The Russian Economy at the Start of 1998

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Six years after the start of the Russian economic reform process, much has been achieved and the continued progress of the economy towards economic normalization is not in doubt. Now the challenge is to move the economy toward sustained growth of output and living standards. That will require many difficult economic decisions, and many political battles -- whose outcomes will determine both the future structure of the economy and its growth performance.

Nineteen ninety seven was a year of achievement for the Russian economy. For the first time since 1992, the economy grew, albeit barely.[2] The current account of the balance of payments was in surplus. The Central Bank of Russia once again proved its professionalism, as inflation continued to decline, and as late in the year it successfully fought off contagion effects from East Asia and maintained the currency band. At the start of 1998, with a broadened currency band, and a non-confiscatory currency reform under way, confidence in the maintenance of monetary stability should continue to strengthen.

In 1997, as in 1996, central government revenue shortfalls constituted the major failure of macroeconomic policy. At the start of 1998, fiscal reform and performance remain both the crucial element and the crucial question at the center of Russia's economic program with the IMF. The reform of the tax code and increased revenue collection are on one side of the equation; on the other side, increasing the efficiency of government spending and strengthening expenditure management deserve no less attention. Equally important for future growth is continued progress with structural reforms, whose implementation had for some years lagged until recently -- but it must be noted and emphasized that the structural components of the Russian reform program moved ahead as agreed with the IMF (indeed even a little faster) during 1997.

I am also happy to report that the IMF Executive Board yesterday completed the delayed sixth quarterly review of the Extended Fund Facility with Russia, and -- laying particular stress on the fiscal action plan agreed between the Russian authorities and the Fund staff in December -- agreed to disburse a $700 million tranche, thus bringing the program back on track.

I. Achievements of the past six years.

Six years ago, Russia set out on the road to a market economy by liberalizing prices and beginning to dismantle the instruments of central planning. In these six years, Russia has made remarkable progress in important areas. These changes have been charted in detail elsewhere,[3] so that a summary will suffice here:

Political development: The Soviet totalitarian system has been buried. Russia has become a democracy, with a President and legislative bodies elected by popular vote, with open political debate and a free press. To be sure, the political system still has to find ways to reach decisions by consensus-building rather than by conflict.

Market development: A large and increasing share of Russian economic activity is channeled through market mechanisms. In its latest *Transition Report*, the EBRD estimates that 70 percent of GDP is accounted for by the private sector.[4] This vibrant private sector, for all its imperfections, has become the major agent of economic growth and change.

Policy-making: The government has created from scratch mechanisms to manage the economy through indirect means rather than through direct commands. Monetary policy is now conducted by a professional central bank, which has made remarkable progress towards price stability. The old central planning establishment has been largely dismantled, and agencies bent on structural reform and deregulation are gaining strength. The main shortcoming in this area is the rudimentary development of instruments to formulate and implement fiscal policy. Still missing are modern tax and budget codes (though both are making their way through the Duma), fully competent agencies to collect taxes and control expenditure, and adequate information systems for fiscal management.

Economic activity: While output is still well below the levels of six years ago, it has begun to grow again; inflation has been reduced to near single-digit levels (see table); and the exchange rate arrangement played a crucial role in maintaining financial stability during the 1996 presidential election, and was successfully defended by the central bank during last month's Asian contagion.

II. Major policy challenges.

The experience of other transition economies, as analyzed in a number of studies, suggests that Russia will move onto a sustained growth path as inflation falls and fiscal adjustment and structural reforms proceed.[5] In many respects, Russia has an exceptionally favorable basis to achieve that end: important natural resources, including minerals and energy; a highly educated labor force, which is still employed to a large extent in the less productive state sector; and a potentially large domestic market with pent-up demand for consumer goods and social infrastructure. However, a major constraint to Russia attaining satisfactory rates of growth is that *the process of structural reform has not gone far enough.*

Indeed, empirical analysis has shown that the main reason why growth in Russia and other CIS countries lags behind the record of the Eastern European and Baltic countries is the slower pace of market-oriented structural reform.[6] While Russia has made substantial strides in some areas of structural reform (notably small scale privatization, the liberalization of the trade and foreign exchange system and, to a lesser extent, natural monopoly regulation), there are important areas where much more progress is needed.

Before turning to those structural reforms, let me start with the fiscal problem. I will not cover monetary and exchange rate policy, because they are both fundamentally on track. Nor will I take up in detail the critical need for vigilance in supervising the banks and the financial system, but the task is a vital one in all countries, including transition economies.

