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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 98/68

10:00 a.m., June 25, 1998

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

S. Fischer, Acting Chairman
S. Sugisaki, Deputy Managing Director

Executive Directors

A.A. Al-Tuwaijri

R.F. Cippà
B. Esdar

D.Z. Guti
K.A. Hansen
A. Kafka
W. Kiekens
K. Lissakers

J.-C. Milleron

G. O'Donnell

K. Yao
Y. Yoshimura

Zhang Z.
A.G. Zoccali

Alternate Executive Directors

M.F. Melhem, Temporary
C.X. O'Loghlin
W. Szczuka
W.-D. Donecker
A. Giustiniani, Temporary
J.M. Jones, Temporary
O.-P. Lehmussaari
O.L. Bernal, Temporary

B.S. Newman
M. Sobel, Temporary
R. Fernandez
M. Daïri
A. Vernikov
J. Shields
W.F. Abdelati, Temporary
A.G. Karunasena
M.A. Cilento, Temporary
J. Guzmán-Calafell
N.K. Gueorguiev, Temporary

C. Harinowo

A.S. Linde, Acting Secretary
P. Cirillo, Assistant
N.M. Hairfield, Assistant

Russian Federation—Extended Arrangement—1998 Program, Review, and Waiver of Performance Criteria
Staff representatives: Citrin, EU2; Schadler, PDR

Also Present
IBRD: H.G. Broadman, D. Pearce, Europe and Central Asia Regional Office. European I Department: M.C. Deppler, Director. European II Department: J. Odling-Smee, Director; B.J. Aitken, G. Bélanger, D.A. Citrin, S.P. Panth, M. Shadman-Valavi, Y. Sun. External Relations Department: S.J. Anjaria, Director. Fiscal Affairs Department: P.S. Heller, Deputy Director; H. M. Petri. Legal Department: R.B. Leckow. Monetary and Exchange Affairs Department: C.H. Dziobek. Policy Development and Review Department: J.T. Boorman, Director; J. Fernandez-Ansola, S.M. Schadler. Research Department: F. Larsen, Deputy Director; E.R. Borensztein, B. Eichengreen, A.J. Richards, J. Zettelmeyer. Secretary's Department: B.A. Sarr. Statistics Department: C.S. Carson, Director. Treasurer's Department: D. Williams, Treasurer; H. Flinch. Western Hemisphere Department: C.M. Loser, Director; M.E. Bonangelino, Deputy Director. Office of the Managing Director: M. Russo, Special Advisor; B. Christensen, O.J. Evans; Office of Internal Audit and Inspection: E. Brau, Director. Advisors to Executive Directors: C.M. Gonzalez, J. Jonáš, J.M. Jones, H. Ogushi. Assistants to Executive Directors: Awang G.G., M. Carlens, A.L. Coronel, H. Hagan, S. Hinata, S.K. Keshava, K. Kpetigo, T.-M. Kudiwu, K. Lai, A. Lucenti, A. Lushin, J. Mafararikwa, S.D. Melese-d'Hospital, D. Merino, J. Nelmes, H. Paris, O. Schmalzriedt, U.Y. Tilyayev, I. Zakharchenkov.

1. REPORT BY FIRST DEPUTY MANAGING DIRECTOR

The First Deputy Managing Director reported on his recent travel to Brazil and the Russian Federation.

The First Deputy Managing Director made the following statement:

I visited Brazil at the end of last week to take part in a seminar in Saõ Paolo on the Brazilian economy, and on the way stopped for a day in Brasilia for extensive discussions with members of the economic team. I also met with President Cardoso.

In meetings with the economic team, which included the board of the central bank, we discussed a variety of issues, including the fiscal difficulties that they face and the fact that the deficit is likely to be about the same as last year's—that is, the general public sector borrowing requirement will probably be somewhere between 6 and 7 percent of GDP. While the deficit was 6.3 percent last year, it is currently running at a rate of 7 percent, but it is expected to decline to close around last year's level by the end of the year, as the effects of the high interest rates during the final quarter of 1997 diminish. We also discussed the structural measures, including social security reform, fiscal federalism issues, and civil service reform.

The authorities emphasized that, while the budget numbers were worrying, they were likely to improve as a result of the decline in interest rates. Most importantly, they emphasized that, in terms of debt dynamics, with privatization revenues running at $16 to $18 billion a year, which is over 2 percent of GDP, financing of the budget is much less of a problem than it would be in other circumstances. They also expressed the hope that they have time, as the underlying changes bringing the state government budget deficits under control begin to take effect.

We had extensive discussions with the central bank authorities on issues of debt management and on whether introducing dollar-linked and overnight-rate-linked market instruments would be sensible. They argued that, at a time when the gap between these rates and those on rates in domestic currency instruments was so large—and, they thought, unwarranted—there was not much danger in continuing their current practices, and that they would have major beneficial effects on the budget. All these things are true, and it is a problem we confront in many countries—namely, if such practices work, then they are very successful; if they do not work, then one pays a high price. It just increases the risk all around, particularly when the debt is dollar-linked (domestic interest rate-linked debt is a less serious concern). The authorities argued that the dollar-linked instruments were being held mainly by Brazilians, not by foreigners, and, since they were payable in domestic currency, they did not pose the sort of risk that the Mexican tesobonos had during the Mexican crisis of 1994-95. As we have seen in other cases, it is not inevitable that the domestic residents stay in domestic currency instruments when trouble arises.

We discussed what would be done if there were another attack on the currency. There is no doubt that the entire team and the President will defend the currency.

I also had a useful meeting with the chief banking supervisor, which confirmed the Fund's Monetary and Exchange Affairs Department's assertion that the Brazilians have improved their banking supervision significantly over the past three years.

In the meeting with the President, he asked about the Fund's analysis of what was happening in the world capital markets and how it related to his country. As a former finance minister, he has a firm grasp of the economic issues. We also had an interesting discussion of the income distribution issues in Brazil, where there have been some important changes. For instance, infant mortality has come down at a significant rate in this decade and the coverage of primary education has expanded rapidly, which is one of the priorities the President has set for himself.

At the seminar, the speakers included the Finance Minister, Professor Fishlow, now of the Council of Foreign Relations, and the head of the Brazilian privatization effort. There were very lively and serious questions, and a lot of interest in what the Fund was doing and how we saw the situation in various other countries. Also, there was great sensitivity in Brazil to what was happening in Russia. All in all, I came away with the view that we were dealing with a very sophisticated economic team that understands quite well what it is doing, that is pushing for the right things, that is having some difficulty with the Congress in getting the right things done, that possibly a few years ago missed its opportunity to push harder on the fiscal side, and that this government will fight very hard if there is an attack on the currency. In terms of certain areas, like the banking system, it is moving quite fast to do the right things to reduce the vulnerability of the system in the event of an attack.

From Brazil, I traveled to Ukraine, where I was accompanied by Mr. Odling-Smee, Mr. Shadman-Valavi, and the Fund's Resident Representative. We met with the Prime Minister, the Deputy Prime Minister in charge of the Fund-supported program, the governor of the central bank, and the President, as well as with a group of parliamentarians. The original aim of the visit was to meet these parliamentarians and explain to them what the IMF was about and why they should support the EFF that the government has signed.

The meetings with the government went well. For the first time in many years, the government of Ukraine and the President have decided that it is essential to get the EFF in place and to undertake the measures that are needed to have the EFF accepted. There is a list of prior actions, and the President decided to go the route of decrees to enact many of the prior actions done, which has not been done before. Of the several meetings I have had with the President, this was by far his most decisive and impressive performance. He started sending these reform measures to the Rada last week. The people we spoke to thought that he had a good chance of getting most of them accepted and that they would probably not be challenged on legal grounds or by the legislature, but that will take about a month to confirm. If those measures go through—we do not know the complete details, but apparently there were a few that may not have been fully in accord with the program—they would go a long way toward meeting the prior conditions. It was a very different tone in Ukraine about what needed to be done and what they hoped could be done. This, of course, is in part because of the urgency of the crisis that confronts them.

We met a group of parliamentarians from a variety of parties. Unfortunately, the meeting took place on the day they were trying to elect the Speaker, so we did not have as much time for serious discussion as we had hoped. All the speakers, bar one, raised very interesting questions and truly wanted to know what the Fund was about. The "bar one" was a person who was described to us as having made a career out of opposing the IMF in political rallies. She made a speech in which she said she had followed our "crimes" closely and she knew exactly what we were about. I answered fairly strongly. But she was followed immediately by someone from the Communist Party, who said, "I want you to know that they represent less than 4 percent of the Rada. They do not speak for the left. We understand there are serious issues here. We have our view. You have different views. We would like to discuss them with you. We could support the right policies." So it was a constructive meeting, and I had the feeling that, if we had had more time, we could have helped this process of trying to get them on board for the program and could have helped it progress more than we possibly did. We also met with a group from the Harvard Institute for International Development, which is also advising the Ukrainian government.

So, in Ukraine we have a situation which is different than we had expected; namely, they have agreed to the conditions for the EFF, and they are now doing everything they can to get them in place. It will take a month before they know whether that can be done, because that is how long these decrees have to run before it is clear whether they will be in place, and there remains a question of whether the budget can be implemented by decree or whether, if it were put to the Rada, it would be approved. But it was very different than had been expected and than it had been in the past, so we can look with very cautious optimism—because it is a complicated situation—at the possibility that we may have a stronger Ukrainian program, certainly, than we anticipated just a few weeks ago.

From Ukraine, I traveled to Russia on Monday, June 22. As you know, Mr. Chubais has been appointed to negotiate with the international financial institutions, including the Fund. I was accompanied there by Mr. Marquez-Ruarte and the Resident Representative, Mr. Gilman. We met for a total of about seven hours with Mr. Chubais in a day and a half, and with the Prime Minister, the Finance Minister, the central bank governor, Mr. Fyodorov, who has been appointed to collect taxes, the chairman of the Duma finance committee, and other officials.

The day after we arrived, the government announced its anticrisis program. We were not given details, but were told the night before that it would be announced on Tuesday, June 23 and were given a rough description of it, but we have not yet had a full analysis. Clearly, it does some useful things, and some which are possibly more difficult to understand. In any case, we made it clear that we need to analyze it very carefully. We do not, for instance, know whether it will reduce or increase the budget deficit, nor were we convinced that the Russian authorities have done those calculations. So the first item for the staff after this Board meeting will be to analyze what is in that program. I had gone there hoping to get discussions started on the possibilities of increased financing from the Fund, in exchange for a significant strengthening of their program, but we spent most of our time discussing the prospective $690 million tranche to be considered for release under the EFF.

As you know, there were three conditions. There was the memorandum of definitions and information that would be provided to the Fund by the central bank. There was a question of oil pipeline access, and there was a question of the treatment of large tax delinquents. The issue of the information provision was essentially settled by Monday and was finally settled on Tuesday, in discussions between the staff and the central bank, which claimed, possibly with reason, that there had been a misunderstanding about this whole issue and that there had never been any intent of not providing the requested information. In any case, that issue was settled fairly easily.

On the oil pipeline access, we settled that issue late on Tuesday night in negotiation with Mr. Chubais and Mr. Kiriyenko. They have published the letter that has been sent to the 13 oil companies and have announced that they expect that several companies will have their access to the pipeline cut on July 1, 1998. As you recall, the agreement was that, if these companies did not pay the taxes, they would be denied access to the oil pipeline. I must confess, as I sat there arguing about how we announce who is going to have access to the oil pipeline, I thought about being a monetary institution—as Mr. Esdar has often reminded us—and worrying about why the IMF has to discuss this, but the answer is that almost no one is paying taxes, and you have to find some route—and we have tried so many—to get the payment of taxes accepted as an obligation in Russia.

On Wednesday, June 24, we met with the Prime Minister and the entire economic team for about two and a half hours, and started by agreeing on the process by which the large companies could pay their taxes. That is one possibility, which we hope is the outcome. The others include bankruptcy and the seizure of assets. The government had to decide how to deal with these. We thought we had a clear understanding yesterday morning. Mr. Odling-Smee tells me there have been more complications today, but we believe now we have the issue finally settled. That will be explained at the beginning of the discussion on Russia.

The rest of the discussion was on the possibilities of enhanced support from the IMF if Russia significantly strengthened its program. We spent about an hour and a half on that, and we basically said there were two conditions under which we will provide further assistance. The first condition would be the decisive settlement of the budget problem, so that the continuation of this fiscal problem finally stops, and that we have a sufficient improvement in the budget that we do not yet again run into situations where a deficit agreed at 5 percent of GDP comes in at 6 or 7 percent and financing becomes impossible. We explained that their situation was somewhat like the position of Italy in the early 1990s, in the following sense: one-third of budget expenditure is interest, and interest rates are very high, and if they could make progress on the primary budget deficit, then they would get the benefit of a multiplier effect by having interest rates come down. So they are in a position in which things could improve more rapidly than just the effort they make on the primary budget. So the situation, which looks daunting in terms of the deficit, is one which is driven entirely by interest rates. The budget deficit is approximately equal to interest payments. With average interest rates about 30 percent, the interest payments account for 5 percent of GDP. If rates came down significantly, that would lead to a large change in the budget situation.

The second condition would be the rapid revitalization of the structural reform program so that economic growth could resume. I noted that we were willing to enter into negotiations. However, we were not certain that they would succeed because we had a fear that they had essentially done everything they could on the fiscal front and that we could not count at the moment on enhanced tax enforcement making a significant difference, although the meeting with Mr. Fyodorov was certainly impressive. He pointed to recent media attention on raids on tax delinquents, and he said that he would do everything he could within the limits of the law to increase tax collection. But those things take time to carry out, and we would need to see measures and effects on the budget before we could go ahead with additional assistance. This was the first meeting with the Prime Minister, and it was also impressive. Negotiations were very straightforward. He was completely in control of the material and straight to the point. I thought it boded well for the negotiations, but there remain major questions about what Russia is capable of doing.

Fortunately, Mr. Chubais had been quoted that morning in the media that he thought the negotiations with the Fund could take one to two months, which helped us because we were pleased to support his statement rather than promise rapid delivery. Mr. Marquez-Ruarte will remain in Moscow and will be joined by the Russian team, if the Board votes to release the next tranche. They will first analyze what is in this anticrisis program, and then continue the discussions. The World Bank in the meantime has sent the Russian authorities a proposal for their next Structural Adjustment Loan, which would be an important contribution to the financing of reform efforts. There is no question, as in the case of Ukraine, about what the government wants to do. The question is what it can deliver.

2. RUSSIAN FEDERATION—EXTENDED ARRANGEMENT—1998 PROGRAM, REVIEW, AND WAIVER OF PERFORMANCE CRITERIA

The Executive Directors considered a staff paper on the 1998 program and seventh quarterly review under the Extended Arrangement for the Russian Federation (EBS/98/100, 6/12/98; Cor. 1, 6/17/98; Sup. 1, 6/12/98; and Sup. 2, 6/24/98).

The staff representative from the European II Department made the following statement:

> I would like to provide further clarification to the remarks made by the Acting Chairman during the report on his travel. On one of the prior actions that had remained to be completed over the last week, we stated in the supplement to the staff report circulated yesterday that the Emergency Tax Commission would meet on June 30 to take action against five more firms, all belonging to the top 20 tax delinquents. The authorities were to have made an announcement to that effect yesterday. In fact, the announcement that they had made was somewhat different. They stated that three companies would be considered at the meeting, which actually is to take place on July 1, not June 30, but the three companies named were not amongst the largest tax debtors. We had extensive discussions with Mr. Chubais over the course of today on this issue, and the authorities have agreed that on Monday, June 29 the bankruptcy agency would decide on actions to take against six companies. They would either immediately initiate bankruptcy proceedings or send these companies to the Emergency Tax Commission for consideration on July 1. Of these six companies, three are amongst the 20 largest debtors and the other three are amongst the largest 50 debtors. So the action that they had taken to complete this prior action is somewhat different from what had initially been envisaged.

Mr. Vernikov, speaking on behalf of Mr. Mozhin, made the following statement:

> The staff has provided us with a thoughtful and well-written report, which is a testimony to their in-depth knowledge of the Russian economy and the Russian circumstances in general. On behalf of my authorities, I wish to thank them for their hard work.
>
> I am in broad agreement with the staff analysis and policy recommendations. In order to avoid repetition, let me try to address a number of the most frequently raised questions.
>
> The Financial Crisis: Why Now?
>
> According to the most recent press reports, it has already become a common view that the current financial crisis in Russia has more to do with Russia's own weaknesses, and, in particular, with the seemingly never-ending fiscal mess than with developments in the financial markets in Asia. I do not disagree with this view, as, indeed, Russia has been affected by the turmoil much more severely than have many other emerging market economies outside

Asia. However, I have to confess that I am still puzzled: Why did the financial crisis hit us when it did?

About a year ago Russia's weaknesses were no less evident, as its fiscal mess was, perhaps, at its highest point, with the non-cash share of the federal government's revenue rapidly increasing. At this time almost every obscure Russian region was planning to issue its own Eurobonds, while highly respected international consultants served as their advisors. Fortunately, only a few regions succeeded before developments outside Russia put an end to these plans.

