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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Mark Sobel (IMF) to David Lipton, Tim Geithner, N. Lee, A. Baukol, and B. Cox re: Update on Russia-IMF (2 pages)	07/08/98	P1/b(1) Unclass.
002. memo	From Mark Sobel (IMF) re: IMF Debrief to G-7 Directors on Russia (2 pages)	08/13/98	P1/b(1) Unclass.
003. note	Karin Lissakers (IMF) to Deputy Secretary Summers, Under Secretary Lipton, & Assistant Secretary Geithner re: Russia (1 page)	08/13/98	P1/b(1) Unclass.
004. briefing paper	re: Mandatory Conversion of GKOs: Russia: Preliminary Considerations (IMF document) (5 pages)	circa Aug. 1998	P1/b(1) Unclass.
005. briefing paper	re: Russia: Scope for Intensification of Exchange Controls (IMF document) (2 pages)	circa Aug. 1998	P1/b(1) Unclass.
006. memo	To the Vice President re: Policy Priorities for Russia (4 pages)	circa Oct. 1998	P5
007. briefing paper	re: Russia Strategy (5 pages)	circa Oct. 1998	P5
008. memo	To the Vice President re: Responding to Russia's Economic Crisis (6 pages)	circa Oct. 1998	P5
009. memo	Senior Deputy Assistant Secretary Truman to Rubin, Summers, & Geithner re: Principals Meeting on Russia (3 pages)	11/12/98	P5
010. memo	To the Vice President re: Russia's Economic Crisis (5 pages)	circa Oct. 1998	P5
011. memo	From Mark Sobel (IMF); For the Files re: Russia - IMF Staff Briefing to Board on Latest Mission (3 pages)	11/02/98	P1/b(1) Unclass.

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[History of the Department of the Treasury - Supplementary Documents] [7]

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012. talking points	re: Russia - Economic Message (6 pages)	circa Dec. 1998	P5
013. memo	From Mark Sobel (IMF); For the Files re: Managing Director's Board Briefing on Russia (2 pages)	03/08/99	P1/b(1) Unclass.

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URGENT

OFFICE OF THE ASSISTANT SECRETARY (INTERNATIONAL AFFAIRS)
OFFICE OF CENTRAL AND EASTERN EUROPE
Rm. 2101, 1440 NY Avenue,
1500 Penn. Ave, NW, Washington, D.C. 20220
Phone: (202) 622-2130 (main number)
Fax: (202) 622-2308

DATE: 7/9/98

TO: Nancy Lee

FAX:

FROM: Tammy

PHONE:

____ page(s) including this cover page

MESSAGE:

Please deliver the attached to NL Before her mtg. w/ Summers.

What have recent events taught us about our policy on Russia's transformation?

-- Have we been pushing for the wrong agenda?
-- Has there been too much emphasis on fiscal adjustment and not enough on structural reform?
-- Is ruble stability still important?
-- Did we push for too rapid capital account liberalization?
-- Has the IMF been either too rigid or too lenient?

- First, on deficit reduction, Mr. Odling-Smee probably laid out the basic math governing Russia's fiscal situation federal expenditures of 16%/GDP federal revenue of 10-11%/GDP and the difference nearly all representing interest payments.

- This generates a borrowing requirement which keeps real interest rates high even in a decent global environment.

    -- The added effect of contagion has pushed rates up so high and reduced rollover so sharply that Russia is firmly in a debt trap.

- You may ask what's so unsustainable a 5-6%/GDP budget deficit. Other countries perk along with deficits at that level without major catastrophes.

- I think there are 4 answers:

    1. Russia has no growth so there is no favorable dynamic involving rising revenues and falling expenditures related to job creation.

    2. Monetization of Russia's economy remains very low, about 12%/GDP (ruble M2 as % of GDP) financial savings available therefore are basically absorbed by the public sector, leading to very large crowing but effects, and smothering growth.

    3. We have the new more difficult environment of contagion and growing skepticism about emerging markets.

    4. The cash deficit understates the magnitude of the problem. Including offsets the deficit was 6.0% in 1997, as compared to the deficit on a cash basis of 5.1%.

- Now, you can argue some ways to address the deficit problem are better than others. I thing we would agree that real tax reform is better than more spending cuts.

- Obviously not and this Administration has consistently pushed a range of growth-promoting reforms, encompassing everything from tax reform, to legislation to legal reform.

- The Treasury perspective on this effort is to increase sharply the WB's engagement with

Russia -- as Larry Summers has put it we want the baton to be passed across 19th. street.

-- Last year, we saw real progress in this regard. For the first time, Bank disbursements of $3 billion exceeded those from the Fund of $2.1 billion.

-- This year things have slipped back a little for a variety of reasons but I think you may see intensified WB engagement with Russia in the months ahead.

- What about the ruble?

-- While is may have been buried in the recent turmoil, the truth is that the ruble anchor has produced real and sustained stabilization results.

-- Inflation has been brought down from 131% in 1995 to 8% projected in 1998.

-- And we don't see a strong empirical case for ruble overvaluation.

-- On a PPP basis it is still undervalued by roughly 25% (Russian Center for Economic Reform).

-- In real terms, the ruble has been fairly steady in 1996-1998 (is has appreciated slightly on a trade weighted basis, but depreciated slightly against the dollar).

-- And Russia average wages are about $175/month, below those of Poland, Hungary, and the Baltics while above those of Ukraine and Belarus.

- Some have suggested that capital account liberalization was too rapid give the fixed exchange rate and that this has left Russia excessively vulnerable to contagion. (This, of course, is not just a criticism leveled in the Russia case.)

- I would respond, first of all, that when confidence was high, foreign inflows reduced Russia's borrowing costs sharply. Inflows were the primary cause of the reduction in GKO yields from an average of 88% in 1996 to less than 20% in the summer of 1997. In Russia's under-monetized economy, foreign flows have been key to financing the deficit.

- Regarding the issue of whether foreigners triggered the current crisis, I think the evidence suggests otherwise.

-- In May and most of June, foreigners reduced their holdings of GKO's by roughly $1.2 billion (6%) non-Sberbank/CBR Russian holders of GKO's withdrew $1.6b from the GKO market (16-20% of their holdings).

- The IMF has been criticized for imposing too much policy conditionality on the one hand and for keeping the program alive despite policy slippages, on the other.

- It seems to me that the IMF has chosen a middle course, and as middle courses so often are, this was broadly appropriate.
  - Remaining engaged has produced some important successes: stabilization, monetary reform, some reform in budgetary procedures, some trade and investment liberalization.
- At the same time, the Fund has withheld a substantial amount of money, either through cutting the size of tracheae or delaying them.
- I don't think it is generally recognized that as of this moment Fund disbursements are about $2b lower than planned under the original EFF program.

Crisis often produce major policy changes for better or worse, but this new government will be hard pressed to build a constructive consensus.

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2-0081

TO: DepSec Summers / Ben Jones

FROM: Andy Baukol
(filling in for Nancy Lee)

→ Russia Update
→ IMF statement
→ GOR statements

RUSSIA NEWS

PM Kiriyenko and CBR Chair Dubinin released a joint statement this morning laying out Russia's actions:

Ruble: GOR announced new band of 6.0-9.5 R/$ (implying a maximum devaluation of 33% from the previous 6.3 R/$ rate). MICEX fixed ruble at 6.43 R/$ today, but **interbank trading is at 7.1 to 7.8 R/$.** In early trading on Chicago futures, the September maturities are trading at 9.3 R/$ in light trading, down from 7.2 R/$ on Friday.

GKO/OFZs: GOR announced that all GKOs and OFZs maturing before Dec 31, 1999 will be restructured. More details to be released Wednesday. Trading is suspended in the meantime.

Bank holiday was not announced. The CBR and GOR will support a 'payment pool' for the interbank market to help maintain liquidity. So far, rhere are no signs that Russian citizens are rushing to withdrawal their deposits or convert rubles to dollars.

GOR also did not announce at guarantee on bank deposits of Sberbank or any other bank. The CBR believes such an announcement would cause more concern than it would relieve.

The CBR raised overnight interest rates to 250%, from 150%.

GOR announced various temporary capital controls, including a 90-day moratorium on the repayment of credits to non-resident financial institutions (This would cover bank-to-bank syndicated loans, margin calls, and forward contracts. It is unclear if trade credits are included.) The GOR also submitted draft legislation to the Duma on new capital controls. The IMF believes this is only to shorten the time period in which import/export proceeds must be repatriated from 6 months to 3 months.

The Duma will meet in emergency session on Friday, according to Zyuganov.

Equities: RTS is currently down 2.4% from Friday. There is still 1 1/2 hours of trading left.

Eurobonds: Yields on Russian $-bonds have risen by about 400 bp in early trading, according to Wallar. The Finance Ministry just announced that its 90-day moratorium on $-payments does NOT affect Eurobonds. This may help the Euro market recover later today.

IMF: Camdessus said "These measures and their potential impact will immediately be analysed by staff and management of the IMF and submitted to the Executive Board. It is important that the international community as a whole, both public and private sectors, show solidarity for Russia at this difficult time." He called on the GOR and Duma to press ahead with the anti-crisis program so that the IMF can release the next tranche of its credit package next month. He also called on the GOR to find "a cooperative solution to the debt problems, in a close dialogue with Russia's creditors."

August 17, 1998

INTERNATIONAL MONETARY FUND
MOSCOW OFFICE

PRESS RELEASE

Russia—Financial Measures

The Managing Director of the International Monetary Fund, Michel Camdessus, made the following statement today:

"On July 20 the Fund's Executive Board approved additional financial assistance to Russia of $11.2 billion in support of a strengthening of Russia's economic program. Implementation of this program has been satisfactory. Despite this, confidence in financial markets has not been reestablished and as a result Russia has continued to lose reserves, and asset prices have fallen sharply. In view of the risks implied by the persistence of these trends, the Russian government has today announced a set of measures designed to bolster confidence, including a change in exchange rate policy, restructuring of government debt, and a temporary restriction on capital payments abroad.

These measures and their potential impact will immediately be analyzed by the staff and management of the IMF, and submitted to the Executive Board. As a preliminary reaction, I am of the view that, in the new context created by these measures, it will be especially important for the Russian authorities to take all necessary steps to strengthen the fiscal position; prompt passage of fiscal measures in the forthcoming session of the Duma will be essential to this end. The authorities should also spare no effort to find a cooperative solution to their debt problems, in a close dialogue with Russia's creditors. I hope that the government's economic program will continue to be implemented in full, so that the economic and financial situation will improve and the IMF can be in a position to disburse the second tranche under the enhanced Fund program in September as scheduled.

More generally, it is important that the international community as a whole, both public and private sectors, show solidarity for Russia at this difficult time."

JOINT STATEMENT

of the Government of the Russian Federation and the Central Bank of the Russian Federation

On Exchange Rate Policy

August 17, 1998

The period after the Government of the Russian Federation and the Central Bank of the Russian Federation had announced medium-term targets of the foreign exchange rate policy for the current period was marked by a major aggravation of foreign economic situation for Russia. Its key factors were the following: the world financial crisis which began in several East Asian countries and evolved on a global scale; the generally depressive situation in all emerging markets, including the Russian financial market; a decline of the world prices on all items which are key Russian exports, in particular, on oil, which resulted in deterioration of the country's external balance of payments.

At the same time, the federal budget has dramatically worsened, and confidence in Russian government securities has declined, which lead to an outflow of foreign capital from Russia and brought about a decline of the country's gold and foreign exchange reserves. In this context, adjustments in the foreign exchange policy pursued by the Russian Federation become inevitable.

To protect national economic interests, avoid a reduction of foreign exchange reserves and eliminate disproportions which have piled up in the foreign economic area, the Government of the Russian Federation and the Bank of Russia hereby make a statement on revising the parameters of foreign exchange policy and methods of setting the ruble exchange rate. In the current situation, it would be unreasonable to continue tight daily exchange rate band in the form of the CBR-announced purchase and sale rate of the U. S. dollar in the interbank foreign exchange market. Accordingly, the procedure of setting the official ruble exchange rate by the Bank of Russia will be amended; the rate will be defined from the outcome of daily operations in exchange and over-the-counter sectors of the domestic foreign exchange market.

