Strategic funds

Russia is facing a challenging choice – it can retain its voting right on the global financial market and turn its wealth into a tool to solve long-term strategic problems, or its wealth will continue to be a mere guarantee of the government's peace of mind.

The recent meeting of the G7 finance ministers with China's and Saudi Arabia's representatives discussed the developed countries' policies in respect of state-run investment funds. State venture funds and attitudes towards them have been much discussed in world's financial mass media, and rightly so. The reason for such spotlighting is an unprecedented growth of these funds that accumulate money of export-rich economies of Russia, Asian, Middle Eastern and other countries worldwide. These funds are rapidly soaring – up more than 20% a year, - and their value exceeded $3 trillion in early 2007 – twice the aggregate value of hedge funds. State-run venture funds are very much alike hedge funds in their proactive behavior on the international capital market not falling under regulative restrictions. The forecasts regarding state investment funds vary greatly, yet all of them suggest that the total amount of money under their control will grow 5-10 times over the next decade.

New players

Emergence of new players in the international financial markets could not go unnoticed, and their rapid growth is not the only reason for that. Their operational methods – having little in common with traditional techniques of investing surplus state funds – were the focus of attention. Conservative institutions by nature, central banks used to prefer low-risk or no-risk financial instruments. They would invest government money in the developed countries' bonds or deposit it into their banks' accounts. That undisturbed state of things was convenient to all until it became clear that a number of states set out to enter the world's capital market with big moneis seeking substantial earnings rather than petty returns. Initially, state venture funds were seen as unwelcome players on the market, especially by western politicians. Some European countries and the United States initiated anti-liberal protectionist acts that introduced artificial constraints for investments opportunities of overseas 'novices'.

The major arguments put forward against state-run investment funds were their non-commercial interests, non-transparency and posing a threat to the national security. They were rumored to purchase stakes in companies to access secret information or impose political pressure on recipient countries. Those ungrounded accusations were especially the case with Russia and China. In Europe, in addition to those scary 'spy' stories, other charges were brought against state-run investment funds. Particularly, there was rhetoric about the threat of re-nationalization coming from abroad. Those theories were built on the question: what was the point of the 1980-90s privatization if the private property is being transferred back to states, this time to foreign ones?

Western politicians have not worked out a new strategy yet, so took a defensive stand to safeguard themselves from contingent risks. Their preventive actions indicate that any attempts of strategic investing will be strictly controlled by their governments. Governments will decide by themselves what countries they want to see as their investors, and Russia and China will likely be the most unwanted lenders.

A shift towards protectionism on capital markets occurred simultaneously with the latest financial upheavals. For the first time in many years the developed economies' financial markets faced a severe crisis. The developing countries however have not been affected by that downturn – unlike, say, Australia or Great Britain.

Whether directly or indirectly, this signifies that the international financial model that has been existent in the past fifteen or twenty years is becoming obsolete. Previously, rich countries would aid poor economies thus maintaining overall stability. Now it is not clear which states should be considered rich and which – poor. Some of those who are now investing dozens, even hundreds billion dollars in foreign assets badly needed international financial support just a couple of years ago.

Defining the role

The International Monetary Fund has acknowledged the commencement of a new epoch in the world of finance and started searching ways to apply its instruments to this changed world. On the one hand, the number of countries that need financial support (in particular, in Africa) has not reduced - these have not yet entered the transition period. On the other hand, some Asian recipients of financial aid now have a strong lending capacity themselves and are even able to set up an IMF-2 should such necessity arise. Financial institutions' concerns with their prospective performance are understandable. If there is no need in financial resources to maintain macroeconomic stabilization, new large-scale tasks should be set out. For instance, they could attempt to occupy a still vacant place of an IMF-2, offering their services as a coordinating body for sovereign funds.

Why such function can be found necessary? Above all, it is very important because the thriving international capital market necessitated streamlining of relations between the market players. Unlike world's commodity market, capital market is going through an early stage of evolution. Global financial liberalization started quite recently – in the 1980s. Emergence of new players complicates and reduces the sustainability of the capital market system that is yet at the formation stage. In this situation, adaptation of present rules to new circumstances is paramount. Apparently, all parties' actions should comply with some general code of reasonable conduct. International regulation standards – that have been largely replaced by rating agencies in the past years – need improving, all the more so because the issue of their adequacy and responsibility is growing increasingly acute in the light of the recent crises.

