The Ministry of Finance of the Russian Federation

PUBLIC DEBT MANAGEMENT POLICY OF THE RUSSIAN FEDERATION FOR 2017–2019

2017

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Abbreviations

ACRA – Analytical Credit Rating Agency

AIIB – Asian Infrastructure Investment Bank

BOFZ – zero-coupon sovereign bonds of the Russian Federation

BSTDB – Black Sea Trade and Development Bank

DIA – Deposit Insurance Agency

EBRD – European Bank for Reconstruction and Development

EDB – Eurasian Development Bank

GSO – government savings bonds

IBEC – International Bank for Economic Cooperation

IBRD – International Bank for Reconstruction and Development

IFIs – international financial institutions

IIB – International Investment Bank

MDBs – multilateral development banks

NDB – New Development Bank

NSD – National Settlement Depository

OFZ – sovereign bonds of the Russian Federation

OFZ-AD – sovereign bonds of the Russian Federation with debt amortisation

OFZ-IN – inflation-linked sovereign bonds of the Russian Federation

OFZ-PD – sovereign bonds of the Russian Federation with a fixed coupon rate

OFZ-PK – sovereign bonds of the Russian Federation with a floating coupon rate linked to RUONIA

OVOZ – domestic bonds of the Russian Federation

REPO – a security sale transaction with the seller's obligation to buy it back at a specified price and time

RUONIA – Rouble Overnight Index Average, indicative overnight rouble deposit rate in the Russian interbank market

UEC – United Engine Corporation

Introduction

In 2013–2016, the Ministry of Finance of the Russian Federation faced new challenges in implementing the public debt management policy. Both internal and external conditions of government borrowing changed fundamentally. Economic slowdown brought about a significant decline in the federal budget's revenues and required the use of all available sources to cover its deficit. Foreign countries restricted trade and investment, blocking access to the international capital markets for many Russian corporate borrowers. These conditions and rising geopolitical tensions led to a significant rouble depreciation, inflation acceleration, lower prices for Russian assets, and loss of an investment grade credit rating by the country and local corporate issuers.

However, mostly because of the pre-crisis conservative budget policy, including the so-called budget rule and "borrow and save" strategy, the Government succeeded in cutting federal budget expenditure, accumulating considerable reserves and keeping Russia's public debt at a safe level. The strategy helped to restore confidence of business entities and adapt the national economy to the new reality. Budget system stability was secured and a low level of public debt retained, which is one of the key competitive advantages of Russia's economy.

In 2017–2019, the public debt management policy will be implemented in an environment significantly different from previous years. Relatively slow GDP growth is likely to remain over this period alongside structural constraints and, consequently, presents serious risks for the federal budget. In a relatively negative market environment, Russia will face the situation typical for sovereign borrowers: instead of using accumulated reserves, the federal budget deficit will be covered primarily by borrowing. As a consequence, the public debt management policy should reflect these new conditions, adjusting its debt capital markets issuance strategy, and a set of measures should be developed to keep the borrowing process flexible.

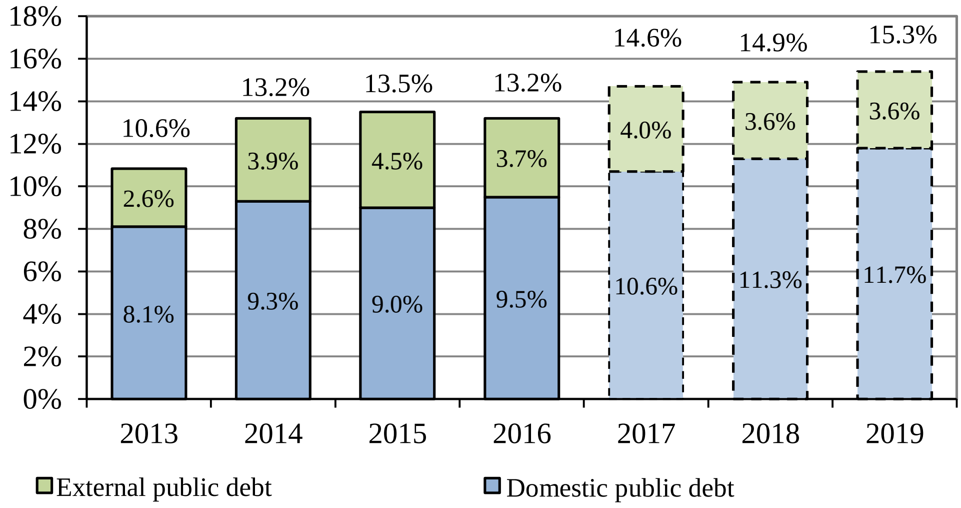
In addition to financing the federal budget by borrowing in the domestic and international capital markets, the debt policy is set to achieve the optimal combination between government bond duration and yields, develop the domestic debt capital market, restore and improve credit ratings, and establish adequate credit risk benchmarks for corporate borrowers. Constituent entities of the Russian Federation and municipalities will be encouraged to pursue a responsible debt management policy, the risk monitoring framework for international corporate borrowings will be refined, and the mechanism of state guarantees will become more adaptable to the needs of a growing economy and diversification of its structure.

1. Results of the Public Debt Management Policy of the Russian Federation for 2013–2016

1.1. Amount and structure of Russia's public debt

From 1 January 2013 to 31 December 2016, Russia's public debt increased from RUB 7.5 tn (10.6% of the GDP) to RUB 11.1 tn (13.2% of the GDP), growing annually by roughly 1.0% of GDP. Nevertheless, by the start of 2017 the country's national debt remained moderate by global standards, at below 15% of GDP (see Chart 1). For the current and projected government debt structure of the Russian Federation please refer to the Annex. Thanks to its modest public debt figures, Russia stands out from both developed and many developing economies (see Chart 2).

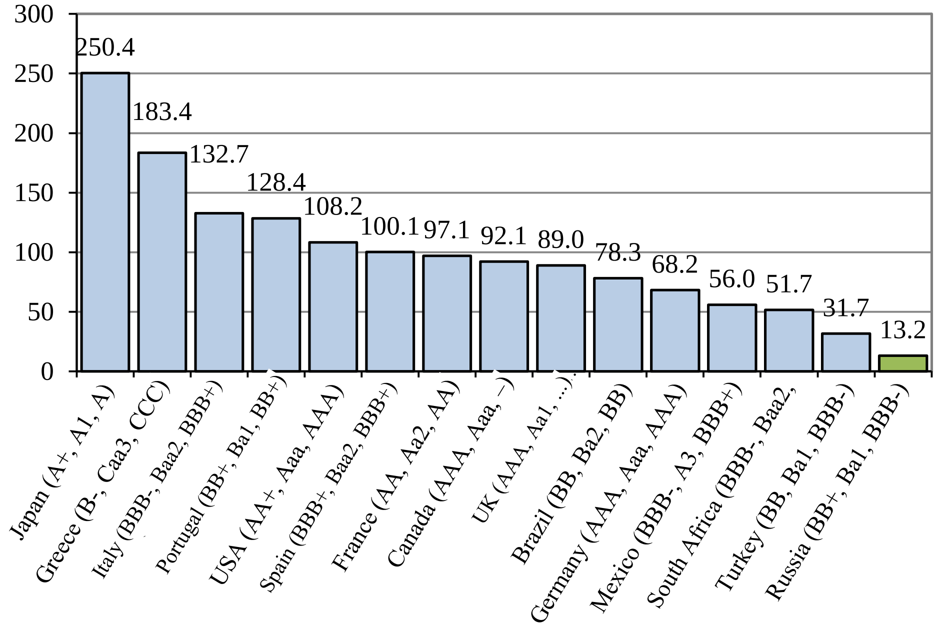
Chart 1. Public debt of the Russian Federation (as at the year-end), % of the GDP



Source: Ministry of Finance of the Russian Federation

Over the past few years the debt policy, including measures set to develop the domestic debt market, has greatly helped to stabilise Russia's public debt service costs. Over the planning period, debt service costs, although gradually increasing, are not expected to exceed 1% of GDP (see Chart 3) given a projected average growth rate for the national debt of 0.6% of GDP (see Chart 1), which is lower than the projected average annual growth rate for the economy of 1.5% of GDP.

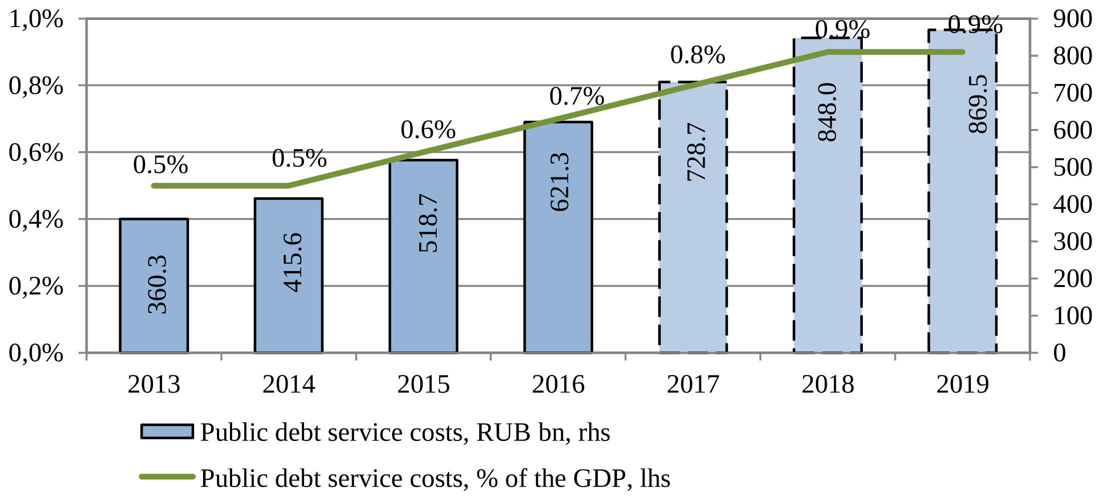
Chart 2. Debt burden and credit ratings of selected countries[1], % of the GDP



Source: IMF, Ministry of Finance of the Russian Federation, as at 2016 year-end

Russia is also unlike many other sovereign debtors that use foreign currency bank loans, including short-term ones. The country's debt mostly consists of securities (around 75%), with the majority of sovereign obligations denominated in roubles (71%).

Chart 3. Public debt service costs of the Russian Federation



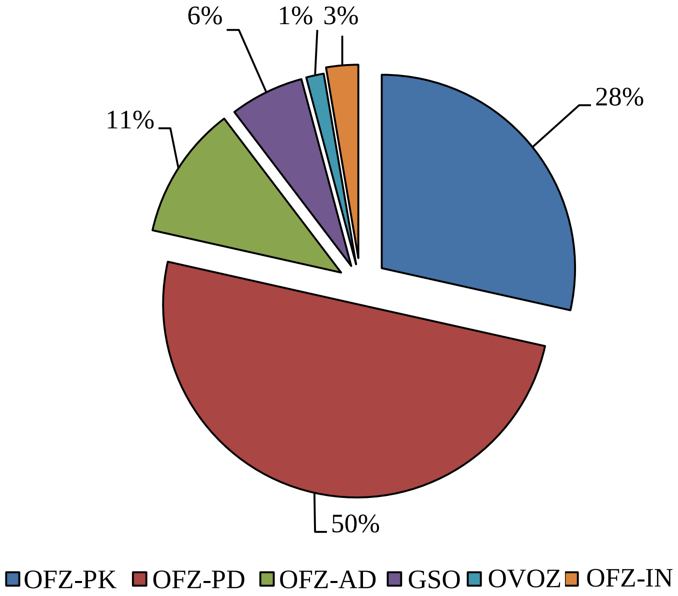
Source: Ministry of Finance of the Russian Federation

[1] The countries' credit ratings presented as follows: Standard & Poor's, Moody's, Fitch Ratings

Refinancing risk is at an acceptable level, since debt securities include 46% medium-term (4 to 10 years) and 26% long-term (10+ years) bonds; the share of relatively short-term (up to 3 years) bonds is 28%, of which 9.2% of the obligations (RUB 707.3 bn) mature in 2017.

50% of the RUB-denominated government securities portfolio are standard federal loan bonds with fixed coupons and bullet repayments (OFZ-PD). Another major category of public domestic debt (28%) is represented by OFZ-PK. The role of other debt securities – GSO, OFZ-AD, OFZ-IN, OVOZ – is relatively modest (see Chart 4).

Chart 4. Domestic public debt structure by type of debt securities, %



Source: Ministry of Finance of the Russian Federation, as at 2016 year-end

In 2013–2016, the debt policy was focused, among other matters, on such key areas as maintaining a moderate debt burden on the federal budget and economy in general, curbing growth of public debt service costs, and ensuring compliance with relevant indicators set by the Public Finance Management and Financial Market Regulation government programme. As shown in Table 1, at the end of each reporting period all common debt sustainability indicators of the Russian Federation were in a safe range.

Table 1. Debt sustainability indicators of the Russian Federation, %

No.	Indicator	2013	2014	2015	2016	2017	2018	2019	Threshold
1	Public debt of the Russian Federation to GDP	10.6	13.2	13.5	13.2	14.6[1]/ 14.7[2]	14.9[1]/ 15.2[2]	15.3[1]/ 15.7[2]	**20.0**
2	Russian Federation public debt service costs as a percentage of total federal budget expenditure	2.7	2.8	3.3	3.8	4.5	5.3	5.4	**10.0**
3	Annual amount of repayment and service of the public debt of the Russian Federation as a percentage of total federal budget revenue	6.8	5.6	10.6	9.2	11.5	11.9	11.6	**15.0**
4	Public debt of the Russian Federation as a percentage of federal budget revenue	58.0	71.0	80.2	82.5	94.0[1]/ 94.9[2]	98.2[1]/ 99.8[2]	101.9[1]/ 104.2[2]	**100.0**
5	Public external debt of the Russian Federation as a percentage of annual exports of goods and services	9.7	14.2	15.2	18.4	18.0[1]/ 18.3[2]	17.0[1]/ 17.6[2]	16.5[1]/ 17.5[2]	**220.0**
6	Service costs of public external debt of the Russian Federation as a percentage of annual exports of goods and services	0.4	0.5	0.7	0.9	0.9	1.2	0.8	**25.0**

Source: Ministry of Finance of the Russian Federation

1.2. Financial instruments and public borrowing mechanisms

In 2013–2015, a series of important initiatives were implemented aimed at liberalising the Russian debt market, modernising its infrastructure, and improving mechanisms for information provision, in particular relating to OFZ auctions. In addition, this period saw the introduction of major reforms

[1] Based on the assumption of Russian state guarantee programmes in roubles and foreign currency 70% and 20%, respectively, completed.
[2] Estimate of the Ministry of Finance of the Russian Federation

in the debt market infrastructure to make government securities more attractive and enhance their role as a key yield benchmark for other Russian borrowers. These reforms included the following.

1) Foreign investors were granted direct access to the Russian government securities market through accounts in the international Euroclear and Clearstream depositary clearing systems. Since February 2013, both systems have provided OFZ transactions settlement.

2) Secondary OFZ trading on the Moscow Exchange was switched to T+1. In March 2015, T+0 and T+2 settlement were replaced with T+1 settlement for secondary OFZ trading on the Moscow Exchange. This helped cut investors' transaction costs in the public debt market and increase trading volumes thanks to replacing the full security requirement with the partial security requirement. T+0 settlement will continue for OFZ auctions.

3) The Moscow Exchange abolished the practice of suspending the Russian external bond trading during coupon payment periods, thus increasing the number of Eurobond trading sessions.

4) The Moscow Exchange launched OFZ "Dark Pool" trading. Since June 2015, the Exchange has used a new mechanism for OFZ block trading (50,000 bonds in one lot) at market prices with T+1 settlement. This mechanism prevents OFZ block trading from having a major impact on the market price and for large orders to be filled as quickly as possible.