Obviously, the Asian crisis was a watershed which caused investors to look at the size of Russia's fiscal deficit and to ask themselves whether or not it could be safely financed. However, even at the time of the Annual Meetings in Hong Kong, the Russian authorities were seriously considering the possibility of a "friendly divorce" from the Fund, as the demand for Russian Eurobonds seemed to be bottomless, and their placement did not require any conditionality. When Russia was first hit in late October last year, this came as a complete surprise.

The two attacks on the ruble that preceded the most recent one were more or less firmly resisted by the Central Bank of Russia (CBR). Many observers expected another attack in mid-spring when, for the whole month, Russia did not have a government at all, and when there was a real chance of a major political destabilization. However, the financial markets remained broadly quiet. Paradoxically, the real crisis hit us exactly at a time when the authorities had finally started to address the fiscal situation, and when serious fiscal measures were already in the pipeline.

So, why now? What has changed between now and then apart from the financial market sentiments?

Exchange Rate Policy: Is There a Case for Devaluation?

This is another question frequently raised by various observers. Indeed, reflecting the steep fall in oil and gas prices, Russia's terms of trade have deteriorated considerably. Moreover, the CBR's policy has been to maintain the exchange rate between the ruble and the U.S. dollar broadly stable in real terms. While the U.S. dollar has been strengthening over the past several years, Russia's external competitiveness has been weakening. Indeed, Russia's current account deficit is projected to increase from 0.1 percent of GDP in 1997 to 1.7 percent of GDP in 1998. Perhaps, in a normal time, there could have been a case for some moderate exchange rate correction. However, we are not in a normal time, and any such exchange rate correction could easily lead to panic, massive capital outflows, and a full-blown exchange rate crisis. Therefore, the CBR has made it clear that it will defend the exchange rate at all costs. As for Russia's external competitiveness, the size of the current account deficit is not too large, and pressures on the ruble are clearly being driven by capital account developments, not by current account developments.

Fiscal Correction: Why is the Emphasis on Expenditure Reduction and Not on a Revenue Increase?

Russia's poor revenue collection has become a cliche. However, when I look at the fiscal data I see that the enlarged government revenue over the period of 1995-97 had been broadly stable at a level of slightly above 30 percent of GDP. This level of revenue was, clearly, too low compared with the level of expenditure in Russia, but not too low compared with the level of revenue in many other emerging market economies. Of course, this is not the whole story, as, over the same period, the share of the federal government in overall revenue had declined at the expense of the share of local governments, while a significant part of the latter had been non-cash. Nevertheless, the question is unavoidable: Are we spending too much? Another question: Isn't it more prudent to make spending plans on the basis of a conservative revenue estimate, especially under conditions of a fall in exports and stagnant output? At the same time, I do not mean to imply that the authorities intend to give up on their efforts to increase revenue. On the contrary, immediately after the appointment of the new government these efforts were intensified.

The 1998 Program: Is It Strong Enough to Regain Market Confidence?

Expenditure reduction at a level of 3 percentage points of GDP is quite radical by any standards, and could be called draconian. The federal fiscal deficit at a level of 5.2 percent of GDP would be a significant improvement. However, even this projected size of fiscal correction may turn out to be insufficient successfully to address the financial crisis. The staff's language on this subject is quite cautions: "The authorities' 1998 program represents a credible plan for addressing Russia's underlying problems. However, it was essentially formulated prior to the most recent bout of financial market turmoil, and may need to be strengthened considerably unless market confidence returns in the period ahead". The problem is that market confidence may not return until the authorities prove that they are capable of implementing this program. Meanwhile, in the absence of market confidence, treasury bill yields may remain extremely high for a long time, and the cost of debt servicing may become unbearable. It may well happen that the only way out of this vicious circle will be to undertake additional fiscal efforts. This option is being considered by the authorities.

Extending his remarks, Mr. Vernikov said that, since the situation in Russia had been changing so dynamically in the past several weeks, his prepared statement did not reflect the latest developments, but tried to address issues of relevance to the broader reform efforts. Nevertheless, he could confirm what had been reported in the staff reports, as well as the most recent update on the completion of one of the prior actions.

Ms. Abdelati, speaking on behalf of Mr. Shaalan, made the following statement:

While the turbulence in Asian financial markets may have been a contributing factor to the recent market volatility, the root of the problem is, of course, the continuing fiscal weaknesses and the repeated postponement of structural measures from one review to the next. Continued delay in tackling these underlying problems will only weaken the resilience of the economy to withstand shocks and could well increase the magnitude of the required corrections. If there is a lesson to be learned from the Asian crisis, it is that it is very difficult to restore market confidence and that swift and resolute actions are needed to turn market sentiment. The Russian economy will remain vulnerable to volatile market reactions until the authorities demonstrate that they have effectively dealt with their budgetary problems, strengthened supervision over the banking sector, and improved accountability in enterprise and government operations. The question therefore is whether the actions taken so far, and those to be taken in the coming weeks and months, are enough to allay market concerns. IMF support cannot make up for the failure to take forceful measures in a concerted way; it can only provide the authorities time to implement corrective actions.

As in previous years, the primary objective for 1998 is to improve the fiscal position by increasing tax revenues, including in particular through strengthening tax collection, and more effective expenditure control. Limited progress has been achieved toward this objective thus far. The projected deficit for 1998 is the same as that at the start of the program in 1995, namely 5.7 percent of GDP; and if the 1998 target is met, federal cash revenues will increase by less than 1 percent of GDP relative to 1995. Tax reform has been hostage to lengthy Parliamentary debates and initiatives launched to strengthen tax collection have been repeatedly side-tracked. The recent proposal to introduce drastic expenditure cuts to offset revenue shortfalls confirms the limited scope for expediting tax reform.

It is not clear that these larger expenditure cuts (3 percent of GDP) are indeed feasible and they could increase the risk of accumulating new expenditure arrears, particularly by the local and regional governments to whom transfers will be reduced. Of course, in order for the fiscal target to be meaningful, any net increase in arrears should be fully recorded in the deficit. But this poses a monitoring problem since local and regional governments do not currently report arrears. This raises the question of whether there is a new reporting mechanism to capture local government arrears in order to ensure that the transparency of government operations is not reduced? In paragraphs 37-41, staff shed some doubt on the capacity for expenditure management and control both in the federal government, as well as in the local governments and with respect to payment of pension benefits. Local governments have in the past exerted pressure on the federal government to provide loans to clear arrears and have borrowed directly from capital markets. Draft legislation to control sub-national borrowing will have to be expedited so as to act as an effective control on local government deficit financing.

The elimination of offset operations and clearance of the outstanding <u>stock</u> of arrears are essential measures for tackling the culture of nonpayment. Progress on these fronts is essential for the credibility of the commitment to fiscal consolidation. The staff raises concerns that the programmed clearance of arrears is complicated by the fact that arrears may be about 40 percent higher than had been envisaged in February due in large part to new claims on the military which the authorities proposed to clear through an offset operation. Has the staff discussed with the authorities a different way to clear these arrears without resorting to an offset operation?

Even if the authorities succeed in cutting expenditures as specified without accumulation of new arrears or resorting to offset operations, there is still a risk that federal revenues will fall short of the revised target of 10 percent of GDP. This underscores the importance of enforcing measures with respect to the collection of arrears from large debtors and expediting the passage of the comprehensive tax package that has been held up in the Duma.

With respect to structural reforms, we welcome the substantial progress achieved to date in a number of areas which are critical for the promotion of private and foreign investment. In particular, we note the steps taken toward adoption of accounting principles that are consistent with the International Accounting Standards for enterprises and banks, the adoption of a new bankruptcy law, development of a framework for land sale, improvements in bank supervision by CBR and closure of several small problem banks. These efforts should be continued and reinforced.

We are sympathetic to the political and systemic considerations requiring a speedy completion of this review, and we fully recognize the importance of supporting this request. Accordingly, we support the proposed decisions regarding the Seventh Review, approval of 1998 program, and program extension into 1999. We hope that the expressed commitment and determination of the new government will enable adoption of pending legislation and strengthening of enforcement capacity.

With these remarks we wish the Russian authorities every success.

Extending her remarks, Ms. Abdelati said that she welcomed the recent steps taken to fulfill the prior actions, particularly the difficult prior actions 1 and 4 regarding measures to collect arrears from the largest tax debtors. She hoped that those efforts would continue uninterrupted in the coming weeks and would result in significant collection of tax arrears. However, she was concerned that some of the actions were being undertaken in a somewhat different format than had been agreed. She also welcomed the steps to pilot a more transparent and competitive privatization procedure, which could become a new standard for future privatizations. The maintenance of such efforts was the only way to help Russia overcome its recent difficulties.

Ms. Lissakers asked why the authorities had included in the prior action on tax delinquents some companies that had not been on the original list of 20 companies. She wondered whether the Fund should agree to the modification.

The staff representative from the European II Department responded that there did not seem to be a clear explanation why the previously agreed five companies had been replaced by five other companies. Perhaps there had been a delay in the preparation of the extensive documentation required to bring companies before the Emergency Tax Commission.

Mr. Vernikov confirmed that, as mentioned by the staff representative, the delay in processing tax delinquent companies had been related to administrative problems. The list of delinquent companies was large, and the set of documents required for the cases had been at different stages of preparation. As a result, the government wanted to ensure that, whenever it brought a case to the Emergency Tax Commission, the case was clear and decisive action could be taken. It was important to ensure that the enforcement mechanism was in place so as to avoid taking a decision that could not be enforced. In addition, proper preparation was essential in order to avoid some unforeseen circumstances during an Emergency Tax Commission meeting that could throw doubt on the level or amount of outstanding debt. Finally, before reaching the Emergency Tax Commission, a case must be reviewed by another commission—the so-called balance sheet commission, which was also intergovernmental and which basically analyzed the situation. As a result, what might appear as an arbitrary choice of which companies to bring before the Emergency Tax Commission was actually a reflection of how advanced the government was in the preparation of a case against particular companies.

Ms. Lissakers made the following statement:

Despite the recent back and forth on the prior actions, Russia has made strides in promoting stabilization and structural reforms, and it has benefited enormously from its entry into the global economy. But over the past year the world financial system has been buffeted by strong winds, and I think that recent developments highlight the vulnerability of transforming economies that have not yet set down deep roots of strong policies and market-based institutions and procedures.

Mr. Mozhin in his statement expressed surprise at the turn of events and the shift in market sentiment toward Russia. I think, as some of us have been saying for some time, countries that rely on short-lived market hubris—or what Alan Greenspan calls irrational exuberance—to validate their policies are bound to be disappointed. If you use easy access to market financing to back weak policies and to compensate for weak economic performance, then sooner or later markets and investors will turn against you. I think that is what we have seen here. Russia is not unique in having had to learn that lesson the hard way.

The question we face today is the same question we have posed before. What is going to be different now in terms of policy performance and policy implementation? We very much welcome the fact that the Fund and Russia have been able to bring the review to the Board for consideration. There has been progress in enhancing budgetary realism, in continuing sound monetary policy, and in improving structural conditions. But once again we had what I complained about previously, a re-run of the "Perils of Pauline." I would say that Pauline came even closer to being run over by the locomotive this time than before. In fact, I would say she lost a chunk of her left foot, and the next time it could be really messy.

I am unhappy that we have had this murkiness up to the last minute regarding the prior actions, that some of the prior actions will remain to be fully implemented even after we have considered the release of the today's tranche, and that, indeed, we had to postpone this review already for some time. Nevertheless, I think there is enough here that one can proceed today on the assurance of the staff and management—which just visited Moscow and presumably has a more direct sense of level of commitment and seriousness of intent on full implementation—and that we can go ahead and approve release of the tranche. I think there is a cleaner, more realistic budgetary blueprint. There is clearer authority for spending cuts. There are public statements-pledges—to avoid offsets. The budget is being evaluated on a commitment basis. The deficit is being reduced under the current plan relative to GDP, and progress is being made in advancing the tax code, which is, in my view, absolutely critical.

The fiscal position, as has already been outlined, however, is weak and the domestic debt has built up quickly with foreign holders playing a major role in the GKO market. And with the loss of confidence, the government, as outlined this morning, is paying the price in terms of higher interest costs on its debt. At these higher real interest rates, of course, there is an incentive for banks to invest in GKOs rather than to provide commercial loans to productive entities. This further hampers the development of the private productive sector in Russia. I would say the authorities have also reverted to less than transparent practices in recent GKO auctions. I hope that will come to an end.

On the spending cuts, achieving the authorities' ambitions will obviously not be easy. Defense procurement spending has been hard to control, especially as key ministries remain outside the purview of the federal treasury. Russia needs to address this problem immediately, as it has pledged to do no later than the third quarter. Cuts in transfers and net lending to regions will also be very difficult if regions do not fulfill their basic obligations, for example funding teachers wages. The fiscal performance continues to be burdened by this mismatch between revenue collection and control as well as between the obligation given and accountability for providing public services. I noticed in point 3 of the supplement that the bulk of the overruns in the deficit is due to regional and local governments, including Rub 6 billion in wage arrears. I wonder how sustainable the staff thinks the proposed reductions in transfers to the regions is given that the regions already have accumulated large wage arrears. There is also a problem of looming overruns in the pension fund. Certainly while further spending efficiencies can be found, the current federal spending-to-GDP ratio, I think, should be seen as closer to the lower bound of what is sustainable.

On the revenue side, we welcome the appointment of a vigorous new head of the STS and renewed efforts by the government to strengthen the emergency tax commission and special tax inspectorate for large firms. The question of whether the emergency commission will go after major firms, seize assets and put them into bankruptcy has been with us for several years, and we still don't have a full answer. What is needed is fair and uniform implementation. The debate about Mr. Mozhin's big fish and small fish, the head of Gazprom's recent public statements and the back and forth on oil pipeline access for firms with tax arrears reinforce doubts about the government's commitment to its fiscal program and further undermine market confidence generally.

The underlying problem is really structural. No tax system can be effective if the incentive structure is wrong. The culture of nonpayment is harder to break if taxpayers face arbitrary, inequitable, or punitive taxation. One commentator at the recent Institute for International Finance conference in Rome said the current tax code in Russia is simply a starting point for negotiations. It is really an invitation to evasion, arbitrariness, and corruption. The passing of an effective new tax regime is absolutely critical to finally putting the fiscal situation on a sustainable path where these monthly or quarterly fiscal crises can finally come to an end. Tax rates have to come down, exemptions should be eliminated, and the tax base broadened. I think President Yeltsin laid out very clearly what he intends. Clearly, the responsibility falls on the Duma to approve a rational, credible and workable tax regime.

I have to say that I don't fully agree with the concerns that the staff has expressed about whether or not the revenue implications from the tax code will be perhaps negative, assuming all other things are equal. The real question, the real focus, needs to be on growth and whether you have a tax regime that fits with a well-performing market-based economy. Now that doesn't mean that one can ignore whether there is going to be a medium-term decline in the tax base. That is not something, obviously, that we can support. But, the key is what the growth outlook for the economy is going to be, because that is what is going to support the revenue stream.

A couple of questions on the fiscal front. Oil prices are below the staff's baseline. I wonder how this factor is woven into the fiscal assessment. I also wonder whether Mr. Vernikov could update us a little bit more on the Duma debate on the tax code and whether he expects the whole code or just the first chapter to be advanced before the recess. It may be too soon to know what the Duma's response will be to President Yeltsin's forceful statement the other day, but I also wonder if the staff could tell us how the announced anticrisis program, which includes many tax and budget measures, relates to the tax code.

Monetary policy remains burdened by fiscal policy, but the Central Bank has continued its record of discipline, allowing further progress in reducing inflation. In particular, the bank's rapid response in raising official interest rates during periods of recent turmoil deserves praise. The achievement of low inflation and stabilization of the ruble through the exchange rate anchor are to date among the most significant achievements of Russian reform. These achievements need to be protected by continued sound policy management. We agree that Russian competitiveness remains secure, especially in light of the data on average dollar wages, but we do have questions on day-to-day exchange rate management. Is the intra day trading band sent transparently? In the staff's view, would a wider intra day band allow monetary policy to be conducted more flexibly? I wonder once the crisis period passes what advice the staff would offer on managing exchange rate policy.

On the banking sector, the authorities appear to be moving systematically to address weaknesses in the system. But there clearly are problems, including some of the features of connected lending that have been so problematic in the Asian context. Also, there is a very large number of banks, the placement of Tokobank into administration, and financial sector indicators all highlight the need for a continued and more rapid action in the banking sector. I wonder if the staff could confirm the Tokobank, before being placed under administration, was not being supervised by the supervisory department of the Central Bank, but rather by the Moscow city branch of the Central Bank? And also, I wonder if Sberbank is injecting funds into Tokobank to keep it going, and if so what are the implications? We would look for some improvements in transparency generally in the management of Sberbank and other government-controlled financial entities.

