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Russia Joining the World Economy

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Executive Summary

Overview

1. This report explores ways to expand Russia's trade in line with comparative advantage and in the process integrate the country into the world economy. Russia's trade has been hit very hard since 1990. Large declines have occurred both in the volume of trade within the Former Soviet Union (FSU) and with the rest of the world. Some of the decline has resulted from reduced demand and falling incomes; some has been due to the breakdown of central planning and because new market mechanisms take time to develop. Longer term declines in international trade were expected, as previous links were not based on comparative cost and location advantage. The precipitous drops in trade volumes that are occurring, however, are a cause of concern because they reinforce the disruption in production and the declines in incomes. Meeting the challenge of expanding trade will require action across a wide ranging policy agenda and particularly in the interlinked areas of trade and price reforms and institutional development. These issues are discussed below and the key recommendations and their sequencing are outlined at the end of this summary.

2. Reforming the trade regime will benefit productivity and economic growth and for this reason the task of opening up to the rest of the world lies with Russia itself. As outlined in the following chapters, despite considerable progress there is still much to do. But the international community also has a responsibility to ease Russia's entry into the world trade system as there are mutual benefits to a country of Russia's size and potential taking a more active role in trade. In the past, the OECD resorted to special measures aimed at countering the potentially disruptive threat from Russia's previously centralized system, including special legal regulations for unfair competition cases. In this regard it is vital that Russia make progress in acceding to the GATT, as this would make most favored nation (MFN) treatment permanent and would provide for dispute resolution in case a trade partner unfairly invoked safeguard mechanisms.

Price and Incentive Reforms

3. Russia has made considerable progress in opening up following dissolution of the planning system during 1991. Trading monopolies have been eliminated, prices partially liberalized and the exchange rate is set by the market. Russia is gradually introducing an administrative framework typical of market economies and the trade regime for FSU and third countries is being integrated. The ground is being laid for the country to take a more active role in international trading organizations. However, most of the progress was achieved early in 1992, and since then the momentum for reform across the board has stalled. The result has been continued macroeconomic turbulence and uncertainty, together with a continuation of misaligned relative prices.

4. Stabilization is an important pre-condition for trade and price reform. If the exchange rate can be stabilized at a more realistic level, there will be reduced pressure for export controls and taxes and import subsidies. As it stands the currency is well out of line with underlying purchasing parity (at prevailing market exchange rates, workers have been earning only about \$15-20 per month). The low

market rate of the ruble is caused by a number of factors, including inflationary expectations and uncertainty, a lack of domestic assets (negative real interest rates) and policies that discourage exports and the repatriation of foreign exchange. Experience strongly suggests that an environment of macro stability, a competitive and reasonably stable exchange rate and currency convertibility will pave the way for a sustained expansion in trade in the longer term. However, changes in trade and price controls should not be delayed until the economy is stabilized. These policies tend to reduce the quantity of foreign exchange and ability to import, thereby making the stabilization effort more difficult. Moreover, for any recovery and growth (when it takes place) to be sustainable, will require restructuring and investment to take place within a coherent price regime. For this reason stabilization and trade and price reform will have to be undertaken in parallel.

5. Price distortions are the key to understanding the structure of the trade regime. Prices for raw materials and energy continue to be suppressed in order to lower the costs and ease the adjustment of using industrial enterprises. Likewise the prices of food are controlled for social reasons. The distorted price structure is supported by export controls (both volume and price) on resource-based products and massive import subsidies on food, medicine and industrial inputs. Comparisons of domestic prices of traded goods (in rubles) with similar products in the world market (in dollars) indicate that volume controls and taxes on exports are the key distortions in the trade regime and reform should emphasize their elimination. Also the large variability in these estimates highlight the need for more uniformity in trade regulation (notably fewer exemptions).

6. The misalignment of export prices is captured by the average price of exportable goods of about 170R/\$ in early 1993, compared to a market exchange rate of 550 R/\$ at that time. The distorted price structure is maintained through export controls (both volume and price) on resource based products. These controls direct export production to the domestic market and limit price increases. As a result the profitability of industries that rely on artificially cheap inputs are supported. Export controls are motivated by two considerations: first, a desire to maintain domestic prices of inputs below international prices, so as to ease the adjustment of using enterprises; and second, residual central planning attitudes that view exports with suspicion and, in a supply constrained environment, consider it desirable to "keep goods a home." Given the enormous profitability in seeking export markets at the market exchange rates, the controls have led to massive illegal smuggling. In practice, export controls have been administered in a non-transparent fashion, with a large number of ad hoc exemptions. As a consequence, the controls have created strong incentives for rent seeking activities, corruption as well as uncertainties and constraints to exporters.

7. On the side of imports, interventions have differing impacts on prices. Import subsidies on some products reduce wholesale prices on domestic markets. For most other goods, tariffs and excise duties on imports have the opposite effect—they raise wholesale prices on domestic markets. The net result of subsidies and taxes is reflected by the average price of imports of 376 R/\$ in early 1993. However, these averages mask considerable variations in import prices and this also causes losses in efficiency. Import subsidies have been the more important source of distortion and a major fiscal burden (accounting for over 15 per cent of GDP as measured in April 1993). The subsidies have spiralled upwards recently with the marked depreciation of the currency, which increased the gap between domestic and world prices. They have placed an enormous financial burden on those taxed in order to meet budgetary demand for foreign exchange. The attempt to finance such subsidies had led the authorities to centralize exports and grant tax exemptions to foreign trading organizations involved in this trade. Transparency has been lessened by the removal of some of these activities off budget by enlarging the role of the central purchasing agent (Roscontract) in cross-subsidizing between exports of raw materials

and imports of industrial inputs. In general, the system of import subsidies has been a costly and inefficient policy instrument. Subsidies on industrial inputs have been mostly appropriated by inefficient enterprises in import-competing sectors and have impeded restructuring. The objectives of subsidizing products such as food could be better met by careful targeting of poorer and disadvantaged members of society.

8. Support of manufacturing industry in Russia is a key issue. As mentioned above, such support comes from cheap raw materials due to export controls on raw materials and import subsidies on selected industrial inputs. There has been little lobbying for more typical support through barriers to competing imports, largely because the exchange rate is overvalued and this is protective. Nevertheless, since the introduction of the revised tariff schedule in mid 1992, there has been a worrisome trend towards greater variability of duty rates by degree of processing. As a result, effective rates of protection for final products have been creeping upwards. The key issue in import policy is to ensure that changes to tariff duties are resisted as the currency strengthens with stabilization, ensuring that enterprises are exposed to world competition.

9. Trade policy has a crucial role in ensuring that producers confront the correct price structure when contemplating new investment. In order to meet this objective the prices of exports and imports should be gradually brought in line with world prices. The report recommends that this process could be achieved by 1995. In this regard, various controls and taxes on exports should be phased out over this period, with the pace of change being faster for non-energy goods. This would be the single most important action to shift domestic prices towards the world relative price structure. Likewise, import subsidies could be removed by early 1994. In the process, the role of Roscontract (the central procurement agency) in centralized imports could be reduced. At the same time, measures could be taken to more effectively target assistance to those in real need (poor and disadvantaged members of society). While there is a role in transition for import tariffs on both protective and fiscal grounds, a lower and more uniform regime should be introduced.

10. The key issues in Russia's trade with FSU countries is how to improve the trading environment during the transition, while at the same time moving towards sustainable long-term policies. The long-run first best policies for Russia's trade with countries of the FSU are relatively clear and in this regard there are two guiding principles. First, is the need to unify the trade regime, so that there would be no difference in the treatment of countries that were part of the FSU and those that are not. Second, there is a need to encourage enterprise-to-enterprise trade and in the process move away from a framework dominated by intergovernmental agreements. Consequently, efficient trade would be facilitated by the establishment of currencies that are convertible on current account. This applies equally to the other countries of the FSU that establish their own currencies as to Russia. In the longer run the trade regime should be free as much as possible from non-tariff barriers on either exports or imports.

11. From an incentives viewpoint, there are two main initiatives that should be taken to improve the trading environment during the transition. The most important is to move away from the obligatory lists that are the basis for intergovernmental agreements. There are all sorts of problems with obligatory list trading including the difficulty in an intergovernmental negotiation to obtain the world market price of hard goods such as oil. In general, state trading is likely to continue interstate terms-of-trade subsidies. Moreover, obligatory trade expands the set of products that are sold at less than world prices, thereby adding to distortions in Russia. Indicative rather than obligatory lists should be used in the short run, when the authorities wish merely to assure an export license.

12. In addition, the so-called free trade area established between Russia and a number of the countries of the FSU could be extended for the medium term. It could be made more effective with the elimination of export controls between the countries. Preferential trade has a transitional role to play in supporting trade in products that are as yet uncompetitive on world markets. But Russia and the FSU countries are inordinately dependent on each other and need to reorient trade so that they are integrated into the world trading system. For that reason a permanent preferential trade area among the countries of FSU may not be advisable since it may impede the longer run adjustment.

13. A central theme of this report is that the incentives regime has a crucial role to play in ensuring that future investment is directed towards activities that are in line with the country's comparative advantage. While incentives reform is an important and necessary condition for efficient resource allocation and productivity growth, it is by no means sufficient. For improved incentives to translate into desirable restructuring there needs to be complementary measures to build factor markets, harden budget constraints and vigorously extend privatization. Many of these issues are being covered in other Bank operations. However, there are pertinent measures of institution building that would contribute to strengthening the linkages between price incentives and production activities covered in this report and they are discussed below.

Developing institutions

14. The areas that require the most extensive institution building efforts are in improving payments methods and access to trade finance, and in encouraging non-traditional exports (mostly manufactured goods). In addition to manufactured exports, foreign exchange can be earned through other non-traditional merchandise exports and services, including shipping, travel and repair and processing. The focus on manufactured exports in this report is due to the judgment that there could be a relatively quick supply response from this sector. Reducing risks of trade transactions and improving the allocation of trade-related credit could do much to stimulate Russia's trade, particularly domestic and interstate trade. Introducing modern methods of payment could be the first step toward developing transaction-based trade finance and could be an integral part of the reform of the system of loan allocation. Such initiatives would particularly facilitate trade in manufactured goods. The benefits of such trade go well beyond the earning of foreign exchange, expanding employment opportunities and diversifying the export base. Manufactured exports are a means of introducing world market competition and accelerating the process of industrial restructuring in an efficient direction.

Methods of payment

15. In economies with developed market institutions, risks of non-performance by sellers and non-purchase by buyers in trade transactions are handled through trade contract enforcement, insurance services and appropriate methods of payment. All of these elements of risk coverage are inter-related and building them is a high priority task. However, in most cases this will at best be achieved in the medium term, particularly implementing and enforcing commercial codes. This report focusses on initiatives that can be taken to improve payment methods, as these can be done relatively quickly and have the added benefit of providing a building block for more efficient loan allocation. A start could be made with the introduction of documentary collection and credit, which basically ensure shipping documents are only released by banks either if payments are made or guaranteed or if stipulated terms and conditions are met. They have the benefit of covering the full range of trade related risks for both suppliers (non-purchasing or payment by buyers) and buyers (non-performance by suppliers).

16. Modern documentary payment methods can be instituted relatively easily as they are

similar to arrangements inherited from the central planning and used up to mid 1992. These methods had some desirable features including: risk coverage of both buyers and sellers, trade finance being extended on the basis of underlying transactions and being self-liquidating. The features that were incompatible with a market-based approach related to budget bailout and ultimate debiting. Because production targets took precedence over financial concerns, enterprises were forced to supply buyers regardless of their solvency, and banks were instructed to grant loans to their clients beyond prudential limits to keep production going. The system worked because the state budget internalized all risks and bailed out the State Bank. Also, branches of the State Bank had the right to ultimately debit accounts of their clients as assurance of sight payment to suppliers or repayment of debt to the bank.

17. The inflationary spiral in early 1992 placed unmanageable strain on the system and the CBR took a number of initiatives to reduce a buildup of interenterprise arrears. In order to relieve the burden of responsibility of collecting payments from the banking system and at the same time enhance the responsibility of suppliers in assessing the credibility of buyers, commercial banks were prohibited from debiting accounts of their clients unless written permission (called a payment order) was received from the owner of the account. The most positive aspect of the old system—the critical role of banks as remitting and collecting agents for sellers—was eliminated. Mistakenly, the CBR did not take any initiatives aimed at encouraging banks to facilitate trade contract enforcement or provide trade transaction-based finance. As a result, trade is now largely based on primitive methods of payment such as advance payments and cash on delivery.

18. Encouraging a return to documentary methods of payment is advisable in the transition as enterprises begin to extend their links in the developing market economy. They are of particular importance in interstate trade where the risk of enterprise-to-enterprise-trade is exacerbated by uncertainty stemming from persistent trade imbalances. The authorities should begin by creating a document against payments scheme. This method will simply require changes in the order of payment and paper flow in the banking system and can be introduced immediately by way of CBR decree. Documentary methods could then be extended by gradually reasserting the role of banks in assessing and bearing risks of transaction. The main task for the CBR is to create legal instruments of debt (promissory notes and bills of exchange). Likewise the CBR could facilitate the use of letter of credit mechanisms to make them internationally accepted (in line with International Chamber of Commerce standards). Various initiatives could be taken quickly to strengthen contract enforcement, including the creation of private notary offices that offer certification of protested bills of exchange. In the case of interstate trade there could be scope to create an arbitration court across national boundaries. In order to encourage commercial banks to use bills of exchange as collateral for their loans, the CBR should institute a rediscounting mechanism of bills of exchange (this would be a first step in developing bills of exchange as money market instruments).

19. A related set of initiatives should be taken to improve the speed of settlement within the banking system. The World Bank is pursuing ways of reducing delays in domestic settlements separately. However, delays in interstate trade payments have been even more problematic. A major cause has been the requirement since mid 1992 for the channeling of interstate transfers through central correspondent accounts (maintained by the CBR) in order to prevent the spillover of inflation from FSU countries to Russia. This bottleneck has caused delays that have been disastrous for the liquidity of enterprises, confidence in trade contracts and certainty of receiving payments. As the FSU countries have created their own currencies, the inflation spillover risk has lessened and the restrictions on interstate fund transfers have been relaxed. Efforts to more widely utilize commercial banks' direct correspondent accounts should be encouraged. Eliminating obligatory list trade (that account for the bulk of transfers through the central accounts) would help to develop more market-based forms of settlement. A multilateral clearing bank such as the proposed Interstate Bank, operating in parallel to commercial bank

correspondent accounts may also prove useful in facilitating direct enterprise-to-enterprise trade.

Trade finance

20. In sequencing market-oriented reforms a high priority should be given to developing modern trade finance instruments and institutions. Currently the Russian banking system does not provide appropriate trade finance services. Loans from the CBR--about half the total loans granted in 1992--are distributed among loss making enterprises, largely to bail them out. The other half was disbursed by commercial banks in the form of general loans that were not linked to trade transactions. Most were short-term loans of less than three months. Banks lack sufficient funds to provide trade finance in foreign exchange, and the CBR does not refinance hard currency loans of commercial banks. Introducing modern methods of payment could be the first step towards developing transaction-based non-inflationary trade finance, and could be an integral part of the reform of the system of loan allocation. These efforts should be complemented by changing the role of the CBR from the distributor of targeted loans to the lender of last resort through the creation of a refinance or rediscount window.

21. Due to the undeveloped banking system, enterprises face difficulties in accessing trade finance. Even those enterprises that have received confirmed letters of credit from hard currency markets may not be able to fill export orders due to lack of trade finance. The CBR needs to play a catalytic role in developing a medium term strategy for modernizing trade finance mechanisms. First the CBR needs to lay the foundation for the legal and administrative framework. Second, it needs to play a leadership role in building the capacity of the commercial banking system to handle these mechanisms, including the organization of training programs. Third, the CBR should ultimately serve as the lender of last resort for banker's acceptance, bill of exchange rediscounting, and other trade finance, as well as the guarantor of hard currencies for high priority import letters of credit opened by Russian banks. In order to have confidence that only performing loans are rediscounted, the CBR should rediscount only those loans backed by export or domestic letters of credit, bills of exchange and other negotiable instruments.

Manufactured exports

22. The report explores how the process of reorienting manufactured exports in line with comparative advantage could be accelerated. Various enterprise interviews pointed to the lack of marketing capacity and access to trade and investment finance as the main constraints to expanding manufactured exports. Foreign collaboration will have an important role to play in helping Russian exporters find markets. But due to the lack of property rights and political uncertainty, non-equity forms of collaboration (such as marketing and sub-contract agreements) are most likely to produce the best results in the medium term. For Russian exporters to take advantage of such links, there is need to encourage information and matchmaking services.

23. The government has announced a comprehensive export strategy that sets out a useful blueprint for expanding manufactured exports. The strategy encompasses a whole range of incentives and infrastructure initiatives including measures to improve access to finance, foreign collaboration and increased market acceptance (including quality certification). The strategy envisages major expenditure on the creation of specialized banks within Russia to provide longer term postshipment and investment finance for manufactured export industries. Aside from subsidies and preferential treatment, many of the measures would contribute to the effective development of manufactured exports. In order to implement them, however, a significant amount of budgetary resources are required. For this reason it is desirable to set the right priorities in terms of implementation timing and resource allocation.

24. The priority short term tasks should be directed to inducing foreign collaboration and establishing a foreign currency import finance and short term postshipment finance system. More aggressive inducement of foreign enterprise collaboration should be the cornerstone of the export strategy. The main challenge is to prepare the legal and policy framework for diversified modes of non-equity partnerships and encouraging information and matchmaking services for foreign partners. Although the strategy paper attaches the highest priority on government support for long term post-shipment financing for exports of turnkey plants and other heavy equipment, it is recommended that foreign currency import financing for parts and equipment needed to modify existing products or produce new products receive greater emphasis. Longer term tasks could include setting up institutional support for post shipment export finance and export credit insurance and guarantee schemes. However, in view of the significant financial and professional resources required to start and operate such institutions, careful planning is needed.

RUSSIA - MATRIX OF TRADE POLICY REFORMS

Objective	Short-term (up to 6 months)	Medium-term (up to 18 months)	Longer-term (beyond 18 months)
1. Phase out import Subsidies	<p>Commence reducing subsidies on industrial inputs and certain consumer goods sold through retail outlets.</p> <p>Assess ways to replace import subsidies with targeted consumer subsidies for socially sensitive goods to assist poorer and disadvantaged members of society.</p>	<p>All import subsidies to be eliminated by the first quarter of 1994. Replace import subsidies with targeted consumer subsidies for socially sensitive goods.</p> <p>Reduce procurement agencies role in cross-subsidizing centralized trade operations.</p>	<p>Privatize trading agencies involved in imports.</p>
2. Phase out export controls and taxes.	<p>Commence expanding volumes of export quotas, with more rapid change for non-energy good.</p> <p>Commence phasing out export taxes, with more rapid change for non-energy goods.</p>	<p>Eliminate export quotas (except those imposed on non-economic grounds and subject to international agreements). Eliminate licensing of strategic exporters. Eliminate export taxes. Reduce extent of centralized exports.</p>	<p>Privatize trading agencies involved in exports.</p>
3. Improve operations of foreign exchange market.	<p>Assess and implement ways to ease entry of small traders into the foreign exchange market.</p> <p>Expand operations of interbank markets to other regional centers.</p>		
4. Rationalize structure of trade taxes.	<p>Assess implications of replacing high import duties with excise taxes on both imports and local production.</p> <p>Outline technical assistance needs of Customs Agency.</p>	<p>Reduce import duties to 50 percent ceiling.</p> <p>Equalize excise taxes on imports and local production.</p> <p>Introduce duty drawback and exemption scheme for exporters.</p> <p>Introduce rules of origin on FSU trade.</p>	<p>Implement low and uniform trade taxes.</p> <p>Build up professional standards of Customs Agency.</p> <p>Build up trade statistics collection capacity.</p>

<p>5. Encourage enterprise-to-enterprise trade with FSU countries.</p>	<p>Commence diversifying contracts under state trading arrangements (giving equal access to private trading companies).</p> <p>Accelerate introduction of multilateral clearing bank (Interstate Bank).</p>	<p>Eliminate negotiated trade (obligatory lists).</p> <p>Maintain preferential trade area with FSU partners as transitional mechanism.</p> <p>Encourage settlement through network of commercial bank correspondent accounts.</p>	<p>Encourage settlement by way of exchange rates.</p> <p>Unify trade regime with FSU and third countries.</p> <p>Provide any subsidies to FSU partners explicitly (and not through the price system).</p> <p>Reassess the need for preferential trade agreements.</p>
<p>6. Modernize trade payments system.</p>	<p>CBR to organize training of commercial banks and enterprises in payment mechanisms such as letters of credit, bills of exchange and bills acceptance.</p> <p>Create sight documentary collection and credit schemes.</p>	<p>Create legal and enforcement mechanisms for enterprise-to-enterprise debt instruments.</p> <p>Develop usance documentary collection and credit schemes.</p>	<p>CBR to create a refinancing scheme based on bill of exchange rediscounting and negotiations of letters of credit.</p>
<p>7. Improve access to trade finance.</p>		<p>Undertake feasibility studies on export-credit insurance guarantee schemes.</p> <p>Assess role of long-term post-shipment finance facilities.</p> <p>Develop short-term import finance of components and raw materials for export production (refinancing scheme).</p>	<p>Develop short term post-shipment finance mechanism (bill discounting and negotiation of foreign letters of credit).</p> <p>Create export-credit insurance scheme.</p> <p>Develop long-term import finance for machinery and equipment.</p>
<p>8. Encourage non-traditional exports.</p>	<p>Prepare legal framework for technical marketing, sub-contract and franchise agreements.</p> <p>Assess marketing assistance schemes for foreign companies.</p> <p>Create comprehensive database on Russian exporters.</p>	<p>Revamp information services on export trends and regulations in foreign countries.</p> <p>Lay the ground for information and matchmaking services for export-oriented foreign/domestic collaboration.</p>	<p>Upgrade certification procedures.</p> <p>Privatize state-owned foreign trading organizations and develop manufacturing export-oriented trading companies.</p> <p>Undertake demarcation EPZ project with emphasis on providing infrastructure.</p>

Chapter 1

Trends and perspectives in trade

Introduction

1.1 Russia's trade has been hit very hard since 1990. Trade volumes have fallen precipitously largely due to political disintegration—first of the Council of Mutual Economic Assistance (CMEA) in 1990 and then with the disintegration of the former Soviet Union (FSU—and so-called interstate trade) late in 1991. However, the declines have also encompassed trade with the rest of the world (in this report referred to as *third countries*). The period of turbulence is not yet over. Notably, the progressive introduction of international prices in interstate trade, though essential for improving resource allocation, is producing significant shifts in terms of trade of different countries adding to the financial burden of those whose terms are deteriorating. This particularly applies to countries receiving energy goods exported by Russia, and is likely to lead to further declines in interstate trade.

1.2 Declines in output and trade have reinforced one another. To some extent, foreign trade has mirrored developments in the Russian economy. Disruption of traditional economic links between manufacturers, a fall in industrial production especially in the main exporting branch (oil production) in particular, and high inflation have adversely affected Russia's foreign trade. After a moderate increase in 1989 and 1990, Russia's gross national product (GNP) dropped abruptly in 1991 by 9 percent and by a further 19 percent in 1992. The economic crisis in Russia resulted in an 18.8 percent slump in industrial output and an almost 8 percent drop in agriculture output. Inflation skyrocketed, reaching 236 percent by the end of 1991 and 3,275 percent by the end of 1992. The exchange rate depreciated continuously, discouraging imports and promoting exports, mainly of natural resources that gradually have become subject to all kinds of tariff and nontariff restrictions. Further details on the collapse in trade are given below.

1.3 Some longer term decline in international trade was expected, as previous trade patterns with FSU countries and some third countries (CMEA, pro-communist less developing countries) were not based on comparative cost and location advantage. The precipitous drops in trade volumes that are occurring, however, are a cause of concern because they contribute to the disruption of production and to the decline in incomes. For this reason this report is directed to finding ways to expand trade in line with comparative advantage and in the process to integrate Russia into the world economy.¹

Trade with FSU and third countries

1.4 Volumes of Russia's current trade with FSU and third countries are probably of the same order of magnitude, as shown in table 1.1. This table shows that the cumulative shares of the main commodities in total exports to FSU and third countries are quite close. This is particularly the case for the main export commodities such as oil and gas. It is estimated that in aggregate these products

Table 1.1 Russia: Output and exports of selected commodities in 1992

<i>Item</i>	<i>Unit</i>	<i>Output</i>	<i>Exports to</i>					
			<i>Third countries</i>	<i>Percentage of output</i>	<i>FSU countries</i>	<i>Percentage of output</i>	<i>Total exports</i>	<i>Percentage of output</i>
Crude oil	mln.tons	393	66.2	16.8	75.5	19.2	141.7	36.1
Natural gas	bln.m3	640	88.9	13.9	106.4	16.6	195.3	30.5
Iron ore	mln.tons	82.1	7.8	9.5	1.7	2.1	9.5	11.6
Coal	mln.tons	337	17.3	5.1	15.8	4.7	33.1	9.8
Coke	mln.tons	71.1	0.1	0.2	0.8	1.2	1.0	1.3
Foundry iron	mln.tons	45.8	1.7	3.7	0.3	0.8	2.1	4.5
Ammonia	mln.tons	10.7	2.3	21.9	0.1	1.4	2.5	23.3
Cement	mln.tons	61.4	0.4	0.6	2.0	3.2	2.3	3.8
Asbestos	mln.tons	1.3	0.1	6.7	0.1	7.7	0.2	14.4
Timber	mln.tons	164	9.9	6.0	6.4	3.9	16.3	9.9
Saw-timber	mln.tons	36.9	3.0	8.0	4.1	11.1	7.0	19.1
Plywood	mln.tons	1.2	0.2	17.8	0.1	11.9	0.4	29.8
Cellulose	mln.tons	2.1	0.4	16.7	0.5	21.8	0.8	38.5
Newsprint	mln.tons	0.9	0.1	15.2	0.3	32.1	0.4	47.3
Cotton fabric	mln.m	3,287	162.0	4.9	615.2	18.7	777.2	23.6
Television sets	mln	3,641	0.1	2.0	0.2	4.8	0.2	6.8
Refrigerators	mln	3,187	0.5	15.0	0.1	4.3	0.6	19.3
Average				9.7		9.7		19.4

Source: Roskomstat.

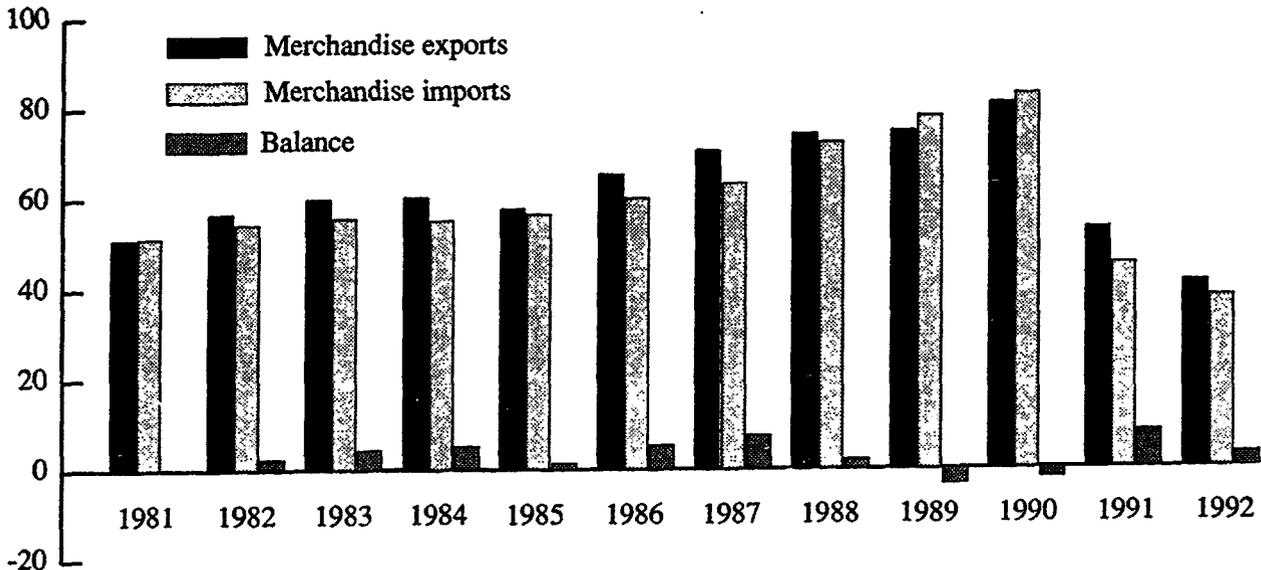
represent about 60 percent of Russian convertible currency exports. Since the selected products of the table are "hard" goods, the share of the omitted products that go to the FSU (some of which can only be marketed in the FSU) would be expected to be somewhat larger. Thus, it appears that the share of Russian exports that went to the FSU remained slightly over 50 percent in 1992. Since the share of Russian trade that went to the FSU was 61 percent in 1990, these data confirm the conclusions that since 1990 there has been a comparable decline in exports to third countries and to the FSU. The average ratio of exports to output of these commodities to both FSU and third countries is 9.7 percent.

Trends in third-country trade

1.5 Estimates of Russia's trade with third countries since 1981 are depicted in figure 1.1. Exports from Russia to third countries steadily expanded over the 1980s and reached a high point of about \$80 billion in 1990. Trade was generally in surplus up to 1988, but in the following two years turned sharply negative. Trade collapsed over the period 1990-92, with exports falling by 49 percent and imports by 45 percent. Despite these falls the country has registered significant trade surpluses in the past two years.

1.6 Russia's trade statistics are sketchy and imprecise, and need to be interpreted with caution. The reasons partly relate to the dissolution of the USSR and to changes in statistical recording methods. Russia's trade with third countries only was recorded separately from 1992 onward (in dollars). In previous years Russia's trade was consolidated with the FSU in total and this total was recorded only in rubles (or so-called *foreign exchange rubles*). Consequently Russia's trade before 1992 can only be

Figure 1.1 Russia: Trends in international trade, 1981-92
(billions of U.S. dollars)



Source: Goscomstat.

estimated on the basis of shares of former republics—and this was only undertaken in late 1991 during elaboration of the interrepublic agreement on the distribution of FSU debts and assets. Russia's share in total FSU trade was established at 78.2 percent for exports and 67.7 percent for imports. Estimating FSU trade in 1992 is difficult because of the lack of customs borders and incomplete data recording. Moreover, government controls on exports through licensing, quotas, and duties—as well as foreign exchange surrender requirements at less than market prices—have created strong disincentives to exports. They have also led to significant unrecorded "illegal" exports, transshipment of raw materials and oil, and to underinvoicing of exports and overinvoicing of imports.

1.7 Dissolution of the USSR in late 1991 converted traditional interstate relations into international trade. Russia's trade with the FSU was supposed to be subject to the same trade regulations as trade with other countries. But since there were no customs borders, it was impossible to unify the trade regimes immediately. An important recommendation of this report is that these regimes ultimately should be unified and should be based on market principles and enterprise-to-enterprise trade. Currently third-country trade is mainly in hard currencies. It is this trade that is officially recorded in the balance of payments (and is calculated in U.S. dollars). Trade with FSU countries is still ruble or barter trade. Documentary collection, letters of credit, and other internationally recognized methods of payments have always been common for trade with third countries (except in recent years when prepayment and payment on delivery became more widespread because of the arrears problems of the Russian government and enterprises). Trade between FSU countries relies on domestic payments (payment orders and requests—discussed in more detail in chapter 4).

1.8 Trade with third countries is regulated mainly by the usual tariff and nontariff instruments, by state orders for exports for central needs, and by state procurement of critical imports. Trade with third countries is based on world prices, although these are not passed on to producers and consumers in many cases because of import subsidies and export taxes. Nevertheless the trade and subsidy data provide enough transparency for at least an educated guess as to the level of implicit subsidies involved. Trade with FSU countries is subject to bilateral trade agreements, which are comprised of obligatory and indicative lists for bilateral deliveries, though enterprise-to-enterprise arrangements also exist. Trade under bilateral agreements is in mutually agreed prices. The implicit subsidies in such trade are much more difficult to assess.

Reasons for the collapse in trade

1.9 There are multiple reasons for the observed collapse in Russia's external trade. The elimination of the central planning system led to a disruption in production and supply of exportables. This in turn, reduced the availability of hard currency required for import purchases throughout the FSU. At the same time market institutions in support of international trade have been slow to emerge. The sharp drop in trade with Eastern Europe following the collapse of the CMEA was an additional problem in 1991. CMEA countries had always represented major markets for Russian exports and imports but after agreement was reached to make all settlements between CMEA countries in hard currencies, previous long-term cooperation between enterprises was disrupted. Enterprises producing goods that are saleable in hard currency markets abandoned their former CMEA customers. Likewise, Russian enterprises found it difficult to sell most products in external markets. The notable exceptions are commodities like energy and raw materials, where quality and marketing aspects are much less of a constraint.

1.10 The decline in trade was particularly severe for manufactured goods. For the FSU as a whole, exports of machinery and equipment fell from \$19.5 billion in 1990 to \$6.6 billion in 1992 (or

by three times). Russia accounted for about two-thirds of such exports. Exports of manufactured goods declined slightly further in 1992. In terms of product groups the largest declines were in rolled steel, fertilizers, and military equipment. In addition to the reasons discussed above, manufactured exports were adversely affected by the lack of long-term postshipment finance. Commercial banks no longer extended such credit due to high inflation and risks of nonpayment by foreign buyers.

