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The Sustainability of Russian Fiscal Policy

Abstract

This paper briefly examines the sustainability of the Russian fiscal policy. Russia has run quite large general government deficits during the transition years. Some simple simulations show that the present policies are not sustainable in the medium-term, unless economic growth accelerates significantly and real interest rate declines. If these positive developments do not materialize, Russia must tighten her fiscal policy.

Keywords: Fiscal policy, public debt, Russia

1 Introduction

The Russian Federation has run large budget deficits since its inseption. In the first years of transition, the Federation had little alternative than to finance its deficits by making the central bank to print roubles, which led naturally to high inflation. As Russian capital markets developed and the Russian Federation gained better access to international lenders, central bank financing ceased and inflation fell. The deficits, however, persist. The 1996 federal government deficit and the general government deficit were both larger than in 1995.[1] In 1997, real interest rates have decreased considerably, but the deficit will still be sizable.

In the second section of this paper, we present a brief discussion of Russia's fiscal policy during transition. To date the Russian Federation's deficit has averaged close to 8 % of GDP every year. In other words, since 1992 the federal deficit has accounted for practically the entire public sector deficit. By 1996, accumulated central government debt had climbed to approximately 50 % of GDP. What conditions and fiscal stance, however, are needed to check further changes in the debt/GDP ratio?

2 Broad trends in fiscal policy

Relatively high public sector deficits have characterized Russia's economic and political transition. Similar deficits have been witnessed in other transition economies, but, for example, Estonia[2] and Turkmenistan have succeeded rather well in achieving nearly balanced budgets during transition. As can be seen from Table 1, large deficits nor their continuation are inevitable byproducts of transition; indeed, many countries of the former Soviet Union are already moving towards deficit reduction.

For most of Russia's transition, local governments and extrabudgetary funds have, on aggregate, run budgetary surpluses. The public sector deficit problem therefore is mainly a problem of

[1] General government budget takes into account also regional entities and extrabudgetary funds.

[2] For more comprehensive survey on the fiscal policies of Estonia and other Baltic countries see Pautola (1997).

Table 1 **General government balances in former Soviet Union countries (percent of GDP)**

	1993	1994	1995	1996
Armenia*	-48.2	-16.4	-9.9	-8.6
Azerbaijan	-13	-14.8	-7	-3
Belarus	-8.3	-2.6	-1.9	-1.4
Estonia	-0.7	1.3	-0.8	-2
Georgia	-26.2	-7.4	-4.5	-4.4
Kazakhstan*	-1.2	-6.8	-2.3	-2.7
Kyrgyzstan	-13.5	-7.7	-12.5	-6.5
Latvia	0.6	-4	-3.3	-2
Lithuania	-3.1	-4.2	-3.3	-4
Russia	-7.6	-10.1	-4.9	-7.7
Tajikistan	-25	-10.5	-11.2	-5.3
Turkmenistan*	-0.5	-1.4	-1.6	-1
Ukraine	-9.7	-8.2	-4.9	-4.5
Uzbekistan	-10.5	-6.1	-4.1	-3.5

*Central government balance. Source: EBRD (1997).

the federal government's inability to balance expenditures and revenues in rapidly changing macroeconomic circumstances. Chart 1 depicts the budget balances of the Russian Federation, local governments and extrabudgetary funds as shares of GDP.[3] In 1992 and 1993, unbudgeted import subsidies are included as they represent a large fraction of the total enlarged government budget deficit. In 1995 and 1996, local governments and extrabudgetary funds had nearly balanced budgets.

