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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 93/5

3:00 p.m., January 11, 1993

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
G. K. Arora	
	Wei B.
T. C. Dawson	
	J. Prader
E. A. Evans	
R. Filosa	J. Papadakis
I. Fridriksson	J. A. Solheim
H. Fukui	N. Tabata
J. E. Ismael	K.-T. Hetrakul
D. Kaeser	K. Link
A. Kafka	M. C. B. Arraes, Temporary
K. G. Kagalovsky	A. Mozhin
	I. Martel
	G. Torres
	P. A. Merino, Temporary
	O. Kabbaj
L. J. Mwananshiku	B. S. Dlamini
D. Peretz	J. Dorrington
G. A. Posthumus	O. Havrylyshyn
C. V. Santos	J.-C. Obame, Temporary
S. Schoenberg	B. Esdar
A. S. Shaalan	Y. Y. Mohammed
D. E. Smee	
A. G. Zoccali	

L. Van Houtven, Secretary and Counsellor
T. S. Walter, Assistant
L. S. Collier, Assistant

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Also Present

IBRD: Y. Huang, Europe and Central Asia Regional Office. European I Department: M. Russo, Director; J. R. Artus, Deputy Director; M. C. Deppler, Deputy Director; C. Atkinson, T. Krueger, M. Mecagni, S. Sharma, G. S. Tsibouris, R. Violi. European II Department: J. Odling-Smee, Director; E. Brau, Deputy Director; E. Hernández-Catá, Deputy Director; J. Berengaut, A. Cheasty, K. B. Dillon, I. Kapur, V. R. Koen, H. R. Lorie, M. Marrese, L. V. Mendonca, P. M. Nagy, P. S. Ross, G. H. Spencer, T. A. Wolf. External Relations Department: S. J. Anjaria, Director; H. P. Puentes, M. A. Seeger. Fiscal Affairs Department: V. Tanzi, Director; T. M. Ter-Minassian, Deputy Director; R. P. Hagemann, E. Ruggiero. Legal Department: F. P. Gianviti, General Counsel; W. E. Holder, Deputy General Counsel; P. De Boeck. Policy Development and Review Department: J. T. Boorman, Director; J. Ferrán, Deputy Director; D. Burton, A. K. McGuirk. Research: C. M. Asilis, J. Baras, M. D. Knight, S. A. Symansky, D. Villanueva. Secretary's Department: J. W. Lang, Deputy Secretary; R. S. Franklin, A. Jbili, A. Leipold, A. Mountford. Southeast Asia and Pacific Department: M. J. Fetherston. Statistics Department: J. B. McLenaghan, Director. Treasurer's Department: D. Williams, Treasurer; K. Boese, W. J. Byrne, J. C. Corr. Personal Assistant to the Managing Director: G. R. Saunders. Advisors to Executive Directors: J. M. Abbott, M. A. Ahmed, P. Bonzom, L. E. Breuer, S. K. Fayyad, B. R. Fuleihan, G. Y. Glazkov, J. Jamnik, W. Laux, R. Meron, M. Nakagawa, A. Raza, A. Törnqvist. Assistants to Executive Directors: S. Al-Huseini, B. Abdullah, G. Bindley-Taylor, G. M. Blome, J. A. Costa, S. B. Creane, D. Desruelle, P. Dognin, R. G. Ferrilo, J. A. Giustiniani, M. A. Hammoudi, O. A. Himani, C. J. Jarvis, T.-M. Kudiwu, K. Langdon, F. J. Matthews, S. McDougall, F. Moss, S. Narube, J. K. Orleans-Lindsay, R. K. W. Powell, E. Quattrociocche, S. Shimizu, F. A. Sorokos, T. P. Thomas, V. Verjbitski, A. Viirg, S. Vori.

1. ITALY - 1992 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/93/4, 1/11/93) their consideration of the staff report for the 1992 Article IV consultation with Italy (SM/92/227, 12/22/92; and Cor. 1, 1/7/93). They also had before them a paper on background developments in Italy (SM/92/232, 12/30/92; and Sup. 1, 1/6/93).

Mr. Merino made the following statement:

Italy, defying predictions of economic gloom, surpassed many other countries in terms of output and productivity growth during the 1980s. At the same time, Italy has experienced higher structural unemployment, inflation, and interest rates than other major countries.

Italy also has one of the largest budget deficits and public debts, expressed as a percentage of GDP, in the European Community (EC). The present problems faced by the Italian authorities are the result of the interaction of an unsustainable policy mix, the slowdown in the world economy, and the exchange rate turmoil that both deepened the magnitude of the crisis and highlighted the importance of that intangible asset, credibility.

It is clear that at the root of the Italian economy's crisis are the fiscal imbalance and the difficulties of converging--in terms of inflation rates--with the most stable EC countries. Therefore, we welcome the commitment of the Italian authorities to make progress in fulfilling the convergence criteria as a realistic way of restoring domestic stability. The stated policy objectives and the stated measures to achieve them should be adopted without delay.

It certainly seems that, if we take into account the commitment to achieve a primary balance of 50 trillion lire and the lasting nature of the measures taken--which have been set in a framework of structural reforms--the 1993 budget and the accompanying reform law represent a change for the better from past actions. However, the measures taken do not seem to be sufficient to put the public finances on a sustainable path, and, therefore, a big effort continues to be needed in terms of fiscal consolidation.

In this sense, Italy should make every effort to reduce its outstanding debt. This task has been complicated by the increase in the differential between real interest rates and real GDP growth. One way to boost the debt-reduction efforts would be to apply all privatization proceeds to debt reduction. In this regard, it is regrettable to learn from Mr. Filosa's opening

statement that the contribution of privatization proceeds to the reduction of public debt is going to be very modest.

Long-term interest rates are high, but the participation of foreign investors is needed to develop the long-term part of the market, and to reduce the differential vis-à-vis Germany. The best way to encourage this participation is to continue with the convergence plan and reduce the uncertainty surrounding future exchange rate movements. In doing this, the Italian authorities can continue issuing long-term securities; at the same time, they can reduce interest expenditures and avoid the rollover problem of short-term securities--not to mention the problems associated with the Treasury's overdraft facility.

Another way of reducing interest expenditures is to adopt economic policies that would lead to a reduction in long-term interest rates. The present differentials vis-à-vis Germany mainly reflect market anticipation of continued exchange rate movements. Credibility is needed to reduce this differential and change expectations in the market. This credibility in the process of disinflating and attaining convergence can be reinforced by restraining wage increases in 1993. Good pieces of news in this area were the July 1992 agreement to scrap the scala mobile and the union leaders' willingness to accept wage restraint.

We agree with the thrust of the staff appraisal and look forward to a successful implementation of the authorities' fiscal plans.

The Director of the European I Department said that, contrary to what many Executive Directors had suggested during the morning discussion, all interest rates in Italy had declined significantly from their crisis levels. For example, the three-month government bill rate had fallen from 18 percent in September 1992 to 13.8 percent recently. However--and not surprisingly, in light of the more uncertain current prospects--those rates were higher than they had been at the beginning of 1992.

Under a system of floating exchange rates, a variety of indicators should be used in implementing monetary policy, the Director considered. In its discussions with the authorities, the staff had cautioned against relying excessively on money supply as an indicator, if only because the other market participants--partly as a result of the uncertainty surrounding the demand for money function--did not attach much weight to it. In light of the lira's expected return to the exchange rate mechanism (ERM) of the European Monetary System (EMS), as well as of the importance of the exchange rate for price expectations, the exchange rate remained a very important--perhaps the most important--indicator for monetary policy in Italy.

The exchange rate also had a strong bearing on Italy's competitiveness, the Director continued. At present, the exchange rate was about Lit 904 per DM, which represented a depreciation of the lira in effective terms of about 14 percent from its pre-September 1992 central rate. The size of that depreciation went far beyond the 6 1/2 percent erosion of competitiveness that, according to the Bank of Italy's estimates--based on relative producer prices--had occurred since 1987. Moreover, only one of the Fund's measures of competitiveness--relative unit labor costs in manufacturing--indicated that Italy's competitiveness had eroded by as much as 14 percent over that period. Therefore, although the current exchange rate did not take into account future inflation rate differentials, the depreciations that had occurred since September 1992 appeared to have provided Italy with more than enough room to restore its competitiveness. However, it should be remembered--particularly at present, when capital movements dominated the balance of payments--that there were other determinants of the lira exchange rate besides competitiveness.

The staff had suggested on page 17 of the report that a successful re-entry of the lira into the ERM would depend on both external support and reserves, the Director recalled. With respect to the first condition, there was the view shared by the authorities and under discussion in the Monetary Committee of the EC that the entire membership of the ERM should defend a member country's exchange rate if the group had accepted that rate as sustainable. With respect to the second condition, Italy would have to replenish its stock of reserves, which had been depleted during the September 1992 exchange rate crisis.

On the fiscal side, the authorities felt that, although the tax amnesty that had been declared in 1992 had been successful, much more revenue could have been obtained, the Director noted. Therefore, they had decided to declare another tax amnesty in 1993, albeit at higher costs to tax evaders than in the previous year. The 1993 program was expected to be successful because the continuing improvement in tax administration was convincing the citizenry that the risks associated with tax evasion were becoming too large.

The figures that had been quoted on tax evasion during the morning discussion were somewhat overstated, the Director added. According to the best available estimates, about 20 percent of taxable income was illegally sheltered from taxation. It was reckoned that if all tax evaders were paying their taxes in full, revenues would rise by 6-6.5 percent of GDP--as opposed to the 21 percent increase mentioned in the Economist. However, the Government did not intend to increase its revenues to that extent; if tax evasion were eliminated completely, the authorities would ease the burden on those law-abiding citizens who were currently paying their taxes in full.

As one Executive Director had noted, the 1993 Financial Bill included a provision specifying that any expenditure-increasing amendment to that Bill would have to be accompanied by a measure to reduce spending by an equivalent amount, the Director remarked. That provision applied only to the 1993

Financial Bill; however, there was nothing to stop the authorities from including a similar provision in the 1994 Financial Bill.

According to the Italian Constitution, new expenditures could be added to the budget only if other expenditures were reduced or revenues increased by an equivalent amount, the Director continued. Unfortunately, that constitutional requirement, although legally binding on all government-financed programs, was weaker than the provision in the 1993 Financial Bill, as it applied only to expenditures made in the first year of multiyear programs. That loophole had permitted Italy's large deficits and growing debt/GDP ratio to emerge, as it was extremely difficult to control spending in succeeding years of government programs.

In the real sector, the Director of the European I Department observed, there was scope for improving productivity in the service sector, including the transportation and telecommunications industries. The authorities also believed that productivity could be increased in many sectors that had thus far been sheltered from competition, such as commerce and banking. Opening those sectors of the economy to competition would not only stimulate growth but would also reduce labor demand, which, in turn, would help in the fight against inflation.

Mr. Schoenberg said that, in measuring the effect of the lira's departure from the ERM on interest rates in Italy, it was somewhat misleading to compare--as some Executive Directors had done--current interest rates with the rates that had been in effect at the beginning of the exchange rate crisis in September 1992. Interest rates had been extremely high in Italy at that time because the authorities had been resisting pressures to adjust the exchange rate of the lira. If, however, the mechanism of the EMS had been applied properly, and the exchange rate realigned in time, Italian interest rates would have been significantly lower at that time.

Therefore, Mr. Schoenberg continued, it would make more sense to compare the current Italian interest rates with the rates that had been in effect before the lira had come under attack. For example, long-term interest rates had increased by 0.5-1 percent since May-June 1992, and the interest rate differential vis-à-vis Germany had widened by an even greater margin over that period. The conclusion to be drawn from those facts was clear: leaving the EMS had not won for Italy more freedom in setting interest rates.

The Director of the European I Department said that, in noting that interest rates had declined in Italy since the exchange rate crisis, he had not meant to imply that Italy's departure from the ERM had given the authorities more room for maneuver in setting interest rates. Although another country that had left the ERM at the same time as Italy had subsequently lowered its rates below those of Germany, Italy had not done so for two reasons: the market had not permitted it; and the Bank of Italy had decided that interest rates should be kept high in order to control inflation.

Mr. Filosa observed that the proper timing of policy actions--on the fiscal and privatization fronts, and in connection with the lira's re-entry into the ERM--had been a recurrent theme in the Board's discussion on Italy. Contrary to what Mr. Kagalovsky had seemed to suggest, time was clearly of the essence in dealing with the fiscal problems. The quantitative fiscal targets and the realistic convergence timetable that the authorities had established to achieve the Maastricht criteria demonstrated their awareness of the situation's urgency. Obviously, as Mr. Evans had pointed out, three or four years would be required to meet those criteria, given the size of the needed adjustment as measured by the debt/GDP ratio.

The Government did not expect that the gap between the 1993 fiscal targets and the actual results would be overly wide, Mr. Filosa commented. Nevertheless, in light of both past slippages and the uncertainty of the 1993 fiscal outcome, it would monitor its fiscal policy performance closely. On the one hand, some factors, such as the size of the slowdown in growth, could be predicted with a fair degree of accuracy; on the other hand, the relative newness of some of the measures to be implemented--including, for example, the proposed minimum tax on the self-employed and the 1993 tax amnesty program--introduced an element of uncertainty into the projections.

The authorities were well aware that they would have to make extra efforts in 1994 and 1995--as well as in the present year--to attain the goals that had been set under their 1993-95 medium-term budget plan, Mr. Filosa added. Supplemental measures to put the program back on track would be identified and enacted in the context of the EC's loan approval process. As a general rule, corrective actions should be taken in those areas of the budget where permanent reductions in expenditures and increases in revenues could be effected.

The proper timing of policy actions would also be essential to the success of the authorities' privatization strategy, Mr. Filosa considered. Prompt agreement on a timetable for privatizing enterprises would add credibility to the political commitment that the authorities had demonstrated in gaining broad parliamentary approval of their privatization program. As part of that strategy, the Government had already presented plans to Parliament for the privatization of four state enterprises and two banks. Foreign investment in those enterprises would be permitted.

The comparison that one Director had drawn between Italy's privatization process and that of other countries--in particular, Russia's--was somewhat misleading, Mr. Filosa continued. The environment in which state-owned enterprises (SOEs) were being sold or liquidated differed widely from country to country. Moreover--unlike most of the Russian SOEs--many of the Italian enterprises were generating profits.

However, the indebtedness of the unprofitable Italian SOEs could pose problems for the privatization process, Mr. Filosa remarked. The need to set explicit limits on the new debts accrued by those enterprises had become more urgent following the Treasury's announcement that it would stand by the

debts of EFIM, a manufacturing activities group that had recently been declared insolvent. Moreover, an understanding should be reached that the financing of enterprises in need of restructuring should generally involve private sector participation; it should also be understood that public sector participation in those financings should be governed by EC directives on state aid.

In that connection, Mr. Filosa added, some of the proceeds from privatization would be applied toward the recapitalization and restructuring of the unprofitable SOEs, while the remainder would be used to reduce the fiscal deficit.

Exchange rate policy--and, more specifically, the question of the lira's re-entry into the ERM--was the third area in which the timing of the authorities' actions would be critical, Mr. Filosa remarked. Although, as speakers had noted, there were risks involved with setting a specific date for re-entry, the Government intended to do as much as it could to rejoin the ERM as soon as possible.

The lira's re-entry into the ERM would depend on several factors, Mr. Filosa continued. First, the Economic and Financial Council of the EC would have to approve Italy's request for a loan, as that would add credibility to the Government's commitment to meet its medium-term fiscal and monetary targets. With the Parliament's acceptance on December 30, 1992 of the 1993 budget, one important step had been taken in that direction.

Second, the rules governing the workings of the EMS--including the obligations of participating countries--should be clarified and tightened, Mr. Filosa stated. It should be made clear to the Italian authorities, for instance, that the lira should re-enter the ERM at a sustainable exchange rate parity, in line with the country's underlying fundamentals. At the same time, the other EMS participants should be made aware of their obligation to defend that new parity. Although, unfortunately, there had been a tendency for member countries to overlook the latter obligation, his authorities considered it to be integral to the system's success.

As several Directors had pointed out, the lira's departure from the ERM had created both costs and opportunities, Mr. Filosa noted. Clearly, there was an opportunity to substitute external for domestic demand by allowing the lira to float at a greatly devalued parity rate; however, his authorities were reluctant to implement what they viewed as a "beggar-my-neighbor" policy that ran counter to the spirit of the EC.

As Mr. Landau and Mr. Schoenberg had observed, one cost of the lira's absence from the ERM--as transmitted through the accompanying increase in exchange rate risk--had been the continuing high level of interest rates in Italy, Mr. Filosa continued. Moreover, as Mr. Landau had suggested, as long as the lira's absence from the ERM precluded the use of the exchange rate as a nominal anchor, the risk of a resurgence in inflation remained strong,

especially in light of the possible pass-through effects of the recent devaluations.

Two Directors--Mr. Smee and, to a lesser extent, Mr. Dawson--had emphasized the opportunities for implementing significant fiscal reform that the lira's exit from the ERM had afforded, Mr. Filosa recalled. However, any discussion on the kind of exchange rate regime that Italy should follow should take into account the structural differences between European and North American economies. In North America, exchange rate movements affected demand, primarily; in Europe, exchange rate movements primarily affected expectations and costs, given the more rigid labor markets of those countries. For that reason--as well as for the more frequently cited political reasons--it made sense for the European countries to band together in a system of fixed exchange rates. Furthermore, the especially strong labor market rigidities in Italy gave his authorities an extra incentive to re-enter the ERM as soon as was feasible--subject, of course, to the conditions for re-entry referred to earlier.

In keeping with the new emphasis on surveillance procedures in the EC, Italy had requested a loan from that institution rather than a stand-by arrangement with the Fund, Mr. Filosa said. Surveillance of member countries' policies--political as well as economic--was playing an increasingly important role in the broad move toward union under way in Europe, and it was an obligation that his authorities took seriously. In the 1992 Article IV consultation discussions, his authorities and the staff had agreed that it would be desirable to expand and integrate the surveillance functions of the Fund and the EC in Italy, Mr. Filosa added. The Government's request for a staff visit to monitor progress under the fiscal adjustment program in the spring of 1993--an action that went well beyond the obligations of membership as described in Article IV of the Articles of Agreement--had been made in that spirit. It was his understanding that France had pioneered in that area some ten years previously, when it had kept the Fund informed of its negotiations with the EC on a loan.

In the area of monetary policy, a number of speakers had praised the Bank of Italy's tight stance, which had helped to restore investor confidence after the September 1992 exchange rate crisis, Mr. Filosa noted. The financial system had proved to be fairly robust in the face of the high interest rates, and a market liquidity crisis had been averted. In implementing monetary policy, the authorities had closely monitored a variety of indicators, including monetary aggregates and the exchange rate, and had tracked other related developments on a daily basis. Looking ahead to 1993, the authorities had in the absence of an exchange rate anchor signaled continued restraint by announcing a restrictive monetary target and tough, albeit informal, guidelines for lira bank credit.

The importance of lower long-term interest rates for economic growth had rightly been underscored by Mr. Schoenberg, Mr. Filosa considered. Other interest rates, including, for example, the treasury bill rate, had subsided to their pre-crisis levels of May 1992--when the lira had been at

the top of the narrow ERM band--and it was expected that the implementation of tight financial policies would enable the authorities to lower long-term rates eventually. It should be emphasized, however, that, although a continuation of high long-term interest rates would be a cause for concern, the authorities had no intention of lowering those rates until substantial progress was being made in the fight against inflation.

The concern expressed in both the staff report and many speakers' interventions about the Treasury's use of its current account facility with the Bank of Italy and--more fundamentally--the autonomy of the latter institution had been overemphasized, Mr. Filosa commented. At no time during the past year--including September, when the Government had covered Lit 17 trillion of its borrowing requirement through the current account facility--had the use of that facility caused an expansion of the monetary base. All such monetary financings of the budget had been absorbed through the instruments that had been introduced to strengthen the financial sector. In the same way, the market had also absorbed a 60 trillion lira bond issue in 1992. More generally, the concern expressed about the autonomy of the central bank was unfounded; with the passage of the Central Bank Law in 1991, its authorities were defining--and meeting--their targets for money, credit, and interest rates.

Furthermore, Mr. Filosa continued, in light of the newly elected Government's heavy 1992 legislative agenda, which had included new laws on privatization and the budget, it would have been almost impossible to amend the Central Bank Law to limit the Treasury's recourse to the current account facility. However, the authorities were committed to winning parliamentary approval for such an amendment--which would comply fully with the relevant EC regulations--in 1993.