1.11 One positive development has been the slight increase in machinery and equipment exports to hard currency markets since 1990. Such exports increased from about \$2.3 billion in 1990 to about \$2.6 billion in 1992. Part of this increase represented a redirection of exports from traditional markets. The main manufactured goods exported to hard currency markets included boilers, refrigerating equipment, tractors, cars, and aerospace equipment. Exports of non-traditional goods such as furniture, watches, and optical equipment have increased rapidly, albeit from a low base.

1.12 Restrictive trade policies have also been a factor in the collapse in trade. During 1992, at the prevailing exchange rates, workers were earning around \$15 to \$20 a month, demonstrating the high value of convertible currency. The low market rate of the ruble is partly caused by policies that discourage exports, through a variety of explicit and implicit controls and taxes. Multiple exchange rates used prior to July 1992 meant that exporters did not benefit from the undervalued exchange rate. Likewise the government imposed both quantitative controls and taxes on exports in order to finance centralized imports and to repay foreign debt. Additional reasons for export controls include: a desire to maintain domestic prices of inputs below international prices so as to ease the adjustment of enterprises; and residual central planning attitudes which view exports with suspicion and, in a supply-constrained environment, consider it desirable to "keep goods at home." In practice, export controls have been administered in a non-transparent fashion, with a large number of ad hoc exceptions. As a consequence, the controls have created strong incentives for rent-seeking activities, corruption, and distortions as well as uncertainties and constraints to exporters (see chapter 2).

1.13 The decline in imports from third countries reflects two main reasons: (i) the decline in incomes and output has resulted in declining demand; and (ii) the fundamental foreign exchange constraint facing the country during this period. Formal import restraints are quite low, as licensing has largely been removed and tariffs are either low or not applied. Competition from abroad is nonetheless weak in most sectors because of high protection against hard currency imports provided by a market rate of exchange which is low relative to purchasing power estimates. In Russia there are extensive foreign exchange subsidies which, however, are available only on import competing products.

Structure of third-country trade

Trade balance in 1992

1.14 According to official trade statistics, Russia recorded a surplus of \$3.1 billion in third-country trade (excluding gold sales) in 1992. Exports to countries outside the FSU were \$40.0 billion of which approximately \$24.5 billion were paid (or debt incurred) in convertible currencies. The remaining \$15.5 billion worth of exports was paid for through barter and clearing account arrangements. Russia imported goods worth \$36.9 billion; \$27.8 billion of which was paid for (or debt incurred) in convertible currencies, \$9.1 billion through barter and clearing accounts arrangements.

1.15 Foreign trade is being undertaken by both Russian enterprises and by Foreign Trade Organizations (FTOs). There are approximately 15 significant FTOs, all reporting to one or several ministries. Russian enterprises reported foreign exchange earnings from the export of goods of \$10.6 billion and foreign exchange expenditures for imports of \$7.2 billion. FTOs earned approximately \$14 billion from exports while they imported (for hard currency) about \$20 billion. Barter trade was conducted primarily, but not exclusively, by FTOs. A breakdown of foreign trade in goods is summarized in table 1.2.

Table 1.2 Russian trade with third countries, 1992 and first half 1993
(billions of dollars)

	1992		1st half 1993	
	Exports	Imports	Exports	Imports
Total goods (excluding gold)	40.0	36.9	18.2	8.8
Barter and clearing accounts	15.5	9.1	7.3	3.2
Foreign exchange trade	24.5	27.8	10.9	5.6
Enterprises	10.6	7.2	n.a.	n.a.
FTOs	13.9	20.6	n.a.	n.a.

Source: Goskomstat and World Bank estimates.

1.16 A striking feature of the trade figures is that trade through barter and clearing accounts account for a disproportionately large, and increasing, share of total trade, about 40 and 26 percent for exports and imports, respectively. The tendency towards barter and clearing account trade has been accelerating during 1992, and preliminary indications for the first half of 1993 suggest a further move away from convertible currency trade. It is somewhat curious that barter and clearing account trade is reported to yield a \$6.5 billion surplus for 1992, and possibly up to \$5 billion during the first half of 1993. Apart from recognized valuation problems for such trade, a surplus on barter trade may be due to accumulations on clearing accounts (which can be only an insignificant amount) and timing differences for reporting of exports and imports in the beginning and the end of the year. Apart from this, barter and clearing account trade should, in principle, register a balanced trade. The most obvious explanation for the registered surplus is that the western partner in the arrangement makes residual payments to the Russian partner, to compensate for the additional Russian export. Not being registered, such payments may be kept in hard currency accounts abroad (a form of capital flight).

1.17 Another striking feature of the trade figures is that out of the relatively small share of convertible currency trade, an even smaller - and almost non-existent - share of hard currency earnings is voluntarily exchanged into rubles, and likewise, only a fraction of import needs are financed through purchases of hard currency in the market. Table 1.3 provides a rough and simplified estimate of the foreign exchange flows from export earnings and foreign credits to the import expenditures.

Table 1.3 Foreign Exchange Flows from Exporters to Importers
Simplified Presentation for Flows in 1992
(billions of dollars)

	Total	Enterprises	FTOs
Export Earnings	24.5	10.6	13.9
Uses:			
Surrender (domestically)	6.0	2.6	3.4
Surrender, directly into ministerial accounts abroad	2.6	2.6	0.0
Deposited abroad for import payment	7.7	n.a.	n.a.
Unidentified Uses, including increase in fx deposits	8.2	n.a.	n.a.
Import Expenditures	27.8	7.2	20.6
Sources:			
Foreign financing	12.8	1.8	11.0
Foreign grants (for imports)	1.9	0.0	1.9
Min. Fin. accounts abroad	2.6	0.0	2.6
Transferred from Ministry of Finance	0.7	0.0	0.7
Unblocked accounts by VEB	1.0	n.a.	n.a.
Uses from own deposits abroad	7.7	n.a.	n.a.
Bought at fx auctions	1.1	n.a.	n.a.

Source: Goskomstat, Ministry of Finance and World Bank estimates.

1.18 As estimated in Table 1.3, out of total export earnings (in hard currencies) in 1992 of \$24.5 billion, exporters surrendered \$6.0 billion to the Republican Hard Currency Fund and the central bank (an outline and discussion of surrender requirements are provided in Chapter 2). In addition, enterprises surrendered an estimated \$2.6 billion directly into accounts held abroad in the name of the Ministry of Finance, partly in return for other compensations such as reduction in export taxes, as discussed in Chapter 2. The approximate balances on the accounts held abroad by the Ministry of Finance was used for critical imports by FTOs. An estimated \$7.7 billion earned for exports was kept temporarily abroad by the exporters and used during the year for imports (data is not available to make a reasonable estimate of the split between enterprises and FTOs). Given these estimates, \$8.2 billion appears unaccounted for; comprising of increases in foreign exchange deposits domestically and abroad (capital flight), increases in foreign exchange cash holdings and exchanges into rubles outside the normal channels of banks. Given the overall increase in foreign exchange deposits in the domestic banking system of close to \$10 billion, it is unlikely that any amount of significance has been exchanged into rubles through such channels.

1.19 Foreign exchange uses for imports amounted to \$27.8 billion, of which \$14.7 billion was financed from abroad; \$12.8 billion through credits, the remaining through grants. FTOs had made

available for their imports the approximately \$2.6 billion surrendered directly by enterprises into Ministry of Finance accounts abroad, and they also received \$0.7 billion from the hard currency budget. During 1992, VEB unblocked foreign exchange accounts on an ad hoc basis to enterprises in particular need of foreign exchange; a reported \$1.0 billion was thus made available to enterprises from their own blocked accounts. As mentioned above, an estimated \$7.7 billion was deposited abroad by exporters for the explicit use of import payments, and, eventually, enterprises and FTOs bought \$1.1 billion at the foreign exchange auctions through the banking system.

1.20 Capital flight reportedly increased in 1992 and without doubt was linked to some unrecorded exports. The declines in exports, however, were so large that they are not likely to reflect simply unrecorded figures. It is estimated, for example, that oil exports (crude and products) fell from 165 million tons in 1990 to 93 million tons in 1992. Even taking into account unrecorded exports — estimated in the 20-30 million tons range, but possibly up to 40 million tons - there was hardly without any doubt a significant real export decline. As mentioned above, surrender requirements, confiscation of exports for state needs, and other constraints imposed by the state on hard currency revenues of enterprises have motivated capital flight from the country.

1.21 Again, caution is needed in interpreting these trade statistics. Hard currency revenues and expenditures are still not reflected properly in the federal budget; the authorities have kept the federal hard currency budget separately from the federal ruble budget, thus obscuring the real amount of state revenues and expenditures. Likewise the Central Bank of Russia (CBR) does not reveal official information on its hard currency reserves, revenues, and expenditures. Moreover enterprises clearly underinvoice their hard currency assets on escrow accounts abroad.

Third-country trade structure

1.22 Major structural changes have occurred in exports and imports over the period 1990–92 (see table 1.4). The share of former socialist countries has dropped from almost 50 to 30 percent in Russia's exports and from 50 to 23 percent in imports. This decrease was mainly due to an abrupt fall in trade with ex-CMEA countries. Organization for Economic Cooperation and Development (OECD) countries have become Russia's leading trading partners with a share of 60 to 65 percent, compared to 35 to 49 percent two years ago. This increase partly was due to a reclassification of trade associated with the reunification of Germany (East and West Germany had always been the main trading partners). More generally, the volume of trade with most European OECD countries increased significantly in 1992, while trade with ex-socialist countries fell at least twofold. Trade with those Asian countries which have always been reliable trading partners also increased in 1992, increasing twofold and more with the Republic of Korea, Singapore, and Thailand, and by 20 to 40 percent with China, Pakistan, and Turkey. Trade with Japan continued to stagnate.

Table 1.4 Russia: Country structure of trade with third countries
(percent)

<i>Region</i>	<i>1990</i>		<i>1991</i>		<i>1992</i>	
	<i>Exports</i>	<i>Imports</i>	<i>Exports</i>	<i>Imports</i>	<i>Exports</i>	<i>Imports</i>
Former CMEA	43	45	23	25	21	16
China, Korea, Lao P.D.R., Yugoslavia	7	6	7	7	9	7
OECD	36	40	57	58	60	64
Developing countries	14	10	14	10	10	13
Total	100	100	100	100	100	100

Source: Roskomstat.

1.23 The adjustment in the structure of Russia's third-country trade reflects profound changes in foreign trade policy. The authorities no longer support developing countries for ideological reasons (trade with Cuba, for example, fell by four times in 1992) and show a willingness to build up hard currency and arms-length trade. The main tendencies in the adjustment of Russia's third-country trade are the following: transition to hard currency settlements with all countries, thus reducing the relative share of clearing settlements and barter transactions; reorientation of trade toward those countries that are ready to repay foreign debts to Russia and to fulfill assumed trade obligations; and more focus on trade with nearby newly industrialized countries.

Commodity structure

1.24 Though mineral fuels have always been the major commodity group in Russia's exports, their relative share continued to increase in the past two years and reached 52 percent of total exports in 1992 (see table 1.5). Despite the slump in oil output, exports for hard currency increased by 17 percent in 1992. Although exports of natural gas remained relatively stable, exports of other raw materials did not perform as well. Exports of electricity, fertilizers, cement, timber, plywood, cellulose, ferrous metals, and coke decreased by 1.2 to 1.5 times during 1992. The relative share of raw materials has increased largely because of a slump in manufacturing exports. As mentioned above this report looks at ways of increasing non-traditional exports (including manufacturing goods) partly because of the benefits in diversifying the export base. Exports of machinery and transport equipment fell by 30 percent in 1992 and now only comprise 10 percent of total exports.

Table 1.5 Russia: Product structure of third country trade in 1992 ^{a/}

Product	Exports		Imports	
	Value	Percent	Value	Percent
All foods	1,042	3	9,154	28
Agricultural raw material	1,365	4	167	1
Mineral fuels	17,461	52	552	2
Crude petroleum	6,446	19	0	0
Refined petroleum	2,794	8	366	1
All manufactures	9,317	28	21,917	68
Chemicals	1,916	6	3,134	10
Textiles and clothing	200	1	2,845	9
Nonelectrical machinery	1,268	4	5,821	18
Electrical machinery	232	1	2,265	7
Transport equipment	2,028	6	2,768	9
Ores, minerals, and metals	4,446	13	361	1
Miscellaneous goods	174	1	7	0
Total	33,804	100	32,157	100

^{a/} Roskomstat can only provide a product breakdown for the amount of imports shown in this Table. Note that the total shown is much less than the aggregated totals outlined in earlier tables.

Source: Roskomstat.

1.25 However, manufactured goods account for more than two-thirds of imports (with machinery and transport equipment alone accounting for 34 percent). Food and agricultural raw materials are the next largest items in Russia's imports (accounting for 29 percent of the total). The relative share of these commodity groups has increased in the past three years, and judging by the commodity structure of Russia's trade it is evident that almost 70 percent of exports are raw materials and 97 percent of imports are manufactures and food products. A large part of natural resource output is exported. For example, exports of crude oil and natural gas to both third countries and the FSU is about one-third of domestic production. Likewise, about 30 to 50 percent of timber, plywood, and cellulose output is exported.

Concentration in exports

1.26 The concentration ratio of Russian exports is extremely high compared to most other countries (see table 1.6). The top three commodities (natural gas, crude petroleum, and petroleum products) occupy half of Russian exports as compared to 18 percent in the United States, 21 percent for Brazil, and 28 percent for India. The top five commodities (listed above plus road motor vehicles and aluminum) account for about 59 percent of Russian exports—that is almost double the percentage of other countries. The top ten commodities (the above plus iron, fresh fish, nickel, fertilizers, and natural abrasives) account for about 70 percent of Russian exports as compared to 37 percent in the United States, 44 percent in Brazil, and 50 percent in India. It could be expected that as Russia continues on the reform path that increased enterprise-to-enterprise trade will result in a greater diversification of the export base.

**Table 1.6 Russia: Concentration ratio of exports
(percentage of total exports)**

<i>Commodities</i>	<i>Russia</i>	<i>United States</i>	<i>Canada</i>	<i>Brazil</i>	<i>Korea</i>	<i>India</i>
Top three	50	18	25	21	17	28
Top five	59	25	35	30	25	35
Top ten	70	37	50	44	39	50

Note: 1992 for Russia, 1987–88 for other countries.

Source: Roskomstat, UNCTAD.

Centralized trade with third countries

1.27 The state directly controls a certain proportion of exports in order to pay for centralized imports and to repay foreign debts. Export quotas to meet state needs are tendered in order to create equal bidding conditions for all Russian exporters and for transparency in general. In practice they are often distributed directly to the most "reliable" state or quasi-state FTOs, as these can guarantee hard currency revenues to the federal budget. According to government regulation number 1043 of December 30, 1992, exports for state needs are supposed to reach \$15.4 billion in 1993 or 39 percent of Russia's exports in 1992 (see table 1.7).

1.28 Centralized imports are expected to amount to about \$19.2 billion in 1993. In order to pay for these imports, the authorities will purchase significant quantities of raw materials on the domestic market for centralized exports. The state will absorb a large part of the exports of ammonia and sawn timber (70 to 80 percent), half the available timber and cellulose, and one-fifth of commodities such as oil, coke, and phosphatic fertilizers. These commodities will be purchased at a domestic price that is well below world prices. The difference between these prices will be used to cross-subsidize imports of food and machinery. In this way the centralized trading system continues to insulate producers and consumers from the world price structure. The need to reduce this distortion is a key issue discussed in chapter 2.

Table 1.7 Russia: Hard currency exports for state needs in 1993

Commodity	Unit	1992				
		Output	Hard currency exports	Volume 1993	Percentage of 1992 output	Percentage of 1992 exports
Crude oil	mln.tons	393.0	66.2	12.0	3.1	18.1
Coal	mln.tons	337.0	17.3	3.5	1.0	20.2
Ferrous metals	mln.tons	46.8	5.8	1.5	3.2	25.9
Coke	mln.tons	71.1	0.1	0.03	0.0	30.0
Aluminum	mln.tons	—	1.0	0.1	—	10.0
Ammonia	mln.tons	10.7	2.3	1.7	15.9	73.9
Fertilizers						
Nitrogenous	mln.tons	—	6.6	0.886	—	13.4
Phosphatic	mln.tons	—	0.1	0.0225	—	22.5
Potassic	mln.tons	—	3.2	1.164	—	36.5
Methanol	mln.tons	—	1.0	0.402	—	40.2
Timber	mln.m ³	164.0	9.9	5.0	3.0	50.5
Saw-timber	mln.m ³	36.9	3.0	2.5	6.8	83.3
Cellulose	mln.tons	2.1	0.4	0.19	9.0	47.5
Total exports	\$ mln		40,000	15,400		38.5

— Not available.

Source: Roskomstat, Government Regulation No. 1043 of December 30, 1992.

Manufactured exports

1.29 The industrial sector in the FSU under a centralized planning system has always been relatively large and considered "an engine of growth." The sector has always received a large share of public investment. Manufacturing industry contributed some 47 percent of FSU net material product in the second half of the 1970s and 36 percent by 1990. In terms of the gross domestic product (GDP) this share was about 30 percent—higher than in most industrialized countries (typically having a share of 20 to 25 percent). The most important subsector, machine building, accounted for more than one-third of all FSU industrial output in 1989. Over 60 percent of FSU industrial output was from the Russian Federation.

1.30 Despite its size, the industrial sector exported little to countries outside the FSU. In FSU input-output tables for 1988, exports accounted for only about 4 percent of total industrial output.² By contrast, Poland's manufacturing exports comprised 16 percent of domestic output at that time. Nonetheless, the FSU export performance was not uniformly bad; some subsectors produced more or less competitive goods (at least by the standards of Eastern European and developing countries) and exported a relatively higher percentage of their output. This included products such as equipment for timber processing and paper industries (33 percent), equipment for textile industry (29 percent), cars (28 percent), and fertilizers (about 20 percent). In absolute terms, however, manufacturing exports of the

FSU were very low. By 1990 they amounted to only \$25.2 billion,³ while smaller countries such as Korea and the Netherlands exported at least three times more.

1.31 Manufactured exports were comprised mainly of heavy material and energy-intensive machinery such as equipment for raw material handling, coke oven and blast furnace installations, and machine tools. Military equipment accounted for almost one-quarter of the manufactured goods exported, with destination markets of primarily developing countries and the CMEA. Competitiveness rested on three factors: cheap raw materials and energy stemming from heavily distorted domestic prices; special payment arrangements with major importers (China, CMEA, and India) relying on multilateral and bilateral clearing (which allowed these countries to save hard currency); and long-term government export finance that enabled FSU enterprises to sell on the basis of deferred payments (up to ten to fifteen years). Many of the FSU allies are insolvent and unlikely to pay, and in these cases Russian exports were given away almost for free. The actual return on non-military manufactured goods exported to the CMEA and to developing countries in 1990 is much less than the \$16 billion recorded (importing countries already owe Russia about \$100 billion, mostly in arrears). In other words, the major reason for the low value of Russian manufactured exports is that they were driven by geopolitical interests rather than by comparative advantage.

1.32 Despite the desperate need of the FSU economy for hard currency to finance the purchase of Western technology and equipment, FSU manufacturing exports to hard currency areas comprised only some \$3.5 billion in 1990. The major reasons for such low sales were the inheritance of the philosophy of autarky from the central planning system and the poor quality of goods. The rule of thumb for planners was that projected volumes of production must satisfy all domestic needs in the first instance, and only the remainder could be exported. In manufacturing industry the quantity of capital was high but the quality of output was low, and after-sales service generally was unavailable for domestic users and particularly for foreign buyers.

1.33 The quality of manufactured goods could have been considerably improved if equipped with imported Western components and other imported inputs. For example, Russian equipment for raw material handling or metal processing machines would be of acceptable quality if equipped with electronics for numerical control. However, FSU enterprises tried to produce as much as possible in-house or relied on raw materials and components produced by other FSU-based enterprises. The guideline applied by Gosplan in determining production and consumption balances was that imports should be used only when there were difficulties producing domestically. The share of imported inputs in industrial output was as low as 1 to 4 percent (varying by sector). On average, imported components have never comprised more than 3 percent of output (see table 1.8). Overcoming autarkic tendencies is a necessary condition in order to expand manufactured exports. The importance of financing imported inputs as a catalyst in such exports is discussed further in chapters 4 and 5.

Factor intensity of exports

1.34 A breakdown of Russian manufacturing exports shows that they are much more pollution intensive than those of other countries (see table 1.9). Polluting industries and capital-intensive manufactures account for 75 percent of Russian exports compared to 21 and 40 percent for world exports respectively. Unskilled labor-intensive exports are relatively low and are comparable to that of Canada. The share of natural-resource-based manufacturing is higher than that observed in all other countries,

including Brazil and Mexico. Surprisingly, the share of high-technology manufactures in exports is the lowest among the listed countries. In general, Russia is an exporter of highly capital-intensive and natural-resource-based manufactures produced by polluting industries. These manufactured goods are not technologically advanced.

1.35 Due to the inefficiency of Russian industry and technological backwardness of equipment, Russia is much more energy and material consuming than Western countries.⁴ This suggests that the major source of competitiveness of Russian manufacturing exports is cheap energy (direct and indirect). In other words, most of these goods were sold only because their cheap prices offset the low quality of products. As domestic prices of energy and raw materials approach world market levels, this competitive advantage will be reduced. Russian exporters will have about two years to: (a) improve the quality of the above listed goods; (b) find new niches for other manufacturing products through developing marketing capacities; and (c) develop trade finance schemes.

Table 1.8 Percentage of exports and imports in domestic output, 1988
(percent)

<i>Sector</i>	<i>Imports</i>	<i>Exports</i>
Electric power	0.6	2.3
Oil and gas	0.4	18.1
Coal	0.9	5.1
Other fuels	0.7	0.5
Ferrous metals	1.1	6.6
Nonferrous metals	3.7	6.2
Chemical	4.5	6.0
Machinery	2.0	4.6
Wood and paper	1.4	7.3
Construction materials	0.9	0.6
Light industry	4.2	3.1
Food industry	5.4	1.5
Other	4.1	2.0
Industry total	2.9	4.6

Source: Dmitri Steinberg, 1991, *The Soviet Economy 1970-1990: A Statistical Analysis*. New York: International Trade Press, pp.47-49.

Table 1.9 Russia: Manufacturing exports by factor intensity

<i>Factor</i>	<i>Russia</i>		<i>World</i>		<i>Canada</i>		<i>Brazil</i>		<i>Mexico</i>	
	<i>Millions of dollars</i>	<i>Percent ^a</i>								
Labor-intensive manufactures	2,515	27	227,533	60	21,280	34	2,803	54	11,475	59
Unskilled labor-intensive	339	4	72,824	19	3,418	6	1,537	30	2,674	14
Capital-intensive manufactures	6,802	73	148,922	40	40,507	66	2,346	46	8,123	41
Human-Capital Intensive	4,039	43	140,493	37	38,852	63	1,290	25	7,578	39
Natural-resources-based manufactures	2,201	24	22,550	6	9,010	15	469	9	496	3
Manufactures of polluting industries	7,049	76	79,196	21	22,563	37	2,127	41	2,613	13
High-technology manufactures	1,174	13	110,133	29	11,989	19	1,179	23	6,224	32
All manufactures	9,317	100	376,455	100	61,787	100	5,149	100	19,598	100

Source: Data compiled from Roskomstat and UN Statistical Office COMTRADE types.

a. As some industries can be classified in more than one category, sums do not add up to totals. Data for Russia relates to 1992. For the other countries data is for 1990.

Russia's access to world markets

1.36 There are benefits to Russia in liberalizing trade in order to enhance productivity and growth. The task of opening up the trade regime lies with Russia itself. As shown in the following chapters, despite considerable progress there is still much to do. But the international community also has a responsibility to ease Russia's entry into the world trading system as there are mutual benefits to a country of Russia's size and potential taking a more active role in trade. In the past, the OECD resorted to special measures aimed at countering the potentially disruptive threat from Russia's previously centralized system including special legal regulations for unfair competition cases. In this regard, it is vital that Russia make progress in acceding to the GATT, as this would make MFN treatment permanent and would provide for dispute resolution in case a trade partner unfairly invoked safeguard mechanisms.

Trade agreements

1.37 Russia now has MFN treatment in the major markets of the US, EC and Japan. The EC has also extended GSP treatment as an exceptional and temporary measure. Because of geographical proximity and the existing transportation network, the most important trading partner within the OECD for Russia is the European Community (EC). The present EC arrangements subject Russia's exports to higher tariffs and to more restrictive nontariff barriers than those encountered by members of the European Free Trade Agreement, Mediterranean and Lomé Convention signatories, and former members of the CMEA. Due to European Association agreements signed with the EC, exports of manufactured goods from the Czech Republic, Hungary, Poland, Romania, and Slovakia are either duty-free or subject to much lower tariff rates than levied on most other exporters. Because of similar industrialization strategies pursued under central planning, Russia is likely to compete in the same markets. However, the lower wage in Russia may not be sufficient to compensate for the country's losses in value added that exporters have to absorb in order to compete effectively in protected markets.

Tariffs and preferences

1.38 Tariffs imposed on FSU exports to OECD markets are about 6 percent, but are higher in several important sectors (table 1.10).⁵ The republics paid an average import duty of about 1 percent on food exports of approximately \$900 million to the EC, Finland, and Japan, with several products (fruit, sugar, and beverages) having average tariffs ranging from 23 to 40 percent. Import duties on some manufactured products such as leather, clothing, and footwear in Japan, or clothing in the EC and the United States averaged between 11 and 30 percent. Overall, the average tariff applied by the EC tends to be higher than in Japan or the United States.

Table 1.10 Average OECD tariffs on main exports of FSU, 1991

<i>Product Group</i>	<i>OECD imports (millions of dollars)</i>	<i>Average tariff rate (percent)</i>		
		<i>EC</i>	<i>Japan</i>	<i>United States</i>
Food products	940	15	15	9
Agricultural materials	2,115	2	2	2
Textile fibers	435	3	2	2
Ores, minerals, and metals	4,022	2	2	1
Manufactured goods	5,048	7	5	5
All goods	29,443	7	5	5

Source: B. Kaminski and A. Yeats, 1993, "OECD Barriers Facing Successor States of the Soviet Union." International Trade Division, World Bank.

1.39 FSU countries, including Russia, often face considerably higher import duties than those paid by other (competing) exporters of the same product due to extensive OECD preferences that differentiate among sources of supply. These adverse tariff margins resulting from preferential trading arrangements such as the EC's Lomé Convention and the EFTA for free trade in manufactured goods, all allow other suppliers to displace or divert potential FSU exports. The extent of the preferences are outlined for selected manufactured products in table 1.11. These show that the FSU rate is more than twice as high as the average duty all exporters pay on these same products and three times the corresponding rate facing developing countries. Again these averages mask considerable product variation. If the tariff on FSU goods were lowered to the average for all developing country exports on a sample of goods, FSU exports are estimated to increase by 15.4 percent, and almost twice this rate if they were eliminated entirely.

1.40 Russian exports of unprocessed or semifabricated commodities face reduced market access through subsidies or indirect support of OECD industries. For example, many OECD agricultural producers benefit from a variety of assistance programs and, expressed in terms of a tariff equivalent, this assistance is very high. Examples include livestock products at 60 percent, sugar at 146 percent, and milk at 152 percent.⁶ Russia could also benefit from further processing of commodities. However, OECD markets are characterized by tariff escalation whereby zero or very low tariffs (and nontariff barriers) are applied on unprocessed commodities, but where restrictions increase with the degree of processing, thus creating a bias against trade in processed commodities. In general, effective tariff rates

Table 1.11 Effect of tariff preferences
(percent)

<i>Commodity</i>	<i>Average tariff facing</i>		
	<i>Developing countries</i>	<i>All exports</i>	<i>FSU countries</i>
Chemicals	1.6	3.5	7.7
Plywood	0.8	1.4	7.1
Paper	1.5	1.8	8.7
Clothing	3.4	3.3	12.1
All manufactured goods	2.0	2.8	6.7

Source: As for table 1.10.

average over twice the corresponding nominal rate, indicating that OECD trade barriers have a far more restrictive effect on the location of processing activity than a superficial analysis of nominal rates suggests.

Nontariff barriers

1.41 Although tariffs are often a serious constraint on FSU exports, in some cases nontariff measures (NTBs) are more important. Such restrictions include quantitative ceilings on imports (including the Multifiber Arrangement); voluntary export restraints; product specific changes such as antidumping and countervailing duties; restrictive licensing requirements; and variable import levies or fees. An indication of their importance is outlined in table 1.12.

1.42 Table 1.12 shows that foods and animal feed is one of the most NTB-ridden product groups in OECD markets. They are applied to 80 percent of EC imports of meat and sugar and slightly less than half of all fresh and preserved fruit products. In the manufacturing sector about 20 percent of imports to OECD markets face NTB restrictions, with a particular emphasis on leather and leather goods; textile yarn and fabrics; ferrous metals and clothing; and footwear. As is the case with foodstuff, studies affirm that very high levels of nominal protection are associated with these NTBS. In short, the message that emerges is that NTBs (as well as tariffs) often constitute a major impediment to Russian exports and, in specific sectors, could prevent any significant trade expansion.

Table 1.12 NTB protection for major FSU exports
(percent)

<i>Product</i>	<i>Share of tariff lines facing NTBs</i>		
	<i>European Community</i>	<i>Japan</i>	<i>United States</i>
All food	39	68	33
Agricultural materials	26	23	6
Wood and lumber	21	0	0
Textile fibers	14	0	13
Ores, minerals, and metals	3	0	0
Manufactured goods	18	10	1
All goods	19	19	6

Source: As for table 1.10

Notes

1. This report builds on studies recently undertaken in the World Bank and particularly on Constantine Michalopoulos and David Tarr, 1992, *Trade and Payments Arrangements for States of the Former USSR*. World Bank Studies of Economies in Transformation 2, Washington, D.C.
2. Dmitri Steinberg, 1992, *The Soviet Economy 1970-1990: A Statistical Analysis*. New York: International Trade Press, p. 3.
3. *Business World Weekly*, February 17, 1992, p.12. Ministry for Foreign Economic Relations of Russia.
4. In 1985 the FSU produced \$218 of gross national product (GNP) for every barrel of oil equivalent in energy consumption, while the United States and the European Community each produced about \$300, and Japan almost \$500 for every barrel—more than twice the gross energy efficiency of the FSU. Furthermore, the FSU produced \$1.34 in GNP per kilowatt-hour of electricity used, well below the \$2 worth of output in Japan.
5. Separate data for Russia are unavailable. However, the FSU estimates will be broadly applicable to Russia.
6. See *Trade Issues Arising in the Transition Process to a Market Economy*, OECD Working Party of the Trade Committee, Paper TD/TC/WP(92) 63/REVZ of March 10, 1993. Paris: OECD.

Chapter 2

Russia's trade and payments system: The third-country regime

Overview

2.1 Until 1991 Russia's trade regime provided an air lock between the domestic and world economies. Planners determined resource allocation with scant regard for comparative advantage. On the contrary, they pursued self-reliance within the FSU. As a result, goods were only imported if they could not be produced locally and exports were a residual after domestic needs were satisfied. The air lock was maintained by monopoly foreign trading organizations, which enforced administratively set prices for traded goods. In effect, the FTOs took advantage of a distorted domestic price structure in order to export raw materials that were easily sold in hard currency markets (they required little marketing). Revenues from such transactions were used to subsidize imports of food and machinery. The strategy chosen by the planners was completely at odds with the outward orientation chosen by the fastest growing countries over the past 30 years.

2.2 Russia has made considerable progress in joining the world economy in the short intervening period. Trading monopolies have been eliminated, prices partially liberalized, and the exchange rate is set by the market. Most of these changes occurred in the early stages of reform. Since mid-1992 the reform momentum has stalled, particularly in a regard to further corrections of domestic price and trade distortions. These distortions continue to be the key to understanding the structure of the trade regime. Prices for raw materials and energy continue to be suppressed to ease the adjustment of industrial enterprises. Likewise the prices of food (such as bread) are controlled, largely for social reasons. As before, the distorted price structure is supported by export controls (both volume and price) on resource-based products and massive import subsidies on food, medicine, and industrial inputs.

2.3 A key theme of this chapter is that the incentives regime has a crucial role to play in ensuring that future investment is directed towards activities that are in line with the country's comparative advantage. For this reason Russia's drift towards protectionism and unevenly applied policy measures should be reversed. The chapter argues that a key area of reform includes eliminating import subsidies and this encompasses reducing the role of Roscontract (the central procurement agency) in centralized imports. Likewise, in order to shift to an outward-oriented development strategy, various controls and taxes on exports should also be phased out. While there is still a role in transition for import tariffs on both protective and fiscal grounds, a more uniform and lower regime should be introduced. Another important element of reform is the elimination of dual trade regimes differentiating between third country and FSU partners. This latter issue is discussed in the following chapter.

Price and exchange rates

Macroeconomic dimensions

2.4 The unstable macroeconomic environment in Russia has caused sharp movements in nominal and real exchange rates. In particular, high inflation has caused a rapid nominal depreciation of the ruble (see table 2.1). The largest movements in the nominal rate occurred in the beginning of 1992 and were due to price liberalization. Tight monetary policy in the second quarter of 1992 strengthened the ruble, but the reversal of this policy resulted in a rapid weakening of the currency from mid-1992. The real value of the ruble also has fluctuated. In the first half of 1992, the real value of the ruble declined sharply, losing 71 percent of its purchasing power. There were less marked changes in the real exchange rate in the second half of 1992. Under some measures, the real rate has even strengthened in this period. Overall, between January 1991 and January 1993, the ruble lost nearly 60 percent of its purchasing power.

