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Domestic market capacity may not be sufficient to meet the government's ambitious borrowing program

Quasi-market instruments or accumulated federal budget funds can be used to finance federal budget expenses

In 2020, the Russian government's financing needs will be notably higher compared to previous years. This is due to the unforeseen economic shocks caused by a slump in oil prices and the COVID-19 pandemic, which have resulted in a shortfall of budget revenues and the necessity to support the economy via deferred payments and increased expenditures.

Unlike many emerging countries, Russia entered the current crisis with a strong macroeconomic position, including a low level of government debt and significant liquid assets that practically cover the debt of the federal government. This liquidity enabled the government to either refrain from borrowing or keep it at a low level. Nevertheless, the government decided to considerably expand its borrowing program. This raises the issue of the capacity of the domestic market.

In ACRA's view, the capacity of the domestic market is limited due to the low volume of long-term ruble liquidity in the economy and the specific business preferences of resident investors (including banks, pension and investment funds, insurers and households). Reliance on non-resident investors will make the domestic market more sensitive to changes in the global economic situation. The government also has the option of increasing its external borrowings, though cautiously taking into account sanctions risk.

Increasing government borrowings may create a crowding out effect that would limit space for corporate borrowers, while the government's current debt repayment profile will lead to an increase in gross borrowing, taking into account the growth in the repayment of government bonds in the coming years.

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Budget financing needs in 2020

The Russian government's budget financing needs will reach a historic high in 2020 due to unforeseen macroeconomic shocks. Namely, the slump in oil prices and contraction in economic demand caused by the quarantine implemented to fight the COVID-19 pandemic.

The Russian Ministry of Finance expects a federal budget deficit at 4.4% of GDP in 2020, compared to a 1.8% surplus last year. This is due to lower tax revenues amid lower GDP and falling oil prices (the shortfall in income will amount to 2.4% of GDP) and the fiscal stimulus package adopted by the government to mitigate the negative impact of the pandemic (expenditures are expected to exceed the start-of-year targets by 2.9% of GDP). Although the budget deficit is going to increase substantially, it should be noted that not all of the government's budget needs will be financed by debt.

At the onset of the crisis, Russia had a substantial amount of liquid assets that could be used to reduce debt financing needs in 2020. The latest version of the budget rule, which was adopted in 2017, allows for automatic compensation of part of lost oil and gas revenues by the National Wealth Fund (NWF). In addition, free federal budget funds can be used to support expenditures.

At the start of this year, budget liquidity (the sum of free cash balances, the liquid part of NWF and other assets) stood at RUB 12.7 tln (11.7% of GDP) and was enough to cover lost revenues in 2020. The NWF stood at RUB 7.7 tln (7.1% of GDP), including the liquid part — RUB 6.1 tln (5.6% of GDP). The NWF's liquid assets were partially used to finance increased expenditures as a result of the deal to buy the stake in Sberbank in H1 2020.

As the cap on federal budget expenditures set by the fiscal rule (which government officials stated will be suspended this and next year) will be lifted, but the Urals oil cut-off price will still be in place, the government will try to offset the loss of revenues mainly with borrowed funds. Additional tapping of the NWF is not expected because the oil cut-off price has not changed.

In ACRA's view, the government will try to borrow until there is a lack of demand for its securities at prices that the Ministry of Finance considers to be acceptable. In the event of significant pressure on yields, the government is more likely to use its free cash balances than borrowed funds.

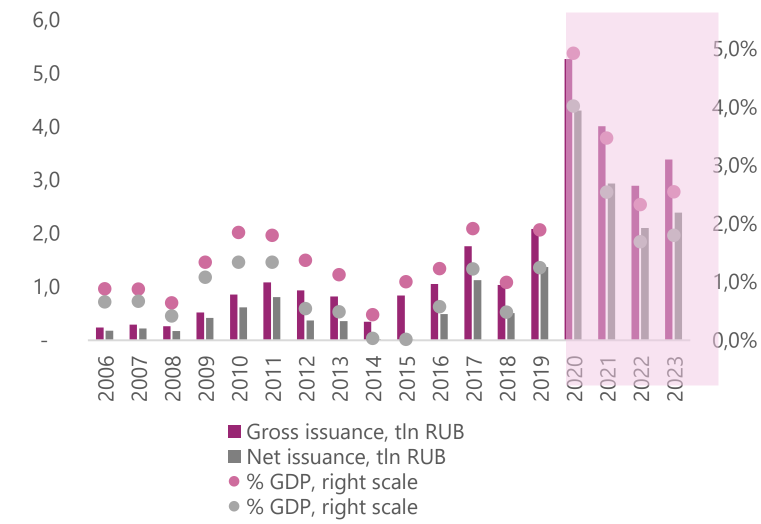
Table 1. Expected volume of federal government issuance in the event of full execution of the budget, % of GDP

	2020	2021	2022	2023
Gross issuance	4.9%	3.4%	2.7%	2.6%
Net issuance	4.0%	2.5%	1.7%	1.8%

