

# **S** o v e r e i g n **W** e a l t h **F** u n d s

**New challenges  
for the Caspian countries**

# Sovereign Wealth Funds:

## New challenges for the Caspian countries

### Summary

This book considers financial management and transparency aspects of Sovereign Wealth Funds (SWF). It also discusses the impact of the global financial meltdown (2008-2009), commodity price fluctuations and the rise of the risks in the emerging world on SWFs financial performance and their investment activities. The book particularly concentrates on Caspian Basin countries (Azerbaijan, Russia, and Kazakhstan) plus Norway as explanatory case studies.



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## **Acronyms**

EITI	Extractive Industries Transparency Initiative
GAPP	Generally Accepted Principles and Practices
GDP	Gross Domestic Product
IFI	International Financial Institutions
IMF	International Monetary Fund
NASDAQ	National Association of Securities Dealers Automated Quotations
NGOs	Non-governmental Organizations
NGPF	Norwegian Government Pension Fund
OECD	The Organization for Economic Cooperation and Development
SOFAZ	State Oil Fund of Azerbaijan Republic
SWF	Sovereign Wealth Funds
USD	United States Dollar
US/G7	United States Group Seven

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## Content

Foreword .....	4
Sovereign Wealth Funds as the emerging players in the global financial arena: characteristics, risks and governance .....	6
Governance, transparency and accountability in Sovereign Wealth Funds: remarks on the assessment, rankings and benchmarks to date .....	47
State Oil Fund of Azerbaijan Republic: Past, present and future .....	73
The National Fund of the Republic of Kazakhstan (NFRK): From stress-test to global future.....	100
Russian Sovereign Wealth Funds .....	130
About authors .....	159

## Foreword

Over the past decade, the boom in commodity prices, global imbalances between savings and investment in major countries and the massive accumulation of foreign exchange reserves have resulted in the rise of Sovereign Wealth Funds (SWF) as major forces on international financial markets and the global economy. In 2011, according to the SWF Institute, the largest Sovereign Wealth Funds manage well over \$4 trillion in assets. The growing influence of SWFs has far-reaching consequences for both host and sponsoring countries. On the one hand, SWFs can play a positive role by financing development projects and serving as an instrument to shield economies against shocks. On the other hand, the economic weight of SWFs may hamper the implementation of effective macroeconomic policies and create additional opportunities for corruption in the sponsoring countries. Furthermore, the economic reach of SWFs engenders concerns about the potential destabilization of financial markets in host countries. Some Western governments are also concerned about transparency and politically motivated investments of SWFs. To address these issues, the International Monetary Fund, jointly with the International Working Group of SWFs, developed voluntary guidelines for the operations of SWFs in 2008. These principles, known as the Santiago Principles, were adopted by many SWFs, enhancing their overall credibility and strengthening transparency of SWF activities.

The recent global financial crisis of 2008-09 elevated the importance of SWFs and temporarily shifted the focus of SWFs from long term investment issues to short-term economic stabilization. SWFs have helped to stabilize economies in a various countries such as Chile, Kazakhstan and Russia; and in some instances provided liquidity to troubled Western financial institutions. SWFs also experienced significant financial losses during the crisis which forced them to re-evaluate their investment strategies. The lessons from the crisis stress the need for strengthening risk management, financial regulation and achieving greater transparency. Specifically, SWFs tend to be more successful if their operations are integrated into the national development goals of their sponsoring governments. In addition, it is important for SWFs to provide adequate information to all stakeholders (particularly citizens, civil society groups and the media) and be accountable to public oversight bodies (national parliaments and supreme audit institutions).

This volume advances our understanding of SWFs by presenting a critical analysis of resource-based SWFs in Azerbaijan, Kazakhstan and Russia. Based upon compelling evidence, this volume makes a strong case for the significance of transparency and accountability in strengthening the performance of SWFs. Most importantly, this volume discusses activities of SWFs from the perspective of nations that established these funds. The present volume pushes the boundaries of public oversight over resource revenue management by demonstrating that the Santiago Principles are insufficient to ensure full transparency and accountability

of SWFs. While SWFs in the Caspian region enabled the countries to weather the global financial crisis, their investment choices have failed to promote long-term development in countries that created these funds. Moreover, the volume critically reviews the existing methodologies of assessing performance of SWFs and proposes new criteria for evaluating performance of SWFs.

This volume provides a valuable resource for anyone interested in assessing the recent performance of SWFs in the Caspian region.

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# **Sovereign Wealth Funds as the emerging players in the global financial arena: characteristics, risks and governance**

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## **1. Introduction**

Since 1997 the world's markets have been experiencing the toughest financial crisis since the 1930s. The financial architecture that was considered to be the basis of the economic welfare of the world is collapsing. Under this crisis saving commodity windfalls in several resource-rich countries has mitigated the impact of commodity price volatility while it has helped several countries to smooth the impact of the ongoing financial crisis. The debate around the "invasive" nature of the Sovereign Wealth Funds has been growing prior to the emergence of the financial crisis being very much a US/G7 concern focusing on the risk of having opaque state controlled foreign investment vehicles possibly taking over strategic economic interests in developed economies. Nevertheless, this has not proved to be the case in the G7 countries where the drying up of investments has added a new shift to the ongoing debate. Developed countries are reconsidering the role and the investment operations of the Sovereign Wealth Funds, looking at possible investments from the latter into developed economies. In this reality the need becomes apparent for a thorough and profound understanding and discussion on the governance of the Sovereign Wealth Funds at the domestic level, on the accountability of the saving and the spending decisions to the citizens and on the role of the legislative bodies in overseeing the management of the Sovereign Wealth Funds. Furthermore, the economic implications of investing windfall gains abroad also have to be clarified. While this does shelter resource-abundant countries from commodity price volatility, it does little to change the structure of the economy and to sustain a public investment strategy aimed at increasing human development and long-term sustainable sources of growth inside the respective domestic economies. In the presence of the ongoing financial crisis, financial liquidity constraints may force even those countries that have been successful so far to resort to this type of investment. Besides, the fact that these assets are possessed by economically unstable and politically unpredictable countries causes serious concerns by the world community.

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The nature of the investment policy of the Sovereign Wealth Funds substantially changes during (and possibly after) financial turmoil. If previously the primary goal of the Sovereign Wealth Funds was considered to be the transparency of windfall funds and their preferable management abroad, at the present and in the case of the exigency to stimulate the economy in natural-resource-rich countries, the management of these assets domestically becomes an imperative. This in its turn can darken the actual evaluation of the government on the withdrawal of the country out of the crisis and worsen the problem of ensuring the accountability of public finance management, thus increasing unlimited transfers and bailout plans. Thus, the ongoing crisis considerably changes the role and the philosophy of the Sovereign Wealth Funds and it introduces the need for a thorough understanding of these institutions. **The most important impediment to the understanding of the Sovereign Wealth Fund remains the absence of the precise institutional as well as procedural limitations capable of decreasing the government's appetite to waste financial funds within the respective economy.** The absence of such limitations creates a self-willed atmosphere on fund spending, consequently misbalancing the financial structure and establishing deep inflationary conditions in the domestic economies. In other words, the absence of limitations on transfers from the Sovereign Wealth Funds to the state budget leads to adverse impacts for macroeconomic equilibrium and has comprehensive socio-economic consequences such as rent-seeking effects, social inequality, ineffective decision making and emergence of economic authoritarian governance.

Taking the above into consideration, the immediate need becomes clear for a careful investigation and clarification of the role of the Sovereign Wealth Funds, of their nature and operational aspects, of the determinants of their investment strategies and the interaction of the latter with the recipient countries. All of the latter cannot be assessed without looking at governance aspects of the Sovereign Wealth Funds and without setting some generally accepted quality norms and interaction levels with the general public and other economic and political settings. For this purpose the present paper develops as follows: Section 1 develops the argument of how the changing global financial balances and the emergence of the Sovereign Wealth Funds as key players in the financial arena urge for a deep understanding of the nature and the role of the Sovereign Wealth Funds. In an attempt to address this challenge this section details some definitive operational and governance aspects of the funds, offering some comprehensive categorization of the latter. Section 2 looks into the risk types that Sovereign Wealth Funds may be faced with while it further investigates the absorptive capacity of the domestic economies and the transparency levels experienced in Sovereign Wealth Funds. Section 3 looks into governance developments of the Sovereign Wealth Funds, identifying the determinants of good governance and the different parties involved in the evolution and the establishment of the latter. The last section draws conclusions.

## **2. Sovereign Wealth Funds: A crucial element of the world economy**

Global imbalances deriving from large current account deficits in major economies like that of the USA and counterbalancing large surpluses in Asian and oil-producing countries have attracted significant attention. These have boosted the foreign reserves of many surplus countries clearly beyond levels seen as necessary for securing their international liquidity. Decision-makers in the surplus countries are seeking to increase the return on their “excess” reserves by managing their foreign reserves more actively. For this purpose, they have established special Sovereign Wealth Funds (hereafter SWFs), with many of them injecting significant amounts of capital into major Western financial organizations. Despite the fact that this flow of finance is welcomed by the organizations hit by the financial crisis and it is good for market stability, concerns have been raised in the United States and Europe about the nature and the intentions of the SWFs.

SWFs’ design, establishment, operation and investment management and allocation are receiving an increasing amount of interest on national as well as international levels. The relatively new and unclear operations of the SWFs urge greater investigation and clarification of the nature of the SWFs as well as of their importance to and interaction with international financial markets. The exploration of SWFs emerges as of primary importance when considering the ongoing financial crisis, where the SWFs emerge as key players in the international financial arena. **Understanding the nature of the SWFs remains particularly important especially after considering the high degree of misconception, confusion and consequent skepticism around the SWFs.** Much of the interest in the SWFs is related to political considerations such as the reintroduction of the failures of public ownership into market economies by the back door where SWFs serve as the moving instrument, whether SWFs use their ownership rights to pursue political goals or whether resistance to foreign ownership emerges as a new form of protectionism. Further concerns related to the SWFs regard economic outcomes such as the relationship of the SWFs to the imbalances in the world economy, how they are affecting financial markets and the policy implications of their growth<sup>1</sup>.

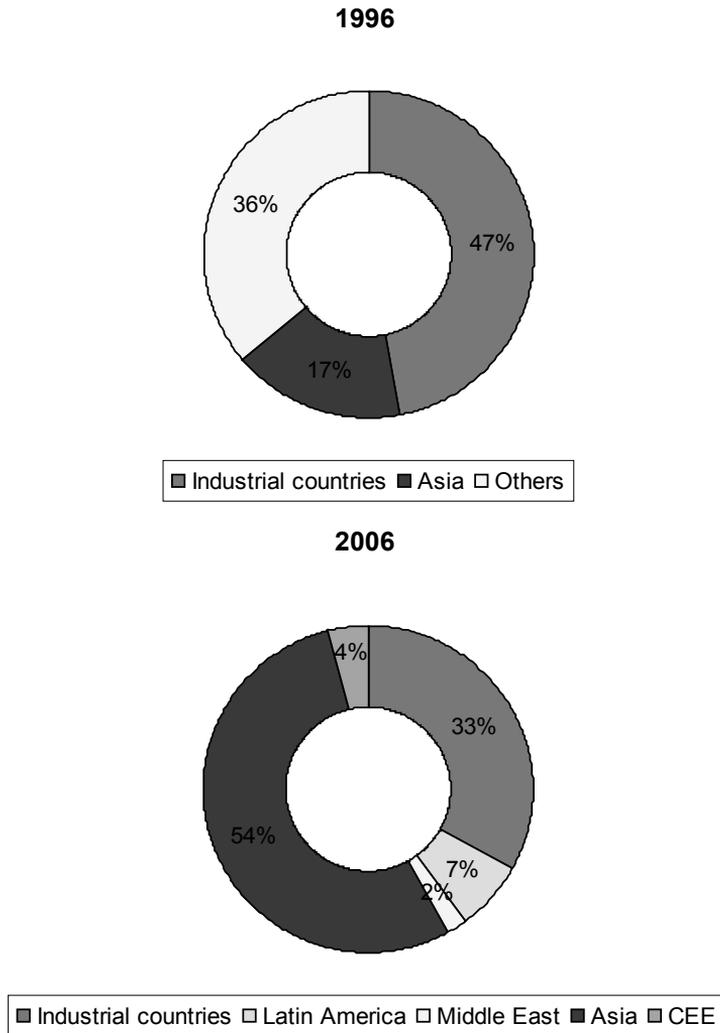
In the current global financial developments SWFs are perceived to represent a permanent re-direction in investment flows and a shift in the dominant sources of financial capital. To date, global financial operations were dominated by Anglo-American financial institutions but recent developments suggest increasing capital flows from emerging to mature economies. In these flows SWFs imply a redistribution of financial and political capital throughout the world. In this reality the presence of a blurring line between finance and politics raises concerns that SWFs will be used illegitimately to advance political, as opposed to commercial, agendas. In many cases SWFs may even be seen as the source of a new “state

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1 Rautava (2008), Gieve (2008), Raphaeli and Gersten (2008)

financial capitalism” raising questions on whether the introduction of public investors into private markets will do for efficiency. Furthermore SWFs investments may be regarded as potentially disguising attempts by foreign governments to obtain technology and expertise benefiting national strategic interests.

**Figure 1. Regional distributions of official reserves in 1996 and 2006  
(official reserves in % of world total)<sup>2</sup>**



<sup>2</sup> Source: Kern (2007), Sovereign Wealth SWFs Institute

In all cases, SWFs are a new source of political intrigue and concern emerging for many as one of the hottest topics in global financial markets. In any respect, SWFs are reshaping the economic and political landscape. Although concerns about emerging market investors are not novel, SWFs do appear to have attracted special attention from policymakers. Explorations of the latter have resulted in new policy proposals for dealing with SWFs being at various stages of consideration and implementation (for example, the U.S. has created a SWF task force to consider its options, Australia and Germany have implemented new rules targeting SWFs, and the International Working Group of Sovereign Wealth Funds has developed a series of voluntary 'generally accepted principles and practices'- known as GAPP or the 'Santiago Principles')<sup>3</sup>.

When taking these later developments into consideration, it becomes clear that in order to understand the urgency of SWFs' exploration a clear definition of such funds should be derived. The consideration of the aspects that lead to the composition of the definition of SWFs can provide a first indication of the crucial urgency of the SWF topic indicating why SWFs have become, and will continue to emerge as, key players in the world economy.

## **2.1. Understanding SWFs: Definitions, nature, financial and regional features**

**A general definition of SWFs would state that SWFs are government owned investment funds operating in private financial markets.** Recent interest in SWFs has failed to come to a consensus as to how SWFs differ from other public investment funds and how they should be defined. Indeed, SWFs differ in ownership, underlying assets, degree of dependence, operational aspects, etc. From the existing SWFs, some are funded from fiscal surpluses or foreign exchange reserves, while others are funded from borrowings from the market. Of the existing SWFs, almost half operate as separate legal entities, while the rest consist of a dependent entity within the Ministry of Finance or the Central Bank of the relevant country. Finally, the SWFs themselves declare various objectives ranging from fiscal stabilization to general savings for future generations to covering expected future pension expenditures. Thus it becomes clear that SWFs vary in nature, operations and ownership, not permitting the crystallization of a clear image of these establishments.

In this reality it remains relevant to identify any commonalities among SWFs that could serve as the basis of an SWF definition. In this direction the following questions can be named as crucial<sup>4</sup>:

- ***Who owns the SWF?***

An overview of the existing SWFs reveals that governments, at central or at sub-national levels, may own the SWFs and exercise control directly or

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3 International Working Group of SWFs (2008), Pihlman (2009)

4 For a detailed discussion see Monk (2009), Das et al (2009), Bartsch (2006), Coper (2007), Eifer et al (2002), Fasano (2000), Friends of Earth (2002), Tsalik (2003), Bacon and Tordo (2006), Goldsmith (2001)

indirectly through the appointment of the SWF board. In this respect SWFs are a meeting point of high politics with high finance; therefore the understanding, the exploration and the observation of the latter remains crucial.

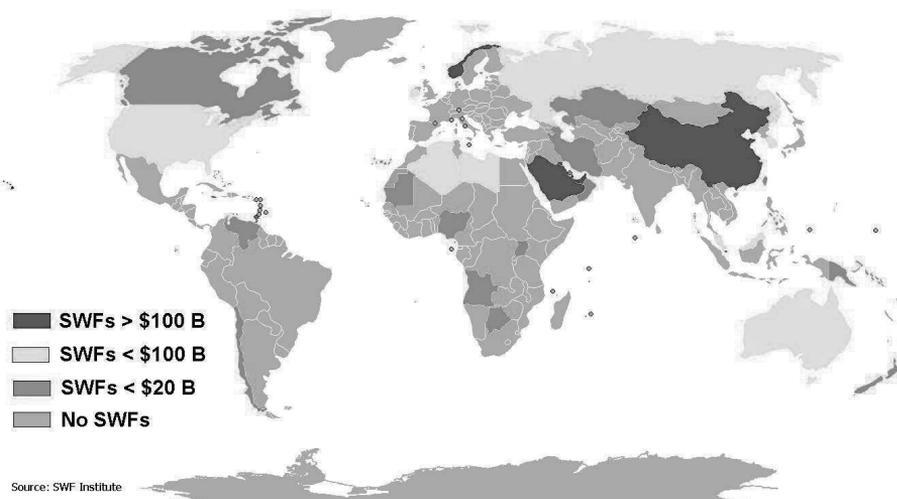
- ***What are the liabilities of the SWF?***

When considering this question the interesting finding is that SWFs have no direct liabilities. Several SWFs have liabilities, such as sterilization debt or some deferred contractual liability to transfer money out of the fund and into the general budget or a social security system. Nevertheless, it appears that SWFs have no non-governmental or outside liabilities. For those funds that do have a liability, it is typically intra-governmental, with one branch of the government owing money to another branch of the government (i.e. the fund may owe to the Ministry of Finance, the Central Bank or the social security reserve funds). SWFs have no external creditor, hence accumulated assets are not subject to outside non-governmental owners property rights. Therefore any existing fund liabilities are part of the broader national balance sheet.

- ***Who benefits from the SWF?***

Despite certain explicit goals (e.g. financing future pension payment requirements), SWFs are managed according to the interests and objectives of the government and/or the sovereign. The final beneficiary of a SWF is not a specific individual, but rather it remains the government, the host country's citizens or the taxpayer in general.

**Figure 2. World map of SWFs and respective SWFs volume**



Considering the answers to the above questions, SWFs can also be defined in more detail as directly or indirectly government-owned and controlled investment SWFs with no outside beneficiaries or liabilities involved in asset investments in the short or long term, according to the interests and the objectives of the sovereign sponsor. In other words, SWFs can be considered government-owned special purpose investment SWFs or arrangements. Serving further macroeconomic purposes of the government, SWFs hold, manage and/or administer assets with financial objectives, developing a set of investment strategies. The latter may also include investments in foreign assets. Investment strategies in any case exclude, among other elements, foreign currency reserve assets held by the monetary authorities for the traditional balance of payments or monetary policy purposes, state-owned enterprises in the traditional sense, government-employee pension funds, or assets managed for the benefit of individuals. **SWFs are commonly established out of a balance of payment surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports.** While SWF is an all-encompassing term, it describes a group of heterogeneous funds existing and operating for years. What remains common to the group of these funds is the public ownership and the fact that these funds are often established to meet a macroeconomic purpose, though these purposes may at times be multiple in nature (e.g. savings and fiscal stabilization). In general SWFs have the capacity to operate over a long-term investment horizon, hence they are usually less risk averse than agencies managing traditional foreign exchange reserves.

Typically, SWF establishment follows commodity price booms, while more recently SWF establishment has followed large export booms like in the case of China. Following immense accumulation of international assets, policymakers in most of the empirical cases have set up a number of objectives considered as “optimal.” When taking this into consideration the presence and the operation of an SWF is primarily linked to whether the country has an “adequate” or “optimal” level of international reserves. Even if the level is “ample” enough, policymakers should decide whether they will use SWF assets to meet the balance of payment needs. In this respect a fund’s presence and operation are also related to whether there exist better alternatives to setting up a SWF. Once an SWF is established, policymakers have to decide on a number of operational questions ensuring that the fund is consistent with its broad policy objectives. In this reality, the identification of the operational objectives is needed in order to derive an appropriate investment policy that will envisage funding, withdrawal, and spending rules of the fund<sup>5</sup>. In line with the sources of their funds, SWFs can be distinguished along their objectives. **Broad categorization based on the objectives of the fund would consider the following different objective categories: (i) reserve investment corporations that aim to enhance returns on reserves, (ii) pension-reserve funds, (iii) fiscal stabilization funds, (iv) fiscal savings funds, and (v) development funds that use returns to invest for development purposes.**

Pension reserve funds seek to build assets to cover an identified liability often

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5 IMF Fiscal Affairs Department (2007), Le Borgne and Midas (2007), Manzano and Rigobon (2001), Mohohlo (2007)

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related to an aging population with the latter being a cause of future economic vulnerability and expenditure, often related to entitlements that were funded by a pay-as-you go system resulting in high economic and social costs. Fund operation under this objective can be identified in the case of Australia, Ireland, New Zealand, and Chile. Depending on the macroeconomic framework in each country these assets are often invested abroad, so that they can be disinvested and used for imports when the domestic population comes of age. Fiscal stabilization and fiscal savings funds are related to natural resource wealth (as in the case of Venezuela or Chile). Natural resource endowments are related to volatile and fluctuating prices as well as to often highly discontinuous quantities, especially in smaller countries with limited resource capacity. Savings funds are concerned with intergenerational equity and transfers. Intergenerational equity focuses on benefiting the current and future generations as equally as possible. This may be done by setting up an endowment type fund that converts a finite (extractive) asset with an infinite string of financial cash flows to benefit the present and all future generations. In some economies, saving assets abroad in an SWF can assist in mitigating “Dutch Disease” symptoms and related macroeconomic consequences. At times, stabilization funds grow beyond what is needed for stabilization purposes, especially when prices are elevated over a prolonged period, and are consequently redesigned as stabilization and savings funds (e.g. Russia).

When considering the objectives of SWF establishment, the urgency of the topic and the exploration of SWF becomes clearer especially after realizing that as circumstances change, the objectives of the SWFs do as well. Considering this reality it is important to recognize what the SWFs’ policy objective and activities are and whether they are consistent with a country’s overall macroeconomic framework. This is because the funds’ assets, and the returns it generates, impact a country’s public finances, monetary conditions, the balance of payments, and the overall balance-sheet. They may also affect public sector wealth and impact private sector behavior while having a significant impact upon international financial markets through their investment decisions and choices<sup>6</sup>.

Operational and policy objectives as well as the nature of the financial tools of funds differ according to the underlying establishment purpose. Stabilization funds having a smoothing government revenue policy objective typically formulate calls for saving commodity revenues if the actual commodity price exceeds a certain reference price, based on a long-term trend, and withdrawing from the fund if the actual price drops below the reference price (e.g. Algeria and Russia). Savings funds formulate their operational objective to spread wealth across generations by aiming to maximize the real annual payout per capita or the payout as a share of gross domestic product (GDP). Depending on the size of population growth and real GDP growth, the variations in formulating the underlying objective can have profound implications. For instance in a country with a declining population while GDP is growing rapidly, transfers in line with GDP imply far larger distributions to distant generations. Assumptions about the discovery of future wealth can be even more important. In practice, several large economies have, over time, found

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6 Jensen and Watchekon (2004), Robinson and Torvik (2005), Sala-i-Martin and Subramanian (2003), Steigum and Thøgersen (1995)

new natural resource deposits that replace those exploited. Ignoring this basic fact could lead to the accumulation of too high a sum of financial assets, as the commodity wealth is massively underestimated.

Funds that aim to improve the return on funded assets tend to maximize returns subject to a given risk tolerance. The expected additional return is a function of the risk that the government or the owner is willing to take. The operational objective can be formulated as a return objective based on an assessment of historic data on the tradeoff between enhanced return and risk. As the longevity of these funds is not always clear, the risk tolerance and investment horizon often remain implicit. The operationalization of the objectives of pension and other liability-focused wealth funds follows the asset liability management approach applied by the pension funds. In contrast to the reserve investment corporations, the horizon over which the liabilities materialize is often well identified. This allows for the explicit maximization of the net value of the funds (in essence the net present value of the investments minus expected payments for the liabilities) over the identified time horizon subject to risk tolerance. In practice, this process is also summarized in the formulation of a concrete return target as the operational objective (e.g. Australia and New Zealand).

SWFs have emerged as crucial operators in the international financial markets and developments in the world economy after considering their key interaction with further institutional arrangements. The experience to date suggests that governance framework in the respective countries provide little indications as to what institutions determine the SWF's policy objectives and overall risk tolerance, its operational objectives, its investment guidelines and who will ultimately be the executor of the latter. This remains of particular interest especially when considering that the latter determine where SWFs' assets are invested. In any case, the investment policy should be consistent with the broad policy objectives. While the operational objectives drive the investment horizon, the risk tolerance and the investment environment (including asset classes and their correlation, asset liability management and other constraints) will determine the strategic asset allocation. All of the latter are key issues and particularly prone to political pressure (especially when considering the decision to invest a share of the funds' assets domestically or abroad). In this context institutional arrangements emerge as detrimental to the fund's investment policy.

## **2.2. The magnitude of the SWFs: An assessment**

SWFs, like other financial institutions, have not been immune to the effects of the global financial crisis and to the sharp downturn in asset prices since early 2008. Many SWFs have suffered significant losses in the presence of the financial crisis. A major part of the financial losses has not yet been realized, as many SWFs are long-term investors and have not needed to liquidate positions. Nevertheless, these losses have to be communicated to the stakeholders like the government and the public sooner or later. Overall SWFs, spurred on by yawning global trade imbalances and a commodity price boom, have roughly \$3-4 trillion under management, which are more assets than the global hedge funds industry. At the end of 2008 **SWFs based on oil and gas revenues accounted for 2/3**

**of total SWFs; nevertheless, the proportion of non-raw material SWFs is on the rise.** Forecasts suggest that this number could approach \$10 trillion by 2015 while further estimations suggest that, despite the economic and financial crisis, SWF assets under management increased by 18% in 2008. In large part, this increase can be attributed to the creation of new SWFs. Indeed, while some SWFs have been around for decades, 28 of the 48 SWFs identified by the U.S. Government Accountability Office were created since 2000, with 12 alone being established since 2005. These SWFs appear to be investing their capital in private, risky assets with considerable focus on the financial sector.

**Table 1. Outlook of several SWFs**

Country	Fund name	Assets managed (in bn USD)	Inception year	Commodity <sup>7</sup>
Algeria	Reserve Fund	25	2000	Oil
Angola	Reserve Fund for Oil	na	2007	Oil
Australia	Australian Government Future Fund (AGFF)	50	2004	N.C
Azerbaijan	State Oil Fund	1.5	1999	Oil
Botswana	Pula Fund	4.7	1993	Diamonds
Brunei	Brunei Investment Agency (BIA)	35	1983	Oil
Canada	Alberta Heritage Fund (AHF)	17	1976	Oil
Chile	Economic and Social Stabilization Fund (ESSF)	6	2007	Copper
	Chile Pension Reserves Fund	0.6	2007	Copper
China	China Investment Company Ltd.	200	2007	N.C
	Central Hujin Investment Corp.	100	2003	N.C
East Timor	Timor-Leste Petroleum Fund	1.2	2005	Oil, gas

<sup>7</sup> N.C stands for non-commodity funds

Hong Kong	Hong Kong Monetary Authority Investment Portfolio	140	1998	N.C
Iran	Foreign Exchange Reserve Fund	15	1999	Oil
Ireland	National Pensions Reserve Fund (NPRF)	29	2001	N.C
Kazakhstan	Kazakhstan National Fund (KNF)	18	2000	Oil, gas, metals
Kiribati	Revenue Equalisation Reserve Fund (RERF)	0.6	1956	Phosphates
Kuwait	Kuwait Investment Authority (KIA)	250	1953	Oil
Libya	Reserve Fund	50	2006	Oil
Malaysia	Khazanah Nasional BHD (KNB)	18	1993	N.C
Mauritania	National Fund for Hydrocarbon Reserves	0	2006	Oil, gas
New Zealand	New Zealand Superannuation Fund	10	2003	N.C
Nigeria	Excess Crude Account	11	2004	Oil
Norway	Government Pension Fund - Global (GPF)	322	1990	Oil
	Government Petroleum Insurance Fund (GPIF)	2.6	1986	Oil
Oman	State General Stabilisation Fund (SGSF)	8.2	1980	Oil, gas
Papua New Guinea	Mineral Resources Stabilization Fund (MRSF)	0.2	1974	Minerals
Qatar	Qatar Investment Authority (QIA)	40	2000	Oil
Russia	Stabilization Fund of the Russian Federation (SFRF)	127	2003	Oil
Saudi Arabia	Various Funds	300	various	Oil

Singapore	Government of Singapore Investment Corporation (GIC)	330	1981	N.C
	Temasek Holdings	108	1974	N.C
South Korea	Korea Investment Corporation (KIC)	20	2006	N.C
Taiwan	Taiwan National Stabilisation Fund (TNSF)	15	2000	N.C
Uganda	Poverty Action Fund	0.4	1998	Aid
United Arab Emirates	Dubai Intern. Financial Centre Investments (DIFC)	na	2002	Oil
	Abu Dhabi Investment Authority (ADIA)	875	1976	Oil
United States	Alaska Permanent Reserve Fund Corporation (APRF)	40	1976	Oil
	New Mexico State Investment Office Trust Funds	15	1958	N.C
	Permanent Wyoming Mineral Trust Fund (PWMTF)	3.2	1974	Minerals
Venezuela	Investment Fund for Macroeconomic Stabilization (FIEM)	0.8	1998	Oil

Total assets under SWFs emerge as an impressive figure, representing a multiple of the assets held a decade ago; nevertheless, they make up less than 1/2 of global foreign exchange reserves, less than 1/6 of global pension assets, around 1/7 of global investment SWFs and insurance assets, less than 1/10 of global stock market capitalization and only 3% of bank assets worldwide. However, the aggregate comparison cannot diminish the importance of individual, often high-profile-investment transactions. Current account surpluses of parent countries of major SWFs have narrowed as trade surpluses declined and dramatically diminished oil and other commodity prices reduced revenues from sales of natural resources, leading to a visibly decelerated accumulation of foreign exchange reserves. Market-to-market values of SWF portfolios are likely to have suffered during the financial crisis. Typical equity portfolios held by SWFs may have lost 45% between end-2007 and early 2009. Additional changes in portfolio values may result from price variations in other asset classes. Overall, such changes in portfolio values have, with very few exceptions, not been realized so far, as SWFs are holding on to their investments.

Long-term prospects for SWFs remain positive albeit the losses in the current financial crisis. Scenarios for the development of assets managed by SWFs

based on past performance of foreign exchange reserves suggests that in 10 years, total assets under SWF management are likely to amount to USD 7 tr with the latter figure being two times larger than the current accumulated volume. Nevertheless, the underlying SWF growth potential is contingent upon the future of globalization. **On the assumption that current account balances resume their recent trend of widening deficits in the US and strongly growing surpluses in the emerging markets, the fundamentals for SWF development remain strong.** If significant reductions in current account balances occur, then SWF inflows are set to remain clearly below the levels seen in the recent past. From the latter it becomes clear that SWFs remain particularly sensitive to the global macroeconomic risks such as exchange rate movements, commodity price changes, trade movements, capital flows, global political risks, potential protectionism in recipient countries, and the political climate between the origin and the recipient governments.

SWFs have long investment horizons and generally have no commercial liabilities, hence in periods of market stress they are likely to face less pressure than most private investors to reduce the size or increase the liquidity of their investments. They are well placed to play a contrarian role and help to stabilize markets by investing in times of stress. For example, when the global equity market fell sharply between 2000 and 2002, the Norwegian Government Pension SWF was a large buyer of global equities. A number of SWFs have played an important stabilizing role during the current financial crisis by providing around \$40 billion of new capital to some of the world's biggest commercial and investment banks.

Taking a broader view, the switch of some reserves from government debt into SWFs which invest in a wider range of instruments should help to improve the allocation of resources if these investments are based on commercial criteria. Investing in equities may also help to reinforce and bring to the surface the common interest that emerging markets and the advanced economies have in the good performance of the companies involved and the markets they operate in. On the other side of the coin, SWF operations raise concerns on their objectives and how far their investments will be driven only by financial returns. SWF objectives might also serve national political interests, such as accessing military technology, controlling strategic resources or markets, and influencing public opinion, with all of the latter being related to transparency aspects of the SWFs.

### **2.3. Commodity price fluctuations and the SWFs**

SWFs are related to two principal challenges in the accumulation of national wealth over time. First, natural resources are exhaustible; once they are extracted and consumed they are depleted. Similarly, superior international competitiveness of domestic industries can be a transitory phenomenon that may substantially change in the course of time. In this light, governments are confronted with inter-generational equity as well as of transforming the present-day revenue streams from the sale of the resources or other export successes into sustainable income. The second challenge is related to the international market for commodities' high level of price volatility. This volatility makes natural resources comparatively risky assets from which societies may wish to diversify. Taking the

above into consideration, the potential advantages of delegating national wealth management to a SWF can be related to inter-temporal stabilization where funds, especially stabilization funds, can help shield an economy against volatility in markets of critical value for an economy, such as oil or other commodities. In this case, the SWFs serve as a liquidity pool which is replenished at times of favorable commodity price conditions or reserve inflows, and which can be drawn upon in cases of low asset prices or shortage of reserves.

SWFs can be related to diversification outcomes. Oil or other commodity exporting economies often run substantial concentration risk from their dependence on the natural resource they sell in international markets<sup>8</sup>. This risk is particularly salient with regard to the exhaustibility of natural resources as well as to the danger of misallocation of capital if the sale of natural resources in turn leads to an appreciation of the real exchange rate and thereby diminishes the competitiveness of other sectors in the economy (also addressed as the “Dutch disease” effect). The diversification of national wealth by investing internationally and in a greater range of assets can help reduce these concentration risks. **Empirical assessment to date indicates that for resource-rich countries with resource funds, the establishment of the fund did not have an identifiable moderating impact upon government spending.** In terms of causality, countries with more prudent expenditure policies tended to establish resource funds, rather than the fund presence itself leading to the increased expenditure restraint. In many cases the establishment of resource funds may have helped maintain cautious policies in the context of ongoing revenue variability. Nevertheless, the coordination of fund operations with overall national fiscal policy (to the extent that this is defined as a policy objective) has been difficult. These results seem to be stronger for countries where the extent of reliance on resource revenues has been larger. In terms of public investment projects, in many cases resource allocation has been determined by political motives rather than economic outcomes or optimal allocation of resources.

### **3. SWFs: Transparency, risks and macroeconomic considerations**

After deriving a comprehensive definition of the SWFs it remains of primary importance to understand the risks that such funds are faced with as well as the transparency that funds experience. Let us first look at transparency aspects.

#### **3.1. Assessing the transparency of the SWFs**

Several attempts have been made at an official ranking of the SWFs based on risk assessment criteria. BV SWF Risk Index ranks the top 20 prominent SWFs according to the potential risk they present to the Western interests<sup>9</sup>. The index scores each SWF from 1 to 5 in each one of the following criteria<sup>10</sup>:

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8 Dunning (2008), Bacon and Tordo (2006)

9 [www.breakingviews.com](http://www.breakingviews.com)

10 Detailed values and respective aspects measured are detailed in Appendix A

**1. Transparency:** This criterion assesses aspects such as:  
 Who calls the shots for the fund?  
 Does the fund make its investments using clearly identified investment criteria or is the fund subject to political control?  
 Does the fund publish details of its investments and its track record?

**2. Strategic control:** This criterion assesses aspects such as:  
 Has the fund sought control of companies in strategic – i.e. defense-related – or semi-strategic – such as banks and utilities – sectors?  
 Has the fund tried to influence decision-making, either by buying a large stake or via board representation?

**3. Political threat:** This criterion assesses aspects such as:  
 How sympathetic is the sponsoring government to western economic and political interests?  
 Will the fund try to interfere and does it have the clout to do so?  
 Is the origin country's regime stable, preferably a democratic regime?

**Table 2. BN SWFs Risk Index<sup>11</sup>**

	Sovereign Wealth Fund	Country	Transparency	Strategic Control	Political relationship	Total score
1	China Investment Corporation	China	4	3	4	11
2	Qatar Investment Authority	Qatar	5	3	2	10
3	National Development Fund	Venezuela	5	2	3	10
4	Abu Dhabi Investment Authority	UAE (Abu Dhabi)	4	3	2	9
5	State General RF	Oman	5	2	2	9
6	National Fund	Kazakhstan	4	2	3	9
7	Stabilization Fund	Russia	2	2	4	8

<sup>11</sup> <http://www.breakingviews.com/2008/01/04/Sovereign%20wealth%20SWFs%20index.aspx?sg=breakingstories>

8	Brunei Investment Agency	Brunei	4	2	2	8
9	Economic and Social Stabilization Fund	Chile	4	2	2	8
10	Kuwait Investment Authority	Kuwait	3	2	2	7
11	National Stabilization Fund	Taiwan	4	1	2	7
12	Isthmar	UAE (Dubai)	3	2	2	7
13	Government of Singapore Investment Corp	Singapore	2	3	1	6
14	Temasek	Singapore	2	3	1	6
15	Dubai International Capital	UAE (Dubai)	2	2	2	6
16	Korea Investment Corporation	Korea	2	2	2	6
17	Khazanah Nasional	Malaysia	2	1	2	5
18	Alaska Permanent Fund	US	1	1	1	3
19	Alberta Heritage Savings Trust Fund	Canada	1	1	1	3
20	Government Pension Fund	Norway	1	1	1	3

The BV index suggests some surprising points to consider. China Investment Corporation, the giant \$200bln SWF that recently acquired stakes in Morgan Stanley and Blackstone, is the top with 11 points. But only two other SWFs are placed in this category: the Qatar Investment Authority and Venezuela's National Development Corporation (both scored 10 points). All three funds also scored high marks for lack of transparency. A further nine SWFs scored between 7 and 9 on the BV index, which makes them medium risk. This group includes Russia's Stabilization Fund, which turns out to be less risky than the Abu Dhabi Investment Authority, the flagship SWF for a country recently hailed by former President Bush as a beacon for the Middle East. That is because the Russian fund only

buys bonds according to clear criteria, while ADIA, which recently took a stake in Citigroup, won't even confirm the size of its funds. Nevertheless, the index omits several high-profile state-owned entities that have also caused alarm. Russia's Gazprom and China Development Bank would no doubt score highly on the index criteria but are operating companies, not SWFs. Also excluded are some western investment groups with close state links, such as Calpers and Hermes, the US and UK pension funds which are occasionally painted with the SWF brush – since these have clear obligations to scheme members.

Overall, the index points to two clear considerations: The first is for western politicians suggesting that they should acknowledge the fact that the bulk of the SWFs pose little threat to western interests. 8 out of the top 20 SWFs scored 6 points or less. That ranks them on a par with many respected US and European private equity firms and hedge funds, which also take controlling interests in companies and are often far from transparent. The index suggests that even high ranking SWFs should not be automatically penalized. They just require closer scrutiny. Deals should be assessed on a case-by-case basis. The second consideration regards the SWFs themselves: if they are alarmed at their high ranking – and the risk unscrupulous western politicians might use it as a cover for protectionism – the solution lies in their hands. Most SWFs could reduce their score simply by improving their transparency. If this is their goal they should do so as soon as possible, acting prior to the publication of future ranking assessments.

**An alternative index of transparency is the Linaburg-Maduell Transparency Index developed by the Sovereign Wealth Fund Institute.**

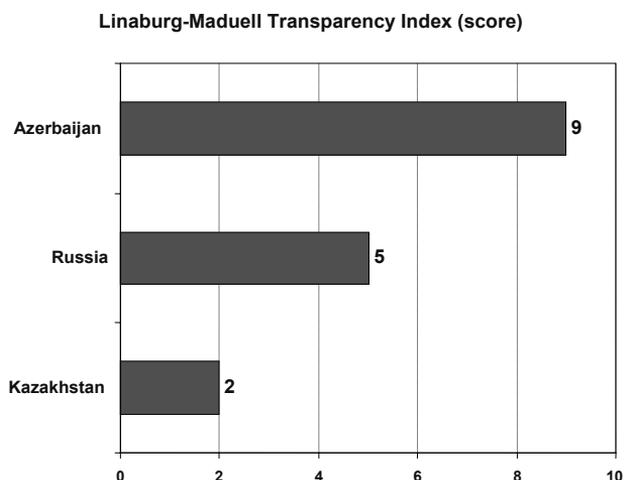
The index assesses 10 essential principles that depict SWF transparency to the public using the Pension Fund of Norway as a leading transparency example and basis. Each of the principles adds 1 point of transparency to the index rating. The index is an ongoing project of the Sovereign Wealth Fund Institute (SWFI). The minimum rating an SWF can receive is 1; however, the SWFI recommends a minimum rating of 8 in order to claim adequate transparency. Transparency ratings may change as SWFs release additional information. There are different levels of depth with regards to each principle; judgment of these principles is left to the discretion of the SWFI. The principles employed by the Linaburg - Maduell Transparency Index assess aspects like:

- Does the fund provide history information including reason for creation, origins of wealth, and government ownership structure?
- Does the fund provide up-to-date independently audited annual reports, ownership percentage of company holdings, and geographic locations of holdings, total portfolio market value, returns, and management compensation?
- Does the fund provide guidelines in reference to ethical standards, investment policies, and enforcement of guidelines?
  - Does the fund provide clear strategies and objectives?
  - If applicable, does the fund clearly identify subsidiaries and contact information?
  - Does the fund identify external managers?

