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Report No. 25478

PROJECT PERFORMANCE ASSESSMENT REPORT

RUSSIAN FEDERATION

REHABILITATION LOAN
(Loan 3513-RU)

SECOND REHABILITATION LOAN
(Loan 3898-RU)

STRUCTURAL ADJUSTMENT LOAN
(Loan 4180-RU)

SECOND STRUCTURAL ADJUSTMENT LOAN
(Loan 4261-RU)

February 24, 2003

Country Evaluation and Regional Relations
Operations Evaluation Department

Currency Equivalents

Currency Unit = Ruble (Rbl)

Average Exchange Rates (Rubles per US$)

Period Average

1992	= 0.196		1997	=	5.785
1993	= 0.933		1998	=	9.705
1994	= 2.205		1999	=	24.62
1995	= 4.562		2000	=	28.129
1996	= 5.126				

Weights and Measures

Metric System

Government Fiscal Year

January 1 - December 31

World Bank Fiscal Year

July 1- June 30

Abbreviations and Acronyms

AAA	Analytical and Advisory Services
ARKO	Bank Restructuring Agency
CAE	Country Assistance Evaluation
CAS	Country Assistance Strategy
CBR	Central Bank of Russia
CIS	Commonwealth of Independent States
CEB	Central Europe and the Baltic
COMECON	Council of Mutual Economic Assistance
CPI	Consumer Price Index
CPPRs	Country Portfolio Performance Reviews
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia (Regional Office)
EFF	Extended Financing Facility
ESW	Economic and Sector Work
FDI	Foreign Direct Investment
GAO	(U.S.) General Accounting Office
GDP	Gross Domestic Product
GEF	Global Environment Facility
GKI	State Committee for the Management of State Property
GKO	Government Short-Term Securities
IAS	International Accounting Standards
IBRD	International Bank for Reconstruction and Development
ICB	International Competitive Bidding
ICRs	Implementation Completion Reports
ID	Institutional Development
IFC	International Finance Corporation
IMF	International Monetary Fund
LFS	Loans-for-Shares
MICEX	Moscow Inter-Bank Currency Exchange
MIGA	Multilateral Investment Guarantee Agency
MPP	Mass Privatization Program
NES	New Economic School
OED	Operations Evaluation Department
OEDCR	Operations Evaluation Department, Country Evaluation and Regional Relations
OFZ	Government Short-Term Securities
PPAR	Project Performance Assessment Report
RECEP	Russian European Center for Economic Policy
RL	Rehabilitation Loan
SAL	Structural Adjustment Loan
SECAL	Sectoral Adjustment Loan
SME	Small and Medium Enterprise
SOEs	State-owned Enterprises
SPAL	Social Protection Adjustment Loan
TA	Technical Assistance
WTO	World Trade Organization

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The World Bank
Washington, D.C. 20433
U.S.A.

GREGORY K. INGRAM
Director-General
Operations Evaluation

February 24, 2003

MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

SUBJECT: Project Performance Assessment Report on the Russian Federation Rehabilitation Loan (Loan 3513-RU); Second Rehabilitation Loan (Loan 3898-RU); Structural Adjustment Loan (Loan 4180-RU); and Second Structural Adjustment Loan (Loan 4261-RU)

The main objectives of the first *Rehabilitation Loan* (*RL I*; $600 million; approved in August 1992) were to support a program of macroeconomic stabilization in conjunction with the IMF, and a specific program of structural reforms necessary for market driven economy. Specifically, the loan aimed to support (a) broad trade and price liberalization; (b) a privatization program encompassing large and small scale enterprises; (c) financial sector reform; and (d) development of a more transparent legal and taxation regime. Subsidiary objectives were to familiarize the authorities with Bank lending operations, as this was the first loan to Russia, particularly with regard to procurement and disbursement procedures, and to finance critical imports necessary to forestall declines in output during the adjustment period. The objectives of the *Second Rehabilitation Loan* (*RL II*; $600 million; approved in June 1995) were similar to the first, with a stronger emphasis on trade liberalization, in particular eliminating export quotas and procedures. This operation was designed as a single tranche loan, with reforms being completed prior to Board presentation.

Progress in attaining the objectives of these loans was mixed. During the three years covered by these two operations, the government's macroeconomic stabilization program was not consistently implemented, although by the end of 1996 a measure of monetary stability was established and inflation was reduced considerably. Fiscal management was deficient with generally weak revenue mobilization and inadequate expenditure control. Substantial progress was, however, achieved in the structural reform agenda, particularly in privatization and trade and price liberalization. By the end of 1996 it was estimated that about 70 percent of GDP was generated in the private sector. Progress had also been made in introducing international standard prudential regulations and strengthening the supervision capabilities of the central bank. More limited progress had been achieved in building the requisite legal and institutional framework necessary for private sector development and in agricultural sector reforms, particularly land reform.

The objectives of the *Structural Adjustment Loan* (*SAL I*; $600 million; approved in June 1997) and the *Second Structural Adjustment Loan* (*SAL II*; $800 million; approved in December 1997) were to assist a new reform-minded Government to (a) stabilize the economy and (b) undertake over the medium term deep policy and institutional reforms aimed at having a major direct positive impact on the structural fiscal balance, at imposing financial discipline on the enterprise sector, and at advancing competitive enterprise and market development in four areas: (i) reform of natural monopolies (electric power, natural gas, and railway sectors); (ii) private sector development; (iii) fiscal reform; and (iv) banking sector reform. *SAL II* also supported (v) trade policy reform.

Their limited achievements pale compared to their shortcomings. There was virtually no implementation of the important agreed reforms, including inadequate fiscal and other policy adjustments to the deterioration in international commodity prices and to the mounting capital flight and speculative attacks on the fixed nominal exchange rate. Both 1997 and 1998 continued to be characterized by poor and deteriorating revenue collections, large capital outflows, unreformed natural monopolies, no transparent privatizations, and a banking sector with serious problems, little capacity to provide normal banking services, and increasingly vulnerable to volatility in exchange rates. *SAL II* moreover contributed to further appreciation of the real exchange rate in early 1998, and thus to the worsening of competitiveness for Russian manufacturing enterprises. The 1998 financial crisis underscored the fragility of the macroeconomic stabilization that had been achieved in the mid-1990s and the incomplete reform agenda. Transforming this large command economy had proven to be politically and economically more complex and more protracted than had been previously thought.

Given that the objectives of *RL I* were only partially achieved, OED rates its outcome as moderately satisfactory and its ID impact as modest, compared to satisfactory and substantial in the ICR review. With regard to *RL II*, while all the required policy reforms were completed prior to Board presentation, these reforms were not sufficient to forestall further declines in output. Furthermore, the monetary stabilization program was never underpinned by adequate fiscal discipline. Therefore, OED rates project outcome as moderately unsatisfactory and ID impact as negligible, compared to satisfactory and modest in the ICR review. For both rehabilitation loans, sustainability is rated as likely and Bank performance as satisfactory. For both *SALs*, OED rates outcome as unsatisfactory and ID impact as modest, but sustainability of the limited achievements as likely. Bank performance is also rated unsatisfactory. These ratings confirm those in the ICR reviews.

Several important lessons may be drawn from these projects. First, sound macroeconomic management is a pre-requisite for the positive responses expected to flow from structural reform, under all policy-based type of lending. Second, country ownership is crucial to the success of assistance. Third, in the face of a poor track record and narrow country ownership of reform, a large adjustment lending program (especially one with front-loaded disbursements) risks delaying rather than accelerating reform. Fourth, in the face of a poor track record and new consensus on a reform program, adjustment lending should be offered after the government has publicly adopted the necessary reforms or has begun implementing them. Disbursements should be backloaded and carefully modulated on the basis of solid progress in implementation, including enforcement of laws and regulations. Fifth, there needs to be strong strategic coordination and integration of actors, instruments, and interventions supporting common objectives both within the country and the Bank and among external development partners. Sixth, the Bank should not ignore in its adjustment lending the quality of public institutions and governance. Finally, the Bank should keep "windows of opportunity" in perspective, as transition and development take time.

Gregory K. Ingram

OED Mission: Enhancing development effectiveness through excellence and independence in evaluation.

About this Report

The Operations Evaluation Department assesses the programs and activities of the World Bank for two purposes: first, to ensure the integrity of the Bank's self-evaluation process and to verify that the Bank's work is producing the expected results, and second, to help develop improved directions, policies, and procedures through the dissemination of lessons drawn from experience. As part of this work, OED annually assesses about 25 percent of the Bank's lending operations. In selecting operations for assessment, preference is given to those that are innovative, large, or complex; those that are relevant to upcoming studies or country evaluations; those for which Executive Directors or Bank management have requested assessments; and those that are likely to generate important lessons. The projects, topics, and analytical approaches selected for assessment support larger evaluation studies.

A Project Performance Assessment Report (PPAR) is based on a review of the Implementation Completion Report (a self-evaluation by the responsible Bank department) and fieldwork conducted by OED. To prepare PPARs, OED staff examines project files and other documents, interview operational staff, and in most cases visit the borrowing country for onsite discussions with project staff and beneficiaries. The PPAR thereby seeks to validate and augment the information provided in the ICR, as well as examine issues of special interest to broader OED studies.

Each PPAR is subject to a peer review process and OED management approval. Once cleared internally, the PPAR is reviewed by the responsible Bank department and amended as necessary. The completed PPAR is then sent to the borrower for review; the borrowers' comments are attached to the document that is sent to the Bank's Board of Executive Directors.

About the OED Rating System

The time-tested evaluation methods used by OED are suited to the broad range of the World Bank's work. The methods offer both rigor and a necessary level of flexibility to adapt to lending instrument, project design, or sectoral approach. OED evaluators all apply the same basic method to arrive at their project ratings. Following is the definition and rating scale used for each evaluation criterion (more information is available on the OED website: http://worldbank.org/oed/eta-mainpage.html).

Relevance of Objectives: The extent to which the project's objectives are consistent with the country's current development priorities and with current Bank country and sectoral assistance strategies and corporate goals (expressed in Poverty Reduction Strategy Papers, Country Assistance Strategies, Sector Strategy Papers, Operational Policies). *Possible ratings:* High, Substantial, Modest, Negligible.

Efficacy: The extent to which the project's objectives were achieved, or expected to be achieved, taking into account their relative importance. *Possible ratings:* High, Substantial, Modest, Negligible.

Efficiency: The extent to which the project achieved, or is expected to achieve, a return higher than the opportunity cost of capital and benefits at least cost compared to alternatives. *Possible ratings:* High, Substantial, Modest, Negligible. This rating is not generally applied to adjustment operations.

Sustainability: The resilience to risk of net benefits flows over time. *Possible ratings:* Highly Likely, Likely, Unlikely, Highly Unlikely, Not Evaluable.

Institutional Development Impact: The extent to which a project improves the ability of a country or region to make more efficient, equitable and sustainable use of its human, financial, and natural resources through: (a) better definition, stability, transparency, enforceability, and predictability of institutional arrangements and/or (b) better alignment of the mission and capacity of an organization with its mandate, which derives from these institutional arrangements. Institutional Development Impact includes both intended and unintended effects of a project. *Possible ratings:* High, Substantial, Modest, Negligible.

Outcome: The extent to which the project's major relevant objectives were achieved, or are expected to be achieved, efficiently. *Possible ratings:* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

Bank Performance: The extent to which services provided by the Bank ensured quality at entry and supported implementation through appropriate supervision (including ensuring adequate transition arrangements for regular operation of the project). *Possible ratings:* Highly Satisfactory, Satisfactory, Unsatisfactory, Highly Unsatisfactory.

Borrower Performance: The extent to which the borrower assumed ownership and responsibility to ensure quality of preparation and implementation, and complied with covenants and agreements, towards the achievement of development objectives and sustainability. Possible ratings: Highly Satisfactory, Satisfactory, Unsatisfactory, Highly Unsatisfactory.

Contents

This report is based on the draft PPARs originally prepared for the two Rehabilitation loans by Roger Robinson in 1998–99 and for *SALs I* and *II* by Prof. William Branson. The Task Manager was Gianni Zanini, who was also responsible for the work during 2001–02 on the Russia Country Assistance Evaluation. Agnes Santos, Betty Casely-Hayford and Roziah Baba provided administrative support.

Ratings and Responsibilities

Performance Ratings

	ECA Region	OED	
	ICR	*EVM/ES**	*PPAR*
Rehabilitation I (3513-RU)	*Feb. 12, 1997*	*June 24, 1997*	
Outcome	Satisfactory	Satisfactory	Moderately Satisfactory
Sustainability	Likely	Likely	Likely
Institutional Development Impact	Substantial	Substantial	Modest
Borrower Performance	Satisfactory	Satisfactory	Satisfactory
Bank Performance	Satisfactory	Satisfactory	Satisfactory
Rehabilitation II (3898-RU)	*Feb. 12, 1997*	*June 24, 1997*	
Outcome	Satisfactory	Satisfactory	Moderately Unsatisfactory
Sustainability	Likely	Likely	Likely
Institutional Development Impact	Not Applicable	Modest	Negligible
Borrower Performance	Satisfactory	Satisfactory	Unsatisfactory
Bank Performance	Satisfactory	Satisfactory	Satisfactory
SAL I (4180-RU)	*July 15, 1999*	*July 20, 2001*	
Outcome	Satisfactory**	Unsatisfactory	Unsatisfactory
Sustainability	Uncertain	Likely	Likely
Institutional Development Impact	Partial	Modest	Modest
Borrower Performance	Satisfactory	Unsatisfactory	Unsatisfactory
Bank Performance	Satisfactory	Unsatisfactory	Unsatisfactory
SAL II (4261-RU)	*July 15, 1999*	*July 20, 2001*	
Outcome	Satisfactory**	Unsatisfactory	Unsatisfactory
Sustainability	Uncertain	Likely	Likely
Institutional Development Impact	Partial	Modest	Modest
Borrower Performance	Satisfactory	Unsatisfactory	Unsatisfactory
Bank Performance	Satisfactory	Unsatisfactory	Unsatisfactory

* While OED conducts an in-depth assessment of only a fraction of closed projects, it reviews all ICRs, validate their ratings, and update its database with information and judgments on various aspects of project performance. The summary findings of these desk reviews by OED evaluators are recorded for each project in a free-format Evaluation Memorandum (EVM) and, since 2001, in its successor template, the Evaluation Summary (ES).

** According to Table 2 of the ICR. The ICR text, however, suggests that a more accurate rating for outcome would be marginally (or moderately) satisfactory (an option available to OED evaluators but not to Bank staff).

Key Project Responsibilities

Project	*Staff*	*Appraisal*	*Completion*
Rehabilitation Loan	Task Manager	Richard Westin	Richard Westin
(3513-RU)	*Division Chief*	Yukon Huang	Richard Westin (Acting)
	Country Director	Russ Cheetam	Yukon Huang
Second Rehabilitation	Task Manager	Richard Westin	Richard Westin
Loan (3898-RU)	*Division Chief*	Pradeep Mitra	Richard Westin (Acting)
	Country Director	Yukon Huang	Yukon Huang
Structural Adjustment	Task Manager	Ulrich Zachau	Harry G. Broadman
Loan I (4180-RU)	*Division Chief*	Pradeep Mitra	Pradeep Mitra
	Country Director	Michael Carter	Michael Carter
Structural Adjustment	Task Manager	Harry G. Broadman	Harry G. Broadman
Loan II (4261-RU)	*Division Chief*	Pradeep Mitra	Pradeep Mitra
	Country Director	Michael Carter	Michael Carter

ICR for *Rehabilitation I* was prepared by:	Richard Westin
ICR for *Rehabilitation II* was prepared by:	Richard Carroll
ICR for *SAL I and SAL II* was prepared by:	John Holsen, Consultant, ECSPE and
	Harry Broadman, Principal Economist, ECSPE

Preface

1. This is the Project Performance Assessment Report (PPAR) for four Bank loans to the Russian Federation: the *Rehabilitation Loan* (*RL I*; \$600 million; Loan No. 3513-RU), the *Second Rehabilitation Loan* (*RL II*; \$600 million; Loan No. 3898-RU), the *Structural Adjustment Loan* (*SAL I*; \$600 million; Loan No. 4180-RU) and the *Second Structural Adjustment Loan* (*SAL II*; \$800 million; Loan No. 4261-RU).

2. *RL I* was approved in August 1992, made effective in December 1992, and closed in September 1994 after a delay of 9 months. It was fully disbursed, with the bulk of disbursements between December 1992 and June 1993. *RL II*, a single-tranche operation, was approved in June 1995, was declared effective and fully disbursed in September 1995 and closed in June 1996. *SAL I*, also a single-tranche operation, was approved, made effective, and fully disbursed in June 1997, and closed in March 1998. *SAL II* was approved and made effective in December 1997, fully disbursed in two equal tranches, in December 1997 and January 1998, and closed in December 1998.

3. The PPAR is based on the Implementation Completion Reports (ICRs) prepared by the Europe and Central Asia (ECA) Regional Office (Reports No. 16298 and No. 16300 dated February 12, 1997 for *RL I* and *RL II*, respectively; Report No. 19572 dated July 15, 1999 covering both *SALs I* and *II*); the President's and Staff Appraisal Reports for the four projects, the legal documents, project files, related economic and sector work, various Country Assistance Strategy (CAS) documents, and discussions with Bank staff, including in the context of the 2002 Russia CAE (Russian Federation: Country Assistance Evaluation; Report No. 24875, dated September 23, 2002).

4. A PPAR mission led by Roger Robinson (then Senior Evaluation Officer, OEDCR) visited Russia in September 1997 and discussed the effectiveness of the Bank's *RLs I* and *II* with government officials, representatives of the civil society and other donors. Following the financial crisis in Russia in August 1998, including the subsequent Government default on domestic debt obligations, and in light of the ECA Region's comments on October 20, 1999, the finalization of this report was postponed to after the completion of the Russia CAE.

5. During November–December 1999, Prof. William Branson (then consultant, OEDCR) taught at the New Economic School (NES) in Moscow and discussed the effectiveness of the Bank's *SALs I* and *II* with government officials and representatives of other donors and the civil society, including through informal exchanges with faculty at NES and at the Russian European Center for Economic Policy (RECEP), his attendance at the annual conference of RECEP, a discussion on the Russian debt situation at a Finance Institute conference, and a seminar at RECEP on the SAL program.

6. Alice Galenson and Laurie Effron (OEDCR) were the peer reviewers. In parallel with the review by the ECA Region, an earlier draft of this PPAR was sent to the Government of the Russian Federation for its review. The Government had no comments. The comments from the ECA Region are attached as Annex F, with a response from OED in Annex G.

1. Background

The Extraordinary Transition Challenge

1.1 The rules of the game changed dramatically in Central Europe and the Soviet Union in the late 1980s and early 1990s, as major political and economic reforms— before and after the collapse of communist rule— opened up new opportunities. It is difficult to overemphasize the magnitude of the changes required to move from a centrally planned to a market economy. On the eve of transition, communist countries had inappropriate policy, institutional and legal frameworks, were over-industrialized, with capital stocks largely unsuitable for production in a market economy, and often provided excessive social protection and infrastructure.

1.2 Planners determined resource allocation, with scant regard for scarcity prices. Resources for inefficient investments were extracted compulsorily through high taxes on enterprise profits and forced savings. Competition, including from trade, was nonexistent. Firms did not have financial independence from the state and rarely had direct contact with their suppliers, wholesale purchasers or final consumers. When planning disappeared, it took a considerable time for firms to create these relationships. To ease the informational demands of planning, firms were gigantic, often highly vertically integrated, and orientated to production rather than sales. Incentives to innovate and improve efficiency were weak, with firms facing soft-budget constraints.

1.3 The structure of output favored industrial production, notably machine tools, heavy industry and defense, while economic geography was determined in ways that would not have emerged through competitive forces (giving rise, for example, to the Soviet mono-towns). Massive restructuring was required to make supply consistent with demand, implying major shifts from industry to services, from heavy to light industry, and from machinery and weapons to consumer goods. Such restructuring depended on the emergence of new firms as much as on a reorientation of existing companies. However, planned economies lacked small firms and the institutional infrastructure to induce and aid their creation (supply of funds, legal frameworks, level playing fields with incumbents, etc.). The political system, largely built on relationships between managers and politicians, also favored incumbents.

1.4 Transition countries faced the dual tasks of building modern political democratic institutions and of transforming their economies from centrally planned to market-based, from state-dominated to private sector-driven, from closed to open, and from industry- to services-oriented. By the end of the 1980s, there was a broad consensus among reformist economists in transition countries and among Western economists that the transition path required macroeconomic stabilization and the eradication of budgetary deficits (eliminating enterprise subsidies); price liberalization; an effective legal framework facilitating voluntary contracts and free entry and exit; competition in private markets to be enhanced through trade opening (exchange rate convertibility, reduced tariffs) and anti-monopoly policy; and the privatization of existing enterprises. Foreign direct investment (FDI) was seen as crucial in supplying private capital, managerial skills, and technology.

1.5 The transition challenge was compounded by the collapse of the Council of Mutual Economic Assistance (COMECON) trading bloc and of the Soviet Union, which caused severe disruptions of trade and inter-enterprise linkages, and extraordinary shifts in internal prices. All the transition economies suffered a decline in output, but with strong reform programs, growth was restored in most of Central Europe and the Baltic (CEB) countries by 1993, and FDI flows were significant by 1994.[1]

Russia's Specific Challenges

1.6 In the early 1980s, with stagnant production per capita and declining efficiency of investment, dissatisfaction with the performance of the Soviet economy was mounting (see table 1.1). In parallel with President Gorbachev's policy of *glasnost* (political openness), *perestroika* (economic restructuring) began in the mid-1980s with an increase in social and investment expenditures, but no adjustment to prices and taxes. Private small-scale initiative, including cooperatives, was permitted. State enterprises gained considerable autonomy, albeit without accountability. This period saw also a liberalization of the banking system and the start of spontaneous privatization—the transfer of state property and enterprises to their managers. Together with declining world oil prices and an anti-alcohol campaign that reduced important sources of government revenues, these policies contributed to higher budget deficits, a dramatic growth in external debt, and growing black markets. The central authorities lost effective control over economic management (Mau 2000).[2] All efforts to frame an economic reform program met with strong internal resistance and only rhetorical backing from Western governments.

Table 1.1: Pre-Transition Economic Indicators of the Soviet Union

(% Change)	*1987*	*1988*	*1989*	*1990*	*1991*
Net Material Product	0.7	4.6	1.9	-3.6	-11.0
Industrial Output (gross)	3.5	3.8	1.4	-0.1	-8.0
Agricultural Output (gross)	-1.2	3.3	1.7	-3.6	-4.7
Consumption	2.7	4.0	5.4	2.0	-11.0
Fixed Investment	6.0	7.6	4.1	0.1	-26.0
Industrial Wholesale Prices	-0.9	2.7	1.2	3.9	138.0
Retail Prices	2.0	0.0	6.0	5.6	90.4
Monetary Growth (M2)	15.5	14.0	14.6	17.6	77.2

Source: Official Statistics.

1.7 A failed coup d'etat in August 1991 triggered the dissolution of the Soviet Union, which was later replaced by a consultative association (the CIS) among most former

[1] In its comments on the CAE, the Government questioned the usefulness of such comparisons, as they "are conventionally used to artificially set in opposition to each other reforms in different countries with different start-up conditions, institutional characteristics, and scope of required change."

[2] Monetary financing accommodated large fiscal deficits and wage increases granted by enterprise managers under pressure from newly empowered workers' collectives. With declining productivity and growth and fixed prices, the supply-demand imbalance intensified commodity shortages, hoarding, barter, black markets, and forced savings by households, which were already endemic to the Soviet economy before *perestroika*. Excess demand became trapped in large accumulated monetary balances—there were virtually no other financial assets in private hands—which stored up an inflationary threat for a time when prices were liberalized. As imports rose, Western commercial banks eliminated short term credit lines, large scale capital flight began, and the balance of payments deteriorated sharply, wiping out international reserves. The Soviet and Russian governments managed the situation with draconian measures to curb imports and by charging former allies world market prices for its exports.

Soviet republics. The independent Russian Federation (Russia) that emerged inherited an industrialized and urbanized society and high level of human capital, but also a backlog of environmental, military, and demographic imbalances. The country was also in a severe recession, but continued to have global significance. It is the world's largest country (17 million square kilometers), covering 11 time zones, and the sixth largest in population (146 million in 2001). It includes 22 percent of the world's forests and 32 percent of its natural gas reserves.

1.8 Russia's initial conditions were more difficult than in the CEB countries. Few Russians had any memory of the brief and distant experience with capitalism, entrepreneurship, and markets before World War I and the 1917 Bolshevik revolution. The economy had been shaped by at least six decades of distorted relative prices, repressed inflation, forced collectivization, and central planning. The country's wasteful, rigid, largely resource-based, military-oriented, and over-integrated economic structures were very vulnerable to shocks and international price fluctuations. Its large size, widely dispersed population, poor transport infrastructure, and economic geography made it difficult for trade to ensure sufficient competition outside a few large urban centers. The federal structure and an inadequate state apparatus added layers of complexity to economic and governance challenges.

