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Russia:
The Multiple Aims Of Russia's Fiscal Policy - Why The 2002 Budget Is Encouraging And Why 2003 Is Manageable

Today, August 21, the Russian government has discussed and approved the 2002 budget. It will be submitted to the Duma by August 26. In addition, the government has discussed a range of fiscal and macroeconomic issues: the macroeconomic outlook for 2002 as well as macroeconomic scenario estimates for 2003-2004 and the 2003-2004 prospective fiscal plan. This note updates and looks again into the 2002 budget in the form the government is likely to approve it, and the fiscal policy context it is part of.

- **Given the multiple aims of the 2002-2004 fiscal policy path, the outlined 2002 budget and the overall fiscal thinking it is part of should be seen as encouraging, realistic and reasonable**. The 2002 budget and the 2003-2004 prospective fiscal policy concept should be considered as market-supportive for both the equity and the fixed income market, as it will continue to promote a broadening of the tax base, while also ensuring 2002 and 2003 debt payments are more than manageable and comprehensive structural reforms are financed.

- **The changes in the 2002 budget since our previous report have further strengthened the case for Russian bonds in the sense the manageability of 2002-2003 debt payments is even clearer**. Criticism regarding the *de facto* rather than formal nature of the "stabilization fund" is largely misplaced, and in our assessment the Ministry of Finance's mechanism is appropriate given Russia's immediate and near-term debt financing needs.

- **The fact that the 2002 budget will be the first Russian budget to formally be approved with an overall budget surplus (i.e. not just a primary surplus) is also important**. This will set the tone for coming couple of years as well; leading to a formalization of budget surpluses already recorded in practice in 2000-2001. **Traditionally a cumbersome and time-consuming political process, a declared ambition to make the budget approval through the Duma smoother could yield notable benefits in terms of policy efficiency**. The idea is to engage Duma forces in extensive budget consultations already ahead of the first reading, seeking to promote less time-consuming succession Duma readings. This model has been used with some success already, for example with regards to the legal reform package.

- **Finally, considering the points above, it is clear the 2002 budget and the medium-term fiscal policy outline it is part of should be beneficial for Russian debt management**. First, the fiscal policy path awards significant flexibility to debt management. Secondly, it is beneficial for new market access over the coming couple of years, as it should support a further lowering of Russia's cost of borrowing.

1. The 2002 budget – principles and parameters[1]

The principles

The 2002 budget includes four main principles, reflecting the multiple aims of Russian fiscal policy at this stage of economic reforms. These principle aims are: *implementation of the tax reforms approved this year* (which will lower the overall tax burden by an estimated 1.8% of GDP)[2], *the financing of comprehensive structural reforms* (e.g. pension reforms, army reforms, legal reforms)[3], *financing full scheduled debt payments*, and *containing non-interest expenditures*. In addition, one could add the issue of "fiscal sterilization" – with effective monetary policy instruments still largely lacking, federal budget cash surpluses have over the last year to year-and-a-half been perhaps the main source (together with Central Bank deposits) of "sterilizing" rouble money supply created by strong dollar inflows[4].

The point about **non-interest expenditures** is important. The establishment of a path of non-interest expenditures for the next three years which would both suffice to finance structural reforms and meet the criteria of restraining any strong pro-cyclical growth tendency of non-interest expenditures was one of the initial principles of forming the budget parameters. Earlier in the summer, Russian authorities were looking at a path of non-interest expenditures as follows: 11.91% in 2002, 11.62% in 2003, and 11.47% in 2004 (all in percentages of GDP). In the current 2002 budget draft, however, the 2002 non-interest expenditures stand at about 12.48% of GDP. Nevertheless, we feel this would still meet the above double-criteria for non-interest expenditures, because GDP estimates underlying the 2002 budget draft is too conservative (see more on this below).[5] In addition, it should be noted some part of the non-interest expenditures are with regards to expenditure restructuring which ultimately will result in less expenditures.

