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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 95/87

10:00 a.m., September 14, 1995

Contents

Executive Board Attendance

S. Fischer, Acting Chairman
A. D. Ouattara, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
M.-A. Autheman	
	E. Srejber
	V. J. Fernández
I. Clark	
	J. M. Jones, Temporary
	J. Shields
K. P. Geethakrishnan	
	L. M. Cheong
	D. Gotz-Kozierkiewicz
A. Kafka	
W. Kiekens	
Y.-M. T. Koissy	
	J. C. Martinez Oliva, Temporary
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H. Mesaki	
A. Mirakhor	
C. Saito	
S. Schoenberg	
	Y. Y. Mohammed
D. V. Tulin	A. V. Mozhin
E. L. Waterman	
J. de Beaufort Wijnholds	
Zhang M.	

W. S. Tseng, Acting Secretary
D. M. Rajnes, Assistant

Also Present

IBRD: P. Mitra, Europe and Central Asia Regional Office. European II Department: J. Odling-Smee, Director; E. Brau, Deputy Director; Y. Horiguchi, Deputy Director; D. A. Citrin, D. J. Donovan, D. Gray, D. P. Hewitt, A. Knöbl, T. D. Lane, M. Shadman-Valavi, S. Tiwari, L. M. Valdivieso. External Relations Department: D. R. Hawley. Fiscal Affairs Department: G. N. Anulova. IMF Institute: A. Ouanes. Legal Department: R. B. Leckow. Policy Development and Review Department: S. M. Schadler. Research Department: G. M. Milesi-Ferretti. Secretary's Department: A. Mountford. Treasurer's Department: G. S. Markosov, A. F. Moustapha. Western Hemisphere Department: E. Hernández-Catá. Advisors to Executive Directors: A. R. Ismael, M. F. Melhem, G. Mucibabici, S. O'Connor, T. Oya, M. Petrie, A. V. Vernikov, R. von Kleist. Assistants to Executive Directors: D. Daco, D. Desruelle, J. C. Estrella, R. Glennerster, Huang X., U. Isaev, T. Isataev, P. Jilek, A. M. Koulizade, E. Kouprianova, B. M. Lvin, N. Prasad, T. Sitorus, V. Verjbitski, E. Zamalloa.

1. RUSSIAN FEDERATION - 1995 ARTICLE IV CONSULTATION; AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1995 Article IV consultation with the Russian Federation and the first quarterly review under the stand-by arrangement (EBS/95/149, 9/8/95; and Cor. 1, 9/13/95). They also had before them a statistical appendix (SM/95/234, 9/11/95).

A Deputy Director from the European II Department said that inflation for August was estimated at 4.6 percent, down from 5.4 percent in July. The current exchange rate was 4,467 rubles per U.S. dollar, compared with 4,442 rubles per U.S. dollar at end-August. Further slight depreciation had also been in evidence in the previous couple of weeks. Growth of the money base for August was, on a preliminary basis, less than 5 percent, following 12 percent growth in July.

Mr. Tulin made the following statement:

This chair is broadly in agreement with the main conclusions and the proposed decisions by the staff. I very much appreciate the impressive work that was done by the Fund's mission and admire their devotion and persistence in monitoring the program with Russia. Their experience under the program was not all roses, at least in terms of the physical strain of monthly and sometimes more frequent consultations with the authorities. In the period under review, economic and political life in Russia posed a number of problems for policy makers, which had to be addressed immediately, and it was due to the combined efforts of both the authorities and the staff, that the program has been kept on track. As it was stressed in the staff report, all the quarterly performance criteria, as well as the monthly indicative targets under the program have been observed. Nevertheless, the results achieved at this stage evoke a number of questions related both to past experience and to the further implementation of the program. Let me elaborate on some of these issues, which might be of interest, probably, not only in view of this particular program, but also for considering other country matters.

How it happened that inflation targets are not being achieved while performance criteria have been observed: the possible impact of the shift in exchange rate policy.

The main intrigue about the program, which ultimately forced the authorities to undertake additional policy measures in an amendment to the originally adopted program, was the slower than expected decline in the inflation rate. Although impressive in dynamics, the reduction in the monthly inflation rate as measured by the CPI (from 17.8 percent in January 1995 to 5.4 percent in July and 4.6 percent in August 1995) still fell short of the program targets. The staff report suggests that the program objective of a monthly inflation rate of 1 percent and less in the fourth quarter of 1995 is still feasible, provided that the authorities comply with the additional requirements under the amended program. At the same time, the staff report implicitly admits the probability of a less favorable scenario, when the unforseen growth of money supply in the second quarter and in July might exert upward pressure on commodity prices in the coming months, unless this pressure is offset by the upward shift in demand for money. The faster than expected growth of base money, caused by the increase of net international reserves of the central bank, was named as the main factor explaining the slower than envisaged reduction in inflation.

These facts and speculations once again highlight the old dilemma of choice between money-based and nominal exchange rate anchor-based approaches to stabilization policies, as well as of the Fund's advice to the program countries on this issue. The comparative advantages and disadvantages of the two stabilization models are broadly described in literature; this problem has been recently addressed in very interesting staff papers with particular reference to the statistical evidence in transition economies (for example, Estonia versus Latvia). It is generally admitted that both models are operational if backed up by the appropriate stance of underlying economic policy, although each of them offers its own logic of the authorities' behavior. Therefore I would fully support the traditional policy of the Fund, which leaves the ultimate burden of decision upon the foreign exchange regime at the discretion of national authorities, while the Fund is supposed to defend the consistency of the chosen exchange regime with the other policy actions under the program. The traditional set of the Fund's quantitative performance criteria--namely the combination of ceilings on net domestic assets with floors on net international reserves--allows for a certain degree of flexibility in the fluctuation of base money under stabilization programs.

Referring to the case of Russia, one can admit that the authorities could have allowed the nominal exchange rate of the ruble to appreciate to higher levels in April-June 1995 and thus could have reduced the growth of international reserves and base money, and could have brought the monthly inflation rate to somewhat lower numbers. It can also be recognized that the commitment by the Russian authorities to sustain a particular exchange rate band inevitably impedes their autonomy in implementing monetary policy, and seriously challenges their ability to keep base money under control, since efforts to fully sterilize the impact of official foreign exchange interventions on base money may not always be successful, given the cost of such sterilizing operations and their possible negative effect on other policy objectives.

At the same time, one can hardly blame the Russian authorities for having followed the example of a vast majority of other transition economies, which either explicitly, or implicitly committed themselves to the policy of managed nominal exchange rates. Such persistence by the transition economies in selecting their exchange rate policies, even with the sacrifice of full control over the money supply, may not be coincidental. It must reflect the extreme sensitivity of the real sector of these economies to exchange rate fluctuations, which prove to be rather disruptive for the fragile, underdeveloped markets. The authorities in these countries seem to be unprepared to attribute to the exchange rate of their national currencies the role of a "shock absorber", and one can draw a parallel between the exchange rate policy of these countries to-day and that of the industrialized countries after the Second World War.

I am convinced that the existing risks and dangers for the implementation of the program with Russia do not come from the domain of the exchange rate policy. Although the feasibility of the monthly inflation target of less than 1 percent toward the end of the year may be questioned, any insignificant discrepancy between the envisaged and actual numbers of the monthly CPI would not undermine the program as a whole if the disinflation process proved sustainable and irreversible. The latter outcome will depend on a number of other factors, which will be the focus of our discussion to-day. Apparently, the Russian authorities were not forced into the exchange rate band by the market forces, it was rather a deliberate shift in their policies based on the perception of the general economic and political situation. With the stability of the ruble exchange rate being a popular political goal in the society, the authorities started to use it as a powerful argument for strengthening fiscal policy--so far, the traditional weak point of any program with Russia--which otherwise would have been less feasible. The authorities are fully aware of the painful political repercussions in the case of failure of the band, and this awareness is expected to make them more resolute in their on-going struggle for a healthier budget, and in resisting pressures of the politically influential interest groups. It is symptomatic that the band was introduced on July 6, 1995, when the upward pressure on the ruble exchange rate had practically ceased and when the authorities had to go to great pains to undertake additional policy measures, in defending the ruble exchange rate against possible downward pressures.

It is obvious that major concerns about the future of the program lie in the area of fiscal policy. Although the achievements of the authorities in this area were quite spectacular--in the first seven months of 1995, the cumulative deficit of the Federal government was reduced to 3.4 percent of GDP compared with 10.9 percent for the whole of 1994--the way by which such progress has been made, can hardly be sustainable. The staff report presents a detailed analysis of severe across-the-budget spending cuts in real and sometimes in nominal terms, which were to be made because of the lower than expected increase in revenues. I am in broad agreement with the conclusions by the staff about the factors that caused the slowdown of revenues as well as their appraisal of the new policy measures already introduced or planned by the authorities.

Let me only add that apart from insufficient persistence in implementing new revenue measures, which was partly explained by political difficulties, there is a large group of technical, and yet very important, factors that explain the low tax compliance. The new policy measures on the revenue side, however attractive they might appear, will reap poor results unless they are supported by an efficient system of taxation based upon the modern accounting system and strict enforcement procedures. The outdated, Soviet-era accounting principles still utilized in Russia for taxation purposes, as well as the extremely inefficient enforcement procedures offer tremendous opportunities for inventive entrepreneurs in their tax evasion practices. In this respect the latest intentions of the Russian authorities to improve the tax compliance ratio by improving the technical side of taxation practices are to be encouraged. Further technical assistance of the Fund in this area would be most welcome.

On balance, the implementation of the program under the stand-by arrangement so far looks satisfactory and, by all standards, drastically better than under the previous programs with Russia under the systemic transformation facility (STF). The lengthy period of the exchange rate stability, the steady--albeit lower than expected--reduction in the monthly inflation rate, and even the growing difficulties in the banking sector--despite the inevitable adverse effect of such difficulties on the course of monetary and fiscal policies--are clear signs of the progress achieved in the financial stabilization policy. The compliance of the policies with the monthly indicative targets, in addition to the quarterly performance criteria under the program, the unprecedented efforts of the Russian authorities in the budgetary area, and the voluntary commitment of the authorities to undertake even stronger actions within the framework of the new exchange rate policy, provide serious arguments in favor of the seriousness--if not yet sustainability--of the current stabilization efforts.

However, one can expect that the program will soon come under a severe test of seasonal spending pressures aggravated by the coming parliamentary elections and, probably, by difficulties in the banking sector. These pressures will obviously be the major source of danger to the program in the coming months, and the authorities are being urged to improve significantly the collection of budget revenues by all available means that would be socially acceptable. The necessity of improving the fiscal policy has become even more important in connection with the exchange rate policy under the band, which the authorities committed themselves to defend at least until the end of 1995.

Mr. Clark made the following statement:

I am generally in accord with the staff appraisal and advice, and therefore support the proposed decision. I have the following brief comments.

