Unstable Stability: Russia and the International Monetary Fund in the 1990s

Introduction

The International Monetary Fund (IMF) was established at the end of the Second World War in order to promote economic stability and openness. While many nations in Europe, the Americas, Africa, and Asia became members of the IMF, the Soviet Union declined to join. Following the Soviet Union’s collapse, many of the Newly Independent States, including Russia, sought membership in order to receive economic advice and loans. These transitioning economies, however, were profoundly different from those the IMF originally was intended to support.

The IMF’s Articles of Agreement require that all member nations have stable, freely-traded currencies. A stable monetary base allows for greater economic stability within a nation, and economically-stable member nations benefit the IMF by requiring fewer loans and less guidance. Furthermore, stable exchange rates stimulate economic growth by increasing the amount of foreign investment and trade. By promoting stable and open monetary regimes, the IMF advances its goals of ending economic inequality, instability, and predatory monetary policies.

In order to comply with the IMF’s requirements, the Russian Federation needed to adopt a new monetary system, since the Soviet Union’s severely restricted the amount of currency that could be traded abroad. Financial instability in the Russian Federation, however, which stemmed from the economy’s rapid transition from a command model to a capitalist model, complicated

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1 See International Monetary Fund, “Articles of Agreement,” 5–6.
2 See Ibid., 2.
the adoption of the new system. While the Russian Federation adopted an exchange rate system that led to technical compliance with the Articles of Agreement, the new monetary regime failed to deliver the financial and economic stability envisioned by the IMF.

In this paper, I present Russia as a case study illustrating the effect of the IMF’s foreign exchange policy on a country that was previously isolated from the international monetary regime. First, I will analyze the factors that contributed to the Soviet Union’s rejection of IMF membership and how this decision affected the structure of its monetary regime. Next, I will analyze the economic factors that later prompted the Soviet Union to seek IMF membership. Then I will assess Russia’s monetary policy during the mid-1990s and deconstruct the ways in which this policy affected economic stability. Finally, I will evaluate the effectiveness of the IMF’s suggested monetary policy.

The Soviet Union and Bretton Woods

During the waning days of the Second World War, delegates of the Allied nations attended a conference in Bretton Woods, New Hampshire, in order to establish a new world economic order that would be impervious to the exchange instabilities of the interwar system. This conference established the Bretton Woods System, an international monetary regime focusing on creating stable yet adjustable exchange pegs and bands, and the International Monetary Fund, an organization allowing countries to maintain the currency peg or band during

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3 In this paper I will primarily use the IS/LM/BP model, an open economic model, as I will be focusing on the effect of the exchange rate on economic stability. I will assume that the consumer’s preference for a certain currency is dictated by how stable they perceive a currency or asset to be and how a certain currency’s or asset’s interest rate compares with the international interest rate. I will assume that consumers prefer stable currencies and assets with relatively high interest rates relative to the international interest rate. As the international interest rate will be analyzed in relative terms, it will not need to be defined directly.
times of financial instability. In order to maintain a soft peg, a country must have enough money in reserve to correct the balance of payment inequalities that occur when real exchange rates change. For example, if the exchange rate for a country is pegged at three units of domestic currency per unit of foreign currency while the real exchange rate is two units of domestic currency per unit of foreign currency, people will sell the domestic currency in order to purchase foreign currency, draining the central bank of foreign exchange and causing a surfeit of domestic currency on the market. This process is known as destabilizing speculation because exploiting the exchange rate discrepancy can cause financial instability due to lack of funds. In order to prevent the collapse of the domestic system, the IMF can provide conditional loans to member nations experiencing financial difficulties due to the pegged exchange rate until the exchange rate is changed. The bilateral system established by the Bretton Woods Conference attempted both to stabilize international exchange rates and to prevent economic collapse caused by improperly pegged exchange rates.

While most developed nations in Europe and the Americas opted to join the Bretton Woods System, the Soviet Union did not. Neither was the Soviet Union a member of the IMF, which outlived the other institutions and standards established by the Bretton Woods Conference. This was primarily due to the perception that the Soviet Union would be beholden to American standards of governance and finance. As a result, the Soviet Union excluded itself from the wider international monetary system both during and after the Bretton Woods System.

