IMF Conditionality and Objections:
The Russian Case

Jorge Martinez-Vasquez
Felix Rioja
Sam Skogstad
Neven Valev*

Georgia State University

September 1999

Abstract

Emerging economies in crisis typically request assistance from the International Monetary Fund (IMF). After evaluating the situation, the IMF makes a loan available to the country conditional on certain policy reforms. Governments usually resist many of these measures and negotiation ensues. This paper analyzes the most contentious measures of IMF conditionality in the context of Russia after the August 1998 crisis. The most discussed measures include the budget deficit, structural reforms, and exchange rate policy. Our analysis suggests that to some extent the disagreement arose because the IMF is focused on changing steady states somewhat ignoring the transition path, while the Russian government is preoccupied with transitional dynamics without a clearly defined steady state concept.

* Corresponding author, Department of Economics, Georgia State University, Atlanta, GA 30303, Tel. (404) 651-0418, e-mail: nvalev@gsu.edu. The authors would like to thank conference participants at the Fifth World Congress of ISINI for helpful comments.
1. **Introduction**

Developments following financial crises in developing countries resemble a well-rehearsed screenplay. Often, the first actor on the scene is an International Monetary Fund (IMF) team who assesses the size and causes of the foreign exchange crisis and drafts stabilization plans. Invariably, there is a domestic government that has an unfinanced gap between foreign exchange payments and inflows expected in the near term. The government typically is reluctant to adopt the conditions attached to the IMF's financial assistance. The IMF team is confronted by indignant government officials who claim that the IMF plan is not specific to the features of the country, is unnecessarily painful, is unreasonable, etc. This recurrent sequence of events has become so familiar to observers that few pay close attention to the specifics of the argument. What does the IMF want to accomplish in that country by way of its proposed policy adjustments? Why does the government so often disagree? Are the government officials simply self-interested? Are there problems in the IMF's plan?

This paper analyzes the basis of IMF conditionality as well as the typical objections of emerging countries' governments. These are difficult issues to analyze in a general context. Hence, this paper concentrates on negotiations between the IMF and the Russian government following the ruble devaluation and implicit debt default of August 1998. While this paper focuses on Russia's case, many aspects of the Fund's conditionality and the home government's objections are common to negotiations with emerging economies world-wide.

Transition has been turbulent in Russia with periods of extreme volatility taking turns with periods of macroeconomic stability. The one persistent theme throughout the
last decade has been a budget deficit as the Russian government inherited a significant mismatch between revenue potential and expenditure needs. The prolonged economic stagnation has not allowed any improvements in this respect. Hence, most of what happened and is happening in Russia circles around the budget. In the early 1990s, the deficit was financed by money creation leading to high inflation. In the late 1990’s, inflation was contained as the government filled the budget gap by borrowing, but as a result private investment was crowded out.

By 1998, the budget and the banking system were deeply entangled. The government needed the banks to channel domestic and foreign savings to the state, and banks were profitable because of the high interest rates on government bonds. It took some external pressures, the Asian crisis, and the collapse in energy prices to reveal the vulnerability to the system. Russians and foreigners lost confidence in the ability of the government to service its obligations and staged a run on the ruble and the banks. Unable to attract fresh funds, the government announced a de facto default on its obligations in August 1998.

This paper proceeds as follows. In section 2, we briefly discuss the philosophy of IMF programs, and how this philosophy materializes into specific conditions. Sections 3 to 5 discuss the main issues of disagreement: tightening the budget, structural reforms, and exchange rate policy, respectively. Section 6 makes concluding remarks.
2. **Philosophy and Implementation of IMF Plans**

In the 1970s and 1980s, IMF conditionality concentrated on restoring stability in a country with balance of payments problems. Conversely, recent IMF plans place equal emphasis on reforms that will lay the foundations for future growth as on simply restoring stability in financial markets. In the words of IMF Managing Director Michel Camdessus: “Our primary objective is growth. In my view, there is no longer ambiguity about this. It is towards growth that our programs and their conditionality are aimed.”

The conditionality of old IMF programs focused on the budget deficit and on sound monetary policy. For example, during the Latin American debt crisis of the 1980s, the IMF provided some liquidity, but largely left negotiations to debtors and creditors. After the collapse of socialist countries of Eastern Europe, a "new conditionality" emerged. This new conditionality maintained the old measures but added new conditions targeted at "structural and institutional" reform. As Feldstein (1998) points out, there was little agreement in the economics profession as to how, or whether, to implement such structural and institutional reforms. This same "new conditionality" was applied to the Asian crisis of 1997-98 with great controversy.

