Fiscal policy, public debt management and government bond markets: issues for central banks

Elizaveta Danilova[1]

Abstract

This paper covers fiscal policy tools that promote sustainability and their influence on monetary policy in Russia, the Bank of Russia's role in public debt management and main features of the domestic currency public debt market. At present Russia's budgetary circumstances are quite favourable, however, the budgetary system remains exposed to the world financial markets conditions and, above all, to oil prices. To reduce the budget's dependence on oil and gas revenues and accumulate reserves in the event that oil prices retreat a special mechanism for the utilisation of oil and gas revenues within the federal budget has been envisaged. Operations to finance the budget deficit affect the Bank of Russia's monetary policy, however, this effect is not significant. The Bank of Russia's role in public debt management is focused on consulting the Ministry of Finance on government securities' issuance and repayment schedules given the impact on banking system and monetary policy priorities. The main funding source of the federal budget deficit is the government securities' market which has shown swift growth over the last decade. The reforms conducted by the Ministry of Finance and the Bank of Russia including the improvement of financial market infrastructure would promote further market development.

Keywords: Fiscal policy, public debt management, government bond markets, emerging markets.

JEL classification: E62, H63

[1] Head of Macroprudential Analysis Division, Financial Stability Department, Bank of Russia.

1. Fiscal policy: mechanisms that promote sustainability and their influence on monetary policy in Russia

At present, Russia's budgetary circumstances are quite favourable – in 2011, public debt-to-GDP ratio stood at about 10.4% of GDP according to the Ministry of Economic Development. (As of 1 December 2011, the public debt of the Russian Federation amounted to $163.3 billion.) At the same time, the Russian budgetary system remains exposed to conditions in the world financial markets and, above all, to oil prices.

In 2011, thanks to the strong price for Urals[2] oil, the surplus of the Russian Federation budget amounted to about $13.4 billion (0.8 % of GDP). High world prices for energy resources should also contribute to a rather high level of predicted budget revenues in the coming years. At the same time, growing budget expenditures increase the probability of a structural deficit in the long run (the Federal Law on the federal budget envisages a budget deficit for the period 2012–14[3]). On this basis, public debt will reach about $380 billion, some 17% of GDP in 2014. But, despite the large public borrowing programme, the debt burden of the Russian Federation remains moderate when compared to that of countries with similar sovereign ratings.

Since 2008, Russia's Budgetary Code has set out a special mechanism for the utilisation of oil and gas revenues within the federal budget with a view to reducing the budget's dependence on oil and gas revenues, as well as to accumulating reserves in the event that oil prices retreat. These revenues, the Code stipulates, should be applied to federal budget expenditures and to the Reserve and the National Wealth Funds.

The Reserve Fund is intended to ensure the financing of the ***oil and gas transfer***[4] in the event of a shortfall in oil and gas budget revenues. It absorbs any surplus in the federal budget's oil and gas revenues over and above the volume of the oil and gas transfer and the Reserve Fund's investment revenues. The prescribed size of the Reserve Fund is limited to 10% of the forecast GDP for the corresponding fiscal year.

The National Wealth Fund's purpose is to co-finance the voluntary pension savings of Russian citizens and to balance the Pension Fund's budget. The National Wealth Fund accumulates the oil and gas revenues of the federal budget that exceed the value of the oil and gas transfer approved for the corresponding fiscal year after the Reserve Fund reaches its prescribed size. It also accumulates the investment revenues of the National Wealth Fund.

The Budgetary Code sets a limit on the ***non-oil-and-gas deficit of the federal budget***[5] (which should not exceed 4.7% of GDP). The non-oil-and-gas deficit is financed by the oil and gas transfer (which is restricted to 3.7% of GDP) and from the deficit financing of the federal budget.

The Reserve Fund was severely depleted in the 2008–09 crisis after the Urals oil price fell from $140 per barrel to below $40 per barrel. In October 2008, the Reserve Fund had reached a peak level of $140.98 billion, of which more than $80 billion was used to finance the budget deficit.

---

[2] In 2011, the average level of oil prices amounted to $110.

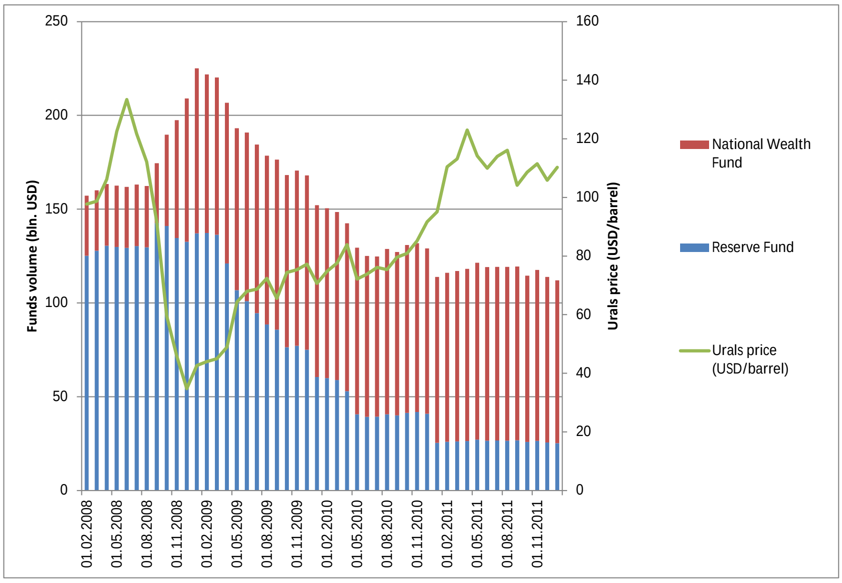
[3] Base on the following forecast oil prices incorporated in the Federal Budget Law: $93 per barrel in 2012, $95 per barrel in 2013, $97 per barrel in 2014.

