The Role of the International Financial Institutions During the Transition in Russia

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Introduction

This paper aims to provide an early assessment of the role played by the international financial institutions during the transition in Russia. The subject is multidimensional and this paper attempts to identify some of the key issues that emerged during the first ten years of Russia's gradual transformation into a market economy. Because the International Monetary Fund (IMF) provided about three-quarters of total multilateral lending during the 1990s, our primary focus will inevitably be on this organization's programs and operations.2 We begin by briefly identifying in section 2 the primary sources of external finance to the Russian government during the 1990s and highlighting the chief characteristics of each. Having shown that multilateral lending played a central role in the provision of resources to the government, we turn our attention in section 3 to the issue of what were the key policy objectives pursued and instruments used as part of the multilaterals' aid effort. We argue that the Fund's approach, in particular, fell well short of achieving the goals established at the outset of the transition. We then look for some explanatory factors, focusing attention in particular on the gap between theoretical insights into the ingredients of sound approaches to economic development on the one hand, and the practice of the development agencies on the other; the role of geopolitical considerations in multilateral lending; issues of IMF jurisdiction; and the limited administrative capacities of the government during the initial

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2 World Bank lending was much smaller in scope, largely focused on specific sectoral reforms, and given at much longer maturities.

stages of the transition. Given the central role played by the IMF during Russia's transition and the continued importance of the organization in assisting other countries in crisis, the paper's last section provides some initial thoughts on IMF reform.

Main Sources of External Finance to the Russian Federation

Table 1 presents the outstanding stock of Russia's public external debt during 1994-2001. There were three principal sources of external funding to the government during the 1990s: multilateral credits from the international financial institutions, particularly the IMF and the World Bank; export credits from bilateral official sources; and, beginning in 1996 and leading up to the August 1998 financial crisis, portfolio inflows from non-resident investors attracted by the high yields in the domestic treasury bill market.3 There were additional inflows of foreign direct investment but these were relatively small and, in any event, not necessarily linked to the public sector. Each of these three sources of finance had its particular characteristics and it is useful to highlight some of the key differences.

Credits from the multilateral institutions were generally linked to macroeconomic policy reforms and, in the case of the World Bank, reforms of a sectoral nature as well (e.g., improving the operations of the coal mines). The IMF disbursed the lion's share of multilateral lending during the 1990s – some $22 billion between 1992 and 1999 – and the funds were the least restrictive form of foreign finance available to the government. Once the resources were disbursed (generally in tranches, subject to compliance on the part of the government and the central bank with respect to the conditionality established in the IMF program), the government could use (and did use) these resources in any way it best saw fit; in Russia this usually meant direct support to the federal budget.

3 This latter category of debt does not appear in the table as the underlying obligations were denominated in rubles.

External debt outstanding *(End of period; in billions of US$)*								
	1994	1995	1996	1997	1998	1999	2000	2001
A. Sovereign debt (B+C) 1/	**127.5**	**128.0**	**136.1**	**134.6**	**158.1**	**155.0**	**139.6**	**131.8**
(in % of GDP)	45.8	36.8	31.6	30.2	48.1	80.2	55.6	42.8
B. Russian-era 2/	**11.3**	**17.4**	**27.7**	**35.6**	**55.4**	**51.4**	**67.3**	**61.5**
Multilateral creditors	5.4	11.4	15.3	18.7	26.0	22.4	18.9	15.5
of which								
IMF	4.2	9.6	12.5	13.2	19.4	15.3	11.6	8.2
World Bank	0.6	1.5	2.6	5.3	6.4	6.8	7.1	7.1
Official creditors	5.9	6.0	7.9	7.6	9.7	9.8	8.5	7.1
Eurobonds	0.0	0.0	1.0	4.5	16.0	15.6	36.4	35.4
Others	0.0	0.0	3.5	4.8	3.7	3.6	3.5	3.5
C. Soviet-era 2/	**116.2**	**110.6**	**108.4**	**99.0**	**102.7**	**103.6**	**72.3**	**70.3**
Official creditors	69.9	62.6	61.9	56.9	59.4	58.4	58.4	55.5
of which								
Paris Club	39.6	41.6	42.3	37.6	40.0	38.7	39.0	36.0
COMECON	25.7	16.6	15.4	14.9	14.8	14.9	14.0	14.0
Commercial creditors	36.0	38.3	37.8	33.9	35.3	36.9	5.9	5.9
of which								
Financial institutions	31.1	33.0	32.5	29.7	31.2	32.8	1.8	1.8
Others	10.3	9.7	8.7	8.2	8.0	8.3	8.0	7.1

1/ The stocks of debt at end-1992 and end-1993 were, respectively, $78.7 and $112.7 billion

No accurate comparable breakdown of these totals, however, is available.

2/ Russian debt is post 1/1/1992; Soviet debt is pre 1/1/1992.

Export credits from bilateral official sources are also called "tied credits," to highlight the fact that the loan is tied to the purchase by Russia (or earlier, the Soviet Union) of goods in the creditor country. A typical transaction might involve the purchase of industrial machinery from some German enterprise to be used subsequently by some Russian factory. The Russian government provides the state guarantee, the Russian enterprise assumes a ruble obligation to the federal budget (which may or may not be subsequently paid; the overwhelming majority of such credits disbursed during the last several years of the Soviet Union, for instance, were never repaid by the Soviet enterprises which received the goods and the state was thus left with the external obligation), and the German export credit agency acts as an intermediary, typically providing insurance cover to the German enterprise.[4] The goods are delivered and the Russian government assumes the obligation without ever having seen any cash.

There is no "policy" component to such lending operations. The creditor government (Germany in the above example; but there were well over a dozen countries providing such credits, with Germany making up about 50% of the total disbursed) is typically only too happy to lend as such operations boost exports, establish a local presence for the country's industry in the domestic economy and can be portrayed as "external assistance" and were typically factored into G7 announcements of aid packages to Russia, particularly during the early years of the transition. (Indeed, reschedulings of previously disbursed export credits were also counted as part of these aid packages.)