1.9 The 1993 constitution provided for a strong presidency and established a bicameral legislature—an upper Federation Council representing the constituent states, and a lower State Duma, representing the disparate interests of political parties. However, neither the Duma elected simultaneously with the constitutional referendum nor the one elected in mid-1995 expressed majorities aligned with the president and his reformist economic team. It was not until the elections of a new Duma in late 1999 and of President Putin in early 2000 that a more harmonious political relationship was established between the legislative and executive branches. The period through late-1999 was characterized by ideological and political splits over market reforms; perceived risk of backsliding; frequent shakeups and major divisions within the Government itself—including between the regions and the center; and parliamentary opposition to the reform efforts. Frequent use of the presidential power to rule by decree also weakened the political consensus. Russia's transition was also hindered by the loss by the state of control over natural resources; hostility to foreign investment; poor compliance by economic agents with the new rules of the game; and a low level of trust vis-à-vis state institutions and among market participants themselves. Sizeable internal population movements (mainly from Siberia to more temperate areas) added to the challenge.[3]

1.10 In addition to these problems, government attention was dominated by crisis management, with short-term and frequently improvised policy reactions to new emergency situations, rather than to the implementation of a longer-term and comprehensive stabilization and reform blueprint. Major reforms came in surges, driven by a thin layer of reformers temporarily enjoying the president's personal support and/or by the imperatives of the latest crisis situations. As a consequence, achievements were

[3] The Government pointed out that the experience of 1998-99, when the executive branch directly relied on parliamentary support in carrying on the work praised by the Bank (see Annex 11 of the Russia CAE), is an example of cooperation among the branches of government.

generally more successful when the state had to stop doing something rather than in longer-term institution building or reforms requiring concerted actions in different sectors. Broader ownership of the reforms and policy implementation capacity remained fundamentally stunted, although the commitment of the reformist wing of the government was never in doubt, all governments pledged their support to the reforms, and the electorate voted at every crucial turn for continuing the transition.

The Government's Initial Reform Agenda

1.11 The key goals of the new reformist Russian administration were to move quickly to a Western-style liberal democracy and to an open, market economy. The creation of a competitive market-based economy in Russia would encompass one of the most pervasive institutional reform efforts ever attempted. This would range from a fundamental change in the legal nature of property rights to creation of an incentive/reward structure that would determine the behavior of all economic agents. The first two post-communist Russian governments (through December 1992) began a series of market-oriented reforms, which proceeded irregularly through the end of the decade. Russia's economic objectives were announced by President Yeltsin in October 1991:

- liberalization of most prices;
- unification of the exchange rate and liberalization of current account transactions;
- macroeconomic and financial stability to reduce inflation;
- accelerated transition to a market-based economy through privatization, regulatory reform, anti-monopoly policies and improvements within the financial sector; and
- provision of an effective social safety net to protect the most vulnerable citizens.

1.12 These reform objectives were reconfirmed in Memoranda of Economic Policies which were submitted to the IMF in March 1992 and to the Bank in July. This initial stabilization effort was supported by an IMF First Credit Tranche Arrangement, which included specific ceilings on credit expansion, a progressive move toward positive real interest rates and measures to reduce the stock of inter-enterprise arrears. The target was to reduce the monthly inflation rate and the consolidated fiscal deficit to below 10 percent by the end of 1992.

1.13 *Domestic price liberalization* was undertaken swiftly in most regions. Between January 1992 and early 1993, price controls were de-facto eliminated on most goods at the retail and wholesale level, with the exclusion of a few sensitive food items, housing rents, utilities and petroleum products. Due mostly to the large monetary emissions and in smaller part to the monetary overhang, officially recorded prices increased over 14 fold in 1992. While most people were adversely affected, the social costs without price liberalization (involving severe shortages and black market activities) might have been higher (Mau 2000).

1.14 A *unified exchange rate system* with a freely floating market determined rate was introduced in the beginning of July.

1.15 *Financial stability.* The Government also sought to address the fiscal imbalances. New taxes were introduced, including a customs tariff, a value-added tax, and excise taxes, and expenditures were reduced in military spending, subsidies, and investment.

Nevertheless the deficit for the first half of 1992 was still about 19 percent of GDP. Attempts were also made to follow a monetary policy that was consistent with a steady reduction in the rate of inflation. The Central Bank of Russia (CBR) refinance rate was progressively increased to 80 percent by June, but interest rates were negative throughout the first half of the year. Therefore with excess demand for credit that could not be met and a build up in inventories due to the breakdown in the trading system, working capital in the enterprise sector declined dramatically. This in turn led to a build up in arrears among enterprises and to the banking sector and the tax authorities. Estimates at the time suggested that these arrears had reached about US$23 billion by mid-1992 (at the auction exchange rate pertaining at that time).

1.16 *Enterprise Reform.* Transferring economic assets to private hands was expected to create a strong constituency for the necessary institutional changes that would underpin enterprise restructuring. The Government developed a multi-layer strategy for reform of state-owned enterprises (SOEs) which was to be directed by the State Committee for the Management of State Property (GKI), in coordination with regional and local state property committees, property funds, and privatization committees. The key component was an accelerated privatization program approved by the Supreme Soviet in June, with an amendment to the earlier Privatization Law (1991) that streamlined extensively the institutional structure of the privatization program. The hope was to have small-scale privatization completed by the end of 1993, although the GKI would have to develop standardized procedures and help the local authorities implement the envisaged program, as this aspect of privatization was their responsibility.

1.17 For medium and large SOEs the first element of the privatization process was the need to clarify ownership rights through a process of corporatization. The target was to have all large-scale firms transformed into joint stock companies by November 1992. For those firms slated to remain in public hands (i.e. natural monopolies or special cases such as defense) a program to improve asset management, accountability and corporate governance was being drawn up, to be implemented in early 1993. Following this corporatization exercise, the GKI was to implement a mass privatization program (MPP) which would include distribution of privatization coupons or vouchers to the general public. Voucher auctions and private investment funds were then to follow in 1993, to allow for diversification of shareholding portfolios and effective managerial oversight. Eager to stop the looting of state property by insiders, the reformers saw the voucher option for the MPP as the only realistic method to privatize quickly and fairly.

1.18 For very large firms it was recognized that the privatization process would be complex and therefore would need to be conducted on a case-by-case basis. A demonstration group of between 5 to 10 firms was to be selected by the end of 1992, with privatization progress made throughout 1993. To support the whole privatization effort an appropriate legal environment was also to be established. This was to involve revisions in the laws on enterprises, as well as new decrees on bankruptcy and liquidation. By mid 1992 the Civil Code was in the process of revision to incorporate modern principles of contract law and the transfer of property rights. These adjustments in the legal environment were planned to be submitted for approval by the Supreme Soviet by the end of 1992.

1.19 *Anti-Monopoly Policies and Controls* - Much of manufacturing, domestic trade and parts of agriculture in Russia were characterized by high degrees of firm concentration and vertical integration. At the regional level, many state enterprises were effectively monopolies, and within the industrial sector the former branch ministries provided a means of centralizing administration in a cartel-like relationship. These institutional structures had proven to be very resistant to change. Attacks on these issues took place on a number of fronts. Russia adopted anti-trust legislation in 1991. Guidelines for the implementation of this anti-trust law were to be finalized and disseminated in the later part of 1992. In addition, during the corporatization process, large conglomerates were to be incorporated at the level of the smallest legal entities within the enterprise. Investment trusts were to be regulated to ensure that diversified portfolios were held, and identified cartels, particularly in distribution, were to be dismantled. Finally, close coordination with the privatization program was to be undertaken to ensure de-monopolization of medium and large-scale firms involved in the privatization process.

1.20 *Foreign Direct Investment.* As of May 1992, the gross stock of FDI in Russia amounted to US$3.4 billion, a very small fraction of the country's total capital stock. The Government was quick to recognize that technology and managerial expertise associated with FDI would provide a valuable contribution to the overall drive to improve factor productivity and product quality and a foreign investment law to improve the enabling environment for investment inflows was adopted in late 1991. Although there were no restrictions on the repatriation of interest and dividends, by early 1992 this law already proved inadequate and in need of amendments. Tax laws were also to be reviewed to ensure non-discrimination, and bilateral tax treaties were to be finalized. Finally, in the context of the privatization program, it was envisaged that foreign investors would be given every opportunity to participate, with the rules and conditions for this participation to be clarified and simplified.

1.21 *Financial Sector Adjustment*. From 1988 to 1991 over 1500 new banks were licensed in the Russian Federation. Many of these banks were formed by enterprises as a means to obtain finance through the central bank's refinance facilities. Supervision of these banks was deficient, and given the economic reforms that occurred in 1991 and 1992, the underlying conditions facing these banks had changed dramatically. Holding of ruble balances declined from 80 percent of GDP at the beginning of 1991 to roughly 15 percent of GDP by April 1992. Under these conditions many of these banks were insolvent, although the Government at the time did not have the capacity to identify which ones and thereby take remedial action. These problems were compounded by the banks continuing to lend to enterprises in distress, with funds from the inter-bank market. The fundamental difficulties of the Russian banking system at this time was intrinsically linked to the problem of enterprise reform and the enforcement of hard budget constraints. By mid-1992 the Government was in the process of developing an agenda of reforms for the financial sector with specific recommendations for improvement. These were to encompass revision of the banking act, the securities act, and the law on collateral security and payment system issues. A revised system of auditing and accounting was developed and was scheduled to be implemented in January 1993, with a new chart of accounts to be adopted in March. Revisions in all the financial laws were expected by the end of 1992.

1.22 *The Social Safety Net.* In the short run, price liberalization, enterprise restructuring, and the removal of subsidies would adversely affect the living standards of various sections of the population. The scope for supplementing incomes from informal economic activity and savings was limited. The rapid rise of inflation in the latter part of 1991 and early 1992 had eroded savings and the nature of prior public sector employment had limited the opportunity to accumulate assets. Therefore, an effective social safety net was a crucial complement to any structural reform program, as its absence could erode public support for the overall reform program. The social protection system Russia inherited required major restructuring. Social benefits needed to be targeted to help those most in need of assistance, such as the unemployed and poor households. Reforms were needed in social insurance institutions to reduce the role previously played by enterprises and improve the administrative capacity at the local government and national levels. In the face of rapidly falling fiscal revenues, many competing demands on the federal budget, and needed fiscal discipline, however, the government's strategy was to control the budgetary demands of the social safety net through improved targeting and rationalization of the extensive range of benefits that had been previously a function of the Soviet system. As will be seen in Section 4 this objective proved to be elusive.

2. The Rehabilitation Loans

The Bank's Country Assistance Strategy, 1992–95

2.1 Following an "approach" phase, during which the Bank studied for the first time the Soviet economy and offered a grant for technical assistance and project preparation, the Russian Federation officially joined the Bank on June 16, 1992. The subsequent "learning and investing" phase from mid-1992 to mid-1995 began with the Bank emphasizing analytical work and staff-level inputs to policy discussions, particularly on the MPP. Given the consensus of the Bank's main shareholders, it also embarked on a rapid expansion of lending.[4] During the ensuing three years the portfolio swelled from almost nil to a cumulative $4.6 billion.

2.2 Bank management was reluctant to provide large-scale budget support in the absence of a credible stabilization and structural reform program. Still in August 1992, at the request of the G-7 and in parallel with the first IMF-supported program, the Bank approved a $600 million *Rehabilitation Loan* (*RL I*) with virtually no conditionalities. On the other hand, Bank management held up Board submission of the *Second Rehabilitation Loan* (*RL II*) until mid-1995, at which time a number of trade reforms had been adopted and a new standby arrangement provided an IMF seal of approval for Russia's macroeconomic management. During this period the Bank lent for 17 investment and technical assistance (TA) projects, in support of structural reforms

[4] *Sources*: OED interviews with Bank staff; U.S. GAO 2000 (p. 48); and information on the web page of the University of Toronto's Library and G8 Research Group about G-7 meetings on April 26 and July 6-8, 1992 ($24 billion multilateral financial-aid package) and on April 14-15 and July 7-9 1993 ($43.4 billion emergency aid package).

(mostly in privatization), institutional development (including procurement, employment services, pension payment administration, private and financial sector development, land, agriculture, environment, housing, and tax administration) and infrastructure rehabilitation (including oil fields, highways, and urban transport).

2.3 A "consolidation" phase followed, when a high share (65 percent) of project commitments experienced serious implementation problems, as Russia's institutions were not prepared to deal with the Bank's financial and administrative requirements.[5] Hence, from mid-1995 to early-1996, the Bank made only $27 million in new commitments to Russia. This phase was marked by an intensification of supervision efforts, the start of annual Country Portfolio Performance Reviews (CPPRs) and major project restructurings. Portfolio performance turned around by 1997. However, within a declining administrative budget, portfolio management work crowded out analytical and advisory services.[6]

The Rehabilitation Loans' Objectives

2.4 The main objectives of *RL I* were to support a mutually self-reinforcing program of (a) macroeconomic stabilization in conjunction with the IMF and (b) structural reforms. The structural reforms were aimed at improving the environment for entrepreneurial activity and investment, both domestic and foreign, which was seen as necessary to ensure progress toward a more open economy driven by market forces, as well as to alleviate foreign exchange shortages. A centerpiece of the Government's efforts was a large privatization program encompassing both large and small-scale enterprises. In conjunction with this effort, a broad program of price liberalization was to be undertaken, and foreign direct investment was to be encouraged through the creation of a stable and transparent legal and taxation framework, together with trade liberalization and financial sector reform. A final subsidiary objective of *RL I* was (c) to familiarize the authorities with Bank lending operations, particularly with regard to procurement and disbursement procedures.

2.5 This operation supported a general commitment by the Government to undertake the policy reform outlined above, but there were no specific policy conditionalities or tranches associated with the reform agenda.[7] At the time the perceived need was for quick disbursing financing for critical imports which in turn would limit the decline in output expected following the introduction of economic reforms. The choice of a "rehabilitation" loan, rather than a more conventional policy adjustment operation, was based upon the belief that the necessary pre-conditions for standard adjustment lending could not be met in Russia for some time given the evolving political situation.[8]

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[5] By mid-1995, the Bank had approved 20 loans for $4.6 billion but had disbursed a little more than $700 million.

[6] The Bank spent $7.5 million during FY1993-94 on ESW, but only $1.6 million during FY1996-97 (in constant 2001 U.S. dollars).

[7] The program of structural reforms agreed with the Government was documented in a "Memorandum on Economic Reform Policies" submitted to the Bank on July 20, 1992 by Mr. Alexander Shokhin, Deputy Chairman of the Russian Government.

[8] For a more complete discussion of the use of rehabilitation loans, see "Rehabilitation Loans in Countries in Transition," SECM93-489, May 18, 1993.

2.6 This was the first loan by the Bank to the Russian Federation, preceded only by a grant-financed TA project. It was designed at a time of massive economic instability, with a strong sense of urgency underpinning the perceived needs for foreign currency to finance critical imports to forestall the continuing decline in output. The structural reform agenda set out at the time that the *RL I* was approved (August 1992) was ambitious. The relevance of this reform agenda, given the objective of the transformation of the Russian economy into one that was market driven, was high. But the complexity of the needed institutional reform effort and the need for appropriate prioritization and sequencing were not fully appreciated when this operation was designed. It was explicitly recognized however that *RL I* represented only the start of a process in which the Bank would be engaged with the Russian authorities in the ongoing transformation agenda.

2.7 More than half the proposed $600 million loan was to finance pre-identified imports ($345 million), and the remainder of the proceeds to be channeled into the Moscow Inter-Bank Currency Exchange (MICEX) to finance private sector imports. For the pre-identified portion, to simplify project implementation, it was decided to use existing government institutions for purchase, shipment, and distribution, with technical assistance provided by the U.K. Know How Fund to ensure that procurement and disbursements followed standard Bank guidelines.

2.8 The objectives of *RL II* were to continue to support the Government's macroeconomic stabilization program in 1995 together with a range of structural reform initiatives. These latter initiatives were focused on trade policies, oil export procedures and other pricing and pro-competition measures. The operation was designed as a single tranche loan, with the reforms being completed prior to Board presentation. The loan was prepared in close collaboration with the IMF, whose Board had recently approved (in April 1995) a Stand-by Arrangement supporting a similar reform agenda.[9]

2.9 Preparation for this follow-up loan, however, was difficult and protracted. It was originally negotiated in August 1993, but a deteriorating political environment and poor macroeconomic management caused processing of the loan to be suspended until the situation clarified. Processing was resumed in April 1994, but a further deterioration in the overall macroeconomic environment in the Fall of 1994, as well as delays in completing the agreed pre-Board actions, meant that Board presentation was postponed to mid-1995. The Bank took the view that substantial progress needed to be made in the variety of macroeconomic targets contained in the IMF Systemic Transformation Facility program (particularly the second tranche requirements). This was never satisfactorily resolved until there was an IMF Stand-by Arrangement in place by the second quarter of 1995.

2.10 In contrast to the first loan, *RL II* with its attendant policy dialogue focused more intently upon liberalizing the trade regime given the difficulties encountered in this area throughout 1993. The implementation difficulties encountered in the first loan affected

[9] The Government's program of structural reforms was specified in the Government's Policy Memorandum entitled "On Some Guidelines for Economic Policies in 1994-95," which was signed by Chairman Chernomyrdin on August 30, 1994.

the design and emphasis of the follow-up operation. More specific policy reform achievements were sought prior to Board presentation, and a stronger effort was made to identify key bottlenecks impeding an improvement in the overall macroeconomic environment.

The Rehabilitation Loans' Implementation

2.11 Implementation of *RL I* did not proceed smoothly, which in part can be explained by the Government's lack of familiarity with the Bank's procedures. Effectiveness was delayed by five months due to the Government's concerns about the negative pledge conditions contained in the loan agreement. Once effective (December 29, 1992), however, the portion of the loan channeled to private importers disbursed rapidly (within four months). The pre-identified component experienced an eight month delay, while procedural difficulties in the formal establishment of the Project Implementation Unit were ironed out and international competitive procedures were being introduced. This delay meant that the bulk of the pre-identified imports did not arrive in Russia until early 1994 (about 15 months after effectiveness and 20 months after Board approval). Furthermore, by the time the administrative impediments were resolved, the nature of the foreign exchange market was such that commercial imports were readily available.

2.12 A further cause of delay in disbursement of *RL I* was the issue of sovereign immunity, which if interpreted in a restrictive way would prevent line ministries from incurring liabilities. Special project implementation units outside the government needed to be appointed to carry out public procurement. Selection was slow, and preparation of lists of eligible goods took longer than expected. Nonetheless, government compliance with all legal covenants and audit reporting requirements was satisfactory. Once *RL II* was approved by the Board, there were no disbursements difficulties or delays, given the single tranche nature of this operation.

The Rehabilitation Loans' Achievements

2.13 While neither *RL I* nor *RL II* was designed as traditional policy based loans with tranched disbursements against specific fulfillment of policy conditionality, the resource transfer and the ongoing policy dialogue within the broad framework of the loans were designed to further the macroeconomic and structural reform agenda.

2.14 Macroeconomic stabilization, however, was not achieved. In the early 1990s, fiscal discipline remained elusive and the central banks in the ruble zone (dissolved in 1993) pursued a highly inflationary monetary expansion that spilled over into Russia. Moreover, the central bank in July 1992 and a new government in December 1992 abandoned all efforts at credit restraint and establishing fiscal discipline. The stabilization strategy finally adopted in 1995 with IMF support rested on three legs: fixing the exchange rate as a nominal anchor, tightening credit to enterprises, and limiting central bank credit to the treasury. This strategy succeeded in reducing annualized monthly inflation to single digits by early 1998, but continuing large fiscal deficits fueled unsustainable public debt dynamics and an increase in budget arrears and non-payment of wages and pensions (see tables 2.1 and 2.2).

Table 2.1 Selected Macroeconomic Indicators (1990–01)

Russia Fiscal Year	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
GDP growth (annual %)	-3.0	-5.0	-14.5	-8.7	-12.6	-4.1	-3.4	0.9	-4.9	5.4	9.0	5.0
GNP per capita growth (annual %)	-3.6	-5.5	-15.3	-8.4	-12.5	-4.4	-3.5	0.7	-6.4	3.3	11.2	7.5
GNP, Atlas method (US$, billion)	..	$569	$469	$412	$343	$333	$348	$383	$331	$256	$246	$253
Inflation, (annual avg. CPI, %)	5.6	92.6	1,354.1	895.3	303.2	188.7	47.5	14.8	27.7	85.7	20.6	21.5
REER index (1997 = 100)	161.2	121.5	16.5	34.0	56.6	68.0	91.7	100.0	72.0	46.0	58.9	70.4
Real Wage Rate (annual growth)					-8.0	-28.0	6.0	4.7	-13.4	-22.0	20.9	
Corporate Profit, (% of GDP)			3.0	2.4	1.3	1.6	0.6	0.7	0.4	1.5	1.5	
Investment (GDFI, % of GDP)	29	23	24	20	22	21	21	19	18	16	18	18
Exports (annual % growth)	..	-30.0	-28.7	2.1	3.3	10.3	8.7	4.6	-2.3	-1.7	2.7	2.8
Current account balance (% of GDP)	..	..	0.1	0.7	2.0	1.7	2.5	0.4	0.3	10.5	16.1	11.2

Source: Official statistics and World Bank Unified Survey, 2002.

Table 2.2 – Selected Fiscal Indicators (1992–2001)

Russia Fiscal Year	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
Federal Govt. Balance (% of GDP)	-10.4	-65	-11.4	-5.7	-8.4	-7.1	-5.9	-4.2	0.9	2.7
Revenue (% of GDP)	16.6	13.7	11.8	12.9	12.5	12.3	11.0	12.8	16.0	14.5
Expenditure (% of GDP)	27.0	20.2	23.2	18.6	20.9	19.4	16.9	17.1	15.1	14.5
Consolid. Govt. Balance (% of GDP)					-8.9	-7.9	-8.0	-3.2	3.2	2.8
Revenue (% of GDP)					33.5	36.5	33.4	34.0	38.4	35.8
Expenditure (% of GDP)					42.4	44.4	41.4	37.2	35.1	33.1

Source: IMF Staff Estimates.

2.15 Several tax measures were introduced to counteract the growing inability of the federal government to collect tax revenues, which fell to less than 12 percent of GDP in 1994, but with declining output, weak tax administration and compliance, flaws in fiscal federalism, and continuous tax exemptions for inefficient enterprises, government revenues remained low.

2.16 Expenditures were also cut, especially in military spending, subsidies, and investment, but not commensurately with the fall in tax revenues. Moreover, although income transfers under various social welfare programs absorbed 8 percent of GDP in 1995, most of these resources were not targeted to the households most in need of such assistance, leaving them with inadequate support. For example, the minimum pension amounted to only 80 percent of the minimum subsistence level for the elderly at the end of 1996, while the minimum unemployment benefit covered only 15 percent of the subsistence level.

2.17 After a tight monetary policy was imposed in early 1995, continuing large deficit financing shifted to new sources: (a) domestic and (after 1996) foreign portfolio investors, who bought high-yielding, short-term, local-currency government securities (GKOs and OFZs) and Eurobonds; (b) the IMF and the Bank, whose annual net resource transfer during 1995–97 was equivalent to 1.1 percent of GDP; and (c) foreign governments, mainly through debt rescheduling.[10] Despite the external financing, these

[10] During 1996, the Government reached agreements with the Paris and London Clubs on a multi-year debt rescheduling program for about $72 billion of Soviet-era external debt, representing roughly 70 percent of the outstanding stock. In addition, the Government received an internationally recognized credit rating in October 1996

deficits caused domestic real interest rates to exceed 80 percent in mid-1996, increasing the cost of domestic debt service for the budget and crowding-out lending to the private sector. Although rates declined during the latter part of 1996, inter-bank lending rates still equaled about 25 percent in real terms in early 1997.

2.18 Progress in the structural reform agenda supported by the rehabilitation loans was mixed. Annexes C and D provide a detailed listing of the reforms undertaken through 1997. Progress was made in privatization (although the process was marked by controversy about its transparency and equity), and trade and price liberalization, but the business climate remained poor.

2.19 By the mid-1990s the private sector was contributing more than 70 percent of GDP. Most enterprises had been sold or otherwise transferred out of state hands, mostly to their workers, but without prior restructuring and break-up to enhance competition. Much of this transfer was done through the MPP. Eager to stop the looting of state property by insiders, the reformers saw the voucher option for the MPP as the only realistic method to privatize quickly and fairly. Transferring economic assets to private hands was expected to create a strong constituency for the necessary legislative and institutional changes that would underpin enterprise restructuring. But involvement by outside investors was minimal, due primarily to management's opposition and the decision to allow majority employee ownership. Enterprise managers eventually succeeded in controlling most privatized enterprises.[11] Subsequent efforts at case-by-case, cash privatization included the loans-for-shares (LFS) scheme, through which the Government divested itself in 1995–96 of 13 large and valuable companies, mostly in the petroleum and metals sectors. This divestiture was done in a non-transparent way, and for only a fraction of the market value of the companies involved.

2.20 Entry, enterprise development, and FDI, however, have been discouraged by corruption, poor macroeconomic management, unreliable enforcement, and unclear and conflicting laws and regulations, particularly those related to property and shareholders' rights. Furthermore, large Government domestic borrowing in an environment of generally tight monetary control led to high real interest rates (exceeding 80 percent in the summer of 1996) and a crowding out of private sector borrowing. The high costs of entry and doing business, including bureaucratic harassment, discouraged small and medium enterprise (SME) growth. The same factors have constrained International Finance Corporation (IFC) and Multilateral Investment Guarantee Agency (MIGA) activities and, thanks also to continuing soft budget constraints, allowed enterprise restructuring to proceed very slowly.