It is welcome that Russia has decided to subscribe to the SDDS, to publish the SEP, and to provide gross reserve data to the markets weekly. We hope the SEP will be published on the web site and the Central Bank of Russia will put its weekly reserve data on line. But paragraph 44 of the staff report notes that the Central Bank has not intervened in the GKO market. One has to ask whether a large state-owned bank, such as Sberbank, is intervening indirectly on behalf of the government or investing in GKO holdings at the behest of the authorities. I wonder if the staff has any assessment of the value of total GKOs currently held by the Sberbank. In paragraph 53 of the SEP the staff notes the authorities will provide the Fund with relevant information on bank balance sheets to monitor the program. I wonder if the staff could assure us that they already have received all the necessary data to do so.

We welcome Tuesday's announcement of the anticrisis emergency program, but as President Yeltsin said, it is important to translate this into action. We certainly hope that Russia will be able to avoid further market disruptions, but the key to doing so will be to put in place further critical reforms that convince markets that Russia will achieve near-term stability and longer term economic success.

Under the circumstances, significant additional IFI resources, not just from the Fund but also from the World Bank, could conceivably play a useful role in helping Russia secure breathing space as it promotes stability. President Clinton has stated that the U.S. would be prepared to endorse additional conditional support from international institutions, including the IMF, as necessary to promote stability, structural reforms, and growth in Russia. I note that similar statements have been made by IMF management and by many European leaders. We, thus, look forward to the staff's upcoming mission to Moscow and discussions with the authorities. But I reiterate my statement that the key is real fundamental, structural change—not just the tax code, but also in completing land reform, housing reform, and other measures.

While the content of an enhanced package is a matter for the IMF and Russia to work out, we would note that in our view such a package should include a strengthening of the fiscal adjustment effort, improving the structure and quality of fiscal policy, implementing critical structural reforms including privatization, and securing greater transparency. Again, clearly, the Duma needs to play a responsible and energetic role. We hope that will be forthcoming.

> Finally, just a quick question. I wonder if the staff could share with us information on the off-balance sheet exposure of the banking system as well as provide the Board with its best judgment on the size of the relevant categories of debt and capital flow that staff believes might be vulnerable to roll-off and on reasonable assumptions about rollover, roll-off rates for these categories.

The Acting Chairman cautioned that, while he agreed with Ms. Lissakers's statement on the importance of growth for the Russian economy, it was crucial not to divert attention from decisive and essential fiscal reforms. The Fund should not encourage the view that the authorities could rely only on economic growth to generate badly needed revenues, while delaying crucial fiscal reforms to improve revenue collection.

Ms. Lissakers said that she agreed with the Acting Chairman that there should be no excuse for delaying essential reforms aimed at increasing tax collection. Indeed, the complications in implementing the latest prior actions raised the question of whether the Russian authorities were truly committed to collecting taxes—especially from large enterprises that had accumulated arrears and that clearly had the capacity to pay. The failure to collect taxes from the largest tax delinquents set a poor example for the rest of the tax-paying base. She had emphasized the tax code in her intervention because the underlying distortions in the tax structure were a major cause of the dysfunction and delay in the tax collection process, which, in turn, was an impediment to growth. It was clear that the longer-term fiscal outlook could not be secure without an early passage by the Duma of the revised tax code, along with a clear commitment on the part of the authorities to collect taxes that were due.

The Acting Chairman underlined that the revenue situation in the Russian Federation had become quite desperate. The failure of the system to collect taxes had required rather draconian measures to be included in the Fund-supported program, including the threat to cut off access to pipelines for those oil companies that had substantial arrears. The incomplete implementation of prior actions was inexcusable, but the authorities had been confronted with enormous pressures resulting from the endemic culture of nonpayment. Clearly, it was essential that the situation be reversed as soon as possible.

Ms. Lissakers said that she agreed with the Acting Chairman's use of the Italian example to stress the possibility of a positive feedback: if confidence in the authorities' fiscal effort was restored quickly, then interest rates could decline, which would lead to a reduction in the fiscal deficit. Indeed, the U.S. chair was among the first to stress that point during the earlier debate on the convergence of economic policies in the context of the drive toward European economic integration. In the case of Italy, about one-third of total expenditures had been committed to interest payments on public debt, and decisive policy performance had led to a reduction of interest rates and a concomitant improvement in the fiscal outlook.

Mr. Giustiniani recalled that the improved situation in Italy had been improved based on specific and credible measures on both the expenditure and revenue sides, which had made the authorities' commitment to fiscal adjustment credible. The Russian authorities would need to mirror that same resolute commitment to actions.

Mr. Kiekens made the following statement:

This Board meeting on Russia is not business as usual. The Board is confronted with three serious problems: how to reduce Russia's financial instability and prevent it from spilling over into other economies; how to limit the Fund's sharply increasing credit risk on Russia; and how to prevent market participants from forming the impression that Fund resources will protect them against a sovereign or banking sector default on external payments or against restrictions on capital outflows from Russia.

There is a coherent strategy for reconciling these three objectives: forceful implementation, by Russia, of the needed fiscal and other reforms, and an unyielding stance on the Fund's part to maintain its conditionality and observe limits on its financial support.

Russia and its creditors should know that the Fund's ability to assist it financially is approaching its limits. Even assuming an extension of the current EFF by one more year, with an additional access of $2.2 billion, Russia's net repayment obligation to the Fund will be $2.2 billion in 1999, and at least $3.8 billion in the year 2000. In other words, even after receiving $5 billion of IMF support this year and next, Russia's net repayment to the Fund over the next two years will rise to $6 billion.

To this prospect we must add worrisome developments in Russia's capital account. No doubt the Fund's continued support for Russia has enabled the country to attract considerable foreign financing for its fiscal deficit, at times on questionably easy terms, which has made the Russian government complacent about the needed reforms. Last year, Russia's Treasury bill market attracted an estimated $10 billion from non-resident investors. This came on top of $8.7 billion in disbursements from bilateral and multilateral sources. Russia's commercial banks also obtained substantial amounts of foreign financing, whose amount is not revealed in the staff paper, but which resulted in an open foreign currency position of $4 billion at the end of 1997. Market sources estimate that this open position increased further to over $6 billion. It is regrettable that the staff paper gives no figures more recent than December 1997, nor any indication on how they compare with the banks' own capital. Simultaneously with these capital inflows, Russia also experienced massive capital outflows—not to say flight—amounting to $17 billion, to which must be added a negative $7 billion in errors and omissions.

All these numbers confirm my concern, expressed during the last Board meeting on Russia in January, that "excessively soft conditions for access to Fund resources...may result in the need for the Fund to provide more emergency support to the country."

Let me now address some key issues of economic policy in Russia.

Recent market pressures have made it painfully clear that financing Russia's high fiscal deficit is becoming more and more difficult. Russia is now extremely vulnerable to changes in market sentiment, and the continuation of her present policies is not sustainable. The longer Russia fails to address its fiscal problems, the more sharply the room for maneuver shrinks. The federal government's interest payments amounted to 38 percent of cash revenues in 1997 and are expected to reach 49 percent of cash revenues in 1998. The high interest rates needed to keep the exchange rate stable make it prohibitively expensive to finance the public debt domestically, so the authorities are planning to seek longer maturities and increase the government's borrowings in foreign currencies. But these are only temporary solutions with problems of their own. It could lock the government into interest rates that would later turn out to be relatively high; and in case of a devaluation, the government would suffer an exchange rate loss. In this connection, I am surprised that the Russian government accepted to borrow on the Euro market for a period of 30 years with a risk premium of 750 basis points. This is an excessively long period. If one assumes that Russia will pursue sound policies in the years to come, and that the markets will therefore lower the risk premium to a normal 250 basis points, the new Euro bonds Russia issued last week will quote at 180 percent or so of their face value. This implies an actual cost of about $2 billion, most of which could have been avoided by borrowing for a shorter period of, say, three years.

These risks do not only affect the government. Last year, Russian banks also looked abroad to finance their domestic assets, increasing their net short foreign exchange positions to an estimated $6.5 billion. A sharp decline in the exchange rate of the ruble could therefore destabilize the Russian banking system.

An important element of Russia's fiscal problems is the federal government's low revenue collection. Political unwillingness to press large nonpayers harder is as much to blame as deficiencies of tax administration and complicated tax laws. The government has repeatedly promised to address its fiscal problems, and many presidential decrees have been issued with no discernible effect. After so many failures, the credibility of initiatives by the new government will be low unless concrete steps actually produce visible results. Until that happens, it is doubtful that the fiscal situation will improve enough to calm market pressures. I wish to welcome the revenue measures mentioned in paragraph 34 of the staff report, particularly the placing of the gas excise tax on an accrual basis. But Russia's taxation of the energy sector remains inadequate: too low by comparison with other energy rich countries, and too exclusively based on the quantity rather than the value of the energy produced. The proposed tax code goes in the right direction. I call on the staff to give continued attention to the structure of the taxation of the energy sector, and to how to promote competition in Russia's energy markets.

The adoption of the new tax code has been stalled for too long. It is unfortunate that the Duma has not only failed to approve the government's draft tax code, but has amended it to leave some of current system's shortcomings uncorrected. This brings me to the general question of the Duma's role in program implementation. The authorities explained to the staff that little can be done to improve tax revenues this year because such improvements require Duma approval, which is unlikely. We should no longer accept Duma intransigence as an legitimate excuse for not implementing the agreed program. The Duma, no less than the government, should be held responsible for program failure and all its consequences in terms of impairing Russia's access to foreign credit.

Revenue collection is not the only serious fiscal problem. The staff mentions many political and administrative obstacles to the proposed spending cuts. I also see problems with fiscal discipline at the level of local governments, as confirmed by the latest figures. They seem under less pressure to rationalize their spending thanks to their easy access to the markets for borrowing. But the trend toward increased debt financing of their spending is risky. The federal authorities should therefore monitor, and, if necessary, curb excessive borrowing by local authorities. This power has now been provided by a welcome Presidential decree imposing prudential requirements on foreign borrowing by local authorities.

Let me now turn briefly to monetary and exchange rate policy. The central bank did a commendable job during May's turbulence, and its policy of sharply increasing interest rates was appropriate. But it is clear that during the present period of external shocks and weak fiscal performance, the cost of keeping the exchange rate stable is rising. Pressure on the ruble is not so much a remote effect of temporary market turbulence in Asia, or of real shocks to the Russian economy itself, but results first and foremost from poor policies, especially the prolonged delay of fiscal and other structural reforms. Unless these reforms are now implemented vigorously and without further delay, continuing to defend the exchange rate with high interest rates may become more costly than a depreciation, and thus ineffective. Recent experience has shown that exchange rate stability should not always be placed before all other considerations.

At the beginning of my statement, I summarized Russia's schedule of repayments to the Fund in coming years. The Fund's credit risk on Russia is obviously much higher than is usual, and the staff report is candid on it. External shocks, renewed market pressures, capital outflows, failure to implement policies as agreed, and the forthcoming elections, all contribute to these risks. They put the Fund into a very difficult position. But the situation in Russia is such that refusing this risk now could prove to be even more risky in the end.

The proposed decision extends the arrangement for a fourth year. I have reservations about the absence of tranching for the SDR 1.56 billion that can be drawn during that year.

The noncompliance with the agreed prior action to start proceedings against at least three of the 20 most important delinquent taxpayers does not concern symbol, but substance. It shows that the Russian administration is insufficiently prepared to tackle cases of major tax arrears, as is also revealed by the excuses Mr. Vernikov offers for the noncompliance. I wonder whether under these circumstances, the Managing Director recommends completion of the review.

The Acting Chairman noted that, in response to Mr. Kiekens's question on the completion of the review, an important point was to ensure that clear public evidence was provided that the authorities would act decisively against tax delinquents. It now appeared that progress would be made in the case of oil companies, as well as other large tax delinquents. It was regrettable that there seemed to be a misunderstanding regarding certain prior actions, but action was being taken to deal with the important issues. The authorities would face a major test of their commitment on July 1, 1998, by which time the large delinquents were required to pay their arrears. If decisive actions had not been taken, had not been the assessment of the authorities' other commitments would need to be reconsidered. However, the authorities' current commitments appeared to be sufficient for management to recommend the completion of the current review.

Mr. Kiekens wondered whether the consideration of the current review should be postponed until after July 1.

The Acting Chairman pointed out that there had been an agreement with the authorities on the announcement of the significant measures to deal with the arrears problem. On the basis of that agreement, he considered that the Fund should complete the current review. While it was the Board's prerogative to require the full and precise implementation of all agreed prior actions before the review was completed, it was important to recall that there had been a significant change in the authorities' public stance on the matter of tax delinquents. Nevertheless, it was clear that, if the authorities did not proceed forcefully against the largest tax delinquents after July 1, that would affect the Board's consideration of any further financial support for the Russian Federation.

Mr. Kiekens said that he agreed that, in the event of inaction on the arrears problem after July 1, the Board would need to consider whether the provision of further financial support to the Russian Federation was appropriate.

The staff representative from the Policy Development and Review Department commented that there was not a requirement that the Fund agree on the proposed tranching for the fourth year of the Extended Arrangement. In fact, all that was necessary was to arrange the tranching for the upcoming year; the precise tranching for future years could be considered at a later date.

Mr. O'Loghlin made the following statement:

> It is regrettable that this review has to be conducted in the midst of financial turmoil in Russia. This has certainly made the task more difficult. However, it also underscores the need for uninterrupted and meaningful reforms, and sensible macro policies in Russia.
>
> While the decline in oil prices and the Asian crisis may have been contributing factors in the recent financial turmoil in Russia, the main factor was a lack of confidence arising from the poor fiscal performance and the failure to address the structural weaknesses of the economy effectively.
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> Russia's performance under the EFF in general has been disappointing. The program has been modified and weakened a number of times, especially on

the fiscal front. The authorities have always been firm in terms of commitment but weak and inconsistent, unfortunately, in terms of implementation. This has damaged the credibility of the government and hampered market confidence.

There is now a team in place with renewed commitment to carry out the program. We are encouraged by the actions taken so far by the new team. However, Russia's poor implementation record makes it difficult to believe that there will be a better outcome this time.

Let me say a few words about the main elements of the program.

Monetary policy has been the only bright spot in Russia's economic performance over the past few years. Under very difficult conditions, the CBR has been able to keep monetary policy on the right track. The readiness to sharply tighten monetary conditions in the face of market pressures over the past few months has helped increase the credibility of the monetary authorities even further. However, I have some concerns about exchange rate policy. Last January, this chair supported the authorities' move to widen the exchange rate band, noting that it would provide the flexibility to deal with unanticipated external shocks. It is clear from the staff report, however, that the effective band is in fact a much narrower, and unspecified, daily intervention band. I would make two observations here. First, in the face of the recent sharp drop in commodity prices, it may be appropriate to allow the currency to depreciate within the wider band. Second, if pressures on the currency continue, and a temporary rise in interest rates does not mitigate those pressures, attempting to maintain exchange rate stability may be too costly. I would be interested in the staff's views on the pros and cons of a further devaluation of the ruble. What is the staff's view on the outlook for commodity prices ? What is the staff's view on the impact of commodity prices on the exchange rate ? And, indeed, is there capacity for a substantial output response if ruble-prices of commodities were to improve ?

The fiscal situation continues to give cause for concern. The fiscal targets under the 1998 program are quite modest. But there are already indications that even these modest targets may not be met. Further, as this chair has repeatedly stated, the Russian authorities cannot continue to compress spending without jeopardizing social stability. The planned level of spending is incompatible with the effective governing of a country the size and complexity of the Russian Federation. The government's top policy priority must be to strengthen its financial position by boosting its cash revenue on a permanent basis. The tax system is clearly dysfunctional, and one-off measures like denying the oil companies with tax arrears access to the oil pipeline do not address the fundamental problems in the tax system. The Duma should be urged to pass the new Tax Code as rapidly as possible.

On structural issues, we welcome the progress so far and the commitment to strengthening the efforts in this area. We are also pleased that detailed structural performance benchmarks have been set for the 1998 program. I would call on the authorities to maintain the momentum of reform, particularly in the banking sector.

Mr. Chairman, with considerable reservations, this chair is prepared to once again give the Russian authorities the benefit of the doubt and support the completion of the review and the 1998 program. However, a clear message has to be conveyed to the authorities that the program represents the minimum required to put their economy on a sustainable path. They should strive for more ambitious reforms.

Finally, should the need arise, we would be prepared to consider an augmentation of the program, but only with much stronger conditionality.

Mr. Donecker made the following statement:

First I want to thank management and the staff for their continuous efforts to tackle the challenging situation in Russia. European II has provided us yet again with a very good paper.

