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The financial crisis in Russia

In 1991-92, the Russian Federation became the legal successor of the superpower, the Soviet Union. Russia is still a major power, and a nuclear power. Last year, in 1997, Russia attained a more dubious status as the "best emerging market" in the world. The *New York Times,* on Oct. 5, 1997, announced that "Russia is hot!" In the summer, *Business Week* advised that any investor who did not have the emerging market of Russia on his radar screen, was simply not serious. And Lord William Rees-Mogg, the former editor of the *Times* of London, said in June 1997 that Russia was not a bear, but a tiger, like the Asian Tigers, that was about to roar. These assertions were based on the insane assumptions of monetarism, run wild: that a speculative bubble means economic growth.

George Soros, the megaspeculator, abandoned his posture that his only interest in Russia was so-called philanthropic activity, and entered the Russian market as co-purchaser of a 25% stake in Svyazinvest, the national communications company.

As quickly as it inflated, this bubble has burst, beginning last fall in the first phase (October 1997 to January 1998) of the current global, terminal crisis of the greatest bubble financial system in history; and now, in the next phase (second quarter of 1998). **Figure 1** shows the plunge of the Russian Trading System index, the Russia stock market. More than $40 billion of nominal capitalization of Russian companies has been wiped out, in the 70% drop of the Moscow stock market, since its peak last summer (**Figure 2**). Volume has trickled down to almost nothing, in "the best emerging market" (**Figure 3**).

FIGURE 1
Moscow stock market RTS index

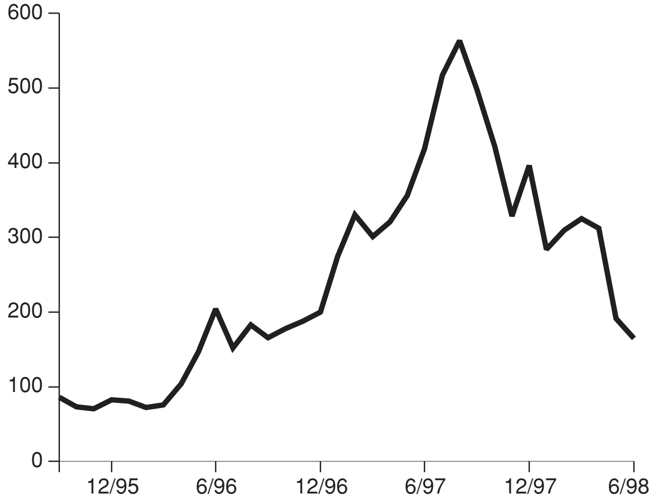
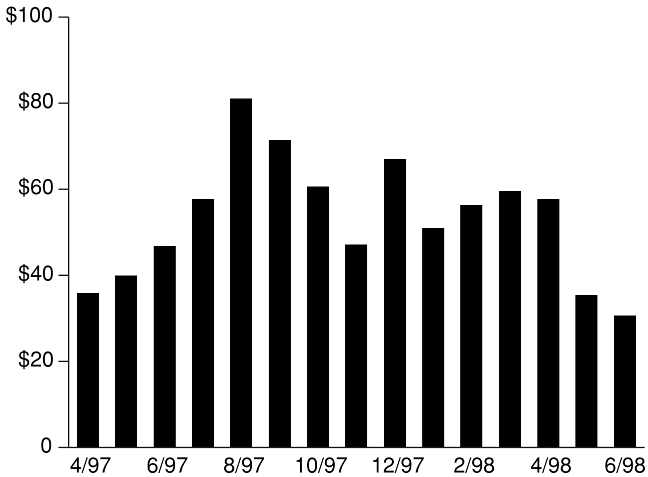


FIGURE 2
Stock market capitalization
(billions $)



The preeminent feature of the financial crisis in Russia, however, is that the very solvency of the state is in question. On the eve of the October-November 1997 crisis, Russia had $24 billion in gold and foreign currency reserves. On the eve of the May-June 1998 collapse, it had only $16 billion. Another margin has now been spent, bringing the reserves down to the $14.5-15 billion range, of which nearly $5 billion is in gold. The convertible currency reserves are approximately $10 billion.

