundamentals-and fundamentals-driven crises” (Hemming et al., 2003: 32). In this regard, although the third generation models of crisis have some common parts with the radical political economic theories of crisis such as financial fragility, over lending issue etc., radical economists still place the third generation models of crisis among mainstream economics. For instance, Muñoz (2011) places the third generation models of crisis together with the first and second generation models of crisis in the orthodox view (Muñoz, 2011: 4-6, 10) although some parts/models out of the third generation models can be accepted as heterodox. This is mostly due to in the radical economics literature, such as Keen, 2012; Kotz, 2012; Kliman, 2012; Devine, 1987, the crisis issue is tackled as an important part of the capitalism, a structural issue, pointing to the acceleration of the financial capital rather than productive capital in economies thus profits are not reinvested in real sector, rather in financial sector and the credit supplies of the banks are mostly outside of the control of the central banks, pointing to the fact that the money is created “endogenously” when the loans are created by the banking sector. In this regard, Muñoz (2011) maintains that the main difference between the orthodox and heterodox views on the crisis is that while orthodox view tackles the crisis as an “exogenous” factor, thus, it is “exceptional”, heterodox view tackles it as “endogenous” factor, thus not “exceptional” rather it is “natural, related to the system”, as “endogenous to the system” (Muñoz, 2011: 21-23). By handling the third generation models and also the model developed by Krugman (1999) within the orthodox view Muñoz (2011) argues that the capital in and out flows together with the risks and returns constitute the



speculative vehicle of the crises as “exogenous to the system” and the bubbles constitute the symptoms (Muñoz, 2011: 4-6, 10).

The general view on the third generation models is that they do not substitute each other; rather they complement each other since they have direct or indirect linkages and several common parts. Although there is no eventual consensus on the third generation models and there can be other classifications, the following classification is thought to be better to handle the third generation models, which is mostly tackled as a combination in this paper, rather than as alternative theories to each other.

2.1. Crises That Stem from the Problems in Financial Sector

2.1.1. Overly Rapid and Complete Financial Liberalisation

It refers to the freeing of capital movements rapidly without undertaking necessary regulations and supervision activities (Furman and Stiglitz, 1998: 15). In this regard, it is argued that such liberalisation leads short term speculative global funds, the so called hot money, resulting with the fragile financial systems and prone to crisis economies. Within the framework of freeing of capital movements as external financial liberalization Furman and Stiglitz (1998) argue that it constitutes another source of greater risks as creating “great volatility in capital flows”, which easily flows in and out of the country in a short while. Thereby, creating the risks both in large capital inflows, especially during the fixed exchange rate systems, and also massive capital outflows thus creating destabilizing effects. They put it as “If virtually all developing countries experience vulnerability when they open up their capital accounts, then the presumption should be that the problem is capital account convertibility (at least given the constraint that macroeconomic policy is never perfect), not macroeconomic policies” (Furman and Stiglitz, 1998: 15).

In the lead up to a crisis, both Furman and Stiglitz (1998) and Chang and Velasco (1999) emphasize the role of financial liberalization in decreasing the “franchise value” of the banks, which find themselves in a more competitive environment when the entry barriers whether for domestic or foreign banks into banking sector were lowered through financial liberalization. So that the existing banks start to behave in a more risky attitude, while offering larger rate of return to its short-term depositors by being in greater fragility since “they have less to lose” with the fall of their franchise value (Chang and Velasco, 1999: 35). In this regard, Arestis and Demetriades (1999) point to the “credit boom” or lending boom of local financial institutions sustained by such large capital inflows by virtue of financial liberalization which create either “overconsumption” or “overinvestment” problem as a kind of distortion (Arestis and Demetriades, 1999: 449). Moreover, Krugman (1998b) mentions that in the case of globalization, namely, easily access to global capital markets, the consequences of this kind of distortion can be easily accelerated. If they did not have such access and they had a fixed supply of domestic savings then the demand for overinvestment would not be realized; interest rates would just rise (Krugman, 1998b: 6).

