Russia and the IMF: The Political Economy of Macro-stabilization
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For the past three and a half years, the Russian reformers have been struggling with the gigantic task of stabilizing the Russian economy while transforming it into a modern and efficient structure able to compete in international markets and respond to the needs of the Russian people. They have travelled a long distance. Since January 1992 the Russian reformers have abolished central planning, sharply cut the system of state orders, decontrolled most prices, at least at the federal level, unified and liberalized the foreign exchange market, made the ruble convertible, and privatized two thirds of the economy. They have accomplished all this in spite of the crushing burdens and the historically unprecedented problems they inherited from the commun ist system: huge industrial enterprises that are unprofitable under the new structure of relative prices and require extensive reorganization or liquidation; an obsolete capital stock; a crumbling energy sector; armies that must be repatriated from distan t countries and resettled at home; and a huge external debt. And they have accomplished all that in spite of constant resistance from political groups opposed to reform, including, until its dissolution in the fall of 1993, the Supreme Soviet.

Most of these impressive achievements have been in the area of *structural reform*. In contrast, success in the area of *macroeconomic stabilization* has remained elusive. From mid-1992 to the end of 1993, consumer price inflation fluctua ted around 20 percent per month (nearly 800 percent at an annual rate), the ruble dropped from Rub 144 to almost Rub 1,250 per U.S. dollar, and capital flight may have been somewhere around $20 billion. Monthly inflation declined to an average of less th an 10 percent in the first 6 months of 1994 and bottomed out at less than 5 percent in August. But it rose after that and by December 1994 it had reached 16 percent, by which time the ruble had dropped to around Rub 3,500 per U.S. dollar.

Why have the Russian reformers failed, so far, to adopt and implement a successful stabilization program? Is it now possible to consolidate the limited progress that has been made and hope that a renewed effort will succeed? This paper attempts to answer these questions from the perspective of a staff member of the IMF who has been deeply involved in negotiations with the Russian authorities since early 1992, and who appreciates the extraordinary difficulties that they confront.

I. Inflation: Fables, Tall Tales and Old Truths

From the outset, the fight for stabilization encountered several difficulties which were certainly not unique to Russia, but were exacerbated by the particular conditions prevailing after the breakdown of the Soviet Union. Some reflected the misconc eptions that were to be expected in a country where economic analysis had been clouded by Marxist ideology for several decades, while others were clearly political.

The first set of difficulties was of an intellectual nature. When the reforms started, most Russians knew very little about the nature, the causes or the consequences, of inflation; or about how to deal with it. After all, prior to 1991 the most re cent experience with high, open inflation dated to World War II and before that to Lenin's days, and few had any clear recollection of what had happened then. The debate about monetary policy and inflation was plagued by numerous misconceptions, and ther e was a great deal of convincing to be done.

In scores of discussions with officials and staff from the government, the central bank and the Parliament, IMF missions argued that high inflation was bound to damage the Russian economy in many ways: by generating uncertainty about key prices, inc luding the real interest rate and the real exchange rate, thus deterring long-term credit, investment and growth; by encouraging unproductive activities aimed solely at hedging against inflation; by hurting those social groups that lack the political stre ngth to protect their real incomes against rising prices; and by contributing to a general climate of uncertainty and lack of confidence in government policies, thus encouraging one-way speculation against the ruble and capital flight. And, of course, IM F teams often referred to the extensive statistical evidence suggesting that, over the medium to long term, low inflation tends to be associated with high growth among both developing and industrial countries.

Another source of controversy related to the causes of inflation. There was a widespread view, included within the central bank, that inflation in Russia resulted from the high degree of monopolization of the economy. But whereas monopolies can lea d to an excessively high price *level* for certain goods, they cannot explain *continuously rising* prices. Besides serious research indicates that the Russian economy is *not* particularly monopolistic by international standards. Others, claimed that inflation resulted from price liberalization. We replied that a comprehensive price liberalization could lead to a once-and-for-all jump in the general price level ‹possibly a very large one if, as in the case of Russia, it occurred ag ainst the background of a sizeable monetary overhang‹ but *not* to a continued inflationary process. The Russian experience clearly supports that view: consumer prices surged by almost 300 percent in January 1992, when most prices were decontr olled; but afterwards, the monthly rate of price increase fell sharply, to 27 percent in February and to 7 percent in July. Inflation began to accelerate in the summer of 1992 as monetary policy became expansionary. By then, however, price decontrol was no longer a significant factor.