Sources: Russian Ministry of Finance, ACRA

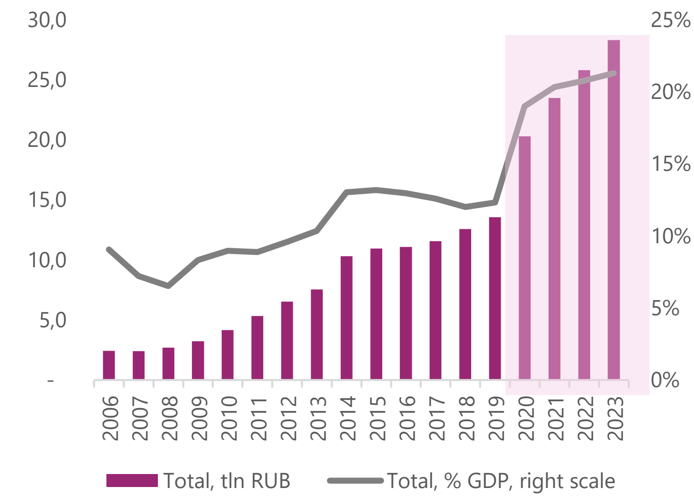
Compared to expected issuance volumes (*Table 1*), the federal budget's gross and net annual issuance for the last five years stood at 1.4% and 0.7% of GDP on average, respectively, indicating a substantial expansion in the supply of state securities (*Fig. 1*). In 9M 2020, the Russian Ministry of Finance raised RUB 2.8 tln through OFZ auctions, just over half (52%) of the new target for this year — RUB 5.4 tln. Therefore, the capacity of domestic market investors may be insufficient for full execution of the government's domestic borrowing program.

Figure 1. Gross and net issuance of debt in local currency



Source: Russian Ministry of Finance

Figure 2. Federal government debt dynamics



Source: Russian Ministry of Finance

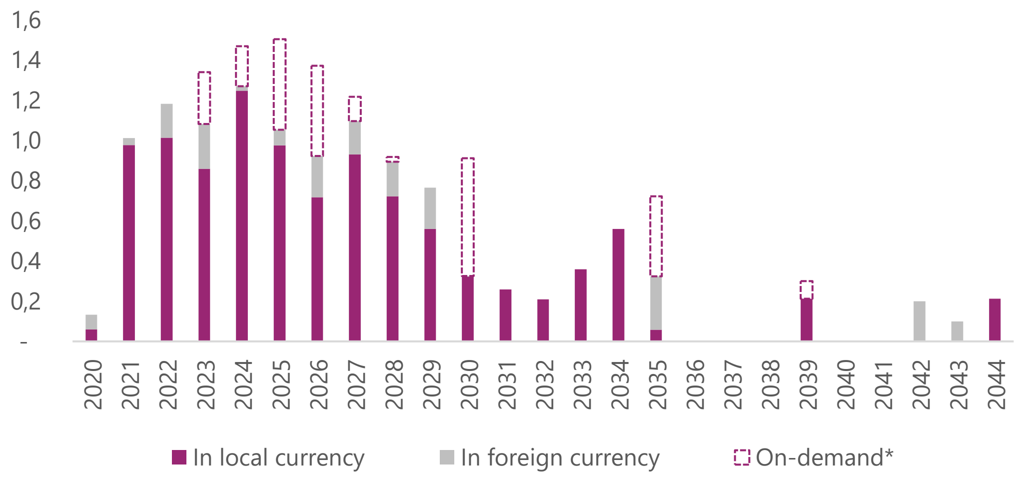
Despite the elevated debt financing needs of the federal budget in 2020, the federal debt burden will remain low at 19.1% of GDP (15.8% excluding guarantees) by the end of this year. It will more than double in absolute terms and reach RUB 28.4 tln, or 21.4% of GDP (*Fig. 2*) by the end of 2023. In ACRA's opinion, the government is likely to continue issuing debt denominated in local currency, while foreign currency debt issuance will probably not serve as a significant source for financing the federal budget deficit.

ACRA's assessments show that the government has a number of options for increasing borrowings in the upcoming years. It can diversify its investor base by attracting new foreign investors and/or promoting government bonds among households or using quasi-market instruments, including long-term repo operations that the Bank of Russia announced this year.

ACRA notes two risk factors that can affect the government's borrowing programs in the coming years. Firstly, the duration of debt placed may fall and demand may grow for medium-term bonds instead of long-term ones due to the significant volume of financing. In this case, the average maturity of the new issues is likely to slightly decrease: in 2019, this indicator stood at 8.5 years, this year it is 7.4 years. This factor could push up the government's debt payout ratio for the next 3–7 years amid an inevitable front-loading in gross borrowing needs.

This trend could potentially lead to a negative impact on yields. In this case, redemptions will increase in the coming years. Taking into account current redemption profile, they will already almost double next year to around RUB 1.0 tln and increase further in 2022 to around RUB 1.2 tln (*Fig. 3*).

Figure 3. Government debt redemption profile as of August 2020, tln RUB

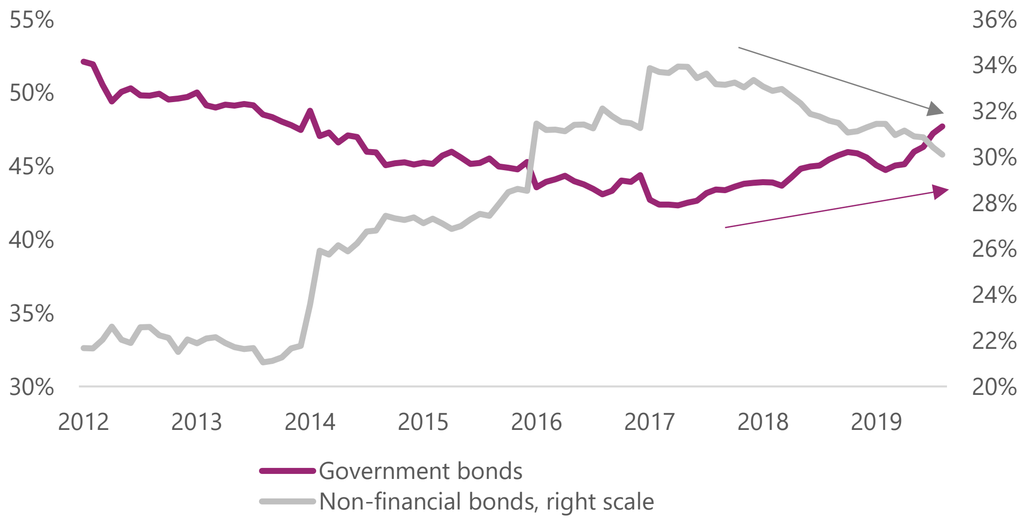


* Bonds that are currently being offered by the Russian Ministry of Finance

Source: Bank of Russia

Second is the risk of increased competition between the public and private sectors for the resources of domestic investors, i.e. the crowding out effect. Higher net government borrowings observed since 2017 have already increased the share of government bonds in the overall bond market in local currency (excluding the Bank of Russia's short-term bonds issued for monetary purposes), while previously this share had been decreasing gradually (*Fig. 4*). Given its ambitious plans to boost borrowings, ACRA believes that the government's share is likely to continue increasing. As a result, the crowding out effect is likely to intensify, cannibalizing the domestic capital market and thereby leaving less market capacity for the private sector to borrow.

