

# The Russian Oil Fund as a Tool of Stabilization and Sterilization

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*The favorable world oil price dynamics has resulted in mounting reserves in the Russian Oil Stabilization Fund (OSF). This has raised the issue of an adequate economic policy response. Initially, the OSF was set up to reduce the vulnerability of the budget to the oil price volatility and to sterilize the impact of oil-related foreign exchange inflows on the money supply. Our findings suggest that the OSF has been instrumental in achieving both goals: it has contributed to macroeconomic stability and has helped decouple the GDP growth rate from oil price dynamics. However, given the current size of the OSF and a widely shared expectation that oil prices will remain comparatively high, the present dilemma is whether the OSF should be increasingly spent or whether it should be saved as a wealth-generating vehicle. Spending from the OSF on a current basis has been resisted so far largely because of rampant corruption and fears of inflation. However, there are several arguments which may support a change in this policy stance. In particular, it seems that concerns about intergenerational solidarity are of minor relevance for Russia; investments in the country's infrastructure are badly needed which, via productivity gains, might counteract the possible Dutch disease effects; moreover, spending on public sector wages could reduce incentives for corruption.*

## 1 Introduction

Russia's economic performance since 2000 has been impressive: the Russian economy grew by some 40% in real terms between 2000 and 2006. The recovery was triggered by the ruble devaluation in the aftermath of the 1998 financial crisis and its positive impact on the country's competitiveness. In parallel, it was increasingly driven by the soaring world prices of oil and natural gas, which account for over one-half of total exports and are thus the country's two main export commodities (see e.g. OECD, 2004). This high share indicates that the Russian economy is vulnerable to energy price volatility, which poses a challenge to fiscal management given the future revenue uncertainty.

Revenue uncertainty affects all countries that show a high degree of dependence on the exports of one particular commodity whose price is subject to sharp and unpredictable fluctuations. In many instances (including the situation in Russia since 2004), the fiscal policy response has been to accumulate extra-budgetary funds (often explicitly referred to as stabilization funds) in times of favorable external developments, with the aim of tapping these funds in case the external conditions deteriorate. In fact, in setting up an oil fund, Russia followed the example of 16 other countries, including Norway, a number of Middle East, African and Latin American countries, but also Kazakhstan and Azerbaijan. The U.S. state Alaska operates two oil funds (one

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each for saving and stabilization purposes),<sup>2</sup> while Chile has established a copper stabilization fund.

The previous experience with stabilization funds has been mixed (see e.g. Bartsch, 2006; Kalyuzhnova, 2006; Vatansever, 2005; Davis et al., 2001; Fasano, 2000). In Kuwait, Norway and Alaska, for example, the funds have indeed been effective tools of asset-building aimed at counteracting a future projected decline in oil revenues or a projected increase in social outlays (as in Norway). However, in some other countries, e.g. Oman, Nigeria and Venezuela, the experience with oil funds has been less positive – arguably because of frequent changes to the fund rules and deviations from its intended purposes. Thus, Venezuela serves as an ironic example of a case in which the whole concept was perverted, as the moneys transferred to the stabilization fund over the 1990s were financed with growing government borrowing. Generally, commitment to fiscal discipline and sound macroeconomic management has been crucial in the successful creation of funds.

This paper deals with the institutional setup, the past performance and the available policy options for the Russian Oil Stabilization Fund (OSF).<sup>3</sup> Section 2 outlines the OSF's rules, while sections 3 and 4 analyze the OSF's performance as a tool of macroeconomic stabilization and monetary sterilization, respectively. Section 5 concludes and outlines future scenarios.

## 2 Features of the OSF

The OSF was established in January 2004<sup>4</sup> with the purpose of (1) reducing the vulnerability of the state budget to the volatility of world oil prices (stabilization function), and (2) sterilizing the impact of oil-related foreign exchange inflows on the money supply and inflation (sterilization function). By the end of last year, the OSF had built up assets worth more than RUB 2.3 trillion (about 9% of Russia's 2006 GDP).

The OSF accumulates money as long as the world price for Russia's Urals oil exceeds the cutoff price (which was initially set at USD 20 per barrel, but was revised to USD 27 starting from January 2006). The OSF can be tapped for covering federal budget deficits when the Urals price falls below the cutoff price.