So, we argued that inflation does not result from price liberalization, market imperfections, greedy workers or monopolists; that, in the end, it results from excessive growth in the money supply, which in turn reflects excessive credit expansion by the central bank. We also maintained that capital flight and the weakness of the ruble did not reflect a conspiracy by speculators at the Moscow Interbank Foreign Exchange market, as a popular tale would have it. To be sure, capital fight reflected in part tax evasion by wealthy individuals and enterprises. But it resulted mainly from a rational assessment of relative rates of return by wealth holders in Russia: at least through mid-1993 the rate of interest on ruble-denominated assets was much too l ow to offset the depreciation of the ruble that was to be expected as long as domestic inflation exceeded inflation abroad by a huge margin.

The implication, of course, was that credit had to be tightened and interest rates raised. But many in Russia ‹and more than a few Western "experts" as well‹ disagreed vehemently. Some because they were persuaded that higher interest rate s would lead to higher prices ‹an interesting, but not entirely new misconception. Others, more sophisticated, because they believed that an anti inflationary monetary policy would exacerbate the fall in production ‹a sort of Russian version of the Phillips curve. But there is no evidence of an inverse relation between inflation and growth in Russia, even in the short run. Output has been fa lling in Russia (as well as in other countries of the former Soviet Union) primarily because state orders have been slashed, particularly for defense industries, and because large segments of the old productive structure are unprofitable under the new, mu ch freer, structure of relative prices. There are other reasons, no doubt, for the recorded fall in production: the collapse of trade with CMEA countries and with other states of the former U.S.S.R.; and the fact that the contribution of output in the n ew private sector, which is growing very rapidly albeit from a very small base, is not adequately captured by the official statistics. But none of this has anything to do with monetary policy being too tight.

Some did not need to be convinced that Russia needed macroeconomic stabilization, and that stabilization required a much tighter monetary policy. In fact, the IMF's message on this point was very similar to the one delivered consistently and to a mu ch wider audience by men like Fedorov, Gaidar and Chubais, who played a leading role in the Russian Government since the re birth of the country in 1991. And while some remain unconvinced, the debate about inflation and macroeconomic policy has helped to persuade many, including at the Central Bank of Russia (CBR), that the IMF's recommendations are in the best interest of th e country. Indeed, a number of officials at the CBR, led by Acting Chairman

Paramonova, are today among the most serious and courageous advocates of financial discipline.

II. Revolt Against Macro-stabilization: Centralized Credits, Inter-enterprise Arrears, Budget Subsidies, and Tax Exemptions

Unfortunately, however, the fundamental root of the opposition to macro-stabilization was political more than intellectual. Within Russia, it came from those who represented ailing, but still powerful sectors and regions such as the Northern Territo ries, agriculture and agro-industry and, to a lesser extent, the military-industrial complex. Outside Russia, it came from many of the other states of the former U.S.S.R. (FSU), where newly created central banks ‹supported by their governments and s ometimes by accomplices in Russia‹ were eager to expand domestic credit, largely by borrowing from the CBR. This indirect source of inflationary pressures apparently disappeared with the collapse of the ruble area in late 1993.

Within Russia, those who lobbied for special interest groups knew that a tighter monetary policy--particularly one that operated indirectly through financial markets and *not* through the centralized distribution of credit--would mean that their share of the pie would be considerably diminished. So they fought to retain the existing system in which the bulk of financial resources was administratively directed *to them*, at heavily subsidized interest rates ‹often well below the centra l bank refinance rate which until the Summer of 1993 was itself well below market rates‹ and with as much flexibility as possible regarding the repayment of principal. As to other borrowers, including many in the incipient private sector, they would , if they were lucky, obtain some credit from commercial banks at market interest rates ‹otherwise they would simply be rationed out. So the system turned into a process of political competition for credit, a political scramble in which each special interest group would use its' political clout with the Government, with the Supreme Soviet, the Credit Policy Commission or even the President, in a race to maximize its share of directed credits and stay ahead of inflation.

