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REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED THIRD STRUCTURAL ADJUSTMENT LOAN

IN THE AMOUNT OF US$1.5 BILLION

TO

THE RUSSIAN FEDERATION

July 26, 1998

RUSSIAN FEDERATION - THIRD STRUCTURAL ADJUSTMENT LOAN

Currency Equivalents

Currency Unit = New Ruble (Rbl)

MICEX Exchange Rates
New Ruble per US$1

	Period Average	End of Period
1995	4.566	4.640
1996	5.129	5.554
1997	5.785	5.554
1998[a]	6.120	6.270

[a]As of 24 July 1998

Weights And Measures

Metric System

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Abbreviations and Acronyms

ADR	-	American Depository Receipt
CAS	-	Country Assistance Strategy
CBR	-	Central Bank of Russia
CIS	-	Commonwealth of Independent States
EBF	-	Extrabudgetary Fund
EDI	-	Economic Development Institute
EFF	-	Extended Fund Facility
FEC	-	Federal Energy Commission
FSRNMC	-	Federal Regulatory Commission for Communications
FSRNMT	-	Federal Regulatory Commission for Transportation
GDP	-	Gross Domestic Product
GKI	-	State Committee for the Management of State Property
GKO	-	Treasury Bill
GOR	-	Government of Russia
GW	-	Gigawatt
IAS	-	International Accounting Standards
IBRD	-	International Bank for Reconstruction and Development
ICR	-	Implementation Completion Report
IFC	-	International Finance Corporation
IMF	-	International Monetary Fund
IPO	-	Initial Public Offering
LDC	-	Local Distribution Company
LIBOR	-	London Inter-Bank Offered Rate
MICEX	-	Moscow Interbank Currency Exchange
MIGA	-	Multilateral Investment Guarantee Agency
MOE	-	Ministry of Economy
MOF	-	Ministry of Finance
MOP	-	Memorandum of the President
NIS	-	Newly Independent States
RAO EES	-	Joint Stock Company- Electrification and Electricity Supply
RFCSCM	-	Russian Federal Commission on Securities and the Capital Market
RTGS	-	Real-Time Gross Settlement
SAL	-	Structural Adjustment Loan
SECAL	-	Sector Adjustment Loan
STS	-	State Tax Service
TA	-	Technical Assistance
VAT	-	Value Added Tax
VChK	-	Emergency Tax Commission
WTO	-	World Trade Organization

Government Fiscal Year

January 1 - December 31

RUSSIAN FEDERATION

THIRD STRUCTURAL ADJUSTMENT LOAN

Loan Summary

Borrower:	Russian Federation
Amount:	US$1.5 billion, in three tranches of US$300 million; US$500 million; and US$700 million
Terms:	Payable in seven years, including three years of grace at the standard LIBOR-based interest rate for US Dollar single currency loans
Commitment Fee:	0.75 % on undisbursed credit balances, beginning 60 days after signing, less any waiver.
Objectives and Description:	The proposed SAL3 would assist the Government to undertake the structural reforms necessary to lay the foundation for renewed economic growth and to maintain macroeconomic stabilization over the medium-term. It would also provide the financing necessary to provide an adequate level of public services during the difficult fiscal transition that has characterized most former centrally planned economies. The proposed operation would support economy-wide structural reforms that (a) advance competitive enterprise and market development and impose financial discipline on the enterprise sector; and (b) have a major direct impact on macroeconomic stability. It would focus on fiscal management reform, private sector development, reform of infrastructure monopolies, and banking reforms.
Benefits:	The loan would encourage and enable the federal government to proceed with key structural reforms to sustain macroeconomic stability and stimulate renewed growth. The low-cost, non-inflationary budget financing provided by SAL3 would confer financial savings as well as economic benefits. The reforms supported would increase efficiency across a range of sectors by helping create a more competitive and open private sector-oriented economy.
Risks:	There are substantial political, institutional, and economic risks associated with this operation, as with other operations in the Bank's Russia portfolio. These risks have been carefully addressed during project preparation but remain high. The risk of macroeconomic instability has been addressed through the operation's strong fiscal management measures, the resources it will provide to the economy, and through coordinating closely with the IMF's ongoing EFF program. The risk of

erratic commitment to reforms has been addressed by designing SAL3 based on strong prior actions and incorporating three progressive tranches. The risk of inadequate implementation of the reforms will be addressed through intensive supervision, including monthly monitoring reports.

Schedule of Disbursement:	Three tranche disbursement, the first immediately after loan effectiveness (expected August 1998); the second and third when pre-identified actions have been undertaken (estimated December 1998 and June1999, respectively).
Rate of Return:	Not Applicable
Poverty Category:	Not Applicable
Project ID Number:	RU-PE-55137
Map:	IBRD No. 27188R

The World Bank project team wishes to thank the Russian authorities, and in particular their counterparts in the Presidential and Government Administrations, Ministry of Economy, Ministry of Finance, Ministry of Fuels and Energy, Ministry of State Property, Ministry of Railways, Ministry of Industry and Trade, Federal Energy Commission, Regulatory Commission for Transport and Communications, Federal Service on Insolvency and Financial Rehabilitation, State Tax Service,and the Central Bank, among other agencies, for their collaboration in preparing the proposed SAL3. The project team would like to thank their colleagues in the International Monetary Fund's Russia team for their collaboration. The project team would also like to express its gratitude to Johannes Linn, ECSVP; Marcelo Selowsky, ECAVP; Michael Carter, ECCRU; Pradeep Mitra, ECSPE; David Pearce, ECCA1; Robert J. Anderson, ECSPE; Sanjay Pradhan, ECSPE; and Homi Kharas, PRMEP for their overall guidance and support. Loan preparation work has been partly funded by a grant from the PHRD Fund of the Government of Japan.

REPORT AND RECOMMENDATION OF THE PRESIDENT OF THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT TO THE EXECUTIVE DIRECTORS ON A PROPOSED THIRD STRUCTURAL ADJUSTMENT LOAN TO THE RUSSIAN FEDERATION

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REPORT AND RECOMMENDATION OF THE PRESIDENT OF THE IBRD TO THE EXECUTIVE DIRECTORS ON A PROPOSED THIRD STRUCTURAL ADJUSTMENT LOAN (SAL3) TO THE RUSSIAN FEDERATION

1. I submit for your approval the following report and recommendation on a proposed third structural adjustment loan (SAL3) to the Russian Federation for US$1.5 billion to support the Government's structural reform program.[1] The loan would be at the Bank's standard LIBOR-based interest rate for US Dollar single currency loans, with a maturity of seven years, including three years of grace.

2. This report should be read in conjunction with the "Country Assistance Strategy (CAS) of the World Bank Group for the Russian Federation" (Report No. 16549-RU, dated May 6, 1997), which was approved by the Board in June 1997. A CAS Progress Report is currently under preparation for distribution and discussion in October 1998.

PART I. COUNTRY CONTEXT[2]

3. Since 1992, the Russian economy has been undergoing a massive transformation to a market system. Russia has had its share of setbacks and triumphs. But its transition is proving considerably more difficult than that of the other countries in Central and Eastern Europe. This is due in part to Russia's vast size, the lack of transparency in the control and use of the country's abundant natural resources, the challenge of harmonizing the reform agendas of the federal and regional governments and creating political consensus for difficult reform, and the much longer history of central planning. Further, Russia's military-industry complex, where many of the enterprise adjustment problems are concentrated, had a much higher share in output than in other transition countries.

4. Mirroring the difficult transition, measured GDP declined continuously between 1991 and 1996. In 1997, the economy grew for the first time since transition began, by 0.8 percent, with GDP recovering slightly to 64 percent of its 1991 level—a cumulative decline of 36 percent nevertheless. Inflation has come down dramatically, falling to 11 percent on an end-year basis by December 1997, and is now heading towards the 7 percent annual range. This has been achieved through tight monetary policy aimed at stabilizing the ruble, combined with debt issuance to break the link between fiscal deficits and money creation prevalent up to 1995. However, domestic debt has grown rapidly owing to unsustainable fiscal deficits stemming from weak enforcement of tax collection and insufficient expenditure commitment control, keeping real interest rates at levels that have stifled investment and growth. At the same time,

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1 The first structural adjustment loan (SAL1), Loan No. 4180-RU ($600 million), was approved by the Board on June 5, 1997. SAL1 became effective on June 17, 1997 and was fully disbursed on June 18, 1997. SAL2, Loan No. 4261-RU, ($800 million) was approved by the Board on December 18, 1997. Its first tranche ($400 million) was made available in late December 1997, and its second tranche ($400 million) in late January 1998.

2 Due to differences in the definitions and methodology underlying the macroeconomic statistics of the Russian Federation and the World Bank, the specific macroeconomic data, estimates, and projections in this Report of the President and the CAS may differ from those in the Government's Letter of Development Policy which is attached.

structural reforms related to creating a favorable climate for private sector development and new private investment have lagged behind. Consequently, the resumption of strong growth has proved elusive. As a sign of the weak investment climate, cumulative foreign direct investment was only about $11 billion over 1994-1997, which is very low compared to levels elsewhere in Central and Eastern Europe, especially when scaled by GDP. Recorded unemployment reached 11.5 percent of the total work force by the end of May 1998, and about 20-30 percent of the total population are living in poverty.

5. ***Recent Developments.*** Two important, unanticipated events have occurred since late 1997: (i) Russia was hit by contagion from the East Asian financial crisis starting in November 1997; and (ii) there was a change of government in March 1998. Contagion from Asia has led to a significant deterioration in the fiscal situation, dampened growth prospects, and highlighted Russia's vulnerability to changing sentiment in the international capital markets. On the political front, President Yeltsin dismissed the government headed by Prime Minister Chernomyrdin on March 23, 1998 and appointed Mr. Kiriyenko as acting Prime Minister. The new government formally took office on April 24, 1998 following confirmation of Prime Minister Kiriyenko's appointment by the Duma. These developments coincided with weakening oil, gas and metals prices, putting pressure on export earnings and tax revenues.

6. The last eight months have been dominated by financial volatility and increasing macroeconomic instability. Russia has suffered three episodes of exchange market instability as investors sought to exit the government securities market (GKOs and OFZs), depleting its foreign exchange reserves in the process. The first episode occurred in November 1997, when the East Asian crisis initially spilled over. The second occurred in late January 1998, when investor concerns switched to Russian risk, centering around the fiscal deficit and structural impediments to private sector development. The third, and most serious, began in mid-May, and has shown signs of abating only with the announcement on July 13, 1998 of the IMF, Bank and Japanese enhanced assistance package.

7. Gross reserves (including gold) have fallen from $23 billion on November 1, 1997 to $13.5 billion in mid-July 1998. In June, 1998, the Government raised $3.75 billion from two Eurobond issues, using the proceeds to pay off maturing GKOs and OFZs. It also received a $670 million tranche from the IMF under the 1998 EFF. Approximately $5.5 billion of reserves were lost between June 1 and July 14 as portfolio investors exited, with an acceleration towards the end. The high interest rates necessary to defend the ruble have postponed growth, as well as adjustment by commercial banks, and have exacerbated an already heavy public debt burden. In the 1998 federal government budget, interest payments are projected at 45-50 percent of revenues. This burden will continue into next year, as interest payments are counted when GKOs, which are discount instruments with a current average maturity of 10 months, mature; but is expected to diminish slightly as new tax measures take effect. Nonpayments and barter have increased significantly. By May 1, 1998, overdue accounts payable to suppliers, to budgets at all levels, social extra-budgetary funds and wage arrears amounted to a little over 1 trillion rubles, about 35 percent of GDP. Barter is estimated to account for about 40-50 percent of enterprise sales.

8. ***Near-Term Economic Outlook.*** Macroeconomic instability has adversely impacted Russia's short-to-medium run economic outlook. Growth, originally projected at 1-2 percent for 1998 is now expected to be –1 percent. Next year, output is not expected to grow much beyond the 0-1 percent range. Inflation gains have been preserved; but real interest rates remain high. This has added to the fiscal burden, and heightened the need for controlling the size of the budget deficit by raising tax collection and implementing fiscal structural reforms to lower permanently non-interest spending. The fiscal deficit target at the federal government level is 5.6 percent of GDP for this year and 2.8 percent for 1999. Declining oil, gas and metals prices have led to a deterioration in the trade balance. Overall, the current

account is expected to slip into a deficit of about $5 billion this year, or 1 percent of GDP, compared to a surplus of 0.7 percent last year.

9. ***The Government's Anti-Crisis Program.*** Recognizing that a comprehensive approach was needed to combat the emerging financial crisis, the new Government formulated an anti-crisis Economic Stabilization and Finance Program[3] in late June 1998. The Government attributes the crisis to actions begun in 1995, when money financing of the deficit ceased: (i) rising fiscal deficits and mounting interest payments; (ii) an unsustainable public debt structure, with predominance of GKOs in new borrowings; (iii) contagion effects from the East Asian crisis, and (iv) the decline in oil and gas prices. In order to overcome the "credibility crisis" and restore investor confidence, the Government has singled out a set of actions that in the main would: (i) aim for a significant primary surplus on the fiscal accounts for 1999, thereby minimizing borrowing and lowering interest rates; and (ii) create structural conditions for growth, and end non-payments and barter transactions, thus engendering income generation and thereby expansion of the tax base.

10. The IMF, Bank and Japanese assistance package announced on July 13, 1998 is targeted to support the Government's stabilization program, and is centered around an enhanced set of reforms designed to eliminate the root causes of Russia's current financial instability, namely, unsustainable fiscal deficits and structural impediments to private sector development and growth. At the same time, the Government announced a debt exchange operation (see para. 15). On July 20, 1998 the IMF Board approved its $11.2 billion enhanced program--comprised of an augmentation of the EFF and a purchase under the CCFF--and a first tranche of $4.8 billion was made available. The July 13 announcement led to a substantial decline in GKO yields: the one-year GKO yield fell to 58 percent on July 14 from a close of 102 percent the previous day. The Government recognizes that decisive follow-through in implementing fundamental fiscal and structural reforms over the next few months—reflected in a further decline in interest rates—is essential to reap the benefits from the additional funds being made available and the financial restructuring of Russia's public debt.

Resumption of Growth: The Need for Further Macroeconomic and Structural Reforms

11. Sustained macro-stabilization and the realization of dynamic private-sector led growth—the key to raising general living standards and easing social tensions in Russia—will thus depend on further fiscal consolidation and the acceleration and deepening of fundamental structural reforms.

12. ***Macroeconomic Reforms.*** A crucial component of the enhanced policy package being supported by SAL3 is a sizable and accelerated fiscal adjustment needed for putting public finances and public debt on a sustainable path. The goal is to move from approximate primary balance at the federal level in 1998 to a primary surplus of 3 percent of GDP in 1999. Achieving this will require building further upon the expenditure reduction plan for 1998 supplemented with a substantial increase in revenues in 1999.

13. The increase in *revenues* will come from a combination of improvements in both tax administration and changes in tax policy. During its extraordinary session July 15-16, parliament passed Part I of the Tax Code, which outlines and clarifies the powers and responsibilities of the tax authorities. The code included amendments removing provisions for offsets and increasing the cap on interest payable from 50 to 100 percent of tax arrears. However, legislation aimed at expanding the personal income tax base and

[3] The core measures incorporated in the program are outlined in two documents, "Stabilization of the Economy and Finance Program" and "Stabilization Measures Plan" issued on June 19, 1998.

shifting 20 percent of personal income tax receipts to the federal level was not passed, although a 5 percent sales tax accruing solely to the member territories was passed. Presidential decrees were passed to move the VAT to an accruals basis, unify it at 20 percent for all items (except bread, milk and baby food, for which VAT will be 10 percent), and to increase land tax rates (which was originally to be passed into law by parliament). A government resolution establishing a 3 percent import duty surcharge (until end-1999) was also passed. As of July 20, measures accounting for Rub 56 billion out of the Rub 80 billion needed for meeting the 1999 fiscal deficit target had been adopted.

14. On the *expenditure* side, the first key step is to implement the expenditure reduction plan for 1998; a further 1 percent of GDP compression in non-interest spending will be required for 1999. Expenditure control is being gradually strengthened through continued development of the federal treasury. All spending by federal budget agencies except for the Ministry of Defense, where only partial progress has been made, and by earmarked budget funds, is now executed through the treasury. The activities of the earmarked budget funds and the Employment Fund will be brought into the treasury beginning in 1999. The foreign exchange accounts of the tax authorities and the off-budget accounts of spending units will be closed and incorporated into the treasury over the course of this year. Measures envisaged for restoring balance to the Pension Fund from August 1, 1998, onwards were not adopted. Legislation to address this will be submitted to the special parliamentary session in August, while as an interim measure, the government will introduce as of August 1, 1998, a 2 percent surcharge on the payroll tax contributions of employees and will expand the base for employer contribution pending a return to balance of the Pension Fund. In order to improve fiscal management and reduce arrears at the *regional level*, the Ministry of Finance will introduce various conditions on resources received by member territories from the federal budget.

15. Public debt dynamics are at the root of the present macroeconomic instability. With growth expected to be stagnant this year and slightly positive next year, and real interest rates still high, the burden will fall squarely on budgetary restraint and fiscal consolidation to keep public debt growth within manageable levels. At a minimum, meeting this and next year's fiscal deficit targets is essential. Russia's international liquidity situation has seriously deteriorated over the last several months as a result of losing reserves and the rapid growth of GKOs/OFZs. Liquidity sharply deteriorated towards the end of 1997 and worsened between mid-May and mid-July. The attempt to enhance international liquidity has three components: (i) an increase in reserves; (ii) the Government's exchange of Rub 27.5 billion of GKOs ($4.4 billion) with maturity dates extending up to January 27, 1999, for seven and twenty year US dollar instruments; and (iii) increased borrowing through long-dated Eurobonds once market expectations stabilize. While such financial restructuring will alleviate short-run liquidity, thereby lowering the pressure on the exchange rate and contributing to a decline in interest rates, it will not be sufficient and will serve only as a temporary palliative unless accompanied by the implementation of the fundamental fiscal reforms proposed as part of SAL3.

16. ***Structural Reforms.*** The resumption of growth in Russia will also depend on further progress in developing and strengthening the institutions and legal/regulatory processes that are the fundamental building blocks for the operation of a market system, including reforms in the social sphere, agriculture and housing. Growth will be propelled by structural reforms that: (i) enhance fiscal management; (ii) improve the efficiency and transparency of the country's monopolistic infrastructure sectors; (iii) develop the private sector, encourage competition and improve corporate governance incentives; and (iv) reform the banking sector. Greater fiscal discipline--through, among other measures, strengthened budget management processes and inter-governmental reforms that both correct mismatches between expenditure responsibilities and revenue assignments, as well as encourage fiscal responsibility and the implementation of key fiscal reforms by sub-national governments--will help the process of

consolidation. Reform of infrastructure monopolies--especially electric power, natural gas, railways and oil transport--will have large positive spillovers throughout the economy and thus make a crucial contribution to renewed productivity. The realization of dynamic private sector growth—through efficiency gains from privatization, competition, restructuring and new investment—will depend mainly on improvements in the overall business environment. Steps in that direction include a more transparent and predictable incentive regime, including stronger contract and property rights enforcement; easier market entry for new businesses and removing barriers to exit for non-viable enterprises. Banking sector reforms—including dealing with illiquid and insolvent banks (including a law on bank bankruptcy and liquidation and a prudent deposit protection system), improving bank accounting and supervision, and fostering competition—will be essential to facilitate the financial deepening that is needed both for the consolidation of stabilization on the monetary and credit side and for effective financial intermediation as a basis for investment and growth.

PART II. THE GOVERNMENT'S ECONOMIC REFORM PROGRAM

A. General Objectives

17. The Government's medium-term program notes that the first phase of structural reforms following the collapse of central planning is substantially completed, and that Russia has become predominantly a market economy. It notes that major progress has been made in liberalization of prices; a mass privatization process has been completed; inflation has been reduced and the ruble stabilized; and trade policy reforms have resulted in lowered tariffs. Building on these achievements, the Government is continuing to undertake structural measures to restore growth, which it sees as a prerequisite for reducing poverty and addressing other social problems.

18. The Government's program argues that structural reform must be underpinned by: a stable macroeconomic environment; increased investment; reallocation of assets and resources currently tied up in non-productive enterprises; openness to international trade and investment; new institutions required to make the market economy operate efficiently; social sector reforms (such as pension, unemployment insurance, health care and housing); and reform of the agricultural sector. Fundamental restructuring of the economy's key sectors is envisaged to take 10-15 years.

19. Although the medium-term program describes a multiplicity of structural measures, the immediate priority—which would be supported under the proposed SAL3, building on the initiatives supported under SAL1 and SAL2—is a set of cross-cutting reforms that will contribute directly to the resumption of growth and the maintenance of macroeconomic stability. These will require action in the following areas:

- **Reform of Infrastructure Monopolies**
- **Private Sector Development**
- **Fiscal Management**
- **Banking Reform**

Key elements of the program in these areas are discussed below.[4]

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[4] Other key elements of the medium-term reform program, such as social protection and coal sector reform, are being addressed under other Bank operations.

B. Reform of Infrastructure Monopolies

20. ***Context.*** Efforts to improve the efficiency, transparency and competitiveness of the electricity, gas, oil and railways sectors will have very substantial efficiency gains with large, positive, economy-wide spillovers and will be critically important for medium-term growth. The Government has initiated reforms in all sectors, both at the enterprise level and at the policy level in terms of pricing and legislative reform. While the reform programs are moving at different paces and with different focuses in each sector, certain themes are common to all: (i) strengthening payment discipline, including taxes, and reducing arrears; (ii) enhancing the environment for private sector investment; (iii) reducing and, where possible, eliminating barriers to competitive supply and protecting against the abuse of monopoly positions; (iv) ensuring that pricing better reflects cost and demand conditions; and (v) enhancing arms-length regulatory oversight where competition is insufficient to protect public interests.

21. ***Reducing Payment Arrears.*** Payment arrears and the prevalence of barter or other non-cash settlements is a major problem for all of the infrastructure monopolies, and is particularly severe in the energy sector. Barter and non-cash settlements, in addition to creating a serious transparency problem, entail burdensome transaction costs which have adversely affected efficiency throughout the sector. Nonpayment problems are aggravated by the fact that energy suppliers are unable to cut off supply to so-called "strategic customers", even when these customers are in arrears. This problem has been compounded by a reluctance on the part of energy providers to cut off supplies to other customers that are in arrears and by the tendency for payments to be captured and retained at the downstream end of the supply chain. The chain of payment arrears has multiplied through the economy, contributing, in particular, to serious wage arrears and increased tax arrears to the budget. These arrears have also, in many cases, threatened the financial viability of companies in the energy supply chain. In January 1997, the Government substantially reduced the list of "strategic customers" – those that remain are almost all entities responsible for Russia's external and internal security. Earlier legal provisions that prohibited suppliers from cutting off services to classes of customers have also been revoked.

22. The Government's attempts to force payment discipline through use of the regulatory system and corporate governance mechanisms have had little success to date. The Government will now pursue a number of coordinated measures designed to address the most persistent payment abuses. The calculation of VAT on an accrual basis will create a significant additional incentive to improve collections. The requirement that all payments for power, heat and gas be channeled through an escrow account will provide a mechanism to eliminate much of the barter trade (payments to the escrow account will have to be made in cash) and to ensure collection of the VAT amounts. The distribution of the funds from the escrow account will also ensure that all elements of the supply chain are treated fairly in terms of payment receipts: by sharing final sale proceeds among all parties of the supply chain, it will reduce incentives for distributors to accept only partial cash payment while running arrears with suppliers. In addition, procedures for termination or limitation of supplies will be simplified.

23. ***Electric Power Sector:*** Russia's electric power sector has an installed generating capacity of about 210 GW, nearly 60% more than peak demand. However, the asset base is aging as little new construction has been commissioned over the past ten years, and considerable investment is needed in deferred maintenance, life extension and replacement. Despite over-capacity, supply problems persist in some regions – in part due to the buildup of payment arrears. The power sector is dominated by RAO UES Rossii (UES), a holding company which owns much of the generation system, as well as the high-voltage transmission and dispatch systems. UES also has a controlling equity stake (typically 51%) in most of the Energos, which are responsible for the distribution of electricity on a regional basis. The 72 Energos

own the smaller generation stations and the distribution networks within their regions. A small share of UES was privatized at the time the company was formed, and the Government has gradually divested its ownership to the present level of 52 percent. Regulation has recently been established at both the federal and regional levels. The institutional capacity and independence of the Federal Energy Commission (FEC) has improved considerably over the past year; however, regulation at the regional level remains weak. In the aggregate, electricity prices have been set at a level to fully finance operating costs and 100% of new investments; however, they still contain a substantial, albeit declining, cross subsidy from industry to households.

24. The Government has assigned a high priority to addressing the problems of the power sector. The goal of the program is to increase the efficiency of the sector's operation by establishing a pattern of prices reflecting economic costs and relative scarcities (demand and supply over time), improving regulatory oversight, bringing financial accounts in line with international standards, improving the quality of service, and enhancing corporate governance, ownership incentives, and operational restructuring. The reforms also include the establishment of a competitive market for electricity, complemented by enhancing the effectiveness of the regulatory regime for the segments of the power market where the competitive provision of service is sub-optimal. The Bank is providing substantial technical assistance to the Government to help define and implement a comprehensive reform agenda along these lines.

25. Considerable progress has already been made in the past year in implementing these initiatives. 1997 was largely a year of consolidation at the center, with the federal government strengthening its governance over the electricity sector, and bringing new management into UES. The new management team has focused its initial efforts on restoring the financial viability of the company. To this end, new financial controls and audit procedures were introduced; the investment program was reviewed and rationalized, and funding withdrawn for approximately 40 projects which were deemed to be non-viable; as a result of a concerted effort to improve collections, cash payments to the UES transmission division increased by 250% and overall cash payments increased from 5 to 20 percent of total revenues; and UES took initial steps to attract new sources of capital, including reformulating new investment projects to include private investors, and making preparations for issuing convertible bonds on international financial markets.

26. Initial steps were also taken to introduce competition. The government created an Independent Financial Operator (IFO) to establish a competitive wholesale electricity market among large industrial customers and generators. Model contracts were established for transactions between these entities, using the network as a common carrier. Principles for access to the transmission and distribution networks and for regulation of tariffs for wheeling were also established. The wholesale market is being piloted in one region, and currently has 3 generators and 8 customers participating. A fundamental prerequisite for participation in the market is an agreement to pay cash, in advance, and to eliminate the stock of arrears. Entities that agree to this receive a discount of approximately 35% on their electricity tariffs.

27. The Government has committed over the coming year to continue the reform and restructuring process, with particular emphasis on further development of competitive markets at the bulk supply level, on improvements in the pricing of regulated services, and on the extension of the reform process to the regional level. The highlights of the program to further develop competitive supply include: (i) codification of operating rules to complete the establishment of a National Energy Market encompassing power plants, Energos and major customers operating in the wholesale market; (ii) development of regulatory guidelines and access rules for non-discriminatory access to the transmission and distribution systems; (iii) introduction of revised dispatch rules to ensure, within the limits of technical constraints,

that generating plants are dispatched on a least-cost basis; and (iv) final development and implementation of a plan to restructure the generating assets of UES into a number of independent generating subsidiaries, sufficient to enable effective competition.

28. Pricing initiatives will focus on strengthening the principles and processes for effective price regulation of monopoly services at both the federal and regional levels. These will include: (i) requiring the development of separate accounts for the generation and transmission/dispatch operations of UES; (ii) requiring a similar accounting separation for the generation, transmission and distribution operations of the Energos; and, (iii) development of revised pricing methodologies and guidelines for each of the network services.

29. At the regional level, the Government proposes to improve the operating and commercial efficiency of the Energos by inviting greater private-sector involvement in the operations and ownership of these enterprises. UES would solicit bids from potential strategic partners to participate in the ownership and/or management of at least 10 Energos, such partners to have a significant financial stake in the profitability and efficient operations of the companies.

30. ***Gas Sector*** The *natural gas sector* is one of the key sectors in the economy: a significant source of export earnings, a prime factor in the current and future competitiveness of the Russian economy, and a major source of tax revenue. The industry is dominated by RAO Gazprom, a vertically integrated enterprise which controls 95% of production and all major transmission corridors, and also has an effective monopoly on domestic gas trading and on export trade. The state owns a 40 percent share in Gazprom; most of the balance is held by employees and Russian investors. Local supply is handled by roughly 300 local distribution companies (LDCs), which are generally majority owned by their employees. However, the financial position of the LDCs is weak, and RAO Gazprom has acquired significant ownership stakes in some of these companies – an undesirable trend towards re-integration of the industry.

31. The integrated structure of the industry, weak regulatory principles and procedures, lack of transparency in reporting of operating and financial data, and ineffective implementation of legislation on open access to pipeline networks, combine to act as a major impediment both to ensuring efficiency of the current supply system and as a barrier to the development of parallel competitive markets. Pricing distortions, particularly with respect to cross subsidies between customer classes and between geographic regions, also send poor market signals both to users and to potential investors. Nonpayments have aggravated the pricing distortions, and have also enhanced the market power of Gazprom, which has been better able to tolerate the situation thanks to its relatively low cash requirements and its access to export markets, and which has therefore gained a significant hold over customers and downstream enterprises. As a consequence, while there are a number of potentially competitive sources of gas supply outside the Gazprom system, including associated gas from oil producing operations, imports from Central Asia, and small fields located close to major markets, RAO Gazprom continues to dominate the market. Not only is low-priced gas being shut out of markets, but also large volumes of associated gas are being flared, with serious adverse environmental consequences.

32. The Government's medium-term reform program for the gas sector is to introduce competition where possible by ensuring third-party access to the transmission system and direct contractual arrangements between independent gas producers and gas consumers, and by holding tenders for the right to develop new gas fields. To date, the Government has taken initial steps to reform the gas pricing system, including clarifying regulatory principles, improving the regulatory process, and reducing cross-subsidies among regions and customer groups.. It has adopted a Resolution mandating the rights of third parties to

access the transmission system, and is codifying the principle of separate, non-discriminatory tariffs for gas transport at both the transmission and distribution level. The Bank is providing technical assistance for gas price reforms, regulation, and the formalization of inter-relationships among enterprises in the gas supply chain.

33. Over the next year, the Government has committed to a significant broadening and deepening of the gas reform agenda. In order to improve regulatory transparency and reduce impediments to independent gas producers' access to the pipeline network, the Government will require RAO Gazprom to reorganize its internal structure, providing greater institutional and managerial separation between its major operating divisions. Transmission operations will be separated from the production and marketing functions, and will be consolidated on a corridor basis. Each functional division will have its own management team, with separate cost and profit accountability and separate, audited accounts based on international accounting standards.

34. Gas excise taxes will be restructured to exempt non-monopoly producers from at least a part of the burden, thereby enhancing the competitiveness of independent gas producers. The Federal Energy Commission will finalize and implement transparent, economically-justified tariffs at each level of the supply chain. Cross subsidies to households at the wholesale price level will be eliminated by the end of 1998, while cross-subsidies across regions will be progressively reduced and eliminated by mid-1999. The Government will also strongly encourage reduced cross-subsidies to households at the gas distribution level, by encouraging the development of responsible regional regulatory authorities, and by ensuring that the level of cross-subsidy is transparent and also communicated to all customers.

35. The Government also proposes a number of direct initiatives to support the development of a parallel competitive market. These include: (i) the development of model contracts for transactions between the transmission company and gas marketing enterprises; (ii) the equalization of transmission tariffs for all customers; (iii) lifting of state regulation on the gas prices charged by independent producers; (iv) modification of the Rules of Gas Supply; and (v) strengthening and broadening of the legislation relating to third party access to the transmission network, including the extension of these rights to foreign gas producers wishing to supply the Russian market.

36. ***Oil Sector*** Russia's oil sector remains one of the largest in the world. In 1997, Russia produced approximately 306 million tons of oil, up 1.5% from the previous year and reversing a long period of steady decline. Last year, exports were 105 million tons. However, output in 1998 may well be lower than last year because low international oil prices and high government take have resulted in many wells being shut-in and capital investment and drilling programs curtailed. Currently, taxes on oil production are now largely based on excise (revenue) taxes rather than on profits. Consequently, although world oil prices have decreased significantly in recent months, the companies are obligated to pay the excise taxes even though they many may operate at a loss. The Government has responded to help producers by reducing the hard currency portion of the pipeline tariff for export volumes by $2.50 per ton, and eliminating the excise tax (approximately $1.60 per ton) on Transneft, the major crude oil pipeline system. Recently, the Government requested the Bank, on an urgent basis, to provide an independent assessment of their current tax system.

37. In order to stimulate increased oil production, an attractive climate for both domestic and foreign investments is essential. The three critical components of an attractive investment climate in the sector in Russia are (i) an competitive and acceptable fiscal regime; (ii) a clear and consistent legal and regulatory regime; and (iii) assured non discriminatory access to oil transportation facilities.

38. Production Sharing Agreements (PSAs) have proved attractive to both foreign and domestic producers in many countries as a mechanism to ensure that fiscal and legal concerns are addressed. The original law on Production Sharing Agreements was passed in 1995. In order to become fully effective, however, additional supporting and enabling legislation must be enacted. In addition, provisions currently in the Tax Code (which will legally supersede the fiscal provisions in the PSA law) may obviate a number of key tax conditions contained in the negotiated PSAs. In the face of this uncertainty, investment in the oil sector has been very sluggish and potential future investments that are estimated in the range of $50 to $70 billion are at risk. Passage of the PSA enabling legislation and modifications to the Tax Code will resolve many of the fiscal and legal concerns and allow new reserves to be developed.

39. Much of the access to markets, however, is controlled by Transneft which operates as a natural crude oil pipeline monopoly. The FEC is addressing the need to regulate Transneft's operations but is hampered by limited data concerning Transneft's operations and the lack of solid legislative backing in the form of a pipeline law. Transneft, the world's largest crude oil pipeline system, and Rosneft are the two largest remaining state-controlled companies in the petroleum sector in Russia. It is critical for the future of the oil sector that Transneft continue to provide access and offer tariffs to shippers on a non-discriminatory basis to provide confidence to investors.

40. The Government is fully cognizant of the need to create an acceptable investment climate for the oil sector if the decline in production levels is to be reversed. The program, therefore, includes as key components enactment of the enabling PSA legislation and modifying the Tax Code to conform it to the principles inherent in the Law on Production Sharing Agreements. The program also includes the conduct of a full operational audit of Transneft, development and passage of an oil pipeline law and the development and implementation of regulations governing crude oil transportation tariffs on Transneft's pipeline system.

41. ***Railways Sector:*** Russia's railway system is the country's largest natural monopoly and its restructuring critical to the economy as rail carries over 80% of all freight traffic and 40% of passenger turnover. Unfortunately, falling traffic, high costs, cross-subsidization of passenger losses by freight customers and structural difficulties have resulted in excessively high rail tariffs that are undermining the recovery of the country's industrial sector and the competitiveness of its exports. Intra-rail competition does not exist and intermodal competition is limited to perishables and high value goods in areas where the highway system is fairly well-developed. The railway's present structure, seventeen geographically separate, but contiguous railways, is centrally integrated and controlled by the Ministry of Railways (MPS). Individual railways are monopolistic operators of traffic within their territories but transit traffic is integrated and controlled by MPS. Individual railways are quasi-separate financial entities, controlling locally generated revenues and expenses and financing most of their capital needs, but MPS reallocates transit revenues among the railways to even out their financial condition and plans and finances development of the overall network. The operating rules and overall financial system provide little incentive to reduce costs or to introduce more commercially oriented services. Wage growth is higher than in the country as a whole and labor productivity far below earlier levels; cuts in staffing and other costs have not kept pace with the declining and changing nature of Russia's more market-oriented freight and passenger demand.

42. Recognizing the need for reform, Government has taken actions to develop a structural reform program in the railway sector. A three year restructuring plan was set forth in an April 28, 1997 Presidential Decree (Number 426) that set forth the broad directions of reform, and a number of measures were implemented in 1997 including: (a) introduction of new procedures and authorities for regulating tariffs previously set by MPS with a view toward lowering overall levels, eliminating preferential

treatment of individual commodities or freight forwarders, increasing transparency, and more effectively taking into account patterns and volume of traffic, increases in labor productivity, restructuring and cost-cutting measures; (b) initial steps to separate passenger from freight services and to phase out compensation of passenger losses by freight traffic; (c) initial steps to separate and divest social and other ancillary services; (d) formation of a working group to plan conditions and timing for separating infrastructure from operations and introducing a framework within which competing freight and passenger companies could operate with equal access. Efforts of this working group culminated in a Government Resolution (Number 448) adopted on May 15, 1998 setting forth a concept document for restructuring the railways and authorizing a working group to carry out the concept in three stages.

43. With respect to unbundling and restructuring, a number of specific measures will be taken over the next year to build on efforts begun during 1997, including: (a) by December 1, 1998 the Government will develop and begin to implement the privatization of enterprises engaged in rolling stock rehabilitation and manufacturing of spare parts identified as candidates for privatization in Resolution Number 338 of March 21, 1998; (b) requiring MPS to submit, by July 30, 1998, a timetable for divesting the social and ancillary assets identified in a list submitted to Government on April 30, 1998 and a report on the book value and divestiture plans with respect to social and ancillary assets not included on the April 30, 1998 list; (c) by December 31, 1998, requiring MPS to provide Government with an action plan to divest assets on the April 30, 1998 list.

44. With respect to separating passenger from freight operations and reducing the cross subsidization of passenger losses by freight operations, Government intends to: (a) prepare by October 1, 1998 a feasibility study to establish long and short-haul passenger companies and establish the first two of these by December 1, 1998; (b) issue a Resolution to enable regional railways to set tariffs for commuter rail services that will also stipulate that any concerned municipalities desiring to lower tariffs be required to pay at least 50% of resulting operating losses; and (c) require MPS to introduce, by September 1, 1998, separate cost accounting and separate income statements and balance sheets for long distance passenger traffic, commuter rail and freight traffic.