The OSF collects revenues from two taxes, (1) a portion of the export duty on crude oil, and (2) a portion of the mineral resources extraction tax on oil. Both refer only to that part of the tax that stems from the world price in excess of the cutoff price.

<sup>2</sup> The stabilization and saving functions are to be distinguished. In line with theory, stabilization is one of the three essential functions assigned to the state (stabilization, allocation and distribution) and consists of smoothing the path of economic growth in the short and medium run by means of countercyclical policy. While the task of stabilization is generally faced by a wide range of countries (which are not necessarily commodity exporters), the need for stabilization in commodity-exporting countries typically results from commodity price volatility. In turn, the saving function applies in the long run and is confined only to countries whose natural resources are potentially depletable. In this case, after the country's available resources have run out, the accumulated savings are intended to maintain the living standards of future generations.

<sup>3</sup> Moreover, recent decisions for OSF reform (adopted by the Russian parliament in April 2007) are taken into account as well.

<sup>4</sup> The bulk of regulations covering the operation of the OSF are contained in *Ministerstvo Finansov Rossiyskoi Federatsii* (2006a, 2006b).

So far, taxes on oil products and natural gas have not been transferred to the OSF, although their prices closely follow crude oil prices.<sup>5</sup>

In addition, parts of the federal budget surpluses (which were attained even though the additional tax revenues from high oil prices were absorbed by the OSF rather than by the current budget) were transferred to the OSF as well. The federal budget surpluses stood at 4.2% of GDP in 2004, 7.5% in 2005 and 8.6% in the period from January to October 2006. The surpluses were partly attributable to deliberate targeting, but they were also helped by the conservative oil price assumptions underlying the budgets.

The OSF is managed by the Ministry of Finance and until mid-2006 was held entirely in Russian ruble that were deposited interest-free at the Central Bank of Russia (CBR).<sup>6</sup> However, in summer 2006, a strategic decision was taken on converting the OSF into foreign-currency denominated assets, and the conversion had been completed by the end of the year. This is in line with the Budget Code provision stipulating that the OSF can be invested in foreign sovereign debt securities. The current government guideline is that these should be high-quality<sup>7</sup> sovereign bonds of 14 developed countries – the euro area countries, the United Kingdom and the U.S.A. Thus, the OSF is currently held in a currency basket with the following composition: 45% in U.S. dollar, 45% in euro and the remaining 10% in pound sterling (this composition can be changed anytime by government decision). Technically, the government regulations provide for two theoretical options of the OSF's placement: Its funds can be used to directly purchase foreign bonds, and/or can be deposited in foreign currency-denominated accounts at the CBR, with the returns on these accounts being based on the performance of the underlying foreign debt securities. Currently, only the second option is being used.

In terms of risk diversification, investing the OSF in foreign (rather than domestic) assets seems justified, since securities issued by countries which would benefit from falling oil prices provide, to some extent, a hedge against excessive reliance on the oil revenues. Indeed, all three above-mentioned currency blocks (the United States, the euro area, and the United Kingdom) are heavily and increasingly dependent on imported fuels. However, in terms of profitability, the decision to hold the OSF in foreign bonds is ambiguous. In particular, it is not clear whether the nominal return of 4% to 5% per annum that these securities typically offer will match the combined effects of the Russian ruble's nominal appreciation and of the nominal return on ruble-denominated assets.

More recently, the government has been considering the option of investing the OSF in high-quality foreign corporate bonds.<sup>8</sup> Investing the OSF in foreign

<sup>5</sup> However, this will be changed as of February 2008 (see section 5 for details).

<sup>6</sup> The main consideration behind keeping the entire OSF in Russian ruble were the perceived fears of the Russian assets 'abroad' being frozen as a result of possible international legal disputes.

<sup>7</sup> With a AAA/Aaa credit rating from at least two of the three rating agencies Standard & Poor's, Moody's and Fitch IBCA.