Table 2.1 Nominal and real exchange rates for Russia

	MICEX nominal rate	MICEX nominal rate index ^a	MICEX real rates ^a	
			retail price deflator	urban price deflator
1991:Q1	31	0.30	0.58	0.58
1991:Q2	37	0.36	0.42	0.42
1991:Q3	53	0.51	0.59	0.59
1991:Q4	105	1.00	1.00	1.00
1992:Q1	177	1.69	0.38	0.30
1992:Q2	134	1.28	0.19	0.15
1992:Q3	178	1.70	0.19	0.14
1992:Q4	397	3.79	0.25	0.13

a. Base is December 1990 = 1.0.

Source: World Bank estimates.

2.5 The real depreciation of the ruble is excessive in the sense that there is a large difference between implied Purchasing Power Parity (PPP) rates and MICEX exchange rates. As shown in table 2.2, the PPP rates (for the whole economy) suggest that the currency should be stronger than indicated by the current nominal rates. In part, this large wedge reflects macroeconomic instability in Russia and the continued underdevelopment of monetary and financial institutions. Due to uncertainty (both political and economic) and highly negative real interest rates in Russia, the asset demand for dollars is particularly strong. This implies that some of the real value of the ruble can be restored when there is a stable macroeconomic environment which allows positive real interest rates and stable investment

opportunities. Real appreciation of the ruble also would follow reforms in the trade regime. As discussed below, continued high taxation of exporters and tax incentives in favor of barter contribute to a scarcity of foreign exchange. This is reinforced by the continued subsidization of centralized imports, that creates artificially high demand for imported goods. Both these factors erode the value of the ruble.

Table 2.2 Nominal and purchasing power parity exchange rates
(rubles to the U.S. dollar)

	1991	1992
(a) World Bank PPP	4.54	64
(b) Nominal exchange rate	55	269
(c) Ratio (a) to (b)	12	4.2

a. Averages for the year.

Source: World Bank estimates.

2.6 There have been mixed developments in foreign exchange markets. Through the early part of 1992 the authorities implemented a number of positive initiatives, including unification of the exchange rate (July 1992) and provision of greater room for market forces. The reforms eliminated a detrimental export tax that the Central Bank of Russia (CBR) had been imposing on exporters by way of a multiple exchange rate. The multiple exchange rate regime had social costs well beyond the efficiency losses generally associated with taxation: it discouraged exports and earnings repatriation and it encouraged barter transactions. The reforms of the system in July 1992 eliminated the foreign exchange surrender tax and the multiplicity of exchange rates. Foreign exchange markets were permitted to function more freely, without imposing direct costs on producers and the broader social costs associated with barter trade. All of these measures strengthened the exchange rate.

2.7 Unfortunately, since mid-1992 some of the reforms were reversed by the actions of the monetary authorities. The backtracking on reforms took a number of forms. First, the CBR failed to compensate exporters in a timely manner for surrendered foreign exchange, thereby effectively imposing a 12 percent tax on those exporters using currency rather than barter-based settlements on trade. This measure encouraged barter transactions as a means of avoiding foreign exchange surrender taxes and restricted the availability of foreign exchange. Second, the authorities reinstated the earlier policy of subsidizing a range of centralized imports using nonuniform exchange coefficients. In effect this implied a return to the multiple exchange rate regime on the import side. All of these measures weakened and depreciated the ruble.

Unfinished price reforms

2.8 The impact of distorted prices is evident in PPP indices for traded goods and in their movement over time. The various PPP exchange rates on export and import goods in Russia at the beginning of 1993 are presented in table 2.3. These exchange rates measure domestic wholesale prices against world prices for the main products that enter export and import trade. They are a summary measure that capture the effects of various trade controls. For example, export quotas direct output of exportable goods to the domestic market and thereby drive down domestic wholesale prices. This result

is clearly evident from the table, where the export PPP is shown to be 171 rubles to the dollar, which is significantly lower than the benchmark interbank market exchange rate of 555 rubles to the dollar in January 1993.

Table 2.3 Implied purchasing power parity for exports and imports (January 1993).

<i>All exports</i>	171	<i>All imports</i>	376
Portland cement	40	Meat, chilled	265
Coal	288	Vegetable oils	186
Crude oil	168	Coffee	1,261
Oil products	212	Tea	722
Natural gas	51	Wheat	175
Nitrogenous fertilizer	217	Barley	178
Wood	163	Sugar	647
Wood products	46	Alcoholic spirits	296
Ferrous metals	112	Cigarettes	467
Copper	214	Medicaments	108
Nickel	284	Plastics and plastic products	279
Aluminum	305	Clothing	487
Lead	422	Footwear	427
Zinc	284	Steel	100
Light vehicles	812	Computers and televisions	554

Source: Institute of Market Forecasting at the Ministry of Foreign Economic Relations of Russia.

2.9 On the import side, subsidies to various products have the effect of reducing wholesale prices on domestic markets (offset to some extent by the tariffs and excise duties on imports). This is reflected in the implied PPP rate on imports of 376 rubles to the dollar. There are two important conclusions to be drawn from these estimates. First, that volume controls and taxes on exports are the key distortions in the trade regime and should receive the highest priority in reform. Second, the large variability in PPP estimates indicates the need for more uniformity in the trade regime (including fewer exemptions).

2.10 There has been a gradual but uneven move to a world market pricing structure in Russia. By the end of 1991 producer prices in industry were more than twice the level at the end of 1990. The largest increases occurred in light industry. In January 1992, price controls were officially lifted and industrial prices increased four fold. The largest increases were for chemicals (8.3 times), forestry and wood processing (8.7 times), and foodstuffs (8.3 times). Through the rest of 1992 there was a notable adjustment in energy prices, partly because they were initially the most distorted. Overall during 1992 inflation was about 3,275 percent. Adjustments for a sample of products were as follows: refined oil (143.5 times), crude oil (100 times), coal (61 times), gas (12 times), light industry (13 times), and machine building (27 times).

2.11 The marked fluctuations in prices makes it difficult to detect any clear tendencies in price adjustment. Disparities in rates of price adjustment are related to changes in the regulatory environment for different goods. Full deregulation of prices was not the general rule. For some goods prices were adjusted, but not totally freed. For other goods price regulation shifted from federal to local authorities. Due to these different approaches to price controls the existing relative price distortions were not eliminated and, in some cases, even worsened. The relative price distortions provide strong incentives both for nontariff (basically quantitative) export controls and for illegal activities in foreign trade such as smuggling and side payments. As a result the authorities are caught in a vicious circle—controls lead to a loss of tax revenue and to further tightening of licensing and extension of centralized exports in order to get resources to pay for strategic imports.

2.12 Some information on relative adjustments in prices for a group of traded goods over the period 1991 to early 1993 are provided in table 2.4. The data in this table compare the domestic price of the sample goods (converted into dollars at the market exchange rate) with the world price of similar goods. A movement towards 100 represents convergence towards the world price. The sample may be divided into four groups depending on their adjustment performance.¹

- **Group 1. Gradual Adjustment to World Prices.** This group includes those goods for which domestic prices are gradually adjusting to world prices, mainly energy products. Although energy products were subject to sharp price increases in 1992, in absolute terms their prices remain well below world prices. The relative prices for oil, gasoline, diesel fuel, and heavy diesel fuel were in the range of 27 to 40 percent of world prices in the beginning of 1993.
- **Group 2. Stable Relative Prices.** This group includes commodities whose relative prices remained more or less stable between 1991 and 1993 and includes mostly agricultural products. The prices of these goods were relatively close to world prices at the beginning of the period.
- **Group 3. Divergence from World Prices.** This group comprises products whose prices have clearly declined relative to world prices. Included in this group are forestry products, textile raw materials, and some nonferrous metals. Controls and restrictions on these products have further distorted their prices relative to those in world markets.
- **Group 4. Unclear Tendencies.** This group contains products whose prices do not exhibit any clear tendency relative to world market prices. Included in this group are metals (ferrous and some nonferrous) and coal. The prices of most of these goods increased in 1992, but then their relative prices dropped abruptly in 1993 to almost their level in 1991.

2.13 The products whose prices have deviated away from world prices include wood and ferrous metal products. Not surprisingly, these products are reported to be subject to large scale smuggling in order to avoid export controls. The huge disparity between domestic and world prices makes such illegal activities highly profitable. There is little justification for maintaining such disparities, and the phasing out of export quotas should start with such products.

Table 2.4 Price adjustment of major traded goods

<i>Group 1</i>	<i>1991</i>	<i>1992</i>	<i>1993</i>
Portland cement	6	14	21
Butter	69	63	85
Petroleum oils	13	25	27
Gasoline	9	28	40
Diesel fuel	9	25	35
Heavy diesel fuel	7	23	37
Natural gas (liquefied)	3	13	14
Fertilizers (nitrogenous)	5	39	37
<i>Group 2</i>			
Wheat	43	42	48
Flat-rolled products (stainless steel)	27	32	21
Maize (corn)	89	86	88
Safflower sunflower/cotton-seed oil	49	50	50
<i>Group 3</i>			
Wood (rough)	76	32	35
Wood (sawn/chipped)	17	15	8
Wool (raw)	71	65	60
Cotton (raw)	63	60	54
Copper and copper products	45	45	37
Zinc and zinc products	83	77	46
<i>Group 4</i>			
Coal	50	70	60
Bars and rods hot-rolled (stainless steel)	25	40	26
Nickel and nickel products	31	50	41
Lead and lead products	51	72	56

Source: Institute of Market Forecasting at the Ministry of Foreign Economic Relations of Russia.

2.14 Despite this mixed performance, price reform in Russia has progressed further than comparable reforms in other FSU countries as shown in table 2.5. This data represents average prices for important products in FSU trade during 1992. For the sample of goods, the FSU price was only 80 percent of the Russian domestic price for the same products. The FSU trade prices were particularly low for petroleum oil and wood products. The differential pace of price reforms have created difficulties in trade relations between Russia and FSU countries and this is discussed further in chapter 3.

Table 2.5 Export prices in Russia and FSU, 1992

<i>Commodity</i>	<i>Unit value (dollars per ton)</i>			<i>Price ratios</i>		
	<i>World price</i>	<i>FSU trade</i>	<i>Domestic</i>	<i>Percent</i>	<i>Percent</i>	<i>Percent</i>
	<i>(a)</i>	<i>(b)</i>	<i>(c)</i>	<i>(b/a)</i>	<i>(c/a)</i>	<i>(b/c)</i>
Portland cement	34	5	11	15	32	48
Coal	41	7	n.a.	17	n.a.	n.a.
Coke	62	34	n.a.	54	n.a.	n.a.
Petroleum oil	129	18	51	14	40	35
Natural gas	84	5	5	6	7	82
Ammonia	75	25	23	33	30	109
Methanol	79	36	49	45	61	74
Fertilizers (nitrogen)	70	43	35	62	50	124
Fertilizers (phosphate)	183	72	90	39	49	80
Fertilizers (potassic)	92	13	5	14	6	245
Wood (rough)	51	7	18	13	35	36
Wood (sawn/chipped)	124	12	36	10	29	35
Plywood	406	61	148	15	37	41
Wood pulp	388	164	204	42	53	80
Newsprint	337	67	130	20	39	52
Cotton fabrics	0.5	0.2	n.a.	45	n.a.	n.a.
Iron and steel	232	74	n.a.	32	n.a.	n.a.
Pig iron	129	43	n.a.	33	n.a.	n.a.
Aluminum	1101	428	n.a.	39	n.a.	n.a.
Average				29	36	80

n.a. Not available.

Source: Roskomstat.

Structural changes in foreign exchange markets

2.15 Foreign exchange market activity centers around the Moscow Interbank Currency Exchange (MICEX) and a network of bilateral foreign exchange transactions between commercial banks. The foreign exchange regime of Russia, broadly speaking, has been a controlled float. In general, forces of demand and supply in foreign exchange markets determine the trend movements in exchange rates (on MICEX). Average transaction volumes in the foreign exchange markets have been increasing steadily through 1992 and early 1993. Despite the continued nominal depreciation of the ruble, demand for foreign exchange remains high and foreign exchange continues to be sold on the market by exporters and by the CBR.

2.16 Despite this growing activity, a large share of recorded international transactions do not pass through official (interbank) foreign exchange markets. More than half are either barter trade or bilateral transactions arranged by commercial banks between their importing and exporting clients. There are many reasons for avoiding the official foreign exchange markets, including attempts to reduce delays in transactions and settlements, tax avoidance and circumventing barriers to small volumes of transactions passing through interbank markets. Some recent developments in the foreign exchange markets are discussed below.

CBR intervention

2.17 The CBR intervenes in the market to smooth sharp movements in exchange rates about some trend and, at times, to prop up the value of the currency². These efforts have failed largely because they have not been coupled with efforts to constrain the growth in the money supply and inflation. Moreover, frequent changes in policy have damaged the developing markets by causing intertemporal speculation in foreign exchange markets about the timing of policy changes, and the determination of the CBR in holding to certain benchmark rates. This creates instability in domestic markets, increases the attractiveness of holding foreign exchange, and further depreciates the ruble in the short term. Frequent policy changes undermine the credibility of policy makers.

Barriers to small traders

2.18 Changes in regulations have influenced the composition and volume of transactions in foreign exchange markets in Russia. First, the demand side of the MICEX³ markets is now much more concentrated (and perhaps less competitive) than it was during 1991 and early 1992. Reportedly, ten to fifteen banks account for 80 percent of the purchases of foreign exchange. In 1991, by contrast, there were many smaller companies that were buying foreign exchange for import or other activities. Now, however, there are more barriers to small traders accessing foreign exchange. Instead, small importers are discouraged from acting independently and are therefore encouraged to act as dealers or distributors of large company products. These impediments include:

- *Restrictions on Commercial Bank Access to MICEX.* To purchase foreign currency through the interbank market, an importer must transact through an authorized bank. In Russia a total of 230 banks have licenses to transact in foreign exchange, but only a fraction of these banks have the general license required for participation in MICEX. Only some 60 banks actively participate in MICEX. Given the limited number of banks with general licenses (and the minimum transaction size of \$100,000), these banks deal primarily with large clients. Small importers must first approach their own commercial bank to facilitate the transaction, and these commercial banks ultimately transact with a bank that holds a general license. Since transaction fees are incurred at each step, access to funds through the interbank market may be costly for the small importer. The alternative is to engage in bilateral foreign exchange transactions, in which commercial banks match the importer with exporters who own and are willing to sell foreign exchange.
- *Import Financing Requirements.* Small and medium-size importers must have available the rubles that are required for purchasing foreign exchange. With underdeveloped financial markets, these financing requirements and associated liquidity constraints may pose greater restrictions on the import activities of small and medium-size importers, as compared with large importers.

- ***Higher Import Taxation via Duties.*** High import taxes discourage demand for foreign exchange. Small importers may be more affected by these duties than large producers that have access to import subsidies and exemptions from import duties. As discussed below, import subsidies and exemptions from import duties primarily apply to food, medicine, and industrial inputs.

Development of foreign exchange markets

2.19 There have been mixed developments in foreign exchange markets in Russia. The markets themselves continue to be focussed on the main centers of Moscow and St. Petersburg. However, most exports are generated in the provinces and are underserved by foreign exchange trading. Exporters in these areas have to resort to the slow domestic payments mechanism and a series of commercial banks in order to transact in foreign exchange. The system implicitly taxes such transactions and provides an additional incentive for non-repatriation of export earnings.

2.20 Other developments have been more encouraging. First, MICEX managers are expanding their operations in international financial instruments, and are now trading in deutsche marks as well as dollars. Second, the MICEX and the CBR are exploring potential transactions with the Ukraine for ruble/karbovanets trade. The CBR and the Bank of Ukraine have reached an agreement providing for joint efforts to establish the margin for fluctuation of exchange quotes of the currencies.⁴ Commercial bank operations with Ukraine are also expanding. Third, the foreign exchange market is making some advances in improving the efficiency of settlement. More than twenty general license banks in Russia have joined electronic networks designed to reduce delays in transfer and settlement. A number of banks have also joined various international electronic clearing systems.⁵

Do exchange rates provide effective signals for resource reallocation?

2.21 Despite these developments in foreign exchange markets there are a number of reasons why price incentives (including exchange rates) may have a limited effect on production in the current economic environment. These reasons are both macro economic and structural and include the following:

- In periods of high inflation, long and uncertain delays in clearing can introduce larger variability in the real return to exports than changes in the nominal exchange rate. Consequently exporters attempt to circumvent the payments system, for example through barter transactions. This reduces the sensitivity of production decisions to fluctuations in the nominal exchange rate.
- Under continued soft budget constraints unprofitable enterprises may continue to produce even when faced with adverse terms of trade shocks. Enterprises can provide their trading partners with interenterprise credit, with the expectation that the government will bail out enterprises that are unable to collect debts in arrears. As a result enterprises are more likely to pass through exchange rate adjustments into price adjustments, as opposed to responding with output adjustments.
- Exchange rate "pass through" and low output response may also result from the concentrated industrial structure found in Russia. The more concentrated and monopolistic is production in an industry, the greater the likelihood that enterprises will respond to exchange rate changes by adjusting output prices so as to maintain market share.⁶

- The recent renewed emphasis on centralized trade, through Roskontract and foreign trade organizations is likely to reduce the direct transmission of world market prices and exchange rates to production choices.

2.22 One implication of these macroeconomic and structural rigidities is that higher taxation of goods may simply: translate into higher prices in domestic markets; be passed through into arrears; or lead to increased underreporting of transactions. The government may actually receive less revenue when tax rates are increased. Efforts to privatize and reduce industrial concentration are likely to increase the effectiveness of price incentives in resource allocation over the medium term. However, in the short term, weak linkages between price incentives and industrial activity continue to be aggravated by (increased) reliance on foreign trade organizations and centralized trading.

The third-country trade regime

Overview

2.23 As discussed earlier Russia embarked on reform in late 1991 within the framework of an isolated economy. Since then the country has gradually introduced the administrative framework typical of market economies. As shown in figure 2.1, most of the administrative changes have occurred in import regulations. Since mid-1992, Russia implemented a tariff schedule and imposed value-added taxes on imports. The various systems have required extensive institution building and will still take some time before they are operating smoothly. While progress has been uneven, the authorities have stressed that reform will continue and have indicated that Russia should ultimately join the GATT. The discussion below stresses action that could be taken to accelerate Russia's integration into the world economy.

2.24 Increased demands have also been made on trade administration by the collapse of the FSU. At first policy makers attempted to regulate trade with FSU partners by way of bilateral agreements and quantitative controls. Over time the focus has shifted towards encouraging enterprise-to-enterprise trade and implementing market-based systems. Success in these policies will mean that the current dual trade regime will gradually converge. The types of restrictions in trade with FSU and third countries is outlined in table 2.6. As shown in this table, the trade regimes have already converged to some degree. Nonetheless the existence of quotas and other distortions has resulted in considerable inefficiency.

2.25 Protection of manufacturing industry in Russia is a key issue. However, this protection is not achieved by the usual barriers on imports (partly because the exchange rate is overly devalued and this is protective). Rather industry is supported by cheap raw materials due to extensive export controls. At the same time, the authorities have subsidized consumers of imported goods (including industrial inputs). The amount of resources directly expended on centralized imports was estimated to be 15 to 17.5 percent of gross domestic product (GDP) in 1992. The subsidies have grown as the exchange rate has depreciated and have placed an enormous financial burden on those taxed in order to meet these foreign exchange budgetary demands. The attempt to finance such subsidies has led the authorities to centralize exports and grant tax exemptions to foreign trade organizations involved in hard currency generating

Figure 2.1 Schedule of foreign trade regulations 1992-93

												Export					
												Value added tax					
												Special export control					
												Strategic exports registration					
												Licensing					
												Quotation					
												Tariff					
												Import					
												Tariff					
												Licensing					
												Special import control					
												Value added tax					
												Excise tax					
												Safety requirement					
Jan.	Feb	Mar.	April	Máy	June	July	Aug	Sept.	Oct.	Nov.	Dec.	Jan.	Feb	Mar.	April	May	June
1992												1993					

Table 2.6 Russia's foreign trade regime in 1993

	<i>Non-FSU countries</i>		<i>FSU countries</i>	
	<i>Exports</i>	<i>Imports</i>	<i>Exports</i>	<i>Imports</i>
Tariff	Yes	Yes	Yes	Yes
Quota	Yes	No	Yes	No
Licensing	Yes	Yes	Yes	No
Strategic commodities regulation	Yes	No	Yes	No
Special export/import control	Yes	No	Yes	No
Value-added tax	No	Yes	No	No
Excise tax	No	Yes	No	No
Safety requirements	No	Yes	No	Yes

trade. In turn the regime of taxation has led to massive rent seeking behavior as other exporters sought to receive similar treatment. This has been an important source of variability in the trade tax system.

2.26 The poor implementation of trade taxes is evident in the government collection of export and import taxes in 1992 (see table 2.7). Instead of the 1.85 trillion rubles expected to be earned during this period, only 400 billion rubles were actually collected. This led to an overall collection rate of 22 percent on direct taxation of import and export taxes in 1992. The low collection rate is largely due to exemptions granted to centralized imports. For 1993, all deliveries of goods for state needs (approximately 40 percent of exports by volume) will be formally export-duty exempt. In addition, exporting regions withheld export taxes, partly because they needed revenues for local services.

Table 2.7 Exemptions from trade taxes and revenue leakages

	(1) <i>Potential collection</i> <i>(billion rubles)</i>	(2) <i>Actual collection</i> ^a <i>(billion rubles)</i>	<i>Ratio (2)/(1)</i> <i>collection rate</i> <i>(percent)</i>
Export duties ^b	1,400	360	26
Import duties ^c	450	40	9
Total	1,850	400	22

a. As reported by the Ministry of Finance.

b. Assumes export values of \$40 billion for 1992, and taxes applying to 70 percent of exports at an average tax rate of 25 percent. Also assumes an average exchange rate of 200 rubles to the dollar for calendar year 1992.

c. Assumes import values of \$37 billion for 1992, and taxes applying for half a year on 90 percent of imports at average tax rate of 15 percent. Also assumes an average exchange rate of 300 rubles to the dollar in second half of 1992.

Source: World Bank estimates.

Export restrictions

Quantitative restraints on exports

2.27 Exports from Russia are subject to a range of quantitative and licensing controls including quotas, licenses, export registration and special export controls (COCOM). The proportion of total exports subject to the various controls is outlined in table 2.8. Export quotas apply to most energy and other raw materials, with these categories accounting for about 70 percent of total exports. This proportion has stayed more or less constant through 1992. The purpose the quotas and licensing requirements is to maintain goods availability within domestic markets. By limiting the amount of domestic production available for export, goods outside of these quotas are constrained to sell in domestic markets. In turn this limits increases domestic prices of these goods. As a result the profitability of industries with export potential is constrained and industries that rely on artificially cheap inputs into production are supported.

2.28 The quotas are based on an assessment of material balances (the difference between projected domestic consumption and production) undertaken by the Ministry of Economy. In effect, the quotas perpetuate the previous centralized regime whereby exports are only undertaken if they are in surplus to domestic needs. However, in periods of price liberalization, export volumes have been

increased. The distribution of export quotas is mostly undertaken by the Ministry of Foreign Economic Relations. During 1992 export quotas were distributed to Roscontract (50 to 55 percent), enterprises (30 percent), regions (10 to 12 percent) and sold by auction (3 to 5 percent). Exports produced by joint ventures as well as commodities produced under subcontract agreements are not subject to quotas.

2.29 Roscontract, which evolved from the former marketing arm of the state planning system, is the main procurement agent for the government. The agency has close relations with state owned enterprises and its extensive regional distribution offices, warehouses and wholesale stores employ 500,000 workers. The agency's main function is to procure goods for state needs. In third country trade these needs encompass purchasing exportable goods in order to earn foreign exchange to finance centralized imports (including those subsidized) and to pay off external debt. In effect, Roscontract administers the mechanism of cross-subsidization between exports and imports. Roscontract receives a monopoly quota which it uses to buy exportable goods on the domestic market (at less than world prices). The "profit" it makes on this procurement is used to undertake centralized imports. Usually Roscontract sells to third countries through state-owned FTOs, which have more connections abroad. The government is increasing Roscontract's control over exports during 1993. These are expected to amount to some \$17 billion during the year (in world prices), while the cost of goods procured at domestic prices will be \$12 billion. The main export revenue sources for Roscontract will be oil and gas (representing about 40 percent of total exports from Russia).

2.30 The volumes of export quotas can only be deduced ex post from the official trade statistics (see table 1.1). Distribution of quotas is undertaken administratively, and although they are not published, it is understood that historical performance is one of the more important criteria. Given the enormous profits to be made, it is not surprising that quotas are subject to intense rent seeking efforts. The profits are most lucrative where the price differences are largest (and the quotas are most restrictive). Some quotas are assigned to exporting regions. These quotas place foreign exchange in the hands of the local authorities (and, in part, are assigned to these regions as a form of economic transfer intended to lessen demands for greater local or regional autonomy). A small portion of the global quota is sold on the commodity exchange. While this allows some flexibility for increasing the share of new entrants into exporting, the effect has been limited by the small volumes.

Table 2.8 Exports subject to control in 1992 ^a
(percent)

<i>Type of regulation</i>	<i>January-June</i>	<i>July-September</i>	<i>October-December</i>	<i>1992</i>
Export tax	71	81	77	75
Quota (subject to licensing)	72	67	68	70
Licensing of non-quoted exports	10	9	9	9
Total licensing	82	77	77	79
Strategic export registration	—	69	65	67
Special export control	1.3	1.2	1.5	1.3

a. Weighted by export values.

Source: World Bank estimates.

2.31 Russia has agreed to adhere to the rules specified by the COCOM restrictions. These types of products that are controlled for these purposes include: raw materials, equipment, technology and information that can be used for military purposes; dual purpose goods and technology; and biological weapons. Licenses are granted by the Ministry of Foreign Economic Relations after special approval by the Ministry of Economy.

2.32 The necessity of having some important categories of goods (mainly raw materials) exported only by registered exporters is a form of non-tariff restriction. About 200 foreign trading organizations and larger enterprises are entitled to export the listed goods. All other exporters of strategically important goods are required to work through the mediation of registered exporters. The asserted objectives of this practice are to organize control over the hard currency activities of exporters and revenue collection and to "protect" small exporters who are supposed not to know how to transact in international markets. The latter exporters are supposed to be responsible for the dumping of Russian raw materials on the world market. However, any dumping that has occurred is likely to have been motivated by the large difference between domestic and world prices for many of these products. The large profits to be made in exports has attracted many small exporters who can still earn healthy profits by selling at what appear to be relatively low prices in world terms.

2.33 There is no justification for using the registers to control the number of exporters once export quotas are lifted. Such an initiative will ensure that domestic prices will move towards world levels and there will be much less incentive to undertake illegal exports (whether at dumping prices or not). Export activity will tend to settle down as profit margins are reduced to normal levels. Continued control over the numbers of exporters will inhibit evolving market structures, and foster greater concentration of industry. The register of exporters only has a role in the short term to help ensure the collection of export taxes. But all interested parties should be registered as a formality. Once export taxes are lifted then the export register should also be scrapped.

Export taxation

Foreign exchange regime as export taxation

2.34 Both in 1992 and in 1993 the Central Bank of Russia (CBR) has been using the foreign exchange regime to implicitly tax exporters. The method of taxation has varied over time, but the result has been the same. One form of taxation was levied in the first half of 1992, when the CBR implemented multiple exchange rates and exporters received less than market exchange rates on the 50 percent of foreign exchange they were obliged to surrender. As shown in table 2.9, in the first half of 1992, this tax on exporters of raw material and energy was at a rate of approximately 30 percent of their export earnings.⁷ This form of taxation burdened exporters even beyond the other taxes to which they were subjected. The implied foreign exchange surrender tax in the first and second quarters of 1992 were 35 and 28 percent respectively for producers of raw materials, and 6 and 4 percent respectively for other categories of export goods, including production of machinery and equipment. Such taxes are particularly onerous as they encourage barter activity and avoidance of transactions that are settled in hard currency. By encouraging barter, this type of taxation also stunts the development of monetary institutions in Russia.

Table 2.9 Foreign exchange surrender (FXS) implied rates of taxation (percent)

	MICEX exchange rate (R/\$)	Exchange rate on 10% FXS (R/\$)	Exchange rate on 40% FXS (R/\$)	Implied FXS tax (percent)		Delayed compensation (months)	Average monthly inflation (wpi) (percent)	Implied FXS tax (percent)
				Raw materials	Machinery			
1/1992	204	90	55	35 ^a	6 ^b	unknown	382	unknown
3/92-6/92	138	90	55	28 ^a	4 ^b	unknown	26	unknown
7/92-12/92	289	n.a.	n.a.	n.a.	n.a.	2	20	9 ^c
1/93-4/93	650	n.a.	n.a.	n.a.	n.a.	2	30	12 ^c

n.a. Not applicable.

a. Raw materials producers subject to a 40 percent foreign exchange surrender requirement at the "commercial exchange rate" plus a 10 percent foreign exchange surrender requirement at the CBR market exchange rate.

b. Other exporters are subject to only the 10 percent foreign exchange surrender requirement.

c. The exporter must surrender 30 percent of foreign exchange earnings to the CBR. Assuming a delay of two months, the real value of this 30 percent is reduced in relation to the monthly rate of inflation.

2.35 In July 1992, the exchange rate was unified, eliminating the explicit export tax associated with multiple exchange rates. But exporters were still required to surrender 50 percent of their export earnings. They surrendered foreign exchange in two ways—30 percent to the CBR and 20 percent through the interbank currency market. The portion surrendered to the CBR was supposed to be at the market exchange rate. Exporters were free to keep the remaining foreign exchange either in dollar accounts in authorized commercial banks or exchange it for rubles on the interbank market. Thus exporters should have received rubles at the market exchange rate for the full portion surrendered.

2.36 In practice, the CBR delayed settlement on that portion of foreign exchange that it received from exporters. The exchange rate used for ruble compensation was the rate applicable at the date of surrender. However, delays in crediting the ruble compensation to the accounts of the exporters were on the order of two months or more. For example, assuming a monthly inflation rate of 30 percent and a two-month delay in settlement, this implies that the CBR imposed an implicit export tax of 12.25 percent of export earnings over and above the formal tax regime. In July 1993, the authorities effectively eliminated this form of taxation by allowing exporters the choice of surrendering foreign exchange to the commercial banking system only.

2.37 As compared with the previous regime, in the first half of 1993 the CBR implicitly taxed machinery, equipment, and nontraditional exporters at a higher rate (12.25 percent compared with 5 percent) and taxed raw materials exporters at a lower rate (12.25 percent compared with 30 percent). But, as is often the case when examining tax incidence in Russia, these taxes are not uniformly applied and must be examined in the context of the range of taxes (and exemptions) on exporters. Nonetheless, it can be concluded, that such taxes provide yet another motive for nonrepatriation of export earnings and another distortion in the trade regime. The experience with management of foreign exchange surrender requirements highlights some of the problems associated with the CBR's implementation of this system. For this reason, proposals for 100 percent foreign exchange surrender are likely to be counterproductive. Some of the problems associated with complete surrender are discussed in box 2.1.

Box 2.1 The case against full foreign exchange surrender

The imposition of full foreign exchange surrender is highly undesirable in the current inflationary environment. In general, such policies are implemented because a government wrongly expects that it can sustain an overvalued exchange rate for its currency. In this scenario, the exporter is compensated for foreign exchange surrender at an exchange rate that is more appreciated than the black market exchange rate. Repeated experience in Russia and worldwide demonstrates that such policies succeed only in driving economic activity underground. The tax base for the government is eroded. Exports are underinvoiced and imports are overinvoiced. The foreign exchange reserves of the government are depleted rapidly, leading to a balance of payments crisis. Such a crisis would be manifested in repeated speculative attacks and realignments of the exchange rate, or in strict current and capital account controls. Neither of these outcomes are consistent with the goal of foreign exchange regime stability, efficiency, or institution building. The goal of currency stability cannot be achieved by forcing full foreign exchange surrender. This goal requires macroeconomic stability and monetary policy measures that are consistent with exchange rate objectives.

2.38 The continued problems with barter and leakages of export earnings have been recognized by Russian officials. The extent of the problem is seen by comparing actual revenues from obligatory surrender of foreign exchange with potential revenues (without barter exemptions). In the first half of 1992, the CBR received about \$2.04 billion in surrendered foreign exchange on export receipts totalling \$17.6 billion. The CBR could have received more than twice this level of revenue if there had been full and effective enforcement (and barter exemptions were excluded).

Explicit export taxation

2.39 Prior to June 1992, minerals and raw materials were the main products subject to export taxes and they accounted for more than 80 percent of Russia's exports. Most taxable goods were subject to levies quoted in ECUs per ton. A smaller proportion were liable to taxes expressed in ad valorem terms. There were two categories of export taxation during this period, with the categories distinguished primarily in terms of the extent transactions were settled via cash payments or barter trade. The tax rate also differed by type of enterprise, with joint ventures receiving favored treatment. The basic tax rates applied to transactions by joint ventures and to exports for which there is cash settlement. A surcharge is applied on all barter trade and on some ruble and joint venture trade. The stated purpose of the surcharge is to penalize those exporters who avoided (implicit) foreign exchange surrender taxes. This penalty has grown progressively higher over time. If the basic tax rate is denoted by B , then the basic rate plus surcharge has evolved as follows:

January 1992 to July 1992	$B (1 + 0.15)$
July 1992 to December 1992	$B (1 + 0.30)$
January 1993 to present	$B (1 + 0.50)$

2.40 Using unit values, the implied average tax rates applied to exports since early 1992 are shown in table 2.10. Although the average rates have fluctuated since early 1992, they have declined

slightly to an average level of 12 percent for cash transactions and 19 percent on barter transactions. However, these averages mark considerable variation at the more disaggregated level. The highest rates applied to metals and mineral fuels (ranging from 0 to 50 percent). The rates on wood products are relatively low on average, despite domestic prices being significantly below world prices.

