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26 MAI 1999

***LA COHERENCE DES POLITIQUES DANS L'ECONOMIE MONDIAL :
AVANTAGES ET ENJEUX DE L'INTERDEPENDANCE***

FEDERATION DE RUSSIE

Déclaration

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SPECIAL DIALOGUE AT MINISTERIAL LEVEL WITH INVITED COUNTRIES

26 MAY 1999

***POLICY COHERENCE IN THE GLOBAL ECONOMY:
OPPORTUNITIES AND CHALLENGES OF INTERDEPENDENCE***

RUSSIAN FEDERATION

Statement

RUSSIAN ECONOMIC REFORMS IN THE GLOBAL ECONOMIC ENVIRONMENT

Report at the meeting of the OECD countries ministers

Paris, 26-27 May, 1999

1. Economic policy at the early stage of reforms

Russia's economic reforms launched in 1992 were intrinsically aimed at consistent liberalization of all aspects of the economic activity and gradual integration of the country into world economic community.

Already in the first years of reforms a significant progress has been achieved: prices were widely liberalized, state monopoly on foreign trade was abolished, and exchange rate began to be determined on the foreign exchange market. In 1992 partial convertibility of ruble on current transaction was established. In July 1996 Russia adopted Article 8 of the IMF Articles of Agreement with respect to current account convertibility and since that time has met all obligations imposed by the Article.

As ruble gradually appreciated, export duties were abolished while import tariffs kept at moderate level (currently about 13 percent). Import and export liberalization and obligation to follow the principles of free trade opened for Russia the way to the World Trade Organization. Russia applied for the membership in WTO in December 1994. The Government has placed a high priority on joining WTO, in part because it would allow Russia using the organization's procedures to combat discrimination against Russian producers and exporters, which the Government believes continues to have a negative effect on Russian export. The Government's commission has been established to ensure that Russia's trade policy is in line with WTO rules, and discussions on Russia's accession to WTO membership are proceeding.

Not of less importance is the elimination of trade discrimination with respect to Russia as a country with non-market economy, and first of all it we have to deal with charges against Russian exporters with dumping. What is also important is balancing between obligations to open domestic market for imported goods and openness of foreign markets for Russian goods and services. At the same time, the conservation of some export and import regulating instruments to protect domestic producers and consumers while negotiating concessions with the counter partners looks reasonable.

Nearly right at the beginning of reforms the country was opened to foreign capital and a process of establishing foreign and joint stock companies began.

Development of financial markets began nearly from scratch and was very fast. Consultations and technical support provided by international financial organizations contributed to the creation of a basis for efficient markets, control systems and market infrastructure. Emergence of financial markets and apparent successful stabilization efforts opened Russian markets for foreign investors.

At the same time, market infrastructure carried a lot of deficiencies. Information disclosure and registration of shareholders' equities were inadequate, shareholders' rights not secured. Delivery against payment system was not introduced in due time.

As for the banking system its key drawbacks were poor prudential regulation and mixture of investment and retail activities in larger banks.

Having obtained international credit rating in October 1996 the Russia gained access to the world capital markets and, thus, larger range of financial instruments. Russian regions and corporate sector followed.

The convergence of domestic price ratios to the world ones became the most visible and important indicator of integration of Russian economy into the world economic community as a result of reforms and market liberalization. This process has completed mainly by 1995. Production volumes have adjusted to the new price structure. In a framework of the overall output contraction, production in the industries that were initially unprofitable at world prices has shrunk most of all. Total amount of subsidies declined considerably: from 11 percent of GDP in 1989 to 3% in 1998.

Concurrently foreign investment in Russian economy were increasing gradually. Total direct investment grew from \$0.5 billion in 1994 to \$4 billion in 1997.

