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Russia Macro View

Fiscal Position: Good From Afar, But Far From Good

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With thanks to
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- **Russian budget looks healthy at US$110-120/bbl** — The government approved proposed revisions to the 2012 budget on 26 April, reducing the deficit to RUB68bn (0.1% of GDP) from the earlier budgeted RUB877bn (1.5% of GDP). The government is planning to spend about 10% of the additional RUB898bn in revenues generated from the higher assumed oil price. Previously, we estimated that pre-election promises made by President-elect Putin would cost the budget some RUB200-300bn this year, but as some of them were already provisioned in the initial budget plan and compensating expenditure cuts will be found for the others, the actual increase will be milder.

- **US$117/bbl oil budget break-even is roughly 10 times what it was 10 years ago** — Russia is ever more exposed to oil price swings and burdened with social spending commitments. We expect the non-oil fiscal deficit to stay near 10% of GDP for the foreseeable future. The government estimates the budget break-even price will fall to US$107 per barrel by 2014, but this is based on optimistic assumptions. We believe the social commitments for 2013-14, costing 0.5-0.7% of GDP (MinEcon's estimate), will increase the break-even oil price by a further US$10/bbl. Failure to tackle the pension system challenges is likely to add another US$5/bbl to the break-even point.

- **There are no easy ways to reduce the break-even price** in our view. On the revenue side, VAT efficiency could be increased, including the elimination of exemptions yielding some results, while income tax is already high (personal income tax plus social contributions). More taxes, such as excises and those on luxury items and property, are unlikely to yield large gains. On the expenditure side, about 75% of total government spending is statutory, meaning a reform plan and legal changes would be required to cut entitlements. Pensions account for most of the increase in consolidated government spending to 37% now from 27% in 2004 and will continue to add pressure on the expenditure side.

- **Fiscal rule could be positive news for investors** as it would limit pro-cycle fiscal policy and reduce exchange rate volatility. In response to the 2008 global financial crisis, the Russian Government suspended the rule that sets maximum non-oil deficits at 4.7% until end-2013; this is now likely to be extended into 2016. The MoF is suggesting revenues in excess of a 10-year oil price average be saved. The proposed rule is less ambitious than the original as the authorities are assuming a moderate nominal increase in oil price; however it will still require significant fiscal effort and would be a positive sign for investors.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Good from afar, but far from good

2012 budget looks healthy at US$110-120/bbl

We expect the consolidated budget deficit to be roughly balanced in 2012 assuming oil prices remain in the US$110-120/bbl range. Following the government's revision to the macro-framework assumptions (most importantly an increase in the oil price assumption to US$115 per barrel from US$100/bbl), the 2012 budget is likely to be close to balanced in 2012. According to preliminary Ministry of Finance estimates, the federal budget registered a deficit of RUB120bn in 1Q. Federal budget revenues in the quarter grew 23.6%. While oil and gas revenues increased by about 37%, non-oil revenues were up by 8%. The original budget was based on an oil price of US$100/bbl and envisaged a deficit of 1.5% of GDP and break-even oil price of US$117/bbl. We estimate each US$10/bbl increase in oil price brings around RUB500bn or 1% of GDP to the budget. However, non-oil revenues could underperform this year due to lower-than-budgeted GDP growth.

Revised 2012 budget allows for a moderate RUB88bn increase in spending. The government approved proposed revisions to the 2012 budget on 26 April, reducing the deficit to RUB68bn (0.1% of GDP) as opposed to the earlier budgeted RUB877bn (1.5% of GDP, Figure 1). (Deputy Minister of Economy Klepach, Reuters, 27 April). The government is planning to spend about 10% of the additional RUB898bn revenues generated from the higher assumed oil price. Previously, we estimated that pre-election promises made by Mr. Putin would cost the budget some RUB200-300bn this year, but as some of them were already provisioned in the initial budget plan and compensating expenditure cuts will be found for the others, the actual increase will be milder. The Ministry of Economy's revised forecast now assumes a higher-than-budgeted increase in pensions, as well as additional indexation of selected wages in the public sector in 3Q, which were part of Mr. Putin's pre-election commitments.

Figure 1. Federal budget official plan (adopted in Dec 2011 subject to revisions during 2012).