Thus, Hallwood and MacDonald (2004) argue that in developing countries “...too much liberalization can be dangerous, there must be some optimal degree of financial repression...” (Hallwood and MacDonald, 2004: 304). This is due to the asymmetric information problem of the nature of financial sectors of developing countries, which indeed do not have perfect competition, pointing to the dangers of “the complete financial liberalisation” in developing countries. Thereby pointing out the market failures in terms of domestic financial liberalization and because of the volatile and fragile



international financial environment; namely, international financial instability, led by highly volatile and speculative capital movements, in terms of external financial liberalization, which all create prone to crisis economies.

2.1.2. Moral Hazard and Adverse Selection

It is pointed out the implicit or explicit government guarantee to the banks combined with the lack of supervision and auditing in the financial sector, resulting with the asymmetric information, “which leads to two basic problems in the financial system (and elsewhere): adverse selection and moral hazards” (Mishkin, 1999: 4). Krugman (1998b) argues that the lack of efficient regulatory laws in the funding of banks results with a kind of crony capitalism, which leads the fact that the banks, of which risk management and capital adequacy ratio are not sufficient, give credits to affiliate companies (Krugman, 1998b: 3-5). By giving the Asian example Corsetti et al. (1999) tackle the moral hazard issue in three different but interrelated levels as corporate, financial and international levels. They explain that moral hazard at the corporate level refers to the overinvestment and miscalculated costs and riskiness of the corporations, which have implicit and explicit government guarantees within the political pressures of governments aiming to maintain high rates of economic growth (Corsetti et al., 1999: 307). Although low or un-profitability is the accelerating case, financial institutions sustaining such foreign funds to such corporate as intermediaries keep going to do it, which points to the moral hazard issue at the “financial level” resulting with “the non-performing loans” (Corsetti et al., 1999: 307) or so-called bad bank loans. They also argue that in such an environment where especially the lack of “standards for sound risk assessments” is the case, the international investors or banks can keep going to lend their large amounts of funds to such domestic intermediaries. This is due to these international investors may have “the presumption that short-term interbank cross-border liabilities would be effectively guaranteed by either a direct government intervention in favour of the financial debtors, or by an indirect bail-out through IMF support programs”. All these point to the moral hazard at international level (Corsetti et al., 1999: 308). Corsetti et al. (1999) conclude that these three different but interrelated levels of moral hazard constitute the vulnerability to financial crisis “either related to sudden switches in market confidence and sentiment, or driven by deteriorating expectations about the poor state of fundamentals” (Corsetti et al., 1999: 309).

2.1.3. The Liquidity Issue/Financial Fragility

Financial fragility, which refers to the fact that short term financial liabilities of a firm are higher than its short term financial assets or mismatches between currencies of two transactions or time inconsistencies as short term borrowing but long term lending, is associated with the concept of international illiquidity, which is defined as “a situation in which a financial system's potential short-term liabilities, in hard currency, exceed the amount of hard currency (that) it can have access to on short notice” and is tackled as “crucial in triggering recent crises” by Chang and Velasco (1999: 14). Chang and Velasco (1999) note that as in the second generation models, negative expectations can result with self-fulfilling, leading both currency and banking crises together (Chang and Velasco, 1999: 46). Krugman (1999) adds another financial fragility situation which occurs when there is “(i) High leverage, (ii) Low marginal propensity to import, (iii) Large foreign-currency debt relative to exports” pointing out that this is different from the financial fragility case such as the mismatch between short-term debt and long-term investments which Chang and Velasco (1999) handle (Krugman, 1999: 468).



2.2. The Crises That Stem From the Problems in the Balance Sheets of Corporations

Krugman (1999) examines the relationship between the balance sheets of corporations, capital inflows and currency crisis. In this regard, the balance sheet approach deals with the two main factors, which were not handled before in the currency crisis models, such as “the role of companies’ balance sheets in determining their ability to invest, and that of capital flows in affecting the real exchange rate” (Krugman, 1999: 460).

