Government Wealth Funds and Monetary Policy

By

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Abstract

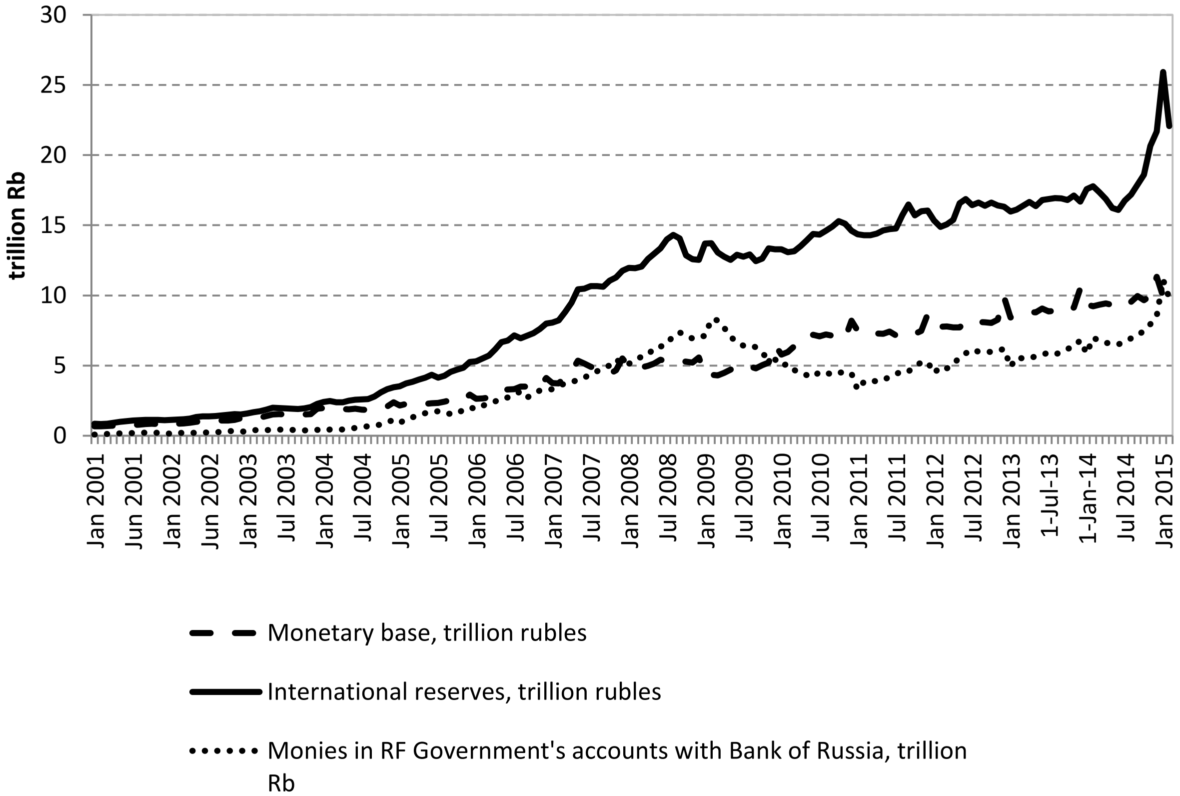
Both economic theory and economic practice reveal a high degree of interdependence between fiscal and monetary policies. This relationship is especially evident if the government accumulates a considerable amount of money in its accounts with the central bank. The article analyzes the impact of the formation and spending of the Reserve Fund and the National Wealth Fund on the monetary policy of the Bank of Russia. This effect is considered from the point of view of the current economic crisis and the need to spend resources accumulated in sovereign wealth funds.

Key words: fiscal policy, monetary policy, sovereign wealth funds, forex interventions, international reserves.

