Sovereign Wealth Funds

New challenges for the Caspian countries

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Summary

This book considers financial management and transparency aspects of Sovereign Wealth Funds (SWF). It also discusses the impact of the global financial meltdown (2008-2009), commodity price fluctuations and the rise of the risks in the emerging world on SWFs financial performance and their investment activities. The book particularly concentrates on Caspian Basin countries (Azerbaijan, Russia, and Kazakhstan) plus Norway as explanatory case studies.

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Acronyms

EITI	Extractive Industries Transparency Initiative
GAPP	Generally Accepted Principles and Practices
GDP	Gross Domestic Product
IFI	International Financial Institutions
IMF	International Monetary Fund
NASDAQ	National Association of Securities Dealers Automated Quotations
NGOs	Non-governmental Organizations
NGPF	Norwegian Government Pension Fund
OECD	The Organization for Economic Cooperation and Development
SOFAZ	State Oil Fund of Azerbaijan Republic
SWF	Sovereign Wealth Funds
USD	United States Dollar
US/G7	United States Group Seven

Content

Russian Sovereign Wealth Funds

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Russia has a relatively long but rather peculiar history of sovereign funds development. Having started in 2004 with one fund - the Stabilization Fund of the Russian Federation - the country had two fairly large funds, including the National Welfare Fund, in 2008 on the verge of the crisis. However, at the end of the crisis in the medium term, both funds may cease functioning, having met only a part of their objectives.

Short History, Mission and Type

Creation of the first Russian sovereign fund, the Stabilization Fund of the Russian Federation, was related to the idea of institutionalizing federal budget surplus generated in the form of balances on the budget accounts with the Central Bank of Russia since 2000. Understanding the situational nature of budget revenues in the background of rising oil prices in the world market, and wishing to avoid a proportional growth of the budget expenditure commitments, the RF government in 2003 proposed establishment of the Stabilization Fund, which would be formed from the excessive revenues from oil production and exports (as compared with the estimated long-term oil price, cut-off price or baseline price).

Federal Law «On Amendments to the Budget Code of the Russian Federation regarding the establishment of the Stabilization Fund of the Russian Federation" No. 184-FZ, on the basis of which the Stabilization Fund of the Russian Federation was created in 2004, was adopted December 23, 2003.

The purpose of the Stabilization Fund of Russia was to ensure the federal budget balance during a decrease in oil prices below the baseline. According to the RF Ministry of Finance, "the Fund contributes to stability and economic development; it is one of the main instruments of binding the excessive liquidity, which is reducing inflationary pressures and the dependence of national economy from adverse fluctuations of revenue from commodity exports." Thus, at the initial stage of establishment, the Fund is a classic version of the commodity fund, designed to suppress fluctuations of the market revenue of the federal government. The Fund assets could be used to cover the federal budget deficit only in the case of oil prices dropping below the baseline. However, if the accumulated amount of the Fund exceeded 500 billion rubles, the excess could be used for other purposes.

From January 1, 2004 the base price was set at $20 per barrel for Urals, and on January 1, 2006, the cut-off price was raised to $27. Despite continued growth in oil prices, there was no further increase in the «cut-off price» because of the risk of rising inflation and increasing budget dependence on the external economic situation.

Since in 2005 the Fund exceeded the level of 500 billion rubles (RUR 1,387.8 bln), a part of the assets was addressed to other purposes, namely for the payment of external debt of the Russian Federation (RUR 643.1 bln) and replenishment of the deficit of the Pension Fund of the Russian Federation (30 billion rubles, see Table 1).

Table 1. RF Stabilization Fund Assets: Dynamics in 2004-2007 (RUR bln)

Year	Proceeds				Utilization			Balance as of the end of the year
	Total	Export duty	Royalty (oil)	Balances of Federal Budget	External debt recovery	Development Institutions financing	RF Pension Fund deficit replenishment	
2004	522.3	240.8	175.5	106.0	–	–	–	522.3
2005	1387.8	663.4	507.3	217.1	643.1	–	30.0	1237.0
2006	1708.6	991.2	646.7	47.8	604.7	–	–	2346.9
2007	1895.9	918.9	674.7	156.7	33.7	300.0	–	3849.1
Total	5514.6	2814.8	2004.1	527.6	1281.5	300.0	30.0	

Source: RF Federal Treasury

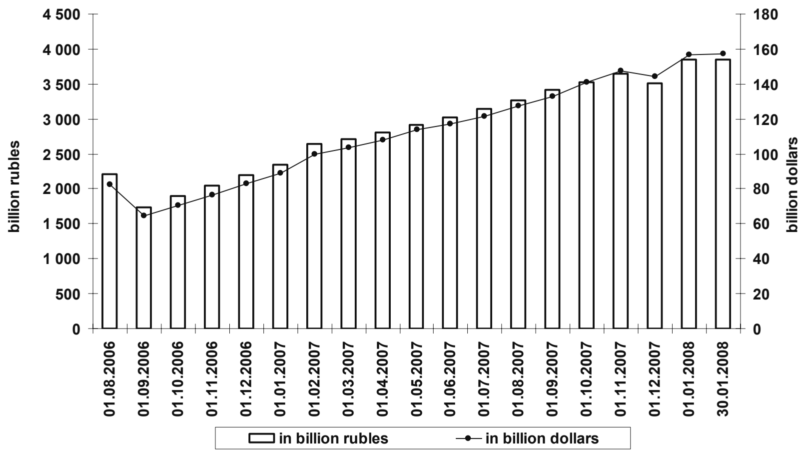
In 2005, at the expense of the Stabilization Fund, repayment of external debt of Russia was made in the amount of 643.1 bln, including:

- 93.5 billion rubles (equivalent to USD 3.3 billion) - the debt to the International Monetary Fund;
- 430.1 billion rubles (equivalent to USD 15 billion) - the debt to the member countries of the Paris Club;
- 123.8 billion rubles (equivalent to USD 4.3 billion) - the debt to Vnesheconombank under credit granted by the Ministry of Finance of the Russian Federation in 1998-1999 for the repayment and servicing of external government debt of the Russian Federation.

In 2006, 604.7 billion rubles and in 2007, 33.7 billion rubles were spent for external debt redemption. In 2005, 30.0 billion rubles (equivalent to 1.04 billion U.S. dollars) were allocated to cover the deficit of the RF Pension Fund, and in 2007 – 300.0 billion rubles to finance development institutions (Rusnano - 30 billion rubles, VEB - 180 billion rubles, Investment Fund - 90 billion rubles).

By the time the Fund split in 2008, the assets' total volume was 3,851.8 billion rubles (157.38 billion U.S. dollars), reaching approximately 11.6% of annual GDP of Russia (*Fig. 1*).

Figure 1. The total volume of the RF Stabilization Fund

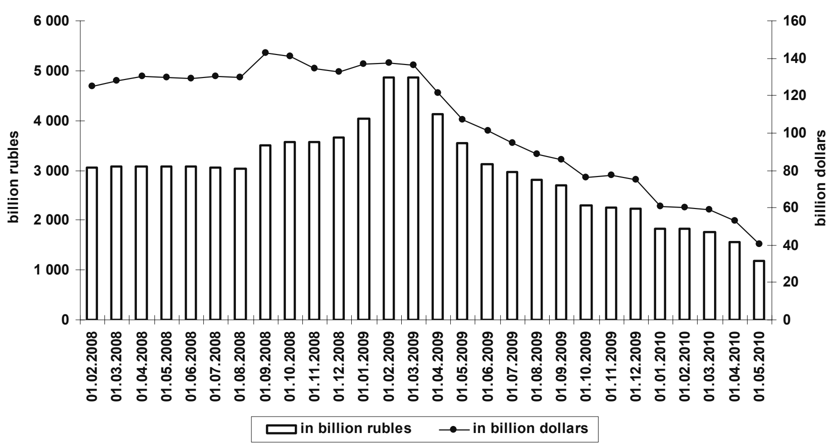


Source: RF Ministry of Finance

Starting in February 1, 2008 the Stabilization Fund of Russia was divided into two parts: the Reserve Fund (with an initial volume of RUR 3069.0 bln) and the National Welfare Fund (initially RUR 782.8 billion), hereinafter referred to as FNB.

The Reserve Fund, like the earlier Stabilization Fund, is a part of the federal budget. The Fund is intended to assist the government to uphold budget spending commitments in the event of low oil and gas revenues. The normative value of the Reserve Fund is established at a level equal to 10% of GDP. In contrast to the Stabilization Fund of the Russian Federation, in addition to federal budget revenues from oil production and export, the sources forming the Reserve Fund also include federal budget revenues from gas production and gas export.

