Markets Under Siege -- Swept Away: How Russia Set Off Wave That Swamped Markets World-Wide --- Flight From Risk Sent Bonds Diverging Madly, Ruined A Host of Financial Bets --- Selling Whatever Can Be Sold

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Abstract:

Big bets by sophisticated investors, many made with borrowed dollars and many having nothing to do with Russia, suddenly went bad. In a scramble to shore up their crumbling finances and meet lenders' demands for more collateral, those investors were forced to sell out of other, safer investments. And as these investments in turn tumbled under the selling pressure, the urge to flee became contagious, spreading quickly until it hammered just about every financial instrument except supersafe U.S. Treasury securities and German government bonds -- which soared.

Much of the damage has been concentrated at securities firms and banks, and especially hedge funds -- investment pools for rich investors that often use arcane trading strategies and borrowed money in a quest for outsize returns. Their holdings of Russian stocks and bonds, needless to say, took a beating. But interviews with scores of Wall Street executives, traders and bankers show that some of the biggest hedge funds, as well as many securities firms in the U.S., Europe and Japan, made three major bets unrelated to Russia that have gone disastrously awry:

Until this summer, Russia made some sense as a place to invest. The Asian turmoil that began with a mid-1997 devaluation of the Thai baht hadn't reached Moscow. Yields on Russia's government debt were high. Major firms such as Goldman, Sachs & Co. and Chase Manhattan Corp. were competing to underwrite government bonds and lead syndicated loans to Russian companies, while hedge-fund investors such as George Soros and Leon Cooperman were

there, too. With such stars paving the way, other investors felt comfortable in the Russian market. Some Wall Street traders bought Russian bonds for their personal accounts.

Full Text:

[First of a Series]

Once again, Russia is the Evil Empire.

This time, it isn't some ill-starred military adventure. Instead, the world is blaming Russia for the chaos sweeping through financial markets over the past month. Russia's abrupt decision in mid-August to let the ruble's value fall and default on part of its debt is widely viewed as the reason for widespread selling in everything from Brazilian bonds to U.S. stocks.

But has an economy that accounts for less than 1% of the world's gross domestic product, even one spinning out of control, really wreaked billions of dollars of market losses? Not by itself, it hasn't.

What the virtual collapse of Russia's markets did was touch off a global flight from financial risk of all kinds. Russia's actions were the trigger for that panicked flight, but once started, it behaved like a chain reaction.

Big bets by sophisticated investors, many made with borrowed dollars and many having nothing to do with Russia, suddenly went bad. In a scramble to shore up their crumbling finances and meet lenders' demands for more collateral, those investors were forced to sell out of other, safer investments. And as these investments in turn tumbled under the selling pressure, the urge to flee became contagious, spreading quickly until it hammered just about every financial instrument except supersafe U.S. Treasury securities and German government bonds -- which soared.

The result is that in the past five weeks, international investors have lost an estimated $95 billion on the stocks and bonds of so-called emerging markets, according to J.P. Morgan & Co. Throughout, huge amounts of debt, built up over years to finance securities purchases, have been unwound. Some victims have disclosed staggering losses.

Long-Term Capital Management, a fund for wealthy investors run by bond legend John Meriwether, has lost $1.8 billion. Credit Suisse First Boston Corp. is out at least $400 million after tax, according to someone familiar with its situation. And Bankers Trust Corp., a firm that had been trying for two years to lower its risk profile, has had its entire third-quarter profit wiped out by losses totaling $350 million before taxes.

Even Merrill Lynch & Co., the most broadly diversified firm on Wall Street, has taken a $135 million hit. And in many cases, securities firms' losses are worse than disclosed because they are using financial reserves to mask their full extent.

To be sure, the trading losses follow year upon year of lush profits by many of the same firms now being punished for aggressively playing international markets. "What we're seeing is the dark side of a truly global marketplace," says Merrill Lynch's chairman, David Komansky. "Going forward, this is what a global, wired economy will look like during a market correction."

While U.S. and European stocks have taken their lumps -- the Dow Jones Industrial Average is 15% below its peak in July -- the losses in these markets are nothing like the carnage in many others, including many kinds of bonds. When Mr. Komansky got home one night, his wife asked him what the U.S. stock market did. His weary reply: "I have no idea -- I've been worried about the global bond markets."

Much of the damage has been concentrated at securities firms and banks, and especially hedge funds -- investment pools for rich investors that often use arcane trading strategies and borrowed money in a quest for outsize returns. Their holdings of Russian stocks and bonds, needless to say, took a beating. But interviews with scores of Wall Street executives, traders and bankers show that some of the biggest hedge funds, as well as many securities firms in the U.S., Europe and Japan, made three major bets unrelated to Russia that have gone disastrously awry:

-- In a bid to take advantage of tiny price discrepancies among types of bonds, Long-Term Capital and many other firms borrowed to finance big purchases of riskier bonds while betting that U.S. government securities' prices would fall.

-- Hedge funds, among them Julian Robertson's Tiger Management, made big wagers that while Japan struggled vainly with its worsening economic malaise, investors would continue to sell the Japanese yen and buy American dollars.

-- Securities firms, chief among them Travelers Group's Salomon Smith Barney, made billion-dollar bets that as European monetary union approached, differences in the yields of various government bonds would narrow.

Indeed, no firm has been more emblematic of the global scope of the losses than Salomon Smith Barney. Even though co-chairman Jamie Dimon had ordered its traders to liquidate their positions in Russia in July, weeks before Moscow defaulted, Salomon has suffered aftertax losses totaling $360 million.

Just $10 million of that stemmed directly from investments in Russia. A further $50 million was from lending to a hedge fund that invested in Russia and went bust. The rest came from bond-market bets that had little or nothing to do with Russia but went bad anyway, as investors' headlong rush for safety confounded expectations of the way various kinds of bonds would behave.

"Russia was the match, but the markets were ripe for dislocation," Mr. Dimon says.

And they haven't settled down yet. The scramble to unload almost any kind of risky investment has been so urgent that some markets, particularly for riskier bonds, are paralyzed, leaving firms holding far more of them than they want. The firms' continuing efforts to cut their holdings suggest more declines ahead.

Beyond that are fears that other nations will follow Russia's lead. Already, Malaysia has applied rigid controls that limit foreign investors' ability to get their money out. Stock markets around the world remain volatile as investors worry about a crisis of confidence erupting in another developing nation.

"It's not like in '87 when the market plunged and by 6 p.m. you knew what your losses were," says Max Chapman Jr., chairman of Nomura Securities Co.'s three regional units outside Japan. "This one is more insidious. It is getting you from all places. If you're a global player, you get kind of dizzy."

Until this summer, Russia made some sense as a place to invest. The Asian turmoil that began with a mid-1997 devaluation of the Thai baht hadn't reached Moscow. Yields on Russia's government debt were high. Major firms such as Goldman, Sachs & Co. and Chase Manhattan Corp. were competing to underwrite government bonds and lead syndicated loans to Russian companies, while hedge-fund investors such as George Soros and Leon Cooperman were there, too. With such stars paving the way, other investors felt comfortable in the Russian market. Some Wall Street traders bought Russian bonds for their personal accounts.

"Interest rates were so high it was almost as if they were giving money away," says Dana McGinnis, a San Antonio manager of three emerging-market hedge funds. His McGinnis Advisors invested a large chunk of its $200 million in Russia.

Then in August, Russian political and economic conditions, which had been slowly worsening, began to disintegrate. Investors increasingly anticipated a ruble devaluation. Yet some, such as Mr. McGinnis, weren't worried. They thought they had purchased protection: the right to convert rubles into dollars at fixed rates, through contracts they had made with Western and Russian banks.

Marc Hotimsky, global-bond chief for Credit Suisse First Boston, met with officials in Moscow and was assured that Russia would meet its obligations and wanted a stable ruble. Leaving the country on Friday, Aug. 14, he says, he "had a sense the situation in Russia was critical, but I didn't think they would default."

On Monday, they did. Although Russia didn't tamper with the government's foreign-currency debt, it announced it would restructure its treasury bills and impose a moratorium on repayment of $40 billion in corporate and bank debt to foreign creditors. It said it would let the ruble's value against the dollar fall by up to 34%. (The ruble didn't stop where it was supposed to, as devalued currencies often don't.)

The news came as a jolt to Rodolfo Amoresano. As chief of emerging-markets proprietary trading for Nomura's New York unit, he was sitting on a $200 million position in Russian treasury bills, traders other than Mr. Amoresano say, after returning from Russia with assurances that the government wanted a stable ruble. Awakened at 3 a.m. by the news, he dashed to the office to warn others of the danger, the traders say. Then he boarded a plane back to Russia to try to sort out the mess.