<sup>8</sup> According to the parliamentary decisions of April 2007 to reform the OSF, part of the OSF will be invested in corporate securities.

equities<sup>9</sup> would be in line with Norway's experience and might have the advantage of higher returns in the long run, as demonstrated by past performance. However, particularly in the short and medium term, equities are riskier than bonds and could therefore create a problem regarding the stabilization function assigned to the OSF. At the same time, investing the OSF in foreign equities might make sense, given that the need for stabilization may be small in the short and medium term (see section 4 for details).

### 3 Sterilization Function

Given the small size of the Russian banking and financial sector and its overall state of development, the CBR has only few instruments at its disposal to sterilize the oil-related (and, since 2006, also capital-related) foreign exchange inflows. Against this background, the role of the OSF as a sterilization instrument has been crucial. As table 1 shows, the CBR's foreign assets have been growing rapidly and now account for nearly all assets. Between January 2004 and November 2006, the value of foreign assets more than tripled in nominal terms, which represents an increase by some RUB 5 trillion. This increase was sterilized only slightly (to the effect of some RUB 0.3 trillion) by a reduction in already modest domestic assets, notably in claims on government and banks. Still, only about one-third of the increase in (net) foreign assets has actually translated into monetary expansion (i.e. monetary base growth), as the value of reserve money increased by only RUB 1.5 trillion over the same period. The reason is that another RUB 3.3 trillion was absorbed by an increase in government deposits, two-thirds of it representing the OSF and the rest accounted for by other deposits (including those of the regional and local governments). Thus, the sterilization function of the OSF arises from the fact that foreign exchange earned from oil exports largely stays with the CBR, as it is held by the government in a CBR account. Alternatively, any use of OSF money for the purchase of domestic assets – whether physical or financial – would increase the monetary base and could lead to inflationary and appreciation pressures.

Obviously, the CBR's sterilization efforts were also supported by the early repayment of the external debt Russia owed the International Monetary Fund (IMF), the Paris Club and Vneshekonombank (which serviced Russia's sovereign external debt following the financial crisis in the period from 1998 to 1999) in summer 2005 and summer 2006 (see table 2). On both occasions, the CBR's foreign assets contracted temporarily, mirrored by a reduction of government deposits on the liability side of the CBR's balance sheet.

In turn, the gradual conversion of the OSF from ruble into foreign currency, which took place in the second half of 2006, did not matter in macroeconomic terms. Also, it cannot be traced from the CBR's balance sheet, at least at the aggregation level presented in table 1. The conversion presumably resulted in a mere substitution of ruble-denominated government deposits by foreign currency-denominated government deposits on the liability side of the CBR's

<sup>9</sup> This proposal was initially put forward by the Russian first deputy prime minister Alexander Zhukov (according to his announcement of May 2006, Russia could invest up to 10% of the OSF in equity – see Pryde, 2007) and re-confirmed recently by the finance minister Alexei Kudrin (International Monetary Fund 2007b).

Table 1

**Balance Sheet of the Russian Monetary Authorities between 2004 and 2006**

RUB billion

	2004		2005		2006		
	1.1	1.7	1.1	1.7	1.1	1.7	1.11
<b>Assets</b>							
<b>Foreign assets</b>	<b>2.391,097</b>	<b>2.739,562</b>	<b>3.610,482</b>	<b>4.623,996</b>	<b>5.554,814</b>	<b>7.112,379</b>	<b>7.448,038</b>
Claims on government	477,639	445,643	426,555	334,788	276,042	248,853	247,957
Claims on nonfinancial public organizations	55	50	39	33	28	28	26
Claims on private sector and households	2,264	2,122	2,282	2,253	2,439	2,419	2,437
Claims on credit organizations	198,742	219,864	178,230	200,222	27,892	24,334	117,159
<b>Liabilities</b>							
<b>Reserve money</b>	<b>1.947,713</b>	<b>1.959,538</b>	<b>2.417,880</b>	<b>2.514,463</b>	<b>2.959,306</b>	<b>3.349,946</b>	<b>3.454,230</b>
<i>of which: money outside banks</i>	1.147,039	1.276,132	1.534,756	1.650,743	2.009,240	2.233,366	2.402,172
Term deposits and foreign currency deposits	5	6	17	10	35	23	17
Foreign liabilities	220,639	235,699	214,928	241,293	298,812	314,285	148,027
<b>Government deposits</b>	<b>446,001</b>	<b>799,740</b>	<b>1.047,912</b>	<b>2.050,321</b>	<b>2.146,032</b>	<b>3.361,712</b>	<b>3.785,069</b>
<i>of which: regional and local government</i>	43,805	100,796	85,580	200,475	126,695	294,730	432,473
Capital accounts	298,234	298,047	188,043	187,826	210,373	210,177	210,041
Other (net)	157,207	114,212	348,806	167,380	246,657	151,872	218,234