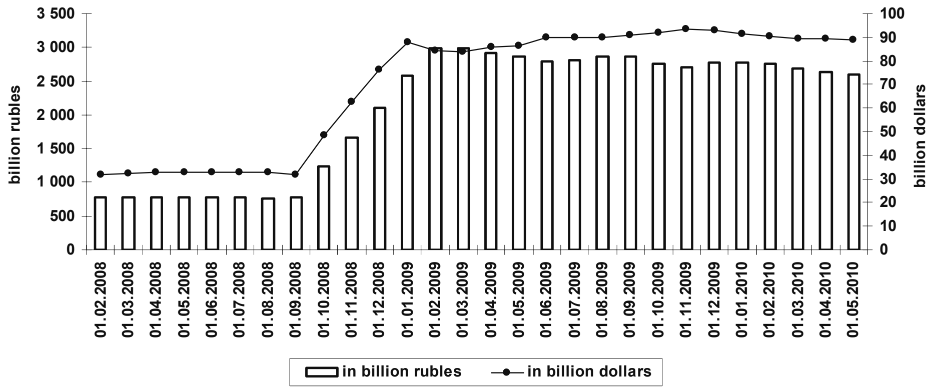
Figure 2. Reserve Fund Total Assets Volume



Source: RF Ministry of Finance

The National Welfare Fund is a part of the federal budget subject to separate accounting and management to ensure co-financing of voluntary retirement savings of the Russian citizens, as well as to cover the deficit of the Pension Fund budget.

Figure 3. National Welfare Fund Total Assets Volume



Source: RF Ministry of Finance

The Reserve Fund actually became a functional successor of the Stabilization Fund as a part of the federal budget with separate accounting and management for the purpose of oil and gas transfers in the event of insufficient oil and gas revenues for the financial support of this transfer. The reserve fund is financed by excess oil revenues of the federal budget in the scope authorized for the financial year in the amount of oil and gas transfers, provided that the accumulated amount of the Reserve Fund does not exceed its established value, as well as from revenues derived from the management of the Reserve Fund. In other words, it is a classic commodity fund.

In turn, the FNB is close to the sovereign funds or future generations funds in nature, and is accumulated from oil and gas revenues of the federal budget exceeding the amount of oil and gas transfers approved for the financial year, in the case that the accumulated amount of the Reserve Fund reaches (exceeds) its established value, as well as revenues derived from FNB management.

As of June 1, 2010 the Reserve Fund of Russia has been reduced to RUR 1,197.66 billion (USD 39.27 billion). The volume of the National Welfare Fund is RUR 2,616.54 billion (USD 85.8 billion).

Legal basis, accountability and reporting

As mentioned above, in 2003 the Federal Law “On Amendments to the Budget Code of the Russian Federation regarding the establishment of the Stabilization Fund of the Russian Federation” of 23.12.2003 No. 184-FZ was adopted, on the basis of which in 2004 the Stabilization Fund of the Russian Federation was established. The law has introduced Chapter 13.1 in the Budget Code, which stipulated fundamentals of the Stabilization Fund and its management procedure.

According to the law, the Stabilization Fund is a part of the federal budget assets, formed from the excess of oil prices over the baseline price, subject to separate accounting, management and use in order to balance the federal budget in case of a decrease in oil prices below the baseline.

The sources of the initial formation of the Stabilization Fund were:

- federal budget surplus revenues, which are assessed as an excess oil prices over the baseline price;
- balances of the federal budget assets at the beginning of the relevant fiscal year, including the proceeds from the Stabilization Fund assets allocation.

Additional federal budget revenues to be credited to the Stabilization Fund in the current month were assessed as the sum of:

- actual revenue to the federal budget from the export customs duty on crude oil obtained in the current month, multiplied by the ratio of the difference between the rate of export duty on crude oil effective in the current month and the estimated rate of that duty with the baseline price for oil to the rate of export customs duty on crude oil effective in the current month;
- actual revenue of the federal budget from severance tax (oil) obtained in the current month multiplied by the ratio of the difference between the severance tax rate effective in the current month for oil extraction and the estimated rate of this tax with the baseline price oil extraction tax rate effective in the current month on extraction of minerals (oil).

Only one target was foreseen in the RF Budget Code for the Stabilization Fund, namely - financing of the federal budget deficit “in the case of a decrease in oil prices below the baseline, as well as for other purposes, if the accumulated volume of the Stabilization Fund exceeds 500 million rubles.”

According to Art. 96.4 BC RF, the Ministry of Finance of Russia was authorized to manage the Stabilization Fund, but some relevant functions could be performed by the Central Bank of the Russian Federation. The list of functions performed by the CBR was not specified in the Budget Code.

As an effect of Chapter 13.1 of the RF Budget Code, amendments were made mainly in regard to the baseline for oil prices, but not affecting the management of the Fund or their target use. At the executive level, the management procedure of the Stabilization Fund was governed by a number of legal acts, the most important of which are:

- The RF Government Regulations No. 508 of 30.09.2004 and No. 229 from 21.04.2006 “On the Procedure of the Stabilization Fund of the Russian Federation Management”
- The RF Government Regulation No. 31 of 23.01.2004 “On Approval of the Rules of transfer to the Stabilization Fund of the Russian Federation of the additional federal budget revenues, balances of the federal budget as of the beginning of the fiscal year, and revenues from the allocation of the Stabilization Fund of the Russian Federation”
- Order of the RF Ministry of Finance No. 20 of 28.01.2004 “On Approval of Rules of assessment and transfer to the Stabilization Fund of the Russian Federation of the federal budget surplus revenues and fund balances of the federal budget by the beginning of the fiscal year,” and
- Order of the RF Ministry of Finance No. 158 of 22.05.2006 “On approval

of the minimum and maximum timelines for repayment of the debt liabilities of foreign countries, in which the Stabilization Fund of the Russian Federation assets can be invested."

Of particular interest are the RF Government Regulation No. 508 of 30.09.2004, "On the order of the Stabilization Fund of the Russian Federation assets management," and No. 229 from 21.04.2006 "On the order of the management of funds of the Stabilization Fund of the Russian Federation." One of the key tasks in the first stage was to set conditions for investment of the RF Stabilization Fund by the Central Bank abroad and to provide at least some safeguards to protect them from claims of foreign creditors. As investments in foreign financial instruments, federal funds lose the status of public funds and, accordingly, any state jurisdictional immunity.

The Regulation No. 508 of 30.09.2004 stipulated the following allocation of investments. The Fund assets were legally separated from the assets of the Central Bank[1] and were legally considered "commercial" investments of the Russian Federation as a legal entity. This created certain risks for foreign investments of the Stabilization Fund, since there was no jurisdictional immunity of the Russian Federation in regard to those funds. As a result, there was a possibility of foreclosure on the Stabilization Fund from foreign creditors.

The government feared the risk of foreclosure on these funds[2], and the adoption of "on the procedure for managing the Stabilization Fund of the Russian Federation" No. 229 from 21.04.2006 tried to give them the status of funds used for "governmental and non-commercial" purposes[3], which are protected with jurisdictional immunity. To this end, the assets placed abroad were transferred to the status of funds belonging to the Central Bank of Russia.

The Regulation provided the following procedure for investing the Stabilization Fund assets: they passed to the Federal Treasury, and the Treasury then placed them in a special account with the RF Central Bank, not on the basis of the assets management contract as it was before, but on the basis of a contract for a bank account. Since the funds deposited in an account with the bank are formally transferred to its ownership, it allowed the Central Bank to invest them abroad as its own funds used for "public non-commercial purposes." Herewith, the Ministry of Finance has retained the key responsibility for management of the investment process for allocation of the Stabilization Fund assets[4].

In particular, the Ministry of Finance was authorized to define:

- the standard currency structure of the Stabilization Fund, the procedure of pursuing the standard currency structure;
- standards of minimum and maximum maturity of debt securities,

1 The assets were transferred under the management contract, concluded between the Russian Finance Ministry and Central Bank, and did not legally become the property of RF Central Bank.

2 See, for instance, United Nation Conference on Trade and Development. World Investment Report: Transnational Corporations, Extractive Industries and Development. new York and Geneva, 2007. P. XVII.; McKnight A. The Law of International Finance. Oxford University Press, 2008. P. 368, 369.

3 Immunity to this category of funds is provided under the United Nations Convention "On Jurisdictional Immunity of the States and their Property" from 02.12.2004.

4 This Decree stipulates "management of the Stabilization Fund by the Ministry of Finance of the Russian Federation".

- the procedure for accounting and crediting interest accrued on balances of the Stabilization Fund accounts, as well as other conditions of the bank account contract; and
- the procedure of interaction with the Federal Treasury in carrying out transactions with the accounts of the Stabilization Fund.

Monitoring of the Russian Finance Ministry control functions over the use of the Stabilization Fund was limited to the duties of providing quarterly annual reports to the Government of Russia on the status of the following indicators:

- the amount of authorized foreign currency purchased and foreign currency placed on the accounts of the Stabilization Fund;
- estimated interest rates for the allocation of the Stabilization Fund assets in the accounts;
- estimated income for the allocation of the Stabilization Fund assets in the accounts;
- names and basic characteristics of foreign countries' debt liabilities acquired with the Stabilization Fund assets;
- income derived from the placement of the Stabilization Fund assets into bonds of foreign countries by type of debt liabilities of foreign countries;
- information on balances of the accounts of the Stabilization Fund (per year);and
- details of interest paid over the past year for the use of Stabilization Fund assets placed in the accounts (per year).

