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Macro "Issue Year 2000" and Medium-Term Financial Stability

Summary

The 1998 financial crisis drastically changed the economic situation in Russia. The twofold devaluation of the national currency in real terms, the banking crisis and the collapse of financial markets resulted in a major decline in the standards of living, the inability to fully serve state debt and a deterioration of the investment climate.

In the period immediately following the crisis, the top priority of the Government's financial policy was to stabilize the economic situation, including such tasks as preventing hyperinflation, working out relations with creditors, restoring the payment system and gradually paying out overdue wages and social allowances. These tasks were resolved as early as before the end of 1998.

Further implementation of the adopted financial policy was facilitated in the last few months of 1998 and in the first months of 1999 by the recovery of industrial output resulting from increased competitiveness of Russian-produced goods. A healthy balance of trade (due, among other things, to an unexpectedly rapid growth of oil prices) compensated both the capital outflow and the significant debt service expenses against the background of minimal new borrowings. Combined with an increased demand for money and a higher degree of monetization within the economy, this made it possible to neutralize inflationary expectations and follow a reasonable monetary policy, even given need to issue direct loans to the Government. Increased federal budget revenues resulting from a re-distribution of regional budget resources and the taxation of additional income generated by exporters made funding the expense side of the budget a relatively easy task.

However, despite certain achievements, the economic situation remains highly complicated, with continuing significant uncertainty both in the short-term and medium-term perspective. At the same time, the role of monetary policy in the resolution of economic issues suffered a major decline, and any opportunities for improvements are now primarily associated with far-reaching institutional and structural reforms aimed at stabilizing the budget situation. Also, year 2000 remains fraught with a serious risk of increased inflation and accelerated devaluation due to the need of additional loans to the government from the Central Bank in the absence of industrial growth and respective demand for money. The greatest hazard in the coming years is first and foremost the increased debt pressure on the budget combined with the likely (if there are no positive developments in the investment climate) industrial stagnation.

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1. ANALYSIS OF FINANCIAL CRISIS

The profound financial crisis of 1998 was the culmination of a whole era of a financial policy relying on hefty budget deficit, a relatively high national currency exchange rate and low efficiency of monetary instruments. "...The fundamental factors, including the structural crisis in the production sector, an overall responsibility crisis manifest in all-permeating, budget and private, non-payments, the absence of investment incentives due to the heavy tax burden, lack of public trust in the national currency, underdeveloped financial sector and services, relatively closed economy, and a slowly evolving political crisis did not allow the financial authorities to reverse the situation"[1].

Throughout the period following the financial crisis there have been much academic debate and practical discussions concerning its nature, results and lessons. The most contradictory issue has been the nature and the characteristics of the financial crisis, namely whether it was a currency and/or budget and debt crisis; was it unavoidable or not; and whether its price was minimized.

The main argument by the proponents of the "currency" nature of the financial crisis[2] is that it was triggered by the negative effects of an overstated exchange rate of the ruble on the national economy during 1996-1998. Those who share this idea recognize the existence of budget problems but consider them to be of secondary importance. Advocates of the "debt" nature of the crisis[3] believe that the determining factor was that the obligations of the Governments permanently exceeded its available resources due to the incompleteness of structural and institutional reforms. In their turn, they recognize currency policy problems but regard them as a consequence of the soft budgetary policy.

Charts 1-3 in the Appendix[4] present a comparative analysis of changes in the real exchange rate, actual GDP and tax receipts within the expanded budget in percent of GDP for the period from 1994 to 1999. These charts and a respective econometric analysis lead to the following two major preliminary conclusions:

- neither the tax receipts into the expanded budget nor the actual GDP depended on the real exchange rate;
- tax receipts into the expanded budget in percent of GDP positively depended on the volume of actual GDP.

