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Economic and Market Analysis, London EC475
Niclas Sundstrom +44 20 7986 3296
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Russia:
2002-2003 Full Debt Payments And Financing Gaps – More Than Manageable

In summary:

- ***On June 22, the Duma is set to continue the wave of liberal tax reforms launched under President Putin's government, most likely approving in a second reading a radical overhaul of the profit tax***. Between now and mid-July, the government will also conclude in all three necessary Duma readings the whole package of the current phase of tax reforms, which apart from a new profit tax includes a unified tax on natural resource extraction, new rules for excises and new rules for tariffs.

- ***Against this background of encouraging tax reforms, primarily aimed at broadening the tax base and making the tax system more transparent, this note summarizes Russia's fiscal cycle over the next two years from the financing perspective***. ***Notably, a conservative analysis – based on the Ministry of Finance's fiscal policy path outlined for the 2002-04 period – indicates that Russia should be able to more than manage even the 2003 debt service peak***. Indeed, as contours of the 2002-04 fiscal policy emerged over the last months, and given early indications of the results of last year's tax reforms and signs of continued reform commitment by Russian authorities, even domestic concerns over the debt service peak have notably moderated.

- The Ministry of Finance's 2002-2004 fiscal projections and policies raise the possibility of refinancing the remaining outstanding Minfin 4 into new Eurobonds, either partly via a new Eurobond issue in 2003, or via a bond exchange ahead of 2003. Thus, Russia is considering, as a matter of budget planning, to in 2003 issue some USD 2-2.5 bn in new Eurobonds as two Eurobonds (the equivalent of USD 1.25 bn and USD 365 mn) and the Minfin 4 (in theory USD 3.46 bn) mature. In our view, a critical factor is that the volume of remaining outstanding Minfin 4s is likely to be far lower than the nominal $3.46 billion, and potentially as low as $1-1.5 bn[1]. This underscores that the 2003 debt service issue has significantly decreased in terms of being a source for concern, especially in the light of the current fiscal policy evolution.

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[1] The result of the combined impact over several years of various offsets (both domestic and external) and more recent buy-back activity. If the Ministry of Finance chooses to re-finance the remaining outstanding Minfin 4 in May 2003 through a new Eurobond issue rather than an exchange into a new Eurobond ahead of 2003, it is likely that the volume of outstanding Minfin 4s will go down further. Given the strong fiscal situation and the way the 2002-04 budget policy is formulated, the Ministry of Finance will retain significant flexibility.

1. The drafting and presentation of the 2002 budget

A few weeks ago, the Russian government approved the main parameters of the 2002 budget, and a prospective fiscal policy path for 2003-04[2]. The full draft 2002 Budget Law is scheduled to be fully approved by the government by August 14, after which it will be submitted to the Duma for the necessary readings during autumn/winter.

In our reading, the 2002 budget and the whole 2002-04 fiscal policy cycle outlined by Russian authorities is encouraging, and should be seen as strongly supportive of both fixed income markets and equity markets. Specifically, there are three key points which the presented fiscal and budget policy have set out to pursue: liberal tax reforms, full debt payments (including a *de facto* or formal stabilization fund), and the financing of major structural reforms. The structural reforms include over coming years the implementation of sweeping labor reforms, pension reforms, municipal reforms, energy reforms and legal reforms. In addition, the fiscal cycle includes a host of initiatives to further encourage regional fiscal reforms and regional fiscal transparency.

Because of such ambitious aims, Russian authorities drafted and presented the 2002 budget in a different way compared to previous years. With the objectives of both implementing liberal tax reforms and pursuing major structural reforms, the Ministry of Finance had to balance these issues. Rather than starting from an average oil price assumption, the Ministry of Finance outlined what would be the level of non-interest expenditures needed in the 2002-04 period in order to support the financing of the above structural reforms. The path of non-interest expenditures also had to meet another constraint – it had to decrease throughout the period. Thus, the Ministry of Finance set the level of non-interest expenditures at 11.91% of GDP (down from 12.62% of GDP expected in 2001) at 11.62% of GDP in 2003 and at 11.47% of GDP in 2004. It was then determined that at an average Urals oil price of 17 dollars per barrel, the budget would be balanced (including interest expenditures, and including the estimated effects of tax reforms pursued during this year).

Thus, the Russian budget in 2002, and over the 2003-04 period, is balanced, based on an oil price of 17 dollars per barrel. While an oil price of 17 was used to balance the budget, the *actual expectation* of the Ministry of Finance in terms of what the 2002 Urals oil price average will be is 22 dollars per barrel. If taking into account this expectation of the actual 2002 average Urals oil price, the 2002 budget (and the 2003-04) would record overall budget surpluses. As per the 2002-04 fiscal policy, all revenues above a balanced budget go towards debt service. ***Once all debt service for the year has been covered, should there still be additional revenues, these will be put into a de facto and eventually a formal stabilization fund, to be transferred over as additional funds for the year after.*** As outlined by Deputy Prime Minister/Minister of Finance Kudrin, the mechanisms of an eventual formal stabilization fund will be drafted alongside the 2002 Budget Law.

