

MEDIUM-TERM MACROECONOMIC OUTLOOK

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Overview

The good macroeconomic performance of the Russian economy since early 1999 is unlikely to be sustainable without a determined and broad-based acceleration of structural reforms. The output recovery has primarily been due to import substitution following the sharp real depreciation of the ruble that took place in the wake of the 1998 crisis, and the prospects for sustained growth in the coming years hinge on the extent to which an acceleration of reforms after the elections will lead to a recovery in non-traditional exports and investments. Similarly, while the notable measure of financial stability is partly a result of determined policy implementation, it reflects also the favorable external position—due to import compression and high energy prices—with the strong ruble subduing inflationary pressures and buoyant revenues ensuring a comfortable fiscal position. Tax and expenditure reforms are needed to strengthen the underlying fiscal position and reduce the risk of renewed foreign exchange market and inflation pressures as energy prices subside from high levels and the import recovery gains momentum.

An acceleration of structural reforms will have considerable macroeconomic implications over the medium term. The savings-investment balance of the non-government sector is set to deteriorate as investment increases, while that of the government sector will be burdened by the need to mobilize resources to support reforms, including for programs to alleviate the social cost of the reforms. The speed with which the domestic savings-investment balance will deteriorate will depend on how fast the reforms impact on economic growth and exports, as well as on developments in the terms-of-trade, to mention a few key factors. However, the direction of the change is clear: like other transition economies, Russia will need to rely on a significant increase in the use of foreign savings—that is, a deterioration in the external current account balance—in order to foster reform. The availability of such savings to Russia will, in turn, depend on the prospects for recovering access to international capital markets, overcoming the problems that have hampered foreign direct investment (FDI), and reversing the high private capital outflows.

* The views expressed in this paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy.

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The medium-term macroeconomic implications of an acceleration of reforms will thus depend on the interplay between a large number of factors. The complexity of these interlinkages, not to speak of data limitations, make it extremely difficult to quantify the medium-term outlook. Nevertheless, by basing the parameters underlying the forecast on the experience of other transition economies, and by using the current macroeconomic situation as the point of departure, the projections provide important insight into the constraints facing economic policy makers. In any case, uncertainty and lack of data provide the background against which economic policy decisions are made.

The medium-term outlook suggests that the needed structural reforms can be financed without recourse to inflationary domestic financing or to external financing that goes beyond what is consistent with external viability. This conclusion hinges crucially, however, on Russia departing from the hesitant and piecemeal approach to reforms seen to date, embarking instead on a broad array of reforms that will test the political resolve to stand up to the vested interests opposing change. Determined pursuit of enterprise and bank restructuring is clearly indispensable in this regard, but measures to improve governance and transparency, including better corporate governance, reduce corruption, strengthen the rule of law, and reduce arbitrary interference in the economy are particularly important if Russia is to stop the hemorrhaging of domestic savings and attract foreign investments. Without such fundamental reforms, intermittent periods of severe macroeconomic instability are likely to remain the norm over the medium term.

Reforms, Output Growth, and Savings and Investments in the Non-Government Sector

A fundamental objective for the medium term is to achieve sustainable economic growth that will underpin an increase in consumption and living standards. Output growth is determined mainly by the rate of labor force growth, the rate of net investment, and the rate of total factor productivity growth. Assuming a determined acceleration of structural reforms in the coming years, a somewhat conservative estimate for the sustainable growth rate that Russia can potentially achieve would be 4½-5 percent annually. The projections assume that this rate could be reached within 3–5 years, as detailed in Box 1.

The key element in achieving the higher growth is a sharp rise over the medium term in productivity. Several studies (including one undertaken by McKinsey in 1999) point to a significant potential for raising productivity from its current very low level through improvements to management and the general business environment.² Productivity growth may also be embodied in new investment, not least FDI, and the ratio of gross private sector investment to GDP should rise significantly from its current low level. Non-energy exports

² The McKinsey study finds that overall productivity is only around 19 percent of the U.S. level and that even new assets achieve only about 30 percent of U.S. levels. The study estimates that old assets, with limited upgrade investments, could achieve as much as 65 percent of U.S. productivity levels if combined with modern forms of organization.

Box 1. The potential growth rate of the economy

In principle, potential output growth depends on the share of labor in output, the rate of potential labor force growth, the rate of net investment, and the rate of total factor productivity (TFP) growth.