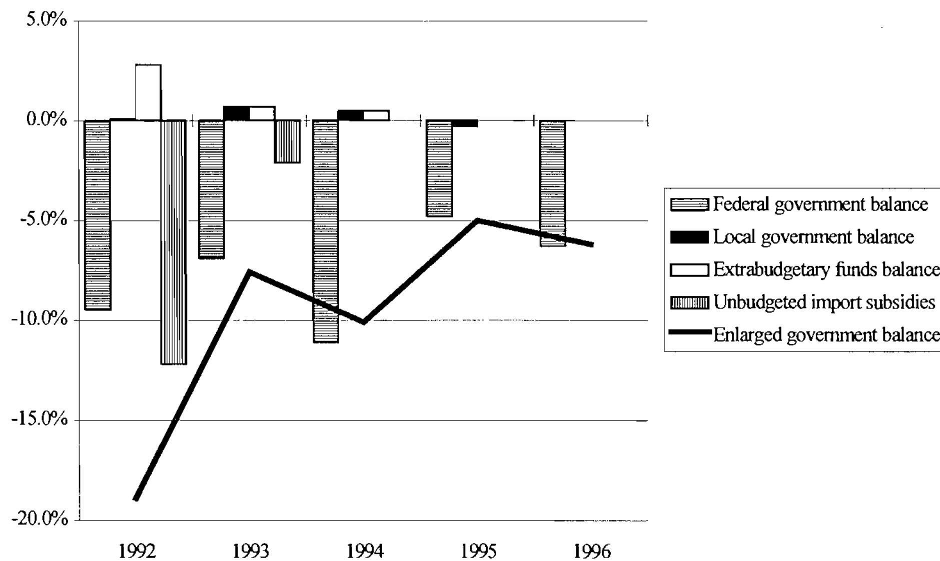
The Russian government's debt/GDP ratio decreased drastically during the first years of economic transition. Inflation decreased domestic debt and real appreciation of rouble lowered the ratio of foreign debt to GDP so that by 1995, the debt/GDP ratio had fallen below 50 %. At the end of 1996, the ratio was back around 50 %.

In the early stages of transition, the budget deficit was almost exclusively covered with central bank credits. In 1993, Central Bank of Russia (CBR) credits amounted to 100 % of the deficit. For 1994, the IMF (1995) reported that CBR credits financed 77 % of the federal government's 1994 budget deficit. This reliance on central bank financing is perhaps understandable, however, given the circumstances. Domestic securities markets were practically non-existent until 1994; their development slowed by a lack of legislative frameworks and market infrastructure as well as a volatile macroeconomic environment. In practice, the Russian Federation had little resort to securities markets – and specifically a treasury bill market – to finance its budget deficit until 1996,[4]

[3] All figures were taken from various IMF publications.

[4] See Korhonen (1997).

Chart 1 **The fiscal balance of enlarged Russian government, per cent of GDP**



when the outstanding stock of T-bills rose from 3.5 % of GDP at the end of 1995 to approximately 9 % at year's end. Also in the early years, Russia's private banking sector was too rudimentary and poor to extend large credits to the government. Banks only began to finance the Russian budget deficit in 1995. Foreign financing of the budget deficit was also almost non-existent in the early years of reform, and new foreign financing was barely enough to cover the repayment on debts inherited from the Soviet Union.

Given recent debt reconciliation agreements and optimism about economic growth, Russia presently is in a position where it can borrow funds to cover its deficit from the capital markets abroad and at home. How long, then, can borrowing on such a scale be sustained?

3 Sustainability of public debt

In this section, we present a simple way to assess the sustainability of public debt. The change in the nominal government debt evolves over time according to the following equation:

$$D_{t+1} = (1+i)D_t + B_t \qquad (1)$$

Here D_t is the stock of debt in period t, B_t is the primary (i.e. before interest payments) balance of the public sector and i is the nominal interest rate on government debt.[5] The proportion of primary balance to GDP (given as the product of the general price level P and the level of real economic activity Y) is denoted by b_t and the proportion of public sector debt to GDP by d_t. After manipulation, we arrive at the change in debt as a share of GDP, Δd_t as

$$\Delta d_t = b_t + (r-n)d_t \qquad (2)$$

where r is the real interest rate of government debt and n is the growth rate of the real level of economic activity.

[5] Here we abstract from capital gains/losses incurred from changes in the valuation of public sector capital.

Equation (2) can be used to assess the sustainability of the public sector fiscal policy; in other words, to determine whether debt as a share of GDP ever stabilizes at a finite level under current policies. The equation also makes it possible to simulate other possible paths of government debt development substituting other plausible parameter values. From this, it is hoped that an observer might be able to assess the probability of changes in the fiscal policy in the near and medium term.

Admittedly, this approach has some big drawbacks, including the fact that our case involves a transition economy. Russia's long history of command economy provides little reference when selecting an appropriate real interest rate or the most probable growth rate. Thus, caution is advised when assessing the results of simulations of the next section.