JEL classification: E43, E520, E620, E630

The creation, in 2004, of the Stabilization Fund, later to be reorganized into the Reserve Fund and the National Wealth Fund, was a major evolutionary landmark not only in the fiscal policy, but also in the monetary policy pursued by the Russian authorities. It should be reminded in this connection that for the greater part of the 2000s, right until the 2008 crisis, the Bank of Russia had maintained the ruble's exchange rate against major world currencies at a fixed level, resorting to substantial forex interventions in the foreign exchange market in order to sustain a positive balance of payments and prevent the ruble's strengthening in nominal terms. At the same time, the ruble-denominated monetary base was rapidly increasing due to the Bank of Russia's forex purchases. To eliminate the monetary factors that could boost inflation, in absence of efficient tools for carrying on open market operations, the alternative sterilization tools designed to counter the excessive money supply effects began to be applied[1]. The main instrument turned out to be the accumulation of state budget surplus in the RF Ministry of Finance's accounts with the Federal Treasury (the monies kept on the RF Government's accounts with the Bank of Russia), primarily in the form of sovereign funds (Fig. 1).

Fig. 1 – The Behavior of Some Components of the Bank of Russia's Balance Sheet over January 2001 – January 2015



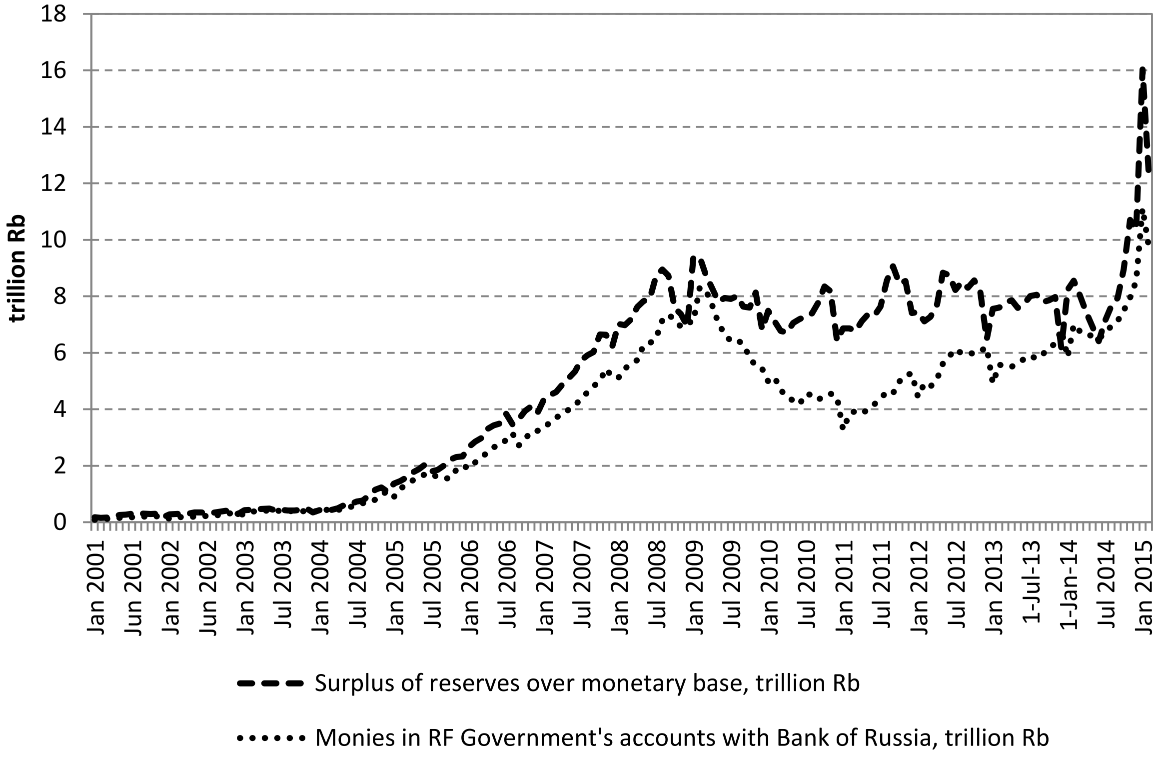
Source: RF Central Bank.

[1] For further details, see: Pavel Trunin. *Major Factors That Determined Money Supply in the Russian Federation: 2007 - First Half of 2011.* Russian Foreign Economic Bulletin, No 4, 2012. P. 111 – 121.