The bills were supposedly protected by forward currency contracts entered into with big Russian banks. But Russia's debt moratorium apparently allows its banks to ignore their forward-contract obligations for 90 days; terms of the freeze are so confused that parties are still haggling over what they mean.

Those holding Russian securities were stuck. There was no trading. No bids, no offers. A trading strategy that had been profitable -- Nomura's New York unit had made a total of about $100 million in Russia in the prior three years, the traders say -- suddenly was destroyed. Nomura ended up with Russia-related pretax losses totaling $350 million, including $125 million in Mr. Amoresano's "book." (The rest came from the London operation.) A Nomura spokesman declines to comment.

Investors in Russian securities weren't the only ones affected; so were those who had lent to such investors. Creditors of hedge funds, convinced the funds wouldn't get back all the money they had put into Russia, issued demands for more collateral, known as margin calls.

The funds had to raise capital to meet the calls, but they couldn't do so by selling Russian securities, with those markets paralyzed. So they began selling other assets, including U.S. stocks.

One who got a margin call was Mr. McGinnis in San Antonio. His funds had $100 million of Russian bonds, bought with leverage; he, too, found that his currency contracts didn't protect him when Russia defaulted. He says Citicorp, First Boston and Lehman Brothers Holdings Inc. demanded more collateral. To raise it, he says, he began dumping "everything else."

It wasn't enough. In late August, Mr. McGinnis's funds sought Chapter 11 bankruptcy protection in San Antonio federal court.

Talk spread that Russian treasury bills might be worth only 10 cents on the dollar. "The second you hear that, you're feeling, `I don't want to hold any other similar emerging-market debt,'" says Philipp Hildebrand, a strategist for the British affiliate of Moore Capital Management, a New York hedge fund. "You had an immediate and substantial collapse in risk appetite." Holders began selling bonds from South Korea, Greece, Turkey, Mexico, Brazil.

But buyers for what they wanted to sell were rapidly disappearing. "If you didn't sell by Aug. 25, you were probably stuck in the mud," says Peter Marber, president of Wasserstein Perella Group Inc.'s asset-management unit, whose two hedge funds incurred big August losses. >From the Friday before Russia devalued until 10 days afterward, the J.P. Morgan Emerging Market Bond Index fell nearly 25%.

One hedge fund, III Offshore Advisors' High Risk Opportunities Hub Fund, faced margin calls from lenders such as Salomon Smith Barney, First Boston, Lehman and Bankers Trust, according to a person familiar with the matter. To raise the money, the fund sought to collect on forward currency contracts it had signed with Deutsche Bank AG, Credit Lyonnais, Societe Generale Group and the ING Barings unit of ING Group.

Although those contracts hadn't yet come due, III Offshore partner Warren Mosler says the hedge-fund firm was entitled to demand some payment -- he puts it at $300 million -- based on the contracts' present value. But the European banks wouldn't pay, he says, and III Offshore, which is based in West Palm Beach, Fla., had to file to liquidate the hedge fund. The banks "defaulted," Mr. Mosler asserts. "What brought down the fund is these guys failed to meet their obligations."

Credit Lyonnais and Societe Generale decline to comment. A spokeswoman for ING says it is unaware of any dispute. Deutsche Bank says it "complied with all contractual obligations."

Even if a firm was prescient, it wasn't easy to move quickly enough. In July, Mr. Dimon hammered home his concerns over Russia and Indonesia to Salomon Smith Barney's risk-management committee. "I want out," Mr. Dimon said, according to some who were there.

The traders were resistant. Indonesia had already taken its licks, and prospects for an IMF-led credit made Russia's situation appear calmer. But the traders went to work, whittling down Russian-bond positions of more than $100 million. Salomon's repurchase-agreement desk, which does overnight financing for institutions such as hedge funds, also started to reduce its exposure to funds investing in Russia. But the effort wasn't rigorous enough. Salomon got stung by a loan of nearly $50 million it made to the III Offshore Advisors fund that is being liquidated. Mr. Dimon declines to comment.

Now, as investors rushed for the sanctuary of U.S. Treasurys, the value of those bonds began to soar. Yesterday the 30-year bond's yield got as low as 5.05% before late trading pushed it back up to a still-ultralow 5.124%. But the same thirst for safety caused investors to flee from riskier bonds, including those of emerging markets, U.S. mortgage-backed securities, high-yield "junk" bonds and even investment-grade corporate bonds. "The whole world was on one side of the ship for three years, and now they wanted to go to the other side of the ship all at once," says Greg Hopper, a portfolio manager at Bankers Trust Global Investment Management.

The shift wreaked havoc with some of the most complex and leveraged market bets made prior to the Russian turmoil. Among them were bets on the spreads between the yields on various kinds of bonds. Many hedge funds and investment banks had wagered that growing demand for riskier bonds around the world would cause these bonds' prices to rise and their yields to fall, but that yields would rise on the safest government bonds. The flight to safety caused the reverse to happen.

At Long-Term Capital's plush headquarters in Greenwich, Conn., traders watched in horror as one after another of the firm's bets exploded. Traders were left to follow "the action on the screens and marvel at the violence out there in the marketplace," a person familiar with the operation says. "When you have a global movement, all the trades go against you at the same time."

Declines in the hedge fund's net worth triggered internal controls requiring that risk be reduced. So it started dumping some securities and unwinding interest-rate bets. Through it all, the firm was being peppered with calls from Lehman and Salomon Smith Barney, two of its lenders, for information about trades and the extent of losses.

Rumors spread that Long-Term Capital was in trouble. They intensified after the New York Stock Exchange, as part of a broader Wall Street sweep, quizzed securities houses about whether Long-Term Capital was meeting its margin calls. It was.

But on Sept. 2, Mr. Meriwether, who once was Salomon Brothers' vice chairman, broke the news to the hedge fund's investors: Its value had plunged 44% in August. The total loss was $1.8 billion. Yet, in a measure of how far the ripples had spread beyond Moscow, only 8.7% of the losses came in Russian markets, says a person familiar with the results.

Nor was Merrill Lynch spared. In the wholesale flight to safety, even U.S. corporate bonds got slammed, and Merrill Lynch, as a leading underwriter and market maker, owned a $5 billion portfolio of them. Making matters worse was that one way Merrill had tried to protect itself from such a decline was by selling U.S. Treasurys short, figuring that if corporate bonds fell, so would Treasurys; when they soared, this bet only worsened Merrill's losses.

Merrill's bond-related losses exceeded $100 million, pretax, traders say. Although the firm has said it had aftertax emerging-markets losses in July and August of $135 million, it won't provide a breakdown.

A broader concern in the bond market has been gridlock. In recent weeks, buyers have simply shunned a broad range of bonds, from U.S. junk bonds to any emerging-market debt. Some emerging-market bonds have vast spreads between the bid price and the offer, making it all but impossible to trade. Last week, recalls Andrew Brenner, a bond trader at Societe Generale, the bid-offer spread on a bond from a Brazilian state water utility known as Sabesp was 15 points -- you could sell it at 70 and buy it at 85. "Obviously, I couldn't get anything done," Mr. Brenner says.

Indeed, not much of anything is going on in broad parts of the bond market -- even on days when the stock market rallies. On Sept. 8, as U.S. stocks were soaring on a bout of investor optimism, Donaldson, Lufkin & Jenrette Inc. executive David DeLucia received word from his top traders that buyers were nowhere to be found in much of the high-yield market. "There's still decent demand for high-quality names, but liquidity seems to dry up for names beneath that," Mr. DeLucia says.

Merrill owned Brazilian corporate bonds that it had hedged by taking short positions in Brazilian government bonds -- that is, it had bet on a decline in the government bonds' price by selling them without owning them. The minute bids for the bonds appeared on traders' screens, they were snapped up. "Any buying was quickly satisfied," Mr. Komansky says. "You couldn't cover your shorts. You couldn't sell your longs."

All the recent turmoil in the bond market has hammered home a lesson in protecting one's assets. Quips Mr. Komansky: "The only perfect hedge is when someone else owns it."

Even when firms have disclosed their global market losses, these amounts often are severely understated. This is because many major brokerage firms have been tapping into reserves they had accumulated during the big bull market to mask the full extent of their recent trading deficits. Though Lehman Brothers, for example, recently announced an aftertax loss of $60 million from emerging-markets woes, Wall Street traders say the firm actually had total pretax losses of about $200 million. Lehman declines to comment on its use of reserves.

Traders say Lehman's losses also were tempered by separate winning trades, including selling emerging-market stocks (which have plunged) and purchasing U.S. government bonds (which have soared). "We lost some money in hedging some securities positions, but offsetting that we were long governments in a big way," says Richard Fuld, Lehman's chairman. "We had a view that during time of turmoil there would be a flight to quality."