With regards to the countries of the Caspian region, compatible scores are 9 for Azerbaijan, 5 for Russia, and 2 for Kazakhstan. Divergences in the scores are an indication of the willingness of the respective governments to disclose information which depend on (i) the scale of the fund, (ii) the learning and the

harmonization with the transparency tools, and (iii) the cooperation with suitable regional and global organizations and initiatives like the Extractive Industries Transparency Initiative (EITI).

**Figure 3. Transparency scores for the SWFs of the Caspian basin countries**



### 3.2. SWFs: Risk overview

Other types of risk to be considered when exploring SWFs are related to the operational, economic and political environment, to the investment choices and to the existing fiscal and institutional structures. Starting with political risks the above are assessed in the following sections.

#### Political risk

The experiences strongly suggest that SWFs are likely to face political risks in both developed and developing economies due to the inherent salient characteristic of the funds, i.e. the government ownership. **However, the political risk in developing economies appears to be higher due to the uncertainties stemming from harder-to-anticipate regime changes and weaker regulatory frameworks.** Nevertheless, since a key objective of the fund is to reap returns higher than those offered by fixed income investments (which generally offer low-risk, capital-protection and low returns), exposure to the higher level of political risks from developing host countries can be justified by the higher rate of returns. Calibrated political-risk-reduction approach and strategy that cover the political, economic and social dimensions can help the SWFs to reduce their risk exposure caused by their respective investments. Given the current climate of skepticism over the SWFs, the need for political risk management by the SWFs can only be

expected to rise, regardless of where they choose to invest<sup>12</sup>.

It is important to remember that SWFs are partly a policy response to the growing calls from the general public to use the burgeoning reserves more productively so that they can make a bigger contribution to the domestic welfare. There are concerns that SWFs may pursue geopolitical or strategic objectives and that those objectives may complicate their pursuit of profit maximization. While there is some element of truth to this, such concerns tend to be overestimated. The primary impetus behind the creation of the SWFs is the popular belief that a potentially valuable national resource is being wasted. More specifically, the primary concern among both policymakers and the general public is that the rate of return on traditional reserve assets is “too low” and that it is incurring a large opportunity cost by foregoing higher-return assets.

### **General economic activity risks**

**The risks that SWFs face in their investment operations can be classified into four broad categories: financial, operational, regulatory, and reputation risks.** The main financial risks are market risk (interest rate, foreign currency, equity and commodity price risks), credit risk (issuer, counterparty, and settlement risks), and liquidity risk. The main operational risks include people risk (incompetence and fraud), business continuity risk, process risk, technology risk, and legal risk. The main regulatory risk stems from changes in the laws and regulations governing the operation of SWFs in countries of origin as well as recipient countries, or from changes in the application of such laws and regulations. Reputation risk is the potential that negative publicity regarding a SWF’s business practices, whether true or untrue, may cause a decline in investment returns, costly litigation, or loss of counterparties, or impair the home country government’s international standing. The risk management framework should include reliable information and timely reporting systems, which should enable the adequate monitoring and management of relevant risks within acceptable parameters and levels, control and incentive mechanisms, codes of conduct, business continuity planning, and an independent audit function.

The measurement and management of financial risks is typically done by using quantitative methodologies and models. To complement these models and to mitigate “model risk,” stress tests should regularly be conducted to evaluate the potential effects of macroeconomic and financial variables or shocks. To assess, manage, or mitigate operational risks, there should be an established and documented framework that has clear lines of responsibility, segregation of duties, and reliable control mechanisms. Codes of conduct and recruitment policies are important to ensure the professional and ethical behavior of staff involved in the fund’s operations. To ensure that the SWF can continue operating in the case of a technology breakdown or natural disaster, contingency planning, including alternative sites of operation, is an important part of the framework. In mitigating regulatory and reputation risks, it is important to have adequate systems to track current regulatory and legal requirements in each recipient country that the SWFs invest in. To satisfy the owner and the governing body that

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12 Rajaratnam (2008)

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those risks in the SWFs are managed properly, the risk management framework should be subject to a regular independent audit.

Risk objectives are typically determined by the owner or the governing body of the SWF. While broad principles are generally established within the law or by the owner of the SWFs, more specific risk management objectives are typically laid out by the fund's managers. SWFs indicate that these are usually set as tracking error limits or risk bands relative to a benchmark index for tactical management. SWFs are particularly sensitive to the global macroeconomic risks such as exchange rate movement, commodity price changes, trade movements, capital flows, global political risks, potential protectionism in recipient countries and the political climate between governments. In addition to tactical risk limits, SWFs typically observe general constraints on investment classes and instruments. Most SWF respondents note that they are not allowed to borrow or use leverage. Several funds point out that they invest in certain asset classes that use leverage (e.g., private equity and multi-strategy funds) or employ derivatives for the purpose of protecting the value or return of their investments. In addition, many SWFs have established limits on stakes that they can hold in companies, the types of investment they can hold (investment grade assets only), and on other characteristics of their portfolio.

For several SWFs the operational risk is controlled through the separation of responsibilities, including front, middle, and back offices. SWFs also mitigate operational risk through the implementation of codes of conduct and policies on conflict of interest for staff and the governing body, regular reconciliation of accounts, and regular and active audits. Several SWFs note that they use back-up facilities, global custodian services and business continuity plans, as well as regularly reviewed operating manuals, to mitigate operating failures. One SWF also monitors operational risk with early warning indicators and by assigning direct responsibility for operational risk monitoring to line managers. Some SWFs note the use of workflow automation and frequent reports by the middle office to management to ensure timely communication and early warning of operational risks.

## **Investment risks and risk tolerance**

Risk tolerance refers to an investor's willingness and ability to handle declines in the value of its portfolio. For example, it can be expressed as the degree of uncertainty that an investor can accept with regard to a negative change in the value of the portfolio<sup>13</sup>. A benchmark portfolio is a reference portfolio or an index constructed on the basis of the investment policy. It serves as a basis for comparison of the performance of the actual portfolio. Asset class refers to a group of securities that exhibit similar characteristics, and behave similarly in the financial market. Examples of asset classes include stocks, bonds, and real estate. The investment policy should guide the SWF's financial risk exposures and the possible use of leverage. Exposures to financial risks (including market, credit, and liquidity risks), the use of derivatives, and leverage commensurate with the SWF's investment horizon and risk-bearing capacity are key determinants of

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13 <http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf>

its ability to meet its investment objectives and contribute to the financial markets stability. Such exposures and the use of derivatives and leverage should be well understood, measured and managed appropriately.

Derivatives are useful in SWFs' operations - some may use them only for hedging purposes, whereas others also use them for active position taking. **While SWFs typically do not use much leverage, this is often an integral part of an SWF's investment, risk management, and cash management frameworks.** It may show up in a variety of forms, including traditional borrowing to finance investments, use of futures and options contracts, interest rate and currency swaps, repos, and buy/sell-back operations. In addition, leverage is an integral part of investing in certain asset classes such as "alternative investments" and real estate (including from a rate of return and from a tax perspective, where appropriate). It is a core principle that SWFs' overarching objective is to maximize risk-adjusted financial returns, given the risk tolerance level of the owner.

SWFs' investment decisions and activities, therefore, should be guided by and be consistent with this objective. The SWF may have a framework that identifies, assesses, and manages the risks of its operations. It is important for the SWF to have a strong risk management culture, where senior management is engaged in crafting and enforcing risk management processes, and a well-functioning risk management framework to ensure that it is able to identify, assess, and manage its risks to protect its assets and stay within the tolerance levels as set in the investment policy. Adherence to high standards in risk management with sound operational controls and systems will also help achieve the aim of preserving international financial stability as well as maintaining a stable, transparent, and open investment environment. The general approach to the SWF's risk management framework should be publicly disclosed. Public disclosure of the SWF's general approach to its risk management policies and key actions related to governance and the soundness of its operations reassures that the fund, its governing body, or management adheres to a high standard of managing operational, regulatory and reputation risks.

The investment policy guides the SWF in implementing activities consistent with the approved investment objectives and strategies, and risk tolerance, as well as its investment monitoring procedures. Although there is no set formula that suits all situations, the investment policy, including the strategic asset allocation, should draw upon appropriate portfolio management principles. The strategic asset allocation is typically embodied in a benchmark portfolio and determined by the SWF's policy purpose, liability profile, horizon over which expected returns and risk are defined, and characteristics of different asset classes. The investment policy normally defines permissible asset classes and gives guidance on concentration of risk with regard to individual holdings, liquidity, and geographical and sectoral concentration. In line with the policy purpose of the fund, the strategic asset allocation may set certain investment parameters, for example, exclusively investing in foreign assets. In addition, the strategic asset allocation may consider the SWF's investments in conjunction with other assets or liabilities of the country, resulting in, for example, investing in assets negatively correlated with the country's natural resources. As the parameters and assumptions underlying the SWF's investment policy – including its strategic asset allocation – change over time, a periodic review is needed (as it is currently

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done by funds in Australia, New Zealand and Singapore).

The risk tolerance is a key constraint on the maximization of the expected return over the investment horizon. The risk constraint is based on the ultimate stakeholders' willingness and ability to take risk. Ideally, the risk preference focuses on the entire investment horizon, and can take the form of a maximum acceptable deviation at the points of withdrawals and the risk/return tradeoffs at these points. In other words, there is less of a need to be concerned about daily volatility if the investment horizon is a year. For example, the value of the investment can increase and decrease daily by ten percent but the key aspect is the value in a year's time when the withdrawal takes place. However, in practice, investors may have some concerns about short-term volatility. A typical constraint in new funds is therefore the sponsor's desire to preserve capital. A capital preservation objective is equivalent to zero tolerance for negative returns, in either nominal or real terms. If formulated with regard to the start of the fund, this constraint has a time dimension: over time a buffer is built up to allow more risk. In other words, adding this constraint of capital preservation allows easing into a risk tolerance that is more reflective of the real investment horizon. In this regard, an early start with investing resources to build up a buffer, having an oversight body with experienced and respected professionals, and educating lay stakeholders can help limit the cost imposed by this additional constraint<sup>14</sup>.

## **Cross-border investments and the risk of protectionism**

The biggest external risk faced by new SWFs is that of financial protectionism, especially from industrialized countries. **The cross-border investments of SWFs not only affect the legitimate interests of home countries but also those of host countries.** As such, foreign investors, whether state-owned or not, have to conform to host-country laws and regulations. However, host-country governments and citizens are sometimes more wary of state-owned investors than private sector investors, and are particularly concerned that their investments may be partly driven by non-commercial objectives. At a minimum, those concerns will subject SWFs to greater scrutiny by host-country governments than their private sector counterparts. More seriously, those concerns may give way to various forms of financial protectionism in host countries. Financial protectionism constrains how and where the new SWFs can invest and thus imposes a significant cost.

The first major rejection of an Arab SWF investment involved Dubai Ports World's acquisition of P & O, a British company that operated six major ports in the eastern United States. Concerns about national security led many in the U.S. Congress to try to block the Dubai company's operation of U.S. ports, an issue settled only when, in March 2006, Dubai Ports World agreed to hand over operation of those ports to the U.S. entities. Similar concerns were raised both in New Zealand and Sweden following Dubai's offers to buy the Auckland International Airport, and the Swedish stock exchange OMX. Though Dubai withdrew its offer for the Auckland airport in the face of opposition, it continues to seek the purchase of OMX, as part of a deal in which it will exchange OMX for NASDAQ's 28% share in the London Stock Exchange and an as-yet unspecified

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14 Das et al (2009)

amount of equity in NASDAQ itself. On September 20, 2007, President George W. Bush stated in a news conference about the then-pending acquisition of NASDAQ that an investment by a government-owned company in NASDAQ would be subject to review by national security agencies, although he provided a provisional welcome of the deal<sup>15</sup>.

## **Fiscal and institutional risks**

The prospect of government support for SWFs may encourage excessive risk-taking. The flip side of this argument is that using SWFs to support the government will also create serious risks for SWFs. In particular, there has to be a clear-cut separation between the foreign exchange assets controlled by the Central Bank and those controlled by the fund. There must be clear ground rules for ensuring that SWF resources will not be used to supplement the central bank's traditional reserves in the event of a financial crisis. Otherwise, having to liquidate long-term assets, which are likely to be a major part of an SWF's portfolio, on short notice will bring about major losses for the SWF. **More generally, serious financial risks for SWFs will ensue if the government views their assets as free fiscal resources to be used ad hoc so as to meet various fiscal needs.** The vast majority of reserves are not fiscal reserves but Central Bank reserves with counterpart liabilities. The balance sheet of even the best-run SWFs will suffer if the government views SWF assets as fiscal assets to be used freely at its own discretion.

Overall, new SWFs simply do not yet have the institutional capacity to effectively manage a portfolio of high-risk, high-return investments. SWFs are financially sophisticated investors with large investments in alternative asset classes such as private equity, venture capital, and real estate. Furthermore, they are often active investors seeking to control or at least influence the management of companies. It is not only unrealistic but also downright dangerous for some countries to believe that it is possible to build capacity overnight. In the absence of adequate investment management capacity, including risk management capacity, pursuing investment strategies creates dangerously high levels of risk. Nevertheless, popular pressures for profits may encourage SWFs to try to run before they can walk, to pursue high-risk, high-return investments without adequate capacity to handle risk. Succumbing to such pressures entails a clear risk of large, even catastrophic, investment losses. In addition, the participation of a foreign SWF in a financial institution (credit institution) may endanger the effective supervision of this institution. Financial supervisors could experience difficulties when they attempt, for instance, in the exercise of their supervisory function, to determine whether the participation of the SWF in a bank jeopardizes the 'sound and prudent management' of the credit institution<sup>16</sup>.

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15 <http://www.meforum.org/1863/sovereign-wealth-funds-investment-vehicles-for>

16 Bart De Meest. Need for a multilateral approach to sovereign wealth funds. Policy Brief No.

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### 3.3. SWFs and the macroeconomic implications

Where the SWF's activities have significant direct domestic macroeconomic implications, those activities should be closely coordinated with the domestic fiscal and monetary authorities, so as to ensure consistency with the overall macroeconomic policies. Since SWFs are often created for macroeconomic purposes, their operations should support and be consistent with a sound overall macroeconomic policy framework. **The SWF's operations can have a significant impact on public finances, monetary conditions, the balance of payments, and the overall sovereign balance sheet.** Thus, operations of the SWF that have significant macroeconomic implications should be executed in coordination and consultation with the competent domestic authorities. For instance, transactions that involve an exchange between domestic and foreign currencies by a SWF may affect monetary conditions, the exchange rate, and the domestic demand conditions. Broadly speaking, there are three main kinds of sovereign wealth funds. The first group contains the natural resources funds, with an estimated 70% of total sovereign wealth fund asset holdings in the hands of resource-rich countries, such as the United Arab Emirates and Norway. The focus of these funds is to maintain economic stability against commodity price fluctuations and to ensure that future generations will not be disadvantaged by the exploitation of natural resources by the current generation. The second group relates to the foreign reserve funds, and notably includes a number of Asian countries such as China, Korea and Singapore. The focus of these funds should be to hedge away the impact of risk factors behind these commercial surpluses, and also to generate higher returns than local sterilization bond costs related to the issuance of sovereign debt aimed at reducing the monetary base expansion related to capital inflows. The last group of funds, which accounts for a more marginal fraction of total sovereign wealth, contains the pension reserve funds for countries such as New Zealand, France or Ireland, which have set aside a portion of their pension funds and manage them separately to prepare for an aging society. Recent advances in dynamic asset pricing theory have in fact paved the way for a better understanding of optimal dynamic asset allocation decisions for such long-term investors, by precisely taking into account the stochastic features of the sovereign funds endowment process (where the money is coming from), the stochastic features of the sovereign fund's expected liability value (what the money is going to be used for), and the stochastic features of the assets held in its portfolio.

For example, in the case of the Norwegian sovereign fund, which is a natural resource fund that has been set up to help meet future pension payments, the optimal allocation strategy should involve a short position in oil/gas commodity futures, or a long position in stocks of companies such as airlines, companies that benefit from decreases in oil prices, so as to diversify away some of the risk exposure in the countries' revenues. It should also include a long position in inflation-linked securities that will help the sovereign state to hedge away some of the inflation uncertainty in future pension payments. Such portfolio strategies are the equivalent for sovereign wealth funds of the liability-driven investment

strategies recently developed in the pension funds industry<sup>17</sup>.

Two major considerations usually guide the allocation and distribution of SWF assets. The first is the accumulation and withdrawal rules regarding the fund's future cash flows where applicable. The second is the fund's objectives. Together, these considerations drive the strategic asset allocation, which reflects the return objective, risk tolerance, and identified constraints (such as liquidity and financing needs, investment horizon, legal and regulatory requirements). SWFs may hold assets with negative correlation to the country's major exports (oil) or offset the price risk of future imports (depending on the country's risk profile) via its strategic asset allocation decisions. SWFs without identified liabilities allow for a more exclusive focus on a return objective and acceptable level of risk. However, for some SWFs, sterilization instruments used to mop up excess liquidity may need to be considered as liabilities, especially from an integrated asset and liability management perspective. The objectives of SWFs could be undermined by the accumulation of liabilities elsewhere in the public sector. Some funds, such as the pension reserve funds, may have identified liabilities to be matched within the strategic asset allocation framework to allow for a clear operational framework and transparent objectives.

Funds' allocations of sovereign reserve assets to domestic investments have macroeconomic implications, especially for developing and emerging market economies. **To invest domestically, SWFs would typically need to convert part of their accumulated assets back into domestic currency, possibly reversing the economic policies that led to reserve accumulation.** Investing domestically could stimulate domestic demand with inflationary consequences. Issues of fiscal accounting, transparency, and risk could also emerge if those investments are actually government spending operations that should take place within the budget. Therefore, domestic investments are generally seen to be ruled out in SWFs. Different types of SWFs could have markedly different strategic asset allocations reflective of their different objectives and constraints. Stabilization funds, for instance, are generally conservative in their strategic asset allocation, using shorter investment horizons and low risk return profiles, or other instruments (perhaps longer-term) that vary inversely with the risk the fund is meant to cover. Typically, such funds are designed to insulate the budget from terms-of-trade shocks and to meet contingent financing requirements. In this regard, they are akin to reserves, which are managed for safety and liquidity, and it is only after such considerations are satisfied that higher risk/return objectives are set. Funds with long-term objectives, such as savings funds, may be better able to accommodate short-term volatility in asset returns. Nonetheless, savings funds and pension reserve funds also aim to preserve a minimum amount of capital, in real terms, so that the purchasing power of the fund is guaranteed. Pension reserve funds with explicit liabilities typically design strategic asset allocation benchmarks that preserve their solvency.

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17 <http://www.edhec-risk.com/edito/RISKArticleEdito.2009-02-24.4440>

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Despite these benefits, many governments in the West are concerned about investments by SWFs. The concerns are based on three domains: national security, corporate governance, and financial stability. The worries that are expressed the most involve concerns of national security. Governments in the West fear that SWFs are being used by governments to pursue their geo-strategic goals, rather than pure profit-maximization. The government as a shareholder, by means of investments through SWFs, distinguishes itself from other shareholders because the government may draw benefits from its participation in ways that other shareholders cannot. As has been indicated, SWFs were at one time considered the 'saviors' of financial institutions that ran into trouble as the credit crisis widened. However, some economists wondered whether it is really desirable that credit institutions that have made serious errors of judgment when granting mortgage loans should not suffer the consequences of their mistakes. Indeed, the functioning of the free market is based on weak companies disappearing and on the survival of only the best corporations. States are also concerned with the possible consequences of investments by SWFs upon financial stability. This is arguably the most real and pressing concern. The enormous amounts SWFs have at their disposal make their activities of 'systemic importance.' This means that negative consequences of their activities may endanger the entire financial system. When a SWF would, for instance, suddenly sell its stake in a corporation, this could give rise to unrest of the financial markets. Other shareholders of this corporation may fear that the SWF has obtained more information than they have and consequently they may want to sell their stakes too. This may spill over to other market participants and result in general financial unrest.

Turning to supportive arguments in favor of the SWFs, recent investments in developed financial institutions are not financial resources buried in the Persian Gulf and discovered by the leaders of those institutions. The assets of the SWFs already are invested abroad - by definition. A significant proportion already is in US dollars probably in the United States. Thus, when SWFs invest in a US financial institution, only the form of its US investment is changed. The SWFs sells one US asset and buys another<sup>18</sup>. Contrary to what the comforting narrative might suggest, a country seeking to use its holdings of dollars so as to influence suitable policy has options that fall short of the "nuclear option" of dumping large quantities of dollar reserves. A creditor government could sell holdings of "risk" assets and purchase "safe" assets, creating instability in certain segments of the market. This could be done without triggering the appreciation of its own currency against the dollar or directly jeopardizing its exports. A creditor government could change how it intervenes in the currency market. A country, for example, could halt its accumulation of dollars without ending all intervention in the currency market if it sells all the dollars it buys in the market for other currencies. Also, a creditor government could stop intervening in the currency market, halting its accumulation of foreign assets, whether in dollars

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18 <http://www.iie.com/publications/papers/paper.cfm?ResearchID=892>

or other currencies. A creditor government could halt its intervention and sell its existing stocks of dollars and dollar-denominated financial assets, the “nuclear option.” If it held a large equity portfolio, this could include large stock sales<sup>19</sup>.

## 4. SWFs: Assessing governance

Assessment of the nature of the SWFs and of the risks associated with the latter indicates the primary importance of the governance quality experienced by the funds. In this context it remains interesting to identify the segments and the factors that affect the development of the latter.

### 4.1. SWFs, public control and public disclosure policy

Often, the officials of the countries of similar SWFs indicate that even if the SWFs do need regular promulgation of information on their activity, this information should be measured out in doses under the strict control of the government. The arguments behind that are well known – the SWF is a specific structure, operating sometimes with colossal resources. SWFs aim at the solution of strategic issues of the state and thus they remain very vulnerable in the eyes of outsiders. Leaks of important information could harm the state interests. Therefore, it is better to be reassured and preclude all possibilities of promulgation of information regarding questions of how and where the SWF’s resources are managed. **Actually, amid the existent 56 similar SWFs, as we can see from practice, the best performing ones are those which truly have real public control and access to most of the information.** Adherence to state interests, i.e. profitable work of the SWF and better integrity with the macroeconomic goals of the state, is particularly well traced here. On the contrary, closed SWFs are very dubious in their state goals and information on their efficient operation is missing or, to put it mildly, is open to question.

SWFs as financial structures working in extremely sensitive financial and investment sites should of course have a special promulgation policy, say, different from that of the state’s budget. However, that does not disaffirm the availability of a more clear-cut and firm policy of public control of information and access to it, but strongly implies it. Following circumstances, need for rather focused public control could possibly be explained in this case:

**1. The state establishes and manages the SWF on behalf of the society and it is accountable to the society.** Therefore, mentioning some separate and out-of-public-control policy of the SWFs contradicts the generally known canons of state building. That is particularly the case if the matter regards the democratic state. It is important to ensure that the control is public and not imitated. It is also important to consider the actual situation, the conditions and the developed practice of decision making in the state. With regards to the case of Azerbaijan: in the Supervisory Board of the State Oil Fund of Azerbaijan (SOFAZ), officially only the President of the Academy of Sciences of Azerbaijan represents the society.

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19 Setser (2008)

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Indifference and inactivity of the aforesaid person to this issue brings the public control over the fund to nothing. At the same time the EITI is successfully being realized in the country and there is a strong civil sector, capable enough to not only criticize the government but to also introduce a motion on improvement of the funds' policy. Thus, the conventionality of Azerbaijan implies that the civil sector successfully engaged in the EITI can effectively exert control over the fund.

**2. An SWF administers colossal resources, which occasionally exceed the capacity of the state budget, thus mistakes could cost too much.** In the overwhelming majority of cases, total assets of the SWFs exceed the budgets of the countries they represent. Stepwise examination, discussion and eventually adoption of the state budget by the respective Parliaments have become a practice with an established foothold. However in the case of the SWFs, this kind of tracking system differs from country to country and in the majority of cases, it is just being formed. Adoption of the next year's state budget as a law implies the same necessary public responsibility which is still missing in many SWFs. It is generally known that discussion and adoption of the law on the next year's budget in the Parliament, in addition to everything else, has the purpose of securing the government against possible mistakes and a lop-sided approach. The essential consensus on more optimal registration of financing of state priorities between the government and the legislators is reached in Parliament. The practice of SWFs' future budget discussions in the Parliament in the context of consolidated budgets certainly smoothes away these defects. However, this practice is not the case in all countries, and most importantly, it covers only the fund resource spending in the framework of the assets' budget for the next year. Meanwhile, SWF assets and their management in the vast majority of cases remain out of discussions and effective control of the legislators.

**3. Assets of the SWFs are generated not by atomized taxpayers, but rather from a single source of raw materials.** The difference of the SWFs from the state budget consists, among other things, in the SWFs' accumulation of assets from a single source – sales of hydrocarbons (hereby we mean only commodity funds). At the same time, it is well known that budget is basically formed at the expense of atomized taxpayers. Like a mirror, the state budget displays the efficiency of the government's economic policy. A sequent of this policy could be a stout or conversely weak budget. However, a good budget could also be the sequent of successful economic performance conducive to the greater budget growth in the future. The goal in this case is to compare the economic nature of these two financial instruments in order to elicit to what extent the public control over SWFs is important. Accumulation of SWFs' assets out of hydrocarbons may not display the real economic situation and it may cause the illusive impression of successful work of the SWFs. In the case, with a budget, economic realities very quickly "bring round" the government, which brokenly looks for means of budget improvement and generally economic policy, whereas with SWFs such a direct link may not appear. For example, if a country is at its peak of production of hydrocarbons and there is an advantageous market situation, then the rate of investments may grow even if the economy is heading in the opposite direction but not demonstrating an adequate trend. Professional public control and full-fledged information access could minimize such deformations and serve as the

missing critical indicator, which in the case of a state budget would display its deficit performance.

**4. The vast majority of the SWFs pertain to the countries of risk, which institutionally still remain weak.** Internal control in this case is insufficient, whilst external is often ineffective. Only 9 out of 56 SWFs belong to the OECD countries (Australia, Canada, France, Ireland, Japan, South Korea, New Zealand, Norway and USA) and the remaining pertain to the countries of high risk. As a rule, no solid good governance is recorded, but it is rather observed a lack of precise system of effective self-control – system of an “iron triangle” (one of the groups grants a power, whilst the other manages and a third runs a business and earns a profit). International Financial Institutions (IFI) who see this gap are trying to fill it by strengthening the international control. However, in the majority of cases that happens to no effect, because one cannot replace the lack of immanent internal control, which at the primary level could ensure a balance of power and natural responsibility of the subject instances before others, with merely an external impact. As a result, we can observe periodically recurring recommendations of international agencies, although implementation of these recommendations leaves much to be desired. One should accept the fact that for the independent states, these recommendations will always remain as recommendations and their implementation is left to the discretion of the states. Once implemented, a practice of effective public control could move all these issues away from the dead point. The public itself (civil sector would be more successful in this role) would be an initiator of such legislative and practical improvement of more accountable management of the SWFs.

**5. Traditions of strong non-governmental movements in the vast majority of those states which have similar SWFs are not developed and are even alien to the public mentality.** 30 out of 56 SWFs belong to countries with poorly developed traditions of civil movements<sup>20</sup>. In some countries such movements do not exist at all. In such conditions, it is extremely difficult to set up public control embodied by civil organizations. However, these very countries above all others need control. Norway, demonstrating brilliant experience of open management of the SWF, is not in acute need of such control. However, it is brilliant here. Yet in Iran where there is no experience, no traditions, and no capacity for such undertaking, the vulnerability of the Reserve Fund is very apparent from the view of its predictable management. Society is on the lookout for the purposes on which the assets of the fund will be spent due to the state of affairs and the nature of the power in the country.

The importance of, and simultaneously acute need for, the increase of the role of the civil sector in countries of risk and intensification of formation works of the first shoots of civil capacity could be a new challenge for the world community in the light of the impact of the SWFs upon the international scene. Civil sector capacity-building efforts in these countries may have far-reaching objectives. The civil sector, initially engaged for this local goal (although from the scope of SWFs' capacity growth this is far from the local objective) can later focus entirely on other important state objectives. A typical example of that could be the civil sector focused on the oil and gas field of Azerbaijan. **Established in 2004, the EITI**

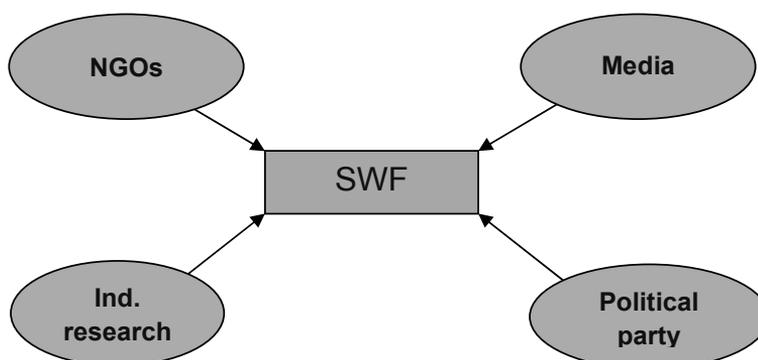
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<sup>20</sup> <http://www.swfinstitute.org/research/transparencyindex.php>

**coalition has evolved from year to year and is capable enough today to set some greater global tasks.** The capacity building that was realized significantly advanced the coalition in the fields of study, watchdog and other activities. Reinforcement of SWFs' international role should become a new challenge for the strengthening of the civil sector capacity in resource-rich countries the same way that the EITI has become an important international initiative due to which knowledge capacity in resource-rich countries was built up.

In this light, the question of how effective control over the activity of the SWFs by the civil society can be arranged remains of primary importance: in an attempt to answer this, four different angles have to be taken into consideration, namely non-governmental organizations (NGOs), the media, independent parties and political parties. In order to ensure effective public control, it is important to have every element of this four-angled scheme functioning as a separate component of a single whole.

**Figure 4. Public control and the SWFs**



## NGOs

**NGOs at this point are entrusted with a special mission. NGOs alongside the media are the structure most interested in securing the transparency of the SWFs.** Apart from this keen interest, non-governmental organizations also have the greatest capacity in this activity. This capacity was accumulated within the last decade owing to different programs, initiatives and other international instruments. The campaign "Publish What You Pay," which is an initiative of more than 400 united NGOs (in 70 countries around the world) and EITI, where the NGO stands as a key chain of trilateral partnership (the state, companies and civil sector) has gained great recognition<sup>21</sup>. However, the problem lies in the fact that none of the previously mentioned instruments are applicable to our end. As was already mentioned, SWFs have specific missions and peculiarities of

work. Obviously, in the course of the development of this work NGOs will have to improve the skills pertaining to the above initiatives to secure the transparency of the work of the SWFs. NGOs will have to come up with a new hybrid and perhaps a brand new instrument to ensure the transparency of the SWFs. The good news is that after the adoption of the “Santiago principles” there is a favorable opportunity for the NGOs. Thus, based on this, an International Working Group (IWG) should deliberate the mechanism of practical work of NGOs with these principles.

## Media

Media is an extremely important component in ensuring the transparency of the SWFs. It is generally known that for transparency there should be access to information and all-round disclosure of it to the wider public. This is a particularly important mission of the media. Thanks to the media, the wider audience learns about SWFs’ activity and their growing capacities. **Unfortunately, in the vast majority of cases, it is mostly a question of international level and world-renowned print agencies and electronic means that rarely get to have materials about SWFs in countries of risk.** Meanwhile, herein one may feel the acute lack of impartial coverage of the activity of these SWFs. The media has an irreplaceable role in the organization of the journalistic investigations on the expenditures and the management of the SWFs’ assets. Certainly, essential qualification is the requirement for this genre as well as any professional activity. Acute lack of this qualification is felt almost in all countries. If the SWFs are truly interested in a qualified army of reporters covering their activity then they should act as initiators of the organization of periodic extensive courses for the journalists, creating opportunities for them to obtain new skills and knowledge. In this view, the experience of the State Oil Fund of the Republic of Azerbaijan (SOFAZ) is positive, as the SOFAZ has sponsored such courses for journalists in Baku.

## Independent investigation

**Activities of the SWFs, just like the activities of any other financial structure, are multidimensional and in their content, they require not only regular press coverage but also thorough elaboration.** This is beyond the power of a regular observer. It requires special qualifications. For instance, the fact of how well information access is arranged and how regularly and comprehensively it is disclosed is a basis to judge the transparency of the SWFs; however, this information is insufficient to judge its efficiency. Even regularly updated information on profitability level is not yet sufficient, as any rate of the profitability of the SWF relates to hundreds of factors which require study and consideration. Only professional experts and financiers can handle this specific job. There is a need for a parallel independent investigation considering the fact that the specialists even of the highest qualification involved in public institutions are subject for engagement. Therefore, independent and simultaneously professional study focused on the appraisal of the SWFs and their successful

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connections with the macroeconomic architecture can be valuable material not only for the international community, but also for the management of the SWFs.

### **Political Parties**

SWFs are always a sensitive object for politicians, populists and other layers of society, which is understandable. The ultimate mission of the vast majority of SWFs is the accumulation of assets received from the sale of non-renewable resources for the next generations as well. That makes this structure socially sensitive and politically vulnerable. Therefore, it is not surprising that in the majority of the resource rich countries, such SWFs are the subject of sharp criticism from the political opponents. **Political parties, as a rule, criticize the authorities for ineffective management of the SWFs' assets and urge the government to have better consideration of the interests of all the layers of society.** The populists propose to distribute part of the assets among citizens, allegedly for the fair consideration of the interests of the entire population. However, as practice shows, for the majority of resource-rich countries, apart from single instances (the Alaska fund can be considered a positive exceptional case), such an experience can hardly be edifying. Thus, politicians try to use any mistake in the management of the SWFs as a "trump card" to stress their own political activity and to win more supporters with this tide. However, the majority of closed countries' authorities leave fewer chances to political opponents due to the amounts of such funds. Thus, on the one hand, existence of the SWF from the standpoint of development of critics may look like a blessing; nevertheless, being a good advantage in the hand of a government, it turns against them. It is not a wonder that political activity in the respective countries leaves much to be desired, while opposition is extremely weak to gain in the majority of the examined countries.

## **4.2. Assessing good governance in the SWFs**

So far the different parties involved in SWF control and overview have been identified. Nevertheless, the nature and the aim of this control depend on what is perceived to be good governance. In this respect, it remains important to identify the characteristics of the latter. These can be summarized as follows:

### **a) *Clarity of goals, roles and responsibilities***

This generally-known principle in the case of the SWFs has a special semantic assignment. SWFs are relatively new agencies in the public administration system. Unlike traditional state structures (for example, the Ministry of Finance), it is sometimes not so easy to clearly define the roles and the destination of the funds, and optimally connect this agency to the management system developed in the country. **The risk of the SWF remaining an alien element in the state organism is high. In this case, as practice shows, this gap is not that much a matter of concern of preservation of assets for future generations. Meanwhile, a policy of stabilization and promotion of macroeconomic**

**development may not gain the necessary support from the SWFs.** That is particularly traceable in Middle Eastern funds. On the contrary, in the OECD countries, we can observe the policy of a good combination of SWFs with both current and strategic policy of the state. Unlike the countries of risk, in developed countries, as a rule, we see a more clear definition of the role and the significance of the SWFs, and that is not a minor factor. Functions and goals are well defined. Thereby, sound legislative basis and strong institutional frameworks have significant importance in the successful functioning of the SWFs. In the absence of such a basis and framework, the respective governments should create all the necessary attributes on the level of the SWF itself to realize the status and the place of the SWF and hence determine the adequate mechanism of decision making in the management of the SWF.

b) ***Sustainable development for the benefit of future generations***

Resource-rich countries suffer most of all from the volatility of the market, hence they have continuous problems stemming from the lack of stable economic growth. Provision of the long-term stability herein is the priority task of the government. Exhaustibility of resources aggravates the execution of this task. **For this very reason, the countries extracting for more than one decade show preference to the establishment of SWFs for future generations.** Thus, the mission of the SWFs directly aims at the provision of long-term stability, which is further ensured by the effective management of the SWF assets. It is worth noting that in a number of countries, whilst separating the two functions of the SWF (stabilizing and accumulative), authorities show preference to the establishment of two separate SWFs (e.g. Russia, Alaska, etc). In other examples, like the case of Azerbaijan, the government prefers to combine these two functions in one SWF. With a purpose of the provision of essential long-term stability, governments are paying more attention to the finding of the optimal proportion between the volumes of the current expenses and the assets preserved for the future generations. Discovery of an optimal point herein is quite a hard task and it depends on many circumstances. Factors predetermining the level of the correlation are the volume of predicted reserves, production rates, macroeconomic strategy, social demographics and other features.

c) ***Transparency and accuracy of information***

Transparency is the key principle of good governance. How is transparency ensured in the case of SWFs and what should be the optimal policy of information access? As a rule, the transparency of the SWFs implies disclosure of regular, comprehensive and understandable information. **It is important to have an opportunity to compare the potential and efficiency of SWF activity with analogical SWFs in other countries based on available information and within its boundaries and its own dynamics.** Once the determinants of good governance are clarified it remains interesting to examine how these principles of good governance can be ensured. All things equal, the better the SWF is administered the more successfully it will develop. Poor management is associated with poor outcome. An SWF, even if it is an independent legal entity,

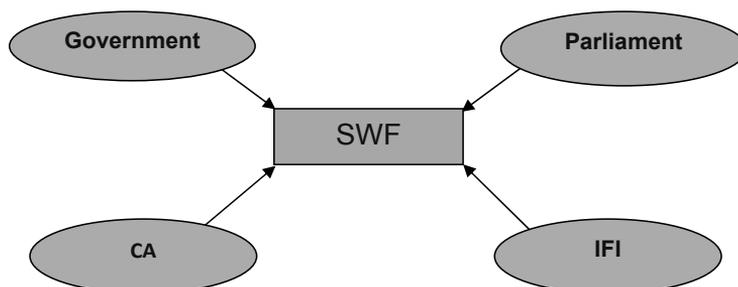
does not operate in a vacuum and bears the marks of the public administration system formed in the country. However, does that mean that there is a rule according to which the success of the SWF follows the level of provision of good governance? Would it be appropriate to mention here the proverb “one can do no more than one can”? The short answer is “no.” More comprehensively, we can operate with historical examples and economic regularities.

A typical example of such inconsistency is the State Oil Fund of Azerbaijan (SOFAZ), which takes its well-deserved place among the top 5 in all the listings, while Azerbaijan as a country in a similar appraisal enjoys a considerably poorer ranking. The level of SOFAZ’s success leaves behind the national indicators. Besides, the principal distinction of the SWFs from other public financial structures consists in the fact that the title “independent” in this content plays a key part. Unlike the Ministry of Finance, these structures are not entirely incorporated into the single public administration scheme and they enjoy a certain autonomy. Even if there is not a practice of legal entity and service of the accounts is performed on a trust basis (as, for example, in Kazakhstan), the SWF would still have an autonomous regime of management due to its special nature and mission. This particular factor makes SWFs special and in a case of good governance, they can indeed end up on a higher level of governance than the country as a whole.

However, this is not the only factor. By virtue of the peculiarity of the assets management, SWFs, as a rule, have a higher level of responsibility and financial accountability (audit) on foreign markets; hence, these structures are treated with special requirements. Eventually, the savings function of the SWFs adds serious requirements, and demands to have a proper approach towards the management of the SWF as the factor of preservation of part of the assets for the next generation seriously urges politicians on, and they are demonstrating herein a certain discipline. Thus, the success of the SWFs with good governance can indeed exceed the success of the country and this appears to be the case in several countries.

The success and the efficiency of SWF management become more apparent in a concentrated form (Fig 5) reflecting the process of decision-making vis-à-vis the SWF management when considering all the different parties involved. These parties are the government, the parliament, the international financial institutions (IFI) and the respective Chambers of Accounts (CA).