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4 See Andrews, 9.
5 These nations will be referred to as the “West” due to both their geographical location relative to the Soviet Union and their open economy policies and free markets, which diametrically opposed the closed command economies of the Soviet Union and Eastern Bloc.
6 See Xenias, 37.
The rejection of the Bretton Woods System and, consequently, the IMF, allowed the Soviet Union to extend its political isolation to financial isolation.

By rejecting the policies outlined by the Bretton Woods Conference, the Soviet Union and the Eastern Bloc opted to function largely as a closed economy. This choice is exemplified by the Soviet Union’s preference for trading in gold and Western debt in order to balance the capital account, the section of the balance of payments that indicates a country’s level of domestic and foreign investment. This system, known as the gold-exchange standard, had largely fallen out of favor in the West following the interwar period. As the West attempted to forge a more stable and multilateral system of trade after the Second World War, the gold-exchange standard was abandoned because of its tendency to promote isolationism and beggar-thy-neighbor policies, which promote manipulation of par values in order to change the direction of the flow of gold. By maintaining a gold-exchange standard, the Soviet Union indicated its dedication to a system of economics largely disentangled from international trade and finance. As the Soviet Union had relatively fewer international economic relations than Western countries and maintained an antiquated system of foreign exchange, its economy functioned more like a closed economy than the economies in the West.

**Economic Collapse and the Soviet Union’s Bid for IMF Membership**

During the 1980s, the Soviet Union faced a series of severe economic crises ultimately leading to insolvency. Although perestroika had attempted to modernize and rebuild the Soviet economy, it instead resulted in the rapid disintegration of the economic system and the

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7 See Grossman and Solberg.
8 See League of Nations, 207.
“[weakening of] state controls over the emission of money in the Soviet system.” Monetary issues and problems associated with modernizing the economy were exacerbated by the collapse of the Soviet oil industry during the latter half of the 1980s. In order to adjust the balance of payments, a decrease in the current account, the section of the balance of payments pertaining to the trade of goods and services, must be offset by an increase in the capital account, the section accounting for the movement of money and bonds. Because of the economic chaos caused by perestroika and the collapse of the oil industry, the Soviet Union became less creditworthy during the 1980s, and Western nations no longer were willing to lend to the financially unstable Soviet Union for fear of default. These economic issues led to increased debt, decreased output, and monetary instability.

Faced with a severe economic crisis during the late 1980s, the Soviet Union attempted to join the International Monetary Fund in order to stabilize its economy. The Soviet Union collapsed, however, before its membership was ratified in 1992, and the newly-formed Russian Federation inherited the Soviet Union’s bid for IMF membership as a result. As a new member of the IMF, Russian was subject both to the prerequisites associated with IMF membership, namely, the ability to take out loans, and to the regulations that attempt to promote financial stability within the Fund. IMF membership represented a new era in Russia’s relationship to the international monetary regime.

**Exchange Rate Policy in Russia during the 1990s**

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9 Barnes, 5.
10 See Gaidar, 168.
11 See ibid.
12 See Gould-Davies and Woods, 6.
The structure of IMF loans makes it imperative that member nations have a stable currency. While the IMF has its own form of reserves known as Special Drawing Rights (SDR), in which it tabulates its holdings, the value of the SDR is derived from a daily conditional valuation of a basket of currencies.\textsuperscript{13} The sudden fluctuation of a country’s currency would therefore effect the amount of reserves in the form of SDR a country could withdraw. For example, if the ruble were valued at fifty per US dollar and suddenly devalued by 100 percent so the exchange rate became one hundred rubles per US dollar, Russia would effectively be able to withdraw 100 percent less reserves in terms of actual value than it could have before the nominal change in the exchange rate. Conversely, the appreciation of a currency would allow a country to withdraw a greater amount of money in terms of real value than it had attributed. Furthermore, an unstable exchange rate can be manipulated easily both by investors and the central banks that control the supply of money. For example, a country experiencing a debt crisis, much like the one the Soviet Union experienced during the late 1980s and early 1990s, may expand the supply of money, effectively devaluing the currency. As a result, the loan provided by the IMF would be ineffective, as it would represent a loan of less money in real terms than the amount promised in the quota.