All that didn't stop some rumors from becoming entrenched. Lehman's already-battered stock was slammed an added 7% on Sept. 11 amid speculation the firm would file for bankruptcy protection. Senior officials scrambled to assure clients Lehman was secure. But so prevalent were the rumors that the New York Stock Exchange examined Lehman's books. Big Board Chairman Richard Grasso personally called Mr. Fuld later in the day to tell him the firm had passed the review. Yesterday, Moody's Investors Service confirmed Lehman's debt ratings and said the firm's ratings outlook is "stable."

Across the Atlantic, another problem was festering. Costas Kaplanis, head of Salomon Smith Barney's global-arbitrage trading group in London, had made good money over two years betting that the differences in yields on various European bonds would narrow as European monetary union neared. Among its billion-dollar trading positions, say people familiar with the situation, was a bet on a convergence in the yields of German and Italian bonds.

But in the flight to quality set off by the Russian crisis, the yields started diverging, because German bonds were regarded as safer than Italian bonds. Executives in New York ordered Mr. Kaplanis to unwind some of the bets and reduce others. The paralysis gripping bond markets hampered the effort, and the global-arbitrage group wound up with $180 million in aftertax trading losses.

More losses arose in Salomon Smith Barney's U.S. arbitrage group. Its traders had placed $1 billion bets on the London Interbank Offered Rate, or Libor, on the expectation that the spread between that rate and U.S. Treasury yields would narrow. Instead, it ballooned, leading to aftertax losses of $120 million.

At New York headquarters, Salomon Smith Barney's senior executives roamed the trading floors telling their traders not to be heroes by taking on risky positions that clients were trying to shed. They were urged to bid for securities 10% to 15% below the last trade, rather than the usual 2%, 3% or 4%. Clients asking the firm to bid on a million shares of stock were rebuffed or got steeply discounted bids. More frequently, traders told clients they would bid for much smaller blocks and try to parcel out the rest of the order.

Steven Black, a Salomon Smith Barney vice chairman, told his troops to balance their priorities: "We can't trade just for the benefit of clients if it would be irresponsible to the firm's position or to shareholders. Anything we do should be prudent."

The U.S. dollar, like U.S. Treasury securities, is a haven for worried investors, but the market has been so topsy-turvy that even some bets on a stronger dollar went sour. With Japanese interest rates extremely low, hedge funds and others had borrowed huge amounts of Japanese yen and sold them in order to buy the higher-yielding securities of other countries. This meant, of course, that eventually the funds would have to buy yen to repay the loans.

In late August, a Japanese official said Tokyo was close to intervening to support the yen.

Meanwhile, plunging U.S. stocks raised fear of a weaker dollar vis-a-vis the yen. Hedge funds abruptly began buying yen to cover their borrowings.

That further strengthened the yen. Mr. Robertson's $21 billion Tiger Management Fund, one of the biggest bettors against the yen, lost 10%, or $2.1 billion, in the first two weeks of September.

Through it all, individual investors in many markets, including the U.S. stocks, were mystified. For the first time since the 1987 crash, falling prices weren't drawing large sums from people intent on "buying the dip." Nor were falling interest rates. Twice in the month following Russia's devaluation, the Dow Industrials slipped close to 20% below their July high, the level loosely regarded as marking a bear market. In one stretch, the Dow Industrials moved up or down at least 100 points in 10 of 12 trading sessions.

Exchange officials grew worried that two "specialist" firms, which buy and sell to meet demand and smooth out trading, would be in danger if the market continued to falter. Big Board officials met with principals of the firms, paving the way for one to get a capital injection from its partners and the other to be absorbed by rival firm.

In contrast to 1987, however, the systems underpinning the U.S. stock market haven't cracked. Trading has been relatively orderly, nothing like the violent selling seen on Oct. 19, 1987.

On Aug. 31, as the market spiraled toward what became a 512-point, 6.37% plunge, Mr. Grasso -- who has been a Big Board executive for more than a decade -- sought a reading from Edward McMahon, Merrill Lynch's chief of trading in exchange-listed stocks. Mr. McMahon had a simple but clear message: "No shouting. Bids wanted."

Translation: Traders were filling orders without panic -- a far cry from the frantic message he heard in 1987.

Matt Murray contributed to this article.

Some Who've Taken Big Hits INSTITUTION DAMAGE BankAmerica $330 million pretax trading losses so far in quarter Bankers Trust $350 million trading losses in July, August Republic New York Russia-related charges of $155 million Salomon Smith Barney $360 million in aftertax trading and Russia-related credit losses Nomura Securities $350 million in pretax Russia-related losses Credit Suisse First Boston $400 million in aftertax Russia-related losses Everest Capital One hedge fund down 52% in August, one down 37% Long-Term Capital Hedge fund down 44% in August III Offshore Advisors One hedge fund filed for liquidation Sources: J.P. Morgan, Telerate!

Markets Under Siege -- Seven-Year Hitch: The Crunch Points: How Russia Staggered From There to Here --- Some Astonishing Missteps Helped Grease the Slide Toward Financial Ruin --- Mr. Gaidar's `Terrible Choice'

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Abstract:

A chronicle of the past seven years shows that the Russian reform effort, wildly ambitious in both scope and pace, suffered from a string of costly miscalculations. It was built on wobbly presumptions -- among them, that old state enterprises could become modern corporations -- and half-measures and compromises born of the country's struggle with its communist legacy. Corruption flourished, while efforts to establish fundamental laws and regulations withered. Inexperienced ministers drifted from indecision to bad decisions. Viktor Chernomyrdin, prime minister from 1992 until last March, provided perhaps the best summary of Russia's reform experiment, commenting on one of the country's earlier crises: "We had wanted the best, but things turned out as always."

Mr. (Iosif) Bakaleynik, the Harvard graduate, returned to Russia in 1994 after a two-year stint with the International Finance Corporation in Washington and became a pioneer of Russia's privatization program. Backed by a Moscow bank, the then-43year-old businessman gained control of a tractor factory in the town of Vladimir, 120 miles northeast of Moscow. At a meeting with his thousands of workers in a local football stadium, he echoed the words of Mr. (Yegor) Gaidar, warning that "the market is cruel" but also that it would reward those willing to work hard.

For Mr. Yeltsin, who had been basking in the approval of Western leaders and the lingering warmth of public regard that helped him unseat Mikhail Gorbachev, this was the first major challenge. Establishing a leadership style rooted in populism and frequently shifting between

boldness and retreat, sickness and health, Mr. Yeltsin flinched this time. He fired Mr. Gaidar and replaced him with Viktor Chernomyrdin, the former head of the gas monopoly now known as RAO Gazprom, who immediately called for an end to Russia's market "bazaar."

Full Text:

[Part of a series]

MOSCOW -- For Vladimir Potanin, a tycoon now scrambling to keep afloat an empire that embraces banking, oil fields and a nickel smelter, the rot set into Russia's reforms a year ago with a brawl over a phone company.

Iosif Bakaleynik points instead to the years he struggled to drag a Russian tractor factory up to free-market speed. The lessons he had learned at Harvard's business school were ill-suited to Russia's treacherous terrain.

And for Yegor Gaidar, hindsight ranges over decades. The plump, squeaky-voiced economist who crafted Russia's exit from Soviet central planning in the winter of 1991-92 believes it was 70 years of communism, more than anything else, that hobbled the nation's rush to reform.

In the wake of Russia's financial debacle, the soul-searching over what went wrong runs as deep as the country's debts. What became of the promise engendered by the toppling of the Soviet Union is much more than a history or economics lesson, or an exercise in finger-pointing. The answers will guide the policies Moscow pursues in the coming critical weeks and months, how governments from Brasilia to Beijing will confront their own woes, and what, if anything, the West can do to help.

As the country gropes for direction after defaulting on its domestic debt and devaluing the ruble, basic questions arise: Was it wrong to believe that Russia could be so rapidly reconstructed? Is there something unique in Russia's history inimical to market economics? If so, do current events mark the end of another spasm of Westernization and the start of a slide back into Russia's own insular and authoritarian past?

A chronicle of the past seven years shows that the Russian reform effort, wildly ambitious in both scope and pace, suffered from a string of costly miscalculations. It was built on wobbly presumptions -- among them, that old state enterprises could become modern corporations -- and half-measures and compromises born of the country's struggle with its communist legacy. Corruption flourished, while efforts to establish fundamental laws and regulations withered. Inexperienced ministers drifted from indecision to bad decisions. Viktor Chernomyrdin, prime minister from 1992 until last March, provided perhaps the best summary of Russia's reform experiment, commenting on one of the country's earlier crises: "We had wanted the best, but things turned out as always."