The IMF, on the contrary, fought to eliminate the centralization and the subsidization of credit, and it did so with the support of then-Finance Minister Boris Fedorov. The existing system needed to be overhauled for both macro- and microeconomic re asons: because the process of political competition it involved made it extremely difficult to limit *aggregate* credit expansion to anything consistent with the goal of reducing inflation; but also because in the absence of restraint on monetary ex pansion, and as long as market conditions did not play a proper role in the allocation of financial resources, Russian enterprises would continue to operate without the discipline of hard budget constraints and one of the key objectives of reforms ‹t o encourage a competitive and profitable enterprise sector‹ would be jeopardized.

For the same reasons, IMF teams opposed any plan to monetize inter-enterprise arrears. The buildup of arrears in the first half of 1992 was, in part, a revolt of state enterprise managers against the tightening of monetary policy sponsored by Acting Prime Minister Gaidar and carried out, albeit not always in good cooperation with the Government, by then-CBR Chairman Georgy Matiukhin. But in July of 1992, Matiukhin was forced to resign by the Supreme Soviet ‹perhaps because he was effectively r esisting exorbitant demands for credit‹ and replaced the head of the CBR by Victor Gerashchenko. A few months later the CBR cleared the net stock of arrears by extending credit to the net creditor enterprises. The action took many by surprise, incl uding officials at the GKI (the government privatization agency) who had elaborated specific plans to deal with the problem without resorting to credit expansion. In 1993, inter-enterprise arrears started to grow again, reaching 7 percent of GDP by June 1994 and prompting the creation of a Government Commission under First Deputy Prime Minister Soskovets to explore ways to resolve the problem. The IMF staff continues to believe that a second bailout by the central bank would be a disaster. Not only wou ld it boost the money supply and raise inflationary expectations, but it would give enterprise managers a clear signal that in the future they can respond to a tightening of credit conditions simply by not paying their bills.

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One of the key elements of IMF-supported programs, the need to reduce Russia's huge budget deficit, was fully accepted by Acting Prime Minister Gaidar and then by Boris Fedorov who became Finance Minister in December 1992. However, in his efforts to tackle the fiscal problem, Fedorov quickly met with the opposition of sectoral lobbyists who wished to maintain the generous transfers and subsidies they received from the budget. A higher budget deficit would have to be financed largely by credit expan sion, thus fueling inflation and eroding the real incomes of the entire population, but this did not bother them; as long as they received a disproportionate share of the budgetary pie, they thought they would come out ahead. The IMF staff, of course, ar gued for cuts in budgetary transfers and subsidies, not only to reduce the budget deficit and the Government's need to borrow from the CBR and thus bring down inflation, not only to do away with the misallocation of resources implied by those subsidies, b ut also to make room for an adequate social safety net and in particular for a well funded unemployment insurance system. Here again macro-stabilization and micro-efficiency objectives pointed in the same direction, and so did social considerations.

But the budget deficit was large, and cutting subsidies would not be enough. A strategy to achieve a sufficient reduction in the deficit had to involve across-the-board restraint on expenditure *and* higher revenue, notably from the VAT and fro m the energy sector, and this would require improvements in tax administration and, at least for some time, higher tax rates. None of this was politically easy, of course. At various times in 1992-93, the Supreme Soviet opposed increased rates on the VA T and reduced the effective yield of various taxes, including the VAT and import duties, by granting a large number of exemptions. Energy companies claimed that they could not pay existing taxes (let alone higher taxes) because Russian households and ent erprises were not paying their energy bills and because continued shipments of natural gas to Ukraine and Belarus had resulted in a huge accumulation of arrears to Gazprom, the Russian natural gas giant. All this was true, but it did not prevent Russian energy companies from holding large bank deposits ‹in rubles as well as in foreign currency‹ that would have allowed them to pay their taxes, had the will been there and the threat of enforcement been credible.

