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The Russian Federation: From Financial Pariah to Star Reformer

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THE RUSSIAN FEDERATION:
FROM FINANCIAL PARIAH TO STAR REFORMER

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The evolution of Russian sovereign debt provides an interesting case study of debt management and restructuring. After the August 1998 crisis, which involved a default on a significant part of public debt and a steep devaluation of the ruble, most observers, both domestic and foreign, predicted that it would take many years for Russia to recover. However, economic growth turned positive very quickly, accompanied by the remarkable improvement in the country's sovereign debt profile. Moreover, at the time of the default, most market participants also predicted that Russia would be cut off from the international capital markets for the foreseeable future. Yet, Russian sovereign debt was upgraded to investment grade within five years of the default. This chapter's focus is on the evolution of Russian debt since the breakup of the Soviet Union (summarized in table 1), the events leading to the debt crisis of 1998, its resolution, and how Russia rose to be a "star performer" among sovereign debtors.

Table 1. External public debt of the Russian Federation, 1993-2005 (billions of US dollars)

(1) Contracted after 01/01/1992; (2) Including ruble-denominated short-term government paper at face value held by non-residents; (3) Contracted before01/01/92.

Source: The Central Bank of the Russian Federation

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Russian Debt (1) (2)	**9.0**	**11.3**	**17.4**	**27.7**	**52.5**	**57.3**	**49.7**	**61.6**	**49.1**	**47.3**	**46.4**	**47.8**	**46.6**
Multilateral Creditors	3.5	5.4	11.4	15.3	18.7	26.0	22.6	18.9	15.1	14.3	14.4	14.4	15.6
IMF	2.5	4.2	9.6	12.5	13.2	19.4	15.2	11.6	7.4	6.5	5.1	3.6	-
Other Creditors (including Paris Club)	5.5	5.9	6.0	7.9	11.0	14.0	9.8	8.4	6.3	5.7	4.9	4.2	3.0
Foreign Currency Bonds	-	-	-	4.5	6.5	14.1	11.8	30.8	27.1	26.7	26.8	28.9	26.7
Eurobonds issued by public subscription and Eurobonds related to GKO restructuring	-	-	-	1.0	4.5	12.2	11.1	9.4	8.5	8.5	7.7	7.3	4.9
Eurobonds related to the London Club restructuring	-	-	-	-	-	-	-	20.5	17.4	16.3	16.8	18.6	19.0
MinFin foreign currency bonds (series VI, VII and 1999)	-	-	-	3.5	2.0	1.3	0.7	0.9	1.1	1.8	2.4	3.0	2.8
GKO-OFZ	-	-	-	-	17.8	5.8	3.6	1.6	0.6	0.5	0.1	-	-
Debt of the former USSR	**105.5**	**116.2**	**110.6**	**108.4**	**93.0**	**97.9**	**96.8**	**65.8**	**61.0**	**55.9**	**58.3**	**56.1**	**34.5**
Paris Club	34.6	39.6	41.6	42.3	37.6	40.0	38.7	39.0	36.3	39.2	42.7	43.3	22.2
London Club	26.0	29.8	31.7	31.1	28.1	29.6	30.6	-	-	-	-	-	-
Debt to former socialist countries	29.0	25.7	16.6	15.4	14.9	14.8	14.8	14.6	11.5	4.2	3.6	2.7	2.2
MinFin foreign currency bonds (series I – V)	1.8	7.6	7.6	7.6	3.2	2.5	1.9	1.3	1.7	2.2	1.4	1.9	2.0
Other	8.9	8.6	7.8	6.7	9.1	11.0	10.8	10.9	11.4	10.4	10.6	8.2	8.2
Total	**114.5**	**127.5**	**128.0**	**136.1**	**145.5**	**155.2**	**148.5**	**128.6**	**111.1**	**104.3**	**106.0**	**105.6**	**82.3**
(percent of GDP)	(62.3)	(46.8)	(37.9)	(32.6)	(40.0)	(48.4)	(76.0)	(49.0)	(36.0)	(31.1)	(24.1)	(17.9)	(10.8)

Sovereign debt in the first years of transition

As of January 1, 1992, total sovereign external debts of the Soviet Union were estimated at about $108 billion or around 50 percent of Russia's gross domestic product (GDP). Those debts were largely accumulated in the 1980s and the beginning of the 1990s and reflected the drastic deterioration of the economic situation. The creditors were mainly governments (Paris Club as well as non-Paris Club countries); international commercial banks (London Club) that had provided loans to the Bank for Foreign Economic Affairs of the USSR (Vneshekonombank); former COMECON countries (member states of the Council for Mutual Economic Cooperation, which had organized trade among former socialist countries); and uninsured suppliers. Initially the debt burden was supposed to be shared between the sovereign states that emerged after the breakup of the Union, with the Russian share being 61 percent. However, in 1993, the new states agreed to transfer all external assets and liabilities of the USSR to the Russian Federation.

