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INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES
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Statement by the Hon. **ALEKSEI KUDRIN**,
Governor of the Fund for the **RUSSIAN FEDERATION**,
at the Joint Annual Discussion

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1. Global Economy and Financial Markets

Since the second quarter of this year we have seen a slowdown in economic activity in developed countries, which led to a downward revision in the projections of global economic growth. The list of major vulnerabilities in the world economy now includes a synchronized slowdown in growth in the major advanced economies, continuing current account imbalances, financial markets volatility, and the possibility of a further rise in oil prices.

It is already clear by now that there was a bubble in the equity markets of developed countries in the late 1990s, when a large gap emerged between actual stock valuations and their economically justified levels. The build-up of the bubble was triggered by euphoria about the IT revolution that occurred in the 1990s, which led to inflated expectations of corporate profits. In addition, the manipulations of financial statements by major corporations that have recently come to light also led to an overstatement of companies' profitability, thus contributing to the formation of the bubble.

We welcome the recent measures undertaken in the United States and a number of other countries to strengthen controls on corporate accounting. They have made it possible to stabilize the situation in equity markets somewhat, although there is still a possibility that stock prices will continue to decline even further. At the same time, the way in which financial regulatory authorities should react to the formation of bubbles, which lead to extremely negative consequences for both the financial and real sectors of the economy, is open to question. We are closely following the discussion in this area, and we trust that an appropriate strategy to prevent financial excesses will ultimately be devised.

One of the risks facing the world economy are global current account imbalances, which have reached an unprecedented scale and could lead to significant disruptions in the event of a disorderly adjustment. One of the main factors contributing to the increase in these imbalances was faster growth in investment over savings in deficit countries. To a significant extent, this occurred as a result of overly optimistic expectations about investment returns related to the IT revolution.

Current account imbalances will be adjusted through a depreciation of the real exchange rates and, possibly, a fall in output growth in deficit countries. The question is whether this will be a relatively orderly process or one that is accompanied by severe disruptions in trade flows and financial markets. It is impossible to predict in advance how events will unfold. At the same time, as shown in the WEO, some measures can increase the likelihood that the imbalances will subside in a benign fashion. Medium-term fiscal consolidation, which allows for an increase in national savings, is such a measure for deficit countries. Surplus countries should implement structural reforms to boost growth potential and support domestic demand. This would promote a smoother redistribution of global demand between deficit and surplus countries without threatening the growth of the world economy as a whole.

2. Economic Developments in Russia

The slowdown in global economic growth has not yet had a visible negative impact on the situation in Russia. While in the first quarter of this year there was some slowdown in economic growth, in the second and third quarters growth, on the contrary, has strengthened. This led to an upward revision in projected growth for 2002, albeit by a slight margin. We currently expect that GDP growth in 2002 will be around 4 percent. The main factor in economic growth is consumer demand, while net exports are gradually shrinking. In 2003 we expect growth to continue at the present rate of around 4 percent, with the latter figure serving as the basis for the 2003 budget parameters.

In order to sustain economic growth in 2003, we are planning to loosen fiscal policy somewhat, which will be reflected in a small reduction of the federal budget surplus. For a number of years the pursuit of responsible fiscal policy has enabled us to service our external debt almost without resorting to external borrowing, and to achieve a substantial improvement in debt sustainability indicators. In 2003 external debt payments will reach a peak of approximately US$17 billion. We do not anticipate any major difficulties in servicing this debt, although we intend to borrow in both domestic and foreign markets.

The conduct of monetary policy in Russia is still complicated by large foreign exchange inflows. On the one hand, in 2002 there has been some reduction in the current account surplus, primarily as a result of an increase in imports. On the other hand, this year there has been a significant reduction in net capital outflows from Russia. Under these circumstances, the Central Bank of Russia is continuing to accumulate foreign exchange reserves, which are close to US$45 billion, and to carry out sterilization of excess liquidity together with the Government. We still expect that by the end of 2002 inflation will not exceed 14 percent, which was the assumption for the 2002 budget. Next year, despite the need for a further increase in regulated tariffs, we expect inflation to drop to 10–12 percent.

