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By A.V. Dvorkovich

2. PROSPECTS FOR BUDGET IMPLEMENTATION IN 2000

The sweeping financial crisis that broke out in 1998 was the epitome of an entire epoch of financial policy characterized by a sizeable budget deficit, a relatively high rate of the national currency and low efficiency of the monetary instruments.

In the aftermath of the financial crisis, an on-going and wide-ranging discussion was held regarding its nature, results and lessons. Characterization of the financial crisis was the most prominent moot question. Was this crisis of a currency and/or budgetary and debt nature? Was the crisis inevitable and was its cost minimized?

Our standpoint consists not in recognizing the fact that the crisis was currency- or debt-related, but that while both problems did exist, the currency crisis and the budget crisis had a synergistic effect on each other. The currency crisis was resolved at the cost of a drastic decline in the standards of living of the major segments of the population and further deterioration of the investment environment resulting from the forced refusal to partially service the debt on the part of the state and private sectors. At present, the key issue is how to tackle the budget crisis while at the same time minimizing the attendant losses. In this case, the monetary and currency policies (given that the currency crisis has been mastered while the budget one was still rampant) for all practical purposes forfeited their regulatory function and are completely dependent on the pace at which the budget problems are overcome.

The performance results for 1999 - the year that followed the far-reaching financial crisis - which have not been summarized as yet do not warrant unambiguous treatment. The year 1999 stands out because its economic indicators turned out to be as remote (in the positive sense) from the majority of the forecasts as today's exchange rate is different from the pre-crisis level. This is true both of the indicators of economic growth and the indicators related to the financial sphere: inflation proved to be moderate while the budget revenues, unexpectedly high.

On the other hand, the year 1999 failed to justify the hopes for the quick-paced progress of economic reforms at a time that was the most advantageous in this respect from the perspective of potential economic growth. In other words, the year 1999 saw minimal changes in the nation's economic system.

Why did not the catastrophic presages of the late 1998 come true?[11] Where did the analysts go astray - in predicting the exogenous conditions, in assessing the domestic economic response to the devaluation or in the economic policy prognosis? The major surprises for the analysts came in the form of the growth of world oil prices (along with those for other Russian export commodities) and implementation of a much tougher monetary and budget policy than could have been expected judging by the pronouncements of the top officials of the Government and the Bank of Russia in late 1998.

Analysis of the export performance reveals that in US dollar terms the volume of oil export to non-FSU countries in 1999 increased by nearly US$4 billion, meaning that the oil export volume was practically as high as the 1996 peak level. Moreover, in the 4th quarter the nominal oil export volume hit an all-time high in Russian history. If one adds to these figures the increment in the export of other Russian goods (due to the price growth), it becomes apparent how significant was the impact of world prices on the balance of payments.

If the world oil prices had remained unchanged at the late 1998 level then, other conditions being equal, the nominal oil export volume would have come up to not more than US$7 billion, or US$6 billion less than estimated for 1999. In this eventuality,

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[11] The majority of analysts projected inflation of consumer prices at 80 to 200% and an economic slump of 4 to 10% in 1999, while in actual practice the respective inflation indicators stood at 36 to 37% and growth of 1.5 to 2% was observed.

assuming that the Bank of Russia saved its reserves, its additional market buying should have amounted to US$6 billion in ruble terms. Then, according to experimental estimates, annual inflation of consumer prices would have risen to not less than 60 per cent.[12]

Another question is whether the growth of the prices for Russian export goods affected the federal budget revenues projected by the analysts to stay at the level observed at the end of last year, or not more than 9 to 10% of GDP. It is possible to infer that the immediate effect was insignificant. This is explained by the fact that in 1999 the major taxpayers (including staple exporters) made tax payments in accordance with the individual agreements with the Ministry for Taxes and Levies. Specifically, until the middle of the year the agreements with the oil exporters were based on the oil prices as of the beginning of the year, that is, bottom prices for the period under review. Starting from the middle of the year, settlement prices for oil were increased roughly to US$15 per barrel, while the actual prices climbed to the US$25-per-barrel mark by the fourth quarter. This means that the tax payments of the oil exporters were based on the prices that averaged 70 to 75% of the actual prices, resulting in acceleration of the tax arrears.

Nevertheless, there was considerable indirect effect made up of the following two key factors:

- an increase in the revenues and profits of the enterprises supplying production for the exporters;
- an increase in the share of cash payments in the economy.