From the very start it was quite clear both for the Russian government and its creditors that Russia would not be able to fully service inherited Soviet debt anytime soon. Indeed, more than $40 billion of debt payments were coming due in 1992-1993 amid falling output, large budget deficits reflecting the fiscal costs of transition and foreign exchange reserves of around $5.0 billion, equivalent to only one month of imports (see table 2). Accordingly, Russia sought to restructure most of its debt obligations.

Table 2. Russian Federation: Selected Economic Indicators, 1993-2005

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (% change)	-8.7	-12.7	-4.1	-3.4	0.9	-5.3	6.3	10.0	5.1	4.7	7.3	7.2	5.5
Consumer Prices (% change)	874	308	198	48	15	28	86	21	22	16	14	11	12
GKO Yield (%)	-	-	-	133.0	65.1	23.4	42.6	24.0	12.6	12.7	12.7	5.4	3.1
General government overall balance (% of GDP)	-7.3	-10.4	-6.1	-8.9	-7.9	-8.2	-3.1	3.1	2.7	0.6	1.1	5.0	7.6
General government primary balance (% of GDP)	-5.4	-8.4	-2.6	-3.0	-3.1	-3.6	2.9	7.5	5.4	2.7	2.8	6.2	8.8
Current account (% of GDP)	3.0	3.1	1.4	0.9	0.8	-0.7	11.6	17.2	10.9	9.0	8.2	10.3	11.9
Official reserves													
in billions of US dollars	5.3	4.9	12.8	12.1	17.3	10.9	12.4	27.9	34.5	47.8	76.9	124.5	188.7
in months of imports	1.2	1.2	2.4	2.0	2.9	2.5	2.4	4.6	5.0	5.6	7.1	8.9	11.8
in % of short-term debt by remaining maturity	-	-	-	-	-	-	-	-	113	245	330	349	528

Sources: Russian authorities and the IMF

There were four rescheduling agreements with the Paris Club before the 1998 crisis covering essentially all Soviet debt (around $40 billion). Also, after long negotiations, the London Club debt was formally rescheduled in 1997. By that time, the debt to the

London Club stood at about $30 billion. Under the 1997 agreement, Russia paid $3 billion up front. The remaining debt was securitized by the issuance by the Vneshekonombank of two debt instruments: bonds to cover principal of the loans (known as principal bonds or PRINs) and special interest arrears notes (interest arrears notes or IANs) to cover past-due interest. British law governed both instruments. Interest payments were made on time until the August 1998 crisis.

The last significant part of the Soviet debt restructured in the early 1990s was the foreign currency denominated accounts held at the Vneshekonombank, which had been frozen in 1991. In 1993, these obligations were restructured into five tranches of marketable securities called MinFins (Ministry of Finance bonds). Two additional MinFins (the sixth and seventh series) were issued in 1996, bringing the total stock of MinFin bonds to approximately $11.0 billion. These instruments were issued in US dollars but were considered a part of domestic debt and governed by Russian law.

Only ad hoc payments were made to COMECON and non-Paris Club official creditors. No payments were made to uninsured suppliers, and no formal agreements on debt restructuring were concluded with any of these creditors.

It is worth noting that under the original debt agreements there was no reduction of the nominal value of debt. Changes in the payments schedule lengthened the maturity structure substantially and thus temporarily reduced debt service pressures. In this regard, it has been argued that the debt strategy based on simple rescheduling at par was not the

best choice for the Russian Federation given the difficulties of transition. It would have been reasonable to aim at a significant write-off of the Soviet debt (Santos, 2003). However, official creditors never seriously discussed such a possibility.

Not only did Russia have difficulty servicing the inherited debt, but it also had additional borrowing needs that it was hard pressed to fill. In the first half of the1990s, Russia did not have access to international capital markets. The only source of external financing was foreign governments and multilateral institutions, with the International Monetary Fund (IMF) playing a major role. By the end of 1995, the IMF accounted for 55 percent of all external sovereign debt accumulated by the Russian Federation since January 1, 1992. At the end of 1998, its share was still around 35 percent, despite the fact that Russia gained market access in 1996, as Russia also increased its debt to the IMF. The IMF loans were used mainly for direct support of the federal budget, and were not needed for balance of payments financing (Kharas, Pinto and Ulatov, 2001). The role of the Fund as the financier of the government was particularly profound during the period from early 1995 to July of 1998 when a total of $17.5 billion of loans were disbursed.

Bilateral official financing was mainly in the form of export credits with Germany accounting for about 50 percent of the total disbursed. The loans were tied to the purchase by Russia of goods in the creditor country. In the case of Germany, export credits helped the former East Germany maintain its traditional markets in the former Soviet Union.

As Russia's primary financing need was budgetary rather than foreign exchange, it also introduced domestic financial instruments. This was seen as a way to support development of domestic financial markets as well as diversify sources of budget financing. In 1993, the government thus began issuing ruble-denominated short-term treasury bills. The bills, known by their Russian acronym GKO, were zero-coupon bonds with a maturity of less than one year. In 1995, the government also launched federal bonds with maturities of one to three years. These bonds were known as OFZs. Initially, the domestic instruments did not play a significant role as the budget deficits were principally financed by direct central bank credit and IMF loans. As of January 1, 1995, government debt to the Central Bank had risen from nothing in 1992 to close to 10 percent of GDP.

