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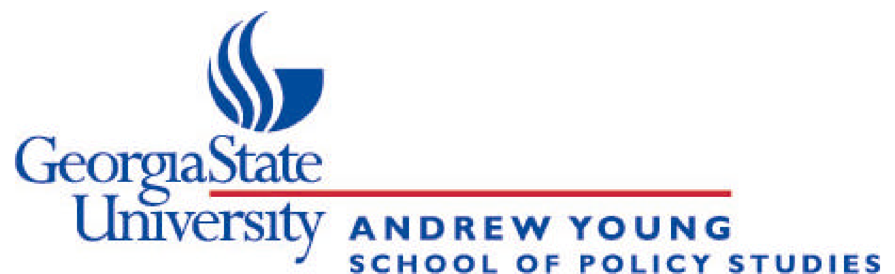

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Abstract

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.

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I

Introduction

Events 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 un-financed 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 much improvement 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 (i.e., the Asian crisis and the collapse in world 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 II, we briefly discuss the philosophy of IMF programs, and how this philosophy materializes into specific conditions. Sections III through V discuss the main issues of disagreement: tightening the budget, structural reforms in banking and bankruptcy, and monetary and exchange rate policy, respectively. Section VI makes concluding remarks.

II

Philosophy and Implementation of IMF Plans

In the 1970s and 1980s, IMF conditionality concentrated on restoring stability in countries with balance of payments problems. Conversely, recent IMF plans place greater emphasis on reforms that will lay the foundations for future growth. 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."[1]

Therefore private investment is a key element in the IMF's programs. According to standard growth theory, higher capital accumulation today pays-off in the future by increased production capacity. To promote investment, the IMF insists on:

A. A stable macroeconomic environment. Low inflation and predictable exchange rates lead to low interest rates and make long-term investment decisions possible. Because large budget deficits lead to either inflation or high interest rates and crowding out of private investment, the IMF insists on reducing the deficit. Fixing the exchange rate along with tightening the budget provides for stable exchange rates.

B. Improving the allocation of savings. Domestic savings and foreign savings (capital inflows) should be effectively channeled to investments with the highest return. In most developing countries, the efficiency of allocation of capital depends on the level of development of the banking system, as broader financial markets do not exist. Therefore, the IMF insists on strengthening banking supervision and on bank

privatization often with the participation of foreign financial institutions. A key element in the development of the credit system is improvement in bankruptcy procedures.

C. Liberalization of markets. Price liberalization, removing trade restrictions, lifting capital and exchange controls are all aimed at promoting a competitive market environment. Liquidation or privatization of state enterprises accompanies these measures. Those lead to increased efficiency and less burden on the budget.

Some of these policies aimed at promoting investment also have a stabilizing effect on the whole economy. Tightening of the budget deficit and fixing the exchange rate, for example, are important for achieving macroeconomic stability and, according to the IMF plan, they also promote growth. Domestic governments, conversely, often believe that some of these measures have detrimental effects. For example, they allege that reducing the deficit by raising taxes on business can slowdown the economy even further. Domestic governments also often argue that reducing social spending and liberalization of some important prices may lead to social unrest. Therefore, disagreement may arise not only from differences in the goals of the IMF and the government but, even if both parties focus on growth, about the right package of policies to achieve that.

In Russia, overall investment by public and private enterprises combined has steadily declined throughout the reform years. The IMF's “new conditionality” in Russia has taken the form of various proposals related to the following three objectives: First,

reducing the budget deficit. Second, improving bankruptcy procedures and reform in the banking system. Third, stabilizing the exchange rate.

After almost a year of negotiations, most of the IMF's proposals were agreed to by the Russian government as stated in their Letter of Intent of July 13, 1999. In the months after the Letter of Intent some of the policies that were agreed upon were implemented, others were not. In the next three sections, we analyze the origin of the problems and the proposal to achieve the three objectives listed above.

