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Alexei Golovkov

13 December 1991

Dear Alexei

Conference of Economics Ministers "Trade and payments in the Soviet area".

As you may know, the European Commission recently co-sponsored a conference of republican economics ministers in London. Ministers from ten republics were able to attend and they considered the conference so valuable that they requested a further meeting. This will be devoted to the specific issue of inter-republican trade and its finance, and will be held in Brussels on Saturday and Sunday 18th and 19th January, arriving the previous day. Papers will be presented by the European Commission and by Prof.Rudiger Dornbusch. The conference will end with lunch on Sunday.

We very much hope that you will be able to attend the conference. Your fares and local expenses will be met by the organisers.

Yours sincerely,

Richard
Richard Layard
Professor of Economics
Director Centre for Economic Performance

Peter Ludlow
Director
CEPS

Statement by the IMF Mission

On the Economic Reform Program of the Russian Federation

During the past week, we have held intensive discussions with Russian officials on the reform program of the Russian Federation. The program includes proposals for unprecedented and bold policy reforms in the transition to a market economy. We warmly welcome the direction of the reforms, in particular privatization, the liberalization of prices and the exchange and trade system, and the intention to stabilize inflation.

But major work needs to be done to ensure that strong stabilization policies are in place by the time the liberalization takes place. We are concerned with the incomplete state of preparations so close to the beginning of 1992 and the date for the liberalization of prices. We are especially concerned that, as far as we can ascertain at this stage, the measures which have been decided by the authorities will be inadequate to contain the strong inflation pressures.

I. Fiscal Policy

The new draft budget aims at eliminating the overall fiscal deficit in the first quarter of 1992 from its notional level of 24 percent of GDP in 1991, taking account of Russia's share of the union budget. While this is an extremely ambitious target by international standards, its attainment is not entirely outside reach. For it to be achieved, however, the present proposal needs to be corrected for certain shortcomings and to be underpinned by a package of additional measures.

As discussed in more detail in the attached appendix, the present budget proposal appears to overestimate revenue collection, mainly because it does not allow for any tax evasion and tax collection difficulties in the introductory period of the VAT, and to underestimate expenditures, mainly because it excludes the cost of certain commitments which have already been made, mainly for wages and domestic debt servicing. After adjustments are made for these and other factors, the fiscal deficit is estimated to amount to rub 81 billion, or about 13 percent of GDP.

Clearly, a fiscal deficit of such magnitude is incompatible with the successful reduction of inflation after the price liberalization. Therefore, additional measures should be introduced immediately. These may involve: (i) the extension of VAT and excise taxes to imported goods and services; (ii) the extension of excises at a high level to petroleum products, with the full proceeds being transferred to the budget; (iii) the rescinding of the indexation of depreciation allowances, which otherwise erodes the profit tax base.

On the expenditure side, the most pressing wage commitments will probably need to be honored; but there may be room for scaling down the demand for wage increases in the education sphere, given that the general 90 percent wage increase will benefit that sector among others. Similarly, debt service payments have to be honored. In addition, all nonessential investment, as well as operational and maintenance expenditure, need to be cut to the bone, and/or postponed.

The mission has two additional concerns about the budget. First, the central authorities may not be able to control effectively much of the expenditure of local authorities. The situation will have to be monitored closely, and action taken to correct any tendencies in this direction, even though the issue is highly political. Secondly, some of the measures in the budget for the first quarter will be unwound subsequently. There is therefore an urgent need to plan now for permanent revenue-raising and expenditure-reduction measures to ensure that the second quarter deficit does not bounce back again.

II. Monetary Policy

Effective monetary policy requires a properly constituted and staffed monetary authority. The monetary authority should be independent of the Government, as is the case in many countries. In practice it is desirable for the Ministry of Finance and the Central Bank to agree on common policy objectives and to cooperate in the design of a consistent stabilization package.

