Risk-free assets: an unreachable dream or a must

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First of all, I would like to thank the BIS management for choosing me as one of the policy-makers for the Panel 3 discussion.

My daily job is heavily linked to the issue of risk-free assets, as I am here in three capacities: as a debt manager responsible both for setting up Russia's borrowing strategy and for daily operations of our debt management office (DMO); as an asset manager responsible for setting up Russia's policy in the field of managing money, accumulated in the Reserve and National Wealth Funds (now it is 9 percent of Russia's GDP), where the Central Bank of Russia is responsible for daily operations; and as the Deputy of the Minister of Finance responsible for both setting up Russia's priorities during our G20 Presidency in 2013 and implementing them. Occupying the first two of these positions, it is definitely a must for me to keep an eye on the local and global debt market developments, including on the risks associated with the very sad fact that some debt securities are losing their status of risk-free assets. In my third capacity, I need to explain why Russia has decided to initiate the discussion between G20 members on sovereign debt issues.

So, my presentation will consist of three parts. In the first one, my story will be about the job of the sovereign wealth fund manager in the recent economic conjuncture. In the second part, I will explain our view on the problem of risk-free assets as a sovereign borrower. And in the third part, I will explain our approach to the G20 tasks in the field of public debt management.

Sovereign wealth fund manager

Let me start with a simple question. Does anyone among us really believe that risk-free assets exist? Deep in our hearts, we all know that such assets never existed and will never exist in the market economy. Otherwise, we would live in a different world, in the world where private initiative and individual decisions are punished, not rewarded as it happens when risks are taken.

Nonetheless, for years market participants have been doing their business on the assumption that there are risk-free assets. I believe that this concept is a natural human reaction to the complexity of the world surrounding us. The risk-free theory was welcomed because it made decision making much easier. And we are always looking for simple decisions! Plus, the risk-free methodology turned out to become the cornerstone in different mathematic models for the calculation of the value of any financial asset. From the very beginning a number of sovereign bonds were treated as risk-free financial instruments. Credit rating agencies helped a lot in this understanding with their "AAA" versus "BBB" or "CCC" references.

Was it bad for practical asset managers? Absolutely not! To the contrary – it helped a lot. When eight years ago at the Ministry of Finance we very unexpectedly

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received the government's order to work out the draft of the rules to be used for managing our Wealth Funds money, our reaction was very simple and – as we were already responsible for debt management – obvious: this money needed to be invested into risk-free assets, as they were safe and liquid. Nobody argued or complained! At the beginning. Only after a number of years we found ourselves under enormous criticism. We were accused of … feeding foreign economies. Now, with the open debate on the status of risk-free assets, we expect that these attacks will intensify.

For those who are in charge of sovereign wealth funds management, the outcome of our debate is that of a practical meaning and of a political dimension. We are being asked to earn more return at the same level of risks. It means, at least, that we will have to buy much longer maturities even if the problem of risk-free assets will stay with us for many years to come. Plus, we'll be in great need of a much bigger tolerance from higher level management if our decisions result in intermediate losses.

So, summing up: in the world of the global economy and heavily linked financial markets, asset managers cannot remain neutral toward the sharp deterioration of the debt-to-GDP ratio in a number of economies, whose sovereign bonds were used for years as risk-free assets. That's why it is very important to see that fiscal authorities in these countries are developing and implementing policies aimed at restoring the status quo: bonds issued by developed economies need to be treated as risk-free assets. For my colleagues and me, it is a matter of professional survival.

Sovereign debt manager

Now, a couple of words from my position as a sovereign borrower. Many emerging market economies (EMEs) have reached the stage when our local currency bond markets (LCBMs) can be 100 percent reliable as a source of financing our budget deficits. Even more, we have evidence that EMEs' sovereign bonds are already being treated as almost risk-free assets. In any case, the demand for this class of financial assets is increasing. For me it means that G8 and afterward G20 initiatives on the development of LCBMs are producing concrete results. I believe it is good news for market participants and for global financial stability.