With those resources, the Russian government of the young former oil company manager and banker Sergei Kiriyenko, in office only since April 24 of this year, is committed to defending the ruble at all costs. That is what the International Monetary Fund (IMF) demands; that is the position of the closest on-site Western advisers to the Russian government in Moscow, a group of chiefly British monetarists, operating out of the Russian European Center for Economic Policy; and, there are political reasons, inside Russia, for the defense of the ruble to be the fervent desire of the government.

FIGURE 3
Moscow stock bubble collapse
(index April 1997 = 1)

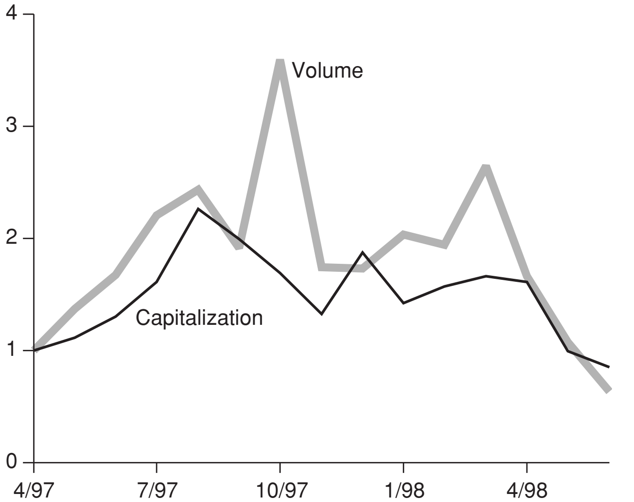
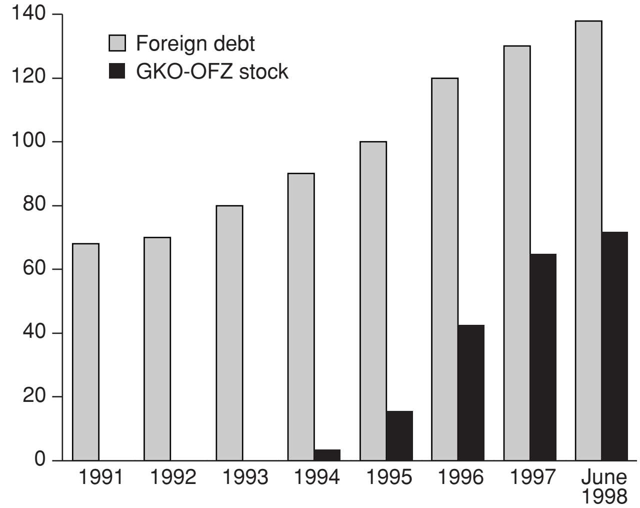


FIGURE 4
Russian foreign debt and GKO-OFZ bonds
(billions $)



But, the crisis-management efforts of President Boris Yeltsin and Prime Minister Kiriyenko and his staff can hardly hope to function, even in the short term. The previous government got through the year-end 1997 phase of crisis by means of a mad scramble to borrow: World Bank loans, contingent on promises of austerity; private commercial borrowings that weren't even announced; and, above all, piling on more state-issued securities to Russia's fast-growing mountain of debt.

The cash scramble has resumed, in the past few weeks. The collapse of world oil prices hits Russia very hard, insofar as petroleum is its major source of export earnings, and the Russian oil companies, which export the oil, are large tax debtors, now unable to pay their taxes. The top demand, in an oil and natural gas industry strike, threatened for late June, is relief from taxes for six months, for the oil companies; this, at the very moment that the IMF is demanding that the government collect more taxes, as a condition for new loans or the release of current ones.

Russia made a sudden $1.25 billion Eurobond issue on June 3, a good portion of the proceeds being used to buy Russian state bonds that have no other takers. There are rumors of the pending sale of a large quantity of the state's palladium reserves, in order to raise $2.5 billion for the payment of state-sector wages. Remember, 600 trains were stalled on the Trans-Siberian Railway for two weeks in April, by coal miners who hadn't been paid in nine months. They protested by camping out on the railroad tracks, joined by teachers and other professionals.