The mission is concerned that there remain major uncertainties about the organization of monetary policy in Russia and the ruble area at this late stage. It is also concerned that there seems to have been very little discussion between the government and the monetary authorities on major elements of monetary policy. The Central Bank of Russia is ill-prepared to institute from January 2, 1992 the tight monetary policy that is needed to ensure that the macroeconomic stabilization is successful.

For effective control of inflation, the banking system should not finance the budget through either credit or purchases of bonds. Nor is the problem avoided if enterprises buy government bonds and finance the purchase with bank credit. The mission is concerned to hear of plans to issue bonds at below market rates which enterprises and banks would be legally required to buy.

Indirect instruments of credit control in Russia are not yet well enough developed to be relied on to control credit to the economy. At least during the period of stabilization, a ceiling on the rate of growth of credit for each bank must be applied transparently. This ceiling should probably be uniform across all banks to make it administratively simple, and capable of extension across the whole ruble area. Central bank rediscounts must be compatible with the ceilings for bank credit.

It appears that unrestrained credit creation by the ex-specialized banks through the MFO system is in large measure responsible for the credit explosion of recent months. As is the authorities' intention, all banks should be shifted to a correspondent account system as soon as possible. Until this can be done, the ex-specialized banks' adherence to well-specified lending limits should be monitored closely. There is no good reason for preferential lending or refinancing conditions for ex-specialized banks.

The discount rate should be raised immediately and substantially and it should be adjusted flexibly in future. This will be an important instrument for containing inflation by encouraging households to save instead of consume, and by making the ruble an attractive instrument to hold thereby limiting its depreciation. Interest rates (including the discount rate) and reserve requirements should be uniform across all banks, so that funds are allocated on efficiency grounds only. Any credit preferences should be provided in the form of explicit budget subsidies, while maintaining the budget deficit target.

III. Price Liberalization

The mission strongly supports the authorities' intention to free domestic prices. This will accomplish both a correction of relative prices and an adjustment of the price level. Even with tight financial policies, it might be hard to hold the price adjustment down to the level required to eliminate the monetary overhang (50 to 75 percent). But budgetary and monetary policies should not be based on a much larger price jump because if they were it would be impossible to prevent such a jump from materializing. After the initial price adjustment, policies should aim at holding the monthly rate of price increase at a very low level, such as 1 percent.

The mission would have preferred an initial increase in the price of oil to a much higher level than Rub 350/ton. A higher increase would reduce the price differential relative to the world price, encourage energy conservation and a more rational allocation of resources, and be very helpful for the budget. The authorities should be prepared to adjust the level of this and other administered prices at regular intervals. To help establish price signals a timetable should be announced for the path which energy prices will follow until they reach world market prices.

The mission supports price regulation for monopolies to prevent excessive price increases, but it would recommend that such price regulation should not take excessively administrative forms. In this context, it would be very important to have an active anti-trust policy which would involve breaking up the largest producers into smaller units.

The April 1991 increase in prices was followed by compensation for deposits. It is essential that this should not occur again this time, since it would perpetuate the monetary overhang, and contribute to inflationary pressures.

IV. Wage Policy

The mission believes that it is extremely important to prevent a wage-price spiral from occurring. In this connection the Fund's experience in many other countries indicates that tax-based wage policy can be very helpful. A wage policy involves efficiency costs, but these are worth paying at a time when everything should be done to reduce the risk of hyperinflation. The mission has already prepared and submitted a note on tax-based wage policies.

The authorities have proposed a mechanism which limits the deductibility of wages for the calculation of profit tax liability. This is not likely to be very effective because the tax rate applied - 35 percent - is not high, while the threshold--four times the minimum wage--is quite substantial. In addition, the authorities propose to give workers an ownership stake in their enterprises in the form of transferable shares, in the expectation that this might reduce workers' wage militancy. The mission is skeptical of such a mechanism simply because experience from other countries indicates that workers prefer the certainty of higher wages over the less certain higher profits in the future. It has been mentioned that the authorities might try to reduce enterprises' ability to increase wages by freezing their deposits with the bank. Such measures should be approached with caution because they might have arbitrary effects on enterprises and could also make large enterprises reluctant to use the domestic banking system for their transactions.

