

## **ECONOMIC SURVEY OF THE RUSSIAN FEDERATION 2006:**

### **FISCAL POLICY: THE PRINCIPAL TOOL FOR MACROECONOMIC MANAGEMENT**

*This is an excerpt of the OECD Economic Survey of the Russian Federation, 2006,  
from the section on fiscal policy in chapter 2.*

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From the first recovery of oil prices in 1999 until the end of 2004, Russia's macroeconomic strategy rested on the assumption that high oil prices were a temporary phenomenon. This may yet prove to be the case – oil prices could fall sharply in coming years – but expectations have shifted. It is now generally believed that oil prices are set to remain at levels that are, by historical standards, rather high. While a world of sustained high oil prices may be good for Russia, the adjustment to this new environment also presents certain challenges, and it is not yet clear that Russia has adapted its macroeconomic strategy to reflect the belief that high oil prices are here to stay.

The first and most immediate problem Russia may face is the increasing cost pressure on tradable sectors arising as a result of the very rapid pace of real exchange-rate appreciation. While labour market adjustments have so far allowed a smooth reallocation of the labour force from the industrial sectors to the services sectors and minimised the risk of “Dutch disease”, continued rapid real appreciation will impede efforts to diversify Russia's production and export structure. The second problem is the inflationary pressure generated by sustained high prices for Russia's major export commodities. Persistent high inflation may not only be detrimental to long-term growth (Barro, 1995, Andres and Hernando, 1999) and dampen incentives to invest (OECD, 2003), it may also increase already large inequalities in income distribution, as low-income households are less likely to be able to protect their savings from purchasing-power erosion and low-income workers are more likely than others to see wage-rises significantly lagging inflation.<sup>1</sup>

This chapter explores the nature of these challenges and proposes a number of measures aimed at enabling the Russian authorities to address both sets of problems. It first examines Russia's trade performance and competitiveness, with particular reference to the impact of windfall-induced exchange-rate appreciation and money-supply growth. The non-resource tradables sector is under increasing pressure as a result of the commodity boom, and some of the factors that facilitated its relatively smooth adjustment in earlier years now seem largely to have run their course. The discussion then turns to the problem of inflation, which the authorities aim to reduce to 4.5–5.0% by 2009. While policy-makers have recently focused much attention on the role of utilities tariffs and other regulated prices in controlling price increases, the primary factors driving inflation are in fact monetary. Large-scale unsterilised interventions on the foreign exchange market, aimed at keeping the nominal effective exchange rate stable, continue to fuel rapid growth of the money supply.

Until the economy adjusts to the new terms of trade, therefore, there will be a need for large-scale fiscal or monetary sterilisation. The options for addressing these challenges *via* monetary policy are limited, given the weakness of the exchange-rate and interest-rate channels. A relatively tight fiscal stance, however, can reduce both inflation and exchange-rate pressures. Fiscal policy should thus be the primary instrument for ensuring macroeconomic balance. More precisely, a clearly defined fiscal rule, relying on the mechanism of the Stabilisation Fund, can play a critical role in ensuring macroeconomic stability, either in the case of a further rise in commodity prices or in the event of a downturn. In insulating the economy from commodity-price volatility, fiscal policy would also enable the authorities to anchor expectations on the real “equilibrium” exchange rate and would thus greatly facilitate the conduct of monetary policy. Whether or not fiscal policy will deliver these benefits depends above all on how commodity windfalls are managed. The main policy recommendations presented below thus focus on the framework for forming, investing and utilising the Stabilisation Fund.

### *The deterioration of the non-oil fiscal balance has so far been limited*

Fiscal discipline has been the cornerstone of the post-crisis economic expansion. While windfall revenues from oil and gas have hugely facilitated fiscal consolidation, the government must be given credit for resisting the temptation to go on a spending spree and for using the opportunity provided by the improving terms of trade to execute a range of important fiscal reforms (OECD, 2004:37–8). As a result, the general government surplus has kept growing and has now reached extraordinary levels – 7.7% of GDP for the consolidated budget in 2005. Moreover, simulations performed by the Economic Expert Group (EEG) attached to the Ministry of Finance suggest that the budget would have shown only a modest deficit even if the price of Urals crude had fallen back to \$ 20/bbl (Gurvich, 2006a). EEG estimates of the constant-oil-price budget balance<sup>2</sup> show that a large share of the extra fiscal revenue arising from higher oil prices since 2002 has been saved (Table 2.4).<sup>3</sup> In 2004–05, around three-quarters of the additional fiscal revenue was saved,<sup>4</sup> amounting to around three-fifths of the total additional income to the economy. The Stabilisation Fund, in which the bulk of the windfall fiscal revenue is accumulated, plays a crucial role in maintaining this fiscal discipline.

