

Russia's Financial Crisis: The Failure of Neoliberalism?

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November, 1998

This article was published in *Z Magazine*, January, 1999, 28-32.

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This past summer Russia suffered a financial crisis so severe that it not only brought down former Prime Minister Sergei Kiriyenko's government but also shook financial markets around the world, including on Wall St. This episode may appear to be just one more failure of the post-Soviet Russian regime, in its so far futile quest to build a stable and prosperous capitalist system. However, there is another side to the Russian travail. Russia's experience in applying neoliberal economic policies can be seen as a metaphor for the destructive social and economic trends unleashed by neoliberalism throughout the world in this decade, including right here in the U.S.A.

Neoliberalism is the contemporary incarnation of the old ideology that asserts the superiority of an unregulated, or "free market," capitalist system. That ideology, which had been dominant in Europe and the U.S. in the 19th century, lost influence after the Great Depression persuaded even apologists for capitalism that the survival of the system required an interventionist welfare state. Then in the late 1970s and early 1980s the old free market religion returned in Britain and the U.S., when the postwar system of regulated capitalism encountered a period of economic and financial instability.

Just when that wave of free market enthusiasm seemed to be waning, it received a powerful boost from the demise of the Soviet Union at the end of 1991. The Soviet demise was interpreted as the final vindication of free market theory, or neoliberalism as it has come to be called. Right wing theorists had always insisted that public intervention in the market, whether reformist or radical, inevitably led to despotism, with Soviet political repression held out as the living proof. Now the pundits claimed that the Soviet demise had also proved that any effort to build a more just economy through collective action was bound to lead, sooner or later, to economic stagnation and eventual collapse. That is, any effort to build socialism, or even engage in social reform through intervention in the market, would not only snuff out freedom but would also bring eventual economic collapse.

In the 1990s the U.S. government, both under Republican President Bush and Democratic President Clinton, has sought to fashion a new world order based on neoliberalism. This calls for elimination of government intervention in the domestic economy and the dismantling of the welfare

state. It demands abolition of barriers to free movement of goods and capital across national boundaries. The only important economic function left to government is the stabilization of the price level through balancing the budget and keeping money and credit scarce.

Russia's Neoliberal Experiment

Nowhere has the neoliberal mission been more successful in determining policies than in Russia. Since 1992 Russia's new leadership, under President Boris Yeltsin, knowing nothing of actual capitalist history, including the role of interventionist states in making capitalism a viable system, took the simplistic neoliberal theory seriously, and has done its best to follow the neoliberal prescriptions to the letter.

American economists do not often get a chance to conduct an experiment, at least not on a large scale. In 1992 they were suddenly handed Russia, a country of some 150 million people. At conferences on Russia that year the glee was evident, as U.S. economists discussed how to remake Russia's economy and society. They had found an ideal opportunity to demonstrate that, once a country burdened by a state run economy was relieved of its burden, a prosperous free market system would spring to life. All the state had to do was immediately eliminate central planning and price controls, privatize state enterprises, and open the country to free trade and investment. To stabilize the price level, the plan called for a dose of responsible fiscal and monetary policy, that is, slashing state spending and tightly restricting money and credit. The famous neoliberal trilogy of liberalization, privatization, and stabilization would rapidly bring a free market utopia to Russia. By doing so, the futility of heresy would be proved once and for all, by the successful conversion of the devil himself.

Critics warned that simply dismantling the Soviet planned economy would not give rise to an effective capitalist system. They noted that history shows that it takes decades of institution-building before a functioning capitalism can arise. They pointed out that, given the presence of superior competitors in the world capitalist market, only active state guidance and assistance could nurture productive capitalist enterprises in Russia. They warned that large cuts in government spending and

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tight monetary policy would guarantee a severe depression and deprive enterprises of the capital needed for restructuring. The critics' warnings were ignored by the economic theorists at the International Monetary Fund (IMF) who, knowing little about the actual history of capitalism and even less about that of Russia, plunged ahead with their plans for a new Russia.

The result of the neoliberal experiment in Russia has been nearly seven years of economic devastation on a scale unseen anywhere else in peacetime in this century. As of the end of 1997, according to official statistics Russia's gross domestic product had fallen by half since 1991 and its investment in new plant and equipment by three-fourths. The only relatively bright spot has been the raw materials and metals sector of Russia's economy, which has declined less than the rest. In a few years what had been a diversified industrial economy has been transformed into a raw materials exporting appendage of Western capitalism. Russia has grown dependent on imported Western consumer goods and even imports more than 40% of its food. The IMF-inspired tight monetary policy has made money so scarce that 70-80% of transactions are conducted via barter.