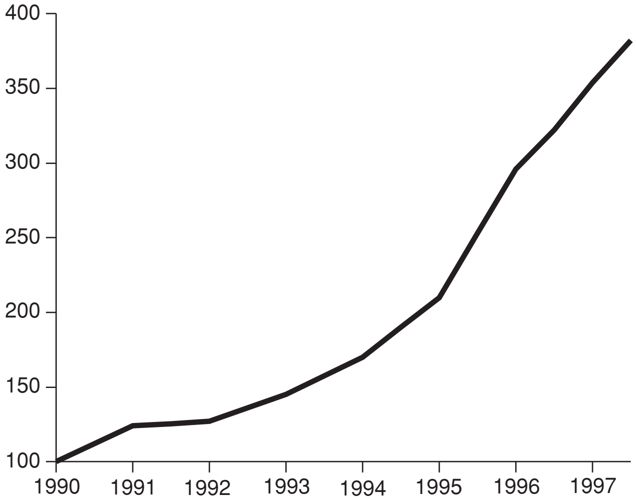
Debt rollover demands

But, Russia has an enormous amount of ruble-denominated state debt that comes due every week. The weekly amount ranges from 6, up to nearly 10 billion rubles in bonds. That's the equivalent of one and a quarter billion dollars that needs to be redeemed or rolled over, with interest, each week for the rest of this year. This market is known as the GKO-OFZ market (the acronyms stand for State Treasury Bonds and Federal Loan Bonds). The OFZs are two- and three-year bonds, the GKOs as short as seven days. Russia issued the first-ever seven-day Treasury bonds in May.

The GKO-OFZ market, management of which now dominates discussion of Russian state finances, did not exist five years ago. The Russian Finance Ministry began to sell ruble-denominated bonds only in 1993, to finance a budget deficit that had soared when the tax revenue base was crushed by the first phase of reform, the so-called shock therapy. Decontrol of prices in 1992, under conditions when most sectors of industry were under 100% monopoly control, led to a year of 2,600% annual inflation. Investment was out of the question; payments among enterprises became extremely difficult. There was a non-payment crisis, in which companies resorted to barter, if any payment at all, and a precipitous collapse of industrial production ensued.

It was only in early 1996, that so-called foreign investors—actually speculators—were allowed freely to participate in this market. Thus, the debt Russia inherited from the Soviet Union was augmented by this new component (**Figure 4**).

FIGURE 5
Growth of Russian debt
(foreign debt + GKO–OFZ, index 1990 = 100)



The foreign debt, summed together with the GKO-OFZ total and shown against the reference date of 1990, resembles one of our hyberbolic curves, going off the chart, or into the wall (**Figure 5**).

Gen. Aleksandr Lebed, the recent winner of the gubernatorial race in Krasnoyarsk, Siberia, and a likely Presidential candidate for the year 2000 (unless the elections are sooner), has warned about "the Albania variant" for Russia. In early 1997, the small nation of Albania, in the Balkans, was convulsed by riots, armed clashes in which youth raided Armed Forces arsenals. This occurred after some 70% of the population lost much or all of their savings, in officially sanctioned pyramid schemes—chain letter-type investment swindles.

In Russia, the GKO market has become a pyramid scheme on the scale of the entire state. The Russian economist Sergei Glazyev, writing for the March 27, 1998 issue of *EIR,* contrasted the return on investment in industry, which he estimated at a maximum of 7%, with the stratospheric returns available on GKOs. Between 1994 and 1996, there were triple-digit interest rates: 120%, 160% annualized yields on these bonds. In 1997, they averaged 26%. The 1998 Russian budget assumed that they would average 25%. They're currently in the range of 70%, and, as is mentioned on *EIR*'s new videotape, in May for a period of a couple of weeks, the Central Bank's annual refinancing rate, which is supposed to serve as a cap on the GKO yields, was 150%.

Who would invest productively, under those circumstances? Everybody played the GKO market. Soros's future business partner in the Svyazinvest purchase, Vladimir Potanin's Oneksimbank, was an early player in the lucrative GKO market. Last summer, the newspaper *Izvestia* alleged that Anatoli Chubais, the mastermind of privatization in Russia and just appointed yesterday [June 17] by President Yeltsin to be Moscow's liaison with the IMF and other international financial institutions, had, together with his fellows at the Center for the Protection of Private Property, invested a $2.4 million interest-free credit from friends of theirs at Stolichny Bank, in the GKO market in 1996, which was paying triple-digit interest rates at that time. When the U.S. Information Agency cut off funding to the Harvard Institute for International Development work in Russia, it was after it turned out that the wife and girlfriend of HIID's Moscow experts were running mutual funds, reportedly invested in GKO and other high-yield securities, out of the back office!