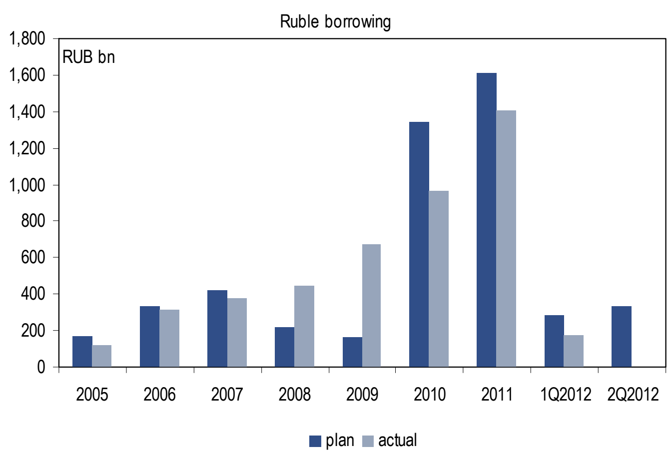
	(billions RUB)			(billions US$)		
	2012F	2013F	2014F	2012F	2013F	2014F
Revenues	11779	12706	14091	410	432	462
%GDP	20.1%	19.6%	19.4%			
Oil and Gas	5575	5646	6127	194	192	201
%GDP	9.5%	8.7%	8.5%			
Expenditures	12656	13730	14583	441	467	478
%GDP	21.6%	21.2%	20.1%			
Deficit	-877	-1024	-492	-31	-35	-16
%GDP	-1.5%	-1.6%	-0.7%			
Non-oil deficit	-6452	-6670	-6619	-225	-227	-217
%GDP	-11.0%	-10.3%	-9.1%			
External borrowing	161	165	174	6	6	6
Disbursement	201	206	214	7	7	7
Amortization	-40	-41	-40	-1	-1	-1
Domestic borrowing	1209	1186	1094	42	40	36
Disbursement	1809	1803	1881	63	61	62
Amortization	-600	-617	-787	-21	-21	-26
Reserve fund	-512	-570	-957	-18	-19	-31
National Welfare Fund	8	10	10	0	0	0
Privatization	300	380	475	10	13	16
GDP	58683	64803	72493			
Inflation	6	5.5	5			
USD/RUB	28.7	29.4	30.5			
Urals oil price	100	97	101			

Source: Ministry of Finance, Citi Investment Research and Analysis

Lower-than-expected budget deficit reduces the need for borrowing. Russia placed US$7bn in Eurobonds in early April – fulfilling the total 2012 foreign borrowing plan, and issued RUB200 in ruble-denominated borrowing, thus raising about RUB375bn in total. Russia can meet the recently budgeted RUB0.8tn increase in Reserve funds, virtually without further borrowings. It is therefore not surprising the MoF recently announced the next external debt issue will not take place before 2013 and even that is not certain (19 April, RIA news). Meanwhile, in the new budget plan, the foreign debt ceiling was increased by US$8.1bn, but we believe external borrowing is not likely to be implemented this year, and this measure acts rather as insurance against tight domestic liquidity. The MoF has also decided to cut domestic borrowing by Rub500bn in 2012 reducing net borrowing to less than Rub1tr (VoA, 23 April). Privatization revenues are unlikely to materialize in 2012, but they are also not needed for budget financing.

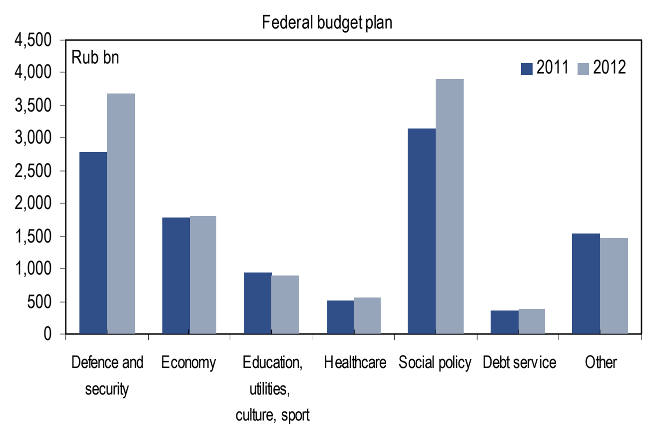
Under either scenario, we expect fiscal policy to drain liquidity in 2012 (Figure 5). We believe the recently adopted plan to increase spending by RUB88bn, a RUB800bn contribution to the Reserve Fund and RUB700bn in domestic borrowing is more realistic than the overly ambitious original budget.