In 2007, the procedure for the formation of funds, accumulating oil and gas revenues of the federal budget, and the procedure to manage the funds were radically amended. Relevant amendments were made with the Federal Law No. 63-FZ of 26.04.2007 "On Amendments to the Budget Code of the Russian Federation in terms of regulating the budgetary process and bringing certain legislative acts of the Russian Federation in line with the budget legislation of the Russian Federation." Under this Act, the Stabilization Fund was split into two parts, and the following were established:

1. a Reserve Fund in order to minimize the risks of the Russian economy in the case of a sharp drop in energy sources' prices in the world markets (Art. 96.9 of the RF Budget Code)
2. a National Welfare Fund, in order to ensure co-financing voluntary retirement savings of the Russian Federation citizens, as well as to ensure the balance (cover the deficit) of the budget of the Pension Fund of the Russian Federation (Art. 96.10 BC Code).

In addition, starting from 2007, a part of the oil and gas revenue was used as a part of the federal budget to implement in particular large-scale social programs and replenishment of the federal budget deficit through the so-called "oil and gas transfers" (Article 96.8 of the RF Budget Code).

Reserve Fund

The reserve fund is formed from the oil revenues of the federal budget exceeding the level of oil and gas transfers authorized for the relevant financial year, provided that the cumulative Reserve Fund does not exceed its established value, as well as from revenues from the management of the reserve fund.

Item 2 of art. 96.9 of the RF Budget Code established a procedure for estimation of the normative values of the Reserve Fund. Under this item, it is assigned an absolute amount, assessed on the basis of 10 percent of GDP planned for the relevant fiscal year.

However, a large part of the provisions of Art. 96.9 of the RF Budget Code were not set to be put into effect until 2013. The relevant decision was taken as part of the anti-crisis measures and approved by the Federal Law No. 314-FZ of 17.12.2009 “On Amendments to Certain Legislative Acts of the Russian Federation” in connection with the Federal Law “On the federal budget for 2010 and the planned period of 2011 and 2012.”

Before 2013, while the revenue from the Reserve Fund management was allocated to financing the budget expenditures, the procedure for the fund assessment, stipulated by Item 2 of Article 96.9, could be ignored. Also, before 2013, the RF Government could, without amending the federal law on the federal budget, make decisions on the use of the Stabilization Fund and other balances of the federal budget for the implementation of payments, reducing debt liabilities, borrowing, and to balance the federal budget execution (including financial support of oil and gas transfers), including the excess of the total federal budget expenditures within increased budgetary allocations of the federal budget to provide intergovernmental transfers in order to balance the budgets of state extra-budgetary funds of the Russian Federation, with the corresponding amendments to the budget registry[5].

National Welfare Fund

According to Art. 96.10 of the RF Budget Code, the National Welfare Fund is formed from oil revenues of the federal budget exceeding the amount of oil and gas transfers approved for the financial year, if the accumulated amount of the Reserve Fund reaches (exceeds) its established value, as well as from the income derived from the National Welfare Fund management. The latter, as well as income from the Reserve Fund management from 2009 through 2013, are allocated to the financing of the budget expenditures[6].

Art. 96.11 of the RF Budget Code establishes the procedure for managing the Funds’ assets, as well as setting up requirements for the assets of the Funds that can be used for investments. These requirements are specified in detail on the sub-law level. According to this article, the Reserve Fund and National Welfare Fund are managed by the Ministry of Finance of the Russian Federation in the manner established by the Government of the Russian Federation. Herewith, some responsibility for managing the Reserve Fund can be performed by the Central Bank of the Russian Federation, and some of those in regard to the National Welfare Fund - by the Central Bank of the Russian Federation and by special financial institutions, in accordance with agreements with the Ministry of Finance of the Russian Federation in the manner prescribed by the Government of the Russian Federation.

5 See Federal Law № 58-FZ of 09.04.2009 “On amendments to the Budget Code of the Russian Federation and some legislative acts of the Russian Federation”

6 See Federal Law № 58-FZ of 09.04.2009 “On amendments to the Budget Code of the Russian Federation and some legislative acts of the Russian Federation”

Currently, the procedure for the management of the Funds is governed by:

- The RF Government Regulation No. 892 of 17.12.2007 “On the estimates and transfer of funds in connection with the formation and usage of oil and gas revenues of the federal budget, oil and gas transfers and the assets of Reserve Fund and National Wealth;”
- The RF Government Regulation No. 955 of 29.12.2007 “On the procedure of the Reserve Fund management;”
- The RF Government Regulation No. 18 of 19.01.2008 “On the procedure of the National Welfare Fund assets management;”
- The Order of the RF Ministry of Finance No. 3 of 16.01.2008 “On approval of the authorized shares in the total volume of financial assets of the Reserve Fund and the procedure for assessment of the actual authorized share of financial assets in the total assets of the Reserve Fund to bring them into conformity with the established rates;”
- The Order of the RF Ministry of Finance No. 26 of 24.01.2008 “On approval of the authorized shares in the total volume of financial assets of the National Welfare Fund and the procedure for assessment of the actual authorized share of financial assets in the total volume of the National Welfare Fund to bring them into conformity with the established rates;”
- The Order of the Ministry of Finance N 517 of 21.10.2008 “On amendments to the Order of the Ministry of Finance of the Russian Federation N 26 on January 24, 2008;”
- The Order of the RF Ministry of Finance No. 24 of 24.01.2008 “On approval of the established foreign currency structure of the National Welfare Fund and the Procedure to bring the actual foreign currency structure of the National Welfare Fund into compliance with the established rates;” and
- The Order of the RF Ministry of Finance No. 5 of 16.01.2008, “On approval of the list of foreign government agencies in which the debt liabilities of the Reserve Fund can be allocated.”

In general, the management procedure of the Funds, established on the basis of the Stabilization Fund, is governed by the logic laid down by the government in the Regulation No. 229 issued in 2006. According to the “new” Order No. 892 of 17.12.2007, the key functions associated with management decisions are performed by the Ministry of Finance, while the Central Bank carries out technical work related to ensuring their implementation. Relations among the Ministry of Finance, Treasury and Central Bank are based on the bank account agreement. The Agreement, as before, is reached between the RF Central Bank and the Treasury.

- According to the Ministry of Finance Order No. 25H of 14.02.2008, the oil and gas revenues of the federal budget, the Reserve Fund and National Welfare Fund are registered in special accounts of the federal budget opened for the Federal Treasury with the Central Bank of the Russian Federation. For these purposes, in accordance with the Bank Account Agreement entered into by the Federal Treasury and the Central Bank of the Russian Federation, on the balance of account No. 40105 “The federal budget,” separate accounts are opened:
- to account for oil and gas revenues of the federal budget;
- to account for the Reserve Fund assets in the national currency of the Russian Federation in the special account of the Reserve Fund;

- to account for the National Welfare Fund assets in the Russian national currency and account for the recording of the National Welfare Fund assets.

Transfer of the oil and gas revenues of the federal budget, the Reserve Fund and National Welfare Fund in the national currency of the Russian Federation is performed by the Federal Treasury upon instructions from the Ministry of Finance of the Russian Federation to conduct transactions on the accounts for the accounting of oil and gas revenues, the Reserve Fund and National Welfare Fund, as well as payment documents.

All the above-mentioned laws provide for the minimum requirements in relation to the control process over investing the Reserve Fund and the National Welfare Fund assets.

Control arises from the fact that the Finance Ministry provides quarterly and annual reports on the management of the Funds assets to the government of the Russian Federation. The reports provided to the Government comprise:

- information on the balances of the Funds;
- information on the volume of the bought and sold assets;
- information on the estimated interest rates for the usage assets of the Fund allocated to the accounts;
- information on the estimated amounts of income derived from the use of the funds allocated to the accounts of the Funds;
- the names and basic characteristics of financial assets, in which the Funds' assets were placed;
- details of income received from the placement of funds.

In addition, no later than on the 20th of each month, the Ministry of Finance compiles and publishes in its website monthly summary reports available for public use. Published reports provide an overview of the total assets of the National Welfare Fund as of the beginning of the reporting month, as well as information on the assets credited to the fund, their placement and use in the reporting month.

These requirements on the control over investment of oil and gas revenues are limited. Speaking of controlling the use of the funds, one should also pay attention to the fact that the representative bodies of the state power are virtually not involved in the control of the funds' investments, and do not make management decisions on these issues.