From abroad, the heaviest foreign investors in Moscow's GKO pyramid were South Korean and Brazilian banks. Their rapid pull-out in November 1997, sent GKO prices plunging, revealing the impact of market globalization. And I think that the words of Dmitri Vasilyev, the Russian Securities and Exchange Commission head, and others, when they announced the GKO market—that this was a state-of-the-art high-technology market, the kind of market infrastructure that will take Russia into the modern era—are coming back to haunt them today.

With Russia, of course, the market's interface with the global circulation of "hot money" flows, goes far beyond the scope of the bond and stock market. With capital flight since the breakup of the Soviet Union estimated at between $500 billion and $1 trillion, Russia has become an integral source of the drug- and crime-driven income streams, which keep the much larger international derivatives bubble aloft.

The toll on the national economy

Meanwhile, the toll on the national economy is indicated by the rate at which servicing the GKO-OFZ debt mass becomes the number-one priority in the federal budget (**Figure 6**). (This portion is far more expressive, than "GKO debt service as a percentage of GDP" and so forth, insofar as about half of Russian GDP is in the criminalized, so-called "shadow" economy, and doesn't even figure in national statistics; never mind the fact, that the head of the State Statistics Committee since 1993 was arrested last week for fraud in abetting tax evasion by major businesses.) At present, 30% of all federal treasury spending is going to service, to pay interest on the GKO rollovers and redemptions. That's as of three weeks ago, so it's rising rapidly with the 70% yields, and these funds are in competition with wages to the coal miners, payments to the military, and to science.

Russia now presents a classic case of the divorce of the financial sphere from the real economy. In the case of Russia, the strategic dimension of such insanity is inescapable.

FIGURE 6
GKO interest devours Russian budget
(percent of federal budget spending)

On Dec. 28, 1991, Lyndon LaRouche warned, "If Yeltsin, for example, and his government, were to go with a reform of the type which Harvard Prof. Jeffrey Sachs and his co-thinkers demand—chiefly from the Anglo-American side—then the result in Russia would be chaos. In such a case, the overthrow of Yeltsin, or somebody, by a dictatorship . . . would probably occur. In that case, then we have a strategic threat."

In 1993, I had the privilege of accompanying a guest from Russia, a distinguished economist, on meetings with members of the U.S. Congress and the Executive branch. We got to listen to a young man from one of the Departments, inform our guest that "all world history" demonstrates that "free trade" and maximum deregulation of finances were the key to economic success. Our Moscow guest advised, "If you want to treat Russia like a banana republic, please remember that we have nuclear bananas."

In 1996, LaRouche updated his strategic assessment of the disastrous impact of the so-called "reforms." Writing in his essay "Russia's Relationship to World History—Letter to a Russian Friend," LaRouche said, "A so-called 'Reform' policy, was jointly imposed upon post-Soviet Russia, Ukraine, and Belarus, by Britain's Prime Minister Margaret Thatcher and the man she has described as her dupe, U.S. ex-President Sir George Bush. That 'Reform' policy, not reversed under U.S. President Clinton, has driven Russia presently to existential extremes, at which some sort of explosion is imminent. 'Explosion' does not signify 'global thermonuclear war,' but the ignition, and spread of chaos, out from Russia, to engulf much of the planet. It appears, that official diplomatic Washington is more concerned with clinging to the appearance of defending a failed, British-designed 'Reform' policy, than replacing London's and the U.S. Republican Party's bankrupt policy with a sane American one."

Collapse of physical goods production

I am illustrating the collapse of Russia's physical economy by the contrast of the debt's growth, with the collapse of the machine tool sector (**Figure 7**). The machine tool sector, once again, is the brains of any economy and its ability to produce real profit. The machine tool sector most embodies the combination of the heavy industry physical capacity in what was the highly militarized Soviet economy, and the skilled manpower of the Russian intelligentsia. The so-called KB, or "design bureaus," of the Russian machine industries, to the extent they survive, are an asset for all humanity.

