EIR Economics

The next 'Russia shock' hits global financiers

by Rachel Douglas

Russia's August 17 freeze on its domestic debt, which halted servicing and redemptions of the ruble-denominated state bonds known as GKO and OFZ, detonated the global derivatives bubble. Long Term Capital Management (LTCM) and other hedge funds that engage in multibillion-dollar arbitrage, betting on such things as the spreads between yields on the bonds of different countries, were caught way out at the end of a limb when GKO yields went to zero, a contingency not provided for in their computerized models. And Russia's step into the domain of "sovereign default"—even though the freeze on the domestic obligations and a 90-day moratorium on commercial foreign debt payments did not apply to the sovereign foreign debt of the Russian Federation—sent waves of panic through the debt and stock exchanges of other countries, victimized by international financiers as "emerging markets."

Three months later, Russia has shocked the London-centered financial cartels again. It is not merely a question of which debt payment due-dates might be missed or the continued threat of a broader Russian default, although those possibilities loom large. Indeed, First Deputy Prime Minister Yuri Maslyukov announced Nov. 4 that the nearly $3.5 billion remaining Russian foreign debt payments, due this year, and $17.5 billion due in 1999 were "an extraordinary task for our weakened economy. Either we adopt an emergency budget and take the harshest measures to wrest this money from all sectors of the economy, or we should come to terms with our creditors, reach an agreement with them that they will restructure our debt. We will be tackling the second task."

The bigger shock is a change in attitude, an incipient shift in policy. Like a handful of countries in Asia, or factions therein, the Primakov government insists on the survival of Russian statehood, regardless of what happens in its relations with international finance. It does so with considerable awareness of the condition of international finances, which Maslyukov expressed after his week of negotiations with an International Monetary Fund (IMF) delegation at the end of October.

In 1996, when he was chairman of the State Duma's (lower House of Parliament) Committee on Economic Policy, Maslyukov more than once related his experience of meeting with an IMF delegation. "It was like Hawaiian Islanders, trying to converse with Eskimos," he would say. In October 1998, things were different. Maslyukov told *Nezavisimaya Gazeta,* in an interview published Oct. 31, that Russia and the IMF could understand each other now, because the IMF is in just as bad shape as Russia.

The International Monetary Fund representatives had admitted that the policies of recent years—not "isolated errors"—were the cause of today's grave state of affairs in Russia, Maslyukov reported. "Actually," he said, giving a flavor of the Primakov government's negotiating style, "Russia and the IMF are almost in an identical position: they pursued a common policy and now experience very similar financial problems. The similarity of their positions helps a certain similarity of views and a bigger mutual understanding than in former years, when relations often were based on the 'at your service, sir' principle."

The IMF mission departed Moscow without deciding on the release of funds pledged before August. Prime Minister Yevgeni Primakov told a press briefing on Nov. 5, "Everybody should firmly know this. It will be easier for us to plant our feet firmly on the ground if we get support. But even if we do not get any support, we will neither fall flat on our back, nor stand on our knees."

Maslyukov confirmed to *Nezavisimaya* that talks are under way with Japan and with Germany, on a bilateral, state-

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to-state basis, "on credits for Russia. We are counting on a positive result."

'Nondeliverable forwards'

Tony Blair's London is the venue for negotiations between the Russian government and a committee of Anglo-American banks, over the disposition of derivatives contracts written by Russian banks. The dispute, as yet unresolved, goes to the heart of global financial policy. The London committee is trying to make the Russians assume responsibility for making good the soured bets of the Western banks, in hopes of crisis-managing a perpetuation of the past decade's lethal "free trade" and global deregulation regime. So far, Moscow will not.

The particular derivatives matter at issue is subsumed under the restructuration of Russian Federation GKO/OFZ bonds, frozen since Aug. 17. Some 30% of them (about $20 billion before the devaluation of the ruble) were held by foreigners. Reported Russian offers have comprised the exchange of the defaulted or frozen bonds for new long-term bonds, some dollar-denominated, at somewhere between 11 and 30% of face value. The Western banks are reportedly demanding to maximize a partial payout in cash.

Foreign investors in GKO/OFZ speculation hedged against the devaluation of the ruble, by getting Russian banks to write forward contracts, to exchange rubles for dollars at a certain rate. The London committee of banks, meeting with Deputy Finance Minister Mikhail Kasyanov, is demanding separate Russian government talks on making good these derivatives gambles, while Moscow's position is that the obligations must be packaged with the GKO workout—if they are to be honored at all.

Deutschebank Morgan Grenfell, Lehman Brothers, J.P. Morgan, Chase Manhattan, Crédit Lyonnais, and Crédit Suisse First Boston are Kasyanov's negotiating partners in London—a group notorious for high levels of derivatives risk, not only in connection with operations in Russia. It is a committee of desperadoes, judging from their actions when the Russian currency forward contracts went bad. In September, Lehman Brothers got a court order in London to seize the London accounts of Inkombank, which had failed to meet currency forward contracts with Lehman Brothers. (The Bank of Russia has since revoked Inkombank's license, beginning the reorganization of the speculation-addicted Russian banking system.) In late October, representatives of the desperado banks were complaining through their press outlets, that the Russians weren't "taking the negotiations that seriously," especially on "reasonable governing principles" for the question of "nondeliverable forwards."