**Figure 5. Decision making process and the SWF governance**



## 1. Government

Government has the principal responsibility for the successful management of the SWF. **The government, usually represented by the Ministry of Finance, is the owner of the SWF.** In the majority of countries, the administration of the SWF is performed by the highest political ranks of the state by the appointment of the specific head of this structure. The government is interested in the optimal incorporation of the SWF to the overall macroeconomic architecture of the country. It is further interested in the resolution of many current financial problems related to the SWF. Thus, in a period of difficulties such as those of the budget and its deficit planning, the government would possibly prefer to have unimpeded access to the SWF reserves. Hence, the government might not be concerned about the legislative limitations over the spending of SWF assets at the government's discretion. This "unrestrained" desire to command the assets of the SWF in practice might not bring anything positive. Higher inflation and macroeconomic imbalance becomes the outcome of such a policy, which in the end results in a loss of the competitive advantage for the country. Considering that the terms of the government's power are discrete and limited in time, the government tends to spend the assets of the SWF for smoothing purposes and economic development over time, handing a legacy of debts and poor economy to the new authority. In the countries with poor institutions, this risk of uncontrolled use of assets (as long as the government may easily trample down all other supervising agencies responsible to oversee the executive power) is imminent. Thus, the goal of carrying out balanced policy of the SWF may make the government exceed its own powers and, in the condition of weakness of other authority agencies, to roll down to the fields of voluntarism. The latter may end with ineffective management and even stealing of the SWF's assets.

## 2. Parliament

For the successful functioning of the SWFs, it is a key requirement to have a strong parliament. **Parliament as the legislative body is able not only to ensure the necessary long-term supervision over the spending of SWF assets but also to restrain the appetite of the government by putting up a legislative screen against the unrestrained spending of the assets.** The experience shows that successful SWFs are generally accountable to the parliament. Norway can be considered a good example in this regard. In the places where such accountability and responsibility is weak or missing, the result is controversial and rather negative. In this sense, the important mission of the legislative body is a legislative restriction of the level of spending of the assets of the SWF inside the country and the mandatory compliance with this rule in practice. In the case of Azerbaijan, the subordination of SOFAZ to the head of the state of Azerbaijan and the poor role of Parliament is actually a weak spot for SOFAZ. The lack of a clear restriction line of the spending of the SWF may (and it already has) lead to serious violation of macroeconomic proportions which results in financial imbalances and unusually high rates of inflation for the respective countries.

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### 3. Chamber of Accounts

The Chamber of Accounts has a key role in securing the external control over the activity of the SWF. For example, in the case of Azerbaijan, in line with the article 92 of the Constitution, CA is established by the Parliament to which it is subordinated. In line with the article 2 of the Law on “Chamber of Accounts,” the Chamber along with a state budget represents the budget-financing control organization and exercises control on out-of-budget funds of Azerbaijan as well. Thus, SOFAZ falls under the full control of the Chamber. **As is stipulated in the aforesaid law, the Chamber exercises control over the volume of the receipts and the expenditure assets of the state budget and out-of-budget SWFs, control over their structure and timely execution in line with their assignment.**

### 4. International financial institutions

Amid all international financial institutions (IFI), the most actively engaged in the process of promotion of the successful management of the SWFs is the International Monetary Fund (IMF). **IMF in the context of the country reviews and regularly develops recommendations on the improvement of the SWF management and expresses special interest in the identification of an optimal model of the SWF development in different countries.** That is understandable because in extracting countries, the process of the management of the hydrocarbons’ revenues has colossal importance for the current policy and determination of the strategy of the perspective development. For instance, the IMF was very active in Azerbaijan from the very beginning of the generation of oil and gas revenues and it has offered many recommendations on this subject to the Azeri government<sup>22</sup>. The role of the IMF is growing in this respect. The IMF initiated the adoption of the Santiago Principles in September of 2008 and the creation of the International Working Group (IWG) including the senior leadership of the 23 significant SWFs around the world. Inauguration of the Forum of the SWFs in October in Baku can also be considered an important milestone on the way to the cooperation of these structures. The IMF coordinates this activity via the Secretariat established especially for the timely management of this activity. The IMF and to a lesser degree other international institutions (such as the World Bank, the European Bank for Reconstruction and Development and the Asian Development Bank) pay special attention to the work on SWFs. Given this reality, and taking into consideration the implications of the ongoing global economic crisis, the need for coordination of efforts by an international institution such as the IMF remains extremely high.

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<sup>22</sup> The study on “Managing oil wealth: the case of Azerbaijan” prepared by John Wakeman-Linn in 2004 could be considered a more successful specialized work of IMF on this matter.

## Conclusion

*The present brief has reviewed SWFs and their emergence as key players in the global financial arena. The latter has stimulated a fresh look at the nature, the operations, the risks and the governance patterns that SWFs experience. Initial assessment of the current developments indicates that under the ongoing global financial developments, SWFs are seen to represent a permanent redirection in investment flows and a shift in the dominant sources of financial capital. To date, global financial operations were dominated by Anglo-American financial institutions, but recent developments suggest increasing capital flows from emerging to mature economies. In these flows SWFs imply a redistribution of financial and political capital. Considering this reality, the presence of a blurring line between finance and politics raises concerns that SWFs will be used illegitimately to advance political, as opposed to commercial, agendas.*

*The conceptualization and the understanding of the latter lie with the thorough clarification of the nature and the operation of the respective SWFs as they seem to differ widely in purpose, maturity, risk attitude and investment preferences. In the present analysis these differences have been identified and analyzed indicating where the peculiarities and the dangers may lie. In particular the experiences to date suggest that SWFs are likely to face political risks in both developed and developing economies due to the inherent salient characteristic of the SWFs of government ownership. These political risks appear to be higher in developing economies due to the uncertainties stemming from harder-to-anticipated regime changes and weaker regulatory frameworks. When considering the financial risks, these are related to the fact that the respective governments might view SWF assets as free fiscal resources to be used ad hoc. Overall assessment of the SWFs and their changing role in the global financial arena indicates that the quality of the governance patterns of the SWFs and the relationship of the latter with the domestic and international economic and institutional structure remain of primary importance. In this context the present attempt has offered some crystallized characteristics of good governance looking at transparency, accountability and public awareness. In this direction of governance strengthening and overall improvements the respective governments, parliaments, civil society groups and international financial organizations emerge as players of key importance.*

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## Recommendations

1. Stakeholders should take into account that the political risk related to SWF activities in developing economies appears to be higher due to the uncertainties stemming from harder-to-anticipate regime changes and weaker regulatory frameworks.

2. In order to assess, manage, or mitigate overall risks, there should be a prescribed and documented framework that has clear lines of responsibility, segregation of duties, and reliable control mechanisms in SWFs.

3. SWFs' financial supervisors could experience difficulties when they attempt the exercise of their supervisory function, to determine whether the participation of the SWF in a financial institution jeopardizes the 'sound and prudent management' of the credit organization.

4. Funds' top managements have to evade serious fiscal risks for SWFs which will ensue if the government views their assets as free resources to be used ad hoc to cover various fiscal needs.

5. In order to ensure predictability of the SWF, its necessary for government, as owner of the fund, to focus on public disclosure and public control issues. This work should be more comprehensive and for this, governments have to provide to IWG the relevant program for further improvements.

6. Local CSO have to work out the program of cooperation with SWF in the resource rich countries and for this they can cooperate with international NGO's. The main line of this program should be "how to achieve good results of the public disclosure policy of the SWF in the country."

7. International financial institutions, particularly the IMF, should develop the indicative assessment mechanism of the SWFs in order to improve good governance practice, and after that they must popularize this practice in the world.

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## Appendix A

For each risk index the points given represent different quality levels. These are:

### Transparency

- 5 - No clearly identified investment criteria; no disclosure
- 4 - No clearly identified investment criteria; limited disclosure
- 3 - Vaguely identifiable investment criteria; limited disclosure
- 2 - Clearly identified investment criteria; limited disclosure
- 1 - Clearly identified investment criteria; full disclosure

### Strategic control

- 5 - Seeks controlling stakes (30% -plus) in strategic industry (defense-related)
- 4 - Substantial minority stakes (10%-plus) or/plus board representation in strategic sectors
- 3 - Substantial stakes (10%-plus) plus board representation in semi-strategic sectors such as banks and utilities
- 2 - Substantial minority stakes (10%-plus) without board representation in non-strategic sectors, no evidence
- 1 - Explicitly limited to small scale investments (less than 10%)

### Political relationship

- 5 - Major non-democratic countries, actively hostile to western-style market economies
- 4 - Major non-democratic countries, potentially hostile to western-style market economies
- 3 - Unstable countries, potentially hostile to western-style market economies
- 2 - Non-democratic western-style market economy
- 1 - Western-style democratic market economy

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# Governance, transparency and accountability in Sovereign Wealth Funds: remarks on the assessment, rankings and benchmarks to date

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## 1. Introduction

Sovereign Wealth Funds (hereafter SWFs) are government-owned investment funds operating in private financial markets. SWFs are commonly established out of receipts resulting from commodity exports, out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations and/or fiscal surpluses. Recent interest in the SWFs has failed to come to a consensus as to how SWFs differ from other public investment funds and how they should be defined. Indeed SWFs differ in ownership, underlying assets, degree of dependence, operational aspects, etc. Of the existing SWFs, almost half operate as separate legal entities, while the rest consist of a dependent entity within the Ministry of Finance or the Central Bank of the relevant country<sup>1</sup>. SWFs themselves declare various objectives ranging from fiscal stabilization or general savings for future generations to covering expected future pension expenditures. Despite certain explicit goals (e.g. financing future pension payment requirements), SWFs are managed according to the interests and the objectives of the government and/or the sovereign. In this respect the ultimate beneficiary of a SWF is not a specific individual but rather it remains the government, the host country's citizens or the taxpayer in general.

Differentials in the nature, the operations and the ownership render the assessment and the comparison of the SWFs difficult. In this reality it remains relevant to identify the communalities among SWFs that could serve as the basis of SWFs definition and assessment. Evidence from the existing SWFs suggests that governments, at central or at sub-national level, may own the SWFs and exercise control directly or indirectly upon them. In this case, SWFs can be seen as a meeting point of high politics with high finance. In terms of the available liabilities, a number of SWFs have liabilities, such as sterilization debt or some deferred contractual liability to transfer money out of the fund and into the general budget or a social security system. However, in the majority of the cases SWFs have no non-governmental or outside liabilities.

Of the SWFs that do have liabilities, these are usually intra-governmental, with

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1 See Ahmadov et al (2009).

one branch of the government owing money to another branch of the government (i.e. the fund may owe to the Ministry of Finance, the Central Bank or the social security reserve funds). SWFs have no external creditor, hence accumulated assets are not subject to outside non-governmental owners' property rights. Hence the existing fund liabilities are part of the broader national balance sheet. In this respect SWFs can be defined in more detail as directly or indirectly government-owned and controlled investment funds, with no outside beneficiaries or liabilities involved in asset investments in the short or long term. The sovereign and the citizens of the country remain the ultimate beneficiaries of the fund's operations.

Following immense accumulation of international assets, policymakers in countries with SWFs have set up a number of considered as "optimal" operational and policy objectives. These "optimal" objectives vary between the existing funds. The differentials among the SWFs, which reflect these different policy and operational objectives, the increasing number of the SWFs and the accumulating assets held and managed by the SWFs, have triggered interest in SWFs and in the establishment of a set of common assessment criteria and benchmarks for SWFs. Indicative are the Truman (2008) scoreboard, the Linaburg-Maduell Transparency Index developed by the Sovereign Wealth Fund Institute, or the guidelines for SWFs developed by the IMF and the OECD. The attempts to establish benchmarks and to rank SWFs have been further intensified as a response to the increasing importance of the SWFs to the international financial markets, especially during the latest financial crisis.

Several SWFs have obtained significant shares in prominent Western financial institutions. The acquired 4.9% stake of Citigroup from the Abu Dhabi Investment Authority in November 2007, the 9.9% stake of Morgan Stanley acquired by the China Investment Corporation in December 2007 or the 9.8% stake of UBS obtained in December 2007 by GIC Singapore are just a few examples to name<sup>2</sup>. Over the last years SWFs have worked as pivotal actors in providing liquidity to Western companies, which has been very much needed in the times of the latest financial crisis. In this respect SWFs have constituted an opportunity significantly related to the future of capital markets (Epstein and Rose, 2009). In this reality the developed assessment and ranking attempts of the SWFs have primarily reflected the concerns that the international financial institutions and individual recipient countries of SWFs' investments have been faced with.

These concerns have primarily regarded the governance structures of the SWFs and the lack of transparency and accountability on funds' operations. Concerns have been exacerbated by the fact that the wide majority of the SWFs are based in undemocratic countries. This has raised further questions on whether political, as opposed to economic, considerations guide fund operations and their activities in the international financial system. To date, the assessment and ranking attempts of the SWFs have been based on the financial performance of the SWFs, on their investment management and on their governance, transparency and accountability standards. The present paper focuses on governance, transparency and accountability perspectives. The aim of the present paper is to critically review the governance, transparency and accountability rankings and benchmarks developed for the SWFs.

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<sup>2</sup> Source: Sovereign Wealth Fund Institute.

The recorded efforts come in large part from Western countries and independent organizations and mainly reflect the needs and the standards required from the international financial markets and countries that are recipient of the SWF investments. In light of this reality, the assessment and the rankings are based on what is “necessary” and “adequate” from the international financial markets’ perspective rather than from what is “beneficent” and “adequate” for the citizens of the countries that remain the ultimate beneficiaries of the operations of the SWFs. Moreover, these attempts develop on the assumption that what is “good” and “working” for one fund or country it should be “good” or “working” for other funds or countries as well. Overview of these attempts further indicates that the methodological considerations should be kept in mind when employing the latter rankings and benchmarks.

The remainder of the paper is structured as follows. Section 2 reviews the conceptual framework relevant to governance, transparency and accountability aspects of the SWFs. This section highlights the critical role of strong governance and transparent and accountable operations of the SWFs for micro and macro developments on an ongoing basis as well as for the performance of the SWFs. Section 3 compares and discusses the existing governance, transparency and accountability benchmarks and ranking attempts. The analysis summarized discusses the main limitations in these attempts indicating their impact upon the obtained results. Arguments that such ranking attempts might reflect specific purposes, or that the rankings may be constructed making specific considerations are further developed. The last section makes conclusions.

## **2. SWFs: The role of governance, transparency and accountability**

The debate and the empirical evidence on SWFs, particularly on those being established out of resource revenues, remain controversial and inconclusive. The scholarly literature on resource-based funds remains patchy and consists mainly of the work by the IMF and the World Bank<sup>3</sup>. In general, it is possible to identify two streams of arguments. The first debates that funds are not necessary. According to this point, if the conditions that are required for the successful functioning of these funds exist, then resource revenues or fiscal surpluses can be managed without them within the budgetary process (Davis et al, 2001). The second stream suggests that even if it is impossible to create ‘ideal’ conditions, the existence of funds could prevent excessive spending. The experience of the successful funds of Alaska or Norway is usually employed in support of this argument (Fasano, 2000; Birdsall and Subramania, 2004). To date, indeed, there are not many examples of success. The Alaskan and Norwegian funds are striking exceptions.

Nevertheless, in these cases, given the broader national policy frameworks and the wide support for deferring some wealth gains for future generations, further questions have regarded whether separate funds were needed in these countries in the first instance. History provides us with many examples of “problematic” funds, like those of Nigeria or Venezuela, the number of which

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<sup>3</sup> Among others see Petersen and Budina (2003), Crain and Devlin (2003), Shabsigh and Ilahi (2007) and Brown et al (2009).

exceeds the successful cases (Davis et al, 2003; Davis et al, 2003; Delvin and Lewin, 2002). With the exception of Norway, with its strong government institutions and healthy democracy, the experiences with resource-based funds have not been encouraging (Birdsall and Subramania, 2004). Moreover, the examples of the countries in the Middle East demonstrate limited success in the functioning of the funds. The reason for the inefficiency of the funds has been attributed to the lack of clear rules and operations, which should be transparent, with stringent mechanisms to ensure accountability and prevent resource misuses (Davis et al, 2003). The operational side of this management could cause further obstacles (Barnett and Ossowski, 2003).

Overall the experience of unsuccessful funds like the Venezuelan Investment Fund or the Nigerian Petroleum Trust Fund has indicated an even more complicated problem: the quest for rigorous governance, adequate transparency and accountability. Governance regards the role of the government, of the governing bodies and of the managers of the SWFs in the decision-making process regarding the flows into and out of the funds, the investments made and the diversion of the accumulated assets to economic ends. Transparency is related to the adequate, full and timely provision of information to the public regarding the operations of the funds as well as with the clear communication of the role of the funds to the broader public. Accountability regards the multilevel oversight of the SWFs and the degree to which the government, the governing bodies and the fund managers are held responsible for their decisions.

Caspian Revenue Watch provides a public debate on these issues suggesting that weak governance along poor transparency and accountability make the funds and the respective countries less likely to convert social expenditures into improved income (Tsalik, 2003). In many countries SWFs are set up following increasing surpluses from exports of natural resources. The literature on resource-rich economies supports the view that natural wealth can pose problems for economic management<sup>4</sup>. In a range of cases, economic performance appears to suffer rather than benefit from the impact of natural resource endowments (Paldam, 1997; Gylfason and Zoega, 2003). The international community and major international financial organizations have become growingly concerned about the effectiveness with which natural resource revenues are used. In particular they are concerned with the question of how funds can contribute towards long-term economic and social development.

The latter is a subject of the political economy of resource-driven growth. Nevertheless, in the investigation of this relationship, it is also acknowledged the crucial dependency of the fund establishment and operational outcomes to implemented policies, in particular with regards to governance, transparency and accountability. SWFs out of natural resource revenues can contribute to economic growth by smoothing some of the instability that may arise from energy

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4 The literature to date offers a growing amount of works in support of the concept that natural resource endowment is an economic curse rather than a blessing (Auty and Mikesell, 1998; Sachs and Warner, 2001; Gylfason, 2001; Auty and de Soysa, 2006).

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price fluctuations. In this attempt the adverse incentives that have plagued some resource-rich countries can be avoided with the employment of strong governance structures of resource wealth management and with the provision of adequate transparency and accountability to the latter.

In this respect a key question to be addressed is whether funds are panacea for the so called “paradox of plenty” or whether they are effective only in circumstances that are in any case particularly benign. In this case funds may serve as a form of “commitment mechanism,” thus substituting for other commitment mechanisms possibly resulting from the involvement of international financial organizations such as the IMF (Kalyuzhnova, 2006). Nevertheless, the key requirements for success with such funds appear to ultimately lie with governance, transparency and accountability standards. Governance, transparency and accountability aspects and their differentials depend in large part on the role that SWFs serve (i.e. accumulating funds so as to stabilize the economy, saving funds for future generations, addressing future payment obligations, etc)<sup>5</sup>. Governance, transparency and accountability aspects that reflect political economy factors related to SWFs, such as institutions and the organizational design, remain important for several reasons.

A first area where governance, transparency and accountability remain important is the microeconomic domain. This regards in particular the rising concerns about rent-seeking and corruption. These problems can be worsened by the lack of strong governance and sound provision of transparency and accountability. The principles where clarity remains of primary importance are the rules that ultimately govern who will benefit from redistribution of the nation’s wealth and how far governmental policies act as disguised transfers in this regard (Tullock, 1997). For resource-based SWFs, the role of the commitment mechanisms is further important in order to limit the possibility of dynamic inconsistency (Dixit, 1996) or of conflicting interests. Overcoming distorted incentives in government intervention could be perceived as a challenge in achieving an optimal path of the public welfare from resources (Kalyuzhnova, 2006). A special reference should be made at this point to rent-seeking behavior of corrupt governments, namely to the aggregate resources absorbed by rent-seeking. In the case of resource-rich countries these rents can be quite large, because as a rule they represent the main sector of the economic activities in these countries. Therefore, the effect of rent-seeking on the organizational design of the governmental programs is significant overall<sup>6</sup>.

A second area where governance, transparency and accountability remain important regards macroeconomic developments and the design and

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5 The literature to date offers a rich discussion and explanation of the differentials that the existing funds experience in their governance, transparency and accountability standards. Moreover, a significant amount of work looks into the role that various parties such as the government, the managing board and the civil society play in the governance of the funds. The discussion on the differentials in governance, transparency and accountability and on the role that each party plays in the governance of the funds extends beyond the aim of the present paper. For a detailed discussion see among others Tsalik (2003) and Bacon and Tordo (2006).

6 Stigler (1975) and Posner (1975) demonstrated that the latter can be particularly observed in the area of regulation.

implementation of fiscal policy in particular. Links to fiscal policy emerge as particularly important in a saving context (Kalyuzhnova, 2006). In successful cases funds should ensure significant public savings. For instance in the case of SWFs being funded out of oil revenues, the creation of the fund, and the agreement on its rules, can be seen as a commitment device. This could further help to build a public constituency for saving part of revenues. In cases where the government finances deficits by borrowing from savings funds, then saving fund assets are merely offset by government debt (Davis et al, 2001). This further highlights the critical link between the fund operations, in this case serving a savings role, and the design of fiscal policy. The key issue in this case is the strict discipline and ability of the government to keep a financial balance in the accumulation and spending of the saving fund income. In this respect, the large accumulation of the fund assets could create political unrest. This could derive from increasing public demands for the government to increase public spending and decrease taxes, etc.

These considerations help address the legitimate question of whether a concrete strategy of public saving for future generations could not be implemented without creating a formal and separate fund. In financial terms this might be the case. Nevertheless, in the case of funds being funded out of resource revenues, their presence can potentially play a key role by helping the promotion of public understanding of the need to save for future generations. However, in order to meet this goal, the analysis needs to be clearly formulated, followed by a set of clear and transparent rules. This is the only case when the analysis can prove persuasive to political circles and to the wider public. In this respect governance is the core challenge.

In the context of preventing corruption, conflicting interests between the public and the private sector and misuse of SWFs' assets at macroeconomic levels, the role of strong governance, transparency and accountability in SWFs remain important. The presence of SWFs poses great policy, political and economic challenges. Among others, these are related to the prudent mobilization of the revenues, to the fair allocation of the resources between generations, to the identification of the best investment alternatives, to the temptations to use the funds for political as opposed to economic purposes and to the favoring of specific social or economic groups against other groups. Where SWF assets are used so as to favor the ruling elite, to keep the inefficient public sector running or so as to promote political goals, successful performance might not be the case. In the presence of strong governance and adequate mechanisms that can guarantee the transparent and accountable management and operation of the funds, the latter temptations or distortions of SWF operations may be prevented, safeguarding the performance of the funds.

Moreover, the tensions created between the public and the private sector as a result of the SWF investments and asset allocations may be mitigated when governance structures are robust. Governance structures that can guarantee a voice for all and adequate representation of different groups in the decision making process may prevent any tensions or any politically motivated investments of the SWFs. Moreover, the clear understanding of the governance structure of the funds regarding the adequate provision of transparency and accountability in their operations may help in the identification of any political objectives that

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the funds may serve along their economic objectives. This may further help the understanding of the SWFs' performance and the acceptance of SWF investments in the domestic economy and in foreign countries.

Governance, transparency and accountability aspects remain important for the welcoming of the SWFs in the international financial markets and the recipient countries of SWF investments. Global imbalances deriving from large current account deficits in major economies, like that of the USA, and counterbalancing large surpluses in Asian and oil-producing countries, have attracted significant attention. This has been triggered by the vast flow of finance from developing countries to developed countries and mature financial markets. This has been welcomed by the organizations hit by the financial crisis and has proved beneficial for market stability. Nevertheless, concerns have been raised in major economies and recipients of SWF investments, such as the United States and Europe, about the nature and the possible political intentions of the SWFs.

In the current global financial developments SWFs are perceived as representing a permanent redirection in investment flows and a shift in the dominant sources of financial capital (Ahmadov et al, 2009). With these flows, SWFs suggest a redistribution of financial and political capital throughout the world. In this reality the presence of a blurring line between finance and politics raises concerns that SWFs will be used illegitimately to advance political, as opposed to commercial, agendas. In many cases SWFs may even be perceived as a source of state financial capitalism. This can trigger further concerns on whether the introduction of public investors into private markets will do for efficiency. In this respect clear governance strictures and provision of adequate transparency and accountability regarding SWFs' governance, operations and investments would ease the concerns of the recipient countries while it could further facilitate their operations in the international financial arena.

Any assessment attempt of the SWFs has to address a set of questions and to further choose the perspective of the assessment employed. For instance, any assessment attempts would have to consider the key objectives assigned to the funds (such as stabilization and/or saving). In addition the framework should be clarified in which their effectiveness can be analyzed. Moreover, the core criteria of success of the funds should be identified (Kalyuzhnova, 2006). In this respect the crucial point is the clear goals of the fund. For instance, the funds of Norway or Alaska pursue stabilization and perform saving functions. Many other funds have the same functions but have not been successful. An alternative set of criteria that have been examined are fund management rules that guarantee accountability.

It is important for every fund to clearly indicate who is managing the fund. For instance the Norwegian fund is managed by the Norwegian Central Bank according to the Ministry of Finance guidelines. The Alaska Permanent Reserve Fund is managed by the Alaska Permanent Fund Corporation while external managers handle equity, fixed income and real estate portfolios. The last but not least set of criteria of success should be connected with a high level of transparency of fund operations. Every fund necessitates professional management. If the fund has independent spending authority, that could undermine the budgetary process. Moreover, regular reporting and audit are quite important. In addition the management of the fund needs to maintain public awareness about the existence

of the fund.

To date, several assessment attempts of the SWFs have been developed from scholars, Western Financial Institutions and independent organizations (Truman, 2008; SWF Institute, IMF, etc). All of these assessment attempts have identified governance, transparency and accountability as of primary importance to the successful performance of the SWFs. The majority of them offer a qualitative approach to the assessment of the SWF, while later efforts attempt a quantitative approach to SWF rankings. Indicative of these efforts are the Truman (2008) scoreboard and the Sovereign Wealth Fund Institute Linaburg-Maduell Transparency Index. Both of the latter attempts have developed a classification system of the existing funds assessing governance, transparency and accountability aspects along financial aspects of the SWFs.

Following the growing international demand for SWFs' governance, transparency and accountability fostering, the International Working Group on the SWFs has developed the "Santiago Principles"<sup>7</sup>. The principles have been a reflection of the increasing demand for clear governance, adequate transparency and accountability, and integration of the SWFs with the international financial markets. The purpose of the principles is to identify a set of generally accepted practices that can reflect appropriate governance, transparency and accountability arrangements as well as to promote SWF investments based upon a prudent and sound economic basis. Acceptance of the principles will allow the respective countries and funds to gain greater understanding at home and in recipient countries as well as in the international financial markets.

Overall clear governance structures and adequate provision of transparency and accountability of SWFs can play a determinant role in micro and macroeconomic developments in the host countries. Moreover it can determine the performance of the funds while it can facilitate their international welcoming. Over the last few years several attempts have been made to assess, evaluate and rank governance, transparency and accountability aspects of the SWFs. These have been developed along with attempts to identify fund cases that could serve as benchmarks and to establish a code of generally accepted practices for SWFs. Nevertheless, the ranking results and the proposed benchmarks should be treated carefully. The ranking results and the benchmark analysis may suffer from several methodological limitations. Moreover, these attempts have reflected in large part the governance, transparency and accountability standards required as minimum by the recipient countries of SWF investments. In this respect the developed rankings and suggested benchmarks and best practices should be treated carefully and their limitations should be acknowledged and addressed.

### **3. SWFs, governance, transparency and accountability: Assessing rankings, benchmarks and best practices**

SWFs vary in objectives and size, and further, they operate in countries that differ in terms of governmental structures. In this respect any comparative assessment has to overcome significant difficulties. However the extraction of a set of core elements that remain important for all the SWFs' short term

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<sup>7</sup> International Working Group on Sovereign Wealth Funds (2008).

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stabilization purposes and long term intergenerational wealth distribution can lead to a significant first step assessment and ranking. To date, several attempts have been made to assess the performance of the SWFs employing a variety of sets of funds and sets of institutional and financial aspects. Fasano (2000) provides a comparative analysis of the operational modalities and of the experience with the resource-based funds suggesting that the funds of Norway, Kuwait, Chile and the State of Alaska have been successful institutions contributing to effective fiscal policy. Eifert et al (2002) tackle the issue of resource wealth and successful funds employing the prism of political economy for the cases of Norway, Venezuela, Mexico, Saudi Arabia, Nigeria, Indonesia and Chad, concluding that technical solutions such as the setting up of resource-based funds will not work unless supportive constituencies are developed in support of such measures.

Similar attempts to offer a policy brief on oil revenue management by oil funds is made by the Friends of Earth (2002). With a reference and a comparative analysis of the cases of Chad, Azerbaijan, Kazakhstan and Uganda the assessment concludes that in the absence of real political will, so as to allow public scrutiny and participation in resource management and the decision-making process, funds will fail to address core issues of civic empowerment and democratic development. Kalyuzhnova (2006), comparing and contrasting the oil funds of Azerbaijan and Kazakhstan, suggests that the key requirements for successful performance of funds lie upon governance issues. In an attempt to address the problem of oil wealth management and mineral funds in the Caspian region Tsalik (2003) incorporates the evidence from the funds of Azerbaijan and Kazakhstan into a wider set of oil funds. In a comparative review the author concludes that the oil funds of Norway, Alaska and Alberta can be proposed as successful fund models. Bacon and Tordo (2006) attempt a comparative analysis and classification of a set of resource-based funds building a more systematic method of comparison. The assessment is based on a set of funding and operational aspects. The authors suggest governance, transparency and accountability to be key success factors that allowed certain funds to be better performers than others.

Truman (2008) offers a first systematic approach of fund ranking and quantitative analysis of fund performance. The starting point of this assessment is the present fund practices, providing a basis for the evaluation of the results of the IMF-sponsored dialogue on SWFs' best practices. The main argument is that no fund should be asked to implement guidance or practices that at least one other fund does not implement or practice already. The scoreboard is constructed using the sum of points that each fund collects in a series of questions, where the respective answers can be either "yes" or "no" giving the relevant point (being 0 or 1, as predetermined for each question) to the fund assessed. The results of this assessment offer a scoreboard that quantifies the degree of successful performance for a wider set of funds considering a range of different assessment elements (Table 1).

The Truman (2008) scoreboard indicates that in a comparative analysis, pension funds are related to better scores of governance, structure, transparency, accountability and behavior. When considering non-pension funds, the SWFs of USA and Norway score higher in the ranking system while the Gulf Countries' SWFs perform relatively lower. The scoreboard provides an indication of

standards and requirements that SWFs can fulfill without providing more information or being more exposed than other funds. In troubled times, such as the latest financial turmoil, the indication of such scoreboards can highlight differentials and possible particularities that are related to each specific fund. Moreover, it can provide information and fair predictability of the nature and decision-making process of the respective funds, lowering the speculative risk, discontent and generated ambiguity over the role and the investment purposes of the relevant funds. Similarly to earlier attempts, Truman (2008) indicates in particular the importance of transparency and accountability of SWFs, suggesting that the latter remains a key point in welcoming investments from SWFs and a further important stabilizing factor in the international financial markets.

**Table 1. Truman (2008) scoreboard of SWFs**

Country	Fund	Structure	Governance	Accountability and Transparency	Behaviour	Total
Canada	Canada Pension Plan	100	100	96	83	95
New Zealand	Superannuation Fund	100	100	100	75	95
USA Alaska	Alaska Permanent Fund	100	80	100	83	94
Canada Quebec	Caisse de depot et placement du Quebec	100	100	89	83	92
France	Fonds de reserve pour les retraites	100	100	89	83	92
Norway	Government Pension Fund Global	94	100	100	67	92
USA California	California Public Employees Retirement System	100	100	96	67	92
USA Wyoming	Permanent Mineral Trust Fund	100	90	82	100	91
Japan	Government Pension Investment Fund	100	90	80	83	87

Ireland	National Pensions Reserve Fund	100	100	86	58	86
USA New Mexico	Severance Tax Permanent Fund	100	50	86	100	86
Netherlands	Stichting Pensio-enfonds ABP	100	100	86	50	85
Australia	Future Fund	100	80	68	83	80
Timor Leste	Petroleum Fund for Timor-Leste	100	40	96	50	80
Azerbaijan	State Oil Fund of the Republic of Azerbaijan	88	60	89	50	77
China	National Social Security Fund	100	40	82	67	77
Canada Alberta	Alberta Heritage Savings Trust Fund	94	60	79	50	74
Chile	Economic and Social Stabilization Fund	94	60	82	17	70
Hong Kong	Exchange Fund	88	40	79	33	67
Kazakhstan	National Fund for the Republic of Kazakhstan	88	60	64	33	64
Botswana	Pula Fund	69	60	54	33	55
Trinidad and Tobago	Heritage and Stabilization Fund	100	60	46	0	53
Korea	Korea Investment Corporation	75	60	45	25	51
Russia	Reserve Fund and National Welfare Fund	72	40	50	33	51
Kuwait	Kuwait Investment Authority	75	80	41	0	48
São Tomé and Príncipe	National Oil Account	100	60	29	17	48
Mexico	Oil Income Stabilization Fund	69	20	43	50	47
Singapore	Temasek Holdings	50	50	61	0	45

Singapore	Government of Singapore Investment Corporation	63	40	39	17	41
Malaysia	Khazanah Nasional	44	50	46	0	38
China	China Investment Corporation	50	50	14	17	29
Kiribati	Revenue Equalization Reserve Fund	69	60	7	0	29
Algeria	Revenue Regulation Fund	56	40	11	17	27
Nigeria	Excess Crude Account	50	30	14	17	26
Iran	Oil Stabilization Fund	50	20	18	0	23
Venezuela	Macroeconomic Stabilization Fund	50	0	18	17	23
Oman	State General Reserve Fund	50	0	18	0	20
Sudan	Oil Revenue Stabilization Account	56	0	14	0	20
Venezuela	National Development Fund	38	0	27	0	20
Brunei Darussalam	Brunei Investment Authority	31	0	25	0	18
UAE Abu Dabi	Mudabala Development Company	44	10	7	0	15
UAE Dubai	Isthmar World	38	10	7	0	14
Qatar	Qatar Investment Authority	34	0	2	0	9
UAE Abu Dabi	Abu Dhabi Investment Authority and Council	25	0	4	8	9

In an attempt to assess SWFs' transparency and accountability provision, the "Linaburg-Maduell Transparency Index" has been developed by the Sovereign Wealth Fund Institute researchers<sup>8</sup>. This is based on Norway's SWF, widely seen as the benchmark of transparency. The index implements 10 "essential

8 <http://www.swfinstitute.org/research/transparencyindex.php>

principles<sup>9</sup>. For each principle assessed there are different levels of depth, the judgment of which is left to the discretion of the Sovereign Wealth Fund Institute. The index results in a transparency index rating from 1 to 10 (Table 2), with 8 recommended from the Sovereign Wealth Fund Institute in order to claim adequate transparency. The Linaburg-Maduell Transparency Index identifies the funds of Alaska, Norway and New Zealand as high scorers by transparency standards.

Similarly to the findings of Truman (2008), Gulf countries' SWFs are found to score low in terms of transparency. The index reveals a very interesting picture when considering the funds established in the Caspian region. The State Oil Fund of Azerbaijan (SOFAZ), although a relatively recent establishment when compared to other SWFs, has managed to succeed in terms of full transparency and accountability, scoring at similar levels to model establishments such as that of Norway. Indeed the SWF of Azerbaijan has been a pioneering establishment in the region in promoting transparency standards and further pushing forward regional standards. In this respect the experience of Azerbaijan and its respective policies towards fund transparency might be useful to the countries of the region.

**Table 2. Linaburg - Maduell Transparency Index<sup>10</sup>**

Country	Fund Name	Index
Azerbaijan	State Oil Fund	10
Chile	Social and Economic Stabilization Fund	10
Ireland	National Pensions Reserve Fund	10
New Zealand	New Zealand Superannuation Fund	10
Norway	Government Pension Fund – Global	10
Singapore	Temasek Holdings	10
UAE - Abu Dhabi	Mubadala Development Company	10
US - Alaska	Alaska Permanent Fund	10
Australia	Australian Future Fund	9
Canada	Alberta's Heritage Fund	9
South Korea	Korea Investment Corporation	9
US - New Mexico	New Mexico State Investment Office Trust	9
US - Wyoming	Permanent Wyoming Mineral Trust Fund	9
Bahrain	Mumtalakat Holding Company	8
China - Hong Kong	Hong Kong Monetary Authority Investment Portfolio	8

9 The principles assessed and the respective points given are summarized in Appendix A.

10 Assessment as of October 2009.

China	China Investment Corporation	6
East Timor	Timor-Leste Petroleum Fund	6
Kazakhstan	Kazakhstan National Fund	6
Kuwait	Kuwait Investment Authority	6
Singapore	Government of Singapore Investment Corporation	6
China	National Social Security Fund	5
Malaysia	Malaysia Development Berhad	5
Qatar	Qatar Investment Authority	5
Russia	National Welfare Fund	5
Trinidad & Tobago	Heritage and Stabilization Fund	5
China	China-Africa Development Fund	4
Malaysia	Khazanah Nasional	4
UAE - Dubai	Investment Corporation of Dubai	4
Vietnam	State Capital Investment Corporation	4
Saudi Arabia	Public Investment Fund	3
UAE - Abu Dhabi	Abu Dhabi Investment Authority	3
UAE - Ras Al Khaimah	RAK Investment Authority	3
China	SAFE Investment Company	2
Libya	Libyan Investment Authority	2
Saudi Arabia	SAMA Foreign Holdings	2
UAE - Federal	Emirates Investment Authority	2
Algeria	Revenue Regulation Fund	1
Botswana	Pula Fund	1
Brunei	Brunei Investment Agency	1
Iran	Oil Stabilization Fund	1
Kiribati	Revenue Equalization Reserve Fund	1
Mauritania	National Fund for Hydrocarbon Reserves	1
Nigeria	Excess Crude Account	1
Oman	State General Reserve Fund	1
Venezuela	FIEM	1

The overview of the different ranking attempts reveals some interesting information with regards to fund level performance. First, the fund of Norway is

repeatedly classified as a “good performer” and employed as a benchmark of governance, transparency and accountability. The Norwegian model is suggested by many as a prime example to follow and indeed several countries have employed the Norwegian model when establishing their funds (like the fund of Kazakhstan). The Norwegian fund remains by far the most examined and best performing fund, especially when governance, transparency and accountability aspects are considered. Nevertheless, when considering the practices that the Norwegian fund has implemented and the suggestions to the larger group of SWFs to follow its example, the specific country characteristics of Norway should be taken into consideration (Box 1). In this respect the employment of the Norwegian SWF as a prototype and a successful performer should not be exaggerated, while the type specifics of the countries/funds that are called to implement similar practices should be further taken into account. Hence the scoreboards and blueprint attempts should further consider the possible limitations of the Norwegian model as a benchmark for other SWFs.

Furthermore, several methodological limitations should be considered when employing these scoreboards. The employment of the quantitative ranking and scoreboard attempts, such as the Truman (2008) scoreboard or the Linaburg-Maduell Transparency Index, should consider the subjective nature of the indexes and the bias that the latter can create. For instance, in the SWF Institute Linaburg-Maduell Transparency Index, for each principle assessed there are different levels of depth, the judgment of which reflects the judgments and the discretion of the Sovereign Wealth Fund Institute. This is indicative of the lack of objective qualitative assessment that may be present in the existing rankings and scoreboards. This can be further exacerbated by the fact that SWFs are often required to assess their own constituents. The available rankings and benchmarks are largely developed based on the available public information on the SWFs. Nevertheless, in some cases these facts have been confirmed with the funds themselves. In this respect the funds are called to comment on their own constituents. Hence the conflict of interests that may emerge for the assessed SWFs might bias the provided information and the derived estimation results, rankings and scoreboards.

### **Box 1. The “Norwegian Model”<sup>11</sup>**

Oil production in Norway started in the early 1970s. During the first oil shock, production was only 32,000 barrels a day. The experience with the spiking oil prices stimulated the production that escalated to about 1 million barrels a day by 1987 and 3 million barrels a day by 1996 (Bacon and Tordo, 2006). Norway has a small population and domestic demand for oil is limited, making it one of the leading oil exporters. Oil riches in Norway fled at a time when the economy was well-developed (Cappelen and Mjoset, 2009). Nevertheless, the scale of the discovery was large in relation to the total size of the economy and it has continued to grow considerably. Over the last decade, oil and gas have accounted for about 17% of GDP and 40% of exports. Since the very beginning of oil development, questions were raised in fear of “Dutch disease” about how

11 Source: Tsani (2009)

to use the revenues without distorting the nature of the economy and society (Hannesson, 2001). Further concerns were raised with regards to the long-term funding needs of the increased pension requirements that the aging population would require (Skancke, 2002). In response to those concerns, in June 1990 the government established by Act 36 of the Storting, the Norwegian parliament, the Norwegian Government Pension Fund (NGPF)<sup>1</sup>.