On the fiscal side, Mr. Peretz had rightly stressed the importance of reforming the wage bargaining system in order to make it more responsive to local market conditions, Mr. Filosa observed. That topic would be discussed during the next round of wage negotiations between the authorities and the trade unions.

On a related point, Mr. Filosa concluded, the spread of inflation from the nontradable goods sector to the tradable goods sector was--as Mr. Landau had pointed out--a cause for concern. It would seem that opening up the nontradable sector to external competition, with a view to eliminating price rigidities, would help solve the problem.

The Chairman made the following summing up:

> Executive Directors endorsed the thrust of the staff appraisal and warmly welcomed the recent actions of the Italian government to address Italy's severe fiscal imbalances. These had plagued the economy for many years and contributed significantly to the collapse of confidence in financial markets in the summer of 1992. However, Directors emphasized that sizable further

measures were still required to set the public finances on a sustainable path and to establish confidence in the Government's ability to continue the disinflation process. Directors pointed to the continued weakness of the lira in foreign exchange markets, despite still high real interest rates, and noted the growing evidence of a marked economic slowdown.

Directors observed that the 1993 budget and accompanying measures, now approved by Parliament, would help to contain the rapid growth in the underlying trade deficit. They noted, however, that, without significant additional measures, the public sector deficit would remain above the Government's targets, both for 1993 and the medium term. Directors welcomed the improved quality of the fiscal adjustment now being implemented, in particular, the emphasis on structural reforms, which would have a lasting impact on the deficit. However, most Directors regretted that there had not been more front-loading of the adjustment proposed for 1993-95, given the size of the fiscal imbalances and the dynamics of deficits and debt, and the financial market tensions.

With regard to 1993, Directors urged the authorities to prepare and implement contingency measures to offset any shortfall from the budget targets, noting that a failure once again to meet the official targets would seriously damage the Government's credibility. Further permanent measures to curb the deficit would also be urgently needed in the 1994 and subsequent budgets. These should focus on expenditure restraint, although a number of Directors noted that, in light of the Government's high level of indebtedness, there was no room for a decline in the tax burden as would happen in the absence of new measures. Many speakers emphasized that privatization would enhance the credibility and quality of the adjustment and constitute an important signal of the Government's determination to pursue a new policy strategy. While privatization could not substitute for a fundamental improvement in the underlying fiscal position, the proceeds could help to reduce the government debt; more fundamentally, the scope for efficiency gains from privatization was very large, given the extensive involvement of the State in the economy. Directors, therefore, welcomed the privatization plan and looked forward to rapid implementation of state divestiture with a clear timetable.

Directors noted that wage restraint would be crucial in supporting the fiscal adjustment and ensuring a permanent gain in competitiveness, which could help to mitigate the effect on output of the slowdown in domestic demand now taking place. They strongly welcomed the agreement among social partners in July 1992 to end the old indexation system. Directors stressed that the maintenance of firm control over public sector wages, as budgeted, would be important in sending a signal to the private sector.

Directors also stressed the need for labor market reform, including further changes in the process of wage determination to allow more flexibility for wages to respond to differing market conditions.

Directors observed that the lira's temporary departure from the ERM made the management of monetary and disinflation policy more difficult. They were pleased to note the authorities' continued commitment to maintain a monetary policy geared to fight inflation, including the announcement of restrictive monetary growth targets for 1993. Despite the absence, for the time being, of an exchange rate anchor, most Directors agreed that, for the conduct of monetary policy, large weight should still be given to the exchange rate, which had been a better-known signal to wage and price setters than the monetary targets. Some Directors noted that, in current circumstances, a pragmatic approach was needed, perhaps using a number of indicators. Speakers urged the authorities to move ahead with the planned bill to eliminate monetary financing for the Treasury as part of the process of strengthening the independence of the central bank. However, many Directors emphasized that the effective independence of monetary policy would require a lasting reduction in the fiscal deficit and the high level of government indebtedness.

Directors noted the authorities' intention that the lira should return as soon as circumstances permit to the ERM. Directors generally agreed that, for re-entry to be successful and a new parity to be credible and sustainable, a restoration of confidence was critical. In this connection, Directors stressed the overriding importance of domestic adjustment being clearly under way, in particular, progress in fiscal deficit reduction, continued wage restraint, and disinflation. Many Directors observed that this would argue for caution in making the decision on ERM re-entry. Several Directors agreed with the staff's and authorities' assessment that an excessive depreciation would jeopardize the chance of wage and price moderation. At the same time, a number of Directors stressed that a new exchange rate peg must be fully credible and should not depend on a level of interest rates that would be perceived to be unsustainable and incompatible with domestic objectives.

Directors were also of the view that less reliance on state subsidies and defensive trade measures in the EC context would help bring about structural change that would promote economic efficiency. In this context, they called on Italy to play its part in the efforts required to bring the Uruguay Round trade negotiations to a timely conclusion. Directors stressed the importance of an adequate level of development assistance despite the overall budget constraint.

Finally, a number of speakers welcomed the very close collaboration between the Italian authorities and the staff in the recent difficult period and noted with approval that a further staff visit to Italy was planned ahead of the next round of annual Article IV consultations.

It is expected that the next Article IV consultation with Italy will be held on the standard 12-month cycle.

2. YUGOSLAVIA - SUCCESSION TO MEMBERSHIP IN THE FUND - REPORT BY STAFF

The Secretary and Counsellor said that the Fund had received notifications from all five of the successors of the former Socialist Federal Republic of Yugoslavia concerning the first of the four conditions established by the Board for their succession to membership in the Fund. As Directors would recall, under the terms of the December 14, 1992 decision, to succeed to membership, a successor must notify the Fund by January 14, 1993 that it agreed to the share in the assets and liabilities of the former Socialist Federal Republic of Yugoslavia in the Fund specified in the decision.

To succeed to membership, the Secretary continued, a successor must meet three other conditions. First, it must have agreed in accordance with its law to succeed to membership on the terms and conditions specified by the Fund. That condition presupposed that the successor had adopted the necessary legislation. Second, it must have eliminated its arrears to the Fund or in the SDR Department. Finally, it must be found by the Board to be able to fulfill the obligations of membership.

Some of the successors were fairly advanced in their arrangements, the Secretary remarked. As of the morning of the present day, Croatia had met all but the fourth condition for succession to Fund membership. Thus, the Fund was in a position to return to the Board in order to find whether Croatia was able to meet its obligations under the Articles of Agreement. In view of the Board's agenda for the coming days, Directors might find it convenient to take up that matter on January 15, 1993.

If Directors wished, the Board could be informed as the remaining successors completed the necessary steps, the Secretary suggested. The Chairman could then propose a date, perhaps four or five days later, for the Board's consideration of that successor's ability to meet its obligations under the Articles.

The Executive Directors took note of the report by the Secretary.

3. RUSSIAN FEDERATION - REVIEW OF DEVELOPMENTS UNDER STAND-BY ARRANGEMENT

The Executive Directors considered a staff report on the review of developments under the stand-by arrangement with the Russian Federation (EBS/92/198, 12/1/92; and Sup. 1, 12/29/92). They also had before them as background material a paper on monetary and payments arrangements in the former Soviet Union (EBS/92/205, 12/8/92) and a note on procedures for credit allocation through the Russian banking system (EBD/93/4, 1/8/93).

Mr. Kagalovsky made the following statement:

The economic problems that we are facing today in Russia are formidable. However, they are also strikingly different from those that we faced only one year ago.

Let me remind you briefly of the situation in Russia in the last quarter of 1991. This was a time of total political disorder and economic chaos. As a result of intense political conflict between the U.S.S.R. authorities and the new leaders of the constituent republics, the financial system had been rapidly falling apart. The ruble had become absolutely unusable, and desperate people had to spend long hours waiting in queues in order to get the most basic necessities. Rationing, as well as local protectionism, had been spreading from one region to another. Traditional supply links between state enterprises had been breaking down, and barter trade had become commonplace.

The new Government that came into office in November 1991 did not have much time for the preparation of economic reform measures. Everything had to be done immediately and simultaneously. The economic program announced by the new Government contained four major elements: financial stabilization, price and trade liberalization, privatization, and the creation of a social safety net. Progress in each of these areas is discussed below.

There is, I think, universal agreement that it is in the area of financial stabilization that further action by the Government is most urgently required. My authorities share completely the staff's concern about developments in the second half of 1992, and especially about the continued high levels of inflation. However, it is certainly not the case that there have been no successes in the policy of financial stabilization in Russia. When the new Government decided to liberalize most prices in one single go it was fully aware of all the dangers involved. The tax system inherited from the past was primitive and had been almost destroyed by the wasteful populist competition between the union and republican authorities in the last year of the existence of the U.S.S.R. Comprehensive tax reform, including the introduction of the value-added tax, had to be implemented simultaneously with price liberalization.

In the event, despite serious problems with tax collection, especially with value-added taxes and export taxes, fiscal results for the first quarter of 1992 were encouraging. On a cash basis the consolidated state budget, comprising federal and local budgets and extrabudgetary funds, was in surplus. This was achieved mainly through radical cuts in budgetary expenditures, especially in the area of consumer price subsidies, defense spending, and investment spending. Fiscal tightening was accompanied by monetary tightening, and the money supply fell by almost two thirds in real terms. As a result, following a one-time price jump in January immediately after price liberalization, the monthly rate of inflation steadily decreased.

However, the early successes of the financial stabilization program proved to be unsustainable. The recession in 1992 was much greater than had been forecast, either by the Government or by the IMF staff. The program assumed a fall in real GDP in 1992 as a whole of 14 percent. The projection in the latest staff report is for a fall in real GDP of 18 percent. The most recent data suggest that the actual fall may have been even larger than this. It would appear that in this respect both the Government and the IMF staff had underestimated the scale of structural distortions accumulated in the Russian economy over more than 70 years of Communist rule.

As the depth of the recession became evident, the pressures on the Government and the Central Bank to act in support of industry became inexorable. Both fiscal and monetary policy were loosened, especially with respect to subsidies and credits to the enterprise sector. As the staff recognizes, it was this more than any other single factor that caused the program to go off track, and it is the reinvigoration of stabilization policy that must and will be the first priority of the Government in the coming months. While there are differences between the staff and my authorities over the precise details of the necessary adjustment, I should stress that there is no disagreement over the analysis of the underlying problems, or over the importance of persistent stabilization efforts.

My authorities recognize that further efforts will be required to bring about a dramatic improvement in the economic indicators. However, they also believe that some of the steps that have already been taken under the program will provide a foundation for these efforts. Although some problems with tax collection still remain, a tax system that can generate sufficient revenue for the needs of the Government has been established. The improvement in value-added-tax collection, which has increased from 6.8 percent of GDP to 12.9 percent of GDP, is particularly encouraging. In the fourth quarter of 1992, fiscal policy was tightened again, and expenditures in unprotected budgetary

categories were cut radically. To a lesser extent, monetary policy was also tightened in the fourth quarter.

At this point I would like to address three specific problems that are critical to the economic reform process in Russia. The first is economic cooperation with the other countries of the former Soviet Union (FSU). The second is coordination of monetary policy within the ruble area. The third is the problem of inter-enterprise arrears.

In some FSU countries the decline in output has been even larger than in Russia. To a large extent, this exceptionally severe recession has been the result of a very negative change in the terms of trade following the dissolution of the U.S.S.R. However, Russia, which experienced a very positive change in its terms of trade vis-à-vis FSU countries, has failed to translate this change into significant material benefits. The main reason for this is that transition to world market prices in trade between Russia and other FSU countries has been much more gradual than is generally perceived. In fact, Russia continues to provide balance of payments support to a number of neighboring states. For example, according to IMF staff estimates, the amount of ruble credits provided in 1992 to Kazakhstan alone was equivalent to about $2.9 billion. This, of course, involves substantial costs for Russia.

Monetary coordination within the ruble area has remained an unresolved problem throughout the year. In a situation of 15 newly independent states, all of which are at an early stage in establishing their political and economic institutions, it was perhaps naive to expect a fully coordinated effort in such a sensitive area as monetary policy. Indeed, many states have not yet made a decision on whether to stay in the ruble area or to leave it. The result has been that the Central Bank of Russia has had to try simultaneously to protect the ruble from imported inflation and to prevent trade relations between the FSU countries from collapsing. In neither respect has it been completely successful, and this has of course exacerbated our difficulties in implementing the stabilization program.

While the problem of monetary coordination within the ruble area is absolutely unique, the problem of interenterprise arrears is rather common for most post-Communist countries. In tackling this problem, my authorities have adopted a two-pronged approach. First, it was necessary to prevent further accumulation of arrears. The imposition of a cutoff date and the changes in the payments and settlements system introduced with effect from July 1 were designed to provide the necessary basis for a solution to this problem. Second, something had to be done with those arrears that had already been accumulated before the cutoff date.

The experience of the whole post-Communist world demonstrates that ultimately, one way or another, they have to be financed by the state. In our case the costs of this painful exercise fell in the third quarter of 1992.

In sum, the substantial loosening of fiscal and monetary policy in the third quarter of 1992 has undoubtedly interrupted progress on the stabilization program. But the loosening of policy, and the deviations from the program that this implied, should not be seen as reflecting any ambivalence about the need for stabilization. The renewed tightening of policy in the final quarter of the year and, above all, my authorities' success in safeguarding such important achievements as price liberalization and unification of the exchange rate and their continued pursuit of the privatization program all testify to the determination of the Russian Government to implement its economic program in the coming year and beyond.

In the area of price liberalization, the achievements of the past year have been quite remarkable. Today all domestic prices except housing rents, public transportation, and utility fares are determined by the market. The latest step was taken in September when domestic oil prices were liberalized. During the course of the year, most export quotas were abolished and the foreign trade system was decentralized radically. Unification of the ruble exchange rate on July 1 paved the way for the development of the legal foreign exchange market, something that was absolutely unthinkable only a short while ago. As the staff points out, export quotas for energy products and several other raw materials remain. My authorities believe that the retention of these export quotas is necessary at present in view of substantial under-valuation of the ruble and its rapid depreciation following the unification of the exchange rate. For the same reason, my authorities consider that it is necessary to preserve for a moment subsidies on such categories of imports as food and medicine.

The role of privatization in making the process of transition to a market economy irreversible can hardly be overemphasized. There has been substantial progress in this area in the past couple of months. Privatization through vouchers is clearly gathering momentum, and by the end of 1992 more than half of the total amount of the vouchers had already been distributed to the population. By the end of the year, about 5,00 large state enterprises had been transformed into joint-stock companies, and for some 2,00 of them, privatization plans had already been approved. There has also been rapid progress in the area of small-scale privatization. By the end of the year, tens of thousands of small business units had been privatized. This process is of course absolutely crucial for the long-term prospects of the Russian economy.

As the staff report indicates, the social safety net is in the process of reform. In pursuit of this, the Government has introduced a number of measures which are being considered by Parliament. However, this is an area where resource constraints complicate the reform process immensely. For example, in the area of pensions, in the staff report on Russia's request for a stand-by arrangement, the staff indicated that pensioners, even if they allocated 80 percent of their pensions to food consumption, could only afford the most basic daily food basket. In their latest report, the staff correctly assert that the real incomes of pension beneficiaries have declined further over the year. In the light of this, it should be recognized that the recommendation in the staff appraisal that the Government should avoid increasing the real value of social money benefits is, if followed, likely to limit the options available in the reform of the social safety net, and to result in severe economic hardship for the poor.

Despite the fact that our first attempt at financial stabilization brought only mixed results, my authorities remain committed to the process. They are well aware of the dangers that hyperinflation would pose to the entire economic reform process. They fully agree with the statement in the staff report that, while the process of macroeconomic stabilization may take longer to complete than originally believed, its achievement remains absolutely crucial and that it is not too late to take decisive action. As discussed above, the most recent developments in the fiscal and monetary area are quite encouraging. In the last quarter of 1992 the budget remained broadly in balance on a cash basis, and monetary policy was tightened again. The ruble exchange rate has been more or less stable for the last five or six weeks, despite the purchase by the Central Bank of some $200 million in December. Perhaps most important, the achievements of the Government in the area of structural reform--especially price and exchange rate liberalization and the continuation of the privatization process--remain intact.

It is also important to remember the situation at the end of 1991, and to keep the problems of the present, critically serious though they are, in a proper perspective. In the past year, a new political and economic order has emerged, the financial system has been preserved, the ruble has become a convertible currency, and allocation of goods by queuing has been replaced by allocation of goods by the market. All of these accomplishments leave my authorities in a strong position to make a renewed start on their stabilization efforts and to build on their achievements in the area of structural reform. They fully intend to do so.

Finally, I would like to express the gratitude of my authorities for the advice and technical assistance being provided by the Fund. The availability of professional and timely advice from

the Fund is a benefit of membership that is worth a great deal to my authorities. And indeed, Russia's assumption of a place in the IMF and more generally in the international financial community, with all of the responsibilities that this implies, is not the least of the achievements of the past year.

Extending his remarks, Mr. Kagalovsky noted that Mr. Fyodorov, Russian Executive Director at the World Bank, had been appointed Deputy Prime Minister in charge of macroeconomics in Russia. During the past week, Mr. Fyodorov had met with former colleagues and the IMF staff to establish new guidelines for economic reform policy that would be placed on the agenda for the next government meeting, about January 20. Those guidelines were very close to the proposals and recommendations contained in the staff report.

He had received many inquiries about the so-called new decree on price regulations in Russia, reported in newspapers recently, Mr. Kagalovsky remarked. The decree had been announced inadvertently; it had never been implemented and had been postponed immediately. His authorities were considering a legal process to cancel the decree.

Mr. Filosa made the following statement:

This is the third time in less than one year that this Board has had the opportunity to discuss economic developments in the Russian Federation. Since the new year has just started and a new Government in Russia has taken office recently, one could not envisage a better opportunity than this meeting to make an overall assessment of the ongoing collaboration between the Russian authorities and the Fund.

Given the unprecedented scope of the transformation to be made, there were no reasons to believe, from the start, that Russia would have experienced a smooth transition to a market economy, particularly because of the strong opposition of some sectors of society. There were, however, well-founded hopes that the impetus toward reform would have gradually gathered momentum if the Government had implemented the program consistently, thus gaining the necessary credibility.

On the contrary, since the beginning of the reform process, a series of delays and slippages in the implementation of the expected policies have given conflicting signals to economic agents and made the transition period more painful and complex than expected.

At the time of the approval of the first credit tranche stand-by arrangement, despite the incomplete implementation of the prior actions and, above all, despite the Central Bank of Russia's decision to expand bank credit in order to clear state

enterprises' arrears, this Board was reassured of the continued commitment of the Russian authorities to the main objectives and policies initially described in the Memorandum of Economic Policies. We believed that if the program were fully implemented, it would have represented a sufficient tightening of financial policies that would have paved the way for an upper credit tranche arrangement within a reasonable period of time.

Unfortunately, the economic situation has continued to deteriorate. Prices are soaring and the real economy is shrinking. Indeed, it is difficult to reap dividends from the reform process when crucial measures to make the process viable are not taken:

First, prices of most goods have been liberalized, but oil prices are still well below the world market level with adverse effects both on production, which represents one of the most important sources of foreign currency, and on the whole structure of relative prices.

Second, subsidies to enterprises have increased, instead of decreasing, thus undermining budgetary discipline already weakened by the partial and delayed implementation of the envisaged revenue measures and by serious tax administration problems.

Third, subsidies have also perpetuated value-subtracting sectors of the economy and prevented the hardening of state enterprises' budget constraints. Clear evidence of this is the excessive growth of real wages and the still considerable labor hoarding.

Fourth, monetary policy has been out of control, and the entire structure of interest rates has remained significantly negative in real terms, thus igniting inflationary pressures and preventing the re-establishment of confidence in the ruble both domestically and beyond the borders of the Federation--as clearly elucidated by the abrupt fall of the exchange rate and by continuing, significant capital flight. This, in turn, has seriously complicated the prospects for maintaining the ruble area. And, if immediately after the breakdown of the Soviet Union, the decision of some former republics to introduce their own currency was particularly induced by the desire to reaffirm their national independence, that decision is now a rational consequence of the failure of the Central Bank of Russia to achieve stable monetary conditions. Russia has indeed missed the opportunity to play the role of anchor country for the stabilization programs of the other states of the FSU.

I welcome the reaffirmed commitment of the Russian authorities to the reform process and their intention, as emphasized by

Mr. Kagalovsky, to take decisive action in order to achieve stable macroeconomic conditions.