Figure 2. During stable times borrowing was lower than planned



Source: Citi Investment Research and Analysis

Figure 3. This year defense and social spending are set to rise



Source: Citi Investment Research and Analysis

Figure 4. Budget timeline

end of April	update of macro forecasts
by June	revision to 2012 budget
June	President's budget message
- Sep 15	Draft budget 2013-16 provided by MoF to the Government - some details usually become available in late July-Aug, deadline
by 1 Oct	daft budget 2013-16 sent to the Duma -
by end of Nov	budget 2013-16 - 1st reading in the Duma - by the end of Oct; 3rd (final) reading
Dec	Budget 2013-16 - Presidential approval

Source: Citi Investment Research and Analysis

Figure 5. Consolidated budget options assuming US$110/bbl average oil price

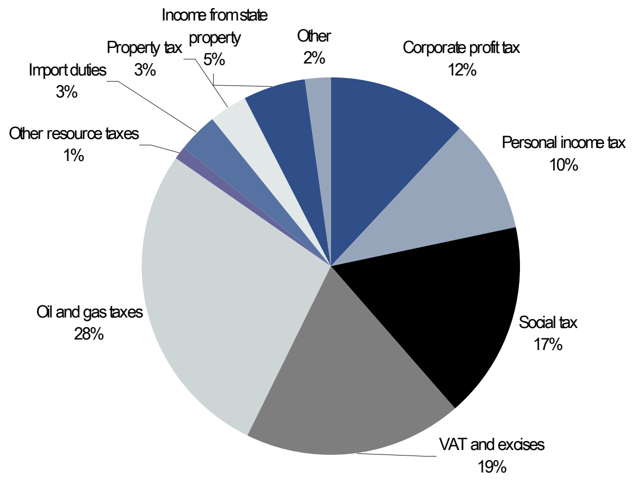
Budget revenues	Net domestic borrowing, RUB bn	Foreign borrowing, US$ bn	Reserve fund	Spending	Budget balance	Liquidity effect
Baseline						
22300	700	7	800	22400	-100	-600
All extra revenues go to the Reserve Fund:						
22300	1200	7	1310	22400	-100	-1100
22300	700	7	810	22400	-100	-600
Budget expenditures are increased by 300:						
22300	1200	7	1110	22650	-350	-850
22300	700	7	710	22650	-350	-350
Reserve fund is increased by 500, all other revenues are spent:						
22300	1200	7	500	23210	-910	-290
22300	700	7	500	22710	-410	-290

Source: Citi Investment Research and Analysis

Oil exposure near all-time high

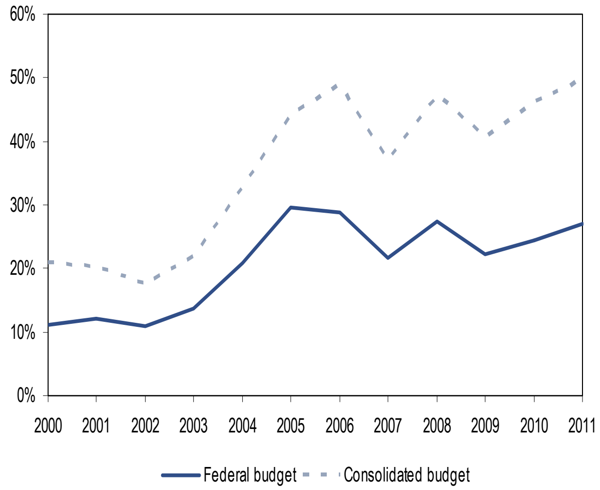
The importance of oil for the sustainability of budget revenues has increased over time, leaving Russia particularly exposed to oil price shocks. Oil and gas revenues were the most rapidly growing component of budget revenues. In 2011, 28% of consolidated budget revenues came from direct taxation on oil and gas export revenues and the mineral extraction tax. In addition, the oil sector also provides a quarter to a third of profit tax and is the driver of many other tax-paying businesses.

Figure 6. Source of government revenues in 2011



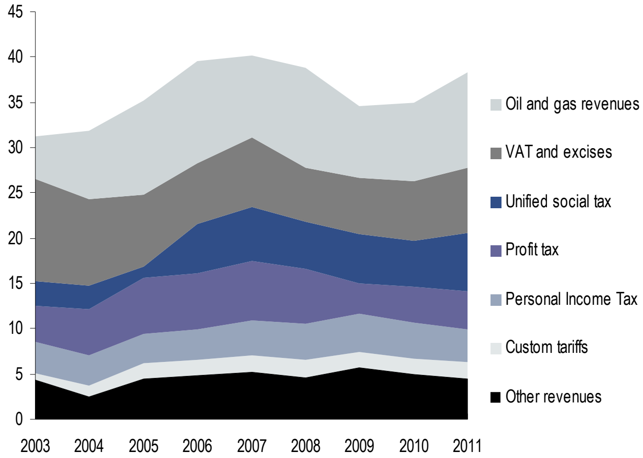
Source: Haver, Citi Investment Research and Analysis

