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Russia and the IMF: Coming to Terms

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SUMMARY

The International Monetary Fund (IMF) has been tasked by the G-7 countries -- the United States, Japan, Germany, France, the United Kingdom, Italy, and Canada -- to lead Western efforts to assist the economic transformation of Russia from a collapsing socialist economy into a market economy. Like some of its past relationships with other countries in need of economic reform, the IMF's role in this process has been controversial.

Western aid programs have been keyed to Russian agreement with the IMF on an economic reform program. So far, Russia and the IMF have failed to achieve agreement on a full standby program. Russia has, however, received $2.5 billion from the IMF, with another $1.5 billion loan agreed to on March 22, 1993. Some have alleged that, as a result of IMF caution, Western financial assistance has been inadequate, causing Russian reform efforts to fail and the reformers to lose power. It has also been suggested that the IMF has lacked sufficient vision for the task.

This report examines the IMF's purposes, how it goes about achieving them, and most particularly, how it has gone about fulfilling its mandate with regard to Russian economic reform. The analysis finds that only during the first quarter of 1992, when Russia was not an IMF member, did Russia successfully implement macroeconomic stabilization policies. Since then, its macroeconomic policies have see-sawed, and Russia has been troubled by high rates of inflation.

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The International Monetary Fund (IMF) has been tasked by the G-7 countries -- the United States, Japan, Germany, France, the United Kingdom, Italy, and Canada -- to lead Western efforts to assist the economic transformation of Russia from a collapsing socialist economy into a market economy. Western aid programs have been keyed to Russian agreement with the IMF on an economic reform program. So far, Russia and the IMF have failed to achieve agreement on a full standby program.[1] Russia has, however, received $2.5 billion from the IMF, with another $1.5 billion loan agreed to on March 22, 1993.

Like some of its past relationships with other countries, the IMF's role in the process of transforming the Russian economy has been controversial. Some have alleged that, as a result of IMF caution, Western financial assistance has been inadequate, causing Russian reform efforts to fail and the reformers to lose power. It has also been suggested that the IMF has lacked sufficient vision for the task. Others, however, have responded that macroeconomic stabilization provides the fundamental underpinnings for all other aspects of economic reform. Thus, without the fiscal and monetary discipline that leads to a lowering of inflation, other aspects of economic reform are likely to fail. In this view, the economic discipline provided by an IMF reform program is absolutely necessary.

This report examines the IMF's purposes, how it goes about achieving them, and most particularly, how it has gone about fulfilling its mandate with regard to Russian economic reform. The analysis finds that only during the first quarter of 1992, when Russia was not an IMF member, did Russia successfully implement macroeconomic stabilization policies. Since then, its macroeconomic policies have see-sawed, and Russia has been troubled by high rates of inflation. Domestic output has dropped dramatically.

THE IMF: LINCHPIN OF THE INTERNATIONAL MONETARY SYSTEM

The IMF is at the center of the international monetary system. It is responsible for fostering the system's smooth functioning. In turn, a well-functioning international monetary system fosters international trade, economic growth, and employment. The IMF's Articles of Agreement promote these broad objectives by establishing a code of economic conduct for the IMF's 178 member countries, particularly with regard to restrictions on international trade and

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[1] A standby loan is an IMF loan that carries conditionality. Such loans are extended for a fixed period of time, usually for one year.

payments. The IMF reviews the economic policies and performance of its members through consultations held under Article IV of its Articles of Agreement. In addition, it provides its members with technical assistance in areas related to its macroeconomic expertise. Finally and most importantly, in order to help member countries that are experiencing balance-of-payments difficulties, the IMF also provides financial assistance.

IMF FINANCING: SOME BASICS

The IMF is a revolving loan fund. The capital contributions of its members constitute its basic financial resource. Currently, these capital contributions or quotas amount to SDR 144.8 billion (about $202.7 billion).[2] Although the IMF has, from time-to-time, borrowed in order to obtain additional financial resources, it is the quota resources that provide the basis for its loan operations. Consequently, failure of a borrowing country to repay the IMF reduces the availability of financing for all other IMF members.

