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1 Introduction

At the end of October 1991, president Yeltsin announced a radical programme of economic reform for Russia. The aim of the programme was to transform Russia from a centrally planned economy into a market economy. The transition process includes stabilization of the economy, liberalization of prices and foreign trade, privatization of enterprises and structural changes in the whole economy.

The long run objectives for Russian monetary policy are macroeconomic stability and growth as well as efficiently functioning banking and financial markets. In the shorter run, the aim was to reduce inflation to a single-digit monthly rate and to restore confidence in the rouble. This was to be achieved through firm control over the money supply and by raising the interest rate on loans to positive levels in real terms. Also, fiscal policy was designed to balance the consolidated budget and to abolish the budget deficit by the end of 1992.

However, these ambitious targets were not achieved. Inflation galloped at an annual rate of 2 500 per cent in 1992 while the central bank and the government continued to grant soft credits to state enterprises. The consolidated budget deficit widened and the rouble depriciated steadily.

For 1993, the objectives for monetary policy remain the same as for 1992. These goals were announced in the economic policy statement by the Government of Russia and the Central Bank of Russia in May 1993.

This paper analyses Russian monetary policy developments since 1992. Section 2 describes the structure and development of the financial system. Section 3 discusses the economic stabilization programme for 1992 and the goals for monetary policy. Section 4 analyzes the actual results of monetary policy in 1992 and discusses reasons for the failure to achieve monetary policy objectives. Section 5 focuses on foreign exchange policy and the final section analyzes the situation in 1993.

[1] The paper benefited greatly from the comments of my colleagues in the Unit for Eastern European Economies, Bank of Finland.

2 The Russian Banking System

The development of the financial and banking system is crucial for the progress of Russian economic reform. Under the Soviet system of planned economy, banks were passive institutions used to implement centrally-designed production and distribution plans. Money had the secondary role of accounting unit, and monetary flows were adjusted to physical targets set in state plans. Therefore, the allocation of the monetary resources was not based on the efficiency of operations. A market economy requires active institutions that allocate financial resources to those economic activities which offer the best return. Hence, changes in the structure of the Soviet banking sector were needed.

Before 1988, the Soviet Union had a monobank system in which the central bank (Gosbank) not only controlled the flow of funds but engaged in commercial banking operations as well. Only three other financial institutions existed, along with their regional branches. Sberbank took in individuals savings, Stroibank was an all-Union construction bank and Vneshtorgbank handled the exchange of foreign currency. In autumn 1988, five specialized banks were established: The Bank for Foreign Economic Affairs (Vneshekonombank), the Industrial and Construction Bank (Promstroibank), the Agro-Industrial Bank (Agroprombank), the Savings Banks (Sberbank) and the Bank for the Housing, Local Government and Social Sectors (Zhilsotsbank). The aim was to establish a two-tiered banking system with Gosbank retaining its central banking functions and the specialized banks taking over the commercial banking functions. The creation of the specialized banks did introduce division of labour, but there was no competition between the banks.

New laws on Gosbank and on banks and banking activity in the Soviet Union were passed in December 1990. These laws failed to have much significance in practice, as some republics had already enacted laws on their own banking systems which were at odds with the all-union banking system. Completely independent banking systems for the republics came into being when the Soviet Union was dissolved at the end of 1991, but the unified banking system had already begun to erode earlier. The laws establishing the framework for Russia's banking system were also passed in 1990. The Central Bank of Russia (CBR) was technically subordinate to Gosbank until late 1991, when Gosbank was merged with the CBR before being officially dissolved shortly therearter.[2]

The framework established in 1990 is still in force, but obviously in need of major revision.[3] Under the law, Russia has a two-tiered banking system. The central bank and its various subunits implement monetary and credit policy and supervise the operations of other banks; the commercial banks constitute the second tier.

[2] Kivilahti et al., 1992.

[3] The reading of the revised versions of the Central Bank Law and of the Law on Banks and Commercial Banking has been delayed in the Supreme Soviet.

2.1 The Functions of the Central Bank of Russia

The Law on the State Bank of the USSR of 1990 made the bank autonomous. Similarly, the Russian Law on the Central Bank, enacted at the same time, gave the Russian central bank autonomy from the Russian government. The CBR is under the rule of the Supreme Soviet which appoints its chairman.

The Russian central bank took over the duties, assets, and liabilities of the former Gosbank. According to the Law on the Central Bank of Russia, the main functions of the Central Bank are to maintain the money supply, preserve the stability of the rouble, pursue a uniform monetary and credit policy, settle payments, issue licences to banks to operate as commercial banks and regulate and supervise commercial banks' domestic and foreign operations.

The CBR has the right to carry out all legal foreign exchange operations in both Russia and abroad. The progress toward economic reform has been clearly reflected in Russia's exchange system. Toward the end of 1980s, several rouble rates emerged alongside the traditional official rouble rate, creating a multiple exchange rate regime. In July 1992, the exchange rate system was unified but the rouble has been only internally convertible. The currency policy of the CBR is further examined in section 5.

The exchange control tasks of the CBR are laid down in the foreign exchange law of October 1992. According to this law, the central bank is the country's major exchange control authority. The central bank has the right to control trade in Russia involving foreign currencies[4], issue licences to commercial banks for undertaking foreign currency operations and to decide on the repatriation of foreign currency. Russia's foreign currency reserves are held by the central bank, the Ministry of Finance, and the Bank for Foreign Economic Affairs.