The behavior of indices shown in Fig. 2 demonstrates that, prior to the 2008 crisis, the fluctuations of those components of the interventions that had been involved in the sterilization process - i.e., those that did not increase the size of the monetary base (excess in the growth of international reserves in ruble terms over growth of the monetary base), were largely compatible with the fluctuations of residuals in the fiscal system's accounts with the monetary regulation bodies. In a situation of a relatively stable exchange rate of the ruble in nominal terms, this was indicative of the ability of the government regulatory bodies to suppress the growth of money supply and inflation by accumulating their sovereign funds. However, sterilization in this case was incomplete: in spite of the rapid accumulation of reserves in the budget accounts with the RF Central Bank, the forex interventions by the Bank of Russia were on such a scale that the monetary base was still increasing at a relatively high rate. This, the Bank of Russia's forex interventions became the main source of growth for the monetary base which, in its turn, was exerting an upward pressure on the inflation rate and so, when coupled with the slow movement of the nominal exchange rate of the ruble, was pushing up its foreign exchange rate in real terms[2].

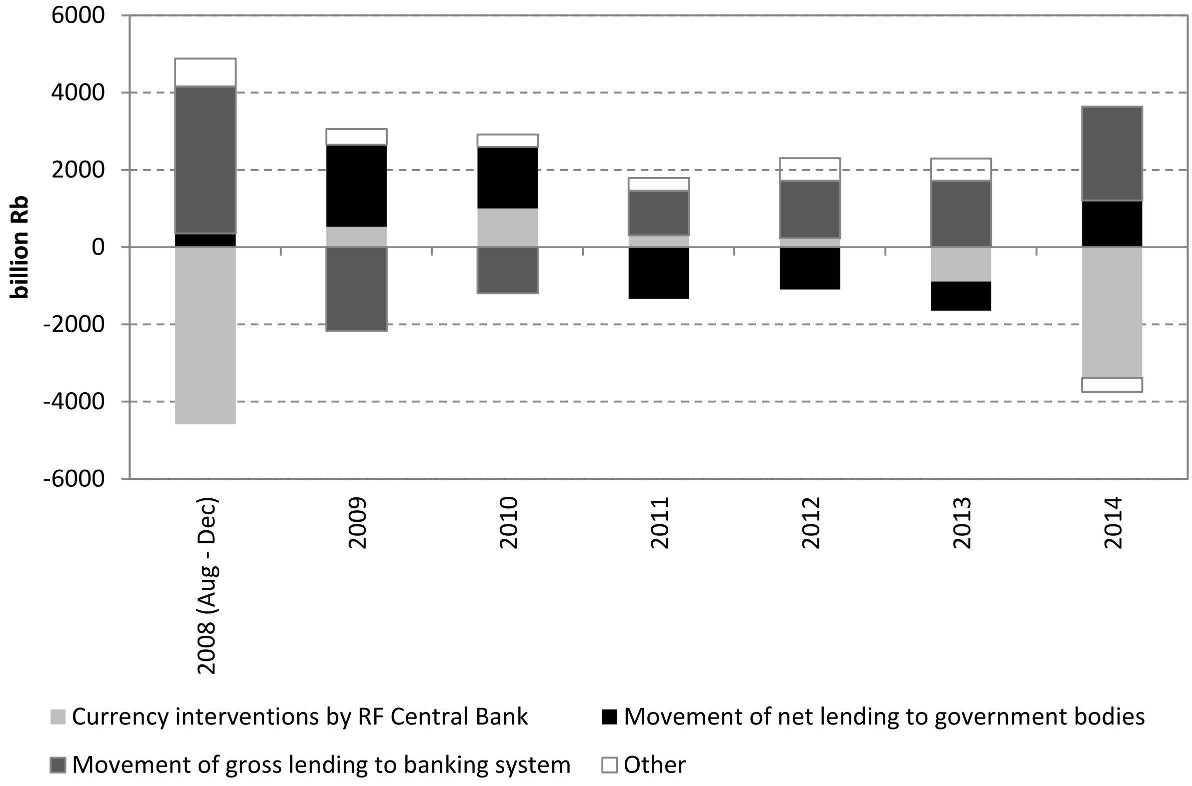
In the post-crisis period, in response to the declining growth rate of the money supply, which was driven down, first of all, by a significant shrinkage of the intervention activities, the values of the indices shown in Fig. 2 began to vary significantly. After the onset of the crisis in 2008, the RF Central Bank's forex interventions were no longer the key factor responsible for the monetary base's growth. In late 2008 and early 2009, as well as in 2014, the Bank of Russia was undertaking massive forex interventions in an attempt to prevent the ruble from losing its value in face of plummeting oil prices and capital outflow from the Russian Federation. As a result, the volume of RF international reserves shrank by more than a third from $ 598bn in August 2008 to $ 380bn in February 2009, and then from $ 509.6bn to $ 385.5bn over the course of 2014. In spite of such impressive currency interventions, the Bank of Russia still managed to avoid a dramatic shrinkage of the monetary base. At the same time, although lending to the banking system by the Bank of Russia had become the primary factor determining the size of the monetary base, fluctuations in the amount of the residuals in the government accounts with the RF Central Bank continued to strongly influence the size and rate of growth of the money supply, as demonstrated by the spending of the resources of the Reserve Fund over 2009-2010 and 2014, and the accumulation of saving in 2011–2013 (Fig. 3).