Since our last formal Board discussion on Russia at the beginning of this year, the economy has faced new challenges and obstacles such as a change in the government, a further weakening of oil-prices, a deepening currency and confidence crisis in South-East-Asia and severe turbulence in the Russian financial markets. On the latter, it is fairly fruitless to speculate whether such turbulence is primarily "homemade" or mainly induced by uncertainties in the international environment. But one thing is quite clear: these obstacles can be tackled and overcome only with a stronger commitment of the authorities than hitherto to forcefully implement the long-discussed fiscal and structural adjustment policies. Simultaneously, the prudent stance of monetary policy should be maintained.

Against this background, the agreement on the 1998 program and the very welcome first actions of the new government to enact it are a big step in the right direction and a clear signal to the markets. To stabilize the still volatile financial situation, it is however of utmost importance to rapidly and comprehensively implement the agreed program measures. Here I fully agree with Mr. Shalaan and Ms. Abdelati that the IMF's support cannot make up for failure to take forceful measures to stabilize the economy in particular the budget situation in a concerted way; it can only buy time for the authorities to implement corrective actions. After the many policy slippages in the past, the new government and the Duma cannot afford to fail yet again to implement the necessary stabilization and reform measures. The recent reactions of financial markets are more than a warning signal. It is crucial that the Russian authorities in particular that the Duma accepts its responsibility to find the right answers to Russia's present economic predicaments and to implement the necessary remedial measures with much more vigor than in the past. There are limits to how far the Fund can continue to grant waiver after waiver. Russia's domestic as well as external creditors and potential investors expect positive actions from the authorities to improve the budget performance and the investment climate to name but two important areas where joint action of the government and the Duma is clearly urgently needed. I therefore welcome President Yeltsin's recent call to the Duma for urgent actions. Let me now focus on the "traditional" areas of policy action:

On fiscal policy, we welcome the preservation of the previously agreed deficit target. However, I share the staff's disappointment that fiscal consolidation has even more taken the form of public expenditure cuts rather than of an increase of public revenues. Although we welcome the expenditure reduction plan of May 26, there remain doubts whether the size of the amount is not too ambitious especially in light of an already very low expenditure to GDP ratio. Also we are concerned about the still insufficient expenditure management and expenditure control mechanism.

Against this background, I agree with Ms. Lissakers that the establishment of an effective new tax regime and decisive action to collect all due taxes are absolutely critical. It would also appear that a widening of the tax base as now intended by the authorities is clearly advisable too.

The monetary authorities have drawn the right lessons from their bad experience in November 1997. They have reacted very decisively and appropriately to the most recent turbulence by flexible use of the interest rate instrument. They must maintain their prudent stance.

With regard to the obviously ongoing discussion in Russia on exchange rate policy one thing is clear, exchange rate policies alone cannot offset the necessary fiscal and structural adjustment.

Turning to the structural front, there was some progress—as mentioned in the staff report—but the reform agenda is still very long. I welcome the front-loaded approach under the new program. In this area two fields for decisive reform action are particularly important:

Firstly, banking sector reform is a crucial element. It is particularly important to improve prudential supervision and to reduce the vulnerability of the system versus volatilities in the financial markets.

Secondly, the privatization process still raises a number of questions. For example, the privatization of the oil company Rosneft failed. I would appreciate it if the staff could elaborate on the reasons for that failure and which lessons can be drawn for further privatization projects. According to press reports, a decree limits the foreign engagement in Russian utility companies to 25 percent. This issue is not addressed in the document and we would appreciate the staff's comments on such restrictions.

Summing up, this chair supports the proposed completion of the seventh review and the granting of the necessary waiver based on management's assessment that all "prior actions" have been implemented, respectively that at least sufficient progress in their implementation has been achieved to allow for the conclusion of the Seventh Review. But I share Ms. Lissakers's concerns in this respect. We also support the request of the authorities to extend the EFF arrangement by another year. We very much hope that the prolonged close cooperation with the IMF will facilitate the integration of the new reform efforts of the authorities, particularly the urgently required substantial improvements in public revenue collection, into a consistent macroeconomic framework. It is also an important signal for the financial markets that Russia will further pursue its reform approach. We can also go along with considerations to possibly provide additional resources by the Fund in the context of a much strengthened stabilization and reform program. But it must be clear that market confidence can only be stabilized and increased through vigorous implementation of the agreed reform measures, not simply by rhetoric and additional international financing. We therefore strongly suggest to frontload the necessary adjustment measures in the fourth program year.

Mr. Yoshimura made the following statement:

Recently, we have been seeing a number of countries in danger of experiencing a serious financial crisis if their economic management fails or their external environment deteriorates further. Russia is certainly one of them, and it is one of the important but weak links in the chain of the global financial system. Needless to say, we should closely watch developments in Russia, as well as in other important but vulnerable countries in other areas, in order to avoid crisis that could have disruptive systemic implications for global financial stability.

Such implications, however, should not compromise our attitude to program implementation. If the reform efforts fall short of our expectations, we cannot complete the review. Therefore, I am glad to hear that all prior actions have now been effectively taken by the Russian authorities, as the Chairman explained this morning, although I have to express my serious concern about the delay in implementing some of them, which makes me think that there should be a stronger commitment by the authorities to the reform program.

Because of the prevailing sentiment of financial uncertainty everywhere in the world, we are now in a very defensive mode and are urging the tightening of economic conditions in many countries to prevent further upheaval in global financial stability. I fully understand the necessity of such a defensive attitude under the present circumstances, but we should not forget that, if such a defensive attitude is prolonged, the opportunity for recovery and growth could be lost. Therefore, in the longer run, we should change from a defensive mode to a positive mode for growth so as to permit a global linkage for recovery and growth to be realized in the world economy.

In this context, the staff's prediction for Russian economic growth should be welcomed. It is predicting 3 percent growth for 1999, and 5 percent growth for the year 2000. Such continuous and strong growth is desirable, not only for Russia but for the global economy as a whole. However, I am afraid there is not much convincing evidence in the staff paper as to how such growth can be achieved. It is my impression that their concern is mainly limited to the present difficulties and that they did not have enough time to deliberate on how sustainable growth could be realized in the medium and long run. I will return to this subject when I discuss monetary policy.

Russia has been pressing ahead with market economy reforms under the EFF-supported program. Their efforts have borne fruit, and I am pleased to see that the growth rate in 1997 was positive for the first time since the transition began and that inflation has been reduced. But, looking at the areas where the reform process has been lagging, I must express my concern about the difficulties that the authorities have shown in improving fiscal conditions and the mixed progress in structural reform, in particular with regard to privatization and elimination of monopolies.

It seems there is much that still needs to be done under the current program. Since the eruption of the Asian crisis, Russia has not been able to escape from the heavy pressure in the financial market. This could be attributed to the concerns in the market about the uncertainty surrounding the economy's prospects and about external fragility. I would therefore urge the authorities to lose no time in implementing the program's reform agenda.

Let me comment on some specific points. There is no doubt that the most important reform item to be implemented is stabilization of the fiscal balance. The most current program agreed by the authorities and the staff employs a different idea of tackling this task--namely, to put more emphasis on expenditure cuts, together with a more realistic assumption on revenues. In view of the track record of failure to attain ambitious revenue targets, this change in emphasis would seem appropriate. But I would like to say that the revenue target agreed this time is, as the staff paper says, the absolute minimum, and I urge the authorities to make all possible efforts to attain this target.

As this chair has stated at previous Board meetings, better management of large taxpayers is critical, and it is the most efficient way to use the limited administrative resources to attain the revenue target. I am very pleased to see that the prior actions to this Board meeting stressed this point. It is also welcome that the power of the tax authorities to seize and sell assets has been strengthened. The seizure and sale of assets should be strictly enforced. To do this, there needs to be adequate human and institutional resources. In this respect, I would like to ask the staff whether progress is being made in strengthening such resources.

On the expenditure side, strengthening expenditure control is an absolute necessity. The expenditure cuts envisaged in this program are quite bold and, as such, will be very difficult to implement. Expenditure cuts have to be implemented by all the relevant spending agencies while avoiding the occurrence of arrears. In this respect, the expenditure commitments made by the spending agencies have to be closely monitored. It is of vital importance to press ahead with the development of the treasury system, in particular with regard to military expenditure, which constitutes about one-fifth of total expenditure. It is also very important to establish better control over the budgetary transfer to local governments.

On the monetary front, in view of the current unstable conditions in the foreign exchange market, I agree with the idea of maintaining the tight stance on monetary policy. On the other hand, I have some concern about whether the staff estimate of 3 percent growth in 1999, followed by 5 percent growth in 2000, is attainable if a policy of high interest rates is pursued for too long under the current situation, where inflation has been subdued. High real interest rates would certainly curb corporate investment. I believe a more growth-oriented stance is necessary in the reform process in order to strengthen the economy and that a prolonged high interest rate policy should be avoided.

Concerning the external fragility of the economy, the Russian authorities have been increasing external borrowing from private banks. We have some concern on this development, as previous speakers already expressed. We need to closely monitor the effect of such borrowing on Russia's external vulnerability. From the same standpoint, it goes without saying that enhancing controls on external borrowing by local authorities is also an urgent task.

On the structural front, it seems to me that we need another jump start, as progress in this area thus far has been mixed. Abolishing the monopoly of the public utility and transportation companies and pressing ahead with the privatization of large-scale enterprises has to be actively pursued with a view to establishing an economic system that is more advanced in accountability and corporate governance. In this regard, it is also important to improve the institutional aspects of the economic system, in particular the accounting and auditing systems and the bankruptcy laws.

Finally, let me reiterate that I am in broad agreement with the contents of the 1998 reform program, but I would like to emphasize, once again, that implementation is the most critical ingredient for the success of the program. I hope the authorities will make their best possible efforts to implement the program without slippage in order to restore confidence in the economy.

With these remarks, I support the proposed decisions and wish the authorities success in tackling the task of calming down the financial market by vigorously implementing the agreed reform program.

Mr. O'Donnell made the following statement:

First of all, let me thank management and the staff for an excellent set of papers and for all the hard work that has been going on over the last many months.

There seemed to me two issues here: the question of the EFF, but also the question of a bigger package. As the Chairman noted, Mr. Chubais has made references to that being one to two months away. I think that reference was helpful, but I think we should think about what that package should contain early. So I would like to say a few things about that first and then go on to the EFF.

It seems to me that there is a great need for us to handle this sensitively. It is not particularly helpful, in my view, that there are large numbers already announced about the size of such a package. That seems to me to be rather unhelpful in terms of managing expectations.

Secondly, in terms of the need for a quick response, which there might be on this, I think it would be helpful if we could be kept informed about where negotiations are. So, if a quick response is needed, we could get our authorities to sign up quickly.

A third point, picking up something that Ms. Lissakers said about the question of medium-term growth and the need to look at structural components. I would be interested in hearing from the staff how those issues are being handled and the relationship between the Bank staff and Fund staff on those issues. Who is doing what, essentially?

Similarly, on the banking sector. Ms. Lissakers referred to a number of measures to do with transparency and the need to look particularly at certain banks. I wonder who is reviewing that data. What is the split, again, between the Bank and the Fund? Are we confident that we have early warning indicators in place in case there is a problem which emerges from the banking sector? That worries me.

Moving on to the EFF, it is logical to start with a question of prior actions. The record until today appeared to be rather good with respect to prior actions, but what the staff made clear at the beginning of this meeting rather worried me. It raises a more general issue about the nature of the prior actions we put forward. Do we point out specific companies? Therefore, to what extent are the answers that we have been given helpful answers about the need for paperwork and all the rest of it? How far do we have some specific prior actions that we could say either yes or no to? How far are we setting up some prior actions that we can never be entirely clear about whether they had been met or not? I think that is a general issue that worries me there. I am left with a feeling that there was a certain amount of last-minute maneuvering, which does not make me entirely comfortable about this process.

On the question of getting the budget under control, I think we all agree—and, indeed, the staff said that it was worried about the extent to which this was happening through spending cuts. As I understand Mr. Kiriyenko's announcement yesterday, the plan is for an 8 percent cut in spending, which includes a 20 percent cut in public sector employment. If that is to be the case, what are the revenue implications of that? Are we expecting that to mean an increase in unemployment? Has that been factored into tax and benefit calculations, for example? So I wonder about the short-term consequences of something like that. I worry as well about the medium-term consequences of big cuts in spending. A number of people have mentioned this. If you cut things like health and education, how consistent is that with the medium-term growth rate?

On the revenue side, I am still puzzled about why the ending of offsets did not result in any extra revenue. Could somebody give me some idea what happened there?

Secondly, on the bankruptcy threat. It seems to me that there are a number of companies here which fit a kind of twofold classification: those who cannot pay and those who will not pay. Those who cannot pay are very clear: we are not going to get any money out of those. Those who will not pay, it is clearly for political reasons. What are the changes in the political power relationships that mean that they now will pay? I think there are reasons to believe that one needs to be somewhat skeptical here. But is there any objective evidence of an improvement in the compliance culture?

The reason I am skeptical is the next set of issues, which relate to oil. My understanding about the changes that have been announced is that the tax burden will be shifted from the production, the upstream end, to the consumption, the downstream end; that is, instead of collecting revenue from a small number of refiners, we will be collecting it from a rather larger number of retailers. That seems to me to generate the possibility, at least in the short run, of a reduction in revenue. I would be interested to know whether the staff agrees with that.

Secondly, the question about the oil price assumptions. It seems to me that one of the greatest sensitivities of the whole program must be a further fall in oil prices. Given what is happening in the rest of the world—we are all busy scaling down our forecasts for world growth—under those circumstances, I would have thought there was more likelihood of a big fall in oil prices than a big rise. What then? In particular, if there were a big fall in oil prices, what would we think about the exchange rate regime? I understand if you do not want to go into that in great detail.

On transparency, I strongly support everything that Ms. Lissakers said and about the need for further transparency. A particular point that has been put to us in Moscow relates to the need for further transparency of the privatization process and a number of further steps for investors protection. Otherwise, there is a real risk of capital flight.

On interest rates, I note the possibilities of a virtuous circle. I am just waiting for the suggestion that Russia sign up to the euro as a common parallel currency to get the rates down. But Mr. Giustiniani is absolutely right: the credibility for Italy came when these things were implemented, not when they were announced.

One final point. I am worried about the realism of the cuts to transfers to the regions. It seems to me quite possible that we simply end up with arrears being built up at the regional level rather than the central level. Do we have any reasons to suggest that that will not happen?

All in all, I suppose, in conclusion, I sit here worried again. This is not the first time. Ms. Lissakers referred to the "Perils of Pauline." The U.K. analogy, I guess, would be to suggest that Russia is in the Last Chance Saloon, a phrase used by one of our former cabinet ministers, rather unfortunately. It seems to me that Russia is becoming a regular in this particular saloon, and I am not sure this is conducive to a sober assessment of the solutions to their problems, so I am very concerned about it. Nevertheless, we are prepared to support this EFF. I just wish that we could do so with more confidence that we will not be back in the saloon all too soon.

Ms. Cilento made the following statement:

Let me start by continuing on the movie theme. I guess one way of looking at it is thinking that the hero, to a certain extent, is the Fund staff racing in, trying to pull Pauline off the tracks in the nick of time. In that regard, I would certainly like to express my appreciation for their hard work in trying to keep the program on the right track.

I would also just like to reiterate Mr. O'Donnell's point with respect to the new package. It would be very useful if the Board could be kept very closely informed about how negotiations are proceeding. We appreciate the need to take up the discussions at very short notice, but it certainly helps us, if we have been kept in the loop, to respond quickly.

Turning now to the EFF. Let me start by saying that we can support completion of the review, but with some reservations. The authorities have made progress. Modest growth was recorded in 1997, inflation has improved, and there has been some progress on the structural reform side. The achievement of the prior actions is welcomed. Nonetheless, we all know that progress has not been smooth, and significant uncertainties remain.

Looking first at the fiscal situation, which has been the focus of the Russian program for some time. Efforts to increase cash revenues have been unsuccessful. The share of cash revenues to GDP is projected to be just over 1 percentage point higher in 1998 than it was several years ago, and 1997 can really only be characterized as a year of nonperformance on the revenue side. The program is now switching objectives, with greater emphasis on expenditure restraint. This is perhaps not surprising after continued efforts to produce results on the revenue side have yielded little, but it is nonetheless very disappointing. More effort needs to be made to increase cash revenues.

I strongly support what I took to be Ms. Lissakers's point earlier on in the discussion. Efforts on the tax front are important not only to boost revenues, but tax reform is also crucial in terms of establishing more appropriate incentives and, therefore, creating a more positive environment for growth over the medium term. We have noted before, and I will state again, that we encourage the authorities to aggressively target large tax delinquents. It is hoped that the achievement of the relevant prior actions confirms that this is the authorities' intention, although, as others have noted, I am less convinced of this now than I was when I came in this morning.

The commitment to stop using offset arrangements is welcome, as is the specification of the federal deficit targets on an expenditure commitment basis, which effectively addresses the problem of arrears accumulation. On the issue of arrears, could the staff comment further on the additional arrears claims that are now coming out of the woodwork. How do the authorities propose to address these claims and ensure that no fraudulent claims are honored inappropriately?