2.21 The accumulated stock of FDI since 1991 equaled roughly $6 billion in early-1997, well below the experience of eastern European countries such as Poland and Hungary. Even in the oil sector, where there was initially strong interest by foreign investors, the stock of FDI was only $1.6 billion at the end of 1996, and declined in absolute terms between 1993 and 1995. As a result, oil production, which provides

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and made its debut in the Eurobond market, with the successful placement of a five-year bond issue for $1 billion at 345 basis points above 5-year U.S. Treasuries.

[11] For the critical reviews by Stiglitz and Ellerman and their suggested alternative, see Annex 1, para. 29 (page 49) and Annex 7, para. 3 (page 59) of the Russia Country Assistance Evaluation by OED.

nearly 25 percent of export earnings, had fallen by almost 50 percent in the mid-1990s from its peak level in 1988.

2.22 Russia made rapid progress in liberalizing its domestic and foreign trade and its payment regime. On the import side, the tariff structure was largely rationalized by 1995, with the import-weighted average duty rate at 13–14 percent with a standard deviation of about 7 percent. Remaining export taxes on oil and oil products were abolished in 1996. The growth of exports outpaced that of imports. The current account balance was positive throughout the decade, and foreign trade amounted to 45 percent of GDP by 1996–97, before the run-up in oil prices. There was a substantial change in the geographical composition of trade, with CIS countries accounting for just 20–30 percent of Russia's exports and imports by 1996.

2.23 On the other hand, exports remain to date dominated by raw materials, of which natural gas, crude and refined petroleum products are the major component, while machinery and foodstuffs are the leading imports. In late 1996 and throughout 1997, a large portion of oil exports (25 percent) was still effectively under a quota system given that it was earmarked for "state needs.". Finally, high subsidization of the domestic economy through price distortions and arrears in the energy sector was at the root of the economy-wide system of "non-payments" and barter, which greatly distorted economic policies and enterprises and consumers' economic decisions and helped conceal fraud and tax evasion.[12]

2.24 The process of reform had been made substantially more difficult, however, by the continuing economic decline. By the mid-1990s, measured GDP had fallen by 40 percent in real terms since 1991, although the large changes in relative prices and the rise of a large unofficial economy make comparisons of economic estimates before and after 1990 unreliable. Moreover, the impact on household welfare has been partially offset by a sharp decline in military and other non-productive expenditures, resulting in an increase in the share of private consumption in GDP. Despite widespread expectations in 1995 of a resumption of growth, GDP declined further by 3.4 percent in 1996. Manufacturing industries, particularly engineering products and textiles, were the most affected by the economic decline, while export-oriented sectors such as energy and metals were relatively more successful. A few sectors of the Russian economy, especially those dealing with finance and trade, had expanded during the early part of the transition, but large portions of the economy were stalled in a web of slack production, depressed investment, and arrears among enterprises, households and governments at all levels. The share of barter transactions in the economy peaked at 54 percent and total domestic payment arrears rose to about 40 percent of GDP in August 1998.

2.25 Unemployment did not increase as rapidly as the decline in GDP, although 1996 surveys indicated that 9.6 percent of the labor force was unemployed. The labor market displayed a high degree of flexibility, not only in terms of real wages but also of hours of work and access to secondary employment in the informal sector. However, locational

[12] Gas and electricity monopolies, which had low marginal costs and were not allowed to stop supplying non-paying customers, found that their cash collections declined to only 12 or 13 percent of domestic sales. Coal companies with their high operating costs received direct government subsidies, which at one point were absorbing almost 2 percent of GDP, and still had massive back-wage obligation to their workers.

disadvantages, such as single company towns, were, and remain a serious problem in some areas. Moreover, different surveys estimated that 25–35 percent of the population was living in poverty in 1996. Many households had experienced at least transitory episodes of economic insecurity as a result of wage and pension arrears, which needed to be addressed in part through structural reforms. There were a large number of severely disadvantaged households, including female-headed households with young children, the handicapped and elderly households receiving a minimum pension below subsistence levels. Inequality had doubled by 1993 to Latin American levels and remained high (the Gini coefficient was estimated at 0.46 in 1993 and 0.47 in 1998). Human development indicators had shown a sharp deterioration between the mid-1980s and the first half of the 1990s.

3. The Structural Adjustment Loans

The Bank's Assistance Strategy, 1996–97

3.1 The "renewed lending" phase began in March 1996, when the Bank came under renewed pressure to lend following approval by the IMF of a three-year, $10.1 billion *Extended Financing Facility (EFF)*.[13] New commitments by the Bank over the next two years amounted to $5.3 billion, much of it ($3.5 billion) for five quick-disbursing adjustment operations. In the four months prior to the July 1996 presidential elections, the authorities moved forward with important decisions and the Bank approved $1.4 billion for investment and technical assistance (TA) projects (for enterprise housing divestment, capital market development, legal reform, and medical equipment) and $0.5 billion for a *Coal Sectoral Adjustment Loan (Coal SECAL I)*. This phase also signaled enhanced attention to the social sectors.

3.2 Until early 1997, the Bank had not taken part in the high-level discussions between the Government and the IMF on the structural reform agenda. Its contribution had been indirect through economic and sector work (ESW) and background inputs to the IMF. In his State of the Union address in early 1997, President Yeltsin signaled his determination to accelerate the pace of economic reform and in March 1997 the new government led by Prime Minister Chernomyrdin appointed key reformers as deputy prime ministers. In their initial public statements newly-appointed members of the Government stressed achieving a sustainable fiscal balance, resolving wage and pension arrears, speeding up the process of privatization and enterprise restructuring, resolving the policy framework for natural monopolies, and paying particular attention to addressing social concerns and streamlining the social safety net. The Bank perceived a new window of opportunity and through December approved loans for an additional $3.4 billion. Of this amount, $3.0 billion was the first installment on a multi-year program of expanded adjustment lending ($1.2–$2 billion annually) to support stabilization and tax

[13] The EFF was to support further reductions of import duties, accession to the World Trade Organization (WTO), improvements in liquidity and solvency of banks, strengthening of supervisory capacity and application of prudential regulations by the CBR, fair and transparent cash privatization, agricultural reform, development of land and securities markets, liquidation or reorganization of insolvent enterprises, and protection of outside investors.

reform; elimination of budget arrears; transparent case-by-case privatizations; pricing reforms and competitive restructurings in power, natural gas and railways; banking reform (*SALs I* and *II*); social protection reform (*Social Protection Adjustment Loan or SPAL*); and further coal sector reform (*Coal SECAL II*).

3.3 The 1997 CAS called for the Bank Group to move forward more aggressively with policy advice, technical assistance, and financial instruments to support private sector investments in natural resources, manufacturing, banking, and consumer industries. The IFC increased its gross investment approvals in Russia to more than $200 million. Demand for MIGA's political risk coverage also rose. With a gross exposure outstanding of about $260 million, Russia is today MIGA's fourth largest client.

3.4 The 1997 CAS also placed great emphasis on regional infrastructure projects (water and sanitation, district heating, urban transport, and highway rehabilitation). Providing assistance to the regions had become popular among donors in the mid- and late-1990s. Subnational units were expected to compete for externally funded projects, based on their interest and commitment to reform. Support for environmental activities, including through the Global Environment Facility (GEF) was highlighted. Finally, the strategy called for selective Bank assistance to high-priority institution-building programs (including legal reform, financial sector development, and science and technology).

3.5 The rationale for the Bank's adjustment lending was explicitly fiscal assistance, as there was no balance-of-payment need, based on three considerations: (a) the cost of financing the existing deficit; (b) the additional fiscal cost of structural reforms and fiscal consolidation; and (c) the Bank's commitment to support Russia as part of an international collaborative agreement. These elements are explicit in the *SAL I* President's Report to the Board (paras 88–90) and are repeated in the *SAL II* President's Report (paras 117–119).

3.6 In some cases, the structural reforms would have negative fiscal consequences in the short term, such as when replacing implicit or regulatory subsidies by explicit subsidies in the budget, eliminating arrears, and introducing a new rationalized tax code with lower marginal tax rates. The fall back options would have been for the Government to issue additional short-term ruble-denominated debt (e.g., GKOs) or to rely on monetary financing. The first option would have further driven up real interest rates and crowded out private investment. The second would have undermined the gains made in inflation control and exchange rate stability. To avoid these unpleasant alternatives, the government aggressively sought financing from external sources, including the multilateral institutions. The *SALs* were seen as part of this financing package.

The *SALs*' Objectives

3.7 *SAL I* was a single-tranche loan for general budget support, with conditions of Board presentation. It was one of the adjustment operations in support of the reform program, to be accompanied and followed by other *SALs* and *SECALs* (in coal, agriculture, and social protection) that would continue support for the implementation of the reform program. This loan was approved on June 5, 1997. Final disbursement of the single-tranche took place on June 17, 1997. The IBRD loan complemented the *EFF* program by the IMF (approved in March 1996 for US$2 billion). *SAL II* was approved on December 18, 1997 as a two back-to-back tranches operation, due to the rush to give a signal to the international capital markets and disburse some of the money in advance of full compliance with all of the loan conditions. Final disbursement took place on January 23, 1998. De-facto, it was a single-tranche operation like *SAL I*.

3.8 The objectives of *SAL I* were to assist a new reform-minded Government to:

- Stabilize the economy. While monetary restraint had brought down inflation to 48 percent in 1996, macroeconomic stability was under threat from a persistent and high fiscal deficit largely financed with short-term debt instruments carrying high interest rates.
- Begin deep policy and institutional reforms aimed at having a major direct positive impact on the structural fiscal balance, at imposing financial discipline on the enterprise sector, and at advancing competitive enterprise and market development in four areas:

(a) Reform of Natural Monopolies (electric power, natural gas, and railway sectors): (i) introduce competition where possible, (ii) reduce subsidies and move prices towards economic costs, (iii) improve the regulatory process, (iv) reduce payment arrears, and (iv) divest selected operations;

(b) Private Sector Development: (i) establish a credible case-by-case privatization program, (ii) improve the competitive environment and the management of state assets, (iii) promote urban land and real estate markets to facilitate the ownership of land by privatized enterprises, (iv) create a leasing market for commercial real estate, (v) improve the allocation and use of undeveloped land; and (vi) introduce international accounting standards (IAS);

(c) Fiscal Reform: (i) reform the overall tax structure, (ii) improve tax administration, (iii) strengthen budget management, including the elimination of budgetary arrears, and (iv) reform inter-governmental fiscal relations;

(d) Banking Sector Reform: (i) deal with problem banks and deposit protection, (ii) improve prudential regulation and supervision, and (iii) improve the functioning of money markets and payment systems.

3.9 The stated objectives of *SAL II* were similar to those of the first operation. On the structural front, *SAL II* supported further measures to advance the reform agenda in the same four areas as under the previous operation. Some post-disbursement measures envisaged under *SAL I* became conditions of Board presentation of *SAL II*, while other post-disbursement measures under *SAL I* remained as such under *SAL II*. In addition, a fifth area was added:

(e) Trade Policy Reform: (i) maintain a liberalized trade regime, no quantitative restrictions, and price-based protection where necessary, (ii) harmonize standards with international practice, (iii) expand production sharing agreements, (iv) implement a market-based system for oil transport, and (v) phase out the oil export for "state needs" program.

3.10 Finally, there was another unstated purpose for *SAL II*, but arguably the most important in explaining its rushed approval:

- Resist speculative pressures on the ruble (the first attacks happened in November 1997) stemming from the spillover of the East Asia crisis and from mounting investors' doubts about fiscal sustainability. A balance-of-payment support rationale, however, was not acknowledged by the Bank, as it projected the current account to move structurally only to a small deficit position of 0.5 percent of GDP in 1998.

The *SALs*' Achievements, 1997–98

3.11 *Macroeconomic objectives* were not achieved and there was limited implementation of agreed steps on structural reform, due to the opposition of key stakeholders, with a correspondingly negligible impact on the economy. During 1997, inflation decreased substantially (to 10.9 percent by year-end from 21.8 percent the year before) and GDP growth turned (slightly) positive for the first time since the transition began (to 0.9 percent from -3.4 percent the year before). Both aggregates reversed direction in 1998, however, with end-year inflation at 84.5 percent and growth at -4.9 percent. While such dismal performance was aggravated by the spillover effects of the 1997 East Asia financial crisis and worsening terms of trade, Russia proved unable to reverse declining revenue collection, including cash collections, and tackle its fiscal imbalances through 1997 (with *SAL I* in place), the first part of 1998 (*SAL II*) and the rest of 1998 (*SAL III*). The consolidated fiscal balance had improved only slightly in 1997 (to -7.9 percent of GDP from -8.9 percent in 1996, compared to the target of 5–6 percent) and remained around –8 percent in 1998 (compared to the target of 5.7 percent), thus keeping the economy on an unsustainable debt path. By mid-1998, debt service absorbed 40 percent of federal government's revenues.

3.12 The fiscal slippage and low world prices for Russia's exports required increasing external borrowing to keep the progressively uncompetitive fixed exchange rate. In August 1998 the stabilization and structural adjustment program collapsed, triggered by declines in oil prices and the spillover of the East Asia crisis that undermined investor confidence.[14] Russia had no choice but to default on its debt and float the ruble (which depreciated by over 60 percent), leading to the insolvency of most banks, a spike in inflation, and a severe, albeit short-lived, recession.

3.13 *Reform of Natural Monopolies*. There was no progress during 1997 and 1998 to improve cash collection and to further competition and, to date, to reform the railway and gas sectors, despite some improvements in pricing methodology applied by the Federal Energy Commission. Very limited progress was made in competitive restructuring and in the reduction of barriers to new entrants, as well as in divestitures on non-naturally monopolistic segments. For example, a decree was issued to allow independent gas producers access to Gazprom's transmission network, but access remained on paper. *SAL II*, nonetheless, may have helped prevent the adoption by the Duma of a discriminatory

[14] The ECA Region noted in its comments on the CAE that Russia could well have been on a path of sustained growth two years earlier, had it not been for the impact of the East Asia crisis.

gas supply law supported by Gazprom. More significant progress on methodology and pricing actions took place in 1998 in electricity, including on cross-subsidization. An Independent Financial Operator was established to get the power wholesale market operating. However, a wholesale market for power is still elusive.

3.14 *Private Sector Development.* Despite an improved institutional and legislative framework for case-by-case privatization in 1997, *SAL I* targets for privatization were not met and actions in other areas were limited to progress in drafting legislation and other preparatory work. Under *SAL II* case-by-case privatization remained stalled. In other areas, some relevant intermediate steps were taken. For example, a new bankruptcy law was enacted, work continued on introducing international accounting standards, and a presidential decree was issued to establish a legal framework for market-based sales of undeveloped land (requiring further legislation for such sales to take place). However, failure to follow-up on implementation meant no results and no impact on private sector development.

3.15 *Fiscal Reform.* Some reforms were formulated, but implementation was disappointing. Legislation regulating sub-national borrowing and tax sharing was adopted in September 1997. Reform proposals were submitted to the State Duma regarding the Tax Code, but these were only partially adopted in mid-1998 (and finally adopted in mid-2000) and many other key revenue reforms failed. Parliament rejected the proposed expansion of the base for the personal income tax, the increase in the land tax, and the expansion of the base for the payroll tax. Measures to address tax and utility payment arrears of large corporations fell short in implementation. Expenditure ceilings were adhered to only on a cash basis. Federal wage and pension arrears were cleared by end-1997, but suppliers' arrears continued to mount.

3.16 *Banking Reform.* While limited advances in improving the payments system and in CBR performance were made, progress in improving supervision, prudential regulations, and financial intermediation was negligible. For example, under *SAL I* the CBR agreed to on-site supervision of at least 15 of the largest 100 banks in each quarter of 1997 and under *SAL II* it agreed to the identification of 27 problem banks among the top 200 banks, and the withdrawal of licenses of 10 banks. However, these steps were inadequate to address the serious shortfalls in the sector.

3.17 *Trade Policy Reform.* A liberalized environment was maintained, but most of the important reforms in the sector occurred prior to 1997–98. *SAL II* did promote reforms to bring technical and product labeling standards in line with international practice, and the emerging framework for "trade safeguards" (anti-dumping, countervailing duties, etc.) was made more consistent with international norms. Proposed principles for a market-based system for oil transport were published, but such system has yet to be implemented.

3.18 *Cumulative Economic, Institutional, and Social Impact.* Despite the structural reforms that had occurred, the Bank's country policy and institutional assessment in the late 1990s through 2001 have put Russia in the middle among transition economies, with high scores for the shift of production towards the private sector and price liberalization, but low scores for financial sector development, competition policy, enterprise reform, corporate governance, environmental sustainability, property rights, and public sector governance (transparency, accountability, and corruption). EBRD transition indicators portray a similar picture.

3.19 Over the past decade, Russia's GNP per capita declined substantially, by more than 50 percent according to official statistics (see table 2.1). While the decline in consumption was more modest, the impact on poverty, income distribution, equity, and human development has been large, both in absolute terms and relative to other transition economies. In mid-1999, 55 percent of the population, especially children and the elderly, was living in absolute deprivation.[15] Inequality had remained stable since 1993 at double pre-transition levels (see para. 2.25). Human development indicators recovered only modestly from their lows in the early 1990s. Health and education indicators dropped, the quality of services worsened, and social and geographical disparities in access grew.

3.20 By 1998 the gains from the transition included the elimination of shortages of consumer goods; greatly improved quality and variety of goods and services; ownership titles to housing for most households; greater social mobility no longer shackled by pervasive administrative restrictions; and expanded access to the domestic political process and global information. New employment services were established, administration of pension benefits improved, and social assistance became better targeted. However, proposed reforms of the labor laws and the pension system had not been adopted, and absolute levels of social benefits remained low.

Recent Developments, 1999–02

3.21 The Primakov government that came to power following the 1998 crisis was widely expected to pursue lax monetary and fiscal policies. Instead, it improved fiscal discipline, kept a lid on inflation, allowed only a moderate amount of food aid so as not to damage agricultural producers' incentives, and abstained from reversing liberalization and other reforms. Unlike other countries which experienced financial crises during the 1990s, Russia overcame the 1998 crisis quickly and without international financial assistance. In mid-2000 the Kasyanov government endorsed a comprehensive medium-term program of policy and institutional reforms. Important reforms have since been adopted, including in tax policy, urban land sales, pension system, land code, and business deregulation. Some, including tax reform, have been successfully implemented.

3.22 The last three years have seen strong economic performance. Good fiscal management, large balance-of-payments surpluses, and an impressive output recovery have been accompanied by an improvement in business confidence and a drastic reduction of barter and enterprise payment arrears. Poverty incidence has declined sharply (from its peak in mid-1999 to 33 percent by end-2000, according to official estimates). The economy has been boosted by higher world energy prices and improved competitiveness of the non-oil export sector, thanks to the 1998 devaluation. Political stability and a broader consensus on reform have also played significant roles. Russia has effectively moved from a centrally planned to a market economy, albeit with considerable

[15] The corresponding share for 1997 was 32 percent. Given methodological changes, these poverty estimates are not comparable with those available for previous years.

distortions and weak social services and safety net. Policy, institutional, and ownership changes have gone too far to be reversed.

4. Overall Assessment

The Rehabilitation Loans

4.1 The February 1997 ICRs for these operations rated the projects' outcome as satisfactory, their sustainability as likely, and the achievement of the institutional development (ID) objective of *RL I* as substantial. Bank performance was similarly rated as satisfactory (with the supervision component of *RL I* rated as highly satisfactory). Borrower performance was also rated as satisfactory (with the preparation component of *RL I* rated as deficient). OED concurred with these ratings in its June 1997 desk review of the ICRs. The ICR for *RL II* marked the achievement of ID objectives as not applicable. OED instead rated ID impact of *RL II* as modest, in light of some changes that had been adopted to the legal and regulatory environment. As a result of the deeper and later scrutiny of the Bank assistance under the PPAR- and CAE-related work conducted during 1999–02, this PPAR downgrades a number of these ratings (Bank and Borrower performance ratings are discussed in the next chapter).

4.2 *Outcome.* The RLs were designed to start a process of structural change in an economic system with distorted prices and pervasive resource allocation anomalies. These types of operations were considered vital in providing the foundations for sustained reform and in providing budget support during a period of economic and fiscal revenue decline. Trade and price liberalization, privatization, and macroeconomic stabilization were all essential for a restoration of growth in Russia.

4.3 Thus, *RL I* was highly relevant, in the face of the extremely complex nature of the task of transforming this command economy into one driven by market forces. This loan provided a positive, albeit modest, contribution to the shift to a private sector led economy and to the high degree of market liberalization that was achieved in Russia between 1991 and 1994. Positive benefits also accrued from changes in state procurement practices. The weaknesses in fiscal management were reasonably expected to be addressed under IMF programs and in other structural policy and institutional areas by contemporary and subsequent Bank loans. The broad objectives of *RL II* were still highly relevant, but the rationale and design of this loan are more questionable, as the weaknesses in fiscal management and other structural policy and institutional areas could have been better addressed. Thus, its overall relevance is rated as substantial.

4.4 In the event, the policy changes achieved under both loans did little to address the key fiscal and institutional weaknesses undermining the country's transition to a market based economy. In both cases, efficacy was modest. Thus, combining the above-mentioned relevance and efficacy ratings, the outcome of *RL I* is rated as moderately satisfactory, and the outcome of the *RL II* is rated as moderately unsatisfactory.[16]

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[16] OED rates outcome on a six-point scale of highly satisfactory, satisfactory, moderately satisfactory, moderately unsatisfactory, unsatisfactory, and highly unsatisfactory.

4.5 *Institutional Development Impact.* Neither loan had a significant ID objective, with the exception of capacity building for international competitive bidding (ICB) in state procurement under *RL I*, a goal that was realized. Other than this, ID impact (including beyond the stated objectives) was limited; hence ID impact for *RL I* was modest and for *RL II* negligible.[17]

4.6 *Sustainability.* Through 1998, the limited achievements in the macroeconomic arena (that is, low inflation after 1995) to which the RLs contributed were unlikely to be sustained, while the sustainability of the limited achievements in the structural arena was uncertain. However, no major structural reform adopted and implemented was ever reversed, even if there were various periods of slow progress or episodes of straying from the path of reform (e.g., the loans-for-shares scheme). Thus, with the benefit of hindsight and giving more weight to the structural reforms undertaken and sustained under these loans than to the poor macroeconomic environment through 1998, the overall sustainability of the limited achievements of these loans is rated as likely. This confirms ex-post the previous evaluators' optimism.[18]

The Structural Adjustment Loans

4.7 *Outcome.* On the basis of the ratings of the elements comprising outcome, that is modest relevance (marginally so for *SAL II*), modest efficacy, and non-evaluable[19] efficiency, this evaluation supports a rating of unsatisfactory outcome for both operations, which is consistent with OED's review of the ICR. The ECA Region, instead, had rated their outcome satisfactory in the ICR.

4.8 The fiscal and structural objectives of both *SALs I* and *II* were relevant to the needs of the country, although trade liberalization had been largely achieved in previous years and, in hindsight, defending the current fixed nominal exchange rate after at least two years of real appreciation was neither desirable nor feasible. However, the operations' timing, size, and design were faulty. The *SAL*s' assumption about the speed with which the reforms could proceed and achieve their stated objectives was unrealistic and raised expectations that were sure to be disappointed. The Bank assumed reforms in all the chosen areas could move in a couple of years from (a) design to (b) embodiment in relevant legislation or directives to (c) passage by the relevant bodies such as the State Duma to (d) administrative implementation. It assumed quick passage of legislation by the State Duma, whose majority was known to oppose the Government's political and economic agenda. While the Bank got sequencing right, given that most actions under the SALs I and II were necessarily either preparatory first steps or legislative proposals, the size of these operations and the front-loading of disbursements was inappropriate.

4.9 The design of the *SALs* has also been criticized on the basis of their being too broad, covering too many areas of reform. The needed reforms in Russia were of a "general equilibrium" nature, with reforms in each of the chosen areas having positive

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[17] OED rates ID impact on a four-point scale of high, substantial, modest, and negligible.

[18] OED rates sustainability on a five-point scale of highly likely, likely, unlikely, highly unlikely, and non-evaluable.

[19] Since the net benefits to the country of reforms are very difficult to quantify and the size of adjustment loans is largely related to ex-ante projections of balance-of-payments and budgetary financing gaps, the efficiency of adjustment operations is usually not rated by OED.

implications for the success of reforms in the other areas. Thus, the ambitious and multi-sectoral reach of the reform program was appropriate. Nonetheless, parallel SECALs instead of SALs might have been better suited to the Russian environment, as they would have been both more manageable and would have allowed more "ownership" of the sectoral reforms by the line ministries and agencies affected. This has been indeed the case for the *Coal SECAL*, but not for the *SPAL*. Thus, the evidence is mixed on this question. In hindsight, small TA projects would have been the better choice for 1997, as the Russian political system was not yet ready to move on the reform agenda.

4.10 On balance, efficacy of both loans was modest, as their limited achievements through mid-1998 pale compared to their shortcomings. Significant results under *SAL I* were fiscal expenditure restraint, the elimination of federal wage and pension arrears, legislation reforming inter-governmental relations, and partial electricity pricing reform. There was progress on other fronts (adoption of a framework for case-by-case privatization and preparation of other legislative measures), but it did not carry through to implementation. Under *SAL II*, pricing and institutional reforms were continued in electricity. A new bankruptcy law was enacted. Wage and pension payments remained current. Regarding land, there was progress in preparing legislation. It has been also argued that the *SALs*' focus on transparent privatization contributed to preventing a repetition of the loans-for-shares deals. Finally, the groundwork carried out under these loans for tax, land sale, and other reforms has borne some fruits since 2000.