**Table 2.4. Fiscal stance (general government balance)**  
% of GDP

	2001	2002	2003	2004	2005 (1)
Budget balance	3.2	1.4	1.8	4.9	7.7
Conjunctural fiscal revenues from oil	1.1	1.4	2.8	5.0	9.2
Constant oil price budget balance (20 \$ Ural) (2)	2.1	0.0	-1.0	-0.1	-1.5
$\Delta$ Budget balance	0.1	-1.8	0.4	3.1	2.8
$\Delta$ Fiscal revenues from oil	-0.6	0.3	1.4	2.2	4.3
$\Delta$ Constant oil budget balance	0.7	-2.1	-1	0.9	-1.5
<b>Urals price (\$/bbl)</b>	<b>22.9</b>	<b>23.7</b>	<b>27.2</b>	<b>34.6</b>	<b>50.5</b>
$\Delta$ Oil-related windfalls to the economy (2)	-2.2	-0.2	3.0	3.9	5.1
<b>NB: Exceptional revenue (Yukos)</b>	-	-	-	0.4	1.0

1. Figure for 2005 is a preliminary OECD estimate.

2. The constant-oil-price budget balance and oil windfalls to the economy are estimated on the basis of the average dollar price of Urals crude in 1994-2003, without taking account of dollar inflation (\$ 20/bbl). 'Normal' export prices for natural gas are set at \$ 78t/cm (roughly the average export netback over the period).

Source: Gurvich (2006a).

While the authorities have done remarkably well in resisting pressure for large tax cuts or aggressive increases in spending, the gradual deterioration of the constant-oil-price balance nevertheless accelerated in

2005, adding a fiscal stimulus to an already buoyant economy. According to the estimates in Table 2.4, the size of this stimulus reached 1.5% of GDP.<sup>5</sup> If the exceptional revenues stemming from Yukos' tax payments are excluded from the estimate of "structural revenues",<sup>6</sup> the impulse reaches around 2%. The deterioration of the non-oil balance resulted from a decrease in non-oil revenues, owing chiefly to a cut in the basic rate of unified social tax (ESN) from 35.6% to 26%. Despite regular increases in public-sector wages and pensions, the ratio of non-interest expenditures to GDP remained stable (Table 2.5). The stability of the expenditure share, however, owes a good deal to the rise in the GDP deflator induced by the positive terms-of-trade shock.<sup>7</sup> As a share of non-oil GDP, expenditures are on a rising trend and, in nominal terms, public expenditures rose by 27% in 2005. The fastest increases in federal expenditure concerned defence and law enforcement (38%), the social sphere (35%) and the transfers to extra-budgetary funds (50% in rouble terms and 0.5% as a share of GDP).

**Table 2.5. The consolidated budget, excluding off-budgetary funds (% GDP)**

	2001	2002	2003	2004	2005 (1)
<b>Consolidated budget</b>					
Revenues	30.0	32.1	31.3	32.0	35.2
Expenditures	27.1	31.6	29.9	27.5	27.5
Balance	2.9	0.9	1.4	4.5	7.7
<b>Federal budget</b>					
Revenues	17.8	20.4	19.5	20.2	23.7
<i>Of which federal part of the ESN</i>	-	3.1	2.7	2.6	1.2
Expenditures	14.8	19.0	17.8	15.9	16.3
<i>Of which debt service</i>	2.6	1.4	1.7	1.2	1.0
Balance	3.0	1.4	1.7	4.3	7.4
<b>Regional budgets</b>					
Revenues	14.3	14.9	14.5	14.3	13.9
Expenditures	14.3	15.3	14.9	14.1	13.6
Balance	0.0	-0.4	-0.4	0.2	0.3

1. Figures for 2005 are preliminary estimates.

Source: IET (2006) and CBR.