The new prime minister, Yevgeny Primakov, a former foreign minister lacking any economic credentials, has put economic policy making in the hands of Yuri Maslyukov, onetime head of the Soviet planning agency Gosplan. The dangers are obvious: Russia has moved far enough since 1991 that the old system cannot be rebuilt; but the system remains close enough that some fragments of the past can be retrieved and pieced back together.

At the height of his authority in 1993, President Yeltsin mused on the failed reforms of czars and general secretaries. "Peter the Great's reforms have not been achieved to this day," he said. Nor have "Lenin's new economic policy, Stalin's industrialization and Khrushchev's thaw . . . changed anything fundamental in Russia."

His own attempt, he declared, would be different.

Where it was unique was the scale. The unraveling of the Soviet Union forced Russians to redraw their borders, both mental and geographic. History, it was said, had come to an end. Russia was its terminus.

When Mr. Gaidar freed prices in January 1992, he told the Russian people to brace for severe pain but promised that their suffering would be rewarded. The past had to be dismantled swiftly, he said, to ensure it would never return. Ever since, Russia and its backers in the West have lived this idea: Fortified by democracy and billions of dollars in aid, the nation would join the advanced world.

Russia's reformers saw themselves as agents of capitalism's inevitable triumph, not politicians selling a program to the masses. Brigitte Granville, a French economist who worked with the reformers from the beginning, recalled a 1993 meeting with many of the leading liberals and officials from the International Monetary Fund and the World Bank. She worried about the impact of reform on ordinary Russians and proposed a social-safety-net loan to cushion the blow. One of the Russians immediately scolded the foreign group, saying, "I didn't know you had a Marxist on your team."

The government made enemies even of the country's most energetic entrepreneurs, the so-called shuttle traders who bought cheap goods in Turkey, China and Dubai for sale in Russia, by saddling them with onerous taxes and duties.

As reform began to bite, many Russians perceived democracy and the free market as their new enemies. The disenchantment was especially deep among some of the country's keen young managers and the workers they tried to convert.

Mr. Bakaleynik, the Harvard graduate, returned to Russia in 1994 after a two-year stint with the International Finance Corporation in Washington and became a pioneer of Russia's privatization program. Backed by a Moscow bank, the then-43year-old businessman gained control of a tractor factory in the town of Vladimir, 120 miles northeast of Moscow. At a meeting with his thousands of workers in a local football stadium, he echoed the words of Mr. Gaidar, warning that "the market is cruel" but also that it would reward those willing to work hard.

For three years, he struggled with overstaffing, outdated equipment and a government more interested in macroeconomics than in the nuts and bolts of change on the shop floor. Last year he gave up. He had slashed his work force to 5,000 from an initial 13,000, but mainly because his markets dried up. Output slumped to 1,800 tractors a year from more than 8,000.

Looking back, Mr. Bakaleynik blames the gap between theory and practice for many of his woes. "The idea of the invisible hand doing the job in two or three years," he says, "was not workable." Instead of nurturing the revival of ailing factories, the government crippled industry through corruption, taxes, shifting policies and monetarist dogma that strengthened the ruble but strangled exports. He left the plant last year and became an oil-company executive in Moscow.

The muddle that came to characterize Russian reform began, oddly, with a decision of uncompromising clarity. By freeing prices only days after the collapse of the Soviet Union, Mr. Gaidar took a wrecking ball to the central tenet of central planning. Fixed prices had smothered incentive to either produce or sell. The only other way to put goods on store shelves was to revive the political terror that had sustained the command economy. "Either you started shooting or you liberalized prices," recalls Mr. Gaidar.

The economic impact was immediate. Prices rose by over 2,000% in 1992, and shop shelves filled up. The political impact was also swift. Their savings wiped out and the rubles in their pocket nearly worthless, many Russians blamed their pain on the country's young reformers, not the communist system that had created the problem.

The communists themselves began to regroup, after being routed the previous year when Mr. Yeltsin defeated a hard-line putsch. Coal miners, who only a few months earlier had been in the vanguard of support for Mr. Yeltsin, staged protests. Impoverished pensioners, many of them reduced to hawking stale Soviet-era cigarettes and old clothes on the street, joined small but angry demonstrations.

For Mr. Yeltsin, who had been basking in the approval of Western leaders and the lingering warmth of public regard that helped him unseat Mikhail Gorbachev, this was the first major challenge. Establishing a leadership style rooted in populism and frequently shifting between boldness and retreat, sickness and health, Mr. Yeltsin flinched this time. He fired Mr. Gaidar and replaced him with Viktor Chernomyrdin, the former head of the gas monopoly now known as RAO Gazprom, who immediately called for an end to Russia's market "bazaar."

Relations between Mr. Yeltsin and the parliament festered in a series of confrontations, and the legislators' opposition soon hardened into hostility. In late 1993, Mr. Yeltsin dissolved the parliament and ringed the chamber with barbed wire. When legislators rebelled, he broke them by sending tanks to shell the parliament building.

Underlying the conflict was a fundamental clash over economics: Should the state spend its money to prop up industry, and who should own property? Moscow only fueled the debate with its other major reform step.

If price reform aimed to put bread in the stores for the short-term, privatization was the long-term plan for turning around the economy. The idea behind the program was the product of a freshly minted theory: transfer ownership from the state to workers and managers to give them a stake in success; issue shares that Russian entrepreneurs would use to take over companies and make them profitable; instead of draining money from the state through subsidies, factories would instead help finance the government with taxes.

The theory's champion was Anatoly Chubais, then head of the State Property Committee. Like Mr. Gaidar, he spoke not only the language of free markets but also English. In them, the West invested its hopes for Russia.

In late 1992, the government launched the mass privatization program by issuing 144 million vouchers that entitled nearly every Russian to secure shares in newly privatized firms. The scheme was ingenious -- democratic in its original conception and conducive to the formation of a new industrial elite. But like many other good reform ideas, it mutated.

Entrepreneur Andrei Volgin was one of the first to try putting the theory of privatization into practice. He took over five state-run enterprises, but he achieved only mixed results. For a bread factory in Vladimir, in which he secured a 46% stake, Mr. Volgin says he needed only half the 600 workers. The plant's management and local government resisted cuts. The general director gave himself a loan to buy an apartment.

What the director did in his factory, the men who should have been Russia's Rockefellers, Mellons and Carnegies were doing on a far larger scale.

Privatization raised the profile of a group of new tycoons known to the Russians as the "oligarchs." Back when the Soviet Union fell apart, they set up banks and used them to help the government pay its bills. The state funneled billions of rubles through their hands. As a stop-gap measure, the arrangement made sense for a government that hadn't yet set up a treasury system. But instead of lending money to entrepreneurs, banks used the government funds to make bets on the ruble and bond markets.

"The 10 biggest banks went to the casino and put Russia on the table," says Mr. Volgin. "They lost."

Alexander Smolensky, president of SBS-Agro, Russia's largest private retail bank, derides talk of an oligarchy, saying, "The richest people here are the bureaucrats." He blames these officials for the financial crisis, which has broken his bank. Surrounded in his headquarters by oil paintings and other trophies of earlier success, he has defied an attempt by the Central Bank to place his enterprise under state administration. A 44-year-old former printer and construction manager, Mr. Smolensky dismisses Messrs. Gaidar and Chubais as "laboratory assistants" in an experiment gone haywire.

Even as Russia's financial collapse has pushed some of the tycoons to the wall, they still have connections. Mr. Potanin, for instance, is struggling with foreign creditors to salvage what remains of the banking arm of his Interros financial and industrial group. But he can point to three yellow telephones on his desk that give him direct access to the government's communications network. "This one is for the big officials, this is for the smaller ones and this is for the governors," he says.

Ahead of parliamentary elections in 1993, the emergent business elite helped finance the campaign of reformist candidates led by Mr. Gaidar. It was a critical time for domestic banks, coinciding with a push by foreign competitors to enter the Russian market. Even before the poll results were in, the government showed its gratitude by blocking the competition.

Despite spending far more than the communists and a party of pugnacious nationalists led by Vladimir Zhirinovsky, however, Mr. Gaidar's party secured only 16% of the vote. Mr. Chernomyrdin sniffed a shift in the prevailing winds of reform, immediately declared an end to the era of "market romanticism," and tried to reimpose some price controls. Although he soon abandoned that plan, he did allow another relic from the past, a group of Soviet-era factory directors, to reassert some of its influence.

Meanwhile, the bargain the state had struck with its bankers stuck, and paved the way for others. It was a cozy setup that took on many forms. Mikhail Khodorkovsky, who founded Bank Menatep, one of Russia's top 10 banks, when he was in his twenties, has described Russia's prime minister as "my boss." Sometimes, though, it was hard to tell who was really in charge. When the ruble crashed in 1994, Mr. Khodorkovsky picked up the phone and persuaded Mr. Chernomyrdin to pressure the Central Bank to inject cash into the banking system.