Source: Central Bank of Russia.

balance sheet and a corresponding replacement of foreign exchange with foreign debt securities within the item “foreign assets” on the asset side of the CBR’s balance sheet.

The sterilization policy by means of the OSF has certainly contributed to macroeconomic stability. Despite the soaring oil prices, the Russian economy has not shown signs of excess aggregate demand, despite buoyant private consumption and rather solid capital formation. Inflation has been falling slightly, and the current account balance is still strongly positive.<sup>10</sup>

#### 4 Stabilization Function

According to the current regulations, the OSF can be spent to cover the federal budget deficit when the oil price falls below the cutoff price. However, it can also be tapped for other purposes in case it has accumulated more than RUB 500 billion. Given the persistently high oil prices<sup>11</sup> that hover far above the cutoff price, the RUB 500 billion threshold had already been surpassed by the end of 2004. As a result, the OSF funds were subsequently used to repay the country’s foreign debt and to cover the public pension fund deficit (see table 2). The RUB 1.25 trillion worth of early settlement of public foreign debt, largely ahead of schedule, enabled the country to economize on interest payments and represented a net financial benefit to the state – even after allowing for the penalties charged to Russia for the premature contract withdrawal. Since the payments were financed from OSF funds, they had no macroeconomic impact within the country. The modest RUB 30 billion

<sup>10</sup> See e.g. Havlik (2007) and Hildebrandt et al. (2007).

<sup>11</sup> The average price of Urals oil rose from USD 34.3 per barrel in 2004 to USD 49.9 per barrel in 2005 and to USD 66 per barrel in 2006.

Table 2

<b>Dynamics of the Oil Stabilization Fund between 2004 and 2006</b>			
RUB billion	2004	2005	2006
<b>Inflows/revenues</b>			
Unspent federal budget surplus from previous year	106	218	48
Oil revenues (export duty plus extraction tax)	416	1175	1643
Interest accrued			23
<b>Outflows/withdrawals</b>			
External debt repayment			
IMF		94	
Paris Club		430	605
Vneshekonombank		124	
Pension Fund		30	
<b>Net inflows</b>	<b>522</b>	<b>716</b>	<b>1109</b>
<b>Balances, end of year</b>	<b>522</b>	<b>1,238</b>	<b>2347</b>

Source: Russian Ministry of Finance, IMF, author's calculations.

worth of allocations to the pension fund had a similarly small, or virtually no impact at all.<sup>12</sup>

Despite these expenditures, the OSF totaled USD 89.13 billion (corresponding to RUB 2.35 trillion) on January 1, 2007. The OSF's pivotal role as a tool of economic stabilization can be seen from the following estimations (Gurvich, 2006). In the period from 2004 to 2005, some 75% of the additional fiscal revenue from the high oil prices were saved (primarily in the OSF), amounting to some 60% of total additional income to the economy. Accordingly, the Russian federal budget would have shown only a minor deficit even if the oil price had fallen back to USD 20 per barrel. The recent economic performance suggests that the OSF, by building up reserves rather than spending extra revenues, has also helped decouple GDP growth from the oil price dynamics. Despite the soaring oil price since 2004, the country's economic growth has been fairly stable at 6% to 7%.

The current size of the OSF is nearly five times the value of the RUB 500 billion threshold, above which the funds can be used for purposes other than budget deficit financing. The pressure to spend the OSF is all the more intense as most short- and medium-term oil price forecasts assume values above USD 50 per barrel, and it seems extremely unlikely that the price will fall below USD 27 (the current cutoff price set for the OSF). This implies that stabilization in the sense in which it was meant at the time when the OSF was set up, i.e. as a buffer for federal fiscal balances, is unlikely to be required anytime soon.<sup>13</sup>

<sup>12</sup> Like in many other countries, the public pension fund deficit in Russia is largely "structural" and is due to the current shift from a "pay-as-you-go" to a funded system.