Do the above conclusions testify to our adherence to the "debt" interpretation of the crisis? In both cases, the answer is no. In the first place, more competitive prices on Russian goods combined with a low exchange rate are an arithmetic actuality which it is impossible to deny. Also, as confirmed by numbers, the higher degree of competitiveness, due to a number of fundamental and short-term factors, made it impossible to secure a stable growth in production of goods and collectibility of taxes. Besides, the high share of external borrowings in total state debt predetermines a deterioration of the budget situation when the national currency is devaluated. As a result, a lower exchange rate of the ruble could not at the time be used as a basis for overcoming budget problems. The situation up to 1998 was a classic opposite, where a higher budget deficit would increase the expenses to serve external debt and, consequently, the

[1] Bureau of Economic Analysis. "Overview of Russian Economic Policy in 1998", p.49.
[2] E. g. A. Illarionov. Report at the Conference, Moscow, November 1999.
[3] E. g. S. Aleksashenko. "The Battle for the Ruble", Moscow, 1998.
[4] Source: Economic Expert Group, materials for presentation at RECEP conference, Moscow, December 1999.

deficit of the balance of payments. Secondly, after the devaluation of the ruble in 1998 changes in the output of tradable goods and services did not match the changes in non-tradables[5]. In contrast to a substantial and quite rapid growth in the former (slightly above the maximum pre-crisis level of the autumn of 1997), the latter suffered a major decline, reflecting the continuing budget crisis. However, after achieving the pre-crisis level, the tradables output showed virtually no change due to the absence of more fundamental (than the real exchange rate) conditions for stable economic growth. Thirdly, even if we do not factor in the impact of the real exchange rate on the production sector, it may be argued that the high ruble rate before the 1998 crisis did not match Russia's level of economic development. The high exchange rate was sustained until 1998 by high prices on Russian exports and by the inflow of short-term foreign capital, both of these factors being incapable (due to their volatility) of becoming a solid basis to support financial stability.

Nevertheless, we do not believe that the devaluation of the ruble may be regarded as a solution of the general economic issues, or even the financial problems in Russia. The fundamental financial problem, one of the gap between the state's resources and obligations, in our opinion, remains the major obstacle to economic development. Before this problem is resolved (along with a number of other commonly recognized problems), a low real exchange rate of the ruble will not produce the desired effect on economic developments.

Moreover, until the above problems are resolved, an excessively low real exchange rate will be a additional obstacle to stabilizing the situation. On the one hand, provided the real exchange rate remains constant, the relative debt burden will increase significantly by the middle of the first decade of the 21st century. On the other hand, a low exchange rate will not be a sufficient incentive for Russian producers who will choose to rely on price advantages rather than taking due care of the quality and assortment of their products. If this is the case, the only way to resolve the latter problem is to encourage internal competition.

Thus, our position is that, instead of recognizing the debt or the currency nature of the crisis, we need to admit the existence of both of these problems, with the currency crisis aggravating the budget one, and vice versa. The toll of resolving the currency crisis was a major decline in the standards of living across the main social groups, and a further deterioration of external investment climate due to a forced refusal on the part of the state and the private sector to serve a portion of external debt. The most topical issue now is how to resolve the budget crisis with minimal losses, considering that the monetary and the currency policy (due to the resolution of the currency crisis against the background of continuing budget crisis) have virtually lost their regulatory role and are now completely dependent on how quickly budget problems are resolved.

2. ANALYSIS OF CURRENT SITUATION: "YEAR 2000 ISSUE"

A preliminary analysis of the results of 1999, the year that followed the deep financial crisis, leave a dual impression. The most notable characteristic of 1999 is that its economic results turned out to be as far a cry (to the better) from most forecasts, as the current exchange rate from that before the crisis. On the other hand, 1999 did not fulfill the promise of speedy continuation

[5] The ratio of tradables prices to non-tradables prices is another measure of the effective exchange rate.

of economic reforms at the most suitable time in terms of potential for economic growth. In other words, 1999 brought around minimal changes in the national economic system.