Figure 7. Share of oil and gas revenues in budget revenues



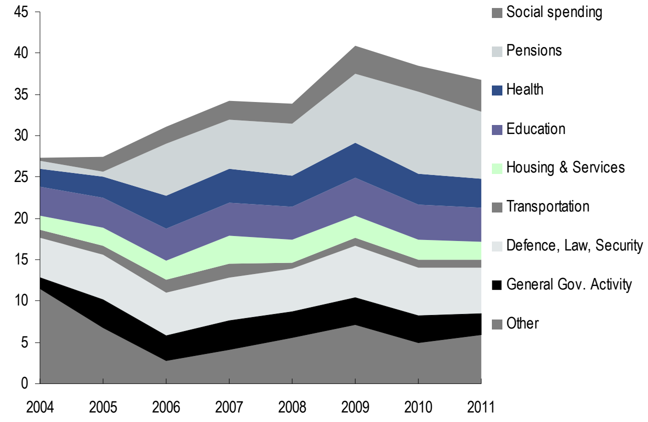
Source: MoF, Haver, Citi Investment Research and Analysis

Figure 8. Fiscal revenues over time (in percent of GDP)



Source: Haver, MoF, Citi Investment Research and Analysis

Figure 9. Government expenditure (in percent of GDP)

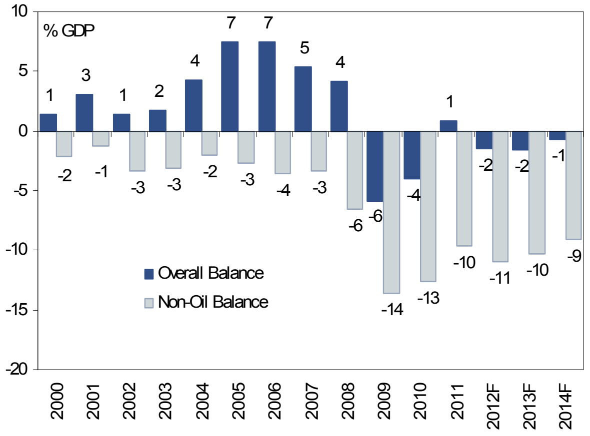


Source: Haver, MoF, Citi Investment Research and Analysis

Higher spending absorbed most of the positive oil shocks in recent years. Consolidated government spending has increased by 10% of GDP to 37% since 2004, mostly due to higher pension spending. About 75% of total government spending is statutory, meaning that a reform plan and legal changes would be required to cut entitlements. The largest increases occurred in the pre-2008 election period and after the end-2008 fall in oil prices and slow ruble devaluation, which lead to a sharp contraction in the Russian economy.

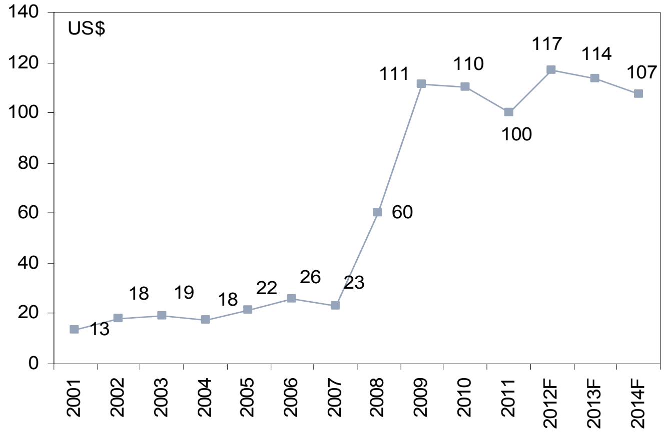
Traditional measures of fiscal performance, such as overall deficit and net government debt, can be misleading. Oil and gas revenues can be highly unstable and represent an extraction of a natural resource that can't be replaced. A large non-oil deficit indicates that the country is highly exposed to negative commodity price shocks and saving little for future generations.

Figure 10. High and persistent non-oil deficits (original 2012 budget)



Source: MoF, Citi Investment Research and Analysis forecasts

Figure 11. Coupled of with high break-even oil price (Federal budget)



Source: MoF, IMF, Citi Investment Research and Analysis forecasts

Break-even oil price is expected to stay above US$100 even under the most optimistic scenarios. Even with existing commitments, the non-oil fiscal deficit is expected to stay near 10% of GDP for the foreseeable future, with the government relying heavily on oil and gas revenues as a proportion of total revenues, this leaves Russia particularly exposed to oil price shocks. The government estimates that the budget break-even price will fall to US$107 per barrel by 2014, but we think this is based on optimistic assumptions. We believe the social commitments for 2013-14 costing 0.5-0.7% of GDP (MinEcon's estimate) will increase the break-even oil price even further by US$10/bbl. Failure to tackle the pension system challenges will result in more pension financing by the budget, which add another US$5/bbl to the break-even level.