In Russia, the IMF's new conditionality has taken the form of the following specific economic measures:

**A. To restore financial stability:**

First, the government's budget deficit (government revenues minus expenditures) should be reduced. A large excess of government expenditures over tax revenues implies either inflation if the deficit is monetized or high interest rates and crowding-out of...
private investment if the government borrows. Russia suffered high inflation in the early 1990s as the budget deficit was covered by printing rubles. After 1995, inflation was brought down by strict control of monetary aggregates. The Russian government turned to borrowing to cover its deficit. Private investment was crowded out as domestic savings and foreign capital were channeled to the government to finance current expenditure. Investment was further reduced by persistent capital flight fuelled by substantial current account surpluses.

Second, the exchange rate should be stabilized either through a fixed exchange rate or a floating exchange rate within a band set by the government. A stable exchange rate would encourage foreign investment and international trade as foreign businesses can more easily evaluate potential profits. Third, the expansion of monetary aggregates (usually net domestic credit) should be restrained. This measure tries to keep inflation from increasing. Fourth, the stability of the banking system should be strengthened using prudential banking standards, supervision, and privatization of banks.

B. To promote growth

As financial stability is restored via the above measures, real interest rates would decline making long-term investment decisions possible. In addition, the IMF has supported the following structural reforms, which are supposed to lay the foundation for persistent growth. First, state-owned firms would be privatized or liquidated. This would reduce well-known inefficiencies in government managed enterprises, as their new private owners would operate in a profit-maximizing efficient scenario. Second, banks would be privatized to improve the allocation of savings to the best private investments.
Hence, government inefficiencies by channeling funds to its preferred customers would be reduced. Third, prices would be liberalized by lifting price controls and subsidies. Fourth, trade barriers would be reduced encouraging freer trade. Fifth, capital controls would be removed encouraging private investors to buy assets in the country.

The Russian government disagreed with and resisted several of these measures. This led to an eleven-month delay in IMF loan disbursement after the crisis. The main issues of disagreement, which are also common to other countries dealing with the Fund, are examined in the next three sections.

3. The Budget

Most countries that call on the IMF for a loan have a government budget deficit. The reduction of such deficit is very often one of the conditions to receive Fund loans. A rule of thumb often used by the Fund is that the deficit must not exceed 4% of GDP. In Russia's case, deficit reduction has been the single most important issue of contention between its government and the IMF. Since the fall of the USSR, Russia has had a persistent federal budget deficit of about 7% of yearly GDP. Russia's inability to raise adequate revenues, combined with its high social expenditures and subsidies, have contributed to its persistent deficit. This section analyzes the nature of Russia's deficit as well as the points of contention with the IMF's recommendations.

3.1 Expenditures
Federal government expenditures in Russia comprised about 15% of GDP in 1998. Table 1 describes the largest expenditure items in the federal budget. The servicing of internal debt is the largest expenditure category, 2.45% of GDP. After the taming of inflation in 1994, the government financed its deficit by selling bonds: the domestic bond market (GKO's) was created. The interest rates offered on such bonds were very high (on average 26% in real terms). After a couple of years of selling such high-interest bonds, interest payments accumulated becoming the largest single item of expenditure.

<table>
<thead>
<tr>
<th>Expenditure item</th>
<th>Percent of total expenditure</th>
<th>Percent of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal debt servicing</td>
<td>15.91</td>
<td>2.45</td>
</tr>
<tr>
<td>Defense</td>
<td>13.64</td>
<td>2.10</td>
</tr>
<tr>
<td>Social policy, education, health, culture, and media</td>
<td>13.64</td>
<td>2.10</td>
</tr>
<tr>
<td>Financial aid to other levels of government</td>
<td>10.91</td>
<td>1.68</td>
</tr>
<tr>
<td>External debt servicing</td>
<td>10.06</td>
<td>1.55</td>
</tr>
<tr>
<td>Industry, energy, and construction</td>
<td>2.59</td>
<td>0.40</td>
</tr>
<tr>
<td>Agriculture and fisheries</td>
<td>0.65</td>
<td>0.10</td>
</tr>
<tr>
<td>Other</td>
<td>35.77</td>
<td>5.51</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
<td><strong>15.14</strong></td>
</tr>
</tbody>
</table>

