The Moscow Times
30 YEARS
INDEPENDENT NEWS FROM RUSSIA

The EU Should Follow Russia's Fiscal Restraint

By Anders Aslund

June 21, 2011

Watching the current euro-zone crisis unfold, Russians can proudly say they eliminated their public debt. By contrast, the euro-zone decision makers have made nearly every conceivable mistake, and they keep repeating them. Their blunders highlight many of the lessons that Russia learned during its financial crisis in 1998.

No government can run large budget deficits for many years without eventual financial collapse. From 1993 until 1998, Russia had an untenable average budget deficit of 9 percent of gross domestic product. In 1998, the long-expected financial collapse hit.

The Greek populism, however, has lasted for much longer. For the last two decades, its average budget deficit has been more than 7 percent of GDP, surpassing the Maastricht budget deficit ceiling of 3 percent of GDP each year. But the purported supervisors — Germany and France — forgave Greece because they also exceeded that limit. Both have accumulated public debts of more than 80 percent of GDP compared with Greece, which has now reached 150 percent of GDP.

Russia's public debt was excessive at merely 66 percent of GDP at the end of 1997, and foreign investors realized that Russia's financial policies were not sustainable and called a halt. The International Monetary Fund was prepared to help with large loans, but it stopped short in July 1998, when the Russian government was unable to persuade the State Duma to promulgate the necessary fiscal adjustments.

In August 1998, the Russian government defaulted on most domestic bonds, the so-called GKOs, saving $60 billion for the motherland and rendering Russia financially viable. That was a real haircut for gambling creditors.

After the 1998 default, nobody wanted to offer Russia any financing, and right they were. At the time, the absence of financing seemed a bane for Russia, but in hindsight it appears a blessing. The financial crash jump-started Russia's stalled market economic reforms. The government could no longer afford harmful practices, such as barter, which was essentially a means of escaping taxes. Without other financing than tax revenues, the state budget had to be balanced, and from 2000 to 2008 it had sound surpluses.

In three years, Russia carried out extraordinary cuts in public expenditure, reducing it from 48 percent of GDP in 1997 to 34 percent of GDP in 2000, a stunning reduction of 14 percent of GDP in three quick years. Meanwhile, Russia moved from a budget deficit of 9 percent of GDP to a surplus of 3 percent of GDP long before oil prices skyrocketed, while revenues actually fell by 2 percent of GDP. The Russian government did it all right: Fiscal adjustment was done fast and hard, mainly by cutting public expenditures.

As for fiscal readjustment, it pursued a sound strategy focusing on three undesirable expenditures. First, the eradication of barter did away with at least 6 percent of GDP in unjustified indirect enterprise subsidies. Second, the targeted elimination of direct enterprise subsidies did about as much. Third, a few percent of GDP spent on pensions for people who were relatively young and still working took care of the balance. In hindsight, we can only regret that the cuts were not larger or included the many privileges of the entrenched nomenklatura.

The sharp reduction of subsidies leveled the playing field and improved the country's competitiveness. Substantial structural reforms followed in 1998-2002. Russia adopted a new tax code with fewer and lower taxes, and it deregulated small and medium-sized enterprises. Russia promulgated major new legal codes, such as the customs and civil codes. Only one year after the default, Russia's economy started growing, and it did so at an annual average of 7 percent for a decade. Clearly, the reforms caused by the default unleashed this growth.

Greece and the European Union could have benefited from some technical assistance from the Russian Finance Ministry or from EU members Estonia, Latvia and Lithuania, which have recently pursued similar feats.

Many claim that Russia benefited mainly from its devaluation that kick-started commodity exports. But long-term benefits derived primarily from the shock of the default. Russia never had a current account deficit and did not need a devaluation to balance its foreign account. Rather, Russia's main problem was its persistently huge budget deficit and its financing with foreign funds. The devaluation hurt the middle class and concentrated profits in the hands of the raw material-exporting oligarchs, undermining what remained of the country's democracy.

The EU and International Monetary Fund's handling of the euro crisis for the past 1 1/2 years is not inspiring confidence.

First, the EU has acted very slowly.

Second, its actions have not been guided by clear, sensible principles, leading to persistent conflicts and policy reversals.

Third, the fiscal adjustment demanded from Greece and Portugal has been far softer than what Russia did in 1998 or the Baltic countries in 2009.

Fourth, although the EU and the IMF funds have been large, they have been insufficient and thus unconvincing, given the soft restructuring.

Fifth, without clear principles, nobody has been able to sell these programs to the public.

In short, the EU has made almost every mistake possible. It has done too little, too late, with too little funding and without clear principles. If you are doing everything wrong, you are likely to fail.

The fault also lies with the IMF. Since 2007, it has been directed by Dominique Strauss-Kahn, who in spring 2008 let one-quarter of the IMF professional staff go in the flawed conviction that no financial crisis would occur any time soon. Then, the IMF called on countries such as Spain to stimulate their economies by expanding their fiscal deficits. Ultimately, he bore the responsibility for the EU-IMF program for Greece of May 2010 being too soft to be financially sustainable, while the IMF risked greater financing than for any other IMF program.

Amazingly, after this dubious IMF management, the euro-zone countries insist on sending another French politician, who has personally contributed to the euro mess, to run the IMF. No merits could be more discrediting, and no conflict of interest more evident. Why should Russia and other non-euro countries accept that?

Just imagine if a Russian had been heading the IMF in 1998 and poured money into Russia. Would that have been good for Russia or the IMF?

Anders Aslund is a senior fellow of the Peterson Institute for International Economics and co-author with Valdis Dombrovskis of the book "How Latvia Came Out of the Financial Crisis."

Original url:
https://www.themoscowtimes.com/2011/06/21/the-eu-should-follow-russias-fiscal-restraint-a7764