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Russia's 2003 Budget:
An Early Preview At Comfortable Financing And Fiscal Policy Principles

- **The 2003 budget process will over the next weeks start more formally**. The presentation of the President's annual budget address, setting out key fiscal policy principles for next year's budget, is imminent. On June 5, the Ministry of Finance will submit to the government a draft 2003 budget, and on June 13, the full government meets to discuss the budget.

- **Against this background, in this note we take an early preview at the overall financing situation for 2003, taking into account the currently available indications regarding 2003 budget parameters and the main fiscal policy principles**.

- **We expect the 2003 budget to be based on an overall surplus of 1% of GDP. Our early preview indicates that on these – as well as on more conservative - budget assumptions, Russia's overall financing situation in 2003 will be comfortable. The often repeated suggestion by Russian policy makers that the 2003 "debt problem" has been dealt with is essentially correct.** Next year is thus likely to be the fourth year running with a budget surplus in practice and the second year running with a budget surplus formally included in the budget. As in 2002, in practice, the surplus budget will be quite resilient to oil price movements**.**

- **More interesting than the financing *per se*, the 2003 budget is set to be based on a continuation of encouraging fiscal policy principles. These include the targeting of an overall budget surplus and the continued use of active debt management to smooth external debt payments. Specifically, two very key priorities are likely to be the financing and the pursuit of approved major structural reforms as well as the pursuit of budget expenditure restructuring – both policy indications of significant importance for the next phase of structural reforms**.

1. The 2003 budget process

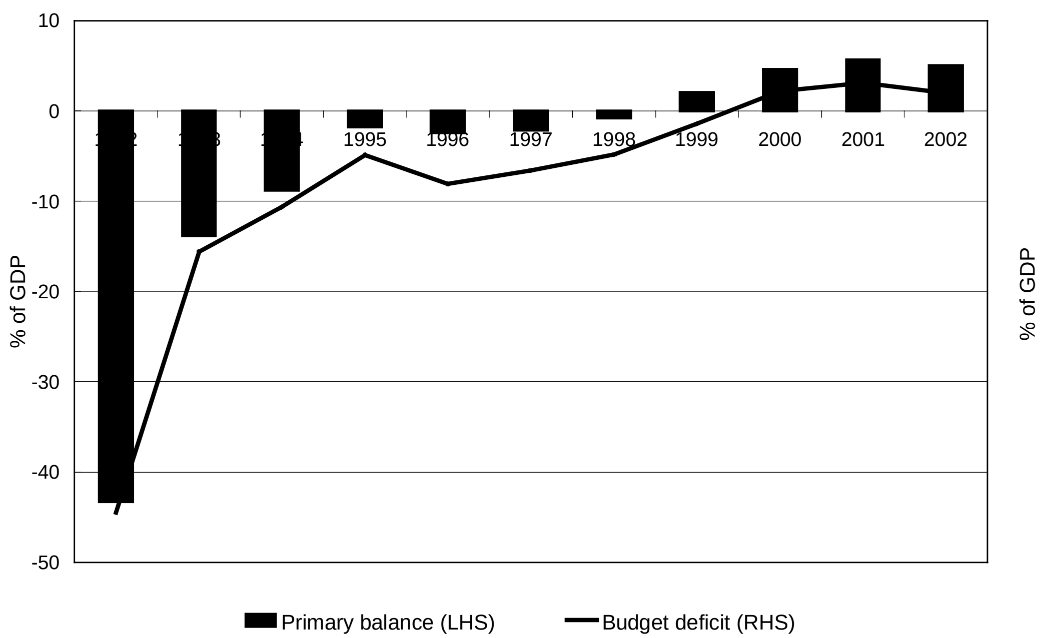
The 2003 budget process will over the next weeks start more formally. During this week (week of May 27), President Putin and the Kremlin have worked on concluding the annual budget address, which could be sent to the government imminently. The President's annual budget address traditionally sets out the main fiscal policy principles for the next year, and is addressed to the government and the federal assembly. Following the overall policy lead from the President's budget address, the Ministry of Finance is expected to submit a draft 2003 budget to the government by June 5. On June 13, a full government meeting will discuss the 2003 budget, as well as underlying macroeconomic assumptions for the 2003-05 period, and possibly the contours of a multi-annual budget plan for 2003-05. After some further drafting, the government is expected to submit the 2003 budget document to the Duma in August.