The assumptions of the models are as follows: “(1) the amount that domestic entrepreneurs can borrow from foreigners to finance investment depends on their wealth” (Krugman, 1999: 466), which is shown as follows: $I_t \leq (1+\lambda) W_t$. Where I is the current investment of entrepreneurs, which is limited by their wealth, W , and foreign borrowing, λ , which depends on the wealth of entrepreneurs in order to finance their investment, assuming that lenders impose a limit on leverage so that entrepreneurs can borrow at most λ times their initial wealth. “(2)... the wealth of each individual entrepreneur itself depends on the level of such borrowing in the economy as a whole, because the volume of capital inflow affects the terms of trade and hence the valuation of foreign-currency-denominated debt” (Krugman, 1999: 466-467), which is shown as follows: $W_t = ay - D - pF$. Where y is income, D is domestic debt, F is foreign debt and p is the real exchange rate.

Krugman (1999) handles the process going to financial crisis as follows: When a decline in capital inflows happens for any reason the balance sheets of domestic entrepreneurs are adversely affected since the value of their foreign debt increases, leading to the decrease of their wealth and reducing their ability to borrow, hence further reducing capital inflows (Krugman, 1999: 467). So, it can be said that the relationship between balance sheets and crises is as follows: By any reasons if negative expectations occur and capital outflows begin, the local currency depreciates and the firms get into trouble because of their existing debts in foreign exchange. Due to the worsening in their balance sheets they will not be able to borrow from abroad, thus not to invest; as a result, total investments in the economy and thus growth rate will decline, by realization of all negative expectations that led to capital outflows (Krugman, 1999: 467).

2.3. The Contagion of Crisis

2.3.1. Herding Behaviour: The Irrational Contagion of Crisis

If the capital outflows from a country start, then it is seen that the capital outflows also realise from the other countries, by spreading the crisis to the others. This result can stem from the prejudice on the cultural linkages between the countries in the investors’ minds or asymmetric information that leads to generalisation on region countries, by just tackling a sample country, due to the costs of collecting information from each country (Pesenti and Tille, 2000: 8-10). In addition, the decisions on the interest rates of the developed countries and monetary and currency policies have also significant impacts on the capital outflows from developing countries. All these also point out the high volatility of capital movements.



2.3.2. The Trade and Financial Linkages between Countries: The Rational Contagion of Crisis

The crisis in a country can spread to the other due to their “structural links and international spillovers” that make the two countries interdependent through, for instance, the trade channel. Moreover, it is argued that contagion can be seen even not through direct trade linkages. In this regard, it can be argued that devaluation in one of the countries, which would increase its competitiveness in international markets eventually, forces the other country to devalue its currency, especially if they sell their products in the same market. In addition, if two countries receive loans from the same foreign creditor, then the crisis, which begins in one of them, influences the other one negatively, due the fact that foreign creditor recall of his loans, including the other loans made to borrowers in the second country, as “a credit crunch” (Pesenti and Tille, 2000: 8).

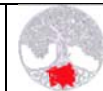
In addition, it is also pointed out the negative effects of derivative instruments as spreading crisis, namely, its contagion effect (Dodd, 2000, 2002). It should be noted that derivatives can easily turn into channels of contagion, which refers to the “the systemic risk in international level”, because of the fact that first, many derivatives involve cross-border counterparts and so, such counterparts will be adversely influenced by the losses of market value and credit rating in the crisis country, due to international nature of markets as herding behaviour or just the fact that they involve cross border counterparts. Second, in crises economies to meet collaterals selling securities in other markets is common (Dodd, 2002: 20).

Moreover, the presence of some specific types of derivatives such as Total Return Swaps (TRS), puttable debt and structured note, also affect the dynamics of crisis in emerging markets due to these specific types of derivatives have some significant risks in their natures which turn themselves into channels of contagion easily.

