



Renaissance
Capital

The Russian Sovereign Funds

A Hidden Quantitative Easing

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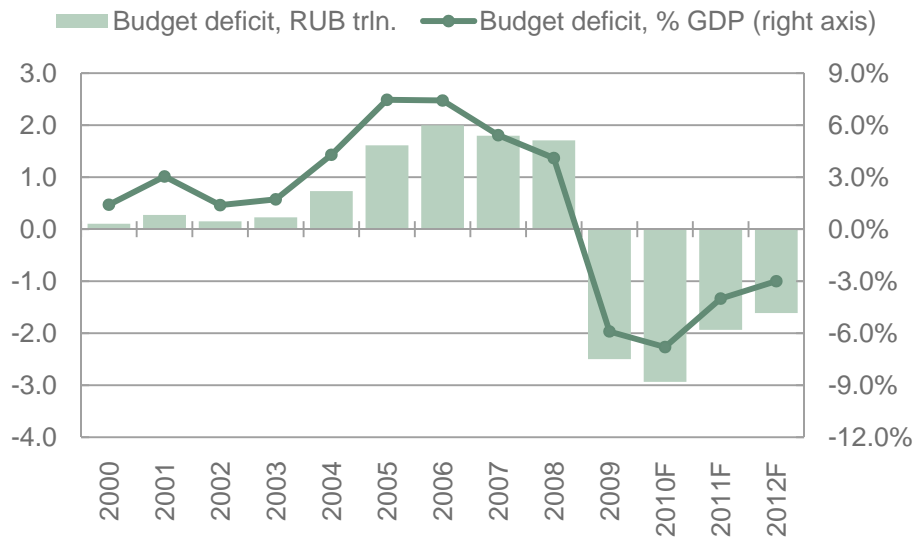
*Edinburgh
June 2010*

- Russian Budget Code officially separates oil-and-gas revenues from non-oil-and-gas ones. Ministry of Finance are keen to secure part of those revenues for the future – for a number of reasons
- Oil-and-gas revenues comprised of the mineral extraction tax (on oil and gas) and export duties (on oil, gas and oil products). Oil-and-gas budget revenues go directly to the oil-and-gas transfer and their excess to sovereign funds.
- Oil-and-gas transfer is aimed at financing non-oil-and-gas budget deficit and is set at no more than 3.7% of projected GDP.
- Excess revenues flow into Reserve fund which maximum value in the year is set at 10% of projected GDP when execution of oil-and-gas transfer is completed. The purpose of the Reserve fund is to finance non-oil-and-gas deficit when oil-and-gas transfer is not enough for that.
- Excess revenues flow into National Welfare Fund when maximum value of Reserve fund is reached. National Welfare Fund is to provide co-financing to bail out the pension system and to balance the budget deficit.
- However, according to the last version of the Budget Code, Russian government is not going to accumulate oil-and-gas transfer and to transfer revenues to sovereign funds till 2013.

The Budget – Not As Bad As The Government Promised

- Official estimate of 2009 budget deficit came out at 5.9% of GDP and appeared to be significantly below initial estimates of 8.5-9.0% of GDP. Budget deficit in nominal terms reached RUB2.5trln and almost all of planned expenditures were executed
- Budget deficit in 2010 is officially estimated at 6.8% GDP. It is unlikely to materialize due to higher economic growth (4.2% vs 3.0% in optimistic government scenario) and favorable commodity market environment (average YtD Urals oil price \$76/bbl vs initially assumed \$58/bbl)

