

Notes for

RUSSIA: WHAT IS TO BE DONE?

by
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1. Ladies and Gentlemen:

It is a great pleasure to have been invited to take part, on behalf of the International Monetary Fund, in this important Colloquium sponsored by the Alfred Herrhausen Society. I would like to start by recounting the economic tasks that faced Russia when it began its reform program at the end of 1991. The goal was to raise the living standards of the Russian people in a sustainable way, with the eventual aim being convergence to the income levels of the advanced industrialized countries. That was a formidable task, which at best would take many decades. It required both the attainment of macroeconomic stability and the structural transformation of the economy.

2. To attain macroeconomic stability it would be necessary to achieve sustainable levels of both the budget deficit and the balance of payments, consistent with monetary stability and the maintenance of low rates of inflation. The structural transformation of the economy would require

- the creation of a modern fiscal system;
- price and trade liberalization;
- privatization and the restructuring of industry;
- the development of a financial system;
- the development of an appropriate legal system and property rights.

¹ First Deputy Managing Director, International Monetary Fund. This is the outline of a presentation delivered at the 5th Annual Colloquium sponsored by the Alfred Herrhausen Society, held at the Deutsche Bank, in Berlin on July 5, 1997. Views expressed are those of the author and not necessarily of the IMF.

3. What has been achieved? On the macroeconomic front, inflation has been reduced to low levels, with the exchange rate behaving predictably in a crawling band arrangement. The Central Bank of Russia stands strong as a bastion of stability in the economy. The decline of output, which was larger than expected, has been arrested, and the economy is probably growing. (Charts 1 and 2). The current account is in surplus. The central government's budget deficit has been sharply cut since 1992.

4. On the structural side, prices and trade have been liberalized, Russia has a convertible currency on current account and has accepted the Article VIII obligations of the IMF, and there are few restrictions on capital account transactions. After an initial period of essentially free banking, the Central Bank of Russia is now strengthening its supervision over the banking system. The stock market is very active, and--as many of you here know to your benefit--attracting a great deal of international attention. Any visitor to Moscow realizes he or she is in a boom town.

5. **These are major achievements: Russia has already traveled a long way down the road to the transformation of its economy.** The IMF is proud to have been able to cooperate with the Russian government to help bring about these results.

6. However the challenges that remain are formidable. Most immediately, the government has to deal with a major fiscal problem (Chart 3), concentrated both in problems in collecting revenue, and in the structure of taxes. Increasing revenue mobilization and improving the structure of the tax system are the major macroeconomic challenges facing Russia, the key to the success not only of its program with the IMF, but also to the maintenance of macroeconomic stability. And because government payments arrears have been a major factor in the overall arrears problem, which is a reflection of the lack of financial discipline as well as a major contributor to public dissatisfaction with the reform process, the revenue problem has even wider implications.

7. The government has set as its highest economic priority for economic reform in 1997 the restoration of credibility to fiscal policy. To do this it has to ensure that it will meet its spending

obligations promptly, without running up arrears, while at the same time firmly enforcing the obligation to pay taxes fairly and without preferential treatment. There have been improvements in revenue collection in the last quarter, and a comprehensive tax reform has passed its first hurdle in the Duma. But this is a battle that continues and that will have to be won if Russia is to build a modern economy.

8. There is also a need for the rationalization of government expenditures. Expenditure reform over the next several years should focus on military expenditures, civil service reform, health and education reform, reform of the system of housing subsidies, and better targeting of social assistance. Reform of the budgetary system, including reform of the extrabudgetary funds, especially the Pension Fund, and improvements in revenue sharing arrangements between the federal and subnational governments, are further important elements in the reform program.

9. If the tide can be turned on fiscal policy in its most important dimensions -- revenue collection, tax reform, the rationalization of expenditures, the elimination of spending arrears, and the avoidance of new arrears -- then the Russian reform program will be firmly back on track. As of the middle of this year, the signs are encouraging.

