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Russia:
2002 Budget Execution And 2003 Debt Financing – Under Control

Recently, Russian finance officials have made a number of comments regarding 2002 budget execution, as well as 2003 debt financing, including the suggestion Russia might refrain from issuing a new Eurobond even in 2003. This note looks into the various issues here involved: actual budget performance, the reasons and context for alleged revenue slippage, the regional budget challenges, including arrears developments, why 2003 budget financing remains manageable and why it is likely a new Russian Federation Eurobond might be issued in 2003. The findings re-affirm fiscal fundamentals remain supportive for Russian financial assets.

- **The year-to-date actual budget execution has been solid: significant overall and primary surpluses have been preserved and expenditure targets met. In the first half of 2002, the overall budget surplus reached 2.9% of GDP, the primary surplus 5.3% of GDP (excluding the social tax, 2.1% and 4.5% respectively). We expect the full-year (cash-based, IMF methodology) overall budget surplus at 2% of GDP and the primary surplus at 5% of GDP.**

- **While actual budget performance has been solid, there has been some revenue slippage compared to monthly targets and some additional expenditures. This is mainly a result of poor monthly "target" planning, new tax reforms, lower first-half oil prices and budget problems in selected regions, and not indicative of changing underlying economic trends. Several of these factors are likely to be reversed in the second half of the year. Importantly, the Ministry of Finance is also sensitive to the approaching electoral-political cycle and is likely keen to de-emphasise available funds.**

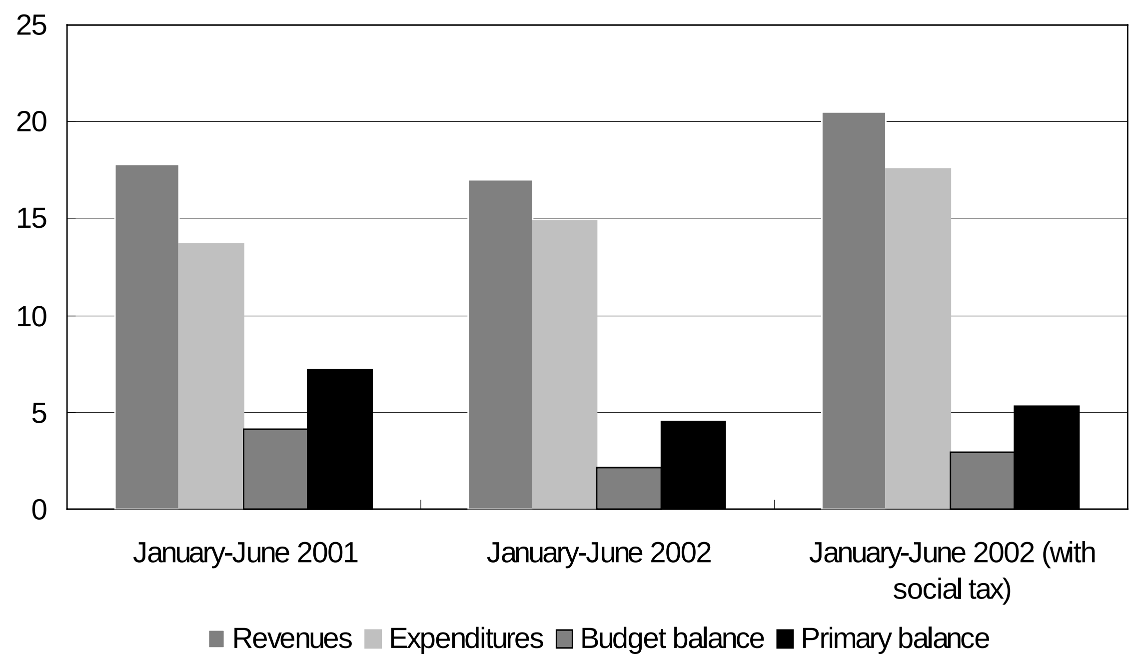
- **Even a significantly lower-than-expected 2002 financial reserve, as well as refraining from both 2002 and 2003 new Eurobonds, still implies Russia would manageably handle overall 2003 financing.**

- **Over the next year and going into this autumn's budget debate, the Ministry of Finance will - especially in the context of an approaching electoral cycle - opt for fiscal caution and conservatism. One element of this will be to not rule out a relatively small new Eurobond in 2003, but at the same time advertise it will seek to manage budget financing without it. We would nevertheless expect the Russian Federation to still issue a relatively small Eurobond in 2003.**