4 Three scenarios

In this section, three alternative scenarios concerning central government debt are considered.[6] We start by asking what the continuation of present policies might mean for the time path of government debt.

At the end of 1996, the share of central government debt to GDP was approximately 50 %. In 1996, when the primary budget deficit was 1.8 % of GDP, the overall deficit, which includes interest payments on government debt, came to 6.3 % of GDP. Thus interest payments on government debt have already reached the point where they constitute a heavy burden on the budget. In addition, 1996 central government revenue only amounted to about 9.5 % of GDP, and real interest rates were quite high. Currently, the annualized yield on Russian treasury bills has fallen below 20 %, and year-on-year inflation is running below 15 %. Assuming inflation continues to slowly decrease as forecast, it would mean that the Russian Federation would end up paying an ex post real interest rate of about 10 % on its domestic borrowing. Foreign financing is probably cheaper. In the first half of 1997 there were many signs that the Russian economy has bottomed out, and that output was no longer contracting.

The fiscal situation, however, deteriorated considerably during the first half of 1997. Revenue performance (i.e. tax collection) was poor, so presently the budget deficit for 1997 is forecast to be approximately 8 % of GDP with the primary deficit in the neighborhood of 3 % of GDP. In response, the Russian Federation stepped up efforts to divest state enterprises or parts of them. Obviously, privatization sales are a one-time-only source of income and not available indefinitely. These trends will affect the conduct of Russian fiscal policy in the coming years.

4.1 Fast growth scenario (4 %)

The first scenario of future Russian fiscal policy assumes rapid economic growth. The present pace of reforms continues, and uncertainty persists as to political processes, and perhaps more importantly, legislative frameworks. These uncertainties hamper investments into Russia, but no major upheavals occur. In this scenario, Russian GDP grows a 4 % annually. While there is no doubt that the Russian economy has a sufficiently educated workforce and natural resources to accomplish such growth, ongoing uncertainty prevents the economy from achieving its full growth potential. While this growth rate is well below growth rates achieved in recent years by some Asian economies, it is still quite respectable in the European context. Of Europe's transition economies, only Poland and the Slovak Republic have been able to maintain growth rates in excess of 4 % for several consecutive years.

The thick solid line in Chart 2 depicts what happens to Russian Federation debt as a share of GDP if the present primary deficit of 3 % of GDP and present real interest rate of 5 % continues for ten years and economic growth accelerates from 1 % in 1997 to 4 % from 1998 onwards. As can be seen, the government debt increases steadily to over 100 % of GDP by 2010 with no sign of stabi-

[6] We restrict our attention to the central government debt as the local governments and extrabudgetary funds have had more or less balanced budgets in the past. This situation is not expected to change considerably in the future, even though some large cities and regions have began to utilize domestic securities markets in funding their budget deficits. Also Eurobonds have been issued, see UEEE (1997).

