

## The systemic threat of disintegration in Russia

by Konstantin George and Rachel Douglas

The cupboard is bare. Heads will roll. By the time of the Russian President's weekly Friday radio address to the nation on Nov. 28, it had dawned on him, and not only him, that his big political promise of the latter half of 1997, to pay state sector wage arrears by the end of the year, was in jeopardy, and that just beyond a failure on that account, could come the crash of the whole charade of this decade's Russian "reforms," in an explosion that dwarfs any other national-sector events in the process of global financial breakdown.

Boris Yeltsin expressed anger, that his wage schedule had been subverted. "The treasury has no money to pay debts to public-sector workers. The obligation of the government to pay them by Jan. 1 is in jeopardy," he said. He threatened to purge the government, yet again: "It's bad when people in the government often change, but it's even worse when bad ministers stay in place." The daily *Nezavisimaya Gazeta*, in a front-page cartoon, depicted Yeltsin as a medieval executioner, measuring the head of First Deputy Premier Anatoli Chubais, while sitting on a pile of skulls of previous, now departed right-hand men. The "Puppets" satirical program on NTV portrayed the whole Russian government, on its way to a session of the Inquisition.

A review of government work on economic policy and personnel set by Yeltsin for Dec. 1, was postponed for at least one week. In the interim, Yeltsin begged the State Duma, Russia's parliament, to give preliminary approval of a 1998 budget for the Russian state. The surviving members of the so-called "young reformers" clique in the government, around Chubais, plunged into a mad scramble for emergency financial aid.

By the beginning of December, the three main sources of cash for the wage pay-out and other state spending (of which

the largest line is debt service, accounting for over one-quarter of expenditures) had disappeared. The International Monetary Fund (IMF) still had a freeze on the latest \$700 million tranche of its three-year credit to Russia, stopped in October because of low tax revenues. The Russian government's plan to raise as much as \$2.5 billion more this year (double the 1997 amount to date) by the sale of state property, announced while Chubais ally Maksim Boyko was still privatization minister, had run aground on the shoals of the international financial crisis: The Nov. 23 auction of 34% of the shares of Eastern Oil Company, revenues from which were going to be used to pay the wage arrears, failed when only one bid was entered. Central Bank head Sergei Dubinin said on Nov. 25 that the privatization schedule had been thrown off by the international financial crisis, because Russian banks were finding it more and more difficult to borrow money.

Third, there was the stampede of foreign funds out of Russia's short-term state securities market, which had already reached at least \$5 billion as of Nov. 21, according to testimony before the Duma by Central Bank chief Dubinin. Financier Boris Jordan, in a statement the day before, estimated the total withdrawn by foreigners from the GKO (three- and six-month treasury bills) market at \$4 billion, and projected flight of another \$1-2 billion in December. Neither figure is iron-clad, because there is a four-week delay in settling up GKO transactions. By Dec. 3, Dubinin was saying that \$8.5 billion worth of GKO had been dumped. The biggest disinvestors in Russia have been South Koreans, who pulled out \$2-3 billion since late October, and Brazilians, with \$1 billion.

The Russian Central Bank has been spending as much as \$1-1.5 billion *every two days*, to intervene in the GKO market. As prices crashed and yields soared to 45% per annum, the

combined GKO holdings of the Central Bank and the state-run savings system, Sberbank, surpassed 85% of all GKOs! According to Dr. Sergei Glazyev's Department of Information and Analysis, at the Federation Council (upper house of parliament), "the bankruptcy of the Russian state" is at hand. The sober analysis by Glazyev's staff (see box) is echoed in panicky commentaries in international financial centers, where the geostrategic meaning of a Russia blowout, transcending the nominal financial dimensions, is not missed.

The London *Economist* of Nov. 22, for instance, projected an existential crisis of Russian state finances, if the GKO market were to collapse. When foreign investors pull funds out of the ruble-denominated GKOs, they convert their funds to dollars, which drains the Central Bank's reserves. If foreign investors were to pull out the entire \$20 billion they hold in GKOs, it would exhaust nearly all the Central Bank reserves, stressed the *Economist*.