Figure 4. Share of Government and non-financial companies' bonds in the ruble-denominated bond market, excluding the Bank of Russia, as of July 2020



Source: Bank of Russia

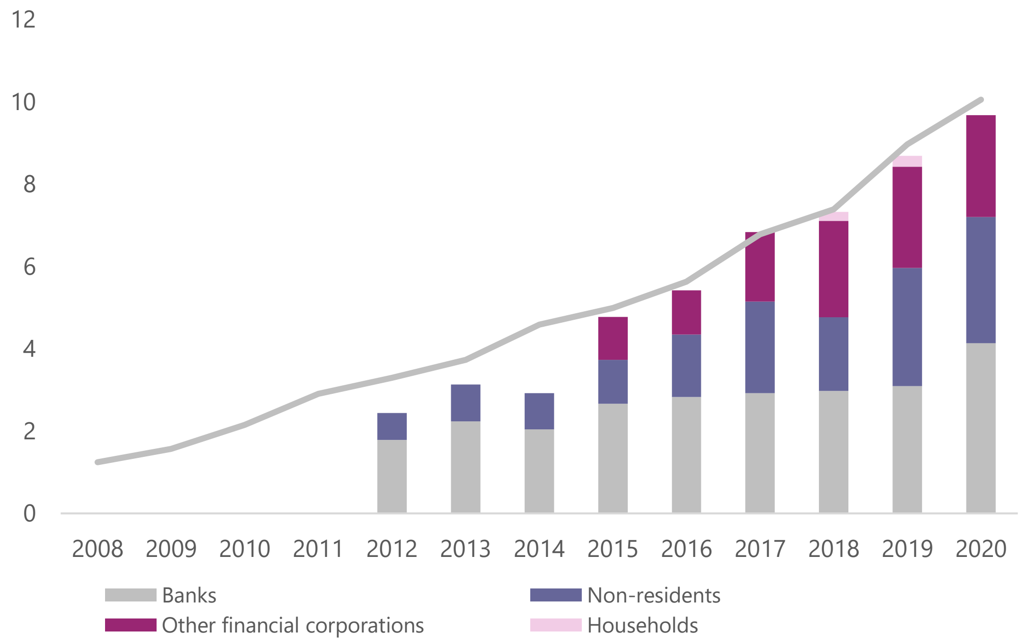
Structure of holders of government debt

The current structure of holders of local currency federal debt is balanced. In recent years, the government's debt policy relied on ruble-denominated debt and developing the domestic market. By the end of August 2020, the federal government's debt in local currency constituted the lion's share of the total federal debt in securities, making up 79.7% of the total. Marketable bonds (OFZs) constituted the largest portion of local currency government bonds (96.7% as of August 2020). ACRA notes that the government has managed to create a liquid yield curve as the benchmark for domestic borrowers and build market infrastructure.

For more information, see ACRA's research "A Brief introduction to the Russian bond market" from February 28, 2019.

These efforts have resulted in a balanced composition of OFZ holders. By the end of 2019, the largest share of these investors was made up of banks followed by non-residents. Other financial corporations (long-term investors), including pension, insurance and investment funds occupied third place (*Fig. 5*)[1]. Households accounted for the smallest part of the government's creditors (2.2%). Thus, the main holders of government debt were traditional domestic investors — banks and financial companies — which accumulated around two thirds of domestic government securities.

Figure 5. OFZ holders, as of June 2020, RUB tln*



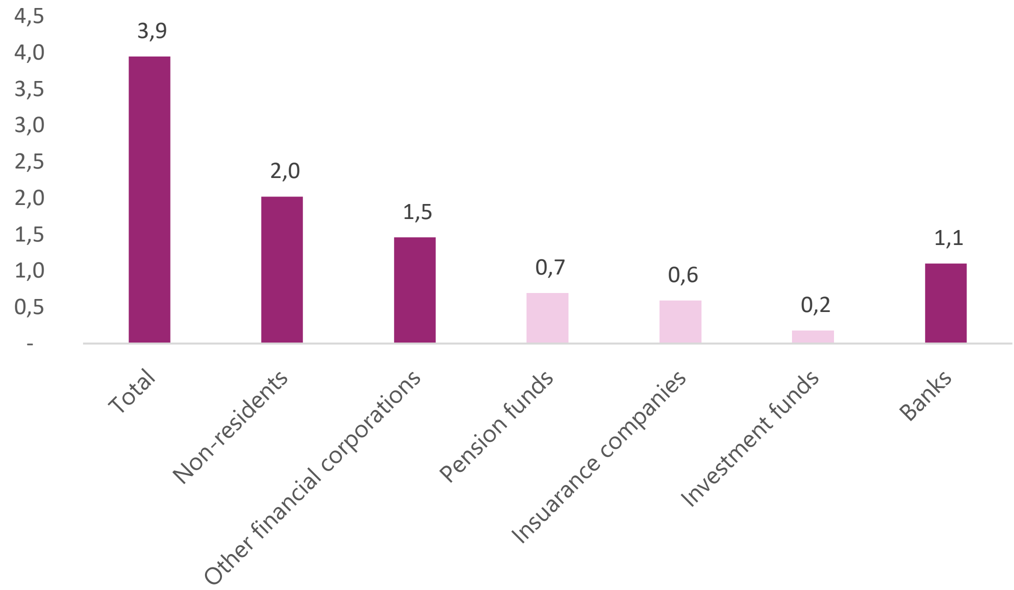
* Data for other financial corporations available from 2015 to 2019, for households for 2018 and 2019.