Source: Russian Economic Trends, April 1999

In addition, external debt payments (i.e., owed to foreign creditors) were about 1.55% of GDP in 1998. Hence, the Russian government has to give up about 4% of GDP to service debt. Following the crisis, Russia's administration requested IMF funds primarily for debt relief. In July 1999, the Fund agreed to lend $4.5 billion to be disbursed over the next seventeen months. However, this loan would simply go towards the $4.8 billion that Russia owes to the IMF over the same period, and the money would
physically never leave Washington, DC (IMF Press Release no. 99/35). More importantly for Russia, not defaulting with the IMF would open up other lines of credit, for example, $3 billion promised by Japan and the World Bank (*The Economist*, May 1, 1999).

Russia has been working (poorly) with creditors to re-schedule several debt payments. The Fund urged cuts on the remainder expenditures, which amount to 11% of GDP. The largest component of these is social policy, education, health, culture, and media. According to a 1996 World Bank country study, employment in education and health has stayed constant or even increased after the reform. However, expenditures on materials, repairs, medication, and textbooks have been decreased sharply reducing the quality of these services. It would have been hard for the IMF to argue for larger cuts in health and education materials. Nevertheless, the IMF recommended reducing expenditures by 2% of GDP. Russia's Letter of Intent (July 13, 1999) indicates that they intend to follow this recommendation. Expenditure cuts would primarily come from two sources. First, the number of employees in the public sector and those in education, transportation, and health care would be downsized. Second, some public programs would be reduced. This Letter of Intent also makes clear that "these cuts will not be sustainable over the medium term..." Some of the poorest segments of the population, namely pensioners, would be badly affected by the spending cuts. Likewise, large numbers of fired public employees could lead to social unrest. While the spending cuts were necessary, it's arguable that the specific items that Russia proposes to reduce will truly reduce the inefficiency of the public sector.

### 3.2 Revenues
What are the sources of revenue for the Russian government? It is well known that tax collection has proven very difficult. Tax evasion and avoidance are common, especially by enterprises and large businesses (more on this later). Table 2 describes the contribution of different types of taxes to the Federal Budget. Reflecting the difficulties of tax collection, the value-added tax (VAT) is the largest source of revenue raising 4.24% of GDP in 1998 (41% of total revenue). However, a law decreasing the VAT rate from 20% to 15% has been approved by the Russian Federal Assembly (the legislative branch composed of the State Duma and the Federation Council) but vetoed by the President. The Fund has strongly opposed this rate decrease as it will most likely lead to a decline in tax revenue in the immediate future. As part of the eventual agreement with the IMF, Russia promised to "forego any reduction in the VAT rate until tax compliance has shown durable improvement…" (Letter of Intent, item 15).

<table>
<thead>
<tr>
<th>Revenue source</th>
<th>Percent of total revenue</th>
<th>Percent of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>VAT</td>
<td>41.16</td>
<td>4.24</td>
</tr>
<tr>
<td>Excise taxes</td>
<td>18.64</td>
<td>1.92</td>
</tr>
<tr>
<td>Profits tax</td>
<td>8.64</td>
<td>0.89</td>
</tr>
<tr>
<td>Taxes on foreign trade and foreign economic operations</td>
<td>11.06</td>
<td>1.14</td>
</tr>
<tr>
<td>Total Tax Revenue</td>
<td>82.33</td>
<td>8.48</td>
</tr>
<tr>
<td><strong>Total Revenue</strong></td>
<td><strong>100</strong></td>
<td><strong>10.30</strong></td>
</tr>
</tbody>
</table>

Source: Russian Economic Trends, April 1999

The non-payment of tax obligation by businesses and enterprises has largely contributed to low tax revenues. In many cases, managers had been negotiating the size
of their payments with the government to reduce their tax liability. These negotiations would result in not only reducing a business' liability, but also in the government agreeing to be paid in form of IOU's, offsets, or in-kind. Such negotiations were strongly opposed by the IMF. At least on paper, Russia's government eventually agreed to eliminate all such negotiations and non-cash payments (Letter of Intent, item 14).

Why have businesses been unwilling or unable to pay their tax obligations? According to Russia's former Prime Minister Yegor Gaidar (1999), the answer lies in the way enterprises operated in Soviet days. Managers in the USSR were not financially accountable for profits or losses (they had a "soft budget constraint"). If losses were made, the state would step in and provide the difference with subsidies or loans. As enterprises moved towards privatization, managers kept using such soft budget constraints. Hence, when unable or unwilling to fulfill their tax obligations, managers sit down to negotiate with government officials. This has led to rampant corruption in the "negotiating" system.

