

The Russian Financial Crisis as it Points up the Failures of Liberalization

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The Russian financial crisis of August 1998, which occurred between the Asian recession and the devaluation of the Brazilian real in January 1999, put a question-mark over many certainties. It demonstrated that the most destructive speculative activities of financial players can only have free rein when there is a collapse of the state. The crisis proved that the markets need a state and cannot replace it. It was also the moment when people became aware of the dynamics of a globalized financial economy (Stiglitz, 1999a; 1999b), leading to a critical rereading of the policies recommended in the 1990s and a direct questioning of the IMF and its actions. In Russia it caused a paradigm shift that could turn out to be salutary. In this regard the August 1998 crisis looks like the endpoint on the route followed since 1992 by the transition in Russia (Sapir, 1999a). We can see in the crisis both elements directly linked to the financial liberalization of 1985–95 and structural elements peculiar to the consequences of the transition and the policies adopted. This is why it suggests a reinterpretation of the entire development of the transition in Russia starting from 1992.

The crisis period

The crisis began on the recently created Russian government stock market and then spread to the banking system. This market was established because a substantial budget deficit had developed that was aggravated by the policies of successive governments after 1992, which neither could nor would reintroduce the fiscal discipline required. Collusion between newly privatized companies and certain members of those governments did not produce the most favourable context for such discipline. In 1994 the abolition of tax on exports of raw materials demanded by the IMF was to precipitate a rise in the deficit. In this situation, and in order to follow the recommendations of international organizations, recourse to borrowing was inevitable and logical.

The infernal machine of debt and borrowing

In order to finance the budget deficit, and with the agreement of the IMF, the Russian government, starting in 1995, issued a large quantity of short-term (1–3 month) domestic stock (GKOs and OFZs) in roubles. This market in government securities, which was organized with the technical assistance of a big American bank, quickly became the

market that set the standard for financial and non-financial players. Initially rates were quite high (over 100% per annum).

The drop in inflation and the opening of the domestic market to non-residents had meant a substantial fall in rates during the first half of 1997, sliding to around 20% by the summer of 1997. True gains – calculated on the basis of the inflation rate – had dropped by more than 40% to 10%. But this fall, even though it was large, did not detract at all from the attractiveness of government stock. Even by the summer of 1997 it was still more profitable than other investments, thus siphoning off domestic savings into speculation at the expense of production.

Following the Asian downturn, but also because of the concerns associated with the rise in the non-recovery of income tax, rates gradually increased again. After a peak of 39.5% in early December 1998 they settled around 30%, close to 20% in real terms. With the troubled change of government in the spring of 1998 they went up to 53% for the 19 May 1998 issue then broke through the 60% barrier at the end of May. A relative fall in rates, to around 40% at the start of June, was only made possible by tight restriction on the real sums invested in the 10 June issue and by borrowing on international markets. The position was to deteriorate yet again at the end of July.

Just to ensure roll-over of the debt existing at the end of 1997 the Russian government had to issue stock worth 7 to 12 billion new roubles every week. Financing the new deficit on the current financial year required an additional sum of between 4 and 6 billion. Altogether the weekly requirement was between 11 and 18 billion (2–3 billion dollars) for the first half of 1998. However stock issues were – at the most – covered for between 10 and 12 billion.

Even with high interest rates and availability opened up to non-residents, the government found it increasingly hard to finance the ongoing management of the existing debt. It should have become obvious to observers that the Russian financial market was not up to supporting the national debt. Other factors were a source of concern in early 1998. The accumulated federal debt exceeded the federal budget's total receipts and of course far exceeded (by about 40%) true tax income. The total value of the GKO's in circulation by 1 March 1998 – around 67 billion dollars – was equivalent to M2 money.

Internationalization of the national debt – through opening the market to non-residents – gave rise to the problem of exchange risk when a third of GKO's were in fact held by foreigners. In fact exchange rate stability is a criterion for portfolio investments at reasonable rates by non-residents. But exchange rate may come under attack when the Central Bank's exchange reserves seem too low. And by late 1997 they were way below non-residents' commitments on the Russian financial market.

Financial players and politicians should not have been surprised by the financial crisis that began to unfold from June onwards. It was inevitable given the financing constraints of the state. The rising volume of transactions on the second market and the heavy marking down of stocks were signs of dealers' growing nervousness at the end of the spring of 1998.

The infection travels via the banks

The Russian banking system created by the reforms was structurally fragile (Sapir & Ivanter, 1995). The banks, which had been set up afresh in 1990, typically had a very low

level of capital. This undercapitalization was unavoidable in an economy in transition and it made the whole system vulnerable.