Spending set to increase…

If nothing is done, budget spending will continue to increase. Lack of clarity regarding policy plans is the key issue for long-term investors. The government appears to be taking on further spending responsibilities without clarifying how they will be financed over the medium term. Key sources of higher spending are pensions, military and healthcare.

Growing pension spending will be a challenge. Without a comprehensive pension reform, the average pension to average wage ratio could fall to as low as 15% in the coming years from an already low level of 24% now. Currently discussed – or, rather, disputed – proposals by the Social Ministry with various other arms of the government include:

- Increasing the minimal required work experience to be eligible for the minimum or base pension (currently it could be as low as 5 years). Base pension is about 50% of the average pension.
- Gradually raising women's pension age in future (2015-50).
- Further increase pension contributions (currently at 30%, up from 26% last year).
- Government taking over the funded part of the pension scheme to finance the pension fund deficit.

In our view, SocMin's proposals would have highly negative implications for medium-term sustainability of pension spending and reflect negatively on the authorities' ability to implement reforms.

Without a major pension reform, further increase in spending is inevitable, in our view. Experts suggest that the pension system deficit will increase progressively from the current 3% of GDP in the following years:

- According to comments by ex-Minister of Finance Alexei Kudrin made in 2011, the pension fund deficit could amount to 10% of GDP by 2017.
- The IMF estimates that the pension system spending will add 4.6% of GDP by 2030, requiring additional revenues[1].
- Russian economist Evsey Gurvich estimates that pensions spending will increase by 8% GDP in 2050 vs 2010.[2]
- Health Ministry expects deficit to fall to 1.8% of GDP by 2014 (RIA, 12 March).

[1] Fiscal Monitor, April 11, http://www.imf.org/external/pubs/ft/fm/2011/01/pdf/fm1101.pdf

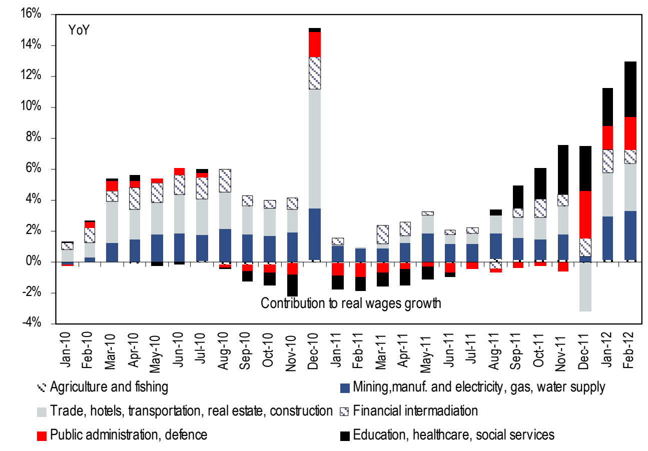
[2] Pension reform, 2011, http://strategy2020.rian.ru/load/366064047

…and tensions are growing around pension reform. Increasing the pension age is a highly sensitive issue in Russia.[3] Pensioners represent not less than 40% of all active voters. Even those already receiving a pension are against an increase in the retirement age, as they see it as a default by the state on the social contract with the citizens. It is therefore not surprising that Mr. Putin and SocMin have been against increasing the pension age; however, the MoF points out that it does not see any other solution but to increase the pension age. We believe that postponing reforms to the system will put public finances on an unsustainable path. Meanwhile, the current President, Mr. Medvedev, has called for the pension reform plan to be ready by 4Q12 (Bloomberg, 24 April), but due to a lack of coordination among officials we would not expect any meaningful short-term measures.

Healthcare, military and social spending is set to rise further. Unfavorable demographic trends will likely lead to a 1.5% of GDP increase on medical services spending by 2030. The government has committed to increase military spending by 1.5% of GDP to 6.6% by 2014 requiring additional financing. Furthermore, pre-election commitments may require about 0.5%-1.5% in additional financing per year. Social spending remains a major tool to "preserve social stability" and the government spent more ahead of the recent Presidential elections. Major pre-election spending commitments made by Mr. Putin include:

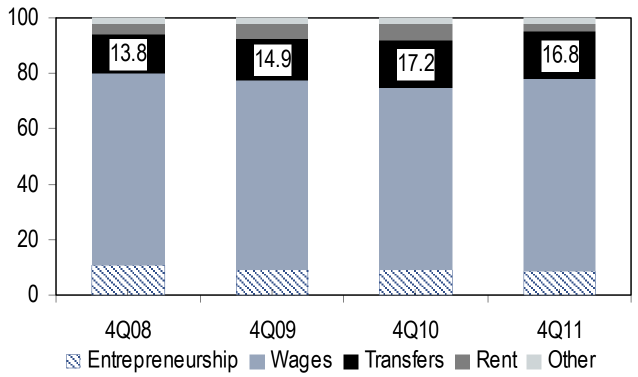
- Increasing teachers' and doctors' wages from September 2012.
- Raising university staff wages in 2013-18 to two times the regional average.
- Granting additional allowance of RUB7,000 (US$235) to families with three children.
- Raising scholarships to RUB5,000 (US$165) for first-year students and to provide permanent dwellings for military workers by mid-2013.

Figure 12. Most of the wages are budget-financed…



Source: Citi Investment Research and Analysis

Figure 13. …as well as total incomes



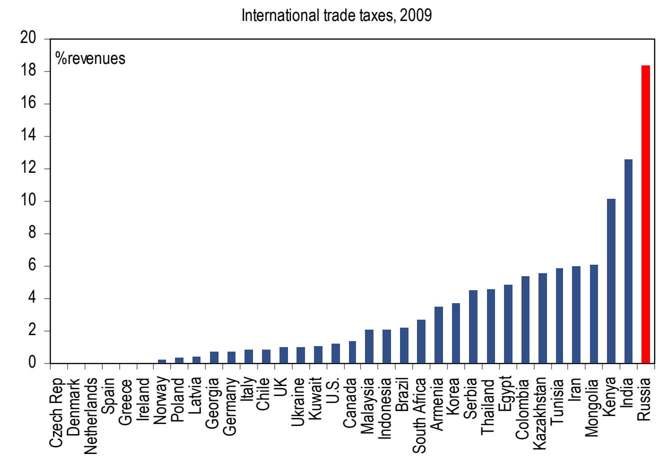
Source: Citi Investment Research and Analysis

[3] Kudrin and Gurvich, April 4, Vedomosti
http://www.vedomosti.ru/opinion/news/1626180/kto_platit_pensii#ixzz1riD37P2L

…making higher borrowing and taxes unavoidable

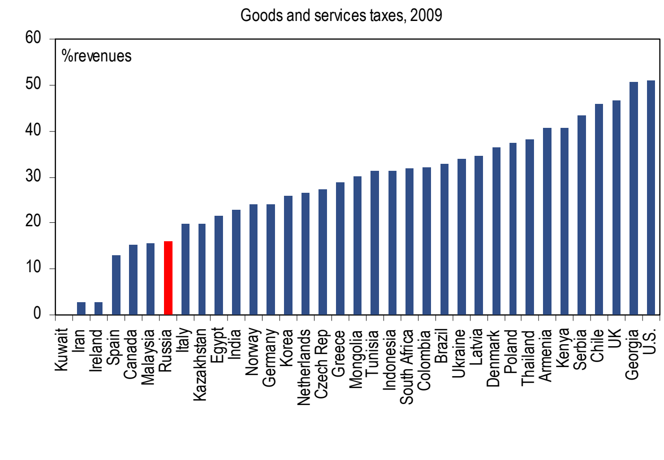
Russia derives most of its fiscal revenues from natural resources, bringing the share of international trade taxes to record levels. Its fiscal revenues structure differs dramatically from that of Europe and the US due to the commodity focus.

Figure 14. Russia relies on oil export duties…



Source: World Bank Development Indicators, Citi Investment Research and Analysis

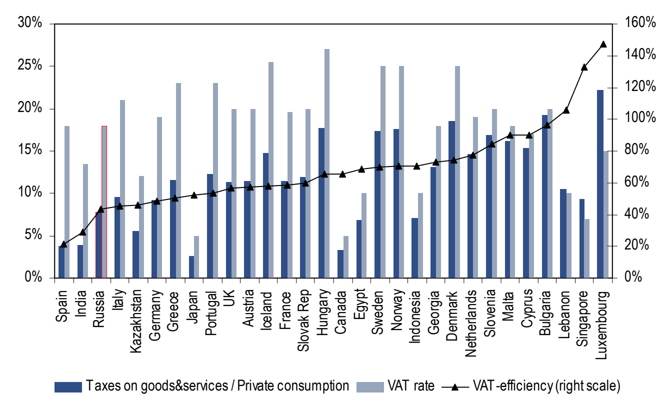
Figure 15. …which makes domestic taxation less important