Expansion of non-residents' involvement in Russian financial markets was even more considerable in volume and important in consequences. Already in 1996 foreign investment in government securities exceeded \$6 billion. In 1996-1998 the share of non-residents in GKO/OFZ market was about 30 percent. Role of foreign capital in stock market developments was of high significance as well. Participation of non-residents and their activities was one of the key factor that determined the state of Russian financial markets. This fact made domestic financial system highly vulnerable to changes in the international economic environment.

Economic reforms in Russia turned to be by far more painful than it was expected. Real GDP volume has contracted by 40% from 1990 to 1996, real disposable per capita income (according to the official statistics) – by 28%. The result though was the creation of market economy's fundamentals, and first steps of its operation. Economy was mainly stabilized by 1997: inflation decreased to 11%, real exchange rate kept constant, real interest rates on government securities went down to some 8%. The stabilization was achieved to a great extent due to the inflow of foreign investment: according to analytical estimates, about 2/3 of the observed decline of GKO interest rates from 1995 to 1997 can be attributed to the inflow of non-residents investment. Stabilization, as in many other countries, resulted in the beginning of production recovery: monthly seasonally adjusted production volume was growing in the 2nd and 3^d quarters of 1997 with a rate equivalent to over 4% annual growth.

2. Economic policy after the financial crisis

Expectations of the forthcoming high sustainable economic growth in Russia were interrupted by the deep financial crisis, which culminated in August 1998 as the Government stopped servicing its domestic securities and followed with restructuring.

The fundamental reasons of the Russian financial crisis include, primarily, insufficient efforts by the Government to implement financial consolidation and structural reforms. This resulted in a chronic budget deficit (its scale has not decreased from 1995 to 1997, remaining in a range 5% to 8% of GDP), increasing budgetary arrears, keeping ineffectively operating firms. A crucial role was played by the weakness of the banking sector, its predominant orientation on investments into the government

securities. Given that, the Russian economy appeared to be critically dependent on the world economic conditions. The stabilization and growth turned to be largely a result of the availability of foreign capital and high prices on the world commodity markets. Deterioration of these conditions revealed immediately the vulnerability of the financial system and made the crisis inevitable. The reverse side of Russia's integration into the world financial system thus showed itself: contributing, on one hand, to the economy stabilization, it created illusions that deep structural reforms can be substituted with relatively "easy" liberalization of capital markets.

It should be admitted that the Central Bank failed to take into account appropriately market exchange rate expectations. Its reluctance to modify the exchange rate targets despite deteriorated terms of trade happened to be one of the main reasons of the crisis.

The 1998 crisis placed the Russian economy into very difficult circumstances. The banking system was brought to the edge of bankruptcy, payment system was paralyzed. Sizable depreciation of the ruble brought about 40 percent jump in prices and sharp reduction of output. As both domestic and international market borrowing became unfeasible the problem of deficit financing has aggravated. Financing programs conducted by international financial organizations were suspended.

In these circumstances the Government and the Central bank had to seriously amend their policies. Some of the measures taken might be of general interest.

The Bank of Russia has switched to the floating exchange rate. On the first stage foreign exchange trading was divided into two sessions (one for exporters and importers and the other for commercial banks). Recently a decision to terminate this practice was taken and by June 30, 1999 two sessions will be combined.

Federal budget for 1999 can be characterized as the most realistic and reliable from the beginning of reforms. For the first time the budget envisages a primary surplus of 2 percent of GDP, while the total deficit is to be reduced to 2 percent of GDP. Four months of 1999 showed that budget parameters are achievable. In particular, in the first quarter of 1999 primary surplus made up 1.5 percent of GDP and in April – 2.5 percent.

The Bank of Russia also adheres to a responsible and confident program. Monetary policy conducted by the Central bank in 1999 is substantially different from the practice of previous years. Its primary goal is not just suppression of inflation, but rather arresting its pace to the degree that will allow for preserving households' real income, stimulating production and restricting recession process. With money supply growth targeted within 18-26 percent range any acceleration of inflation should be avoided, while necessary satiation of the economy with money achieved.