A 'system of measures'

On Saturday, Oct. 31, Prime Minister Primakov chaired a cabinet meeting on economic policy and briefed the press on it. The document debated by the government is titled "Measures Aimed at Stabilizing the Economic and Social Situation in the Country." It is not "a program," stressed Primakov, but "a system of measures," which "as a system of measures is a self-developing system." Where it goes, he said, will depend not only on the internal Russian economic dynamics, but on the world financial situation: "We proceed from the assumption that this system will not be a static one and that it will steadily develop with account of changes in the situation. Changes in the situation in the country and in the world."

As he has since before his appointment as Premier, Primakov reminded that "it is not by our own fault, alone, that we find ourselves in our present circumstances," singling out the role of the IMF. The government's top order of business, he repeated, is "measures aimed at ensuring life-support priorities. We should focus on the creation of measures that would help us live through the coming severe Russian winter. Those measures are priorities."

Beyond that, he highlighted four points.

1. Finance Minister Zadornov will give a public account of government spending, on the last day of each month, to make it possible to analyze why, "in some sector of our society or some geographic area, people fail to get payments."

2. The purpose of the "system of measures," is "primarily to move the country out of the grave situation in which it has found itself. But that certainly does not mean that the system of measures does not lay the foundation for further headway. In fact, it implies such forward movement, even though it does not go into concrete mechanisms in deep detail. That will be done later, at subsequent stages. What would I like to say in principle? The market system will undoubtedly remain in place and will develop. What had been done before us had been primarily done not to develop the real sector of the economy. And I would like to note that a market system cannot function normally unless production develops, if only some infrastructure is being formed for [the market's] development and only financial stabilization is attained at the macroeconomic level. That is extremely important, but it should serve the development of the real economy."

3. State regulation has an essential role, "especially as the country is moving out of a crisis." Among the countries that have "gone through that stage," Primakov cited the United States under Franklin Delano Roosevelt, West Germany after World War II, and Austria. In Russia's case, a key role of the state is "to establish economic order," meaning "implementation of the budget, enforcement of all contracts and other documents, mandatory payment of taxes, pressing out the shadow economy, and creating conditions for better performance by producers."

4. Protection for domestic producers is "certainly not to the detriment of foreign investment, direct foreign investment into the real sector of the economy. It is important for us—and it is not import-substitution in its classic form—the main thing for us is to create conditions in which, regardless of who owns an enterprise, in whose hands it is, whether it has foreign

participation, or even if it is a fully foreign-owned one but located on the territory of Russia, it works here first and foremost to satisfy the needs of the population, produces commodities that are in high demand."

Answering questions, Primakov commented more sharply on the posture of the IMF. "As to the IMF," he said, "we are having now what I regard as a dialogue. They presented their remarks. We can agree with some of them and, in my opinion, we cannot accept some." He said that some IMF negotiating positions, "directed against state intervention, against serious work on the micro level" of the economy, contradicted public statements by Managing Director Michel Camdessus in a recent interview with the Paris daily, *Le Monde*. At the same time, he pointed out that Camdessus's own assertion, that the IMF has promoted "direct investments" in Russia, was untrue.

Egyptian TV asked whose fault Russia's situation was, if not its own? Primakov replied that Russia's situation was "definitely not through any fault of Egypt!"

He said that the reimposed state monopoly on alcohol would be a source of substantial funds, as would "improved utilization of state property." A crackdown on corruption and crime, said the Premier, would create "serious reserves" for the economy.

Primakov said that price controls are being applied only to certain products, such as medications for patients with serious disease (insulin, anti-TB medicines, oncological medicines). "As for foodstuffs, I don't think so. Market prices will exist for foodstuffs."

Locomotives for growth

Obshchaya Gazeta asked Primakov to tell more about the planned National Development Bank, in connection with which Russian government experts are studying postwar German industrial banking (see box). He replied, "I cannot go into greater detail, because the idea of its creation is just being considered. I would rather not rush to conclusions, and I would prefer my answer to your question not to be regarded as the final decision in connection with the bank's creation."

In his *Nezavisimaya Gazeta* interview, Maslyukov outlined a concept of economic growth engines, citing another aspect of the experience of Germany's industrial sector. Asked, "Where will you get the necessary resources?" Maslyukov replied, "In my opinion, the natural monopolies can serve as locomotives capable of pulling the country's economy out of the crisis. In order to utilize the possibilities, say, of the oil and gas sector, it is necessary to make fuller use of the capacities of the defense industry—which so far are not fully utilized. The German Union of Machine Builders is a model of such cooperation of the leading sectors in the real sphere of the economy. It is very demanding toward the enterprises that are its members, it sets production quotas and determines the size of exports, and it conducts talks with the government on benefits in this or that area. I can describe the Union of Users of Oil and Gas Equipment as an embryo of such a structure in Russia."