45. With respect to tariffs, a number of steps have been taken to limit the overall growth and further regulate tariffs. These include: (a) issuance of Resolution No. 12/1, dated April 14, 1998, by the Federal Service Regulating Monopolies in Transport, to limit freight tariffs to increases in the industrial producer price index less 0.75 percentage points on an average quarterly basis and less 3 percentage points on an annualized basis; (b) establishment of a Government commission to improve tariff policy pursuant to Resolution No. 507, dated May 26, 1998; (c) lowering the base tariff structure for key bulk commodities including coal, ore crude oil and black oil pursuant to Resolution No. 19/1 dated June 9, 1998 of the Federal Service Regulating Monopolies in Transport; (d) eliminating, by December 31, 1998, any discrimination between tariffs for domestic and export traffic; and, (e) by June 30, 1999, setting rail tariffs are set on a uniform basis for all commodities.

C. Private Sector Development

46. ***Context.*** Dynamic private sector development will be the key to the resumption of sustained growth in Russia. With price and trade liberalization substantially completed, this will mainly depend on reforms in areas that, taken together, create a fertile business environment, including: (i) enhancing and accelerating the program for transparent and competitive privatization; (ii) establishing institutions and policies that promote rules-based competition and facilitate market-based entry and exit, effective corporate governance incentives, and labor mobility; (iii) creating functioning markets for urban land and real estate, which are critical for new startups and the reallocation of assets to higher values in use; (iv)

implementation of financial accounting and auditing practices in line with international standards; and (v) liberalizing the policy regimes for international trade and foreign direct investment.

47. In 1993-94, under the *voucher* mass privatization program, the Government transferred, either completely or partially, over two-thirds of all large- and medium-sized enterprises and over 80 percent of all small enterprises to private ownership, including minority stakes in most of Russia's largest enterprises. The voucher program gave substantial benefits to "insiders". In the second stage of privatization (1995-96), the Government sold share packages in several thousand more enterprises for cash. It also transferred controlling shares in a few of the largest and most attractive enterprises in trust to Russian banks in exchange for loans--the so-called *loans-for-shares* scheme. The lack of transparency in the way these latter privatizations were carried out raised serious concerns about equity, concentration of market power, and corporate governance. Moreover, because the processes utilized were insufficiently competitive, government revenues from the transactions were substantially reduced. In late 1996, the Government announced it would initiate a third stage of privatization, based on a*case-by-case* approach, to be implemented under the support of SAL1 and SAL2. It is targeted at large enterprises and can involve a combination of transaction methods, including use of strategic investors, competitive tenders and auctions, and initial public offerings (IPOs). More generally, in 1997 the Government committed itself to carry out future privatizations using transparent and competitive procedures.

48. The pressure for firms to compete against one another remains low in Russia. With blunted *external* incentives to become efficient, due to inter-regional barriers to competition, weak exercise of creditors' rights and impediments to new competitors (including foreign invested firms), Russian enterprises are still in the early stages of restructuring. There remains huge scope for output and profit gains from the reallocation of existing capital to higher value uses. Still, a nascent legal framework for bankruptcy and liquidation acts as a critical constraint on competition and the restructuring of enterprises. At the same time, weak*internal* incentives for commercially-oriented corporate governance in large enterprises--both those that are privately owned and those that continue to be state owned/controlled--also stifle restructuring. Application of international accounting and auditing standards is critical to instill transparency and accountability, thus providing for effective internal "checks and balances." Improving both external and internal incentives for enterprises is a key aspect of the Government's reform program for private sector development.

49. ***Transparent and Competitive Privatization***. The Government's priority objective in the enterprise sector is to revitalize privatization with a credible program that is based on the principles of transparency, openness and competition. Despite the extent of Russia's earlier privatization initiatives in transferring assets to private ownership, the state remains the largest property owner, and the federal government continues to retain majority ownership or control in many large enterprises. This underlines the importance—both in strategic and fiscal revenue terms—of implementing future privatizations in a sound manner.

50. Privatizing these remaining assets—and doing so using competitive and transparent procedures—is necessary so as:

- *to increase efficiency in use of the assets* by improving enterprise management and corporate governance, enhancing restructuring incentives, and locking in "hard" budget constraints. Under competitive privatization procedures, the winning bidders are more likely to be those who can best manage the assets—and thus produce the highest value added for the economy.

- *to send a signal to both domestic and foreign investors* that Russia's business environment is open, competitive, and investor-friendly, and that private sector development is market-driven. Transparent privatization militates against insider deals and sends the signal that regulatory and other similar decisions in Russia are made predominantly on commercial, economic grounds.

- *to promote domestic support for overall market reforms* and to demonstrate to the Russian population that privatization can be open and fair. The Russian public is extremely disenchanted with many of the recent transactions that have transferred assets to a select group of insiders at give-away prices.

- *to raise substantial budget revenues.* Cross-country experience shows that competitive and transparent privatizations could generate billions of dollars in needed fiscal revenue over the next several years.

51. The process by which privatizations are carried out has important ramifications for the efficiency of resource allocation, further investment from domestic and foreign sources, public support for reform, and budget revenues. Thus future privatization procedures—especially for the largest companies—should adhere to the following principles:

- *The design of each transaction should be tailored* to the enterprise's and purchaser's specific situation--this is the hallmark of the "case-by-case" approach. The transactions should be done in the context of an overall privatization process that is well planned and executed in conformity with international investment practices and capital market standards.

- *Transactions should be transparent and competitive* to ensure equal access by all potential investors, including foreign participants. Reputable and experienced independent financial advisors are critical to safeguard the integrity of the process; their involvement is integral to the case-by-case framework that has been established (see below).

- Maximum restructuring efficiency and financial returns to the government from a sale will likely come by *utilizing outside, strategic investors* who can bring renewed commitment and fresh ideas to the business.

52. To meet these objectives in the case-by-case privatization program, the Government issued two resolutions—Government Resolutions No. 363 of April 1, 1997 and No. 564-R of May 12, 1997—specifying rules and implementation procedures for such privatizations. The resolutions require the case-by-case privatizations to be fully open and competitive (including through equal and open access to domestic and foreign buyers), and using openly and competitively selected financial advisors. The privatization transactions themselves will also be widely advertised domestically and internationally. Enterprises will be valued at market prices or, if they are not traded, based on international business valuation procedures.

53. More generally, the Government has committed to implementing future privatizations on the basis of a common framework of principles and procedures that ensures transparency, openness and competition. The law "On Privatizing State Property and on the Principles of Privatizing Municipal Property in the Russian Federation" was adopted by the State Duma on 24th June, 1997 (the *Privatization Law*). In accordance with the Privatization Law, the Government submitted to the State Duma the "State Program of Privatization in the Russian Federation" (*State Privatization Program*), which identifies state enterprises held in federal property and subject to reorganization into open joint stock companies and

privatization beginning in 1998, and joint stock companies whose federally held shares are subject to sale beginning in 1998.

54. Under SAL3, the 1998-99 privatization program will expand and accelerate significantly the process of transparent and competitive privatization in accordance with Government Resolutions 363 and 564 of 1997, and through the significant reduction in the number of firms currently denoted as "strategic" and their privatization. To this end, a special Policy Statementwas issued on July 20, 1998 by the Chairman of the Government of the Russian Federation announcing these initiatives. The policy statement will be published widely in the international media.

55. By July 15, 1998 the Ministry of State Property will issue an ordinance establishing a list of 15 enterprises that are part of the draft State *Privatization Program* and are to be privatized according to the case-by-case procedures. The ordinance will establish a schedule for privatizing these enterprises such that they will be offered for sale not later than December 31, 1998, if such dates are determined on advice of independent financial advisors as most desirable based on market conditions. The percentage of equity offered will be determined in consultation with independent financial advisors. These enterprises are: OAO Orenburg Oil JSC (Orenburg oblast); OAO "Kovrovo Electric Machine Plant" (Vladimir oblast); OAO Western-Siberian Iron & Steel Factory (Kemerovo Oblast); OAO "Stupino Iron & Steel Factory" (Moscow Oblast); OAO "Nizhni Novgorod Machine Building Plant"; OAO "Oil & Gas Co. "Slavneft" (Moscow); Rybinsk Instrumentation Factory (Yaroslavl Oblast); Kemerovo Mechanical Plant (Kemerovo Oblast); Kamensk Chemical Factory (Rostov Oblast); Factory "Krasny gigant" (Penza Oblast); PO (Prod. Association) "Avangard" (Ufa); GPO "ZiM named after Maslennikov (Samara Oblast); Plant "Kommunar"; NPO "Geofizika" (Moscow); Vysokogorsky Mechanical Works (Sverdlovsk Oblast).

56. By August 31, 1998 the Ministry of State Property and the Russian Federal Property Fund will hold competitive bids and select 9 to 11 independent financial advisors among experienced, reputed international investment institutions. These advisors will be engaged to (i) carry out pre-sale preparation of the largest Russian enterprises, including but not limited to those denoted in the draft *Privatization Program*, and (ii) place shares of these enterprises on world markets in accordance with Government Resolutions 363 and 564 of 1997. These advisors will, among other things: audit and appraise the enterprises; suggest the likely market price of the transaction; recommend any required organizational/managerial restructuring prior to sale; work out the optimal privatization scheme, including the percentage of equity to be offered; and ensure that bids will be welcomed from all physical and legal persons and foreign investors eligible under Russian law.

(i) Within this framework, beginning July 31, 1998, the following ten tenders will be offered on domestic and international markets before December 31, 1998, if such dates are determined on advice of independent financial advisors as most desirable based on market conditions: Rosneft, Sviazinvest, SIBUR, LUKOil, Cheliabinskinform, Electrosviaz (Moscow Oblast), Novossibirsk Electrode Plant, Slavneft, NORSI-Oil, RAO UES.

(ii) Within the same framework, beginning by the end of each quarter following July 31, 1998—i.e., September 30, 1998, December 31, 1998, March 30, 1999, June 30, 1999, September 30, 1999, and December 31, 1999—at least 7 firms listed on the draft *Privatization Program* issued by the Government on April 21, 1998 shall be brought to point of sale within the subsequent six months, if such dates are determined on advice of independent financial advisors as most desirable based on market conditions.

57. To increase the scope of privatization, the Government issued Resolution No. 784 on July 17, 1998 that significantly reduced the list of "strategic" enterprises barred from any privatization to either domestic or foreign investors from 3,000 to 697 firms. The enterprises removed from the "strategic" list will be subject to transparent and competitive privatization processes, beginning September 30, 1998 to December 31, 2000. In accordance with market conditions as assessed by independent financial advisors, at least 10 percent will be brought to the point of sale by December 31, 1998, at least 15 percent by March 31, 1999, at least 25 percent by June 30, 1999, at least 30 percent by September 31, 1999, 40 percent by December 31, 1999, and 100 percent by December 31, 2000.

58. In addition, by October 31, 1998 the Government will adopt selection criteria as to which of the existing 6,500 agro-industrial enterprises will remain under exclusive federal ownership until the year 2000. Based on these criteria, by November 30, 1998, the Government will issue a Resolution specifying the list of agro-industry enterprises that will remain under federal ownership until 2000. The list will specify the name, legal address, core activity, and institutional and legal status of the enterprise. Starting from January 1, 1999, the Government will, market conditions permitting, bring to the point of sale by December 31, 1999, at least 10 percent of the enterprises not included on the list. Subsequent sales will be announced in the future. The privatization process will be carried out according to the rules governing competitive cash auctions, without distributing majority shareholding to suppliers of raw materials under preferential terms.

59. ***Fostering Exit of Non-Viable Firms.*** To meet the Government's objective of establishing institutions and policies that facilitate market-based exit, the policy framework for bankruptcy is being improved. A new Bankruptcy Law became effective in March 1998. Relative to the previous law, the new legislation provides for: (i) an increased role for creditor committees in the resolution of insolvency cases; (ii) more expeditious appointment on a competitive basis of licensed trustees with authority to replace incumbent enterprise managers; (iii) differentiation of classes of creditors; and (iv) stricter observance of time limits for workout and liquidation proceedings by all parties. Nonetheless, the new framework contains a bias towards reorganization rather than liquidation of enterprises. To this end, by September 30, 1998, the Government will submit to the Duma with a view to enactment by December 31, 1998 amendments to (i) the Bankruptcy Law that eliminate court discretion in overruling the creditors' decision to liquidate the debtor enterprise and (ii) amendments to the Civil Code to strengthen the rights of secured creditors. In addition, the government will take all necessary steps to implement the new laws on enforcement of court judgements, including by fully staffing the court officers' corps by December 31, 1998.

60. In addition to the actions aimed at improving the bankruptcy legislative framework, the restructuring process in the Russian economy could be expedited by implementing pilot projects targeted towards bankruptcy of insolvent enterprises in cases that are especially difficult in such a way that minimizes possible negative social consequences of bankruptcy. For such purposes, and taking into account the basic provisions of the new Bankruptcy Law, the Government will approve, by adopting appropriate directives, a procedure for implementing and financing bankruptcy pilot projects involving insolvent enterprises. The Federal Service on Insolvency and Financial Rehabilitation (FSIFR) will implement at least 4 bankruptcy pilots embracing large enterprises that experience serious financial difficulties and have bad market prospects. The results of the pilots implemented will be widely reflected in a report of the FSIFR to (i) provide arbitrators with data on the relevant procedures; and (ii) provide creditors and other persons concerned with the most detailed information about the mechanisms and advantages of hearing bankruptcy cases in the court.

61. ***Enhancing Inter-Firm Competition and New Entry.*** The Government's program contains measures to lower barriers to new entrants and to enhance inter-firm competition. To this end, the Government will

implement by September 30, 1998 measures to strengthen the mission of the Antimonopoly Committee, both at the Federal and sub-federal levels, with a view towards introducing a more effective rules-based institutional regime for competition policy throughout the Federation, ensuring that territorial branches exist in each region. Through such measures and in the 1999 budget, the Antimonopoly Committee will be given adequate financial and human resources commensurate with its revitalized mission. The mission of the Antimonopoly Committee will have as principal objectives the creation of a unified economic space throughout the Russian Federation and preventing restrictive business practices, in particular anti-competitive mergers and acquisitions. The Antimonopoly Committee will develop and implement policy measures that deal with reducing anti-competitive horizontal and vertical concentration and integration in key product and geographic markets, including industrial and financial groups (FIGs) and the petroleum sector.

62. By November 30, 1998 the Antimonopoly Committee will issue for public comment explicit and well-defined merger guidelines that establish general policy parameters to distinguish between pro-competitive and anti-competitive mergers based on similar guidelines consistent with international practice. Following public comment, these new merger guidelines will be published widely by December 31, 1998.

63. The Antimonopoly Committee, in collaboration with other federal organs, will implement by September 30, 1998 new measures to remove administrative and policy-induced barriers at Federal and sub-Federal levels to the free movement of goods and services throughout the Russian Federation. The measures will include stronger enforcement penalties than presently exist. To introduce at the Federal and sub-federal levels new rules-based, streamlined business licensing procedures and fee structures, the Government will seek passage of the Law on Licensing by December 31, 1998.

64. In order to foster resolution of business disputes, new measures will be implemented by July 31, 1998 that strengthen and enlarge the bailiff service so as to provide for more effective enforcement compliance, including criminal sanctions, by losing defendants in *arbitrazh* court cases.

65. ***Improving Corporate Governance and Strengthening Investor Rights.*** As a high priority, the Government will take steps to protect shareholders' rights and to introduce market-based incentives for more effective corporate governance. To this end, the Government will submit to the Duma with a view to enactment by December 31, 1998, legislation that amends the Federal Law "On Joint-Stock Companies" stipulating, in particular, protection of minority shareholders' rights, including protection from transfer of assets to parent (affiliate) companies, by enhancing the penalties for violating investors' rights.

66. By September 1, 1998, the Federal Securities Commission (FSC) will adopt a Resolution on the procedure governing compilation and submission of quarterly reports by issuers of securities, with a special focus on information disclosure by enterprises quoted on public exchanges. By July 30, 1998, the Government of the Russian Federation will adopt and initiate implementation of the State Program on Protection of Investors' Rights that will spell out further key tasks and measures to be undertaken in 1998 and 1999. The Government will also ensure that the FSC will be provided sufficient resources to enforce investors' rights. This will be achieved by assigning a share of fee revenue from licensing of securities' market participants to the FSC.

67. By October 31, 1998 the Government will publish procedures consistent with Decree No. 395 and Decree No. 392 for restructuring the debts of agricultural enterprises. By December 31, 1998, the Government will implement the above mentioned procedures. In any new legal enactments regarding the

establishment of joint stock companies in the agricultural sector and the legal status of such companies, the Government will affirm and protect the right of members of the joint stock company to invest the use right of land in the charter capital of the enterprise while retaining ownership of the land.

68. ***Fostering Labor Mobility.*** Pro-competitive restructuring of enterprises depends on the efficient allocation of labor in the economy. With this objective in mind, the Government will submit to the Duma by November 1, 1998, a new Labor Code that would bring the labor laws in compliance with the requirements of a market economy. The Code will establish a realistic and feasible minimum of social guarantees, enhance the role of individual labor agreements, including a more simplified procedure for dissolving individual labor agreements (such as excluding the need for consent of trade unions and finding alternative employment), and expand the ability to enter into fixed term and multiple-work contracts. The Code will also contain provisions targeted at forming and implementing collective agreements at the level of individual enterprises, as well as ensure the establishment of efficient institutions ensuring implementation of individual and collective agreements, settlement of collective disputes and compliance with the requirements of the labor legislation.

69. ***Developing Land and Real Estate Markets.*** Reforms in the areas of land and real estate have lagged behind overall economic reform in Russia. An inadequate legal framework for sale, lease and other transactions in land and real estate represents a major constraint for entrepreneurship and new business entry. Effective monopoly ownership and control over urban land is exercised by municipal administrations. This monopoly has led to artificial limits on the supply of urban land and real estate made available for competitive commercial lease. It has also led to the widespread misallocation of commercial real estate. In the absence of a comprehensive framework governing transactions in land and real estate at the federal level, regions have proceeded independently to pass their own legislation. Some subjects of the federation prohibit privatization of land, while others have initiated their own reforms ahead of the federal authorities (e.g., Samara, Saratov, Tatarstan, Khanty-Mansy autonomous region.)

70. Land issues have become a political question as well as an economic one. The tense political struggle regarding transactions in land and real estate has resulted in a deadlock over enactment of a Land Code that would confirm the constitutional rights of citizens to own land and engage in transactions mediated through markets. Since 1992 most land reform has been carried out on the basis of presidential decrees and government resolutions. The threat that the Duma will withdraw rights at present affirmed by presidential decrees is a serious impediment to further development of land markets. In December 1997 a presidential Round Table meeting on land reform was convened. In accordance with the Decision of the Round Table, the President directed the Government to develop a program of measures to further land reform, and to draft priority legislation for consideration by the Duma, including laws on state and municipal ownership of land, on land management, on appraisal, and on regulations regarding land transactions. In the spring of 1998 a new Governmental structure was created through merger of the former Ministry of Construction, State Land Committee and State Committee on cartography into one Ministry of Land Policy, Construction and Housing. The merger is intended to ensure comprehensive and consistent policy with regard to land and real estate.

71. The law on *State Registration of Property Rights and Transactions with Real Estate* passed in July 1997 and came into effect in February 1998. A Registry for real estate was established at the same time, although the registration system requires further development in order to become fully operational. Payment for use of land has been introduced with differentiated rates of land tax and lease payments depending on the location and quality of land plots. Land and real estate taxes brought revenues of 9.4 billion Rbs to the budget in 1997. In July 1998 the Government submitted to the Duma a proposal to increase sharply the land tax as one of several revenue-enhancing measures. Since the Duma failed to

pass the land tax increase as it was proposed by Government, it was enacted by a Presidential Decree No. 854 of July 18, 1998.

72. The *Mortgage Law* was passed by the Federal Assembly on July 9, 1998, and came into force on July 22, 1998, thereby facilitating new financial instruments to accelerate activity on real estate markets. However, the new law does not allow for mortgage of land that is state and municipal property and of land belonging to agricultural entities, farmers and field plots. Further action by the Government is needed in this area

73. To accelerate the pace of change in the areas of land and real estate, the Government has committed itself to approve by late August 1998 the *Federal Program on Development of Land Reform in the Russian Federation in 1998-2001* to be enacted by the end of September 1998 by a Presidential Decree. The Program will include an affirmation of the rights of citizens to engage in transactions in land, including purchase, lease, and mortgage, and will specify a program of actions to facilitate transactions. The reform strategy outlined in the Program will focus on pragmatic and readily implementable steps to clarify rights in land, transferring commercially valuable land from municipal and state ownership to either private ownership or long term (49 years) lease, and simplifying the procedures by which transactions in land can take place. The Program will be supported by an action plan for implementation to be approved by October 30, 1998. In addition, the Government will strengthen implementation of Presidential Decree "On Exercising Individuals' Constitutional Rights to Land" No. 337 of March 7, 1996 in order to ensure that agricultural enterprises using land owned by shareholders enter into formal contracts regarding land use.

74. In view of the continuous delay in passing a market-based Land Code and the deleterious effects of the delay on land markets and land values, the Government will submit to the Duma with a view to enactment by December 31, 1998 legislation dealing with such issues as land management, appraisal, cadastre, and delineation of ownership rights over publicly held land by state and municipal authorities. By December 31, 1998, the Government will adopt and start implementing a resolution to establish the program for the phased introduction of the uniform system of state registration in accordance with the law on *State Registration of Rights and Transactions in Real Estate*. The resolution will clarify the steps that will be taken to have functioning registration offices established at the rayon level, the specific nature of inter-agency cooperation required, and the sources of financing for implementing this plan.

75. ***Accounting and Auditing Reform.*** Without timely and accurate information that conveys an enterprise's financial performance and condition, market signals and incentives cannot work to encourage economically efficient enterprise management, restructuring and investment. A prerequisite to efficient working of the financial sector is the emergence of an environment which encourages enterprises to provide such information to would-be lenders and investors. Therefore the Government's objective in this area is to improve the quality of financial information available for managers and investors and help attract more capital, beginning with the development of financial accounting and auditing standards for enterprises consistent with international practice.

76. ***Introduction of International Accounting Standards.*** In 1998 the Government undertook an important step towards implementing International Accounting Standards (IAS) by adopting a nationwide program for accounting reform based on IAS. The program envisages the creation of national accounting standards fully compliant with IAS, adjusting the existing legislative base with due regard for the requirements of a market economy and international practice, establishment of the accounting profession, and training and retraining of accountants.

77. Russian accounting remains in many ways an instrument of a command economy and gives primacy to administrative functions. Russian accounting also lacks the functional division between internal (management) accounting and external (financial) accounting. IAS is directed at providing information to interested users—namely, investors—for the purpose of carrying out economic decisions. In a market economy accounting standards are subject to regulation so as to ensure the usefulness of information for outside users.

78. The objectives of the Government's accounting reform program are: (i) to establish accounting and reporting standards that ensure the full disclosure of information that permits assessment of the financial performance of organizations for a wide range of interested users; (ii) to ensure that accounting standards in Russia are harmonized with those utilized internationally; and (iii) to provide methodological assistance to enterprises in comprehending and introducing a system of management accounting.

79. The program calls for the priority ten national accounting standards to be implemented by January 1, 1999. The new Chart of Accounts for commercial entities, budgetary entities, and professional participants in the securities market and investment funds is to be adopted by the beginning of 1999. Establishment of the accounting profession will be completed through development of professional ethics standards, certification of professional accountants, and retraining of accountants in enterprises by 2000.

80. ***International Standards of Auditing.*** A parallel set of activities to those described above regarding accounting reform are also to be undertaken to introduce independent audits of enterprises. The Government will finalize the draft law *On Auditing in the Russian Federation* and submit it to the State Duma by November 30, 1998, with a view to enactment by March 31, 1999. The draft law will provide for the gradual transition of auditing regulation powers from Federal bodies to the self-regulating independent auditing profession. In accordance with the 1998-1999 Program of Auditing, where the accounts (financial statements) of economic entities are to be subject to auditing standards based on international practice, the Government will ensure implementation ofnecessary measures to arrange for national auditing regulations (standards) to be developed on the basis of the International Standards on Auditing (ISA). By December 31, 1998 the Government will adopt twenty two audit standards (inclusive of those adopted earlier) in compliance with ISA. By May 31, 1999, an additional eleven auditing standards based on ISA will be adopted by the Government.

81. ***International Trade And Foreign Direct Investment Policy Reform.*** Russia's trade policy has remained liberal over the years of reform. Tariff and non-tariff restrictions on exports ceased to exist as of 1996. As of early 1998, programs for oil exports for "state needs" were also canceled. The trend for import regulation is also generally positive, if more mixed. Beginning in 1996, import duties previously above 30 percent were reduced to this level, and there has been no major increase over last two years. Moreover, in the Government recently issued several resolutions reducing import duties from 30 to 20 percent for one-third of the tariff lines previously at the maximum level. As a result, the average import duty has remained below 15 percent since the last across-the-board revision in 1995.

82. However, with the domestic currency appreciating in real terms over threefold since 1992, domestic producers' pressure for protection against imports has been gaining momentum. Restrained from adopting discretionary quantitative restrictions on imports by obligations undertaken under the SAL program, increasing attention is being paid by the Government to protectionist options available in the context of import safeguards, compensatory, technical and other restrictive mechanisms. In view of this, the Government's compliance with internationally accepted procedures for introducing such restrictions will become of crucial importance for preserving the liberalization that has been achieved.

83. ***Maintaining a Liberalized Trade Regime.*** Under the SAL program, trade policy commitments have been made to prevent quantitative restrictions on international trade transactions. If protection measures are necessary to prevent injury to domestic producers (of a product or close substitutes) from imports, they will be price-based, precisely defined, temporary, and nondiscriminatory, and will be introduced after appropriate procedures consistent with WTO rules are followed, and taking into account the costs to consumers and users. Centralized trade will continue to be limited to arms exports and defense-related equipment. Trade under intergovernmental agreements and credit arrangements guaranteed by the government will be conducted on the basis of market-based procurement, with prices at world levels, and related expenditures and receipts will be reflected in the budget. The Government will refrain from operating any system of export controls under the disguise of mandatory monitoring of quantity, quality, or price of exports.

84. ***Harmonizing Standards and Certification Procedures with International Practice.*** Under the SAL program, a commitment to avoid setting up new technical barriers and to reduce existing ones for international trade also has been made. A new procedure for mandatory certification will become effective in 1998, which will both reduce the number of imported goods subject to mandatory certification, and simplify imposed requirements. An approved Concept for Developing Certification will target gradual substitution of a producer's declaration for the current pre-market certification. Duplication of certification procedures applied by different ministries will be eliminated. By end-1999, harmonization of Russian standards in priority sectors with internationally accepted ones will be essentially completed.

85. ***Improving the Policy Regime for Foreign Direct Investment.*** The Government is committed to enhancing the enabling environment for foreign direct investment. To this end, by September 30, 1998 a special Policy Statement will be issued by the Chairman of the Government, which will be published widely in the international media, that states the Government's commitment to continue to improve the policy framework for foreign direct investment by bringing the fiscal, regulatory and legal policy regime in line with international standards. Measures to bring about such changes will include the following reforms: (i) "national treatment" will be adhered to both for right of establishment and for post-establishment operations; (ii) the number of restricted sectors and limitations on foreign direct investment will be substantially reduced; (iii) enforcement of property rights will be strengthened; (iv) investor-State dispute resolution mechanisms will be made more efficient, including giving foreign investors the opportunity to seek neutral, binding international arbitration; (v) foreign investor registration procedures will be simplified, rules-based, and made transparent; (vi) guarantee schemes covering basic non-commercial risks will be maintained and extended; and (vii) restrictionson foreign investment in services sectors will be reduced.

D. Fiscal Management

86. ***Context.*** Fiscal reform has become the *sine qua non* for restoring market confidence in Russia's ability to maintain macroeconomic stability. The Government is keenly aware of the need for fiscal reform and, in particular, raising the primary fiscal surplus in order to sharply reduce government borrowing. Federal revenue collection has worsened while the interest debt burden on the budget has swelled, rising to a forecast 40%-50% of 1998 government revenues. To hold to federal budget deficit targets the government has again been forced this year to sequester expenditures and take emergency civil service cuts. The rapid growth in short term debt financing of the deficit led to increasing uncertainty over the sustainability of Russia's debt burden, and provoked the government into announcing the anti-crisis Economic Stabilization and Finance Program in late June 1998. Key fiscal measures under the

program include improvement of tax administration, raising and rationalizing select taxes, and restructuring of budget commitments.

87. A Presidential Decree setting out the budget parameters for 1999 was issued on July 16, 1998. Subsequently, a Presidential Address that formulates the 1999 budget—including key measures to underpin the budget targets—was signed on July 17, 1998 (and published on July 20, 1998). The Government's strategy focuses on further reducing the budget deficit by turning around the ongoing serious erosion in revenue collections while also making more effective use of limited fiscal resources. The federal government has committed itself to undertaking measures aimed at increasing total revenue collection from around 10.6% of GDP projected in 1998, to a targeted level of 13.2% of GDP in 1999, while holding constant nominal federal non-interest expenditures. As a result, the 1999 primary fiscal balance is targeted to improve to nearly 3% of GDP from a small negative balance this year. This dramatic shift will be achieved through efforts to broaden the tax base, improve revenue collection, strengthen budget management, rationalize government spending, reform intergovernmental fiscal relations, and strengthen debt management and monitoring capacity. In addition, the government is committed to improving the management and cost efficiency of extrabudgetary funds, including the Pension Fund, Social Insurance Fund, Employment Fund and Road Fund, together representing nearly 10% of GDP.

88. ***Eliminating Non-payments and Arrears***. Russia faces a non-payments crisis that has severely undermined fiscal policy and management at every level of government. Arrears in wages, enterprise payments, and public expenditures threaten the very foundations of the cash economy. To address the non-payments crisis several measures are being adopted to compel both governments and enterprises to effect timely cash payment. At the sub-national level the government is committed to making federal transfers to regional governments conditional on maintaining current accounts payable of 45 days or less of sales to infrastructure monopolies, liquidation of arrears outstanding to these natural monopolies, and maintenance of wage and payroll tax arrears at 30 days or less of the current wage bill. Conditionality is also to be applied by regional governments with respect to their intra-regional transfers to municipalities to help in tackling the chronic problem local utilities face in payments enforcement. All transactions are to be done on a cash basis, eliminating the use of tax offsets as a vehicle for payment. These conditions are to be applied beginning with the 1999 budget.

89. Collection of tax arrears from large debtors will also remain a central element of the revenue collection strategy. The Emergency Tax Commission, established last year and then dormant during the political transition to the new Kiriyenko government, has been reconstituted and will meet monthly to enhance measures targeting collection from the 20 largest remaining tax debtors. The Government's commitment to this has been evident in efforts to get the largest tax debtor,Gazprom, to adopt a plan for scheduled repayment of its nearly $2 billion in outstanding arrears.

90. ***Reforming the Tax Structure***. A principal government objective of fiscal reform is improving the tax system to reduce distortions, strengthen compliance, and boost collection levels. The present tax system has many shortcoming which act to distort incentives across sectors of the economy and further encourage widespread tax evasion. Declining tax revenues have resulted both from shortcomings in tax administration, enforcement, and in the structure of taxes. The high level of inter-enterprise arrears has led to a decline in tax liabilities. Barter transactions in the economy have become widespread, with as much as 40% of GDP transacted outside of formal cash channels. These problems have deeply crippled the revenue capacity of government at every level, and fundamentally compromise the efficiency of the tax system.

91. The Government's plan for a major overhaul of the current tax system is centered around the Tax Code, which provides for a comprehensive and consistent legal basis for the Russian tax system. Part I of the Code (focussed on tax administration) was passed by both chambers of the Federal Assembly in mid-July 1998. (The Presidential Address of July 17 instructs the Government to seek passage of amendments to Part I of the Tax Code by end-1998.) Part II of the Tax Code (on tax structure) is expected to be considered by the Duma in late 1998, and the Government is working closely with the Duma and Federation Council with a view towards securing enactment by the end of the year. Beyond the recent adoption of the Tax Code, both chambers of the Federal Assembly also passed a law removing tax exemptions for closed territories by January 1, 2000 or when the existing agreements expire, whichever occurs first. They have also passed a law approving a 5 percent sales tax (albeit with exemptions for bread, milk, and children's food and clothing, among other provisions).

92. However, at the same time the parliament rejected: expansion of the base for the personal income tax; transfer of 20 percent of personal income tax proceeds from the local to the federal governments; an increase in the land tax; and expansion of the base for the payroll tax. In light of these actions, the following steps have been or will be taken: (i) regarding the personal income tax, the Duma will be asked in a special session in August to approve an expansion in the base and a shift of 20 percent of the tax to the federal government; (ii) regarding the increase in the land tax, the change in tax rates was introduced by Presidential Decree on July 18; and (iii) Pension Fund finances will be addressed through amendments to the current law on pension contributions, which will be submitted to the special parliamentary session in August, and through other actions (see below) to increase employee payroll tax contributions (from 1 to 5 percent) and reduce employer contributions (from 28 to 24 percent).

93. In mid-July the Duma also passed tax legislation calling for a reduction in the oil excise tax and in the profit tax. Taken together these actions would have involved a revenue loss of Rub 12-13 billion in 1999. Presidential Decrees vetoing these tax reductions were issued on July 18, 1998.

94. In the coming months the Government intends to rationalize the system of capital income taxation, and has submitted legislation to introduce an improved framework. This is the first comprehensive legal treatment of capital taxation in the Russian Federation, and is a high priority for legislative reform. Under current legislation, differing rates of tax treatment across securities, savings deposits, and other savings instruments introduce distortions that will reduce savings options facing consumers and deter development of long term savings instruments. To improve this framework before implementation, the government intends to revise the Tax Code with the objective of adopting uniformity of tax rates and treatment for securities and other financial assets, including elimination of double taxation on investment through collective investment vehicles such as mutual funds.

95. ***Improving Tax Administration.*** In addition to rationalizing the tax structure, the Government is committed to strengthening tax administration and efficiency of the Treasury. The State Tax Service (STS) has been hampered in its ability to collect taxes by several features of the law which restrict its authority to levy fines and enforce payment. The Government is committed to rectify this through upcoming amendments to Part I of the Tax Code, including reduction of excessively restrictive time limits on assessing taxes or fines for non-payment of taxes, removal of interest rate caps placed on fines levied on tax arrears, simplification of tax administration procedures of the tax authorities, and elimination of deferrals for taxpayers with arrears from the budget. The Government is also developing plans to restructure the STS to both reduce excessive staffing in regional and local government offices, while strengthening capacity of the federal STS offices. Streamlining of the STS will include making both the Federal Agency for Foreign Currency and Export Control and the Tax Police subordinate to the STS, and duplication of these offices' functions will be eliminated. Other initiatives under way include

steps to make tax agents who fail to transfer withheld taxes to the budget subject to criminal liabilities, and giving the tax authorities the ability to issue liens on the bank accounts of tax delinquents.

96. The role of banks in enforcing tax collection through the banking system needs to be revamped as the current system has negatively affected financial intermediation through the banking system. By September 1, 1998, the Government will establish a plan to remove tax administration functions from the banking system. In particular, legislation will be passed defining procedures for the STS to issue liens on any bank account and resources held in the banking system in line with international practice. A major goal of this plan will be to eliminate the use of settlement accounts by the tax authorities by January 1, 1999. In line with international practice, the STS will begin seizure of real assets or initiate bankruptcy proceedings against any enterprises for which there has been a lien on bank accounts for 60 days or more.

97. ***Reform of Extra Budgetary Funds(EBFs).*** Significant progress over the last two years has been made in reducing the number of EBFs operating outside budgetary oversight. Remaining EBFs are largely confined to provision of social insurance. The major exception to this is the Road Fund, which the Government is committed to bringing onto the budget in 1999 and to including its revenues fully in the federal budget. However, among the remaining earmarked EBFs -- the Pension Fund, Employment Fund, Medical Insurance Fund and Social Insurance Fund -- several shortcomings remain which the government is committed to addressing.

98. The Pension Fund (PF) is the largest EBF and has been exposed to persistent budgetary problems due to inefficient distribution and administration, payroll tax collection and enforcement difficulties, and political pressures to frequently adjust and augment benefits beyond the revenue capacity of the PF's pay-as-you- go system. Deteriorating revenue collection and an increase in pension payments in March 1998 helped cause the re-emergence of pension payment arrears during 1998, which currently stand over $2 billion. To restore solvency in the PF, the Government is committed to taking several measures to raise collection capacity, cut expenses, and maintain affordable benefit adjustments commensurate with the PF's revenue base. A Government Resolution has been issued that introduces, as of August 1, 1998, a temporary 2 percent earmarked tax surcharge on the personal incomes to be paid to the Pension Fund. This same resolution will also expand the base for the employer contribution. The surcharge will remain in place and further increases in pension benefits will be avoided as long as the Pension Fund remains in deficit or new pension arrears are being accumulated. In addition, legislation will be proposed to the Duma in the special August session that will expand the base for both employee and employer payroll tax contributions, and will shift the burden of the tax from employers to employees. Should these measures prove insufficient to restore Pension Fund balance by September 1, 1998, the Government will either reduce pension benefits starting with those above the minimum or further increase the payroll tax surcharge. Further efforts will also be made to reduce the administration costs of the Pension Fund. In order to ensure budget organizations comply with their obligations to the PF, from September 1, 1998 the Federal Treasury will transfer directly to the PF federal allocations for payroll tax payments on budgetary employee's wages.

99. The Social Insurance Fund (SIF) is the second largest EBF, financed from a 5.4% payroll tax and equivalent to about 1 percent of GDP in total expenditures, and has been running a surplus in recent years. The main function of the fund is to provide sickness benefits, maternity benefits and insurance for temporary incapacitation in the workplace. The SIF has, in addition, been providing a range of services that are not related to its social insurance function and are inappropriate to public provision or use of earmarked public funds, such as health spas and vacation supplements. The Government is committed to eliminating these non-insurance related expenditures and to streamlining and reducing the burden of financing the SIF through the payroll tax. To this end, the Government is committed to cutting the

payroll tax contributions to the fund from 5.4% to 4.9%, and to an objective of reducing overall expenditures of the fund by 25% in 1999. Any surplus generated by the SIF and not used in the provision of insurance related benefits will be transferred to the Pension Fund due to the chronic problem of pension financing and the recent decline in revenues of the PF. This should lead to a transfer of as much as one sixth of SIF revenues in 1999.