The IMF is the international lender-of-last resort. Countries failing to repay the IMF are, therefore, likely to be cut off from all other sources of international finance and forced to operate on a "cash-and-carry" basis. Conversely, an IMF loan is viewed as an international "Good Housekeeping Seal-of-Approval" and is likely to open up additional sources of finance for the borrower, often in amounts well in excess of the IMF loan itself.

A country's access to borrowing from the IMF is determined by its quota, which is assigned at the time of its accession to membership. The size of a country's quota reflects the size of it economy. It is calculated on the basis of a variety of economic data. These are then adjusted for comparability to existing members with economies of similar size and characteristics. A country's IMF quota also determines the size of its capital subscription, its voting rights, and the size of any allocation of SDRs.

Russia's quota is currently SDR 4,313.1 million (about $6,039.2 million). It is the ninth largest quota, ranking Russia, within the IMF, immediately after Canada. Under current access limits, a member can potentially borrow up to 68 percent of its quota annually, with a cumulative limit of 300 percent, net of repurchases (repayments). Russia could, therefore, borrow up to SDR 2,932.9 million annually, up to a maximum of SDR 12,939.3 million (currently about $4,106.6 million and $18,117.5 million, respectively.)

CONDITIONALITY: THE KEY

Conditionality is a unique feature of IMF loans. Conditionality consists of the macroeconomic policy changes and the economic performance targets that

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[2] The SDR or "Special Drawing Right" is the international reserve asset created by the IMF and used to denominate its accounts.

borrowing countries agree to undertake or meet in exchange for an IMF loan. Conditionality is intended to ensure that the IMF, since it is a revolving fund, gets its money back. Private loans and most official loans do not carry conditionality of the kind borne by IMF loans. Indeed, it is conditionality that has turned an IMF standby agreement into the international "Good Housekeeping Seal of Approval." By helping to ensure that the borrower is taking steps to remedy its economic problems, IMF conditionality helps as well to provide assurances to other lenders that they too will not just be throwing good money after bad. In this manner, IMF loans can act as a catalyst, opening up financing from other sources.

The IMF provides loans to ease the adjustment of an unsustainable balance-of-payments position. Specifically, the borrowing country has a current account deficit that cannot be sustained over the medium-term by autonomous inflows on the capital account.[3] The imbalance may have an number of causes. One such cause is adverse external "shocks." An example of this is the dramatic oil price increases of the 1970s, which caused balance-of-payments difficulties for many oil-importing developing countries. More commonly, domestic economic policies overstimulate aggregate demand and cause a current account deficit. An overvalued exchange rate may also result in an unsustainable current account deficit. Structural problems may also lead to balance-of-payments difficulties. The long-term effects of an international trading regime based on import substitution is one significant example of a structural feature that can lead to balance-of-payment difficulties.

IMF conditionality is intended to correct the borrower's current account deficit. Conditionality, therefore, is intended to bring about macroeconomic adjustment, that is, the correction of over-stimulative fiscal and monetary policies. In particular, the IMF focuses on the excessive expansion of domestic credit. Budget deficits are also to be cut in order to reduce the demand for domestic credit. The Fund has found that, unless the monetary character of payments imbalances is addressed, the problem will persist and that monetary

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[3] The current account is a major component of the balances of payments that represents the net balance of payments arising from the export and import of goods and services, together with unilateral transfers (such as gifts, emigrants' remittances). The capital account is also a major component of the balance of payments that represents the net balance of all short- and long-term financial movements, including loans, credits, direct and portfolio investment. The balance of payments, of which the current and capital account, constitute two major parts, is a statistical statement summarizing the economic transactions, during a given period, usually one year, between the residents of one country and the rest of the world. A current account deficit indicates that a country is spending more abroad than it is earning abroad. A current account deficit is financed by inflows on capital account.

data are still the most accurate and readily available.[4] Thus, the Fund's approach tends to be essentially monetarist in nature.