Considering that sustainability of the fiscal consolidation effort has always been difficult for the authorities to achieve, the successful initiation of a renewed effort over the past few months is laudatory. However, as the staff notes, it has been achieved despite a weak revenue performance and because of an extraordinary expenditure control effort, characterized in part by lower transfer payments to junior levels of government, loan reductions and broad cuts in program spending. These contingency efforts to achieve fiscal deficit goals rely on the strong surplus position of junior governments and a cushion of excessive spending in program budgets. Clearly, however, there are limits to this approach over the longer run, but it should not be dismissed as a positive initiative in the short term especially if these expenditure savings become permanent reductions in program spending.

The initiatives taken to raise tax revenues through the elimination of exemptions and the increase in excise tax rates on selected imports and on oil and gas are positive actions. Similarly, the steps taken to improve tax administration and collection, including the collection of outstanding tax arrears, is further evidence of commitment to fiscal reform. However, I agree with the staff that while the impact of these tax improvements totaling 1 percent of GDP is significant, it is not yet sufficient to generate the public sector savings necessary to eliminate the fiscal deficit and encourage strong private sector growth. Indeed, at this stage where the fiscal policy commitment has traditionally begun to waiver, further initiatives to raise tax revenues, combined with permanent reductions in unproductive spending, will significantly improve confidence in the authorities' commitment to fiscal reform.

While declining velocity may indicate that money demand is strengthening, falling real interest rates on deposits and persistent inflation above target levels suggest that monetary base growth is still too fast. Although inflation may be presently stable at around 5 percent per month, the short lag between base growth and inflation observed in the past raises the risk of higher inflation over the coming quarter. As the staff suggests the problem seems to be an inability to meet both inflation and nominal exchange rate targets simultaneously.

Stronger capital inflows are apparently pressing the nominal exchange rate against the upper bound of its target band. The monetary authorities are responding with unsterilized intervention. The staff recommends that the authorities take action to sterilize these interventions through the sale of treasury bills or reverse credit auctions. However, the staff also describes a financial system that is so fragile that interbank loan markets actually experienced bouts of gridlock at the end of last month. In fact, the monetary authorities were forced to inject even more liquidity into the financial system to break the gridlock and prevent market collapse. Although the staff suggests that the market is again operative and interbank loan rates have declined toward more normal levels, the average bid-ask spreads in this market, based on data in Table 29, have increased from 8 percent to 20 percent over the past few months. On this basis, it seems unlikely that the authorities can rely heavily, at this point, on existing banking and financial markets as a robust mechanism for sterilized intervention. I would appreciate the staff's comments on the robustness of banking and financial markets in Russia and on whether or not the Central Bank has been able to reverse the temporary injection of liquidity to buoy interbank markets at the end of last month?

A more reliable approach to ensuring disinflation may be to permit more flexibility in nominal exchange rate movements. As this chair has noted on many occasions, it is real and not nominal exchange rates that reflect trade competitiveness and persistent high inflation will not only result in real exchange rate appreciation, but will also increase ultimate adjustment costs more than otherwise. Furthermore, nominal exchange rate adjustment is a price rationing mechanism, which in this case would help slow the pace of capital inflows to a more sustainable level through nominal appreciation. The authorities may consider widening the exchange rate band further--or even better, eliminating it in favor of hard inflation targets. The empirical link between monetary growth and near-term inflation found in recent studies on the transition economies is sufficiently strong to justify this approach as a feasible alternative. I would appreciate staff's comments on this point as well.

As a final point here, I would add a couple of comments to Mr. Tulin's excellent statement. I believe that he may be too quick to dismiss the prospect of monetary policy failure and higher inflation as a main risk to the success of the program. Unless financial and banking system reforms are quickly and firmly engaged, effective monetary policy, price stability, and strong and sustainable economic growth cannot be achieved as the recent World Economic Outlook has argued. In fact, I was surprised that the staff did not discuss more fully these interactions.

I must admit that I was pleased to see that the authorities were cautious in their reaction to the rather rosy medium-term scenario that the staff outlined in the report. The staff scenario would appear to be an almost best-case scenario where the Fund's advice is quickly implemented and economic conditions--both domestic and international--glide smoothly into stable steady state environments. While it certainly illustrates the upside possibilities of the Fund program, it is, in effect, a 'no stress' test. I would hope that the robustness of the program and the effectiveness of contingency plans have been evaluated in a way that would apply a little more stress on the authorities and the program. For example, a report on the outlook in the event of substantial banking failures and the implications for monetary and fiscal policies might have been a useful illustration of downside risks. I did note a number of debt strategy scenarios based on different rescheduling assumptions, but the fiscal policy and macroeconomic implications were not discussed.

I will finish by urging the authorities to persist in their efforts which have begun to take positive hold on the Russian economy and wish them continued success in their program.

Ms. Srejber made the following statement:

I am very encouraged by the fact that the quantitative targets and performance criteria continue to be observed. It is also encouraging that the most serious risks and concerns mentioned when we adopted this stand-by arrangement so far have not materialized. As I broadly agree with the staff appraisal, I just want to make a few comments.

I am impressed with the firmness with which government spending so far has been kept under control in order to keep the program on track. It is an evidence of the strong commitment to the program, but is clearly not sustainable, as is also acknowledged by Mr. Tulin in his statement. While I welcome the initiatives taken to raise tax revenues, further steps will be needed, together with more permanent reductions in unproductive spending, to bolster the program as well as the confidence in the authorities' stabilization efforts. Thus I agree with the staff that another push in these directions seems required at this stage.

The current level of inflation in clearly too high. The staff argues that the cessation of the decline in economic activity and strong export growth should facilitate the effort to reduce inflation. This may be so, but to the extent that it contributes to more sustainable and tight fiscal policies. I would rather see the causation the other way around; lower inflation supported by sufficiently tight macroeconomic policies, provides the best environment for growth. I think it is fair to say that this has probably been the most important lesson for many countries in transition in recent years, as it is as well in other parts of the world. This also has a bearing on structural policies, as macro stabilization backed up by structural reform is a key element in transition. Here, as said in the staff report, it is necessary to push forward.

Russia has clearly come a long way in the area of privatization, but the effort has to continue. However, the methods how one privatizes are not unimportant and, as said before, the idea that has been put forward--although, as said in the staff report, maybe that has faded a bit in intensity--to let some commercial banks take over enterprises in exchange for lending to the Government is clearly not a good idea.

As we all know, it is not enough with a formal shift in ownership, it is also necessary to improve corporate effectiveness. In this area, further efforts in Russia to strengthen the owner control are necessary. So far, in many cases insiders still have a too dominant influence on how companies are managed. Protection of the shareholders should be further strengthened. This leads me to laws and regulation. These should be implemented in a predictable way and not be subject to ad hoc changes or retroactive implementation if an environment conducive for private initiative and private investment should be developed.

The incomplete land reform and the weak financial sector also hinder increased corporate efficiency, both within industry and agriculture, and clearly here much more needs to be done, although it might be politically difficult with the land reform.

This leads me to comment a bit on the financial sector. Recent problems with failing banks is a sign that stabilization bites. In one way, thus, it is encouraging. Earlier, too many non-serious banks mushroomed in the speculative environment of inflation and currency depreciation. The painful adjustment with losses and bankruptcies that has started is necessary to create a healthy banking system that actually performs its tasks of channeling savings to borrowers. A main risk at present is that the banking sector is to vulnerable to ensure sound monetary policies in circumstances with strong capital inflows; in particular, when the room for maneuver is restricted by the present exchange rate regime. This fragility has been underscored by recent events. Unlike Mr. Clark, I would however not recommend an abolishing of the exchange rate band system at this stage.

I do not want to restart today our eternal discussion of this question; I just want to draw the attention to that in the analysis of stabilization in CIT that we discussed some months ago, we saw that countries in transition that had adopted a fixed exchange rate successfully with the proper backing of sound macroeconomic policies had a faster decrease in the interest rate differentials vis-à-vis abroad.

Turning back after this excursion to the banking sector, it seems clear that appropriate measures are needed in order to address in an orderly way the weaknesses of the banking sector and of the financial markets.

Mr. Schoenberg made the following statement:

We join staff in welcoming the firm resolve of the Russian authorities to achieve decisive progress in stabilization and structural reform to set the stage for sustained growth and development. While we commend the authorities for the success achieved so far, we also have to recognize the uncertainties and remaining difficulties in three important areas, namely inflation, fiscal performance and structural policies.

Turning first to inflation, one has to note, as Ms. Srejber did, that it is still unacceptably high. The objective to reach a monthly inflation rate of 1 percent is in itself only modest; with the current set of policies, we have serious doubts about the attainability and sustainability of that goal. In this connection, I was a little bit worried by Mr. Tulin's sibyllic mentioning of possible "insignificant discrepancies" between the envisaged and actual numbers of the monthly CPI. I hope that the Russian authorities have not abandoned the goal of achieving a monthly inflation rate of 1 percent or less. Turning from inflation targets to the underlying causes of sustained price pressures, the staff document makes it very clear that the inflow of foreign reserves and their sterilization in connection with the exchange rate band were responsible for the overexpansion of the monetary base during the recent months. It seems that the past few weeks have witnessed only subdued activities on exchange rate markets; considering the investment potential in Russia, however, I would venture to guess that capital inflows will soon pick up again, especially since first steps have been taken to resolve the latest banking crisis. Staff states very clearly that even with the additional measures agreed to curb monetary growth, abatement of foreign capital inflows is a key condition to make the inflation target achievable. I have some difficulty in understanding the wisdom of a possible necessity to suppress capital inflows, when the country is in such dire need of foreign investment. It is here once again a great pity that staff and Management have not yet been able to offer the Board a document on the fundamental issues regarding exchange rate options and their benefits and drawbacks. As in many other countries in transition, we can assume that the transition process in itself, with all the structural changes and huge productivity gains involved, leads to a steep appreciation of the equilibrium real exchange rate. If the transition process is to be successfully completed and sustained growth and development are to be achieved, this upward movement of the equilibrium real exchange rate cannot be prevented. The basic policy question is whether to achieve this real appreciation through higher domestic inflation or an appreciation of the nominal exchange rate. I have not heard any convincing arguments which point to a superiority of the inflation approach. In any case, as Mr. Clark rightly observes, it is not possible to meet both inflation and nominal exchange rate targets simultaneously.

Mr. Tulin comments extensively on this point in his statement, and I very much appreciate his efforts to explain to the Board the wider political and economic context in which the recent policy adjustments in Russia have been taken. While I admire his modesty in comparing Russia with Estonia and Latvia, I do not think that this comparison is fully appropriate in this context. Without going into details, it suffices to say that the difference between "big" and "small" countries in exchange rate questions is especially important. Russia is without any doubt actually and especially potentially a "big" country, maybe the only "big" country in transition in Middle and Eastern Europe. The experiences of other, smaller transition economies and the solutions found there may, therefore, not be appropriate for Russia, especially regarding exchange rates. We, therefore, fully support staff's assessment that the authorities would need to consider an adjustment to the band, or to put it more succinctly than staff expresses itself, to free the exchange rate.