3. The Russian Crisis of 1998

Having devaluated its currency, rouble, declared a default on most of its government debt and a moratorium on debt principal payments to foreigners on 17 August 1998, Russia underwent a severe crisis (European Bank for Reconstruction and Development, 1998: 12). It is argued that the crash of the system goes to the early years of the transformation of a huge central economy to a market oriented one. From 1985 to 1991, a two-track reform package as first “glasnost” (openness) in the political arena and second “perestroika” (restructuring) in the economic arena were undertaken by General Secretary, Gorbachev. However, Golov and Matthews (1999b) maintain that this process caused a rapid distortion of the economy, with the collapse of the Soviet Union. The main problem in 1990-1991 was the budget deficit, which stemmed from the political competition having resulted with populist actions as increases in social expenditures and tax rate reductions (Golov and Matthews, 1999b: 3-4).

The following Table 1 indicates the economic situation of Russia in the 1990s:

**Table 1:** Main Economic Indicators of Russia in the 1990s

		1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Nominal GDP	USD bn				171.4	276.2	310.5	388.5	401.3	271	195.9	259.7
GDP per capita	USD	0	0	0	1155	1861	2093	2622	2713	1835	1331	1772
GDP growth (real)	% yoy	-3	-5	-14.5	-8.7	-12.7	-4.1	-3.6	1.4	-5.3	6.4	10
CPI	% yoy eop		161	2506	840	219.4	131.3	21.8	11.1	84.4	36.4	20.2
CPI	% yoy aop	6	158.3	1571	874.3	307.5	197.5	47.9	14.7	27.7	85.7	20.8
Oil price, brent blend	USD/bbl aop	23.7	20	19.3	17.1	15.9	17	20.6	19.2	12.8	17.8	28.4
Current account	USD bn			3.1	-2.7	8.3	7.5	11.7	-0.1	0.2	24.6	46.8
Current account	% GDP			-12.7	-1.6	3	2.4	3	-0	0.1	12.6	18
Intern. reserves (excl. gold)	USD bn eop		0	2	5.8	4	14.4	11.3	12	7.8	8.5	24.3
External debt	USD bn		67	108.3	112.6	132.1	134.3	137.6	170.8	189.9	179.7	158.2
External debt	% GDP	0	0	0	0	0	43.3	35.4	42.6	70.1	91.7	60.9
External debt (gov. & mon. aut.)	USD bn		67	108.3	112.6	127.5	127.5	128.5	138	160.4	150.5	127.5
External debt (gov. & mon. aut.)	% GDP			245.9	65.7	46.2	41.1	33.1	34.4	59.2	76.8	49.1
Short-term debt	USD bn	11.8	12.6	13.1	8.2	9.8	10.2	12	5.9	14.7	15.7	15.6
Short-term debt	% reserves				140.9	245.1	70.9	106	45.8	188.8	186.2	64.4
Fiscal balance	% GDP						-4.9	-7.4	-6.4	-4.8	-1.2	2.4

Source: Deutsche Bank Research, <http://www.dbresearch.com>.

After the collapse of the Soviet Union and building of the independent Russia, the pure market oriented approach rapidly and completely took place in the country. However, between 1989 and 1996, annually 8 per cent decline in GDP and an enormous inflation of 1500 per cent in 1992, pointing out a hyperinflation (Golov and Matthews, 1999b: 3-4), and as a result of this inflation and lack of confidence in government policies, the dollarization problem with a 10 per cent of GDP (Buchs, 1999: 710) were experienced. It was a result of several factors, most of which were stemming from the Soviet's economic and social legacy. It is noted that consuming more than one third of the GDP the Soviet defence sector, with the supporting of millions of Russian citizens in the "company town", constituted an old style economy of the 1930s and 1940s, having wasted resources without creating revenues, by the support of the state (Golov and Matthews, 1999: 3-4). In this regard, Tomita (2000) also argues that the high budget deficits of government stemmed from the failure of tax collection due to some unproductive tendencies of the enterprises that got used to government subsidies, coming from the past system (Tomita, 2000: 6).

