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Russia: The Financial Reserve – A Primer

> - **This note summarizes the main features of Russia's so-called financial reserve, year-to-date developments and end-year expectations**. It is a companion note to our recent report *Russia: 2002 Budget Execution And 2003 Debt Financing – Under Control.*
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> - **The financial reserve, in its current format, was created as an instrument of accumulating excess budget revenues to serve as a pool of financing primarily for future debt service, in particular debt payments in 2003, the formal debt service peak. The reserve has already proven it is one of the reasons why Russia credibly can say it will be in a position to fully, manageably handle 2003 financing – even under very conservative borrowing programs.**
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> - **However, it is not a formally legislated, best practice, stabilization fund in an international sense, and this is the main drawback. It is a *de facto* stabilization fund, more at the discretion of the Ministry of Finance and lacking fully clear and transparent rules of accumulation and spending as well as a fully clear reporting system. This has led to some lack of clarity with regards to flows in and out of the reserve, as well as to some uncertainty over what can be expected of this financial reserve during the course of this year.**
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> - **In any case, the range of expectations for the financial reserve at year-end, approximately RUB 70 bn to RUB 120 bn (highly conservative to optimistic) represent substantial sums and is consistent with manageable 2003 financing.**

1. The formal framework

While not established as a formal, legislated, international best practice, stabilization fund, the financial reserve does have at least two legislative platforms. Politically, the idea was legitimised in President Putin's annual budget address in 2001[1]. The financial reserve concept was then debated when preparing 2002 fiscal policy, and eventually formalized in the two first paragraphs of the 2002 Budget Law. This is the basic budget-legislative framework so far, although more may come in the form of Budget Code amendments later this year (more on this below).

[1] In terms of economic policy, most leading Russian economists – although sometimes differing over exact rules and mechanisms - have been in favour of establishing a stabilization fund, notably e.g. Professor Yegor Gaidar and Andrei Illarionov, presidential economic adviser. President Putin's call for some type of stabilization fund in his 2001 annual budget address was basically a result of this economic policy debate. The most substantial study into Russia and the concept of stabilization funds, including proposals for a Law on a stabilization fund, is IET-The Institute for the Economy In Transition (A. Zolotareva et al*) Perspektivy sozdaniya stabilizatsionnova fonda v RF*, Nauchnye trudy 27, May 2001. See also Tsentr Razvitia, *Ot finansovovo rezerva k rezervnomy fondu*, April 2002, mimeo.

- According to the 2002 Budget Law (Article 1), the 2002 budget surplus (the RUB 178.4 bn surplus originally budgeted) should be divided in the following way: RUB 68.6 bn for debt financing and RUB 109.8 bn **to contribute to the formation of a financial reserve**.

- Following this, Article 2 **establishes that sources of creating the financial reserve, apart from the part of the 2002 budget surplus mentioned above, are also excess funds transferred from 2001** (RUB 88.8 bn). The third explicitly mentioned source is **excess 2002 revenue collection**, i.e. over-and-above the budgeted parameters.

- Article 2 also establishes that funds in the financial reserve can only be used for: **replacing as budget financing domestic debt issuance, privatization revenues, external financing sources, and to amortize government debt**. While in the financial reserve, funds can be invested in various instruments. Income received from management of the financial reserve will go back into the financial reserve. Finally, it is established that the government will report quarterly to the Duma on the size and uses of the financial reserve (this appears to not have actually taken place so far, at least in any consistent manner).

- **The rules on managing funds in the financial reserve were subsequently elaborated in a government decree signed by Prime Minister Kasyanov in May this year, "On the Procedures For Managing Funds of the Financial Reserve".** According to this decree, the Ministry of Finance can invest in liquid, high-class government securities traded on organized markets, specifically such as Russian Federation government securities, both denominated in hard currency (Eurobonds) and roubles, and securities of foreign governments with the highest credit ratings. When making such operations, the Ministry of Finance's agents were designated as the Central Bank and Vneshekonombank.

- **The May government decree also established that the Ministry of Finance could use the financial reserve for early debt repayment of Russian government debt, subject to government approval**. The reporting requirement – the Ministry of Finance to present each quarter a report on the management of the financial reserve – was repeated in the decree.

Then there are two other articles in the 2002 Budget Law with consequences for the financial reserve, as outlined by Article 1-2.

- Article 3 in the 2002 Budget Law goes on **to mandate the government to in 2002 use the following sources for decreasing Russia's debt: the net balance from operations on the government debt market, privatization revenues, precious metals sales, and international credits of all kinds**.