[2] For further details, see: Sergey Drobyshevsky, Sergey Sinelnikov-Murylev, Pavel Trunin. *G20 Coordinated Anti-crisis Economic Policy Decisions and Russian Experience*. Russian Foreign Economic Bulletin, No 5 – 6, 2011.



Source: RF Central Bank.

Fig. 2 – Sterilization of Forex Purchases by the Bank of Russia in January 2001 – January 2015



Source: RF Central Bank.

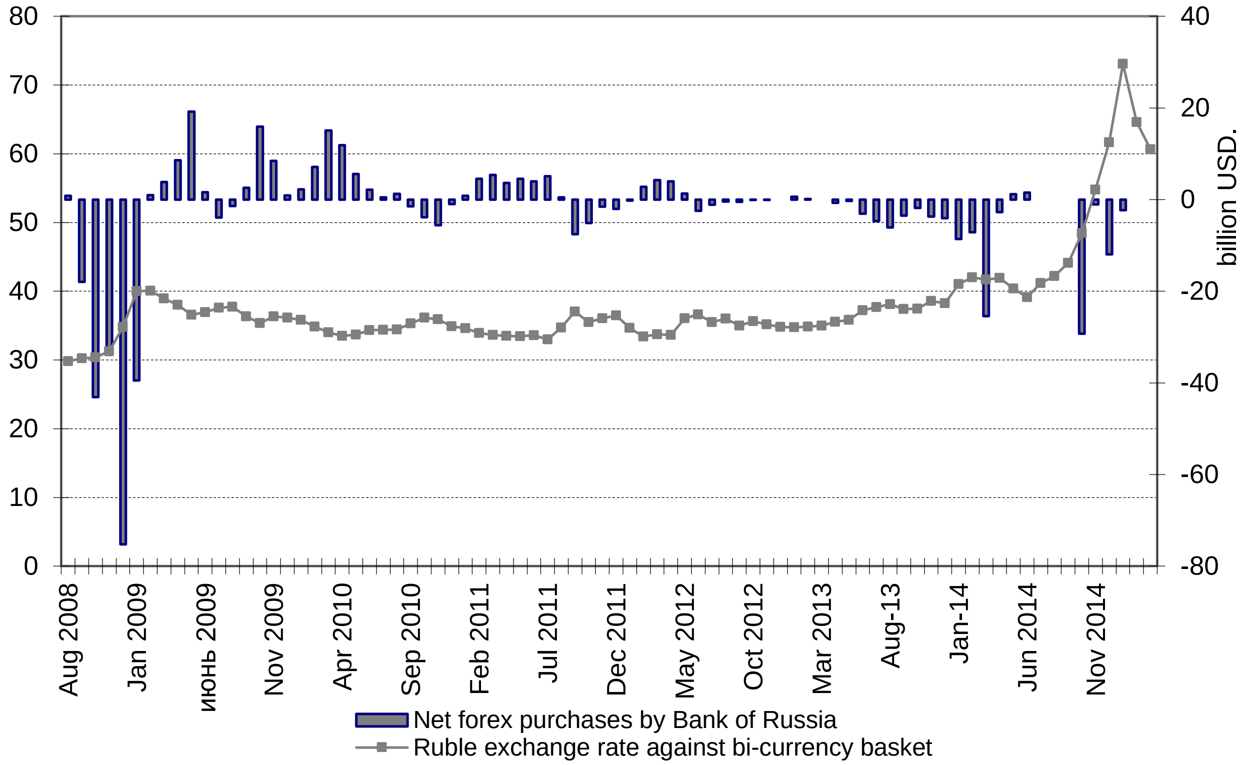
Fig. 3 – Factors Responsible for Changes in the Monetary Base over August 2008 – December 2015

