

## **Brief information on the Analysis of Internal Public Debt of the Russian Federation carried out by the Accounts Chamber of the Russian Federation for the period of 2004 to 2006.**

In accordance with paragraph 4.4.22 of the Work Plan of the Accounts Chamber of the Russian Federation for 2006, the offices responsible for control over the public debt, banking system, Central Bank of the Russian Federation, financial institutions and financial markets, carried out an expert and Analysis of the internal public debt of the Russian Federation.

The objective of the event was the study of the status of public internal debt over the period of 2004 to 2006.

The main results of the research are:

1. For the time being, there are both market and non-market obligations in the structure of the internal public debt.

Debt obligations with a non-market origin that appeared in early 1990s were not direct borrowings of the state. These obligations were entailed by the funding shortfall of primary critical public needs in 1985-1995 that were later on converted into the indebtedness of the state to the banking system and/or certain industries of the economy.

As of January 1, 2004, the public internal debt of the Russian Federation constituted 681.56 billion roubles. For the last three years, the public internal debt has increased by 381.77 billion roubles and reached 1,063.3 billion roubles as of January 1, 2007. Within the whole scope of the public debt, the portion of obligations ensuing from public securities was 96.37% as of early 2004, 97.24% as of early 2005, 97.24% as of early 2006, and 96.68% as of early 2007. A certain reduction in the market borrowing portion within the said period was caused by a sharp (more than 4 times) growth of the amount of the state guarantees granted.

2. More than 95% of internal borrowings are effected through placing government securities at the organized securities market.

For further development of the securities market, a qualitative improvement of the market's characteristics is required, which implies, above all:

- extension of the borrowing terms (duration);

- increase of the number of investors;
- reducing the volume of securities of one type in the portfolio of a confined investor group (which significantly influences the securities pricing and yield policy);
- increasing turnover on the securities;
- reducing the yield of the securities (federal budget expenses).

Starting from 2005, the Ministry of Finance of Russia started placing Bellwether (indicative) issues of bonds with fixed circulation period of 3, 5, 10, 15 and 30 years that are marked by significant volumes.

In addition, 3- and 5-year bonds are redeemed in full within the set term, longer-term securities have a depreciation redemption structure.

Among the total volume of government securities placed in 2006, more than 55% are “long papers” with the redemption term of more than 10 years; this factor constituted 44.9% in 2005, and 39.5% in 2004. In 2006, the securities with redemption term of 30 years were placed for the first time, the primary distribution reached more than 80%, while their placement at the secondary market was about 20% of the amount of the securities placed.

This dynamics indicates the improvement of duration (mean term of bond payments) of the securities market in case of insignificant increase of weighted average price profitability for the “long papers” (up to 8.43%), which remains lower than the inflation factor.

The market stability is also characterized by investor activity factors and the increase of placement volumes:

The values of activity factors versus types of securities evidence an increase in securities turnover and the increase of the number of investors. According to the Bank of Russia data, more than 200 investors are trading participants presently. In this regard, both major commercial banks and investment companies are leading operators of the short-term State Treasury Bills and Federal Loan Bonds market (dealers); the list of bidding participants at the Moscow Interbank Currency Exchange is published in the reporting of the Bank of Russia, the types and scopes of operations of the participants are confidential and may only be disclosed with the investor’s consent. Specifically to increase the number of investors and to diversify their

community, the Government of the Russian Federation, starting from July 1, 2006, cancelled the existing restrictions for investing the funds of non-residents into government securities of the Russian Federation, which extended the circle of potential investors.

The number of transactions concluded at the securities market, the number of different market participants, as well as the scope of the transaction effected may be attributed to indirect characteristics of the securities market liquidity as a whole. In addition, one of the main tasks aimed at establishing a liquid market is to support the diversity of the market participants, their differentiation in terms of the types of transactions effected, risk perception, or investment opportunity. One of the main objectives is also the task of preventing the occurrence of “monopolists” at the market, concentrating a significant portion of the issue in their portfolios, which makes the market unavailable for smaller investors and worsens its liquidity.

During the period under consideration, the weighted average price at auction placing was lower than the face value for medium-term securities and was mostly higher than the face value for “long” securities. The profitability slightly oscillated for the weighted average price, and for “long securities” placed in 2006, the weighted average price yield is lower than for shorter-term securities placed during the previous periods, which reflects the interest of investors to rouble instruments.