New common rules

The transparency issue is directly related to formation and adaptation of the global capital risk regulation system. Claims are often filed against the new capital market players – state-run investment funds. However, the logics underlying such accusations have one serious flaw. There are no consensus transparency criteria fitting into the today's changed conditions. Criteria should be worked out, and, to make them work, they must be beneficial to both investors and recipients.

To solve these problems efficiently, new international mechanisms of interest adjustment should be created. They must be based on the WTO guiding principles – mutuality and indiscriminateness of protective measures. These mechanisms may prevent certain countries from entering domestic capital markets – provided unbiased official criteria are used and inevitable response measures will follow. Western states used to voice straightforward statements, one of them suggesting that there were nothing bad in Qatar's buying Great Britain's largest retail network, Sainsbury, but maintaining that Gazprom's purchasing pipelines in Europe should be blocked only because the deal was initiated by president Putin (Gazprom is not a state-run investment fund, but the example is still valid). This is pure discrimination – not political, but personal. A new international market model should be free from such tactless argumentation of protective measures.

Financial OPEC

Countries that hold state investment funds could initiate modernization of the global financial model because they are interested in such innovation. The first step may be consolidation of efforts, and Russia, with its extensive diplomatic experience and affluence, could initiate the beginning of the integration process.

The new organization's primary task would be coordination of actions on the political arena and, in future, probably coordination of national investment funds' actions on financial markets. The basis for such coordination is similarity of tasks they face, in particular, ensuring long-term stable return on investments. They could divide the market by negotiating strategic investments. In this way they could minimize mutual losses and strengthen impacts on recipient countries who lead protectionist policies. Attempts to effect sizeable transactions, even if they fail, would not disappear without traces: introducing bans, western states will hurt the reputation of their markets, which will affect their investors' trust. Meanwhile, coordinated and consistent actions will force recipient countries into compromise.

Presence of common interests in countries who are holders of state investment funds will strengthen their position in negotiations with their western counterparts. As for the prospects of the global capital market, it is better to reach multilateral agreements rather than respond to bans by unilateral counteractions. One-sided actions are a direct way to disintegration and merchandise wars that are absolutely unacceptable in the 21st century. The developing countries need full-featured participation in world's financial markets, while the developed need to be present in the developing markets that hold basic sources of future incomes.

Government horizons

A beneficial external political context ensured by the formation of a common coordinating structure of national investment funds could seriously stimulate growth in Russia's interest towards efficient investing of public finance in the international financial markets.

It first of all concerns the Stabilization Fund that will be converted into the Oil and Gas Fund next year. Despite the made alterations – which will be tackled later – the issue of optimal management of this fund remains unsettled.

It is evident that efficient management pursues a certain goal that should be clearly outlined. With an objective set, it is easier to build up a strategy including in the field of financial policies. Without setting objectives, there is no point in discussing efficiency criteria and evaluate the results of governmental bodies' activities.

The state differs from other entities (households and private companies) with broader decision-making opportunities and longer-term goals. The government must take into account interests of both the present and future generations. A future-oriented approach should underlie economic management on the whole and financial management in particular.

The Finance Ministry does take attempts to broaden the decision-making horizons. The transition to budgeting for three years ahead was a right step. However, long-term target indicators required for the state's financial asset and liability management have not been set forth so far. These indicators should in their turn be based on the most important long-term tasks the country faces.

Efficient use of the Stabilization Fund has been a key point of discussions in the past years. Retaining its major part of financial provisions, totaling 10% of the GDP, the Russian government rests on the necessity to protect the federal budget against falls in petroleum prices. If oil prices are lower than a given level, current budgetary expenses will be finances from the Contingency Fund.

Why is the Contingency Fund so large? From the governmental viewpoint, it is necessary to secure stability of expense funding during several years (5 to 10 years, depending on the parameters of annual fiscal gap) in the conditions of a long-lasting external market decline.

This approach shows certain logics based on the desire to eradicate short-term budgetary risks.

