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Stanley Fischer

Russian Economic Policy at the Start of the New Administration

Remarks by Stanley Fischer, Acting Managing Director of the IMF¹

Prepared for the conference on

"Investment Climate and Russia's Economic Strategy"

State University: Higher School of Economics

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1. It is a great pleasure to be taking part in this timely conference at the Higher School of Economics on the economic policy choices that confront the incoming Putin administration. And it is an extra pleasure to be participating in a conference organized by my friend and widely respected colleague, Professor Yevgeni Yasin, with the participation of so many other leading Russian economists and policy analysts.

2. I will make four main points:

- After ten years of experience in over 25 transition economies, the evidence is clear that the basic economic reform and growth strategy recommended by mainstream economists works.
- Despite the many disappointments and setbacks in Russian economic reform, we should not underestimate what has so far been achieved in Russia.
- The way ahead for economic policy in Russia at this critical moment is clear. To achieve sustained and equitable growth in Russia will take a strengthening of macroeconomic stability and the intensification of sectoral structural reforms, including improving the social safety net.
- Worldwide experience shows that economic programs are most likely to succeed when they are "owned" by the country implementing them, and if necessary supported by the international financial institutions and bilateral lenders. Russia's economic program is more likely to succeed the more it is designed by Russians. The IMF and the international community stand ready to help support a serious Russian economic reform program, whose seriousness is demonstrated by progress in its implementation.

International Experience

3. The experience of the transition economies that started on the process of economic reform at the end of the Cold War has been studied intensively. There has rarely been an occasion when so many countries changed economic policies at the same time; this makes it possible to use econometrics to study the determinants of their growth experience since the start of transition. My IMF colleague, Ratna Sahay, and I have examined this experience, using data from the 25 countries for which it was available.² We measure the extent of structural reforms using the indices of different elements of structural reform constructed by the EBRD. We conclude that the basic strategy advocated by market-oriented proponents of reform a decade ago is correct: namely that both stabilization policies and structural reforms, particularly privatization, contribute to growth; and that the faster is the speed of reforms, the quicker is the recovery from the inevitable initial recession, and the more rapid is growth.

4. To say that the basic strategy is well understood is not to say that carrying out a reform program is easy, nor to deny that the way the strategy should be applied in each case varies from country to country, nor to deny that policymakers face technically and politically difficult choices every day. That is all true, and we must salute those policymakers who have succeeded through their insights, technical and political skills, and courage, in moving furthest in the transition process.

5. But it is also true that since the basic growth strategy is understood, it is necessary to ask what determines the extent to which a country embraces transition and is effective in undertaking the needed economic reforms. An answer relevant for some countries is that they lack the technical expertise to implement the required policies. That could have been true at some early stages of reform in Russia, but given the technical skills and sophistication of policymakers in this country, it certainly cannot have been true for most of a decade. The answers must lie elsewhere, in the political realm, in a lack of effective political or societal support, and in problems of governance. I will return to some of those issues at the end of my remarks today.

Russia's achievements

6. This seminar is taking place at a time when the public debate in Russia and abroad has been dominated for some time by disappointment about the achievements to date and some cynicism about the future. Much of this skepticism has remained despite the favorable events in the Russian economy over the past year. While there is much to be disappointed about, and many negative developments that need to be reversed, Russia also has had positive achievements during the last decade. I am not talking here only about the great historical achievement of the last decade, the remarkable extent to which democracy is becoming entrenched in Russia. Much has also been achieved in the

economic sphere:

- Most fundamentally, a consensus has been reached that the process of transition is irreversible and that the establishment of a truly market-based economy should continue to be an overriding policy objective and the road to sustained growth and future prosperity in Russia.
- A commitment to low inflation and sound fiscal policies has taken hold across a broad segment of the public as well as within the political elite. After the 1998 crisis, some Russian policymakers argued that the country should welcome moderate--say 40-60 percent--inflation, and that larger budget deficits were desirable. That did not happen. There is a clear resolve to limit public expenditures to available revenues and to avoid inflationary financing. And that is being done.
- There has been considerable domestic market liberalization, including price and wage liberalization and the dismantling of most of the system of state direction of economic activity. Privatization, while flawed in several respects, has allowed much of economic activity to be governed by the incentives of the market. There has also been far-reaching exchange and trade liberalization, with liberalization of exports and imports, introduction of current account convertibility, and unification of the exchange rate.
- The institutional setting for the conduct of macroeconomic policies has been strengthened. A modern central bank and payments system have been established. Interest rates have been liberalized and the elimination of low-interest CBR direct credits has strengthened the capacity to conduct monetary policy. Fiscal reforms include large reductions in subsidies, improvements in the tax system (although this is a job that certainly is not yet finished), and the establishment of a treasury.
- In addition to significant privatization, we have also seen the introduction of institutions and legislation required for a well functioning market economy. These include bankruptcy procedures, competition policy and anti-monopoly regulations, improvements in accounting standards, a securities commission, and regulatory agencies for the natural monopolies. To be sure, , the implementation and enforcement of new laws and regulations has been inconsistent. Nevertheless, many of the basic underpinnings of a market economy have been put in place.

7. There has been real progress in these areas, even though these reforms are incomplete or highly imperfect. Nonetheless, the disappointments about the overall progress of the last decade are valid,

and the setbacks have been dismaying. One needs only to look at the basic social indicators, with life expectancy declining and the incidence of poverty increasing. And that takes us to the next question:

What needs to be done?