100. The Employment Fund (EF) is charged with providing unemployment benefits and job search assistance, and is funded through a 1.5% payroll tax on enterprises. Unemployment varies significantly across regions in Russia. In some oblasts with large industrial enterprises that have closed or declined sharply, unemployment levels are extremely high, and the tax base has fallen to levels far below requirements for meeting unemployment benefits requirements. Other regions have relatively low unemployment and contributions rates far exceed regional needs. With only 20% of total revenues centralized at the Federal level, many regions remain unable to provide benefits and have large accumulated arrears, while others have excess funds being spent on less essential and unrelated purposes. In an effort to improve its effectiveness and strengthen oversight of expenditures, the Employment Fund will be subjected to treasury control from October 1, 1998, and will be recorded as an earmarked item in the Federal Budget. In addition, the Employment Fund's revenues are to be collected by the STS as of January 1, 1999 on an earmarked basis.

101. ***Strengthening Budget Management.*** The basis for reformulating the budgetary system and improving budget management is embodied in the Budget Code, first introduced to the Duma in 1997, and finally passing both Duma and Federation Council readings mid-July 1998. Its provisions on budget responsibilities, comprehensiveness, unification, monitoring, reporting, auditing, etc. provide a solid basis for regularizing the entire sphere of budget operations and dramatically improving their transparency and efficiency. Although adoption of the Code represents a major step forward, it is not without some shortcomings and inconsistencies that will need to be addressed through subsequent amendments to the Code. Implementation of the new Budget Code in formulating the 1999 Budget Law is a basic objective of the Government this year.

102. To accelerate processing and control over disbursement of budget funds the Government has made substantial progress in the expansion of the computerized treasury system, allowing for unified accounting and direct payments. The volume of payments processed by the federal treasury has steadily increased through 1998, and now accounts for over half of all payments. The Government is committed to moving all federal agencies fully into the Federal Treasury with a single treasury account by January, 1999, including the Ministry of Defense, the earmarked budget funds, and all foreign exchange accounts of the STS and State Customs Committee.

103. The Government is also committed to downsizing and improving the design and capacity of the civil service. As part of the emergency fiscal package announced in June 1998, the Government decided to reduce total civil service employment by nearly 200,000 positions. To avoid unnecessary costs and deficiencies in the quality of public services as a result of this downsizing and further restructuring efforts, the government has completed a civil service census and is committed to build on this through preparation this year of a strategic program and timetable for administrative reform.

104. ***Reforming Intergovernmental Fiscal Relations.*** Issues of decentralization and intergovernmental relations are at the heart of many of Russia's key fiscal problems, not least because the success of tax and other budgetary reforms fundamentally relies on their voluntary implementation and enforcement at the regional and local levels. The current system of intergovernmental fiscal relations is expensive and inefficient. Many regions receive unconditional grants, and the system does not provide a

sufficient equalizing effect given the large fiscal imbalance among regions. There is also growing evidence that regional administrations do not fully implement federally designed and mandated structural reforms. This is one of the reasons why implementation of reforms in key areas such as housing, real estate and land market policy has been so slow. Finally, there is a need for further clarification of tax and expenditure sharing at each level of government because under current arrangements, incentives to improve tax collections at regional and local levels are inadequate, and the revenue base is not designed to systematically take into account expenditure assignments. This has made restructuring of revenue and expenditure assignments, and attention to unfunded expenditure mandates, central issues of intergovernmental fiscal reform.

105. The Government has decided to undertake a comprehensive restructuring of intergovernmental fiscal relations and has set up a tripartite Working Group, including representatives of the Government, Duma and Federation Council, to develop the fiscal reform program. An initial concept paper for restructuring of fiscal federal relations was adopted in April, but is being reformulated and finalized in July. This will serve as the basis for fiscal-federal reforms scheduled for implementation through reformulated legislation or amendments of existing legislation, including the Budget Code, Tax Code, and Law on Fundamental Financial Principles of Local Self Governance. Preparation of the annual Budget Laws will in turn be made consistent with these new legal foundations. A separate Concept Paper is bring prepared through the tripartite Working Group to formulate principles for restructuring of intra-regional fiscal relations, and is due to be completed by end-September, 1998. The Government is committed to reformulating the legal basis for revenue and expenditure assignments at each level of government. The timetable for this is to have reformulated fiscal foundations embodied in new legislation drafted and submitted to the Duma by April, 1999, and to have this fully reflected in preparation of the 2000 Budget Law.

106. Reformulation of the system of federal transfers is central to this agenda. Several measures have or are being undertaken in this regard. Special subventions to Moscow and Sochii have been eliminated, and traditional budget subsidies to the remote regions will be eliminated. The Ministry of Finance has already signed agreements with most regional governments with respect to conditioning repayment of outstanding budgetary loans. Debts will be restructured and/or forgiven on condition of, *inter alia*, eliminating wage arrears, stopping the practice of budgetary offsets, restructuring local civil servant wage scales in accordance with federal guidelines, bringing tariffs for housing and utilities in line with federal standards, and establishing energy consumption limits for budget-financed entities. Failure to comply with these conditions will result in regional allocations from the Federal Fund for Support to Regions (the equalization fund) being substantially reduced.

107. The current system of federal transfers is also to be basically restructured, ending the opaque and inefficient system of individually negotiated 'mutual settlements' with the regions. These flows will be channeled through three mechanisms: the Fund for Financial Support to Regions (FFSR- transfers for equalization), the Fund for Regional Development (FRD-loans and grants for public investment), and the Fund for the Development of Regional Finances (FDRF-loans for reform). Initially, allocation of the FFSR (equalization funds) is to be formulated around actual revenue performance in 1997, while during the course of 1999 a new formula will be established based on the principles of (i) reducing inequality of revenue capacity of subjects of the federation, (ii) use of federally defined expenditure norms to define expenditure needs, and (iii) strengthening incentives for regions to increase revenue collection.

108. ***Debt Management and Monitoring.*** The Ministry of Finance system for debt management and monitoring is at present fragmented across departments responsible for foreign debt, domestic debt, debt with the IFIs, and obligations with CIS countries. Of even greater importance is addressing weakness in

the capacity of the Government to coordinate strategy for selection of debt instruments, structure, and composition across sources of financing. To strengthen capacity in this area the Government is committed to developing a unified debt reporting structure, and to improving the coordination and management of external and domestic debt, at both federal and sub-national levels, within the Ministry of Finance. By January, 1999 the Government will initiate implementation of an integrated public debt monitoring system intended to cover both sovereign and sub-national debt, including all obligations of federal and sub-national authorities. In the process of implementing this system the Government also intends to adopt a new and more comprehensive definition of public debt to include all public contingent liabilities or conditional obligations, including guarantees, and all public bonds and securities.

109. Growth of largely unregulated subnational borrowing has become a serious concern for the federal government as significant regional defaults could have national consequences for public finance, with a direct impact on federal budget obligations, and serve to raise borrowing costs for both federal and subnational governments. As a consequence, the Government is committed to improving the oversight of sub-national debt and enacting legislation to establish transparent prudential limitations and conditions for sub-national borrowing. The Ministry of Finance will play a key function in both monitoring and verifying contracting of these obligations as a condition for subnational borrowing. In order to fulfill this responsibility the Ministry of Finance will establish a strengthened central registry for the public debt of sub-national governments.

E. Banking Sector Reform

110. ***Context.*** Increasing the role of financial intermediation in the Russian economy by deepening banking reform is a necessary condition for longer term macroeconomic stability and a sustainable financial system. By international comparison, the Russian banking system is small: the total assets of the system account for only 25 percent of GDP and deposits represent only 11 percent of GDP. In the initial years of transition, a large number of poorly capitalized banks were established. More recently, in an effort to minimize systemic risks, the Government and the CBR have made substantial efforts to improve banking legislation, strengthen the regulatory environment and bank supervision. As a result, the banking sector has started consolidating, although at present there are still approximately 1,700 banks in Russia.

111. The authorities have developed a systemic approach to address the problems in the banking system. This will be aimed at (i) not only resolving problems of weak and insolvent banks, but also at (ii) strengthening supervision and compliance, (iii) improving the accounting, legal and regulatory framework, including an efficient payment system and (iv) formulating a longer term strategy for developing competition. They are also (as noted earlier) changing the role that banks are playing in the administration of taxes, which has negatively affected financial intermediation.

112. ***Strengthening Supervision and Resolving Problem Banks.*** The CBR has made substantial progress in improving the quality of bank supervision. However, implementation of prudential supervision needs to be strengthened in order to minimize the effects of weak banks on the stability of the banking system. This would entail upgrading the supervisory capacity of CBR to identify banks with actual and potential weaknesses and to apply sanctions to weak banks before they become so fragile that they need to be restructured. In 1998, banks have engaged in a variety of foreign exchange forwards and options in order to hedge the foreign exchange risk. The use of those instruments has in turn brought about a significant level of counterpart credit risk which has not been reflected in the banks' balance sheets. This practice only exacerbates the fragility of Russian banks which continue to rely heavily on

short term trading of government securities and face a risky and increasingly impaired asset portfolio. In order to minimize those potential risks to the banking system, new prudential rules are needed.

113. To this end, more stringent prudential rules, especially with regard to banks' foreign exchange operations and positions, will be adopted. The requirement to provide consolidated reports beginning on January 1, 1999 will be extended to non-bank financial institutions. The government and the CBR will make every effort to ensure that amendments to the Central Bank Law to expand consolidated reporting to non-bank subsidiaries of commercial banks will be adopted by January 1, 1999, sufficiently prior to the implementation of such reporting from July 1, 1999. Prudential norms on banks' off-balance sheet foreign currency exposure also will be strengthened, by September 30, 1998, through the imposition of limits on single party and connected party exposure, and out-of-money options will no longer be considered adequate for covering on-balance sheet exposure.

114. Over the short to medium term, the CBR will continue withdrawing licenses of weak and insolvent banks and streamlining the banking sector. Liquidation of small insolvent banks (with capital of less than ECU 1 million) will be stepped-up and their licenses will be revoked by January 1, 2000 should they not reach the new minimum requirement. With regard to medium and large banks, the CBR and the government will devise a comprehensive approach for addressing problem banks which will include: (i) diagnosis; (ii) corrective action; (iii) bank restructuring; and (iv) bank liquidation. Such a strategy will be reflected in a bank restructuring framework to be prepared by October 31, 1998. The framework will be formulated on the basis of a full diagnosis of the size and nature of the problem and will involve setting out uniform rules and procedures to be followed.

115. The government and the CBR also will make every effort to have the Bank Bankruptcy Law and the laws amending the CBR Law and the Law on Banks and Banking Activities enacted by end-1998 to improve the CBR's supervisory powers and to provide an adequate legal basis for the bank restructuring framework. These laws will include adequate provisions to strengthen the regulatory powers of the CBR, including revoking licenses, effectively liquidating insolvent banks, and imposing further liability on banks' shareholders.

116. ***Enhancing Transparency.*** Banks still operate under accounting standards that do not comply with international standards. Introduction of full international accounting standards for all banks would bring about transparency and confidence in a banking system based on reliable information. Banks are currently required to submit accounts according to the recently modified Russian accounting standards. All banks under the World Bank's FIDP project are also required to produce IAS accounts, but only a few of these banks have actually implemented IAS as the basis for their internal information and control systems. One of the reasons why the authorities and the banks have been reluctant to the introduction of international accounting systems is that the Russian accounting system allows the banks to continue to control enterprise payments (i.e. function as the treasuries of the enterprises), assess their tax liability and make payments of taxes due. To this end, by September 30, 1998, the CBR will adopt a timetable to introduce accrual accounting for banks, with a view to introduce such accounting on January 1, 1999 if the Tax Code is in effect at that time. By January 1, 1999, and in tandem with the Tax Code, the CBR will bring the Russian accounting standards in full conformity with the main principles of the International Accounting Standards (IAS).

117. At the same time, the CBR will continue to increase the transparency of its own operations and will put in place requirements to increase transparency for commercial banks. The policy of announcing weekly data on external reserves, begun in June 1998, will be expanded to include the announcement of base money. The CBR will publish summary information on the financial situation of the 30 largest

banks on a monthly basis and a requirement will be introduced for banks to provide quarterly disclosures of key information. The standards for disclosure by banks holding more than 10 percent of household deposits in the banking system will be significantly expanded. By August 1, 1998, the ten largest banks will be required to publish quarterly accounts, have annual accounts prepared and audited by a reputable, qualified firm, and make the results public.

118. ***Fostering Competition.*** Finally, the Government is keen on the establishment of a competitive banking system, which can efficiently intermediate savings into investment, as an integral part of the development of Russia' private sector in the medium term. The degree of concentration in banking is high--the 10 largest banks account for about 50 percent of total assets, and Sberbank alone accounts for about 75 percent of all household savings deposits. Most banks continue to concentrate their asset positions in maximizing returns on short positions in government securities and foreign exchange. In addition, banks still have weak credit assessment and risk management capabilities. To this end, he CBR will formulate a strategy by the end of 1998 for fostering competition and a strong and efficient banking sector in the long run.

PART III: PROGRESS UNDER THE SECOND STRUCTURAL ADJUSTMENT LOAN

119. In June 1997, the Board approved the first structural adjustment loan for Russia (SAL1), a single tranche operation. SAL2, a two tranche operation, was approved in December 1997. **Attachment 5** contains the **Policy Reforms Program Matrix,** which describes the measures under SAL1, SAL2 and the proposed SAL3. What follows is a summary of progress under SAL2.

120. All prior actions for SAL2 were implemented by late November 1997, and it was approved, became effective, and its first tranche ($400 million) disbursed in late December 1997. During the December 18, 1997 Board presentation of SAL2, staff noted: (i) that the trend of most macro-economic indicators was positive; (ii) that the Government had accelerated implementation of structural reforms in 1997; and (iii) most importantly, that the Government had begun to implement a strong, newly formulated "Fiscal Action Plan to Increase Tax Collection and Reduce Federal Budget Expenditures" and had also made significant progress towards establishing a credible new macro-economic framework. Taken together, this provided a sufficient basis to proceed with adjustment lending despite continued weak revenue collection and expenditure management, as well as a brief delay in the completion of the IMF's 6th Quarterly Review of the EFF.

121. In early January 1998, the IMF's Executive Board approved the 6th Quarterly Review of the EFF. Macro-economic indicators for end-1997 confirmed the positive trends noted earlier and, following through on the critical actions taken in mid-November, all basic elements of the Fiscal Action Plan were implemented. Progress on the 1998 budget framework reinforced the prospect of its satisfactory implementation. Against this background, the judgement was made that a fully satisfactory macro-economic framework was in place, and the second $400 million tranche of SAL2 was disbursed at the end of January 1998.

122. Since then, overall implementation of structural reforms has been uneven, although in the last month it has improved. Progress in the banking/financial sectors and in trade policy has been good; and, in fiscal management and the reform of infrastructure monopolies (electric power, natural gas, railroads), it has been steadily improving. However, there have been serious delays in the quantity and quality of the privatization effort, especially in moving forward with the transparent, competitive "case-by-case" (CBC) privatization of large, strategic firms. Progress in specific areas is summarized below:

a) *Financial Sector.* The introduction of measures to improve banking supervision, regulation and payment systems reflects both the commitment and capability of the Central Bank of Russia (CBR). Improvements have been strongest in prudential regulation and in the treatment of problem banks, although much work remains to be done. Introduction of IAS accounts has also begun but needs to be intensified. The banking system continues to face serious challenges in bringing about effective intermediation. Exposure to potential volatility in the foreign exchange market has become a key issue.

b) *Trade Policy.* Steps have been (and are still being) taken to bring technical and product labeling standards in line with international practice. The emerging framework for "trade safeguards" (anti-dumping, countervailing duties, etc.) has been made more consistent with international norms.

c) *Fiscal Management.* For much of 1998, the Government has been facing the challenge of implementing the November 1997 Fiscal Action Plan, designed to strengthen tax collections and to manage effectively the reduction of expenditures while reducing the distortionary impact of the tax system. It is putting in place a system of regular monitoring and reporting on tax expenditures, and expanding the capacity of the Federal Treasury. In recent weeks, significant progress has been made in enacting key fiscal elements of the June 1998 anti-crisis program. As noted earlier, Part I of the Tax Code has been passed by both chambers of the Federal Assembly, as have a national sales tax and the Budget Code. A Presidential Decree was issued setting out the budget parameters for 1999, and a Presidential Address formulating the 1999 budget—including key measures to underpin the budget targets—was also issued. On the other hand, the parliament rejected expansion of the base for the personal income tax; the transfer of 20 percent of personal income tax proceeds from the local to the federal governments; an increase in the land tax; and expansion of the base for the payroll tax. Fiscal management has been weak in the enforcement of sanctions against large corporate tax delinquents; measures to reduce the cost to the budget of special allowances and subventions; and, the elimination of non-payments practices through tax, wage and payments arrears, especially at the sub-federal level.

d) In *infrastructure monopolies*, progress has been most obvious in electricity, where steps have been taken to reduce cross-subsidization, e.g., by decreasing prices to industry and increasing those to households. Establishing a wholesale market for electricity is also proceeding. In natural gas, prices have continued to be re-balanced in line with efficiency principles. The authorities have put in place a "third party access" decree to enable independent gas producers to gain access Gazprom's transmission network, although implementation has been problematic. In railways, cross-subsidization is being reduced by lowering freight tariffs and raising passenger fares, although there is some recent evidence that pricing of freight is being set to help solve specific export sectors. However, in the infrastructure monopolies overall, progress in competitive restructuring, de-monopolization, reducing barriers to new entrants, and divestiture and privatization of vertical and horizontal segments that are not "naturally" monopolistic has been slow.

e) As far as *private sector development* is concerned, a new bankruptcy law has been enacted and progress has been made on the preparation of a legal framework for land transactions, although a Land Code providing for comprehensive private ownership of land remains elusive. In addition, work has begun to phase in (over several years) generally accepted accounting principles consistent with International Accounting Standards (IAS), as well as to phase in independent audits. Critically, however, owing in part to serious conflicts between various interests within and outside the government, the new "case-by-case" (CBC) privatization program, which is predicated on the use of independent financial advisors to assist in the sale of large, strategic firms in a transparent and competitive manner, appeared until very recently to have stalled. The recent failed attempted sales of Rosneft epitomize the authorities' partial commitment to the CBC framework: financial advisors hired to carry out pre-sale preparation were given only two weeks for a highly sophisticated transaction that usually would require several months; and, there was no competition or arms-length procedure employed in the marketing of the tender and the transaction itself. In recent weeks, however, the authorities have acknowledged these weaknesses in their utilization of the CBC framework and have now signaled they will more fully embrace CBC procedures.

PART IV. THE PROPOSED THIRD STRUCTURAL ADJUSTMENT LOAN

A. Rationale and Objectives

123. ***Country Assistance Strategy.*** The last full CAS, approved by Executive Directors on June 5, 1997, envisaged expanded lending to Russia during FY98-99 on the order of $2-3 billion annually (of which up to two-thirds in adjustment lending), subject to the authorities' commitment to accelerate the pace of structural reforms. In this connection, SAL1 and a Social Protection Adjustment Loan (SPAL) totaling $1.4 billion were approved on June 5, 1997 and SAL2 and Coal SECAL2 totaling $1.6 billion on December 18, 1997. This substantial outcome was triggered by the authorities' commitment to and effective implementation of overall structural, social protection and coal industry reforms particularly during calendar 1997. Meanwhile, although the last CAS assumed a transition from mainly adjustment to mainly investment project lending by the year 2000, recent external and domestic policy developments suggest that the share and also absolute amount of adjustment lending that may be needed during the next 18-24 months will possibly be higher than originally contemplated. This issue, and related implications for FY99-00 lending and Bank exposure, as well as Russia's creditworthiness, will be addressed in a CAS Progress Report planned for distribution to Executive Directors in October.

124. ***Economic Justification for Adjustment Lending.*** The economic justification for the proposed SAL-3, and more generally for enhanced adjustment lending to Russia during the period immediately ahead, is twofold:

(a) *Accelerated economy-wide structural reforms.* The authorities' structural reform program covers a wide agenda, and adjustment lending is the most effective instrument for supporting the process. Moreover, the main revenue benefits of key fiscal reform measures will materialize only in the medium term;

(b) *Fiscal adjustment during external shocks.* Since late 1997, Russia has experienced two external shocks: sharply lower international prices for two of its leading exports (oil and base metals); and, the contagion effect of the East Asian financial crisis. Both have adversely affected public revenues and exacerbated the fiscal deficit.

125. Consequently, even with strong efforts at fiscal consolidation, the Government will continue to have considerable financing needs for the budget in the short term. Financing these deficits by issuing T-bills (GKOs) is still expensive, and maintaining price stability will require continued tight domestic credit, thus precluding any significant borrowing from commercial banks. The Government is thus seeking financing from external, non-inflationary sources, including multilateral institutions and the Eurobond market. As part of this financing package, World Bank adjustment lending would provide

some additional non-inflationary budgetary support during the next stage of economic transition, providing breathing space while structural reforms help strengthen the Government's revenue base and reduce expenditure pressures.

126. ***Features of the Policy Package for SAL3.*** The proposed SAL3 focuses on cross-sectoral, economy-wide reforms that have an immediate impact on macro-fiscal balances and are critical for renewed growth. The policy targets are specified for the remainder of 1998 through mid-1999 and beyond. The Government's structural reform program supported by SAL3 is reflected in the **Letter of Development Policy (Attachment 4).** The fourth, fifth and sixth columns of the **Policy Reforms Program Matrix (Attachment 5)** show the set of reform measures supported by SAL3 over time: (i) those that will have been completed between the presentation of SAL2 to the Board and the presentation of SAL3 to the Board (the first tranche), and those that are to be completed for the (ii) second and (iii) third tranches.

127. The same broad components that comprised SAL2—fiscal management, private sector development, infrastructure monopolies, and financial sector reform—underpin the basic structure of SAL3. However, given the new challenges and opportunities presented by the recent crisis, the proposed SAL3 incorporates a significantly enhanced reform package as follows:

> Broader Sector Coverage. Within a given component, measures cover a greater number of sectors. In infrastructure monopolies, for example, in addition to electric power, natural gas and railroads, the operation covers reforms in the oil sector. Under private sector development, new areas include competition policy, corporate governance and investor protection and the agro-industry sector. The international trade component includes measures to improve the policy regime governing foreign direct investment. Fiscal management includes measures to monitor and manage sovereign and subnational borrowing. Banking reform includes measures to enhance competition.
>
> Deeper Sector Coverage. In certain areas, SAL1 and SAL2 laid the institutional framework for reforms that necessarily precede fundamental policy changes. SAL3 provides support for such changes. In the infrastructure monopolies, for example, the framework for a wholesale electric power market has begun to take shape, but the establishment of independent generation companies and/or divestiture of local Energos has not heretofore been on the SAL agenda. Under the proposed SAL3, effective implementation of such reforms are targeted. Previous SAL reforms in natural gas have focused on pricing issues and creating an institutional framework for third-party access to Gazprom's transmission network; under SAL3, competitive restructuring of Gazprom has been placed on the agenda. In the other components of the proposed operation, similar deepening is incorporated.
>
> Growing Parliamentary Involvement. It is increasingly evident that the deepening of reform will require broader "ownership" of Russian society, including Parliamentary involvement. Accordingly, the proposed SAL3 contains several measures that require parliamentary passage of legislation, not simply Government submission of legislation. Examples include the completion of the Tax Code, an Oil Pipeline Law, amendments to the Bankruptcy Law, amendments to the Production Sharing Agreements statute, a law on Shareholders' Rights, a Law on Business Licensing, an Audit Law, among others.
>
> Back-Loading of Tranches. The proposed operation incorporates a design of progressive implementation of more difficult measures, a realistic reflection of the challenge of Russia's

reform process. Accordingly, tranche amounts have been back-loaded, with progressively larger increments over the operation's time-frame.

128. The proposed SAL3 has been prepared in parallel with the IMF's (i) 1998 EFF and (ii) recently approved enhanced assistance package; this is reflected in the Statements of Economic Policies and Letters of Intent for those two programs). The close collaboration between the Bank, the IMF, and the Russian authorities has helped to strengthen substantially the content of the Government's structural reform program. The proposed SAL3 also provides a crucial vehicle for intensive technical assistance to the Government both in the detailed design and in the implementation of measures under the program.

129. ***Roadmap Beyond SAL3.*** SAL1, SAL2 and SAL3 have been designed to support a comprehensive, extended structural reform program that at this stage is seen as lasting at least until the beginning of 2000. So far, much of the detailed structural reform agenda has been specified through the third quarter of 1999, with a few measures beyond (as reflected in the **Policy Reforms Program Matrix**). Possible future adjustment loans could continue to be cross-sectoral or may be more sector-specific. They could support implementation of reforms in late 1999 and into and beyond the first half of 2000, in parallel with the Fund's 1999 EFF program.

B. Benefits and Risks

130. ***Benefits.*** The loan would encourage and enable the federal government to accelerate and deepen a broad range of structural reforms, some of which were initiated under SAL1 and SAL2 as well as the EFF program. As discussed above, these reforms are critical to sustaining macroeconomic stabilization and stimulating renewed economic growth. The low-cost, non-inflationary budget financing provided by the proposed SAL3 would, at the margin, confer financial (debt service) savings as well as significant economic benefits (lower domestic borrowing, lower interest rates, lower inflation, higher investment, and ultimately higher growth). The reforms supported by the proposed SAL3 would help increase efficiency across a wide range of sectors by helping create the conditions for a more competitive and open private sector-oriented economy.

131. The joint SAL/EFF process has already generated considerable benefits by assisting the authorities to articulate an integrated program with complementary macroeconomic and structural reform priorities. These benefits would be significantly enhanced over the course of this and next year by more frequent monitoring (see below), during which Bank specialists would work closely with the authorities to help carry through and build on the key reforms being supported. During the supervision process, Bank staff would help the authorities elaborate the next stage of reforms for late 1999 and beyond.

132. ***Economic Risks.*** Russia faces a number of serious economic risks. The main *exogenous risks* are twofold: further declines in the prices of oil, gas, petroleum and other key products; and possible continuing contagion from financial crises in East Asia and elsewhere. The main *policy risks* are that the ambitious fiscal deficit targets for 1998 and 1999 may not be achieved; that the actions needed and the political will required to raise tax collections and to enforce spending discipline may be delayed or be inadequate; and likewise that key structural reforms aimed at improving the climate for private sector development will not be implemented fully. In addition, there are *financial risks* related to the vulnerability of the banking system. There is also the risk that bankruptcies and layoffs may compound existing *social tension;* while it is difficult to gauge the severity of the latter, this is clearly an issue that needs to be addressed in the coming months.

133. While international price movements for key commodity exports are clearly beyond Russia's control, the situation can be partly helped by creating a better climate for new investments and greater efficiency in existing operations through improved transparency and competition, e.g., by passage of PSA legislation and the Tax Code. Unsustainable public debt dynamics need to be addressed through a permanent reduction in the fiscal deficit. The chances of achieving this may be higher than before because: (i) the recent crisis has forced the new Government to recognize this is an immediate, fundamental issue; (ii) the institutional framework for revenue collection and expenditure control has been enhanced; and (iii) the leadership of the STS has been greatly strengthened. In spite of these favorable factors, it will not be easy to put public finances on a sustainable path, thereby engendering lower real interest rates, nor to implement fundamental structural reforms, thereby establishing policy credibility and restoring investor confidence.

134. ***Programmatic Risks.*** The Bank's program in Russia faces substantial political, economic, and institutional risks, which were discussed in detail in the last CAS. In addition, implementation of SAL1 and SAL2 demonstrated, on the one hand, that technical support was essential to the success of the reform agenda, but, on the other hand, that even with such support, there is no certainty that the Government, or in certain cases the parliament, will successfully implement the reforms.

135. The proposed SAL3 is clearly a "high-risk-high-reward" operation, and experience with SAL1 and SAL2, as well as the specific risks of the proposed SAL3, suggest certain additional mitigation measures. First, although substantial progress was made in earlier structural reforms (especially price and trade liberalization), the experience indicates *the importance of a stable macroeconomic environment* for reform in many key areas. As noted, the proposed SAL3 supports key structural measures in the fiscal management and banking reform areas. In addition, the EFF's fiscal and monetary policy programs are expected to continue reducing inflation and achieving a viable fiscal deficit, including through tight controls over fiscal subsidies and credit expansion. Nonetheless, there remain major risks associated with macroeconomic instability, compounded by the turbulence in international currency markets. The proposed operation will help to mitigate this risk not only through its strong fiscal management measures and the resources it will provide to Russia's economy, but also through close coordination with the IMF's ongoing EFF program.

136. Another lesson is the *importance of a intense monitoring and supervision* to ensure that the reforms are implemented properly. As many of the reforms are complex, supervision efforts need to be adequately staffed to provide detailed technical assistance as necessary. In addition, due to the increasing political sensitivity of many of the reforms proposed, supervision will need to focus attention on critical measures at the highest political level.

137. Finally, given the risk that the measures supported under SAL3 may *not be followed through* by the Russian authorities adequately, the proposed operation is back-loaded, with progressive tranching.

138. ***Creditworthiness and Bank Exposure.*** While Russia's long-term creditworthiness prospects are fundamentally favorable, they have worsened significantly in the short term, owing partly to factors already noted earlier, namely: the East Asian crisis that has affected emerging markets globally; the deteriorated terms of trade as a result of lower energy and minerals prices; and, the authorities' poor fiscal performance. High interest rates, the mounting debt service burden on the budget, and weak revenue mobilization all underscore the crucial importance of strengthening fiscal capacity and accelerating the structural reform agenda. At the same time, Russia will soon face a decline in net external transfers as principal and interest payments to the IMF and the Paris and London Clubs increase rapidly during 1999-2000. Total debt service is projected to increase significantly – to over 18 percent of

exports of goods and services by 2001 – but should remain manageable, given current expectations about export performance, terms of trade, and assuming effective implementation of fiscal and structural reforms. However, negative external official transfers commencing in the year 2000 will have significant implications for the financing of the budget deficit, underscoring the Bank's role as Russia's largest official creditor commencing 1999.

139. In this connection, assuming new commitments of about $3.1 billion in FY99 (including the proposed SAL3) and $4.5 billion during FY00-01 and assuming no further adjustment lending after FY01, the Bank's exposure in Russia (debt outstanding and disbursed) is projected to increase from an estimated $9.6 billion by end FY99 to $12.9 billion by end-FY01. While the latter would remain just below the current $13.5 billion single country exposure ceiling, it would essentially eliminate the headroom available for responses to possible future emergencies. It would also pose significant risks. The planned "back-loading" of SAL3 is thus designed to ensure that the fiscal and structural measures needed to underpin systemic macroeconomic and structural reforms--and also to improve the country's short-term creditworthiness--are fully in place before the main enlargement in Bank exposure.

C. Coordination with the IMF

140. The proposed SAL3 has been developed in close collaboration with the IMF to ensure consistency and complementarity between the macroeconomic program and structural reforms. At the request of the Government, Bank staff began working with Fund staff and the Government in early 1995 to develop the structural components of the Fund's EFF for 1996, which was approved in March 1996. Since then, Bank staff have worked with Fund staff in designing and implementing the EFF, and most recently the Fund's enhanced assistance package. As noted earlier, the design of the proposed SAL3 builds on that close collaboration. The policy content of the Government's reform program supported by SAL3 and the 1998 EFF and the Fund's enhanced assistance package have been elaborated in intensive tripartite discussions between the Bank, the Fund, and the authorities—with Bank and Fund taking the lead in the structural and macroeconomic areas, respectively, and with the coordination and collaboration giving rise to substantial synergies.

D. Board Conditions and Tranche Triggers

141. ***Prior Actions for Board Presentation.*** During negotiations, it was agreed that a set of prior actions would be undertaken before presenting the loan to the Board. These prior actions include: (i) approval of the IMF's enhanced program; (ii) RAO UES to publicly announce its intention of increasing private sector participation in Energos in which RAO UES has a stake; (iii) a Government Decision requiring RAO Gazprom transmission, production and supply enterprises to operate as separate cost/profit centres, with separate management teams and their own accounts based on international accounting and auditing standards; (iv) establishment of an interagency commission on Competitive Restructuring of Infrastructure Monopolies; (v) issuance of a resolution requiring RAO UES and Energos to establish separate accounts for generation and transmission; (vi) issuance of a resolution providing for elimination of state regulation of prices for gas produced by non-Gazprom producers; (vii) issuance of revised oil pipeline pricing methodology for public comments; (viii) the Ministry of Railways to provide the Government with book value and ownership details of assets identified for divestiture; (ix) the Ministry of State Property to issue a list and timetable of 15 enterprises to be privatized under case-by-case procedures; (x) issuance of a resolution mandating audits of EBFs; and (xi) issuance of a resolution approving Concept Paper on Subnational Reform.

142. ***Tranche Triggers.*** As noted above, SAL3 is designed as a back-loaded adjustment operation, with progressively larger tranche amounts. Accordingly, disbursement of $300 million of the $1.5 billion loan would be available immediately upon loan effectiveness. A second tranche of $500 million would be available following completion of the measures outlined in Box 1 (estimated December 1998). A third tranche of $700 million would become available following completion of the measures outlined in Box 2 (estimated June 1999).

Box 1: SAL3 Conditions for Second Tranche Release

RAO GAZPROM has reorganized its regional transmission operations into a single integrated transmission enterprise or into a number of transmission enterprises solely being responsible for gas transmission services, established in compliance with the Civil Code and based on major transmission corridors. RAO GAZPROM has further established separate management, separate accounts based on international accounting standards and separate cost/profit responsibility for the new transmission enterprise or enterprises, the production enterprises, and its gas wholesaling enterprise or enterprises.

The Government has established a revised system of gas excise taxes which applies the production rent component of the tax at the level of monopoly producers, including producers which are part of the Gazprom system, Yakutskgazprom, Norilskgazprom and Sakhalinmerneftegaz, without reducing Federal tax revenue.

The proposed Law on the Introduction of Changes and Additions to Legislative Acts of the Russian Federation ensuing from the Federal Law On Production Sharing Agreements, the implementation regulations relating to the Law on Production Sharing Agreements and any necessary amendments to the Tax Code to harmonize its provisions with the tax regime provided for in the Law on Production Sharing Agreements have been enacted and entered into force.

The Government is current with the implementation of the measures set forth in the privatization action plan agreed upon by the Government and the Bank as set out in Paras. 3.1- 3.5 of the Letter of Development Policy.

An amendment to the Joint Stock Company Law has been adopted and entered into force providing for adequate protection of minority shareholders.

The proposed Law on Licensing has been adopted and entered into force.

The Government has issued a formal decision requiring all consumers of gas, heat and electricity to make payments for their purchases of gas heat and electricity into escrow accounts established jointly by producers, transporters, distributors and any other entities in the supply chain and has furnished a report to the Bank demonstrating it has taken all measures necessary on its part for the implementation of such decision.

Box 2: SAL3 Conditions for Third Tranche Release

The Federal Energy Commission has introduced differentiated and separate prices for gas production, transmission and supply (delivery) services fully reflective of a revised methodology agreed upon by the Government and the Bank.

New oil pipeline legislation has been adopted and entered into force.

The board of directors of RAO UES Rossii has adopted a plan for the establishment of a sufficient number of independent generation companies as legal subsidiaries of RAO UES Rossii to enable effective competition.

The Government is current with the implementation of the measures set forth in the privatization action plan agreed upon by the Government and the Bank as set out in Paras. 3.1- 3.5 of the Letter of Development Policy.

The proposed Laws on State and Municipal Land, on the State Land Cadastre, on the Appraisal of Land and on Land Management have been adopted and entered into force.

The Law on Auditing has been adopted and entered into force providing for gradual transition of regulatory powers relating to auditing from the Federal bodies to a self-regulating independent auditing profession and regulations have been issued defining thirty three auditing standards in accordance with international standards for auditing.

The Government has submitted to the Duma appropriate legislative drafts on sub-national fiscal reform or has issued other legal acts to provide for clear assignments of revenue and expenditure responsibilities for each level of government consistent with the concept papers prepared by the Government under the program.

The Government has provided to the Bank a report, in such scope as has been agreed upon by the Government and the Bank, demonstrating that the accounts payable of Federal budget organizations to infrastructure monopolies do not exceed thirty days of current sales incurred after July 1, 1998 and Federal transfer payments to regions are made in compliance with the principles set forth in Presidential Instruction No. PR-994, dated July 17, 1998.

The Government has taken all measures necessary (i) to include guarantees, other public contingent liabilities or conditional obligations in the definition of public debt applicable to the federal and sub-national level; (ii) to establish a public debt monitoring system including a comprehensive monitoring system of sub-national debt portfolios; (iii) to establish transparent prudential limitation and preconditions for sub-national borrowing; and (iv) to provide for verification by the Ministry of Finance that any sub-national debt is incurred in accordance with such limitations and preconditions for it to become a valid obligation of the respective sub-national entity.

E. Supervision, Implementation and Technical Assistance

143. ***Supervision.*** Close monitoring of the implementation of the structural reform program supported by SAL3 is essential in view of the broad range of the program and the importance of the reforms envisaged by the Government. To achieve this, the functions and responsibilities of the current Government-Bank-IMF "Structural Working Group" (SWG) will be strengthened. As the main vehicle for monitoring and for raising implementation problems that need addressing, and it will meet at least monthly following loan effectiveness. Moreover, the Government team on the SWG will prepare and circulate to the Bank and Fund, three business days prior to each SWG meeting, a draft comprehensive monthly report on the implementation of the program. After review in the SWG, an updated report will be sent to the Government, with a copy to the Bank and the Fund, for information/action. Such reports will pay due attention to implementation of the agreed measures.

