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A Timetable for Macroeconomic Stabilization in Russia

1. For several important reasons, Russia and the West should set a clear <u>timetable</u> for macroeconomic actions during the next few months. This timetable should define Russian macroeconomic policy actions and corresponding Western support (conditional on the fulfillment of the reform actions by the Russian Government). The forthcoming elections and the beginning of a new calendar year are the crucial markers around which policy must be devised.

2. We propose the following timetable:

<u>October</u>

The Russian Government and Central Bank of Russia (CBR) would agree to monetary targets, already outlined by Finance Minister Federov, that would have the effect of holding overall money growth to around 25 percent for the fourth quarter, or around 8 percent per month. The exchange rate could remain stable at least till the end of the year under such policies, and there would be a good chance for inflation to come down to single digit rates by early 1994. Specific credit targets would be as follows. Total credit emission by the CBR would be limited to 6 trillion rubles (4.6 trillion to the budget, 1.4 trillion to the commercial banks). Assuming a decline in net international reserves of $1.75 billion (as Russia uses part of the IMF and World Bank money), and the maintenance of a stable exchange rate of 1150 rbls/$, the monetary base would increase by 4 trillion rubles, on a base of around 15 trillion rbls at the end of September.

Based on these targets, the IMF and Russia would agree on the release of the <u>$1.5 billion STF</u>. An agreement with the IMF should be reached in the second half of October, for disbursements available starting in November. Similarly, the <u>$600 million World Bank Rehab Loan II</u> should also be renegotiated in October for release in November.

<u>November-December</u>

Russia would maintain the targets set in the October accord with the IMF and World Bank. Russia would also complete a framework budget and monetary program for 1994, as well as an agreement with the regions on expenditure and tax assignment for 1994.

Russia and the IMF would immediately enter into new negotiations for 1994. There would be two goals: a one-year standby loan and the activation of the ruble stabilization fund. Simultaneously, Russia and the World Bank would enter into negotiations over a $1 billion package of social support funds: $500 million in a new Oblast Support Fund and $500 million in a new Social Safety Net Loan (both loans have already been announced in principal, but not yet negotiated). The target date would be March 1, 1994 for implementation of these two new World Bank loans.

January 1994

Assuming that the previous months' policies have gone well, Russia would be in a position to implement a publicly announced pegged exchange rate. The rate could still be around 1100-1200 rbls per dollar following the successful implementation of the monetary program for the fourth quarter of 1993.

The new pegged exchange rate would be backed by the $6 billion stabilization fund arranged in November-December. (After significant stabilization has been achieved, the pegged rate could be converted into a crawling peg). The IMF standby loan would also be in place as the new Parliament gets organized. New Parliamentary leaders would be briefed on the $13 billion or so of foreign assistance soon to come on line ($4 billion IMF standby; $6 billion stabilization fund; $1 billion in World Bank support for the social sector; $2 billion in privatization funds and World Bank financial sector restructuring loans). The cliche of "no real Western assistance" would be definitively laid to rest as Russia's new Parliamentary democracy gets underway. President Clinton might well be on hand for his summit with President Yeltsin to help explain the new package.

February or March

The new Parliament would begin sitting.

3. Some important comments are in order, especially about the very real obstacles that could frustrate this proposal. The first potential obstacle is of course the current management of the CBR. While progress is conceivable now under the current management, it would be vastly more likely with a new Central Bank management. The senior management of the CBR is once again trying to undermine monetary discipline, this time by promising to transfer new Russian currency notes to other CIS states before there is any demonstration whatsoever of adequate budgetary, monetary, banking, privatization, or trade policies in those other states. The current CBR leadership has all along been aiming to reconstruct the Soviet Union and Gosbank along with it. On much more mundane matters, the CBR continues to hide data from the Government, and gives every sign of internal disarray and corruption (e.g. kickbacks on bank loans).

4. The second potential obstacle is the "ruble area" itself. If the current CBR leadership succeeds in transferring new ruble notes abroad and (even more important) starts honoring non-cash money in

other republics as Russian rubles, the chances for stabilization might suddenly be lost. The IMF should send Yeltsin and Chernomyrdin a strong letter advising them that any sudden actions to unify the ruble again with the neighboring states would almost surely delay rapid disbursements of aid, by undermining effective monetary controls once again. The IMF would have to enter into detailed negotiations with the partner countries before Russia could qualify for a program. The U.S. Treasury should similarly weigh in with a warning that new, open-ended monetary commitments by Russia to other states would undercut the basis for rapid Western help to Russia. There is incredible naivete on the issue of the ruble zone at the top of the Russian Government, where the idea of a unified currency sounds nice, wholesome, and easy. The top leaders apparently do not understand why it is taking Europe forty years or more to reach a single currency.