A. Fiscal reform

Currently available estimates indicate that in 1997 Russian federal government spending amounted to 18.3 percent of GDP, while revenues were only 10.8 percent of GDP, implying (on the IMF's accounting definitions) a deficit of 7.5 percent of GDP. Cash revenues were 9.1 percent of GDP, the rest being collected in the form of non-cash arrangements featuring the mutual clearance of tax and spending arrears. Low revenues and the corresponding high deficit are the major macroeconomic problems now confronting the Russian economy.[7]

The Russian tax system is complex, with many types of taxes, numerous (and sometimes arbitrary) exemptions, narrow tax bases and, partly as a result, very high tax rates. Tax administration is clearly inadequate. Such conditions create uncertainty, discourage domestic and foreign investment, encourage tax evasion, and foster the expansion of underground activities. Improvements in tax administration are needed, not only to raise revenue, but also to reduce the effective burden on compliant taxpayers, increase the equity and transparency of the tax system, and permit a reduction in excessively high tax rates. The need for a tax reform that would simplify the tax system and broaden the tax base has been widely accepted for some time. Now, after several years of drafting and debate, the government has submitted to the Duma a comprehensive draft Tax Code that pursues those objectives.

In addition to the new code, it is also necessary to improve tax collection. This will likely require reorganization of the 180,000 strong State Tax Service and coordination with the Tax Police and Customs Service. To provide some of the necessary incentives to taxpayers, it is essential to enforce realistic penalties on those that do not pay taxes, or pay them late. It is sometimes said that taxes will not be paid until companies are forced into bankruptcy for non-payment, but that is an exaggeration -- the need is to penalize non-compliant taxpayers, not necessarily to force them into bankruptcy. That is why some cases recently in the limelight are so critical as potential signals and examples of the beginning of a change in the culture of non-payment of taxes. At the same time, and no less important, it is critical to end the practice of permitting non-monetary tax payments. Success on this front, besides being important in its own right, will also contribute to reducing the more general problem of payments arrears and non-cash forms settlement in the economy.

On the spending side, efforts are needed in particular to redefine the role of the government in the Russian economy and ensure that spending decisions are based on efficiency and equity considerations. In setting spending priorities, it will be important to:

- strengthen expenditure management and control, in particular by strengthening the Federal Treasury;
- reform the civil service by shedding redundant workers while providing competitive wages to retain high-quality staff ;
- downsize the workforces in public health and education while improving the provision of services;

- improve the targeting of social benefits while strengthening the social safety net; in particular, phase out the generalized subsidization of utilities, housing, etc.;

- implement reforms to ensure the financial viability of public pension schemes while reducing the government's role and enhancing the rate of return on retirement savings.

The Russian government is moving forward in many of these areas, as part of its fiscal adjustment program, which is the central element in its IMF-supported economic program. Progress has not been easy, partly because of political difficulties, partly because of the heavy decentralization of the Russian administration. Indeed, in implementing its reform program, the Russian government has been fighting an administrative system inherited from the Soviet bureaucracy that devolved substantial powers to largely autonomous agencies, enterprises, and local governments.[8]

B. Structural reforms

With macroeconomic stability close to being attained, the focus now must shift to structural reform, particularly *private sector development*. A fast pace of economic recovery will demand substantial increases in efficiency and capital accumulation, and these in turn demand a competitive business environment. Certain elements of such a business environment (such as a market culture) cannot be developed rapidly or established by government action, but other major elements (including the legal and institutional framework) can be. Such efforts are under way in several areas:

1. *Faster, more transparent privatization and improved management of state-owned enterprises*. The privatization program was stepped up in 1997 after a disappointing record in 1996, and the Government's privatization plan for 1998 envisages a further acceleration. The new privatization norms call for an open, transparent, and competitive process -- elements of which were missing in earlier waves of privatization. To increase efficiency and accountability, the enterprises remaining in state ownership should be made subject to hard budget constraints and profit objectives.

2. *Restructuring and pricing of natural monopolies (gas, electric power, district heating, and railways)*. A long-term objective is to introduce competition into these sectors where possible, but limited headway has been made. Where demonopolization is not possible, it will be necessary to put in place appropriate regulatory systems.

3. *Urban land and real estate reform*. It is critical to establish a legal framework that supports full private ownership and development of land, and its utilization as collateral in credit transactions. Progress in this area has been hampered by lack of cooperation between the executive and legislative branches. In addition, it is necessary to foster a private market in land by making it possible to register land ownership, to encourage regional authorities to allow the sale of leased land (especially under privatized enterprises), and to promote the creation of a mortgage market.

4. *Further progress in capital market development*. Although this has been one of the most successful reform areas in recent years, the agenda remains long: strengthened corporate governance and protection of outside investors, including through better disclosure and

registration requirements; a more effective legal framework for securities transactions; and a stronger securities commission.