- Article 112 **mandates the government to issue a new Eurobond of up to USD 2 bn** (to be exact the upper limit of non-tied financial external credits is set at USD 2.19 bn). The government is also mandated to undertake larger external borrowings if it is part of restructuring debt and decreasing debt service costs.

While none of the mentioned 2002 Budget Law articles specifically states that, e.g., privatization revenues or proceeds from a Eurobond issue can or can not be used to boost the financial reserve per se, as all of these – the financial reserve, privatization revenues, international borrowing e.g. – are designated to be used for financing purposes, there appears to be the case that such revenues would *de facto* be part of the financial reserve. This is also more or less confirmed by how policy-makers view e.g. a potential new Eurobond – it would be part of financing for 2003.

2. The financial reserve: year-to-date developments and end-year expectations

The above has outlined the formal, announced framework and rules for the financial reserve. In practice, however, it has been less than fully clear what is going on. In this section we outline an analysis of year-to-date developments of the financial reserve, and a likely size of the financial reserve by January 1, 2003.

While the starting point of the financial reserve (the RUB 88.8 bn transferred in excess 2001 funds into 2002) is well reported in budget documents, absent a formal, ongoing public reporting system, an assessment of year-to-date developments is built on conversations with policy-makers and other communication. In consequence, numbers mentioned below should be seen as approximate or indicative. The main and so far most detailed public outline of financial reserve developments (during the first quarter) are in a speech Deputy Prime Minister/Minister of Finance Kudrin delivered in late May this year[2].

Based on this the table below outlines the likely financial reserve developments in the January-June period of this year. As of January 1, 2002, the financial reserve stood at RUB 88.8 bn. During the first quarter, some RUB 8.3 bn was added to the reserve. At the same time, in line with the 2002 budget and the government decree, mandating the Ministry to use the financial reserve for various debt management purposes, a part of the financial reserve was used for such purposes, including early debt repayment. Of in total (the equivalent of) RUB 75.8 bn in debt amortization conducted in the first quarter, RUB 49.5 bn came from the financial reserve. Thus as of April 1, the financial reserve stood at RUB 47.6 bn. Subsequently, Ministry of Finance officials have indicated that as of July 1, the financial reserve was some RUB 40 bn. This use of the financial reserve is in some sense a positive – it cuts the stock of debt and reduces future debt service.

Russia: The Financial Reserve – Estimated Developments 2002 Based On Ministry of Finance Annual Target

Date/Event	RUB bn
January 1, 2002	88.8
Increase during Q1 2002	8.3
Funds from reserve used for debt amortization during Q1 2002	49.5
April 1, 2002: funds in reserve	47.6
July 1, 2002: funds in reserve	38-40
Funds to be accumulated during Q3-4 2002	81.3
Funds available at January 1, 2003	**121.3**
Net addition to financial reserve during 2002, based on Ministry of Finance annual target (before spending)	89.6 (RUB 178.4 bn minus RUB 8.8 bn))

Source: Ministry of Finance, Citigroup

In terms of end-year expectations, there are different ways of approaching the issue. In 2003 budget documents, it is established that including the funds transferred from 2001 into 2002 (the RUB 88.8 bn), the financial reserve for 2002 and for use in 2003 is expected at RUB 178.4 bn. However, this is assuming nothing has been spent from the reserve during the course of the year. If one seeks to find the potential actual cash size of the financial reserve on January 1, 2003, as implied in the 2003 budget documents, one could approach it in the following way. If RUB 178.4 bn is the *ceteris paribus*, total annual 2002 financial reserve, then the expected annual *addition* should be some RUB 89.6 bn. With some RUB 8.3 bn already added during the first quarter – and assuming nothing was added in the second quarter, some RUB 81.3 bn would have to be accumulated during the second half in order to meet the expected annual addition to the financial reserve. **Assuming nothing more is spent from the financial reserve in the second half of the year, the financial reserve should**

[2] *Vystuplenie Zamestitelya Predsedatelya Pravitelstvo Rossiiskoi Federatsii, Ministra Finansov A.L. Kudrin*, mimeo, May 2002, the Ministry of Finance.

then stand at RUB 121.3 bn by year-end (that is, RUB 81.3 bn plus the RUB 40 bn allegedly in the financial reserve as of July 1).