5) In July 2015, the Moscow Exchange launched the OFZ Market Making programme with T+1 settlement in the main market section of the MICEX Stock Exchange in order to increase OFZ trading liquidity. Programme participants commit to a minimum intraday value and to supporting quotes. The programme has become one of the drivers of demand for government securities.

The reforms helped boost the attractiveness of the domestic debt market vs foreign ones while increasing foreign investor participation, particularly institutional investors, to improve the foreign investor base structure, while maintaining the competitive positions and leading role of Russian participants of the government securities market. In addition transaction costs were materially reduced, and the domestic market benefited from higher capacity and better liquidity.

Along with the market infrastructure modernisation, the reporting period saw the following steps taken to improve the mechanism of sales and information provision for OFZ auctions.

1) From April 2013, the Russian Ministry of Finance switched to publishing auction schedules for the next quarter without specifying OFZ issue numbers and placement volumes planned for specific dates, but only providing information on the total OFZ offering size and breakdown by maturity. These changes helped to take investor and market participants' opinions into account more precisely.

2) The practice of publishing price guidance for OFZ bonds offered at auctions was abolished. From 2014, in accordance with the new procedure and in order to enhance competition among bidders and decrease volatility in the secondary market before the auction, information on bond issues and offering sizes is now published one day before the auction.

3) The procedure for submitting and filling competitive and non-competitive orders at OFZ auctions was changed. From January 2014, the maximum share of non-competitive orders was increased from 25% to 90%. From July 2014, competitive orders have higher priority than non-competitive orders.

In general, these changes resulted in a more flexible auction policy and higher-quality OFZ pricing in the primary market.

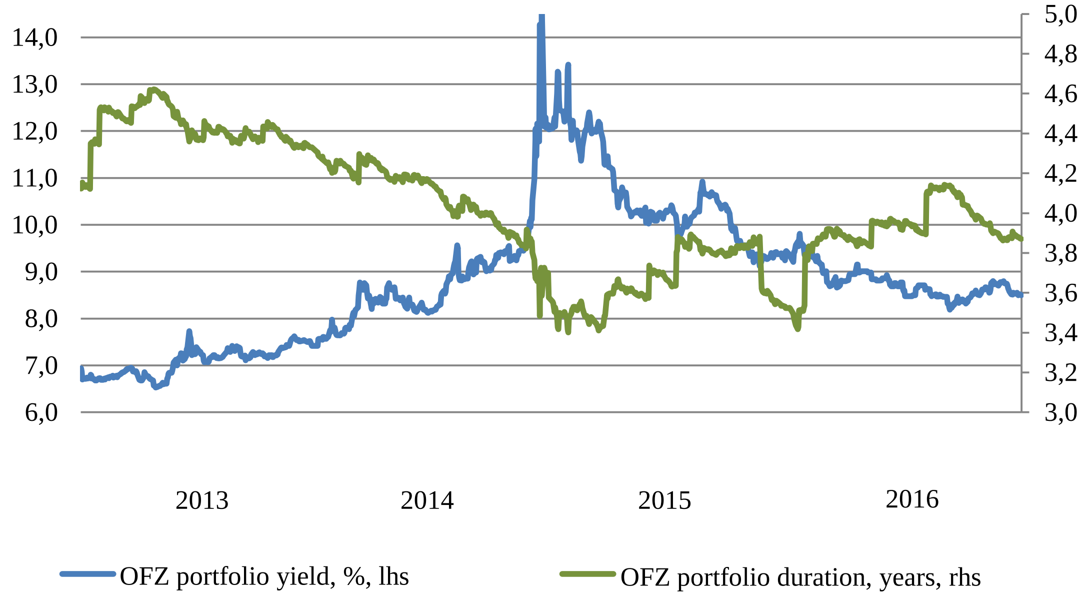
In 2015, as part of managing funds kept in a single federal budget account, the Federal Treasury started carrying out REPO transactions secured by OFZs, mostly for a one-day period. Given that the Bank of Russia, also starting in 2015, nearly abandoned such short-term refinancing operations, the said REPO transactions of the Federal Treasury have become a key element of the debt market, adding a new instrument to the range of OFZ bonds.

Development of the domestic debt market was an important factor in the overall successful implementation of Russia's domestic public borrowing programmes. In 2013, the country's proceeds from domestic borrowing set a new record in its recent history: RUB 821.7 bn, or approximately 92% of the total size of the relevant programme. Moreover, the funds were raised on much better terms than in the previous years, with 2013 government bond yields dropping by 90 bps (to 6.9% from 7.8% in 2012) and their average duration increasing by 0.6 years (to 5.8 years from 5.2 years). Consequently, total duration of the OFZ portfolio was extended to 4.3 years, while its yield decreased by 0.5 pp to 7.4% per annum.

However, the situation changed dramatically in 2014. OFZ bonds were placed domestically under much more challenging geopolitical and economic conditions. This period was characterised by lower demand for government bonds, higher yields and shorter OFZ portfolio duration. Some foreign participants left the market. As at end-2014, the OFZ portfolio duration decreased to 3.6 years, down by 0.7 year compared to the beginning of the year, while its yield grew by 460 bps to 12.0%, at some points going as high as 14.3% (see Chart 5). The programme for 2014 was significantly reduced: from RUB 808.7 bn to RUB 459.7 bn (excluding RUB 200.0 bn for the non-cash exchange of illiquid OFZ issues). The Ministry of Finance only entered the market at most favourable periods, sometimes deciding to reduce auction offerings or cancel them altogether. The actual amount raised in the domestic market in 2014 was RUB 348.9 bn, or 76.1% of the planned (reduced) target.

At the same time, some of the 2014 borrowings were unique in Russia's recent history. For the first time, the country saw a private OFZ-PK offering for RUB 1,000.0 bn to provide asset contribution to the DIA. As a result, the total amount of 2014 government securities placed in the domestic market reached RUB 1,348.9 bn at face value. In addition to the above, the following securities were offered: OFZ-PD (auction placements, RUB 145.7 bn), BOFZ (private placement as part of liquidity management operations related to infrastructure projects financing through the National Wealth Fund, RUB 103.6 bn), and GSO bonds (private placement to invest pension savings, RUB 100.0 bn).

Chart 5. OFZ portfolio yield and duration in 2013–2016



Source: Bank of Russia

Therefore, in 2014 OFZ bonds were piloted as an instrument to support the banking sector under the Russian Government's anti-crisis plan. In December, the Ministry of Finance issued 5 series of **OFZ-PK** bonds maturing in 10 to 20 years with a total nominal value of RUB 2 tn. For the first time these Russian instruments had their coupon rates linked to RUONIA, one of the key money market indicators. Bonds totalling a nominal amount of RUB 1 tn (RUB 200 bn from each series) were transferred by the Ministry of Finance as an asset contribution of the Russian Federation to the DIA. The remaining bonds (nominal amount of RUB 1 tn) were set aside for further placement among a wide range of investors at regular auctions to provide liquidity for the outstanding issues.

Focusing on the instruments' key feature – lower price volatility as compared to fixed income bonds and the resulting lower interest rate risk– paid off in full. In 2015, the Ministry of Finance increased the offering at auctions of OFZ-PK bonds maturing in 3, 5 and 10 years. The outcome resulted in high demand for these instruments. At some auctions, orders significantly exceeded the offering. Therefore, in 1H 2015 62% of the funds (RUB 221.6 bn) were sourced through OFZ-PK placement, resulting in 48.3% completion (RUB 338.4 bn) of the domestic borrowing programme for 2015.

In July 2015, the Ministry of Finance offered another new instrument to the market – bonds with a nominal value set in line with Russia's consumer price index (**OFZ-IN**). These securities enabled investors to insure against risks of dramatic changes in the inflation rate, had less price volatility than OFZ bonds with a fixed coupon, provided an opportunity for both diversifying investment portfolios and, given the high correlation between the inflation rate and the rouble exchange rate, mitigating currency risks for non-resident investors.

The Ministry of Finance's assumptions were confirmed in full. The introduction of OFZ-IN sparked great interest amongst investors. The first placement was 2.6 times oversubscribed. The overall demand at book closing was RUB 198 bn, from a total of 71 Russian and international investors. The issue was mainly placed among banks and asset managers. An additional driver behind the participation of investors from the US, UK, Continental Europe and Asia was OFZ-IN bonds were included in the indices[1] tracked by international index funds. About 17% of the issue (RUB 18.3 bn) was purchased by investors over-the-counter, via Euroclear and Clearstream. Settlements for the major part of the issue were made at the Moscow Exchange.

The Ministry of Finance allocated the bonds based on the need to address a number of issues at the same time:

1) Meeting significant demand from non-resident investors was a priority. Despite the challenging geopolitical situation, Russia's new government bonds, issued under Russian law and denominated in the national currency, saw significant demand from leading international investors. Non-resident bids were intentionally accepted at a higher rate than those from domestic bidders. At the close of the book non-residents accounted for 26%. The major outcome of the issue was confirmation of Russia's access to the international capital markets.

2) Attracting a new type of national investor – pension fund managers – to the government bond market. Before the instrument was offered, Russian pension funds and asset managers represented a very minor part of the market. The OFZ-IN issue provided this type of investor with conditions for investing in a financial instrument largely meeting the objectives of pension management, i.e. ensuring a rate of ROI higher than that of inflation. As a result, 31 pension funds

[1] In February 2015, OFZ-IN bonds were included in Barclays's Emerging Markets Government Inflation-Linked Bond Index (EMGILB)

and management companies invested in the first issue of OFZ-IN bonds. Their share in the allocation was 59%. Russian bidders (18 investors) accounted for 33% of the funds invested by pension fund managers.

3) Ensuring liquidity of the new issue required allocation of a significant part of the issue (41%) amongst Russian banks. A focus on pension funds and asset managers alone would not have supported active trading in the new bonds on the secondary market. It was also expected that a considerable backlog of demand for OFZ-IN bonds after the allocation would support the liquidity of the new issue.

The successful placement of the bonds was a very important event for the Russian debt market. It was the first issue of bonds fully protecting investments against inflation, i.e. ensuring that investors would have a positive fixed income in the long term. In addition, it was the largest-ever single placement not only on the OFZ market but on the Russian debt market as a whole. Another new feature of the issue was selling the bonds via the book building procedure (different from traditional auctions) typical of the Eurobond market, with the book opened for 36 hours for maximum coverage of investors all over the world.

As the OFZ-IN became not just another issue but a new type of debt instruments in the Russian market, they were offered with a so-called “issue premium” (a discount to the price). Investors’ interest in the bonds provided grounds to expect growth in the OFZ-IN price going forward, just as had been the case with OFZ-PK bonds. For this reason there was a deliberate decision to offer 50%, not 100%, of the issue. By the end of 2015, the remaining securities were almost completely sold out at the Ministry of Finance’s regular auctions.

At the same time with the new-type issues, the Ministry of Finance continued its efforts to improve the liquidity of the government bond market by increasing the volume of OFZ issues outstanding, and exchanging non-liquid and non-standard bonds for new securities. This activity was structured as follows.

1) The size of outstanding standard issues of OFZ-PD bonds was increased from RUB 150 to 250 bn. This measure was aimed at offsetting the negative impact of one issue’s average maturity reduction, which resulted in a need either to boost the number of issues on offer (which, in turn, may result in the “dilution” of liquidity), or to increase the amount of each particular issue. It was eventually decided to pursue the latter option. This decision met the following objectives: it boosted the liquidity of “standard” (benchmark) issues, improved the pricing efficiency at bond sales and was representative of the yield curve, and brought about higher demand from investors prone to invest funds relying on global bond indices.

2) There was a transition to using active government debt management operations. As part of the programme to boost the liquidity of listed securities, in 2015 the Ministry of Finance exchanged six issues of amortising sovereign bonds, with a total nominal value of RUB 199.97 bn, for five issues of sovereign bonds with a fixed coupon, with a total nominal value of RUB 156.3 bn. The Russian Federation's obligations under four of the issues were deemed met in full, and the issues were recognized as redeemed early, on 31 August 2015. The Russian Federation's obligations under two of the issues were deemed met in the amount of RUB 29.98 bn and RUB 39.99 bn, respectively. The listed issues were reduced by those amounts.

On the whole, following the exchange, Russia's domestic sovereign debt decreased by RUB 43.6 bn. The maximum single-owner holding any issue of Russia's listed sovereign securities decreased from 100% to 12%. As a result, these measures also supported increased liquidity of the Government's securities.

Compared to the successful performance under the domestic borrowing programme in 2013–2015, the results of the external borrowing turned out to be more modest. Only the programme for 2013 was completed in full with a single bond offering of USD 7.0 bn. The book was built within 24 hours without a need for a road show. A debut euro-denominated Eurobond issue, along with three USD tranches, were issued, helping to develop a representative yield curve in various currencies. The issue consisted of three USD bond tranches totalling USD 6.0 bn and one tranche of EUR 750.0 m.

In 2014–2015, Russia refrained from tapping the international debt market as a sovereign borrower. The following adverse factors were taken into account: a fall in the oil price and considerable weakening of the rouble compared to foreign currencies; a slowdown in economic growth and a surge in inflation; Russia's sovereign credit ratings were cut to "junk" with a negative outlook by two of the three international credit rating agencies (Standard & Poor's and Moody's); overall reduction in demand for Russian assets from international investors due to increasing geopolitical tensions; a start of the gradual tapering of the QE programme in the US, and; expectations of a tighter monetary policy by the Fed, all in all bringing about a general fall in the demand for EM sovereign Eurobonds.

However, Russia has always been engaged in an ongoing dialogue with the international investment community. Regular meetings were held with market participants in the UK, US, Switzerland, and Hong Kong. As a result of these meetings, international investors had an opportunity to keep up-to-date with the economic situation in Russia, and Russia's budget policy and sovereign debt status.

Consequently, the objectives of the Public Debt Management Policy of the Russian Federation for 2013–2015, in particular maintaining a moderate debt burden and turning the domestic capital market into a stable source for covering budgetary needs, can be considered to have been met on the whole. There are good reasons to believe that over the recent years the Russian sovereign securities market has become much more integrated into the international capital market. A new type of long-term international investor from the largest investment companies, sovereign and pension funds entered the market of sovereign bonds and consolidated their positions, the market saw a boost in the liquidity of outstanding sovereign securities, and the OFZ yield curve became a sound pricing benchmark for debt instruments issued by the Russian Federation's regional, municipal and corporate borrowers.

1.3. Implementation of 2016 borrowing programmes

In contrast to the preceding two years, when Russia's net borrowing remained negative, 2016 saw public borrowing emerge as one of the key financing sources to cover the federal budget deficit. Net borrowing totalled RUB 606.6 bn (including RUB 500.0 bn and RUB 106.6 bn in domestic and external borrowing respectively). This effectively meant that capital markets helped cover one fifth of Russia's total budget deficit.

Rising oil prices, a stronger rouble, decelerating inflation, and ample liquidity available in the Russian banking sector were among the key drivers the Bank of Russia relied on to introduce two reductions in its key interest rate, slashing it by a total of 100 bps. The positive developments also resulted in strong demand for OFZs (including from non-residents) throughout 2016. As a result, by December 2016, OFZ yields were down across the curve, going back to their pre-crisis levels of around 8.5% per annum. Given the improved market environment, Russia increased its gross domestic borrowing by RUB 200 bn to a total of RUB 1,000 bn, a record high since 2012. The borrowing programme was especially successful in Q4 2016, with the Ministry of Finance raising as much as 21% of the financing under the expanded 2016 borrowing programme in just 1.5 months.