On the other hand, in this transition process, it is stressed that almost overnight the destruction of "the tight production and supply links", which constituted the core of the centrally planned system, with the accompanying payments system, made the economy prone to crisis. The mechanism worked as follows: Since the most of the real sector entrepreneurs, especially the energy sector, was not operating productively, due to their "non-modernisation of long-term equipment", the costs were too high. By the price liberalisation, the bills were not able to be afforded by customers. Due to these arrears of the customers, both inter-enterprise arrears and tax arrears were experienced, having led, in turn, the fact that government could not afford the payments to the public employees and pensioners. This cycle created virtual economy in the Russia, which is defined as "an economy in which what is reported, especially about the industrial sector, bears little resemblance to the realities of the situation. [So] The



gap between the virtual and the real economy in Russia is manifested in unpaid wages, taxes, pensions and so on...” (Golov and Mattheews, 1999b: 1, 16). Due to this virtual economy, between 1996 and 1998, although Russia made a number of progresses in the political development, market development, policy making, international trade and economic activity such as the decrease of inflation in 1997 and tendencies in increase of GDP, and several restructuring reforms as practical military reform, reform of enterprises, a contest system of purchases of state etc., the overall picture was not as much as perfect as the official data indicated (Golov and Mattheews, 1999b: 6-7, 12).

Due to some faults about tax system, such as tax exemptions in huge amounts and also overlapping federal and local taxes, which created unaffordable tax burden to entrepreneurs, tax evasion, different from the tax arrears, mentioned above, was experienced. So the underground economy of unrecorded cash, deals, and second job, the so called “shadow economy”, which is predicted as up to 70 per cent of the economy, with the ratio of two thirds of entrepreneurs that were not paying taxes (Golov and Mattheews, 1999b: 16-19), were added to this big picture. All these issues constituted the pre conditions of the crisis. In 1995, it is noted that Russia adopted a pegged exchange rate system as a corridor or band (\$ 1= Rb 4,300-4900) and a more strict monetary policy in order to reduce its hyperinflation and create financial stability. As a result, in 1995 CPI was reduced from 130 per cent to 22 per cent in 1996 (Tomita, 2000: 6).

Due to the fact that since 1995, within the stabilisation programme, Russian government did not use the tool of “printing money” to fill the gap in its budget, in order not to create inflationary pressures, and also could not increase adequate taxes, it started to use some government bills, such as GKO, short-term high yielded zero-coupon Russian Government Treasury bill, and OFZs, medium and long term government bonds, in order to borrow domestically first (Golov and Mattheews, 1999b: 19-20). However, the short term borrowing of government was not used for short-term economic problems, having led risks for future. In addition, in 1997, these markets were opened up to foreigners, which took positions in derivative markets by signing forward contracts with the central bank of Russia. Beside them Russian banks, which also did not want to miss the speculative gains, started to borrow from abroad by “registering a rise in their foreign liabilities as a proportion of assets (mostly in domestic government securities that were to become worthless) from 7 percent in 1994 to 17 percent in 1997” (Desai, 2000: 49). All this created risks in terms of open positions in their balance sheets and time inconsistency.

By the time, the short term debt of Russian government reached huge amounts as Palma (1998) put it: “Keynes once said that if a customer owes (say) 1 million sterling to a bank, it is the customer’s problem. But if the debt is 100 million sterling, it is the bank’s problem. If he were alive today he would probably add that if the debt is 200 billion US dollars (which is what Brazil and Russia owe today), then that would be everybody’s problem” (Palma, 1998: 798).