In every sector, Russia in the 1990s has collapsed. In producer goods—raw materials, semi-manufactured and finished producer goods—there's a little bit less steep decline in the raw materials sector, and then the steep bottom two lines, show machine-tool and tractor production (**Figure 8**). Productive employment has fallen in all industries. **Figure 9** shows the rate of change, year to year, in employment of what

FIGURE 7
Russia: bubble vs. real economy
(index 1990 = 100)

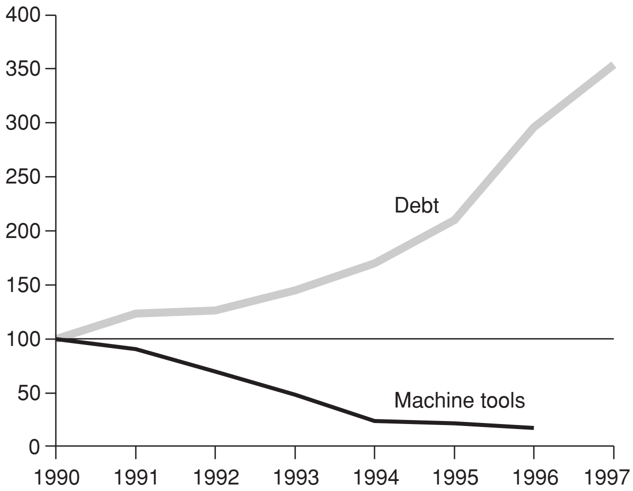
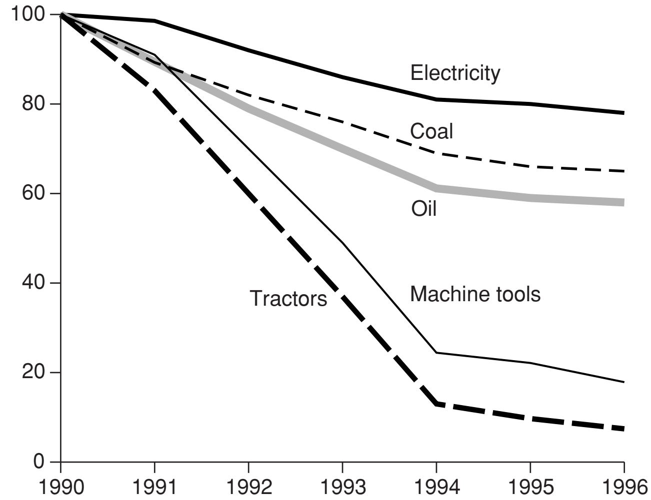


FIGURE 8
Russia: producer goods
(index 1990 = 100)



we call operatives (PPP is a Russian acronym), or employees who produce tangible wealth. It has fallen in all industries, only relatively less in the raw materials-producing industries that produce more for export. But the steep declines are in timber- and wood-processing, and also machine-building and metal-processing industries. The analysis by Russian economist S.M. Belozerova, appeared in *EIR* last year.

Russia no longer supplies its own population's needs (**Figures 10** and **11**). Surely, you would say, consumption has not fallen that much! Indeed, the share of imported consumer goods is now over 60% on the Russian market, in categories where they were nearly 100% self-sufficient. As of 1996, Russia was 40% import-dependent for food. In the big cities, the level is closer to 80%. Here lies one of the government's

FIGURE 9
Annual rates of change in industrial employment for sectors of industry, 1985-96
(PPP employment, expressed as percentage of the preceding year)