Source: World Bank Development Indicators, Citi Investment Research and Analysis

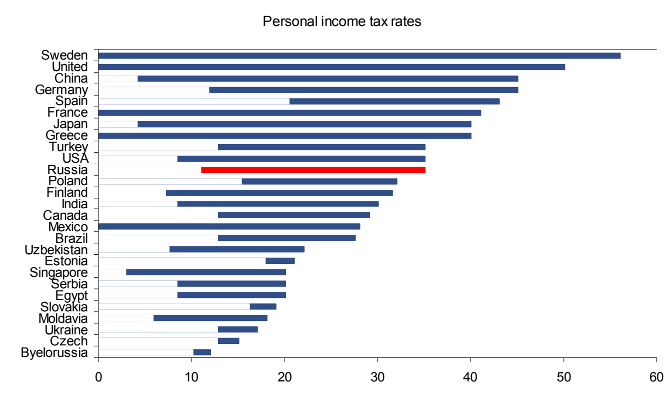
Russia still has the potential to increase tax system efficiency, and hence, additional revenues could be achieved without dramatic rate hikes.

Figure 16. Tax on goods efficiency is one of the lowest



Source: Haver, IMF, Citi Investment Research and Analysis

Figure 17. Low personal income tax is compensated with SST



Source: IMF, Citi Investment Research and Analysis

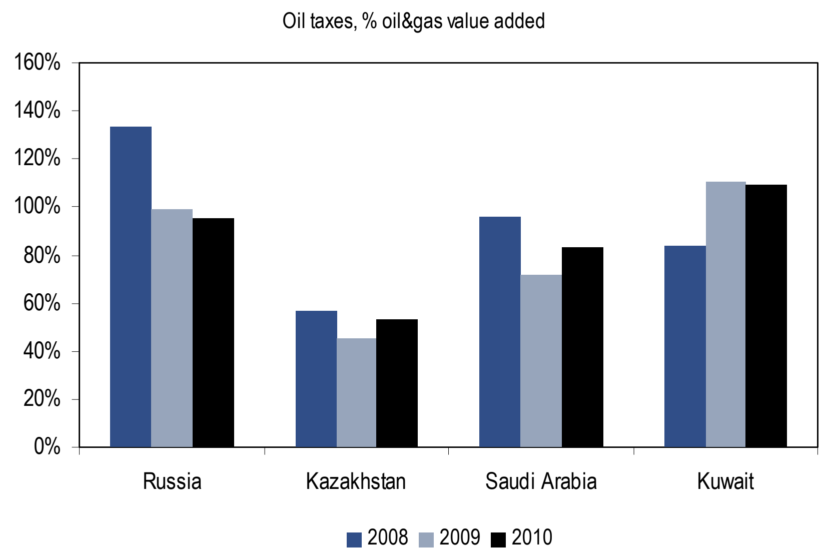
Over time taxes and borrowing are likely to rise, in our view. Mr. Putin stated during his pre-election campaign that taxes on the non-commodity sector should not be increased (Vedomosti, January 30); however, the authorities have not yet identified areas for expenditure cuts. Russia's discretionary spending accounts for only 9% of GDP (total consolidated spending is 37% of GDP). This means that most of the measures to cut spending would require serious structural reforms. Instead, the authorities recently put forward several options to increase tax revenues. While we believe that room on the tax side is limited, the following measures seem most likely:

- Introduction of luxury tax and revisions to the property tax.
- Higher social contributions. Already at 30%, these may increase further. However, after the last increase, tax collection rates have begun to suffer.
- Further increases in excise taxes, including on alcohol and tobacco.
- The gas and oil sectors may be a source of additional revenues. Citi's oil and gas analysts believe that further taxes are expected in oil and gas sector. The IMF believes that changing the tax structure could lead to a substantial increase in contributions from these sectors.
- Borrowings. We estimate the local financial system can absorb new government borrowings of RUB1.0-1.5tr pa without placing pressure on interest rates. In addition, the government could increase external borrowing to US$10-15bn per year from the currently budgeted US$7bn.
- Privatization will likely be introduced in the medium term, though the authorities appear to see it as less urgent. It is budgeted to contribute US$10bn per year.
- Finally, the reserve fund (RF) is at US$62bn and the national welfare fund (NWF) at US$90bn (about 8% of GDP combined). The budget assumes an accumulation into the RF of US$20-US$30bn per year, which could be reconsidered.

We believe other measures will not be implemented – such as the introduction of a progressive personal income tax, tax on 1990s privatizations, and replacement of the VAT with a sales tax. While personal income tax rate (13% on wages, 35% on gains) may seem low, the increase is unlikely. Effectively, incomes are taxed considerably higher as both personal income tax and social security tax (30% in 2012) are based on wages.