At the same time, the Government of the Russian Federation and the Bank of Russia take an obligation to use budget, monetary and foreign exchange policy to maintain such conditions in the foreign exchange market which are necessary for maintaining a predictable exchange rate path. As before, unrestrained purchase and sale of foreign exchange by organizations and population will be ensured in the context of the current laws and on the basis of a market exchange rate.

The Government of the Russian Federation and the Bank of Russia believe that, provided that legislative support is obtained, implementation of the Government's stabilization economic measure package, as well as gold and foreign exchange reserves available at this point of time, make it possible to maintain the ruble exchange rate in the band of Rub 6.0 to 9.5 per 1 US$ in the remainder of the year.

The exchange rate policy in the new conditions will be based on a balanced budget policy and a sufficiently tight monetary policy. The key role will be played by a flexible interest rate policy which will ensure a curb on inflationary expectations and sufficiently attractive investment in assets denominated in the Russian domestic currency, while government foreign exchange reserves will be maintained at a sufficient level. Defining the official ruble exchange rate on the basis of its market prices will make it possible to allay speculative attacks on the Russian ruble, which incur unreasonable spending of the Bank of Russia's foreign exchange reserves.

At the same time, the Government of the Russian Federation and the Bank of Russia are introducing restrictions, necessary under current conditions, on nonresidents' foreign currency conversion capital account operations, with the view of protecting the Russian market from a destabilizing impact of global movements of short-term speculative capital. Also, the Government of the Russian Federation and the Bank of Russia fully confirm their international obligations taken in 1996 to eliminate restrictions on ruble conversion in the current balance of payments operations.

S. Kiriyenko
Chairman of the Government
of the Russian Federation

S. Dubinin
Chairman
Bank of Russia

STATEMENT

of the Government of the Russian Federation and the Central Bank of the Russian Federation

August 17, 1998

The financial markets crisis hit the Russian economy at the beginning of its recovery. Since October 1997, the Government and the CBR have been defending the major achievements in economic policies of the recent years, i.e., stable prices and a strong ruble, and, consequently, the nation's living standards.

As a result of deterioration of the foreign economic situation and an unsatisfactory budget revenue situation, the problem of the state debt management has worsened. Expenditures on redeeming the previously issued government securities and interest payments at the time of the low level of tax collections have become an excessive burden on the state budget. The Government of the Russian Federation is forced to reduce domestic debt by cutting federal expenditures and by borrowing abroad. In July, the Government's economic program was supported by international financial organizations and by the leading countries of the world.

However, the deepening crisis in Asia and a new decline in the world oil prices have not made it possible to restore confidence in the Russian securities, and consequently to make the budget situation easier. Reduction of the country's foreign exchange reserves continues, and the banking system has started experiencing certain difficulties.

In this situation, the Government and the CBR deem it necessary to undertake a complex of measures aimed at normalizing the financial and fiscal policies.

1. Starting from August 17, 1998, the CBR switches to implementation of the floating exchange rate policies within the new boundaries of the "exchange band" set at the level of 6 to 9.5 rubles per US dollar. CBR interventions will be used to smooth out sharp fluctuations of the ruble exchange rate. The CBR will use interest rate policies to pursue the same goal.

2. Government securities (GKOs and OFZs) with due dates through December 31, 1999, will be rescheduled into new securities. Technical parameters for the conversion will be announced on Wednesday, August 19, 1998. Trading sessions in the GKO-OFZ market will be suspended until the rescheduling of government securities is completed.

3. In accordance with the provisions of the IMF Articles of Agreement, the Government and the CBR introduce temporary restrictions on capital account foreign exchange operations by the residents of the Russian Federation. Starting from August 17, 1998, there will be a 90-day moratorium on repayment of financial credits extended by the nonresidents of the Russian Federation, on insurance payments on credits backed up with the pledged securities, and on forward foreign exchange contracts. At the same time, a prohibition is introduced for nonresidents of the Russian Federation to invest in ruble assets with maturities of 1 year or less.

4. The Government and the CBR view a stable operation of the banking system and the system of payments and settlements in the Russian Federation as one of the top priorities. In this context, the Government and the CBR support a payments pool to be set up by the largest Russian banks, aimed at maintaining the stability of interbank settlements. At the same time, the CBR intends to make an additional effort to strengthen the Russian banking system, and involve both stable Russian banks and leading foreign banks in the solution of this task.

5. To restore the financial market, the Government of the Russian Federation will in the nearest future begin the placement of short-term (one or two week) government securities. The range of securities issued for population will be extended.

6. The Government and the CBR are submitting legislative initiative to the Federal Assembly to tighten control over the outflow of foreign exchange resources abroad. At the same time, the Government and the CBR intend to take urgent actions in this area within their current authority.

7. The Government of the Russian Federation once again call on the State Duma with a proposal to hold an emergency session before the end of August, and to adopt the key draft laws which will ensure the timely payment of pensions and wages to the budgetary employees, develop legislative procedures for rehabilitation of banks, and strength the system of foreign exchange regulations and foreign exchange control.

Chairman of the Government
of the Russian Federation

S.V. Kiriyenko

Chairman
of the CBR

S.K. Dubinin

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
005. briefing paper	re: Russia: Scope for Intensification of Exchange Controls (IMF document) (2 pages)	circa Aug. 1998	P1/b(1) Unclass.

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RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

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1998-SE-012042

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

October 21, 1998

MEMORANDUM FOR DEPUTY SECRETARY SUMMERS
ASSISTANT SECRETARY GEITHNER

FROM: Deputy Assistant Secretary Medish MCM
Nancy Lee NL

SUBJECT: Russia Trip Report: October 13-16, 1998

Russian political economy: principal impressions

The pervasive feeling is that Russia is in the eye of the storm. A temporary calm has descended after the initial shock of the devaluation and the collapse of the banking system. People are now braced for high inflation, shortages, continued ruble inconvertibility, and external debt default, with little expectation of a decisive response from the Primakov government.

Political unrest is expected to remain muted, with the possible exception of food shortage protests in remote regions this winter. Outside Moscow, the crisis has driven people deeper into the non-monetized economy. In Moscow, the crisis has devastated the service economy and demand for consumer goods. There has been a sharp rise in the numbers of unemployed financial and marketing professionals. No one is predicting early translation of this dissatisfaction into formation of political parties or movements. But there is a widely shared view that these people embody a fundamentally changed constituency and will somehow sustain Russia's connections and slow convergence with the West.

Focus on the possibility of early presidential elections is intensifying. The crisis appears to be driving Russians to look more urgently for a savior rather than a new ideology or strategy. As a consequence, we are likely to see burgeoning political activity rather than dramatic new directions in economic policy in the coming months. Calls for a clearly incompacitated President Yeltsin to step down are heard from nearly all points on the political spectrum, including for the first time from Luzhkov. (If he resigns, elections would have to be held within 3 months.) Sergei Vasiliev judges the odds of a presidential election by spring to be significant. The two viable candidates remain Luzhkov and Lebed, although some argue that, despite his explicit lack of political ambitions, Primakov may emerge as a consensus candidate.

No consensus has emerged about what policies to try next, but there is a palpable tilt toward monetary expansion, protectionism, and subsidies to promote domestic industry. The view that under-monetization in Russia has been caused by monetary restraint is becoming more fashionable, even among those who acknowledge that Russia's fiscal stance has been untenable. Arguments for protection and subsidies are framed in import substitution terms and will be difficult for the United States to counter given our likely course of action on steel. The good news is that many, including "traditional economists", share the West's structural reform agenda, especially deregulation, better corporate governance, fighting corruption, and creating a fair,

cc: M. Froman

workable tax system. Interestingly, views on Prime Minister Primakov are sharply divided. Some view him as the first skillful, coalition-building politician in the Western European mold. They support his decision
not to promulgate any comprehensive economic plan which would galvanize opposition, and they cite his concerted effort to reach out for a broad range of advice, including from foreign investors. These observers predict that Primakov will take discrete actions to deal with successive "squeaky wheels", which they view as the best strategy.

Others view Primakov as delaying essential decisions, failing to provide leadership, and ultimately doomed by his inability to act and worsening economic straits. Sergei Vasiliev argues that he is an explicitly transitional figure, with a limited mandate to maintain stability until Russia can elect a new President. In Vasiliev's view, any Primakov effort to take decisive action would immediately undermine his support.

There is no divergence of views about Primakov's cabinet which reportedly was forced upon him. With the exception of Zadornov, they are viewed as retrograde or incompetent or both. They are expected to be tossed aside as conditions worsen even if Primakov himself remains. Zadornov is severely weakened by the actions of August 17, his failure to bring back IFI money from the IMF/World Bank meetings, and what many view as his green eye-shade focus on fiscal issues.

At the moment, the oligarchs are weakened politically as well as financially. Primakov owes them nothing. But they will certainly re-emerge. Those with assets in the real sector -- e.g., Boris Jordan and Potanin -- are concentrating on running oil and mining companies (and probably their externally held assets). And, based on the experience of recent weeks, their ability to engineer bank bailouts from the central bank probably remains intact.

Berezovksy, acknowledged to be ascendant among the oligarchs, is intensively courting Lebed (largely for negative reasons, especially his hatred of Luzhkov). Jordan noted that Berezovsky's influence over Lebed is now nearly total. Jordan observes no coherent policy content in this influence; Berezovsky's preference is rather for promoting the ongoing turmoil which plays to his strengths.

What we should do

Our actions over the next few months should be governed by the following considerations:

(1) Russians are clear about their problems but not about policy solutions. They are searching for a transformation model that will work for them. Primakov, especially as a non-economist, seems genuinely interested in our views. We should make a concerted effort to help him and other key Russians draw lessons from their own experience and that of other countries and to shape a new growth-oriented strategy.

(2) There is more consensus about structural reforms needed than about how to fix the macro imbalance. We should not neglect efforts to promote structural reform in the period ahead even

if stabilization is not going well.

(3) We should pick a few structural policy areas -- maybe bank restructuring, the rule of law, promotion of small and medium (cash) enterprises through tax and regulatory reform, and transparency and corporate governance -- focus technical assistance in these areas, and press hard for real reform.

(4) A shift in emphasis toward promoting FDI may be appropriate at this point. Given the unlikelihood of comprehensive tax and legal reform, an attempt to promote predictable rules and tax schemes for foreign investors (as China did) might be a good near-term, second-best strategy, with demonstration effects for the rest of the economy.

(5) Whatever the reform path, the West can and should help with discrete problems. There will likely be food shortages in remote regions this winter. We should try hard to reach agreement with the GOR on food aid, while making a maximal effort to try to ensure that the food goes to the right people. We should intensify efforts to enhance nuclear and defense cooperation.

(6) Primakov appears inclined toward a non-confrontational strategy with the IFIs and foreign creditors. We should respond with a low-key, constructive strategy on Russia's Paris Club obligations, urging Russia to develop a realistic schedule of payments with rational burden-sharing among non-IFI creditors.

(7) Down the road, if the policy/regulatory environment for the private sector improves, we should promote large-scale public/private sector partnerships for building infrastructure. A key vehicle could be vitalization of World Bank and other IFI guarantee programs in Russia.

Updates on key issues

IFI relations and macroeconomic/financial policy: IMF and World Bank outlooks diverge somewhat. Bank staff (Carter) are pleased that the central bank is finally engaging with them on bank restructuring and see some prospect for progress in one or two areas of structural reform (perhaps under the SAL and coal loans). The Fund (Gilman), on the other hand, reports a fundamental lack of understanding on the part of the new government that a viable economic program has to provide the basis for Fund financing. Gilman also highlights renewed monetary growth (base money jumped 5% the second week of October after growth leveled off during end-September), a return to offsets, and miserable tax collection. The Fund thinks Russia needs a primary surplus of 4% of GDP in 1999, even without solving the pension and banking problems. But the Fund will remain engaged; a mission arrives this week. There does seem to be a clear Russian understanding that the R100 billion Q4 budget deficit advanced during the Fund/Bank meetings is a nonstarter as far as the IFIs are concerned. Vyugin told us that the Finance Ministry is now considering a R70 billion Q4 deficit financed in part by a drawdown in reserves and in part by a new quasi-offset scheme whereby a firm pays taxes in cash to the government which then immediately returns part or all of the money in payment for goods and services. But the assumption about cash revenues, R70 billion for the quarter, is clearly unrealistic.