The most controversial bargain came in 1995. In December of the previous year, President Yeltsin had launched a brutal war against the breakaway republic of Chechnya that killed more than 50,000 and drained as much as $5 billion from state coffers just as the country's finances were beginning to stabilize. The huge outflow of public funds tightened the embrace between the state and a few well-connected businessmen. Desperate for cash, the government mortgaged some of its most lucrative assets for a fraction of their real value in return for loans from a handful of bankers. Meeting in secret, they carved up the spoils. Government bureaucrats colluded in the so-called loans-for-shares deals, allowing ownership of the stock-in-trust to be awarded at rigged auctions.

There wasn't even a semblance of propriety. At a news conference in 1996, a Menatep executive could hardly contain his laughter when he claimed, implausibly, that he didn't know who owned the subsidiary that had just bought Yukos, Russia's second-biggest oil company. Russian journalists, served cognac by the bank's staff, guffawed in disbelief. Menatep had run the auction and the bank, it would later disclose, controlled the firm that entered the winning bid.

Beneath the jaunty confidence, though, lurked a constant fear that the state might reclaim what it had relinquished. Mr. Khodorkovsky often joked to associates, "I don't own anything. I rent it."

To protect the lease, the bankers banded together. In 1996, Russia's tycoons went into overdrive in support of Mr. Yeltsin's successful re-election campaign against his communist rival Gennady Zyuganov. As well as providing funds, they mobilized their media interests -- newspapers and television -- to serve Mr. Yeltsin's campaign. Boris Berezovsky, a former mathematician who had parlayed a car dealership into one of Russia's biggest personal fortunes, was frank about his motives. If Mr. Yeltsin won, he said of his tennis partner and friend, "maybe my assets are worth billions of dollars"; if he lost, "maybe nothing."

All the while, the government was going broke. It couldn't collect the taxes it needed to pay its bills. So it built a rickety structure of domestic and foreign debt, creating the pyramid that collapsed in August and pushed Russia into default.

The speed with which the edifice crumbled reflected the speed with which it had been built. From the start, Russian reformers and their Western advisers wanted to move quickly, believing that financial markets, no matter how imperfect their construction or regulation, would entrench change and begin to work their magic on Russian enterprises and the economy. The West contributed billions of dollars and Russia quickly had a secondary market for stocks and bonds.

Foreign investors piled in. At one point, 80% of all trade in the stock market was from offshore investors. Bernard Sucher, one of the founders of Troika-Dialog brokerage house in Moscow, heard a knock on his door at 4 a.m. one day in 1994 from a drunken foreign hedge-fund manager desperate for a fix. "He said it didn't matter what stock or what price. He just had to have more."

The stampede blinded investors to the reality behind glossy brochures and lavish road shows. Russian accounting practices warped losses into profits. Regulation was virtually nonexistent. Companies diluted stockholding at will and trampled the interests of minority investors. The Russian Securities Commission had a mandate to prevent this and dollops of Western aid, but no real power.

The Central Bank fared no better in imposing order. Its chairman, Sergei Dubinin, claimed last year that $500 million in government bonds had been improperly diverted through two commercial banks. A week later, an unidentified gunman opened fire on Mr. Dubinin's home. (No one was hurt.)

According to Mr. Potanin, though, Russia's crisis sprang not from this chaos but from an attempt by the government to enforce some rules. A critical turning point, he says, was last's year's auction of the telephone company Svyazinvest. Embarrassed by the furor over loans-for-shares deals, the government organized a relatively fair and transparent sale. Forced to compete, instead of collude, Russia's barons went to war. Destroyed in the hostilities was the nonaggression pact that bound government and business together. The sale, says Mr. Potanin, was "100% correct, but led to disaster."

For all the shortcomings of reform, Russia still managed, on one level, to get things almost right. By last year, basic economic indicators held out the promise of recovery. Inflation had been tamed, the ruble was stable and gross domestic product grew for the first time in a decade, albeit by only 0.8%. Mr. Yeltsin defied the odds once again, surviving quintuple-bypass surgery and double pneumonia. The press and politicians pointed to the rising anger of workers over unpaid wages, which had ballooned to more than $10 billion. But predictions of widespread chaos in the streets and industrial unrest came to nothing.

Upon returning to the Kremlin in the spring of 1997, Mr. Yeltsin brought a clutch of reformers into the government. With parliamentary elections two years away, they had a rare opportunity to take tough decisions previously dodged -- such as cracking down on tax deadbeats, accelerating bankruptcies and laying off workers.

In December 1997, a special commission headed by Mr. Chubais to collect taxes decided to seize and sell the assets of two provincial oil refineries belonging to the empires of Mr. Berezovsky and Mr. Potanin. The tycoons, however, marshaled their forces, and a week later, with Mr. Chernomyrdin chairing a meeting of the commission, the decision was overturned.

A cascade of accidents, bad luck and blunders followed. The price of oil and other commodities that provided more than two-thirds of Russia's hard-currency earnings began to plunge. Mr. Yeltsin shattered the political equilibrium by abruptly firing Mr. Chernomyrdin and naming a 35-year-old political neophyte, Sergei Kiriyenko, as prime minister. The financial maelstrom that had begun in Asia the previous summer looked around for its next victim and found Russia, after seven years of muddle, ripe for disaster.

The International Monetary Fund and other lenders rushed in with a promise of $22.6 billion to try to break Russia's fall, but investors' confidence continued to plummet. As Russia's markets crumpled, Mr. Gaidar, Mr. Chubais and other no-longer-so-young reformers who had laid their foundations years before came together for a last desperate attempt to preserve what they had tried to build. On the weekend of Aug. 15-16, they huddled together in the White House, the seat of the Russian government. Also there were Mr. Potanin, Mr. Berezovsky and most of Russia's other business barons. The IMF's senior Russia expert had rushed to Moscow to add his voice, but left his checkbook in Washington.

Mr. Gaidar, though long out of office, found himself confronted with "a terrible, unpleasant choice," almost as fateful as the one he faced when the Soviet Union fell apart. Reformers, he says, had for years feared such an across-the-board financial collapse. Now it had come. "It was our worst nightmare," says Mr. Gaidar.

On the morning of Aug. 17, Prime Minister Kiriyenko and Central Bank Chairman Dubinin announced the result of the weekend conclaves. Russia would default on government debt, devalue the ruble and impose a moratorium on the repayment of foreign private debt.

As so many times before, the government wanted to offer something for everyone, except for foreigners who had no political clout. This time, though, the attempt at compromise led to disaster. The currency sank; the banks became insolvent; and the government ruined, probably for years, its ability to borrow. A week later, Mr. Yeltsin sacked Mr. Kiriyenko, Mr. Chubais and their colleagues. Instead of saving reform, Russia's reformers ceded the initiative to the communists. The new government headed by Mr. Primakov is now groping for a third way between the familiar tensions of the state vs. the market, economic populism vs. austerity, and Russian answers vs. Western solutions.

The man who launched Russia's reforms still clings to his convictions and believes the country, after another failed search, will return to his path. Says Mr. Gaidar: "I'm absolutely sure that I'm right."

Credit: Staff Reporters of The Wall Street Journal

Markets Under Siege -- Limits of Power: How Global Crisis Grew Despite Efforts Of a Crack U.S. Team --- Rubin, Summers, Plus Fischer At IMF Got Economics Better Than the Politics --- Blocking a Japanese Remedy

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Mr. Clinton wanted bold solutions as big as the problem. But Mr. (Robert) Rubin wanted to be cautious; he worried that a meeting of world leaders would create unrealistic expectations. To channel the president's desire for action into more-acceptable directions, Deputy Treasury Secretary Lawrence Summers and aides worked through the weekend to come up with alternatives.

Mr. Clinton's impatience was understandable. Not long ago, Mr. Rubin and Mr. Summers were being compared to Douglas MacArthur, the general who reshaped Japan after World War II. Under their leadership, Americans were remaking Asia's dysfunctional crony capitalism -- with its close links between government, corporations, banks and in some cases, ruling families -- in America's free-market image.

Mr. Rubin and Mr. Summers bristle at the comparison of this crisis to Vietnam. "They are totally not analogous," Mr. Rubin says. "They are different issues, different times, different people, and the role of this country is different." The U.S. now must respond to "enormous forces" as effectively as it can, but accept the limits of its ability to control them, he says.

Full Text:

[Part of a series]

"If there was ever anything that bound the men . . . together, it was the belief that sheer intelligence and rationality could answer and solve everything."