It should be noted that the year 2009 saw a qualitative change in the foreign exchange policy of the RF Central Bank - it reduced the volume of its interventions in the forex market by comparison with the previous years[3]. The upshot of this change was that the process of accumulating international reserves began to slow down. Official data indicate that the RF Central Bank usually undertook currency interventions at the points of the ruble's nominal exchange rate major rises against the bi-currency basket. At the same time, the RF Central Bank effectively abstained from any interference with the functioning of the forex market during the periods of the ruble's weakening (Fig. 4). This practice was discontinued in 2014, when over the course of the entire year the RF Central Bank had been carrying on interventions with its reserves until this policy was finally abandoned toward the year's end. As a result, in 2014 there was an overall dramatic shrinkage of the money supply, which was set off, among other things, at the expense of the Reserve Fund.

However, as seen from Fig. 3, the period 2011–2013 saw a growth of funds in the government accounts with the RF Central Bank which, from the point of view of the behavior of

[3] See: Anna Kiyutsevskaya. *Floating Exchange Rate of the Russian Ruble: Myth or Reality? Voprosy Ekonomiki*, No 2, 2014. pp. 50 – 67.

the money supply, was not offset by the forex interventions by the Bank of Russia in the form of currency purchases. Moreover, in 2013 the RF Central Bank was selling foreign currency from its international reserves, which means that both the government fiscal policy in the form of creating the Reserve Fund and the National Wealth Fund and the forex interventions by the RF Central Bank were designed to contract the monetary base. In order to eliminate the effects of these factors, the Bank of Russia was increasing the scale of its lending to commercial banks - by means of repo transactions with securities used as collateral or loans secured by a pledge of non-marketable assets[4]. At present, it is also the RF Central Bank's refinancing operations that are the principal factor responsible for money supply growth in the RF.



Source: RF Central Bank.

Fig. 4 – The Bank of Russia’s Forex Interventions and the Movement of the Ruble Exchange Rate against the Bi-currency Basket in August 2008 – March 2015

It should also be noted that, irrespective of the existence or absence of a reserve fund or a national wealth fund (the budget rule), the international reserves at the RF Central Bank's disposal enable the authorities to enjoy more freedom in pursuing their fiscal policy. Whenever there is a budget surplus and, consequently, a money supply contraction, the RF Central Bank

[4] The collateral used to secure these loans, which are granted by the RF Central Bank in the framework of its Provision 312-P, is mostly a pledge of claim due under a loan agreement.

may purchase foreign currency to replenish its reserves and thus to limit the effects of a tough fiscal policy. And vice versa, during the periods of a less constrained fiscal policy, when the budget is funded by increasing money supply (directly, if budget expenditure is covered by the money spent from a government account with the RF Central Bank; or indirectly, if the budget issues bonds to be sold in the market, which are then accepted by the RF Central Bank as collateral to secure its loans issued to commercial banks), the RF Central Bank may sell foreign currency for rubles issued by way of executing budget expenditure.