A considerable effort had been made by the Central Bank since 1994 to reintroduce some discipline, with a reduction in payment deadlines (which had been allowed to stretch beyond two months in 1992 and 1993). However, two fundamental characteristics remained. On the one hand the banks had dangerous portfolio structures; 'endogamous' borrowing (within the same group or holding), where the lender is dependent on the borrower (if the latter goes bust and can drag the lender down too), was often the rule. On the other hand, the new banks had their hands tied as far as refinancing was concerned. The poverty-stricken country could manage only a low level of savings, and these were quickly siphoned off by the market in government bonds. As for the Central Bank, after the IMF'S liberal strictures, it held off from intervening in the refinancing of the banks.

Just prior to the crisis Russia had a banking system with, on the one hand, a large number of regional banks with reduced capacity that were the face of banking throughout the country, and, on the other hand, a relatively small number of big financial institutions, which monopolized all the really profitable operations. This system was segmented even within the large Moscow or St Petersburg institutions. Successive banking crises since 1994 had finally blown the inter-bank market apart. So the big institutions got together and formed clubs where the internal rules of solidarity had more to do with political objectives than economic judgements.

Thus it is easy to understand why credit for business was particularly underdeveloped in Russia. For the most part the banks drew the resources they needed, given the nature of their portfolios, from very short-term operations on the financial markets or, from 1997 onwards, the property market. Because speculative operations played a large part, other kinds of activity were scarcely developed.

Since, as a consequence of an extremely restrictive monetary policy whose aim was to combat inflation, there was no chance of refinancing by the Central Bank, imbalances were made worse. Thus Russian banks were forced into speculation by the monetary policy pursued from late 1993, as forecast by early theoretical studies (Stiglitz & Weiss, 1981). The signs of a systemic instability in the banking sector were evident to those observers who were not blinkered by ideology. The inter-bank market collapsed in 1996 in a violent crisis from which it never really emerged. Runs on liquidity, such as the one that toppled TverUniversalbank (1995) or Tokobank (spring 1998), were liable to occur at the drop of a hat.

Furthermore the weakness of the large banks' financial situation quite naturally encouraged them to take relatively substantial risks in order to ensure a profit flow sufficient to make up for their low level of capital. In this regard the exchange positions taken up in the spring of 1998 by the nine main Russian banks for more than 50 billion dollars, although their capital did not exceed 3.8 billion, was an additional cause for anxiety at the end of spring 1998.

The Central Bank allowed such behaviour only because it had already drawn heavily on the banks' liquidity since the beginning of 1998, and also because of the well-known links between the then directors of the BCR (Dubynin and Alexachenko) and some of the owners of the big Russian banks. However it was obvious that Russian operators had taken a crazy degree of risk which could only be explained by their certainty that Russia

would always and in any circumstances be bailed out by western nations. This is a perfect illustration of the phenomenon of moral risk.

The nature of the crisis

The Russian crisis unfolded according to an implacable scenario. A sudden flight of capital, when non-residents realized in July that the government could not continue to support the debt, forced the Central Bank to exhaust its reserves before throwing in the towel. The banks had their liquidity cut off and stopped honouring payments. The government was instantly obliged to devalue the rouble and announce that it was defaulting on its domestic debt.

This crisis reminds us of familiar dynamics: a newly created and liberalized financial market, fed with highly profitable stock issued by a state with recurring budget difficulties, turns into an instrument for pure speculation (Rodrik, 1998). Speculation attracts the banks, which, because of financial liberalization, can create considerable leverage by getting into debt buying dollars to invest in domestic stock. Arbitrage effects on the market in government stock become larger and more violent and are directly destabilizing (Jordan & Radner, 1982; Green, 1977; Salop & Stiglitz, 1977).

Opening the market to non-residents implied that the exchange rate was more or less guaranteed. But this guarantee resulted in an over-valuation of the currency between 1994 and 1996, which destroyed the real economy. The importance assumed by speculative activities in total banking operations distracted institutions from offering credit to the economy. So the transition took place in a context of threefold liquidity shortage, because of the Central Bank's policies, the attitude of commercial banks, and finally the contraction in public spending. An extremely violent reduction in economic activity became inevitable. As a result the state's tax income was affected, worsening the budget deficit problem, and the trade balance was compromised. The financial system became increasingly dependent on the inflow of non-resident capital, and the state was forced to carry on increasing its debt at a greater and greater cost. The risks taken were less and less calculated by economic operators, who were prisoners of a 'market myopia' and the delusion that there was an international guarantee of last resort (moral hazard). The speculative behaviour of operators here just goes to illustrate the fact that the efficiency of markets is only that of the institutions that support them (Grossman & Stiglitz, 1976; 1980).