### ***The fiscal reserves accumulated in the Stabilisation Fund are under growing pressure***

Despite the fiscal stimulus, the Stabilisation Fund continued to capture, and thus neutralise, most windfall oil income. In absolute terms, the scale of fiscal sterilisation increased dramatically in 2005, reaching an estimated 6.4% of GDP, as against 3.1% in 2004.<sup>8</sup> In 2005, roughly \$ 49 billion in surplus revenues was channelled into the Fund. Some \$ 25 billion of this was retained in the Fund to insure the budget against any future oil-price drop, just over \$ 1 billion was used to cover the deficit of the Russian Federation Pension Fund and \$ 23 billion was used for early debt repayment, mainly to the Paris Club. As a result, public external debt fell from 17.9% of GDP at end-2004 to 10.8% at end-2005 (Table 2.6). Federal expenditure on external debt service is expected to amount to 0.8% of GDP in 2006, down from 2.6% in 2001 (Table 2.5).<sup>9</sup> Reducing the burden of external debt is growth enhancing, particularly for low-to-middle income countries (Patillo *et al.*, 2002). The government's decision to repay Soviet-era debts to the Paris Club in full in the summer 2006 is thus to be welcomed (another tranche of \$ 22 billion was paid off to the creditor nations in August).

**Table 2.6. Evolution of public debt (% GDP)**

	2001	2002	2003	2004	2005
<b>Public Debt</b>	<b>45.5</b>	<b>36.1</b>	<b>29.5</b>	<b>22.4</b>	<b>14.8</b>
Of which external debt	39.8	30.1	24.5	17.9	10.8
<i>Long term</i>	33.6	25.9	21.0	16.0	8.5
<i>Short term</i>	6.2	4.2	3.5	2.0	2.3
Of which domestic debt	5.7	6.0	5.0	4.5	3.9

Source: Central Bank of Russia, Ministry of Finance.

The original 2006 budget envisaged a 1.3 percentage-point increase in federal expenditures as a share of GDP in order to cover substantial increases public-sector wages and public investment. The initial budget law, however, was drafted on the basis of a very conservative oil-price assumption (\$ 40/bbl). Actual oil prices have been much higher, so once again, rising terms of trade have pushed the GDP deflator well above CPI inflation, enabling the authorities to increase spending fairly rapidly without raising the expenditure-to-GDP ratio. The medium-term fiscal plan for 2007–2009, however, is based on more realistic assumptions (\$ 65/bbl [Urals] in 2006, \$ 61 in 2007 down to \$ 48/bbl in 2009). This points to an increase in the expenditure ratio in 2007 (Table 2.7), prolonging the fiscal stimulus. The budget surplus is projected to shrink rapidly, as the ratio of federal revenues to GDP decreases with oil prices. In 2006, the anticipated reduction in the federal budget surplus, despite a rise in oil prices, means that the non-oil fiscal balance is set to deteriorate further.

**Table 2.7. Medium-term budget plan (Federal budget, % GDP)**

	2004	2005	2006	2006	2007	2008	2009
			Budget law	Projected execution			
Revenues	20.5	23.7	20.7	22.6	22.3	19.8	19.3
Expenditures	16.1	16.2	17.5	16.1	17.5	17.3	17.1
Balance	4.4	7.5	3.2	6.5	4.8	2.6	2.2
Urals price (\$/bbl)	34.6	50.5	40.0	65.0	61.0	54.0	48.0

Source: Ministry of Economic Development and Trade.

The deterioration in the non-oil fiscal balance in 2006 partly reflects the decision to raise the cut-off price for the Stabilisation Fund – the oil-price threshold above which surplus revenues flow into the Fund – from \$ 20 to \$ 27 a barrel. This implies that a smaller share of oil revenues will be sterilised at any given oil price. Such a move may be justified if it reflects a well founded revision in the government's assessment of the long-run average price of oil. However, the resulting fiscal easing should not be executed in a short period but should rather be smoothed over the cycle in order to take account of current imbalances between demand and supply.<sup>10</sup> It is therefore important that the authorities stick to their commitment to maintain the cut-off price at its current level for 2007 and 2008. In that respect, the introduction of three-year budget planning is to be welcomed. However, the move to three-year planning, which is undoubtedly a step forward, will only bring real benefits, in terms of predictability, transparency and expenditure control, if Russia refrains from its recent practise of increasing fiscal spending *via* the regular adoption of amendments to be budget law during the course of the year.