10. But much more needs to be done for sustained growth to begin. The evidence from the transition economies is clear. Countries that do not stabilize do not grow in a sustained way. But the achievement of sustained growth takes more than stabilization -- it requires also structural reforms in the five areas previously discussed. Here the complaints of businessmen about the difficulties of doing business in Russia reflect the priorities: the delay in economic growth is in large part a result of the absence of a framework in which private sector activity can flourish. The needs are for a simple and transparent regulatory system, an effective legal and judiciary system, and of course, a simple and broad-based tax system. Legal reform, the fight against corruption, and the simplification of business regulations are therefore all high priorities. These changes will promote vitally needed foreign investment; even more important, they will promote investment by Russians, and reverse Russia's capital flight.

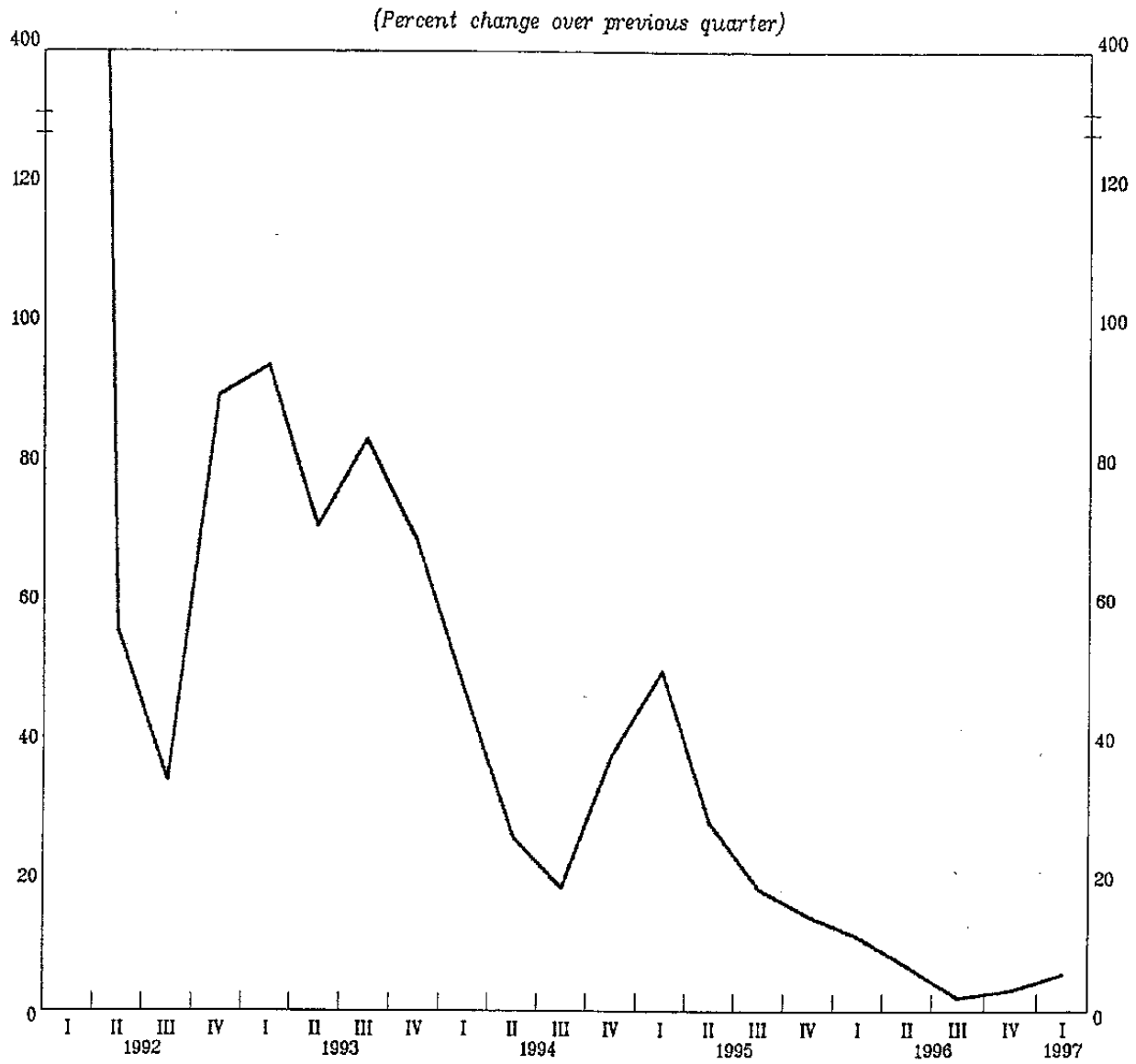
11. In addition, there is a need for a substantial acceleration of reform in banking, agriculture and land use, privatization, and the regulation of natural monopolies. Many of the remaining large enterprises need to be divested, closed down, rehabilitated, or restructured in a manner that is seen to be fair. In the area of privatization, the major focus of the government's reform program in 1997, as reflected in its EFF agreement with the IMF, will be on case-by-case sales to attract strategic investors (including foreign investors) and raise revenue. In the area of natural monopolies, there is an immediate need to strengthen the regulatory agencies and to adopt a rational pricing policy, including a reduction in cross-subsidization in the railway and energy sectors.