The road to default

In 1995, after several years of hyperinflation, the Russian authorities introduced an ambitious new stabilization program with the aim of achieving a decisive reduction in inflation via a tight monetary policy. The program, developed in cooperation with the IMF, raised interest rates to high real levels and introduced an exchange rate band system with the ruble depreciation rate well below the inflation rate. Hence, it used the exchange rate as a "nominal anchor" for monetary policy.

The unsustainable fiscal situation was not well addressed as part of the new policy, and budget deficits remained persistently high (see table 2). Budget financing, however,

changed from direct central bank credit, which was now prohibited as part of the new policy, to mainly domestic bond and bill financing and IMF injections. The new domestic market financing led to a rapid build-up of short-term government debt. The high real interest rates on this debt required large borrowings to cover the rising debt servicing burden, which meant that, along with the continued need to finance the primary deficit, the debt stock compounded rapidly. The share of the GKOs and OFZs grew from 10 percent of total public debt in 1995 to close to 30 percent by the end of 1997.

Supported by the exchange rate anchor and reliance on non-inflationary sources of government financing, inflation fell from above 300 percent in 1994 to less than 10 percent in the first half of 1998. The mix of high fiscal deficits and declining inflation reconciled by an exchange rate anchor, tight monetary policy, and heavy government borrowing continued without major changes until the crisis and default of 1998.

Initially, only residents were allowed to invest in the GKO market. In 1996, non-residents were allowed to invest in the treasury bills, with some limitations. By early 1998, however, restrictions on foreign participation in and repatriation of proceeds from the market for domestic debt were substantially eased to encourage larger portfolio inflows and non-resident participation, as the fiscal funding requirements had grown bigger and bigger.

In 1996 and through much of 1997 there was a considerable demand for ruble-denominated Russian government securities, both domestically and abroad. Given high

local interest rates and the pegged exchange rate, returns on GKOs, in particular, were among the highest in the world, and because these instruments were short-term, investors felt that risk was limited. On the surface Russian indicators looked positive: the level of public debt was relatively low, inflation was falling, and Russia was expected to register positive growth for the first time since the start of the transition. However, the positive indicators were driven by relatively high oil prices, rather than fundamental changes in the economy. Real economic activity was stagnant, and monetary policy was so tight that barter was pervasive throughout the economy.

The significance of the accumulating debt problem was masked by a relatively strong external current account, rising gross international reserves and an appreciating real exchange rate until well into 1997. During this period foreign investors and analysts mainly focused on the size of the debt stock, which was quite moderate by international standards. However, much less consideration was given to the fiscal capacity to handle the debt-servicing burden given the very short-term structure of the debt. Also, the risk that Russia would devalue was not properly taken into consideration. However, those weaknesses began to dawn on investors from late 1997 onward when the economic and financial environment turned sharply negative.

Diminishing growth prospects, failure of fiscal consolidation, the virtual disappearance of the current-account surplus due to the fall in oil and gas prices and the general deterioration in investor sentiment towards emerging markets following the onset of the Asian crisis raised concerns about Russia’s public debt dynamics. The authorities were

then forced to raise interest rates sharply to defend the exchange rate band and find buyers for maturing GKOs that needed to be rolled over. High interest rates{1} necessary to finance budget deficits generated an even more rapid spiral of government debt.

By the summer of 1998, the total outstanding domestic debt stock was approximately $70 billion. Non-residents directly held close to 30 percent of the debt. Some analysts estimated that the actual foreign share of domestic debt might have been closer to one half or $30-35 billion (Sutela, 1999) in a country with official reserves of only $17 billion. This was dangerous: even though the government obligations were in local currency, many foreign investors had hedged their ruble exposure, creating a massive demand to convert rubles into dollars at the first sign of exchange-rate trouble. Indeed, the Central Bank had to intervene heavily in the foreign exchange market in the face of capital outflows, as confidence in the policy mix waned. In July 1998 alone, Russia lost almost 40 percent of its official reserves.

As already noted, the ruble debt stock was very short-term, which meant that close to $33 billion worth of domestic debt was scheduled to mature over the last seven months of 1998. The need to keep pace with maturing issues and meet surging interest payments meant that net financing (after debt-service costs), which had been 85 percent of new issues in 1993, dropped to less than 10 percent in 1997 and zero at the beginning of 1998 (Sutela, 1999). Likewise, the cost of debt servicing surged. During the first half of 1998, more than 50 percent of federal tax revenue was needed to service the debt.

Realizing that the debt situation was getting out of control, the authorities tried to reduce immediate cash needs by replacing domestic debt with longer-term foreign debt from the

international financial institutions and through market borrowings at lower nominal interest rates. In June 1998, two Eurobond issues were placed to raise a total of $3.8 billion. GKO auctions were discontinued and the dollar proceeds of the Eurobonds were used to redeem maturing treasury bills. However, this strategy, endorsed by IMF, was extremely short-sighted, as it focused on one risk, maturity risk, at the expense of another risk, currency risk. If the ruble were to devalue, the debt and debt refinancing costs would now multiply in local currency terms.