I would not argue with Mr. Tulin's argument that the real sector of transition economies is sensitive to exchange rate fluctuations. I would observe, however, that the real sector is equally sensitive to fluctuations in the costs of the domestic factors of production, i.e., wages and interest rates. The transition process will not suddenly become a smooth path, without economic and political bumps and potholes, if the exchange rate is fixed. We only assign other variables the function of "shock absorbers" as Mr. Tulin has very aptly named a flexible exchange rate. Since the room for maneuver in the public budgets is small in Russia, the real economy will have to absorb those additional shocks which the fixed exchange rate passes on mercilessly. The situation of the real sector, therefore, becomes worse, rather than better. I also have doubts whether an appreciating nominal exchange rate, which increases the buying power of the local population in foreign currency terms, should be less popular than a stable ruble exchange rate with accompanying high inflation rates which erode savings and real income, especially of the most vulnerable parts of the population. If economic policy as a whole does not create a climate of trust and stability, no exchange rate band will be able to defend the ruble against capital flight and a subsequent possible devaluation. To sum this point up, if the Russian authorities continue on a stability- and market-oriented economic course, the nominal exchange rate of the ruble should be allowed to appreciate together with the equilibrium real exchange rate.

My remarks on my second point, fiscal policy, can be much shorter. I fully support staff's assessment that the severe compression of expenditures may not be sustainable. While we highly commend the authorities for sticking to the deficit targets, even though revenue development has been adverse, we join staff in urging a fundamental reassessment of the tax base and revenue structure. We want to draw particular attention to the so-called "autumn expenditure fever" we have witnessed during the past few years. Does staff feel that the forces which led to overshooting expenditures are in check this year? Did staff discuss contingency mechanisms with the authorities if such seasonal overspending should again occur?

The third point I want to make concerns the privatization process and developments in the banking sector. We feel that the privatization process has stalled and urge the authorities to introduce more dynamism into their efforts. We would also like to hear staff comments on the so-called "bank consortium proposal" for the interim management of a number of companies, which the staff describes in the document as having "lessened momentum." According to recent newspaper reports, however, a plan which allows private investors to manage the state stake in key companies in exchange for loans was signed into law by President Yelsin two weeks ago. Did the authorities discuss this plan with staff? What is staff's assessment of the basic principles of this scheme? Maybe Mr. Tulin could also offer some helpful comments on this issue, which was not touched on by his statement. Concerning the banking crisis, the situation seems to have returned to normal during the past few days. There is anecdotal evidence, however, that the authorities may try to delay the necessary restructuring in the banking sector, which would lead to closure of some of the 2,500 banks currently doing business in Russia until after the upcoming elections. As experiences in other countries have shown, it is extremely dangerous to try to postpone such a necessary restructuring in the banking sector. It is a bad omen for any meaningful progress in this area if current discussions on reducing banks' capital quotas would be carried further.

This being said, I can agree to the proposed decision.

Mr. Abbott made the following statement:

Russia is making good progress under its stand-by program, and we are pleased to support the completion of the quarterly review. I would also like to compliment the close cooperation between the Russian authorities and the staff in ensuring the success of the monthly monitoring arrangement under this program. I also took a great deal of reassurance from the Acting Chairman's remark earlier that Prime Minister Chernomyrdin had talked with the Managing Director earlier to reconfirm his commitment to the program.

Russia has met or exceeded all quantitative program targets during the five months since the program was approved. Success in reducing the fiscal deficit to 3.4 percent of GDP through July, compared with a program limit of 5.3 percent, is particularly impressive. Results of these efforts are seen in the continued strength of the ruble and steadily falling inflation.

Summer spending pressures have been the Achilles' heel of the Russian budget in each of the past two years. Thus we are particularly encouraged by Russia's strong budget performance through the summer months. However, despite the full observance of the quantitative targets, the economic situation remains fragile. Much work remains to be done to put the budget on a sustainable footing. For the short run, spending compression has compensated for a revenue shortfall, but a more durable and balanced adjustment is needed.

We are encouraged by the authorities' agreement to implement new revenue measures this year, equivalent to about 1 percent of GDP. These additional measures will provide Russia more scope to maintain sound financial and monetary policies while relaxing the unsustainable compression of government spending. The first steps Russia is taking to raise additional revenues from Gazprom will bring the contribution of the natural gas sector to the budget more in line with its wealth and position in the economy. This will represent an efficient and equitable sharing of the tax burden, and a strong signal of the Government's commitment to implement rigorous fiscal policies. We strongly encourage the authorities to follow through fully on the agreed Gazprom measures, both this year and next.

Progress is being made on some structural reforms, including liberalization of the oil sector and foreign trade. Privatization, however, has been disappointingly slow, with little movement over the last year. The staff report indicates the authorities have recently taken steps to accelerate progress on privatization, and we look forward to reports of re-energized activity in this area in future reviews.

We fully support the staff's intention to make structural reform of the banking system an important element of a successor arrangement to this present stand-by arrangement. The collapse of the interbank market last month exposed weaknesses in the banking sector that will become even more unsustainable as stabilization takes hold. Substantial restructuring will be required for banks to assume their proper role as intermediaries between savers and investors.

We share the staff's concern over the slower-than-anticipated fall in inflation. The staff attributed that retardation largely to strong money growth resulting from central bank accumulation of foreign exchange reserves. Money growth must remain a concern while inflation persisted above program objectives. We agree that priority should be given to quickly bringing inflation down to sustained low levels, and on the need to strictly control the growth of Central Bank credit. Monetary developments would therefore require close scrutiny in the future.

Ruble appreciation and reserve accumulation, particularly in May and June in the context of tough financial policies, were evidence of a strong rise in the demand for money. As stabilization takes hold, we should expect remonetarization and dedollarization. In this context, the accumulation of reserves by the Central Bank may be less a source of inflationary pressure than the staff fears. In this context, I would like to comment on the staff's discussion of the relation between monetary policy and the exchange rate regime.

The staff notes that, should upward pressure on the ruble resume, tension may arise between preserving the present ruble exchange rate band and maintaining low rates of growth for monetary aggregates. The staff recommends that, should such a situation develop, the authorities will first need to sterilize their foreign exchange purchases and then to consider modification of the exchange rate band. This is an area where some careful judgment is going to be required.

If ruble appreciation is driven by rising money demand and accompanying dedollarization of the economy, we are skeptical that sterilized intervention will be effective in stemming appreciation pressures or that sterilization would necessarily be the appropriate policy response. At present, the ruble is well within its exchange rate band and has room for further appreciation. However, if new appreciation pressures threaten the band, we believe it would be appropriate to assess carefully the underlying strength of money demand and await carefully the trade-offs between adjusting the exchange rate and meeting some of the pressure through reserve accumulation.

In conclusion, let me recommend the Russian authorities for their successful economic performance and urge them to persevere in their efforts during the coming months. We also welcome the report that discussions between the staff and the Russian authorities on an extended arrangement are under way, and we encourage both parties to work hard to develop a solid successor program to the present stand-by arrangement.

Mr. Kiekens made the following statement:

I would like to join previous speakers and the staff in commending the Russian authorities for their good performance in implementing their stand-by program, and meeting all quantitative targets for the first few months of the program. This illustrates the authorities' strong commitment to reform.

The authorities did not have to wait long for positive developments in the real sector to materialize. The decline in the real GDP has been halted, and it is even expected to grow somewhat during the rest of the year. Both exports and imports have registered strong growth, reflecting the revival of economic activity in a number of sectors, as well as growing consumer confidence. Although troubling in itself, the substantial increase in unemployment does clearly show that enterprise restructuring is actually taking root.

Mr. Tulin's statement and the staff report highlight two major disappointments which threaten the program--namely, the slower than expected pace of disinflation and the lamentable situation in the fiscal area. I will first focus on these two important issues and then make some comments on structural reform.

Even though inflation has been declining steadily since the beginning of the program, monthly inflation is still substantially above the program expectations. In what nowadays appears to be a CIS-wide phenomenon, large capital inflows are complicating the conduct of monetary policy. If these inflows are not sufficiently sterilized, the rapid growth of net international reserves causes broad money to rise sharply. This, in turn, becomes a major source of inflation.

Both the authorities and the staff recognize that the major reason for Russia's inflation subsiding more slowly than envisaged is that base money is growing faster than expected. By my own calculation, reserve money stood 33 percent higher at the end of July than had been foreseen under the monetary program. I wonder, therefore, why the authorities' supplemental letter of intent contains no indicative targets for reserve money or any other broad monetary aggregate.

Let me make clear that I am not advocating targets for reserve money. On the contrary, given the complexity of the factors which, over time, determine the optimal size of monetary variables--including the demand for money, velocity and the money supply--I believe that elevating such targets into performance criteria would create undesirable rigidities. However, I would still have preferred to see an indicative target for reserve money, as was recently introduced in the revised monetary program for Kazakhstan and proposed by the Turkish authorities during the review of their stand-by arrangement.

In their supplemental letter of intent, the authorities write: "To control the growth of money supply in the context of the exchange band regime that has been adopted, we have decided to revise downwards the ceiling on the stock of net domestic assets of the monetary authorities as well as the limits on the stock of net claims of the monetary authorities on the federal and the enlarged government. As set out in the attached table, revised targets have also been set for the stock of official net and gross international reserves." In fact, in their proposal for new performance criteria, the lower ceiling for net domestic assets would be more or less offset by raising the floor for net international reserves. I therefore fail to see how these new performance criteria provide the Fund with greater assurance that reserve money will be controlled better from now on than in the past.

I would also like to point out that, under the staff's projections for the monetary accounts in Table 7 on page 38 of the staff report, net international reserves are estimated at 24.5 trillion rubles at the end of September, and 21 trillion rubles at the end of December. However, the newly proposed performance criteria for these aggregates are 6.9 trillion rubles for end-September and 5.9 trillion rubles for end-December, or approximately 28 percent of the projected amounts. I wonder whether the proposed performance criteria are sufficiently relevant for monitoring the implementation of the program.

That being said, I welcome the authorities' intention to keep the growth of base money within limits consistent with the projected inflation. The authorities are probably correct in expecting that seasonal fluctuations and projected decreases in net international reserves during the second half of 1995 will help them to slow the growth of broad money. But upward pressures on the ruble may still persist and may even be augmented by the present restrictions on the growth of net domestic assets. In the worst case scenario, the authorities will have to intervene substantially to defend the existing exchange rate band, and will be forced to absorb the significant quasi-fiscal costs of the accompanying sterilization operation.

In the fiscal area, Russia's situation is worrisome. The impressive firmness of expenditure control and the ruthless cutting of federal expenditures--which satisfy the form without improving the substance--are not sustainable. Although I am somewhat encouraged by the new package of fiscal measures to which the authorities have finally agreed, their prospects seem rather grim. Indeed, one of the principal potential sources of government revenues--eliminating loopholes in taxation of the gas sector--will not be fully implemented until next Summer.