The indexation of wages in both the enterprise and government sectors has been institutionalized in legislation. This increases the risks of a wage price spiral and encourages inflationary expectations. Such legislation should be rescinded, preferably as soon after the price liberalization as possible.

V. Social Safety Net

Protecting the most vulnerable groups of the population during economic reforms is particularly important in economies in transition, where some basic elements of a social safety net need to be established. In the view of the mission, the state should retain the responsibility for ensuring only a minimum living standard during the transition period. Some improvements in the present system could be made to increase its efficiency and/or reduce its cost.

As mentioned under fiscal policy, the cost of consumer subsidies should be fixed in a system of limited subsidies, under which essential commodities would be made available at administered prices to the targeted groups of the population, but in a limited quantity--for example, through a coupon system. The remaining basic goods would be sold at free market prices.

Looking ahead to reforms beyond the next month or two, a major problem of the pension system is the lack of sufficient benefit control. As a result, the social security rates increased steeply in recent years from 12 percent in 1989 to 31 percent in 1992--a rate that could not be further raised without adversely affecting the contribution base through increased evasion. The current proposals for unemployment insurances are overly generous. They provide disincentives to work on the one hand, and are likely to result in high budgetary transfers to the Employment Fund on the other hand.

VI. Exchange Rate Policy and The Exchange And Trade System

The new exchange and trade regime should support external adjustment by reversing the declining trend in exports which would allow imports to expand in line with the needs of the economy and ensure a more efficient allocation of imports. It should also aim at rechannelling the parallel market transactions through the banking system.

The envisaged dual exchange rate system with a major initial depreciation of the commercial exchange rate constitutes a major improvement compared with the present system of multiple and highly distortionary exchange rates and different surrender requirements. Nevertheless, a unified exchange rate should remain the goal for the very near future. The Government should announce a timetable for the unification of the exchange rate.

A dual exchange rate system as envisaged by the Government will tax certain exporters and also lead to a more depreciated market exchange rate and therefore higher import prices than would otherwise be the case. This implicit taxation will benefit the budget (through lower debt service payments) and goods imported at the commercial rate.

Ideally, no imports should take place at the commercial rate. The experience of other countries shows the difficulties in resisting public pressure for extending the import window at the appreciated rate--once opened--to a broader range of imports. Any widening should be strictly resisted.

As more transactions take place in the market for foreign exchange, measures to improve the functioning of the thin interbank market and auctions in foreign exchange should be taken. The existing restrictions applying to such transactions should be removed. And efforts should be made to widen the geographical coverage of the interbank market and to ensure effective arbitrage between the markets to prevent multiple exchange rates from emerging in different regions.

It is unclear why quotas for key export commodities should remain in force to protect the domestic market when prices are being liberalized. For the commodities with administered prices, the difference between world market prices and these prices could be made up by export taxes. If export taxes were initially set so as to equal the difference in price levels, administered domestic prices should move in tandem with the movement in world market prices reflecting also changes in the exchange rate. Otherwise, the difference in price levels might quickly widen and exports would risk becoming uncompetitive.

The focusing on liberalization of current account rather than capital account transactions is appropriate in the first stage of the reform process. The repatriation of dividends to encourage foreign investment should, however, also be free from the beginning. For all foreign exchange regulations, there is a need for speedy adoption of exchange regulations in support of the new exchange system.

External debt management should aim at making the RSFSR creditworthy in the international capital markets soon again, so that individual enterprises, banks and the government have access to external borrowing. There is presently a vacuum of regulations for external borrowing in the transition from the previous monopoly of the Vneshekonombank to more diversified external borrowing. The supervision of the banks' foreign exchange transactions also needs to be substantially tightened compared to present practices, including regular--and enforced--reporting requirements and limits on foreign exchange holdings of banks abroad.