The majority of Russia's population has been impoverished by the neoliberal experiment. The buying power of the average real wage fell in half, but even the meager wages are usually not paid on time. To comply with the IMF's stringent budget-cutting requirements, the government simply stopped making timely payment of wages, pensions, and debts to suppliers. This sent a wave of non-payments of wages and taxes coursing through the economy. One study estimated that in 1996 30% of workers were paid in full and on time, 31% were paid late, and 39% were not paid at all. Much of Russia's population survives by growing vegetables in small back-yard plots for their own consumption.

Some have not survived at all. Since 1991 more than two million premature deaths have resulted from increases in alcoholism, suicide and murder, infectious diseases, and stress-related ailments. A recent study estimated that 2 million children have no family caring for them, of whom only 650,000 are in orphanages. The rest live in abandoned houses or in the sewer system of large cities.

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While the majority have sunk into desperation, a few well-placed insiders have been handed the gems of the Soviet inheritance. Russia's new oil and gas magnates, bankers, speculators, and real estate operators live out a Gilded Age stereotype of conspicuous consumption. These new "oligarchs" control all the major mass media and, until the recent financial meltdown, dominated the government. Their rivalries often turn murderous, as contract killings, carried out by laid off military specialists, have become commonplace.

Russia's collapsing economy did not prevent a boom in its financial markets. Russia's new oligarchs made fortunes exporting oil, speculating in securities, and lending money to the government. Anxious to obtain a share of these gains, foreign portfolio capital began to flow in, culminating in a \$44 billion inflow in 1997. That year Russia had one of the world's best performing stock markets, as oil and bank stocks were grabbed up by domestic and foreign investors. Foreign banks helped to finance an orgy of speculation in Russian government bonds, which paid real interest rates of 77% in 1995, 44% in 1996, and 11% in 1997.

While the Russian disaster may seem bizarre and extreme, its central features bear an uncomfortable similarity, in kind if not in degree, to the trends that neoliberalism has unleashed elsewhere. In the U.S. during the 1990s, neoliberal policies have dominated, including deregulation of business, cutbacks in social welfare programs, pursuit of balanced budgets, tight monetary policy, and freedom for international traders and investors. The dismantling of the regulationist state has been much less complete here than in Russia, and the economic and social consequences have likewise been milder. However, the change has been in the same direction. In the 1990s the U.S. has experienced sharply rising inequality as the rich have gotten richer while the average real wage declined and poverty and homelessness spread. The stock market reached record heights, while the real economy since 1991 has posted the most sluggish business cycle expansion of the entire post-World War II era -- real GDP grew at 2.8% per year while the Dow Jones average grew at 14.0% per year after correction for inflation. As in Russia, we also are burdened with a politics and mass media run ever more openly by big money.

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The Russian experiment shows what actually happens if neoliberalism is followed to its logical conclusion, with the state more or less destroyed to leave the field open for the free market. What follows is a brutal war within the elite for property and privilege. Great fortunes are gained, via transfer of resources and the milking of nature's gifts and the inheritance of the past, but nothing productive takes place. From its beginnings capitalism has been able to produce economic progress of a sort only when it operates within a strong framework of state, and other non-market, regulation. Such a framework, built up over generations in the US, is not easily dismantled, even by a succession of presidents dedicated to doing so. Russia shows what happens if the full conditions of free market utopia are actually fulfilled.

Behind the Russian Financial Collapse

In the summer of 1998 the disjuncture between Russia's booming financial markets and its collapsing economy came to an end as the financial crisis struck. Although not its ultimate cause, the Asian financial crisis was the precipitating event for Russia's sudden financial collapse. Starting in the summer of 1997, a financial crisis hit Thailand, Malaysia, Indonesia, and finally South Korea. The IMF moved in quickly with big bailout packages and austerity plans, and investors hoped the crisis would be contained. However, by the late spring of 1998, the hopes for recovery in Asia dimmed, as economic forecasts for the IMF's new wards in Asia grew increasingly pessimistic. This made investors wary of all "emerging markets," and foreign money began to move out of Russia.

At the same time, partly because of the disappearance of East Asia's formerly rapid growth, a surplus of oil appeared on the world market, driving down its price. Oil exports had been Russia's main source of foreign currency earnings, but this source of export earnings fell by almost half in the first six months of 1998, compared to the same period in 1997. Foreign investors knew that, without large oil export revenues, which had assured a trade surplus every year, Russia would be unable to service its foreign debt. The ebbing oil revenues began to speed the exit of foreign capital.

Russia's financial collapse was not an unfortunate accident -- it stemmed from the distorted economy which neoliberalism had produced in Russia. The financial boom was driven by two "gold

mines," oil profits and interest payments on the public debt. Primary products such as oil tend to have very unstable prices unless an effective cartel is operating – and none has been in operation since the decline of OPEC after 1979. Had no Asian crisis occurred, another event would eventually have brought a drop in oil prices, undermining the financial boom.