Tax reform and collection: The new government has not yet endorsed a new tax reform strategy, so at the moment the action has shifted to the Duma committees which are marking up the previous government's proposals. When the government reaches agreement, it will propose changes to Part I of the tax code (already passed) to strengthen the authority of the tax services, as well as separate bills for individual taxes. The Finance Ministry's views on individual taxes do not appear to have changed greatly, but there is no certainty that the rest of the government will agree. Vyugin hinted at a decline in Finance Ministry primacy. Just as Vyugin was assuring us that The Finance Ministry still supports unification of the VAT, press reports indicated that Primakov supports lower rates for food and other essential consumption items. When asked about the principal measures contemplated for raising revenues, Deputy Finance Minister Motorin cited the creation of a state alcohol distribution monopoly, regional excise stamp taxes and sales taxes, and intensive work with large tax payers. (VAT accrual, which has been legally struck down, will now be incorporated into the VAT bill.) The new head of STS, Mr. Boos, is inexperienced (comes from the Duma) and apparently in denial on key issues. He asserted that he has no special problems at the moment with large tax payers, having negotiated agreements with them on the taxes they owe for the rest of the year.

Bank restructuring: The news on bank restructuring is not altogether encouraging. While we were there, Deputy central bank governor Kozlov described for us the just released outline of the principles governing bank restructuring. Banks are to be divided into four categories: solvent, solvent but illiquid, insolvent, and insolvent but too big or socially important to fail. Too big or socially important is apparently a broad concept that encompasses large obligations of any kind, not just individual deposits. He indicated that bank audits are now being done to divide banks into these categories but was vague about how accurate information is to be developed given banks' primitive and unreliable accounting. EBRD staff are helping; they report that central bank staff lack the expertise and no one else, including the World Bank, is putting in the time to do proper due diligence. We should certainly do all we can to organize a technical assistance effort in this area. Kozlov said that the central bank has strongly hinted to the World Bank that it will seek financing for bank restructuring, but that the World Bank has not responded. But when asked if the central bank is willing to reach agreement with the World Bank on which banks ought to be closed, Kozlov stressed that these decisions have to be made by the central bank. EBRD staff, observing renewed bank bailouts, are worried that Russia will loose this opportunity to start fresh with a stronger banking system.

Debt restructuring: There is little risk that foreign holders of GKO debt will fare worse than domestic holders. The negotiations on conversion of foreign-held debt, including forward contracts, into eurobonds will likely take another two weeks but differences are narrowing. The Russians are negotiating with five Western banks who are supposed to be representing broader interests: Deutsche Bank, CSFB, Merrill, Chase, and Lehman. Merrill reps report that resolution of forward foreign exchange contracts has become more important than GKO terms because GKOS have lost value while forwards have gained. Western banks may accept a low payoff on the GKOs if they also receive a cash payment on the forwards.
Restructuring the domestically held debt will likely take a lot longer. Domestic GKO holders will be given ruble debt which may be exchangeable for tax obligations or equity (state-owned shares in companies).

1998-SE-012097

Department of the Treasury

Office of the
Deputy Assistant Secretary
for Eurasia and the Middle East

to: Larry Summers
Tim Geithner

room: ______ date: 10/22/98

For review tonight.

Mark

Mark C. Medish
Deputy Assistant Secretary
room 3221
phone 622-0770

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
006. memo	To the Vice President re: Policy Priorities for Russia (4 pages)	circa Oct. 1998	P5

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1998-SE-012191

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

October 26, 1998

ASSISTANT SECRETARY

INFORMATION

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: ASSISTANT SECRETARY GEITHNER TFG

SUBJECT: Russia Strategy

Attached are two papers on Russia: (1) a Medish/Lee memo outlining a Russia reform and engagement strategy ; and (2) a (similar) memo for the Vice President on Russian reform priorities which is to be attached to a letter from the Vice President to Russian Prime Minister Primakov.

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
007. briefing paper	re: Russia Strategy (5 pages)	circa Oct. 1998	P5

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
008. memo	To the Vice President re: Responding to Russia's Economic Crisis (6 pages)	circa Oct. 1998	P5

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
009. memo	Senior Deputy Assistant Secretary Truman to Rubin, Summers, & Geithner re: Principals Meeting on Russia (3 pages)	11/12/98	P5

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MEMORANDUM FOR: **X SECRETARY X DEPUTY SECRETARY** ☐UNDER SECRETARY ☐ ASSISTANT SECRETARY ☐ ACTION **X BRIEFING** ☐ LEGISLATION ☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH ☐ TESTIMONY ☐ OTHER ______________

FROM: Ted Truman, Senior Deputy Assistant Secretary, International Affairs

SUBJECT: Principals Meeting on Russia

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1998-SE-012878

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

DRAFT

BRIEFING

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Mark Medish
Deputy Assistant Secretary

SUBJECT: Principals Meeting on Russia

DATE AND TIME: Thursday, November 12, 5:00-6:30PM

LOCATION: Roosevelt Room

PARTICIPANTS IN MEETING:

Treasury:	RER (?) DepSec Summers Ted Truman
State:	Sec. Albright Strobe Talbott
NSC:	Sandy Berger Carlos Pascual
NEC:	Gene Sperling
OVP:	Leon Fuerth
Other:	TBD

BRIEFING: Overview/Objectives

Attachments

0. NSC Agenda/Overview (to be provided)
1. Treasury economic 'nonpaper'
2. Macroeconomic Background
3. Summary of GOR economic plan
4. IMF criticism of GOR plan
5. GKO/OFZ restructuring update
6. Bank restructuring update
7. External debt note
8. Talbott speech, November 6
9. Market graphs

DRAFT

Russian Policy Steering Group

Overview: This agenda meeting for the meeting includes economics, non-proliferation, and military decommissioning. The economics discussion will draw on Treasury's non-paper (attached), which was circulated to agencies last week and is being passed to Prime Minister Primakov. The list of modes for U.S. engagement include: (1) humanitarian assistance, (2) technical assistance, including for banking reform, (3) project financing from the World Bank and EBRD, (4) on stabilization, forbearance on external debt (esp. Paris Club debt), and (5) emphasis on FDI, including consideration of development of special tax and regulatory regimes.

Key Points:

- ***Note that GOR is not coming to grips with key economic issues.***

  – *GOR Plan Disjointed, Unworkable*: The GOR's economic plan contains few details on how GOR will address most difficult issues: fiscal, ex-rate, banking, and debt. The IMF has criticized many of its elements.

  -- *GKO Negotiations Leave Out Forward Contracts*: The GOR and Western banks have agreed in principle on a debt restructuring deal that would give ruble-denominated debt to GKO holders. The deal would exclude all forward contracts. Western banks may quickly turn to litigation against Russian banks to secure partial repayment on forward contracts.

  – *Bank Restructuring Plan Unclear:* The broad outlines of the Central Bank's bank restructuring plan appear reasonable, but in practice it is likely that too many banks will be saved and the Central Bank will not force removal of their management.

  – *No Strategy on Official Debt:* The GOR has publicly admitted it will not be able to pay its official debt, but it has yet to describe its strategy for engagement with creditors.

- ***Emphasize that, as a result, inflation, shortages, and output contraction will get worse.***

  – Russian economy enjoyed a respite in October: ruble was stable around 16 R/$, inflation was only about 3-5%, tax collections were up slightly over poor September receipts.

  – But, inflationary elements of GOR policy (% increase in base money since August) will begin to affect prices in late 1998-early 1999 (usually a 6-month lag). Moreover, GDP decline and contraction of imports/exports have already begun to bite.

- ***Note that West has limited ability to press Russia on macroeconomic issues, but should emphasize other forms of positive engagement, as highlighted in nonpaper.***

  - USG does not want to be implicated in Primakov plan and worsening economic situation. Thus, we should not give public or private support to policy that is likely to fail.

  - IMF may return to Moscow in mid-November if GOR has drafted 1999 budget. IMF staff judge that GOR may be open to limited IMF program in early 1999, at earliest.

  - USG should focus on non-IMF areas of engagement with Russia. These include:

  - (1) Large food aid package should be characterized as clear demonstration of US willingness to respond to Russian problems in a way that is mutually beneficial.

  - (2) USG should continue to intensify technical assistance on both stabilization and micro issues, including banking and tax reform. USG can offer increased TA to help in other areas, such as fighting corruption/money laundering.

  - (3) We should step up project lending to Russia from World Bank and EBRD, esp. to support development of infrastructure and other public goods. This kind of spending might be a good focus for Marshall Plan-like efforts in Russia.

  - (4) USG should continue to take a low-key strategy on Paris Club debt and emphasize need for Russia to craft rational repayment strategy that shares pain among creditors.

  - (5) Should draw from the China model to encourage FDI in Russia through second-best policy expedients, i.e., even without a strong legal, regulatory, and investment policy environment.

  - USG can also support other non-economic assistance, such as the "Fuerth agenda,"(support for military decommissioning), which have broad congressional support and build on our shared security interests.

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
010. memo	To the Vice President re: Russia's Economic Crisis (5 pages)	circa Oct. 1998	P5

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RUSSIA: MACROECONOMIC SUMMARY
November 10, 1998

Overview: After six weeks in office, PM Primakov's government appears no closer to developing an effective plan for stabilizing the Russian economy. There is no apparent coordination between the CBR and Ministry of Finance on anti-crisis strategies, and ad hoc policies implemented so far have been either ineffective or counter-productive. To the extent that the GOR has outlined its economic strategy, it has been poorly received: the IMF and markets harshly criticized measures included in an anti-crisis plan approved by the GOR on October 31. In the meantime, economic and financial conditions continue to deteriorate. Russian currency, bond, and equity markets are now in ruins. Revenue shortfalls resulting from continued inadequate tax collection efforts and the economic downturn have opened up a substantial fiscal hole. Monetary policy has begun to loosen, and recent GOR economic policy proposals include large spending provisions, implying equally large monetary emissions in the future. The ruble has stabilized, although this is largely due to increasingly tight control by the CBR over hard currency transactions. The effects of the crisis are beginning to be felt in the real economy through import compression and renewed economic contraction. GDP is now expected to decline by more than 6% in both 1998 and 1999, and Russians now face the real prospect of sharply rising inflation, unemployment, and shortages of key goods.

Financial Markets as of November 2:

	Year to Date	Since August 14
Equities	-85.3%	-49.2%
Currency	-62.2%	-60.1%
Eurobond Spreads over U.S. Treasuries	↑ 3259 bps	↑ 2128 bps

Reserves: CBR gross international reserves were $13.6 billion on October 30, up $300 million from the previous week.

Fiscal Policy: IMF staff now estimate that Russia is headed toward a 7-8%/GDP budget deficit for the year. With no means to finance this gap beyond printing money, the GOR risks fueling much higher inflation. The few details that have emerged on the government's Q4 "emergency" budget look unrealistic: it calls for R130 billion in expenditures and the R65-70 billion in revenues (no sign that revenue target is attainable given cash tax revenues for October of R12.2B), with unspecified foreign financing to fill the gap. The IMF and GOR also remain far apart on parameters for the '99 budget: the Fund is urging the Russians to take additional revenue measures and cut expenditures to achieve a 3%/GDP primary surplus and 0.75%/GDP overall deficit, while the GOR wants to lower tax rates and increase spending on state development projects. Passage of the final '99 budget is now not expected until February: after the GOR submits its draft (around Dec. 1), Duma consideration and approval will take approximately three months.

Monetary and Exchange Rate Policy: Inflation in September was 38%, up from 15% in August, as the price impact of the August 17 devaluation became apparent. Price increases have slowed considerably since then, with inflation in October only about 3-5%. Monetary policy under current CBR Chairman Gerashchenko has been moderately restrained with total lending to banks of about 14B rubles. Additional emissions seem inevitable: Primakov has promised to clear a substantial portion of government wage and pension arrears (estimated at R22B ($1.3 billion)), while MinFin Zadornov has proposed amendments to the Q4'98 budget calling for R20B in CBR credits to finance the deficit.