VII. <u>State enterprises</u>

The reform program is likely to be accompanied by major changes in relative prices and costs which, together with macroeconomic stabilization, might create financial difficulties for many enterprises. Moreover, if some of the major monopolies stop producing essential inputs for other industries, a chain reaction might occur. It is therefore important to prepare, in all possible ways, to avoid a collapse in output and employment of such a magnitude that the sustainability of the reform process is endangered.

A quick and relatively painless response in output could be accomplished through immediate privatization of small-scale enterprises, shops and services. This would be a visible and positive impact of the reform efforts. At the same time, privatization of the transportation and distribution services would provide much needed flexibility for the distribution sector, including for agricultural products.

The early moves towards privatization of housing in Moscow and St. Petersburg are to be welcomed. Local governments could be encouraged to extend them quickly to other cities as well.

The big state enterprises, including the monopolies, constitute the most difficult problem. They should immediately be put on a commercial basis, i.e. operate on the basis of market-determined costs and prices without preferential treatment. Pressure for using the banking system for implicit subsidization of these enterprises should be vigorously resisted. However, the monetary program should be designed so that state enterprises do not face a severe credit crunch. In general, Government subsidies should be resisted. If they are absolutely necessary they should be made explicitly through the budget, and a timetable for phasing them out announced so that their managers can adjust accordingly. Eventually, of course, they should be privatized.

VIII. Inter-Republican Relations

The mission wishes to emphasize two aspects of Russia's inter-republican relations. On the one hand, it is important to preserve in as large a part of the territory of the former U.S.S.R. as possible, a common economic space for free trade. The maintenance of trade is essential, if the decline in output is to be minimized. On the other hand, Russia's inter-republican relations should take a form that does not unduly complicate the implementation of economic reforms.

The maintenance of a common economic space would be helped by Russia's charging broadly the same prices for its regulated products to her republican trading partners as to domestic residents. At the same time, taking into account that the other republics will experience sharp terms of trade shocks in 1992, it would be important for Russia to be willing to help the other republics by extending financing and/or grants.

The requirement that the fundamental aspects of Russia's economic reform need to be coordinated with the other republics of the Commonwealth, and of the ruble area in general, should not necessarily slow down the implementation of reforms in Russia. Nevertheless, rapid progress should be sought on agreements with other republics in key areas such as credit policy, budget deficits and price reforms so that policies in those republics do not undermine the Russian program or lead to trade barriers.

International Monetary Fund
Moscow
December 21, 1991

APPENDIX

Evaluation of the 1992 First Quarter Budget

The new draft budget, which has been prepared on the basis of the guidelines of Mr. Gaidar, aims to eliminate the fiscal deficit in the first quarter of 1992 from its notional level of around 24 percent of GDP in 1991, taking account of Russia's share of the union budget. This target is extremely ambitious by international standards, but it is warranted in our view by the seriousness of the present economic situation of the Russian Federation. However, for the target to be credible and successful, it has to be solidly underpinned by a package of feasible and effective measures.

It seems to us that the budget in its present form still contains shortcomings, which may undermine the success of its implementation at the very beginning. We also believe, however, that these shortcomings can be in large part removed with the help of additional measures. In the following, we shall highlight our main areas of concern, specifying the amount of the imbalance that we see in the present proposal; and then propose a number of measures that would result in substantially reducing this potential imbalance.

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1. Assessment of the present budget

On the revenue side, relative to the budget, a shortfall of revenues can be envisaged for the following reasons: (1) there is no allowance made for a certain degree of tax evasion and noncompliance which should be expected both on account of the introduction of a relatively new tax (the VAT), with a very high rate, and on account of lower profit tax collection due to enterprise restructuring and subsequent liquidation and closure of firms; (2) the present budget may still contain assumptions from an earlier, higher-inflation version, in particular in the calculation of the profit tax base; (3) there is no allowance for the likely erosion of the profit tax base due to possible large wage increases, and the indexation of depreciation allowances. To quantify the magnitude of the impact of these factors, it is assumed that tax evasion or collection difficulties in the introductory period of the VAT would result in a loss of about 25 percent of the potential tax, and that profit taxes are likely to be 20 percent lower than the full collection amount. As a result, revenue is likely to be lower by roughly rub 34 billion (5.4 percent of GDP) than in the budget.

