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See Russian Federation and the IMF

The Russian Economy: Prospects and Retrospect

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Introduction

First of all, very many thanks to my old friend Evgenii Yasin[2] for the very kind words of introduction, and to the Higher School of Economics for the wonderful and unexpected honor of being made an Emeritus Professor of your institution.

Two years ago, when the MIT Department of Economics told me that the rules prevented my continuing as a member of the Department, they offered me the possibility of becoming an Emeritus Professor. I must confess that I said: "Well, *emeritus* is for very old people." But to be awarded this title by this university on this occasion is a great honor that I'm very, very happy to receive – particularly since I did nothing at all to deserve it. Thank you all very much indeed.

It's a great pleasure to appear before this audience on what I expect to be my last visit to Russia as a member of the IMF. Fortunately, the economic situation now is much less dramatic than it was on some of my earlier trips. Looking around the audience, I am sure that several of you, including Sergei Dubinin, remember well one of the more dramatic visits, in July 1998, when we discussed the very tough alternatives that faced the economy at that time. The sense of growing normalcy that I've had on my last two visits to Russia – particularly this time – is in many ways the main achievement of Russian economic policy during the past decade, and especially during the past three years.

I want to focus tonight on the current challenges facing Russian economic policy. But I will also look back a bit to what has been achieved during the past decade and then, at the very end, look forward and discuss future relations between Russia and the IMF.

The Current Situation

It is not so long ago, in 1997, that growth of half a percent seemed like a great achievement. Now we can look back at two years in which growth has come in at 5.4 percent (in 1999) and 8.3 percent (in 2000) respectively. The economy is expanding more slowly now: the official forecast for this year is around 4 percent, and it could come in a little lower than that. But in any case, these growth rates are much more consistent with what should have been happening in Russia in earlier years.

Russia's stronger growth performance is due in large part to two factors: the real devaluation, and higher energy prices. But we should not underestimate either the importance of the strategic decisions taken following the devaluation and the debt default in 1998, or the progress that has been made in structural reforms. The Primakov government, which came to power proclaiming that it would take another route, soon realized that the Russian people had no desire for high inflation and no desire to abandon the effort to develop a market economy. Together the Finance Ministry and the Central Bank were able to keep a lid on inflation, and eventually – with a few changes of Prime Minister, and a change of President – policy returned more decisively to the reform path that had been chosen a decade ago.

The economy is operating in an extraordinary fashion now. The current account surpluses of 18 percent of GDP last year and 12 percent of GDP expected for this year are not the sort of phenomenon that most industrial economies have to deal with. They pose a real dilemma for macroeconomic policy, because the reserve inflows they imply tend to cause a real appreciation and loss of competitiveness. This can come about through inflation or an appreciation of the nominal exchange rate, but one way or another it is hard to avoid.

What can be done? Obviously, given the gains generated by the post-crisis devaluation, no one wants a significant real appreciation in the short run. So the choices are: to tighten fiscal policy; to sterilize reserve inflows; or a combination of the two.

In the short run, finance ministries prefer central banks to deal with these problems by sterilizing, and central banks prefer finance ministries to deal with these problems by running bigger budget surpluses. But your budget surplus, current account surplus, and reserve inflows, are all so large that both sides will likely have to contribute.

Further, we should bear in mind that once relations between the central bank and finance ministry are regularized – with the central bank recapitalized, and a sound legal basis established for returning central bank profits to the government – any losses that the central bank makes on sterilization will ultimately fall on the Treasury. Any losses that the central bank makes in the meantime will also fall on the Treasury, since those losses will affect the amount the Treasury will have to provide to recapitalize the central bank. Ultimately, the cost of sterilization has to come out of the government's pocket.

But that does not mean at we should be indifferent between the use of sterilization and fiscal adjustment. In current circumstances you need both. Recent data suggest inflation will exceed this year's 14 percent target, possibly significantly so. But we are only 5 months into the year, and where inflation ends up depends a lot on the policies pursued during the remainder of the year – in particular, how much of the pressure from reserve inflows is taken on the exchange rate and how much on inflation.

So long as Russia has a strong current account, the dilemma that is being faced now will continue. What is more, the dilemma is likely to become even more acute when confidence in investing in the Russian economy resumes and brings about a reversal of capital flight. To the extent that this translates into an increase in Russia's low investment rate, it will contribute to the long-run growth of the economy without necessarily putting pressure on the real exchange rate. But to the extent that it is used to purchase existing assets, it will put further upward pressure on the exchange rate. Structural reform has a vital part to play in ensuring that the real exchange rate appreciates through improvements in productivity, via higher investment and more efficient business organization.

Structural Reform

I'd like now to move on to discuss structural reforms, because the macroeconomic situation is in a fundamental sense under control. Dealing with capital inflows and budget surpluses is not easy. But there are worse problems to have.