Yet this approach does not fit into long-term objectives of financial management. Accumulated assets enable governments to concentrate on settling long-term strategic tasks. The present financial strategy of the state is inefficient and needs reconsidering. However, even this government strategy has a reserve for enhancing efficiency of management of that part of the

Finance Ministry's assets that will be invested in the global securities portfolio represented by the National Wealth Fund.

Russian assets in the global context

Prior to defining an efficient approach to public asset management, let us briefly outline the position of Russian assets in the global context.

In early September 2007, the Stabilization Fund totaled 3.4 trillion rubles ($132 billion), or 11% of the GDP projected for the next year.

Is it little or much? There is no unambiguous answer to this question. It makes sense to compare the Stabilization Fund with sovereign funds of other countries and assets of the global financial market.

Russia holds the eights position among sovereign funds – of which there are forty – so is quite a large player. The aggregate value of sovereign funds totals $3.2 trillion of which $2.15 trillion account for petroleum funds. Around a half of all funds was created not long ago, in the 1990s-2000s.

However, the total value of sovereign funds is small if compared to the world financial markets. Sovereign funds' aggregate assets are almost twenty times less than the global banking assets ($63.5 trillion) and almost six times less than the aggregate amount of pension funds ($17.9 trillion). In quantitative expression, this is a small segment of the global financial market.

Nevertheless, as was stated above, sovereign funds play a special role in the world's financial system. First, countries invest insignificant parts of their assets in international financial markets. Meanwhile, sovereign funds are used to a full extent for investments in foreign assets. Secondly, sovereign funds, unlike central banks whose share in global assets is somewhat larger, practice more 'aggressive' investment strategies.

The level of 'aggressiveness' of a given state's investment fund directly depends on its structure, size and regulative standards determined by the government. In this connection, the alterations that will soon take place in the structure of the Russian Stabilization Fund are very important. The Fund will be split into two parts in February 2008: the Contingency Fund that will support the budget and the National Wealth Fund to act as a state investment fund. The Contingency Fund is estimated at 10% of the GDP, or 3.12 trillion rubles ($122 billion) for early 2008. Unlike the Contingency Fund, allocations to the National Wealth Fund are not quantified. It will be formed as a balance after of oil and gas payments to the non-petroleum budget and appropriations made to the Contingency Fund. The National Wealth Fund will be grown only if the petroleum price will reach a certain level ($50-52 per barrel).

Based on this formula, the projected volume of the National Wealth Fund for early 2008 is 0.75-1 trillion rubles (around $30-40 billion). It means that the most probable Contingency Fund/National Wealth Fund ratio will be 4:1 by early 2008. This proportion is evidently conditioned by the government's intent to ensure stability of current budgetary expenses within several years. At the same time, this approach does not fit into long-term objectives of financial management.

Active reserves

A marked shift towards the budgetary reserve in the Russian model of financial management greatly differs from experiences of other countries - large petroleum exporters - and have substantial sovereign funds.

Norwegian experience is drawn as an example most often: owing to transparency standards operational in the country, maximum information on this experience is available. The first and foremost, Norway's petroleum fund is not divided into the contingency and investment segments. All extra income coming to the budget from trading in petroleum has been allocated to the single investment fund that has been recently transformed into the government pension fund of

Norway, Global. Its market estimation in the end of the first half of 2007 totaled $340 billion, or 130% of the GDP (reference information: Norway's population is 4.3 million people, i. e. there is around $80 thousand per each citizen; in Russia, the value of the National Wealth Fund per capita is forecasted at $250 for early 2008).

From the viewpoint of the asset mix, the Global fund is formed from fixed-income stocks and instruments. Until recently, their proportion was 40% : 60%. However, this spring a statement was made about a change in this proportion: 60% for stocks and 40% for bonds. Purely market circumstances pushed Norway towards that serious step: to maintain the previous ratio under the conditions of growing quotes it would have to sell stocks and buy bonds. Careful Norwegians' opting for a more active investment position and a new structure of portfolio is not accidental. It better suits the fund's long-term objectives of ensuring firm return on and safety of investments. With these amendments, the share of corporate securities in the Global portfolio grew to 80%. Maximum diversification of assets is an important guarantee: the fund's portfolio holds stocks and bonds of more than 3,500 issuers. Besides, Global risk management is carried out by means of a special insurance fund of $2.8 billion.