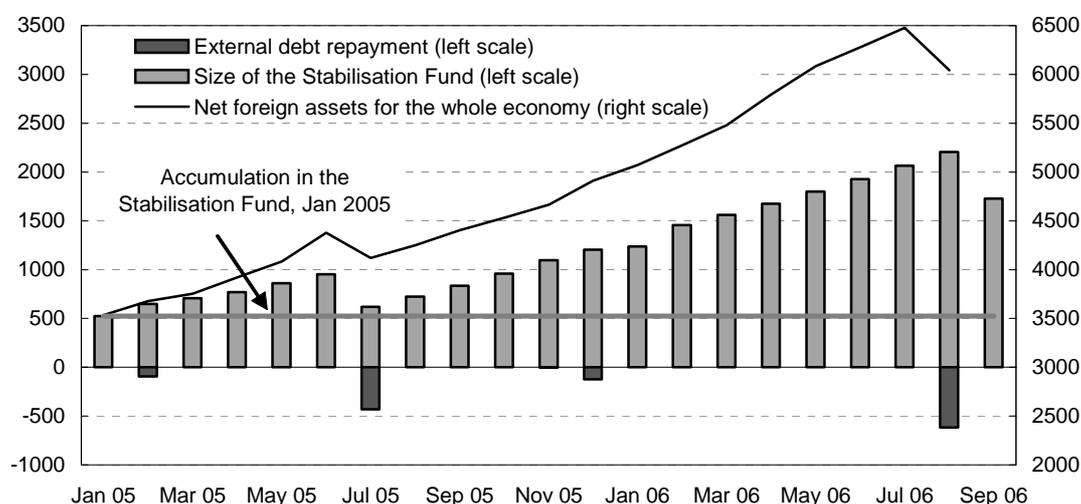
### ***Fiscal discipline is ever more important – and ever more challenging***

Given the CBR's limited room for manoeuvre, fiscal discipline must be seen as the key to managing imbalances between demand and supply and to reducing inflation while limiting the pace of rouble

appreciation. If the authorities choose to spend more of the commodity windfalls, they will have to accept a significantly faster rate of real appreciation and, if they wish to spend more while bringing down inflation, they will have to accept faster nominal appreciation as well.<sup>11</sup> To the extent that the Stabilisation Fund can capture, and thus “neutralise”, windfall income, the authorities can mitigate exchange-rate pressures without stimulating faster money-supply growth. Though created to insure the budget against fluctuations in oil prices, the Stabilisation Fund is also the most efficient instrument for curbing inflation. If over-reliance on monetary policy – and on the exchange rate channel, in particular – could prove risky in the event of a sudden drop in oil prices (a rapid nominal depreciation could trigger a surge in inflation), there is no such downside risk associated with the Stabilisation Fund. On the contrary, it could, in the event of a negative terms-of-trade shock, play a critical role in sustaining not only budgetary expenditure but also growth and exchange-rate stability.

The management of the Stabilisation Fund and the determination of the cut-off price should, of course, be seen as part of a broader fiscal framework, which determines the scope for fiscal sterilisation. The structure of the tax system is also critical, since the tax take can be adjusted upward or downward at any given oil price. Although estimates vary, it appears that the state captures about 84% of the marginal revenue from crude oil and oil products for each one-dollar increase in the price of Urals crude above \$ 25/bbl. It also captures about 42% of the additional income from natural gas exports for each additional dollar on the oil price.<sup>12</sup> This means that the windfall revenues pouring into the economy as a result of high oil prices are far larger than those being captured by the state. In other words, fiscal sterilisation would have to be significantly greater in order to neutralise completely the inflationary impact of higher oil prices. In 2005, around two-thirds of the *increase* in revenues from oil, gas and oil product exports was actually sterilised *via* the Stabilisation Fund.<sup>13</sup> Consequently, the volume of fiscal sterilisation was significantly smaller than the increase in net foreign assets (Figure 2.16).

**Figure 2.16. Growth of net foreign assets and of the Stabilisation Fund**  
RUB billion



Source: Central Bank of Russia, Ministry of Finance.