After interviewing several managers on condition of anonymity, Buckberg (1997) describes the manager's point of view on tax compliance. Their main complaints are that the system is overly complex, unfair, and that the various taxes, if paid, would effectively drive profits to zero. In addition, the tax system is perceived to be unfair because inspectors apply the code differentially depending on the business. The tax code allows many tax preferences that are applied based on the tax official's criteria. Larger and better connected businesses receive preferential treatment. Managers have reacted to the system with sophisticated evasion techniques. As Buckberg (1997) describes, this has taken the form of reporting "all profits as accruing to offshore subsidiaries, underinvoicing of
exports and over invoicing of imports..." These actions effectively hide profits so that they cannot be taxed.

According to government statistics, the total tax revenue is only about 10% of GDP (see Table 2). Conversely, Illiarionov (1998) estimates the total tax revenue as a share of "legal GDP" is already about 50%! He defines "legal GDP" as officially reported GDP minus the underground economy's GDP. For example, taxes from the "virtual" economy (part of the underground activity where transactions are settled by IOU's or barter), are very hard to collect. Given that this underground sector evades taxation, Illiaronov (1998) estimates that about one-half of the formal sector's GDP is already taxed away. Higher tax rates, given this situation, would strangle the formal sector. Hence, many have been pushed into the informal sector. Conversely, lowering taxes would probably raise revenues in the long-run but not in the short-run.

Despite all these difficulties, the IMF's insistence on a 2% budget surplus for 1999 were eventually accepted by Russia. Some of the promised measures to raise revenue include using a temporary export tax on oil, metals, and petro-chemicals, the reduction of tax preferences in the tax code, and the improvement of compliance. Large oil and gas companies will henceforth be required to pay all of their taxes in cash. Failure to do so would result in denial of access of export pipelines to delinquent companies. While the IMF's demands have been satisfied on paper, achieving these goals will be particularly painful to powerful interest groups that are not without influence in government.
4. Structural Reforms

4.1 The Barriers to Investment

Private investment is a key element in the IMF’s program for growth. According to standard growth theory, higher capital accumulation today pays-off in the future by increased production capacity. In Russia, overall investment by public and private enterprises combined has steadily declined throughout the reform years due to a number of factors. The largest barriers to investment in Russia appear to be the following:

1. Inadequate amounts of lending
2. The "virtual economy": a vicious circle of barter and non-payments among enterprises that creates inefficiency
3. Weak bankruptcy procedures
4. Unstable socio-political-economic conditions that make investors lack confidence in the safety of investing in Russia

Barriers 1, 3, and 4 are commonly found in developing countries, while barrier 2 is very specific to Russia and has its origins in the Soviet years. A detailed discussion of these barriers follows.

The first obstacle to investment has been banks not being able or willing to loan to the business sector. Given the high rates of return offered by the government on its bonds, Russian banks, with limited experience on lending to businesses, found it advantageous to purchase large amounts of such bonds. Net government debt went from 19% of total domestic credit in 1993 to 57% in 1997. As a result, investment was crowded-out: only a reduced amount of loanable funds were available to the business sector at high interest rates (structural reform in banking is discussed later in Section 4.3).
The second barrier to investment is known as the "virtual economy": the system of non-payments and barter that has become the way that many Russian enterprises deal with each other. Non-payments and barter have crippled the ability to collect taxes and hence have contributed to the present crisis. Enterprises simply do not receive enough cash to pay their tax obligations because they get paid themselves in kind or with promissory notes. The Interdepartmental Balance Commission (IDBC) studied 210 enterprises, including gas and oil companies, nuclear power plants, utilities, coal mining, railway, and car manufacturers. It found that only 27% of these enterprises' proceeds were in cash. The enterprises paid 85% of their total tax liability--out of this only 8% was paid in cash. Both the government and the enterprises' creditors were paid the difference in the form of promissory notes (which promise payment in 3 to 10 years), by bartering, or by mutual offsets.

Another detrimental effect of barter is potential inefficiency in investment. That is, cashless enterprises must search for a double coincidence of wants match to purchase equipment they need. While it is true that some facilitators (individuals or groups of individuals whose job is to match the double coincidence of wants) have been operating, and that some quasi-moneys have been used (e.g., veksels), these have not entirely eliminated those inefficiencies in investment that solely arise from not using cash.