On structural reforms, I welcome the narrowing of the gap between the domestic and international price of oil. This reduces an important source of distortion between Russian enterprises and enterprises in other CIS countries. I therefore join the staff in calling on the authorities to promptly implement the reduction of export duties, which will further narrow the energy price gap.

I notice that the list of public enterprises whose privatization will continue to be restricted is now complete. Can the staff provide further details on the nature of the enterprises on this list and their overall economic importance? Can the staff estimate what fraction of all enterprises has already been privatized? Finally, what are the prospects for speeding up the privatization of land ownership?

The Russian stabilization program has successfully passed its first test, and I agree with the proposed decision. The upcoming parliamentary elections and the seasonal rise of spending pressures represent a further set of difficult obstacles which the authorities must overcome to preserve the integrity of the program. I wish them every success.

The Acting Chairman requested clarification from the staff representative on the apparent inconsistency of the program targets for net international reserves.

The staff representative from the European II Department noted that the figures in Table 7 of the staff report, to which Mr. Kiekens had referred, were expressed in trillions of rubles. The figures in Table 3, on which the performance criteria and indicative targets under the program had been based, were expressed in billions of U.S. dollars. Therefore there was no inconsistency between the net international reserve targets under the program and those underlying the monetary framework.

Mr. Shields made the following statement:

I join others in stressing how delighted I am that we are at this point in the first quarter review, having seen all the performance criteria been met and having witnessed demonstrations over the last few months of a very strong commitment to the reform program. The Government is moreover intending to stay within the program at very high cost in terms of the cuts in real expenditures which have been achieved this year.

I think the authorities' performance has been more than credible. I am also very happy to note a much greater willingness, than under previous Russian programs, to maintain the dialogue with the staff regarding new developments and issues as they arise. Obviously, that has been helped by the system of monetary monitoring, which does seem to have operated very well in revealing problems at an early stage. I would like to commend the authorities for having accepted this close monitoring process and having worked so well within it.

There are obviously two major areas of concern. I refer to the failure of inflation to fall as fast as the program envisaged, and the dramatic growth in broad and narrow money. As others have already noted, we are seeing here, as with a number of FSU economies, the problem of determining the right stabilization program. When I say "right," I mean in terms of what targets are most appropriate, bearing in mind the possible inconsistencies between monetary based stabilization--involving at least implicit base monetary targets--and exchange rate based stabilization. I do not have very strong views on which is the most appropriate approach. But I do believe that it is always important for the authorities to know which aspect of the stabilization should receive their dominant attention. In exchange rate stabilization it is critical to remain aware of what is happening to monetary growth; and, by contrast, with a monetary target there is a need to pay attention to information provided by the exchange rate itself.

What worries me in this program is the switch that has occurred during the last few months. We have witnessed the authorities' success in maintaining the exchange rate band, but alongside that success lies the worry about what will happen when the exchange rate comes under severe pressure. My guess is that, allowing for shifts in money demand, there will be downward pressure on the exchange rate leading to re-entry problems.

Obviously, in trying to minimize these potential difficulties, the crucial element of the program will be to maintain firm control of the fiscal deficit and net domestic assets. I therefore welcome the adjustments made to the program to ensure that the room created by the undershooting of Central Bank credit to the Government in the first quarter will not be allowed to result in excessive credit growth to government in the second half of the year. However, I do note that there has not been an equivalent tightening in the fiscal deficit target itself.

When looking at the operation of policy, and the need to adhere to base money and net domestic asset targets, the crucial question is the cost of sterilization operations. I think that is the reason why one needs to constantly reassess the whole thrust of the program in terms of its ultimate objective of bearing down on inflation.

In the staff report, there is mention of these monetary conflicts, but I thought in a slightly muted style, and I would have appreciated a more graphic presentation of the pressures on monetary policy, and particularly the staff's views on how appropriate the decision was to implement an exchange-rate band. I appreciate the warnings presented in the report concerning what to do when pressures arise. Nevertheless, I think there is great benefit in laying these things out as explicitly as possible.

Lastly, on monetary policy, I was wondering about the strain expected on treasury bill sales over the next few months, given the revised program and given what happened to liquidity as a result of the banking crisis.

On the details of fiscal policy, I commend the authorities for adhering to the tight deficit target. On the other hand, as the staff points out, there is the issue of sustainability. I appreciated Mr. Tulin's very candid comments about the difficulties in the fiscal area, and the need to improve revenue collections. So I welcome the revenue measures set out on page 9 of the staff report. My worry is that, given the past implementation record, these measures may not raise the required revenue. I certainly hope I am proved wrong on that.

As far as the 1996 budget is concerned, there are reservations quite clearly expressed in the staff paper about the preliminary status of next year's budget. I would like to have seen more numerical elaboration of the issues involved, for example, on the desired budget targets for next year.

Turning to structural policy, clearly there has been much improvement in the oil export regime, although it is not yet a fully transparent and market-based system. I was surprised that there was not more information on structural policies in the staff paper, given that we are completing an Article IV consultation today. Obviously this is a crucial element of the extended arrangement, and so I am looking forward to more information on this subject. I note the comment that a lot of papers have been prepared for the extended arrangement, so the earlier we can see those, I think, the better we will feel about it. I hope particularly that these papers will include details on agricultural reform, an area which seems to be lagging far behind.

On the staff paper itself, I have a couple of comments. I am normally very much in favor of Article IV reports being short and pithy, but we are looking here at a major world economy and a major debtor. I would like to have seen a more substantial Article IV report in this case. I have mentioned some areas where I thought there could have been more information, for example, on the current account projections and on developments in the real economy. It is important in the case of Russia that we maintain both the depth and breadth of our coverage.

Lastly, one thing the staff paper mentions very clearly is the recent banking crisis. It has been clear for some time that the number of banks needs to be reduced, and it is preferable for adjustments to happen sooner rather than later. So far I can commend the authorities' approach and look forward to more improvements in banking supervision and regulation. In conclusion, I believe the authorities have done exceptionally well this year, but there are many obstacles ahead. In particular, I think the announcement about the exchange rate band means that the authorities have set themselves a very public and a very ambitious objective. I wish them every success.

Mr. Wijnholds noted that had the staff made greater use of graphic illustrations and numerical enumeration, as Mr. Shields had requested, the circulation period for the Russia staff papers may have been considerably shortened. The six-day circulation period was already considered quite short and was understood to be an exception to the normal rule.

The Acting Chairman said that the Russia case was considered an exception to the rule by management. However, the bulk of the staff work had been completed somewhat earlier than six days prior to the board meeting. The Board's concern over this exceptionally short period would be noted.

Mr. Autheman made the following statement:

I found this short staff report excellent. It was well preceded, indeed, by the short and straightforward monthly review we discussed earlier. I support the proposed decision and, like previous speakers, I welcome the significant progress achieved under the present stand-by arrangement. There is now serious hope that the passage through the feared third quarter, which has been such an obstacle in previous arrangements, can be negotiated successfully. This would be a major achievement which would strengthen Russia's credibility.

There are still many remaining problems, mostly the disappointing performance in the area of inflation and the worrying continued decline of revenue performance. We are all aware that management's task in its discussions with Russia is quite difficult, since management is caught between the staff's well-argued preference for money-based policy and Russia's obvious preference for an exchange-based policy. I will therefore address this dilemma. I hope that the Acting Chairman will be able to draw some guidance from the great variety of views he will hear today.

We all know that a money-based policy can be extremely effective in the short run to combat inflation, because the correlation between inflation and money growth is well documented in Russia. But we have also learned that a program based on the control of monetary aggregates does not create sufficient political pressure to rein in, on a lasting basis, the fiscal policy. Furthermore, we know that it would be illusory, not to say dangerous, for the Fund to try to maintain money-based programs while the authorities have decided to follow an exchange rate policy.

We all know also that an exchange rate based program in the case of Russia would in the short run weaken the fight against inflation. Among other reasons are the potential impact of inflows of funds, the limited room to manoeuvre of fiscal policy, the limited degree of influence of the Central Bank on market interest rates, and possibly the fragility of the banking system. I am, however, prepared to look with an open mind at the argument presented by Mr. Tulin that an exchange-rate-based program can provide a very strong political tool to strengthen the credibility and sustainability of fiscal stance.

The staff skepticism is fully appropriate, and I encourage Mr. Horiguchi to remain a skeptic. I hope that Mr. Tulin will acknowledge that the burden of proof is on Russia's side. I expect that the Russian authorities will continue to press for an evolution of their program in the direction of one based on the exchange rate. I would therefore point to three fundamental conditions which need to be agreed for the Fund to be able to support such an approach.

First, we must be confident that there will be a resurgence of revenue, and on this the jury is still out. The package of additional measures is welcomed, but it remains of relatively small magnitude compared to the undershoot of revenue with respect to the forecast in the first half of 1995, and we cannot expect at this stage an orderly reversal of revenue decline. In this regard, the fact that the elimination of Gazprom's tax deductibilities, which had been promised or expected at the time of this review, has been once more postponed is a matter of serious concern.

Second, there are direct links between the stability of the exchange rate and the health of the banking system. By moving toward a more stable exchange rate, the authorities would deprive many banks of their only source of profit, and therefore it is essential that we reach a common understanding that the Russian authorities are ready to address forcefully the needed restructuring of the banking sector, which would imply in my view a lot of bank closures.

Third, we would need to be confident that there is no expectation by the Russian authorities that the adoption of an exchange rate based program would bring higher financing from the Fund. Indeed, such expectation would be counterproductive since it would weaken our confidence that the main criteria of the Russian authorities is their resolve to strengthen their fiscal policy stance.

I would add one related aspect to this condition. We need to consider whether the Russian authorities are presently overfinanced, or run the risk of being overfinanced in the future, especially if the success of the program leads to the resumption of capital flows. At the present time, if I understand the monetary tables correctly, the Central Bank does not provide, except when there is an emergency situation, any net financing to the banking system. This leads to a decoupling of the interest rates set by the Central Bank and of market interest rates, which seriously affects the effectiveness of monetary policy, especially in the defense of a given exchange rate arrangement. Therefore, an exchange rate-based policy could not be considered if we are not confident that this risk of overfinancing, for which we may be partly responsible, is not fully addressed.

Mr. Zhang made the following statement:

It is encouraging to see that the authorities have made notable progress in implementing the current economic program, as evidenced by the progress in arresting the decline in output, a stronger balance of payments, and a more stable exchange rate. As shown in the comprehensive staff paper, all the quarterly performance criteria and the monthly indicative targets under the program have been observed, which undoubtedly represent a significant improvement compared with the previous programs with Russia under the STF.

However, the authorities are faced with daunting challenges in fully completing this program, particularly in accelerating the pace of disinflation. Although monthly inflation has been moderated in recent months, it still remains in excess of the program objective, a result primarily of the expansion of base money prompted by a rapid accumulation of international reserve. Under this circumstance, it is warranted to make certain adjustments to the program.