Furthermore, the 2002 budget is decidedly **forward-looking**, in the focus it gives not only to the implementation of tax reforms and financing of structural reforms, but also in the debt financing issues addressed. It is indicative that the government will discuss the 2002 draft budget alongside several companion policy documents, most notably a medium-term prospective fiscal policy plan (for 2002-2004) as well as the medium-term macroeconomic framework underlying the fiscal

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[1] This report is a companion note to *Russia: 2002-2003 Full Debt Payments And Financing Gaps – More Than Manageable*, EC475, Niclas Sundstrom, June 21, 2001. For the current report, we rely on the following material: *O federalnom byudzhete na 2002 god – Predvaritelny proekt*, the Ministry of Finance, August 2001, *Proekt Osnovnykh napravleny byudzhetnoy I nalogovoy politik na 2002 god I srednesrochnuyo perspektivyi*, the Ministry of Finance, August 2001, *Osnovnye podkhody k formirovanie proektirovok osnovnykh kharakteristik federalnovo byudzheta na 2002 god I na period do 2004 goda*, the Russian government, June 2001, *Ob itogakh ispolneniya federalnovo byudzheta za 2000 god I zadachakh organov finansovoy sistemy Rossiiskoi Federatsii na 2001 god I na srednesrochnuyo perspektivy*, Deputy Prime Minister/Minister of Finance Kudrin, April 2001, *Programma razvitia byudzhetnovo federalizma v Rossisskoi Federatsii na period do 2005 god*, the Ministry of Finance, 2001.

[2] These key tax reforms concerned are as follows: the lowering of the profit tax to 24% (from 35%) and the simultaneous abolishment of profit tax exemptions, the introduction of a new and unified natural resource tax, new excises rules and rates, the abolishment of VAT exemption on residential housing construction and, as part of the tax reforms to be pursued in the autumn, a lower overall unified social tax and strengthening further the regressive element of the unified social tax.

[3] In addition, the next 6-12 months will see an increasing effort at reforming and restructuring the whole state employment sector bureaucracy (i.e. not just the army). On August 20, it was announced President Putin has signed a resolution ordering the creation of a Commission For Reforming The State Service Of The Russian Federation, and appointed Prime Minister Kasyanov as its chairman. In addition, President Putin in the same resolution created an inter-agency working group, led by First Deputy Chief of Staff of the presidential administration, Dmitri Medvedev, which will be involved in the technical preparation of the specific reform initiatives in this field.

[4] See e.g. the interview with Anton G. Siluanov, Head of the Macroeconomic Policy and Banking Activity Department of the Ministry of Finance, in *Rossiiskaya Gazeta*, August 21, 2001 ("Eto sladkoe slovo 'profitsit').

[5] Encouragingly, the policy focus in terms of fiscal expenditures lies not only with the level per se, but with expenditure restructuring. This is reflected in the expenditure assignments in the 2002 draft budget, for example with regards to army reforms and legal reforms. Also, the whole bloc of special federal budget programs have been cut from 133 to 48, and streamlined, which although in expenditure terms have not meant a decrease, it represents an expenditure restructuring. In addition, it is reflected in the above footnote. As has been established in both past and recent research on the matter, for sustainable fiscal expenditure reforms, the expenditure side has to be restructured – a mechanical lowering of the absolute level might not be effective per se. See e.g. Gupta, Sanjeev et al, "Transition Economies: How Appropriate Is The Size and Scope of Government", *IMF Working Paper*, May 2001.

plan. Also, the focus on continuing to encourage regional fiscal reform and sanitation will be expressed through the discussion on measures to unify regional budget procedures and classification with the federal system.

In addition, **the government and the Kremlin are looking to change the nature of the political budget approval process**. Essentially, the idea is to start shortening the usually very cumbersome and time-consuming budget approval process through the Duma, by pursuing detailed and intense consultations with the Duma already ahead of the first reading. This is what some government officials have called *nulevoe chtenie*, or "reading zero".