Third, weak bankruptcy procedures, along with the cashless economy, have allowed a number of inefficient firms to survive despite subtracting value from the economy in their production process. Gaddy and Ickes (1998) have studied the issue showing how enterprises produce output while subtracting value from the inputs they use. For example, an enterprise "pays" 100 rubles for its inputs. The inputs are then combined
in producing a good that is only worth 60 rubles. Such enterprise in a market economy would go bankrupt. However, some Russian enterprises that operate in this fashion stay in business thanks to the non-payment system and weak bankruptcy procedures.  

Finally, the fourth barrier to investment has been the weak socio-political conditions. This is a characteristic shared by many developing economies. Frequent changes in cabinet or government, which results in erratic policy changes, can scare investors. Russia's President Yeltsin has had various cabinet changes in his tenure (five different prime ministers were named to the post between January 1998 and August 1999). In addition, the strength of the communist party in the State Duma discourages investors due to a potential reversal to central planning.

Low real interest rates are thought to be the stimulus for investment. To attain low interest rates, the IMF usually advises moving towards a balanced budget and restoring confidence in the domestic currency. Then as the inflation rate also declines, investment and growth start to increase. This was essentially the idea behind Russia's 1994 consultation with the IMF. The high inflation of the early 1990s was reduced following strict monetary policy, and the exchange rate was also kept stable after 1994. However, two very important provisions in the Fund's plan for Russia were not satisfied. 1) The budget was not balanced, which led to large scale government borrowing. 2) Monetary

---

2 Given that many enterprises choose to barter instead of using cash, there must be a clear advantage to bartering from their point of view. The incentives for barter are not readily apparent. Gaddy and Ickes (1998) describe enterprises as carrying on with two types of activities: formal and informal. Formal activities involve cash transactions and are, hence, easily taxable. Informal activities, on the other hand, involve transactions settled in kind and with promissory notes. Informal activities are then much less tractable for taxation purposes. Formal activities generate cash flows and tax obligations. When tax obligations are not met, the government can freeze and seize an enterprise's bank accounts. Hence, minimizing formal activities may then be rational from the enterprise's point of view. In addition, tight monetary policy after 1994, which caused a liquidity crunch, effectively contributed to the growth in the "virtual economy." Banks had little liquidity to loan to enterprises, which had to resort to barter and non-payments in a larger scale.
expansion was not linked closely to changes in net international reserves. Thus in fairness, the Fund's plan was not fully implemented. In any event, even if interest rates decreased, it is not clear this would overcome the barriers to investment specified above. Key structural reforms such as banking reform, land reform, and privatization are needed to encourage investment. These three are discussed in detail below.

4.2 Banking reform.

If there is something the IMF insists on in all countries, it is strengthening the financial system. While the primary emphasis of IMF programs is exchange rate and inflation stabilization, long-run growth cannot be achieved without a well functioning financial system that channels savings efficiently to their most productive use. Hence, the IMF stresses sound regulation and supervision of financial markets and privatization with the participation of foreign institutions.

The liberalization of banking in Russia began as early as 1987 when joint ventures and semi-private cooperative banks were allowed to operate. As of December 1997, Russia had a large number of credit organizations, 1,789, most of which were small banks. Between 1994 and 1997, the five largest banks held only about 40% of total assets (this is the lowest of all transition countries) while the remaining 60% were in small banks. In addition, Russia ranks high relative to other transition countries, for example Poland, Croatia, and Slovenia, in terms of the proportion of assets in the banking system that are held in majority private-owned banks (around 70%).

Despite this apparent liberal banking environment, financial intermediation has not developed sufficient depth. This is clear by looking at the ratio (in percent) of broad money, which includes currency in circulation and bank deposits, to GDP, which
declined from 24% in 1993 to 17% in 1997. In 1997, of all transition economies, Russia’s financial depth measured by that ratio is higher only than Kazakhstan’s. In addition, Russia has relatively small participation by foreign institutions in banking, which only held 5% of total assets in the 1994-1997 period. The last piece of evidence showing Russian financial underdevelopment is that most household savings go to one of the large state-owned banks, Sberbank.³

The crisis of August 1998 revealed the weaknesses of the banking system. Most banks derived revenue from holding high-interest government bonds. Some banks had entered into risky contracts of foreign exchange hedging with foreign institutions. Basically, rather than collecting savings and making loans, Russian banks behaved more like casino gamblers making large, risky bets. Once the market for government securities collapsed (i.e., government default), banking problems came to light. Ex-post, lack of prudential supervision was blamed for their problems. In other words, the authorities should not have allowed banks to undertake such large exposure.