Oil and gas revenues are not the whole story. Export revenues have also been pushed up by rising prices for other major export commodities, particularly metals. While such commodities account for a far smaller share of export revenues than do hydrocarbons, rising prices for non-fuel exports create an additional sterilisation problem. According to EEG simulations, the windfall revenues from non-fuel products are far from negligible and account for roughly 15% of the Russian economy’s so-called “conjunctural income” (Gurvich 2006a).<sup>14</sup> The overall effective tax burden on non-fuel resource sectors is

lower than that on the oil and gas sector (and lower, indeed, than the effective tax burden on manufacturing),<sup>15</sup> and marginal tax rates on non-fuel exports are also lower, being roughly equal to the corporate profit tax rate (24%). As a result, the fiscal system largely fails to neutralise the windfall revenues arising from high non-fuel commodity prices. The EEG estimates that only 70% of total commodity windfalls are captured by the budget – far lower than the share of oil windfalls – and that just 47% of the total commodity windfalls are sterilised *via* the Stabilisation Fund (Gurvich, 2006b). A comprehensive policy of insulating the economy and the budget against commodity-price fluctuations should also address non-fuel commodity windfalls.

With fuel and metals prices expected to remain high, the pressure on fiscal policy is likely to be even greater in the short-to-medium run. From 2000 through 2006, successive federal budgets were based on very conservative oil-price assumptions, a practice that helped restrain the growth of spending in the absence of an expenditure rule. This has changed with the adoption of the revised medium-term fiscal plan: its oil-price assumptions might best be characterised as realistic – they are certainly not overly optimistic but neither are they conservative. This adjustment to oil-price assumptions creates scope for much faster increases in discretionary spending at a time when there is growing pressure for further large tax cuts or spending increases. Moreover, since there is no mechanism to prevent the rapid re-spending of Stabilisation Fund revenues above the RUB 500 billion “floor”, there is a real danger of substantial and rapid fiscal slippage, particularly if growth should flag in the run-up to the 2007–08 electoral cycle.

The risk here is not that fiscal sustainability would be put in question – unless there is a catastrophic drop in commodity prices or a truly spectacular increase in spending, the budget is unlikely to move into deficit. The risk is rather to macroeconomic balance: fiscal relaxation would stimulate consumption, which is already booming. At the same time, there is growing evidence that capacity constraints are already starting to affect industrial growth, raising doubts about the ability of domestic producers to respond to further domestic demand growth. Stimulating consumption in present circumstances would probably just add to inflationary pressures, accelerate real appreciation and fuel the growth of imports, aggravating “Dutch disease” pressures.

### ***The arrangements for managing the Stabilisation Fund need to be revised and elaborated***

This absence of legislative protection and clearly-defined rules governing the accumulation of assets in the Fund leads to endless debate and speculation concerning their use. Such speculation may even make exchange-rate management more difficult, since expectations that the government’s discipline will weaken tend, paradoxically, to reinforce pressure on the rouble to appreciate. There is thus an urgent need to revise the legislative framework governing the Stabilisation Fund in order to take account of the pressures arising from a period of sustained very high commodity prices. In addition to insuring the budget against oil-price fluctuations, the Fund can provide an effective mechanism for smoothing the effects of terms-of-trade shocks on the economy as a whole. It can also become an important source of investment income: to the extent that the accumulated windfalls exceed what is required to protect the budget, there is scope for investing some of the Fund in riskier but higher-yield assets.

The key priority should be to establish a clear fiscal rule that would further insulate the economy and the budget from commodity-price fluctuations. A first step might be to broaden the Fund’s revenue base. The current Stabilisation Fund framework is based on a relatively simple approach: the cut-off price reflects an (implicit) assumption about the long-run average price of Urals crude, and the structural balance corresponds to a constant-oil-price balance at the cut-off price. This arrangement means that a large share of commodity windfalls is not transferred into the Fund. Excess income from the export duties on oil products and natural gas is not captured by the Fund, nor are windfalls arising from exceptionally high prices for metals and other commodities. Moreover, one way to mitigate “Dutch disease” pressures and to foster diversification is to increase taxation of resource sectors (not only oil) while reducing general

taxation.<sup>16</sup> It should, however, be noted that expanding the range of commodities for which windfalls are captured in the Fund does not necessarily mean that the volume of sterilisation at a given price would be higher. The taxation profile could be adjusted so as to make the change revenue-neutral.