Last year I attended a conference organized by the Higher School of Economics at which I was struck by how focused and how uniform thinking about structural reform had become. No-one was taking the old line: "Let's have a nice moderate 50 percent inflation, and cheap credits for the industrialized groups". I asked Professor Yasin, who organized the conference, whether they had invited only reformers. He answered: "No, we invited all the economists. The other types aren't around any more." The theme of that conference was how to improve the investment climate, and that turned out to be a very convenient organizing principle for talking about what structural reforms were necessary.

The Tax System

It's been 14 months since then, and there have been real achievements on the structural side. The political effort has focused on strengthening the central government, but that has also meant consolidating fiscal federalism which is economically important. Thinking back to some of the laws that were passed and not passed in July 1998, a key goal was to strengthen the fiscal position of the federal government: getting revenues that should have belonged to the center back to the center, and trying to organize better the revenues in the regional and local governments. That issue has not been finally resolved, but it is being tackled and part of the fiscal improvement that we see has come about as a result of improvements in the structure of fiscal federalism.

You now have four out of five – perhaps even four-and-three-quarters out of five – chapters of Part Two of the Tax Code passed, including setting the income tax rate at a flat 13 percent. Revenues from the income tax have increased during this process – perhaps as a result of higher tax compliance, or perhaps because of very rapid income growth. And you are about to complete the reform of the corporate tax system. These are considerable achievements.

Land Reform

Russia is making progress on urban land reform. Unfortunately legislators became extremely excited during the Duma debate, indicating the extremely strong feelings on this issue. When and if agricultural land reform will be undertaken, I do not know. But that too is important.

Financial Sector

There is one other critical set of reforms. It is striking that reform of the financial system does not appear to be very high on the agenda. Yet the banking system is dominated by the state banks, and although large companies are able to get credit, small and medium-sized firms – typically the motor of growth – are not well served by the Russian financial system.

Creating a modern capital market, strengthening the banking system and banking supervision, should be high priorities. During this visit I have several times heard the argument that financial sector reform cannot be very urgent since the economy is growing so well anyway – evidently companies can finance themselves internally, and the banks are being recapitalized by the economic recovery. But to focus on existing firms is to miss the point, which is that Russia has a latent entrepreneurial class that could create numerous new enterprises if there was an efficient way of financing them.

Progress to Date

Several other important measures are in the legislative pipeline: reform of taxation of natural resources, the Labor Code, the deregulation package supported by Minister Gref, pension reform, and legal reforms. This is a very full agenda, and there is considerable uncertainty about what will be passed this year. But it is impressive that the government is committed to this ambitious agenda. For those who recall the 1996 Extended Fund Facility program, the only source of regret is that these good things did not happen some years ago.

Of course, one has to have reservations. After all, nobody feels comfortable supporting wholeheartedly what any government is doing – and that tendency may be stronger even in Russia than in most other countries, for people feel the need to make it clear that they would do it much better if they were in charge. A few months ago one would have made the general criticism that reform was proceeding very slowly and that the Tax Code was the only major achievement. But now there is a lot more in train and probably more to come. One has to be concerned about the cost of some of the concessions, particularly on the tax code, that have been made to get reforms through. One has to note that some of the reforms have only just been submitted. And of course, laws are not the same as their execution, and it remains to put all this into practice – and that is no small challenge.

I read with great interest and pleasure the President's Address to the Federal Assembly on April 3. This is a remarkable document that lays out the full reform agenda, clearly inspired in part by the Gref commission. In addition to the measures I have already noted, the President mentioned a new privatization law, the removal of currency controls, improvements in the health and education systems, financing for science, and an oil stabilization fund.

Adding together the measures in the Duma, the measures potentially in the Duma, and those in the President's speech, there is an impressive reform agenda here that is going to take many years. But finally Russia is tackling many of the key structural reforms that they have long known are necessary.

In my attic I have a box that is labelled "Russia's stabilization plans", and it is nearly full. Last year, when I heard about the latest reforms, I wondered whether they too would be going into the box, never to be read again. Fortunately, this time it seems to be different. I hope that the inevitable political opposition can be overcome and that the process continues. But we should not underestimate the vested interests that still have to be confronted. Some fight with their fists, as in the Duma debate on urban land reform; some fight with more than their fists, and they are probably more effective.

Looking Back after a Decade of Reform

Now let me reminisce breifly about how I feel at the end of ten years of some involvement with Russian reform. Let me say that I do not suffer from the illusion that foreigners made the main decisions about economic reform in Russia. A while back it was fashionable in the United States to say: "The IMF lost Russia". I reply: "First of all, Russia is not lost, it's still there. Secondly, if you read what Russians write about Russian reforms, they seem to have the impression that they made the decisions, not the IMF, not the World Bank, not the US government". We should not have illusions about the influence of outsiders, but I will talk a bit later about the contributions outsiders may have made.

