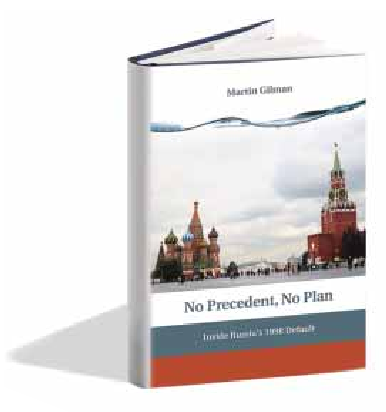
Revisiting Russia's Crash



Martin Gilman

No Precedent, No Plan

Inside Russia's 1998 Default

MIT Press, Cambridge, 2010, 416 pp., $29.95 (cloth).

The global financial crisis has revived interest in previous crises. Martin Gilman's book, the most substantial contribution to date on the Russian financial crash of August 1998, is therefore timely. Gilman was the IMF's senior resident representative in Moscow in 1996 and has lived there for all but three years since; he offers excellent insights into Russian policymaking, the work of the IMF, and the evolution of the crisis. He knows the actors, Russia, and the relevant literature.

The Russian financial crash was spectacular. It hit with a triple whammy: default on domestic treasury bills, sharp devaluation of the ruble, and a three-month freeze of foreign bank payments. Fears abounded of hyperinflation and an end to Russia's experiment with a market economy. This crash was a turning point—for the better. Remarkably, Russia's GDP fell by only 5.3 percent in 1998, and it grew by an annual average of 7 percent for the next decade. Most of the domestic debt could be written off.

This book is a chronological-thematic narrative of the build-up, the peak, and the outcome of the financial crash. Gilman tells this exciting story well. His is an easy read without unnecessary professional jargon or technicalities, and the author is refreshingly candid about his own views. His favorites are the Russian reformers and the IMF management of Michel Camdessus and Stanley Fischer, while he harbors no sympathy for red directors, communists, nationalists, oligarchs, or Joseph Stiglitz. His many personal observations are both telling and revealing. "The problem on the government side was that no one was clearly in charge." Key insights include the miserable state of Russian institutions, the severity of the economic problems, and the weakness of the state after the collapse of the Soviet Union. Concerted policymaking was missing and vital information did not flow. Gilman displays many examples of the absence of policy coordination. Incredibly, the finance minister and the chairman of the central bank refused to talk to one another during the financial crisis, while decisions were often made by people without government posts.

Gilman gives a good picture of how the IMF works. Its access to Russian policymakers was impressive, but often its staff did not know what was really going on. Outsiders will obtain an uncommonly clear picture of what the IMF could and could not influence. Most will realize how great the limitations on its power are. The author rightly emphasizes that its greatest role was to promote good policy discussion. On specific policies, he is critical of his longtime employer for having opposed export taxes, flat income taxes, and the stabilization fund. I think his balance is accurate: the IMF is good at acting fast and sensibly, but its policy thinking is intelligent and decent rather than outstanding.

Gilman takes satisfaction in discrediting three myths. Contrary to widespread but false media reports, nobody stole the IMF disbursement of $4.8 billion in July 1998. Nor "was there evidence that the Bank of New York laundered billions of dollars from the Russian mafia." Months later, after successive front-page stories, *The New York Times* backtracked on its allegations of money laundering and disingenuously buried its condemnation of its main source for those claims in a large article in its business section. Third, and despite unfounded allegations particularly emanating from economist Joseph Stiglitz, capital flight was not caused by capital liberalization enforced by the IMF. Russia did not liberalize capital account operations until 2006—eight years after the IMF program—when the weak state found it impossible to control capital flows.

Curiously, the author is reticent to draw all the conclusions from the crash of 1998, which in hindsight turned out to be such a success. He emphasizes that the absence of financing imposed fiscal discipline on the government, promoted a profound tax reform, and led to the completion of various structural reforms. But he is not prepared to say that it was good that the crash came early so that Russia could preserve $10 billion of reserves or that the default allowed Russia to write off some $60 billion of treasury bills. This crash was Russia's real shock therapy and it worked. Yet, the crash also promoted Vladimir Putin's authoritarian rule.

Gilman calls the 1998 crisis "a humbling lesson for the IMF," but was it in substance? The IMF offered reasonable policy advice and a large amount of financing to resolve Russia's hardship in July 1998. Alas, the Russian parliament refused to legislate the necessary measures. Then the IMF honestly carried out its threat to stop financing. The Russian crash ensued, and taught Russian policymakers why. On their own, they did what the IMF had suggested. A successful crisis resolution followed. After all the recent Western financial folly, we are surely more tolerant of the early failures of Russia, which since has learned its lessons so well.