4.11 As discussed in the preceding chapter, however, there was virtually no implementation of the important agreed reforms, including inadequate fiscal and other policy adjustments to the deterioration in international commodity prices and to the mounting capital flight and speculative attacks on the fixed nominal exchange rate. There was minimal or no follow-on implementation of the medium-term structural reform program through June 1998, before the Board presentation conditions for *SAL III* forced another round of partial and inadequate reforms. Both 1997 and 1998 were characterized by poor and deteriorating revenue collections, large capital outflows, unreformed natural monopolies, no transparent privatizations, and a banking sector with little capacity to provide normal banking services and increasing vulnerability to exchange rate volatility. *SAL II* moreover contributed to further appreciation of the real exchange rate during the first half of 1998, and thus to the worsening of competitiveness in domestic and foreign markets for Russian manufacturing enterprises.

4.12 *Institutional Development Impact*. The *SALs I* and *II* were designed to produce substantial ID impact. However, most of the policy and institutional changes designed to improve the rules of the game, organizational incentives, and capacity building were not implemented. Given the limited achievements discussed in the previous chapter, the rating for ID impact cannot be more than modest.

4.13 *Sustainability*. A month after the closing of *SAL II*, the August 1998 crisis engulfed the economy. This was in part the consequence of the lack of fiscal adjustment during the *SALs*. The crisis made the sustainability of the structural part of the *SALs I* and *II* program tenuous through mid-1999. But there was little retreat from the reform program that was (partially) in place. The rebound from the macro crisis has been relatively speedy. The reform process, broadly conceived, has become embedded in economic thinking in the elite. The idea of structural reform has taken solid root. Thus, the reaction to the crisis and subsequent events indicate that the limited achievements and the general direction reform under *SALs I* and *II* are likely to be sustained.

5. Contributions to Development Effectiveness

Borrower Performance[20]

5.1 The main reason for the poor transition outcomes in Russia through 1998 lies in the difficult political climate for reform due to the political instability and the highly complex governance issues. Both the Government (to be understood as including all arms and all levels) and the country were divided on the best transition path to a market economy. On any issue, various interest groups, including powerful factions in the State Duma, regional political figures, line ministries, vested private economic interests, the "oligarchs," and criminal elements, enjoyed the ability to co-opt, delay, or block almost any policy initiative. Reformers in government were willing to commit to reform, but in general unable to forge a consensus that would support their strong implementation.

5.2 Through 1999, the Russian Federation failed to adopt many of the fiscal and structural reforms (beyond price and trade liberalization and privatization) necessary for macroeconomic stabilization and growth, despite its promises to the international financial institutions. These were the same reforms that it finally embraced in 2001–02. In particular, government institutions, policies, and regulations perpetuated soft budget constraints for enterprises and banks and tolerated a dramatic increase in barter and in tax, wages, pensions, and suppliers' arrears within the public sector and among energy and infrastructure monopolies.[21] In the hands of managers incapable of or unwilling to restructure and under pressure from import liberalization, shrinking private and public demand, the real appreciation of the ruble, and the high real interest rates, enterprises and banks readily seized on the government's political unwillingness to cause bankruptcies and root out the "non-payments system".

5.3 Thus, considering the scope and speed of the early privatization and price and trade liberalization reforms, Borrower performance is rated on balance as satisfactory for *RL I*. But for all other three subsequent operations (*RL II* and *SALs I* and *II*), the weight of the Government's role in the failed macroeconomic stabilization, the shortcomings in the privatization program, and the missed structural policy and institutional reforms justify an unsatisfactory performance rating.

5.4 An example of the difficulties of reform due to the complex governance system and the political economy of Russia is provided by the Bank-supported attempt to "clean up" the banking system. The Government developed a law on bank bankruptcy under *SAL I* in 1997. The State Duma did not pass it until March 1999. The law mandated a bank restructuring organization, ARKO, which began operations in June 1999. Meanwhile, a leak of the central bank's study identifying the "problem banks," which

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[20] This is rated on a four-point scale of highly satisfactory, satisfactory, unsatisfactory, and highly unsatisfactory.

[21] Federal wages and pension arrears were cleared in 1997 and did not re-accumulate thereafter.

were candidates for restructuring by ARKO, provided a signal for these banks to move their assets to "shadow" banks, leaving ARKO larger net liabilities. Given its limited budget, this created an incentive for ARKO to proceed slowly, if at all. The banks whose licenses CBR and ARKO had revoked under the new law appealed to the Supreme Court, which found flaws in the law and restored the licenses. Proposed legal amendments to meet the Court's objection have been pending before the Duma since.

5.5 A second example also relates to the financial sector. In parallel with *SALs I* and *II*, the Bank provided substantial TA for banking reform. A key factor in the failure of these efforts was a massive and chronic failure of strategic and operational coordination. The Ministry of Finance and the CBR were not pursuing a common strategy for strengthening the banking sector; coordination among donors as well as among different units within the Bank was weak; and supervision within the Bank was not as close as it should have been.

5.6 The role of interests groups, and particularly of private sector special interests, in influencing both the executive and the legislature undermined Borrower ownership and the capacity of the core economic ministries to get the *SAL* program adopted by other parts of government and the legislature. The *SAL* program was (correctly) seen as eliminating economic rents without compensation to the losers, while the Government did not sell well to the public and the beneficiaries the potential "general equilibrium" efficiency gains from structural reform. Through mid-1999, none of the Bank or IMF documents, for instance, were disclosed to allow the general public a full appreciation of the aims, the coverage, and the costs and benefits of the agreed reforms programs.

5.7 In 1997, moreover, the Government only agreed to conditions for the disbursements of *SALs I* and *II* related to preparing the program and submitting legislation to the State Duma. While the Government thus was able to meet the letter of the agreed conditionalities, it failed at meeting their spirit through effective consensus-building and strong post-disbursement implementation of follow-up actions. The Government was unable to improve revenue collection and reduce the fiscal deficit as called for under the agreed program with the IMF, thus exacerbating the underlying unsustainable public debt dynamics. Similarly, the Duma agreed to the negotiated program in principle, but it rejected specific legislation in several areas. The Borrower (Government and Duma) failed to go beyond promises and preparatory activities on all key components of the agreed structural reform program, including those carried over from *SAL I*. The adoption of the first part of the Tax Code in mid-1998 was more attributable to the mounting financial pressures that led to the August collapse and to *SAL III* pre-Board conditionality, rather than to Borrower's performance under *SAL II*. Even if some credit were given to *SAL II* for this step, late timing and failure to adopt the second part of the Tax Code fatally undermined the attempts by the Government and the international community to restore investors' confidence.

5.8 Thus, the performance of the Borrower (the Government and the Duma) has been unsatisfactory under both *SALs I* and *II*. This judgment does not agree with the satisfactory rating of Borrower performance in the ECA Region's ICR of *SALs I* and *II*, but is consistent with OED's review of the ICR and with the unsatisfactory rating of

Borrower performance in the May 2001 ICR of *SAL III* (mid-1998 to end-2000), an operation whose reform coverage overlapped to a large extent with the previous *SALs*.

Bank Performance[22]

5.9 For *RL I*, Bank performance is rated as satisfactory. Project processing for *RL I* was expeditious, reflecting the urgencies in Russia, and supervision was intensive. In particular, close attention was paid to procurement and distribution issues. But the procedural difficulties predicted in the loan's President's Report, related to procurement and disbursement, especially for the pre-identified import component, undermined one of the key objectives of the loan. The goal of a speedy alleviation of foreign currency shortages was not achieved. These problems arose for rehabilitation loans in other transition countries, and with hindsight this component should not have been included. The policy issues identified by the Bank and on which it sought agreement with the authorities were comprehensive and relevant, although perhaps too ambitious. The lack of formal or detailed set of policy conditions, given that this was Russia's first involvement with the Bank and the urgent need of liquidity support, was appropriate.

5.10 The Bank learned the lesson of experience on pre-identified imports and *RL II* was appropriately structured as a quick-disbursing, balance-of-payments/general budget support operation, utilizing the existing commercial foreign currency market. While it is questionable whether a single-tranche operation was the most suitable vehicle to achieve sustained impetus on the part of the authorities toward the key areas of structural reform, the gestation period for this operation was lengthy and the Bank was right in withholding its presentation to the Board until an acceptable overall macroeconomic policy framework backed by a Fund program was in place. Although fiscal adjustment could have been emphasized more, the Bank supported a relevant policy reform agenda. Thus, Bank performance was satisfactory for *RL II*.

5.11 The design of *SALs I* and *II* was aimed at preparatory activities for structural reforms to be implemented after their disbursements and under subsequent adjustment loans (a series of SALs was envisaged). The areas covered by *SALs I* and *II* were important and the specific measures were necessary steps to achieve the objectives. However, they were not sufficient.

5.12 Although the unsustainability of deficit financing became apparent only gradually, as yields fluctuated widely in 1996 in reaction to the president's electoral and health prospects and decreased in early 1997, the high risks to the success of the operations medium-term objectives due to the narrow ownership and consensus in the country on the reform program were clear in early 1997 and even more so in late 1997. However, the Bank did not adequately assess during the preparation of *SAL I* the likelihood for delays in the adoption of the agreed measures and subsequent, expected follow-up actions. Instead of drawing the right lesson from the poor experience with the recent single-tranche *RL II*, the Bank proved too eager to seize what it perceived as a window of opportunity brought about by a new government with key reformers in senior positions.

[22] This is rated on a four-point scale of highly satisfactory, satisfactory, unsatisfactory, and highly unsatisfactory.

5.13 In light of prior experience in Russia with very brief windows of opportunity and with stop-go implementation of agreed reforms, the Bank should have been more cautious in the *SALs* timing and design. A SAL should have been approved only at a more advanced stage of preparation (and with substantial ESW backing it up), and preferably after concrete signs of government commitment to implementation (as was the case for the *Coal SECALs*). Given the economic and political conditions in mid-1997, the Bank should have only offered the government analytical and advisory services and technical assistance. The Bank's desire to gain a seat at the policy making table would have been more efficiently served by helping the IMF review the structural components of its *EFF*. A second-best option for risk mitigation would have been for the Bank to offer a back-loaded, multi-year, adjustment operation (or preferably, a series of SECALs) with floating tranches. Thus, Bank performance is rated unsatisfactory for *SAL I*, consistent with the ICR review.

5.14 During preparation and approval of *SAL II*, the Bank continued to fall short in assessing the degree of ownership and commitment to reform among key constituencies. Without adequately heeding the lessons from the negligible efficacy of *SAL I*, disbursement and conditionalities were still inappropriately targeted to preparatory activities rather than implementation of reforms. The Bank showed poor judgment in assessing implementation of *SAL I* as satisfactory in the Board documentation for the approval of *SAL II*, and consequently in not re-assessing the modalities of its assistance. Given the economic and political conditions at end-1997, the Bank should have postponed a second SAL and instead only offered the government analytical and advisory services and technical assistance. In November and December 1997, instead, the Bank rushed to prepare, approve, and disburse this de-facto single-tranche loan out of fear of the consequences for Russia and the rest of the world from the spillover from the East Asia crisis. Alternative options may not have been available to Bank management and staff, given the considerable external pressures by major shareholders for the Bank to provide massive and quick support to the new government. Due to these mitigating circumstances, OED rates Bank performance for *SAL II* as unsatisfactory rather than highly so. This rating is consistent with that in OED's review of the ICR.

5.15 The ECA Region's management disagree that the shift from investment lending to structural adjustment lending was a misguided response, as the risks involved were worth taking at the time given the potential rewards. While retrospectively questioning the amount of structural adjustment lending, management believe that restricting Bank assistance to AAA and small loans would have meant a perpetuation of the Bank's limited impact on policy formulation. The 1997 *SALs* and the *SPAL* were necessary to influence the design of the structural reform agenda, beyond the limited impact of analytical and advisory services. *SAL II*, moreover, was justified by the need to address the fallout from the East Asia crisis. Management further argue that the lack of fundamental reversals in economic policy, as well as improved Russia-Bank relations, would not have taken place without the trust-building by virtue of the approval of *SAL I* and *II* and the *SPAL*. Moreover, these operations sowed the seeds of the reform program adopted in 2000 and currently under implementation.

6. Lessons

6.1 The Bank's experience with the two *RLs* confirms a number of lessons that have been learned in other emergency support operations:

- Assure flexibility in the use of rehabilitation loans and avoid pre-identification of specific imports. For operations designed to address key social needs and/or production bottlenecks, projects require a maximum degree of funding flexibility. Earmarking portions of rehabilitation loans complicates implementation and in some cases can delay disbursements beyond a time when they are urgently needed.
- Ensure adequate supervision coefficients. For rehabilitation loans and emergency import projects, standard supervision coefficients may not be appropriate. This is especially for so for new borrowers unfamiliar with Bank procedures.
- Sound macroeconomic management is a pre-requisite for the positive responses expected to flow from structural reform, under all policy-based type of lending.

6.2 The lessons from the Bank's experience with *SAL I* and *SAL II*, although not fully recognized in the ICR, have been subsequently incorporated in *SAL III*:

- Broad country ownership is crucial. Thus, it is important for the Bank to pay close attention to the political and institutional aspects of reforms and consult with all relevant units of government and civil society, so as to improve the relevance and design of its activities and avoid operations where commitment is weak.
- In the face of a poor track record and narrow country ownership of reform, a large adjustment lending program, especially one with front-loaded disbursements, risks delaying rather than accelerating reform.[22]
- In the face of a poor track record and a new consensus on a reform program, adjustment lending should be available only after the government has publicly adopted the necessary reforms or has begun implementing them, as was the case for the Coal SECALs. Separate sectoral operations, back-loaded disbursements, and floating tranches should be used to assure a tighter linkage between increases in the country's debt to IBRD and the implementation of irreversible reform measures. Disbursements should be backloaded and carefully modulated on the basis of solid progress in implementation, including enforcement of laws and regulations.[23]
- There needs to be strong strategic coordination and integration of actors, instruments, and interventions supporting common objectives in programs

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[22] ECA management is skeptical that advice alone, however useful, could have carried much weight in Russia.

[23] The Coal SECALs and SAL III, especially after their restructuring in 1999, were good examples of such an approach. The ECA Region's management, however, in their comments to a previous ICR review by OED of *SALs I* and *II* and again to the Russia CAE, have questioned whether adjustment loans should only be offered after adoption of reforms. In their view, in cases where the Bank is called upon to provide adjustment lending to help resolve a rapidly unfolding crisis, for example, it is unrealistic to think that such support should only be provided when there is strong prior political ownership and consensus about the reform path. Moreover, there is often a lag in the take-up of new policies, as in Russia prior to the year 2000.

supported by the Bank as well as by Russia's other development partners. For the most part, the TA provided to the Russian authorities under *SALs I* and *II* worked well in the design of specific measures and in their implementation. But in some areas, the integration between TA and on-the-ground implementation of policy measures was insufficient, such as in the financial sector.

6.3 Common to all four operations as well as the rest of the Bank's assistance in Russia are other important lessons:

- The Bank should pay attention to the quality of public institutions and governance. While considerable Bank support has been provided for institutional development since the inception of the Bank's program of assistance to Russia, the problem of governance was not frontally addressed. It is clearly a serious impediment to development—the absence of rule of law, for example, has been one of the most serious deterrents to foreign direct investment and a major factor behind capital flight. The issue has been complicated by the weak tradition of property rights, exacerbated in the communist period, where control rather ownership has long been the basis for the beneficial use. It has also been complicated by the major distortions in Russia's post-communist economy, which have created all kinds of perceived inequities, and by the use of wild accusations of corruption as a standard part of the political battle. In terms of ensuring that the funds it lends are safeguarded, the Bank should address the important challenge of improving the overall quality of expenditure controls and accountability in Russia's budgetary system.
- Keep "windows of opportunity" in perspective. One of the clearest lessons from all the Bank assistance in Russia is the under-estimation of the complexity of the task of structural reform. Deep-rooted political, social, and individual behavioral changes are necessary before the transformation will be complete. This will take time—perhaps another generation. In this context, the focus must be maintained on structuring operations that bring about and support the implementation of medium- and long-term structural change, not "quick fixes." This is another argument for TA and multiple-tranche operations, in support of well-articulated medium and long-term reform roadmaps.

Basic Data Sheet

REHABILITATION LOAN (LOAN 3515-RU)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	600.0	600.0	100
Loan amount	600.0	600.0	100
Cofinancing	0	0	-
Cancellation	0	0	-

Cumulative Estimated and Actual Disbursements

	FY92	*FY93*	*FY94*	*FY95*	*Total*
Appraisal estimate (US$m)	N/A	N/A	N/A	N/A	600
Actual (US$m)	0.9	371	226	1.5	600
Actual as % of appraisal	N/A	N/A	N/A	N/A	100
Date of final disbursement: February 1, 1995					

Project Dates

	Original	*Actual*
Initiating Memorandum	N/A	N/A
Negotiations	N/A	07/92
Letters of Development Policy	N/A	07/92
Board Approval	N/A	08/92
Signing		11/92
Effectiveness	08/91	12/92
Closing date	12/93	09/94

Staff Inputs (staff weeks)

	Revised		*Actual*	
Stage of project cycle	*Weeks*	*US$*	*Weeks*	*US$*
Appraisal – Board approval	130	480,000	103	370,000
Board approval – Effectiveness	20	75,000	16	58,000
Supervision	85	320,000	69	247,000
Completion	15	56,250	6	20,600
Total	**250**	**931,250**	**194**	**695,600**

Mission Data

	Date (month/year)	No. of Persons	Days in Field	Specialization[a]	Performance Rating[b] Implementation Status	Development Status	Type of Problems[c]
Preparation	04-06/92	4	12	E,F	N/A	N/A	
Supervision	10/92	4	4	E,F	2		F
	05/93	2	11	E,F	1		M
	09/03	3	9	E,F	2		
	04/94	1	4	E			
	06/94	1	11	E			
	09/94	2	10	E			

[a] **Specialization**
E = Economist
F = Financial Analyst

[b] **Performance Rating**
1 = Minor Problems
2 = Moderate Problems
3 = Major Problems

[c] **Types of Problems**
F = Financial
M = Managerial

Other Project Data

Loan Title	Purpose	Year of Approval	Status
Preceding Operations			
None			
Following Operations			
1. Privatization Implementation Assistance	Privatization, Enterprise Restructuring	FY93	Under Implementation
2. Employment Services and Social Protection	Poverty Reduction, Build Capacity in Employment Services	FY93	Under Implementation
3. Oil Rehabilitation I	Oil Sector Reforms, Expand Production Capacity	FY93	Under Implementation
4. Oil Rehabilitation II	Oil Sector Reforms, Expand Production Capacity	FY94	Under Implementation
5. Rehabilitation II	Stabilization and Structural Reforms	FY95	Closed

SECOND REHABILITATION LOAN (LOAN 3898-RU)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	600.0	600.0	100
Loan amount	600.0	600.0	100
Cofinancing	0	0	-
Cancellation	0	0	-

Cumulative Estimated and Actual Disbursements

	FY96
Appraisal estimate (US$m)	N/A
Actual (US$m)	600
Actual as % of appraisal	N/A
Date of final disbursement: October, 1995	

Project Dates

	Original	*Actual*
Identification	N/A	N/A
Preparation	N/A	05-06/93
Appraisal Mission	N/A	07/93
Negotiations	N/A	08/93
Letter of Development Policy (if applicable)	N/A	08/30/94
Board Approval	N/A	06/06/95
Signing	N/A	07/07/95
Effectiveness	07/95	09/28/95
Closing date	N/A	06/30/96

Staff Inputs (staff weeks)

	Actual	
Stage of project cycle	*Weeks*	*US$*
Through Preappraisal	49	153,800
Appraisal - Board approval	96	290,400
Board approval – Effectiveness	35	109,900
Supervision	N/A	0
Completion	4	12,500
Total	**180.5**	**566,600**

Mission Data

	Date (month/year)	No. of Persons	Days in Field	Specialization[a]	Performance Rating[b]: Implementation Status	Performance Rating[b]: Development Status	Type of Problems[c]
Preparation	05-06/93	3	12	E,F,G	N/A	N/A	
Appraisal	07/93	3	12	E,F,G	N/A	N/A	
Appraisal to	08/94	2	12	E,G	N/A	1	
Board approval	04/95	1	12	E	N/A	2	P
Board	07/95	1	10	E	N/A	2	P
approval to effectiveness	08/95	1	10	G	N/A	1	

[a] Specialization
E = Economist
F = Financial Analyst
G = Energy Specialist

[b] Performance
1 = Minor Problems
2 = Moderate Problems
3 = Major Problems

[c] Types of Problems
P = Political

Other Project Data

Loan Title	Purpose	Year of Approval	Status
Preceding Operations			
1. Rehabilitation Loan	Stabilization and Structural Reforms	FY93	Closed
2. Employment Services and Social Protection	Poverty Reduction, Build Capacity in Employment Services	FY93	Under implementation
3. Privatization Implementation Assistance	Enterprise Restructuring	FY93	Under implementation
4. Oil Rehabilitation I	Oil Sector Reforms, Expand Production Capacity	FY93	Under implementation
4. Oil Rehabilitation II	Oil Sector Reforms, Expand Production Capacity	FY94	Under implementation
Following Operations			
5. Standards Development	Harmonization of Product Standards for WTO Entry	FY96	Under implementation

Basic Data Sheet

STRUCTURAL ADJUSTMENT LOAN I (LOAN 4180-RU)

Key Project Data *(amounts in US$ million)*

Item	*Appraisal Estimate*	*Actual*	*Actual as% of Appraisal*
Total project costs	600	600	100
Loan amount	600	600	100
Cofinancing	0	0	-
Cancellation	0	0	-

Cumulative Estimated and Actual Disbursements *(in US$ million)*

	FY97	*FY98*	*Total*
Appraisal Estimate	600.0	N/A	600.0
Actual	600.0	N/A	600.0
Actual as % estimate	100%	N/A	100%
Date of final disbursement: June 17, 1997			

Project Dates

	Date Planned	*Actual Date*
Identification (IEPS)	N/A	12/96
Preparation	N/A	01-02/97
Appraisal	N/A	03/97
Negotiation	N/A	04/97
Letter of Development Policy	N/A	04/97
Board Presentation	N/A	06/97
Signing	N/A	06/97
Effectiveness	06/97	06/97
First Tranche Release	N/A	N/A
Project Completion	[a]	[a]
Loan Closing	03/98	03/98

[a] SAL I and SAL II are part of continuing series of structural adjustment operations supporting Russia's transition to a market economy. In this sense, the "project" has not yet been completed. In the sense of completion of disbursements for each loan, SAL I was completed in June 1997 and SAL II was completed in January 1998.

Staff Inputs (staff weeks)

	Planned		*Actual*	
Stage of Project Cycle	*Weeks*	*US$*	*Weeks*	*US$*
Preparation	43.0	268.0	40.9	241.2
Appraisal	36.4	129.1	36.9	124.1
Negotiations to Board	11.7	39.7	15.1	64.5
Supervision	23.7	69.5	26.0	77.4
Completion	3.0	16.7	0.0	0.0
Total	**117.8**	**523.0**	**118.9**	**507.3**

Notes: Costs are in thousands of US$. Actual staff inputs and dollar costs are as of May 20, 1999.

Mission Data

	Date (month/year)	*No. of Persons*	*Days in Field*	*Staff Type*[a]	*Performance Rating*[b] *Implementation Status*	*Performance Rating*[b] *Development Status*	*Type of Problems*[c]
Preparation	12/96	4	10	E,F			
	01/97	7	10	E,F			
Appraisal	02/97	5	10	E,F			
	03/97	5	10	E,F			
Supervision	07/97	5	12	E,F	2	2	M

[a] **Staff Type**
E = Economist
F = Financial Sector Specialist

[b] **Performance**
1 = Minor Problems
2 = Moderate Problems
3 = Major Problems

[c] **Types of Problems**
M = Project Management

Other Project Data
Related Operations

Loan/Credit Title	*Purpose*	*Year of Approval*	*Status*
Privatization Implementation Assistance Loan	Support the Government's privatization program	FY93	Completed
Coal Sector Adjustment Loan	Support the Government's sector restructuring program	FY96	Completed
Social Protection Adjustment Loan	Establish effective and sustainable system of income support and poverty relief	FY97	Under Implementation
Coal Sector Adjustment Loan II	Support the Government's sector restructuring program	FY98	Under Implementation
Structural Adjustment Loan III	Continue support for return of structural policies and institutions	FY99	Under Implementation

STRUCTURAL ADJUSTMENT LOAN II (LOAN 4261-RU)

Key Project Data *(amounts in US$ million)*

Item	*Appraisal Estimate*	*Actual*	*Actual as% of Appraisal*
Total project costs	800	800	100
Loan amount	800	800	100
Cofinancing	0	0	0
Cancellation	0	0	0

Cumulative Estimated and Actual Disbursements *(in US$ million)*

	FY97	*FY98*	*Total*
Appraisal Estimate	N/A	800	800
Actual	N/A	800	800
Actual as % estimate	N/A	100%	100%
Date of final disbursement: Jan. 23, 1998			

Project Dates

	Date Planned	*Actual Date*
Identification (IEPS)	N/A	06/97
Preparation	N/A	07-08/97
Appraisal	N/A	10/97
Negotiation	N/A	11/97
Letter of Development Policy	N/A	11/97
Board Presentation	N/A	12/97
Signing	N/A	12/97
Effectiveness	12/97	12/97
First Tranche Release		
Project Completion	[a]	[a]
Loan Closing	12/98	12/98

[a] SAL I and SAL II are part of continuing series of structural adjustment operations supporting Russia's transition to a market economy. In this sense, the "project" has not yet been completed. In the sense of completion of disbursements for each loan, SAL I was completed in June 1997 and SAL II was completed in January 1998.