Sources: Russian Ministry of Finance, Bank of Russia, NAUFOR

ACRA notes that the share of non-resident OFZ holders grew considerably from 20.2% at the end of Q4 2014 to 30.8% as of Q4 2019 (latest available data on all holders). Non-residents made the biggest contribution to the state's debt holdings in that period (*Fig. 6*). Since the start of 2020, the share of non-residents has fallen slightly and reached 29.4% of domestic debt in securities as of August 2020. Another rapidly growing group of investors is domestic financial institutions. Growth of OFZ holdings of domestic banks was mainly driven by the RUB 1.0 tln recapitalization program in 2014–2016 and stood at 41.5% of the total OFZ market as of August 2020.

[1] ACRA used various sources because there are no publicly available centralized statistics on government debt ownership. Thus, data for certain years does not sum up to the total.

Figure 6. Contributions of different types of investors to the growth of government OFZ debt from Q4 2014 to Q4 2019, RUB tln



Sources: Russian Ministry of Finance, Bank of Russia

Capacity of non-residents

Can non-residents increase their holdings of Russian state debt? Compared to banks and other financial corporations, the capacity of non-residents to invest in Russian state debt is virtually limitless. What matters is their willingness to invest, which is defined by their assessment of the credit and foreign currency risks associated with Russian government bonds relative to other emerging markets.

Unlike many other emerging market countries, Russia entered the current crisis with one of the lowest levels of debt (12.3% of GDP or 10.8% of GDP excluding guarantees as of the end of 2019) and a substantial amount of liquid assets in the form of the NWF and other cash reserves. Russia's debt is likely to rise to 21.3% of GDP by the end of 2023, but still remain modest by international standards.

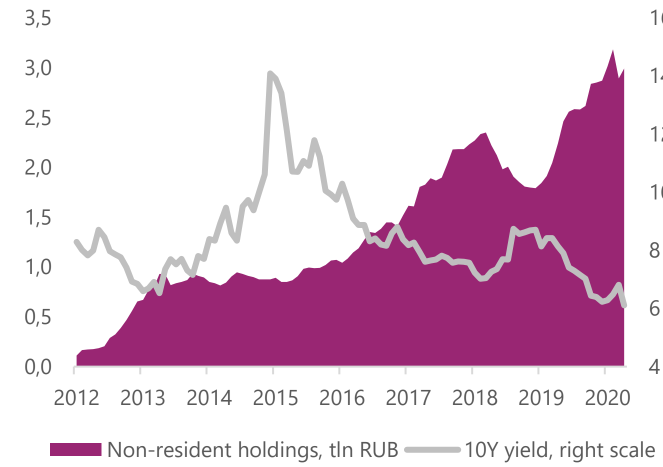
Although non-residents' capacity to absorb the debt is practically limitless, the volatility of their sentiments makes governments of emerging markets wary of non-residents holding a significant share of their debt. Non-residents' appetites to invest tend to wane during global risk-off periods like the taper tantrum in 2013, the sharp ruble depreciation in 2014, and the threat of the imposition of additional sanctions in 2018. The COVID-19 sell-off in March 2020 is the most recent example of this (*Fig. 7*).

In the Russian market, non-residents' holdings are unevenly spread across government bonds with different characteristics. In particular, their holdings are mostly concentrated in the most liquid bonds and bonds with longer maturities. Although at the end of July 2020 the share of non-residents accounted for 29.7% of total outstanding OFZs[2]. Their share increases to 39.1% if only the key instrument — liquid plain vanilla bonds (OFZ-PD) with fixed coupons and bullet maturities[3] —

[2] Taking into account special OFZs for retail investors (OFZ-n).
[3] Excluding the RUB 212.6 bln 26231RMFS issue which was transferred to VEB.RF in full.

is taken into account. This indicator increases even further, to 48.9%, if liquid OFZ-PD with maturities longer than 10 years are considered. Certain OFZ-PD issues are dominated by non-resident holders, namely: 26212RMFS (7.05%, January 2028) — 69.4% and 26207RMFS (8.15%, February 2027) — 62.6%. The high concentration of non-residents in these issues means that their value is considerably exposed to the sentiment of these investors.

Figure 7. Non-resident holdings and government bond yield, as of July 2020



Sources: Bank of Russia, Reuters

Figure 8. Non-resident holdings of OFZ-PD by maturity, as of July 2020

Sources: Russian Ministry of Finance, National Settlement Depository

In ACRA's view, non-residents will continue to buy ruble-denominated government debt as they are attracted by Russia's strong macroeconomic fundamentals and less volatile (compared to previous risk-off periods) national currency. Moreover, the level of non-residents' holdings of general government debt[4] — 30.1% at the end of Q1 2020 — is still below the threshold considered by the IMF as the upper benchmark for general government debt for emerging countries (45.0%). However, increasing non-residents' holdings and their concentration in a particular spectrum of state debt could elevate the risks of a sudden selloff by investors and a market freeze, which would force the government and corporates to postpone borrowing plans and increase borrowing costs.