1. Actual federal budget execution 2002

In terms of current budget performance, all data indicates a continued solid outcome. In the first six months of the year, (cash-based, IMF methodology) the overall budget surplus reached 2.9% of GDP and the primary surplus 5.3% of GDP. Even if excluding the so-called unified social tax (ESN), the overall surplus was 2.1% and 4.5% of GDP respectively. The graph below compares the first half of 2002 with the corresponding period last year. In terms of actual roubles, the overall budget surplus, on a commitment-financing basis (counting all budget assignments made, even those assigned but not actually spent), the overall budget surplus was RUB 77.1 bn in the January-June period 2002. Even on this measure, the first-half budget surplus was 1.6% of GDP, basically identical to the originally budgeted full-year surplus of 1.63% of GDP. Recently, the Ministry of Finance has revised the full-year budgeted surplus from 1.63% to 0.77% of GDP (0.53% if assuming so-called conditional expenditures will be met, in which case the surplus would equal RUB 58.3 bn). However, based on the actual first-half outcome and likely trends in the second half, we believe actual budget performance will most likely exceed this revised Ministry of Finance estimate (more on this below). Including the ESN tax and on IMF methodology, the first-half surplus was RUB 139 bn and excluding the ESN tax and on IMF methodology, it was RUB 101 bn. Furthermore, in general the regional budget situation is not bad (although in a sub-group of regions there are persistent problems, also more on this below). In the January-May period (the period for which we have data), the total regional budget surplus was 1.4% of GDP, and the number of regions with a deficit was a mere 14, out of 89.

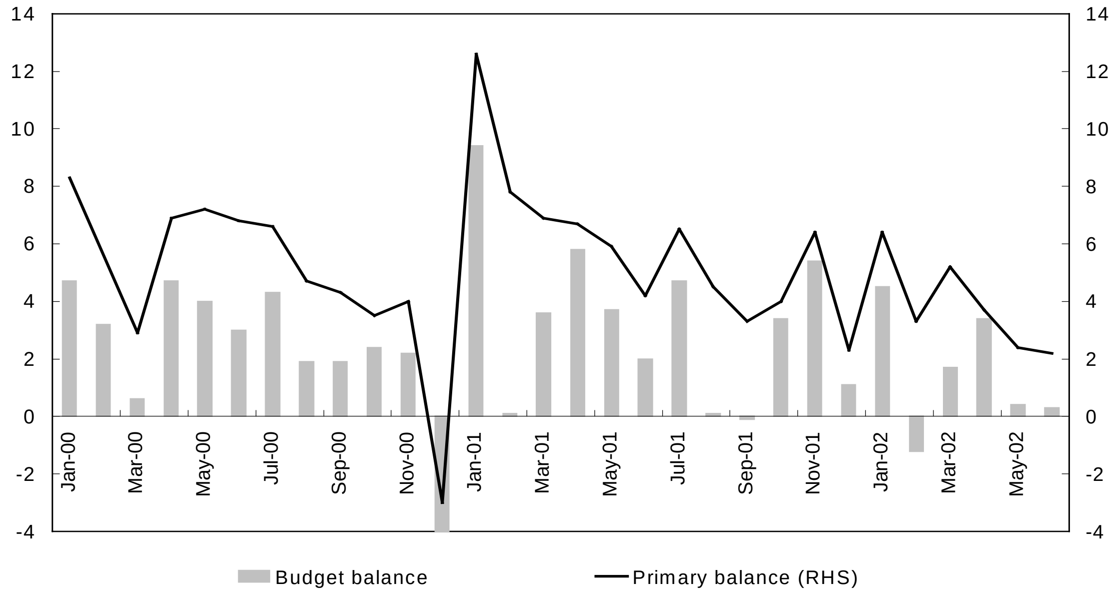
Russia: Federal Budget Execution, January – June 2002 (% of GDP)



Source: Citigroup, the EEG-the Ministry of Finance, as per IMF methodology.

The graph below outlines monthly data on IMF methodology budget surpluses. This data series should only be taken as indicative, because monthly GDP is not formally published and represent informal estimates. Nevertheless, from abnormally high monthly surpluses, it is clear the 2002 budget has managed to maintain decent surpluses in an environment where fiscal deficits in transition economies have increased sharply (see e.g. Central Europe).