With this process approaching, this is a good opportunity to have a preliminary look at the overall financing situation for 2003, taking into account what we know at the moment regarding the overall development of fiscal policy and some specific elements of the 2003 budget.

2. The fiscal policy principles – overall budget surplus policy to continue , budget expenditure reforms and structural reforms in focus

In terms of fiscal policy, the picture is encouraging. **The underpinnings of the dramatic improvement in fiscal policy over the last three years will remain** (see graph below).

Russia's Fiscal Turnaround (primary balance and budget balance, 1992-2002F)



Specifically, an explicit overall budget surplus policy, codified for the first time in the 2002 budget, will be retained also for the 2003 budget. In practice, 2003 will likely by the fourth year running of Russia achieving an overall budget surplus. Other fiscal policy priorities will include ensuring the financing and pursuit of approved major structural reforms (such as pension, social, banking, legal and army reforms, as well as small business tax reforms), the continued use of advantageous external conditions to pursue active debt management to reduce the external debt burden, and budget expenditure reforms (including the abolishment of so-called non-financed mandates).

The areas of facilitating approved structural reforms and of pursuing budget expenditure reforms are of special importance[1]. Budget expenditure restructuring is one of the last areas of Russia's fiscal policy that remains to be tackled in a serious way. This is not primarily with regards to the level of expenditures, and is rather in connection with reforming the government's spending priorities and cutting a still large number of inefficient spending categories. Regarding the pursuit of approved structural reforms, President Putin is likely in his annual budget address, as in his annual speech to the Federal Assembly on April 18, to make a particular point about the importance of making significant progress in implementing

[1] Notably, prominent economists and policy-makers such as Professor Gaidar, Professor Mau and First Deputy Minister of Finance Ulyukaev have repeatedly emphasized the importance of budget expenditure reforms/restructuring/optimization. For a recent contribution, see "Ya drugoi takoi…" (interview with Y. Gaidar), *Zhurnal*, May 7, 2002.

the complex “second-generation” structural reforms. In the general context of such priorities being laid out, it is likely that policy focus will also turn further towards the vital area of civil service/bureaucracy reforms. For many, civil service reforms is perhaps alongside financial system reforms the most important priority over the coming years, and it is a priority for which President Putin outlined a strong support for in his April 18 speech to the Federal Assembly[2].

One strategic element that may change in the overall fiscal strategy underlying the 2003 budget as compared with the 2002 budget, is with regards to domestic debt issuance. Both Prime Minister Kasyanov and the Central Bank leadership, in particular First Deputy Central Bank Governor Vyugin, have indicated support for the idea that alongside a continuous decrease of the external debt stock, Russia should seek to more actively develop the domestic debt market. This is important, not because Russia primarily needs it to finance a budget deficit (it will most likely continue to run a surplus), but because it is an important part of re-developing a liquid domestic debt market and restoring monetary policy tools. While the Ministry of Finance has been somewhat hesitant to consider increasing net domestic debt issuance, we believe it is likely we could see net domestic debt issuance of around (the equivalent of) USD 1.5 bn in 2003.

Finally, a novelty of the 2003 budget process may be the consideration of the “budgets” of the natural monopolies, an initiative originally launched by presidential economic adviser Andrei Illarionov.

3. The underlying macroeconomic estimates and main budget parameters – an early look

While still at a draft stage (see the above time table for the budget process), the Ministry for Economic Development and Trade presented on May 20 an amended version of 2003-2005 macroeconomic estimates, which will support the construction of the 2003 budget[3]. As in previous years, there are different oil price scenarios, specifically one where Urals is seen to average USD 18.5 dollars per barrel in 2003, and another where Urals averages USD 21.5 dollars per barrel. Real GDP growth, in the range between these two oil price scenarios, is seen at 3.4-4.4%, while inflation is expected at 10-12%, and the average rouble/dollar exchange rate at 34. Other assumptions include an investment growth of 7.5% and a growth of real incomes of 6%. As far as 2003 goes, these assumptions could be viewed as feasible and not overly optimistic. For 2002, the Ministry for Economic Development and Trade estimates that January-April real GDP growth reached 3.7% YOY, and that growth accelerated to 4.5% in April compared to the corresponding month last year. The full-year 2002 government expectation is for growth of 3.6%, which may well be too low. For 2004 and 2005, the draft estimates expect a growth range of 4-5.4% and 4.4-5.9%, respectively.