Deep structural reforms are needed in order to achieve sustainable growth in the medium to long-term. This year we managed to make significant progress in this direction. In particular, a new land code has been adopted, which will promote the development of a land market and agriculture as a whole. The Russian government has prepared and sent to Parliament legislative proposals that need to be adopted for the reform of monopolies in electricity and rail transport. The Central Bank of Russia is making considerable efforts to speed up the process of banking sector reform. In addition, the draft budget for 2003 provides for the allocation of significant funding for judicial and military reforms.

3. The Fund and the International Financial System in the Process of Reform

In an environment of increasing trade and financial integration, surveillance of the global economy and developments in financial markets remains one of the main tasks of the IMF and the World Bank. Over the last several years a great deal of work has been done to strengthen surveillance. Initiatives such as the introduction of the Special Data Dissemination Standard, the preparation of Reports on Observance of Standards and Codes, and the conduct of Financial Sector Assessment Programs play an important role in strengthening surveillance. Ultimately, all this work is aimed at preventing financial crises, because timely identification of weaknesses and vulnerabilities and well-timed provision of technical assistance to correct them are of great significance.

Unfortunately, it is hardly realistic to expect preventive measures to be 100 percent effective—crises will occur. It is interesting to trace the evolution of our understanding of the nature of crises. Initially we noticed that countries with fixed exchange rate regimes turned out to be particularly prone to crises. Today we see that crises may occur even with floating exchange rates, when a sharp devaluation of a national currency resulting from an abrupt capital outflow leads to a significant increase in the debt-to-GDP ratio. As a result, we now witness some countries encountering great difficulties with debt servicing even though just a short time ago their level of external debt was not a cause for particular concern. Given this situation, debt sustainability should be analyzed in more depth.

Inevitably, in some instances crisis resolution will require sovereign debt restructuring. The Fund is currently working on two complementary approaches—a contractual approach and a statutory one. With regard to the contractual approach, the introduction of collective action clauses into the bulk of sovereign debt contracts will require prolonged effort. In this connection we welcome the intention of the EU countries to make the use of collective action clauses a standard practice as part of their sovereign bond issues.

At the same time, the contractual approach does not fully address the problem of creditors' collective actions insofar as it remains possible for a minority of creditors to block the decision of the majority. In order to eliminate this possibility it is necessary to adopt an international treaty that makes the decision of the majority binding on all creditors in all jurisdictions. Perhaps, this could be done on the basis of a corresponding amendment to the IMF Articles of Agreement.

4. Implementation of the Monterrey Consensus

Today, as it is emphasized by the conclusions of numerous post-Monterrey meetings, the major priority is the implementation of the Monterrey Consensus. We believe that it could be useful to agree on a respective working schedule with a clear assignment of tasks and responsibilities. These plans should include the Bretton-Woods institutions (BWI). Of course, their role in implementing the Consensus should reflect their real institutional capacity and comparative advantages.

Of crucial importance for the success of the whole process are BWI activities aimed at improving poor countries' access to developed countries' markets, strengthening international financial architecture as well as preventing and orderly resolving financial crises.

It is important to emphasize that the only way to create conditions for sustainable development and for solving social problems is to pursue sound economic and social policies, maintain an adequate institutional capacity at every level of government, assure proper public expenditures prioritization and control, and involve civil society in setting up development programs' priorities and monitoring their results.

Furthermore, a key condition for enhancing and scaling-up effect of individual projects is to fully involve existing administrative structures of recipient countries in their implementation. Although establishing parallel structures to implement individual international aid projects may in some instances help accomplish immediate tasks, in the medium and long term this approach does not contribute to improvement of existing institutional capacities and involves additional costs.

We also fully agree that the limited resources allocated for development assistance are not always being spent in the most productive way. Improving cost-effectiveness of this assistance and getting maximum possible results from each available dollar is of a critical importance. Specifically, a considerable portion of the resources allocated for technical assistance is spent on foreign consultants, whose selection is often outside the control of the recipient country. As a result, the country is unable to monitor the quality of the services it receives. Aid effectiveness could be substantially increased by using local expertise and controlling the cost and quality of services financed with assistance funds.