\textbf{Interest Rates, Government Debt, and Monetary Policy}

During the 1990s, the Russian Federation attempted to follow a monetary regime that would promote economic and financial stability. While the Russian Federation originally adopted a managed float in 1992, it changed its exchange regime to a forward-looking crawling peg.\textsuperscript{14} One advantage of a crawling peg is that the system is able to adjust for inflation and

\textsuperscript{13} See International Monetary Fund, “Special Drawing Right (SDR).”
\textsuperscript{14} See Bubla and Ötker-Robe, 34.
remain stable regardless of economic fluctuations. As previously mentioned, the IMF attempts to promote stable monetary regimes within its member nations as it both promotes economic stability and safeguards the IMF from manipulation of the loan process. Furthermore, unlike fixed pegs and currency boards, crawling pegs change over time, adjusting to financial realities. Theoretically, the forward-looking horizontal peg is able to adjust to future economic conditions, such as inflation, making it more stable than traditional fixed pegged systems, such as the gold standard, which never adjust the par value. One fundamental flaw of this system, however, is that sudden shocks in the market invalidate the predictions on which the changes of the peg are based.

One of the main reasons Russia adopted a forward-looking crawling peg was to prevent hyperinflation. During the early 1990s, following the collapse of the Soviet Union, many of the Newly Independent States experienced hyperinflation, the breakdown of a monetary system caused by the rapid expansion of the supply of money. This led the IMF to urge Russia to adopt an exchange rate regime that would be immune to hyperinflation. A crawling peg is an effective system for avoiding hyperinflation because it prevents a state from expanding its monetary base too quickly while still allowing for the adjustment of the exchange rate. Furthermore, any expansionary monetary policy must be undone immediately due to increased demand for foreign exchange and decreased demand for the domestic currency. This change in foreign exchange preferences occurs because the sudden influx of domestic currency into the market causes domestic interest rates to drop in relation to international interest rates. As a result, the central bank must buy back excess domestic currency and sell foreign exchange to the market in order to re-establish equilibrium. Hyperinflation cannot, therefore, occur in a system with a

15 See Odling-Smee, 154–55.
crawling peg, since any change in the monetary base would be negated by changes in foreign exchange preference. The choice of a crawling peg as the exchange regime in Russia reflected the IMF’s fears that the new Russian economy would experience hyperinflation on account of the rapid expansion of the monetary base.

While the forward-looking crawling peg effectively prevents hyperinflation, it has flaws that may have prevented it from functioning ideally in the newly-formed Russian Federation. One of the main goals laid out for the Russian Federation by the IMF was the swift transition from a command economy to a market economy, a goal that is difficult to achieve with the forward-looking crawling peg.\(^{16}\) This need for rapid change effectively destabilized the Russian economy by rendering it vulnerable to small variations in market conditions.\(^{17}\) While all fixed exchange-rate regimes allow for some fluctuation of the exchange rate due to external factors like the cost of shipping money or transfer fees, pegged exchange-rate regimes allow the least movement away from the fixed exchange rate. This restrictiveness is not ideal in a rapidly changing economy such as Russia’s in the 1990s, since sudden changes or fluctuations in economic circumstances cause the financial markets to be pushed out of equilibrium.