The huge profits from investing in Russian bonds were bound to turn into losses. The Russian government had for several years been financing its budget deficit by selling short-term bonds. Russia was unable to reduce its budget deficit, which stayed around 5% of GDP, because, despite its steady reduction in public spending, tax collections declined just as rapidly. Only a magician could have conjured up tax revenues from Russia's impoverished population or money-losing privatized enterprises, while the new oligarchs were too powerful for Russia's weakened state to tax. Unable to collect much taxes, Russia had to rely more and more heavily on borrowed funds. Russia had become vulnerable to a classical debt trap, should interest rates suddenly rise.

As the Asian crisis fostered capital flight in the early summer of 1998, the interest rate Russia had to pay to attract buyers for its new bonds rose to 300%. In July monthly interest payments on Russia's debt rose to a figure 40% greater than its monthly tax collections. One last IMF bailout was arranged that month, for \$22.6 billion, after a desperate plea by Boris Yeltsin to Bill Clinton. It held for a few weeks, enough time for the first installment of \$4.8 billion to arrive and immediately disappear. By mid August money was fleeing again, and this time the US/IMF refused further aid. On August 17 Russia was forced to postpone payments on its foreign debt for 90 days, announce a restructuring of its entire debt, and devalue the ruble.

World-Wide Consequences of Russia's Financial Collapse

Russia's financial meltdown of August, 1998, had three key impacts. It spread panic throughout the world financial system. It spurred questioning of the neoliberal model around the world. And it produced what appears to be a decisive turn away from neoliberal policies in Russia itself.

The U.S. stock market, following a decade of rapid and accelerating increases, began to slip

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in early August of 1998, amid fears about Asia and Russia. Then the Russian financial collapse sent world stock markets tumbling. The Dow Jones Industrial Average fell 984 points, or 11.5%, in 3 days at the end of August, to a level 19% below its July peak. This more than erased the year's market gains. The U.S. stock market remained depressed until October, when a series of interest rate reductions by the Federal Reserve propelled it back upward.

The late summer stock market stampede stirred fears of a 1930s-style world financial collapse. There was a "flight to quality," meaning that international investors suddenly feared holding securities that posed any repayment risk at all. Investors fled all kinds of stocks and private corporate bonds, seeking the safety of U.S. Government securities, thus causing difficulty for corporations in need of borrowed funds. The Russian crisis prompted an accelerating flight of capital out of Brazil, the world's eighth largest economy, forcing the IMF to intervene with a \$41.5 billion bailout package.

It may seem surprising that a financial crisis in Russia, whose shriveled economy is slightly smaller than that of the Netherlands, could shake the entire world capitalist financial system. Some big international investors, such as Bankers Trust Company, lost a few hundred million dollars on Russian bonds, but losses on that scale were easily absorbed by such giant institutions. The world-wide impact stemmed from the failure of the U.S.-IMF team to control and stop the Russian financial crisis, coming right after investors realized that the effort to contain the Asian crisis had also faltered. This shook the faith of international investors in the safety of the international financial system.

The global financial crisis that followed the Russian meltdown has spurred widespread questioning of the neoliberal model. The financial crisis imposed large real costs on many countries, rapidly driving down living standards and causing mass unemployment. Observers could not fail to notice that China and India, two large countries that did not open their financial markets to free capital flows as demanded by neoliberal theory, escaped the financial crisis largely unscathed. China, the world's best performing economy by almost any conventional measure over the past two

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decades, has entirely rejected the neoliberal model, instead following a gradualist and heavily state-guided route toward capitalism. Even within the World Bank, doubts have been raised about the wisdom and effectiveness of some aspects of the neoliberal strategy. The rising chorus of criticism, some moderate and some more thorough-going, has caused predictions of the imminent demise of neoliberalism. These predictions are probably overly optimistic, although a swing back in the direction of regulated capitalism is a possibility, if far from a certainty at this point.

Whether or not neoliberalism has been vanquished in the world at large, the Russian financial crisis appears to have finished it off within that country. The financial crisis rendered most of Russia's big banks insolvent, as their large holdings of government bonds fell to 15% of their former value. This dealt a sharp blow to the new oligarchy, several of the richest and most powerful members of which are the heads of newly insolvent banks. As the value of the ruble fell by some 2/3, consumer goods disappeared from the shelves in anticipation of large price increases – the first time this had happened since the last years of the Gorbachev era. The new middle class suddenly was unable to withdraw money from the bank, and even when they could, they were being priced out of the market for their usual import purchases. While the neoliberal regime of President Yeltsin had previously impoverished ordinary people, now its policies had taken away the savings of the middle class, which had loyally supported the Yeltsin regime, and even undermined the oligarchy, its most important political base.