In the mid-1997, in this highly fragile and prone to crisis economic conditions of Russia, some external shocks were experienced. Golov and Mattheews (1999b) list them as follows: 1- Sharp fall in the demand of raw materials, such as oil and natural gas, which were the most important export items of Russia due to the Asian crisis and the warm weather conditions in the Northern hemisphere. 2- The increase of the global supply of such items by the decision of the OPEC. All these created drastic falls in export gaining of Russia (Golov and Mattheews, 1999b: 24). Desai (2000) maintains that due to the collapse of the South East Asian currencies, because of the Asian crisis and the fall in oil prices and nonferrous metal prices, combined with the sharp increase of the interest costs of the foreign



borrowing, influenced by the Asian crisis negatively, current account was negative in the amount of five billion dollars. The massive capital outflow could not be stopped although a dramatic increase in interest rates was realized, as 150 per cent, in June 1998 (Desai, 2000: 50).

On the 17th of the August, 1998 despite the IMF loan of 4.8 billion dollars, the Russian government declared its crisis by having devaluated its pegged exchange rate through reducing its corridor, having declared a 90- day moratorium on private foreign debt and having announced a long term debt for refinancing after it had closed the GKO market. In 1998, the inflation reached 85 per cent, real rate of economic growth reduced to -4.9 percent (Tomita, 2000: 7).

4. Explaining the Russian Crisis within the Framework of the Third Generation Models

Since the third generation models can be handled as a combination of theories and also share some significant points with the other two models by handling both the fundamentals and non-fundamentals such as self-fulfilling and multiple equilibria, it seems it is better to evaluate the Russian crisis mainly within the framework of the third generation models. This is due the third generation models much more focus on micro economic fundamentals, beside macroeconomic ones, combining alternative theories such as overly rapid and complete liberalisation, financial fragilities, financial market failures, highly volatile capital flows and contagion problems which the Russian case extensively covers.

As Golov and Matthews (1999a) put it "...Failure of the Russian market system stems from a misunderstanding of the role of institutions in capitalism and underestimation of the length of time necessary for such institutions to evolve...Early reformers and their Western advisers assumed that such institutions would emerge almost overnight if only assets were privatised and markets created..." (Golov and Matthews, 1999a: 2-4). Moreover, although the sequencing of the liberalisation process can be crucial to have the benefits of liberalisation and to avoid its possible detriments to developing economies Golov and Mattheews (1999b) argue that in the Russian case such sequencing was not implemented. In this regard, although the lack of competitiveness of the real production sector was the case, domestic real sector liberalisation was not made before external market liberalisation and domestic financial market liberalisation. So Golov and Mattheews (1999b) argue that it caused huge decreases in the real production sector, namely fixed capital investment, by the result of import competition with the appreciated exchange rate (Golov and Mattheews, 1999b: 13). On the other hand, the radical economists maintain that not the lack of the sequencing of the liberalisation but the liberalisation/neoliberalisation, itself, is the main problem behind the crises. In this regard, Kotz (1999) argues that on the way going to the Russian Crisis "the new capitalism", which is referred to the one where investing in "financial sector" is the key factor, lead to the "financial boom" in Russia that was driven by the "two gold mines" such as "oil profits" and "interest payments on public debt" (Kotz, 1999: 6-7). Kotz (1999), which maintains that behind the Russian crisis there was the "distorted economy" in Russia which had been produced by the neoliberal perspective, blames the neoliberalism for the Russian Crisis (Kotz, 1999: 6).

It can be argued that in the transition economies where the whole economic system with the tendencies of people and corporations, which is the most difficult one to change, are tried to be altered, and such transformations are forced to be done in short times, then the government cannot be the only guilty in this failure. On the other hand, Boettke (1999) argues that the shock therapy was needed since "the judgement of the attending doctor the patient had so lost sight of reality that a drastic measure was



required to get the patient back on a path toward recovery” (Boettke, 1999: 377). However, in reality, it seems that the doctor made the patient “paralyzed” in this shock treatment.