In recent years, IMF conditionality has also focussed on a number of issues beyond macroeconomic stabilization. Since the cost of restraining domestic demand is almost always a loss of production and employment, the IMF has paid more attention to the developing "growth-oriented" adjustment programs. Because the poor may be disproportionately hurt by a slow-down in economic growth, IMF programs have been paying greater attention to the distributional impact of adjustment programs. Most importantly, recent Fund programs have increasingly included structural adjustments, particularly price liberalization, trade liberalization, and privatization. Finally, environmental issues and military spending are also issues that are now receiving some attention.

IMF adjustment programs are embodied in a "letter of intent." The letter of intent details the economic policy actions that the borrower will take as a condition of receiving IMF financing. The required actions almost always include monetary and fiscal restraint and, sometimes, an exchange rate adjustment. The letter of intent may also have an attached memorandum that provides greater detail about the promised policy changes. As noted by Jacques Polak, however, the best indication of a member's economic policy intentions are "prior actions."[5] Indeed, some countries find it to their advantage to undertake "preemptive reform."

The IMF uses performance criteria, that is, quantitative targets for key macroeconomic variables, to determine whether or not a borrower is fulfilling its promises. Because IMF funding is generally disbursed on a quarterly basis, failure to achieve these targets can lead to a cut-off of IMF funding. In cases where the borrower may not be at fault or the lapse is inconsequential, a waiver may be granted and the borrower may still be able to draw down on a loan despite a failure to meet a particular target.

IMF adjustment programs with a member country are the results of negotiation between the IMF and the borrower. They are not imposed, but the letters of intent are often drafted by IMF staff. Evidence has been accumulating, however, that a major determinant of an adjustment program's success is the extent to which the government "owns" or identifies with its own economic adjustment program.[6]

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[4] Polak, Jacques J. *The Changing Nature of IMF Conditionality*. Princeton [Sept. 1991] 13.
Essays in International Finance, no. 184.

[5] Ibid.

[6] See. for example, Overseas Development Institute. *Does the IMF Really Help Developing Countries*, p. 3.
Briefing Paper, April 1993.

Trade-offs must be made between the amount of available financing and the country's political capacity to carry forth an austerity program. The success of an IMF stabilization program is, therefore, hostage to political constraints. Ultimately, it is the government itself that must make the decision regarding the program's political viability. Conditionality is an attempt to fortify borrowers in their efforts to be wise in their own behalf, as well as to enhance prospects of repayment. Conditionality also permits the government to use the IMF as a "scapegoat" for unpopular, but necessary, decisions -- an uncomfortable role that the IMF understands and accepts.

IMF LOAN APPROVAL: THE G-7 CALLING THE "SHOTS"

The IMF largely reflects the international financial policies of the G-7 industrial nations. The United States, with 18.3 percent of total quotas, is the single largest IMF shareholder. Together, the G-7 countries account for nearly half (46.1 percent) of all quotas. Since the 1970s, none of the major industrial countries have borrowed from the IMF. Their participation within the context of the IMF is, therefore, as lenders, further buttressing their power within the IMF. The major industrial countries, thus, have both the votes and the financial clout substantially to control the IMF's lending policies.

The IMF's Board of Governors consists of a Governor and an Alternate from each member country, usually a country's finance minister and the head of its central bank. The Board of Governors meets once a year at the IMF's annual meeting. The day-to-day responsibilities of running the IMF, including decisions regarding loans, are delegated by the Board of Governors to an Executive Board, which has 24 members. Five Executive Directors -- from the United States, Japan, Germany, France, and the United Kingdom -- are appointed. The remaining nineteen members of the Executive Board are elected by groups of the remaining member countries of the IMF. Russia has a seat on the Executive Board, but its influence is substantially diminished by its status as a borrower.

