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Why Russia Is More Than An "Oil Play": Reforms, Growth, And Macroeconomic Preparedness

Given recent oil price volatility, the role of oil in the Russian economy has yet again been a focus. We will here discuss why Russia is increasingly to be seen as more than an "oil credit", and why the combination of a strong starting position, preparedness and economic reforms imply the move to a lower oil price will not threaten macroeconomic stability. On reforms, we are optimistic – we believe it is more likely than not that the mix of recent global economic and international security developments have further strengthened the internal Russian resolve to pursue the structural and institutional reforms underway.

- **The role of oil and commodities in the Russian economy is significant and it will remain so over coming years.** However, it is not static. It is changing. This process has still a far way to go, but the process is underway. The significant role of oil and commodities serves as both a target and motivator of the current economic reform drive.

- **The Russian economy is now in a radically different starting point compared to when oil prices last fell**. The key differences could be summarized under the headings: economic growth, major fiscal surplus, very high external surpluses, higher domestic confidence, structural and institutional reforms which are improving the investment climate, very different debt situation, and very different political situation.

- **A fall in the oil price to an average of 17 dollars per barrel Urals contract prices in 2002 would be manageable, both in fiscal terms and in balance of payments terms**. We estimate real GDP growth in 2002 at some 3.5%, still a growth rate consistent with manageable budget financing. Even in the low oil price scenario, Russia would post major external surpluses: some USD 35 bn in trade surplus and some USD 23 bn in a current account surplus, while the budget would be at least balanced.

- **The Kremlin and the Russian government are now operating in a very different political context compared to earlier years**. We believe the political "reserve" for additional economic policy action, should so be required, is substantial.

- **While a lower oil price environment will be manageable, it will still require active policy vigilance**. While the role of oil will be changing through above mentioned economic reforms, in the short-term the role will still be substantial. A lower oil price environment could make the policy resolve in this respect *stronger*, not weaker. In this context, it will be crucial for the government to resist any watering down of or increased spending in the 2002 budget in the remaining three Duma readings, plus it will be important to pursue all other reforms underway – e.g. the next tax reforms, pension reforms, labor reforms, corporate governance reforms. When the right time presents itself, the establishment of a formal stabilization fund will be a good policy step.

A. The oil price and the Russian economy: a significant but changing role

The role of oil and commodities in the Russian economy is significant. This can most easily be judged from the external accounts, where natural resources of various kinds make up around 65% of exports. There is also a direct fiscal link, although this is less significant than generally assumed and less significant than most comparable emerging markets (oil exporting) peers. In addition to more direct links, there are also various indirect effects from the commodity-dominated external sector to the rest of the economy, both positive and negative.

Both historically and currently, the role of oil and commodities in the Russian economy and the interaction with economic policy is *multi-faceted* and quite complex. In terms of the political economy of oil and reforms, one can make the case that, traditionally, the higher the oil price, the more difficult for economic reforms, in the sense that reform complacency sets in. If there is a commodity boom in the context of a weak institutional framework, such a boom can lead to difficult distribution conflicts[1]. Thus, one of the notable achievements of the Russian government under President Putin is that ambitious economic reforms have successfully been pursued, even under very high oil prices. A significant part of the motivation behind the current Russian economic reform strategy stems from a wish to decrease Russia's dependency on oil and natural resources. The Russian economic policy debate has over the last year been more or less focused on exactly this issue, hence the stress on structural and institutional reforms[2].

Table 1. Russia: Key Export Categories, Selected Years (% of total exports).

	1996	1998	2001E
Oil and oil products	28.7	22.4	25
Natural gas	19.4	22.4	20
Metals	21.5	24	20

Source: Schroder Salomon Smith Barney. For 2001, estimated full-year outcome given first quarter result and outlook.

Given Russia's strong macroeconomic starting position, the level of preparedness and the pursuit of economic reforms underway as well as substantial policy flexibility, a move to a lower level of oil prices will be manageable and will not represent a major threat to Russia's macroeconomic stability[3]. Even with a low oil price, Russia will post very large trade and current account surpluses, suggestive of a balance of payment with fundamental strength. The global economic slowdown will likely affect Russian external demand mainly through the price channel rather than production volumes. The indirect effects from a lower oil price on investment demand and consumption decisions we assess to be relatively muted, given the growth recovery underway, the recent broadening of economic growth and the strong level of domestic corporate and consumer confidence. In terms of economic reforms, the weaker global backdrop is likely to further strengthen the resolve rather than weaken it.