On the expenditure side, we recognize the efforts that the Russian authorities are making. Some very positive steps have been taken. Nonetheless, we share the staff's concerns that the large expenditure cuts will require a degree of commitment which the Russian authorities have not yet demonstrated. We are particularly concerned about the ability of the authorities to achieve these targets, with the defense sector remaining outside treasury control for some time, as other Directors have noted. It is also unclear whether regional and local authorities will adjust to the cuts in federal government expenditure imposed on them. Here I support Mr. O'Donnell's comments. The bottom line is that slippages on the expenditure front are unlikely to be treated more kindly by the markets than poor revenue collection.

In terms of the outlook for growth, I agree with Mr. Yoshimura's comments about the medium-term outlook, but I also think, in light of recent financial pressures and falling oil prices, that 1 percent is now optimistic for 1998. I would appreciate staff's comments on this.

Mr. O'Donnell also touched on the outlook for the exchange rate. My recollection was that Mr. Mussa brought this up in the last WEMD session in the context of questioning the link to the U.S. dollar and whether that needed to be looked at again. To a certain extent, this was also touched on in Mr. Mozhin's preliminary statement. I would appreciate the staff's comments on this as well. Others have touched on the financial sector and the need to push ahead with banking sector reforms. We support that as well.

We note the efforts to encourage greater involvement by the private sector and public utility and transport monopolies. However, it appears that in some cases assets are being sold at a very large discount and that public monopolies are in many instances simply being converted to private monopolies. Related to this, the reference in the staff report to political resistance to the establishment of more transparent privatization processes is very worrying. We strongly support the adoption and implementation of transparent processes, and wonder why only 15 of the 60 enterprises to be privatized will be dealt with under the case-by-case approach. If it is simply a question of capacity, would it not be better to proceed more slowly but with greater transparency? If the case-by-case approach is simply too cumbersome, especially for smaller enterprises, we would argue that a more efficient alternative to ensuring transparency be developed. Does the staff have any comments on the authorities' commitment in this area?

Turning specifically to the privatization of Rosneft we have heard reports that some in the market believe that the minimum price now being discussed, at 1.6 billion, is still too high. Does the staff have a view on this or knowledge of what the authorities intend to do if Rosneft is independently valued at less than 1.6 billion?

One of the problems we have seen in some of the Asian crisis countries is that the lack of legal infrastructure and sound bankruptcy laws hinders direct investment and private sector development. The staff report notes that the new bankruptcy law is considered to be an improvement. To my mind, that does not sound overly encouraging. Does the staff consider that more work needs to be done in this area? If so, is it a priority?

To conclude, it has become very clear that Fund programs without sustained commitment and implementation on the part of the authorities do not of themselves reinstate market confidence. Meeting expectations will be difficult, but it appears that there is now little room for slippage in Russia.

Mr. Zoccali made the following statement:

I join previous speakers in thanking the staff and management for their extraordinary efforts to help maintain the momentum of reforms in Russia. As Mr. Mozhin notes in his helpful an candid statement "the real crisis hit (us) at a time when the authorities had formally started to address the fiscal situation." Regrettably, however, performance under Russia's EFF program for 1997 was mixed. On the positive side: growth driven by rising household consumption–noted by Mr. Yoshimura–turned positive for the first time since the beginning of the transition process, inflation fell to 11 percent by the end of the year, a rate that compares favorably with that of many Eastern European countries; the economy has been opening-up, as attested to by the expansion of foreign trade and the increase in foreign portfolio investment since 1996; and some structural reforms continued. On the other hand, important policy decisions in many areas, particularly the tax system, lagged with dangerously high fiscal deficits clouding the transition process. The recent sharp drop and less than buoyant prospects for oil prices also serve as a reminder of Russia's dependency on oil production and exports and its large vulnerability to terms-of-trade shocks.

Against this backdrop, I will focus my remarks on three issues.

First, the central bank's swift defense of the ruble gave a clear signal to the market about the monetary authorities' commitment to exchange-rate stability. In the context of a relatively low level of wages in U.S. dollar terms, compared with selected transition economies (Chart 4), and non-energy export volumes that are projected to increase by about 6 percent in 1998, a faster depreciation of the ruble does not appear justified on external competitiveness grounds.

A more pressing concern relates to the existence of indicators of financial fragility, such as declining bank profitability, a segmented interbank market, a large proportion of connected lending and non-performing loans, and an inadequate accounting system. In addition to continuing with the consolidation of the banking system, it will be enforcement and the authorities' ability to deal decisively with weak banks that will reduce vulnerability to changes in market sentiment given an incomplete agenda of structural reforms. The staff's assessment that about 80 percent of the banks taken as a group are liquid and highly capitalized, should not lead to slackening of the effort to strengthen the prudential architecture. The current restrictive monetary stance, while necessary, only heightens the systemic threat for the banking system if not accompanied by a more balanced financial policy mix, in the context of a clear blueprint to improve the resilience of the banking system to macroeconomic shocks and, more importantly, creditors' and depositors' perceptions of its soundness. A run on deposits may prove devastating for the maintenance of the main anchor in the Russian economy, its exchange rate policy. In this regard, I attach particular importance to the ongoing work of collecting and analyzing data on financial and banking sector developments and to wonder whether the introduction of concrete prudential measures, including the dissemination of critical data, have been envisaged among the program's performance criteria.

On the fiscal front, the staff and previous speakers have discussed in detail the fiscal shortcomings, the difficulties in implementing prior actions and needed corrective measures to support growth. Suffice it to associate myself with those observations, while keeping in mind the impact of the dramatic fall in oil prices following the expanding wake of the Asian crisis on Russia's fiscal revenues. In particular, I should underscore the need for tax reform, to improve expenditure management and control, to abandon the practice offsets and, not least, to show political-will to collect taxes, particularly, from the largest taxpayers.

Unless clear progress is made in moving to a primary fiscal surplus, the debt dynamics in the context of high real interest rates will rapidly become explosive. Debt-service already accounts for some 30 percent of all federal budgetary expenditure. Moreover, the past practice of resorting to large non-interest expenditure cuts in the past have been accompanied by a sharp rise in net arrears, suggesting that the identified cuts in defense and transfers to local governments will be especially difficult to carry out. Perhaps the staff could comment on the prospects for making federal transfers to local governments conditional on policy undertakings employed elsewhere.

Lastly, domestic policy slippages have in great measure been responsible for the increased vulnerability of the Russian economy to changes in market sentiment and capital flight. Mr. Mozhin asks why a financial crisis now? It seems to us that the most recent attacks on the ruble, and on other currencies in particular of emerging economies, are also highly correlated to the spill-over from the uncontained Asian crisis. The Russian authorities should be commended for their swift defense of the ruble through a courageous monetary tightening. At the same time, recent experiences show that financial markets have become more prone to panic and overreacted to real or perceived weaknesses in emerging economies. In such scenarios, stabilization of financial and exchange markets has also required signals of adequate support from the international community. As previously noted, the ruble exchange rate still seems appropriate as the projected Russian current account deficit remains moderate and as noted by Mr. Mozhin "pressures on the ruble are clearly being driven by capital account developments". Therefore, in addition to decisive and bold action in the fiscal and banking areas in the context of a reinvigorated economic program for 1998 and 1999, international financial support for Russia's stabilization effort is critical for the stability of the ruble, as well as of other currencies. Fiscal consolidation efforts alone will not eliminate the pressing need to roll-over the stock of public debt in the short and medium-term, and the distinction between flows and stocks must be kept particularly in mind in this case. In this regard, the proposed completion of the EFF program review, giving access to a further SDR 500 million, might well prove insufficient to support authorities' determination to avoid a devaluation if market sentiment should deteriorate again. Additional support from the IMF and/or other creditors, predicated on appropriately supportive measures, might well be needed in such circumstances. As Mr. O'Donnell, I would attach importance to the Board being kept informed of developments to ensure a quick reaction in the future. In any event, could the staff shed some light on the maturity profile of the Russian public debt for the rest of 1998, including the scheduled redemption of GKO's held by foreigners?

With these remarks, this supports the proposed decision and wishes the Russian authorities every success in the implementation of the recently announced anti-crisis program and of critical pending structural reforms.

Mr. Milleron made the following statement:

Like others, I welcome the renewed commitment made by the Russian government to the program, as exemplified by the end of May statement on fiscal measures, the letter of intent presented to us today and the so called new anti-crisis program. On this basis and the fulfillment of the prior actions, although I am concerned with the remaining uncertainties, I am prepared to support the completion of the seventh review. As usual with Russia, however, the greatest challenge lies more on a sustained implementation of policy measures than on strong announcements and political impetus; the current situation clearly appears not to provide any room for maneuver. As a consequence, I look forward to a strict enforcement of the envisaged fiscal plan which looks bold and demanding.

An important and immediate effort by the authorities to improve tax collection is clearly required to meet the 1998 target, which has been revised twice downward since the beginning of the year. In this regard, I expect vigorous actions by the State Tax Service, particularly those aimed at pursuing not only the so-called rich and famous individuals but primarily the largest corporate tax debtors. I also attach much importance to the mechanism ensuring that no oil company in tax arrears would have access to the oil export pipelines and that there will not be any new recourse to monetary offsets. Beyond this, as repeated many times and by many speakers today, the adoption of a new Tax Code aiming at simplifying the current system and making it more efficient is essential. As for public spending and the domestic debt, I fully share the analysis provided by the staff. It appears indeed indispensable that spending control be enhanced so as to address the noticeable risk of renewed budgetary arrears: as a matter of fact, the last two years have largely illustrated how the culture of nonpayments has constituted a real plague for the economy of Russia, obstructing an efficient allocation of resources and inhibiting market confidence. I also consider that the policy aimed at restructuring the domestic debt should follow a cautious approach, given the high spreads currently being offered to Russia.

With regard to structural reforms, I certainly agree with the emphasis placed on the improvement of corporate governance through law enforcement and stricter and more transparent rules. Special attention will have to be paid to the restructuring of the banking sector. While progress has been made and the related efforts of the Central Bank deserve praise, the absence of full accrual accounting and account consolidation is a matter for concern. The staff alludes to the vulnerability of the sector but reveals that, due to a lack of information, a full assessment is difficult. Addressing this shortcoming should be given high priority and I look forward to the establishment of risk indicators for systematically important banks and, with the help of the World Bank, to the identification of a concrete strategy to vigorously restructure the banking sector and to improve the supervision system.

With these comments, I support the proposed decision. If it is judged appropriate and needed, my authorities would be ready to back additional financial assistance contingent upon the major two conditions described by the Chairman, namely settling fully the budgetary problem and getting the structural program really moving forward. In light of the great vulnerabilities that Russia is facing and the need to improve market confidence, as emphasized by Ms. Lissakers, there is no viable alternative and there should not be any ambiguity on this.

Mr. Szczuka made the following statement:

According to the staff report from May 1997, Russia's EFF-supported program for 1997 aimed to secure further progress in macroeconomic stabilization by reinvigorating the process of fiscal consolidation on the basis of measures which should lead to reversing the declining trend in revenues (...) and laying the foundations for a strengthening in collections (...). Unfortunately, the Russian authorities clearly failed to reach this overall objective and were unable to break the vicious circle of tax and payments arrears. Neither could the declining trend in revenues be reversed nor the basis for strengthening in collections be laid. The poor implementation of fiscal policy almost completely overshadowed some significant achievements in other areas (like further reduction of inflation and progress in structural reforms) and, in particular, when combined with the worsening of external environment, made Russia an easy target for repetitive rounds of speculative attacks on its currency. The staff report indicates that the adoption of an unrealistically high revenue target in the 1997 budget was at the roots of Russia's fiscal problems. Unfortunately, the same mistake was repeated in the current year's budget. To avoid such problems in the future it would be important to study to what extent the failure to reach the revenue targets resulted from imperfect macroeconomic assumptions and projections, and to what extent it reflected weak and inconsistent implementation of fiscal policies. Because one of the prominent Russian politicians recently referred to the shaping of Russia's economic reforms over the last several years as to a kind of a "joint venture" between the government and the IMF, it would also be important to state whether the Fund has at any time and in any form endorsed these unrealistic revenue targets.

The new sets of fiscal measures announced on May 26 and June 23 are a clear sign that the Russian authorities are seriously trying to address their fiscal problems. The real issue is, however, whether the design of the revised fiscal program is appropriate and whether there are realistic chances of implementing all the announced measures. I see at least two important weaknesses of the new strategy which puts the main burden of fiscal consolidation on drastic cuts in expenditure. First, there is a significant risk of the emergence of new expenditure arrears. It may prove to be very difficult to implement all proposed spending cuts without an effective expenditure control mechanism. Even more so that the large part of the intended cuts affects the spending by defense and other "force" ministries, where the control instruments of the Treasury are not yet fully operational. I wonder also whether it was appropriate to reduce funding for the emergency and disaster fund and I would like to caution, in light of the experience of other transition economies, that it may take more time to replace budget allocations to R&D activities with private contributions.

Second, in view of the limited control of the federal government over expenditures at the regional and local levels, there is a risk that spending cuts at the central level will result in an increased deficit of the rest of the enlarged government. This view is corroborated by the alarming indication that the bulk of the enlarged government deficit overrun in the first quarter of 1998 was attributable to the regional and local governments. The lack of fiscal discipline at the lower levels of the government clearly calls for the speedy approval of the proposed law introducing control of subnational borrowing. I would also like to ask the staff to clarify the apparently strange statement in para. 40 that a deficit had to be assumed in order to "accommodate some market borrowing". One may have the impression that this rather unorthodox causal link resembles putting the carriage in front of the horse.

I welcome the authorities' commitment to eliminate the practice of mutual clearance of tax and spending arrears through offsets. I hope that the Presidential decree barring this practice will be fully implemented and that the additional offsets carried out in 1998 were really justifiable on "technical" grounds. I support the staff's position that any write-offs of arrears of the government to the military sector against tax arrears would have to be considered as an offset and, therefore, a violation of the relevant performance criteria.

Regarding the recent attempts to lengthen the average maturity of Russia's debt by issuing new foreign currency denominated bonds, I fully share the staff's view that the current conditions for conducting such an operation are not optimal as it leads to locking in very high spreads and increases foreign currency exposure. However, I would expect the staff to issue a clearer warning on this matter. In my view, and I share here the opinion presented by Mr. Kiekens, the latest placement of 30-year bonds with the spread exceeding

750 bps provides an example of a very poor debt management, both because of the selected ultra-long maturity and because of the timing coinciding with the IMF announcement of the postponement of the Board discussion on Russia. Assuming that the expected stabilization of the Russian economy in the medium term will lead to significant reduction in spreads, I would suggest limiting the maturity of new foreign borrowing to three to five years and I would rather prefer seeking recourse to the more flexible bank borrowing. I would also appreciate it if the staff could present some additional information on the current level and structure of Russia' s short-term foreign debt, including the foreign holdings of rouble denominated Treasury papers.

Russian monetary authorities deserve credit for their decisive steps to defend the rouble during the recent bout of the financial crisis. While I agree that the CBR should maintain an appropriately restrictive monetary policy stance, there is also an obvious need to gradually reduce the interest rates in order to lessen the pressures on the budget and to create conditions for the continuation of growth. The reduction of interest rates should be, however, preceded by further stabilization of market conditions and by the implementation of credible measures aimed at reducing the fiscal imbalances. Stabilization of the exchange rate clearly belongs to the most important achievements of Russia's economic transformation. I broadly agree that maintaining rouble stability could lead to restoring market confidence and would be important for preserving the gains in reducing inflation. However, there are clear limits to such a policy and one should not disregard other factors like the level of official foreign exchange reserves, continuous deterioration of the current account position and the impact of lower oil prices on the profitability and tax contributions of the oil and gas industry. As Mr. Mozhin admits in his very helpful and frank statement, under more "normal" market conditions there could be some justification for a moderate exchange rate correction, and in my view one should at least carefully study other policy options keeping also in mind that Russia's case is different from that of China or Hong Kong. Could the staff explain whether the option of moving to a crawling band system with a pre-announced rate of crawl has been considered in Russia, and what are the advantages of the present policy of a gradual crawl within the band which obviously requires periodic, discrete adjustments of the central rate in order to achieve the brad stability of the real exchange rate? Could the staff also clarify whether, when assessing the external competitiveness of the Russian economy in 1997, it is more appropriate to refer to the depreciation of the rouble on the annual average basis, as in paragraph 48 on page 18, or to the real appreciation, as in Box 2 on page 19.

As noted by the staff, the recent financial turbulence has been not only due to problems on the fiscal side, but also due to certain doubts about the stability of the Russian banking system. Unfortunately, relevant and reliable data on credit risk and foreign currency exposure is still alarmingly incomplete. Additional efforts to strengthen the banking supervision, introduce international accounting standards and improve the quality and timeliness of banking statistics are clearly necessary to reassure market participants. I also urge the authorities and the staff to proceed vigorously with investigation of the systemic risks posed by the bank under temporary administration and by other big banks. Given the importance of strengthening the banking sector, it is rather surprising that the program for 1998 includes only one structural performance benchmark relating to the improvements in the Russian banking sector.