The parameters

In the draft 2002 budget, total **federal budget revenues** amount to RUB 1995.4 bn, or some 18.82% of GDP. Importantly, this total federal revenue figure includes the intake from the unified social tax (the ESN), related to the Pension Fund. Excluding the ESN, federal revenues amount to RUB 1737 bn, or about 16.4% of GDP. The tax collection rate is expected to climb to 90.6% of GDP. For comparison, it is estimated to reach 88.8% in 2001, up from 86.7% in 2002. On the expenditure side, total **federal expenditures** (including expenditures financed by the ESN tax) amount to RUB 1868.7 bn, or about 17.63% of GDP. Excluding the Pension Fund expenditures, the figure is RUB 1579.2 bn, or 14.9% of GDP. Non-interest expenditures, excluding ESN-related expenditures, amount to about RUB 1322 bn, or 12.48% of GDP. In total, the federal budget is thus drafted with an overall surplus of RUB 126.5 bn, or some 1.19% of GDP[6].

The main **macroeconomic assumptions** underlying the 2002 budget includes, as outlined in the table below, a nominal GDP estimate of RUB 10600 bn, CPI at 10-13% and real GDP growth at 4.3%. The exchange rate assumption is 31.5 roubles per dollar on average. In addition, it is expected industrial production will grow by 4% and investments will grow to amount to slightly above 18% of GDP, while the current account surplus will moderate to about USD 30 bn.

Russia: Budgets - Outcomes, Assumptions, Projections, 1999-2002

	1999 BL	1999 Actual	2000 BL	2000 Actual	2001 BL	2002 Budget Projection
Nominal GDP, RUB bn	4000	4757		7063	7750	10600
Real GDP growth, %		5.4	5.5	8.2	4	4.3
Inflation, %	30	36.6	18	20.2	12	10-13
RUB/USD, average	21.5	24.8	32	28.1	30	31.5
Urals, $ per barrel, Average contract prices			16.4	24.7	21.2	22/17
Total revenues, RUB bn	473.7	597.6	792.2	1127.6	1193.5	1995.4
Of which:						
Tax revenues	399.9	505	675	965.5	1117.9	1626.3
Non-tax revenues	33	37.4	61.6	69.6	61.7	97.7
Budgetary funds	41.6	55.2	60.6	92.5	13.9	13.9
Unified social tax						257.5
Total expenditures, RUB bn	575	662.8	855.1	953.9	1193.5	1868.7
Interest payments	166.8	162.6	220.1	172.2	242.7	289.7
Non-interest expenditures		500.2	635	781.7	950.8	1579.2
Budget balance, + deficit, - surplus	101.4	65.2	57.9	-173.7	0	-126.5
Domestic financing	55.9	57.9	39.1	-81.7	11.5	
Foreign financing	45.5	7.3	18.8	-92	-11.5	
Primary balance, - surplus		-234.8	-162.2	-345.9	-242.7	

Source: The Ministry of Finance, EEG, The Ministry for Economic Development and Trade, SSSB. BL=Budget Law.

6 These are the figures from today's approved budget document. They had changed only marginally from what was discussed over the last week.

Regarding **the role of the oil price** in the drafting of the 2002 budget, it is important to recognize the change in approach from previous years, as we have explained in a previous report[7]. Essentially, the Russian government has started from the side of non-interest expenditures, in order to establish a level at which structural reforms can be financed over the next three-year cycle, but also a path of non-interest expenditures which constrain any strong tendency of pro-cyclical movements. Once this path was set, the revenue side has been constructed, with quite conservative assumptions. The result is that the 2002 budget is balanced even at an oil price of 17-18 Urals per barrel on average for 2002 in terms of <u>contract</u> prices. However, an oil price of 17 dollars per barrel for Urals in average <u>contract</u> prices is not what the Ministry of Finance *actually expects* will occur in 2002. Rather, the expectation is for an average Urals <u>contract</u> price of 22 dollars per barrel.