Overall, the terms and conditions of the new debt raised in 2016 were much more favourable than those seen in previous years. An average auction day brought in almost RUB 22.0 bn worth of new bonds, compared to RUB 15.4 bn in 2015 (OFZ bonds issued in 2016 had an average yield of **8.7%** vs **10.0%** in 2015). Average duration of new bonds increased by 0.4 year compared to 2015: from 5.1 to 5.5 years. Consequently, total duration of the OFZ portfolio was extended by 0.4 year to 3.9 years, while its yield decreased by 1.0 pp to 8.5% per annum.

In 2016, fixed income OFZ (OFZ-PD) bonds re-emerged as the key financing instrument. Compared to 2015, their share increased by 27 pp to 60%[1], while the share of long-term OFZ-PD bonds was increased by 18 pp to 30%[2].

Despite the challenging geopolitical backdrop, the share of non-residents in the OFZ market saw no reduction, remaining at a stable level of no less than 25%. As at end-2016, international investors held approximately RUB 1.45 tn in nominal value of Russia's sovereign bonds.

In 2016, the Ministry of Finance continued its programme to exchange illiquid (non-standard) OFZs for standard marketable bonds in an attempt to boost public debt liquidity in the secondary market. OFZ-AD bonds with an aggregate nominal value of RUB 63.7 bn were exchanged for RUB 56.4 bn in aggregate nominal value of OFZ-PD. The exchange was done as an auction, a new tool introduced into the programme in 2016 as a way for the Ministry of Finance to set the final exchange parameters via a competitive procedure. Russia's obligations under the OFZ-AD issues were deemed duly discharged, and the outstanding bonds were reduced by the respective amounts. The exchange programme helped eliminate RUB 7.4 bn of Russia's domestic public debt.

Combined, the bond exchange transactions effected by the Ministry of Finance in 2015 and 2016 delivered a total of RUB 264.0 bn reduction in the nominal value of Russia's outstanding illiquid OFZ bonds. Still, OFZ issues with low liquidity continue to make up a considerable part of the OFZ portfolio: estimated at around RUB 680 bn in nominal value, they account for as much as 17% of the OFZ market at large – and this excludes the OFZ transferred by the Ministry of Finance as an asset contribution to the DIA.

The year 2016 was also marked by a number of milestones in new public debt raised abroad. Following a two-year hiatus, Russia re-entered bond markets with a successful offering of USD 1.75 bn and a subsequent tap of USD 1.25 bn of 10-year Eurobonds maturing in 2026 and yielding 4.75% and 3.90%, respectively. The new debt was priced considerably below the levels seen in 2013, when the sanctions against Russia were first imposed[3], and was offered on standard terms: governed by English law, the Eurobonds were listed on the Irish Stock Exchange and structured as both Rule 144A and Regulation S offerings to target US and European investors, respectively.

The books for the two transactions were well oversubscribed (2x and 6x, respectively) as investors across the board generated a strong demand for Russian exposure. Most of the first tranche (around 75%) was distributed to investors from the UK, France and Switzerland, as well as Asia and the US.

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[1] OFZ-PK (floating coupon rate): 39%; OFZ-IN: 1%
[2] Medium-term OFZ (up to 10 years) had a share of 70.0%
[3] In September 2013, Russia priced its USD-denominated Eurobonds at 5.11% per annum.

Russian banks, asset managers and brokers accounted for just 25%. The second tranche was limited to international investors, with demand from the US, Europe, and Asia making up 53%, 43% and 4%, respectively. The key purchasers of both tranches included asset managers, various investment funds, and banks, which combined took up more than 80% of the offering.

An important feature was that neither of the two deals involved any foreign banks to help arrange and manage the offering – currently a standard condition for Eurobond deals. In addition, the Russian government chose not to engage a fiscal agent from abroad to fill the role usually assigned to a major global bank. For the first time ever, Russia sold Eurobonds in a deal that relied solely on domestic debt market infrastructure. VTB Capital acted as the lead manager and the National Settlement Depository (NSD) in its capacity as the central depositary was appointed registrar and fiscal agent.

The success of the offering showed that deals in the international debt market are perfectly capable of bringing the issuer and its investors together directly– with no traditional financial intermediaries involved. The new bond offering structure was a strong contributor to market positions and reputation of the Russian financial sector. In November 2016, the new Eurobonds were included in J.P. Morgan's EMBI (Emerging Markets Bond Index), once again proving the excellent quality of the transaction.

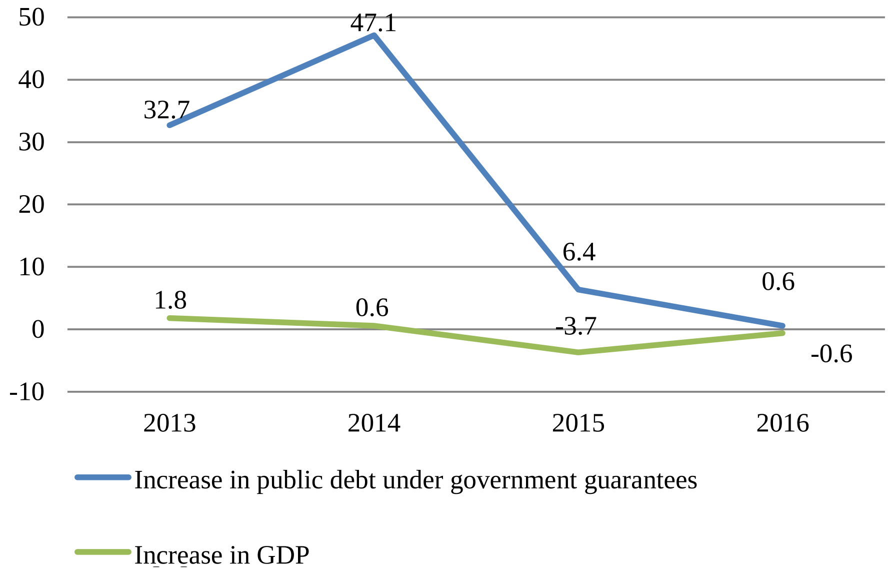
1.4. Guarantee support in 2013–2016

The period saw the continued trend of government guarantees being used to tackle matters of social and economic development. In total, the government issued around ten types of guarantees. Despite the decrease in the growth rate of public debt with government guarantees, it was still much higher compared to GDP growth (see Chart 6).

Over the period, public debt with government guarantees increased due to the guarantee volume growth outpacing the expiry and retirement of the respective obligations. The risk of having to execute these guarantees put increasingly high debt pressure on Russia's federal budget (see Chart 7).

In spite of this pressure, however, none of Russia's annual guarantee programmes were fully implemented in that period under the federal laws on the federal budget for the relevant years. The actual volume of RUB-denominated government guarantees was around 66% of that planned for the period (see Chart 8), while the share of executed guarantees in foreign currencies was just 16%.

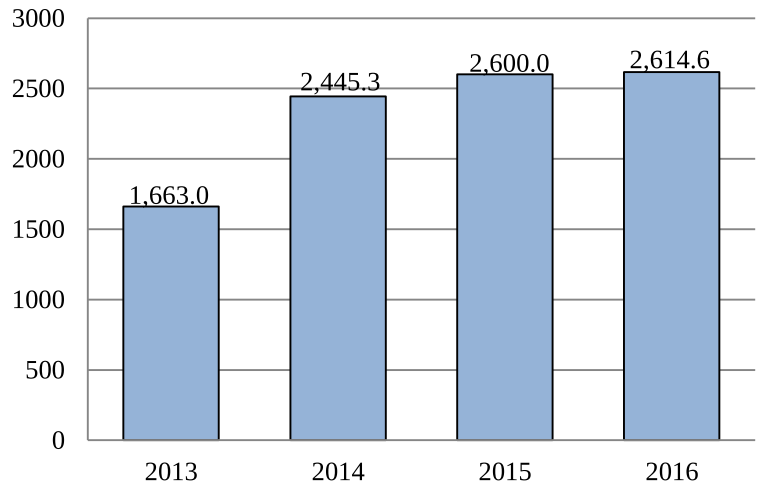
Chart 6. Annual increase in public debt with government guarantees and GDP, %



Source: Ministry of Finance of the Russian Federation

Over the period, the limits for almost all types of guarantees set out in the federal budget law were much higher than the actual volume of issued guarantees, which shows the inflated nature of guarantee projections by the federal executive authorities. Meanwhile, these are the projections the Ministry of Finance uses to develop Russia's government guarantee programmes.

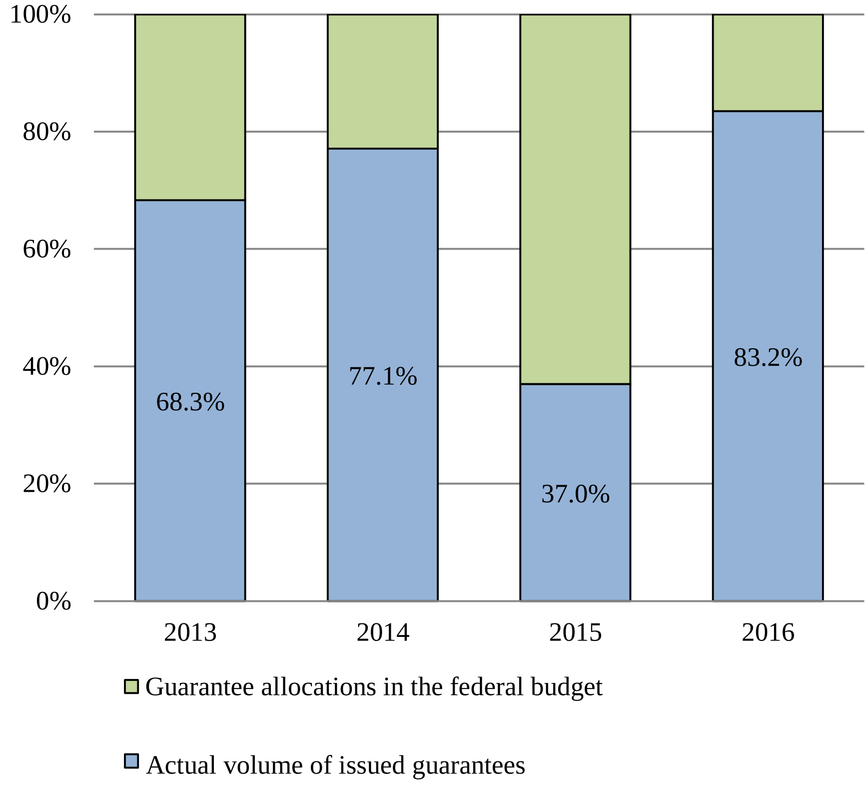
Chart 7. Evolution of Russia's public debt with government guarantees (as at year-end), RUB bn



Source: Ministry of Finance of the Russian Federation

Charts 9 and 10 demonstrate the structure of the government guarantee portfolio for the reporting period, denominated in roubles and foreign currency, respectively. Anti-crisis contingent obligations accounted for over half of the government guarantees.

Chart 8. Actual volume of RUB-denominated guarantees as part of total guarantee allocations in the federal budget, %

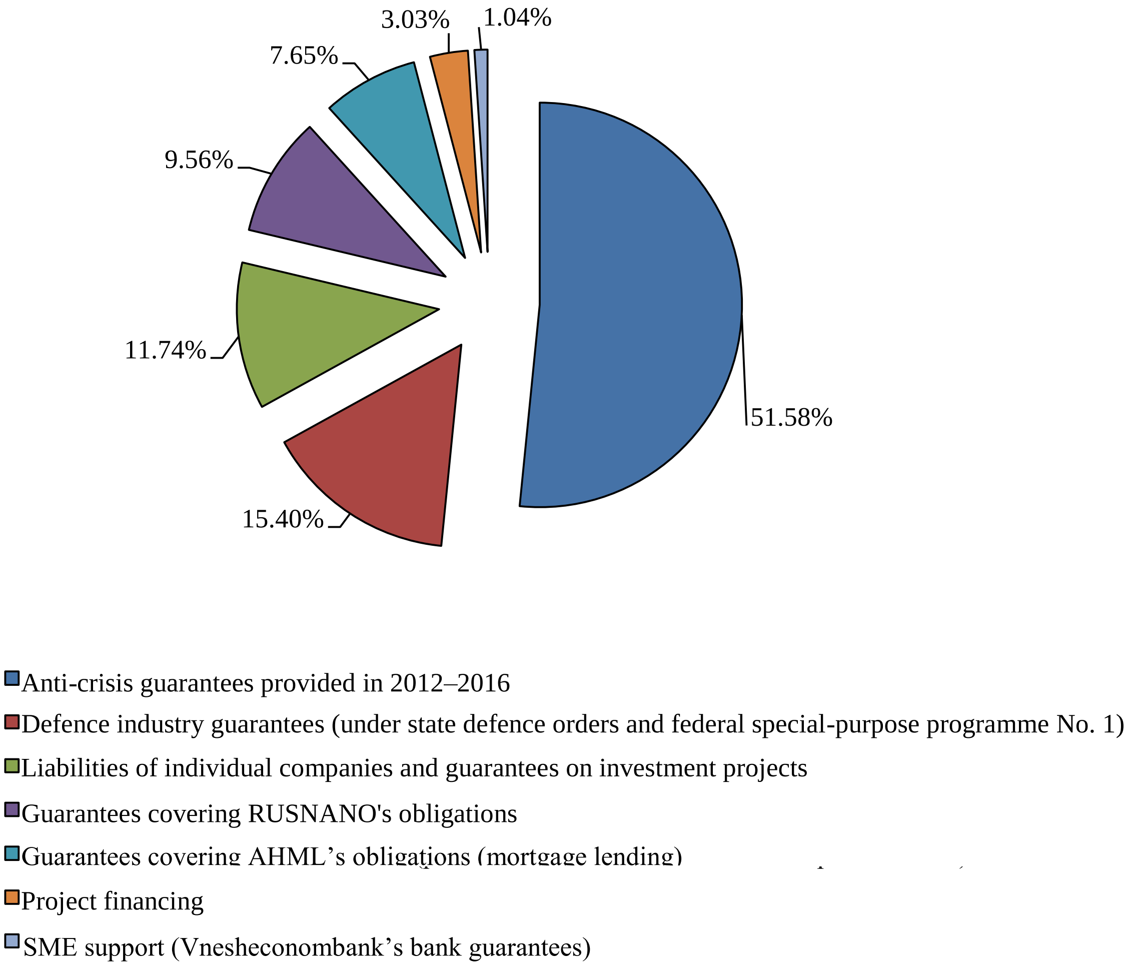


Source: Ministry of Finance of the Russian Federation

Other heavily-guaranteed areas are the defence industry (over 15% of the portfolio), individual companies and investment projects (almost 12%), and RUSNANO (almost 10%). Government guarantees in foreign currency were for the most part focused on exports of Russia's high tech products (over 96% of the portfolio).

In 2013–2016, borrowers ("principals" or "principal enterprises") independently fulfilled the majority of obligations that were covered by government guarantees and matured in this period. During that time, the Ministry of Finance received claims to execute ten government guarantees for a total of RUB 4.3 bn (less than 1% of the issued guarantees).