The functions of the CBR differ in several ways from those of Western central banks. Lending to the government accounted for nearly 35 per cent of the central bank's total assets of 10 500 billion roubles in 1992. This includes the financing of government expenditure and loans to the Ministry of Finance, which relends to specific economic sectors or to the public sector. Short-term central bank lending, which accounted for 25 per cent of total assests in 1992, consists of loans to commercial banks for centralized lending programmemes and direct loans to enterprises. Another 20 per cent of the assets consists of loans and payments to the central banks of the other states of the former Soviet Union.[5]

An interesting feature of the CBR liabilities is the large share of commercial banks' correspondent accounts. The importance of correspondent accounts is explained by the payment system. The central bank settled every banking transaction. This created an extremely inefficient system with large sums of money for settlements deposited in the central bank.[6] Traditionally, households could only use cash money (nalichnye dengi) as a means of payment, and enterprises had to

[4] There has been much discussion on banning the use of foreign currencies in Russia's internal trade. In February 1993, the CBR published instructions concerning the restriction of foreign currency operations within the territory of Russia.

[5] Ekonomika i Zhizn, 29/1993.

[6] Fuchita et al., 1993.

use non-cash deposit money (beznalichnye dengi) with payments made principally through bank accounts. Lately, the complicated and unreliable payment system has been largely circumvented and payments are settled outside the banking system.

2.1.1 Monetary Policy Instruments of the Central Bank of Russia

The most important monetary policy instrument for the Central Bank of Russia is the quantity of credit extended. This is also the most controversial instrument, since the CBR has continued to issue credits to support state enterprises. Total domestic credit of the CBR can be divided into net lending to the general government, gross credit to banks, and net lending to other central banks in the former Soviet Union. A considerable share of the credits to commercial banks and to government are in fact re-lent to state enterprises, often at subsidized interest rates. According to International Monetary Fund (IMF) and World Bank calculations, nearly 50 per cent of CBR credits in 1992 were intended for industrial enterprises.

The CBR depends largely on two indirect instruments in implementing monetary policy: the discount rate and reserve requirements. As the securities markets are only beginning to develop in Russia, it has not yet been possible for the Russian central bank to implement monetary policy through open market operations.[7]

The discount mechanism encompasses several arrangements designed to influence the level of central bank credit to the banking system. It consists of the discount rate, that is the interest rate on central bank loans to commercial banks, and the amount of credit that the central bank makes available to the borrower.

The CBR liberalized commercial bank lending and deposit rates at the end of 1991, but the interest rate on bank credit has generally been significantly below the level of inflation. This has led to negative real interest rates. In January 1992, the central bank raised its annual discount rate for banks to 20 per cent in January 1992, from an average rate of around 8 per cent in 1991. In April, the CBR discount rate was raised to 50 per cent and on May 29, 1992 to 80 per cent.[8] As the inflation rate in 1992 was 2500 per cent, real interest rates remained highly negative. The negative real discount rate encourages big enterprises to establish their own banks to provide them with cheap loans.

Even though commercial banks have gained a considerable spread on their interest rate, commercial banks' lending rates have also remained negative in real terms. The persistence of negative real interest rates of commercial banks can be explained by the ownership structure of the banks. As stated in section 2, the cross-ownership between commercial banks and their clients is significant. The banks are often unable, or unwilling, to refuse the enterprises credits on favourable terms. Therefore, the amount of credit issued is largely independent of the

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[7] By the beginning of August, 1993, there have been three auctions of the Russian Government's three-month bills, totalling 9.5 billion roubles. In the future, the bond market could provide an important means of financing the budget deficit without just printing money.

[8] Aukutsenek and Belyanova, RFE/RL Research Report, No 4, January 22, 1993.

interest rate frequently set at an arbitrary level. Negative interest rates are also an important reason for the extensive capital flight from Russia.

A reserve requirement is one means of controlling the adequacy of liquidity in the banking system. In most industrial countries, interest rates are the most important instrument for short-term monetary control, and the reserve ratio is usually fixed. In Russia, however, as the influence of interest rates is highly uncertain, adjustable reserve requirements are needed to control the money supply. The ability of CBR to alter the reserve ratios makes it a powerful tool of monetary policy. The Central Bank of Russia increased reserve requirements gradually from an effective rate of 0.7 per cent in 1991 to a statutory rate of 15–20 per cent at the beginning of April 1992. For time deposits of less than one year, the reserve requirement is 20 per cent; deposits of more than a year are subject to a 15 per cent requirement.[9] Commercial banks responded to increases in the discount rate and reserve requirements by raising their lending and deposit rates, but not to positive levels in real terms.

An ironic result of the large amount of CBR targeted credits allocated through commercial banks is that banks have been holding large excess reserves, amounting to almost a half of commercial banks' total liabilities. This has happened because loans are offered at subsidized interest rates and the Ministry of Finance, which pays the subsidy, is often late in paying it. Therefore, there is a delay in the extension of loans to enterprises. Meanwhile, the banks are not allowed to lend the funds to other enterprises. Hence, they hold large reserves at the Central Bank.[10]

The CBR can also effect monetary policy through its inspection and licensing of commercial banks. The Russian central bank has also frequently supervised and regulated commercial banks by issuing specific instructions.

2.2 Commercial Banks

Figures supplied by the Association of Russian Banks show that at the end of 1992 the country had about 1 700 commercial banks with 2 000 branch offices. Most of them were small and only some 30–40 of the biggest commercial banks could function at an internationally-comparable level. In 1992, almost two thirds of the banks had equity capital of less than 50 million roubles. The commercial banks were required to increase their minimum capital to 100 million roubles by July 1, 1993, which is still small considering the rate of inflation.[11]

Commercial banks can be grouped into three types. More than half of the current commercial banks were formed from regional branches of the former state specialized banks. Their capital shares have been distributed mainly to the state

[9] Lewarne, 1993.

[10] Ickes and Ryterman, 1993.