RUSSIA AND THE IMF[7]

Russia became a member of the IMF on June 1, 1992. The relationship between the IMF and Russia, however, antedated Russian accession to membership. Beginning in October 1991, the IMF and Russia entered into a "special association," with the IMF opening an office in Moscow, only the IMF's third overseas office. With special association, the IMF, at the behest of the G-7, began providing technical assistance and advising the Russian government on

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[7] For a detailed discussion of Russian economic reform and the role of the IMF, see U.S. Library of Congress. Congressional Research Service. *Russian Economic Reform and the IMF: Mission Possible?* by Patricia A. Wertman. [Washington] 15 p.
IB92128. Updated regularly.

economic reform. Indeed, IMF approval of a "shadow" economic program for Russia was a condition of debt deferral by the G-7 countries.[8] Since Russia was not, at the time, an IMF member, however, the shadow program was not backed by financing from the IMF. The shadow program was, nevertheless, widely viewed as a substitute for and a precursor to a full IMF standby program.

When Russia joined the IMF, it was well understood that the transformation of the Russian economy was a monumental task. It was also widely anticipated that Russia would successfully agree upon a standby program soon after becoming an IMF member. To date, however, no standby agreement has been achieved. Nevertheless, the IMF has adapted its loan process to accommodate the unprecedented difficulty of the task.

During the summer of 1992, in the wake of a mid-June bilateral summit between Presidents Bush and Yeltsin and with a G-7 summit scheduled for Munich in early July, the IMF was under pressure by the Bush Administration to extend a loan to Russia. As a result, on July 5, 1992, the IMF agreed to a first credit tranche drawing of $1.0 billion (SDR 719 billion) by Russia.[9] First tranche agreements are unusual. Their key characteristic is that they carry less conditionality than borrowing in the upper credit tranches. As part of the first tranche agreement Russia agreed to reduce the government budget to 5 percent of GDP and its monthly inflation rate to below 10 percent. The $1.0 billion drawn by Russia was to be retained in its international reserves.

In the spring of 1993, the IMF announced a new loan facility -- the "Systemic Transformation Facility" (STF) -- intended specifically for Russia, but available to other formerly socialist economies as well. The intent of the facility was to streamline and focus conditionality. More precisely, it was intended to ease conditionality and, thus, meet criticism that the IMF had not been sufficiently responsive to Russia.

Countries borrowing under the STF are not required to have a standby program in place. In countries where inflation is "unacceptably high or is accelerating," however, macroeconomic stabilization efforts are of primary importance in receiving STF loans. Access to the STF is limited to 50 percent of quota. Funds from the STF are structured so as to be rapidly disbursing. The loans are made available in two tranches, with the first half dispensed immediately. The STF is a temporary loan facility that expires at the end of 1994; drawings must be completed by the end of 1995.

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[8] For details of Russia's debt problems, see U.S. Library of Congress. *International Debt and the ex-Soviet republics: Mortgaging the Future* by Patricia A. Wertman. [Washington] August 12, 1992. 33 p.
CRS Report 92-678 E.

[9] The word "tranche" is derived from French, meaning slice, section, or portion. IMF credit is made available in four tranches, each of which is equal to 25 percent of a member's quota.

On June 30, 1993, the Executive Board of the IMF approved a drawing of $1.5 billion (SDR 1,078.275) for Russia, the first half of a proposed $3.0 billion STF loan. Once again, Russia's key commitment was to reduce its budget deficit to 5 percent of GDP and its monthly inflation rate to a "low single-digit level" -- effectively the unmet targets of 1992's first tranche agreement. While the first half was disbursed last summer, agreement between the IMF and Russia on the second tranche of the STF loan proved to be extremely difficult. The accord was reached only after direct negotiations between IMF Managing Director Michel Camdessus and Russian Prime Minister Viktor Chernomyrdin. In addition to the $1.5 billion that the IMF will provide under the STF second tranche, Russia's agreement with the IMF is also expected to lead to debt relief on payments due to the Paris Club of official creditors in 1994.