2. The tax reforms

Taking into account the twin tasks of pursuing further liberal tax reforms while also implementing major structural reforms and budgeting for full debt payments, we feel the chosen budget construction is not disappointing, rather it is encouraging. It should be noted that in addition to the tasks outlined above, another effect would be to restrain and decrease the level of non-interest expenditures over the period, thus counteracting any tendency of pro-cyclical fiscal policy.

The key point really is the tax reforms. The current package of tax reforms in the Duma, awaiting the second and third reading, would basically conclude the wave of reforms in this area initiated last summer. If the package is approved, it is estimated that the tax burden would go down by some 1.8% of GDP next year. Recall that in the first wave of overhauling the tax system, the Russian government concentrated on personal income tax and social taxation, introducing as of January 1, 2001, a single income tax rate of 13% and a unified social tax. The results have been dramatic. The expectation was that these measures would over time broaden the tax base, but that initially tax collection might fall. Instead, it has jumped. Personal income tax collection in the first five

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[2] The key documents are *Osnovnye podkhody k formirovaniyu proektirovok osnovnykh kharakteristik federalnovo byudzheta na 2002 god I na period do 2004 goda*, Ministerstvo Finansov, June 2001, and *Proektirovki osnovnykh parametrov federalnovo byudzheta na 2003-2004 gody*, Ministerstvo Finansov, June 2001.

months of 2001 compared to the same period in 2000 is up over 50%. Collection of the unified social tax is up 40% in the same period. While some of this improvement is due to further tightening of discipline and better collection methods, much of it is a very rapid reaction to incentive-compatible, liberal, tax reforms.

The encouraging early indications of last year's tax reforms have led the government to radicalize further the current package of reforms, especially with regards to the profit tax. Initially, in the first reading, this reform was mainly about simplifying, restructuring and making this tax more transparent, although the headline tax was cut from about 43% to 35%. Ahead of the second reading – also spurred on by the Duma Budget Committee – the government has opted for a proposal to decrease the headline profit tax to as low as 25%, with the option of regions lowering it another 5%, in a step to encourage some regional tax competition. Of the 25% profit tax, it is proposed 8 percentage points would go to the federal budget, and 17 percentage points to regional budgets. Apart from being bolstered by the impact of the earlier tax reforms, the deal is also that in exchange for such a significant decrease of the profit tax, all current profit tax exemptions and special deals would be abolished. The influential Duma Budget Committee has instead proposed to decrease the profit tax to 23%, with the option for regions to lower it by another 3%. This proposal includes a division of 7 percentage points to the federal budget, and 16 percentage points to regional budgets.

According to Ministry of Finance/Ministry for Economic Development and Trade calculations, the total budget system would loose some RUB 160 bn if the profit tax is lowered to 25%, and some RUB 200 bn if it is lowered to 23%. However, the effects from a dynamic broadening of the tax base and the abolishment of exemptions could be very substantial, at least over time (and potentially quicker than thought, as shown by the personal income tax response). According to the Ministry of Tax, the budget is every year losing some 46% of all nominal profit tax due, because of all the various exemptions and special deals – which is the equivalent of over RUB 400 bn.

Russia's Tax Reforms, 2000-2001: The Main Items
Approved 2000, in effect as of January 1, 2001:
a) Single personal income tax rate of 13%
b) Unified social tax (pension fund, social insurance, and obligatory medical insurance)
c) VAT reforms
d) Excises reforms
Tax reforms awaiting full approval by mid-July 2001, to go into effect January 1, 2002:
a) New profit tax – simplification, more transparency, headline rate no higher than 25%
b) New unified tax on natural resource extraction
c) New tax rules for excises
d) New tariff tax rules

Source: the Ministry of Finance, SSSB.

3. The 2002 budget and overall financing

As the financing scenario below outlines, 2002 is more than manageable, even with conservative estimates. Not insignificant funds could be transferred into 2003 as an additional debt service cushion.

Russia: The 2002 Budget And Overall Financing – A Conservative Scenario (USD bn)

Budget balance	0
Net domestic debt issuance	0
External debt amortization	6.8
Gap:	***6.8***
Financing:	
Funds transferred from 2001	2.5
2002 excess budget revenues	4.8
Privatization	0.6
Eurobond new issuance	0.5
Difference:	***+1.6***

The balanced budget is based on Urals average 17, and RUB/USD average at 31.5.

The above table summarizes a conservative financing situation for 2002, based on the draft 2002 projections and assumptions. It is conservative for a number of reasons.

