INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
INTERFUND

January 24, 1992

Dear Mr. Gaidar:

I have attached for your consideration a statement incorporating the preliminary conclusions of the Fund mission. I would like to take this occasion to thank you and your colleagues for your cooperation.

Sincerely yours,

E. Hernandez-Cata

E. Hernandez-Cata
Deputy Director
European Department

Attachment

Mr. Yegor Gaidar
First Deputy Prime Minister
Russian Federation

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INTERNATIONAL MONETARY FUND

Statement by the IMF Mission
On Economic Policies in the Russian Federation

Moscow, January 24, 1992

This statement presents the preliminary conclusions of the Fund team at the end of its current round of discussions with the Russian authorities. We would like to emphasize that these conclusions are tentative, and subject to revision in light of the reaction of the Russian authorities. This is particularly the case in the monetary area, where the mission has only begun to gather the information required for an adequate assessment of current developments and the stance of monetary policy. But there are also uncertainties in other important areas, including fiscal developments and the relations among former republics. Therefore, considerable work remains to be done before we would be in a position to frame a quantified macroeconomic program that would provide a basis for negotiations with the authorities.

We would hope that the mission that is expected to visit Moscow beginning on February 10 will be able to move rapidly toward this objective, but this will require considerable progress in the availability of data, particularly in the monetary area. More importantly, it will require the definition of specific targets for both fiscal and monetary policy and the identification of concrete measures to achieve these targets. We would also hope that an information system for short-term monitoring of economic developments could be put in place as soon as possible, to assist the authorities in evaluating progress in the implementation of policies.

We welcome the liberalization measures introduced at the beginning of this year as a major step in the process of reforming the Russian economy. These measures must now be extended and supported by adequate macroeconomic policies to set the stage for sustained, noninflationary growth.

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In the area of fiscal policy, the budget for the first quarter of 1992 envisages a deficit of rub 10 billion (1 percent of GDP) for the general government of Russia. This would imply a very large reduction from the deficit of over 20 percent of GDP estimated for 1991. 1/ For a number of reasons, however, we believe that the actual deficit in the first quarter of 1992 is likely to be considerably larger than budgeted.

First, the revenue estimates in the budget include external borrowing (of approximately rub 30 billion) which must be reclassified as financing. Second, the expenditure estimates do not include the bulk of the interest payments on the domestic debt (around rub 36 billion). Third, it seems unlikely that the estimated revenue from privatization will be forthcoming. Adjusting for these three factors would raise the estimated deficit in the first quarter to rub 80-90 billion, or 8-9 percent of GDP. In addition, our estimate of export receipts for the first quarter suggests that the revenue from the export tax is likely to be considerably lower than budgeted, and there are questions about the estimated revenue from the VAT given the problems that are likely to arise in the early stages of its

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1/ In addition to the actual fiscal deficit of the Russian government, this number includes the estimated Russian share of the overall Union budget in the first ten months of 1991 but excludes the impact of the debt write off and of the compensation of deposits.

operation. 1/ On the spending side, we are concerned that the apparent ability of local authorities to set prices for certain goods might lead to higher-than-budgeted subsidies. Doubts have also been expressed, notably in the context of our discussions with Parliament, about whether the costs associated with the budgeted decline in military spending have been fully taken into consideration.

Taken together, these factors suggest that the deficit in the first quarter could well be in the neighborhood of 10 percent of GDP. A deficit of this magnitude would represent a major improvement in relation to 1991, but it would involve a financing requirement that would be inconsistent with the need to make rapid and substantial progress in reducing inflation and stabilizing the Russian economy.

It is now important that the attention of the authorities turn to the fiscal situation beyond the first quarter of 1992, and that explicit targets be defined for the path of the budget balance during the course of the year. Our assessment of the probable outcome for the first quarter indicates that achievement of a balanced budget, which we consider essential, would require additional deficit reduction measures in the order of 10 percent of GDP during the next few quarters. Efforts to improve tax administration and the early introduction of import duties would help to move in this direction, as would the extension of the value added and excise taxes to all imports from outside the Commonwealth. At the same time, pressures to lower tax rates and introduce tax exemptions must be resisted.

1/ A team from the Fiscal Affairs Department of the Fund is scheduled to visit Moscow in mid-February to provide technical assistance in the area of tax administration.

Part of the fiscal adjustment probably will need to come from the spending side, and serious consideration should be given to further expenditure cuts in areas other than those related to social safety nets, including defense, subsidies and civil service employment. Looking beyond the short-term, we would stress the importance of selecting deficit reduction measures so as to minimize adverse effects on incentives to work and to invest, which points to the need to emphasize expenditure cuts rather than increases in tax rates. Finally, to ensure that the revenue and spending targets are being achieved, it will be important to establish a system to monitor the Government's accounts with the banking system on a regular basis.

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As indicated at the beginning of this statement, the information gathered so far by the Fund team is insufficient to allow a full assessment of the present stance and the appropriate future course of monetary policy. Data for the first 11 months of 1991 indicate that total credit expansion has been very rapid--not only to the government, but also to the rest of the economy. At the same time, interest rates have been allowed to increase, but they remain highly negative in real terms.

It is now urgent to direct the focus of monetary policy squarely to the crucial objective of reducing inflation. Indeed, we believe that inflation should be brought down to low single-digit levels by the end of the year. There is no doubt that this will require a sharp deceleration in the rate of expansion of domestic credit. A tight fiscal policy will clearly help to achieve this goal, but it is likely that a sharp reduction in the growth of credit to the rest of the economy also will be required. To achieve this result, the monetary authorities must begin to implement a system designed to control credit expansion by the banking system. 1/ In this regard, we welcome the intention of the Central Bank of Russia to increase reserve requirements on bank deposits. We feel, however, that this action will need to be complemented by strict limitations on the provision of central bank credit to the banks as well as the establishment of credit ceilings for individual banks. In our view, these ceilings should be uniform across banks, and we would caution against attempts to influence resource allocation by discriminating among sectors through credit allocation mechanisms.