At the same time, however, I cannot but emphasize my concerns about emerging and alarming evidence of potential deviations from the envisaged course, such as the monetary authorities' attitude of disregarding the fundamental monetary character of the ongoing inflationary process, or the proposal for "centralized exports," or the reintroduction of price controls for some goods. Furthermore, I wish to express my deep concern about the difficulties faced by the staff in gathering adequate data, particularly in the monetary area, and in engaging in comprehensive discussions on fiscal and credit policy with the authorities. I sympathize with the staff in reminding the Russian authorities of their obligations under the Articles of Agreement and the terms of the stand-by arrangement. I hope that such events may turn out to be only a last unpleasant accident. At this crucial juncture, it is vital that the Russian authorities strengthen their collaboration with this institution, which has already devoted a significant part of its human resources to helping Russia take its first steps on the road to reform.

In order to overcome the present economic deadlock, the new Government seems to be inclined to assume a more active role in the economic process. In this regard, two considerations are crucial.

First, given the situation, a more interventionist policy of the Government cannot be deemed inappropriate, provided that its aim is to complement market forces and not to replace them. In this context, government investment policy should focus on those sectors that could represent the linchpin of economic recovery and not perpetuate unprofitable industries which destroy, not produce, value. Taking into account the strong link between the fiscal deficit, money creation, and inflation, such an investment policy should be financed through either a requalification of public expenditure or a greater contribution by the revenue side of the budget.

Second, slowing down the reform process should not be pursued as a viable avenue; doing so will only prolong the problems, worsening them and making their solution more painful. The only way out is to strengthen and accelerate the reform process. This must be supported by rapid stabilization of the macroeconomic situation, which represents the sine qua non for the success of structural reforms and for fostering the domestic savings necessary to finance investment and sustain growth in the medium term. In the case of Russia, the situation is made more complex by the collapse of the trade and payments system that linked Russia to the other states of the FSU. Precisely for this reason,

however, it would be illusory to believe that less firm and less pervasive policies would be able to solve Russia's problems. The measures to be implemented are clearly put forward by the staff in its appraisal, which I fully endorse.

The experience gathered so far in other reforming countries has also shown the crucial link between macroeconomic stabilization and structural reforms. Neither can succeed without the other. However, notwithstanding the substantial progress in the area of privatization, structural reforms have moved slowly.

The creation of a new institutional setting will require time. Because of this, however, major structural reforms should be started soon to remove the supply-side constraints. Major changes are especially required to permit the development of an efficient banking and financial system, which is essential in order to mobilize domestic saving, to channel it to the most profitable sectors of the economy, and to provide instruments for the conduct of monetary, fiscal, and exchange rate policies.

Even though economic developments so far might foster deep pessimism about Russia's outlook, we have to bear in mind, as Mr. Kagalovsky rightly emphasized, the position on the verge of economic and political chaos from which the Russian authorities started. Since then, Russia has witnessed such intense changes that its chances of successfully rekindling economic activity in a framework of market democracy are greater than they were just one year ago. Some groundwork for the new Russian house has been laid down; now it is time to intensify the efforts to reach the upper levels.

Mr. Fukui made the following statement:

Today's discussion is important in the sense that we, as the Fund Board, will be sending messages to the Russian authorities that will be useful and helpful in the formulation of their adjustment policies in the period ahead. In particular, I think it is an opportune time for us to have such a discussion, immediately following the new Russian Administration's taking office last month. With this in mind, I would like to make a few general remarks before turning to my specific comments on each area of economic policy.

First, it is deeply regrettable that a major part of the policy commitments under the first credit tranche program in the fiscal, monetary, and structural areas were not observed and that important financial targets for the fiscal deficit and the monthly inflation rate are projected to be overrun by a significant amount. The situation could be described as off track, and, judging from their performance so far, it cannot be denied that the

authorities' credibility with respect to their ability to implement a Fund-supported program has been considerably undermined.

The failure to establish a track record in the very first step of the three-step phased approach is very worrisome and makes it extremely difficult to see how the authorities can proceed to the next stage. To do so, the first--and very least--thing that they must do is to make every effort to get back on track, in addition to agreeing on a workable and sustainable arrangement for monetary policy coordination with other FSU states in the ruble area. We want to emphasize that there is no reasonable basis for us, as the Executive Board of a monetary institution based on a membership system, to apply a different standard when considering the Fund's financial assistance to Russia.

In this connection, I would like to register my strong concern about the authorities' limited degree of cooperation with the Fund. I was very surprised to read in several parts of the report about the staff's complaints on this point, for example (page 28), "the staff regrets that its access to data--particularly in the monetary area--has not been greater as it has sought to assess performance under the first credit tranche arrangement. Furthermore, the reluctance of the authorities to engage in comprehensive discussions of fiscal and credit policy has also been regrettable."

It is quite unusual for the staff to register in its report such explicit and strong frustration about the lack of cooperation from a member country. This is truly regrettable. The authorities need to reconsider what it means to be a member of the Fund and the implications of their obligations as a member.

It is also to be hoped that the Fund's management and staff will continue their dialogue with the Russian authorities and make the maximum effort so that a succeeding program supported by a stand-by arrangement can be put in place as soon as possible.

Given Russia's difficulties in meeting its external debt obligations and its precarious external position, a smooth relationship with its external creditors, both bilateral and multilateral, is essential; I believe that a succeeding program with the Fund would provide the basis for normal relations with creditors. I therefore hope that the authorities and the Fund will make the greatest effort to see that such a program is in place as soon as possible.

On the assessment of the challenges facing the authorities in each of the policy areas, the staff report provides a reasonable analysis, and I can endorse most of it. However, I would like to

touch briefly on some points that need to be stressed in each of the policy areas.

First, it is regrettable that a serious policy slippage has occurred in the fiscal area, which is the centerpiece of the first credit tranche program. Corrective measures on both the revenue and expenditure side are urgently needed. Failure to take any such measures would be taken as an indication that the authorities had abandoned their will or commitment to stabilize the economy.

Given the large slippage that occurred on the expenditure side, the authorities should make much stronger efforts to cut expenditures. In particular, further efforts to cut defense expenditures and subsidies, such as producer and import subsidies, are needed. At the same time, the expenditure control and monitoring system needs to be strengthened through the Fund's technical assistance.

On the revenue side, while we welcome the fact that value-added tax and profit tax revenues have been buoyant, and that tax revenue exceeded the targeted level under the program, it is regrettable that the initial plan to introduce and strengthen the tax on oil and gas was delayed and has been only partially implemented. Mainly because of this, the revenue-strengthening package in the first credit tranche program has raised only limited additional tax revenues. The authorities are urged to take those measures that have not yet been implemented, including the introduction of a tax on natural gas.

Tax administration, particularly of newly introduced taxes, has emerged as an Achilles' heel. In view of the difficulties attached to further expenditure cuts, improvement in tax administration is crucial for fiscal strengthening, and further efforts should be made on a continuous basis, with the help of Fund technical assistance. In this connection, we wonder whether government officials who have the basic skills could be more effectively mobilized or redeployed for this purpose.

We share the staff's concern about the 1993 budget; given last year's fiscal performance, the staff's projection could even turn out to be too optimistic.

In sum, the authorities need to implement much stronger measures to drastically improve the fiscal balance in 1993. This is one of the necessary conditions for averting possible hyperinflation. The strengthening of fiscal policy is also a very important indication of the firmness of the authorities' commitment to stabilization. The occurrence of a further slippage in the fiscal area could be regarded as tantamount to the abandonment of their

commitment to stabilization, and it would make their transition to a market economy much more painful.

Second, the accelerated monthly inflation rate was no doubt a product of the lax monetary policy of the Central Bank of Russia since last summer. In order not to lose what has been achieved so far during the transition, the most urgent task for the Central Bank is to quickly control the expansion of credit.

The most serious concern related to Russia's monetary situation is the rapid shift of the financial portfolio away from ruble assets to others, such as dollar-denominated assets and goods. The sharp drop in the ruble's exchange rate vis-à-vis the dollar since last summer and the continued capital flight in the latter part of 1992 are clear evidence of this shift. A substantial tightening of monetary policy is urgently needed to stop and then reverse this shift. Together with a tightening of credit, more active use of interest rates, including the Central Bank's finance rate, is needed.

The Central Bank explains that a large proportion of credits in effect have been extended under pressure from various governmental ministries and the Supreme Soviet. However, the Central Bank's actions in the second half of last year were clearly a mistake. Their policy measures during that period were based on misjudgment and did not lead to what was needed, namely, the containment of inflationary pressure. Although the Central Bank is an autonomous institution, regrettably it was not able to conduct monetary policy as an autonomous central bank, independent of the ministries and without political interference. As a result, the Central Bank's expansionary policy fed inflation and did not lead to anything productive. We wonder whether the Central Bank's financing was used just to accommodate wage payments or the need for running capital. On this point, I agree with the staff (EBD/93/4) that the authorities "have also emphasized that the credit subsidies are needed to offset temporarily the various inefficiencies that had been built into the system over many decades under a command economy. However, the staff has noted the need to tie these subsidies to the restructuring of enterprises. Thus, rather than covering operating losses due to inefficiencies, these subsidies should support concrete efforts to increase operating efficiency."

Third, we are deeply concerned that there is virtually no incomes policy in place. This is fueling inflationary pressure in the Russian economy. After a sharp fall in real wages following the price liberalization in January 1992, real wages continued to increase the following month. Judging from the experience in other Central and Eastern European countries, Russia needs to have a strong incomes policy in place to serve as an anchor to contain

inflation. I would appreciate it if the staff or Mr. Kagalovsky would comment on this point.

Fourth, on external policies, the authorities' rapid accumulation of arrears to foreign creditors last year is a matter of serious concern. While I welcome the fact that a unified exchange rate system has been in place since last summer, it is regrettable that the benefit that should have been seen in domestic prices, namely, the pass-through of international prices, has been substantially lessened by the expansion of the import subsidy beyond what was anticipated in the program. I urge the authorities to review the import subsidies.

On "centralized exports," I have a different view from that of the staff. I understand the staff's arguments. However, given the difficulties the authorities have in meeting the external debt-service requirement and the urgent need to strengthen foreign reserves, I believe that, at least on a temporary basis, centralized exports could provide a secure source of foreign exchange.

In this connection, I would advise the authorities to strengthen their control of foreign exchange in order to use it in the most productive way. I am not advocating strengthening foreign exchange restrictions. I believe it is important, at least in the initial stage of the transition, for the Government to set up an effective system of control over its scarce foreign exchange and to secure its most productive and efficient use. I would appreciate additional comments from the staff on this point.

With respect to the structural area, I welcome the achievements in privatizing public enterprises during the program period. However, I want to make two additional points. First, from the standpoint of the urgent need to establish the market mechanism, the present authorities' efforts toward public enterprise reform, which focus on privatization, do not go far enough. According to a survey by The Economist, under the central planning system of the former Soviet Union, production was divided into nearly 8,000 product groups, of which nearly 80 percent were produced by monopolies. The monopolistic, large-scale public enterprises need to be dissolved and divided into smaller units to provide more market participants. A greater number of active market participants and more competition among them are essential for an effective market mechanism and price stability. Unless this is achieved, it is hard to imagine that a strong market force based on the price mechanism will work in the production and distribution sectors of the Russian economy.

Equally important in public enterprise reform is commercialization along with privatization. This means placing more emphasis on self-discipline in the management of enterprises, on a

commercial merit basis. In this connection, I would like to reiterate the importance of fostering and supporting small and medium-sized enterprises, which actually embody the major part of entrepreneurship. We encourage the authorities to give consideration to this issue. One option would be to establish a special public bank to adequately finance small and medium-sized enterprises that have good growth prospects.

Second, on structural issues, admittedly there will be some time before the benefits of such drastic public enterprise reform will be felt in the form of increased output. Meanwhile, therefore, there is a need for the Government to supplement the still weak market forces by allocating resources to the basic industries and exporting sectors to make them an engine for future growth. This does not necessarily mean direct government intervention or restrictions. Instead, we recommend that the Government exercise influence through indirect measures such as tax incentives or financing through the banking system.

Lastly, I would like to comment briefly on the issues relating to the interstate monetary and payments arrangements. The staff's analysis of these issues seems to be reasonable, and I can endorse the conclusions of the staff paper. In particular, I welcome the fact that the staff's position on the monetary arrangements has shifted toward the early introduction of a separate national currency. Frankly, the prospect of an agreement among countries in the ruble area on a sustainable and viable arrangement for monetary coordination remains dim, despite the strenuous efforts made so far. Therefore, a stronger emphasis by the Fund on the preparation for a national currency is warranted and could provide a more practical solution to this issue.

On the interstate payments arrangement, I also endorse the staff's conclusion. In particular, I would like to emphasize the importance of the separation of payments arrangements from the interstate credit arrangements.

In conclusion, as I stated at the outset, my comments have been made in the hope that they may be helpful to the new Russian Administration in their continuous efforts at transition. I would like to ask Mr. Kagalovsky to convey to his authorities my hope that they will understand the spirit in which my remarks were meant.

Mr. Dawson made the following statement:

Today is the first Board discussion of the Russian Federation with Mr. Kagalovsky as Executive Director. His presence on the Executive Board is testimony to the dramatic and welcome changes that have occurred over the past year. Thus, there is room for

satisfaction in today's discussion of the Russian economy, although there is also room for considerable concern.

Early in 1992, we were highly encouraged and emboldened by the significant economic reforms taken and planned in the new Russian republic by then acting Prime Minister Gaidar. In the first quarter of 1992, Russia freed virtually all prices, slashed subsidies and military expenditure, reined in money supply growth, and began the process of unifying the exchange rate and undertaking a privatization program. These were historic developments and represented a bold departure on the path toward building a genuine market economy. These developments were all the more extraordinary because only little more than one year ago, the Soviet Union still existed.

This institution responded quickly to this opening, bringing Russia and the other states of the former Soviet Union into the Fund. We subsequently presented Russia with the early opportunity to consolidate its economic gains through the first credit tranche arrangement, under the three-phased strategy of cooperation between the Fund and Russia.

Since then, though, very serious policy slippages have emerged which threaten to limit the progress Russia has made toward building a market economy. I will focus on these in a moment. Further, Russia's apparent lack of cooperation with, or lack of understanding of, the Fund is a matter of extreme concern that conflicts with the fundamental purposes and obligations of this institution; it is a matter that should be rectified at once.

First, let me make a few general observations about the reform process itself. Difficulties are always to be expected, and we recognize the uniqueness and enormity of the transformation being attempted in Russia, which has led some to question the efficacy of traditional policy prescriptions. But the accumulated experience of the world in addressing basic economic questions has yielded certain fundamental truths. One of these is that inflation--and particularly hyperinflation--breeds uncertainty and discouragement, and undermines popular support for economic policies. A stable macroeconomic environment is necessary for fundamental structural changes to take place, and that presupposes that responsible fiscal and monetary policies are in place.

We further appreciate that the fall in growth is extremely difficult. But the causes of the steep drop in output in 1992 should not be confused. It is not caused by the reforms or financial policies taken last year, which only began to have a chance to take effect, but is mainly due to the collapse of the central planning system, including the former trade arrangements. The experience of Eastern Europe has shown that the damaging

effects of long-existing central planning cannot be changed overnight. It is critical to use the transition phase, which will inevitably be bumpy, to introduce appropriate systemic reforms that will establish a basis for future growth. Otherwise, the benefits of market-led growth cannot emerge, and the adjustment pains will only be extended.

Turning to more specific points, on fiscal policy, important and encouraging steps were taken in the early part of 1992, and even later in the year there were pockets of successful action. But overall, Russia has failed to implement many of its key commitments and to demonstrate adequate attention to the critical need for concrete fiscal discipline. Without fiscal discipline, Russia will not be able to control its money supply and reduce the Government's claim on the economy in order to free resources for growth. The result has been a domestic financing requirement more than twice that targeted, a level that simply cannot be sustained.

Public enterprise policy seems to be the biggest problem in this context. The largest single source of expenditure overruns was in credits and subsidies to public enterprises. The staff update notes that explicit financial transfers to the state enterprises equaled 35 percent of GDP in the first three quarters of 1992. Recent comments by the new Cabinet would seem to indicate that this policy will only be intensified.

However, there were other areas of poor execution of the fiscal measures under the stand-by arrangement program, including delays in implementing key measures, such as increases in oil prices and the introduction of new excise and customs taxes. Other planned fiscal measures were simply never taken, such as the natural gas price hike. While some recontrol over fiscal accounts was achieved late in 1992, a significant amount of the improvement through temporary measures, such as sequestration, either cannot be repeated or will with time be undone. Fundamental permanent improvement in the fiscal structure is needed and is a necessary condition for financial stabilization.

On monetary policy, the goal of single-digit monthly inflation rates by the end of 1992, which had seemed within the realm of possibility as recently as August 1992, has been widely missed. Indeed, inflation moved in the wrong direction owing to wholly inappropriate and expansionary monetary policies. Not only was credit growth higher in the third quarter of 1992 than targeted for the entire second half of the year, but it was under the worst possible conditions, with credits directed toward maintaining production in nonviable enterprises that were not making any progress toward commercialization.

We are particularly concerned about the lack of an active interest rate policy and the subsequent failure to move toward positive real interest rates, both aspects to which Russia was committed under its arrangement. The discount rate has remained unchanged since May despite double-digit monthly inflation rates. Negative real interest rates have a dampening and destructive effect on the reform process by discouraging saving, preventing development of financial markets, and encouraging capital flight, which we understand is very large and is diverting resources that would otherwise support growth and investment. We were distressed to hear reports from the Central Bank of Russia that capital flight in 1992 might total up to 50 percent of all exports for the year. If true, this amount, roughly $18 billion, would be close to the total amount of Western financial assistance for the same period. Mr. Fukui's statement on the need for more centralized foreign exchange gathering does not offer a solution. His opinion also seems counter to his chair's position on escrow accounts.

The flip side of excessive credits and subsidies to public enterprises, and the inadequate payments and settlements system, is the continued existence and growth, albeit reportedly at a slower rate, of interenterprise arrears. Without a binding budget constraint, kept alive by accommodating fiscal and monetary policy, these enterprises do not seem to be operating for the overall benefit of the economy but are more in line with narrower interests and are not being kept in check by market pressures. We are highly disappointed that the Russian authorities have made little progress on a proposal to address these arrears through the planned new Agency for Management of Enterprise Debts. Recent reports suggest that these arrears have risen anew to rub 3 trillion; we would be interested in staff comment on these reports.

In summary, we have broad concerns regarding the current effort to restructure the enterprise sector. While the creation of joint stock companies and voucher distribution under the mass privatization program are welcome, these steps alone do not suffice to change the incentive structure under which firms operate. This requires imposing hard budget constraints, weaning firms from subsidies, and introducing fair access to credit on commercial terms, as well as lowering inflation so that relative prices are clearly understood.

Briefly on sectoral issues, two sectors have great untapped potential for improving foreign exchange earnings in Russia--energy and agriculture. Structural problems in these sectors should be eliminated quickly to allow the appropriate supply responses to work through.

As to structural reforms, many of the steps optimistically planned as recently as August 1992 have apparently been pulled off

the table, such as the introduction of a government bill market in early 1993; and many of the most positive steps already taken are in danger of being undone. For example, the unification of exchange rates has, too well, served to mirror the rapid deterioration of the domestic economy owing to lax fiscal and monetary policies. The reflection is so strong, in fact, that rather than correct the economic fundamentals, the Central Bank's Deputy Chairman was quoted last month as saying that unifying and floating the ruble was a mistake--at the same time that he expressed the desire to continue with low-cost credits to the industrial sector through specialized big state banks. Furthermore, the staff report also notes the prospect of reintroducing price controls, which has now been echoed by other reports to the same effect. We would be interested in staff comment on the extent and mechanism of these new price controls, if it is true that they are now back in place. We were happy to hear from Mr. Kagalovsky that price liberalization was possibly the single most impressive market reform implemented in 1992, and we hope that reports of its reversal continue to be exaggerated.

Adding to the difficulties in adopting appropriate financial policies within Russia is the lack of an agreement on inter-republic relations, particularly on monetary and trade policy, as well as on a mechanism for payments. Given the difficulties in coordinating economic policies even among well-developed countries with relatively stable economies, as pointed out by Mr. Kagalovsky it might have been unrealistic to expect a quick conclusion to the efforts to coordinate monetary policy among those states remaining in the ruble area. As to future Fund involvement in these issues, we might argue that providing substantial technical assistance and advice could be possibly the most valuable role of all.

The cumulative effect of all these policy problems widened Russia's 1992 financing need and raises serious questions regarding the outlook for 1993. The prospect of a larger gap in 1993 looms greater. There is little indication that flight capital will be curtailed this year if current policies continue.