It is not surprising that the regime had to struggle to survive. The oligarchy demanded that President Yeltsin fire the pro-U.S. Prime Minister, Sergei Kiriyenko, who had presided over the financial collapse, and replace him with one of their own, former Prime Minister and natural gas magnate Viktor Chernomyrdin. However, the suddenly emboldened opposition in the duma, Russia's ordinarily toothless parliament, led by the Communist Party, forced Yeltsin to withdraw Chernomyrdin's nomination. Yeltsin was compelled to name as prime minister Yevgeny Primakov, a political centrist, along with a high-ranking Communist, Yuri Maslyukov, as First Deputy Prime Minister in charge of the economy.

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The new government is widely seen as representing center and left opposition forces, which have long argued for abandoning the neoliberal strategy. The policies of the new government are not yet entirely clear, but the IMF has seen enough to hold up further installments of its bailout loan. The IMF is demanding continuing cutbacks in government spending, higher taxes, and tighter money and credit. The Primakov government appears ready to do the opposite. It has said it will immediately begin paying all wages and pensions on time, and start to pay back wages, printing money to do so if necessary. It talks about asserting control over and restructuring Russia's banks. It plans to reduce some key tax rates, such as the value-added tax. It is requiring exporters to sell 75% of hard currency earnings to the government. It plans to introduce price controls for essential consumer goods and for goods sold by monopolies. And it is seeking to renegotiate the payments on Russia's nearly \$200 billion foreign debt.

The Primakov government appears to be following a Keynesian-type expansionary policy, which it argues, with some merit, is fully justified in an economy that has contracted by some 50%. It appears ready to intervene actively to control certain prices, to allocate foreign exchange toward essential purposes, and to stabilize the banking system. Such policies potentially represent a workable first step toward ending Russia's long economic depression, as well as resolving Russia's financial crisis.

What long-run development path Russia will pursue depends on future political developments that are impossible to predict. However, the most influential opponents of Russia's failed neoliberal model have long viewed with favor China's alternative path from state socialism to capitalism. Primakov appears to be sympathetic to the Chinese path to capitalism, as do some leaders of the Communist Party. The Chinese strategy entails maintaining a strong state-run sector of the economy while promoting the gradual development of a private capitalist sector alongside it. Under this strategy, the capitalist sector eventually displaces the state sector as the dominant part of the economy – as has happened in China after 20 years of following this strategy. China has shown that this statist road is a potentially successful route from state socialism to capitalism.

The Quandary of the Left

The left faces a reality in which the only viable challenge to the neoliberal model, in Russia and in the U.S., comes from a renewed call for regulated capitalism. A meaningful demand for moving beyond capitalism would require two elements that are now missing. One is a clearly articulated vision of an alternative system. The second is a popular movement demanding radical change.

Russia has, on paper, a large and powerful left-wing party. The Communist Party of the Russian Federation dominates the duma. Its official program cites some of the most powerful passages from the writings of Marx and Engels, calling for a classless society, a genuine democracy based on soviets and workers' self-management, a society in which "the free development of each is the precondition for the free development of all."

However, few in Russia believe such words. Their appeal has been destroyed by seventy years of pseudo-Marxist theory as the official dogma of the repressive Soviet regime. Seventy years of state socialism also transformed the Russian population, which in 1917 overthrew the Tsarist regime and installed the world's first self-proclaimed revolutionary socialist government, into a depoliticized mass of people unable even to mount effective protests against their own impoverishment, the destruction of their society, and the loss of all of their social rights.

In this political vacuum, the neoliberal regime has ruled for nearly seven years on the narrow base of Russia's new oligarchy and its small new middle class. Even if the Communist Party wins the presidency, in the absence of a radical mass movement it is unlikely that a Communist-led government would go beyond seeking a more humane and effective path to capitalism. Real power is likely to go to the section of Russia's new propertied class which owns and controls the large part of Russian industry outside the raw materials and banking sector. This group has seen neoliberal policies decimate its holdings, and it is likely to pressure any new non-neoliberal government to follow an effective state-managed route to capitalism. Russia has a small and not very influential democratic left, which is forced to make a Hobson's choice between different routes to capitalism.

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The left in the U.S. faces similar problems. Neoliberalism here has been undermining the living standard and quality of life of the majority. This has generated various protest movements, including a newly activated, politically bold labor leadership seeking to defend the welfare of the majority of people. However, these protest movements have been unable to do more than try to save what remains of the welfare state. Until the left persuades a critical mass of people that capitalism, in any version, cannot bring a decent life for ordinary people, and articulates a believable vision of an alternative system, we will continue to be confined within oscillations between neoliberal capitalism and regulated capitalism. In the absence of such a vision and a radical mass movement, we on the left will remain critics of neoliberalism who cannot hope for more than a return to a Keynesian-type welfare state regime -- the very regime, in protest against which, many of us first began our journey to the left several decades ago.