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WORLD BANK GROUP
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES
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Statement by the Hon. **MIKHAIL MIKHAILOVICH ZADORNOV**,
Governor of the Bank for the **RUSSIAN FEDERATION**,
at the Joint Annual Discussion

ADDRESS
by M. M. Zadornov, Minister of Finance of the Russian Federation,
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At a Joint Plenary Session of the Annual Meetings
of the IMF and IBRD Boards of Governors

October 6, 1998, Washington, D.C.

Mr. Chairman, Mr. Camdessus, Mr. Wolfensohn, Esteemed Colleagues, Ladies and Gentlemen:

When we met in Hong Kong a year ago, the first serious waves of the financial hurricane had already swept over East Asia. But I doubt that many of us foresaw the situation in which we would meet this time. Cautious optimism did not turn into reality—the crisis has deepened, striking more countries and destabilizing the financial and commodity markets to an even greater degree. The crisis has been transformed from local into global, and from financial into systemic.

As a result, the role of the Bretton Woods institutions becomes particularly important. They are expected to provide answers to a number of fundamental questions. They are expected to take decisive and broad actions designed to cope with the crisis.

Among the questions that face the international community and that directly concern the Fund and the Bank, the following especially stand out.

What economic policy can help solve the crisis
while meeting the needs of long-term development?

This question is a long way from being resolved. Most diverse solutions are being proposed — from currency board arrangements to suspending the current and even the capital account convertibility of national currencies. There is also a wide range of recommendations regarding fiscal policy. Countries affected by the crisis are advised, on the one hand, drastically to tighten their fiscal policy and thereby ease the pressure on the credit and currency markets, and on the other, -- to relax their fiscal policy just as drastically, so as to stimulate the economy and expand social welfare programs. Should we be tough and let the insolvent financial institutions go bankrupt in order to demonstrate impartiality or, conversely, should we support them, based on their systemic role in financial intermediation?

Without doubt, the ultimate responsibility for decisions on these and other issues lies with national governments. They make their choices based on local political realities and public preferences. Nevertheless, a clear and consistent position taken by the international financial institutions has an extraordinary, and often decisive, importance. Failure to formulate such a position, or inconsistency in carrying it out, could have a devastating effect on the reputation of these institutions. And this is true not only in the case of small and medium-size nations but also the developed countries which play a leading role in the world economy.

What are the best ways to improve the architecture of the international financial system?

In our view, the best prospects for improvement lie in strengthening the national financial and banking systems, increasing their transparency, applying international standards and upgrading the quality, timeliness and availability of financial information. We agree with the main thrust of the international financial organizations' work in this area.

Unfortunately, the world community has done a poor job of learning lessons from the previous financial crises. As a result, the principal efforts now are focused, as in the past, on coping with the crises rather than on measures to prevent crisis-related problems. There remains a major unresolved question: what are countries to do if they have allowed short-term foreign capital into their markets without adequate preparation and without the appropriate conditions? Obviously, when there is a sudden and massive outflow of capital, these countries find themselves in a desperate situation and are often forced to take measures that meet with disapproval in the international community.

In other words, there is an urgent need to develop concrete and universally accepted mechanisms for dealing with such crisis situations. Specifically, we need internationally recognized procedures for considering issues of restructuring, defaults and bankruptcies. In particular, in this context more headway could be made in solving the highly important problem of ensuring private sector participation in dealing with crises.

Are the financial capabilities of the international institutions adequate for the demands of combating a large-scale crisis?

Unfortunately, the answer to this question is obvious. We face an immediate challenge—to ensure that the role and status of the international financial institutions are fully supported by the financial sources at their disposal.

We are alarmed by the fact that the Fund's liquidity has dropped to a critically low level. I believe it is essential, as quickly as possible, to complete the 11^{th} Quota Review, to approve the New Arrangement to Borrow and to adopt the amendments to the Articles of Agreement on additional SDR allocation.

As for the Bank, we are concerned by the decline in its net income, caused both by an increased demand on its financial resources and by a diminishing profitability of its operations. On our part, we favor a carefully modulated approach to strengthening the Bank's financial stability. Such an approach should be based on the principle of fair burden sharing and should include both an increase in the cost of borrowing and restraint in the financing of new initiatives, strictest adherence to budgetary discipline and greater utilization of earmarked funds. Unfortunately this approach has yet to find support of the Bank's Executive Board.