We are extremely concerned regarding the level of cooperation on the part of the authorities, particularly the monetary authorities. We cannot stress strongly enough that provision of data to, and full cooperation with, Fund staff is a fundamental obligation of membership. Therefore, we are concerned about the reports of unwillingness to engage in substantive policy discussions and the quite sizable gaps in the data that seriously cripple policy analysis. A full and open exchange of ideas and information is essential, and a successful relationship between Russia and the Fund cannot continue without it.

Some elements in Russia seem determined to try to set back the clock, in order to maintain the status quo, and perhaps we should have expected this turn of events. While it is our strong belief that a return to stable and sustainable macroeconomic policies and reform is inevitable, the question remains how long and how damaging will be the intervening process. It is important to keep in mind that the primary responsibility for reform rests with the Russian people. Our highest responsibility is to support the reform process, and we remain committed to doing our part, but foreign assistance cannot be used effectively absent meaningful reform, nor should this institution extend its monies under these circumstances.

Therefore, we urge Russia to get back on the path of reform in full cooperation with this institution. Otherwise, Russia is likely to be outpaced by its reforming neighbors; its people will not secure the benefits of a free market economy; the patience of the international financial community will wear thin; and history may be a harsh judge of those responsible.

Finally, I would like to comment on the thoroughness and frankness of the staff report on Russia. We would like to see this paper used as an example for staff reports on other republics of the former Soviet Union, and indeed for staff reports on other regions as well.

Mr. Fukui remarked that he wished to clarify one point. He considered it important to use foreign exchange in the most productive way, and to achieve that purpose, it was necessary to have better control over foreign currency.

He was flexible about the escrow account approach, if it could be used productively, for example, linked in some way to oil production or rehabilitation and, under that system, ensuring efficient use of foreign exchange, Mr. Fukui noted. The objective of his suggestion was not to achieve control but to make the best use of foreign currency.

Mr. Kagalovsky reported that escrow accounts would be discussed the following day by the World Bank Board of Executive Directors, and he suggested that the issue be left to their consideration for the moment.

Mrs. Martel made the following statement:

Several evolutions have marked the first year of implementation of Russia's economic reform program:

First, as in all other countries in transition, the shock of reform has triggered a significant fall in output. From the figures available, it does not seem, however, that the loss has

been bigger than the one observed in other countries in similar circumstances.

Second, unemployment has nevertheless been kept to a very low level, which can certainly improve the acceptability of the reform process, but which might also signal some specific rigidities in the reallocation of resources. For the most part, the fall in output has been absorbed by an equivalent decrease in real wages.

Third, structural reforms have been started on a wide-ranging basis. Ambitious schemes of privatization have been launched and are currently being implemented. All evidence points to the emergence of a strong and dynamic private sector. The exchange rate has been unified and is now managed according to market forces. Considerable progress has finally been made in establishing the basis for a renewed and modern system of taxation.

Fourth, important efforts toward fiscal consolidation have been undertaken. Obviously, significant slippages have occurred, compared with the program targets. It must also be recognized that expenditure sequestration, however efficient it might be in the short run, could not be sustainable to the same extent over a longer period and cannot substitute for more fundamental expenditure restructuration. But it has been the constant aim and endeavor of the authorities to try to keep the fiscal situation under control. Priority consideration should now be given to enhancing the tax base, especially on energy products.

But what has marked the most recent period and endangers the whole success of reform is a fifth evolution, namely, the shift in monetary policy that occurred in July 1992 and that has led to the situation we now observe of high and dangerously unstable inflation. In the present circumstances, I will focus my remarks on monetary matters before saying a few words on the external sector.

My first comment is, of course, that monetary policy does matter. In the third quarter of 1992, it was significantly loosened, with respect both to actual policy during the first half of 1992 and to policy commitments for the second half of 1992. The monthly rate of increase of broad money jumped from an average of 11 percent during the first semester of 1992 to an average of 34 percent in July and August. The indicative second semester ceiling for growth of net domestic assets of the Central Bank of rub 1.4 trillion was already exceeded by more than rub 200 billion at the end of August.

The Central Bank's commitment to fight inflation appears to be mitigated--to say the least--by the desire to provide enough bank credit to prevent a further reduction in output and by the

belief that structural adjustments need to be made before inflation can be substantially reduced. This chair agrees with the staff that there is an intrinsic link between credit, monetary growth, and inflation that has been observed in a wide range of countries over many years. I note in support of this view that inflation in the Russian Federation surged from 7 percent in August to 31 percent in October following the monetary expansion of July and August.

We cannot ensure that the present inflationary situation is stable. In the past three months, inflation stayed above 25 percent on a monthly basis. All past experience shows that the probability of a further increase is extremely high in those circumstances. Any shock to the economy, be it of domestic or foreign source, manmade or caused by nature, could trigger a further increase in the inflation rate and push the economy into the realm of hyperinflation. It is therefore vital that inflation be quickly reduced.

A large share of the increase in broad money is a result of the Central Bank's practice of earmarked lending, that is, credit supplied directly by the Central Bank to particular sectors and regions. In my view, a permanent improvement in the conduct of monetary policy requires structural reform that would prohibit such lending. The functions of supplying general credit to the economy and of supplying credit to specific sectors and regions must be separated. All appeals for specific credits should be addressed to the Government, and the supply of such credits should be accounted for in a transparent manner in the Government's budget.

The impact of a tight monetary policy on output and employment can be minimized if wages are adjusted in an appropriate way. Therefore, it might be suitable to complement a strict stand on monetary policy with an incomes policy aimed at controlling wages. This would certainly contribute to reducing the internal opposition against a stricter monetary policy. I would welcome the staff's elaboration on the desirability and feasibility of cost-wage controls.

I hope that the difficulties in providing the Fund with appropriate and up-to-date information about the monetary situation can be solved as soon as possible. This would be a strong signal of the willingness of Russia's monetary authorities to cooperate fully with the Fund. This would also create the basis for the necessary improvement in the operation of monetary policy.

On the external sector, I shall make three remarks. First, the unification of the exchange rate has been an important

landmark of the reform program. It is essential that, under the pressure of the present period, this reform not be put into question.

It is also important that all of the benefits that can be derived from the unification of the exchange rate be allowed to effectively materialize. In this regard, the authorities had committed themselves to implementing, in parallel with the unification of the exchange rate, a series of measures by August 1, 1992. These measures included strict control of import subsidies and the substantial elimination of export quotas. In fact, import subsidies on centralized imports averaged between 60 percent and 70 percent of the imports' foreign currency value during the latter part of 1992, and export quotas remain today on many important goods in addition to energy products.

The continuing high level of subsidies on many imports is misleading to economic agents as regards the true cost of imported goods, while export quotas artificially decrease the domestic price of and the demand for goods in which Russia has a comparative advantage. These two measures deprive the economy of the benefit of the exchange rate's unification, namely, correct relative pricing of domestic and foreign inputs in all sectors of production, correct relative pricing of domestic and foreign goods and services, and consequently an optimal allocation of the economy's scarce resources.

In this regard, the new proposal for centralized exports is not a step in the right direction, as it would drive a greater wedge between the domestic and external prices of traded goods. Instead, we encourage the authorities to fulfill the commitments that were made on export quotas and import subsidies.

During the past weeks, the ruble exchange rate has stabilized after a quick fall in the fourth trimester of 1992. This might be the reward for what could have been a somehow tightened monetary policy in the months of November and December. This also provides an opportunity that should not be missed to trigger a renewal of confidence through an appropriate and speedily implemented stabilization package. As I said, correcting the course of monetary policy is, in this regard, a prerequisite.

I have been struck by the figures quoted in the staff report concerning capital outflows, which are grossly equivalent to the new credits committed to Russia during 1992. This is, of course, an additional reason to strengthen quickly and decisively the financial policies so as to allow the Russian economy to benefit fully from the incoming private capital inflows and foreign assistance. I certainly hope, in this regard, that the discussions between Russia and its public creditors could lead

very soon to an agreement. My authorities are, as you know, working very hard in the direction of this objective.

Russia's economic reform program is certainly at a crossroads. It is very encouraging that, as stated by Mr. Kagalovsky, "it is the reinvigoration of stabilization policy that must and will be the first priority of the Government in the coming months." Past experience shows that it might be impossible to implement continuously a structural reform program in a context of high financial instability. If the necessary course of action is taken, Russia certainly deserves, in the difficult times that lie ahead, the full cooperation and assistance of this institution.

Mr. Esdar observed that the staff report provided a candid and clear picture of the economic situation in Russia. While some progress had been achieved, the implementation of other agreed measures had been incomplete, and progress in the direction of financial stabilization had been limited. The future course of economic policy remained clouded by a high degree of uncertainty.

It was regrettable that progress in macroeconomic stabilization and structural reform had not been faster, Mr. Esdar continued. Certainly that was partially caused by insufficient support of the reform process by certain Russian authorities, but it was also caused by the tremendous problems involved in that process, which had been perhaps underestimated. To expect smooth and rapid progress could only lead to disappointment. It had to be recalled that there were no universally applicable textbooks for a process of transformation.

Despite all those difficulties, he was confident that Russia would continue the reform process, Mr. Esdar remarked. That objective had been confirmed by President Yeltsin to Chancellor Kohl when he had visited Russia three weeks previously.

It was crucial that the international community remain committed to assist Russia and the other successor states of the former Soviet Union in the difficult transformation from centrally planned to market economies, Mr. Esdar noted. The comprehensive concept of "help for self-help," agreed between the major industrial countries and Russia at the last world economic summit, remained valid. That concept included the considerable amount of financial and technical support that had been provided--as promised--by the international financial organizations and by industrial countries in 1992. That support had to be continued. In addition, the recently established consultative group for Russia should be used intensively to provide comprehensive and well-coordinated technical assistance and advice in a most effective way. In that process, the microeconomic level should not be neglected.

The Fund, together with the World Bank, played a crucial role in that area, Mr. Esdar commented. The Fund had to continue its policy dialogue

with the Russian authorities. The outcome of the forthcoming referendum, for example, should not be regarded as an excuse or reason to take a waiting position. The negotiations for a comprehensive credit arrangement should proceed rapidly in order to achieve an agreement on a realistic and effective program as soon as possible. Moreover, the intensive technical assistance that had been provided by the Fund in a very impressive manner should be continued and, if possible, intensified. In particular, that should include technical assistance in setting up the necessary institutional framework in the fiscal and monetary areas and in solving the problems of the ruble area.

However, technical assistance as well as financial support could only be effective if the framework was right, Mr. Esdar said. Mr. Kagalovsky had emphasized in his statement the value his authorities attached to the timely advice provided by the Fund staff. In contrast, I noted with some concern from the report that the staff sometimes had run into difficulties in obtaining the required data or receiving clarification about the intentions concerning the conduct of economic policy. He would like to emphasize that cooperation could not be seen as a one-way road.

In his statement, Mr. Kagalovsky reviewed some of the progress achieved in the process of transformation, Mr. Esdar noted. First and foremost, the comprehensive liberalization of prices had to be mentioned. In that regard, furthermore, the trade system had been liberalized dramatically, although there were still areas where improvements were needed. The exchange rate unification and the reform of the foreign exchange markets also constituted a remarkable step forward, although the beneficial effects could have been larger if external transactions had not been distorted by lasting structural distortions and obstacles; he would return to that point later. Last but not least, the progress achieved in initiating the privatization process was impressive and a firm indication of the irreversibility of the reform process.

Also, Mr. Kagalovsky stated that there was universal agreement in the Russian Government that, in the area of financial stabilization, further action was needed, Mr. Esdar continued. He welcomed that announcement; indeed, the beneficial effects of price and trade liberalization would have been much more pronounced and visible if there had been more success in achieving macroeconomic stability. One should be aware that many of the hardships for which the reform policy was being blamed were caused by insufficient backing by comprehensive macroeconomic stabilization and structural reform.

The staff had pointed out the areas where actual developments had deviated from expectations, and he generally agreed with its policy recommendations, Mr. Esdar said. In particular, he fully shared the view that it was necessary to contain inflationary pressures as quickly as possible. In that context, it might be useful to recall that inflation was among the most prominent causes of the deterioration in living standards,

particularly for the more vulnerable parts of the population. Anti-inflationary policy was a very efficient social policy at the same time.

Fortunately, Mr. Kagalovsky had pointed out that there was no disagreement on the negative effects and on the need to reduce inflationary pressures rapidly, Mr. Esdar remarked. He concurred with the staff that there was an urgent need to contain credit expansion in order to avoid the emergence of hyperinflation. Attempts to use monetary policy to compensate for the lack of progress in other policy areas would be highly counter-productive. The channeling of large volumes of central bank credit into specific regions or sectors at subsidized interest rates would undermine the need for adjustment, as it would maintain structural distortions and would tend to postpone structural reform into the future at then higher costs.

Interest rates remained highly negative in real terms, Mr. Esdar stated. He fully endorsed the staff's view that it was crucial to bring interest rates to positive levels in real terms as soon as possible. Adequate domestic interest rates were a critical precondition to avoid large-scale capital flight and to improve resource allocations.

The conduct of monetary policy had certainly been complicated by the unsettled situation within the ruble area, as the staff and Mr. Kagalovsky had correctly indicated, Mr. Esdar commented. It was, therefore, necessary to deal urgently with that lack of coordination and cooperation, and he asked the staff whether progress had been made in reaching an operative monetary arrangement. More coordination and cooperation were required as well to reinstate mutually beneficial trade and payments relations.

The need to effectively control credit expansion was not limited to the Central Bank and to the banking system alone, Mr. Esdar said. It was similarly important to reduce the ability of the enterprise sector to influence the growth of credit by accumulating interenterprise arrears. Given the discontinuation of recording arrears, it was difficult to judge the extent to which those arrears were still rising. The staff assumed that the growth of arrears had slowed down; however, he was not sure whether--to a certain extent--that did not reflect the increased availability of bank credit to enterprises and therefore monetary financing that would contrast with stabilization needs. A lasting resolution of that problem would be to pay due regard to the need to avoid moral hazard problems and to prevent the re-emergence of future arrears by implementing adequate bankruptcy regulations and by establishing hard budgetary constraints for the state enterprises.

The staff rightly pointed out that fiscal policy had to be strengthened significantly as well, Mr. Esdar added. Previous speakers had addressed that area explicitly, and he would not repeat their remarks.

One area of concern remained the widespread practice of import subsidies, Mr. Esdar noted. According to the staff report, those budgetary subsidies covered a large part of imports and averaged two thirds of the

foreign currency value of the respective imports. Such subsidies tended to undermine the effectiveness of the foreign exchange markets, thwarted the beneficial effects that could be expected from the unification of the exchange rates, and caused an enormous drain on budgetary resources. They had amounted to some 10 percent of GDP in the third quarter of 1992; those resources could have been used more effectively, for example, in the area of social policy.

Debt-service obligations were quantitatively the most significant element causing the large balance of payments deficit, Mr. Esdar remarked. It was essential that the reform process in Russia and in the other successor states of the former Soviet Union not be unduly strained by those debt-service payments. It was therefore necessary to grant a more extended breathing space than that provided by the deferral agreed in January 1992. Germany, as Russia's largest creditor, had advocated offering Russia most generous rescheduling conditions by Paris Club creditors; he hoped that a rescheduling agreement could be finalized as soon as possible. Such a generous rescheduling agreement should ease the pressures arising from external debt and should contribute to maintaining Russia's creditworthiness as a precondition for the inflow of fresh money.

Russia's balance of payments problems could not, however, be overcome exclusively by addressing the debt problem, Mr. Esdar observed. Of equal importance was the inflow of new capital, from both official and, increasingly, private sources. An agreement on a Fund-supported program, which should be achieved as soon as possible, would improve the preconditions for such an inflow significantly. In that context, he wondered whether the staff could provide information about a possible time frame for further negotiations on a follow-up stand-by arrangement.

The actual balance of payments projections in the staff report reflected staff figures that had already been provided in October 1992, Mr. Esdar remarked. He wondered whether those projections remained valid even though crucial assumptions--for example, those regarding monetary and fiscal policies--had not materialized, and whether the staff would be in a position to provide updated figures in that regard.

Finally, he looked forward to additional staff comments on the announced "centralized exports," Mr. Esdar concluded. He would be especially interested in having estimates of the magnitude of the differences between world market and domestic purchase prices, which could be regarded as budgetary revenues and if so should be seen as hidden export taxes.

Mr. Fridriksson made the following statement:

> At the outset, I would like to say that I agree with the appraisal and recommendations of the staff in the papers before us today.

My authorities wish to commend the Russian authorities for the major systemic reforms that they have initiated, particularly in the areas of privatization and price liberalization. These should be firmly continued. Prompt and comprehensive structural reforms will be essential if Russia is to reach a path of sustainable growth. This includes privatization, commercialization of large state enterprises, and the rapid introduction of the legal framework necessary for a market economy to function properly.

I was pleased to note the indications referred to by the staff--strongly supported by anecdotal evidence--that a supply response to the new market conditions has become more pronounced since the second quarter of last year. However, my authorities are deeply disappointed that, in other areas, the program associated with the first credit tranche arrangement has been poorly implemented, and the large capital outflows that apparently took place last year are alarming.

Moreover, we are concerned about the failure to provide adequate and timely monetary data, as well as information on the fiscal accounts, which makes it difficult, for both the authorities and the Fund, to adequately monitor economic developments. Similarly, it is a matter of serious concern that the authorities were reluctant to engage in comprehensive policy discussions with the Fund staff. The reference of the staff to the obligations associated with membership in the Fund is therefore entirely appropriate.

Owing to the lax financial policies in the latter half of last year, it is now even more urgent than before to sharply strengthen macroeconomic policies. Previous large imbalances have widened sharply. In the current situation, it is of the utmost importance to defuse the threat of hyperinflation. Decisive and firmly implemented economic policy as well as a final agreement on the allocation of debt of the FSU are also crucial for the generation of the needed financial flows from abroad, and we are not talking about small numbers for the financing requirement in 1993.

As confirmed by Mr. Kagalovsky, it is in the area of financial stabilization that further action by the Government is most urgently needed. The authorities must regain control over the excessive credit expansion, in conjunction with a radical tightening of fiscal policies. Without firm macroeconomic policies, progress in the structural area will be undermined and the achievements obtained so far will be compromised.

The exchange rate of the ruble has served as a barometer of the adequacy of financial policies in the latter half of 1992, and I would like to echo the advice of the staff that the authorities

refrain from reintroducing trade controls or multiple exchange rates.

A significant tightening of monetary control, establishment of a market-oriented interest rate structure, and effective measures to stop the accumulation of interenterprise arrears are also important to secure and enhance the benefits of structural reforms. Moreover, it is essential to reach an agreement quickly among the states of the FSU on monetary and payments issues and to establish a single monetary authority for the countries that continue to use the ruble as their currency. All the FSU states will have to decide whether they will remain in the ruble area or introduce their own currencies. Russia has a special responsibility for the establishment of functioning payments relations throughout the region. This means, inter alia, that Russia should actively contribute--without seeking complete control--to the creation of a reasonable and workable framework for the interstate bank, as well as negotiate bilateral agreements with non-ruble-area states.

The establishment of an orderly and efficient payments and settlement system is essential, not only for Russia, but for other countries that either were, or remain, in the ruble area. Continued difficulties in trade among these countries only serve to exacerbate their output contraction, and their prospects for recovery are strongly affected by their ability to maintain traditional trade relations. In this connection, the paper on interstate monetary and payments arrangements in the FSU provides good proposals for improving the system.

We share the staff's view that the use of escrow accounts in external financing, and, in particular, the potential proliferation of such accounts, may have serious macroeconomic and structural implications, as well as weaken the implementation of appropriate macroeconomic and structural policies. Moreover, I would like to encourage the centralization of official foreign exchange holdings and urge the authorities to eliminate the various foreign currency funds associated with Russian enterprises, as had been expected.

We would like to stress the importance of sticking, to the extent possible, to the timetable in the strategy of phased cooperation between Russia and the Fund, bearing in mind the character and size of the problems confronting Russia. Even if the process of macroeconomic stabilization turns out to take longer than earlier expected and than we would have liked to see, my authorities consider it essential that the Fund continue to be actively involved in supporting the reform efforts. However, I wish to emphasize that such support must not entail any deviation from standard conditionality in upper credit tranche arrangements. It must not be compromised.

When the first credit tranche arrangement was endorsed in August, the apparent lack of a general consensus in Russia on the necessity for structural and institutional reform, together with an appropriate adjustment policy, left us unsure about the Russian authorities' ability to deliver on what they had undertaken. This lack of consensus and a difficult political climate undoubtedly compounded the problems of economic management in the latter half of 1992. I take comfort in Mr. Kagalovsky's statement that the Government fully intends to make a renewed start in its stabilization efforts and to build on what has been achieved so far in the area of structural reform.