Capacity of banks

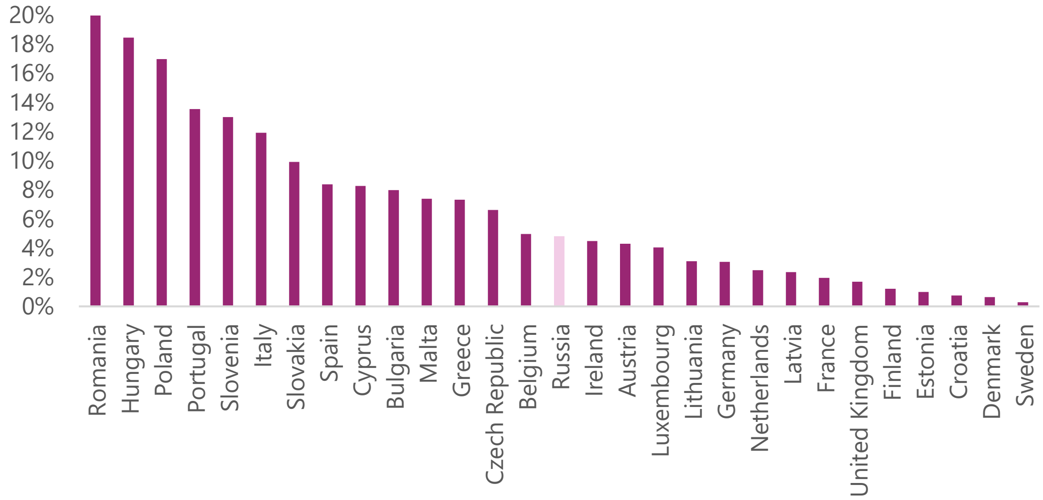
How large is domestic banks' capacity to invest more in the state debt? ACRA assumes that the banking sector's additional capacity to absorb an increased government bond supply is limited, although banks in Russia have relatively less exposure to the government compared to other countries (*Fig. 9*).

Studies show[5] that banks in emerging markets (EMs) tend to hold two times more government bonds compared to banks in developed markets (DMs), 10.4% and 5.1% of total assets on average for 2010–2016, respectively. This is driven by less diverse financing options available to EM sovereigns, fewer investment

[4] Federal, sub-federal and municipal debt except guarantees in local and foreign currencies. It is assumed that non-residents only own federal government debt.
[5] IMF Working Paper, "Banks' Holdings of Government Securities and Credit to the Private Sector in Emerging Markets and Developed Economics", October 2019.

opportunities, sometimes falling demand for credit in the private sector in EMs, and a bigger share of state-owned banks and higher interest rates in EMs. During periods of financial distress, banks rebalance their portfolios in favor of safer assets. It is noteworthy that banks' claims on the government are usually negatively correlated to private sector credit growth.

Figure 9. Share of general government debt in banks' assets, as of 2019

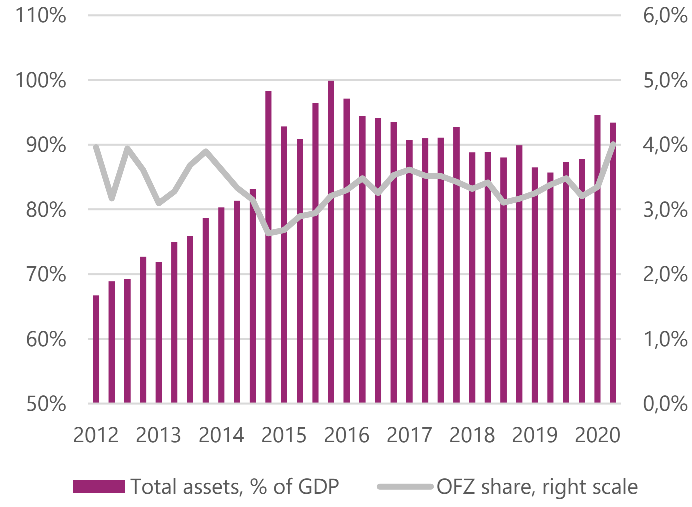


Sources: ECB, Bank of Russia

Banks' total capacity (assets) in Russia has been declining as a share of GDP since 2016 (a recent spike was driven by the reevaluation of foreign currency denominated assets, rather than growth of the local currency component). Since then, banks' exposure to OFZs has remained almost unchanged at around 3% of their total assets (*Fig. 10*). Holdings of general government debt, including government eurobonds and sub-federal debt, stood at 4.5% of total assets in August 2020.

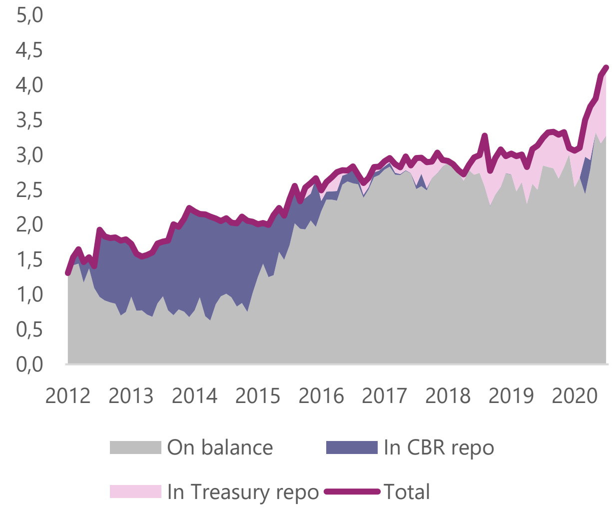
One of the main reasons why banks accumulated OFZs was the recapitalization program, which was aimed at supporting the banking system after the 2014 shock. In December 2014, the government issued 1.0 tln in OFZ bonds as part of this program and transferred them to Deposit Insurance Agency (DIA), the operator of the program. The DIA transferred most of these bonds to banks in 2015–2016 under certain conditions, including that the banks keep credit growth at a certain level and limit wages paid to their employees.