III

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. Since the fall of the USSR, Russia has had a persistent federal budget deficit of about 7% of yearly GDP. In 1998, Russia's deficit was about 5% of GDP. Their largest expenditure was for debt servicing (both internal and external) which amounted to 4% of GDP. After the crisis, the IMF insisted on Russia achieving a 2% of GDP *primary* surplus on the budget. That is, a 2% surplus not counting debt servicing expenditures.

Why has Russia had such a difficult time with its budget? Basically, their 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.

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, a government bond market was created were GKOs (essentially treasury bills) were issued by the government. The interest rates offered on such bonds were very high (on average 40% 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 1
Federal Budget Expenditures in 1998

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

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 New York (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).

While encouraging Russia to work together with its creditors to reschedule debt, 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 is arguable that the specific items that Russia proposes to reduce will truly reduce the inefficiency of the public sector.

Another measure suggested by the Fund was establishing a system of pre-approval for all federal contracts. Once the upper bound on budget expenditures is reached, all contracts would be denied. Hence this system would put a cap on excessive spending.

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 2
Federal Budget Revenues in 1998

Revenue source	Percent of total revenue	Percent of GDP
VAT	41.16	4.24
Excise taxes	18.64	1.92
Profits tax	8.64	0.89
Taxes on foreign trade and foreign economic operations	11.06	1.14
Total Tax Revenue	82.33	8.48
Total Revenue	**100**	**10.30**

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 overinvoicing of imports…" These actions effectively hide profits so that they cannot be taxed.

At the same time, many Russian enterprises have become part of the "virtual economy": the system of non-payments and barter amongst 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. According to Karpov (1997), 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. The IMF insisted that the Russian government reduce non-cash payments, to which they agreed. Russia Letter of Intent states that by the end of 1999 cash collection for electric power, district heating, and natural gas would be raised to 40% and that of freight services would be raised to 60%. Although these levels of increased collection were promised, the Russian government was concerned that many people would have trouble paying their heating bills during the winter season.

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.

3. Progress After the Agreement

In the six months following the July 1999 agreement between Russia and the IMF, Russia has complied on several of its promises but not all. The promised primary surplus of 2% was reached thanks mainly to higher world prices from oil and gas which raised the energy sectors' revenues, and hence their tax payments. In addition, higher tax

payments were received from the industrial sector whose output increased about 8% in 1999 (Russian Economic Trends, February 2000).

Despite meeting these IMF budget targets, the IMF found that progress in "structural reforms" was not satisfactory and stopped the planned loan disbursement. Though most of the items listed as unsatisfactory are discussed in later sections, two of them concern the budget. First, the Fund claims that Russia failed to implement the pre-approval system for government contracts. Second, Russia has not restructured unpaid arrears from previous years. These two items are part of the list of reasons for freezing disbursement of funds as of March 2000 (IMF Survey December 13, 1999). However, some Russian sources believe the disbursement freeze was due to the war in Chechnya which was opposed by the West.

IV

Banking Reform and Bankruptcy

1. Bank Restructuring

As we discussed in Section II, improving the efficiency of allocation of savings to their best use is an integral part of the IMF program. Hence, the IMF stresses sound regulation and supervision of banks, bank consolidation, improving capital adequacy requirements, 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 was 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.[2]

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.[3]

To deal with resolving the difficulties in the banking system, the Russian government set up the Agency for Reconstructing of Credit Organizations (ARCO) which is designed to facilitate the process of bank restructuring and consolidation. 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.

Indeed, the problems faced by ARCO appear to be mostly of political nature. A good example is Argo, a bank, which was viewed by agricultural firms as a means for agricultural subsidies through favorable credit terms. The liquidation of Argo has proven very difficult politically even though the bank is insolvent.

2. Bankruptcy

One of the legal weaknesses of post-soviet Russia has been its bankruptcy procedures. These 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.