In the case of oil products and natural gas, earmarking surplus revenues is relatively easy, since there are sector-specific taxes and duties on which to rely, and it would certainly be desirable to channel excess income from these sources into the Fund. In other resource sectors, this would be more difficult, and trying to include them in the Fund's income base would probably be overly complicated. However, the authorities may nevertheless want to consider excess profit taxes or other measures aimed at capturing non-fuel resource windfalls without deterring investment in these sectors. Non-fuel resource sectors currently tend to have lower effective tax burdens even than manufacturing. It is not clear why this should be so or why they should capture windfalls arising from very high prices when – as in the fuel sector – the resources in the ground ultimately belong to the state.

As a second step, there should be a transparent procedure for assessing expected long-run oil prices and estimating the “conjunctural” or “windfall” income (or losses) arising from high (or low) prices, for purposes of defining the cut-off price for the Fund. While long-term historical averages are unlikely to yield very accurate estimates of future prices, any significant deviation from past long-term averages should be well founded. In any case, the methodology employed should take account of the fact that oil-price cycles can be very long. Making 15- or 20-year moving averages at least a part of the pricing formulae would ensure that the government's ability to raise spending as prices rose would increase only gradually and would also mean that the impact of falling prices fed through only gradually, making fiscal adjustments less painful and abrupt. In order to avoid excessive rigidity, it would be desirable to include a mechanism for revising the actual pricing formula or formulae, to allow the authorities to respond to major shifts in market conditions. However, like the pricing formula itself, any such mechanism should be limited, in order to avoid sudden increases in spending. While there is considerable scope for debate over the exact design of such mechanisms, the critical factors will be transparency and accountability: at every stage, the government should be clear about what it is doing and why, clearly signalling changes in its definitions, assessments and policy stances. This should make fiscal policy more predictable and thus enable other agents to operate with greater confidence over longer time horizons.

As a third step, the government might adopt clearer rules governing the use of Stabilisation Fund resources to cover shortfalls arising as a result of oil-price fluctuations. There are three specific problems here:

- At present, the law stipulates that a minimum of RUB 500 billion must be maintained in the Fund unless the oil-price drops below the cut-off price.<sup>17</sup> This minimum amount is not indexed to inflation or GDP growth. It was equivalent to roughly 3% of annual GDP when the Fund was created, but it represents only about 2% of expected 2006 GDP. It is far too small to absorb any sustained drop in oil prices to levels much below the new cut-off price of \$ 27/bbl, and, given current inflation and growth rates, it is likely to continue falling rapidly relative to GDP.<sup>18</sup> The minimum “floor” in the Fund should be raised substantially and indexed to nominal GDP.
- The legislation says nothing about how – or how fast – such funds are to be spent during periods of very low oil prices.<sup>19</sup> Rules governing the use of the fiscal reserve to stabilise the economy should be sufficiently tough to reinforce fiscal discipline, but they should also be sufficiently soft to be credible. Arrangements that impose an inflexible fiscal straitjacket on the government are more likely to be broken under strain than those that permit some flexibility.

- Sums accumulated in excess of the required minimum can currently be spent at the authorities' discretion. While the risk of volatility points to the need for some flexibility in the management of the Fund, this arrangement depends far too much on political will.

A fourth problem concerns the need for some adjustment of the Fund's goals. It is increasingly likely that the Fund already is – or soon will be – larger than is needed to insure the budget against an oil-price correction. This does not mean that it is time to start spending the Fund aggressively, but it does point to the need to change somewhat the way the Fund is managed. In particular, it would be appropriate to distinguish between two objectives for the Fund: ensuring macroeconomic stability by protecting the budget from commodity-price fluctuations and using windfalls *in a macroeconomically responsible way* to generate future income streams that could help cover structural deficits. The government is now working on measures to divide the fund into two parts along these lines. This approach could prove a promising way forward.