So, over the past 15 years, the accumulation of budget funds in the government accounts with the RF Central Bank was one of the significant factors that have been shaping the monetary policy, and so it is important to undertake a more in-depth analysis of the links between the process of accumulating/spending sovereign funds and monetary policy.

It should be reminded that from the point of view of normative regulation, in accordance with the RF Budget Code, the RF Reserve Fund is to be replenished by the surplus oil and gas revenues received by the federal budget until its total accumulated volume amounts to its normative value of 7% of GDP. The surplus oil and gas revenues of the federal budget are understood as the difference between the amount of oil and gas revenues calculated on the basis of oil price forecasts or the actual amount of such revenues received by the federal budget over a fiscal year (reporting period), and the calculated amount of oil and gas revenues to be received at a given estimated base price of oil. Besides, the RF Reserve Fund is replenished by the investment income generated by the Reserve Fund's asset managers. The National Wealth Fund is formed by the investment income generated by its asset managers and the surplus oil and gas revenues of the federal budget received in excess of the normative size of the RF Reserve Fund.

After the introduction, as of 25 December 2012, of amendments to the RF Budget Code, its aforesaid articles were suspended until 1 February 2016, and so all the surplus oil and gas revenues received by the federal budget and the incomes generated by the Reserve Fund and the National Wealth Fund's asset managers were to be earmarked for federal budget expenditure. From the point of view of economics, the accumulation of budget funds in the form of a reserve fund (or a national wealth fund) over the periods of high prices for energy carriers, to be spent in later years when the situation in the energy carrier market is less favorable is similar, both in essence and in terms of its influence on monetary markets, to the accumulation of revenues generated by taxes and received from other sources during one budgeting period, and their spending within the same budget period - that is, within one and the same year. By way of example, we may assume that if the budget planning and execution period should last for two or ten years, the process of accumulating and spending the Reserve Fund (or the National Wealth

Fund) is in no way different from the routinely uneven budget revenue and expenditure execution pattern over the course of one year.

An important consideration is the way that this uneven budget execution pattern shapes the situation in the monetary sphere. When the treasury has an account with the central bank, the inflow of funds (in the form of taxes and other revenues) into that account depletes the monetary base and money supply, while the execution of expenditures increases monetary aggregates[5]. To avoid such fluctuation of monetary aggregates, the authorities in the majority of economically developed countries strive to sterilize the effect, on the money supply, of the fluctuating residuals in the treasury account with the central bank. This can be achieved, for example, by operating treasury accounts with commercial banks or dealing in short-term securities. So, for example, if the residual in its account with the central bank exceeds a certain ceiling, the ministry of finance may place some of its funds as deposits with commercial banks, or to buy out a certain amount of short-term government bonds. The target minimum for residual budget funds in an account with the central bank, say, in France is set at € 100m, and in Sweden at 0[6], and it is achieved by placing the temporarily free budget funds in the banking system or in financial markets (as a rule, these are bond markets). At the same time, the task of neutralizing money supply fluctuations by treasury operations is assigned to the central banks, which apply the available standard monetary policy tools for keeping the money supply at a stable level.

Thus, the accumulation of budget resources in the Reserve Fund (or the National Wealth Fund) or their spending is equivalent, from the point of view of monetary policy, to monetary base contraction (in the case of accumulation) or simply to money emission (when the funds are being spent). The existence of the Reserve Fund in this case is equivalent to a certain budget rule whereby the fiscal policy is stabilized. In accordance with that rule, budget surplus in a favorable economic situation is accumulated in the budget accounts at the RF Central Bank, and when the economic situation goes bad, an emission of money follows (in accordance with the same rule), thus making it possible to cover the new budget deficit.

In present-day Russia, the accumulation of the Reserve Fund and the National Wealth Fund occurs as follows: the budget receives revenues denominated in rubles and executes expenditures in amounts that are less than the amount of the received revenues, which results in shrinkage of the monetary base. According to the budget rule, when oil prices are high, part of the revenues generated by those prices goes to the Reserve Fund, which is also charged to the RF Treasury's account with the RF Central Bank, but is denominated in a foreign currency.