As per Ministry of Finance calculations, at this oil price, the budget will result in an overall surplus of RUB 128.1 bn (taking into account a one-off expenditure increase compared to the balanced budget case). In other words, the draft 2002 budget is in effect a balanced budget if oil is at 17-18 dollars per barrel in Urals <u>contract</u> prices, and in surplus with oil anywhere about that level. Put differently, expenditures have been drafted using the average Urals <u>contract</u> price of 17-18, whereas revenues have been drafted on the expectation of an average Urals <u>contract</u> price of 22. **As stressed by Deputy Prime Minister/Minister of Finance Kudrin, this implies that even under a very pessimistic oil price scenario (which Urals at an average 17-18 would have to be counted as), the budget will still be a no-deficit budget.**

As a sign of the continued broadening of the tax base as economic growth is expected to continue and tax reforms to be implemented, **profit tax and VAT revenues are expected to make up nearly 44% of all tax revenues in 2002**. On the expenditure side (excluding ESN-related expenditures), the single largest category is debt service, national defense and regional transfers. In terms of changes in the relative share of total expenditures (excluding ESN-related expenditures), however, an interesting picture emerges. **Expenditures on army reform will go from about 0.4% of expenditures to around 2.9%, and expenditures on the legal system (including legal reforms) will go from approximately 0.9% to 1.2%**. Expenditures on transport and infrastructure (reflecting natural monopoly and municipal reforms) will go from about 2.6% to 3.6%. At the same time, spending on national defense will decrease from 18% of expenditures to 17.4%, and debt service goes down from 20.1% to 18%, approximately.

In its *entirety*, the 2002 budget must be labeled realistic. It does not include IMF borrowing, it includes full scheduled debt payments, it is balanced even at an average Urals contract price of 17 dollars per barrel, and it is forward-looking in the sense of preparing for 2003. In terms of the main underlying parameters, one observation – as with the 2001 budget e.g. – is in our view that growth estimates are too conservative and the inflation assumption too optimistic. As a matter of budget politics, however, this may not be a bad tool, obviously. In our estimate, nominal rouble GDP in 2002 will be around RUB 11100 bn compared to the budget's RUB 10600 bn, which will decrease the share of non-interest expenditures of GDP, but increase the budget revenues, as the inflation assumption, we believe, is too optimistic. We are looking for an inflation in 2002 at around 15% compared to the budget's 10-13%. A higher-than-budgeted inflation outcome tends to aid revenues, as expenditures are fixed but nominal revenues are not. Another side of this analysis is that we expect real GDP growth to be higher than the 4.3% in the budget, perhaps closer to 5%. In particular, we would expect GDP growth to continue to be driven by investment growth and domestic demand. Notably, we would expect investments, as a share of GDP to reach some 21% of GDP in 2002, compared to the 18.1% assumed in the macroeconomic projections underlying the budget.

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[7] See *Russia: 2002-2003 Full Debt Payments And Financing Gaps – More Than Manageable*, EC475, Niclas Sundstrom, June 21, 2001.

2. End of "budget trading" with the Duma?

As noted above, a leading idea in terms of the political part of the budget process is to avoid time-consuming "budget trading" with the Duma. **The wish to move to a process which is not only smoother but also where the government is firmer in defending its submitted budget and resists potential Duma calls for e.g. spending increases was indeed specifically expressed in President Putin's annual budget address earlier this year**. Following this, the government has repeatedly signaled it plans to avoid the usual "budget trading" with the Duma, and the above mentioned attempt at significant consultations ahead of the first reading could be one method of making the budget approval more efficient.

Nevertheless, this does not mean there will not be some high-profile discussions and exchange of views with the Duma on key budget points, indeed this should still be expected. It could also be beneficial, in terms of politically anchoring and expanding on the key ideas included in the budget. The government will thus still have to be prepared to defend its budget concept. In terms of aspects likely to draw most attention from the Duma, one would mention the whole issue of **excess budget revenues** and the government's flexibility in administering those revenues. The 2002 budget rightly proposes the establishment of a de facto financial reserve, to be used for debt service and financing preparation for the later debt service peak. While some parts of the Duma may object to the control the 2002 budget awards to the government over such excess revenues (e.g. in comparison to 2001 when a compromise division between debt service and non-interest expenditures was reached), the government should have a good chance of explaining that this is necessary given the financing challenges over the next three years. One important and supporting argument in favor of the government is that the 2002 budget and the medium-term prospective fiscal plan can be expected to contribute to continued lowering of Russia's cost of borrowing, which will be clearly beneficial as new market access is attempted again in 2002-2003. Another point of discussion may become **the federal-regional revenue division**, where the current budget draft in practice probably favors the federal centre over the regions somewhat, rather than the 50/50 division prescribed by the Budget Code.