Moreover, as noted above, from 2009 to 2013 the decisions on the use of the Reserve Fund were made by the RF Government with no changes to the law on the federal budget; that is, the fund not only invests, but also partly spends the Fund assets without the approval of the Parliament. Therefore, the management of the Funds is virtually beyond the Parliament's control.

On May 6, 2010 the RF Government Regulation No. 267 of 21.04.2010 "On the suspension of the acts of the RF Government on the formation and use of oil and gas revenues of the federal budget, income from management of the Reserve Fund and National Welfare Fund" came into effect, under which the following requirements for the Ministry of Finance are cancelled:

- publishing of information on the Russian Ministry of Finance website about the collection and use of oil and gas revenues of the federal budget, their enrollment in the Reserve Fund and National Wealth Fund, and the admission of income from management of the Reserve Fund and National Wealth Fund to the

Fund (before February 1, 2012);

- submission of reports to the Government of Russia on the formation of the Reserve Fund and National Welfare Fund and on the revenue from the use of oil and gas revenues of the federal budget (before January 1, 2013).

In addition, issues of the formation and usage of the oil and gas revenue from before January 1, 2013 are excluded from the review for the formulation and approval of the federal budget for the next fiscal year and the planned three-year term.

Thus, this Regulation establishes a departure from the concept of separation of the budget by oil and gas and non-oil and-gas components and of oil and gas transfer as a source of funding the non-oil budget deficit, and makes the RF Ministry of Finance and the Government of Russia virtually unaccountable to the State Duma in terms of both Funds' assets management.

However, it should be noted that the RF Ministry of Finance continued to publish information on the status of the Funds on its website as of June 1, 2010.

Institutional base and institutional quality

Creation of the RF Stabilization Fund in 2004, although it goes beyond the chronological framework, should be considered in the context of the overall logic of economic reforms of V.V. Putin's first term in office (2000-2003), of the so-called "Gref Program"[7] or "Strategy-2010." In the framework of this program, radical tax reform was carried out, the foundation was laid for the new fiscal policy (transition to three-year budget planning), and the contours of major institutional reforms were outlined (administrative reform, judicial reform, reform of natural monopolies), although the latter ones, unfortunately, have remained largely unimplemented. In addition, when making economic policy decisions, the then-recent events of the crisis that happened in August 1998 were taken into account, leading to the national currency devaluation, the enlarged debt burden on the budget and the fear of uncontrolled government deficit. In particular, the dynamics of oil prices in the world markets, even in the short term, seemed extremely volatile, as there was a high probability of a new decline thereof to the level of $9-10 per barrel, as was observed in 1998-1999.

In this context, the authors of the concept of the Stabilization Fund faced the task of developing a reliable, sustainable mechanism for the protection of export revenues to the budget from their usage for the current budget commitments and emerging new budgetary commitments in the case of a short-term increase in oil prices, as well as minimization of the negative impact of the inflow of export revenues on the economy in general (namely, preventing the accumulation of liquidity in the economy, the situation of a deficit of investment projects, and the willingness of businesses and banks to invest in the real sector).

Thus, as stated above, in institutional terms, the RF Stabilization Fund was a part of the federal budget assets, subject to separate accounting, management and utilization. In other words, the Fund assets were accounted for and placed in a special account of the RF Ministry of Finance with the RF Central Bank of Russia. The planned revenue to the Fund for the relevant fiscal year and the

7 Named after the Minister of Economic Development G. O. Gref.

amount of the Fund as of the end of each financial year were approved by the Federal Assembly (Parliament) of Russia by the law on the federal budget for the next fiscal year and the planned three-year term.

Management of the Fund was executed by the RF Central Bank under an agreement with the RF Ministry of Finance. Herewith, the Bank of Russia, in fact, acted as the management company, and the RF Government and the Russian Ministry of Finance defined the strategy for the management of the Fund and a scope of permissible assets.

The RF Reserve Fund of Russia and the National Welfare Fund also make up a part of the federal budget subject to separate accounting and management. At the same time, they are (at least until the beginning of May 2010) subject to the same institutional constraints and conditions as the Stabilization Fund of Russia.

Assessing the overall quality of the institutional environment of the Russian sovereign funds, one can distinguish the following advantages and disadvantages.

Advantages

- Strong legal status of the Funds through the addition of individual Chapters to the Budget Code, which before the crisis created a reliable system for protecting the Funds' assets from political and situational temptations on the part of both the RF Government and representatives of the power authorities.
- Formation of the funds in special accounts of the RF Government in the Bank of Russia, which minimized the effect of additional situational revenues from oil exports not only to the budget system, but also on monetary-credit and exchange rate policies.
- An adequate linking of the sources of the Funds' formation with the market revenues from oil exports. Calculations show that in 2005-2008, when the level of oil prices in the world market was above $35-40 per barrel versus the national market, up to 95% of the surplus income from oil exports were addressed to the Stabilization Fund in the form of export duties and mineral extraction tax.
- Splitting of the Stabilization Fund into the Reserve Fund and National Welfare Fund in 2008. Even during the worst crisis situation in Russia, in 2008-2009, and the high budget deficit in the subsequent years, the institutional conditions allowed the National Welfare Fund to be saved as a sovereign fund for future generations, using it for financing the federal budget deficit. Obviously, if only one of the Stabilization Funds had been maintained during this period, its funds would have been fully spent for the solution of the current budgetary problems.

Shortages

- The conservative management scheme of the Funds. Management of all Fund assets remains in the hands of the agencies, for which this issue is outside their main objective (RF Central Bank and the Russian Ministry of Finance). Involvement of private professional management companies (Russian or foreign) in the management of the Funds remains politically unacceptable.
- The lack of a legal framework for targeted parameters of the National Welfare Fund. Despite the fact that the objective of the National Welfare Fund was declared the "co-financing of voluntary retirement savings of Russian citizens,"

as well as “recovering of the (deficit) budget of the Pension Fund,” the required parameters are not in place to link to the pension fund reform. Under these circumstances, the National Welfare Fund could exclusively become a source of funding for the current deficit of the Pension Fund, and not a tool for solving long-term problems of the pension system in the Russian Federation.

- The lack of institutional capacity to develop individual strategies for managing the assets of the two existing Funds, not only based on principles of risk management, but also to ensure maximum yield at a given level of risk.

Investment Portfolio and Asset Management

In the period from 2004 to 2006, the following requirements were applied to assets that can be invested in the Stabilization Fund:

a) the issuer of the debt liabilities should have a long-term credit rating of not lower than the level “AAA” by the classification of Fitch Ratings or Standard & Poor’s, or not below the level of “AAA” under the rating agency Moody’s Investors Service;

b) maturity of debt securities is fixed; the terms of issue and circulation do not provide the issuer the right to affect their early redemption (maturity) or the right of the owner to submit them for redemption (maturity) by the issuer of debt instruments ahead of schedule;

c) the current maturity date of issue does not exceed one year for discount liabilities or 10 years for coupon bonds;

d) coupon rate paid on coupon bonds is fixed

e) the bond value is denominated in one of the authorized foreign currencies and payments toward the debt liabilities are made in the currency of its denomination;

f) the volume of the debt liabilities issued in circulation is not less than US$ 1 billion for the debt liabilities denominated in U.S. dollars, Euro 1 billion for debt liabilities denominated in Euro, or GBP 1 billion for the bonds denominated in pounds sterling.

From 2006 to 2007 the requirements underwent minimal changes whereby the volume of debt liabilities in circulation and denominated in pounds sterling was reduced from GBP 1 billion to 0.5 billion.

Also in the Resolution No. 229 of 21.04.2006 there appeared a clarifying requirement that the issuance of debt liabilities in which investments are made should not be issues intended for private (non-public) placement. In addition, it was stated in the Regulation that the standards of the minimum and maximum term to maturity of the bond issues are established by the Ministry of Finance.

The distribution of shares among the various types of investment instruments used for placement of the Fund assets was established by the Order of RF Ministry of Finance No. 157 of 22.05.2006, providing for the following foreign currency structure of the Stabilization Fund:

- U.S. Dollar - 45%;
- Euro - 45%;
- Pound Sterling - 10%.

The limits of permissible deviations of actual monetary structure of the

Stabilization Fund from the estimated foreign currency structure were:

- for the Stabilization Fund in U.S. dollars - + / - 5 percentage points;
- for the Stabilization Fund in Euro - + / - 5 percentage points
- for the Stabilization Fund in British pounds sterling - + / - 2 percentage points.

In 2007, the Finance Ministry also clarified the requirements for the minimum and maximum maturity of debt by the Order of the RF Ministry of Finance No. 737 of 05.12.2007 “On approval of standards for the minimum and maximum maturity term of bond issues of foreign countries in which the assets of the Stabilization Fund of the Russian Federation may be located.” For the debt instruments denominated in U.S. dollars and Euro, the minimum term to maturity has been set at 2 months, and the maximum - 15 months. For the liabilities denominated in British pounds sterling the minimum term to maturity was set at 3 months and the maximum term - 36 months.

