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To: Members of the Executive Board
From: The Secretary
Subject: Russian Federation - Recent Developments

There is attached for the information of Executive Directors a note, prepared by the staff, on recent developments in the Russian Federation.

Att: (1)

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Department Heads

INTERNATIONAL MONETARY FUND

Russian Federation - Recent Developments

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April 24, 1992

1. Recent economic developments

In the first quarter, industrial output declined by 13 percent year-on-year. The volume of oil production also fell by 13 percent; output of natural gas remained unchanged. Comprehensive output data are not available on a quarterly basis. The index of retail prices increased by some 500 percent, with most of the increase taking place in January in the aftermath of a comprehensive price liberalization, but with monthly inflation still in the 20-30 percent range in early April. Real wages in industry and in the budgetary sphere have fallen by roughly 50 percent since December 1991.

The budget in the first quarter was in rough balance on a cash basis; on a commitments basis, the deficit was equivalent to 8 percent of GDP, compared with around 20 percent of GDP in 1991 and 14 percent assumed in the Memorandum of Economic Policies (MEP). The better than targeted performance of the budget was mainly due to revenues exceeding projected levels, with expenditures slightly below projected levels. On the revenue side, despite some initial problems, receipts from the VAT performed as originally envisaged in the MEP, revenue from the profit tax was higher than projected. Revenue from export taxes was very weak through mid-March and while they rose sharply in the second half of March, they are still below the level envisaged in the MEP for the first quarter.

Credit policy was tightened sharply in January but loosened somewhat in February and March. ^{1/} In January, the finance rate of the Central Bank of Russia was raised from 2-9 percent to 20 percent per annum and phased increases of reserve requirements began. The finance rate was further increased in early April to 50 percent per annum (and to 100 percent on overdrafts). Inter-enterprise arrears have risen from a low level at end-1991 to more than rub 900 billion at present owing, in part, to problems with slow settlement of payments.

Russia registered a US\$2 billion trade deficit with countries outside the territory of the former U.S.S.R. in the first quarter of 1992, with exports declining by 20 percent and imports increasing by 15 percent from the first quarter of 1991. The deferrals of official and commercial debt principal have been extended through June 1992; however, only a small part of debt service is being paid owing to lower export levels and less than full compliance with surrender requirements. Arrears, in particular on

^{1/} Data for end-March are not yet available.

letters of credit obligations, have risen substantially. Trade with other former republics is reported to have declined sharply, with Russia running a modest overall surplus.

2. Energy pricing policies

Following the liberalization of prices in January 1992, the price of crude oil and other energy products--although raised fivefold to rub 350 per ton (exclusive of VAT)--remained at less than 5 percent of the world market price. The authorities noted in the Memorandum of Economic Policies their intention to liberalize the price of oil by April 20, but to maintain it at around some rub 2,500 per ton through a system of export taxes. Subsequently, after strong domestic opposition to the announced liberalization and in response to representations from other republics, the authorities decided to postpone it. However, citing the financial needs of the energy producing enterprises, the authorities have allowed them to sell 40 percent of their output at free prices. As a result, local authorities recently have raised prices to the consumers (e.g., on gasoline) often by as much as five times. The authorities are considering permitting energy prices to rise but with the imposition of a progressive tax on oil prices which would effectively limit the price of oil to around rub 2,500 per ton. Natural gas and coal prices would likely be raised more or less proportionately. The timing and exact modalities of this measure as well as later liberalization in conjunction with a new system of export taxation, are still under discussion.

3. Fiscal policy

The revised draft of the second quarter budget (originally submitted to Parliament on March 10) is still being discussed within the Government. Until its formal approval by the Supreme Soviet, government spending is guided by the Law on Budgetary Procedures, according to which only up to one-third of the first quarter expenditure can be spent in April. On the revenue side, plans to introduce increases in energy taxation (on both domestic production and exports) have been delayed. In the meantime, export tax exemptions of some rub 150 billion for the year as a whole were granted by the Government under the pressure of various autonomous regions during the run-up to the Sixth Congress of People's Deputies. Other taxes, however, may continue to show a relatively satisfactory performance.