3. Debt management: strategy, flexibility and a de facto financial reserve

A specific element of the 2002 budget and of the 2002-2004 prospective fiscal policy plan is a substantial flexibility for debt management. This aspect should also be seen in the context of **the comprehensive medium-term debt management strategy** (up to 2005) prepared by the Ministry of Finance and approved in July, as well as the encouraging draft **plans to overhaul the debt management system**, a plan also driven by the Ministry of Finance and Deputy Minister of Finance Kolotukhin and his team. The program for reforming Russia's debt management system is expected to be finally submitted to the government in mid-September. There are four aspects to note regarding debt management, debt payments and the 2002-2004 fiscal policy plan:

- The 2002 budget establishes that all "excess revenues" over a balanced budget goes towards debt service, budget financing and the formation of a financial reserve. **More specifically, the estimated 2002 overall budget surplus of RUB 126.5 bn would be channeled all towards debt service (principal payments). The 2002 budget then establishes that anything above this estimated overall budget surplus goes towards debt management and budget financing. Once such needs for 2002 have been met, any further excess revenues would go towards a de facto "stabilization fund", explicitly for 2003 financing**[8].

- According to Ministry of Finance calculations, with an Urals oil price at 23.5 per barrel, some

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[8] The preliminary 2002 budget draft establishes already in the second paragraph the right of the government to use the following sources of funds for debt service and debt payments which decrease the debt of the Russian Federation: net domestic debt issuance, net sales of precious metals, international borrowing, cash balances on budget accounts. Interestingly, the 2002 budget draft also establishes that the government has the right to use debt service *savings* (arising presumably from effective debt management) for increasing the allotment of funds towards principal external debt payments.

USD 0.5-1.5 bn could be transferred into such a de facto stabilization fund. (The tables further below present from what sources such a financial reserve would in practice be formed) As announced, there will be a separate paragraph in the budget document outlining this de facto financial reserve, which in practice would most likely be a special account in the Ministry of Finance treasury system. While some Duma deputies may object to the de facto nature of this “stabilization fund”, in practice the mechanism outlined will serve exactly the main purpose any stabilization fund formally established would have had over the next three years in any case. Thus, it is fair to say that the idea of a “stabilization fund” is in practice being realized, in so far as any stabilization in Russia’s current situation would have had to be focused on ensuring financing for the 2002-2004 period, including the 2003 debt payments peak.

- **The medium-term debt management strategy (up to 2005) is based on a gradual decrease of the external debt stock and a professional, transparent and measured approach to new borrowing, in the context of working towards securing Russia’s return to international capital markets on as advantageous conditions as possible in 2002-2003**. Recall the approved 2002 budget includes a provision for new Eurobond issuance of up to USD 1.5-2 bn, following an increase in the target for possible fund raising on international markets. This will obviously depend on market conditions, and we will assume new Eurobond issuance of USD 1 bn in 2002. From a medium-term perspective up to and including 2004, the Russian government envisages borrowing about USD 1 bn per annum on average on international capital markets (in practice most of Eurobond issuance is likely to take place in 2003, and this is also our assumption in the 2003 financing table below). In addition to the policy of continued restraint on IMF borrowing, Russia’s external debt stock will thus continue to decrease. In this context, Russia has and will be utilizing an active debt management approach to smooth peak payments, avoid Paris Club restructuring and refrain from IMF borrowing. According to the draft document on medium-term fiscal policy, it is estimated total government debt would reach some USD 158.5 bn or 48.2% of GDP by the end of 2002, and represent no more than about 40% of GDP by the end of 2004[9].

- **Also, the debt management strategy contains the ambition of fully regularizing the still non-resolved Soviet-era debt categories by mid-2002, as recently confirmed by Deputy Minister of Finance Kolotukhin**. The first tranche of the FTO debt exchange and the IIB/IBEC debt exchange are targeted to be concluded before the end of this year. Deputy Minister of Finance Kolotukhin has also outlined that by mid-2002, Russia furthermore aims to have regularized remaining bilateral non-regularized Soviet-era debt, such as the Soviet debt to East Germany and Soviet bilateral debt to countries not part of the Paris Club.

