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Russia's Hidden Underbelly of Debt

Maya Rostowska

Despite the reigning consensus that the Russian economy is facing trouble ahead, some indicators suggest that the situation is not as dire as first appeared. Moreover, it may seem that the fiscal situation in the country—particularly its copious foreign currency reserves and substantial sovereign wealth funds—could still help extricate Russia from its economic difficulties. However, the very difficult budgetary situation in the regions and the staggering levels of debt of its companies suggest that economic problems could hit the country hard. Investors should remain vigilant of social and political tensions and the possible further deterioration of the business environment in Russia.

It is a truth universally acknowledged that the Russian economy's vital signs—including investment, consumer confidence and industrial production—are deteriorating. Not only that, they are likely to suffer even more from Western sanctions and a worsening business climate linked to a lack of reform. It may therefore surprise some that the country's debt is under control and its reserves are still strong. Savings in its two sovereign wealth funds and its foreign currency reserves have got Russia out of economic hot water before. Today they seem substantial enough to do it again. But a closer look at the country's regional budgets reveals the dark underbelly of Russia's fiscal situation and suggests that path may not be available this time around.

Russia's Economy: More Smoke than Fire?

Much has been said and written about the economic difficulties facing Russia. In July, the International Monetary Fund (IMF) published a report showing that sanctions had had a deep impact on the Russian economy, particularly affecting investment. The IMF predicts a growth rate of 0.2% for Russia in 2014.[1] Former Finance Minister Alexei Kudrin has predicted recession for 2014, and current Minister of the Economy Alexei Ulyukayev has said growth will be around zero for the first quarter of the year.[2] In March, the World Bank predicted growth of 1.1% in 2014 in its low-risk scenario (which assumes peaceful containment of the crisis in Ukraine and a lack of further sanctions) and 0.8% in its high-risk scenario

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[1] International Monetary Fund, *Russian Federation: 2014 Article IV Consultation*, IMF Country Report No. 14/75, July 2014, www.imf.org, p. 34.
[2] O. Tanas, "Russian Growth Slowest since 2009 on Sanctions, Poll Says," *Bloomberg*, 14 May 2014, www.bloomberg.com.

(which assumes an intensification of political tensions and heightened uncertainties regarding the possibility of further sanctions).[3]

These forecasts seem well-founded. Even before the crisis in Ukraine heated up, the Russian economy was already in a state of slowdown, with growth at 1.3% in 2013, failing to reach the World Bank prognosis of 3.6%.[4] This is due to falling investment, industrial production and consumption (linked to falling wage growth and consumer confidence).[5] All this has been exacerbated by Russia's actions in Ukraine. The first quarter of the year saw capital flight in excess of $51 billion (compared to $60 billion in the whole of 2013).[6] Sanctions and falling energy prices are likely to further dampen growth as they affect exports and export income. Meanwhile, corporate debt is ballooning, and increasingly reliant on external sources. Russian companies' foreign debt reached 30% of GDP ($628 billion) in the first half of 2013, approaching the pre-crisis peak of 35.4% and exceeding the international reserves of the CBR.[7] Many of these companies are for all intents and purposes state-owned, and may struggle to find external financing if sanctions against Russia are extended or the political situation in the country deteriorates.

Meanwhile, pressure on the budget is rising. Federal spending is likely to rise due to President Vladimir Putin's 2012 electoral pledges, costs linked to the annexation of Crimea,[8] and upcoming infrastructure projects, including those related to the 2018 World Cup, the planned gas pipeline to China, and the Kerch bridge to Crimea. Russia is also likely to incur more military expenditures: last year it overtook the U.S. in relative terms, spending a staggering 3.4% of GDP (i.e., $73.2 billion) on defence; now it has announced an increase of 18.5% on those figures in 2014, with a further 21.7% increase in 2015.[9] The aging population also foretells of ballooning expenditures in years to come: pension spending is expected to rise to 14% of GDP in 2030 (from 9% in 2012).[10] What is more, Russian government bond ratings have been cut to BBB-, on par with Azerbaijan,[11] in a move that will make financing federal government expenditures more difficult and expensive.