As regards expenditure, there is a risk that expenditure will be higher than projected in the budget in the following areas:

(a) the impact of former commitments for wage increases is not included in the budget. In the case of miners this would have an annual impact of rub 22 billion, and for employees in the education sphere President Yeltsin's first decree contained a commitment to raise the level of the average wage in education to that in industry which might cost as much as Rub 40 billion in higher outlays in 1992. (b) The drastic cut foreseen in the size of the army does not appear to be fully reflected in higher compensation and unemployment benefits.

(c) Consumer subsidies are exposed to the risk that higher input costs (not least on account of a likely substantial devaluation of the ruble, which is not accounted for in the budget) may result in much higher-than-budgeted expenditures.

(d) There is no provision made for debt servicing in the budget. This is in part due to the fact that, at the time of its preparation, the details of foreign trade taxation and the trade and foreign exchange regime had not been worked out. However, domestic debt servicing--both that of the Russian Federation and of Russia's share of the Union debt--is similarly omitted. The amount of expenditure that is not included in the budget is estimated at roughly rub 46 billion, or 7.3 percent of GDP. Of this amount, rub 34 billion (5.3 percent of GDP) relates to domestic debt (under the assumption of an average interest rate on government debt of only 20 percent).

On the basis of these tentative adjustments, the mission believes that the present budget proposals could imply a fiscal deficit of rub 81 billion, or 12.7 percent of GDP.

2. Additional Measures

A fiscal deficit of such magnitude is incompatible with the successful reduction of inflation after the price liberalization. Hence there is an urgent need for a set of additional measures to be put in place immediately. These measures have to be feasible on the one hand, and quick-yielding on the other hand. We suggest that action on the revenue side should follow the main recommendations of the team of the Fiscal Affairs Department of the IMF. These involve the extension of the VAT and excises to imports, the extension of the excise tax at a high level to petroleum products, and rescinding the indexation of depreciation allowances.

However, the impact of these measures in the short-run will not be sufficient to balance the budget. Therefore, well-targeted expenditure cuts and/or postponements, supported by a strict budgetary control mechanism, are called for. Over the short horizon of the first quarter, all non-essential expenditures have to be severely cut and/or postponed. As a first step, expenditures have to be re-prioritized. First, wages have to be paid, in full accordance with former obligations. Therefore, the committed wage increases to miners have to be honored. Politically, it may be more feasible to postpone the increase in the average level of wages in education to that in industry, particularly because of the general 90 percent wage increase that is in any event granted to all nonproductive sector employees, including education. Second, the subsidy system could be changed so that only a fixed amount is made available through targeted social support in cash, and/or targeted distribution of a limited amount of subsidized goods, with the rest of the goods being sold at free prices. Third, only the absolute minimum of operational and maintenance expenses should be financed. Finally, all other non-essential expenditures, investment, operational and maintenance alike, should be postponed or drastically cut.

However, even if all these measures were put in place, due to the difficulties associated with fiscal federalism, a crucial element may be missing from the program: an effective mechanism of strict budgetary control. Indeed, it is to be feared that the central authorities will not be able to control effectively a large amount of expenditure that is delegated to the levels of the local authorities. Local governments may act in the same way that the republics did with the Union budget this year: they may retain, through orders to the banking system to block tax transfers to the center, a larger share of the revenue collected in their jurisdiction than was envisaged in the Budget Law. Such a development would prevent the central authorities from exercising strict budgetary control. This is, of course, a highly political issue which will nevertheless have to be tackled directly should it occur.

Another potential problem with the budget is that some of the emergency measures for the first quarter of 1992 (e.g. postponement of expenditure) will have to be unwound in the second quarter. There is therefore an urgent need to plan during the first quarter new, more permanent revenue-raising or expenditure-reduction measures to ensure that the second quarter deficit does not bounce back again.