[11] Kommersant 12.-18.4.1993.

enterprises in the corresponding sector.[12] Commercial banks of the second type have been created by large industrial enterprises of a particular industrial sector. For example, the Aeroflot Bank was founded by several airline companies from all 15 independent states of the former Soviet Union. Banks of the third type are founded by new commercial organizations, including several joint ventures.[13]

In many respects, the Russian financial system has not changed even though its organizational structure has changed. According to Medvedkov (1993), nearly 80 per cent the banks' equity capital came from state enterprises in 1992, which limits the independence of the commercial banks. The cross-ownership between state enterprises and banks reduces the effectiveness of the banking system, as decisions to grant credits are not based on credit worthiness. Hence, the old practice of credit allocation to state enterprises has continued. In a sense, the decentralization and the creation of new commercial banks have merely led to a considerable increase in the number of financial intermediaries through which the state is allocating financial resources to enterprises.

A general shortcoming of the Russian banking system is the lack of adequate legislation. As is clear from the above discussion, there is a lack of rules limiting bank ownership by industrial or commercial enterprises. As there is virtually no commercial bank supervision on the part of the central bank, the banking system is exposed to fraud. Bankruptcy procedures are not clearly defined and there have been virtually no bankruptcies, even though the law on bankruptcy came into force in March 1993.[14] Furthermore, the payment system is very unreliable, as documents are lost and money transfers take weeks.

As there are few restrictions on the scope of banking operations, the major commercial banks are engaged in various activities such as real estate investment, leasing, factoring or rare metals trading. But yet, they are not familiar with some areas of banking operations common in the West. Typically, individual deposits account for a small percentage of commercial banks' borrowings, as the savings banks dominate in terms of individual customers. Banks also lack international financial dealings, and credit card and cheque services, for example, are very rare.

By Western standards, Russian commercial banks enjoy a wide difference between interest paid and interest received. This margin does not, however, guarantee them protection against inflation and losses in the value of their capital. Therefore, banks try to shorten the maturities of their loans or find areas of activity where they can realize very high profits. As commercial banks trade in short-term deposits and loans, long-term investment in production suffers.

Two other general shortcomings of the Russia's banking system are the underdevelopment of the branch network and the absence of competition. Apparently, the procedure for opening a branch office is very complicated, even in the case of relatively big banks. The Association of Russian Banks has strongly

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[12] Many of the specialized banks began their existance as commercial entities with so called bad loans on their books. These loans are mainly the result of enterprises' soft budget constraints and are not likely to be paid back.

[13] Aukutsenek and Belyanova, RFE/RL Research Report, No 4, January 22, 1993.

[14] According to Izvesitija 2.7.1993, the Russian government is planning to form an agency in connection with the State Committee for the Magagement of State Property in order to implement the law on bankruptcy.

opposed the permitting of foreign competition in the banking sector, but some foreign banks have been granted a banking license. The minimum capital requirements are, however, much stricter for foreign banks. Many Russian commercial banks are insolvent, their balance sheets weighted down with non-performing loans. Changes in the banking system are likely to have extensive effects on the whole economy due to the distortions in the ownership structure discussed above. Therefore, reductions in the total volume of credit leading to closures of unprofitable enterprises and liquidation of insolvent banks face strong political resistance.

3 Economic Stabilization Programme of 1992

The ideas underlying the Russian stabilization programme of 1992 were formulated in October 1991. President Boris Yeltsin presented these ideas to the Fifth Congress of People's Deputies, which granted Yeltsin special powers for implementing the programme. Jegor Gaidar, Minister of Finance and Economics and Deputy Prime Minister (subsequently appointed acting Prime Minister), was the intellectual father of the programme and its chief implementer.

The two main aims of the economic programme adopted by the Gaidar government were macroeconomic stabilization and liberalization of the economy. Macroeconomic stabilization included reform of the fiscal system and strict monetary policy. Liberalization of the economy was intended to end state controls in order to create the basis for a market economy. This included price liberalization, liberalization of international trade and privatization of the economy.

The economic programme was revised on several occasions in 1992. In February–March 1992, the aim of joining the International Monetary Fund was taken into account in formulating economic policy. This meant controlling inflation, curbing the fall in production and improving foreign trade prospects. The aim of monetary policy was to achieve the inflation objective of single-digit monthly inflation by the end of 1992 and to restore confidence in the rouble. An ambitious objective of fiscal policy was to balance the consolidated budget by the end of the year.

In August 1992 the IMF approved Russia's request for a first credit tranche stand-by arrangement. The first credit tranche is automatically granted after becoming a member in the IMF and does not require an economic programme unlike the actual credits granted by the Fund. The arrangement represented the first stage of the strategy of cooperation between Russia and the Fund. Once conditions for implementing an effective system of monetary control within the rouble zone were in place, negotiations with the IMF on an economic programme could begin. In order to implement these policies and strengthen economic reforms, Russia's economic programme was reviewed in autumn 1992 when the government published a programme for extending the economic reform.

Unfortunately, these rather ambitious goals were not achieved. The Russian economic situation deteriorated in 1992. Liberalization of the economy was less complete than planned. Macroeconomic stabilization was not achieved, as the budget deficit widened, prices rose by 2 500 per cent, and the rouble depriciated sharply.

4 Monetary Policy 1992

The economic situation in the Soviet Union at the beginning of the 1990s was marked by a deep recession with declining gross domestic product, high inflation, a continually increasing budget deficit, rapid monetary growth, external insolvency and the collapse of the external value of the currency. In 1991 the rapid issue of new money led to a 94 per cent increase in the circulation of cash within the rouble zone. Bank lending rose by 85 per cent. At the same time, the rouble lost 86 percent of its value against the dollar in 1991 on the official Moscow interbank foreign exchange market.[15]

In addition to the poor economic situation, many structural distortions inherited from the Soviet Union complicated the process of economic reform and the stabilization of monetary conditions.

