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## **The Draft Federal Budget for 2002**

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### **Macroeconomic parameters**

The forecast of macroeconomic indicators for the development of Russia for the year 2002 was developed with a regard for the provisions and parameters of the principal program documents of the government, including the Message to the Federal Assembly and Program for the Socioeconomic Development of the Russian Federation for the Medium Term (2002-2004). However, the baseline information for constructing the forecast was data on the current state of the economy and the trends that are being observed in it.

The forecast of the socioeconomic development of the RF in 2002 relies on indicators that were recorded in the first half of 2001 and the forecast values for 2001 as a whole, once again based on the results for January-June of the current year. Meanwhile, the data from recent months testifies to a series of changes in the nature of economic processes. The growth in industrial production accelerated sharply in May-June in particular. The dynamic of such indicators as the real incomes of the population and domestic demand, on the contrary, has slowed. After a local drop in April and June, prices rose for oil again. The market conditions in world markets for the other principal commodities of Russian exports also remain favorable as a whole.

At the same time, recent data in the economic development of the leading countries testifies that negative trends are being sustained. The recent tragic events in the United States have also had a negative impact on the development of the world economy. A reconsideration in the direction of reducing the forecasts for 2002 relative to the growth rates of individual countries and the economic community as a whole was the result.

These data and a number of others testify to the high degree of uncertainty in the dynamic of the fundamental indicators (the GDP, prices for oil, consumer demand) and nature of development of the situation, both within Russia and beyond its borders. The approach used in the development of the document and the two scenarios under consideration, which differ in their assumptions in relation to oil prices -- optimistic and pessimistic -- thus seems sensible under those conditions. The choice of oil prices as the "critical" parameter was warranted by the specific nature of that indicator. On the one hand, its dynamic is not very predictable, since it is under the influence of many varied factors and is subject to powerful fluctuations. On the other hand, the level of oil prices largely defines the state and conditions of development for the Russian economy.

Recent trends in the development of the Russian economy still provide no grounds to speak of any transition to the phase of stable economic growth. Growth in production continued in August 2001, although the picture of the economic dynamic looks far from unequivocal.

Output in five base sectors in August rose appreciably in relation to July (by 2.1%), while the physical volume of the GDP went up 0.4% (here and below in this section, all indicators are adjusted to eliminate seasonal factors). This is the highest monthly production level since the beginning of 1994. It is more than 6.5% above than the average monthly physical volume of the GDP for 2000.

The dynamic of the GDP in the first seven months of the year as a whole was trending close to linear at a growth rate of 0.9% per month. The real volume of the GDP in January--July, according to our estimates, was 5.5% higher than for the corresponding period of last year. Output in the five base sectors also grows in almost linear fashion, at an average growth rate of 1.1%.

Production growth broken down by the largest sectors in July was provided from industry (where output increased by 3.1%) and agriculture (where the growth was 5.9%). At the same time, output declined in construction (by 0.4%), retail trade (by 1.3%), and transport (by 2.7%).

Industrial production rose by 2.4% in July when computed per effective work day. That growth was concentrated by and large in the raw materials sector and in sectors producing consumer goods. Output rose sharply compared to June in the light (10.2%) and food (5.5%) industries, non-ferrous metallurgy (7.1%), and the chemical and petrochemical industries (3.1%). At the same time, a drop (albeit lesser in size) was recorded in electric power (2.0%), machine building (0.8%), and ferrous metallurgy (0.5%).

An analysis of the dynamic of demand shows that there was again a decline in domestic demand in July, as there had been in June. It declined by 1.2% (the decline was less in June, totaling 0.7%). This trend calls into question the prospects for a continuation of growth in production. It is also important to note that this year, for the first time, consumer demand dropped sharply (which is explained by the decline in real incomes of the population). Investment demand dropped by 0.9%, which, it is true, could still be considered a correction after the sharp jump upward in May -- the dynamic of investments continues to have an ascending trend overall. A resumption of the expansion of investment demand, given a stabilization of consumer demand, could prove sufficient for a continuation of economic growth.

The combination of production growth in consumer products in the face of a decline in domestic demand was evidently the result of cutbacks in consumer imports (although there are still no corresponding data for July).

