December 15, 1999

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Final Minutes of Executive Board Meeting 97/91**

The following correction has been made in the final minutes of EBM/97/91 (9/3/97):

Page 53, first para., line 11: for "of monetary offsets" read "of mutual offsets"

A corrected page is attached.

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The underlying problems of the still inadequate revenue collection mechanisms, as compared to the expenditure commitments, are, in our view, much more worrisome. 7.1 percent of GDP of cash revenues for the federal government continues to be a dangerously low level for a country like the Russian Federation. Just one quick look at Table 4 of the report suggests that in the first six months of 1997, the total government expenditures exceeded more than twice the total cash revenues (Rub. 108.3 and 219.6 trillion correspondingly). Such levels of both revenues and expenditures clearly could not be sustained. Under these circumstances, as it appears from paragraphs 8, 9 and 22 of the staff report and from the authorities' Letter of Intent, the elimination of mutual offsets has been delayed, while ·another mutual arrears-clearing operation is planned to be conducted. Apparently neither the authorities, nor the staff have a clear and precise picture of the current stock of budget arrears, while additional spending commitments have been undertaken to clear local arrears with federal funds. The accumulation of the new federal wage arrears in June has proved that there is no room for any complacency on the fiscal front.

As regards Russia's balance of payments development, I noticed that the projections for 1997 have been revised in light of changes to the 1996 outturn, as well as the larger-than-expected capital inflows in the first half of 1997. I wonder, however, what the implications of the US dollar rise versus the Deutsche mark would be for Russia's external account. More precisely, does staff expect a further deterioration of Russia's trade account given its vulnerability to the US dollar appreciation? Moreover, given the fact that both the EU and Central and Eastern Europe (former COMECON) are the source of one third of Russia's import, while almost half of Russia's export are oil and gas, sectors where Russia might face deteriorating terms of trade, what would be staff's recommendation if the authorities are to limit possible external imbalances?

On the structural side, important initiatives have been proposed and adopted, but their real implementation, and/or enforcement, is still in the very initial stages. Notable progress was achieved on the privatization side with the recent completion of several large privatization deals. With respect to other structural measures, like tax and land reforms, the possible outcome within the horizon of the current program implementation, is not yet clear.

While not having enough information for a comprehensive assessment of the reform in the housing sector, as recently announced by the Russian authorities, I still feel that the proposed measures may not be ambitious enough. One could hardly imagine any powerful incentives for a meaningful restructuring of this sector, while heavy utility subsidies are still envisaged for the next few years. Local governments will probably not be able exercise subsidies' cuts of their own, as they are currently in need of federal assistance to clear their own arrears.

In sum, while supporting the proposed decision, we do not fully share staff's conclusion that developments during the first months of the 1997 program have been very, as the staff put it, encouraging. At this stage of the

program implementation, we would rather prefer the term promising developments, and we are quite willing to again extent the benefits of the doubt to Russian reformers. Representing a constituency with a number of neighboring countries of the Russian Federation, as well as its trading partners, I would like to emphasize that the success of economic reforms in Russia would extend its benefits to regional trade and the development of reforms in other transitional economies.

On the other issue, important to my Ukrainian authorities, we tend to agree with the staff rather than with the Russian authorities, who are claiming that the alcohol import licensing system is working well. Let me remind the Board that the mentioned licensing scheme was introduced in late 1996 instead of quantitative restrictions for alcohol imports, which have been explicitly prohibited by the current program. During the latest discussions with the authorities in Russia staff have expressed concerns that the licensing system has not been working as claimed, and is likely to be restricting the flow of imports. To prove that view, let me just mention that, according to the data furnished by my Ukrainian authorities, in the period January-June of 1997 the exports of Ukrainian ethyl alcohol to Russia has decreased by 95,2 percent compared to the corresponding level of the first half of 1996. My Ukrainian authorities are also not fully convinced, that the selective price-based restrictions imposed by the Russian Federation on sugar imports from Ukraine are in line with the spirit of the Russian arrangement with the Fund. For the Russian economy volumes of losses involved in both cases may not seem to be important, but for Ukraine in January-June 1997 these losses have already exceeded 0.5 percent of GDP in dollar terms, thus having an adverse effect on the current account of Ukraine, which is also a program country. If the problem is not addressed, the additional new current account deficit of Ukraine by the end of the year would exceed the Fund financing of the Ukrainian program.

Mr. Zhang made the following statement:

At the outset, we commend the Russian authorities for their strong commitment to the program and the encouraging progress in economic performance during the first half of this year, as evidenced by the visible signs of a turn-around in output and growing optimism about the prospect. Like others, we hope this improved environment will lead to further consolidation of stabilization gains and the acceleration of structural reforms toward laying a solid condition for longer-term sustained growth.

I am in broad agreement with the analysis and recommendations in the well-written staff report and appreciate Mr. Mozhin's candid and informative preliminary statement. Here I would like to make a few comments for emphasis.

We share the concern over the uncertain inflation outlook indicating that the hard-won stabilization gains have yet to be solidified. While the authorities' response to the challenge posed by the large capital inflow is appropriate, extreme vigilance over capital inflow developments and prompt