According to the act, all oil-related revenues are paid into the NGPF, as are any interests or dividends earned on assets already held. The management of the fund has been entrusted to the Ministry of Finance. Since 1996 the Ministry has delegated responsibility for management to the Central Bank (Norges Bank). Norges Bank has further contracted external managers for part of the portfolio but it has also managed a large part of the portfolio itself. From the very beginning, all the investments of the fund have been made outside Norway. This was due to the fear of distorting the relatively small economy by the injection of large sums of financing. The Ministry of Finance along with the government has further issued instructions to the Norges Bank regarding investments in socially responsible activities<sup>2</sup>. According to the fund establishing act the deficit on the government non-oil budget, determined by the Parliament, is paid out of the fund while surpluses remain in the fund (Bacon and Tordo, 2006). In this respect neither the income nor the capital of the fund is safeguarded, as the Parliament could authorize a budget deficit large enough to use all current oil revenues and some of the accumulated past revenues. This is related to the fungibility of resources, as transfers into or out of the fund take place according to the non-oil deficit of the central government, which itself is determined through normal parliamentary budgetary processes.

Debt in Norway is small and a stable fraction of GDP, while the fund already accounts for a value of 60% of GDP<sup>3</sup>. Hence its assets correspond approximately to the net financial position of the central government. This enables a profound provision of transparency. The assets of the fund and their trajectory correspond to government savings, and people are thus well informed of the net position of the government through the fund's highly publicized annual reports (even if they are less well informed on the magnitude of overall government debt). When considering the Norwegian fund the distinctive feature is that the fund is, de jure, part of the general budget process. The only explicit use of the fund is to support non-oil budget deficits. Similarly, the status of the fund is such that at any time the Parliament can withdraw as much as it wishes from the fund to support the non-oil budget deficit. In this respect, absence of no accumulation or withdrawal rules makes the fund very flexible. In practice, the fund has been de facto used largely as a savings fund, although there have been substantial year-to-year variations in the proportion of oil revenues saved.

1 The fund is also known as the Norwegian Government Petroleum Fund.

2 In 2001, the environmental fund has been established as sub-portfolio held in the NGPF. Its purpose is to hold equities based on sound environmental criteria. In 2004, following the debate on the budget and the report of the Committee on Ethical Issues for the Petroleum Fund (Graver Committee), the Ministry of Finance issued new guidelines with regards to ethical investments undertaken by the fund.

3 As of 2006.

The contrasting nature of what might be done with the fund, and what has actually been done, illustrates the strong discipline of the Storting. Such structure could be particularly vulnerable to a political election cycle, and over longer periods, this may prove to be an important factor in the use of the fund. The discipline of Storting is further accompanied by the limited role of the Parliament and bodies outside the Ministry of Finance. The wide publicity given to the performance and management of the fund through the widespread publication of the reports can influence the activities of the fund through the democratic process. In short, the operation and management of the NGPF has been successful in accumulating funds for the Norwegian state. It remains to be seen whether the aggressive saving of oil funds and sophisticated investment policies followed by the government will be able to accumulate sufficient funds to finance future spending needs at a time when oil production will be in decline.

Attempts such as those of Truman (2008) or the SWF Institute Transparency Index employ a set of questions according to which funds are ranked. In this case a “yes” or “no” answer is enough so as to grant or not grant further points to each fund. Nevertheless, this approach does not allow for the control of quality discrepancies between the funds. For instance, funds will be given extra points in terms of transparency and accountability if they operate a website. Nevertheless, the quality and the quantity of the information provided in the respective funds are not really assessed. Hence funds that provide very basic information on their website may be granted the same points as funds that operate a more detailed and more frequently updated website. In addition the assessment questions employed might address overlapping aspects.

For instance, funds that regularly publish annual reports might also publish information on the geographical spread of their investments or on the performance against the established portfolio benchmarks. In contrast, funds that would choose to be secretive in their operations would choose to do so in a set of information given to the public. In this case non-identification of the commonalities between the questions employed and the common variance might lead to duplication of the transparency and accountability aspects assessed. This can duplicate the points awarded in each case and artificially inflate the quantitative results.

The employment of scoreboards and benchmarks should consider in addition the motivation, the objectives and the perspective for the construction of these indexes. The quantitative rankings and scoreboards of the SWFs to date reflect the need for the international financial markets, the International Financial Institutions and independent countries to understand the role of SWFs. This has come as an outcome of the realization that SWFs are becoming increasingly important participants in the international financial system. In addition, recipient countries have realized the potential benefits of openness towards the SWFs. Nevertheless, the debate on the role of the SWFs is ongoing. Supporters consider them long-term investors that have provided very-much-needed capital injections in times of financial distress like the latest financial crisis. Skeptics highlight the political controversy related to SWFs not only in the recipient countries but in many cases in the host countries as well.

In an attempt to address the later debate, the IMF, the OECD, the USA and the EU have been working on the establishment of best practices on the SWFs<sup>12</sup>. This has been shaped and in its turn it has been shaping the assessment attempts of the SWFs. The assessment attempts have been much more concerned with governance, transparency and accountability standards that are needed in the international financial markets rather than with what would be adequate for the citizens of the host countries. For instance, in cases like that of Azerbaijan or Kazakhstan, the attempts of the respective funds to improve their governance, transparency and accountability standards employing the benchmarks and recommendations established by the international initiatives have led to improved rankings for the respective countries. The State Oil Fund of Azerbaijan has been actively working towards the provision of higher standards of transparency and accountability leading to significant improvements in the respective ranking attempts such as the Linaburg-Maduell transparency index.

Nevertheless, when assessing the later developments, it should be kept in mind that full presidential discretion on the release and the utilization of the accumulated funds still remains in place. Developments are similar in the case of Kazakhstan. In both cases the presidents enjoy significant power. In this context the respective funds have been working towards greater provision of transparency and accountability; nevertheless, little has changed in their governance as both funds remain governed by presidential decrees. Thus the funds emerge as the “king (under the pressure of the IMF) binding his own hands by his own rules” (Heuty and Aristi, 2009). In this case the increased transparency and accountability recorded over the last years might merely work as an apparatus for public demonstrations of openness without essentially affecting the underlying power relationships.

In a similar way international initiatives such as the Santiago Principles have been aiming at addressing primarily concerns raised by Western countries<sup>13</sup>. The Santiago Principles have developed in an attempt to put Western concerns at ease over the lack of accountability and transparency of the SWFs. In this respect they have been developed with a preemptive purpose so as to control the possible adoption of protectionist or nationalist policies. This, however, has been attempted carefully so as to not affect the free investment flows and to not discomfort the SWFs that claim their investments are based purely on economic grounds. Similarly, the principles make use of the same values that the scoring and ranking attempts make.

In the same way, the Santiago Principles develop from an international perspective, hence transparency and accountability towards the citizens of the host countries is not addressed to the same extent. The effectiveness of such initiatives and the degree to which they can benefit the citizens of the host countries can be further challenged once the voluntary nature of the commitment to the Principles is considered. Further concerns would emerge once the

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12 See The Times (2007), The Sunday Times (2007), The Guardian (2007), IMF (2008a; 2008b), European Commission Communication (2008), European Commission press release (2008) and US Treasury Department press release (2008a; 2008b).

13 Several scholars consider the Santiago Principles as the outcome of the influence of a group of Western Countries. For a detailed discussion see Rose (2008).

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implementations and enforcement limitations present in the very nature of the Santiago Principles are taken into consideration. In this respect, views range from considering the Santiago Principles deficient (Rose, 2008) to a “band-aid over a gaping wound” (Wong, 2009).

Overall governance, transparency and accountability improvements of the SWFs remain a core aspect of their effectiveness and their success. This is related not only to the international welcoming of the SWFs but to the benefit of the domestic economies and the citizens of the respective host countries. The developed scoreboards, ranking attempts and the suggested sets of best practices should be considered, acknowledging their methodological limitations and their international perspective. The involved parties and policymakers should actively work in improving these scoring attempts and identified best practices. These efforts need to address not only international skepticism towards SWFs’ operations and investments; they should further address the concerns about SWFs in the host countries. The latter can be addressed with the clear formulation of the goals and the operations of the funds to the public. This can enforce the legitimacy of the funds, allowing public scrutiny and reducing rent-seeking or of political benefit actions. Developments in the assessment of the SWFs as well as in the identified best practices have to be conducted enforcing the provision of greater transparency and accountability towards the citizens of the host countries. The latter can significantly reduce the margin for misinterpretation in such initiatives and in the identified best practices.

#### **4. Conclusion and policy recommendations**

The experience to date suggests that strong governance structures, transparency and accountability remain key factors of success for the SWFs. Success is related to the welcoming of the SWFs in the international financial arena as key players and to the welcoming of their investments in the recipient countries. In addition, success is related to the ease of controversy surrounding SWFs in the host countries. Strong governance and adequate provision of transparency and accountability can foster success in combating political misuse, rent-seeking and corruption in SWF operations.

For countries endowed with natural resources and SWFs established out of natural resource revenues, this would foster the control of revenue management and the prudent intergenerational and intra-generational allocation of the finite national wealth. In macroeconomic terms, strong governance and provision of adequate transparency and accountability would foster fiscal sustainability of the respective countries, further enforcing their international positioning. Strong and transparent governance can strengthen public constituency on the mobilization and the use of the SWF assets. In addition, it would facilitate the monitoring of the financial commitment of the politicians and their consistency in maintaining a financial balance in the accumulation and spending of the SWF, overcoming problems of political misuse of the assets and subsequent political unrest.

Reflecting in large part the needs of the international financial markets, the perceptions of the International Financial Institutions and the concerns of major Western economies, several attempts have been made at providing scoreboards and quantitative rankings of the SWFs. These attempts have progressed along

the lines of the development and the establishment of a set of generally accepted best practices as suggested by organizations like the OECD, by International Financial Institutions such as the IMF, or by individual countries or group of countries like the USA or the EU.

The most characteristic of such attempts remains the Santiago Principles. Similar to the earlier attempts, the Santiago Principles reflect in large part Western worries and the need of international financial markets for transparency and accountability provision from the participating financial actors such as the SWFs. Nevertheless, the need for strong governance structures and the provision of adequate transparency and accountability towards the citizens of the host countries should not be disregarded. In this respect, the existing scoreboards address these needs to a limited degree. Furthermore, the voluntary nature of the commitment to international initiatives and the limited reference to provision of transparency on national levels leaves significant room for improvements on national levels.

The overview of the assessment attempts, the scoreboards of SWFs and the proposed fund benchmarks and best practices developed to date further indicate the necessity of a better understanding of their particularities and their methodological limitations. The subjective nature of the criteria employed and the assessment provided, the international perspective employed and the conflicting interests involved might hinder the estimation results and consequent recommendations. Moreover, the adoption of specific fund cases as benchmarks might not be applicable to every single fund and country. Macroeconomic differentials, the pace of institutional development and integration, and fiscal needs might render the "one-size-fits-all" approach unrealistic. On the other hand, the vast discrepancies between different funds and their performance indicate that they cannot be studied in a group or assessed against each other unless a set of generally accepted principles and practices is put in place.

In the absence of the latter, the welcoming of SWFs in the international financial arena and of their investments in the recipient countries can be subject to skepticism. This becomes more apparent when considering the injection of vast amounts from the SWFs of countries like China or Qatar towards the Western markets in times such as the latest financial turmoil. The latter shift in the world economic balances has made many international organizations and individual countries highlight the need for the establishment of a generally accepted set of practices and standards of transparency and accountability to be adopted by the SWFs. In addition many Western countries have clarified their position towards the investments made by the SWF and their final legitimacy to protect their national interests.

In this respect policymakers and international financial institutions should keep working on fostering the existing sets of best practices and on promoting the active engagement of the SWFs and the respective countries to the latter. Nevertheless, these attempts should not disregard that little provision is made in the existing practices for the fostering of governance, transparency and accountability towards the citizens of the countries that remain the legitimate beneficiaries of the fund operations and the ultimate domestic monitoring apparatus. Systematic monitoring of the SWFs against the set of good practices and international benchmarks should continue. Nevertheless, this should

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develop so as to further ensure that the citizens benefit from SWFs operations and investments and they receive full transparency and accountability. If this parameter is not taken into serious consideration the assessed and recorded levels of governance strengthening might merely monitor superficial public demonstrations of transparency and accountability without essentially affecting the underlying power relationships.

In order to strengthen governance, transparency and accountability of the SWFs:

**1. International initiatives should keep working on the fostering of good governance, transparency and accountability practices and on their being embraced by a larger group of SWFs.** Experience with successful SWFs should be used as a starting point so as to derive a set of governance, transparency and accountability practices that can foster the efficiency and the international welcoming of the SWFs. Systematic monitoring of SWFs against the set of good practices and international benchmarks should continue. Nevertheless, such attempts should consider the country-fund specifics that might make the replication of the same model in each case unrealistic. In addition, the fact that the citizens remain the ultimate beneficiaries of the SWF operations and the most appropriate domestic monitoring apparatus of political misuse should be kept in mind in the latter efforts.

**2. Employment of the existing SWF rankings and scoreboards should acknowledge their international perspective and the methodological limitations present.** These might significantly affect the obtained rankings and the subsequent recommendations. In this area the international organizations, the International Financial Institutions, individual countries and SWFs have to further work on improving the existing methodology employed. At the same time any assessment making use of the scoreboards and rankings to date should carefully consider whether the recorded improvements of changes represent real changes in the existing power relationships.

**3. The ranking attempts and the international initiatives on best practices should not disregard the fact that the citizens of the countries remain the ultimate beneficiaries of the SWF investments and operations.** Citizens can further provide valuable support in monitoring the politically motivated uses of the SWFs or the political misuse of the accumulated assets. In this respect, any assessment attempts should further consider governance, transparency and accountability developments vis-à-vis the citizens of the countries. International initiatives can be used as leverage in fostering governance, transparency and accountability changes not only towards the international markets but towards the citizens of the countries as well.

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## Appendix A

**Table 3. Principles of the Linaburg-Maduell Transparency Index**

<b>Point given</b>	<b>Principle</b>
1	Fund provides history including reason for creation, origins of wealth, and government ownership structure
1	Fund provides up-to-date independently audited annual reports
1	Fund provides ownership percentage of company holdings, and geographic locations of holdings
1	Fund provides total portfolio market value, returns, and management compensation
1	Fund provides guidelines in reference to ethical standards, investment policies, and enforcer of guidelines
1	Fund provides clear strategies and objectives
1	If applicable, the fund clearly identifies subsidiaries and contact information
1	If applicable, the fund identifies external managers
1	Fund manages its own web site
1	Fund provides main office location address and contact information such as telephone and fax

## **State Oil Fund of Azerbaijan Republic: Past, present and future**

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### **Introduction**

Throughout the former socialist camp, Azerbaijan was the first to establish a stabilization fund for the accumulation of income from hydrocarbon exports, and in late 1999, by a special decree of the President, the State Oil Fund of Azerbaijan Republic (SOFAZ) was founded. Establishment of the Fund coincided with the period when in public opinion, in the run-up to the expectations of incredibly high oil revenues, there was a sense of transformation of Azerbaijan to a second Kuwait in the near future. SOFAZ was established for collection and effective management of funds from the sale of profit oil extracted by both local and foreign companies as well as for direction of these funds to development of leading spheres and implementation of significant projects. For this period, as it was supposed by experts, Azerbaijan didn't turn into Kuwait. However, the wide experience in management of oil and gas revenues which was collected during this period appears to be a remarkable lesson for many resource-rich countries.

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## **SOFAZ's history and governance principles**

The State Oil Fund of the Republic of Azerbaijan (SOFAZ) was established in accordance with the decree of the President of the Republic of Azerbaijan dated December 29, 1999 "On Establishment of the State Oil Fund of the Republic of Azerbaijan." Statutory Regulations of the State Oil Fund of the Republic of Azerbaijan were approved by the President of the Republic of Azerbaijan dated December 29, 2000. The cornerstone of the philosophy behind the Oil Fund was to ensure intergenerational equality of benefit with regard to the country's oil wealth, whilst improving the economic well-being of the population today and safeguarding economic security for future generations<sup>1</sup>.

A number of agreements on joint development of oil and gas resources were signed with foreign investors which have been being realized since 1994. The issue on effective management of revenues from implementation of these agreements was brought to the agenda. SOFAZ has the purpose of formation of such a mechanism. The Fund's activity is directed toward the achievement of the following objectives: (i) preservation of macroeconomic stability, ensuring fiscal-tax discipline, decreasing dependence on oil revenues and stimulating development of the non-oil sector; (ii) taking into account that oil and gas are deployable resources ensuring intergenerational equality with regard to the country's oil wealth and to accumulate and preserve oil revenues for future generations; (iii) financing major national scale projects to support socio-economic progress.

SOFAZ's activities in the field of assets accumulation and spending are overseen by a Supervisory Board. The Board is to review the Fund's draft annual budget, annual report and financial statements along with auditor's opinion and provide its comments. Members of the Supervisory Board are appointed by the President and represent mainly state bodies. In accordance with the presidential decree dated November 27, 2008, seven new members of the Supervisory Board were appointed. Prime Minister Arthur Rasizade was re-elected Chairman of the SOFAZ Supervisory Board. Civil society's participation in the management of SOFAZ hasn't been implemented yet.

SOFAZ's daily management is vested with the Executive Director, appointed by and accountable to the President. SOFAZ's Executive Director as a chief executive officer is vested with the powers to be a legal representative of the Fund, organize and conduct business of the Fund including appointment and dismissal of employees, management and disbursement of the assets of the Fund in conformity with the rules and regulations approved by the President of Azerbaijan. The Executive Director is responsible for the preparation of the annual budget of SOFAZ, incorporating an annual program of the Fund's assets utilization, and its submission for the approval of the President of Azerbaijan.

Regarding "Decree of the President of the Republic of Azerbaijan on establishment of the State Oil Fund of the Republic of Azerbaijan" (29.12.1999) SOFAZ fulfilled its operations through a special account of the National Bank. SOFAZ is accountable and responsible to the President of the Republic of Azerbaijan. The Fund is an extra-budgetary institution. The Fund is a legal entity

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1 <http://www.oilfund.az>

and must have a settlement account and other accounts at banking institutions<sup>2</sup>. A Supervisory Board exercises general control over establishment and spending of the Fund's assets. **The main responsibility of the Fund is to ensure collection and effective management of foreign currency and other assets that are generated from the implementation of agreements signed in the field of oil and gas exploration, and development, as well as from the Fund's own activities, in the interest of citizens of the Republic of Azerbaijan and their future generations.** The Fund's assets form on the account of the following sources:

- Revenues generated from implementing agreements on exploration, development and production sharing for oil and gas fields in the territory of Azerbaijan;
- Net revenues from the sale of hydrocarbons falling to the share of Azerbaijan;
- Oil and gas agreements' signature or performance bonuses paid by investors to the State Oil Company of the Azerbaijan Republic;
- Acreage payments;
- Dividends and profit participation revenues falling to the share of Azerbaijan;
- Revenues generated from oil and gas passing over the territory of Azerbaijan;
- Revenues generated from the transfer of assets from investors to the State Oil Company or within the framework of oil and gas agreements;
- Revenues generated from the placement, management, sale or other utilization of the Fund's assets and revenues from asset revaluation and other related revenues;
- Grant and other free aid, and other revenues and receipts in accordance with the legislation.

The Fund's assets under management are placed in investment-grade rated banks and instruments. The Supervisory Board of the Fund determines rules for accounting and reporting the use of the Fund's assets. Utilization of the Fund's assets is carried out in accordance with main directions to be approved each year through Presidential Resolutions. The Fund's assets may be used for solving the most important nationwide problems, and for construction and reconstruction of strategically significant infrastructure facilities for the purpose of the country's socio-economic progress.

For decreasing the risks in the management of the Oil Fund's foreign currency assets, their limits shall be defined on the basis of the following principles<sup>3</sup>: defining credit risk, i.e. maximum limit of the amount invested in one financial institution and asset and the minimum sufficient credit rating; defining liquidity risk, i.e. maximum maturity of the investment portfolio and minimum liquidity limit for standards periods; and defining market risk (currency risk and interest rate risk) as well as each currency included in the investment portfolio and maximum weight of the investment assets dominated in these currencies, and maturity of the investment portfolio.

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2 "Regulations (Statute) on the State Oil Fund of the Republic of Azerbaijan" approved by the Decree of the President of the Republic of Azerbaijan № 434 dated December 29, 2000.

3 "Rules on holding, placement and management of foreign currency assets of the State Oil Fund of the Republic of Azerbaijan" approved by the Decree of the President of the Republic of Azerbaijan № 511 dated June 19, 2001

The Oil Fund's budget is an annual financial program prepared in compliance with the legislation of Azerbaijan to ensure the implementation of the Oil Fund's objectives and functions and reflects the Oil Fund's revenues and expenditures. The preparation and execution of the Oil Fund's budget shall be based on the principle of the implementation of a coherent macroeconomic policy in Azerbaijan and the consolidation of revenues and expenditures of the consolidated government. Effecting of any expenditure on Oil Fund's assets extraneous from the Oil Fund's budget by the Oil Fund is inadmissible. Expenditures that can arise from the Oil Fund's assets' revaluation in the Oil Fund's reported currency (Azerbaijani manat) as well as expenditures in connection with payment of lawfully determined taxes and any other obligatory payments are not intended in the budget of the Oil Fund and are in fact reflected as extra-budgetary expenditures in the balance of the Oil Fund. Budget expenditures of the Oil Fund as well as financing lawfully determined taxes and any other extra-budgetary obligatory payments are effected on the Oil Fund's assets in the national currency of the Republic of Azerbaijan and foreign currency. Financing the Oil Fund's expenditures and payments in the national currency of the Republic of Azerbaijan is provided in compliance with the legislation of Azerbaijan by conversion of the Oil Fund's foreign currency assets to the national currency of Azerbaijan<sup>4</sup>.

A long-term strategy on management of oil and gas revenues, which covers the period 2005-2025, establishes the principles for the use of oil and gas revenues and medium-term expenditures policy for this period<sup>5</sup>. This strategy ensures the management of the revenues acquired from sale of natural gas and oil in conformity with the sources described below, accrued in the State Oil Fund of the Azerbaijan Republic, and in the state budget. The principles for long-term use of oil and gas revenues are as follows: when forecasting the amount of long-term expenditures from oil and gas revenues, the 'constant real expenditures' principle shall be used as a basis and annual limits shall be set for these expenditures that are to be made within the period covered by the strategy; when incomes from oil and gas revenues peak, at least 25 percent of them is saved; the regulations adopted for spending oil and gas revenues shall remain unchanged during the effective period of the long-term strategy on management of oil and gas revenues and the expenditure limits projected on the basis of the constant real expenditures principle is observed; the volume of medium-term expenditures shall be determined based on the non-oil deficit (the difference between revenues and expenditures of the consolidated budget of the country, excluding the oil sector) and taking account of the long-term expenditure limit. Sharp year-to-year fluctuations in expenditures are undesirable and the non-oil deficit may not be abruptly changed; investment expenditures shall be made in the framework of the medium-term State Investment Program that is drafted annually; meeting the current high demand of Azerbaijan for investment will result in larger expenditures during the initial period and create conditions for the development of the non-oil

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4 "Rules on the preparation and execution of the annual program of revenues and expenditures (budget) of the State Oil Fund of the Republic of Azerbaijan" approved by the Decree of the President of the Republic of Azerbaijan № 579 dated September 12, 2001

5 "Long-term strategy on the management of oil and gas revenues" approved by the Decree of the President of the Republic of Azerbaijan № 128 dated September 27, 2004

sector and the gradual reduction in the dependence on oil and gas revenues. The development of the non-oil sector based on the use of long-term oil and gas revenues will help in reducing the country's need for external borrowing. The strategy on use of oil and gas revenues includes the following objectives, while aiming at retaining macroeconomic stability:

- developing the non-oil sector, regions, SMEs;
- large-scale development of infrastructure; fulfillment of poverty reduction measures and the solution of other social problems;
- stimulating the improvement of the intellectual, material, and technical base of the economy; development of "human capital;"
- consolidating the defense capabilities of the country;
- executing projects relating to reconstruction activities in liberated territories and the return of internally displaced persons to their native lands.

SOFAZ's activities are regulated by regulations. But there are critics by EITI NGO Coalition that the main regulatory document should be law. ***Azerbaijani civil society groups have already prepared a draft law on SOFAZ.*** Regarding that draft law:

"administration expenses of the Fund shall not be more than 5% of its annual revenue. It is impossible to substantiate the 5%, as the international standards contain the limit of 5% as an exceptional case. In my opinion, we may preserve 10% and not write any other figures here. The Fund shall be accountable and responsible to the Milli Mejlis of the Republic of Azerbaijan. The liquid funds of the Fund will be preserved in the highly rated and internationally recognized banks determined by the Supervision Board with the assets expressed mainly in US dollars, Euro, British pound sterling and Japanese yen and in other currencies not exceeding 10%. The assets preserved with any banks may not exceed 20% of the Fund's liquid funds. 30% of the Fund's annual revenues shall be allotted for collection purposes within each fiscal year. The Funds collection assignment assets are preserved for needs of the next generations, and excluding provisions contained in this law, it cannot be used for other goals. By release of the occupied Azerbaijani lands, approximately 50% of the Fund's stocking assignment assets may be used for the purpose of financing of actions related to the reorganization of these territories and returning of refugees to their homeland. The Fund's stocking assignment assets may be sued if the net revenues generated from sale of hydrocarbons falling to the share of the Azerbaijan Republic are less than those generated from placement and management of the Fund's assets.

The Fund's Investment portfolio is placed based on the following principles: the weight of one direction in the investment portfolio may not exceed 50%; the share of one continent in the investment portfolio may not be more than 50%; the share of investments in the investment portfolio may not be more than 50%. The Fund's investments are implemented based on the following criterion: the ethical principles prepared by the Supervision Board are applied to the investments; the state authorities without a strategic plan may not be allotted any funds; the share in the inter-country investments by small and average enterprises may not exceed 30%. Fund assets may be assigned to finance projects aiming at

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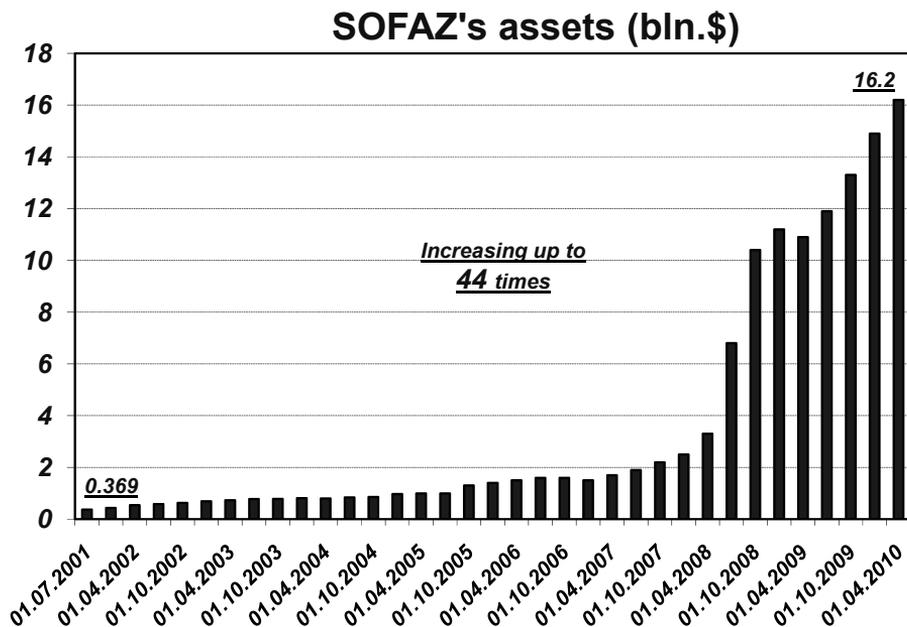
development of the non-oil sector of the economy, as well as small and medium-sized entrepreneurship based on preserving the macroeconomic stability. The list of financed projects is determined by the Fund's Supervisory Board according to the proposals of the related executive authority. Approximately 1% of the revenues generated by the Fund within a year is to be directed towards financing of the social investment programs. The financing within the framework of the social investment programs is assigned to the civil community institutions based on the competitions carried out according to the rules determined by the Supervisory Board. The expenditure of assets allotted for projects' implementation will be under control of the Supervisory Board. **The amount transferred from the Fund's assets to the budget each year shall not exceed 20% of the Fund's annual revenue.**

The Supervisory Board of the Fund can include 9 members. 3 members of the Supervisory Board from the corresponding executive authorities are appointed by the President of the Azerbaijan Republic. 6 members of the Supervisory Board from the candidates of the field trade union organizations acting in the oil and gas industry, NGOs specializing in the corresponding fields and scientific institutions are selected by the Milli Mejlis of the Azerbaijan Republic. The Executive Director shall be appointed for 3 years. The same person shall not have the right to be the Executive Director twice. The activity of the Fund is audited by the Audit Chamber of the Azerbaijan Republic and the independent foreign auditor. Information regarding the Fund's activity including the Fund's profits, assets, other information concerning the placing and use of these funds may not pertain to the range of information with restricted access”.

## **SOFAZ's asset and revenue management**

SOFAZ's assets are managed in accordance with the “Rules for accumulation, investment and management of assets of the State Oil Fund of the Republic of Azerbaijan” (Investment Guidelines) approved by a presidential decree of June 19, 2001. According to these Rules the purpose of management of the Oil Fund's foreign currency assets is to hold foreign currency assets of the Oil Fund securely and to generate revenues by effective management. Outside the Republic of Azerbaijan, the current accounts of the Oil Fund should be opened with banks rated by reputable international rating agencies such as Standard & Poor's, Moody's and Fitch with a long-term credit rating not lower than: “AA-” as defined by Standard & Poor's or Fitch, or “Aa3” as defined by Moody's. The Fund's counterparts in international financial markets might be institutions with long term credit ratings not less than BBB (by Standard and Poor's), BBB (by Fitch) or Baa (by Moody's). The maximum weight of one financial institution or one investment in the investment portfolio of the Fund is set at 15% of the total amount of the investment portfolio (exceptions are central banks, custodian banks and external managers). 50% of the total amount of the investment portfolio of the Fund is to be invested in assets denominated in US Dollars, and 40% in assets denominated in Euro, 5% in assets denominated in GBP, whereas 5% of the total amount of the investment portfolio of the Fund is to be invested in assets denominated either in currencies of countries with long-term country ratings (sovereign debt) not less

than the credit ratings A (Standard & Poor's, Fitch) or A2 (Moody's); in US Dollars or in US Dollars, Euro and GBP based on their respective weight<sup>6</sup>.



*Source: State Oil Fund, author calculations*

According to investment policy, up to 60% of the Fund's investment portfolio can be managed by external managers. The assets given to an external manager cannot exceed 15% of the total amount of the investment portfolio. SOFAZ's investment portfolio should not be invested in currency arbitrage, swaps, forwards and futures (except for the purpose of hedging or optimizing the currency composition of the investment portfolio and structure of the SOFAZ's assets), precious metals and stones, or real estate.

The main projects are financed by SOFAZ include: a) "State Program on education of Azerbaijani youth abroad in the years 2007-2015"; b) "Baku-Tbilisi-Kars New Railway" Project; c) constructing a water pipeline from Oguz-Gabala region to Baku city; d) reconstruction of the Samur-Absheron irrigation system; e) Formation of the statutory capital of Azerbaijan Investment Company; f) Settlement of the problems of refugees and internally displaced persons who were forced to flee their native lands as a result of Armenian invasion on the Nagorno Karabakh region of Azerbaijan; g) Baku-Tbilisi-Ceyhan Main Export Pipeline.

As a result of three quarters of 2010, the SOFAZ continued the policy of placing the investment portfolio in the short-term instruments, and the share of funds invested for up to five years makes up 94.85 percent of the assets. In total,

<sup>6</sup> <http://www.oilfund.az>

the investment portfolio of SOFAZ accounts for 99.82 percent (\$21.681 billion) of the total assets. As of October 1 2010, 38.02 percent of the portfolio has been placed in securities for a period exceeding one year, 25.93 percent - from one to three years, 30.99 percent - from three to five years and 4.97 percent, including 0.1 percent of income in assets - more than five years. Currently, 43.59 percent of the Fund's investment portfolio has been placed in securities rated AAA, 21.74 percent - AA, 27.55 percent - A, 7.09 percent - BBB, 0.04 percent accounts for other. SOFAZ's assets have been placed partly in securities and monetary market instruments (deposits, bank accounts). Only 0.1 percent of the Fund's portfolio has been placed in shares. Currently, 34.08 percent has been placed in the bonds of agencies and international organizations, 13.35 percent - sovereign debt securities, 3.54 percent - deposits and monetary market instruments and 4.08 percent - bank accounts. Geographic placement of the assets of the Oil Fund is as follows: 73.66 percent placed in European countries, 10.82 percent - North America, 8.04 percent - in international financial institutions, 4.31 percent - Asia and others. As of Oct. 1, 2010, SOFAZ's assets increased 45.8 percent compared with the beginning of this year (\$14,900.4 billion), amounting to \$21,720.8 million.

### **SOFAZ's relations with the state budget**

The revenues of the State Oil Fund of Azerbaijan Republic (SOFAZ) made up 8,176.7 million AZN and its expenses 5,294.5 million AZN in 2009. The incomes of the Fund were fulfilled by 97.8% and expenses by 99.5%. The greatest part of the Fund's income (93.4%) was provided by the profit table sale of oil and gas. It's probably impossible to evaluate the economic-budget model of recent years without the SOFAZ / state budget relationship. The transfers of the Oil Fund to the budget as of 2003 gave a start to this relationship. The growth of these transfers year by year and its budget share of almost 50% at the present considerably improve this relationship. Such a situation itself causes certain anxiety. Hence, the growth strengthens the dependence of the budget upon the oil fund and weakens its motivation for tax collections. The share of transfers in budget incomes exceeded 40% (AZN 4915 million) during the crisis year. The transfers are going to comprise half of budget incomes that will be reduced next year. The increase of the amount of transfers directs the attention to SOFAZ and necessitates the acceptance of fiscal policy guidelines based on serious principles for the fund-budget relations. The current estimations show that the most suitable figure for Azerbaijan in this regard is 30% of SOFAZ assets<sup>7</sup>.

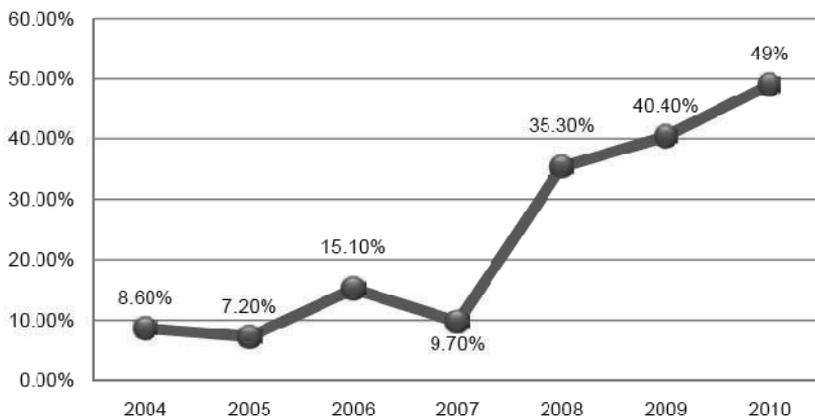
The approved budget incomes of SOFAZ have been approved as 5,963,126.7 thousand AZN and expenses as 5,428,431.2 thousand AZN. As is seen the Fund is going to spend almost all of its revenues (91%) during the current year which is happening for the first time in the history of its activity. It should be mentioned that the greatest part of this amount (90.5%) belongs to state budget transfers. The concern related to the expansion of the dependence upon oil factor is already quite obvious in 2010. *Thus it's clear that the tendency of the Oil Fund to become the main donor of the state budget is growing and reaching a level*

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7 Dr. İngilab Ahmadov, Kanan Aslanli, Shahriyar Ahmadov. "Global economic crisis and state budget: The case of Azerbaijan", National Budget Group, Baku 2010

that can become dangerous for the continuous development perspectives of the economy. When reviewing the dynamics of the link between the state budget and SOFAZ, things become fairly clear.

### Share of SOFAZ transfers in budget incomes



Note: Indicators for 2009 and 2010 are approved budget figures.

Source: National Budget Group

If the amount of Oil Fund transfers to the state budget was 100 million AZN in 2003, the figure went up to 130 million in 2004, to 150 million in 2005, 585 million in 2006, another 585 million in 2007, 1.1 billion in 2008 and 4.9 billion in 2009 and finally 4.915 billion in 2010. However, the point of concern is not only the increased amount of transfers, but also the Fund's decision to spend the greatest portion of its budget in 2010. It should be mentioned that the Presidential decree of September 27, 2004 on "Long-term Strategy for the Utilization of Oil and Gas revenues" specifically notes that at least 25% of oil and gas revenues shall be accumulated for the coming generations during the peak periods. Without a doubt, the lack of precise standardization mechanisms in the above-mentioned strategy makes it more complicated to legally evaluate how much the management of Oil Fund resources in 2010 complies with the Presidential decree. And namely this fact makes it necessary to accept a perfect law on SOFAZ. Such a law would also eliminate the problem of the missing limitation mechanism. It's worthwhile to mention that the EITI NGO coalition functioning in Azerbaijan has carried out continuous activities in this field and developed the project of the Law on "Oil Fund." Despite all this, the decision of the Fund to spend the greatest portion of its resources obtained during the crisis period indicates to its tendency to solve the problem of the shortage of means of the state treasury through an easier way under an unfavorable economic condition. When taking a look at the dynamics of SOFAZ profitability and budget transfers we come up with some curious outcomes. Though not observed in 2007, the increase of budget transfers against the decrease of tension in 2008 and 2009

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is the problem of alarming fiscal tension. Though profitability went down in 2008 and 2009 compared to 2007, the 549% increase in transfers is proof of our point. The increase of SOFAZ payments in budget incomes especially during the crisis year denoted that the global crisis did not bypass Azerbaijan and the government was obliged to rely on the resources accumulated in the oil fund and treat them as an income source. The year of 2010, which is still impacted by the crisis, witnesses the continuation of the alarming tendency both in the state budget and oil fund budget. Now the fund will be providing 50% of budget incomes. Along with this, no growth is expected in the profitability of the oil fund itself.

Budget revenues of the State Oil Fund of the Republic of Azerbaijan (SOFAZ) for the period of January to December 2009 reached 8,176.7 billion manat, while budget expenditures constituted 5,294.5 billion manat. 2009 budget revenues and expenditures of the Fund were executed accordingly: 97.8 percent and 99.5 percent. Revenue of 7,870.8 billion manat was received from implementation of oil and gas agreements, including 7,702.6 billion manat from the sale of profit oil and gas, 156.8 million manat from Azerbaijan's State participation share in the Heydar Aliyev Baku-Tbilisi-Ceyhan (BTC) Main Export Pipeline, 8.9 million manat as transit payments, 1.1 million manat as acreage payments, 0.8 million manat as bonus payments and 0.6 million manat from sale of assets received from foreign companies. The revenues from managing assets of the Fund for the reporting period amounted to 305.9 million manat. The Fund's extra-budgetary revenues related to the revaluation of foreign exchange totaled 97.6 million manat. As per the 2009 budget of the Fund, 4,915.0 billion manat were transferred to the state budget. The expenditures in the amount of 89.9 million manat were directed to financing of improvement of social condition of refugees and internally displaced persons, 130.0 million manat and 120.0 million manat were accordingly used for financing the reconstruction of the Samur-Absheron irrigation system and financing construction of the Oghuz-Gabala-Baku water supply system. 22.1 million manat were directed to financing Baku-Tbilisi-Kars railway and 7.9 million manat to financing «The state program on the education of Azerbaijani youth abroad in the years 2007-2015.» The Fund's administrative and operational expenses in this period were 9.6 million manat. The transfer from SOFAZ to the 2011 State Budget was increased to 9,203,200.0 thousand manat from the previous 6,480,000.0 thousand manat in July 2011<sup>18</sup>.

