IMF, Macroeconomic Stabilization and Currency Crises in selected CIS Countries*

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Introduction

The IMF has supported the transition process in a number of FSU countries[1]. This support involved concessionary financing, policy advice and technical assistance. Notwithstanding temporary conflicts, the cooperation between the Fund and FSU countries throughout the period was described by the Fund as generally successful. It was argued that it contributed to the macroeconomic and financial stabilization[2]. Yet, the financial crisis of 1998 wiped out this stabilization and proved that previous policies were fully unsustainable. This paper attempts to answer the crucial question why countries collaborating closely with the IMF and implementing policies supported by the Fund had to undergo deep currency crisis. The question is made more intriguing by earlier research[3] showing that this was a first-generation crisis – that is, one caused by bad policies that led to macroeconomic imbalances. While the core of the problems was domestic, deterioration of external conditions was the trigger that started the inevitable collapse. True, it is also well understood now that vested interests, insufficient structural reforms and lack of political will were crucial factors preventing necessary policy adjustments. But has the Fund influenced the pace of structural reforms and fiscal tightening? Should the IMF have been more insistent on reforms through tighter conditionality or have allowed for more reform ownership? Finally, should it have withdrawn long before 1998 and not underwritten unsustainable policies?

Before we proceed with addressing these questions we would like to make a short comment on the methodology. In order to evaluate the impact of the IMF program on the economic situation we have to distinguish some specific questions. First, the original design of the program (assumptions and targets) and its adequacy for the economic problems of the countries under investigation are discussed. Second, the implementation of the program is evaluated, especially the compliance with the performance criteria. Third, if the IMF chooses to support the program even though some of its key parameters are breached, we conclude that the Fund is still sharing ownership for the final outcome. One of the advantages of case studies, as opposed to large multi-country studies[4], is the ability not only to test the significance of the sheer existence of the program but also to better evaluate its key parameters and consider the quality of its implementation. At the same time we believe that the group of countries under investigation – Russia, Ukraine,

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[2] The large majority of IMF documents related to the programs in transition economies (at least until the 1998 crisis) began and concluded with the praise of stabilization achievements and progress in structural reforms. Compare: IMF (MEP, LI, A4C, RED, SP), Camdessus (1994) and Fischer (1998).

[3] See Antczak (2000), Markiewicz (2000), Radziwill (2000) and also Siwinska (2000).

[4] See Haque and Khan (1998) for discussion.

Moldova, Georgia and Kyrgyzstan (RUMGK) – is large and diversified enough to allow for some generalization of results.[5]

There is also a problem of the baseline scenario against which one can compare the outcome of IMF-supported programs. In the literature[6] there are three major approaches. The before and after approach simply compares the situation in the country before and after the adoption of the IMF-supported programs. This approach is imperfect especially if the country has faced an important exogenous shock or had to undertake fundamental changes in its economic structure. For that reason, this approach is not suitable for the evaluation of programs in transition economies. Another popular approach is to compare countries that adopted the IMF program with countries of similar characteristics (in terms of economic structures and exposure to external shocks) that did not. In the case of FSU countries there is no such control group as virtually all transition countries cooperated with the IMF[7]. The only theoretically reliable method of assessing the impact of this program is based on the construction of the counterfactual scenario: "*comparing the macroeconomic outcomes of a program with the corresponding outcomes obtained under an alternative set of feasible policies is the most appropriate way of judging the effects of programs. However, the difficulties involved in using this criteria should not be underestimated*[8]". Actually this approach is especially difficult in the case of transition countries. With a newly emerging and constantly changing structure of the economy, it is impossible to build a full structural model of the economy. However, throughout the discussion of the political economy of reforms and moral hazard we cannot avoid asking "what if…". The last methodological point is more trivial and relates to scarcities of data. As details of program arrangements, at least until 1998, were generally confidential, it was "*extremely difficult for outside observers to prepare a serious quantitative analysis appraisal of IMF policies*". [9] We try to overcome the problem through extensive use of published materials and materials released by the governments of the countries in question.

The remainder of this paper is organized in the following way. Chapter one presents the character and main causes of the currency crisis in CIS countries. Chapter two discusses what impact IMF policies could have had in crisis prevention. It also presents the general logic of IMF programs and prior experience of the Fund that contributed substantially to the way it handled cooperation with transition countries. Against this background, chapter three describes the design and scale of the IMF programs in the region. Chapter four identifies program deficiencies and shows their impact on the policies. Chapter five concludes by commenting on the institutional factors that could have contributed to these weaknesses.

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[5] The choice of the group of CIS countries was also related to personal experiences of authors, who had been working as advisors to the governments and central banks in respective countries.

[6] Ibid.

[7] Among 26 transition countries, only Turkmenistan did not have at least one IMF-supported program.

[8] Haque and Khan (1998).

[9] Jeffrey Sachs, cited in Bandow and Vasquez (1994).

The nature of crisis in CIS countries

From a number of broad types of economic and financial crisis that can be distinguished[10] currency crisis occurs when there is a speculative attack on the domestic currency. Banking crisis refers to a actual or potential bank runs or failures that induce banks to suspend the internal convertibility of their liabilities or which compels the monetary authorities to intervene to prevent this by extending assistance on a large scale. Debt crisis is a situation in which a country cannot service its obligations foreign or domestic, or both, whether sovereign or private. Balance of payment crisis is a structural misbalance between deficit in current account (absorption) and capital and financial account (sources of financing) that after exhausting international reserves leads to a currency crisis.[11] Systemic financial crisis may involve these types of crises that are not mutually exclusive, but any of these crises does not necessarily lead to a full-scale systemic financial crisis. Elements of currency, banking, debt, and balance of payment crises may be present simultaneously, because they imply some degree of causality.

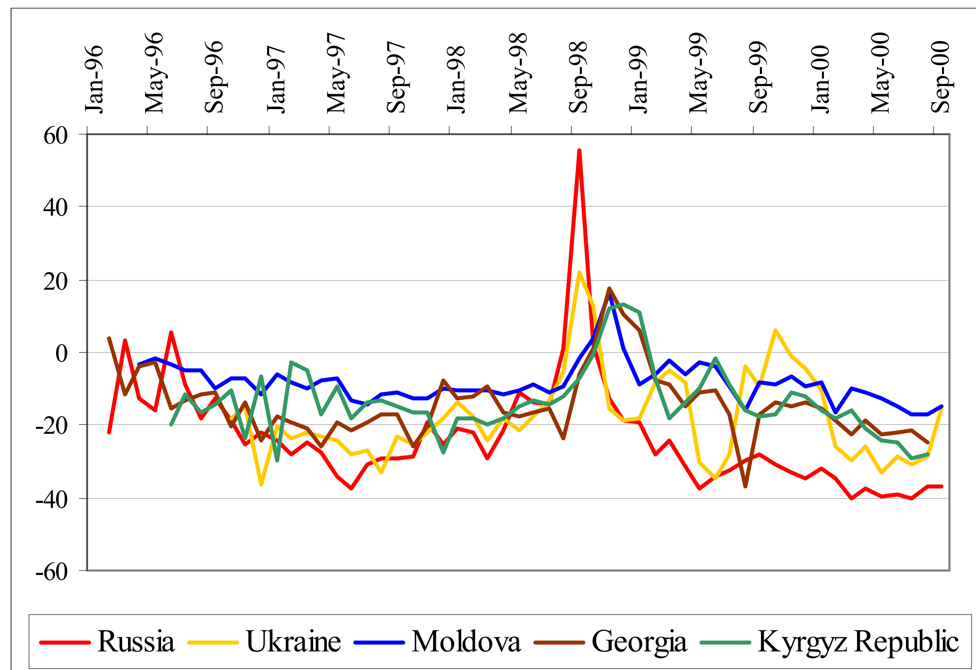
Russia, Ukraine, Moldova, Georgia, and Kyrgyz Republic experienced a typical currency crisis. The underdevelopment of financial markets in most CIS countries except foreign currency market made fully-fledged financial crisis in Ukraine, Moldova, Georgia, and in Kyrgyz Republic practically impossible. Only Russia has experienced elements of banking panic, bankruptcy of banks, and massive sovereign and non-sovereign debt default. The currency crisis in RUMGK is defined according to the Eichengreen, Rose, and Wyplosz [1994] index of exchange market pressure (EMP). The EMP index combines all channels of speculative pressures on financial markets: exchange rate volatility, changes in international reserve, and interest rate differentials.[12] The arbitrary chosen threshold of speculative pressure resulting in a currency crisis is a period (month in our sample) in which EMP is at least one and a half standard deviation above the sample means. Additionally, to exclude high volatility of financial markets in CIS countries we require at least two months of pressure on markets. It is indicated by positive value of the EMP index (see, Figure 1). According to that rule, Russia has experienced currency crises from August to October 1998, Ukraine from September to October 1998, Moldova from October to December 1998, Georgia from October 1998 to January 1999, and Kyrgyz Republic from November 1998 to January 1999. If over a year has passed when the Asian crisis (devaluation of the Thai bath on July 2, 1997) reached Russia (August 17, 1998) contagion and spillover effects were almost immediate in Ukraine (September 5, 1998) that in Moldova and Georgia (October 1998), and finally in Kyrgyz Republic (November 1998).

[10] World Economic Outlook (1998).

[11] Balance of payment crisis is often treated as a synonym of a currency crisis as the first-generation model of crisis results from balance of payment crisis.

[12] The foreign currency is the U.S. dollar and the interest rate differential is a difference between domestic money market rate and the Fed rate. Reserves are net international reserves of monetary authorities in U.S. dollars without gold. The weighted average of the three components has the same weights for all five countries and is necessary to equalize their high volatility and prevent any one of them from dominating the index.

Figure 1: The index of exchange market pressures in Russia, Ukraine, Moldova, Georgia, and Kyrgyz Republic, 1996-2000



Source: IMF IFS, authors' calculations.

The currency crisis that affected FSU countries in 1998 can be convincingly explained by fundamental macroeconomic imbalances.[13] Loose fiscal policy and the lack of structural reforms resulted in unsustainable internal and external positions. Without rapid policy adjustments, this situation had to lead to a financial crisis. For Russia the turmoil in financial markets following the Asian crisis in 1997 combined with the falling prices of oil constituted the trigger that revealed existing imbalances and especially the accumulation of debt service liabilities. For other countries, the clear contagion pressures from Russia (operating both through the trade and financial market channels) led to open crisis only in economies with similar fundamental weaknesses. Among these weaknesses the most easily visible was a deep fiscal deficit.[14] Fiscal imbalances were permanently very large in all five countries studied here, with the possible exception of Ukraine, where the deficit was not above 5 percent of GDP since 1995. Figure 2 presents deficits on cash basis. Commitment deficits in Russia, Ukraine and Moldova were even larger in the period preceding the crisis, as policies in these countries led to systematic accumulation of expenditure arrears.

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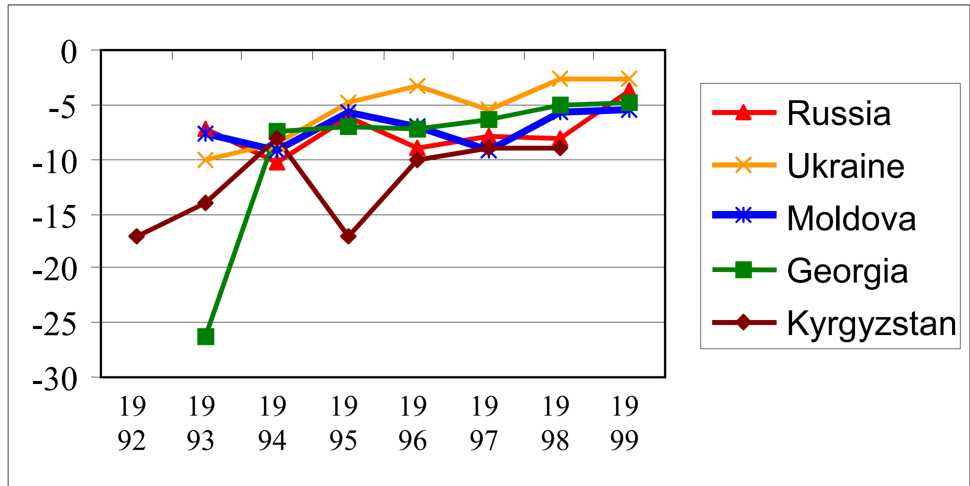
[13] Compare footnote 3.

[14] Dabrowski (1999b) writes, "*Experience of transition process gives a lot of evidence that fiscal policy performance reflects a quality of economic policy and systemic reforms in the specific country. Any inconsequence of the conducted policy, delay in transition on the microeconomic level, weakness of government institutions and favorable political climate for intensive rent seeking negatively influence fiscal balances. Thus fiscal equilibrium depends not only on the fiscal policy itself but also on the speed, quality, and consequence of overall reform process.*"

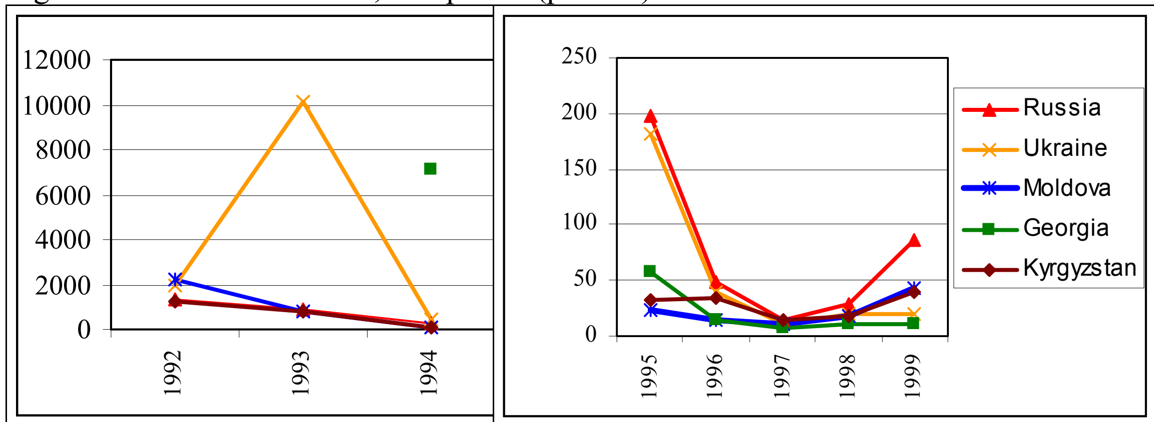
Figure 2: General government balance (the cash basis), percent of GDP



Source: IMF (RED).