The indicators pertaining to the financial status of enterprises are also contradictory. The trend that had been noted since the beginning of February of a decline in net profits continued in June. They dropped to 10.6% of the GDP (compared to 15.4% of the GDP in May, of this year and 12.3% of the GDP in June of last year).

The real magnitude of the working capital of enterprises (after such a sharp rise in May) declined sharply in June. Whereas working capital had increased in real terms (with the deflation of producer prices) by 6.8% in real terms, it dropped by just as much in June.

On the other hand, the expansion of lending to producers continued: the total credit to enterprises and organizations in real terms rose by 2.9% in June (the average growth rate last year had been roughly 2.5% per month).

Estimates that take into account these trends make it possible to make the following forecasts for the year 2001:

- GDP growth of 5.0--5.5%;
- actual GDP of 8.9--9.1 trillion rubles;
- industrial production growth of 5.5--6.0%.

It may thus be acknowledged that the GDP estimate for 2001 used in predicting socioeconomic development is a cautious but realistic one.

The computational data cited in the document testify to the substantial differences between the optimistic and the pessimistic versions of the forecast for 2002. The two scenarios differ not only by the state of the balance of payments, but also of the budget sphere and the real sector of the economy. Inflation in both cases is set at the same level of 11--13%. The stability of inflation is partly a consequence of the fact that this value is considered a target indicator. What is more, the responsibility for regulating the situation in the monetary and credit sphere lies with the Central Bank.

A position like that is not entirely justified. First of all, the capabilities of the Bank of Russia to have any effective impact on the state of the money and capital markets, as well as the development of inflationary processes, are still limited. First of all, by virtue of the lack of a basic tool at its disposal -- market securities -- as well as by virtue of the narrowness of the financial markets, the weakness of the banking system, and the poor efficiency of the transmission mechanisms. Second, the factors that will determine inflation next year, to all appearances, will be analogous to those that are active this year. They include, aside from the factors pertaining to the monetary sphere, such factors as the increased rates for products and services of the natural monopolies and the rise in rates for paid public services (housing and municipal services, transport, communications). These factors are exerting appreciable upward pressure on both the dynamic of prices and inflationary expectations, but they are outside the control of the Central Bank.

The achievement of the prescribed benchmark by tightening monetary and credit policy does not seem expedient at this stage. The contraction of the money supply, the more so

under conditions of the continued low level of monetization of the economy, high share of non-monetary forms of settlement, and scarcity of financial resources, could have a distinctly pronounced negative impact on growth in economic activity and the dynamic of industrial production and the GDP.

It thus seems reasonable to increase the inflation forecast to 13--14%, and to differentiate its value among the variations.

The state of the Russian balance of payments in the first half of 2001 continued to be characterized by an exceedingly high positive net balance of trade and current account operations, which totaled \$21 billion and \$28 billion respectively. The balance of trade and net current operations will continue to decline in 2001-2002 by virtue of the rapid growth in imports, but it will remain extremely favorable.

The absence of any significant deterioration in the balance of trade in the first half of 2001 compared to the prior year's level occurred because of:

- the significant rise in world prices for natural gas;
- the increased physical volumes of export deliveries of most goods,<sup>1</sup> despite the strengthening of the ruble.

As a result of the rise both in prices and in physical amounts of deliveries in the first half of 2001, the value of exports exceeded the level for the same period of 2000 by 6% and totaled \$52 billion. A slowdown in growth is expected in the second half of the year. However, by virtue of the continuation of more favorable world market conditions than were expected, exports could exceed the 2000 level somewhat based on the results for 2001, and could total \$107--108 billion. The increased exports compared to forecast values that were used in calculating the draft budget is explained by the temporary price factor. That increase in the base will accordingly not change the export forecast for 2002.

The effects of the drop in world oil prices on exports in 2002 will be eased by the delayed reaction of world prices for natural gas and a continuation of growth in the physical amounts of non-energy exports. So even in the pessimistic variation for oil prices (\$18 per barrel of Urals grade oil), a moderate decline in exports is expected (within the limits of 10% compared to the 2001 level). Small growth in exports (on the order of 3%) is possible in the optimistic variation, with minimal declines in world prices. The export forecast used in the compilation of the draft budget fittingly reflects the inherent assumptions regarding world prices as a whole. However, the scenario of relatively high world prices for oil becomes more likely against the current background of the increased complexity of the political situation around the world associated with the sweeping terrorists acts in the United States.