During 1991S98, TFP growth in Russia has been sharply negative and among the worst performances among the Baltics and other countries of the former Soviet Union. In the Baltics, TFP growth had turned sharply positive by 1995. Also, compared to CEE countries, Russian TFP fell more sharply and recovered more slowly than these economies at similar stages of their transition process. In Poland, which began its transition process in 1989, TFP growth turned positive in 1992 and averaged close to 4 percent during 1992S98, while in Hungary and the Czech and Slovak Republics, TFP growth averaged 1S2 percent during 1992S98.

The future path of TFP is by its nature endogenous to the overall economic policy environment and as such, is subject to a considerable element of judgement. There could be considerable gains in productivity arising from improvements to management and the general business environment (see e.g. McKinsey 1999). Productivity growth would also be embodied in new investment, not least foreign direct investment (FDI) which, through the transfer of new technology and human capital, has played an important role in most other countries during their take-off. Based on evidence from other comparable countries, where the transition process is more advanced and FDI has been a significant factor, it would seem conservative to assume a TFP growth rate of 2-3 percent over the medium- to long term while 4 percent would not be unrealistic.

Potential labor force growth depends mainly on demographics and assumptions about labor force participation. While the latter has been declining during the 1990s, partly due to the collapse in output and use of early retirement, and some further reduction may occur as the restructuring process progresses, one would expect this tendency to be gradually reversed as growth picks up. Assuming tentatively that the labor force grows by 1 percent per year, and that the share of labor in output is around 2/3 (similar to comparable countries), potential output growth could easily be 22S32 percent, even with no new net investment.

Potential output growth would be even higher to the extent that additional new investment takes place as a result of an improved investment climate. A stable political and macroeconomic environment, coupled with an ambitious and comprehensive structural reform program, is a sine qua non for the economy to achieve high and sustainable investment led growth. Such circumstances would attract foreign savings through FDI and restoration of access to international capital markets as well as help to mobilize domestic savings that to a large extent have fled abroad. Capital flight has amounted to US\$10S20 billion annually in recent years, and a reversal of this could provide a very large pool of investment resources. Including an increase in investment, potential output growth of 42S5 percent would, therefore, appear to be a conservative estimate, and significantly higher rates of growth could be achieved if TFP and investment growth is stronger than assumed.

are also assumed to expand steadily. The pace of these increases will depend fundamentally on how quickly the overall investment climate can be strengthened and this, in turn, will depend on progress in implementing structural reform.

The increase in productivity growth should also lead to a recovery in real incomes and consumption, which were severely depressed as a result of the crisis in 1998. It would also be consistent with some real appreciation of the ruble over the medium term, without this appreciation jeopardizing the prospect for a sustained increase in exports. An important underlying assumption is that in periods of temporary strength in the external terms-of-trade, for example due to high energy prices, a sharp real ruble appreciation in excess of what is consistent with underlying fundamentals would not be allowed to crowd out non-traditional exports.

Notwithstanding the assumption about preservation of “competitiveness,” the external current account is expected to deteriorate significantly over the medium term, reflecting the high import content of new investment and the observed high price elasticity of import demand, in addition to the assumed normalization in the external terms-of-trade and the associated decline in enterprise sector savings. Thus, the contribution of the foreign balance to growth would be negative, which is merely a restatement of the aforementioned point that the acceleration of reform and the accompanying investment-led growth will require an increase in the use of foreign savings.³

External Financing

The basic conclusion from the medium-term scenario is that Russia will be able to finance the deterioration in the external current account stemming from the acceleration in reforms, while graduating from using exceptional balance of payments support from the Paris Club and others within 2–3 years. At the same time, Russia would be able to rebuild its foreign reserves to a level necessary to instill confidence in the ability to handle sudden shifts in the balance of payments without resorting to trade and exchange restrictions.⁴ This conclusion depends on two key assumptions: (i) FDI will increase significantly from the very low level at present. The projections assume an increase to around 25–30 percent of GDP annually within 3–5 years—a level that is still low by comparison to other transition economies; (ii) private capital outflows will decline sharply from the current high levels of \$10–20 billion annually.

³ Developments in household savings relative to GDP in the wake of the 1998 crisis are difficult to ascertain because of inadequate data.

⁴ The dependence on exports of natural resources, notably oil and gas—the prices of which are subject to considerable fluctuations—suggests that reserves should be relatively high to allow the authorities to cushion external shocks and avoid recourse to restrictions in the short run. Reserves are assumed to increase to the equivalent of 3.5 months of imports.