However, even under fiscal policy that is unsustainable in the longer run, short-term monetary stabilization can be achieved. This was accomplished by stabilizing exchange rates in Russia, Moldova, Georgia, and Kyrgyzstan beginning in mid-1994, and in Ukraine beginning in mid-1995, and lasted until the August 1998 crisis. Stable exchange rates were maintained at the expense of central banks interventions (especially in Russia and Ukraine), while foreign currency reserves were replenished by disbursements from the IMF. The proceeds from sale of reserves served in turn as a source of budget deficit financing in these two countries. Moldova, Georgia and Kyrgyzstan relied mainly on government official transfers and contracted foreign debt to support exchange rate stabilization and finance budget deficits. As a result of exchange rate based stabilizations and external sources of deficit financing CPI inflation (and inflationary expectations) in RUMGK was lowered to moderate levels during 1995-1998. Low inflation rates and stable exchange rates also allowed for issuance of treasury papers to residents and non-residents to attract foreign portfolio investors to finance fiscal deficits.

Figure 3: CPI inflation rate, end-period (percent)



Source: IMF (RED).

Changing the pattern of deficit financing was a step in the right direction but was not followed by the hard budget constraints necessary for the market economy to function properly. This inconsistency led to accumulation of high debt burdens with an unfavorable structure (i.e., a large share of short-term liabilities held by non-residents). The prevailing view at the time was that deficits in transition could be accepted as long as they are caused by transitional expenditures.[15] However, the primary reasons behind fiscal deficits in the countries under investigation were delay in fiscal reforms and maintenance of pre-transition budgeting practices, and not the costs of reforms. As a result, additional resources and time were lost: foreign financing was used for current spending and not for implementing necessary reforms.[16] This left the countries extremely vulnerable to change in risk perceptions on international financial markets.

When the currency crisis already happened in 1998 its economic consequences and economic costs were tremendous for all countries in our sample. As a result of depreciation costs of debt service increased rapidly crowding out other budgetary spending, including social protection. Dramatic fiscal adjustments brought by lack of borrowing opportunities were inevitable anyway, however the prioritization of expenditures was scant and sectors that suffered the most were health and education. Still most of countries could not service the debt fully and consequently their access to the international financial markets was stopped for many years. While it may be even advantageous for the government sector not to accumulate further external debt, the real sector was affected, as domestic firms are still not able to raise international capital in order to restructure and update production facilities. On the other hand fall in imports were accompanied by dramatic decline in consumption (including imported foodstuff, medicine and energy) and the poverty gap widened abruptly, while unreformed social safety nets could not respond to the pressure adequately. Banking sector crisis in Russia put additional burden on depositors and individuals in all countries lost large part of their savings in national currency as inflation peaked. But probably the largest single cost in the medium term would be the dramatic increase in indebtedness due to exchange rate depreciation, especially for the group of smallest countries. The heavy debt burden might limit prospects of growth for many years to come.

Table 1: Projected vs. actual debt in 1999

	Moldova		Georgia*		Kyrgyzstan**	
	projected in 1996	actual	projected in 1996	actual	projected in 1997	actual
External debt as % of GDP	25	80	24	63	67	112
Debt, US$ mln	978	1041	1861	1720	1292	1382
GDP, US$ mln	3912	1304	7754	2728	1928	1232

Source: IMF and WB (2001).
* There was revision of GDP methodology in Georgia after 1996. ** Excludes non-guaranteed debt.

[15] Compare Sachs (1994). For the contrary view see: Dabrowski (1995).
[16] Dabrowski (1999a).

The Role of the IMF

The crises in the region have originated mainly from irresponsible fiscal policies. Therefore, the role that the IMF played needs to be evaluated on the basis of the impact that IMF-supported programs had on the fiscal stance. This impact could be made through the following methods for correcting imbalances:

- tight performance criteria (ceilings on budget deficits, accumulation of debt and arrears, and financing from central banks);
- relevant structural benchmarks related to reform of the fiscal sector (tax system, expenditures and their prioritization, budgetary process) and policy advice;
- strict conditionality regarding compliance with performance criteria and structural benchmarks.

These three interdependent aspects could have enabled governments to run restrictive policies, even if the current political situation created pressure for unsustainable policies. If domestic reformers were prepared to follow the path of responsible policies, external binding commitment could give them an additional political instrument. However, other aspects of the program have to be taken into account too:

- unrealistic assumptions concerning GDP growth, exports, and budget revenues that led to formulation of programs that were sustainable only if these assumptions were realized;
- lax conditionality, undermining macroeconomic discipline;
- a lenient approach to accumulation of arrears and debt;
- improving access to non-inflationary sources of deficit financing;
- ineffective conditionality in the area of structural reforms, stimulating ”paper reforms” and not real restructuring of the economy.

In our view, this group of factors (discussed at length later in this paper) was detrimental to necessary fiscal adjustment and undermined the possible disciplinary effects outlined before. This weakness was tightly linked to the changes in the way the IMF has been operating since the debt crisis in the beginning of the 1980s.

IMF: evolution prior to transition

Of all international organizations, the IMF played the most important role in the process of transition of post-communist economies [17]. This is explained by the fact that by the early 1990s the IMF acquired significant experience not only in macroeconomic policy but also in structural and institutional reform. It was, therefore, perceived as fully prepared to assume responsibility to monitor, manage, and support the transformation process in the medium term. But all these activities were quite different from the tasks for which the IMF was originally designed.

[17] Dabrowski (1995) and Gomulka (1995).

The IMF was established in 1946 as the part of the Bretton Woods system. The Fund's role was to provide short-term financing to countries with balance of payment problems in order to avoid the repetition of interwar protectionist practices and competitive devaluations. The IMF had a systemic role in supporting the global exchange rate system. Accordingly, it worked mainly with developed countries and its focus was constrained to the main monetary and fiscal aggregates. Structural policies were largely absent in IMF-supported programs and the importance of conditionality was rather weak. Conditionality was formally added to the Articles of Agreement only in 1968 and until the mid-1970s included only macroeconomic aggregates. However, after 1971, in the aftermath of the collapse of Bretton Woods system, the IMF lost its core task. Floating exchange rate regimes among most developed countries did not require constant surveillance and support from the Fund. As Milton Friedman put it[18]: *"the IMF has lost its only function and should have closed shop*". Instead, in the 1970s the scope of Fund's activities started to move increasingly towards cooperation with developing countries. The outbreak of the debt crisis in 1982 is generally seen as a major turning point in this process (usually dubbed "mission creep"). In the following years, Fund activities were concentrated on financial support and technical assistance for developing countries affected by the crisis. This change was reflected in the lengthening average duration of programs, broadening of program objectives and change in the character of conditionality. "*In response to the substantial changes in the nature and magnitude of economic disequilibria facing members, IMF-supported programs have for several years placed more emphasis on structural reforms and the achievement of sustainable economic growth*".[19] This was, in part, a response to the growing criticism of the IMF as the "austerity" institution that focused excessively on domestic demand reduction and not sufficiently on domestic supply development.

Table 2: Goals of IMF-supported programs

Official goals:
• Improvement in the balance of payment (without policies detrimental for the growth of world trade)
- Inherent role of the IMF
• Increase in longer term growth
- Receiving increased attention after 1982
• Better utilization (allocation) of production potential
- Especially crucial in transition economies
Other goals, declared in program memoranda, public statements and staff papers:
- Poverty alleviation
- Environmental protection
- Containment of military expenditure
- Political considerations

Source: IMF (1987), IMF (LI, MEP).

[18] Friedman (1998).
[19] IMF (1987).

The change in the hierarchy of goals and in the character of problems in major client countries has led to the lengthening of the duration of stand-by arrangements to three years and the introduction of new medium-term programs such as EFF, SAF, and ESAF (see Table 2). The rationale for establishment of the EFF in 1974 was to address the problem of "*an economy experiencing serious payments imbalance relating to structural maladjustments [...] or an economy characterized by slow growth and an inherently weak balance of payment position which prevents the pursuit of active development policy*[20]". Similarly the aim of SAF *was "the alleviation of structural imbalances and rigidities*" in low-income countries, "*many of which [had] suffered for many years from low rates of economic growth and declining per capita incomes*".

Table 3: The IMF basic facilities

Stand-by arrangement (SBA, since 1952)

- Financing for balance of payment deficit of temporary or cyclical nature
- Purchases: 6-36 months (initially 6-12 months), repurchases 3.5-5 years afterwards
- Originally conditionality limited to macroeconomic policies, since 1980s also structural elements
- Reviewed annually

Extended Fund Facility (EFF, since 1974)

- Financing for medium term adjustment of chronic or acute balance of payment deficit due to structural distortions or weak growth performance
- Purchases: 3 years (can be extended to 4 years), repurchases: 4.5-10 years
- Conditionality includes more structural elements than SBA
- Reviewed annually

Structural Adjustment Facility (SAF, since 1986)
Enhanced Structural Adjustment Facility (ESAF, since 1987)

- Highly concessionary financing for medium-term macroeconomic adjustment in low–income countries described in the policy framework paper
- Purchases: 3 years (can be extended to 4 years), repurchases: 5.5-10 years
- Stronger conditionality, including structural policy criteria
- Reviewed semi-annually

Poverty Reduction and Growth Facility (PRGF, since 1999)

- Replacement for SAF and ESAF programs with strong focus on poverty reduction with the medium term policies stipulated in the poverty reduction strategy paper
- Purchases: 3 years (can be extended to 4 years), repurchases: 5.5-10 years
- Strong conditionality, including structural policy criteria
- Reviewed semi-annually

Source: www.imf.org.

In order to compensate the IMF for the additional risk that it faces when lending on concessionary terms to troubled countries for longer periods, conditionality was constantly intensified throughout the 1980s. The fastest increase was in the area of structural benchmarks linked to improving long term growth prospects. While in beginning of the decade structural elements were exceptional, roughly two thirds of the Fund's programs included some structural elements by the end of the decade, and the average number of structural benchmarks reached almost three per program.[21]

[20] IMF (2001a)
[21] IMF (2001b)

Originally, the rationale for conditionality was to make sure "*that the member country is pursuing policies that will ameliorate or eliminate its external payments problem*" and therefore also *"be able to repay IMF in a timely manner – which allows the Fund's limited resources to revolve and be available to other members.*"[22] However, as a result of introducing medium-term programs and difficulties in healing the developing economies, conditionality was turned to as an instrument for micro managing member economies. At the same time, IMF resources started to be locked in several problematic countries. Many governments became permanently dependent on IMF resources. As Bird (2000) notes "*the image of the Fund coming into a country, offering swift financial support, helping to turn the balance of payments around, and then getting out, is purely and simply wrong*".[23] The lengthening of the programs contributed only partially to this dependence.

Another factor was the long series of generally unsuccessful programs. For example, Brazil had eight separate stand-by programs between 1965 and 1972, and Peru had 17 different arrangements between 1971 and 1977.[24] In general, evaluation of the IMF-supported programs in developing countries is controversial. While empirical research shows frequently negative impact on growth and positive impact on current account in the shorter run and positive impact on growth in the longer run, results are generally inconclusive.[25] Some authors argue that the willingness of the Fund to support unsustainable policies actually led to such policies.[26] The IMF strongly rejects the views about its negative impact on policies, but recognizes its limitations in imposing good policies on member countries[27].

With this recent history of focus on delivering growth to poorly developed economies and some reluctance of governments of the recipient countries to impose austere adjustment measures, the Fund started its support for the post-communist economies. In these countries structural reforms were particularly important due to the expectations that the initial decline of output would be followed by rapid growth generated by the improved structure of the economies. Therefore the role of the IMF as a technical assistance agency (as opposed to its systemic role of maintaining liberal trade conditions) gained even more significance.

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[22] IMF (1998a)

[23] Return of the IMF to its original purpose that is short-term, emergency lending was urged by many authors; compares Meltzer and Sachs (2000).

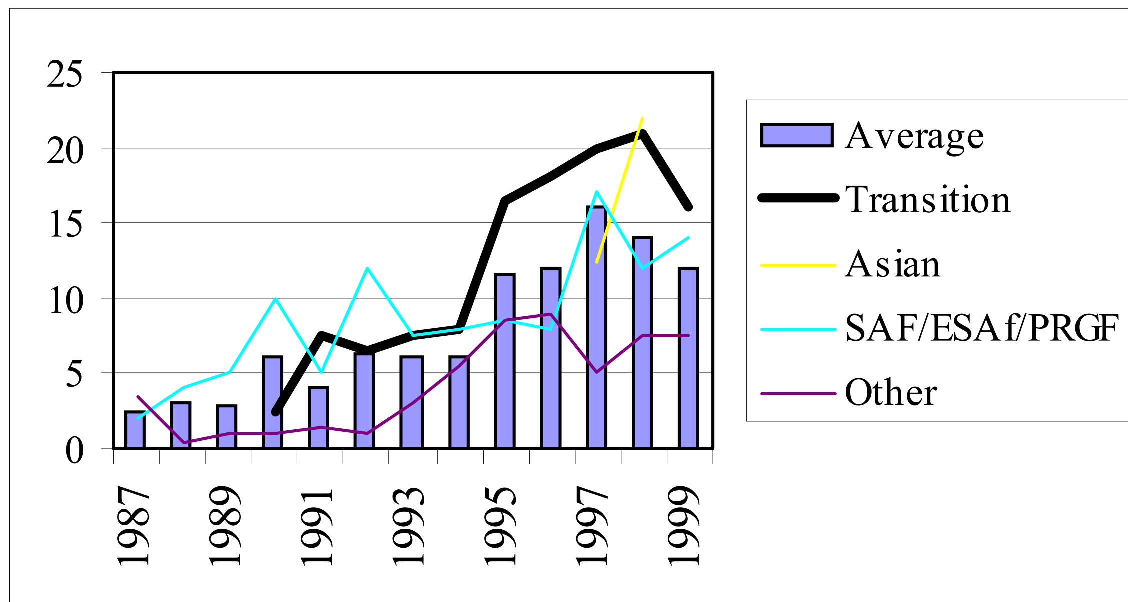
[24] McQuillan (1998).

