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## Sacrificing Stability?

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Prudent fiscal policy has probably been the Russian government's single most important contribution to sustaining economic growth over the last five years. Following a decade of large deficits, the federal budget has been in surplus since 2000. To be sure, fiscal responsibility has been facilitated by growing revenues due to favorable terms of trade and strong growth. However, the government has largely resisted the temptation to spend this windfall, instead using a significant part of it to repay debt and accumulate some reserves. Indeed, the federal budget would probably have remained in rough balance even had oil prices been at long-term average levels throughout the period. The maintenance of such exemplary fiscal discipline over the last half-decade has been a major achievement. Unfortunately, the outlines of the 2005 draft budget suggest that the government is in danger of throwing this achievement away. It seems to have opted instead for an unnecessary and potentially unsustainable relaxation of fiscal policy.

On the face of it, all is well. The draft envisages a surplus of more than 1 percent of GDP. However, this assumes a projected average oil price of \$26 per barrel -- well above the long-term average of around \$19 for Urals crude. Moreover, the authorities anticipate spending a substantial portion of the windfall revenues generated by above-average oil prices to cover the deficit that the State Pension Fund is expected to run next year, following the planned reduction in the unified social tax. Finally, the draft federal budget incorporates assumptions about expenditure cuts at regional and local levels that look rather heroic.

In any economy, such a relaxation of fiscal policy at this point in the economic cycle would be questionable: The planned relaxation is, after all, clearly pro-cyclical. In an economy such as Russia's, however, such fiscal loosening is downright dangerous. To understand why, it is necessary to consider briefly the implications for fiscal policy of Russia's economic structure.

At present, Russia is highly dependent on the export of a limited range of natural resources, chiefly hydrocarbons and metals. Indeed, this dependence has been growing in recent years, and it will not rapidly be reversed. This resource dependence makes the economy especially vulnerable to external shocks arising from fluctuations in the international prices of its major export commodities, above all oil. The government is well aware of the riskiness of such resource-dependent development and rightly regards economic diversification as a key long-term goal. Yet policies promoting diversification will take time to bear fruit. Even if diversification policies are spectacularly successful and Russia increases sharply its exports of more sophisticated manufactures, they will remain modest for quite some time, simply because they start from such a low base.

The difficulties of managing a resource-based economy have prompted some economists to view rich natural resource endowments as a "curse." Yet talk of a "resource curse" is greatly overblown. The risks of resource-dependent development are manageable, given the right policies and institutional framework. Prudent macroeconomic management, in particular, is of vital importance. Regardless of the success or failure of diversification-oriented structural policies over the long run, the sine qua non for sustaining growth over the short to medium term will be sound macroeconomic policy.

In this context, fiscal discipline is crucial to reducing Russia's vulnerability to commodity price cycles, particularly in view of the sensitivity of budget revenues to oil price fluctuations. Good fiscal policy cannot eliminate external vulnerability altogether, but it can do much to mitigate it. Fiscal irresponsibility, however, will tend to magnify, rather than mute, the effects of commodity price movements, contributing to boom-and-bust cycles. It is therefore vital to keep the budget in balance across the oil price cycle. If budgetary oil price assumptions are above long-term averages, then budgets should be drafted to achieve corresponding surpluses. A budget that balances thanks only to an exceptionally high oil price is not in balance at all. The outlines of the draft 2005 federal budget must therefore cause concern.

So must the plans for spending windfall revenues above and beyond those to be accumulated in the new stabilization fund. Given the importance of ensuring fiscal balance across the oil price cycle, the creation of the fund is a welcome development. However, if it is indeed to serve this purpose, it must be large enough to insure the budget against

several years of below-average oil prices. This implies that the amount to be accumulated in the fund should be raised. It is currently planned to accumulate 500 billion rubles in the fund, roughly 3.8 percent of 2003 GDP. This is a much smaller figure than was first proposed: The Finance Ministry's initial aim was to accumulate the equivalent of almost 9 percent of GDP in the fund.

The size of the stabilization fund is particularly relevant in the context of the 2005 budget, because it now appears that the fund will pass the 500 billion ruble mark early next year. Thereafter, the government plans to use half of the surplus revenues generated by above-average oil prices for debt repayment and the other half to finance the deficit in the pension fund that will result from cutting the unified social tax. While the former option would be welcome, the latter implies using windfall revenues arising from the current economic conjuncture to finance a permanent tax cut. Whatever the ultimate size of the fund, it may at some point be sufficiently large that further accumulation would be unnecessary and inefficient. The government will then need to decide what to do with any further windfall revenues arising from high oil prices. The temptation to use them to finance tax cuts or higher non-interest spending should be resisted, as this would be strongly pro-cyclical and would thus increase the risk of overheating. It would also risk jeopardizing the fiscal position as and when oil prices eventually fell.

The urge to spend at least some windfall revenues is, of course, understandable, given the many urgent calls on the public purse. So is the desire to ease the tax burden on business. However, if the authorities wish to use windfall revenues to finance sustainable tax cuts or expenditure increases, then the best strategy would be to use surplus revenues in the first instance for early debt repayment. This would reduce the government's future liabilities and thus allow for higher spending or lower taxation in subsequent years -- without betting on continued high oil prices. Using surplus revenues for debt repayment would also help to reduce the risk of currency crises and to limit the impact of such crises if they occur.

A larger stabilization fund, moreover, would have two other advantages. First, it would strengthen Russia's bargaining position vis-a-vis OPEC, since it would reduce the potency of any threat to initiate a price war. Second, it would reduce the danger of potentially disruptive exchange-rate movements in response to oil-price fluctuations. By law, stabilization fund revenues may be invested only in foreign government securities. This means that the investment and spending pattern of the fund will contribute to capital outflows when oil prices are high, thereby reducing the upward pressure on the ruble and helping to counteract "Dutch disease." When oil prices are low, the stabilization fund will contribute to capital inflows, thus reducing the risk of a sharp devaluation.

The 2005 budget cycle is just getting under way, and there is time for the government to ensure that the budget ultimately reflects Russia's real, cyclically adjusted fiscal position. Ultimately, however, the crucial issue is not the detail of one budget, but what that budget suggests about how the authorities view fiscal policy. Russia is, and will remain for some time, a highly resource-dependent economy. Fiscal policy must reflect a proper appreciation of what that implies.

Any other course risks betting the nation's economic future on the price of Urals crude.

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