The Russian crisis is part of the context of policies of over-enthusiastic liberalization that have resulted in a weakening of the institutions of markets (Rodrik, 1997; Stiglitz, 1998). In Russia attitudes and mechanisms can be identified that are similar to those in Southeast Asia or Latin America. However some behaviours are comprehensible only in the structural context peculiar to the Russian transition, and this context alone supplies the key to the overall dynamic of the crisis and its violent nature.

The crisis as part of the transition phase

It is thus essential to understand the origin of the behaviours and mechanisms that led to this situation. Any analysis must therefore move from the contingent to the structural

level. And this analysis can be carried out only if we remember that the Russian economy is an economy in transition. The term 'transition' means that economic institutions are unstable, incomplete and so only partially effective. Realizing this is particularly important if we wish to understand the effects of macroeconomic policies that assumed, at least implicitly, that the institutions of a mature market economy were already in place in Russia (Sapir & Ivanter, 1995).

And so the story of the August 1998 financial crisis only takes on its full meaning when it is placed in the context of the story of the transition in Russia and also the USSR.

The Russian economy's move into finance

Until 1 January 1990 the Soviet economy had in fact been operating within a 'monobank' system, which had been set up at the end of the 1920s when the commercial banks had been merged with the Central Bank and the practice of credit between companies (discounting) had been strictly forbidden. The confusion between a commercial bank's functions and that of a Central Bank prevented the state from carrying out truly effective ongoing regulation. It is not well known but well documented that the Soviet system passed through the equivalent of several financial crises (Sapir, 1989). Though the nature of economic fluctuations in the USSR was determined by the economic and financial system's structures – justifying Lucien Febvre's aphorism '*les économies ont la conjoncture de leurs structures*' (economies enjoy the position dictated by their structures) – it is equally true to say that the evolution of these structures was the product of both local and central reactions to the economic situation. In a sense, from a dynamic viewpoint, another aphorism proves just as relevant: '*les économies finissent par acquérir les structures de leur conjoncture*' (economies end up with the structures dictated by their situation). Within companies there was a financial expertise developing that was considerable but entirely shaped by the combination of explicit and implicit rules that characterized the Soviet financial system.

It was precisely the inability of state bodies to assume a continuous financial monitoring role in regard to companies that had convinced the Soviet leaders of the *perestroika* period of the need for liberalization of the financial system.

This liberalization was rolled out over a period of seven years, from the moment when the decree relating to co-operative banks came into force, signalling the demise of the monobank (1 January 1990), to the opening of the market in government stock to non-residents (1 January 1997). The rouble became convertible, the principle of issuing stocks and shares was introduced, securitization of debt was made possible, and finally a stock market (forward and spot) was created. There are few, and probably no, historical examples of such a fundamental transformation in so short a time. Just with respect to currency convertibility western European countries took thirteen years (1945–1958) to achieve complete current account convertibility and much longer for capital convertibility. The deregulation of financial markets did not come about until the 1980s.

As for Russia, it attempted to create for itself the entire apparatus of financial instruments of a mature market economy, when the simplest and most basic instruments had been banned since 1929. We should add that this liberalization took place in a political and psychological context where the smallest degree of state regulation was seen by most

of the press and the other media as a return to a 'totalitarian economy'. Though it is possible, and rightly so, to see it as unrealistic to wish to reconstruct a whole financial system in just seven years, attempting to do so while simultaneously dismantling the state's regulatory and monitoring mechanisms was truly suicidal. Nevertheless Russia's liberal leaders rushed headlong down that road, partly through inexperience, partly because of the ties connecting some of them with financial players who were profiting substantially from the situation.

Before 1990 operators' financial practices – whether legal or illegal – were consistent with a certain framework. In order to institute new practices, it would have been necessary to replace the existing framework instantly with another coherent range of institutions. This implied a strong presence for the state and prudential authorities. Such a scenario was fundamentally at odds with the dominant vision of the figures at the centre of the political process. The transition in the monetary and financial area was thus more an extension of previous practices, through the collapse or withering away of the few existing instruments of control, than a process of change in behaviour directed by a coherent institutional framework.

Identifying what the chaos of the transition owes to the Soviet era in no way exonerates the leaders during the transition period, since in the final analysis it was their choices that made the situation possible.