The state of domestic – corporate and household – confidence is important. It will impact on both the path of capital flows and that of domestic investments. Over the last year, there have been increasing signs of Russian capital expanding into domestic sectors (see also the comment on capital flows below). Such examples include Russian capital being invested into the Russian automotive industry, machine-building industry, food industry and agriculture. Indeed, on October 3, in a notable sign Russian corporate confidence is still strong, the holding company Interros announced a USD 300 mn investment into creating a large Russian agricultural company, with another USD 50 mn investment before the end of 2001[4]. Furthermore, it is estimated Russian households currently hold some USD 19-20 bn in cash foreign currency, which apart from a store of wealth also represents possible consumption, which could be utilized even in the face of a global economic slowdown if confidence regarding the domestic prospects remain supported[5].

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[1] For the role of the oil sector in the decline and then collapse of the Soviet economy, and a discussion of the various political economy links, see the impressive study by Vladimir Mau and Irina Starodubrovskaya, in *Velikie revolyutsii ot Kromvelya do Putina*, Vagrius, Moscow, 2001.

[2] For a recent and insightful analysis of the components in this debate, see Professor Evgeny Yasin, *Ekonomichesky rost kak tsel I kak sredstvo (o sovremennoi situatsii I perspektivakh rossiiskoi ekonomiki)*, Fond Liberalnaya missiya, 2001, mimeo.

[3] This is also the declared view of the IMF. See also the excellent research note *O proekte federalnovo byudzheta 2002 goda*, EEG-the Ministry of Finance, Moscow, September 2001, mimeo.

[4] These signs of Russian capital expanding into domestic sectors are also evident on a regional level. For example, in conversations with regional authorities, we have learned that over the last 12 month, some USD 1.5 bn have been invested in mainly the Nizhny Novgorod oblast, with the overwhelming part of such investments being Russian capital.

[5] Consumer confidence surveys indicate impressions of both current material well being and expectations for the economy over the next 12 months continue to improve, from already strong levels. In July 2001, the index for current material well being was 186% up over January 1999, and the index for the expectation for the economy over next 12 months was 77% up on the January 1999 level. See Tsentr Razvitia, *Indeks potrebitelskikh nastroeny*, continuing series. Corporate surveys indicate a similar picture of strong domestic confidence, with production expectations very strong and weak barter expectations. See IET, *Rossiisky byulleten konyunkturnykh oprosov*, continuing series.

We would argue the key fundamental risk to Russian economic growth is not oil prices *per se*, but the persistence behind and depth of the various reforms now pursued. In Russia's present situation, it is the *failure* to follow-through on deep structural reforms that could make oil a more serious risk[6]. A specific perspective on this problem in the Russian economic policy debate is what has come to be called *chaebolization*[7]. In essence, the fear is that as the initial expansion of Russian capital into domestic sectors have mostly originated in natural resource sectors, the lack of a functioning financial system could lead to the creation and ossification of large and ultimately inflexible structures controlling most of the domestic economy. In this scenario, financial intermediation for entities outside these structures is seen as difficult. While this development is probably inevitable and not really negative in the short-run, it stresses the importance of a continued push for corporate, financial, structural and institutional reforms, which all work towards improving the investment climate and promoting microeconomic restructuring. Russian economic authorities thus need to always be vigilant and push the agenda of reforms, in order to continue the process by which the role of oil and natural resources is transformed, and the Russian economy becomes progressively more broadly based. Certainly, once the right time appears, it would be a good policy step to formally establish an oil stabilization fund[8].

B. Structural reforms, continued economic growth and a broadening of the tax base

Over the last year or so, indications of a broadening of Russian economic growth are notable[9]. The leading sectors in industrial production growth are now pre-dominantly domestic sectors[10]. Domestic investment growth, which jumped nearly 18% in 2000, has continued to grow at a decent rate in 2001. The structure of investments has also changed for the better. Whereas in 2000, about half of all investments went to the energy sector, in 2001 most investments (up to 70%) is in domestic, non-energy, sectors[11]. It is now generally accepted in Russian economic analysis that demand-side factors such as household demand and investments are the drivers of economic growth, whereas net exports is decreasing in importance[12].