Economic developments in the first half of 1992 were dominated by comprehensive price liberalization in January 1992.[16] Even though most of the prices were liberalized, this took place within a "closed" economy. Price liberalization did not include all important branches of the economy nor did it entail currency convertibility or liberalization of foreign trade.[17] Vernikov (1993) argues that this kind of liberalization does not achieve the objective of bringing domestic prices in line with world prices but merely leads to the same relative price at a much higher level. This could follow from the macroeconomic imbalances of the pre-liberalization period, excess demand and shortages in most areas of output.

In January 1992, the monthly inflation rose to 245 per cent. Cash shortages emerged in the first half of 1992 due to the inflation, and the authorities responded by issuing larger denomination notes. The inflation did, however, solve the problem of monetary overhang inherited from the Soviet system of fixed prices, soft budget constraints and shortages of goods.[18] The inflation rate slowed down during the months following January as fiscal and monetary policies were tightened in early 1992. In August–September, the monthly inflation fell to approximately 10 per cent.

Under to the programme agreed with the IMF in summer 1992, ceilings on the net domestic assets of the CBR were established. The growth of central bank credit to the banking system was limited to 700 billion roubles in the second half of 1992. A ceiling of 600 billion roubles was also set on net bank credit to the government. Tighter credit policies, including a shift toward positive real interest rates and a reduction in production subsidies, were expected to harden budget

[15] Ellman, RFE/RL Research Report No 34, August 28, 1992.

[16] 90 per cent of all retail prices and 80 per cent of wholesale prices were liberalized. Not liberalized were basic food stuffs, energy products, agricultural procurement prices, most imports, transportation and local government services. In September 1992, there was a considerable price rise allowed in the energy sector, but energy prices remained controlled.

[17] Even though export controls were reduced, more than 70 per cent of Russian exports remaided subject to export quotas and licenses.

[18] For a discussion of monetary overhang, see Rautava 1993a.

constraints for enterprises and therefore to discourage the accumulation of inter-enterprise arrears.

There was, however, a considerable loosening of monetary policy in the last two quarters of 1992. Total bank lending to the economy grew, reflecting mainly the expansion in CBR lending to commercial banks and to other central banks in the rouble area. Also, the financing requirement of the government increased. Most of the loans, made available at subsidized interest rates, were directed toward particular sectors, especially agro-industrial and energy complexes, and certain regions represented by a strong agro-industrial lobby.

According to Viktor Geraschenko, chairman of the CBR, the central bank allocated 2.879 billion roubles in centralized credits through commercial banks in 1992. Cash in circulation increased 10.4 times and total money in circulation 7.5 times. At the same time, the real value of bank deposits fell, reflecting the fact that households and firms are driven out of bank deposits because of high inflation and negative real interest rates.

Table 1 shows the domestic credit extended by the Central Bank of Russia.

Table 1. **Total Domestic Credit Extended Quarterly by the Central Bank of Russia, billion roubles**

	Quarter ending				
	March 1992	June 1992	September 1992	December 1993	March* 1993
Recipient					
central government	142	486	1240	1972	3692
commercial banks	286	568	1290	2624	3515
CIS countries	40	314	627	916	1447

Source: Kommersant No 12, April 19–25, 1993.

Table 1 divides total domestic credit of the CBR into net lending to the central government, gross credit to banks, and net lending to other central banks in the former Soviet Union. The table shows the considerable increase of nominal credit granting towards the end of 1992. It also gives the preliminary estimates of domestic credit for the first quarter of 1993. Credits to commercial banks account for the largest share of CBR credit. These credits are mainly issued to be re-lent to enterprises. Credits to government consist of financing the budget deficit but they also include credits to enterprises through the Ministry of Finance. Credits to former Soviet republics have been issued mainly in order to maintain their purchases of Russian goods.

The considerable growth of the money supply led to a new acceleration of inflation towards the end of 1992 and nearly to hyperinflation by the end of 1992. At the same time, the external value of the rouble depreciated sharply. At this point, we take up some of the important underlying reasons for the failure of monetary policy.

4.1 Political Factors

A dominant feature affecting Russian economic reform, especially since the second half of 1992, has been the accelerated power struggle among the highest authorities. The president and the government have been facing growing opposition from the conservative Russian Parliament. The power struggle has slowed down the necessary economic reforms, as the Parliament as the highest legislative body has not approved radical reform policies. A basic dilemma concerning the role of the Central Bank of Russia is that the CBR is responsible to the conservative parliament. The central bank has continued the Soviet-style automatic credit granting and subsidizing of state enterprises in accordance with the Parliament. On the other hand, the government has not been able or willing to control the budget deficit, which has increased inflationary pressures.

One of the goals for the economic programme of 1992 was the rationalization and contraction of the system of state subsidies and transfers. As Russia lacks a functioning social security system, neither the government nor the CBR have been willing to tolerate the politically difficult consequences of tighter monetary policies. According to IMF and World Bank estimates, the explicit budgetary subsidies amounted about 22 per cent of GDP in 1992. These include import subsidies, interest rate subsidies and producer subsidies. Directed credits to enterprises from the CBR and the Ministry of Finance constitute another important form of transfers, amounting to 21 per cent of GDP in 1992. These credits, administered mainly by the commercial banks, are made available at subsidized interest rates. Implicit price subsidies on energy consumption, for example, are the largest form of subsidy but also the most difficult ones to measure.[19]

An important event from the point of view of the monetary policy was the resignation of the chairman of the Central Bank of Russia, Georgy Matyukhin, in the summer of 1992. He was replaced by the former chairman of the Gosbank, Viktor Geraschenko. A change in central bank policy followed. As a broad generalization, it could be stated that during Matyukhin's era monetary policy was tighter but the payments system was overly centralized. In Geraschenko's era, the payment system has been somewhat decentralized but monetary policy has been eased.