Why is that the doomsday forecasts of late 1998 failed to "come true"?[6] Where did analysts make the mistake: when predicting the external environment, estimating the internal reaction of the economy to devaluation, or projecting the future economic policy? The biggest surprises for analysts were higher world prices on oil (and other Russian exports) and a tighter monetary and budget policy than could be expected judging by what the top officials of the Government and the Bank of Russia were saying in late 1998.

2.1. The role of global oil prices

Table 2.1 below shows the volume of oil exports to non-CIS countries in US Dollars, the physical volume of oil exports and changes in average annual contract prices for Russian oil in 1992-1999.

Table 2.1 Oil exports

	Volume, million $	Volume, million tons	Price per ton, $
1992	8544.8	66.2	129.1
1993	8369.6	79.9	104.7
1994	11513.1	95.4	120.6
1995	10412.5	96.2	108.2
1996	13848.6	105.0	131.9
1997	13013.0	109.8	118.6
1998	8790.0	117.9	74.5
1999[7]	12800	118	108

As is seen from the Table, the growth of oil exports to non-CIS countries in 1999 in dollar terms totaled approximately $4 billion, returning to almost the same level as in 1996, the peak year for oil exports. Moreover, in the fourth quarter the nominal volume of oil exports was an all-time record for Russia. Combined with increased exports of other Russian goods (due to higher prices), it evidently shows the magnitude of the impact world prices had on the balance of trade.

If world prices on oil had remained the same as in the end of 1998, then, other factors equal, the nominal volume of oil exports would not exceed $7 billion, or would be $6 billion less than the 1999 estimate. In this case, assuming the Central Bank would have the same reserves, its additional purchases on the market would total $6 billion in ruble equivalent, resulting in annual consumer price inflation of at least 60 percent, according to a hypothetical estimate[8].

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[6] Most analysts estimated consumer price inflation at 80-200% and an economic recession of 4-10% in 1999, with the actual inflation and decline standing at 36-37% and 1.5-2%, respectively.

[7] Annual estimate on the basis of express data of the State Customs Committee of the Russian Federation for 10 months.

[8] This estimate was made with no account taken of potential requirement for additional purchases of hard currency by the Central Bank resulting from possible absence of any growth in prices on other Russian exports (besides oil).

Another question is whether increased prices on Russian exports affected federal budget revenues which were estimated by analysts at the level of the end of prior year, or 9%-10% of GDP. It can be argued that the direct impact was insignificant due to the fact that in 1999 the largest taxpayers (including major exporters) paid taxes on the basis of individual arrangements with the Ministry of Taxes and Levies. Thus, up until the middle of the year agreements with oil exporters were based on oil prices as of the beginning of the year, i. e. minimum prices for the analyzed period. In the second half of the year estimated oil prices were marked up to approximately $15 per barrel, whereas actual prices by the fourth quarter reached $25 per barrel. That is, tax payments by oil exporters were based on prices averaging 70%-75% of actual prices, resulting in rapid accumulation of tax arrears.

However, the indirect impact was quite significant and manifested itself in the following two main factors:

- increased revenues and income of the exporters' suppliers;
- a greater share of cash-based settlements within the economy.

At the present, it is difficult to measure these effects in quantitative terms, but the three main components of increased federal budget revenues were as follows:

– re-distribution of regional budget revenues in favor of the federal budget through changes in the budget and tax legislation;
– growth of corporate revenues and profits as enterprises capitalized on the benefits of devaluation;
– the effect of higher prices on Russian exports.

In the absence of the third effect the Government would be facing the need of either scaling down federal budget expenses resulting in increased accounts payable or requesting additional direct loans from the Central Bank. Most analysts predicted the latter, adjusting the annual inflation estimate for an extra 10-15 percentage points[9].

An increase in the share of cash-based settlements which continued until the middle of 1999 also had a major positive effect on the federal budget cash revenues. The Government managed to secure practically the same ratio of revenues to GDP as before the crisis, but without the various non-monetary mechanisms factored in.