Table 2. Russia: The External Sector – A Changing Role

	1999	2000	2001	2002
Net exports, % of GDP	18.3	20.7	17.8	10
Exports, % of GDP	40	42	35	26
Investments, % of GDP	16	17.9	19	20

Source: Schroder Salomon Smith Barney. For 2001, estimated full-year outcome given first quarter result and outlook. For 2002, forecasts.

Recent economic data confirms this picture of a gradual broadening of economic growth. According to very latest preliminary data covering the full first three quarters of 2001, domestic food industry and the machine-building sector (including the automotive industry where growth is very strong) were the key drivers behind industrial production growth[13]. In August, e.g., these two sectors accounted for nearly 90% of total industrial production growth[14]. The figures also confirm investment growth is continuing, with the YOY growth rate probably up to 7.7% in the first nine months of the year, and retail trade up over 10% YOY for the

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[6] The idea that the institutional and structural environment, the extent of deep economic reforms, will matter greatly in terms of how oil exporters handle oil price movements is treated in R.Hausman, "Venezuela's growth implosion: A neo-classical story?", April 2001, Harvard University, mimeo.

[7] See for example the perceptive analysis in Professor Gavrilenkov, *Aziatsky rost*, Expert, September 10, 2001.

[8] On a full analysis of stabilization funds in the Russian context, see the excellent report A. Zolotareva et al, *Perspektivy sozdaniya stabilizatsionnova fonda v RF*, IET Nauchnye trudy 27, 2001.

[9] We have covered this in-depth and repeatedly in other publications over the last year. For a major assessment of this development, see also TSMAKP, *Sostoitsya li ekonomichesky podyem v Rossii – mekhanizm ekonomicheskovo rosta v 1999-2000 gg I prognoz na srednesrochnuyu perspektivy*, April 2001, mimeo.

[10] A theme which is well researched by the Institute of Economics at the Academy of Sciences. See e.g. *Ekonomichesky rost opravdal ozhidaniya*, Vedomosti, September 26, 2001.

[11] This development has been covered in-depth by Professor Gavrilenkov at the Higher School of Economics and the Bureau for Economic Analysis. See *O strategii rosta I osnovnykh trebovaniyakh k makroekonomicheskoi politike*, BEA, June 2001.

[12] Another development which underlined the possibility that the role of oil may have been somewhat overestimated in the post-1998 growth recovery was the recent revision of GDP, industrial production and investment time series for 1998-2000. For example, 1999 real GDP growth was revised from 3.2% to 5.4%, which means that the previous "jump" in 2000 real GDP growth over 1999 was not so large. This puts the role of oil in a different light.

[13] See the Institute of Economics, the Academy of Sciences, *Import nachal yvyadat*, Vedomosti, October 4, 2001.

[14] See TSMAKP, *Ekonomicheskaya konyunktura v avguste-sentyabrye*, Nr.30, 2001.

same period. Economic data also points to a new growth push having started this spring, and interestingly, this growth push – driven primarily by domestic factors and combined with still rising real incomes – appear to have taken place while the YOY import growth rates have moderated (during the third quarter). This could be suggestive of economic restructuring underway on the micro level.

Another important development is the change in capital flow patterns[15]. Over the last year, there have been signs capital outflows have moderated, not merely in relative terms but also in absolute terms. Russian government economists are now expecting capital outflows to total some 6% of GDP in 2001, down from a usual about 10% of GDP. In addition to this, there are increasing signs of previous capital outflows starting – gradually and from a low base – to return, to be invested in the Russian economy (see above). The Russian government is pointing to such indications being increasingly notable during this year. The start of such changes in the capital account structure is a positive signal, and could be seen as a consequence of the increase in corporate and household confidence over the last two years, as evidenced by corporate and consumer surveys.