The HIPC Initiative

The results that have been achieved up to this point confirm the viability of the Initiative, its effectiveness and considerable role in alleviating the hardships caused by the excessive burden of foreign debt. Since joining the Paris Club, Russia has taken part in measures implemented under the Initiative to the greatest extent possible.

Nevertheless, we are troubled by the continuing rise in estimates of the costs associated with carrying out the Initiative. The success of the Initiative to a decisive degree hinges on it being fully backed by financial resources.

Cooperation between the Bank and the Fund

In light of the latest crisis-related developments, cooperation must be strengthened between the World Bank and the IMF. In many areas, including the HIPC Initiative and reform of the public sector, both organizations have demonstrated the advantages of close coordination. Ultimately the Bank and the Fund have common strategic objectives. But there is nothing surprising in the fact that, from time to time, we see an overlap of responsibilities, frictions and even serious disagreements. We must not forget that there is a division of labor between the Bank and the Fund: while the Fund's efforts are aimed at maintaining macroeconomic stability and the efficient functioning of the international monetary and financial system, the Bank deals with specific projects, supports structural reforms and places its emphasis on social issues and sustainable development. This division of labor seems fully justified.

In the Asian countries affected by the crisis, the Bank and the Fund failed to set up effective early coordination. At the same time, it is obvious that the nature of the crisis requires a qualitatively new level of cooperation between the Bank and the Fund. The proposal to establish a special Liaison Committee dealing with restructuring of the financial sector deserves particular support. This Committee should facilitate closer contacts between the Bank and the Fund. Moreover, it should be noted that a wider use of joint missions would not only help to optimize the utilization of both organizations' resources, but also promote a genuine culture of cooperation. The Managing Director of the IMF and the President of the World Bank were absolutely right when they pointed to the need for such a culture in their joint report.

What has happened in Russia?

Just a year ago, most observers shared the confidence of the Russian leadership that the most difficult period of economic reforms was over. We had managed to reduce inflation to a record low and to maintain a stable exchange rate for a long period of time. Signs of growth had appeared in the real sector of the economy.

The Asian crisis dealt a double blow to Russia. First, there was a drastic change in the overall attitude of investors toward developing and transition countries. Above all, this change affected short-term capital flows and led to extremely grave consequences for the stock markets and the government debt markets. Second, the sharp deterioration in Asia resulted in a steep decline of world prices for energy resources and raw materials. Revenues dropped not only for the Russian exporting industries but for the budget as well. The current account turned negative for the first time since 1991.

The impact of these external factors sharply exacerbated domestic problems that had remained unsolved. The principal one among them is the extremely grave condition of the federal budget. An inefficient structure of budget obligations still persists in Russia, and the numerous attempts to reform this system have continually run into political difficulties. When production is declining and tax system remains inefficient, the burden of traditional commitments becomes more and more onerous.

The global crisis has revealed the existing shortcomings of financing the deficit with short-term domestic debt. This debt was characterized by very short maturity and by high real rates of interest. The relative accessibility of international short-term capital in 1996-1997 led to a certain slowdown in public sector reforms.

The efforts to solve the accumulated structural problems have proceeded with great difficulty, above all in the area of government regulation of the financial and banking sectors, the energy sector, natural monopolies and relations in the agrarian sector. The responsibility of economic agents for fulfilling their obligations, including those to the budget, has grown weaker as a result of inadequate efforts to apply legal means such as bankruptcy procedures.

We hoped—and I believe with good reason—that the restoration of economic growth would create more favorable conditions for solving all these and many other problems. Unfortunately, it turned out that Russia did not have sufficient immunity to global contagion. The macroeconomic stabilization that had been achieved was too fragile to withstand the shock of the crisis, and the domestic government debt market eventually collapsed, in spite of all the attempts by the government and the IMF to keep the situation under control.

As a result, we are now forced to struggle with the consequences of an unprecedented drop in the exchange rate of the ruble. We are making every effort to solve the domestic debt problem that erupted after August 17. At the very same time we must also act to restore the solvency of the banking system, normalize the national payments system and revitalize tax revenues. It will hardly be news to anyone if I say that international assistance—above all from the Bretton Woods institutions—is absolutely essential for a successful solution of these highly complex problems. We intend to maintain open and constructive relations with our partners, and we are counting on their understanding.