When, in 1993, during his tenure as finance minister, Boris Fedorov expressed some misgivings about the general utility of tied credits, his remarks were unwelcome in the

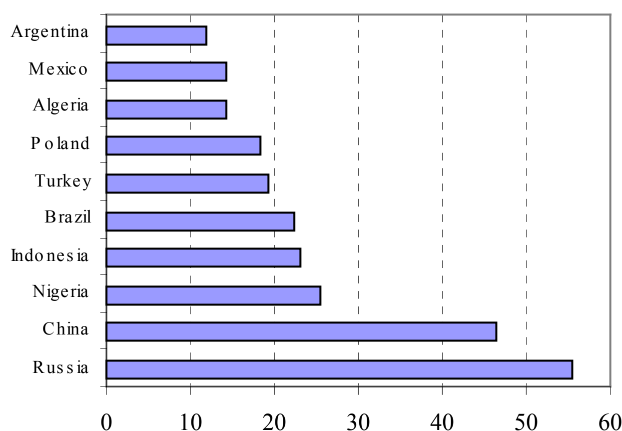
4 For an interesting overview of some of the irregularities associated with the disbursement of export credits see the article by Sabrina Tavernise, "Russia Trying to Head Off Debt Squeeze," The New York Times, 14 April 2001.

capitals of the main creditor countries. It is not unfair to say that such credits, with some exemptions, were more about supporting domestic industry and/or agriculture in the creditor country, than about providing tangibly useful help to Russia. This was particularly the case when, after German reunification, one useful way to assist enterprises in the former East Germany, to mitigate the adverse impact of competition from their peers in the more developed West, was to keep alive for a few more years their traditional markets in the Soviet Union. As long as the Soviet (and later, Russian) government was willing to assume the obligation and provide the guarantee, this was an excellent business for Germany. Thus, in a very tangible way, Russian taxpayers are still paying for the effects of German economic support. For instance, payments due to official creditors during the period 2002-10 on export credits disbursed to the Soviet Union before 1992 amount to US$31 billion, roughly 11 times the total annual sum spent by the federal government on social transfers, or more than 8 times the yearly amount spent by the local governments on health.[5] Data released by the IMF in 2001 show that by 1999 the largest exposure of export credit agencies to selected major developing countries was to Russia, followed by China, Nigeria, Indonesia and Brazil (see chart).

5 Annual debt payments on Soviet-era export credits actually rise after 2010 and peak in 2015 at US$4billion. These figures exclude amounts due to official creditors on export credits disbursed to Russia beginning in 1992; the total debt burden on account of this type of debt is thus much higher.

Chart 1: Exposure of Export Credit Agencies, 1999

(In billions of US$)



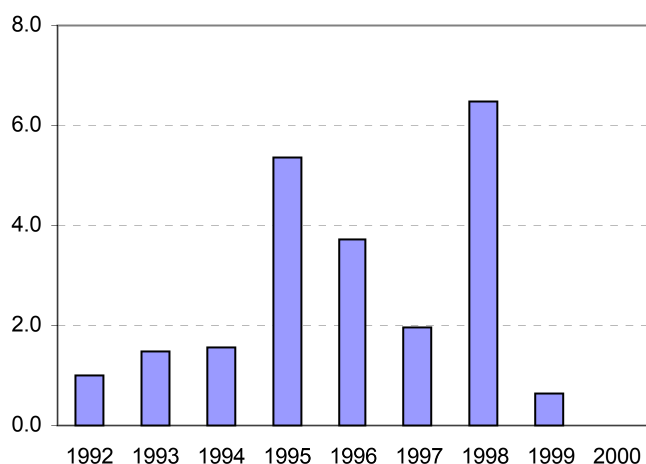
The development of the treasury bill market in the mid 1990s eventually became an important source of external funding to the Russian government. The amounts, particularly in 1996-98, were large, highly volatile, extremely expensive (dollar returns in excess of 50% were not unusual, particularly after 1995 when the IMF and the authorities agreed to peg the ruble, thereby providing investors an effective guarantee of a high dollar return) and were eventually a precipitating factor in the 1998 financial crisis.6 As with bilateral official credits, there was no policy reform component to this form of lending. With the capital account liberalized, non-resident investors provided the funds because the returns were among the highest in the world. The government opened the treasury bill market to them because it proved an easier and faster source of funding, supplementary to IMF lending, than collecting taxes from Gazprom, the oil companies, and the public more generally. Indeed, as access to foreign borrowing through the sale of treasury bills rose rapidly, the government revenue/GDP ratio fell precipitously; by 1998 the federal government was collecting the equivalent of 10.7% of GDP in annual revenues, down from 17% of GDP in the early phase

of the transition. It was also *barely* able to finance the payment of wages (with some delays) and interest on the public debt.

Of the above three sources, by far the most important was multilateral lending. It was the largest in magnitude. It had the best terms – grace periods, maturity and interest rates. It was not subject to the extreme volatility of portfolio inflows. Most importantly, it brought with it enormous potential leverage to advance the cause of Russian economic transformation. This was particularly the case for lending by the IMF, due to the fast disbursing nature of its funding and the organization's focus on macroeconomic policy reforms.

Chart 2: Annual disbursements by the IMF to Russia

(In billions of US$)



Policy Objectives and Instruments

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6 According to the IMF, net nonresident purchases of ruble treasury bills (the so-called GKOs and OFZs) amounted to $6 billion in 1996, $10.9 billion in 1997 and $2.8 billion in 1998.

The IMF seeks the promotion of economic policies which are conducive to sustainable growth. It tries to do this in two ways: helping strengthen the economic policies of its individual member countries, and safeguarding the soundness of the international trade and financial system, two clearly interrelated objectives. Unlike the World Bank, whose focus is on investment and sectoral policies, the Fund's focus is largely on exchange rate and macro policies and issues of international monetary cooperation. Although the Fund endeavors to assist its members to avoid economic crises altogether, the situation most often encountered is that of a country where inappropriate policies have been pursued for an extended period of time, leading to severe imbalances, in the form of an unsustainable budget deficit, accelerating inflation, and/or distorted prices and exchange rates which discourage productive activity and encourage speculation, the emergence of black markets, capital flight, etc. These were certainly the starting condition in Russia in late 1991/early 1992, when the Russian government, with IMF assistance, decided to launch an economic stabilization program.[7]

As in other countries in crisis, the Fund very much saw its role in Russia as that of providing assistance to make the inevitable adjustment away from central planning less traumatic, more conducive to the long-run health of the economy, while providing financing and helping to generate additional resources from other creditors and donors in support of the government's program. The specific measures and overall aims and objectives were essentially the same as those pursued in dozens of other such programs: namely, to control inflation, to improve efficiency in resource allocation, and to help the country attain a more

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7 For a description of the starting conditions faced by the Gaidar government in late 1991, see: Augusto Lopez-Claros and Mikhail M. Zadornov, "A Decade of Russian Economic Reforms" www.zadornov.com. For a shorter version of the same article, see: The Washington Quarterly 25 (2002): 105-116.

sustainable balance of payments position. These objectives were sought because they were seen as essential conditions for sustainable growth and economic development.