It is unclear to me how many people--or what share of the population--would be covered by the social safety net, as well as what has been done to improve the system. Could the staff comment on this and about the potential implications of the likely rapid increase in unemployment?

In conclusion, Annex III of the staff report shows clearly the large-scale technical assistance that the Fund has provided to Russia, and this should dispel any misunderstanding or misrepresentation that the Fund has had but a token presence in Moscow.

Mr. Smee made the following statement:

The documents prepared by the Fund staff in support of the Board discussion portray a bleak picture of developments in Russia since the Board approved the first credit tranche stand-by arrangement.

At that time (8/5/92), the Managing Director expressed the view that the program outlined in the Russian letter of intent was "a good basis for a first credit tranche arrangement." He was, nevertheless, "not fully satisfied" with the degree of monetary restraint contemplated by the authorities. In reporting to the Fund Board on the outcome of his negotiations with the Russian authorities, he compared the first tranche agreement to a "damage control" operation, which could be useful in bridging the Russians to a fully articulated stand-by arrangement.

Subsequent developments have vindicated the Managing Director's concerns regarding the resolve of the monetary authorities to exercise monetary restraint. Less than six months later, hyperinflation threatens to generate an even greater collapse of output and widespread social unrest.

It is interesting to note that in the same time period, several other FSU countries facing circumstances at least as difficult--and in the case of the Baltics, even worse--have made more progress than Russia in macroeconomic stabilization and their

prospective economic situation looks better for it. It is also interesting to note the example of other countries that have more lax policies than Russia, and they are doing worse than Russia. Surely this demonstrates that adjustment brings rewards.

According to Mr. Kagalovsky, the Russian Government's reintroduction of limited controls on the prices of key foodstuffs was a mistake, and I hope that this is indeed the case. Nevertheless, I am concerned that enough consideration had been given to such a measure that it had been signed in the first place. To return to such a system, which had been proved as unworkable, would make the situation even worse--resulting in black markets and hoarding with the concomitant decline in production.

Nevertheless, as Mr. Kagalovsky noted, Russia has come a long way, nevertheless, from a year ago, even though not nearly as far as we had hoped. I agree with him--and Mrs. Martel--that it is in the area of financial stabilization that further action is most urgently required.

The most worrisome policy slippage under the first credit tranche agreement has occurred in the conduct of monetary policy. The goal of the agreement was to limit monthly inflation to single digits by the end of 1992. Instead, monthly inflation has accelerated to 25-30 percent, equivalent to an annual rate of about 2,000 percent. Monetary policy would seem to be out of control, as none of the key policy commitments have been fulfilled. It obviously bears repeating that there is no substitute for financial discipline in fighting inflation. An increase in real interest rates to positive levels is the most important policy requirement facing the Russian authorities.

The monetary authorities seem to view inflation as a structural problem caused by the highly monopolistic structure of Russian industry. The Central Bank has extended credit to support production as necessary in the battle against inflation. In other words, the Central Bank seems to have reversed the order of causation in the monetary dictum: inflation reflects too much money chasing too few goods.

Increased credit and the extension of subsidies to state enterprises perpetuates the existing industrial structure by permitting these insufficient monopolies to remain in operation and allows them to bid resources away from the nascent competitive private sector. This is clearly reflected in the fact that, although industrial production has collapsed, unemployment is negligible and real wages remain roughly at their 1987 level.

In other words, lax monetary policy is hurting not only macroeconomic stabilization but also structural reform. Positive

real interest rates will reinforce financial discipline, promote more efficient allocation of resources, help stabilize the ruble, and reduce capital flight by increasing the attractiveness of assets denominated in rubles. I know that the Central Bank of Russia reports to Parliament, not to the Government, but that is an excuse, not a solution. This situation must be changed so that the Central Bank is brought into the full reform program to play its proper role.

The difference in tone between the staff's latest review and the pre-membership review of Russia is striking: the staff was highly laudatory in the pre-membership review, citing the "bold" and "courageous" reforms contemplated by the Russian authorities; the staff now reports that the authorities have "failed to provide adequate and timely data" and, indeed, that some important policymakers are reluctant to even engage the staff in policy discussions. I agree with previous speakers, who have all stated that there are obligations to membership, one of which is cooperation. So, with respect to the provision of data, I would like to propose that the staff be asked to report back to the Board at the time of the next Article IV consultation--sometime this spring, I understand--on whether the authorities have improved their provision of data. In that way there is some follow-up to the concern universally noted here in the Board by the members of the Fund.

With respect to the issue of staff policy discussions with the Russian authorities, it appears that a formal Fund-supported program will not be in place until some time in the future. I hope that the Fund and Russia can develop some sort of regular, continuing relationship--other than an Article IV-type consultation--that allows Russia the opportunity to access the tremendous stabilization policy expertise in this institution. At the same time, this will allow us to maintain an admittedly slender thread of continuity to the Fund's relationship with Russia, which is important not only for reporting back to our authorities, but also for building relationships with other creditors and investors in Russia.

On foreign financing, it is frequently and increasingly heard that "more needs to be done" for Russia, implying that the multilateral institutions and the industrial countries are not adequately supporting Russia's reform efforts. As noted in the staff report, however, Russia has received substantial amounts of external assistance. The bulk of the widely cited figure of $24 billion--admittedly, minus the $6 billion Ruble Stabilization Fund not yet in place--has either been committed by industrial countries or has been disbursed through bilateral credits, technical assistance, debt relief, and the multilateral

institutions--the first credit tranche drawing from the Fund and the initial portion of the World Bank rehabilitation loan.

External assistance, however, is only useful if it is tied to the introduction of necessary reforms; it is not, and cannot be, a substitute for those reforms. In this regard, the amount of capital flight projected to have occurred in 1992--roughly $10 billion--is staggering. Not only is it indicative of underlying weakness in the reform effort but underscores my earlier point that a tightening of financial policies is crucial, particularly if the reform effort is to continue to receive substantial support from external sources. We have all learned from the Third World debt problem of the 1980s that we do not want to be the source of financing for capital flight. As I understand it, there was a 1-to-1 relationship in 1992 between resources going into Russia and the amount of capital flight, which obviously is not helping economic reform. But, in many respects, Russian policies were were capital flight of this magnitude.

Also, I would like to take this opportunity to address some comments made frequently in the press and other forums--spearheaded by Mr. Sachs--that call on the industrial countries to provide a Marshall Plan-type of assistance package for Russia. Mr. Sachs has also leveled criticism at the Fund for imposing unreasonable conditions on the Russian authorities.

While I recognize that there are a few important caveats, I would argue that the package of financial assistance committed by the industrial countries to Russia in 1992 was in fact more favorable on a per capita basis than the average annual postwar assistance provided to Europe through the Marshall Plan. Also, contrary to popular wisdom, the Marshall Plan was not untied balance of payments support. It imposed strict conditionality promoting the adoption of market-based economic policies. In some cases, this conditionality was more onerous than that attached to Fund stand-by programs.

It is also important to note that the main vehicle of the European postwar recovery was through domestic savings and not financing by external resources. The Marshall Plan acted as the catalyst in encouraging these savings and their use domestically; this is the kind of response we would like to see our support generate in Russia.

The Marshall Plan's main achievement was in breaking the policy paralysis, which reflected the lack of political will to implement the measures needed to promote stability. There was not any fundamental dispute with any of the countries that received Marshall Plan support over the nature of reforms. There was, however, a broad social consensus in Europe on the goal of fostering

private markets and, of course, long experience with the operation of a market-based system, neither of which is present in Russia.

The most difficult aspect of the "Russian problem" is the capacity of the Russian Government and people to implement and accept unpopular but necessary measures. Failure to do so will only result in the continuing immiserization of the population and will reduce any prospect for reviving growth and attaining prosperity under a market-based system.

Mr. Peretz made the following statement:

Like others, I welcome the opportunity to discuss the progress of economic reform in Russia and Russia's relations with the Fund. I hope that we will continue to have similar occasions for discussion in the future, on a more or less regular basis.

On the whole, I share the assessment of others, including that of Mr. Kagalovsky. Regrettably, the Russian authorities either failed to implement, or implemented only partially or late, many of the actions agreed for the first credit tranche drawing. As a result, inflation remains high, and economic stability is no closer than it was last summer. At the same time, Mr. Kagalovsky is right to remind us of the substantial achievements that have been made over the past year. The benefits of price and trade liberalization are beginning to come through; good progress is being made with privatization; and private sector activity, while small, is expanding rapidly. His authorities' intentions for the future are also encouraging--although less so than if his authorities had not expressed their intentions in rather similar terms immediately ahead of the policy slippages in the summer.

Urgent action is clearly needed from the new Government to tighten monetary and fiscal policies, to avoid the very real risk of hyperinflation. For Russia, loose fiscal and monetary policies do not offer a gentler or more gradual approach to economic development. The economy has already suffered a shock--or rather, at least three shocks: the irretrievable collapse of the state planning system; the collapse of what was a highly integrated trading system within the Soviet Union and within the Eastern bloc; and the end of the cold war, which has brought with it a collapse in demand for what was the nation's principal product: defense services. In the circumstances, overloose monetary and fiscal policies will not increase useful output: they will simply lead to higher inflation. The end result is likely to be slower growth, not faster growth--since inflation is itself disruptive, and hyperinflation could be expected to undermine popular support for reform. The result is also likely to be greater inequity, since inflation is a form of tax that usually falls particularly

heavily on the poor. The real losers from hyperinflation would be the Russian people.

Continuing loose monetary policy is probably the most immediate cause for concern. Indeed, what has happened in Russia is not a good advertisement for independent central banks. It is regrettable that no action has been taken to increase interest rates, which remain highly negative in real terms, that a high proportion of lending remains at subsidized rates, even below the official lending rates, and that the rate of credit expansion has remained extremely high. Incidentally, I believe that raising interest rates is the only effective way to reverse capital flight, and in this connection I agree with Mr. Dawson--rather than Mr. Fukui--and concur with Mr. Smee on the importance of positive real interest rates. On a different issue, it is also unfortunate, although in retrospect perhaps not surprising, that no effective system of monetary control was established for the ruble area as a whole. I strongly endorse the conclusions in the paper on interstate monetary and payments arrangements.

Fiscal policy is not satisfactory, either. The fiscal deficit for 1992 was also significantly above the target level, despite efforts--and some apparent success--of the Government to restrain expenditure toward the end of the year. The Government should resist pressures to reduce existing tax rates and take steps to improve collection of new taxes and reduce exemptions. I also agree with the staff that the authorities should not expand the scheme for the "indexation" of firms' working capital and should avoid increasing the real value of social benefits.

Putting macroeconomic policy back on track is, for Russia, only a relatively small part of the story. Structural reform is the key to future growth in useful economic activity. I agree with Mr. Kagalovsky that much has already been achieved, and I know the Russian authorities are working increasingly closely with the World Bank on key areas of structural reform; indeed, I hope that the newly appointed Russian Deputy Prime Minister will be well placed to intensify that cooperation further. It is, therefore, particularly disappointing that the recent decree on price controls appeared to imply some backtracking on past achievements. I was reassured by Mr. Kagalovsky's statement on the decree, and I hope that he will be proved to be correct. Some regulation of monopoly profits is of course desirable and does occur in most countries, but a general reintroduction of price controls would be likely to introduce new distortions, sharply curtail the growth of the private sector, and result in the re-emergence of shortages and queues.

I hope that structural reform can continue, even if macro-economic policy remains off track for a period. Implementation of

structural reform is much more difficult under conditions of high inflation, but much can still be done. The decision to distribute privatization vouchers to the population was a bold and imaginative one. The first share auctions have been a success and signs of public support for the program are encouraging. The recent increase in the secondary market price of the vouchers reflects growing confidence in the privatization program. It will be important to maintain the momentum of privatization to encourage a quick and appropriate supply-side response.

With respect to the policy dialogue between the Fund and the Russian authorities, I agree with Mr. Kagalovsky that this dialogue has been and will continue to be immensely important. What is a historic task for the Russian authorities is also a historic challenge for the Bretton Woods institutions. Like others, I hope that, in the short run, the Fund will continue to provide technical assistance and advice where it believes that this will be helpful, and that over the months ahead the staff will continue to work toward agreement on a full stand-by arrangement. In this context, I find it particularly discouraging that the Fund has had difficulties in obtaining accurate and timely data in a number of areas, particularly with respect to monetary statistics. It is essential--and indeed an obligation of membership--that the relevant Russian authorities cooperate fully with the Fund. Full information is needed if accurate and relevant advice is to be provided and if Russia is to become fully integrated into the international financial community. Given the difficult macroeconomic decisions to be made, it is essential that all the relevant Russian authorities be ready to engage in full and frank policy discussions with the Fund staff, based on mutual trust and shared information.

It is important that the Board be kept fully up to date with developments in Russia and progress toward negotiating a full stand-by arrangement. Given the importance of the subject I would like to see regular Board discussions. As a first move, I suspect an annual Article IV consultation must be due, since Russia has now been a member for nearly a year. It would be useful for the Board to have an opportunity to discuss an Article IV paper before the spring meetings. That would also be a good opportunity, as Mr. Smee suggested, for the staff to report on the improvement that, I hope, will be seen by then in the provision of data to the Fund. After that, i hope that it will be possible to move as quickly as possible to a stand-by arrangement with an upper credit tranche drawing. I was also attracted by Mr. Smee's suggestion for continued close monitoring and Board involvement even in advance of an agreement on a stand-by arrangement. I am encouraged by the appointment of a my former colleague in the World Bank, Mr. Fyodorov, as Deputy Prime Minister, and by Mr. Kagalovsky's statement on the prospects for

future policy. I am sure that the course that he and the staff hope to steer is the best one by far for the Russian people.

Mr. Fridriksson remarked that, as Mr. Smee had referred to the achievements of the Baltic countries, he would add that in December the monthly rate of inflation in Estonia had been brought down to 3.3 percent and in Latvia to 2.8 percent--very close to the targets that had been set in the program negotiated the previous summer, although the path to those goals had been somewhat different from that envisaged at the time.

The Deputy Director of the European II Department commented that the view of the Russian Government, and certainly of the former Acting Prime Minister, was that monetary policy--not incomes policy--was the essential ingredient of price stabilization; if monetary policy was sufficiently tight, then an incomes policy was not necessary. However, there was some measure of incomes policy in Russia in the form of a limitation on the deductibility of labor costs from the profits tax. While by no means a comprehensive incomes policy, it was interesting to note that the limitation had brought in a substantial amount of revenue, demonstrating that the measure had not achieved the intended goal. However, in past discussions with the Russian authorities, the staff had advocated the introduction of a prohibitive tax on wages--a proposal that had not been accepted. As long as monetary policy was loose, such measures could not be successful; if the Central Bank provided money to finance wage increases, incentives were given at the enterprise level to do so, and there were no hard budget constraints, it was likely that any wage norm would be violated.

The main issue was monetary policy: to bring inflation down it was indispensable to bring down the rate of credit expansion by the Central Bank, the Deputy Director stated. If that were achieved, then perhaps an incomes policy could play a complementary role by ensuring that the slowdown in prices was broadly accompanied by a slowdown in wages, thus avoiding a squeeze on profits. However, Russia did not seem to be facing that problem now.

Concern had been expressed by Mr. Fukui about the estimates of capital flight that had been reported in the press and that could be deduced from the staff's balance of payments table showing fairly substantial net outflows of banking capital, and also large net outflows in errors and omissions, the Deputy Director continued. Questions had been raised as to whether control over scarce foreign exchange resources might not be needed, and about the role of the incentives given to Russian enterprises to maintain their funds in the form of ruble-denominated assets. He would not oppose implementing foreign exchange regulations, or requiring enterprises to abide by the law. However, the present behavior of Russian enterprises was, in one way, perfectly rational, as illustrated by activity in the new forward exchange market in Russia: the ruble for delivery in April 1992 was quoted at rub 746 per $1, which implied a depreciation of 78 percent on a quarterly basis. At the same time, the rate of return on ruble-denominated deposits was about 75 percent a year. As long as that situation existed,

people would decide that investing in foreign-denominated assets was highly profitable, and it would be extremely difficult, as experience everywhere else in the world had shown, to stop it.

The forward discount on the ruble was understandable because the rate of inflation had shot up to more than 30 percent in October and was currently about 25 percent a month, the Deputy Director explained. Hence, with annual inflation in the United States at 3-4 percent the ruble was expected to depreciate sharply vis-à-vis the dollar. Again, action should be taken by the Central Bank of Russia to end capital flight by restoring an adequate rate of return on ruble-denominated assets. To do so would require restraint on credit expansion, one component of which fell directly under the control of the Central Bank--lending to enterprises.

Fund assistance with regard to the introduction of new currencies had been provided to countries of the former Soviet Union beginning in January 1992, the Deputy Director reported. At that time, in an interstate conference in Brussels, the Fund had, with the Ukrainian and Russian authorities, prepared a blueprint on the introduction of the Ukrainian currency that would not create problems for the Ukrainians or their partner countries. The Fund had continued to provide assistance, on request, including to Estonia and Latvia, and had made it clear to all other countries that, whenever they were interested, the Fund would be willing to help in all aspects, including on the logistics of introducing the currency and on financing the nation's problems that would arise with monetary independence.

On interenterprise arrears, there was some uncertainty because the previous source of data ("File No. 2") had been closed as of July 1, 1992, and the data from the new source applied only to a part of the economy, the Deputy Director said. However, the behavior of those numbers was consistent with a decline in arrears, at least in real terms. Anecdotal evidence indicated that, after July 1, the creditor enterprises had been concerned that there would be no bailout of the arrears and, hence, had demanded payment in advance; later, of course, they had been somewhat disappointed in that expectation. The Central Bank of Russia had decided to unfreeze the net creditor position of the creditor enterprises and to extend credit to the debtor enterprises to liquidate their arrears. Perhaps some managers of Russian enterprises were not ruling out the possibility that the Central Bank might do so again. That situation illustrated Mr. Smee's remark that the monetary policy pursued by the authorities had not only obvious, adverse macroeconomic consequences, but perhaps less obvious, microeconomic consequences on the behavior of enterprises through the problem of moral hazard. The staff had alerted central bank officials to that problem in the past, but unfortunately to no avail.

Cooperation in the ruble area had been reflected in improvement in the interstate payments system, the Deputy Director noted. Following a number of meetings in Minsk and Moscow, agreement had been reached in principle, at the expert level, on the charter of a new Interstate Bank--on the basis of a

proposal made by Fund staff representatives at those meetings. However, two issues remained unresolved. The first was the settlement currency that would be used by the Interstate Bank in its functions as a clearing system. The charter had proposed that the Russian ruble be used as a settlement currency, and some of the states represented at the conference--including Ukraine and Belarus--had agreed to that proposal; others, including Kazakhstan, had objected to the term Russian ruble in the charter. The second issue, an important and long-standing one, was voting power, with the non-Russian countries wanting one state/one vote, and Russia preferring a voting formula that would give it 50 percent or at least a veto in the key decisions of the Interstate Bank.

Ukraine had introduced its own currency, Azerbaijan had indicated that it would do so, and others were making plans, at least on a contingency basis, to introduce independent currencies, the Deputy Director reported. Little progress had been made in reaching agreement on monetary policy among the countries that remained in the ruble area, either at the multilateral level or through bilateral agreements. Topics in the payments area would be taken up at the meeting of Heads of State January 20-22.

Meanwhile, the situation was unsatisfactory in that there was no effective mechanism for coordinating monetary policy in the ruble area, the Deputy Director continued. The Russian ruble, issued by printing presses in Russia and distributed by the Central Bank of Russia, continued to circulate as cash currency in all the states in the ruble area, the Deputy Director observed. But at the same time, the market was beginning to value national deposit rubles at different exchange rates. In the Latvian market, for example, the value of a ruble deposit claim on Russia was different from the value of a claim on Kazakhstan, Georgia, or Armenia. The same cash currency was circulating, but with de facto different deposit currencies in the various states of the ruble area. One reason was the elimination by the Central Bank of Russia on July 1, 1992 of the automatic provision of credit to other central banks through their corresponding accounts with the Central Bank of Russia.

The present situation was clearly unsustainable, and the staff had advised all the countries in the region to make a clear and quick decision between two alternatives: to agree with Russia on an effective and common monetary policy, established and implemented by a common authority; or to introduce their own currency, the Deputy Director of the European II Department concluded. Whichever their decision, the Fund would help them to the best of its ability.

Mr. Fukui said that he continued to have some questions with respect to incomes policy, specifically concerning the Central Bank's accommodating the significant financial needs of enterprises. Those enterprises had to pay increases in wages, along with rising costs, thus they needed financing from the Central Bank. But a more effective incomes policy could affect the underlying conditions that led to financing, or monetary policy. There was

a close relationship between incomes policy and monetary policy, and on that basis, more emphasis should be placed on incomes policy.