The revised program calls for a tight monetary and credit policy to achieve a marked reduction in monetary expansion. However, as the staff has noted, there is a possibility that the restrained pace of credit expansion could produce further pressure toward an appreciation of the ruble, and if sterilized intervention goes beyond the authorities' capacity, would jeopardize the sustainability of the exchange rate band. This possibility raises the issue of the relative importance between the two goals of fighting inflation and preserving the exchange rate band, when they cannot be met simultaneously. We would appreciate the staff's elaboration on the feasibility of realizing the inflation objective while preserving the band. As Mr. Tulin emphasized in his very helpful statement, since the stability of the ruble exchange rate is a popular political goal in the society, we think it is very important for the authorities to defend the exchange rate band by all possible means, but not at any cost. Once there is evidence that the sterilized intervention has gone beyond the authorities' capacity and the actual inflation performance has fallen far short of the envisaged objective, the authorities would need to consider the staff's recommendation of fine-tuning the exchange rate band.

Fiscal policy is crucial to the satisfactory completion of the revised program. The need for improving the fiscal policy has become more important in helping sustain confidence in the exchange rate band. Given that the compression of expenditures has been heavily burdened in meeting the fiscal deficits targets, which casts doubts on the sustainability of the fiscal adjustment effort, the urgency of reversing the poor revenue performance cannot be overemphasized, and it is time to implement a supplementary package of revenue measures. The authorities are urged to take firm actions to achieve the revenue collection objectives. In addition, it is necessary for the authorities to pursue continued adherence to a tight expenditure plan under the seasonal spending pressures.

Any effective policy should be supported by parallel institution building, particularly for transition economies. In this context, I share the view expressed by Mr. Tulin in his statement, that the new policy measures on the revenue side will only reap satisfactory results when supported by an efficient system of taxation based on the modern accounting system and strict enforcement procedures. The authorities are encouraged to continue their efforts in improving the taxation system, and further Fund technical assistance would be helpful to facilitate this process.

The authorities are commended for making considerable progress in structural reforms, particularly the liberalization of the trade and oil sectors. Further efforts are encouraged to significantly increase the market orientation of the Russian economy and lay a solid foundation for attaining positive growth as early as possible.

With these remarks, I support the proposed decision and wish the authorities success in implementing the program. We believe that the successful implementation of this program will pave the way for the Board to consider and approve a Fund-supported extended arrangement to Russia.

Mr. Schoenberg, echoing a question previously asked by Mr. Zhang about the exchange rate target and monetary growth, noted that the staff's analysis demonstrated clearly the problems encountered when the Russian authorities had switched to a different stabilization policy. A number of Directors emphasized the incompatibility of an exchange rate target and a money supply target, and argued that capital inflows should be sterilized. However, based on past experience, it was clear that sterilization of capital flows was not a sustainable solution over the medium term. Moreover, as Mr. Clark had argued, the present state of the Russian financial system was not very conducive to the efficient sterilization of capital inflows on an ongoing basis.

Mr. Abbott said that there was a risk of drawing too fine a distinction between the various stabilization approaches. The program was based on an assumption of a reduction in the velocity of circulation of about 8-10 percent. With growth estimates subject to a certain degree of uncertainty, it would be difficult to prejudge the degree of sterilization that might or might not be desirable. Mr. Schoenberg's comments appeared to imply a far more stable demand for money than could be justified under current conditions.

Mr. Fernández remarked that he fully supported Mr. Schoenberg and Mr. Clark with regard to the stabilization approach. It was curious to him that the stand-by arrangement remained intact even though the authorities had made a fundamental shift to an exchange rate based stabilization strategy, even in face of the staff's clear preference for a monetary base stabilization strategy. There was also the problem of forcing the authorities to deal with the inconsistency of supporting an exchange rate rule while at the same time having to observe monthly inflation targets. A note from the staff concerning the economics of the fixed exchange rate rule would be helpful to clarify future discussion.

The Deputy Director of the European II Department stated that the authorities had assured the staff that there would be no autumn spending burst. However, the authorities expected less of a spending compression than in the first half of the year. In that regard, the staff would welcome a small increase in spending, because the current level of about 13 percent of GDP relative to the annual programmed average 18 percent of GDP, was not sustainable. The authorities' strategy had been to curtail spending during the first half of the year so that a higher level of expenditure could be supported later in the year. They were also committed to maintaining the nominal budget deficit target of between 5.5 to 6 percent of GDP, in spite of generally stronger growth in economic activity.

While there had been little discussion of possible contingency measures so far, the authorities' revenue package, entailing about 1 percent of GDP of additional revenue, did provide some breathing room, the Deputy Director remarked. However, many of the measures the authorities would have liked to introduce would require approval by the Duma, and that was a time-consuming process.

Extensive discussions had already taken place on the broad parameters of the budget for 1996, the Deputy Director confirmed. The authorities envisaged increasing budgetary revenues by about 2.5 percentage points of GDP for the period. Continued discussion would be necessary to iron out precisely which revenue measures would be feasible and in line with recommendations of a Fiscal Affairs Department technical assistance mission that had occurred in July. A constructive dialogue was fully anticipated. In the event of a revenue shortfall, the authorities remained committed to further spending compression.

Responding to a question about the underlying inflation assumption in the budget forecasts, the Deputy Director said that about 1.2 percent per month on average had been assumed. A successor program could call for a somewhat lower rate of inflation, but that was to be discussed at a later time.

Mr. Shields asked whether the monthly inflation target of one percent by the end of the year was realistic.

The Deputy Director of the European II Department responded that both the exchange rate and money supply growth had thus far behaved according to program objectives, giving cause for some optimism that the rate of inflation may reach the target of 1 percent per month by the end of the year.

With regard to the taxation of Gazprom, about Rub 3.5 trillion worth of revenue was expected during the four-month period remaining in 1995, the

Deputy Director continued. More than half of that amount was to be derived from an increase in the excise tax rate to 35 percent, and the abolition of all the tax deductibility of transfers made to the Gazprom Stabilization Fund.

Regarding structural issues, a presidential decree had recently been issued setting out the modalities of a bank consortium arrangement, covering inter alia the method of collateralization of loans by participating banks, the Deputy Director stated. The staff were in the process of studying the details of the scheme.

The most critical element in the stabilization fight was the rate of growth of the money supply relative to the rate of growth of money demand, the Deputy Director said. For that reason, the staff had emphasized the deceleration of money base growth, and also broad money growth. However, capital flows in the second and third quarters had complicated the task of reducing the money supply. Since the exchange rate band had been introduced in early July, the exchange rate had remained comfortably within the band, and had not been interfering with the control of the money base. However, the question persisted of how to deal with a further bout of pressures toward appreciation. On that subject, the staff view was that the government could consider changing the exchange rate band if necessary.

Mr. Abbott asked whether any change in the money multiplier had been factored into the staff estimates.

The Deputy Director of the European II Department replied that the consequence of the central bank's failing to issue credit to ailing banks had been a tightening of monetary conditions. That in turn implied a decline in the money multiplier and a somewhat smaller growth rate of broad money relative to the monetary base. The authorities' reaction to the banking crisis in August had spurred the staff's confidence in their monetary policy stance. Moreover, the Central Bank was monitoring the situation closely and was preparing itself for any contingency should more insolvent banks fail.

Under the current program, monthly monitoring was executed done on the basis of indicative targets for the deficit and net domestic assets, the Deputy Director remarked. However, formal program reviews, rather than performance vis-à-vis indicative targets, were the vehicle for approval of purchases.

In response to Mr. Schoenberg, the Deputy Director of the European II Department said that the staff had not developed a view on the medium-term equilibrium exchange rate. Real exchange rates over the long run were not a monetary phenomenon, and were more related to what happened to such fundamental economic variables, such as productivity growth.

With regard to treasury bills, the treasury had to forgo one auction in the aftermath of the August banking crisis, the Deputy Director continued.

Since that time there had been a steady decline in interest rates that were now oscillating between 120 percent and 140 percent. Those rates were no different from the rates prevailing prior to August. However, the apparent interest rate stability should not be taken as a sign of total stability in Russia's banking sector. It should also be borne in mind that the volume of interbank transactions had declined to about half its previous level, and that decline could have implications for liquidity in other segments of the money market. However, some analysts saw the contraction in the volume of interbank market transactions as a healthy sign that the banking system was capable of discriminating between poor-performing and efficient banks. In fact, the interbank market came into existence only about 18 months previously with about ten large banks as the main transactors. Smaller banks had gradually been incorporated into the interbank market. The subsequent sorting-out process was viewed by the staff as a healthy sign in terms of the longer term efficiency of the interbank market.

Looking at the economy as a whole, the level of capital inflows and the relatively strong current account balance had given rise to substantial increments in net international reserves, the Deputy Director stated. The strength of the current account meant that the economy was adequately financed. By contrast, because of weaknesses in revenue performance, there remained a question of how to pay for the Government's external debt obligations. Therefore, a distinction was needed between the two financing perspectives.

Mr. Autheman asked whether sterilization of capital inflows was costly from the fiscal point of view.

The Deputy Director of the European II Department responded that since both the Central Bank and the Ministry of Finance were recipients of Fund disbursements, there was an accounting problem in isolating who bore the cost of sterilization. But, the staff was not of the view that the pace of Fund disbursements should be slowed down to ease the cost of sterilization.

The staff representative from the European II Department remarked that several categories of firms were not on the eligibility list for privatization. Those were largely natural monopolies in the gas, railroads, and electrical power sectors. The staff had estimated that about half of the medium- and large-scale enterprises now had a state ownership share of less than 25 percent. In addition, about 80 percent of small-scale firms had been privatized. Prospects for land reform remained very difficult, although the staff was hopeful that in the context of the successor extended arrangement, major progress could be made in that area. Possibilities for reform were intricately linked with the broader economic problems of the agricultural sector.

The staff representative from the Policy Development and Review Department said that there had been several staff papers on the general issue of exchange rate policy and, more specifically, on the degree to which countries used nominal anchors. In those papers, arguments for and against exchange-rate-based versus money-based stabilization had been taken up at length based on extensive literature on the subject. In addition, there had been a paper by the Research Department in 1990 that was the first to summarize extensively the analytical arguments on various exchange rate policy strategies. The latest conditionality review also explored the question based on an analytical comparison of the experiences of about 15 countries using nominal anchors, and 20 countries that did not use nominal anchors. More recently, a paper on the experience of the Baltic countries, Russia, and the other countries of the former Soviet Union had been discussed in the Board in February. On related issues, there had been a Board seminar two years previously on exchange rate strategies for dealing with capital inflow surges.

It was difficult to form a strong view on the equilibrium medium-term exchange rate, the staff representative said. However, there was an assumption in the medium-term scenario that there would be constant relative unit labor costs after 1995. Moreover, effective stabilization had been associated with an appreciation of the real exchange rate in almost all of the Baltic countries, Russia, and the other countries of the former Soviet Union.