I started my involvement with the Russian economy as I left the World Bank in 1990. In 1990 at the Houston Summit, the g-7 requested the IMF, the World Bank, the OECD, and the EBRD to undertake a study of the Soviet economy, and I headed the World Bank team on that study. I have been fortunate to come back to Russia at least once a year since then, including during the four years when I was at MIT between leaving the World Bank and joining the IMF. Although I was not in the international financial institutions when the Yeltsin/Gaidar reforms began at the end of 1991, I was busy following and writing what was happening here, with admiration at the courage of the reformers, and concern for the economic difficulties the Russian people were suffering.

Things that look obvious in retrospect are not so obvious at the time, and it is only those with foresight and courage who can make the radical decisions that may be necessary. As I recall, the decision at the end of 1991 to free prices was criticized as being a simplistic textbook recommendation. Well, I have a personal interest in believing you should take the advice of textbooks seriously – and in the case of how the price system works, the textbooks are pretty good.

I was first actively involved in Fund negotiations with Russia in the 1995 stand-by, during which inflation was stabilized. Russia's compliance with the terms of that loan was exemplary. There was monthly conditionality, and for 9 of the 12 months Russia essentially met all the conditions.

The IMF decision to sign the EFF with Russia in March 1996, a few months before the election, was controversial. The management of the IMF believed that, since Russia had done extremely well in meeting the conditions of the preceding standby, we should go ahead with the loan. In any case, monitoring during the early stages of the EFF was monthly, and the loan could have been cut off soon after the election if a newly elected government had rejected it. We also thought it would be useful to have a policy framework in place for any new government taking power in mid-1996, since it always takes new governments several months at least to formulate their own plans and begin to put them in place.

The 1995 loan was very successful, but it did put in place the crawling band exchange rate that was a source of trouble in the future. The controversies over the 1996 EFF are understandable. The sad fact is that the government was exceptionally weak after the election, and basically unable to carry out – except sporadically – the agreed policies. Every now and then the IMF would begin to believe that it would be possible to get the program back on track again, but political instability and the weakness of the presidency prevented that happening.

Then came the drama of the July 1998 package, its failure, and the crisis. At the heart of the crisis was a fiscal problem: the central government was unable to collect revenues, it was dependent on the capital markets and external financing, and even so it was unable to pay its bills.

Contributing to the severity of the crisis was the combination of the fixed rate and the opening of the capital account, which encouraged all those capital inflows. Before coming on this trip, I had been inclined to count the opening of the capital account as an independent cause of the crisis. But yesterday I was talking to somebody who was active in policy at that time, and he said: "It wasn't the capital account opening that led to the crisis. It was the crisis that led to the capital account opening, because we couldn't get financing any other way. We opened the capital account to pull in foreign financing for the budget". I had assumed that the capital account had been opened for ideological reasons rather than in desperation as a way of attracting budget financing. In any case, the weak fiscal situation, the Asian crisis and the associated weakening of capital flows to emerging markets, and the collapse of oil prices, all hurt the economy and made it impossible for Russian government to continue to service its debt.

There was at the time a discussion of whether to devalue or restructure the debt. On this issue, I share the view of Russian policymakers that there was no choice. You couldn't restructure the debt without being forced to devalue, and you couldn't devalue without being forced to restructure the debt. In the end Russia had to do both.

There were only two nights during my time at the IMF when I was unable to sleep. One was the night before the Russian devaluation. My worrying didn't make any difference to what happened, but in terms of the magnitude of the impact on the rest of the world, I was right to worry. The other sleepness night was the night before the Brazilian devaluation, when I thought: "Here we go again. It's going to be Russia all over again. This will hit Latin America, then it will rebound to Asia, then it will hit Eastern Europe." But nothing happened, and the Brazilian devaluation was more the end of a crisis than the beginning. So, on that occasion I didn't need to worry.

The Russian devaluation and debt restructuring set off a huge crisis for the rest of the emerging markets. One has to wonder how people can both have been investing at triple digit interest rates and expecting that in the end the West would find the money to enable Russia to continue to pay. Surely they should have understood that the markets were telling them something. Actually, there may be an explanation. The people who did not expect Russia to be able to pay were already out of the market. Those who remained in the market were the optimists, who thought that somehow the market had got it wrong. Those were the people who appeared genuinely shocked when Russia could no longer pay.

In retrospect, the collapse of the currency and the removal of much of the debt burden were probably instrumental in the subsequent improvements in the Russian economy. As mentioned earlier, when Russians faced the prospect of higher inflation and a return to state control, they decided that was not the path they wanted to take. And gradually the Russian economy recovered, albeit with extreme hardship for many citizens because of what had to be done to stabilize the budget, for example on pensions. Then Russia's luck turned to the good, and oil prices improved. But we need to remind ourselves, it was not only luck, it was also better policies.