Exchange rate volatility observed in September has subsided for now, but this appears due to CBR efforts to limit f/x transactions by excluding banks from trading on their own behalf (only allowing trading for documented foreign trade transactions) on the currency market. CBR Chairman Gerashchenko indicated in talks with the IMF that the segmentation this system was meant to achieve was breaking down and would soon be eliminated altogether.

Debt Moratorium: The 90-day moratorium on principal payments on syndicated and repo loans (roughly $19B) and on settlements of forward contracts (roughly $10B) has been, if anything, counterproductive. It has put the entire Russian banking system into technical default, has not prevented isolated incidents of litigation and asset attachments by Western creditors, and, because the CBR has taken no action, has not lead to comprehensive negotiations on private debt restructuring. The moratorium is set to expire on November 15, unless extended. CBR has said it will not be extended but this may depend on the status of negotiations on GKO and forward contract restructuring. Meanwhile, the freezing of external debt payments has contributed to the collapse of the payment system as many banks have used the excuse of a freeze on external payments to stop paying domestic obligations.

In September, Lehman Brothers successfully attached Oneximbank and Inkombank assets held in each bank's London branch and a French bank attached the assets of a Russian owned London bank. According to an analysis by Baker & McKensie, the moratorium does not have solid legal footing in either foreign or international law.

GKO Deal Likely: The GOR and Western banks have reached preliminary agreement on a deal for restructuring Russian GKOs into ruble debt. The sides will meet again in mid-November to try to finalize the deal that calls for a small (10%) ruble payment in the first year, followed by a restructuring of the remaining debt into 3 to 5 year ruble bonds. The deal would exclude forward currency contracts held between Western and Russian banks.

Paris Club Status: As of October 30th, Russia has failed to pay a total of $750 million to Paris Club creditors, most, if not all of it, pre-1992 Soviet debt. Of this the Germans are owed $450 million and the US $60 million. Payments due in the remainder of 1998 amount to about $700 million. Most of this is debt contracted by the Russian government since January 1992 (so-called "post-post cutoff" debt).

Payments to Paris Club creditors will spike in 1999 with large payments due in February and August as the result of the semi-annual payments under Russia's rescheduling agreements. A full $1.8B of the $5.5B owed during 1999 falls due in the first quarter. Of that amount, $453 million is "post-post" debt contracted since January, 1992.

Background on Russian Economic Plan

The Russian government adopted a new economic program on Saturday and will present it to parliamentary leaders this week. This is the third incarnation of Russia's anti-crisis plan. While some problem elements presented in previous drafts are gone, the current plan remains fundamentally deficient in several important respects. First, it will worsen Russia's fiscal situation by reducing revenues and increasing expenditures. Second, some elements of the plan represent a distinct step away from market-based economic policies. Finally, the current plan asserts the need for exchange rate and price stabilization without offering a realistic plan for achieving these goals, and provides no strategy for dealing with Russia's debt situation. The key points of this draft are summarized below.

Fiscal policy: The plan appears likely to increase Russia's budget deficit by sharply increasing expenditures while simultaneously decreasing revenues. These fiscal measures include:

Increases Expenditures:

- ensure full payment of current government wages/pensions as of Oct. 1,
- clearance of some government wage and pension arrears (unspecified amount) this quarter, with remainder of arrears rolled over into 1999.
- indexation of pensions, welfare benefits, and minimum wages,

Decreases Expenditures:

- (no measures specified)

Decreases Cash Revenues:

- offset of overdue payments between different levels of government
- gradually reduce VAT (no rate specified) and maintain VAT on destination basis.
- cut the profit tax rate to 30% from 35%, with 11% going to federal budget, 19% to regional budgets.
- introduce more moderate personal income tax (rate unspecified)
- eliminate emergency 3% customs duty and reduce regular duty on imported food, medicine.
- reduce fines, penalties for nonpayment of taxes.
- allow enterprises to pay past tax debts with state securities (GKOs),

Increases Cash Revenues:

- impose a state monopoly over the production of liquor,
- introduce unspecified export duties on raw materials,
- set 0.5% tax rate on personal property.
- set 20% tax rate on incomes from secondary employment
- ensure dividends from GOR stakes in companies are credited to federal budget,
- amend Part I of Tax Code to broaden enforcement powers of tax authorities,
- reduce exemptions on tax, customs payments.
- renegotiate agreements on tax breaks for offshore companies, free economic zones
- require a unified state taxpayer register based on taxpayer ID numbers.
- accelerate implementation of law on imputed business tax.

Monetary, exchange rate: Like previous versions, the current plan calls for a floating exchange rate system with intervention to smooth short-term fluctuations. The Central Bank is tasked with promoting exchange rate stability and will be empowered to take administrative action against banks or other entities who engage in speculative exchange rate operations.

Price policy: The plan calls for monthly inflation of 3-4% by end '98 and annual inflation of 20-30% in 1999. To control inflation, the plan calls for the GOR to regulate prices of basic goods and communal service charges (such as rent, electricity).

Banking: The plan calls for the Central Bank to take a number of steps to strengthen the banking system and increase household deposits. In addition to enumerating the broad outlines of the GOR/CBR banking sector restructuring strategy, the plan asks the Central Bank to:

- request that Duma pass law creating a Bank Restructuring Agency empowered to effect bank reorganizations or liquidations, remove inefficient management of insolvent banks.
- provide secured credit to commercial banks that have feasible plans for returning to normal operation (basis for securing credit unspecified),

Foreign trade: The plan envisions changes in hard currency surrender requirements in order to reduce capital flight and promote CBR reserve accumulation. It also seeks to facilitate importation of equipment not available from domestic producers. These measures would:

- require exporters to sell 75% of their foreign currency earnings (eliminates required sale of 25% directly to the Central Bank),
- reduce the deadline for the repatriation of export earnings (currently 180 days), with timeframe to be differentiated by commodity groups,
- provide tax/customs breaks for equipment imports.

Government Debt: The plan calls for restarting the secondary market in GKO/OFZs. (The GOR is still finalizing its plan to restructure these frozen GKO/OFZs.) A new system to monitor and manage state debt will be established and will include debts of regional administrations, enterprises, and banks.

Anti-market measures: In addition to increasing exporters' hard currency surrender requirement and introducing price controls to stem inflation, the plan calls for measures that would substantially increase state intervention in the economy. Non-market measures include:

- continued failure to address non-payments problem by increasing reliance on non-cash settlement through offsets and barter,
- instead of restructuring or closing non-viable enterprises, bundling them into large, government-controlled corporations,
- create new state development bank to direct credit flows.

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011. memo	From Mark Sobel (IMF); For the Files re: Russia - IMF Staff Briefing to Board on Latest Mission (3 pages)	11/02/98	P1/b(1) Unclass.

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Tentative Deal on GKO Restructuring 11/9/98

There appears to be an agreement on the basic terms of a ruble-only deal for GKOs, which leaves forward contracts (NDFs) to be dealt with separately. Resolution of the talks was reportedly driven by the Russian Finance Ministry which needed clarity on GKO restructuring so it could develop a 1999 budget.

Terms of the deal (with some details to be worked out):

- The value of GKOs is defined as face value discounted back from maturity date to August 19th at 50%.
- 10% in up-front cash in rubles, delivered in four quarterly installments. For foreigners, funds would flow into S-accounts and there would presumably be restrictions on converting funds to hard currency.
- 70% in 4 and 5 yr ruble bonds paying a declining coupon rate starting at 30% in yr 1 and falling to 10% in yr 5.
- 20% in a so-called "cash value instrument" which would be a 3 yr ruble zero coupon which could be used to buy capital in Russian banks or to pay tax arrears.
- The new bonds would be tradable, probably on MICEX, with restrictions. Any money foreigners earn from selling the new instruments will go into special S-accounts where it will be unavailable for conversion to hard currency for a period which has yet to be specified

Russian press reports indicate that the parties will meet the week of Nov 16th to finalize the deal. The GOR is meeting with Russian GKO holders this week.

Implications of not dealing with NDFs

NDFs will now be dealt with one of three ways:
--In bilateral talks between Russian banks and their Western creditors;
--In multilateral talks coordinated by CBR and MinFin;
--Through litigation.

While a multilateral process is certianly the prefered outcome, litigation may be number #1 option for many creditors. There apparently has already been action by Merrill (supposedly one of the doves in the negotiations) to freeze Vneshtorgbank (VTB) accounts in NY, including accounts of Russian exporters that are not even VTB's own money. Also, Lehman has apparently extracted some cash from Uneximbank in exchange for dropping its earlier suit. This perceived success could motivate other creditors to try a similar approach.

Additional legal action to seize Russian bank assets may occur after November 15th when many Sberbank and VTB forwards come due and the debt moratorium expires.

Summary of Russian Bank Restructuring
11/9/98

Overview

The CBR is meeting this week to finalize its bank restructuring plan. The latest plan contains many elements previously recommended by the World Bank and, if correctly implemented, could be a strong overall framework for revitalizing the banking sector. But the plan lacks specifics, and the IMF reports that the Russians still envision saving too many banks. The authorities may also lack the political will to eliminate the equity of politically powerful owners. Reports of CBR capital infusions to commercial banks which have not yet been audited (R14B so far since August), the recent veto of the bank bankruptcy law, and the continued functioning of insolvent banks such as SBS-Agro under current ownership, all are negative signs. CBR has put the price tag of bank restructuring at R61 billion, but it will be much higher if Russia chooses to bail out a large number of banks.

The Plan

The plan's basic features are:

- Make detailed audits of banks and divide them into four categories.
  - 1) Solvent banks (mostly smaller regional banks) which will receive some assistance;
  - 2) Solvent but illiquid banks which CBR would take over for about 3 years and help recapitalize;
  - 3) Insolvent banks that would be liquidated in the 1st half of 1999;
  - 4) Insolvent banks that are too big or socially important to fail. Deputy Central Bank Governor Kozlov described too big or socially important as a broad concept that encompasses large obligations of any kind, not just individual deposits.
- Increase bank capital with CBR bonds, debt equity swaps and foreign investment.
- Improve asset quality by transferring non-performing assets of liquidated banks to new RTC-like agency. (The plan would place this agency within the CBR which the IMF feels would set up a conflict of interest.)
- Restructure liabilities/capital by extending debt maturities, transferring deposits, and writing down original owners capital.
- Increase liquidity by allowing GKOs to be used as collateral for CBR credits.
- Increase revenues by CBR issuing higher yielding bonds.
- Cut operating costs.
- Improve supervision and introduce international accounting standards.

The process of performing outside audits of the banks, the first step to implementing any plan, is beginning but is hampered by banks' primitive and unreliable accounting. Using TA offered by the EBRD, the process of auditing large banks should take 1-2 months.

Donor Coordination

In the context of uncertainty on the status of the CBR plan, donor coordination on bank restructuring continues to be confused. We have urged the World Bank quickly to take charge of developing a framework into which TA efforts by the Bank, the Fund, the USG, the EBRD, the EU and others can be plugged. So far this has not happened, though the Bank and Fund have acknowledged their lead role. The Fund in particular feels that to ensure CBR cooperation with donor TA, the CBR should be the "official" coordinator (though the Bank/Fund will actually do the work). Unfortunately, this seems to be causing delay in getting the coordination process moving. Meanwhile the EBRD is pushing forward on its own to set up teams to audit and restructure selected banks (at the moment Inkombank and Menatep) and the EU has been holding separate meetings with the IFIs to determine where to spend its 1999 TA budget. The Bank held an initial coordination meeting in Moscow on November 5th (possibly the result of US calls for faster action), and Johannes Linn will meet with the EBRD next week to discuss cooperation.

Obstacles to effective bank restructuring

- Pressure to save oligarchs: The CBR/GOR may not have the will to eliminate current owners' capital and transfer control of large banks to new ownership. Reports in the press have quoted large bank owners as "satisfied" with the plan which implies that they think they will be bailed out rather than replaced.

