Précis

OED

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Assisting Russia's Transition: An Unprecendented Challenge

The Country Assistance Evaluation (CAE) for Russia, covering the period from 1992 to 2001, showed disappointing but improving results for the World Bank's activities in the Russian Federation. Although OED rated the outcome of World Bank assistance to Russia as unsatisfactory during 1992-1998, with only a modest impact on institutional development, for the period 1998-2001 it rated the outcome satisfactory and institutional development impact substantial.

The Russia CAE found that an assistance strategy oriented around analytical and advisory services (AAA) with limited financial support for Russia would have been more appropriate than one involving large volumes of adjustment lending, since such lending in 1996-97 may have delayed rather than accelerated needed reforms. Disbursements should have rewarded actions rather than promises. In support of its overall outcome rating through June 1998, OED highlighted the large size of quick-disbursing and investment loans with unsatisfactory outcomes. It noted that research and evaluation findings confirmed that large amounts of lending could not be relied upon to ensure country ownership.

A Decade of Rapid Political and Economic Transformation

When it joined the Bank in June 1992, soon after the dissolution of the Soviet Union, Russia was in the midst of a protracted and deep recession. Inflation was high and accelerating and the balance of payments was under severe pressure, compounded by the heavy external debt inherited from the Soviet Union and a disintegrating ruble zone. The dissolution of the institutional framework for most of Russia's trade exacerbated the extraordinary shifts required in relative prices. The Russian people were hesitant about the move toward a market economy, unsure of what this would entail for their livelihoods, and concerned about the risks of a possible political backlash. The obstacles to reforms included:

- State institutions designed for command and control of economic activity instead of regulation and oversight
- An economic structure based on central planning rather than incentives and comparative advantage
- Production and distribution systems dominated by large state-owned enterprises that also delivered social services and provided social protection

- A newly created, poorly regulated financial sector
- A non-functional payment system
- Weakening authority in a central, complex federal system.

The Russian transition has been more difficult than expected by the international community. Successive Russian governments launched stabilization and adjustment programs in the early to mid-1990s, with assistance from the International Monetary Fund (IMF) and the Bank, and encouragement from the international community. Most of these programs were only partially implemented due to weak institutional capacity and insufficient political will. In August 1998, a year-long stabilization and structural adjustment program collapsed because of external shocks and inadequate fiscal adjustment. Russia defaulted on its debt, the ruble was floated (depreciating by over 60 percent), and output dropped by more than 5 percent.

Asset and income inequality have increased, partly through a process initiated in the 1980s, when enterprise managers and senior government and party officials began to take over state enterprises and their assets in what is referred to as "spontaneous privatization." But some aspects of the formal privatization process also contributed. Poverty has increased and indicators of social and human development have declined, social services have deteriorated, and "market-type" social protection mechanisms have been slow to develop. Macroeconomic stability has been difficult to achieve, partly because the authorities lacked the instruments for indirect control of the economy, but also because there was no consensus on how to spread the costs of adjustment. Small and medium-size enterprise (SME) has been discouraged by high costs of entry and of doing business, including weak rule of law and bureaucratic harassment.

Yet, there have been no major policy reversals and the economy has finally begun to recover. The rapid privatization, dismantling of controls, and price and trade reforms carried out through the mid-1990s have made the process irreversible, although it is unclear whether an easier transition path could have been found given the initial conditions and the political realities. The 1998 crisis was a turning point in Russia's transition. Over the past three years, the government has made significant progress in fiscal adjustment, the incentive regime, legislation approvals for structural reforms, the strengthening of public institutions, and the restoration of public trust in its ability to conduct policies. Aided by a positive terms of trade shock and the effects of the devaluation, growth recovered and inflation has been reduced.

From Investment to Adjustment Lending

The Bank, the IMF, and the European Bank for Reconstruction and Development (EBRD) were asked by their shareholders to work together in providing advice and financial assistance to facilitate the transition. The Bank was entrusted with the responsibility of encouraging and overseeing structural reforms. This was an unprecedented challenge for the Bank since it lacked country knowledge and historical precedent for this type of process. A series of strategy documents established that, beyond its complementary assistance in support for IMF-funded stabilization efforts, the Bank's focus would be on helping build the institutions of a market economy, developing the private sector, and mitigating the social costs of the transition. To this end, the Bank committed 55 loans for $12.6 billion through end-FY01, of which US$7.8 billion has been disbursed and US$2.4 billion cancelled. Through FY96 lending focused on rehabilitation and investment (with a heavy involvement in energy). Thereafter, most lending was directed to adjustment operations. Policy advice was provided through economic and sector work, technical assistance, and design and implementation of lending operations.