The Budget: Ministry of Finance's Plan



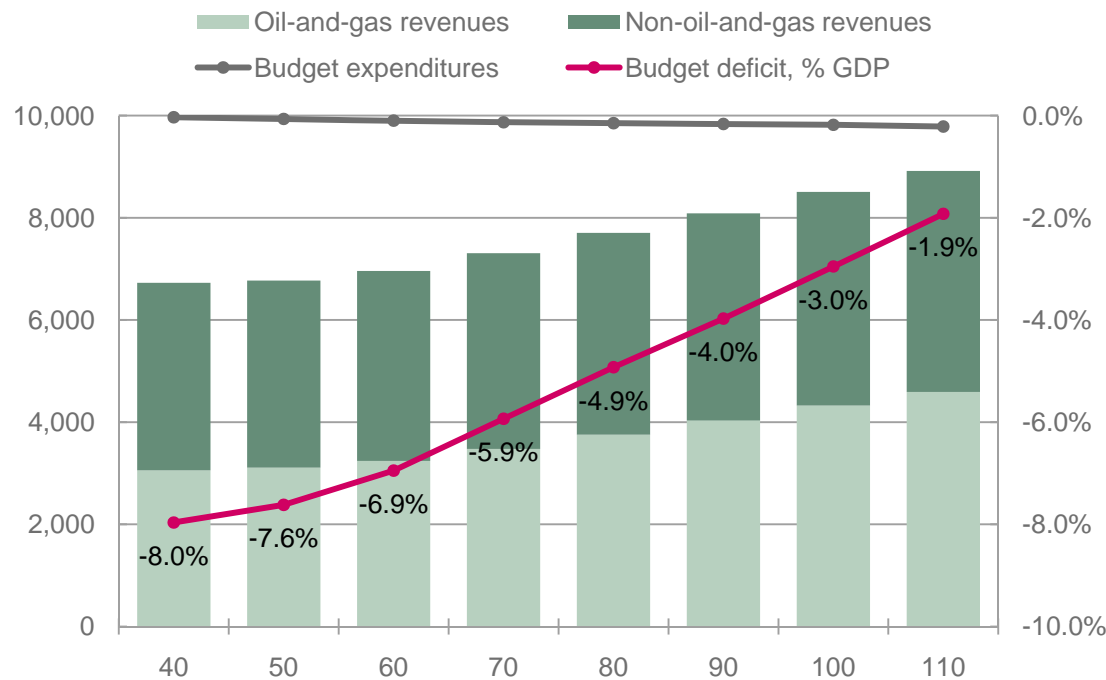
Monthly budget deficit in 2009-10



The Budget – So Where Does It Balance?

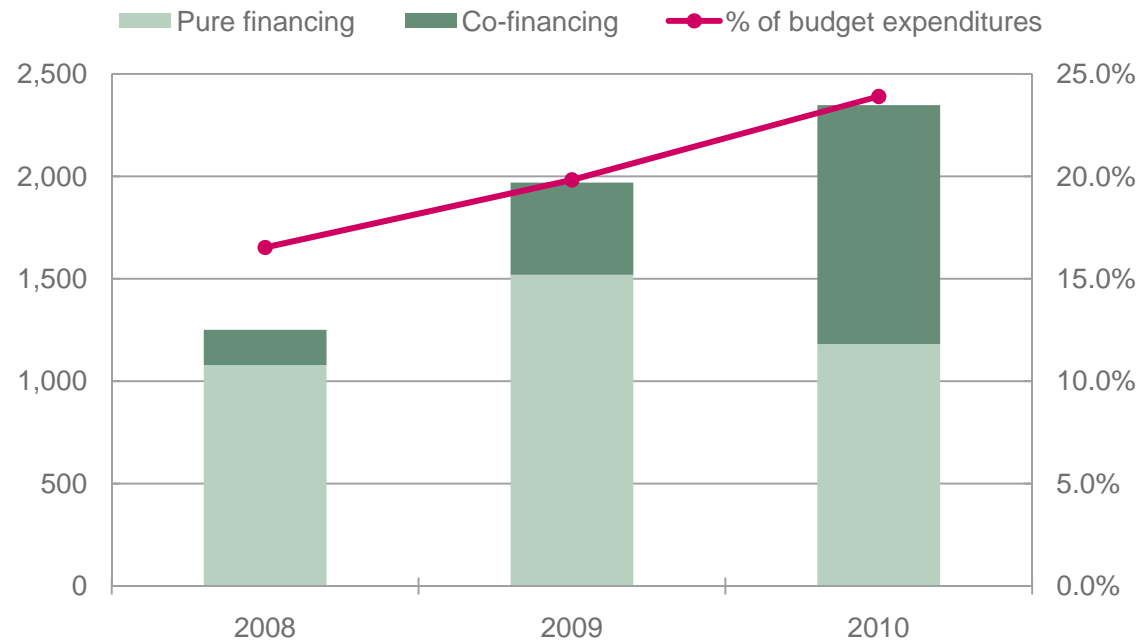
- We agree with Mr Kudrin – unless last year's spending hikes are rolled back, which is not very likely, the budget will only balance at Urals near \$100/bbl
- To run an acceptable level of the deficit at below 3% of GDP, oil prices in 2010 need to be above \$90/bbl
- The good news is that the spending targets are unlikely to be fulfilled and the actual deficit will likely be lower