Finally, the third question is how increased prices on Russian exports affected economic growth. Export-focused and associated industries enjoyed the biggest gains. According to our preliminary analysis, the advantages of increased export revenues did not spread over the whole of the economy in general. However, even isolated growth in specific sectors became a major contribution to overall economic growth. According to initial estimates, this contribution amounted to 2-3 percentage points in the overall increase in industrial output and 1-2 percentage points in total GDP growth. In other words, without higher prices on Russian exports, 1999 would hardly have shown any GDP growth, and industrial growth would have been much lower.

[9] This estimate does not factor in the insignificant effect of increased global prices on domestic prices, which were contained by non-payments, state regulation and limited demand.

Thus, increased prices on oil and other exports had a major effect on economic development in 1999. In the absence of this growth, inflation would have been much higher (at least 70%-75%), and overall economic growth would have been virtually nil. These conclusions also accentuate the role of oil prices in the evolution of the 1998 crisis, which some analysts have tended to downplay.

2.2. The role of economic policy

In late 1998 experts would largely base their conclusions on the various Government statements to the effect that there is a need to reinstate effective demand and enhance the role of the Central Bank in financing the economy via loans. Also, virtually all forecasts seriously underestimated the internal potential for federal budget revenue growth. Thus, the forecasts of the Institute of Transition Period Economic Issues were based on the assumption that federal budget revenues would constitute 7%-9% of GDP, while we believed that they may amount to 9%-11%.

Actual revenues, as indicated above, reached 13% of GDP, with not all of the growth due entirely to external factors. One of the main reasons for this growth was a greater than before share of federal budget in consolidated and expanded budget revenues which was purely a factor of the tax and budgetary policy and the federal Government's policy in respect of the regions. The ability of the federal Government to "appropriate" part of the revenues from regional budgets (which was achieved partially through the Law on the Federal Budget for 1999, and partially by refusing to lower the VAT rate and gradually raising export duties) came as a complete surprise for the analysts. Also, individual arrangements with taxpayers became common practice. A long-standing scheme with regional authorities, such arrangements are inefficient from the economic point of view, but are probably effective in terms of formal fulfillment of the budget.

Finally, experts were caught absolutely off-guard by the approval in the Parliament of a budget with a healthy initial surplus and minimal Central Bank funding. More than that, it was this very budget that was in fact fulfilled (with all target parameters exceeded, including dollar injections by the Central Bank). Even if the projected budget revenues appeared unrealistic in the beginning of the year in view of low prices on oil and suggestions to reduce the VAT rate, one of the objectives of a relatively stern budget was to establish tighter than otherwise limits for non-interest expenses.

Thus, the actual financial policy of the Government was quite a surprise for the analysts and made it possible to prevent a major aggravation of inflation. Suffice to say that an extra two or three percentage points of GDP growth due to higher revenues and/or higher expenses funded by Central Bank loans would have resulted in additional inflation of 30%-45%, with overall inflation reaching 100% in light of the estimates outlined above.

2.3 Macro "Issue Year 2000": Theses

THESIS 1: the budget is unfeasible, but it will be fulfilled

Table 1: Fulfillment of the federal budget in 1997-1999 and draft budget for 2000

	1997	1998	1999	2000
% of GDP			expected	budget
Revenues (cash)	9.8%	9.0%	12.8%	14.9%

incl. tax revenues	7.9%	7.7%	10.9%	12.6%
Expenses	16.6%	13.9%	14.5%	16.0%
Servicing of debt	4.6%	4.0%	3.9%	4.1%
domestic	3.7%	2.4%	1.6%	1.2%
external	0.9%	1.5%	2.4%	2.9%
Non-interest expenses	12.0%	9.9%	10.6%	11.9%
Deficit	6.8%	4.9%	1.7%	1.1%
internal financing	4.7%	2.4%	1.1%	0.7%
incl. Central Bank (gross borrowings)	1.3%	3.9%	3.5%	0.6%
external financing	2.0%	2.6%	0.7%	0.4%
incl. IMF (gross borrowings)	0.4%	0.6%	0.4%	1.6%
Initial deficit	2.2%	1.0%	-2.2%	-3.0%
GDP	2 563	2 685	4 450	5 350