While a discussion of the theoretical foundations of Fund programs is outside the scope of this paper, it is possible to provide a brief synthesis of the essence of the macroeconomic policy advice provided by the Fund to the Russian authorities beginning in 1992, when the first arrangement was negotiated and the government received its first $1 billion IMF credit. In essence, the Fund's policy advice consisted of four ingredients. First, an economy will be better prepared to adjust to shocks when greater scope is given to market forces. Second, financial policies must be geared to ensure a stable macroeconomic framework. Third, to improve competitiveness, the domestic economy must gradually integrate with the world economy. Lastly, policy reforms must be supported by regulatory and institutional improvements. Each of these four messages in turn brought with it fairly specific policy recommendations which were incorporated into the Fund's programs with the Russian government. A brief elaboration is useful, if only to highlight the key philosophical underpinnings of Fund advice in Russia.

The role of market forces

A system in which prices reflect relative scarcities in the market place was presented as one of the most effective instruments of adaptation, providing a decentralized system of signals and incentives for the allocation of resources. The Russian economy would be more dynamic and flexible, better able to cope with external shocks, if decision-making was decentralized and greater scope was given to market forces. Such flexibility was especially important for economies with sharply fluctuating export earnings on account of their dependence on a few primary commodities – oil, gas and metals in Russia accounting for about 80% of total exports. Price liberalization and an easing of administrative controls thus

became a key feature of Fund programs in Russia. The definition of price flexibility in the Russian context was quite broad, applying also to those prices having a direct bearing on the macroeconomic environment, such as the exchange rate and interest rates.

A stable macroeconomic environment

A stable financial environment was seen as essential for the successful implementation of other (so-called "structural") reforms, and the establishment of a macroeconomic environment supportive of private sector activity. Russia was to pursue prudent fiscal policies that allowed adequate levels of private sector credit while limiting the growth of total credit to levels consistent with non-inflationary growth in the money supply and a viable external position. Cautious fiscal and monetary policies that contributed to low inflation rates and a more stable domestic environment were also to contribute strongly to business confidence and the willingness of domestic and foreign investors to undertake investment projects. Government economic policies that reduced inflation and encouraged macroeconomic stability were thus to play a critical role in fostering economic growth in Russia. Lastly, policies were also to aim at maintaining a competitive exchange rate while establishing a liberal trade and payments regime in which private firms and investors would have free access to foreign exchange and imported goods, with the allocation determined by market forces rather than administrative means.

Integration with the world economy

A more outward-looking orientation was seen as an essential component of reforms in Russia. In addition to the well-known gains from international trade, relative openness and strong links with the world economy would impose on domestic producers the valuable discipline of international competition and provide opportunities for new exports. It would

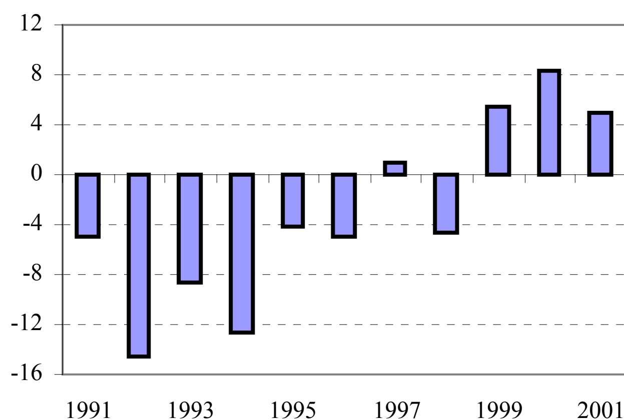
also serve as an important channel for absorbing technological advances from abroad. An open orientation would also attract much needed capital and expertise, thus enhancing the prospects for growth through increased efficiency. This approach was regarded as particularly important for Russia, given a long legacy of excessive state interference in the economy involving, for instance, the administrative allocation of foreign exchange and other regulatory requirements, the absence of a competitive banking system, inadequate expenditures for maintenance and investment in socially productive infrastructure, and the maintenance of inefficient public enterprises.

Institutional reforms

The gist of the advice here was as follows: the regulatory system, including, most importantly the tax system, needed to be freed from excessive intervention, arbitrary decisions, inconsistent application of rules and policies, all of which were likely to hinder business activity and slow the pace of private sector development. The ultimate aim was to be the establishment of a simple regulatory and tax framework based on transparent rules. Investment decisions, whether by domestic or foreign investors, involved issues of long-range planning; from the investor's perspective a well identified, simple, and stable set of rules would always be preferable to one perceived to be opaque and subject to unpredictable changes.

Chart 3: Real GDP

(% change)



The above summary is fairly consistent with the broad thrust of policy advice provided by the Fund to its member countries everywhere. Two points warrant further elaboration. First, the relative weight given to each of the various components described above will vary significantly across countries, depending on the particular circumstances of each individual member – the readiness and/or willingness of the authorities to carry out specific policies, the perceived priorities of the government, the staff of the Fund, and, in some cases and at various times, even those of the Fund's largest shareholders. In Russia, the overwhelming focus of the reforms was on macroeconomic stabilization. That is, to bring inflation down by restraining the budget deficit and, hence, the need to limit the scope for the authorities to take recourse to monetary financing. While there was discussion of other issues – trade liberalization and the unification of the exchange rate in mid-1992 come to mind as two areas where there was progress early on – these tended very much to take a secondary place to the goal of achieving price stability.8

8 For a fuller discussion of these issues, including the limitations of the Fund's "financial programming" approach to program design and the implications for the work of the Fund more generally see the author's 1996 paper "The Fund's Role in Russia", available at the Institute for the Economy in Transition's web site: www.iet.ru.

Second, while the content of Fund programs – as gleaned from a careful reading of the Letters of Intent of the four programs negotiated between early 1992 and early 1996 – would always contain key elements of the four broad policy areas identified above, this did not immediately translate itself into tangible policy reforms on the ground. Reflecting the Fund's focus on stabilization, its conditionality in Russia was overwhelmingly focused on traditional macroeconomic targets and parameters, such as: the net international reserve position of the Central Bank of Russia; the size of the budget deficit; the pace of expansion of "net domestic assets" of the central bank, a broad measure of liquidity used by the Fund to monitor credit conditions in the economy. Measures with a structural component requiring long periods of gestation for adequate formulation and design tended either to be largely ignored or, at best, allowed to lapse into future programs.

Thus, while the Fund's approach tended to be fairly broad on paper, in practice the *effective* policy content of its programs was rather more limited, with several glaring omissions. For instance, by failing to incorporate social protection elements in the early phase of the transition, to mitigate the sharp erosion in living standards for large segments of the population, the Fund ended up undermining the effectiveness of its overall approach. First, the government eventually realized that structural reforms were not central to IMF program design (in the specific sense of being incorporated as part of the Fund's conditionality *and* disbursements being actually withheld because of non-compliance) and that the policy focus would likely remain on the stabilization front: reducing the budget deficit, limiting the growth of credit, and so on. Not surprisingly, this led to a weakening of government resolve in this area. Second, lack of adequate progress on structural reforms delayed the economic recovery, prolonged the plight of vulnerable groups and ended up undermining public support for the reforms.