Although at present these factors defy quantitative estimation, there can be identified four major components contributing to the growth of federal budget revenues:

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[12] Recall that this estimate was performed without taking into account the additional need for the CBR to buy currency due to the potential lack of price growth for other Russian export goods (apart from oil).

– improvement of the financial status and more intensive monetization of the real sector (owing in part to the growth of revenues and profits of the enterprises which took advantage of the devaluation);
– redistribution of the revenues of regional budgets in favor of the federal one as a result of amendment of the budget and tax legislation;
– growth of physical production volumes;
– impact of higher prices on Russian export goods.

If the latter had not made itself felt, it would have been necessary either to cut the federal budget expenditures with an attendant increase in payables or to resort to additional direct crediting of the Government by the CBR. In their prognoses the majority of the analysts favored more the latter option that would have added 10 to 15 more percentage points to the annual inflation estimate[13].

In late 1998 the experts based their assumptions primarily on the pronouncements of the top Government officials regarding the need to revive effective demand and raise the profile of the Central Bank in crediting the economy. Besides, practically all prognoses severely underestimated the internal potential for growth of the federal budget revenues. More specifically, the projections of the Institute of Economic Problems of the Transition Period were based on the assumption that the federal budget revenues would amount to 7 to 9% of GDP. At the time, our estimate was that the revenues might reach 9 to 11% of GDP.

As already mentioned above, in reality the revenues were upwards of 13% of GDP.

And, finally, another surprise for the experts was the parliamentary approval of the budget characterized by a substantial primary surplus and minimal financing on the part of the CBR, a budget which was put into practice (with overfulfillment of all indicators, including US dollar financing by the CBR). Even considering that the forecast of budget

[13] This does not take into account the insignificant impact of the growth of world prices on the domestic prices which were held back by the non-payments, state regulation and limited demand.

revenues seemed unrealistic early in the year in view of the low oil prices and proposals to lower the VAT, the role of a relatively tight budget consisted in setting tougher limits for noninterest-bearing expenditures than it could have otherwise been. It goes without saying that an increase in the deficit by 2 to 3 percentage points of GDP caused by higher expenditures and/or lower revenues financed at the expense of the CBR's credits would have resulted in additional inflation amounting to 30 to 45%, while total inflation with allowance for the above estimates could have topped 100%. In this way, the Government's financial policy took an unexpected turn for the analysts and curbed inflation to a manageable level.

In 2000 the budget may encounter two problems: a level of revenues lower than anticipated and less than planned external credits.

As already noted, the growth of revenues in 1999 was attained to a large extent owing to the redistribution of the revenues of regional budgets in favor if the federal one, growth of the revenues and profits of the enterprises which took advantage of the devaluation and the impact of higher prices on Russian export goods. However, in 2000 the potential for utilization of these reserves may be drastically limited, while other short-term reserves are as good as non-existent.

Thus, in our opinion, the following year may see certain further growth of the federal budget revenues but this is hardly likely to exceed one percentage point of GDP.

Pursuant to the Budget Law, in the current year about US$6 billion should be borrowed from external financing sources, out of which the IMF credits account for US$2.6 billion. Analysis of the development of Russia's relations with the international financial institutions suggests that financing on the part of the IMF is not forthcoming until the middle of the year and the total amount of financing will be much lower than the figure provided for in the budget. In principle this can bring about, first, weakening of the ruble and, second, a shortfall of budget financing. At the present time, the only realistic alternative to this source of financing are the credits of the Central Bank (as it was last year). But, given a sufficiently limited potential for sterilization of the money supply, the CB's credits to the Government represent an additional source of inflation. According to our estimates, realistic expectations for attraction of external credits are in the range from US$2.8 to 4.3 billion. The question is, what can the consequences be of insufficient revenues and insufficient external financing.

We carried out model calculations for different combinations of revenues and external credits. In doing so, we assumed a "moderately optimistic" option in terms of the revenues envisaging growth of the revenues to 14% of GDP and a "normative" option under which the revenues amounted to 14.9% of GDP as per the budget. In relation to the attraction of external credits, the options providing for borrowing US$2.8 and 4.3 billion were considered.

Under all scenarios it was assumed that the Government would resort to the CB's credits to the extent that would make it possible to fully discharge the expenditure obligations under the budget (in nominal terms, apart from servicing of the external debt which is accounted for in US dollar terms).