12. In considering the situation in Russia, it is common to point to the many tasks that remain, and to succumb to pessimism. There is indeed a vast amount still to be done, and it is possible that the reform momentum will again slow, and growth be set back. But that is not now the most likely outcome, and it is easy to overdo the pessimism. Russia is very close to the point where sustained growth will take place -- indeed the turning point has probably already been reached. It has in place an economic team headed by individuals of remarkable talent, determination, and accomplishment, headed by a President who time and again has demonstrated his commitment to the reform process. It has a highly educated and technically skilled workforce and an incomparable natural resource base. Potential business opportunities are vast. The government has already achieved many of the prerequisites for growth, most notably macroeconomic stabilization. It knows what needs to be done, it intends to succeed, and it very likely will. We know from the experience of Eastern Europe and other countries that the economic outlook changes -- albeit with a lag -- when growth begins. Pessimism gradually gives way to optimism, and what seemed impossible -- sustained growth -- becomes a fact of life.

13. The course of economic reform in Russia is of immense importance, in the first instance to the Russian people, but also to their near neighbors, to Europe and to Asia, and indeed for world peace. Russia has made an historic decision to pursue peace, cooperation, and economic integration with the rest of the world. Whether Russia succeeds depends primarily on the Russian

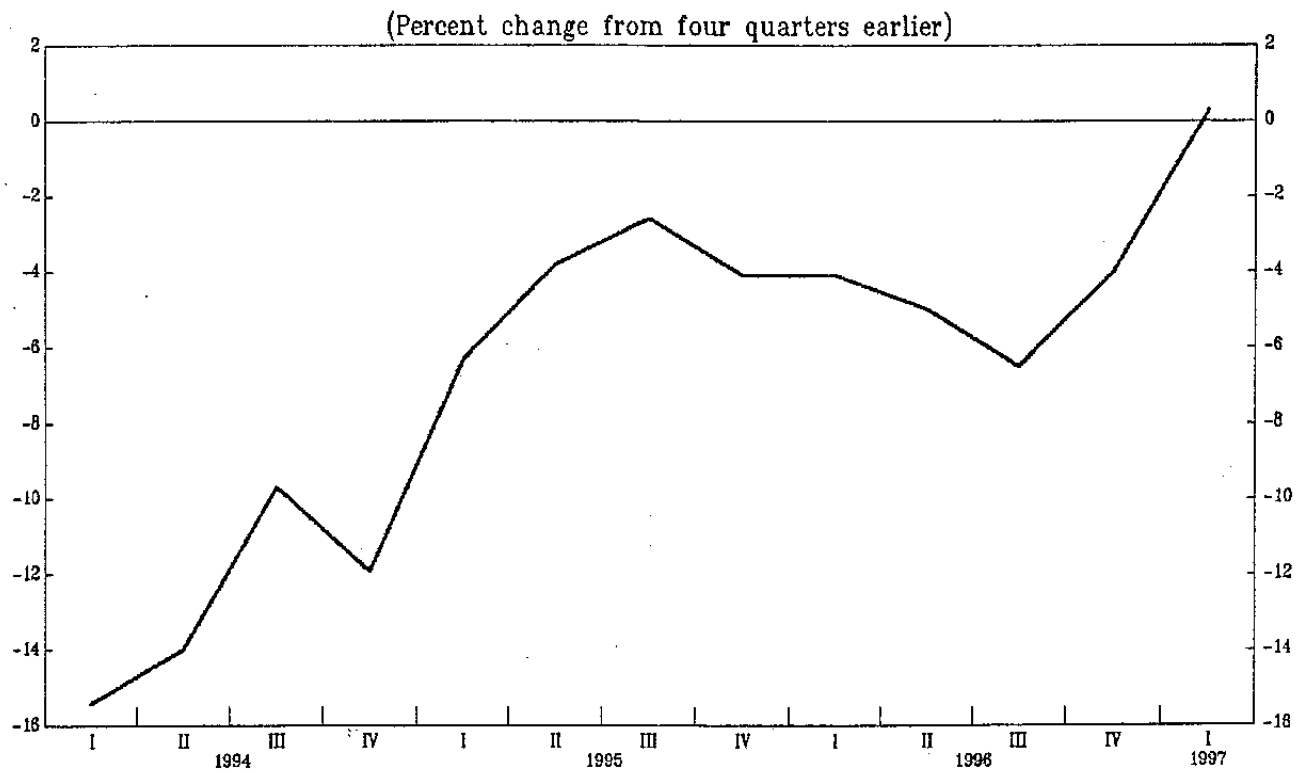
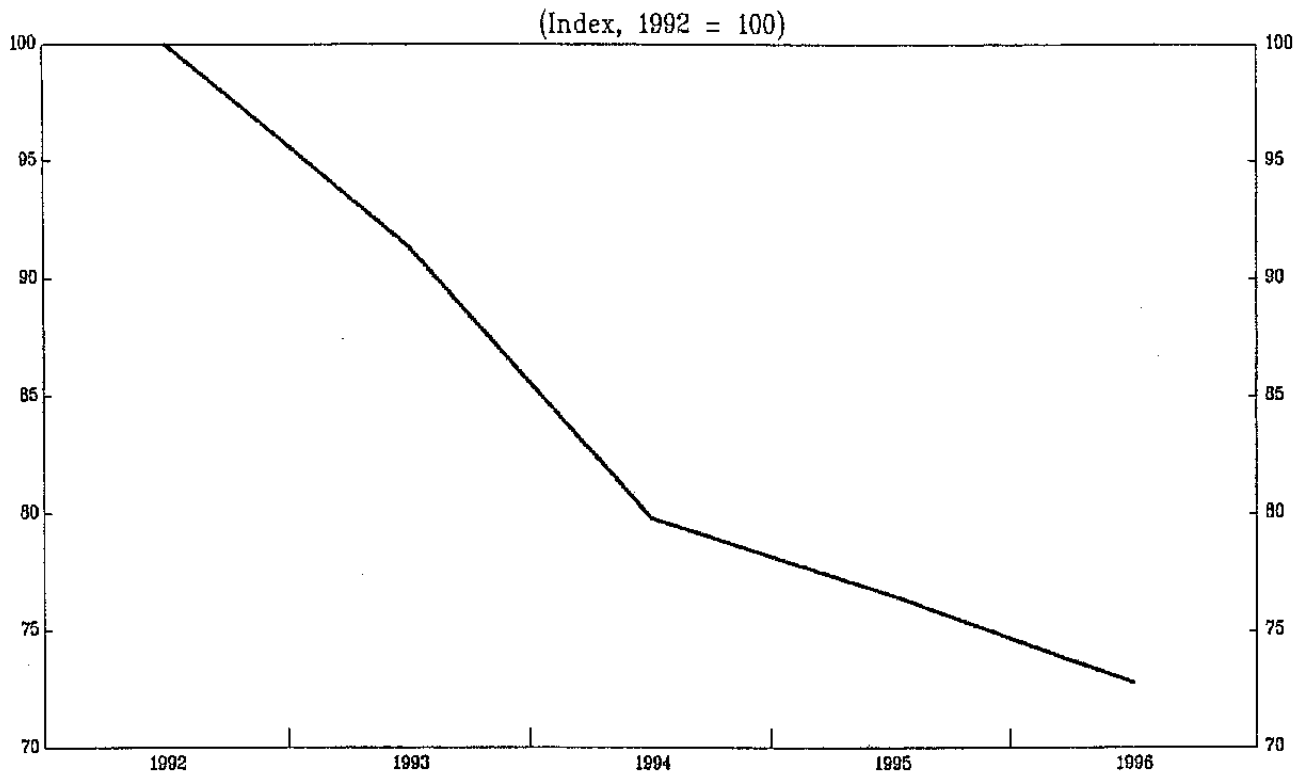
people. But they deserve help from the rest of the world. This help should be provided in the first instance through trade and investment; it is also coming in the form of financial assistance through the IMF and other international institutions, as well as bilaterally -- and here I would like to pay tribute to the remarkable assistance Germany has given to Russia, some of it at critical moments. While the tasks remaining are indeed immense, so are Russia's achievements to date. If this government continues down the reform road to which it recommitted itself earlier this year, sustained economic growth will begin soon, and the Russian economy will gradually achieve, and be seen to be capable of achieving, its remarkable potential.