During the functioning period of the Stabilization Fund the procedure of its investment policy had been developed only in general and was insufficiently detailed[8]. There were no rules governing the formation of the investment policy of the Russian Ministry of Finance. In particular, there was no clear regulation of the order of information interaction between the Ministry of Finance and Treasury, although the need for such a procedure was mentioned in the regulations of the Government.

Once the Stabilization Fund was split into the Reserve Fund and National Welfare Fund, the regulation of matters related to investment of their assets was detailed[9]. In particular, the order of the RF Ministry of Finance No. 25H from 14.02.2008 regulated the issues of the information exchange with the RF Treasury.

According to Resolutions No. 955 and No. 18, the Russian Ministry of Finance established:

a) a standard foreign currency structure of assets of both funds, the procedure for bringing the actual foreign currency structure of the Funds into alignment with the established standards;

b) the share of financial assets authorized for allocation in the total Fund assets within the prescribed requirements and procedure for estimates of the actual share of financial assets authorized for allocation in the total Fund assets (bringing them into conformity with the normative shares);

c) standard minimum and maximum maturity terms of debt liabilities of foreign countries, foreign government agencies and central banks, and of international financial organizations, including those in securities;

d) a list of foreign government agencies into the debt instruments of which the Fund assets can be placed;

e) standard minimum and maximum terms of placing the funds on deposit with foreign banks and credit institutions;

f) procedures for estimates of credits and interest earned on funds deposited in the Fund accounts and other provisions of the bank account contracts;

8 These were provided in the RF government Regulation No. 508 of 30.09.2004 and in the Annex to the RF government Regulation No. 229 of 21.04.2006.

9 List of normative acts regulating the management of investment funds policy is given above.

g) procedures of interaction with the Federal Treasury in carrying out transactions with the Fund accounts in the management of the Reserve Fund;

h) procedures of interaction with Federal Treasury in determining the terms of the contract with bank accounts in the management of the Funds assets.

In addition, the two Regulations (in the annexes) have approved detailed requirements for financial assets in which the National Welfare Fund and Reserve Fund assets may be placed.

Thus, the regulation of issues related to the process of the Funds' management has become more detailed in general. However, the procedures are still insufficient to regulate how individual authorities manage the Funds' assets by means of specialized financial institutions, as well as their involvement in the implementation of those powers[10].

There is a lack of clarity in the issues related to the implementation of investment transactions by the Central Bank that carries out the actual allocation of the funds. Currently, there are no internal Central Bank regulations governing such functions in this area.

Thus, in 2004 and 2005 there were no investment transactions of the Stabilization Fund assets. During the period from July 24, 2006 (the starting date of investment of the Stabilization Fund) through December 15, 2007, the total income from the investments amounted to 174.8 billion rubles. (Over the year from December 15, 2006 to December 15, 2007 the revenue reached 151.9 billion rubles). Therefore, the returns from investments in U.S. dollars for the year amounted to 10.94% per annum and in rubles - about 5%. Given the annual rate of inflation (respectively 11.7% and 10.9%), we can see a negative return on the Fund.

Table 2. Stabilization Fund Growth Rate in RUR[1)] and in USD[2)], %

	01.09.2006	01.10.2006	01.11.2006	01.12.2006	01.01.2007	01.02.2007	01.03.2007	01.04.2007	01.05.2007	01.06.2007	01.07.2007	01.08.2007	01.09.2007	01.10.2007	01.11.2007	01.12.2007	01.01.2008
1	-21.6	9.4	8.2	6.8	7.2	12.8	2.3	3.8	3.9	3.6	3.8	3.9	4.5	3.2	3.7	-3.6	9.4
2	-21.2	9.3	8.3	8.6	7.1	11.9	3.8	4.4	5.2	2.8	4.1	4.8	4.3	6.1	4.6	-2.1	8.6

Source: RF Ministry of Finance

10 The need for such regulation is expressly provided by the Resolution № 18, which obliged the Ministry of Finance jointly with other agencies (Ministry of Economic Development, Federal Financial Markets Service, the Ministry of Justice and Central Bank) to "develop and submit to the Government of the Russian Federation the draft Regulation in the established procedure."

Requirements for placing assets of the Reserve Fund

In general, the requirements for the Fund assets are stipulated in Art. 69.11 of the RF Budget Code, and also given in detail at the sub-law level[11]. The Article presents various requirements for the investment of the two Funds.

Options for allocation of the Reserve Fund assets are much more limited than those for the placement of the Fund of National Welfare assets. Reserve Fund assets may be placed in foreign currency and in the following types of financial instruments denominated in foreign currency:

- debt liabilities of foreign countries;
- debt liabilities of foreign government agencies and central banks[12];
- debt liabilities of international financial organizations, including securities[13];
- deposits and balances in bank accounts with foreign banks and credit organizations;
- deposits and account balances with the Central Bank of Russian Federation.

RF Government Regulation No. 955 of 29.12.2007 «On the management procedure of administration of the Reserve Fund» clarifies these requirements, setting minimum and maximum shares of the allocated assets, as well as more detailed requirements for them.

Thus, the share of foreign countries' debts should be from 50 to 100%. Herewith, such assets can be invested exclusively in debt instruments in: Austria, Belgium, Britain, Germany, Denmark, Ireland, Spain, Canada, Luxembourg, Netherlands, USA, Finland, France and Sweden.

The Regulation contains an open list[14] of recommended international financial institutions whose debt liabilities can be used for investment. They are: Asian Development Bank, ADB; Council of Europe Development Bank, CEB; European Bank for Reconstruction and Development, EBRD; European Investment Bank, EIB; Inter-American Development Bank, IADB; International Finance Corporation, IFC; International Bank for Reconstruction and Development, IBRD; Nordic Investment Bank, NIB; and International Monetary Fund, IMF.

The right to define the currency structure of both Funds, as before, was provided to the Ministry of Finance. According to the Sub-Item A, Item 4 of the Regulation No. 955, «On management of the Reserve Fund, the Ministry of Finance approves ... normative currency structure of the Reserve Fund» and

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11 See the RF Government Decree № 955 of 29.12.2007 "On the management procedure of the Reserve Fund" and the RF Government Decree № 18 of 19.01.2008 "On the management procedure of the Fund of National Welfare".

12 The share of foreign government agencies and central banks assets should not exceed 30%. See the RF Government Decree № 955 of 29.12.2007 "On the management procedure of the Reserve Fund".

13 The share of these assets should be 15%. See the RF Government Decree № 955 of 29.12.2007 "On the management procedure of the Reserve Fund"

14 The regulation uses the following wording: "the debt liabilities of international financial organizations, in which the Funds assets can be invested include the debt liabilities, securities among them, of the following financial institutions ...." That is, other instruments besides those among the listed "including the securities" are likely to be used.

the procedure for bringing the actual currency structure of the Reserve Fund into accordance with the established standard.

Currently the currency structure of the Reserve Fund is governed by the Order of the RF Ministry of Finance No. 3 of 16.01.2008. The Order established the following authorized shares in the total amount of the Reserve Fund:

- debt liabilities of foreign countries - 95%;
- debt liabilities of foreign government agencies and central banks - 0%;
- debt liabilities of international financial organizations, including securities - 5%;
- deposits in foreign banks and credit institutions - 0%.

This limits the permissible deviations of actual shares of the financial assets in the total amount of allocated funds from the Reserve Fund from the established shares as follows:

- for the debt liabilities of foreign countries - +/- 5 percentage points;
- for the debt liabilities of international financial organizations, including securities, - +/- 5 percentage points.

In addition, the Ministry of Finance has approved the formula for assessment of the actual share of financial assets of the Reserve Fund and deviations of the actual share of financial assets from the established share of financial assets.

The Regulation No. 955 of 29.12.2007 imposes the following requirements for the debt instruments for the investment of the Reserve Fund:

- the issuer of the debt instruments should have a long-term credit rating not lower than «AA- according to the classification of Fitch-Ratings or the Standard & Poor's rating agencies or not below the «GaAs» by classification of Moody's Investors Service rating agency. If the issuer of debt liabilities is assigned different long-term credit ratings by those agencies, the lowest assigned long-term credit rating is selected. Compared with the requirements to the selection criteria in relation to assets used to invest the Stabilization Fund assets, the requirements contained in the RF Government Regulation No. 955 of 29.12.2007 were reduced. As mentioned above, previous requirements to the assets were «AAA»15 level or «AAA»16 ratings;
- Maturity terms of the debt liabilities are fixed; the conditions of issue and circulation do not provide the issuer the right to carry out their early redemption (maturity) and the rights of the owner of the debt to submit them for redemption (maturity) by the issuer ahead of schedule;
- standards of the minimum and maximum maturity terms for the bond issues, established by the Ministry of Finance of the Russian Federation, are mandatory;
- coupon yield rate on coupon bonds, and the nominal value of the debt liabilities, are fixed;
- denomination of debt is expressed in U.S. dollars, Euro and Pounds Sterling, and payments under debt liabilities are made in the currency of denomination;
- the volume of debt liabilities issued in circulation is not less than US$ 1 billion for debt liabilities denominated in U.S. dollars, not less than EUR 1 billion

15 According to classifications of Fitch-Ratings or Standard & Poor’s rating agencies.

16 According to classifications of Moody’s Investors Service rating agency.

for the debt liabilities denominated in Euro, and at least BSP 0.5 billion for debt liabilities denominated in pounds sterling;

- debt liability issuance is not intended for private (non-public) placement;
- the nominal amount of debt liabilities purchased from one issue should not exceed 15 percent of the nominal amount of the issue;
- the total volume of the Reserve Fund invested on deposit in foreign banks or credit institutions shall not exceed 25 percent of the total Reserve Fund.