In terms of fiscal parameters, the expectation is that the 2003 budget will retain an overall budget surplus policy, budgeting with an excess of revenues over expenditures. On our indications, the overall budget surplus will be around 1-1.1% of GDP. Specifically, similar to the 2002 budget construction, revenues will be budgeted using the

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[2] For an excellent analysis of the background to the challenge of Russian civil service/bureaucracy reforms, as well as an outline of the reform approaches being drafted in this area, see the report by First Deputy Minister of Economic Development and Trade Mikhail Dmitriev: *Samaya trudnaya reforma: gosudarstvo, rabotayushee na rezultat*, May 2002, mimeo.

[3] Importantly, in amending the macroeconomic estimates for the 2003-05 period, particularly the growth estimates, the government withstood the temptation of seeking “quick fixes” to increase short-term growth. Some upward adjustments were made to growth estimates for 2003, 2004 and 2005, compared to the earlier March drafts, but the revisions were not substantial overall. Under some pressure, the government – from Prime Minister Kasyanov to Deputy Prime Minister/Minister of Finance Kudrin and Minister for Economic Development and Trade Gref – stood their ground and maintained the realism of the growth estimates, while focusing on pursuing structural reforms to lay the foundation for medium- to long-term growth. For a very good summary of these policy discussions, see the analysis by E. Gurvich in *Glavnoe, chtoby dyelo ne svelos k izmeneniyu prognozov*, May 30, 2002, mimeo, the EEG-Ministry of Finance.

higher oil price scenario of Urals 21.5, whereas expenditures will be budgeted using the lower oil price scenario of Urals 18.5. As such, this is actually a more conservative approach than in the 2002 budget, where revenues were based on Urals 23.5 and expenditures on Urals 18.5. Essentially, this construction can be viewed in the following way: at an average Urals oil price of 18.5, the budget is balanced. In reality, there is likely be a further buffer, so that the budget is balanced even at Urals oil prices around 17 dollars.

4. The 2003 budget – comfortable financing

The table below summarizes our 2003 overall financing analysis for Russia. As can be seen, 2003 financing is well covered, even under quite conservative assumptions. The three different scenarios outlined differ with regards to the budget balance and whether or not there is net domestic debt issuance and Eurobond issuance. In all scenarios, within different degrees, financing appears comfortable. In particular, note that the USD 9 bn in external debt amortization assumes full and scheduled amortization payments, including a full, scheduled redemption payment on the Minfin 4 of USD 3.5 bn. In practice, however, indications are authorities have been engaged in buy-backs over the last years, which together with the effect of earlier off-sets, have brought down the outstanding redemption payment on the Minfin 4 substantially. This is important, because the Minfin 4 amortization payment in May 2003 is really the main difference between 2003 and previous years. Without the Minfin 4 payment, 2003 is very similar to previous years in terms of debt service. The Ministry of Finance has also engaged in active debt management with regards to other external debt categories, such as bilateral Soviet-era non-Paris Club debt as well as early debt repayment of IMF debt, operations which have also affected the actual amount due in external debt amortization in 2003.