When the transition destroyed the currency

The process of moving into finance not only happened at an amazing rate; it took place in a macroeconomic context of deep recession, with a fall in output of around 50% and a sharp initial rise in inflation followed by a spectacular deflationary turn. This contraction in economic activity made production unprofitable except for imports of raw materials. So economic operators who could afford it turned to buy and selling and finance.

The vigorous macroeconomic policies adopted to bring down inflation had as a corollary a gradual demonetization of the economy. The extent of this may be estimated by the proportion of business-to-business trade that was barter, a proportion which was set to exceed 50% just before the crisis. To that must be added the issue of stock, called *Veksels*, which was often only redeemable for goods (Rodionov *et al.*, 1998).

This creeping demonetization began to take off in the autumn of 1993, when monetary policy became really restrictive. The liquidity level of the Russian economy was extremely low just before the crisis erupted, with an M2/GDP ratio of 13%, compared with 60–100% for the European Union countries and 35% for a country like Brazil, which also experienced serious inflation.

Demonetization of the economy indicated that financial players could not rely on the savings of non-financial groups as a possible source of liquidity. It was caused by a break in the link between the world of the real economy and the world of the financial economy, which is a systemic trigger of vulnerability in the latter. Demonetization is essentially the result of under development of the banking system combined with the shortage of liquidity caused by monetary policy (Marin, 2000; Sapir, 1999b).

However, the increase in barter means abandoning a bilateral method for transactions and adopting a method dependent on the operation of a network, which is what was

observable in Russia from the start of 1994. And networks operate because of technical complementarity, which in Russia was in part a product of the Soviet legacy and in part simply the consequence of the industrial system and its complexity (Richardson, 1972; Ravix, 1990).

These networks come into play all together, in the absence of banks and institutions that build 'confidence' in contracts. And it is well known from the work of Durkheim (Durkheim, 1981/1893) that the confidence essential to a contract does not derive from the contractual relationship, which is never self-created and can only function if it is backed up by institutions – and sometimes in the most material sense of the word – and a moral system that is really none other than the shape assumed by the legitimacy of these institutions (Etzioni, 1988; Etzioni & Lawrence, 1991). Thus the adoption of networks in the productive sector in Russia should not be seen as an extension by inertia of the Soviet model, even if many networks indisputably imitate pre-1991 relationships, but as a functional response to a massive institutional deficit.

The outcome of this situation is a dichotomy between the financial sector and the real world. Then speculation becomes not the exception but standard behaviour among financial actors, as the proliferation of financial pyramids demonstrates, the most famous being the MMM company. And so this speculation is fed not only by the simple existence of temporarily higher gains to be made in the financial sphere, but also by the fact that the financial sphere is being forced to operate in a vacuum.

Thus the extremely unwise behaviour of financial operators, widely condemned by observers, has less to do with some Russian cultural peculiarity, a hypothesis that would mean going back to the aberrations of Spencer's kind of sociology, than with the existence of a context that amounts to a truly global social phenomenon, to re-use Durkheim's terminology. The explosion of an entirely speculative financial sector into a deeply depressed real economy is without doubt one of the specific features of the Russian situation.

The crisis and the phase of globalization and collusion

In this way the gamble of borrowing massively in dollars in order to buy GKO's, a gamble that precipitated the collapse of the big banks just prior to devaluation, can be better understood. It follows the logic of the casino player, which is inescapable for the reasons set out above. However, this gamble is not fully comprehensible without an analysis of some of the players. Certain banks, those owned by the people called 'oligarchs', were able to influence the rules of the game. Heavily involved as they were in Yeltsin's political system, which they were financing – as was shown by the 1996 elections – these institutions had the feeling they could behave with complete impunity. These big banks had been beneficiaries of the 1995 'loans for shares' operation (an underpriced privatization of the large exporting companies in return for loans to the government) and had taken over direct management of government finances, in the absence of the equivalent of a system like the Trésor in France, with the assistance of liberal reformers like Anatoly Chubais and Boris Nemtsov. So now they thought they were permanently protected against the effects of their imprudent actions. The moral risk in Russia was the consequence of the collusion and corruption that were institutionalized into a system (Sapir, 1998 & 2000a; Wedel, 1998).