The issue of capital flight was very frustrating for Japan, as one of Russia's creditors, Mr. Fukui stated. According to some papers, about $6-8 billion was missing without a trace. The authorities must act to prevent such an untenable situation. Perhaps some regulatory control over the foreign currency holdings of the commercial banks might prevent the banks from accumulating foreign currency and possibly participating in capital flight operations.

The Deputy Director of the European II Department agreed that actions on incomes policy and commercial bank regulation could be helpful. However, the effectiveness of these measures would be minimal so long as credit expansion by the Central Bank sustained price inflation at a monthly rate of 25-30 percent. Apparently, much of the capital outflow was not occurring through commercial banks but was reflected in errors and omissions, which meant that the people involved did not have a great interest in publicity; to that extent, controls on the positions of commercial banks would not be effective.

The staff had recently held constructive discussions with Mr. Fyodorov, the Deputy Director noted. As Mr. Kagalovsky indicated, the Deputy Prime Minister intended to submit to the Prime Minister and the Government a set of recommendations before the end of January. The staff would then resume the policy dialogue with the Russian authorities, including possibly an Article IV consultation, and at that point an assessment would be made of whether the Russian Government was willing to commit itself to a package of policies that was strong enough so that negotiations on an upper credit tranche arrangement could begin.

Mr. Esdar remarked that it seemed that only two or three countries remained in the ruble area. The present period seemed to be one of transition, and he wondered if there continued to be a need for cooperation in the ruble area and if, in fact, the ruble area was heading toward disintegration in the near future.

The Deputy Director of the European II Department commented that it was difficult to reply with precision because views in those countries had been evolving. In a recent meeting of heads of state, President Yeltsin and President Nazarbayev of Kazakhstan had indicated that they were interested in cooperation, and they had asked their technical people to work out a compromise. When, however, the question reached the monetary technicians, it was difficult to resolve the problem because it affected the surrender of sovereignty to one particular central bank that would define and implement monetary policy, or to a supranational authority, with issues such as voting rights at stake. Because failures--multilateral and bilateral--had been registered in trying to achieve a common monetary policy, the growing consensus at the technical level and in some cases at the political level was that issuing a separate currency would be attractive. That step was not

considered a transitional one; and for that reason decisions were being taken deliberately, taking into account all the implications. Many countries feared that the introduction of their own currency would in some way jeopardize their relations with Russia, for example, as regards technical credits by the Central Bank of Russia, trade or commodity arrangements, and in particular the price of imported oil. Another consideration was financial stability and inflation in the ruble area, where recent experience had tilted the decision of these countries toward leaving the area.

The staff representative from the European II Department said that the staff, as indicated in the report, was concerned about the policy of centralized exports. As presented in the draft 1993 budget, centralized exports would amount to over 10 percent of Russian exports, and recent reports--not yet confirmed by the authorities--indicated that they might even amount to one third of 1993 exports. The staff believed that the centralized exports approach--buying from producers, mainly of oil and gas but also of some precious metals, at about 70 percent of world market prices in rubles and reselling at world market prices, resulting in an implicit export tax--would constitute a significant step backward toward the system of centralized state trading that had prevailed under the old system. Also, it would have the effect of diverting a substantial proportion of foreign exchange from exporters in the interbank market, which the authorities were intent on broadening. If the goal was to achieve a more stable exchange rate in the future, a broader market was necessary, and the centralized export policy would seem to work against that objective.

Furthermore, it was unclear whether the authorities could achieve full compliance with the centralized export scheme, which on the one hand, given what he had said earlier, would be beneficial, but on the other hand, would only lead to a further reduction in the credibility of the Government to implement its announced policies, the staff representative continued. Even compliance accounting for anywhere from 10 percent to one third of exports would not stop capital flight with respect to the remaining exports. The authorities should rely on market-based mechanisms to stop capital flight as well as to broaden the exchange market and appreciate the exchange rate to the extent that the budget could afford to buy in the market the foreign exchange that it required for its needs.

Since mid-1992, when File No. 2 in the banking system had been closed, estimates of interenterprise arrears were based on data collected by Goskomstat, on a survey basis and not including the entire economy, the staff representative noted. Rough estimates indicated that the existing stock of arrears--assuming that the old stock under the previous system had essentially been retired through the netting-out process, which involved significant bailing out--in nominal terms might be about rub 3 trillion but in real terms about one half that amount. Therefore, while not, in real terms, of the same magnitude as that in mid-1992, the level of arrears remained a source of concern. The staff would urge the authorities to avoid any further bailout; as several Directors had mentioned, it was necessary to

solve the problem through measures such as higher interest rates and hard budget constraints.

In the context of the forthcoming Article IV consultation, the staff's balance of payments projections would be elaborated, the staff representative continued. Revisions were under way for 1992, but final agreement with the Russian authorities had not yet been reached. On the one hand, it was possible that the trade balance might be more positive than initially projected; revised figures had been received from the statistical office in that area. On the other hand, because of looser than envisaged financial policies in the second half of 1992, the partial reversal of capital flight in the second half of 1992 assumed in the projections was unlikely. It was still early, but it seemed plausible to assume that there would probably not be a significant impact on the overall balance.

For 1993, the staff would be looking again at the balance of payments in the context of the Article IV consultation, the staff representative remarked. Until the policy environment for 1993 was better defined, it would be premature to speculate on how the balance of payments might differ from provisional estimates. It would be necessary to take into account the fact that the substantial tightening of financial policies in the fourth quarter of 1992, assumed in the note prepared in early October, did not take place at least to the extent anticipated, and to review the trade projections and the assumptions with respect to capital flight.

A number of elements were included in the coverage of the social safety net, ranging from unemployment benefits to pensions to social insurance, the staff representative from the European II Department noted. It was especially difficult in the Russian case at present to estimate those benefits quantitatively as a percent of GDP, for essentially two reasons. First, the staff had not had sufficient access to most of the extrabudgetary funds data; consequently, there was no clear indication of their position. Second, concerning unemployment benefits, apparently a dismissed employee would receive benefits from his former employer for the first three months of his unemployment, but the staff did not have quantitative information on the benefit. Nevertheless, excluding that latter point, it could be assumed that all the social benefits might amount to about 15 percent of GDP in 1992; the situation could be different in 1993 as a result of higher levels of unemployment.

Mr. Al-Jasser made the following statement:

> During the discussion of the Russian Federation's request for a first credit tranche arrangement with the Fund, it was widely acknowledged that the Russian authorities had embarked on a historic and momentous adjustment effort, which warranted the strong support of the international financial community. The impressive and ambitious measures that were implemented at the beginning of 1992 and that later were buttressed by a package of measures that was the precursor of the Fund-supported program,

augured well for the authorities' transformation effort. Nonetheless, prior to the approval of the program, domestic pressures led to a weakening of this strong start. Indeed, the vacillation in policies caused considerable concern as it risked compromising the success of the transformation effort.

In this light, the stopgap first credit tranche program was viewed as a crucial and initial step to help contain inflationary pressures and provide the authorities with an essential breathing space, in order to lay the foundation for a far more ambitious adjustment package. While the authorities' privatization program continues to merit strong praise, the overall performance under the Fund-supported program is disappointing. As indicated in the staff report, substantial slippages in fiscal and monetary policy led to inflationary pressures, a sharp depreciation of the exchange rate, and an aggravated balance of payments deficit.

In the fiscal area, although some of the slippages were due to lack of approval by the legislature, others were due to the partial and delayed introduction of measures. Consequently, the third-quarter general government deficit reached 19 percent of GDP compared with a program target of 6 percent. More recently, the authorities began tightening the fiscal policy through expenditure cuts and sequestrations. The supplement to the staff paper indicates that this positive trend has been sustained in the fourth quarter. Nevertheless, I fully share the staff's view that it is imperative to reintroduce permanent budgetary discipline through a firm implementation of all agreed revenue measures, a reduction in subsidies, and a resolute resistance to pressures for deficit-increasing measures.

As a result of these fiscal slippages, monetary financing of the deficit exceeded the program target by a large margin. Moreover, the Central Bank's lending to commercial banks increased substantially, and most of this credit was targeted to specific sectors at subsidized rates. Again, I agree with the staff that it is of utmost importance to control credit expansion and pursue an active interest rate policy, in order to contain and reduce inflation. Here, I echo the views of the staff and other speakers on the issue of interenterprise arrears. In addition, containing excessive wage growth in the public enterprise sector is an essential component of any anti-inflationary strategy.

While the lack of progress toward economic stabilization concerns me, I am deeply troubled by the possibility that the authorities may reverse some of their main achievements. In this regard, the recent restoration of price controls raises serious concerns. Moreover, pressures to reintroduce multiple exchange rates or trade controls should be resisted, as the reintroduction will prove ineffective and will send wrong signals, both

domestically and internationally. Also, the prospect of introducing a scheme for "centralized exports," reintroducing price controls, and the possible use of "escrow accounts" is alarming. In the latter regard, I share the staff's strong reservation that the use of escrow accounts undermines the development of a broad-based foreign exchange market and weakens the link between strong adjustment policies and external financing. On a related issue, it is imperative for the authorities to live up to their commitment to the Paris Club to service all obligations falling due on post-cutoff-date debt. Indeed, the failure to fulfil these obligations adversely affects the authorities' credibility and, consequently, Russia's access to external financing.

The task confronting the Russian authorities is daunting and will prove very difficult to implement. Hence, while domestic pressures could understandably increase the attractiveness of a relaxation in the adjustment process, postponing necessary adjustment measures will only intensify the difficulty of economic stabilization. More significantly, the perception that the authorities are reluctant to engage the staff in comprehensive policy discussions is very troubling. Such an attitude could only complicate the onerous task facing the authorities. However, while an important opportunity--namely, the full implementation of the first credit tranche program--has been missed, all is not lost. The new Government could still retain the momentum of reform and economic adjustment if it resolutely implements the staff's recommendations. As the authorities recognize, it is not too late to take decisive action. Here I am encouraged by Mr. Kagalovsky's statement that the reinvigoration of stabilization policy must, and will be, the first priority of the Government in the coming months. It is my sincere hope that they succeed.

Mr. Shaalan made the following statement:

Although regrettable, difficulties and slippages in the implementation of the economic program supported by a first credit tranche arrangement with Russia are not altogether surprising. At the time of the discussions on Russia's request for a first credit tranche drawing last August, it was clear that given the uncertainty attached to Russia's reform agenda in the face of the costs attached to the unprecedented transformation of the economy, questions were raised about the realism of the program. The reforms contemplated over a few short months were by any standard overwhelming, even with the best intentions, and leaving aside the political and social dimensions, I would like to highlight the limited administrative capacity to implement the reforms. In Russia as well as in developing countries, these must be accorded due weight in formulating programs.

I, therefore, fully agree with the staff when it asserts that the process of macroeconomic stabilization may take longer to complete than originally envisaged. Undoubtedly, as many Directors have noted, the serious slippages in the financial area have contributed to the present difficulties. Having said that, I believe it would be a mistake to underestimate the achievements in this area, given the formidable and historically unprecedented problems facing not only Russia but also its complex economic relationships with the FSU states, as eloquently detailed by Mr. Kagalovsky. Moreover, the structural reforms introduced over the past several months are noteworthy; that is not to say that there is much more that needs to be done in the period ahead.

In this context, I would urge the Russian authorities to continue discussions with the Fund aimed at reaching an agreement on a stand-by arrangement without delay to consolidate the gains already achieved and to address the many problems that remain. I am encouraged by Mr. Kagalovsky's confirmation that the authorities are, in spite of the difficulties, fully committed to continuing the reform. It needs to be stressed, however, that unless a determined effort is mounted to achieve financial stability, the pressures for reversal of structural reforms could seriously build up to the point where it becomes difficult to withstand.

On the whole, I agree with the thrust of the staff appraisal and would underscore the staff's concerns regarding access to data. However, I have to say in passing that I was not quite clear on the staff's statement that "the Government must resolutely oppose parliamentary pressures to reduce existing tax rates...in the absence of compensating measures" (page 24 of EBS/92/198). Without necessarily passing a judgment on the advisability of opposing parliamentary pressures, I believe that recent events in Russia would seem to suggest that it is, as a practical matter, difficult to resist, much less oppose, parliamentary pressures. To the extent that is the case, the focus must be on enhancing public awareness of the trade-offs involved and on working closely with the authorities on developing alternative measures when substitution becomes necessary.

Mr. Wei made the following statement:

The process of transformation and stabilization in Russia over the past year offers us useful food for thought. The Russian authorities have taken bold measures to tackle the collapse of the economy. Mr. Kagalovsky has given us a helpful summary of the economic program and the preliminary positive results brought about by those measures. However, the process was both difficult and complex.

First, because "the new Government...did not have much time for the preparation of economic reform measures," as Mr. Kagalovsky has admitted, some of the reform measures may therefore have seemed premature. As a matter of fact, in my view, not everything had to be done immediately and simultaneously.

Second, the Russian economy has continued to deteriorate in a number of areas since our August discussion on Russia's request for the first credit tranche stand-by arrangement, and I am not surprised that there have been slippages in the implementation of the program.

Two immediate general remarks come to mind. First, as this chair has stated on several previous occasions at the Board, the Russian authorities are confronted with an increasingly severe challenge in fully implementing the program in the face of a deteriorating economic situation and unsettled institutional framework. Second, the program, which, in our view, is too ambitious, reveals that the staff understood the magnitude of the immediate economic and financial situation as well as the social difficulties and impediments in the ailing economy. However, we say it is too ambitious because it appears that the authorities as well as the staff may still have underestimated the difficulties of implementing such a program despite the fact that implementation has already been phased out.

Two things can be done simultaneously in this regard. While prompt implementation of the remaining measures under the program is crucial, as already stressed by management and staff, the program may need to be modified in order to suit Russia's specific case, which, due to its huge size is different from most of the Eastern European countries and the other states of the FSU. Against this backdrop, may I venture to say that Russia's initial transformation experience has shown that even shock therapy is not totally compatible with Russian circumstances.

I shall touch upon a few specific policy issues. On the fight against the first enemy--the current hyperinflation, I believe that there is no need to argue the importance of winning that victory in the process of stabilization, as early as possible. Judging from the monthly inflation performance in the first three quarters, the goal to reduce monthly inflation to below or close to 10 percent by end-1992 could still be possible if the monetary authorities would confine themselves to credit and monetary targets consistent with the goal. One major problem is the failure of the majority of the loss-making enterprises to improve their efficiency, even in the transformation climate in which the authorities are still forced to guarantee the supply of subsidized credit to these enterprises. Hyperinflation could not

possibly be stopped unless credible and tight credit and monetary policies were implemented.

The overall fiscal performance for 1992 was disappointing, in spite of some impressive progress achieved in the control of government finance. In this regard, I must admit that, in retrospect, the program's fiscal target was not realistic. Nevertheless, there may be some merit in setting a lower target, taking into account possible slippages. The main problem here is that the root of the fiscal difficulties has not yet been eliminated and, as a result, fiscal performance is still extremely unstable.

On price reform, the new Government liberalized prices for most goods in early 1992, which has contributed to unavoidable and substantial increases in prices. It is understandable that the positive effects of the price reform may take time to materialize. In this regard, I do not think that the recent move announced by the new Prime Minister to restore price controls on some basic foods is necessarily a bad thing. It is an exaggeration to say that the move would represent a dramatic step backward to the command economy of the past. Instead, I support the view that the move was a reasonable correction of what seemed to be irrelevant for Russia in the price reform. It may be good for social stability.

As regards structural reforms, progress in some areas, such as privatization and the tax system, has been impressive. However, reform in the financial sector seems to be slow and is certainly a drag on the entire reform process.

On the whole, looking back at the Russian transformation process over the past year, it is fair to say that there has been a mingling of successes and failures. The main concern now is that current hyperinflation together with a slump may persist for an uncertain period of time, and that the twin problem continues to be an obstacle to further reform efforts by the Russian Government. In addition, one can see other uncertainties plaguing the authorities. All these would endanger their ability to implement any ambitious program. In this sense, a less shocking but sustainable program may do Russia more good than harm.

Finally, my sincere thanks go to the staff for keeping us abreast of recent developments in the Russian economy and its transformation process.

Mr. Posthumus made the following statement:

I shall limit my remarks to a few issues only, mainly because I support the staff's appraisal, both in its praise and in its concern. Let me say first that, while a new political and

economic order may have emerged in Russia, as Mr. Kagalovsky states, it has not yet taken over. The Russian economy, like most other former centrally planned economies, is at this time in a no-man's-land: it is not a planned economy, and it is not a market economy. Important measures have been taken in the field of privatization and price liberalization. Large problems remain, particularly inflation. I share the outspoken concern of the staff about Russia's performance under the current credit arrangement. Also, the difficulties that the staff has met in obtaining access to monetary data and the reluctance of the authorities to engage in comprehensive discussions on fiscal and monetary policy are worrisome. Fund membership involves mainly obligations, of which providing information to the staff is an essential one; even superpowers do this.

It is generally recognized as crucial that present hyperinflation should not take hold. The way to attain a reduction of inflation now is mainly to reduce substantially the provision of credits to the enterprise sector and to prevent the continuation of interenterprise credits. However, the authorities and in particular the Central Bank seem not willing or able to implement such policies at this moment. The extension and occurrence of such credits hamper the restructuring of the enterprise sector. This may indeed be their intention. It is true that the restructuring process, if continued, would involve a decline in output and employment. But such a decline is not necessarily undesirable, because probably a large part of present production will not be sustainable in the market. This process, with all its political and financial implications, has been at work also in the other former planned economies. Privatization of enterprises at as fast a pace as possible is the only way out, so that viable enterprises can emerge. Russia has moved quite fast in this respect, but it will have to persevere. While the social consequences of a further drop in production and therefore in the rate of employment are indeed painful, such consequences cannot be avoided by the inflationary subsidization of nonviable enterprises, or by administered selection of potentially viable enterprises that are then given privileged access to resources. This underlines the importance of the social safety net, of course, which should also help employees to find other jobs rather than remain stuck in nonviable enterprises.

The staff writes that an obstacle to the privatization of large companies has been the leasing of industrial enterprises to the managers or to their business associates. I would like to ask the staff what is known about these leases and, in particular, about the financial terms and conditions under which they have been extended. Another question is whether privatization is so far a highly localized phenomenon, limited to a few large cities.

I note the statement on page 27 of the appraisal that the staff has strong reservations about the use of escrow accounts in external financing. On page 16, the staff writes that there is little information on the amount of the disbursements under medium- and long-term credits--mainly bilateral tied export credits--that have been linked to escrow accounts. We have had an informal Board discussion on this issue, and I fully share the staff's reservations. More information on the extent of the use of escrow accounts will be necessary to judge the repurchase capacity or possible future Fund financing; escrow accounts are not the World Bank's or creditors' business only.

Finally, the review before us today gives no indication of how cooperation between Russia and the Fund will proceed from here on. I would like to caution against an upper credit tranche arrangement very soon, because it would have to be put together overhastily. Still, Fund involvement of a visible nature is useful for all parties concerned. I said in the Board some time ago that Article IV consultations on the one hand, and stand-by arrangements on the other, are two sides of the same coin that is called surveillance. We have developed a monitoring procedure. Perhaps we can think of an intensified Article IV consultation process that involves monitoring during which a quantified program might be discussed, even if it does not have the support of the Fund, in Article IV-report fashion. This might help in proceeding toward a stand-by arrangement. Certainly, another unsuccessful stand-by arrangement would be unfortunate.

Mr. Prader made the following statement:

The staff documents before us clearly demonstrate the depth and seriousness of the economic problems that Russia faces today, and I can broadly agree with the staff's analysis. I fully concur with Mr. Kagalovsky that it is necessary to put the current economic situation in the proper perspective, but this does not mean to compare it only with the situation a year ago but also with the prospects in the forthcoming period, particularly if the policy stance remains basically unchanged or if it eases even more.

There has been little or no stabilization of the economy in the period since the first credit tranche arrangement has been approved. Progress in financial stabilization achieved in the first half of 1992 seems to have been even partly reversed during the first credit tranche arrangement. For some observers, this result is evidence of too ambitious goals on the part of the Fund. However, it would be an illusive strategy for the Fund--with consequences not only for Russia--to give in at this crucial moment to calls for a less demanding stabilization effort in this country and let its policy recommendations be guided primarily by

the perceived domestic political constraints of Russia. The most compelling reason for stabilization is that the current economic situation is characterized by many unsustainable tendencies, and in any event some adjustment and corrections will have to be made sooner or later.