[5] For further details, see Bell S. “Do Taxes and Bonds Finance Government Spending?” Journal of Economic Issues, Vol. 34, No. 3 (Sep., 2000), pp. 603-620; see also Dornbusch R., Fischer S., Macroeconomics, 6th edition, ch.14-3.
[6] See Pattanayak S. and I.Fainboim. “Treasury Single Account: Concept, Design, and Implementation Issues”. IMF Working Paper WP/10/143. May 2010.

If the reserve funds were to be denominated in rubles, the process of their accumulation would have been identical to that of uneven budget execution, and resulted in shrinkage of the money supply. However, in Russia the monies earmarked for the Reserve Fund and the National Wealth Fund and kept in the accounts of the RF Treasury with the RF Central Bank are denominated not in rubles, but in foreign currencies (in USD, Euro and GBP, in separate accounts), while the RF Central Bank manages the Reserve Fund as part of its international reserves. This fund accumulation procedure is equivalent to the procedure of forex purchasing by the budget from the RF Central Bank's foreign reserves. In this case, the Reserve Fund acquires some real features, and so begins to be different from simply being a budget rule. Hypothetically, foreign exchange resources may be directly used as budget expenditure; thus, forex resources may be allocated to some or other recipients of budget funding. Of course, there are no such provisions in the RF Budget Code, but this is one example of how budget funding denominated in a foreign currency does not exert any direct influence on the money supply. Since in reality the expenditures allocated from the Reserve Fund are denominated in rubles - that is, the actual foreign currency becomes once again part of the RF Central Bank's forex reserves (the budget sells foreign currency to the RF Central Bank for rubles), the existence of the Reserve Fund (or the National Wealth Fund) is also similar to the existence of a budget rule that determines the procedure for reducing expenditure and the monetary base during the accumulation phase, and increasing expenditure with the corresponding money emission in the spending phase.

In other words, this means that when the funds earmarked for budget expenditure are denominated in rubles, it is by no means necessary to spend the RF Central Bank's international reserves. Therefore the existence of forex reserves in the Reserve Fund (or the National Wealth Fund) during the spending phase (in accordance with the budget rule) only provides the RF Central Bank with the opportunity to sterilize the effect of its money emission. At the same time, the RF Central Bank is not obliged to act in this way if it does not aim at preventing the possibility of accelerating inflation as a result of increased money supply, or at sustaining a stable exchange rate of the ruble against the world's major currencies. Nevertheless, from 1 October 2013 onwards, if the RF Ministry of Finance orders the RF Central Bank to buy or sell foreign currency from its foreign exchange accounts in the forex market, the latter should increase/reduce its forex interventions in the domestic foreign exchange market by an amount equivalent to the volume of forex purchase/sale by the Federal Treasury from or to the RF Central Bank relating to the accumulation or spending of sovereign funds. As a result, the international reserves held by the RF Central Bank will be changed by the amount equivalent to the value of the forex purchase or sale transaction. However, the RF Ministry of Finance and the RF Central Bank will still reserve the right of non-market conversion of their forex monies (held in the Reserve Fund and the National Wealth Fund) into rubles, and so the RF Central Bank will be able to keep its international reserves while spending the resources from the two funds.

It should be noted that if the RF Ministry of Finance, in the accumulation phase, were allowed to directly trade its monies held in the Reserve Fund (or the National Wealth Fund) for foreign currency in the foreign exchange market (and then to trade its forex funds for rubles in the spending phase), the resulting effect on the money in circulation would have been transitory and similar to that during any interval between the moment when an income in received and the moment when it is spent. That is, direct market exchange into a foreign currency of the ruble-denominated budget savings kept in the RF Treasury's accounts with the RF Central Bank would have eliminated any effect of such savings on money supply.