The most important performance targets of both the 1992 first tranche loan and the 1993 STF loan were identical. The agreed conditionality, therefore, emphasized macroeconomic stabilization -- consonant with the IMF's institutional role and experience. It is also consonant with a view widely held by mainstream economists that macroeconomic stabilization is the necessary precondition for successful economic reform, particularly where the reforming country is at risk of high rates of inflation or hyperinflation.[10]

In January 1992, following price liberalization, Russia had a monthly inflation rate of 296 percent.[11] As shown in figure 1,[12] in July 1992, Russia's monthly inflation rate reached what was to be its lowest level in a 25-month period -- 7.1 percent. The level of inflation lags monetary growth by about four months.[13] Thus, the low level of inflation during the summer of 1992 was the product of the restrictive monetary and fiscal policies that were implemented during the first quarter of 1992.

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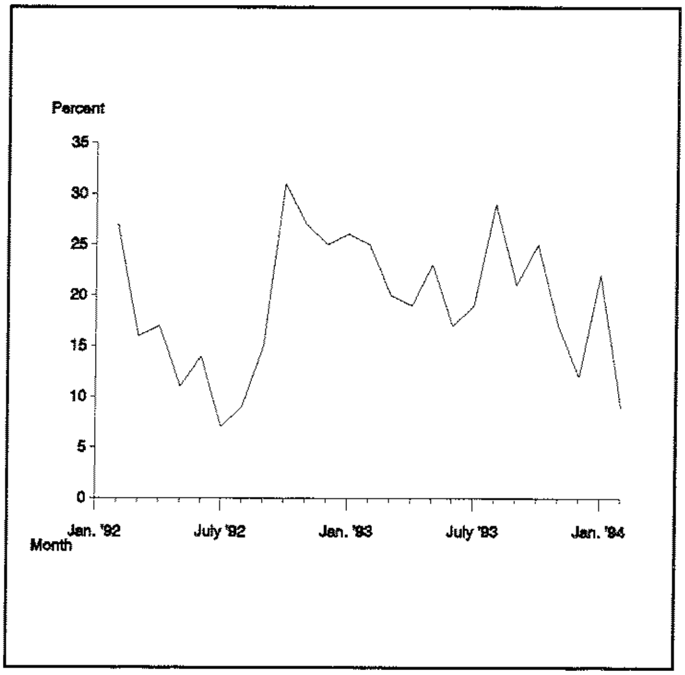
[10] The World Bank, for example, has just issued a comprehensive study of 29 sub-Saharan economies that shows that countries that undertook stabilization and reform programs achieved more economic growth than those that did not. In the words of World Bank Vice President Edward V. K. Jaycox: "good policies work." Friedman, Thomas L. *Africa's Economies: Reforms Pay Off.* New York Times, March 13, 1994, p. A18.

[11] IMF. Economic Reviews. *Russian Federation.* [Washington] June 1993, p. 88.

[12] Through March 1993, data for figure 1 are from IMF. Economic Reviews. *Russian Federation*. [Washington] June 1993, p. 88. After March 1993, Russian Government data, as reported by *Interfax*, were used.

[13] The World Bank. Financing the Storm: Russia's Inflation Crisis by William Easterly. *Transition*, Oct.-Nov. 1993, p. 4. The study covers the period up to September 1993. The four-month lag may not necessarily continue to hold after September 1993.

Figure 1 Russia's Monthly Inflation Rate, Feb. 1992-Feb. 1994



Since the first quarter of 1992, Russian macroeconomic policies have see-sawed, and its monthly inflation rates have remained high. An easing of restrictive fiscal and monetary policies began in the second quarter of 1992. In late 1992, a moderately restrictive policy was imposed, and, again, in the spring of 1993, when the Russia Government and the Central Bank reached agreement on a set of measures to control inflation. Despite the accord between the government and the central bank, money creation began, once again, to accelerate after May 1993.[14] This was followed by a tightening in fall 1993.