The support that this system's instigators (Chubais, Khodorkovsky, Fyodorov and Nemtsov) received from the IMF and western governments, headed by the American government, raises directly the question of the responsibility of the west (Sapir, 2000a). Western experts and international organizations would not ring alarm bells while there was still time (Pagé, 2000). Precise accusations relating to collusion and converging interests between western advisers and Russian leaders have never been rebutted (Wedel, 1998). In any event in September 2000 the American government sued for 120 million dollars André Shleifer, the former head of the University of Harvard group of advisers in Russia, the Harvard Institute for International Development. In early 2000 the university had in fact decided to disband the HIID following an internal inquiry.¹

Analysis of these networks is extremely instructive. Lucy Edwards, one of the Bank of New York's top executives, who was sacked at the time of the scandal, was the wife of Peter Berlin, a Russian émigré who had formed a company, Benex, through which 4–10 billion dollars had been laundered since early 1998. Berlin was well known as one of the contacts between the American financial community and the new Russian bankers.² Kagalovsky, a director of the Russian bank MENATEP founded by one of the young Russian liberals Mikhail Khodorkovsky, was the first Russian representative at the IMF. In 1991 he was one of the intermediaries between Jeffrey Sachs and Gaidar. His wife, Natasha Kagalovsky, headed the operations conducted from London by the Bank of New York on behalf of Russian holders of accounts in the USA.³ These networks were no longer the result of simple ideological affinities but the structure for relations motivated by personal interest, which were partially illegal, as the lawsuits involving a number of the protagonists were later to reveal. The American government had been regularly informed of instances of embezzlement committed by the Russian 'liberals' and had equally regularly refused to listen to the warnings issued by its own officials.⁴

Collusion definitely increased the influence of those in the banking world who wanted the financial mechanisms described to be pursued as long as possible in Russia because of the profits they were making from them. A former official of the CIA and the National Security Council, Fritz Ermarth, did not hesitate to air this problem in public.⁵

The Russian crisis in perspective

The 1998 crisis points up a serious problem of institutional coherence. The policy of the liberal groups around Yeltsin who conducted Russian politics from 1992 onwards was to prioritize the destruction of the old Soviet system. However, fear of a return to a Brezhnev type of policy, which might have been promoted by the pitiful attempt at a coup in August 1991, was totally unfounded. This reasoning was only a pretext for consolidating positions of power and personal advantage.

The swift destruction of institutions inherited from the Soviet past implied the equally rapid construction of new institutions, or if not, the proliferation of local institutions growing up and in a way continuing the old system that it was in fact intended should be destroyed (Sapir, 2001). But rapid building of institutions would have required a strong and legitimate state (Sapir, 2000). The liberals kept confusing the power of the executive with the strength of the state. In all likelihood this confusion was inevitable in the context of Russian post-Soviet political culture. But it is more surprising, and reprehensible, that

westerners should have encouraged it. This political error, together with macroeconomic policies whose purpose was purely monetary stabilization, was at the root of a process of destruction of the state that eventually turned back on the liberals themselves in the form of a gradual weakening of the executive power in which they were placing their hopes.

The result of this strategy was not an institutional vacuum in the strict sense of the term, but a proliferation of local institutions at regional, city or company level, some legal and some illegal and criminal. The development of the mafia phenomenon in Russia, and the way it infiltrated the 'official' economy and the financial world, is in the end only one of the forms assumed by this proliferation of institutions brought about by the incapacity of the state.

Whether we are looking at the rift between the financial sphere and production, at the influence and the nature of operators' strategic actions, or even at the strength some of them achieved during that period so as to set themselves up as alternatives to the state, all the pathologies that are at the root of the 1998 crisis come down to the problem of institutional incoherence. Behind the financial crisis there lies, without a doubt, the issue of the post-Soviet social order.

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Notes

1. Carey Goldberg (2000), US seeks millions in suit against advisers to Russia, *New York Times*, 27 September.
2. See R. Bonner (1999), Bank of New York dismisses second employee in laundering case, *New York Times*, 3 September, electronic edition.
3. See D. Hoffman (1999), In Russia the money doesn't add up, *Washington Post*, 29 August, p. A1, and NY probe unsettles Moscow magnates, *Washington Post*, 31 August, p. A7. See also the evidence given by T.A. Renyi, chairman of the directorate of the Bank of New York Co. Inc., to the House of Representatives committee on banking and financial services, Washington, 22 September 1999 (Internet – <http://www.house.gov/banking/testoc2.htm>).
4. R.G. Kaiser (1999), Pumping up the problems: Has investing in the Yeltsin machine put America's relationship with Russia at risk?, *Washington Post*, 15 August, p. B01.
5. F.W. Ermarth (1999), Testimony of Fritz W. Ermarth on Russian organized crime and money laundering before the House committee on banking and finance, 21 September, Washington, USGPO (Internet – www.house.gov/banking/testoc2.htm).