Historically, RF budget surplus was typical of the times when world prices for energy carriers were high[7]. As shown earlier, that was the time when the balance of payments was in surplus, and the RF Central Bank maintained the quasi-fixed exchange rate of the ruble in nominal terms by buying up (that is, monetizing) that surplus. In that situation, the monies kept in the Reserve Fund (and the National Wealth Fund), which were converted into forex assets not by way of market transactions, but by way of currency purchases by the budget from the RF Central Bank, were being used not only as a budget sustainability tool, but also as a tool designed to sterilize the effect of the ruble interventions by the RF Central Bank, when it was buying up foreign currency. If during that period the ruble's foreign exchange rate would have been floating, the accumulation of the Reserve Fund by the RF Ministry of Finance would have had a contractionary effect on the monetary base, and the counter-cyclical nature of the Reserve Fund would have become even stronger.

Under the current conditions, when the RF Ministry of Finance has begun to cover the budget deficit by the resources set aside as the Reserve Fund or the National Wealth Fund, so far as the Reserve Fund or the National Wealth Fund are converted into rubles via the RF Central Bank, and not in the foreign exchange market, the effect of spending these two funds is similar to the effect of money emission. At the same time, depending on the goals pursued by the RF Central Bank at this time, as well as on the specificity of its exchange-rate policy, the RF Central Bank may either apply certain sterilization tools at the expense of its forex reserves, or to abstain from any such operations. Thus, the availability of forex reserves in the phase of spending the Reserve Fund (or the National Wealth Fund) (in compliance with the budget rule) enables the RF Central Bank to sterilize the money emission effects.

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[7] See: Alexander Knobel. The Risks of Fiscal Policy in Countries Rich in Natural Resources. Economic Policy, No 5, 2013. pp. 29 – 38.

This year, in accordance with the alterations to the law on the 2015 federal budget introduced in April 2015, the RF Ministry of Finance plans to spend Rb 3.1 trillion from the Reserve Fund to cover budget deficit. This operation can potentially have a very strong effect on the money supply in the RF and trigger a rise in the rate of inflation, which has already risen to nearly 17% over the past 12 months - from April through March. As of 1 January 2015, the monetary base in the RF amounted to Rb 11.3 trillion. In accordance with its *Guidelines for the Single State Monetary Policy in 2015 and for 2016 and 2017*, the RF Central Bank predicted that the monetary base will increase in 2015 by approximately 10%, or by Rb 1.1 trillion. Significantly, these predictions had been made prior to the approval of the alterations to the budget law, while it had not yet been planned that part of the Reserve Fund should be spent in 2015. This means that in absence of sterilizing operations, over the year the spending of the Reserve Fund may expand the monetary base fourfold on its projected value - which will inevitably boost inflation.

As we have pointed out earlier, the RF Ministry of Finance can sell its forex reserves directly in the market, thus eliminating the impact of these operations on the money supply. However, foreign currency sales at this scale ($ 50-60bn) will inevitably result in the ruble's strengthening, and then its exchange rate against major foreign currencies will, most probably, decline once again when these transactions are completed. Besides, these foreign currency sales will further deplete the available international reserves. As of mid-April, the reserve amounted to slightly more than $ 350bn, and so their further shrinkage as a result of direct market exchange transactions may have a negative effect on Russia's macroeconomic stability, as well as on the confidence of international investors in the ability of Russian companies to buy foreign currency in order to service their foreign debt and at the same time to avoid the ruble's sharp weakening. So it appears feasible to convert the forex assets from the Reserve Fund inside the RF Central Bank, without spending the Bank’s international reserves. In this connection, it must be understood that such operations involving the spending of reserves will inevitably boost the money supply. However, we believe that the RF Central Bank will be able to sterilize this effect by reducing its lending to commercial banks. In early April, the amount of banks' debt to the RF Central Bank exceeded Rb 7 trillion. Consequently, the RF Central Bank can offset the money supply growth as a result of spending the Reserve Fund by bringing down the scale of its loans to the banking sector. As a result, the RF Ministry of Finance and the RF Central Bank will be able to spend their funds in such a way as to neutralize the possible effects on both the international reserves and the inflation processes.