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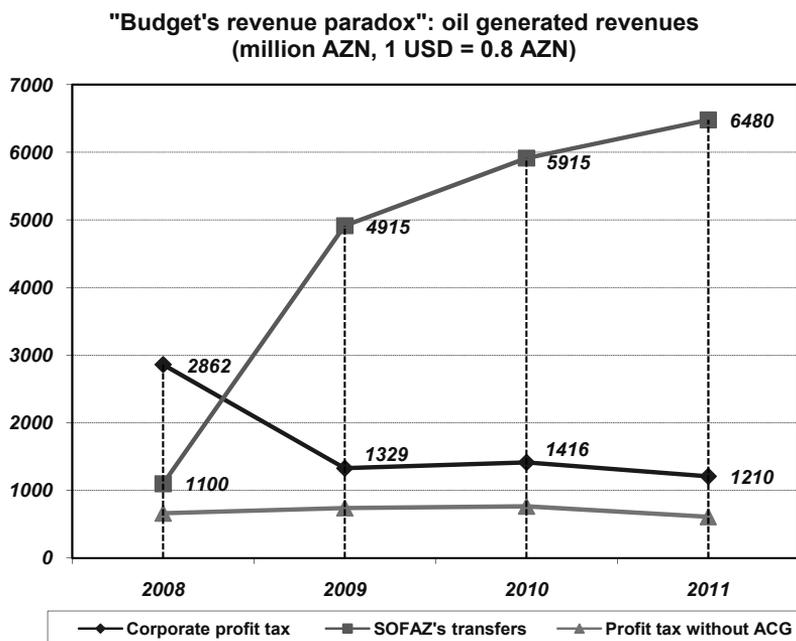
18 <http://www.oilfund.az>

**Table 1. Dynamics of transfers from SOFAZ to state budget**

Years	SOFAZ's transfers to state budget (million AZN)	Growth dynamics	Share in state budget	Share in SO-FAZ's expenditures
2003	100	--	8.2%	41%
2004	130	30.0%	8.6%	77%
2005	150	15.4%	7.2%	70%
2006	585	290.0%	15.6%	59.6%
2007	585	0.0%	9.7%	55.1%
2008	1100	88.0%	35.3%	88.5%
2009	4915	346.8%	40.4%	92.8%
2010	5915	20.3%	51.4%	90.5%
2011	9203	9.6%	58%	93%

*Source: National Budget Group, author calculations*

Since the establishment of SOFAZ, its revenues amounted to \$40 billion, \$20 billion of which has been spent. Half of SOFAZ's revenues were maintained for future generations in accordance with SOFAZ's total strategy. SOFAZ's income from bonuses hit 0.8 million manat, from dividends on the Baku-Tbilisi-Ceyhan oil pipeline - 156.8 million, from transit payments -- 8.9 million manat in 2009. About 25 percent of revenues in the oil fund must be kept in accordance with the strategy of a long-term oil revenue management, approved by the president in 2004. But so far the fund has more than 50 percent of revenue. The increase in transfers to the state budget from the oil fund, determined at the amount of 6.48 billion manat in 2011, is associated with a reduction of impact of rising oil prices on the state budget. Regardless of changes in oil prices and foreign exchange rate, we must provide the state budget with transfers to the amount of 6.48 billion manat. It will ensure the stability of the country's fiscal policy and reaffirm SOFAZ's role as a buffer. The oil price was set at \$60 per barrel, and the rate of dollar for the next year at 0.8 manat to form the budget forecasts for 2011.



*Source: National Budget Group, author calculations*

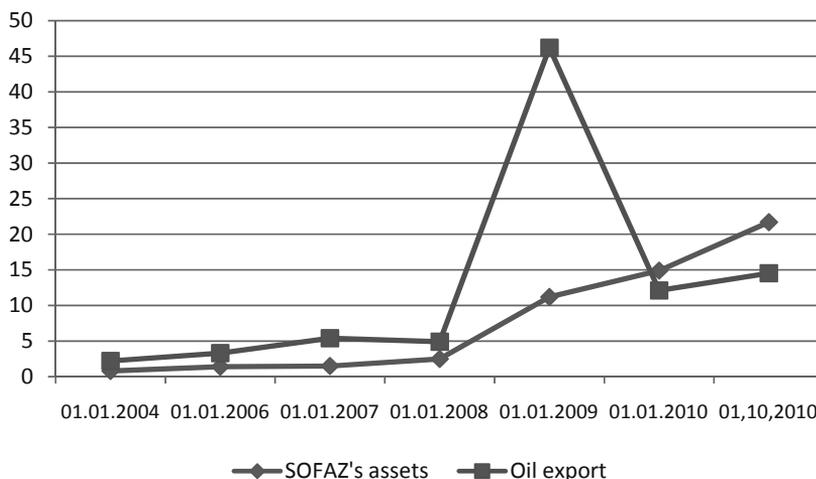
If the oil prices and expenses of the Fund remain at current levels, the State Oil Fund can accumulate up to \$50 billion. Over the past three years, the resources of SOFAZ have increased ten times. So far, Azerbaijan has gained about \$40 billion from oil revenues, and half of these funds - about \$20 billion - is stored in the SOFAZ. Given the fact that in the next 15 years, oil revenues amount to about \$200 billion, then if SOFAZ will save half of these revenues, the country will have revenues of \$100 billion. Due to increased revenues from management of Fund's assets, in the future, the level of transfers to the public budget can remain at current levels due to revenues from asset management. SOFAZ has received \$1 billion from the asset management up to now. With a minimum profitability on assets placed at 5 percent, after 15 years we can reach the level of \$6 billion income from asset management per year. If we continue to adhere to these principles and criteria, after some time the government of Azerbaijan will be able to keep a constant level of transfers at the expense of revenues only from the management at current levels. SOFAZ expects its revenues to exceed forecasts. The State Oil Fund revenues for this year were approved at 5.96 billion manat, and expenditure at 5.43 billion manat; that is, 90 percent of revenues is actually planned to cover expenditure. A very conservative approach was taken in preparing budget forecasts. The budget of the Fund was made by calculating the price of oil at \$45 per barrel. However, since the beginning of the year, oil prices range between \$70-80 per barrel, and this confirms the fact that 90 percent of additional revenues will be kept. The average price for Azerbaijani oil in 2009 was \$56 dollars per barrel, while in 2008 it totaled \$70 per barrel. As a result of

2009, State Oil Fund expenditures amounted to 5.29 billion manat compared to 4.29 billion manat in 2008. In 2007 this figure amounted to 1.06 billion manat, and in 2006 - 981.4 million manat. During 2001-2009, the transfers from SOFAZ to the public budget amounted to 10.26 billion manat. The government has plans to diversify funds in subsequent years in riskier assets, but one of the most important investments is education. The fund is financing a special education program allowing Azerbaijani citizens to receive an education in the world's best universities.

### **SOFAZ's durability in global turmoil**

The global financial crisis affected the activity of SOFAZ only in view of its income cut. The State Oil Fund does not face any difficulty due to the global financial crisis. SOFAZ held a conservative and protective position by foreknowing the crisis. Therefore, the crisis only affected the fund's income. At present many countries' funds have lost billions. There are funds which devalued by 30 percent, but SOFAZ completed 2008 with income worth \$300 million. Therefore, there will not be any problems with financing projects and it will be implemented as part of the budget. The SOFAZ funds were deposited in high qualitative securities. These include securities of the government, international organizations, World Bank, Asian Development Bank, and European Bank for Reconstruction and Development, and these securities can be sold at a high price at any time. Due to SOFAZ's position, if the necessity arises today, Azerbaijan can exchange \$10 billion deposited in securities into money.

International rating agency Standard & Poor's says in its outlook «How does Azerbaijan react to the world economic crisis?» that if prices for oil increase and expenditures do not exceed the oil price level stipulated in the state budget, then by the end of 2009 the volume of finances in State Oil Fund of Azerbaijan will grow up to \$11.5-12 bln versus \$11.2 bln in December 2008. As for April 1, 2009, this figure decreased to \$10.9 bln compared to \$11.2 bln in December 2008. «In this case the positive balance of the Azerbaijan state sector in 2009 can increase up to 32.3 percent of GDP,» the outlook says. The agency claims that "the Fund is a kind of buffer allowing solution of problems appearing in the country's budget and giving the government a possibility to follow a counter-cycling policy." The report also says, «the Fund's finances are invested in the non-oil sector and can promote economy diversification and reduce its dependence on the oil and gas industry.» Analysts of Standard&Poor's believe SOFAZ can promote reduction of inflation caused by a large flow of hard currency as a way of investing «superfluous» money outside of Azerbaijan.



Source: National Budget Group, author calculations

Even if the financial crisis has affected the profitability of SOFAZ, 3.79 percent is not a bad figure in such circumstances. SOFAZ has proven that it has come out of the global financial crisis without losses. The financial crisis is over and an economic crisis is starting. SOFAZ will not provide a mandate to new foreign managers to handle its funds. On the contrary, consultations are already underway with the current management, who will be told to be more responsible about their obligations. They will be offered to diversify their portfolio with more lucrative financial instruments. Due to the global financial process, the yield from SOFAZ funds managed by foreigners aside from the WB Treasury was close to zero last year. The foreign managers department runs about \$20 million, excluding the WB Treasury's funds. The few foreign asset management companies SOFAZ engaged included Clariden Leu and Deutsche Asset Management. Earlier, the Fund had made plans to expand the list of external managers to an increase in the fund's stock portfolio. The head of SOFAZ said the fund's investment policies will be reviewed, and SOFAZ funds will be diversified with more long-term instruments, including shares.

Because of the uncertain situation in global financial markets, SOFAZ has refused to invest its resources in highly profitable and risky financial instruments, particularly in shares, in 2010. Today an uncertain economic situation still covers the world, so we expect the improvement of the situation in world markets to diversify our investment portfolio. Earlier the World Bank offered Azerbaijan to reconsider its investment policy and invest into more risky financial instruments. Such long-term investments for a period of 10-20 years have always justified themselves, as the return on them is higher than on bonds. In a short period of time the situation is usually resolved and the stock management revenues rise a number of times. Before transition to such an investment policy, the country must be ready for any changes in stock prices. So far SOFAZ has been pursuing a conservative investment policy, because a platform for management of funds

was being formed during that period. However, it is high time to invest in more sophisticated financial instruments. They will give more revenues to the country. SOFAZ announced its plans to expand the stock portfolio, but they have been postponed due to the global processes. This decision was correct, as evidenced by the fact that the crisis has had no impact on SOFAZ revenues, though stock prices fell by nearly 50 percent. When the crisis slows down, SOFAZ will reconsider its investment policy before the end of 2009 or beginning of 2010 and will invest funds in securities of the companies which decreased their stock prices but are not close to bankruptcy.

The volatility of the dollar and the euro since early 2010 has affected the amount of assets of SOFAZ. The income and assets continue to increase. The fund's assets amounted to \$14.9 billion in early 2010. Now their volume exceeds \$16 billion. Despite the increase in assets, SOFAZ has no plans to expand the list of foreign managers. Petroleum Fund cooperates with the program RAMP (Reserve Assets Management Program). Currently, the World Bank Treasury Management has \$114 million. RAMP has been in operation for more than 40 years. SOFAZ assets as of January 1, 2010 increased 32.8 percent compared to early 2009. They hit 11 966.5 million manat (14 900.4 million). SOFAZ's assets at the moment of its creation in 1999 amounted to \$271 million.

SOFAZ, together with the International Finance Corporation (IFC), the Dutch PGGM, the Korea Investment Corporation and the Saudi Arabian Foundation, will invest in the newly-created African, Latin American and Caribbean Fund under the auspices of the IFC. The new fund is expected to accumulate \$1 billion and these funds will be managed by an IFC asset management company. This, in turn, will create conditions to improve the capacity of developing countries by investing in investor equities such as sovereign and pension funds with the IFC. Under the first tranche, the fund will manage \$600 million, of which \$100 million will be provided by SOFAZ. These investments are an important step in building the fund's long-term strategy to improve and protect the wealth of the state. In 2009, the crisis year, due to a sharp reduction in oil prices in the world market, the Fund accumulated 14 billion 900 million dollars of income, instead of the expected approximately \$18 billion in assets.

### **SOFAZ's transparency and accountability**

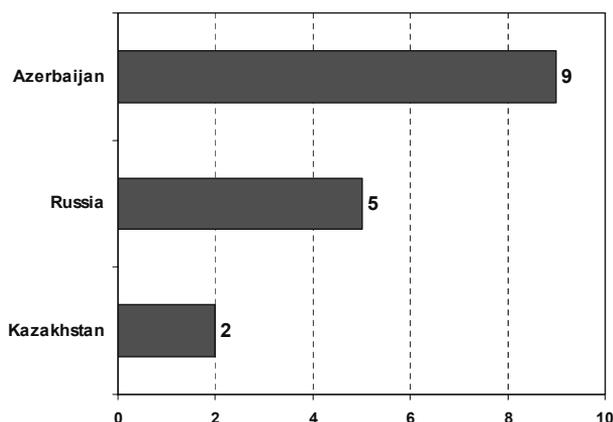
SOFAZ represents Azerbaijan in the Extractive Industries Transparency Initiative (EITI). Thus, the country has the opportunity to become the first full EITI member. Additionally, one of the priorities for SOFAZ is to assist other countries in the EITI. Kazakhstan, Yemen, Mongolia, Nigeria and other countries have applied to Azerbaijan in this connection. EITI unites 26 members. Azerbaijan has an opportunity to further improve the extractive industry accountability system. The multi-stakeholders group (consisting of SOFAZ and foreign companies) and the NGO Coalition have held meetings to discuss possible changes and improvements in EITI. EITI includes all extractive industries. Accountability covers not only the oil-and-gas industry, but also all types of extractive industries. In line with queue principles, companies involved in extractive industries will pay for the audit. Deloitte developed the 10th EITI report on 2008 outcomes. Deloitte held

audits for 2003, 2004, 2005 and the first half of 2006; AGN Mak Azerbaijan LTD (part of Accountants Global Network) developed a report on the first half of 2005. Moore Stephens designed reports for 2006 and 2007 and the first half of 2008. Ernst & Young Holdings (CIS) B.V. was appointed as the auditor of the Fund's financial statements for 2010, 2011, and 2012 by the president of Azerbaijan.

As an independent auditing and financial control body, The Chamber of Accounts must inform the society about the results of the budgetary expenditure checkups in accordance with Clause 6.0.3 of the national law on the Main Principles of Information. It has to take into account that SOFAZ is Azerbaijan's largest financial institution managing public funds<sup>9</sup>.

International tools have also been developed to measure accountability and transparency of sovereign wealth funds, including SOFAZ. One of them is the Linaburg-Maduell Transparency Index which was developed at the Sovereign Wealth Fund Institute by Carl Linaburg and Michael Maduell. The Linaburg-Maduell transparency index is a method of rating transparency in respect to sovereign wealth funds. Pertaining to government-owned investment vehicles, where there have been concerns of unethical agendas, calls have been made to the larger "opaque" or non-transparent funds to show their intentions. As of March 2008, the Government Pension Fund-Global of Norway ranks second among the largest sovereign wealth funds with approximately US\$ 380 billion; this fund also ranks among the highest in transparency. Norway currently leads the way in reducing the need for a code of conduct, possibly to the benefit of all sovereign investors. This index of rating transparency was developed around this fund, as it is known to be the pinnacle of clear investment intentions.

Linaburg-Maduell Transparency Index (score)



Source: <http://www.swfinstitute.org>

<sup>9</sup> [http://www.turan.az/Default\\_en.asp](http://www.turan.az/Default_en.asp)

This index is based on ten essential principles that depict sovereign wealth fund transparency to the public. The following principles each add one point of transparency to the index rating. The index is an ongoing project of the Sovereign Wealth Fund Institute. The minimum rating a fund can receive is a 1; however, the Sovereign Wealth Fund Institute recommends a minimum rating of 8 in order to claim adequate transparency. Transparency ratings may change as funds release additional information. There are different levels of depth in regards to each principle; judgment of these principles is left to the discretion of the Sovereign Wealth Fund Institute. Principles of the Linaburg -Maduell Transparency Index are the following: the fund provides history including the reason for creation, origins of wealth, and government ownership structure; the fund provides up-to-date independently audited annual reports; the fund provides ownership percentage of company holdings, and geographic locations of holdings; the fund provides total portfolio market value, returns, and management compensation; fund provides guidelines in reference to ethical standards, investment policies, and enforcer of guidelines; fund provides clear strategies and objectives; if applicable, the fund clearly identifies subsidiaries and contact information; if applicable, the fund identifies external managers; the fund manages its own web site; the fund provides a main office location address and contact information such as telephone and fax. As you see below, Azerbaijan, Kazakhstan and Russia obtained different scores pertaining to the Linaburg-Maduell transparency index. The respective scores are 9 for Azerbaijan, 5 for Russia, and 2 for Kazakhstan. Of course, this is a result of the willingness of countries (governments) to disclose information about (i) scale of the fund, (ii) learning and harmonization with transparency tools, and (iii) cooperation with suitable regional and global organizations and initiatives (like EITI). The second point means that it is more complicated for Russia to disclose financial reports of the National Welfare Fund, which accumulated \$162.5 bln, than Azerbaijan's State Oil Fund with \$21 bln.

## **SOFAZ and civil society sector**

The experience of interaction between the Fund and civil sector has a unique sense. A well-known EITI initiative is a main factor here. Because of EITI, in the last 7 years SOFAZ gained valuable experience of cooperation with the civil sector of Azerbaijan, which ultimately improved the image of the Fund in the eyes of both the local community and the world community. It should be noted that of more than 30 countries involved in EITI, perhaps only in Azerbaijan the Foundation acts as a stakeholder. As a rule, in other countries, this function is performed by the relevant ministry in the mining sector. In this sense, Foundation attachment to public operation can be estimated as a very wise and far-sighted decision. The Fund, as a newly established agency, without having the ballast of the Soviet past and numbed bureaucracy, can quite comfortably fit into the EITI rules and procedures. In its turn, EITI has brought and continues to bring a much-needed positive reputation score to the Fund.

In Azerbaijan, as a former Soviet country which gained national independence only 19 years ago, there is still a sense of discomfort about establishing an active dialogue between the authorities and civil sector. In some spheres civil society

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activity is evaluated as harmful. Lack of effective interaction of authorities with the non-government sector, many public officials' misunderstanding of NGOs in the current conditions, and finally the weak capacity of the knowledge and skills of the civil sector-- in a sense, the politicization of NGOs-- are the main obstacles in the creation of a regime of full and effective dialogue. Against this background, the positive fact is unusually active work of the government in EITI, the essence of which involves the work of its three supporters in a single multilateral group (government, business and civil sector). In 2004, a state government panel on EITI was established by a special decision of the Cabinet of Ministers and the Fund was determined by a responsible government agency. We can't say that during this period the process of the Fund's partnerships with NGOs (in Azerbaijan this NGO coalition plays role of «increasing transparency in the extractive sector») has developed smoothly. There were many discussions about EITI prospects and the nature of interaction on ensuring transparency in the extractive sector between government and NGOs. Even today parties still have a number of disagreements regarding information detailing EI companies' payments, as well as the role of NGOs in this issue. На латинице NGOs still have a number of complaints and dissatisfactions related to the government and particularly with EI companies' work. But the fact remains that EITI is one of the few platforms where active interaction between government and NGOs has concrete positive results. The Fund, thanks to EITI, has already managed to recruit and gradually increase the potential for successful interaction with the civilian sector, which has a positive effect in general for all its activities in terms of working with the public.

But along with this, there is an exigency for mutual cooperation of the Fund with the civil sector in organization of monitoring of investment projects in the domestic economy financed by the Fund. There are many gaps and even legislative cases in this area. For example, the civil sector still doesn't have a clear answer to the question of which authority is responsible for efficient and transparent spending of funds for Oguz-Gabala-Baku water supply system and other similar projects. According to the Order dated February 24, 2006, № 42 "Azersu" Joint Stock Company was entrusted with construction, management and implementation of customer's functions for "Oguz-Gabala-Baku" WSS project by the Cabinet of Ministers of Azerbaijan Republic. In January 01, 2010 SOFAZ appropriated funds totaling 547.4 million manat and an additional 200 million this year for financing the project. Repeated requests to the Fund about enabling monitoring of this expensive project yield no positive results. The standard answer of management is that the Fund is not responsible for the target and the transparent use of funds in these projects, so it is better to appeal to public operators, in this case the state water company Azersu. Obviously, this answer can't suit an NGO. It is also clear that the promotion of NGOs in monitoring is in the interests of the Fund also, which is high in the ratings of good and transparent governance and tries to hold this position.

## Conclusion

The management approach envisions the full or partial reserve of the revenues when exploitation levels of natural resources are on the upswing and when the raw materials command high prices. The approach also stipulates the use of the reserved monies in periods of reduced production or a fall in prices, that is, pre-distribution of budget resources over time. This kind of revenue management is useful for moderating state expenditures and ensuring long-range macro-economic stability. In the most concise form, the functions of SOFAZ, without exception, may be ranked as follows: accumulating income for future generations; ensuring macro-economic and financial stability; ensuring liquidity of the state; raising transparency of state expenditures; more accurately reflecting the base level of the budget deficit; fighting corruption; and protecting the monies from politicians. Thus, with respect to the importance of the mission of the oil funds, it must be mentioned that many of them continue to suffer from ineffective management and especially from the obsolete macroeconomic instruments in the hands of the government.

The efficiency gap in the management of oil money in Azerbaijan is enormous. Improvements need to be made in the oil money accumulation, saving and spending processes so that this short-term national resource can better serve the long-term development needs of the nation. The necessary changes include redefining and streamlining the Oil Fund in parallel with improvements in budgetary and public investment work. Sustainable long-term development needs to be a major focus and the only criterion for the use of oil money, as with any public resource. The short-term availability of this resource, however, makes the issue more subtle and brings additional concerns. The need for sustainable long-term development makes the macroeconomic concerns a priority. This is to say that the nation's strategy for the use of oil money needs to focus on the long-term growth of GDP, fiscal stability and independence, and monetary concerns in order to avoid inflation, account for the capacity of the public sector and prevent the creation of an environment conducive to corruption. The strategy must clearly delineate the share and dynamics of national consumption, public investments, government expenditures and trade with other countries with the hydrocarbon resources deducted and oil money added to the national assets. A good strategy will measure and use the oil money not for separate consumption expenditures or investment projects, but in line with all public spending, while accumulating and saving that oil money separately.

Macroeconomic development strategies flow into the financial strategy of the Oil Fund as an institution that accumulates and saves money. Once the extent of the application of oil money is determined to reflect the nation's the most pressing long-term interests, then strategies for portfolio investments, transfers to the state budget and public investment projects must be adopted and implemented. The Fund is not directly responsible for ensuring economic growth, supporting macroeconomic equilibrium, or deficit of public finances. In this sense, the scope and range of action, mutual liabilities between government agencies, and finally, fear of the fund's failure of the plan is much smaller than, for example, in the Finance Ministry.

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The improvements regarding the development of the institutional and legal framework will address and make the implementation of the proposed financial strategy for the Oil Fund possible. This will include the development of instructions, guidelines and standards for portfolio investments as well as the rules and standards for transfers from the Fund to the state budget and other domestic public and private uses. The recommended institutional and legal improvements are, on the other hand, based on the existing situation and current practices, and have political feasibility implications for the suggested changes, which are more extensively discussed in the analysis section of this paper. A strategy is important for creating the rules for the effective management of the Fund. Additionally, it is important to take into consideration all impacted monetary and fiscal factors during allocations, as well as transfers from funds. There is a simple reason why natural resource revenue funds don't usually contribute to better fiscal policy in those countries which are heavily dependent on oil-gas exports. The reason is that the economic considerations that are usually used to motivate funds support only a certain optimal fiscal policy, and are silent on what is the right institutional framework for implementing that policy. However, the political economy of power rivalry can create incentives for rapid overspending of natural resource revenues relative to the ideal levels of expenditure of any given government. These adverse effects are strongest when political divisions are deep, when institutions and policies are otherwise weak, where political and economical power are concentrated, where transparency is comparatively limited, and where there are risks of rapid changes of government. The first item to consider is how much of the oil money to save, i.e. accrue in the Fund, and how much to consume, i.e. allocate for state budget expansion. This is not a *consume or invest* question, however, because the elements of the state budget may also suggest investments in the future. Instead, it is a question of how much money from the current economy needs to be taken and saved in the Fund. This requires an analysis of where that money will provide the best long-term benefit for society. Regarding suitable calculations (taking into consideration budget income and SOFAZ active's forecasting), empirical evidence and expert opinions, we presume that transfers from SOFAZ to the state budget in Azerbaijan shouldn't exceed **30%** of the total SOFAZ assets regarding its own budget receipts.

The status of Oil Fund of Azerbaijan is off-budget organization, such as the State Social Protection Fund. In this sense, the reflection of the budget of SOFAZ, its discussion and approval by parliament, along with the Foundation for Social Protection's annual budget in overview of the country, is completely logical. But at the same time, SOFAZ is a special government organization that does not fit into the traditional structure of public administration of the country. Прослушать Peculiarities of the operation and management of this structure are explained by the following circumstances. На латинице Regulations of the Fund clearly predetermined sources of income, which are all payments from the oil and gas sector of the country, except the taxes that accumulated in the state budget. Thus, the Fund does not work with taxpayers in their traditional form, but only accumulates the non-tax part of payments, the main one of which is the profit of oil, part of the tax payments which fall to the share of the PSA contracts. Indirectly, this fact means that the Fund is not responsible for the improper accumulation of taxes. As noted by the government, reduction of income of the Fund was a

result of economic downturn in the world market, expressed by a sharp drop in oil prices.

In the country, the Fund has only a narrowly delineated range of partners on the state management system which it contacts by financial flows. In the annual budget of the Fund approved by the Parliament, as a rule the lion's share of expenses is intended to be transferred to the state budget, which consequently makes the Ministry of Finance its main financial partner. The Fund works only with selected government agencies and in this sense it is not fully incorporated into the domestic state control system like other state agencies. However, there remains a huge responsibility for the Fund to ensure the effective management of the Fund's assets, which, incidentally, is related to its activities abroad. This factor underlines the importance of focusing primarily on the global financial market situation. Simultaneously, this same factor underlines some of the concerns regarding the Fund's management of the increasing funds spent in the domestic economy. After all, it is obvious that for effective management of Fund assets, i.e., greater profitability, SOFAZ is interested in minimizing the expenditure of funds within the country, in order to operate with a large amount in foreign investment markets.

## **Recommendations**

1. SOFAZ's activities should be regulated with law status regulatory acts;
2. Government should create opportunity for civil society organizations to take part in SOFAZ's Board;
3. Fiscal rules regulating transfers from SOFAZ to the state budget should stipulate conditions and limitations for such transfers;
4. The Chamber of Accounts should be entrusted with obligations to audit SOFAZ's accounts;
5. SOFAZ has to frame new strategy encompassing long-term asset management and indices issues;
6. The Government should link SOFAZ's asset management policy with general fiscal and macroeconomic policy.

### Addendum 1. SOFAZ (Azerbaijan) compliance with Santiago principles

Principles	In Azerbaijan
<p>GAPP 1. Principle The legal framework for the SWF should be sound and support its effective operation and the achievement of its stated objective(s).</p> <p>GAPP 1.1 Subprinciple The legal framework for the SWF should ensure the legal soundness of the SWF and its transactions.</p> <p>GAPP 1.2 Subprinciple The key features of the SWF's legal basis and structure, as well as the legal relationship between the SWF and the other state bodies, should be publicly disclosed.</p>	<p>Applicable</p> <p>The requirements of both sub-principles have been fulfilled. Public awareness on both the legal base and the structure has been provided through SOFAZ web site. Also "Information Policy" including the detailed response to surveys on these issues was accepted in April 2007.</p>
<p>GAPP 2. Principle The policy purpose of the SWF should be clearly defined and publicly disclosed.</p>	<p>Applicable</p> <p>Indeed there are arguments about the degree to which the Oil Fund is reaching the goals set (especially, the goal of equal distribution of oil revenues among generations). However, the goals have been clearly declared and are not hidden from the public.</p>
<p>GAPP 3. Principle Where the SWF's activities have significant direct domestic macroeconomic implications, those activities should be closely coordinated with the domestic fiscal and monetary authorities, so as to ensure consistency with the overall macroeconomic policies.</p>	<p>Not applicable</p> <p>Given the increase of the budget transfers despite the decline of profitability rate of SOFAZ assets management there is need to review the coordination of fiscal and macroeconomic policies.</p>
<p>GAPP 4. Principle There should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF's general approach to funding, withdrawal, and spending operations.</p>	<p>Applicable</p> <p>There are certain concerns in this field. The condition of the assets in the banks that SOFAZ is in partnership with and the non-accountability of the investment projects of the Fund give more ground to state this.</p>

<p>GAPP 5. Principle</p> <p>The relevant statistical data pertaining to the SWF should be reported on a timely basis to the owner, or as otherwise required, for inclusion where appropriate in macroeconomic data sets.</p>	<p>Applicable</p> <p>SOFAZ provides this through its quarterly reports and web site.</p>
<p>GAPP 6. Principle</p> <p>The governance framework for the SWF should be sound and establish a clear and effective division of roles and responsibilities in order to facilitate accountability and operational independence in the management of the SWF to pursue its objectives.</p>	<p>Not applicable</p> <p>Though the management system of SOFAZ is sufficiently effective for this principle, the fact that the Supervisory Board includes no civil society representative causes concern.</p>
<p>GAPP 7. Principle</p> <p>The owner should set the objectives of the SWF, appoint the members of its governing body(ies) in accordance with clearly defined procedures, and exercise oversight over the SWF's operations.</p>	<p>SOFAZ's management is vested with the Executive Director, appointed by and accountable to the President of the Republic of Azerbaijan. SOFAZ's Executive Director as a chief executive officer is vested with the powers to be a legal representative of the Fund, organize and conduct business of the Fund including appointment and dismissal of employees, management and disbursement of the assets of the Fund in conformity with the rules and regulations approved by the President of Azerbaijan. <a href="http://www.oilfund.az/en/content/4">http://www.oilfund.az/en/content/4</a></p>
<p>GAPP 8. Principle</p> <p>The governing body(ies) should act in the best interests of the SWF, and have a clear mandate and adequate authority and competency to carry out its functions.</p>	<p>Not applicable</p> <p>There is a need to accept a law on Oil Funds in order to fulfill this principle.</p>
<p>GAPP 9. Principle</p> <p>The operational management of the SWF should implement the SWF's strategies in an independent manner and in accordance with clearly defined responsibilities.</p>	<p>Not applicable</p> <p>Particularly the fact that limitation of SOFAZ transfers to the budget has not been determined makes it impossible for its activities to fully comply with its strategy.</p>

<p>GAPP 10. Principle The accountability framework for the SWF's operations should be clearly defined in the relevant legislation, charter, other constitutive documents, or management agreement</p>	<p>Not applicable</p> <p>There is a need for an improved law on Oil Funds.</p>
<p>GAPP 11. Principle An annual report and accompanying financial statements on the SWF's operations and performance should be prepared in a timely fashion and in accordance with recognized international or national accounting standards in a consistent manner.</p>	<p>Applicable</p> <p>SOFAZ reports are being prepared on time. SOFAZ also prepares its financial reports in accordance with International Financial Reporting Standards (IFRS).</p>
<p>GAPP 12. Principle The SWF's operations and financial statements should be audited annually in accordance with recognized international or national auditing standards in a consistent manner.</p>	<p>Applicable</p> <p>SOFAZ reports are audited by big four international audit companies. The most recent annual report was audited by Deloitte.</p>
<p>GAPP 13. Principle Professional and ethical standards should be clearly defined and made known to the members of the SWF's governing body(ies), management, and staff.</p>	<p>Not applicable</p> <p>SOFAZ has no professional and ethical code determined.</p>
<p>GAPP 14. Principle Dealing with third parties for the purpose of the SWF's operational management should be based on economic and financial grounds, and follow clear rules and procedures.</p>	<p>Not applicable</p>
<p>GAPP 15. Principle SWF operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate.</p>	<p>Applicable</p> <p>Certainly SOFAZ meets all the agreed requirements in areas where it implements its investment projects.</p>

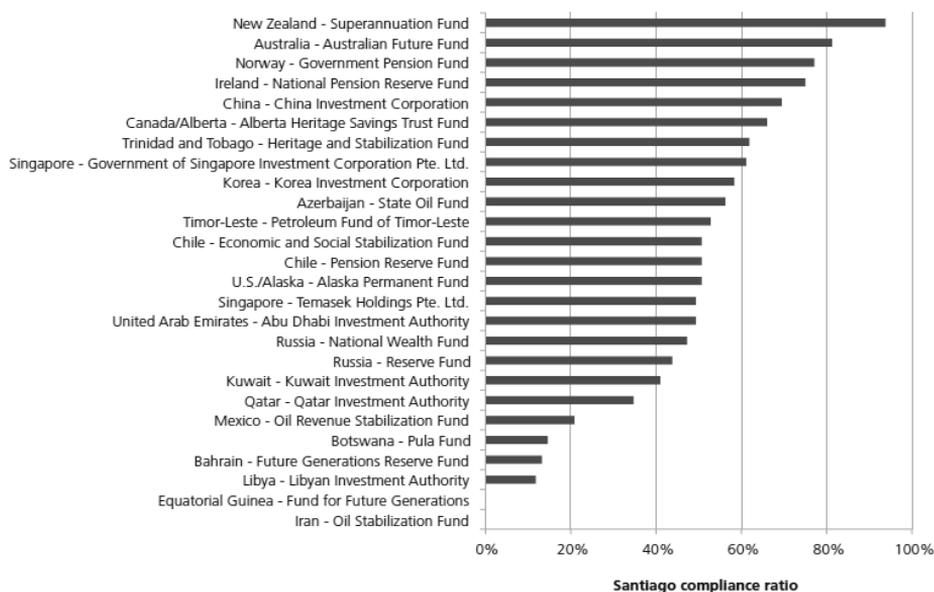
<p>GAPP 16. Principle The governance framework and objectives, as well as the manner in which the SWF's management is operationally independent from the owner, should be publicly disclosed.</p>	<p>Applicable</p>
<p>GAPP 17. Principle Relevant financial information regarding the SWF should be publicly disclosed to demonstrate its economic and financial orientation, so as to contribute to stability in international financial markets and enhance trust in recipient countries.</p>	<p>Applicable</p> <p>SOFAZ discloses relevant statistical data in this regard. It's due to this fact that Azerbaijan was among the top 5 on Linaburg-Maduell index declared in the fourth quarter of 2009. <a href="http://www.swfinstitute.org/research/transparencyindex.php">http://www.swfinstitute.org/research/transparencyindex.php</a></p>
<p>GAPP 18. Principle The SWF's investment policy should be clear and consistent with its defined objectives, risk tolerance, and investment strategy, as set by the owner or the governing body(ies), and be based on sound portfolio management principles.</p> <p>GAPP 18.1 Subprinciple The investment policy should guide the SWF's financial risk exposures and the possible use of leverage.</p> <p>GAPP 18.2 Subprinciple The investment policy should address the extent to which internal and/or external investment managers are used, the range of their activities and authority, and the process by which they are selected and their performance monitored.</p> <p>GAPP 18.3 Subprinciple A description of the investment policy of the SWF should be publicly disclosed.</p>	<p>Applicable</p> <p>SOFAZ investment policy follows these principles.</p>
<p>GAPP 19. Principle The SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds</p>	<p>Applicable</p> <p>SOFAZ follows a very careful policy. The fact that its profitability, though small, was noticeable even during the crisis can be explained by this policy.</p>

<p>GAPP 20. Principle The SWF should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities.</p>	<p>Applicable</p>
<p>GAPP 21. Principle SWFs view shareholder ownership rights as a fundamental element of their equity investments' value. If an SWF chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protects the financial value of its investments. The SWF should publicly disclose its general approach to voting securities of listed entities, including the key factors guiding its exercise of ownership rights.</p>	<p>Applicable</p> <p>These principles are followed during SOFAZ activities and its investment policy.</p>
<p>GAPP 22. Principle The SWF should have a framework that identifies, assesses, and manages the risks of its operations.</p> <p>GAPP 22.1 Subprinciple The risk management framework should include reliable information and timely reporting systems, which should enable the adequate monitoring and management of relevant risks within acceptable parameters and levels, control and incentive mechanisms, codes of conduct, business continuity planning, and an independent audit function.</p> <p>GAPP 22.2 Subprinciple The general approach to the SWF's risk management framework should be publicly disclosed.</p>	<p>Applicable</p> <p>This issue at SOFAZ is dealt with by the Risk Management Department that is included into the Asset Management Group. State Oil Fund of Azerbaijan Republic (SOFAZ) signed an agreement with RiskMetrics Solutions Inc. that was the winner of the tender on software for risk assessment system conducted in accordance with the requirements of the Law of Azerbaijan Republic on "State Procurements" on January 29, 2010. The value of the contract on risk assessment system is USD 160 thousand annually. The duration of the contract is 5 years. The system is considered to be implemented within 6 months.</p> <p><a href="http://www.oilfund.az/az/news/267">http://www.oilfund.az/az/news/267</a> As is seen, the information taken from the official SOFAZ website confirms that information on risk assessment and management is disclosed to the public without any problems.</p>

<p>GAPP 23. Principle The assets and investment performance (absolute and relative to benchmarks, if any) of the SWF should be measured and reported to the owner according to clearly defined principles or standards.</p>	<p>Applicable</p> <p>SOFAZ has been both preparing its reports and assessing its asset and investment activities in accordance with International Financial Reporting Standards.</p>
<p>GAPP 24. Principle A process of regular review of the implementation of the GAPP should be engaged in by or on behalf of the SWF.</p>	<p>Not applicable</p> <p>No such opinion in this regard has been stated by SOFAZ.</p>

## Addenda 2. Santiago Compliance Index

Figure 1. Santiago Compliance Index as of March 2010



## The National Fund of the Republic of Kazakhstan (NFRK): From stress-test to global future

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*Acknowledgment: I would like to thank Gonzalo Pastor and Max Watson for their helpful comments of the earlier drafts of this paper. All errors remaining rest with the author.*

### Executive summary

Sovereign Wealth Funds (SWF) have different titles, goals and rules, but they share the underlying objective of helping governments deal with the problems created by large and variable revenues from energy (or other commodity related) sectors. In Kazakhstan, such a fund (the National Fund of the Republic of Kazakhstan (NFRK)) was established in 2000, when the oil prices were rising and an economic recovery was on a map for the Kazakhstani economy. This fund operates as both a *stabilisation* and a *savings* fund.

The first test for the NFRK was the 2007-2009 financial crisis, where the NFRK “saved” the economy and guaranteed its speedy recovery. It is important to emphasize the proactive stance of the government to protect some key sectors of the economy on the basis of their implications to the local economy. The consequences of the crisis will clearly result in changes in investment portfolio strategy as well as in the general rules and principles of functioning of the fund, although the full implications remain to be seen. The NFRK has not escaped the effects of the global downturn, and although its total assets fall as a result of the drop in value in its investment, it is likely that the fund will remain a vitally important source of capital in the international financial markets, and will make important investments across all the different asset classes in the future.

There is a certain concern that the NFRK is not, at the present time, a part of the Santiago principles initiative for SWF. It is of paramount importance that the government of Kazakhstan produce some substitute governance guidelines to Santiago principles for the NFRK, especially with regards to the fund’s investment strategy in the years ahead.

The financial crisis has shifted the emphasis in the policy of the NFRK from issues of performance at the firm level to the portfolio strategy and the investment horizon of NFRK. It is understandable that the consequence of the crisis is a more active involvement of the Kazakhstani government in the governance of the NFRK, which will be reflected in a more sensitive attitude to the social needs of the Kazakhstani citizens.

The challenge ahead for the Kazakhstani economy is clear: to ensure that the economic progress initiated by the seed capital of hydrocarbon development prior to the 2007-2009 financial crisis proves stable and sustained. The government of

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Kazakhstan has discussed the need to have a long-term vision and determination in pursuing their policies of management of the oil revenues, which should contribute to the sustainable development.

One important lesson is that its emphasis on liquid external savings helped moderate the domestic boom and also allowed a wholly credible insurance or collateral role during the crisis. A second is that there was then scope – at least for a period – to use resources in the fund to help repair the damage to the domestic economy. Time will tell how efficient these latter involvements have been, and also how to restore the former insurance role by building up liquid foreign assets in the future.

But under all options for its investment strategy, the case made in this paper is the core importance in Kazakhstan of continuing to enhance governance and transparency of the sovereign wealth fund in order to maximize the chances of success. Inevitably this limits government discretion in disposing of the mineral wealth of the nation. It is, however, essential to build public support for the funds, and to leverage their economic impact through a strong influence on market expectations.

There are overall recommendations which we draw from the analysis:

First of all, it is crucial that in the future the government will be determined to achieve the non-resource fiscal balance with the robust programme of diversification.

Secondly, it would be beneficial if the Kazakhstani government could establish a system of particular indicators for the non-resource deficit in order to monitor as well as to reduce resource dependency.

Third, the fact that domestic investment for economic diversification provides more stability and economic resilience should be taken into account when the Kazakhstani government is designing the investment portfolio strategy of the NFRK for the near future.

Fourth, although Kazakhstan did not accept (no one from the officials in the Kazakhstani government was invited to Santiago) the Santiago Principles, a transparent and accountable governance structure of the NFRK is required for the future success of the policies conducted by the fund.

Fifth, well managed oil wealth would be central in financing these reforms, and at the same time it would be important not to misuse the NFRK in strategically oriented investment rather than commercial investment.

Sixth, in its investment strategy the NFRK has to arrive over time at a diversification in its asset allocation which would correspond to the longer term needs and welfare of Kazakhstani citizens.

Finally, at the present time Kazakhstan already has a history in designing an effective framework for managing its hydrocarbon wealth; however, improvement in the petroleum taxation regime would be required as an additional instrument in managing the oil and gas revenues, namely neutrality, capture of rent, stability and timing of revenue, progressivity and adaptability, administrative simplicity and enforceability as well as international competitiveness. The Kazakhstani government needs to reassess its risk preferences and its willingness to share them with the investors in the oil and gas sector after the recent crisis.

## 1. Context and importance of the problem<sup>1</sup>

Oil revenues offer important opportunities to enhance economic development. But they are also volatile, unpredictable, and ultimately exhaustible; and they can thus greatly complicate economic management. In Kazakhstan, the starting assumption must be that resource endowment is potentially a “blessing” that can help overcome transition disruptions. But the lesson of experience elsewhere is that realizing this promise – and avoiding the risk of natural resources becoming a “curse” – is crucially dependent on policies, including a commitment to enhanced policy transparency.