The Dec. 3 status report from the Federation Council's research service clocked the process of drainage of Central Bank reserves at \$8 billion spent, \$4.5 billion still held in gold, and \$10 billion in currency remaining. Dubinin's Dec. 3 figures showed only a slightly less disastrous rate of dissipation: \$18 billion was left of gold and currency reserves, he said, of which \$4.8 billion was in gold, and \$13.2 billion in liquid cash.

The eagerness of London and IMF financiers to patch together an illusory bailout of Russia, is matched by that of the Russian comprador caste, which has ruled and bled Russia white by IMF-mandated looting practices for six years, but faces political elimination when the crisis of state finances reaches a point of no return.

### **S.O.S. from Russian free-marketeers**

Even the publicly reported sequence of events illustrates the desperation of the Russian comprador group and its Western superiors.

On Nov. 26, Central Bank Deputy Chairman Sergei Aleksashenko and Sergei Vasilyev, deputy head of the Presidential Administration, flew to Washington for urgent talks at the U.S. Treasury, the IMF, and the World Bank, seeking a multi-billion-dollar bailout package. Figures in the \$5-7 billion range, or as high as \$10 billion, were leaked as the magnitude of funding they wanted, to stabilize the ruble, although Chubais claimed that "no concrete quantitative targets or parameters were discussed." Minimally, if the frozen IMF tranche were issued, and matched by release of an early-1998 tranche, that would bring \$1.4 billion in IMF funds, and free up \$1 billion from the World Bank, which is contingent on IMF approval of Russia's performance. The duo was expected to begin making arrangements for a much larger bailout sum, to be provided by the United States, Germany, and other Group of Seven members.

On Sunday, Nov. 30, German Chancellor Helmut Kohl

met with Yeltsin in his residence outside the Russian capital. As Kohl confirmed to reporters at the airport as he departed, international financial aid for Russia was high on their agenda.

On Dec. 1, Yeltsin chaired a session of the Russian Security Council on the crisis of state finances and the Russian banking sector, the first time such an agenda at a Russian Security Council meeting, with the President in the chair, has been announced.

That same Monday, an IMF mission arrived in Moscow for a week of talks, which obviously would go far beyond the issue of the suspended \$700 million tranche. Chubais, acknowledging that that was not enough, let it be known that he was approaching Salomon Brothers, Crédit Suisse First Boston, Chase Manhattan, and Deutsche Morgan Grenfell—leaders among the private financial agencies involved in Russia—to assemble an emergency bridge loan for Russia. It would not be the first such private bailout operation, since George Soros stepped in to tide the Russian government over on earlier occasions, but it was the first time a high-ranking government official has publicly lobbied for such an intervention. On Dec. 4, a Crédit Suisse First Boston spokesman said that such a credit was indeed in the works, and wire services, citing London banking sources, described it as a 6- or 12-month \$2 billion credit. Russia will have to pay a premium.

In advance of putative larger funding packages, the Russian authorities are scrounging for any other peanuts they can find, to provide stability day-to-day. The only money actually scooped up, during the first week of December, was a \$200 million add-on to a Russian state Eurobond issue from earlier this year, managed by SBC Warburg of London. SBC Warburg announced success in finding suckers to buy the debt of a nearly bankrupt great power: In contrast to the earlier Eurobond issue, which was bought by Central Banks and large investment funds, the purchasers this time were medium-sized funds and retail buyers.

Chubais, in the Nov. 28 statement in which he tried to convince the press that Russia was not chasing after emergency funds from the IMF, revealed that he will try to resurrect a new version of his notorious "loans-for-shares" scheme, as an element of the government's scramble for funds. In "loans-for-shares" privatization, banks loaned money to Russian state-owned companies, then grabbed their stock at fire-sale prices, when the firms defaulted. This time, said Chubais, the object is the state's share in Rosneft, the largest remaining state-owned oil company. Its privatization will not be able to take place this year, but the funds are needed immediately, "given the difficulties that have now emerged," so the Rosneft shares may be used as collateral, to borrow funds in advance of the privatization auction.

### **Banking emergency**

On Dec. 2, the Central Bank convened leaders of Russia's top ten financial conglomerates, for emergency consultations

on the financial crisis. Under discussion was a potential \$1 billion fund, which the Russian banks would extend to the state until an international bailout materialized. *Kommersant-daily* reported on Dec. 3 that the meeting was a rough one, as the heads of Oneksimbank, Menatep, Sberbank, Most Bank, SBS-Agro, and Inkombank chorused that the Central Bank's measures were "absolutely inadequate" in the face of the world financial crisis, and accused Dubinin of planning to sacrifice some of the banks.