- Lack of legal authority: Earlier CBR attempts to take control of SBS-Agro failed due to lawsuits in regional courts. While a new bank bankruptcy law may help in the future, Koslov has said that CBR needs special authority from the Duma to fully write down ownership capital to cover losses.

- Lack of private Russian expertise/capital: Koslov admits that there are very few untainted Russians with capital or expertise to takeover a bank and run it effectively. Foreign capital and expertise or nationalization then become the only options.

- Lack of CBR capacity to carry out the plan: CBR doesn't have the expertise to perform audits much less takeover and restructure and large number of banks. Technical assistance can help but only if CBR is willing to do the right things.

- Suspicion of foreign banks: The plan calls for greater foreign participation in the banking system, but, when pressed, officials have been vague about how much or in what form this would be allowed or whether Russia would repeal the current 12% of total bank capital limit. Some foreign investment in Russian banks may result from the GKO restructuring deal which allows new ruble bonds to be exchanged for equity in Russian banks.

Treasury Language on prospects for Russian debt restructuring

Russia clearly cannot pay all the $20B of external debt falling due through the end of 1999 and thus will either try to continue selective defaults on certain categories of its debt or it will need a broad debt restructuring. In examining ways to deal with severe debt crises such as the one in Russia, the G-22 recommended that restructuring be as inclusive as possible, covering all categories of external debt (except for the IFIs who are defacto senior creditors) on an comparable basis. For Russia, such a comprehensive debt workout would entail restructuring of official bilateral and privately held sovereign debt and private Russian bank obligations. In an ideal world, this would provide the best outcome for both Russia and its creditors. Unfortunately, several factors, including Russia's failure to develop a realistic economic plan, its fragmented and potentially uncooperative private creditor base, and the imminent prospect of litigation against Russian banks following the lifting of the debt moratorium on November 17th is likely to make this kind of orderly global solution difficult to achieve. A more limited restructuring, which could still provide needed debt relief, could be possible provided Russia develops a new economic plan and adopts a more open, cooperative approach to its creditors.

By not making payments to Paris Club creditors on debts contracted by the former USSR, Russia has secured a *de facto* partial restructuring of its debt through the accumulation of arrears. For us to agree to pursue any formal debt restructuring through the Paris Club, Russia must have agreed to a realistic economic reform strategy that can be endorsed by the IMF. This is necessary because debt service relief will only contribute to economic recovery in the context of a solid policy foundation and restructuring will only be viable if it is grounded on the ability to repay which requires a reasonable economic foundation. The current Russian economic plan does not provide a sustainable basis for recovery and thus would need to be substantially revised before any debt restructuring negotiations could begin.

With a proper policy framework in place, a debt workout program could be considered. A key principle, supported by the G-22, is that restructuring should seek parity between official and private creditors. This principle has previously been applied by the Paris Club creditors, who have insisted that commercial banks offer comparable debt relief as a condition for official debt relief. Excluding $5B in IFI debt service which should not be rescheduled, the Russian government owes the Paris Club and private creditors about $7B each through end-1999. (Overall the Russian government owes $60B in official bilateral debt and $46B to private creditors). This rough parity provides a reasonable starting point for fair burden sharing. While the Paris Club could easily shift into formal restructuring discussions, the thousands of private holders of eurobonds, London Club bonds and MinFin bonds could be difficult to organize. So far, in Russia's one attempt to engage with Western creditors, negotiations with the group of western banks on restructuring of domestic bond debt have been strained, although a partial agreement potentially has been reached. Nevertheless, this forum could be the basis for negotiating with private creditors if the Russian government truly commits to a cooperative and transparent approach to debt restructuring.

The most we can offer Russia at this stage is to consider support for Paris Club restructuring in the context of a realistic, IMF endorsed, economic program and corresponding (and comparable) restructuring of other categories of privately held sovereign debt. Restructuring of Russian bank debt to foreign banks, which may involve litigation and a more complex negotiating structure should be left to the Russians and the individual banks involved.

GOGOL'S TROIKA:

THE CASE FOR STRATEGIC PATIENCE IN A TIME OF TROUBLES

An address by Strobe Talbott, Deputy Secretary of State,
at a conference on "Russia at the End of the 20th Century,"
School of Humanities and Sciences, Stanford University,

November 6, 1998

EMBARGOED UNTIL DELIVERY, 4:30 PM PST, November 6, 1998

Text as prepared for delivery

Thank you, Bill [Perry], for that introduction and for the chance to work with you for four years. I suspect that everyone here appreciates the crucial role that you played in managing U.S.-Russian relations. Just to cite one example: it is because of Bill Perry's statesmanship that Russian officers and troops are keeping the peace in Bosnia today side-by-side with the forces of NATO.

There are lots of other friends and colleagues here, but I want to single out the mastermind and master of ceremonies of this conference, Grisha Freidin, who has been my friend and mentor for more than 25 years.

The topic that Professor Freidin has assigned to all of us for our homework, "Russia at the End of the Twentieth Century," is especially on the minds of President Clinton and Secretary Albright these days. That's for reasons that are obvious from the newspaper headlines.

But Russia is always on our minds, and that's for reasons that are reflected in history and literature. In the final passage of *Dead Souls*, Nikolai Gogol compared his homeland to a troika, hurtling across the snowy steppe, while other nations "gaze askance" and wonder, along with Gogol himself, where this wild ride is headed. A century and a half later, quite a few Russians think the answer is: straight off the edge of a cliff.

I'm here with a different answer. Is Russia a troika-wreck waiting to happen? Maybe, but not necessarily. More than other countries, Russia's future is in doubt, but that is not new. That was part of Gogol's point. Gloom and doom are no more justified now than was euphoria a few short years ago. Yes, much of what is happening in Russia is obscure; yes, some of it is ominous. But this much is clear: the drama of Russia's transformation is not over; its ending is neither imminent nor foreordained; and the stakes, for us, are huge.

As the Russians seek to work their way out of their current crisis, they will be making decisions that determine what sort of relationship they can have with the outside world for decades to come. Russia's choices will have a lot to do with what kind of world Americans live in — how safe we are, and how much we have to spend on our safety. Therefore, under two Administrations — President Clinton's and what I'll call here "the Rice Administration" — the U.S. has been committed to encourage and assist Russia in its evolution toward becoming a normal, modern, prosperous, democratic state — at peace with itself and its neighbors, a full member and beneficiary of an increasingly interdependent world community.

For the last decade or so, despite the zigs and zags, Russia has been moving in that direction. The question of the last several months is whether Russia has, in some fundamental way, shifted course, heading at break-neck speed back to the future, or over the precipice.

That question arises because of the crisis, largely though not wholly self-inflicted, that has befallen the economy. Less than a year ago, Russia seemed to be poised for an economic take-off. But then internal weaknesses combined with outrageous fortune, especially the worldwide fall in commodity prices, to stampede the government into the devaluation of the ruble and a partial default on many of its debts. In a matter of a few weeks this past summer, Russians saw much of their savings evaporate, many of their banks go belly-up, the bottom fall out of their fledgling stock market, goods disappear from stores, and a burgeoning middle class sent reeling.

Even before Black Monday, August 17, and the crash that followed,the mood had already changed dramatically in ways that are captured by several of the papers that have been presented at this conference. For example, what Peter Holquist calls "Soviet exceptionalism" had long since given way, first, to post-Soviet relief, then to post-post-Soviet letdown — to reform fatigue on the part of the élite and to a backlash against reform on the part of the citizenry.

Another participant in the conference, Natalya Ivanova, has referred to the late '80s and the '90s as *smutnye* (dark and troubled) years. They were also, of course, *chudyesnye* (a time of miracles). They were the years when Russia won for itself unprecedented economic and political freedom — and when Russia liberated its former satellites and fellow inmates in the prison house of nations. But Dr. Ivanova is right about the perceptions, disappointments and anxieties of many Russians today.

Language itself has been turned on its head. As the '90s unfolded, "reform" and "market" went from being part of the vocabulary of triumph and hope to being, in the ears of many Russians, almost four-letter words. The noun *kapitalizm* came increasingly to be modified with the adjective *dikyi* (savage). Accordingly, "the West" went from being an object of emulation to a target of resentment. In the meantime, another word, "left," has come back into fashion. The Communist Party of the Russian Federation and its parliamentary allies have called for a "return" to a compassionate, paternalistic and pervasive state that looks out for workers, soldiers and pensioners.

The composition of Russia's new government, led by Prime Minister Primakov, is representative of this mood and of these trends. It has largely rejected what its officials call the "Western" way of managing their economy; they are groping for a "Russian" way instead.

Oksana Bulgakowa's paper explains what the Russian way means in architecture: phantasmagoric knockoffs of Stalinist monuments, czarist palaces and pre-Christian temples, appealing to nostalgia for a supposedly simpler, nobler past. But what does the Russian way mean in economics? Part of the answer is paying wages and pensions and reviving the industrial sector, which are sensible, indeed indispensable goals. Our concern is that, in trying to reach those goals, the Primakov team is prepared to abandon a stable currency, a viable exchange rate and a sound monetary policy. It is operating with neither a realistic budget nor a credible system for collecting taxes. That means Russia is at the mercy of the printing press, cranking out rubles to meet payrolls and keep bankrupt enterprises afloat.

The point here is that the economic rules that the custodians of the Russian economy are threatening to defy are not so much "Western" as they are a matter of simple arithmetic. Since the numbers don't add up, the intended remedies only aggravate the disease. Inflation is almost 50% higher than it was a year ago; many Russian banks are unable to meet the repayment obligations on their outstanding loans; billions of dollars in capital have fled the country since August.

There is another consequence, too: It has become all but impossible for the International Monetary Fund to weigh in with macroeconomic stabilization funds that might help in arresting and reversing the slide. Money from outside will do no good if it is inflated away or if it pauses only briefly in Russia before ending up in Swiss bank accounts and Riviera real estate.

Without external support, it is likely that the Russian government will face three disagreeable choices: 1) crank the printing presses even faster, 2) plunge deeper into default, or 3) stop paying wages and pensions and conducting basic government functions. Whatever combination of these measures the government adopts, Russia's economic situation is likely to deteriorate further.

Economic decline carries with it the danger of political drift, turmoil, and even crackup.

Why is Russia in this situation? Part of the answer is the drag of recent history. Russia's 74-year experiment with Communism is like a black hole: the Soviet system imploded eight years ago, yet this dead star, even though it emits no light, still exerts a powerful gravitational pull that threatens to suck Russia backward and inward.

But that is by no means all that is happening in Russia today. Political and economic culture are not immutable; they're not like astrophysics; the dynamics by which they operate can change — and change for the better. Over time, the tug of the Soviet experience will weaken.

That process will take a generation or more, not least because part of the process is, precisely, *generational*. There is an irony here: because the disintegration of the Soviet system was remarkably peaceful, many of those who had been vested in, and responsible for, the old order are now shaping the new one. That's the bad news, reflected in the dismal economic statistics. The good news is in the actuarial tables. The young have certain advantages over the old in the struggle for over future.

Another factor shaping and guiding Russia is globalization. That country today is part of the world to an extent and in a way that it never was in the past. Russia's susceptibility to the Asian contagion has been a reminder of the downside of globalization. But there is an upside too: counteracting the old temptations of autarky and regression are new and powerful forces pulling Russia outward and forward, toward integration, not just integration with the global marketplace but also with what Manuel Castells and Emma Kiselyova describe, in their paper, as the global "network society." Literally and figuratively, Russia is now plugged into the rest of the world, through cellular telephones, fax machines, modems and PC's.

This trend has been under way for some time. In the '70s and '80s, Russia was Exhibit A for the proposition that George Orwell's nightmare vision for 1984 was wrong: the communications revolution weakened Big Brother rather than strengthening him. The quantum leap in the number of Russians who travel abroad and surf the Internet may yet turn out to be what Professor Castells and Dr. Kiselyova call "the dynamic core" of Russian modernization and thus constitute a hedge against the old Big Brother's ever making a comeback.

Because it has occurred against this backdrop, democratization has taken hold surprisingly quickly and proved remarkably durable. The Primakov government came into being because President Yeltsin and the Parliament played by the rules of a post-Soviet constitution that was approved by popular referendum. That is not, to put it mildly, the way Russian politics worked in the past. Russians of almost all stripes seem to cherish their new freedom and responsibility to vote freely, fairly and often; many are suspicious of grand schemes that feature an all-powerful state as the panacea to their problems.