In the end, efforts to increase revenue failed. Indeed, federal revenue fell in relation to GDP by almost 3 percentage points from 1992 to 1993. The proliferation of tax exemptions granted to sectoral lobbyists was a major cause of this deteriorati on but other factors also played a role, including the shift in production toward a services-intensive private sector which often escaped taxation, and disputes between federal and regional governments over revenue sharing. In particular, the autonomous republics of Tatarstan, Bashkortostan and Chechnya unilaterally declared that all taxes would be collected by the regional authorities and that revenue sharing would be the subject of subsequent negotiations with the federal authorities.

III. Changing the Structure of Deficit Financing as an Alternative to Fiscal Adjustment: A Fairy Tale

As if domestic political opposition to budget cuts had not been enough, we drew some unexpected fire from Professor Jeffrey Sachs. On various occasions Mr. Sachs argued that the IMF was wrong in asking for deep budget cuts; this, he said, was not ne cessary to reduce inflation. The IMF had failed to understand, and therefore had failed to explain to the Russians, that monetary financing of the budget deficit (and therefore inflation) could be reduced quite simply by increasing the proportion of the deficit financed by borrowing from abroad or by issuing domestic interest bearing debt. A remarkably simple proposition that lead to an obvious question: why would any country that has benefitted from such good advice continue to suffer from high inflat ion? Perhaps because things are not quite that simple.

First, *foreign* financing does not grow on trees. To be sure, and contrary to Professor Sachs' allegations, Russia did receive considerable external financing ‹altogether around $60 billion in the two-year period 1992-93. It is true th at most of it has been in the form of debt rescheduling or tied export credits, and it can be argued that these do not provide cash financing to the budget. It would certainly have been much better if external financing had been predominantly in the form of long-term credits to the Government or, even better, in the form of grants. But large-scale financing of this type is not available. One can hope for a world in which Parliaments and public opinion in the wealthy countries recognize that the international community is facing a challenge of h istorical significance ‹that of ensuring the transition from a totalitarian, centrally planned, and bellicose Soviet state to a new, peaceful, democratic and free Russia‹ and that this extraordinary challenge requires a measure of sacrifice in t he form of a temporary increase in taxes to finance temporary assistance to Russia and the other countries in the former U.S.S.R. But that, unfortunately, is not the world in which we live today. Foreign financing on favorable terms is, and will continu e to be, limited.

There is another unfortunate complication that Mr. Sachs chooses to ignore in his analysis. External debt ‹unless it is entirely in grant form‹ must be serviced. And, of course, this applies also to *domestic* debt. It is fine to sa y that bond financing can substitute for monetary financing; in fact, the IMF has encouraged the Russian authorities to create a market for Treasury bills and provided technical assistance to speed up the process. But we recognize, as many Russians do, th at there are risks in going too far and too fast in this direction. If, in present circumstances, the Russian Government attempted to finance a large share of its budget deficit by issuing Treasury bills, the public probably would insist on very short mat urities and very high real interest rates, and the resulting debt burden could well mean a *higher* deficit in subsequent years, even in percent of GDP. This would be particularly the case given the less than perfect record of Russian (and Soviet) go vernments in meeting their financial obligations, of which last year's demonetization of "old rubles" and continued arrears on internal commodity debt are only two examples. The more general point here is that Russia's fiscal problem is a structural problem that must be resolved over time: the deficit cannot be eliminated in one year (this would be socially and politically impossible); but deficit-reduction cannot be postpon ed indefinitely, it must begin now. This means that a serious fiscal program must involve from the outset a combination of financing and adjustment: there must be some domestic financing ‹hopefully with a rising share of debt financing and a dimini shing share of monetary financing over time‹ and there should be some external financing ‹if possible on better terms than we have seen so far. But the program will not be credible unless it involves a substantial dose of fiscal adjustment, so that structural deficits are reduced year after year and there is a reasonable expectation that Russia will be able to avoid excessive reliance on both indebtedness and inflationary financing in the foreseeable future.

Incidentally, some of the points made above also apply to financing by the international organizations, including the IMF which contributed a total of $4 billion in 1992-94 in support of adjustment programs that did not work very well. This included a $1 billion first credit tranche arrangement in 1992, and two drawings of $1 1/2 billion each in 1993 and 1994, respectively, under the Systemic Transformation Facility (STF) ‹a facility that was created especially to assist economic reform in coun tries like Russia. And the Fund's contribution could increase substantially: negotiations are currently under way on a program that could be supported by a full stand-by arrangement under which Russia could receive additional credits of several billion dollars.