Arab countries' petroleum funds, according to some data, are characterized by equity/fixed income proportions similar to those of the Global fund. Thus, the world's largest petroleum fund, Abu Dhabi's ADIA has an around fifty-fifty ratio of stocks and debt securities.

At this background, Russian model of financial management looks at best a bit too watchful. Even if the National Wealth Fund will be divided between the stocks and debt capital in the moderate proportion of 50% : 50%, the share of stocks in the general Oil and Gas fund of Russia will total only 10-15%.

Issues of mobilization

A small part of non-debt instruments in Russia's total sovereign fund is not the only reason why it should reconsider the government's financial strategy. Other underlying principles are somewhat doubtful, too.

First, a reserve of 10% of the GDP was initially created as an 'airbag' that would protect the country in the event of drastic changes in the world markets and financial crisis. On the one hand, the Contingency Fund insures the budget against reduction in tax inflows. On the other, the same fund is seen as the government reserve to support anti-crisis actions. However, in the latter case the possibilities of using the Contingency Fund are limited because a financial crisis will likely unfold according to a scenario totally different from the 1998 pattern (the existing risks are: real estate market bubble, indebtedness in the corporate sector and a looming banking crisis). In this event, the state's huge liquid reserves may turn of little help for anti-crisis actions. Besides, the United States mortgage and liquidity crises showed that utilization of budgetary funds for saving bankrupts (including households, mortgage companies, hedge funds, construction companies etc.) including those that contributed, whether directly or indirectly, in the crisis, would be totally wrong.

Secondly, speaking about Russia's security with financial reserves, we should take into consideration total foreign currency assets, i.e. official provisions of the bank of Russia, a part of which is the Stabilization Fund (part of the Central Bank's liabilities). The general currency asset mix is extremely conservative. In this relation, world's leading economists (like Lawrence H. Summers) made recommendations to alter the structure of official foreign currency reserves, especially to the states that accumulated large volumes of currency.

Third, storage of liquid reserves is a problem more to the Central Bank than to the Finance Ministry. The Central Bank needs a stock of liquid funds to ensure cash flow and prevent speculative attacks. Liquid reserves play a key role when the national currency is overstated as it was in 1995-1997 (although the Central Bank's actions to protect the ruble at any cost in 1997-1998 were erroneous — it would be better to allow timely depreciation).

At present, the ruble is rather understated (taking into account potential capital inflow), and no threat of devaluation will appear in the years ahead. Russia should consider transition to a fluctuating exchange rate, which would eliminate the problem of over-accumulation of currency reserves (and inflation pressure).

And, finally, here is an important political and economic argument: the liquid Contingency Fund has been a potential 'pie' for lobby groupings. This fund can be used, if required, even if the petroleum prices will exceed the $50 for barrel mark. And the temptation to 'adjust' the limit of withdrawals will grow in proportion to growth in this fund's value.

When a state has gigantic funds, the pressure on increasing expenses increases, too. And legislative amendments opening the Contingency Fund for 'immediate' and 'strategic' needs alike can be always applied.

Something of the kind happened in 1996-1997, when internal debt capital market was thrown open for residents outside Russia. The government developed an illusion of being secured with finance that contributed to the decision to adopt highly indebted budgets in 1997 and 1998 and a consequent crisis. The negative motivation (moral risks) is a factor and should not be disregarded.

From this point of view, the Finance Ministry funds should be better held as less liquid (thus better protected from lobbyists) high yield assets.

Retirement plan

Today, despite the adoption of a three-year budget, financial management is still steered by current fiscal tasks. The state's main task, in the event of any negative changes in the world market, is keeping current budgetary expenses unchanged.

However, utilization of the Oil and Gas Fund for securing current expenses with prejudice to settlement of long-term strategic tasks contradicts the nature and objectives of this fund that is designed for future generations.

There are many variants of using the funds designed to meet the needs of future generations and support long-term economic development projects like road construction, education, nano-technology, alternative sources of energy, machine-building etc. No doubt, all these projects are very important. But there are dozens of them, and using the strategic reserve for their implementation will be not money well spent as it will produce a new spiral of lobbyism.

It would be wiser to turn our Oil and Gas Fund into an operating, profit-bringing mechanism, and it can be started to be built even in the tight framework of the National Wealth Fund.