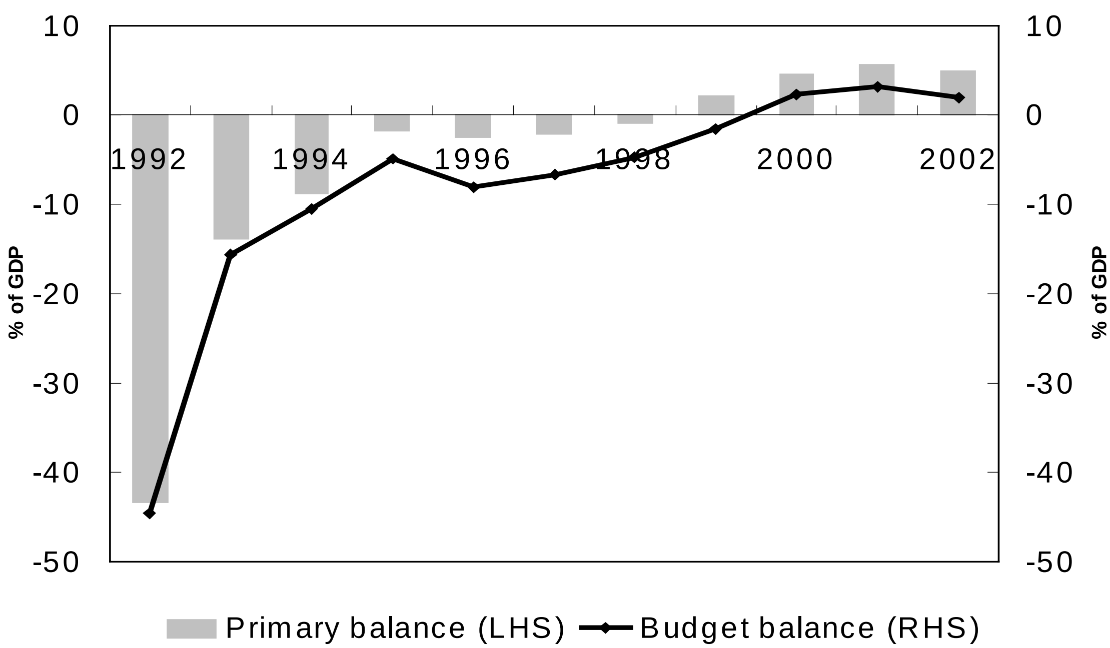
Russia: Federal Budget Execution, 2000 – 2002 (monthly, % of GDP, IMF meth.)



Source: Citigroup, the EEG-the Ministry of Finance.

It is also vital to consider the strategic fiscal policy background to above short-term fiscal outcomes. As noted, we expect – and this estimate is supported by the first-half outcomes and reasonable fiscal expectations for the second half – a full-year 2002 budget surplus at 2% of GDP and a primary surplus of 5% of GDP. This path is ultimately supported by the policy consensus behind Russia's dramatic fiscal turnaround over the last four years remain in place, as the graph below illustrates.

Russia: The Fiscal Turnaround, 1992 - 2002



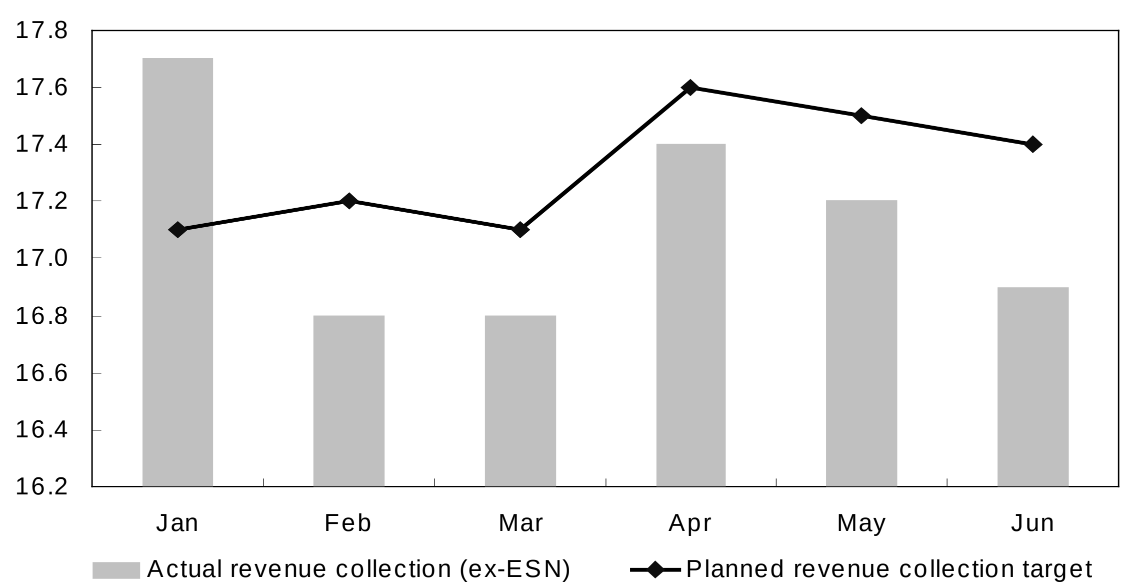
Source: Citigroup, the Ministry of Finance.