Explanatory Factors

One possible way to characterize the Fund' policy advice and lending operations in Russia is to say that while the broad thrust of the policies being advocated, however incomplete they may have been, was broadly appropriate, the whole approach fell captive to other considerations, either of a political or institutional nature. These might include: the inherent problems in trying to transform key theoretical insights from the development and economics literature into objective realities on the ground, in the context of a country undergoing major systemic changes; the role of strategic political factors and the perceived interests of some of Russia's most important bilateral partners; issues of IMF jurisdiction and, specifically, the inability of the Fund to force policy changes in fields outside its "traditional" areas of expertise; the limited administrative capacities of the government, which may have sharply limited what could objectively be achieved in the short-term. We look at each of these issues in turn and assess the extent to which they can be identified as factors that could explain the ultimate inadequacy of the Fund's work in Russia. This discussion has broader implications for the work of the Fund – for instance, its relations with other neighbouring countries in the Commonwealth of Independent States (CIS), several of which, having started the 1990s with zero external debt, may soon be joining the group of "highly indebted poor countries" – and the developing world more generally.

Theory Versus Practice

Partly as a result of falling levels of income per capita in Sub-Saharan Africa and rising income disparities everywhere, the last couple of decades have witnessed a remarkable broadening of the debate as to what are the ingredients of successful economic development. This debate has been particularly intense in connection with the lending activities of the World Bank and the Fund, the two central providers of development finance. Perhaps the

most tangible shift has been in the extent to which a calculated neglect of "soft-headed" concerns (to use Amartya Sen's characterization), such as the role of safety nets to protect the very poor, or the provision of political and civil rights, has given way to an approach that recognizes their importance and actually tries to incorporate them in the design of programs and development strategies.[9] Even in the IMF, for decades committed with single-minded determination to the notion that the best way to achieve macroeconomic stability is to better "manage aggregate demand" (e.g., to reduce the budget deficit, to restrain credit growth), the focus in a growing number of its programs has now shifted to creating the conditions for so-called "high quality growth," a term that explicitly recognizes the importance of policies aimed at reducing poverty, improving opportunity, and protecting the environment.

While this broadening of the debate is most welcome, it is legitimate to ask to what extent it has gone beyond the stage of "heart warming sentiments" (another Sen term), such as can be found, for instance, in the speeches of the heads of the international financial institutions, or other official policy statements. For it is only when poverty, equity, environmental and other such concerns get *explicitly* incorporated into the design and conditionality of economic programs financed by the development agencies that one can hope to begin to see the benefits on the ground, where it matters most. Regrettably, there continues to be a huge "gap" between theory and practice. The "gentler" approach to development advocated by Sen, the recognition, until recently, that we may have missed out on key elements of the development process and, hence, ill-served the interests of large segments of the world's population, has not yet been reflected in the day-to-day work of these organizations, particularly the IMF and especially during its decade-long involvement with Russia. A couple of examples will clarify the point.

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9 For a fuller discussion of these issues see: Amartya Sen, Development as Freedom (Oxford: Oxford University Press, 1999).

It is now universally accepted that macroeconomic policies can have significant effects on the distribution of incomes and thus on social equity and welfare. A responsible program must therefore take these effects into account, particularly as they impinge on the most vulnerable groups in society. Indeed, proper consideration of the impact of economic policy measures on the poor can produce stronger public support for a particular program, and thus improve its sustainability. The provision of nearly $22 billion of IMF loans to Russia during 1992-99 coincided with a pronounced deterioration in living conditions for the Russian population, including a catastrophic reduction in the value of the pensions received by 37 million pensioners, a full 25% of the population. While some deterioration in the standard of living was probably inevitable, reflecting the gradual elimination of distortions and rigidities inherited from the Soviet era, it also reflected massive failures in governance. On a number of occasions during this period the government, through the granting of tax exemptions to vested interests or the give-away of state assets through corrupt privatization schemes, deprived the budget of massive resources that sharply limited its ability to respond to growing social needs.[10] Many of these initiatives took place under the umbrella of fully operational IMF programs. So, in a very tangible way, with serious long-term welfare implications because of the rising external debt burden implied by IMF loans, the "new approach" to development, advocating the importance of good governance and transparency and the central role of the social safety net, was largely empty rhetoric in the case of Russia.

The opportunities that people have to determine who should govern them and on what principles and, more generally, the idea that the legitimacy and credibility of the government matter for the successful implementation of economic policies, is another of those ideas that

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10 For a listing of some of the most important tax exemptions in force in Russia during 1992-96, see: Augusto Lopez-Claros and Sergei Alexashenko, "Fiscal Policy Issues During the Transition in Russia," Occasional Paper 155, International Monetary Fund, March 1998, 18-21.

have become part of the emerging consensus on sound approaches to development. Only governments that have the credibility that is derived from periodic legitimization of power through elections and that have shown a minimum of competence in economic management have a fighting chance of putting to good use IMF loans and other non-concessional aid flows. And yet, the IMF has a long history of lending to governments barely (if at all) able to meet the most elementary standards of good governance. The period of fastest IMF lending to Russia was 1995-96, a period which coincided with some of the most glaring abuses in the management of public resources. A single tax exemption in place during this period, granted to the National Sports Foundation, Russia's largest importer of alcohol, tobacco, and luxury cars, deprived the Russian budget of the equivalent of $3-4 billion in annual revenue, a figure only slightly less than the magnitude of annual IMF financial support during this period.

Thus, there would appear to be an urgent need to rapidly bridge the gap between theoretical insights derived from development pioneers such as Sen, and the effective everyday practice of development practitioners like the IMF. The examples above do not reflect failures of economic theory or an inadequate understanding of what makes good development policy (although, surely, this is not to say that we have yet got the full picture right). Rather, they reflect failures of leadership, both by the governments who receive the aid and by the donor institutions who provide it. Ultimately, this gap must be narrowed in a major way if the international financial institutions are to remain relevant to the achievement of the mandate for which they were created: "the promotion and maintenance of high levels of employment and real income and the development of the productive resources of all members as primary objectives of economic policy" (Article I(ii), IMF Articles of Agreement; we come back to this issue in the last section of this paper).