[4] Comprising the oil and gas revenues of the federal budget and the Reserve Fund.

[5] The non-oil-and-gas deficit of the federal budget represents the difference between the revenues of the federal budget without oil and gas revenues and the revenues from the management of the Reserve and the National Wealth Funds, and federal budget expenditures in the corresponding financial year.

Graph 1

Evolution of the Reserve Fund and National Wealth Fund



Source: Ministry of Finance of Russia; Bloomberg.

In 2010, following heavy anti-crisis spending within the federal budget, it was decided to suspend the use of the above-mentioned mechanism for oil and gas revenues and use them to finance the budget deficit.

In 2011, the non-oil-and-gas deficit dropped to 9.7% of GDP (in 2010, it reached 12.6% of GDP), while oil and gas revenues totalled nearly $174 billion. As a result the 2011 federal budget generated a surplus of 0.8% of GDP, allowing $31 billion in oil and gas revenues to be allocated to the planned replenishment of the Reserve Fund.

Table 1

International reserves of the Russian Federation vis-à-vis public debt

Date	Accumulated public debt, *$ bn*	Including foreign debt, *$ bn*	International reserves, *$ bn*
2006	92.4	52.0	303.7
2007	97.9	44.9	478.8
2008	91.6	40.6	426.3
2009	107.0	37.6	439.5
2010	136.9	40.0	479.4
1 December 2011	163.3	35.8	510.9
1 January 2012	n/a	n/a	498.6

Russia's public debt is completely covered by the Federation's international reserves,[6] which include the Reserve Fund and the National Wealth Fund (see table below). The aggregate assets of the Reserve and National Wealth Funds amounted to $112.4 billion as of 1 December 2011.

Operations to finance the budget deficit affect the Bank of Russia's monetary policy because allocations of debt securities on the primary market lead to liquidity outflows from the banking sector into general government accounts at the Bank of Russia.

However, this effect is not significant for the following reasons:

1. The volume of government securities is relatively small (at the end of 2011, total outstandings in the OFZ federal loan bonds market was an estimated $78.4 billion).
2. Most of the borrowed Treasury debt market funds eventually return to the banking system in the form of budgetary expenditure or through allocation of temporarily available budgetary funds to bank deposits (the amount of deposits of the general government in commercial banks totalled approximately $48.8 billion on 1 December 2011).
3. Credit institutions use the purchased securities as collateral for refinancing operations of the Bank of Russia.

2. The Bank of Russia's role in public debt management

The Bank of Russia supports the government in realising its fiscal policy. In particular, the Bank acts as the agent of the Ministry of Finance in conducting operations with domestic debt securities, taking into account the impact of these operations on the banking system and its own monetary policy priorities. The Bank of Russia submits recommendations to the Ministry of Finance, which sets the key direction for debt policy and issues advice on the issuance, distribution and redemption of government securities on domestic and foreign markets.

The Bank of Russia does not conduct monetary operations of a quasi-fiscal or non-traditional nature. The Bank of Russia is prohibited by law[7] from financing the federal budget deficit and from buying government securities in the primary market.

In recent years, the Bank of Russia has not frequently been involved in purchasing government securities in the secondary market (other than when fulfilling obligations in repurchase agreements). The Bank of Russia does not make such purchases in order to influence the yield curve. Rather, short-term lending operations are used for this purpose.

Nor do these operations constitute any part of the central bank's anti-crisis policies. During the 1990s, the Bank's purchases of government bonds in the secondary market were the main instrument of liquidity provision to commercial banks (indeed, the volume of government securities held by the Bank of Russia at times amounted to more than twice the monetary base). However, in 2008–09, it was principally credit operations that were used for this purpose. Over the same period, the total amount of purchases of OFZ and foreign currency-denominated government securities by the Bank of Russia amounted to only about

6 The international reserves comprise highly liquid financial assets that are held by the Bank of Russia and the Russian Government, including foreign exchange reserves and monetary gold, as well as the foreign currency holdings of the Reserve Fund and the National Welfare Fund.