Requirements for placing assets of the National Welfare Fund

According to Art. 96.11 of the RF Budget Code, the National Welfare Fund may also be allocated in all of the above instruments, except for deposits in foreign banks. However, the Fund assets may additionally be invested in:

- deposits and bank account balances with banks and credit organizations, as well as in the State Corporation «Bank for Development and Foreign Economic Affairs (Vnesheconombank);»
- debt securities and stocks of legal entities;
- shares (stakes) of investment funds.

In addition, the National Welfare Fund assets can be transferred to the trust management of specialized financial institutions.17

Provisions of the Budget Code are detailed in the RF Government Regulation No. 18 of 19.01.2008 «On the procedure of management of the Fund of National Welfare." To a large extent, they repeat the requirements for assets used for the placement of the Reserve Fund. Thus, the Resolution No. 18 has stipulated:

- a similar list of countries whose debt liabilities (as well as the liabilities of their agencies and central banks) may be used for allocation of assets;
- a similar list of international financial organizations,
- similar requirements for long-term credit rating of foreign issuers of debt liabilities.

However, since the list of assets used to invest the National Wealth Fund assets is broader, the RF Government Regulation No. 18 of 19.01.2008 mentions a number of specific requirements. Thus:

- among other things, the Regulation includes the following requirements to the debt liabilities of the Russian companies. Russian issuers of debt liabilities should have a long-term credit rating not lower than the "BBB-" level by the classification of Fitch Ratings or Standard & Poor's, or not lower than the level of "Baa3" by the classification of Moody's Investors Service rating agency. If the Russian issuer is assigned different long-term credit ratings, the lowest assigned is selected as the long-term credit rating.

Thus, the requirements for the debt liability rating of foreign issuers[18] are higher than the requirements for the Russian ones.

17 The founder of the of the National Welfare Fund trust management is the Russian Federation. The Ministry of Finance of the Russian Federation is in charge of legal relations in connection with the establishment of the National Welfare Fund trust management on behalf of the Russian Federation.

18 As mentioned above, their rating has to be at least level "AA-" under the classification of Fitch-Ratings or Standard & Poor's, or at least level "Aa3" under the classification of Moody's Investors Service.

- in relation to shares and stocks (shares of participation) of investment funds, the following requirements are established[19]:

- shares of legal entities should be included in the quotation list of at least one stock exchange;
- shares of foreign issuers should be included in the lists of securities used to estimate the stock indices of MSCI World Index and FTSE All-World Index;
- shares of Russian companies should be included in the lists of securities used to estimate the stock indices of RTS or MICEX;
- the structure of the assets of investment funds, whose issued shares (stakes) should include only the authorized financial assets.

- in relation to deposits and accounts with the banks and credit institutions, the following requirements are established. The bank or credit organization should have a long-term credit rating not lower than "AA-" according to the classification of Fitch-Ratings or Standard & Poor's rating agencies or not below the level of "Aa3" by the classification of Moody's Investors Service rating agency. If a bank or credit organization is assigned a different of long-term rating by of those agencies, the lowest rating is assigned as a long-term credit rating;

- in relation to deposits of the State Corporation «Bank for Development and Foreign Economic Affairs (Vnesheconombank), the following requirements are established:

- the funds can be placed on deposit in Russian rubles, U.S. dollars, Euro and Pounds Sterling;
- the maximum total amount to be placed on deposits in Russian rubles is 655 billion rubles. At the same time, up to 175 billion rubles can be placed on deposit, the amount, term and other essential provisions of which are determined by the Ministry of Finance.

With regard to the National Welfare Fund, the Ministry of Finance[20] has also established the authorized standard shares of the total assets of the Fund in foreign currency to be invested in financial instruments, denominated in foreign currency:

- debt instruments of foreign countries - 80%;
- debt liabilities of foreign government agencies and central banks - 15%;
- debt liabilities of international financial institutions, including securities - 5%;
- deposits and balances in the accounts with foreign banks and credit institutions - 0%;
- stocks and shares (stakes) of foreign legal entities - 0%;
- debt liability securities of foreign legal entities - 0%.
- the Order of the RF Ministry of Finance No. 24 of 24.01.2008 approves the following normative currency structure of the National Welfare Fund:
- U.S. Dollar - 45% +/- 5 percentage points,
- Euro - 45%, +/- 5 percentage points;

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19 If acquired shares of legal entities or stocks (shares of participation) of investment funds do not match any of the above requirements, such shares or stocks (shares of participation) of investment funds are to be sold within 3 months from the date of inconsistency arising.

20 See the Order of the Ministry of Finance No. 517 from 21.10.2008 "On Amending the Order of the Ministry of Finance of the Russian Federation No. 26 of January 24, 2008".

• Pound Sterling - 10 %,+/- 2 percentage points.

Thus, the currency structure of the National Welfare Fund is no different from the currency structure of the Stabilization Fund.

During the first year after the Reserve Fund and the National Welfare Fund formation (from February 1, 2008 to February 1, 2009), their management had negative US$ returns, which amounted to -2.47%. Given those dynamics, the Russian Ministry of Finance has proposed a new index -- the so-called aggregate profitability-- which does not take into account the fluctuations of the Euro, Pound Sterling and US dollar. The aggregated index of return in the currency basket for the year amounted to 5.41% (*see Table. 3*).

Table 3. Annual Revenue from the Reserve Fund and National Welfare Fund management (over the year from 02.2008 to 02.2009),%

Currency	Account currency	In USD	In RUR
USD	3.9	3.9	35.14
Euro	5.94	–4.99	23.67
GBP	9.58	–19.8	4.57
Total	5.41	–2.47	26.92

Source: RF Ministry of Finance

When converted into Euro, the total gain would amount to 9.3% per annum, and into rubles - more than 26% per annum. The main reason for the loss of funds in dollar terms was the U.S. dollar’s strengthening against the Euro and British pound sterling in 2008. Setting a tight limit on currencies prevented the compensation for the negative impact of weakening currencies, in which 55% of both funds were denominated.

Macroeconomic and fiscal linkages; highlights of political economy

In terms of macroeconomic effects and implications of the sovereign wealth funds’ formation in Russia, there are three noteworthy aspects:

1. Intertemporal stabilization of the federal budget.
2. Support to the RF Central Bank’s anti-inflationary policy and policies of limited RUR appreciation.
3. Funding of anti-crisis measures in 2008-2009.

Budget Policy

As mentioned above, the main objective of the RF Stabilization Fund establishment was institutionalized accumulation of surpluses of the federal budget under the circumstances of the external environment due to the high oil revenues. Oil and gas revenues include proceeds from taxes on mineral extraction of hydrocarbons, export duties on crude oil, natural gas, and goods produced from crude oil.

Some oil and gas revenues are addressed toward financing current expenditures of the federal budget (oil and gas transfer), and the balance can be saved. To assess the short-term risks in terms of stability of public finances, the non-oil deficit indicator is important, representing the difference between the non-oil revenue and the total budget expenditures (see Table. 4). Accordingly, the amount of the fund is increasing (*see Figs. 4*).