Lending Driven by Strategic Considerations

There is a growing body of literature on the subject of who are the chief beneficiaries of foreign aid. Alesina and Dollar (1998) make several interesting observations about bilateral aid flows.[11] First, patterns of aid seem to be largely dictated by political and strategic considerations that have little to do with rewarding good policies or helping more efficient, less corrupt governments. Second, an inefficient, closed (in an economic sense), mismanaged, non-democratic former colony that remains loyal to its former colonizer, receives far more aid than a country with similar per capita income, better policies but without the equivalent colonial ties. Third, there is no evidence that foreign aid encourages the adoption of good macroeconomic policies. Fourth, foreign direct investment seems to be more closely correlated with the kinds of variables that one would like to see as basic elements of the institutional and policy framework of developing countries: political stability, democratization, a liberal trade regime, financial stability, a working judicial system and, more generally, the rule of law. Lastly, with the possible exception of bilateral aid provided by the Nordic countries, much of it is actually wasted or, worse, only serves to legitimize and keep in power people who would otherwise not deserve to be in power.

From this perspective, to the extent that narrow strategic/political interests figure less prominently in their decision-making process, multilateral aid may be better. The evidence that this was so in Russia is not compelling. By the mid-1990s, IMF lending to Russia was less driven by policy content and the associated conditionality than by geopolitical considerations defined by the Fund's largest shareholders. Indeed, during much of the 1990s the Fund was used as the main conduit for G7 support for Russian economic reforms. "Strategic" lending, however, brings with it a number of risks for the borrower. First, the strategic interests are those of the shareholder leaning on the multilateral institution to

11 See Alberto Alesina and David Dollar, "Who Gives Foreign Aid to Whom and Why?" NBER Working Paper No. W6612, June 1998.

proceed with the lending, *not* of the borrower. The interests of the borrower and, ultimately, the taxpayers who will carry the future debt burden, are very much an afterthought, if they enter at all into the picture. In Russia these interests were multidimensional; they reflected the desire by the Fund's largest shareholders to reward president Yeltsin's otherwise largely pro-Western foreign policy; the perceived need to prevent possible political instability in a country undergoing profound political and social change and armed with thousands of nuclear weapons; the apparent conviction that lending would strengthen the hand of reformist elements within the government who were sympathetic to free market policies (and who, the argument went, were fighting a rearguard battle against the forces of vested interests); the need to support president Yeltsin's reelection campaign in 1996, against the background of the growing public appeal of the Communist party, among others.[12]

Second, and perhaps more importantly, the focus of attention for the authorities shifts from how best to advance the economic policy agenda, to how best to make sure that the government does the minimum necessary to qualify for the next IMF tranche, given that a proper reading of the strategic considerations underlying the lending has convinced the authorities that the funds will be forthcoming in all probability. This type of consideration in Fund lending operations has ill-served the interests of the Russian public; we take up this issue further in the last section of this paper when the question of IMF reform is examined. Lastly, in times of crisis, such as after the treasury bill default in August of 1998, the countries at whose behest the "geo-politically inspired" lending took place have few options beyond expressing solidarity for the country's authorities, as the public gears up to pay back

12 That, by early 1996, the Communist Party should have been perceived by many within Russia as a viable political force is itself an interesting indicator of public disaffection with key elements of the reform process and the particular way in which it was being implemented.

the loans. In Russia's case, in early 2001, the German government was quite aggressive in rejecting (poorly articulated) Russian requests for debt relief on Soviet-era export credits.

Issues of Jurisdiction

Even if the two factors mentioned above had not been present in the background of multilateral lending to Russia during much of the 1990s, some would argue that the Fund, nevertheless, would have faced issues of jurisdiction in trying to push for reforms in specific areas. There are at least two aspects to this question. First, that the Fund has a limited mandate to impose conditionality on policies outside its traditional areas of expertise: Fund executive directors often remind each other during Board discussions of programs about "the monetary nature of the Fund." From this perspective, the Fund can push for a lower budget deficit, but cannot effectively press governments to introduce social safety nets or prevent the introduction of questionable privatization schemes. Second, the Fund has limited leverage to coerce governments to implement particular policies, even if it felt that these were essential for the success of the program. The Fund is ultimately a cooperative institution lacking in enforcement mechanisms that could ensure a particular outcome, much as a national central bank has, for instance, vis-à-vis the commercial banks under its jurisdiction. As regards "the monetary nature of the Fund" limiting the ability of its staff to venture into areas well beyond inflation control and deficit reduction: the point is largely irrelevant.

Monetary phenomena cannot be examined in isolation from other elements of the macroeconomy. If, in fact, the Fund has a mandate to promote "high quality growth" (and a careful reading of the Fund's Articles makes this an inescapable conclusion), then it cannot walk away from such issues as whether the government is reducing the budget deficit by building up wage and pension arrears, thereby alienating broad segments of the population and undermining its own credibility with the public, or whether the fiscal adjustment is being

made more onerous than would otherwise be the case because the government is giving tax breaks to well-connected lobby groups. When the Fund does so, as it most definitely did in Russia during the mid-1990s, the results are heartbreakingly disappointing.

It is an entirely different issue whether the Fund has the *expertise* to address effectively the broad range of concerns identified by Sen (1999) as part of an integrated approach to economic development. Here many would argue that where it does not, it would be better to leave these to other donors or to the authorities themselves. So, social protection issues, for instance, in which the Fund has limited expertise, might best be left to the World Bank and its lending operations. The problem with this approach is that the fast-disbursing nature of the Fund's resources gave the organization effectively far greater policy leverage vis-à-vis the government than the Bank ever had; indeed the Bank's leverage in Russia was often *derived.* The more important point here is that if strengthening the social safety net was seen as essential to ensure the sustainability and efficiency of Russia's transition to a market economy, then the international financial institutions should have organized their lending operations (including associated conditionalities) during the 1990s so as to ensure this outcome.