Mr. Mesaki made the following statement:

Like previous speakers, I commend the Russian authorities for having pressed ahead with economic reform based upon the stand-by arrangement program and for having achieved impressive results. Although only five months have passed since the approval of the stand-by arrangement, it seems that people are beginning to change their view on the firmness of the authorities' commitment to economic reform. I believe the enhanced credibility accounts for the recent exchange rate stability.

I also commend the members of the Russia team for their dedication to their work. They go to Moscow every month and perhaps spend more time talking to the Russian authorities than in talking with their families. It is impressive that they continue to produce excellent papers despite the extremely tight mission schedules.

As important points have already been covered, and as I agree with most of the staff's views, I will make only a few comments.

Despite the recent favorable developments, the current level of inflation is still too high. It is welcome that the staff and the authorities reached an agreement on the revised program for more speedy disinflation. However, as the staff rightly points out, stronger monetary measures for disinflation could have repercussions on the behavior of the exchange rate under the band regime. The staff suggests interventions with sterilization operations; however, I share the authorities' concern over the possible fiscal costs of sterilization operations. The authorities should be prepared to consider an adjustment to the band in case appreciation pressures are beyond sterilizing capacity. This provides another basis for an argument against a nominal anchor system.

Immediate priority should also be given to revenue measures. I fully commend the authorities' recent decision to implement a new revenue package. However, it is clear that the authorities should do more. Although ambitious revenue measures are likely to face strong political resistance, I would emphasize that the successful introduction of significant revenue measures will be essential for sustained macroeconomic stability. I fully support the view of management and the staff that the elimination of the tax deductibility of all of Gazprom's transfers to its stabilization fund should be a prior condition for the next arrangement.

With these remarks, I support the proposed decision.

Mr. Martinez Oliva made the following statement:

I am convinced that the positive results yielded to date by the stand-by arrangement are remarkable and, as previous speakers have pointed out, witness the Russian authorities' commitment and ability in vigorously pursuing the set of measures agreed with the Fund. The outcome in terms of continuing stabilization, incipient growth recovery, and stronger balance of payments and exchange rate is sizable and cannot be overlooked.

Nonetheless, the risks underlying the program are still significant, and I appreciate that both the clear staff paper and Mr. Tulin's excellent statement are fairly outspoken in this respect. In particular, I share the concerns expressed by Mr. Clark and other speakers that the consequences of a failure of the monetary program--constrained by the managed exchange rate regime established in July and confirmed in August 24--may be extremely painful and that such a possibility cannot be neglected.

The announcement of the ruble exchange rate band was founded on the basic assumption that there is room in the Russian economy for sufficient sterilization measures. These measures, such as reverse credit auctions by the Central Bank or additional sales of Treasury bills, may prove to be not as easy as originally envisaged--in the wake of the recent banking crisis--and could bring about undesired policy effects, particularly a rise in government bond yields and a more difficult noninflationary financing of the budget deficit. Therefore, depending on the feasibility of efficient sterilization operations, and the willingness of the authorities to bear the cost of them, a conflict might arise--in case of pressures against the lower limit of the band stemming from capital inflows--between the defense of the exchange rate and the recognized circumstance that the slower than expected reduction of inflation has been chiefly due to a sharp increase in the net international reserves of the monetary authorities from exchange rate interventions. Pressures toward ruble appreciation are anything but theoretical, given the credit tightening required by the program, and, like Mr. Schoenberg, one wonders if resisting is the best choice.

This is not to come to the conclusion that the strategy chosen by the authorities is inappropriate. As Mr. Tulin observes, many countries in transition have somehow adopted explicit or implicit managed nominal exchange rates. I would like just to recall the doubts expressed by this chair on other occasions about the timing and actual sustainability of currency pegs. These caveats, and the need for strong, consistent policies supporting the adoption of managed exchange rate regimes are all the more compelling in a moment when the Fund is preparing to sustain member countries which engage in exchange-rate-based stabilization programs by providing substantive financial assistance.

The exchange rate anchor, which the Russian authorities seem to be inclined to progressively adopt, would imperatively require further restricted room of maneuver for the fiscal policy, which will need not to rely any more on expense sequestration--clearly unsustainable over the long run--but on a much improved tax collection. Moreover, a firm attitude against deficit spending pressures will have to be displayed at the very moment in which seasonal tensions and the parliamentary elections approach. Finally, the banking crisis which struck the financial system in the last week of August needs to be carefully managed by avoiding excess liquidity injections, drastically improving supervision and accountability and inducing a much-needed consolidation of the sector through mergers, takeovers and, if needed, some bankruptcies.

With these remarks, I can support the proposed decisions and wish the Russian authorities every success in their endeavors.

Mr. Saito made the following statement:

At this stage of the discussion, I will limit my remarks to just a few points for emphasis.

The staff reports and other speakers have clearly highlighted the important progress made by the Russian Federation in reducing inflation and implementing structural reforms in the period 1992-94, supported by financial arrangements from the Fund. The loosening of policies that began in the second quarter of 1994 leading to the acceleration of monthly inflation to 17.8 percent in January of this year also points to the fragility of the effort to sustain the process of macroeconomic stabilization and to consolidate credibility regarding the future course of economic policies. Nonetheless it is encouraging that the authorities have stayed the course and that both the quarterly performance criteria as well as the monthly indicative targets under the program have been observed.

In this context, I consider the decision to introduce a monthly monitoring of the 1995 program appropriate in terms of results and to help maintain the focus of policies on bringing inflation down and on accelerating the move to a market economy to reduce both the economic and social costs of transition. I also agree with Mr.Tulin that the Russian authorities have demonstrated "the seriousness," if not yet sustainability, "of the current stabilization efforts" and deserve the continued support of the international community.

Difficult challenges lie ahead in the context of the still high monthly inflation rate and the severe compression in public expenditure in nominal and real terms, which cannot be viewed but a short-term response to a disappointing public revenue performance. As the staff and other speakers, I share the emphasis placed on the strengthening of public revenue and welcome the authorities decision to eliminate tax deductions and exemptions and to address the fundamental problem of tax compliance. In this context, I would also endorse the call for accelerating the pace of privatization not only in view of its contribution to deficit reduction but to improved efficiency through badly needed modernization to enhance competitiveness. These actions are all the more important in light of the deliberate policy shift toward greater exchange rate fixity as a means of anchoring expectations. The recent introduction of an exchange rate band while clearly restricting degrees of freedom also generates a window of opportunity for strengthening fiscal policy and for eliminating distortions through structural reforms, which ultimately underpin macro-economic stability. Given the seasonal spending pressures, the uncertainties associated with parliamentary elections and the difficulties in the banking sector, it is to be hoped that Fund staffs assessment which I share, may translate into concrete policy action to improve confidence and sustain the adjustment effort.

In closing, I support the proposed decisions and wish the Russian authorities well at this crucial stage of the stabilization and reform effort.

Mr. Al-Tuwaijri made the following statement:

I join other Directors in noting the progress made by Russia in reforming its economy during 1995. As indicated by the staff report, the authorities have met all end June performance criteria, as well as July quantitative indicative targets specified under the stand-by arrangement. Indeed, the fiscal position was substantially stronger than programmed on both the federal and local levels. Moreover, it is encouraging that the decline in output has been arrested.

These developments notwithstanding, a number of challenges persist. As noted in the staff paper, inflation remains too high and the sharp reduction in expenditure continues to cast doubt on the sustainability of the fiscal effort. These are important concerns, since slippages in the fiscal area have been the weakest link in previous stabilization efforts, and pressures to raise spending usually intensify in the fall. Therefore, the authorities are urged to enhance revenues and be resolute in resisting pressures to increases expenditures. In this connection, the authorities' decision to implement a new set of additional revenue measures is encouraging. In addition, further strengthening of the revenue administration should remain a priority.

Addressing the continued high inflation is also a priority. Under the current exchange rate regime in Russia, failure to reduce inflation sharply would lead to real effective exchange rate appreciation and reduced competitiveness. This could have a negative impact on the budding signs of growth. the staff comments on this issue will be useful. I am also interested in the staff comments on the realism of their expectations regarding the sharp reduction in inflation by the last quarter of this year especially in view of the new set of revenue measures that are being implemented.

On structural reform, the progress made in tariff reforms and in exchange system liberalization are welcome. The slow progress on legislation that clearly defines the rights of land ownership, however, is disappointing. Accelerating this process is essential, for the development of property rights throughout the economy. The privatization process also needs to be accelerated in order to enhance efficiency and to contain the pressures emanating form interenterprise arrears. Moreover, emphasis should be placed on reforming the banking sector. Without a sound financial system, the ability to conduct monetary policy effectively will be greatly hampered, as noted by other Directors.

In conclusion, the Russian authorities have made good strides in adjusting and reforming the economy in 1995. It is essential however, that the pace of adjustment be sustained and that the authorities intensify their efforts to normalize relations with all of their creditors.

With these remarks, I support the proposed decision and wish the authorities success.

Mr. Koissy made the following statement:

Reflecting the decisive efforts undertaken by the Russian authorities, under the present stand-by arrangement, significant progress has been made with regard to macroeconomic stabilization and structural reforms. In this respect, there is much to be optimistic about recent developments in the Russian economy, especially regarding the indications that economic decline has stopped and that growth of exports and imports have been strong. These together with the decline in inflation and a more stable exchange rate indicate that the basic elements for economic recovery are being laid down.

I would like to join others in commending the Russian authorities for their sustained implementation of the measures envisaged and for complying fully with the quantitative indicative targets. I am also encouraged by the authorities' readiness to implement additional measures in the key areas of the economy so as to ensure that the program's targets for the last quarter of 1995 are met. Meeting of these targets will be crucial to the credibility of the Russian authorities' efforts.

Notwithstanding the impressive efforts of the authorities, weaknesses remain. Of major concerns are the shortfall in fiscal revenue, higher than programmed inflation and the issue of monetary policy and its effects on exchange rate policy. Previous speakers and the staff have commented in depths on these issues. I generally share the concerns that have been expressed.

On the issue of fiscal revenue, I would like to add that while I note the willingness of the authorities to introduce additional revenue measures, I also note the doubt expressed by the staff concerning the revenue projection. This doubt seems to be confirmed in Mr. Tulin's informative statement where he explains that the lack of compliance is mostly due to a large number of technical factors. In the event, it would seem that more attention needs to be given to these factors, before any medium term program can be put in place, and Mr. Tulin's call for further technical assistance in this area is well placed.

With these comments, I support the proposed decisions, and hope that the main elements of a medium term program that could receive Fund support can be put in place soon, so as to accelerate the transition of the Russian Federation to a market economy.

Mr. Kafka made the following statement:

We would like to congratulate the Russian authorities on achieving all program targets.