7 Federal Law no 86-FZ dated 10 July 2002: "On the Central Bank of the Russian Federation (Bank of Russia)".

$5 billion. At the same time, the Bank's claims on credit organisations at the peak of crisis exceeded $120 billion (for instance, as of 1 February 2009).

The Bank of Russia is also empowered to issue its own bonds. These short-term securities are used to manage excessive liquidity in the banking sector. Between February 2007 and August 2010, the Bank of Russia regularly issued short-term bonds with a maturity of six months. After November 2010, the maturity of this issuance was reduced to three months. Since mid-October 2011, the Bank of Russia has suspended bond issuance due to a shortage of market liquidity.

3. Main features of the domestic currency public debt market

At present, the Government of Russia borrows mainly by issuing debt securities on the domestic market. (Domestically issued securities account for up to 78% of internal public debt in the form of debt securities.)

Before the 2008 crisis (when the government budget was in surplus) domestic public borrowing, in the form of OFZ, was relatively low (ranging between $5.3 billion and $7.8 billion annually). Since 2009, however, the budget deficit has been financed mainly via the domestic public debt market. Over the last decade, Russia's rouble-denominated public debt market has increased in volume (doubling over the last two and a half years to $78.4 billion). At present, federal loan obligations (OFZ) account for a significant share (37%) of the entire Russian rouble-denominated debt market.

The expansion of the public debt market has contributed to the development of the internal money market. For instance, repo operations are developing rapidly. As of end-December 2011, public securities accounted for 26% of domestic repo operations (Graph 2).

Government securities (OFZ) are issued with maturities of up to 30 years. However, the most liquid (benchmark) issues have maturities of up to 10 years. New OFZ issues from the Ministry of Finance have maturities of 10 years or less. The maturity of public debt obligations is not increasing; longer-term issues imply higher borrowing costs under current market conditions.

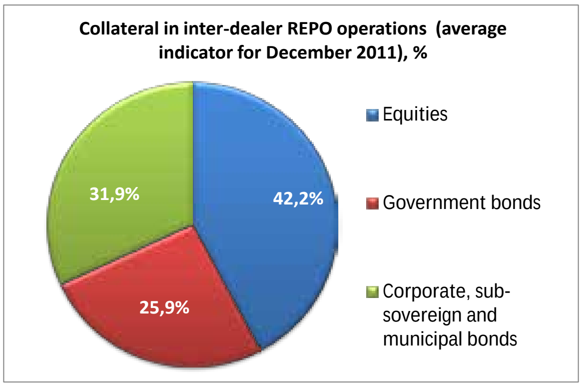
Despite these positive trends, the Russian public debt market remains underdeveloped. This is due not only to Russia's long period in budget surplus, during which there was no need for large-scale borrowing but also to perceived access problems for international participants in the Russian market. International investors are ready to take credit risk on rouble-denominated debt obligations, but they would require high premiums to compensate them for the risks associated with Russian financial market infrastructure.

A very limited number of state-associated banks and the Pension Fund of the Russian Federation are the main investors in the public debt market; the share of non-residents in trading is minimal (Graph 3). Thus, the Russian public debt market lacks institutional investors with long-term investment strategies.

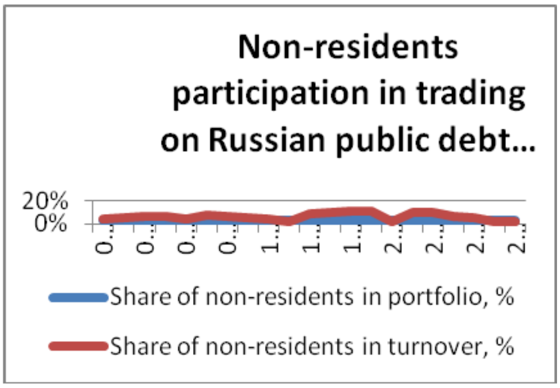
In this connection, the Ministry of Finance and the Bank of Russia are seeking to liberalise the public debt market. Until recently, there was only one trading platform for Russian government bonds – a special section of MICEX. Since January 2012, however, government securities can also be traded on the securities section of the combined MICEX-RTS exchange, as well as on the OTC market. The Bank of Russia expects that these reforms will help broaden the investor base to international participants, as well as improve the market's liquidity and capacity.

The Federal Law of 7 December 2011 no 414-FZ "On the Central Depository" provides that, from 1 July 2012, central depositories active in the Russian market will be able to open custody accounts for foreign nominee holders of international centralised depositories or securities settlement systems as well as national depositories, securities settlement systems and clearing organisations. This provision is expected to increase the attractiveness of the Russian government securities market to foreign investors by mitigating the risks faced by foreign investors who use such financial market infrastructures (FMIs) in their jurisdictions. At present, foreign FMIs can only open accounts at Russian depositories, which exposes foreign investors to risks in the event of financial problems at foreign FMIs.

Graph 2



Graph 3



Source: Bank of Russia

As non-residents account for a minimal level of Russian debt holdings at present, the reorientation of public borrowing towards the domestic market will not expose the market to a higher degree of risk from external shocks and does not present any additional risk to financial stability.