What has not yet been decided is whether this adjustment will be in the form of a reintroduction of regulations and restrictions on the functioning of market forces or whether it will proceed in the framework of a liberal market economy. The reintroduction of price controls on some goods that has been recently announced, with the goal of fighting inflation, could be interpreted as a sign of the authorities opting for the first alternative. Since there have been conflicting interpretations of this move, I would be interested in the staff's assessment of the recent policy announcement of the Russian Government. In any event, the Fund should use both its surveillance and financial assistance capacity to convince the authorities of the long-term benefits of a pro-market solution and the long-term costs of reintroducing administrative controls. Mr. Kagalovsky's statement makes me confident that such an effort could be fruitful.

The performance of the Russian economy in 1992 has been disappointing in a double sense: not only was the output decline, characteristic of all reforming economies, significant, but in contrast to most other countries in transition, it was accompanied by a relaxation, and not by a tightening, of macroeconomic policies. The Russian experience serves as persuasive empirical evidence that relaxed financial policies will not stop the decline of production in the short run and will only impair prospects for its revival in the medium and long term. In addition, the failure to meet macroeconomic targets was coupled with serious slippages in programmed policy implementation. Obviously, there is a close relationship between policy slippages and missed quantitative targets.

As I already mentioned, the current macroeconomic situation is not sustainable in the basic sense that continuation of prevailing trends in fiscal and monetary areas will hit the Government's budget constraint sooner or later. Even excess expenditures financed through hyperinflation cannot continue forever, as experience from other hyperinflationary episodes demonstrates, and, one way or another, adjustment will have to be made. The only way to prevent the retreat even from those positive measures that were already implemented, such as price liberalization and unification of the exchange rate, is to narrow decisively the gap between budget expenditures and revenues.

In this respect, the level of explicit financial transfers to state enterprises, reaching an unbelievable 35 percent of GDP in

the first ten months of 1992, should be the first target of the expenditure-reducing exercise. Foreign financing of the budget deficit reached, in the first three quarters of 1992, nearly 10 percent of GDP, and this level is certainly neither sustainable nor desirable in the long run. With few alternatives except central bank financing of potential future deficits available, the absence of a decisive movement toward fiscal consolidation could lead either to hyperinflation or to the reintroduction of price controls. No matter how painful initially fiscal consolidation can be, the balance of costs and benefits of these policy options in the longer perspective should be made clear to the authorities.

The Russian Government is worried about the impact of economic reform on the poorest segments of the population, and I am sure that nobody will challenge the legitimacy of this concern. However, one of the well-established principles of economic analysis is that economic policy should target the aspect of market behavior that it desires to influence. For the objective of preserving the minimum level of living standard and consumption of the population, the most inefficient way is to subsidize the production of enterprises, many of them with negative value added at market-determined relative prices. Unfortunately, the enterprise sector--by maintaining inefficient production and overemployment in Russia--in fact replaces to a large extent the role of the ordinary social safety net.

I understand the Russian authorities' concern about the 20 percent slump in production in the course of 1992, and I also place high priority on halting that decline. But there is no way of achieving this goal by relaxing fiscal policies and by injecting large soft credits with nearly zero percent chance of repayment. Such financing will be predominantly reflected in the movements of nominal and not real variables. If the authorities are consistent in their effort to halt the decline in production and living standards, then they should focus primarily in their output-stimulating endeavor on the endogenous factors that the staff identifies, among others on page 3, as the main factors contributing to the accelerated decline in output in 1993, namely, the disruption in the payments system and intra-FSU trade, and investment cutbacks.

Like others, let me express our serious concern about the lack of cooperation of the Russian authorities in providing data to the staff and the unwillingness to engage in policy discussions. I hope that this is more the result of insufficient administrative capacity than of a deliberate effort to undermine the role of the Fund in dealing with the serious economic problems Russia is currently facing. I also support the call of Mr. Esdar and Mr. Dawson for an intensification of technical assistance efforts in Russia.

A reference was made by Mr. Esdar to the financial responsibility of the international community, and he made it clear that the solution to the problems of Russia depends not only on Russia alone. In his usual polemical manner, Jeffrey Sachs in a recent article titled "Home Alone 2" has made a similar point by attacking the stinginess of Western countries. By the same token, it is clear that whatever economic program will be negotiated between the Fund and the Russian authorities, the outcome will be carefully monitored by other FSU countries in the process of reform and adjustment. I hope that they will not hesitate in their reform efforts if the adjustment process in Russia were to continue to stall.

Mr. Kaeser said that, first, he would like to express his admiration for the Russian population, which had proved to be patient in the ongoing economic transition process, despite the fact that the negative effects had been much harder and had lasted longer than predicted by many Western economists.

Like other speakers, he regretted the reluctance of the Russian authorities to provide the information needed by the Fund to follow and assess the development of the Russian economy, Mr. Kaeser continued. Cooperation required transparency and openness.

He would address only one aspect of the reform process, Mr. Kaeser said. It had been, and was, widely agreed that agriculture had been the most striking failure of the former Soviet economy. Accordingly, successful agricultural reform would give the Russian Federation the opportunity to feed its population, to improve substantially its balance of payment situation, and to reduce its reliance on external financial support. To date, the vast bulk of Russian agriculture remained in collective hands. It was true that, on the basis of a legislation establishing the right of private farms to exist, the number of private farmers had increased. About 140,000 Russians were private farmers, up from 4,500 in the spring of 1992, but they accounted for only 2 percent of the total land area. He would appreciate information from the staff on the main obstacles to the privatization of Russian agriculture, which was the precondition for strong improvement of that sector's performance. Perhaps surviving ideological objections hampered the passing of legislation providing individuals with the right to own, to sell, and to mortgage land. Could the staff state whether the thousands of civil servants who ruled 25,000 collective farms were strong enough to jam privatization, and whether the fact that the collective farms provided a social safety net and retirement benefits to their members was a sufficient reason for the authorities to slow down land reform.

Mr. Mwananshiku made the following statement:

Two observations stand out with respect to the transformation process in Russia: one is that it has been more costly than anticipated; the other is that, despite the progress made so far, the program appears to be far from achieving its main objective of stabilization. Regarding the former, the decline in output is severe and has led to a serious deterioration in standards of living. As for the impact of the program, there is the looming fear that the country could get trapped in the inflation-devaluation vicious circle, quickly becoming a victim of adjustment fatigue.

The staff report points to slippages in policy implementation, especially in the areas of monetary and fiscal policies. These are, no doubt, contributing to the widening imbalances in the economy. The importance of improving public sector finances and containing monetary expansion cannot be overemphasized. However, the apparent collapse of the real economy, manifested by the 18 percent decline in industrial production for the first nine months of 1992, the more than 40 percent drop in capital construction for the same period, and the overall 20 percent decline in net material product in 1992, raises the question of reform sequencing and, in particular, whether stabilization could be achieved as a precondition for structural transformation and long-term growth.

The economic program under the stand-by arrangement emphasizes demand management. But the facts just mentioned suggest a serious problem with production, which is also affecting inflation as well as the feasible limits within which the authorities can take steps to maintain restrictive fiscal and monetary policies. This is where we, perhaps, need to examine the transformation strategy to ascertain its effectiveness in dealing with the real side of the economy. Not only is this important to ensure macroeconomic stability, it is also necessary in order to maintain political support for the reform effort itself.

We have only just begun to appreciate the complexity of transforming the Russian economy. One of the observations that has emerged is that Russia has to address the problem of capital flight and mobilize additional resources if it is to make a rapid transformation to a market economy. Fund resources can play only a small part. Ultimately, a market economy has to thrive on private capital. The problem is that foreign private capital, which is crucial, is at present uncertain about the direction of reform. Some way has to found to break this impasse. In this regard, I welcome the confirmation by Mr. Kagalovsky that his authorities remain committed to the reform process despite the great challenges they are facing.

Mrs. Hetrakul made the following statement:

I am in broad agreement with the staff appraisal and have little to add to the extensive comments by previous speakers. I sympathize with the Government of the Russian Federation on the extremely difficult task of having to implement tight fiscal, monetary, and external policies while having to deal with a great number of problems to establish appropriate economic and political structures in the country.

In my opinion, if the guidelines outlined in the economic memorandum are followed closely they would, in the long run, assist the country in thwarting the risk of hyperinflation, forestalling a further decline in output, and re-establishing the credibility of the transformation program, as well as restoring the confidence of the international community.

I agree with other speakers that the authorities should try to contain, as quickly as possible, the recent acceleration of inflation by strengthening both their fiscal and monetary stance. Tax administration should be improved to increase revenue collection, while expenditures, especially those for military spending, should be limited. Tighter credit policies should be followed. I would like to emphasize here that the use of any measures that would introduce deviations from the free market mechanism should be avoided.

A reintroduction of price controls may help alleviate the inflation problem in the short run, but these controls will create supply distortions as well and, therefore, need to be phased out as soon as possible. The maintenance of subsidies, whether for imports or for producers, would also lead to inefficiency in production.

The authorities should also try to stop subsidizing interest rates, as it would encourage the inefficient use of credit. With the present negative interest rates, the authorities are actually providing an undesirable incentive to firms to produce more at higher costs, to borrow to finance unnecessary stocks, to set prices above their market-clearing level, and to accumulate stocks by running up debt to each other.

On trade, while the focus should be on improving intra-trade with FSU states, the authorities should be encouraged to move toward freer markets by phasing out export quotas, export taxes, and the practice of centralized exports. These measures may increase revenue in the short run, but they will have negative incentives for exporters in the longer run, thereby reducing export competitiveness and promoting inefficient use of resources.

Finally, prompt action is needed to create a competent administrative agency to look after the interenterprise arrears problem with the aim of discontinuing the accumulation of additional arrears while trying to reduce existing ones.

Mr. Obame made the following statement:

The staff report and supplement clearly indicate that the Russian economic program, supported by a first credit tranche stand-by arrangement, has suffered several setbacks since its inception, owing to partial implementation and delays in putting in place the envisaged measures. Indeed, reflecting slippages that occurred mainly in the fiscal and monetary areas, inflationary pressures have accelerated, leading to a sharp depreciation of the ruble. Moreover, the macroeconomic imbalances have widened, with a decline in output now estimated at more than 18 percent, as indicated by Mr. Kagalovsky. However, it is refreshing to note that impressive results have been achieved in the area of structural reform with regard to price and exchange rate liberalization and the privatization process.

I agree with Mr. Kagalovsky's emphasis on the underestimation by both the authorities and the staff of the scale of structural distortions accumulated in the Russian economy over more than 70 years of Communist rule. This view is also well summarized by the staff when it recognizes that "performance under the program has been affected by the unprecedented magnitude of the challenge of structural transformation of the economy, the lack of a recognition among a sufficiently broad segment of society of the necessity of passing through a difficult transitional period." With these remarks in mind, it is unfortunate that the output loss seems to have gone far beyond what had been anticipated by the authorities and the staff. Under these circumstances, we have some sympathy with the authorities' views that the loosening of financial policies and deviations from the program do not imply a departure from the adjustment process but instead, a pragmatic approach aimed at safeguarding the necessary social and political consensus on the policies required to bring the adjustment back on track. However, as others have noted, the risks facing the current program are enormous and strengthening dialogue between the authorities and the staff is needed in order to consolidate the reform process, restore financial equilibria, and ensure continued support by the international community.

Since I share most of the recommendations made by the staff, I will make only a few points of clarification and emphasis. First, the staff has indicated that the decline in output might be overstated because of underreporting of economic activities in the private sector. Could the staff elaborate more on this point and, specifically, on the statistical improvements envisaged to

alleviate discrepancies and to better assess economic trends in Russia?

Second, on inflation, the need for tight demand-management policies in Russia at this juncture could not be overemphasized to prevent the danger of hyperinflation in the economy. In this respect, we concur with the staff that emphasis on price controls as a way of controlling inflation cannot substitute for financial discipline. Reliance on this temporary measure will only complicate the authorities' income policies and the achievement of the fiscal targets and will accelerate the depreciation of the ruble.

Finally, safeguarding the necessary social and political support for the adjustment process is a key element for the success of the program. In this respect, appropriate financing to support the safety net program is called for. This is particularly relevant when considering from experience that it is difficult to implement a deep-seated reform program if a large segment of the population cannot afford its basic needs.

Ms. Arraes observed that one of the temptations for countries experiencing high inflation was widespread indexation of contracts. Various countries in her constituency had given in to that temptation, viewing it as a mechanism that would make living with inflation less traumatic. That had proved to be a serious mistake. Not only had inflation been perpetuated but price behavior had tended to become more explosive. And, the higher the initial rate of inflation, the larger the possibility of inflation running out of control.

The Central Bank of Russia seemed to be favoring recovery through negative real interest rates, Ms. Arraes continued. That was obviously not the way to go for a country that badly needed stabilization.

She was fully aware that some kind of transition period might be necessary before the Central Bank stopped extending credit to industries at subsidized interest rates, Ms. Arraes stated. In the meantime, perhaps, a second-best solution might be to devise ways to allocate those credits at gradually higher interest rates, in the way suggested by the staff in the paper on credit allocation (EBD/93/4). Doing so would make it clear that the enterprises were being financed through money creation, a fact that imposed increasing costs on the rest of the economy.

Mr. Kabbaj made the following statement:

We welcome this opportunity to review developments under the stand-by arrangement with the Russian Federation. Like other Directors, we note that performance thus far under the program has fallen short of expectations.

At the time of the Board's discussions on the stand-by arrangement on August 5, 1992 (EBM/92/101 and EBM/92/102), all Directors had pointed out the clear and tangible risks regarding the achievement of the authorities' objectives and the crucial need for them to be rigorous in monitoring the implementation of their policies. While some policies have indeed been pursued, implementation in a number of key areas has lagged behind. As a consequence, macroeconomic imbalances have widened sharply; inflation still remains at an unacceptably high level, and other elements in the overall macroeconomic picture are cause for concern. There is now a clear risk that unless measures are immediately taken to address present difficulties, Russia's entire reform effort and the willingness to continue to move toward a market economy could be placed in jeopardy.

It is true that stabilization policies and structural reforms have proved to be more difficult and time consuming than originally envisaged and that performance under the program has been affected by the unprecedented magnitude of the challenge of structural transformation and other shifts in policymaking responsibilities. However, if Russia is to avert a slide into hyperinflation, the agenda for immediate action is clear: giving high priority to macroeconomic stabilization while accelerating those reforms that are the key to restructuring the economy and fostering growth in new areas of economic opportunity.

The staff is therefore broadly correct in its assessment of what needs to be done to ensure a rapid return to the original path of adjustment and the importance of taking decisive and bold action to achieve that goal. We, therefore, particularly welcome Mr. Kagalovsky's statement that his authorities have no disagreement with the analysis of underlying problems in Russia and that the reinvigoration of stabilization policy and further progress in the area of structural reform will be the first priority of the Government in the coming months.

Beyond these general remarks, I would like to make some specific comments. On exchange rate policy, we share the authorities' concern about the sharp depreciation of the ruble, which has greatly exacerbated the difficulties of implementing the stabilization program. However, the fall in the exchange rate and evidence of continued capital flight are clear indications that financial policies have been insufficiently tight. As progress is made toward bringing the macroeconomic situation under control, we would urge the authorities to move to a more stable exchange rate regime--as was originally intended--which could provide an important anchor for, and impart a strong element of discipline to, their continued stabilization efforts.

We appreciate the authorities' concern about protecting the most vulnerable groups from the real income shifts and the high levels of transitory unemployment that are inevitably associated with stabilization efforts. However, this raises two issues.

First, it appears that, following a sharp decline at the time of price liberalization, real wages have tended to increase. Unless this trend is checked, there is a risk of developing a wage-price spiral that would be difficult to reverse. We recall that the Government had earlier opposed a tougher incomes policy on the grounds that it would run counter to the objective of liberalization and would not be politically acceptable. The staff, however, has continued to press the authorities to consider the early implementation of a scheme for progressive taxation of excess wage growth. While hardening the budget constraint against enterprises should bring some discipline in this area, there is clearly a need for a more effective mechanism for containing excessive real wage growth.

Second, in regard to public enterprise reform, we note the persistence of labor hoarding against the backdrop of a fall in output. Of course, there is a difficult dilemma here: on the one hand, there are pressures to contain the decline in output and employment in the short run. On the other hand, the authorities would want to expedite the pace of restructuring and therefore the rate of economic recovery in the medium term. It is difficult to know where the right balance lies; decisions on tolerable rates of enterprise restructuring and/or closure will naturally vary, depending on political mandates and the adequacy of safety nets. Now that the safety net is in place and appears to be well funded, the authorities should be encouraged to expedite the process of labor restructuring in the enterprise sector.

Let me conclude by saying that in urging the authorities to move decisively forward, we do not wish to minimize the enormity of the challenge that they face. The task ahead is indeed daunting. While flexibility in the policy approach is important, it is wise to remember that successful transitions unavoidably require tough measures. There may thus be little choice but to pursue the policies set out in the Economic Memorandum if Russia is to achieve an early breakthrough into a period of renewed growth with stability.

Mr. Arora noted that Mr. Kagalovsky's statement that the reports regarding debt or the recently introduced liberal market-based price system were greatly exaggerated gave welcome assurance of what was happening in Russia. Nevertheless, grave concerns had been expressed by Directors about policy slippages and the failure to implement commitments made by the Russian Government. He wished that he could join his colleagues in expressing similar concerns. He would not overlook the dangers of

hyperinflation--a characteristic not only of ex-centrally planned economies; the experience of Latin America showed that hyperinflation had certain structural features, even though that might be denied--nor would he minimize the importance of fiscal and monetary prudence, but, as Mr. Kagalovsky had correctly reminded Directors, some sense of perspective was needed.

The surprise was not that slippages had occurred, Mr. Arora continued; the surprise--and a welcome one--was that the far-reaching reforms introduced in 1992 had held up as well as they had. Considering the background preceding the introduction of reform, the magnitude of the achievements became clear. He referred not only to the political turmoil in 1991, but also to the continuing confrontation between the Presidency and the Supreme Soviet and the Government's limited mandate in regard to the restructuring of the economy. Therefore, the pattern of one step forward and two steps backward that had developed in 1992 was not unexpected.

In December 1990, when the Fund-Bank report on the Russian economy had been discussed, he had raised the question of the constituency for reform in Russia, Mr. Arora recalled. At that time--Mr. Gorbachev had still been head of state and had attended the London summit six months later--the constituency had not existed and, consequently, it was not surprising that it had taken so long to introduce the reforms. Mr. Kagalovsky referred to the scale of structural distortions accumulated in the Russian economy over more than 70 years of Communist rule. Of course, that was accepted conventional wisdom, and there could be no objection to that statement. But he would remind Mr. Kagalovsky of one episode in those 70 years that could throw some light not only on what could have been done but also on what might be done in the future. Between 1921 and 1924 of the then new economic policy, market forces had been allowed in a limited way on the Russian scene, and the strategy had been to have the supply-side response appear first before other strategies, such as decelerating inflation. Market forces had been allowed in the area of distribution and, more pertinently, agriculture. Of course, uncertainties had arisen concerning retail prices, transportation in the wholesale system, and progress had been extremely slow in the agricultural sector.

Perhaps the more recent history of reform in Russia might include an argument for price liberalization at a later stage, when some supply responses had taken hold as a result of structural reform, to which Mr. Peretz had referred, Mr. Arora commented. Therefore, even now the Russian Government might be well advised to look at areas in which a constituency for reform could be developed quickly. Those areas in which the supply response could come quickly included agriculture--as mentioned by Mr. Kaeser--and the oil and natural gas industry, where infusion of investment in the economy would provide breathing space for reforms. Large-scale development of the oil and natural gas sector, with an effort to welcome foreign equity, would be the way to proceed, rather than simply focusing on exercising monetary and fiscal prudence. The latter was important, but without developing the constituency for economic reform, not much progress would be made.

Mr. Evans made the following statement:

One point that has not received much attention relates to unemployment. Industrial output in Russia has fallen by about one third in the space of the past year, yet unemployment is estimated to be about 1 percent. Clearly, there is massive disguised unemployment, associated with the hoarding of labor, and if we look more carefully at that, we would find the source of a large part of the fiscal problems and the source of credit demand. The staff might look more closely at the labor market practices that are leading to labor hoarding and how they might be replaced by changes associated with an appropriate safety net.

Another point that has been referred to by most speakers except, notably, Mr. Kagalovsky, is the inadequate cooperation of the Russian authorities with the staff, which, as several have noted, constitutes a breach of Russia's obligations under the Articles. We have procedures for dealing with breaches of obligations--procedures that were recently strengthened by the Third Amendment. But the fact that Mr. Kagalovsky has not referred to this matter, notwithstanding the prominence it is given in the staff report, suggests that the seriousness with which we view these matters may not be well understood by the Russian authorities. Therefore, I would suggest that the Chairman might convey the Board's concerns formally to the Russian authorities and report back to the Board within a reasonable period of, say, a month or so.