- A substantial portion of the Fund would continue to be earmarked purely for fiscal stabilisation. It should be invested abroad in highly liquid, low-risk instruments – preferably the kind of foreign government securities already authorised under the government decree on investing the Fund.<sup>20</sup> The fact that such investments generate relatively low yields should not be seen as a problem; security and liquidity are the crucial concerns.
- The rest of the Fund would be used to generate investment income and would be thus available for investment in a wider range of instruments than the “fiscal insurance” part of the Fund. However, any movement in this direction would need to be gradual, in order to limit the risk of large-scale mismanagement. It would probably, therefore, make sense to begin by transferring a relatively small portion of the Fund (perhaps 5%) onto a somewhat more liberal investment-management regime, with a view to gaining experience and capacity-building. Over time, this part of the Fund would grow and the range of instruments in which it could be invested would be liberalised. It will probably be some time before the authorities should consider investing any portion of it in Russian assets. In the first instance, it should be invested abroad.<sup>21</sup>

The income-generation portion of the fund would thus come to resemble the Norwegian Government Pension Fund more closely, since only the income from the Fund's investments would be transferred to the budget in order to finance current spending. However, wholesale adoption of the Norwegian model is probably not entirely appropriate for Russia. In Norway, all oil revenues are channelled into the Fund and only the investment income is available to cover the non-oil deficit. By contrast, the model described above would still leave a significant portion of current oil revenues available to the budget: only windfalls would be earmarked for the Fund.<sup>22</sup> The Russian budget is already heavily dependent on oil revenues, so any rapid transition to a “pure” Norwegian model would either involve a period of radical cuts in spending or large increases in non-oil taxation, neither of which would be desirable. What is critical is that the Russian budget's reliance on oil revenues should reflect a realistic assessment of long-run average prices and production trends. Moreover, the existing Stabilisation Fund arrangements should be taken into consideration: building on what exists is likely to be far less disruptive than trying to redesign the whole framework just two or three years after it was created. The difference here also reflects the fact that one of the main priorities of the Norwegian Fund is inter-generational equity: it aims to ensure that future generations also profit from the current exploitation of a non-renewable resource. This issue is less compelling in an emerging economy such as Russia's: there is good reason to expect that, given reasonable macroeconomic management, future generations of Russians should be substantially wealthier than the current generation.

It is macroeconomic balance, then, rather than inter-generational equity, which determines the rate at which Russia might prudently use its resource wealth to enhance living standards. Using current windfalls

to pump up consumption very rapidly would be very dangerous, as it would tend to drive up the exchange rate, suck in imports and, in the end, probably lead to slower growth. However, as long as the windfalls are managed in a macroeconomically responsible and transparent manner aimed at sustaining growth and investment, there is probably scope for greater expenditure sooner than an approach dominated by inter-generational equity concerns would allow.

### ***Management of the Stabilisation Fund should be based on an assessment of long-run sustainability***

The critical question which arises in light of the foregoing analysis concerns the optimal size of the “fiscal insurance” portion of the Fund and the basis on which the adequacy of fiscal insurance might be assessed. Reliance on the cut-off price has proven a simple and efficient mechanism for earmarking resources to be accumulated in the Fund allocation. However, this does not mean that an optimal fiscal policy should focus solely on such a constant-oil/commodity price balance when assessing fiscal sustainability. A broader set of indicators could and should be used as guidelines, such as the ratio of the non-oil fiscal balance to non-oil GDP or the ratio of expenditures to windfall-adjusted GDP (Gurvich 2006a). Such indicators try to assess the fiscal position with a complete neutralisation of the impact of shifts in oil and other commodity prices on the economy. Taking into account the non-renewable character of the resources in question, they offer a way to assess the optimality of fiscal policy in an intertemporal perspective (Barnett and Ossowski, 2003). In any case, the development and publication of such indicators could enhance the transparency of fiscal policy and strengthen the defence of fiscal prudence by making a clear distinction between structural changes in fiscal policy and revenue fluctuations resulting from commodity price movements.

These indicators, together with the debt position, could then contribute to the definition of a medium-term target for fiscal policy and a sustainable level for the structural (non-oil or non-commodity) deficit chosen as a benchmark. Such an assessment would also be of use in determining the minimum size of the “fiscal insurance” portion of the Fund. As noted above, the current minimum size represents only 2% of estimated GDP for 2006. Given that the standard deviation in oil price fluctuations over the past ten years reaches around \$ 11, the protected part of the Fund looks very small. A cautious approach would consist in raising this size to a level that would ensure the economy against a sharp drop below the cut-off price for a period of three to five years. This might imply a buffer of perhaps 10% of GDP.<sup>23</sup> Moreover, there should be some provision for revising the protected minimum upwards as and when the cut-off price rises – a higher cut-off price implies greater risk of actual prices falling below the cut-off price and thus a need for more insurance.