[25] Haque and Khan (1998) offer the survey of evaluations of IMF-Supported programs.

[26] Meltzer (1998) suggests that "*without the IMF and the U. S. Treasury, Mexico would learn to run better policies, would have less debt and, I believe, would have made more progress*".

[27] Considerations about the interactions of the program conditionality, national ownership of policies and their quality are reflected in the current debate within the IMF about changes in conditionality. Compare: IMF (2001a).

Figure 4: Average number of structural benchmarks per program (1987-1999)



Source: IMF (2001b).

Expectations of future high rates of growth and considerations about costs of reforms led to reluctance to impose restrictive fiscal policies on transition economies. In our opinion this neglect had a profound impact on future developments. It soon turned out that the countries that benefited from this cooperation with the IMF were the countries with strong national ownership of reforms – mainly Central European countries and the Baltic States. Characteristically, these countries followed the path of more fiscal restraint than the bulk of the FSU countries. Initial stabilization programs were generally successful, and at later stages the process of accession to the OECD and especially the EU drove more comprehensive structural reforms. Thus, IMF financing was not needed any more in most cases.

However, in the majority of FSU countries policies remained undisciplined in spite of initial macroeconomic stabilization and the end of hyperinflation. Conditionality failed to steer policy, confirming the well-known assertion that the IMF cannot effectively impose good policies. The sequence of unsuccessful programs, double standards, and long-term dependence on IMF resources has been repeated. Finally, the mirage of macroeconomic stabilization that underpinned willingness of the IMF to support the economies evaporated in the Russian crisis in 1998. The next two chapters describe these developments in more detail.

IMF programs in FSU countries

The IMF stepped in to support transition economies very forcefully. Virtually all countries undertaking reform efforts received financial support. The table below presents major programs that were received by countries investigated here. Generally speaking, external financing was provided in support to efforts to stabilize and reform post-

communist economies. Russia, due to its size and importance, received the most sizable financing (in nominal terms) of all transition countries, followed by Ukraine. However, the importance of the IMF programs and their impacts on policies were higher in smaller countries like Kyrgyzstan, Moldova or Georgia. Still, there are important common patterns in the disbursement of IMF resources to countries in the region.

Table 4: IMF facilities for investigated countries

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Russia	SBA	STF	STF	SBA	EFF			SBA		
Ukraine			STF	SBA	SBA	SBA	EFF			
Moldova		STF	SBA	SBA	EFF				PRGF	
Georgia			STF	SBA	ESAF					PRGF
Kyrgyzstan		STF	SBA	ESAF			ESAF			

Sources: www.imf.org.
Notes: Excluding CCFF.

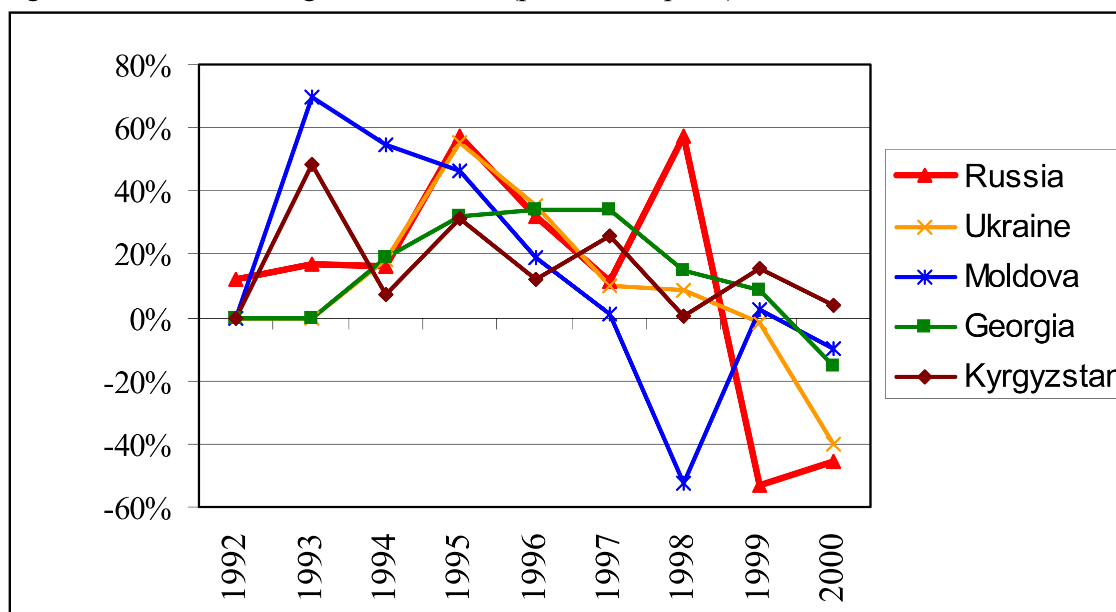
The IMF lending to FSU countries started with the SBA for Russia in 1992. The program did not involve strict conditions, and the Yeltsin-Gaidar reform strategy was concerned mainly with liberalization, privatization, and institutional reforms, and not at all with detailed stabilization policies.[28] All other countries started cooperation with the Fund with the Structural Transformation Facility (STF), a program designed specially for transition economies under severe trade and payment disruptions (between 1993 and 1995). This program not only supported countries at the initial stage of transition but also prepared them to receive standard Fund facilities. The disbursements of funds under the STF were relatively small and involved very little conditionality (mostly successfully implemented prior actions). Performance criteria were loose, with fiscal deficits of up to 10 percent of GDP permitted.[29] Afterwards, the series of short-term arrangements (SBAs) followed. It is common to view[30] STFs and SBAs as the first generation programs that strove to establish basic short-term macroeconomic stability and stop hyperinflation. The only structural measures for obtaining these aims included price, exchange and trade liberalization, and dismantling of the system of state orders.

In contrast, medium-term EFFs and ESAFs were the second-generation programs that aimed at providing a basis for long-term growth and stabilization. Accordingly, these programs involved much more comprehensive conditionality. Kyrgyzstan was the first country to sign such a program (in 1994), and the biggest wave took place in 1996, when Russia, Moldova, and Georgia signed their second-generation programs. Ukraine was lagging behind other countries and signed a medium-term program only shortly after the outbreak of the Russian crisis (beginning of September 1998). Earlier it had three stand-by arrangements, reflecting its lack of a consistent reform program and policy slippages rather than any conscious cooperation strategy.[31] Among countries under investigation,

[28] Citrin, Daniel A., Ashkok K. Lahiri (1995), p.112
[29] Dabrowski (1995)
[30] IMF (2001b)
[31] IMF (2001a) calls these facilities “a holding operation” and “an interim solution”, respectively.

EFFs were given to Russia, Ukraine and Moldova, perceived as more developed countries, and concessionary ESAFs to Georgia and Kyrgyzstan.[32]

Figure 5: Net financing from the IMF (percent of quota)



Source: www.imf.org.

Another aspect of the financing is the overall size of net financing received under various facilities. Georgia and Kyrgyzstan have received a relatively constant net inflow of IMF resources, although there was a moderate declining trend (especially in Georgia after 1997). More importantly, there was no particular shock in 1998, as at least loose cooperation with the IMF was unbroken up to the moment of the Russian crisis. Moldova represents a somewhat different pattern: after close cooperation with the Fund in the first years of transition, when the country secured a relatively high level of financing, later flows to Moldova more closely resembled the volatile and unpredictable flows to the largest countries – Russia and Ukraine.

Although Russia started cooperation with the Fund and switched to medium term programs much earlier than Ukraine, financial flows to these two countries in the period of 1994-1997 are almost identical, which may suggest some sort of "financing contagion", usually attributed to political factors. For Russia, Ukraine, and Moldova the gradual decline in 1994-1997 is a sign of policy slippages and missed disbursements. Only in 1998 do we see a dramatic difference. While Russia receives a record high last-chance package, Ukraine receives minimal funds, and Moldova faces a dramatic and probably destabilizing net outflow of IMF funds. Russia undergoes a period of substantial negative financing in 1999 and in 2000, as does Ukraine in 2000. In these years, the perception of Moldova changed, and this country started to be eligible for the same concessionary programs as Georgia or Kyrgyzstan.

[32] In the aftermath of the crisis Moldova is qualified together with Georgia and Kyrgyzstan to PRGF, the successor of ESAF.

Obviously, this is a very superficial picture. Financing from the IMF reflected not only the donors' choices but also – in theory at least – a combination of financing needs, underlying assumptions of reform strategies and compliance with conditionality. The following chapter describes in detail the mechanisms of program financing and points out major deficiencies. Still one crucial characteristic must be noted: all five countries received funds from the IMF in every year of the pre-crisis period. [33]

Program deficiencies and their consequences

First generation programs (STF and SBA) that aimed to establish basic macroeconomic stability generally achieved their goals. Although at varying rates, inflation in all five countries was brought down to lower two-digit numbers. This stabilization was not, however, underpinned by fiscal adjustments and was therefore short-lived.[34] Second-generation programs aimed to close this gap. In this section we discuss two factors that in our opinion underlay the failure of the second-generation programs: lax conditionality and overoptimistic assumptions, whose fulfillment was a necessary condition for program sustainability. These factors led to certain myopia in the Fund-supported programs that caused short-term macroeconomic stabilization to be perceived as a sign of the long-term sustainability of the economic situation.

Growth assumptions

Partly due to the legacy of the 1930s and to the experience in the Fund after the debt crisis in the 1980s, it was almost impossible for the Fund to design a program that did not assume prompt real economic growth, led by exports. Assuming declines could raise questions concerning the Fund's mission of bringing sustainable growth and would bring criticism of austerity measures. Equilibrium with low levels of output and expenditures is largely viewed within the Fund as suppressed disequilibrium.[35] Obviously, it is now even clearer than before that debt service is viable only if there is real economic growth. However, it is one thing to realize this fact, and quite another to build programs on unrealistic growth assumptions, making them impossible to implement and, more importantly, unsustainable in the longer term. While it was understandable that "*initially it was hoped that reforms would quickly lead to a pick-up of economic growth and inflows of foreign direct investment*"[36], the continuation of such predictions at later dates was simply wishful thinking.

Growth figures predicted (mainly) under the medium-term programs (and program reviews) are presented below. Two groups of countries can be clearly distinguished: Russia, Ukraine and Moldova (RUM) with EFF programs, and Kyrgyzstan and Georgia

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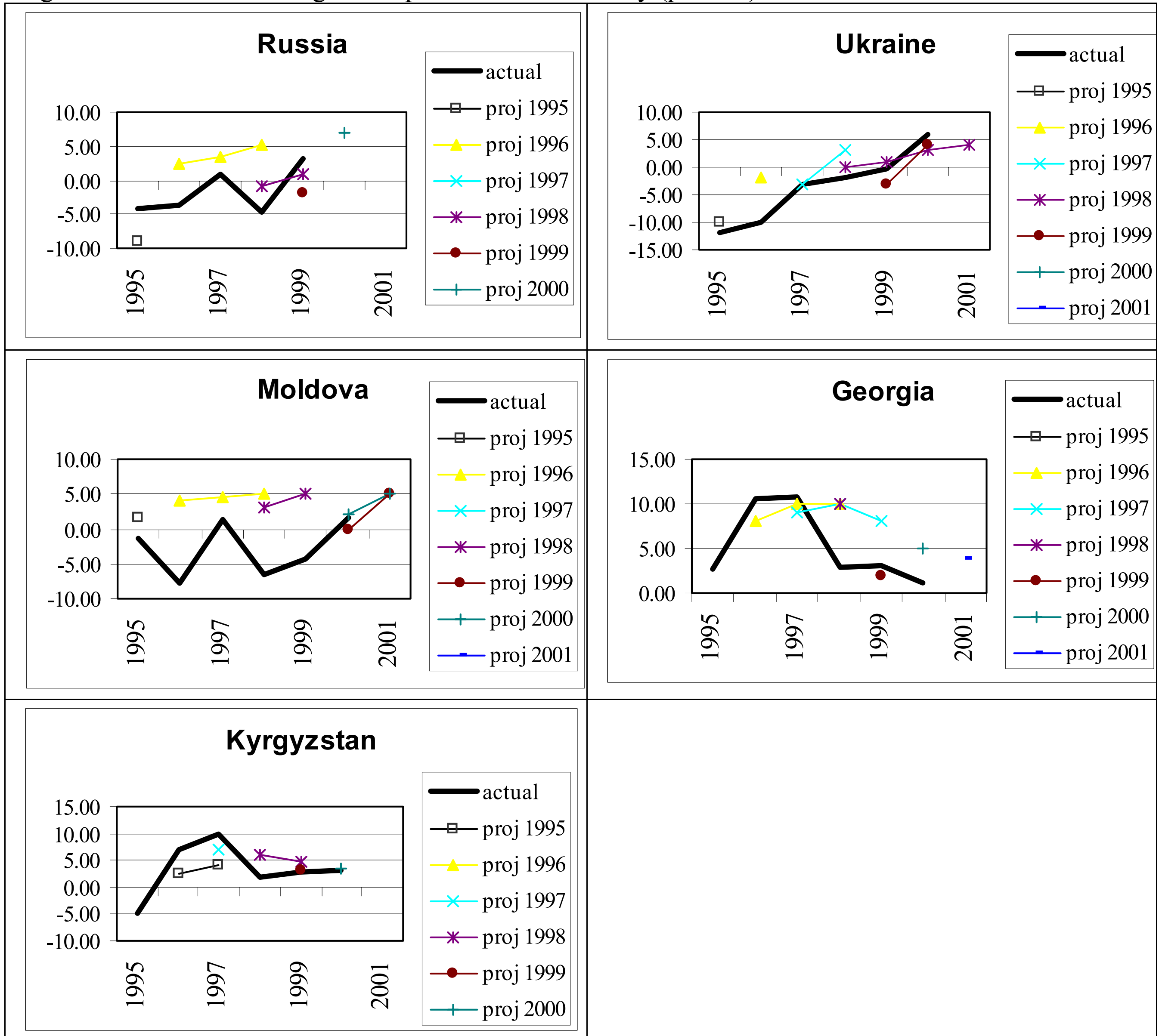
[33] Although in Moldova in 1998 new disbursements only insignificantly exceeded repurchases.
[34] Compare "unpleasant monetarist arithmetic": in the longer term, fiscal and monetary policies cannot be separated, and debt is inflationary (Sargent and Wallace, 1981).
[35] IMF (1987)
[36] IMF and WB (2001).

with ESAF programs. In case of RUM, the IMF systematically overpredicted real growth rates. This is especially true in the case of the medium-term EFF programs, built on the assumption that implementation of the recommended structural measures would lead to growth. The growth performance in Georgia and Kyrgyzstan was rather different. In Georgia, the end of armed conflicts and the discovery of gold fields in Kyrgyzstan at roughly the same time as the implementation of the ESAF program brought economic growth at high rates. At later stages, however, projections overpredicted growth, especially in Georgia.