[19] For a discussion of subsidies, see Rautava, 1993b.

4.2 Financing Government Expenditure

The Russian Ministry of Finance is also partly responsible for the failure of monetary policies, as the budget deficit is an important source of inflation. The government's monetary and fiscal policies have often been inconsistent with decisions made on an ad hoc basis. Either due to parliamentary pressure, internal conflicts within the government or to the unwillingness to make politically unfavourable decisions, the government has not been able to fulfill its promises. The division of labour between the CBR and the Ministry of Finance is somewhat unclear, as both of these institutions, as well as the commercial banks, are involved in the complex system of credits and subsidies. Boris Fjodorov, the current deputy Prime Minister and Minister of Finance, who has become the figurehead of the government's reform programmeme, has on several occasions demanded that all subsidies should be allocated through the budget, so that the true size of the budget deficit can be exposed. The division of labour between the Ministry of Finance and commercial banks in gathering information on enterprises, i.e. for taxation purposes, is also unclear.

The overall budget deficit of the Soviet Union in 1991 was officially estimated to be 22 per cent of the Union's GDP. Adjusting this figure in line with international norms raises it to over 30 per cent of GDP.[20] The reform programme of the Gaidar Government projected Russia's budget deficit to be 0.9 per cent of GDP in the first quarter and declared the aim of balancing the budget by the fourth quarter.[21] The agreement reached with the IMF required that the budget deficit be reduced to 5 per cent of GDP. Official figures indicate that the budget deficit in 1992 amounted to 5–7 per cent of GDP. According to Western estimates, it was around 25 per cent. In any case, the deficit objective was not achieved.

Traditionally, the central bank has financed the budget deficit by granting credits to the government.[22] According to Alexashenko (1993), the internal debt of the USSR inherited by Russia totalled SUR 1 150 in January 1992. Credits to finance the budget deficit grew rapidly in 1991 using resources from the banking sector and creating a shortage of credit for the economy.[23] In 1992, a large share of the budget deficit was also financed by foreign loans.

According to the chairman of the CBR, the nominal government debt to the CBR reached 2 500 billion roubles in 1992. Fiscal balance disappeared as the re-

[20] Much of the difference in Russian and Western estimates of the budget deficit comes from the differences in recording techniques. Russians record some of the expenditures in funds outside of the budget. Furthermore, they record foreign credits as budgetary revenue. The World Bank estimates that the budget deficit in 1991 was 31 per cent of GDP.

[21] When external financing was excluded from the revenues, costs of servicing the internal state debt were included in expenditures and above-plan expenditures already incurred were added, the deficit for the first quarter of 1992 rose to more than 10 per cent of GDP at the time of the publication of Gaidar's plan.

[22] The government has paid 10 per cent annual interest on these loans.

[23] The internal debt also includes automatic subsidizes to producers of food and other goods through Gosbank and institutionalized state borrowing e.g. through the issuance of state bonds.

venue side of the budget collapsed and budgetary expenditures accelerated. An important reason for Russia's fiscal crises has been the inability to end the extensive price controls. The government has continued to control energy prices, infrastructure prices, including transportation and housing rents, and other import items subject to import subsidies. In the case of oil, for example, domestic prices are kept considerably below world prices through a system of export quotas. In the second half of 1992, subsidies of centralized imports have proven especially expensive amounting to 17.5 per cent of GDP. As section 5 shows, the weakening rouble made imports exceedingly expensive. A large share of the import subsidies were, however, financed with foreign loans.

Shortfalls in budgetary income have further increased the budget deficit. The decline in economic activity and the almost 20 per cent drop in production have resulted in a shrinking tax base. A substantial reduction in the value of foreign trade led to a decline in tax revenue from foreign economic activity. Furthermore, the tax collection system has proven to be very inefficient.

4.2.1 Need for Fiscal Reform

Like money, the fiscal system also played a secondary role in the Soviet economy. The Soviet state was the owner of all state enterprises and of their financial resources. The financial system entailed central government reallocation of financial resources among different sectors. Fiscal flows followed from the physical allocation of resources. When the Soviet system collapsed, the need for fiscal reform became apparent.

Alexashenko (1993) discusses aspects of the Soviet fiscal legacy that hinder the process of economic reform. The tax collection system in the Soviet Union was generally ineffective. Personal taxation never played an important role – the effective income tax rate never exceded 10 per cent during the last two decades. There was no tax structure regarding state-owned enterprises in the USSR until 1991. The network deteriorated even further after it was passed on to Russia. New taxes were not collected.[24] The fiscal system faces other institutional problems, including the need to establish a new system of budget planning and implementation.

In 1992, the ineffective turnover tax was replaced in most of the republics by the value added tax (VAT). VAT has been one of the most important single sources of budget revenue. The Russian Parliament decided, however, to lower the value added tax from 28 to 20 per cent from the beginning of 1993.[25] Russian tax officials estimate that only some 60 per cent of the potential VAT revenue was collected in 1992.

Furthermore, Alexashenko describes ideological problems assiciated with the tax system. The so-called "one-channel" tax system was implemented in the USSR in 1991. According to this system, all taxes go into the local republican budget and the republics then contribute to the central budget as agreed. This system

[24] It has been estimated that overall tax evasion may have amounted to 20-25 per cent of collected taxes in 1991 and over 30 per cent in 1992.

