Russian budget policy may ease in 2019

The preliminary federal budget surplus of 2.7% GDP in 2018 is driven by solid non-oil revenues and restrained spending, and the Finance Ministry remains conservative for 2019-21. Yet this year it will be hard for the government to avoid using budget or quasi-budget instruments to support corporate activity and household income

Source: iStock

RUB2.7tr

Preliminary 2018 federal budget surplus

likely to be revised upwards

Higher than expected

2018 budget execution better than expected thanks to better non-fuel balance

The Russian Finance Ministry (MinFin) reported its preliminary estimate of the federal budget surplus for 2018 at RUB2.7 trillion (2.7% of GDP), which is higher than the officially drafted RUB2.1

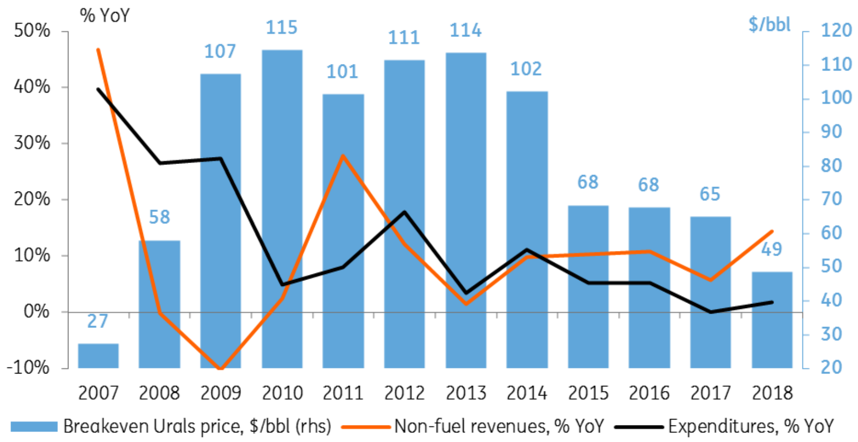
trillion, consensus forecast and our above-consensus expectations of RUB2.6 trillion. We note that the preliminary data usually overestimate the expenditures, so the final surplus to be reported later should be around RUB2.8 trillion, or 2.8% of GDP. The outperformance was thanks to both the revenue and expenditure sides.

The usual suspects driving Russia's fuel revenues, including the US$17 YoY increase in the average Urals price to US$70/bbl in 2018 and RUB4.5 weakening to RUB62.8/USD, explain around 55% of the overall RUB4.4 trillion YoY increase in the total revenues, however, the outperformance vs 2018 expectations was due to other revenue factors. The key positive surprise was the above expected 15% YoY increase (+RUB1.3 trillion YoY) in non-oil revenues thanks to more efficient VAT collection. Finally, around RUB0.5 trillion YoY increase came as a result of higher fuel revenues per RUB oil price, which indicates higher physical volumes of fuel extraction & exports and/or more efficient taxation.

On the expenditure side, the government posted only a minor 2% YoY, or RUB0.3 trillion, increase, which is RUB0.1 trillion below plan. This resulted in a material decline of the federal expenditures in real terms to 16.4% of GDP in 2018 from 17.8% in 2017 and around 19% of GDP in 2011-16. We note, however, that the volume of federal spending was artificially lowered by RUB0.6 trillion in 2017 and RUB1.1 trillion in 2018, as the National Wealth Fund (NWF) channelled those sums directly to finance part of the off-budget State Pension Fund's (PFR) deficit, while normally the support to the PFR comes via the federal budget. Nevertheless, even on a pro-forma basis the federal expenditures would have been 17.2% of GDP in 2018, still below historical levels.

As a result, the budget breakeven Urals price was lowered to US$49/bbl (or to US$55/bbl if one is to incorporate the abovementioned NWF spending), which is significantly lower than the average US$90/bbl seen in the previous 10 years and is the lowest level since the US$58/bbl seen in 2008. The headline size of NWF as of year-end 2018 is reported at US$58.1 billion (3.8% GDP), yet another US$66.5 billion of FX accumulated in 2018 under the budget rule will be added to it in mid-2019, making the current total state savings at US$125 billion, or almost 8% of GDP. The better-than-expected non-oil balance allowed the government to place a net RUB0.5 trillion in local state bonds (OFZ) vs the drafted RUB0.7 trillion, likely keeping Russia's overall state debt at last year's level of 9-10% of GDP, which is a very low level by international standards.

Non-fuel parameters of the Russian budget



Source: Finance Ministry, Bloomberg, ING

Finance Ministry intends to maintain a conservative approach in 2019-21

The current official projections for 2019-21 suggest that the government intends to remain conservative going forward. Even though an 8% YoY increase in spending is planned for 2019F in order to fulfil the President's inaugural promises, the federal expenditures are expected to remain at a low level of 17% of GDP, and no extra spending from NWF is planned, as the balance of the State Pension Fund will likely improve as a result of the increase in the retirement age effective this year. Moreover, the increase in the nominal federal spending will be financed via a hike in the VAT rate from 18% to 20%, increase in the excise tax and higher overall taxation of the fuel industry.