The staff believe that achieving a sharp reduction in inflation over the remainder of the year would require a marked reduction in monetary expansion. Mr. Tulin's statement clearly shows the authorities' willingness further to reduce the original program target of the average base money growth for the remainder of the year. We understand the authorities' decision, nevertheless, to use a nominal exchange anchor-based approach to stabilize the economy, reflecting the extreme sensitivity of the population to exchange rate fluctuations. However, if an exchange rate anchor is to be successful, Russia may have to rely a good deal on sterilization of capital inflows, which will increase the quasi-fiscal deficit and/or call for more revenue or less expenditures. How much margin is there for such policies? Certainly, the present width of the exchange rate band should not be narrowed, other things being equal. We support, to use a hallowed phrase, the thrust of the rest of the staff recommendations.

We agree with the proposed decision and commend the efforts being made by the Russian authorities, and wish them well.

Mrs. Gotz-Kozierkiewicz made the following statement:

Overall, I agree that the Russian authorities have committed themselves to far-reaching stabilization measures. The announced fiscal measures should strengthen revenue performance. Efforts to address the fundamental problems of low tax compliance will help to not only strengthen the fiscal position, but also to sustain confidence in the authorities' commitment to stabilize macroeconomic conditions. The revised monetary program to accelerate the pace of disinflation should also contribute to this aim. Like other speakers, I would however like to point out that the recent banking crisis could potentially undermine the stabilization efforts. The monetary authorities must maintain a tight reign over financial policies and avoid a bailout of ailing banks. Parliamentary elections are up in December, and a major financial crisis could have political consequences. Financial sector reforms are therefore urgently warranted. In this regard, I welcome the planned tightening of banking supervision by the monetary authorities. After these general comments, allow me to focus my remarks on three issues which in my opinion deserve particular attention. All of them concern--directly or indirectly--short-term capital inflow.

Attention to the latter issue is justified not only by its ever increasing importance in recent years, but also by the scale of potential risks and costs associated with it.

Short-term net capital inflow, quite substantial in the second quarter after huge net inflows in 1994, has been one of the major factors responsible for the monetary policy scenario in 1995 and represented the main source of increase in monetary aggregates. They put considerable pressure on both monetary and fiscal policies and limit their efficient use to bring inflation down very quickly to its targeted rate. According to the staff, at current interest rates, sterilizing US$1 billion increase in net international reserves would entail an interest cost of about 1/2 percent of GDP. I have some doubts with regard to the staff assumption that net capital inflow for 1995 will amount to $2.5 billion of which only 0.7 billion in the second semester.

I think these figures are underestimated for reasons I shall give in a moment. But if this is the case, and short-term capital inflow turns out to be significantly higher, then the cost of shifting stabilization efforts toward fiscal policy under sterilized intervention is likely to become disproportionately high.

Indeed, with continued stabilization efforts that even increased in the second half of 1995, a perverse effect is likely to come to existence from the pursuit of restrictive monetary and fiscal policy. Under these circumstances, short-term capital net inflow may grow rather than be reduced.

The chance to reduce the monthly inflation rate to about 1 percent in the short period left until the end of 1995 seems to be rather low. This will limit the scope for interest rate reductions enough to significantly diminish profitability of short-term capital investment.

Moreover, the perverse effect on short-term capital inflow comes also from the expected nominal appreciation of the exchange rate of the ruble against the U.S. dollar.

My second point is that the exchange rate regime, actual and foreseeable in the not very distant future, offers an example of certain inconsistencies in its development.

Between May and August, we saw a high real appreciation of the exchange rate, if measured by the index of relative prices between Russia and the United States. This real appreciation, critical, as it appears to be from the point of view of export promotion in the medium to longer term, may be not that negative in the short period--when taking into account the deep reduction in wages in some months, at least months covered by the staff review in 1995. A question may be raised, however, if such a real appreciation should be taken for granted if the main underlying factor would be short-term capital inflow.

A rapid growth in short-term capital inflow cannot be recognized as justifying a real appreciation of the exchange rate, in spite of the fact that its actual impact on the exchange rate level may be like this. A justification for a real appreciation should be rather looked for in an autonomous long-term capital inflow as a part of the mechanism of transfer of financial resources. Therefore, the eventual strengthening of the exchange rate of the ruble as nominal anchor in terms of its real appreciation caused by short-term capital inflow should be assessed as very doubtful.

The authorities, faced with two options--high costs of sterilized intervention on the one hand, or an adjustment to the band on the other, in case short-term capital inflow should continue on a substantial scale in the second half of 1995--decided to choose the first one.

This means that under the target of reduction of the overall deficit of the "enlarged" government and of federal government, the additional cost of sterilized intervention would have to be offset by further reduction in noninterest expenditures which have already been cut by 20 percent below program in the first semester of 1995.

In case, when an adequate sterilized intervention does not take place, the expected higher inflation should be taken into account as an almost unavoidable cost.

As far as the government deficit is concerned, let me just remind you of the fact that this deficit would be bigger in case the general international rules in the value-added tax assessment, i.e., the country-of-destination principle, had been accepted by the Russian Federation.

There has been a relatively high and growing export surplus in the trade of the Russian Federation with the other former Soviet republics. As long as the Russian Federation applies the country-of-origin principle in the value-added tax, it takes advantage of additional tax revenue at the cost of less revenue in importer countries.

With these remarks I wish the Russian authorities every success in their efforts.

Mr. Wijnholds said that he agreed with the staff appraisal and supported the proposed decision. He stressed that abandoning the exchange rate band soon after having introduced it would erode the credibility of the Russian authorities. However, in the case of Russia, the importance of exchange rate considerations might not be quite the same as in some other transition countries with more open economies.

A move toward an extended arrangement for Russia would make sense as it would enable Russia to complete the main elements of its transition, and could also assist the authorities in their struggle with nonreformist parties to have a longer-term agreement with the Fund, Mr. Wijnholds added. However, it should be stressed that, before moving toward an extended arrangement, inflation would need to be reduced further to bolster the success of reforms in other areas, particularly structural reforms.

Mr. Fernández made the following statement:

I will make a few brief points in addition to my previous intervention. First of all, I am very pleased by the answers of the staff concerning my questions. I like the staff's pragmatic position has helped clarify my own views with regard to the intervention of Mr. Autheman. Also, I continue to share the views of Mr. Schoenberg and Mr. Clark. I believe the staff response does not contradict these views. In particular, I would suggest that what is recommended on page 8 of the staff paper, with regard to the matching of targets and instruments, be included in the summing up, because I believe it is a very reasonable and pragmatic compromise.

Finally, I would like to ask what is the envisaged role of the interest rates if support of the exchange rate is eventually needed? Irrespective of the monetary target debate, I believe fiscal discipline will be required. In this area, I fully support the views of the staff. Finally, I agree with the proposed decision and, as others, I also found Mr. Tulin's excellent statement very informative and helpful.

Mr. Jones made the following statement:

It is encouraging that the program is helping to lay the foundation for a coherent medium-term adjustment strategy that could be the basis for continued Fund assistance to the Russian Federation. I note, in this regard, the progress recorded on the inflation front and the structural reforms aimed at further liberalizing the economy. It is important at this juncture that the authorities stay the course, especially with regard to the exercise of financial restraint, which is critical to the attainment of a stable macroeconomic environment.

The authorities have made the effort to comply with the quantitative indicative targets and performance criteria. This is a plus for the strict monitoring procedures attached to the stand-by arrangement. The economy has also shown positive performance in a number of key areas: export growth has been strong; net international reserves have gone up substantially; and the deficit of the federal government is down. However, the economy continues to reveal some fundamental weaknesses. GDP is expected to fall further in 1995; the rate of unemployment continues to rise; the financial system is being strained by the rise in the number of loss-making banks; and revenue is below expectation, something which casts a shadow over the ability of the authorities to sustain the pace of fiscal adjustment. At some point, the economy will suffer adverse consequences from too deep a cut in expenditure, especially if productive investment is held back. Clearly, improvement in revenue performance is critical, and steps in this direction should not be limited to just adding on more and more taxes. Priority should be given to improving tax compliance.

The medium-term outlook of the staff is encouraging, but seems rather optimistic. For instance, the strong growth projection assumes, among others, a rapid improvement in the efficiency of investment and confidence on the part of foreign investors. Both of these require that the authorities be prepared to take even stronger actions over the medium term.

Finally, I welcome the preparatory work that is under way as part of the effort to map out a medium-term program. It is important that sufficient attention is paid to the question of reviving and sustaining growth, necessary for preventing adjustment fatigue and maintaining the political consensus that is needed to quicken the pace toward a market-oriented economy.

I with the authorities success in their endeavors.

Mrs. Cheong made the following statement:

I compliment the progress made by the Russian authorities under the program and welcome what seems to be a more concerted commitment to the program. As most of the points have been raised by Directors, I will mention a few specific issues.

In the monetary area, the rapid monetary expansion and inability to sterilize goes deeper than the cost consideration. Several Directors, Ms. Srejber, Mr. Clark--and later very well articulated by Mr. Autheman--raised the issue of the relationship between the health of the banking system and efficacy in implementing monetary policies. About six months ago, when discussing progress of adjustment in transition countries, many

Directors agreed that a sound institutional set up, especially in the banking sector, is critical to successful implementation of monetary policies. The staff says that in the short term, present developments in the banking sector will not compromise program targets. But the Fund program is not short-term; rather, it is designed to establish a strong foundation for long-term economic stability. Therefore, I would attach greater significance to the need for reform in the banking sector than that accorded by the staff.

The problem in this area is that work on reform of the banking sector is being undertaken by the World Bank. Lack of progress in this work, will in the long term, constrain development and deepening of the financial sector that will make implementation of monetary policies difficult. I feel that there should be greater coordination in this area between the two institutions.

On the exchange rate issue, this chair has raised many times before, the wisdom of recommending appreciation of the exchange rate to address the short-term capital inflow problems. In past deliberations, we have stated that appreciation of exchange rate due to capital inflows would be destabilizing for smaller countries, a point detailed by Mrs. Gotz Kozierkiewicz in her statement. However, in the case of larger countries, I sense that this same policy stance will also be equally destabilizing.

In the fiscal area, reduction of the deficit through cut-backs made only on the expenditure side could have significant implications on future growth, as this will likely mean very low capital expenditure. On revenue collection difficulties, Mr. Tulin, in his frank statement, mentioned that the poor revenue performance was due to outdated accounting systems in the taxation area. The issue is not that tax collection systems are out-dated. What is important is that there should be a proper tax accounting system. For example, very old systems inherited from the British Administration are still good working system. The more relevant issue is that such systems should be properly implemented. More assistance to probably modernize these old systems is required. It is not necessary to have completely new systems.

Mr. Mirakhor made the following statement:

Without repeating their arguments and explanations, I share other Directors' concerns about the speed of disinflation, challenges in domestic resource mobilization, the pace of privatization and financial sector fragility. The unanimity among Directors in their appreciation of the Russian authorities' achievements, is noteworthy. We are all conscious of where Russia was just a year or two ago and also where it could have been without the admirable resolve of the authorities to undertake the painful task of adjustment to bring order to their economy.