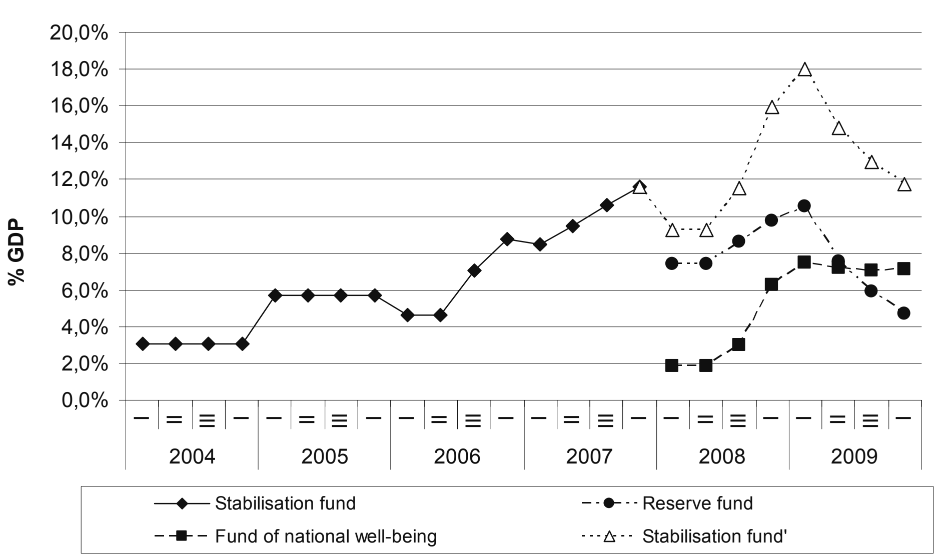
Table 4. Revenues and Expenditures of the Federal Budget in 2000-2009. (% of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Expenditures (1)	14.2	14.8	18.9	17.8	15.8	16.3	15.9	18.1	18.2	24.7
Revenues (2)	15.5	17.8	20.3	19.5	20.1	23.7	23.3	23.6	22.3	18.8
Including non-oil revenue (2.1)	11.7	13.1	15.1	14.1	13.5	13.6	12.7	14.6	11.8	11.2
Oil revenue (2.2)	3.8	4.7	5.2	5.4	6.6	10.1	10.9	9.0	10.6	7.6
RF federal budget surplus (3)=(2)–(1)	1.4	3	1.4	1.7	4.3	7.4	7.5	5.5	4.1	–5.9
Non-oil deficit (4)= (2.1)–(1)	2.5	1.7	3.8	3.7	2.3	2.7	3.4	3.5	6.4	13.5

Note: when assessing the non-oil deficit in 2009, income from the management of the Reserve Fund and National Welfare Fund, which amounted to respectively 0.8% of GDP, were taken into account.

Source: Federal Treasury of Russia

Figure 4. Stabilization Fund, Reserve Fund, the National Welfare Fund in 2004-2009, % of GDP



Note: The Stabilization Fund is a hypothetical fund equal to the amount of the Reserve Fund and National Welfare Fund

Thus, during the period of a favorable external market situation, the presence of the Stabilization Fund was a serious institutional constraint to the growth of budgetary expenditures. At the same time, even such a constraint had a limited effect, and in 2007-2008, during in the peak in oil prices, a marked increase in the federal budget expenditures was observed in real terms.

In turn, in 2009-2010, the Reserve Fund became the main source of financing the federal budget deficit, formed due to reduction of the budget revenues, as well as due to adoption of the package of anti-crisis measures. However, the scope of the budget deficit in the RF (like in many countries around the world) clearly exceeds expectations. For example, if the initially estimated scope the Stabilization Fund, and then the Reserve Fund, was assessed based on the need to finance the deficit of 3% of GDP for the term not exceeding three years, when in 2009 the deficit of the federal budget amounted to 5.9%, in 2010 it is expected to amount to 6-7% of GDP, which means a complete exhaustion of the Reserve Fund already in the current year. Because in the future the government of Russia expects the federal budget deficit to be sustained (with a gradual decrease to 2% of GDP in 2013 with an average oil price of not below 70 dollars per barrel), there is a risk of needing the involvement of the National Welfare Fund for the budget deficit financing as well.

Monetary and Exchange Rate Policy

The availability of budgetary sovereign funds, as well as their allocation in the international reserves of the Bank of Russia, has important implications for the monetary and exchange rate policy in Russia.

Thus, the total volume of monetary supply, withdrawn from the economy and allocated to the accounts with the RF Central Bank as of January 1, 2009, was approximately 120% of the monetary base (high-powered money) at that time. Saving this volume of monetary supply in the economy over 2004-2008 would increase the rate of the monetary supply growth by about 15-20 percentage points per year. The inflationary consequence of this could be the increase of the average annual inflation rate from 11.35% per annum (which is one of the highest rates in the world) to 13.5-14% per annum.

At the same time, the total amount of funds placed in the foreign currency is about 35-40% of the total surplus of the Russian balance of payments from 2006 through the first six months of 2008. Accordingly, a demand was formed from the Russian Ministry of Finance for such inflow of the currency to the domestic market, which has helped the Bank of Russia to keep the ruble rate at a level no higher than 23.5-24.0 rubles per dollar. Modeling a situation where in 2006-2008 there was no need to allocate the funds in foreign currency shows that in this case, the nominal ruble exchange rate could rise to the level of 13-15 rubles per dollar by August 2008. Accordingly, the real effective ruble rate by the beginning of the crisis in autumn 2008 would have amounted not to 116.5% as compared with July 1998 (the maximum value of the real exchange rate before the 1998 crisis), but to 180-200%, which would mean a complete loss of competitiveness of domestic producers and a sharp slowdown in economic growth, even against the background of high prices for oil and other Russian export goods in 2007.

Anti-crisis measures funding in 2008-2009

Financing of large-scale measures for the support of the national economy without the involvement of external borrowing in 2008-2009 was possible thanks to the reserves accumulated during the economic growth. In fact, oil and gas revenues became the main sources to support the balance of the federal budget in 2009. In particular, to finance the budgetary expenditures from the Reserve Fund, about RUR 2.964 trillion was allocated. This fact allows us to conclude that the idea of forming an oil and gas fund was fully justified, and can be regarded as an advantage in the national fiscal policy.

Table 5. Dynamics of Formation and Use of Oil and Gas Assets in 2009 (RUR bln)

Fund	Balance as of late 2008*	Revenue over 2009:		Expenditure over 2009:		Balance as of late 2009*
		Oil and gas revenue	Revenue from assets management	Support of the federal balance solvency	Support of oil and gas transfer	
Reserve Fund	4027.6 (9.8% of GDP)	488.5	205.0	2964.8	179.4	1830.5 (4.7% of GDP)

National Welfare Fund	2584.5 (6.3% of GDP)	–	92.5	–	–	2769.0 (7.1% of GDP)
Total	6612.1 (16.0% of GDP)	488.5	297.5	2964.8	179.4	4599.5 (11.8% of GDP)

** Balances are estimated at the exchange rates of January 1, 2009 and January 1 of 2010, accordingly.*

Source: Federal Treasury

Formally, the assets of the National Welfare Fund were not used to finance the federal budget deficit and the financing of anti-crisis measures. However, starting from October 13, 2008, the RF President Dmitry Medvedev signed a package of laws previously enacted by the State Duma and approved by the Federal Council on the stabilization of the financial system during the financial crisis: in particular, legislative amendments allowed placement of the National Welfare Fund assets with the Vnesheconombank deposits until December 31, 2019, totaling no more than 450 billion rubles at the rate of 7% per annum.

Thus, there was only a change in the portfolio of fixed assets for the allocation of the National Welfare Fund; it was replenished with the ruble-denominated deposits of the RF Vnesheconombank. In the future, the use of those resources for the implementation of anti-crisis measures was already implemented by the RF Vnesheconombank. In particular, 404 billion rubles were granted to 14 Russian commercial banks in the form of subordinated loans and 30 billion rubles were transferred to the “Russian Development Bank” for crediting SME.

In general, analyzing the role of the Reserve Fund as a source of financing of the federal budget deficit in Russia over 2009-2010, one should take into account three issues related to the proper understanding of the “reserve” nature of these funds:

1. On the one hand, the use of the Reserve Fund assets to cover the budget deficit is a common monetary emission of the Central Bank, since in practice such an operation means the flow of funds in the RF Central Bank from the special accounts of the RF Government to the monetary base (through the current account of the Government). The non-emission nature of this operation could take place if the Bank of Russia at the same time would sell foreign currency (which is formally a counterpart of the Reserve Fund), but after a downfall to its lowest level in January 2009, the international reserves of the Bank of Russia have considerably grown. Thus, in terms of monetary policy, the Fund is not a reserve, but is a separate channel for the money inflow in the economy.
2. On the other hand, the described effect of monetary emission from the budget account is observed every time when the government spends money on the basis of the existing RF system of the Treasury, which has budgetary accounts with the Bank of Russia, i.e. those withdrawn from the monetary supply.

Irregular fluctuations are observed within the year (e.g., the sharp growth of monetary assets in December, when the budget expenses are performed when the money base is reduced each month in the last days of the month, when taxes are paid), but by virtue of the budget reporting term, namely the fiscal year, as a rule, only the final impact of the budget execution on the money supply is taken into account. If, however, we extend the period of consideration from one to, for example, 5 years, then the use of the Reserve Fund shall cease to be a mere emission, since the money accumulated in it within such a term may be regarded as temporarily withdrawn and returned to the economy assets.

3. From another perspective, in terms of fiscal and debt policy, the Reserve Fund assets certainly can be regarded as a reserve of the RF Government, as they make it possible to replenish the budget deficit without borrowing in the debt market and avoiding the increase of the government debt. At the same time, as the experience of EU countries, USA, Japan, UK and others shows, the growth of public debt to finance the anti-crisis measures package has become one of the key challenges for the economic policy at the stage of recovery from the crisis. In this regard, the existence of the Reserve Fund in Russia can be regarded as a potential allowing the country to avoid the growth of debt burden and to shift current budget expenses for the future generations.