In order to improve the effectiveness of resources, they should, whenever possible, be allocated directly to the level where they will be used. The actual outcome of aid redistribution, however, depends on the administrative structure and the relationship between the central and local governments in each country. As the document correctly points out, any internationally funded program can succeed only when it is consistent with the existing system of governance and takes into account the budgetary linkages among the various levels of public administration. Moreover, one of the most important political priorities in many countries is to increase responsibility for, and oversight of, the expenditure of financial resources at every level. Aid programs should not conflict with these priorities, particularly where loans with sovereign guarantees are involved

The proposals for more flexible financing arrangements for development programs deserve special attention, particularly the proposal to move away from the rigid linkage of such financing with capital investments. It is worth giving this complex issue careful study and finding an acceptable, balanced solution. We should also seek to enhance predictability in allocation of donors' resources, for example, by creating insurance mechanisms to cover unexpected costs and bridge temporary interruptions in aid flows.

The enhanced focus on results presupposes a fundamental improvement in the system for measuring, monitoring and managing the effectiveness of development programs. However, these tasks present substantial methodological and practical challenges. Solutions to these problems are presently a long way off. It is also unclear whether they can be solved at all. It should be emphasized that they are all highly sensitive politically, for donors and recipient countries alike, which may make progress in this direction more difficult.

The ability to collect and disseminate knowledge and information about development, along with a national statistical capacity, are critical for monitoring development outcomes. Progress in these areas will have a positive impact on the quality of governance. This is especially important when it comes to evaluating the effectiveness of government expenditures. In this connection, we fully endorse the relevant international initiatives aimed at developing national statistical systems.

We support initiatives to improve national statistical systems that should be regarded as an integral and vital part of building national institutional capacity. These efforts can be supported by loans and technical assistance from international institutions (IFIs), as well as bilateral donors' grants. It should be borne in mind, however, that setting-up a modern statistical service requires substantial resources and a considerable amount of time. In any case, high statistical standards cannot be imposed from outside.

A focus on results is entirely feasible at this stage in the World Bank's activities. The final outcomes of operations can appropriately be added to existing quantitative and qualitative indicators. The only problem here is the danger that an inadequate risk management system may emerge. For example, if quantitative results, which may not be completely reliable, are overemphasized, this may significantly distort the incentives of IFIs, prodding them toward opportunistic behavior in order to minimize risks.

It is also important to bear in mind the high cost of shifting to measurable results-based approach, both in financial terms and in terms of the actual institutional capacity of the participants in the development process. Investments in measurement and monitoring systems will make sense only when they are recouped through increased investments and improved quality of assistance in the future. In any case, the alleged lack of reliable systems for measuring results must not be an argument for curtailing aid programs and fight against poverty.

5. Implementation of the HIPC Initiative

We have closely followed the efforts of the international community to provide effective assistance to low-income countries. We welcome the substantial progress achieved within the framework of the HIPC Initiative, including on the issue of its financing. Our own contribution to the implementation of the Initiative consists, in part, of debt relief granted to those HIPC countries that are our debtors. We continue to believe, however, that debt relief alone will not yield the desired results without the implementation of sound economic policies and the strengthening of governance in the poorest countries themselves. In this connection, we are concerned with the fact that many of the HIPC countries are performing poorly under their PRGF programs, especially in the period between the decision and completion points. We believe that creditor countries should adopt a stricter and more coordinated position in relation to those HIPC countries that pursue irresponsible economic policies and do not implement their PRGF programs.

For various reasons, many HIPC countries may approach the completion point of the Initiative with deteriorating debt indicators. The enhanced framework of the Initiative includes the possibility of additional debt relief at the completion point. We would like to emphasize that this provision should be invoked only in those instances when the deterioration of the country's economic situation, including its debt indicators, is exclusively the result of exogenous shocks, as the rules of the Initiative stipulate. Moreover, we think it is essential to resist the temptation to boost the HIPC Initiative by easing the eligibility threshold while expanding the overall number of beneficiaries.

It is along the same lines that we approach the proposed two-year extension of the sunset clause under the Initiative in order to accommodate potential new entrants. This is the third such proposal, bringing the total extension to six years. In our view, this runs counter to the originally stated intention not to turn the Initiative into a permanent debt relief mechanism. The Initiative's rigorous time limits were, among other things, intended to encourage potential participants to speedily adopt appropriate structural reforms. Consequently, even though we are prepared to agree to the proposed new two-year extension, we would urge both management of the Bretton-Woods institutions and donor countries to use this period to devise future strategy and alternative approaches to those countries that will have failed to meet eligibility criteria at the expiration of the proposed extension.