Long-term debt instruments are used by the state and investors to sterilize excess monetary stock.

The general indices of the securities market liquidity have also improved due to the restructuring of debt obligations in the portfolio of the Bank of Russia, by means of conversion of state treasury bills with fixed coupon into Federal Loan Bonds with depreciation of debt with the redemption terms of more than 5 years. Owing to a new public bond portfolio, the Bank of Russia intensified its operations at the open market through forward and backward REPO, as well as through placing a part of its securities portfolio under market conditions, using blocks of Federal Loan Bonds with depreciation of debt as a monetary control instrument, since those bonds are issued in large amounts and their yield is comparable to other securities.

Actual emission of all the types of public securities from early 2004 to early

2007 was 669.16 billion roubles, net attraction (actual increase of the principal debt) constituted 371.93 billion roubles. Federal budget expenditures for principal debt servicing expressed in securities (interest costs) were 135.75 billion roubles. Thus, 236.18 billion roubles were received by the federal budget in 2004-2006 for operations with rouble securities.

3. Federal budget expenditures for servicing the public internal debt in securities (interest costs) for 2004-2006 reached 137.75 billion roubles, obligations for the main debt were repaid for the amount of 294.41 billion roubles and 0.065 billion roubles were written off the main debt due to expiration of the limitation period. Net receipt of funds to the federal budget on operations with securities for 2004-2006 was 236.18 billion roubles.

4. In 2004-2006, the basic factor determining the amount of borrowings in the internal market was the implementation of the state policy aimed at replacing external borrowings by internal ones, segmentation of the government securities market and the increase of the market liquidity.

5. Qualitative criteria determining positive changes in the status of the public internal debt of the Russian Federation should include:

- reduction of the expenditures for managing the public debt based on reducing the profitability of debentures, optimization of their structure;
- termination of the short-term borrowing practice at the internal market;
- restructuring of debentures within the portfolio of the Bank of Russia, which allowed the Bank of Russia to use blocks of Federal Loan Bonds with depreciation of debts as an instrument of monetary control;
- systematic redemption of debt obligations to citizens of the Russian Federation.

6. Within the framework of the debt policy of the Government of the Russian Federation for 2003 – 2006, the state activity in the government securities market was based on:

- increasing the level of disclosure of information on the planned operations of government bond distribution;

- the practice of placing additional issues of Federal Loan Bonds aimed at increasing the supply of the circulating issues and creation of market benchmarks for medium- and short-term instruments;

- using auctions as the main way of attracting funds when placing government securities;

- introduction of operations with government securities at two market segments – a securities market for passive investors has appeared;

- extending the number of investors due to canceling restrictions for participation of non-residents in the trading;

- introducing an off-system transaction regime from the mid-2005 enabling the conclusion of address transactions during the main trading hours without preliminary 100 per cent deposit of funds and closing the off-system transactions on a day other than the day they were concluded.

7. Beside positive changes, the following negative factors are to be noted:

- with general reduction of non-market debt obligations, the obligations to the population reflected in the structure of the public internal debt have increased from 4.5% (special deposits and car checks) to 14.2% (target 1990 loan). Actually, these debts are being repaid for more than 15 years already, however, in spite of their insignificant amounts, they are the most delicate because they relate to a certain person. The amount of letters and claims to public authorities (Russian Ministry of Finance) is not reducing. A more open stance on cutting the obligations will help the Ministry of Finance of Russia to avoid expenditures for legal fees;

- a comparatively sharp increase in the amount of the state guarantees granted by the Russian Federation without recourse for the purposes of developing dwelling mortgage lending, small business and development of infrastructure in the regions have provided a possibility to start implementation of the projects significant for the economy without direct allocating budgetary funds. However, to reduce the risk of unreasonable use of the borrowed funds received against the state guarantees, the Government of the Russian Federation and the Ministry of Finance of Russia should more strictly meet the terms and conditions of granting guarantees determined by the provisions of the Budget Code in terms of tendering, recourse claim to the borrower,

and assessment of the borrower's financial situation;