Chart 1. Russian Federation: Consumer Price Index,
1992 Q1 to 1997 Q1



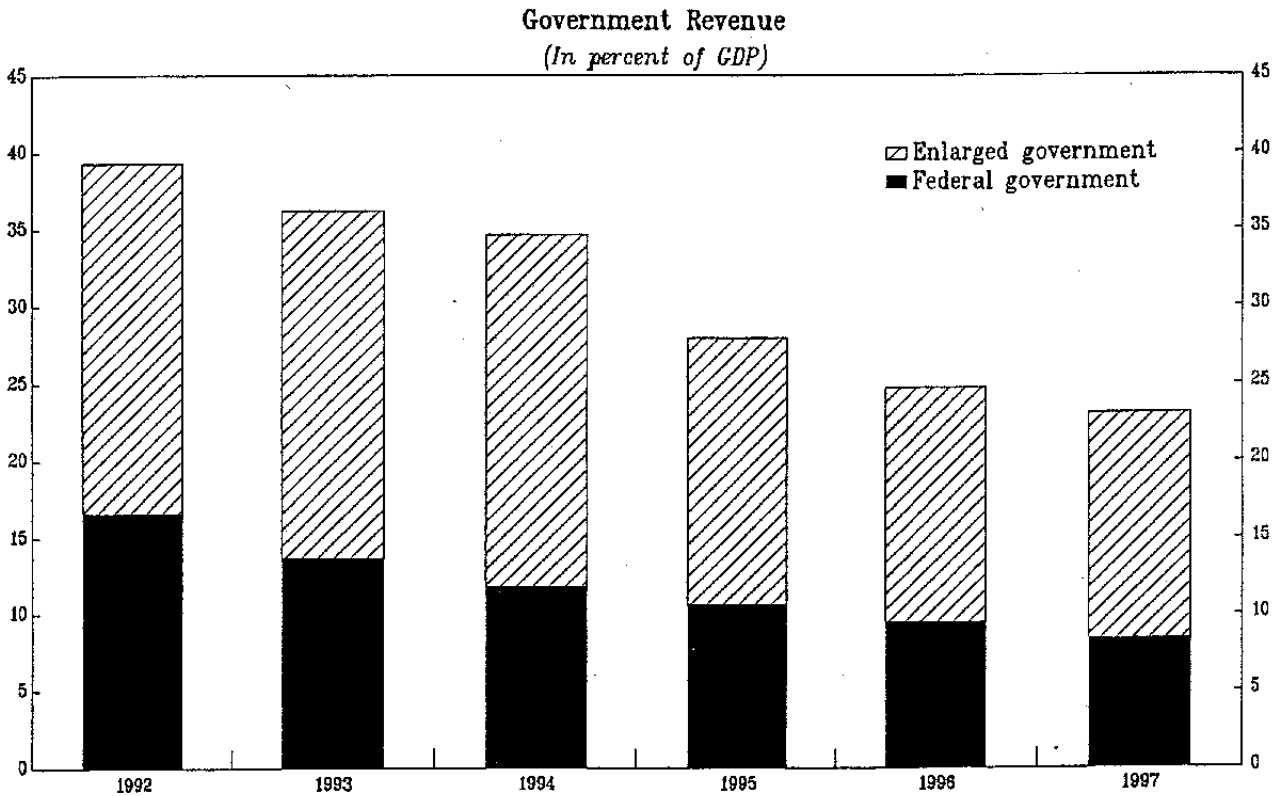
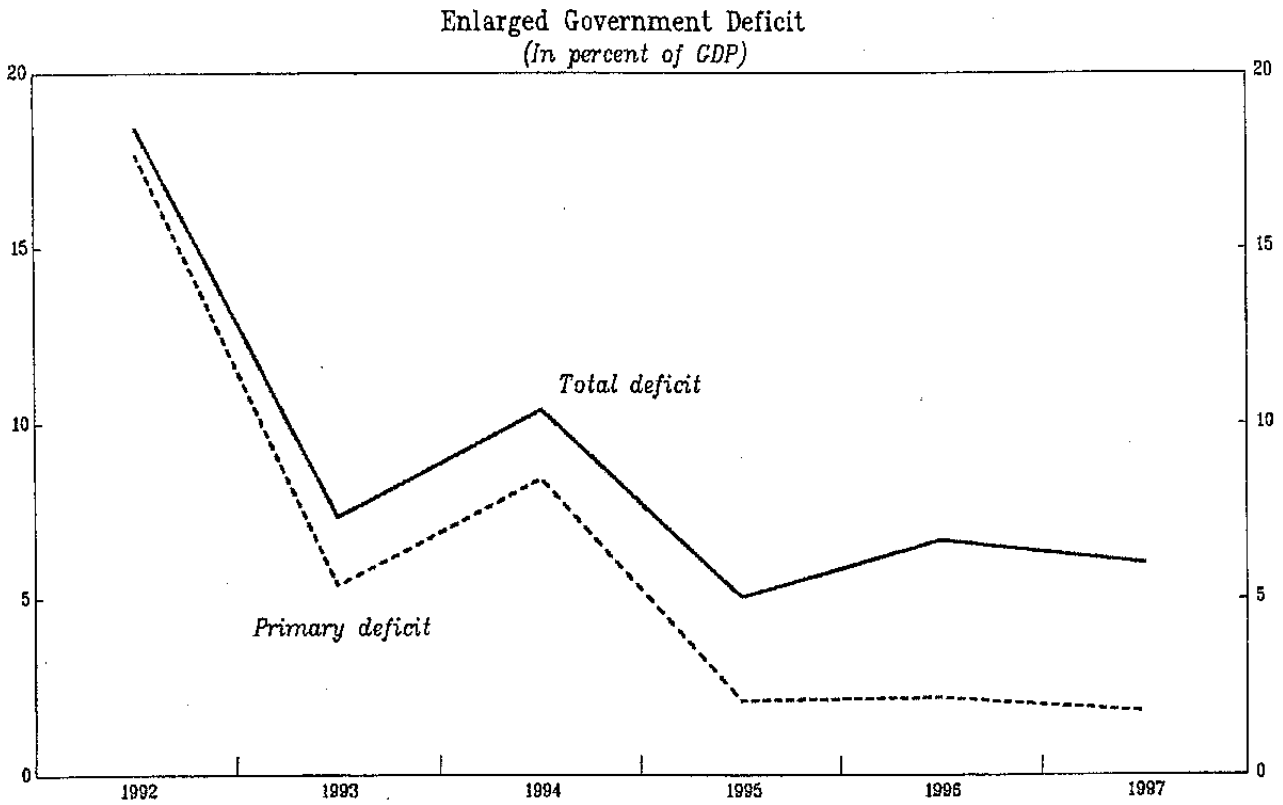
Sources: Russian authorities and IMF staff estimates.

Chart 2. Russian Federation: Level and Growth of Output



Sources: Russian authorities and IMF staff estimates.

Chart 3. Russian Federation: Government Deficit and Revenue, 1992-97



Sources: Russian authorities and IMF staff estimates.