In July 1998, an agreement on a $22.6 billion emergency package to support the ruble and restore confidence was reached with the IMF, World Bank, and the Government of Japan. Key features of the program were a massive debt-based liquidity injection, fiscal and structural reforms to achieve a primary surplus and ensure long-term fiscal sustainability, and a market-based debt swap from short-term, high-interest GKOs into long-term dollar-denominated Eurobonds to reduce interest costs and refinancing risk. The strategy to defend the ruble was seen by its architects as sensible. The ratio of government debt to GDP in Russia was lower than that in most industrial countries while the current account was roughly in balance. Also, the primary fiscal deficit was less than the average primary deficit of the United States over the preceding decade. The alarming debt dynamics were mainly due to very high domestic real interest rates and short debt maturity. Even though inflation had come down, interest rates had not followed the expected path of retreat owing to the need to compensate for the rising expectation that the ruble would be devalued. Consequently, the major aim of the July package was to lengthen the maturity of the debt and restore confidence, thereby reducing pressure on the

ruble and allowing interest rates to come down. If this scenario were achieved, the prospect was that Russian public finances could return to a more sustainable path. Ruble devaluation was not even considered at that time. It was thought that the devaluation and its aftermath would end the Russian reform effort. Hence, there was no alternative strategy that the Russian government and its official creditors were prepared to pursue.

As per the agreed program, on July 14, 1998, the Russian Government made an offer of a voluntary, market based exchange of GKOs maturing before July 1, 1999 for dollar-denominated Eurobonds. The swap was equivalent to issuing Eurobonds for dollars and using the dollar proceeds to retire GKOs. However, there was not much demand for the Eurobonds. The amount of debt converted was about a tenth of the amount eligible (approximately $40 billion) and failed to ease budgetary pressures. The bulk of GKO holders preferred to hold on to their one- to four-months paper rather than swap it to 7-year and 20-year Eurobonds.

It was clear to the market by the time of the July package that the situation had become unsustainable. Consequently, investors might have had reasonable doubts about the ability of market-based restructuring alone to fundamentally change the country's debt dynamics. Also, there might have been concerns that the IMF/World Bank/Government of Japan liquidity injection under the program would only worsen the public debt profile further. At the same time, this injection might have been the reason GKO holders did not take up the swap offer; i.e. the new money might have persuaded GKO holders that the crisis would at least be postponed for a while and encouraged them to continue enjoying

artificially high returns on short-term paper for a few more months without incurring long-term exposure to the Russian market. Investors might have expected Russia to fail, but not before their GKOs matured and they cashed out. In other words, investors might have acted on the belief that Russia would not be allowed to fail, at least in the near term, rather than on economic fundamentals.

However, this scenario of even temporary rescue did not materialize. With mounting capital outflows, reserves at very low levels , and without prospects for more disbursements under the July 1998 program (only about a quarter of the package was actually disbursed), on August 17, 1998, the authorities announced a series of emergency measures: a large devaluation of the ruble (followed by the decision to float the currency in September 1998), the unilateral exchange into longer maturities of ruble-denominated debt falling due between August 19, 1998 and December 31, 1999 (except paper held by households and the central bank), and a 90-day moratorium on private sector payments of external liabilities enforced through extensive capital and exchange controls. All legal entities (banks and non-banks) were forbidden to service their external debts, which meant that the controls not only covered capital (principal) but also current transactions (interest).

Cumulatively, between May and August Russian-era foreign currency government debt had increased by close to $16 billion, compared with a debt stock of $36 billion at the start of the year. It would have been about $36 billion bigger if the majority of investors had converted their GKO holdings into Eurobonds

It has been argued that the better strategy would have been a preemptive currency float combined with both domestic and external debt restructuring. The main advantage of this strategy would have been much less accumulation of external debt in an attempt to defend the ruble (Kharas, Pinto and Ulatov, 2001). This outcome, however, was hardly possible. Russian authorities as well as IMF considered the fixed exchange rate regime and associated fall in inflation to be the major macroeconomic achievement. Besides, there were no conventional signs that the ruble was overvalued as during this period the current account was either in surplus or roughly balanced. The overvaluation was masked by a strong energy sector.

It has also been suggested that while the August 1998 devaluation was imminent, the default on ruble-denominated debt instruments subject to local law was absolutely unnecessary (Popov, 1999). In the past, all countries in similar situation had chosen to inflate away their domestic currency debt problems. In this regard, some analysts have suggested that the decision to default may have been influenced by the negative experience with high inflation and economic contraction of the not so distant past (Santos, 2003). Whatever the motivation, the default likely prevented a much larger inflationary outburst.

Post-crisis debt restructuring

The debt crisis took place in two phases, each of which had to be addressed. That is, first, the government suspended servicing on GKOs and OFZs in August 1998. Second, Russia stopped servicing the Soviet-era debt that had earlier been restructured, as described above.