The recent literature on resource-rich economies supports the view that oil and gas revenues can pose problems for policy-makers, and highlights the possibility that natural resource endowment can be an economic curse rather than a blessing (Auty, 1998, 2006, Gylfason, 2001; Kalyuzhnova 2008, Kalyuzhnova et. al., 2006, Sachs et al., 2000, etc). In a range of cases, economic performance has indeed appeared to suffer rather than benefit from the impact of natural resource endowment (Gylfason and Zoega, 2003; Paldam, 1997).

As a consequence, the international community, including notable international financial institutions, has become increasingly concerned about the effectiveness with which natural resource revenues are used, and in particular how they can help foster economic and social development in the long run. This latter concern is part of a wider topic: the political economy of resource-driven growth.

The governments of resource-rich countries face the challenge of devising policies that can effectively channel “income transfers to governments and the inflow of foreign exchange from foreign investments.” (Kalyuzhnova, 2002: 79). To tackle this challenge, many oil-producing countries are setting up national oil funds. Such funds have become fashionable in the wake of recent high and volatile oil prices, and with new discoveries of hydrocarbon deposits.

Sovereign Wealth Funds (SWF) have different titles, goals and rules, but they share the underlying objective of helping governments deal with the problems created by large and variable revenues from energy (or other commodity related) sectors. In Kazakhstan, such a fund (the National Fund for the Republic of Kazakhstan (NFRK)) was established in 2000, when the oil prices were rising and an economic recovery was on the map for the Kazakhstani economy. This fund operates as both a *stabilisation* and a *savings* fund.

In light of emerging experience (especially since 2007) with such funds, there is a need to explore under what circumstances they can become part of a policy solution – rather than ending up as a part of the problem. The core question is whether the NFRK, generically, is panacea for the so called “paradox of plenty;” whether its effectiveness depends on specific operating conditions and rules; or whether, more pessimistically, it delivers results only in national circumstances that are in any case particularly benign.

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<sup>1</sup> Some of the parts of this paper are based on a revised version of Chapter 2 by Y. Kalyuzhnova, “Economics of the Caspian Oil and Gas Wealth: Companies. Governments. Policies.” 2008. Palgrave Macmillan, reproduced with permission of Palgrave Macmillan.

In this context, NFRK identifies as a tool that may help in addressing two specific problems associated with oil revenues--the unpredictability and volatility of world market prices, and the concern to save part of the revenues for future generations—"The Permanent Income Hypothesis" (PIH). In this context, this fund may serve as a form of "commitment mechanism," thus substituting for the IMF commitment mechanism. A further problem could in principle also be mitigated by oil funds: "Dutch Disease."

The first test for the NFRK was the 2007-2009 financial crisis, where the NFRK "saved" the economy and guaranteed its speedy recovery. It is important to emphasize the proactive stance of the government to protect some key sectors of the economy on the basis of their implications to the local economy.

The consequences of the crisis will clearly result in some changes in investment portfolio strategy as well as in the general rules and principles of functioning of the fund, although the full implications remain to be seen. The NFRK has not escaped the effects of the global downturn, and although its total assets fall as a result of the drop in value in its investment, it is likely that the fund will remain a vitally important source of capital in the international financial markets, and will make important investments across all the different asset classes in the future. Some priorities in this regard are discussed below, including the trade-offs between greater domestic involvement in the short run and the requirements of a resumed "insurance" role in the face of future shocks.

Whatever investment choices are made, however, the issue of transparency is crucial for any SWF, both domestically and because the funds have been receiving increased scrutiny due to their growing presence in global financial markets. In this respect there is a certain concern that the NFRK is not, at the present time, a part of the Santiago principles initiative for SWF along with other large SWF like other world's largest funds of Libya, Brunei, Malaysia, Hong Kong, etc. It is of paramount importance that the government of Kazakhstan will produce some substitute governance guidelines to Santiago principles for the NFRK, especially with regards to the fund's investment strategy in the years ahead.

## **2. Critique of policy option(s)**

In Kazakhstan, the oil fund (the National Fund of the Republic of Kazakhstan (NFRK)) was established in August 2000. Legal aspects were defined by Presidential Decree N402 of 23 August. The NFRK is managed by the National Bank of Kazakhstan and is overseen by a governing board chaired by the President of Kazakhstan, Prezident Nazarbayev, and including the prime minister, the heads of the two chambers of parliament, the National Bank chairman and the finance minister. Information on the fund's revenues, expenditure, and the audit result is published in the local press. The fund is subject to an annual independent audit.

The NFRK invests in liquid foreign equities, and will be capitalized by corporate income taxes, VAT, royalties, bonuses, and Kazakhstan's revenues from production sharing agreements. Initially, the Fund had a long-term investment function-saving portfolio (75%) and a smaller stabilisation function-saving portfolio (25%), and later these figures were altered to 80% and 20% respectively.

## 2.1 Economic context

The rules governing the accumulation and use of resources in oil funds differ widely. The differing features of the funds must be understood, in part, in light of the economic situation of each country, which results in varying priorities. It is useful to analyse the rules governing the NFRK.

First, the Kazakhstani government and the international agencies consider the estimated life of the hydrocarbon deposits as a decisive argument for and against placing the funds' investment portfolio abroad, whence income will be accrued on the PIH. Originally, given the scale and pace of exhaustion of reserves in Kazakhstan, the IMF had originally assumed the year 2045. However, this projection did not take account of then-unproven reserves. Recent exploration in Kazakhstan has led to the discovery of the Kashagan field in the Caspian Sea. This alone is believed to hold nearly 40 bln bbl of oil reserves. Estimates of how long the country will remain a significant oil producer need to take into account anticipated future discoveries set against future rates of production. These production rates are based on extraction and transport costs at the contemporary and projected world price. Kazakhstan's proven reserves may well amount to 18 bln bbl (including Kashagan's proven reserves).

Second, investment ratios in the Kazakhstani economy have been high, and external financing has been drawn on to differing degrees in achieving this. Prior 2007 financial crisis Kazakhstan, exhibits a high share of capital formation in GDP (27%), which is well above that of other transition economies. That Kazakhstan has drawn heavily from abroad for its capital finance may be implied, in part, by its high ratio of external debt to GDP – in 2004 68.9%, which of course triggered Kazakhstan's exposure during the 2007-2009 credit crisis. At that time, the moratorium on disbursements from the "oil fund" was in force, hence the Kazakhstani government was not achieving its high investment rate through the use of its fund.

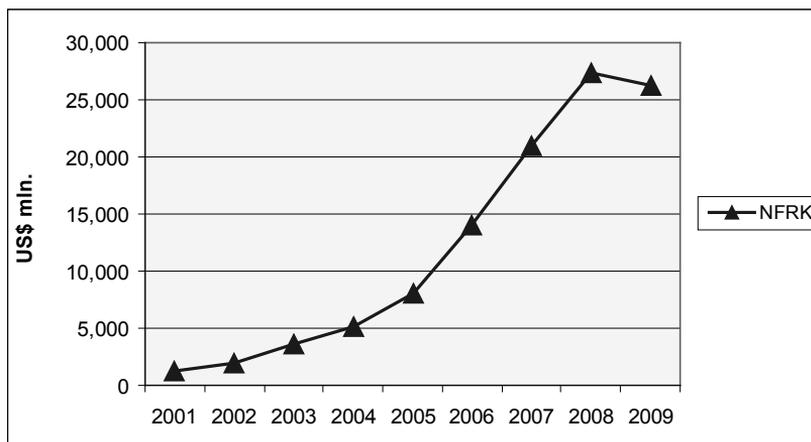
## 2.2 Mapping goals to national priorities

This economic context in Kazakhstan helps one to understand the specific design of the oil fund. The NFRK is designed to save resources for future generations and avoid undue pressure on the domestic economy - and layered on this is a stabilization function. President Nazarbayev made clear at the outset that resources would not be spent on covering current expenses, but would accumulate in the NFRK for future generations, as well as for the contingency of economic recession. Stabilization by the NFRK is achieved by means of "reference prices" for gas, oil, and four metals (chrome, zinc, lead and copper). The nine largest oil companies and three from the metals sector are subject to transfers based on the reference price. When the targets are exceeded, surplus tax payments are transferred to the NFRK. On the other hand, if market prices are below the reference prices, the Fund provides revenue to the government. The stabilization portfolio must constitute at least 20% of NFRK assets.

Prior to 2007, with the Kazakhstan budget in a strong position, and oil prices rising in the recent past, this strategy proved entirely workable. During the first five years of its existence the NFRK has accumulated extra payments made to the republic's budget from major companies operating in the raw materials (oil and gas) sector. In 2003 the fund began accumulating proceeds from the sale of

state property. In 2008, the fund's reserves exceeded US\$ 27.4 bln. (see Figure 1). However, since 2009, according to the National Bank of Kazakhstan the assets in NFRK have fallen to US\$ 26 bln. Kazakhstan has been drawing heavily on its rainy-day fund as it attempts to stabilize its economy. Overall, in 2009, profitability of both portfolios was 7.31% (where stabilisation and saving portfolios were 1.24% and 10.19% respectively). (See Figure 2)

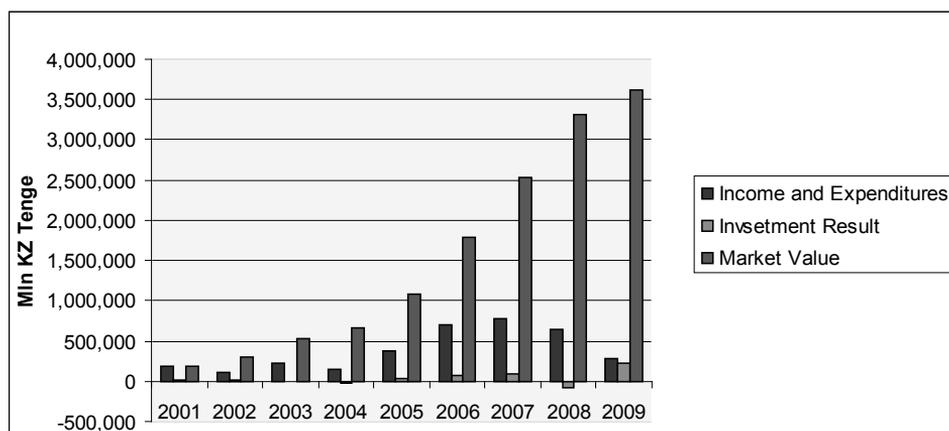
**Figure 1. NFRK, 2000-2009, US\$ mln**



*Source: NFRK annual reports.*

Throughout the years since the NFRK's conception we could observe a steady increase in its market value (see Figure 2).

**Figure 2. NFRK: The Main Indicators, Mln.KZ Tenge**



*Source: NFRK annual reports.*

The differing roles and objectives of national governments are reflected in the investment strategy of their wealth funds. In Kazakhstan, the investment strategy of the NFRK was based, from its conception, on the rules governing the foreign exchange reserves of the National Bank of Kazakhstan: eligible assets were low-risk interest-bearing securities (AA- grade or better). According to the FitchRatings agency “the NFRK offers a good degree of fiscal and balance of payments support, but as its assets are still not especially large, this support is finite. Assets should rise more rapidly during the coming years, in part related to the timing of additional oil production, although the authorities might wish to revisit the question of the trigger price to ensure regular and reliable inflows into the Fund.” (FitchRatings, 2003: 12). Of course, a prudent strategy of investing resources in high quality external assets could be compatible with a more diversified portfolio approach in the future.<sup>2</sup> Until 2008 Kazakhstan has been very cautious on this front and has been praised by IMF (see IMF, 2004: 73) Prior to the 2007-2009 crisis the Kazakhstani government combined a quite conservative fiscal policy with rapid financial development and expansion of its monetary base. The large reserves were saved abroad and private banks’ credit growth was tremendous, resulting in significant asset bubbles<sup>3</sup>.

To summarize, examining the recent operations of the NFRK:

It was planned that the NFRK would not be touched for the first five years of its existence.

In terms of investment targets the NFRK invested only abroad.

To the extent that sovereign wealth funds serve a useful purpose, this is at once a more modest and more ambitious one. Modest, because a realistic goal is to achieve some degree of pragmatically-based smoothing and inter-temporal redistribution, with no pretence of optimality. Ambitious, because their value can lie in reinforcing the transparency, implementation, and credibility of key fiscal rules – thus addressing at the source a number of the institutional weaknesses that may lie behind the poor performance of many resource-rich economies.

As Glennester and Yongseokh showed (2003), transparency is correlated to improvements in investment and growth performance. Kazakhstan is already known as a country with a low level of transparency and opportunities for fraud and corruption (see Transparency International’s Corruption Perception Index). Without doubt, the country needs to improve its disclosure of negative practices. Kazakhstan did not accept the Santiago principles (for the principles’ description please see Appendix 2) which provided the further platform for the transparency development for the SWF. The main limitation of the Santiago principles is that

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2 It is important to note that already at the present stage the management of the fund could envisage a longer-term investment horizon and a broader diversification. Although investments in equity instruments involve a higher risk of exposure to short term fluctuations in market value compared to bonds, historically they have provided a better average return. Whether risk-adjusted returns are higher depends on the adjustment made for risk and the investor’s risk-aversion. Generally only the richest countries (e.g. Kuwait) invest any more than a very small proportion of their assets in equities.

3 Later, when the crisis affected all areas of the Kazakhstani economy the government did not have a choice as it bailed out the banking sector by depleting NFRK assets.

disclosure requirements are limited, "...a further enhancement of the Principles and the surrounding governance framework will be mandatory in order to alleviate protectionist pressure in recipient countries once financial crisis is overcome". (Beck, Fidora, 2009:364) Table 1 shows that around 50% of the richest SWF do not recognise these principles as their rules of life. It is possible to debate and discuss the immaturity of the governments involved, but there is still a long way to go by the international community in order to convince the governments of some resource rich countries that the higher level of transparency is desirable for the successful management of the hydrocarbon revenue.

However, the circumstances of Kazakhstan's failure to attend the meeting in Santiago are unclear and there remains some ambiguity about whether Kazakhstan has rejected the Santiago principles as such. Three senior governmental officials related to the NFRK from the Ministry of Economy, Ministry of Finance and also National Bank of the Republic of Kazakhstan were asked by the author why Kazakhstan did not participate in the Santiago 2008 meetings as well as why Kazakhstan does not recognise the Santiago principles and the answer was unanimous: "Never heard about the Santiago principles. Kazakhstan was never invited to join the Santiago meeting." (Interviews were conducted in May 2010). Moreover, the senior representative of Soros Foundation in Kazakhstan also was not aware of the existence of the Santiago principles. In addition, a number of the Kazakhstani analysts who are studying the NFRK were also confused when asked about the Santiago principles and Kazakhstan's perception of them. The conclusion is very straightforward; the international working group of sovereign wealth funds (IWG) should make contact with the NFRK and establish a dialogue on Santiago principles and the NFRK's involvement into this process.

What is true for the economy at large is true for the resources concentrated in the SWF. Transparency in the management of oil revenues is essential to prevent a few interest groups from appropriating oil resources by allowing a democratic debate and avoiding corruption and waste of public resources. Part of this initiative is to increase transparency with respect to revenues by those host country governments. Resource revenue transparency has been advocated by international financial institutions, including the IMF (2004). The concept of transparency is expected to focus initially on the transparency of the general government, but because of the special needs of transition economies it should be extended also to relevant stakeholders (including companies investing in the sector and financial and strategic investors supporting lending).

Five dimensions of transparency deserve particular attention in this connection: a clear definition of goals; rules-based operations; the public availability of information; and the adequacy of internal accounting and auditing of the funds; and arrangements for the appointment of officials and managers. Experience in Kazakhstan is considered briefly below in light of these priorities, illustrating that transparency is a significant issue for the fund.

In the next two to three years the management of the NFRK would need to re-assess the asset class level for the fund. It would be of paramount importance to identify a long-term portfolio strategy and the investment horizon of NFRK.

## 2.3 Definition of goals

In Kazakhstan the main objective for the management of NFRK is defined to be the investment of capital in such a way that the international purchasing power of the Fund is maximized, taking into account an acceptable level of risk. "Following also IMF guidelines, the investment portfolio of the 'oil funds' is best placed abroad. In sum, both domestic electorate and the international community should have confidence that the funds are well-managed, transparent, and used for the purposes set out by law." (Kalyuzhnova et. al., 2005: 16).

## 2.4 Rules-based operations

As to whether the funds are rules-based, in a mechanical sense this is broadly satisfied. In Kazakhstan, much of the legislation and administrative infrastructure was borrowed from Norway's oil fund. However, the closer implementation of the Norway's model based on a non-oil deficit target rule could be a way to enhance the transparency of the NFRK. Broader recommendations for Kazakhstan to increase its degree of transparency include consolidation of the treasury reports and better integration of all fiscal costs and risks associated with extra budgeting operations (including NFRK itself).

In 2006, in order to establish a long-term strategy for the use and accumulation of oil revenues, the rules governing the NFRK were redesigned (see Appendix 1). Under the current system, fiscal payments from identified companies in the natural resources sector are subject to transfer to the NFRK. In 2004 the number of companies was reduced and the transfer of their fiscal payments is calculated on the basis of a reference oil price. However, the main criticism of the original reference price (US\$19/bbl), which was established a long time before the oil boom, is that this does not reflect the true situation.<sup>4</sup> The original rules for placing resources in the NFRK allowed the government to deplete the balance if prices were to fall significantly below the reference price. The practical difficulty here was that the rules were not applied vigorously, due to the fact that the definitions of oil income and oil enterprises could be interpreted differently and easily changed, depending on the intention to save less or more than the rule currently commits the government to.

Overall, even if at first sight the rules look quite straightforward, practice has demonstrated that the reality was a complex one with all the computations, etc. So, inflow rules include: saving: 10% of baseline budget oil revenues from identified companies (for the list see Makhmutova, 2008); stabilization: oil revenue above the baseline price; *ad hoc* privatization and bonus receipts. Outflow rules are clearly stated that transfers to state and local budgets are allowed only after the approval by the president of the country. The Kazakhstani authorities fully integrated the NFRK with the budget. All central government oil revenue accrues to the NFRK, from 2007 onwards, and flows into the fund via the budget. Prior to the crisis it was an agreement that some funds will be released back to the budget to finance development spending. There was the intention to set clear limits on how much can be spent in any one year. In addition, ceilings were set for three-

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4 At the present time this price is around US\$80.

year periods. These changes aim to strike a balance between meeting current development needs and providing a savings cushion for future generations. The NFRK used to include “excess” revenues not only from the oil sector but also from other sectors such as metals. As of mid-2006, all taxes collected from oil companies accrue to the fund.

Four more general considerations are also relevant:

It can be argued that the principles of operation should be formally enshrined in legislation to guarantee reliable functioning of the oil fund over the long term. Legitimacy and permanence would be improved by having the formation of oil funds come from national parliaments, rather than presidential decrees, and this is true in Kazakhstan as in other cases.

Issues of implementation matter. The relevant question in each case is not just the principles agreed upon at the outset, but also the question of how transparent the implementation is likely to be.<sup>5</sup>

It was a fear that as a consequence of the 2007-2009 crisis, the NFRK may tend to invest domestically when domestic equity prices are rising, and on the contrary, to go abroad if foreign prices are attractive, although with caution, but the Kazakhstani authorities took a different view, that basic trade-off needs to be faced and that a true insurance role will require adequate stock of external and liquid assets.

Since the crisis began in 2007 the political establishment has been more involved in governance of the NFRK.

## 2.5 Public availability of information

In terms of public availability of information, in the first years of establishment of the NFRK the population in Kazakhstan was largely unaware of its existence.<sup>6</sup> But they should have a primary voice in their country's development since the citizens of Kazakhstan will face the economic, environmental, human rights, and social impacts of hydrocarbon development. By involving them in the process the problem of corporate and governmental accountability could be partially solved. The Kazakhstani citizens have to know how much income was taken from the fund, on what grounds, and how that money was spent.

The question of awareness about the existence of the oil fund in Kazakhstan comes from the 2006 and 2010 Survey of Households commissioned by The Centre for Euro-Asian Studies (UK) and carried out by the Agency of the Republic of Kazakhstan on Statistics (ARKS) on 640 households across all the regions,

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5 In April 2003, Kazakh National Bank Chairman Marchenko endorsed President Nazarbaev's decision to divert over US\$1 bln from a secret account into the NFRK, telling journalists that “this was the right decision from the economic point of view,” although it may have been flawed from a political or legal perspective. (Reuters and Interfax-Kazakhstan, 2003). The Kazakhstani officials claim that almost US\$880 mln of the US\$1 bln deposited five years ago in Swiss bank accounts was used to pay off pension arrears and support the national budget. Mr. Marchenko refused to reveal how much money the government still has in foreign bank accounts on the grounds that it is a state secret.

6 Author's interviews with a number of citizens of Kazakhstan in 2002-2003.

designed to be nationally representative.<sup>7</sup>

The survey also included questions relating to individual well-being<sup>8</sup>. The questions related to life satisfaction as well as the impact that the reforms have had on individual perceptions of well-being which allows a clear picture to be drawn and links between individual well-being and existence of oil funds.

From the question *Do you know about the existence of the National Fund of Republic of Kazakhstan?* We learned that 45% of the Kazakhstani population do not have any idea about NFRK; however, in the 2010 survey this figure declined to 30%. In 2010 through the regional analysis we found out that the majority of unawareness is concentrated in the regions of Mangistau (54%), Karaganda (48%), and Akmolinskaya (43%). In contrast, Southern Kazakhstan has the highest awareness among all regions, where only 1% of the population do not know about NFRK.

In analysing the educational level of the population which is not aware of the existence of the NFRK, we found that the largest percentage (60%) of people with primary education are not aware of the existence of the NFRK, although this result is based on the interviews of a small group of respondents.

Overall we found a pattern of increasing awareness of the existence of the NFRK with the level of education (e.g. three quarters of people with higher education knew about the existence of NFRK, or based on a small number even 86% with postgraduate education).

The respondents who were aware of the existence of the NFRK were asked *To what extent does the National Fund of Republic of Kazakhstan influence your standard level of living?* Overall a very small percentage of people think that the NFRK has a significant impact on their well-being (17% in 2010, which is slightly higher compared with the survey of 2006 where the respective figure was 13.8%). The striking fact from the 2010 survey was that almost two-thirds of respondents either did not know or gave a non-valid answer to this question.

More people with a higher education thought that the NFRK has a positive effect on the standards of living (19.2%). Similarly, more also think that there is no influence (28.5%). In general, those with the lowest levels of education were also least inclined to give a valid answer. In terms of regions, Atyrauskaya and Kzyl-Orda regions thought the NFRK had a positive influence on standards of living (40.7% and 69.4%, respectively). Respondents in Kustanai region and Astana city were most inclined to think the NFRK had no impact on standards of living (40.6% and 37.5%, respectively).

In a broader context of assessing the oil wealth of the country, the respondents were asked where, from their point of view, the oil money should be spent<sup>9</sup>. From the 6 possible answers (health care, economy, oil and gas, agriculture, welfare, and population) which could be chosen as single as well as multiple, the most popular answers were in 2010 "health care" (48.2%), "social sector"

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7 For the methodology of the survey please see Chapter 1 in Kalyuzhnova (2008).

8 It includes information on income, expenditures, the nature and quality of housing, and other household characteristics such as number and age of household members, labour force status, educational attainment, health status, etc., across all the regions of Kazakhstan.

9 The actual question in the survey was: From your point of view what for oil money should be distributed?

(38.6%), “economy” (32.9%) and “population” (11.7%). This proved the point that the population thinks about the present day and perceives the oil wealth as a blessing of today rather than tomorrow. In particular, an interesting fact is that the answer “oil and gas sector” received the support of only 4.9% of the population.

In the Akmolinskaya region, respondents wanted to put oil money into the economy (37.5% in 2006 and 45.3% in 2010) from the total of respondents’ answers for the region). The populations of Kustanai region (40.6% from the total of respondents’ answers for the region) as well as Eastern Kazakhstan (30% in 2006 and 45.7% in 2010 from the total respondents’ answers for the region) had the same opinion as respondents in the Akmolinskaya region. With regard to health care, the population of Almatinskaya, Kostanai and Karagandinskaya, SKO, and Astana regions (53.5%, 60.4%, 59.6%, 68.2%, 62.5% of the total respondents’ answers for the region) strongly supported this option. The respondents from the Mangistau region in particular wanted to distribute oil money among the population (57.5%; 37.5% in 2010 from the total respondents’ answers of the region). The respondents from the agricultural regions of Kustaniskaya and Almatiskaya (45.8% and 45.6%) Kyzyl-Orda and Southern Kazakhstan strongly supported the investment of oil money into agriculture, with 25%, 19.4%, 44.1% 23.3% in 2010 of respondents, respectively, favouring this.

The investment in “welfare social sector” was supported in Karagandinskaya, Astana and Almatiskaya and SKO (53.7%, 54.2%, 48.2% and 47% respectively). This should perhaps not be surprising since two-thirds of respondents are not satisfied with the provision of unemployment benefits. Similarly, 70% are not satisfied with the functioning of the health sector.

“Unfinished higher education” as well as “higher education” groups of respondents would like to invest the assets from the NFRK into the social sector (50% and 41.9%, respectively). Based on very small numbers some 60% of respondents with “primary education” only would like to invest the NFRK’s money in the social sector. With respects to health care, there is in general a high consensus with regards to investing in this sector (all are above 50%). The “postgraduates” group is most supportive of investing the assets of the NFRK into the “oil and gas sector” (14.3%). The investment into agriculture is relatively uniformly supported across the educational groups (approximately a quarter).

## **2.6 Accounting and auditing**

In terms of adaptation of best practices in accounting and auditing, the NFRK reports quarterly to the press on the total amounts of assets, inflows received, expenditures, and interest earned by the funds. The fund has its own web site. These visible attributes of transparency are the main arguments used by the management of the fund in the debates about transparency.

Since its inception, external audits of the NFRK have been conducted (by Ernst &Young), and the most recent one is currently underway. Although the NFRK has a website, it only gives information on the total National Fund assets, broken down by portfolio. Commentators have criticized this point and claim that it demonstrates a lack of transparency.

An annual audit of the fund is prima facie evidence of transparency, but

it is only the tip of the iceberg as regards high standards of governance. It is encouraging that in Kazakhstan increasing emphasis is being laid at present on the transparency and efficiency of investment processes in the fund. Close attention should be paid to compliance with the rules under which the fund was set up and to diversification of investment projects within the areas of fund operations.

## **2.7 Appointment of officials and managers**

Analysis of the NFRK highlights some structural weaknesses. The fund has been characterised as representative and participatory. The rule is that the President approves all the members of the board and all of them are government officials. This strong control by the executive branch has enabled uses of the fund that are contrary to its purposes. The official explanation for this is that the maturity of the society is quite rudimentary and by allowing other people (for example the parliament) to decide the strategy for using the oil fund, control over the oil wealth could be lost. If transparency of the oil fund is to be established in a credible manner, the structure of the fund management needs to become more representative and less dominated by the government. Only through such a structure can the high level of political influence be overcome.

By 2003 Kazakhstan saved 63% of its oil-windfall in the NFRK, which by all standards demonstrates a remarkably prudent fiscal stance and gives rise to hope for cautious optimism for the future. However, with the onset of the global crisis, circumstances changed dramatically, and with them the operations of the NFRK.

## **2.8 NFRK and recent financial crisis**

The importance of the NFRK for the Kazakhstani economy has been raised considerably since the recent global financial crisis hit the country. "The financial crisis has served as a 'stress test' on the sturdiness of fiscal instruments in the face of economic shocks, and their relevance to economic diversification in resource dependent economies" (Heuty and Aristi, 2009). By 2008 NFRK became one of the world's largest sovereign wealth funds alongside the oil-producing countries of the Middle East and Russia (see Table 1). Initially when the crisis started, the Kazakhstani government was reluctant to use the assets of the NFRK, but since the crisis was becoming deeper and deeper the government of Kazakhstan "opened" the NFRK and took the \$10 bln (9.5% per cent of GDP) which was used for stabilization of the financial system, support of the housing programme, SMEs and industrial innovation development (anti-crisis plan) (see Table 2). Thus, already by the end of the first quarter of 2009 the assets of the NFRK decreased by 20% and were around \$ 22 bln. Unfortunately for Kazakhstan the banking system was fairly open to global financial markets with weak regulation. The anti-crisis plan was combined with the efforts of the government, National Bank of Kazakhstan and Financial Security Authority, with Samruk-Kazyna acting as the main body for crisis relief. Overall, the NFRK has distributed US\$10 bln, of which US\$9 bln were provided to Samruk-Kazyna in the form of debt (US\$ 5

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bln) and a capital injection (US\$ 4 bln). KazAgro National Holding received the remaining US\$ 1 bln for the support of the agricultural sector. It is likely that the Kazakhstani government could be exposed to some contingent liabilities from the anti-crisis programme through Samruk-Kazyna (IMF, 2009: 8).

The NFRK incurred losses on its investments in the economic and financial downturn, with the equity portfolio among those hit. There are no data available on the NFRK yet, but by the author's estimations, the equity portfolio held by NFRK may have lost approximately US\$1 mln since 2008, reducing the overall portfolio by around 0.64%. There are clearly a number of factors posing potential risk to the growth of the NFRK in the near future, namely: commodity price fluctuations, changes to global capital flows along with potential protectionism in the NFRK recipient countries, and exchange rate movements. It is interesting to note that Kazakhstan has leveraged more funds to its NFRK than its foreign currency exchange reserves, which reflects more an aggressive policy to receive higher returns. By the end of 2009, total assets were around \$26.2 bln. What are the growth prospects for the NFRK? Based on the data from the Ministry of Economy in 2009-2012 the receipts to the NFRK are expected to be \$9.3 bln; \$10.7 bln; \$11.2 bln, respectively, which reveals that the NFRK will be still an important player in the years ahead both domestically and in the international financial market.

The financial crisis has shifted the emphasis in the policy of the NFRK (whether the management of the fund likes it or not) from issues of performance at the firm level to the portfolio strategy and the investment horizon of NFRK. In the short term, the impact has been to reconsider the investment strategy, which will remain an external one rather than being oriented towards more domestic involvement (as was initially thought by some analysts and observers). Over time the external insurance role will doubtless need to be rebuilt also, to guard against the impact of future shocks. It is understandable that the consequence of the crisis is (and will be for the next several years) a more active involvement of the Kazakhstani government in the governance of the NFRK, which might be reflected in a more sensitive attitude to the social needs of the Kazakhstani citizens. In other words, the government could be in the position to accept investments not with higher social returns, but low private ones (investments in the industries with lower economic performance). Overall, at the present time the investment policy of the NFRK is based on Rules on Investment Operations of the NFRK (Ruling of National Bank of the Republic of Kazakhstan, N65, 26 July 2006); however, it was indicated by one of the National Bank senior officials that it is more likely that the NFRK investment strategy will be more closely focusing on the Asian market (including Australia).

**Table 1. The world's largest SWF**

<b>Sovereign Wealth Fund</b>	<b>Country</b>	<b>Assets in USD bn</b>	<b>Accepted Santiago Principles</b>
<b>Oil-Exporters</b>		<b>1240-2220</b>	
Abu Dhabi Investment Authority	UAE (Abu Dhabi)	400-800	Yes
Government Pension Fund-Global	Norway	373	Yes (observer)
SAMA	Saudi Arabia	300	Yes (observer)
Kuwait Investment Authority	Kuwait	213	Yes
Investment Corporation of Dubai	UAE (Dubai)	20-80	Yes
Qatar Investment Authority	Qatar	20-60	Yes
Libya Investment Authority	Libya	20-60	No
Brunei Investment Agency	Brunei	10-50	No
Future Generations Fund	Russia	~24	Yes
Government Pension Fund-Norway	Norway	~20	Yes
National Fund	Kazakhstan	~22	No
Khazanah Nasional Berhad	Malaysia	~18	No
<b>East Asia</b>		<b>~585</b>	
China Investment Corporation	China	~200	Yes
Government Investment Company	Singapore	~130	Yes
Exchange Fund Investment Portfolio	Hong Kong	~112	No
Temasek Holdings	Singapore	~108	Yes
Korea Investment Corporation	Korea	~20	No
National Stabilisation Fund	Taiwan	~15	No
<b>Others</b>		<b>~138</b>	
Government Future Fund	Australia	~49	Yes
Alaska Permanent Fund	US	~38	No
Permanent University Fund	US	~20	No
New Mexico State Investment	US	~16	No

Alberta Heritage Savings Trust Fund	Canada	~15	Yes
<b>Total</b>		<b>1963-2943</b>	

*Source: The classification is taken from R. Beck and M. Fidora, "The Impact of Sovereign Wealth Funds on Global Financial Markets", Review of European Economic Policy (2008).*

"The banking crises in Kazakhstan, Kuwait, Qatar, Nigeria and Russia raise questions about the effectiveness of stabilization mechanisms in resource rich countries, and calls for a fresh look at domestic investment to finance economic diversification and development strategy of resource rich countries" (Heuty and Aristi, 2009:23). Did the NFRK fulfill its purpose in the 2007-2009 crisis? Today we could say that the NFRK worked for Kazakhstan, despite the fact that institutional quality was not as high. This reflected in part the strong leadership of the president of the country in favor of prudent policies and the limited involvement of the public. Another factor which made the use of the NFRK a relative success is that Kazakhstan is an upper-middle-income economy; this level of development helped the country to overcome the crisis in a relatively short period of time, although at the same time the loose monetary policy led to a financial bubble which exaggerated the consequences of the crisis and ultimately the country needed the massive injection into economy to rescue the financial sector. In broad terms, one can say that transfers to the fund did help mitigate the pressure on resources in Kazakhstan's economy during the upswing, and left it better prepared for the external shock that finally came. Moreover, it was crucially important that the bulk of the fund's assets were invested externally in liquid assets, and that it thus was able to serve as a risk buffer and as a form of "collateral" for the economy during the crisis. In this regard, the favorable impact of the fund far exceeded the actual drawings made to support the economy.

From the 2010 CEAS Survey we found that 70% of respondents support the fact that the money from the NFRK was used during the recent crisis, only 4% of respondents thought that it was a bad idea, and 25% were undecided.

With regards to the educational level, respondents with a low level of education were generally more in favor of the Kazakhstani government spending money from the NFRK during the 2007-2009 crisis period (70-75%); whereas the respondents with a higher level of education were less supportive of this (60-65%).

Across the regions, respondents in Kostanaiskaya region were very supportive of the governmental decision of spending funds from the NFRK; a high level of support was also registered in the SKO, Aktubinskaya and Pavlodarskaya regions (92.4%, 74.5% and 75%, respectively). The least support for this policy was found in the Almatyinskaya, Akmolinskaya and Mangistau regions (52%-58%).

**Table 2.**  
**Summary of the Anti-Crisis Plan in the Republic of Kazakhstan**

	Amount (US\$, bln)		Comment
	Allocated	Disbursed	
<b>Support to:</b>			
Financial sector	4.0	4.0	Capital and deposits provided.
Mortgage loan refinancing	1.0	1.0	Provided to banks to refinance existing mortgages.
Construction sector	2.0	0.0	To finish uncompleted housing projects.
Agriculture	1.0	0.0	Provided to KazAgro.
SMEs	1.0	1.0	Provided to banks for onlending.
Infrastructure/Industry	1.0	0.0	
<b>TOTAL:</b>	<b>10.0</b>	<b>6.0</b>	
<b>Financing from:</b>			
NBRK	10.0	10.0	US\$9 bln. Already transferred to Samruk-Kazyna and US\$1 bln. to KazAgro.
<b>Memo items:</b>			
Distressed Asset Fund	1.0	0.6	Capital provided from budget.
Tax cuts	4.0	...	Implemented Jan 1, 2009.
Lower reserve requirements	3.0	...	

*Source: Kazakhstani authorities and the IMF, 2009.*

Overall, the 2010 Survey highlighted that the Kazakhstani population felt that the impact of the crisis was relatively limited as for the economy as a whole and their personal lives (58%-59%). This could be explained by the “cushion” which the NFRK provided to the Kazakhstani economy during 2007-2009 crisis. An interesting implication of the success of the use of the NFRK by the Kazakhstani authorities has been expressed in the strong opinion of support by the respondents across the regions for the greater governmental (state) prominent role in the economic life of Kazakhstan (the actual question was *Taking into account the recent financial crisis, do you consider that the Kazakhstani economy requires stronger government control?*) Almost 90% of respondents supported greater government control in banking, oil & gas, manufacturing and education.

There are some doubts in the country about the complete effectiveness of using US\$ 10bln; mainly that not all the money is still “implemented” to the economy. There is certain criticism that the NFRK was “forced” to buy securities

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in the Kazakh Tenge denomination (5 bln KZ Tenge) issued by Samryk-Kazyna and KazAgro, and by this the NFRK has now two parts (a KZ Tenge part and a hard currency part), although the Tenge part is not large compared with the currency part. So, at the end of 2009, according to the NFRK Annual Report, the total market value of the NFRK portfolio was US\$26 bln, including currency portfolio US\$24 bln and securities portfolio Samryk Kazyna and Kazagro US\$1.8 bln.

### **3. Policy recommendations**

#### **3.1 Future challenges for the NFRK**

The NFRK is new and therefore it is necessary to keep this fact in mind in order to judge its performance, success and failures. The establishment of the sovereign wealth fund is itself a major change in fiscal practice, as the NFRK was required to accumulate funds for five years without spending from it. The recent market context of high oil prices provided some test as to whether the existence of the funds will result in greater fiscal restraint.

In parallel with this public sector restraint, however, the economy experienced a massive private sector boom, fuelled by capital inflows through the banking system, and much of this activity centred on the real estate sector. By 2007 commercial bank foreign borrowing reached around 70% of total funding in some cases and at the same time the loan/deposit ratios at some banks we accounted at 400%. The private sector is significantly much more externally exposed than the Kazakhstani economy. By 2007 net foreign assets of commercial banks were around 35% of Kazakhstani GDP. In addition, Kazakhstan has accumulated reserves abroad, which made the country attractive to foreign lenders. As a consequence the banking sector became particularly vulnerable to the liquidity crisis started in the US and Europe.

“The oil wealth accumulated in the oil funds was central to the authorities’ response to the 2008-09 global financial crisis” (Goldsworthy and Zakharova, 2010:3). In order to preserve its banking sector and boost the economy the Kazakhstani government did not have a choice but to use US\$10 bln from NBRK to support the economy and recapitalize the banking system, to shore up the domestic equity market, and to push credit to small and medium enterprises. Overall, Kazakhstan was able to mobilize resources created during the period of raising oil prices to find the options to respond to the crisis and to finance the significant fiscal stimulus in 2009 in order to support domestic demand. There is no doubt that Kazakhstan made the right decision to use the NFRK’s money to save the banking system. It is clear that the Kazakhstani economy would have suffered a much more serious “meltdown” without the oil fund, and that it would also have recovered much more slowly after the crisis.

The challenge ahead for the Kazakhstani economy is clear: to ensure that the economic progress initiated by the seed capital of hydrocarbon development prior to the 2007-2009 financial crisis proves stable and sustained. The experience to date of resource-rich countries in operating oil funds demonstrates empirically that these are no panacea for the “paradox of plenty,” but the Kazakhstani

government which prudently built up the large SWF disbursed its funds under the anti-crisis plan. The path of oil prices over time does not encourage a view that funds can be designed to achieve an optimal smoothing of income or assurance of inter-temporal equity.

The government of Kazakhstan discussed the need to have a long-term vision and determination in pursuing their policies of management of the oil revenues, which should contribute to the sustainable development. Among these goals, greater confidence in the transparent management of the NFRK, and greater public understanding of its objectives and operations, are essential in order to safeguard the sustainability and efficiency of the future for the NFRK.

So, already in March 2010, Kazakhstan decided to restrict the amount state-owned companies can borrow from the NFRK by imposing caps. According to Economic Development and Trade Minister Zhanar Aitzhanova, annual spending on servicing government debt must not exceed the NFRK's "annual conditional set investment income" of 4.5%. The amount of money in the NFRK which cannot be used must be equal to at least 20% of planned GDP. The government is confident that these measures will help the NFRK to grow to US\$90 bln by 2020, equal to about 30% of GDP (Bloomberg.com; 16 March 2010).

A long period of time is needed to determine the real impact of the fund. One important lesson is that its emphasis on liquid external savings helped moderate the domestic boom and also allowed a credible insurance or collateral role during the crisis. A second is that there was then scope – at least for a period – to use resources in the fund to help repair the damage to the domestic economy. Time will tell how efficient these latter involvements will have been, and also how easy it is to restore the former insurance role by building up liquid foreign assets in the future.

But under all options for its investment strategy, the case made in this paper is the core importance in Kazakhstan of continuing to enhance governance and transparency of the sovereign wealth fund in order to maximize the chances of success. Inevitably this limits government discretion in disposing of the mineral wealth of the nation. It is, however, essential to build public support for the funds, and to leverage their economic impact through a strong influence on market expectations.