In an attempt to present a balanced view, I would like to focus briefly on the area of structural reform, for it is in this area that there has been considerable progress: the exchange rate has been unified; many prices have been deregulated; and the program of privatization and corporatization of state enterprises has proceeded pretty much according to plan. We should not lose sight of these positive developments, even if they are but a few shining lights straining to be seen through the thick fog of bad news on the macroeconomic front, because the structural measures that have been taken will be the foundation of the Russian market economy in the period ahead.

The privatization program has been a particularly bright light. The initial delays in proceeding with the corporatization of large firms were of some concern, but the authorities appear to have overcome some of the teething problems here, and it is encouraging that almost all large corporations have now been transformed into joint stock companies. The partial nature of the land-ownership reforms will, eventually, need to be addressed, but in the meantime the sharp increase in the number of private farms suggests that the population is responding favorably to the reforms. Other systemic reforms, such as an overhaul of the legal

and regulatory framework, will be required to complement the reform measures taken so far, and the authorities are encouraged to continue with the same vigor that they have applied thus far.

Unfortunately, the "good news" finishes here--macroeconomic performance under the stand-by arrangement has been poor. Monetary policy has been far too loose, the authorities failed to implement fiscal policy measures agreed with the staff, and even those that were implemented were delayed and incomplete. As a result, the Russian economy is now further away from macroeconomic stabilization than it was five months ago, and a dramatic turnaround in financial policies will be required if hyperinflation is to be avoided.

Reasons for the failure of the authorities to implement the much-needed macroeconomic reforms are not difficult to find, for they appear to stem from a lack of collective will on behalf of the Russian population to bear the costs of transformation to a market economy. As I, and others, suggested in August, it is up to the government of the day to ensure that the need for tighter macroeconomic policies and their impact, both in the short term and long term, are understood by the Parliament and the populace in general. We should not accept arguments that reform measures have been delayed because they do not have popular support; it is up to the Government to create the popular support necessary for the effective implementation of its policies.

But the problems in Russia seem to go deeper than this. In particular, there appears to be disagreement within the Government on how macroeconomic stabilization should be achieved. To some extent, this disagreement stems from the "economics" that these people know and trust. The basic tenet of this brand of economics appears to be that the solution to an economic problem is to inject more money into it. To an institution such as the Fund, such a "solution" is simply nonviable, and there is a plethora of evidence from market economies all around the world to prove so.

This has clearly been the approach adopted thus far for monetary policy. Large amounts of credit have been provided by the Central Bank of Russia to failing enterprises in an attempt to keep them operational. In the Russian command economy that once existed, where there was no inflation, and queuing served as the rationing mechanism, an injection of liquidity would not pose a macroeconomic problem. But in a market economy, toward which Russia is moving, credit growth of the magnitude seen in the second half of 1992 will result not in an increase in output but in a large increase in inflation and a debasing of the currency. Inflation is not caused by a monopolistic market structure; it is caused by excessive domestic credit growth. In this regard, the decision reported last week that price controls will be restored

on some goods in an attempt to reduce inflation will surely prove to be counterproductive and should be regarded as a step backward.

Furthermore, the operation of monetary policy will continue to be problematic for as long as those states of the former Soviet Union remaining in the ruble area continue to try and outdo each other in expanding domestic credit. I fully support the work the staff is doing in this area and encourage them to continue to aim at the development of effective monetary, payments, and trade arrangements. Given the relative size of the Russian Federation, it will be important that the Russian authorities take a leading role in this regard.

The old command system mentality also clearly still permeates the operation of fiscal policy. The further worsening of the consolidated budget in the September quarter because of expenditure overruns concentrated in the area of subsidies is particularly worrying. While there does appear to have been some progress in reducing the deficit since the month of September, the sustainability of that progress must be doubted: the good performance of the value-added tax is partly the result of a one-off change in procedures; profit tax receipts have been artificially boosted by the disfunction of the tax-based incomes policy; performance of new taxes has been generally weak; and sequestration of expenditures is likely to be temporary. A lasting solution to the fiscal problems will require both the resistance of parliamentary pressures to reduce taxation and increase expenditure and the implementation of substantial new deficit-reducing measures on both the revenue and the expenditure side. In particular, given the progress made in corporatization and privatization, production and consumption subsidies should be heavily reduced.

Excessive wages growth is yet another symptom of the general underlying policy dilemma. Providing excessive credit growth to enterprises in the guise of the settlement of net interenterprise arrears or injections of "working capital" has allowed enterprises to effectively circumvent the tax on excessive wages growth. As a result, real wages grew by about 75 percent during the first three quarters of 1992, at a time when real wage restraint was needed. Again, without broad-based community support for the reform program, including recognition of the need for real income losses during transition, ways around the tax-based incomes policy devices will always be found, the more so when enterprises do not face a real budget constraint.

We have all recognized for some time that the transformation of the Russian economy to one based on the market would be a long and difficult process. Yet, I think that we hoped that, with appropriate advice and support from the Fund and the international

community more generally, Russia could have, by now, moved closer toward macroeconomic stabilization. Unfortunately, this has not been the case. Even more unfortunate is that many in Russia appear to regard the worsening state of the Russian economy as a reflection of the implementation of policies suggested by the Fund. Of course, this is not the case. Structural reforms, as I said earlier, can be the foundation of a market economy, but they must be supported by market-oriented macroeconomic policies. Much will need to be done before Russia can get back on the road to macroeconomic stabilization. As a starting point, a major tightening of monetary and fiscal policies will be required. This tightening will need to occur before this Board could consider any further Fund-supported program.

Mr. Torres made the following statement:

The complexity and difficulties of transforming the Russian economy into a market economy are proving to be by far larger than originally believed. Because of this, we should accept Mr. Kagalovsky's invitation to "keep the problems of the present, critically serious though they are, in a proper perspective."

Financial stabilization appears to be, if not the most important, at least the most urgent requirement to provide viability to the transition to a market economy. If such stabilization does not take place, hyperinflation may develop soon, and this would obviously disrupt the whole transition process and make it more painful for the society as a whole. Many factors appear to be affecting adversely the financial program. I will comment on two: according to the staff report, the Central Bank believes that apart from fighting inflation it is also its task to provide sufficient credit to forestall a further decline in output. I think this is an institutional confusion. It is not the role of a central bank to provide credit to augment output. Even more, if decline in output is determined by structural factors, as it is believed, then the result of central bank intervention can only be higher inflation. So here, my recommendation is to clarify the responsibilities of the different institutional actors and policies in promoting sustainable and sound economic growth.

My second observation concerns the existence of many newly independent states using the same currency but each having its own independent monetary authorities. According to the staff reports, there has been a variety of unsuccessful efforts to obtain efficient monetary coordination among FSU countries. The obstacles to such coordination are comprehensible as all these states are just starting to develop their political and economic institutions. But monetary coordination can not wait for these developments to take place. The moment has come for the Russian

authorities to establish a deadline for the FSU countries to decide on whether to accept a common monetary policy under a single monetary authority or to create a separate currency. The sooner this deadline can be established the better for all the FSU countries.

On fiscal policy, I agree with the staff report that the postponement of expenditures as a measure to reduce the deficit can only be seen as a temporary expedient. In fact, it may be a dangerous expedient as it affects important infrastructure investment needed to improve the general efficiency of the economy. It would seem wiser to reduce producer and import subsidies and to take advantage of the international political atmosphere to cut further defense spending. In this regard, I would like to hear comments from the staff or Mr Kagalovsky on how much room they think there is for such spending cuts.

On foreign exchange policy, there seems to be significant pressure for the reintroduction of multiple exchange rates and trade controls as a result of the recent sharp depreciation of the ruble. This would be the wrong prescription and its consequences extremely disturbing for the whole economic reform program. Again, it must be emphasized that in order to maintain a stable ruble, fiscal and monetary discipline is urgently needed in the first place. There is no economic or noneconomic substitute for these strictly necessary measures.

Along the same lines, I suggest that the Russian authorities evaluate other countries' experiences with "foreign exchange budgets" and "centralized exports." In Latin America, these expedients have been used. To my knowledge, these experiences have been a failure. They produce an inefficient allocation of resources in the economy and leave room for corruption. They demand increasing administrative controls, which finally are beyond government capacity.

On the systemic reforms, the Russian authorities should be commended for the advances achieved and should be encouraged to maintain the pace. These reforms, especially privatization, are the only ones that, on the one hand, make the reforms irreversible and, on the other, confer viability in the long term on economic growth. Nevertheless, I would like to express my concern about the changes in the regulatory frameworks that should take place as part of the privatization program. Without such changes, one of the most important objectives of a privatization program--to promote competition--will not be achieved. It seems, from the staff report, that changes in the regulatory frameworks of the different economic activities have not kept pace with the sale of assets and enterprises.

On the same issue of privatization, I believe that to go faster and further in this key systemic reform, the restructuring of public enterprises should be clearly connected to the aim of divestiture and at the same time, as the staff suggests, the subsidies given by the Government to the public enterprises should be used to facilitate that transition.

As to the role of the Fund, I agree with what is being done and with what has been defined as the main objectives pursued by the Fund staff. I would only add that there might be a strong need for assistance in the area of institutional capabilities for the formulation, execution, and evaluation of macroeconomic policies in a market economy.

Finally, I welcome Mr. Kagalovsky's assertion of his authorities' commitment to the reforms, despite all the difficulties they are facing, and we wish them well in these formidable tasks.

The Deputy Director of the European II Department commented that, on the alleged reintroduction of a degree of price regulation, he would agree with Mr. Smee that the Russian authorities must be told that a return to price control was a bad idea that would not work. He knew that Mr. Kagalovsky and many high-level officials of the Russian Government agreed; the problem was that some authorities in Russia, having some political influence, had different views. That variance applied also to the problem of cooperation that had been noted by Executive Directors. The complaints about lack of cooperation contained in the staff papers regrettably reflected facts. It was important to note, however, that many Russian officials, including several Deputy Prime Ministers, had provided enthusiastic cooperation to the Fund staff.

On the underreporting of output, apparently the statistical system was not capturing the new private sector, which predominantly took the form of small street businesses, the Deputy Director noted. Gradually the statistical authorities would have to develop the capabilities--initially, probably in the form of surveys--to gauge the extent of that economic activity, which thus far was small in relation to GNP but for which there was rapidly increasing visual evidence in urban centers in Russia, as well as in Eastern Europe. Tax evasion--and perhaps also the perception of a risk of future reintroduction of controls--provided incentives to those small firms not to volunteer information to the statistical agencies.

The staff representative from the European II Department remarked that the leasing of enterprises, or parts thereof, to managers was seen in Russia as an obstacle to privatization because it introduced an element of nontransparency and could discourage investment by others outside those enterprises in existing firms. Only anecdotal, rather than systematic, evidence existed of the extent of that activity. Although the issue was

hard to detect, it was frequently pointed out as a serious problem by the officials responsible for privatization.

As to the obstacles to land reform--why it had not proceeded more rapidly and why the Supreme Soviet had not allowed a more radical land reform and ownership system to emerge--the point made by Mr. Arora was relevant, the staff representative continued. Collectivization and state farms had been in existence for about 60 years, even before the first Five-Year Plan. Therefore, over a few generations there appeared, on the one hand, managers of sometimes enormous farms who had obviously a vested interest in holding on to their privileges and power; and on the other hand, people doing manual work on those farms who essentially had become hired laborers. Obviously, in the past few years when the issue of land reform--and returning the land to the peasants--had been raised, there had been reluctance on the part of those people who had not had responsibility for the care of the land for 60-odd years.

The figures that Mr. Kaeser had mentioned could be interpreted in another, more positive light, the staff representative from the European II Department remarked. The fact that there had been such rapid growth in private farms--even though they still represented a small proportion of output--was a surprisingly encouraging development in 1992. Over time, there would be a demonstration effect showing that a number of successful farmers had had access to inputs and credit on an equal basis. Then, a number of their former colleagues on state and collective farms would be encouraged to take up the land on their own.

Mr. Kagalovsky said that his authorities would take Directors' comments into consideration in deliberating current economic policy. He would agree with Mr. Fukui that there was no reason to apply different standards to Russia than to other countries. Certainly, many important and exceptional circumstances distinguished Russia from other countries in transition; nevertheless, his authorities were not seeking excuses or exceptions, and certainly not with respect to the possible future upper credit tranche arrangement.

He had noted the concern expressed by Directors, particularly Mr. Posthumus, about the lack of sufficient cooperation and the supply of data, Mr. Kagalovsky continued. He would convey that message to his authorities; there were no serious problems concerning cooperation with the Government but, unfortunately, problems existed in the Central Bank, and his authorities were working to solve them now. The suggestions of Mr. Evans could be useful.

He also agreed with those members of the Board who had commented on the need to cut budget expenditures drastically, Mr. Kagalovsky stated. Military expenditures had been cut sharply, although in principle they should be cut further. The process was complicated, however; for example, the recent START II agreement signed with the United States was a significant

historical achievement, but additional money from the budget would be required to fulfill the obligations under the treaty.

Lengthy discussions had been held with the staff concerning incomes policy, Mr. Kagalovsky noted. The problem was that since 1985, various wage restriction schemes had been introduced, with only negative results. Following such experience, new methods of wage restriction had been avoided. The most damaging measure would be to introduce a new law that would not work and would only undermine the authority of the Government.

He hoped that Directors would not base their conclusions concerning capital flight on reports in the newspapers, Mr. Kagalovsky commented. Care should be taken in estimating real amounts of capital flight. His authorities agreed with the staff that the crucial element was monetary policy, which would have to be improved radically; otherwise, capital flight, export quotas, import subsidies, and enterprise arrears would not be corrected.

Finally, Mr. Kagalovsky said, he wished to express his authorities' thanks to the staff for the establishment of what was seen as a good long-term relationship--despite the situation in the Central Bank alluded to earlier. Prospects were favorable for cooperation in the future.

The Chairman made the following concluding remarks:

> In view of the importance of this review of the first credit tranche arrangement with Russia, and in order to facilitate our reporting to the Russian authorities of the Executive Board discussion, I believe it would be appropriate to capture the thrust of Directors' comments in the following concluding remarks.
>
> Executive Directors broadly endorsed the staff appraisal. They acknowledged that adjustment policies in Russia and the ambitious transformation of the economic system had to be carried out under extremely difficult conditions. The challenges faced by the economic policymakers have been, and remain, unprecedented. Against this background, Executive Directors welcomed progress in implementing structural reforms, especially the recent acceleration of the corporatization and privatization programs.
>
> I note also that Directors regretted that the staff was not in a position to describe Russia's performance under the stand-by arrangement in terms of the indicative targets because of inadequate access to data, especially in the monetary area. Directors were emphatic in saying that unless cooperation with the staff was significantly improved, the prospects for further use of Fund resources would be affected. Executive Directors also expressed concern about the lack of implementation of policy commitments made in the authorities' letter of July 10, 1992; they stressed that it would be necessary to devote greater attention to implementation in any future negotiations on a Fund-supported

program. From the importance that Directors correctly attached to full cooperation on the part of the Russian authorities and the provision of data as required under the Articles, I conclude that it is essential that this matter be resolved fully and durably in the context of the forthcoming Article IV consultation discussions. I noted with pleasure that Mr. Kagalovsky, inspired by the same spirit, seemed to be in agreement with the thrust of these suggestions.

Executive Directors observed that the key objectives of the economic program supported by the stand-by arrangement have not been met. Inflationary pressures in the economy, instead of being contained as envisaged, have risen owing to a substantial loosening of monetary and financial policies beginning in the third quarter of 1992. Directors warned that if current trends continued, hyperinflation was likely; such an outcome would place at risk the entire reform program and must therefore be avoided at all cost. Directors emphasized that macroeconomic stabilization should come to the forefront of policy priorities. In this context, Directors welcomed Mr. Kagalovsky's statement that further action by the Government in the area of financial stabilization is most urgently needed. They noted the essential role of monetary policy in reducing inflation, and they called on the Central Bank of Russia (CBR) to act promptly to bring down inflation by decreasing sharply the rate of credit expansion.

Directors also noted that the overall effectiveness of monetary policy was seriously handicapped by a number of factors, including the predominance of directed sectoral credits, often at heavily subsidized interest rates, and the ceilings on deposit rates at the Savings Bank. These factors contributed to a structure of interest rates that was sharply negative in real terms, which discouraged domestic saving and encouraged capital flight; they also distorted the allocation of credit among sectors and enterprises, and hindered the goal of introducing hard budget constraints on enterprises. Directors stressed the importance of eliminating these impediments.

On the budget, Directors commended the authorities for their determination in controlling the growth of expenditures since September through sequestering, but they noted that this could be effective only on a temporary basis. They stressed the importance of curtailing subsidies to producers and importers and continuing to reduce defense spending and centralized investment, while noting the very relevant point Mr. Kagalovsky made on the high initial cost of actions to reduce military expenditures.

Directors regretted that important revenue measures that were to be taken as prior actions under the stand-by arrangement were not implemented or implemented only partially. These measures--

especially in the energy field--are an essential component of any stabilization effort, and Directors hoped that these measures would be fully implemented as part of the 1993 budget. Directors also pointed out that measures need to be identified and implemented to offset the decrease in the level of the value-added tax rate that has been adopted by the Supreme Soviet for 1993.

Directors noted with concern that most interenterprise arrears outstanding as of July 1, 1992 had been cleared with CBR financing. This constituted a major contributing factor to the acceleration of inflation. Arrears would continue to grow unless effective measures to impose a hard budget constraint were taken, which would need to include a tightening of monetary policy and the implementation of an effective bankruptcy law.

Directors viewed the ruble's sharp depreciation as a reflection of the loosening of financial policies. They stressed that the unification of the exchange system had been a major milestone in the transition to a market economy, and they urged the authorities to maintain a unified system and avoid recourse to restrictions. Most Directors noted that a tightening of financial policies was the only sustainable way of ensuring a broad exchange market, reversing capital flight, and strengthening the value of the ruble. Several Directors expressed dismay at the size of the alleged capital outflow, which provided particular reason to strengthen financial policies.

Directors underscored the importance of continuing with systemic reforms in the transition to a market economy. In addition to the privatization program and effective procedures for bankruptcy, the need to expose state enterprises to market conditions called for rapid progress in implementing reforms of the commercial and property laws. Directors stressed that resolute implementation of market reforms, combined with macroeconomic stabilization, was the most effective way of setting the stage for sustainable growth in Russia. They noted that the liberalization of prices in January 1992 had been a major achievement of the reform program, and they cautioned the authorities against any reimposition of price controls.

This being said, Executive Directors expressed understanding for the immensity and difficulty of the Russian authorities' task of stabilizing the economy while transforming its basic features, and they said that the Fund was prepared to assist in this process. Directors stated that the Fund would be ready to move quickly toward the objective of an upper credit tranche arrangement, provided that all necessary data would be forthcoming in a regular fashion and that the policy environment would permit the elaboration of an adequately strong adjustment program. All Directors agreed on the critical importance of continued close

involvement between the Fund and Russia, both through the provision of technical assistance--and several Directors expressed satisfaction with the magnitude of the effort already in place--and advice on policy formulation. In that connection, importance was attached to the completion of the forthcoming Article IV consultation by the time of the spring 1993 ministerial meetings in Washington, D.C.; the consultation, several Directors suggested, would be a milestone in the direction of an upper credit tranche arrangement.

4. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Filosa upon completion of his service as Executive Director.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/93/4 (1/11/93) and EBM/93/5 (1/11/93).

5. ESTABLISHMENT OF ADMINISTERED ACCOUNT - JAPAN - AMENDMENT

As requested by the Ministry of Finance of Japan (letter dated January 4, 1993, EBS/93/1, Annex I), paragraph 1 of the Instrument established pursuant to Decision No. 9091-(89/27), adopted March 3, 1989, is amended to read as follows:

The Managing Director is hereby authorized to establish an Account for the administration of resources to be contributed by Japan in order to assist countries with overdue obligations to the Fund, which are cooperating with the Fund in the context of the intensified collaborative approach as endorsed by the Interim Committee at its meeting on September 25-26, 1988, by providing resources to help secure the financing necessary for the implementation of an adjustment program (a) which has been endorsed and is being monitored by the Fund or (b) which has been otherwise formulated in consultation with the Fund. (EBS/93/1, 1/4/93)

Decision No. 10268-(93/5), adopted
January 11, 1993

APPROVED: September 27, 1993

LEO VAN HOUTVEN
Secretary