The payment arrears cycle, pointing out the early and mismanaged shifting to the capitalist system, which has long term experiences of more than hundred years in the west, created virtual economy, which points out the lack of transparency and information distortions, as market failures, which can be handled in terms of the third generation models. The underground economy of unrecorded cash, deals, and second job, the so called “shadow economy” refers the “dual economy”, which is the main distortion of the market economy, pointing out the none operating of price mechanism and thus, market failures, as pre-conditions of the crisis, which can be handled in terms of the third generation models.

In this regard, Golov and Mattheews (1999b) point out that the rapid pace of liberalisation and privatisation in the transition process of “a heavily militarised, centrally planned economy to a free market economy” (Golov and Mattheews, 1999b: 4), which have not sufficiently accompanied with the development of institutions to back a well functioning market economy, caused market distortions as well as the huge gaps between sectors, such as banking sector and real sector. Buchs (1999) argues that all these distortion of fiscal situation by large budget deficits and domestic banking system focusing on speculative activities rather than financing the real side of the economy constitute the financial fragility of the Russian economy, creating the vulnerability to the crisis (Buchs, 1999: 700-709), which can be handled in terms of the third generation models.

Although, the year 1997 was marked as low inflation, stable exchange rate and increase in GDP since 1992, and surplus in CAD, Golov and Mattheews (1999b) argue that the structural problems stemming from the markets were the hidden risks and the official data was not indicating the realities (Golov and Mattheews, 1999b: 18). However, the positive expectations of the financial creditors, with the prediction of “heading for a boom” made massive capital inflows into the country, especially the short-term ones that financing the budget deficit by government bills. Buchs (1999) notes that the financial support from the IMF and WB, and the likely diminishing of political uncertainties, high profitability in government bills (Buchs, 1999: 689), and more importantly, pegged exchange rate supported the “virtuous cycle of economic expansion and capital inflows” due to “stability” that pegged exchange rate created, pointing out the bubbles in assets in the Russian economy. In this regard, it can be said that the self-fulfilling expectations of the foreigner creditors played a vital role in this case, by also pointing out the negative expectations, since if it becomes the case that “once doubts arise about the sustainability of a country’s current account deficit, huge capital inflows can become huge capital outflows” (Tomita, 2000: 8-9). In this regard, Buchs (1999) maintains that the role of Asian crisis in creating pessimistic investor behaviour triggered the capital outflows, by having created liquidity problems and currency collapses (Buchs, 1999: 699) as well as some specific types of derivatives having required margin calls or collaterals in the wake of the crisis (Dodd, 2002: 8-14).

Gurvich and Andryakov (2002) put the Russian crisis as “...the macroeconomic policy pursued by the monetary authorities was not robust in the medium run, but, in the absence of external shocks, it was far from a crisis area, and required moderate, feasible modifications to be viable” (Gurvich and Andryakov, 2002: 10). They argue that Russian crisis was “ignited by unexpected external shocks” in the conditions of the dependency of government to the investors’ decision to roll-over the debt, due to its high amount of short term debt, which was below its current fiscal revenues, and because of the fact



that the government tackled the problem as a short term liquidity problem, which would be recovered by the increase of the prices of her export items (Gurvich and Andryakov, 2002: 10).

As an external factor that triggering the crisis the IMF has been criticised due to its financial support was too little and too late compared to the Brazil's. Moreover, the IMF has been also criticised due to its moral hazard problem, accepted as having forced Russia to change the debt payment action, under the influence of US, which was initially no immediate payment to dollar-denominated securities, and thus, having created additional significant burden to Russian government. All these factors with mostly the ones stemmed from the market failures both in the domestic and international financial arena can be handled in terms of the third generation models.

On the other hand, the short term borrowing of government was not used for short-term economic problems, having created risks for future. In this regard, Desai (2000) argues that in 1997, in Russian case, these short term government bonds markets were opened up to foreigners, which took positions in derivative markets by signing forward contracts with the central bank of Russia. Beside them Russian banks, which also did not want to miss the speculative gains, started to borrow from abroad, having created risks in terms of open positions in their balance sheets and time inconsistency (Desai, 2000: 49). All these point out the complex and speculative picture of financial system that resulted with the crisis, which refer to the third generation models.