Long-term active strategy should be built based on long-term governmental tasks determining the financial policy goals. Let us consider the issue of the Russian pension reform as an example. First, it is most important socially and economically. Secondly, implementation of the pension reform sets clear and transparent target parameters for long-term financial policies.

The pensions reform, aimed at transition to a system of accumulation of pension rights, is a vital task for the Russian economy. Why is it more important than other tasks? The thing is, it solves three problems at once.

First, it will help reduce the demographic load on working generations provided there are proper retirement plans for future generations. Secondly, it will lower the fiscal burden without which Russia will not be able to compete with, say, China who practically has no pension obligations and other countries who introduced the new pension system. If Russia does not join these countries, it will have low chances to win in the international competition. Thirdly, transition to the accumulation pension system gives a strong impulse for development of Russian financial markets, which is very important for continued economic growth.

The state's key role in carrying out the pension reform should consist in an oversight during the transition period and in settling principal problems the major of which is uneven burden on different generations. The young should continue to finance liabilities to the old in the framework of a distribution system, at the same time accumulating pension funds for themselves.

It means that the young need support from the state, otherwise the pension system will face a huge financial gap (estimated at 50 to 75% of the GDP). An important task of the long-term financial management is the problem of closing this gap. The state assets, primarily the Oil and Gas Fund, must be aimed at settling this particular problem.
When the pension reform was planned and commenced, only debt instruments could be used (although these arguments seemed irrelevant because of the 1998 crisis). Now, with accumulated financial resources, there are more opportunities for securing the transition process, and they must be efficiently employed by the state.
The estimates show the following: to bridge the fiscal gap of 50% of the GDP by 2022 (in fifteen years) with average yearly growth of the GDP per capita of 5% and real return on assets of the National Wealth Fund of 15%, it is necessary to invest 12% of the GDP, or around $140 billion (according to the effective exchange rate), in this fund. Thus, investing all finance of the Stabilization Fund to the National Wealth Fund starting from 2008 would solve the problem of subsequent additional transfers from the budget.
However, it would be more realistic to rest on the current situation where no more than 3% of the GDP will be allotted to the National Wealth Fund. But even with these limits, efficient finance management based on long-term target parameters will enable the government to eliminate the fiscal deficit of 13% of the GDP, which is approximately one-fourth of the potential gap with no additional transfers.

A strategic choice

The IFS research reveals that this goal can be achieved. In fact, it is all about dynamic generalization of a standard efficient portfolio task of minimum volatility with a given estimated return on investments.
An analysis of the model, taking into account particular conditions in which it will be implemented, shows that two strategies of management are possible, each determined based on the forecasts of fiscal authorities and dictates time-specific optimal portfolio structure for the National Wealth Fund in terms of risks/returns.
The first strategy should be implemented if forecasts for distant future (a definite time period is meant) are pessimistic and the near-term projections are bright. In this case the share of risk-imposing investments should be higher in the initial period of investing. Consequently, return on assets will be also high in the same period. As time will pass and the period of hardships will approach, the share of risky investments must reduce simultaneously with asset growth. For a vivid illustration we can compare this strategy with playing golf when players make strong initial strikes and then – weaker strikes for accurate hitting the mark.
If the government, on the contrary, believes that flourishing is guaranteed to the country for years ahead after it passes a couple of tough years, the share of risky investments should be small in the initial period. With such projections, reduction of current volatility is more preferred, so it would be wise to wait with risky investments until some time passes.
The analysis of this model prompts us towards an important conclusion: if a task is set to reach the target level of the National Wealth Fund within a certain period of time (say, 10 to 15 years), a foreseeing government should make more risky investment in the initial period, gradually reducing them afterwards.
Until recently, the Russian government practiced quite the opposite approach. The target reserve is 10% of the GDP and the risky part of the Oil and Gas Fund will expand over time, provided petroleum prices do not fall and budget remains in surplus.
It means either that the fiscal authorities are short-sighted, i.e. they are hardly concerned with Russia's development, or that they act not smartly (due to their reluctance to take short-time risks).

The government's opting for a non-performing financial strategy means that it cannot ensure the target assets (i.e. the level of long-term profitability) or that it will ensure it due to unreasonably high risks in the future.