Apart from active debt management in various ways, the so-called 2002 financial reserve is another support for 2003 financing[4]. In our early preview of 2003 financing scenarios, we assume the equivalent of some USD 4.5 bn will be transferred from 2002 into 2003, as potential financing, composed of roughly the same amount of excess revenues transferred from 2001 into 2002 (some RUB 90 bn) as well as the revenues from a likely new sovereign Eurobond of up to USD 2 bn to be issued later this year. This estimate, of a 2002 financial reserve of USD 4.5 bn available for 2003 financing, is feasible. The Ministry of Finance expects a total 2002 financial reserve of some RUB 198 bn (USD 6.3 bn at the average 2002 budgeted exchange rate). During the first three months of 2002, the financial reserve increased to RUB 97.1 bn, which after RUB 49.5 bn used for external and domestic debt service, left RUB 47.6 bn as of April 1, 2002. Indeed, the budget performance in the first four months of 2002 has been strong, despite oil prices being well-below what was budgeted in the 2002 budget. The overall budget surplus (excluding the unified social tax) in the January-April period is estimated at 3.2% of GDP, with the primary surplus at nearly 6% of GDP (on a cash basis and IMF methodology). Urals oil prices in the first quarter averaged 19.8 dollars per barrel, compared to the budgeted annual average of 23.5 dollars per barrel (at which an overall surplus was budgeted to emerge).

On the borrowing side, as noted above, our expectation is that net domestic debt issuance will be somewhat more in focus, and thus could be larger than in previous years. As for Eurobond issuance, indications are the Ministry of Finance might include at least the provision for another new Eurobond issue, but at the fairly small size of USD

[4] Prime Minister Kasyanov on May 21, 2002, signed a government decree setting out the rules and procedures for managing the financial reserve, including debt management jurisdiction. This was the first formalization of debt management practices in a wider sense the Ministry of Finance has received. It is likely to be followed-up by further codification of debt management as part of Russia's debt management reforms, e.g. the likely adoption of a Law on Government Debt. We have recently summarized the main features of the financial reserve and the procedures laid out in the government decree, see the note *Russia: The Ministry of Finance Gets Right To Invest 2002 Financial Reserve In Russian Federation Eurobonds – Additional Demand For Russian Eurobonds*, May 22, 2002. See also the analysis by Tsentr Razvitia, *Ot finansovovo rezerva k rezervnomy fondy*, April 22, 2002, mimeo, for a discussion on possible future legislative versions of a financial reserve.

1 bn. In any case, the financing scenarios below indicate that with a solid 2002 financial reserve, 2003 financing is in most cases very comfortable. Note also that Russia will continue to refrain from IMF borrowing, and we have added a quite restrictive assumption of zero bilateral borrowing, and only some USD 400 mn of World Bank and EBRD financing.

Finally, apart from the strong starting position and the buffer inherent in previous active debt management, it is important to emphasize that Russia has significant fiscal policy flexibility. In other words, should it be required, it is reasonable to expect a fairly quick policy response in corrective budget action, for example on the expenditure side, to rectify any worsening in the fiscal path due to e.g. worsening external conditions.

Russia: The 2003 Budget And Overall Financing – Scenarios (structured after budget balance, net domestic debt issuance and Eurobond issuance), USD bn

	Budget surplus, net domestic debt issuance, new Eurobond (Urals average $21.5)	Balanced budget, net domestic debt issuance, new Eurobond (Urals average $18.5)	Budget surplus, zero net domestic debt issuance, no new Eurobond (Urals average $21.5)
Budget surplus	4	0	4
Net domestic debt issuance	1.5	1.5	0
External debt amortization	-9	-9	-9
Gap:	**-3.5**	**-7.5**	**-5**
Financing:			
Funds transferred from 2002	4.5	4.5	4.5
Privatization, precious metals sales	1.8	1.8	1.8
World Bank, EBRD	0.4	0.4	0.4
IMF	0	0	0
Bilateral borrowing	0	0	0
New Eurobond issuance	1	1	0
Difference:	**+4.2**	**+0.2**	**+1.7**

Source: Ministry of Finance, SSSB. At Urals $21.5 per barrel average, the budget surplus is assumed at 1.1% of GDP. At Urals $18.5 per barrel average, the budget is assumed balanced. The average rouble/dollar exchange rate applied is 34. Net domestic debt issuance is estimated at RUB 50 bn. Funds transferred from 2002 – the financial reserve – is estimated as the combination of some RUB 90 bn in excess revenues, similar to the transfer from 2001 to 2002, and the revenues from a Eurobond issuance of up to USD 2 bn in 2002. Privatization revenues are estimated at RUB 50 bn and precious metals sales at RUB 10 bn.