

The Stabilization Fund and the Priorities for Financial Policy

Presentation for Milken Conference

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The second version

As a practitioner, I was involved during quite a long time in government debt management, at period when this problem was of highest superiority for Russia. Nowadays, the urgency of this problem has dramatically diminished: the major part of government debt has “negative sign” and is called Stabilization Fund (Stabfund). The “pie” of Stabfund is \$ 103 bln or 2.7 trill. rubles (8.8% of Russian GDP) by March 2007.

Now the main problem for authorities is how to spend accumulated state assets. Not surprisingly, quite a lot of suggestions on how the “pie of Stabfund” should be divided are currently debated. Here I would like to present my view on the problem, making emphasis on strategic goals of the Russian economy and some aspects of its financial integration with the world.

1. Current trends

Before I suggest my solution of the problem, let me briefly outline some current tendencies. As a result of favorable situation, Russian currency reserves have increased to \$310 bln (27% of GDP). The government has spent \$45 bln on pre-term debt redemption, and the external state debt has been reduced to \$46 bln (4% of GDP). On first glance, the Russian economy is defended by reserves from negative external shocks. Nevertheless macroeconomic fragility is evident in current tendencies.

First, Stabfund is closely correlated with oil price, as clearly seen from the graph, showing movements of Stabfund and oil price.

Figure 1. Dynamics of Stabfund and oil price

Second, the total amount of foreign debt has notably increased, and the structure of foreign debt has reversed due to external borrowings by the corporate and banking sectors (Table 1). The large part of corporate debts has been made by big companies in the basic sectors affiliated with the state. In this situation, a dramatic drop of oil price may induce debt crisis at home that will adversely affect the whole economy.

Table 1. Russian foreign debt, \$ bln.

Debt	2003	2006*
Government	97	46
Corporate and banking sectors	48	214
Total	152	269

* October 2006

Third, a serious macroeconomic risk is connected with the balance of payments. Net foreign reserves of the Russian economy, calculated according to the IMF methodology, indicate the overall situation with assets and liabilities. Figure 3 demonstrates dynamics of this indicator. Russian net foreign reserves raised notably in 2000, up to \$50 bln, due to the beginning of oil price upsurge. But subsequently, since 2001, these reserves are shrinking. By the beginning of 2006 they have reduced to – \$ 44 bln. Formally speaking, Russia, as a nation, could bankrupt even now, if all financial liabilities were claimed immediately. In fact, the accumulation of official reserves comes ultimately through financial account of the balance of payments, due to corporate borrowing and foreign direct investment.

Anyway, the decline of net foreign reserves is an alarming signal of possible future meltdowns.

Figure 2. Dynamics of net foreign reserves (Russia and China)

Fourth, Russian economy has already switched into regime of latent deficit financing: under constant oil price, the federal budget deficit was increasing roughly by 1% of GDP per annum over the last 5 years. This trend is reinforced by the current pre-election phase of political cycle.

Figure 3. Federal budget deficit under constant oil price

2. New approach of the government

In view of these trends, Russian financial authorities should switch policy from passive behavior to active financial management pursuing long-term strategic goals. Nowadays, some attempts are made to modify government finance. First, a three-year state budget for 2008-2010 is processed. Second, Stabfund will be transformed into two parts as it amounts to 10% of GDP. The first part, the Reserve Fund, will be maintained at this level. The second part, the Future Generations Fund, will be formed on the basis of subsequent oil and gas budget transfers.

This is a first step in right direction. But even this new approach lacks strategic vision. In the last year I suggested an idea becoming more and more popular among Russian economists and top officials: Stabfund should be used in its entirety for radical reforming of the pension system!

3. Stabfund and the Pension reform

Transformation of the Russian pension system started 5 years ago. Unfortunately, it is rather an imitation of reform, only slightly modifying the pay-as-go system. Obviously, it has failed, both in terms of very low share of population involved, and because of extremely low real return on pension assets under the state agency (Vnesheconombank) control. The real rate of return was only 1.3% in 2005 and became negative, -3.3%, in 2006.

The failure of the pension reform will be very unfavorable for the long-term economic development of Russia. I view radical transformation of the pension system as the pillar of economic modernization. Potentially, such reform could pursue a three-fold task.

a) Firstly, the pension problem per se. The post-war generation of baby-boomers has already reached the pension age, and the share of pensioners in population will continue to increase. Current obligations of the government to future pension generations are unsustainable within the existing system.

b) The second task is to lay timely the grounds for long-run competitiveness of Russian economy. The problem is that the pay-roll (wage) tax is the most

burdensome for businesses in Russia. The rate of this tax should be reduced to 5 through 10%.

c) Finally, the pension reform will become a catalyst for the development of financial system. As suggested by substantial cross-country evidence, the quality of financial markets and institutions has significant positive effect on long-term economic growth.

In what follows I will return to the latter issue.