Table 2.10 Evolution of export taxes ^a
(percent)

	<i>Basic average tax</i>	<i>Basic average tax plus barter surcharge</i>	<i>Basic average tax plus implied foreign exchange tax ^b</i>
January to February 1992	20	23	55
March to June 1992	10	12	38
July to December 1992	16	21	25
January 1993 to mid 1993	12	19	24

a. All estimates are weighted by export value in 1992.

b. Surcharge applies to activities that are not subject to surrender requirement including barter, joint venture operations, and other non-cash transactions.

Source: World Bank estimates

2.41 Higher tax rates on barter have not deterred barter transactions. As discussed earlier, foreign exchange surrender taxes on raw materials and minerals were approximately 30 percent in the first half of 1992. When taxation of cash transactions is included, there remained a large tax advantage associated with barter throughout the first half of 1992.

2.42 The export tax regime was completely overhauled in mid-1992. First, rates of direct export taxation were significantly altered, with the scope of taxation expanding. For example, most foodstuffs, pharmaceuticals, and chemical products, were included and subject to high rates of export taxation (ranging from 20 to 40 percent of export value). Second, higher penalties applied to barter trade. The export tax rate surcharge was raised from 15 to 30 percent in an effort to deter barter. These changes were undertaken against the backdrop of unification of the exchange rate regime and the elimination of the foreign exchange surrender tax. The net result was a less differentiated regime with reduced incentives for barter trade. These were positive steps in the reform of the international trade regime.

2.43 Unfortunately, the second half of 1992 was marked by a retreat from these improvements, with reduced transparency and increased inefficiency and restrictiveness of the export regime. Export tax exemptions were widespread, as was tax evasion. Barter also declined, but only temporarily as the CBR used a different tool for taxing export transactions that were settled in foreign exchange. As discussed earlier, delays in settlement of surrendered foreign exchange led to an implicit tax of 12 percent on cash transactions. Combined with the explicit tax of some 16 percent, meant that exporters paid on

average about 28 percent as a total export tax. Despite the tax penalties imposed on barter-based transactions, barter remained a relatively advantageous choice for exporters.

2.44 The export tax schedule changed once again in January 1993, resulting in tax rates that differed sharply from those implied in previous periods. Average taxation rates on many products declined and exemptions were codified. Nonetheless, the tax regime was characterized by a high degree of differentiation both within and across product categories. The export taxes varied considerably, but on average are in the range of 25 to 30 percent of the world market price for those goods taxed.⁸

Import subsidies and import barriers

Import subsidies

2.45 Import subsidies are a carryover from the former price equalization mechanism that had been part of the system of socialist trade. Import subsidies were used in this system to isolate domestic users from differences between domestic and world prices. With the collapse of the central planning system and until mid-1992, the import subsidies were a component of a system of multiple exchange rates aimed at providing for basic import needs for final consumption (mostly food) and for ensuring that intermediate inputs for selected sectors and enterprises were provided at subsidized prices. In mid-July 1992, the transparency of the system was improved by the replacement of multiple exchange rates with a uniform rate (determined by the interbank auction) together with direct budgetary subsidies, by way of import coefficients. In effect, the subsidy coefficients maintained multiple exchange rates on the import side. More recently, the import subsidy system has been changed yet again and, in the process, taken a backward step. Through 1993 the Ministry of Finance has assumed responsibility for subsidizing food and medicine directly through the budget, while industrial inputs will be cross-subsidized through the operations of Roscontract (effectively taking these items off-budget). The latest changes will make the system less transparent and more difficult to assess since Roscontract's operations are not disclosed publicly.

2.46 The import subsidies are a major fiscal burden and are estimated to account for about 17.5 percent of GDP. The subsidies have spiralled upwards recently with the marked depreciation of the currency, which increased the gap between domestic prices and the world price of subsidized goods. The subsidies applied to imports valued at about \$18.6 billion in 1992 (see table 2.11). The subsidy coefficients varied from 61 percent on food products to 90 percent on food processing equipment. In other words, users were supposed to pay 10 percent of the market valuation of food processing equipment. In practice, the subsidies were higher, because users did not even pay the required amounts. Based on the official coefficients, it is estimated that some 55 percent of the trade subsidy was for industry, while 45 percent was for food products (and their inputs). Financing of import subsidies comes from taxation of exporters and by borrowing externally. About 70 percent of these subsidies were financed using loans provided by foreign governments and agencies. The government is forced to rely on foreign borrowing for centralized imports because only a small portion of export proceeds finds its way onto the interbank auction market, and enterprises have found means of circumventing the hard-currency surrender requirements.

2.47 Industrial enterprises argue that they need imported inputs for technological reasons. For example, they require spare parts for already purchased western machinery. They also claim that their underlying competitiveness does not allow them to pay for imports at the current high exchange rate. But the import subsidies are being appropriated by mostly inefficient enterprises in import-competing

sectors. This leaves fewer resources for export-oriented activities and impedes restructuring of the economy in general. Likewise, subsidies on food are justified on social grounds. However, there are more effective ways of targeting poorer members of society. Moreover, import subsidies often do not reach intended beneficiaries. In the case of consumer goods, leakages and diversions occur along the distribution chain. The misuse of industrial inputs and spare parts is less common than consumer goods, since many of the industrial inputs can be used only by a limited number of technologically compatible enterprises. However, even industrial inputs are sometimes resold to other enterprises or through commodity exchanges.

Table 2.11 Estimated distribution of import subsidies, 1992

<i>Product groups</i>	<i>Value of imports (1992, millions of dollars)</i>	<i>Subsidy rate ^a (percent)</i>	<i>Estimated share of total subsidies (percent)</i>
Food products	7,651	61	35
Raw materials for food products	1,673	73	9
Raw materials for industrial production	688	63	3
Iron and steel	573	76	3
Machinery and equipment, of which:	7,975	80	49
Food processing equipment	493	90	3

a. Average rate applied on imports within the product group.

Source: Institute of Market Forecasting at the Ministry of Foreign Economic Relations (estimates undertaken in mid-1992).

Import barriers

2.48 The structure of the import regime during 1992 is outlined in table 2.12. Imports of goods into Russia are relatively free of quotas and licensing. The main interventions are in the form of various taxes (customs duties, excise and VAT). During the early part of 1992, most imports were tax exempt, except for a minor surcharge (administrative fee of 0.15 percent). The basic duty structure was introduced in July 1992 with rates in the range 5 to 25 percent (increasing by degree of processing). The tariff schedule comprised four columns depending on the source: least developed countries (zero rate); developing countries (half the basic rate); MFN countries (basic rate); and non-MFN countries (twice the basic rate). The customs duties applied to about three-quarters of Russia's imports and were about 4 percent on average (import weighted).

Table 2.12 Imports subject to control in 1992 ^a
(percent)

Tariff	74.7
Licensing	2.9
Special import control	0.2
Value-added tax	67.3
Excise tax	4.2
Safety requirement	46.1

a. Weighted by import values.

2.49 The tariff schedule has been changed substantially three times since mid-1992 and this has led to confusion and uncertainty among importers. The net result of these changes has been a significant increase in the variability of duty rates as they now range from 0 to 100 percent (rates above 25 percent mostly apply to alcoholic beverages). The average import weighted duty rate increased to about 11 percent in late 1992, but subsequently declined to the current level of about 6 percent. Variability in the duty structure also is caused by the recent practice of granting exemptions to importers of centrally procured goods. This was done partly to cushion the effects of reducing direct import subsidies, but it also had the effect of lessening the transparency and uniformity of the import taxation regime. There is no justification to selectively favor certain importers and the exemptions should be abolished. The only exemptions that should be allowed are for imports used in export production.

2.50 As mentioned above, licensing plays a minor role in restricting imports and is used largely to protect public health (industrial waste and certain chemicals). Licenses are administered by the Ministries of Agriculture and the Environment and apply to only some three percent of imports. The customs authorities require quality certification for almost half of total imports (reputable foreign certificates are accepted). The procedures are not intended to delay imports in order to protect local industry.

Policy recommendations

2.51 Trade policy, and foreign exchange regime management play crucial roles in ensuring that producers confront the correct price structure when contemplating new investment. This applies to both existing public enterprises and the newly emerging private sector. In order to increase the efficiency of production, the prices of exports and imports should be gradually brought in line with world prices. The target should be to reach this objective by 1995. This will involve significant changes in the relative price structure, and in the process create both winners and losers. The authorities should refrain from cushioning enterprises from these changes, for example through credit subsidies. Subsidies and soft budget constraints are undesirable precisely because they reinforce price distortions and defer restructuring. But there is a role for carefully thought out and well targeted consumption subsidies to protect poorer and disadvantaged members of society.

2.52 Macroeconomic stabilization can reinforce and facilitate important improvements in Russia's trade policies. Stabilization and increased credibility of macro policy would lead to real appreciation of the ruble and thereby reduce the pressure for export taxes and import subsidies. At the same time, changes in trade policies need not await stabilization and related external financial support.

These policies tend to reduce supply of foreign exchange and increase its demand, thereby making the stabilization effort more difficult. Experience also suggests an environment of macro-economic stability, a competitive and reasonable stable real exchange rate and currency convertibility are an essential precondition to a strong trade performance in the longer term. Some improvements in the operation of foreign exchange markets would help in this regard. The elimination of policies that favor barter over monetary transactions are required. Barriers to smaller enterprises accessing the auction market could be eased, including restrictions on minimum transaction size. Likewise convertibility would be facilitated by extending the network of auction markets, particularly to export producing regions. This would reduce transaction costs and increase incentives for repatriation of export earnings.

2.53 Import subsidies represent a major distortion in the economy (amounting to some 17.5 percent of GDP) and it is time to drastically reduce their scope and find better ways of achieving some of their objectives. By distorting domestic demand in favor of imports, the subsidies have lessened incentives for domestic production (especially import substitution) and placed pressure on the balance of payments through weakening the ruble. Import subsidies could be removed by early 1994. The scope for reducing subsidies immediately is greatest in the case of imported inputs for industry. For such goods, the centralized import operations of Roscontract (the procurement agency for state needs) should be placed on a market basis and made more transparent. At the same time measures could be taken to more effectively target assistance to those in real need (poor and disadvantaged members of society). Even during the transition, subsidies only should apply to good that can be distributed under control. For most other products, leakages and diversions have meant that consumers have not benefitted.

2.54 Russia should move to a development strategy that promotes exports rather than restrain them. In this regard, quantitative restrictions and licensing requirements for exports should be removed with the exception of controls on military and internationally regulated products. This would be the single most important action to shift domestic prices towards the world relative price structure. The most effective way of phasing out export quotas would be to expand the volumes licensed over the course of the following eighteen months and in accordance with a specific schedule. The pace of change could be faster for non-energy goods. Nevertheless the objective should be to eliminate quotas for oil, gas, and a number of petroleum products by the end of 1994. Licensing of exporters of so called strategic goods should also be eliminated (by the end of 1993). This requirement would no longer be needed as traded goods prices approach world levels. However, licensing would remain for those goods stipulated by restrictive trade practices of other countries and for the existing products controlled for environmental and public health reasons.

2.55 In the same vein, various explicit and implicit taxes on exports should be lifted. First, explicit export taxes should be gradually phased out by early 1995. As in the case of export quotas, progress could be faster for non-energy products. Second, implicit taxes on exports should be eliminated immediately. The recent move by the CBR to allow exporters the choice of surrendering foreign exchange to commercial banks only is a step in the right direction. Given the current inflationary environment, exporters should continue to be allowed to retain half of other export earnings. Forcing full surrender will be counterproductive. Third, the level of centralized exports should be gradually reduced. This will be consistent with allowing a greater role in foreign trade for private firms operating on a commercial basis at normal market prices.

2.56 Experience has shown that protection aimed at easing the costs of adjustment could be provided through moderate tariffs that preferably do not vary significantly by sector, or at least have a narrow range, and could decline over time as the economy becomes more fully integrated in international

trade. Most developing countries which have made an effective transition from a heavily protected environment while sustaining a strong export performance have imposed tariffs in the 15 to 25 percent range. In Russia's case there is scope to introduce a more uniform and lower import tax regime. In this regard a lower tariff ceiling of 50 percent could be introduced. Importantly policymakers should resist changing the tariff structure as the currency strengthens with stabilization, ensuring that enterprises are exposed to world competition. Likewise, most exemptions to import duties should be abolished (particularly for centrally procured goods). For those imported goods subject to an excise tax, the general principle should be for the rates to be the same on imports as their domestically produced substitutes.

Notes

1. The methodology for the calculations was as follows. Domestic wholesale prices were used for end 1991, mid-1992, and the beginning of 1993. They were converted to U.S. dollars at the market exchange rates, which were 150 rubles/U.S. dollar, 161 rubles/U.S. dollar, and 560 rubles/U.S. dollar respectively. Domestic prices in dollar terms were compared with world prices. Given the violent fluctuations in the exchange rates, the results of the calculations are very sensitive to the periods chosen.
2. The interventionist strategies of the CBR were underscored by the announced (on February 25, 1993) that a fixed exchange rate system would be introduced, perhaps in the form of an adjustable peg regime. The CBR retracted this decision within days of the announcement.
3. Although the discussion focusses on the MICEX, the same forces operate in the St. Petersburg Currency Exchange.
4. *Commerzant*, 11 March 1993, p.11.
5. Note that these improvements in settlements are linked to MICEX transactions. However, as discussed below, there are still long delays in CBR settlements of ruble compensation to exporters for surrendered foreign exchange.
6. See R. Dornbusch, "Exchange Rates and Prices," *American Economic Review*, for the linkage between exchange rate pass-through and industrial structure. For an analysis of the Soviet case, see Goldberg and Karimov (1992), *Policy Initiatives, Internal Currency Markets and Production Choices in the former Soviet Union*, C. V. Starr Center working paper, New York University. 1987.
7. See L. Goldberg, *Foreign Exchange Markets in Russia: Understanding the Reforms*, Papers on Policy Assessment and Analysis, International Monetary Fund, 1993. These are conservative estimates. Exporters of raw materials and energy were subject to two sets of foreign exchange surrender requirements: 10 percent of their earnings were to be turned over to the CBR and 40 percent were turned over to the government. The taxation rate of 30 percent arose because of a large differential between the exchange rate in the interbank market and the exchange rate offered to these exporters on their surrendered foreign exchange. All other exporters were subject only to the 10 percent surrender requirement. For this latter group, this form of foreign exchange surrender effective taxation implied a tax rate of approximately 5 percent of export earnings.

8. The export tax obligation is converted into a ruble obligation using the exchange rate at the date of the calculation. Customs can offer exporters a payment delay on this duty. If the exporter delays payment by more than two months, a penalty is imposed by customs.

Chapter 3

Russia's trade with countries of the FSU

3.1 This chapter focuses on trade and payments arrangements between countries of the FSU during the transition period. The long-run first-best policies for trade with the countries of the FSU are relatively clear.¹ The overarching need is to move away from State controlled trade to a market oriented system that facilitates enterprise-to-enterprise trade. According to respondents in a World Bank survey, political interventions are one of the main barriers in the way of interstate industrial cooperation. To quote one company director "... the state mixes politics and economics and very often economic relations become the basis for political bargaining and an instrument of pressure. Once the politicians come to an agreement we can solve all the problems with our partners in the republics."

3.2 Efficient trade would be facilitated by the establishment of currencies that are convertible on current account. This applies equally to the other countries of the FSU that establish their own currencies as to Russia. It would also be desirable in the long run to develop a trade regime that is as free as possible from nontariff barriers on either exports or imports, and that would allow unregulated enterprise-to-enterprise trade. Tariffs that apply would be low and relatively uniform. More generally, in the long run it would be best to unify the trade regime; that is, there would be no difference in the treatment of countries that were part of the FSU and those that were not. The present situation, however, is quite far from the ideal long-run optimum. The questions addressed in this chapter therefore are second-best questions of how to improve the trading environment during the transition, while at the same time moving the policies in the direction of the long-run optimum.

3.3 The first section discusses recent problems in trade between FSU countries; the second section discusses the trade regime between these countries, with emphasis on the intercountry lists and their implications; and the third section examines the network of free-trade agreements. The fourth section discusses payments arrangements between FSU countries; an appendix to the chapter elaborates the issues of a clearing and payments union. Each section begins with a descriptive portion and concludes with policy suggestions. The chapter concludes with a brief overview of the long-run goal for the trade regime and a summary of the five principal policy suggestions of the chapter.

Recent problems in trade between FSU countries

3.4 During the era of the former Soviet Union (FSU), trade between the countries was part of the overall central planning mechanism. The pattern of trade that emerged was unusual by the standards of market economies in two notable respects: (a) trade was highly concentrated—often a good was produced by a single or very few producers for the entire FSU; and (b) trade within the FSU absorbed an unusually high proportion of total trade, even when compared with other regional trading blocs. In table 3.1 it is shown that Russia was the least dependent on trade with the other republics accounting for 61 percent of its total trade, compared with over 80 percent for the others in 1990.

Table 3.1 Total and intraregional foreign trade as a percentage of GNP: FSU, Eastern Europe, CMEA, and EC members

<i>Region</i>	<i>Foreign trade</i>		<i>Share of intraregional</i>
	<i>Total</i> ^a	<i>Intraregional</i> ^b	
<i>FSU (1990)</i>			
Russian federation	18.3	11.1	60.6
Ukraine	29.0	23.8	82.1
Belarus	47.3	41.0	86.8
Uzbekistan	28.5	25.5	89.4
Kazakhstan	23.5	20.8	88.7
Georgia	28.9	24.8	85.9
Azerbaijan	33.9	29.8	87.7
Lithuania	45.5	40.9	89.7
Moldova	33.0	28.9	87.7
Latvia	41.4	36.7	88.6
Kyrgyzstan	32.3	27.7	85.7
Tadjikistan	35.9	31.0	86.5
Armenia	28.4	25.6	90.1
Turkmenistan	35.6	33.0	92.5
Estonia	32.9	30.2	91.6
<i>Eastern Europe (CMEA) (1989)</i>			
Bulgaria	30.1	16.1	53.4
Czechoslovakia	23.0	10.9	47.2
Hungary	34.1	13.7	40.3
Poland	19.6	8.4	43.1
Romania	17.6	3.7	21.0
<i>EC (1990)</i>			
Belgium	74.2	44.5	60.0
Denmark	32.7	13.7	41.7
Germany	29.8	14.4	48.2
Greece	26.8	13.3	49.4
Spain	19.8	9.0	45.3
France	23.3	13.0	55.6
Ireland	59.9	38.9	64.9
Italy	20.4	9.7	47.5
the Netherlands	54.4	34.2	62.9
Portugal	42.1	24.6	58.4
United Kingdom	26.0	10.7	41.2

Sources: FSU: Goskomstat for trade data in foreign trade prices and unpublished World Bank estimates for GNP; Eastern Europe: UNECE (1990) for trade data and World Bank Atlas for GNP; Pisani-Ferry and Sapir for the EC. Data for 1990 are used for the FSU and for the EC; 1989 data for Eastern Europe.

a. Trade is measured by the average of exports and imports as a percentage of GNP.

b. Intraregional trade refers to trade within the FSU, the CMEA, or the EC respectively.

Table 3.2 Trade between the countries of the FSU, 1990-92
(millions of constant 1990 rubles)

Country	1990			1991			1992		
	Exports	Imports	Balance	Exports	Imports	Balance	Exports	Imports	Balance
Armenia	28	3,715	-287	2,315	2,456	-141	1,529	1,688	-159
Azerbaijan	6,105	4,247	1,858	4,439	2,778	1,661	2,838	1,890	949
Belarus	17,224	14,841	2,383	12,972	10,024	2,948	9,106	6,651	2,455
Estonia	2,900	3,158	-258	2,116	2,079	36	1,405	1,392	12
Georgia	5,724	4,949	775	3,939	3,209	730	2,295	2,161	134
Kazakhstan	8,443	14,314	-5,871	6,431	9,575	-3,144	4,181	6,403	-2,222
Kyrgyzstan	2,446	3,179	-733	1,698	2,098	-400	1,106	1,417	-311
Latvia	5,028	4,711	317	3,724	3,215	509	2,480	2,157	323
Lithuania	5,349	6,022	-673	3,904	4,164	-260	2,666	2,800	-135
Moldova	5,853	4,992	861	4,003	3,350	653	2,307	2,255	51
Russia	74,710	67,284	7,426	51,379	48,344	3,035	33,585	32,147	1,438
Tajikistan	2,377	3,359	-982	1,607	2,186	-579	1,025	1,513	-488
Turkmenistan	2,469	2,923	-454	1,819	1,850	-31	1,251	1,225	26
Ukraine	38,319	38,989	-670	28,776	26,343	2,433	19,102	17,335	1,767
Uzbekistan	8,169	11,864	-3,695	5,735	7,655	-1,920	3,831	5,156	-1,325
Total *	188,544	188,547	-3	134,855	129,325	5,530	88,706	86,191	2,515

Sources: CIS Goskomstat; Russian Goskomstat; World Bank and IMF staff estimates.

3.5 Both extrarepublic and interrepublic trade declined by slightly over 50 percent between 1990 and 1992 (see Table 2 for developments in trade between the countries of FSU).² The decline in extrarepublic trade occurred mostly in 1991, since following the collapse of the Council for Mutual Economic Assistance (CMEA) trade with the CMEA partners declined precipitously. The decline in interrepublic trade occurred mostly in 1992, after the breakup of the FSU.

3.1 Total and intraregional foreign trade as a percentage of GNP: FSU, Eastern Europe, CMEA, and

3.6 The high dependence on trade between countries of the FSU would be expected to diminish over time. The problem is that, given the concentrated nature of production and market linkages, the sharp decline in trade between FSU countries that occurred in 1992 exacerbated the output decline in the independent countries.

Payments problems

3.7 At the root of the trade collapse of 1992 between FSU countries were the problems with the monetary and payments system. During the first half of 1992, Russia alone could print rubles, but the central banks of all the countries in the ruble zone could expand the money supply by creating credit in rubles. In the absence of monetary coordination, this quickly gave rise to a "free-rider" problem, because monetary restraint by some central banks could be exploited by others that were able to expand their money supply independently. Not only did this situation contribute to inflation, but it also impeded efforts to stabilize the ruble and posed difficulties for trade and payments. It did so by creating a disparity in incentives to export between enterprises and the economy as a whole: assuming enterprises felt they had as much chance of getting paid (in rubles) when exporting to another country as when selling in the domestic market—not always a valid assumption—they would be indifferent between the two markets. For the country as a whole, however, it would be less advantageous to exchange goods for rubles since the central bank could create all the noncash rubles it wanted.

3.8 As 1992 unfolded, Russia, notwithstanding its own considerable monetary expansion, accumulated a significant trade surplus with other countries. This reflected, in part, traditional structural relationships and also the relatively larger upward adjustment in the price of oil, Russia's main export. To stem the outflow of goods and to control the provision of credit to other countries, Russia established a network of correspondent accounts for the central banks of the countries, which monitored all bilateral transactions, and after July 1992 credit limits were imposed on these accounts. When a country exceeded its limit, the Russian central bank would refuse to clear payments orders (such as checks) of enterprises in the debtor country, meaning that Russian exporters would not be paid for the goods they shipped to that country (this is discussed below).

3.9 Exacerbating matters was the dramatic decline in the efficiency of the banking system used by the FSU countries following the dissolution of the Gosbank, once the central bank for all the countries.³ Exporters and importers found that it took two to three months to clear payments orders—a risky business in an environment of high inflation.

Trade regime

3.10 Perhaps the most significant trade barrier—both for interstate and convertible currency area trade—was the widespread use of export licenses and quotas. The motivation for these controls derives from two main considerations.

- Given a lack of monetary coordination within the ruble zone, each country had a strong incentive to import goods and pay for them in rubles, which their central banks could create independently. One way countries could guard against this was to impose quantitative limits on exports.
- Given that the extent of price liberalization varied greatly from country-to-country, there were significant price differences in a number of products. Moreover, many prices, notably for energy, were still well below the world level. Without export restraints, such products would be exported to world markets or to other countries that have higher prices.

3.11 On the import side, formal restraints were quite low as licensing had largely been removed and tariffs were either low or not applied. Competition from abroad was nonetheless weak in most sectors because the implicit protection against hard currency imports was very high. The basic reason is that those who must pay market rates for foreign exchange use a substantially undervalued ruble. There are extensive foreign exchange subsidies which, however, are available only on nonimport competing products.

3.12 Given prevailing market rates of the ruble to the U.S. dollar in most countries in 1992, workers have been earning only about \$10 to \$20 a month, demonstrating the very high value of convertible currency and the high cost of imports at market exchange rates. The undervaluation of the ruble is caused by a number of factors, most notably policies that (a) discourage the repatriation of foreign exchange, such as real interest rates which have remained negative, frequently by 50 percent a month or more; and (b) policies which discourage exports for convertible currency. The latter include licenses and taxes on exports, along with requirements to surrender foreign exchange earnings at rates much lower than those prevailing in the free market.

State trading through bilateral arrangements

3.13 In an effort to deal with trade problems between the countries of the FSU, countries resorted to many of the features that characterized trade under central planning. By March 1992 an extensive network of bilateral trade agreements had been signed that divided trade into "obligatory" and "indicative" trade. Trade not under the agreements was to be enterprise-to-enterprise based.

3.14 In the first category, trade was conducted on the basis of a large intergovernmental barter of 100 to 150 of the most important products traded between the FSU countries—such as energy products and raw materials—much as had occurred under the former CMEA. Commitments obligate the country to fulfill the contract, and maximum allowable prices are specified for many products. Although an effort was made to roughly balance this portion of the trade by assigning prices and adjusting volume, Russia accumulated large interstate trade surpluses as prices were realigned.

3.15 The second category differed from the first in that although both countries agreed to automatically provide export licenses for all enterprise-to-enterprise negotiated contracts up to the quota amounts specified in the protocols, no trade could take place unless the enterprises agreed on the terms of the sales, including price and credit conditions. Depending on the specific country, there were 1,000 to 1,500 products on the indicative lists, including a wide range of machinery and agricultural and consumer products. This type of trade closely resembles what took place in Eastern Europe in 1991, except that hard currency settlement is not required in the FSU.

3.16 All remaining products were to be freely traded at the enterprise-to-enterprise level. Moreover, products could be traded in multiple ways; in particular, oil was traded in all three categories. However, the majority of trade in value terms was in the first two categories.

3.17 But these bilateral agreements fell far short of alleviating the myriad of trade and payment problems. It was unclear how frequently and exactly how trade imbalances between the countries should be settled—convertible currency, rubles, and additional goods shipments have been proposed as means of payment, with payment periods ranging from one month or shorter, to a year. There are also significant problems with fulfilling obligatory trade agreements, largely as a result of the continuation of price controls, which reduce the incentive to export. At the same time, the system of state orders had either broken down or become less effective. As a result, enterprises that either did not find it profitable or that lacked the necessary inputs, often did not supply the agreed-upon quantities. More fundamentally, as long as trade was conducted on the basis of bilateral pacts, it was governments rather than markets that determined the allocation of resources.⁴

Trade and payments data for countries of the FSU

3.18 Table 3.3 presents data on Russian exports and imports through the intergovernmental agreements (row 1), total exports and imports of Russia (row 2), and (in row 3) the aggregate value of the total financial flows between Russia and the other countries of the FSU as recorded in the central bank correspondent account information of the central bank of Russia. From rows 1 and 2, it can be seen that over 70 percent of total trade was trade negotiated under the intergovernmental agreements. Comparing rows 2 and 3, it can be seen that the trade balance in favor of Russia (298 billion rubles) is substantially less than the net financial obligations of the other countries as recorded in the correspondent accounts of the central bank of Russia (1,505 billion rubles from row 3). One important reason that payments due to Russia (2,874 billion rubles) exceed the total value of recorded exports is capital flight from the currencies of the other countries (especially Ukrainian karbovenets) into Russian rubles.⁵ On the other hand, that Russian payments to other countries of the FSU (1,369 billion rubles from row 3) are less than the value of imports can be explained by the interenterprise arrear problem. Officials of the central bank of Russia have stated that Russian enterprises owe substantially more to enterprises in the Ukraine than conversely.⁶

Table 3.3 Russia: trade with FSU countries in 1992
(billions of rubles, current domestic prices)

<i>Item</i>	<i>Exports</i>	<i>Imports</i>	<i>Balance</i>
Trade under intergovernment agreements	1,507	1,475	32
Total trade with FSU countries	2,147	1,849	298
Correspondent accounts settlements	2,874 ^a	1,369 ^b	1,505

a. Payments to Russia.

b. Payments from Russia.

3.19 Table 3.4 presents the central bank of Russia correspondent account information decomposed by country. It includes data showing the amount of currency printed by Russia and supplied to the other countries, and the quantity of technical credit officially provided by the central bank of Russia to the other central banks. As discussed above, payments include payments for goods and services, but also include capital movements. What is ignored in the correspondent account data is interenterprise arrears. A nonofficial errors and omissions column has been added to reconcile the differences in the raw data of the central bank of Russia. This data shows that Russia ran a payments surplus with nearly all countries (the exception being Lithuania); the largest imbalances were with Kazakhstan and the Ukraine (accounting for almost half the surplus).

Table 3.4 Russia: Correspondent accounts settlements with FSU countries in 1992
(billions of rubles)

Country	Balance (first half) (1)	Payments to Russia (2)	Monetary emission (3)	Payments from Russia (4)	Repaid	Errors and omissions (6)	Balance (7)	Total balance (8)
					technical credit (5)			
Ukraine	-159.3	486.2	n.a.	157.8	15.0	29.9 ^b	-283.5	-452.8
Belarus	-22.0	210.3	n.a.	127.0	40.0	-32.0 ^b	-75.3	-97.3
Kazakhstan	-46.7	580.7	142.7	259.3	160.0	-40.1	-344.2	-390.9
Uzbekistan	-13.9	317.9	168.8	103.0	50.0	118.9	-214.8	-228.8
Tajikistan	-3.7	46.4	9.8	14.2	6.0	5.5	-30.5	-34.2
Turkmenistan	-18.1	200.9	55.0	86.7	61.5	-4.5	-112.2	-130.3
Kyrgyzstan	-4.5	47.7	11.2	20.8	9.5	1.8	-26.8	-31.4
Moldova	-4.6	2.4	2.4	21.1	7.5	-40.9	17.1	-21.5
Armenia	-2.3	38.5	5.9	18.1	12.0	-13.0	-27.3	-29.6
Azerbaijan	-15.9	51.1	18.0	20.6	5.0	-32.3	-32.3	-48.7
Georgia	-11.3	77.9	26.8	29.5	22.0	-1.8	-55.0	-66.3
Latvia	-1.4	12.5	n.a.	17.2	0.5	-5.3 ^b	-0.1	n.a.
Lithuania	-9.0	14.5	n.a.	23.3	0.0	0.3 ^b	9.1	n.a.
Estonia	-3.7	n.a.	n.a.	n.a.	0.0	—	n.a.	n.a.
Total	-316.5	2,087.0	440.6	898.6	389.0	-13.5	-1,210.0	-1,531.8

— Not applicable.

n.a. Not available.

a. Errors and omissions are World Bank staff calculations defined as columns 7 - [4 + 5 - 2 - 3].

b. Errors and omissions include zero valuation for monetary emission for these countries.

Source: Central Bank of Russia.

Trade regulatory environment between FSU countries

3.20 Russian trade with the FSU is currently subject to both nontariff and tariff barriers. The regulatory environment is discussed below and the discussion is summarized in table 3.5.

Table 3.5 Russian regulatory regime between countries of the FSU

	Free trade agreements				MFN agreements		
	Export licensing and quotas	State obligations	Trade taxes		Export licensing and quotas	State obligations	Trade taxes exports & imports
			Exports	Imports			
Obligatory list goods	Yes	Yes	No	No	Yes	Yes	No
Indicative list goods	Yes	No	Yes	No	Yes	No	Yes
All other goods	No ^a	No	Yes	No	No	No	Yes

a. An exception is that goods not on the indicative lists, but which are subject to licensing to third countries, are also subject to licensing in interstate trade.

Nontariff barriers

3.21 There are quantitative restraints imposed on trade between the FSU countries according to lists of products. Trade is divided into three categories under the intergovernmental trade agreements: (a) indicative lists; (b) obligatory lists; and (c) unlicensed commodities. The tariff and tax regime in trade between FSU countries is summarized in the following section.

Indicative lists

3.22 Supplements 1 and 2 to the agreements, which we refer to as the indicative lists, specify the most important products in trade between Russia and the other countries of the FSU that are subject to export licenses. In the case of Russia, the set of products that are subject to licensing under these lists are intermediate products including energy, timber, nonferrous metal, fish, chemical fertilizer, and rare metal products. This list of products will vary by FSU country and is separate from the somewhat broader list of products that is subject to export licensing without an indicated country of destination.

3.23 The list of products subject to export licensing is much broader than the list of products that are subject to price controls domestically.⁷ Export controls, however, are employed by the

authorities for the purpose of increasing supply to the domestic market and suppressing the domestic price.⁸

3.24 The indicative lists also specify the maximum quantity or quota that will be licensed for export to each country. There is no state obligation to supply the amounts specified in the indicative lists,⁹ but each government agrees to provide export licenses up to the amount specified provided that agreement is reached at the enterprise-to-enterprise level. That is, individual enterprises are responsible for the terms of the sale including the price and financing arrangements.