<sup>13</sup> A compromise solution which has been adopted by the Russian parliament in April 2007 is to divide the OSF into two parts from February 2008, (1) the so-called Reserve Fund, which will be maintained at 10% of GDP and which will serve the purpose of fiscal stabilization (in line with its original goal) and will be invested in highly liquid and low-yielding foreign securities, and (2) the Future Generations Fund, which will preserve the oil-generated wealth in the long term and could be partly invested in corporate securities (OECD, 2006; IMF, 2007a).

## 5 Assessment and Outlook

The present dilemma for the Russian authorities is to decide whether the OSF should be increasingly spent or saved as a wealth-generating vehicle, which would make it more similar to Norway's Government Pension Fund based on the idea of intergenerational equity.<sup>14</sup>

According to some projections (e.g. World Bank, 2006), if the OSF is not tapped, its value may reach USD 400 billion in 2010 and USD 900 billion in 2020 (in real terms). One forward-looking possibility for the government would be to refrain from tapping the OSF for some time, e.g. until 2015, then to keep the real value of the OSF constant and, in line with the above projections, still have annual funds of some USD 80 billion at its free disposal. These funds would stem from the newly accrued real interest on existing OSF assets and from the new oil revenues. They are comparable with the current annual budget share of the mineral resources extraction tax and the export duty on oil. This scenario is rather conservative, but it is still less conservative than the so-called bird-in-hand rule that was implemented in Norway in 2001, whereby only newly accrued interest on fund assets is spent. There is good reason for the conviction that the Russian model should be less conservative than the Norwegian one. Given that the Russian economy is likely to grow much faster than the Norwegian one (in line with the hypothesis of beta convergence), concerns about intergenerational solidarity appear to be less relevant in the case of Russia, as future generations will presumably be much wealthier than the present generation of Russians (OECD, 2006).

Alternatively, the government could decide to spend at least part of the accumulated OSF money now, or else spend (part of) the future inflows into the OSF on a current basis. Among the projects which have been proposed recently as possible candidates for OSF financing are the construction of an oil pipeline to the Pacific coast, development loans, asset acquisitions in the Commonwealth of Independent States (CIS) and Eastern Europe as well as financing a value added tax reduction. However, no commitments have been made so far – except for the early repayment of external debt mentioned above and the minor allocation to the pension fund.

Apart from precautionary considerations (which are subsiding, though, for the reasons outlined above), two main arguments have been typically raised by Russian liberal-minded economic policymakers<sup>15</sup> against spending the OSF money already now or on a current basis. They maintain that (1) given the extensive corruption at all government levels, any spending within Russia would be inefficient, and that (2) any domestic spending of the OSF money would be inflationary.

Nevertheless, recent estimates by the IMF (which usually advocates a cautious approach in fiscal issues) suggest that the current volumes of federal government spending in Russia are not only far below levels that would be unsustainable in the long run, but are in fact suboptimal (IMF, 2006).

<sup>14</sup> Following the parliamentary decisions for OSF reform of April 2007 (see previous footnote), the considerations have to be related to the issue of designing saving and spending of oil-generated revenues in the framework of the Future Generations Fund.

<sup>15</sup> Including the finance minister Alexei Kudrin and the former presidential economic adviser Andrei Illarionov.

In particular, primary budget expenditures would have to be raised by some 5 percentage points of GDP in the medium term in order for the government to reach the so-called permanent consumption rule, which maximizes consumption (expressed as a constant share of expenditures to GDP) over time.