2. 2002 revenue slippage compared to monthly targets

While actual budget execution has remained solid, economic policy officials have indicated repeatedly over the last months that some revenue slippage has taken place in the first half of this year. **We stress that this revenue slippage is said to occur despite the overall budget parameters being essentially on track: as noted above, even on a commitment-financing basis, the first half budget surplus was 1.6% of GDP, same as the annual budgeted surplus originally included in the 2002 budget**. It is important when assessing this situation to stress that the mentioned slippage is <u>in relation to monthly planned targets</u>. At the same time, there have been some additional expenditures this year (more on this below), which has recently led the Ministry of Finance to revise the previous budgeted full-year budget surplus estimate from 1.63% of GDP to 0.77% of GDP (0.53% if assuming so-called conditional expenditures will be met). According to the Ministry of Finance, the reasons behind their revision of the 2002 expected budget surplus are tax reform-specific and regional, in particular effects from the new corporate profit tax and VAT rules and higher expenditures from support to selected regions with budget arrears problems. However, even so, the now-revised 2002 budget surplus appears highly conservative and it is hard to how actual budget performance would not exceed this.

To begin with, <u>overall</u> fiscal revenue collection is doing fine. In the first half of the year, <u>overall</u> fiscal revenue collection was above plan, at 101.3%. It is in sub-dividing the collection data the "under-performance relative to plan" emerges. The overall over-performance is mainly due to strong collection of the unified social tax (the ESN) and Property Ministry revenues. Taxes collected by the Ministry for Tax, on the other hand, has under-performed, in the first half of the year, collection here was at 93.7% of plan. The ESN tax collection was on the other hand some 128.1% of plan, the Property Ministry revenue collection 122.7% of plan, and Customs Committee collection 102.3% of plan. Also, the expenditure side is more or less being met – the plan for non-interest expenditures were met by 99% in the first half of the year.

Russia: Revenue Collection Versus Plan (monthly, % of GDP, ex – ESN)