[25] For certain food products, VAT was reduced to 15 per cent in July 1992.

became one of the prime factors in the financial collapse of the USSR in 1991, because the republics never agreed on the basic aspects for implementing the system. The one-channel has also been discussed in a Russian context, but the issue is highly controvesial. The current tax system seems to be marked by tax avoidance, little tax inspection and insufficient and faulty financial statistics.

4.3 The Problem of Inter-enterprice Arrears

The inter-enterprise debt crises is a feature unique to economies in transition from command to market economy. Normally, in a market economy, enterprises offer one another credit in order to expand or encourage sales. In economies in transition, economic reform measures create financial pressure on enterprises, which then obtain credit by simply not paying for goods or services received from other firms. At the same time, legal procedures for giving creditors leverage with respect to debtors have existed only for a short period of time and have not been adequately implemented. In these circumstances, such involuntarily extended trade credit reduces enterprise liquidity, spreads the potential for default to profitable and unprofitable enterprises alike and can compromise the government's ability to maintain monetary control of the economy.[26]

Inter-enterprise arrears surged in the first half of 1992. By August 1992 mutual non-payments of enterprises had reached the amount of 3 200 billion roubles.[27] The nominal value of non-payments was expected to rise over the first half of 1992 with the surge in inflation due to price liberalization, but the debt expanded rapidly in real terms as well.

Under central planning, all enterprises had accounts at Gosbank. When an enterprise delivered goods to another enterprise, the seller's account was automatically credited and the buyer's account debited. If sufficient funds were not available, purchasers accumulated debts to their suppliers. These imbalances in inter-enterprise accounts were settled by Gosbank at the end of the production cycle.[28] As a result of such practice, enterprises were not used to demanding payment from customers.

A key assumption of the reform programme was that enterprises could be induced to behave like market-oriented firms. Subsidies were to be eliminated and enterprises were supposed to face hard budget constraints. This policy regime was not, however, perceived as credible and many enterprise managers continued to behave as if budget constraints were still soft. Enterprise managers did not believe that the government would be willing to tolerate the unemployment consequences of large numbers of enterprise closings. As a result, inter-enterprise debt surged.

[26] Erik Whitlock, RFE/RL Research Report, No 40, October 9, 1992.

[27] The figures not only refer to trade credits between non-banking enterprises, but to a broader category of inbedtedness of enterprises to one another. According to the CBR, "mutual non-payments of enterprises and organizations" also include bad bank debts. A portion of these arrears involve cross-border transactions.

[28] Ickes and Ryterman 1992.

The surge of inter-enterprise debt can be further explained by the general features of the transitional period. As firms adjust to the new conditions of price liberalization, some may find that the higher prices they charge for their products do not offset higher production costs. Due to incomplete price liberalization, certain enterprises – in the energy or agricultural sectors – remain under some form of price control that prevent these enterprises from rising their prices. A large part of the arrears can be explained simply by the unreliable, undeveloped banking system, which is marked by long delays in payments and lack of standard payment mechanisms. Other reasons for financial distress are shrinking markets due to reduced state orders, falling consumer incomes, and deteriorating distribution networks.

In August 1992, the Russian authorities began the process of netting the stock of inter-enterprise arrears, as at end-July. The CBR authorized an issue of 1.2 trillion roubles in new credits in order to cover the massive indebtedness of state enterprises.[29] For this purpose, commercial banks were to set up special off-balance-sheet accounts for enterprises. These accounts were used by banks for the process of clearing mutual claims. Most enterprises had both payables and receivables, and gross debt was much greater than net debt. The final net amount was only 450–500 billion roubles, but the core problem was not solved.[30]

From July 1, 1992, a system of prepayment was introduced. The selling enterprise was instructed to postpone delivery until it received payment. Thus, this policy attempts to restrict the amount of arrears by outlawing them. This change had made it difficult for enterprises to obtain inputs. Therefore, the incentive for enterprises to continue to extend credit to trade partners remained strong. With the introduction of the prepayment system, the central bank has increased its credit emissions dramatically since summer 1992. In this way, the buden of financing production has been transferred from enterprises to the central bank.

The situation was aggravated again towards the beginning of 1993. In January 1993 the debt reached 5 000 billion roubles in nominal terms.[31] As inter-enterprise arrears were not caused simply by tighter monetary policy, the problem could not be cured by simply netting the arrears. The Russian government and the CBR failed to signal their commitment to imposing financial discipline on enterprises in order to prevent the redevelopment of a chain of arrears. In 1993, the CBR and the government agreed not to extend more credits for the clearing of arrears. Recent estimates of the arrears vary considerable and, due to the high inflation, it is becoming increasingly difficult ot evaluate the true size of the problem.

[29] The contents of Geraschenkos's authorization telegram were never made public. The telegram was rescinded as a compromise between the government and the CBR was reached on the remedies for the inter-enterprise debt problem.

[30] Ickes and Ryterman, 1993.

[31] Due to exteremely high inflation, it is difficult to evaluate the true extent of the real arrears.

4.4 The Rouble Zone

By early 1992, all the countries in Commonwealth of Independent States (CIS) had established their own central banks. In most cases, they were set up as successors of branches of the former Gosbank. Almost all of the CIS states have at least discussed the possibility of introducing their own currencies, but some of the states have announced their wish to remain within the rouble zone.[32]

A central problem resulted from the continuation of a single currency area without a single monetary authority. The creation of separate central banks led to a lack of coordination of monetary policy among the states, with each central bank independently extending credit to the government and commercial banks of the respective states. Divergent policies emerged with respect to interest rates and reserve requirements. The Central Bank of Russia, however, has had the sole power of issuing rouble currency. Nevertheless, the non-Russian central banks could isolate themselves from the relatively tight credit policy of the Russian government in early 1992 by borrowing from the CBR, by creating bank reserves, by issuing parallel currencies (coupons), and by applying lower central bank discount rates. This created a free-rider problem with each state expanding credit faster than the average and exacerbating the inflationary pressure for the whole rouble area.