RenCap forecast of the federal budget in 2010, RUB bn



Pension fund financing

- One of the major sources of the budget deficit is financing the Pension Fund deficit, which has increased markedly in recent years as the government exercised what it calls “socially-responsible policy”
- The reform has stalled, and the only thing the government has done was throwing away those contributors, who are better-off



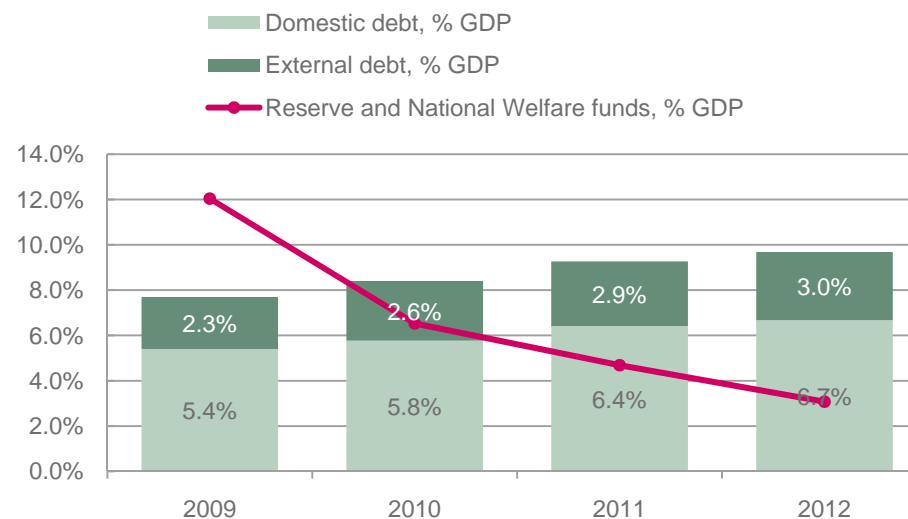
So are we up to a budget crisis?

- Higher economic growth and favorable commodity market environment are likely to support Russia's budget. Hence, deficit is expected to materialize at 5.9% of GDP in 2010
- Recent Alexey Kudrin's comments suggest more efficiency in government expenditures and we expect significant budget sequestrations in coming years. We estimate that deficit reaches acceptable level of 3% of GDP as early as in 2011
- Massive borrowing programs in 2010-12 are unlikely to have material effect on sovereign debt position. Moreover, government may have enough reserve funds to cover the deficit in 2013
- What next, depends on timing. Now Russia no longer has a scope for the budget maneuver. If good times last longer than 5-7 years, it will regain it

