



The development of the GKO futures market in Russia

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Abstract

This study analyzes two issues related to the GKO futures market in Russia in 1996 and 1997. First, we evaluate the existence of a risk premium in this market. We show its existence providing a functional form for the premium. The main result is that risk premium depends positively on the time before delivery of the futures contract. We provide anecdotal evidence in support of our results. Secondly, we study the degree of integration between GKO secondary and futures markets and its evolution over time. There is evidence of such integration, we found that this measure is time-varying and reveals the presence of a structural break in the market integration from April 1997 onwards. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

The government short-term bonds (GKO) market in Russia was officially created in May 1993 and reached its peak in 1997 before its collapse in August 1998. Trading in GKO had quite a complex structure, with informational linkages

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among all the various sectors: the primary auction, the secondary market, the futures market and the repo market.¹ From the point of view of the Russian government, it was important to monitor not only the situation in the primary auction sector but also the behavior of the secondary market, given that the financial authorities used to place additional tranches of the issued GKO in the secondary market. Furthermore, GKO secondary market prices were often used to gauge inflationary expectations.² The major role played by the GKO market on government finance makes it very important to investigate the whole structure of the market and the interaction of all its segments. Thus, the main aim of this research is to analyze different aspects of the interaction between the GKO futures market and the GKO secondary market. This suggests an econometric investigation of two phenomena: the presence of the risk premium in the GKO futures market and the degree of integration between the GKO secondary market and GKO futures market.

Evidence of risk premium in futures bonds markets is widely documented in the literature on well-developed futures markets, such as those for Western European and US Treasury Bonds.³ Whether a risk premium existed in the market for Russian GKO futures was of interest to both domestic and foreign investors. For these agents, the possible presence of a risk premium in the futures market was a major determinant of the cost and benefits associated with hedging. Moreover, the risk premium was of importance to the Russian government as it could help to characterize the expectations of investors and, therefore, it may have been a useful indicator of the future spot rates for GKOs. As already mentioned earlier, the GKO market in Russia collapsed in the aftermath of the August 1998 crisis when it was defaulted and despite various attempts in 1999 and 2000 there is not yet a clear debt restructuring scheme. Why then is it still of interest to study this market now? Mainly because lessons can be learnt from what happened to the GKO market in the past for the Russian bond market in the future. Since the default of the GKO obligations in August 1998, the general principles of fiscal policy of the Russian Government have changed drastically. The rising of oil prices (with obvious benefits to the state budget which is largely dependent on oil revenue), better macroeconomic conditions and less uncertain political climate envisage deficit-free budgets, and by far lower reliance on domestic borrowing. However, the government has to honor the defaulted debt. Thus, Russia will have to resort to larger domestic financing. In fact the GKO/OFZ (see below) market is gradually recovering. Four new GKO placements were conducted in the year 2000 and the Budget

¹The repo market was not a market in the fullest sense: repo operations were allowed for some big GKO holders (banks) and with the Central Bank only.

²Quantitative and qualitative analyses of the GKO-OFZ (see below) market can be found in MICEX (1995) and in related works by Dvorkovich and Gurvich (1998) and Ivanter and Peresetsky (1999).

³See for instance Thompson and Waller (1988), Followill and Helms (1990), Smith and Whaley (1994), Shyy and Lee (1995), Pirronmg (1996) and Breedon and Holland (1998): the last paper presents investigations on futures traded in two markets (two exchanges) resembling very much the Russia's GKO futures case.

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