The value of goods imports increased by 20% in the first half of 2001 compared to the level for the same period of 2000, against a backdrop of a strengthening of the national currency and GDP growth. It is expected that the growth rate will be sustained at the level of the first half of the year, based on the results for 2001. So the estimate for

imports in 2001 (\$51 billion) inherent in the budget looks to be understated. Increasing it to \$52--53 billion would change the forecast for 2002 as well (the base effect).

The growth in imports will continue in 2002 even at the GDP growth rates inherent in the budget, and the ruble exchange rate will be about 10%. Growth in imports accordingly looks to be understated in the pessimistic variation, while the optimistic forecast looks much more likely.

The negative net financial account in the balance of payments in the first half of 2001 was preserved at the level from the first half of 2000. The influx of foreign capital to the banking sector and the sector of non-financial enterprises has remained very weak. The outflow of Russian capital from the private sector has declined compared to the level from the first quarter of 2000, when the elections for the president of the Russian Federation were being held. Nevertheless, the outflow of capital measured as a percentage of the GDP remained higher than the pre-crisis level in the first quarter of 2001.

The outflow of capital will be \$26 billion, or 9% of the GDP, if the trends from the first half of the year in 2001 (with a regard for seasonality) are sustained. Due to the lack of any signs of a radical change in the investment climate in Russia in 2002, only a small reduction in capital outflow to 8% of the GDP or \$25 billion can be predicted. To all appearances, there will be no significant changes in relation to foreign investors in Russia in 2002. The draft budget should accordingly be based on more considered estimates pertaining to the dynamic of capital flows.

Based in the trends enumerated above and the forecasts for the individual macroeconomic components, we can expect the following macroeconomic indicators in 2002:

- GDP growth of 3.5%;
- consumer price inflation of 13.5% (December to December) or 14.0% (year to year);
- GDP deflator of 10% (year to year);
- GDP in actual prices of 10.2 trillion rubles; and
- exchange rate of 32 rubles to the dollar (average for the period).

The GDP forecast given in the draft federal budget in actual prices (10.6 trillion rubles) seems to be somewhat too high.

## **Budget parameters**

### *Revenues*

The revenue portion of the budget was calculated based on the macroeconomic forecast for 2002. The changes in the tax system that had been adopted at the legislative level as of the moment of compilation of the draft budget were taken into account therein.

The changes that have been adopted in the tax system are reflected in the reduction of the tax rates for the tax on profits, the elimination of individual taxes that were inefficient, the institution of a tax on the extraction of minerals to replace those latter that creates a more efficient mechanism for collecting rent while preserving production incentives, the revocation of inefficient tax concessions, and the adjustment of the tax base for individual taxes (the tax on profits) to the standards of the market economy. The steps that were taken will provide for a rise in the efficiency of tax policy, and facilitate a reduction and more equitable distribution of the tax burden.

The measures of tax administration envisioned in the budget will ease the negative consequences of tax reduction on budget revenues. The aggregate negative impact from the tax changes is estimated by the government to be 0.3% of the GDP compared to the expected value for the current year. The range of error of that estimate is quite large, but it seems to be cautious enough as a whole. In any case, analogous measures for the year 2001 in relation to the income and social tax did not cause a decline in the corresponding tax receipts.

At the same time, it must be noted that the expected tax revenues execution for the current year used in the calculations seems to be understated by approximately 60 billion rubles or 0.8% of the GDP. The revenues of the federal budget totaled 17.5% of the GDP in April--July 2001, including 16.2% of the GDP for tax revenues, and there are still no grounds to expect any marked changes in these indicators before the end of the year. Since the presumed oil prices in the 2002 draft (\$23 a barrel for Urals oil, *i.e.* about \$26 dollars a year for a barrel of Brent oil) correspond to the average price for oil in January--July 2001 (\$26.50/barrel of Brent oil), it would be logical to assume that the tax revenues for 2002 will stay at the current level. More precisely, they could decline by 0.3% of the GDP as a consequence of the changes in tax legislation. Thus, at the level of oil prices prescribed in the draft budget, tax receipts in 2002 should be 15.9% of the GDP. However, a different value of 15.3% of the GDP is inherent in the budget. So it would seem that federal budget revenues are understated by a minimum of 60 billion rubles.