We believe there would be only a marginally positive gain from increasing the tax pressure on oil companies, as the taxation system already absorbs most of the gains, and Russian oil tax revenues as a share of GVA are among the largest in the world.

Figure 18. There is little scope to increase tax pressure on oil and gas companies



Source: Haver, Citi Investment Research and Analysis

On the other hand, gas taxation lags behind oil, and most of the discussed reforms are likely to take place:

- Splitting the gas tariffs hike gains (due on 1 July) 80:20 between the government and Gazprom, will bring an additional Rub50bn into the budget this year, and Rub140bn and Rub170bn in 2013 and 2014, respectively.[4]
- Increasing the mineral extraction tax by 15% for Gazprom and doubling MET for the independent gas producers to make them in line with Gazprom's contributions (Interfax, 28 April).
- Raising the tax burden for the gas industry to the level of oil – proposed by MinEcon (Bloomberg, 19 April).

However, new projects (like shelf gas) are increasingly being taken offshore.[5]

Fiscal rules could be good news for investors

The MoF is suggesting a return to fiscal rule in 2016 where all revenues above the 10-year average oil price are saved in the reserve fund. In response to the global financial crisis, the government suspended the rule that sets maximum non-oil deficits at 4.7% until end-2013; this is now likely to be prolonged until 2016. The IMF estimates that this rule would make Russia's fiscal policy sustainable with oil prices at about US$82 using permanent oil income model.[6] Even if implementation does not take place until 2016, the MoF suggests that the rule should be spelled out in the coming budget. The proposed rule is less ambitious than the original, as the authorities are assuming a moderate nominal increase in oil price, however it will still require significant fiscal adjustment. The MoE is suggesting taking the 3-year average oil price; in our view the MoE proposal will not be effective in preventing a pro-cyclical fiscal policy.

Accumulating oil revenues in funds could limit excess exchange rate volatility. If the windfall oil revenues are not spent immediately on higher wages and social transfers, the strong current account would have a milder effect on the exchange rate. Moreover, sovereign funds could become the basis for a stronger and a more sophisticated financial system in Russia. IMF analysis shows that an oil exporter will even benefit more throughout the cycle if it saves more than US$1 for each extra $1 in oil revenues[7].

[4] MinFin confirms it wants to raise Gazprom taxes substantially in 2013, https://www.citivelocity.com/geo/pdf/SGLZZBGL.pdf

[5] Shelf taxation plan prepared by MinEnergo, https://www.citivelocity.com/geo/pdf/SGLRVG3X.pdf

[6] Strengthening Russia's Fiscal Framework, C.Gust and D..Zakharova, http://www.imf.org/external/pubs/ft/wp/2012/wp1276.pdf

[7] Commodity Price Swings and Commodity Exporters, http://www.imf.org/external/pubs/ft/weo/2012/01/pdf/text.pdf

Figure 19. Summary of Russian funds

Fund	Assets, US$ bn	2011 incomes from taxes or budget, RUB bn	Description	Asset management	Incomes from asset mgnt, RUB bn	2011 expenses, RUB bn
Pension Fund of Russian Federation	NA	2402.6	Pensions and transfers management	The Fund allows its investors to choose one of the 'trustworthy' asset management companies or invest in government securities or the 'extended portfolio'	32.9	4068.7
Reserve Fund	62.3 as of 1 April	695.4	Balancing the budget if oil revenues decrease	Foreign bonds and currency held with the CBR	15.7	NA
National Wellbeing Fund	89.5 as of 1 April	1243.0	Long-term pensions financing	Foreign bonds and currency held with the CBR, selected Russian and foreign securities	55.0	NA
Direct Investments Fund (under Vneshekonombank)	10	NA	Private equity investment	Investment of up to US$1bn in potentially successful private equity	NA	NA
Social Security Fund	NA	463.8*	Social support (maternity, compensations for the work in a dangerous environment)	Allocation of temporarily free assets to the banks' deposits, 1y, max. RUB8bn	0.1	492.0
Healthcare Fund	NA	326.6	Healthcare services financing	Allocation of temporarily free assets to the banks' deposits, 3mo, max. RUB10bn	0.1	309.4
Rosimushestvo	NA	NA	Management of the real assets owned by the government	Earnings of the corporates, renting out, privatization	228, of which 113 privatization, 77.5 earnings of the state-owned corporates	NA

Source: Citi Investment Research and Analysis

*2010 data

Appendix A-1

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The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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