By establishing periodic auditing and analysis of the management performance, it is possible to ensure the sustainability and efficiency of the management revenue. The fund's assets should be placed abroad (to provide protection from the populist ideas to help the local economy with investments from the fund) and greater diversification of the assets portfolio is required (as it was demonstrated in case of the NFRK). To date it is difficult to confirm whether the NFRK has gained public support. The public is hardly aware that such funds exist.

An important issue related to the future development of the NFRK (its sustainable growth) is the fiscal regime that would be designed in order to secure the government's maximum hydrocarbon revenue and at the same time to provide an optimal regime for the investors to undertake the hydrocarbon activities. The key point here is provision by the government of an adequate return associated with the risk to the investors. "The country experiences of Azerbaijan and Kazakhstan suggest that aggregate fiscal discipline is essential for the effective

management of oil revenues” (Usui, 2007:11).

In 2009 Kazakhstan introduced the New Tax Code, according to which the rent tax on crude oil and gas condensate exports (between 7% and 32%) is to be paid by all physical persons and legal entities that export crude oil and gas condensate. Exempt were companies that enjoy a stable tax regime under PSAs signed with the government of Kazakhstan before January 1, 2009. However, in January 2010 statements made by Kazakhstan President Nursultan Nazarbayev and Minister of Energy and Mineral Resources Sauat Mynbayev suggest that Kazakhstan will take steps to implement new laws regarding the taxes and duties that IOCs will be obliged to pay, canceling the original agreements (PSAs) that were negotiated in the 1990s. According to the PSAs, the international oil companies (IOCs) were for the most part allowed to develop and export hydrocarbons under exemption from normal customs procedures.

President Nazarbayev said at a government meeting on 22 January 2010 that foreign companies currently enjoying a special status could lose this protective immunity if adjustments are made to the country's tax laws. “We have to...depart from this arrangement of immunity so that everyone works in line with the same legislative changes that will happen in the future,” he said, according to the *SR/* news agency. “All the contracts currently operate in accordance with the legislation that was in place at the time of their signing... Times are changing and life is changing the entire world, and state interests are pushing us in this direction. We have to work more thoroughly and constructively.” Energy Minister Mynbayev told the Kazakhstani parliament on 26 January that following the president's order would not be a simple matter: “Abandoning tax exemptions is a big question. We will separately discuss...how we will implement it through concrete steps, taking into account the order.” (Middle East Economic Survey, <http://www.mees.com/cms/category/oil-gas/>) This new step by the Kazakhstani government is considered as another attempt to draw larger financial benefit and consolidate more influence over the hydrocarbon sector of the country, and now there are doubts that in the future this step will have its implications on the assets of the NFRK.

In 2010 the Kazakhstani government presented a draft of a “New Concept of Forming and Using Assets of the NFRK” according to which the stabilisation function of the fund will be implemented through the guarantee transfer to the Republican Budget, which will be fixed on a level of US\$8 bln instead of the previous rule of 1/3 of the assets of the NFRK. The rest of the assets which should be not less than 20% of the GDP forecasted are defined for the implementation of the savings function. The Kazakhstani government realised that the management of the NFRK is playing a key role in the sustainable development of the country and is one of the most important factors in the governmental economic policy. Therefore the New Concept contains the following restrictions with regards to using the assets of the NFRK: annual expenditures for serving the state debt on average during the decade should not be more than 15% of the income to the budget, including the transfer from the NFRK. Loans to the quasi-state sector from the NFRK and other additional transfers are prohibited.

## 3.2 Recommendations

What should be the core of the long-term strategy for the Kazakhstani government based on the lessons of the 2007-2009 financial crisis? First of all, it is crucial that in the future the government be determined to achieve the non-resource fiscal balance with the robust programme of diversification.

Secondly, it would be beneficial if the Kazakhstani government could establish a system of particular indicators for the non-resource deficit in order to monitor as well as to reduce resource dependency. "Tracking the non-resource balance allows for a solid sense of the available development financing, which should also help calibrate the medium and long-term fiscal framework. This approach assumes that governments have the capacity to determine and adjust long term commodity prices independent from political pressures" (Heuty and Aristi, 2009).

Thirdly, the fact that domestic investment for economic diversification provides more stability and economic resilience should be taken into account when the Kazakhstani government is designing an investment portfolio strategy of the NFRK for the near future. This policy will require a medium term fiscal framework that step by step increases the share of resource revenues used for public investment until investment represents 100 percent of resource revenue spending.

Fourth, although Kazakhstan did not accept the Santiago Principles, a transparent and accountable governance structure of the NFRK is required for the future success of the policies conducted by the fund. An effective strategy will also require that fiscal instruments are integrated into the budget process in order to provide a guarantee in terms of long-term development strategy of the country as well as optimal management of hydrocarbon windfalls. This strategy also requires close coordination with future monetary policies in order to avoid the creation of asset bubbles like those Kazakhstan experienced in the recent past. Kazakhstan and the NFRK need to reconsider their perception to GAPP and if not accept them, at least get a more pragmatic basis for the investment strategy of the NFRK in the short term.

In light of the recent crisis it is unlikely that Kazakhstan will soon join the Santiago Principles; however, it is crucial that the Kazakhstani government and society would be able to recognise the importance of transparency towards international markets rather than domestic accountability to citizens as well as a straightforward framework without room for different interpretations. It should be a normal practice that the NFRK is systematically monitored against good practice and international benchmarks to make sure that the Kazakhstani citizens benefit from their hydrocarbon sector in the optimal way.

It would be desirable that the international working group of sovereign wealth funds (IWG) make contact with the NFRK and establish a dialogue on the Santiago principles and the NFRK's involvement in this process.

Fifth, it is clear that hydrocarbon wealth is going to play a vital role in ensuring economic stability and sustainability of public finance of Kazakhstan. This make Kazakhstan focused on reducing raw materials dependency in order to mitigate Dutch disease, while financing crucial public sector reforms. Well-managed oil wealth would be central in financing these reforms, and at the same time it would

be important not to misuse the NFRK in strategically-oriented investment rather than commercial investment.

Sixth, in its investment strategy the NFRK has to arrive over time at a diversification in its asset allocation which would correspond to the longer-run needs and welfare of Kazakhstani citizens. This will mean carefully reviewing how efficient its recent domestic resource allocation has been, following the crisis, and learning lessons where needed. But it will also mean considering how far and how fast the fund can rebuild its role as an external buffer for the economy, as well as an institution that dampens domestic pressures when energy prices are rising sharply. Both of these latter goals would seem to imply a return, over time, to a role where increases in the fund's resources are quite strongly allocated to external liquid assets.

Finally, at the present time Kazakhstan already has a history in designing an effective framework for managing its hydrocarbon wealth; however, the improvement in the petroleum taxation regime would be required as an additional instrument in managing of the oil and gas revenues; namely neutrality, capture of rent, stability and timing of revenue, progressivity and adaptability, administrative simplicity and enforceability as well as international competitiveness (based on Goldsworthy and Zakharova, 2010). The Kazakhstani government needs to reassess its risk preferences and its willingness to share them with the investors in the oil and gas sector after recent crisis.

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## Appendices

### *Appendix 1. New Rules of NFRK*

From July 2006 changes took place in the NFRK's rules. New mid term strategy with formalised method of the balanced budget is outlined below:

$$E = G_{NO} + G_o + D, \text{ where} \quad (1.1)$$

E - national budget expenditures

$G_{NO}$  - non-oil sector revenue

$G_o$  - guaranteed transfer from the fund estimated based on the average volume of expenditures for budgetary development programmes for a certain period

D - net public borrowings, for which the annual average value limit for a 5 year period is set the level of 1% of GDP for a respective year.

$$G_o = A + bNFRK_{t-1}e \quad (1.2)$$

A - const approved by the law and set in Tenge

b - coefficient equal to the average level of investment income for a certain period

$NFRK_{t-1}$  - assets of the NFRK as of the beginning of a financial year

e - Tenge rate to the reference currency of the fund

So, as you could see from equation (1.2) the main concern is constant A, which is set up by the parliament. Although "by selecting various parameters for the rule" there is a hope that the selection will be driven by "how much of the volatility in prices and quantities will be transferred to the economy via the fiscal framework" (World Bank, 2005:35), the main concern is remained: how independently and based on the economic sense rather than on a political one this process could be.

## Appendix 2. Generally Accepted Principles and Practices (GAPP)— Santiago Principles

Principle	General Description
GAPP 1	The legal framework for the SWF should be sound and support its effective operation and the achievement of its stated objective(s).
GAPP 1.1. Sub- principle	The legal framework for the SWF should ensure the legal soundness of the SWF and its transactions.
GAPP 1.2. Sup-principle	The key features of the SWF's legal basis and structure, as well as the legal relationship between the SWF and the other state bodies, should be publicly disclosed.
GAPP 2	The policy purpose of the SWF should be clearly defined and publicly disclosed.
GAPP 3	Where the SWF's activities have significant direct domestic macroeconomic implications, those activities should be closely coordinated with the domestic fiscal and monetary authorities, so as to ensure consistency with the overall macroeconomic policies.
GAPP 4	There should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF's general approach to funding, withdrawal, and spending operations.
GAPP 4.1. Sub- principle	The source of SWF funding should be publicly disclosed.
GAPP 4.2. Sub- principle	The general approach to withdrawals from the SWF and spending on behalf of the government should be publicly disclosed.
GAPP 5	The relevant statistical data pertaining to the SWF should be reported on a timely basis to the owner, or as otherwise required, for inclusion where appropriate in macroeconomic data sets.
GAPP 6	The governance framework for the SWF should be sound and establish a clear and effective division of roles and responsibilities in order to facilitate accountability and operational independence in the management of the SWF to pursue its objectives.
GAPP 7	The owner should set the objectives of the SWF, appoint the members of its governing body(ies) in accordance with clearly defined procedures, and exercise oversight over the SWF's operations.
GAPP 8	The governing body(ies) should act in the best interests of the SWF, and have a clear mandate and adequate authority and competency to carry out its functions.
GAPP 9	The operational management of the SWF should implement the SWF's strategies in an independent manner and in accordance with clearly defined responsibilities.

GAPP 10	The accountability framework for the SWF's operations should be clearly defined in the relevant legislation, charter, other constitutive documents, or management agreement.
GAPP 11	An annual report and accompanying financial statements on the SWF's operations and performance should be prepared in a timely fashion and in accordance with recognized international or national accounting standards in a consistent manner.
GAPP 12	The SWF's operations and financial statements should be audited annually in accordance with recognized international or national auditing standards in a consistent manner.
GAPP 13	Professional and ethical standards should be clearly defined and made known to the members of the SWF's governing body(ies), management, and staff.
GAPP 14	Dealing with third parties for the purpose of the SWF's operational management should be based on economic and financial grounds, and follow clear rules and procedures.
GAPP 15	SWF operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate.
GAPP 16	The governance framework and objectives, as well as the manner in which the SWF's management is operationally independent from the owner, should be publicly disclosed.
GAPP 17	Relevant financial information regarding the SWF should be publicly disclosed to demonstrate its economic and financial orientation, so as to contribute to stability in international financial markets and enhance trust in recipient countries.
GAPP 18	The SWF's investment policy should be clear and consistent with its defined objectives, risk tolerance, and investment strategy, as set by the owner or the governing body(ies), and be based on sound portfolio management principles.
GAPP 18.1. Sub- principle	The investment policy should guide the SWF's financial risk exposures and the possible use of leverage.
GAPP 18.2. Sub- principle	The investment policy should address the extent to which internal and/or external investment managers are used, the range of their activities and authority, and the process by which they are selected and their performance monitored.
GAPP 18.3. Sub- principle	A description of the investment policy of the SWF should be publicly disclosed.

GAPP 19	The SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds.
GAPP 19.1. Sub- principle	If investment decisions are subject to other than economic and financial considerations, these should be clearly set out in the investment policy and be publicly disclosed.
GAPP 19.2. Sub- principle	The management of an SWF's assets should be consistent with what is generally accepted as sound asset management principles.
GAPP 20	The SWF should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities.
GAPP 21	SWFs view shareholder ownership rights as a fundamental element of their equity investments' value. If an SWF chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protects the financial value of its investments. The SWF should publicly disclose its general approach to voting securities of listed entities, including the key factors guiding its exercise of ownership rights.
GAPP 22	The SWF should have a framework that identifies, assesses, and manages the risks of its operations.
GAPP 22.1. Sub- principle	The risk management framework should include reliable information and timely reporting systems, which should enable the adequate monitoring and management of relevant risks within acceptable parameters and levels, control and incentive mechanisms, codes of conduct, business continuity planning, and an independent audit function.
GAPP 22.2. Sub- principle	The general approach to the SWF's risk management framework should be publicly disclosed.
GAPP 23	The assets and investment performance (absolute and relative to benchmarks, if any) of the SWF should be measured and reported to the owner according to clearly defined principles or standards.
GAPP 24	A process of regular review of the implementation of the GAPP should be engaged in by or on behalf of the SWF.

Source: IWG (2008) *Sovereign Wealth Funds. Generally Accepted Principles and Practices. "Santiago Principles"*. <http://www.iwg-swf.org/pubs/eng/santiago-principles.pdf>

## Russian Sovereign Wealth Funds

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Russia has a relatively long but rather peculiar history of sovereign funds development. Having started in 2004 with one fund - the Stabilization Fund of the Russian Federation - the country had two fairly large funds, including the National Welfare Fund, in 2008 on the verge of the crisis. However, at the end of the crisis in the medium term, both funds may cease functioning, having met only a part of their objectives.

### Short History, Mission and Type

Creation of the first Russian sovereign fund, the Stabilization Fund of the Russian Federation, was related to the idea of institutionalizing federal budget surplus generated in the form of balances on the budget accounts with the Central Bank of Russia since 2000. Understanding the situational nature of budget revenues in the background of rising oil prices in the world market, and wishing to avoid a proportional growth of the budget expenditure commitments, the RF government in 2003 proposed establishment of the Stabilization Fund, which would be formed from the excessive revenues from oil production and exports (as compared with the estimated long-term oil price, cut-off price or baseline price).

Federal Law «On Amendments to the Budget Code of the Russian Federation regarding the establishment of the Stabilization Fund of the Russian Federation» No. 184-FZ, on the basis of which the Stabilization Fund of the Russian Federation was created in 2004, was adopted December 23, 2003.

The purpose of the Stabilization Fund of Russia was to ensure the federal budget balance during a decrease in oil prices below the baseline. According to the RF Ministry of Finance, “the Fund contributes to stability and economic development; it is one of the main instruments of binding the excessive liquidity, which is reducing inflationary pressures and the dependence of national economy from adverse fluctuations of revenue from commodity exports.” Thus, at the initial stage of establishment, the Fund is a classic version of the commodity fund, designed to suppress fluctuations of the market revenue of the federal government. The Fund assets could be used to cover the federal budget deficit only in the case of oil prices dropping below the baseline. However, if the accumulated amount of the Fund exceeded 500 billion rubles, the excess could be used for other purposes.

From January 1, 2004 the base price was set at \$20 per barrel for Urals, and on January 1, 2006, the cut-off price was raised to \$27. Despite continued growth in oil prices, there was no further increase in the «cut-off price» because of the risk of rising inflation and increasing budget dependence on the external

economic situation.

Since in 2005 the Fund exceeded the level of 500 billion rubles (RUR 1,387.8 bln), a part of the assets was addressed to other purposes, namely for the payment of external debt of the Russian Federation (RUR 643.1 bln) and replenishment of the deficit of the Pension Fund of the Russian Federation (30 billion rubles, see Table 1).

**Table 1. RF Stabilization Fund Assets: Dynamics in 2004-2007 (RUR bln)**

Year	Proceeds				Utilization			Balance as of the end of the year
	Total	Export duty	Royalty (oil)	Balances of Federal Budget	External debt recovery	Development Institutions financing	RF Pension Fund deficit replenishment	
2004	522.3	240.8	175.5	106.0	–	–	–	522.3
2005	1387.8	663.4	507.3	217.1	643.1	–	30.0	1237.0
2006	1708.6	991.2	646.7	47.8	604.7	–	–	2346.9
2007	1895.9	918.9	674.7	156.7	33.7	300.0	–	3849.1
Total	5514.6	2814.8	2004.1	527.6	1281.5	300.0	30.0	

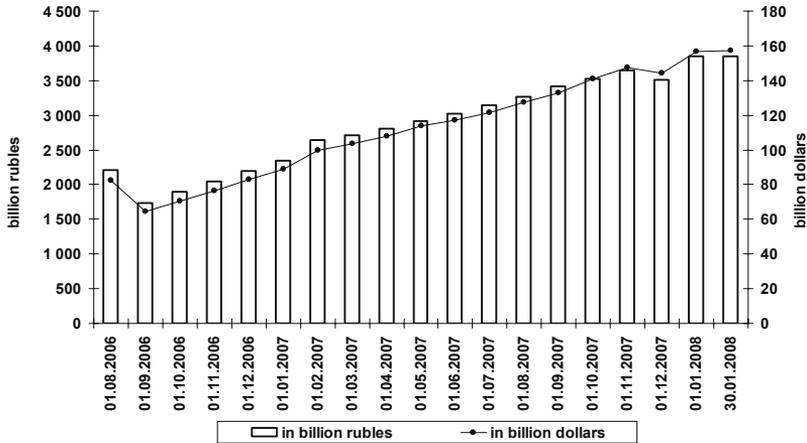
*Source: RF Federal Treasury*

In 2005, at the expense of the Stabilization Fund, repayment of external debt of Russia was made in the amount of 643.1 bln, including:

- 93.5 billion rubles (equivalent to USD 3.3 billion) - the debt to the International Monetary Fund;
- 430.1 billion rubles (equivalent to USD 15 billion) - the debt to the member countries of the Paris Club;
- 123.8 billion rubles (equivalent to USD 4.3 billion) - the debt to Vnesheconombank under credit granted by the Ministry of Finance of the Russian Federation in 1998-1999 for the repayment and servicing of external government debt of the Russian Federation.

In 2006, 604.7 billion rubles and in 2007, 33.7 billion rubles were spent for external debt redemption. In 2005, 30.0 billion rubles (equivalent to 1.04 billion U.S. dollars) were allocated to cover the deficit of the RF Pension Fund, and in 2007 – 300.0 billion rubles to finance development institutions (Rusnano - 30 billion rubles, VEB - 180 billion rubles, Investment Fund - 90 billion rubles).

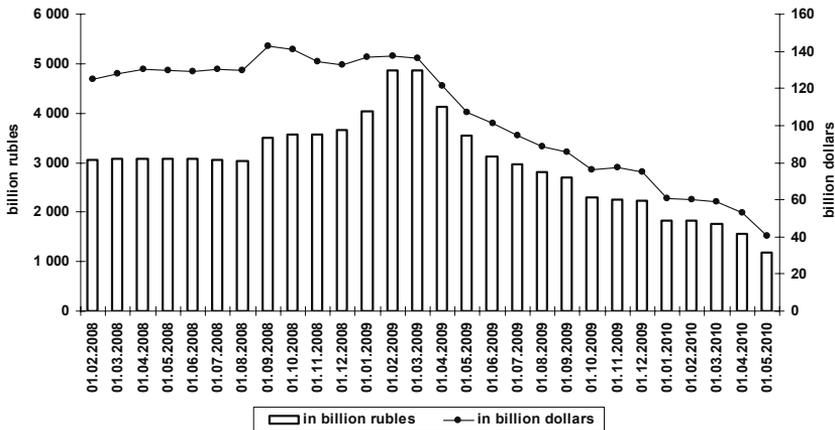
By the time the Fund split in 2008, the assets' total volume was 3,851.8 billion rubles (157.38 billion U.S. dollars), reaching approximately 11.6% of annual GDP of Russia (*Fig. 1*).

**Figure 1. The total volume of the RF Stabilization Fund**

Source: RF Ministry of Finance

Starting in February 1, 2008 the Stabilization Fund of Russia was divided into two parts: the Reserve Fund (with an initial volume of RUR 3069.0 bln) and the National Welfare Fund (initially RUR 782.8 billion), hereinafter referred to as FNB.

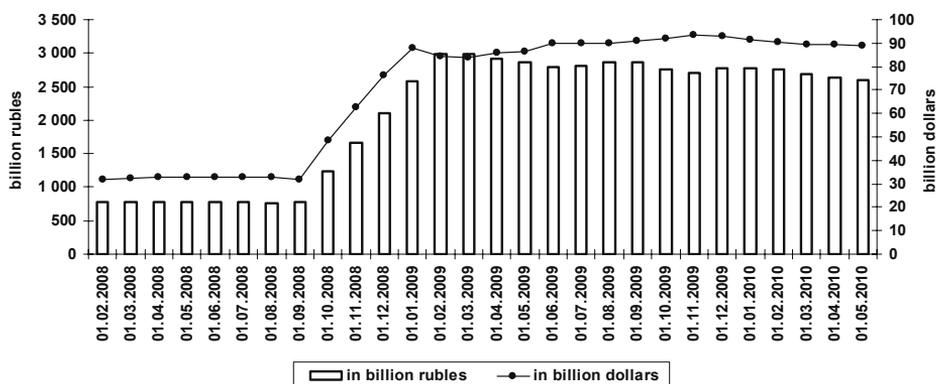
The Reserve Fund, like the earlier Stabilization Fund, is a part of the federal budget. The Fund is intended to assist the government to uphold budget spending commitments in the event of low oil and gas revenues. The normative value of the Reserve Fund is established at a level equal to 10% of GDP. In contrast to the Stabilization Fund of the Russian Federation, in addition to federal budget revenues from oil production and export, the sources forming the Reserve Fund also include federal budget revenues from gas production and gas export.

**Figure 2. Reserve Fund Total Assets Volume**

Source: RF Ministry of Finance

The National Welfare Fund is a part of the federal budget subject to separate accounting and management to ensure co-financing of voluntary retirement savings of the Russian citizens, as well as to cover the deficit of the Pension Fund budget.

**Figure 3. National Welfare Fund Total Assets Volume**



*Source: RF Ministry of Finance*

The Reserve Fund actually became a functional successor of the Stabilization Fund as a part of the federal budget with separate accounting and management for the purpose of oil and gas transfers in the event of insufficient oil and gas revenues for the financial support of this transfer. The reserve fund is financed by excess oil revenues of the federal budget in the scope authorized for the financial year in the amount of oil and gas transfers, provided that the accumulated amount of the Reserve Fund does not exceed its established value, as well as from revenues derived from the management of the Reserve Fund. In other words, it is a classic commodity fund.

In turn, the FNB is close to the sovereign funds or future generations funds in nature, and is accumulated from oil and gas revenues of the federal budget exceeding the amount of oil and gas transfers approved for the financial year, in the case that the accumulated amount of the Reserve Fund reaches (exceeds) its established value, as well as revenues derived from FNB management.

As of June 1, 2010 the Reserve Fund of Russia has been reduced to RUR 1,197.66 billion (USD 39.27 billion). The volume of the National Welfare Fund is RUR 2,616.54 billion (USD 85.8 billion).

### **Legal basis, accountability and reporting**

As mentioned above, in 2003 the Federal Law "On Amendments to the Budget Code of the Russian Federation regarding the establishment of the Stabilization Fund of the Russian Federation" of 23.12.2003 No. 184-FZ was adopted, on the basis of which in 2004 the Stabilization Fund of the Russian Federation was established. The law has introduced Chapter 13.1 in the Budget Code, which

stipulated fundamentals of the Stabilization Fund and its management procedure.

According to the law, the Stabilization Fund is a part of the federal budget assets, formed from the excess of oil prices over the baseline price, subject to separate accounting, management and use in order to balance the federal budget in case of a decrease in oil prices below the baseline.

The sources of the initial formation of the Stabilization Fund were:

- federal budget surplus revenues, which are assessed as an excess oil prices over the baseline price;
- balances of the federal budget assets at the beginning of the relevant fiscal year, including the proceeds from the Stabilization Fund assets allocation.

Additional federal budget revenues to be credited to the Stabilization Fund in the current month were assessed as the sum of:

- actual revenue to the federal budget from the export customs duty on crude oil obtained in the current month, multiplied by the ratio of the difference between the rate of export duty on crude oil effective in the current month and the estimated rate of that duty with the baseline price for oil to the rate of export customs duty on crude oil effective in the current month;
- actual revenue of the federal budget from severance tax (oil) obtained in the current month multiplied by the ratio of the difference between the severance tax rate effective in the current month for oil extraction and the estimated rate of this tax with the baseline price oil extraction tax rate effective in the current month on extraction of minerals (oil).

Only one target was foreseen in the RF Budget Code for the Stabilization Fund, namely - financing of the federal budget deficit "in the case of a decrease in oil prices below the baseline, as well as for other purposes, if the accumulated volume of the Stabilization Fund exceeds 500 million rubles."

According to Art. 96.4 BC RF, the Ministry of Finance of Russia was authorized to manage the Stabilization Fund, but some relevant functions could be performed by the Central Bank of the Russian Federation. The list of functions performed by the CBR was not specified in the Budget Code.

As an effect of Chapter 13.1 of the RF Budget Code, amendments were made mainly in regard to the baseline for oil prices, but not affecting the management of the Fund or their target use. At the executive level, the management procedure of the Stabilization Fund was governed by a number of legal acts, the most important of which are:

- The RF Government Regulations No. 508 of 30.09.2004 and No. 229 from 21.04.2006 "On the Procedure of the Stabilization Fund of the Russian Federation Management"
- The RF Government Regulation No. 31 of 23.01.2004 "On Approval of the Rules of transfer to the Stabilization Fund of the Russian Federation of the additional federal budget revenues, balances of the federal budget as of the beginning of the fiscal year, and revenues from the allocation of the Stabilization Fund of the Russian Federation"
- Order of the RF Ministry of Finance No. 20 of 28.01.2004 "On Approval of Rules of assessment and transfer to the Stabilization Fund of the Russian Federation of the federal budget surplus revenues and fund balances of the federal budget by the beginning of the fiscal year," and
- Order of the RF Ministry of Finance No. 158 of 22.05.2006 "On approval

of the minimum and maximum timelines for repayment of the debt liabilities of foreign countries, in which the Stabilization Fund of the Russian Federation assets can be invested.”

Of particular interest are the RF Government Regulation No. 508 of 30.09.2004, “On the order of the Stabilization Fund of the Russian Federation assets management,” and No. 229 from 21.04.2006 “On the order of the management of funds of the Stabilization Fund of the Russian Federation.” One of the key tasks in the first stage was to set conditions for investment of the RF Stabilization Fund by the Central Bank abroad and to provide at least some safeguards to protect them from claims of foreign creditors. As investments in foreign financial instruments, federal funds lose the status of public funds and, accordingly, any state jurisdictional immunity.

The Regulation No. 508 of 30.09.2004 stipulated the following allocation of investments. The Fund assets were legally separated from the assets of the Central Bank<sup>1</sup> and were legally considered “commercial” investments of the Russian Federation as a legal entity. This created certain risks for foreign investments of the Stabilization Fund, since there was no jurisdictional immunity of the Russian Federation in regard to those funds. As a result, there was a possibility of foreclosure on the Stabilization Fund from foreign creditors.

The government feared the risk of foreclosure on these funds<sup>2</sup>, and the adoption of “on the procedure for managing the Stabilization Fund of the Russian Federation” No. 229 from 21.04.2006 tried to give them the status of funds used for “governmental and non-commercial” purposes<sup>3</sup>, which are protected with jurisdictional immunity. To this end, the assets placed abroad were transferred to the status of funds belonging to the Central Bank of Russia.

The Regulation provided the following procedure for investing the Stabilization Fund assets: they passed to the Federal Treasury, and the Treasury then placed them in a special account with the RF Central Bank, not on the basis of the assets management contract as it was before, but on the basis of a contract for a bank account. Since the funds deposited in an account with the bank are formally transferred to its ownership, it allowed the Central Bank to invest them abroad as its own funds used for “public non-commercial purposes.” Herewith, the Ministry of Finance has retained the key responsibility for management of the investment process for allocation of the Stabilization Fund assets<sup>4</sup>.

In particular, the Ministry of Finance was authorized to define:

- the standard currency structure of the Stabilization Fund, the procedure of pursuing the standard currency structure;
- standards of minimum and maximum maturity of debt securities,

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1 The assets were transferred under the management contract, concluded between the Russian Finance Ministry and Central Bank, and did not legally become the property of RF Central Bank.

2 See, for instance, United Nation Conference on Trade and Development. World Investment Report: Transnational Corporations, Extractive Industries and Development. New York and Geneva, 2007. P. XVII.; McKnight A. The Law of International Finance. Oxford University Press, 2008. P. 368, 369.

3 Immunity to this category of funds is provided under the United Nations Convention “On Jurisdictional Immunity of the States and their Property” from 02.12.2004.

4 This Decree stipulates “management of the Stabilization Fund by the Ministry of Finance of the Russian Federation”.

- the procedure for accounting and crediting interest accrued on balances of the Stabilization Fund accounts, as well as other conditions of the bank account contract; and
- the procedure of interaction with the Federal Treasury in carrying out transactions with the accounts of the Stabilization Fund.

Monitoring of the Russian Finance Ministry control functions over the use of the Stabilization Fund was limited to the duties of providing quarterly annual reports to the Government of Russia on the status of the following indicators:

- the amount of authorized foreign currency purchased and foreign currency placed on the accounts of the Stabilization Fund;
- estimated interest rates for the allocation of the Stabilization Fund assets in the accounts;
- estimated income for the allocation of the Stabilization Fund assets in the accounts;
- names and basic characteristics of foreign countries' debt liabilities acquired with the Stabilization Fund assets;
- income derived from the placement of the Stabilization Fund assets into bonds of foreign countries by type of debt liabilities of foreign countries;
- information on balances of the accounts of the Stabilization Fund (per year);and
- details of interest paid over the past year for the use of Stabilization Fund assets placed in the accounts (per year).

In 2007, the procedure for the formation of funds, accumulating oil and gas revenues of the federal budget, and the procedure to manage the funds were radically amended. Relevant amendments were made with the Federal Law No. 63-FZ of 26.04.2007 "On Amendments to the Budget Code of the Russian Federation in terms of regulating the budgetary process and bringing certain legislative acts of the Russian Federation in line with the budget legislation of the Russian Federation." Under this Act, the Stabilization Fund was split into two parts, and the following were established:

1. a Reserve Fund in order to minimize the risks of the Russian economy in the case of a sharp drop in energy sources' prices in the world markets (Art. 96.9 of the RF Budget Code)

2. a National Welfare Fund, in order to ensure co-financing voluntary retirement savings of the Russian Federation citizens, as well as to ensure the balance (cover the deficit) of the budget of the Pension Fund of the Russian Federation (Art. 96.10 BC Code).

In addition, starting from 2007, a part of the oil and gas revenue was used as a part of the federal budget to implement in particular large-scale social programs and replenishment of the federal budget deficit through the so-called "oil and gas transfers" (Article 96.8 of the RF Budget Code).

### **Reserve Fund**

The reserve fund is formed from the oil revenues of the federal budget exceeding the level of oil and gas transfers authorized for the relevant financial year, provided that the cumulative Reserve Fund does not exceed its established value, as well as from revenues from the management of the reserve fund.

Item 2 of art. 96.9 of the RF Budget Code established a procedure for estimation of the normative values of the Reserve Fund. Under this item, it is assigned an absolute amount, assessed on the basis of 10 percent of GDP planned for the relevant fiscal year.

However, a large part of the provisions of Art. 96.9 of the RF Budget Code were not set to be put into effect until 2013. The relevant decision was taken as part of the anti-crisis measures and approved by the Federal Law No. 314-FZ of 17.12.2009 "On Amendments to Certain Legislative Acts of the Russian Federation" in connection with the Federal Law "On the federal budget for 2010 and the planned period of 2011 and 2012."

Before 2013, while the revenue from the Reserve Fund management was allocated to financing the budget expenditures, the procedure for the fund assessment, stipulated by Item 2 of Article 96.9, could be ignored. Also, before 2013, the RF Government could, without amending the federal law on the federal budget, make decisions on the use of the Stabilization Fund and other balances of the federal budget for the implementation of payments, reducing debt liabilities, borrowing, and to balance the federal budget execution (including financial support of oil and gas transfers), including the excess of the total federal budget expenditures within increased budgetary allocations of the federal budget to provide intergovernmental transfers in order to balance the budgets of state extra-budgetary funds of the Russian Federation, with the corresponding amendments to the budget registry<sup>5</sup>.

### **National Welfare Fund**

According to Art. 96.10 of the RF Budget Code, the National Welfare Fund is formed from oil revenues of the federal budget exceeding the amount of oil and gas transfers approved for the financial year, if the accumulated amount of the Reserve Fund reaches (exceeds) its established value, as well as from the income derived from the National Welfare Fund management. The latter, as well as income from the Reserve Fund management from 2009 through 2013, are allocated to the financing of the budget expenditures<sup>6</sup>.

Art. 96.11 of the RF Budget Code establishes the procedure for managing the Funds' assets, as well as setting up requirements for the assets of the Funds that can be used for investments. These requirements are specified in detail on the sub-law level. According to this article, the Reserve Fund and National Welfare Fund are managed by the Ministry of Finance of the Russian Federation in the manner established by the Government of the Russian Federation. Herewith, some responsibility for managing the Reserve Fund can be performed by the Central Bank of the Russian Federation, and some of those in regard to the National Welfare Fund - by the Central Bank of the Russian Federation and by special financial institutions, in accordance with agreements with the Ministry of Finance of the Russian Federation in the manner prescribed by the Government of the Russian Federation.

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<sup>5</sup> See Federal Law № 58-FZ of 09.04.2009 "On amendments to the Budget Code of the Russian Federation and some legislative acts of the Russian Federation"

<sup>6</sup> See Federal Law № 58-FZ of 09.04.2009 "On amendments to the Budget Code of the Russian Federation and some legislative acts of the Russian Federation"

Currently, the procedure for the management of the Funds is governed by:

- The RF Government Regulation No. 892 of 17.12.2007 “On the estimates and transfer of funds in connection with the formation and usage of oil and gas revenues of the federal budget, oil and gas transfers and the assets of Reserve Fund and National Wealth;”
- The RF Government Regulation No. 955 of 29.12.2007 “On the procedure of the Reserve Fund management;”
- The RF Government Regulation No. 18 of 19.01.2008 “On the procedure of the National Welfare Fund assets management;”
- The Order of the RF Ministry of Finance No. 3 of 16.01.2008 “On approval of the authorized shares in the total volume of financial assets of the Reserve Fund and the procedure for assessment of the actual authorized share of financial assets in the total assets of the Reserve Fund to bring them into conformity with the established rates;”
- The Order of the RF Ministry of Finance No. 26 of 24.01.2008 “On approval of the authorized shares in the total volume of financial assets of the National Welfare Fund and the procedure for assessment of the actual authorized share of financial assets in the total volume of the National Welfare Fund to bring them into conformity with the established rates;”
- The Order of the Ministry of Finance N 517 of 21.10.2008 “On amendments to the Order of the Ministry of Finance of the Russian Federation N 26 on January 24, 2008;”
- The Order of the RF Ministry of Finance No. 24 of 24.01.2008 “On approval of the established foreign currency structure of the National Welfare Fund and the Procedure to bring the actual foreign currency structure of the National Welfare Fund into compliance with the established rates;” and
- The Order of the RF Ministry of Finance No. 5 of 16.01.2008, “On approval of the list of foreign government agencies in which the debt liabilities of the Reserve Fund can be allocated.”

In general, the management procedure of the Funds, established on the basis of the Stabilization Fund, is governed by the logic laid down by the government in the Regulation No. 229 issued in 2006. According to the “new” Order No. 892 of 17.12.2007, the key functions associated with management decisions are performed by the Ministry of Finance, while the Central Bank carries out technical work related to ensuring their implementation. Relations among the Ministry of Finance, Treasury and Central Bank are based on the bank account agreement. The Agreement, as before, is reached between the RF Central Bank and the Treasury.

- According to the Ministry of Finance Order No. 25H of 14.02.2008, the oil and gas revenues of the federal budget, the Reserve Fund and National Welfare Fund are registered in special accounts of the federal budget opened for the Federal Treasury with the Central Bank of the Russian Federation. For these purposes, in accordance with the Bank Account Agreement entered into by the Federal Treasury and the Central Bank of the Russian Federation, on the balance of account No. 40105 “The federal budget,” separate accounts are opened:
  - to account for oil and gas revenues of the federal budget;
  - to account for the Reserve Fund assets in the national currency of the Russian Federation in the special account of the Reserve Fund;

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- to account for the National Welfare Fund assets in the Russian national currency and account for the recording of the National Welfare Fund assets.

Transfer of the oil and gas revenues of the federal budget, the Reserve Fund and National Welfare Fund in the national currency of the Russian Federation is performed by the Federal Treasury upon instructions from the Ministry of Finance of the Russian Federation to conduct transactions on the accounts for the accounting of oil and gas revenues, the Reserve Fund and National Welfare Fund, as well as payment documents.

All the above-mentioned laws provide for the minimum requirements in relation to the control process over investing the Reserve Fund and the National Welfare Fund assets.

Control arises from the fact that the Finance Ministry provides quarterly and annual reports on the management of the Funds assets to the government of the Russian Federation. The reports provided to the Government comprise:

- information on the balances of the Funds;
- information on the volume of the bought and sold assets;
- information on the estimated interest rates for the usage assets of the Fund allocated to the accounts;
- information on the estimated amounts of income derived from the use of the funds allocated to the accounts of the Funds;
- the names and basic characteristics of financial assets, in which the Funds' assets were placed;
- details of income received from the placement of funds.

In addition, no later than on the 20th of each month, the Ministry of Finance compiles and publishes in its website monthly summary reports available for public use. Published reports provide an overview of the total assets of the National Welfare Fund as of the beginning of the reporting month, as well as information on the assets credited to the fund, their placement and use in the reporting month.

These requirements on the control over investment of oil and gas revenues are limited. Speaking of controlling the use of the funds, one should also pay attention to the fact that the representative bodies of the state power are virtually not involved in the control of the funds' investments, and do not make management decisions on these issues.

Moreover, as noted above, from 2009 to 2013 the decisions on the use of the Reserve Fund were made by the RF Government with no changes to the law on the federal budget; that is, the fund not only invests, but also partly spends the Fund assets without the approval of the Parliament. Therefore, the management of the Funds is virtually beyond the Parliament's control.

On May 6, 2010 the RF Government Regulation No. 267 of 21.04.2010 "On the suspension of the acts of the RF Government on the formation and use of oil and gas revenues of the federal budget, income from management of the Reserve Fund and National Welfare Fund" came into effect, under which the following requirements for the Ministry of Finance are cancelled:

- publishing of information on the Russian Ministry of Finance website about the collection and use of oil and gas revenues of the federal budget, their enrollment in the Reserve Fund and National Wealth Fund, and the admission of income from management of the Reserve Fund and National Wealth Fund to the

Fund (before February 1, 2012);

- submission of reports to the Government of Russia on the formation of the Reserve Fund and National Welfare Fund and on the revenue from the use of oil and gas revenues of the federal budget (before January 1, 2013).

In addition, issues of the formation and usage of the oil and gas revenue from before January 1, 2013 are excluded from the review for the formulation and approval of the federal budget for the next fiscal year and the planned three-year term.

Thus, this Regulation establishes a departure from the concept of separation of the budget by oil and gas and non-oil and-gas components and of oil and gas transfer as a source of funding the non-oil budget deficit, and makes the RF Ministry of Finance and the Government of Russia virtually unaccountable to the State Duma in terms of both Funds' assets management.

However, it should be noted that the RF Ministry of Finance continued to publish information on the status of the Funds on its website as of June 1, 2010.

### **Institutional base and institutional quality**

Creation of the RF Stabilization Fund in 2004, although it goes beyond the chronological framework, should be considered in the context of the overall logic of economic reforms of V.V. Putin's first term in office (2000-2003), of the so-called "Gref Program"<sup>7</sup> or "Strategy-2010." In the framework of this program, radical tax reform was carried out, the foundation was laid for the new fiscal policy (transition to three-year budget planning), and the contours of major institutional reforms were outlined (administrative reform, judicial reform, reform of natural monopolies), although the latter ones, unfortunately, have remained largely unimplemented. In addition, when making economic policy decisions, the then-recent events of the crisis that happened in August 1998 were taken into account, leading to the national currency devaluation, the enlarged debt burden on the budget and the fear of uncontrolled government deficit. In particular, the dynamics of oil prices in the world markets, even in the short term, seemed extremely volatile, as there was a high probability of a new decline thereof to the level of \$9-10 per barrel, as was observed in 1998-1999.

In this context, the authors of the concept of the Stabilization Fund faced the task of developing a reliable, sustainable mechanism for the protection of export revenues to the budget from their usage for the current budget commitments and emerging new budgetary commitments in the case of a short-term increase in oil prices, as well as minimization of the negative impact of the inflow of export revenues on the economy in general (namely, preventing the accumulation of liquidity in the economy, the situation of a deficit of investment projects, and the willingness of businesses and banks to invest in the real sector).