But if it is not the case, the remarkable thing about risk-free assets is that any sovereign needs to keep in mind that within its own territory there are hundreds if not thousands of economic agents for whom sovereign bonds are risk-free assets, no matter what credit rating agencies think about them. Let us have a look at the Central Bank of Russia instruction on the way risks are assessed and reserves accumulated. In Russia the regulator makes its position clear: national government bonds are risk-free instruments. They are included in the first (highest) group of financial assets and their risk coefficient is stipulated as zero. By the way, in the same group the Central Bank of Russia keeps credit claims on multilateral development banks (MDBs). Their bonds have the same status. Economic agents are in great need of this kind of asset. Locally, our bonds and that of MDBs are of the same quality even though credit rating agencies still treat Russia as a "BBB" borrower and the World Bank, for example, as a "AAA" borrower.

So, any market economy needs to have risk-free financial instruments. For any DMO, to issue one should be a must, not purely an unreachable aim. We fully support the BIS initiative to start a comprehensive discussion of this issue including the possibility of deep change in the whole mandate of DMOs.

Russia's proposals within our G20 Presidency

There are a number of reasons why we decided to pick up public debt management as one of Russia's priorities. First, it looks a bit strange that sovereign debt issues are still not on the G20 agenda while they are on the front pages of the mass media. For us, since we are buying huge amounts of sovereign bonds, it is quite natural to try to fill this gap. Second, at G20 level we are very close to the final stage of implementation of the LCBM initiative. So, we believe that the more access borrowers from EMEs have to the debt markets, the more responsibly public debt management will need to be pursued. Third, we believe it is high time to study lessons of recent sovereign debt crises, since the most critical stage has already passed and G20 discussions would not harm the markets.

Clearly, debt issues have a lot of dimensions. But not all of them are worth discussing. For example, we are being approached by non-governmental organizations with proposals to restart examining the possibility of reaching agreement on a statutory approach to debt restructuring. But we will never attempt such an examination, since I know for sure before discussion even starts that there is only one practical way to come to an agreement – to negotiate. That is why we are going to advise the G20 finance ministers and central bank governors at the meeting in Moscow in February to endorse the Addendum to the "Principles for Stable Capital Flows and Fair Debt Restructuring" developed by the IIF.

So, we are looking at the debt problem differently and, by the way, in line with many of you sitting around this table. Our basic assumption is the following. The debt market situation has changed dramatically. For many years to come the debt-to-GDP ratio will remain at very high levels, new sovereign borrowings will serve the need of debt repayments, and sooner or later interest rates will start rising, making debt service for a number of economies unaffordable. All these would mean that DMO operations on debt markets would not remain neutral toward fiscal and monetary policies as they were during the last decade in many countries including Russia. We can predict, for example, that central banks will be very active at the longer end of the yield curve though it never happened previously. It looks like, for many DMOs, it will be quite difficult to sell sovereign bonds on the basis of the classical approach, when their aims are to minimize the borrowing cost in the medium-term horizon subject to acceptable levels of risk. The refinancing risks are becoming quite high for many sovereigns.

If our colleagues from the G20 agree to this very preliminary analysis we will propose to go further in the following directions.

First, to see whether a number of documents agreed on at the multilateral level can still be relied upon as the basis for setting up national borrowing strategies and for doing market operations. I am speaking about the IMF and World Bank "Guidelines for Public Debt Management," "Guiding Principles for Managing Sovereign Risk and High Levels of Public Debt," the IMF tool for "Public Debt

Sustainability Analysis," the IMF Fiscal Monitor, the G20 Toronto debt targets and other international and national fiscal rules and frameworks.

Second, to analyze the usefulness and feasibility of merging them into one single set of principles/guidelines/frameworks or into something else.

Third, to discuss a possible new role (mandate) of DMOs in the changed global macroeconomic environment.

Fourth, to see whether it is possible and reasonable to make the above mentioned rules binding for the IMF members. Another option is to think about an internationally agreed set of budget rules. In Russia we already have one, but it is rather complicated, as it links the management of oil and gas revenues, the budget deficit and sovereign borrowing. I personally like the way it was done in Switzerland with the budget rule named "debt brakes." In any case, based on the outcomes of our conference we can look forward to setting up new principles for the work of DMOs, including one linked to the necessity of keeping sovereign bonds as risk-free assets.