Another approach would be to proceed from an annual budget surplus expectation. As we have explained elsewhere, with the still solid budget surpluses achieved in the first half of this year, we expect a 2002 budget surplus of about 2% of GDP. As per IMF methodology (and excluding the social tax), the budget surplus in the first half of this year was the equivalent of RUB 101 bn. Given a full 2002 budget surplus expectation of 2% of GDP, one would expect about RUB 110 bn in a second-half surplus. We then assume this second-half surplus gets distributed between 2002 debt financing and the financial reserve as is implied in Article 1 of the 2002 Budget Law: about 60% of the budget surplus would go towards the financial reserve. **Thus, about RUB 66 bn should in this case be added to the financial reserve in the second half of this year, which implies the reserve would stand at around RUB 100 bn by year-end** (assuming the financial reserve as of July 1 was about RUB 40 bn, see above). **For comparison, other independent estimates of the financial reserve range between RUB 90 bn and RUB 150-180 bn**[3].

Both of above cases, the implied financial reserve as per the 2003 budget and the financial reserve following our 2002 budget expectation, while not as high as originally budgeted or thought earlier this year, still represent large sums. Indeed, we have elsewhere analysed how a financial reserve even at much lower levels, highly conservatively in a range of RUB 60-80 bn, would still imply fully manageable 2003 financing (see more on updated financing scenarios below). This excludes a potential 2002 Eurobond – if this is issued, one would *de facto* (see the first section on the formal framework for Russia's financial reserve) add such proceeds to the financial reserve. In the updated financing scenarios below, we retain this highly conservative estimate of the end-2002 financial reserve at RUB 70 bn (mid-range of RUB 60-80 bn), as it highlights a solid 2003 financing situation.

In the face of a still solid fiscal performance and large overall budget surpluses, there could be reasons to believe the size of the financial reserve may be underestimated to some extent[4]. For example, as of January 1, the financial reserve was at RUB 88.8 bn, and during the first six months of this year, the overall budget surplus – even counting all designated but not yet actually spent budget assignments – was RUB 77.1 bn (different budget surplus measure from the one used above), whereas Ministry of Finance officials have estimated the financial reserve at only RUB 38-40 bn as of July 1.

Whatever the "exact" size of the financial reserve at mid-year, it is likely to grow further in the second half of this year, as higher oil-related budget revenues (the oil export tariff) will kick-in. Also, the economy could well start to do increasingly better, as evidenced by the June production numbers. The new tax rules, particularly profit tax innovations, which have created tax base problems in the first half, may create less problems in the second half and onwards.

The dynamics behind various comments from officials regarding the financial reserve could by governed by political economy. Essentially, the Ministry of Finance could be keen to downplay the extent of funds in the "financial reserve" for political reasons as well as exhibiting caution in other fiscally related questions, going towards this autumn's budget debate and more importantly the approaching election season (2003-

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[3] See e.g. the EEG-the Ministry of Finance, which expects about RUB 90 bn (E. Gurvich, *Obzhegshis na dolgovoi probleme, pravitelstvo dazhe boitsya k nyei podoiti*, EEG-the Ministry of Finance, August 8, 2002, and Tsentr Razvitia, (*Kuda delsya finansovy rezerv?*, July 29, 2002, mimeo) which expects RUB 150-180 bn.
[4] This analysis is also shared by one of the leading Russian economic institutes. See the interesting study by Tsentr Razvitia, *Kuda delsya finansovy rezerv?*, July 29, 2002, mimeo. For an analysis of the actual solid budget performance year-to-date, see our recent report *Russia: 2002 Budget Execution And 2003 Debt Financing – Under Control*, August 6, 2002.

2004, Q1). This could be one contributing reason why there have been suggestions of "shortfalls" in the accumulation of the financial reserve, whereas the actual fiscal performance remains solid.

Apart from the approaching electoral season, there is a movement afoot in the Duma to press for clearer, legislated rules for the financial reserve. We would support as market-positive a move towards a formally legislated and transparent stabilization fund, and proposals along this line have been prepared for some time by Yegor Gaidar's Institute for the Economy In Transition. However, the government may be concerned that as part of the 2003 budget debate, and with the approaching electoral season in mind, some Duma forces may be tempted to push for a less-than-optimal legislated financial reserve/stabilization fund, perhaps making the financial reserve more at the discretion or influence of the Duma than by the government. As Russia approaches the formal debt service peak next year, the government would quite likely not welcome this. On its part, the Ministry of Finance has been fielding proposals for adding clearer and more stringent rules of the current financial reserve via amendments to the Budget Code, and these may be debated in the Duma this autumn. It remains unclear if this will be accepted as sufficient by the Duma, or if there will be demands for more substantial new legislation in this regard. Nevertheless, if legislation for a proper, transparent and internationally comparable stabilization fund was to be supported by a majority, we feel this is the right way to go, and over the long-term, the government would benefit from transparent rules.