However, the government had no incentive to introduce strict supervision when it needed to borrow at will in order to finance a budget deficit. Sound supervision also cannot exist in an environment where the policy of soft budget constraints continues albeit through bank loans and not through direct budget subsidies. Banks were rewarded with high interest payments and implicit guarantees. For those reasons, the investment behavior of privately owned banks was no more prudent than the actions of publicly owned banks. Solving the problems in the banking system through improved supervision requires that the conflict of interest problem on the part of the government be solved first.

The IMF’s press release announcing the stand-by loan in August 1999 states that “many directors [in the IMF] were disappointed by the slow progress made in bank restructuring.” More resolute steps are called for to deal with insolvent banks in spite of the “fierce opposition from vested interests.” Russia was also urged to “create a level playing field for domestic and foreign banks.” The letter of intent by the Russian government has similar spirit and discusses at length the measures that will be undertaken to resolve the current problems such as “empower and regulate the activities of the Agency for Reconstructing of Credit Organizations.” Measures will be taken to improve transparency, increase the requirements for entry into banking and to strengthen supervision.

4.3 Land reform

Land reform has been one of the most controversial issues of the transition process in Russia. There is still little consensus about the future of Russian agriculture. Frequent changes of the rules regarding land ownership have lead to fast deterioration of the agricultural sector. Between 1994 and 1997, agricultural output declined by 12.3 percent in real terms (GDP declined by 6.7 percent) making a country with 0.88 hectares of arable land per capita (highest in the world) dependent on imports for close to half of its food consumption.\(^4\)

The difficulties with land privatization in the 1990’s derive from the process of land nationalization in the beginning of the century. In pre-Soviet Russia, land was the primary source of livelihood as well as means of wealth accumulation. Hence, abolishing private ownership in favor of cooperatives had strong opposition. Even subsistence
farmers were not certain that they would fare better in a cooperative. It took years of
sometimes-forceful persuasion to create the kolhoz (cooperative). The success of the
cooperatives was imperative as a proof of the superiority of the Soviet system. It turned
out that many benefited as this system of redistribution of income eradicated extreme
poverty in some regions. Hence, from an ideological and, for some, from a practical point
of view, collective farming is the preferable form of agriculture. This, along with the fear
that urban residents will acquire large holdings of farming land (possibly for alternative
uses), has generated strong political opposition to the development of free market for
land.

It is difficult to pin down an official IMF position regarding land reform. A 1996
press release by the IMF regarding the extension of a three-year credit facility to Russia
states that “much remains to be done in the area of land reform” but does not specify the
parameters along which this should be accomplished. Reformers in the Russian political
scene have supported privatization and removing restriction on transfer of ownership.
Clearly, such a task is difficult to accomplish given the realities in Russia. The legislation
on land ownership has been a sequence of proposed laws by the Duma and decrees and
vetoes by President Yeltsin. Presently, Russian citizens can own land but a number of
restrictions prohibit the free transfer of ownership. On the other hand, foreigners cannot
own land.

The uncertainty regarding rules and the limitations on free transfer of ownership
have lead to a number of problems. The first, and perhaps most serious problem, is that
land is seldom used as collateral. Interest rates on agricultural loans, if they could be
obtained at all, have been prohibitive. The problem was further exasperated following the

mid 1990s IMF program that required cuts in government subsidies for agriculture in order to control the budget and reduce inflation. Large-scale government borrowing after 1995 further crowded out the loanable funds market. According to a 1994 World Bank survey, insufficient capital and not land ownership restrictions was the main reason why Russians stayed away from the agricultural sector. As a result, the number of private farms as well as their average size has remained small and without a change since 1993. Private farms contributed only 5 percent of the agricultural output in Russia in 1997.\(^5\)

Second, restrictions of land ownership by foreigners may have discouraged some international firms from building facilities in Russia. During the 1993-97 period, among all economies in transition, Russia surpassed only Uzbekistan and Belarus in Foreign Direct Investment (FDI) as average annual inflow of foreign direct investment was only 0.38 percent of GDP.\(^6\) FDI is of significant importance in a country that badly needs investment and technological innovation, and desires integration in world markets. Clearly there are a number of reasons for the low FDI including political uncertainty and complexity of the regulatory environment. However, the negative effect of such deterrents is only strengthened by lack of clarity regarding land property rights.

