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Russia Panel Presentation

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I. The Problem

- Large fiscal deficits over a number of years (7–9 percent of GDP in 1996–98) led to a **rapidly growing debt service burden.** With high real interest rates and until 1997 a contracting economy, interest payments reached 7 percent of GDP, and 70 percent of federal cash revenue, by mid–1998.

- **Large net capital inflows made it possible to maintain high fiscal deficits while reducing inflation** (and controlling the rate of ruble depreciation). In recent years, the inflows reflected large foreign purchases of GKOs and placements of Eurobonds in international capital markets.

- The situation has changed fundamentally due to the default on GKOs. Even under the most optimistic assumptions about support from official creditors, including multilateral institutions, **Russia will see a sharp drop in net inflows from international capital markets in the foreseeable future.** (The problem is not only due to developments in Russia, but also to the situation in international capital markets and the large deterioration in the terms of trade.)

- **The decline in net inflows makes a sharp reduction in the fiscal deficit—which was in any case necessary before August 1998—unavoidable. The fundamental choice** facing Russia is whether the needed adjustment will take place in an **orderly manner** with limited inflation, in the context of a program that the Fund and the international community can support, or if it will take place in a **disorderly manner**, through a process that involves very high inflation and/or further government expenditure arrears. (Note: with debt service payments on Soviet debt suspended and payments on Russian debt made mostly from reserves, the current double digit monthly inflation rates must mainly reflect domestic deficits and credit provision to banks).

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[1] International Monetary Fund.This is the outline of comments to be presented in a panel discussion at the U.S.–Russian Investment Symposium, Cambridge, MA, on January 15, 1999.

II. The Need for Fiscal Adjustment

- **There is an immediate need for fiscal action**. In order to create a virtuous circle of lower deficits and lower interest payments, the budget needs to target a primary surplus.

- The Fund believes that a federal government **primary surplus of 3–4 percent of GDP** (implying an overall federal deficit of 3–4 percent of GDP) is needed for 1999, with further adjustment over the next several years. This adjustment is fundamentally the same as in the July 1998 agreement with the IMF.

- **The current budget proposal before the Duma is neither sufficiently ambitious nor realistic.** Fund staff estimate that it falls some 3–4 percentage point of GDP short of what is needed. It will entail a continuation of the cycle of large deficits and ever–growing interest payments that led to the current crisis

- In the short–run, the burden of adjustment will inevitably fall on cutting spending. There is substantial scope for **reducing unproductive expenditures**, including subsidies to industry and housing, military spending, and wages for an overly large civil service.

- On revenue, the focus of efforts should be on **improving compliance of large taxpayers**. The key issue is a political willingness to stand up to vested interests, insisting that they pay their fair share of taxes.

- As increased tax compliance becomes secured, there is room for a **reduction in tax rates** to lower the very high marginal rates that exist at present. It is premature to cut major tax rates (e.g. the VAT) this year.

III. The Need to Tackle Underlying Structural Problems

- This fiscal problem is largely a reflection of the **deep structural problems** afflicting the Russian economy. The failure to address these issues is a reflection of the power of **vested interests**.

- A recent brainstorming seminar at the Fund, involving outside experts from many fields, confirmed that **macroeconomic stabilization will be unsustainable if not accompanied with a much more determined implementation of structural reform.**

- The **culture of nonpayment**, which has made it impossible for the government to raise sufficient cash revenue, reflects **lack of genuine privatization and failure to impose financial discipline through bankruptcy procedures**. The government is itself also responsible, through not paying its bills and requiring enterprises to behave in non– market ways (e.g. preventing utility companies cutting off delinquent customers; not allowing labor shedding or closures).

- The **failure to restructure industry** has meant that the budget has at least indirectly continued to be burdened by the need to support large loss–making enterprises. There is a need to start to close large loss–making enterprises. At the same time, programs to alleviate the social impact of such closures need to be in place.

- Russia needs to create a **favorable business environment** to turn around the massive capital flight and attract the foreign direct investment that was to have financed its economic takeoff. This will require that tax laws are simplified, and discretion of tax officials strictly limited; that onerous regulations and licencing requirements be lifted; and that issues of corporate governance and corruption be addressed.

- **As for bank restructuring,** criteria for recapitalization of ailing banks should be open and transparent, with existing share-holders taking losses first, and funds for this purpose should come from the budget rather than from the CBR.

IV. The Role of IFIs

- **The IFIs need to stay engaged,** working with the authorities to try to get Russia back on track.

- **Financial support will have to be conditional on bigger efforts** than in the past to overcome the fundamental fiscal and structural problems of Russia. The government needs to demonstrate that it has the capacity to make such efforts.