3. The final 2003 budget and financing scenarios – domestic and/or external borrowing?

The table below summarizes and updates two financing scenarios, based on the final 2003 budget draft submitted to the government on August 8. The first scenario can be called the "official" one, based on Ministry of Finance expectations as expressed in the 2003 budget and accompanying documents. The second scenario is our benchmark version, including a highly conservative end-2002 financial reserve (see discussion above).

Even on conservative assumptions on funds transferred from 2002 into 2003 and conservative borrowing strategies, Russia can manageably handle 2003 debt financing. To some extent, all the financing scenarios for 2003 is about choosing between re-developing the domestic debt market or to come back to the markets with new, small Eurobond issuance. Recall Deputy Prime Minister/Minister of Finance Kudrin repeatedly over the last week has indicated that a right to issue a small Eurobond will be retained in the 2003 budget, but that the Ministry of Finance will strive to avoid using that right. We have elsewhere concluded that if no 2002 Eurobond were issued, we would nevertheless expect a small Eurobond to be issued in 2003, despite these indications from the Ministry of Finance. As the table indicates, the "official" scenario is easily balanced and even in surplus with either a small new Eurobond or a modest increase in net domestic debt issuance. *If* Russia really wants, it will be able to handle financing in both 2002 and 2003 without issuing new Eurobonds.

However, one need not *a priori* rule out both coming back to the markets with a small new Eurobond either in 2002 or 2003 <u>and</u> a more serious push to re-develop domestic debt markets. This is because in net terms, Russia's stock of internationally traded bonds would decrease significantly even in the face of a small new Eurobond (in the 2001-2003 fiscal period, bonds equivalent to over USD 6 bn mature), and of course the <u>total</u> Russian external debt stock continues to decrease by more than that, with Russia meeting fully scheduled Paris Club payments and continuing to refrain from IMF borrowing (Russia has not borrowed from the IMF since 1999 and has not issued a new, non-debt exchange related Eurobond since June 1998). Against the background of a continued net decrease in the stock of external debt, including the sub-segment of internationally traded bonds, the Russian government could also pursue a more notable strategy to re-develop the domestic debt market.

While the 2003 budget documents include a net domestic issuance figure of RUB 49.7 bn, the Budget Code allows the Ministry of Finance to during the fiscal year change between debt categories.

Russia: 2003 Financing Scenarios, USD bn (updated with final 2003 budget version)

	The 2003 budget scenario (assuming right to issue Eurobond will not be used)	Our benchmark expectation
Budget surplus	2.3	2.3
Net domestic debt issuance	1.5	2.1
External debt amortization	-10.8	-10.8
Gap:	**-7**	**-6.4**
Financing:		
Funds transferred from 2002, on January 1 2003	3.6	2.1
Privatization, precious metals sales	2.1	2.4
IMF	0	0
Bilateral borrowing, tied credits (one small WB credit)	0.7	0.7
New Eurobond issuance	0	1.5
Difference:	**-0.6**	**+0.3**
Difference (if right to issue Eurobond – USD 1 bn - is used)	**+0.4**	
Difference: (if additional RUB 20 bn in net domestic debt issuance)	**0**	

Source: Ministry of Finance*: Osnovnye napravleniya byudzhetnoi I nalogovoi politiki na 2003 god*, Citigroup. The “2003 budget scenario”: Net domestic debt issuance is as included in the 2003 budget documents, RUB 50 bn. Privatization revenues and precious metals sale are also both as per the final 2003 budget documents. If Russia were to issue a small Eurobond of USD 1 bn, the financing requirements are more than covered. If instead adding RUB 20 bn to net domestic debt issuance, financing is covered. Our benchmark expectation: The funds transferred to 2003 are assumed at RUB 70 bn, excluding a 2002 Eurobond. If a 2002 Eurobond were issued, these funds would be correspondingly higher. Net domestic debt issuance is expected at RUB 70 bn, RUB 20 bn above what is formally underlying the final 2003 budget. We also expect precious metals sales to be somewhat higher than in the 2003 budget, at RUB 30 bn. We also include an assumption of a small new Eurobond to be issued in 2003 – if no Eurobond is already issued in 2002.