- unified system of record and registration of public borrowings of the Russian Federation is not implemented in full, which does not allow us to deeply consider and confirm the interrelation of the internal debt growth and the external debt reduction;

- a unified, integral public debt management system has not been established yet, because the existing public debt management scheme by the Ministry of Finance of Russia through agents does not enable prompt transactions with the debt obligations. Moreover, operative debt management is obstructed by the problems in accounting the debt obligations, in reflecting such operations basing on the outcomes of the federal budget execution and on the draft federal law on the federal budget for the next fiscal year;

- there are still peak loads for the federal budget connected with payments of the internal debt of the Russian Federation converted into the government securities;

- the emission and placement of the government securities in the amounts exceeding the federal budget needs for payment connected with obligations assumed earlier, evidences that the issue of those debt instruments in a number of cases is not caused by the need of the budget in additional financing sources, but is caused by the necessity of settling the problems of the macro-economic and monetary policy, and above all, of binding the free liquidity;

- a special place is maintained for the public debt as regards savings of the citizens in the Sberbank of Russia and public insurance organizations, placed before 1992. Savings of citizens are recognized the public debt; however, they are not taken into account in the bulk of the public internal debt; in this case, the expenditures for compensation payments to the population do not reduce the debt. Such a situation requires its own legislative settlement;

- centralized emission of securities is used in the global practice as an instrument of public regulation of the economy influencing the monetary circulation and management of the money stock, as well as a tool of non-monetary coverage of the deficit of the federal and local budgets, and as the way of attracting monetary

funds of enterprises, organizations and the population in order to settle specific financial problems. However, the majority of population of the Russian Federation are not participants of the Open Securities Market.

8. The debt policy of the state for 2007-2009 will be based on the following priorities:

- development and segmentation of the market of government securities designed for different groups of investors. As the result, the structure of the public internal debt of the Russian Federation expressed in the government securities will change;

- the reduction of relative amount of the public debt will be maintained due to the lack of external borrowings and to the redemption (planned or early) of the public external debt; the nominal internal debt will increase;

- the yield for redemption of treasury bonds traded at the market, like in the previous years, will significantly depend on the current situation at the currency and monetary markets. However, the situation will remain where the yield level of the government bonds (index of the State Treasury Bill / Federal Loan Bond portfolio) will be lower than the current inflation. At the same time, real yield of the government bonds will tend to be growing;

- expenditures for the external debt servicing will tend to be reducing, while the expenditures for servicing the internal debt will be successively growing. The dynamics of the expenditures variation repeats the corresponding variation trends of the external and internal debt amounts. At the same time, the total budget load as regards the servicing of the public debt of the Russian Federation will reduce, which is determined by the interrelation of the GDP growth, aggregate expenditure of the federal budget, and the structure of debt obligations.

9. It is expedient to consider the following issues to make effective use of internal debt instruments, subject to both positive and negative experience of internal borrowings:

- to make amendments to the Budget Code of the Russian Federation connected

with the issues of managing the public debt as a whole and public internal debt in particular;

- to work out a new specialized law on the public debt;
- to work out regulatory documents making possible the assessment of the changes of the debt obligations as coordinated with financial assets;
- to develop criteria and mechanisms of assessing the efficiency of borrowing and debt policies.
- to develop the regulatory base for transactions with called (early redeemed) securities. For a better structuring of the debt obligations and the possibility of managing the federal budget assets, reuse of the government bonds called by the issuer;
- to consider the inclusion of a portion of the state's insurance expenses (fulfillment of guarantees granted without recourse) into the expenditures of the federal budget, which will allow the state not to exceed the borrowing limit for guarantee fulfillment set by the law on the federal budget;
- it is expedient to develop mechanisms and regulatory base for exchanging major blocks (lots) of bonds before their redemption date for other bond issues in order to smoothen the payment peaks – a considerable amount of payments on one date. Moreover, the exchange, like the auction placement, should be performed by the issuer on a voluntary basis under predetermined regulations.

The outcomes of the expert analysis of the internal public debt of the Russian Federation over the period of 2004 to 2006 were approved by a resolution of the Collegium of the Accounts Chamber of the Russian Federation dated February 16, 2007 (Minutes No. 7 K (525)). The materials have been forwarded to the State Duma and the Federal Assembly of the Russian Federation.