TO DEFAULT OR NOT DEFAULT, THAT IS THE QUESTION.

By Michael S. Bernstam and Alvin Rabushka

In the first week of January 2001, the Russian government defaulted on a Deutschmark 10 million payment owed to Hermes, the German export credit guarantee group which holds much of Germany's Russian debt. This default, the first of 2001, was another in a chain of Russian defaults that we described on page 2 of Chapter 1 in *From Predation to Prosperity* and which we forecast will continue. We described the entire period of 1992-1999 as continuous contraction and serial default, allowing for sporadic interregnums. For defaults, the interregnum of 2000 seems to be over. The government defaulted on a further DM 100 million due in the second week of January. On January 16, Russia also defaulted on an initial payment of $6 million owed to Japan.

On January 9, the Russian government did transfer $10 million to the Paris Club of 19 sovereign lenders that holds former Soviet-era debt. But this interest-only payment relates to the "tied credits" part of the debt of 1989-1990, which took the form of equipment and consumer goods shipped to Russia. On the same day, Prime Minister Mikhail Kasyanov said that the government planned to skip repayment of $1.5 billion, due during the first quarter of 2001, which it owes the Paris Club on $48 billion of Soviet-era debt. Russia faces debt service payments totaling $560 million in January, $1.27 billion in February, and $3.8 billion for all of 2001. The prime minister previously hinted on January 4 that Russia might not meet its debt obligations on schedule, but he has also said on other occasions that Russia would pay a certain percentage of its obligations on particular categories of debt, without specifying exact values.

Various Russian officials have made similar statements. On January 12, Deputy Prime Minister Alexei Kudrin stated that the Russian government would make a decision on repayment of a certain amount of debts to the Paris Club *only after* the IMF approves Russia's economic program. He emphasized that Russia would be unable to make some repayments before negotiations with the IMF are concluded, too late to meet January's obligation.

On January 13, Deputy Finance Minister Sergei Kolotukhim was reported as saying that Russia would delay a debt repayment of $285 million due in January to the Paris Club. It would only repay $31.5 million, instead of the full $316.4 million as scheduled. On January 16, he ruled out borrowing from the Central Bank's hard currency reserves to fund debt payments, noting, in part, that the IMF is opposed to borrowing from the Central Bank to pay the government's debt.

The speaker of the Russian parliament, Gennady Seleznyov, also stated on January 13 that the Duma would not reduce any expenditures in the 2001 budget to free up funds to make full scheduled repayments to the Paris Club.

To justify its position, the Russian government points to the likelihood of a smaller trade surplus in 2001 due to lower prices for oil and other commodities. The government claims it needs the money for domestic programs. It warns that if the price of oil falls by a few dollars, the balanced budget recently adopted by the Duma for 2001 would be put at risk, jeopardizing government spending and macroeconomic stability. Russia's 2001 budget assumes a $2.2 billion reduction in Paris Club payments and $1.8 billion credit arranged with the IMF.

The chairman of the Paris Club, Mr. Jean-Pierre Jouyet, sent a stern letter to the Russian government on January 8 warning against default. The Club is demanding that Russia pay in full on time. The chairman said that the Club would not condone a unilateral default. The German government, which holds 40% of this debt, has threatened to suspend export credit guarantees to Russia if payment is not made.

Mr. Jean Lemierre, president of the European Bank for Reconstruction and Development and former head of both the Paris Club and French Treasury, stated that Russia can afford to service its debts because higher oil and gas prices have resulted in a large current account surplus, roughly $40 billion during the past 12 months.

Mr. Lemierre also stated that any agreement between the Paris Club and the Russian government on easing payments through a wider debt restructuring agreement should be conditional upon an agreement between Russia and the International Monetary Fund on a further round of economic reforms in Russia. Another IMF staff mission is due in Moscow sometime in February. The Russian government is actively seeking a standby loan from the IMF. If granted, it would be seen as a statement that Russian reforms are on track, thereby qualifying Russia for easier debt payment terms. The Russian government has successfully negotiated three sets of repayment terms. The prime minister's statement that Russia will suspend repayment in the first quarter of 2001 presages a fourth round of negotiations, perhaps taking the form of relief during the next two years.

It is this latter condition, further agreement with the IMF over the course of Russian reforms, that poses genuine problems for the Russian government. For a decade, Russia's young reformers largely followed the prescription of the IMF, the World Bank, the U.S. Treasury, and other international advisers, for which they received tens of billions of dollars in global financial assistance and attracted additional billions in private investment. The prescription rests on the troika of stabilization, liberalization, and privatization, what we have termed SLiP. The results were devastating. The economy contracted by 45% between 1991 and 1999. Whatever else happened, one thing is clear: IMF-prescribed economic reforms were not, and are not, the answer to Russia's economic problems. Insisting that any easing of the Paris Club's demand for repayment of Russian debt be conditional on further agreement between the Russian government and the IMF amounts to inviting the fox inside the henhouse. Note that an improvement in Russia's economic performance in 1999-2000 and in debt service in 2000 came exactly when the IMF had given up on Russia and left the country to its own smarts.

It's time to change terminology. Economic reform is a trite cliche with little meaning. What's required is a serious discussion of economic policy, which depends on a correct diagnosis of Russia's current economic situation. More SLiP is not the answer.

The first step is to recognize that Russia has not evolved into a market economy. Rather, the application of SLiP played a substantial role in causing the mutation of central planning into a new form of socialism, what we call enterprise network socialism (ENS). Transforming ENS into a market economy requires, first and foremost, breaking up the inherited network of enterprises.

The goal of achieving a market economy in Russia is correct, but the conventional prescription of SLiP has not only failed, it has made matters worse. If the Russian government were to shift its focus from further application of IMF medicine and, instead, began to dismantle enterprise network socialism by shutting down value-subtracting enterprises, it would have little need of debt rescheduling or IMF loans. The government can achieve, in a quick period of time, a one-time 50% increase in GDP simply by eliminating value-subtraction. This analysis appears in Chapter 1 of *From Predation to Prosperity*.

In a purely accounting sense, there are more than sufficient foreign reserves among the assets of the Central Bank for the Russian government to meet its repayment schedule to the Paris Club, assuming that the government is willing to borrow from, or use some of its rubles to buy foreign currency from, the Bank. Thus far this year, the Russian government is resisting that step. But the current defaults, however small, should not be taken lightly. They are several more in a long series since the birth of modern Russia. A decade of SLiP has not fixed the underlying problems. Until SLiP gives way to policies that move Russia from enterprise network socialist to a market economy, Russia will continue to suffer serial defaults.