As economic growth has broadened over the last years to now be primarily driven by domestic demand and investment growth, the tax base has broadened too. For example, of the RUB 300 bn plus in excess budget revenues expected for full-year 2001, below 50% is associated with external factors[16]. In this process, tax discipline has improved significantly as well, an important factor when considering the impact of commodity prices on fiscal accounts. For any given oil price, an environment with a tighter tax payment discipline will collect more taxes than what mechanical sensitivities might suggest (see below)[17]. The first phase of the tax reform push approved in 2000 and into force this year has helped also in this direction. With the second phase approved this year, and further steps to be taken over the next year, Russia's major overhaul of the tax system is likely to yield further dynamic benefits over time.

C. Russia's oil and commodity sensitivities

The "rules-of-thumb" effects on trade and the budget – the change in USD bn per every 1 dollar change in the oil price - are summarized in the table below. We have divided both the trade and the fiscal effect into oil and oil products, and a second, more encompassing effect, taking into account the effect of oil price movements on gas prices, for example. These trade and fiscal effects are certainly significant, but in a comparison across emerging market oil exporting peers they are not excessively significant. In an emerging markets comparison for the trade channel, Russia is the least sensitive of CEEMEA oil exporters, and in Latin America only Colombia comes out as less sensitive. A similar pattern is evident for the fiscal channel. *To underline a point already mentioned: this is not to say Russia is not dependent on the oil price or that oil does not play a significant role*. It is to say that the role of oil in the Russian economy is quite complex. For example, in 1997-98, the then oil price fall had a very large, non-linear, impact, because that fall took place as the Russian economy was contracting, real interest rates were sky-high, barterization very widespread, political stagnation evident and so on.

Table 3. Russia: Oil And Commodity Price Sensitivities (effect in USD bn per every 1 dollar change in the oil price)

	Oil, oil products	All commodities	Effect in % of GDP (all commodities)	Lag between spot oil prices and contract prices/full impact (all commodities)
Effect on exports	-1.3	-2	0.57	6-9 months
Effect of federal budget revenues	-0.4	-0.8	0.23	3-4 months

Source: Schroder Salomon Smith Barney. the Ministry of Finance, the Ministry for Economic Development and Trade.

Given above sensitivities, we have assessed the impact of a move to an average Urals contract oil price of

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15 For a full analysis of this issue, see our previous report *Russia: Russian Capital Returning And Other Issues – Discussions With Policy-Makers In Moscow*, EC473, September 5, 2001.

16 See A. Belousov, TSMAKP, *O proekte federalnovo byudzheta na 2002 god*, September 10, 2001, mimeo.

17 Indeed, with improved tax collection rates, fiscal authorities may collect similar amounts at a lower oil price and a higher oil price, if in the latter the tax collection rate is poor. Over the last 2-3 years, the tax collection rate has been on an improving path in Russia, going from 86.7% in 2000, to a 90.6% assumption in the 2002 budget.

17 in 2002, both on the external accounts and on the fiscal accounts[18]. In addition, we have made an assessment of the indirect effects on real GDP over baseline, through the production, investment and consumption channels. As already noted, wealth effects will be relatively muted, due to inelasticities, still very high external surpluses, strong domestic confidence, and the strength of economic policy. Our outlook for the global economy is also important here, where we allow for a rather sharp US recovery in the second half of 2002. The results are summarized in the table below. On the trade side, a 2002 average Urals oil price would lead exports to drop by about USD 15 bn. Taking into account our import forecast – which is for continued growth but at a more modest pace than in 2001 – the trade surplus would decrease to about USD 35 bn and the current account surplus to about USD 23 bn. Russia would thus still post very large external surpluses, both in absolute and relative terms. The current account surplus would represent some 6.5% of 2002 estimated GDP.

Taking into account the full balance of payments effects (e.g. capital account flows), the Central Bank of Russia would still be able to accumulate reserves in 2002, albeit certainly at a lower rate than in 2001. We expect end-2002 CBR reserves to hover around USD 42-43 bn, a respectable stock of reserves. The only realistic way – bar a drop to dramatically low oil prices - to generate a result of zero CBR reserve accumulation, or a decrease, in 2002 is to assume a major *jump* in relative capital flight/outflows. When analyzing full balance of payments effects of changes in commodity prices, it is key to consider the appropriate capital flight/outflows dynamics. Given the current reform effort underway, the strong state of domestic corporate and consumer confidence, and the strong initial macroeconomic starting position, there are no reasons to expect a major jump in capital flight/outflows in a lower oil price environment (see the discussion above)[19]. Whereas for much of the 1990s annual capital flight was around and even exceeded the annual current account surplus, over the last 2-3 years this ratio has decreased significantly, and will be between 40-50% in 2000-2001.