At the behest of the international community, the Bank rushed the processing of many projects, both for investment and general budget support, even though the prospects for their success were highly uncertain. These high-risk/high-payoff operations did not succeed, as the Bank did not command the resources or the influence to overcome the unprecedented constraints described above. Results were better in operations dealing with privatization and social protection than those dealing with stabilization, the financial sector, and oil restructuring. Bank advice and lending played a positive but marginal role in the design of policies and in their implementation until 1998. Since then, however, many of the lessons drawn from Bank operations and analytical advice have been put to work. This helps explain why the sustainability ratings of Bank-financed operations are higher than the outcome ratings. Their modest but cumulative benefits, together with the positive impact of Bank advice, contributed to building the foundations for Russia's recent turnaround.

After the August 1998 financial crisis, both the relevance and efficacy of assistance improved significantly. The Bank has been cautious in new lending, which has been focused on long-term social and institutional development. The continued policy dialogue on structural reforms and the Bank's outreach activities played a role in preventing policy reversals, in formulating the current reform program, and in strengthening client ownership. The Bank has become the main external interlocutor on the microeconomic and social reform agenda, and the government has adopted many of the policies that the Bank had recommended. Achievements supported by Bank interventions include the improvement in fiscal management, the targeting of social assistance programs, and the restructuring of the coal sector. Portfolio performance has also improved since 1999, partly through the cancellation of troubled projects and partly through joint Russia-Bank efforts to speed up implementation. An open question is the resilience of these achievements to external shocks, in particular to a significant drop in the prices of oil or other export commodities.

Box 1: IFC and MIGA Activities in Private Sector Development

An in-depth evaluation of the activities of the *International Finance Corporation* (IFC), the private sector financing arm of the World Bank Group, was undertaken by the IFC's independent Operations Evaluation Group (OEG). Through the end of 2001, IFC devoted the bulk of its efforts to technical assistance. This strategy reflected Russia's needs during the first half of the 1990s, the availability of ample investment financing from the EBRD, and IFC's continuing concern with the high risks of investment operations in the country. Commitments for loans and equity investments in 48 financial sector, manufacturing, and retail private enterprises amounted to US$ 0.71 billion (US$ 0.51 billion in 34 companies, net of cancellations). This was about one-seventh the scale of funding by the EBRD. IFC's caution in making investments was prudent in the circumstances and reflected a successful and laudable resistance to external pressure and internal approvals incentives.

OEG found that the IFC had an impressive record of technical assistance operations; they addressed strategic needs and contributed materially to Russia's transition process. But along with other development finance institutions, IFC ramped up its investments in 1993-98 ahead of the reform process, with attendant disappointing outcomes. Mainly as a result of the 1998 crisis and the generally difficult business environment that led to losses for most private companies, particularly in the financial sector, only 35 percent of the IFC's investment projects achieved satisfactory development outcomes. By contrast, 96 percent of the donors' grants channeled through IFC for technical assistance achieved satisfactory development outcomes. Nonetheless, despite the success of 1,100 privatization auctions the IFC helped conduct for SMEs in the early 1990s, IFC had not yet established a sustainable wholesale channel for investments in SMEs. Looking forward, OEG's evaluation supported the planned expansion of IFC activities in response to the improving investment climate in the past two years.

According to a desk review by its Operations Evaluation Unit (OEU), the Multilateral Investment Guarantee Agency's (MIGA) guarantee program met prudently and selectively the demands from private foreign investors for political risk insurance. As a result, it has not suffered any claims losses in Russia, which is ranked in the top five countries in the Agency's portfolio. Before the outbreak of the financial crisis, MIGA covered transfer risks but did not offer coverage for currency convertibility. MIGA continued to support projects after the country's default on foreign debt. Although there was relatively low demand for MIGA's products, its $549 million in coverage issued for 18 projects—mainly in agribusiness, food processing and beverages, finance, and extractive industries—nonetheless facilitated an estimated $1.3 billion of foreign direct investment in Russia (see CAE Annex 12). In investment marketing services, the Web-based PrivatizationLink Russia was launched in October 2000, providing important and timely information to potential foreign investors. OEU suggested that in the future the Agency should strive to maximize the amount of foreign direct investment it facilitates while diversifying its portfolio and minimizing net exposure in Russia.