The model calculations performed by us demonstrate that the situation remains well under control even despite the combination of unfavorable factors. One of the reasons for this is that the realistic GDP forecast is somewhat higher than the figure of 5350 billion rubles featuring in the Budget Law and amounts to around 5500 billion rubles at the 18 to 20% inflation. Besides, if problems arise in relation to the revenues or attraction of credits, expansion of emission financing of the budget is quite likely, thus causing a certain rise in inflation and further growth of GDP in nominal terms. By this means, the budget revenues that would increase in nominal terms would make it possible to finance in full scope the noninterest-bearing expenditures envisaged (although in real terms they would fall short of the target figures).

A worst-case scenario might require soliciting additional credits from the CB in the amount of up to US$2.8 billion, which would have the effect of boosting inflation (up to

31% according to the estimates). In this event, the deficit and primary surplus indicators as a percentage of GDP would approximate those envisaged in the budget and would be the most advantageous in nominal terms. In real terms, noninterest-bearing expenditures would be smaller as compared to 1999 (whereas these are supposed to increase based on the parameters laid down in the Budget Law), but this reduction appears to be not so substantial. The ruble would be somewhat weakened, bot not to a significant degree (on average by 2.8% per annum) .

If the revenues run high and external financing is low (or in the event of moderately high revenues and moderately low external financing), the CB's credits may be substantially lower (on the order of US$1.5 billion). In the first case, the deficit indicators look especially impressive: the total deficit tends to nil while the primary surplus stands at 3.8% of GDP.

And, finally, almost no increase in monetary financing would be required (it could amount to a mere US$0.5 billion) in the event of high revenues and attraction of US$4.3 billion worth of credits, while noninterest-bearing expenditures would increase in real terms as compared to 1999.

To sum up, if a conservative policy is pursued, the main budget objectives may be attained even in the face of relatively unfavorable conditions. Naturally, the growth of inflation will affect the investment process, it will not be feasible to build up the gold and currency reserves of the CB on a major scale, but in any event the macroeconomic situation will not deteriorate as compared to the last year.

The estimates cited above are based on a sufficiently cautious estimate of the oil prices, assuming an average world price for Brent crude of US$18.5 per barrel in 2000. If the price is higher, the situation will naturally be better both from the standpoint of budget revenues and that of the ruble rate.

The table below contains the EEG's estimates regarding likely implementation of the budget based on different assumptions in terms of the revenues and attraction of external credits as compared to the Federal Budget Law.

Federal Budget Indicators under the Budget Law and According to the EEG's Estimates

	Budget	Revenues at 14% of GDP, borrowing of US$2.8 billion	Revenues at 14.9% of GDP, borrowing of US$2.8 billion	Revenues at 14% of GDP, borrowing of US$4.3 billion	Revenues at 14.9% of GDP, borrowing of US$4.3 billion
bn Rbs					
Revenues	797	810	851	785	825
Expenditures	855	860	858	848	847
Debt servicing	220	224	222	214	212
Noninterest-bearing expenditures	635	636	636	634	635
Deficit	58	50	7	62	22
Internal financing	7	132	88	93	53
External financing	51	-82	81	-31	-30
Borrowing	220	92	90	132	130
Repayment	169	173	171	162	160
Primary surplus,	162	174	215	152	190
% of GDP					
Revenues	14.9	14.0	14.9	14.0	14.9
Expenditures	16.0	14.9	15.0	15.1	15.3
Debt servicing	4.1	3.9	3.9	3.8	3.8
Noninterest-bearing expenditures	11.9	11.0	11.1	11.3	11.5
Deficit	1.1	0.9	0.1	1.1	0.4
Internal financing	0.7	2.3	1.5	1.7	0.9
External financing	0.4	-1.4	-1.4	-0.5	-0.5
Borrowing		1.6	1.6	2.3	2.3
Repayment	3.2	3.0	3.0	2.9	2.9
Primary surplus	3.0	3.0	3.8	2.7	3.4
Alteration of noninterest-bearing expenditures as compared to 1998 in real terms (%)	5.1	-3.4	-2.1	-0.4	1.0
CB's currency credits (US$ bn)	1.0	3.8	2.5	2.8	1.5
GDP (bn Rbs)	5350	5786	5710	5610	5536
Inflation (Dec. To Dec.)	18%	31%	28%	24%	21%

Average exchange rate (Rbs/US$)	32	32.7	32.3	30.7	30.2
Alteration of real ruble exchange rate as compared to 1999 (%)	-7.8*	-2.8	-2.8	-1.5	-1.5

- The resultant estimated value is negative due to the lower than expected exchange rate in 1999 (in fact, it averaged 24.67 Rbs to the dollar). In relation to the assumed average rate of 26 Rbs to the dollar, the forecast suggests that the real exchange rate will remain unchanged