However, many of the indicators that seemed to suggest serious economic difficulties ahead for Russia have seen a recovery. Following Moscow's annexation of Crimea in March, Russian markets plummeted—massive selloffs caused the RTS index to fall by 13.8% to its lowest level since the 2009 crisis, and the trading of several stocks was suspended after they fell by more than 20%. But the RTS has now recovered to its January 2014 levels. Meanwhile, the Central Bank of Russia (CBR) was able to soon restore confidence in the rouble—which was undergoing speculative attacks—by spending $11.3 billion of its international reserves on 3 March to support the exchange rate (about 2.3% of its total reserves).[12] Finally, although it has been increasing minimally in recent years, Russia's government debt is still very small compared to that of other countries (Russian public debt came to 12.7% of GDP in 2013, compared to 101.5% for the U.S., 90.6% for the United Kingdom, 78.4% for Germany, 50.7% for Poland, and 22.4% for China).[13]

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[3] World Bank, "Russian Economic Report: Confidence Crisis Exposes Economic Weakness," no. 31, March 2014, p. 24, www.worldbank.org.

[4] *Ibidem*, p. 21.

[5] *Ibidem*, p. 23.

[6] International Monetary Fund, *op. cit.*, p. 14.

[7] C. Weaver, C. Glover, "Russia's Sergei Storchak Warns on Corporate Foreign Currency Debt," *Financial Times*, 5 September 2013, www.ft.com.

[8] A. Dyner, "The Annexation of Crimea: A Challenge for Russia to Balance the Books," *PISM Bulletin*, no. 71 (666), 22 May 2014, www.pism.pl.

[9] C. Caffrey, "Russia Commits to 18% Budget Rise," *Janes*, 3 April 2014, www.janes.com.

[10] Standard & Poor's estimate. H. Meyer, "Putin Balks at Pension Threats as Aging Russians Hold Trump Card," *Bloomberg*, 22 October 2012, www.bloomberg.com.

[11] A. Andrianova, "Russia Debt Rating Cut to Step Above Junk at S&P," *Bloomberg*, 25 April 2014, www.bloomberg.com.

[12] World Bank, *op. cit.*

[13] International Monetary Fund, "Data and Statistics," www.imf.org.

Reserves to Cushion the Fall

As well as recovery in these indicators, it would seem that the Russian coffers are substantial enough to cushion a fall. In the past, Russia has been able to mitigate difficult economic situations thanks to its large reserves, accumulated in foreign currencies and its sovereign wealth funds.

As Russian export revenues increased with oil prices in the early 2000s, domestic investment did not follow suit, leaving the country with large amounts of foreign currency savings. In 2004, the Oil Stabilisation Fund (OSF), Russia's first sovereign wealth fund, was created. As soaring world oil prices (from $33.7/bbl in 2004 to $99.6/bbl in 2008)[14] brought ever-higher revenues, in 2008 the OSF was split into two separate entities: the Reserve Fund (RF) and the National Welfare Fund (NWF). Both received portions of oil and gas revenues. The RF was designed to act as a stabiliser, conservatively investing energy profits and budget surpluses to cushion the economy in the event of a fall in oil prices. The NWF would pursue the OSF's savings objectives by investing in higher-risk, higher-return assets and be used to fill funding gaps in the pension system.

Prudent fiscal policy and use of funds from the RF staved off the impact of the international financial crisis on Russia until 2009. The government provided enterprises and the financial sector with conditional support, such as lowered tax burdens. Nevertheless, when the crisis finally hit, Russia's GDP contracted by a substantial 7.9%. Government expenditures rose and income fell, causing the country's first budget deficit in a decade. As money was transferred to cover the budget deficit, the RF was depleted, decimated by about $57.56 billion in 2009 and $34.19 billion in 2010 in outflows to finance the federal budget deficit (Figure 1).[15] Meanwhile, the Russian Central Bank sold foreign currency reserves to achieve a gradual devaluation of the rouble to help exporters (Figure 2). This tapping of its reserves allowed Russia to cushion the effects of the global financial crisis on its economy. The federal budget deficit was stemmed (shrinking from -7.9% of GDP in 2010 to -3.9% in 2011, and a surplus of 0.8% in 2012).[16] Growth returned relatively quickly (from -7.9% in 2009 to 4.5% in 2010).[17]

It would seem that the current fiscal situation in Russia would allow for a re-run of the 2009-2010 strategy of cushioning the crisis with transfers from the sovereign wealth funds and international reserves. After all, at $175.6 billion, funds in the RF and NWF are already above the 2009 total of $168 billion, and edging towards pre-crisis levels (Figure 1).[18] International reserves are at $467.2 billion, of which $423.8 billion is in foreign currency reserves (Figure 2).[19] Moreover, although the federal budget is once again running a deficit after one year in the black (it ran a surplus of 0.8% of GDP in 2012), this is planned to be only -0.5% of GDP in 2014—hardly an insurmountable figure.[20]