Table 4. Russia: Cumulative Effects Of A Move From A $24.5 dollar oil price (2001 average) to $17-18 dollar (2002 average est.)

	All commodities	2002 SSSB forecast
Effect on exports, USD bn	-15	
Effect on federal budget revenues, USD bn	-6	
Estimated 2002 real GDP growth revision to baseline, % points	-1.5	
Real GDP growth, %		*3.5*
Trade balance, USD bn		*35*
Current account balance, USD bn		*23*

Source: Schroder Salomon Smith Barney. The oil price refers to Urals. The table takes into account the effects on all commodities from oil price changes. The estimated change in real GDP growth from a move between the two oil price outcomes takes into account the effect from net exports, as well as provides for some effect on other components of the GDP demand side.

D. What about the 2002 budget?

For the impact on fiscal accounts, the key question is what is already priced in - in terms of what the government has budgeted with[20]. The less cautious the baseline budget, the more adjustments e.g. in terms of expenditure reductions needed, the more cautious the larger the room for maneuver. Russia stands here out as one of the best prepared emerging markets for a likely lower oil price over the next year, as we will see below. We have in detail analyzed the 2002 budget process elsewhere[21]**.**

The relevant scenario is the "pessimistic" oil price scenario: the 2002 budget is <u>a balanced budget</u> at an average Urals contract oil price of 17 barrels per dollar[22]. This provides a significant cushion, in the sense

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[18] There is one aspect about Russian oil exports one should note, in an international comparison. Russia's export revenue streams are *private sector* revenue streams. Oil export revenues are not captured directly by the government treasury. In many emerging market oil exporting countries, the oil exporting companies have a much closer link with the authorities, if not even completely state-owned.

[19] For a full analysis of Russian capital account movements and the dynamics of capital outflows, see the coming book by Evgeny Gavrilenkov & Niclas Sundstrom, *The Russian Economy Under Putin: Policy, Challenges, Prospects – A Discussion*, 2001, SMF-London (under publication).

[20] See also the excellent research in *O proekte federalnovo byudzheta 2002 goda*, EEG-the Ministry of Finance, Moscow, September 2001, mimeo, and A. Belousov, TSMAKP*, O proekte federalnovo byudzheta na 2002 god*, September 10, 2001, mimeo, and Tsentr Razvitia, *Chestny byudzhet 2002?*, September 3, 2001, mimeo.

[21] See primarily *Russia: The Multiple Aims Of Russia's Fiscal Policy – Why The 2002 Budget Is Encouraging And Why 2003 Is Manageable*, EC473, August 21, 2001. This paper deals with other, positive, features of the 2002 budget, including reforms of the expenditure side.

[22] It should be stressed the 2002 budget has been constructed in a different way compared to earlier years. The Ministry of Finance proceeded from the

that it implies a fall to such oil price levels would not require major fiscal adjustments. Clearly, the separate fact that the Russian government will probably end 2001 with the equivalent of some USD 4 bn in cash fiscal surpluses to be transferred into 2002 provides an underlying cushion[23].

However, we understand Russian economic policy authorities *may* have built in even further room for maneuver[24]. There are some indications that the budget *may* still be in some overall surplus, even with Urals at 17 dollars. The table below summarizes the situation. From empirical data, federal tax revenues are about 16.3% of GDP at an oil price of 22-23 dollars. One could assume this would be the case as well next year, should such oil prices prevail, all else equal. For next year, though, we need to take out the overall effect of the new tax reforms. This is estimated at –0.3% of GDP. Thus, at a 22-23 dollar oil price, federal tax revenues should be some 15.9% of GDP. In the revised 2002 budget, however, tax revenues are equivalent to about 15.6% of GDP, in a 22-23 dollar oil price scenario and at the SSSB 2002 GDP estimate (i.e. not the government's 2002 GDP estimate)[25].