Observance of the principle of conservativeness in the formulation of the draft revenue portion of the budget is an undoubted merit of the government forecast. However, it was not done quite correctly, since the juxtaposition of the current values with the forecast ones makes it possible to speak of a presumed worsening of the collectibility of taxes.

#### *Debt servicing (and repayment)*

The servicing and repayment of state debt obligations is envisioned in full in the draft budget. The payments on foreign debt -- \$7.4 billion on interest and \$6.8 billion on debt principal<sup>2</sup> -- are a heavy burden on the budget and the entire economy. But the fulfillment of its debt obligations will be a material factor in the restoration of confidence in Russia in the international capital markets. This will in turn make it possible in the future to reduce the cost of foreign borrowings, the necessity for which could arise in connection with a deterioration of the economic situation or the necessity of carrying out structural reforms.

The program of foreign borrowings envisions a small amount of financial credit from the WBRD [World Bank for Reconstruction and Development] and the governments of foreign nations (in the amount of \$190 million). What is more, the possibility of attracting \$2 billion (about 63 billion rubles) in the Eurobond market is envisioned as well. The goal of the euro borrowing is effectively the creation of a financial reserve, the funds from which could be expended in two areas. First of all, to replace the shortfall of funds in 2002, *i.e.* to finance the obligations of 2002, both those associated with debt payments and non-interest expenditures. Second, for the debt payments of 2003. The additional revenues received over and above the approved projection for 2002 and the funds balances from 2001, which are estimated to be in the amount of 80--90 billion rubles, will also be sources for the formation of the reserve therein. In any case, the draft budget does not have any estimates of the amount of those funds.

It should be noted that even given the fulfillment of the budget projections, some of the borrowing (more than 5 billion rubles) should be expended already in 2002.

The **chief shortcoming** of the draft budget is the fact that it was effectively intended only for the optimistic scenario of development, *i.e.* with average annual oil prices for Urals oil of \$23.50 per barrel. Despite the official statements that the budget will be fulfilled even if the pessimistic scenario is the one that actually occurs, *i.e.* at prices of \$18.50 per barrel, that does not correspond to reality. In actual fact, under the pessimistic variation, according to government calculations a financial discrepancy will be opening up in the amount of 126 billion rubles, *i.e.* no sources of the repayment of debt in that amount are envisioned. Measures to eliminate that gap -- a reduction in non-interest expenditures, and either the restructuring of debt or new borrowings -- are not envisioned either.

*Domestic borrowing* -- is aimed first and foremost at the development and normal functioning of the market for short- and medium-term state securities [GTsB], which is the foundation of the money and financial markets.

The development of the GTsB market will facilitate the creation of effective instruments for the sterilization of excessive growth in the money supply caused by the growth in international reserves.

It should be noted that the amounts of borrowing in the domestic market could also be greater in the event the pessimistic scenario comes to pass. However, additional borrowings of not more than 40--50 billion rubles, in our opinion, will not have any negative consequences for the financial market.

It is also worth noting that the surplus presumed by the draft budget does not signify the removal of financial resources from the economy, since the principal portion of the surplus will be directed toward the repayment of state debt. In the event of the repayment of domestic debt, the financial resources are simply redistributed among economic agents within Russia. In the event of the repayment of foreign debt, the government exchanges rubles for the dollars of exporters, but the rubles received by the exporters also do not

disappear someplace and can be used by the latter within the country. Removal occurs only with the accumulation of funds in government accounts at the Central Bank. A measure like that is sometimes necessary to accumulate funds for future payments, so a small accumulation (about 58 billion rubles) is entirely warranted in 2002.

### *Expenditures*

As is well known, the Russian Federation will have to pay foreign lenders about \$19 billion in the year 2003, which is \$4--5 billion more than the corresponding payments in 2001-2002. In his Message to the Federal Assembly, the president of the RF demanded "a civilized approach to the solution of the debt problem," which signifies first and foremost a concentration of the maximum efforts on ensuring timely and complete payments on debt obligations. The 2002 budget should be considered from the standpoint of the problems of 2003 in this regard.