4. Assessment of financial gap

I had begun to analyze the variants of pension reform in Russia few years before it actually started. On the formal level, I viewed transition to the new system as a dynamic policy problem that ensures:

a) dramatic reduction of tax and debt burden on the economy;

b) smoothing of income gaps between different pension generations (members of younger generations will take the main burden of transition, because they will finance state obligations to the older ones as well as personal pension accounts).

Only if these conditions are fulfilled, the radical reform can be successful. But implementation of such a strategy implies deficit of the pension system for quite a long time period.

I with my colleagues simulated transition paths under various real rates of return on pension assets. Our estimates of financial gap during the period of deficit in the pension system in 2012-2037 are moderate and vary in the interval 1-1.5% of GDP on average. But the net present value of this gap amounts to 50-75% of GDP (under 5% discount rate).

Figure 4. Transition under 5% real rate of return on pension assets

The main conclusion from our simulation was that transition to the new system is impossible without government debt policy. I made this conclusion at crisis time, almost 10 years ago, when no one could imagine the current state of government finance, with the “pie of Stabfund”. As a financial source of transition, this pie should be used in combination with various debt instruments to close the

financial gap. Thus, our conclusion concerning the importance of debt policy is still valid.

5. The integrated system of state liabilities-assets management

Optimal debt policy should be incorporated into a more general system of government finance, which I call *the integrated system of liabilities-assets management*. What are the main features of this system?

A) First of all, a flexible mechanism of risk management. The main argument against private pensions system is presence of investment risks. I think this argument is invalid, provided that the authorities create an adequate, market-based mechanism of dealing with risks.

In my view, the strategy of risk-return management must be flexible and adaptive to gaps between current assets and future liabilities. The level of risk-taking should not be set in advance, but rather be defined basing on the fiscal gap assessment.

B) Secondly, the integrated system must be basing upon sufficiently wide spectrum of instruments supplied on the global financial market. Government papers are not only low-income, but eventually more risky in real terms, as compared with globally diversified portfolio of assets including shares, corporate bonds, commodities, real estate, etc.

C) Thirdly, the authorities have to define a guideline for assessing the long-term return. A good example in this case is conservative institutional investors, like university funds in the USA, that are able to ensure more than 10% of real return in the long term.

Applying the similar strategy would provide ten-fold increase of Stabfund assets over 25 years and the state budget gain of at least 8% of budget incomes per annum.

For comparison: under 5% real return, the growth of assets would be 3.4 times, and the budget gains would be near 0.4% per annum (over the same period).

6. Potential impact of new system on domestic economy

Suppose that Russian authorities radically change their approach and decide to adopt the Pension reform of the sort I recommend. This will cause dramatic qualitative transformation of the whole Russian financial system.

A) The structure of financial institutions will change in favor of institutional investors supplying long money. Increased demand for portfolio risk management will provide stimulus to growth of financial intermediating activity.

B) Domestic financial markets will be deepening because a large part of savings will be channeled to financial markets instead of banks. The existing banking system in Russia does not provide satisfactorily transformation of savings to investment. All attempts to reform this system have failed. I think that the structural shift in favor of market-oriented financial system will have a very positive impact on economic growth.

C) New large-scale financial activity will improve ultimately the skills of specialists in the financial sector. The role of the government in this respect is to organize reeducation and involvement of young talented people in this sphere.

Besides that, the proposed reform would change government finance. The budget process will concentrate on long-term decision making. Russian fiscal authorities declared many times desirability to lengthen planning horizon. In existing system, they have no strong incentives to deviate from the one-year budget routine.

Radical transformation of the pension system will change the style of macroeconomic policy-making. Domestic financial markets will become less fragile to capital reversals, because of deepening and globalization of domestic portfolios. In this case it will be easier for monetary authorities to turn to flexible exchange rate regime.

Finally, the pension reform will have positive effect on the long-run social policy. Nowadays, only very rich people are able to invest money in global portfolios of assets. If a large number of Russian citizens participate in the global portfolio, they will ultimately become wealthier.

7. Potential impact on global markets

Potentially, the radical pension reform even in one large country (and I think Russia is not small) may influence global financial markets. Management of personal pension accounts is supposed to be conducted by private pension funds. But still, there will be need in a government agency implementing (or coordinating) large-scale debt-asset management to provide transition to the new system.

Appearance of a very big player on the global market with supply of hundred(s) billion dollars will cause certain shifts. Its strategy will radically differ from standard actions by official investors like Central Banks. The goal of this agency will be to earn money on long horizon, while the Central Banks are constrained by short-term liquidity requirements. They invest in government papers and lose in real terms in the long-run. Another difference is that Central Banks coordinate actions when it is necessary to maintain stability of international currency system. This is not a goal of the agency managing national assets and liabilities.

Further, imagine that some other countries will decide to implement the similar reforms and establish the similar agencies. With no incentives to coordinate, they will compete with each other, generating an up-going trend in the global asset market. In this case it will be important to take advantage of leadership and begin large-scale investment timely, at lower prices.