It suggests federal tax revenues *might* be underestimated by some 0.3% of GDP in the "optimistic" scenario, or RUB 36 bn. It would imply the revised 2002 budget surplus of RUB 178.3 bn would be more like RUB 214 bn, if the underestimation were added. Given that we know the fiscal impact for every 1 dollar change in the oil price, we can then estimate the loss of revenues moving from the 22-23 oil price scenario to the 17-18, at about RUB 126 bn. Such a move, however, would not result in a balanced budget, but could still imply a budget in an overall surplus. Even discounting any possibility for tax revenue underestimation, a five dollar change in the oil price from a budget surplus of RUB 178.3 bn would, according to our fiscal oil sensitivities (-126 bn roubles), still result in somewhat of a surplus. While this issue *in practice* may turn out to be different, the exercise serves to highlight at least the potential for some additional room for maneuver even in the low oil price scenario.

Table 5. Russia: The 2002 Budget And Changes In Commodity Prices

	% of GDP	USD bn	RUB bn
Normative federal tax revenues at at a 22-23$ oil price	16.3		
Effects of tax reforms in 2002	-0.3		
Estimated normative 2002 federal tax revenues	15.9		
Revised 2002 federal tax revenue, % of GDP (SSSB GDP estimate)s	15.6		
Underestimated 2002 federal tax revenues	*0.3*	*1.1*	*36*
Revised 2002 budget surplus at a 22$ oil price			178.3
2002 budget surplus plus the underestimation at a 22$ oil price			214
Effects on tax revenues moving from a 22$ oil price to a 17$ oil price (taking into account the effects on all commodities)			-126
Difference, all else equal			88

Source: Schroder Salomon Smith Barney, EEG. Underlying GDP estimate is SSSB's estimate. RUB/USD average 31.5.

expenditure side, to establish a reasonable path of non-interest expenditures, juggling the multiple tasks of financing structural reforms, the effects of lowering the tax burden, and restraining pro-cyclical growth of non-interest expenditures. Once such a path had been established, it was established that at an average Urals contract price of 17 dollars, the budget would be a balanced budget. Sometimes it is referred to that the budget is balanced at a Urals oil price of 18.5 dollars. This price refers to the Urals price on the Rotterdam exchange. We understand from Russian authorities that the budget though is constructed in such a way so that at Urals contract prices of 17, the budget is balanced. At the same time, the Ministry of Finance did not and does not expect the actual average 2002 contract price to be 17. They expect it to be 22-23 dollars per barrel. If that expectation were to materialize, Russia would run a budget in a significant overall budget surplus. This is why the 2002 budget is also sometimes presented as a budget with an overall surplus – while expenditures are planned using the lower, "pessimistic" oil price forecast, the budget surplus has been produced by pencilling the revenues after the "optimistic" oil price expectation.

[23] See also Tsentr Razvitia, *Byudzhet podpravili*, October 1, 2001.

[24] This whole issue was first analysed by the EEG in Moscow, and this section relies on the EEG research. See *O proekte federalnovo byudzheta 2002 goda*, EEG-the Ministry of Finance, Moscow, September 2001, mimeo.

[25] The 2002 budget was revised so that RUB 103.6 bn was added in terms of federal tax revenues and RUB 23.7 bn in additional unified social tax revenues. In addition, nominal GDP was revised upwards, from RUB 10 600 bn to RUB 10 950 bn, but still below our own GDP estimate for 2002. In our calculation of 2002 revised tax revenues, we have added RUB 103.6 bn to the previous tax revenues, but excluded the additional unified social tax, and then applied this to our own 2002 GDP estimate to come up with the underestimation.

E. What about 2002 financing at a low oil price?

We have looked at Russia's overall financing situation in the lower oil price scenario. We ignore here the above possibility of some overall budget surplus even at lower oil prices, and assume a balanced budget. To make our case conservative also from other perspectives, we include only modest net domestic debt issuance (we believe another RUB 60 bn could be done), only modest IFI financing and zero IMF funding, only USD 1 bn in new Eurobonds while USD 2 bn is provisioned for and fully feasible in our view, and reasonable, if now low, privatization and precious metals assumptions. As the table below indicates, even in such a conservative scenario, Russia's financing for 2002 is fully manageable.