Whereas, as we are aware, increased revenues in 1999 were the result of:

– a re-distribution of regional budget revenues in favor of the federal budget through changes in the budget and tax legislation;
– growth of corporate revenues and profits as enterprises capitalized on the benefits of devaluation;
– the effect of higher prices on Russian exports,

in 2000 there are very limited opportunities for using such reserves and virtually no opportunities for employing other short-term reserves. The reasons are as follows:

1. As shown in Charts 1-3, expanded budget revenues in 1999 returned to their "normal level", and any growth in federal budget revenues will most probably require a re-distribution of other budgets' revenues. Such re-distribution has been planned but it cannot secure the expected increase in budget revenues.
2. Even if domestic production will be increasing induced by a higher effective demand, we do not believe that it can bring around a sizable increase of the share of revenues in GDP. According to our estimates, each percent of economic growth in prior years yielded a 0.1-0.2 percentage points of revenue growth in percent of GDP.
3. Even provided the prices on Russian exports remain high throughout the year (against last year's smooth growth to the present level), an increase in revenues in percent of GDP cannot be significant due to the delayed impact of the prices on the nominal GDP as such.

Consequently, we believe that the following year may show some further growth in federal budget revenues, but even under a best-case scenario it will not exceed one percentage point of GDP.

Table 2: Law on the Budget and EEG forecasts

	2000	2000	2000
% of GDP	budget	forecast 1	forecast 2
Revenues (cash)	14.9	13.0	13.6
incl. tax revenues	12.6	10.9	11.6
Expenses	16.0	15.0	14.7
Servicing of debt	4.1	3.8	3.7
domestic	1.2	1.1	1.0
external	2.9	2.7	2.7
Non-interest expenses	11.9	11.2	11.0
Deficit	1.1	2.0	1.1
internal financing	0.7	3.5	1.5
incl. Central Bank (gross borrowings)	0.6	3.0	1.0
external financing	0.4	-1.5	-0.4
incl. IMF (gross borrowings)	1.6	0	0.6
Initial deficit	-3.0	-1.8	-2.6
GDP	5,350	5,650	5,800

Table 2 presents EEG forecasts as compared to the Law on the Federal Budget. Forecast 1 reflects our expectations in case the conditions for implementing the budgetary policy are the same as in 1999 (i. e. a slight decline in oil prices and little probability of IMF loans). Forecast 2 is a more optimistic scenario which may come true under favorable external and internal political conditions.

As is seen from the table, when translated into nominal values, a higher level of GDP under scenario 2 (due to higher inflation) enables a complete fulfillment of the budget in nominal terms. However, performance indicators in percent of GDP deteriorate significantly.

THESIS 2: as in 1999, the Central Bank will bear the burden of deficit financing

As shown in Forecast 1 (inertia-based projection), there is a high probability than the main burden of funding the budget deficit will be borne by the Central Bank, as it was in 1999. First and foremost, the Government will need resources to serve and repay external debt. In this case the policy of the Central Bank will become almost purely a function of budget requirements, as the Central Bank will be forced to buy $4-5 billion on the market. Under an alternative scenario, the Central Bank will also be forced to buy hard currency on the market, but in much smaller quantities, allowing it to continue a reasonably flexible policy.

In any case, both scenarios are based on the assumption of some external financing. In the absence of such financing, the Central Bank's situation will be even graver, with inevitable inflationary effects.

THESIS 3: the opportunities for sterilizing excessive liquidity have shrunk

Why would the Central Bank's policy become almost completely dependent on the budgetary policy? First and foremost, as a result of the absence of adequate instruments to sterilize the excessive money supply. The application of relatively "crude" instruments of monetary policy (such as reserve requirements) has almost exhausted its potential. The Central Bank is still unable to resume its bond issues which may become (even if in the short-term perspective only) an instrument of sterilizing cash liquidity in an environment of weak demand for low-yield deposits. However, if the overall macro-economic situation does not show signs of improvement, Central Bank bonds will be unable to emerge into a solid deterrent to inflationary expectations, as they will have to be serviced through money-printing. The issuance of liquid bonds by the Government of the Russian Federation is equally unlikely given the high political and inflation uncertainty.