Despite encouraging progress in some areas like dealing with public utilities and transport monopolies, the overall progress in implementing structural reforms remains mixed. In this regard, the failure to adopt the new Tax Code by the Duma as well as the insufficient progress in reforming inter-governmental relations were the most striking disappointments. Tax collection cannot be seriously improved until an appropriate legal framework has been created. Even though the original draft Code had to be modified and therefore does not represent an optimal solution, the enforcement of the revised Code remains of key importance for the Russian economy and the authorities should spare no effort to ensure its passage by the Duma.

In the area of trade reform, I regret that the staff accepted the substantial revision of the previous commitment with respect to the reduction of maximum tariffs. This can be seen as an important concession of the increasing protectionist pressures in Russia. To further give way to these pressures, which have already led to proposals for introducing quantitative restrictions on certain imports, would seriously endanger the commendable record of trade liberalization in Russia since 1992. Developments in the area of trade policy thus require a particularly close monitoring in the period ahead.

I fully agree with President Yeltsin's statement, as quoted by the press, that radical measures and serious corrections of economic policy are needed to stabilize and revitalize the Russian economy and to restore market confidence. The proposed program for 1998, despite all its risks and weaknesses, could help to achieve these goals provided that it will be implemented with full force and determination. I agree with the staff and with Mr. Mozhin that the Russian authorities should stand ready to introduce additional strong measures in case the current program and the envisaged additional financing package will not lead to regaining the confidence of market participants.

Before concluding, I would like to say that I share the disappointment of other Directors that one of the prior actions has been implemented only partially and in a modified form. However, I would like to remind that the list of prior actions was very long (27) and I would like to express appreciation for management's decision to postpone the Board's discussion on Russia, despite strong market pressures, in order to secure the implementation of prior actions. In regard to prior actions, I would like to make a broader comment on the balance between prior actions and performance criteria in the design of the Fund's programs. I see a certain risk that putting too much stress on prior actions may lead some borrowers to the wrong conclusion that the performance criteria are of lesser importance, even more so that a waiver can always be requested for their non-observance. Such a risk should clearly be avoided at any price.

I would also like to join Mr. O'Donnell in requesting management to keep the Board informed about the progress in discussions on the new financing package for Russia. I find it rather unfortunate that I had to learn first from the press, and not from the Fund's internal sources, about the preparations for such negotiations and also about the date of today's Board meeting.

I support the proposed decision and wish the Russian authorities every success in their difficult struggle.

Mr. Giustiniani made the following statement:

The fact that we are at this point indicates that progress in implementing important parts of the current program was made by the new Russian government. However, I wish to join previous speakers in expressing our concern and disappointment for the way in which prior actions have been implemented. The policy agenda that the Russian authorities are facing remains long and articulated.

The bare figures of the results achieved under the EFF program show that the fiscal is the "make or break" area. From 1996 to early 1998, over the three years of the program, tax revenue fell by 4 percent of GDP, and even with the rest of the 1998 program implemented on schedule, the fall at year-end will still be of 3 percent of GDP. At the same time expenditure will have fallen by 5 percent of GDP. This is not a sustainable situation, nor a healthy one for social stability, and we believe it will not be sustained for long, even in the presence of, or perhaps because of, foreign financing of the budget deficit. The new Russian government must take control of the fiscal situation, particularly of revenue, and increase it progressively and significantly until more normal levels are reached. The system of sharing fiscal responsibilities between the central and local governments has to be reviewed and improved in order to avoid that efforts made at the federal level might be dissipated at the regional and local levels. The new Russian government must ensure that basic state obligations are met and services delivered. This is not only a fiscal and macro stability imperative, which it clearly is, but also a governance imperative. Without establishing its authority over policy, its firm control over public finances, and without showing its capacity to slowly improve the delivery of public services and payments, this government will fail, and so will the Russia that we know and want to support.

Once this is done, the rest can and will fall into place. With less recourse to foreign borrowing and more reliance on domestic savings, the government will see confidence return, internally and externally. Interest rates will progressively fall, particularly if fostered by continued price stability, and investment—domestic and foreign—will pick up and drive economic activity. Without success in redressing quickly the fiscal imbalance, confidence will not return and a financial-exchange rate crisis will become very likely. There are practically no degrees of freedom left, we are afraid.

Again, after stabilization, reforms will have to start again in earnest. Here we enter the domain of the next possible IMF program in support of them.

To deserve and obtain further Fund support, after what has happened since 1996 and under present resource constraints, Russia must take substantial action before and during the program. Additional Fund resources are justified only if they go to sustain a broad-based, very well defined, realistic and implementable package of reforms, covering, in our view, three essential areas: reform of the tax code and of tax administration, definition of land rights, and transparency in fiscal and financial matters. Substantial prior actions in all these areas and consistent follow up will be necessary. Fund conditionality must apply to actions taken, not simply to attempts by governments to take action, no matter how fervid and sincere.

Within the lifetime and scope of the possible new program, and naturally with the right timing and in the presence of appropriate safeguards (policy and financial), the issue of the real exchange rate and competitiveness of the Russian economy will have to be addressed. A progressive and orderly adjustment of the exchange rate will have to be part of it and begin as soon as feasible. For without adequate incentive to the production of tradables, neither domestic nor foreign productive investments will occur on the scale necessary to push forward the Russian economy and to ensure that its enormous potential is fully exploited. Growth, and proper sharing of it, is in turn a key condition for transformation to continue. Otherwise the process will come to a complete halt. And we are not too far from that point now.

Mr. Guzmán-Calafell made the following statement:

The medium term program set in motion by the Russian authorities in 1996 has allowed significant progress in a number of areas. The rate of inflation has declined substantially, GDP growth is finally showing positive figures, the exchange rate has behaved broadly as envisaged, and while the current account deficit is increasing it is expected to remain in 1998 within reasonable levels. This headway has been accompanied by the continuation of structural reform efforts.

Notwithstanding these positive results, the overall picture that emerges from the implementation of the medium-term program is worrisome. As noted by other speakers, the main problems are related to the conduct of fiscal policy, where the results have been disappointing, especially regarding the behavior of revenues. Moreover, some slippages have also been recorded in the process of structural reform and doubts persist in several other areas, including the vulnerability of the banking system to potential shocks. Against this background, the emergence of serious difficulties in the foreign exchange and financial markets is not surprising, although one can raise questions on the timing, as noted by Mr. Mozhin in his statement.

The commitment of the new government to the EFF is encouraging. While the lags involved in the delineation of the strategy to be adopted this year contributed to accentuate market uncertainty, the economic program for 1998 represents a step forward in attempting to strengthen confidence and increase the economy's efficiency.

The fiscal measures considered in the program include efforts on both the revenue and the expenditure sides, and a number of innovative elements have been incorporated to meet the envisaged spending cuts. Nevertheless, the fiscal situation remains very vulnerable. First, the deficit of the enlarged government is expected to reach 5.7 percent of GDP in 1998, a level which is still very high, and the staff's preliminary estimates for the first quarter already suggest the possibility of deficits at least 0.5 percent of GDP above these figures. Second, according to the staff, the program for 1998 was mostly formulated prior to the recent financial difficulties, and it is unclear to what extent will public finances be affected by the impact of the uncertainty observed recently in the financial markets. This is an issue which should be clarified by the staff. Third, public finances in Russia face significant downside risks from factors such as the upcoming elections and the evolution of oil prices. Fourth, with further expenditure cuts raising the risk of an additional accumulation of arrears and efforts on the revenue side constrained by political developments, the margins of maneuver for the Russian authorities in the face of additional pressures on public finances do not seem to be very wide. In any event, I welcome the authorities' recognition that the situation of the economy leaves no room for a deficit above that incorporated in the program, and I hope that the measures envisaged under the new anti-crisis plan will go even beyond this objective.

The potential problems posed by the large stock of short-term domestic debt are another source of concern. Given the need to rollover the equivalent of some 1.5 billion dollars in government securities weekly, the authorities are searching for means to lengthen the maturity structure of domestic debt. The staff is of the view that the timing may not be optimal in view of the high spreads for Russia in international markets and the increase in foreign currency exposure that the issue of foreign debt would imply. I share the staff's concerns, but I would like to have more details on the costs resulting from the need to rollover large amounts of maturities weekly.

Under the 1998 program, the main objective of monetary policy is to allow a gradual depreciation of the ruble within the established band, so as to maintain the real exchange rate broadly unchanged. The flexibility allowed by the new exchange regime will be used only if outflows are large and persistent. This policy course requires obviously a flexible management of interest rate policy, and the policy response of the authorities to the recent difficulties in the financial markets is an indicator of their commitment in this respect. Adherence to this strategy suggests that after a certain threshold the depreciation of the ruble even within the band is likely to be more costly than an increase in interest rates. Thus, it would be interesting to hear the staff's views on the potential impact on the economy and especially on the fiscal accounts and on the banking system of upward movements in interest rates, vis-á-vis the possible implications of a more rapid depreciation of the exchange rate within the band. I am also interested in some further insight on Russia's vulnerability to capital outflows. In particular, like Mr. Zoccali and Mr. Szczuka, I would appreciate some more details on the amounts of short-term foreign investment in Russia's financial system.

The measures of structural reform included in the economic program for 1998 are ambitious and comprehensive. I am glad to see that these policies were designed jointly with the World Bank, and that the structural reform program is heavily front-loaded. It is clear that in view of the urgent need to enhance the economy's efficiency, the strict adherence to the timetable set under the program is absolutely essential. While the staff reports that the implementation of structural measures in 1997 was broadly in line with the program, there have existed some delays and misunderstandings which should not be repeated.

With these comments, I wish the Russian authorities every success in overcoming their difficult economic situation and I support the proposed decision.

Mr. Hansen made the following statement:

At this late stage of the discussion, I don't think I can add much value to our discussion. I very much agree with what has been said by others, not least by Ms. Lissakers and Mr. O'Donnell.

Notably, I consider it very unfortunate to be confronted with less than completely implemented prior actions, following an extended tug-of-war on these issues. Moreover, valuable time in terms of program implementation has been lost in recent months. Russia has a long way to go to restructure the economy. To a large extent, Russia is faced by home-grown problems. As stated by Mr. Donecker, there are limits to how far the Fund can go in granting Russia waiver after waiver. As I broadly agree with the staff's appraisal, let me just briefly add four points.

First, although economic activity was positive in 1997, growth stagnated during the first four months of 1998 and investment growth has been negative. Furthermore, the program's underlying macroeconomic framework, reflecting the objectives of the program, in my opinion, builds on rather optimistic assumptions. In view of this, I would tend to be somewhat less optimistic regarding the prospects for economic growth than the authorities are in presenting their programme for 1998.

Second, the lack of progress on containing the budget deficit and improving revenue collection has been a recurrent problem in Russia's arrangements with the Fund over the last couple of years. It is therefore crucial that the proposed program's performance criteria for federal government cash revenues and the deficit of the federal government be strictly adhered to, (and that the structural performance benchmarks with respect to public utilities and transport monopolies be observed). The recently adopted expenditure reduction plan is indeed a welcome step in this direction. However, successful implementation will, to a large extent, depend on efforts to strengthen expenditure management and control.

The fiscal (financial) situation appears to be increasingly vulnerable to external circumstances, in particular, because the government's borrowing requirement will remain sizeable in 1998. It is the short term debt that should be of immediate concern, since a relatively large part of the treasury bills are held by foreign investors. Even though, in principle, it would be desirable to extend the maturity of the existing short term debt, I agree with the staff that prudence must be observed considering the current high yields.

Third, Russia's external balance is indeed particularly vulnerable to world market developments in oil and gas prices. It is therefore important that further progress is made with respect to developing the private sector and liberalizing the Russian economy and its foreign trade - thus diversifying Russia's export capacity and attracting foreign direct investment.

On the point of developing the private sector, I welcome the government's commitment to pursuing a broad-based reform agenda. However, I believe that even more attention should be given to encouraging new business activity. Legal aspects such as an effectively working bankruptcy law, land reform, and improved corporate governance are of outmost importance if a private-sector-led recovery is to take place. The new Bankruptcy Law should be promptly enforced and allowed to show its teeth also in action. In addition, the Bankruptcy Agency needs to be provided with adequate staffing and financing. On land reform, I welcome the important steps that are planned to be taken during the coming months. I believe that companies' credit status could be enhanced immensely if land could be used as collateral in credit arrangement.

Fourth, I am concerned about the fragility of the Russian banking system. The staff highlights several indicators, such as high credit risk exposure, and increasing foreign exchange exposure, which demonstrates the precarious state of the banking sector. The fact that bank accounts are not properly consolidated, and the apparently general lack of relevant and reliable data, further contribute to my sense of unease. I would have appreciated more emphasis on banking issues in the program and, fundamentally, I have the same worries as referred to, inter alia, by Ms. Lissakers and Mr. O'Donnell.

To conclude, I can support the completion of the seventh quarterly review. We will also, in a positive spirit, consider further support, as necessary and as appropriate, but on the strict conditions referred to by Mr. Donecker, Mr. Milleron, and the Chairman.

The staff representative from the European II Department, in response to questions from Executive Directors, made the following remarks:

On the anticrisis plan, as stated at the outset of the meeting, the staff is just beginning to study the details. The cuts that were announced on the spending side, however, are not additional to what has been assumed under the program. We understand that on the revenue side the authorities are estimating that the plan is targeting for an increase in revenues of Rub 20 billion, but we have not been provided with the calculation to date. A number of measures in the plan are not new and are already assumed under the program—for example, putting the value-added tax and gas excise on an accrual basis.

There were a few questions with regard to whether there has been any improvement in tax compliance to date and why the elimination of tax offsets had not had a bigger impact so far. We do see signs that the authorities have become more serious about collecting taxes, including through the implementation of several measures. It is still too early to say whether these measures will have any impact. Indeed, the latest data indicate that revenue collection in May amounted to Rub 20 billion, which is slightly below the pace we would have desired under the program. So there is still a lot more to do in terms of increasing actual collection. There are two main reasons for the limited impact of the elimination of offsets. First, perhaps some of the amounts that were reported as noncash revenue last year that came in the form of offsets were fraudulent; for example, inflated claims by the companies in terms of over-invoicing of goods supplied to the government. Some of that money may not ever be translated into actual cash revenues. Second, the other main factor may be the fact that the public is still not convinced that offsets have been eliminated once and for all, so they may still be withholding money in the hope of obtaining some offsets later in the year.

There were a few questions related to the implication of lower oil prices on revenues. Under the program, we had assumed prices roughly comparable to currently prevailing prices, and we had estimated that the direct impact of lower prices this year would be about Rub 5 billion on budget revenues. There are also indirect effects related to the willingness of the oil companies to pay their statutory obligations. We estimated that the oil companies would lose roughly Rub 20 billion in export proceeds from the price decline this year. So, the impact on revenues could be anywhere between Rub 5 to 20 billion.

Turning to fiscal federalism and concerns related to the finances of the local governments, indeed this is a main concern—and perhaps risk—under the program, as evidenced by the outturn for the first quarter of 1998. The authorities are intending to take a number of measures to strengthen the pension fund. In addition to the revenue measures mentioned in the staff report, we understand they are taking steps perhaps even to roll back some of the pension benefit increases that were mandated by the Duma earlier this year, which would be a very courageous and major step. In addition, they intend to introduce added conditionality in the policy of transfers, for example linking transfers to local governments to the elimination of offsets at the regional level, and also trying to encourage local governments to put in place detailed expenditure reduction plans of the type that have been instituted at the federal level.

With respect to the banking sector, there were some specific questions on Tokobank. Indeed, Tokobank had been supervised by the Moscow branch of the Central Bank of Russia's supervisory structure rather than the central unit dealing with the largest banks, but this is not unusual. In terms of Sberbank's role, we are not aware of any support provided by Sberbank to Tokobank in the latest days and weeks. Indeed, we have advised the authorities that, in designing any type of rescue strategy, it would be critical that Sberbank not be involved. At the same time, Sberbank is one of the shareholders of Tokobank, and to the extent that all the shareholders may be asked to inject additional capital, they may be expected to participate in that.

Is Sberbank intervening in the GKO market? We estimate that Sberbank holds about one third of the outstanding stock of GKOs. We have been assured by the central bank, however, that they do not intervene on behalf of the central bank, but, of course, they will be buying and selling GKOs. We know very little about the balance sheet exposure of Sberbank and the central bank. We have designed a set of indicators, taking into account the various Fund-wide initiatives to increase transparency and monitoring of the banking sector activities, and the authorities have agreed to the provision of this data under the program, and we expect to begin receiving a more comprehensive and enhanced data set shortly.