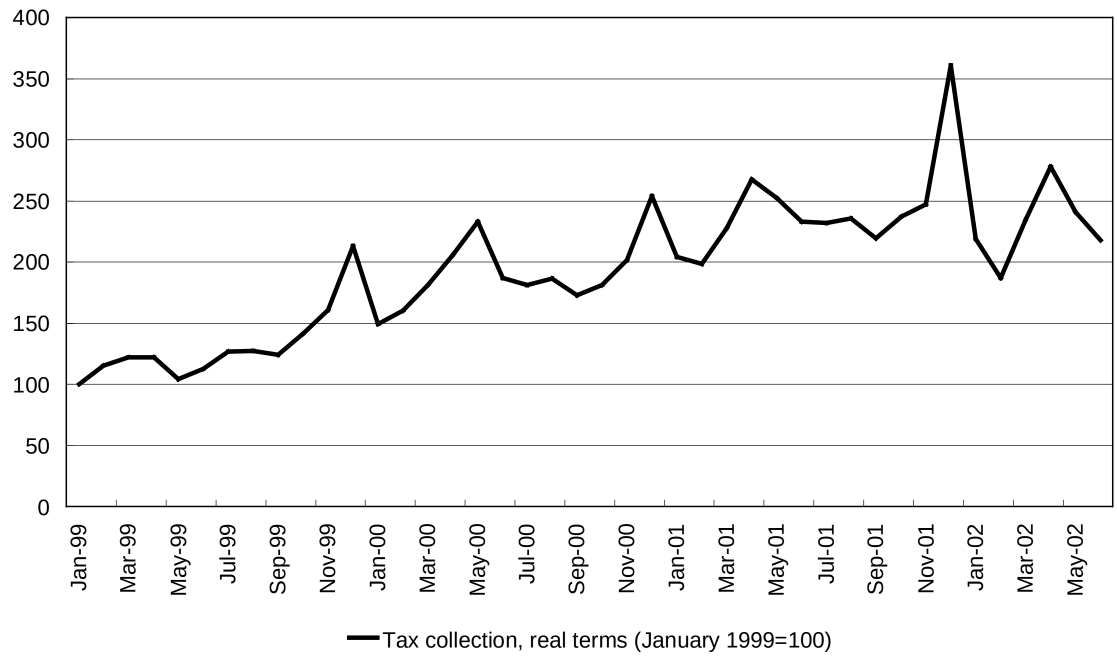


Source: Citigroup, the EEG-the Ministry of Finance.

Nevertheless, while the fiscal revenues collected by the Tax Ministry appears to have slipped compared to planned targets, in real terms Tax Ministry collection has remained high. The graph below outlines the monthly Tax Ministry fiscal revenue collection in real terms

(January 1999=100). In real terms, Tax Ministry collection in the first half of 2002 is on average near identical with first half 2001.

Russia: Tax Ministry Revenue Collection (real terms, January 1999=100)



Source: Citigroup, the IET.

In our analysis, the main reasons for the "under-performance relative to plan" by the Tax Ministry are poorly set monthly planned targets, a lower average oil price in the first half than what was budgeted annually, and consequences/digestion problems with new tax reforms, primarily the new profit tax. Regarding the oil price, the average Urals oil price was some 21.7 dollars per barrel in the first six months of this year, compared to the 23.5 dollars with which the revenue side of the 2002 budget calculated. Per the data available to us on actual oil export contract prices (non-CIS and CIS), the January-April average actual contract price was some 128 dollars per ton, compared to 155 dollars per ton in the same period last year. More importantly, because of low oil prices early in the year (in January, the Urals oil price averaged 18.5 dollars per barrel), the oil export tariff has been very low on average in the first six months of this year, as this is set with a two-month lag to actual oil price developments. In the January-June 2002 period, the average oil export tariff was 12.9 dollars per ton, whereas in the corresponding period 2001 it was 20 dollars per ton. The oil export tariff is now since recently above 20 dollars again, and higher fiscal revenues will start to kick in during the second half of this year.

Regarding tax innovations, the main change this year are new profit tax rules, as part of the liberal profit tax reform enacted last year. These appear to have created some collection problems for the federal budget (although not for regional budgets). There is a new methodology for calculating the tax base (now many previously forbidden deductions are allowed e.g.), as well as the decrease of not only the overall headline profit tax, but also the federal budget share of the profit tax, from 11% to 7.5%.

What about regional fiscal problems and arrears?

As with structural reforms in general, the propagation of fiscal reforms *in the regions* will be a very important issue to deal with over the next year. Politically, this has proven a challenge in the past, and with the next electoral cycle approaching, will be no less so. Nevertheless, starting with Prime Minister Kasyanov, regional fiscal reforms, including ensuring balanced regional budgets, establishing regional financial reserves and other measures to push regional fiscal sanitation, has been put on top of the current policy agenda and the government is engaging in the mentioned initiatives.

These challenges have been highlighted recently by the growth of some regional wage and other regional budget transfer arrears. As of July 1, there was RUB 2.9 bn in these types of arrears, growing by RUB 1.2 bn in the first half of the year (most of it in June, an increase which is quite seasonal). **It is important to realize this is <u>not</u> a Russia-wide problem, and that this is not the same type of problem as the arrears issue before 1998. There are <u>no</u> federal budget wage arrears – all federal wages are being paid in full and on time**. Among the regions where wage arrears have arisen, only in 9 regions are these arrears the equivalent of over 2 weeks of pay. Out of Russia's 89 regions, in 58 there are no wage arrears at all. In the remaining regions, wage arrears are between 10-40% of one month's pay. As we have noted, in general the regional budget situation is not bad. In the January-May period, the total regional budget surplus was 1.4% of GDP, and the number of regions with a deficit was a mere 14. Not surprisingly, there is some connection between the deficit-regions and the regions with budget arrears accumulating: in the former, the problem of the latter is worse. Nevertheless, it is important to deal with, and the federal Ministry of Finance has committed to ensuring these problem regions have dealt with their arrears by this September.