Staff Inputs (staff weeks)

	Planned		*Actual*	
Stage of Project Cycle	*Weeks*	*US$*	*Weeks*	*US$*
Preparation	43.6	187.5	56.9	232.7
Appraisal	16.2	46.3	16.2	114.0
Negotiations to Board	19.6	72.1	19.6	149.9
Supervision	26.1	96.0	65.0	189.0
Completion	3.0	16.7	0.0	0.0
Total	**108.5**	**418.6**	**157.7**	**685.6**

Notes: Costs are in thousands of US$. Actual staff inputs and dollar costs are as of May 20, 1999.

Mission Data

	Date (month/year)	No. of Persons	Days in Field	Staff Type[a]	Performance Rating[b]: Implementation Status	Performance Rating[b]: Development Status	Type of Problems[c]
Preparation	7-8/97	5	12	E,F			
Appraisal	10/97	5	12	E,F			
Supervision	01/98	10	12	E,F	2	2	M
	02/98	5	10	E,F	2	2	M
	04/98	5	10	E,F	2	2	M
	06/98	5	10	E,F	2	2	M

[a] Staff Type
E = Economist
F = Financial Sector Specialist

[b] Performance
1 = Minor Problems
2 = Moderate Problems
3 = Major Problems

[c] Types of Problems
M = Project Management

Other Project Data
Related Operations

Loan/Credit Title	Purpose	Year of Approval	Status
Privatization Implementation Assistance Loan	Support the Government's privatization program	FY93	Completed
Coal Sector Adjustment Loan	Support the Government's sector restructuring program	FY96	Completed
Social Protection Adjustment Loan	Establish effective and sustainable system of income support and poverty relief	FY97	Under Implementation
Coal Sector Adjustment Loan II	Support the Government's sector restructuring program	FY98	Under Implementation
Structural Adjustment Loan III	Continue support for return of structural policies and institutions	FY99	Under Implementation

RUSSIA: REHABILITATION LOAN (RL I)
STATUS OF POLICY AGREEMENTS AS OF MAY 1, 1995 [1]

I. ENTERPRISE REFORM

A. Privatization of small-scale enterprises	
i. GKI will prepare a simplified and flexible scheme for small-scale privatization which is to be introduced by end of August 1992.	**Done.** GKI reports that 90,000 small-scale enterprises (constituting 80 percent of enterprises with fewer than 200 employees) had been sold as of en-June, 1994.
ii. GKI will provide technical assistance on small-scale privatization to regional and municipal governments; this assistance will be available beginning in September 1992.	**Done.** There have been local variations in the pace of small-scale privatization, essentially related to the commitment of the local authorities responsible for implementing the program.
B. Privatization of medium and large-scale enterprises	
i. A detailed plan for mass privatization of medium and large scale state enterprises is now being prepared and is to be completed during the third quarter of 1992.	**Done.** The privatization program for 1992/93 was approved on June 11, 1992. By end-June 1994, 20,000 of the 28,000 large and medium-size state-owned enterprises earmarked for privatization under the program had been corporatized, and 12,000 enterprises had auctioned a majority interest for vouchers and had state shares of less than 25 percent.
ii. Implementation will begin with the distribution of vouchers in the fourth quarter; auctions of specific enterprises will start soon thereafter.	**Done.** Distribution of vouchers began in late-1992, and 148 million vouchers were eventually issued. Approximately 145 million vouchers (98 percent of the total) had been redeemed for shares by end-June 1994.
iii. Private investment funds will be allowed to organize this will permit (i) individual investors to have diversified holdings and (ii) investment funds to control blocks of shares large enough to oversee performance of enterprise managers.	**Done.** As of end-September 1994, 638 investment funds were registered with GKI.
iv. As a start in privatizing large enterprises, a demonstration group of 5-10 large enterprises will be identified and investment advisers appointed by December 1992. Participation by foreign investors will be encouraged. It is hoped that some of these demonstration enterprises will be privatized by mid-1993.	**Done.** As of end-January 1994, 94 very large enterprises had been privatized by voucher auctions, although with only limited participation by foreign investors.
C. Corporate governance	
i. A program for corporate governance will be formulated by December 1992, including the drafting the necessary legislation.	**In progress.** Several decrees on the institutional mechanisms for corporate governance of state-owned enterprises were issued during the first half of 1994; detailed regulations for their implementation are still in the process of preparation. The corporate governance mechanism for joint stock companies is contained in the draft law on joint stock companies.

[1] Source: Implementation Completion Report prepared by the ECA (Report No. 16298; February 12, 1997) for *RL I*

ii. Implementation of the program will begin in selected enterprises in January 1993.	**Delayed.**

D. Legal framework for a market economy

i. The civil code, incorporating modern principles of contract law and defining property rights, is being drafted and should be introduced in the Supreme Soviet before the end of 1992.	**Partially Done.** The first part of the Civil Code has been approved by the State Duma and became effective in November 1994. The second part of the Civil Code (which includes provisions relating to commercial transactions) is expected to be submitted to the State Duma in the summer of 1995.
ii. Laws on enterprises, joint stock societies and partnerships are being revised and will be submitted to the Supreme Soviet by the end of 1992.	**Done.** The draft law on joint stock companies was submitted to the State Duma in October 1994 and is currently being reviewed by committees.
iii. A foreign investment law was adopted in 1991; a number of amendments to strengthen the law have been submitted to the Supreme Soviet.	**Not done.** The 1991 Law on Foreign Direct Investment remains in effect. Subsequent decrees contradict certain provisions of the Law, creating grounds for confusion.
iv. A Presidential Decree on bankruptcy was issued in June 1992; this will remain in effect until the Supreme Soviet has adopted a bankruptcy law.	**Done.** The Bankruptcy Law was adopted by the Supreme Soviet in November, 1992 and became effective on March 1, 1993. Presidential Decree N 1114 of June 2, 1994 permits the sale of insolvent enterprises, while procedures for voluntary liquidation and the provision of state support to enterprises are contained in Government Decree N 498 of May 20, 1994. As of end-1994, 1358 enterprises were classified as insolvent; bankruptcy procedures had been initiated for 183 enterprises.

II. PRO-COMPETITION AND ANTI-MONOPOLY POLICIES

A. Demonopolization of existing structures.

i. When large enterprises are corporatized this will be done at the level of the smallest legal entity.	**Partially done.** With very few exceptions, the smallest legal entity was the basis for corporatization. However, in some cases, all plants and factories in different parts of Russia were considered as sub-divisions of a single legal entity, rather than as separate entities.
ii. Profile restrictions, which require firms to continue particular product lines will be phased out as rapidly as conditions permit.	**Done.** Historically, about 30 percent of small-scale enterprises were privatized with profile restrictions. GKI recently confirmed that in practice, profile restrictions are not being renewed upon their expiry.
iii. The newly organized investment companies will be required to hold diversified portfolios rather than holdings in a number of companies engaged in the same economic activity.	**Done.** Licensed voucher funds were limited under the 1992 Privatization Program to holding no more than 1o percent of the stock in any one enterprise, with no more than 5 percent of their portfolio in any one enterprise. The Government introduced the restrictions to limit the ability of investment funds to form cartels; however, it also limited the ability of investment funds to oversee the performance of enterprise managers. The 1994 Privatization Program (Presidential Decree N 2284 of December 24, 1993) allows investment funds to own up to 25 percent of the stock in any enterprise.

iv. During the third quarter of 1992 the Government will issue an order calling for the reorganization of "concerns" and other entities that might become the basis for cartelization of particular areas of industrial production.

Partially Done. Concerns, which were generally organized by the former branch ministry, were required to reorganize as joint stock companies or holding companies during 1992. No special regulations were placed on joint stock companies. But very restrictive rules were applied to holding companies (Presidential Decree N 1392 of November 16, 1992). In practice, no specific actions were taken to prevent cartelization, and in some industries (e.g., coal), the former branch ministry has been a major factor in promoting cartelization, generally through preferential access to subsidies or other benefits. The 1994 Privatization Program places restrictive rules on the participation of enterprises with more than 25 percent state ownership in all types of associations.

v. By August 1992, a temporary inter-agency working group will be established to further develop mechanisms for demonopolization of existing enterprises. Its

Not Done. GKAP and GKI agreed on a set of rules to work together, but GKAP has not developed an effective strategy in the area of anti-monopoly policy. Progress in this area has depended largely on the outlook of the local anti-monopoly department and its cooperation with the local GKI.

B. Encouragement of new enterprises

i. By September 30, 1992, an inter-agency working group will prepare recommendations on measures to promote greater competition output and employment through the creation of new small enterprises. Recommendations will cover required legislation as well as access to finance and specific problems such as registration and access to necessary real estate.

Done. The Federal Program of State Support to Small Business for 1994-95 was approved by the Government in April 1994. This includes a variety of provisions to support new private enterprises, as well as authorizing funding for several pilot programs during the latter part of 1994. The draft law on state support for small businesses has passed the first reading in the State Duma. Presidential Decree N 2270 of December 22, 1993 granted taw privileges to new private small enterprises in designated priority sectors.

III. FOREIGN DIRECT INVESTMENT

A. Foreign Direct Investment

i. Government will encourage foreign investors to participate in the privatization of medium and large enterprises. Rules and conditions for participation will be simplified and steps will be taken to see that information on investment opportunities is available.

Done. The 1994 Privatization Program allows foreign investors to take part in property auctions, bids, and investment tenders on a non-discriminatory basis.

ii. The Government will not discriminate against foreign investors. It will seek in reach agreements on double taxation with as many countries as possible.

Done. GKI Regulations (registered with the Ministry of Justice in mid-march 1994) stipulate that the amount of investment offered will be the sole criteria for choosing the winner of investment tenders, with no differentiation between domestic and foreign investors.

IV. FINANCIAL SECTOR REFORM

A. Interagency working group on financial sector reform issues

i. A new commercial banking law will be submitted to the Supreme Soviet before the end of October 1992.	**Done.** The law on banks and banking activities was passed by the State Duma at the first reading in July, 1994, and it is expected to be considered for its third and final reading by the end of June 1995.
ii. Before the end of 1992, proposals will be prepared on a plan to liquidate, restructure, or recapitalize banks.	**Not Done.** High inflation during 1992 reduced the immediate portfolio problems of the banks, but portfolio problems could reemerge as the rate of inflation declines. There is a need to restructure the large former state-owned banks.
iii. Before the end of 1992, the problems of high spreads will be studied and proposals for reform will be made. This will be followed by drafting new legislation on taxation of financial intermediaries, which will then be submitted to the Supreme Soviet.	**Partially Done.** High interest rate spreads shrank substantially during 1994 as a result of increases in deposit rates and reductions in the lending rates.
iv. Over the next 12 months, the authorities will introduce international standards of accounting, and they will conduct audits of at least 15 large banks.	**Done.** The Central Bank has introduced a System of Broadly-Adapted Financial Statements, and audits of a number of banks have been completed to international standards.
v. A comprehensive program for dealing with the issues of bad debt management and bank recapitalization will be completed by June 1993.	**Delayed.** High inflation has resulted in most banks being under-capitalized. The Central Bank recently issued regulations to raise capital requirements for commercial banks.
vi. Draft legislation of a securities act and collateral security will be submitted to the Supreme Soviet before the end of 1992.	**Done**. A law on collateral security was adopted on May 29, 1992. The law on securities markets passed the second reading in the State Duma on April 26, 1995.
vii. A comprehensive review of the payments system, including inter-CIS payments, will be completed by march 1993; some of the recommendations should be in place by June 1993.	**Done.** Payments within Moscow can now be settled within a day, although improvements in payments in other regions of Russia have lagged behind. In the meantime, a number of commercial banks have implemented high-value payment systems based on correspondent accounts. Payments between CIS countries are no longer based on ruble transactions, given the introduction of separate national currencies.

V. THE SOCIAL SAFETY NET

A. Defining the poverty line and adjusting benefits

i. The minimum benefit for the main programs (pensions and unemployment compensation) will be set at or above the basic benefit.	**Partially Done.** In November 1993, the Pension Fund introduced flat rate indexation of pensions on a temporary basis in order to maintain the financial viability of the Pension Fund and protect people who earn the minimum pension. Unemployment benefits, although legally set at 75 percent of the pre-employment wage, rarely amount to that, and the average unemployment benefit in 1993 was 11 percent of the average wage. The Government has indicated that legislation to increase unemployment benefits will be submitted to the State Duma during 1995.

ii. For citizens whose eligibility for other benefits has been exhausted, or whose entitlement is inadequate, the Government will introduce a means-tested system of social assistance as a benefit of last resort.	**Not Done**. Expected to be undertaken in 1995.
iii. By September 30, 1992, the Government will have completed recommendations for the redesign of the system of cash entitlements, including social assistance. Implementation of the main elements of the new system will begin by the end of 1992, with full implementation by the end of 1993.	**Not Done.** Expected to be undertaken in 1995.
B. Meeting needs resulting from increased unemployment	
i. The Government will provide supplementary financing from the budget to cover the costs of unemployment compensation.	**Not Yet Needed.** Registered unemployment has not increased as rapidly as expected, although open unemployment (based on the ILO definition) accounted for 7 percent of the labor force at the end of 1994. While the Federal Employment Fund continues to be in an overall surplus position, several regional Funds are running large deficits that are funded through the Federal Employment Fund.
ii. By September 30, 1992, the Government will complete the design of a proactive system of employment services, including job search, training and possible participation in labor-intensive public works. Implementation of this program will begin by December 31, 1992.	**Delayed.** Funding for the implementation of this program is included in the bank's Employment Services and Social Protection Project.

RUSSIA: SECOND REHABILITATION LOAN (RL II)
STATUS OF POLICY AGREEMENTS AS OF DECEMBER 16, 1996 [1]

I. Structural Policy and Institutional Changes:

1.1 To eliminate controls on prices and profitability and trading margins, including those in wholesale and retail trade, except for cases specified in the draft of the government law on natural and state monopolies.	**Partly Done**. Government Decree N 229 of March 7, 1995. Such controls have been kept in some regions, though.
1.2 To ensure enforcement of the Presidential decree of the Russian Federation on sale of insolvent enterprises (N 1114 of June 2, 1994).	**Ongoing**. Presidential Decree n 1114 of June 2, 1994 applies to the mandatory sale of insolvent state-owned enterprises (federal level only); however, till Fall 1996 most insolvent enterprises had not felt significant pressure from the federal government, and only severe budgetary problems have caused intensification of the process.
1.3 To streamline licensing of business activities of enterprises. By this it is supposed to define the bodies responsible for issuing licenses, and to reduce the range of activities which are subject to licensing, and to limit the maximum fees to be charged for issuing licenses.	**Done.** Government Decree N 1418 of December 24, 1994.
1.4 Not to renew the established profile restrictions on privatized enterprises upon their expiry. Any profile restrictions on newly privatized enterprises will be established for a period which does not exceed one y ear.	**Partly Done.** The established profile restrictions are not being renewed upon expiry. However, the Privatization Program for 1996 does not establish any time limit for mandatory profile restrictions on newly privatized enterprises in trade, public catering and communal service sectors.
1.5 (a) To take a decision on land title registration and to submit draft legislation on mortgages to the State Duma.	**Partly Done.** Since Land Code, which is suppose to regulate all aspects of land ownership, has not yet been passed by the Duma, Presidential Decrees No. 337 of March 7, 1996, and No. 293 of February 28, 1996 regulate land title registration and mortgage.
(b) To ensure enforcement of the Presidential Decree on Land Reform (N 1767 of October 27, 1993), ensuring in particular that all land owners will be issued with land ownership certificates and that land auctions will begin to take place.	(b) Partly Done. Presidential Decree No. 1270 of August 27, 1996 stipulates that all land owners are entitled for land ownership certificates. However, the number of land auctions has been limited to a few pilot programs so far.
1.6 To conform to the legislation to carry out the program approved by the President, that provides for abolishing existing restrictions by executive bodies of the subjects of the Russian Federation and local authorities on sales of land earmarked for commercial activity and leased commercial buildings to privatized enterprises (at least 80 percent privately owned).	**Partly Done.** The 1996 Privatization Program contains relevant provisions. However, Moscow is still exempted from the general privatization scheme and maintains specific restrictions. In addition, several other subjects of the Russian Federation keep such restrictions in place without any legislative ground, but the Federal authorities do not initiate any sanctions against them.
1.7 To process by end-1994 all outstanding applications by privatized enterprises for purchases of leased commercial premises and occupied land.	**Ongoing.** The Government currently considers various mechanisms -- including giving away -- for transferring occupied land to privatized enterprises.

[1] Implementation Completion Report prepared by the ECA Region (Report No. 16300; February 12, 1997) for *RL II*

1.8 To carry-out necessary preparatory work leading to the introduction of a system of differentiated transportation tariffs and prices for natural gas by region by the beginning of 1996.	**Ongoing.** The necessary preparatory work has been completed, and introduction of a system is now expected by the beginning of 1997.
1.9 To take measures to ensure that transfers from the State Employment Fund are not used by enterprises for support of production: purchase of raw materials, equipment, replenishment of working assets, repayment of debt related to wages and other similar expenditures.	**Done.** Transfers from the State Employment Fund have been limited to programs of support for job re-training, and for disabled and young.
1.10 To prepare, before the end of 1994, a program to rationalize the coal sector including : a phased closing of the most inefficient mines; initially capping subsidy flows and then eliminating those covering operating losses over a three year period; elimination of cross subsidies between coal basins early in the process of reorganization; and preparation of measures to facilitate a reduction in employment in the sector.	**Ongoing.** The relevant program has been worked out in 1996, in the context of the Bank Coal SECAL, and is currently under implementation.
1.11 To establish and implement, by the end of 1994, arrangements to analyze the effective rate of state support provided to specific industries, very large enterprises, and insolvent enterprises (including tax credits, subsidies, directed credits, customs duties exemptions and other privileges), and publishing the obtained results in public press.	**Not Done.** Though some preparatory studies were carried out by the Government's Center for Economic Reform, no report has yet been published, and no arrangements for carrying out such studies on regular basis have been established.
1.12 To submit draft legislation on joint stock companies to the President.	**Done.** The law was passed by the Duma on November 24, 1995, and subsequently revised on June 13, 1996.
1.13 To continue, with the Central Bank, upgrading financial reporting based on international standards and bringing the supervision of commercial banks closer to international standards.	**Ongoing**. Presidential Decree N 1184 of June 10, 1994 instructs the Central Bank to strengthen banking supervision, with comprehensive auditing of commercial banks to be carried out at least once every two years.
1.14 To ensure enforcement of the Presidential Decree (N 1183 of June 10, 1994) requiring truth in the advertising of financial institutions.	**Done.** The State Anti-Monopoly Committee (GKAP) had sent about 130 warnings to financial institutions under the provisions of this Decree, and cases were initiated n 20 instances. Most of the violations have since stopped. A new Law on Advertising, addressing inter alia these issues, was passed by the Duma on June 14, 1995.
II. Foreign Trade Policy	
2.1 To abolish export quotas and licensing of oil and oil products as of January 1, 1995.	**Done**. As of April 1, 1995 export quotas for oil and oil products were abolished, bringing completing the process of export quotas elimination.
2.2 Before the end of 1994 to eliminate lists of commodities allowed for export only by specially registered exporters.	**Done.** Presidential Decree N 245 of March 6, 1995 abolished the system of specially registered exporters.

2.3 To give up exports of commodities for state needs.	**Done.** The Law on Procurement for Federal and State Needs N 60-FZ of December 13, 1994 abolished the system of mandatory exports for state needs and established rules for a new market-based system of procurement for shipments under international commitments, such as interstate agreements on oil shipments.
2.4 To seek to discontinue obligatory lists of commodities in trade with CIS countries beginning 1995 in the context of bilateral negotiations.	**Done.** The elimination of export quotas has prompted the removal of obligatory lists from intergovernmental agreements with CIS countries. All such lists have become indicative since then.
2.5 To abolish by end-1994 export duties on agricultural products and to reduce the export duty rate for other commodities so that the weighted average will be no more than 50 percent of the level in the beginning of 1994. To eliminate all export duties before the end of 1995.	**Done.** All export duties were abolished by July 1, 1996 (GOR Decree No. 479 of April 1, 1 996).
2.6 To submit to the State Duma a draft law on harmonizing methods for calculating excise tax for domestically produced and imported products. Upon approving legislation by the Duma, to harmonize excise tax rates for domestically-produced and imported products.	**Ongoing.** The Draft law were submitted to the Duma in June 1996, and, after revision, was approved in the first reading in December 1996.
2.7 To initiate rationalization of import tariff structure so that all tariff bands will be divisible by five. To exempt goods, for which present import tariff rate is 1-2 percent, from import duty.	**Done.** The new import duty schedule contains only duty bands divisible by five. In accordance with the agreement with the IMF, all 1-2 percent bands have been raised to 5 percent.
2.8 To reduce present import duties so that rates do not exceed 20 percent. The Government reserves the right to increase these rates above 30 percent only temporarily, and they would apply to no more than 5 percent of imports.	**Done.** Government Decrees No. 998 of August 13, 1996 and No. 1105 of September 19, 1996 reduced all import duties, with the exception of alcohol, to not more than 30 percent.
2.9 To design and publish a timetable, by October 1994, to reduce import duties over the next three to five years. The program will consist of periodic across-the-board cuts in tariff rates starting in January 1995, without exceptions for specific products. In three years, the average tariff rate (import-weighted) will be reduced from 15 percent to 10 percent, and in two years upon Russia's accession to GATT/WTO it will be reduced to 5-7 percent.	**Done.** Government Decree n 190 of February 28, 1995 stipulated that the average weighted rate of import tariffs should be reduced to 80 percent of the 1995 level by 1998, and to 70 percent of the current level in 2000. In addition, the maximum rate of import tariff should be reduced to 20 percent by January 1, 1998, the Ministry of Foreign Economic Relations published an indicative timetable to implement these reductions in import duties over the next five years (with intermediate targets for a three year period).
2.10 To start in a phased manner a move to a system based on market principles for providing access to oil pipeline transport. As a first step, to introduce, simultaneously with the elimination of all export quotas for oil and the abolition of the list of strategic exporters, procedures for access to pipelines by all potential exporters, including new producers and traders, in a non-discriminatory manner. This system should include market-based processes for transferring access rights to pipelines.	**Done.** Several Government Decrees (No. 1446 of December 31, 1994, No. 94 of January 30, 1995 and No. 209 of February 1995) implement the program of non-discriminatory access to oil export pipelines, including market-based procedures for transferring access rights to pipelines. However, joint ventures and exports under state agreements still enjoy a privileged access to export pipelines.

2.11 To ensure the enforcement of the Presidential Decree (No. 1007 of May 23, 1994) abolishing all export and import duty exemptions as of July 1, 1994, with the exception of a limited number of cases specified in the Decree.	**Done**. Presidential Decree N 244 of March 6, 1995 and Federal Law "On Providing Exemptions in Foreign Trade" N 31-FZ of March 13, 1995 abolished all export and import duty exemptions not provided for in the federal law on Customs Tariff.

RUSSIA: STRUCTURAL ADJUSTMENT LOANS (SALs) I and II
STATUS OF POLICY AGREEMENTS AS OF JULY 26, 1998 [1]

REFORM OF INFRASTRUCTURE MONOPOLIES

Policy Objective	Actions Taken For Board Approval of SAL I	Actions Taken For Board Approval of SAL II	Actions Taken Prior to Board Presentation of SAL III
I. Cross-Sectoral Program			
To improve the transparency, fiscal accountability and competitiveness of infrastructure monopolies, and to reduce barter and non-payments.	The Government has made adequate provisions in the 1997 budget to pay for the fuel and energy consumption of the remaining "strategic customers" who may not be disconnected for nonpayment, as listed in the Government Decree 74, issued January 28, 1997. On April 3, 1997, the Government approved an action plan for the phased elimination of cross-subsidies among consumer groups for all natural monopoly services (Government Resolution No. 389 "On the Gradual Reduction of Cross-Subsidization in Sectors of Natural Monopolies").	The Government has adopted Resolution # 928 of July 27, 1997 that establishes a procedure for clearing payment arrears for supplied fuel and energy resources. In August 1997 the Government outlined an action plan for restructuring the electric power and natural gas sectors.	As it has throughout 1997, in 1998 the Government will ensure that there are no arrears to energy suppliers on account of the remaining strategic customers. A Government Instruction (SK-P7-13321, May 10, 1998) has been issued to prepare guidelines for implementation of quarterly accounts based on International Accounting Standards (IAS) for RAO Gazprom, RAO UES Rossii (UESR), the Railways, and Transeft, and requiring the preparation of quarterly accounts for RAO Gazprom, and RAO UESR starting from the third quarter of 1998. A report has been issued to the Government–and published–on the amounts of dividends on federally-owned shares in infrastructure utilities not transferred to the federal budget. Article 105 of the 1998 Budget Law and Presidential Decree No. 396 of April 16, 1998 are intended to eliminate such exemptions; a draft law has been prepared to implement Article 105.

[1] Source: SAL III President's Report (No. P-7256-RU; July 26, 1998), Abridged Attachment 5 (SAL III Policy Reforms Program Matrix, less the two columns describing the actions to be taken prior to the second and the third tranche releases of SAL III).