4. The 2002 and 2003 debt payments and financing gaps – why it should be more than manageable

Based on preliminary 2002 budget information and the 2002-2004 prospective fiscal policy plan, we analyzed already in June this year why full debt payments over this cycle, including in 2003, appears more than manageable[10]. In the tables below, we revisit this analysis, updating with the few changes/clarifications which have taken place between June and the now approved 2002 budget. **The result is that the 2002 situation looks even more solid, which in turn should enhance the financing prospects for 2003**.

The main changes for 2002 pertain to funds transferred from 2001, international borrowing plans and precious metals sales. On international borrowing, the government-approved 2002 budget includes a provision for new borrowing on international markets at up to some USD 1.5-2 bn. In addition, there is the possibility of borrowing from international multilateral institutions (excluding the IMF from which Russia will not borrow in 2002) including mainly World Bank

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[9] Proekt Osnovnykh napravleny byudzhetnoy I nalogovoy politiki, the Ministry of Finance, 2001.

[10] See *Russia: 2002-2003 Full Debt Payments And Financing Gaps – More Than Manageable*, EC475, Niclas Sundstrom, June 21, 2001.

credits that would have to be taken into account. We estimate such possible multilateral and bilateral borrowing at USD 360 mn and USD 500 mn respectively. The net domestic debt issuance target is kept at around the equivalent of USD 300 mn, and privatization revenues at around USD 600 mn (or RUB 18 bn)[11]. Precious metals sales are now targeted at some RUB 21.1 bn for 2002. An important change is with regards to our estimate of excess funds transferred from 2001. As fiscal data has continued to be very strong through the first seven months of 2001, it is now clear the amount of funds transferred from 2001 into 2002 may be higher than our earlier estimate of RUB 80 bn. We have revised this estimate to RUB 120 bn, tracking the cash balances in federal budget accounts.

Russia: The 2002 Budget And Overall Financing, (USD bn)

Budget balance	0
Net domestic debt issuance	0.3
External debt amortization	6.8
Gap:	***6.5***
Financing:	
Funds transferred from 2001	3.8
2002 excess budget revenues	4.8
Privatization	0.6
Eurobond (up to USD 1 bn)	1
IFI	0.36
Bilateral borrowing	0.5
Precious metals	0.7
Difference:	***+5.26***

Source: SSSB, the Ministry of Finance. The balanced budget is based on Urals average 17, and RUB/USD average at 31.5.
Notes:
- In terms of funds transferred from 2001, we assume RUB 120 bn.
- We assume USD 1 bn in new Eurobond issuance, but as noted it might be higher.
- In terms of 2002 excess budget revenues we assume some RUB 150 bn, This is very conservative. The Ministry of Finance estimate of the revenue difference between an Urals average contract price of 17 and 22 is RUB 154 bn, also conservative in our view.
- The IFI money included above represent mainly World Bank structural credits, but no IMF funding.

For 2003, the assumptions are essentially unchanged. Despite the stronger performance in 2002 (see above), we assume for conservative purposes in 2003 that the equivalent of USD 3 bn gets transferred over from 2002. The 2003 assumptions below also notable includes no IFI financing – no IMF and no World Bank or EBRD financing. This is a very conservative assumption, and thus the table below has further in-build flexibility. Not only is it likely with some World Bank projects, but it is also possible that an active IMF program could be revived in 2003 – although most likely in the context of Russia continuing to in a net sense decrease the stock of IMF debt.

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***
Financing:	
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***

Source: SSSB, the Ministry of Finance. The balanced budget is based on Urals average 17, and RUB/USD average at 32.5.
Notes:
- In terms of funds transferred from 2002: we assume USD 3 bn.
- In terms of 2003 excess budget revenues, we assume some RUB 160.7 (USD 5 bn).

[11] This excludes funds generated from management of state property, such as dividends from companies and income from the rental of state property.

- Note that no IFI financing is taken into account.
- Note the above table assumes the full USD 3.5 bn of the Minfin 4, maturing in 2003, is still outstanding, which is also a very conservative assumption.