The restructuring affected over $30 billion in Russian domestic debt at the pre-crisis exchange rate (close to 8 percent of GDP), of which about $13 billion was held by foreign investors (Santos, 2003). Under the terms of the novation scheme finalized in March 1999, investors received 10 percent of the face value of the bonds in cash, 20 percent in short-term (3 and 6 month) debt securities and 70 percent in long-term (from 4 to 5 year) securities. The proceeds received by non-residents were deposited into special ruble-denominated accounts that were not freely convertible into foreign exchange or cash rubles. The majority of creditors (over 95 percent by value) signed on.

Probably due to the complexity of the scheme, estimates of the loss incurred by investors vary widely. At the time of the deal, some analysts estimated that returns to investors would be around 5 cents on the dollar with ruble depreciation accounting for more than 70 percent of the loss (IMF, 1999). It turned out that the scale of the possible ruble decline had been overestimated as the Russian government made all payments under the scheme. Hence, investors have likely sustained lower losses than originally feared.

Indeed, according to later analyses, investors might have received between 16 and 45 cents on the dollar. (Sturzenegger and Zettelmeyer, 2005)

Following the dramatic depreciation of the currency, the fiscal burden of foreign currency debt became so high as to make the servicing of all scheduled payments unrealistic. In 1999 total scheduled debt payments equaled the entire revenue of the federal budget (Koch and Korhonen, 2000). Under the circumstances, the Russian government followed a strategy of servicing only the part of foreign debt incurred by the Russian Federation itself, as opposed to the inherited debt of the Soviet Union.

There could be a number of reasons for pursuing such a strategy. The service of the Eurobond debt did not require much money in 1998 and 1999, so that Russia could afford to keep paying it. At the same time, because of cross-acceleration clauses a small missed interest payment on Eurobonds would have made the entire stock of the Russian-era debt including all Eurobonds immediately due. Also, by staying current on the Russian part of the debt, the Russian authorities might have expected that the country's exclusion from the world capital markets would not last as long as otherwise.

Unlike the external debt of the Russian Federation, the default on the Soviet-era debt was expressly excluded as a cross-default event in the legal documentation of the Russian debt (Nadmitov, 2004). Besides, securities issued by the Vneshekonombank to London Club creditors under the 1997 agreement could not be strictly classified as sovereign obligations. Indeed, the Vneshekonombank, bankrupt since 1991, has never been

incorporated and never got a banking license in the modern Russia. Its sole shareholder remained the former Soviet Union. In 1992, by the decree of the Supreme Council (a predecessor of the Russian Parliament) the bank was subordinated to the Central Bank of Russia, which is independent from the Russian Government (Nadmitov, 2004). Consequently, legal actions by the London Club creditors did not pose a threat to Russian assets abroad.

Significantly declined service ability as well as concerns about prospects of market access notwithstanding, there could be another reason for not paying the Soviet-era debt. The crisis situation might have encouraged the Russian authorities to try to apply pressure on the creditors to get some reduction of this debt.

Thus, servicing stopped on the debt outstanding to the London and Paris Clubs and the Russian government began accumulating arrears on its Soviet-era debt. Neither Paris nor London Clubs declared Russia officially in default which allowed some time to agree on a compromise.

Russia stayed current on all its Eurobond issues and other external debt denominated in foreign currencies contracted by the Russian Federation. Scheduled payments were made from funds lent to the government by the Central Bank. The selective default strategy and discriminative distinction between the Russian and Soviet debt seems to be well founded. This approach allowed the country to gain some breathing space and, while

creditworthiness was obviously damaged by the default, the legal (and political) distinction between Soviet and Russian debt possibly helped prevent even worse damage.

An important precondition for the resolution of the foreign debt arrears was the negotiation of a new arrangement with the IMF. That agreement in July 1999 hinged on a wide range of measures that were much more stringent than usual. However, it seems that the major purpose of the new loan was for Russia to stay current on its payments to the IMF and to reach agreements with other creditors. Indeed, the money was kept in a special escrow account in Washington and as soon as Russia was able to service multilateral debts with its own resources the IMF withheld the remaining tranches of the July debt program.

In any event, the agreement with the IMF allowed Russia to proceed with the new rescheduling of the Soviet-era debt. In August 1999, a fifth rescheduling without any debt reduction was agreed with the Paris Club. The agreement included the restructuring of the stock of arrears plus maturities falling due from July 1999 through December 2000 in the amount of $8 billion. In early 2001, Russia again began accumulating arrears hoping to negotiate debt relief. However, when it became clear that debt reduction was not possible, the country accelerated payments, cleared all arrears and has stayed current ever since.

In May 1999, the Russian Government also defaulted on a Soviet era, domestically issued dollar denominated bond, the MinFin III (about $1.3 billion) that had just matured. According to an exchange offer announced in November 1999 and modified in January

2000, bondholders were offered either a new eight-year bond similar to the original instrument, or a four year ruble denominated OFZ. The resulting haircut for the bondholders is estimated to have been between 63 and 41 percent (Sturzenegger and Zettelmeyer, 2005).

