Let us begin by recalling what we asserted in the discussion of the Russia CAS in June 1997: “the slow progress in structural reform in the low and medium scenarios places the resumption of growth at risk. This in turn, increases the probability of a swift policy reversal that could raise serious reservations on the viability of the overall development program”. Since then this slowdown in reforms has materialized, and together with the reduction in the price of oil and gas and the contagion effects of the East Asian crisis, has resulted in the most severe crisis in Russia in the present decade.

Russia economic and social panorama is highly worrisome. Real GDP is collapsing, poverty is spreading and deepening, there is a full fledged banking crisis, hyperinflation is on the doorstep, reserves are being depleted, federal tax revenues are declining, federal and local government have defaulted on their debt, interest rates are skyrocketing.

This is a critical situation, but we are not pessimistic. We have seen countries in similar situations turn around in a few years. However, what makes the Russian situation more complex is: the very weak institutions related to the efficient functioning of the market system; and the required change in economic culture to permit the flourishing of an economic system based on competitive markets as opposed to one full of imperfections and opportunities for corruption.

The Government of Russia’s (GOR) initial reaction to the crisis is particularly distressing. In an attempt to avoid social collapse, the GOR is reacting by imposing distortions and rigidities in the operation of the economic system, precisely when, because of the significant adjustments required in a crisis period, what is required is flexibility. Price controls, multiple exchange rates, tailor made import tariff increases and the use of offsets as a government finance mechanism, have been proven ineffective and welfare reducing, time and again in crisis and non-crisis situations. These are serious reversals in structural adjustment policies, precisely when what is needed is to accelerate structural adjustment to facilitate a rapid supply response to minimize the negative effects of the crisis. The response of Mexico itself and other LAC countries to the Mexican crisis has demonstrated
that the acceleration of structural reforms is the most effective way to arrest a crisis. Moreover, the IMF program is not yet in place, and the fiscal gap derived from the heavy debt burden, the fiscal needs to restructure the banking system and the recent reduction in the value-added tax could be insurmountable.

Currently the Bank’s portfolio is deteriorating, and in particular, the Bank’s structural reform program SAL3, Coal2 and SPAL have shown significant delays. Moreover, there is the fundamental question about the consistency of the GOR policy directions with the proposed reform program. In this context, we wonder if it is wise to continue advancing in the preparation of the proposed five investment loans/guarantees. In a distorted economic environment, pure investment lending could be further welfare reducing if, at least, the appropriate sector frameworks are not in place.

We think that in these times of uncertainty about the GOR policy framework, the Bank should focus on ESW. In particular, on issues related to structural reforms for creating/improving the market institutions required to address the crisis period and the resumption of long term growth. Strengthening property rights, judicial reform, including the reform of the tax tribunals, bankruptcy laws and others. Our approach to lending should be piecemeal. This is an opportunity to try new lending instruments like, lightly front-loaded PSALS, and APLs.

To close, we feel that staff is well endowed to help the GOR to successfully address this difficult circumstance. We wish both the best in this effort.