3.25 For a product subject to export licensing, the amount of the aggregate quota (to all destinations) is specified by the Ministry of Economy after consultation with the relevant ministries. The aggregate quota is allocated as follows: (a) part of the quota is allocated to the Ministry of Foreign Economic Relations (for its subsequent allocation to foreign trade organizations and enterprises) to meet long-term government commitments with third countries (for example, oil for Cuban sugar); (b) part of the quota is allocated to domestic foreign trade organizations (usually Roskontrakt) to meet state obligations under the trade agreements between the FSU countries (to satisfy the obligatory lists as described below); (c) part of the quota is allocated directly to enterprises, without an obligation to export to any country in particular; and (d) regional governmental bodies receive some of the quota, which they typically allocate to enterprises in their jurisdiction in return for importing goods of interest (typically food products) into the region.

3.26 Although it is unlikely to be implemented, the Price Commission has proposed to regulate prices in trade between FSU countries, where indicative list trade would be conducted at a discount relative to world prices. The use of price controls in these agreements during 1992 was an important reason for the unwillingness of enterprises to conclude contracts on an interstate basis, and it would be problematical to determine a regulatory mechanism that would induce enterprises to export to the FSU at a price less than could be received on their third-country trade.

Obligatory lists

3.27 The obligatory lists form a subset of the products on the indicative lists.¹⁰ The obligatory lists obligate both participating governments to supply the specified quantities. In 1993 obligatory list trade is said to be considerably reduced relative to the amount of trade that was ostensibly conducted under state orders in 1992. Russian trade officials estimate that only about 5 to 10 percent of total trade between FSU countries will be conducted under the obligatory lists; on the other hand, about 30 percent of the allocation of all quotas are for the obligatory list trade. Although the products do vary across countries, in 1993 the obligatory lists comprise only five to fifteen of the most important products in the bilateral trade with each country (usually energy, raw materials, and foodstuffs). An important feature of the trade under the obligatory lists is that it is supposed to balance. That is, it is conducted under a "mini-clearing" system where the prices and quantities of the commodities are negotiated in advance such that trade under the obligatory lists exactly balances if both countries meet their obligations.

3.28 Prices under the obligatory lists are denominated in U.S. dollars. In principle, prices are supposed to approximate world market prices. In practice, the price determination process involves a negotiation which may, according to some Russian trade officials, result in a continuation of the Russian terms-of-trade subsidy to other countries, albeit at a reduced rate relative to previous years.

3.29 Although there is a state obligation to supply the product under the obligatory lists, in Russia the system of state orders has been completely abolished. Instead, the government of Russia appoints an agent to fulfill the contract. The agent is almost always Roskontrakt, which has evolved from the former Ministry of Trade and Material Resources, which in turn evolved from Gosnab of the FSU. Regarding foreign trade, Roskontrakt specializes in state-negotiated agreements in which goods exchange for goods.¹¹ Roskontrakt must be able to offer terms sufficiently attractive to the producing enterprise that it is induced to sell. Inasmuch as Roskontrakt exports products under the intergovernmental agreements that are subject to export quotas (typically energy products) which depress the domestic price (sales to Roskontrakt to meet the state obligations do not count against the export quota of the enterprise), Roskontrakt can purchase the products for export at prices well below world market levels. Then it is not difficult typically for Roskontrakt to avoid losses on transactions under the intergovernmental agreements, even as it sells the imports at prices below world market levels.¹²

3.30 The state obligatory trade, however, increases the number of products that trade at less than world market prices in Russia. That is, Roskontrakt typically sells the imported products (for example, cotton from Uzbekistan) at prices within Russia that are below world market levels. Thus, the distortion of state obligatory trade has two components—the interstate subsidy of selling Russian oil at less than world market prices and the sale of imported products in Russia at less than world market prices.

3.31 It is well known that in recent years (such as the final years of the CMEA) state obligations have not been met under intergovernmental clearing agreements. It is possible, however, that there will now be greater success in inducing fulfillment of deliveries. This is because in some cases the number of products under the obligatory agreements is much smaller than in previous agreements, and because deliveries will be monitored on a monthly or at least a quarterly basis. Underfulfillment of the contract by one party will entitle the other party to immediately suspend deliveries. Since so few products are involved on both sides, the threat of suspension of deliveries is more credible.¹³ Moreover, on the Russian side, both the importing and exporting of the contract will be executed by a single company (Roskontrakt) that will not be subsidized (other than through trade finance on favorable terms). Underfulfillment may induce losses by Roskontrakt and a reduction in its commissions.

Unlicensed commodities

3.32 Products that are not on the indicative lists typically trade without export licenses with the following exception: all products that are subject to licenses to third countries are also subject to licenses in trade between FSU countries. The list of products on the indicative lists varies by FSU country and is not as broad as the list of products that are subject to export licensing to third countries.¹⁴ Since the indicative lists include a large share of the products that are licensed to third countries, however, if a product is not on the indicative list it is typically permitted to trade without a license. These products, however, are subject to trade taxes as specified below.

Policy conclusions

3.33 Trade negotiated between governments of the FSU countries creates a number of problems that indicate that this should be discontinued by 1994 to the fullest extent possible.¹⁵ Trade should be enterprise-to-enterprise based, and indicative lists rather than obligatory lists should be used when the government wishes merely to assure an export license. Problems with state trading include the following.

- It is difficult in an intergovernmental negotiation to obtain the world market price of hard goods such as oil. Governments selling goods such as various machinery products will claim their goods are of high quality but only by the negotiation of independent agents in the market can the market price be determined. Thus, state trading is likely to continue the interstate terms-of-trade subsidy. To the extent that Russia wishes to extend subsidies between the FSU countries after January 1994 (a date that represents more than two years of transition), it should avoid doing so through the price system and should provide these subsidies explicitly.
- Obligatory trade between the countries of the FSU expands the set of products that are sold at less than world market prices in Russia. Thus, state trading adds to the domestic price distortions in Russia, as the imported goods acquired by Roskontrakt under obligatory agreements are often sold in Russia at less than world prices.
- Possibly most important, state trading is a remnant of the planning system, in which governments rather than markets determine what is traded. State trading impedes adjustment toward a market-oriented determination of the trade pattern, but experience has shown that state trading has not been successful at maintaining trade.

3.34 In order to encourage competition in the procurement and delivery of bulk commodities, contracts under state trading arrangements should be diversified. Since a market-based trading system will require intermediaries (trading companies) in bulk commodities, diversification of state trading contract awards will facilitate the development of, and competition among, these intermediaries. Some of the state trading arrangements (either the arrangements with smaller countries or part of the arrangements with larger countries) could be administered by foreign trade organizations (FTOs), both public and private, other than Roskontrakt. This would allow other FTOs to acquire experience in handling bulk commodities in trade between FSU countries. Moreover, private companies should be given equal access to these contracts (including equal access to the financing provided by the Ministry of Finance to facilitate the state trade), and the state FTOs should be encouraged to privatize. The latter is proposed in the government's Manufactured Export Strategy Paper—see chapter 4 for details.

Free trade agreements and customs unions

Trade taxes on trade between FSU countries

3.35 The export and import tax regime that applies in trade between the countries of the FSU depends on the type of trade agreement negotiated between Russia and the other independent country, as well as on whether the good is on the indicative, obligatory, or unlicensed list. In particular, the trade agreements between Russia and the other independent countries are referred to as either Most Favored Nation (MFN) or Free Trade Agreements (FTA). Under an FTA, no import taxes are imposed, but export taxes *are* imposed except on products exported under the obligatory lists.¹⁶ Under an MFN agreement, trade taxes are imposed on all imports (the average import tariff equals about 18 percent) and exports except for obligatory list trade. As of late April 1993, Russia has negotiated FTAs with all FSU countries except for the Baltics, Georgia, and Ukraine. With Ukraine an MFN agreement has been arranged, but a staged process leading to an FTA by July 1, 1993 is anticipated. An MFN agreement with Latvia is in place and it is hoped that MFN agreements will be concluded with Estonia, Lithuania,

and Georgia. Until agreements with Estonia, Latvia, and Georgia are signed, import duties against these countries will be assessed at twice the MFN rate (see table 3.5).

VAT and excise taxes

3.36 Russia employs a value added tax (VAT) of 20 percent on the destination principle; that is, VAT is imposed on domestic production and imports, but not on exports. In addition, there is an excise tax imposed on imports of between 10 to 150 percent depending on the commodity.¹⁷ According to a regulation issued on January 30, 1993 by the Customs Service and the Federal Tax Service, no VAT or excise taxes will be applied on imports of goods from within the FSU countries that have negotiated FTAs in 1993.¹⁸ The lack of VAT or excise taxes on imports from FTA countries implies discrimination against domestic production in trade with FTA countries.¹⁹

3.37 However, the application of these taxes along with double MFN import tariffs on a number of the countries of the FSU implies a gross disparity in trade preferences offered to the various countries of the FSU. With such significant disparities in the taxes that apply on imports among the FSU countries, trans-shipment (especially by exporters from the Baltics through Belarus into Russia) might be expected. To counteract trans-shipment for the purpose of tariff and tax avoidance, Russia has indicated that it intends to implement a certificate of origin system. The system will be implemented through the relevant industry group of the Chambers of Commerce in those countries with which it has negotiated an FTA. For example, meat products entering Russia through Belarus will have to be accompanied by a certificate of origin provided by the meat industry association of Belarus. Although the Russian Department of Customs assesses that the system will not be costly to implement, there is reason to believe that if the tariff differences across countries are large, the costs of enforcing such a system will become excessive.

3.38 A variety of problems may develop as a result of a certificate of origin system, that are best seen through the use of an example. Consider the case of meat exports from Belarus to Russia. The meat industry association within the Chamber of Commerce of Belarus will be asked to allocate certificates of origin to its members, for the purpose of export to Russia. One problem is that the system can result in the enforcement of monopoly prices for meat products. Suppose that the Belarus meat association is attempting to fix cartel prices for its meat products, either within Belarus or for export. Individual producers will always have an incentive to cheat on the cartel and to charge a lower price. The certificate of origin system, however, will provide the meat industry association with a vehicle to discipline or punish those producers who are inclined to price competitively, thereby allowing it to force them to raise their prices.

3.39 A second problem is that a certificate of origin system may lead to rent-seeking and rent-dissipation activities. Byelorussian meat producers, who are members in good standing of the meat association of Belarus and who desire to re-export Baltic meat products, may request certificates of origin for capacities in excess of their ability or may desire to export their own products to Russia. The meat association may attempt to control these re-exports, but the association would be subject to "lobbying" from its members, which would waste resources.

3.40 However, the meat association may only loosely monitor the issuance of certificates of origin. In that case individual Byelorussian meat producers may be able to obtain certificates of origin

in sufficient quantity that they will be able to re-export Baltic meat exports to Russia without wasteful rent-seeking activities.

3.41 In either event (rent-seeking activity in Belarus or not) Russia will not be able to rely solely on the Chambers of Commerce of the other countries to control re-exports, and Russian customs will have to be involved. An extensive verification system enforced by Russian customs (where goods are checked against certificates of origin, certificates of origin are checked for their authenticity, and an effort is made to determine the true origin of the goods when the papers are in order) is likely to add significant delays to border processing, and may also contribute to corruption at the borders (already reported as a problem). Estimates from the "Costs of Non-Europe" project have shown that customs delays and procedures have added between 1 and 2 percent to the costs of imported goods within the European Community.²⁰ Given the longer delays that are reported, the costs are likely to be higher in the case of Russia. Thus, even if a common external tariff is not mutually agreed through a common tariff commission, it is advisable to avoid large differences in import taxation of countries external to the FTA so as to minimize the incentive for tariff arbitrage.

3.42 Moreover, the wide disparity in import taxes will serve to redirect trade, in particular for the Baltics. The redirection of trade for the Baltics will occur over time in any event, but the Baltics will be compelled to redirect exports toward Western and Northern Europe faster than they otherwise would.²¹ This will increase the transition costs for Russia, as well as for the Baltics.

Policy conclusions

A temporary preferential trade area, based on moderate tariffs, may prove useful ²²

3.43 Russia and the other countries of the FSU are inordinately dependent on each other for trade and need to reorient trade so that they are integrated into the world trading system. For that reason a permanent preferential trade area among the countries of the FSU may not be advisable since it may impede the long-run reorientation of Russia and the other economies of the region into the world trading system.

3.44 Russia and a number of the countries of the FSU have established (what is inappropriately referred to as) a free trade area. If this free trade area is based on moderate tariff preferences, it may provide some benefits during the transition.²³ In the short term, the undervaluation of the Russian ruble, and of most of the other currencies of the region, in relation to purchasing power parity estimates imply that there remains a strong incentive to import from within the FSU. As currencies stabilize and strengthen, as is happening in Latvia and Estonia, imports from these countries will have to compete with third-country imports. Without a preferential trade area, if all countries try to buy their goods from the least-cost (possibly third-country) supplier, they will then collectively suffer a decline in export demand for their uncompetitive industries possibly before they can adjust and reorient output. In the longer term, and after a suitable transition period, the preferential trade area could be terminated—through a combination of lowering tariffs to the third countries and raising them to members of the preferential area. Moreover, participation in a preferential trade area need not overlap with an effectively functioning ruble zone that might be established in the future.

3.45 It should be emphasized that agreements which impose export taxes as well as export licenses on intraregional trade on a wide variety of products cannot truly be considered Free Trade Agreements. Trade remains highly regulated by taxes and licenses (albeit on exports) between those

states participating in the network of "Free Trade Agreements" which is contrary to the idea of what is meant by a Free Trade Agreement.

Preferential tariffs should be moderate

3.46 High tariff rates should be avoided—even temporarily—because they may result in the continuing operation of negative value added industries, raising rather than reducing the adjustment costs to the economy. Moreover, as discussed above, high tariffs in the emerging free trade area will encourage tariff arbitrage, with resulting loss of tariff revenue, costs of enforcement, and loss of efficiency in shipping. If protection is only moderate, a temporary preferential trade area appears to accommodate the long-run reorientation and at the same time eases the transition.

Payments arrangements

The payments mechanism in 1992

3.47 In early 1992, when all countries of the FSU were part of the ruble zone, the central bank of Russia initiated the system of correspondent accounts among the central banks of the FSU, initially simply to monitor the emission of credit provided by the other countries. Russia required that all financial transactions between Russia and the other countries of the FSU pass through the central bank correspondent accounts. Since the central banks of all the independent countries could create noncash rubles, they could finance their bilateral trade deficits by money creation. The situation arose where exporting within the FSU was viewed as valueless by the governments of the FSU because all they received in return for their exports were ruble credits in their banking system, something their own central banks could easily create.

3.48 As a result of a decline in the efficiency of the payments mechanism, as well as other factors such as price controls in trade agreements between the FSU countries and interenterprise arrears, other forms of payment in trade between these countries developed. Barter of various types became quite important, and other forms of payment were used such as direct cash payment and bilateral or multilateral clearing among enterprises.²⁴

3.49 By June 1992 the central bank of Russia observed through the central bank correspondent accounts that, due primarily to a trade surplus with the other countries (from an improved terms of trade),²⁵ it was providing mounting credits to the other countries of the FSU. The central bank of Russia thus changed the use of the central bank correspondent accounts as of July 1, 1992. After this date, the central bank correspondent accounts were used to control the credit (called "technical credits") provided to these countries by the central bank of Russia. If the correspondent account of a central bank (say, in Ukraine) exceeded its credit limit, payments orders of individual Ukrainian enterprises for the purchase of Russian goods would not be honored. That is, even if a Ukrainian enterprise had adequate rubles in its account in a Ukrainian commercial bank to pay for the Russian imports and had authorized payment, if the central bank of Ukraine had exceeded its credit limit in its correspondent account at the central bank of Russia, the Russian enterprise would not receive payment. This had certain offsetting effects for trade between Russia and the other countries. First and foremost, it changed the incentives of the non-Russian governments: exporting for Russian rubles became something that was necessary in order to import from Russia (unless the deficit with Russia could be financed either from other sources or by negotiated credit with Russia).²⁶ Thus, non-Russian enterprises were given greater latitude by

their governments to export to Russia.²⁷ On the other hand, there was an added risk for Russian enterprises in their exporting to the FSU, which tended to reduce Russian exports.

The payments mechanism in 1993

3.50 By early 1993 (starting with Estonia in June 1992), a number of countries in the FSU had introduced their own currencies. The introduction of new currencies considerably changed the incentive structure that led to credit limits being imposed through the central bank correspondent accounts. In particular, central banks with independent currencies cannot create noncash rubles and enterprises that wish to import from Russia must first acquire Russian rubles. For these countries, Russian rubles must be obtained through exporting to Russia or by obtaining credit from Russia (or the country can use assets acquired through trade or credit with other countries or donors to purchase Russian rubles). Thus, there is no need to force all trade transactions through the correspondent accounts of the central bank of Russia.

3.51 In fact, a relatively liberal set of restrictions on Russian central banks applies for transactions with FSU countries that have left the ruble zone. In the case of Ukraine, for example, Ukrainian commercial banks may maintain correspondent accounts in Russian commercial banks in rubles (and as of February 1993, Ukrainian commercial banks may maintain Ukrainian karbovenet accounts in Russian commercial banks), and Russian commercial banks may maintain correspondent accounts denominated in Ukrainian karbovenets in Ukrainian commercial banks.²⁸ If a Ukrainian enterprise wishes to buy Russian goods (for an amount of, say, 1 million Russian rubles) it is possible to avoid transactions that go through the central bank correspondent accounts. The enterprise can approach a Ukrainian bank and ask what price in karbovenets it must pay for the rubles. The Ukrainian bank will negotiate with Russian banks the price of 1 million rubles in terms of karbovenets and inform its customer of the price. Or the Ukrainian bank will attempt to obtain the rubles in the interbank market in Ukraine. There are indications, however, that the market for obtaining rubles in Ukraine is rather imperfect—because of convertibility problems there are delays in obtaining rubles in Ukraine for the import of Russian goods. If the price is acceptable to the Ukrainian importer, he or she will initiate a payments order that will allow the Russian exporter to be paid in Russian rubles through a commercial bank correspondent account of the Ukrainian bank with the Russian bank.²⁹

3.52 Some of the larger banks in Russia and the Ukraine maintain multiple correspondent accounts for the purpose of negotiating and facilitating transactions of this type. These banks claim that they can process transactions through their correspondent accounts in three days, compared with two to three months on transactions conducted through the central bank clearing mechanism. They indicate that for the reason of speed in clearing transactions demanded by their customers, almost all their transactions with Ukraine are handled through their commercial bank correspondent accounts.

Policy conclusions

A multilateral clearing bank may be useful

3.53 One problem with relying totally on correspondent accounts among commercial banks is that some of these new currencies may be inconvertible for a time (even against the ruble, for example, there is some evidence of partial inconvertibility of the karbovenet for the ruble in Ukraine). That is, Russian rubles may be rationed in some of the countries that introduce their own currencies. Then enterprises in other countries would not be able to contract directly with Russian enterprises through the

use of the banking system (since a currency rationing process is involved), and there is a danger that barter will continue to dominate. Thus, a system of multilateral clearing with short settlement periods (a clearing union) should be introduced in parallel to the developing network of commercial bank correspondent accounts. Such a system would allow enterprises in different independent countries to make contracts with each other without the involvement of the country and to utilize the banking system for payment. It would also economize on the use of hard currency reserves by permitting transactions at the enterprise level to be conducted in national currencies. Only the multilateral balance within the union would be settled among participating central banks. In the long run, it is desirable to have all payments between FSU countries processed through the network of commercial bank correspondent accounts in the manner employed by countries with hard currencies. Provided a clearing union does not impede the development of the commercial bank correspondent accounts, it will do no harm, and may serve a useful purpose.

3.54 The recent agreement among the heads of countries of ten countries (excluding the Baltics, Azerbaijan, and Georgia) to establish an Interstate Bank offers a promising approach to the regional clearing and payments problems. This bank, which is not intended to play a monetary role, will have as its main objective the establishment of an institutional mechanism for multilateral clearing and settlement of payments between FSU countries in Russian rubles (or hard currency), based on a short settlement period and strict credit limits. Since different exchange rates are emerging for different "national" rubles, and countries like Ukraine are planning to participate, the Interstate Bank may emerge essentially as a multilateral clearing house for countries with different currencies, rather than a ruble zone institution. Although it may fall short of including all new independent countries, and many of its features are clearly transitional, the Interstate Bank can serve a useful role in addressing the need for establishing a regional multilateral clearing mechanism.

A payments union may be counterproductive

3.55 It is explained in some detail in the appendix to this chapter why more elaborate payments arrangements that involve long settlement periods and the provision of substantial external credit (patterned after the postwar European Payments Union) are not recommended. Briefly, such arrangements may tend to discourage the development of commercial bank correspondent accounts and the movement toward convertibility.³⁰ They also raise questions as to whether the credits provided finance a structural deficit or the outcome of ineffective overall macroeconomic policies. In short, additional automatic external financing and credit through a payments arrangement is not the preferred vehicle for providing balance of payments support or for stimulating trade among these countries.

Conclusions

3.56 In the long run, trade between Russia and the other countries of the FSU would be facilitated by the establishment of currencies that are convertible on current account. This applies equally to the other countries of the FSU that establish their own currencies and to Russia.³¹ As has been explained, the lack of convertibility of national currencies against the Russian ruble contributes to the problems of the trade regime.

3.57 It would also be desirable to unify the trade regime in the long run with low and relatively uniform tariffs. That is, there would be no difference in the treatment of countries that were part of the FSU and those that were not. Moreover, the trade regime would be as free as possible from nontariff barriers on either exports or imports, and would allow unregulated enterprise-to-enterprise trade.

3.56 This chapter has emphasized the transition steps that could be taken in moving toward this long-run goal. The five most important policy recommendations that can be taken in the near term are as follows.

- Obligatory trade negotiated between governments of FSU countries creates a number of problems which indicate that it should be discontinued by 1994 to the fullest extent possible. Trade should be enterprise-to-enterprise based, and indicative lists rather than obligatory lists should be used when the government wishes to assure an export license.
- In order to encourage competition and the development of market institutions in the procurement and delivery of bulk commodities, contracts under country trading arrangements should be diversified and private trading firms should be provided equal access to the contracts.
- A temporary, preferential trade area that includes as many of the newly independent countries of the FSU as possible, may prove useful. It is crucial that any tariff preferences provided be *moderate* so as to avoid costly tariff arbitrage and the variety of costs associated with a certificate of origin system, and to avoid protecting negative value added industries.
- A multilateral "clearing bank" or "clearing union," such as the proposed Interstate Bank, *operating in parallel to commercial bank correspondent accounts*, may prove useful in facilitating direct enterprise-to-enterprise trade. It is explained in the appendix to this chapter that a clearing bank has nothing to do with the "clearing arrangements" that characterize large barter arrangements between FSU countries.
- More elaborate payments arrangements that provide for the provision of substantial credit (a "payments union") are not recommended.

Notes

1. For an elaboration of the long-run options see W. Max Corden, 1992, "Trade Policy and Exchange Rate Issues in the Former Soviet Union" Policy Research Working Paper 915, Trade Policy Division, Policy Research Department, The World Bank, Washington.
2. Updated data for interrepublic trade in 1992 are available, but have not been placed on a comparable basis with the earlier interrepublic data.
3. The Gosbank guarantee for interstate transactions was removed and payment orders had to be cleared through the newly emerged fifteen central banks, clogging the system.
4. Barter. Another way of coping with the confused trade and payments situation was by resorting to barter, although the price liberalizations that began in early 1992 significantly reduced the pressure for barter within each country. But preliminary estimates indicate that barter in trade between the countries was high for a number of reasons. First and foremost, because of provisions in the intergovernmental protocols, price controls were much more prevalent in interstate than in domestic trade. Second, there were higher risks and costs associated with using the banking system. Third, arrears between enterprises was a large problem in most countries, and the risk of nonpayment was even greater on interstate sales.
5. For example, as Ukraine introduced its new currency, rather than turning over Russian rubles for karbovenets, Ukrainian enterprises could send a payments order to a Russian exporter in advance of the receipt of goods. This would represent a financial transaction recorded in the correspondent accounts of the central bank of Russia, but since no goods crossed the border it would not be recorded as a Russian export. In principle, barter trade is supposed to be recorded by Goskomstat, and is therefore part of the data in row 2 of table 3.4. This is because trade data are recorded as a result of reports of exports and imports by enterprises to regional statistical agencies which in turn report to Goskomstat. Enterprises, in principle, are to report all trade data.
6. This is explained by the fact that monetary expansion in the Ukraine has been greater than in Russia, despite a significant monetary expansion in Russia. If a Russian enterprise imports goods from Ukraine, it reports the value of the import to the statistical agency even if it has not made payment; that is, the financial component is part of the interenterprise arrear problem. In such cases, the value of the import would appear as part of the trade between the countries, but there would be no financial flow recorded.
7. Strictly controlled prices are natural gas, electricity for home use, some medicines, and some food products (mainly for children). There are also a number of products on which the profit margin is regulated. These include oil products, electric power, precious metals, most transportation services, and some services such as communications. Price Commission officials claim that since investments may be included in the cost base for the purpose of calculating a profit margin, firms in the oil industry have not found the profit constraint a binding restraint on pricing. Moreover, the profit margin constraint does not apply to foreign trade either to the FSU or to third countries. In addition, regional and local authorities have the authority to regulate city transportation fees and the prices of important staples such as bread, milk, and certain children's food products.

8. If the supply elasticity of the industry to the average (or composite) price of output is large (as would be expected from a constant returns to scale industry in the long run), then the export controls will actually decrease the supply to the domestic market and increase the domestic price of the product. This suggests that even the narrow objective of increasing supply to the domestic market will not be achieved if export controls are retained beyond the short term.
9. In the case of the Baltics, there is no maximum amount of exports from the Baltics to Russia in the indicative lists, and there are no obligatory lists.
10. For Ukraine, however, there are products on the obligative list that are not on the indicative list. The obligatory lists typically are supplements 3 and 4 to the protocols, but in the case of Uzbekistan involves additional supplements.
11. Roskontrakt purchases goods on the domestic market for export in return for quantities of imported goods specified under the intergovernmental agreement. The imported goods are also sold on the domestic market; thus, from the perspective of Roskontrakt, these contracts only involve Russian rubles.
12. Other than the credit it receives, Roskontrakt is expected to carry out its importing and exporting operations without assistance from the Ministry of Finance.
13. For example, suppose that Uzbekistan fails to deliver cotton to Russia on schedule. Since the only product Uzbekistan is supposed to deliver to Russia on an obligatory basis is cotton, there are no other industries receiving goods from Uzbekistan that will lobby the Russian government to continue oil deliveries to Uzbekistan.
14. Thus, for example there are products that require export licenses when exported from Russia to Armenia or Tadjikistan, but where these products are not on the indicative lists between Russia and these countries.
15. As discussed above, there are some products which remain under domestic price controls, such as natural gas. Without a state agreement regarding these products, it may be difficult to arrange interstate trade. The set of products subject to domestic price controls should be minimized for reasons of efficient domestic resource allocation as well as international efficiency. The set of products under explicit price controls, however, is relatively small compared to the set that is under export licenses and which, as a result of the export licenses, sells in Russia for lower prices than on the world market. For those products that are under export licenses, but not price controls, there is no need to involve state obligation in trade. Enterprises in other states are free to compete in the market with enterprises from third countries for the exports of Russian enterprises.
16. VAT, which is imposed on imports, is not considered a tax that discriminates against imports since it is imposed on a destination principle; that is, Russian exports are exempted and imports pay the VAT.
17. For example, fur, leather goods, and automobiles are assessed an excise tax of about 25 percent, and the rate on wine is 30 percent. Domestic excise tax rates, however, do not correspond precisely to excise taxes on imports, so any higher rates on imports discriminate against imports (and indirectly on exports).

18. As of late February 1993, the Customs Service interpreted this to mean that no VAT or excise taxes will be applied within the FSU except for the Baltics, Georgia, Moldova, and Tajikistan.
19. Since Russia applies VAT on a destination basis, it should not be concerned if one of its FTA partner countries applies VAT on an origin basis; that is, if the partner country applies VAT on exports but not on imports. Imports and domestic production will be treated neutrally from all countries if it applies VAT on all imports and waives VAT on exports.
20. See Michael Emerson and others, 1988, *The Economics of 1992: The E.C. Commission's Assessment of the Economic Effects of Completing the Internal Market*. Oxford: Oxford University Press.
21. Evidently for Estonia, Finland had already replaced Russia as its principal trading partner as of early 1993.
22. This argument is developed in further detail in Constantine Michalopoulos and David Tarr, 1992, *Trade and Payments Arrangements for States of the Former USSR*. World Bank Studies of Economies in Transformation 2, Washington D.C.
23. Given the likely unemployment, due to other causes, as the nontariff barriers to imports are removed (and barring production subsidies) moderate transitional tariff protection would be warranted for positive value added industries. The reasons are that the opportunity costs of primary factors are very low and many industries would be expected to contract significantly under open world competition. The only way that transitional tariff protection could protect the former domestic market of the FSU is through a temporary preferential trade area. If preferences are based on tariffs, interstate trade would initially not be subject to external tariffs.
24. This refers to various schemes that were developed to avoid the banking system. For example, partnerships or joint ventures between Russian and Ukrainian firms arose in which when a Ukrainian enterprise sold goods in Russia, the Russian partner would collect the money in rubles and buy goods on the Russian market to send to the Ukrainian partner. The Ukrainian firm would play the same role for the Russian firm in Ukraine.
25. See David Tarr, forthcoming, "The Terms-of-Trade Effects on Countries of the Former Soviet Union of Moving to World Prices." *Journal of Comparative Economics*.
26. In practice the technical credits were periodically negotiated on a bilateral basis with the central bank of Russia.
27. The individual enterprises always had the incentive to export to Russia, since prior to July 1, 1992, they were indifferent to ruble balances obtained on exports to Russia or to ruble balances obtained from domestic sales.
28. The main restriction on these accounts is that they be used for the purchase of goods and services, rather than for financial transactions.
29. The Ukrainian bank has its correspondent account in Russia credited with 1 million rubles and it credits the correspondent account of the Russian commercial bank with the karbovenet equivalent of 1 million rubles (or debits its karbovenet account in the Russian commercial bank). The Ukrainian bank

processes a payments order for its client of 1 million rubles in return for debiting the account of its client by the karbovenet equivalent of the 1 million rubles plus its commission. When the payments order clears, the Ukrainian bank is left with an unchanged ruble position, and has changed the karbovenet deposit of its client for, except for commission, an exactly offsetting karbovenet deposit of the Russian commercial bank. The Russian bank gains a deposit of karbovenets equal to the equivalent of 1 million rubles at the Ukrainian commercial bank, but has increased the deposit of its client by 1 million rubles. Thus, since the transaction was an export from Russia, there is an increase in the holding of karbovenets.

30. If a country receives credit through participation in the multilateral payments union, the central bank will have an incentive to channel its payments for imports through the payments union, and to avoid payments through commercial bank correspondent accounts (where it can receive no credit). Thus, a payments union may discourage the important development of the network of commercial bank correspondent accounts.

31. This would apply to the ruble zone, rather than to Russia alone, if there is a ruble zone larger than Russia.

Appendix

Clearing and payments union issues

What is a clearing union?

A3.1 A clearing union allows transactions to be denominated in a common unit of account (say for convenience in U.S. dollars), allows private agents to pay for imports and to receive payment for exports in their national currencies, and settles in convertible currency the multilateral balance among the participating countries in full after fairly short settlement periods.¹ A payments union differs from a clearing union by allowing for substantial credit in the settlement of the multilateral balance. When countries have different currencies that are inconvertible, direct trade among individual agents without government foreign exchange rationing will be severely hampered unless institutions are developed to facilitate direct trade. In these circumstances, clearing or payments unions are sometimes recommended. A clearing union is recognized as being inferior to convertibility, and it is hoped that clearing arrangements will not retard progress toward convertibility.

A3.2 Clearing and payments unions have no function and are not employed between countries that have convertible currencies. They are also not employed *within* a country or within a common currency area that has an inconvertible currency, because direct trade among individual agents is possible in all of these cases through the use of domestic currency.

A3.3 This fundamental observation on the function of clearing and payments unions leads to an important conclusion. During the first six months of 1992, the FSU was a common currency area. (The correspondent account limits imposed by the central bank of Russia after July 1992 distinguished the different national rubles.) Although the decline of trade among the countries of the FSU was related to payments questions, they were not the type of payments question that could be resolved by clearing or payments unions. Payments problems among the countries of the FSU must be addressed by the creation of a monetary framework that provides an incentive to export. This will require, among other things, the adoption of independent national currencies or, for those few countries that may choose to remain in the ruble zone, monetary coordination and solution of the free-rider problem.

Advantages of a clearing union

A3.4 In addition to facilitating direct trade between individual agents, a clearing union will economize on the use of hard currency reserves, since only the multilateral balance need be cleared in hard currency, while individual transactions will be conducted in national currencies. Moreover, since it is only the multilateral balance that is relevant to settlement, a clearing union removes any incentive to bilaterally discriminate among trading partners within the clearing union.² As some countries in the FSU have introduced new currencies and others are expected to do so in the near future, and given that some of these currencies are not convertible, it would appear that a clearing union would be desirable for the FSU.

Disadvantages of a payments union

A3.5 A payments union acts like a clearing union except that it adds substantial amounts of credit to a clearing union. The multilateral balance need only be paid in part. Once a country exhausts its credit limit it must pay its balance in full at each payment period. A payments union is sometimes recommended because it is hoped that it would somehow accomplish one or more of the following three objectives: (a) provide an incentive to intraregional trade; (b) provide balance of payments support; or (c) establish a payments facility among countries that may for a time have inconvertible currencies.

A3.6 It is suggested below that in general there are superior instruments available to meet each of these objectives. In particular, the first objective is best met by a preferential trade area, the second by bilateral balance of payments support, and the third by a clearing union. Moreover, a payments union creates certain problems.