The new agreement with the London Club was finalized in August 2000. Under the agreement, two new Eurobonds of the Russian Federation for a total of $21.0 billion were issued in exchange for PRINs and IANs with an original nominal value of $31.8 billion. A portion of the haircut of slightly over 50 percent in present value terms (Kharas, Pinto and Ulatov, 2001) could be seen as compensating creditors for the seniority upgrade of their claims. Indeed, there was an upgrade in the obligor, which became the Russian Federation rather than Vneshekonombank. Also, the new Eurobonds included expanded cross-acceleration clauses linking default on them to any other issues of Russian Federation Eurobonds (including new issues) and vice versa (Sturzenegger and Zettelmeyer, 2005).

The terms of the London Club agreement including reduction of debt and exchange for Russian Eurobonds became a model for subsequent agreements with other commercial Soviet-era creditors. In December 2002, the Russian Finance Ministry exchanged the first tranche (about $1.3 bln) of debt owed mainly to uninsured foreign suppliers for Eurobonds. The remaining portion (about $1.7 bln) was restructured in September 2006.

The quest for debt sustainability

The immediate impact of floating the ruble was sharp depreciation, a brief rise in inflation and a significant decline in output. However, contrary to numerous gloomy predictions, this did not last long. It soon became clear that the devaluation was leading to the revival of the import competing sector and helping create an economic environment conducive to turnaround in government finance. In addition, higher commodity prices made exports more profitable. Overall, the recovery was led by both import-substituting and export-oriented industries. The speed of the recovery could also be partly explained by the low dependence of most Russian firms on the financial sector, a factor that limited the impact on the real sector of the financial and banking crisis that was part and parcel of the crisis in sovereign debt and its foreign financing. Besides, foreign currency assets of the private sector far exceeded liabilities. Russian GDP reached pre-crisis level by mid-1999 and has been growing on average by more than 6 percent per annum since then.

With industrial recovery and the positive export environment there was significant improvement in the finances of Russian companies. The devaluation of the ruble and higher international commodity prices boosted profitability in almost all sectors of industry. For instance, in 1999 compared to the previous year, profits increased by 400 percent in oil and gas, and 600 percent in metallurgy. But recovery was also strong in import-competing sectors, where the devaluation boosted earnings 185 percent in machinery, and 175 percent in light industry and food (Pool and Kolchina, 2000).

The improved financial position of the enterprises brought about a substantial increase in tax revenues. For instance, payments of the profit tax increased four-fold during the course of 1999. While strong growth and high world oil prices contributed importantly, improved fiscal performance has also been the result of spending restraint. There have been very deep cuts on the expenditure side with reductions in expenditure relative to GDP accounting for more than half of the fiscal adjustment. Of course, the default also substantially reduced interest payments for the government.

As a result, in 1999, the federal deficit was 3.1 percent of GDP as compared to a deficit of between 6 and 10 percent in 1992-1998 (see again table 2). Since 2000 the federal budget has been in surplus. Overall, the fiscal adjustment amounted to around 10 percentage points of GDP from 1997 to 2001.

Since 2000, when higher oil prices began affecting budget revenues, the government has largely resisted the strong pressures to spend the windfall. Non-interest expenditures have increased, but to a lesser extent than the rise in oil revenues. The government is using a significant part of additional revenues to repay debt and accumulate reserves. Also, unlike in the pre-crisis period, the budgets have been drafted to be in surplus under very conservative oil price assumptions.

The benign fiscal situation also made it easier for the government to implement a reform of the tax system. The major thrust of the reform was greater simplicity and efficiency of

taxation as well as decreasing general taxation on the non-oil sector, and increasing taxation on the resource sector and tying it to commodity prices to capture a larger share of natural resource rents, especially windfall profits from high oil prices. In this regard, a mineral extraction tax was levied on all extracted oil at a rate of 22 percent of excess over $9 per barrel of Urals crude. Also an export customs duty on oil with the rates proportional to the level of price of Urals crude was introduced in 1999I. It is worth noting that, at the time of the default, the budget revenues were not tied to oil prices via ad valorem taxes. A new taxation scheme has contributed importantly to better fiscal performance.

While helping capture the oil price windfall, the tax reform has made fiscal performance even more sensitive to oil prices. For instance, with the rise in oil prices, the share of oil revenue in federal budget receipts climbed from 33 percent in 2002 to 56 percent in 2005. Also, it has been estimated that a $1 decline in oil price would reduce revenue by about $1.5 billion (Hessel, 2004) or close to 2 percent of budget receipts. To lessen this sensitivity, a mechanism was created that would capture windfall oil revenues at times of high oil prices in a fund insulated from current spending pressures. The Oil Stabilization Fund was legislated by the Duma (the lower house of the Russian Parliament) and became effective on January 1, 2004.

The Fund was to accumulate Rb500 billion (approximately $18.0 billion), or close to 3 percent of GDP. All “surplus” revenues resulting from oil prices above $27 (initially $20) per barrel (Urals) are automatically transferred to the fund. The Fund may be used to

finance the federal budget deficit when the current oil price is below the reference price (now $27 per barrel). According to the government, a fund of Rb500 billion would ensure the financing of the budget shortfall arising from two consecutive years with oil prices averaging $15 per barrel. The only instruments in which stabilization fund revenues may be invested are government securities of developed countries.{2} By the end of 2005 the Fund's assets reached $40 billion, far exceeding the initial target.