Apart from the revenue considerations above, there have been additional expenditures this year, notably increased military compensation and compensation for floods, as well as the support of selected problem regions, where regional wage and other regional budget arrears have built up (see above). Regarding regional support, in the first half of the year, the federal budget paid out 62% of the annual allocation in regional transfers. In addition, the federal budget supported regions with temporary cash problems with RUB 12 bn, including RUB 5 bn in June in relation to wage and other regional budget arrears. The fact that the budget surplus even on a commitment-financing basis was identical in the first half to the originally budgeted full-year surplus of 1.63%, despite these above plan regional support spending, suggests again that full-year performance should be under control.

3. The 2002 financial reserve and 2003 financing scenarios: domestic and external borrowing strategies

<u>The 2002 financial reserve</u>

Following above issues, the Ministry of Finance has also repeatedly suggested the financial reserve is not accumulating in the way it was budgeted. Rather than the RUB 179.6 bn first suggested would be in the financial reserve as of January 1, 2003, the Ministry of Finance is expecting the financial reserve at about RUB 71 bn (this excludes the budgeted, and now most likely scrapped, new Eurobond of USD 2 bn in 2002). The Ministry of Finance has indicated the financial reserve stood at RUB 38-40 bn as of July 1. During the first quarter, the financial reserve increased to RUB 97.1 bn, and the difference between this and the RUB 38-40 bn on July 1 <u>has mainly been used for debt management purposes, which has decreased the stock of debt and will serve to decrease future debt service</u>.

The financial reserve is likely to grow further in the second half of this year, as higher oil-related budget revenues (the oil export tariff) will kick-in. Also, the economy could well start to do increasingly better, as evidenced by the June production numbers. The new tax rules, particularly the profit tax innovations, which have created tax base problems in the first half, may create less problems in the second half and onwards. As noted, the Ministry of Finance expects to end this year with some RUB 71 bn in the financial reserve, and on a conservative estimate, we would see it at no less than in the range of RUB 60-80 bn. While this is well below the previously expected RUB 179.6 bn, it would still imply fully manageable overall debt financing in 2003, as Russia had pencilled in various rooms for manoeuvre in any case in the 2003 financing scenarios (at a RUB 179.6 bn financial reserve, 2003 financing was well "over-financed") – see more on this below.

In the face of a still solid fiscal performance and large overall budget surpluses (see above), there could be reasons to believe the size of the financial reserve may be underestimated to some extent. For example, as of January 1, the financial reserve was at RUB 88.8 bn, and during the first six months of this year, the overall budget surplus – even counting all designated but not yet actually spent budget assignments – was RUB 77.1 bn, whereas the Ministry of Finance estimate the financial reserve only at RUB 38-40 bn as of July 1. In any case, we understand that most of the funds spent from the financial reserve in the first half of this year has gone towards paying down on the debt stock and debt management, thus it is basically positive.

The dynamics behind various comments from officials regarding the financial reserve could by governed by political economy. Essentially, the Ministry of Finance could be keen to downplay the extent of funds in the "financial reserve" for political reasons as well as exhibiting caution in other fiscally related questions, going towards this autumn's budget debate and more importantly the approaching election season (2003-2004, Q1). This could be one contributing reason why there have been suggestions of "shortfalls" in the accumulation of the financial reserve, whereas the actual fiscal performance remains solid.

Apart from the approaching electoral season, there is a movement afoot in the Duma to press for clearer, legislated rules for the financial reserve. We would support as market-positive a move towards a formally legislated and transparent stabilization fund, and proposals along this line have been prepared for some time by Yegor Gaidar's Institute for the Economy In Transition. However, the government may be concerned that as part of the 2003 budget debate, and with the approaching electoral season in mind, some Duma forces may be tempted to push for a less-than-optimal legislated financial reserve/stabilization fund, perhaps making the financial reserve more at the discretion or influence of the Duma than by the government. As Russia approaches the formal debt service peak next year, the government does quite likely not welcome this. Nevertheless, if legislation for a proper, transparent and internationally comparable stabilization fund was to be supported by a majority, we feel this is the right way to go, and over the long-term, the government would benefit from transparent rules.