In designing a strategy to deal with the banking sector, Mr. O'Donnell asked whether it was the Fund or the Bank taking the lead. There are several initiatives under way. We commenced earlier this year a study of the banking sector. The staff from the Monetary and Exchange Affairs Department have begun some work and received an initial data set; they have asked for more data and were following up and hoped to have a study ready by this summer. At the same time, we are collaborating quite closely with the World Bank, who have their own staff working intensively in this area, and who are discussing with the authorities appropriate strategies for dealing with problems in the banking sector. When we discussed the possibility of additional measures in the forthcoming mission, our strategy in general on the structural side was to have a joint program, fully coordinated with the Bank staff, who will be traveling to Moscow over the weekend as well.

A number of Directors expressed concern that there is too little in the program dealing with the banking sector. We restricted ourselves to a number of improvements in prudential regulations under the existing program. However, we did stipulate that the next program review would include as a major element a review of the banking situation, and we will agree as needed on any enhanced measures dealing with the banking sector in the context of the next review.

There were some questions on the maturity structure of the external debt. Over the course of the remainder of the year, there is about \$5 billion of external debt coming due. This includes \$1.75 billion in amortization payments and just over \$3 billion in interest. This figure, of course, excludes any redemptions of GKOs which we still estimate at roughly \$35-40 billion over the remainder of the year, which includes both ruble- and dollar-denominated debt. There is about \$1.5 billion coming due every week on average that needs to be redeemed, of which about one-quarter to one-third is held by foreigners.

There were some questions on the recent Eurobond issue. First of all, we were not consulted on the timing of the Eurobond issue, nor did the authorities know in advance of the timing and nature of the decision on the Board meeting last week. We estimate that perhaps about a half percentage point increase in borrowing costs resulted from the announcement in the middle of the issue that the Board meeting would be delayed. At the same time, we do not necessarily agree with the view that the terms were all that bad. Indeed, given the heavy concentration of debt service over the next three to five years, longer term bond financing was appropriate, and an interest rate of about 12.75 percent—especially under current conditions—can be seen as a positive outcome. So, I think we would be less negative in assessing the results of last week's Eurobond issue. There also is a ten-year call option for investors, so we would consider it to be a ten-year issue rather than a 30-year issue.

There were some questions on the exchange rate and the advantages and disadvantages of a devaluation. If one looks just at the partial equilibrium impact, the devaluation could even be viewed as positive on the fiscal outlook. The net impact of increased domestic currency value on net foreign financing and increase in revenues associated with trade taxes would outweigh the expenditure effects. Also, if one assumes no change in money velocity, then there would be some associated seigniorage gain. However, there are two substantial disadvantages. One is the possible impact on the banking system, but more generally we feel that the stability of the ruble is the main anchor underpinning inflationary expectations at this time. A devaluation that is unaccompanied by any fiscal adjustment would destroy confidence in the ruble, lead to a redollarization of the economy, and set Russia back in terms of its stabilization effort. Indeed, one could argue that the desire to defend the ruble is one of the main incentives underpinning the desire of the authorities to undertake strong fiscal action. At this time, the staff supports the authorities in their desire to maintain the stability of the ruble. At the same time, while certainly the oil price decline has led to an adverse terms of trade shock for Russia, looking at the relative labor cost indicators, we do not see a particular problem in terms of competitiveness. That said, we will be discussing with the authorities on the next mission possible improvements to the operation of the current exchange rate regime. We also have some questions about how they are operating the band on a day-to-day basis. They see perhaps some ad hoc adjustments in both intervention policy and in managing the width of the narrow band on a day-to-day basis, and we will discuss with them whether it makes sense to have a bit more predictability over the short run, and a preannounced crawl could be one of the options we discuss with them.

In the area of privatization, why did the Rosneft privatization fail? I think largely because the authorities misjudged the market. The new price might still be too high. The first scheduled auction was in the middle of the financial turbulence that emerged in late May, which turned out to be the major factor behind the failure.

Turning to the prior actions, are they clear enough and to what extent should we have been more specific? For example, on the measure related to the

Emergency Tax Commission, we did not tell the authorities specifically which companies to pursue. We gave general guidelines, such as that they should be chosen amongst the largest group of 20 debtors. Beyond that, I think we should leave it to the authorities to choose which specific companies they are going to pursue and at which time.

Similarly, the question was asked whether there were too many measures specified and whether it was appropriate to include them as performance criteria. Given the nature of the measures, we find that there are often legal and political obstacles that come into play as the measures are implemented, and often the measures as implemented are somewhat different in precise character to what was intended when they were initially negotiated. As long as the spirit of the measure is being observed, we prefer to have them as prior actions or quarterly benchmarks, and not precisely as performance criteria.

Finally, on the question of growth, if we look at both the latest figures and the fact that interest rates—if they stay at current levels—are higher than we had assumed under the program, then growth is likely to turn out to be less than assumed under the program. I think the figures for the first five months of the year on average show zero growth relative to last year and on a 12-month basis; we had assumed 1 percent under the program for 1998. Clearly, if interest rates stay high, then we will have to take that into account as well, although given the relatively small size of the banking sector in Russia, the impact of interest rates is somewhat lower than normally is the case in other countries.

Mr. Szczuka asked whether the staff could comment briefly on the latest financial market developments. There had been quite a substantial softening of the ruble and widening of yields. He wondered what the reasons were behind such movements, other than the speculation that the Fund might delay the decision to release the next tranche. He wondered what was the actual level of usable foreign exchange reserves, and reiterated his question on what the difference was between gross and net international reserves.

The staff representative from the European II Department agreed with Mr. Szczuka that the latest market developments had not been positive. The two reasons mentioned in the financial news wires were that banks needed funds both to settle some external obligations at the end of the quarter and also to pay taxes. With respect to net international reserves, the central bank had just announced figures for last Thursday, June 18, which showed gross reserves of $14.7 billion including about $5 billion in gold. That amount did not include the amounts raised through the Eurobond sale the previous week, so the actual level of reserves currently would be higher. The main difference between gross and net international reserves was liabilities to the Fund.

Mr. Sobel stressed the importance of the early receipt from the authorities of comprehensive data on the banking system. It was regrettable that the information had not been forwarded to the Fund earlier. With respect to Ms. Lissakers's earlier question on the tax code, there had been various reports that the first chapter was moving through the Duma, but only included definitions, and that other chapters might not be realized until later. Another scenario recently reported was that chapter 1 would be amended to include some of the key rate changes and eliminate exemptions. The anticrisis program apparently included value-added tax changes and excise and personal income tax changes. He asked the staff to clarify the prospects for the tax code.

The staff representative from the European II Department responded that the staff team in Moscow had been told by the head of the Duma budget committee that Part I of the tax code would be submitted to the Duma the following week for the second reading and should pass by mid-July. Part I included the administrative and procedural elements, but not the tax policy changes. It was not clear when Part II would proceed through the Duma. The main stumbling blocks were the many tax policy changes included, and the fact that many interest groups were attempting to influence the outcome. The anticrisis package included a number of changes to the regulations that would involve amendments to the current tax code. Also, it included a number of provisions reforming the tax code, and the authorities had preferred to bring some of those elements forward through separate legislation. It was not clear how the changes that were being proposed in the context of the Duma process would be worked out.

Mr. Guzmán-Calafell noted that the staff representative had explained the disadvantages of devaluation, basically stating the importance of the ruble as a nominal anchor. However, an intermediate option might exist: faster depreciation of the exchange rate within the band. There was a trade-off between increasing interest rates and movements in the exchange rate. From the comments made during the current Board meeting, it was clear that increasing interest rates had had a very important cost to the economy. Perhaps the staff would elaborate on the possible implications of a somewhat faster depreciation of the exchange rate within the band, which might alleviate upward pressures on interest rates. Otherwise, all the burden of the adjustment would fall on interest rates, and the cost would be very high.

The staff representative from the European II Department responded that a faster rate of crawl might actually hurt the situation, because it could be seen as a weakening of the authorities' resolve to defend the exchange rate band. Not much room existed to maneuver within the current corridor, and a slight change in the pace of crawl in the face of weak confidence in financial markets and capital outflows not only would not be a solution but might also put upward pressure on interest rates.

Mr. Yoshimura said that he was somewhat puzzled by the staff representative's remarks on the implications of the recent Eurobond issue by the Russian authorities. He wondered whether such a large spread of the borrowing for 30 years would be justified because of the possible prolonged uncertainty surrounding the performance of the Russian economy. Also, Mr. Kiekens had pointed out the possible large capital gain that could be realized by bondholders if the Fund's additional assistance strengthened market confidence in Russia. He wondered whether such a development might raise moral hazard concerns.

The staff representative from the European II Department responded that the relatively large spread paid by the Russians on the recent Eurobond issue reflected greater concerns about the short-term financial uncertainties and possibility of depreciation, rather than the longer-term prospects. Certainly, if a depreciation were to materialize, that would lead to the effects described by Mr. Yoshimura. At the same time, the rate that the authorities were able to procure was somewhat attractive. Overall, the specific bond issue did lead to some alleviation in the total borrowing costs, but, in view of the uncertainty over the exchange rate, the staff would advise caution with respect to increasing substantially external debt obligations. It was important to consider the appropriate balance between raising more funds currently at a lower cost overseas and not being willing to impose a large burden in the face of exchange rate uncertainty.

Mr. Melham made the following statement:

> Following this morning's comprehensive discussion on Russia, I can be very brief.
>
> I just would like to say that I share many of the concerns raised by previous speakers. I support the proposed decision and wish that the fiscal problems will be resolved. I have one question, basically. I have been covering Russia in the Board for five years, and I am less certain now about the main weakness in the fiscal accounts. Is it on the revenues, is it on the expenditures, is it in the provincial government, or is it in the central government?

The staff representative from the European II Department responded that the weaknesses in the fiscal accounts were attributable to many factors stemming from many sources.

Mr. Daïri made the following statement:

> We agree with the thrust of the staff analysis and policy advice. Russia has taken considerable strides toward establishing a stable and market-oriented economy. Nevertheless, as the recent turbulence in financial markets has demonstrated, the achievements under the EFF-supported program remain tenuous and vulnerable to shifts in market sentiment.
>
> At the heart of Russia's difficulties lies the problem of fiscal management. We realize that this is a deep-seated and complex issue that does not admit easy solutions. Nevertheless, if the Russian economy is to be placed on a sound footing and markets assured of the authorities' determination to come to grips with the economic difficulties, the fiscal problems will need to be addressed in a decisive and forceful manner. The promptness of the authorities' response, which demonstrates that they understand how much is at stake, is encouraging.
>
> There is a heavy reliance on expenditure cuts to meet deficit targets in the 1998 budget. While this may be an appropriate short-term strategy, there is the risk that absent well-functioning expenditure control mechanisms, new expenditure arrears will emerge. While the revenue target is modest and should be more easily achievable, it should be regarded as a minimum that must be met at all costs. The authorities are urged to boldly follow through on the strong measures they have formulated to deal with the largest tax debtors, including, most importantly, ensuring that the tax authorities have the requisite political backing.
>
> Monetary policy, especially in 1998, responded promptly to emerging pressures and helped send the positive signal of the authorities' commitment to

financial stability. The credibility of this policy needs to be safeguarded. We support the policy of a gradual exchange rate crawl within the new wider band and the objective of keeping the real exchange rate broadly constant. Given the slight depreciation of the ruble against the U.S. dollar in 1997 and the presently low level of wages in U.S. dollar terms relative to its competitors, we agree that the external competitiveness of Russia does not appear to be of immediate concern. Nevertheless, this is an area of policy that warrants careful monitoring.

The program's structural reform agenda is appropriately frontloaded and comprehensive. We support the emphasis on improving corporate governance in the utilities and transport sectors, furthering the privatization process, reducing distortions, and simplifying the trade regime. We wish to underscore the importance of addressing market concerns about the resilience of the banking system, especially given the banks' growing vulnerability to shifts in the sentiment of foreign lenders.

While the program represents a bold and concerted effort to move the Russian economy forward and should foster a return of confidence, the staff is right to caution that it carries many risks emanating from uncertain domestic and external developments. Nevertheless, we are encouraged by the authorities' commitment to the program and their firm determination to move ahead with the tough measures necessary to further Russia's transition to a private sector based growing economy.

We support the proposed decision and wish the Russian authorities further success in their endeavors.

Mr. Yao made the following statement:

We welcome the further progress made by Russia towards a stable market economy in 1997. In particular, we note the positive economic growth that took place for the first time, since the transition began, and the important contribution of the structural reform measures to this development. However, the continued weaknesses of the government finances due mainly to weak tax administration, remains a source of concern, and overall performance remains below expectations. In the face of declining energy prices, the strengthening of fiscal performance has become more urgent than ever; and unless forcefully addressed, the weak government finance could undermine the hard-earned gains of the past few years.

We are, therefore, encouraged by the determination and commitment of the Russian authorities to stay the course and to continue with the adjustment process. In this context, we welcome the steps taken recently by the authorities to strengthen the program. In particular, the objective of further reducing the fiscal deficit in 1998 is appropriate, but the attainment of this objective will require a major political commitment in enforcing the tax laws. Therefore, I thank management for supporting the Russian authorities in their adjustment efforts.

The renewed effort to collect arrears and to eliminate offsets are commendable, but we are of the view that the time frame for the implementation of this policy could have been lengthened, due to the apparent weakness of the administrative apparatus. The 1998 fiscal program contains a number of important measures which can begin to address some of the weakness that have been identified both on the revenue and on the expenditure side, and we would urge the authorities to continue their efforts to implement them as quickly as possible.

In the monetary and exchange rate areas, we broadly agree with the policy stance of the authorities. However, we note the continued difficulties in the banking system and we would underscore the need to accelerate the reform process in this area. Our experience in Asia has clearly shown that measures to strengthen the banking system should be implemented expeditiously in order to reap the benefits of measures being introduced in other sectors. While an increase in the interest rate can help in the short run, it is costly to the budget, and can only worsen the financial situation.

In conclusion, we would urge the authorities to continue to take vigorous actions to strengthen the public finances, to improve transparency and address more forcefully governance issues and also to continue their efforts to improve the soundness of the banking system. We also note the commitment of the authorities to continue the adjustment process, and their determination to take additional measures. We can, therefore, support the proposed decisions.

Mr. Zhang made the following statement:

I would like to begin by complimenting the staff for its comprehensive paper and concrete analysis of Russia's economic development. I would also like to commend the authorities for their renewed efforts in economic stabilization and their encouraging accomplishments: positive economic growth was registered for the first time since transition; inflation decelerated in line with the program; the exchange rate was maintained within its announced corridor; structural reforms gained renewed momentum in important areas; and monetary policy was successfully sustained with large capital inflows. It is expected that economic growth will gain further momentum in the years ahead, and inflation will decline as targeted. However, progress in addressing the fundamental problems with fiscal management and its uncertainties are cause for our deep concern. I broadly agree with the thrust of the staff appraisal, and would like to make the following comments for emphasis.

First, I appreciate the authorities' determination and political commitment to achieve the fiscal target. We also welcome the measures taken by the authorities in the prior actions. I am pleased to note from the staff that the budget plan, approved by the Duma, is consistent with the Fund program and that the authorities have allocated spending agencies a different spending limit, which not only forms a legal but also a practical basis for accomplishing the spending cut targets. In addition, the authorities have taken a series of policy measures in expenditure control, including improvements in the treasury system, monitoring mechanisms, and sanction punishments. On revenue collection, we share the staff's view that with additional efforts the revised revenue collection target could be achieved. The authorities seem to be in a more favorable position to achieve their program target. However, given the complexity of Russia's fiscal problems, I remain concerned about the difficulties in implementing the program. I share the staff's concern on the defense cut, and I am particularly concerned about the consequences of the spending cuts in transfers and net lending to regions. I note from the staff report that the enlarged government deficit in the first quarter has exceeded the program ceiling—possibly attributable to the regional and local governments. The cuts in federal transfers and net lending to the regional and local governments will doubtless put increasing pressure on lower level budgets and force them to adjust their own financial positions through the capital market. Therefore, I also wish to underscore the need and importance to effectively strengthen federal control over lower-level governments' borrowing and spending, without which efforts to obtain fiscal targets cannot be successful. The staff's elaboration or report on developments in this respect in our future discussions would be appreciated.

Second, I concur with the authorities and the staff that the monetary policy objectives should be built on the basis of a stable exchange rate, and interest rate flexibility should be allowed in response to foreign exchange market fluctuations. In addition, continuous restrained credit policy is welcomed.

Third, on the external sector, apart from the impact of the oil price reduction on Russia's current account deficit, I am especially concerned about the impact of the huge short-term maturity Treasury bills on the capital account. Our concern is for two reasons: on the one hand, foreign investors accounted for about one third, about Rub 20 billion; and on the other hand, the Treasury bill maturities are mainly short-term. Any fluctuation in the exchange market may cause capital outflow and close monitoring of market developments is necessary.

Fourth, the banking system needs to be further strengthened and data availability should be improved. As mentioned in the staff report, when Russia's external vulnerability becomes apparent and acute, the importance of strengthening the banking sector increases. However, insufficient data impairs our judgement on Russia's banking sector adequacy. I welcome the authorities' efforts in stepping up banking supervision and data publication, and encourage them to further improve the availability of data on economic and financial developments.