8. In 1996 there was decisive progress in achieving macroeconomic stability in Russia. However fiscal policy and the record of policy implementation in the structural area after that was poor. While the government's medium term program adopted in 1996 constituted a coherent and comprehensive structural agenda, performance in that area during the life of that program was very weak, and was a fundamental factor leading to the Russian financial crisis in 1998. And little has been done to tackle Russia's deep-rooted structural problems since then.

9. Russia's commitment to low inflation and sound fiscal policies is evident in the continuing decline in inflation over the past year, and in the improving fiscal situation. However it will take a broad-based acceleration of structural reforms, not only to increase growth, but also to maintain macroeconomic stability.

- The recovery in output, the improvement in the fiscal position, and the notable measure of financial stability that has been achieved has in large part--though not entirely--due to the effects of the sharp real depreciation of the ruble in the wake of the 1998 crisis, as well as the jump in world oil prices.
- Sustained growth and the further fiscal consolidation that is needed to maintain macroeconomic stability will require an acceleration in structural reforms to spur investment activities and strengthen exports, as well as comprehensive tax and expenditure reforms.
- The goal of many of the needed structural reforms is to improve the investment climate, primarily for Russian investors, but also and importantly for foreign investors. The large amounts of Russian capital now abroad will begin to return only when the investment climate changes, and as it comes back and investment picks up, so too will growth--and here I echo the theme of this conference, on the investment climate and the prospects for economic growth in Russia.

10. What should be the focus of the structural reform effort? There are 19 groups in this conference discussing different areas of reform, and the new government will have to make progress in all those areas. Four topics are grouped under the heading "state regulation of the economy: freedom and the rule of law". That is critical. It is part of the pressing need to increase transparency in the economy, in both the public and private sectors. This will be a crucial factor in assuring external support

for the Russian economy.

11. Rather than go in detail into the overall program, let me select six priorities:

- industrial restructuring, including privatization, and other measures needed to improve the business climate--especially in corporate governance and strengthening of the rule of law
- measures to eliminate the nonpayments and barter problems;
- restructuring of the banking system, including reform of the central bank;
- tax reform, and expenditure reform, including reform of the civil service, which has grown remarkably in the last decade;
- strengthening of the social safety net;
- agricultural reform and land ownership reform.

With progress in these areas, the stage will be set for Russia to begin sustained growth, allowing its people to fulfill their potential.

Program ownership

12. It cannot be overlooked, however, that many if not most of the proposed measures have already been part of government programs in the past--they have just not been implemented. Why? The poor record reflects, fundamentally, a failure to overcome fierce resistance from vested interests in the face of weak government consensus. There are many examples, but let me mention three areas that have been the subject of discussion in this conference--bank restructuring, tax reform, and the rule of law:

- Following the collapse of a large number of banks in the aftermath of the 1998 crisis, the authorities made little use of the authority granted within the existing legal framework to place ailing banks under administration. By the time these banks were subjected to bankruptcy procedures, they had become mostly empty shells. One result is that bank restructuring will be more expensive than it otherwise would have been.
- Tax enforcement is another key area. Politically influential enterprises have been able to pay well below their statutory tax obligations for years, without effective government penalty. Indeed, instead of strict enforcement backed up by bankruptcy or criminal proceedings against owners and managers, we have witnessed numerous schemes of tax restructuring and

rescheduling, and negotiated settlements. This treatment of large taxpayers has been accompanied by much tougher treatment of smaller enterprises and individuals. Against the background of very favorable energy prices, revenue performance in the last year has improved, but this problem still remains.

- The failure to strengthen the rule of law and improve governance both in the public and corporate sectors is at the heart of weak investment, the failure of enterprises to restructure, and capital flight. It helps account for the extremely low level of foreign direct investment. FDI in Russia has run below 1 percent of GDP, compared with around 3 percent of GDP in the Central European transition economies. An improvement in the investment climate could reap big rewards for the economy in this regard. It could also help reverse capital flight, which has averaged \$10-20 billion per year since the early 1990s. Russia's economy, and Russia's financial needs, will look very different when Russian savings, instead of fleeing abroad, is used to finance productive investments in the domestic economy.

13. Why mention these past failures? Because this, the start of a new administration, working with a new Duma, presents a rare opportunity for a second beginning. Many of the problems of the past occurred because there was not sufficient support for the economic reform program within the political system and the society. Some of those problems happened because the policies were badly implemented. Many lessons have been learned about policy in transition economies in general, and in Russia in particular. The question now is whether it will be possible for Russia to develop its own economic reform program, a program worked out by Russians, and effectively supported by the society, a program owned by Russia.

14. We have seen in this conference that there is no shortage of good ideas about what those policies should be. What is needed now is to translate this knowledge and energy into a coherent reform strategy that is backed by strong public consensus and leadership, **and that is implemented**. If that happens, the IMF--and I am sure also the rest of the international community--will be ready to do what it can to support and strengthen the program and Russia's economy.

Thank you.

¹Prepared for the conference on "Investment Climate and Prospects for Economic Growth in Russia", State University: Higher School of Economics, Moscow, April 5-6.

²See Stanley Fischer and Ratna Sahay, "The Transition Economies After Ten Years", IMF Working Paper, WP//00/30, February 2000.