Figure 10. Total bank assets and domestic government bond holdings, as of June 2020



Source: Bank of Russia

Figure 11. Banks' OFZ holdings, RUB bln, as of August 2020



Sources: Bank of Russia, Federal Treasury

Currently, the banking system has a structural surplus of liquidity, so there is no need to attract it from the Bank of Russia. However, due to the uneven distribution of liquidity, individual banks lack it and actively use repo operations with the Federal Treasury; in these transactions, banks receive liquidity in exchange for OFZs. The government, which has a significant amount of available funds on its balance sheet, provides liquidity through deposit auctions, repo operations, and currency swap operations. In September 2020, the government allocated a total of RUB 2.0 tln, or 1.9% of GDP (in September 2019, this figure peaked at RUB 3.4 tln, or 3.1% of GDP).

The consequences of the large-scale sale of OFZs by non-residents in March 2020 were largely offset by banks increasing their share of OFZs while simultaneously increasing funds attracted from the budget secured by OFZs. In recent months, banks have significantly increased the amount of funds raised from the Federal Treasury on OFZs (*Fig. 11*), which can support regular auctions of the Ministry of Finance.

ACRA estimates that the factors listed below will support bank demand for government bonds:

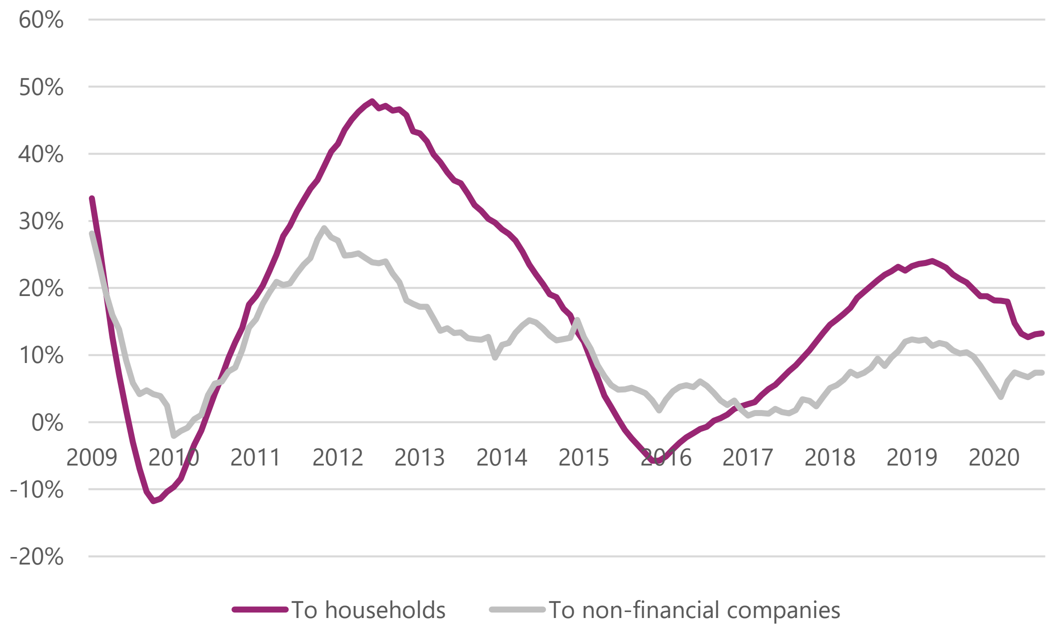
- In times of crisis, banks prefer liquid assets. The economic shock of 2020, which reduced banks' risk appetite (despite anti-crisis measures to ease regulation on banks facing a deterioration in the financial situation of households and businesses), contributed to the accumulation of liquidity. These funds can be allocated to OFZs.
- Sovereign risk is more attractive in a crisis than the creditworthiness of businesses and households experiencing financial difficulties.
- Expectations of low interest rates in the medium term increase the attractiveness of long-term investments (including investments in government bonds) and compensate for market risks and liquidity risks for banks. As the key rate reduction cycle ends, the demand for fixed-coupon OFZs (OFZ-PD) will decrease, while floating-rate OFZs (OFZ-PK) and inflation-linked OFZs (OFZ-IL), on the contrary, will increase. In August of this year, the share of OFZ-PK and OFZ-IL in domestic government debt in securities stood at 21.5%, with OFZ-PK at 17.2%. These levels are still safe

for the budget, but a significant increase in OFZ-PK and OFZ-IL placements will increase the dependence of debt service costs on interest rate dynamics, which will reduce the flexibility of budget expenditures during periods of increased rates.

However, there are factors that limit bank demand for government bonds:

- Interest rate volatility has a greater impact on the marking to market bonds with longer maturities. This may put pressure on bank capital in the medium term.
- Decrease in cash in the national currency. In August 2020, this figure decreased to 0.9% of total assets (RUB 0.8 tln) compared to 2.0% in 2013. In addition, RUB 0.8 tln was invested in Bank of Russia bonds and another RUB 1.4 tln was placed on deposits with the Bank of Russia. These funds may be partially used to purchase OFZs, while, based on the greater urgency of the latter, banks may require a premium.

Figure 12. Bank loans in rubles y-o-y, August 2020



Source: Bank of Russia

ACRA believes that the limiting factors will outweigh the supporting factors, and therefore the banking sector is unlikely to significantly increase its share of public debt.

However, the Bank of Russia can use quasi-market instruments to maintain demand for OFZs, primarily long-term (one year) repo operations announced this year. This tool was used by the Bank of Russia to provide banks with funds in the national currency during a liquidity shortage in 2014. This year, the Bank of Russia resumed use of this instrument to support the system during a period of increased volatility and due to uneven liquidity distribution in the banking system. At the same time, the Ministry of Finance can utilize this tool to increase public debt issues. Banks can participate in OFZ auctions, then receive liquidity from the Bank of Russia using the purchased OFZs as collateral and use the liquidity to purchase more government securities. The attractiveness of these operations for banks will depend on the positive difference between the bond yield and the cost of liquidity from Bank of Russia (repo rate). As a result of using the operations described above, the Bank of

Russia will actually finance the government, meaning that Bank of Russia's claim on government will increase.