On the expenditure side, the Government may be able to limit somewhat the indexation of budgetary wages called for by the recent Congress. The Government has decided to increase pensions and the minimum wage roughly 2 1/2 times, although the timing of the implementation is uncertain. Other expenditures, however, such as subsidies on earmarked credits are likely to be substantial, and also rise (see section 4). Moreover, the defense budget in the second quarter may be more than double its size in the first quarter. It is also expected that certain extrabudgetary funds, such as the Employment Fund and the Social Support Fund, will become operative, with potential claims on budgetary resources. On a commitments basis, the

deficit in the second quarter may be at least as large in relation to GDP as that in the first quarter; a modest surplus was envisaged in the Memorandum of Economic Policies. This would mean that for the first half as a whole, the deficit could be around 8 percent of GDP compared to 4 percent in the Memorandum.

4. Monetary policy

In response to recent pressures stemming from the Congress of People's Deputies, the authorities have agreed to an increase of rub 200 billion in Central Bank lending to priority sectors (including agriculture). Other credit allocations have also been discussed. A large share of this lending may take place at interest rates subsidized by the budget, and may be at the expense of lending to other sectors. To address the problems of growing inter-enterprise arrears and the continuing cash shortage, the authorities are considering the possible institution of a clearing mechanism for the arrears and are receiving technical assistance on the settlements system.

As yet, Russia has set no ceilings on balance of payments financing of the other former republics through the correspondent accounts mechanism set up in January. This financing amounted to around rub 7 billion at end-February and current indications are that this financing increased significantly in March. Bilateral negotiations are underway about appropriate credit limits. Russia also uses the correspondent accounts to deliver currency to other former republics. Currency amounting to more than rub 30 billion was issued outside Russia in the first three months of 1992, compared with around rub 80 billion within Russia. The demand for currency in a number of the republics as well as in various regions of the Russian Federation has not been satisfied. A draft agreement is being discussed by Russia and Ukraine on the return of rubles to Russia in the event of the introduction of the hryvnia by Ukraine.

An Inter-Bank Coordination Council for monetary policy in the ruble area is to be established by seven of the CIS states on the basis of a protocol signed in Minsk on March 30, 1992. The signatory central banks have committed themselves to coordinate their monetary and exchange rate policies, as well as to adopt similar ceilings on budget deficits in relation to GDP. The signatories agreed to set unified reserve requirements, and on a floor of 20 percent for the central bank lending rate, but were unable to agree on a policy regarding currency issue.

5. External policies

The authorities did not unify the foreign exchange market on April 20 as planned, mainly because of the implications for the budget. In addition, centralized imports for foodstuffs are now transacted at a new exchange rate of rub 20 per U.S. dollar. The authorities expect that unification would be achieved as soon as possible, probably by mid-year, and that there would be

no special, appreciated exchange rate applying to capital inflows. It is not yet clear to what extent a crawling peg arrangement is under consideration.

Although the surrender requirements of 40 percent on exports of energy and raw materials to the Republican Hard Currency Fund and of 10 percent of all export earnings to the Central Bank continues to be in effect, the authorities have granted several exemptions following regional pressure to keep foreign exchange with the local governments.

A number of the steps to improve the liquidity and efficiency of the exchange market have been taken as planned. Banks may now establish foreign exchange bureaus and there is no limit on the exchange rate set on transactions between their clients conducted through the banks; participation in the Moscow Interbank Currency Exchange has been expanded, and the number of auctions has been increased to two per week since early April. Nonetheless, barriers continue to exist between the cash and noncash foreign exchange markets. The foreign exchange law, which is to provide in principle for current account convertibility, is still in Parliament, but passage is expected in the coming weeks. Arrangements ensuring the access of the other members of the ruble area to foreign exchange holdings of the Central Bank of Russia are still to be agreed. The interbank rate emerging from the auction on April 23 was rub 150 per U.S. dollar; weekly volume has remained at about US\$10 million.