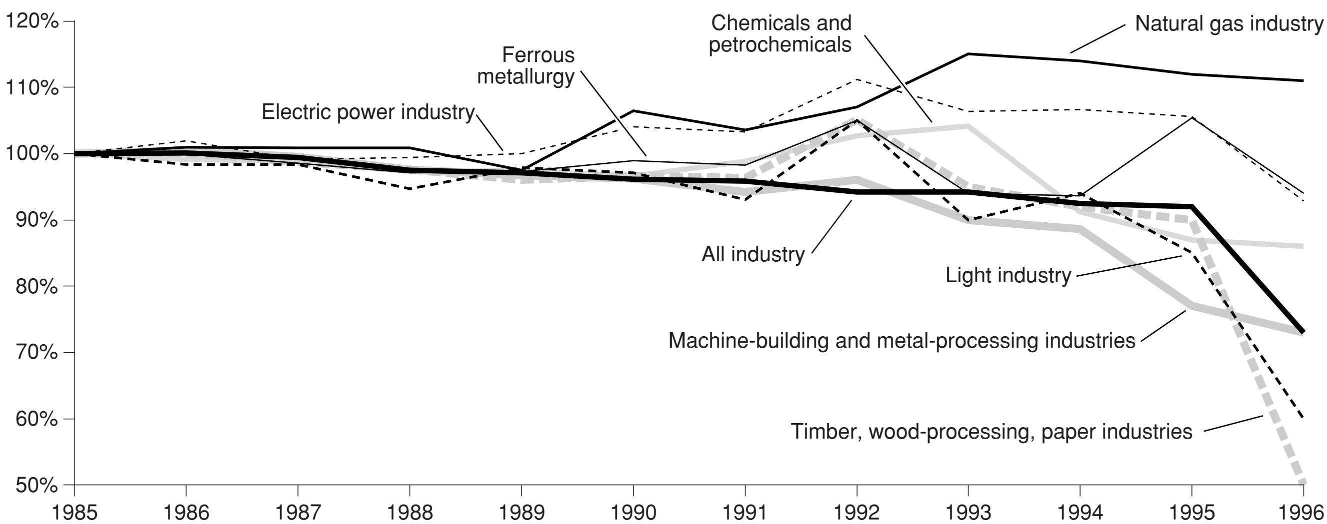


FIGURE 10
Russia: consumer goods
(index 1990 = 100)

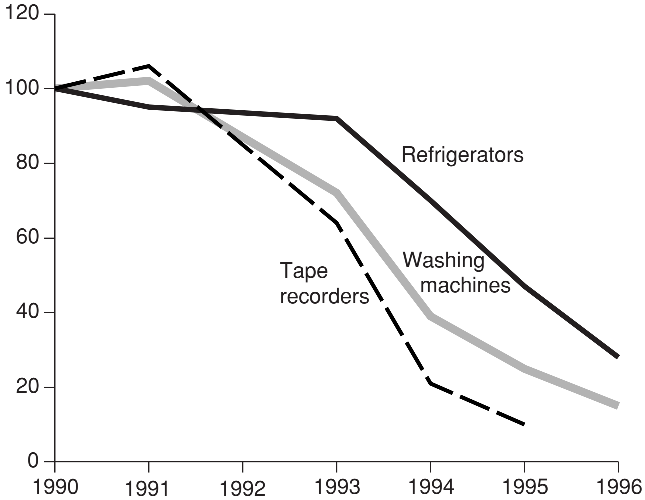
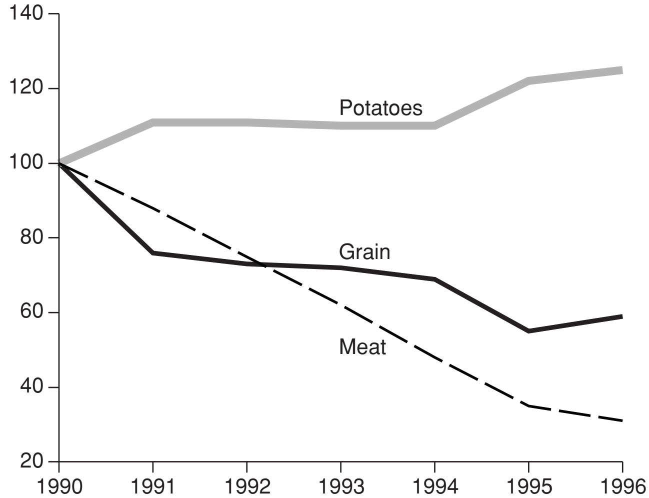


FIGURE 11
Russia: agricultural production
(index 1990 = 100)



anxieties about a devaluation of the ruble. The population would instantly be far less insulated from the financial sector crisis, than is now the case, were the ruble to be devalued and the prices on these imports soar.

'Genocide'

The ultimate measure of success in physical economy, is the population's ability to reproduce itself. Life expectancy for men in Russia fell further to 57.6 years of age, in 1994 (**Figure 12**).

The population also has declined in absolute numbers. Russia has experienced increased mortality, the excess of deaths over births, in the range of 300,000 to 1 million people per year, since 1992. Even with offsets from immigration (from the former Soviet republics), the population of the Russian Federation fell from 149 million in 1992 to, in the latest report, 146.6 million people. There are peculiarities, such as the incidence of alcohol poisoning, but the increases in morbidity and mortality apply across all segments and age groups of the population.

