EU Frontiers

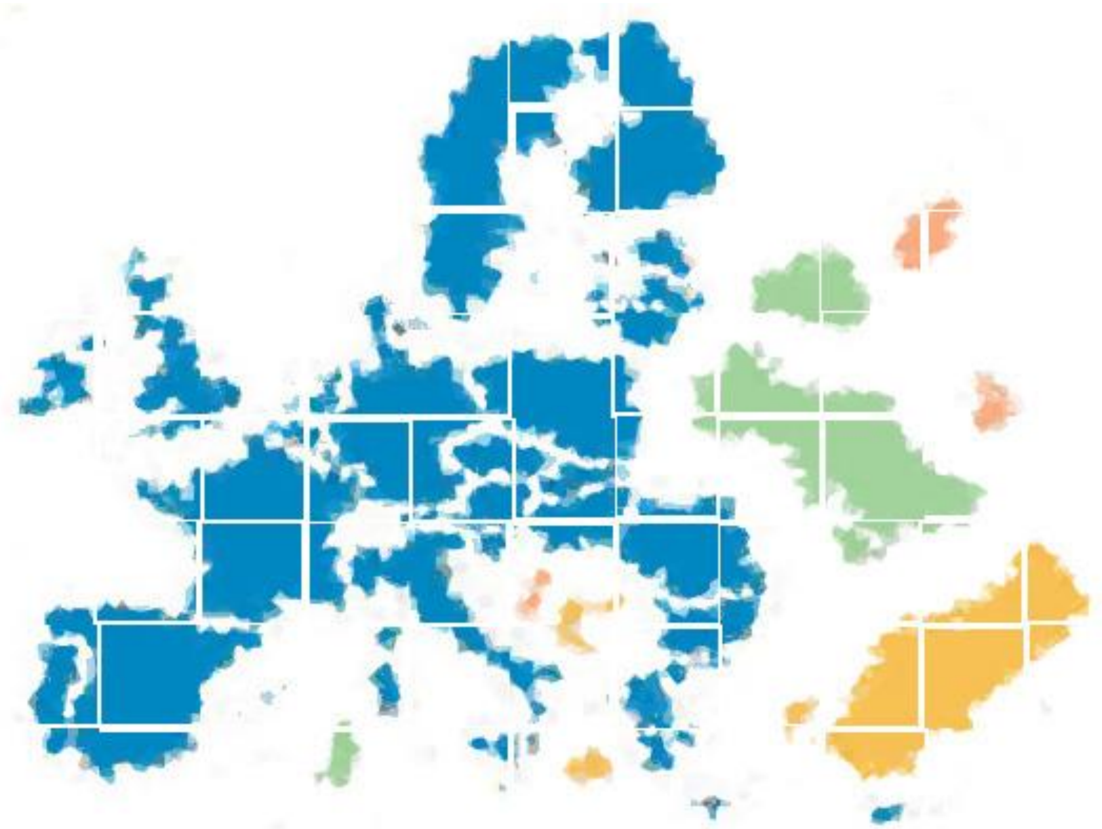
Policy Brief

No. 12

Budget Constraints as the Main Challenge to Russia's Economic System

Dynamics of Russian corporate foreign debt

Andrey Chernyavskiy



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Andrey Chernyavskiy is Senior Research Fellow at the Institute "Development Center", National Research University Higher School of Economics in Moscow. He graduated from Moscow State University, Economic Faculty (1970-1975), PhD (1982). His profile of activity includes among others monitoring of problems in the public finance sphere at the federal and regional budget levels, analysis of the income and expenditures of federal and regional budgets, examination and preparation of opinions on draft laws on the federal budget, forecasting of parameters of the federal budget and the budgetary system for the medium and long term, analysis of the dynamics and structure of public and corporate debt. He has over 80 articles published in Russian and foreign journals.

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Dynamics of Russian corporate foreign debt

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Abstract
This paper looks into Russian economy growth rates versus the emerging and advanced economies and the world in general. It contains the analysis of key federal budget indicators dynamics in 2000–2016, as well as the draft 2017–2019 Federal Budget law. The paper highlights the challenges associated with the planned budget consolidation. In addition it reviews Russian corporate foreign debt dynamics or the period after imposing sanctions. The paper emphasizes that currently Russian corporations are successfully coping with external debt redemption and servicing.