Both of these assumptions hinge crucially on the effectiveness of reforms in a broad range of areas, but in particular on improving governance, both in the public and corporate sectors.⁵

Under these assumptions, the scenario suggests the existence of external financing gaps—i.e., the need to mobilize additional external support from as yet unidentified sources—for a 2–3 year period. However, the projected gaps are relatively small and declining. In this regard, official creditors have underscored their willingness to continue to support Russia through exceptional balance of payments support provided that reforms are advanced along the lines assumed in the scenario. It therefore appears that the projected financing gaps should not pose any risk to the medium-term outlook.

Assumptions about access to international capital markets are conservative. It is assumed that the private sector will gradually restore access to trade- and reform-related borrowing. The government is assumed to begin rolling over existing maturities in 3–4 years, when exceptional balance of payments support from official creditors is expected to cease. The assumption about gradual restoration of capital market access hinges on the facts that the depicted scenario is consistent with reductions in Russia’s debt service ratio and government indebtedness to levels that are generally considered to be sustainable over the medium term, and that the external current account deficit is also not allowed to rise above what international comparisons suggest is prudent (see Box 2).

Fiscal Policy

Fiscal policy is constrained over the medium term by the need to reduce the public sector debt and debt service burden to more manageable levels, and in the short term by financing constraints and the objective of restoring international reserves. While medium-term considerations suggest that there is room to reduce the primary surplus from its current level to the extent that additional reform-related expenditures need to be undertaken, the limited access to domestic and international capital markets in the short term and time needed to establish credibility in the fiscal adjustment process warrants great caution in easing the fiscal stance. The primary surplus of the federal government is assumed to remain at about 3.5 percent of GDP in 2001, and to decline only modestly from that level over the medium term, stabilizing at about 2 percent of GDP.

Should the terms-of-trade remain stronger than anticipated in the medium-term scenario, the government should increase revenues from the energy sector and its primary surplus relative to the baseline (allow “automatic stabilizers” to operate), thus making room for a more rapid accumulation of reserves and countering excessive upward pressures on the exchange rate. This would not change the fiscal stance.

⁵ See “Capital Flight”, Prakash Loungani and Paolo Mauro; “Corruption in Russia”, James Roaf; “Enterprise Restructuring”, Itzhak Goldberg and Alfred J. Watkins; and “Promoting Competition and Entrepreneurship”, Mark Dutz, Steven Fries, and Maria Vagliasindi.

Box 2. Balance of payments and fiscal sustainability

External viability may be defined as a situation where the external debt and debt service ratios have stabilized at reasonable levels, access to international capital markets has been restored, the need for exceptional balance of payments support has been phased out, and foreign exchange reserves are adequate to cushion external shocks.

The dependence of the Russian economy on exports of natural resources, notably oil and gas—the prices of which are subject to considerable fluctuations—suggests that the reserve cover (in terms of months of imports) should be relatively high (at least 32).

The recent debt and debt service reduction agreement with commercial bank creditors and very strong external current account position have resulted in a significant decline in the external debt burden. Further progress toward external debt sustainability will be achieved despite a gradual decline in the current account surplus, especially to the extent that these were financed by foreign direct investment or reduction in private capital outflows. Such investments would be attracted by the potentially large returns to capital during the period of transition. Evidence from other countries suggests that current account deficits of no more than 5–6 percent of GDP would be tolerable, provided high output growth rates were achieved, but somewhat lower deficits would be advisable given Russia's vulnerability to external shocks. Such a policy would also enable a gradual reduction in the ratio of external debt service payments to exports from the current level of over 30 percent—which is well above what is generally considered prudent by international standards (20 percent is a rule of thumb).

On the fiscal side, the government debt burden remains high even taking into account the London Club agreement, and the objective should be to gradually reduce this burden to more manageable levels. While there are generally no hard and fast rules regarding a reasonable target for the stock of public debt for a country like Russia, the 60 percent threshold that member states of the European Monetary Union have to respect provides some guidance. Compared to these countries, the much lower level of federal government revenues in Russia, the higher cost of debt service reflecting the substantial risk premium, and the dangers posed for fiscal revenues by a possible fall in oil prices, suggest that a prudent policy would be to converge toward a significantly lower level. The medium-term scenario assumes that the debt ratio is reduced gradually to below 40 percent of GDP.