Bowing to one of the Russian bankers' demands, Dubinin on Dec. 3 announced that the Central Bank refinancing rate would "soon" be raised from 28% level to 36%. Two days earlier, the Central Bank had raised its Lombard rates, the rates on direct lending to the commercial banks, to 36%—attempting, without great success, to keep that rate higher

than the effective yield on GKO's. There is evident fear that the foreign investors' dumping of GKO's will trigger a last wave of exit from that market, by Russian GKO holders. But the bankers complained about the discrepancy between what they pay to borrow from the Central Bank, and the refinancing rate, which has been an approximate ceiling on the return on GKO's.

The banks, like the government, are scavenging for money. In the last week of November alone, Oneksimbank and Menatep got cash injections in the forms of European Bank for Reconstruction and Development loans of \$100 million and \$60 million, respectively. On Nov. 25, *Nezavisimaya Gazeta* reported that Russia's leading banks were in a financial crisis. Other such articles appeared in subsequent days. The Central Bank and most Russian media have worked over-

## Russia on the verge of bankruptcy

As of Dec. 3, the Information and Analysis Department of the Russian Federation Council estimated that Russian Central Bank foreign currency reserves could be exhausted in a matter of days. According to the service, which is headed by Dr. Sergei Glazyev, "the Central Bank is spending its last currency reserves to buy up the GKO's [short-term state securities] dumped by foreigners, who are liberating their capital from the Russian state securities pyramid. For this purpose, the Central Bank is selling \$1-1.5 billion of foreign currency every two days, and has spent approximately \$8 billion for this purpose already. The remaining currency reserves, totalling no more than \$10 billion, will suffice only until the end of the week, if the situation continues. After that, the financial bankruptcy of the state may ensue."

The ruble was allowed to fall to over 6,000 to the U.S. dollar, because the state could not afford to support it at a higher level. GKO prices fell by 3 to 5 percentage points at the beginning of the week of Dec. 1, while other state bonds fell by 5-10%. Yields on some state securities rose above 40% per annum.

The Information and Analysis Service reported: "The Bank of Russia's decision to widen the currency corridor testifies to the shortage of currency reserves. The volume of gold and currency reserves was estimated at approximately \$22.5 billion at the beginning of November [of which approximately \$4.5 billion was in gold], while the

volume of foreign investment in state bonds was estimated at \$20 billion. The outflow of Western investments from the GKO market, according to some estimates, has already reached \$4-5 billion. Support of the GKO market alone, cost the CB 1 trillion rubles per day [the week of Nov. 24]. . . . As of [Dec. 3], the CB is virtually the only remaining buyer for GKO's, and has concentrated around half of the total portfolio of such bonds; together with the Sberbank [state savings bank], which the CB controls, the total is 85-87%. Thus, in trying at all costs to preserve its reputation in the eyes of the IMF and foreign speculators, the CB is spending its last currency reserves to fulfill its obligations to them, shifting the entire weight of the looming financial collapse onto the population's savings in the Sberbank, and the state. In the framework of this policy, a decision is being readied to sell the gold reserves, that are in the CB's control, for the same purposes. But, considering that non-residents have had around \$15 billion in GKO's in the most recent period, even that may be insufficient to maintain the financial pyramid."

Instead of looking for IMF emergency credits, the Federation Council advisory service recommended imposing exchange controls: "In the national interest of Russia, it would be appropriate temporarily to halt the free export of capital from Russia and to stop, until the situation can be calmed, the free convertibility of the ruble into foreign currency for purposes of taking it abroad, with the exception of servicing import operations."

Unless these and related measures for de-dollarization of the economy are adopted, the report concluded, "paralysis may soon grip the entire monetary and payments system of the country. Operations on the interbank market have come to a halt, while interest rates have risen to 50%."

time to denounce “rumors” of a banking crisis, but, on Dec. 1, there was near-paralysis on the Moscow interbank exchange system.