Beyond sustainability: curtailing vulnerability

Once the Fund exceeded Rb500 billion, additional revenues could be spent for unspecified "other" purposes. The government intended to use most of the additional revenues for early repayment of foreign debt.

Strong economic growth and budgetary surpluses reduced external government debt in terms of GDP from close to 80 percent in 1999 to below 11 percent in 2005 (see table 1). Besides, reserves grew to more than five times the year's short-term debt obligations (table 2). Also, reflecting an increase in budget revenue and declining debt, the cost of servicing government foreign debt by 2006 declined to around 4 percent of central government revenue (1.0 percent of GDP) from 23 percent (about 3.2 percent of GDP) in 2000.

Although the Russian government chose not to return to international borrowing as soon as it might have, the fact that the City of Moscow was able to access the market in

October-December 2001 is taken as an indicator of how quickly Russia regained "market access" (IMF, 2005, p. 17). Then, in October 2003 the international rating agency Moody's Investors Service raised Russia's sovereign rating to investment grade for the first time ever, reflecting the strengthening of the Russian government's commitment to prudent fiscal and debt management policies, as well as improvements in debt and liquidity ratios. Moody's also pointed out that Russia would be likely able to withstand a significant downturn in commodity prices over the medium term without risking timely debt servicing. Fitch Rating and Standard and Poor's upgraded the Russian sovereign debt to investment grade in 2004 and 2005 respectively. Many investment funds, particularly pension funds, are barred from investing in sovereign debt instruments until the country receives an investment grade rating from at least two of the three major international rating agencies.

Despite the fact that all debt indicators in Russia appeared to be quite favorable compared to most countries, the Russian authorities pressed forward building additional protection against volatility. Unlike developed countries, the Russian economy depends heavily on oil and gas exports and thus is much more vulnerable to risks of sharp price swings. Therefore, its public debt indicators should likely be significantly lower than in those countries to achieve the same degree of debt sustainability.

Accordingly, the government policy on public debt has been aimed at its further reduction to make a room for additional external borrowing during periods of low oil prices. Also, the Russian authorities have a strong interest in increasing official capital

outflows to offset the strong inflow of foreign exchange and ease upward pressure on the ruble. Initially, this was done mainly by not rolling over maturing foreign debt and by purchasing foreign assets for the Stabilization Fund. After the target level was reached, a significant share of oil-related excess revenues was used to accelerate debt redemptions. It is also notable that in addition to economic considerations, there might have been political motivations to pay down the debts owed to official creditors as quickly as possible.

In 2002-2005, the government repaid all debt owed to the IMF, with a large part of it being paid ahead of schedule. The question herein though is why the Russian government decided to accelerate payments on this less expensive debt, when buying back more of its outstanding market debt would likely have a bigger impact on future financing and debt service costs. It seems that the government considered non-financial costs of IMF debt to be too high.

Along with the reasons noted above, the early repayment of the Paris Club debt may also have been a reaction to the German government's 2004 securitization of a part of its Paris Club claims on Russia, which threatened to disrupt the market for Russian debt. While this had not been Germany's intention, it was a possible consequence to which Russia did not want to remain vulnerable.

Germany, which had been passing through several stagnant economic years, decided to engage in such an operation in order to finance a part of its budget deficit in a way that

avoided raising its gross public debt level above the maximum under European Union policy rules of 60 percent of GDP. In other words, Germany decided to raise funds by "privatizing" an official asset – Russian Paris Club obligations to Germany – rather than borrow directly all the funds needed to cover the deficit.

This approach involved the creation of a "special purpose vehicle" (called the Aries fund) that in June 2004 issued credit linked notes (CLNs) in the amount of approximately $6 billion, or more than a quarter of Russia's Paris Club debt to Germany. Proceeds from the sale of the notes were transferred to Germany's treasury and the funds to service the notes had to be transferred from the treasury to the Aries fund over the duration of the notes in amounts matching the debt-servicing payments by Russia to Germany. Service payments on the notes were thus linked to the Russian government's track record in servicing Paris Club debts to Germany.

The debt securitization by Germany impacted Germany, Russia and the emerging market debt market in general. For Germany, what was essentially an accounting trick appeared to be very expensive. It incurred interest obligations on the CLNs that were well above the Russian interest payments on the debt that was securitized. In other words, there would be a continuing cost to the German budget from the deal, despite little risk of Russian sovereign default. It has been suggested that Germany could have saved around 2.5 percentage points of interest a year had it instead directly arranged a repurchase by Russia, given the interest rate on comparable Russian bonds. Furthermore, had it pursued direct borrowing in the market on its own account, Germany would have been able to

issue at an interest rate of some 5 percentage points below the Aries level (El-Erian, 2004).