In order to isolate monetary conditions in Russia from the actions of other central banks in the rouble area and to limit CBR financing of payments imbalances between the states, the CBR limited its provision of credit to other central banks on July 1, 1992. In spite of the new restrictions, credit expansion to other central banks remained substantial, consisting mainly of credits to maintain other republics' purchases of Russian goods.

The evolution of monetary policy in Russia influenced monetary conditions and inflationary pressures in the rouble area. Financial conditions were complicated by the shortage of currency and the use of coupons by some countries. The unrestricted emission of coupons by some states resulted in the dumping of excess rouble balances in neighbouring states to purchase goods, contributing further to the depriciation of the rouble.

The countries of the former Soviet Union are also facing problems connected with the payments system. The inefficiency of the system has exacerbated the decline in interstate trade. As the old system of clearing across republics ceased to operate, bilateral correspondent accounts were created at each country's central bank. This greatly increased the lag in payments, lengthening the chain of inter-enterprise arrears.

[32] In 1992, Estonia, Latvia, Lithuania, and Ukraine left the rouble zone. In 1993, Kyrgyzstan issued its own currency. Some other states, such as Azerbaijan, Moldova and Georgia have announced their intention to introduce separate currencies.

5 Foreign Exchange Policy

Macroeconomic stabilization is usually presented as a prime precondition for currency reform. Monetary stabilization requires the dampening of inflationary expectations, and this leads to improved confidence in the national currency. Another precondition for convertibility is bringing domestic prices into line with world prices. During 1992, these conditions were not acheived in Russia.

Until the late 1980s, the official exchange rate was used only for accounting ppurposes in the USSR. The black market for hard currency cash had existed for a long period of time. The situation changed in 1989 when non-state enterprises were given the right to engage in foreign trade. A system of multiple exchange rates began to operate.

Until the end of 1990, the Soviet Union maintained a complicated system of multiple exchange rates. This included at least the official exchange rate, the commercial exchange rate, exchange rates used in surrendering foreign exchange earnings and a tourist rate. In January 1991 this system was replaced by a more unified, but still controlled, exchange rate regime. The multiple exchange rate regime existed in Russia until July 3, 1992, when the process of exchange rate unification began.

From January 1, 1992 Russian exports were subject to two sets of foreign exchange surrender requirements. First, 40 per cent of export receipts were collected by the government to pay for external debt services and centralized imports. Prior to the unification, exporters were compensated at a special commercial exchange rate of 55 roubles per U.S. dollar. This rate was determined by the CBR together with the Ministry of Finance. Exporters were also required to sell an additional 10 per cent of their foreign exchange earnings in the currency markets in order to facilitate the CBR's task of stabilizing exchange rates by intervening in the foreign exchange markets. The compensation rate for this, a market exchange rate of the CBR, fluctuated from 110 to 90 roubles per dollar. Since the black market rate was around 125 roubles per dollar, the multiple exchange rate system created strong incentives for exporters to avoid the repatriation of exchange earnings. Later in 1992, the surrender requirements were changed to 30 and 20 per cent respectively, and exporters were compensated at the market rate for the rouble.

As to the rest of earnings, enterprises could choose between selling their hard currency through an interbank system of foreign exchange transactions, primarily through the Moscow Interbank Currency Exchange (MICEX), or retaining the hard currency for foreign currency expenditures. Of those export earnings actually repatriated, only a small share was sold through the interbank market.

5.1 Exchange Rate Intervention by the Central Bank of Russia

In late 1991, the Russian authorities announced their intention to make the rouble convertible. It was hoped that this first move toward currency convertibility would ease the acute foreign exchange shortage and reduce price distortions. More generally, it was hoped that it would facilitate economic growth and improve Russian residents' ability to consume.

Hence, the CBR announced that a floating exchange rate would prevail after July 3, 1992. In May and June of 1992, the central bank intervened in the foreign exchange markets to bring the interbank rate closer to a targeted post-unification exchange rate of 80 roubles per dollar. As a result of these interventions, the rouble appreciated from 150 to 112 roubles per dollar in the interbank market between April 1992 and June 1992. These interventions were extensive, as the volume of foreign exchange sold in interbanks markets in June 1992 exceeded the combined totals of the previous four months, in spite of the lower prices.[33] The exchange rate unification of July 3 was effected at an exchange rate of 133 roubles per dollar.

The intervention experience proved to be exceedingly costly for the government, and the target rate was not achieved. One important reason for this was that the loosened monetary and fiscal policies were not consistent with the objective of strengthening the rouble. Therefore, this objective was not perceived as credible by the market. Furthermore, the government failed to account for the distinction between observed and "effective" exchange rates when setting the rate target. This led to exporters and importers taking advantage of the implausible central bank target rate. From the point of view of exporters, the intervention increased the black market premium on foreign exchange from export receipts, encouraging greater under-reporting and under-invoicing of export earnings. Due to extensive stockpiling, exports declined during this period, indicating exporters' expectations of steeply depreciating post-reform exchange rates. The appreciation of the rouble sharply reduced the price of foreign exchange for importers so that foreign exchange became cheaper in the interbank market than in the black market. Therefore, there was an increase in the demand for foreign exchange in the interbank market. This can be also interpreted as reflecting importers' expectations of depreciation of the rouble.[34]

Overall, the Central Bank of Russia spent nearly 1 billion U.S. dollars to support the rouble in 1992. According to the central bank, in the first half of 1992, its sales of dollars made up about 60 per cent of the volume of trade on the Moscow Interbank Currency Exchange. In the second half of the year, this share dropped to 30 per cent.[35] The interventions, in any case, were ineffective in halting the rouble's depreciation. The roubles per dollar exchange rate rose from 140 on July 1, to around 450 roubles per dollars in late November.