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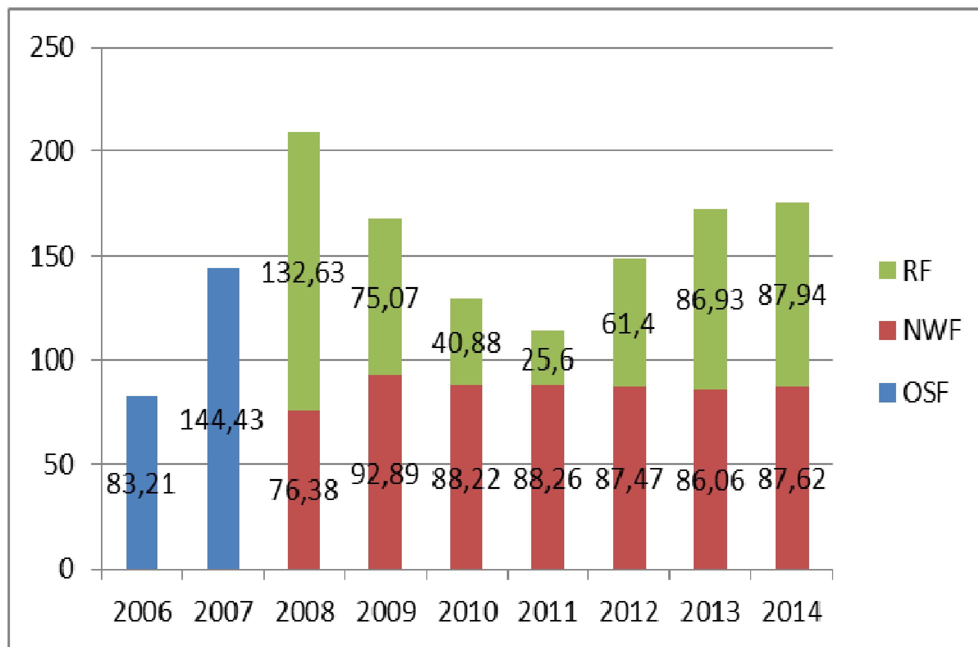
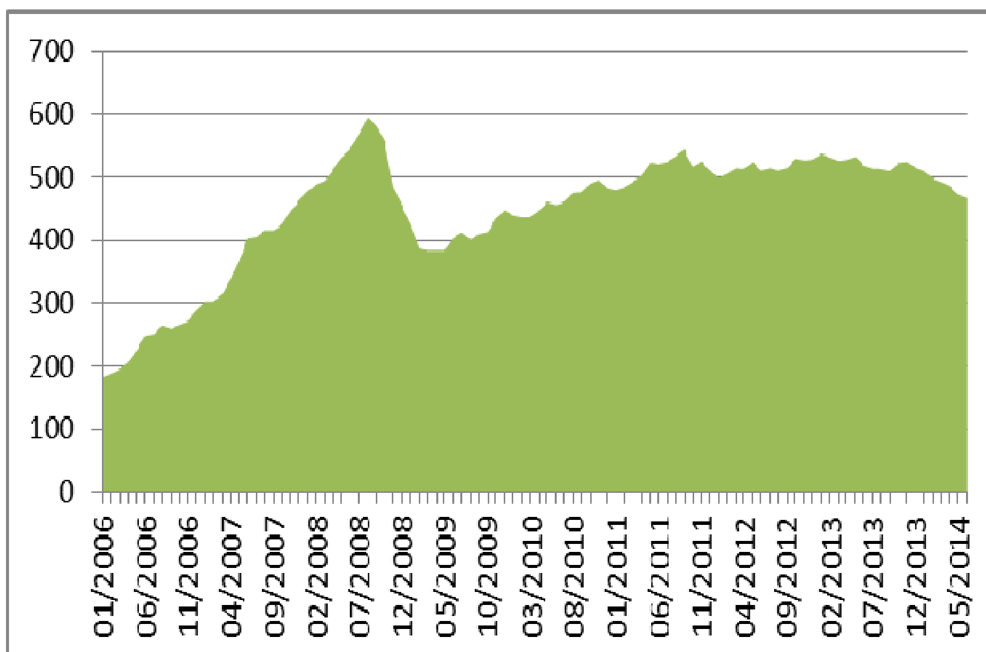
[14] "World Oils," www.worldoils.com.
[15] Ministry of Finance of the Russian Federation, "Funds flow on the Federal Treasury's account with the Bank of Russia in rubles in 2010," www.minfin.ru.
[16] Trading Economics, "Russia Government Budget," www.tradingeconomics.com.
[17] World Bank, "GDP Growth (Annual %)," www.data.worldbank.org.
[18] Ministry of Finance of the Russian Federation, "National Wealth Fund," "Reserve Fund," www.minfin.ru.
[19] "International Reserves of the Russian Federation," www.cbr.ru.
[20] Trading Economics, *op. cit.*

Figure 1. Russia's OSF, RF and NWF (2006–2014, in $ billions)



Source: Ministry of Finance of the Russian Federation; 1 December each year, except 2014 (1 May).