The budget obligations assumed by the government in the 2002 budget and the spending corresponding to them can be divided into three groups. Some expenditures could lead to a reduction in the expenditure obligations of future years. The classic example of those expenditures is the early buyout or repayment of debt. We can cite among other examples energy-conserving measures or the payment of benefits through cutbacks in civil servants. Other expenditure obligations could lead to a rise rather than a reduction in spending in future years. These include in particular such things as the assumption of obligations associated with wage increases in the budget sphere, transfers to the public or the financing of multiple-year investment projects. A reduction in such payments is theoretically possible in the future, but it is unattainable due to political considerations. Finally, we can relegate "neutral" obligations to the third type of obligation, *i.e.* those that do not have any impact on future spending, and could be reduced quite painlessly where necessary. A host of examples of "neutral" obligations exist. The most topical for Russia could be the repeal of programs in support of small business and short-term economic projects.

Bearing in mind the inevitable necessity of reducing non-interest expenditures in 2003, it would be logical to concentrate 2002 resources on expenditures that reduce future budget payments and, to some extent, on "neutral" expenditures. However, judging from the statements of managers at the Ministry of Finance, the draft budget assumes the principal growth in spending for such line items, and a reduction in the future financing on them does not seem possible. Their growth is not too large in principle, but room to maneuver will be reduced significantly in 2003. In the event of unfavorable foreign economic conditions, this could create the preconditions for an "uncivilized" resolution of the debt problem in 2003.

Unfortunately, the materials accompanying the draft budget do not make it possible to assess the problem described above in numbers. The reason for that is the lack of an economic classification of the spending. Despite the fact that the presence of economic classification is envisioned by the Federal Law On the Budget Classification of the



Russian Federation, neither reports on budget execution nor draft budgets contain this classification in full.

Thus, the principal conclusions regarding the draft federal budget for 2002 are as follows:

- The proposed draft budget was composed in accordance with the declared priorities of the government -- judicial reform and social policy.
- The direction of increasing federal budget control over revenues of the budget system is continued in the draft. It is assumed in particular that 63% of the revenues of the consolidated budget (with a regard for a portion of the social tax) will be going to the federal budget in particular. Some 37% of revenues will go to the budgets of the regions accordingly. The spending of the federal budget and the budgets of constituent entities of the Federation will be equal therein; that will be achieved through the corresponding transfers from the federal budget. Such a practice is advantageous to the poorer regions.
- The revenue portion of the federal budget is understated by a minimum of 60 billion rubles (in the assumption that the average oil price in 2002 will be \$23 per barrel for Urals oil). This "slack" seems justified, since no one is insured against lower oil prices.
- Despite the stated resistance of the budget to external economic market conditions, the draft does not envision funds to cover a possible financial gap. Thus, in the event of a decline in oil prices to \$18/barrel, the financial gap will be 126 billion rubles. One source to partially cover it could be the additional revenues of the 2001 budget, but the draft budget has no directives for this variation.
- The draft budget does not implement the two-level structure of the federal budget proposed by the president of the RF -- a separation of expenditures into permanent and "depending on foreign market conditions" is not spelled out.
- As a result, the proposed increase in some line items of federal spending will evidently reduce appreciably the opportunities for the government to make a favorable resolution of the debt "problem of 2003." More precise estimates cannot be made owing to the lack of an economic classification of the expenditures.
- The draft budget is quite realistic as a whole, but there is a serious danger of inflating the expenditure portion when it is passing through parliament. Increased spending in an amount of more than 60 billion rubles would create stress in the budget system in 2002 and worsen the opportunities for the complete and painless fulfillment of state obligations in 2003.

### **Footnotes**

1. The chief exception is natural gas. The physical volumes of exports of this good declined by 13% in the first half of 2001 compared to the same period for last year. The physical volumes of exports rose as a whole by just 1% as a result.

2. This includes payments to service the currency credit of the Bank of Russia of \$200 million in principal and \$400 million in interest.