Balance of payments support

A3.7 First consider the question of who will provide the credit to start a payments union. It appears that the countries of the region, including Russia, are unwilling to provide the substantial credit needed to start the payments union. The question then is whether donor nations or multilateral institutions should provide the credit in this manner as opposed to bilateral aid. A principal problem with multilateral institutions providing credit through a payments union is that credit is provided on the basis of the deficit within the payments union; that is, a payments union will provide balance of payments support for debtor nations within the payments union. (This is objective (b) above.) But since the rules of payments unions allow access to credit on the basis of predetermined credit limits, conditionality for this balance of payments support is difficult to implement. Countries that are pursuing the worst macroeconomic policies may run the larger deficits in the union and draw most heavily on the credit. Then balance of payments support would be allocated in inverse proportion to the countries whose adjustment programs are most worthy of support.³ Moreover, the participating nations of a payments union may have a greater need for balance of payments support to finance imports from outside the payments union, but credit provided to a payments union is restricted to balance of payments support within the region. Thus, balance of payments support appears to most efficiently be provided through bilateral loans.

Incentive to regional trade

A3.8 Regarding objective (a), it is sometimes argued that a payments union will encourage intraregional trade. But it is only through preferential trade arrangements that intraregional trade can be encouraged. A payments union provides an incentive to the country to trade on an intraregional basis. But how will the incentives to the country be transmitted to the individual agents who make the decisions to import? The country will have to offer incentives through the trade regime (such as higher tariffs or nontariff barriers against third countries) in order to internalize the softness of the payments into the decisionmaking process of individual agents. For some countries imposing tariffs on third countries may represent a step backward in their trade regime. The level of tariff preference for intraregional trade is best considered through the negotiation of a preferential trade area, in which the costs of trade diversion

and benefits of trade creation are directly considered. It is argued above that a temporary preferential trade area with moderate and declining tariff preferences will likely provide some net benefits in terms of the reduction of unemployment costs during the transition, but that preferences should vanish after a transition period. But any regional preferences provided through a preferential trade area are transparent, unlike regional preferences that proponents of a payments union hope will arise.

Facilitating payments among agents in countries with inconvertible currencies

A3.9 Finally, regarding objective (c), it has been argued that a clearing union can directly address the problem of facilitating transactions among individual agents in countries that have inconvertible currencies. A payments union will also accomplish that objective, but the provision of credit which is not necessary to accomplish this objective creates problems. In addition to the lack of conditionality in the balance of payments support, the softness of payments within a payments union may prolong inappropriate macroeconomic policies in the countries receiving the credit; in particular, it may prolong the period during which the country operates without a convertible currency. Such arrangements may tend to discourage the development of commercial bank correspondent accounts and the movement toward convertibility upon which the future integration into the world economy depends.⁴ Moreover, without preferential tariffs, deficit countries within the payments union may quickly exhaust their credit, after which the payments union will offer little help with any of the three objectives above.

Conclusion

A3.10 In accordance with well-established principles of economic theory, one should always use the instrument that most directly attacks the problem at issue.⁵ A payments union does not directly attack any of the three objectives mentioned above. On the other hand, a preferential trading area, bilateral balance of payments support, and a clearing union are the instruments that attack the problems directly, and all of these instruments may be usefully employed.

Notes

1. For an explanation of the mechanics of transactions within a clearing union, see Constantine Michalopoulos and David Tarr, 1992, *Trade and Payments Arrangements for States of the Former USSR*. World Bank Studies of Economies in Transformation 2, Washington, D.C.
2. If a network of debit-credit positions among the countries exists, without a clearing union there is an incentive to bilaterally discriminate. The home country will favor importing from countries that owe the home country money and will disfavor importing from countries to whom it is in debt.
3. Although not supported by external aid, this was the case in the payments union of the Central American Common Market, when Nicaragua obtained most of the credit after 1979 and the payments union collapsed as a result. The payments union of the Central American Common Market ceased to operate even as a clearing union after it collapsed.
4. If a country receives credit through participation in the multilateral payments union, the central bank will have an incentive to channel its payments for imports through the payments union, and to avoid payments through commercial bank correspondent accounts (where it can receive no credit). Thus, a payments union may discourage the important development of the network of commercial bank correspondent accounts.
5. This has been developed by a number of authors, most notably by J. Bhagwati, Harry Johnson, V. Ramaswami, and T. N. Srinivasan. See, for example, J. Bhagwati, "The Generalized Theory of Distortions and Welfare," in J. Bhagwati, R. Jones, R. Mundell, and J. Vanek, eds., *Trade, Balance of Payment and Growth*. Amsterdam: North Holland.

Chapter 4

Manufactured export development

4.1 Manufactured exports have played a catalytic role in growth and development throughout the world. The benefits of such exports include the earning of foreign exchange, expanding employment opportunities and diversifying the export base. But manufactured exports can play a much broader role in Russia as they are a means of introducing world market competition to enterprises and the banking system. Price reform together with carefully thought out institutional support will help enterprises overcome a traditional orientation towards the domestic market and help integrate Russia into the world economy. Importantly, export orientation can accelerate the process of industrial restructuring in an efficient direction.

4.2 Political and economic changes within Russia and nearby trading partners have shown that the past pattern of trade in manufactured goods was not sustainable. This chapter explores how the process of reorienting manufactured exports in line with the country's comparative advantage could be accelerated. First, the chapter outlines the main domestic constraints to manufactured exports and in so doing draws upon the findings of various enterprise interviews. The main constraints discussed in this chapter are a lack of marketing capacity and access to trade finance. The opening section highlights the role of foreign collaboration in helping Russian exporters find markets. It is argued that due to the lack of property rights and political uncertainty, non-equity forms of collaboration (marketing and sub-contract agreements) are most likely to produce results in the medium term. For Russian exporters to take advantage of such links, there is need to encourage information and matchmaking services and provide better access to trade finance. The chapter then briefly outlines the comprehensive export strategy outlined by the government. On the whole, the strategy sets out a useful blueprint for expanding manufactured exports. However, given the ambitious scope of the strategy (and the lack of funds) the chapter concludes by outlining priorities and points to areas that need further elaboration before commitments are made to extensive institution building.

Major factors constraining manufactured export development

Survey of manufactured export potential

4.3 The mission undertook a number of interviews with manufacturing enterprises, trading companies and commercial attaches. Enterprise views on export potential and constraints are summarized in Box 4.1. Although the interviews confirmed that Russia's export market development is still at an early stage and is confronted with many constraints, it is apparent that many enterprises are restructuring and increasing their external contacts (in many cases with foreign partners). Such enterprises have reversed the previous practice of treating manufactured exports to hard currency markets as a residual. They realize that entering the world market with modified or new products may be the only way to survive. These positive developments were refreshing compared to the many difficulties in broader economic policy.

4.4 This chapter focusses on two of the key constraints raised by enterprise managers: lack of marketing capability and inability to modify products to the more demanding export standards; and difficulties accessing pre- and post-shipment export and investment finance. They also confirmed that most enterprises relied extensively on domestically produced inputs, even when products were directed to hard currency markets. This suggests a lack of specialization in processes and components that hinders export development. In many cases access to certain import components could help raise product quality and thereby facilitate increased export sales. In addition, many exporters pointed to difficulties in shipping goods through congested ports and transport facilities. This report will not cover this point in much detail as it has been extensively covered in a recent World Bank report on Russia's Transport Sector Strategy.

Box 4.1 Enterprise Views on Export Potential

A number of enterprise surveys indicated a consensus on the potential and constraints on expanding manufactured exports. Nearly all the respondents considered they could increase exports, but in most cases this would require investment in new equipment and technology. The favorable exchange rate makes exports an attractive proposition. However, until recently this was offset by various implicit taxes on exports. Some of these taxes have since been eliminated. Close to two-thirds of respondents now have direct contacts with foreign partners or mediators and visiting the main buyers of their goods is a common occurrence. However, enterprises were concerned about the lack of information on how to choose foreign partners. Institutional barriers such as unstable and complex customs regulations are a problem. However, enterprises acknowledged that they have insufficient qualified personnel to handle new procedures. In the past, they had relied on foreign trading organizations. The survey results on factors influencing export potential (in order of importance) are summarized as follows:

Favorable factors

Price competitiveness in world markets
Profitability of exports (lower domestic prices)
Quality of production

Unfavorable factors

Obligatory surrender of foreign exchange
Absence of information on foreign markets
Unstable customs system
Lack of credit (particularly in hard currency)
Disruption of ties within FSU and CMEA (including payment delays)

Export marketing capability

4.5 The finding that Russian enterprises' lack of overseas marketing capability is one of the most important constraints on Russia's manufactured export development is not surprising in view of the legacy of the inward-oriented industrial and trade policies of the planning system. In the past, enterprises depended exclusively on state foreign trading organizations (FTOs) and governmental multilateral or bilateral trade agreements for their exporting efforts. Despite their lack of overseas marketing capability, manufactured exporters receive little support from FTOs and the Chamber of Commerce and Industry for export marketing, as described in box 4.2.

Export marketing channels

4.6 The current marketing channels for Russian exports to hard currency markets are shown in figure 4.1. Strategic goods which comprise about three quarters of Russian exports (produced by about 330 enterprises) are sold to overseas buyers through: 25 specialized FTOs under the MFER, 50 to 75 specialized FTOs under other ministries, 70 regional FTOs, or directly by producing enterprises. A question is raised as to why there are so many FTOs involved in exporting strategic goods, for which little active marketing is required. The answer is that they are interested in sharing the rent generated by the differences between domestic and world prices for primary commodities. The numbers of such FTOs, could easily be reduced and this is likely to happen when they are fully privatized and access to trading is opened. As mentioned below, the government export strategy proposes such a course of action. Nonstrategic goods are also sold to overseas buyers through numerous FTOs and trading companies (most of them are specialized trading firms) or directly by producing enterprises. However, most manufacturing enterprises export directly with the marketing assistance of foreign partners (rather than Russian or overseas trading companies). Exporter interviews confirm that almost all manufacturing enterprises used to deal with FTOs before the dissolution of the FSU. Now enterprises have become used to contacting foreign buyers directly.

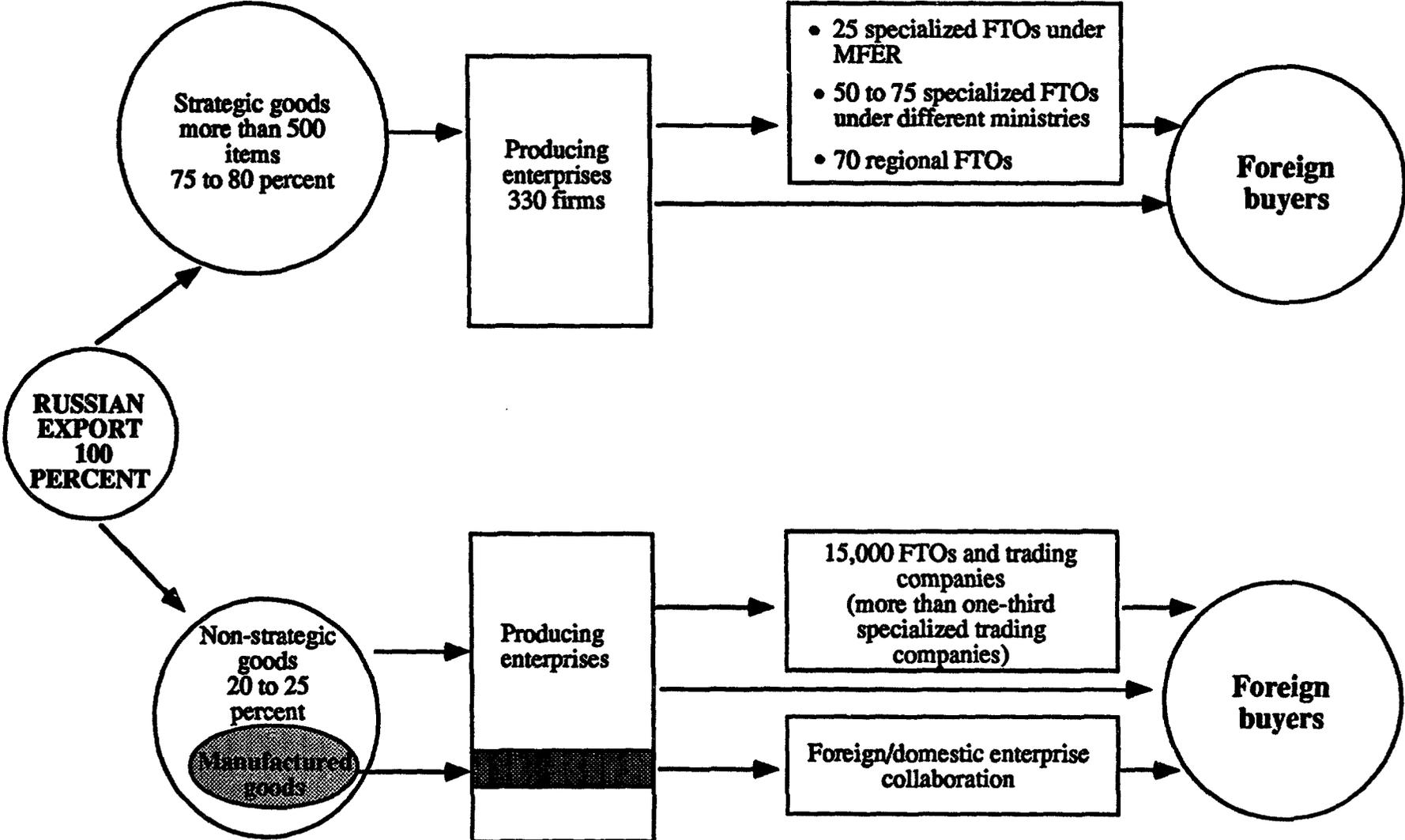
Box 4.2 Historical Perspective on Marketing Channels.

All union FTOs. In the FSU, FTOs (belonging to the Ministry of Foreign Trade) monopolized foreign trade. They were specialized in particular groups of products. While FTOs' overseas transactions were at world market prices, their purchases from Russian suppliers for export and their sales of imports to domestic buyers were at fixed domestic prices (there were some export bonuses paid to producing enterprises in the late 1980s). Gains or losses stemming from the differences between the world market and domestic prices were surrendered to or paid by the State Budget. The VEB and the State Bank provided trade finance for FTOs and domestic enterprises as well as settled payments on behalf of FTOs. Under this system, manufacturing enterprises did not have opportunities to learn overseas marketing. Also, FTOs did not develop overseas marketing capability for manufactured goods of the sort provided by private multinational general trading companies. This is because the trade they specialized in did not demand much external marketing in terms of products and trade arrangements (most trade was conducted under the government-level agreements with CMEA or socialist developing countries).

Liberalization of trading activities. In 1988, some producing enterprises and FTOs under other ministries were given the right to trade in international markets. Subsequently all producing enterprises were given the same right. However, they were allowed to export only those products produced in excess of targets and to import only those items and quantities not specified in the Export-Import Plan of the MFER. Finally, in February 1992 the creation of private trading companies was allowed, and international trading activities were completely liberalized. A backward step was taken in mid-1992 with the government imposed requirement that exporters of strategic goods be registered (largely raw materials).

Chamber of commerce and industry. The Russian Chamber of Commerce largely provides information on the Russian market to overseas suppliers and investors. Overall, the Chamber has not been active in providing overseas marketing support, other than organizing overseas fairs for exporters. However, the Chamber does have widespread interests such as holding fairs in Russia (through Expocentre), providing import and export inspections (mostly raw materials) and settling trade-related disputes as well as maritime matters.

Figure 4.1: Russian export marketing channels in non-FSU countries



New product development

4.7 Interviews with commercial attaches revealed that western buyers have a low level of interest in Russian manufactured goods primarily due to poor product quality and unreliable suppliers. Consequently, the task of building international competitiveness in manufacturing should start with the acquisition of marketing know-how with the objective of modifying existing products or producing new products that meet world market standards. This will require changing production lines, tools and equipment. It is encouraging that most enterprises interviewed were moving in this direction: about 70 percent of them had changed their product specifications in order to meet buyer demands.

Foreign enterprise collaboration

4.8 The main elements that determine foreign interest in Russian export manufacturers include the general business environment and access to information about their capacity and future profitability. In this regard, foreign partners measure Russia relative to other potential locations around the world. The general factors influencing an assessment of Russia's business environment encompass: incentives policies and regulations; certainty of property rights; workers wages and other costs; availability of infrastructure; and social and political stability. Interviews with commercial attaches in Moscow revealed that one of the more important factors that impeded more active foreign enterprise collaboration in Russia is the lack of clearly defined property rights and lack of trade and investment contract enforcement mechanisms. The uncertainty surrounding the rules relating to leasing and owning land is a particular stumbling block.

4.9 A key finding of enterprise interviews is that some form of collaboration with foreign partners has been instrumental in helping Russian exporters enter world markets. Most of the enterprises that have attempted direct exporting had difficulty penetrating overseas markets. The absence of overseas marketing assistance from FTOs or other trading companies means that in the short term enterprises will have to acquire marketing know-how by themselves. The characteristics of various modes of foreign/domestic enterprise collaboration is outlined in table 4.1. Of these categories, foreign direct investment/joint ventures appear to be the most attractive. Aside from access to external market networks and technical know-how, they can also bring financial resources for fixed and working capital. But foreign investors are unlikely to commit significant resources in Russian manufacturing over the medium term due to the high risks involved (elaborated below). For this reason, policymakers should focus on non-equity foreign involvement in the short run. Such involvement encompasses most of the critical factors needed for Russia's entry into world markets, but it does mean that alternative access to various forms of import finance becomes critical. As suggested by firm-level research in other countries, the most efficient way for Russian workers to acquire skills in export production and sales is likely to be through on-the-job training and learning-by-doing on the factory floor and sales rooms of enterprises with foreign collaboration. Over the longer run equity-based investment could become more important.

4.10 As indicated in table 4.1, the alternative forms of foreign collaboration are characterized by different combinations of revenue sharing and risk taking. In equity-based foreign/domestic collaboration, foreign partners take equity risk for expected profit. Foreign partners take different types of risk in non-equity involvement: in technical/marketing agreements the risk is that the local partner repudiates the royalty contract; in sub-contracting there is the risk of misuse of intermediate inputs; and in turn-key plants the risk of non-payment. In technical assistance, foreign consultants do not risk anything while receiving a fixed fee. Addressing these risks through improved policies and new initiatives will be a key issue for promoting manufactured exports (discussed below).

Table 4.1 Modes of outward-oriented foreign/domestic enterprise and personnel collaboration

	Non-equity involved F/D enterprise collaboration			Equity-involved F/D enterprise collaboration	F/D personnel collaboration (consultant)
	(a) Technical/Marketing Agreement	(b) Sub-contract Agreement	(c) Turn-key plant	(d) Joint Venture or FDI	(e) Technical/marketing consulting
Foreign partner brings in:					
i. Access to established external market network	Yes	Yes	Yes (if combined with (a) or (b))	Yes	No
ii. Technical/marketing know-how	Yes	Yes (partly)	Yes (if combined (a) or (b))	Yes	Yes (partly)
iii. Company management in international environment	Yes	Yes (partly)	Yes (if combined with (a) or (b))	Yes	No
iv. Financial resources/capital goods	No	No	No	Yes	No
v. Intermediate inputs	No	Yes	Yes (if combined with (b))	Yes or No	No
Foreign partner's return or revenue	Royalty payments (during contract periods) in proportion to export sales	Processed output less processing fees	Turn-key plant value	Profit	<u>Fixed consulting fees</u>
Foreign partner's risk-taking	<u>Local partner's royalty contract repudiation</u>	<u>Local partner's intermediate input misuse</u>	<u>Local partner's non-payment of turn-key plant value or wrongful calling of stand-by L/C</u>	Equity	<u>No</u>
Local partner's risk-taking	<u>No</u>	<u>No</u>	TP performance (if not guaranteed by stand-by L/C)	Equity (in the case of JV)	Uncertain performance
Impact of export policy regimes (less than free trade status, etc.) on foreign partner's return or revenue	<u>No</u>	<u>No</u>	<u>No</u>	Critical	No

4.11 In general, Russia is perceived as a risky place in which to do business--the current status of foreign involvement in the country is outlined in box 4.3. In the following sections the emphasis will be on measures to maximize the inflow of non-equity based foreign collaboration in manufacturing industries. These measures encompass schemes to cover the risk of the local partners' contract repudiation and information and match-making services. For equity-based investment the emphasis is on measures to increase the risk coverage of foreign direct investment and joint ventures. There are schemes to cover political risks that include currency nonconvertibility as well as war damage and confiscation/expropriation risks. However, there are no schemes that cover the usual commercial risks.

Box 4.3 Status of foreign involvement in Russia

Joint ventures and FDI. The Russian Law on Foreign Investment enacted in July 1991 has provided the legal framework for foreign investment and joint ventures in Russia. The Russian Agency for International Cooperation and Development (RAICD) was created in August 1992 as the agency in charge of inward foreign investment and technical assistance. The RAICD issues foreign investment licenses for foreign equity over 100 million rubles. For smaller foreign equity investments, regional authorities issue licenses. The minimum level of investment to register as a foreign investor is just 10,000 rubles. At end 1992, about 6,000 joint ventures were registered, and the total value of foreign investment was estimated to be about \$4 billion. The size distribution of the registered joint ventures (shares in the total number of registration) is as follows:

More than 100 million rubles	0.4 percent
10 million rubles to 100 million rubles	3.8 percent
1 million rubles to 10 million rubles	19.8 percent
Below 1 million rubles	76.0 percent

Most joint ventures are very small and are concentrated in trade, service, or consulting. There is some foreign investment in such primary good industries as oil/gas, ferrous metals, and timber. There are also some foreign investment in the chemicals, food processing, and machine building sectors. However, there is no information available regarding the export shares of the joint venture enterprises.

Nonequity involvement. No agency keeps track of enterprises that have nonequity foreign enterprise collaboration (such as technical/marketing agreements, subcontracting, and turnkey plants). However, it is believed that nonequity involvement is currently more important in Russia than equity collaboration, due to the reluctance of foreign enterprises to take equity risks due to political, social, and economic uncertainty.

4.12 **FOREIGN INVESTMENT GUARANTEES.** Many Russian enterprises interviewed by the mission were searching for joint venture investment, both to obtain access to marketing/technical assistance and capital goods. While many multinational firms maintain offices in Moscow (or other regional centers) their main interest has been to sell manufactured goods from their home base to Russia. This is particularly the case for consumer goods, because this was the most suppressed market in the FSU. In addition, they are keen to import raw materials from Russia. So far they have been cautious in committing equity funds in Russia. As mentioned above this is largely due to political, social and economic uncertainty. Such uncertainty leads to high demands for investment (insurance) guarantees designed to cover political risks. Currently Russia is one of the 103 member countries of the Multilateral

Investment Guarantee Agency (MIGA) which is a member of the World Bank Group. In June, 1993, MIGA provided its first guarantee for a \$10 million foreign investment project in Russia. MIGA already has a sizable number of applications for coverage of prospective investments in Russia. The organization is also exploring the establishment of a Sponsorship Trust Fund (STF) for Russia. Several countries, including Russia, are considering becoming the initial sponsors of such a fund which would have an asset base of \$100 million. There are many advantages of such a fund arrangement; these include the utilization of MIGA's underwriting capabilities and guarantee administration, the ability of the trust fund mechanism to reinsure national and private investment insurance companies. Although there is a large gap between the demand for investment insurance (or guarantees) and the supply, such schemes together with national investment schemes of the OECD countries, seem to be the most practical mechanism to lessen investor's fears about political risks. Proposed schemes for guarantees underwritten by the Russian government lack credibility. In such schemes investors are essentially being asked to believe that in return for paying a premium they will be compensated by a government entity for losses (such as expropriation) that another part of the government has caused (and probably refused to render adequate compensation).

4.13 **COVERAGE FOR CONTRACT REPUDIATION IN NON-EQUITY INVESTMENT.** Foreigners face both political and commercial risks in non-equity involvement in Russia. In principle, most of the commercial risks can be covered by the export credit insurance and guarantee schemes of OECD countries. This would include: repudiation of royalty contracts under technical marketing agreements; and non payment for plant or the risks of wrongful calling of standby letters of credit in turnkey projects. However, the existing schemes do not appear to effectively cover such risks. Most of them include export-oriented foreign collaboration in Russia in the off-cover list. Currently intermediate input misuse risks in sub-contracting arrangements are not covered. Doing so would require Russia to develop letter of credit facilities backed by preshipment export finance guarantee schemes.

4.14 **INFORMATION SERVICES.** In interviews with Russian exporters it was apparent that a lack of information on potential foreign collaborators is a negative factor that limits export expansion. In turn, commercial attaches suggested that a lack of information on Russian enterprises is one of the negative factors constraining foreign collaboration or trade contacts. The problem of imperfect information is one of the major constraints limiting increased inflow of foreign enterprises for nonequity involvement with Russian manufactured export activities. The RAICD has been involved in assessing about 600 joint venture proposals prepared by Russian enterprises (there is no information regarding the share of manufactured export-oriented foreign collaboration proposals). The organization has followed up the progress of potential matchmaking for only fifteen of the projects. There are also several private matchmakers for joint ventures in Russia. However, these private companies devote most of their attention to attracting large foreign companies to domestic privatization projects. The private matchmakers provide legal and administrative services, as well as identify potential partners. A privatization Information Center has been established by the authorities in order to provide information on privatization opportunities for potential foreign investors. The feasibility of including information services for manufactured export-oriented non-investment collaboration could be considered.

Access to import finance for export production and investment

4.15 In interviews most enterprises indicated difficulties in access to: (a) short-term import finance for foreign-made components and parts needed for export production; and (b) longer term import finance for foreign-made capital goods needed for export production. This was ranked as an important factor constraining their entry into world markets. Nearly all the exporters felt that they can increase their export volume if they can access investment loans to be used to import capital goods and foreign

know-how. They estimated their investment finance needs ranging from 40 to 50 million rubles to 10 million dollars. More than half of the enterprises interviewed revealed that the most important source of financing imported components or capital goods is their export earnings (more than half of their export earnings were used to meet such import needs). Commercial attaches also felt that poor banking services and delays in obtaining finance for trade activities are two of the important factors constraining business activities. These findings are critical for Russia particularly because foreign non-equity partners are unlikely to bring in investment or working capital. Furthermore, expected contributions to Russian entry into the world market by nonequity partners would be limited, if local partners have difficulties in having access to needed finance.

Sources of short-term import finance

4.16 The infant stage of Russia's short-term trade finance is characterized by: (a) self-finance; (b) reliance on trading partners (such as advance payments or arrears); (c) sectoral loans from the CBR; and (d) commercial bank loans allocated to shareholders or collateralized by insurance company guarantees. Many Russian manufactured exporters have difficulty fulfilling export orders because the system of trade finance has not been developed.

Sources of longer term import finance

4.17 Russian bank loans are predominantly short-term loans (more than 80 percent of the total). Less than 8 percent of the total bank loans in the last quarter of 1992 were long-term capital investment loans for enterprises. In addition to the short-term nature of ruble loans, the small size of most commercial banks makes it difficult for manufactured exporters to rely on ruble loans and MICEX for their import finance needs. Some banks provide foreign currency loans, but these loans are mostly short-term and the interest rates are two to three times higher than the international interest rate. Such huge margins reflects both excess demand for foreign currency loans and risk premiums. Furthermore, as argued in Chapter 5, the lending criteria of the CBR and commercial banks are not based on project profitability or loan payback ability. For this reason there is a reasonable chance that many potentially profitable export projects are underfunded.

Free trade status for export activities

4.18 LACK OF FREE ECONOMIC ZONE POLICY AND ADMINISTRATION. Russian authorities have recognized the value of export processing zones (EPZs) as a tool to induce foreign enterprises into manufactured export activities by offering: (a) free trade status and foreign exchange rules; (b) factory buildings or land (for rent); (c) international communication and transport infrastructure; and (d) additional incentives in terms of tax holidays, opportunities to sell part of the products in the local market after paying import duties, secure property rights, liberal labor and employment rules, and flexible application of immigration laws. The lessons from international experience with EPZs is outlined in Box 4.4. Many areas have been declared as free economic zones (FEZs): Altai, Kaliningrad, Karelia, Kemerovo, Nakhodka, Novgorod, Primore, Sakhalin, Sheremetievo, St. Petersburg, Vyborg, Zabaikalie, and Zelenograd. FEZs are much broader areas than EPZs. Prevarication by the authorities' on economic zone policy reflects the instability and uncertainty in the country in general. In particular, the achieving Federal/Regional policy coordination has been a stumbling block. For example, the first FEZ in Nakoddka started in 1990. In October 1992, the Nakoddka FEZ Committee adopted its own customs regulation in order to allow duty-free import for export production. After only one month's implementation of the duty-free regime, the Federal Customs intervened to suspend the duty-free regime on the ground that the region lacked the authority to do so. But the Federal authority did not have an

effective customs law as an alternative. Not only is the Russian Law on EPZs yet to be enacted and implemented, but there are no immediate plans to build the necessary infrastructure for most of the declared zones. Appropriate physical infrastructure is critical for inducing foreign enterprises into export activities.

Box 4.4 Experience with Export Processing Zones

An EPZ is an industrial estate that offers exporters duty-free imports, a favorable business environment, few regulatory restrictions, and a minimum of red tape. EPZs are found mainly in developing economies, while the three other commonly used systems - in-bond, duty-exemptions and duty-drawback are used in most countries. For economies at an early stage of economic development with limited administrative capability, high distortions, and little local technological, marketing, or management capability, EPZs can be an appropriate way to attract foreign and domestic investment to exports-oriented manufacturing in a limited geographical area.

The review of experience with EPZs yields several lessons: (i) economy-wide duty-free systems should be emphasized over specific EPZs; (ii) support to EPZs should be considered in the context of broader trade policy reforms involving a shift toward outward-oriented development; and (iii) private development and management of EPZs is to be encouraged, and when public development is required, special arrangements ought to be put in place to ensure full cost recovery and efficient management. The importance of the EPZ as a policy instrument tends to diminish as an economy becomes successful in its outward-oriented strategy, though its value as an industrial estate may remain.

4.19 IMPORTED INPUTS FOR EXPORT PRODUCTION. The existing trade policy regime does not allow exporters to import inputs free of duty. According to interviews more than 60 percent of exporters cited problems with the Customs Agency as one of the factors that hinder export development. They pointed to the complex export and import procedures as well as to the financial burdens associated with duties levied on imported inputs for export production. Providing speedy access to duty and indirect tax-free access to imported inputs with minimum delays and administrative costs is one of the most important components of export policies.

4.20 The authorities have prepared a draft law on customs regimes such as duty drawback and exemption schemes, duty free procedures for EPZs, and bonded manufacturing warehouses. In addition, the system of zero rating of value added taxes (VAT) and refunds for export activities was introduced earlier in the year. These are all steps in the right direction. However, in order to implement these new regulations there will need to be extensive institution building, including the design of administrative mechanisms and staff training.

Specialization in processes and components

Legacy of inward-orientation

4.21 Enterprises indicated in interviews that Russian manufacturers rely almost exclusively on domestically produced inputs for their production including those for the export market. This is not surprising, in view of the legacy of the inward-oriented industrial structure of the FSU. According to the 1988 input-output table of the FSU, the average import share of the interindustry demand matrix was less than 3 percent. The system of large integrated factories in which most of the parts and components were produced in-house left little room for specialization of processes and parts/component manufacturing. Since a make-import choice based on international comparative advantage was not the criteria for domestic production and trade, imports of parts and components were treated as a residual. Nevertheless there is evidence that enterprises are now taking a much more flexible approach to the sourcing of parts and components. Difficulty in accessing import finance and a lack of knowledge on overseas marketing makes it difficult for Russian manufactured exporters to practice an efficient make-import choice.

Physical infrastructure

4.22 Poor physical infrastructure is another constraint on Russian exports of both manufactured and primary goods. Insufficient sea port and inland transportation facilities have been cited by foreign companies as a major obstacle for Russian trade. Setting priorities is critical in light of the huge resources required for physical infrastructure building. There is a need for national port, aviation, and land transport strategy in order to manage the transition from a transport system organized to service a planned economy to one that is cost-based, efficient and responsive to shippers in a market-based economy. In this context, the infrastructure aspect of EPZs should not be overlooked in addition to the export policy and foreign enterprise inducement policy aspects.

Manufactured export development strategy

Government's manufactured export development strategy paper

4.23 On March 31, 1993 the Government adopted a Manufactured Export Development Strategy Paper prepared by the Ministry of Foreign Economic Relations (MFER). The Strategy Paper has recognized most of the major issues that need to be resolved for Russia's manufactured export development. The measures proposed in the Strategy Paper are quite extensive, and can be classified into the following categories (ranked roughly in importance attached to them by the government):

- Finance/insurance/guarantees.
- Physical infrastructure.
- Tax and other incentives.
- Privatization/trading companies.
- Foreign enterprise collaboration.
- Information services.
- Measures to increase world market acceptance.

The proposed measures are briefly summarized below.

Finance/insurance/guarantees

4.24 The major recommendations are to create a Russian EXIM Bank (with \$500 million equity) and a Russian Bank for Reconstruction and Development (RBRD) with equity of 100 billion rubles. The tasks of the EXIM Bank would be to provide longer term postshipment finance (foreign currency loans) for turnkey plant and heavy equipment export. In addition, the EXIM Bank would provide contract performance bond guarantees for turnkey plant exports. The task of the RBRD would be to provide investment finance for manufactured export industries. A further initiative in banking is the proposed establishment of foreign/domestic joint commercial banks with annual budget support of \$100 million. These banks would be directed to granting short-term trade loans. Various financial and guarantee support is envisaged, that would include support for the development of Russian leasing companies operating overseas and also an export credit insurance scheme.