REFORM OF INFRASTRUCTURE MONOPOLIES

Policy Objective	Actions Taken For Board Approval of SAL I	Actions Taken For Board Approval of SAL II	Actions Taken Prior to Board Presentation of SAL III
	On April 28, 1997 Presidential Decree No. 426 "On Fundamental Principles of Structural Reforms in Sectors of Natural Monopolies" was issued as outlined in the Concept Paper "On Developing Plans for Structural Reforms of Natural Monopolies" submitted to the Government on March 26, 1997. The decree instructed the Government to approve a detailed medium-term restructuring program to be adopted by a government resolution by June 30, 1997.		The Government has required (Government directive No. 968-r of July 17, 1998) that, starting with the financial accounts for 1998, the consolidated IAS financial accounts of Gazprom, RAO UESR, and Transneft, and, starting with the financial accounts for 1999, the Railways, are to be audited and published annually by June 30 of the following year by independent qualified auditors in accordance with international auditing standards. The Government has required (Government Resolution No. 786 of July 17, 1998) that VAT be calculated and collected on an accrual basis. The Government has simplified (Government Resolution No. 789 of July 17, 1998) the procedures for termination or limitation of electricity, heat, and gas supplies to organizations and consumers in the event of failure to pay for fuel and energy resources supplied. By July 31, 1998, the Government will issue a Resolution that establishes an inter-agency commission that coordinates and oversees reforms, including development of measures and timetable of actions, for the horizontal and vertical competitive restructuring of key infrastructure monopolies. This will cover the electric power, natural gas, railroads, telecommunications and oil transport sectors.
		The Government is ensuring the independence and effectiveness of the regulatory agencies for energy (FEC), transport (FSNMT), and telecommunications (FSRNMC).	

Policy Objective	Actions Taken For Board Approval of SAL I	Actions Taken For Board Approval of SAL II	Actions Taken Prior to Board Presentation of SAL III
II. Electric Power Sector Program			
To make major progress towards creating an electric power sector with diversified ownership and open to competitive forces.	In the period up to April 30, 1997, the Government took steps to ensure that the representative group of government officials on the Board of RAO UESR have clear instructions to implement governmental policies in the electric power sector.	The Government introduced a two-block tariff for household electricity consumption that is differentiated by levels of consumption; this policy is based upon recommendations from the FEC dated April 25, 1997. Implementation has been undertaken in most regions. The Government established an Inter-Ministerial working group to ensure that its reform agenda for the power sector would be pursued. Improvements in corporate governance were punctuated during the Annual General Meeting of the shareholders of RAO UESR on May 28, 1997, when the leadership for the reform agenda was established. The Government has created an Independent Financial Operator (IFO) to establish a competitive wholesale electricity market under FEC Protocol #97 dated June 25, 1997. It is in the process of establishing a Supervisory Council for the Wholesale Market composed of representatives of market participants (with no participant having a dominant position). The composition of the Supervisory Council will be finalized by the end of February 1998. Industrial customers that clear their arrears and pay cash in advance receive electricity at an economically efficient price. In June 1997, RAO UESR announced that, as of July 1997, it would accept cash payments only (eliminating barter, promissory notes and limited use of mutual settlements). Improvements have been gradual (as	The Federal Energy Commission (Directive 17/6, April 17, 1998) has adopted dispatching guidelines and procedures in the electricity sector to provide for the minimization of costs of energy supply to the wholesale electricity market. Dispatching guidelines have been implemented in at least one regional electricity grid. A comprehensive Wholesale Market Agreement is currently being drafted. By August 1, 1998, RAO UESR will publicly announce its intention of increasing private sector participation in Energos in which UESR has an equity stake. By August 1, 1998, the Government will issue a Resolution in which RAO UESR will be required to establish separate accounts for generation and transmission (including dispatch) for regulatory purposes. The Resolution will direct the Federal Energy Commission: (i) by September 1, 1998, to develop pricing methodology and issue guidelines for the network services provided by AO Energos; (ii) by December 1, 1998, to develop pricing methodology and issue guidelines for transmission and dispatch services provided by RAO UESR. The same Resolution will require that each AO Energo will establish separate accounts for generation, transmission (lines used exclusively for

Policy Objective	Actions Taken For Board Approval of SAL I	Actions Taken For Board Approval of SAL II	Actions Taken Prior to Board Presentation of SAL III
		existing barter agreements had to be respected) but significant. Cash payments for RAO UESR transmission services have nearly doubled between June and September 1997. This enabled RAO UESR to fully pay its tax obligations for 1997, and become current with its salary payments to staff. The FEC has made public preliminary wholesale market agreements under FEC Protocol #104, dated August 29, 1997. These contractual agreements specify the duties and responsibilities of current participants in the competitive Wholesale Market, and were issued by the IFO in September, 1997. Direct agreements between energy producers and consumers have also been drafted and will be approved by the FEC by end-November, 1997. Two generation companies and four customers are currently operating in the Wholesale Market and expansion is actively being pursued. The FEC has submitted a letter to the Government, dated August 20, 1997, articulating the general principles for commercial licensing of participants in the wholesale power market. The Government has submitted a draft law on licensing to the Duma, including amendments with regard to licensing for activities in the wholesale power (capacity) market and services for its operations. When the law is approved, the Government will issue a Resolution giving the FEC the exclusive right to issue licenses for activities in the wholesale power (capacity) market to participants in the power market.	transmission of bulk power) and distribution for regulatory purposes.

Policy Objective	Actions Taken For Board Approval of SAL I	Actions Taken For Board Approval of SAL II	Actions Taken Prior to Board Presentation of SAL III
		The Government has outlined general pricing principles and procedures for encouraging efficient production and usage of electric power, and these will continue to be refined and made more detailed. The Government passed Resolution No. 1231 on September 26, 1997 providing annual targets for the reduction of cross-subsidies in electricity consumption, ending with its elimination by mid-2000. The first steps have been taken this year resulting in price increases in most regions.	
III. Natural Gas Sector Program			
To promote efficiency in the natural gas industry, achieve greater transparency and accountability in the operations of Gazprom, and facilitate pipeline access for independent gas producers, including those who are currently flaring gas.		In accordance with Government Resolution #987, 1997, the Anti-Monopoly Committee has registered RAO Gazprom as an economic entity controlling more than 35% of its corresponding market pursuant to the law "On Competition and Restriction of Monopoly Activities in Commodity Markets". The Ministry of Fuel and Energy has established a group within the Ministry to review further structural changes necessary to improve the efficiency of natural gas supply. The Ministry of Economy has prepared a draft Discussion Paper (October 14, 1997) outlining general pricing principles and procedures to encourage efficient production and usage of natural gas. The draft principles also provide that, until a competitive market for gas production is introduced, wholesale gas prices will be regulated: (a) at the city gate, with tariffs of gas transmission set separately; or (b) as a combination of well-head prices and gas transmission prices, each set separately. The FEC has issued Resolution No. 119/6, dated October 31, 1997	The Federal Energy Commission (Directive 12/5) has reduced cross-subsidization in natural gas (and the need for budget subsidies for gas consumed by households) by increasing the wholesale price of gas for household use (net of gas excise tax) to 76 percent of the industrial wholesale price. The Government has instructed (Government directive No. 952-r of July 16, 1998) the Board of State Representatives of RAO Gazprom to seek to reorganize, by December 31, 1998, the existing regional transmission operations of RAO Gazprom into a single transmission enterprise or a number of enterprises, based on major transmission corridors, such enterprise or enterprises to be in compliance with the Civil Code. A draft Law has been submitted to the Duma requiring to move gas excises to an accruals basis. By August 1, 1998, the Government will issue a decision requiring Gazprom to operate the company's transmission, production and supply enterprises will operate as separate cost/profit

Policy Objective	Actions Taken For Board Approval of SAL I	Actions Taken For Board Approval of SAL II	Actions Taken Prior to Board Presentation of SAL III
		establishing the procedures for regulating wholesale gas prices. The Ministry of Fuel and Energy has initiated negotiations with the firm of consultants selected to carry out a World Bank-financed Gas Pricing Study starting November 4, 1997, which will assist the Government to define the detailed pricing methodology and procedures to be applied in setting gas prices at various levels in the gas supply chain. In August 1997 the Federal Energy Commission published temporary rules and procedures for setting differentiated wholesale prices for natural gas. FEC Resolution 110 of September 26, 1997, provides that, effective December 1, 1997, the regional wholesale natural gas price differential between the minimum and maximum price will be increased from the current level of 12 percent to at least 25 percent. In Resolution No. 858 of July 14, 1997, the Government adopted procedures for granting access by independent producers of gas to the pipelines of RAO Gazprom. In Resolution No. 1269 of September 30, 1997, the Government approved a regulation outlining the responsibilities and operating procedures for the Inter-Branch Commission which was formed under Resolution 858 to review issues related to access by independent producers.	centers with separate management teams and their own accounts based on international accounting and audit standards. The transmission enterprise(s) will only provide gas transmission services. By July 31, 1998, the Government will adopt a Resolution that provides for the elimination of state regulation of prices on gas sold by gas-producing organizations not affiliated with RAO Gazprom.

Policy Objective	Actions Taken For Board Approval of SAL I	Actions Taken For Board Approval of SAL II	Actions Taken Prior to Board Presentation of SAL III
			The FEC will continue the process of delegating the power to implement the regulation of gas distribution tariffs and gas prices for final consumers to the regional energy commissions (RECs), where such regulation follows pricing principles and procedures prepared by the FEC. The RECs to which authority will be delegated will have met the following criteria as set out by the FEC: (i) appropriate legal basis for implementing the regulations in question; (ii) adequate professional staffing; (iii) operational rules approved by the FEC; (iv) a chairperson approved by the FEC; and (v) an established panel of independent experts for advice and comment.
IV. Oil Sector Program			
To improve the efficiency of oil transport through regulatory reform, ensuring equitable access to pipelines, and creating a favorable investment climate.		On July 8, 1997, President Yeltsin issued decree No. 694 "On Production Sharing Agreements (PSAs)" ensuring rights and benefits of the Russian Federation in implementing PSAs. In accordance with the Federal Law "On Sites of Natural Resources Deposits Entitled for Use under PSAs" there are seven sites that can be developed in accordance with PSAs. The sites include five oil and gas fields, one iron ore deposit and one gold mine. By December 1, 1997, the Government will submit to the Duma a draft Law on Expansion of PSAs to additional areas. The Government has begun to put into place a market-based (nondiscretionary and transparent) system for access to oil transportation capacity in the Novorosiisk and other constrained pipelines. A new regime has been implemented through Presidential Decree No. # 693 of July 8, 1997 and Government	In late 1997, the FEC published its initial views on the principles on the methodology for setting regulated crude oil transportation tariffs on Transneft's pipeline system. By July 31, 1998, the FEC will publish for comment its revised proposals on this methodology, incorporating principles which will (i) ensure that Transneft can recover prudently incurred costs of service from shippers, including a reasonable return on investment; (ii) encourage efficient operations, and (iii) be based on costs so that the tariffs should fully reflect differences in costs of service. Access by oil producers to the oil pipeline network now contingent on compliance with agreements to clear outstanding tax arrears (see Fiscal Management reforms).

Policy Objective	Actions Taken For Board Approval of SAL I	Actions Taken For Board Approval of SAL II	Actions Taken Prior to Board Presentation of SAL III
		Resolution # 1130, issued on September 2, 1997, in which access is allocated in proportion to total production. This regime will be effective throughout 1998. However, oil producers will have the right to trade access rights. All resolutions and directives covering programs of export of oil and oil products for State needs were eliminated on March 16, 1997, except for those under Government Resolutions #579 of May 14, 1996, #208 of February 28, 1996, and #736 of June 24, 1996. Under Presidential Decree 693 of July 8 and Government Resolution #988 of August 7, the government abolished these oil export programs effective October 1, 1997.	
V. Railways Sector Program			
To improve efficiency within the railway system, ensure reasonable tariffs, and create the basis for privatization of certain services.		In the April 28, 1997 Presidential Decree No. 426, the Government took actions to set forth the main thrust of structural reform in the railway sector. The decree set forth a staged plan of restructuring over a three year period. With respect to improving the railway's competitive market structure, the following measures were included on the agenda for 1997: (a) to introduce a new procedure of Government regulation of freight tariffs that would take into account patterns and volume of traffic, increases in labor productivity, restructuring and cost-cutting measures, etc.; (b) to phase-out cross-subsidization of passenger losses by freight customers and provide compensation for passenger losses in Federal and local budgets as appropriate; (c) to lower freight tariffs; (d) to separate unused facilities and divest these and other ancillary activities; (e) to create conditions for the development of competition in the	The Government approved (Government Resolution No. 448 dated May 15, 1998) a Concept for Structural Reform of Federal Railway Transport which broadly outlines plans for separating passenger and freight services and identifies major assets to be allocated to each business. The Government has agreed to develop proposals on budget subsidization of railway passenger traffic. It was also agreed that the remaining federal privileges on the fares of individual passenger categories are to be financed from the federal budget. In the 1998 budget, a sum of Rb 450 million is included for Federal compensation of intercity passenger losses. For most products, preferential tariffs expired on December 31, 1997. MPS has drafted regulations providing for elimination of most of the remaining

Policy Objective	Actions Taken For Board Approval of SAL I	Actions Taken For Board Approval of SAL II	Actions Taken Prior to Board Presentation of SAL III
		rail services market that would provide equal access to rail infrastructure and repair facilities to different owners of rolling stock; and (f) to complete the establishment of the Federal Service to Regulate Natural Monopolies in Transport (FSNMT). The head of the FSNMT was appointed. On September 30, 1997, the Government issued a resolution reducing average rates for freight (total revenues divided by ton-kilometers) by 5 percent compared to rates effective in September 1, 1997. Several other freight rate reductions were introduced as of July 1, 1997 including (a) reductions on specific commodities at specific rates, as set forth in a June 13, 1997 minutes of a meeting held by First Deputy Prime Minister Nemtsov with Deputy Ministers of MOE, MOF and MPS; and, (b) on new traffic (against previous year totals for individual shippers) provided the increase is of certain volume (3000 tons), and on existing traffic to shippers relative to the time of downpayment. To enhance transparency regarding the provision of preferential tariffs and to clarify the framework under which regional railways can offer discounts to shippers, and in compliance with clause 4 of Government Resolution #410 of April 8, 1997, the FSNMT issued regulations and methodologies governing railway tariffs, including discounts and preferential tariffs.	preferential tariffs. FSNMT adopted (Directive 12/1 of April 14, 1998) regulations limiting freight railway tariff adjustments to increases in the industrial producer price index less 3 percentage points on an annualized basis throughout the year. Government Resolution No. 338 of March 21, 1998 approves a list of railway transport ancillary services for divestiture. A list of social assets has been approved by MPS Letter No. K-4687 of May 20, 1998. Government Directives Nos. 424 and 425 transfer some social assets to municipalities. By July 30, 1998, MPS will provide the Government with the book value and current railway ownership of assets identified in the list it submitted to the Government on April 30, 1998, together with a timetable for their divestiture.

Policy Objective	Actions Taken For Board Approval of SAL I	Actions Taken For Board Approval of SAL II	Actions Taken Prior to Board Presentation of SAL III
		The Government is establishing general pricing principles and procedures that will help to encourage efficient provision and usage of railway services. In compliance with Government Resolution #410 of April 8, 1997, an order dated May 14, 1997 was jointly issued by the Ministry of Railways and Ministry of Economy that outlines a methodology for regulating railway freight tariffs. Resolution #410 also ordered that changes in railway tariffs and fee rates shall not exceed the index of wholesale prices for industrial goods producers across the Russian Federation in the respective period. This measure is evidence that the Government is coming to grips with the problem that rail rates have risen faster than inflation. However, in order to ensure that the effects of this measure are long-lasting, future indexation should not be automatic as it has in the past since there is agreement that freight rates can be further reduced. As it may be difficult to evaluate, on a timely basis, submissions by MPS of cost data justifying tariff increases, a simpler approach under consideration is to permit automatic indexing of freight rates to the wholesale industrial price index and promote additional reductions on the overall levels. Specifically, the FSNMT is considering limiting the overall increase of average freight rates in 1998 to the wholesale price index minus 3 percentage points, to be measured on a quarterly basis, i.e. 0.75% per quarter. The present pricing methodology mentions the need to take into account railway restructuring plans and cost-reduction measures, but does not explicitly tie	

Policy Objective	Actions Taken For Board Approval of SAL I	Actions Taken For Board Approval of SAL II	Actions Taken Prior to Board Presentation of SAL III
		the railways to any specific restructuring plan. In the longer term, it is anticipated that the railways will restructure in a way that would make the industry more competitive and commercial. Thus, in time, it is hoped tariff regulation of freight traffic would be based more on an exception basis, where there is little competition or a clear possibility for abuse of monopoly power. In the meantime, however, as passenger losses are shifted to the budget, manufacturing and social assets divested and other cost-cutting measure introduced, it is anticipated that there should be additional decreases in the minimum freight tariff rates. Cross-subsidies of passenger losses through freight rates are being phased out by a combination of measures including: raising passenger fares; devolving suburban services to municipal and regional Governments and ensuring that losses on these services are compensated through budgets of subjects of the Federation as appropriate; by separating passenger from freight services and taking measures to cut costs where appropriate; by compensating intercity passenger losses through the Federal budget and/or eliminating remaining federal privileges on the fares of individual passenger categories. On September 15, 1997 the Government issued Resolution No. 389, which, effective that day, increased intercity passenger rates by 10 percent; destinations to the Baltics and CIS countries were increased 65%.	

PRIVATE SECTOR DEVELOPMENT

Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
I. Privatization			
To increase the efficiency in the use of assets employed in firms and stimulate investment so as to resume economic growth and create jobs, and to engender revenues for the state budget.			On July 20, 1998, a special Policy Statement was issued by the Chairman of the Government of the Russian Federation, which will be published widely in the international media, that states the Government's commitment to expand and accelerate significantly the process of transparent and competitive privatization of Russian enterprises in the process of implementing the 1998–99 privatization program. This will be accomplished through case-by-case privatization of the largest enterprises in accordance with Government Resolutions 363 and 564 of 1997, and through (i) the significant reduction in the number of firms currently denoted as "strategic" and (ii) their privatization.
a. Privatization of Large Enterprises	On April 1 and May 12, 1997, the Government issued Resolutions No. 363 ("On the Procedure Governing the Implementation of Case-by-Case Privatization Projects") and No. 564 ("On the Introduction of Changes in Resolution No. 363 of the Government of the Russian Federation Dated April 1, 1997 'On the Procedure Governing the Implementation of Case-by-Case Privatization Projects' "), respectively, specifying rules and	The Ministry for State Property (MSP, formerly GKI) announced a change in the composition of the firms to participate in the 4-firm pilot Case by Case Privatization Program, as identified in earlier Government Resolutions Nos. 363 and 564, and GKI Directive No. 356-r due to the fact that (i) Domodedovo Production Association for Civil Aviation is to be split into three entities and (ii) Pulkovo Airlines and Rosgosstrakh are no longer under consideration to be included in the CBC program (at least not in 1997). On July 31, 1997, GKI Directive 670-R specified that the 4 participant firms are: Domodedovo Aeroservice, Domodedovo Airlines, Kama Pulp and Paper, and Russkii Dizel.	*Financial Advisors' pre-sale preparation work for Kama Pulp and Paper and Russkii Dizel underway, but experiencing delays. Tenders expected early autumn 1998. Government suspended privatization of Domodedovo Airlines and Domodedovo Aeroservice due to regional authorities' objections.* The 1998 program will expand and accelerate the process of transparent and competitive Case-by-Case privatization. On July 7, 1998 the Ministry of State Property issued an ordinance establishing a list of 15 enterprises that are part of the draft State Privatization Program and are to be privatized according to the case-by-case procedures

PRIVATE SECTOR DEVELOPMENT

Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
	implementation procedures for case-by-case privatization requiring them to be fully open and competitive (including through equal and open access to domestic and foreign buyers), and using openly and competitively selected, internationally reputable financial advisors. The privatizations are to be widely advertised domestically and internationally. Enterprises will be valued at market prices or, if they are not traded, based on standard business valuation procedures. Financial advisors will be reputable, and valuation will be done based on international standards. For the initial 4-firm pilot program, to be completed in 1997, on May 15, 1997, the Government selected four companies from the following list of 10 enterprises for case-by-case privatization in 1997 under the principles established by Government Resolutions No. 363 and No. 564: Tyrnauz Tungsten-Molybdenum	The above changes, in part, contributed to the inability to meet the June 30, 1997 program date for inviting financial advisors to submit bids to assist with the privatization of the four firms and the August 31, 1997 deadline for the tender committees to issue tenders. Following consultation with the World Bank, which is supporting (through the PIAL loan) the technical assistance for completing 3 of the 4 pilot transactions, MSP issued in correspondence dated October 10, 13, and 22, 1997, a timeline that specifies the complete timetable of actions to be taken for all 4 firms. For the 3 transactions receiving financial support from the World Bank, the key points of this timetable are: (i) "Bidding Package" (Letter of Invitation + Terms of Reference + Standard Contract) to be sent to short-listed Financial Advisors (FAs) by the following dates: Kama Pulp and Paper: August 22, 1997, Domodedovo Airlines: August 28, 1997, and Russkii Dizel: October 24, 1997; (ii) Negotiations to commence with the selected FAs by the following dates: Kama Pulp and Paper: October 23, 1997 and Domodedovo Airlines: October 22, 1997 and Russkii Dizel: January 5, 1998 (iii) Contracts to be signed with the selected FAs by the following dates: Kama Pulp and Paper: November 14, 1997, Domodedovo Airlines: November 6, 1997; and Russkii Dizel by January 26, 1998. The Government is committed to implementing future privatizations on the basis of a common framework of principles and procedures that ensures transparency, openness and competition. The methods for carrying out future privatizations shall	specified in Government Resolutions 363 and 564 of 1997. The ordinance will establish a schedule for privatizing these enterprises such that they will be offered for sale not later than December 31, 1998, if such dates are determined on advice of independent financial advisors as most desirable based on market conditions. The percentage of equity offered will be determined in consultation with independent financial advisors. These enterprises are: 1. OAO Orenburg Oil JSC (Orenburg oblast); 2. OAO "Kovrovo Electric Machine Plant" (Vladimir oblast); 3. OAO Western-Siberian Iron & Steel Factory (Kemerovo Oblast); 4. OAO "Stupino Iron & Steel Factory" (Nizhni Novgorod Oblast); 5. OAO "Nizhni Novgorod Machine Building Plant"; 6. OAO "Oil & Gas Co. "Slavneft" (Moscow); 7. Rybinsk Instrumentation Factory (Yaroslavl Oblast); 8. Kemerovo Mechanical Plant (Kemerovo Oblast); 9. Kamensk Chemical Factory (Rostov Oblast); 10. Factory "Krasny gigant" (Penza Oblast); 11. PO (Prod. Association) "Avangard" (Ufa); 12. GPO "ZiM named after Maslennikov (Samara Oblast); 13. Plant "Kommunar"; 14. NPO "Geofizika" (Moscow);

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Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
	Kombinat (Kabardino- Balkar Oblast), Domodedovo Production Association for Civil Aviation (Moscow Oblast), Taganrog Sea Trade Port (Rostov Oblast), Kamsk Pulp and Paper Kombinat (Perm Oblast), Mosfilm (Moscow), Lumber Factory No. 21 (Vologda Oblast), Troitsk Iodine Plant (Orenburg Oblast), Pulkovo Airlines (Leningrad Oblast), State Enterprise Russkii Dizel (St. Petersburg), Rosgosstrakh (Moscow). These four enterprises are: Domodedovo Production Association for Civil Aviation, Kamsk Pulp and Paper Kombinat, Pulkovo Airlines, and Rosgosstrakh. Three enterprises have been selected as possible substitutes if the implementation of case-by-case privatization of any of the four above enterprises prove impossible because of insurmountable legal or technical difficulties that constitute a case of force majeure. These are: Mosfilm, Russkii Dizel, and Taganrog	be "commercial competitive bidding", and "auctions" or "specialized auctions" as defined in law, including "On Privatizing State Property and on the Principles of Privatizing Municipal Property in the Russian Federation" adopted by the State Duma on 24th June, 1997 (the Privatization Law). In accordance with the relevant laws, bidding procedures will encourage all interested parties to participate; privatizations will be widely advertised, including internationally where this could attract additional qualified buyers; when employed, financial advisers will be reputable, and engaged through a transparent, competitive process; conflicts of interest will be avoided; and bid evaluations will be carried out objectively. In accordance with the Privatization Law, in August, 1997 the Government submitted to the State Duma the "State Program of Privatization in the Russian Federation" (State Privatization Program), which identifies two lists: (i) 37 state enterprises held in federal property and subject to reorganization into open joint stock companies and privatization beginning in 1998; and (ii) 29 open joint stock companies whose federally held shares are subject to sale beginning in 1998. Not counting the four pilot case-by-case transactions initiated in 1997, at least a quarter of the enterprises which are on the lists (i) and (ii) above, and which will experience continuation of privatization measures initiated in 1997 or initiation of such measures in 1998, will be privatized through "case-by-case" transactions as defined by Government Resolutions 363 and 564-R of 1997 (involving in particular the engagement of financial advisers as early as possible in the process),	15. Vysokogorsky Mechanical Works (Sverdlovsk Oblast).