Figure 6: Real economic growth: predictions and reality (percent)



Source: IMF (MEP, LI, A4C, RED).
Notes: Series "proj xxxx" contains projections made in year xxxx.

Fiscal policy and sustainability of programs

These false assumptions had an important impact on the sustainability of the programs. First, prospects for high growth rates limited the pressure on adjustments, as debt accumulation did not significantly exceed real GDP growth and was, therefore, not seen as an important problem. According to the IMF, successful programs would require "*some combination of increasing output and reducing absorption*".[37] Given high predicted rates of growth, however, reducing absorption did not receive enough attention. Moreover, there is a more profound problem with this approach: in the economies of former socialist countries, with hypertrophied public sectors, growth without fiscal adjustment was impossible. The public sector share had to shrink to make room for the private sector, which is the main source of economic growth. In transition countries sound fiscal policy was therefore a precondition for achieving economic growth in the long run, the precondition that was not put in place. Second, if predictions for the revenue side of the budget (dependent on growth) are too high, the extent of adjustment in expenditure commitments necessary to achieve any given deficit is underestimated. As long as policy-makers tend to neglect realistic revenue forecasting, the chances for sustainable and efficient fiscal policy are low. But revenues were systematically below expectations[38], which led to increasing deficits.

Impact of large fiscal deficits on growth is not self-evident. Indeed fiscal expansion is usually seen as stimulating economy in shorter term. However, it is well established now that transition countries that implemented tight fiscal policy resumed the growth sooner and it was both more stable and higher in comparison to countries with large and unsustainable budget deficits and associated high levels of government spendings.[39] Unsustainable fiscal policy put all the responsibility of maintaining stabilisation on the monetary policy, which led directly to the necessity for further monetary tightening. Even restrictive monetary policy characteristic for smaller countries of our sample could not, however, compensate for the weakness of fiscal budget in a longer time. High real interest rates held by the deficit borrowing requirements led to the reduction of the capital available to the growth-generating private investments, deterioration of liquidity in the economy and the emergence of inter-enterprise arrears, barter and netting-out operations. Falling competitiveness of domestic production was the reflection of external financing of government outlays. The soft budget constraint should be viewed as a microeconomic characteristic of loose fiscal policy that discouraged restructuring: economic agents acted in a system with explicit and implicit subsidies, tax exemptions granted at the discretion of government officials, that created incentives for intensive rent-seeking rather than real adjustments.

In addition, fiscal performance criteria were calculated initially in the IMF programs on a cash basis. Accordingly, in many FSU countries, arrears appeared to be the most important and persistent source of budget deficit financing (calculated on the accrual basis). In response to lower than expected revenues, the government was also more likely

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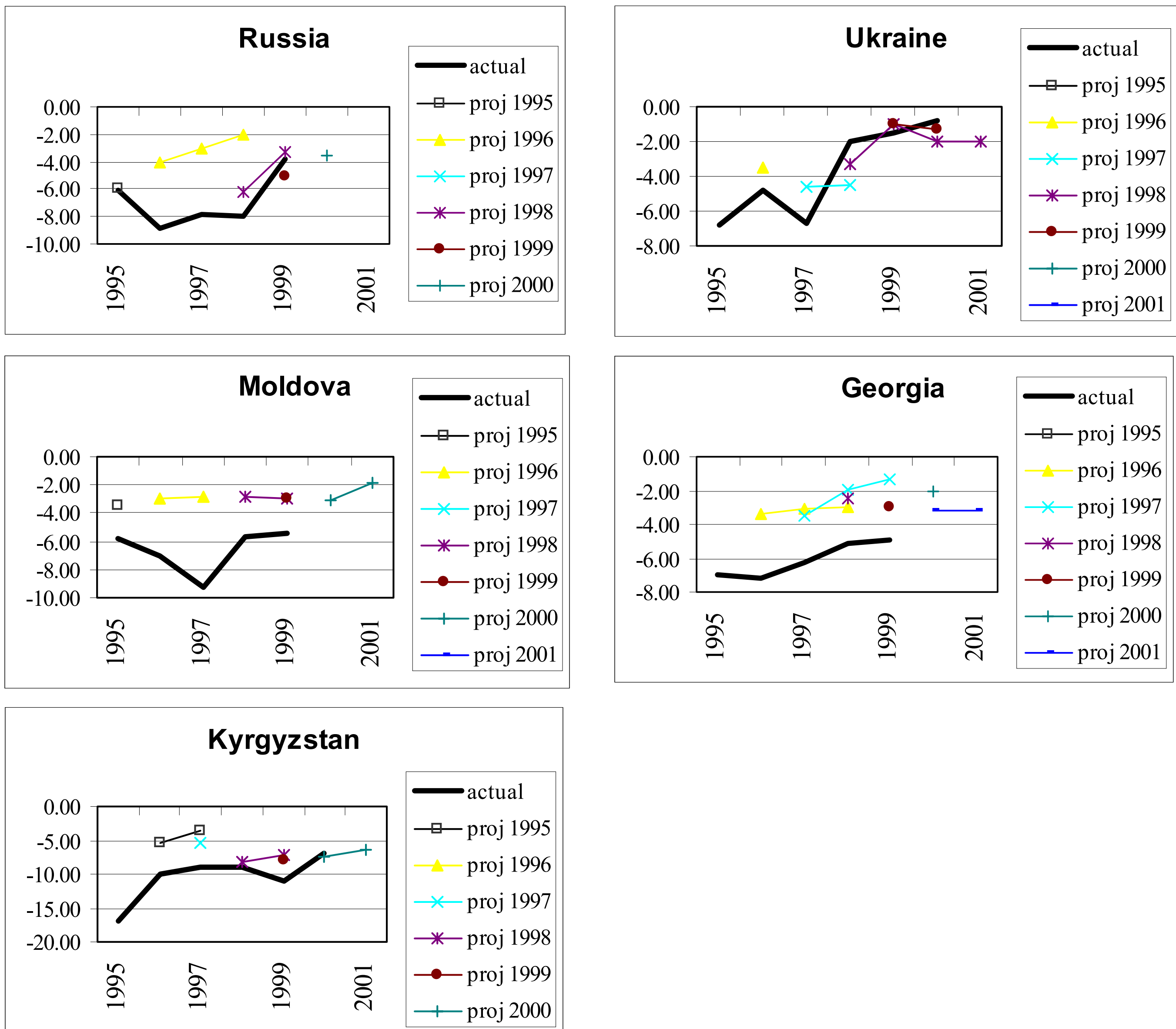
[37] IMF (1987).
[38] Programs also frequently assumed improvements in tax compliance.
[39] See Campos and Coricelli (2000).

to introduce across the board cuts in expenditures and freeze pensions and wages of public employees. Such reduction in expenditures was also often short-lived, as the period of wage freezes was predictably followed by rapid growth of wages.[40] The failure of government to collect projected revenues and execute planned expenses also pushed the governments towards involvement in dubious non-cash operations that both decreased the efficiency of the government and distorted economic life. Moreover, governments shifted some of the operations off budget making the commercial banks and the national bank to pursue quasi-fiscal operations, thus leading to drop in budget expenditures recorded in fiscal statistics. Yet the IMF adopted (at least until the crisis) quite a liberal approach to all these distortions, as these actions helped to keep cash deficits in check. Accordingly Buiter (1998) stated that the cash deficit indicators used widely by the IMF in its programs were "myopic" and "more than useless" in the evaluation and design of macroeconomic policy packages. When IMF recognized the accumulation of arrears they were included in the list of program objectives. An illustration comes from Ukraine. Budgetary arrears were growing remarkably since 1995. At the first time as the program objective they were included in 1997 SBA. Program assumed that consolidated deficit will not grow (and not drop as well) and existing budgetary arrears should have to be reduced while avoiding new arrears. However, until 1998 crisis budget deficits as well as arrears were growing.

Finally, the generally liberal attitude of the Fund towards fiscal slippages could also be partly blamed for the unprogrammed high budgetary outlays, as the external pressure from the IMF that governments faced was not strong enough to oppose domestic pressures for more expansionary fiscal policies.

[40] This is what happened in Russia in 1995 and in the beginning of 1996 before the presidential elections.

Figure 7: Cash fiscal balances: IMF programs and reality (percent of GDP)



Source: IMF (MEP, LI, A4C, RED).
Notes: Series “proj xxxx” contains projections made in year xxxx.

Due to the lack of necessary adjustments, the fiscal positions of all five countries were unsustainable throughout the transition. Table 5 presents the results of the IMF study on fiscal sustainability conducted under relatively favorable assumptions. Even given the small interest rate differentials and relatively high rates of growth that indeed characterized FSU economies in 1997, the fiscal adjustment gap is exceeded by at least three percentage points in each country.

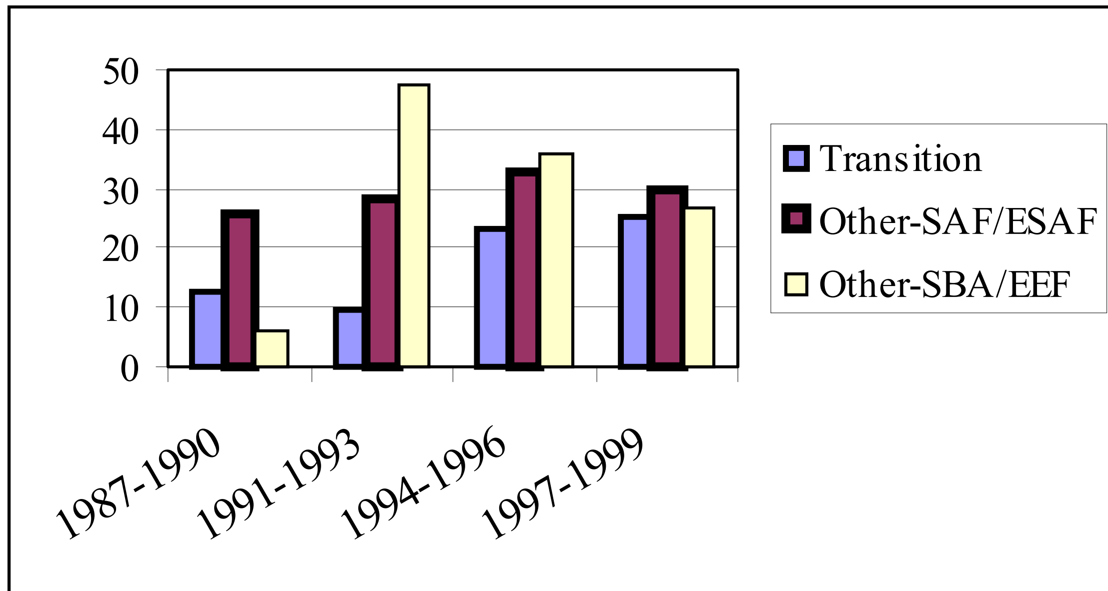
Table 5: Primary balances (percent of GDP)

	1997 (actual)	Sustainable
Russia	-3.1	0.4
Ukraine	-3.2	0.4
Moldova	-3.1	0.8
Georgia	-2.4	0.6
Kyrgyzstan	-7.7	0.8

Source: IMF (1998b).
Notes: A sustainable primary balance is defined as the primary balance that would allow for stabilizing the public debt-to-GDP ratio at the end of 1996 level, under assumptions of nominal GDP growth of 8 percent and interest rate differentials of 2 percentage points.

This is not to claim that the IMF did not express concern about the fiscal position throughout the period. Indeed, fiscal adjustment was the declared aim of virtually all the programs, and the need for it was the basic message of all program reviews and Article IV consultations. Additionally, the large and increasing share of the overall number of structural conditionality benchmarks was related to the reform of the fiscal sector. The latter trend was peculiar to transition economies in the second half of the 1990s.