Finally, I would like to reiterate that the political commitment and forceful implementation of the program and policy measures which the authorities intend to take, are vital to Russian economic stability.

With the above remarks, I support the proposed decision and wish the authorities every success in tackling future challenges.

Mr. Gueorguiev made the following statement:

Russia continues to advance toward a stable market economy. On top of the encouraging 1997 macroeconomic results, the stabilization shows a lot of resilience in the face of the adverse external environment brought about by the Asian crisis. Due credit must be given to the authorities, whose decisive actions are responsible to a large extent for stemming large capital outflows and the preservation of the still fragile stability.

Fiscal policy actions are of overriding importance now. The weight of chronic fiscal problems—insufficient cash revenue, weak control over expenditures leading to big arrears—as one of the fundamental causes of the May crisis should not be underestimated or forgotten quickly. We welcome the authorities' fiscal policy package from May 29 as a sign of their serious intention to break with the past and stop the erosion of fiscal revenue. We also hope that the new anticrisis program advances further in this direction. In the same time, we would like to emphasize the importance of putting expenditure under firm control with the new Treasury system and to encourage the authorities to extend the coverage of this system over military spending as soon as possible. Otherwise there is a serious risk that the sizable spending cuts (3 percent of GDP) would become new expenditure arrears. The elimination of tax and expenditure arrears' offsets, a practice particularly harmful for cash revenue collection in the past, is also a major positive fiscal development. We support the staff's decision to make this a continuous performance criterion for the 1998 program.

An important issue is the implications of Russia's external vulnerability (stemming largely from the huge domestic short-term debt—40 billion with maturity less than a year) for the banking system. For banks of systemic importance, liquidity and capital adequacy (20 percent on risk-weighed basis) seem adequate. The latter may be overstated, though, as banks are not required to consolidate their accounts with their fully owned and controlled entities. The required risk-weighted capital adequacy ratio is 7 percent, which seems too low for a transition economy. We understand that the CBR have a plan to increase it to 8–9 percent by February 1999 and to 10–11 percent by January 2000. We would encourage them to phase these ratios as early as possible, as this should also prove helpful for banking system consolidation.

Furthermore, banks seem to be subject to serious risks: (i) interest rate risk - coming from the large share of T-bills in their portfolios; (ii) foreign exchange risk - as a whole, banks maintain a negative (short) open position, as they borrowed in foreign exchange and attracted a lot of foreign exchange deposits; (iii) credit risk - the staff report mentions that the shares of connected lending and non-performing loans are high by international standards. We would like to ask the staff to comment on the performance of the banking system in the May crisis with respect to these risks.

On the structural side, we welcome the authorities' determination to proceed with trade liberalization, but regret that the maximum import tariff will be reduced from 30 to 20 percent for only one-third of the goods it applies to.

We would encourage the authorities to consider such a decrease for the remaining two thirds soon, possibly in the context of their policies for the extension of the EFF-supported program. Limiting import duty exemptions will minimize the fiscal impact of lower tariffs. We also support the authorities' endeavor to introduce more transparency, payment discipline and private sector participation in utilities and transportation. Finally, we would encourage the authorities to make an effort in supplying more timely monetary statistics to the Fund. We understand that the latest monetary data at staff's disposal are dated May 15, which makes the assessment of the May crisis's repercussions on the financial system problematic. We are reassured by the understanding reached with the CBR on this important issue.

With these remarks, we support the proposed decision on the Seventh Review of the program, endorsement of the 1998 program and program extension for an additional year.

Mr. Harinowo made the following statement:

I joined the other Directors in commending the staff for its remarkable job on Russia. Russia's economy actually experienced a considerable progress under the program in 1997. For the first time, the economy registered a positive growth since the transition, inflation continued to decelerate and the exchange rate was maintained within the band. This is indeed a commendable performance judging from the complicated problems that were faced by the country. It is unfortunate that the recovery process of this country was derailed by financial turbulence due to several exogenous factors as well as home grown problems.

The turbulence in the Russian markets related closely to the erosion of market confidence. This loss of confidence led to the flight of capital from the Russian banking system, the sell out of the stocks and other securities and also the Treasury bills. The sudden movement of capital in a major way certainly put a tremendous pressure on the ruble which in turn affected significantly on the level of interest rates. The Asian crisis contributed largely on the change of market sentiment. The fact that the start of the turbulence in Russia coincided with the beginning of the Asian crisis clearly indicated a positive relations between the two. The fall of the oil prices deteriorated further the market sentiment about the country. These two factors were significant enough to create a turbulence on the financial market. The perceived political uncertainty created by the change in the government indeed put fuel to the fire.

In our view, the slippages in the fiscal policy as well as the structural reforms, while it certainly contributed to the worsening situation, were not really the core of the current crises. The faltering fiscal position indeed made a certain pressure on the monetary situation as well as on the external balance. The fact that a significant amount of Treasury Bills were purchased by foreign investors had certainly affected both the monetary position as well as the external balance. At the time of a positive market sentiment, the ability to sell Treasury Bills to the foreign investors will make the fiscal stance to weaken since any fiscal gap that arise can be financed by the issuance of Treasury Bills.

However, at the reverse situation, especially when the cumulative amount of Treasury Bills in the hand of foreign investors are significantly large, the sell out of the securities will put a tremendous pressure on the external balance, monetary situation as well as the fiscal position. The sales of the Treasury Bills by the foreign investors in this particular case was triggered by the change in the market sentiment, not otherwise. However, the news that there are fiscal slippages could certainly weaken the market sentiment. It is in this context that I agree fully with the program to improve significantly the fiscal policy. Continued accumulation of government debts resulting from the fiscal deficits has certainly posed the Russian financial credibility to the volatility of the global finance. Therefore, early resolve of the fiscal deficiency will enhance the overall stance of the Russian economy.

From the staff report, the program for 1998 will place a new emphasis on expenditure reduction and control and to reverse the deterioration of the revenue performance so that the fiscal situation will be back on track. At the same time, a consistent and restrained monetary policy stance will be kept to protect the external position. Alongside with this is the strengthening of the banking system which continues to be the target of speculation. On the structural reforms, progress from the previous program will be further strengthened and will cover the restructuring of the monopolies, privatization, development of the legal and institutional framework, and the strengthening of corporate governance and transparency.

These programs will certainly be helpful in strengthening the structure of the whole economy and lay the stronger foundation for the further development. Implementation of such a strong program will enhance the credibility of the government. However, with these programs, the Russian authorities will certainly face a very busy schedules in 1998. With little time remaining for 1998, there are possibilities that the Authorities might not be able to implement fully the program for reasons that we could fully understand. Therefore, some kind of flexibility could be granted especially for a certain measure that may not be too crucial for the success of the program.

We support the proposed decisions regarding the seventh review, approval of the 1998 program, and program extension into 1999.

With these remarks, we wish the Russian authorities every success.

Mr. Jones made the following statement:

I will just make a few points for emphasis.

The first is that the way forward in the Russian Federation is not so much to get the right agenda as it is to have the authorities implement forthrightly the measures that have been identified as crucial to establishing and sustaining a market-based economy. In that regard, we too would lend our voice to the concern that has been expressed by most Directors about tax administration and expenditure control.

The other point we want to make is that the slow recovery in the Russian Federation may well be one of the problems in complicating the path of reform. We believe that getting Russia on a sustained growth path remains a major challenge.

Finally, the difficulties with privatization, the recurring problem of revenue shortfalls, and lapses in control of expenditures all call attention to the importance of addressing institutional rigidities--what we now refer to as governance issues.

Mr. Bernal made the following statement:

Real GDP increased in 1997, influenced by household consumption, and the inflation rate declined. For 1998, real GDP growth is projected to increase further by about 1 percent and to accelerate in 1999 and in 2000, with the impetus to growth shifting from consumption to investment. At the same time, inflation is projected to decline further in 1998 and beyond. Monetary policy was restrained during 1997, and is expected to continue to remain so. Moreover, the implementation of structural reforms was in line with the 1997 program, and a medium-term restructuring program for the electricity, natural gas, and railways sectors was adopted. There has been progress toward introducing internationally accepted accounting principles, while a new Bankruptcy Law became effective on March 1, 1998. Land reform moved ahead and the government made some progress with regard to structural fiscal reforms. Trade policy measures and banking sector reforms were implemented. For 1998 and beyond, there is also a major agenda of structural reforms.

However, the Russian Federation continues to experience difficulties in moving to a modern market economy, and the government continues to be plagued with tax collection problems, forcing it to cut its spending plans.

As has been the case for the past two years, revenue collection did not improve as targeted under the 1997 program. Moreover, as the staff is saying, recent increases in interest rates needed to maintain the stability of the exchange rate have the potential to damage further fiscal consolidation and undermine the long expected economic recovery. For 1998, the authorities are contemplating only a very modest improvement in revenue performance and establishing a new emphasis on expenditure reduction and control. The staff, however, emphasizes that planning for a larger expenditure cut would increase the risk of an accumulation of new expenditure arrears. Therefore, we share the suggestion for a reinforced revenue collection effort.

In our view, an IMF-supported program should be viewed as a program for the whole country. A program with only the support of the administration, without the support of the Duma, has a great probability of failure. Nevertheless, the authorities are taking a number of actions on the revenue side directed at reinforcing collection from delinquent enterprises and are eliminating the practice of mutual clearance of tax and spending arrears through offsets. Although we all know this is not the optimal solution, we have no choice but to support the Russian authorities in this difficult moment. Also,

> we fully understand that with the forthcoming elections it would be very difficult to receive Duma support for the authorities' macroeconomic policies.
>
> Finally, there is no doubt that Russia's EFF supported program for 1998 and beyond, must be fully implemented by the authorities with an emphasis on reversing the declining trend in government revenue and accelerating structural reforms. We would also like to reiterate that the IMF must be increasingly careful to make sure that equity of treatment among countries is being preserved and seen to be preserved.
>
> With these remarks, we support the proposed decision and wish the authorities every success.

Mr. Karunasena said that he would emphasize the necessity of effective fiscal adjustment and implementation of structural reforms without further delay in order to overcome the present economic problem in Russia. He said that he supported the proposed decision and wished all success to the Russian authorities.

The staff representative from the European II Department, in response to questions from Executive Directors, made the following remarks:

> Mr. Yao asked about the problem of staffing in the tax service and whether that was a constraint. We do not believe that that is the issue. We believe the issue is mainly one of political will. Indeed, I think that, in relation to the nominal amount of revenues collected, the various tax services in Russia have among the highest staffing in the world.
>
> This morning I pointed out a possible reason why the authorities had implemented the prior action on large tax delinquents in a somewhat different manner than had been envisaged. Before the authorities can take a case to the Emergency Tax Commission, they need to ensure that the legal case is airtight. The documentation would need to be well prepared, because the company would often have counterclaims against the government. Given that the commission meeting was scheduled for July 1, perhaps the choice of firms was dictated by the level of preparedness in a legal sense. That said, we do think that there are ways in which the tax services should redeploy and reorganize their staff. The main aspect in that regard is that, under the program, there are measures to put in place large taxpayer units and to concentrate the authorities' resources in collecting taxes from the large taxpayers rather than a multitude of small taxes and small taxpayers. But in principle the issue remains one of political will.
>
> In terms of the impact of the latest developments on the banks, certainly the interest rate risk is high, and the prevailing high interest rates are putting pressure on the banks. So far, only Tokobank is known to have liquidity problems. When we look at the monetary data for May, we see that there was an increase in central bank gross credit to banks of Rub 2.5 billion, so there was some recourse to the credit facilities offered to the banks. There are a few other weak banks that are also of concern. The government is reviewing its strategy with regard to the banking sector.

On the issue of the customs union, the authorities do need to consult with their customs union partners in lowering tariffs and, ultimately, do need to coordinate their tariff policy. At a minimum, they have to notify them three months in advance of any changes in their tariff structure. But I do not think that that was the main constraint in the context of the negotiations.

Mr. Vernikov made the following concluding statement:

This was, as always, a very productive discussion. I accept what Directors had to say about Russia's economic policy, and I also appreciate their goodwill in interpreting the intentions of my authorities and the preparedness of my colleagues to give, once again, the benefit of the doubt to the authorities in what they intend to do.

Certainly, in the usual fashion, I will transmit to the Russian authorities the contents of this discussion, and I sincerely hope that they are as anxious to learn the comments of the Executive Directors as they are to learn about the very fact of the decision taken today.

To conclude, I would like to apologize for the procedural shortcuts we had to undertake in order to make this meeting possible. The fact that the announcement about this meeting was made only yesterday afternoon has probably strained the human capacity in some of the offices. However, I appreciate this flexibility, once again, and I am grateful to everybody for the interest expressed with regard to Russia's program.

The Executive Board took the following decision:

1. The Russian Federation has consulted with the Fund in accordance with paragraph 3 of the Extended Arrangement for the Russian Federation (EBS/96/31, Sup. 6), the letters of the Prime Minister of the Russian Federation dated March 6, 1996 and April 30, 1997, and the letter of the Chairman of the Central Bank of the Russian Federation dated March 12, 1996.

2. The letter of the Prime Minister of the Russian Federation dated June 15, 1998, with the attached Statement of the Government of the Russian Federation and the Central Bank of the Russian Federation on Economic and Structural Policies for 1998, shall be attached to the Extended Arrangement, and the letter dated March 6, 1996, with the attached Statement of the Government and the Central Bank of the Russian Federation on the Medium-Term Strategy and Economic Policies for 1996, and the letter dated March 12, 1996, as modified, shall be read as supplemented and modified by the letter, dated June 15, 1998, and the attached statement.

3. Accordingly, the Extended Arrangement for the Russian Federation shall be modified in the following manner:

a. The first line of paragraph 1 shall be modified by deleting "three" and by replacing it with "four".

b. Paragraph 2 shall be modified by deleting that portion of the paragraph that follows "SDR 4,336,264,000 until" and by replacing it with the following:

> "August 15, 1998, the equivalent of SDR 4,836,264,000 until November 15, 1998, and the equivalent of SDR 5,336,264,000 until February 15, 1999."

c. Paragraph 3(a)(ix) shall be modified by deleting "is not observed;".

d. The following paragraph shall be added to the Extended Arrangement after paragraph 3(a)(ix) as paragraph 3(a)(x): "the limit on the outstanding stock of external debt contracted by the government, the Central Bank of the Russian Federation, or other agencies on behalf of the government, in maturities of one year or less, as described in paragraph 23 and in Table 1 of the statement attached to the letter dated June 15, 1998, is not observed; or"

e. Paragraph 3(b)(ii) shall be modified to read: "if, at any time during the period of the Extended Arrangement, the federal government permits the settlement of any tax obligation by issuing any new tax offset or monetary offset, or by engaging in any nonmonetary fiscal transaction that involves the mutual clearance of budgetary spending arrears against tax obligations or the forgiveness of tax debts, as described in Table 1 of the statement attached to the letter dated June 15, 1998;".

f. Paragraph 3(c) shall be modified by deleting that portion of the paragraph that follows "January 31, 1998," and by replacing it with the following: "August 14, 1998, November 14, 1998, and February 14, 1999 until the respective reviews referred to in the letters of the Prime Minister of the Russian Federation, dated March 6, 1996, April 30, 1997, and June 15, 1998, and in the letter of the Chairman of the Central Bank of the Russian Federation, dated March 12, 1996 are completed; or".

g. The performance criteria for paragraphs 3(a)(i) through (x) of the Extended Arrangement for June 30, September 30, and December 31, 1998 shall be as specified in paragraphs 4 and 23 and in Table 1 of the statement attached to the letter, dated June 15, 1998.

4. The Fund decides that the twelfth review contemplated in paragraph 3(c) of the Extended Arrangement for the Russian Federation is completed and that the Russian Federation may continue to make purchases in accordance with the provisions of the arrangement, notwithstanding the nonobservance of the performance criteria specified for December 31, 1997 in paragraphs 3(a)(vii) and (viii) of the arrangement.
(EBS/98/100, Sup. 1, 6/12/98)

Decision No.11748-(98/68), adopted
June 25, 1998

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/98/67 (6/24/98) and EBM/98/68 (6/25/98).

3. ANDORRA—TECHNICAL ASSISTANCE

In response to a request from Andorra for technical assistance, the Executive Board approves the proposal set forth in EBD/98/63 (6/18/98).

Adopted June 24, 1998

4. INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—RELEASE OF INFORMATION AND SPECIAL PROCEDURES FOR TRANSMITTAL OF DOCUMENTS

The Executive Board approves the proposal on the release of documents under the HIPC Initiative as set forth in EBD/98/64 (6/19/98), provided that the relevant member, through its Executive Director, will be given 15 working days from the date of issuance of the documents to the Executive Board, to identify and delete from them data that it deems to be confidential, or to object to the documents' release.

Adopted June 24, 1998

APPROVAL: June 2, 1999

REINHARD H. MUNZBERG
Secretary