As the authorities and the Fund continue their vigilance, the authorities deserve all the encouragement commensurate with their exceptional resolve to forge ahead with their stabilization and reform efforts. The staff certainly seems to believe that the authorities are up to the task and we look forward to Executive Board discussion of an extended arrangement.

We support the proposed decision.

Mr. Mohammed stated that he agreed with the staff appraisal and supported the proposed decision.

The Deputy Director of the European II Department remarked that the Central Bank was equipped to undertake potentially extensive sterilization operations. However, the question remained about the quasi-fiscal cost of sterilization operations. Given the constraints on interest rates, now higher than 100 percent, any sterilization operations would be associated with a large fiscal cost.

There had been large capital inflows in the first half of the year, the Deputy Director confirmed. However, those inflows were accompanied by a large real appreciation of the ruble. In the second half of the year, short-term capital inflows should be more subdued. However, should that assumption prove faulty, and capital inflows were larger than anticipated, the authorities would have to engage in sterilized intervention, subject to further consultation with the staff.

With regard to the role of interest rates in support of the exchange rate band, the authorities were fully aware that they could not fix both the exchange rate and the interest rate, the Deputy Director said. Interest rates in Russia were essentially free of administrative intervention except for a limited number of deposit rates in some state banks. Market rates were not subject to intervention, and the authorities were fully prepared to let interest rates play their appropriate role in resource allocation.

The authorities were determined to tackle the question of the longer-term health of the banking system, the Deputy Director added. Moreover, banking system issues were to figure prominently in the next monthly staff visit.

Cooperation between the Fund and the World Bank had been very productive, the Deputy Director concluded.

Mr. Tulin made the following concluding statement:

I have already paid my tribute to the staff in my initial statement, but allow me add a few words not only in appreciation of its efforts but also in defense of complaints by some Directors about the late release of the staff report. You can imagine that, among other members of the Board, I was even more concerned about this delay. But I ultimately took a philosophic approach. Since we urged the staff many times in recent months to strengthen surveillance, this probably is an illustration of strengthened surveillance even if the convenience of the Board members was to be sacrificed in the process.

My opinion can be challenged by management that the staff could have released the report at least a week before without violating any legal or procedural rules, but they wanted to be on the safe side and wait for further measures on the part of my authorities. Such zeal should not be admonished.

I am also very thankful to Directors for their support of the program at this stage and for their most helpful comments. The summary of today's meeting will be submitted to my authorities, and I am sure they will be very interested in reading all your comments and remarks. I think they will be especially moved by Mr. Autheman's concerns about being overfinanced or the possibility of being overfinanced in the future. This will probably give them an opportunity to look upon their problems from a totally different angle.

To be brief, may I take the liberty of elaborating on some of the answers to the questions posed today. Although I am in full agreement with the excellent answers provided by the Deputy Director of the European II Department and the staff representative of the Policy Development and Review Department, I could add some local flavor to the analysis of the situation. I will concentrate on the banking sector issues and their possible repercussions on the implementation of the program.

The authorities promptly reacted to the crisis of liquidity or the crisis of confidence in the banking sector, and the measures they undertook were timely and efficient and absolutely consistent with the program. At the same time, many observers and experts in Russia still think that these were only the first signs of major difficulties in the banking sector, and that liquidity problems can be caused by the poor quality of the assets of the commercial banks, that is, the growing proportion of bad loans in their portfolios. These problems are familiar to many countries emerging from a recession and, at the same time, undertaking bold stabilization efforts. This phenomenon may have a neutral, or even a favorable, impact on the program provided that the authorities are professional enough in tackling the problem. In the future, some surgery operation may have to be made upon the banking sector.

I was impressed by the shrewdness of Mr. Autheman's observation that a number of banks will be deprived of their revenues because of the stability of the ruble exchange rate. Certainly I could reject his concerns, saying that, for example, such insignificant banks are not worthy of our attention. But I would sacrifice my integrity, because I know by experience that even large and solid banks in Russia used to rely on this revenue.

Moreover, the banks could also make their profits at the expense of corporate customers, because corporate customers in Russia are not so sophisticated in foreign business. However, the overwhelming majority of transactions effected through commercial banks were made on a best-effort basis. I expect that pressures on the banking sector will grow, and this will be a major challenge for my authorities.

I have a few words about the impact on the credit multiplier. The immediate result of the difficulties in the banking sector was that major banks were urged to increase their free reserves to levels higher than they had been before the crisis. I do not know how this phenomenon can be translated into an assessment of the size of the monetary base. If we use the broader definition, under the name of reserve money in this institution, the credit multiplier would likely decline in the medium-term. Banks will have to be more prudent and they will have to take all the necessary precautions to have their loans repaid.

Again, I am very thankful for today's discussion.

The Acting Chairman made the following summing up:

Executive Directors agreed with the broad thrust of the staff appraisal and commended the Russian authorities on their strenuous efforts to stay the course of stabilization thus far in 1995. The progress achieved had been impressive, especially seen against the record under previous Fund-supported programs and the conditions prevailing at the beginning of the year. There were signs that the real economy had finally begun to recover from its collapse since 1991, and inflationary pressures had eased considerably. Nonetheless, important challenges remained, most notably bringing inflation down in a decisive manner, continuing successfully to hold expenditure firmly in line against the fall spending pressures, pushing ahead with fiscal reforms, and addressing more vigorously a wide range of structural issues. The hope was expressed that progress would continue at a sufficient pace, and in a way that would establish a track record for a successor extended arrangement.

Directors particularly commended the resolve with which the authorities had pursued the goal of fiscal deficit reduction as set under the program. Despite a very weak revenue performance, expenditure had been severely compressed to ensure that the monthly deficit targets of the Federal Government in nominal terms had been met with ample margins through July. At the same time, however, Directors expressed concerns over the sustainability and possible economic costs of that compression.

Noting that the fiscal situation remained fragile, they stressed that permanent reductions in unproductive spending, together with measures to improve revenue performance, were urgently needed. They welcomed the revenue package introduced recently by the authorities, but thought that more needed to be done to ensure the viability of fiscal policy over the medium term. Directors noted that it was important to follow through on revenue measures relating to the gas sector in order both to increase revenues and to spread the tax burden more evenly. In that connection, Directors urged the authorities to bring forward the timing of the elimination of the tax deductibility of all of Gazprom's transfers to its stabilization fund; indeed, some Directors indicated that the total elimination of this tax break as well as the increase in the gas excise tax to 35 percent should be prior actions for a successor arrangement. Directors also emphasized that the beneficial effects of new revenue measures could only be fully realized with strong efforts to address the fundamental problem of low tax compliance.

Directors underscored that the further reduction of inflation must remain the policy priority. It was noted that the present inflation rate remained excessively high and that the growth of the monetary base needed to be firmly restrained. Directors stressed that the monetary authorities would have to pay particularly close attention to the operation of the exchange rate band. They cautioned that, should the restrained pace of credit expansion envisaged in the revised monetary program bring with it further pressures toward ruble appreciation, such pressures would have to be met by intervention, which in turn would need to be accompanied by sterilization operations. A number of Directors, however, took the view that should inflows continue on a scale that was beyond the authorities' capacity for sterilized intervention and further fiscal measures--with a clear risk for undermining the disinflation process--the authorities would need to consider an adjustment to the band. Some Directors questioned the appropriateness of sterilization, given the possible shifts in money demand that accompany the disinflation process. Some Directors also questioned the feasibility of maintaining the exchange rate band and sticking to the revised money growth path needed for a visible disinflation simultaneously. Those Directors thought that greater exchange rate flexibility and the use of an inflation target might be more effective in achieving the stabilization objective. All Directors emphasized the need to keep exchange rate policy under continuous review, and for the authorities to remain prepared to make adjustments if necessary.

Directors expressed concern over recent difficulties in the banking system, which highlighted the problem of bad loans that were, in general, likely to emerge in the transition process. Directors broadly agreed with the authorities' policy of providing needed liquidity support to the banking system while eschewing bail-outs. At the same time, Directors encouraged the authorities to take strong steps to improve banking supervision and accelerate reforms that would lead to the restructuring of the banking sector. Many Directors also expressed concern that the fragility of the banking sector might seriously complicate the pursuit of a tight monetary policy needed for disinflation.

While noting the evident progress in liberalizing the oil export regime, Directors expressed continued concern about problems in that sector arising from a lack of transparency. In a number of other structural areas, Directors urged the authorities to accelerate the pace of reform, notably with respect to land reform and privatization.

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

The Executive Board took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision in concluding the 1995 Article XIV consultation with the Russian Federation, in the light of the 1995 Article IV consultation with the Russian Federation conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Russian Federation maintains restrictions on payments and transfers for current international transactions, described in EBS/95/149 (9/8/95), in accordance with Article XIV, Section 2. The Fund encourages the Russian Federation to eliminate these measures as soon as its balance of payments position permits.

Decision No. 11067-(95/87), adopted
September 14, 1995

Review Under Stand-By Arrangement

1. The Russian Federation has consulted with the Fund in accordance with paragraph 3(c) of the stand-by arrangement for the Russian Federation (EBS/95/46, Sup. 3) and Section XII of the

Annex to the Statement on Economic Policies for 1995 attached to the letter from the Chairman of the Government of the Russian Federation, dated March 14, 1995.

2. The letters of the Chairman of the Government of the Russian Federation and the Acting Chairperson of the Central Bank of the Russian Federation dated August 25, 1995 and August 31, 1995, respectively, shall be attached to the stand-by arrangement, and the letter dated March 14, 1995, with the attached Statement on Economic Policies for 1995, as modified, shall be read as supplemented and modified by the letters dated August 25, 1995 and August 31, 1995, respectively.

3. Accordingly, the performance criteria set out in paragraphs 3(a)(i), 3 (a)(ii), 3(a)(v), and 3(a)(vi) of the stand-by arrangement for the Russian Federation for September 30, 1995 and December 31, 1995 shall be as specified in the table attached to the letter dated August 31, 1995.

4. The Fund decides that the fourth review contemplated in paragraph 3(c) of the stand-by arrangement for the Russian Federation is completed. (EBS/95/149, 9/8/95)

Decision No. 11068-(95/87), adopted
September 14, 1995

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/95/86 (9/13/95) and EBM/95/87 (9/14/95).

2. ADVISORS TO EXECUTIVE DIRECTORS - REMUNERATION

The Executive Board approves the recommendation to increase the remuneration of Advisors to Executive Directors as set forth in EBAM/95/47 (9/8/95).

Adopted September 13, 1995

3. 1995 ANNUAL MEETING - EXECUTIVE BOARD - REPRESENTATION EXPENSES

The Executive Board approves the recommendation of the Committee on Executive Board Administrative Matters concerning representation expenses at the time of the 1995 Annual Meeting as set forth in EBAM/95/146 (9/8/95).

Adopted September 13, 1995

APPROVAL: May 13, 1997

REINHARD H. MUNZBERG
Secretary