In an environment of galloping inflation, sharply depreciating domestic currency, highly negative real interest rates, and considerable foreign exchange surrender requirements, Russia experienced extensive capital flight. There is considerable disagreement about the size of capital flight, partly due to errors and omissions in the statics. IMF estimates indicate that capital flight from Russia amounted to 10–20 billion dollars in 1992, but according to Minister of Foreign Trade Sergei Glasjev, it amounted to only 4 billion dollars.

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[33] Goldberg, 1993.

[34] Goldberg, 1993.

[35] Supplement to the RFE/RL Research Report, No 7, February 12, 1993.

6 Monetary Situation in 1993

High inflation remains the primary economic problem for Russia, even though the monthly inflation rate has diminished from January's near-hyperinflation to about 20 per cent per month in the second quater of 1993. Guidelines for Russian monetary policy were given in the economic policy statement of the Government of Russia and the Central Bank of Russia on May 24, 1993. According to the statement, fiscal and monetary policies will aim at pushing monthly inflation below 10 per cent by the end of 1993 and to making further progress towards price stability in 1994. In order to achieve these objectives, the CBR and government further agreed to keep total credit expansion within quarterly ceilings, to raise the CBR discount rate to market levels by July 15, to allocate all subsidized credits through the budget and to reduce lending to other CIS countries. The parties further agreed not to authorize the extension of credits for the purpose of clearing inter-enterprise arrears. Also, the government announced a cut in import subsidies of 40 per cent and the further liberalization of exports.[36]

The May agreement was a necessary precondition for the International Monetary Fund's approval of Russia's loan request under the systematic transformation facility (STF). The STF was developed earlier in 1993 in order to help in the transformation of ex-socialist countries. The first half of the USD 3 billion loan was granted to Russia in July 1993 and the timing of the second half of the loan will depend on the implimentation of the May agreement. Russia also hopes to start negotiations with the Fund for a stand-by credit later this year.

Russian and foreign experts, however, doubt the CBR's willingness to uphold the agreement and the government's ability to reduce the budget deficit. The monthly inflation rate has remained around 20 per cent and there are increasing inflationary pressures. According to the Russian Government's Center for Economic Reform, the budget deficit constitutes the most important source of inflation. In January–May 1993, 42 per cent of the CBR's credit emission was for deficit coverage.[37] Some progress, however, has been made. In order to reduce monetary growth, the CBR and the government set quarterly limits on the growth of central bank lending to the government, to banks, and to other central banks in the former Soviet republics. It is estimated, that these credits rose by over 50 per cent during the first quarter of 1993.[38] According to the technical annex of the May agreement, growth of CBR lending is limited to 30 per cent in the second quarter, and 20 and 15 per cent in the third and fourth quarters. According to Deputy Prime Minister Boris Fjodorov, these limits were met in the second half of 1993 and the government cut its budget expenditures to stay within the limits.

The Russian central bank raised the annual discount rate on several occasions from 80 per cent in April to 170 per cent in July 1993. This is close to the market

[36] The agreement signed by the government and the CBR is published, for example, in Rossijskije Vesti, 1.6.1993.

[37] Izvestija, 2.7.1993.

[38] Åslund, 1993.

rates, which are still clearly negative in real terms, as the inflation rate is estimated to be 700–900 per cent in 1993.

Due to the high inflation, the rouble depriciated sharply from 450 roubles per dollar in January to over 1 100 roubles per dollar in June, 1993. Towards the end of the second quarter of 1993, there have been some successful attempts to stabilize the external value of the rouble and increase the volume of currency trading. Firstly, the MICEX switched to daily sessions for rouble trading in June. Secondly, according to the May agreement, foreigners are allowed to sell roubles from July 1, and from September 1, to buy roubles at the MICEX. For this purporse, the CBR issued instructions permitting foreign firms and citizens to open rouble accounts in Russia's commercial banks. Thirdly, an important increase in the volume of currency exchange resulted from the rule changes regarding foreign exchange surrender requirements. From July 1, 1993 exporters were required to sell all 50 per cent of the foreign currency earnings at the currency exchanges. Fourthly, the CBR has restricted the open dollar position of commercial banks in order to help stabilize the exchange rate. Following these changes, the rouble has appreciated to under 1 000 roubles per dollar in late July.

The Russian central bank has also made some efforts to increase its control over the banking system. Measures have been taken to enforce the new regulations on the minimum capital requirement of 100 million roubles by July 1, 1993.[39] At the end of June, the CBR froze all operations of 22 commercial banks because their expenditures had exceeded their income over a long period of time.[40]

At the end of July, 1993, the Central Bank of Russia authorized a withdrawal from circulation of all pre-1993 banknotes.[41] The CBR's instructions were somewhat changed by president Yeltsin, by whose decree Russians are allowed to change 100 000 worth of old roubles to new banknotes by the end of August 1993. All additional old banknotes must be deposited for 6 months in Sberbank's account. The central bank's inadequately prepared anouncement has created a lot of confusion and criticism among the Russian people. Also some reformers of Russian government and their foreign advisers have attacked the decision, anticipating that it will increase inflation and weaken the rouble.[42] Of the former Soviet republics still using the rouble as their currency Georgia, Azerbaijan, Moldova and Turkmenistan have annouced that they will speed up the introduction of their own currencies.

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[39] Ekonomika i Zhizn, 29/1993.

[40] Izvestija, 30.6.1993.

[41] Rossisjkaja Gazeta, 27.7.1993.

[42] Financial Times, 30.7.1993.

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