But the IMF's money belongs to the international community. It is there to help member countries deal with *temporary* balance of payments difficulties and therefore it can only be made available subject to certain *conditions*. The ration ale for these conditions is well known: to provide reasonable assurance that existing imbalances will be corrected so that the country will be in a position to repay its liabilities to the Fund and, more importantly, so that its economic situation will s how a lasting improvement. Here, too, financing can complement adjustment; but there is no substitute for fiscal adjustment.

IV. The May 1993 Program

The difficulties that have been faced in the struggle for macroeconomic stabilization in Russia can be illustrated with reference to the history of two recent IMF programs. In May 1993, the representatives of the Russian Government and the CBR, head ed by Finance Minister Fedorov, agreed with an IMF staff team on a program which was subsequently approved by Prime Minister Chernomyrdin and CBR Chairman Gerashchenko in the form of a *Statement of Economic Policies of the Russian Federation*. On J uly 1, 1993, the program was approved by the Fund's Executive Board and supported by a credit of $1.5 billion under the Systemic Transformation Facility. Two aspects of this program are worth noting.

(1) The program specified that the $1.5 billion to be obtained from the Fund would *not* have to be added to the stock of Russia's official international reserves, but would be available to provide additional credit to the economy (including to the budget) *without* relying on monetary expansion. In other words, IMF financing was to facilitate a *gradual* adjustment in the fiscal position while beginning the process of reducing credit growth and inflation. (To some extent, the progr am was doing what Mr. Sachs accuses the IMF of not having done.) Logically, financing was to be coupled with adjustment: it was expected that the deficit of the enlarged government- including federal and local budgets, extra-budgetary funds and unbudgeted import subsidies- would fall from 11 percent of GDP in the second quarter of 1993 to 8 1/2 percent in the fourth quarter which would have made it possible for inflation to drop from a monthly average of 17 percent in the second quarter to 8 percent in the fourth quarter. This, of course, was still 150 percent at an annual rate, but given the failures of the past, it seemed preferable to make sustained, albeit undramatic progress.

(2) The financial program envisaged not only a decline in the rate of growth of money and credit, but also a number of measures aimed at breaking the system of politically motivated, administratively directed and heavily subsidized credits, and repl acing it by a system in which financial markets would play an increasing role and a restrained monetary policy would have a chance of success. To achieve that objective, the program included five key elements: (i) upward pressure on market-determined in terest rates through a reduction in the growth of net domestic credit and base money; (ii) a rule tying the CBR lending rate to the market-determined, Moscow interbank rate; (iii) a commitment by the CBR not to extend credit to enterprises (directly or th rough commercial banks) at interest rates below the CBR's normal lending rate; (iv) a commitment to limit budgetary interest rate subsides; and (v) a commitment of both government and central bank not to repeat the bailout of inter-enterprise arrears that had occurred in 1992.

The program went on to a good start. In June-July 1993, the Government liberalized the price of coal and took several measures to reduce the budget deficit, including cuts in import subsidies and in subsidies to grain producers. The Central Bank of Russia, still under the chairmanship of Victor Gerashchenko, increased its lending rate from 100 percent in May 1993 to 170 percent on July 1 and then honored its commitment under the program by allowing its lending rate to rise along with the interbank rate. The results came very soon: the ruble, which had been losing value almost continuously against the U.S. dollar for about one year, appreciated by more than 10 percent from mid-June to end-July 1993, and the CBR found itself intervening in the fore ign exchange market to moderate the appreciation of the ruble, to the tune of $1.2 billion. The Russian economy appeared to be on the way to stabilization.

Unfortunately, soon after that the economic program went off track, and its monetary and fiscal targets for the third and fourth quarters of 1993 were exceeded by wide margins. Monthly inflation averaged around 20 percent in the second half of 1993 and by the end of the year the ruble had lost all the ground it had gained in June-July, in spite of substantial intervention by the CBR.