The 2003 domestic debt program

The government has approved a 2003-2005 domestic debt program, which represents a phased increase in net issuance, from about RUB 40 bn in 2003 and 2004, to RUB 45.4 bn in 2005. The domestic borrowing program envisages auctioning monthly some RUB 12-13 bn, and expects a daily turnover on the market of some RUB 1-1.5 bn. The Ministry of Finance is not looking to specifically attract foreign investors to the domestic debt market. For next year, the Ministry of Finance is looking at short-term bond rates at 14-15% and long-term at 16-19%, thus positive real interests, as the government's inflation expectations are 10-12% for next year. These domestic debt plans are still quite conservative, especially in the context of the multi-annual budget plan for the 2003-2005 period, which includes not only preserved overall budget surpluses, but rising such surpluses and falling non-interest expenditures. There is a substantial reserve for also increasing net domestic debt issuance this year – in the first six months of this year, net new issuance was a mere RUB 8.8 bn. **The ambition to re-develop domestic debt markets is primarily a financial market policy (to enlarge the arsenal of monetary policy instruments, and also as preparation for the accelerating pension reforms), rather than driven by fiscal requirements**.

Russia: The Domestic Debt Program 2003: Issuance Structure (draft)	RUB bn, planned issuance
Shorter-term T-bills (GKOs)	55
Longer-term rouble bonds (OFZ)	86
GSO	10
OGNZ	15
Other savings/population bonds	4

Source: Ministry of Finance, SSSB. GSO, OGNZs – various types of state savings bonds, with GSO being a new instrument in relation to pension reforms.

The 2003 external borrowing program – expect a new Eurobond

Returning to the question of external borrowing in 2002-2003, as per our previous information, it is most likely Russia will refrain from issuing a new Eurobond in 2002. The idea has instead been to issue a new Eurobond, of up to USD 1 bn, preferably a 10-year but no shorter than a 5-year, in 2003. However, recently Deputy Prime Minister/Minister of Finance Kudrin announced the Ministry of Finance is looking into *possibilities* of avoiding issuing a new Eurobond even in 2003, relying instead on the budget surplus, domestic debt, privatization revenues and precious metals sales.

Under reasonable assumptions, Russia could indeed feasibly manage without issuing a Eurobond, as the table below outlines. We have replaced the planned USD 1 bn Eurobond with the equivalent increase in net domestic debt issuance, and increased somewhat privatization and precious metals sales revenues, as suggested by the Ministry of Finance. Assuming the external debt amortization schedule is as formally scheduled (which is likely a conservative assumption, given ongoing active debt management) and the very low budgeted bilateral/multilateral borrowings, as well as a financial reserve of only RUB 71 bn, overall financing is basically balanced.

Russia: The 2003 Budget And Overall Financing (in a "no Eurobond, lower financial reserve"-scenario), USD bn	The draft 2003 budget
Budget surplus	3.1
Net domestic debt issuance	2.2
External debt amortization	-10.8
Gap:	**-5.5**
Financing:	
Funds transferred from 2002, on January 1 2003	2.1
Privatization, precious metals sales	2.6
World Bank, EBRD	0
IMF	0
Bilateral borrowing, tied credits	0.7
New Eurobond issuance	0
Difference:	**-0.1**

Source: Ministry of Finance, SSSB. Net domestic debt issuance is assumed as per the draft domestic debt program for 2003 plus the equivalent of a USD 1 bn Eurobond. Estimates for privatization revenues and precious metals sales have been increased from RUB 60 bn to RUB 90 bn.

No final decision has yet been taken regarding cancelling the 2003 planned Eurobond, but *the mere study* of such a scenario in the Ministry of Finance again emphasises the nature of Russia's conservative debt management. Note though that the Ministry of Finance is not seeking to *a priori* rule out a 2003 Eurobond, rather they are interested in signaling a commitment to seek to avoid it if possible. **This approach should be seen in the context of an understandable and encouraging ambition not to let the approaching electoral-political cycle negatively impact the fiscal achievements over the last years**[1]. The Ministry of Finance

[1] Interestingly, President Putin has recently publicly emphasized the need for Russia to commit to not only balanced budgets, but

will be very interested in maintaining discipline even through the election season (2003-first quarter 2004), and might therefore want to play down the access to markets and not "advertise" the availability of funds. As with the above reasoning of the financial reserve, this understandable aim should nevertheless not be an argument to not introduce a more transparent "financial reserve", through legislating a so-called stabilization fund – as long as such legislation would not be constructed in such as way so that the fund would be "hostage " to political trends in the Duma.