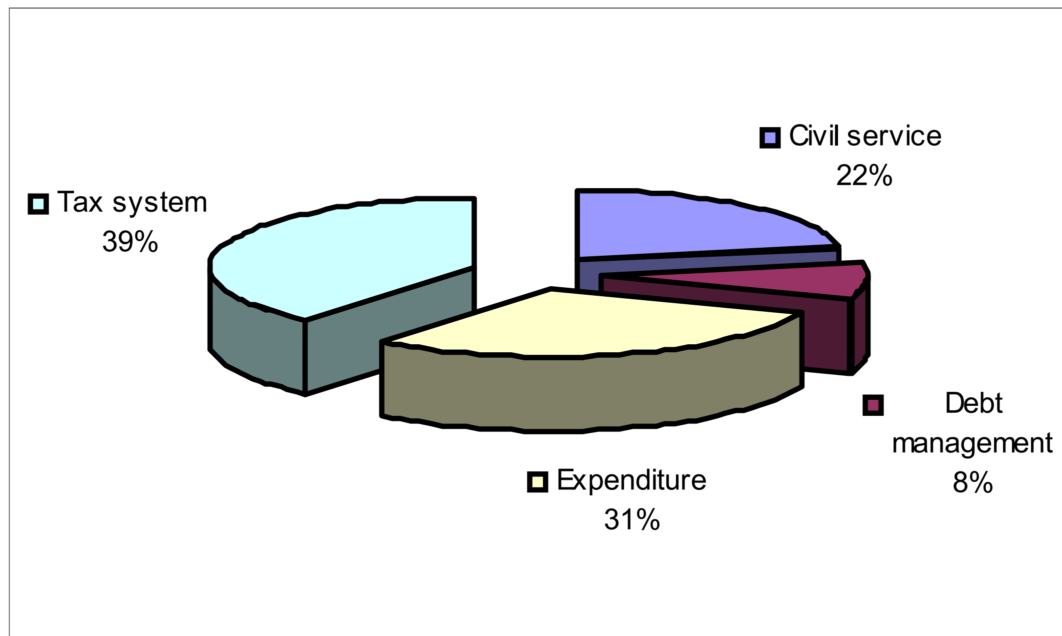
Figure 8: Share of overall number of structural benchmarks[41] related to the reform of fiscal sphere 1987-1999



Source: IMF (2001a).
Notes: The second and third bars in each set represent non-transition economies (recipients of concessionary and non-concessionary IMF facilities, respectively, excluding programs for countries affected by the 1997 Asian crisis).

[41] The lower share of number of structural measures related to fiscal sector in transition economies in comparison to other recipients is the result of great number of benchmarks related to the transition process, especially privatization.

Figure 9: Distribution of fiscal oriented structural benchmarks



Source: IMF (2001b).

But as we have seen, this lip service was very poorly reflected in performance criteria, which were relatively lenient and exhibited poor conditionality. The fiscal adjustment that the IMF advocated as the crucial element of stabilization programs simply did not happen. Still, the IMF continued to provide support to countries with very high fiscal imbalances, often praising them for the progress towards the market economy, stabilization, and long-term growth. Even if fiscal slippages led to a program's going off-track, new programs were granted almost immediately. Therefore, we argue that fiscal outcomes have been so weak partly because of the IMF's misconceptions about growth prospects and its reluctance to insist on unpopular and difficult fiscal adjustment measures. Nevertheless, while long-term fiscal sustainability was somehow neglected, the negative influence of budget deficits in the short term had to be tackled in order to maintain shorter-term stabilization.

Myopia in action

Expansionary fiscal policies led to excess aggregate demand that was not met a by supply side response. Given the very limited stock of domestic savings and low monetization constraining the accumulation of internal debt, this pressure could be resolved either by increases in the price level or by an increase in the current account deficit. The first scenario was particularly likely if budget deficits were financed by central bank credits, as the corresponding increases in the money supply inevitably led to inflation. The second alternative was more likely if foreign borrowing financed budget deficits. Under this scenario, capital inflows led to real exchange rate appreciation and growth of imports. Therefore, the IMF had to decide whether to concentrate on fighting inflation or avoiding external debt accumulation. Clearly, the chief consideration of the Fund in making such decisions was consolidating the major achievement of the first-generation

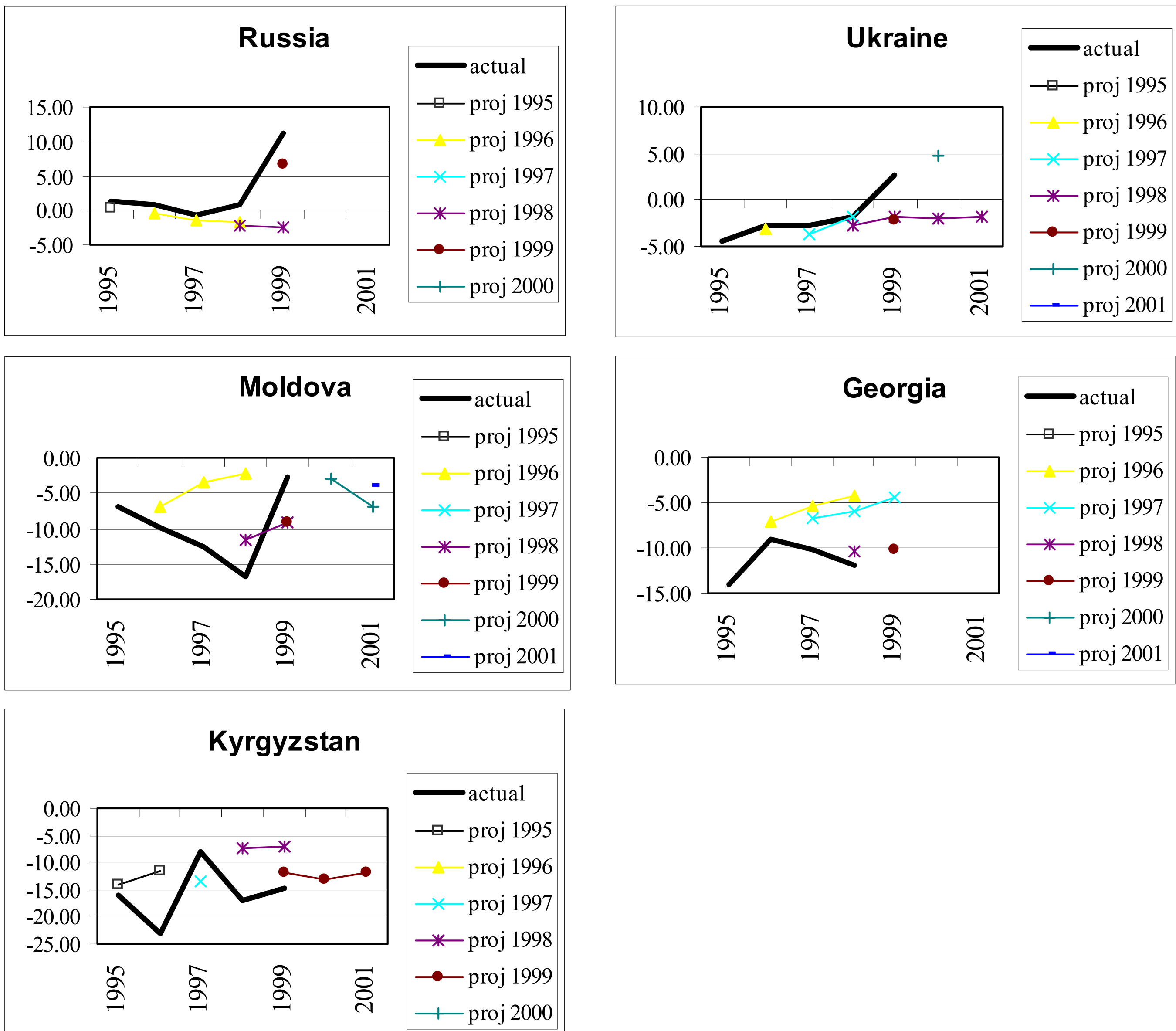
programs; namely, the short-term stabilization, reflected in low inflation and stable exchange rates.

The focus on short-term inflation targets, with some neglect of the debt problem, can be clearly seen if we compare the outcomes of inflation and current account predictions in the smaller countries with those in the bigger ones. In the smaller countries monetary policy was much more disciplined for several reasons: central banks were stronger, the influence of the IMF greater and the external borrowing smaller in absolute terms (as it easier to generate credits of several million rather than several billion dollars). Accordingly, the disinflation process under second-generation programs was generally successful. Unfortunately, monetary discipline did not lead to improvement of fiscal balances, and non-monetized budget deficits led to rapid accumulation of external debt. Substantial current account deficits (systematically over 10 percent of GDP in Moldova, Georgia, and Kyrgyzstan) were the flip side of this coin. An interesting example comes from Moldova, where in the first quarter of 1998 the IMF saw a need for appreciation of the exchange rate in order to maintain low inflation[42], as the budgetary sector was continuing to borrow abroad. This advice was given irrespective of a current account deficit that had, in the previous year, exceeded 13 percent of GDP and been covered mainly by short-term borrowing.[43] This is a somewhat surprising attitude given the original role of the IMF as the balance-of-payments watchdog.

In Russia and Ukraine, current accounts did not constitute a threat to macroeconomic stability, and program projections were generally met. This was due partly to the relatively loose monetary policy: internal imbalances were reflected mainly in inflation. These countries had stronger negotiation positions vis-a-vis the IMF and weaker central banks. Our criticism is not intended to advocate more expansionary monetary policies, but rather we argue that the IMF was advocating delaying the crisis (adjustment) for too long, while sending wrong signals both to governments and investors. Unfortunately, such policy advice was welcomed by domestic authorities, as "*a finance minister faced with this choice will almost always prefer to avoid the crisis now, at the risk of a future larger crisis, than accept the crisis now when may critics are ready to claim that the crisis is avoidable*".[44]

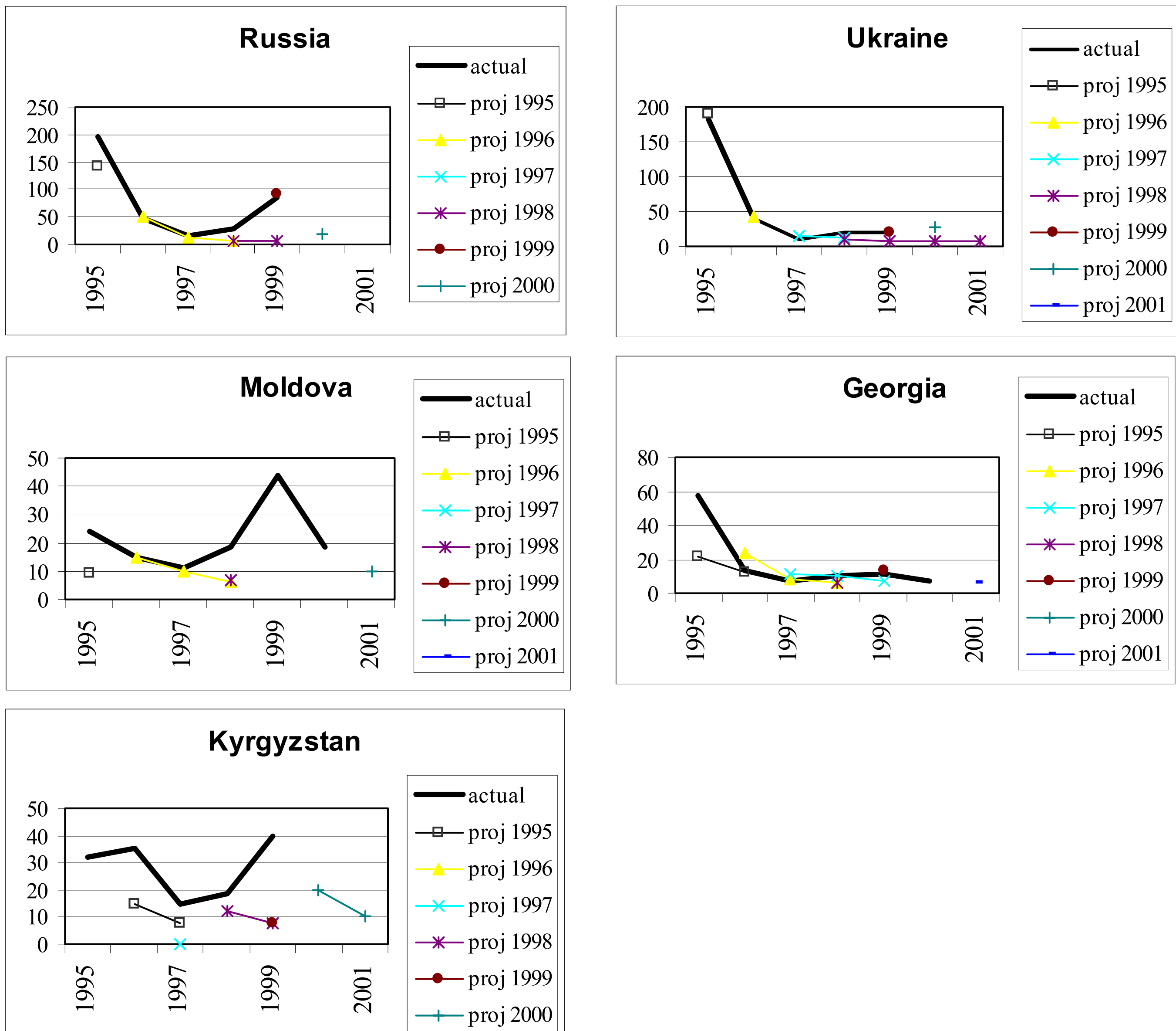
[42] IMF (1998c). The same document argues, however, that fiscal policy tightening is the major instrument for reducing macroeconomic imbalances and points to the increasing risk of financial and currency crisis.
[43] Real exchange rate appreciation additionally aggravated the problem due to high elasticity of import with respect to exchange rate movements.
[44] Meltzer (1998)

Figure 10: Current account balances: IMF programs and reality (percent of GDP)



Source: IMF (MEP, LI, A4C, RED).
Notes: Series "proj xxxx" contains projections made in year xxxx. For Georgia, official transfers are excluded. For Kyrgyzstan, grants are excluded.