THESIS 4: additional real devaluation is unlikely because the balance of trade will counterbalance any factors whatsoever

According to our balance of payments projection, an additional real devaluation as compared to the current level of the real exchange rate is unlikely even under a relatively unfavorable scenario.

Table 3: Balance of payments - aggregate forecast

	1999	2000 (1)	2000 (2)
Balance of trade (goods and services)	29	31	32
Exports	81	86	88
Imports	52	55	56
Public administration sector balance	-8	-12	-10
Private capital balance	-19	-19	-19
Inflow	7	6	6
Outflow (including omissions and errors)	26	25	25
Change in foreign exchange reserves (at a constant real exchange rate)	2	0	3

Thus, the situation on the currency market should remain relatively stable throughout the year, although there will be a certain dependency on seasonal factors, as well as on the balance between capital inflow and outflow in the public administration sector in various months.

THESIS 5: the achievement of target inflation parameters is unlikely, as short-term opportunities for strengthening the financial policy are virtually exhausted; significant economic growth over the year is possible, but through demand rather than supply

Considering that the Central Bank will be forced to heavily buy currency to secure the repayment of foreign debt, money supply will grow significantly. Our estimates show that money supply over the year may increase by 35%-45%. However, with higher reserve requirements for deposits and the availability of certain (albeit very limited) means of sterilizing an increased money supply, it is unlikely to exceed 30%. In this case, and subject to the absence of growth, inflation will probably approximate the increase in money supply or, in case of limited growth (1.5%-3%), may decrease to 25%-27%. We believe there are no reasons to expect a greater demand for money, since the industries focused on the end user will be encouraged to convert part of the generated profits into hard currency for subsequent import purchases which will enjoy higher demand as disposable income increases.

THESIS 6: 1999 was lost in terms of serious economic transformations, 2000 may share the same fate

Despite an unexpectedly pragmatic financial policy in 1999, this year was virtually lost in terms of serious economic reform. Progress across all areas was extremely slow, and no reform program was put together. The main reason for this was the frequent government reshuffle and a universal anticipation of nearing elections, rather than and in addition to the difficult financial position of the Government.

Unfortunately, although the election campaign will be over as early as in the second quarter, we do not expect any active efforts in the area of economic transformations in 2000, even assuming the new President will be reform-minded.

First of all, the reform program is still in the making, and our estimates show that to secure good results, work will have to continue at least until the middle of the year.

Secondly, the President will not wish to immediately sacrifice political stability (based, among other things, on good relations with the Communists) for speedy reforms.

Thirdly, before the war in Chechnya is over, the Government will not be able to concentrate on Russia's economic problems in general.

Four, the President will have no desire and will be unable to ensure a quick adoption in Parliament of a package of budget reforms required to achieve the medium and long-term goals of the Government, fearing negative social consequences. In our opinion, an adequate PR campaign will require at least six months, and even then the laws will take effect at the best no earlier than as of 2001. If this proves to be true, year 2000 may be considered a success. If the adoption of the budget reform package is postponed until 2001, year 2000 will be lost entirely.

Five, the President and the Government will have their hands tied until there are clear agreements with Russia's creditors. According to the information we have, the Paris Club intend to resume talks no earlier than in September. If this is the case, financial uncertainty will not be resolved until 2001, although if the negotiations are actually completed in year 2000, we will not necessarily have to regard 2000 as lost time.

Six, subject to all of the above limitations, the President, the Government and the Central Bank will tend to resolve problems using largely administrative measures, which may slow down not only the pace of reforms as such, but also the process of designing the necessary economic solutions.