In these times of market turmoil, this entrenched policy stance should serve Russia well. The underlying aim is to continue with a persistent decrease in external debt exposure (which has collapsed over the last years, and <u>total</u> debt should be below 40% of GDP end-2002) and decrease reliance on external debt markets, while gradually as this takes place (alongside continued prudent budget policy), re-develop a viable domestic debt market for monetary policy purposes. Nevertheless, 2003 is some time off, and the budget approval process will play out over this autumn. Russia could of course still decide to enter international markets in 2003.

Our assessment is that on balance, despite the latest comments from the Ministry of Finance, it is likely that Russia will issue a new, relatively small Eurobond in 2003 (USD 1-2 bn), if not for financing reasons, *than for technical reasons*. This assessment is based on acknowledging the solid underlying debt dynamics (which imply that in net terms, the stock of debt, even the stock of internationally traded Russian sovereign bonds/debt paper, would continue to shrink) and likely benefits from renewing private sector borrowing guidance.

On the first point, it is important to understand that, quite probably unprecedented for a leading emerging market, Russia has not issued a (non-debt exchange related) Eurobond or re-financed in the Eurobond or other international bond markets since June 1998, over four years ago, relying instead mainly on substantial budget surpluses. In addition, Russia has borrowed very little from bilateral and multilateral sources (including zero from the IMF since 1999), as well as fully met scheduled debt service, including that to the Paris Club. In combination with active debt management, these developments have cut the stock of external debt very significantly over the last years. Looking at the stock of internationally traded Russian sovereign bonds/debt paper, it is clear that over the present and coming fiscal cycle, Russia is following a very conservative policy.

Even if a relatively small Eurobond is issued in 2003, the <u>net</u> decrease in the stock of <u>internationally traded Russian sovereign bonds/debt paper</u> will be substantial. If we take the 2001-2003 period, the equivalent of over USD 6 bn will mature (this includes the Minfin 4 and three Russian Federation Eurobonds, of which the USD 1 bn Eurobond issued in 1996 matured in 2001). Thus, looking over the 2001-2003 period, even a relatively small new Eurobond issue in 2003 would still imply a very significant decrease in the stock of internationally traded Russian sovereign bonds/debt paper[2].

On the second point, it is clear that since the return of the Russian non-sovereign, corporate

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continued overall budget surpluses. The government has also over the last month, in connection with finalizing the 2003 budget, stepped up efforts at communicating to regional authorities the need to press on with regional fiscal reform and enhanced regional fiscal transparency. The coming 2003 budget debate will be one testing ground for the ambition to retain achieved fiscal discipline. Recall the 2003 budget will be submitted to the Duma by August 26, and the full Duma returns for the autumn session in mid-September. For an excellent analysis of the importance of retaining the achieved fiscal discipline even in the context of the elelctoral-political cycle, see E. Gaidar, *Pereotsenka urovnya dostignutoi finansovoi stabilnosti mne kazhetsya ochen seryezhym riskom*, July 8, 2002, mimeo.

[2] In this context, it is important to also mention the so-called FTO and IIB/IBEC debt exchanges. While these exchanges will result in additional 2010s and 2030s Russian Federation Eurobonds, these are operations within the overall stock internationally traded Russian bonds/debt paper. According to the Ministry of Finance, they expect at most some USD 1.8 bn in new 2010s and 2030s as a result of the FTO debt exchange, and at most some USD 1.1 bn as a result of the IIB/IBEC debt exchange. However, while these exchanges will increase the outstanding stock of the individual bonds 2010 and 2030, because of the haircut involved in the financial terms as well as the reconciliation process, these exchanges are in fact decreasing the overall, nominal stock of debt.

and banking sector to the international Eurobond market last year, the demand for international borrowing in the shape of Eurobonds has grown in the Russian private sector. While the rouble corporate bond market is developing quite rapidly and presenting additional financing options for Russia's private sector, it is still the case that there are few alternatives to the international bond market if a Russian private sector entity is looking for long-term borrowing, in excess of 5 years. As the Russian corporate sector is engaged in a quite broad restructuring process, and as the time horizon of corporates has been stretched out, the importance of medium- to long-term financing has been emphasized. Indeed, the mere fact that the rouble corporate bond market is developing so strongly is a reflection of the lack of a functioning bank credit system. Nevertheless, the rouble corporate bond market is not yet ready for large-scale, long-term borrowing of the kind that international bond markets provide. It is in this context a new, even if relatively small, Russian Federation Eurobond, a new benchmark, could potentially be quite useful for the private sector in guiding private sector borrowing costs.