6. Interstate trade

Russia has signed bilateral trade agreements with all the 14 former republics except Georgia, but indicative lists of traded goods have not been agreed with Lithuania and Turkmenistan. The agreements with the Baltic states and Turkmenistan provided for the establishment of clearing arrangements with settlement in convertible currencies. The other states are being kept informed about the upcoming changes in energy prices in Russia, which are to apply equally to the domestic market and to trade with those states. Russia had a modest trade surplus with the other states combined during the first two months of 1992. It has not yet extended export tariffs to trade with the former republics, including the Baltic states. There are no tariffs on imports from either the republics or from the rest of the world.

7. Summary

Since signing the Memorandum of Economic Policies in late February, the authorities have succeeded in keeping the budget in broad balance on a cash basis and the first quarter deficit on a commitments basis was considerably lower than that projected in the Memorandum. Credit growth has accelerated somewhat since mid-February, although the Central Bank recently raised significantly its finance and overdraft rates.

The authorities have gone ahead with the planned liberalization of those consumer goods prices that had still remained administered in January, and several important steps have been taken to broaden the interbank market for foreign exchange. The April 20 deadlines for liberalization (subject to export tax) of oil prices and unification of the exchange system, however, were not met. When these measures will be implemented is now under discussion.

In the run-up to the recent Congress of People's deputies, and in response to various of its resolutions, the authorities have found it necessary to accommodate certain pressures coming from both sectoral and regional interests. They have agreed to extend large earmarked credits, a large part of which are to be granted at subsidized interest rates, and which may displace lending to other sectors. They have also agreed to further significant indexation of budgetary wages and sizeable tax exemptions, notably on export taxes.

The authorities succeeded in obtaining an endorsement from the Congress of the broad aims of their program, and they can now be expected to push ahead with it although possibly with less ambitious near-term goals for the budget deficit and inflation. The elaboration of a strong program backed by external financial assistance--drawing on the policy framework set forth in the Memorandum--will require the working out of a number of detailed measures and careful consideration of the timetable for their implementation.

Table 1. Russian Federation: Selected Economic Indicators

(Percentage change over same period one year earlier,
unless otherwise specified)

	1990	1991 Est.	1992 Est. First Quarter
Real gross industrial output	-0.1	-8.0	-13
Production volumes of:			
Oil	-6.5	-10.7	-13
Coal	-3.5	-10.6	-1
Natural gas	4.0	0.4	-- 1/
Retail trade in comparable prices 1/	7.4	-6.0	-51
Household money incomes	16.6	120 2/	370
Average industrial wage level, in rubles	311	580	2,450
Retail prices			
Year average	5.2	90	
Within-year	...	152	
Within quarter 3/			425-570 4/
Industrial wholesale prices			
Year average	3.9	138	
Within-year	...	236	
Within quarter 3/			1,000
Registered unemployed (end-period, in thousands)	...	59	118
State budget deficit (in percent of GDP)			
Cash basis			--
Commitment basis		19.9 5/	8
Credit to the economy (end-period) 6/			89 3/4/
Broad money (end-period)			36 3/4/
Exports in U.S. dollars 7/	...	-30	-20
Oil exports (in volume) 7/	...	-42	-16
Natural gas exports (in volume) 7/	...	-4	-2
Imports in U.S. dollars 7/	...	-46	15

Sources: Goskomstat of the Russian Federation; Central Bank of Russia;
and staff estimates and projections.

1/ 1992 data exclude services.

2/ Including deposit compensation for the April 1991 price increases.

3/ Cumulative increase for December 1991 to March 1992.

4/ Preliminary, subject to further revisions.

5/ Notional basis (see SM/92/59).

6/ Excluding credit to government.

7/ Excluding shipments to or from other former republics.