Budget deficit forecasts, % GDP



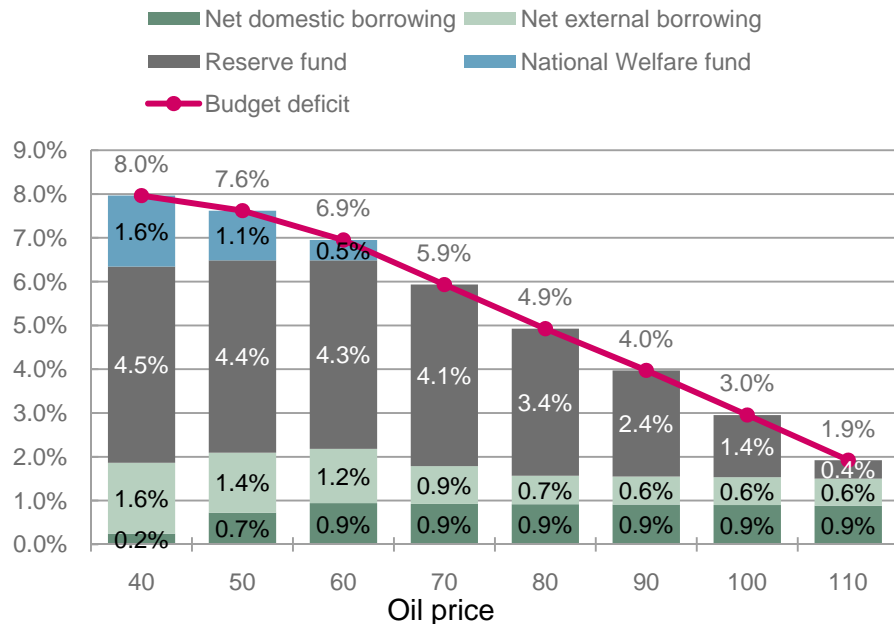
Russia's sovereign debt



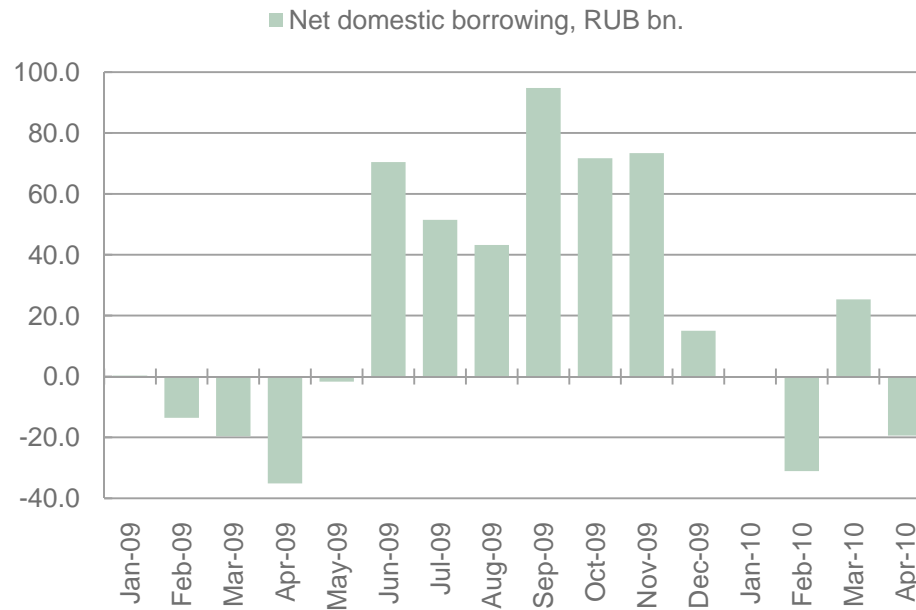
The Budget Deficit – How To Finance?

- The government uses the Reserve Fund as the financing of choice
- Government will borrow domestically as much as it can, but below the target levels as YtD borrowing is negative
- However, if oil prices average in 2010 below USD 65/bbl for Urals, National Welfare Fund will be tapped.
- Minfin has already placed Eurobonds for USD 5.5bn. External funds will be drawn up to the earmarked limit if oil price falls below \$50/bbl