Figure 2. Russia's international reserves (2006–2014, in $ millions)[21]



Source: Central Bank of Russia.

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[21] Here, "international reserves" refer to foreign exchange reserves, SDRs, reserve position in the IMF, and gold. See: "International Reserves ...," *op. cit.*

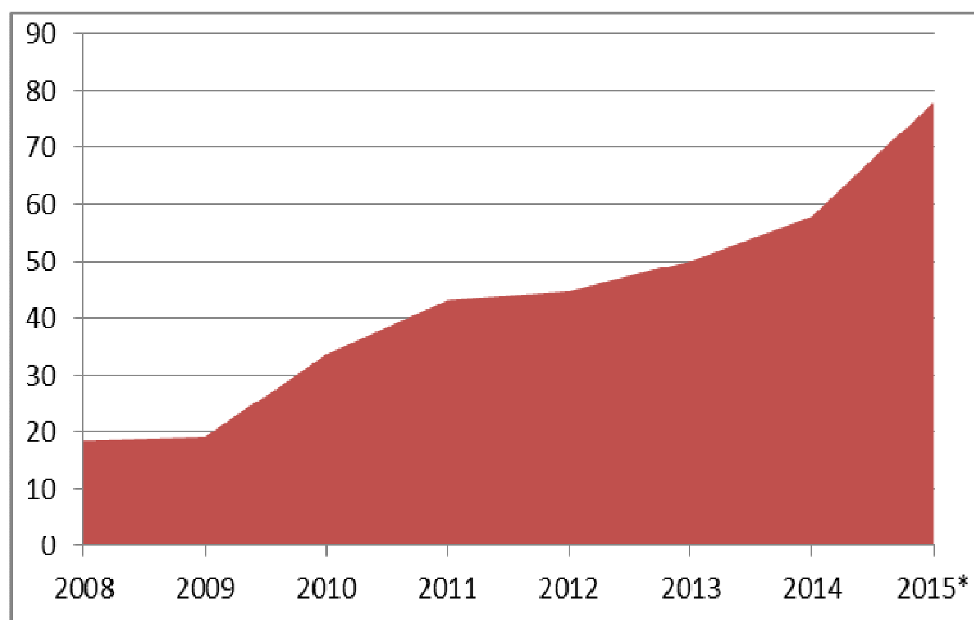
The Hidden Threat: Sub-Par Subnational Budgets

Although federal finances seem to be ticking along nicely, the fiscal picture at the sub-regional level is nowhere near as rosy. Regional governments are responsible for spending in areas such as healthcare, education, social welfare, and housing. These expenditures are financed by revenues from a share of federal taxes, grants from the central government, and some regional taxation—although subnational governments have very restricted autonomy in terms of tax policy. While regional governments account for 28% of general government revenue, their share of overall expenditures is almost 37%.[22]

The regions' fiscal situation has been going downhill since the 2000–2001 reforms that significantly increased the share of the central government in the consolidated budget to their detriment (from 44% in 1999 to 66.2% in 2007). This was exacerbated by a 2005 law that redirected the bulk of profitable tax revenue to the central budget away from the regions, including excise taxes[23] (although the regions were accorded slightly higher shares of corporate income tax and some excise taxes following the financial crisis). Moreover, several subnational taxes were abolished outright, including those on housing and utilities.[24] As a result, the dependence of subnational budgets on transfers and grants from Moscow has grown considerably.

Moreover, federal subjects have access to far fewer debt reduction mechanisms than the central government. Most rely on high-interest short-term bank loans and a limited supply of bonds and budget credits, such as federal loans, to finance their debt.[25] Although most regional governments managed to keep their debt in check until 2008, since the global economic crisis the majority have seen their debt more than double (Figure 3). Aggregate regional public debt has risen from $18.5 billion in 2008 to $58 billion in 2014—and it is expected to rise to $103 billion by next year.[26]

Figure 3. Russian regional debt, 2008–2014 (in $ billions)



Source: Ministry of Finance of the Russian Federation; Standard & Poor's (* denotes estimate).