Control of credit expansion would have to be accompanied by steps to bring up real interest rates to positive levels, in the sense that nominal interest rates would eventually exceed the projected rate of inflation adjusted for changes resulting directly from price liberalization. This would help to avoid an excessive depreciation of the exchange rate by improving the attractiveness of ruble assets relative to those denominated in foreign currencies.

In view of the high degree of uncertainty surrounding the relationship between the monetary aggregates and nominal spending, even the firm control of the expansion of money and credit may well be insufficient to ensure satisfactory progress in reducing inflation. For that reason--and, more generally, to bring real wages into better alignment with productivity--we

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1/ Control of credit expansion and other urgent issues will be the subject of a mission from the Fund's Central Banking Department, which has been invited to visit the Central Bank of Russia in mid-February.

continue to believe that the introduction of a highly progressive tax on excessive wage increases by state enterprises should be a key ingredient of the stabilization package. 1/ The mission would also caution against the inflationary potential of wage indexation.

To conclude our discussion of the domestic macroeconomic area, we believe that the policies now in place are insufficient to achieve satisfactory progress in stabilizing the economy. While a considerable effort is being made on the fiscal side, significant new deficit reduction measures will need to be introduced. Furthermore, there is an urgent need to develop and to implement a monetary strategy aimed at bringing inflation under control. It must be emphasized that in the absence of visible steps to implement the macroeconomic strategy outlined above, it will be impossible to design a program that the Fund staff could recommend to the international community.

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Appropriate macroeconomic policies will have to be accompanied by continued reform of the Russian economy. In this regard, the liberalization of prices at the beginning of this month was a major, indispensable step for which the authorities should be commended. The sharp jump in prices in the past three weeks must now be arrested and, if possible, partially reversed, which will require a substantial tightening of both budgetary and credit policies. We recognize, however, that a good part of the price increase has resulted from monopolistic practices. It is therefore important to match

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1/ A note containing a more detailed discussion of this subject was submitted to the Government in December.

the boldness of price liberalization with measures to increase competition, including rapid privatization, especially in the area of trade and services, commercialization of those state enterprises that cannot be privatized quickly, and demonopolization. The experience of Eastern Europe suggests that privatization in certain areas, including the trading sector, can proceed fairly rapidly.

We also believe that a bolder approach toward energy pricing is called for. The intended increase in the domestic relative price of energy has been eroded by the surge in the overall price level. We would recommend that domestic energy prices be allowed to rise to world market levels within, say, two years. This could be achieved by setting an export tax which would be phased out over time. A rise in the relative price of energy would encourage conservation as well as production, help to improve the fiscal position, and expand Russia's capacity to export.

Recent measures in the exchange rate area have made major headway toward reducing distortions in the exchange market, but the market continues to be segmented. We would urge the authorities to move toward unification of the exchange system as soon as possible, which will help to improve resource allocation. For example, the exchange rate applying to foreign direct investment and other capital flows should be the same as that applying to other transactions, to avoid discouraging foreign investors. A number of measures to improve the interbank market in foreign exchange should be seriously considered. Banks should be allowed--within well-defined limits--to hold open positions in foreign exchange, and restrictions on interbank transactions should be eliminated, including those limiting the ability of foreign investors and banks to buy and sell foreign exchange. It might also be desirable to hold the fixing twice a week, or even more frequently, and to set up similar markets in other regions within the Russian Federation.

On the external debt, we would stress the importance of preserving Russia's creditworthiness to support the reform program. To avoid endangering Russia's fragile relations with foreign creditors and risk an interruption of new commitments, it is essential to avoid unilateral actions and to service the debt in accordance with the recent agreements. To establish the confidence of the outside world, it is important to clarify as soon as possible the legal and regulatory framework for foreign exchange transactions, the status of the Vneshekonombank, and the debt service sharing arrangements with the other former republics. Furthermore, a mechanism for regular transfers of foreign exchange from the Vneshtorgbank to the Vneshekonombank should be established without delay.

As regards trade policy, we welcome the import liberalization that has taken place. However, the export regime continues to be heavily regulated, which conflicts with the general spirit of the reforms and the need to promote exports and increase foreign exchange reserves. The existing quota and licensing system should be abolished, except perhaps for those goods that remain subject to price controls.

Turning to relations among the former republics, it is in the interest of Russia to promote a common economic space in the ruble region. In this regard, it is essential to avoid a proliferation of trade barriers among the former republics, and to roll back those which have been imposed. Of course, this would be greatly facilitated if price liberalization proceeded at a broadly uniform pace in all states within the ruble area. If a rise in the price of energy were to lead to a substantial terms of trade shock to the other former republics, Russia could ease the transition by providing financing.

Providing a clear indication to the outside world that interrepublican relations will be based on cooperation is likely to increase the support of the international community for Russia's reform program. The Central Bank of Russia should also attempt to work closely with the other former republics to pursue anti-inflationary policies and to prevent problems connected with interstate payments and settlements from leading to trade restrictions and a collapse in interstate economic relations. Finally, if the next Fund mission is to be successful in designing an economic program, it will need to have a clear understanding of the current situation regarding interstate trade and financial relations, and of the policies affecting those relations.