That this expertise was not immediately available among the Fund staff is hardly relevant. Such expertise exists and it should have been brought to bear in the design of Fund programs – a tiny fraction, say 0.1% of the total amount disbursed by the Fund, is still a very large sum, which could have financed the creation of a high-level task force of the world's best experts.13 That it was not reflects mainly lack of recognition on the part of Fund staff and management of the central role of social equity issues to successful economic development. Similar comments apply to other elements of Sen's agenda, including the

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13 Indeed, there were a number of governments who would have been only too willing to defray the bulk of these costs out of their international technical assistance budgets.

whole range of issues that fall under his category of "transparency guarantees." That loans-for-shares privatization was not stopped by the Fund in its tracks had nothing to do with the inability of its staff to adequately gauge the inefficiency of opaque ownership schemes; it had much more to do with Fund staff and management not thinking that it was a particularly deleterious policy, certainly not one that would have warranted stopping monthly disbursements of debt which continued without interruption as loans-for-shares got underway. Thus, in the end, it represented a massive failure of governance on the part of the Russian government for coming up with a corrupt privatization scheme and of the Fund, who could have stopped it but chose not to.14

Administrative capacities

Some would argue that the ability of the international financial institutions to design more elaborate programs was constrained to some extent by the limited administrative capacities of the Russian government. This reflected a number of interrelated factors: during the Soviet period the exceptionally talented made their way into the military industrial complex, not the civil service. By the time the Soviet Union was dissolved, much of the top echelons of the Union administrative cadre were on their way out, leaving government service altogether and opting for new careers in some form of private sector activity. This was a particularly serious problem in 1992-93, the early phase of Russia's transition. Faced with a serious dearth of suitably qualified personnel, with relevant administrative and managerial experience, the Fund and the Bank did what they could in terms of policy design and implementation.

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14 In what is surely a bitter irony, the scheme's chief protagonists on the Russian side were some of the same "reformers" on behalf of whose efforts much of the "strategic" lending took place.

Our own view is that while this was a serious problem at the outset of the transition, by the mid-1990s staffing pressures had been considerably relieved in key sectors of the public administration. In any event, the Fund's leverage to elicit policy responses from the government was not uniform throughout the six-year period over which the $22 billion of financial assistance were disbursed. As is clear from Chart 2 total Fund disbursements during the three year period through end-1994 amounted to $4.2 billion, three quarters of it disbursed in two tranches under the Systemic Transformation Facility, a low conditionality financing window specially created to assist countries in the early stages of the transition. The Fund's real leverage began in early 1995, with the negotiations of the first standby arrangement which contemplated monthly program monitoring and disbursements and much higher levels of access to Fund resources. Russian debt to the Fund in the next two years nearly tripled and the staffing constraints which had plagued the early period were much relieved. In those areas where it felt that the administrative capacities of the government or the central bank needed to be strengthened through technical assistance, the Fund had no problems making provisions for it. This was particularly the case at the central bank and the treasury, in a broad range of areas deemed to be essential for appropriate monitoring of monetary and expenditure control operations. Presumably expertise in other areas could likewise have been boosted through the timely provision of relevant technical assistance.

Reforming the IMF

The latest events in Argentina raise, once again, serious questions about the current approach to crisis management in emerging markets, the chief characteristic of which seems to be large-scale improvisation and ad hoc arrangements with costly social and political

repercussions.[15] The IMF has found itself in the middle of each of these debacles, and questions about its effectiveness have been raised every time; indeed some have argued that the organization is no longer needed in an environment of largely floating exchange rates. It is clear, however, that because today's world is one of closely integrated markets and in which linkages are becoming evermore complex, an institution that will have sufficient resources to deal with occasional episodes of financial instability and that will help cushion or prevent the effects of future crises is indispensable. Some ideas follow on the sort of reforms that could make the world's only "financial peacekeeper" a more effective crisis manager.

As presently structured, the IMF falls far short of the role played by central banks in national economies. Like a national central bank, it can create international liquidity through its lending operations and the occasional allocations to its members of Special Drawing Rights (SDRs), its composite currency. Thus, as Richard Cooper has pointed out, the IMF already is, in a limited sense, a small international bank of issue. As seen during much of the past decade, beginning with the Mexican crisis in 1994/5, the Fund can also play the role of "lender-of-last-resort" for an economy experiencing debt-servicing difficulties. But the amount of support it can provide has traditionally been limited by the size of the country's membership quota and there is obviously an upper limit on *total* available resources; at the end of 2001 this amounted to some $90 billion, a relatively small sum, equivalent to less than 1% of cross-border claims of BIS reporting banks.

In addition to the paucity of resources, which do not allow the Fund to respond to more than a handful of crises in a few medium-sized countries, there are other serious structural flaws in its lender-of-last-resort functions. To begin with, its regulatory functions

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15 This section draws from other work being done by the author on crisis management in emerging markets and the future of the international financial system.

are extremely rudimentary. Its members are sovereign nations that are bound, in theory, by the Fund's Articles of Agreement, but the institution has no real enforcing authority, other than some limited functions through the "conditionality" it applies to those countries using its resources. In particular, the Fund has no authority to enforce changes in policies when countries are engaged in misguided or unsustainable policy paths but are otherwise not borrowing from the Fund—this was the case with the Asian countries in 1997. What little enforcement authority the IMF does have is sometimes eroded when the country in question has a powerful patron, who may try to persuade the Fund and its managers to exercise leniency or "turn a blind eye" if policies appear to be going awry. Contrast this situation with that of a typical national central bank, which has enormous leverage vis-à-vis the commercial banks under its jurisdiction when making resources available to them, particularly in the midst of a crisis. The IMF simply does not have an analogous authority at the international level vis-à-vis the countries that are eligible to use its resources.

There are a number of possible ways to deal with these shortcomings. One proposal is to create an International Financial Stability Fund, to supplement IMF resources. This would be a facility that could be financed by an annual fee on the stock of cross-border investment; a 0.1% tax could generate, according to Edwin Truman, a former Assistant Secretary at the U.S. Treasury, some $25-30 billion per year, which could then be used over time to create a $300 billion facility.[16] This would deal with the relative scarcity of IMF resources and would partially de-link its lender-of-last-resort functions from the periodic allocations of national currencies that currently form the basis of IMF liquidity growth. An alternative proposal would give the Fund the authority to create SDRs as needed, as a national central bank can in theory, to meet calls on it by would-be borrowers.

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16 Edwin M. Truman, "Perspectives on External Financial Crises," Institute for International Economics, December 2001.

When this idea was first put forward, in the early 1980s, concerns were raised about the possibly inflationary implications of such liquidity injections, but international inflation was a serious problem then in ways that it is clearly not one today and measures could be introduced to safeguard against this. This, of course, would involve giving the Fund considerably more leverage vis-à-vis the policies of those countries willing to have much larger potential access to its resources. Nobody questions the right of central banks to have a major say over the prudential and regulatory environment underlying the activities of the commercial banks under their jurisdiction; it is seen as a legitimate counterpart of its lender-of-last-resort functions. A much richer Fund would, likewise, have to have much stronger leverage and independence.

The above says nothing about the kinds of policies which the IMF advocates and whether these are generally welfare enhancing or not. The recent crisis in Argentina, as well as earlier devastating episodes in Russia and Asia, have generated heated debates as to whether the IMF is part of the problem, part of the solution, or a bit of both. Whatever be the justice of these respective positions, it is clear that giving the Fund potential access to a much larger volume of resources would have to be accompanied by significant internal reforms, both in terms of the *content* of the policies it advocates, as well as its internal *management*. Both areas have received scant attention in the past decade, with the focus having largely been on the type of facilities through which resources are made available and the bureaucratic underpinnings of each.