For Russia, the German deal raised the supply of Russia-linked debt in the market and thus the prospect of a rise in borrowing costs. Indeed, in 2004-2005, the market absorbed $10 billion of Russia-linked debt resulting from the Aries plan, which was equivalent to around one-third of outstanding traded Russian sovereign debt. While the Russian government did not need to borrow in the international markets at that time, nor for the foreseeable future,,, the country's private firms could be adversely affected from a continuation of such a situation.

In light of the above, one of the important motives behind the early Paris Club repayment proposal might well have been to maintain control over the "Russian sector" of the international capital markets. In May 2005, the Russian Federation concluded the first prepayment agreement with the Paris Club, which led to the prepayment of $15 billion of debt during the summer of 2005. And in June 2006 agreement was reached on early repayment of the remaining Paris Club debt (about $22 billion). This operation represented the largest prepayment ever made to Paris Club creditors (Paris Club, 2006). After the early prepayment, Russia would no longer be a Paris Club debtor, while remaining a major creditor within the Club.

Unlike the early repayment of $15 billion which was made at face value, it was agreed that in the second and final repayment Russia would pay a premium of $1 billion to

compensate creditors for a loss of future fiscal income from interest payments. Germany, which held the biggest share of the Russian debt, was to receive a premium of $700 million, with France, the Netherlands and the United Kingdom sharing the rest. According to the Russian Government, Russia will nonetheless save $7.7 billion on interest payments.

The Aries deal and subsequent early repayment of Russia's debt to the Paris Club, as well as to the IMF, marked the beginning of a broader trend of reverse flow of funds from the strongest emerging economies to multilateral institutions and industrial country public sector creditors. One reason might be that there was a concern that the practice of Paris Club debt repackaging might became widespread and make all emerging markets face increased financial costs. In addition, with heavy reserves accumulation, prepayments were possible. All in all, it reflects a transfer of emerging market sovereign debt from official multilateral and bilateral to private creditors.{3} In this case, both industrial and developing countries should aim at finding the most efficient, cost effective, and transparent ways in which these reverse flows can be carried out.

Concluding remarks

The Russian experience shows that sovereign insolvency cannot be resolved by debt-based liquidity injection or debt restructuring on market terms (i.e., without debt or debt-servicing reduction that reduces the public sector borrowing requirement). This could only increase future debt burden and worsen further the public debt profile.

Instead, the move to pro-growth policies is needed as part of a debt workout, accompanied by significant reduction in the debt stock. In the Russian case, the pro-growth policies took the form of a considerable ruble devaluation that drastically raised profitability of most sectors of the economy, more accommodative monetary policy, unilateral restructuring of domestic debt and reduction of external debt to commercial creditors. The post-crisis debt restructuring in Russia has highlighted the importance of a well-defined strategy for debt crisis resolution following the default, aimed at maximum gain in fiscal space with least lasting damage to overall creditworthiness.

The developments that followed the Russian crisis have also shown that default may not preclude relatively quick return to market access. Markets are forward looking and Russia's improving economic fundamentals and new political environment appeared to be much more important to investors than the history of default.

The Russian case has demonstrated that the sovereign debt-to-GDP ratio per se may be misleading as far as debt sustainability is concerned. It does not tell much about actual debt-servicing burden and capacity. Indeed, prior to the 1998 crisis, the level of public debt was slightly above 40 percent of GDP, which was not excessive by international standards. At the same time, more than 50 percent of federal tax revenue was needed for servicing the debt. The attempts to reduce the debt-servicing burden by exchanging "expensive" domestic currency debt for "cheap" foreign-currency obligations proved to

be ill-founded. After the August 1998 devaluation, foreign-currency debt and debt refinancing costs multiplied in local currency terms.

Because of its heavy dependence on oil and gas exports and thus vulnerability to risks of sharp price swings, the Russian public debt should likely be significantly lower than in countries with a more diversified export base to achieve the same degree of debt sustainability. This holds for any country depending heavily on export of a certain commodity.

The Russian debt saga has also drawn attention to the fact that heavy dependence on energy exports, first of all oil, leaves a country vulnerable to the adverse impact of external shocks and thus requires creating the capacity to operate appropriate counter-cyclical fiscal and debt management policies. In other words measures should be taken to ensure capacity to undertake fiscal and debt stabilization across the oil price cycle. This includes drawing the budgets under conservative oil price assumptions as well as building budget reserves and paying debts ahead of schedule during periods of high oil prices to prevent drastic fiscal expenditure cuts in less favorable circumstances.

Endnotes

1. In June-July 1998, average GKO yield was around 60 percent, far above the less than 10 percent twelve-month inflation during this period.

2. For a more detailed description of the Stabilization Fund, see, for instance, (OECD, 2004).

3. For instance, Peru repaid almost half its debt to the Paris Club in 2005, while in 2006 Algeria made early repayment of $4.3 billion (half of its Paris Club debt) and Nigeria bought back the final $12 billion in its debts that had not yet been cancelled or paid under its complex arrangement with the Club. Argentina and Brazil prepaid their entire outstanding obligations to the IMF, while Indonesia and Uruguay decided on early repayment of half of their obligations to this institution. Also, Mexico announced its intention to repay early $7 billion to the World Bank and Inter-American Development Bank.

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