It should be stressed again that what matters is the basic fiscal rule, not the mechanisms used to operationalise it. The proposals put to the government by the Ministry of Finance at the end of August 2006 are therefore to be welcomed and merit serious attention. The ministry has proposed both division of the Stabilisation Fund similar to that outlined above and a methodology for calculating the non-oil fiscal balance – initially, perhaps, for analytical purposes, but with a view to making such calculations an important part of the budget process in due course. While the specific parameters of these proposals are still open to debate – the proposal to limit the spending of oil and gas revenues to 4% of GDP in any given year may prove to be too severe – but the overall approach is promising.

## NOTES

1. Empirical research finds that reducing the level and volatility of inflation is associated with reductions in poverty and inequality, especially in countries with high inflation. See, *e.g.*, Galli and van der Hoeven (2001); Easterly and Fischer (2001); and Powers (1995).
2. The constant-oil balance calculated here obviously depends on the long term-oil price taken as a reference. However, the fiscal stimulus or tightening, which is given by the *change* in the non-oil balance, does not depend on this choice.
3. The fiscal stimulus in 2002 was relatively large, but may have been justified by the slowdown in growth that year. During 2003–2005, around 80% of extra fiscal revenues from oil and gas were saved.
4. If exceptional Yukos-related revenues are counted as conjunctural income.
5. If the fiscal stance were computed as a share of non-oil GDP, the size of the stimulus would be even greater (as the share of the oil sector in nominal GDP is naturally increasing with dramatic oil price increases).
6. In other words, if they are treated as a one-off, like the proceeds from a large privatisation deal.
7. Dramatic terms-of-trade gains mean that the GDP deflator has in recent years been far greater than CPI inflation. As a result, a large real-terms increase in spending (i.e. adjusted for CPI inflation) does not necessarily push the expenditure-to-GDP ratio up.
8. See Kudrin (2006).
9. Domestic public debt is also very low, reaching around 3.9% of GDP at end-2005.
10. This is particularly the case given the magnitude of the increase: a \$ 7 per barrel rise in the cut-off price increases budget revenues by around 1.7% of 2005 GDP.
11. For a detailed discussion of the trade-offs involved, see Gurvich (2006c).
12. See Gurvich (2006a); and Ahrend and Tompson (2006).
13. Oil revenues increased by \$ 50 billion in 2005, while the Stabilisation Fund either accumulated or neutralised (*via* early debt repayment) \$ 33 billion more than in 2004.
14. Estimated here on the basis of a constant real-dollar price for major non-fuel commodities and a medium-term reference price of oil of \$ 23/bbl.
15. See the estimates in Vasil'eva and Gurvich (2005).
16. See OECD (2004:63–4). In particular, reducing direct taxation of producers could help to offset the effect of “Dutch disease” pressures; see Gianella and Tompson (2005).
17. This minimum was meant to insure the budget against two years of revenue losses in the event of a drop in oil prices from \$ 20 to \$ 15 (that is only \$ 5 below the initial cut-off price).
18. By at least 15% per year (and even more if terms of trade continue to improve).

19. For example, it is not clear if only the revenue shortfalls from the designated oil-sector taxes that finance the Stabilisation Fund would be made up or if the authorities could tap the Fund to *increase* spending in an effort to administer a fiscal stimulus.
20. Investment of the Stabilisation Fund into AAA governments bonds issued by euro-area countries, the United States and the United Kingdom began in the summer of 2006.
21. Some portion of the income-generation fund might eventually be invested in Russia itself, where returns would probably be higher than in more developed economies. However, the scope for investing the fund domestically would be limited by the economy's absorption capacity and the need to ensure that the fund continued to play a role in insulating the economy from terms-of-trade fluctuations. Moreover, particular care would need to be taken to prevent corruption and to ensure that such investments were taken on sound commercial grounds rather than in response to lobby pressures; the governance risks associated with such investment are such that it would be preferable to invest the fund abroad for some time to come. It would probably also be advisable also to refrain from investing in the securities issued by state-owned companies.
22. The Russian model would also tend to insulate the economy from commodity-price movements somewhat less than the Norwegian arrangement.
23. Finance Minister Aleksei Kudrin has spoken of a buffer of 7–10% of GDP; *Moscow Times*, 14 September 2006.

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