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[22] E. Jarocińska, *Institutions of the Russian Fiscal Federalism: 20 Years of Evolution*, CASE Network E-briefs No. 02/2014, June 2014, p. 1, www.case-research.eu.
[23] J. Rogoża, *Federation without Federalism: Relations between Moscow and the Regions*, OSW Studies No. 49, April 2014, pp. 13–14, www.osw.waw.pl.
[24] E. Jarocińska, *op. cit.*
[25] *Ibidem*.
[26] Standard & Poor's estimate; "Russia's Growing Debts Threaten Stability," *Stratfor*, 20 January 2014, www.stratfor.com.

In fact, of the 83 Russian regions, it is estimated that 63 will be facing bankruptcy by 2015.[27] This is because the regions will bear much of the financial brunt of President Putin's electoral promises, such as increasing regional and municipal wages (to the tune of some $56.6 billion over the next two years) and replacing all dilapidated housing by 2016 without any help from Moscow.[28]

What is more, the situation could deteriorate further in the mid-term. The Kremlin is planning mass reindustrialisation of the regions in an attempt to diversify the economy and reduce its reliance on energy. The idea is to construct factories and plants across Russia, with a goal of creating 25 million industrial jobs by 2020, in sectors as diverse as processed food, meat, dairy, metals, the auto industry and mining. But this strategy is set to put further financial pressure on the regions. Although the details of how the plan will be funded have not yet been revealed, it will be done through regional, federal and foreign investment. Given the current geopolitical situation—which is scaring off foreign investors and creating new costs for the federal budget—the regional budgets are likely to feel the pinch even more once this plan is set in motion.

Finally, the fiscal situation of Russia's regions is also likely to be put under pressure by future oil prices. There are many signs that Russia is in for a rough ride, fiscally speaking. While executing the federal budget as planned is likely to require oil prices as high as $115/bbl,[29] these averaged $110/bbl in 2013. The price of oil is as important for regional government budgets as much as it is for the federal budget. Sub-national governments have limits imposed on their deficits, debts and borrowing, which are set in accordance with the average oil price for the last five years. Meanwhile, world energy prices are expected to lag in the long term. In the case of oil, this could result from rising supplies of unconventional oil, efficiency gains, as well as substitution away from oil. In the case of gas, substitution and efficiency gains could be exacerbated by the potential arrival on world gas markets of U.S. gas in the wake of its shale gas revolution.[30]

Conclusion

The increasingly difficult fiscal situation of the regions reflects the overall deteriorating situation in the Russian Federation. Under President Putin's tenure, elections for governors have been scrapped and governors and speakers of regional parliaments have been excluded from the Federation Council, the very body that is supposed to promote the interests of the regions in Moscow. Now, the constantly changing fiscal regulatory framework, set entirely by the federal centre, creates an unpredictable environment for subnational governments, and makes it difficult for them to forecast and plan revenues and expenditures.[31] Falling revenues have further forced many regions to cut investment programmes, including infrastructure projects, even in the more developed parts of the country, such as Irkutsk or Sverdlovsk. Others have had to make unpopular cuts in social spending, including reductions in benefits and school closures.[32] Public dissatisfaction is spreading, and could likely spur a crackdown on civil society and regional governments.

Combined, all these factors suggest a deteriorating political and business environment for foreign investors in Russia. Spending by the central government may be squeezed as it is redirected towards new expenditure commitments and Moscow is forced to increase transfers to struggling subnational budgets. As a result, the government's ability to provide stimulus packages to boost the lagging economy will suffer. The corporate sector may struggle to finance its activity if further sanctions are imposed on Russia. With public dissatisfaction growing and the economy wilting, further tightening of the screws can be expected, on foreign business (in the form of administrative pressures or even expropriations and nationalisations) as much as on civil society, as has been the form in President Putin's Russia in the past.

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[27] *Ibidem*.
[28] "Russia's Growing Debts …," *op. cit.*
[29] Alfa Bank estimate, "Rise in Russian Oil Output Supports Overstretched Budget," *Reuters*, 2 January 2014, www.reuters.com.
[30] M. Rostowska, "Energising TTIP: A Step towards Better EU Energy Security," *PISM Bulletin*, no. 57 (652), 30 April 2014, www.pism.pl.
[31] E. Jarocińska, *op. cit.*, p. 2.
[32] J. Rogoża, *op. cit.*, p. 38.