5. *Development of a sound and efficient banking system.* So far the Russian banking system remains too small to serve the financing needs of the private sector — particularly given the large borrowing needs of the government sector — largely because of the adverse effect of earlier high inflation on real financial savings, tax evasion, and concerns about bank soundness. With the decline in inflation and a more stable exchange rate, confidence in the banking system can be restored through action to eliminate insolvent institutions, improve banks' internal governance, and strengthen the regulatory and supervisory framework. Headway has been made in these directions, but faster progress is needed.

6. *Setting up a legal and institutional framework* to make it easier to exercise and transfer property rights and to enforce contracts.[9] Very important, in particular, is *a bankruptcy mechanism* that permits insolvent enterprises to be liquidated or reorganized rapidly and efficiently.

7. *Liberalizing the housing market* and encouraging the mobility of workers from traditional sectors to new and more productive activities.

8. *Promoting agricultural efficiency and productivity.* Agricultural land and management remain largely collectivist, even though the largest share of land is non state-owned. It is important to strengthen individual rights to land ownership, create fully functioning land and mortgage markets, improve the performance of the marketing system, reorient government expenditure in agriculture away from subsidies to targeted income support, and in general facilitate farm restructuring.

9. *Continuing to open the economy to foreign trade and investment*, by eliminating remaining trade barriers and resisting pressures for import protection.

10. *Eliminating behavior by government officials that impedes investment,* in particular corruption, arbitrariness, and complex administrative rules (red tape).

Together these reforms are likely to strengthen growth prospects by directly improving the environment for and scope of private sector activity and investment, while scaling back the size of the public enterprise sector.

III. Concluding remarks

Progress in implementing these reforms is likely to be difficult,[10] but if the specified policies are followed, the Russian economy can achieve:

A sustained rate of growth of real national income and private consumption. If the progress towards price stability can be maintained, and fiscal adjustment and structural reform can move forward, as envisaged above, then the IMF staff envisages that output will be growing by about 6 percent a year early in the next decade. Even with high rates of saving, private consumption would be rising at a similar pace.

A low budget deficit and a sustainable public debt position. Fiscal reforms can set the basis for substantial fiscal adjustment: an adequate revenue performance, and levels of spending consistent with government priorities and low borrowing requirements. With decisive efforts, it would be possible to cut the deficit of the general government by half or more to the range of 3-4 percent of GDP early in the next century. If so, public debt would be stable or falling modestly in relation to GDP.

A low rate of inflation. The Central Bank of Russia is aiming to achieve a single-digit annual rate of inflation in 1998, a goal that is within reach. Six years from now, if the fiscal deficit can be kept at the 3-4 percent level, Russia could have a price performance closer to that of the major industrial countries.

An improved rate of investment, financed largely through national saving and foreign direct investment. Structural reforms would increase the prospects for investment, including foreign direct investment. At the same time, a continuation of low inflation, and stronger domestic credit markets, should encourage a shift of portfolios of domestic residents towards domestic assets. The external current account deficit will probably shift into deficit, and it will be a challenge for policy-makers to keep the deficit manageable.

In summary, Russian economic reform is entering a less dramatic phase than that of the last few years: the most important battles in securing macroeconomic stabilization and creating a market economy have been won; but much remains to be done to secure the future growth of the economy.

Up to this point, the optimists on Russia have been more right than the pessimists. There is good reason to believe the optimists will continue to be right.

Russian Federation Macroeconomic Indicators, 1993-97

	1993	1994	1995	1996	1997 Actual/ Estimated
	(Annual percentage changes unless otherwise indicated)				
Production and prices					
Real GDP	-8.7	-12.6	-4.0	-2.8	0.3
Change in consumer prices					
Annual average	895.9	302.0	190.2	47.8	14.7
12-month	841.6	202.7	131.4	21.8	11.4
	(In percent of GDP)				
Gross national saving	26.6	29.7	25.2	22.4	22.2
Federal Government	-3.9	-8.4	-3.8	-6.8	-6.0
Other	30.5	38.1	29.0	29.2	28.2
Foreign saving	-1.4	-3.8	-1.3	-0.5	-0.8
Gross domestic investment[1]	25.2	26.0	23.9	21.9	21.4
Enlarged government deficit	7.4	10.4	5.7	8.2	...
Federal government (cash basis)					
Fiscal deficit	6.5	11.4	5.4	8.0	6.5
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