Still, it is too early to proclaim Russian democratization irreversible. The longer the economic meltdown continues and the more serious it becomes, the harder it will be for Russia to sustain and consolidate the various institutions and habits of what might be called political normalcy: constitutionalism, give-and-take compromises, constituency politics, coalition building, all of which need for their sustenance an atmosphere of pluralism, vigorous public debate and open media.

Therefore the principal point of suspense today is whether the new cooperation between the executive and legislative branches will prove, over time, conducive to more rationality and common sense in the economic sphere.

By the same token, depending on how far and for how long the pendulum swings to the left, Russian foreign and defense policies could also come under the sway of nationalism in its more contentious, self-delusional and self-isolating form — call it post-Soviet exceptionalism. As Russia asserts its own special needs and distances itself from the West on the economic front, we may be in for heightened tensions over security and diplomatic issues.

But, friends and colleagues, so far that has not happened. The United States and Russia today are still cooperating far more than we are competing; we are still agreeing more than we are disagreeing. And where we disagree, we are, by and large, managing our disagreements.

Whether that continuity can be sustained will depend in part on whether Prime Minister Primakov and Foreign Minister Ivanov let the policy preferences of a dyspeptic Duma and an often combative élite greatly influence the work of that Stalin-gothic skyscraper that houses the Foreign Ministry on Smolenskaya Square, where Mr. Primakov himself worked until September 11.

The pressure is likely to mount. The mood in the Duma is bilious. Many parliamentary deputies depict the unresolved issues between the U.S. and Russia in terms of concessions that we Americans are supposedly trying to extract from them or as favors we are asking them to do for us.

Nothing could be further from the truth. Virtually every issue between us can be boiled down to a matter of mutual interest and mutual benefit. Russia needs an effective non-proliferation regime since Russian cities would be vulnerable if its most dangerous technology ends up in the wrong hands. Russia needs strategic arms reduction since it cannot afford to maintain its arsenal at Cold War levels. And Russia definitely needs a collaborative relationship with Europe, including with NATO and the European Union.

Peter Holquist's paper describes how the Soviet experience deepened Russia's sense of not really belonging to Europe. Post-Soviet Russia has already gone a long way toward joining the European mainstream. It is now a member of the G-8; the Council of Europe, the Arctic Council, the Council of Baltic Sea States, the Permanent Joint Council created by the NATO-Russia Founding Act and the Contact Group on the Balkans.

To its credit and benefit — and to ours as well — Russia has gone from being a spoiler to a joiner.

However, whether this trend in Russian foreign policy continues is also a matter of some suspense. How Russia defines its role in the world and its relations with other states will depend crucially on how it defines itself and its own statehood.

My friend and former colleague Chip Blacker led a discussion on this topic earlier today. On that panel, Sergei Kortunov raised what in some ways is *vopros voprosov*, the question of questions: what is Russia's national identity? Gogol was grappling with the same question in *Dead Souls*. The quandary has become even more acute and vexing since the end of the Soviet period of Russian history, when many Russians felt that their Motherland was, virtually overnight, deprived of its name, its flag, nearly half of its territory, its defining ideology, its governing structure and its protective alliance.

So what is the *idea* of Russia today? As Sergei makes clear, it's easier to answer that question in the negative than in the positive. "The new Russia," he says, "is not the Soviet Union; nor is she the old Russian empire." Rather, "Russia's new borders, possibilities, culture, civilization, inner development have all contributed to making Russia a new state."

Yes, but what *kind* of a new state? I gather Chip & Company reached a consensus around another negative answer: whatever Russia becomes, it will never again be a monolith, in which political power flows rigidly from the top down and from the center outward. I agree. That particular Humpty-Dumpty can't be put together again. Russia today is a crazy-quilt of regions with wildly different economic and political structures. Some parts of the country are, at least relatively speaking, oases of liberalization. For example, Novgorod, Nizhny Novgorod, Samara, Leningrad and Sverdlovsk oblasts. Others remain Jurassic-like theme parks of Soviet-era policies and personalities. To wit: Kursk, Krasnodar, Belgorod, Pskov, Volgograd. A few are simply weird, like Kalmykia, where President Ilyuzhimov reigns as a kind of Wizard of Oz. Emil Pain's paper describes regionalization run amok in his Scenario 4.

The new Russia, like its predecessor the Soviet Republic, calls itself a Federation. But the term "federation" is like "reform" and "market": Russia has yet to define what it means. Grisha Freidin could help. Indeed, he *has* helped: in 1990, he translated into Russian and distributed, under the imprint Chalidze publications, this little blue book: *The Federalist Papers*. It offers a home truth that is simple, that is global, and that is more valid at the end of the 20th century than it was when Hamilton, Madison and Jay were writing their essays at the end of the 18th: a successful state — especially one that stretches the length of Eurasia — must make its diversity a source of strength; it must foster governance on a scale that allows citizens to feel connected to decisions that affect their lives.

American diplomacy recognizes the devolution of power downward from the top and outward from Moscow. Our ambassador in Moscow, Jim Collins, and his colleagues make a point of fanning out around the country, working with grass-roots organizations, developing relations with Russia's governors and mayors (more than 100 of whom are 35 or younger). We'll do everything we can, despite budgetary stringencies, to make the most of our three regional outposts — the consulate-generals in St. Petersburg, Yekatrinburg and Vladivostok.

Mr. Primakov is also reaching out to the regions. In his speech to the Duma the day he was confirmed as Prime Minister, he said that his priority was *yedinstvo* — the unity of Russia — thus clearly implying that the matter is in some doubt, even in some jeopardy. For many Russians, angst about their future is compounded by suspicion about the U.S.'s strategic intentions. The Russian press has carried numerous articles suggesting that under the guise of "partnership," the U.S. is pursuing a hidden agenda not only to keep Russia weak but to bring about its fragmentation.

Once again, nothing could be further from the truth. The U.S. supports a unitary Russian state, within its current borders. The violent breakup of Russia would be immensely dangerous and destabilizing. When Czechoslovakia split in two in 1992, it was called the velvet divorce. But multiple divorces among, and perhaps within, the 89 regional entities of Russia would almost certainly not be velvet. The horror that has unfolded over the past several years in the Balkans might be replayed across eleven times zones, with 30,000 nuclear weapons in the mix.

This afternoon Emil Páin argued that that apocalyptic danger has receded. We must certainly hope so. The ability of Mr. Primakov and his successors to preserve unity will depend in no small measure on two issues. One is how they handle the economy in general and the ruble in particular. A nation's currency is a key manifestation and underpinning of its sovereignty — and its unity. This century has already shown that hyperinflation can destroy states, or turn them into monsters.

The other defining issue for Russia's *gosudarstvennost'* — the coherence and viability of its sense of its own statehood — is how its leaders, now and in the future, handle relations with their immediate neighbors. As has often been the case when empires dissolve, the ethnographic map — in this case, of "post-Soviet space" — does not coincide with the new political one. Many members of the Russian elite feel the loss of empire like a phantom pain in a lost limb, not least because the dissolution of the USSR stranded twenty-five million fellow ethnic Russians on the far side of what became, eight years ago, international borders. Those Russians now outside of Russia rightfully want to be full citizens of their newly sovereign homelands. Any grievances they have, legitimate or otherwise, play into the hands of ultra-nationalists back in Russia. That is one of many reasons why we have advocated the adoption of citizenship laws in the Baltic states that meet international norms of inclusive, multi-ethnic democracy.

By and large, Russia has kept irredentist impulses largely in check. Not long after the breakup of the USSR, President Yeltsin made an historic decision: he affirmed the old inter-republic borders as the new international ones. He has, at several key points, repudiated the more bellicose claims of his noisier opponents.

But just because Russia has been relatively restrained to date does not mean it will be so forever. Mr. Pain warns in his paper that the threat to Russia's future, and indeed to its integrity as a state, comes not from secessionism on the part of its own ethnic minorities — Chechens, Tatars, Yakuts, Chukchis, Kalmyks, Ingush, Ossetians, Mordovians — but from what he calls "maniacal great-power chauvinism… xenophobia and national close-mindedness" on the part of some forces within the Russian majority. He is referring to Russians who would like to make expansionist or annexationist common cause with Russian *minorities* in the so-called "near abroad." He singles out Crimea, northern Kazakhstan and Transnistria, in Moldova, as the flash points.

Georgia might be added to the list, not because of the Russian minority there (which is small), but because of a temptation on the part of some in Russia to fish for geopolitical advantage in the troubled waters of Georgian ethnic disputes and political vendettas. The short-sightedness of this sort of mischief-making is a lesson Russia should already have learned. In 1993, Russia fanned the flames of the Abkhazian secessionist movement, only to find that sparks from that conflict jumped from the Southern Caucasus to the Northern Caucasus, contributing to what became the conflagration in Chechnya.

On the positive side of the ledger, in the last couple of years Russia has begun cooperating more with the United Nations and the Organization for Security and Cooperation in Europe in the quest for peaceful settlements in the various civil wars, secessionist struggles and ethnic conflicts in the South Caucasus and Central Asia.

Still, anxieties among Russia's neighbors about how Moscow will handle its relations with them have only grown in the last several months, now that some of the more nationalistic elements in the Duma have become partners-in-power with the executive branch. There is more skepticism than ever among the non-Russian member states of the Commonwealth of Independent States about the future of that organization. Whether it survives and prospers will depend in large measure on whether it evolves in a way that vindicates the name. If its largest member tries to make "commonwealth" into a euphemism for a sphere of influence or an infringement on the independence of its neighbors — then the CIS will deserve to join that other set of initials, USSR, on the ash heap of history.

U.S. policy will continue to focus not just on Russia but on its neighbors as well. We want to see all the new independent states of the former Soviet Union survive, and thrive, to become *old* independent states, just as we want to see Russia's own full integration into what might be called the *global* commonwealth of genuinely independent, mutually respectful states.

A final point — not so much about Russia as about the American view of Russia. Part of Russia's problem is, as Gogol put it, that the rest of the world "gazes askance" at what is happening there. The image of Russia in the mind of America is increasingly ugly. It has become a cliché of Hollywood to depict Russia not just as a failed state but as a criminal one. Here are just a few examples: "Crimson Tide," "The Jackal," "The Saint," "Goldeneye," "The Peacemaker," "Air Force One," "Ronin," even "Blues Brothers 2000." In every one, Central Casting has provided as villains Russian mafiosi, renegade generals and former KGBniks, usually trafficking in loose nukes and dirty money.

This image of feral Russia on the silver screen is mirrored in adventure comic books, on op-ed pages, in fire-and-brimstone statements on the floor of Congress and at conferences of academics and think-tank experts. According to a new conventional wisdom, *smutnoye vremya* — the Time of Troubles — is Russia's natural state; the phenomenon we have witnessed over the last dozen years — what we, and many Russians, rightly celebrated as Russia's winning for itself economic and political freedom and liberating its former satellites and fellow inmates in the prison house of nations — now looks like a false spring in the midst of the endless Russian winter. Russians, it is often implied, are destined to live in a Hobbesian state of nature, exiled by the twin curses of history and geography from the civil society envisioned by John Locke; a predisposition to authoritarian rule at home and aggressive behavior abroad is encoded in their genes.

This kind of strategic pessimism, if it were to be the basis of U.S. policy, would lead, at a minimum, to disengagement with Russia — a time-out, a pull-back, a heavy dose of benign neglect. The Russians are so cranky and confused, it is suggested, that perhaps we should give them a breathing space — a *peredyshka* — even if they use it to drive Gogol's troika right off the edge of that cliff.

Some serious commentators and political figures go a step further, suggesting that it is time to dust off that old bumper sticker that summarized U.S. policy toward Russia for nearly five decades: containment. I've even heard the word "quarantine" suggested as the most prudent way to deal with what ails Russia.

This bleak view of Russia's future is, at a minimum, premature. It may turn out to be dead wrong. Or, perversely, we could make it come true, since if we write Russia off and brace ourselves for a new Cold War, our pessimism could become self-fulfilling. Russia will make its own choices and often its own mistakes, but it will make both in no small measure in response to us.