3. ANALYSIS OF MEDIUM-TERM PERSPECTIVE

When formulating the realistic medium-term scenario of economic development, we proceeded from the following assumptions[10]:

- Foreign borrowings will amount to $4.3 billion in 2000, $4.0 billion in 2001 and $3.7 billion in 2002, with the volume of sovereign loans gradually diminishing (from $4.3 billion in 2000 to $4 billion in 2001 and $3.7 billion in 2002) to be replaced by borrowings on international markets ($1billion in 2001 and $2 billion in 2002).
- Foreign debt servicing and repayment were factored in with account taken of the possible restructuring options and assuming payments of $10-11 billion a year.
- Federal budget revenues were calculated based on an estimate of their principal components, in the amount of approximately 13% of GDP.
- The shortage of external borrowings against the planned parameters of the Law on the Budget will be offset by an additional $1.5 billion loan from the Central Bank.
- The pattern of global oil prices in 2000 was assumed to show a certain decrease compared to the current, extremely high, level. However, it is expected that the average Brent price in 2000 will be somewhat higher than in 1999 ($18.5 per barrel in 2000 against $18 per barrel in 1999). It is assumed that contract prices for exported Russian crude will be lower than the world price on Brent oil by $3.3 per barrel (actual figure for the third quarter of 1999). Exports of crude to non-CIS countries in 2000 are estimated at 122 million tons.

  Prices on Brent oil in 2001-2002 will slide back to their average level in 1999 ($18 per barrel), and the difference between the Brent price and contract prices for Russian crude exported to non-CIS countries will decrease to $3 per barrel. Crude exports to non-CIS countries will increase to 124 million tons and 127 million tons in 2001 and 2002, respectively.

  European prices on natural gas, which tend to respond to changes in prices on crude oil with a certain time lag, will increase by 26% compared to 1999 (average for the year). Average contract prices for natural gas exports to non-CIS countries will show a modest decrease compared to 2000, stabilizing at $76 per one thousand cubic meters, with shipments of natural gas to non-CIS countries increasing to 137 and 141 billion cubic meters in 2001 and 2002, respectively.
- It is assumed that the outflow of Russian capital (without foreign currency in cash) through banks and companies in 2000 will differ little from that of 1998-1999, totaling $26 million. In 2001-2002 capital outflow is expected to reduce by $2 billion annually.

  Current foreign debt owed by the corporate and banking sector will be repaid within the next six years. Payments in 2000 will approximate $6 billion (including interest). In 2001-2002, as settlements continue, payments will gradually decrease to $5.6 billion in 2001 and $5.3 billion in 2002. No new borrowings by the private sector are expected in 2000-2001. In 2000 the private sector will regain access to capital markets, with resulting borrowings totaling $2 billion.

[10] The forecast for 2000 under this scenario does not completely coincide with the previous one as it is based on a different model; however, the qualitative estimate is the same.

- Direct and portfolio investments into the banking and corporate sector in 2000 will remain at virtually the same level as in 1998-1999, amounting to $3.2 billion. In 2001-2002 investments will slowly increase to $3.7 billion in 2001 and 4.3 billion in 2002.
- Gross external reserves in 2000 will amount to three months worth of imports of goods and services, increasing in 2001 and 2002 to 3.4 and 4.0 months worth of imports, respectively.

Projections for 2000 yielded the following results (Table 4):