Chart 9. The structure of RUB-denominated government guarantee portfolio of Russia, %

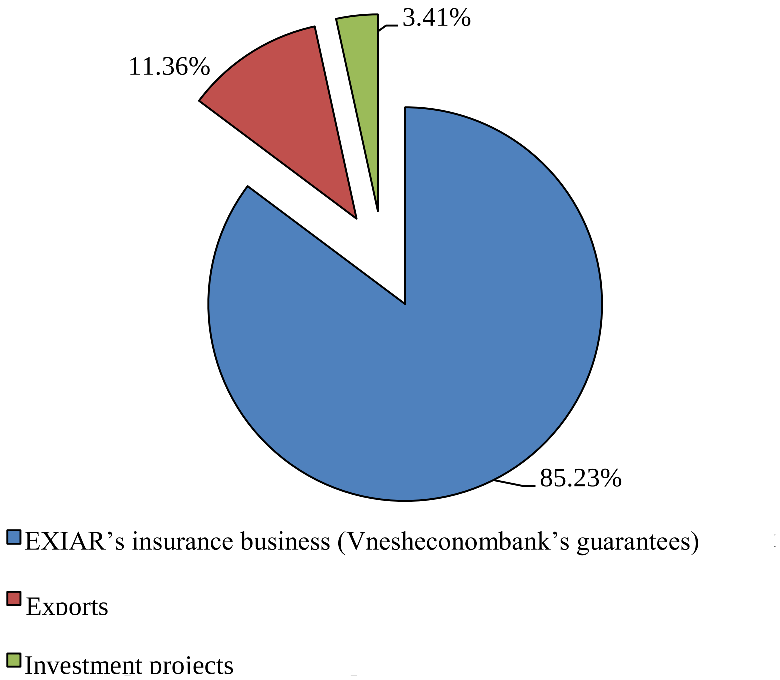


Source: Ministry of Finance of the Russian Federation, as at 2016 year-end

The Ministry of Finance has paid out a total of RUB 2.9 bn (this amount includes the claims received in 2012) to beneficiary banks under ten government guarantees provided in 2009–2010 as part of anti-crisis support. Of this amount, RUB 0.9 bn went to Sberbank of Russia under two guarantees, and RUB 2.0 bn to Russian Agricultural Bank under eight guarantees.

By the start of 2017, the actual number of RUB-denominated government guarantees issued by Russia stood at 287 (RUB 1.9 tn), and the country's foreign currency support included 10 guarantees for a total of USD 11.7 bn and 1 guarantee for EUR 0.16 m. This puts the total amount of public debt with state guarantees at RUB 2.62 tn. Government guarantees therefore account for over 23% of Russia's public debt.

Chart 10. The portfolio structure of Russian government guaranties in foreign currency, %



Source: Ministry of Finance of the Russian Federation, as at 2016 year-end

2. Key factors determining the nature and priorities of the debt management policy of the Russian Federation for 2017–2019

In the upcoming period, several factors will work together shaping the public debt landscape.

2.1. Macroeconomic and external conditions of debt policy implementation

The upcoming period of 2017–2019 is associated with considerable macroeconomic uncertainty and significant risks for the national economy. If materialised, they could result in a shortfall of federal budget revenues, fewer sources to finance the federal budget deficit, as well as new initiatives to increase government spending.

According to the Budget Management Policy for 2017–2019, the development of the national economy will be significantly affected by such external factors as slow recovery of the global economy, weak external demand and depressed (traditional Russian) commodity markets. The accumulated structural imbalances could manifest themselves in emerging markets, including Russia, exacerbating ongoing pressures on global GDP growth.

Along with relatively unfavourable external conditions, the Russian economy continues to be battered by unresolved country-specific issues. These include poor economic diversification, challenging demographic trends, a shrinking proportion of working age population and a growing proportion of the elderly population, low (relative to GDP) level and quality of investments, considerable structural deficit of the federal budget on the back of high government spending as a percentage of GDP, inefficient budget spending structure as a demand stimulation tool, low efficiency of state-owned companies and high regulated tariffs of natural monopolies. Such internal conditions will, to a large extent, inhibit Russia’s economic recovery. These challenges make structural economic transformation vital.

Oil price performance will remain one of the key risks for the Russian economy over this period. Given global demand and supply trends, oil prices over this period are expected to fluctuate between USD 40 and USD 60 per barrel.

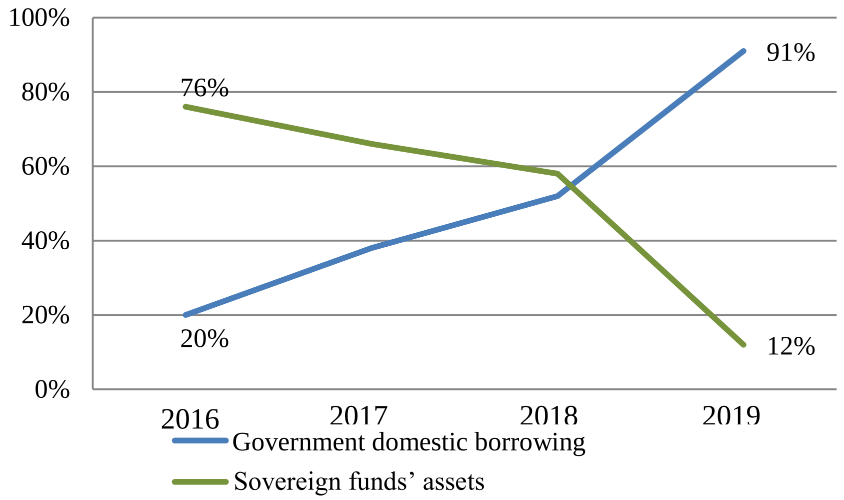
On top of that, geopolitical tensions remain a significant risk inhibiting access of systemically important Russian companies to global debt capital markets. The threat of escalation of these tensions has an adverse impact on business and consumer activity.

Another factor adversely affecting the level of demand in the domestic debt market is the decision to “freeze” the funded portion of the state pensions until 2019. This element of the pension system is essentially a natural source of long-term money, the availability of which is among the key prerequisites for debt market stability in any country.

The key enablers of a sustainable federal budget in the upcoming period are initiatives to reduce the federal budget deficit by 1 pp per annum and re-instatement of the “budget rule” setting forth a special procedure for distributing oil and gas revenues and seeking to mitigate the adverse impact of the volatility of surplus revenues. As is known, the rule was suspended in 2016 due to the need to adjust the federal budget to the changed external and internal conditions. At the same time, the Budget Management Policy for 2017–2019 states that the revised version of the “budget rule” will curb federal spending, if oil prices grow above a projected level, and will ensure debt sustainability, if federal revenues drop as a result of falling oil prices.

The stringent monetary policy pursued by the Bank of Russia over recent years was useful in bringing inflation down from ca. 17% in early 2015 to 5.4% in late 2016. Continued efforts in this area will ensure that the strategic goal of reaching 4% inflation will be achieved by the end of 2017. The upcoming period is expected to see the banking system evolve from having a structural liquidity deficit (chronic shortage of money in the economy and the need for Bank of Russia loans to commercial banks on an ongoing basis) to a structural surplus (no outstanding debts to the lender of last resort). The surplus of disposable resources and the obligation of the banks to comply with the short-term liquidity requirements will drive demand for high quality, low risk financial assets. These factors will be key to shaping sustainable demand for government securities and are expected to be instrumental in creating appropriate conditions for raising the resources required for federal budget purposes in the domestic capital market at an acceptable yield.

Chart 11. Structural changes in the key financing sources for the federal budget deficit, %



Source: Ministry of Finance of the Russian Federation

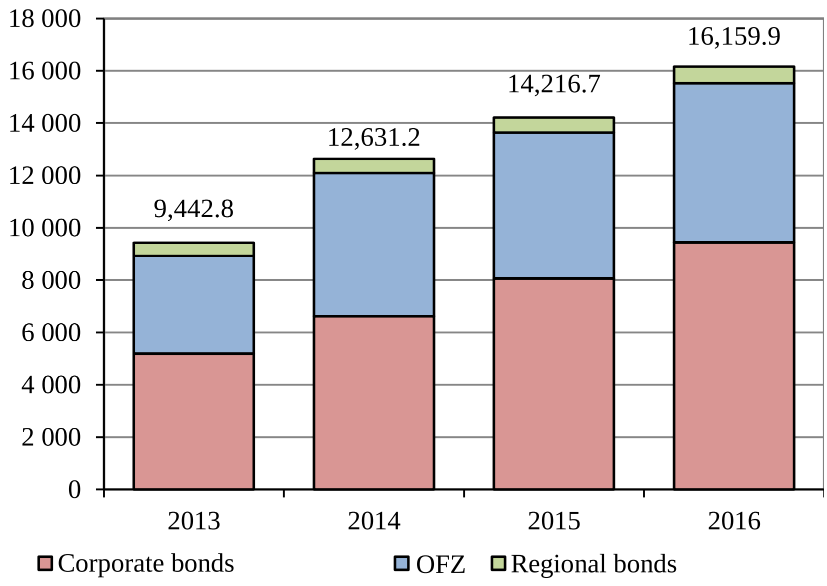
2.2. Federal government borrowing as a main source of financing for the federal budget deficit

According to the federal law on the federal budget for 2017 and the planning period of 2018–2019 the budget deficit will remain high. In 2017 it will amount to 3.2% of GDP, in 2018 and 2019 2.2% and 1.2%, respectively. At the same time, the structure of financing sources for this deficit will see some major changes. The depletion of funds accumulated in the Reserve Fund and the National Wealth Fund will drive (primarily) domestic borrowing upwards. By the end of the planning period, government borrowing will most likely be the main financing source for the federal budget deficit, increasing from 20% in 2016 to 91% in 2019 (see Chart 11).

Meanwhile, the amount of net external debt in the form of debt securities will turn negative: RUB -21.2 bn, RUB -60.1 bn and RUB -13.2 bn in 2017, 2018 and 2019, respectively. By contrast, gross domestic borrowing is set to rise from 1.2% of GDP in 2016 to 1.7% of GDP in 2019. The year's net domestic borrowing is set to reach 1.1% of GDP compared to 0.6% of GDP in 2016. This will be a record-high in Russia's recent history.

All this contributes to some growing risks with respect to the budget, including, at the very least, a potential deterioration of borrowing terms for the Russian Federation as a sovereign borrower, and an increase in the debt burden. In the worst-case scenario, it could result in Russia's inability to borrow the required amounts on reasonable terms.

Chart 12. Russia's domestic debt market structure (as at 2016 year-end), RUB bn



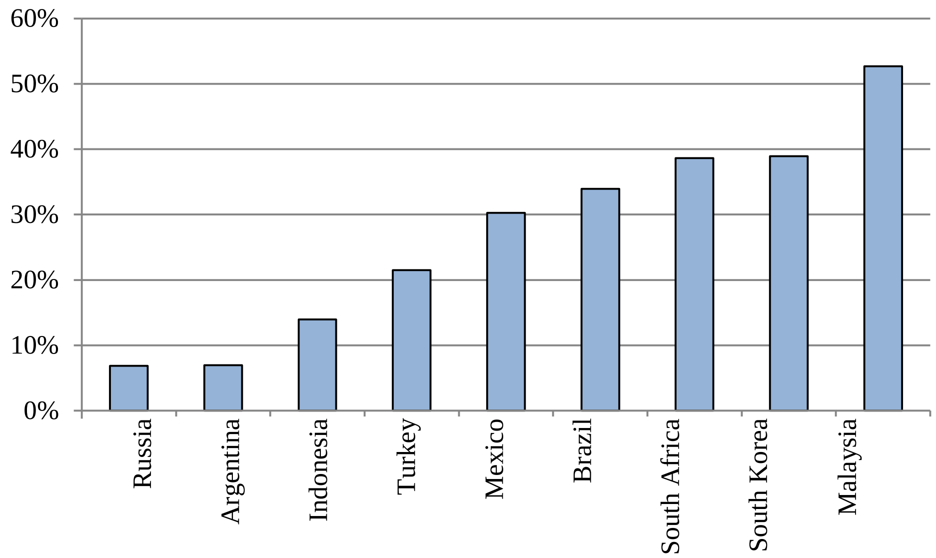
Source: CBonds, Ministry of Finance of the Russian Federation

2.3. Domestic debt capital market

In 2013–2016, the volume of Russia's domestic debt market grew from RUB 9.4 tn to RUB 16.2 tn (Chart 12), or from 13.3% to 19.5% of GDP. The market's average annual growth rate was around 20%. Over the same period the government securities segment rose by RUB 2.3 tn to RUB 6.1 tn, while the corporate bonds segment increased by RUB 4.2 tn to RUB 9.4 tn. The corporate debt market performed slightly better, growing annually by 22.1% compared to 17.7% growth in the public debt segment.

Currently, the capacity of the Russian RUB-denominated government bond market is still noticeably behind the majority of local currency bond markets in other countries with similar levels of development (Chart 13). However, given that average annual gross borrowing will amount to RUB 1.6 tn in the forthcoming period (up 60% vs 2016), Russia's government bond market has significant growth potential. Provided that Russia's public domestic borrowing programmes are fully implemented, by 2019 the volume of the government securities market will increase by RUB 3.3 tn to RUB 9.4 tn, or from 7.4% to 9.5% of GDP. Over a three-year period, it will grow by 53%, which is almost 1.5x higher compared to the period of 2013–2016 (39%).

Chart 13. Capacity of local currency government bond markets, % of GDP



Source: BIS as at the end of 2015

During 2013–2016 Russia's debt market reported higher figures for both the volume and the number of participants. The number of corporate borrowers increased from 353 to 389[1], while the number of sub-federal and municipal borrowers increased from from 38 to 46[2].

In the reporting period the daily turnover of government securities rose from RUB 15 bn to RUB 19 bn[3], while for corporate and regional bonds it remained flat at an average of RUB 24 bn and RUB 1.8 bn[3], respectively.

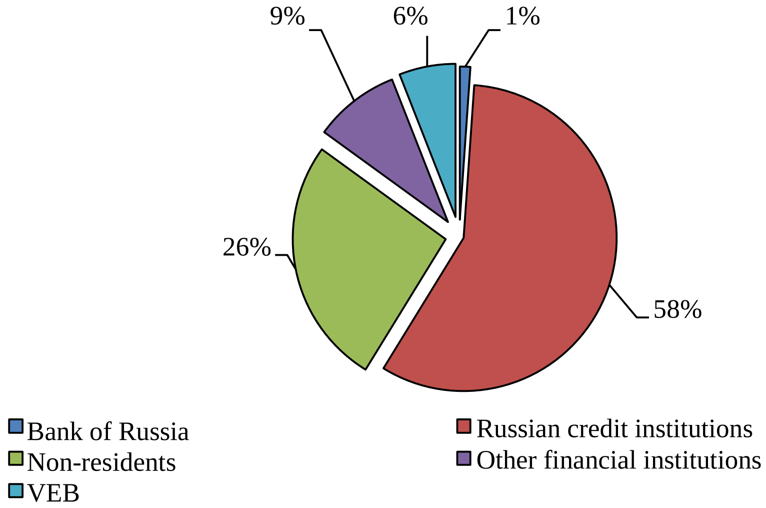
[1] The number of issuers with bonds outstanding at the beginning of 2013 and at the end of 2016, respectively, CBonds data

[2] The Ministry of Finance of the Russian Federation's data

[3] CBonds data

Key OFZ holders (Chart 14) are Russian credit institutions using government securities as REPO collateral with the Bank of Russia and the Federal Treasury. Russian banks invest in OFZs mostly to meet short-term liquidity requirements, manage overall liquidity, and implement short-term investment strategies. The share of conservative institutional investors from among non-banking institutions in the OFZ market is currently insignificant. At present these investors in the sovereign bond market are represented by Vnesheconombank, as a state-owned pension manager, and a number of non-resident companies (for example, the Government Pension Fund of Norway). The domestic debt market does not receive any significant funds from Russian oil, gas, and commodity exporters either.