Another issue with the forward-looking crawling peg is that it adjusts the exchange rate based off of a preset figure calculated to accommodate inflation.\(^{18}\) The mechanism of the crawling peg can be understood best through Neoclassical analysis. In the Neoclassical model of macroeconomics, all economic decisions and policies are assumed to be rational, meaning that economic authorities analyze all available information before making a decision that maximizes utility, and only unknown shocks to the economy create market disequilibria. Rationality in the

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\(^{16}\) See Ibid.  
\(^{17}\) See Ibid.  
\(^{18}\) See Bubla and Otker-Robe, 15.
context of forward-looking crawling exchange rates means that a valid calculation of the amount that the exchange rate changes per year should always be accurate unless there is an unknown shock to the market. Russia, however, could not operate according to rational models due to the extreme political and economic upheaval of the 1990s. The government was headed by Boris Yeltsin, a man described as being “intuitive, not logical” and who was “constantly bringing problematic situations to the boiling point.”\footnote{Morozov, Wessell, and Vale, 43.} Clearly, Russia was not acting in a manner consistent with the rational expectations that validate adherence to a forward-looking crawling peg. Consequently, the fundamental principle of the crawling peg, the rational action of the economic authorities of a nation, was nullified by Russia’s political and economic chaos in the 90s.

Russia’s ability to implement rational policy was further impaired by conflicts between President Boris Yeltsin and parliament. Following the 1993 elections, the largest block of the State Duma was nationalist and opposed to economic and political reformations.\footnote{See Åslund, 135.} This illustrates one of the primary issues of rationality: it assumes that policy can be stipulated in such a manner that it will be accepted universally. Clearly, this was not the case in Russia, as the plurality of economic ideologies led to infighting and poorly-executed economic policies. For example, the State Duma’s anti-reform majority, which included both communists and extreme right wing nationalists, refused to pass measures that would have increased compliance with existing tax measures and government revenue in turn.\footnote{See Gilman, 67.} Since tax non-compliance decreased government revenue, the state had to turn to other measures, such as government bonds, in order
to fund the budget and support economic development and growth.\textsuperscript{22} By prioritizing ideological positions over necessary governmental policy reforms, the Russian government acted irrationally and jeopardized the stability of the economy and the success of IMF policy.

Throughout the 1990s, Russia experienced high interest rates, which encouraged foreign investment. As previously mentioned, in this decade Russia adopted a forward-looking crawling peg that prevented the manipulation of the domestic interest rate through the expansion or contraction of the monetary base. The exchange regime therefore encouraged high interest rates that could not be lowered through expanding the monetary base. Furthermore, Russia’s interest rates were comparatively higher than the interest rates in developed nations. For example, in 1995, its real interest rate was 72.225 percent, while the United States’ was 6.606 percent.\textsuperscript{23} High relative interest rates encourage foreign investment, since foreign investors expect higher returns. At high interest rates, people tend to invest rather than spend, leading to a potential excess of loanable funds on the market as well as the misallocation of funds.

While high interest rates usually discourage domestic borrowing, Russia’s monetary constraints prompted a large-scale borrowing of foreign money. One major deterrent to the growth and stabilization of the Russian economy was the government’s inability to promote economic growth due to severe budgetary restrictions.\textsuperscript{24} Because Russia could not expand its monetary base to cover its budgetary debts, it accepted substantial Western loans to fund the government.\textsuperscript{25} Russian banks welcomed Western loans also as a source of quick and supposedly

\textsuperscript{22} See Nesvetailova, 57.
\textsuperscript{23} See World Bank Group.
\textsuperscript{24} See Gilman, 66.
\textsuperscript{25} See Nesvetailova, 57.
risk-free income, using borrowed money to invest in high-yield investments. Because foreigners were willing to invest in Russia, and Russians were willing to borrow money at high interest rates, Russia’s debt increased.

The structuring of government bonds further contributed to the 1998 economic crisis and debt default. As previously noted, the forward-looking crawling peg prevents the expansion of the monetary base and thus prevents nations from funding their deficits through monetary expansion. A nation experiencing rapid economic transformation would therefore have to find an alternative source of funding for its deficit. In Russia, economic funding took the form of governmental bonds known as GKOs (gosudarstvennoe kratkosrochnoe obiazatel’stvo, “government short-term commitment”), which replaced the role of monetary expansion in financing national debt. Bonds are traditionally considered a safer type of investment, as they are guaranteed by the government and backed by the stability of a nation’s currency. Thanks to the measures of the IMF that focused on decreasing inflation, the ruble strengthened in the mid-1990s, and investors began to view GKO as relatively risk-free investments.