Physical infrastructure

4.25 Wider utilization of naval bases for trade is proposed in order to ease the limits of the commercial port facilities. In addition, a major renovation of sea ports, terminals, storage facilities, and rail transport systems is proposed with expenditure of \$500 million during 1993--95. In turn, it is proposed that the railway authorities finance their imported equipment with transport charges (foreign currency).

Tax and other incentives

4.26 The strategy paper proposes an ambitious range of incentives to encourage more highly processed manufactured good exports. These incentives would extend the scope of exemptions and increase the variability in the incentives regime. For exports the main incentives proposed are export earning reinvestment tax incentives, accelerated depreciation allowances and a decrease in foreign exchange surrender requirements for high-tech goods. Moreover, the Ministry proposes to use the state procurement system to promote exports (presumably by continuing the practice of cross subsidies). Other programs include the financing of promotion of service exports and the development of Russian equipment after-sales service overseas. The Strategy envisages increased export taxes on technology, in order to develop manufactured exports based on Russian technology. In effect, this will be an implicit tax on technology output and contradict the desire to expand service exports. The Ministry estimates that the export programs would result in annual revenue foregone of about \$500 million.

4.27 For imports, an extension of subsidies for selected components and technology is proposed. The strategy of supporting manufactured industry is also reflected in the proposals on import duties--selective infamy industry protection coupled with lower duties on industrial inputs (thereby increasing effective rates of assistance to industry). Taken together the proposed incentives and promotion programs would cost over \$1.5 billion. Placed in perspective, this is about half the value of manufactured exports. Such a large budgetary cost is unrealistic given the tight budgetary constraints faced by the government.

Privatization of trading companies

4.28 The privatization of FTOs specializing in manufactured exports is proposed, together with a limit of five to ten strategic exporters specializing in energy exports. A useful initiative is the possible creation of joint venture trading companies with the participation of FTOs, enterprises, regions, and overseas foreign trading companies. The approach suggested is to encourage privatization of the entire production chain for manufactured exports. This may require merging FTOs with manufacturing enterprises.

Foreign enterprise collaboration

4.29 The Strategy Paper endorses EPZs as an effective tool to induce manufactured export-oriented foreign investments. Export and import tax exemptions and suspension of the foreign exchange surrender requirements are proposed in order to promote subcontract agreements and other forms of foreign enterprise collaboration in manufactured exports.

Information service

4.30 The creation of a modern information system for exporters is proposed. In particular, the need for a data bank on legal, quality, environmental, and other standards required by the potential importing countries of Russian manufactured exports is emphasized.

Measures to increase world market acceptance

4.31 The following measures are proposed in order to enhance the world market acceptance of Russian manufactured goods:

- Join the GATT as soon as possible.
- Provide patent registration of Russian goods and technologies.
- Join international organizations that could facilitate Russian manufactured good exports.
- Implement certification of Russian manufactured exports by the State Committee on Standardization with the participation of the leading foreign organizations (annual budget needs are estimated at \$100 million).

Recommendation for Manufactured Export Development Strategy

4.32 The manufactured export development strategy should strike a balance between short-term efforts to expand exports utilizing existing facilities and longer term efforts to change the export and manufacturing structure in accordance with Russia's underlying comparative advantage. However, the former effort should not be allowed to delay or interfere with the latter effort. The best way to achieve the desired balance would be to phase out most of the subsidy schemes so as to provide world market prices for all inputs. This will allow enterprises to make rational business decisions regarding the "make-import choice" as well as what to produce for export. In this context, the resources associated with import subsidies can be better used for manufactured export development and particularly if these are directed to reducing imperfect information and difficulties accessing necessary finance. Export promotion could encompass activities such as export marketing, foreign enterprise collaboration inducement, overseas information service, or perhaps trading company development. In terms of export financing the emphasis should be on assuring access to export finance at world market or domestic interest rates for

all activities that generate export value added rather than interest subsidies granted for only selected exporters.

4.33 Aside from subsidies or preferential treatment, many of the measures proposed in the Strategy Paper would contribute to the effective development of Russia's manufactured exports. In order to implement them, however, a significant amount of budget resources are required. For this reason it is desirable to set the right priorities in terms of implementation timing and resource allocation. In setting priorities, the main consideration is the likely costs and benefits of the initiatives and the time required to build up institutions such as the EXIM Bank. Figure 4.2 sketches the essence of our recommendations on Russia's manufactured export development strategy. These recommendations are largely in agreement with the measures proposed in the government's Manufactured Export Development Strategy Paper.

Short-term tasks

4.34 The priority short-term tasks could be composed of the following three elements:

- Induce manufactured export-oriented foreign enterprise collaboration;
- Establish a foreign currency import finance and short-term postshipment finance system; and
- Establish a rational export policy regime.

Strategy to induce manufactured export-oriented foreign enterprise collaboration

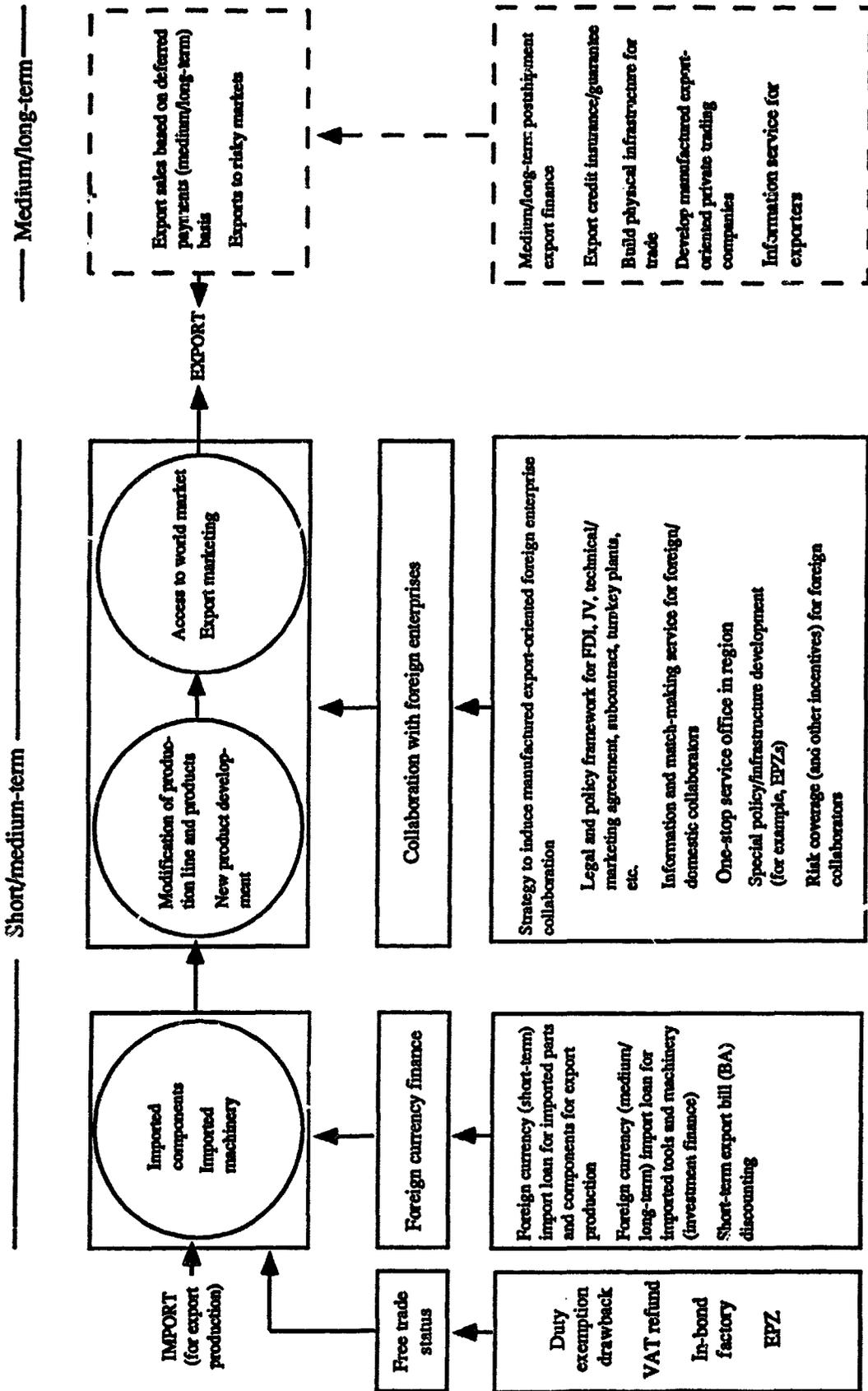
4.35 More aggressive inducement of foreign enterprise collaboration should be the cornerstone of the short-term tasks of the manufactured export development strategy. As discussed earlier, the lack of export marketing capability makes it difficult for exporters to modify products or produce new products that meet overseas buyers' demands. The most effective way to acquire such capability is to collaborate with foreign enterprises. The challenge is to:

- Prepare the legal and policy framework for diversified modes of non-equity partnerships;
- Provide information and matchmaking services for foreign partners;
- Establish a one-stop service office for foreign partners in the regions;
- Provide special infrastructure policy packages;
- Provide risk coverage schemes for foreign non-equity partners.

In carrying out these tasks, closer coordination will be needed between the MFER and the RAICD, the two main agencies involved in export and investment promotion.

4.36 **INFORMATION SERVICE.** RAICD and MFER could jointly develop an innovative private matchmaking mechanism with possible public incentive support, designed to speed up the inducement of manufactured export-oriented foreign enterprise collaboration. Private matchmaking services should also include legal and administrative services. As a first step, the RAICD and MFER could jointly publish information summarizing current rules and regulations on foreign collaboration and export policy regimes and listing foreign companies located in Russia. Developing an innovative information and matchmaking mechanism should be the centerpiece of the short-term tasks of the Russian export development strategy. This may be the most effective way of providing government or international support to restructure the Russian manufacturing industries for international competitiveness at this early stage.

Figure 4.2 Strategy for manufactured export development



4.37 **ONE-STOP OFFICE FOR FOREIGN PARTNERS.** Potential foreign partners are often confused about the federal and regional jurisdiction on the various procedures needed to do business in Russia. Since the administrative procedures related to the physical location of foreign enterprises are dealt with by Regional authorities, one-stop service offices could be created in the regions for foreign partners in order to facilitate the necessary paperwork (such as fire permits and health permits).

4.38 **SPECIAL INFRASTRUCTURE/POLICY PACKAGE.** An EPZ offers a special package of export and investment policy and factory buildings tied to trade infrastructure. For this reason in many countries EPZs have been instrumental in inducing manufactured export-oriented foreign investors. Recognizing this, the Export Strategy Paper lists the development of EPZs as an urgent task. To this end the government should enact the EPZ Law and develop necessary administrative arrangements to implement the law as soon as possible. The Law should encourage the development of private EPZs (including foreign private investors). The latter have performed remarkably well in other countries.

4.39 **RISK COVERAGE SCHEMES FOR FOREIGN PARTNERS.** Currently, MIGA and the national schemes of the major Western countries appear to be the only schemes to cover political risks, even though the aggregate amount of foreign investment that can be covered by them appears to be quite small compared with the potential demands for foreign investment in Russia. However, the diversified forms of manufactured export-oriented foreign enterprise collaboration are not the main subject of the risk coverage of these schemes. In fact, the biggest concern of potential foreign partners appears to be the commercial risks associated with the Russian partners' potential contract repudiation. The Strategy Paper states that foreign investment guarantees will be handled by the State Investment Corporation yet to be set up. As mentioned earlier, it will be difficult to convince foreign investors of the credibility of such an organization. Political and economic stability would do more to encourage foreign investors. Nevertheless any guarantee schemes should include cover of risks in non-equity collaboration.

Import and short-term postshipment finance

4.40 Although the Strategy Paper attaches the highest priority on government support for longer-term postshipment financing for exports of turnkey plants and other heavy equipment (by creating the Russian EXIM Bank), it is recommended that foreign currency import financing designed to finance parts and components and equipment needed to modify existing products or produce new products receive greater emphasis.

4.41 **IMPORT FINANCE.** The greatest need for Russian enterprises is short-term import finance for manufactured export production. In this regard a Short-Term Import Finance Fund for manufactured exporters could be established in an apex institution. The short-term import loan disbursement and liquidation mechanisms could be instituted so that eligible exporters have access to loans through commercial banks. To develop the supervisory capability of the apex institution and build up the import loan-handling capability of commercial banks, external technical assistance may be needed.

4.42 **SHORT-TERM POSTSHIPMENT FINANCE.** Modern mechanisms of short-term postshipment finance rely on accepted usance trade bills or bankers' acceptance (BA) discounting. The Strategy Paper overlooks the need for these methods of short-term postshipment finance. In order to promote such mechanisms by commercial banks, it is recommended that the CBR establish a trade bill or BA rediscount system (chapter 5 provides the details on this recommendation).

Development of export policy regime

4.43 Another important export promotion initiative would be to allow duty-free imports on inputs for manufactured export production. The Strategy Paper appears to suggest that allowing such imports should be considered a special incentive for exporters (and treated as foregone revenue). This is incorrect as the role of export policy is to provide a neutral policy regime by correcting tariff and other distortions in the system (and this is allowed by GATT rules). The government should develop the administrative arrangements needed to implement duty exemption, drawback, and in-bond factory schemes once the new Customs Law is passed. Also, it is recommended that the government implement the VAT refund scheme for exporters by instituting the necessary administrative mechanisms.

Longer term tasks

4.44 Longer term tasks should be directed toward establishing:

- Longer term postshipment export finance systems.
- Export credit insurance/guarantee schemes.
- Trade-related physical infrastructure.
- Private trading companies.
- Exporter information service systems.

These initiatives are directed towards the longer term because considerable building of institutions and infrastructure is needed. Nevertheless, preparatory work should commence at an early stage.

4.45 **LONGER TERM POSTSHIPMENT FINANCE AND EXPORT CREDIT INSURANCE/GUARANTEE.** The Strategy Paper proposes the establishment of a Russian EXIM Bank for the purpose of granting longer term postshipment loans for turnkey plant and other heavy equipment exports based on deferred payments. Another proposed task of the Bank is to provide turnkey project performance bond guarantees in order to protect Russian banks issuing such bonds against the risk of wrongful calling by foreign contractors. In turn, the Strategy Paper proposes the establishment of export credit insurance/guarantee schemes in order to protect Russian exporters and banks against foreign buyers' nonpayment risks. Such institution building would be justified as a longer term task in light of the current and future manufactured export structure of Russia. However, in view of the significant financial and professional resources required to start and operate these institutions, careful planning is needed. Therefore, it is recommended that the government form a task force that can start the necessary planning work for the creation of these institutions and schemes with possible external assistance. The feasibility study must study among other things the possibility of locating a separate entity dealing with export credit insurance/guarantees in the Russian EXIM Bank to save the overhead costs of establishing a separate agency.

4.46 **PHYSICAL (TRADE) INFRASTRUCTURE.** The Strategy Paper attaches a high priority to the tasks of improving trade-related infrastructure. Clearly this is one of the key longer term tasks for the development of both manufactured and primary exports. Again, in view of the huge financial resources required, it is recommended that a comprehensive evaluation of various alternatives be carried out before any new infrastructure is built. The evaluation should also include the proposed EPZ-related infrastructure building and possible modes of financing (including allowing private EPZs).

4.47 PRIVATE TRADING COMPANIES. The Strategy Paper's recommendation to privatize the public FTOs and to promote private trading companies specializing in manufactured exports is an important recommendation. The proposed privatization could be initiated immediately. One obstacle to such privatization is the inclusion of government debt (incurred by the former VEB) on the accounts of many trading companies. Taking this debt "off the books" will be a necessary first step. Consideration could be given to finding ways to encourage such trading companies to handle and promote manufactured exports over the longer term.

4.48 INFORMATION AND OTHER SERVICES FOR EXPORTERS. The Strategy Papers' recommendation for the creation of exporters' overseas market information service is consistent with the demands of some manufactured exporters interviewed. In this kind of institution building, it is important to distinguish clearly the type of overseas market information that can and should be handled by trading companies or export manufacturers themselves in collaboration with foreign enterprises and the type of information that can and should be collected and disseminated by a public agency. A careful assessment should be carried out in order to determine the proper types of information service for exporters and take into account cross-country experience. Likewise, the proposed measures to increase world market acceptance of Russian goods (such as certification) could help promote exports. However, the authorities should guard against complex procedures that may create unnecessary barriers against exporters.

Chapter *Methods of payments and trade finance*

5.1 Building modern methods of payment to facilitate contract enforcement and access to trade finance has an important role in ensuring that opening up the domestic and international trade systems spurs economic growth. Reducing risks of trade transactions and improving loan allocations by basing them on trade transactions will help stimulate trade, particularly domestic and interstate trade. Consequently, Russia's ongoing efforts at structural reform should be supplemented by efforts to modernize trade-related methods of payment and trade finance, which will require an extensive institution-building effort.

5.2 Trade transactions usually involve regular commercial risks taken by trading partners. Suppliers bear the risk that buyers may refuse to buy goods by the time the production process starts (risk of nonpurchasing) or fail to pay for already received merchandise (risk of nonpayment). Buyers, in turn, take the risk that suppliers will not deliver at all or that shipments will not meet quality, time, and other requirements (risk of nonperformance). Usually these risks are handled through trade contract enforcement, insurance services, and appropriate methods of payments, but currently, none of these mechanisms of risk coverage is available in Russia. These elements of risk coverage are inter-related and building them is a relatively quick and high priority task. Modern payment services can be provided by existing commercial banks, which would contribute to the development of experience and skills of Russian bankers in internationally accepted techniques of trade-related payments. However, creating and enforcing commercial laws is at best a medium-term prospect.¹

5.3 In addition, the Russian banking system does not provide appropriate trade finance services. Loans from the Central Bank of Russia (CBR)—about half of the total loans granted in 1992—are distributed among loss-making enterprises, largely to bail them out. The other half was disbursed by commercial banks in the form of general loans that were not linked to trade transactions. Most of these were short-term loans of less than three months. Banks lack sufficient funds to provide trade finance in foreign exchange, and the CBR does not refinance scarce hard currency loans of commercial banks. Introducing modern methods of payment could be the first step toward developing modern transaction-based noninflationary trade finance, and could be an integral part of the reform of the system of loan allocation. These efforts should be complemented by changing the role of the CBR from the distributor of targeted loans to the lender of last resort through creation of a refinance or rediscount window.

5.4 This chapter discusses both domestic and international trade related payments and finance, since they are closely linked (for example, trade with FSU countries is an extension of domestic trade). In order to clarify the current transitional arrangements, the chapter outlines relevant features of the recently abandoned FSU systems. The argument is made that certain positive elements of the previous system could be reintroduced in a modified form to provide a bridge to a more modern framework. The chapter concludes by recommending a schedule for reform.

Methods of payments and trade finance under the FSU

Domestic trade

5.5 Enterprises and the State Bank in the FSU lacked independence as they were simply agents fulfilling planning requirements. Payments between enterprises had to be made in the form of noncash rubles through interest-free current accounts in the regional branches of the State Bank. The State Bank dictated to enterprises particular methods of payment and provided automatic access to trade finance. In reality there was not much choice in payment methods. Most enterprises relied on the "payment request" method for their trade-related payments. Other methods such as payment orders, letters of credit (L/Cs), and checks were seldom used. The payment request scheme is summarized below.

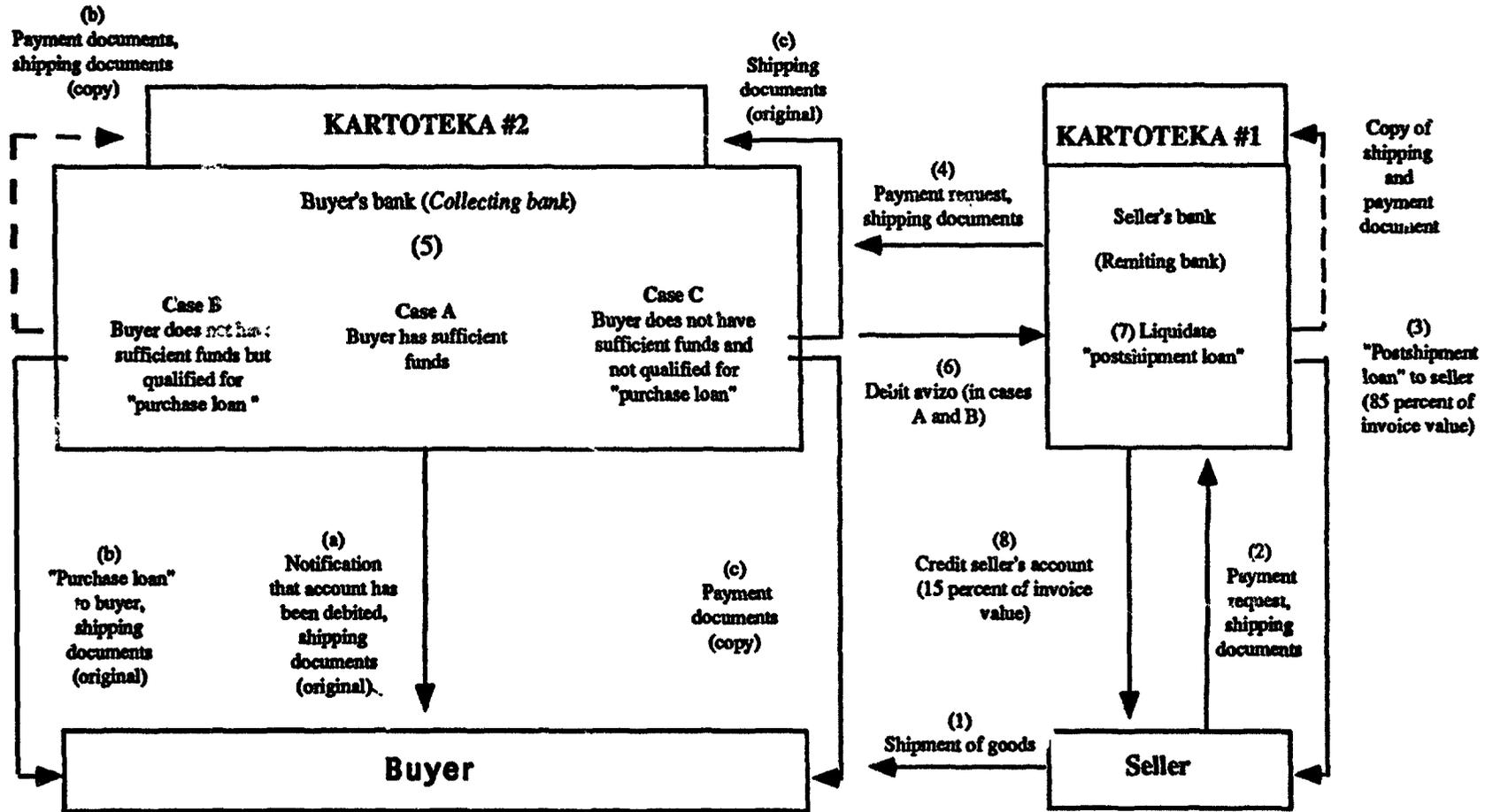
Payment request

5.6 In theory, payment requests were designed to ensure that transfer of funds between enterprises were tied to trade transactions; that suppliers received payment for delivered goods only if they met conditions of the relevant trade contracts (suppliers filed payment documents to the bank for collection along with shipping documents and the respective contracts with their buyers); and that buyers would pay for their purchases (banks arbitrarily debited the account of the buyer). Payment requests also served as a mechanism for disbursement of transaction-based loans to trading enterprises, depending on need and eligibility.

5.7 The payment request mechanism and related finance is outlined in figure 5.1 and the key points are summarized as follows. The supplier shipped goods to the buyer, but released shipping documents to the buyer's bank along with the request for collection payment (payment request). To ensure immediate payment to the seller, the seller's bank automatically² granted a *postshipment loan* at the time the payment request (backed by shipping documents) was submitted by the supplier. The postshipment loan used to be up to 85 percent of the invoice value (meant to reflect the underlying cost of the merchandise). The supplier's bank registered the loan in a card file (Kartoteka #1) and extinguished it on receipt of actual payment from the buyer. On receipt of payment the bank credited the remaining 15 percent of the proceeds to the supplier's current account.

5.8 The buyer's bank took one of three actions on receipt of the payment request from the supplier's bank. First, the buyer's bank automatically debited the buyer's account if there were sufficient funds, released the shipping documents (confirming title of ownership for the goods) to the buyer, and sent a form called a debit avizo to the supplier's bank notifying that the payment request had been honored. Second, if the buyer had insufficient funds but was within credit ceilings, the buyer's bank extended a purchase loan (by honoring the supplier's payment request), released the shipping documents, placed copies of the shipping and payment documents to another card file (Kartoteka #2) for recording the buyer's outstanding loans, and sent the debit avizo to the supplier's bank. Third, if the buyer had insufficient funds and was above the credit ceiling, the buyer's bank held the shipping documents (along with the payment request) in Kartoteka #2 and did not honor the payment request of the supplier. In this case the supplier's bank had to roll over the postshipment loan to the supplier (backed in Kartoteka #1) until the buyer was in a position to pay. The third option was rarely used as the buyer's bank usually provided a loan, under pressure from the planning authorities.

Figure 5.1 Payment request



5.9 In theory, the payment request method protected both trading partners from risks of nonpayment and nonperformance; buyers were protected because settlement was tied to satisfaction in terms of delivery and quality of goods, and suppliers were protected because the buyer's bank was responsible for collection of payment and released documents to the buyer only against payment or a loan. The card file Kartoteka #2 (considered interenterprise arrears) was maintained at a manageable level when there was macroeconomic stability or when the banking system was able to accommodate a flexible adjustment of the banks' credit ceilings. Even if interenterprise arrears accumulated, sellers could receive payment as long as the seller's banks were able to grant a postshipment loan. The only risk taker in this scheme was the buyer's bank when it was forced to grant loans to its client beyond prudential limits. However, the State Bank periodically wrote off this bad debt and received compensation from the budget.

5.10 It is clear from the above summary of the payment request mechanism that sight payments were guaranteed by the State Bank for all trade-related payments. No advance or deferred payments were allowed or were necessary (payment delays associated with Kartoteka #2 occurred after shipments were received by buyers). The following are the key features of the FSU payment system:

- *No interenterprise credit.* Selling on credit was not allowed as part of a trade contract because all traders had to make sight payments based on noncash rubles through the State Bank. In general, such credit was not necessary because the State Bank assured sight payments for all trade transactions.
- *No nonpayment risks for buyers.* Sellers did not have to worry about buyers' nonpayment risks because the State Bank served as the guarantor of sight payments (and ultimate settlements) for sales transactions.
- *No nonperformance risk of sellers.* In theory, buyers did not have to worry about nonperformance of the sellers since the State Bank did not allow final settlement of the trade transaction to be made unless the buyer was satisfied with the delivered goods. Of course, in a sellers market of chronic shortages, buyers seldom refused delivery of sub-standard goods.
- *Trade transaction-based finance.* The system automatically provided preshipment and postshipment finance based on the trade transaction. Other preshipment financing needs of enterprises were met by their own working capital (the share of working capital in total capital was usually 50 to 60 percent).
- *Self-liquidating finance.* Trade transaction-based loans under the centrally planned system were self-liquidating. For example, a postshipment loan granted by the seller's branch of the State Bank was liquidated by the buyer's payment (possibly based on a purchase loan).
- *Trade contract enforcement.* Since trade contracts were part of the state plan, the stability of trade contract enforcement was maintained as long as the planning system was intact. In a way the banking system was the final guarantor of maintaining stability in trade contract enforcement through its operation in the trade-related methods of payments and trade transaction-based finance.
- *Budget bail-out and ultimate debiting.* The payment procedures underlying the payment request method was similar to those of the documentary collection method, used in developed countries. However, because production targets usually took precedence over financial concerns, enterprises were forced to supply buyers irrespective of their solvency, and banks were instructed to grant loans to their clients beyond prudential limits to keep production process going. The system worked because the state budget internalized all risks and bailed out the State Bank. Also, branches of the State Bank had the right to ultimately debit accounts of their clients as assurance of sight payment to suppliers or repayment of debt to the banks.

Fund transfer mechanisms

5.11 The CBR Decree of July 1992 prohibited direct fund transfers between the regional cash clearing centers of the FSU countries, and required that fund transfers be made through the FSU Central Banks' correspondence accounts in order to prevent the spillover of inflation from the FSU countries. As the FSU countries created their own currencies, the inflation spillover risk through single noncash ruble was eliminated, and therefore the above restrictions on fund transfers have been relaxed, giving more autonomy to commercial banks' correspondence accounts. Efforts have also been made to reduce intercity and inter-FSU fund transfer delays through the wider utilization of commercial banks' direct correspondence accounts and the more mechanized facilities (see details in chapter 3).

International trade

5.12 As part of the FSU, Russia's foreign trade was carried out on the basis of the Export-Import Plan that was part of Gosplan. Such trade can be classified into two categories—nonarms-length trade and arms-length trade. The methods of payments and trade finance were markedly different between these two categories.

Nonarms-length trade

5.13 Nonarms-length trade accounted for the bulk of FSU trade with the rest of the world (with a share of about 85 percent). The bulk of nonarms-length trade was with the CMEA countries and relied on a multilateral clearing arrangement based on an artificial currency (transferable ruble). Trade with countries such as China, Finland, and India relied on bilateral clearing mechanisms with Vnesheconombank (VEB). This bank was created in the 1930s as a specialized branch of the State Bank. A small amount of trade was with political and military allies of the FSU (such as Libya and Vietnam) and relied either on long-term soft state credits or grants, usually paid in kind (in other words, a variation of barter).

5.14 **TRADE WITH CMEA.** Trade with CMEA was based on annual bilateral intergovernmental protocols in which the respective governments agreed to supply certain quantities of listed goods. The International Bank for Economic Cooperation (IBEC), which was specially created for payment settlements and for financing CMEA trade, counted each transaction in transferable rubles, crediting and debiting correspondent accounts held in the IBEC by authorized national banks. If required, IBEC provided automatic short-term crediting (which subsequently could be rolled over and even converted to the medium- and long-term loans) in transferable rubles of any overdraft run by a member country as a result of unbalanced bilateral trade. The main method of payment used by foreign trading organizations (FTOs) in trade with CMEA partners was very similar to that used in domestic trade—a payment request with subsequent acceptance. After the shipment of goods to a foreign buyer by a domestic producer the FTO created its own invoice based on CMEA prices, and submitted this along with the shipping documents to VEB. VEB immediately paid rubles to the FTO at the official rate between the transferable ruble and the ruble. At this stage the transaction was over for the exporter. VEB immediately sent documents to the bank of the importer. In turn, the importer's bank automatically debited the invoice value in local currency (at the official exchange rate of transferable ruble to the ruble) from the importer's account and subsequently passed on the shipping documents. The claims of VEB against the importer's bank were settled by IBEC through crediting VEB's correspondent account against the authorized bank of the importer in transferable ruble. Upon receiving documents from the authorized bank, the importer had the right to deny payment within fourteen days.

5.15 **BILATERAL ARRANGEMENTS.** Unlike the CMEA arrangements, bilateral clearing agreements did not rely on any credit institutions such as the IBEC. Any bilateral overdraft beyond certain swing limits was to be settled either in convertible currency or by an additional supply of merchandise. In bilateral clearing agreements with former socialist countries, FTOs and VEB relied on the same payment request method as in trade with CMEA. In clearing agreements with nonsocialist countries the prevailing method of payment was documentary collection. VEB required letters of guarantees from reputable banks in support of all bills drawn on foreign buyers. When FSU enterprises shipped goods to their counterparts in allied countries on the basis of intergovernmental credit agreements (usually machinery, equipment, and military hardware) VEB received ruble payments directly from the Ministry of Finance immediately after the shipment. Importers were meant to pay their governments, which in turn settled with the Ministry of Finance of the FSU. The Ministry of Finance authorized FTOs to collect payments in kind and to distribute any received goods (such as tropical fruits and sugar) among final consumers at domestic prices.

Arms-length trade

5.16 Only some 15 percent of FSU trade was undertaken with hard currency partners. This trade relied mainly on modern methods of payments, and the major items of FSU exports to these markets were energy, timber, gold, and munitions. The FSU imported mostly food, machinery, steel, and fertilizers; most of the payments for FSU trade with these countries were settled by documentary collection. VEB usually required letters of guarantees from reputable banks to support bills drawn on foreign buyers. The bank provided such letters for FSU buyers upon request from foreign suppliers. A relatively small part of such trade was conducted on the basis of documentary credit; the rest was paid on open account and through other methods (other than bills). Due to the state monopoly on foreign trade and foreign exchange, international partners perceived the financial obligations of FTOs and VEB as undertakings of the government. Therefore, foreign suppliers trusted their FSU partners and usually did not require anything in addition to acceptance by FTOs. Letter of credit were largely required if the length of credit provided to the FSU buyers exceeded the usual three- to six-month terms of commercial crediting. Suppliers were satisfied with letters of credit opened by the VEB and usually did not seek confirmation by foreign banks. A brief overview of the main methods of payment in arms-length trade is provided in box 5.1.

Trade finance

5.17 As mentioned earlier, trade intermediation was monopolized by FTOs and trade finance was monopolized by the VEB. Unlike industrial enterprises, FTOs did not have their own current assets and had to rely entirely on loans from the VEB, although these were usually disbursed automatically. In practice, VEB worked as a single clearing and crediting unit for all FTOs. The procurement of goods from domestic producers and on-selling to foreign buyers was considered by the VEB as a single export transaction. Likewise the purchase of goods from foreign suppliers and on-selling to FSU consumers was treated as a single import operation. Technically the finance of export and import operations of FTOs used to be provided through credit lines opened for them by the VEB. These credit lines were consistent with the annual credit plan of the VEB. Each FTO held an "Export Loan Account" and an "Import Loan Account" in VEB, used for disbursement for export and import goods. Financial settlements with foreign partners and multilateral agencies (such as IBEC) were managed by the VEB on behalf of FTOs. The ruble equivalent of these payments were entered by the VEB either to export or import loan accounts, but foreign exchange proceeds were surrendered to the account of the Ministry of Finance held in the VEB.