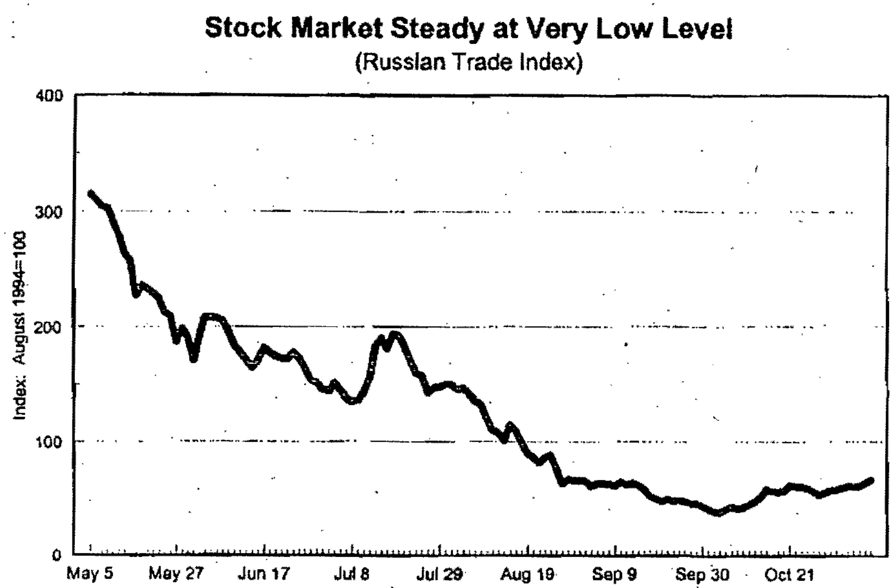
The alternative to strategic pessimism is not so much optimism, which assumes a happy ending, as it is realism about the complexity of the challenges and the uncertainty Russia faces. That is a mindset that assumes nothing, that does not prejudge the future, that is ready for anything, not just the worst. The policy that flows from realism is one of strategic patience and persistence. That means continuing engagement. Even though international macroeconomic support of the kind that we provide through the IMF must wait until the Russian government shows itself willing and able to make the difficult structural adjustments necessary for recovery and growth, we will stay engaged in four key areas:

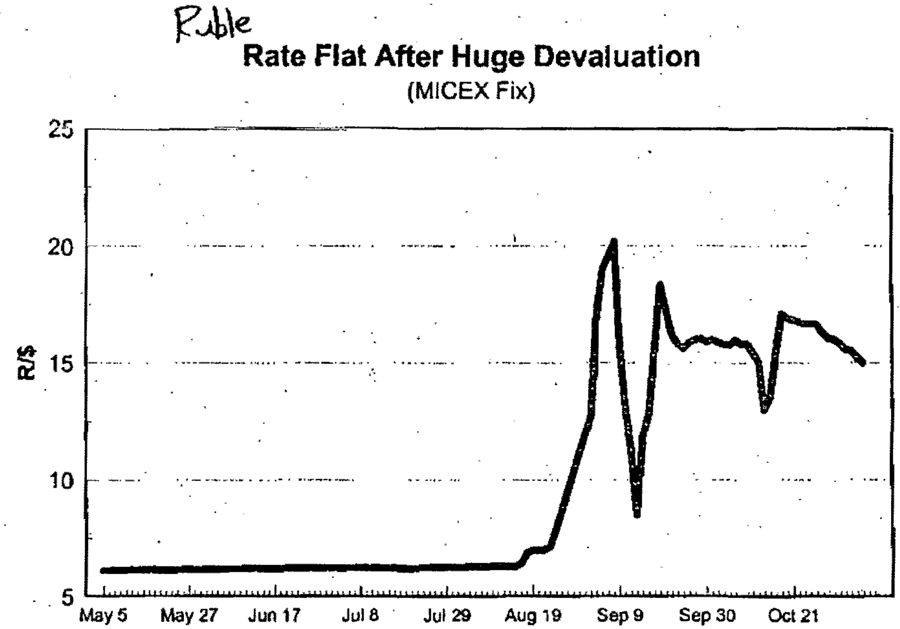
- **THE BANKING SECTOR.** The silver lining of the collapse of the banking system is that it has created an opportunity to create real banks that do real business, rather than just engage in speculation and arbitrage.
- **THE ENERGY SECTOR.** Russia will need close to $15 billion a year invested in its energy sector for each of the next seven or eight years just to get back to 1988 production levels. Western energy companies want in. But they will not invest in long-term projects unless the tax regime is clear, property rights are secure and they can take disputes to international arbitration. Russia knows the laws it needs to pass. And now is the time when Russian oil companies need to make clear to their legislators that foreign investment is not selling the patrimony, but preserving it from destruction.
- **FOOD.** Russia's bad luck over the past year included the worst grain harvest in 45 years. Despite large stocks from last year, it could use up all current food supplies by the end of the winter. The far north and the east will be hard hit, as will vulnerable groups in big cities who cannot afford to pay high prices. We have told the Russians that we are willing to help, and we are discussing the options. The key factor in whether we go forward is whether the Russians have a clear strategy for distribution and accountability, and we get incontrovertible assurances exempting any food assistance we provide from customs and taxes.
- **EXCHANGES AND NON-GOVERNMENTAL ORGANIZATIONS.** These are people-to-people programs designed to broaden the base of support in Russia for open society and rule of law. We will keep using some of the money available to us under the FREEDOM Support Act to bring local politicians, entrepreneurs and NGO representatives to the U.S. on exchanges, and to strengthen regional development. We will also continue to encourage Russia's participation in the global network society through programs like our Internet Access and Training Program, which connects libraries, universities and schools across Russia with each other and with counterpart institutions around the world.
- **COOPERATIVE THREAT REDUCTION.** The U.S. is safer today because of the investment we have made in our own security through initiatives like the Nunn-Lugar program, which helps Russia dismantle its most lethal weapons in accord with treaties like START I and the Chemical Weapons Convention. We will continue to work with the Russians to help them meet the financial costs of compliance with international arms-control and non-proliferation agreements.

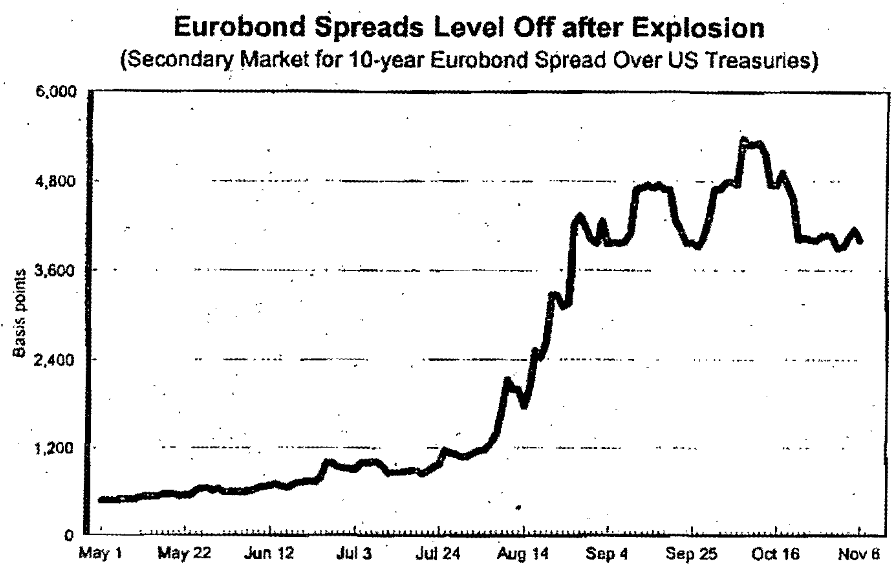
By remaining engaged with Russia on all of these critical fronts in the months ahead, we will be demonstrating to the Russian government and the Russian people our determination not to give up on them, even — perhaps even especially — in a time of troubles; we will keep plugging away at the task of supporting the many passengers in Gogol's troika who long to live in what they call "a civilized country." Their aspirations and their eventual answer to the question of questions may yet coincide with our own long-term interests.

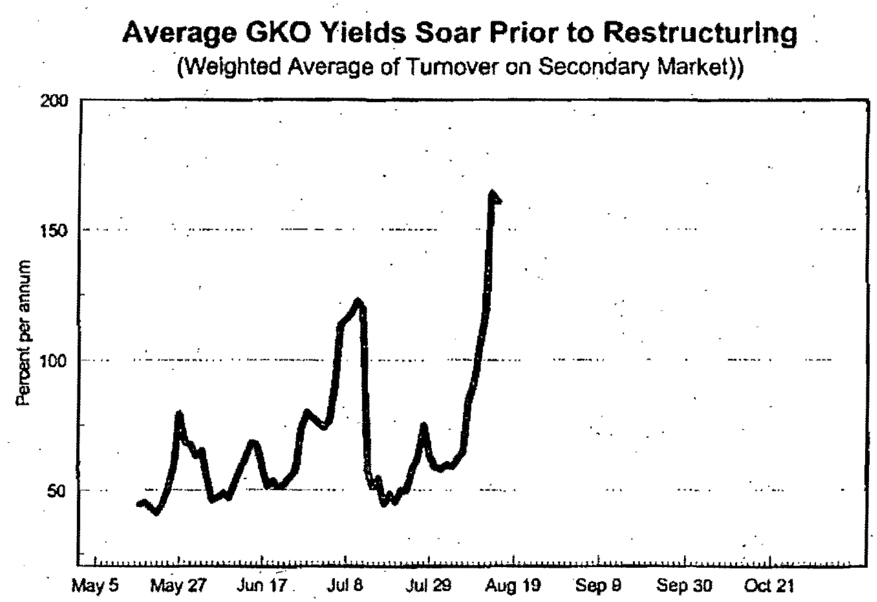
That outcome is far from a certainty, but it is not an impossible dream either. Rather it is a possibility that we must, for our sake as well as theirs, do everything we can to keep alive.

Recent Russian Economic Trends









From: Sheryl Sandberg
To: fromanm, comstockn
Date: 12/10/98 3:03pm
Subject: LS from Russia

Larry called from Russia. He had 3 thoughts to pass on to the Secretary. (Mike/Neal - please pass on.)

1. He has seen no evidence to counter the proposition that some problems don't have answers.
2. As he listened to two 45 minute lectures via translation, he thought about how much the Secretary would be enjoying this trip if he had gone.
3. He has heard a range of views, but relative to what he thought when he left, Larry believes that giving them money is less of a good idea and some kind of debt restructuring is more of a good idea.

CC: geithnert

1998-SE-014142

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

December 16, 1998

MEMORANDUM FOR SECRETARY RUBIN

FROM: **Ted Truman** EMT

SUBJECT: **Approach on Russia**

You asked in your comment to David Bloom over the past weekend on the "hot issues" of December 4, what is our recommended approach to Russia on our then forthcoming trip. Meanwhile, we have been there and back, and you have seen Larry's and my report on the visit.

The attached "economic message" is the script that Nancy Lee and I worked out, under Larry's guidance, in advance of our trip as a basis for Larry's various presentations. He drew upon most of it over the course of our meetings, but rarely did he have the time to discuss it in full. Moreover, as we progressed through our meetings the focus narrowed once again to the budget to the exclusion of the important microeconomic and structural issues.

Attachment

cc: Deputy Secretary Summers, Medish & Lee

Withdrawal/Redaction Marker
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
012. talking points	re: Russia - Economic Message (6 pages)	circa Dec. 1998	P5

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b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

March 4, 1999

ASSISTANT SECRETARY

MEMORANDUM FOR DEPUTY SECRETARY SUMMERS

FROM: Ted Truman
Assistant Secretary (International)

SUBJECT: Scenarios for a small 15 month IMF program for Russia

Overview

You asked for analysis of a possible minimalist IMF program that, along with significant debt restructuring, could get Russia through the next scheduled presidential election in June 2000. By our calculation, if Russia receives a full rollover of its IMF debt from April 1999 to June 2000 and defaults on or reschedules its other external debt obligations other than Eurobonds (scenario 1), only a small primary surplus of 0.1% of GDP in 1999 is required to keep price and exchange rate changes within acceptable bounds. If Eurobonds are also included in the restructuring (scenario 2), Russia could run a small primary deficit of 0.8% of GDP in 1999.