It is becoming increasingly clear, however, that at least some of the instances of unsuccessful intervention by the IMF in recent years (that of Russia springs most readily to mind, though Paul Krugman thinks Argentina qualifies as well) may reflect less lack of resources and more old fashioned policy mistakes, arising from the Fund's own intellectual biases, its particular views as to what makes for good economic policy, and the vagaries of its

internal decision-making processes, which suffer from a number of serious flaws. As noted above, in Russia the IMF disbursed some $22 billion of debt between 1992 and 1999 but, clearly, without eliciting much in the way of policy reforms in return. Indeed, six years of IMF involvement collapsed in August of 1998 and, along the way, with the cognizance of the IMF, the government was allowed to give away its best assets under extremely corrupt privatization schemes. Simultaneously, as noted earlier on, the Russian population endured a more pronounced decline in living standards than was warranted by the elimination of some of the distortions of the central plan, greatly undermining public support for market-oriented reforms. During a visit to Moscow last year a senior IMF official characterized the 1995 standby arrangement as "very successful" and "a key achievement" because inflation came down. The consensus in Moscow, however, remains that the 1995 program was an "unmitigated disaster;" for what virtue could there be in bringing inflation down (temporarily -- it came back with a vengeance after the collapse of the ruble in 1998) if this is at the cost of the state building up massive wage and pension arrears, thereby signaling to tax payers that, since the state fails to fulfil its own obligations, others may legitimately follow suit?

So, if the Fund is to be given more of the functions of a lender-of-last-resort to the likes of Argentina, Turkey, and Russia, then it needs a new philosophy, bringing into the centre of its programs (and its conditionality) the kinds of concerns and policies which, so far, it has only tended to espouse in theory. In their public speeches the Fund's top managers speak of transparency, social protection, good governance, and "high quality growth," but they have not yet managed to incorporate these laudable aims into IMF program design. Indeed, it is becoming increasingly evident (as the crisis in Argentina has dramatically demonstrated) that only programs perceived as meeting actual needs and as being just and equitable in their objectives can hope to engage the commitment of the people, upon whom successful implementation ultimately depends. By this yardstick, most IMF programs yield

distressingly disappointing results. Not surprisingly, the Fund finds itself increasingly at the center of ineffective programs, blamed for the failure of its policy prescriptions.

Easing the task of evolving new paradigms of intervention, a wealth of illuminating material already exists in the field. A perusal of Sen's *Development As Freedom* provides a compelling list of the ingredients of a successful approach to economic development, soon bearing home upon the reader that fiscal austerity is not the sole remedy available. Indeed, as UK Chancellor of the Exchequer Gordon Brown recently noted, the assumption that "just by liberalizing, deregulating, privatizing and simply getting prices right, growth and employment would inevitably follow" has "proved inadequate to meet the emerging challenges of globalization."17

A broadening of the policy content of Fund programs, to meet the challenges of Sen's much wider vision of successful development, to be credible, would need to be accompanied by a structural reorganization, whereby the Fund's shareholders assigned it a greater measure of intellectual independence, making it at the same time more accountable for the consequences of its decisions. It would seem desirable to separate the Fund's surveillance activities from its decisions in respect of lending, so that glaring conflicts of interest might be avoided. Gordon Brown's call for a "more transparent, more independent and, therefore, more authoritative" Fund is certainly a step in the right direction, as is his call for new approaches to sovereign debt restructuring and the implementation of code standards for fiscal, monetary and other policies, to diminish the likelihood of future crises. In these discussions the focus should overwhelmingly shift to crisis prevention rather than crisis resolution.

But even an updated set of policy prescriptions is unlikely to suffice without corresponding reforms in the internal workings of the organization. As a preliminary

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17 Speech given by Chancellor of Exchequer Gordon Brown to the Federal Reserve Bank of New York, 16 November 2001.

measure, the international community might finally break with the convention adhered to ever since the IMF's creation, which establishes that its managing director must be an EU citizen. (A similar recommendation applies to the World Bank, whose president has traditionally been a U.S. citizen). The organization is too important and its mistakes too socially costly for the nationality of the candidate for Managing Director to be the determining factor in assessing suitability for the job. The unseemly negotiating process that is entered into every few years as efforts are once more set in train to locate the most suitable candidate from a specific country is inherently offensive to the peoples of those countries who have to endure the rigors of IMF austerity; not to mention that it exemplifies that very inefficiency which IMF officials are quick to condemn in dealings with the Fund's member countries. (Doubtless the practice could not be sustained under present-day judicial codes, embodying as it does the particular conceptions of a world recently emerged from the trauma of world war). Another desirable reform along these lines would be to accord the managing director a non-renewable fixed term of service, thereby freeing him from the conflict that may otherwise result between the interests of those who hold his appointment in their hands, and the countries which it is his mission to serve: in this way, he may never feel himself under pressure to forgo his principles by reconciling these divergent stances.

On this question of the controlling interest in the organization, it may be noted that the salaries of the Fund's managing director and of its entire staff (as well as other administrative expenditures) are financed precisely by the interest paid by tax-payers in Argentina, Turkey, Russia and other users of Fund resources. Whereas IMF lending operations have no budgetary implications for members such as the U.S. and the EU – indeed they earn a return on their SDR reserve assets – a country such as Russia, by contrast, has paid, since August 1998, over $3 billion in interest charges on previous Fund loans. Such a circumstance alone, one would think, might go some way to counter the existing notion that, because the large

shareholders "contribute" more to the organization, they are in some manner entitled to oversee its operations as well, particularly since they have already the largest voting shares at the IMF Board.

This raises a second observation: namely, that increasingly there is a tendency for the markets, borrowers and other economic agents to view the Fund as subservient to its main shareholders, a proxy of G7 foreign policy or, worse, as Paul Krugman recently expressed it, "a branch of the US treasury."18 Such a perception is deeply damaging to the organization's ability to act effectively. It encourages countries to gauge their relationship with the IMF in terms of short-term political advantage rather than of lasting economic gain. In Russia, for instance, in the mid-1990s, the government realized that "the money was coming in any event"; the will for policy reforms died at about the same time. A similar calculation may be underway in Turkey at the moment, as the country amasses a mountain of debt to the IMF at a vertiginous pace, breaking and confounding all previous historical parameters that linked the amount of external funding to the scale of the policy adjustment, and destroying the long-respected Fund principle of equality of treatment across its member countries.19

The present organizational structure has implications too for the Fund staff, who cannot under the present regime be held accountable for policy miscalculations. Deprived of

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18 See: Paul Krugman, "Argentina's Crisis Is a U.S. Failure," The International Herald Tribune, 21 January 2002.