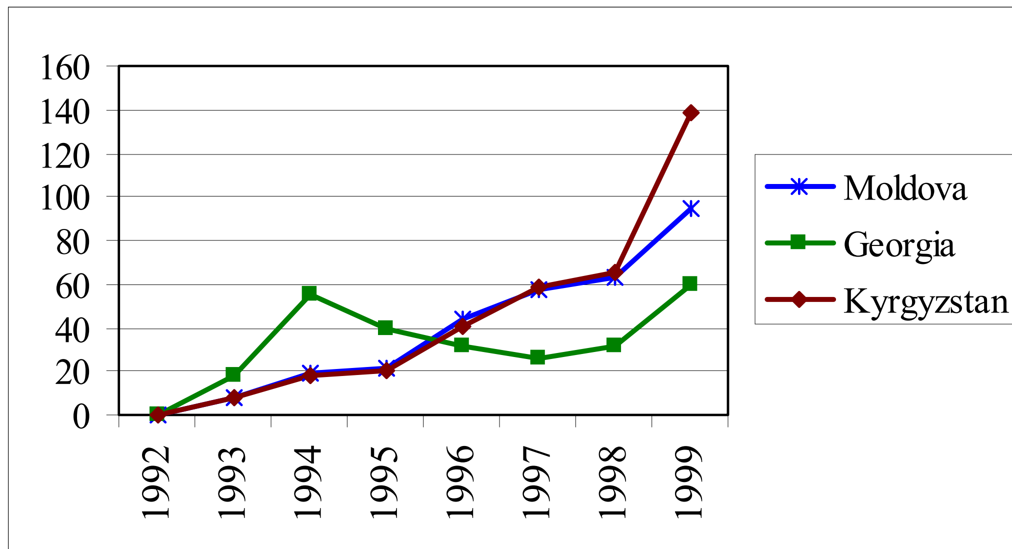
Figure 11: End-period annual CPI inflation: programs and reality (in percent)



Source: IMF (MEP, LI, A4C, RED).
Notes: Series "proj xxxx" contains projections made in year xxxx.

High debt ratios are very costly because they press up real interest rates and increase the debt service component of the deficit. In the five countries under consideration, debt-servicing expenditures became one of the most important items on the expenditure side of the budget. The long-term costs of short-lived disinflation under loose fiscal policy appear to have been especially high for small and highly indebted countries. Georgia and Kyrgyzstan are following the path of long-term dependence on external aid. Moldova, having disappointed initial hopes, is also set to follow this path.

Figure 12: Government external debt (percent of GDP)



Source: IMF and WB (2001).

When financial market participants refused to buy new treasury bills, governments faced three choices: a decrease in the fiscal deficit, an increase in seigniorage revenues, and a delay in debt repayment. In all five countries we observe a mix of these measures. Fiscal adjustment was carried out with higher levels of debt, high real interest rates, limited demand for treasury securities, under mandatory debt restructuring (e.g. Russia, Ukraine) and with weakened central bank independence.

Weak conditionality

The IMF-supported programs, in spite of discussion of fiscal problems, failed to bring any significant fiscal consolidation. This failure is linked to the important issue of reform ownership. The most fundamental problems can be solved only if national authorities with broad political support assume the ownership and full responsibility for reforms and necessary policy corrections. Unfortunately, in countries of weak reform ownership, policies were assumed (and reluctantly followed) just to please the IMF and receive disbursements, rather than to solve the problems of the country.[45] But even in such cases, the programs could induce better policies, through enhancing the credibility of reforms and helping reformist governments to overcome political opposition to the program. But this is possible only if the IMF program provides a binding commitment. With "soft" conditionality this goal cannot be reached, even if in most cases there was a relevant (although standard) set of performance criteria. Usually, the key quantitative benchmarks are as follows:

[45] In some cases the letter of intent and economic policy memorandum are not prepared by the member country, but by the IMF staff, subject to bargaining on selected performance criteria. This is in contradiction to official line of the IMF, whereby "*each IMF-supported program is designed by the member country in the close collaboration with the IMF staff*" (IMF, 1998a).

– The upper limit for the cumulative change in net credit (of the monetary authorities and/or the banking system)[46] to the general government;
– The upper limit for the cumulative deficit of the general government (later also the accumulation of arrears);
– The upper limit for the cumulative change in net domestic assets (of the monetary authorities and/or the banking system);
– The lower limit for the cumulative change in net international reserves (of the monetary authorities and/or the banking system)

The IMF study shows that compliance with such performance criteria is strongly associated with growth[47] (although there is no causation established; rather, it is rightly supposed that reform ownership is a common immeasurable factor for the two). This is borne out by the experience of the most advanced reformers in Central Europe, which have, by far, the highest scores in this ranking. But compliance under the medium-term programs declined sharply in all countries under investigation (with the exception of Kyrgyzstan), which partly explained the failure of second-generation programs. However, non-compliance rarely led to program suspension.

Table 6: Compliance with the IMF quantitative conditionality

Country	Program	Compliance (full = 100)
Russia	SBA (1995)	100
Russia	EFF (1996)	77
Ukraine	SBA (1995)	(off track) 76
Ukraine	SBA (1996)	99
Ukraine	SBA (1997)	(off track) 62
Moldova	SBA (1993)	86
Moldova	SBA (1995)	100
Moldova	EFF (1996)	82
Georgia	SBA (1995)	100
Georgia	ESAF (1996)	89
Kyrgyzstan	SBA (1993)	(off track) 70
Kyrgyzstan	ESAF (1994)	86

Source: Mercer-Blackman and Unigovskaya (2000).
Remarks: The index is calculated as the simple average of compliance on each performance criteria at each test date. Compliance on a given condition at a given date is evaluated using the following scale: met=100, waived=50, met after modification=50, waived after modification=30, not met=0.

Another aspect of conditionality is the implementation of structural benchmarks. It is easily seen that the number of structural benchmarks varies significantly across SBA programs and is much higher in the case of medium-term programs (both EFF and ESAF). This reflects the different logic behind the second-generation programs. The

[46] The choice of the monetary authorities or the banking system depends on the specific situation of each country and the rigidity of the program.
[47] Mercer-Blackman and Unigovskaya (2000)

share of benchmarks applied to the key fiscal sector also varies greatly, with almost half of the benchmarks related to fiscal reform under the EFF for Russia.[48]

Table 7: Compliance with IMF structural conditionality

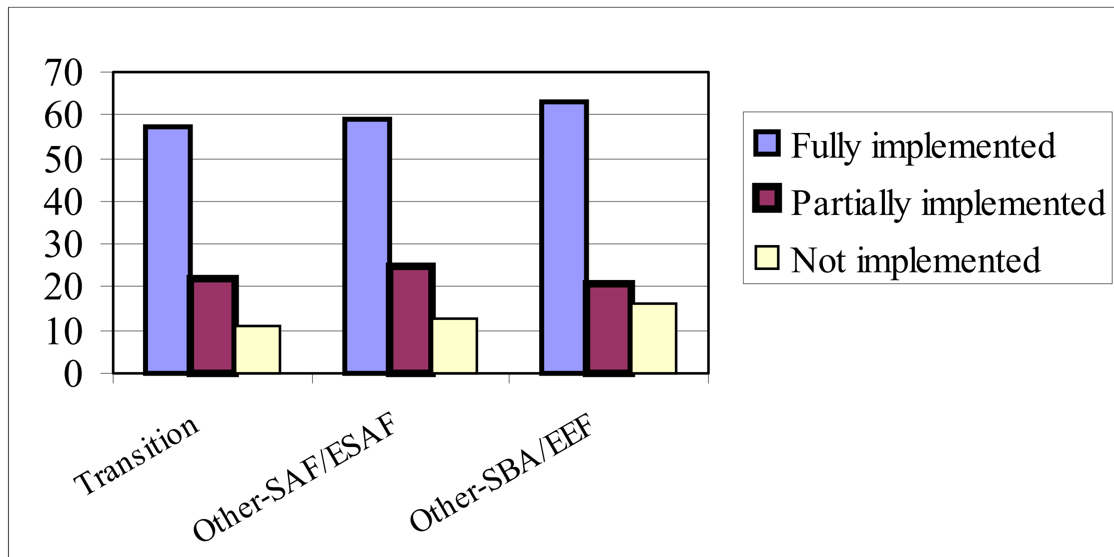
Country	Program	Number of structural benchmarks								Compliance (full = 100)
		Trade/ Exchange System	Pricing	Public Enterprise	Fiscal sector	Financial sector	Privatization	Other	Total	
Russia	SBA	3	-	-	1	-	-	2	**6**	**50**
Russia	EFF	2	1	1	18	7	6	2	**37**	**73**
Ukraine	SBA	2	-	-	1	1	5	3	**12**	**68**
Ukraine	SBA	1	2	2	1	2	1	2	**11**	**83**
Moldova	SBA	4	1	-	3	2	3	-	**13**	**81**
Moldova	SBA	2	-	1	-	-	2	-	**5**	**75**
Moldova	EFF	6	1	1	2	1	4	1	**16**	**90**
Georgia	SBA	1	-	3	8	2	3	-	**17**	**77**
Georgia	ESAF	-	2	1	5	5	4	5	**22**	**79**
Kyrgyzstan	SBA	-	4	-	-	-	1	1	**6**	**0**
Kyrgyzstan	ESAF	1	-	7	10	8	4	5	**35**	**79**

Source: Mercer-Blackman and Unigovskaya (2000).
Remarks: The index of compliance (last column) is calculated as the simple average of compliance on each structural benchmark at each test date. Compliance on a given benchmark at a given date is evaluated using the following scale: met=100, met to certain extent or with insignificant delay=50, insufficient information about outcome=50, not met=0.

The compliance index is consistently higher when medium-term programs are considered. Overall Moldova, Georgia and (surprisingly) Ukraine are countries with the best record of compliance with structural benchmarks, while Kyrgyzstan and Russia improved their low compliance records only under medium-term programs. This international comparison also shows that implementation of the structural benchmarks in transition economies was not extraordinarily low. A comment is in order, however, concerning the role of structural benchmarks in the assessment of reform performance. Apart from the difficulties in measuring compliance, quite often fulfillment of structural benchmarks implied only “paper reforms”; i.e., passage of laws that were never enforced. On the other hand, detailed conditionality that captured particular elements of the reform was missing the broad picture and the final aim of the reform. Therefore, structural benchmarks reflected rather purely fundamental improvements in the institutional set up. What is characteristic, leading CEE reformers exhibit low scores and there is apparently no link between compliance and growth.[49]

[48] Also in the EFF program for Ukraine, 35 of 88 condition were related to the fiscal sector, but this program was initiated after the crisis.
[49] Ibid.

Figure 13: Compliance with IMF structural conditionality



Source: IMF (2001b).
Notes: The second and third sets of bars represent non-transition economies (recipients of concessionary and non-concessionary IMF facilities, respectively, excluding programs for countries affected by the 1997 Asian crisis).

The official IMF evaluation of first- and second-generation programs in RUMGK indicates rather high compliance with IMF conditionality. In our opinion this is highly questionable. Russia, the FSU country most generously financed by the IMF, provides the most striking evidence of non-compliance. We analyze this case in detail below. However, very similar patterns were clearly visible in the other four countries[50].

Box 1: IMF Conditionality: The case of Russia

The IMF decided not to put rigorous conditions on the SBA in 1992, and the Yeltsin-Gaidar reform program dealt mainly with liberalization, privatization, and institutional reforms, and not at all with detailed stabilization policies. The one distinctive feature of this stabilization plan was that neither the wage nor the exchange rate would serve as a nominal anchor. The inflation objective was below 5 percent per month, which was not very ambitious. The political weakness of the Yeltsin-Gaidar government became apparent with the nomination of Victor Gerashchenko, who represented interests of lobbies (industrialists, regions, FSU countries, etc.) demanding credits from the authorities, as Chairman of the Central Bank of Russia. Monetization of an enlarged government deficit representing almost 20 percent of GDP and generous credit lines to the FSU countries led to CPI inflation of over 20 percent monthly in the fourth quarter of 1992. Obviously, all the IMF targets were exceeded at the very beginning of the program in September-October 1992. In the overall appraisal of the achievements of Yeltsin-Gaidar program, the defeats outnumbered the gains. The macroeconomic policy lacked monetary and fiscal tightening. The policy of the CBR was aimed at supporting production and propping up financially inefficient state enterprises and cooperative

[50] These cases are not included in this article in order to avoid repetition.

farms. Foreign trade was only partly liberalized. Incomplete deregulation of prices (combined with the slow pace of demonopolization of the economy) caused shortages, and pressure for massive state interventions (softening of monetary and fiscal policies) grew. The Yeltsin-Gaidar government decided not to start privatization of agriculture. Finally, both the IMF and the Russian authorities followed an inconsistent policy related to abandoning the ruble zone with other ex-Soviet republics, which led to huge transfers of the Russian GDP and further boosted inflation. In December 1992 Yegor Gaidar was replaced by Victor Chernomyrdin, a moderate representative of the "red directors" lobby preferred by the majority of parliamentarians.

The first Article IV consultation was concluded on April 21, 1993.[51] On June 30, 1993, the Executive Board approved an economic program to be supported by a two-tranche purchase under the Systemic Transformation Facility (STF). Russia purchased the first tranche of SDR 1,078.3 million (equivalents to 25 percent of quota) from the IMF on July 6, 1993. The STF, as a brand-new IMF facility, made it possible to credit the new Russian government irrespective of the failure of the previous program. Also, there were many new features in the program. Firstly, the STF specified that the purchase from the IMF would not have to be added to the stock of Russia's official international reserves but would be available to provide additional credit to the economy (and to the budget). This represented a major departure from the IMF's primary goal of providing financial assistance to countries experiencing temporary balance of payments problems. In doing so, the IMF entered terrain usually reserved for the World Bank and its agencies financing government projects (or, more precisely, budgetary expenditures). The conditions of the STF program remained broadly the same as those of the SBA, but this time included explicit targets rather than soft projections.

