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EBS/95/149
Correction 1

CONFIDENTIAL

September 13, 1995

To: Members of the Executive Board

From: The Acting Secretary

Subject: Russian Federation - Staff Report for the 1995 Article IV Consultation and First Quarterly Review Under the Stand-By Arrangement

The following corrections have been made in EBS/95/149 (9/8/95):

Page 12, second full para., line 8: for "imports and exports"
read "imports and domestic goods"

Page 15, lines 9-11: for "Nonresident individuals,...held by nonresidents in "T" accounts"
read "Nonresidents,...held in "T" accounts"

Corrected pages are attached.

Att: (2)

Other Distribution:
Department Heads

The new excise rate schedule for oil was introduced effective June 1, and based on preliminary data for production and tax collections, the compliance rates for the oil and gas excises appear to have reached the targeted level in June. With regard to the import duty exemptions provided to certain organizations such as the National Sports Foundation, while the exemptions had indeed been formally eliminated as of mid-March, deferrals on duty payment obligations had been extended through mid-July, leading to a buildup of significant tax arrears. The revenue package (discussed above) includes steps to recoup a portion of the overdue obligations and to eliminate further exemptions--except on a temporary basis for a small amount of imports already under contract as of September 1.

The staff had further discussions on the revised draft 1996 budget, which was about to be submitted to the Duma. 1/ On the basis of the official budget accounting methodology, the draft budget envisages revenues of 15.7 percent of GDP and expenditures of 19.6 percent of GDP, leading to a deficit of 3.9 percent of GDP. 2/ While welcoming the authorities' efforts to trim planned expenditure from the level initially considered, the staff expressed continued skepticism concerning the revenue projection. Notwithstanding the revenue package currently under consideration, further significant steps would be needed to yield the level of revenues forecast in the 1996 budget, including through increases in direct taxes and concrete steps to improve tax compliance. Further discussions in this area would be held in the context of negotiations on a medium-term program to be supported by an EFF arrangement.

3. Program financing

Despite delays in reaching agreements with the London Club of commercial bank creditors and national groupings of suppliers, as well as delays in Russia's initial approach to international capital markets as a sovereign borrower, the external financing of the 1995 program appears to be satisfactory. It is now estimated that external financing, including debt relief, will be of an amount similar to the $31 billion projected under the program. The larger rescheduling of debt service by the Group of Participating Official Creditors than originally envisaged under the program, assuming comparable treatment from other creditors, has more than compensated the delayed market financing. 3/

Further progress was made in discussions with commercial bank creditors at the meeting in Frankfurt in early July, but no agreement on a term sheet was reached. There continue to be some issues to resolve on terms, especially the maturity and interest capitalization of a debt stock

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1/ The budget was subsequently submitted to the Duma on August 28.

2/ The staff has considerable questions regarding the official macroeconomic assumptions, but efforts have been underway to reconcile the differences.

3/ See Annex I to EBS/95/105 (6/30/95).

operation which will not entail any debt reduction. 1/ Both sides are optimistic that a final agreement can be reached by the end of 1995. Finally, preparations are underway to issue bills of exchange to suppliers with uninsured commercial claims. However, the authorities are awaiting the outcome of forthcoming negotiations with official creditors on a medium-term rescheduling in order to apply comparable terms across different types of creditors.

4. Structural policies

a. Trade policies

Further liberalization of the foreign trade regime has been introduced under the program, notably with regard to exports (as imports were already free of quantitative controls). A review of trade policies carried out in conjunction with World Bank staff indicates that the trade regime has been in general operating as foreseen under the program. Following the elimination of remaining export quotas and the system of specialized exporters, no new restrictive measures have been introduced, centralized exports apply now only to arms and defense-related goods, and there are no obligatory features in trade agreements with other FSU countries. In other areas, the authorities have been generally successful in resisting pressures to reinstate aspects of the earlier Soviet-style system. The recorded large increase in non-FSU exports in the first half of 1995 (by 24 percent in dollar terms) seems to reflect, at least in part, the liberalization of the export regime that took place at the beginning of the year.

Regarding the import regime, commitments under the program to adjust import duties have been met, particularly introducing a 30 percent ceiling and a 5 percent minimum duty. 2/ At the same time, the Government did not, until recently, resolve the issue of import duty exemptions. As noted above, however, the Government has recently decided on a program to fully eliminate the remaining exemptions between September 1 and December 1. While the June 30, 1995 date specified in the program for harmonization of excise duty rates on imports and domestic goods was not met, the authorities informed the staff that this process will be completed by September 1. 3/ An issue of concern that needs to be reviewed during the next mission relates to the agreements which the Government has signed with certain

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1/ Commercial bank claims on Russia are trading at an increasing discount, currently about 70 percent of face value.

2/ The monitoring of the average import duty rates under the program has been complicated by difficulties in obtaining the requisite data from the State Customs Committee, although discussions to resolve this issue are underway.