The growth of Russia’s debt followed the pattern of an economic bubble in three significant ways and demonstrated the principle that investors will attempt to find the highest return with the lowest perceived risk. First, the interest rate on government bonds was significantly higher than the interest rate on debt in the private economy—as high as 200 percent—which encouraged both foreign investors and domestic banks to buy up a large number of bonds. High bond rates resulted in the misallocation of resources, as money that could have

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26 See Gilman, 138.
27 See Ibid.
28 See Nesvetailova, 57.
bolstered the economy through the immediate purchase of goods was instead funneled into the bonds market. Second, Russian banks had acquired large amounts of bad debt that were unknown to the IMF and therefore could not be written off or otherwise absolved.\(^{30}\) This directly impacted the financial stability of Russia’s banking sector because banks borrow on leverage, augmenting both their returns and losses. Finally, government bonds were perceived to be more stable than they actually were; advisory organizations, including the IMF, did not closely analyze the financial soundness of the bond market, so investors believed that they were hedging their investments in an unstable global economy when they were actually participating in destabilizing economic activity.\(^{31}\) By falsely hedging their purchases against global uncertainty through the purchase of Russian bonds, investors misallocated their resources and fueled the inflationary period of the business cycle.

The government bond market collapsed in 1998, leading to an economic crisis. In 1997 Asia experienced a financial downturn that led to a contraction in credit and at the same time caused the price of oil, a principal Russian export commodity, to plummet.\(^{32}\) The trajectory of the 1998 crisis mirrored the Soviet Union’s credit collapse in the late 1980s. First, a decrease in the price of oil led to a decrease in revenue. This imbalance in the current account needed to be stabilized by an increase in capital account funds in order to readjust the balance of payments. Next, decreases in government revenues and illiquidity caused by the conversion of debts from rubles to dollars led to instability in the bond market and the implosion of the debt scheme.\(^{33}\) The illiquidity that triggered the collapse of the governmental debt scheme was a direct consequence

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30 See Gilman, 138.
31 See ibid., 139.
32 See Odling-Smee, 170.
33 See Nesvetailova, 58.
of the exchange-rate regime’ rigidity. Since a crawling peg is incapable of adjusting to sudden shocks to the market, Russia could not devalue its currency to encourage the acquisition of foreign exchange.

**Extensions and Conclusions**

One possible solution to Russia’s exchange rate issues would have been to adopt a crawling horizontal band, which prevents hyperinflation by minimizing the exchange rate’s fluctuation, instead of a crawling peg. The wider range of exchange rate fluctuation, however, would have allowed the financial market to engage in limited monetary expansion. This would have alleviated the tension within the bond market by lowering both the domestic interest rate and the interest rate on bonds. This measure would have promoted monetary stability and prevented hyperinflation further by impeding the sudden inundation of new currency into the financial markets.

Another issue that exacerbated problems associated with the exchange rate policy is Russia’s dependence on oil and gas exports for government revenue. As mentioned before, both the financial collapse of the Soviet Union and the 1998 debt default were preceded by falling oil prices, which led to balance of payments crises and decreases in government revenue. While the exchange rate policy is responsible in part for the growth of an unstable economic system prone to failure, Russia’s reliance on oil revenues for funding clearly contributed to the sudden and dramatic failure of this system. A more diverse economy would have made Russia more immune to global economic trends such as Asia’s recession.

Finally, further research is needed in order to calculate the effects of IMF policy on financial instability. Because the IMF was created to help rebuild Europe following the Second World War, many of its measures are designed to stabilize developed countries with Western-
style democracies. Little research has been done, however, to quantify the impact of IMF conditionality on undeveloped or transitioning economies. In order to better understand the financial impact of the IMF’s exchange rate policy, more study is needed on the impact of exchange rate controls in former Soviet Republics and countries transitioning from a command style economy to a free market economy.
Works Cited