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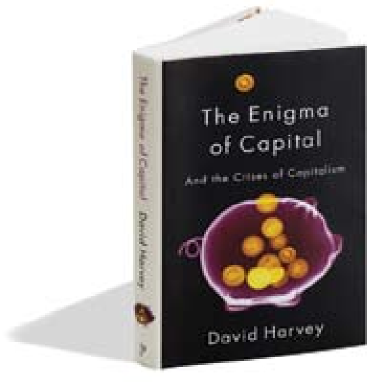
Mysterious Money



David Harvey

The Enigma of Capital

Profile Books, London, 2010, 256 pp., $24.95 (cloth).

The global financial crisis has naturally given rise to a great many theories about its cause. Whereas most theories focus narrowly on one factor or another—global imbalances, excessively low policy interest rates, failings of financial regulation—David Harvey's *Enigma of Capital* provides a more sweeping explanation. For Harvey, who analyzes the crisis largely through a Marxist prism, the root cause of the crisis is the class struggle between capital and labor over distribution of the economic pie.

Harvey's basic story runs as follows. In industrialized countries, sustained capital accumulation and the consolidation of capitalists' economic power were held in check through the 1960s by a shortage of labor. Immigration—including guest worker programs in Europe and the 1965 immigration reforms in the United States—labor-saving technological change, and outsourcing to countries like China meant there was a gradual shift in the bargaining power between capital and labor.

By the time Reagan and Thatcher came along, labor was politically subdued, and real wages for workers were no longer keeping pace with rising productivity. But for capital to be able to sell its wares, workers need sufficient income (there are only so many yachts a billionaire can buy). So how could demand be sustained in the face of a falling income share for labor? By extending easy credit! This provides both effective demand for goods and, through interest payments, an additional source of income to capital. And that, according to Harvey, is exactly what happened.

In the United States, for example, the share of wages and salaries fell from about 53 percent of GDP in the 1960s to less than 50 percent in the 1980s and by 2005 was hovering around 45 percent; meanwhile, the consumer debt service ratio (debt service payments in proportion to disposable income) rose from about 10 percent in 1980 to more than 13.5 percent by 2005. Eventually, of course, the house of cards came tumbling down: without a real rise in income, workers were unable to repay their mounting debts, and a financial crisis ensued.

How plausible is this story? First, there are some (largely uncontroversial) facts: at least in the United States and the United Kingdom, income inequality has worsened over the past 25 years or so; there was a boom in consumer (especially home mortgage–related) lending; and we have just seen the worst financial crash since the Great Depression. (Indeed, as Harvey points out, similar trends of rising inequality and of increasing household indebtedness were evident before the 1929 financial crash.)

Harvey is not the only one to notice these trends: in *Fault Lines*, Raghuram Rajan tells a similar story, albeit based on the college education premium rather than on class struggle. Rajan emphasizes the 90–10 divide: between 1975 and 2005, the purchasing power of those in the 90th percentile of the income distribution saw their wages rise by 65 percent more than those in the bottom 10th percentile. For the latter (mostly those who lack a college degree in an increasingly skill-based economy), the politically expedient solution was to provide easy credit, particularly through Fannie Mae and Freddie Mac. This made home ownership affordable to those who could not really afford it. Beyond that, Harvey's and Rajan's explanations are pretty much the same: the bubble collapses when the debt-financed consumption boom becomes unsustainable.

Harvey analyzes the crisis largely through a Marxist prism.

So has Harvey solved the mystery of the financial crash? Not quite. He has a plausible tale, but what economists will find frustrating with *The Enigma of Capital* is that the details are not worked out. The book covers a great many important and interesting ideas but none in sufficient detail to yield testable hypotheses. For instance, when does the declining income share of labor become a critical constraint for capital to sell goods? Does the theory require that real wages actually decline or just not keep pace with rising productivity and real GDP? And does rising demand from Chinese workers—whose real wages are increasing—not help offset the lower demand from American workers whose jobs are being outsourced? Harvey does not articulate his ideas with sufficient precision to pin down such questions. Fortunately, however, others are already at work modeling this theory with the analytical rigor that economists are likely to demand. Meanwhile, Harvey has written a thought-provoking book that is an important contribution to the "how-on-earth-did-this-all-happen?" literature.

So do I buy Harvey's theory of what caused the global financial crisis? Not yet. Would I buy his book? Definitely.

