Bringing Stability to Russia

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One of the more strongly held opinions among international investors about the recent evolution of the Russian economy is that "it is all about oil." That is, Russia has benefited in a major way from the sharp recovery of oil prices that began in the first quarter of 1999 and the timing of the next crisis will be determined to a large extent by the next sustained reducetion in the price of a barrel of oil. More recently there has been gradual recognition that a cautious fiscal policy in the aftermath of the 1998 financial crisis has made an important contribution to the recovery and that progress in the implementation of structural reforms could further reduce the vulnerability of the Russian economy to external shocks. But, still, the overwhelming perception remains that Russia's GDP is narrowly determined by the evolution of its commodity exports, the prices of which are determined outside the boundaries of the Russian state. This view, perhaps unfair in light of the serious recent attempts on the part of the government to push forward with reforms in a number of key areas, finds some echo in Soviet and Russian history.

The last two crises

There is broad consensus that the collapse of oil prices that took place in 1986 was a precipitating factor in the future unravelling of the Soviet economy and, later on, the Soviet Union. Indeed, Russian taxpayers are still suffering the economic consequences of that oil shock. Faced with rapidly declining income from energy exports, the Soviet government borrowed abroad in a major way; between 1986 and 1990 the external debt more than doubled and these Soviet-era debts are still being serviced by the federal budget, limiting the ability of this and future governments to respond more effectively to urgent social and other needs. And, of course, there is hardly any doubt that in 1998 declining oil prices made the task of fiscal adjustment very difficult. The Russian budget was too weak, for the public finances to be able to sustain a sharp erosion in the price of Russia's key commodity exports.

For all these reasons, when it emerged earlier this year that the government was discussing the idea of possibly creating a stabilisation fund, investors were very encouraged and supportive. What are the pros and cons of a stabilisation fund and would it be in the interests of Russia to create one?

What is a stabilisation fund?

A stabilisation fund, in the sense understood in the outside world, is a formal institutional mechanism whereby the government collects and invests on an ongoing basis a share of the taxes paid by, say, the oil and gas sectors. These resources accumulate over time and there are fairly detailed guidelines as to how the money may be invested and used. Such a fund is usually regulated by special legislation and, once created, is taken off the political agenda. Its primary purpose is to build up a cushion of long-term resources which can be used to deal with unforeseen contingencies (a sustained drop in the price of key commodities) or with fully foreseen contingencies, such as the ageing of the population which will put pressure on pension resources, or the gradual exhaustion of oil supplies which are a non-renewable natural resource. A stabilisation fund, therefore, is ultimately a tool of long-term fiscal management and its creation thus is a sign of the authorities' concerns for the long-term welfare of the population.

The Norwegian experience

It is useful to review briefly, by way of illustration, the key features of the most successful such fund presently in existence, the Norwegian Government Petroleum Fund (NGPF). The NGPF was

established in 1990 and the primary motivation of the authorities was two-fold. First, the need to smooth short-term fluctuations in oil and gas revenues. Second, the realisation that oil and gas revenues will eventually run out and the government will confront rapidly rising expenditures on old age and disability pensions. By exchanging physical oil and gas reserves with financial assets in the NGPF the government hoped to reduce the country's future dependence on oil revenues.

On June 30, 2001, the market value of the assets accumulated in the NGPF was about US$60 billion, equivalent to about 35% of GDP. The NGPF did not actually begin to accumulate resources until early 1996 and thus its recent performance has been impressive. Projections done by the Ministry of Finance of Norway (based on conservative oil price assumptions) indicate that by the end of 2010 the NGPF will have assets equivalent to well over 120% of GDP. The income of the NGFP is derived from the net cash flow from oil and gas activities plus the return earned on the assets of the fund. More specifically, the revenues are derived from four main sources: from the sale of oil and gas owned by the state; from the profit taxes paid by the private oil companies; the profit taxes paid by the gas company; and investment returns. The expenditures of the NGPF are the transfers made to the government budget to finance non-oil activities. The NGPF is thus fully integrated into the government public finances. Increased government expenditures or lower tax revenues from non-oil activities result in smaller allocations to the NGPF.

The NGPF consists essentially of an account denominated in krone at the Norges Bank, the Norwegian central bank. The central bank in turn buys a corresponding amount of financial instruments abroad in its own name. According to the law the manager of the NGPF is the Ministry of Finance. The government establishes the guidelines that regulate the operation of the NGPF, in consultation with parliament. Furthermore, the government is required by law to inform regularly to parliament about developments in the NGPF. The central bank has responsibility for accounting and reporting, risk management, and helping to carry out investment strategy under the overall direction of the Ministry of Finance. The central bank manages the assets in the NGPF completely separately from its own international reserves, of which it has around $21 billion.

All the funds accumulated in the NGPF are invested abroad. This helps to offset the impact of inflows associated with the current account surpluses and reduces pressures for a stronger exchange rate and/or lower interest rates. Thus the NGPF also plays an essential role in macroeconomic management, protecting the economy from some of the effects of high oil and gas revenues. This is a key policy consideration in Russia, given the problems the authorities have had this year in managing liquidity inflows through the balance of payments. The large current account surpluses of the last couple of years have boosted ruble balances, put upward pressure on prices, and complicated exchange rate management.

What About Russia?

There would appear to be no downsides to the creation of such a stabilisation fund in Russia. The existence of such a mechanism sends a powerful signal to investors that the country is being managed cautiously, that provisions are being made to reduce the country's dependence on energy or, more generally, commodity exports. Some politicians may dislike the idea of being constrained not to spend all revenues from all sources *this* year. But by agreeing to set some revenues aside, politicians are acting like credible statesmen, thinking about the well being of the population and not giving undue attention to short term political considerations.

There is not a credible argument why the Russian government should not follow the Norwegian example, as soon as possible. In fact, Russia is far more dependent on commodity exports than Norway. It has a more vulnerable economy, with a private sector that is only now emerging from a

prolonged crisis. Foreign direct investment remains low, partly because investors worry about the possible effects of the next oil shock. Will the ruble then be devalued? Will the government then, once again, be forced to restructure its debts? Government officials may, naturally, now say NEVER. But investors understand that such decisions are not likely to be confronted by ministers in office *today* but by others who will have been unlucky to have inherited the next crisis tomorrow. But this environment of uncertainty (which is always negative for investment) can be greatly improved by establishing a stabilisation fund. There can be no doubt whatsoever that if Russia, like Norway, managed to accumulate over time a sizeable cushion of resources (and it would not have to be as gigantic as Norway's), investment to Russia would pick up in a major way, providing investors with the "insurance policy" which they feel they now lack. It would also lead to credit ratings upgrades and accelerate Russia's return to the international capital markets. Then, the next time oil prices come down, Russian ministers would sleep peacefully and investors would continue to bring their money to invest in Russia, secure in the knowledge that crises like those in 1986 or 1998 would be part of Russia's ancient history!

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