What went wrong? The answer is simple: the program was working. But once again, tight financial policies met with political resistance and sabotage from those special interest groups that were deprived of the subsidies and the cheap credits to whi ch they had become accustomed and to which they thought they were entitled. These groups pressured and lobbied through the Supreme Soviet and within the Government; and in the end, in spite of staunch resistance by Fedorov and his associates, they obtain ed the support they were seeking ‹not all of it, but enough to derail the program.

A few examples, by way of illustration. First, grain subsidies were cut as had been expected, but this was more than offset by a large increase in budgetary spending on agriculture, including a rise in the procurement price of grain over and above w hat could be justified by market conditions, and large subsidies for cattle raising. Second, the scheduled reimbursement to the federal government of a Rub 1 trillion loan (roughly 1 percent of GDP in those days) by *Rosskhleboprodukt,* the state gr ain procurement agency, failed to materialize. Third, in a courageous move the Government liberalized the price of coal, but this was followed by a substantial rise in government support to the coal sector. Fourth, the Supreme Soviet refused to increase excise taxes on energy and to raise the VAT by 7 percentage points, as had been proposed by the Government. Fifth, under pressure, the Government and the CBR extended large scale, unscheduled credits to the agricultural sector and the Northern Territori es, breaking the commitment under the program to phase out the direct allocation of subsidized credits to specific sectors and regions.

This is the story of the May 1993 program. It went off track because it was not adhered to; and it was not adhered to because major political forces within the country refused to live by its provisions and because the Government, in spite of the eff orts of Boris Fedorov and his associates, was not able to protect the program against those who wanted to derail it. In the last months of 1993, Fedorov used the only weapon that remained in his arsenal: he simply refused to pay. The policy of aggressi ve sequestration continued in the first half of 1994 and, coupled with a restrained monetary policy by the CBR, it helped to achieve a significant, albeit temporary reduction in inflation. But the other result of sequestration was a buildup in government arrears, some of which would have to be repaid, thus raising the base on which sequestration would have to be applied in the future.

V. The March 1994 Program

Boris Fedorov resigned on January 16, 1994, following by a few weeks the resignation of Egor Gaidar as Deputy Prime Minister and Minister of the Economy. Anatoly Chubais, another key figure among the reformers, remained in the Cabinet; but he could not be expected to play a leading role in the stabilization effort, as he would have to devote all his energies to the continuation of the privatization plan that his GKI had implemented so successfully. But many of Fedorov's former associates in the Min istry of Finance remained in place, including his former Deputy, Sergei Dubinin, who was appointed Acting Finance Minister. In January-March of 1994, a Russian negotiating team headed by Dubinin and including senior Finance Ministry and central bank offi cials worked out with an IMF staff team an economic program on which final agreement was reached on March 20 between Prime Minister Chernomyrdin and the Managing Director of the IMF. The program was approved by the Fund's Executive Board on April 20 and supported by a second credit of $1.5 billion under the STF.

The major goals of the program were to safeguard the achievements of reform in the areas of price and exchange market liberalization, extend privatization, make some progress in liberalizing external trade, and reduce the monthly rate of inflation to 7 percent at the end of 1994, on the way to further reductions in 1995. The fiscal program included revenue measures expected to yield 2 1/2 percent of GDP in 1994 and a tight expenditure plan. The monetary program envisaged a gradual reduction in the g rowth of money and credit, a gradual increase in the share of central bank credit extended through credit auctions and other market-related mechanisms, and a gradual phasing out of directed credits. For all the fables about "shock therapy" and "big bang, " gradualism was the key operating concept ‹not out of design, but because a more audacious approach was not politically acceptable.

In the first quarter of 1994, the Government managed to keep its borrowing from the CBR under control in spite of a collapse in revenue, mainly through aggressive sequestration of expenditure. Although government borrowing picked up in the second qu arter, by end-June all the fiscal and credit targets of the STF program had been met; official international reserves (including holdings of foreign exchange and gold by both the CBR and the Ministry of Finance) were above the minimum levels specified in the program; and the monthly rate of inflation fell to 6 percent in June, compared with 18 percent in January and an STF program projection of 10 percent. The budget for 1994 was finally approved by both the Duma and the Federation Council in June 1994. During the preceding Parliamentary debate the Government managed to deflect pressure for a large increase in defense spending, but it did have to accept a rise in expenditure, particularly in the form of higher transfers to agriculture.