144. Technical assistance for policy implementation under the SAL program continues to be needed and is available in several sectors. Support for preparation of the overall program, with a focus on fiscal management, is being supported by a Policy and Human Resources Development (PHRD) grant from the Japanese Government. TA for power sector reform is being supported by the Bank through the Portfolio Development Loan and the Electricity Support Reform Project. TA for natural gas reform is being provided through the Energy Efficiency Project. TA for privatization is being provided through the Privatization Implementation Assistance Loan and a PHRD grant from the Japanese Government. TA for legislative reform is being provided through the Legal Reform Project. If additional technical assistance is needed, additional resources will be sought.

F. Financial Arrangements

145. ***Loan Amount and Borrower.*** The proposed SAL3 of US$1.5 billion, in the form of a single currency, US dollar loan would be made to the Russian Federation, represented by the Ministry of Finance. Disbursements under the proposed SAL3 will be made to an account ('Deposit Account') of the Ministry of Finance established at the Central Bank of Russia for this purpose. The loan will have a term of seven years, including three years of grace, and a standard interest rate for LIBOR-based US dollar single currency loans.

146. ***Loan Management.*** Loan administration will be the responsibility of a loan manager designated by the Ministry of Finance. The loan manager will be responsible for preparing the withdrawal applications, maintaining the Deposit Account and arranging for its timely audit (if requested by the Bank), and monitoring overall loan implementation. The loan manager will also be responsible for coordinating the preparation of the Borrower's contributions to the Implementation Completion Report and for writing those sections relating to loan administration.

147. ***Disbursements.*** Upon notification by the Bank of loan effectiveness, the proceeds of the loan will be deposited by the Bank into the Deposit Account at the request of the Borrower. If after deposit in this account, the proceeds of the loan are used for ineligible purposes (i.e., to finance items imported from non-member countries, or goods and services on the Bank's standard negative list), the Bank will require the Borrower to either: (a) return that amount to the account for use for eligible purposes; or (b) refund the amount directly to the Bank (in which case the Bank will cancel an equivalent undisbursed amount of the loan). In accordance with the Operational Directive on the Simplification of Disbursement Rules under Structural Adjustment and Sectoral Adjustment Loans (February 8, 1996), disbursements will not be linked to specific purchases and, hence, there will be no procurement requirements.

148. ***Reporting, Accounting, and Auditing.*** Although routine audits of the Deposit Account will not be required, the Bank reserves the right to require audits at any time.

149. ***Closing Date.*** The expected closing date of the proposed loan will be December 31, 1999.

G. Poverty Implications

150. The operation is being proposed in the context of the Bank's overall strategy in Russia for poverty reduction through economic growth and to cushion the impact of the economic transition on vulnerable groups. The main focus of the proposed SAL3 is on the key steps needed to create an enabling environment for private sector development, essential for a sustained increase in incomes. Moreover, the increase in economic efficiency arising from more efficient infrastructure monopoly pricing and the further consolidation of fiscal stabilization and reduction in inflation resulting from the Government's tax and budget management reforms will also help reduce poverty. To support more direct efforts to reduce poverty in Russia the Bank has carried out a poverty assessment and is working with the Government to follow up in a wide number of areas, including child allowances, housing allowances for poor households, unemployment insurance, pension reform, and the overall targeting of health, education, and other public services to improve coverage of poor groups. The primary lending vehicles at present for conducting the overall dialogue with the Government on poverty reduction are the SPAL (Social Protection Adjustment Loan) and SPIL (Social Protection Implementation Loan) operations.

H. Environmental Impact

151. Each of the components of the proposed SAL3 has potentially positive environmental effects. The efficiency enhancing reform of monopolies in the energy and infrastructure sectors, including improved pricing methods and collection mechanisms, along with the phasing out of cross-subsidies among consumer groups, offers an opportunity for substantial environmental impact, particularly with regard to the reduction of air pollutants and greenhouse gas emissions. The restructuring of existing firms and industries through private sector development and privatization, as well as from competition from international trade, could foster environmental gains associated with improved management and efficiency. Enhanced fiscal management and the associated improvements in tax collection and budget administration may over time lead to an increase in funds available for public expenditures, which include wastewater treatment, the protection of forests and natural reserves, and other environmental costs. Additionally, a higher rate of tax collection could include an increase in the actual payment of pollution charges placed on firms. Lastly, banking reforms will facilitate the availability of credit needed for investments in energy efficient technologies and in environmental sciences.

PART V: RECOMMENDATION

152. I am satisfied that the proposed Loan would comply with the Articles of Agreement of the Bank and I recommend that the Executive Directors approve it.

James D. Wolfensohn
President

Washington, D.C.
Attachments

RUSSIAN FEDERATION
THIRD STRUCTURAL ADJUSTMENT LOAN

Table 1: Key Economic Indicators

Indicator	Actual			Estimate		Projected		
	1993	1994	1995	1996	1997	1998	1999	2000
National accounts (as % GDP at current market prices)								
Gross domestic product	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture[a]	7.6	6.1	6.9	7.0	7.5	..	..	..
Industry[a]	40.5	41.2	39.3	37.7	34.0	..	..	..
Services[a]	46.4	49.7	47.1	49.2	51.9	..	..	..
Total Consumption	69.1	69.7	73.2	73.3	75.5	78.3	77.3	76.8
Gross domestic fixed investment	20.4	21.8	20.0	20.0	19.3	18.0	19.0	19.9
Government investment	..	6.1	5.2	4.5	4.3	4.4	4.5	4.6
Private investment (includes increase in stocks)	..	19.4	18.0	18.2	17.5	15.6	16.5	17.3
Exports (GNFS)[b]	35.5	27.7	25.6	24.1	22.7	20.6	20.7	20.5
Imports (GNFS)	31.6	22.9	22.1	20.1	20.0	19.0	19.0	19.2
Gross domestic savings	30.9	30.3	26.8	26.7	24.5	21.7	22.7	23.2
Gross national savings[c]	28.5	28.7	25.1	24.9	22.5	19.0	19.1	19.6
Memorandum items								
Gross domestic product (US$ million at current prices)	183,780	277,025	357,348	429,278	449,851	456,577	475,439	503,903
Gross national product per capita (US$, Atlas method)	2,770	2,330	2,240	2,400	2,740	3,000	3,110	3,310
Real annual growth rates (%, calculated from 1996 prices)								
Gross domestic product at market prices	-8.7%	-12.6%	-4.1%	-3.5%	0.8%	-1.0%	1.0%	3.0%
Gross Domestic Income	-10.1%	-12.6%	-4.4%	-3.3%	1.0%	-3.0%	0.6%	2.6%
Real annual per capita growth rates (%, calculated from 1996 prices)								
Gross domestic product at market prices	-8.6%	-12.5%	-4.0%	-3.2%	1.1%	-0.8%	1.1%	3.6%
Total consumption	8.1%	-3.0%	-0.3%	3.1%	4.7%	-2.0%	-0.8%	2.4%
Private consumption	7.3%	13.2%	-0.5%	11.6%	4.7%	-2.9%	-1.5%	2.3%

(Continued)

Table 1: Key Economic Indicators (Continued)

Indicator	Actual 1993	1994	1995	1996	Estimate 1997	Projected 1998	1999	2000
Balance of Payments (US$m)								
Exports (GNFS)[b]	65244	76667	91610	103459	102196	94012	98441	103177
Merchandise FOB	58422	67716	81552	90513	88676	83374	87147	91153
Imports (GNFS)[b]	58110	63448	78885	86216	90065	86589	90505	96989
Merchandise FOB	44219	48005	60084	67557	71350	69354	72577	78042
Resource balance	7134	13219	12725	17243	12131	7423	7935	6188
Net current transfers (including official current transfers)	..	-59	108	167	138	193	206	220
Current account balance (after official capital grants)	5477	9576	6155	8776	2273	-4602	-8982	-11894
Net private foreign direct investment	386	637	2017	2478	6241	3300	4300	5300
Long-term loans (net)	-10780	-12904	-10479	-2434	-3947	8490	2030	-5116
Other capital (net, including errors and omissions)	8317	-1378	7236	-13681	-3468	-4040	4571	19643
Change in reserves[d]	-3400	4069	-4929	4861	-1098	-3148	-1919	-7933
Memorandum items								
Resource balance (% of GDP at current market prices)	3.9%	4.8%	3.6%	4.0%	2.7%	1.6%	1.7%	1.2%
Real annual growth rates (1996 prices)								
Merchandise exports (FOB)	..	..	..	..	5.1%	2.5%	3.0%	3.5%
Primary	..	..	..	..	4.5%	2.5%	3.0%	3.5%
Manufactures	..	..	..	..	4.8%	2.5%	3.0%	3.5%
Merchandise imports (CIF)	..	..	..	..	12.0%	-1.5%	1.5%	4.5%

(Continued)

Table 1: Key Economic Indicators (Continued)

Indicator	Actual 1993	Actual 1994	Actual 1995	Estimate 1996	Estimate 1997	Projected 1998	Projected 1999	Projected 2000
Public finance (as % of GDP at current market prices)[e]								
Current revenues	38.6	36.7	32.7	29.5	30.6	27.2	29.0	30.3
Current expenditures	42.6	40.7	33.2	33.3	33.9	28.7	28.9	28.7
Current account surplus (+) or deficit (-)	-4.1	-4.1	-0.5	-3.8	-3.3	-1.5	0.0	1.6
Capital expenditure	4.8	7.4	6.0	5.2	5.4	5.0	5.1	5.2
Foreign financing	3.2	1.3	2.1	2.7	2.0	5.1	-0.3	-2.3
Monetary indicators								
M2/GDP (at current market prices)	23.9	21.2	16.9	16.7	17.8	21.3	23.3	26.6
Growth of M2 (%)	286.6	216.5	112.6	33.1	26.1	27.7	17.6	23.4
Private sector credit growth / total credit growth (%)	..	..	..	..	..	77.0	83.4	79.0
Price indices (1996 =100)								
Merchandise export price index	..	..	..	100.0	93.2	85.6	86.9	87.8
Merchandise import price index	..	..	..	100.0	94.9	93.0	95.9	98.7
Merchandise terms of trade index	..	..	..	100.0	98.3	92.0	90.6	89.0
Real exchange rate (US$/LCU)[f]	35.9	59.7	74.4	100.0	98.7	98.7	98.7	98.7
Consumer price index (% growth rate)	895.3%	303.2%	188.7%	47.5%	14.8%	7.0%	6.0%	6.0%
GDP deflator (% growth rate)	888.1%	307.3%	178.4%	39.9%	17.3%	7.8%	6.3%	5.2%

a. Sectoral GDPs are measured at factor cost.
b. "GNFS" denotes "goods and nonfactor services."
c. Includes net unrequited transfers excluding official capital grants.
d. Includes use of IMF resources.
e. Data refer to general government.
f. "LCU" denotes "local currency units." An increase in US$/LCU denotes appreciation.

RUSSIAN FEDERATION
THIRD STRUCTURAL ADJUSTMENT LOAN

Table 2: Key Exposure Indicators

	Actual				Estimate	Projected		
Indicator	1993	1994	1995	1996	1997	1998	1999	2000
Total debt outstanding and disbursed (TDO) (US$m)[a]	112940	121921	120461	124786	123497	151750	162046	166174
Net disbursements (US$m)[a e]	4334	1089	4619	6082	8292	29752	8872	3018
Total debt service (TDS) (US$m)[a d]	2333	3674	6303	7168	6353	8806	17542	19394
Debt and debt service indicators (%)								
TDO/XGS[b]	171.7	157.3	129.7	119.2	119.0	159.9	161.5	158.2
TDO/GDP	61.5	44.0	33.7	29.1	27.5	33.2	34.1	33.0
TDS/XGS [d]	3.5	4.7	6.8	6.8	6.1	9.3	17.5	18.5
IBRD exposure indicators								
IBRD DS/public DS (%)[d]	0.5	1.0	0.9	1.7	2.7	6.0	4.8	7.0
Preferred creditor DS/public DS (%)[c d]	11.5	13.7	13.6	18.8	23.9	26.5	41.9	43.2
IBRD DS/XGS (%)	0.0	0.0	0.1	0.1	0.2	0.6	0.8	1.3
IBRD TDO (US$m)	367	684	1524	2509	5266	7539	11627	12949
Share of IBRD portfolio (%)	0.4	0.6	1.4	2.3	4.9	6.2	9.2	10.1

a. Includes public and publicly guaranteed debt, private nonguaranteed, use of IMF credits and net short-term capital.
b. "XGS" denotes exports of goods and services, including workers' remittances.
c. Preferred creditors are defined as IBRD, IDA, the regional multilateral development banks, the IMF, and the Bank for International Settlements.
d. Debt service paid (after rescheduling).
e. Amortization paid (after rescheduling).

RUSSIAN FEDERATION
THIRD STRUCTURAL ADJUSTMENT LOAN

Table 3: External Financing
(US$ millions at current prices)

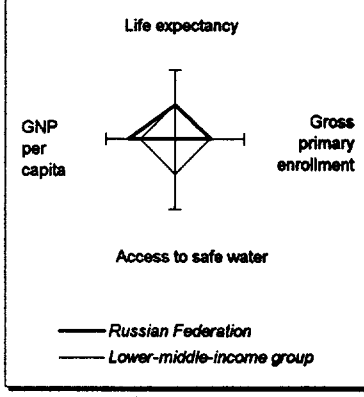
	Estimated 1997	1998	1999	*Projection* 2000
Sources	49,079	54,663	35,905	33,389
Non-interest current account balance	13,869	3,896	4,513	1,887
Disbursement	10,429	32,441	14,344	9,741
IMF	2,020	13,800	2,100	0
Other medium- and long term	7,300	17,461	10,949	8,330
of which IBRD	2,691	2,422	4,370	1,811
Net short-term	1,109	1,180	1,295	1,412
Private investment	17,741	8,754	7,268	8,320
Direct foreign investment	6,241	3,300	4,300	5,300
Portfolio investments (net)	11,500	5,454	2,968	3,020
Debt relief[a]	7,836	9,573	9,780	13,441
Uses	49,079	54,663	35,905	33,389
Debt service due	19,081	18,377	27,322	32,835
of which IBRD	172	528	845	1,348
Repayments (including IMF)	8,281	9,880	13,826	19,054
Interest payments	10,800	8,497	13,495	13,780
Increase in gross reserves	2,584	16,621	-689	2,524
Other capital flows	27,414	19,664	9,273	-1,970

a. The debt relief includes the debt rescheduling of USSR external liabilities to Paris Club and London Club creditors and similar treatment for non-Paris-Club official and supplier creditors.

Table 4: Russian Federation at a Glance

POVERTY and SOCIAL	Russian Federation	Europe & Central Asia	Lower-middle-income
Population mid-1996 *(millions)*	147.7	479	1,125
GNP per capita 1996 *(US$, Atlas method)*	2,400	2,180	1,750
GNP 1996 *(billions US$, at Atlas conversion factor)*	354.6	1,043	1,967
Average annual growth, 1990-96			
Population *(%)*	-0.1	0.3	1.4
Labor force *(%, Russia: 1992-96)*	-1.1	0.5	1.8
Most recent estimate *(latest year available since 1989)*			
Poverty: headcount index *(% of population)*	25	..	..
Urban population *(% of total population)*	73	65	56
Life expectancy at birth *(years)*	66	68	67
Infant mortality *(per 1,000 live births)*	17	26	41
Child malnutrition *(% of children under 5)*	3	..	..
Access to safe water *(% of population)*	..	..	78
Illiteracy *(% of population age 15+)*	0.2	..	..
Gross primary enrollment *(% of school-age population)*	108	97	104
Male	108	97	105
Female	107	97	101

Development diamond*

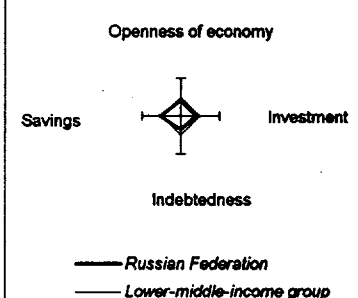


KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1975	1985	1995	1996
GDP *(billions US$)*	..	..	357.3	429.3
Gross domestic investment/GDP	..	..	23.2	22.7
Exports of goods and services/GDP	..	..	25.6	24.1
Gross domestic savings/GDP	..	..	26.8	26.7
Gross national savings/GDP	..	..	25.1	24.9
Current account balance/GDP	..	..	1.8	2.2
Interest payments paid/GDP	..	..	0.8	0.9
Total external debt/GDP	..	..	33.7	29.1
Total debt service paid/exports	..	..	6.8	6.8
Present value of debt/GDP	..	..	..	20.8
Present value of debt/exports	..	..	..	91.3

	1975-85	1986-96	1995	1996	1997-05
(average annual growth)					
GDP	..	..	-4.1	-3.5	3.4
GNP per capita	..	..	-4.4	-3.5	3.3
Exports of goods and services	..	..	7.0	2.3	4.2

Economic ratios*

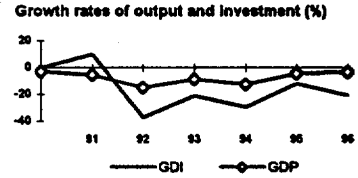


STRUCTURE of the ECONOMY

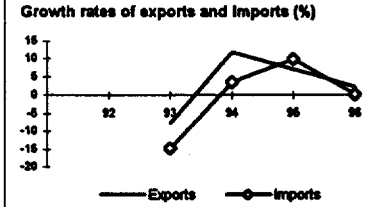
	1975	1985	1995	1996
(% of GDP)				
Agriculture	..	..	7.4	7.3
Industry	..	..	42.1	39.1
Manufacturing	..	..	..	..
Services	..	..	50.5	53.6
Private consumption	..	..	59.0	61.8
General government consumption	..	..	14.1	11.5
Imports of goods and services	..	..	22.1	20.1

	1975-85	1986-96	1995	1996
(average annual growth)				
Agriculture [a]	..	..	-8.0	-7.0
Industry [a]	..	..	-4.5	-4.0
Manufacturing	..	..	..	..
Services [a]	..	..	-10.0	-8.5
Private consumption	..	..	-0.9	11.3
General government consumption	..	..	0.1	-27.3
Gross domestic investment	..	..	-12.0	-21.1
Imports of goods and services	..	..	9.8	0.2
Gross national product	..	..	-4.5	-3.9

Growth rates of output and investment (%)



Growth rates of exports and imports (%)



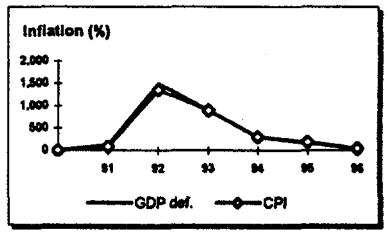
Note: 1996 data are preliminary estimates.
a. Sectoral GDP are estimated at factor cost.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

Table 4: Russian Federation at a Glance (Continued)

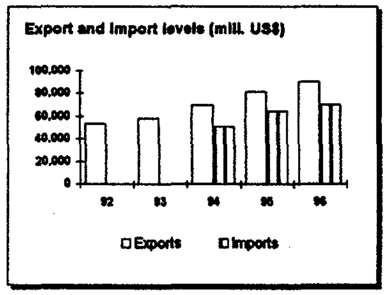
PRICES and GOVERNMENT FINANCE

	1975	1985	1995	1996
Domestic prices				
(% change)				
Consumer prices	..	..	188.7	47.5
Implicit GDP deflator	..	..	178.7	39.9
Government finance				
(% of GDP)				
Current revenue	..	..	32.7	29.5
Current budget balance	..	..	-0.5	-3.7
Overall surplus/deficit	..	..	-5.6	-8.7



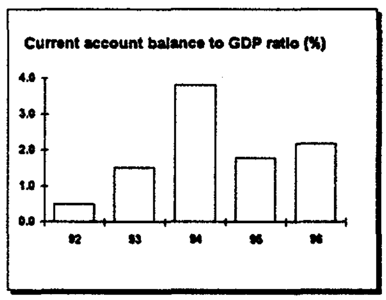
TRADE

	1975	1985	1995	1996
(millions US$)				
Total exports (fob)	..	..	81,552	90,513
Crude oil	..	..	12,741	15,724
Natural gas	..	..	13,391	15,487
Machinery, equipment, vehicles	..	..	6,240	8,200
Total imports (cif)	..	..	64,198	70,021
Food	..	..	13,041	11,500
Fuel and energy	..	..	1,584	1,848
Machinery, equipment, vehicles	..	..	15,700	14,400
Export price index *(1987=100)*	..	..	..	..
Import price index *(1987=100)*	..	..	..	..
Terms of trade *(1987=100)*	..	..	..	..



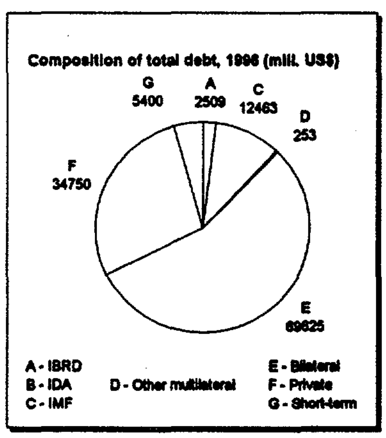
BALANCE of PAYMENTS

	1975	1985	1995	1996
(millions US$)				
Exports of goods and services	..	..	91,610	103,459
Imports of goods and services	..	..	78,885	86,216
Resource balance	..	..	12,725	17,243
Net income	..	..	-6,331	-8,171
Net current transfers	..	..	108	167
Current account balance, before official capital transfers	..	..	6,502	9,239
Financing items (net)	..	..	-1,573	-14,100
Changes in net reserves	..	..	-4,929	4,861
Memo:				
Reserves including gold at end of year *(mill. US$)*	..	..	17,207	15,324
Conversion rate, average *(local/US$)*	..	..	4,562	5,126



EXTERNAL DEBT and RESOURCE FLOWS

	1975	1985	1995	1996
(millions US$)				
Total debt outstanding and disbursed	..	..	120,461	125,000
IBRD	..	..	1,524	2,509
IDA	..	..	0	0
Total debt service paid	..	..	6,303	7,168
IBRD	..	..	57	121
IDA	..	..	0	0
Composition of net resource flows				
Capital transfers	..	..	-347	-463
Official creditors	..	..	98	2,029
Private creditors	..	..	-1,043	968
Foreign direct investment	..	..	2,017	2,478
Portfolio equity	..	..	-1,434	8,400
World Bank program				
Commitments	..	..	1,684	1,923
Disbursements	..	..	824	1,097
Principal repayments	..	..	0	0
Net flows	..	..	824	1,097
Interest payments	..	..	57	121
Net transfers	..	..	767	976



Note: Estimates for the former Soviet republics are subject to more than the usual range of uncertainty.

Status of Bank Group Operations in Russian Federation
IBRD Loans and IDA Credits in the Operations Portfolio

Project ID	Loan or Credit No.	Fiscal Year	Borrower	Purpose	Original Amount in US$ Millions				Difference Between expected and actual disbursements a/		Last ARPP Supervision Rating b/	
					IBRD	IDA	Cancellations	Undisbursed	Orig	Frm Rev'd	Dev Obj	Imp Prog
Number of Closed Loans/credits: 10												
Active Loans												
RU-PE-8809	IBRD 36233	1993	RUSSIAN FEDERATION	OIL REHAB.	10.00	0.00	0.00	6.98	199.20	15.45	U	S
RU-PE-8809	IBRD 36232	1993	RUSSIAN FEDERATION	OIL REHAB.	170.00	0.00	0.00	5.24	199.20	15.45	U	S
RU-PE-8809	IBRD 36231	1993	RUSSIAN FEDERATION	OIL REHAB.	158.00	0.00	41.60	.65	199.20	15.45	U	S
RU-PE-8809	IBRD 36230	1993	RUSSIAN FEDERATION	OIL REHAB.	272.00	0.00	142.15	2.58	199.20	15.45	U	S
RU-PE-8810	IBRD 35460	1993	GOVT OF RUSSIA	PRIVATIZATION	90.00	0.00	0.00	14.22	14.22	14.22	S	S
RU-PE-8822	IBRD 35320	1993	GOVERNMENT OF RUSSIA	EMPLOYMENT SERV. & SOCIAL PROT	70.00	0.00	10.00	26.64	36.63	5.76	S	S
RU-PE-8805	IBRD 37682	1994	RUSSIAN FEDERATION	OIL REHAB. II	90.40	0.00	0.00	2.82	206.86	202.14	S	S
RU-PE-8805	IBRD 37681	1994	RUSSIAN FEDERATION	OIL REHAB. II	51.10	0.00	4.72	4.87	206.86	202.14	S	S
RU-PE-8805	IBRD 37680	1994	RUSSIAN FEDERATION	OIL REHAB. II	24.70	0.00	0.00	4.91	206.86	202.14	S	S
RU-PE-8805	IBRD 3768C	1994	RUSSIAN FEDERATION	OIL REHAB. II	99.60	0.00	0.00	26.57	206.86	202.14	S	S
RU-PE-8805	IBRD 3768B	1994	RUSSIAN FEDERATION	OIL REHAB. II	108.90	0.00	0.00	60.44	206.86	202.14	S	S
RU-PE-8805	IBRD 3768A	1994	RUSSIAN FEDERATION	OIL REHAB. II	125.30	0.00	0.00	102.54	206.86	202.14	S	S
RU-PE-8839	IBRD 3763A	1994	GOVT. OF RUSSIA	ENTERPRISE SUPPORT	196.00	0.00	0.00	175.92	139.92	0.00	S	S
RU-PE-8811	IBRD 37570	1994	REP.OF RUSSIAN FED.	AGRIC. REFORM IMPL.	240.00	0.00	80.00	122.02	182.02	50.15	U	U
RU-PE-34579	IBRD 37560	1994	REP OF RUSSIAN FED	LAND REFORM IMPL. SU	80.00	0.00	0.00	61.50	51.50	0.00	S	S
RU-PE-8828	IBRD 3734A	1994	MOF	FINANCIAL INSTITUTIO	187.62	0.00	0.00	140.91	140.93	48.73	S	S
RU-PE-8808	IBRD 37060	1994	RUSSIAN FEDERATION	HIGHWAY REHAB & MAIN	300.00	0.00	0.00	49.40	3.43	0.00	S	S
RU-PE-8806	IBRD 38850	1995	RUSSIAN FEDERATION	URBAN TRANSPORT	329.00	0.00	0.00	108.90	73.91	0.00	S	S
RU-PE-8803	IBRD 38760	1995	RUSSIAN FEDERATION	RUSSIA ENERGY EFFICY	106.50	0.00	36.50	68.31	93.21	24.31	U	S
RU-PE-40409	IBRD 38726	1995	RUSSIAN FEDERATION	EMERG. OIL SPILL MIT	29.60	0.00	0.00	21.13	21.12	0.00	S	S
RU-PE-38572	IBRD 38530	1995	GOVT. OF RUSSIA	TAX ADMINISTRATION	16.80	0.00	0.00	11.03	11.05	7.55	S	S
RU-PE-8827	IBRD 3850A	1995	RUSSIAN FEDERATION	HOUSING	363.72	0.00	0.00	264.19	167.06	0.00	S	S
RU-PE-8823	IBRD 38440	1995	GOVERNMENT OF RUSSIA	PORTFOLIO DEVELOPMEN	40.00	0.00	0.00	31.59	31.57	12.81	S	S
RU-PE-8826	IBRD 38240	1995	RUSSIAN FEDERATION	MANAGEMENT AND FINAN	40.00	0.00	0.00	14.01	8.31	0.00	S	S
RU-PE-8821	IBRD 38060	1995	RUSSIAN FEDERATION	ENVIRONMENT MANAGEME	110.00	0.00	0.00	74.20	1.69	0.00	S	U
RU-PE-45622	IBRD 40590	1996	RUSSIAN FEDERATION	COAL IAP	25.00	0.00	0.00	20.63	6.13	0.00	S	S
RU-PE-8831	IBRD 40350	1996	GOVT. OF RUSSIA	LEGAL REFORM PROJECT	58.00	0.00	0.00	53.37	17.86	0.00	S	S
RU-PE-38571	IBRD 40330	1996	GOVERNMENT OF RUSSIA	MEDICAL EQUIPMENT	270.00	0.00	0.00	137.48	-2.53	0.00	S	S
RU-PE-42622	IBRD 40290	1996	GOVT. OF RUSSIAN FEDERATI	CAPITAL MARKET DEV.	89.00	0.00	0.00	84.70	17.70	0.00	S	S
RU-PE-36973	IBRD 40120	1996	RUSSIAN FEDERATION	ENTP.HOUSING DIVESTI	300.00	0.00	0.00	291.62	18.62	0.00	S	S
RU-PE-35761	IBRD 40090	1996	GOVT. OF RUSSIA	COMMUNITY SOCIAL INF	200.00	0.00	0.00	190.02	19.53	0.00	S	S
RU-PE-35764	IBRD 39900	1996	RUSSIAN FEDERATION	BRIDGE REHABILITATIO	350.00	0.00	0.00	323.78	99.78	0.00	S	S
RU-PE-8837	IBRD 39610	1996	GOVT OF RUSSIA	STANDARDS DEVELOP.	24.00	0.00	0.00	19.94	10.45	0.00	S	S
RU-PE-38573	IBRD 42030	1997	RUSSIAN FEDERATION	SOC. PROTECT. ADJ.	800.00	0.00	0.00	250.00	250.00	0.00	S	S
RU-PE-44200	IBRD 41850	1997	RUSSIAN FEDERATION	BUREAU OF ECON.POLIC	22.60	0.00	0.00	19.56	-2.24	0.00	S	S
RU-PE-46448	IBRD 41840	1997	MINISTRY OF FINANCE	ENTERPRISE RES.SERVS	85.00	0.00	0.00	85.00	1.90	0.00	S	U
RU-PE-8825	IBRD 41830	1997	GOVT. OF RUSSIA	EDUCATION INNOVATION	71.00	0.00	0.00	69.62	.12	0.00	S	S
RU-PE-8814	IBRD 41820	1997	GOVERNMENT OF RUSSIA	HEALTH REFORM PILOT	66.00	0.00	0.00	64.50	3.80	0.00	S	S
RU-PE-50891	IBRD 41810	1997	RUSSIAN FEDERATION	ELECTR. SECTOR REFOR	40.00	0.00	0.00	40.00	10.50	0.00	U	U
RU-PE-42720	IBRD 41440	1997	RUSSIAN FEDERATION	ST. PETERSBURG REHAB	31.00	0.00	0.00	29.27	3.48	0.00	HS	S
RU-PE-50486	IBRD 42620	1998	RUSSIAN FEDERATION	COAL SECAL II	800.00	0.00	0.00	400.00	0.00	0.00	S	S
RU-PE-46496	IBRD 42340	1998	GOVERNMENT OF RUSSIA	SOC. PROTECT. IMPL.	28.60	0.00	0.00	28.60	3.50	0.00	S	S
Total					6,569.44	0.00	314.97	3,509.66	3,473.13	1,438.17		

	Active Loans	Closed Loans	Total
Total Disbursed (IBRD and IDA):	2,744.81	3,222.05	5,966.86
of which has been repaid:	2.99	29.30	32.29
Total now held by IBRD and IDA:	6,251.47	3,192.75	9,444.22
Amount sold :	0.00	0.00	0.00
Of which repaid :	0.00	0.00	0.00
Total Undisbursed :	3,509.66	0.00	3,509.66

a. Intended disbursements to date minus actual disbursements to date as projected at appraisal.
b. Following the FY94 Annual Review of Portfolio performance (ARPP), a letter based system was introduced (HS = highly Satisfactory, S = satisfactory, U = unsatisfactory, HU = highly unsatisfactory): see proposed Improvements in Project and Portfolio Performance Rating Methodology (SecM94-901), August 23, 1994.

Note:
Disbursement data is updated at the end of the first week of the month.

Russian Federation
STATEMENT OF IFC's
Committed and Disbursed Portfolio
As of 30-Jun-98
(In US Dollar Millions)

		Committed				Disbursed			
		IFC				IFC			
FY Approval	Company	Loan	Equity	Quasi	Partic	Loan	Equity	Quasi	Partic
1993	Polar Lights	18.93	0.00	0.00	0.00	18.93	0.00	0.00	0.00
1993	Vasyugan	1.88	0.00	1.50	0.00	1.88	0.00	1.50	0.00
1994	Framlington Fund	0.00	8.00	0.00	0.00	0.00	8.00	0.00	0.00
1994	Russia Registry	0.00	1.50	0.00	0.00	0.00	1.50	0.00	0.00
1994	RTDC	0.00	7.50	0.00	0.00	0.00	7.50	0.00	0.00
1995	A.O. Volga	26.77	11.00	0.00	34.87	26.77	11.00	0.00	34.87
1995	Depsona Z.A.O.	5.30	1.50	0.00	0.00	0.00	1.50	0.00	0.00
1995	First NIS Fund	0.00	15.00	0.00	0.00	0.00	15.00	0.00	0.00
1995	Russ Tech Fnd	0.00	2.00	0.00	0.00	0.00	1.00	0.00	0.00
1995	SCF	0.00	4.53	0.00	0.00	0.00	4.53	0.00	0.00
1996	Alpha Cement	0.00	13.49	0.00	0.00	0.00	13.49	0.00	0.00
1996	Pioneer First	0.00	4.00	0.00	0.00	0.00	4.00	0.00	0.00
1996	UNEXIM Bank	15.00	0.00	0.00	0.00	7.50	0.00	0.00	0.00
1997	Aminex RUS	17.00	5.49	0.00	0.00	0.00	5.49	0.00	0.00
1997	PBCM	25.00	0.00	0.00	15.00	18.75	0.00	0.00	11.25
1997	PLM Eastern Hold	0.00	5.50	0.00	0.00	0.00	5.50	0.00	0.00
1998	Alfa Cement	0.00	2.10	0.00	0.00	0.00	0.00	0.00	0.00
1998	Borsteklo	0.00	15.00	0.00	0.00	0.00	15.00	0.00	0.00
1998	Mosenergo	20.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
1998	Toribank	0.00	12.24	0.00	0.00	0.00	12.24	0.00	0.00
Total Portfolio:		129.88	108.85	1.50	49.87	73.83	105.75	1.50	46.12

		Approvals Pending Commitment			
		Loan	Equity	Quasi	Partic
1996	ALPHA CEMENT	20.00	0.00	0.00	0.00
1998	DEPOSITORY CLEAR	.50	.05	0.00	0.00
1997	DEPSONA B LOAN	0.00	0.00	0.00	5.20
1998	DREVO	0.00	.90	0.00	0.00
1998	ELCOTEQ	0.00	.10	0.00	0.00
1998	GARANTI MOSCOW	5.00	3.00	0.00	0.00
1997	INTL. BOTTLERS	0.00	5.00	0.00	0.00
1998	PAKENSO	6.00	1.50	0.00	0.00
1997	POKROVSKIY MINE	16.00	0.00	0.00	32.30
1998	RAMSTORE	36.00	0.00	0.00	48.00
1997	RUSSIAN IT FUND	0.00	15.00	0.00	0.00
1998	SEVERSTAL POWER	25.00	0.00	0.00	67.00
1997	ZOLOTO MINING	0.00	4.00	0.00	0.00
Total Pending Commitment:		108.50	29.55	0.00	152.50

Generated by the Operations Information System (OIS) on 07/24/98

Attachment 3

RUSSIAN FEDERATION

THIRD STRUCTURAL ADJUSTMENT LOAN

TIMETABLE OF KEY PROCESSING EVENTS

(a) Time taken to prepare:	5 months
(b) Prepared by:	Government with the assistance of IBRD staff and consultants
(c) Preparation and appraisal missions:	February/April 1998; June/July 1998
(d) Negotiations:	July 1998
(e) Planned Board presentation:	August 6, 1998
(f) Planned date of effectiveness/first tranche:	August 1998
(g) Estimated date of second tranche:	December 1998
(h) Estimated date of third tranche:	June 1999
(i) Expected program completion:	December 1999

Attachment 4

RUSSIAN FEDERATION

THIRD STRUCTURAL ADJUSTMENT LOAN

LETTER OF DEVELOPMENT POLICY

July 17, 1998

RUSSIAN FEDERATION

LETTER OF DEVELOPMENT POLICY FOR THE THIRD STRUCTURAL ADJUSTMENT LOAN

INTRODUCTION

Since late last year, Russia's financial markets have been in turmoil. Despite the policies implemented by the new government since it was appointed earlier this year, market confidence has not been restored, and capital flows have remained volatile. Against this background the government has recognized the need for a further strengthening of policies. The government's strategy in addressing the present emergency contains four main elements: (i) a radical tightening of the federal budget; (ii) the bolstering of international reserves of the CBR through the access to substantial foreign financing; (iii) the lengthening of debt maturity to reduce the vulnerability arising from the short-term structure of domestic debt; and (iv) accelerated structural reform, which we see as key to creating the conditions for longer term economic growth.

The financial market turmoil has been caused by several factors. Weaknesses in public finances have, over time, made Russia increasingly vulnerable to changes in financial market sentiment, in particular as the continuing fiscal deficits have led to a rapid build-up of short-term government debt. A succession of destabilizing events in late 1997 and early 1998 contributed to the recent financial market pressures, including the ripple effects of the financial crisis in Asia, the drop in world commodity prices, the change in government, and social unrest.

Financial instability has altered the macroeconomic outlook for the near term. Real GDP declined by 0.2 percent in January-May 1998, when compared with the same period in 1997, and is likely to decline on an annual basis this year. Even with the restoration of market confidence, it is expected that some negative impact on economic growth will be felt also in 1999.

1. THE MACROECONOMIC PROGRAM

1.1 During 1996–97, Russia made important strides in several key areas. Continued progress was made towards macroeconomic stability; inflation declined gradually, the exchange rate was maintained within its predetermined band, and the balance of payments position remained favorable. Also, an open external trade system was maintained. The economy has responded favorably to these accomplishments, registering positive growth in 1997 for the first time since the breakup of the former Soviet Union.