19 To put things in perspective, consider the following statistic. Were Argentina later this year to return to the Fund with a coherent economic program and ask for levels of access to IMF resources broadly similar to those granted to Turkey, it could qualify for a $50 billion loan, equivalent to about 60% of total net uncommitted usable IMF resources. Nobody thinks that Argentina would ever be given a credit of this magnitude, no matter how ambitious and comprehensive its program. However, by end-2002 Turkey could well account for 35-40% of the total debt of the entire IMF membership. As in Russia, one can be sure that long after the Fund is no

full freedom to make intellectually independent assessments, inasmuch as the controlling influence rests with the large shareholders, who, as indicated, may be answerable to various "strategic," meaning political, interests of their own, they are constrained to represent themselves merely as executors – not a role calculated to enhance their standing with their counterparts in the Fund's member countries. And to the extent that they be viewed by the countries concerned as mere functionaries, their ability to act more generally as advocates for change will be impaired.

Emerging from the 1944 Bretton Woods conference at which both the IMF and the World Bank were created, John Maynard Keynes expressed the view: "As an experiment in international cooperation, the conference has been an outstanding success." The world has changed beyond recognition in the meantime, and, with the emergence of one global economy, the case for an institution that will help further the cause of international cooperation and be identified with the promotion of economic policies supportive of improved efficiency and equity has only become stronger. Conditions seem now propitious for the convocation of a global conference of heads of state to consult upon the policy and institutional requirements for a more stable world financial system in the era of globalization. How to promote better ownership of programs, and how to engage more effectively in the decision-making process the countries most affected by such crises are clearly two central questions that would need to be addressed. Indeed, the time may be fast approaching for a new Bretton Woods conference aimed at turning our two premier development organizations into more flexible and effective instruments for the promotion of global welfare.

Conclusions

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longer an active lender, tax payers will be making the necessary sacrifices to repay more than $30 billion in IMF loans.

There are at least three ways to look at the role of the international financial institutions in Russia during the past decade. Due to the unprecedented policy leverage which the IMF enjoyed during some of the most critical periods of Russia's transition, the much larger volume of resources it provided, their fast-disbursing nature, and the relatively shorter repayment periods (which put a heavier burden on efficient utilization of the loans), this paper has focussed on the operations of the Fund. The Fund can be seen to have provided assistance to the Russian government in three broad areas. First and foremost, the Fund was the principal financier of the government; this role was particularly intense during the three-and-a half-year period from early 1995 to July of 1998, when a total of $17.5 billion of debt were disbursed. Second, the Fund provided technical assistance to the central bank and other public sector institutions, both in the context of policy formulation during program negotiations and program implementation and through the provision of external advisors with specific terms of reference (e.g., assisting the State Tax Service in tax administration issues; the central bank in monetary operations). Third, membership in the Fund opened to the Russian authorities new avenues of international cooperation; for instance vis-à-vis CIS neighbours, for which Russia was the most important trade partner and creditor.

Of these three forms of assistance by far the most "valuable" was the technical assistance component, particularly that part of it that was focused on specific needs and delivered at particular institutions. The value of technical assistance provided in the context of program negotiations and subsequent implementation is more difficult to gauge. Some of it clearly forced government officials to look at policy reforms at an earlier stage; the Fund was certainly a useful catalyst in focusing government attention on priority areas and assisting in the design of plans and strategies. That many of these subsequently fell captive to government inertia, the power of vested interests, or administrative limitations in the public sector does not take away the fact that the *process* of formulating policies, identifying

priorities and imbedding these within a consistent program framework were useful in themselves. So, the purely non-financial aspects of Russia's evolving relationship with the international financial institutions, involving mainly an intellectual dialogue on the policy requirements of economic reform, may be one of the more enduring and valuable aspects of the IFIs involvement in Russia during the first decade of the transition. That membership in the Fund and the Bank also opened avenues for the interaction by senior Russian officials with their peers abroad on issues of international economic cooperation is another aspect worth highlighting and contributing in tangible ways to accelerate Russia's integration with the global economy.

Whether it was necessary for the Russian government to acquire $17.5 billion of debt along the way (we exclude here the amounts disbursed during the period 1992-94 which were relatively small and for which the policy reform component was not insignificant)[20] is a separate issue altogether. It is this author's assessment that, on balance, the effects of large-scale Fund financing during the period 1995-98 were largely detrimental. First, because the government used IMF loans as a substitute for tax collection; as noted above the revenue/GDP ratio fell drastically over this period, under the weight of tax exemptions, tax arrears and offsets, and the pernicious effects of expenditure sequestration.[21] Indeed, the period of largest Fund financial support coincided with the most severe erosion in the ability of the state to collect taxes and in the willingness of corporations and households to pay them. Second, because this large scale funding brought with it very little in the way of actual economic reforms. To the extent that Fund lending largely reflected the strategic

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20 For instance, the 1992 program, involving a one-time disbursement of $1 billion brought with it the unification of Russia's inefficient and corruption-ridden system of multiple exchange rates.

21 For a discussion of the effects of budget execution and, in particular, expenditure sequestration, on the willingness of corporations and households to pay taxes, see Lopez-Claros and Alexashenko, "Fiscal Policy Issues During the Transition in Russia," 29-34.

considerations noted earlier on, it was much easier for the authorities to lobby their G7 patrons for "Fund flexibility" in interpreting the program's agreed conditionality (or for the prime minister to lobby the Fund's managing director), than, for example, to eliminate tax exemptions or collect taxes due from the energy or metals sectors.

Third, because there were no safeguards in place to ensure that the resources disbursed would be efficiently utilized. Much of IMF lending during this critical period involved direct support to the federal budget (as opposed to international reserve build up at the central bank); once the tranches were released it was left to the government to decide how to allocate the funds. Since during much of this period (1995-98) the government was mainly able to finance only the payment of wages and interest payments on the public debt, one can infer that little of it went to finance productive investments aimed at enhancing the economy's growth potential. Lastly, since IMF funds were loans, after 1998 the country was left with a $28 billion future claim on the budget (including interest charges), payable through 2008. That Russia has since been able to fulfil its financial obligations to the Fund on a timely basis is more a reflection of the sharp recovery of oil and other commodity prices which began in early 1999, than the delayed effects of IMF reforms. Both the Russian budget and the Fund's reputation were thus "saved" by higher oil prices; not a particularly cheerful commentary to characterize the Fund's ten-year involvement with Russia.