3/ Among other developments in the trade policy area, Russia signed on July 17 a trade agreement with the EU which provides a consultation mechanism for bilateral trade relations, and the WTO working party on Russia's accession met to begin the process of membership on July 17-19.

exchange system has undergone a process of dramatic liberalization over the past few years. Authorized banks now freely purchase and sell foreign exchange in currency exchanges in several different centers across the country and in a growing interbank market outside of the exchanges. Moreover, the Russian Federation now maintains a liberal regime governing the making of payments and transfers for current international transactions. In this regard, resident individuals and enterprises are freely permitted to make payments for virtually all current international transactions. Nonresidents, however, are subject to some restrictions arising from limitations on the convertibility of ruble balances held in "T" accounts and in the ruble accounts of nonresident banks. 1/ The Russian authorities are prepared to consider the appropriate timing of acceptance of Article VIII obligations in the context of a medium-term program.

5. Medium-term outlook

The medium-term scenario discussed with the authorities illustrates a likely evolution of the Russian economy as the process of its transition to a market-based system deepens further under the conditions of increased macroeconomic stability. The scenario assumes that measures are taken during the second half of this year to ensure that the objectives of the SBA are achieved and that restrained financial policies continue beyond 1995. The overall deficit of the enlarged government is targeted to fall further in 1996 to about 4 percent of GDP and to about 3 percent of GDP in 1997, and to stabilize at 2 percent of GDP thereafter. 2/ Under these assumptions, monthly inflation would decline to slightly less than 1 percent starting early 1996. Against the background of increased macroeconomic stability and an intensification of the structural reform process, real GDP would rise in 1996, consolidating its initial recovery, and growth would be sustained at a relatively high rate over the rest of the decade (Table 8).

1/ These measures are maintained under the transitional arrangements of Article XIV, Section 2. In addition, the Russian Federation continues to impose exchange restrictions against the Federal Republic of Yugoslavia (Serbia/Montenegro) in compliance with the relevant resolutions of the United Nations Security Council; these measures have been notified to the Fund pursuant to Decision No. 144-(52/51) (EBD/93/58).

2/ The Government should be able to finance a deficit of this size without any recourse to direct credit from the CBR, including CBR purchases of Treasury bills in the secondary market. (Of course, the CBR could buy and sell Treasury bills in the secondary market but strictly for monetary policy purposes). Also, a deficit of around 2 percent of GDP can be seen as appropriate on the grounds that infrastructure investment of some 4 percent of GDP that is estimated to be necessary for the medium-term growth path envisaged can be financed in equal proportion by current and future generations.

Reflecting a more favorable economic climate, domestic investment would rise gradually from a little below 28 percent of GDP in 1995 to 29 1/2 percent by 1998 and beyond. The higher investment ratio becomes a key factor in sustaining growth at a rapid pace over the medium term once the capacity utilization rate reaches high levels following the first few years of economic recovery. Initially, the rise in the investment ratio would require an increased reliance on foreign savings as the improved financial position of the enlarged government would be partially offset by a decline in private savings, that in time would result from the reduced pace of erosion of real wealth in an environment of sharply lower inflation. Once stability and the economic recovery become firmly established and financial market reform progresses, national saving is forecast to rise, with a turnaround in 1998. The current account of the balance of payments would move from deficit towards balance by the end of the decade.

The baseline scenario envisages that Russian exports would increase at an annual average of 8 1/4 percent in dollar terms. Imports would rise at an annual average rate of 10 percent over the same period. 1/ Trade would be increasingly redirected toward non-FSU countries. Gross international reserves would rise from the equivalent of nearly 2 months of imports of goods and nonfactor services projected for the end of 1995 to 3 months by the end of 1997. The scenario assumes a significant improvement in external investor confidence and the regularization of financial relations with creditors and debtors. Accordingly, there would be a substantial repatriation of flight capital and large increases in foreign investment. Disbursements of public or publicly guaranteed foreign loans would remain at moderate levels in keeping with the authorities' intention to reduce use of tied credits while making greater use of multilateral borrowing and regaining access to international capital markets.

The authorities broadly agreed with the staff's projections, but noted that the above scenario might be somewhat optimistic in several respects. In particular, the authorities are less sanguine about the recovery in output in 1996 than the staff, although they agreed with the scenario's medium-term growth rate of around 6 percent. 2/ Also, the authorities were not confident that the major boost in private direct and portfolio investment flows postulated by the staff scenario would materialize. At the same time, they argued that it was difficult to envisage a rapid growth of non-energy exports, given the outdated technology and product lines associated with much of Russia's current productive capacity and the long lags between new investment and resulting increases in exports.

1/ Faster growth of imports (than exports) reflects not only the higher growth of the Russian economy relative to its trading partners that is projected but also a somewhat greater elasticity of imports with respect to domestic income than that of exports with respect to foreign economic activity.

2/ In the preparation of the 1996 budget, the authorities have set an inflation target which is similar to that assumed in the staff's scenario.