1.2 However, financial instability towards the end of 1997 and first half of 1998 sharply altered the near term outlook. Several external factors contributed to this shift, including; (i) global fallout from the sharp contraction in growth of Asian economies, (ii) a heightened perception of risks in emerging markets which raised Russia's external borrowing costs, (iii) a major strengthening of the US dollar, to which the ruble is closely linked, and consequent appreciation of the ruble against major trade partners, and (iv) a rapid decline in international prices of oil, natural gas, and precious metals which has sharply worsened Russia's terms of trade. These external factors served to sharpen the impact of adverse domestic developments, in particular rising concern over deteriorating fiscal performance and the sustainability of meeting rising domestic debt service costs. During the first five months of 1998 GDP growth has declined by 0.2% and is expected to remain negative for the year. High interest rates and weak fiscal performance have curtailed consumption growth, slowed investment demand, and forced sharp reductions in public expenditure.

1.3 These developments threaten the achievements of the last two years, and place top priority on rapid and credible measures to strengthen fiscal performance. To solve persistent fiscal imbalances a radical tightening of the budget is required, accompanied by structural measures to fundamentally strengthen revenue collection capacity and eliminate the non-payments and arrears cycle that has crippled effective budget execution. To this end, the federal government is committed to raising total revenues by 2.6 percent of GDP in 1999 while holding constant nominal federal non-interest expenditures. As a result, the 1999 primary fiscal balance is targeted to improve to nearly three percent of GDP from a small negative balance this year. This dramatic shift will be achieved through efforts to broaden the tax base, improve collection and enforcement of tax arrears payments, increase the federal government's share of total revenues, and reduce subventions in the economy.

1.4 To reduce the debt service burden on public finances the government is pursuing a two pronged approach. Cutting reliance on costly short term domestic borrowing to finance the deficit is critical. New issuance of short term treasury bills has already fallen dramatically in 1998, and by sharply reducing the 1999 public deficit (from a projected 5.6% of GDP in 1998 to 2.8% targeted in 1999) further issuance of treasury bills is expected to fall to roughly half the level of 1997. At the same time the Government has launched a new program to lengthen the maturity of its domestic debt through offering holders of short term T-bills the opportunity to exchange them for foreign currency Eurobonds with much longer maturities, at market rates. This will serve to both reduce the public interest burden in the 1998 and 1999 budgets, and to sharply reduce Russia's vulnerability to shifting market sentiment through by cutting short term exposure.

1.5 Monetary policy and exchange rate policy will remain largely unchanged, with the primary objective of further reducing inflation and promoting a sound balance of payments position. To this end bolstering of international reserves through access to substantial foreign financing is a central objective of establishing confidence in exchange rate and price stability. In conjunction with the borrowing program from the IMF, reserves are to be maintained at around three months of import coverage and the Central Bank of Russia will continue to pursue an interest rate policy geared towards maintaining the real exchange rate broadly constant. Inflation is targeted to be brought down from around 7% on average for 1998 to about 6% in 1999. The implementation of monetary policy will be supported by a comprehensive set of monetary policy instruments, further consolidation of the banking system, and improvements in the payments system, as elaborated in the structural discussion below.

1.6 The key to success of this macroeconomic framework is to both maintain the credibility of fiscal reforms and to significantly accelerate the structural reform agenda. Restoring long term growth depends crucially on these elements progressing in tandem.

THE STRUCTURAL REFORM PROGRAM

The structural measures are designed to: (i) improve the competitiveness, transparency and accountability of infrastructure monopolies; (ii) enhance the development of the private sector; (iii) liberalize international trade and encourage foreign direct investment; (iv) enhance fiscal management; and (v) reform the financial sector.

2. REFORM OF INFRASTRUCTURE MONOPOLIES

General

Overarching Goal: To improve the transparency, fiscal accountability and competitiveness of infrastructure monopolies, and to reduce barter and non-payments.

2.1 By July 30, 1998 a government decision will be issued requiring that, starting with the financial accounts for 1998, the consolidated IAS financial accounts of Gazprom, RAO UES Rossii, and Transneft and, starting with the financial accounts for 1999, the Railways, are to be audited and published annually by June 30 of the following year by independent qualified auditors in accordance with international auditing standards.

2.2 The following actions will be undertaken in order to reduce and, subsequently, eliminate non cash payments and arrears in infrastructure monopoly sectors: (i) by August 1, 1998, a legal act will be adopted requiring that VAT be calculated and collected on an accrual basis; (ii) by August 1, 1998, the Government will issue decisions simplifying the procedures for termination or limitation of electricity, heat and gas supplies to organizations and consumers in the event of failure to pay for fuel and energy resources supplied; (iii) by October 1, 1998, the Government will announce and by November 1, 1998 implement a procedure requiring all consumers of gas, heat and electricity to make payments for these purchases to escrow accounts established jointly by producers, transporters, distributors and any others in the supply chain, to administer the collection of these amounts and their fair distribution to them. Any participant in the supply chain will have the right to apply the procedures mentioned in (ii) above to any consumer/purchaser that accumulates 45 days arrears for purchases made after July 1, 1998 and/or fails to comply with a schedule agreed between them for the liquidation of arrears relating to products and services provided prior to July 1, 1998. (Failure to reach agreement on such a schedule within 60 days will be grounds for applying these procedures); and (iv) by October 1, 1998, the Government will develop and announce a new procedure governing settlements by non-budget sector organizations for purchases of gas, heat and electricity. This procedure will be applicable effective November 1, 1998 to any such organization that has 30 days' or more of arrears. It would give the right to any participant in the supply chain to require that such an organization establish and maintain unconditional letters of credit in favor of the relevant escrow account to cover payments for 30 days' worth of purchases. This requirement could remain in effect for a reasonable time period (to be defined within the procedure).

2.3 By July 31, 1998, the Government will issue a Resolution that establishes an inter-agency commission that coordinates and oversees reforms, including development of measures and timetable of actions, for the horizontal and vertical competitive restructuring of key infrastructure monopolies. This will cover the electric power, natural gas, railroads, telecommunications and oil transport sectors.

Electric Power Sector

Overarching Goal: To make major progress towards developing an electric power sector with diversified ownership and open to competitive forces.

2.4 The Government will issue a Resolution by August 1, 1998, in which RAO UES will be required to establish separate accounts for generation and transmission (including dispatch) for regulatory purposes. The Resolution will direct the Federal Energy Commission to develop pricing methodology and issue guidelines for transmission and dispatch services provided by RAO UES by December 1, 1998.

2.5 The same Resolution will require that each AO Energo will establish separate accounts for generation, transmission (lines used exclusively for transmission of bulk power) and distribution for regulatory purposes. The Resolution will direct the Federal Energy Commission to develop pricing methodology and issue guidelines for the network services provided by AO Energos by September 1, 1998. Costs associated with non-core activities should be accounted for separately and not be included in costs used to establish the regulated price.

2.6 By January 1, 1999 the Government will issue a Resolution requiring non-discriminatory access to transmission and distribution services and to direct the Federal Energy Commission to develop regulatory guidelines and access rules by June 30, 1999.

2.7 The Government will foster the complete establishment of the National Energy Market (NEM), a non-commercial partnership involving power plants, AO Energos and large industrial users operating in the federal wholesale power market, by December 31, 1998. By October 1, 1998, the Government, through its representatives on the Board of RAO UES, will direct RAO UES management to issue corporate guidelines requiring the change in dispatch rules with a goal of decreasing operating costs. By March 31, 1999, RAO UES will issue guidelines to increase the role of the Uniform Dispatch Units in providing economic dispatch and settlements.

2.8 By June 30, 1999 the Government will instruct its representatives on the Board of Directors of RAO UES to seek adoption by RAO UES of a plan for establishing a sufficient number of independent generation companies to enable effective competition. The plan will provide for these generation companies to be established as legal subsidiaries of RAO UES, each with an initial comparable competitive position, by December 31, 1999.

2.9 By August 1, 1998, RAO UES will publicly announce its intention of increasing private sector participation in Energos in which UES has an equity stake. A list of Energos that will be available for consideration, along with a package of relevant technical and financial information will be issued by October 1, 1998 enabling due diligence to take place. By October 1, 1998, RAO UES will solicit offers from the private sector for participation in Energos. The bidders would be permitted to make a variety of offers, including, but not limited to equity investments, management contracts, concession or leasing arrangements. Offers would be made to RAO UES by January 1, 1999. RAO UES would review these offers and negotiate Term Sheets by March 1, 1999. An independent evaluation of these offers will be undertaken by April 1, 1999. Final decisions on these offers would be made by RAO UES no later than June 1, 1999, and would result in private sector participation in at least ten Energos.

Natural Gas Sector

Overarching Goal: To promote efficiency in the natural gas industry, achieve greater transparency and accountability in the operations of Gazprom, and facilitate pipeline access for independent gas producers, including those who are currently flaring gas.

2.10 To facilitate effective regulation and support customers' access to lower-cost gas supplies, by August 1, 1998 the Government will issue a decision requiring Gazprom to reorganize, by January 1, 1999, its existing regional transmission operations into a single transmission enterprise or a number of enterprises, based on major transmission corridors, such enterprise or enterprises to be in compliance with the Civil Code. In addition, by August 1, 1998, the Government will issue a decision requiring Gazprom by January 1, 1999 to operate .the company's transmission, production and supply enterprises as separate cost/profit centers with separate management teams and their own accounts based on international accounting and audit standards. The transmission enterprise(s) will only provide gas transmission services.

2.11 By December 31, 1998, the Government will establish a revised system for gas excise taxes which applies the production rent component of excise at the level of monopoly producers, without reducing Federal tax revenue. The production rent component would be: (i) applied at a uniform level to all volumes entering the main transmission network from the Gazprom system at each major access hub or for other monopoly producers at the wellhead; (ii) differentiated to reflect the weighted average production cost of gas at each of the major access hubs/wellheads; and (iii) remitted by gas wholesalers.

2.12 By August 31, 1998, the FEC will issue revised interim Regulations on state regulation of differentiated wholesale prices for natural gas. The Regulations will incorporate the principles that prices should: (i) ensure that supplying enterprises can recover prudently incurred costs of service from customers, including a reasonable return on capital; (ii) encourage efficient operations at all levels in the supply chain, and (iii) incorporate the principle that tariffs should fully reflect differences in costs of service among different customer classes and geographic regions. Prices based on the new interim Regulations will be announced by November 30, 1998, and applied effective January 1, 1999. In order to lessen the shock of transition to full cost-reflective tariffs, it is expected that these prices would incorporate increased regional differentiation of wholesale prices.

2.13 By November 30, 1998, the Government will approve a methodology for setting separate prices for gas production, transmission and supply (delivery) services which will supersede the above-noted interim Regulations as a basis for determining wholesale gas prices. The methodology will reflect the pricing principles outlined above with respect to the interim Regulations. Differentiated and separate prices fully reflective of the revised methodology will be introduced by the FEC not later than July 1, 1999.

2.14 By August 31, 1998, the FEC will approve and make public a revised methodology for determining service tariffs (including local transportation tariffs) for gas distribution companies and by September 30, 1998 will issue and make public recommendations for setting retail prices for different customer groups. The methodology and recommendations will be based on principles that prices should (i) ensure that distribution companies can recover prudently incurred costs of service from customers, including a reasonable return on capital; (ii) encourage efficient operations on the part of the distribution companies; and (iii) fully reflect differences in costs of service among different customer classes. Prices based on the revised methodology and recommendations will be introduced for the non-residential customers of gas distribution companies no later than December 31, 1998. The FEC, in cooperation with the REC, will also make public, for each distribution company, both the calculated cost-based prices and the actual prices for each customer group (including the level of cross-subsidies).

2.15 The FEC will continue the process of delegating the power to implement the regulation of gas distribution tariffs and gas prices for final consumers to the regional energy commissions (RECs), where such regulation follows pricing principles and procedures prepared by the FEC. The RECs to which authority will be delegated will have met the following criteria as set out by the FEC: (i) appropriate legal basis for implementing the regulations in question; (ii) adequate professional staffing; (iii) operational rules approved by the FEC; (iv) a chairperson approved by the FEC; and (v) an established panel of independent experts for advice and comment.

2.16 In order to increase the transparency of relationships between the gas transmission and gas delivery monopolies of RAO Gazprom, and at the same time develop an environment which is more conducive to the development of competition, the FEC will (i) by November 1, 1998, develop model contracts for transactions between gas delivery organizations and gas transmission companies for transportation services, issue a resolution directing that these contracts will apply to all transactions effective January 1, 1999; and (ii) by July 31, 1999, issue a resolution providing that prices charged to independent gas producers and gas delivery companies for the use of the transmission system of RAO Gazprom are equivalent to tariffs which are charged to Mezhregiongaz for the same services.

2.17 By July 31, 1998, the Government will adopt a Resolution that provides for the elimination of state regulation of prices on gas sold by gas-producing organizations not affiliated with RAO Gazprom. By September 30, 1998 the Government will prepare, adopt and implement "Rules of Gas Supply" that address, inter alia, the rights and responsibilities of gas producers independent of RAO Gazprom and the rules of supply to household customers. By September 30, 1998, the government will publish a review for public comment of the effectiveness of Resolution 858 (on providing access to the gas transmission networks by independent gas producers) in increasing the market share of independent gas producers. The review, carried out by independent consultants, shall include (i) comparative statistical data with respect to growth over the preceding year in terms of market shares, deliveries, and new contracts for independent producers; (ii) a comparison of the prices paid to independent producers relative to the regulated city-gate prices; and, (iii) a survey of at least 10 independent producers, including both participants and non-participants, to obtain their assessments of the strengths and weaknesses of the program. Based on the review (and public comments thereon), the government will, by October 31, 1998, adopt and implement a Resolution which will improve the effectiveness of the rules and procedures in promoting non-discriminatory access by independent producers and suppliers, and will extend the access rights to allow non-discriminatory access by foreign producers of gas to Russian markets.

Oil Sector

Overarching Goal: To improve the efficiency of oil transport through regulatory reform, ensuring equitable access to pipelines, and creating a favorable investment climate.

2.18 In late 1997, the FEC published its initial views on the principles on the methodology for setting regulated crude oil transportation tariffs on Transneft's pipeline system. By July 31, 1998, the FEC will publish for comment its revised proposals on this methodology incorporating principles which will (i) ensure that Transneft can recover prudently incurred costs of service from shippers, including a reasonable return on investment; (ii) encourage efficient operations, and (iii) be based on costs so that the tariffs should fully reflect differences in costs of service. After taking into account the views of interested parties, the FEC will issue by September 15, 1998 a resolution which provides for revised tariffs which will be applied effective January 1, 1999.

2.19 By November 30, 1998, the MOFE will have signed a contract with a independent reputable experienced consulting firm selected after an international competition to conduct and publish a comprehensive operational audit of Transneft to assist the company in improving its operational efficiency.

2.20 The Government will submit a draft oil pipeline law to the Duma with a view to enactment by April 30, 1999. This comprehensive law will include provisions for non-discriminatory access and tariffs, and limitations on integration of ownership of assets in oil trunk transmission with ownership of assets in other oil sector activities. It will be enacted prior to the Government proceeding with the privatization of Transneft's core business assets.

2.21 The Government will submit to the Duma with a view to enactment by November 30, 1998 the law "Introduction of Changes and Additions to Legislative Acts of the Russian Federation ensuing from the Federal Law On Production Sharing Agreements" together with other related enabling legislation. This related legislation will incorporate provisions directed at: (i) preventing any undue restriction on the eligibility of oil developed under PSA arrangements; (ii) constraining excessive limitation on access to international goods and services, technology, and professional experience; and (iii) avoiding penalization of any group of investors. In addition, the Government will ensure consistency of Part II of the Tax Code with the Law on Production Sharing Agreements. (See Fiscal Management for further discussion on the Tax Code.)

Railways Sector

Overarching Goal: To improve efficiency within the railway system, ensure reasonable tariffs, and create the basis for privatization of certain services.

2.22 By December 31, 1998, rail freight tariffs will be adjusted to eliminate any discrimination between domestic and export rates. By June 30, 1999, rail freight tariffs will be determined uniformly on a cost-basis for all commodities.

2.23 Separate cost accounting will be introduced and separate income statements and balance sheets prepared for long distance passenger traffic, commuter rail traffic and freight traffic within MPS by September 1, 1998.

2.24 By July 30, 1998 MPS will provide the Government with the book value and current railway ownership of assets identified in the list it submitted to the Government on April 30, 1998, together with a timetable for their divestiture. By November 30, 1998 it will submit a report to the Government listing: (i) the social and ancillary assets, together with their book value and current owners, remaining on the books of railways which also could be divested if recipients agreed to accept the financial responsibility for their operations; (ii) the social and ancillary assets, together with their book values and current owners, that MPS has determined should not be divested within the next five years, together with a rationale for this determination. By December 31, 1998, MPS will provide the Government with an action plan for divesting the social and ancillary assets listed included in the April 30, 1998 list and a timetable for divesting the assets referred to in (i) above.

2.25 By September 30, 1998, the Government will issue a Resolution conferring on regional railway administrations the sole right, effective January 1, 1999, to fix tariffs for commuter rail services. The Resolution will also stipulate that, in cases where the concerned municipalities desire lower tariffs than those representing full cost recovery, they will pay at least 50 % of the resulting operating losses.

2.26 By October 1, 1998, the Government will prepare a feasibility study for establishing long- and short-haul passenger service companies. By December 1, 1998, the first two companies shall be established.

2.27 By September 1, 1998, the Government will develop and begin to implement a schedule for the privatization of companies engaged in rolling stock rehabilitation and manufacturing of spare parts and other railway-related items, as well as general construction companies.

3. PRIVATE SECTOR DEVELOPMENT

Privatization

Overarching Goal: To increase the efficiency in the use of assets employed in firms and stimulate investment so as to resume economic growth and create jobs, and to engender revenues for the state budget.

3.1 The 1998-99 privatization program will expand and accelerate significantly the process of transparent and competitive privatization of Russian enterprises. This will be accomplished through case-by-case privatization of the largest enterprises in accordance with Government Resolutions 363 and 564 of 1997, and through the significant reduction in the number of firms currently denoted as "strategic" and their privatization. To this end, a special Policy Statement will be issued by July 31, 1998 by the Chairman of the Government of the Russian Federation announcing these initiatives. The policy statement will be published widely in the international media.

3.2 By July 15, 1998 the Ministry of State Property will issue an ordinance establishing a list of 15 enterprises that are part of the draft State Privatization Program and are to be privatized according to the case-by-case procedures specified in Government Resolutions 363 and 564 of 1997. The ordinance will establish a schedule for privatizing these enterprises such that they will be offered for sale not later than December 31, 1998, if such dates are determined on advice of independent financial advisors as most desirable based on market conditions. The percentage of equity offered will be determined in consultation with independent financial advisors. These enterprises are: OAO Orenburg Oil JSC (Orenburg oblast); OAO "Kovrovo Electric Machine Plant" (Vladimir oblast); OAO Western-Siberian Iron & Steel Factory (Kemerovo Oblast); OAO "Stupino Iron & Steel Factory" (Moscow Oblast); OAO "Nizhni Novgorod Machine Building Plant"; OAO "Oil & Gas Co. "Slavneft" (Moscow); Rybinsk Instrumentation Factory (Yaroslavl Oblast); Kemerovo Mechanical Plant (Kemerovo Oblast); Kamensk Chemical Factory (Rostov Oblast); Factory "Krasny gigant" (Penza Oblast); PO (Prod. Association) "Avangard" (Ufa); GPO "ZiM named after Maslennikov (Samara Oblast); Plant "Kommunar"; NPO "Geofizika" (Moscow); Vysokogorsky Mechanical Works (Sverdlovsk Oblast).

3.3 By August 31, 1998 the Ministry of State Property and the Russian Federal Property Fund will hold competitive bids and select 9 to 11 independent financial advisors among experienced, reputed international investment institutions. These advisors will be engaged to (i) carry out pre-sale preparation of the largest Russian enterprises, including but not limited to those denoted in the draft Privatization Program, and (ii) place shares of these enterprises on world markets in accordance with Government Resolutions 363 and 564 of 1997. These advisors will, among other things: audit and appraise the enterprises; suggest the likely market price of the transaction; recommend any required organizational/managerial restructuring prior to sale; work out the optimal privatization scheme, including the percentage of equity to be offered; and ensure that bids will be welcomed from all physical and legal persons and foreign investors eligible under Russian law.

(i) Within this framework, beginning July 31, 1998, the following ten tenders will be offered on domestic and international markets before December 31, 1998, if such dates are determined on advice of independent financial advisors as most desirable based on market conditions: Rosneft, Sviazinvest, SIBUR, LUKOil, Cheliabinskinform, Electrosviaz (Moscow Oblast), Novossibirsk Electrode Plant, Slavneft, NORSI-Oil, RAO UES.

(ii) Within the same framework, beginning by the end of each quarter following July 31, 1998—i.e., September 30, 1998, December 31, 1998, March 30, 1999, June 30, 1999, September 30, 1999, and December 31, 1999—at least 7 firms listed on the draft Privatization Program issued by the Government on April 21, 1998 shall be brought to point of sale within the subsequent six months, if such dates are determined on advice of independent financial advisors as most desirable based on market conditions.

3.4 To increase the scope of privatization, a Government Resolution will be issued by July 31, 1998 that reduces the list of "strategic" enterprises under Government Resolution 949 of September 18, 1995 barred from any privatization to either domestic or foreign investors from 3,000 to less than 1000 firms. The Resolution shall specify that the enterprises removed from the "strategic" list will be subject to transparent and competitive privatization processes, beginning September 30, 1998 to December 31, 2000. For the enterprises removed from the "strategic" list, in accordance with market conditions as assessed by independent financial advisors, at least 10 percent will be brought to the point of sale by December 31, 1998, at least 15 percent will be brought to the point of sale by March 31, 1999, at least 25 percent will be brought to the point of sale by June 30, 1999, at least 30 percent will be brought to the point of sale by September 31, 1999, 40 percent will be brought to the point of sale by December 31, 1999, and 100 percent will be brought to the point of sale by December 31, 2000.

3.5 By October 31, 1998 the Government will adopt selection criteria as to which of the existing 6,500 agro-industrial enterprises will remain under exclusive federal ownership until the year 2000. Based on these criteria, by November 30, 1998, the Government will issue a Resolution specifying the list of agro-industry enterprises that will remain under federal ownership until 2000. The list will specify the name, legal address, core activity, and institutional and legal status of the enterprise. Starting from January 1, 1999, the Government will, market conditions permitting, bring to the point of sale by December 31, 1999, at least 10 percent of the enterprises not included on the list. Subsequent sales will be announced in the future. The privatization process shall be according to the rules governing competitive cash auctions, without distributing majority shareholding to suppliers of raw materials under preferential terms.

Bankruptcy

Overarching Goal: To make the bankruptcy process more efficient.

3.6 The government will implement measures to eliminate the bias in the bankruptcy law towards reorganization rather than liquidation of enterprises. To this end, by September 30, 1998, the Government will submit to the Duma with the view to enactment by December 31, 1998 amendments to (i) the Bankruptcy Law that eliminate court discretion in overruling the creditors' decision to liquidate the debtor enterprise and (ii) amendments to the Civil Code to strengthen the rights of secured creditors. In addition, the government will take all necessary steps to implement the new laws on enforcement of court judgements, including by fully staffing the court officers' corps by December 31, 1998.

Competition Policy

Overarching Goal: Strengthening the government's capacity to intervene to promote competition.

3.7 The Government will implement by September 30, 1998 measures to strengthen the mission of the Antimonopoly Committee, both at the Federal and sub-federal levels, with a view towards introducing a more effective rules-based competition policy institutional regime in the Russian Federation, ensuring that territorial branches exist in each region. Through such measures and in the 1999 budget, the Antimonopoly Committee will be given adequate financial and human resources commensurate with its revitalized mission. The mission of the Antimonopoly Committee will have as principal objectives the creation of a unified economic space throughout the Russian Federation and preventing restrictive business practices, in particular anti-competitive mergers and acquisitions. The Antimonopoly Committee will develop and implement policy measures that deal with reducing anti-competitive horizontal and vertical concentration and integration in key product and geographic manufacturing and infrastructure monopoly markets, including industrial and financial groups (FIGs) and the petroleum sector.

3.8 By November 30, 1998 the Antimonopoly Committee will issue for public comment explicit and well-defined merger guidelines that establish general policy parameters for distinguishing between pro-competitive and anti-competitive mergers based on similar guidelines consistent with international practice. Following public comment, these new merger guidelines will be published widely by December 31, 1998.

3.9 The State Antimonopoly Committee, in collaboration with other federal organs, will implement by September 30, 1998 new measures to remove administrative and policy-induced barriers at Federal and sub-Federal levels to the free movement of goods and services throughout the Russian Federation. The measures will include stronger enforcement penalties than presently exist. To introduce at the Federal and sub-federal levels new rules-based, streamlined business licensing procedures and fee structures, the Government will seek passage of the Law on Licensing by December 31, 1998.

3.10 In order to foster resolution of business disputes, new measures will be implemented by July 31, 1998 that strengthen and enlarge the bailiff service so as to provide for more effective enforcement compliance, including criminal sanctions, by losing defendants in *arbitrazh* court cases.

Corporate Governance and Investor Rights

Overarching Goal: Clearly signaling the government's determination to protect investors.

3.11 The Government will submit to the Duma with a view to enactment by December 31, 1998, legislation that amends the Federal Law "On Joint-Stock Companies" stipulating, in particular, protection of minority shareholders' rights, including protection from transfer of assets to parent (affiliate) companies, by enhancing the penalties for violating investors' rights.

3.12 By September 1, 1998, the Federal Securities Commission (FSC) of Russia will adopt a Resolution on the procedure governing compilation and submission by issuers of securities of quarterly reports, with a special focus on information disclosure by enterprises quoted on public exchanges.

3.13 By July 30, 1998, the Government of the Russian Federation will adopt and initiate implementation of the State Program on Protection of Investors' Rights that will spell out further key tasks and measures to be undertaken in 1998 and 1999. The Government will also ensure that the FSC will be provided sufficient resources to enforce investors' rights. This will be achieved by assigning a share of fee revenue from licensing of securities' market participants to the FSC.

3.14 By October 31, 1998 the Government will publish procedures consistent with Decree No. 395 and Decree No. 392 for restructuring the debts of agricultural enterprises. By December 31, 1998, the Government will implement the above mentioned procedures. In any new legal enactments regarding the establishment of joint stock companies in the agricultural sector and the legal status of such companies, the Government will affirm and protect the right of members of the joint stock company to invest the use right of land in the charter capital of the enterprise while retaining ownership of the land.

Fostering Labor Mobility

3.15 The Government will submit to the Duma by November 1, 1998, a new Labor Code that would bring the labor laws in compliance with the requirements of a market economy. The Code will establish a realistic and feasible minimum of social guarantees, enhance the role of individual labor agreements, including a more simplified procedure for dissolving individual labor agreements (such as excluding the need for consent of trade unions and finding alternative employment), and expand the ability to enter into fixed term and multiple-work contracts. The Code will also contain provisions ensuring that social partnership be targeted at forming and implementing collective agreements at the level of individual enterprises, as well as ensure the establishment of efficient institutions ensuring implementation of individual and collective agreements, settlement of collective disputes and compliance with the requirements of the labor legislation.

Land/Real Estate

Overarching Goal: To further develop the legal and institutional framework for full private ownership and development of land and real estate markets.

3.16 By August 30, 1998 the Government will approve the Federal Program on Development of Land Reform in the Russian Federation in 1998-2001 and ensure that by September 30, 1998 a Presidential Decree is issued to enact the above Program. The Program shall include an affirmation of the rights of citizens of the Russian Federation to engage in transactions in land, including purchase, sale, rental, and mortgage, and shall specify a program of actions to facilitate transactions. The reform strategy outlined in the Program will focus on pragmatic and readily implementable steps on clarifying rights in land, transferring commercially valuable land from municipal and state ownership to either private ownership or long term (49 years) lease, and simplifying the procedures by which transactions with land can take place. The Program should be supported by an action plan for implementation thereof to be approved by October 30, 1998. At the same time the Government will encourage implementation of Presidential Decree "On Exercising Individuals' Constitutional Rights to Land" No. 337 of March 7, 1996 with a view to facilitate entering into agreements for the use of land shares by all users of agricultural land.

3.17 The Government will submit to the Duma with a view to enactment by December 31, 1998 legislation that includes the draft Federal Laws "On State and Municipal Land," "On the State Land Cadaster," "On Appraisal of Land," and "On Land Management". Such laws will be aimed at further liberalization of the land market. The Federal Law on Cadastre will provide for establishment of the basic cadastre, that is information on parcel existence, location, and approximate boundaries, and allow for establishment of additional layers of cadastral information by agencies responsible for such work.

3.18 By December 31, 1998, the Government will adopt and start implementing a Resolution to establish the program for the phased introduction of the uniform system of state registration in accordance with the Federal Law "On State Registration of Rights and Transactions in Real Estate" and Government Resolution No. 1378 of November 1, 1997, which implements the law. Such Resolution shall clarify the steps that will be taken to have functioning registration offices established at the rayon level, the specific nature of inter-agency cooperation required, and the sources of financing for implementing this plan. By March 30, 1999 a Government Resolution shall be approved specifying detailed procedures for the registry offices' functioning.

Accounting and Auditing

Overarching Goal: To achieve substantial progress in implementing financial accounting and auditing standards and practices in line with international principles.

3.19 With regard to accounting reform, the Government will ensure the implementation of the measures specified in the Action Plan of the Accounting Reform Program based on International Accounting Standards (IAS) approved by Resolution No 283 of the Government to develop national accounting standards consistent with IAS and to support the establishment of the self-regulating independent accounting professional body. By December 31, 1998, under the guidance of the Interagency Commission for Accounting and Reporting Reform, the Ministry of Finance will develop the first 10 accounting rules (standards) fully consistent with international requirements (IAS); and will ensure that such rules are made effective as of January 1, 1999. In addition to development of new and revision of previously approved national accounting standards based on IAS, by September 30, 1998 the Government will revise the rules for forming financial statements of commercial organizations and consolidated financial statements for groups of organizations in compliance with IAS; will prepare standard recommendations on the organization of accounting for small business entities in compliance with IAS; and will develop Standards of professional ethics of accountants in compliance with international practice.

3.20 By December 31, 1998 the Government will develop new Charts of Accounts in compliance with IAS for commercial entities, budgetary organizations, professional participants of the securities market and investment funds; will revise the source accounting documentation with account taken of the requirements of the market economy and international financial reporting standards.

3.21 With regard to auditing reform, the Government will finalize the draft law "On Auditing in the Russian Federation" and submit it to the State Duma by November 30, 1998, with a view to enactment by March 31, 1999. The draft law will provide for the gradual transition of auditing regulation powers from Federal bodies to the self-regulating independent auditing profession. In accordance with the 1998-1999 Program of auditing the accounts (financial statements) of economic entities using auditing standards based on international practice, the Government will ensure implementation of measures to arrange the auditing activities in the Russian Federation in compliance with the existing regulatory framework and national auditing regulations (standards) which are being developed on the basis of the International Standards on Auditing (ISA). By December 31, 1998 the Government will adopt 22 audit standards (inclusive of those adopted earlier) in compliance with ISA. By May 31, 1999, an additional eleven auditing standards based on ISA will be adopted by the Government.

Liberalizing the International Trade and Foreign Direct Investment Regimes

Overarching Goal: To send a clear signal to foreign investors of the government's intentions to ensure they receive fair treatment and to harmonize production certification standards with international practice so as to reduce barriers to foreign trade.

3.22 By September 30, 1998 a special Policy Statement will be issued by the Chairman of the Government of the Russian Federation, which will be published widely in the international media, that states the Government's commitment to continue to improve the policy environment for foreign direct investment by bringing the fiscal, regulatory and legal policy regime in line with international standards. Measures to bring about such changes will include the following reforms: (i) "national treatment" will be adhered to both for right of establishment and for post-establishment operations; (ii) the number of restricted sectors and limitations on foreign direct investment will be substantially reduced; (iii) enforcement of property rights will be strengthened; (iv) investor-State dispute resolution mechanisms will be made more efficient, including giving foreign investors the opportunity to seek neutral, binding international arbitration; (v) foreign investor registration procedures will be simplified, rules-based, and made transparent; (vi) guarantee schemes covering basic non-commercial risks will be maintained and extended; and (vii) restrictions for foreign investment in services sectors will be reduced.

3.23 By October 1, 1998, a new procedure for mandatory certification will become effective, which will envisage both reduction in the number of goods subject to mandatory certification, and simplification of imposed requirements. An approved Concept for Developing Certification will target gradual substitution of a producer's declaration for the current pre-market certification. The Government will submit to the Duma with a view to enactment by December 31, 1998, a law to reduce duplication of certification procedures applied by different ministries to the homogeneous groups of goods. By December 31, 1999 harmonization of Russian standards in priority sectors with internationally accepted ones will be essentially completed.

4. FISCAL MANAGEMENT

Elimination of Non-Payments and Arrears

Overarching Goal: To eliminate arrears and the practice of non-payments.

4.1 On the basis of a Presidential Instruction issued by July 17, 1998, the Government will prepare and submit to the Duma a draft 1999 Budget Law which will include a requirement that regions will receive substantially reduced federal transfer payments, grants or loans unless they meet the following conditions: (i) maintain accounts payable of 45 days or less of sales equivalent to infrastructure monopolies in respect of services provided after September 30, 1998; (ii) comply with a schedule agreed with infrastructure monopolies for the liquidation of arrears relating to products and services provided prior to September 30, 1998; (iii) maintain wage and payroll tax arrears at 30 days or less of the current wage-bill; (iv) ensure that all transactions are on a cash basis; (v) meet federal targets for cost recovery on housing and communal services; and (vi) themselves apply conditions (i)-(v) above in respect of their transfers, grants or loans to municipal governments.

Tax Administration and Policy

Overarching Goal: To strengthen revenue collection performance, improve tax administration, and reduce distortions in the tax structure.

4.2 To improve tax administration, the Government will seek to have Part I of the Tax Code enacted by July 20, 1998, and the government will introduce into the Duma legislation to amend some key deficiencies of Part I of the Tax Code by January 1, 1999. This amended version will give the tax authorities broad powers to collect both tax principal and interest and fines without recourse to the court system, eliminate deferrals for tax payers with arrears from the budget, and permit the tax authorities to issue broad instructions to enforce tax laws without having detailed tax administration provisions codified in the law. The amended Part I of the Tax Code will also contain improvements in the tax administration such as making tax agents who fail to transfer withheld taxes to the budget subject to criminal liabilities and giving the tax authorities the ability to issue liens on the bank accounts of tax delinquents.

4.3 To reduce tax distortions and encourage long term savings instruments, the Government will seek to amend Part II of the Tax Code by September 30, 1998 to, *inter alia*, (i) ensure that taxation of interest earnings on all deposit accounts in banks will be at uniform rates with those applied to all non-government securities, (ii) the principles of sharing between the government and developers after payment of appropriate investment and expenses are consistent with the provisions in the Law on Production Sharing Agreements. The Government will seek to have Part II of the Tax Code signed into law by January 1, 1999.

4.4 In order to further streamline tax administration, by July 17, 1998 the Federal Agency for Foreign Currency and Export Control and the Tax Police will be made subordinate to the Minister Head of the STS. By September 1, 1998, the government will take a decision concerning the appropriate responsibilities of the Federal Agency for Foreign Currency and Export Control with a view to eliminate duplicate functions and redundant activities.

4.5 Collection of arrears from large tax debtors will continue to be a central element of the revenue collection strategy. From July 1, 1998 and during the remainder of the year, the Emergency Tax Commission will meet monthly, to take steps to collect arrears in each quarter from at least the 20 largest remaining tax debtors. Further, a newly created Federal Debt Center will begin sales of the assets seized from tax debtors. All necessary steps will be taken to ensure that the specialized tax inspectorate, established under Government Resolution No. 9 within the State Tax Service (STS) to monitor the largest tax payers, will operate effectively.

4.6 The role of banks in enforcing tax collection through the banking system needs to be revamped as the current system has negatively affected financial intermediation through the banking system. By September 1, 1998, the Government will establish a plan to remove tax administration functions from the banking system. In particular, legislation will be passed defining procedures for the State Tax Service (STS) to issue liens on any bank account and resources held in the banking system in line with international practice. A major goal of this plan will be to eliminate the use of settlement accounts by the tax authorities by January 1, 1999. In line with international practice, the STS will begin seizure of real assets or initiate bankruptcy proceedings against any enterprises for which there has been a lien on bank accounts for 60 days or more.

Expenditure Management And Policy

Overarching Goal: To improve control over and efficiency of public expenditure.

4.7 To improve budget management and execution, the Government will seek to have the Budget Code signed into law.

4.8 Building upon the census and rationalization of government employment under the Fiscal Action Plan, the Government will, by December 1, 1998 present its proposals for Administrative Reform to the President, specifying the functions that the government will be carrying out in the future and steps aimed at improved efficiency in government structure and staffing.

4.9 To control cash spending and improve expenditure management the government will adopt by executive order a revised timetable by July 17, 1998 to complete moving all federal agencies into the federal treasury by January 1, 1999. This will include all budget recipients of the Ministry of Defense, the operations of all the earmarked budget funds, (including the Road Fund and Customs System Development Fund), and all foreign exchange accounts of the STS and State Customs Committee. The government will by September 1, 1998, close all off-budget accounts that are of a budgetary nature and have flows intermediated by the federal treasury.

4.10 A law will be submitted to the Duma by September 1, 1998 to allow the federal treasury to pre-approve contracts that are to be financed from federal budget funds, with a view to enactment by October 31, 1998. This law will specify that contracts that are not registered will not be a legal obligation of the federal government, and that only contracts within the financial ceilings established by the federal budget will be registered. In addition, the federal treasury will put in place a reporting system allowing the amount of registered contracts to be monitored against budget limits on an ongoing basis.

4.11 The Government will ensure that the accounts payable of budget organizations to infrastructure monopolies at no time exceed 30 days of current sales for sales after July 1, 1998.

Reform of Extrabudgetary Funds and Earmarked Budget Funds

Overarching Goal: To improve transparency and reduce waste in extrabudgetary funds.