I agree with Sergei Glazyev, who titled his latest book on the impact of the reforms in Russia, *Genocide*.

In 1995, LaRouche wrote testimony for the Economic Policy Committee of the Russian State Duma (lower house of Parliament). The title of his memorandum was "Prospects for the Economic Recovery of Russia." (*EIR,* March 17, 1995; it was published in Russian by the Schiller Institute in Moscow.)

The physical and intellectual capacities he emphasized therein, above all the machine-tool and aerospace sectors and the minds of the Russian intelligentsia and skilled labor force, still exist—just barely. The distinguished chairman of the Economics Division of the Russian Academy of Sciences, Academician Dmitri Lvov, has just presided over a conference that made an inventory of the physical wealth and potential of Russia. (Academician Lvov's earlier study appeared in *EIR,* Feb. 21, 1997, with LaRouche's introduc-

FIGURE 12
Male life expectancy
(years)

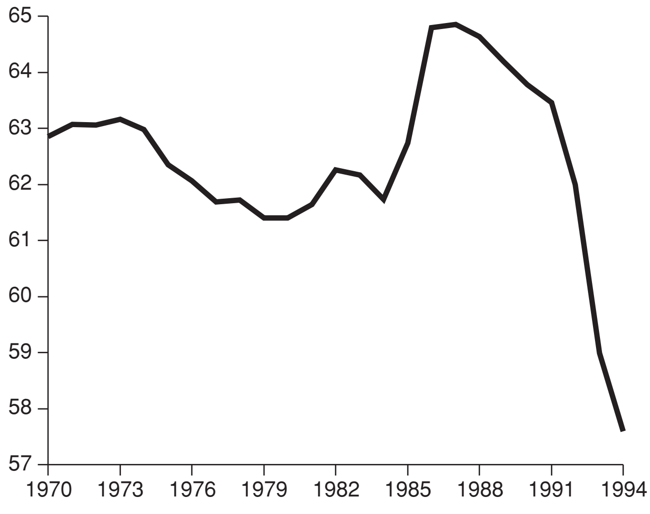


FIGURE 13

The Moscow newspaper Nezavisimaya Gazeta *publishes* EIR*'s map of the Eurasian Land-Bridge, with the title, "Contours of a New Russian Strategy: The Country Can Only Be Saved by Its Central Position on the Geo-Economic Map of Eurasia."*

tion, titled "Russia's Liberal Reforms: Anatomy of a Catastrophe.") Academician Lvov has called LaRouche's science of Physical Economy—LaRouche's second book published in Russian was titled *Physical Economy*—"the ray of light in the kingdom of darkness of monetarism."

Two springs ago, in April 1996, LaRouche keynoted a six-hour seminar on the global financial crisis, with leading members of the Academy of Sciences in Moscow. Academician Leonid Abalkin and some other participants clearly took to heart, the warning from LaRouche and from Marivilia Carrasco of Mexico, about the "Mexico scenario" of debt-enslavement engulfing Russia. Others were more skeptical about LaRouche's evaluation of the financial crisis as global, and systemic. Now, they must be remembering his words.

Resistors against the IMF, and the political-financial cartels it acts for, will find allies in Russia. Malaysian Prime Minister Mahathir bin Mohamad's speech at last September's Hong Kong IMF meeting, in which he called to ban currency speculation, has been widely circulated in Russian translation.

In March, the leading Moscow daily *Nezavisimaya Gazeta* carried a long article, illustrated with a map that will be familiar to those of you who have *EIR*'s Special Report, "The Eurasian Land-Bridge: The 'New Silk Road'—Locomotive for Worldwide Economic Development," from 1996 (**Figure 13**). Here, it has a Russian caption. The author of the article is Dr. Sergei Rogov, head of the Academy's think-tank on the United States. The title is, "Contours of a New Russian Strategy: The Country Can Only Be Saved by Its Central Position on the Geo-Economic Map of Eurasia." The map is a reproduction from *EIR*'s "Land-Bridge" report, and is captioned, "Map from the 'Trans-Eurasian Bridge' report, issued by the Lyndon LaRouche Institute, Washington, D.C." The name of the institute is not quite accurate, but the idea is absolutely right.