Chart 14. Breakdown of OFZ holders, %

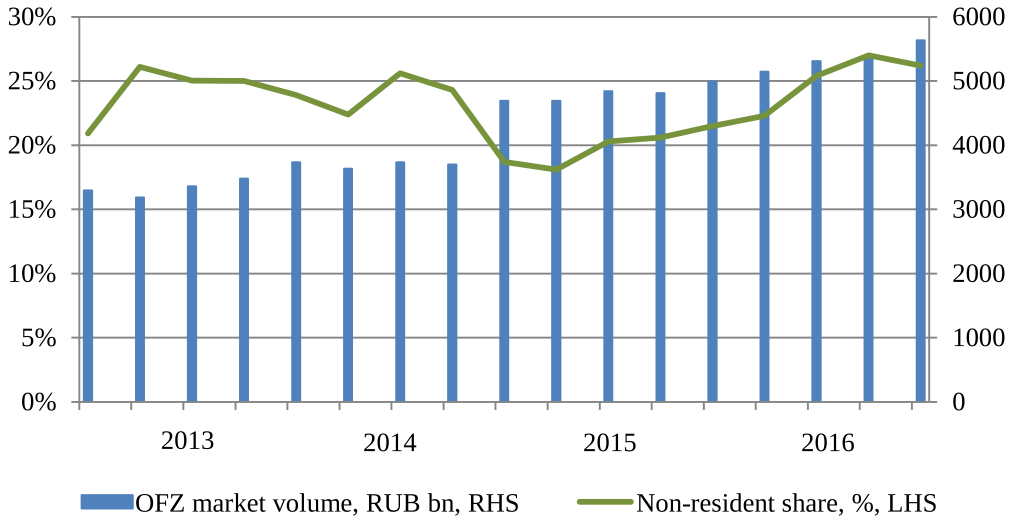


Source: Ministry of Finance of the Russian Federation, Bank of Russia, as at the end of 2016

As at end-2016, the RUB-denominated government bonds portfolio held by Vnesheconombank totalled around RUB 339.0 bn, i.e. nearly 6% of the OFZ market. In 2015, the Russian Government decided to reduce the share of government securities in Vnesheconombank's expanded investment portfolio from 50% to 40% to drive up the share of corporate bonds, including those issued to finance infrastructure projects. This reduction did not result in the sale of government securities by Vnesheconombank but it did reduce the potential for further purchases of these securities. The real impact of this decision on the debt market and government borrowing is yet to be seen and assessed.

Insurance companies, with reserves similar to those of private pension funds, represent significant potential future OFZ investors. Currently, however, insurance companies and pension funds do not invest much in government securities. This is partially due to the fact that these securities have to be revalued by asset managers at year-end. To avoid revaluation risk, pension fund managers opt for private bank deposits rather than government securities, thus narrowing OFZ demand. This brings about a need for prompt reconsideration of the above requirement both to support the long-term investment market, which is essential for development of the national economy, and to boost government borrowing. The share of non-resident investments in OFZs has remained fairly high over several years (Charts 14 and 15). In 2016, they represented a quarter of outstanding government securities. One of the factors contributing to their demand and influencing their market behaviour is the share of Russian government bonds in global bond indices. Russia holds quite a strong position in these indices as a sovereign borrower. As at end-2016, Russian bonds were included in a number of key global indices, including JP Morgan's EMBI Global Diversified, Barclay's Global Aggregate Bond Index, and Citigroup's EMGBI.

Chart 15. OFZ market and non-resident shares in 2013–2016



Source: Ministry of Finance of the Russian Federation, Bank of Russia

OFZ presence in the various global indices shows that the Russian domestic debt market and government bond issue parameters are in line with the requirements of the global investment community. At the moment the market has all the elements of a well-developed debt market in place and boasts a stable investor base. That said, the planned offering of government securities over the next three years could test the current market capacity. In this light, the diversification of debt instruments offered to the market and development of the investor base cannot be overstated.

To this end, a dramatic improvement in the credit ratings assigned to Russia as well as certain issues of government bonds, especially international ones, could prove helpful. However, in early 2015, rising geopolitical risks and stronger negative trends in the Russian economy (a slowdown in GDP growth, the outflow of capital, etc.) made all three international rating agencies downgrade Russia's long-term foreign currency sovereign credit ratings. Standard & Poor's assigned the highest available non-investment grade rating BB+ to Russia's foreign currency bonds with a negative outlook. After that, Moody's assigned Ba1 to the Russian foreign and local currency bonds, with a negative outlook, and Fitch Ratings downgraded Russia's foreign currency bonds to BBB-, the lowest investment grade rating, with a negative outlook. Meanwhile, Standard & Poor's and Fitch Ratings affirmed Russia's local currency bonds at BBB-.

Russia's sovereign downgrades were obviously caused by a number of geopolitical factors. When assigning ratings to Russia, certain evidence of its strong economy and stable financial system was almost disregarded. This included, in particular, the accumulated volume of foreign currency reserves, including sovereign funds' assets, a strong current account surplus, a floating exchange rate maintained by the Bank of Russia, etc.

In 2016, the ratings were partially revised. In March 2016, Moody's placed Russia along with a number of other oil-exporting sovereigns into the category "on review for downgrade". However, in April the agency excluded the country's sovereign rating from that category. In September 2016, Standard & Poor's affirmed Russia's sovereign rating at BB+, revising its outlook from negative to stable. In October 2016, Fitch Ratings also revised Russia's sovereign rating outlook from negative to stable. By the beginning of 2017, Russia's sovereign credit ratings assigned by the international credit rating agencies were as follows: Standard & Poor's – BB+, outlook stable; Moody's – Ba1, outlook negative; Fitch Ratings – BBB-, outlook stable. These agencies put Russia on par with the Dominican Republic, Costa Rica, and Serbia, however their outstanding bond yields are 150–175 b.p. higher than those of Russian Eurobonds[1].

Paradoxically, Russia's credit assessment assigned on the one hand by market participants and on the other by the credit rating agencies are not consistent. This phenomenon can be easily explained: among other factors, it confirms Russia's ability to remain stable amid severe external shocks. Concerns have been raised with respect to the agencies' ratings disregarding Russia's fundamentals, although in 2016 Standard & Poor's and Moody's have revised their outlook for Russia from negative to stable.

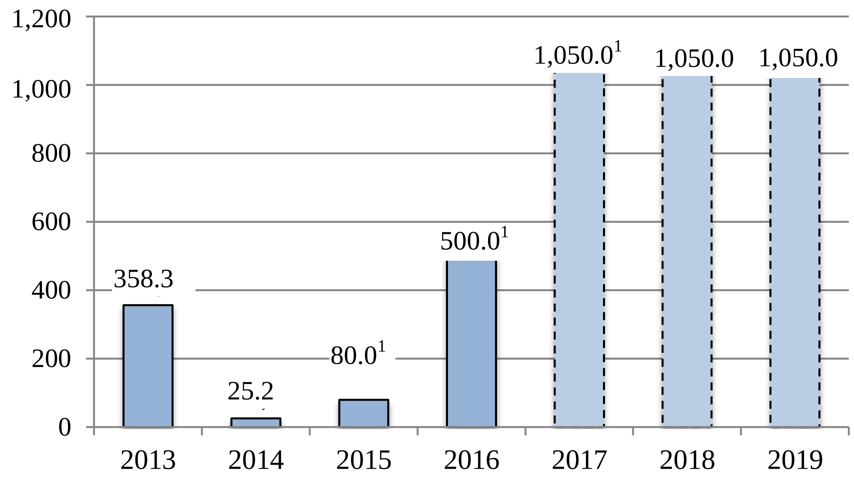
With a view to establishing a favourable climate for government borrowing, the Russian Ministry of Finance, together with other federal institutions and bodies of the executive branch, is maintaining an ongoing dialogue with the international rating agencies to disclose Russia's detailed plans for improving its economy and laying a foundation for further sustainable growth.

[1] Reuters News Agency, 10-year US dollar bond yields as at the end of 2016

Rating judgements produced by the international agencies were widely debated and gave rise to a nationwide discussion on the future prospects of the rating business in Russia. In 2015, ACRA (Analytical Credit Rating Agency) was established by 27 major Russian companies and financial institutions, strongly supported by the Bank of Russia and the Russian Government.

It is expected that the national rating agency will offer an alternative well-reasoned position on the borrowing capacity of Russia and its debt instruments' reliability, promoting fair competition with the international rating agencies. The establishment of ACRA gave debt market participants access to another independent opinion often needed to make investment decisions. Moreover, the Russian financial authorities are now less dependent on the foreign agencies' ratings in their prudential supervision and financial market regulation functions.

Chart 16. Net borrowing in the form of RUB-denominated government securities in 2013–2019, RUB bn



Source: Ministry of Finance of the Russian Federation

3. Priorities and instruments of the debt policy

3.1 Domestic borrowing

3.1.1. Macroeconomic assumptions for increasing domestic borrowing

As noted above, during the period 2017-2019 the domestic debt market will be the main funding source of the federal budget deficit. In 2017–2019 net domestic borrowing is expected to exceed RUB 1 tn per year (Chart 16). These borrowing targets will be more than three times the average annual net domestic borrowing over the past six years.

[1] Net of exchange transactions

Plans to dramatically increase borrowing with no risk of falling into a debt spiral, and without impairing the corporate debt market, are realistic for the following reasons. First of all, inflation is expected to fall to 4%, with interest rates in the economy remaining at the corresponding moderate level, which will make fixed income instruments more attractive. Another essential prerequisite is that Russian banks acting as anchor investors in the domestic debt market are expected to have significant liquidity primarily resulting from the federal budget funds channelled into the economy. Therefore, market players will have an opportunity to increase their investments in government securities.

Non-residents will still operate in the Russian government bond market, but they are very unlikely to build up their OFZ holdings at the same pace as Russian investors. Therefore, although foreign investments will grow in absolute terms, the share of non-residents in the debt market will gradually decline to below the current estimated figure of 26%[1].

The substantial share of non-resident holdings of government securities acts as evidence that the Russian debt market has matured. However, due to the mobility of capital and specific preferences in terms of debt securities, the activity of international investors is associated with certain risks for the stability of the domestic market and, therefore, is subject to oversight by both the Ministry of Finance and the Bank of Russia. The expected decline in the share of non-residents will therefore help mitigate these risks.

3.1.2. Instruments to implement the borrowing programme

Delivering on the borrowing targets requires diversification of debt instruments offered to the market by type and maturity, along with consistent maintenance and development of the investor base.

OFZ-PD and OFZ-PK will remain the key instruments for the domestic public borrowing programme. However, compared to the previous period, the role of floating rate instruments will increase.

With a relatively stable market environment and downward trend in interest rates, focus will be on medium- and long-term OFZ-PD. Conversely, during periods of higher interest rate volatility, “defensive” securities – OFZ-PK and OFZ-IN – will be the instruments of choice for issuance. Regardless, OFZ-IN will not form a significant source of financing for the federal budget deficit. This instrument will be mainly used as an adequate borrowing cost benchmark for corporate borrowers and a metric reflecting inflation expectations of the market.

[1] Bank of Russia as at the end of 2016.

Floating rate bonds (OFZ-PK and OFZ-IN) will serve as a means of minimising long-term public borrowing costs in an environment where interest rates on fixed income instruments (OFZ-PD) are objectively too high. However, the issuance of such bonds may pose a risk of growing debt servicing costs (interest rate risk) for the issuer going forward. Therefore, the issue size for these instruments should be limited. We assume that the combined share of OFZ-PK and OFZ-IN in the total domestic public debt will not exceed 20–25%. Currently this figure has already reached 17%[1].

One additional driver of OFZ market appeal is the development of the derivatives market for government securities. Since 2011 the Moscow Exchange has been offering investors OFZ basket futures with maturities ranging from two to fifteen years, and since 2016 RUONIA futures have served to hedge the risk for floating rate OFZ bonds. However, trading volume for these instruments is minor and substantially below that for OFZs. The immaturity of this segment is due to both objective factors (limited number of players: only 3 out of the 13 leading OFZ traders operate in this segment) and regulatory constraints of collective investment management (ban on the use of derivatives for companies that have pension assets under management). Nevertheless, over the period 2017-2019 matters concerning the development of the OFZ derivatives market will be further reviewed to reduce investors' costs of managing interest rate risk, increase liquidity of the OFZ spot market, and therefore improving the appeal of government securities and decreasing public borrowing costs in the domestic capital market.

Currently, the range of debt instruments offered by the Ministry of Finance fully meets the needs of different categories of domestic capital market players. Therefore, during this period non-marketable debt instruments, such as GSOs issued in the previous years in order to meet the demand of Russian institutional investors managing pension savings, will not be offered again.

The priority will be to issue medium- and long-term government securities. Despite the risks of somewhat shorter maturities needing to be issued to meet the significant increase in supply, the strategic goal remains to increase the average duration of the debt portfolio to 5 years (compared to 3.9 years as at end-2016).

During this period the Ministry of Finance will continue to take steps to boost the liquidity of government bonds and improve access to the public debt market in order to ensure a bigger share of Russian instruments in the global bond indices. Achieving this ambition will drive the demand for these securities, as it is directly related to the necessity of many institutional investors and funds to replicate global indices in their portfolios.

[1] According to the Ministry of Finance as at the end of 2016, excluding OFZ-PK bonds transferred to member banks of the Deposit Insurance Agency (DIA) on condition that OFZ coupon payments are to be paid back to the budget through the DIA.

3.1.3. Convenient and secure access to the government bond market for individuals

During the period 2017-2019 new debt instruments are to be issued exclusively for Russian individuals, a category of investors currently representing a very small share among government bond holders. These special government securities are to be issued not merely for fiscal purposes, but rather for promoting financial literacy, and fostering a culture of savings and investments, among other things through encouraging medium- and long-term savings. In this case, at least at the initial stage, the potential of this instrument for borrowing programme purposes will be very limited (annual "retail" OFZ issuance at RUB 20–30 bn). We have to take into account the fact that the issue is associated with high transaction and administrative costs mainly attributable to establishing and supporting a distribution system for these securities.

For individuals, an important distinction of these bonds from traditional OFZs will be the non-market nature of the new instrument, with no secondary market trading and a ban on holding by legal entities. In terms of parameters and risk exposure, individuals will perceive these bonds as positioned between bank deposits and conventional OFZ bonds traded in an organised financial market. For this reason, the new securities are unlikely to compete with bank deposits. For individuals other than professional market participants, purchasing and holding "retail" OFZ bonds will be an intermediate step between traditional savings instrument such as bank deposits and higher-risk marketable securities.

3.1.4. Active debt management

Significant amounts of non-marketable government securities offered earlier (through direct placements rather than through auctions), are still held in the portfolios of market participants, and the Ministry of Finance will continue the practice (which was initiated in 2015) of exchanging these securities for standard OFZ bonds in the period 2017–2019 in order to further enhance the liquidity and develop the domestic debt capital market. Moreover, the practice of exchanging outstanding soon-to-mature securities losing their liquidity for on-the-run issues is to become more regular. These operations are conventional in terms of global public debt management best practice and are targeted at maintaining the liquidity of outstanding debt instruments at key points on the yield curve on an ongoing basis.

The exchange operations will also pursue the following objectives:

– replacing issues of non-standard (small) volumes with benchmark issues of an outstanding volume of at least RUB 250 bn;

– reducing public debt and/or its servicing costs;

– adjusting pricing "irregularities" of the bonds traded on the market, and enhancing the representative nature of the OFZ yield curve;

– reducing the Bank of Russia's holding of certain issues of government bonds.

Higher liquidity of the outstanding OFZ bonds resulting from the implementation of the above objectives will promote the growth of the share of government securities in the global bond indices, whose key requirement for inclusion is the liquidity level of the debt instruments. This, in turn, will boost demand for Russian exposure from non-residents.