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Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
	Sea Trade Port. (GKI Directive 356-r.) On April 24, 1997, the Government appointed tender committees for these privatizations (GKI Directive 317-r).	financial advisers as early as possible in the process), and building on any experience from the four pilots. The Government will take all reasonable steps to ensure State Duma deliberation on the State Privatization Program, and to facilitate its passage. Should the State Duma not approve the legislation in a timely fashion, the Government will take all necessary and feasible steps in conformity with the legislation in force to enable the privatizations referred to in (i) and (ii) above to proceed in 1998–99 in accordance with the approaches defined above. Government Resolution # 989 (issued August 7, 1997) on the "Procedure for Transferring Federally Owned Shares of Joint Stock Companies Created in the Course of Privatization to Trust Managers and Concluding Trust Management Agreements Regarding those Shares" met many, but not all, of the criteria set out under the program for implementing market-based guidelines for trust management arrangements, including the competitive selection of trust managers. MSP will issue a directive by November 30, 1997 that contains detailed implementing regulations that specify: (a) a trust management contract has the objective of improving the financial operation of enterprises and to prepare them for privatization following the expiration of the contract; (b) contracts are to specify performance based compensation linked to financial results; (c) compensation is to be paid through the term of the contract, not a lump-sum paid at the contract's expiration. It is noted, that according to Article 1015 of the Second Part of the Civil Code, property shall not be subject to transfer under trust management to	

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Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
		a state agency or a local self-government body. An individual entrepreneur or a for-profit organization except for a unitary enterprise may act as a trust manager. In accordance with Government Resolution 989, evaluation of contract bids is to be carried out using methods that are consistent with international standards of competition, neutrality and equity.	
b. Reduction of Lists of "Strategic" Firms			Government Resolution No. 784 of July 17, 1998 reduced from 3,000 to 697 the number of firms included in the list of "strategic" enterprises under Government Resolution No. 949 of September 18, 1995 barred from any privatization to either domestic or foreign investors. The Resolution specifies that the enterprises removed from the "strategic" list will be subject to transparent and competitive privatization processes, beginning September 30, 1998 to December 31, 2000. For the enterprises removed from the "strategic" list, in accordance with market conditions as assessed by independent financial advisors, at least 40 percent will be brought to the point of sale by December 31, 1999, and 100 percent will be brought to the point of sale by December 31, 2000.
II. Bankruptcy			
To make the bankruptcy process more efficient.	The Federal Service on Insolvency and Financial Rehabilitation, based on an assessment of completed bankruptcy cases to date, developed and made public recommendations to increase	The Gov't. sent a draft bankruptcy law to the Duma. Relative to current law, the new draft provides for: (i) an increased role for creditor committees in the resolution of insolvency cases; (ii) more expeditious appointment on a competitive basis of licensed trustees with authority to replace incumbent enterprise managers; (iii) differentiation of classes of	The new Bankruptcy Law became effective in March 1998.

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Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
	the speed and effectiveness of the bankruptcy process.	creditors; and (iv) stricter observance of time limits for workout and liquidation proceedings by all parties.	
			In addition to the actions aimed at improving the bankruptcy legislative framework, the restructuring process in the Russian economy could be expedited by implementing pilot projects targeted towards bankruptcy of insolvent enterprises in cases that are especially difficult in such a way that minimizes possible negative social consequences of bankruptcy. For such purposes, and taking into account the basic provisions of the new Bankruptcy Law, the Government of the Russian Federation will approve, by adopting appropriate directives, a procedure for implementing and financing bankruptcy pilot projects involving insolvent enterprises. In compliance with the above mentioned procedure as well as in accordance with the goals outlined in the first sentence of the current paragraph, the Federal Service on Bankruptcy Matters and Financial Rehabilitation, shall implement in 1998 at least 4 bankruptcy pilots embracing large enterprises that experience serious financial difficulties and have bad market prospects. The results of the pilots implemented will be widely reflected in a report of the Federal Service of Russia for Bankruptcy Matters and Financial Rehabilitation to (i) provide arbitrators with data on the relevant procedures; and (ii) provide creditors and other persons concerned with the most detailed information about the

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Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
			mechanisms and advantages of hearing bankruptcy cases in the court.
III. Competition Policy			
Strengthening the government's capacity to intervene to promote competition.			In order to foster resolution of business disputes, new measures shall be implemented by July 31, 1998 that strengthen and enlarge the bailiff service so as to provide for more effective enforcement compliance, including criminal sanctions, by losing defendants in arbitrazh court cases.
			The mission of the Antimonopoly Committee should have as principal objectives the creation of a unified economic space throughout the Russian Federation and preventing restrictive business practices, in particular anti-competitive mergers and acquisitions. The Antimonopoly Committee will develop and implement policy measures that deal with reducing anti-competitive horizontal and vertical concentration and integration in key product and geographic manufacturing and infrastructure monopoly markets, including industrial and financial groups (FIGs) and the petroleum sector.
IV. Corporate Governance and Investor Rights			
Clearly signal the government's determination to protect investors.			By July 1, 1998, a Presidential Decree will be issued that implements measures to protect depositors' rights, including measures towards liquidation (bankruptcy) of non-licensed companies, sale of such companies' assets, and paying compensation to victimized investors.

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Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
			Government Resolution No. 785 of July 17, 1998 adopted and initiated implementation of the State Program of Protection of Investors' Rights, which spells out key tasks and measures to be undertaken in 1998 and 1999. The Government will also ensure that the Federal Securities Commission (FSC) will be provided sufficient resources to enforce investors' rights. This will be achieved by assigning a share of fee revenue from licensing of securities' market participants to the FSC.
V. Fostering Labor Mobility			
VI. Land/Real Estate			
To further develop the legal and institutional framework for full private ownership and development of land and real estate.	Presidential Decree No. 485 "On Guarantees to Owners of Real Estate to Buy Land on Which These Assets Are Located" was issued on May 16, 1997 to establish the necessary legislative framework to enable all owners of privatized non-land real estate assets (including production complexes, buildings, and unfinished construction) to acquire the land on which these assets are located. For all future privatization of such assets, the associated land plots will be included in the transaction package.	Under the program, by June 30, 1997 a presidential decree was to be issued to cover four main goals to foster land/real estate transactions: (i) create a legal framework requiring that the sale of all premises belonging to the federal Government which are currently under lease to commercial entities be carried out at market rates; (ii) eliminate all existing restrictions on the market sale of such real estate; (iii) all future leases of the federal owned property will be at market prices; and (iv) recommend that all the procedures outlined in the decree be followed by regional and local Governments. A presidential decree was not issued; a new privatization law was passed by the Duma in June 1997. An analysis was performed by MSP that assesses the nature of the gaps between the earlier agreed objectives and the privatization law. The analysis indicates that many of the above-mentioned objectives are covered.	In December 1997, model municipal regulations and procedures were prepared for the sale of unoccupied and/or undeveloped land through auctions and competitive tenders.

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Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
		Presidential Decree No. 1263 was issued on November 26, 1997, which establishes a legal framework for market-based sales of undeveloped land and/or land not currently in use (including nonagricultural land bordering city limits) to be used for commercial development, including through auctions and competitive tenders.	
VII. Accounting and Auditing			
To achieve substantial progress in implementing financial accounting and auditing standards and practices in line with international principles.			
a. Accounting		The Government approved an Action Program to introduce generally accepted accounting principles consistent with International Accounting Standards (IAS). The Action Program: (i) identifies any necessary amendments to laws or other normative acts to facilitate the use of IAS by Russian issuers in disclosure of financial information; (ii) requires the MOF to approve regulations by October 31, 1997 mandating IAS-consistent disclosure by January 1998 of financial information to investors by Russian enterprises which have a significant secondary market in their securities or which propose to offer	

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Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
		their securities to the public, and to require the same for all other enterprises by January 1999; and (iii) outlines a strategy and timetable for adaptation of the entire accounting system for enterprises to bring it into conformity with international practices. This strategy and timetable will include: steps for transition to a revised chart of accounts; a plan for training of accounting personnel; further improvement of the process of certification of professional accountants and auditors; and an approach to developing accounting and audit practices such that any authorized system using accounting information will not preclude IAS-consistent financial accounting information. With respect to (ii), the MOF issued the regulations on October 14, 1997.	
			With regard to accounting reform, the Government will ensure the implementation to January 1999 of the measures specified in the Action Plan of the Accounting Reform Program based on International Accounting Standards (IAS), approved by Government Resolution No 283, to develop national accounting standards consistent with IAS and to support the establishment of the self-regulating independent accounting professional body.
b. Auditing		A parallel set of activities to those listed above regarding the introduction of financial accounts based on int'l. standards was initiated to introduce independent audits of such accounts in enterprises. In particular, the Government approved and published for public comment an Action Program to require, no	

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Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
		later than June 1999, independent audits of the financial accounts of enterprises.	
VIII. Liberalizing the International Trade and Foreign Direct Investment Regimes			
To send a clear signal to foreign investors of the government's intentions to ensure they receive fair treatment and to harmonize production certification standards with international practice so as to reduce barriers to foreign trade.	Under the program, trade policy commitments have been made to preserve what liberalization has already been achieved. No quantitative restrictions will be introduced on international trade transactions, with the possible exception of any protectionist measures that might be taken fully consistent with WTO rules. The Government will also strive to reduce import tariff exemptions, laying the basis for an eventual reduction in import tariffs. Centralized trade will continue to be limited to arms exports and defense-related equipment. Trade under intergovernmental agreements and credit arrangements guaranteed by the government will be conducted on the basis of market-based procurement, with prices at world levels, and related expenditures and receipts will be reflected in the budget. The Government will refrain from operating any system of export controls under the guise of mandatory monitoring of the quantity, quality, or price of exports.		
a. Foreign Direct Investment Policy			
b. Production Certification Standards		In August 1997, amendments to draft legislation were introduced to ensure that the emerging legal framework for trade measures (safeguards, anti-dumping, countervailing duties, etc.) will be in line with international norms. In August 1997, Government Resolution No. 1037 was issued that revises product labeling standards. Detailed information of what retailers are to provide shall be clearly specified, as will be the list of	Revisions and harmonization of Russian legislation, regulation and other measures, and their practical application to international trade and investment continue to be made in accordance with international standards and practices.

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Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
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Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
		products subject to the regulation; the classification system has been streamlined; and national treatment standards have been incorporated. In September 1997, Government Resolution No. 1193 was issued that revises the system for marking products to ensure against counterfeiting in line with international standards. The coverage of products requiring such markings have been reduced and mandatory restrictions have been narrowed; the certification process has been streamlined.	
c. Tariff Reductions			The Safeguard Commission approved a list of 300 items for which the import duty rate will be reduced from 30 percent to 20 percent by December 31, 1998, and a Government Resolution adopting this was issued on June 3, 1998.

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The government announced its anti-crisis Economic Stabilization and Finance Program in late June 1998. Key fiscal measures under the program include improvement of tax administration, raising and rationalizing select taxes, and restructuring of budget commitments. A Presidential Decree setting out the budget parameters for 1999 was issued on July 16, 1998. Subsequently, a Presidential Address that formulates the 1999 budget—including key measures to underpin the budget targets—was signed on July 17, 1998 (and published on July 20, 1998). The Government's strategy focuses on further reducing the budget deficit by turning around the ongoing serious erosion in revenue collections while also making more effective use of limited fiscal resources. The federal government has committed itself to undertaking measures aimed at increasing total revenue collection from an around 10.6% of GDP projected in 1998, to a targeted level of 13.2% of GDP in 1999, while holding constant nominal federal non-interest expenditures. As a result, the 1999 primary fiscal balance is targeted to improve to nearly three percent of GDP from a small negative balance this year. This dramatic shift will be achieved through efforts to broaden the tax base, improve revenue collection, strengthen budget management, rationalize government spending, reform intergovernmental fiscal relations, and strengthen debt management and monitoring capacity. In addition, the government is committed to improving the management and cost efficiency of extra budgetary funds, including the Pension Fund, Social Insurance Fund, Employment Fund and Road Fund, together representing nearly 10% of GDP.			
I. Elimination of Non-Payments and Arrears			
To eliminate arrears and the practice of non-payments.			The Deputy Prime Minister signed a resolution on June 18, 1998 stipulating that agreements between the State Tax Service and oil producing enterprises will be prepared and signed within a week and oil holdings with outstanding tax arrears not in compliance with these agreements will be denied access to the oil pipeline. It has been publicly announced that nonpayment by July 1 will automatically and immediately lead to curtailed pipeline access. On July 17, 1998, a Presidential Address on the principles of the 1999 budget was issued instructing the Government to prepare and submit to the Duma a draft 1999 Budget Law which stipulates terms and conditions to be met by regions in order to qualify for their full share of federal transfer payments.

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Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
II. Tax Administration and Policy			
To strengthen revenue collection performance, improve tax administration, and reduce distortions in the tax structure.			
a) Design overall tax reform package	The Government submitted the draft Tax Code, through which it intends to undertake a significant reform of tax policy, to the State Duma on April 30, 1997.	The draft Tax Code passed its first reading in the State Duma; however, the Duma decided to send the Code back for a new first reading. The Government continued to work closely with the State Duma to secure final adoption of the Code on a timely basis. As part of the draft Tax Code, the Government submitted draft legislation to introduce an improved framework for the taxation of capital income. This framework includes shifts toward: (i) uniformity of tax rates and treatment for securities and other financial assets, including removal of tax privileges or exemptions for specific types of securities; (ii) elimination of double taxation on investment through collective investment vehicles such as mutual funds; (iii) deductibility of capital losses from the sale of securities. Moreover, the draft Tax Code does not stipulate any transaction taxes or fees on the circulation of securities.	The Federal Assembly adopted Part I of the Tax Code in its third reading, with the provision for offsets eliminated and the cap on interest increased from 50 percent of tax arrears to 100 percent.
b) Reform of the structure of individual taxes	Among many improvements, the Code envisages the elimination or phase-out of almost all existing exemptions for the VAT and the deduction		The Federal Assembly adopted legislation approving a 5 percent sales tax, with exemptions for bread, milk, and children's food and clothing, as well as provisions allowing the regions to introduce their own exemptions on

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Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
	of normal business expenses when measuring the profit tax base. It also includes the adoption of accrual accounting; the indexation of specific excise rates for inflation; the elimination of preferential rates under the profit tax; and a simplification of filing requirements under the profit tax and personal income tax.		social grounds. The revenue impact of the exemptions is small. A Presidential Decree was issued raising rates for the land tax. The tax rate on profits was reduced from 35 percent to 30 percent. Means-tested subsidies have been introduced.
c) Assessment of tax exemptions	On April 4, 1997, the Government eliminated the tax deductibility of transfers by RAO UES Rossii to its Investment Fund, with no accompanying increase in electricity prices (Government Resolution No. 390).		The Federal Assembly adopted a law removing exemptions for closed territories. The exemptions will be allowed to expire as initially planned, but no later than January 1, 2000.
d) Develop an efficient and impartial tax administration that can overcome a pervasive "non-payment culture"	In the period up to May 15, 1997, the Government notified more than 15 of the largest debtors to the federal budget that within one month, they will have to decide among three options for resolving their outstanding tax arrears: (i) paying their arrears in full; (ii) participating in the announced scheme of collateralized restructuring of	As of September 30, 1997, the Government has established and made operational large taxpayer units of the Federal State Tax Service in five regions. In November 1997, the Government introduced a new Action Plan to Increase Collection of Taxes and Reduce Federal Budget Expenditures. Major steps that will be taken under this action plan include: (i) the termination of noncash arrangements ("offsets") for clearing tax and spending arrears, which will become effective on January 1, 1998, as stipulated in a November 7, 1997 Presidential Decree; (ii) the	The Large Taxpayer Inspectorate is not fully operational, but central offices of 17 large financial-industrial groups have been shifted under its jurisdiction. The employees of the Inspectorate still need to be relocated to one single office. The Government has issued an order allocating the resources to cover the expenses of the Inspectorate. A legal framework has been established for tax authorities to seize the assets of tax delinquents.

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Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
	arrears; and (iii) initiating bankruptcy proceedings. The Government endorsed an action plan to establish large taxpayer units in the State Tax Service (STS Orders No. BA-3-20/27 of February 17, 1997, BA-3-32/57 of March 25, 1997, and PV-3-32/104 of May 13, 1997). The Government has adopted an action plan to strengthen the collection of alcohol taxes, including steps to control domestic commercial traffic in excisable goods, to ensure that the excise tax on domestic alcohol and alcohol products is payable at the time of shipment, and to improve the excise stamp program (Government Resolution No. 297 of March 14, 1997, submission of the draft Tax Code to the Duma on April 30, 1997, and various Customs Committee orders).	establishment of firm expenditure control through the consolidation of all federal spending under the Treasury, supported by sanctions against officials of institutions receiving budgetary resources for undertaking expenditure liabilities not covered by budgetary funding, improved reporting of expenditure arrears, and other expenditure control mechanisms; (iii) the development and implementation of a realistic spending plan to underpin the 1998 budget, including spending norms for such items as electricity and heating; (iv) strong measures to improve tax collection, including taking actions against large high-profile tax debtors and enterprises that do not carry out the decisions of the Emergency Tax Commission (VChK), creating the infrastructure for effective implementation of levies on property of tax debtors, and accelerating tax arrears rescheduling efforts; (v) introducing the invoice system for VAT collection and making the transition to collection of VAT, profit taxes and excises based on the accrual method; and (vi) inventorying all off-budget accounts of budgetary organizations.	Collection of arrears from large tax debtors will continue to be a central element of the revenue collection strategy. From July 1, 1998 and during the remainder of the year, the Emergency Tax Commission will meet monthly, to take steps to collect arrears in each quarter from at least the 20 largest remaining tax debtors. Further, a newly created Federal Debt Center will begin sales of the assets seized from tax debtors. All necessary steps will be taken to ensure that the specialized tax inspectorate, established under Government Resolution No. 9 within the State Tax Service (STS) to monitor the largest tax payers, will operate effectively. In order to further streamline tax administration, Government Directive No. 969-r of July 17, 1998 has made the Federal Agency for Foreign Currency and Export Control and the Tax Police subordinate to the Minister Head of the STS.

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Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
III. Expenditure Management and Policy			
To improve control over and efficiency of public expenditure.			
a) Maximize transparency and minimize disruptions through ad-hoc sequestration.	The Government submitted to the State Duma, on April 30, 1997, a law proposing expenditure ceilings for 1997 which are consistent with the program. This level of expenditure will be sufficient to provide for the basic needs of the Federal Government while at the same time ensuring that there will be no incurrence of new arrears.	In an effort to establish an instrument for the regular and accurate monitoring and assessment of tax expenditures, an amendment was made to the draft Budget Code in September 1997 for consideration by the State Duma in the second reading, so as to make the evaluation of actual Government tax expenditures a mandatory component of the annual budget execution reports at all levels of Government. As of September 30, 1997, the Government has kept its cash budget expenditures in line with its sequestration budget proposed to the Duma in late April and the cash deficit remained under control.	The Government's Economic Stabilization and Finance Program is being implemented and the 1999 federal budget is being prepared in accordance with the parameters set forth in the Presidential Address of July 17, 1998.
b) Control spending commitments and eliminate budget arrears through enhanced monitoring and the establishment of a Treasury controlled payments mechanism.	The Government confirmed in early May 1997 that a mechanism was launched for the Treasury to issue directly payment orders for wages of the Ministry of Defense. On May 12, 1997, Presidential Decree No. 467 ("On Terminating the Practice of Issuing Guarantees and Warrants Covered by the Federal Budget") was issued eliminating the system of	As of October 31, 1997, all federal pension arrears and all federal wage arrears have been repaid by the Government. The Ministry of Finance began an assessment of the level and structure of federal budgetary arrears to suppliers as of June 30, 1997. The Government adopted a decision to instruct the Ministry of Finance and Goskomstat to develop a statistical format for monthly reporting by budgetary organization on the stock of their outstanding arrears to suppliers, starting in January 1997. A Presidential Decree was signed and became effective on November 7, 1997 to (i) instruct the	For 1998, the Ministry of Finance is developing a procedure to strengthen Treasury control over payments to energy suppliers by budget organizations and government agencies so as to prevent the unauthorized reallocation of budget funds to other categories of expenditures and help reduce budget arrears to energy providers. At the same time, 1998 budget allocations will provide sufficient funding for financing energy consumption within agreed limits. (Ref.: GOR Resolution No. 1129). A draft law has been prepared which would amend the Civil Code to allow the Federal

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Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
	government guarantees on commercial bank financing of budgetary organizations and enterprises.	federal Government to end, as of January 1, 1998, the use of all types of mutual offsets, including cash offsets, for clearing federal tax and budgetary arrears; and (ii) recommend to regional Governments to end, as of January 1, 1998, the use of arrears offset arrangements at the regional level. Further to Government Resolutions #903, 927, 928, on September 2, 1997, the Government issued Resolution #1129, amending the framework for clearing the existing stock of energy arrears (budgetary arrears to energy suppliers and suppliers' tax arrears).	Treasury to pre-authorize contracts signed by budget-funded organizations. In the interim, Government Resolution No. 441 of May 14, 1998 (on implementing the 1998 federal budget) establishes a mechanism for enhanced Treasury measurement of commitments, including sanctions for officials who sign contracts in excess of approved spending limits.
			The Government will ensure that the accounts payable of budget organizations to infra-structure monopolies at no time exceed 30 days of current sales for sales after July 1, 1998.
c) Switch to new computerized Treasury system of accounting.		The Government has made substantial progress in introducing the computerized treasury system of accounting and direct payments. The volume of payments processed by the federal Treasury has been steadily increased through 1997 and as of September 30, 1997, the Government is processing 31 percent of the monthly outlays of the federal budget through this system.	In the context of broad reform of the budget execution system the Government will during 1998: (i) develop a system with a single Treasury account; (ii) transfer off-budgetary accounts of budgetary organizations to the Treasury; (iii) issue regulations and streamline procedures of the Treasury system of budget execution, including procedures for main distributors, distributors and end-users of budgetary funds; (iv) unify the information and telecommunication systems of the Treasury; and (v) serve budgetary organizations, located in the regions without federal Treasury branches, by Treasury branches in neighboring regions. (Ref. Government Resolution #1082).

FISCAL MANAGEMENT REFORM

Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
			To control cash spending and improve expenditure management the Government has adopted (Government Directive No. 970-r of July 17, 1998) a revised timetable to complete moving the operations of all federal agencies into the federal treasury by January 1, 1999. This includes all budget recipients of the Ministry of Defense, the operations of all the earmarked budget funds, (including the Road Fund and Customs System Development Fund), and all foreign exchange accounts of the STS and State Customs Committee. Customs operations will be transferred to the Federal Treasury only on January 15, 1999. As of July 16, 1998, only one of nine military districts is in the Treasury; for the rest, there has been no budget financing since July 1, 1998.
d) Move extrabudgetary funds onto the budget and the treasury system.		The Government's 1998 budget includes the budgets of the social extrabudgetary funds in parallel with the federal budget.	
e) Establish sound legal-institutional basis for budget and treasury management		A new draft Budget Code developed by the Government and the State Duma has been passed in its first reading by the State Duma. Its provisions on budget responsibilities, comprehensiveness, unification, monitoring, reporting, auditing, etc. provide a solid basis for regularizing the entire sphere of budget operations and dramatically improving their transparency and efficiency.	The Law on the Budget Code was adopted by the Federal Assembly.

FISCAL MANAGEMENT REFORM

Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
f) Rationalize government spending	Presidential Decree No. 305 "On Priority Measures to Combat Corruption and Reduce Budget Expenditures Through Organizing Auctions to Procure Goods, Construction Works, and Services for State Needs" was issued on April 8, 1997 to reform public procurement procedures, requiring standardized, competitive, open, and nondiscriminatory bidding procedures, and establishing conflict of interest regulations. The decree requires competitive bidding procedures for all federal agencies.	The Government has undertaken a number of steps to accelerate reforms in the housing sector and to reduce the fiscal burden associated with housing subsidies, which are the single largest subsidy item remaining in the fiscal system. A Government Commission was established to oversee housing and utility reforms, led by the First Deputy Prime Minister. The Government has approved a system of federal standards in housing policy, which provides subnational Governments with explicit benchmarks for reform implementation and budget savings. The Commission has worked out a medium term plan for the preparation of Government decisions to accelerate sector reforms. As a result, average housing (utility and maintenance) prices charged to households have risen by 10 percent in real terms, as of the end of September 1997, compared to the end of 1996. The Government has submitted to the State Duma a draft law to reform public procurement procedures requiring standardized, competitive, open, and nondiscriminatory bidding procedures which has passed its first reading. As of June 30, 1997, all grain and food procurement using federal budgetary funds is subject to competitive tendering. The Government has conducted no less than 10 competitive tenders for large (i.e. valued in excess of Rbl 50 billion) capital projects.	The Government's Economic Stabilization and Finance Program is being implemented and the 1999 federal budget is being prepared in accordance with the parameters set forth in the Presidential Address of July 17, 1998.

FISCAL MANAGEMENT REFORM

Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
IV. Reform of Extrabudgetary Funds and Earmarked Budget Funds			
To improve transparency and reduce waste in extrabudgetary funds.			By July 31, 1998, the Gov't will issue a resolution mandating annual audits, carried out in line with int'l auditing standards & supervised by the Min. of Fin., of the Social Insurance Fund, Medical Insurance Fund & the Road Fund. A Presidential Decree dtd Jul 4, 1998 prohibits all federal extrabudgetary funds (with the exception of the Pension Fund) from borrowing from any private financial institution. The Decree as issued gives the Pension Fund scope for borrowing beyond what is needed to manage liquidity. The Ministry of Finance has prepared a draft proposal to limit the Pension Fund's borrowing to the level on April 1, 1998. A number of actions are envisaged to restore the solvency of the Pension Fund. A Gov't. Resolution has been issued that introduces, as of August 1, 1998, a temporary 2 percent earmarked tax surcharge on the personal incomes to be paid to the Pension Fund. This same resolution will also expand the base for the employer contribution. The surcharge will remain in place and further increases in pension benefits will be avoided as long as the Pension Fund remains in deficit or new pension arrears are being accumulated. In addition, legislation will be proposed to the Duma in the special August session, that will expand the base for both employee and employer payroll tax contributions, and will shift the burden of the tax from employers to employees.