Chart 2 **Debt/GDP in fast growth scenario (4 %)**

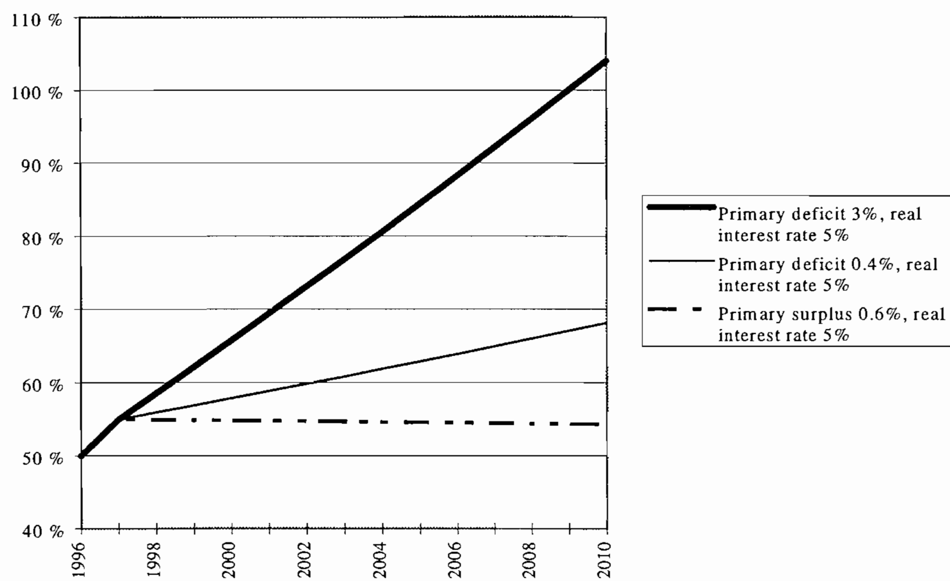


Chart 3 **Debt/GDP ratio in really fast growth scenario (6 %)**

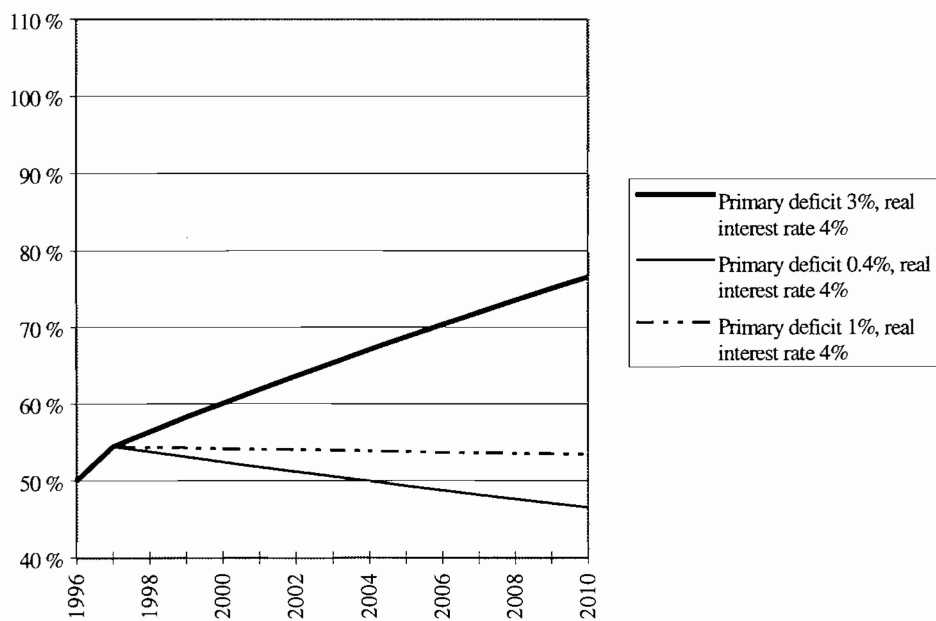
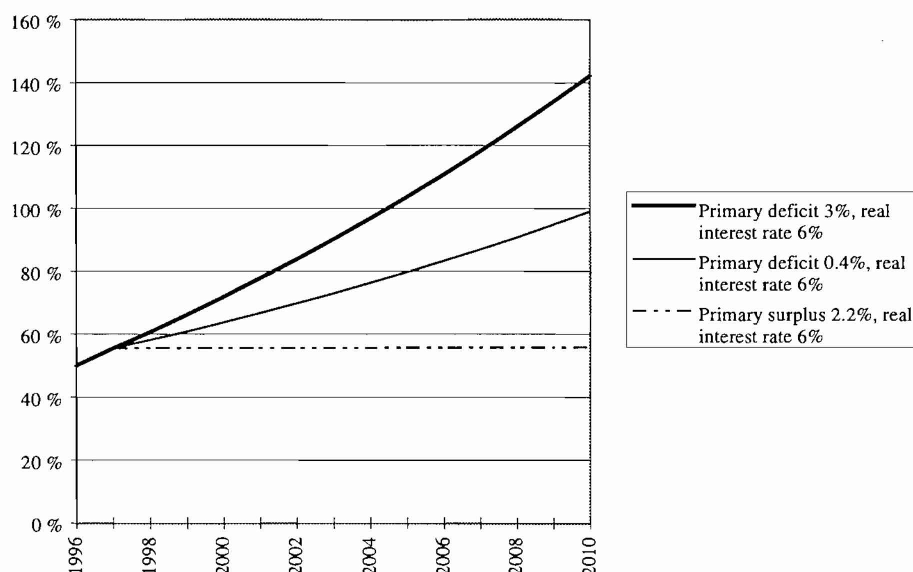


Chart 4 **Debt/GDP in slow growth scenario (2 %)**



lization. While some OECD countries presently have public debts of over 100 % of GDP, it is arguable whether investors would be willing to Russia a similar dispensation.