3.1.5. Maintaining an effective dialogue with the market

As the issuer of government securities, the Ministry of Finance places a great emphasis on maintaining a constructive dialogue with all categories of investors. The main goal of this interaction is to establish a feedback process with market players to identify market sentiment and preferences, and receive detailed up-to-date information about investor demand by type, maturity, and volume of debt instruments. To this end, the following activities are planned:

1) holding regular (at least quarterly) meetings and conference calls with key market participants;

2) publishing up-to-date information on public debt and Russia's macroeconomic environment, public borrowing plans, *Public Debt Management Policy of the Russian Federation* in Russian and English, quarterly schedules of OFZ offering auctions and other relevant data on the official website of the Ministry of Finance;

3) clarifying decisions taken in the area of public debt;

4) improving the sections of the official website of the Ministry of Finance dedicated to public debt policy of the Russian Federation on an ongoing basis and bringing them in line with global best practices.

In addition, as part of the initiatives to improve the investment case of the Russian government bond market for international investors, we will continue cooperating with entities engaged in the calculation and publication of global bond indices serving as benchmarks for different categories of global capital market players.

3.2. Borrowing in international capital markets

3.2.1. Priorities and objectives

Given the projected current account surplus in 2017, Russia has no real need for foreign currency borrowing as it would only put additional pressure on the national currency. To this end, borrowing in international capital markets in 2017–2019 is scheduled to remain limited. This is necessary to maintain Russia's market presence as a sovereign borrower and support a benchmark yield curve for foreign currency debt, as well as reach more investors that are willing to purchase Russian sovereign bonds and lay the foundation for better borrowing terms for Russian corporates.

Offerings in external debt markets will continue to target non-residents. This fully meets the above-mentioned foreign borrowing purposes, making it a perfectly suitable approach. Investors with capital that originates in Russia are expected to focus on RUB-denominated sovereign debt instruments as the terms and types of OFZ bonds currently available generally cover their needs.

Eurobond deals over the next three years will continue predominantly in US dollars, with the USD-denominated global debt market boasting the best capacity and lower costs of borrowing. At the same time, should circumstances allow it, investors will also be offered bonds in other currencies, such as euros. The choice of currency for external borrowing will be based on the necessity to create the respective yield benchmarks for Russian corporate borrowers. To this end, Russia will continue exploring the possibilities and opportunities of RMB-denominated borrowing.

A strong track record in 2016 has proved the efficiency of the national financial market infrastructure for the purposes of Eurobond deals. However, cooperation with major international (foreign) financial institutions will continue, especially with those willing to work in, and with, Russia despite the pressures put on them. Russia will definitely be fostering its relations with Euroclear and Clearstream, international settlement and clearing systems that provide international investors with convenient access to the Russian debt market both in foreign and national currencies.

To meet the demand for Russian exposure from non-residents, it would be advisable to provide global custodian banks with the right to open foreign nominee accounts with Russia's central depository – the National Settlement Depository (NSD). At the moment, this right is available only to foreign central depositories and settlement and clearing systems.

In the upcoming period, Russia plans to offer new Eurobonds in exchange for previously issued foreign currency debt instruments as a way to support external public debt management and smooth the debt burden of the Federal Budget.

3.2.2. Alternative markets

Continuing geopolitical tensions have resulted in restricted access for Russia and Russian companies to international financing, which makes access to alternative borrowing sources for Russia and its businesses a matter of high relevance. In this regard, the priority is to leverage the national financial market infrastructure and domestic financial institutions to issue debt securities governed by Russian law.

The most promising option is the placement of RMB-denominated OFZ bonds on the Moscow Exchange to target domestic investors in mainland China. The main advantages of using the Chinese national currency for the first bond issue are the high capacity of the country's debt market, strong viability of yuan as a new reserve currency, and the importance of fostering bilateral financial and economic ties with China.

This process cannot be expedited or forced due to China still imposing foreign exchange restrictions and other limitations on its currency. At the same time, a foray into the Chinese market requires pre-existing agreements with local regulators and necessary organisational prerequisites. The parties have been taking the necessary steps towards fully-fledged cooperation. One such step is the Memorandum of Understanding and Cooperation between the Russian Federation's Ministry of Finance and the People's Republic of China's Ministry of Finance, which was signed on 17 December 2015. The document describes access to the national financial markets of both Russia and China for issuers of corporate and sovereign bonds as a key focus of their efforts.

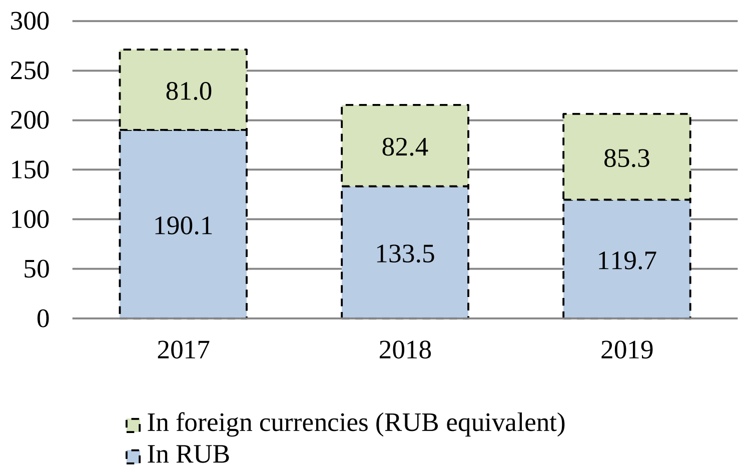
Currently, a bond offering of this type may be interesting for Russian providers of financial market services and Russian subsidiaries of several Chinese banks alike. However, the performance of Russian bonds on the Chinese market will to a large extent be shaped by the Chinese regulators allowing investors from mainland China to discover the Russian market and to be able to buy the previously unavailable sovereign bonds with no restrictions.

3.3. Government guarantees

3.3.1. Types and size of government guarantees

As in previous years, Russia's government guarantee programmes for the upcoming period were put in place based on proposals submitted by the relevant executive agencies responsible for shaping governmental policies for the respective industries, taking into account the track record of providing government guarantees over the past years. RUB-denominated government guarantees planned for 2017 total RUB 190.1 bn, down 87% compared to 2016. The trend for scaling down government support will persist in 2018 and 2019, with scheduled guarantee allocations standing at RUB 133.5 bn and RUB 119.7 bn, respectively. The guarantees denominated in foreign currencies will remain unchanged over the next three years, amounting to an average equivalent of RUB 83.0 bn per year (see Chart 17).

Chart 17. Government guarantees scheduled for allocation by Russia, RUB bn

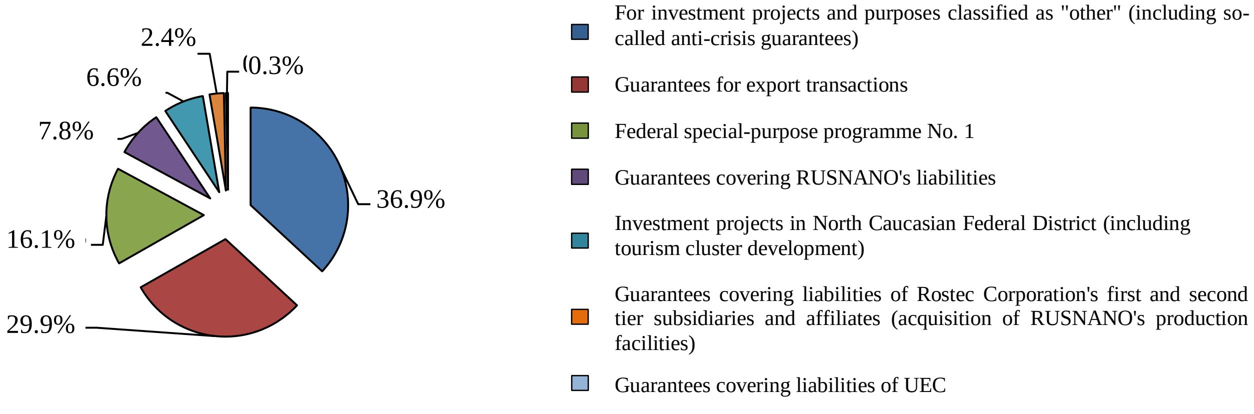


Source: Ministry of Finance of the Russian Federation.

The upcoming period will see a significant decrease in guarantees for investment projects (down by an average of 43% as compared to 2016), despite this support tool being viewed as one of the government's priorities. Government guarantees will be allocated to projects in designated industries and sectors (among other things, as part of *Development of the Military-Industrial Complex of the Russian Federation for 2011-2020*, a federal special-purpose programme, and engine building for civil aviation) and also target some of Russia's regions (North Caucasian Federal District). The government will also keep providing support to RUSNANO, including through state guarantees for loans taken out by investors to purchase RUSNANO's production facilities.

In 2017–2019, the government will keep supporting exports of industrial products and services, with the annual guarantee allocation limit set at the same level as in 2016 (USD 1.2 bn).

Chart 18. Government guarantees scheduled for allocation by Russia in 2017[1]

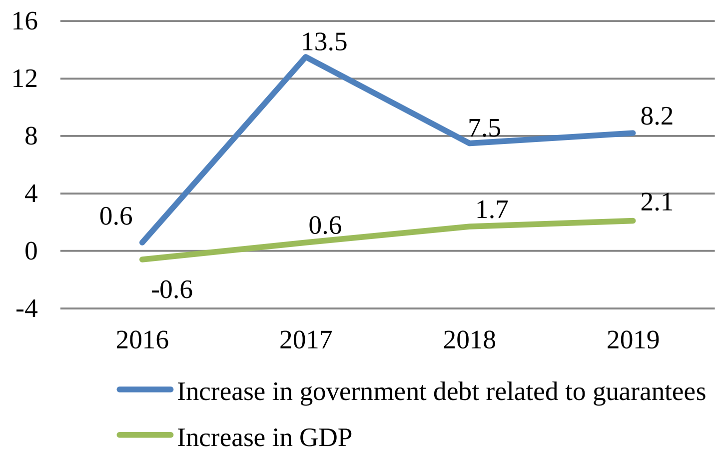


Source: Ministry of Finance of the Russian Federation.

Government guarantees scheduled for allocation are therefore structured in such a manner as to assist Russian companies dealing with the aftermath of the economic crisis and also to support major investment projects and projects involving exports of Russia's high tech products (see Chart 18).

Given the scale of budgeted guarantee support and consistently high demand from lenders and borrowers alike, the government debt under state guarantees will remain on the rise in 2017–2019 (see Chart 19), albeit at a slower pace than previously. As a result, the pressure on the federal budget associated with government guarantee risks will be fairly high and keep growing.

Chart 19. Estimated evolution of government debt under state guarantees and GDP, %



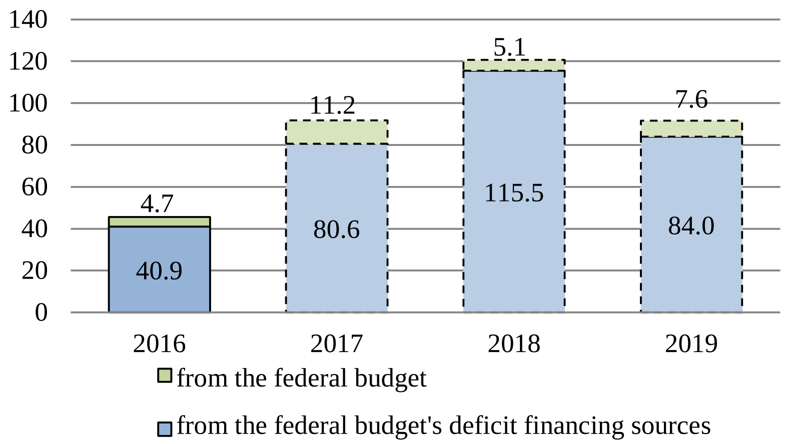
Source: Ministry of Finance of the Russian Federation.

[1]Guarantees for export transactions are stated in the RUB equivalent at the USD exchange rate projected for 2017 (RUB 67.5 per USD)

The increase in the Russian government debt related to guarantees will lead to higher budget allocations required to deliver on such guarantees (see Chart 20). Since government guarantee liabilities are classified as long-term (up to 30 years), future budgets will take the greatest part of the burden to honour those. Allocation caps are calculated for government guarantees effective at the budgeting date based on the actual volume of covered liabilities and risk probabilities.

The upcoming period will require considerably higher annual budget allocations (by an average of 122% or RUB 55.7 bn) to deliver on RUB-denominated guarantees as compared to 2016. On the other hand, allocations for government guarantees denominated in foreign currencies are to be cut by an average of 47% (RUB 3 bn). Moreover, these will be financed only from sources of federal budget deficit funding and not from federal budget expenditures, which have no respective allocations planned as in 2017–2019 there will be no effective government guarantees denominated in foreign currencies with no right of recourse.

Chart 20. Budget allocations planned for government guarantees in RUB bn



Source: Ministry of Finance of the Russian Federation.

3.3.2. Adjustment of principles and priorities of government guarantee support

By the end of the planned period, government guarantee support will expand to the point where public debt incurred through federal budget contingent obligations are among the material factors impacting Russia’s financial stability. This calls for not only a more conservative government guarantee policy, but also for eliminating a number of gaps in the current procedure. These include:

– no responsibility on the part of the principal for failure to execute investment projects supported by the government;

– no unified approach in providing government guarantees with similar objectives (guarantees for investment projects or anti-crisis guarantees), irrespective of the recipient;

– insufficient harmonisation of government guarantee support;

– poor assessment and management of risk sharing between the government and parties to a transaction (project) that has received the guarantee;

– provision of government guarantees to loss-making projects and financially inefficient enterprises (those with poor financial standing);

– recipients' non-compliance with certain restrictions during the term of guarantees, such as bonuses paid to senior management;

– non-adherence to the basic premise of government guarantee support, which implies that the government acts as a guarantor for organisations that are either engaged in the key (strategically important) industries or are facing temporary challenges in raising loans as a result of macroeconomic changes that cause lenders to adjust their approaches to accepting and assessing risks.

The inability and/or lack of willingness to eliminate these gaps may often result in the business community viewing Russia's government guarantees merely as deferred budget financing designed to provide lenders with profitability and recoverability of their loans, with no need for an adequate risk assessment to be performed. As a direct consequence of this interpretation of the government guarantee mechanism, lending banks have no incentives to monitor the financial position of their borrowers (principals), manage credit risks, or conduct adequate comprehensive assessment of the borrower's (principal's) financial position and/or the economic viability of the project.

With volumes of government guarantees going up, the largest banks (including state-run banks) now often treat state support as a standard (typical) type of security for the loans they provide. In addition, more and more banks are attempting to use government guarantees to deal with toxic assets by refinancing non-performing liabilities and passing on all the risks of working with a troubled borrower to the federal budget. This goes against the principle of equal risk distribution between the lender and the guarantor, and it puts Russia inherently at a disadvantage: while not enjoying its full rights as a party to guarantee deals, the guarantor is unable to manage the existing business risks.

In this connection, it is important to note that government guarantees are provided free of charge. Unlike, for example, the member countries of the Organisation for Economic Cooperation and

Development (OECD), Russia does not have a system of providing guarantees at a fee, which would directly tie the cost of the guarantee to the risk level of the project (principal). In addition to guarantee risks, the practice of providing and administering government guarantees is associated with other fixed costs that Russia bears as the guarantor. This can only be done properly when an agent of the Government of the Russian Federation is engaged for a fee, especially given the scale of the government guarantee support. Monitoring the obligations covered by government guarantees (including security assessment) and evaluating the financial position of the principal are also quite expensive, with costs totalling several billions of roubles annually. The existing budgetary constraints and the scale of government guarantees mean that government guarantees extended for a fee are no longer outside the realm of possibility.