FISCAL MANAGEMENT REFORM

Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
V. Intergovernmental Fiscal Relations			
To put in place basic elements of inter-governmental fiscal relationships that encourage reform, improve tax collection, eliminate unfunded mandates, and promotes equitable treatment of regions.	Government Resolution No. 621 issued on May 5, 1997, requires transfers from the Federal Equalization Fund to be made conditional on regions' compliance with newly established federal guidelines and standards on housing reform. This lays the basis for the first type of conditional transfers in Russia.	The Government has decided to undertake a comprehensive restructuring of intergovernmental fiscal relations and set up a Working Group of its Government Commission on Economic Reforms to develop the reform program. The Working Group has developed a program for restructuring the current system of federal budget transfers to regions for 1998–99. The Federal law "On Fundamental Financial Principles Of Local Self-Governance In The Russian Federation" adopted on September 25, 1997 provides a new legal framework for intergovernmental tax revenue sharing. The Government's 1998 budget: (i) requires a concentration of federal transfers among the most needy regions; (ii) reflects the recommendations of the Protocol of the Commission on Housing Reform of July 22, 1997 and makes the level of equalization transfers to regions conditional on compliance with federal housing standards; and (iii) introduces a separate mechanism for ear-marked federal transfers to regional Medical Insurance Funds. An Instruction was issued by the Government Commission on Housing and Utility Reform in August, 1997, which specifies rules and procedures for determining the level of federal transfers to regions conditional on the extent of compliance with federal housing standards.	**The Government is introduce amendments to the Law on Fiscal Foundations of Local Self-governance to make it fully consistent with the provisions of the Tax and Budget Codes (sections concerning intergovernmental fiscal relations).** Government Resolution No. 555 specifies conditional budget transfers to regions based on meeting 40 percent target for cost recovery on housing and communal services. Average cost recovery is now 42 percent. A draft concept paper for the reform of fiscal federal relations has been prepared and discussed in Government, and minutes of a Government review meeting have been signed. By July 30, 1998, the Government will approve a revised Concept Paper on Sub-National Fiscal Reform which will, inter alia, provide clear conceptual guidelines for the reform of sub-national fiscal relations between the federal and regional levels of government.

FISCAL MANAGEMENT REFORM

Policy Objective	**Actions Taken For Board Approval of SAL1**	**Actions Taken For Board Approval of SAL2**	**Actions Taken Prior to Board Presentation of SAL3**
		By November 30, 1997, the Government of the Russian Federation issued a resolution authorizing the Economic Reform Commission to develop, by January 31, 1998: (i) the concept of reforming the system of interbudgetary fiscal transfers; and (ii) an action plan and implementation schedule, starting from a detailed survey of the reform program (including consultations with regional bodies of executive power and the State Duma), and stipulating its incorporation in the Government's draft budget for 1999. In accordance with that resolution, the Government's concept of reforming the system of interbudgetary fiscal relations includes: (i) rationalization of the system used to classify regions into categories; (ii) changing the criteria determining the amount of transfers (based on the assessment of the regional GDP and/or fiscal capacity of the region, and standards, level and cost of provision of public services); (iii) introduction of arrangements that would encourage regions to implement reforms in the budget sector; (iv) introduction of conditionalities of transfers (including the implementation of satisfactory independent audits of the budget and ensuring compliance with the federal legislation); (v) gradual transition to the delivery of federal transfers exclusively through the Treasury system; and (vi) introduction of special transfer arrangements for regions heavily dependent on federal transfers.	

FISCAL MANAGEMENT REFORM

Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
VI. Sovereign and Subnational Borrowing			
To ensure that public borrowing is monitored and held within prudent limitations.	On May 12, 1997, comprehensive legislation regulating subnational government borrowing was submitted to the State Duma. This draft legislation included: (i) a definition of the types of securities that can be issued by local/regional governments and extrabudgetary funds; (ii) conditions for issuance of these securities (e.g., disclosure rules, collateral requirements, and debt ceilings); and (iii) exposure limits.	The draft law regulating subnational borrowing that had been submitted by the Government to the State Duma in May 1997 has been passed in its first reading. With its passage and final enactment remaining uncertain as of mid-November, 1997, the Government has submitted to the Office of the President a draft Presidential Decree to regulate subnational Governments' external borrowing through issuance of securities. The draft decree (i) requires, inter alia, the compliance of borrowing subnational governments with federal fiscal regulations; and (ii) includes monitorable ceilings on both the total debt stock and the annual debt service flow of subnational Governments. Until the relevant regulation becomes effective, through either law or Presidential Decree, the Ministry of Finance will not register international security issues by subnational Governments, and any such registration would require, at a minimum, compliance with the conditions on subnational borrowing by the regions of Moscow, Nizhniy Novgorod, and St. Petersburg outlined in Presidential Decree No. 304 of April 8, 1997. Moreover, the federal Government continues to refrain from any guarantees on borrowing by subnational entities.	

FINANCIAL SECTOR REFORM

Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
I. Banking Reform			
To improve the soundness, efficiency, transparency and competitiveness of the banking system.			The CBR will continue to increase the transparency of its own operations and will put in place requirements to increase transparency for commercial banks. The policy of announcing weekly data on external reserves, begun in June, will be expanded to include the announcement of base money. The CBR will publish summary information on the financial situation of the 30 largest banks on a monthly basis and a requirement will be introduced for banks to provide quarterly disclosures of key information. The standards for disclosure by banks holding more than 10 percent of household deposits in the banking system will be significantly expanded.
			By August 1, 1998, the ten largest banks will be required to publish quarterly accounts, have annual accounts prepared and audited by a reputable, qualified firm, and make the results public.
a) Facilitate resolution of illiquid or insolvent banks.	On the basis of its evaluation of the largest 200 banks and other available information, the CBR has identified those banks that have negative capital or other serious problems. At end-February 1997 the CBR informed such banks that they will be required to prepare plans for increasing their capital and for their operational	On the basis of plans submitted by problem banks, CBR has decided whether these banks are to be recapitalized and rehabilitated, or whether other statutory procedures as per the banking legislation should be applied, including the withdrawal of bank licenses. Of 27 identified problem banks in the top 200 banks, 10 banks have had their licenses withdrawn. A number of banks have had their licenses restricted.	The CBR continuously monitors the implementation of the recapitalization and rehabilitation plans of the identified problem banks. Should the recapitalization rehabilitation fail to achieve its objectives, the CBR will take necessary actions including the withdrawal of licenses. New problem banks are being identified through the CBR's on-going on-site inspections and future evaluation of other banks. Those identified problem banks are required to submit recapitalization rehabilitation plans. Based on

FINANCIAL SECTOR REFORM

Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
	rehabilitation, for submission to the CBR on or before April 30, 1997.		an assessment of those plans, the CBR will decide whether to place the banks under rehabilitation, interim administration, or external management or to withdraw their licenses.
b) Put in place effective bank bankruptcy and liquidation legislation.	In March 1997, steps were taken to modify the current legislation in order to specify the procedures for withdrawing bank licenses and for the subsequent timely liquidation of the delicensed institutions.	Legislation on bankruptcy of financial institutions was submitted to and passed in its first reading by the State Duma in June 1997. The Government and the CBR took measures to ensure expeditious State Duma deliberation of the law on bankruptcy of lending institutions, and took steps to facilitate passage of this law.	The CBR continues to build up the necessary institutional capacity to ensure that the new legislation on the bankruptcy of financial institutions can be implemented effectively once it is passed by the Duma.
c) Ensure that any deposit guarantee scheme that is adopted has prudent coverage of financial institutions and deposits and is self-financing.		The Government and the CBR took measures to ensure State Duma deliberation of the law on deposit insurance and took steps to facilitate passage of this law. Any deposit insurance schemes that is implemented will be funded only by premiums of participating banks and the associated investment income, with no use of CBR or government resources.	Draft legislation currently under revision to make it consistent with the banking sector competition strategy being developed by the CBR.
d) Strengthen banking supervision through greater use of on-site inspections and improved prudential regulations.	On-site inspections of 53 of the largest banks were completed by the end of June.	On-site inspections of another 15 of the 100 largest banks have been completed in the third quarter of 1997. In the first nine months of 1997, 68 bank inspections were completed. The CBR has continued to improve the system of prudential regulations established by Instruction 1 of January 30, 1996, with a view to moving prudential regulations closer to international standards. During	The program of on-site inspections has expanded. During 1998, the CBR will continue to improve the system of prudential regulations to meet – or where appropriate exceed – international standards. The CBR has simplified (CBR Directive No. 156-u of February 1, 1998) reserve requirement

FINANCIAL SECTOR REFORM

Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
		1997, the CBR has, inter alia: revised procedures for calculating banks' own resources (capital); increased capital adequacy requirements and lowered the tied credit ratio; and introduced necessary changes in the calculation of banks' prudential requirements, with a view to incorporating off-balance-sheet claims and liabilities.	procedures through establishment of a single uniform rate for funds denominated both in rubles and in foreign currency, regardless of the term for which the resources are obtained. CBR Regulation No. 29-p of May 12, 1998, On Consolidated Reports of Lending Institutions, is approved. The CBR set a list of lending institutions to provide consolidated reports, starting with reports on July 1, 1998 (CBR Directive No. 260-u of June 6, 1998).
e) Reform accounting requirements for banks by moving toward international standards.		The CBR, MinFin, and STS revised the procedure of making and use of loan provisions, with a view to making the necessary reserves in all cases where repayment in full is considered unlikely, including cases where loans are not currently nonperforming but there are reasons to believe that the borrower is insolvent. In doing so, the CBR, the Ministry of Finance, and the State Tax Service are not allowing banks' tax burdens to increase unduly as a result of the new provisioning rules.	The finalized chart of accounts has been applied by lending institutions in their operations as of January 1, 1998.
f) Improve functioning of money markets by putting in place new monetary instruments and developing open market operations to give banks the liquidity management	The CBR introduced reverse repo operations to allow for a temporary reduction in the volume of liquidity in the banking system.	The Central Bank has drafted regulations specifying the procedures for conducting transactions for giving Lombard credits and same-day settlement loans collateralized with government securities based on preliminary deposits of securities by banks on special DEPO bank subaccounts. The Central Bank will approve the above regulations so as to provide for their implementation. The CBR put in place an arrangement to allow primary dealers to take short positions in government securities, and it will also repeal the prohibition on the use by all banks of government securities as	CBR has taken steps to establish an interbank repo market for a wide number of banks both in Moscow and in the regions. CBR Executive Order No. OD-267 of June 5, 1998, On Making Operations to Refinance Banks by the Bank of Russia made effective Resolution No. 19-p of March 6, 1998, On the Procedure of Providing Credits by the Bank of Russia to Banks, Collateralized with Government Securities, and expanded it to banks of Moscow region.

FINANCIAL SECTOR REFORM

Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3
management tools available in other developed banking systems.		collateral, and will ensure that mechanisms are in place to pledge collateral for same-day transactions.	
g) Improve payment system by introducing a real-time gross settlement system and providing incentives for banks to use new electronic settlement services.	On February 28, 1997, the CBR introduced a multi-window system for processing commercial banks' payments in Moscow region, making payments from banks' accounts irrevocable once a payment order is submitted to the CBR. Following each window, the CBR provides information to banks on their correspondent account balances. A "cut-off" hour for same-day client payments was introduced to allow banks to settle their positions during the last window by borrowing in the interbank market or from the CBR.	In June and July 1997, the CBR issued normative concepts for the Real-Time Gross Settlement (RTGS) system and for the development of the settlements system.	The CBR has introduced (CBR Directives No. 18-p of February 20, 1998 and No. 191-u of March 24, 1998) the technology of settlements without paper documents between the credit institutions in Moscow. The CBR has developed and approved the normative framework to ensure the functioning of the RTGS system.

PPARs for Rehabilitation Loans I & II and SAL I & II

ECA Regional Management Comments

Overall Assessment of the PPARs

ECA management welcomes the opportunity to comment on the PPARs for Rehabilitation Loans I and II and SALs I and II. We appreciate that some of our earlier comments related to the CAE have been included in the PPARs for these operations, but nevertheless consider that the main disagreements remain largely unresolved.

At the heart of the debate are two problems. First, there is the issue of the timescale of the evaluation. The PPARs for these loans will be distributed in early 2003, some four years after the closure of SAL II and some six years after the closing of the second rehabilitation loan. If the PPAR had been issued soon after the closure of SAL II, its arguments might have carried greater weight. However, from the vantage point of the present day, it is rather difficult to argue that these operations failed, even if the timescale for the reforms which were supported under these loans was longer than originally envisaged. It is clear that most of the reforms which were supported under these operations have now been implemented. In fact, the PPAR recognizes this implicitly by noting that sustainability of the reforms supported by the SALs is "likely".

Second, we continue to be extremely skeptical that the "alternative paradigm" of large-scale technical assistance without financial support would have worked. We doubt very much whether, without the SALs, we could have focused Government attention on the longer-term reforms which were key to sustained and equitable growth. We recognize that there could have been stronger up-front conditionality for prior actions, more focus on implementation and more buy-in from Parliament and other stakeholders. But the PPAR fails to recognize that the package of SALs was precisely that, a package underpinning a longer-term programmatic view, which makes it inappropriate to judge each one of the SALs solely on its own merits and its short-term actions or outcomes. The PPAR acknowledges, as have we consistently in ICRs and in our comments on the CAE, that SAL I and SAL II were part of a series of three SALs. We do not, therefore understand why SAL III was not included in the evaluation.

Seen in their entirety, we would argue that the SAL program was successful in:

(a) introducing and maintaining a strong focus on a broad-gauged systemic structural reform process. Prior to (and without the SALs) there was inadequate attention to the structural and social reform agenda; the SALs also made clear to the Authorities that we were a steady and supportive partner through difficult times;

(b) setting up a broad-gauged systemic reform agenda, and instilling in our counterparts the notion that such an agenda was indeed necessary. This eventually led to the current government's own program which, in approach, content and design, is clearly consistent with the "road map" which SAL 1 laid out and which was consistently supported by the Bank during the subsequent years;

(c) maintaining steady reform progress, albeit slow at times, throughout the 1996–99 period, and preventing major reversals, especially after the 1998 crisis;

(d) preparing the ground for and beginning to put in place many important changes in the legal and regulatory environment, a tedious process that does not lead to immediate results, since implementation is ultimately what matters, but without which no real reform is really conceivable.

Specific Issues

Both Russia's political economy and the fiscal structures at the time were such that it was critical to have a broad and comprehensive reform program. This broad approach helped bring counterparts together on the Russian side and was an essential vehicle for considering and deciding on complementarities and tradeoffs among different reform areas, and their sequencing and phasing. Partial approaches were doomed both because of their vulnerability to vested interests, and because of the side effects on the fiscal side (plugging one hole would only intensify the fiscal problems in other areas). Arguably, the coal SECALs would not have worked without complementary fiscal action. There is no evidence to support the argument that smaller/narrower operations or TA would have worked better.

The discussion of Rehabs I and II in the OED PPAR is generally accurate and clearly acknowledges the limited nature and objectives, as well as the achievements, of these strictly transitional instruments. Given this, we noted with surprise that the PPAR has downgraded the ratings for Rehabs I and II from Satisfactory (ICR and OED EVM/ES) to Moderately Satisfactory in the case of Rehab. I and to Moderately Unsatisfactory in the case of Rehab. II. The PPAR asserts that the Rehab. loans failed to address satisfactorily the underlying fiscal problems at the root of Russia's macroeconomic instability. Maybe so, but that was never their objective. The Rehab. Loans were: (a) not macroeconomic adjustment operations; and (b) had strictly limited policy objectives (very modest for Rehab. I and somewhat more ambitious for Rehab. II, with all the policy actions completed before Board approval). The Executive Directors were fully informed about the limited nature of the Rehab. loans, the appraisal documents were equally transparent, and in truth, the division of labor between the Bank and the Fund in place at that time did not envision a role for the Bank in macroeconomic dialogue on fiscal and monetary issues (see also final paragraph). The PPAR has therefore imputed objectives for the Rehab. loans that were never envisioned at the time.

Regarding the SALs, the PPAR makes only a half-hearted attempt to analyze the counterfactual; i.e. what would have happened in their absence? As noted above, the reforms supported by the SALs have in the main been implemented and sustained.

Single-tranche operations were clearly appropriate for the first SAL—simply because it ensured that actions were completed by Board and there was *some* immediate impact, which was essential both for risk mitigation, and for funding continuity. In all likelihood, with multi-tranche operations, there would either have been multiple waivers or the operations would have stalled.

We disagree with the judgment that "The SALs' assumption about the speed with which the reforms could proceed and achieve its stated objectives was unrealistic and raised expectations that were sure to be disappointed. The Bank assumed reforms in all the chosen areas could move from (a) design to (b) embodiment in relevant legislation or directives to (c) passage by the relevant bodies such as the State Duma to (d) administrative implementation in a couple of years. *SAL I* supported design and preparation of measures within six months that would take years even in OECD countries." It is incorrect that the Bank assumed completion of all reforms within two years—as is clear from the President's Reports. The fact that the Bank's loan documentation sketches out a process for moving through the steps is a good thing, not a bad thing. The comparison with OECD countries is inappropriate, as reforming transition economies naturally have undertaken and do undertake major systemic reforms faster than stable OECD countries—it is simply in the nature of transition. If there is any doubt about this, the record of the Russian Government since 2000 demonstrates a momentum for passage of legislation which would certainly have taxed most OECD governments.[1]

We disagree with the statement that "the Bank did not adequately assess during the preparation of SAL I the likelihood for delays in the adoption of the agreed measures and subsequent, expected follow-up actions. In light of prior experience in Russia with very brief windows of opportunity and with stop-go implementation of agreed reforms, the Bank should have been more cautious in the SALs timing and design. A SAL should have been approved only at a more advanced stage of preparation (and with substantial ESW backing it up), and preferably after concrete signs of broad commitment to implementation (as was the case for the Coal SECALs)." The preparation of SAL I took one year—there was a lot of intensive analytic work, including much sector-specific work, and a lot of discussions. The comparison with the Coal SECALS is emblematic of the misunderstanding of the process demonstrated in the PPAR. As we had previously noted in the discussion of the CAE, Coal SECAL I was approved and implemented without any certainty of Government "ownership" of the reforms.

The timing for SAL I—beginning after the first significant period free from volatile and/or high inflation—was appropriate. There was a window of opportunity, and it would have been inappropriate if the Bank had risked policy-based lending to Russia in support of structural reforms. The fact that some of the risks materialized does not mean that the timing or strategy were wrong.

SAL II was not rushed in its preparation, as the PPAR states. It was under preparation even as SAL I was going to the Board—since a series of SALs had been envisioned from the outset. Although it is true that the SAL II Board presentation was accelerated, the lion's share of the work had already been done. It was prudent to split SAL II into two tranches, and to resist the pressure for a one tranche SAL which existed at the time.

The PPAR states that "Given the economic and political conditions in mid-1997, the Bank should have only offered the government analytical and advisory services and technical assistance." We believe that the high quality analysis which supported SALs I and II (especially on the Russian side, but also by the Bank), was critical as a basis for some of the later reforms. This work helped create and consolidate ownership, and without it, there would be much less ownership of the reform program today. At the time, there was a large group of strong reform champions as well as a significant group of less reform-minded counterparts—the classical situation where it is the Bank's responsibility to work with and strengthen the proponents of reform.

Finally, it is inappropriate for the PPAR to suggest that "SAL II contributed to further appreciation of the real exchange rate in early 1998" absent a serious discussion in the PPAR of the consequences of the fiscal and exchange rate policies supported by the IMF during this period. This is perhaps not the place to argue the merits or otherwise of these policies, although many observers have noted that the over-valued exchange rate prior to the crash of August, 1998 directly encouraged capital flight and corruption and hindered import substitution. However, the coincidence between the devaluation (which did not produce high inflation) and the resumption of growth, is difficult to ignore. The policies supported by SALs I-III have certainly helped to produce the sustained growth which has followed the 1998 crash and continues to this day.

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[1] The reference to OECD countries has been removed.

OED Response to Management Comments

OED believes that no change in the PPAR ratings is warranted, since the Region's arguments were already considered at the time of the drafting and reviewing of OED's Country Assistance Evaluation (CAE), as well as during OED's review of the Implementation Completion Report for SALs I and II. Moreover, these arguments have already been addressed in the body of this PPAR.

The Region argues that the entire SAL program (SALs I, II, and III) ought to be seen as a success, but their own evaluation of SAL III (Implementation Completion Report, No. 22172, 2001) concluded in paragraph 4.1 that: "The outcome of the project in terms of the achievement of its objectives is assessed as **unsatisfactory** [bolded in the original text]. This assessment arises from both the perspective of the implementation of specific structural reforms in the program as well as the broader objectives of medium-term macroeconomic stabilization and growth to which these reforms were expected to contribute. While Russia has seen improved macroeconomic performance over 2000–01, this was generated by the large forced devaluation in 1998—which induced efficient import-substitution and some non-oil export growth—and the dramatic improvement in the terms of trade. The systemic changes in policies and institutions that have occurred during this period (principally in the fiscal and non-payments areas) are too recent to have yet had a discernible impact on the economy, and too limited in scope to establish a firm basis for future growth." This assessment was endorsed by OED in mid-2001, during its review of the ICR. In the subsequent CAE, OED acknowledged the pace of reform since mid-2001 and the achievements of SAL III beyond its September 2000 closing date. But OED has not changed its assessment of the preceding loans.

In response to some specific comments:

With regard to the comment that there is no evidence to support the argument that smaller/narrower operations or TA would have worked better, the CAE (p. 31) lists numerous examples of good results achieved since 1998 through smaller, narrower operations, including technical assistance, but arguably better economic management and the resumption of the overall reform program were critical to these successes. OED's argument in para. 4.9 of the PPAR, however, is not that smaller/narrower operations or TA would have worked better in the non-conducive policy and institutional environment of 1997–98, but that they were a better choice, as they would have allowed the Bank to remain engaged in its advisory role while limiting its financial exposure and Russia's debt obligations.

The ECA Region argues that it was never the objective of the Rehabilitation loans to address the underlying fiscal problems at the root of Russia's macroeconomic instability. OED notes that both Rehabilitation loans did in fact have macroeconomic stabilization as an explicit objective. The RL I President's Report (No. P3854, 1992) devotes many passages to the Bank's strategy of assisting the government's stabilization program and explicitly states that this loan "would ... finance imports in support of Russia's program of stabilization and economic reform" (see, for example, summary project description, and paragraphs 1, 161, and 163). The RL II President's Report (No. P6621, 1995) contains similar passages (e.g., paragraph 52: "The Second Rehabilitation Loan would provide $600 million equivalent in support of the following objectives: (i) support the Government's program for macroeconomic stabilization during 1995; and (ii) support an agreed program of structural reforms including ...").

As to the assertion that it is incorrect that the Bank assumed completion of all reforms within two years, the Bank was clearly counting on the passage within months of all necessary laws, although this was not part of the loan conditionality. The President's Reports for both operations emphasized a medium-term horizon for the reform agenda, but not a long-term implementation challenge. According to the SAL II President's Report (p. 35, para. 123), SALs I and II were designed "to support an on-going phase of reforms that at this stage can be seen lasting at least until the end of 1998" and to "provide a framework for timely completion of reform measures (in the form of prior actions) and a vehicle for effective implementation requiring the completion of a work program of critical intermediate steps supported through technical assistance." Furthermore, the "deepening" of the reform program in all key areas was envisaged by the Bank "over the next two years," e.g., 1998–99 (para. 117 of SAL II President's Report).

The Region comments that Coal SECAL I was approved and implemented without any certainty of Government "ownership" of the reforms. However, OED notes that the Government had already issued a pivotal document about the coal sector reform program following broad consultations and preceding approval of the Bank's loan. Moreover, it had actually began implementing such programs before the Bank approved its first coal loan.

Finally, in response to the comment about whether SAL II contributed to further appreciation of the real exchange rate, the IMF has also re-assessed the macroeconomic rationale for the large balance-of-payments support provided since the end of 1997 to stave off exchange rate pressures due to the international financial crisis and loss of confidence in Russia's economic management. In the words of the IMF chief economist, Kenneth Rogoff, "in Russia in 1998, ... the official community threw money behind a fixed exchange-rate regime that was patently doomed. Eventually, the Fund cut the cord and allowed a default, ... But if the Fund had allowed the default to take place at an earlier stage, Russia might well have come out of its subsequent downturn at least as quickly and with less official debt."[1] The Bank came to this realization late, but nonetheless ahead of the Fund. OED discussed this issue at more length in the Russia CAE (p. 30), offering a positive assessment of the Bank's stance in the spring of 1998 (early staff warnings to the IMF; reluctance to underwrite the emergency financial package; minimization of its financial participation in the mid-1998 international emergency financial package; backloading of disbursements of SAL III; and stronger conditionalities).

[1] "The IMF Strikes Bank." *Foreign Policy,* Jan./Feb. 2003, p.41.