The case for spending more becomes even stronger if we allow for the possibility that the money is not just used for consumption, but also invested. Such investment could, for instance, be directed to upgrading the country's infrastructure, thus encouraging private investment in the nonenergy branches of economy. In this way, if the government decided to use the OSF money domestically, it would contribute substantially to the diversification of the Russian economy, which is certainly one of its goals. This diversification would, in turn, contribute e.g. to the stability of public finances. Besides, any resulting productivity improvements in the nonenergy tradable sector would counteract the possible Dutch disease effects stemming from higher inflationary pressure and an additional ruble appreciation potentially associated with spending part of the OSF reserves.<sup>16</sup>

The government could also target e.g. education, health and ecological cleanup activities with these investments. Although the value of such investment might be difficult to quantify in economic terms, it is fairly obvious that it would raise the living standard of the population. In addition, it could also lay the foundation for long-term sustainable economic growth, e.g. thanks to human capital accumulation.

Provided that the (net) benefits are positive, additional spending could be advocated even if institutional weaknesses limit the effectiveness of public expenditures. One might also argue that some additional spending, e.g. in the area of public sector wages, in combination with other measures, could even reduce the incentives for corruption in these areas, which in many cases reflect peoples' efforts to make ends meet.

Any sizeable domestic spending of the OSF money would pose a serious challenge to the country's macroeconomic management. In particular, it is essential that any major withdrawal of government foreign currency-denominated deposits at the CBR and their subsequent conversion into ruble be accompanied by corresponding policy coordination with the CBR.<sup>17</sup> The aim of such an approach would be both to avoid unwelcome appreciation pressure (and the likely speculation on such appreciation) and to leave open the possibility for counteracting any unwarranted depreciation pressure in the future. At the same time, the appreciation pressure (and the inflationary pressure alike) is likely to be kept within limits as long as additional government spending is import intensive, e.g. made within the framework of infrastructure development programs involving large-scale imports of investment goods.

<sup>16</sup> See also Barisitz and Ollus (2007), who argue that, in the recent past, curtailment of domestic demand through the OSF has doubtlessly contributed to countering Dutch disease pressures.

<sup>17</sup> For instance, the ministries of finance in the Czech Republic and Poland had explicit agreements with the respective central banks on depositing privatization-related one-off foreign currency inflows in a special account and on converting funds from these accounts into national currency directly with the central bank, i.e. off market.

Leaving aside economic considerations as to whether part of the OSF money should be spent sooner rather than later, we may also ask whether it might be appropriate to redesign some rules governing the OSF. In particular, the threshold of RUB 500 billion above which the government is free to decide on tapping the OSF could be adjusted upward to make it more meaningful. Fixing the nominal level of the threshold disregards both economic growth and inflation. Meanwhile, the task of stabilizing a bigger economy would clearly require a greater pool of resources and therefore a higher threshold value. This would not preclude spending the OSF funds above a new threshold. On the contrary, it may well serve to assuage the precautionary considerations of those opposed to any spending of the OSF.<sup>18</sup> Furthermore, it would make little economic sense to continue excluding exports of natural gas and oil products from the sterilization and stabilization approach underlying the OSF.<sup>19</sup>

All in all, the unexpectedly favorable world oil price dynamics and the resulting rise in OSF reserves have raised the issue of what is an adequate economic policy response under the new circumstances. The question of how to optimally invest OSF assets and whether or not – and how – to spend them for purposes other than stabilization will remain important in the macroeconomic policy debate in Russia for some time to come.

Cutoff date: April 30, 2007.

<sup>18</sup> In this vein, the piece of legislation enacted in April 2007 within the framework of the far-reaching budget reform and maintaining a sizeable part of the OSF, namely 10% of GDP, for stabilization purposes (see footnote 13 in section 4) is to be welcomed.

<sup>19</sup> In this respect, it is encouraging that the new legislation of April 2007 takes a more comprehensive approach. In line with the current budget reform, Russian federal public finances will be split into an “oil” and a “non-oil” part. From 2008 onward, the “oil” budget will be fed from all oil- and gas-related tax revenues (rather than only from tax revenues stemming from the oil price exceeding the cutoff price, as has been the case so far). Besides, the new legislation sets limits on the size of the “non-oil” deficit (4.7% of GDP) and on the maximum transfer from the “oil” to the “non-oil” budget (3.7% of GDP). Both limits will only become effective starting from 2011, while in 2008 to 2010, the size of the “oil transfer” is expected to be significantly higher at up to 6.1% of GDP in 2008 (Deutsche Bank, 2007).

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