It follows from the above that there is no need for fiscal policy to counter the projected significant deterioration in the external current account over the medium term, reflecting the relatively strong starting position. Nevertheless, a determined effort to cut unnecessary spending and improve tax collections will be required because of the need to mobilize budgetary resources to support reforms and to reduce the relatively high tax rates:

The cost of reforms. The cost of reforms is likely to be substantial. It will include the cost of recapitalizing state banks.⁶ It will also include the cost of restructuring large, socially significant enterprises that are making heavy losses and cannot be expected to restructure spontaneously, including those in the Northern Territories and so-called one-enterprise towns. One of the papers for the conference proposes the introduction of an explicit fiscal subsidy to a limited number of energy-intensive enterprises in lieu of the current quasi-fiscal subsidies provided by utilities.⁷ More generally, unless programs to alleviate the social cost of reforms are adequately funded, political pressures on enterprises to delay restructuring and down-sizing are likely to continue to hamper reforms. While the fiscal impact will be determined by the strategy ultimately pursued by the government, the cost of reforms is assumed to rise to 2 percent of GDP annually as reforms take hold, but this estimate is subject to very large uncertainty at this stage.⁸

Tax reforms. Tax reform should to a large extent entail simplifying the tax system and shifting the burden from direct income taxes to consumption taxes as well as reducing high effective tax rates.⁹ While effective tax rates are high in part as a result of shared and incorrectly defined tax bases (as is the case for e.g. the profit tax), the desirability to cut certain relatively high tax rates and eliminate duplication in taxation could entail some revenue loss, although these changes are likely to enable a broadening of the tax base, making the loss difficult to estimate.

These considerations suggest that permanent fiscal measures yielding 2S3 percent of GDP will be needed in order to maintain the primary surplus within limits consistent with aforementioned constraints while mobilizing additional resources for structural reforms and implementing tax reforms. In light of the severe expenditure compression that has taken place in recent years, a comprehensive review of expenditure priorities and of the

⁶ “Banking System Restructuring”, William E. Alexander, David S. Hoelscher, and Michael J. Fuchs.

⁷ “Banks and Financial Discipline: Principles of a Solution Strategy”, Christian Mumssen.

⁸ Studies estimate that the implicit subsidy provided by the utility companies through barter etc. currently amounts to around 5 percent of GDP.

⁹ “Tax Policy for Russia”, Victoria P. Summers.

mechanisms for expenditure control will be needed in order to identify sustainable savings.¹⁰ Moreover, tax reforms should be mostly revenue neutral in that reforms that will entail revenue losses should be implemented gradually so as to allow losses to be mostly offset by gains from strengthening tax administration and collection.

Monetary Policy

Monetary policy is assumed to be geared toward reducing inflation further to about 5S6 percent over the medium term, allowing for a relatively slow process of disinflation from the current moderate level to ease the required adjustment of relative prices. This target is based on the assumption that, over the medium term, relatively fast productivity growth in the traded goods sector, compared to the non-traded goods sector, should make it possible to have a rate of inflation that is somewhat above the level of main trading partners without endangering competitiveness.¹¹

Monetary policy is severely circumscribed at present by the very low monetization of the Russian economy compared to other transition economies. The assumed continued reduction in velocity is key to ensuring an increase in credit in real terms to the non-government sector. For this reduction to materialize, it is crucial that monetary policy is steadily geared towards inflation control, and that the CBR is not diverted from this objective by being required to support the liquidity needs of specific sectors. Another important prerequisite for a remonetization of the economy and the reversal of private sector capital outflows is the existence of a sound banking system which will only emerge after the bank restructuring program has been implemented. Accordingly, the CBR is also assumed to rely increasingly on its market-based instruments, as the current policy of using frequent changes in legal reserve requirements to manage liquidity is contributing to the large spread between deposit and lending rates, leading to dis-intermediation and slowing growth.

¹⁰ “Russia: Issues in Public Expenditure Policy”, Alexander Morozov and Mark W. Sundberg; and “Russia: Post-Election Strategy on Public Expenditure Management”, Jack Diamond.

¹¹ This is the “Belassa-Samuelson” effect. Experience from more advanced transition economies suggests that this effect may be in the order of 2S3 percentage points. It is likely to be somewhat higher in the case of Russia given its earlier stage of development.