The program got off to a good start, but as early as the third and the fourth quarters of 1993, targets were exceeded by wide margins. The reason was that tight monetary policy was not accompanied by fiscal adjustment, as President Boris Yeltsin vetoed the 1993 budget (with a deficit of 20 percent of GDP) and then dissolved the Supreme Soviet. In the last months of 1993, Minister of Finance Boris Fedorov made an attempt to limit expenditures and refused to pay. The result of sequestration was a buildup in government arrears, some of which would have to be repaid. Therefore, most monetary and fiscal conditions were not fulfilled. Also, the fulfillment of the monetary conditions was spurious as the official increase in the CBR interest rate brought preferential central banks credits below this rate. Accordingly, the next IMF condition, concerning liberalization of the exchange rate, ended up in CBR interventions to maintain the exchange rate of around 1000 rubles per U.S. dollar. Real appreciation of the ruble led to an increase in imports, dwindling reserves, and finally depreciation of the ruble by 20 percent in September-October 1993. The second tranche of STF was to be disbursed in September 1993, after a review of the program; however, the failures of 1992 were repeated, and all conditions were broken within a quarter after the signing of the agreement.

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[51] According to Article IV, Section 3 of the IMF Articles of Agreement, the IMF has the mandate to oversee the compliance of each member with its obligations, and each member should provide the IMF with necessary information.

On April 20, 1994, the IMF Executive Board approved the next program of the new Russian government[52] supported by a second tranche of SDR 1,078.3 million under the STF. The major goal of the program was to safeguard the fragile achievements in the Russian reforms, especially in the areas of price and exchange rate liberalization, and foster structural reforms, including privatization, foreign trade liberalization, increased competition, and transparency. Gradualism was officially the key operating concept both for Prime Minister Victor Chernomyrdin and the IMF. Again, conditions of the second STF program were similar to those of the first STF.

The second STF combined the macroeconomic conditionality of the first STF with structural reforms, especially mass privatization, managed by Anatoly Chubais, who was in charge of the State Privatization Committee. In the second quarter of 1994 program implementation was on target. The monthly inflation rate fell to 6 percent in June 1994 and to 4.5 percent in August 1994. The government managed to keep its borrowing from the central bank within the program targets, but mainly through aggressive sequestration of expenditures as budget revenues collapsed. In the third quarter, however, credits from the central bank surged as revenues fell in relation to GDP and subsidies to agricultural sector, the Northern Territories, and other customary recipients of budget financing rose sharply. The government's ability to use sequestration diminished and the Parliament rejected most of the revenue measures specified in the second STF. In mid-1994, the authorities ran down official reserves in an attempt to offset the impact of the surge in net credit to the government on the monetary base and inflation. After international reserves dropped by almost US$4 billion in the third quarter of 1994, foreign exchange market participants started to speculate against the ruble. Market participants were fully aware of the inconsistencies in the expansionary fiscal policy and quasi-tightening of monetary policy, which limited credits to banks but expanded financing of the deficit. On October 11, 1994, the ruble tumbled in the Moscow interbank market by over 20 percent against the U.S. dollar. "Black Tuesday" became the first currency crisis in post-communist Russia. In the fourth quarter of 1994, the central bank limited credit expansion to banks and the government, and the Ministry of Finance restricted expenditures but also started issuing government securities well below the market rate.[53] The credit crunch led to a rise in interest rates, but inflation continued to increase reaching a monthly rate of 16 percent in December 1994 – twice the STF projection. Fiscal targets were exceeded by wide margins, the stock of international reserves dropped below the target, the exchange rate depreciated by 45 percent during the second half of 1994, and the majority of liberalization measures was not implemented. The second STF failed as completely as its predecessor.

The rise in inflation, the accumulation of budgetary arrears, and the exchange rate crisis on October 11, 1994, led to the next reshuffling of the Russian Cabinet. Finance Minister Sergei Dubinin and CBR governor Victor Gerashchenko were fired. Anatoly Chubais

[52] Victor Chernomyrdin remained Prime Minister and Sergei Dubinin was nominated as Minister of Finance.

[53] Issuance of new kinds of government bonds, including medium-term ones, was planned in the second STF program with a goal to establish a market for government securities and increase the portion of non-inflationary financing of the budget deficit.

was appointed First Deputy Prime Minister in charge of economic policy, Yevgeny Yasin became Minister of the Economy, and Tatyana Paramonova became Acting Chairperson of the CBR. Negotiations with the IMF resumed, this time concerning a program that would be supported by a stand-by credit of up to SDR 4,313 million (100 percent of quota). As in previous years, a major tightening of monetary and fiscal policies took place at the beginning of 1995. In January, the stock of credit to the government was frozen, the CBR increased reserve requirements, and – as international reserves kept declining – the monetary base shrank by 9 percent. Inflation slowed to 10-11 percent in February-March. On March 10, 1995, in a letter to IMF Managing Director Michel Camdessus, President Boris Yeltsin expressed his support for the new arrangement. On April 11, 1995, the IMF Executive Board approved the stand-by arrangement supported by a credit of SDR 4,313.1 million for a period of 12 months. Additionally, the IMF waived Article V, Section 3(b)(iii), and increased the limit of lending to 200 percent of the Russia's quota. According to official statements, the SBA was aimed at decisive progress in stabilization and structural reform during 1995 and envisaged the same measures as in the previous programs, both from macroeconomic and structural perspective.

In the course of the stand-by program quantitative targets were all met month by month with comfortable margins. The most vulnerable situation remained in the fiscal sector, because of substantial revenue shortfalls that persisted throughout 1995. Measures to improve revenues were implemented only partially or with a lag. Major revenue categories barely exceeded the program's projections in nominal terms in spite of substantially increased inflation, and for 1995 the ratio of revenue to GDP turned out to be nearly 3 percentage points below the programmed level. Under these circumstances, in order to meet the deficit target the authorities contained spending (in relation to GDP), keeping it below programmed levels. On the monetary side, while credit targets were met, large capital inflows put pressure on the ruble, leading to nominal and real appreciation and/or growth of the monetary base (given limited capacity for sterilization). Growing confidence in the ruble and the increase in reserves allowed for introduction of an exchange rate corridor on July 5, 1995 (4,300 – 4,900 ruble per U.S. dollar). However, in the second half of October, pre-election pressure became evident as fiscal policy started to drift away from targets. The previously accumulated margins (with respect to the cumulative ceilings for the credit aggregates, fiscal deficit, and international reserves) allowed the targets for October and November to be met. In December (especially in the last ten days of the month), the authorities probably used "window dressing" to achieve the targets. Therefore, the tendency of policies to drift in the last quarter continued in 1995, and as with the previous programs, it had a negative impact on inflation (3.5 percent in December 1995, instead of 1 percent).

Structural reforms, especially bank restructuring, were considered relatively sluggish. This became evident when an interbank liquidity crisis emerged toward the end of August 1995. The pace and scale of privatization fell short of expectations, and transparency of the whole process due to the introduction of the loans-for-shares scheme became doubtful. Finally, little progress was achieved in the area of land reform.

Summing up, in 1995 the Russian authorities apparently decided to fulfill macroeconomic targets but abandon structural reforms that conflicted with the interests of various lobbies and were therefore politically difficult. The relative success of the 1995 stand-by (in comparison with the performance of the previous arrangements) allowed the Russian authorities to request IMF support for the medium-term program of macroeconomic stabilization and structural reform.

In a letter dated March 6, 1996, the Russian government requested a three-year arrangement under the EFF in the amount of SDR 6,901 million, or 160 percent of the quota. The ongoing stand-by program would then be cancelled as of the date of approval of the extended arrangement. This trade off yielded positive results: almost immediately, on March 26, 1996, the IMF Board approved the program (and again waived Article V).

The proposed strategy for 1996-1998 aimed at establishing a foundation for sustainable growth by lowering inflation to a single-digit annual rate, implementing key structural reforms, and achieving medium-term viability of the balance of payments. The 1996 program was based on quite optimistic forecasts, such as a high annual rate of GDP growth (6 percent starting in 1997), 1 percent inflation monthly beginning at the end of 1996, recovery of money demand, repatriation of flight capital, increase in foreign direct investments, and a comprehensive restructuring of debt obligations (US$7 billion). The debt service burden was especially large for the federal budget, as the accumulation of maturities and arrears during the following years was already foreseen in 1996. However, the critical element of the medium-term strategy was a further reduction in the overall fiscal deficit of the general government from around 6 percent of GDP in 1995 to 4 percent of GDP in 1996 and 2 percent of GDP in 1998. Local governments and off-budget funds were to balance their budgets or finance deficits from non-inflationary sources (without credits from the CBR). A net increase in revenues of close to 5 percentage points of GDP was planned for the medium term (via an increase in tax rates and broadening of the tax base through elimination of tax exemptions and preferential treatment, especially for fuel producers). The monetary framework targeted the same parameters as previous programs, limiting the pace of credit expansion and monetization of the budget deficit. The programmed domestic assets expansion would not result in growth of the monetary base because it was exactly offset by a decline in the monetary authorities' net international reserves. The same was true of the 1995 program – the sale or use of foreign reserves of the central bank was included as part of the monetary authorities' net credit to the federal and enlarged governments. Therefore, the IMF's intention was clearly non-inflationary deficit financing.

The period of 1996-1998 reflected elusive macroeconomic stabilization. Since 1995, Russia had not been able to achieve its main fiscal policy objectives, which were a reduction in the unsustainably high deficit, a reversal of the decline in budget revenues, and a reduction of expenditures. The general government primary deficit rose from 2.6 percent of GDP in 1995 to 3.1 percent of GDP in 1997, and the overall deficit increased from 6.1 percent to 7.7 percent of GDP in the same period. At the same time, general government revenues only increased from 33.5 percent of GDP in 1995 to 35.5 percent of GDP in 1997, whereas expenditures increased from 39.6 percent to 43.2 percent of GDP

in the same period. This reflected a number of fundamental factors, but perhaps the most important among them was a continued recourse to non-monetary fiscal operations and tax offset schemes on the revenue side and expansion of interest payments on the debt on the expenditure side.[54]

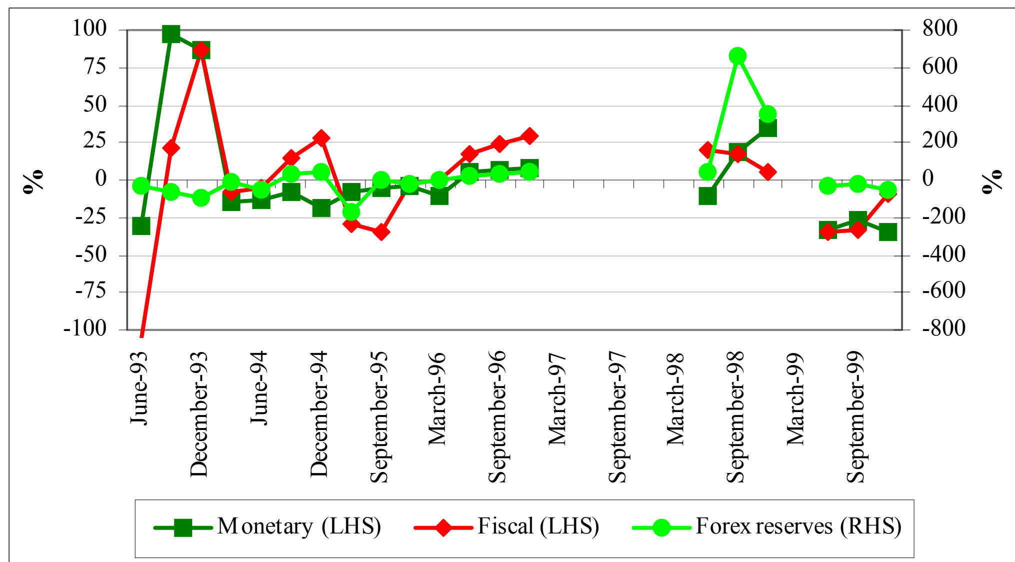
In mid-1998, the accumulation of macro- and microeconomic problems coincided with the cumulating maturity of debt payments due in the third quarter of 1998, amounting to one third of budget revenues, and with a current account deficit resulting from a decline in world fuel prices. Moreover, the Asian crisis in 1997-1998 had increased financial market volatility and investor pessimism about the performance of the Russian economy.

Some adjustment measures implemented at the beginning of 1998 by the government of Prime Minister Sergei Kiriyenko, especially sequestration of expenditures and proposed changes in tax law, were not effective (the Parliament's willingness to support the government's plans was very limited). Capital flows remained volatile and market confidence was not restored. The Russian authorities proposed to implement radical measures and expected support from the IMF. On July 16, 1998, a Memorandum of the Government of the Russian Federation and the Central Bank of the Russian Federation on Economic and Financial Stabilization Policies was signed with the IMF. The government program was basically identical to those supported by the IMF but not realized throughout the previous five years. It aimed at radically tightening the federal budget and lengthening debt maturity, and the authorities expected "substantial foreign financing" for the program. The proposed package of measures for 1998 was partially based on the ongoing EFF arrangement. However, the Duma rejected the proposed changes in tax policy (broadening the base of the Personal Income Tax and transferring a higher share of PIT revenues to the federal budget, increasing the land tax, and balancing the budget of the Pension Fund). The Russian government was to provide a supplementary memorandum to the IMF on July 20. On July 31, the IMF tried to avert crisis by disbursing a SDR 3.4 billion tranche. However, this in fact only hastened the inevitable deep correction of the exchange rate made necessary by accumulated macroeconomic imbalances.

With the crisis of August 1998, Russia exceeded all quantitative targets established in the EFF program. IMF disbursements to Russia came to a halt. The latest program, SBA for SDR 3.3 billion (55.5 percent of quota) for a period of 17 months, was signed on July 28, 1999. Through the end of 2000, Russia has made only one purchase. Quantitative performance criteria for the end of July, the end of September, and the end of December 1999 were reached (many with large margins). However, there were many shortfalls relative to structural benchmarks for the third and fourth quarters of 1999.