- It assumes zero net domestic debt issuance, whereas in practice the Ministry of Finance may opt for up to the equivalent of up to USD 1 bn in net domestic debt issuance in 2002. This would decrease the financing requirement to USD 5.8 bn, and raise the difference between the financing sources and the gap to + USD 2.6 bn.
- Estimated excess budget revenues (at RUB 150 bn, or USD 4.8 bn at the budgeted RUB/USD rate of 31.5) should be considered as cautious. The Ministry of Finance is estimating, at a Urals oil price of 22 dollars per barrel, excess revenues (over a balanced budget based on 17 Urals) at RUB 129 bn. This is very conservative, thus we have added somewhat to this, to increase the estimate to RUB 150 bn. However, it remains conservative because this estimate mainly relies on effects from external sector-related taxation, and does not fully capture effects via profit tax, and not at all from VAT and personal income tax collection.
- We estimate the volume of 2001 excess budget revenues to be transferred into 2002 at RUB 80 bn. On June 1, 2001, the federal budget had RUB 80.1 bn excess liquidity in accounts.
- The balanced budget includes zero IMF financing, and only modest World Bank project financing.
- The estimate of Eurobond issuance could be considered as conservative, at only USD 500 mn. It should be little problem for Russia to issue up to USD 1 bn in new Eurobonds in 2002. Note that over this cycle, 2001-2004, Russia will follow the policy of issuing at most as much as is maturing, preferably less, thus continuing to decrease the stock of external debt.
- The table does not include estimates for precious metals sales. These could be between USD 100-200 mn in practice. If adding precious metals sale and net domestic debt issuance, the financing surplus rises thus further (and more can be transferred to 2003).

4. The 2003 budget and overall financing

The 2003 situation, as shown below, should also be manageable, with a conservative scenario resulting in basically covered financing requirements despite the debt service peak. Notably, Russia is on a stronger footing than generally believed, due to the combination of the current fiscal policy evolution, debt management reforms, and the issue of the Minfin 4. On the last point, the Ministry of Finance is clearly indicating in its 2003 projections the idea of re-financing the still remaining outstanding Minfin 4 into new Eurobonds, either partly via a new Eurobond issue in 2003, or via a bond exchange ahead of 2003. Thus, Russia is considering, as a matter of budget planning, to in 2003 issue some USD 2-2.5 bn in new Eurobonds as two Eurobonds (the equivalent of USD 1.25 bn and USD 3645 mn) and the Minfin 4 (in theory USD 3.46 bn) mature. However, the volume of still remaining outstanding Minfin 4s is likely to be far lower than the nominal USD 3.46 - as per our indications potentially as low as USD 1-1.5 bn[3]. **If this were taken into account, it would emphasize further that the 2003 debt service issue has significantly decreased in terms of being a source for concern, especially in the light of the current fiscal policy evolution**.

Russia: The 2003 Budget And Overall Financing – A Conservative Scenario (USD bn)

Budget balance	0
Net domestic debt issuance	0.5
External debt amortization	11.8
Gap:	***11.3***
<u>Financing</u>:	
Funds transferred from 2002	3
2003 excess budget revenues	5
Privatization	0.5
Eurobond new issuance	2.5
Precious metals sales	0.15
Difference:	***-0.15***

The balanced budget is based on Urals average 17, and RUB/USD average at 32.5.

As with the 2002 situation above, this is also a conservative scenario.

- Excess budget revenue estimates at RUB 160.7 bn (or USD 5 bn) are conservative for the same reasons mentioned above. For 2003, we estimate RUB 80 bn gets transferred from 2002 (based on the existence of net domestic debt issuance and precious metals sales in 2002).
- In 2003, two Eurobonds mature, at the equivalent of USD 1.25 bn and USD 365 mn. In addition, the Minfin 4, in theory USD 3.46 bn matures. Russia is projecting it could issue up to USD 2.5 bn in new Eurobonds instead of these maturing bonds. It should be noted that the actual remaining outstanding of the Minfin 4 is likely to be far less than the nominal USD 3.46 bn, maybe as small as USD 1-1.5 bn. If this were taken into account, the financing requirement would significantly decrease.
- As in 2002, it is notable that there is zero IMF financing included in 2003 budget as well, and only modest World Bank project financing.
- Also, the 2003 projections do not include the possibility of borrowing for external debt service purposes from the Central Bank (whose reserves are booming), as was done with the blessing of the IMF in 1999.

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[3] The result of the combined impact over several years of various offsets (both domestic and external) and buy-back activity. If the Ministry of Finance chooses to re-finance the remaining outstanding Minfin 4 in May 2003 through a new Eurobond issue rather than an exchange into a new Eurobond ahead of 2003, it is likely that the volume of outstanding Minfin 4s will go down further. Given the strong fiscal situation and the way the 2002-04 budget policy is formulated, the Ministry of Finance will retain significant flexibility.