Table 6. Russia: The 2002 Budget And Overall Financing, (USD bn) at Urals $17

Budget balance	0
Net domestic debt issuance	0.3
External debt amortization	6.8
Gap:	***6.5***
Financing:	
Funds transferred from 2001	3.8
Privatization	0.6
Eurobond (up to USD 2 bn)	1
IFIs	0.36
Bilateral borrowing	0.5
Precious metals	0.7
Difference:	***+0.46***

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 Russia has provisioned for up to USD 2 bn.
- The IFI money included above represent mainly World Bank structural credits, but no IMF funding.

As the above discussion has implied, Russia is relatively well prepared for lower oil prices. This comes out also in an international comparison. The table below summarizes some emerging markets oil exporters and some key fiscal and oil characteristics.

Table 7. Russia: The Oil Price And Fiscal Implications – Some Emerging Market Oil Exporters

	Russia	Mexico	Ecuador	Venezuela
Oil price assumption in 2002 budget	$17	$18	20	20
Average price of relevant basket, Jan-Sep 01	24.79	19.60	21.14	21.8
Current price of relevant basket	20.32	17.60	16.7	22.24
Average spread to benchmark, Jan-Sep 01	-1.59	-8.02	-6.96	-6.26
Current spread to benchmark	-1.5	-3.96	-6.35	-3.13

Source: As of September 28. Schroder Salomon Smith Barney.

F. What is different this time – Russia's room for maneuver

A very important aspect of any assessment of oil and commodity price movements and the Russian economy already alluded to are the many differences compared to 1997-98. Russia has now a very different starting position, and a set of important buffers. To summarize the key ones:

- **Russia has now major fiscal surpluses which give a large room for maneuver**. Russia is currently running some 6-7% of GDP in primary surplus, and 3-4% of GDP in overall budget surplus. At the end of 2001, there will be a financial reserve of around USD 4 bn available for transfer into 2002. The combined funds in Ministry of Finance and Pension Fund accounts as of August 1 was RUB 350 bn, nearly some USD 12 bn. To these surpluses, one should also add Russia's fairly flexible expenditure situation – cuts or cancelled expenditures can usually be made without much political fuss.

- **Russia is faced with no external bond rollover need in 2002**. The domestic debt market is small and under control. We estimate Russia could issue another up to RUB 60 bn in new domestic debt without upsetting the market. All debt ratios are improving and are under control, e.g. external debt to GDP could be below 40% end-2002. Given Russia's de facto and budgeted fiscal surpluses, the stock of debt continued to decrease.

- **Due to the various time lags involved in Russian natural resource contracts, Russia has additional room for maneuver**. It means the effects of a lower 2002 oil price on average will be distributed most likely not all in on year, but across two years. This will make for a smoother transition. The lag between spot Urals and actual contract prices is 3-4 months, the lag between oil prices and gas contract prices is between 6-9 months. Given the high Urals oil price prices in August, Urals oil contract will end this year and possibly start next year with high prices. For the same reason, Russian gas contract prices will be high throughout the first quarter of 2002.

- **The Russian economy enters now a period with lower oil prices with a growing economy rather than a contracting economy**. De-barterization has been very notable over the last couple of years. As the oil price collapsed in 1997-98, this was at a time when the Yeltsin political regime had long run out of steam, structural reforms absent, a contracting economy, huge fiscal deficit, and very low monetization of the economy.

- **Russian authorities are pursuing an ambitious program of structural and institutional reforms**. We have been encouraged by the progress over the last year, and latest indicators are that further reform optimism is warranted. Irrespective of the oil price, the domestic Russian investor base for Russian capital markets is set to expand further over next years. The Duma will make pension reform legislation one of the key priorities in the autumn and winter. Chances are strong pension reforms will be initiated early next year. Already in the early phases, this has the potential of bringing in substantial funds to the Russian Eurobond market.

- **Russia also has additional flexibility from the fact that it has currently no active IMF program**. If need be, Russia could revive both IMF discussions and explore the possibilities of a Paris Club deal covering 2003. There are reasons to believe Russia's situation regarding the latter would be stronger, should there be an objective need.