The IMF now estimates that the baseline 1999 Russian budget will produce a primary deficit of 2.2% of GDP. The primary balance has actually moved further into deficit in the last few weeks because of decisions to eliminate the export tax on gas, lower gas excise taxes and suspend the oil export tax due to a decline in oil prices. The IMF also doubts that the GOR will be able to cut non-interest spending in real terms by 35%. The bottom line is that, in the context of an IFI rollover program and assuming payment of Eurobonds, Russia will need to produce additional measures leading to fiscal adjustment of 2.3% of GDP to keep y/y inflation around 50% and the ruble in the 30-35/$ range.

Assumptions

Monetary/Exchange Rate[1]:

- CBR Finance: R40B in 1999, R26B in 2000 (0.9% of GDP) (See table)
- Inflation: For 1999, assume current IMF estimates of 50% y/y, 102% annual average. For 2000, assume 30% within period, reflecting continued fiscal weakness.
- Average exchange rate: R30/$ in 1999; R35/$ in first half of 2000.

[1] The assumptions on monetization of the deficit, inflation and the exchange rate follow those in the IMF's latest budget analysis.

Financing

The tables assume a full IMF rollover package of $4.1B in 1999 and $2.1B in the first half of 2000 consisting of a combination of CCFF and Standby funding. Another option would be a smaller IFI package consisting only of CCFF funding which could be a maximum of $2.4B in 1999 (30% of quota). However, given the inverse relationship between the size of the IMF program and the required primary surplus, this option sets up a somewhat unrealistic scenario where greater adjustment equates to a lower IMF package.

IBRD structural adjustment lending is assumed at $400M in 1999, a relatively low estimate which takes into account the lack of progress in recent GOR-World Bank talks on structural lending, the need for a track record before any significant disbursements are made, and the difficulty of enacting major structural reforms during an election cycle. The pace of IBRD disbursement is assumed to increase modestly in 2000. IBRD financing is assumed to trigger $700M in linked JExim funding in 1999, with the remaining $400M in committed JExim funds disbursed in 2000.

On domestic financing, the scenarios account for the expected costs of the GKO restructuring and assume zero new domestic debt issuance in 1999, with a small amount (R10B) of new domestic debt in the first half of 2000.

Debt Repayment

In scenario 1, we assume that Russia defaults on or reschedules all external debt other than obligations to the IFIs and Eurobond interest. 1999 Eurobond interest is roughly 1% of GDP. Scenario 2, which includes Eurobonds in debt rescheduling, lowers the required primary surplus in 1999 by 0.8% of GDP, given that Russia has already paid $300M in 1999 Eurobond interest.

The IMF disbursement presumably would be credited directly to Russia's IMF obligations.

Note on primary balances

There is a significant difference between the required primary balance in 1999 and 2000. In scenario 1, it is +0.1% of GDP in 1999 vs. -1.6% of GDP in 2000. This is due primarily to the reduced costs of domestic debt restructuring in 2000. Given this discrepancy, we could opt for a more front-loaded IMF program that would allow for a more level deficit path. If $0.9B of IMF funding is shifted from the first half of 2000 to 1999, the 15 month primary deficit could be equalized (at 0.6% of GDP in scenario 1 or 1.4% of GDP in scenario 2). This would require providing some IMF funds to Russia above and beyond what Russia owes in 1999.

cc: U/S Geithner

IMF Program Scenario 1: Pay IFIs (-SRF), Eurobonds/Full IFI Refinance

	1999			H1 2000			15 MONTH PROGRAM (TOTAL)		
	inflation: 102% annual average (50% within period) -7% GDP growth exchange rate: R30/$			30% inflation 0% GDP growth R35/$					
	R billion	$billion	%/GDP	R billion	$billion	%/GDP	R billion	$billion	%/GDP
Primary Balance:	**3.8**	**0.1**	**0.1%**	**-47.6**	**-1.4**	**-1.6%**	**-43.7**	**-1.2**	**-0.6%**
Adjustment from current '99 budget (1)	105.0	3.5	2.3%						
Financing Inflows:	**117.6**	**3.9**	**2.6%**	**83.6**	**2.4**	**2.8%**	**201.2**	**6.3**	**2.7%**
Foreign	**43.8**	**1.5**	**1.0%**	**25.6**	**0.7**	**0.9%**	**69.4**	**2.2**	**0.9%**
IBRD/EBRD projects (2)	10.8	0.4	0.2%	6.3	0.2	0.2%	17.1	0.5	0.2%
Tied export credits	33.0	1.1	0.7%	19.3	0.6	0.6%	52.3	1.7	0.7%
Domestic (3)	**33.8**	**1.1**	**0.7%**	**32.0**	**0.9**	**1.1%**	**65.8**	**2.0**	**0.9%**
New GKO/OFZ	0.0	0.0	0.0%	10.0	0.3	0.3%	10.0	0.3	0.1%
Gold sales	10.8	0.4	0.2%	7.0	0.2	0.2%	17.8	0.6	0.2%
Privatization	23.1	0.8	0.5%	15.0	0.4	0.5%	38.1	1.2	0.5%
Planned CBR credit (4)	40.0	1.3	0.9%	26.0	0.7	0.9%	66.0	2.1	0.9%
Financing Outflows:	**277.5**	**9.2**	**6.0%**	**134.0**	**3.8**	**4.5%**	**411.5**	**13.1**	**5.4%**
Domestic Debt (5)	87.9	2.9	1.9%	22.0	0.6	0.7%	109.9	3.6	1.4%
Interest	66.9	2.2	1.5%	22.0	0.6	0.7%	88.9	2.9	1.2%
Principal	21.0	0.7	0.5%	0.0	0.0	0.0%	21.0	0.7	0.3%
FX Debt Service:	**189.6**	**6.3**	**4.1%**	**112.0**	**3.2**	**3.7%**	**301.6**	**9.5**	**4.0%**
IMF	123.9	4.1	2.7%	73.5	2.1	2.5%	197.4	6.2	2.6%
IBRD/EBRD	17.7	0.6	0.4%	10.5	0.3	0.4%	28.2	0.9	0.4%
Eurobond interest	48.0	1.6	1.0%	28.0	0.8	0.9%	76.0	2.4	1.0%
IFI Program:	**156.0**	**5.2**	**3.4%**	**98.0**	**2.8**	**3.3%**	**254.0**	**8.0**	**3.3%**
IMF (6)	123.0	4.1	2.7%	73.5	2.1	2.5%	196.5	6.2	2.6%
IBRD adjustment	12.0	0.4	0.3%	10.5	0.3	0.4%	22.5	0.7	0.3%
JExim (7)	21.0	0.7	0.5%	14.0	0.4	0.5%	35.0	1.1	0.5%

(1) Latest IMF estimate of primary balance resulting from current GOR measures is -2.2% of GDP.
(2) Based on World Bank staff estimate of disbursements of $20-40 million per month under current, low-case lending scenario.
(3) Based on GOR'99 plans, with gold and privatization adjusted for inflation.
(4) Current IMF working assumption for'99 CBR net credit to government = R40 billion. H1'00 = 1999 net credit as a % of GDP.
(5) For '99, consists of costs associated with GKO restructuring as provided for in '99 budget.
(6) Combination of CCFF and Standby arrangement. Maximum CCFF in 1999 would be $2.4B (30% of quota).
(7) In '99, level assumed in GOR budget. In H1'00, balance of committed funds.
(8) Current IMF estimate for '99 GDP = R4600 billion. GDP for H1'00 is estimated to be R2990 billion, equal to one half of: 99 IMF GDP projection of R4600 billion, assumed 0% GDP growth, and 30% annual average inflation.

IMF Program Scenario 2: Pay IFIs (-SRF)/Full IFI Refinance (Do not pay future Eurobond interest)

	1999			H1 2000			15 MONTH PROGRAM (TOTAL)		
	inflation: 102% annual average (50% within period) -7% GDP growth exchange rate: R30/$			30% inflation 0% GDP growth R35/$					
	R billion	$billion	%/GDP	R billion	$billion	%/GDP	R billion	$billion	%/GDP
Primary Balance:	**-35.2**	**-1.2**	**-0.8%**	**-75.6**	**-2.2**	**-2.5%**	**-110.7**	**-3.3**	**-1.5%**
Adjustment from current '99 budget (1)	66.0	2.2	1.4%						
Financing Inflows:	**117.6**	**3.9**	**2.6%**	**83.6**	**2.4**	**2.8%**	**201.2**	**6.3**	**2.7%**
Foreign	**43.8**	**1.5**	**1.0%**	**25.6**	**0.7**	**0.9%**	**69.4**	**2.2**	**0.9%**
IBRD/EBRD projects (2)	10.8	0.4	0.2%	6.3	0.2	0.2%	17.1	0.5	0.2%
Tied export credits	33.0	1.1	0.7%	19.3	0.6	0.6%	52.3	1.7	0.7%
Domestic (3)	**33.8**	**1.1**	**0.7%**	**32.0**	**0.9**	**1.1%**	**65.8**	**2.0**	**0.9%**
New GKO/OFZ	0.0	0.0	0.0%	10.0	0.3	0.3%	10.0	0.3	0.1%
Gold sales	10.8	0.4	0.2%	7.0	0.2	0.2%	17.8	0.6	0.2%
Privatization	23.1	0.8	0.5%	15.0	0.4	0.5%	38.1	1.2	0.5%
Planned CBR credit (4)	40.0	1.3	0.9%	26.0	0.7	0.9%	66.0	2.1	0.9%
Financing Outflows:	**238.5**	**7.9**	**5.2%**	**106.0**	**3.0**	**3.5%**	**344.5**	**11.0**	**4.5%**
Domestic Debt (5)	87.9	2.9	1.9%	22.0	0.6	0.7%	109.9	3.6	1.4%
Interest	66.9	2.2	1.5%	22.0	0.6	0.7%	88.9	2.9	1.2%
Principal	21.0	0.7	0.5%	0.0	0.0	0.0%	21.0	0.7	0.3%
FX Debt Service:	**150.6**	**5.0**	**3.3%**	**84.0**	**2.4**	**2.8%**	**234.6**	**7.4**	**3.1%**
IMF	123.9	4.1	2.7%	73.5	2.1	2.5%	197.4	6.2	2.6%
IBRD/EBRD	17.7	0.6	0.4%	10.5	0.3	0.4%	28.2	0.9	0.4%
Eurobond interest	9.0	0.3	0.2%	0.0	0.0	0.0%	9.0	0.3	0.1%
IFI Program:	**156.0**	**5.2**	**3.4%**	**98.0**	**2.8**	**3.3%**	**254.0**	**8.0**	**3.3%**
IMF (6)	123.0	4.1	2.7%	73.5	2.1	2.5%	196.5	6.2	2.6%
IBRD adjustment	12.0	0.4	0.3%	10.5	0.3	0.4%	22.5	0.7	0.3%
JExim (7)	21.0	0.7	0.5%	14.0	0.4	0.5%	35.0	1.1	0.5%

(1) Latest IMF estimate of primary balance resulting from current GOR measures is -2.2% of GDP.
(2) Based on World Bank staff estimate of disbursements of $20-40 million per month under current, low-case lending scenario.
(3) Based on GOR'99 plans, with gold and privatization adjusted for inflation.
(4) Current IMF working assumption for'99 CBR net credit to government = R40 billion. H1'00 = 1999 net credit as a % of GDP.
(5) For '99, consists of costs associated with GKO restructuring as provided for in '99 budget.
(6) Combination of CCFF and Standby arrangement. Maximum CCFF in 1999 would be $2.4B (30% of quota).
(7) In '99, level assumed in GOR budget. In H1'00, balance of committed funds.
(8) Current IMF estimate for '99 GDP = R4600 billion. GDP for H1'00 is estimated to be R2990 billion, equal to one half of: 99 IMF GDP projection of R4600 billion, assumed 0% GDP growth, and 30% annual average inflation.

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