[54] See Antczak (2000) for an analysis of the Russian crisis in 1998.

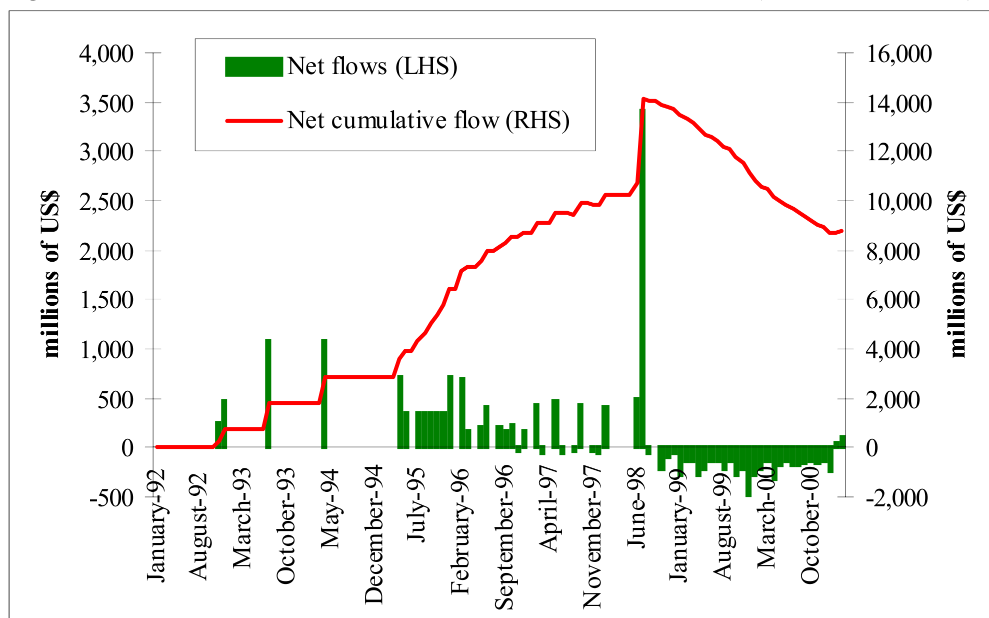
Figure 14: Russian Federation, compliance with the IMF quantitative monetary, fiscal, and exchange rate targets in 1993-1999 (in percent)



Source: IMF (A4C, IFS, RED, SP).

Note: Exceeding of targets should be viewed as noncompliance with conditionality. Targets are equally weighted.

Figure 15: IMF net disbursements to Russia in 1992-2001 (millions of US$)



Source: www.imf.org.

The example of Russia (to which we could easily add similar cases from the other four countries) clearly shows that from the very beginning of the transformation the IMF was not insistent enough on its conditionality, especially in the area of fiscal adjustment. It also shows that the conditionality was effectively much weaker than is suggested by the relatively high scores on compliance presented by IMF sources. This inconsistency stems

from issues of transparency in the performance criteria. The attempts to circumvent imprecision were also one of the reasons for the proliferation of arrears, sequestration, explicit and implicit guarantees, and quasi-fiscal operations. It is important that the majority of "more than useless" indicators were created in the crucial sector of public finance. While the promotion of public awareness and responsibility should be one of key functions of the Fund[55], it has long given a rather idealized picture of the FSU countries. The public could not generally access surveillance data or memoranda on policies or criteria breaching. Instead, as Boris Fedorov put it, "*the IMF was pretending that it was seeing a lot reforms. Russia was pretending to conduct reforms*".[56] Similarly, *The Economist* (1996) quotes an anonymous Russian minister's comments on the March 1996 negotiations to the effect that "*bookkeeping tricks were pulled on both sides*".

A further factor in the weakening of conditionality was the changing weight given to performance criteria and program reviews. Performance criteria (and prior actions) should generally be very precisely defined and provide a ready test for the compliance of policies with the program. Non-implementation can still be accepted through the issuance of a waiver; however, conditionality based on performance criteria is generally less lax and less likely to be affected by political considerations. On the other hand, program reviews that mix ex-post evaluation with expectations towards future actions provide much more room for discretion. Coupled with the increasing number of waivers and modification in the program criteria, this undermined the "binding commitment" role of conditionality. The final, and probably most important, factor behind lax conditionality is the ease with which the Fund continued to work with countries with very bad track records. Again, the case study of Russia shows this very clearly, but a similar pattern can be observed in most of the countries under investigation here: new programs were continually covering up the fundamental weakness of the FSU economies.

To sum up, the conditionality exhibited excessive leniency, allowing recipient countries to avoid fiscal and other kinds of necessary adjustment. While flexibility is important, as it allows for corrective measures in cases of external shocks, it has been clearly abused in the case of the FSU. Again, the prior experience of the IMF appears to be at fault. Instead of promoting good policies in a decisive manner, the Fund was showing that it "*pays due regard to the domestic social and political objectives*"[57] – even if these objectives were detrimental to long-term growth and stabilization.

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[55] Compare, for example, Brown (1998).

[56] Cited in McQuillan (1998).

[57] IMF (2001a). Compare also Camdessus (1994): "*(...) policies may indeed need to be adjusted pragmatically in light of circumstances and developments. One example has been fiscal policy. (...) In many cases, after careful assessments, the Fund has agreed in these circumstances to the temporary relaxation of fiscal deficit targets in programs it has supported, while of course continuing to focus on the requirements of lowering inflation and achieving medium-term fiscal sustainability*". Developments proved, however, that it is extremely difficult to achieve sustainability when adjustments are repeatedly delayed and "temporary relaxations" persist.

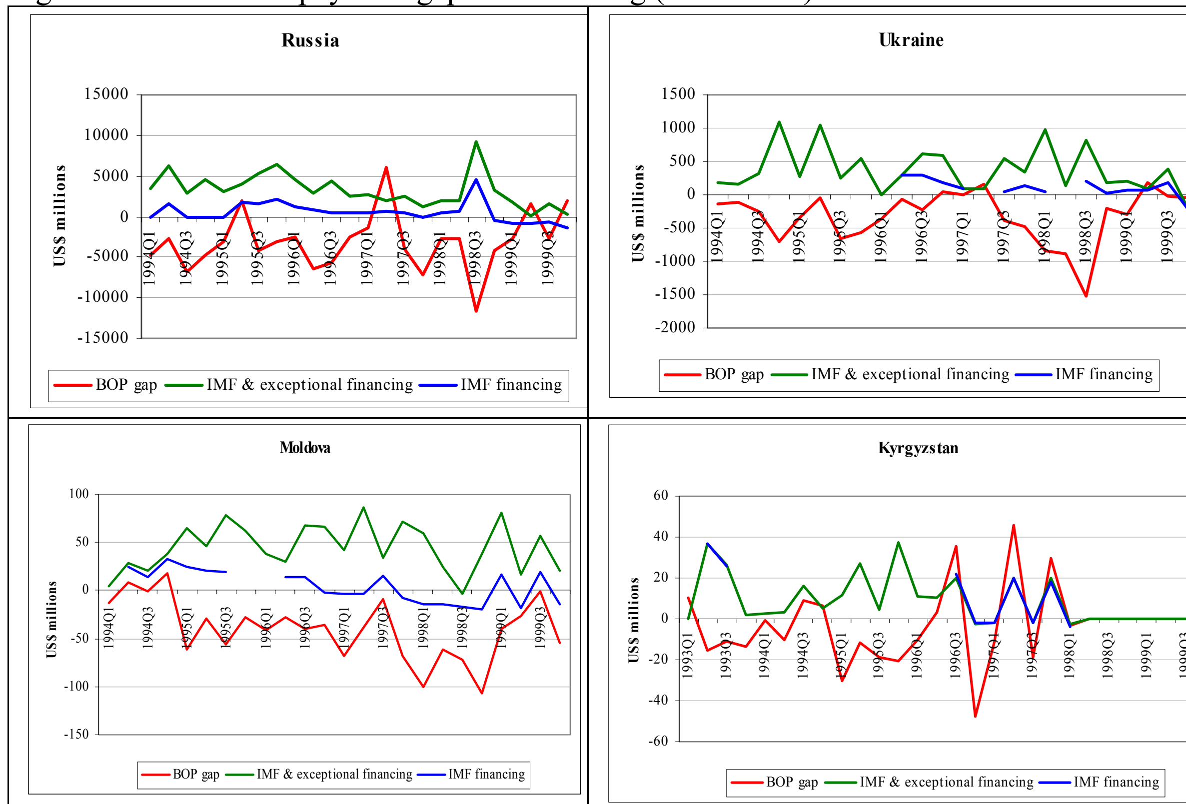
Soft financing

Throughout this paper we have argued that the IMF was not insistent enough on fiscal adjustment. We now wish to take this argument further and show that the IMF programs were actually detrimental to true fiscal adjustment. As the IMF was consistently softening governments' "hard budget constraints" by providing non-monetary sources of deficit financing, the political support for fiscal tightening was even more difficult to generate than would have been the case in the absence of IMF programs.

The support of the IMF for the development of non-monetary deficit financing in RUMGK was twofold. First, the IMF was willing to indirectly finance FSU governments. The STF in 1993 specified that the purchase from the IMF would not have to be added to the stock of Russia's official international reserves but would be available to provide additional credit to the economy (and to the budget). The same was the case of the 1995 program: the sale or use of government holdings of reserves was included as part of the monetary authorities' net credit to the federal and enlarged governments. In so doing, the IMF was attempting to finance the budget deficit in a non-inflationary manner. Indeed, in our five countries, all of whose central banks were directly financing the budgets, the IMF funding was transferred to the budget and consumed. Ukraine serves as a good example. The Ukrainian EFF program included a target for central bank gross purchases of treasury bills from the primary market. Agreements with the IMF also allowed for negotiations with debtors on rescheduling of payments. Such re-schedulings were to constitute a source of balance of payment financing referred to as "exceptional financing". Russia, as the legal successor to the debt (as well as the assets) of the USSR and net creditor to the rest of the FSU countries, received the largest rescheduling of debt payments. The existence of the ruble area until July 1993, inter-republican trade and financial links, and the similarity of transformation problems led to the adoption of a common approach to all FSU countries by the Western governments and international financial institutions. In practice, informal rescheduling of the Russian debt payments was often conditioned on the Russian government's rescheduling of debt payments it was owed by Ukraine, Moldova, Georgia, or Kyrgyzstan. This multilateral credit approach was used in relations amongst most FSU countries. Therefore, the IMF disbursements can – together with exceptional financing (i.e., debt relief and arrears) – be treated as a form of financing of the twin deficits (balance of payments and budget deficits).

The unjustified "seal of good housekeeping" further softened budget constraints, as the economic policy memoranda with the IMF opened the door to cooperation with other multilateral and bilateral donors. IMF programs constituted a stamp of approval for government policies, tending to bring improvements in the countries' ratings and new capital inflows. This catalytic role is explicitly recognized as one of the main functions of the IMF in support of adjustment. However, when the IMF underwrites unsustainable policies, the effect is disastrous for the borrowing country: external debt accumulates and incentives for adjustments are diminished.

Figure 16: Balance of payment gap and financing (1994-1999)



Source: IMF (IFS).
Note: The balance of payments gap is defined here as the sum of the current account, capital account, financial account, and errors and omissions. IMF and exceptional financing are financing items in the balance of payments. The residual from these two is the change in net international reserves of the monetary authorities. Balance of payment data on Georgia is scarce.

For smaller countries this foreign financing led to a debt trap. Wrong signals sent to private creditors and governments had a highly detrimental impact on the economic situation of these countries. Policies based on increasing debt-to-GDP ratios were unsustainable, but could be maintained as long as financial markets did not fully realize this. An interesting example of such an attempt to change market sentiment was the arrangement negotiated for Russia in 1998, which aimed to use external financing to prolong the fragile stabilization.[58] Later on, however, the IMF admitted that crisis was inevitable unless the "steadier process at work" were fundamentally reversed[59].

Worse, a general sense of implicit guarantees ("too big to fail"), especially in case of Russia was built up over the course of years. While the role of IMF in the modern world should be the prevention of crisis through the surveillance of national policies, transparent information and reduction of moral hazard, the practice was exactly opposite. Meltzer (1999) concludes: "*Moral hazard lending to Russia, encouraged by the bail out of foreign lenders to Mexico, permitted Russia and other countries to finance large*

[58] Stanley Fischer (1998) stated at the beginning of 1998 that "*the Russian economy has broadly achieved stabilization and the future should bring much more peaceful days*".
[59] IMF (RED) on Russia, issued in September 1999.

unbalanced budgets by borrowing externally. The result is a much larger financial problem for international lenders and for the economies of other countries". In consequence, the IMF's opening of access to external savings delayed the change in direction of capital flows and therefore induced reluctance to apply remedies. Without the IMF, Russia and other countries in the region might have had better policies.

Conclusions: Political and institutional considerations

How could the IMF have made such mistakes? The answer to this question is basically beyond scope of this paper. We will simply note that it is most likely of a political nature. As Meltzer (1999)[60] explains: "*The G-7 governments either were unwilling or believed themselves unable to obtain funding for the transformation from their parliaments. The IMF agreed to accept responsibility. In doing so, it reached far beyond its competence*". The influence of politics over economics, and especially on the quality of conditionality, can be summarized in the popular adage that "*saving Russia from communism matters more than the niceties of monthly bookkeeping*".[61] Another group of factors that could contribute to this problem is related to the system of incentives facing the IMF bureaucracy.[62] The IMF as an institution has a stake in the "success" of the program. It is, therefore, difficult for its officials to declare the program a failure, even if it cannot impose its real implementation. Finally, the IMF wants to stay in the country, as it considers some influence on policy to be better than no influence at all. This is, however, not the case if it leads the Fund to underwrite bad policies.

[60] Compare also Dabrowski (1995). Several authors argue that a politically independent IMF would be more effective at promoting international financial stability; compare De Gregorio et al. (2000).
[61] The Economist (1996)
[62] Vauber (1994)

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