Finally, Russia’s dependence on imported food products made the devaluation of August 1998 much more painful. Under such conditions, the trade balance cannot respond fast to a devaluation because imports cannot decline and relieve the pressure on the foreign exchange market.

### 4.4 Enterprise Privatization

\(^6\) The World Bank, World Development Indicators (1998).
The 1998 Transition Report of the EBRD reports that 70% of Russian GDP was produced in the private sector in 1997. In comparison, this percentage in some of the most successful transition economies, the Czech Republic and Poland, are 75% and 65%, respectively. In addition, this same report gives Russia grade of 3- (out of 4) on large-scale privatization and 3+ (out of 4) on small-scale privatization. It would then appear that the privatization process has been successful in Russia. As Boettke (1999) suggests, while the Russian government has de jure followed the privatization recipe of the IMF, this is largely an illusion. According to Boettke (1999), the government still has ownership of at least 20% of one-quarter of privatized companies and at least 10% of one-third of them. In addition, Goldman (1996) reports that 90% of privatized enterprises have the same management staff as when controlled by the state. The government and Soviet-style managers have effectively kept control of many privatized enterprises. Not surprisingly, "privatization" and liberal markets have not generated investment and economic growth in Russia.

However, even privatized businesses with the best intentions of restructuring and profit maximization have run into obstacles. Buckberg (1997) discusses a number of obstacles to doing business in Russia such as complexity and uncertainty in the tax system, corruption, excessive red tape, and weak legal structure regarding contract law and property rights. The adverse implications for private businesses of most of these obstacles were already discussed in previous sections.

Although the recent agreement between the IMF and Russia does not explicitly address more enterprise privatization, it does address their bankruptcy and accounting standards. Russia's Letter of Intent (1999) states that the Law of Insolvency
(Bankruptcy) will be amended to "eliminate the bias in the law towards reorganization rather than liquidation of enterprises, eliminate court discretion in overruling the creditors' decisions to liquidate the debtor enterprise…" This tries to address the IMF's concern that investors (domestic and foreign) were not adequately protected. Their investments were most often unrecoverable once an enterprise got into financial trouble. The troubled enterprise would be re-organized or merged so that investors and creditors had no claim over its assets. Even if creditors agreed to liquidate the remaining assets a court could overthrow this decision. While Russia has promised to change this law, it remains to be seen if such change is approved and enforced.

5. **Exchange Rate Policy**

The Russian ruble was fairly stable from 1995 up to the crisis in August 1998. As in Asia, the pre-crisis stability in the currency attracted foreign capital into Russia--much of it short-term. Once the devaluation hit and Russia defaulted on debt, investors tried to flee leading to large outflows of capital. In addition, some Russian businessmen took their dollars out of the country contributing to ongoing capital flight. Over the six-month period after the crisis, capital outflows averaged $1.5 Billion per month. The ruble lost about 400% of its value over the same period.

In response to large outflows, the government imposed exchange and capital controls. For example, temporary restrictions to foreign exchange trading were imposed on small and medium size banks. The business deals of importers who buy hard currency to pay for imports were carefully scrutinized. Required reserves on corporate ruble
deposits were raised from 5% to 7% in order to make banks keep more rubles and, hence, less hard currency (Russian Economic Trends, April 1999).

These controls are targeted to prevent extreme fluctuations of the exchange rate. However, the IMF opposes capital controls and would rather stabilize the exchange rate by keeping strict control of monetary aggregates. At the beginning of negotiations, the IMF proposal was to peg the ruble to another, more stable currency. Some analysts even considered a currency board for Russia (i.e., an extreme version of a fixed exchange rate). A fixed exchange rate would serve as a nominal anchor and help reduce inflation but its maintenance imposes constraints on monetary policy. To be credible, a peg requires tight fiscal and monetary control. Currency boards as substitutes for central banks are even more extreme in that money supply is directly linked to the foreign exchange reserves of the central bank. In its Orthodox form, a currency board has no responsibilities to provide liquidity to the banking system, to finance the budget deficit or to fight unemployment.