Based on the above, the following approaches are proposed:

– project risks (in government-guaranteed deals) shall be split equally among the borrower (project initiator), lending bank, and the government (guarantor);

– interest payments (bond income) shall no longer be covered;

– state guarantees that cover 100% of the principal's loan repayment obligations shall only be reserved for extreme cases, when national interests are at stake and provided that any other security is unavailable or associated with unsustainable costs;

– recourse claims on the Russian Federation upon the calling of a state guarantee shall be provided at all times;

– government guarantees shall be made unavailable for beneficiary banks that have failed to either make sure the loan is used as intended or to control the security provided by the principal;

– government shall gradually move away from guaranteeing loans that are repaid from the federal budget;

– lending banks shall agree to decrease (limit) the cost of government-guaranteed loans for principals;

– legal groundwork shall be introduced for a concept of providing government guarantees for a fee, with the agent using the proceeds to cover its costs;

– eligibility requirements for projects and borrowers (principals) shall be tightened;

– liability shall be expanded for all parties (including beneficiaries) linked to how the loans are used, which is expected to prevent unfair practices and misconduct;

– government shall discard those types of guarantees that have overlapping purposes, terms and conditions to eventually discontinue the practice of granting unique, non-standard guarantees.

4. Borrowing policy of Russian Federation's sub-sovereigns

Given the federal structure of Russia and the vast authority possessed by the regions (including in financial policy development and implementation), the government needs to develop and apply strict approaches and criteria to regulating sub-sovereign borrowing. Irrespective of their debt sustainability indicators, the regions’ debt always represents federal contingent obligations for the Russian government.

4.1 Amount and structure of Russia’s sub-sovereign public debt

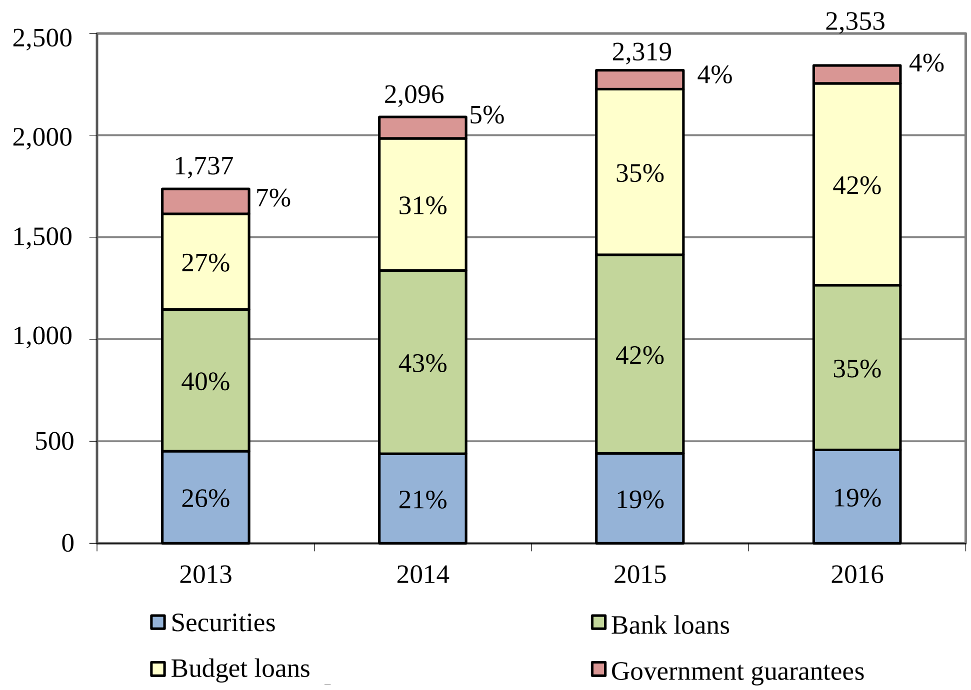
From end 2013 to early 2017, the public debt of Russia's sub-sovereigns increased by 35% (see Chart 24), growing by an average of over 10% per annum. This trend was mainly caused by declining revenues due to the country's unfavourable economic backdrop, as well as by increased spending under social commitments. As a result, in 2016 Russia’s sub-sovereign public debt reached RUB 2.4 tn (2.8% of the GDP), the majority of which was RUB-denominated. Debt obligations denominated in foreign currencies made up 0.01% of total. Based on the budget laws of sub-sovereigns, their public debt is expected to continue growing in 2017.

There have been significant changes in the debt structure of sub-sovereigns due to the policy of substituting (often through refinancing) market debt with budget loans. Over the period of 2014–2016, the share of obligations under securities and bank loans dropped from 66% to 54%, while the share of debt outstanding under budget loans increased from 27% to 42% (see Chart 21).

Although regions are able to take out budget loans at an extra low interest rate of 0.1% per annum, this trend is not necessarily positive. A higher share of such loans in the overall debt structure of a region indicates that borrowers are having trouble accessing market resources, i.e. bond markets and bank loans. Too many budget loans promptly leave a mark on the sub-sovereign’s credit history and rid them of debt management experience. This negatively affects the prospects of Russian regions as market-oriented sub-sovereigns, and investor interest in them will dwindle rather than improve.

According to the instruction of the President of Russia, sub-sovereigns should treat bonds as long-term financing to cover the deficit in regional and local budgets while trying to minimise the use of bank loans. Thus, the substitution of sub-sovereign market debt with budget loans is a temporary anti-crisis measure employed by federal authorities in response to an extreme shortage of sustainable market borrowing in a high interest rate environment. As the debt market recovers, regions will be encouraged to cover most of their borrowing needs through debt raised in the market, with securities as the main instrument. This will allow such sub-federal borrowers to enjoy a stable access to funding sources, actively manage their debt (thanks to better bond liquidity compared to bank loans), mitigate risks, and be independent from the federal budget. Regular issuances of bonds and their servicing will contribute to sub-sovereigns' public credit history, gradually attract more investors, and decrease the cost of debt. Borrowing from a single lender has none of these advantages.

Chart 21. Russia's sub-sovereign public debt, RUB bn, %



Source: Ministry of Finance of the Russian Federation.

Nevertheless, not many regions are actively issuing bonds: most of them take out bank and budget loans. In 2016, 74 sub-sovereigns planned on applying for bank loans and 27 entities intended to issue bonds. Of them, only 22 regions executed the offering, raising a total of RUB 153.5 bn. Also, in contrast to the federal government, regional authorities most often (in 17 out of 21 offerings) issue bonds through a book building process as opposed to regular auctions.

Despite the above-listed trends seen in regional borrowing today, the results of the debt sustainability assessment of 1 January 2016 are somewhat contradictory.

1) *Sub-sovereign public debt as a percentage of total budgetary revenue net of grants from the federal budget*

The current version of the Budget Code of the Russian Federation caps this percentage at 100%, and at 50% for sub-sovereigns whose consolidated budget has a large share of external donations.

The average sub-sovereign leverage rate was 36.4% of the entities' projected revenue for 2016. This can be considered an acceptable value as it does not carry any material debt crisis risks.

However, in a number of regions this indicator does pose some risk. In 8 regions, debt exceeded 100% of projected own revenue, and another 12 saw it rise above 85%, with the 100% threshold expected to be broken by some regions in 2017. These 20 borrowers, which can be described as troubled, accounted for almost a fifth (RUB 446 bn) of total sub-sovereign public debt, making this a high-risk situation given the high costs of market borrowing and low flexibility of regional budgets in terms of reducing the budget deficit.

2) *Debt servicing costs as a percentage of total budgetary expenses*

The current version of the Budget Code sets the threshold for this indicator at 15%, which seems excessive. As at 1 January 2016, its average value for all sub-sovereigns was 2.3%, while for 16 regions it was above 5%. However, borrowers have been known to have problems even when the indicator is low. Therefore, the debt service ratio of 10% appears to be more reasonable.

3) *Annual public debt repayment and servicing costs as a percentage of total tax and non-tax regional budget revenue and donations from other budgets*

This is a new indicator that is not yet included in the current version of the Budget Code. The proposed threshold is 20%.

As at 1 January 2016, its average value for all sub-sovereigns reached 12% (compared to 9% as at 1 January 2015). That said, this indicator was above 20% of the expected revenue for 33 regions, and for another 3 it was above 50%.

4) *Short-term debt as a percentage of a region's total public debt*

This is also a new indicator that is not in the current version of the Budget Code. The proposed threshold is 15%. As at 1 January 2016, the share of short-term debt exceeded 15% for as many as 12 sub-sovereigns, amounting to RUB 92 bn.

This ratio came about due to some regions resorting to short-term debt in an attempt to cut their debt servicing costs. Increased short-term debt makes regional authorities highly dependent on the financial market environment. In a best case scenario for a region with a high share of short-term liabilities, a surge in market interest rates can drive debt servicing costs up; under the worst case, however, the borrower would be unable to perform under the contract unless the existing debt is refinanced.

To summarise, the current shape of sub-sovereign public debt is marked by a considerable volume of debt outstanding (for some regions nearing the level of their annual revenue), high leverage rate of regional budgets, high share of obligations owed to the federal budget, and a substantial share of short-term debt. This skewed structure of sub-sovereign debt reflects gaps in the borrowing policy and also signals the need for developing and implementing a package of measures aimed at increasing sub-sovereign responsibility to carry out a prudent borrowing policy.

4.2. Improvement of tools for monitoring and regulating sub-sovereign borrowing

The existing system for regulating sub-federal borrowing is inefficient due to the following reasons:

1) Restrictions set by the Budget Code of the Russian Federation do little to curb the growing sub-sovereign debt. Some of them are too lenient to have a tangible effect, while others are hamstrung by their timing, which makes it easy for regional authorities to ignore them. For example, until 1 January 2018 there is no requirement for sub-sovereigns to include the total or the current year's budget loans in their maximum public debt, making this indicator unreliable for determining their real leverage rate. Debt servicing costs for sub-sovereign public debt is capped at 15% of budgetary expenses. This is much too lenient and can hardly provide an accurate representation of a region's solvency.

2) Debt sustainability parameters set out in the Budget Code are insufficient. They include only two indicators: a) ratio of sub-sovereign public debt to total budgetary revenues net of grants from the federal budget, and b) debt servicing costs as a percentage of total budgetary expenses. This set of indicators has been shown to be inadequate for accurately assessing a region's debt sustainability.

3) There is no uniform approach to regulating sub-sovereign access to different forms of borrowing. The Ministry of Finance only registers borrowing in the form of bond issues. This means that regional authorities make virtually unchecked use of loans raised from commercial banks, often with little concern for the sub-sovereign's debt sustainability.

These reasons were the catalyst for the amendments to the existing legislation. In the new version of the Budget Code, the Ministry of Finance proposed to improve the system for assessing sub-sovereign debt sustainability based on the best practices of public debt management by expanding the set of indicators, revising caps for the existing indicators, and classifying Russian regions into groups based on their debt sustainability.

The above-mentioned parameters will make it possible to regulate sub-sovereign debt by putting the entities into different groups based on their debt sustainability. This process will be controlled by the Government of the Russian Federation, which will make use of three ratios (with the respective cap values) outlined in the new version of the Budget Code (see Table 2). The third ratio will be "short-term debt as a percentage of a region's total public debt".

Sub-sovereigns will be placed into a debt sustainability group based on the following principles. The first group are regions with adequate values for all the three indicators. The third group are those who have two or more indicators failing to meet the mark. The rest of the regions go into the second group. Sub-sovereigns with low debt sustainability and are in the third group shall not be included in the high debt sustainability group within three years after attaining adequate values, irrespective of their actual debt sustainability indicators.

Similar approaches will be utilised when classifying municipalities into these debt sustainability groups, but in this case the assessment will be made by the sub-sovereign's financial authority.

Table 2. Classification of Russian sub-sovereigns based on their debt sustainability

Indicator	Group 1 (high debt sustainability)	Group 2 (medium debt sustainability)	Group 3 (low debt sustainability)
Sub-sovereign public debt as a percentage of budgetary revenues net of grants from the federal budget	≤ 50% / ≤ 25% for active donation receivers	50–85% / 25–45% for active donation receivers	> 85% / > 45% for active donation receivers
Debt servicing costs as a percentage of total budgetary expenses (net of subvention-funded expenses)	≤ 5%	5–8%	> 8%
Annual public debt repayment and servicing costs as a percentage of budget revenues (tax, non-tax and donations)	≤ 13%	13–18%	> 18%

Source: Ministry of Finance of the Russian Federation.

These risk groups will determine the rigidity of the requirements imposed on the regions: highly sustainable sub-sovereigns will not be obliged to approve their regional borrowing and state guarantee programmes with the Ministry of Finance, in contrast to regions with medium to low debt sustainability, where this requirements will be mandatory. Borrowers with low sustainability will have access to market borrowing only for the purpose of refinancing their existing debt. They will also have to approve solvency recovery plans signed off by the Ministry of Finance.

The proposed classification of regions is aimed at identifying downward trends in regional debt sustainability in advance, immediately placing them into the respective group and imposing restrictions and requirements as needed. These measures shall support regions in dealing with their debt problems.

The debt sustainability provisions of the new version of the Budget Code are planned to take effect on 1 January 2019. However, the Ministry of Finance already started a pilot test to monitor sub-sovereign debt sustainability in 2016, and on 1 January 2018 – the date when the majority of other provisions of the new version of the Budget Code become effective – the ministry will start classifying regions and publishing all the relevant information on its official website.

Another proposed measure that aims to improve the regional debt policy is a Budget Code provision that would require regional authorities to develop and approve the main focuses of the sub-sovereign's debt policy for at least the next three years, as well as submit the draft to the Ministry of Finance for pre-approval. This initiative is in line with the instructions given by the Russian President. This document will contain the following: the results of the previous period's debt policy and the current level of the sub-sovereign's public debt; the factors determining the nature and priorities of the debt policy; targets, objectives and implementation tools of the policy, and; the analysis of budgetary risk arising in the process of sub-sovereign public debt management.

The regions in the first group will not be required to approve the main provisions of their debt policy with the Ministry of Finance. Sub-sovereigns with medium and low debt sustainability will have to submit such provisions to the Ministry, along with their public borrowing and state guarantee programmes that require approval, no later than 1 November of each year. Group 3 borrowers will only be allowed to borrow for the purpose of refinancing their existing debt, and the interest rate charged on budget loans can be reduced (this will not be applicable for the first and second groups). The person holding the highest office in a Russian sub-sovereign or municipality that has low debt sustainability and fails to carry out the solvency recovery plan may be suspended from their position.

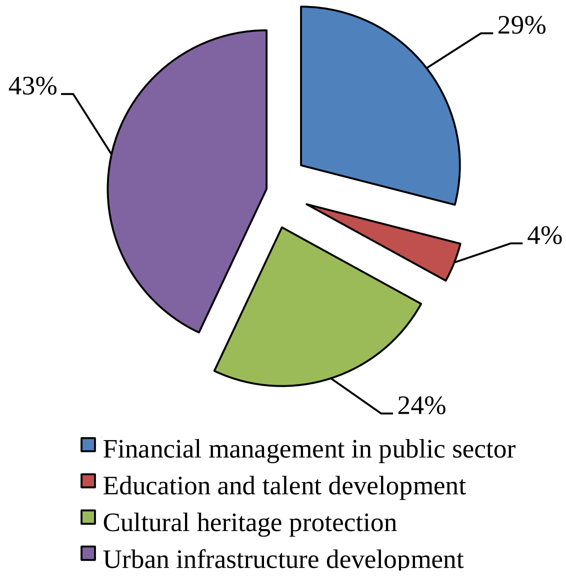
To help regions improve their debt policy, the Ministry of Finance provides them with methodological support in the form of Recommendations on Responsible Debt Management Policy for Sub-Sovereigns, which have been published on the Ministry's official website. The document is based on provisions of the Public Debt Management Policy of the Russian Federation, as well as global best practices and recommendations of international financial institutions. The plan going forward is to regularly review the performance in this aspect at special seminars and at a Moscow Financial Forum session.