So how much tightening of fiscal policy is needed to stop the debt from growing under our above assumptions? Russian government's budget proposal for 1998 calls for primary deficit of 0.4 % of GDP. If this primary balance could be maintained and the other factors (GDP growth and real interest rate) are held constant, the government debt would remain under 70 % of GDP. The thin solid line in Chart 2 depicts this scenario.

If the primary balance is zero from 1998 onwards, the government debt would still rise somewhat, but only to approximately 60 % by 2010. With a primary surplus of 0.6 % to GDP, the debt/GDP ratio would start to decline, albeit very slowly. This scenario is illustrated in Chart 2 with the dotted line. Thus, even in a fairly benign macroeconomic environment, the Russian Federation would have to run a primary surplus just to maintain the current debt/GDP ratio. Given the difficulties Russian Federation is currently experiencing with tax collection, this target seems hard to achieve.

4.2 Really fast growth scenario (6 %)

In the second scenario, GDP growth is assumed to be 6 % a year from 1998 onwards. This positive scenario is possible if political (especially legal) uncertainties decrease notably. Clearing the outlook would probably decrease the real interest rate as risks associated with investing in Russia are reduced. Thus the real interest rate is assumed to be 4 % on the average from 1998 onwards. Chart 3 depicts the behavior of government debt under these assumptions. Again, the continuation of present policy of 3 % deficit in primary balance results in debt growing without stabilization. This result is illustrated by the thick solid line. The second variant assumes that Russian government manages to push the primary deficit down to 0.4 % of GDP in 1998 and keeps it there for the next twelve years. This possibility is illustrated by the thin solid line, and here we can see how the ratio of government debt to GDP starts to decrease immediately in 1998 as economic growth accelerates. This means that Russian Federation could even run a small primary deficit, and the combines forces of rapid economic growth and fairly low real interest rates would decrase the debt/GDP ratio. The dotted line in Chart 3 illustrates the case

where Russia runs a primary deficit of 1 % of GDP. We can see that debt/GDP ratio remains constant. Thus, the required stance of fiscal policy depends very much on the growth of the economy. This example also illustrates how reforms in some areas, e.g. legislation, which enhance the growth prospects of the Russian economy, will have positive effects also in other areas.

4.3 Slow growth scenario (2 %)

In this scenario, political uncertainty continues and possibly even increases, legislation concerning investments and property rights is not enforced. As a result investments into Russian economy do not increase and real interest rate remains high. These factors, in turn, affect economic growth so that the average growth rate of GDP during the next decade is only 2 %. The real interest rate is 6 %. The thick solid line in Chart 4 shows that continuation of the present fiscal policy with the primary deficit of 3 % is clearly unsustainable. Government debt has shot up to 140 % of GDP by 2010! Even if the government would succeed in pushing the primary deficit to 0.4 % in 1998 and keeping it there, debt/GDP ratio would reach 100 %. This alternative is illustrated by thin solid line. Only with a primary surplus of 2.2 % of GDP would the debt/GDP ratio stabilize. Thus, Russian Federation would be forced to pursue exceptionally stringent fiscal policy merely to keep the growth of government debt in check.

5 Some concluding comments

After examining three scenarios concerning the development of Russian Federation's debt/GDP ratio, we can conclude that, except under conditions of quite rapid and sustained growth, debt in relation to GDP will grow, which eventually will force the Russian Federation to tighten fiscal policy considerably to stabilize the debt/GDP ratio. Clearly, the present stance of fiscal policy with primary deficit at 3 % of GDP is unsustainable. Beyond the obvious need for Russia to gain control over tax collection and expenditures, any changes should also leave room for expansionary fiscal policy in the event the economy is hit by some large negative shock. Only then could the Russian Federation run a larger deficit without the debt/GDP ratio rising excessively. Of course, the behavior of debt/GDP ratio also depends on the real interest rate, which is not directly controllable by the Russian government (although the Russian government can control to some extent the risk premium investors require from Russia).

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