Financing sources for budget deficit in 2010



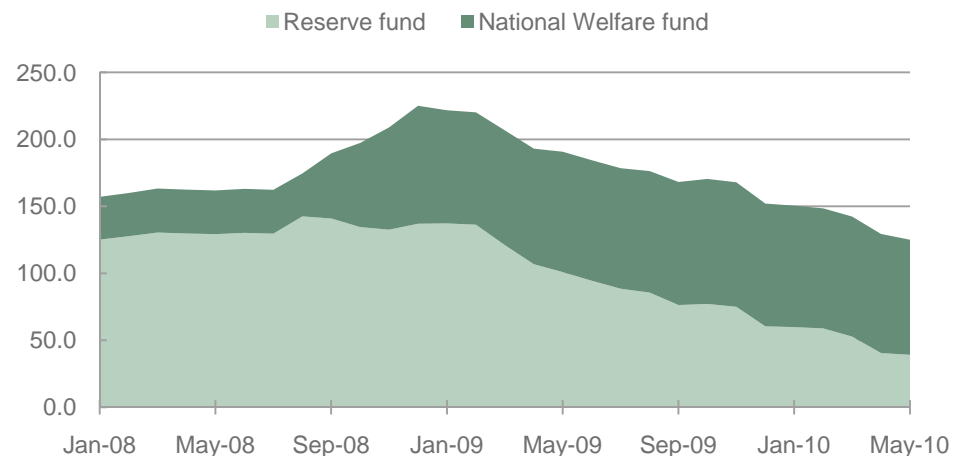
Monthly net domestic borrowing



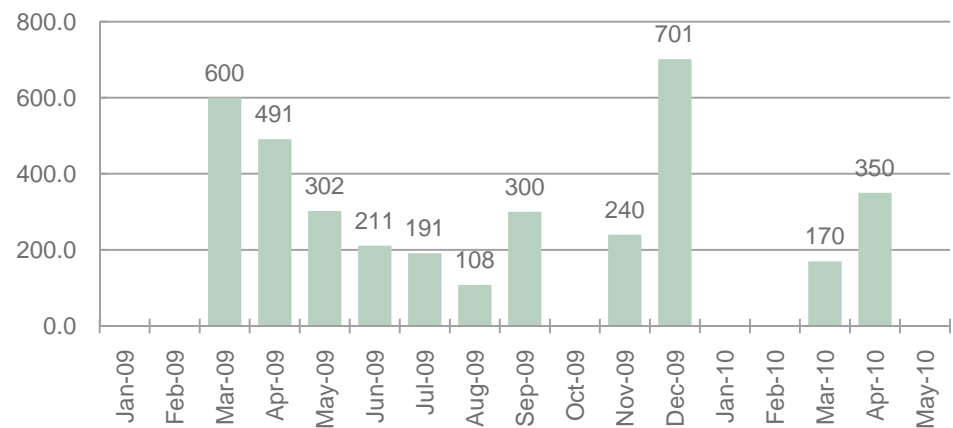
Russia's sovereign funds: a cow to milk?

- **Reserve fund – main financing source.** Since the crisis began, Reserve fund has become the major financing source for federal budget deficit. Ministry of Finance received RUB3.1trln in order to fill the budget gap and cover debt redemptions in 2009.
- Despite fast spending of Reserve fund in 2009, we estimate that it is unlikely to be exhausted by the end of 2009. Moreover, Russian government will have **enough funds to cover its budget gap beyond 2012.**
- **National Welfare fund still remains a “sacred cow”.** Russian government didn't tap it and considers to use it in the future either in case of emergent deficit needs or co-finance pension system when new demographic wave comes. For the first time in history, Ministry of Finance transferred RUB2bn in April '10 in order to co-finance pension payments.

Russia's sovereign funds



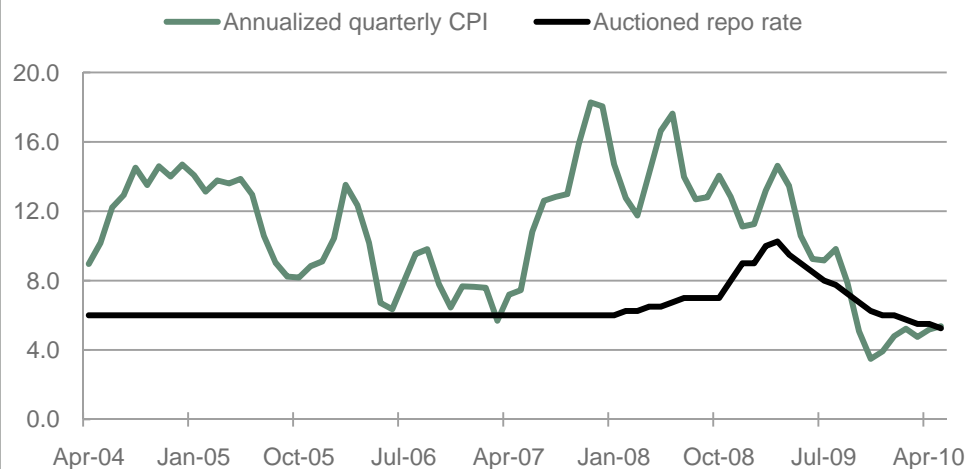
Transfers from Reserve fund to the federal budget