5. The third potential obstacle is the natural view among some Western participants that we should proceed cautiously, one step at a time, without laying out any timetable beyond the disbursement of the $1.5 billion STF. According to this view, we should finish the STF, see how it goes, let the Parliament be elected, and then return in early 1994. It seems to us that logic and international experience points powerfully in the other direction. We have a very strong opportunity to help keep Russia in the reform path by setting aid targets and policy guidelines that will bridge the elections, and that will therefore be in place as a new Parliament comes into office. Of course, if things go badly, then the program will stop.

This powerful bridging mechanism is clearly at work in Poland. Thank goodness for the two-step Polish debt reduction, which requires the new government to stay on track with the IMF in order to qualify for the second stage of debt relief. Remarkably, during the Polish campaign, the post-communists (SLD) made a strong point of saying that while they wanted to renegotiate the IMF program they would do nothing without reaching a prior agreement with the Fund.

6. The fourth potential obstacle is the fear among some Western participants that we (and Russia) should not commit to a stable exchange rate at the "start" of stabilization. The risk, it is argued, is that an IMF stabilization fund will be quickly exhausted, or that the Russian Government will quickly lose credibility. Unfortunately, this kind of pessimistic incrementalism is almost guaranteed to become a self-fulfilling mechanism for failure. High inflations end rapidly, not gradually. Almost all successful stabilization programs around the world have involved some sort of decisive package of actions, including a combination of foreign aid, domestic reforms, and exchange rate pegging. By coming as a highly publicized package of actions, the government thereby sends a clear signal of commitment to the population (and, very importantly, to its own bureaucracy). This

was the mechanism of the 1985 Israeli program, which was coordinated with U.S. aid; the 1987 Mexican Pacto; the 1990 Balcerowicz Plan, dramatically backed up by a $1 billion stabilization fund; the 1991 Argentine Convertibility Plan; the 1992 Estonian currency board; and so forth).

7. The fifth potential obstacle is the Russian Government's constricted view of what is possible. We risk, as usual, getting stuck in a vicious circle. The Russians think that no real aid is going to be forthcoming, at least not soon enough to make strong commitments. The IMF thinks that only limited policies are going to be implemented. We end up in the equilibrium trap of lowered expectations on both sides. If the West can agree to a serious and ambitious timetable, it would be useful for Camdessus, Summers, Stern, Bruno, etc., to go to Moscow, to brief the Russian leadership and try to get something in place soon. <u>President Yeltsin and Prime Minister Chernomyrdin should understand clearly and categorically, that more than $10 billion of rapidly disbursable aid depends on choices on the ruble zone, the Central Bank, and the budget.</u> This message should be delivered within the next few days at the very highest levels of the Russian Government (and not just to our reform friends in the cabinet via an IMF mission!).

8. The main analytical point is that real stabilization is possible, and has been possible for several months. Indeed, the ruble exchange rate has depreciated by only 20 percent during four months, or by 5 percent per month. The budget is in difficulty, but the fears of its getting completely out of control resulted from Parliamentary threats, and internal divisions in the government (while Lobov was still Economy Minister) rather than economic fundamentals. Foreign exchange reserves have accumulated on net during the period since June. Regions are once again paying their taxes, and there is room for a real fiscal agreement with the regions for 1994 (based on a new scheme for tax assignment, giving more flexibility to regional governments). Under plausible conditions, money growth can be held to around 6 percent per month in the last three months of the year.

Some Russian and Western observers currently feel that stabilization is beyond reach. Such a mistaken feeling has been characteristic of every high-inflation country on the brink of stabilization. (Who really believed as of November 1989 that Poland would soon have a stable, convertible currency? Or that Israel, or Argentina, or the others, could quickly end years of chronically high inflation?). Perhaps surprisingly, the economic and political fundamentals in Russia bring stabilization within reach: the budget is actually manageable; the political timetable is favorable; the Russian people desire monetary stability. This is not an opportunity to be missed.