4.12 In order to achieve the necessary adjustment in federal expenditures and meet the 1999 fiscal targets, the Government will seek to remove the earmarked status of the various budget funds in the 1999 Budget Law (in particular of the Road Fund and Customs System Development Fund), and have their revenue sources accrue to the general revenue of the federal budget. The expenditures of the Road Fund will be closely scrutinized with a view to reducing their outlays by 30 percent in 1999. The expenditures of the Road Fund will be brought under federal treasury control and its expenditure commitments will be subject to the same contract preapproval as other budgetary spending.

4.13 The budget address of July 17, 1998 will instruct the government to ensure the reduction of the payroll tax earmarked for the Social Insurance Fund to 4.9 percent (from 5.4 percent) and at the same time the government will elaborate measures to reduce the overall expenditures of the Social Insurance Fund by 25% in 1999. This will involve eliminating all expenditures that are not directly related to providing insurance related benefits (eg. sick leave and maternity benefits). Any resulting surplus in the SIF will be transferred to the Pension Fund for payment of pension benefits.

4.14 The Employment Fund will be subjected to treasury control from October 1, 1998. In addition, the Presidential address on the principles of the 1999 budget of July 17, 1998 will instruct the Government to have the Employment Fund's revenues collected by the STS as of January 1, 1999 on an earmarked basis.

4.15 The Government envisages a number of actions to restore the solvency of the Pension Fund. A Government Resolution has been issued that introduces, as of August 1, 1998, a temporary 2 percent earmarked tax surcharge on the personal incomes to be paid to the Pension Fund. This same resolution will also expand the base for the employer contribution. The surcharge will remain in place and further increases in pension benefits will be avoided as long as the Pension Fund remains in deficit or new pension arrears are being accumulated. In addition, legislation will be proposed to the Duma in the special August session, that will expand the base for both employee and employer payroll tax contributions, and will shift the burden of the tax from employers to employees. Should these measures prove insufficient to restore Pension Fund balance by September 1, 1998, the Government will either reduce pension benefits starting with those above the minimum or further increase the payroll tax surcharge (in order to restore Pension Fund balance). Further efforts will also be made to reduce the administration costs of the Pension Fund. In order to ensure budget organizations comply with their obligations to the PF, from September 1, 1998 the Federal Treasury will transfer directly to the PF federal allocations for payroll tax payments on budgetary employee's wages.

4.16 By July 31, 1998, the Government will issue a resolution mandating annual audits, carried out in line with international auditing standards and supervised by the Ministry of Finance, of the Social Insurance Fund, Medical Insurance Fund and the Road Fund. Contracts for the first of these audits will be awarded by November 1, 1998 for audit of 1998 accounts, to be completed by December 31, 1999.

Intergovernmental Fiscal Relations

Overarching Goal: To put in place basic elements of intergovernmental fiscal relationships that encourage reform, improve tax collection, eliminate unfunded mandates, and promote equitable treatment of regions.

4.17 By July 30, 1998 the Government will approve a revised Concept Paper on Sub-National Fiscal Reform which will, *inter alia*, provide clear conceptual guidelines for the reform of sub-national fiscal relations between the federal and regional levels of government. By September 30, 1998 the Government will prepare another detailed Concept Paper establishing the principles for reform of sub-regional government fiscal relations. These two concept papers will cover the formulation of expenditure and revenue assignments for the different levels of Government, and a reformulated system of financial flows from federal to regional governments. Three mechanisms for channelling all federal support to the regions will be set out in detail in these papers; the Fund for Financial Support to Regions (FFSR- transfers for equalization), the Fund for Regional Development (FRD- loans and grants for public investment), and the Fund for the Development of Regional Finances (FDRF-loans for reform).

4.18 As an intermediate step, a new formula for allocating resources transferred to regions through the FFSR, based on the Concept Paper on Subnational Fiscal Reform, will be incorporated in the draft 1999 Budget Law. By June 1, 1999 additional revisions to the formula for transfer allocation will be adopted through a government resolution, to be incorporated in the 2000 Budget Law, which will be based on the objectives of (i) reducing inequality of revenue capacity of subjects of the federation, (ii) use of federally defined expenditure norms to define expenditure needs, and (iii) strengthening incentives for regions to increase revenue collection.

4.19 By April 1, 1999, appropriate legislation will be submitted to the Duma or other legal acts will be completed, to provide clear assignments of revenue and expenditure responsibilities for each level of government. These measures will establish *inter alia*, (i) a more stable and fully transparent system of revenue assignments, (ii) total budget revenue capacity at each level of government commensurate with their respective expenditure responsibilities, (iii) clear criteria under which regional and local authorities may be allowed to set regional tax rates, (iv) the principles under which loans, transfers and grants between levels of government will be conditional on compliance with stated criteria or on the basis of bilateral agreements, and (v) terms under which resources of the FDRF will be made available to regional governments. These principles will be fully reflected in preparation of the 2000 Federal budget and the budgets of subjects of the federation.

Sovereign and Subnational Borrowing

Overarching Goal: To ensure that public borrowing is monitored and held within prudent limitations.

4.20 The government will strengthen sovereign and sub-national debt monitoring to significantly improve the coordination and management of external and domestic debt, at both federal and sub-national levels, within the Ministry of Finance. To this end the Government will initiate an integrated public debt monitoring system in the Ministry of Finance by January 1, 1999 which will cover both sovereign and sub-national debt, including all obligations of federal and sub-national authorities. In particular, the debt management system will cover all public debt including guarantees, and other public contingent liabilities or conditional obligations. Any necessary legal acts or decisions to implement this expanded definition of public debt will be adopted before September 1, 1998. By February 1, 1999 the Government shall complete a Report with comprehensive and detailed accounting of all *federal level* obligations as of December 31, 1998. A Report with comprehensive and detailed accounting of all *sub-national level* obligations shall be prepared by May 1, 1999, with reporting current through December 31, 1998.

4.21 To improve oversight of sub-national debt, the Government will submit to the Duma with a view to enactment by January 1, 1999, or will issue regulations, as necessary, to (i) establish satisfactory and transparent prudential limitations and preconditions for sub-national borrowing, (ii) provide for verification by the Ministry of Finance that these limitations and preconditions have been met, as a condition for such borrowing to be a valid obligation of subnational governments, and (iii) establish a central registration capacity of sub-national public debt in the Ministry of Finance.

5. FINANCIAL SECTOR

Banking Reform

Overarching Goal: To improve the soundness, efficiency, transparency and competitiveness of the banking system.

5.1. More stringent prudential rules, especially with regard to banks' foreign exchange operations and positions, will be adopted. The requirement to provide consolidated reports beginning on January 1, 1999 will be extended to nonbank financial institutions. The government and the CBR will make every effort to ensure that amendments to the Central Bank Law to expand consolidated reporting to non-bank subsidiaries of commercial banks will be adopted by January 1, 1999, sufficiently prior to the implementation of such reporting from July 1, 1999. Prudential norms on banks' off-balance sheet foreign currency exposure will be strengthened, by September 30, 1998, through the imposition of limits on single party and connected party exposure, and out-of-money options will no longer be considered adequate for covering on-balance sheet exposure.

5.2 By September 30, 1998, the CBR will adopt a timetable to introduce accrual accounting for banks, with a view to introduce such accounting on January 1, 1999 if the Tax Code is in effect at that time. By January 1, 1999, and in tandem with the Tax Code, the CBR will bring the Russian accounting standards in full conformity with the main principles of the International Accounting Standards (IAS). The appropriateness of the introduction, by January 1, 1999, of 100 percent pre-tax provisioning for bad loans of commercial banks will be assessed in the context of the review of the program.

5.3 The CBR will begin developing a strategy for fostering competition and a strong and efficient banking sector in the long run. A draft of such a strategy will be prepared by end-1998. Over the short to medium term, the CBR will continue withdrawing licenses of weak and insolvent banks and streamlining the banking sector. liquidation of small insolvent banks (with capital of less than ECU 1 million) will be stepped-up and their licenses will be revoked by January 1, 2000 should they not reach the new minimum requirement. With regard to medium and large banks, the CBR and the government will devise a comprehensive approach for addressing problem banks which will include: (i) diagnosis; (ii) corrective action; (ii) bank restructuring; and (iii) bank liquidation. Such a strategy will be reflected in a bank restructuring framework to be prepared by October 31, 1998. The framework will be formulated on the basis of a full diagnosis of the size and nature of the problem and will involve setting out uniform rules and procedures to be followed.

5.4 The government and the CBR will make every effort to have the Bank Bankruptcy Law and the laws amending the CBR Law and the Law on Banks and Banking Activities enacted by end-1998 to improve the CBR's supervisory powers and to provide an adequate legal basis for the bank restructuring framework. These laws will include adequate provisions to strengthen the regulatory powers of the CBR, including revoking licenses, effectively liquidating insolvent banks, and imposing further liability on banks' shareholders.

5.5 The CBR will continue to increase the transparency of its own operations and will put in place requirements to increase transparency for commercial banks. The policy of announcing weekly data on external reserves, begun in June, will be expanded to include the announcement of base money. The CBR will publish summary information on the financial situation of the 30 largest banks on a monthly basis and a requirement will be introduced for banks to provide quarterly disclosures of key information. The standards for disclosure by banks holding more than 10 percent of household deposits in the banking system will be significantly expanded. By August 1, 1998, the ten largest banks will be required to publish quarterly accounts, have annual accounts prepared and audited by a reputable, qualified firm, and make the results public.

Sergei Kiriyenko	Sergei Dubinin
Chairman	Chairman
Government of the Russian Federation	Central Bank of the Russian Federation

Attachment 5

RUSSIAN FEDERATION

THIRD STRUCTURAL ADJUSTMENT LOAN

POLICY REFORMS PROGRAM MATRIX

REFORM OF INFRASTRUCTURE MONOPOLIES					
Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
I. Cross-Sectoral Program					
To improve the transparency, fiscal accountability and competitiveness of infrastructure monopolies, and to reduce barter and non-payments.	The Government has made adequate provisions in the 1997 budget to pay for the fuel and energy consumption of the remaining "strategic customers" who may not be disconnected for nonpayment, as listed in the Government Decree 74, issued January 28, 1997. On April 3, 1997, the Government approved an action plan for the phased elimination of cross-subsidies among consumer groups for all natural monopoly services (Government Resolution No. 389 "On the Gradual Reduction of Cross-Subsidization in Sectors of Natural Monopolies"). On April 28, 1997 Presidential Decree No. 426 "On Fundamental Principles of Structural Reforms in Sectors of Natural Monopolies" was issued as outlined in the Concept Paper "On Developing Plans for Structural Reforms of Natural Monopolies" submitted to the Government on March 26, 1997. The decree instructed the Government to approve a detailed medium-term restructuring program to be adopted by a government resolution by June 30, 1997.	The Government has adopted Resolution # 928 of July 27, 1997 that establishes a procedure for clearing payment arrears for supplied fuel and energy resources. In August 1997 the Government outlined an action plan for restructuring the electric power and natural gas sectors.	As it has throughout 1997, in 1998 the Government will ensure that there are no arrears to energy suppliers on account of the remaining strategic customers. A Government Instruction (SK-P7-13321, May 10, 1998) has been issued to prepare guidelines for implementation of quarterly accounts based on International Accounting Standards (IAS) for RAO Gazprom, RAO UES Rossii (UESR), the Railways, and Transeft, and requiring the preparation of quarterly accounts for RAO Gazprom, and RAO UESR starting from the third quarter of 1998. A report has been issued to the Government–and published–on the amounts of dividends on federally-owned shares in infrastructure utilities not transferred to the federal budget. Article 105 of the 1998 Budget Law and Presidential Decree No. 396 of April 16, 1998 are intended to eliminate such exemptions; a draft law has been prepared to implement Article 105. The Government has required (Government directive No. 968-r of July 17, 1998) that, starting with the financial accounts for 1998, the consolidated IAS financial accounts of Gazprom, RAO UESR, and Transneft, and, starting with the financial accounts for 1999, the Railways, are to be audited and published annually by June 30 of the following year by independent qualified auditors in accordance with international auditing standards. The Government has required (Government Resolution No. 786 of July 17, 1998) that VAT be calculated and collected on an accrual basis.	In order to reduce and, subsequently, eliminate non cash payments and arrears in infrastructure monopoly sectors: (i) by October 1, 1998, the Government will announce, and by November 1, 1998 implement, a procedure requiring all consumers of gas, heat and electricity to make payments for these purchases to escrow accounts established jointly by producers, transporters, distributors and any others in the supply chain to administer (a) the collection of these amounts and (b) their fair distribution to them. Any participant in the supply chain will have the right to apply the procedures mentioned in Government Resolution No. 789 of July 17, 1998 to any consumer/purchaser that accumulates 45 days arrears for purchases made after July 1, 1998 and/or fails to comply with a schedule agreed between them for the liquidation of arrears relating to products and services provided prior to July 1, 1998. (Failure to reach agreement on such a schedule within 60 days will be grounds for applying these procedures.); and (ii) by October 1, 1998, the Government will develop and announce a new procedure governing settlements by non-budget sector organizations for purchases of gas, heat and electricity. This procedure will be applicable effective November 1, 1998 to any such organization that has 30 days' or more of arrears. It would give the right to any participant in the supply chain to require that such an organization establish and maintain unconditional letters of credit in favor of the relevant escrow account to cover payments for 30 days' worth of purchases. This requirement could remain in effect for a reasonable time period (to be defined within the procedure). The Government will issue a formal decision requiring all consumers of gas, heat, and electricity to make payments for their purchases of gas, heat, and electricity into escrow accounts established jointly by producers, transporters, distributors, and any other entities in the supply chain, and has furnished a report to the Bank demonstrating it has taken all measures necessary on its	

REFORM OF INFRASTRUCTURE MONOPOLIES					
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			The Government has simplified (Government Resolution No. 789 of July 17, 1998) the procedures for termination or limitation of electricity, heat, and gas supplies to organizations and consumers in the event of failure to pay for fuel and energy resources supplied. By July 31, 1998, the Government will issue a Resolution that establishes an inter-agency commission that coordinates and oversees reforms, including development of measures and timetable of actions, for the horizontal and vertical competitive restructuring of key infrastructure monopolies. This will cover the electric power, natural gas, railroads, telecommunications and oil transport sectors.	part for the implementation of such decision.	
		The Government is ensuring the independence and effectiveness of the regulatory agencies for energy (FEC), transport (FSNMT), and telecommunications (FSRNMC).			
II. Electric Power Sector Program					
To make major progress towards creating an electric power sector with diversified ownership and open to competitive forces.	In the period up to April 30, 1997, the Government took steps to ensure that the representative group of government officials on the Board of RAO UESR have clear instructions to implement governmental policies in the electric power sector.	The Government introduced a two-block tariff for household electricity consumption that is differentiated by levels of consumption; this policy is based upon recommendations from the FEC dated April 25, 1997. Implementation has been undertaken in most regions. The Government established an Inter-Ministerial working group to ensure that its reform agenda for the power sector would be pursued. Improvements in corporate governance were punctuated during the Annual General Meeting of the shareholders of RAO UESR on May 28, 1997, when the leadership for the reform agenda was established. The Government has created an Independent Financial Operator (IFO) to establish a competitive wholesale electricity market under FEC Protocol #97 dated June 25, 1997. It is in the process of establishing a Supervisory Council for the Wholesale Market composed of representatives of market participants (with no	The Federal Energy Commission (Directive 17/6, April 17, 1998) has adopted dispatching guidelines and procedures in the electricity sector to provide for the minimization of costs of energy supply to the wholesale electricity market. Dispatching guidelines have been implemented in at least one regional electricity grid. A comprehensive Wholesale Market Agreement is currently being drafted. By August 1, 1998, RAO UESR will publicly announce its intention of increasing private sector participation in Energos in which UESR has an equity stake. By August 1, 1998, the Government will issue a Resolution in which RAO UESR will be required to establish separate	By September 1, 1998, the Federal Energy Commission to develop pricing methodology and issue guidelines for the network services provided by AO Energos. Costs associated with non-core activities should be accounted for separately and not be included in costs used to establish the regulated price. By October 1, 1998, RAO UESR, will solicit offers from the private sector for participation in Energos. The bidders would be permitted to make a variety of offers, including, but not limited to, equity investments, management contracts, concession or leasing arrangements. A list of Energos that will be available for consideration, along with a package of relevant technical and financial information will be issued by October 1, 1998, enabling due diligence to take place. By October 1, 1998, the Government, through its representatives on the Board of RAO UESR, will direct RAO UESR management to issue corporate guidelines requiring the change in dispatch rules with a goal of	By January 1, 1999 the Government will issue a Resolution requiring non-discriminatory access to transmission and distribution services and to direct the Federal Energy Commission to develop regulatory guidelines and access rules by June 30, 1999. Offers from the private sector for participation in Energos would be made to RAO UESR by January 1, 1999. RAO UESR would review these offers and negotiate Term Sheets by March 1, 1999. An independent evaluation of these offers will be undertaken by April 1, 1999. Final decisions on these offers would be made by RAO UESR no later than June1, 1999. and would result in private sector participation in at least ten Energos. By March 31, 1999, RAO UESR will issue

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		participant having a dominant position). The composition of the Supervisory Council will be *finalized by the end of February, 1998.* Industrial customers that clear their arrears and pay cash in advance receive electricity at an economically efficient price. In June 1997, RAO UESR announced that, as of July 1997, it would accept cash payments only (eliminating barter, promissory notes and limited use of mutual settlements). Improvements have been gradual (as existing barter agreements had to be respected) but significant. Cash payments for RAO UESR transmission services have nearly doubled between June and September 1997. This enabled RAO UESR to fully pay its tax obligations for 1997, and become current with its salary payments to staff. The FEC has made public preliminary wholesale market agreements under FEC Protocol #104, dated August 29, 1997. These contractual agreements specify the duties and responsibilities of current participants in the competitive Wholesale Market, and were issued by the IFO in September, 1997. Direct agreements between energy producers and consumers have also been drafted and will be approved by the FEC by end-November, 1997. Two generation companies and four customers are currently operating in the Wholesale Market and expansion is actively being pursued. The FEC has submitted a letter to the Government, dated August 20, 1997, articulating the general principles for commercial licensing of participants in the wholesale power market. The Government has submitted a draft law on licensing to the Duma, *including amendments with regard to licensing* for activities in the wholesale power (capacity) market and services for its operations. When the law is approved, the Government will issue	accounts for generation and transmission (including dispatch) for regulatory *purposes. The Resolution will direct the* Federal Energy Commission: (i) by September 1, 1998, *to develop* pricing methodology and issue guidelines for the network services provided by AO Energos; (ii) by December 1, 1998, to develop pricing methodology and issue guidelines for transmission and dispatch services provided by RAO UESR. The same Resolution will require that each AO Energo will establish separate accounts for generation, transmission (lines used exclusively for transmission of bulk power) and distribution for regulatory purposes.	decreasing operating costs. By December 1, 1998, the Federal Energy Commission to develop pricing methodology and issue guidelines for *transmission and dispatch services* provided by RAO UESR. By December 31, 1998, the Government will complete the establishment of the National Energy Market (NEM), a non-commercial partnership involving all power plants, AO Energos and large industrial users operating in the federal wholesale power market.	guidelines to increase the role of the Uniform Dispatch Units in providing economic dispatch and settlements. By June 30, 1999, the Federal Energy Commission to develop regulatory guidelines *and access rules ensuring non-discriminatory* access to transmission and distribution services. By June 30, 1999, the Government will instruct its representatives on the Board of Directors of RAO UESR to seek adoption by RAO UESR of a plan for establishing a sufficient number of independent generation companies to enable effective competition. The plan will provide for these generation companies to be established as legal subsidiaries of RAO UESR, each with an initial comparable competitive position, by December 31, 1999.

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		a Resolution giving the FEC the exclusive right to issue licenses for activities in the wholesale power (capacity) market to participants in the power market. The Government has outlined general pricing principles and procedures for encouraging efficient production and usage of electric power, and these will continue to be refined and made more detailed. The Government passed Resolution No. 1231 on September 26, 1997 providing annual targets for the reduction of cross-subsidies in electricity consumption, ending with its elimination by mid-2000. The first steps have been taken this year resulting in price increases in most regions.			
III. Natural Gas Sector Program					
To promote efficiency in the natural gas industry, achieve greater transparency and accountability in the operations of Gazprom, and facilitate pipeline access for independent gas producers, including those who are currently flaring gas.		In accordance with Government Resolution #987, 1997, the Anti-Monopoly Committee has registered RAO Gazprom as an economic entity controlling more than 35% of its corresponding market pursuant to the law "On Competition and Restriction of Monopoly Activities in Commodity Markets". The Ministry of Fuel and Energy has established a group within the Ministry to review further structural changes necessary to improve the efficiency of natural gas supply. The Ministry of Economy has prepared a draft Discussion Paper (October 14, 1997) outlining general pricing principles and procedures to encourage efficient production and usage of natural gas. The draft principles also provide that, until a competitive market for gas production is introduced, wholesale gas prices will be regulated: (a) at the city gate, with tariffs of gas transmission set separately; or (b) as a combination of well-head prices and gas transmission prices, each set separately. The FEC has issued Resolution No. 119/6, dated	The Federal Energy Commission (Directive 12/5) has reduced cross-subsidization in natural gas (and the need for budget subsidies for gas consumed by households) by increasing the wholesale price of gas for household use (net of gas excise tax) to 76 percent of the industrial wholesale price. The Government has instructed (Government directive No. 952-r of July 16, 1998) the Board of State Representatives of RAO Gazprom to seek to reorganize, by December 31, 1998, the existing regional transmission operations of RAO Gazprom into a single transmission enterprise or a number of enterprises, based on major transmission corridors, such enterprise or enterprises to be in compliance with the Civil Code. A draft Law has been submitted to the Duma requiring to move gas excises to an accruals basis. By August 1, 1998, the Government will	RAO Gazprom will reorganize its regional transmission operations into a single integrated transmission enterprise or into a number of transmission enterprises solely being responsible for gas transmission services, established in compliance with the Civil Code and based on major transmission corridors. RAO Gazprom will establish separate management, separate accounts based on international accounting standards, and separate cost/profit responsibility for the new transmission enterprise or enterprises, the production enterprises, and its gas wholesaling enterprise or enterprises. The Government will establish a revised system of gas excise taxes which applies the production rent component of the tax at the level of monopoly producers, including producers which are part of the Gazprom system, Yakutskgazprom, Norilskgazprom, and Sakhalinmerneftegaz, without reducing Federal tax revenue. By August 31, 1998, the FEC will issue revised interim Regulations on state regulation of differentiated wholesale prices for natural gas. The Regulations will	By July 1, 1999, the Federal Energy Commission will introduce differentiated and separate prices for gas production, transmission, and supply (delivery) services fully reflective of a revised methodology agreed upon with the Bank. By July 31, 1999, the FEC will issue a resolution providing that prices charged to independent gas producers and gas delivery companies for the use of the transmission system of RAO Gazprom are equivalent to tariffs which are charged to Mezhregiongaz for the same services.

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		October 31, 1997 establishing the procedures for regulating wholesale gas prices. The Ministry of Fuel and Energy has initiated negotiations with the firm of consultants selected to carry out a World Bank-financed Gas Pricing Study starting November 4, 1997, which will assist the Government to define the detailed pricing methodology and procedures to be applied in setting gas prices at various levels in the gas supply chain. In August 1997 the Federal Energy Commission published temporary rules and procedures for setting differentiated wholesale prices for natural gas. FEC Resolution 110 of September 26, 1997, provides that, effective December 1, 1997, the regional wholesale natural gas price differential between the minimum and maximum price will be increased from the current level of 12 percent to at least 25 percent. In Resolution No. 858 of July 14, 1997, the Government adopted procedures for granting access by independent producers of gas to the pipelines of RAO Gazprom. In Resolution No. 1269 of September 30, 1997, the Government approved a regulation outlining the responsibilities and operating procedures for the Inter-Branch Commission which was formed under Resolution 858 to review issues related to access by independent producers.	issue a decision requiring Gazprom to operate the company's transmission, production and supply enterprises will operate as separate cost/profit centers with separate management teams and their own accounts based on international accounting and audit standards. The transmission enterprise(s) will only provide gas transmission services. By July 31, 1998, the Government will adopt a Resolution that provides for the elimination of state regulation of prices on gas sold by gas-producing organizations not affiliated with RAO Gazprom.	incorporate the principles that prices should: (i) ensure that supplying enterprises can recover prudently incurred costs of service from customers, including a reasonable return on capital; (ii) encourage efficient operations at all levels in the supply chain, and (iii) *incorporate the principle that tariffs should fully reflect* differences in costs of service among different customer classes and geographic regions. In order to lessen the shock of transition to full cost-reflective tariffs, it is expected that these prices would incorporate increased regional differentiation of wholesale prices. By August 31, 1998, the FEC will approve and make public a revised methodology for determining service tariffs (including local transportation tariffs) for gas distribution companies. The methodology (and subsequent recommendations) will be based on principles that prices should (i) ensure that distribution companies can recover prudently incurred costs of service from customers, including a reasonable return on capital; (ii) encourage efficient operations on the part of the distribution companies; and (iii) fully reflect differences in costs of service among different customer classes. The FEC, in cooperation with the RECs, will also make public, *for each distribution company*, both the calculated cost-based prices and the actual prices for each customer group (including the level of cross-subsidies). By September 30, 1998, the FEC will issue and make public recommendations for setting retail prices for different customer groups. By September 30, 1998 the Government will prepare, adopt and implement "Rules of Gas Supply" that address, inter alia, the rights and responsibilities of gas producers independent of RAO Gazprom and the rules of supply to household customers. By September 30, 1998, the Government will publish a review for public comment of the effectiveness of Resolution 858 (on providing access to the gas transmission networks by independent gas producers) in increasing the market share of independent gas	

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				producers. The review of the effectiveness of Resolution 858 (on providing access to the gas transmission networks by independent gas producers) in increasing the market share of independent gas producers, carried out by independent consultants, shall include (i) comparative statistical data with respect to growth over the preceding year in terms of market shares, deliveries, and new contracts for independent producers; (ii) a comparison of the prices paid to independent producers relative to the regulated city-gate prices; and, (iii) a survey of at least 10 independent producers, including both participants and non-participants, to obtain their assessments of the strengths and weaknesses of the program. Based on the review (and public comments thereon), the Government will, by October 31, 1998, adopt and implement a Resolution which will improve the effectiveness of the rules and procedures in promoting non-discriminatory access by independent producers and suppliers, and will extend the access rights to allow non-discriminatory access by foreign producers of gas to Russian markets. By November 1, 1998, the FEC will develop model contracts for transactions between gas delivery organizations and gas transmission companies for transportation services, issue a resolution directing that these contracts will apply to all transactions effective January 1, 1999, and work with the government to ensure the adoption of any necessary legislative basis for this resolution. By November 30, 1998, prices based on the new interim Regulations on state regulation of differentiated wholesale prices for natural gas will be announced, and applied effective January 1, 1999. By November 30, 1998, the Government will approve a methodology for setting separate prices for gas production, transmission and supply (delivery) services which will supersede the interim Regulations as a basis for determining wholesale gas prices. The methodology will reflect the pricing principles outlined above with	

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				respect to the interim Regulations. By December 31, 1998, introduce prices for the non-residential customers of gas distribution companies based on the revised methodology for determining service tariffs (including local transportation tariffs) for gas distribution companies and recommendations for setting retail prices for different customer groups. By December 31, 1998, the Government will establish a revised system for gas excise taxes which applies the production rent component of excise at the level of monopoly producers, without reducing Federal tax revenue. The production rent component would be: (i) applied at a uniform level to all volumes entering the main transmission network from the Gazprom system at each major access hub or, for other monopoly producers, at the wellhead; (ii) differentiated to reflect the weighted average production cost of gas at each of the major access hubs/wellheads; and (iii) remitted by gas wholesalers.	
			The FEC will continue the process of delegating the power to implement the regulation of gas distribution tariffs and gas prices for final consumers to the regional energy commissions (RECs), where such regulation follows pricing principles and procedures prepared by the FEC. The RECs to which authority will be delegated will have met the following criteria as set out by the FEC: (i) appropriate legal basis for implementing the regulations in question; (ii) adequate professional staffing; (iii) operational rules approved by the FEC; (iv) a chairperson approved by the FEC; and (v) an established panel of independent experts for advice and comment.		
IV. Oil Sector Program					
To improve the efficiency of oil transport through regulatory reform, ensuring equitable access to pipelines, and creating a favorable investment climate.		On July 8, 1997, President Yeltsin issued decree No. 694 "On Production Sharing Agreements (PSAs)" ensuring rights and benefits of the Russian Federation in implementing PSAs. In accordance with the Federal Law "On Sites of Natural Resources Deposits Entitled for Use under PSAs" there are seven sites that can be developed in accordance with PSAs. The sites include five oil and gas fields, one iron ore deposit and one gold mine. By December 1, 1997, the Government will submit to the Duma a draft Law on Expansion of PSAs to additional areas. The Government has begun to put into place a market-based (nondiscretionary and transparent) system for access to oil	In late 1997, the FEC published its initial views on the principles on the methodology for setting regulated crude oil transportation tariffs on Transneft's pipeline system. By July 31, 1998, the FEC will publish for comment its revised proposals on this methodology, incorporating principles which will (i) ensure that Transneft can recover prudently incurred costs of service from shippers, including a reasonable return on investment; (ii) encourage efficient operations, and (iii) be based on costs so that the tariffs should fully reflect differences in costs of service. Access by oil producers to the oil pipeline network now contingent on compliance	After taking into account the views of interested parties, the FEC will issue by September 15, 1998 a resolution which provides for revised crude oil transportation tariffs which will be applied effective January 1, 1999. The Government will submit to the Duma, with a view to enactment by November 30, 1998, the law "Introduction of Changes and Additions to Legislative Acts of the Russian Federation ensuing from the Federal Law On Production Sharing Agreements" together with other related enabling legislation. This related legislation will incorporate provisions directed at: (i) preventing any undue restriction on the eligibility of oil developed under PSA arrangements; (ii) constraining excessive limitation on access to international goods and services, technology, and professional experience; and (iii) avoiding penalization of any group of investors.	Revised crude oil transportation tariffs will be applied effective January 1, 1999. The Government will submit a draft oil pipeline law to the Duma with a view to enactment by April 30, 1999. This comprehensive law will include, inter alia, provisions for non-discriminatory access and tariffs, and limitations on integration of ownership of assets in oil trunk transmission with ownership of assets in other oil sector activities. It will be enacted prior to the Government proceeding with the privatization of Transneft's core business assets. New oil pipeline legislation has been adopted and entered into force.

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		transportation capacity in the Novorossiisk and other constrained pipelines. A new regime has been implemented through Presidential Decree No. # 693 of July 8, 1997 and Government Resolution # 1130, issued on September 2, 1997, in which access is allocated in proportion to total production. This regime will be effective throughout 1998. However, oil producers will have the right to trade access rights. All resolutions and directives covering programs of export of oil and oil products for State needs were eliminated on March 16, 1997, except for those under Government Resolutions #579 of May 14, 1996, #208 of February 28, 1996, and #736 of June 24, 1996. Under Presidential Decree 693 of July 8 and Government Resolution #988 of August 7, the government abolished these oil export programs effective October 1, 1997.	with agreements to clear outstanding tax arrears (see Fiscal Management reforms).	By November 30, 1998, the Ministry of Fuel and Energy will have signed a contract with an independent, reputable, experienced consulting firm selected after an international competition to conduct and publish a comprehensive operational audit of Transneft to assist the company in improving its operational efficiency. The proposed Law on the Introduction of Changes and Additions to Legislative Acts of the Russian Federation ensuing from the Federal Law On Production Sharing Agreements and the implementation of regulations relating to the Law On Production Sharing Agreements have been enacted and entered into force.	
V. Railways Sector Program					
To improve efficiency within the railway system, ensure reasonable tariffs, and create the basis for privatization of certain services.		In the April 28, 1997 Presidential Decree No. 426, the Government took actions to set forth the main thrust of structural reform in the railway sector. The decree set forth a staged plan of restructuring over a three year period. With respect to improving the railway's competitive market structure, the following measures were included on the agenda for 1997: (a) to introduce a new procedure of Government regulation of freight tariffs that would take into account patterns and volume of traffic, increases in labor productivity, restructuring and cost-cutting measures, etc.; (b) to phase-out cross-subsidization of passenger losses by freight customers and provide compensation for passenger losses in Federal and local budgets as appropriate; (c) to lower freight tariffs; (d) to separate unused facilities and divest these and other ancillary activities; (e) to create conditions for the development of competition in the rail services	The Government approved (Government Resolution No. 448 dated May 15, 1998) a Concept for Structural Reform of Federal Railway Transport which broadly outlines plans for separating passenger and freight services and identifies major assets to be allocated to each business. The Government has agreed to develop proposals on budget subsidization of railway passenger traffic. It was also agreed that the remaining federal privileges on the fares of individual passenger categories are to be financed from the federal budget. In the 1998 budget, a sum of Rb 450 million is included for Federal compensation of intercity passenger losses. For most products, preferential tariffs expired on December 31, 1997. MPS has drafted regulations providing for	By September 1, 1998, separate cost accounting will be introduced and separate income statements and balance sheets prepared for long distance passenger traffic, commuter rail traffic and freight traffic within MPS. By September 1, 1998, the Government will develop and begin to implement a schedule for the privatization of companies engaged in rolling stock rehabilitation and manufacturing of spare parts and other railway-related items, as well as general construction companies. By September 30, 1998, the Government will issue a Resolution conferring on regional railway administrations the sole right, effective January 1, 1999, to fix tariffs for commuter rail services. The Resolution will also stipulate that, in cases where the concerned municipalities desire lower tariffs than those representing full cost recovery, they will pay at least 50 % of the resulting operating losses. By October 1, 1998, the Government will prepare a	By June 30, 1999, rail freight tariffs will be determined uniformly on a cost-basis for all commodities.

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		market that would provide equal access to rail infrastructure and repair facilities to different owners of rolling stock; and (f) to complete the establishment of the Federal Service to Regulate Natural Monopolies in Transport (FSNMT). The head of the FSNMT was appointed. On September 30, 1997, the Government issued a resolution reducing average rates for freight (total revenues divided by ton-kilometers) by 5 percent compared to rates effective in September 1, 1997. Several other freight rate reductions were introduced as of July 1, 1997 including (a) reductions on specific commodities at specific rates, as set forth in a June 13, 1997 minutes of a meeting held by First Deputy Prime Minister Nemtsov with Deputy Ministers of MOE, MOF and MPS; and, (b) on new traffic (against previous year totals for individual shippers) provided the increase is of certain volume (3000 tons), and on existing traffic to shippers relative to the time of downpayment. To enhance transparency regarding the provision of preferential tariffs and to clarify the framework under which regional railways can offer discounts to shippers, and in compliance with clause 4 of Government Resolution #410 of April 8, 1997, the FSNMT issued regulations and methodologies governing railway tariffs, including discounts and preferential tariffs. The Government is establishing general pricing principles and procedures that will help to encourage efficient provision and usage of railway services. In compliance with Government Resolution #410 of April 8, 1997, an order dated May 14, 1997 was jointly issued by the Ministry of Railways and Ministry of Economy that outlines a methodology for	elimination of most of the remaining preferential tariffs. FSNMT adopted (Directive 12/1 of April 14, 1998) regulations limiting freight railway tariff adjustments to increases in the industrial producer price index less 3 percentage points on an annualized basis throughout the year. Government Resolution No. 338 of March 21, 1998 approves a list of railway transport ancillary services for divestiture. A list of social assets has been approved by MPS Letter No. K-4687 of May 20, 1998. Government Directives Nos. 424 and 425 transfer some social assets to municipalities. By July 30, 1998, MPS will provide the Government with the book value and current railway ownership of assets identified in the list it submitted to the Government on April 30, 1998, together with a timetable for their divestiture.	feasibility study for establishing long- and short-haul passenger service companies. By November 30, 1998, MPS will submit a report to the Government listing: (i) the social and ancillary assets, together with their book value and current owners, remaining on the books of railways which also could be divested if recipients agreed to accept the financial responsibility for their operations; (ii) the social and ancillary assets, together with their book values and current owners, that MPS has determined should not be divested within the next five years, together with a rationale for this determination. By December 1, 1998, the first two long- and short-haul passenger service companies shall be established. By December 31, 1998, rail freight tariffs will be adjusted to eliminate any discrimination between domestic and export rates. By December 31, 1998, MPS will provide the Government with an action plan for divesting the social and ancillary assets listed included in the April 30, 1998 list and a timetable for divesting the assets remaining on the books of railways which also could be divested if recipients agreed to accept the financial responsibility for their operations.	

REFORM OF INFRASTRUCTURE MONOPOLIES					
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		regulating railway freight tariffs. Resolution #410 also ordered that changes in railway tariffs and fee rates shall not exceed the index of wholesale prices for industrial goods producers across the Russian Federation in the respective period. This measure is evidence that the Government is coming to grips with the problem that rail rates have risen faster than inflation. However, in order to ensure that the effects of this measure are long-lasting, future indexation should not be automatic as it has in the past since there is agreement that freight rates can be further reduced. As it may be difficult to evaluate, on a timely basis, submissions by MPS of cost data justifying tariff increases, a simpler approach under consideration is to permit automatic indexing of freight rates to the wholesale industrial price index and promote additional reductions on the overall levels. Specifically, the FSNMT is considering limiting the overall increase of average freight rates in 1998 to the wholesale price index minus 3 percentage points, to be measured on a quarterly basis, i.e. 0.75% per quarter. The present pricing methodology mentions the need to take into account railway restructuring plans and cost-reduction measures, but does not explicitly tie the railways to any specific restructuring plan. In the longer term, it is anticipated that the railways will restructure in a way that would make the industry more competitive and commercial. Thus, in time, it is hoped tariff regulation of freight traffic would be based more on an exception basis, where there is little competition or a clear possibility for abuse of monopoly power. In the meantime, however, as passenger losses are shifted to the budget, manufacturing and social assets divested and other cost-cutting measure introduced, it is anticipated that there should be additional decreases in the minimum freight			

REFORM OF INFRASTRUCTURE MONOPOLIES					
Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
		tariff rates. Cross-subsidies of passenger losses through freight rates are being phased out by a combination of measures including: raising passenger fares; devolving suburban services to municipal and regional Governments and ensuring that losses on these services are compensated through budgets of subjects of the Federation as appropriate; by separating passenger from freight services and taking measures to cut costs where appropriate; by compensating intercity passenger losses through the Federal budget and/or eliminating remaining federal privileges on the fares of individual passenger categories. On September 15, 1997 the Government issued Resolution No. 389, which, effective that day, increased intercity passenger rates by 10 percent; destinations to the Baltics and CIS countries were increased 65%.			