Russian economy institutional quality and growth rates

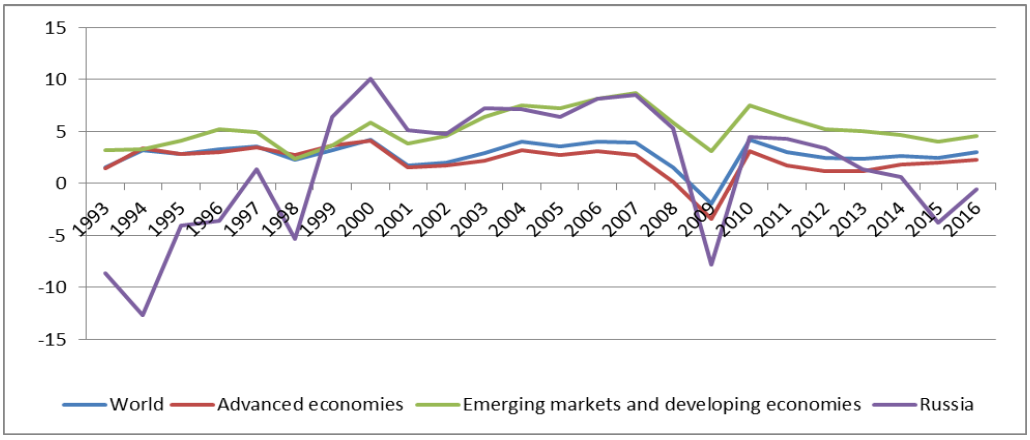
The budget-related issues have become extremely acute due to the reduction of oil prices. The outlook for Russian economy for the period of next 12-15 years largely depends on the way those issues are resolved. In 2015, Russia faced economic recession and aggravation of budget problems. Revision of the previously planned 2015 budget commitments and plans for their reduction in real terms in 2016 and in 2017-2019 are evidencing that the federal budget is not sustained to external shocks (reduction of oil prices, sectoral sanctions and others) and to overall economic downfall. The regions were forced to make more significant expenditure cuts versus the federal budget. Regional budget problems manifested themselves earlier, i.e., starting from 2012 – as a negative reaction to the economy deceleration and new "unfunded mandates".[2]

Currently many experts are discussing the weaknesses of Russian institutes. According to (Nort at al),[3] developed democracies are wealthier than the countries with underdeveloped institutes not due to their faster development during all time periods, but due to their ability to maintain sustainable

[1] Research on this topic received funding from the Basic Research Program at the National Research University-Higher School of Economics.
[2] Mandates associated with the RF President's Decrees of May 6, 2012.
[3] D. Nort et al. Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History, 2009

growth rates. Economic downfalls are less frequent and less painful in developed democracies. Russia as the country with numerous unresolved institutional problems is very likely to enter the period of protracted crisis, when all economic achievements of 2000s may be lost (Fig. 1.)

Fig 1. Growth rates of world economy, advanced economies, emerging markets and developing economies and Russia (1993-2015 – fact, 2016 – IMF forecast)