The Law of Insolvency (bankruptcy law) in Russia presently encourages reorganization of troubled businesses instead of liquidation. The IMF, however, has supported amendments to this law since it did not protect investors (domestic and

foreign) adequately. 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. The Russian government agreed to try to get these amendments approved by the Duma. Russia's Letter of Intent (1999) states that the Law of Insolvency 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." However, this amendment was not passed over the remainder of 1999. Hence, the Fund included this item in the list of structural benchmarks that had not been satisfied (*IMF Survey*, December 13, 1999).

V

Monetary and 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. That contributed to the ongoing capital flight, which, according to the Economist Intelligence Unit is estimated at around 150 billion USD since 1991.[4] 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 in order to make banks keep more rubles and, hence, less hard currency. 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.[5]

A fixed exchange rate would serve as a nominal anchor and help reduce inflation but its also imposes constraints on monetary policy. To be credible, a peg requires tight fiscal and monetary control. The Russian government has been unwilling to accept such constraints. The reasons are several. First, reducing the fiscal deficit significantly appeared difficult. Second, most Russians believe that tight money (low inflation, high interest rates) 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 creation whenever the government was unable to 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. 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 has been 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 will conduct monetary policy in a flexible exchange rate regime. The Central Bank of Russia (CBR) will closely monitor inflation and the exchange rate. The CBR will also try to fine-tune the monetary base so as to respond timely 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. During 1999, the CBR was in fact effective in keeping inflation from accelerating (though inflation was about 60% in 1999). In the first three months of 2000, inflation further fell to about 4% per month. The CBR has also managed to achieve some stability for the ruble (though it has depreciated gradually in 1999). Consequently, these developments in the monetary and exchange rate front have satisfied the IMF's conditions as agreed by Russia in their Letter of Intent.

VI

Conclusions

This paper has analyzed IMF conditionality in the latest Russian case. It would be fair to state that both the government of Russia and the IMF want economic success for Russia. In fact, the goal of IMF conditionality, as expressed by its Managing Director Michel Camdessus is persistent growth. The foundation for persistent growth is private investment. In post-soviet Russia, however, several barriers to private investment exist

like chronic fiscal deficits, deficient allocation of savings, and an overall unstable macroeconomic environment.

Following the August 1998 crisis, the IMF made new loans disbursements to Russia conditional on several measures. An agreement was not signed until almost a year later. Some of the conditions imposed on Russia included trimming down of expenditures, raising tax revenues, reforming banking, adopting stronger bankruptcy procedures, and exchange rate management. As described in this paper, many of these measures were politically unpopular so they were received with resistance by the Russian government. Some reforms were unpopular because they represented at least short-run pain for different sectors of society ranging from workers to influential oligarchs.

The IMF's view seemed to be that the obstacles to achieving Russia's economic success were simply inertia in the system and lack of political will. However, this view somewhat ignored the fact that reforms like instituting property rights, bankruptcy procedures, or reforming the tax system require a transition period. Moreover, quick implementation of policy reforms has been difficult due to powerful "counter-reform vested interests."[6]

The Russian government, on the other hand, appeared focused on simply not making a bad situation worse following the crisis. Hence, the reform process was slowed down, and new reforms were viewed with caution since they could lead to political unrest.

In more technical terms, the IMF has focused on changing steady states somewhat ignoring the transition path, while the Russian government has been preoccupied with transitional dynamics without a clearly defined steady state concept. Russia eventually

signed an agreement to the IMF's conditions in July 1999. However, the Russian government was unable or unwilling to pass and implement a number of structural reforms in the six months following the agreement which led to the IMF so far not disbursing promised funds.

Notes

1. Remarks to the UN, quoted by Tony Killick (1995).
2. EBRD *Transition Report* (1998)
3. 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.
4. Economist Intelligence Unit, Country Background, February 28, 2000.
5. A currency board is a fixed exchange rate regime where the central bank keeps sufficient foreign currency reserves to cover a monetary aggregate, usually the monetary base. See Schwartz (1993).
6. Boettke (1999).

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