5. Other considerations of public debt management policy

5.1. Cooperation with multilateral development banks

The current stage of Russia's relations with international financial institutions (IFIs), including multilateral development banks (MDBs), is in a number of ways special and different from what has been in place so far. Firstly, Russia decided to stay out of the so-called budget support loans, i.e. those raised from IFIs to finance budget deficits. Secondly, Russia's role in IFIs is above all that of a shareholder engaged in their policy-making. Thirdly, as a result of Western sanctions, Russia has remained focused on bringing on stream the top priority projects that target specific industries of the national economy and had been approved before July 2014. Another major effort for the Russian Government is putting together projects that are expected to rely on loans from new MDBs, as well as other sources, including domestic ones.

Chart 22. MDB loan structure by industry in 2016, %

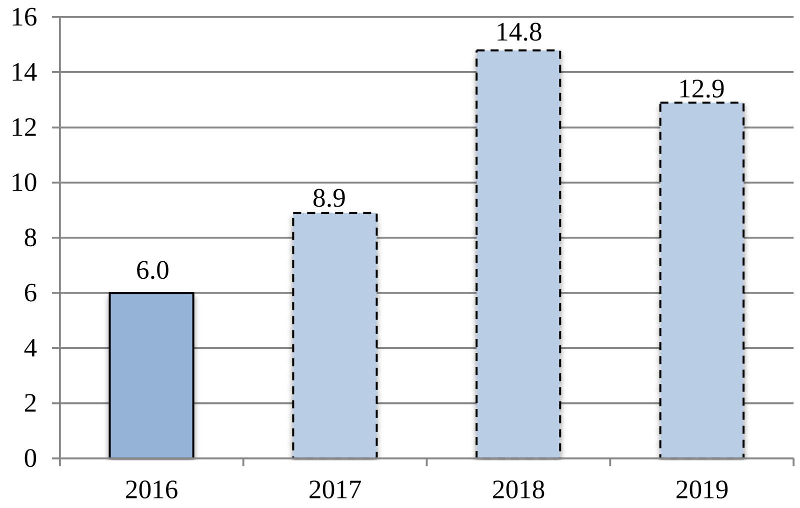


Source: Ministry of Finance of the Russian Federation

Currently Russia is among the shareholders of seven MDBs: International Bank for Reconstruction and Development (IBRD), European Bank for Reconstruction and Development (EBRD), Asian Infrastructure Investment Bank (AIIB), New Development Bank (NDB), Black Sea Trade and Development Bank (BSTDB), International Investment Bank (IIB), and International Bank for Economic Cooperation (IBEC). Through its MDB engagement as a sovereign borrower, Russia has initiated approximately 20 projects to raise a total of around USD 5.0 bn in debt. However, the sanctions against Russia prevented some of the projects (all of them at different stages of development) from being submitted to MDBs for executive approval and coming on stream. As a result, obligations under IFI loans as a share of Russia's total external debt has been declining steadily, dropping below 2.0% by the end of 2016.

The existing MDB projects in Russia target a broad range of matters. Among other things, they aim to improve the public finance framework, promote financial awareness and literacy, contribute to better standards of financial education, revamp and add new equipment to the properties and buildings of the Federal Service for Hydrometeorology and Environmental Monitoring of Russia (Rosgidromet), restructure the housing and utilities sector, streamline the national statistics system, support the national judicial reform, preserve and manage Russia's cultural heritage, and reshape the forest protection and management industry, etc. (see Chart 22). Today, the most relevant projects of MDBs include those in housing and utilities, systems for state registration of property rights and the judiciary.

Chart 23. Loans from MDBs, RUB bn



Source: Ministry of Finance of the Russian Federation

Assuming current geopolitical tensions persist, Russia's total debt outstanding (existing drawdown) to MDBs will stay below an average of USD 215.4 m or RUB 14.8 bn a year in 2017–2019 (see Chart 23). Most of the increase will come from the new MDBs, above all NDB, while some of the historically prevailing banks, such as IBRD and EBRD, are expected to see their project portfolio shrink further.

In 2015–2016, two new MDBs (NDB and AIIB) became operational. In July 2016, the Board of Directors of the NDB approved the first private loan for the purpose of building two small capacity hydropower plants in Karelia. In the AIIB, Russia is the third largest shareholder, after China and India, and also holds one fifth of the shares in the NDB, along with four other member nations.

Thanks to its considerable shareholdings in both financial institutions, Russia is in a position to influence key decisions at the AIIB and NDB. When laying out their lending policies, the management of the two development banks chose to focus on a risk minimisation strategy. In line with this vision, both AIIB and NDB approved lending policies that target mostly sovereign loans, loans guaranteed by member nations, and (NDB only) lending to national development institutes to allow onlending via loans to the private sector on preferential terms. Given the current geopolitical environment, Russia is able to use only the former two of the above tools. However, it is expected that some relief of the sanctions would allow Vnesheconombank to become considerably involved in financing private sector projects, which in turn would alleviate the strain on the federal budget.

Returning to the practice of attracting considerable volumes of sovereign loans from MDBs is currently extremely relevant, and there are several reasons for this. Firstly, the budget constraints severely limit the opportunities to provide funding to systemically important projects, above all in infrastructure, from the federal budget revenues. Resources of the leading MDBs can be an important solution in tackling the problem of non-existent long-term liquidity. Secondly, cooperation with these banks will give access to their expertise, improve financing rules and project implementation procedures used in Russia (which would help build trust with private businesses), and boost private investment. Besides, projects will enjoy flexible financing schemes that can optimise volumes of funding sought from MDBs[1]. Finally, an important benefit is the low cost of debt, along with access to additional financing such as grants by participating in MDB endowment programmes.

Russia's track record of cooperating with MDBs to date shows that the crucial and most urgent issue is to develop a sufficient number of projects that can be classified by MDBs as bankable and in line with both their internal policies and national strategies. Like most of other MDB shareholders, Russia is facing serious challenges here. A good illustration is the fact that the Eurasian Development Bank (EDB) did not launch a single project in Russia in 2016 despite having more than USD 1 bn at its disposal. Project identification and selection for the NDB is not going smoothly either.

In view of the above, cooperation with MDBs in the upcoming period will be based on the following approach:

[1] The amount and terms of borrowing can be revised depending on changes in market conditions.

1) search for, prepare and implement projects within Russia involving above all NDB and AIIB, and ensure Russia is actively engaged in the activities of other MDBs as a shareholder in order to facilitate effective use of their resources for Russia's benefit, and also to develop and implement measures aimed at clearing limitations that the IBRD and EBRD face in dealing with Russia;

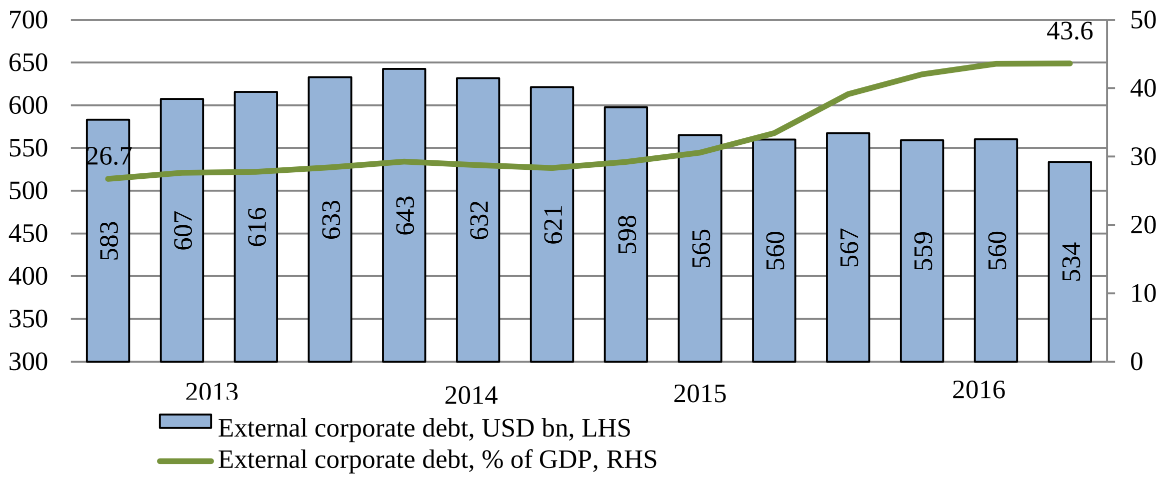
2) focus on expanding the portfolio of projects that MDBs have in Russia with no financial obligations on the part of Russia;

3) participate in various initiatives and tools aimed at using flexible tools of cooperation, including implementation of projects jointly with MDBs.

5.2. Corporate debt monitoring

Although in recent years, due to geopolitical tensions, restrictions in mutual trade and investments, have caused many Russian companies and banks, which traditionally used to be active players in the international debt markets, to lose access to external financing, adequate monitoring of corporate debt obligations to foreign lenders is still relevant. For most Russian borrowers, loss of access to the capital markets merely reversed the trend of growing external corporate debt.

Chart 24. External corporate debt in foreign currency



Source: Bank of Russia, Ministry of Finance of the Russian Federation

According to Ministry of Finance estimates, as at 1 July 2016 international obligations of Russian companies in foreign currency amounted to USD 534 bn. Since 2014, when sanctions against a number of Russian companies were introduced, these liabilities significantly decreased, by USD 87 bn or 14%. However, the depreciation of the rouble pushed the foreign corporate debt to

GDP ratio upwards (see Chart 24). As most revenues of Russian business entities are RUB-denominated, and they still cannot refinance their foreign currency debt in the international markets, the capacity for these debtors to service and repay their debt remains a pillar of stability for the entire financial system.

However, analysis of the current situation with respect to external corporate obligations shows that risks to financial stability are marginal. This is due to the following factors:

1) leading Russian exporters that account for the bulk of corporate debt generate sufficient cash flows in foreign currency to service and repay their debt, while their relatively low leverage enables them to partially refinance their external debt obligations in the domestic capital market;

2) according to the Ministry of Finance, the share of intra-group loans is considerable – they account for up to 25% of the total external corporate debt. Active use of the extension mechanism for this type of borrowings helps to keep actual loan repayments at up to 60% of the amounts provided for in the consolidated schedule of external debt repayment; as a result, in 2017 actual repayments may reach USD 45–50 bn vs USD 78 bn stated in the Bank of Russia reports;

3) An additional stability factor is the accumulated volume of foreign currency reserves (USD 387 bn as at end-2016), fully covering Russian debt obligations in foreign currency maturing over the next few years; if necessary, the Bank of Russia is in a position to provide funding in foreign currency to corporate borrowers in order to meet their external debt repayment schedules.

4) The Bank of Russia operates a system of ongoing monitoring of external corporate debt obligations; the Bank of Russia and the Ministry of Finance promptly exchange data on the structure and volume of Russian corporate debt; to maintain stability in terms of foreign currency liquidity, the Bank of Russia employs a set of refinancing instruments in foreign currency (currency swaps, REPO transactions, loans in foreign currency secured by a collateral of receivables under loans in foreign currency extended to leading exporters) which have proved their efficiency.

In general, Russian business entities have adapted themselves to the new borrowing environment, in particular, thanks to opportunities to refinance their foreign currency debt in the domestic capital market. At the same time, prerequisites for re-entering international capital markets for non-“sanctioned” Russian companies are underway. Moreover, a number of Russian corporate borrowers took advantage of lower prices for their own bonds and repurchased their debt obligations in foreign currency.

Overall reduction of risks associated with external borrowings of Russian companies was reflected in Russia’s credit ratings from the leading international rating agencies. The latest press releases from these agencies no longer include this risk in the list of key threats the Russian economy faces or may face.

5.3. Compensation for savings held by citizens of the Russian Federation

Another issue of the effective debt policy is compensation for savings held by citizens of the Russian Federation and accumulated before the collapse of the Soviet Union. Obligations associated with these savings are discharged from the funding sources for the federal budget deficit, i.e. from domestic public borrowings.

Pursuant to Federal Law No. 73-FZ dated 10 May 1995 *On Recovery and Protection of Savings of Citizens of the Russian Federation* and a number of other federal laws, these savings are to be recovered based on the purchasing power of the Soviet rouble in 1991. However, these laws do not establish the sources of financing for the relevant budget expenditures.

According to the applicable laws of the Russian Federation, compensation covers the four financial instruments below: deposits in the Savings Bank of the Russian Federation as at 20 June 1991, contributions (payments) to the state insurance companies of the Russian Federation as at 1 January 1992, State Treasury Bills of the USSR and savings certificates of the Savings Bank of the USSR sold on the territory of the Russian Federation prior to 1 January 1992.

The federal budget annually allocates funds for the relevant payments in an amount consistent with its capacity. In 2013–2016, RUB 29.3 bn of the federal budget’s funds were used for compensation, including RUB 9.2 bn in 2013, RUB 7.8 bn in 2014, RUB 6.8 bn in 2015, and RUB 5.5 bn in 2016. Annual payments of RUB 5.5 bn have been budgeted for 2017–2019.

Conclusion

Irrespective of the geopolitical and macroeconomic landscape, or the international and domestic market environment, the public debt policy during the period will be focused on ensuring the capability of the Russian Federation to borrow the amounts required to meet its social and economic objectives on conditions acceptable for the country as a reliable sovereign borrower, in terms of both price and structure. This will be supported by the permanent presence of Russia in the domestic and international debt capital markets, involving, inter alia, pursuance of a transparent and consistent auction policy, ongoing information exchange with the investment community and rating agencies, consistent increase in the number and range of investors interested in government securities of the Russian Federation, and further modernisation of the domestic debt market infrastructure.

The actual public borrowing volume will depend on the performance of the federal budget and on the domestic and international market environment. Aggregate domestic and external debt levels will remain within a range precluding threats to the country's debt sustainability. The debt policy will also be aimed at improving the country's credit ratings and ensuring its unconditional solvency.

Annex

Public debt of the Russian Federation in 2013–2019, RUB bn

Debt category	2013	2014	2015	2016	2017	2018	2019
Public debt of the Russian Federation	**7,548.3**	**10,299.1**	**10,951.9**	**11,109.8**	**12,680.5**	**13,778.6**	**15,133.7**
Domestic public debt of the Russian Federation:	**5,722.2**	**7,241.2**	**7,307.6**	**8,003.5**	**9,241.4**	**10,430.7**	**11,602.2**
including							
government securities of the Russian Federation denominated in local currency	4,432.4	5,475.7	5,573.1	6,100.3	7,205.2	8,301.0	9,388.8
other	0.0	0.0	0.0	0.0	0.0	0.0	0.0
state guarantees of the Russian Federation denominated in roubles	*1,289.9*	*1,765.5*	*1,734.5*	*1,903.1*	*2,036.2*[1]	*2,129.7*[1]	*2,213.5*[1]
External public debt of the Russian Federation:	**1,826.1**	**3,057.9**	**3,644.3**	**3,106.3**	**3,439.0**	**3,347.9**	**3,531.5**
including							
government securities of the Russian Federation denominated in foreign currency:	1,331.2	2,209.9	2,617.7	2,281.3	2,526.4	2,426.6	2,555.0
external bonds	1,331.0	2,209.6	2,617.3	2,281.1	2,526.2	2,426.4	2,554.8
sovereign bonds (OVGVZ)	0.2	0.3	0.4	0.2	0.2	0.2	0.2
loans due to foreign governments	69.9	101.2	89.2	62.4	51.3	46.9	44.6
loans due to multilateral development banks	51.2	65.9	70.4	49.9	50.6	41.3	32.6
other	0.7	1.1	1.5	1.2	1.5	1.5	1.6
state guarantees of the Russian Federation denominated in foreign currency	*373.1*	*679.8*	*865.5*	*711.5*	*809.2*[1]	*831.5*[1]	*897.7*[1]

[1] Based on the assumption that Russian state guarantee programmes in roubles and foreign currency are 70% and 20%, respectively, completed.