Next Steps

Bank management agreed with the OED's recommendations that the Bank should focus its assistance even more sharply on areas with strong government commitment to reform and relative social consensus. Public sector management, legal and judicial reform, investment and business climate, pension reform, land markets, and coal and electricity sector restructuring now offer high-potential development rewards. The ongoing policy dialogue and technical advisory program on banking sector reform should continue. Responding to client demand, Bank assistance should provide for an expanded program of good practice advice and strengthen the public debate on reforms. Policy-based lending should be designed to ensure a tight linkage between progress of reform and actual disbursements. The Bank should also consider targeting part of its assistance to selected regions committed to reform.

Lessons Learned

The key generic lesson of the Bank's experience in Russia is that country ownership is crucial to the success of assistance. Thus, it is important for the Bank to pay close attention to the political and institutional aspects of reforms and consult with all relevant units of government and civil society, to improve the relevance and design of its activities and avoid operations where commitment is weak. There are a number of other general lessons:

- In the face of a poor track record and narrow country ownership of reform, a large adjustment lending program (especially one with front-loaded disbursements) risks delaying rather than accelerating reform.
- In the presence of a poor track record and new consensus on a reform program, adjustment lending should be offered after the government has publicly adopted the necessary reforms or has begun implementing them, as was the case for the Coal Sectoral Adjustment Loans (SECALs). Disbursements should be backloaded and carefully modulated on the basis of solid progress in implementation.
- Adequate analytical work should be available upstream of lending. AAA should be funded to the extent commensurate with the role the Bank is expected to play.
- Timetables for implementation should be realistic.
- For physical rehabilitation and investment projects to achieve their development objectives, progress on policy and institutional reform is necessary.

Box 2: Management and Government Response

Bank management disagrees that the shift from investment lending to structural adjustment lending was a misguided response to the systemic reform challenges that Russia faced in 1996. In their view, restricting assistance to AAA and small loans as the OED's counterfactual suggests would have meant a perpetuation of the Bank's limited impact on policy formulation. The 1997 Structural Adjustment Loans (SAL I and II) and Social Protection Adjustment Loan (SPAL) were necessary to influence the design of the structural reform agenda. These operations, Bank management further argues, provided the right tools and built the necessary trust to help prevent economic policy reversals, improve Bank-Russia relations, and sowed the seeds of the reform program first endorsed by the government in 2000 and currently under implementation.

The Russian authorities found that the CAE "presents a sufficiently objective picture of developments in Russia over the past decade and outlines the factors behind the Bank's successes and setbacks." While they "for the most part agree with the [CAE's] assessments of the results of the Bank's activity in individual sectors," they assessed its overall outcome as satisfactory, as the process of transition has been "very rapid" and the positive developments post-1998 resulted from efforts made in the previous period and the important role played by the Bank and Fund. Regarding the relatively high share of problem projects in the past, they pointed to shared responsibility with the Bank, as many operations "did not rely on a thorough understanding of the existing problems." Finally, they found OED's recommendations to "coincide to a greater extent with the provision of the Program for Russia's Cooperation with the Bank recently approved by the government."

Box 3: Executive Directors' Perspective

The Executive Board's Subcommittee of the Committee on Development Effectiveness (CODE) discussed both the OED and OEG reports on May 8, 2002. They broadly supported the evaluations' recommendations and noted management's assurances that they will be incorporated into the Country Assistance Strategy scheduled to be considered by the full Board in June 2002. Members urged greater coherence, coordination, and information sharing between the Bank and the IFC. The chairman concluded by underlining the importance of country ownership of reforms and capacity to implement them; the need for the Bank to work in partnership with other donors; and the vital role of Bank engagement in building ownership and strengthening institutions early in the process of transition.

In the course of the discussion, some Subcommittee members wondered whether the large amount of adjustment lending in the early years might not have retarded reforms by postponing the need to deal with critical structural issues. They felt that an assistance strategy oriented around AAA with limited financial support for Russia would have been more appropriate than one involving large volumes of adjustment lending. Others, however, felt that the leverage provided by lending had been critical to the Bank's dialogue with the Russian authorities and that AAA alone would likely not have captured the government's attention. Thus, they argued that it could be difficult to wait to build broad consensus, especially when faced with crisis situations. In such circumstances, the Bank might have to accept greater risks in acting —particularly when it has relatively less understanding of the economy—and try to build ownership through its engagement, even though there might be divided views in the country.

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