- A minor economic growth is expected, to the tune of 0.4%, 1.4% and 1.5%. in 2000, 2001 and 2002, respectively.
- Inflation in 2000 (CPI December-to-December) will be higher than planned in the Law on the Budget due to additional emission and will constitute 26%. If foreign debt is successfully restructured and sufficient external financing is secured in subsequent years, inflation may go down to approximately 10% a year.
- The real exchange rate will remain virtually unchanged in 2000, followed by a gradual strengthening of the ruble in subsequent years (an average of 5% in 2001 and 8% in 2002). The nominal average annual exchange rate in 2000 will be lower than expected (approximately RUR31 per $1).
- Higher inflation in 2000 will result in GDP above the projected level (over RUR 5,600 billion).
- Initial budget surplus in 2000 may approximate its nominal value as per the Law on the Budget but smaller in percent of GDP (2.9%). In subsequent years, we may expect it to reduce to 2.6% of GDP (in 2001) and 2.0% of GDP (in 2002).
- Deficit may amount to 0.8% of GDP in 2000, with subsequent slight growth as sources of financing expand (to 1.5% of GDP and 2% of GDP in 2001 and 2002 respectively).
- The volume of internal financing is assumed to remain relatively constant (about 1.5% of GDP), but Central Bank loans will be gradually replaced by market borrowings. Net domestic financing will change from negative in 2000 to zero in 2001 and positive (0.7% of GDP) in 2002.
- Interest expenses in 2002 will demonstrate a slight downward trend (to 3.7% of GDP), but will subsequently grow to 4% of GDP (primarily due to increased servicing of foreign debt).
- Non-interest expenses in 2000 will reduce significantly in real terms (by 9%), returning to their 1999 level only in 2002.

<u>Table 4</u>: Realistic medium-term macro-economic forecast

	1999	2000	2001	2002
<u>Federal budget performance, % of GDP</u>				
Revenues	13.0	13.1	13.0	12.9
Expenses	15.1	13.9	14.5	14.9
-interest	3.9	3.7	4.2	4.1
external debt	2.4	2.6	3.0	3.2
internal debt	1.5	1.1	1.1	0.9
-non-interest	11.2	10.2	10.3	10.8
Deficit (-), surplus (+)	-2.1	-0.8	-1.5	-2.0
Net external financing	-1.3	-0.7	0.0	0.7
-received	1.6	2.4	2.6	2.7
-repaid	2.9	3.1	2.6	2.0
Net internal financing	3.4	1.5	1.6	1.3
Initial deficit (-), surplus (+)	1.8	2.9	2.6	2.0
Total state debt as at the end of period	105	80	68	64
incl. internal debt	12	10	9	9
Non-interest expenses in real terms, % to 1997	82	74	76	81
		-9.0%	2.9%	6.4%
External state debt				
Interest payments by the Government of the Russian Federation, $ billion	4.2	4.7	5.9	6.8
Repayment of principal by the Government of the Russian Federation, $ billion	5.2	5.5	5.0	4.1
Total payments in settlement of external debt by the Government of the Russian Federation				
-$ billion	9.4	10.3	10.9	10.9
-% of GDP	5.2	5.7	5.6	5.2
-% of Federal budget revenues	0.4	0.4	0.4	0.4
Total payments in settlement of external debt	0.6	0.6	0.5	1.5
by the Central Bank of Russia, $ billion				
External borrowings, $ billion	2.8	4.33	5.0	5.7
External state debt as at the end of period				
-$ billion	153	114	114	116
-% *of GDP*	93	70	59	54
Macro-economic performance indicators				
GDP				
-change from *previous year, %*	2.1	0.4	1.4	1.5
-physical volume, *% to 1997*	97	98	99	101
-RUR billion	4,450	5,606	6,853	7,717
-$ billion	181	182	193	211
Gross investments, % of GDP	10.0	7.8	9.6	12.5
Balance of payments, $ billion				
-export of goods	72.4	79.3	81.3	83.2
-import of goods	40.1	41.1	44.5	48.9
-balance of trade	32.2	38.2	36.7	34.3
-current *account* balance	22.6	31.4	29.5	27.2
Inflation (consumer price index), %				
-year-over-year	86	26	21	11
-December-to-December	38	26	14	9

Exchange rate, RUR per $1				
-average for the *year*	24.6	30.9	35.5	36.5
-as at *year-end*	27.0	34.3	35.5	36.4
Real exchange rate, % *to 1997*	55.8	56.2	58.9	63.5
Gross external reserves		0.7%	4.9%	7.9%
-$ billion	11.2	13.5	16.6	21.0
- in months of imports of goods and services	2.6	3.0	3.4	4.0
For reference only:				
Average world price on Brent crude, $/bbl	18.0	18.5	18.0	18.0