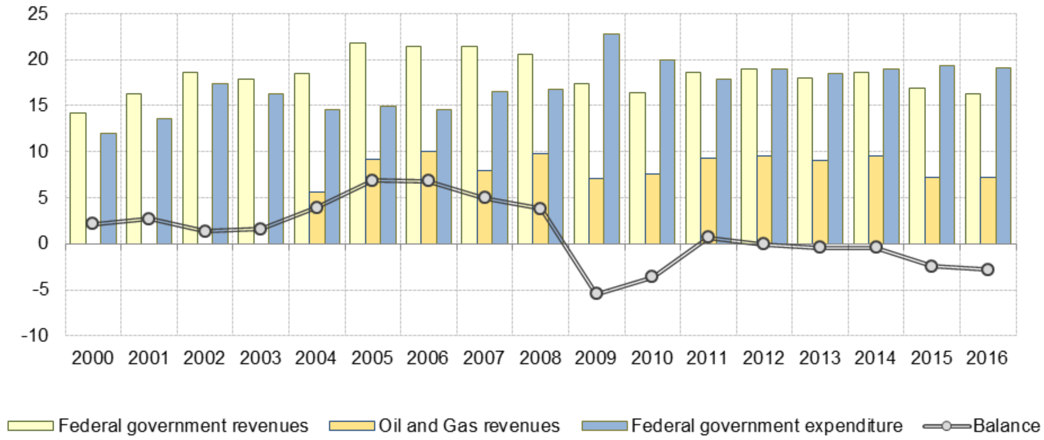
Source: IMF

The period starting from early 90s can be broken down into several stages by the ratio between Russian economy growth rates and growth rates of advanced and emerging economies. In 1993–1998 Russia was undergoing painful transformation into market economy, and suffered negative growth rates. In 1999–2001, the growth rates of Russian economy were higher versus the average growth rates of the developing countries. In 2002-2008, Russian economy supported by super profits in oil-and-gas sector demonstrated approximately the same growth rates as developing countries including fast-growing China. In those years, Russia's share in global GDP was growing steadily. During 2000–2008, Russian economy grew by 83%, and global economy – "only" by 46%. However, due to weak institutions and market environment these high growth rates did not provide for laying the foundation for future sustainable growth. After the economic crisis of 2008–2009, which brought for Russian economy a more severe decline than for the majority of other countries, Russian economy growth rates in 2010–2012 were in line with those of the global economy in general, which is behind the developing countries growth rates approximately by two percentage points. In 2013, GDP growth rates in Russia came down to the level of advanced economies making just 1.3%. Finally, in 2014, Russia was behind even the slowly growing developed countries, and then starting from early 2015 demonstrated negative dynamics. Thus, IMF data on Russian economy and global economy growth rates support the idea of Russian macroeconomic indicators being unsustainable.

Dynamics of key federal budget indicators in 2000-2016

In 2000–2015, market factors (such as the plunge in global oil prices) and changes in taxation defined the dynamics of federal budget revenues. Federal expenditure dynamics during those years reflected a compromise between the hunger for spending all the received revenues and the intent to restrict the use of budget revenues based on high oil prices.

Fig 2. Revenues, Expenditure and Balance of Federal Budget in 2000-2016 (% of GDP)



Source: Ministry of Finance of the Russian Federation (Mindfin RF)

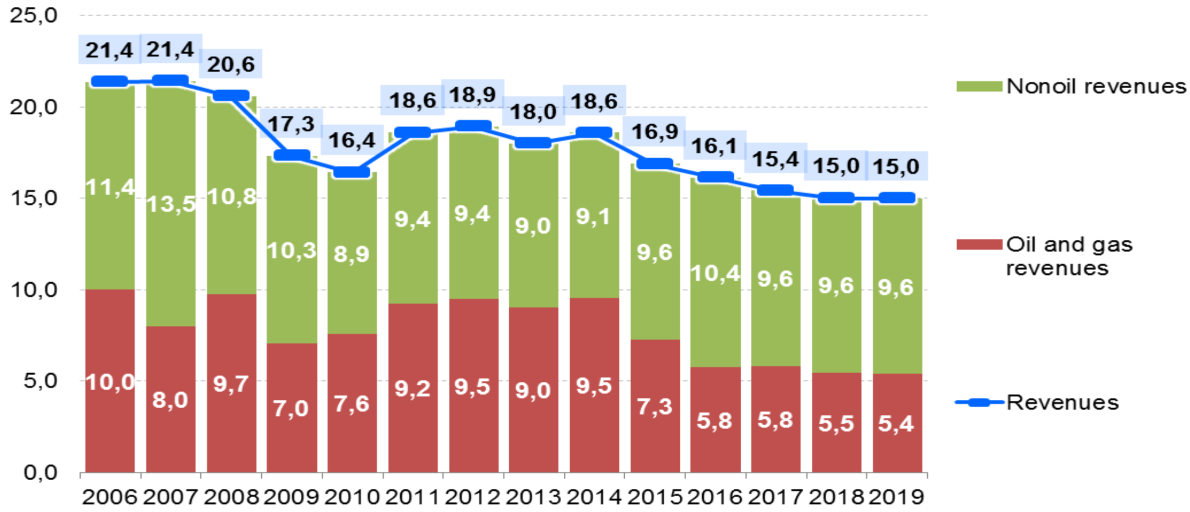
In 2001–2002, federal budget revenues consisted mainly of total coverage taxes and made respectively 15.4% and 17.8% of GDP, which was significantly lower than in the following years. Rental income did not play a particularly important role, in 2001 payments for the use of natural resources and the total amount of collected customs duties made 24% of the overall federal budget revenues. In 2002, after the start of oil price growth, tax legislation underwent significant changes, in particular in the oil-and-gas sector. These changes continued in 2004 (extract tax calculation formula for oil was changed, as well as oil export duty). It resulted in budget revenues reaching 20% of GDP in 2002–2004. In 2005–2008, they continued their growth, making 23% of GDP on the average. However, in 2009-2014, the revenues versus GDP went down again from 2002–2004 levels. The key reason for this decrease was relative reduction of oil-and-gas revenues, and reduction of VAT revenues from domestically sold goods. Also the federal part of corporate income tax rate reduced from 6.5% to 2% in 2009.