As a result, the overall oil breakeven level is expected to remain around the low US$50/bbl Urals level. Provided the budget rule remains intact, all fuel revenues received thanks to the Urals price exceeding US$41.6/bbl in 2019 will be transferred to the NWF. Simultaneously, Russia will have to boost local state debt by a massive RUB1.7 trillion, however, that sum could be reduced should the actual RUB exchange rate be weaker than the drafted RUB63.9/US$ and/or non-fuel revenues exceed expectations. The key parameters and our understanding of the Minfin's logic are outlined in the chart below.

> *The main goal of the current approach is to preserve the budget stability, which is the government's main macro achievement in the 2015-18 period.*

Key components and logic of Finance Ministry's plan for 2019-21

	2018	2019F	2020F	2021F
Average USD/RUB (affects fuel revenues)	62.8	63.9	63.8	64.0
Basic Urals price, $/bbl (determines basic fuel rev.)	40.8	41.6	42.4	43.3
Basic fuel revenues, RUB trln	4.8	4.9	5.2	5.4
Non-fuel revenues, RUB trln	10.4	11.7	12.3	13.0
Expenditures, RUB trln	16.7	18.0	19.0	20.0
Budget balance under basic Urals, RUB trln	**-1.5**	**-1.4**	**-1.6**	**-1.7**
Sources of financing	1.5	1.4	1.6	1.7
Gross spending of NWF, RUB trln	*1.1*	*0.0*	*0.0*	*0.0*
Net placement of local state debt (OFZ), RUB trln	*0.5*	*1.7*	*1.8*	*1.6*
Other sources of financing	*-0.2*	*-0.3*	*-0.3*	*0.1*
Actual Urals, $/bbl	70.0	63.4	59.7	57.9
Extra fuel revenues (actual-basic) to be -> into NWF	**4.2**	**3.4**	**2.8**	**2.6**
Actual headline budget balance	**2.7**	**1.9**	**1.2**	**1.0**
...% of GDP	*2.7%*	*1.8%*	*1.1%*	*0.8%*
Local state debt, % GDP	9.5%	10.8%	11.9%	12.5%
State savings, % GDP	3.6%	7.5%	10.2%	11.9%
Breakeven Urals price, $/bbl	49	49	50	51
Sensitivity of fuel revenues to macro conditions				
+10 $/bbl of Urals price equals to extra RUB ... trln	1.4	1.5	1.6	1.8
+10 to USD/RUB rate equals to RUB ... trln	1.4	1.3	1.2	1.3

Source: Finance Ministry, ING

The government may become tempted to use the budget as a tool to support GDP growth and popular support

This year we see several potential challenges to the current budget conservatism:

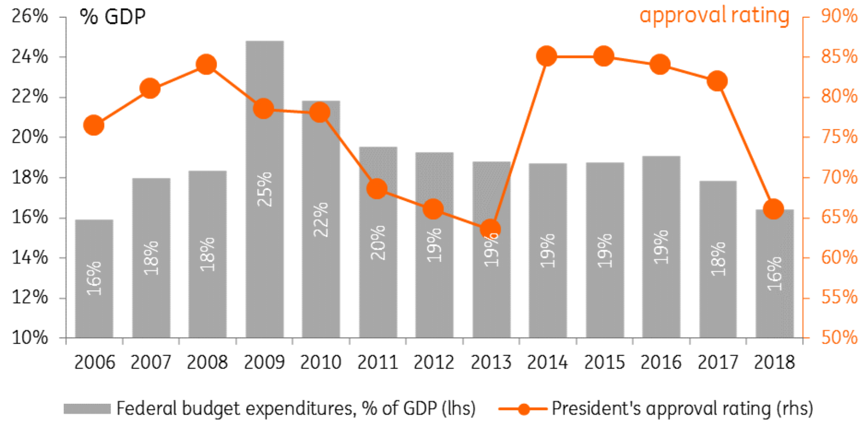
- Higher excise on oil products has already resulted in upward pressure on retail gasoline prices, and the current freeze brokered between the government and the oil producers expires at the end of March. The government might face the need to revise its tax relationship with the oil sector in order to avoid CPI exceeding the mid-year 6% target set by the Central Bank of Russia and to prevent further deterioration of inflationary expectations.
- The budget may be facing the risk of VAT undercollection vs targets due to the weakening consumption trend and an overall slowdown in GDP growth. However, the likely acceleration in the average CPI above the 4.3% level targeted by the government for 2019 may partially offset the negative effect of the likely underperformance of the real GDP rate on the non-oil revenues.
- The low 17% of GDP federal expenditure target may prove unsustainable given the return of the popular support to pre-2014 levels, while the financial capabilities on the regional budgets are unlikely to improve.
- As the size of the NFW is likely to officially reach 7% of GDP this year, the Finance Ministry will be allowed to expand the list of assets for investment. This may ultimately result in the increase of off-budget infrastructural spending accounted for as investments.

Overall, we expect at least some of those risks to materialise and result in some easing in the budget policy relative to the original plan.

> *That would not create an immediate threat to the budget stability in the mid-term, but it might be considered an important indicator of how the government prefers to address the current challenges to growth.*

Non-monetary and non-fiscal measures aimed at boosting local productivity, though more difficult and time-consuming, are more likely to create a positive and lasting effect on investors, corporates and households.

Budget spending and popular support



Source: Finance Ministry, Levada Centre

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