Results of the first months of 1999 have confirmed the effectiveness of such policies. Beginning 1999 inflationary dynamics was effectively arrested. Rates of inflation dropped from 8.5 percent in January to 3.0 percent in April and 2.5 percent in May. Taking into account downward trend, yearly inflation will not exceed 50%. Measures taken by the Central bank on foreign exchange market allowed to ease the market and restrain speculative component of the demand for dollars. From October 1998 to May 1999 nominal depreciation of the ruble went in line with inflation. Compared with the beginning of the year, foreign exchange reserves decreased by \$0.6 billion, mainly due to foreign debt payments of some \$3 billion.

One of the most important achievements of the Government was a substantial improvement of the payment system. Instead of accumulation a gradual reduction of federal budget arrears is going on. Wage arrears both in the budget and corporate sectors are declining rapidly. Over the fourth quarter of 1998 and first quarter of 1999 stock of pension arrears decreased by 40 percent.

Restoration of settlement system and payment function of commercial banks in couple with some growth of monetization facilitated production revival. Estimated GDP dynamics evidence that economic recovery has begun since October 1998. The last 6 months saw increase of seasonally adjusted GDP volume by 8%. Thus, actual course of events doesn't support the 'disastrous' forecasts, which (not only immediately after the crisis, but also quite recently) predicted very deep economic decline for the current year – up to 7% or even 10%. The Government expects that the GDP decline will not exceed in 1999 1-2%.

3. Role of cooperation with the international financial organizations

Cooperation with international financial organizations was a crucial factor for implementation of economic reforms in Russia. The Russian Federation officially joined the IMF in May 1992. Since then Russia has used a wide range of available financing facilities: Stand-By Arrangement, System Transformation Facility, Extended Fund Facility, Compensatory and Contingency Financing Facility, Supplemental Reserve Facility. The IMF recommendations were mostly related to the macroeconomic policy stance. Transformations on the micro-level were supported by the World Bank for Reconstruction and Development, which has been implementing structural adjustment programs in Russia in close cooperation with the IMF and the Ministry of Economy of the Russian Federation.

Many progressive economic reforms were carried out in Russia with the support of the International Monetary Fund. It would be enough to mention privatization of more than 90% of state-owned enterprises, creation and evolution of foreign exchange market, creation of the market for domestic debt instruments, shaping of instruments of monetary policy, reduction of monthly inflation to single-digit level. A number of important changes were introduced in the field of reforming government finance. The System of Federal Treasury has been created; now Federal Treasury keeps all the accounts of public sector enterprises and organizations, financed from the federal budget (except the Defense Ministry). In course of the IMF programs implementation the Ministry of Finance of the Russian Federation has switched to international budget classification. All these achievements are important for Russian economy, both in the medium- and in the long-term perspective.

Meanwhile it is worth mentioning some drawbacks of the IMF programs implemented in Russia. Quite often programs were based on optimistic projections, which made them vulnerable to deterioration of macroeconomic situation. When external conditions deteriorated, a combination of constant real exchange rate targeting and capital flows liberalization fuelled the emerging of financial crisis in Russia. Rapid accumulation of short-term GKO debt stock did not attract proper attention.

Analysis of the recent economic policy in Russia allows to suggest the following general conclusions.

- Of paramount importance for the transitional economies is synchronizing pace of the capital (especially short-term) flows liberalization with that of structural reforms, and development of the market infrastructure and legal system.
- Exchange rate policy should correspond to the extent of structural reforms, and its targets should not deviate persistently from the market expectations.
- Following the IMF recommendations on liberal economic policy it is crucial to keep in mind that their implementation is possible only on the basis of advanced legislation and broad political consensus in the country.

It is important to stress that Russian Government continues to adhere the policy of economy liberalization and integration to the world economic community. In particular, over the last few months bills creating more favorable conditions for foreign investment have been passed. At the same time, the Government realizes that further deep economic reforms are required to lessen dependence of Russian economy on the external shocks.