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Russia's New Budget Confronts Sanctions, Slump and Oil Price Crash

By The Moscow Times

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An expected weakening of the ruble will cover part of the budget hole, bringing in an extra trillion rubles or so next year, according to the budget.

Russia presents its toughest budget in years on Thursday, relying on optimistic forecasts for oil prices at a time when borrowing abroad to cover any deficit slippage will be tough due to tightening Western sanctions.

With the economy slowing to a crawl, the 2015-2017 budget proposes possibly tapping into the country's reserves for the first time since the 2008 global crisis, while foreseeing an end to real wage growth, a struggle to tame inflation and a falling ruble.

The first budget since Russia's costly seizure of Crimea from Ukraine keeps the deficit at a relatively modest 0.5-0.6 percent of gross domestic product for the three-year period.

However, the government of President Vladimir Putin faces a grueling challenge to make ends

meet due to the weak economy and the effects of the sanctions, imposed by the United States and European Union after the annexation in March and tightened since then over Moscow's support of Ukrainian separatists.

Deputy Finance Minister Alexei Lavrov has warned Russians to expect tight spending. "There cannot be more money in the budget than there is already. There is only as much as the economy generates," he said earlier this week.

Economic growth is ebbing fast and is expected to be 0.4 percent at best this year, with recession a possibility if the West takes more measures against Moscow.

The budget assumes prices of oil, Russia's chief export, will average $100 per barrel. Although a little lower than earlier forecasts, analysts say this seems ambitious.

"It is quite optimistic given where oil prices are at now and given how much the Russian budget depends on oil revenues," said Liza Ermolenko, an emerging markets analyst at Capital Economics in London. "For the next year, it's more likely that the oil prices will be lower than what they are pencilling in."

Oil and gas produce about a half of Russia's government revenues. Urals, the country's chief crude blend, stood at around $96 per barrel on Wednesday and Capital Economics sees benchmark Brent crude — which usually trades at a slight premium to Urals — at $90 by the end of next year.

Poor but Proud

Should oil prices end up lower than the Finance Ministry's assumption, the budget deficit will become larger and financing it will be difficult, Ermolenko said.

"Even running a small budget deficit is difficult given the current environment, given the fact that they are not really able to raise finances externally, given the current political situation," Ermolenko said.

Sanctions have cut Russia's access to foreign capital, forcing it to turn east, mainly to China, to seek funds. Funding at home is equally problematic as the domestic debt market is weak. Borrowing there would be expensive due to high yields, and the government has cancelled nine straight weekly debt auctions, blaming "unfavorable market conditions."

The budget projects that the economic effect of the sanctions will result in a revenue shortfall of nearly two trillion rubles ($52 billion) over the next two years.

An expected weakening of the ruble will cover part of this hole, bringing in an extra trillion rubles or so next year, according to the budget. The rest is to come mainly from funds redistribution — assuming oil prices hold.

About 100 billion rubles could come from the state's proposed sale of a 19.5 percent stake in Rosneft, Russia's largest oil company. The firm, however, has been hit by Western sanctions and has asked the government for $40 billion in aid.

More money, or 309 billion rubles, will be saved by the government deciding for a second year

in row not to transfer money to the country's Pension Fund in 2015.

But if oil prices fall, the Finance Ministry is left with few options. Russia has a small debt amounting to only around 11 percent of annual economic output and, sanctions notwithstanding, it could increase foreign borrowing from the $7 billion already penned it for next year.

But fiscal discipline and low public debt are a priority for Putin. He has dismissed calls for more borrowing as a "irresponsible policy" akin to that of the late President Boris Yeltsin which led to the state defaulting on its debt in 1998.

"We would rather be poor but proud," said a government source, referring to the Kremlin's attitude on foreign borrowing. "The memories of 1998 and of us begging abroad for money are still painful, still humiliating."

The Finance Ministry envisages that growth in real wages will end next year, but analysts say that any significant cuts in social spending are unlikely.

"For the government this is the key electorate, the public sector employees and pensioners," Ermolenko at Capital Economics said. "So obviously they will prefer to cut other areas but they will continue financing pensions and salaries."

There is also no mention in the budget of introducing a retail tax, an issue hotly debated in Russia in recent months, but which could add another 1-1.5 percentage points to already troublesome inflation, according to government estimates.

"We will not increase taxes, we will not increase the budget deficit," Finance Minister Anton Siluanov said earlier this week. "We will find this [needed] amount within the budget."

Hemorrhaging Rainy-Day Fund

With nearly half a trillion dollars in foreign currency and gold reserves, Russia could weather a severe economic downturn for the next two years or so.

But the Finance Ministry is allowing, if the need arises, for the possibility of taking funds from the sovereign wealth fund next year for the first time since the aftermath of the global crisis. The Reserve Fund, which collects windfall oil revenue and was set up to cover budget shortfalls, stood at $91.7 billion as of Sept. 1.

"To ensure the unconditional fulfillment of all of the obligations in 2015, in a situation if federal budget revenues come short ... the government will have the right to direct the resources to fill the shortfall of up to 500 billion rubles from the Reserve Fund," the Finance Ministry said in the budget.

Economists have warned that once the government starts digging into the stash, it can be depleted within around a year if Moscow is hit with more punitive measures by the West and if oil prices drop significantly.

Russia's vulnerability to oil prices makes it even riskier. A drop to $38 per barrel after the crisis erupted forced a 7.8 percent fall in Russian gross domestic product. Reserves fell

$200 billion within a few months as the government tried to defend the ruble, which still lost a third of its value.

The Finance Ministry, which has spent many a sleepless night crunching the numbers, sources say, admitted the situation is shaky.

"In 2014 and on the short-term horizon of 1.5 years, the dynamics of key macroeconomic situation will be affected by the consequences of the Russian economy experiencing the structural and cyclical crisis as well as geopolitical risks, including those associated with the sanctions regime," the ministry said in a memorandum accompanying the budget.

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