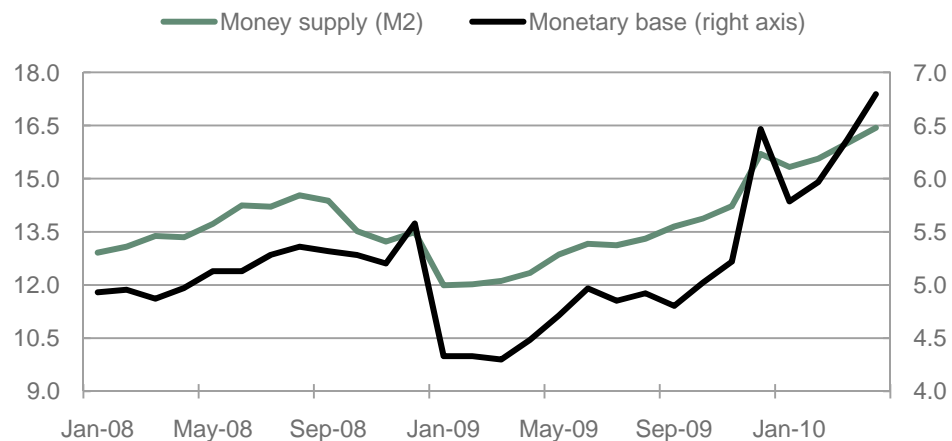
Spending reserve fund adds to fiscal pressures

- **Real rates high but nominal at record lows.**
Russia has turned into positive real rate environment in the end of 2009 while the potential for further rate cuts remain at 75-100 bpts
- **Money herding.** On the one hand, money multiplier is above pre-crisis levels in recent months as a result of abundant money supply. On the other hand, money velocity falls reflecting excessive money supply growth without effect on economic growth

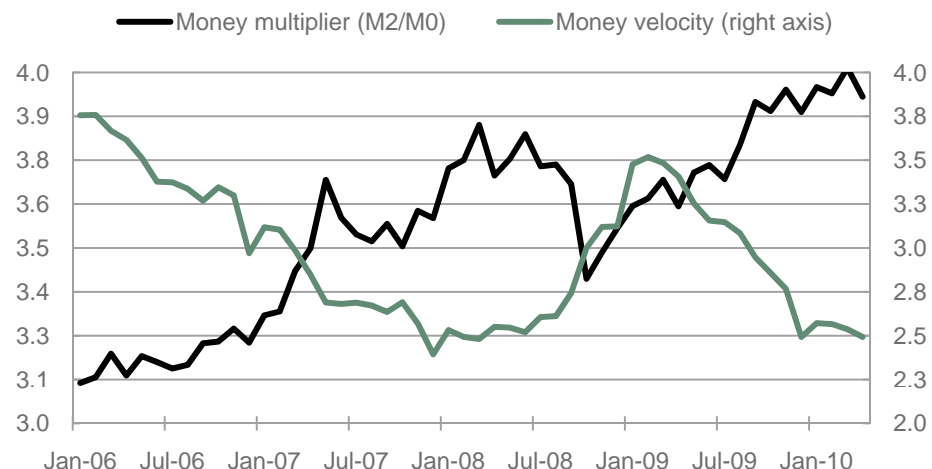
Nominal interest rates and consumer inflation in Russia