Domestic financing[2]	6.6	11.4	5.6	7.4	5.1
External financing[3]	-0.1	0.0	-0.2	0.6	1.4
			(Percent change)		
Money and credit (end-period change)[4]					
Base money, narrow definition	647.1	185.7	117.6	26.2	28.0
Net domestic credit of the banking system	358.0	263.1	141.5	54.8	...
Ruble broad money	429.0	197.7	127.4	33.6	30.0
Ruble money velocity, level	11.1	11.0	12.1	11.2	8.2
Interest rates, percent per annum					
Deposit	...	...	86.9	48.6	15.0[5]
Credit	...	...	160.3	103.0	32.0[5]
Interbank rate	...	...	171.8	101.7	19.0[5]
Central Bank of Russia refinance rate	210.0	180.0	160.0	48.0	21.0[5]
Treasury bill rate	...	...	176.0	102.0	40.4[6]
			(In billions of U.S. dollars)		
Total exports, fob	58.3	69.6	81.5	90.2	88.8
Total imports, fob	44.2	48.5	64.0	73.9	72.2
External current account (deficit -)	2.6	10.4	4.5	2.2	3.9
Public external debt service due	19.3	19.2	18.4	14.8	10.4
Public external debt service after rescheduling	2.8	3.7	6.4	9.5	6.3
			(In percent of exports of goods and nonfactor services)		
Public external debt service due	29.6	24.4	19.6	14.5	10.2
Public external debt service after rescheduling[7]	4.3	4.7	6.8	9.3	6.2
			(In months of imports of goods and nonfactor services)		
Gross reserves coverage	1.7	1.2	2.4	2.0	2.2
Memorandum items:					
GDP in trillions of rubles	172	611	1,630	2,256	2,678
Exchange rate rubles per US$1 (pd. average)	933	2,205	4,557	5,123	5,780
GDP in billions of U.S. dollars	184	277	358	440	463

Sources: Russian authorities; and Fund staff estimates and projections.

[1]Investment includes both capital formation and capital repair, as consistent with the methodology of Russian Goskomstat.

[2]Includes domestic bank financing, change in the stock of government securities held with the private sector, proceeds from privatization and the sale of gold and other precious metals, principal repayments to domestic nonbanks, and other financing.

[3]Includes rescheduling of principal and interest plus (net) disbursements.

[4]Monetary data calculated as percent change for same month in preceding year.

[5]September data.

[6]Data as of December 16.

[7]During the period 1992-96, cash payments fell significantly short of amounts falling due, with the remaining debt service obligations either being rescheduled or falling into arrears pending discussions on debt rescheduling with various creditors.

[1]First Deputy Managing Director of the International Monetary Fund. These remarks were prepared for delivery at the 1998 U.S.-Russian Investment Symposium, at Harvard University, on January 9 1998.

[2]Macroeconomic data are presented in the table at the end of the paper.

[3]See Anders Aslund, How Russia Became a Market Economy (Brookings, Washington, D.C., 1995); and "The Russian Economy: Where Is It Headed? " (The Ernest Sturc Memorial Lecture, 1996); European Bank for Reconstruction and Development (EBRD), 1997 Transition Report ; Richard Layard and John Parker, The Coming Russian Boom: A Guide to New Markets and Politics (The Free Press, New York, 1996); and Organization for Economic Cooperation and Development, OECD Economic Surveys: Russian Federation 1997.

[4]EBRD, op. cit. , page 14.

[5]See, e.g., Stanley Fischer, Ratna Sahay, and Carlos Vègh, "From Transition to Market: Evidence and Growth Prospects, " in S. Zechini (ed.), Lessons from the Economic Transition.

[6]Differences in initial conditions are also important in the early years of the transition. For a review of the issues and a detailed econometric study, see Andrew Berg, Eduardo Borensztein, Ratna Sahay, and Jeromin Zettelmeyer, "The Evolution of Output in Transition Economies: How Different is the FSU? ", mimeo (IMF, July 2, 1997). EBRD, op.cit. Chapter 6 also stresses the importance of structural reforms for growth.

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[8]On the decentralization of power during the Brezhnev and Gorbachev eras, see Anders Aslund, How Russia Became a Market Economy , in particular p.15 and pp.33-34.

[9]On the importance of the legal framework in economic reform, see J.F. Sachs and K. Pastor (eds.), The Rule of Law and Economic Reform in Russia, (Westview Press, 1997).

[10]One impediment to structural reform in Russia is the sheer size and spread of the defense establishment (including the armed forces and the military-industrial complex) inherited from the Soviet Union. On the legacy of the defense complex, see Clifford Gaddy, The Price of the Past: Russia's Struggle with the Legacy of a Militarized Economy (Brookings, Washington DC, 1996).