The trouble, as had been the case in previous years, came in the summer. Net central bank credit to the government surged in the third quarter of 1994 as government revenue continued to drop in relation to GDP and subsidies to the agricultural secto r, the Far North and other customary recipients of government handouts rose sharply while the government's ability to use sequestration diminished. (Given the failure to obtain Duma approval for most of the revenue measures specified in the second STF pr ogram, sequestration had become the only instrument of budgetary control.) Yet inflation remained relatively subdued in the third quarter: the monthly rate of increase in consumer prices fell to 4 1/2 percent in August, the lowest monthly rate registere d in the period 1992-94, before rising to just under 8 percent in September ‹still below the STF program's projection for that month.

But this combination of rapid growth in credit to the government and relatively moderate inflation was unsustainable, for two reasons. First, the average lag of 3-4 months between money growth and inflation in Russia meant that the acceleration of m oney and credit in the Spring of 1994 would show up eventually in the inflation numbers ‹as it did in the fourth quarter. Second, beginning in July 1994 the authorities attempted to offset the impact on the monetary base and inflation of a surge in net credit to the government by running down official international reserves. But the game could not last. From end-June to end-September 1994, international reserves dropped by almost US$4 billion and participants in the foreign exchange market, recogn izing that the underlying fiscal position was out of control and that international reserves were finite, took aim at the ruble. On October 11, 1994 the ruble tumbled in the Moscow interbank market by more than 20 percent against the U.S. dollar.

"Black Tuesday", as October 11, 1994 was subsequently referred to, was the first full fledged financial crisis in the history of post-communist Russia. It reflected a rational reaction of market participants, by now well informed, quick to move, and aware of the lagged but predictable effects of monetary expansion on inflation and exchang e rates. It was a rational reaction to bad macroeconomic policies, and particularly to an unsustainable fiscal deficit, and the appropriate response should have been to correct those policies. Instead, and in spite of the fact that the ruble recovered i ts previous losses on October 12-13, Acting Finance Minister Dubinin and CBR Chairman Gerashchenko were fired; and federal agents were sent to the Central Bank and the Moscow foreign exchange market in a futile attempt to identify the authors of an allege d "financial coup".

In the fourth quarter the CBR limited credit expansion to the Government. The Ministry of Finance reacted by resisting strong expenditure pressures, but also by stepping up issues of government securities including, in-spite of IMF objections, secur ities bearing interest rates well below market levels. The CBR also reduced net lending to commercial banks, which led to a sharp increase in interest rates. Nevertheless, inflation continued to rise, and in December 1994 it reached a monthly rate of 16 percent, more than double the STF target. By the end of 1994, the fiscal targets under the STF program had been exceeded by a wide margin and the stock of international reserves had dropped well below the program floor.

While the sequence of events had been different, the March 1994 program seemingly had failed as completely as its predecessor. The Central Bank of Russia had kept credit expansion to the commercial banks within the program targets and managed its le nding rate prudently, keeping it above the Moscow interbank rate ‹sometimes by a wide margin‹ and significantly above the rate of inflation. But a tight monetary policy could not undo the damage caused by a federal fiscal deficit in excess of 1 0 percent of GDP.

The rise in inflation, the accumulation of government arrears and the exchange market crisis of October 11, all gave ammunition to those who distrusted markets mechanisms and wished to re instate administrative controls. But, just when things looked the darkest, a number of key appointments strengthened the position of those in the government and the CBR that continued to fight for reform and stabilization. Chubais was appointed Deputy Pr ime Minister in charge of macro-economic policy; Yevgeni Yasin became Minister of the Economy; and Tatiana Paramonova was made Acting Chairman of the Central Bank of Russia. Negotiations with the IMF resumed, this time on a program that could be supporte d by a stand-by credit of up to US$6 billion, and the Government submitted to the Duma a budget for 1995 that envisaged substantial cuts in subsidies and lending to agriculture and the coal sector, and a reduction in federal transfers to regional governme nts and the Northern territories. The struggle for macroeconomic stabilization continued.