The Russian government has been unwilling to accept such constraints. The reasons are numerous. First, reducing the fiscal deficit significantly appears not only politically unpopular but also outright impossible in the immediate future. Second, most Russians believe that tight money (hence low inflation) has not worked in the last four years. Clearly, years of low inflation did not produce new investment and growth. Third, the Russian government wants to keep the option of monetary accommodation in case of need. In fact, an earlier proposal by the Russian Academy of Sciences called for money

\[ \text{For example, if the monetary base, which includes currency and bank reserves, is 100 billion rubles and the foreign exchange reserves are 20 billion USD, the implied exchange rate is 1 USD=5 rubles. See Schwartz (1993) for a discussion on the history and operation of currency boards.} \]
creation whenever the government cannot fulfill its obligations such as paying soldiers, teachers, etc. (Kommersant Daily, November 15, 1998). Since then, the talk of printing money has been subdued but nevertheless, the government has been cautious not to fall in a position where it needs a monetary boost and cannot afford one. Fourth, currency board regimes can put much strain on the banking system since domestic money is tied to international reserves and disturbances in the foreign exchange market directly cause fluctuations in interest rates. The Russian banking system is not in a condition to sustain such pressure. Finally, pegging the exchange rate to another country’s money may be regarded as losing monetary independence particularly with respect to the reserve country. It is difficult for Russians to accept that Russia will lose any form of independence to the West.

Given these circumstances, the outcome of negotiations was that Russia would conduct monetary policy in a flexible exchange rate regime. The Russian central bank will closely monitor developments with inflation and the exchange rate and will try to fine-tune the monetary base so as to respond in time to shifts in money demand. The capital and exchange controls that were introduced in the wake of the crisis will be gradually removed and channels for illegal outflows of capital will be closed. The Central Bank of Russia will intervene occasionally in the foreign exchange market to smooth out extreme fluctuations. In other words, a compromise was reached where Russia will maintain a degree of monetary independence but will liberalize its capital and exchange regime.

6. Final remarks.
The IMF and the Russian people share a common goal: Russia's economic success. As described by Treasury Under Secretary David Lipton this goal involves a country with “fair tax laws and enforcement, private ownership and free land markets, independent courts that enforce laws and contracts, strong banks that safeguard peoples’ savings…legitimate investor rights…social spending to those in need, etc.”

Nevertheless, there are disagreements on the appropriate policies to achieve this goal.

The fundamental question is what are the primary obstacles to successful transformation at this point: the entrenchment of vested interests or a condition of the economy and society that is beyond any hope of fast repair even if such interests are overcome. The former problem can potentially be remedied by drastic measures executed by a strong government committed to building “a robust set of political, legal, and economic institutions”. If the latter problems are prevailing, drastic measures are not justified as the benefit is small while the potential destabilizing effects severe. For example, should Russia hurry to liquidate all inefficient state-owned enterprises? Our readings suggest that the problems are of such magnitude and complexity that rapid recovery is not very likely and thus promises of significant changes are not credible. Yet, rules need to change if any progress is to be made. In this sense, the success seems to rest on acts of credible discretion, as the volatility of the economic situation does not allow for the straightjacket of blind rules.

The disagreement arises because the IMF appears to insist that the obstacles to achieving Russia's economic success are simply inertia in the system and lack of political will. This implies no need for a transition period for reforms like instituting property

---

rights, bankruptcy procedures, or reforming the tax system. Conversely, the Russian government appears focused on simply not making a bad situation worse. In more technical terms, the IMF is focused on changing steady states somewhat ignoring the transition path, while the Russian government is preoccupied with transitional dynamics without a clearly defined steady state concept.

A natural question is whether this result was the inevitable outcome of transition in Russia. Boettke (1999) argues that the inconsistency and, thus, lack of credibility of the reform process allowed the development of powerful counter-reform vested interests. The reform efforts were half-hearted and did not deliver a strong message capable of convincing economic actors that the rules had changed. Public funds could be drained at the expense of taxpayers. In this sense, a “shock therapy” could have set the economy on a different path, one without soft budget constraints. That was the idea behind the IMF plan for Russia back in 1995. The monetarist part of that plan was executed but the lack of fiscal consolidation undermined the effort. Hence, we will not know if shock therapy could have been successful because it was never tried.
References


International Monetary Fund. *International Financial Statistics*, various years.


Russian European Centre for Economic Policy, *Russian Economic Trends*, various years (www.hhs.se/site/ret/ret.htm).