Political factors largely defined the dynamics of the federal budget expenditure. Similar to the revenues, the expenditure dynamics demonstrates several stages. 2000–2001 period showed relatively low expenditure – respectively 13.0% and 14.8% of GDP. Foreign debt relief was the key priority during those years. In 2002-2003, the expenditure level grew up to 17-18% of GDP. In 2004-2006, the government successfully implemented the policy for limiting budget expenditure and their level fluctuated around 16% of GDP. However, in 2007–2008, the federal budget expenditure grew up to 18-18.3% of GDP, and in 2009 – the year of crisis – they rocketed almost up to 25% of GDP. During the period of 2010-2016, the average expenditure level made 19% of GDP, and no trend for their reduction was observed during the recent five years despite the statements of the RF Ministry of Finance about the need to resolve this issue. During 2000-2014, the federal budget expenditure grew 3.6 times in real terms. Social budget commitments demonstrated even higher growth, thus creating the basis for the current budget problems.

Federal budget and budget system revenues and expenditure in 2016-2019

The key focus of the draft 2017-2019 Federal Budget law is budget consolidation. The basic assumptions for the next three years are as follows: the sanctions and counter-sanctions regime will stay, oil prices will stabilize at the level of $40/barr., and the federal budget expenditure in 2017-2019 will be frozen at the level of RUB 15.8 trillion (not accounting for some one-off payouts). This will allow for bringing down the federal budget deficit from 3% of GDP in 2017 to 2% in 2018 and to 1% of GDP in 2019. Borrowings in the domestic market will be the main financing source for the budget deficit during these years. The Reserve Fund will be depleted in 2017 already. Fig.3 presents the federal budget revenues structure. The key trend for changing this structure during the next three years shall be reduction of the oil-and-gas revenues share (down to 5.4% of GDP in 2019).

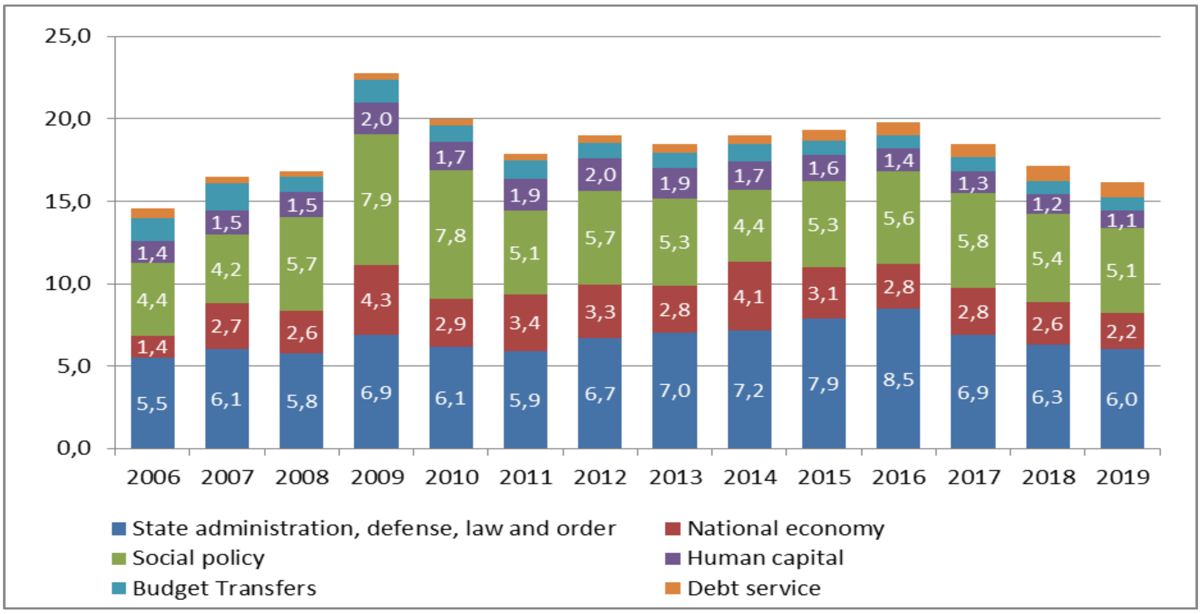
Fig.3 Dynamics and Structure of Russian Federal Budget Revenues (% of GDP)