Many of the top Russian banks have new troubles because of a peculiar derivatives operation, related to the agreement on rescheduling \$31 billion of old Soviet debt, which was signed on Dec. 2 between Russia and the London Club of commercial banks. Some \$28 billion of those debts were converted into long-term bonds, called VEB bonds after Vneshekonombank, the Russian Foreign Economic Bank. The VEB bonds were being bought and sold on a secondary debt market, already some months ago. Russian banks were the heavy buyers. They snapped up the VEB bonds at 70% of face value, betting on a rise in price, and tidy profits, after the London Club agreement were signed. If sold now, however, the VEB bonds would fetch only 50-53% of face value.

Once the London Club agreement is signed, on Dec. 5, these bonds must be recorded on the balance sheets of the Russian banks, showing the loss. Vneshekonombank Chairman Andrei Kostin, who negotiated the London Club agreement, said on Dec. 2 that the losses will be large, but “only in the tens of millions of dollars, not in the hundreds of millions of dollars.” However many grains of salt need to be taken with Kostin’s figures: The Russian banks will either have to sell the bonds at a hefty loss, or try to confine their losses to the balance sheet, hanging onto the VEB bonds in a gambler’s hope that they will rise at some later point.

## Panic

Despite the Russian government’s scavenger hunt for a bailout, no big package has come together. The IMF is still refusing even to speed up disbursement of the suspended \$700 million tranche, unless Russia meets new standards of austerity. Martin Gilman, head of the IMF Moscow office, said of the Dec. 1 mission to Russia, that new disbursements any time before February were unlikely, unless “the Russian authorities were to propose a series of measures, particularly in the fiscal area, that would significantly strengthen the package now under discussion.”

The dilemma of the IMF and affiliated financiers was expressed in the Dec. 2 lead editorial of the London *Financial Times*, which warned that the Russian financial crisis, particularly any “sharp drop in the ruble,” could have “dangerous political consequences” and “could even precipitate the downfall of the government.” In the event of such a collapse, “the risks to global political stability are evident,” but, the *Financial Times* fretted, the IMF cannot ignore Russia’s fulfillment of conditionalities and simply step in as lender of last resort, for “if it gave in to Russia, it would be inundated with requests for help from other countries” — which is the case already!

The Jan. 1 wage arrears deadline looms, without the means yet secured, for paying the more than \$1.5 billion due

to state sector workers (out of a total of \$10 billion public and private sector unpaid wages). Deputy Prime Minister Oleg Sysuyev said on Nov. 25, that the government would likely fail to do so. A week later, Sysuyev had to leave the capital to head an investigation in the Kuzbass, the politically volatile Siberian coal district where the worst coal mine accident in Russian history took the lives of 67 miners. The Russian coal industry is deep in arrears, for maintenance as well as labor, and early reports blamed faulty equipment for the methane explosion.

Yeltsin returned to Moscow on Dec. 4 from a state visit in Sweden, during which he exhibited the worst signs of fatigue and confusion since his return from heart surgery and pneumonia nearly a year ago. He rushed to the Duma on the morning of Dec. 5, where he motivated adoption of the government’s 1998 budget draft in the first reading (it passed, by a vote of 239-137), with words that referenced the global dimension of the crisis in his country, “Not only Russia, but the whole world, is awaiting the Duma’s decision, because the whole world financial system is in fever.”

## Free-trader Klaus falls in the Czech Republic

by Angelika Beyreuther-Raimondi

Over the weekend of Nov. 29-30, the Czech government of Prime Minister Vaclav Klaus fell, over a classic scandal of political-financial donations. One company which had profited from a privatization decision of the government, “donated” a sum of money, out of gratitude for receiving privileged treatment, and the money landed in an account of the governing party, the Civic Democratic Forum (ODS). The chairman of the party, Klaus, claims he knows nothing about it, while his vice chairman and former foreign minister, Josef Zieleniec, who had resigned suddenly in October, claims that Klaus was informed about all aspects of the millions of dollars worth of donations from the very beginning. Now, accusations are growing in the Czech media, that the ODS has illegal bank accounts in Switzerland with considerable sums of money parked in them, money paid in by those who profited from the great number of privatizations.

The government was a coalition composed of the ODS, the Christian Democrats (KDU-CSL), and the Civic Democratic Alliance (ODA). On Dec. 13, at the latest, a special party congress of the ODS will elect a new party leadership,