PRIVATE SECTOR DEVELOPMENT					
Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
I. Privatization					
To increase the efficiency in the use of assets employed in firms and stimulate investment so as to resume economic growth and create jobs, and to engender revenues for the state budget.			On July 20, 1998, a special Policy Statement was issued by the Chairman of the Government of the Russian Federation, which will be published widely in the international media, that states the Government's commitment to expand and accelerate significantly the process of transparent and competitive privatization of Russian enterprises in the process of implementing the 1998-99 privatization program. This will be accomplished through case-by-case privatization of the largest enterprises in accordance with Government Resolutions 363 and 564 of 1997, and through (i) the significant reduction in the number of firms currently denoted as "strategic" and (ii) their privatization.		
a. Privatization of Large Enterprises	On April 1 and May 12, 1997, the Government issued Resolutions No. 363 ("On the Procedure Governing the Implementation of Case-by-Case Privatization Projects") and No. 564 ("On the Introduction of Changes in Resolution No. 363 of the Government of the Russian Federation Dated April 1, 1997 'On the Procedure Governing the Implementation of Case-by-Case Privatization Projects' "), respectively, specifying rules and implementation procedures for case-by-case privatization requiring them to be fully open and competitive (including through equal and open access to domestic and foreign buyers), and using openly and competitively selected, internationally reputable financial advisors. The privatizations are to be	The Ministry for State Property (MSP, formerly GKI) announced a change in the composition of the firms to participate in the 4-firm pilot Case by Case Privatization Program, as identified in earlier Government Resolutions Nos. 363 and 564, and GKI Directive No. 356-r due to the fact that (i) Domodedovo Production Association for Civil Aviation is to be split into three entities and (ii) Pulkovo Airlines and Rosgosstrakh are no longer under consideration to be included in the CBC program (at least not in 1997). On July 31, 1997, GKI Directive 670-R specified that the 4 participant firms are: Domodedovo Aeroservice, Domodedovo Airlines, Kama Pulp and Paper, and Russkii Dizel. The above changes, in part, contributed to the inability to meet the June 30, 1997 program date for inviting financial advisors to submit bids to assist with the privatization of the four firms and the August 31, 1997 deadline for the tender committees to issue tenders. Following consultation with the World Bank, which is supporting (through the PIAL loan) the technical assistance for completing 3 of the 4 pilot transactions, MSP issued in correspondence dated October 10, 13, and 22, 1997, a timeline that specifies the complete timetable of actions to be taken	Financial Advisors' pre-sale preparation work for Kama Pulp and Paper and Russkii Dizel underway, but experiencing delays. Tenders expected early autumn 1998. Government suspended privatization of Domodedovo Airlines and Domodedovo Aeroservice due to regional authorities' objections. The 1998 program will expand and accelerate the process of transparent and competitive Case-by-Case privatization. On July 7, 1998 the Ministry of State Property issued an ordinance establishing a list of 15 enterprises that are part of the draft State Privatization Program and are to be privatized according to the case-by-case procedures specified in Government Resolutions 363 and 564 of 1997. The ordinance will establish a schedule for privatizing these enterprises such that they will be offered for sale not later than December 31, 1998, if such dates are determined on advice of independent financial advisors as most desirable based	Beginning July 31, 1998, the following ten tenders will be offered on international markets before December 31, 1998, if such dates are determined on advice of independent financial advisors as most desirable based on market conditions: Rosneft, Sviazinvest, SIBUR, LUKOil, Cheliabinskinform, Electrosviaz (Moscow Oblast), Novosibirsk Electrode Plant, Slavneft, NORSI-Oil, RAO UESR. By August 31, 1998, the Ministry of State Property and the Russian Federal Property Fund will hold competitive bids and select 9 to 11 independent financial advisors from among experienced, reputable international investment institutions. The independent financial advisors will be engaged to (i) carry out pre-sale preparation of the largest Russian enterprises, including but not limited to those denoted in the draft Privatization Program, and (ii) place shares of these enterprises on world markets in accordance with Government Resolutions 363 and 564 of 1997. These advisors will, among other things: audit and appraise the enterprises; suggest the likely market price of the transaction; recommend any required organizational/managerial restructuring prior to	By the end of each quarter following July 31, 1998—i.e., September 30, 1998, December 31, 1998, March 30, 1999, June 30, 1999, September 30, 1999, and December 31, 1999—at least 7 firms listed on the draft Privatization Program issued by the Government on April 21, 1998 shall be brought to point of sale within the subsequent six months, if such dates are determined on advice of independent financial advisors as most desirable based on market conditions.

PRIVATE SECTOR DEVELOPMENT					
Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
	widely advertised domestically and internationally. Enterprises will be valued at market prices or, if they are not traded, based on standard business valuation procedures. Financial advisors will be reputable, and valuation will be done based on international standards. For the initial 4-firm pilot program, to be completed in 1997, on May 15, 1997, the Government selected four companies from the following list of 10 enterprises for case-by-case privatization in 1997 under the principles established by Government Resolutions No. 363 and No. 564: Tyrnauz Tungsten-Molybdenum Kombinat (Kabardino- Balkar Oblast), Domodedovo Production Association for Civil Aviation (Moscow Oblast), Taganrog Sea Trade Port (Rostov Oblast), Kamsk Pulp and Paper Kombinat (Perm Oblast), Mosfilm (Moscow), Lumber Factory No. 21 (Vologda Oblast), Troitsk Iodine Plant (Orenburg Oblast), Pulkovo Airlines (Leningrad Oblast), State Enterprise Russkii Dizel (St. Petersburg), Rosgosstrakh (Moscow). These four enterprises are: Domodedovo Production Association for Civil Aviation, Kamsk Pulp and Paper Kombinat, Pulkovo Airlines, and Rosgosstrakh. Three enterprises have been selected as possible substitutes if the implementation of case-	for all 4 firms. For the 3 transactions receiving financial support from the World Bank, the key points of this timetable are: (i) "Bidding Package" (Letter of Invitation + Terms of Reference + Standard Contract) to be sent to short-listed Financial Advisors (FAs) by the following dates: Kama Pulp and Paper: August 22, 1997, Domodedovo Airlines: August 28, 1997, and Russkii Dizel: October 24, 1997; (ii) Negotiations to commence with the selected FAs by the following dates: Kama Pulp and Paper: October 23, 1997 and Domodedovo Airlines: October 22, 1997 and Russkii Dizel: January 5, 1998 (iii) Contracts to be signed with the selected FAs by the following dates: Kama Pulp and Paper: November 14, 1997, Domodedovo Airlines: November 6, 1997; and Russkii Dizel by January 26, 1998. The Government is committed to implementing future privatizations on the basis of a common framework of principles and procedures that ensures transparency, openness and competition. The methods for carrying out future privatizations shall be "commercial competitive bidding", and "auctions" or "specialized auctions" as defined in law, including "On Privatizing State Property and on the Principles of Privatizing Municipal Property in the Russian Federation" adopted by the State Duma on 24th June, 1997 (the Privatization Law). In accordance with the relevant laws, bidding procedures will encourage all interested parties to participate; privatizations will be widely advertised, including internationally where this could attract additional qualified buyers; when employed, financial advisers will be reputable, and engaged through a transparent, competitive process; conflicts of interest will be avoided; and bid evaluations will be carried out objectively. In accordance with the Privatization Law, in August, 1997 the Government submitted to the State Duma the "State Program of Privatization in the Russian Federation" (State Privatization Program), which identifies two lists: (i) 37 state enterprises held in federal property and subject to reorganization into open joint stock companies and privatization beginning in 1998; and (ii) 29 open joint stock companies whose federally held shares are subject to	on market conditions. The percentage of equity offered will be determined in consultation with independent financial advisors. These enterprises are: 1. OAO Orenburg Oil JSC (Orenburg oblast); 2. OAO "Kovrovo Electric Machine Plant" (Vladimir oblast); 3. OAO Western-Siberian Iron & Steel Factory (Kemerovo Oblast); 4. OAO "Stupino Iron & Steel Factory" (Nizhni Novgorod Oblast); 5. OAO "Nizhni Novgorod Machine Building Plant"; 6. OAO "Oil & Gas Co. "Slavneft" (Moscow); 7. Rybinsk Instrumentation Factory (Yaroslavl Oblast); 8. Kemerovo Mechanical Plant (Kemerovo Oblast); 9. Kamensk Chemical Factory (Rostov Oblast); 10. Factory "Krasny gigant" (Penza Oblast); 11. PO (Prod. Association) "Avangard" (Ufa); 12. GPO "ZiM named after Maslennikov (Samara Oblast); 13. Plant "Kommunar"; 14. NPO "Geofizika" (Moscow); 15. Vysokogorsky Mechanical Works (Sverdlovsk Oblast).	sale; work out the optimal privatization scheme, including the percentage of equity to be offered; and ensure that bids will be welcomed from all physical and legal persons and foreign investors eligible under Russian law. By the end of each quarter following July 31, 1998—i.e., September 30, 1998, December 31, 1998, March 30, 1999, June 30, 1999, September 30, 1999, and December 31, 1999—at least 7 firms listed on the draft Privatization Program issued by the Government on April 21, 1998 shall be brought to point of sale within the subsequent six months, if such dates are determined on advice of independent financial advisors as most desirable based on market conditions.	

PRIVATE SECTOR DEVELOPMENT					
Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
	by-case privatization of any of the four above enterprises prove impossible because of insurmountable legal or technical difficulties that constitute a case of force majeure. These are: Mosfilm, Russkii Dizel, and Taganrog Sea Trade Port. (GKI Directive 356-r.) On April 24, 1997, the Government appointed tender committees for these privatizations (GKI Directive 317-r).	sale beginning in 1998. Not counting the four pilot case-by-case transactions initiated in 1997, at least a quarter of the enterprises which are on the lists (i) and (ii) above, and which will experience continuation of privatization measures initiated in 1997 or initiation of such measures in 1998, will be privatized through "case-by-case" transactions as defined by Government Resolutions 363 and 564-R of 1997 (involving in particular the engagement of financial advisers as early as possible in the process), and building on any experience from the four pilots. The Government will take all reasonable steps to ensure State Duma deliberation on the State Privatization Program, and to facilitate its passage. Should the State Duma not approve the legislation in a timely fashion, the Government will take all necessary and feasible steps in conformity with the legislation in force to enable the privatizations referred to in (i) and (ii) above to proceed in 1998-99 in accordance with the approaches defined above. Government Resolution # 989 (issued August 7, 1997) on the "Procedure for Transferring Federally Owned Shares of Joint Stock Companies Created in the Course of Privatization to Trust Managers and Concluding Trust Management Agreements Regarding those Shares" met many, but not all, of the criteria set out under the program for implementing market-based guidelines for trust management arrangements, including the competitive selection of trust managers. MSP will issue a directive by November 30, 1997 that contains detailed implementing regulations that specify: (a) a trust management contract has the objective of improving the financial operation of enterprises and to prepare them for privatization following the expiration of the contract; (b) contracts are to specify performance based compensation linked to financial results; (c) compensation is to be paid through the term of the contract, not a lump-sum paid at the contract's expiration. It is noted, that according to Article 1015 of the Second Part of the Civil Code, property shall not be subject to transfer under trust management to a state agency or a local self-government body. An individual entrepreneur or a for-profit organization except for a unitary enterprise may act as a trust			

PRIVATE SECTOR DEVELOPMENT					
Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
		manager. In accordance with Government Resolution 989, evaluation of contract bids is to be carried out using methods that are consistent with international standards of competition, neutrality and equity.			
b. Reduction of Lists of "Strategic" Firms			Government Resolution No. 784 of July 17, 1998 reduced from 3,000 to 697 the number of firms included in the list of "strategic" enterprises under Government Resolution No. 949 of September 18, 1995 barred from any privatization to either domestic or foreign investors. The Resolution specifies that the enterprises removed from the "strategic" list will be subject to transparent and competitive privatization processes, beginning September 30, 1998 to December 31, 2000. For the enterprises removed from the "strategic" list, in accordance with market conditions as assessed by independent financial advisors, at least 40 percent will be brought to the point of sale by December 31, 1999, and 100 percent will be brought to the point of sale by December 31, 2000.	By October 31, 1998 the Government will adopt selection criteria as to which of the existing 6,500 agro-industrial enterprises will remain under exclusive federal ownership until the year 2000. Based on these criteria, by November 30, 1998, the Government will issue a Resolution specifying the list of agro-industry enterprises that will remain under federal ownership until 2000. The list will specify the name, legal address, core activity, and institutional and legal status of the enterprise. For the enterprises removed from the "strategic" list, in accordance with market conditions as assessed by independent financial advisors, at least 10 percent will be brought to the point of sale by December 31, 1998.	For the enterprises removed from the "strategic" list, in accordance with market conditions as assessed by independent financial advisors, at least 15 percent will be brought to the point of sale by March 31, 1999, and at least 25 percent will be brought to the point of sale by June 30, 1999. For the enterprises removed from the "strategic" list, in accordance with market conditions as assessed by independent financial advisors, at least 30 percent will be brought to the point of sale by September 30, 1999.
					Starting from January 1, 1999, the Government will, market conditions permitting, bring to the point of sale by December 31, 1999, at least 10 percent of the enterprises not included on the list of agro-industry enterprises that will remain under federal ownership until 2000. Subsequent sales will be announced in the future. The privatization process shall be according to the rules governing competitive cash auctions, without distributing majority shareholding to suppliers of raw materials under preferential terms.
II. Bankruptcy					
To make the bankruptcy process more efficient.	The Federal Service on Insolvency and Financial Rehabilitation, based on an assessment of completed bankruptcy cases to date, developed and made public recommendations to increase the speed and effectiveness of the bankruptcy process.	The Government sent a draft bankruptcy law to the Duma. Relative to current law, the new draft provides for: (i) an increased role for creditor committees in the resolution of insolvency cases; (ii) more expeditious appointment on a competitive basis of licensed trustees with authority to replace incumbent enterprise managers; (iii) differentiation of classes of creditors; and (iv) stricter observance of time limits for workout and liquidation proceedings by all parties.	The new Bankruptcy Law became effective in March 1998.	The government will implement measures to eliminate the bias in the new bankruptcy law towards reorganization rather than liquidation of enterprises. By September 30, 1998, the Government will submit to the Duma, with the view to enactment by December 31, 1998, amendments to (i) the Bankruptcy Law that eliminate court discretion in overruling the creditors' decision to liquidate the debtor enterprise and (ii) amendments to the Civil Code to	

PRIVATE SECTOR DEVELOPMENT					
Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
				strengthen the rights of secured creditors. By December 31, 1998, the government will take all necessary steps tc implement the new laws on enforcement of court judgements, including by fully staffing the court officers' corps.	
			In addition to the actions aimed at improving the bankruptcy legislative framework, the restructuring process in the Russian economy could be expedited by implementing pilot projects targeted towards bankruptcy of insolvent enterprises in cases that are especially difficult in such a way that minimizes possible negative social consequences of bankruptcy. For such purposes, and taking into account the basic provisions of the new Bankruptcy Law, the Government of the Russian Federation will approve, by adopting appropriate directives, a procedure for implementing and financing bankruptcy pilot projects involving insolvent enterprises. In compliance with the above mentioned procedure as well as in accordance with the goals outlined in the first sentence of the current paragraph, the Federal Service on Bankruptcy Matters and Financial Rehabilitation, shall implement in 1998 at least 4 bankruptcy pilots embracing large enterprises that experience serious financial difficulties and have bad market prospects. The results of the pilots implemented will be widely reflected in a report of the Federal Service of Russia for Bankruptcy Matters and Financial Rehabilitation to (i) provide arbitrators with data on the relevant procedures; and (ii) provide creditors and other persons concerned with the most detailed information about the mechanisms and advantages of hearing bankruptcy cases in the court.		
III. Competition Policy					
Strengthening the government's capacity to intervene to promote competition.			In order to foster resolution of business disputes, new measures shall be implemented by July 31, 1998 that strengthen and enlarge the bailiff service so as to provide for more effective enforcement compliance, including criminal sanctions, by losing defendants in arbitrazh court cases.	The proposed Law on Licensing will be adopted and enter into force. By September 30, 1998, the Government will implement measures to strengthen the mission of the Antimonopoly Committee, both at the Federal and sub-federal levels, with a view towards introducing a more effective rules-based competition policy institutional regime in the Russian Federation, ensuring that territorial branches exist in each region. Through such measures and in the 1999 budget, the Antimonopoly Committee shall be given adequate financial and human resources commensurate with its revitalized mission. By September 30, 1998, the State Antimonopoly Committee, in collaboration with other federal organs, will implement new measures to remove administrative and policy-induced barriers at Federal and sub-Federal levels to the free movement of goods and services throughout the Russian Federation. The measures will include stronger enforcement penalties than presently exist.	

PRIVATE SECTOR DEVELOPMENT					
Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
				By November 30, 1998 the Antimonopoly Committee will issue for public comment explicit and well-defined merger guidelines that establish general policy parameters for distinguishing between pro-competitive and anti-competitive mergers based on similar guidelines consistent with international practice. Following public comment, these new merger guidelines shall be published widely by December 31, 1998. To introduce at the Federal and sub-federal levels new rules-based, streamlined business licensing procedures and fee structures, the Government will seek passage of the Law on Licensing by December 31, 1998.	
			The mission of the Antimonopoly Committee should have as principal objectives the creation of a unified economic space throughout the Russian Federation and preventing restrictive business practices, in particular anti-competitive mergers and acquisitions. The Antimonopoly Committee will develop and implement policy measures that deal with reducing anti-competitive horizontal and vertical concentration and integration in key product and geographic manufacturing and infrastructure monopoly markets, including industrial and financial groups (FIGs) and the petroleum sector.		
IV. Corporate Governance and Investor Rights					
Clearly signal the government's determination to protect investors.			By July 1, 1998, a Presidential Decree will be issued that implements measures to protect depositors' rights, including measures towards liquidation (bankruptcy) of non-licensed companies, sale of such companies' assets, and paying compensation to victimized investors. Government Resolution No. 785 of July 17, 1998 adopted and initiated implementation of the State Program of Protection of Investors' Rights, which spells out key tasks and measures to be undertaken in 1998 and 1999. The Government will also ensure that the Federal Securities Commission (FSC) will be provided sufficient resources to enforce investors' rights. This will be achieved by assigning a share of fee revenue from licensing of securities' market participants to the FSC.	An amendment to the Joint Stock Company law will be adopted and enter into force providing for adequate protection of minority shareholders. By September 1, 1998, the FSC of Russia will adopt and implement a Resolution on the procedure governing compilation and submission by issuers of securities of quarterly reports, with a special focus on information disclosure by enterprises quoted on public exchanges. By October 31, 1998 the Government will publish procedures consistent with Decree No. 395 and Decree No. 392 for restructuring the debts of agricultural enterprises. By December 31, 1998, the Government will implement the above mentioned procedures. In any new legal enactments regarding the establishment of joint stock companies in the agricultural sector and the legal status of such companies, the Government will affirm and protect the right of members of the joint stock company to invest the use right of land in the charter capital of the enterprise while retaining ownership of the land.	

PRIVATE SECTOR DEVELOPMENT					
Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
				The Government will submit to the Duma, with a view to enactment by December 31, 1998, legislation that amends the Federal Law "On Joint-Stock Companies" stipulating, in particular, protection of minority shareholders' rights, including protection from transfer of assets to parent (affiliate) companies, by enhancing the penalties for violating investors' rights.	
V. Fostering Labor Mobility					
				By November 1, 1998, the Government will submit to the Duma a new Labor Code which will bring the labor laws in compliance with the requirements of a market economy. The Code will establish a realistic and feasible minimum of social guarantees, enhance the role of individual labor agreements, including a more simplified procedure for dissolving individual labor agreements (such as excluding the need for consent of trade unions and finding alternative employment), and expand the ability to enter into fixed term and multiple-work contracts. The Code will also contain provisions ensuring that social partnership be targeted at forming and implementing collective agreements at the level of individual enterprises, as well as ensure the establishment of efficient institutions ensuring implementation of individual and collective agreements, settlement of collective disputes and compliance with the requirements of the labor legislation.	
VI. Land/Real Estate					
To further develop the legal and institutional framework for full private ownership and development of land and real estate.	Presidential Decree No. 485 "On Guarantees to Owners of Real Estate to Buy Land on Which These Assets Are Located" was issued on May 16, 1997 to establish the necessary legislative framework to enable all owners of privatized non-land real estate assets (including production complexes, buildings, and unfinished construction) to acquire the land on which these assets are located. For all future	Under the program, by June 30, 1997 a presidential decree was to be issued to cover four main goals to foster land/real estate transactions: (i) create a legal framework requiring that the sale of all premises belonging to the federal Government which are currently under lease to commercial entities be carried out at market rates; (ii) eliminate all existing restrictions on the market sale of such real estate; (iii) all future leases of the federal owned property will be at market prices; and (iv) recommend that all the procedures outlined in the decree be followed by regional and local Governments. A presidential decree was not issued; a new privatization law was passed by the Duma in June 1997. An analysis was performed by MSP that assesses the nature of the	In December 1997, model municipal regulations and procedures were prepared for the sale of unoccupied and/or undeveloped land through auctions and competitive tenders.	By August 30, 1998 the Government will approve the Federal Program on Development of Land Reform in the Russian Federation in 1998-2001 and ensure that by September 30, 1998 a Presidential Decree is issued to enact the above Program. The Program shall include an affirmation of the rights of citizens of the Russian Federation to engage in transactions in land, including purchase. sale, rental, and mortgage, and shall specify a program of actions to facilitate transactions. The reform strategy outlined in the Program will focus on pragmatic and readily implementable steps on clarifying rights in land, transferring commercially valuable land from municipal and state ownership to either private	By March 30, 1999, a Government Resolution shall be approved specifying detailed procedures for the registry offices' functioning. The proposed Laws on State and Municipal Land, on the State Land Cadastre, on the Appraisal of Land, and on Land Management will be adopted and enter into force.

PRIVATE SECTOR DEVELOPMENT					
Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
	privatization of such assets, the associated land plots will be included in the transaction package.	gaps between the earlier agreed objectives and the privatization law. The analysis indicates that many of the above-mentioned objectives are covered. Presidential Decree No. 1263 was issued on November 26, 1997, which establishes a legal framework for market-based sales of undeveloped land and/or land not currently in use (including nonagricultural land bordering city limits) to be used for commercial development, including through auctions and competitive tenders.		ownership or long term (49 years) lease, and simplifying the procedures by which transactions with land can take place. The Federal Program on Development of Land Reform should be supported by an action plan for implementation thereof to be approved by October 30, 1998. At the same time the Government will encourage implementation of Presidential Decree "On Exercising Individuals' Constitutional Rights to Land" No. 337 of March 7, 1996 with a view to facilitate entering into agreements for the use of land shares by all users of agricultural land. The Government will submit to the Duma, with a view to enactment by December 31, 1998, legislation that includes the draft Federal Laws "On State and Municipal Land," "On the State Land Cadastre," "On Appraisal of Land," and "On Land Management". Such laws will be aimed at further liberalization of the land market. The Federal Law on Cadastre will provide for establishment of the basic cadastre, that is information on parcel existence, location, and approximate boundaries, and allow for establishment of additional layers of cadastral information by agencies responsible for such work. By December 31, 1998, the Government will adopt and start implementing a Resolution to establish the program for the phased introduction of the uniform system of state registration in accordance with the Federal Law "On State Registration of Rights and Transactions in Real Estate" and Government Resolution No. 1378 of November 1, 1997, which implements the law. Such Resolution shall clarify the steps that will be taken to have functioning registration offices established at the rayon level, the specific nature of inter-agency cooperation required, and the sources of financing for implementing this plan.	
VII. Accounting and Auditing					
To achieve substantial progress in implementing					

PRIVATE SECTOR DEVELOPMENT					
Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
financial accounting and auditing standards and practices in line with international principles.					
a. Accounting		The Government approved an Action Program to introduce generally accepted accounting principles consistent with International Accounting Standards (IAS). The Action Program: (i) identifies any necessary amendments to laws or other normative acts to facilitate the use of IAS by Russian issuers in disclosure of financial information; (ii) requires the MOF to approve regulations by October 31, 1997 mandating IAS-consistent disclosure by January 1998 of financial information to investors by Russian enterprises which have a significant secondary market in their securities or which propose to offer their securities to the public, and to require the same for all other enterprises by January 1999; and (iii) outlines a strategy and timetable for adaptation of the entire accounting system for enterprises to bring it into conformity with international practices. This strategy and timetable will include: steps for transition to a revised chart of accounts; a plan for training of accounting personnel; further improvement of the process of certification of professional accountants and auditors; and an approach to developing accounting and audit practices such that any authorized system using accounting information will not preclude IAS-consistent financial accounting information. With respect to (ii), the MOF issued the regulations on October 14, 1997.		By September 30, 1998, the Government will (i) revise the rules for forming financial statements of commercial organizations and consolidated financial statements for groups of organizations in compliance with IAS; (ii) prepare standard recommendations on the organization of accounting for small business entities in compliance with IAS; and (iii) develop Standards of professional ethics of accountants in compliance with international practice. By December 31, 1998, under the guidance of the Interagency Commission for Accounting and Reporting Reform, the Ministry of Finance will develop the first 10 accounting rules (standards) fully consistent with international requirements (IAS); and will ensure that such rules are made effective as of January 1, 1999. By December 31, 1998, the Government will develop new Charts of Accounts in compliance with IAS for commercial entities. budgetary organizations, professional participants of the securities market and investment funds; will revise the source accounting documentation with account taken of the requirements of the market economy and international financial reporting standards.	The Ministry of Finance will will ensure that the first 10 accounting rules (standards) fully consistent with international requirements (IAS) are made effective as of January 1, 1999.
			With regard to accounting reform, the Government will ensure the implementation to January 1999 of the measures specified in the Action Plan of the Accounting Reform Program based on International Accounting Standards (IAS), approved by Government Resolution No 283, to develop national accounting standards consistent with IAS and to support the establishment of the self-regulating independent accounting professional body.		
b. Auditing		A parallel set of activities to those listed above regarding the introduction of financial accounts based on international standards was initiated to introduce independent audits of such accounts in enterprises. In particular, the Government approved and published for public comment an Action Program to require, no later than June 1999, independent audits of the		By November 30, 1998, the Government will finalize the draft law "On Auditing in the Russian Federation" and submit it to the State Duma, with a view to enactment by March 31, 1999. The draft law "On Auditing in the Russian Federation" shall provide for the gradual transition of auditing regulation powers from Federal bodies to the self-	By May 31, 1999, an additional eleven auditing standards based on ISA will be adopted by the Government. The Law on Auditing will be adopted and enter into force providing for gradual transition of regulatory powers relating to auditing from the

PRIVATE SECTOR DEVELOPMENT					
Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
		financial accounts of enterprises.		regulating independent auditing profession. In accordance with the 1998-1999 Program of auditing the accounts (financial statements) of economic entities using auditing standards based on international practice, the Government will ensure implementation of measures to arrange the auditing activities in the Russian Federation in compliance with the existing regulatory framework and national auditing regulations (standards) which are being developed on the basis of the International Standards on Auditing (ISA). By December 31, 1998 the Government will adopt 22 audit standards (inclusive of those adopted earlier) in compliance with ISA.	Federal bodies to a self-regulating independent auditing profession, and regulations have been issued defining thirty three auditing standards in accordance with international standards for accounting.
VIII. Liberalizing the International Trade and Foreign Direct Investment Regimes					
To send a clear signal to foreign investors of the government's intentions to ensure they receive fair treatment and to harmonize production certification standards with international practice so as to reduce barriers to foreign trade.	Under the program, trade policy commitments have been made to preserve what liberalization has already been achieved. No quantitative restrictions will be introduced on international trade transactions, with the possible exception of any protectionist measures that might be taken fully consistent with WTO rules. The Government will also strive to reduce import tariff exemptions, laying the basis for an eventual reduction in import tariffs. Centralized trade will continue to be limited to arms exports and defense-related equipment. Trade under intergovernmental agreements and credit arrangements guaranteed by the government will be conducted on the basis of market-based procurement, with prices at world levels, and related expenditures and receipts will be reflected in the budget. The Government will refrain from operating any system of export controls under the guise of mandatory monitoring of the quantity, quality, or price of exports.				
a. Foreign Direct Investment Policy				By September 30, 1998 a special Policy Statement will be issued by the Chairman of the Government of the Russian Federation, which shall be published widely in the international media, that states the Government's commitment to continue to improve the policy environment for foreign direct investment by bringing the fiscal, regulatory and legal policy regime in line with international standards. Measures to bring about such changes will include the following reforms: (i) "national treatment" will be adhered to both for right of establishment and for post-establishment operations; (ii) the number of restricted sectors and limitations on foreign direct investment will be substantially reduced; (iii) enforcement of property	

PRIVATE SECTOR DEVELOPMENT					
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				rights will be strengthened; (iv) investor-State dispute resolution mechanisms will be made more efficient, including giving foreign investors the opportunity to seek neutral, binding international arbitration; (v) foreign investor registration procedures will be simplified, rules-based, and made transparent; (vi) guarantee schemes covering basic non-commercial risks will be maintained and extended; and (vii) restrictions for foreign investment in services sectors will be reduced.	
b. Production Certification Standards		In August 1997, amendments to draft legislation were introduced to ensure that the emerging legal framework for trade measures (safeguards, anti-dumping, countervailing duties, etc.) will be in line with international norms. In August 1997, Government Resolution No. 1037 was issued that revises product labeling standards. Detailed information of what retailers are to provide shall be clearly specified, as will be the list of products subject to the regulation; the classification system has been streamlined; and national treatment standards have been incorporated. In September 1997, Government Resolution No. 1193 was issued that revises the system for marking products to ensure against counterfeiting in line with international standards. The coverage of products requiring such markings have been reduced and mandatory restrictions have been narrowed; the certification process has been streamlined.	Revisions and harmonization of Russian legislation, regulation and other measures, and their practical application to international trade and investment continue to be made in accordance with international standards and practices.	By October 1, 1998, a new procedure for mandatory certification will become effective, which will envisage both reduction in the number of goods subject to mandatory certification, and simplification of imposed requirements. An approved Concept for Developing Certification will target gradual substitution of a producer's declaration for the current pre-market certification. The Government will submit to the Duma, with a view to enactment by December 31, 1998, a law to reduce duplication of certification procedures applied by different ministries to homogeneous groups of goods.	By December 31, 1999, harmonization of Russian standards in priority sectors with internationally accepted ones will be essentially completed.
c. Tariff Reductions			The Safeguard Commission approved a list of 300 items for which the import duty rate will be reduced from 30 percent to 20 percent by December 31, 1998, and a Government Resolution adopting this was issued on June 3, 1998.		

FISCAL MANAGEMENT REFORM					
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The government announced its anti-crisis Economic Stabilization and Finance Program in late June 1998. Key fiscal measures under the program include improvement of tax administration, raising and rationalizing select taxes, and restructuring of budget commitments. A Presidential Decree setting out the budget parameters for 1999 was issued on July 16, 1998. Subsequently, a Presidential Address that formulates the 1999 budget—including key measures to underpin the budget targets—was signed on July 17, 1998 (and published on July 20, 1998). The Government's strategy focuses on further reducing the budget deficit by turning around the ongoing serious erosion in revenue collections while also making more effective use of limited fiscal resources. The federal government has committed itself to undertaking measures aimed at increasing total revenue collection from an around 10.6% of GDP projected in 1998, to a targeted level of 13.2% of GDP in 1999, while holding constant nominal federal non-interest expenditures. As a result, the 1999 primary fiscal balance is targeted to improve to nearly three percent of GDP from a small negative balance this year. This dramatic shift will be achieved through efforts to broaden the tax base, improve revenue collection, strengthen budget management, rationalize government spending, reform intergovernmental fiscal relations, and strengthen debt management and monitoring capacity. In addition, the government is committed to improving the management and cost efficiency of extrabudgetary funds, including the Pension Fund, Social Insurance Fund, Employment Fund and Road Fund, together representing nearly 10% of GDP.					
I. Elimination of Non-Payments and Arrears					
To eliminate arrears and the practice of non-payments.			The Deputy Prime Minister signed a resolution on June 18, 1998 stipulating that agreements between the State Tax Service and oil producing enterprises will be prepared and signed within a week and oil holdings with outstanding tax arrears not in compliance with these agreements will be denied access to the oil pipeline. It has been publicly announced that nonpayment by July 1 will automatically and immediately lead to curtailed pipeline access. On July 17, 1998, a Presidential Address on the principles of the 1999 budget was issued instructing the Government to prepare and submit to the Duma a draft 1999 Budget Law which stipulates terms and conditions to be met by regions in order to qualify for their full share of federal transfer payments.	On the basis of a Presidential Decree issued on July 16, 1998, the Government will prepare and submit to the Duma a draft 1999 Budget Law which will include a requirement that regions will receive substantially reduced federal transfer payments, grants or loans unless they meet the following conditions: (i) maintain accounts payable of 45 days or less of sales equivalent to infrastructure monopolies in respect of services provided after September 30, 1998; (ii) comply with a schedule agreed with infrastructure monopolies for the liquidation of arrears relating to products and services provided prior to September 30, 1998; (iii) maintain wage and payroll tax arrears at 30 days or less of the current wage-bill; (iv) ensure that all transactions are on a cash basis; (v) meet federal targets for cost recovery on housing and communal services; and (vi) themselves apply conditions (i)-(v) above in respect of their transfers, grants or loans to municipal governments.	
II. Tax Administration and Policy					
To strengthen revenue collection performance, improve tax administration, and reduce distortions in the tax structure.					
a) Design overall tax reform package	The Government submitted the draft Tax	The draft Tax Code passed its first reading in the State Duma; however, the Duma decided to send the	The Federal Assembly adopted Part I of the Tax Code in its third reading,	To reduce tax distortions and encourage long term savings instruments, the Government will seek to	By January 1, 1999, the government will introduce into the Duma legislation to amend some key

FISCAL MANAGEMENT REFORM					
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	Code, through which it intends to undertake a significant reform of tax policy, to the State Duma on April 30, 1997.	Code back for a new first reading. The Government continued to work closely with the State Duma to secure final adoption of the Code on a timely basis. As part of the draft Tax Code, the Government submitted draft legislation to introduce an improved framework for the taxation of capital income. This framework includes shifts toward: (i) uniformity of tax rates and treatment for securities and other financial assets, including removal of tax privileges or exemptions for specific types of securities; (ii) elimination of double taxation on investment through collective investment vehicles such as mutual funds; (iii) deductibility of capital losses from the sale of securities. Moreover, the draft Tax Code does not stipulate any transaction taxes or fees on the circulation of securities.	with the provision for offsets eliminated and the cap on interest increased from 50 percent of tax arrears to 100 percent.	amend Part II of the Tax Code by September 30, 1998 to, inter alia, (i) ensure that taxation of interest earnings on all deposit accounts in banks will be at uniform rates with those applied to all non-government securities, (ii) the principles of sharing between the government and developers after payment of appropriate investment and expenses are consistent with the provisions in the Law on Production Sharing Agreements. The Government will seek to have Part II of the Tax Code signed into law by January 1, 1999. Any necessary amendments to the Tax Code to harmonize its provisions with the tax regime provided for in the Law on Production Sharing Agreements will be enacted and enter into force.	deficiencies of Part I of the Tax Code. This amended version will give the tax authorities broad powers to collect both tax principal and interest and fines without recourse to the court system, eliminate deferrals for tax payers with arrears from the budget, and permit the tax authorities to issue broad instructions to enforce tax laws without having detailed tax administration provisions codified in the law. The amended Part I of the Tax Code will also contain improvements in the tax administration such as making tax agents who fail to transfer withheld taxes to the budget subject to criminal liabilities and giving the tax authorities the ability to issue liens on the bank accounts of tax delinquents.
b) Reform of the structure of individual taxes	Among many improvements, the Code envisages the elimination or phase-out of almost all existing exemptions for the VAT and the deduction of normal business expenses when measuring the profit tax base. It also includes the adoption of accrual accounting; the indexation of specific excise rates for inflation; the elimination of preferential rates under the profit tax; and a simplification of filing requirements under the profit tax and personal income tax.		The Federal Assembly adopted legislation approving a 5 percent sales tax, with exemptions for bread, milk, and children's food and clothing, as well as provisions allowing the regions to introduce their own exemptions on social grounds. The revenue impact of the exemptions is small. A Presidential Decree was issued raising rates for the land tax. The tax rate on profits was reduced from 35 percent to 30 percent. Means-tested subsidies have been introduced.		