Source: Ministry of Finance of the Russian Federation (Minfin RF)

The three-year outlook for the federal budget expenditure (amounts and structure) looks as follows:

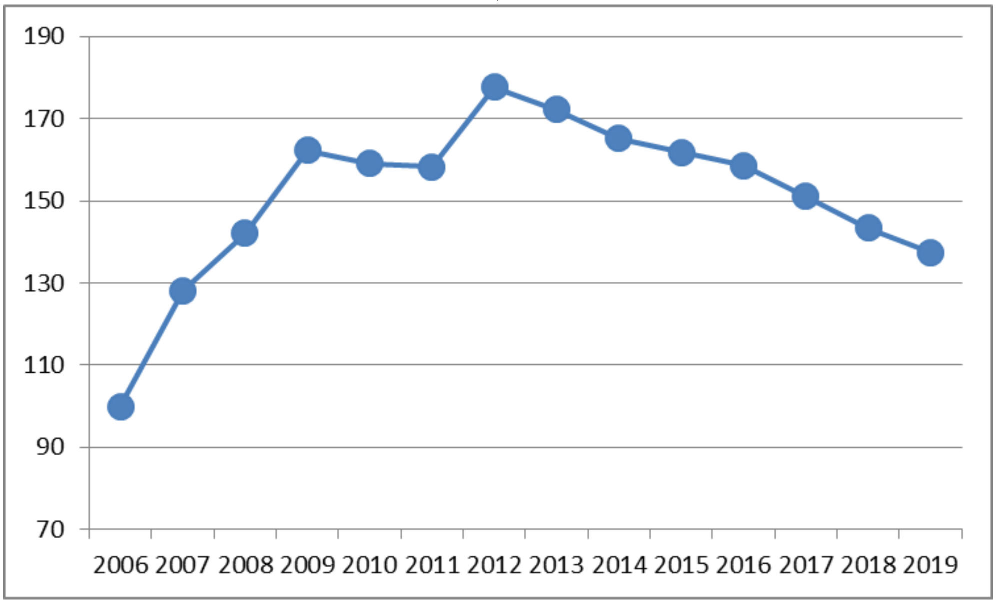
Fig.4 Federal budget expenditure (% of GDP)



Source: Ministry of Finance of the Russian Federation, Federal State Statistics Service of the Russian Federation (Rosstat)

Now let us look at the federal budget expenditure dynamics in constant prices.

Fig.5 Dynamics of federal budget expenditure in constant prices (2006 = 100%)



Source: Ministry of Finance of the Russian Federation, Federal State Statistics Service of the Russian Federation (Rosstat)

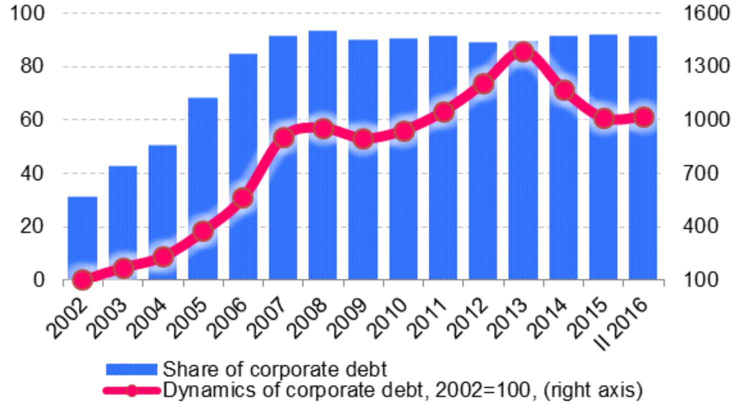
Graph No.5 shows that starting from 2013, the federal budget expenditure in constant prices were going down. It leads to the conclusion about the high price of budget consolidation in Russia, which affects all areas of public expenditure. In 2019, Russian federal budget expenditure in constant prices will be approximately at the level of 2007 expenditure. The General government expenditure dynamics overall mirrors the federal budget expenditure dynamics, but looks smoother, because the Pension Fund expenditure until 2016 were indexed in accordance with the inflation, and in 2017–2019 indexation of pensions in accordance with the inflation is also stipulated (except for working pensioners).