The second non-standard financial instrument could be the purchase of government bonds by the Bank of Russia on the secondary market. However, at the most recent press conference, the head of the Bank of Russia said that this is not being considered. ACRA notes that at the end of 2019, the Bank of Russia owned a small amount of OFZ (RUB 34 mln). Developed countries use this instrument quite widely, as their ability to stimulate the economy by reducing policy rates is limited because rates have already reached zero or near-zero levels. However, during the current crisis, the central banks in emerging countries (Poland, Turkey, South Africa, the Philippines, etc.) have also resorted to similar operations to support the budget by providing credit resources and reducing their cost.

Capacity of financial companies

To what extend can financial companies buy government debt? Unlike national banks, which hold a small amount of government debt relative to their balance sheet, financial companies (long-term investors such as pension and investment funds, insurance companies) have government bonds as the second largest asset in their portfolios. In Q2 2020, they accounted for 16.5% of the total assets of long-term investors. Since 2015, this share has increased by 5.1 p.p. This is comparable to the increase in the share of corporate bonds, which over the same period increased by 5.2 p.p. to 28.3%.

According to ACRA, increasing the share of long-term investors in the national debt is a matter of medium- and long-term prospects. These investors need their assets significantly expanded, which could come from changes in regulation and/or economic recovery.

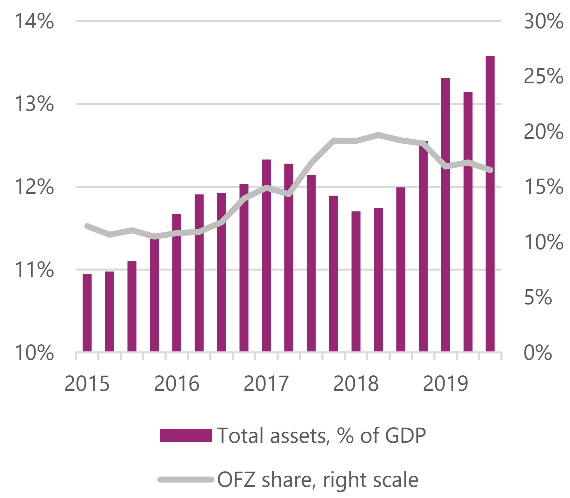
The total amount of assets under the management of financial companies in Q2 2020 amounted to 13.4% of GDP (*Fig. 13*), which is low compared to other countries (*Fig. 14*). In countries with developed pension systems, the assets of pension funds are close to or exceed GDP. This is due to the existence of a developed corporate pension system, which accumulates significant funds in addition to state pension provisions. The accumulation of non-state pensions is also supported by tax benefits.

The incomplete pension reform in Russia limits the growth of pension fund assets. The Russian pension system is financed by mandatory payments (22 p.p. out of 30% of total social contributions) and contributions to non-state pension funds. Until 2014, mandatory pension payments were divided into two parts: 16 p.p. went to finance current pension payments and 6 p.p. to funded pensions, which were the main sources of long-term money in the domestic market. During the 2014–2015 crisis, the government decided to freeze contributions to funded pensions and use these funds to pay current pensions in order to reduce transfers from the federal budget to the Pension Fund of Russia. The freeze is still in effect, and the pension system is undergoing reforms. The reforms assume a guaranteed pension plan, which will be formed at the expense of voluntary contributions from citizens and stimulated by tax benefits. Therefore, currently, only non-state pension provisions serve as a source of long-term money in the domestic market.

The growth of insurance company assets is expected to slow down amid a decrease in insurance premium growth rates. At the same time, the life insurance segment will continue to grow, which will support the demand for long-term assets. Investment funds could grow as the level of household involvement in the capital market increases. In 2019, household investments increased by 69.4% year-on-year to 3.0% of GDP.

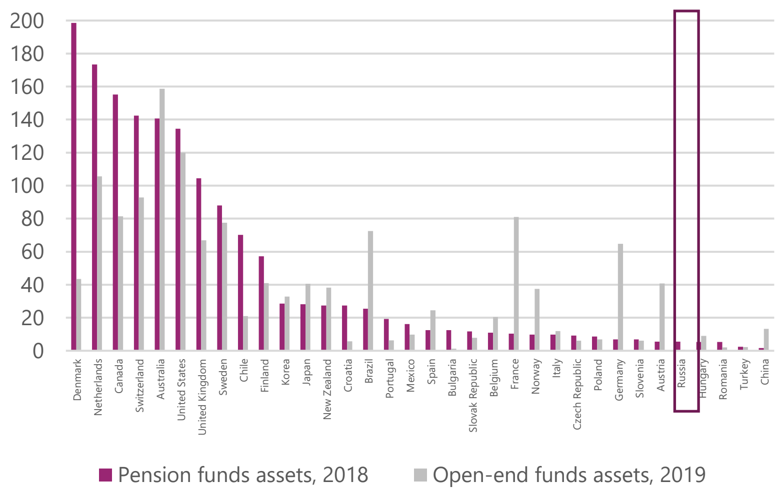
Long-term investors provided significant support to the OFZ market in 2018 during the large-scale sale of bonds by non-residents, which was provoked by the threat of sanctions on Russian government debt. According to ACRA, the ability of this type of investor to absorb the increased OFZ supply is limited due to a slight increase in their assets and reduced amounts of available funds. Since 2015, the share of their cash and deposits has decreased by 4.5 p.p. (to 14.4% of total assets as of Q2 2020).