Box 5.1 Terminology in payments and trade finance

Different methods of payments

Specifying particular methods of payment is a key component of a trade contract. Concerns about risks of contract enforcement (that is, buyers' nonpayment or nonpurchase risk or seller's nondelivery risks) lead to certain method of payment. So does the availability of preshipment and postshipment financing for both the buyer and the seller. Therefore, many methods of payments are geared to meet trade financing needs. The main methods of payment include documentary collection; documentary credit; cash against delivery; advance payment; and barter.

Documentary collection and documentary credits protect both sellers and buyers against various risks of nonperformance. Under *documentary collection* the shipping documents are sent from the seller to the buyer's bank. The buyer's bank releases the documents after the buyer pays a bill of exchange. This can be either a document against payment or acceptance. A bill of exchange is a legal, negotiable document requesting payment at a fixed time to the seller. A letter of credit is a document issued by a bank on behalf of the buyer declaring acceptance or payment of a bill of exchange drawn on by the seller as long as delivery and shipping conditions have been met. Such a transaction is called *documentary credit*. The main benefit of these forms of payment is that they provide protection for both the buyer and the seller. The cost is that these methods are relatively expensive because they are time-consuming and involve more work.

Composition of trade finance

Trade finance is composed of export (or sales) finance and import (or purchase) finance. Export finance is composed of preshipment finance, short-term postshipment finance, and medium- or long-term postshipment finance. In turn, preshipment export finance is composed of production finance, inventory finance, import finance, and domestic input purchase finance. These trade finance needs can be met by self-finance, interfirm credit, bank loans, or bank credit.

5.18 **NONARMS-LENGTH TRADE.** Because the payments request method was used in trade with CMEA and other socialist countries, the finance mechanism was similar to domestic trade finance. In export transactions the VEB provided loans to FTOs to procure goods, but expected foreign buyers to pay as soon as shipping and payment documents arrived. The buyer's bank provided import loans to its client, in local currency. The total trade balance between the FSU and partner countries was financed by the IBEC in transferable rubles or directly by the VEB (in the case of bilateral clearing arrangements) in the form of technical credit in rubles. These had to be extinguished during the next reporting period by the supply of additional goods.

5.19 **EXPORT FINANCE UNDER ARMS-LENGTH TRADE.** In trade with hard currency markets, the VEB provided regular short- and long-term postshipment and import finance for FTOs; and in the late 1980s for large state-owned enterprises (SOEs). As the share of manufactured goods in FSU exports to hard currency markets was small, the percentage of export letters of credit in total trade was negligible. Long-term postshipment finance was provided by the VEB for the sales of munitions and construction of military installations. Long-term loans comprised the bulk of trade finance. The risks of nonpayment by buyers from developed countries were low, because FTOs dealt with large reputable companies that

had long-term traditional relations with the FSU. The risks of nonpayment by the buyers from developing countries were somewhat higher, but in order to enforce payment the FSU exercised political pressure. All risks of nonpayment were internationalized by the VEB (and thereby the budget).

5.20 IMPORT FINANCE UNDER ARMS-LENGTH TRADE. Short-term import finance was available for FTOs from the VEB, which sometimes opened three- to six-month letters of credit. In many cases foreign suppliers relied on documentary collection and sometimes required letters of guarantee from the VEB. The VEB also provided medium- and longer-term import finance. Given the high percentage of machinery in FSU imports, two- to three-year import loans took the largest share in the VEB's import finance. Until 1988 the VEB provided import finance only for those goods that were in the Export-Import Plan and, hence, were paid by the government. From 1988 the VEB also started to provide import finance of machinery and equipment purchased by SOEs beyond the target of the Export-Import Plan. Under pressure from industrial ministries and communist party leaders VEB provided import credit guarantees and foreign exchange loans for SOEs. However, the VEB could not back these loans by collateral, because SOEs did not have property and the government did not provide guarantees of repayment. Because SOEs were not under the tight budget constraints and were accustomed to obtain imported equipment at a subsidized rate, many of them purchased excess equipment and could not use them efficiently. As a result, the loans were not paid, resulting in VEB's bankruptcy.

Methods of payments and trade finance in Russia during 1992-93

Collapse of the FSU system

5.21 The FSU system could maintain stability in contract enforcement as long as the banking system could serve as the final guarantor. But such a guarantee was possible only to the extent that internal consistency in the State Plan was maintained and there was macro stability. With the breakup of the FSU, it became evident that these conditions could not be maintained. On the one hand, the rigid methods of payment that did not allow enterprise autonomy became incompatible with the overall direction of reforming the economy in a market-oriented direction. On the other hand, the banking system was losing its capacity to serve as the final guarantor of trade contract enforcement. The tight monetary policy of early 1992 coupled with price liberalization caused unmanageable strains on the payments system.

5.22 Since mid-1992 the banking system no longer provided contract enforcement services, resulting in a decline in documentary methods of payment and a rapid growth of "risky" methods such as advanced payments and cash on delivery. As a result, primitive methods of payment such as barter, cash and interenterprise clearing expanded in order to circumvent the banking system. At the same time the replacement of central interbank settlement by the system of Cash Settlement Centers (CSCs) resulted in delays of fund transfer in intercity and especially in interstate settlements.³ The spillover of inflation between the former republics and stoppages of interstate payments after the introduction of direct correspondent accounts further aggravated settlement delays. In trade finance rapid growth of enterprise-to-enterprise credit resulted in huge interenterprise arrears. More generally, transaction-based banking finance was replaced by general loans of commercial banks and targeted loans by the central bank.

5.23 The collapse of the FSU also resulted in a rapid decline in nonarms-length trade with CMEA countries and other bilateral agreement countries. At the same time part of what was before domestic trade became foreign trade with the FSU countries. As mentioned in chapter 3, this trade was governed largely by intergovernment agreements and settlement was made through central bank correspondent accounts. The monopoly on foreign trade by FTCs was abolished and the whole trading system was shaken by the bankruptcy of the VEB. A new bank, Vneshtorgbank (VTB) was established to absorb the activities of VEB.

Changes after the CBR decree of July 1992

5.24 Due to undeveloped factor markets and a lack of credible bankruptcy procedures, price liberalization in early 1992 led to inflation rather than restructuring. Enterprises thwarted the tight money policy at that time by relying heavily on interenterprise credits, which ultimately led to huge arrears (credit creation was much lower than inflation). The growth of arrears was evident in the various card files in the banking system (Kartoteka #2 grew very quickly and this triggered the growth of Kartoteka #1). The old payment request method fueled the growth in arrears as it did not stimulate suppliers to check the credibility of their partners who continued to expect the banking system to collect payments from buyers. The new commercial banks did not want to finance the card files and shifted the burden of arrears to trading enterprises.

CBR decree of July 1992

5.25 In order to relieve the burden of responsibility for collecting payments from the banking system and at the same time to enhance the responsibility of suppliers in assessing the credibility of buyers, as of July 1992 the CBR prohibited commercial banks from debiting accounts of their clients unless written permission (called a *payment order*) was received from the owner of the account. This action reflected the government's recognition of the collapse of the old system. In essence, it attempted to allow complete autonomy of enterprises and banks in choosing their methods of payment for trade. The centerpiece of the decree was the "payment order" scheme (discussed below). The most positive aspect of the old system—the critical role of banks as remitting and collecting agents for sellers—was eliminated. Mistakenly, the CBR did not take any initiatives aimed at encouraging banks to facilitate trade contract enforcement or to provide trade transaction-based finance.

Payment order scheme

5.26 The payment order scheme is no more than a means of transferring funds from one bank account to another, based on the instructions of the account holder. Banks react to enterprise requests to make payments to sellers, without concern for the underlying trade contract. This would be harmless in achieving stability in trade contract enforcement as long as most of the trading partners relying on the payment order scheme are related parties of the same enterprise or different enterprises that have built trust through long business relations under a market environment. However, most enterprises do not belong to these categories and therefore the scheme has not contributed to reducing the instability in trade contract enforcement created by the collapse of the FSU.

Resort to primitive methods of payment

5.27 The most common method of payment for domestic and interstate trade under the payment order scheme have been advance payments forced by monopoly sellers. In this case sellers protect themselves against the potential risk of buyers' nonpayment. However, buyers have suffered because of sellers' nonperformance risks and the lack of trade finance. The second most widely used method of payment has been the combination of cash on delivery and differed payments imposed on weak sellers with huge inventories by buyers who do not have enough working capital. The various types of risks faced by buyers and sellers under different payment methods are summarized in table 5.1.

5.28 The payments order scheme has contributed to the build-up in interenterprise arrears because sellers have not been protected against buyers' nonpayment risks. These arrears have been more serious in trade with the FSU countries than in domestic trade—for example as of January 1993, there was a debt of 700 billion rubles by Russian enterprises to Ukraine enterprises, and a debt of 200 billion rubles by Ukraine enterprises to Russian enterprises. In turn, a significant portion of domestic and trade between the FSU countries has been carried out outside the banking system (through barter and direct cash payments). The share of barter trade was more than half of the interstate trade. A further 5 to 10 percent of interstate trade was carried out under cash and other payment settlement means. In other words, only about one-third of interstate trade was carried out by the banking system.

5.29 **FUND TRANSFER MECHANISMS.** The mechanisms of fund transfer were changed in 1991 after the monobank system was abolished and commercial banks were allowed. The CBR continued to be the only clearing center for all noncash payments. Some of the branches of the former State Bank were transformed into 1,400 regional cash settlement centers throughout Russia. These now clear noncash payments between banks and, hence, control credit created by commercial banks.⁴ In effect banks no longer clear payments by themselves but have to go through an additional tier, as cash settlement centers enter every transaction. As a result the clearing process takes much longer than before. Given the vast territory of the country and the fact that transfer of large noncash funds relies on paper delivery, introduction of the new clearing mechanism has resulted in delays of three to four weeks in intercity payments (compared to delays of three to seven days in 1991). Delays in interstate transfers are even longer. They also resulted in a huge credit float in favor of the CBR which, in a highly inflationary environment, is disastrous for the liquidity of enterprises, confidence in trade contracts, and certainty of receiving payments.

5.30 The CBR decree of July 1992 prohibited direct fund transfers between regional cash clearing centers of the FSU countries, and required that fund transfers had to be through the FSU Central Banks' correspondence accounts in order to prevent the spillover of inflation from the FSU countries. As the FSU countries created their own currencies, the inflation spillover risk through single noncash ruble was eliminated, and therefore the above restrictions on interstate fund transfers have been relaxed, giving more autonomy to commercial banks' correspondence accounts across FSU countries as well as inside Russia. Efforts have also been made to reduce intercity and interstate fund transfer delays through the wider utilization of commercial banks' direct correspondence accounts and the more mechanized facilities (see details in chapter 3).

Table 5.1 Payment risks

<i>Method of payment</i>	<i>Risk of nonpurchasing (supplier's risk)</i>	<i>Risk of nonpayment (supplier's risk)</i>	<i>Risk of nonperformance (buyer's risk)</i>
Advance payment	no	no	yes
Cash on delivery	yes	yes	no
Payment request	yes	no	no
Documentary collection:			
-against payment	yes	no	no
-against acceptance	yes	yes	no
Documentary credit	no	no	no

5.31 The collapse of the FSU banking system also eliminated the previous system of transaction-based trade finance. It is estimated that more than half of most enterprises' domestic and interstate trade finance needs have been met by involuntary interenterprise credits. About half of these credits have been transformed into interenterprise arrears. The remaining trade finance needs have been met by a combination of self-finance and bank loans. Commercial banks have not yet established a system of granting loans based on careful screening and project profitability or loan payback criteria. Likewise they have not yet begun to grant loans based on self-liquidating trade transactions even though this would be one of the best ways to select loans (discussed in more detail below). So far Russian banks have relied on three main ways to grant loans—pressure from shareholders; loan guarantees of insurance companies or foreign exchange collateral; and transmitting CBR's directed loans. The CBR has never supplied funds to banks based on the above market criteria or through discount windows. Its fund supply has been primarily based on targeted loans to specific sectors or enterprises at a subsidized interest rate.

Methods of payments and trade finance for third-country trade

Methods of payments

5.32 Exact data on the proportion of payments handled by Russian banks on behalf of Russian exporters and importers in third-country trade is not available. Various assessments suggest that foreign banks provide from 10 to 40 percent of payment services for Russian enterprises trading with third countries beyond the official credit lines of Western government and multilateral credit agencies. Almost all import payments made from offshore accounts are advance payments, while a fairly large percentage of offshore export payments are cash-on-delivery. The bulk of settlements made from Russia were undertaken by two banks—Vneshtorgbank (VTB) and the International Moscow Business Bank.

5.33 **IMPORT PAYMENTS.** In 1992 about 90 percent of import payments made by Russian banks on behalf of Russian enterprises were advance payments. One reason for such a large percentage of advanced payments is the inability of most Russian banks to provide letter of credit services in international payments. Because foreign suppliers don't trust letters of credits issued by Russian commercial banks, they always require confirmation by Western banks, which, in turn, also don't have confidence in most of the Russian banks and therefore require full deposit from them. Few Russian commercial banks have well-developed correspondent relations with foreign banks or belong to international electronic networks. In general most Russian banks lack the technical abilities to transfer funds for confirmation of their letters of credit quickly enough. Indeed only two Russian banks, the VTB and International Moscow Business Bank (a joint venture), provide a major part of letter or credit

services. Because Russian foreign exchange legislation prohibits payment of more than 30 percent of import contracts in advance, the inability of banks to provide letter of credit services provides an additional stimulus for enterprises to hold their assets abroad.

5.34 EXPORT PAYMENTS. In contrast to imports, the majority of export payments (about 60 percent) are cash-on-delivery, with about 30 percent being sight letter of credits, and the rest usance letter of credits. The low share of usance letter of credits is due to the minor percentage of manufacturing exports (which usually require sales on a deferred basis) and the inability of the banking system to finance exporters willing to sell on credit. Russian exporters, in turn, are so desperate to sell their usually uncompetitive goods for hard currency that they are willing to take the risk of nonpayment by foreign buyers even when exporting to areas of higher commercial risk (such as to developing countries and to Eastern Europe). Therefore, the existing pattern of export payments imposes on exporters the extra risk of nonpayment by foreign buyers due to the low bargaining power of Russian suppliers. This worsens the competitiveness of manufacturing exporters and deprives them of the chance to sell on credit.

Trade finance

5.35 In sequencing market-oriented reforms a high priority should be attached to developing the modern trade finance instruments and institutions. The CBR has allocated loans directly to selected sectors and enterprises (at low interest rates) rather than through rediscount mechanisms. Almost half of the total ruble loans were created by the CBR in the form of targeted loans to finance working capital of large state-owned enterprises. Most of these loans were disbursed at a subsidized rate of 8 to 20 percent through commercial banks which were directed to pass on these funds to specified recipients. The directed credit programs should be replaced by a discount window or credit auctions.

5.36 The first step to market-based banking is to ensure that projects and borrowers are selected on market principles. Banks must decide which projects are likely to yield the highest return, or are most likely to yield sufficient returns to enable borrowers to repay. The second step is to ensure monitoring of the proper use of loans in order to ensure that they will be repaid. Due to imperfect information on projects and borrowers, banks are often unable to apply market principles properly for their lending operations. However, trade finance has characteristics that can help overcome these drawbacks. Specifically short-term trade finance is fundamentally different from other types of finance because it is trade transaction-based and self-liquidating. Backed by modern settlement instruments, it is similar to fully collateralized bank lending. Another benefit of trade finance is that it is neutral with respect to particular productive sectors. Consequently, implementing the so-called *real bills doctrine* at the initial stage of reform is critical.⁵ Cross-country experience with the real bills doctrine is outlined in box 5.2.

5.37 Due to the underdeveloped banking system, enterprises face difficulties in accessing trade finance. Even those enterprises that have received confirmed letters of credit from hard currency markets may not be able to fill export orders due to difficulties in accessing trade finance. Providing such access is critical for developing enterprise-to-enterprise trade under market prices. Cross-country experience in the role of government in establishing instruments and institutions for trade finance mechanisms is discussed in box 5.3. Easing the bottlenecks in trade finance are discussed below.

Box 5.2 Real bills doctrine

U.K. experience

Bill discounting and rediscounting have been two of the most important activities of the Bank of England since its foundation. The rediscount policy of the Bank of England in the early 19th century was guided by two principles—the ultimate responsibility of a central bank to meet the short-term liquidity needs of business through discounts and rediscounts of bills; and the responsibility of a the central bank to prevent speculation and overheating of the economy. In essence, the real bills doctrine guided the Bank of England's monetary policy as well as bills discounting and rediscounting policy in the early 19th century.

U.S. experience

The real bills doctrine had been at the heart of the discussions on banking reform even before the Federal Reserve system (FRS) was created. The ostensibly decentralized structure of the FRS as enacted in 1914 was theoretically justified by this doctrine—the principle of the self-regulating character of a system of note issue founded on banks' investment in short-term self-liquidating papers arising from the normal conduct of production and trade. Even though the original eligibility requirements for FR rediscounting have been relaxed considerably, part of the real bills doctrine survives in the provision that FR banks may rediscount or take as security only short-term, self-liquidating paper. In short, in both the United Kingdom and the United States rediscounting based on trade bills has received a high priority so as not to create excess liquidity.

5.38 EXPORT FINANCE. The infant stage of Russia's domestic trade finance extends to foreign trade finance as well. There are few problems for those fortunate enterprises that have access to CBR sector loans or to commercial bank loans allocated to share holders (or collateralized by insurance company guarantees). Those not in this position find it difficult to fulfill export orders backed by confirmed letters of credit, because the system of transaction-based short-term preshipment finance has not been developed. Importantly, Russian banks lack the capacity to extend short-term foreign currency import finance, partly because the CBR has not developed a rediscount mechanism. Some commercial banks grant short-term foreign currency loans, but at interest rates two to three times above international rates. Few commercial banks have had experience with bill discounting even though this is the easiest and surest financing mechanism. Similarly, the CBR lacks experience with export letter of credit-related bill rediscounting. Commercial banks are unable to grant longer-term postshipment financing or foreign currency import financing (for manufactured exporters' machinery import).

5.39 IMPORT FINANCE. Russian importers have paid in advance for most imports and lacked access to import finance. On the few occasions that overseas suppliers have extended documentary credits, Russian enterprises have had to make full deposits at commercial banks before opening import letters of credit. In general, Russian importers have lacked access to postshipment finance provided by foreign shippers. The only notable import finance has been that provided by (or guaranteed by) Western export credit or credit insurance agencies (often counter-guaranteed by the VTB). Even these sources of import finance have been drying up due to difficulties in honoring payment schedules.

Box 5.3 Bill-based trade finance

In the United Kingdom, where bill discounting was the genesis of commercial banking and where the discount market emerged naturally as a consequence of the growth of trade, the role of the government was critical in developing the money market. It provided a proper regulatory framework, through such means as the Bill of Exchange Act, and supplied needed funds as lender of last resort, through such means as bill rediscounting and open market operations. In the United States the Federal Reserve Board also attempted to stimulate the market for trade financing through rediscounting schemes. The Board also provided a framework for transaction-based, self-liquidating trade financing by issuing criteria and regulations for eligibility for rediscounting and accepting bills as security. Likewise the role played by the Bank of Japan in trade financing during 1950 to 1970 was critical, because of the virtual nonexistence markets for various bills.

An equally important aspect of trade financing relates to the handling of the risks of exporter nonperformance and buyer nonpayment, which is critical in assuring access to trade financing. The information function (that is, collection and dissemination of information on overseas buyers and traders, including indirect exporters) carried out by merchant banks and trading companies in Japan was as critical as the provision of financial resources. The British and Japanese experience confirms that the capacity of banks and trading companies to trust traders is critical for credit-based trade financing. In turn, that capacity stems from a willingness and capability to know traders, as well as a capacity to sustain unexpected temporary financial losses.

Trade credit insurance and guarantee schemes

5.40 EXPORT CREDIT INSURANCE. A draft law on State Insurance/Guarantee of Export Credits has been drafted, but not yet enacted. It foreshadows the creation of a special fund for this purpose with contributions from the State Bank, Ministry of Finance, and the state-owned insurance company Gosstrakh. Because turnkey plants and capital equipment exports need export credit insurance and guarantee coverage, the government's Manufactured Export Development Strategy Paper proposes the creation of an export credit insurance and guarantee scheme (see chapter 4). Such an initiative is desirable but will require considerable institution-building and funds. The only organization which has some experience with export credit insurance is Ingosstrakh, an affiliate of Gosstrakh, but Ingosstrakh is inactive in this field due to a lack of funds.

5.41 IMPORT CREDIT GUARANTEE. In time the commercial banking system should be able to take care of import payment guarantees. For this reason the authorities should implement measures to make Russian commercial banks more creditworthy and to improve their reputation in the trading community. In this way, letters of credit and other guarantees could take care of import payment guarantee needs. In the transition to a modern banking system, there may be need for the government to provide support to import guarantees. The VTB has provided finance and payment guarantees for capital goods imported under foreign credits. The risk of extending these guarantees has increased recently because of Russia's external debt problems. A preshipment export finance guarantee scheme could also include coverage for import finance.

Recommendations

Documentary methods of payments

5.42 In economies with developed market institutions, non-performance risks in trade transactions are handled through trade contract enforcement, insurance services and appropriate methods of payment. All of these elements of risk coverage are interrelated and building them is a high priority. However, in most cases this will at best be achieved in the medium term, particularly implementing the full commercial code. This report focusses on initiatives that can be taken to improve payment methods, as these can be done relatively quickly and have the added benefit of providing a building block for more efficient loan allocation based on trade transactions. Modern payment services could be provided by the existing system of commercial banks. Doing so will contribute to the development of experience and skills of Russian bankers in internationally accepted techniques of trade related payments. A start could be made with the introduction of documentary collection and credit.

5.43 Documentary methods are advisable for Russian domestic trade as a transitional instrument toward the creation of trust between enterprises and between the enterprises and the banks, and toward achieving more stable and predictable trade relations until market-oriented legal and commercial systems are in place.⁶ Risk coverage provided by these instruments is of particular importance in a country where most of the entities only have recent business relations, where the financial status of most enterprises is uncertain, and where the legal system is underdeveloped. Documentary methods are of particular importance for interstate trade where the risk of enterprise-to-enterprise trade is exacerbated by complicated political relations between FSU countries and by uncertainty stemming from persistent trade imbalances. Broader reliance on these methods in trade with third countries will enhance the competitiveness of Russian nontraditional exports, save some foreign exchange for importers, and contribute to the reduction of capital flight.

Documentary collection

5.44 The authorities should *begin by creating a document against payment (D/P) scheme*. This method will simply require changes in the order of payment and paper flow in the banking system. The paper flow will be the same as the payment request method—the supplier's bank will take the shipping documents and payment request from the supplier, mail them to the buyer's bank, and instruct the latter on the terms of releasing the documents to its client (any fees can be split by the banks). The buyer's bank will ensure that the buyer obtains title of ownership only against payment. However, unlike the old scheme, the buyer's bank will not take responsibility for payment collection. Thus banks should not have the right of ultimate debiting of accounts, as this is not in conformity with market principles. The attractiveness of such a D/P scheme is that it can be introduced immediately by way of CBR decree, and commercial banks will have few problems with implementation.

5.45 Since the D/P scheme does not allow suppliers to sell on credit—which is critical for many Russian enterprises producing manufacturing goods (especially those under conversion)—the second step could be building a *documents against acceptance (D/A) scheme*. Introducing a D/A scheme will require creating a legal instrument of enterprise-to-enterprise debt to enable banks to use it as a "promise to pay"—promissory note and/or bill of exchange. Up to the 1930s bills of exchange (and promissory

notes) had been extensively used for domestic and international trade payments in the FSU (having ratified the Geneva Conventions of 1930 and adopted the text of the Uniform Law on Bills of Exchange and Promissory Notes of 1930). Despite the gap of seventy years, the fact that the legal and administrative infrastructure for the bill of exchange system existed before in the FSU provides a justification (and confidence) to initiate immediate measures necessary to make the B/E as the cornerstone of trade-related payments could be readily implemented. In fact, the 1937 law on B/Es is still effective, and therefore there is a legal basis for the immediate implementation of this system. The benefit of both schemes is that the buyer is protected from the risk of nonperformance, because goods are received prior to payment, and the supplier is protected from the risk of nonpayment, because the bank will not release documents to the buyer unless the latter pays or accepts the payment.

5.46 To strengthen contract enforcement, the following measures could be taken: (a) providing in the new Bill of Exchange Act for bills of exchange to be backed by property; (b) creating private notary offices that offer certification of protested bills of exchange; (c) creating an interstate arbitration court (encompassing disputes about bills of exchange); (d) obliging commercial banks to expedite collection of payments from clients deemed liable to pay under court decisions; and (e) creating at commercial banks a special card file of the collection orders issued by courts or arbitration and instructing banks to debit accounts of their clients to fulfill such orders. In order to encourage commercial banks to use bills of exchange as collateral for their loans, the CBR should institute a rediscounting mechanism of bills of exchange (this would be a first step to developing bills of exchange as money market instruments).

5.47 Unfortunately, documentary collection methods do not protect suppliers from the risk of nonpurchase by buyers (see table 5.1). In order to lessen this risk, a *documentary credit (L/C) method of payment should be developed*. Technically, the major difference between documentary collection and documentary credit is that a bank, not the buyer, guarantees that payment will be made (if the supplier performs). Once a letter of credit is opened, the issuing bank must pay even if the buyer withdraws. As in documentary collection, it is easier to begin with building a mechanism where the bank guarantees immediate payment on delivery (sight letter of credit). As banks accumulate the credit history of their clients, they will be in a position to guarantee payments of their customers at a future date (usance L/C).

5.48 In order to develop sight letters of credit, a two-step approach may be considered. At first, if a supplier trusts the buyer's bank, The letter of credit scheme can be considered as a modified version of the existing payment request-order scheme in which the buyer's bank opens sight L/Cs by blocking the relevant funds on the current account of the buyer. The issuing bank would require a full deposit from the buyer, remit the payable funds to the supplier's bank, and deposit them on on-call correspondent accounts.⁷ This scheme will tie up the funds of the buyer (which it would pay anyway in the case of advance payment), but will offer protection from seller's nonperformance risk. As a second step, as trust between reputable banks is built, these banks will be in a position to confirm each other's letters of credit without asking for prior deposit of funds. This will allow the banks not to rely on collateral to open letters of credit (as opposed to blocking funds). Moreover, the CBR could facilitate the use of letter of credit mechanisms by revising the Decree of July 1992 so as to make them internationally accepted (in line with International Chamber of Commerce standards). Accepted bills could be used as money market instruments.

Export finance

Export finance

5.49 The emphasis should be implementing a rediscounting mechanism by the CBR for pre- and post shipment export loans (or domestic sales loans) granted by commercial banks. In order to have confidence that only performing loans are rediscounted, the CBR should rediscount only those loans backed by export or domestic sales letters of credit, bills of exchange, and other negotiable instruments. While domestic bills of exchange and letters of credit are being developed, the CBR can provide on-call refinancing loans to commercial banks backed by available transitional documentary instruments. As Russian exporters and commercial banks establish a network of foreign clients, the CBR will be able to rediscount and negotiate nonconfirmed papers as well.

5.50 The most important element of preshipment export finance in Russia is the finance of imported parts, semi-finished products, and raw materials for manufactured export production. It may be desirable for the government to establish a short-term foreign currency import loan scheme for manufactured exporters. In chapter 5 it is suggested that consideration be given to the establishment of a longer-term import finance scheme in order to support imports of capital goods for the purposes of manufactured exports.

Longer-term postshipment finance

5.51 The government's Manufactured Export Development Strategy Paper proposes the establishment of a Russian Export-Import Bank (EXIM Bank) for the purpose of granting medium/long-term postshipment loans for turnkey plant and other heavy equipment exports based on deferred payments. In chapter 5, it is recommended that in view of the time required to build such institution, the task be treated as a medium- to long-term goal. In addition, the capacity of the proposed Russian Bank for Reconstruction and Development to provide long-term preshipment finance could be developed (as outlined in the government's Manufactured Export Development Strategy Paper). However, these banks (which inevitably will be state-owned) should not simply substitute the role of the dismantled State Bank, that financed heavy machinery exports in the past. Doing so will simply preserve an inefficient export structure and most likely lead to bad debts. Given the small capital base of the proposed banks, initially these institutions should focus on providing guarantees for commercial bank loans, rather than on disbursing funds directly to borrowers.

Import finance

Buyer's usance system

5.52 In the case of a shipper's usance letter of credit, postshipment finance is provided by the shipper. However, in the case of a buyer's usance letter of credit, the shipper receives the sight payment. Therefore, short-term postshipment finance must be provided by the banker's acceptance (created by the usance letter of credit) discounting bank. This scheme is called as a domestic usance system in some countries. It is recommended that the CBR provide a rediscounting mechanism for the banker's acceptance created by buyer's usance.

Export credit insurance/guarantee

5.53 The government's Manufactured Export Development Strategy Paper proposed the creation of an export credit insurance/guarantee agency. In chapter 4, it is recommended that the creation of such an agency should be considered as a medium-term task in view of the preparation and feasibility studies needed. It is recommended that the feasibility study include a review of the need for and operational feasibility of import finance guarantees as part of pre-shipment export finance guarantees in addition to the review of the main activities of an export credit insurance/guarantee agency designed to protect exporters and bankers against buyers' nonpayment risks.

Institution-building tasks

Commercial banks

5.54 The World Bank has recently recommended that International Standard Banks (ISBs) should form the core of the new financial system. ISBs would finance successful private firms and highly creditworthy public enterprises under a special incentive structure applied to carefully selected banks. One of the important requirements that individual banks must meet in order to qualify as ISBs should be the potential and willingness to build the capability to implement modern methods of payment and the related trade finance mechanisms (summarized in table 5.1). Ultimately all commercial bankers must be asked to handle modern methods of payments and related trade finance mechanisms. However, the use of CBR rediscount mechanisms should be limited initially to ISBs in order to prevent any risk of the misuse of the mechanism. Also, the initial handling of the proposed import finance schemes should be limited to ISBs.

Central Bank of Russia (CBR)

5.55 The CBR needs to play a catalytic role in developing a medium-term strategy for modernizing payment methods and trade finance mechanisms. First, it needs to lay a foundation for the legal and administrative framework for modern methods of payment and trade finance. Second, the CBR needs to play a leadership role in building the capacity of the ISBs and commercial banks to handle these mechanisms. It should also assist the operation of the proposed Short-Term and Medium/Long-Term Import Finance Funds. Third, the CBR must serve as the lender of last resort for banker's acceptance, bill of exchange rediscounting, and other trade finance, as well as the guarantor of hard currencies for high-priority import letters of credit opened by Russian banks.

Import Finance Funds

5.56 An apex organization should be created in order to monitor the operation of any Import Finance Funds. Technical assistance may be needed to help the organization acquire skills to supervise disbursement of funds by the banking system.

Export credit insurance/guarantee

5.57 In order to establish and operate an Export Credit Insurance/Guarantee agency proposed in the government's Manufactured Export Development Strategy Paper, intensive training of staff internally or in reputable export credit insurance/guarantee agencies should be given a high priority as part of the preparation for the creation of the institution.

Notes

1. Currently Russia lacks a commercial code, bankruptcy procedures, and commercial courts. It takes up to six months to take a dispute through the limited number of state arbitration courts, which are overloaded with commercial cases. Even if the dispute is solved in arbitration there is no enforcement mechanism. There is no arbitration capacity at the inter-republican level. In turn, the lack of a commercial legal framework holds up the development of commercial insurance and keeps costs at a high level.
2. Provided that the total amount of payment loans did not exceed the quarterly credit ceiling of the bank branch and the seller's credit ceiling imposed by a predetermined ratio between own and borrowed current assets.
3. Clearing of payments between branches of the State Bank (regardless of the method of payment) was done through interbranch accounts called MFO (*mez-filialnyi oborot*). Each branch held its own memo-type MFO account and settlements were made across this account. The credit balances of MFO accounts represented the credit float; that is, money in transactions. Historically, balances of MFOs contributed about 6 to 7 percent of State Bank liabilities. Importantly the MFO system was designed to work only for clearing payments between branches of a single bank. If MFO accounts had been managed by independent banks, the latter would have been able to arbitrarily credit their MFO accounts; that is, to "create" credit resources.
4. After July 1, 1992, commercial banks were allowed to form their own clearing centers, provided, however, that either their cash settlement centers and the banks are served by one computer electronic center monitoring the payments, or that they are linked by the computing system of an electronic information exchange with their respective cash settlement centers.
5. See Ronald McKinnon, 1993, *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy*. Baltimore, Md.: The Johns Hopkins University Press.
6. Due to the tradeoff between risk exposure and cost, cash-with-order, cash-on-delivery, and open accounts are more frequently used in trade between partners having a long history of business relations, with well-known reputable companies and between branches of transnational corporations. Documentary collection and documentary credit are more common between new partners or in large transactions. Documentary methods are more widespread in international trade and trade in regions with unstable political and economic environment. In international trade they account for about 30 to 40 percent of payments. In domestic trade of major western countries documentary methods used to contribute about half of all trade related payments before modern legal and commercial systems had been developed (late last century). Nowadays their relative importance has decreased to less than 10 percent.
7. A similar mechanism is used for confirmation of Russian import letters of credit by Western banks.