-- David Halberstam in "The Best and The Brightest"

WASHINGTON -- With little notice, President Clinton summoned his top advisers to the Oval Office on Labor Day for a late-night huddle on the spreading global financial crisis.

His anxiety about the adequacy of the U.S. response had been building for weeks. From vacation on Martha's Vineyard, Mass., he had phoned Treasury Secretary Robert Rubin, fly-fishing in Alaska, almost daily. On his trip to Moscow, he hectored top aides for new ideas. He and his political soulmate, British Prime Minister Tony Blair, talked about convening an emergency meeting of world leaders. Chief of Staff Erskine Bowles spoke of calling "a new Bretton Woods," referring to the 1944 conference that created the postwar economic order.

To the president, a speech set for Sept. 14 at the Council on Foreign Relations in New York was the place to prove that the U.S. and Bill Clinton could lead the world out of economic turmoil, Kenneth Starr and Monica Lewinsky notwithstanding.

Mr. Clinton wanted bold solutions as big as the problem. But Mr. Rubin wanted to be cautious; he worried that a meeting of world leaders would create unrealistic expectations. To channel the president's desire for action into more-acceptable directions, Deputy Treasury Secretary Lawrence Summers and aides worked through the weekend to come up with alternatives.

In the end, Mr. Clinton backed down. "I don't ever want to do anything that's going to be good for two days and then bad for two months," he said, according to a participant in the Labor Day session. The Sept. 14 speech was well-received, but its specifics were modest.

Mr. Clinton's impatience was understandable. Not long ago, Mr. Rubin and Mr. Summers were being compared to Douglas MacArthur, the general who reshaped Japan after World War II. Under their leadership, Americans were remaking Asia's dysfunctional crony capitalism -- with its close links between government, corporations, banks and in some cases, ruling families -- in America's free-market image.

Today, a less-flattering analogy comes to mind: The year-long financial firestorm may be turning into a Vietnam for Washington's "best and brightest" economic minds.

Through hubris, political clumsiness and the unintended consequences of well-meant policies, the Clinton administration and its allies at the International Monetary Fund have, so far, failed to contain what President Clinton now calls "the worst financial crisis in half a century."

The glimmers of hope in Thailand and South Korea, where interest rates are down and currencies are up, have been overwhelmed by economic collapse in Russia, threats to Latin

America and worry about the risk of global recession. The power of the United States, in many ways mightier than ever, seems no match for international flows of money unleashed, in part, at the urging of the U.S. itself.

Robert McNamara, an architect of America's venture in Vietnam, says this reminds him of that war. Even though Mr. Rubin and Mr. Summers are "absolutely terrific," he says, "events are beyond their ability to shape and control. The best of intentions aren't good enough.

"The parallel," he adds, "is that you have to dig deeply and understand your problems and do it early. We didn't understand the political or economic problems in Japan, Indonesia or Russia early enough."

Mr. Rubin and Mr. Summers bristle at the comparison of this crisis to Vietnam. "They are totally not analogous," Mr. Rubin says. "They are different issues, different times, different people, and the role of this country is different." The U.S. now must respond to "enormous forces" as effectively as it can, but accept the limits of its ability to control them, he says.

Mr. Rubin, whose world view was shaped by decades at the investment bank of Goldman, Sachs & Co., counters the Vietnam analogy with one of his own: the 1973-74 stock-market decline that devastated Wall Street.

"The difference between the people who were smart and shrewd, and the people who weren't really smart and shrewd?" he says. "Those people who were really smart and shrewd lost a lot of money. The people who weren't really smart and shrewd got wiped out."

Success, he says, "meant that you managed extremely difficult forces effectively enough to . . . come out the other end."

To the Treasury and IMF today, success means restoring economic growth to countries now suffering the worst recessions in a generation and persuading fickle global investors -- who just a few years ago were pouring billions into emerging-market economies -- to stop pulling money out.

"There is zero question in my mind that the world is substantially better off than it would have been without the efforts of the international community," Mr. Rubin says.

It will be years before the world can fully understand what went wrong and whether different policies might have staved off some of the pain. But the need to devise responses today requires an attempt at understanding where America's best and brightest succeeded and where, in retrospect, they failed.

A Bare Cupboard

A pattern was established back in July 1997, when Thailand, with an economy smaller than the state of New York's, ran out of foreign-exchange reserves and was forced to devalue its currency, the baht, and turn to Washington for help.

The Clinton administration wanted to help, but would have to do it on the cheap. The U.S. foreign-aid budget is now the smallest, adjusted for inflation, it has been in 25 years. The U.S. would have to rely instead on the IMF.

And because this is an age in which financial markets often are more powerful than armies, the Treasury Department would call the shots instead of the State Department, which traditionally handles international affairs. Many key decisions would be made by Mr. Rubin in consultation with Federal Reserve Chairman Alan Greenspan, a Rubin-Summers fan who also has lent them his substantial credibility. Decisions often would be shared after the fact with the State Department.

In many ways, Thailand's plight was similar to Mexico's situation in 1994, only less severe. In mid-1997, Mexico's response to the medicine it received seemed to Messrs. Rubin and Summers a spectacular victory. So they prescribed a similar remedy: Thailand would get $17 billion in an IMF-led loan package in exchange for promising to impose high interest rates, restrain government spending, close insolvent banks and let its currency fall in order to expand exports and curtail imports.

"Mexico worked. How could they not try to repeat the Mexican rescue?" says economist Paul Krugman of the Massachusetts Institute of Technology.

Although Mexico endured a painful recession, its rebound boosted the Rubin Treasury's self-confidence. During that episode, Mr. Summers often quipped, "My human capital is denominated in pesos," his way of saying that his reputation rose or fell with Mexico's fortunes. By July 1997, the Mexican peso had been stable for a year.

The relationship between Mr. Rubin and Mr. Summers, the understated Wall Street veteran and the supercharged Harvard professor, is close and comfortable. "When the history of this is written 10, 15, 20 years from now, if they interview me, I'll tell them all the mistakes Larry made," Mr. Rubin jokes in an interview.

"I don't sign the dollar bills," Mr. Summers shoots back.

"There is that," Mr. Rubin concedes.

Supporting Mr. Rubin and Mr. Summers is a quieter Harvard-trained economist, David Lipton, the Treasury's undersecretary for international affairs, who has nearly two decades of experience at nursing troubled economies.

At the IMF, Mr. Summers installed Stanley Fischer, a Zambian-born M.I.T. economist, in the agency's No. 2 position, a post the U.S. traditionally fills. The two men talk almost daily. IMF Managing Director Michel Camdessus, though he occasionally riles U.S. officials, brings a decade's experience in wrestling with recalcitrant politicians that has been important at pivotal moments.

For all this expertise and brilliance, though, they stumbled. The Mexican formula didn't fit in Thailand. The biggest difference: Mexico shared a border with the largest and healthiest economy on the planet; the U.S. pulled Mexico out of recession. The biggest economy in Thailand's neighborhood, Japan, weakened as the crisis unfolded, and has been impervious to U.S. pressure. But that wasn't obvious in July 1997.

The Treasury pushed the IMF to make a big loan to Thailand, but didn't offer any additional U.S. money, a sharp contrast to its decision to offer Mexico $20 billion in early 1995.

The reasons for Mr. Rubin's tight-fistedness were straightforward. For Mexico, Mr. Rubin had tapped the Treasury's Exchange Stabilization Fund, a kitty that he and the president controlled. Subsequently, an angry Congress slapped restrictions on its future use. Those restrictions were about to expire when Thailand hit. To avoid provoking Congress into extending the restrictions, the Treasury kept its wallet in its pocket. "It was important that we have the freedom to use the ESF when it was needed," Mr. Rubin says. He argues that Thailand suffered more from the dithering of its politicians in the summer of 1997 than from inadequate U.S. aid.

What seemed reasonable in Mr. Rubin's office played poorly in Bangkok and elsewhere in Asia. Thailand felt abandoned, and other Asian governments -- as well as some players in financial markets -- wondered if the U.S. would come to their aid if necessary.

Unhappy at the Treasury's call, the State and Defense departments complained about the decision in interagency meetings. But when the White House asked if they had money in their budgets to send Thailand, they came up empty handed.

Months later, as Mr. Rubin listened uneasily, Defense Secretary William Cohen told the House Banking Committee the administration erred in not lending at least a token amount to Thailand. "The very notion that the United States was unwilling to participate in some form . . . sent the signal that perhaps the United States was pulling away," Mr. Cohen said.

Shooting Down Japan's Plan

Japan tried take advantage of the situation. At annual meetings of the IMF and the World

Bank last fall in Hong Kong, it proposed an "Asian Monetary Fund." While vague on details, Japan urged Asian countries -- pointedly excluding the U.S. -- to chip in as much as $100 billion in all to cope with regional crises.