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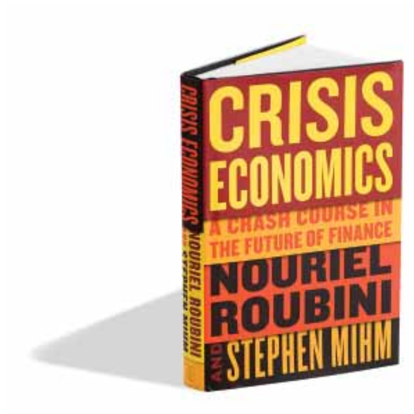
The Man Who Saw It Coming



Nouriel Roubini and Stephen Mihm

Crisis Economics

A Crash Course in the Future of Finance

Penguin Group (USA) Incorporated, New York, 2010, 368 pp., $27.95 (cloth).

Nouriel Roubini, one of the authors of *Crisis Economics*, is known as the man who saw the global financial crisis coming. This book is a chronological thought process of how he managed to do it. Each crisis is different, but the principal thesis of this book focuses on the strong common factors of crises that make them both probable and predictable. The message is that capitalism and crises are natural bedfellows. "Creative destruction"—the mechanism by which technical innovation drives economic growth—necessarily causes crises. What the book counsels is controlled creative destruction, which comes from understanding and managing crises. The book takes the reader through the great thinkers in economics who have written on business cycles and financial meltdowns: J.S. Mill, Jevons, Marx, Schumpeter, Keynes, Fisher, and Minsky. While no surprise to the scholar, the general reader will find a contemporary resonance in 19th-century economist J.S. Mill's description of a credit boom and crash.

This book has the pace and verve of a thriller. The narrative is littered with context and clues, and there are many villains (including Alan Greenspan) but few heroes. Roubini may be viewed as one of the heroes, though there are others less well known. But nobody listens to anyone warning of the dangers of alcohol abuse at a fraternity party. The book takes the reader into the bewildering world of financial engineering. As part of the explanation of securitization, it describes the "originate and distribute" model and explains the workings of collateralized debt obligations (CDOs), CDOs-squared, and CDOs-cubed. It also refers to bankers' bonuses, risk taking, moral hazard, deregulation, over-leveraging, global savings, easy credit, and the growth of the shadow banking system. Chapter 4 describes how a cocktail of these elements led to the subprime crisis and not just the collapse of two investment banks but the near-collapse of Fannie Mae, Freddie Mac, and AIG—and with them, the undermining of the creditworthiness of the United States.

The book describes how the infection in the U.S. financial system developed into a global epidemic, laying low the myth of decoupling. However, no matter how close the world came to repeating the experience of the Great Depression, lessons had been learned and the major central banks deployed innovative and radical policies to prevent a reccurrence. Those radical policies are discussed, but the authors speculate about whether the cure is simply delaying the onset of the next crisis. Intervention by the authorities did not distinguish among the good, the bad, and the ugly. It has left open the inevitability of the next downturn.

Later chapters bring the reader to policy actions. The authors argue that prior to the crisis, the prevailing philosophy was that the "market knows best." But this is not what is taught in economics courses. Market failures from uncertainty, asymmetric information, and moral hazard are standard in economics programs. Ignoring what is taught in economics is not a crisis for economics but may be one for economists, who were slow in sounding the warning sirens. A number of practical proposals—most of which have been discussed in the media—are examined, from the structure of bankers' bonuses to the inclusion of the toxic assets designed by Wall Street's financial engineers as part of the bonus pool. Other proposals include "dynamic provisioning" (raising capital requirements during a boom to cover inevitable losses in a downturn), tighter liquidity management rules, the return of a form of Glass-Steagall (the separation of investment banking from commercial banking), stronger capital requirements for hedge funds that trade in credit default swaps (an insurance contract that meets payments in case of default but can be traded so that an agent with no insurable interest can hold it), improved corporate governance, the need to reduce the dependence on rating agencies, and the need to limit bank size. Much of this is sensible; some of it is contentious.

The title of the book is perhaps a misnomer. Crisis economics does not require a special type of economics. What needs changing in response to the crisis is how economics is taught in the mainstream. There is nothing wrong with rigor and model building as long as students are taught the critical evaluation that should accompany them. Even the proponents of the Efficient Markets Hypothesis have long abandoned the naive versions, and there is ample empirical refutation. The best way of developing critical evaluation is through the study of economic history, and that is the lesson I take away from this book. Unfortunately, many economics departments have relegated economic history to the periphery of the curriculum. As the authors state, "History promotes humility, a quality that comes in handy when assessing crises." Who can disagree with that?

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