In January 1994, the monthly inflation rate was 22 percent, equivalent to an annualized rate of 1,087 percent; in February, 9.9 percent or an annualized rate of 310 percent. Viktor Gerashchenko, the normally prodigal head of the Russian Central Bank and an ally of the Prime Minister, is reportedly continuing the financial squeeze of late 1993 by undershooting credit targets by 40 percent.[15] This appears to have provided the "window of opportunity" necessary for IMF action.

In Russia, the size of the budget deficit, which is financed by central bank credit, is critically important in determining the rate of inflation. Russia's fiscal performance, therefore, was the primary issue in its negotiations with the IMF. With tax revenues dropping dramatically and substantial pressures for increased expenditures, the prospects in 1994 are for a ballooning budget deficit, increased credit creation, and increased inflation. Reportedly, the Russian Government has agreed to send to the State Duma by mid-April a package of legislative

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[14] For a discussion of the accord between Russian Government and the Central Bank and of credit creation during 1993, see U.S. Library of Congress. *Russian Currency Exchange: Shrinking the Ruble Zone*, by Patricia A. Wertman. [Washington] Aug. 31, 1993. 9 p.
CRS Report 93-785 E.

[15] Lloyd, John. IMF Chief Steps Into Russia's Gathering Economic Storm. *Financial Times*, March 17, 1994, p. 2.

initiatives that are intended to revoke a number of laws, presidential decrees, and government resolutions that would have increased spending. Ways of increasing revenues are also under consideration.[16] Much, therefore, depends on whether Russian Prime Minister Viktor Chernomyrdin has the personal and political resolve to hold the line on the budget.

CONCLUSIONS

A brief "window of opportunity" for financially supporting Russian economic reform was missed during the first quarter of 1992 -- a period that followed immediately on the heels of the break-up of the Soviet Union and the subsequent January 3, 1992 announcement by the United States Government of its support for Russian membership in the IMF. Russia became an IMF member on June 1, 1992. By that time, its economic policies had already eased and were clearly setting the stage for further difficulties, although its performance still reflected first quarter stabilization efforts.

During the first quarter of 1992, it may not have been clear to G-7 policy makers that Russian stabilization efforts were succeeding. Data on economic performance always lags the implementation of policy. In the case of Russia, problems of availability, timeliness, accuracy, and comparability of economic data have been very substantial. The data problem also undoubtedly complicated the calculation of Russia's initial quota, thereby further slowing the admission process.

For much of 1992 and 1993, Russia was sustaining high rates of inflation.[17] Given the severe economic and political consequences of high rates of inflation, macroeconomic stabilization was the appropriate policy goal. Thus, the IMF's policy recommendations to Russia have been consistently, even relentlessly, anti-inflationary. While some economists might argue with the specific numbers agreed between Russia and the IMF for the size of Russia's budget deficit and for the rate of its monthly inflation, few economists would dispute the goal itself. Nor would they dispute that Russia has fallen far short of reaching the agreed targets.

Finally, the IMF is an international institution with a limited, technical purpose: the financing of macroeconomic stabilization. The broader goal of supporting Russian economic reform by supporting the reformists is, therefore, more appropriately carried out in another venue. Such a political goal is the responsibility of the G-7. As Samuel Brittan has suggested, "[i]f opportunities have been missed, the IMF is . . . only a minor culprit. A decision to use

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[16] *Interfax*, March 23, 1994.

[17] Hyperinflation is defined as a monthly inflation rate of 50 percent or more. The highest monthly inflation rate during the two-year period shown in figure 1 occurred during September 1992, when the monthly inflation rate was 31.1 percent. This represents an annualized rate of 2,578 percent.

economic aid to sustain particular governments in Russia or elsewhere is a summit one to be made by presidents and prime ministers and they abandon their duty if the delegate it to "experts."[18] Ultimately, however, only the Russians themselves can ensure successful economic reform.

[18] Brittan, Samuel Post-communism: the Rival Models. *Financial Times*, February 24, 1994, p. 14.