Thus, as stated above, in institutional terms, the RF Stabilization Fund was a part of the federal budget assets, subject to separate accounting, management and utilization. In other words, the Fund assets were accounted for and placed in a special account of the RF Ministry of Finance with the RF Central Bank of Russia. The planned revenue to the Fund for the relevant fiscal year and the

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7 Named after the Minister of Economic Development G. O. Gref.

amount of the Fund as of the end of each financial year were approved by the Federal Assembly (Parliament) of Russia by the law on the federal budget for the next fiscal year and the planned three-year term.

Management of the Fund was executed by the RF Central Bank under an agreement with the RF Ministry of Finance. Herewith, the Bank of Russia, in fact, acted as the management company, and the RF Government and the Russian Ministry of Finance defined the strategy for the management of the Fund and a scope of permissible assets.

The RF Reserve Fund of Russia and the National Welfare Fund also make up a part of the federal budget subject to separate accounting and management. At the same time, they are (at least until the beginning of May 2010) subject to the same institutional constraints and conditions as the Stabilization Fund of Russia.

Assessing the overall quality of the institutional environment of the Russian sovereign funds, one can distinguish the following advantages and disadvantages.

### **Advantages**

- Strong legal status of the Funds through the addition of individual Chapters to the Budget Code, which before the crisis created a reliable system for protecting the Funds' assets from political and situational temptations on the part of both the RF Government and representatives of the power authorities.

- Formation of the funds in special accounts of the RF Government in the Bank of Russia, which minimized the effect of additional situational revenues from oil exports not only to the budget system, but also on monetary-credit and exchange rate policies.

- An adequate linking of the sources of the Funds' formation with the market revenues from oil exports. Calculations show that in 2005-2008, when the level of oil prices in the world market was above \$35-40 per barrel versus the national market, up to 95% of the surplus income from oil exports were addressed to the Stabilization Fund in the form of export duties and mineral extraction tax.

- Splitting of the Stabilization Fund into the Reserve Fund and National Welfare Fund in 2008. Even during the worst crisis situation in Russia, in 2008-2009, and the high budget deficit in the subsequent years, the institutional conditions allowed the National Welfare Fund to be saved as a sovereign fund for future generations, using it for financing the federal budget deficit. Obviously, if only one of the Stabilization Funds had been maintained during this period, its funds would have been fully spent for the solution of the current budgetary problems.

### **Shortages**

- The conservative management scheme of the Funds. Management of all Fund assets remains in the hands of the agencies, for which this issue is outside their main objective (RF Central Bank and the Russian Ministry of Finance). Involvement of private professional management companies (Russian or foreign) in the management of the Funds remains politically unacceptable.

- The lack of a legal framework for targeted parameters of the National Welfare Fund. Despite the fact that the objective of the National Welfare Fund was declared the "co-financing of voluntary retirement savings of Russian citizens,"

as well as “recovering of the (deficit) budget of the Pension Fund,” the required parameters are not in place to link to the pension fund reform. Under these circumstances, the National Welfare Fund could exclusively become a source of funding for the current deficit of the Pension Fund, and not a tool for solving long-term problems of the pension system in the Russian Federation.

- The lack of institutional capacity to develop individual strategies for managing the assets of the two existing Funds, not only based on principles of risk management, but also to ensure maximum yield at a given level of risk.

## **Investment Portfolio and Asset Management**

In the period from 2004 to 2006, the following requirements were applied to assets that can be invested in the Stabilization Fund:

a) the issuer of the debt liabilities should have a long-term credit rating of not lower than the level “AAA” by the classification of Fitch Ratings or Standard & Poor’s, or not below the level of “AAA” under the rating agency Moody’s Investors Service;

b) maturity of debt securities is fixed; the terms of issue and circulation do not provide the issuer the right to affect their early redemption (maturity) or the right of the owner to submit them for redemption (maturity) by the issuer of debt instruments ahead of schedule;

c) the current maturity date of issue does not exceed one year for discount liabilities or 10 years for coupon bonds;

d) coupon rate paid on coupon bonds is fixed

e) the bond value is denominated in one of the authorized foreign currencies and payments toward the debt liabilities are made in the currency of its denomination;

f) the volume of the debt liabilities issued in circulation is not less than US\$ 1 billion for the debt liabilities denominated in U.S. dollars, Euro 1 billion for debt liabilities denominated in Euro, or GBP 1 billion for the bonds denominated in pounds sterling.

From 2006 to 2007 the requirements underwent minimal changes whereby the volume of debt liabilities in circulation and denominated in pounds sterling was reduced from GBP 1 billion to 0.5 billion.

Also in the Resolution No. 229 of 21.04.2006 there appeared a clarifying requirement that the issuance of debt liabilities in which investments are made should not be issues intended for private (non-public) placement. In addition, it was stated in the Regulation that the standards of the minimum and maximum term to maturity of the bond issues are established by the Ministry of Finance.

The distribution of shares among the various types of investment instruments used for placement of the Fund assets was established by the Order of RF Ministry of Finance No. 157 of 22.05.2006, providing for the following foreign currency structure of the Stabilization Fund:

- U.S. Dollar - 45%;
- Euro - 45%;
- Pound Sterling - 10%.

The limits of permissible deviations of actual monetary structure of the

Stabilization Fund from the estimated foreign currency structure were:

- for the Stabilization Fund in U.S. dollars - + / - 5 percentage points;
- for the Stabilization Fund in Euro - + / - 5 percentage points
- for the Stabilization Fund in British pounds sterling - + / - 2 percentage points.

In 2007, the Finance Ministry also clarified the requirements for the minimum and maximum maturity of debt by the Order of the RF Ministry of Finance No. 737 of 05.12.2007 "On approval of standards for the minimum and maximum maturity term of bond issues of foreign countries in which the assets of the Stabilization Fund of the Russian Federation may be located." For the debt instruments denominated in U.S. dollars and Euro, the minimum term to maturity has been set at 2 months, and the maximum - 15 months. For the liabilities denominated in British pounds sterling the minimum term to maturity was set at 3 months and the maximum term - 36 months.

During the functioning period of the Stabilization Fund the procedure of its investment policy had been developed only in general and was insufficiently detailed<sup>8</sup>. There were no rules governing the formation of the investment policy of the Russian Ministry of Finance. In particular, there was no clear regulation of the order of information interaction between the Ministry of Finance and Treasury, although the need for such a procedure was mentioned in the regulations of the Government.

Once the Stabilization Fund was split into the Reserve Fund and National Welfare Fund, the regulation of matters related to investment of their assets was detailed<sup>9</sup>. In particular, the order of the RF Ministry of Finance No. 25H from 14.02.2008 regulated the issues of the information exchange with the RF Treasury.

According to Resolutions No. 955 and No. 18, the Russian Ministry of Finance established:

a) a standard foreign currency structure of assets of both funds, the procedure for bringing the actual foreign currency structure of the Funds into alignment with the established standards;

b) the share of financial assets authorized for allocation in the total Fund assets within the prescribed requirements and procedure for estimates of the actual share of financial assets authorized for allocation in the total Fund assets (bringing them into conformity with the normative shares);

c) standard minimum and maximum maturity terms of debt liabilities of foreign countries, foreign government agencies and central banks, and of international financial organizations, including those in securities;

d) a list of foreign government agencies into the debt instruments of which the Fund assets can be placed;

e) standard minimum and maximum terms of placing the funds on deposit with foreign banks and credit institutions;

f) procedures for estimates of credits and interest earned on funds deposited in the Fund accounts and other provisions of the bank account contracts;

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<sup>8</sup> These were provided in the RF government Regulation No. 508 of 30.09.2004 and in the Annex to the RF government Regulation No. 229 of 21.04.2006.

<sup>9</sup> List of normative acts regulating the management of investment funds policy is given above.

g) procedures of interaction with the Federal Treasury in carrying out transactions with the Fund accounts in the management of the Reserve Fund;

h) procedures of interaction with Federal Treasury in determining the terms of the contract with bank accounts in the management of the Funds assets.

In addition, the two Regulations (in the annexes) have approved detailed requirements for financial assets in which the National Welfare Fund and Reserve Fund assets may be placed.

Thus, the regulation of issues related to the process of the Funds' management has become more detailed in general. However, the procedures are still insufficient to regulate how individual authorities manage the Funds' assets by means of specialized financial institutions, as well as their involvement in the implementation of those powers<sup>10</sup>.

There is a lack of clarity in the issues related to the implementation of investment transactions by the Central Bank that carries out the actual allocation of the funds. Currently, there are no internal Central Bank regulations governing such functions in this area.

Thus, in 2004 and 2005 there were no investment transactions of the Stabilization Fund assets. During the period from July 24, 2006 (the starting date of investment of the Stabilization Fund) through December 15, 2007, the total income from the investments amounted to 174.8 billion rubles. (Over the year from December 15, 2006 to December 15, 2007 the revenue reached 151.9 billion rubles). Therefore, the returns from investments in U.S. dollars for the year amounted to 10.94% per annum and in rubles - about 5%. Given the annual rate of inflation (respectively 11.7% and 10.9%), we can see a negative return on the Fund.

**Table 2. Stabilization Fund Growth Rate in RUR<sup>1)</sup> and in USD<sup>2)</sup>, %**

	01.09.2006	01.10.2006	01.11.2006	01.12.2006	01.01.2007	01.02.2007	01.03.2007	01.04.2007	01.05.2007	01.06.2007	01.07.2007	01.08.2007	01.09.2007	01.10.2007	01.11.2007	01.12.2007	01.01.2008
1	-21.6	9.4	8.2	6.8	7.2	12.8	2.3	3.8	3.9	3.6	3.8	3.9	4.5	3.2	3.7	-3.6	9.4
2	-21.2	9.3	8.3	8.6	7.1	11.9	3.8	4.4	5.2	2.8	4.1	4.8	4.3	6.1	4.6	-2.1	8.6

*Source: RF Ministry of Finance*

<sup>10</sup> The need for such regulation is expressly provided by the Resolution № 18, which obliged the Ministry of Finance jointly with other agencies (Ministry of Economic Development, Federal Financial Markets Service, the Ministry of Justice and Central Bank) to "develop and submit to the Government of the Russian Federation the draft Regulation in the established procedure."

## Requirements for placing assets of the Reserve Fund

In general, the requirements for the Fund assets are stipulated in Art. 69.11 of the RF Budget Code, and also given in detail at the sub-law level<sup>11</sup>. The Article presents various requirements for the investment of the two Funds.

Options for allocation of the Reserve Fund assets are much more limited than those for the placement of the Fund of National Welfare assets. Reserve Fund assets may be placed in foreign currency and in the following types of financial instruments denominated in foreign currency:

- debt liabilities of foreign countries;
- debt liabilities of foreign government agencies and central banks<sup>12</sup>;
- debt liabilities of international financial organizations, including securities<sup>13</sup>;
- deposits and balances in bank accounts with foreign banks and credit organizations;
- deposits and account balances with the Central Bank of Russian Federation.

RF Government Regulation No. 955 of 29.12.2007 «On the management procedure of administration of the Reserve Fund» clarifies these requirements, setting minimum and maximum shares of the allocated assets, as well as more detailed requirements for them.

Thus, the share of foreign countries' debts should be from 50 to 100%. Herewith, such assets can be invested exclusively in debt instruments in: Austria, Belgium, Britain, Germany, Denmark, Ireland, Spain, Canada, Luxembourg, Netherlands, USA, Finland, France and Sweden.

The Regulation contains an open list<sup>14</sup> of recommended international financial institutions whose debt liabilities can be used for investment. They are: Asian Development Bank, ADB; Council of Europe Development Bank, CEB; European Bank for Reconstruction and Development, EBRD; European Investment Bank, EIB; Inter-American Development Bank, IADB; International Finance Corporation, IFC; International Bank for Reconstruction and Development, IBRD; Nordic Investment Bank, NIB; and International Monetary Fund, IMF.

The right to define the currency structure of both Funds, as before, was provided to the Ministry of Finance. According to the Sub-Item A, Item 4 of the Regulation No. 955, «On management of the Reserve Fund, the Ministry of Finance approves ... normative currency structure of the Reserve Fund» and

11 See the RF Government Decree № 955 of 29.12.2007 "On the management procedure of the Reserve Fund" and the RF Government Decree № 18 of 19.01.2008 "On the management procedure of the Fund of National Welfare".

12 The share of foreign government agencies and central banks assets should not exceed 30%. See the RF Government Decree № 955 of 29.12.2007 "On the management procedure of the Reserve Fund".

13 The share of these assets should be 15%. See the RF Government Decree № 955 of 29.12.2007 "On the management procedure of the Reserve Fund"

14 The regulation uses the following wording: "the debt liabilities of international financial organizations, in which the Funds assets can be invested include the debt liabilities, securities among them, of the following financial institutions ...." That is, other instruments besides those among the listed "including the securities" are likely to be used.

the procedure for bringing the actual currency structure of the Reserve Fund into accordance with the established standard.

Currently the currency structure of the Reserve Fund is governed by the Order of the RF Ministry of Finance No. 3 of 16.01.2008. The Order established the following authorized shares in the total amount of the Reserve Fund:

- debt liabilities of foreign countries - 95%;
- debt liabilities of foreign government agencies and central banks - 0%;
- debt liabilities of international financial organizations, including securities - 5%;
- deposits in foreign banks and credit institutions - 0%.

This limits the permissible deviations of actual shares of the financial assets in the total amount of allocated funds from the Reserve Fund from the established shares as follows:

- for the debt liabilities of foreign countries - +/- 5 percentage points;
- for the debt liabilities of international financial organizations, including securities, - +/- 5 percentage points.

In addition, the Ministry of Finance has approved the formula for assessment of the actual share of financial assets of the Reserve Fund and deviations of the actual share of financial assets from the established share of financial assets.

The Regulation No. 955 of 29.12.2007 imposes the following requirements for the debt instruments for the investment of the Reserve Fund:

- the issuer of the debt instruments should have a long-term credit rating not lower than «AA- according to the classification of Fitch-Ratings or the Standard & Poor's rating agencies or not below the «GaAs» by classification of Moody's Investors Service rating agency. If the issuer of debt liabilities is assigned different long-term credit ratings by those agencies, the lowest assigned long-term credit rating is selected. Compared with the requirements to the selection criteria in relation to assets used to invest the Stabilization Fund assets, the requirements contained in the RF Government Regulation No. 955 of 29.12.2007 were reduced. As mentioned above, previous requirements to the assets were «AAA»<sup>15</sup> level or «AAA»<sup>16</sup> ratings;

- Maturity terms of the debt liabilities are fixed; the conditions of issue and circulation do not provide the issuer the right to carry out their early redemption (maturity) and the rights of the owner of the debt to submit them for redemption (maturity) by the issuer ahead of schedule;

- standards of the minimum and maximum maturity terms for the bond issues, established by the Ministry of Finance of the Russian Federation, are mandatory;

- coupon yield rate on coupon bonds, and the nominal value of the debt liabilities, are fixed;

- denomination of debt is expressed in U.S. dollars, Euro and Pounds Sterling, and payments under debt liabilities are made in the currency of denomination;

- the volume of debt liabilities issued in circulation is not less than US\$ 1 billion for debt liabilities denominated in U.S. dollars, not less than EUR 1 billion

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<sup>15</sup> According to classifications of Fitch-Ratings or Standard & Poor's rating agencies.

<sup>16</sup> According to classifications of Moody's Investors Service rating agency.

for the debt liabilities denominated in Euro, and at least BSP 0.5 billion for debt liabilities denominated in pounds sterling;

- debt liability issuance is not intended for private (non-public) placement;
- the nominal amount of debt liabilities purchased from one issue should not exceed 15 percent of the nominal amount of the issue;
- the total volume of the Reserve Fund invested on deposit in foreign banks or credit institutions shall not exceed 25 percent of the total Reserve Fund.

## **Requirements for placing assets of the National Welfare Fund**

According to Art. 96.11 of the RF Budget Code, the National Welfare Fund may also be allocated in all of the above instruments, except for deposits in foreign banks. However, the Fund assets may additionally be invested in:

- deposits and bank account balances with banks and credit organizations, as well as in the State Corporation «Bank for Development and Foreign Economic Affairs (Vnesheconombank);»
- debt securities and stocks of legal entities;
- shares (stakes) of investment funds.

In addition, the National Welfare Fund assets can be transferred to the trust management of specialized financial institutions.<sup>17</sup>

Provisions of the Budget Code are detailed in the RF Government Regulation No. 18 of 19.01.2008 «On the procedure of management of the Fund of National Welfare.» To a large extent, they repeat the requirements for assets used for the placement of the Reserve Fund. Thus, the Resolution No. 18 has stipulated:

- a similar list of countries whose debt liabilities (as well as the liabilities of their agencies and central banks) may be used for allocation of assets;
- a similar list of international financial organizations,
- similar requirements for long-term credit rating of foreign issuers of debt liabilities.

However, since the list of assets used to invest the National Wealth Fund assets is broader, the RF Government Regulation No. 18 of 19.01.2008 mentions a number of specific requirements. Thus:

- among other things, the Regulation includes the following requirements to the debt liabilities of the Russian companies. Russian issuers of debt liabilities should have a long-term credit rating not lower than the “BBB-” level by the classification of Fitch Ratings or Standard & Poor’s, or not lower than the level of “Baa3” by the classification of Moody’s Investors Service rating agency. If the Russian issuer is assigned different long-term credit ratings, the lowest assigned is selected as the long-term credit rating.

Thus, the requirements for the debt liability rating of foreign issuers<sup>18</sup> are higher than the requirements for the Russian ones.

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<sup>17</sup> The founder of the of the National Welfare Fund trust management is the Russian Federation. The Ministry of Finance of the Russian Federation is in charge of legal relations in connection with the establishment of the National Welfare Fund trust management on behalf of the Russian Federation.

<sup>18</sup> As mentioned above, their rating has to be at least level “AA-” under the classification of Fitch-Ratings or Standard & Poor’s, or at least level “Aa3” under the classification of Moody’s Investors Service.

- in relation to shares and stocks (shares of participation) of investment funds, the following requirements are established<sup>19</sup>:

- shares of legal entities should be included in the quotation list of at least one stock exchange;
- shares of foreign issuers should be included in the lists of securities used to estimate the stock indices of MSCI World Index and FTSE All-World Index;
- shares of Russian companies should be included in the lists of securities used to estimate the stock indices of RTS or MICEX;
- the structure of the assets of investment funds, whose issued shares (stakes) should include only the authorized financial assets.

- in relation to deposits and accounts with the banks and credit institutions, the following requirements are established. The bank or credit organization should have a long-term credit rating not lower than “AA-” according to the classification of Fitch-Ratings or Standard & Poor’s rating agencies or not below the level of “Aa3” by the classification of Moody’s Investors Service rating agency. If a bank or credit organization is assigned a different of long-term rating by of those agencies, the lowest rating is assigned as a long-term credit rating;

- in relation to deposits of the State Corporation «Bank for Development and Foreign Economic Affairs (Vnesheconombank), the following requirements are established:

- the funds can be placed on deposit in Russian rubles, U.S. dollars, Euro and Pounds Sterling;
- the maximum total amount to be placed on deposits in Russian rubles is 655 billion rubles. At the same time, up to 175 billion rubles can be placed on deposit, the amount, term and other essential provisions of which are determined by the Ministry of Finance.

With regard to the National Welfare Fund, the Ministry of Finance<sup>20</sup> has also established the authorized standard shares of the total assets of the Fund in foreign currency to be invested in financial instruments, denominated in foreign currency:

- debt instruments of foreign countries - 80%;
- debt liabilities of foreign government agencies and central banks - 15%;
- debt liabilities of international financial institutions, including securities - 5%;
- deposits and balances in the accounts with foreign banks and credit institutions - 0%;
- stocks and shares (stakes) of foreign legal entities - 0%;
- debt liability securities of foreign legal entities - 0%.
- the Order of the RF Ministry of Finance No. 24 of 24.01.2008 approves the following normative currency structure of the National Welfare Fund:
  - U.S. Dollar - 45% +/- 5 percentage points,
  - Euro - 45%, +/- 5 percentage points;

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19 If acquired shares of legal entities or stocks (shares of participation) of investment funds do not match any of the above requirements, such shares or stocks (shares of participation) of investment funds are to be sold within 3 months from the date of inconsistency arising.

20 See the Order of the Ministry of Finance No. 517 from 21.10.2008 “On Amending the Order of the Ministry of Finance of the Russian Federation No. 26 of January 24, 2008”.

- Pound Sterling - 10 %, +/- 2 percentage points.

Thus, the currency structure of the National Welfare Fund is no different from the currency structure of the Stabilization Fund.

During the first year after the Reserve Fund and the National Welfare Fund formation (from February 1, 2008 to February 1, 2009), their management had negative US\$ returns, which amounted to -2.47%. Given those dynamics, the Russian Ministry of Finance has proposed a new index -- the so-called aggregate profitability-- which does not take into account the fluctuations of the Euro, Pound Sterling and US dollar. The aggregated index of return in the currency basket for the year amounted to 5.41% (see *Table. 3*).

**Table 3. Annual Revenue from the Reserve Fund and National Welfare Fund management (over the year from 02.2008 to 02.2009),%**

Currency	Account currency	In USD	In RUR
USD	3.9	3.9	35.14
Euro	5.94	-4.99	23.67
GBP	9.58	-19.8	4.57
Total	5.41	-2.47	26.92

*Source: RF Ministry of Finance*

When converted into Euro, the total gain would amount to 9.3% per annum, and into rubles - more than 26% per annum. The main reason for the loss of funds in dollar terms was the U.S. dollar's strengthening against the Euro and British pound sterling in 2008. Setting a tight limit on currencies prevented the compensation for the negative impact of weakening currencies, in which 55% of both funds were denominated.

## **Macroeconomic and fiscal linkages; highlights of political economy**

In terms of macroeconomic effects and implications of the sovereign wealth funds' formation in Russia, there are three noteworthy aspects:

1. Intertemporal stabilization of the federal budget.
2. Support to the RF Central Bank's anti-inflationary policy and policies of limited RUR appreciation.
3. Funding of anti-crisis measures in 2008-2009.

### **Budget Policy**

As mentioned above, the main objective of the RF Stabilization Fund establishment was institutionalized accumulation of surpluses of the federal budget under the circumstances of the external environment due to the high oil revenues. Oil and gas revenues include proceeds from taxes on mineral extraction of hydrocarbons, export duties on crude oil, natural gas, and goods

produced from crude oil.

Some oil and gas revenues are addressed toward financing current expenditures of the federal budget (oil and gas transfer), and the balance can be saved. To assess the short-term risks in terms of stability of public finances, the non-oil deficit indicator is important, representing the difference between the non-oil revenue and the total budget expenditures (see Table. 4). Accordingly, the amount of the fund is increasing (see Figs. 4).

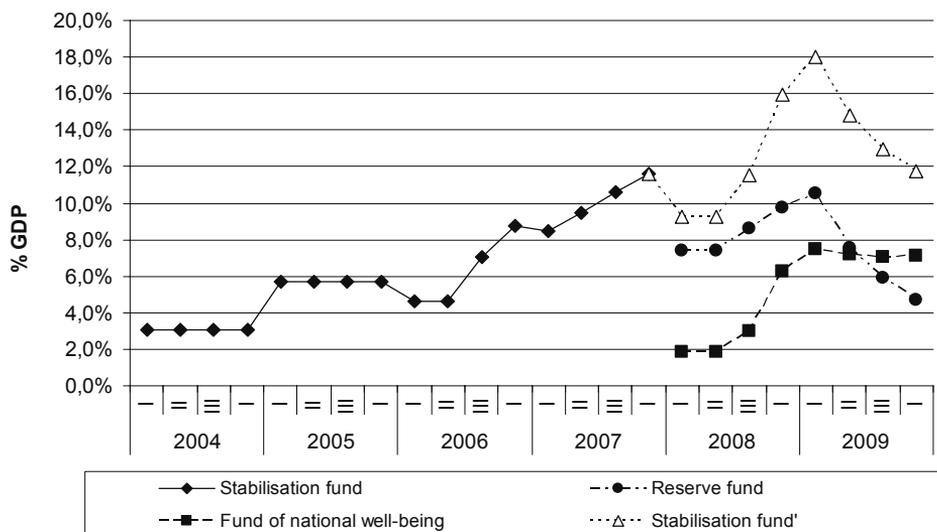
**Table 4. Revenues and Expenditures of the Federal Budget in 2000-2009. (% of GDP)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Expenditures (1)	14.2	14.8	18.9	17.8	15.8	16.3	15.9	18.1	18.2	24.7
Revenues (2)	15.5	17.8	20.3	19.5	20.1	23.7	23.3	23.6	22.3	18.8
Including non-oil revenue (2.1)	11.7	13.1	15.1	14.1	13.5	13.6	12.7	14.6	11.8	11.2
Oil revenue (2.2)	3.8	4.7	5.2	5.4	6.6	10.1	10.9	9.0	10.6	7.6
RF federal budget surplus (3)=(2)-(1)	1.4	3	1.4	1.7	4.3	7.4	7.5	5.5	4.1	-5.9
Non-oil deficit (4)= (2.1)-(1)	2.5	1.7	3.8	3.7	2.3	2.7	3.4	3.5	6.4	13.5

*Note: when assessing the non-oil deficit in 2009, income from the management of the Reserve Fund and National Welfare Fund, which amounted to respectively 0.8% of GDP, were taken into account.*

*Source: Federal Treasury of Russia*

**Figure 4. Stabilization Fund, Reserve Fund, the National Welfare Fund in 2004-2009, % of GDP**



*Note: The Stabilization Fund is a hypothetical fund equal to the amount of the Reserve Fund and National Welfare Fund*

Thus, during the period of a favorable external market situation, the presence of the Stabilization Fund was a serious institutional constraint to the growth of budgetary expenditures. At the same time, even such a constraint had a limited effect, and in 2007-2008, during in the peak in oil prices, a marked increase in the federal budget expenditures was observed in real terms.

In turn, in 2009-2010, the Reserve Fund became the main source of financing the federal budget deficit, formed due to reduction of the budget revenues, as well as due to adoption of the package of anti-crisis measures. However, the scope of the budget deficit in the RF (like in many countries around the world) clearly exceeds expectations. For example, if the initially estimated scope the Stabilization Fund, and then the Reserve Fund, was assessed based on the need to finance the deficit of 3% of GDP for the term not exceeding three years, when in 2009 the deficit of the federal budget amounted to 5.9%, in 2010 it is expected to amount to 6-7% of GDP, which means a complete exhaustion of the Reserve Fund already in the current year. Because in the future the government of Russia expects the federal budget deficit to be sustained (with a gradual decrease to 2% of GDP in 2013 with an average oil price of not below 70 dollars per barrel), there is a risk of needing the involvement of the National Welfare Fund for the budget deficit financing as well.

### Monetary and Exchange Rate Policy

The availability of budgetary sovereign funds, as well as their allocation in the international reserves of the Bank of Russia, has important implications for the

monetary and exchange rate policy in Russia.

Thus, the total volume of monetary supply, withdrawn from the economy and allocated to the accounts with the RF Central Bank as of January 1, 2009, was approximately 120% of the monetary base (high-powered money) at that time. Saving this volume of monetary supply in the economy over 2004-2008 would increase the rate of the monetary supply growth by about 15-20 percentage points per year. The inflationary consequence of this could be the increase of the average annual inflation rate from 11.35% per annum (which is one of the highest rates in the world) to 13.5-14% per annum.

At the same time, the total amount of funds placed in the foreign currency is about 35-40% of the total surplus of the Russian balance of payments from 2006 through the first six months of 2008. Accordingly, a demand was formed from the Russian Ministry of Finance for such inflow of the currency to the domestic market, which has helped the Bank of Russia to keep the ruble rate at a level no higher than 23.5-24.0 rubles per dollar. Modeling a situation where in 2006-2008 there was no need to allocate the funds in foreign currency shows that in this case, the nominal ruble exchange rate could rise to the level of 13-15 rubles per dollar by August 2008. Accordingly, the real effective ruble rate by the beginning of the crisis in autumn 2008 would have amounted not to 116.5% as compared with July 1998 (the maximum value of the real exchange rate before the 1998 crisis), but to 180-200%, which would mean a complete loss of competitiveness of domestic producers and a sharp slowdown in economic growth, even against the background of high prices for oil and other Russian export goods in 2007.

#### **Anti-crisis measures funding in 2008-2009**

Financing of large-scale measures for the support of the national economy without the involvement of external borrowing in 2008-2009 was possible thanks to the reserves accumulated during the economic growth. In fact, oil and gas revenues became the main sources to support the balance of the federal budget in 2009. In particular, to finance the budgetary expenditures from the Reserve Fund, about RUR 2.964 trillion was allocated. This fact allows us to conclude that the idea of forming an oil and gas fund was fully justified, and can be regarded as an advantage in the national fiscal policy.

**Table 5. Dynamics of Formation and Use of Oil and Gas Assets in 2009 (RUR bln)**

Fund	Balance as of late 2008*	Revenue over 2009:		Expenditure over 2009:		Balance as of late 2009*
		Oil and gas revenue	Revenue from assets management	Support of the federal balance solvency	Support of oil and gas transfer	
Reserve Fund	4027.6 (9.8% of GDP)	488.5	205.0	2964.8	179.4	1830.5 (4.7% of GDP)

National Welfare Fund	2584.5 (6.3% of GDP)	–	92.5	–	–	2769.0 (7.1% of GDP)
Total	6612.1 (16.0% of GDP)	488.5	297.5	2964.8	179.4	4599.5 (11.8% of GDP)

*\* Balances are estimated at the exchange rates of January 1, 2009 and January 1 of 2010, accordingly.*

*Source: Federal Treasury*

Formally, the assets of the National Welfare Fund were not used to finance the federal budget deficit and the financing of anti-crisis measures. However, starting from October 13, 2008, the RF President Dmitry Medvedev signed a package of laws previously enacted by the State Duma and approved by the Federal Council on the stabilization of the financial system during the financial crisis: in particular, legislative amendments allowed placement of the National Welfare Fund assets with the Vnesheconombank deposits until December 31, 2019, totaling no more than 450 billion rubles at the rate of 7% per annum.

Thus, there was only a change in the portfolio of fixed assets for the allocation of the National Welfare Fund; it was replenished with the ruble-denominated deposits of the RF Vnesheconombank. In the future, the use of those resources for the implementation of anti-crisis measures was already implemented by the RF Vnesheconombank. In particular, 404 billion rubles were granted to 14 Russian commercial banks in the form of subordinated loans and 30 billion rubles were transferred to the “Russian Development Bank” for crediting SME.

In general, analyzing the role of the Reserve Fund as a source of financing of the federal budget deficit in Russia over 2009-2010, one should take into account three issues related to the proper understanding of the “reserve” nature of these funds:

1. On the one hand, the use of the Reserve Fund assets to cover the budget deficit is a common monetary emission of the Central Bank, since in practice such an operation means the flow of funds in the RF Central Bank from the special accounts of the RF Government to the monetary base (through the current account of the Government). The non-emission nature of this operation could take place if the Bank of Russia at the same time would sell foreign currency (which is formally a counterpart of the Reserve Fund), but after a downfall to its lowest level in January 2009, the international reserves of the Bank of Russia have considerably grown. Thus, in terms of monetary policy, the Fund is not a reserve, but is a separate channel for the money inflow in the economy.

2. On the other hand, the described effect of monetary emission from the budget account is observed every time when the government spends money on the basis of the existing RF system of the Treasury, which has budgetary accounts with the Bank of Russia, i.e. those withdrawn from the monetary supply.

Irregular fluctuations are observed within the year (e.g., the sharp growth of monetary assets in December, when the budget expenses are performed when the money base is reduced each month in the last days of the month, when taxes are paid), but by virtue of the budget reporting term, namely the fiscal year, as a rule, only the final impact of the budget execution on the money supply is taken into account. If, however, we extend the period of consideration from one to, for example, 5 years, then the use of the Reserve Fund shall cease to be a mere emission, since the money accumulated in it within such a term may be regarded as temporarily withdrawn and returned to the economy assets.

3. From another perspective, in terms of fiscal and debt policy, the Reserve Fund assets certainly can be regarded as a reserve of the RF Government, as they make it possible to replenish the budget deficit without borrowing in the debt market and avoiding the increase of the government debt. At the same time, as the experience of EU countries, USA, Japan, UK and others shows, the growth of public debt to finance the anti-crisis measures package has become one of the key challenges for the economic policy at the stage of recovery from the crisis. In this regard, the existence of the Reserve Fund in Russia can be regarded as a potential allowing the country to avoid the growth of debt burden and to shift current budget expenses for the future generations.

### **The impact on poverty eradication, social policy and labor market**

From the point of view of the current social effects and support of the living standards of the population of Russia, the sovereign wealth funds provide limited and, for the most part, indirect effects. It is extremely difficult to distinguish the impact of each of the existing funds.

From our point of view, the most important impact on the population living standards is the provision of an anti-inflationary effect of the RF Stabilization Fund (see above). We estimate the total increase in income in real terms due to lower inflation in the period of 2004-2008 at about 20 percentage points.

Another important consequence of the Reserve Fund's existence is funding of the federal budget deficit in 2009. The social projects in particular, which allowed a growth in real incomes by 2.3% in the situation of a severe crisis (decline in real GDP in 2009 by 7.9%), reduced the negative impact of lower domestic demand and ensured the growth of household savings. Herewith, as noted above, those expenditures have been financed without increasing the national borrowing and, consequently, the growth of the borrowing puts a burden on the future generations.

The role of the National Welfare Fund in solving the social problems at the moment is extremely small. Moreover, the National Welfare Fund obviously does not play the role imposed on it-- but not ensured in institutional and legislative terms-- as an instrument for the long-term solutions of the pension system in Russia. We will consider the tentative options of the National Welfare Fund in this area in the final section of this memo.

### **Compliance with Santiago Principles**

*Table 6* shows our expert assessment of compliance of the RF Reserve Fund and National Welfare Fund with the Generally Accepted Principles and Practices (GAPP), or Santiago Principles. Compliance with these principles is presented

for each fund separately, although, as shown above, the legal provisions of their operation, management system and the requirement to investments of the funds are practically identical. Nevertheless, based on the different nature and purposes of each of the funds' formations, the extent of their compliance with the Santiago Principles varies.

**Table 6. Santiago Principles and Implementation thereof for the Russian Sovereign Wealth Funds**

Principles	RF Reserve fund	RF National Welfare Fund
GAPP 1	+	+
GAPP 1.1	+	+
GAPP 1.2	+	+
GAPP 2	+	-
GAPP 3	+	+/-
GAPP 4	+	+
GAPP 4.1	+	+
GAPP 4.2	+	+/-
GAPP 5	+ (?)	+ (?)
GAPP 6	+/-	-
GAPP 7	+/-	-
GAPP 8	+/-	-
GAPP 9	-	-
GAPP 10	+/-	+/-
GAPP 11	+	+
GAPP 12	-	-
GAPP 13	-	-
GAPP 14	-	-
GAPP 15	+	+
GAPP 16	+/-	+/-
GAPP 17	+	+/-
GAPP 18	+/-	-
GAPP 18.1	+/-	-
GAPP 18.2	+	+/-
GAPP 18.3	+/-	+/-
GAPP 19	+/-	-
GAPP 19.1	+	+/-
GAPP 19.2	+/-	-
GAPP 20	+	+
GAPP 21	-	-

GAPP 22	–	–
GAPP 22.1	–	–
GAPP 22.2	+/-	+/-
GAPP 23	+/- (?)	+/- (?)
GAPP 24	–	–

Therefore, as seen from the above estimates for the RF Reserve Fund, compliance with the Santiago Principles is observed in nine positions (and six sub-positions), and partial compliance in eight positions (four sub-positions). In seven positions (and one sub-position) there is no compliance.

For the National Welfare Fund, the situation looks even worse:

- compliance - in 6 positions (3 sub-positions)
- partial compliance – in 5 positions (5 sub-positions)
- inconsistency – in 13 positions (3 sub-positions).

It should be noted that for both Funds full compliance by one position and partial compliance with the other positions are in question because of the above-mentioned decision of the RF Government, which has refused to provide the information on the Funds' status for public disclosure since May 2010.

### **Perspectives and Predictability after the Global Economic Crisis**

As stated above, the situation with the dynamics of both Russian sovereign funds during the recent crisis is ambiguous. At the beginning of the crisis in the Russian Federation in autumn 2008 (October 1, 2008), the volume of the Stabilization Fund of Russia amounted to about 141 billion US dollars, and the National Welfare Fund – 48.7 billion US dollars. All assets were placed in highly reliable securities denominated in US dollars, Euro, pounds sterling and Japanese yen. Thus, from the beginning of the crisis despite the devaluation of the ruble, as well as lower interest rates in the leading global economies for the ruble, assets began to grow. In contrast to the assets of other sovereign funds, in the Russian funds there were no assets in corporate securities (stocks), so the downfall in the stock market did not have serious consequences on them.

At the same time, the growth of the federal budget deficit and the RF Government's need for additional financial resources have resulted in attracting the funds to meet current financial demands. Falling oil prices in the world markets and the reduced inflow of export earnings to the country led to the disappearance of the income part of both funds. By early June 2010, the balance in the Reserve Fund should not exceed 40 billion US dollars, and all the money from the fund should be allocated to finance the federal budget deficit in 2010. However, in our view, the utilization of the fund in 2009-2010 can not be regarded as a loss because the assets were used for the implementation of the fund's main objective - to recover a budget deficit that arose in consequence of short-term and cyclical swings in revenues. In addition, availability of this source to finance the budget deficit allows Russia to avoid the trap into which other economies of the world fall, namely the rapid accumulation of public debt. The renewal of revenue inflow to the Reserve Fund of Russia is expected not earlier than in 2012-2013 (in the case of the moderately optimistic scenario, reviving the global economy and the

preservation of the global oil prices at not less than 70 US dollars per barrel).

National Welfare Fund assets were not directly used to finance the federal budget deficit, and the assets spent in the context of an anti-crisis measures package for operations in the stock market of Russia and the support of the banking system in Russia were provided as the conversion of funds from foreign currency into rubles and their allocation in ruble assets (approximately 20% of the National Welfare Fund). Those RUR investments are potentially lost, but due to their long-term nature they will be reflected in an explicit form later. Thus, with regard to the effect of the ruble devaluation and the fact that buying the Russian companies' shares was carried out at close to a minimum price, specifically in times of crisis, the Fund has not suffered losses in ruble terms. Losses were recorded in 2010, as the nominal exchange rate, and consequently, ruble ratings were reduced, affecting the fund assets. Similar losses were observed in the pre-crisis period, when the ruble was also rapidly strengthening against the major world currencies.

However, in the absence of fiscal consolidation in 2011-2013, the RF government will be compelled to finance the federal budget deficit at the expense of the National Welfare Fund, down to its full exhaustion (except for the amount of the long-term ruble-denominated investments made in the framework of Anti-Crisis Measures). Accordingly, one can mention the following main recommendations to improve the functioning of the Russian sovereign funds:

1. With respect to the **Reserve Fund of Russia** – the soonest return to the accumulation of the assets at the high profitability in the long term period.

2. With respect to the **National Welfare Fund** – the RF Government should clearly define the strategic objectives of the Fund. Currently the Fund, in essence, is a separate fund of the RF Government, protected from spending to cover the budget deficit financing (so far!), which has no clear purpose. For the purposes of the Fund, one can propose its transformation into a savings pension fund (for example, like the Government Pension Fund of Norway), i.e., it could be addressed to resolve the shortage in the pension system over the prospect of at least 15-20 years. It is therefore necessary to revert to the accumulation of assets in the National Welfare Fund.

Current volume of the Fund (less than 10% of GDP) is clearly insufficient to solve any serious problem. In addition to the short-term revenues from exports of raw materials, the most obvious source for the replenishment of the Fund may be the proceeds of privatization of the state assets and real assets owned by the state. As of 2007 (prior to the crisis events in the global economy), assessment of such assets and property is not less than 57% of the Russian GDP. In the case of transfer of these funds to the National Welfare Fund, with a real return on the investments of the Fund at the level of 4.5% per year, the amount of the Fund by the end of 2015 should amount to 70.6% of GDP and by the end of 2025 – 80.5%, which is enough to keep the replacement rate of retirement pension at 30% until 2025.

3. **With respect to both funds** - principles and approaches to managing the funds' assets should be differentiated. In particular, the National Welfare Fund should be managed essentially on different terms than the Reserve Fund. In other words, an authorized structure of assets and management mechanism should be revised.

First, the National Welfare Fund has a longer prospectus for investment than the Reserve Fund, and the National Welfare Fund assets can be invested in more volatile and profitable financial instruments.

Secondly, the National Welfare Fund short-term liquidity has a lower value, and consequently, it is permissible to invest it in non-marketable assets.

Third, international experience shows that to improve efficiency of management and profitability of such a sovereign fund, it is reasonable to transfer management of such a sovereign fund to private professional management companies, rather than to the Central Bank or a specialized state agency.

Therefore, a change in the institutional and legal bases of both funds' functions is required to improve their compliance with the Santiago Principles.

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