It is noted that the legal framework for finance and also implementing process were inadequate, so that vulnerability of banking sector was high, due to their open foreign exchange positions and off-balance sheet-activities like derivatives, especially TRS. Moreover, the banks especially financed government deficits, not the real sector, causing banking sector and government highly vulnerable to the volatilities of international capital markets (European Bank, 1998: 2-9). In this regard, Taylor (1998) argues that the Russian financial institutions, especially banks were in short position in dollar by borrowing from abroad in huge amounts and in long position in rubbles in order to speculate on the short-term liabilities of government as GKO's (Taylor, 1998: 675). It can be said that all these refer to micro economic weaknesses and market failures, since the financial markets do not work properly by not financing the real sector and their investments thus, refer to the third generation models.

5. Conclusion

It can be said that among the other financial crises in the 1990s, such as the Mexican Crisis and the South East Asian Crisis, the Russian Crisis maybe seems the most appropriate one to be handled in terms of the first generation models, due to her high budget and the current account deficits, pointing out her macroeconomic weaknesses. However, if it is more deeply and comprehensively looked at the determinants of the crisis it can be argued that constituting a typical case of the 1990s' crises, which happened in the unstable and fragile international markets of the 1990s, it has several compounds, which cannot be easily tackled in terms of either first generation or second generation models.

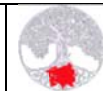
First of all, there were significant micro fundamentals behind the government deficits and the huge positions of the foreign investors. It is argued that the budget deficit resulting with the crisis, stemmed from a sharp increase in interest rates, which were already relatively high compared to abroad. Due to the fact that since 1995 Russian government did not use the tool of "printing money", inconsistent monetary policy was not the case. In addition, borrowing from abroad, namely using NCI, so indirectly creating CAD, was not the case, initially. Moreover, her later CAD in 1998 was mostly



stemmed from the external factors as a result of the contagion of the Asian crisis and sharp decreases in oil and natural gas prices, pointing out the falls in its export gains. However, the short term borrowing of government was not used for short-term economic problems, having created risks for future. In this regard, Russian financial institutions, especially banks were in short position in dollar by borrowing from abroad in huge amounts and in long position in rubbles in order to speculate on the short-term liabilities of government as GKO's (Taylor, 1998: 675). All these refer to micro economic weaknesses and market failures, since the financial markets were not working properly by not financing the real sector and their investments.

Second, although it is argued that sequencing of the liberalisation process can be crucial to have the benefits of liberalisation and to avoid its possible detriments to developing economies in the Russian case such sequencing was not implemented. So it caused huge decreases in the real production sector, by the result of import competition with the appreciated exchange rate (Golov and Mattheews, 1999b: 13). It can be argued that in the transition economies where the whole economic system with the tendencies of people and corporations, are tried to be altered, and such transformations are forced to be done in short times, then the government cannot be the only guilty in this failure. The payment arrears cycle, pointing out the early and mismanaged shifting to the capitalist system, which has long term experiences of more than hundred years in the west, created virtual economy, which points out the lack of transparency and information distortions, as market failures. If the contagion issue of the Asian crisis and also derivative transactions, both in terms of the creating and the triggering effects, are added to this big picture and also the moral hazards at three levels including the international one as the IMF's are considered then it gets more complex to define it basically as a first or second generation model.

Since the third generation models can be handled as a combination of theories and also share some significant points with the other two models by handling both the fundamentals and non-fundamentals such as self-fulfilling and multiple equilibria, it seems it is better to evaluate the Russian crisis mainly within the framework of the third generation models. This is due the third generation models much more focus on micro economic fundamentals, beside macroeconomic ones, combining alternative theories such as overly rapid liberalisation, financial fragilities, financial market failures, highly volatile capital flows and contagion problems which the Russian case extensively covers.

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