The sum was immense, but Mr. Rubin and Mr. Summers feared the fund would offer big loans with less-stringent conditions than the IMF's and would threaten U.S. economic supremacy. Treasury officials worked the corridors of Hong Kong's convention center and the city's private dining rooms to slow the Japanese plan's momentum. China, South Korea and other nations suspicious of Tokyo's ambitions leaned toward the U.S.

Ultimately, the Treasury prevailed, though some both within and without the administration today wonder if the victory was pyrrhic.

Just before Thanksgiving, finance officials from the U.S., Japan, China and 11 other Asian countries gathered for two days in Manila, where the central bank was decorated with an electronic scoreboard that posted the nation's currency reserves. In drafting sessions and corridor conversations, Mr. Summers deftly put an end to Japan's Asia-centric proposal.

Its denouement was embarrassing for Tokyo. At one meeting, a Malaysian turned to Japan's Eisuke Sakakibara, vice finance minister for international affairs, and asked: "What happened to your proposal for $100 billion?" participants say.

Mr. Sakakibara's response: "If we could do anything, maybe we could do $3 billion."

A victorious Mr. Summers declared afterward, "U.S. economic leadership is crucial to avoid a descent into the kind of regionalism and protectionism that we saw in the periods between the first and second world wars." In a dig at Mr. Sakakibara, who is nicknamed "Mr. Yen," Mr. Summers privately referred to himself as "Dr. Dollar."

Jagdish Bhagwati, a professor at Columbia University, says, "the U.S. faced a dilemma: It wanted Japan to come in and put in real resources, but the U.S didn't want to give up influence in the area."

The Treasury and the IMF still think the Asian Monetary Fund was a bad idea. But with IMF reserves running low and Congress so far unwilling to refuel the agency, the sharp U.S. reaction is questioned in some quarters. Humiliated by the U.S., Japan never again stepped forward to offer such heavy financial support. And to Asian eyes, the IMF looked, more than ever, like a pawn of U.S. interests. In the parlance of Vietnam, the Treasury had "Americanized" the crisis -- without either sufficient money or congressional support for the strategy.

IMF Medicine

Had Dr. Dollar and his allies produced a quick recovery in Asia, there would be little second-guessing. But they didn't. It's like less-than-successful chemotherapy: The side effects are miserable, the cancer is unconquered and the patient is questioning the doctor's competence.

In the face of such criticism, the Treasury and the IMF counsel patience. Officials observe often that conditions in Thailand and Korea, where new governments embraced IMF-backed reforms, appear to be improving. Conditions in Russia are worse, as are those in Indonesia, which for many months balked at IMF advice.

To bolster the point, administration officials circulate charts showing that trends in exchange rates, interest rates, trade balances and unemployment rates in Thailand and Korea track Mexico's at similar points after its late-1994 crisis. "If you take Thailand and Korea," Mr. Rubin says, "the situations are very substantially better than they would have been without their reform programs and the IMF."

But even early supporters of the Treasury-backed IMF approach are uneasy. Mr. Greenspan told Congress last week he thought the IMF had "misread the depth of some of the really fundamental problems that were involved in the crisis that evolved." He added: "I think their actions were somewhat misguided in the early stages."

Harsher critics say that the IMF made the same mistake President Hoover did when he tried to balance the budget in the face of the Great Depression -- that it forced painfully high interest rates in an unnecessary effort to lift Asian currencies and that it encouraged counterproductive currency devaluations.

Slashing Subsidies

In pushing for budget cuts, the IMF was misled by its own optimistic assumptions. Incorrectly forecasting only mild downturns in Asia, the IMF demanded that governments reduce spending to offset the expense of restructuring banks. That pulled money out of economies that, in retrospect, needed more, not less, government spending; it was like siphoning gasoline out of a truck already low on fuel.

Mr. Rubin now concedes it was an error. "I think they may have been somewhat more stringent than they should have been." But he and Mr. Fischer say the IMF called for easier government budgets as the crisis intensified.

The human cost was greatest in Indonesia, where the IMF insisted on curtailment of fuel and cooking-oil subsidies. It reasoned that the subsidies required to keep prices from rising were growing rapidly as the falling rupiah pushed up import costs, threatening hyperinflation. Indonesia dithered for months, but in May it abruptly cut subsidies and pushed up gasoline prices by 71%, bus fares by 67% and kerosene and cooking oil by 25%. That sparked riots in which hundreds died, and eventually led to Mr. Suharto's resignation.

IMF officials are unrepentant. They note that they didn't demand overnight price increases and that Indonesia didn't take some IMF suggestions -- such as offsetting the effects of fuel prices on bus fares -- that would have protected the poor. "When a government wants to go in a certain way, especially in cutting subsidies, there is a moment when we must accede to what they want to do," Mr. Camdessus says.

But some U.S. officials are haunted by the deaths, and wonder privately if violence might have been avoided had the subsidy cuts been handled differently, perhaps delayed till students were home on vacation.

Few issues are as hotly debated as the currency devaluations that accompanied the problems in Thailand, Indonesia and Korea. To the IMF and Treasury, devaluations are a consequence, not a cause, of failed economic policies. When Mexico or Thailand or Korea ran out of dollars to support their currencies against the assault of the merciless markets, they had no choice but to let the currencies go down. But in each case, the devaluations were far deeper than Washington anticipated.

To a set of conservatives who are influential with congressional Republicans, devaluations are a cause of the problem. They blame the IMF for encouraging such moves, saying that countries, such as Argentina, that firmly and credibly declare they won't devalue are more likely to withstand market attacks.

The Interest-Rate Cure

Neither the Treasury nor the IMF expresses misgivings about advising high interest rates, even to countries that are as bad off as Thailand, Indonesia and Korea. Tight money is the classic prescription for countries that need to support a weak currency, since higher rates generally draw domestic and foreign investors.

But at the World Bank, chief economist Joseph Stiglitz is honing a critique, presented in detail at a recent Brookings Institution seminar, that high interest rates in Asia did more harm to highly leveraged businesses than good in terms of boosting exchange rates.

And Jeffrey Sachs, the Harvard economist who worked closely with the IMF in Eastern Europe and now counsels developing countries to look elsewhere for advice, argues that high rates spooked investors. "The IMF and the U.S. thought the orthodox approach would calm markets and the high-profile approach would instill confidence, and they didn't," he says. "They set off a first-class financial panic."

Mr. Summers and Mr. Fischer, who note that Thai and Korean interest rates have fallen from their peaks, have little patience with these arguments. They say critics don't acknowledge the likely consequence of holding down interest rates: even deeper and more destabilizing devaluations than occurred. "All the caterwauling about a low-interest-rate approach basically keeps avoiding the hard question: 'Why not call it the big-devaluation approach?' " he snaps.

Perhaps the most glaring flaw in the initial U.S.-IMF response was a reluctance to help Asian banks and corporations get out from under debts they would never be able to pay.

In large measure, the issue was ideological: The IMF and Treasury have long helped governments cut deals with their lenders, but have been reluctant to interfere in private debts, such as Indonesian corporate debt or Korean bank borrowing from foreign banks. Indonesian companies, most them near bankruptcy because they had borrowed so heavily in dollars, got sympathy but little else from Washington. Borrowers should negotiate with creditors, the U.S. and IMF said.

All that changed just before Christmas. In early December, the IMF and U.S. assembled a $58 billion rescue package for South Korea that didn't succeed. To their surprise, much of the money they put in immediately flowed out to pay Korean banks' debts to foreign banks. But Korea's foreign-exchange reserves were nearly gone; without them, Korean banks would be forced to renege on their debts. If that happened, the consequences for other indebted countries would be calamitous, Mr. Rubin feared.

Restructuring Debts

As Korea's plight worsened, Mr. Rubin and Mr. Greenspan tossed ideas back and forth with top aides during a long dinner and, later, in a four-hour telephone conference call. Repeatedly, according to other participants, Mr. Rubin said there was no solution to Korea's crisis unless U. S. and other foreign banks agreed to delays on loans that were coming due.

The Japanese, worried about the health of their banks already, were resistant. "Japan would sooner put in aid money and have their banks made whole," says David Folkerts-Landau, a top IMF economist at the time of the Thai crisis who is now at Deutsche Bank AG. The Germans vacillated. The proud Koreans, horrified at being seen as deadbeats, were reluctant, but also determined to cut the best deal possible.

The Treasury, the Fed and the IMF joined forces to put pressure on the international banks, summoning top bankers to a meeting at the Federal Reserve Bank of New York to underscore the urgency. The banks first agreed to extend Korean banks' loans temporarily, then in laborious negotiations agreed to new terms. Default was averted.