In 1999 we signed a new standby with Russia. That program foundered at the end of the year in arguments over reserve management, money laundering, and a variety of other things that many Russians felt very unhappy about. I'm often asked whether we treat Russia differently than other countries, with the implication being that we were tougher on Russia at the end of 1999 than we are on other countries. I don't think that's the case. More likely, for some time we may have been a bit less tough on Russia than on other countries. And then, at some point, late in 1999, people said it was time to treat the Russian program on the same basis as all other programs.

What has the IMF's relationship with Russia achieved? First, the stabilization in 1995 was achieved with the help of an IMF-backed program. That was a key achievement.

We also helped with important structural and institutional reforms. The IMF's technical assistance and program conditionality helped create a modern central bank in Russia, one that – despite policy disagreements some might have with it – operates more or less as other central banks do. We also played a large role in helping create a modern treasury with control over spending in all parts of the government. And we helped in many other institutional reforms, including those of the tax system, and to some extent in the banking system.

But the IMF's most fundamental contribution has been to stand consistently for a particular approach to economic policy, in favor of macroeconomic stability, in favor of market-oriented structural reforms, in favor of integration into the global economy. We were not the only ones to stand for those principles – the reformers in Russia stood for exactly the same things. But we were able to support them and we were able over a sustained period to bring the same set of views consistently before the Russian people and before the Russian policy makers. I hope and believe we contributed a bit to the consensus on economic policy that now exists in Russia. Today one does not see people in Russia wanting to go back to the past, one does not see them looking for a third way, and that, I believe, is in large part what we contributed to.

The Future

What about the future? Possibly Russia will one day need the IMF's financial support again. Measures are now being taken to tackle Russia's prospective debt servicing problem in 2003, but if external conditions worsen severely, then external help may be needed. And if Russia does need a program again, it is a member of the IMF, and it is entitled to have a program if it meets the required conditions. Major industrialized countries – Italy, France and the UK – had programs twenty-five years ago, and it would not be extraordinary for Russia to have a program at this stage of its development. Under Mr. Köhler's leadership, we have begun to streamline the conditions attached to Fund loans, to focus on those elements that relate most closely to macroeconomics. So a future program could be more streamlined than those in the past – if it were to be needed.

But it may well not be needed. Then Russia's role in the IMF will be like that of other non-borrowing countries. Russia will be subject to the surveillance of the IMF. Regular Article IV missions will come, and they will report to the IMF Board on what is happening. We hope that those Article IV reports would be published, so that the rest of the world could share the IMF's evaluation of the Russian economy.

No doubt, we would continue to provide technical assistance as well where it is requested. Over the course of time, we can see Russia increasingly taking its role as a major country in the international system, helping lead the IMF and helping develop the international system. Russia and the IMF would also cooperate to solve problems that we have in common, for example the difficulties of the Central Asian republics. They need the help of the international community, provided through the IMF, but their problems cannot be solved without Russia's assistance.

Whether there is a program or not, there will still be good relations between Russia and the IMF, a constructive relationship in which the IMF contributes to Russia, and Russia increasingly contributes to the IMF. I don't know in which year Russia will have its last IMF program, whether within 5 years, or in 10 years, but the need for IMF financial support for Russia will end at some point.

Increasingly the Russian economy will become an economy like all others, and at that point, we will all be very happy that our relationship has shifted. We will look back, as I have been looking back today, with some satisfaction on our relationship in the past, when Russia needed the assistance of the IMF, and we will look ahead to a future in which each can contribute to the well-being of both the Russian economy and the international financial system.

Conclusion

I am extremely grateful to have had the opportunity to help, through the IMF, to contribute to what has been achieved in the last decade in Russia. Even though it looked like very little just three years ago, it is becoming increasingly clear that Russia is on the path to creating a modern economy.

I am grateful to the Russian friends here with whom I have cooperated over the past seven years, and I am extremely grateful to my IMF colleagues, who worked tirelessly on the Russian program. And I am grateful too to Evgenii Yasin, whom I met the first time I visited Russia and have met every visit since. As the economy improves, Evgenii looks more and more healthy. May you both continue to grow healthier in the future.

Thank you all very much indeed.

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[1] First Deputy Managing Director, International Monetary Fund. This paper is based on a transcript of a lecture delivered at the Higher School of Economics, Moscow, on June 19, 2001. Views expressed are those of the author, not necessarily of the International Monetary Fund. I am grateful to Robert Chote and Ratna Sahay for assistance, and to John Odling-Smee and members of the Russia team for their suggestions.

[2] Professor Evgenii Yasin, Academic Supervisor of the Higher School of Economics, was formerly Minister of the Economy.

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