FISCAL MANAGEMENT REFORM					
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c) Assessment of tax exemptions	On April 4, 1997, the Government eliminated the tax deductibility of transfers by RAO UES Rossii to its Investment Fund, with no accompanying increase in electricity prices (Government Resolution No. 390).		The Federal Assembly adopted a law removing exemptions for closed territories. The exemptions will be allowed to expire as initially planned, but no later than January 1, 2000.		
d) Develop an efficient and impartial tax administration that can overcome a pervasive "non-payment culture"	In the period up to May 15, 1997, the Government notified more than 15 of the largest debtors to the federal budget that within one month, they will have to decide among three options for resolving their outstanding tax arrears: (i) paying their arrears in full; (ii) participating in the announced scheme of collateralized restructuring of arrears; and (iii) initiating bankruptcy proceedings. The Government endorsed an action plan to establish large taxpayer units in the State Tax Service (STS Orders No. BA-3-20/27 of February 17, 1997, BA-3-32/57 of March 25, 1997, and PV-3-32/104 of May 13,	As of September 30, 1997, the Government has established and made operational large taxpayer units of the Federal State Tax Service in five regions. In November 1997, the Government introduced a new Action Plan to Increase Collection of Taxes and Reduce Federal Budget Expenditures. Major steps that will be taken under this action plan include: (i) the termination of noncash arrangements ("offsets") for clearing tax and spending arrears, which will become effective on January 1, 1998, as stipulated in a November 7, 1997 Presidential Decree; (ii) the establishment of firm expenditure control through the consolidation of all federal spending under the Treasury, supported by sanctions against officials of institutions receiving budgetary resources for undertaking expenditure liabilities not covered by budgetary funding, improved reporting of expenditure arrears, and other expenditure control mechanisms; (iii) the development and implementation of a realistic spending plan to underpin the 1998 budget, including spending norms for such items as electricity and heating; (iv) strong measures to improve tax collection, including taking actions against large high-profile tax debtors and enterprises that do not carry out the decisions of the Emergency Tax Commission (VChK), creating the infrastructure for effective implementation of levies on property of tax debtors, and accelerating	The Large Taxpayer Inspectorate is not fully operational, but central offices of 17 large financial-industrial groups have been shifted under its jurisdiction. The employees of the Inspectorate still need to be relocated to one single office. The Government has issued an order allocating the resources to cover the expenses of the Inspectorate. A legal framework has been established for tax authorities to seize the assets of tax delinquents. Collection of arrears from large tax debtors will continue to be a central element of the revenue collection strategy. From July 1, 1998 and during the remainder of the year, the Emergency Tax Commission will meet monthly, to take steps to collect arrears in each quarter from at least the 20 largest remaining tax debtors. Further, a newly created Federal Debt Center will begin sales of the assets seized from tax debtors. All necessary steps will be taken to ensure that the specialized tax inspectorate, established under Government	By September 1, 1998, the government will take a decision concerning the appropriate responsibilities of the Federal Agency for Foreign Currency and Export Control with a view to eliminate duplicate functions and redundant activities. The role of banks in enforcing tax collection through the banking system needs to be revamped as the current system has negatively affected financial intermediation through the banking system. By September 1, 1998, the Government will establish a plan to remove tax administration functions from the banking system. In particular, legislation will be passed defining procedures for the State Tax Service (STS) to issue liens on any bank account and resources held in the banking system in line with international practice. A major goal of this plan will be to eliminate the use of settlement accounts by the tax authorities by January 1, 1999. In line with international practice, the STS will begin seizure of real assets or initiate bankruptcy proceedings against any enterprises for which there has been a lien on bank accounts for 60 days or more.	By January 1, 1999, eliminate the use of settlement accounts by the tax authorities.

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	1997). The Government has adopted an action plan to strengthen the collection of alcohol taxes, including steps to control domestic commercial traffic in excisable goods, to ensure that the excise tax on domestic alcohol and alcohol products is payable at the time of shipment, and to improve the excise stamp program (Government Resolution No. 297 of March 14, 1997, submission of the draft Tax Code to the Duma on April 30, 1997, and various Customs Committee orders).	tax arrears rescheduling efforts; (v) introducing the invoice system for VAT collection and making the transition to collection of VAT, profit taxes and excises based on the accrual method; and (vi) inventorying all off-budget accounts of budgetary organizations.	Resolution No. 9 within the State Tax Service (STS) to monitor the largest tax payers, will operate effectively. In order to further streamline tax administration, Government Directive No. 969-r of July 17, 1998 has made the Federal Agency for Foreign Currency and Export Control and the Tax Police subordinate to the Minister Head of the STS.		
III. Expenditure Management and Policy					
To improve control over and efficiency of public expenditure.					
a) Maximize transparency and minimize disruptions through ad-hoc sequestration.	The Government submitted to the State Duma, on April 30, 1997, a law proposing expenditure ceilings for 1997 which are consistent with the program. This level of expenditure will be sufficient to provide for the basic needs of the	In an effort to establish an instrument for the regular and accurate monitoring and assessment of tax expenditures, an amendment was made to the draft Budget Code in September 1997 for consideration by the State Duma in the second reading, so as to make the evaluation of actual Government tax expenditures a mandatory component of the annual budget execution reports at all levels of Government. As of September 30, 1997, the Government has kept	The Government's Economic Stabilization and Finance Program is being implemented and the 1999 federal budget is being prepared in accordance with the parameters set forth in the Presidential Address of July 17, 1998.		

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	Federal Government while at the same time ensuring that there will be no incurrence of new arrears.	its cash budget expenditures in line with its sequestration budget proposed to the Duma in late April and the cash deficit remained under control.			
b) Control spending commitments and eliminate budget arrears through enhanced monitoring and the establishment of a Treasury controlled payments mechanism.	The Government confirmed in early May 1997 that a mechanism was launched for the Treasury to issue directly payment orders for wages of the Ministry of Defense. On May 12, 1997, Presidential Decree No. 467 ("On Terminating the Practice of Issuing Guarantees and Warrants Covered by the Federal Budget") was issued eliminating the system of government guarantees on commercial bank financing of budgetary organizations and enterprises.	As of October 31, 1997, all federal pension arrears and all federal wage arrears have been repaid by the Government. The Ministry of Finance began an assessment of the level and structure of federal budgetary arrears to suppliers as of June 30, 1997. The Government adopted a decision to instruct the Ministry of Finance and Goskomstat to develop a statistical format for monthly reporting by budgetary organization on the stock of their outstanding arrears to suppliers, starting in January 1997. A Presidential Decree was signed and became effective on November 7, 1997 to (i) instruct the federal Government to end, as of January 1, 1998, the use of all types of mutual offsets, including cash offsets, for clearing federal tax and budgetary arrears; and (ii) recommend to regional Governments to end, as of January 1, 1998, the use of arrears offset arrangements at the regional level. Further to Government Resolutions #903, 927, 928, on September 2, 1997, the Government issued Resolution #1129, amending the framework for clearing the existing stock of energy arrears (budgetary arrears to energy suppliers and suppliers' tax arrears).	For 1998, the Ministry of Finance is developing a procedure to strengthen Treasury control over payments to energy suppliers by budget organizations and government agencies so as to prevent the unauthorized reallocation of budget funds to other categories of expenditures and help reduce budget arrears to energy providers. At the same time, 1998 budget allocations will provide sufficient funding for financing energy consumption within agreed limits. (Ref.: GOR Resolution No. 1129). A draft law has been prepared which would amend the Civil Code to allow the Federal Treasury to pre-authorize contracts signed by budget-funded organizations. In the interim, Government Resolution No. 441 of May 14, 1998 (on implementing the 1998 federal budget) establishes a mechanism for enhanced Treasury measurement of commitments, including sanctions for officials who sign contracts in excess of approved spending limits.	By September 1, 1998, a law will be submitted to the Duma to allow the federal treasury to pre-approve contracts that are to be financed from federal budget funds, with a view to enactment by October 31, 1998. This law will specify that contracts that are not registered will not be a legal obligation of the federal government, and that only contracts within the financial ceilings established by the federal budget will be registered. In addition, the federal treasury will put in place a reporting system allowing the amount of registered contracts to be monitored against budget limits on an ongoing basis.	The Government will provide to the Bank a report, in such scope as has been agreed upon with the Bank, demonstrating that the accounts payable of Federal budget organizations to infrastructure monopolies do not exceed thirty days of current sales incurred after July 1, 1998 and Federal transfer payments to regions are made in compliance with the principles set forth in the Presidential Address of July 17, 1998.
			The Government will ensure that the accounts payable of budget organizations to infrastructure monopolies at no time exceed 30 days of current sales for sales after July 1, 1998.		
c) Switch to new computerized Treasury system of accounting.		The Government has made substantial progress in introducing the computerized treasury system of accounting and direct payments. The volume of payments processed by the federal Treasury has	In the context of broad reform of the budget execution system the Government will during 1998: (i) develop a system with a single	The government will by September 1, 1998, close all off-budget accounts that are of a budgetary nature and have flows intermediated by the federal treasury.	By January 1, 1999, complete moving all federal agencies into the federal treasury.

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		been steadily increased through 1997 and as of September 30, 1997, the Government is processing 31 percent of the monthly outlays of the federal budget through this system.	Treasury account; (ii) transfer off-budgetary accounts of budgetary organizations to the Treasury; (iii) issue regulations and streamline procedures of the Treasury system of budget execution, including procedures for main distributors, distributors and end-users of budgetary funds; (iv) unify the information and telecommunication systems of the Treasury; and (v) serve budgetary organizations, located in the regions without federal Treasury branches, by Treasury branches in neighboring regions. (Ref. Government Resolution #1082). To control cash spending and improve expenditure management the Government has adopted (Government Directive No. 970-r of July 17, 1998) a revised timetable to complete moving the operations of all federal agencies into the federal treasury by January 1, 1999. This includes all budget recipients of the Ministry of Defense, the operations of all the earmarked budget funds, (including the Road Fund and Customs System Development Fund), and all foreign exchange accounts of the STS and State Customs Committee. Customs operations will be transferred to the Federal Treasury only on January 15, 1999. As of July 16, 1998, only one of nine military districts is in the Treasury; for the rest, there has been no budget financing since July 1, 1998.		

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d) Move extrabudgetary funds onto the budget and the treasury system.		The Government's 1998 budget includes the budgets of the social extrabudgetary funds in parallel with the federal budget.			
e) Establish sound legal-institutional basis for budget and treasury management		A new draft Budget Code developed by the Government and the State Duma has been passed in its first reading by the State Duma. Its provisions on budget responsibilities, comprehensiveness, unification, monitoring, reporting, auditing, etc. provide a solid basis for regularizing the entire sphere of budget operations and dramatically improving their transparency and efficiency.	The Law on the Budget Code was adopted by the Federal Assembly.		
f) Rationalize government spending	Presidential Decree No. 305 "On Priority Measures to Combat Corruption and Reduce Budget Expenditures Through Organizing Auctions to Procure Goods, Construction Works, and Services for State Needs" was issued on April 8, 1997 to reform public procurement procedures, requiring standardized, competitive, open, and nondiscriminatory bidding procedures, and establishing conflict of interest regulations. The decree requires competitive bidding procedures for all federal agencies.	The Government has undertaken a number of steps to accelerate reforms in the housing sector and to reduce the fiscal burden associated with housing subsidies, which are the single largest subsidy item remaining in the fiscal system. A Government Commission was established to oversee housing and utility reforms, led by the First Deputy Prime Minister. The Government has approved a system of federal standards in housing policy, which provides subnational Governments with explicit benchmarks for reform implementation and budget savings. The Commission has worked out a medium term plan for the preparation of Government decisions to accelerate sector reforms. As a result, average housing (utility and maintenance) prices charged to households have risen by 10 percent in real terms, as of the end of September 1997, compared to the end of 1996. The Government has submitted to the State Duma a draft law to reform public procurement procedures requiring standardized, competitive, open, and nondiscriminatory bidding procedures which has passed its first reading. As of June 30, 1997, all grain and food procurement using federal budgetary funds is subject to competitive tendering.	The Government's Economic Stabilization and Finance Program is being implemented and the 1999 federal budget is being prepared in accordance with the parameters set forth in the Presidential Address of July 17, 1998.	Building upon the census and rationalization of government employment under the Fiscal Action Plan, the Government will, by December 1, 1998 present its proposals for Administrative Reform to the President, specifying the functions that the government will be carrying out in the future and steps aimed at improved efficiency in government structure and staffing.	

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		The Government has conducted no less than 10 competitive tenders for large (i.e. valued in excess of Rbl 50 billion) capital projects.			
IV. Reform of Extrabudgetary Funds and Earmarked Budget Funds					
To improve transparency and reduce waste in extrabudgetary funds.			By July 31, 1998, the Government will issue a resolution mandating annual audits, carried out in line with international auditing standards and supervised by the Ministry of Finance, of the Social Insurance Fund, Medical Insurance Fund and the Road Fund. A Presidential Decree dated July 4, 1998 prohibits all federal extrabudgetary funds (with the exception of the Pension Fund) from borrowing from any private financial institution. The Decree as issued gives the Pension Fund scope for borrowing beyond what is needed to manage liquidity. The Ministry of Finance has prepared a draft proposal to limit the Pension Fund's borrowing to the level on April 1, 1998. A number of actions are envisaged to restore the solvency of the Pension Fund. A Government Resolution has been issued that introduces, as of August 1, 1998, a temporary 2 percent earmarked tax surcharge on the personal incomes to be paid to the Pension Fund. This same resolution will also expand the base for the employer contribution. The surcharge will remain in place and further increases in pension benefits will be	Should these measures prove insufficient to restore Pension Fund balance by September 1, 1998, the Government will either reduce pension benefits starting with those above the minimum or further increase the payroll tax surcharge (in order to restore Pension Fund balance). Further efforts will also be made to reduce the administration costs of the Pension Fund. In order to ensure budget organizations comply with their obligations to the PF, from September 1, 1998 the Federal Treasury will transfer directly to the PF federal allocations for payroll tax payments on budgetary employee's wages. In order to ensure budget organizations comply with their obligations to the PF, from September 1, 1998 the Federal Treasury will transfer directly to the PF federal allocations for payroll tax payments on budgetary employee's wages. The July 17, 1998 presidential address on the principles of the 1999 budget will instruct the Government to have the Employment Fund's revenues collected by the STS as of January 1, 1999 on an earmarked basis. The Employment Fund will be subjected to treasury control from October 1, 1998. By November 1, 1998, award contracts for the audits of 1998 accounts of the Social Insurance Fund, Medical Insurance Fund and the Road Fund. The president's budget address of July 17, 1998 instructs the government to ensure the reduction of the payroll tax earmarked for the Social Insurance Fund to 4.9 percent (from 5.4 percent) and at the	In order to achieve the necessary adjustment in federal expenditures and meet the 1999 fiscal targets, the Government will seek to remove the earmarked status of the various budget funds in the 1999 Budget Law (in particular of the Road Fund and Customs System Development Fund), and have their revenue sources accrue to the general revenue of the federal budget. The expenditures of the Road Fund will be closely scrutinized with a view to reducing their outlays by 30 percent in 1999. The expenditures of the Road Fund will be brought under federal treasury control and its expenditure commitments will be subject to the same contract preapproval as other budgetary spending. By December 31, 1999, complete audits of 1998 accounts of the Social Insurance Fund, Medical Insurance Fund and the Road Fund.

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			avoided as long as the Pension Fund remains in deficit or new pension arrears are being accumulated. In addition, legislation will be proposed to the Duma in the special August session, that will expand the base for both employee and employer payroll tax contributions, and will shift the burden of the tax from employers to employees.	*same time the government will elaborate measures to* reduce the overall expenditures of the Social Insurance Fund by 25% in 1999. This will involve eliminating all expenditures that are not directly related to providing insurance related benefits (e.g. sick leave and maternity benefits). Any resulting surplus in the SIF will be transferred to the Pension Fund for payment of pension benefits.	
V. Intergovernmental Fiscal Relations					
To put in place basic elements of intergovernmental fiscal relationships that encourage reform, improve tax collection, eliminate unfunded mandates, and promotes equitable treatment of regions.	Government Resolution No. 621 issued on May 5, 1997, requires transfers from the Federal Equalization Fund to be made conditional on regions' compliance with newly established federal guidelines and standards on housing reform. This lays the basis for the first type of conditional transfers in Russia.	The Government has decided to undertake a comprehensive restructuring of intergovernmental fiscal relations and set up a Working Group of its Government Commission on Economic Reforms to develop the reform program. The Working Group has developed a program for restructuring the current system of federal budget transfers to regions for 1998-99. The Federal law "On Fundamental Financial Principles Of Local Self-Governance In The Russian Federation" adopted on September 25, 1997 provides a new legal framework for intergovernmental tax revenue sharing. The Government's 1998 budget: (i) requires a concentration of federal transfers among the most needy regions; (ii) reflects the recommendations of the Protocol of the Commission on Housing Reform of July 22, 1997 and makes the level of equalization transfers to regions conditional on compliance with federal housing standards; and (iii) introduces a separate mechanism for ear-marked federal transfers to regional Medical Insurance Funds. An Instruction was issued by the Government Commission on Housing and Utility Reform in August, 1997, which specifies rules and procedures for determining the level of federal transfers to regions conditional on the extent of compliance with federal housing standards.	The Government is introduce amendments to the Law on Fiscal Foundations of Local Self-governance to make it fully consistent with the provisions of the Tax and Budget Codes (sections concerning intergovernmental fiscal relations). Government Resolution No. 555 specifies conditional budget transfers to regions based on meeting 40 percent target for cost recovery on housing and communal services. Average cost recovery is now 42 percent. A draft concept paper for the reform of fiscal federal relations has been prepared and discussed in Government, and minutes of a Government review meeting have been signed. By July 30, 1998, the Government will approve a revised Concept Paper on Sub-National Fiscal Reform which will, inter alia, provide clear conceptual guidelines for the reform of sub-national fiscal relations between the federal and	By September 30, 1998, the Government will prepare another detailed Concept Paper establishing the principles for reform of sub-regional government fiscal relations. The two concept papers will cover the formulation of expenditure and revenue assignments for the different levels of Government, and a reformulated system of financial flows from federal to regional governments. Three mechanisms for channeling all federal support to the regions will be set out in detail in these papers: (i) the Fund for Financial Support to Regions (FFSR-transfers for equalization), (ii) the Fund for Regional Development (FRD- loans and grants for public investment), and (iii) the Fund for the Development of Regional Finances (FDRF-loans for reform).	The Government will submit to the Duma appropriate legislative drafts on sub-national fiscal reform or has issued other legal acts to provide for clear assignments of revenue and expenditure responsibilities for each level of government consistent with the concept papers prepared by the Government under the Program. By April 1, 1999, appropriate legislation will be submitted to the Duma or other legal acts will be completed, to provide clear assignments of revenue and expenditure responsibilities for each level of government. These measures will establish inter alia. (i) a more stable and fully transparent system of revenue assignments, (ii) total budget revenue capacity at each level of government commensurate with their respective expenditure responsibilities, (iii) clear criteria under which regional and local authorities may be allowed to set regional tax rates, (iv) the principles under which loans, transfers and grants between levels of government will be conditional on compliance with stated criteria or on the basis of bilateral agreements, and (v) terms under which resources of the FDRF will be made available to regional governments. These principles will be fully reflected in preparation of the 2000 Federal budget and the budgets of subjects of the Federation. As an intermediate step, a new formula for allocating resources transferred to regions through the FFSR,

FISCAL MANAGEMENT REFORM					
Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
		By November 30, 1997, the Government of the Russian Federation issued a resolution authorizing the Economic Reform Commission to develop, by January 31, 1998: (i) the concept of reforming the system of interbudgetary fiscal transfers; and (ii) an action plan and implementation schedule, starting from a detailed survey of the reform program (including consultations with regional bodies of executive power and the State Duma), and stipulating its incorporation in the Government's draft budget for 1999. In accordance with that resolution, the Government's concept of reforming the system of interbudgetary fiscal relations includes: (i) rationalization of the system used to classify regions into categories; (ii) changing the criteria determining the amount of transfers (based on the assessment of the regional GDP and/or fiscal capacity of the region, and standards, level and cost of provision of public services); (iii) introduction of arrangements that would encourage regions to implement reforms in the budget sector; (iv) introduction of conditionalities of transfers (including the implementation of satisfactory independent audits of the budget and ensuring compliance with the federal legislation); (v) gradual transition to the delivery of federal transfers exclusively through the Treasury system; and (vi) introduction of special transfer arrangements for regions heavily dependent on federal transfers.	regional levels of government.		based on the Concept Paper on Subnational Fiscal Reform, will be incorporated in the draft 1999 Budget Law. By June 1, 1999 additional revisions to the formula for transfer allocation will be adopted through a government resolution, to be incorporated in the 2000 Budget Law, which will be based on the objectives of (i) reducing inequality of revenue capacity of subjects of the federation, (ii) use of federally defined expenditure norms to define expenditure needs, and (iii) strengthening incentives for regions to increase revenue collection.
VI. Sovereign and Subnational Borrowing					
To ensure that public borrowing is monitored and held within prudent limitations.	On May 12, 1997, comprehensive legislation regulating subnational government borrowing was submitted to the State Duma. This draft legislation included: (i) a definition of the types	The draft law regulating subnational borrowing that had been submitted by the Government to the State Duma in May 1997 has been passed in its first reading. With its passage and final enactment remaining uncertain as of mid-November, 1997, the Government has submitted to the Office of the President a draft Presidential Decree to regulate subnational Governments' external borrowing through issuance of securities. The draft decree (i)		The government will strengthen sovereign and sub-national debt monitoring to significantly improve the coordination and management of external and domestic debt, at both federal and sub-national levels, within the Ministry of Finance. Any necessary legal acts or decisions to implement an expanded definition of public debt–to include budget arrears, guarantees, and other public contingent	The Government will take all measures necessary (i) to include guarantees, other public contingent liabilities or conditional obligations in the definition of public debt applicable to the federal and sub-national level; (ii) to establish a public debt monitoring system including a comprehensive monitoring system of sub-national debt portfolios; (iii) to establish transparent prudential limitation and preconditions for sub-national borrowing; and (iv) to provide for verification

FISCAL MANAGEMENT REFORM					
Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
	of securities that can be issued by local/regional governments and extrabudgetary funds; (ii) conditions for issuance of these securities (e.g., disclosure rules, collateral requirements, and debt ceilings); and *(iii) exposure limits.*	requires, inter alia, the compliance of borrowing subnational governments with federal fiscal regulations; and (ii) includes monitorable ceilings on both the total debt stock and the annual debt service flow of subnational Governments. Until the relevant regulation becomes effective, through either law or Presidential Decree, the Ministry of Finance will not register international security issues by subnational Governments, and any such registration would require, at a minimum, compliance with the conditions on subnational borrowing by the regions of Moscow, Nizhniy Novgorod, and St. Petersburg outlined in Presidential Decree No. 304 of April 8, 1997. Moreover, the federal Government continues to refrain from any guarantees on borrowing by subnational entities.		liabilities or conditional obligations–will be adopted before September 1, 1998.	by the Ministry of Finance that any sub-national debt is incurred in accordance with such limitations and preconditions for it to become a valid obligation of the respective sub-national entity. By January 1, 1999, the Government will initiate an integrated public debt monitoring system in the Ministry of Finance which will cover both sovereign and sub-national debt, including all obligations of federal and sub-national authorities. In particular, the debt management system will cover all public debt including budget arrears, guarantees, and other public contingent liabilities or conditional obligations. To improve oversight of sub-national debt, the Government will submit to the Duma with a view to enactment by January 1, 1999, or will issue regulations, as necessary, to (i) establish satisfactory and transparent prudential limitations and preconditions for sub-national borrowing, (ii) provide for verification by the Ministry of Finance that these limitations and preconditions have been met, as a condition for such borrowing to be a valid obligation of subnational governments, and (iii) establish a central registration capacity of sub-national public debt in the Ministry of Finance. By February 1, 1999 the Government shall complete a Report with comprehensive and detailed accounting of all federal level obligations as of December 31, 1998. By May 1, 1999, a Report with comprehensive and detailed accounting of all sub-national level obligations shall be prepared, with reporting current through December 31, 1998.

FINANCIAL SECTOR REFORM

Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
I. Banking Reform					
To improve the soundness, efficiency, transparency and competitiveness of the banking system.			The CBR will continue to increase the transparency of its own operations and will put in place requirements to increase transparency for commercial banks. The policy of announcing weekly data on external reserves, begun in June, will be expanded to include the announcement of base money. The CBR will publish summary information on the financial situation of the 30 largest banks on a monthly basis and a requirement will be introduced for banks to provide quarterly disclosures of key information. The standards for disclosure by banks holding more than 10 percent of household deposits in the banking system will be significantly expanded.		
			By August 1, 1998, the ten largest banks will be required to publish quarterly accounts, have annual accounts prepared and audited by a reputable, qualified firm, and make the results public.	The CBR will begin developing a strategy for fostering competition and a strong and efficient banking sector in the long run. A draft of such a strategy will be prepared by end-1998.	
a) Facilitate resolution of illiquid or insolvent banks.	On the basis of its evaluation of the largest 200 banks and other available information, the CBR has identified those banks that have negative capital or other serious problems. At end-February 1997 the CBR informed such banks that they will be required to prepare plans for increasing their capital and for their operational rehabilitation, for submission to the CBR on or before April 30, 1997.	On the basis of plans submitted by problem banks, CBR has decided whether these banks are to be recapitalized and rehabilitated, or whether other statutory procedures as per the banking legislation should be applied, including the withdrawal of bank licenses. Of 27 identified problem banks in the top 200 banks, 10 banks have had their licenses withdrawn. A number of banks have had their licenses restricted.	The CBR continuously monitors the implementation of the recapitalization and rehabilitation plans of the identified problem banks. Should the recapitalization rehabilitation fail to achieve its objectives, the CBR will take necessary actions including the withdrawal of licenses. New problem banks are being identified through the CBR's on-going on-site inspections and future evaluation of other banks. Those identified problem banks are required to submit recapitalization rehabilitation plans. Based on an assessment of those plans, the CBR will decide whether to place the banks under rehabilitation, interim administration, or external management or to withdraw their licenses.	The CBR and the government will devise a comprehensive approach for addressing medium and large problem banks which will include: (i) diagnosis; (ii) corrective action; (ii) bank restructuring; and (iii) bank liquidation. Such a strategy will be reflected in a bank restructuring framework to be prepared by October 31, 1998. The framework will be formulated on the basis of a full diagnosis of the size and nature of the problem and will involve setting out uniform rules and procedures to be followed.	Over the short to medium term, the CBR will continue withdrawing licenses of weak and insolvent banks and streamlining the banking sector. liquidation of small insolvent banks (with capital of less than ECU 1 million) will be stepped-up and their licenses will be revoked by January 1, 2000 should they not reach the new minimum requirement.
b) Put in place effective bank bankruptcy and liquidation legislation.	In March 1997, steps were taken to modify the current legislation in order to specify the procedures for withdrawing bank licenses and for the subsequent timely liquidation *of the delicensed institutions.*	Legislation on bankruptcy of financial institutions was submitted to and passed in its first reading by the State Duma in June 1997. *The Government and the CBR took* measures to ensure expeditious State Duma deliberation of the law on bankruptcy of lending institutions, and took steps to facilitate passage of this law.	The CBR continues to build up the necessary institutional capacity to ensure that the new legislation on the bankruptcy of financial institutions can be implemented effectively once it is passed by the Duma.	The government and the CBR will make every effort to have the Bank Bankruptcy Law and the laws amending the CBR Law and the Law on Banks and Banking Activities enacted by end-1998 to improve the CBR's supervisory powers *and to provide an adequate legal basis for the* bank restructuring framework. These laws will include adequate provisions to strengthen the regulatory powers of the CBR, including revoking licenses, effectively liquidating insolvent banks, and imposing further liability on banks' shareholders.	
c) Ensure that any deposit guarantee		The Government and the CBR took measures to ensure State Duma	Draft legislation currently under revision to make it consistent with the banking sector		

FINANCIAL SECTOR REFORM

Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
scheme that is adopted has prudent coverage of financial institutions and deposits and is self-financing.		deliberation of the law on deposit insurance and took steps to facilitate passage of this law. Any deposit insurance schemes that is implemented will be funded only by premiums of participating banks and the associated investment income, with no use of CBR or government resources.	competition strategy being developed by the CBR.		
d) Strengthen banking supervision through greater use of on-site inspections and improved prudential regulations.	On-site inspections of 53 of the largest banks were completed by the end of June.	On-site inspections of another 15 of the 100 largest banks have been completed in the third quarter of 1997. In the first nine months of 1997, 68 bank inspections were completed. The CBR has continued to improve the system of prudential regulations established by Instruction 1 of January 30, 1996, with a view to moving prudential regulations closer to international standards. During 1997, the CBR has, inter alia: revised procedures for calculating banks' own resources (capital); increased capital adequacy requirements and lowered the tied credit ratio; and introduced necessary changes in the calculation of banks' prudential requirements, with a view to incorporating off-balance-sheet claims and liabilities.	The program of on-site inspections has expanded. *During 1998, the CBR will continue to improve the system of prudential regulations to meet – or where appropriate exceed – international standards.* The CBR has simplified (CBR Directive No. 156-u of February 1, 1998) reserve requirement procedures through establishment of a single uniform rate for funds denominated both in rubles and in foreign currency, regardless of the term for which the resources are obtained. CBR Regulation No. 29-p of May 12, 1998, On Consolidated Reports of Lending Institutions, is approved. The CBR set a list of lending institutions to provide consolidated reports, starting with reports on July 1, 1998 (CBR Directive No. 260-u of June 6, 1998).	Prudential norms on banks' off-balance sheet foreign currency exposure will be strengthened, by September 30, 1998, through the imposition of *limits on single party and connected party exposure*, and out-of-money options will no longer be considered adequate for covering on-balance sheet exposure.	More stringent prudential rules, especially with regard to banks' foreign exchange operations and positions, will be adopted. The requirement to provide consolidated reports beginning on January 1, 1999 will be extended to non-bank financial institutions. *The government and the CBR will make every* effort to ensure that amendments to the Central Bank Law to expand consolidated reporting to non-bank subsidiaries of commercial banks will be adopted by January 1, 1999, sufficiently prior to the implementation of such reporting from July 1, 1999. From July 1, 1999, expanded consolidated reporting to non-bank subsidiaries of commercial banks will be implemented.
e) Reform accounting requirements for banks by *moving* toward international standards.		The CBR, MinFin, and STS revised the procedure of making and use of loan *provisions, with a view to making the* necessary reserves in all cases where repayment in full is considered unlikely, including cases where loans are not currently nonperforming but there are reasons to believe that the borrower is insolvent. In doing so, the CBR, the Ministry of Finance, and the State Tax Service are not allowing banks' tax burdens to increase unduly as a result of the new provisioning rules.	The finalized chart of accounts has been applied by lending institutions in their operations as of January 1, 1998.	By September 30, 1998, the CBR will adopt a timetable to introduce accrual accounting for banks, with a view to introduce such accounting on January 1, 1999 if the Tax Code is in effect at that time.	By January 1, 1999, and in tandem with the Tax Code, the CBR will bring the Russian accounting standards in full conformity with the main principles of the International Accounting Standards (IAS). The appropriateness of the introduction, by January 1, 1999, of 100 percent pre-tax provisioning for bad loans of commercial banks will be assessed in the context of the review of the program.

FINANCIAL SECTOR REFORM

Policy Objective	Actions Taken For Board Approval of SAL1	Actions Taken For Board Approval of SAL2	Actions Taken Prior to Board Presentation of SAL3	Actions To Be Taken Prior to Second Tranche Release of SAL3 (estimated December 31, 1998)	Actions To Be Taken Prior to Third Tranche Release of SAL3 (estimated June 30, 1999)
f) Improve functioning of money markets by putting in place new monetary instruments and developing open market operations to give banks the liquidity management tools available in other developed banking systems.	The CBR introduced reverse repo operations to allow for a temporary reduction in the volume of liquidity in the banking system.	The Central Bank has drafted regulations specifying the procedures for conducting transactions for giving Lombard credits and same-day settlement loans collateralized with government securities based on preliminary deposits of securities by banks on special DEPO bank subaccounts. The Central Bank will approve the above regulations so as to provide for their implementation. The CBR put in place an arrangement to allow primary dealers to take short positions in government securities, and it will also repeal the prohibition on the use by all banks of government securities as collateral, and will ensure that mechanisms are in place to pledge collateral for same-day transactions.	CBR has taken steps to establish an interbank repo market for a wide number of banks both in Moscow and in the regions. CBR Executive Order No. OD-267 of June 5, 1998, On Making Operations to Refinance Banks by the Bank of Russia made effective Resolution No. 19-p of March 6, 1998, On the Procedure of Providing Credits by the Bank of Russia to Banks, Collateralized with Government Securities, and expanded it to banks of Moscow region.		
g) Improve payment system by introducing a real-time gross settlement system and providing incentives for banks to use new electronic settlement services.	On February 28, 1997, the CBR introduced a multi-window system for processing commercial banks' payments in Moscow region, making payments from banks' accounts irrevocable once a payment order is submitted to the CBR. Following each window, the CBR provides information to banks on their correspondent account balances. A "cut-off" hour for same-day client payments was introduced to allow banks to settle their positions during the last window by borrowing in the interbank market or from the CBR.	In June and July 1997, the CBR issued normative concepts for the Real-Time Gross Settlement (RTGS) system and for the development of the settlements system.	The CBR has introduced (CBR Directives No. 18-p of February 20, 1998 and No. 191-u of March 24, 1998) the technology of settlements without paper documents between the credit institutions in Moscow. The CBR has developed and approved the normative framework to ensure the functioning of the RTGS system.		

MAP SECTION

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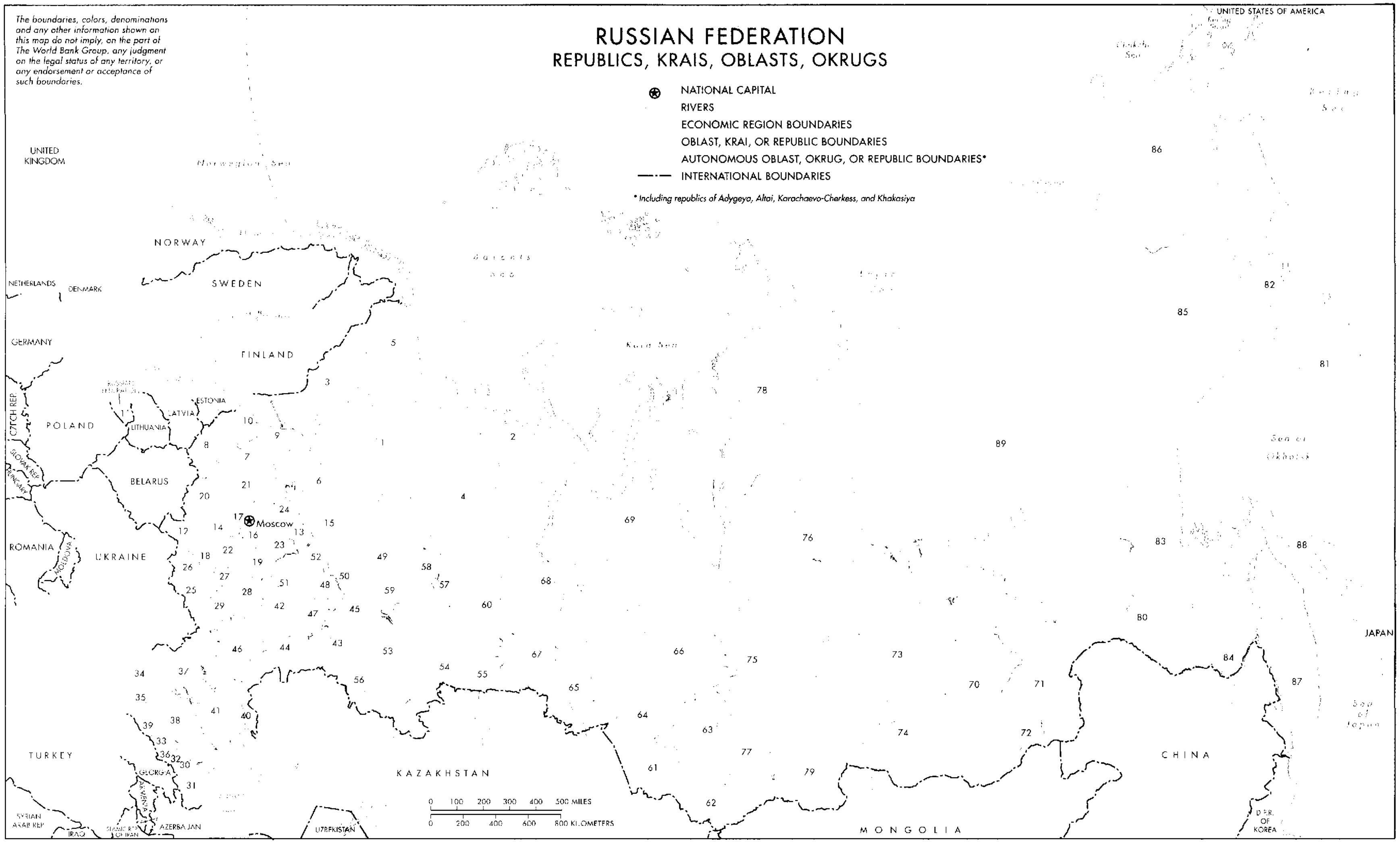

1. Arkhangel
   2. Nenetz
3. Karelia
4. Komi
5. Murmansk
6. Vologda

7. Novgorod
8. Pskov
9. Leningrad
10. St.Petersburg City
11. Kaliningrad

12. Bryansk
13. Ivanovo
14. Kaluga
15. Kostroma
16. Moscow
17. Moscow City
18. Orel
19. Ryazan
20. Smolensk
21. Tver
22. Tula
23. Vladimir
24. Yaroslavl

25. Belgorod
26. Kursk
27. Lipetsk
28. Tambov
29. Voronezh

30. Chechen
31. Daghestan
32. Ingush
33. Kabardino-Balkar
34. Krasnodar
   35. Adygeya
36. North Ossetia
37. Rostov
38. Stravropol
   39. Karachaevo-Cherkess

40. Astrakhan
41. Kalmykia-Khalmg Tangch
42. Penza
43. Samara
44. Saratov
45. Tatarstan
46. Volgograd
47. Ulyanovsk

48. Chuvash
49. Kirov
50. Mariy El
51. Mordov
52. Nizhniy Novgorod

53. Bashkortostan
54. Chelyabinsk
55. Kurgan
56. Orenburg
57. Perm
   58. Komi-Permiak
59. Udmurt
60. Sverdiovsk

61. Altai
   62. Gorny Altai
63. Kemeravo
64. Novosibirsk
65. Omsk
66. Tomsk
67. Tymen
   68. Khanty-Mansi
   69. Yamalo-Nenets

70. Buryat
71. Chita
   72. Agin Buryat
73. Irkutsk
   74. Ust-Ordyn Buryat
75. Krasnoyarsk
   76. Evenk
   77. Khakas
   78. Taimir
79. Tuva

80. Amur
81. Kamchatka
   82. Koryak
83. Khabarovsk
   84. Jewish AO
85. Magadan
   86. Chukot
87. Primorski
88. Sakhalin
89. Sacha (Yakut)

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