Mr. Rubin sees the pact as a model for the future: a kind of orderly and voluntary international bankruptcy reorganization in which private creditors pay a price for having risked money, but the debtor still has to pay most of what it borrowed eventually. With much of corporate Indonesia, Thailand and Korea essentially bankrupt, the Treasury is speeding work on one of the "new ideas" it offered Mr. Clinton on Labor Day: finding a way to get banks to accept equity in exchange for forgiving loans to corporate borrowers.

But why did it take so long to do what, in hindsight, seems obvious? "There was risk in this," Mr. Rubin says. "If the world views this as having been a coerced restructuring, which it was not . . . , the banks could have felt, `They may force us elsewhere. Let's pull out of other places.'"

And then there were tactical considerations. Korea was down to about $5 billion in international reserves and using about $1 billion a day, he recalls. "Unless you were looking down the gun barrel, I think it might have been difficult to get people to focus with sufficient seriousness and speed on the need to work out some kind of voluntary arrangement."

How to Handle Suharto?

If the U.S. team was well stocked with economic talent, it was short on people who could navigate the intricate politics of Indonesia, Japan and Russia. "For the most part, our economic sense of these things has been pretty good -- in fact, very good," Mr. Rubin says. But "it's very hard to figure out how the politics in some other country are going to work."

In Indonesia, the issue was whether to try to cajole Mr. Suharto into embracing economic reforms or to seek a replacement who would be more to U.S. liking. The Treasury and IMF saw Mr. Suharto, the aging dictator whom they had once celebrated for bringing millions of his people out of poverty, as an obstacle to restoring financial-market confidence in the country. Mr. Summers came away from a January meeting with him discouraged.

The State and Defense departments saw no clear Suharto successor -- a contrast to Philippines in 1986, where popular Corazon Aquino replaced Ferdinand Marcos -- and worried about disintegration and bloodshed in the world's fourth-most-populous nation should Mr. Suharto be forced out.

If the U.S. had recognized Mr. Suharto's weaknesses earlier, says Sandra Kristoff, a hard-boiled, chain-smoking Asia hand on the National Security Council at the time, "there would have been earlier and more-public debate on the kinds of political steps that had to accompany economic reform." Because the Indonesian people had no voice in politics, they refused to accept economic sacrifice, she says. "Everybody missed that in the administration -- except for a few."

The issue came to a head in January and February, when the White House staff was preparing

Mr. Clinton for telephone calls to put pressure on Mr. Suharto to get with the IMF program. The rupiah was in free fall. A Suharto son, defying the IMF, had opened a new bank on the site of his old one closed at IMF insistence.

In White House meetings, the question was whether and, if so how, to distance Mr. Clinton from Mr. Suharto. White House aides James Steinberg and Daniel Tarullo feared the president would be embarrassed unless he was strict with Mr. Suharto, both publicly and privately. State and Defense urged caution: Concentrate on the economic reforms, they said; don't push for political change. Pentagon strategists concluded that the best outcome if Mr. Suharto went was military dictatorship, and the worst was a bloody civil war. Neither was appealing.

Influenced by its Embassy in Jakarta, the State Department urged Mr. Clinton to avoid anything that looked like a U.S. plan to depose Mr. Suharto. The Treasury wanted to push for both economic and political reforms, but -- in a rare setback -- found itself overruled by those with more political expertise.

But by March, when Mr. Clinton dispatched former Vice President Walter Mondale in another attempt to turn Mr. Suharto, the U.S. had decided to press for both political and economic change. It was too late. Mr. Mondale's hour-long meeting was a failure, as he had warned the White House it would be.

"I came back with a pessimistic report," Mr. Mondale says. Mr. Suharto "felt he was being victimized. He gave a long speech about how well he had done in the past." What the IMF and the U.S. sought, Mr. Suharto asserted, was "suicide."

The Russia Question

With much of Asia ailing, the administration hoped to prevent Russia from succumbing as well. Overlaid on problems similar to those battering Asia -- too much short-term debt and too little hard currency to pay it -- was the risk of political chaos in a nation still armed with thousands of nuclear weapons.

But how to help? Mr. Rubin and Mr. Summers tried two opposite approaches over the spring and summer. First, they supported pumping more money into Russia; then they agreed to cut Russia off. Neither tactic succeeded.

At the end of May, President Clinton surprised IMF negotiators in Moscow by issuing a statement, at Treasury's urging, endorsing a bigger loan for Russia than the IMF team was negotiating. Mr. Fischer sided with the U.S., arguing that the billions of dollars could prevent Russia's economy from imploding and the global financial crisis from spreading to Latin America.

But some top IMF staffers thought putting more money into Russia was a waste. "I've had deep concerns about how we proceed in the Russian case," says Michael Mussa, the IMF's chief economist, who nonetheless supported the larger loan as "a last-chance effort to avoid catastrophe." During a closed-door meeting months later at the Institute for International Economics, a Washington think tank, Mr. Mussa branded the Russian government a "bunch of criminals" that didn't deserve further aid, according to several witnesses.

The $22.6 billion loan package -- three times as large as the one the IMF first offered -- was a flop. The first installment of $4.8 billion didn't bolster confidence in the ruble, but merely helped those seeking to convert rubles into dollars. The Russian central bank spent nearly all the IMF money bankrolling capital flight.

Russia appealed for more money, but this time the U.S. balked. At a mid-August meeting in the White House situation room, Treasury officials batted down a suggestion from Stuart Eizenstat, undersecretary of state for economic affairs, that the U.S. put together an additional $15 billion lifeline for Russia to give it more time to make economic reforms. That would be throwing good money after bad, Treasury hands argued, and would weaken support on Capitol Hill for added U.S. funding of the IMF.

In a series of conference calls among officials from the U.S., the IMF, Germany and other countries, the IMF warned that failing to bail out Russia could lead to a disruptive devaluation, a default on Russia's foreign debt or both. But the IMF had committed about $26 billion of its own money to Russia since 1992, and Mr. Fischer thought it imprudent for his agency to spend any more. And the industrialized nations -- including Germany, whose support was essential for building consensus in Europe -- were unwilling to put up money.

Mr. Fischer was bitter; he thought more money from them might have bought Russia time to right itself. In an unusual display of public anger against a major stockholder, he told a German newspaper: "I'm not sure whether Chancellor Helmut Kohl wouldn't have acted differently if elections were two years away and not six weeks."

Russia's default on Aug. 17 sent a message to investors world-wide that the rules had changed. The IMF couldn't be counted on any longer for a bailout. Investments as far away as Buenos Aires suddenly seemed riskier, and Latin American stock markets and currencies dived.

"It's a great time," says former Vice President Mondale, "to realize humility about the capacity of even the United States to influence events in a swift and decisive way."

Key Events in Financial Crisis 1997 -- July 2, 1997 Thailand devalues the baht -- Aug. 20, 1997 $17.2 billion IMF rescue for Thailand arranged -- Oct. 29, 1997 Greenspan sees impact of Asia on U.S. as "modest, but not negligible" -- Oct. 31, 1997 $42 billion IMF rescue for Indonesia arranged -- Nov. 7, 1997 New Thai government takes over -- Nov. 23, 1997 Clinton labels crisis a "few glitches in the road" -- Dec. 3, 1997 $58 billion IMF rescue for South Korea arranged -- Dec. 12, 1997 IMF resumes lending to Russia -- Dec. 18, 1997 Korea elects Kim Dae-Jung as president -- Dec. 24, 1997 U.S., others push big banks to reschedule loans to Korea 1998 -- Jan. 15, 1998 Suharto announces reforms; currency falls anyway -- Jan. 29, 1998 Korea cuts deal on debt with foreign banks -- Feb. 10, 1998 Suharto begins flirting with currency board -- March 4, 1998 Mondale meets with Suharto -- May 4, 19! 98 Indonesia cuts fuel subsidies, sparks riots -- May 21, 1998 Suharto resigns -- May 31, 1998 Clinton calls for more IMF money for Russia -- June 18, 1998 U.S., Japan intervene to boost yen -- June 27, 1998 Clinton, in Beijing, praises China, criticizes Japan -- July 20, 1998 IMF assembles $22.6 billion in loans for Russia -- Aug. 14, 1998 Hong Kong authorities buy stock to prop market -- Aug. 17, 1998 Russia lets ruble fall, defaults on some debt -- Sept. 1, 1998 Malaysia imposes currency controls -- Sept. 4, 1998 Greenspan says U. S. can't remain "an oasis of prosperity" -- Sept. 9, 1998 Japan cuts interest rates for first time in three years -- Sept. 14, 1998 Clinton calls it "worst financial crisis in half a century" -- Around Sept. 15 IMF opens talks with Brazil on possible rescue

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