Figure 13. Financial corporations, Q2 2020



Source: Bank of Russia

Figure 14. Financial corporations, % GDP



Sources: OECD, Investment Company Institute, Bank of Russia

Capacity of households

Are households active investors in the public debt market? Currently no, as this is more of a medium- to long-term issue. This type of investor is new to the Russian market. As part of the current stimulating cycle of monetary policy, deposit rates are falling, and therefore the population will look for more attractive alternatives to invest their savings, including government bonds.

By the end of 2019, households had invested a total of RUB 265 bln in OFZs, which is RUB 47.0 bln more than a year earlier. This was mainly due to increased household activity in capital markets. However, the share of OFZs in the total financial assets of households decreased in 2019 from 11.3% to 8.1%. This was due to a more active increase in investments in other instruments. Therefore, the total investment of Russian citizens in securities had reached RUB 3.3 tln by the end of 2019 (3.0% of GDP), compared to RUB 1.9 tln in 2018.

In Russia, as in many other countries with a few exceptions, household exposure to government debt is small. In 2019, the share of households in the total volume of OFZs was about 3.0%. In Italy, for example, households owned 5.0% of the national debt at the end of last year, and in Poland that figure was 4.1%. Hungary's figure is high, as the government decided to reduce non-resident participation in public debt and resorted to a policy of attracting household funds to the government bond market. As a result, in 2019, the share of this category of investors in Hungary's public debt was about 30%. Therefore, although household savings cannot be considered the main source of budget financing, they obviously have some potential for this role.

Currently, consumers in Russia can place their savings either through standard brokerage accounts or through trust management accounts. In order to increase household involvement in capital market operations, individual investment accounts (IIAs) were introduced in 2015. These are both special brokerage accounts and trust management accounts, for which tax benefits are provided. The total amount of funds in IIAs reached RUB 220.0 bln in 2019 (0.2% of GDP), of which 11.4% (RUB 25 bln) was invested in OFZs. In 2020, the government announced measures to make IIAs more attractive, including increasing the limit on annual deposits from RUB 1.0 to 3.0 mln, allowing early withdrawals, and using IIA funds for certain purposes.

To expand its investor base, the government has been offering special non-traded retail bonds (OFZ-n) since 2017. Residents can buy these bonds via their brokerage accounts (not IIAs). The total amount of OFZ-n outstanding is negligible, standing at RUB 43.4 bln in August 2020 (0.4% of OFZ market). The Russian government has recently announced incentives to make its debt more attractive for households. Previously, households buying government bonds were exempt from coupon payment taxation. However, recent changes in the tax system have eliminated this benefit. To keep households interested in OFZ-n, the government has decided to compensate by reducing the issue price of these securities.

For more information, see the joint analytical study conducted by ACRA and Golden Credit Rating, titled "What do the Chinese and Russian bond markets have in common? And how do they differ?," from February 28, 2019.

Due to decreasing interest rates, the attractiveness of the deposits is diminishing. In August 2020, deposits stood at 29.1% of GDP, of which 23.1 p.p. was in rubles. Under these conditions, more households, attracted by higher yields on government bonds compared to deposits, can enter the capital market. In ACRA's view, households have the capacity to support the government's plans. However, as the experiences of other countries have shown, the government may have to offer additional premiums to ensure significant demand for public debt from this type of investor.

External markets

Will borrowing in foreign markets help? Yes. Despite the US sanctions, the European market remains open for borrowing, and Asian markets can also be tapped. Historically, the government has issued bonds in the external market to form a benchmark (yield curve) for corporate borrowers, maintain its presence in the external market, and interact with non-resident investors.

In 2019, the government placed eurobonds worth USD 5.5 bln and EUR 0.75 bln. Traditionally, demand from investors has exceeded placement volumes. This is due to the high appetite of investors for sovereign risk in foreign currency, given Russia's strong macroeconomic indicators and low public external debt.

In August 2019, the Office of Foreign Assets Control (OFAC) of the US Department of the Treasury issued a CBW (Chemical and Biological Weapons) Act Directive that prohibits US banks from "participating in the primary market for non-ruble denominated bonds issued by the Russian sovereign." Despite the fact that Russia did not use US banks either as underwriters or as depositaries in previous eurobond placements, payments in USD are likely to be cleared ultimately through US banks and therefore, eurobond issuances in USD pose sanction risks.

The Russian government can borrow in euros as European countries have not imposed anti-Russian sanctions similar to those of the US. The government recently confirmed its intention to place eurobonds in euros this year, but the increased risks of additional sanctions may suspend or postpone this initiative for a considerable period. If the government does not place eurobonds in 2020, it will have to further increase domestic borrowing or use accumulated cash balances.

Asian markets can also be considered as an option for placing government securities, considering that the Russian Ministry of Finance began preparing for the placement of bonds in Chinese yuan several years ago. The government intends to gain access to a new type of investor, namely, domestic long-term Chinese investors (by placing yuan-denominated bonds on the Moscow Exchange).

Initially, an estimated placement volume was announced equaling USD 1 bln, but this figure may increase in the future due to the large capacity of the domestic Chinese market. Previously, the measures imposed by the Chinese government against capital outflows from the country posed an obstacle to the placement. However, since 2019, these restrictions have been relaxed, which has opened up opportunities to place Russian government bonds.

The capacity of the Chinese domestic market can help Russia meet its borrowing goals. In addition, these placements can be conducted on a regular basis, setting a benchmark for borrowing in yuan for Russian companies. This will also contribute to further economic cooperation between Russia and China.

ACRA believes that the government can increase the annual external borrowing program by more than USD 3.0 bln (the amount that the government has traditionally put in the external state borrowing program in the last few years) over the next three years to ease the pressure on the domestic market. This could help Russia expand its investor base and diversify currency risks while maintaining an acceptable level of external public debt.

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