The impact on poverty eradication, social policy and labor market

From the point of view of the current social effects and support of the living standards of the population of Russia, the sovereign wealth funds provide limited and, for the most part, indirect effects. It is extremely difficult to distinguish the impact of each of the existing funds.

From our point of view, the most important impact on the population living standards is the provision of an anti-inflationary effect of the RF Stabilization Fund (see above). We estimate the total increase in income in real terms due to lower inflation in the period of 2004-2008 at about 20 percentage points.

Another important consequence of the Reserve Fund's existence is funding of the federal budget deficit in 2009. The social projects in particular, which allowed a growth in real incomes by 2.3% in the situation of a severe crisis (decline in real GDP in 2009 by 7.9%), reduced the negative impact of lower domestic demand and ensured the growth of household savings. Herewith, as noted above, those expenditures have been financed without increasing the national borrowing and, consequently, the growth of the borrowing puts a burden on the future generations.

The role of the National Welfare Fund in solving the social problems at the moment is extremely small. Moreover, the National Welfare Fund obviously does not play the role imposed on it-- but not ensured in institutional and legislative terms-- as an instrument for the long-term solutions of the pension system in Russia. We will consider the tentative options of the National Welfare Fund in this area in the final section of this memo.

Compliance with Santiago Principles

Table 6 shows our expert assessment of compliance of the RF Reserve Fund and National Welfare Fund with the Generally Accepted Principles and Practices (GAPP), or Santiago Principles. Compliance with these principles is presented for each fund separately, although, as shown above, the legal provisions of their operation, management system and the requirement to investments of the funds are practically identical. Nevertheless, based on the different nature and purposes of each of the funds' formations, the extent of their compliance with the Santiago Principles varies.

Table 6. Santiago Principles and Implementation thereof for the Russian Sovereign Wealth Funds

Principles	RF Reserve fund	RF National Welfare Fund
GAPP 1	+	+
GAPP 1.1	+	+
GAPP 1.2	+	+
GAPP 2	+	–
GAPP 3	+	+/–
GAPP 4	+	+
GAPP 4.1	+	+
GAPP 4.2	+	+/–
GAPP 5	+ (?)	+ (?)
GAPP 6	+/–	–
GAPP 7	+/–	–
GAPP 8	+/–	–
GAPP 9	–	–
GAPP 10	+/–	+/–
GAPP 11	+	+
GAPP 12	–	–
GAPP 13	–	–
GAPP 14	–	–
GAPP 15	+	+
GAPP 16	+/–	+/–
GAPP 17	+	+/–
GAPP 18	+/–	–
GAPP 18.1	+/–	–
GAPP 18.2	+	+/–
GAPP 18.3	+/–	+/–
GAPP 19	+/–	–
GAPP 19.1	+	+/–
GAPP 19.2	+/–	–
GAPP 20	+	+
GAPP 21	–	–

GAPP 22 GAPP 22.1 GAPP 22.2	– – +/–	– – +/–
GAPP 23	+/– (?)	+/– (?)
GAPP 24	–	–

Therefore, as seen from the above estimates for the RF Reserve Fund, compliance with the Santiago Principles is observed in nine positions (and six sub-positions), and partial compliance in eight positions (four sub-positions). In seven positions (and one sub-position) there is no compliance.

For the National Welfare Fund, the situation looks even worse:

- compliance - in 6 positions (3 sub-positions)
- partial compliance – in 5 positions (5 sub-positions)
- inconsistency – in 13 positions (3 sub-positions).

It should be noted that for both Funds full compliance by one position and partial compliance with the other positions are in question because of the above-mentioned decision of the RF Government, which has refused to provide the information on the Funds' status for public disclosure since May 2010.

Perspectives and Predictability after the Global Economic Crisis

As stated above, the situation with the dynamics of both Russian sovereign funds during the recent crisis is ambiguous. At the beginning of the crisis in the Russian Federation in autumn 2008 (October 1, 2008), the volume of the Stabilization Fund of Russia amounted to about 141 billion US dollars, and the National Welfare Fund – 48.7 billion US dollars. All assets were placed in highly reliable securities denominated in US dollars, Euro, pounds sterling and Japanese yen. Thus, from the beginning of the crisis despite the devaluation of the ruble, as well as lower interest rates in the leading global economies for the ruble, assets began to grow. In contrast to the assets of other sovereign funds, in the Russian funds there were no assets in corporate securities (stocks), so the downfall in the stock market did not have serious consequences on them.

At the same time, the growth of the federal budget deficit and the RF Government's need for additional financial resources have resulted in attracting the funds to meet current financial demands. Falling oil prices in the world markets and the reduced inflow of export earnings to the country led to the disappearance of the income part of both funds. By early June 2010, the balance in the Reserve Fund should not exceed 40 billion US dollars, and all the money from the fund should be allocated to finance the federal budget deficit in 2010. However, in our view, the utilization of the fund in 2009-2010 can not be regarded as a loss because the assets were used for the implementation of the fund's main objective - to recover a budget deficit that arose in consequence of short-term and cyclical swings in revenues. In addition, availability of this source to finance the budget deficit allows Russia to avoid the trap into which other economies of the world fall, namely the rapid accumulation of public debt. The renewal of revenue inflow to the Reserve Fund of Russia is expected not earlier than in 2012-2013 (in the case of the moderately optimistic scenario, reviving the global economy and the preservation of the global oil prices at not less than 70 US dollars per barrel).

National Welfare Fund assets were not directly used to finance the federal budget deficit, and the assets spent in the context of an anti-crisis measures package for operations in the stock market of Russia and the support of the banking system in Russia were provided as the conversion of funds from foreign currency into rubles and their allocation in ruble assets (approximately 20% of the National Welfare Fund). Those RUR investments are potentially lost, but due to their long-term nature they will be reflected in an explicit form later. Thus, with regard to the effect of the ruble devaluation and the fact that buying the Russian companies' shares was carried out at close to a minimum price, specifically in times of crisis, the Fund has not suffered losses in ruble terms. Losses were recorded in 2010, as the nominal exchange rate, and consequently, ruble ratings were reduced, affecting the fund assets. Similar losses were observed in the pre-crisis period, when the ruble was also rapidly strengthening against the major world currencies.

However, in the absence of fiscal consolidation in 2011-2013, the RF government will be compelled to finance the federal budget deficit at the expense of the National Welfare Fund, down to its full exhaustion (except for the amount of the long-term ruble-denominated investments made in the framework of Anti-Crisis Measures). Accordingly, one can mention the following main recommendations to improve the functioning of the Russian sovereign funds:

1. With respect to the **Reserve Fund of Russia** – the soonest return to the accumulation of the assets at the high profitability in the long term period.

2. With respect to the **National Welfare Fund** – the RF Government should clearly define the strategic objectives of the Fund. Currently the Fund, in essence, is a separate fund of the RF Government, protected from spending to cover the budget deficit financing (so far!), which has no clear purpose. For the purposes of the Fund, one can propose its transformation into a savings pension fund (for example, like the Government Pension Fund of Norway), i.e., it could be addressed to resolve the shortage in the pension system over the prospect of at least 15-20 years. It is therefore necessary to revert to the accumulation of assets in the National Welfare Fund.

Current volume of the Fund (less than 10% of GDP) is clearly insufficient to solve any serious problem. In addition to the short-term revenues from exports of raw materials, the most obvious source for the replenishment of the Fund may be the proceeds of privatization of the state assets and real assets owned by the state. As of 2007 (prior to the crisis events in the global economy), assessment of such assets and property is not less than 57% of the Russian GDP. In the case of transfer of these funds to the National Welfare Fund, with a real return on the investments of the Fund at the level of 4.5% per year, the amount of the Fund by the end of 2015 should amount to 70.6% of GDP and by the end of 2025 – 80.5%, which is enough to keep the replacement rate of retirement pension at 30% until 2025.

3. **With respect to both funds** - principles and approaches to managing the funds' assets should be differentiated. In particular, the National Welfare Fund should be managed essentially on different terms than the Reserve Fund. In other words, an authorized structure of assets and management mechanism should be revised.

First, the National Welfare Fund has a longer prospectus for investment than the Reserve Fund, and the National Welfare Fund assets can be invested in more volatile and profitable financial instruments.

Secondly, the National Welfare Fund short-term liquidity has a lower value, and consequently, it is permissible to invest it in non-marketable assets.

Third, international experience shows that to improve efficiency of management and profitability of such a sovereign fund, it is reasonable to transfer management of such a sovereign fund to private professional management companies, rather than to the Central Bank or a specialized state agency.

Therefore, a change in the institutional and legal bases of both funds' functions is required to improve their compliance with the Santiago Principles.