Monetary base and money supply



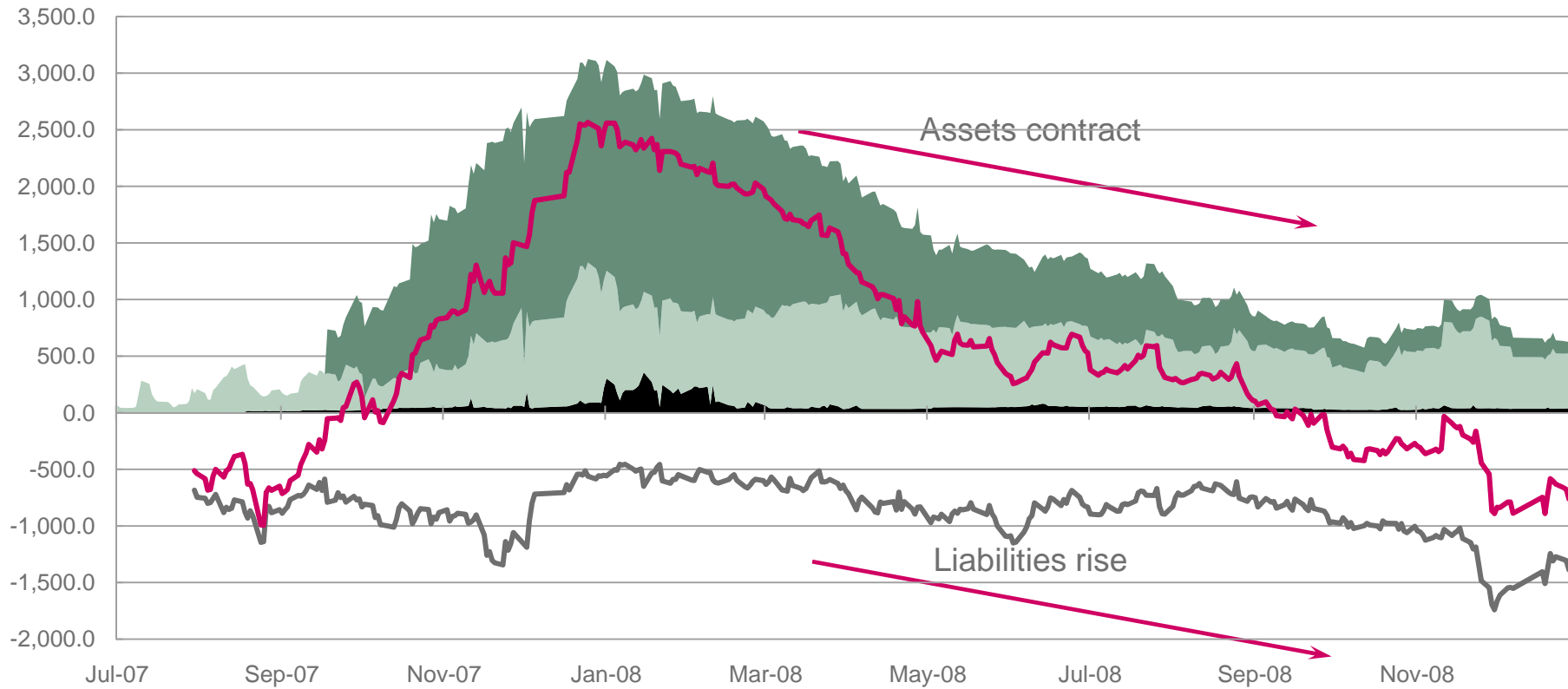
Money multiplier and velocity



Money herding – full evidence

Bank of Russia balance sheet

- Overnight, lombard and fixed repo lending
- Auctioned repo and other lending
- Uncollateralised lending
- Correspondent accounts, bank deposits and OBR
- Net balance



We expect liquidity pressures to continue to build

- As is demonstrated above, BoP and budget financing will remain core sources of liquidity inflow.
- This will eventually result in a pick up of consumer and investment spending, but only over time
- In the meanwhile, we expect all these funds to be a fuel for new bubbles in the securities and real estate bubbles