Dynamics of Russian external corporate debt

Russian economy faced the current crisis burdened with significant corporate foreign debt. As of today, its refinancing for major financial and non-financial corporations is associated with significant difficulties or is impossible due to sectoral sanctions. Nevertheless, Russian corporations are successfully coping with their foreign debt settlement. In the economic recession environment, the absolute debt is decreasing, but the debt burden on the economy is growing.

The first half of 2000s witnessed the sovereign debt reduction and active growth of corporate external debt, which achieved approximately 90% of aggregate foreign debt by 2007 (fig. 6). From late 2002 until early 2014, the debt of financial and non-financial companies of Russia grew almost 14 times (!) – from USD 47.0 bln to USD 651.2 bln. This indicator reached the highest value of USD 659.4 bln by mid-2014 when sectoral sanctions were imposed limiting access of major Russian companies to foreign financial markets.

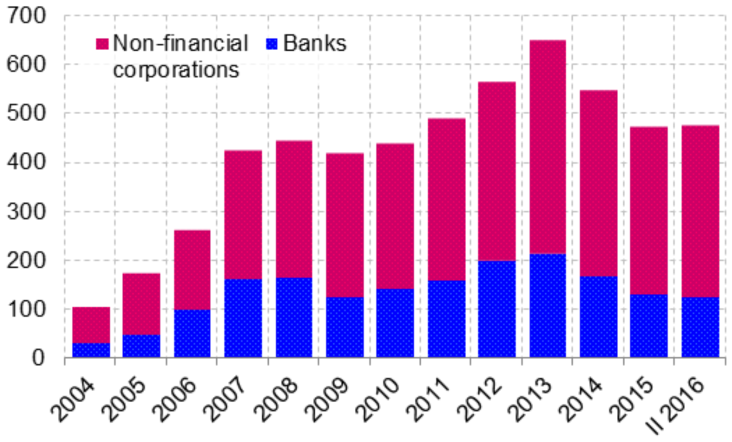
Fig. 6 Dynamics and share of Russian corporate debt



Source: Central Bank of Russia, Federal State Statistics Service of the Russian Federation (Rosstat)

After imposing sectoral sanctions, the absolute amount of corporate debt started to decrease. As per the CBR data, by the end of Q2 2016 corporate debt made USD 477.7 bln after 28% reduction versus mid-2014. The bank sector has about 27% share of corporate foreign debt, and the remaining part accounts for the debt of non-financial organizations (fig. 4.3). Let us note that in 2016 Russian non-financial corporations began building-up their foreign debt again. This also relates to certain Russian companies such as Gazprom, which is not under sanctions in Europe.

Fig.7 Structure of Russian corporate debt (USD bln)



Source: Central Bank of Russia

However, *in relative terms the debt load of Russian economy grew.* As we can see from Fig. 7, starting from the beginning of crisis, the debt grew significantly as percentage of both GDP and export. It may be explained by GDP shrinking, Ruble devaluation and export reduction due to the slide of global energy prices. In principle, such increase may become an independent driver of Russian domestic consumption and accumulation decrease, because foreign debt retirement will require big resources.

Fig.8 Russian corporate debt as % of GDP and export

Source: Central Bank of Russia, Federal State Statistics Service of the Russian Federation (Rosstat)

International experience and Russian practice confirm that the government is to that or another extent engaged in settlement of corporate foreign debt, especially with respect to the state-owned corporations. High foreign debt of the banking sector may constitute the biggest problem for Russian economy. It may lead to backbone banks losing their liquidity and financial solvency, which, in its turn, may result in full-scale bank crisis requiring public resources for overcoming it.

Currently Russian banks are successfully coping with their foreign debt. During the period starting from early 2014 until the end of Q2 2016, the foreign debt of the banking sector decreased by 40% – from USD 214.4 bln down to 127.7 bln. It should be noted that in 2014 and 2015 three major Russian banks (VTB, Gazprombank and Rosselkhozbank) received government aid from NWF (National Wealth Fund); in 2015, commercial banks had an opportunity to raise their capitalization via a special issue of Federal Loan Bonds. In 2016, support of commercial banks is not part of the government anti-crisis plan; nevertheless, Vnesheconombank – Russian development institute – is to receive a serious transfer from the federal budget associated, among other things, with the need to settle foreign debt. Currently foreign assets of Russian banks exceed their foreign liabilities; however, the capacity of certain banks to timely discharge their liabilities remains questionable.

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D. Nort et al. Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History, 2009.

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