Since formation of the new cabinet in September, Maslyukov has visited Norilsk Nickel, the giant mining company above the Arctic Circle, while Primakov in late October spoke before the Greater Volga Association Council in Saransk. The leaders of seven major industrial cities in this region, where over two-thirds of Russia's automotive industry and half of its aerospace firms are located, have formed a new association.

While focussing on industrial policy, Maslyukov again denied that the government would crank up the money printing presses 'round the clock. "I am convinced that hyperinflation is as big a woe for a country as is the absence of money," he said.

A Russian 'Kreditanstalt für Wiederaufbau'

One of the key issues of the Russian government's anti-crisis plan, furiously rejected by the International Monetary Fund, is the proposal to create a "state-owned bank for reconstruction." The references by both Prime Minister Yevgeni Primakov and Deputy Prime Minister Yuri Maslyukov to the strong state role in the postwar German reconstruction period, indicate that the model for such a new bank is the Kreditanstalt für Wiederaufbau (KfW), or Reconstruction Loan Corp., founded in November 1948 in Frankfurt, West Germany. For 50 years now, the KfW has played a crucial role as a state-run instrument for dirigistic economic activities, with special emphasis on infrastructure financing; assisting private, medium-sized business; and fostering German exports through credit grants.

During 1948-52, the U.S. government supported the economic buildup in western Europe with its Marshall Plan credits. In the absence of any noteworthy hard currency reserves, such funds allowed the import of the most urgent food necessities, and raw materials by German industry. But far more important than the initial credits as such, was the special way in which the repayments on the credits were later put back into circulation again and again. A group of German bankers around Hermann-Josef Abs went to the leadership of the U.S. occupation forces in Germany, and proposed to create a new state-owned bank for reconstruction, which would use the (local currency) repayments of Marshall Plan credits from German companies as its core capital. The U.S. officials agreed to the plan

By what rules

The Primakov government's moves have been greeted with consternation on the part of international financiers and their press mouthpieces. "Russian liberals, like the IMF and Western governments, are worried that the current crisis might signal the end of post-Soviet Russia's experiments with free market capitalism," proclaimed a Nov. 1 Reuters wire, which also cited Interfax leaks about the IMF delegation's concern over Russia's " 'step backward' in the process of moving toward free market reform." London financial editors' anxiety over Russian policy was rivalled only by their chagrin about China's latest moves to protect itself against the consequences of financial speculation, exemplified by an Oct. 29 London *Financial Times* article on how China had begun "to test—indeed, strain—foreign nerves" with the closing of Guangdong International Trust and Investment Corporation.

Just before the demise of LTCM, megaspeculator George Soros told the U.S. House of Representatives Banking Committee that there ought to be international insurance for derivatives operators—"borrowers who play by the rules." U.S. Secretary of State Madeleine Albright, in an Oct. 2 speech on Russia, complained about the "talk in recent days, about printing new money, indexing wages, imposing price and capital controls, and restoring state management of parts of the economy. We can only wonder if some members of Primakov's team understand the basic arithmetic of the global economy."

Not everybody has caught on, that nations can change the rules and the arithmetic.

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because of the convincing argument by the German bankers, that this policy would be fully in line with the successful economic policies of President Franklin Roosevelt. Due to the creation of the KfW, the German economy was able to take the greatest advantage from the Marshall Plan, although it was far from the leading recipient of such funds (**Table 1**).

TABLE 1
Total U.S. Marshall Plan aid through the end of 1952
(millions $)

Country	Amount
Great Britain	3,165.8
France	2,806.3
Benelux countries	1,532.8
Italy	1,515.0
West Germany	1,412.8
Austria	711.8
Greece	693.9
Denmark	275.9
Sweden	107.1

With a balance-sheet volume of 278 billion deutschemarks at the end of 1997, the state-owned KfW is today among the biggest German banks. During 1997 alone, its total commitments of loans and grants had a volume of DM 59.9 billion.

The primary activity of KfW is the granting of loans at below-market interest rates to well-defined categories of private business. The focus of such loans is financing for:

- business investment and investment in environmental protection by small and medium-sized enterprises in Germany;
- business investment by small and medium-sized enterprises outside Germany;
- technology, innovation, and equity participations; and
- the construction and modernization of housing.

Another priority is the promotion of local infrastructure projects, such as:

- water supply and sewage disposal systems;
- solid waste management;
- projects in the energy sector;
- local transportation infrastructure;
- social facilities.

Furthermore, KfW grants export loans and project financing loans in the following economic sectors:

- aircraft production;
- shipbuilding;
- transport infrastructure;
- raw materials extraction;
- telecommunications;
- energy;
- manufacturing industry and technology.

Finally, KfW is engaged in financial cooperation with developing countries.

After German reunification, the reconstruction of East Germany became a key activity of the KfW. By the end of 1996, the total volume of KfW credits into eastern Germany amounted to DM 105 billion, triggering investments of DM 190 billion, that is, 20% of all public and private investments into eastern Germany during this period. In times of speculative bubbles, it is noteworthy as well that, according to a 1997 statement by KfW chairman Gert Vogt, the quick action by KfW, to grant additional large emergency credits for local infrastructure, was vital to the stabilization of the German economy right after the stock market crash of 1987.—*Lothar Komp*