Debt Crisis in Russia:
The Road from Default to Sustainability

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The history of Russia's debt is a central element in understanding the 1998 crisis. Russia's debt stock at the time of the crisis was not overwhelmingly high—especially once account is taken of the fact that the bulk of the debt stock was Soviet-era debt that the Russians rarely paid, and for which creditors had little political will and imperfect mechanisms to enforce payments. The debt problem that drove the crisis was mainly a failure to bring fiscal deficits under control and, therefore, a failure to limit the growth of short-term financing needs. If this flow problem could have been addressed, the stock issue relating to the Soviet-era debt, although a heavy burden, could likely have been resolved. Indeed, international financial markets appear to have operated on this assumption—for example, Russia was able to issue significant amounts of new Eurobonds in 1996–97 while having large external arrears.

Understanding the evolution of the debt stock requires an appreciation of a complex set of political factors. Russia became financially indebted in 1993 when, in agreement with other countries of the former Soviet Union, Russia assumed responsibility for the external obligations of the Soviet Union in exchange for the sole claim on its assets. How large a burden Russia assumed is hard to say, but one of the motivations for the agreement was that a package of financial aid was being held up because creditors did not wish to provide additional funds to...
the region without clarification on who would ultimately be responsible for repaying the outstanding debts. However, it soon became clear that the combination of the fall in output with the fiscal costs associated with the transition made the scheduled debt service a significant burden. In the end, Russia largely did not pay the debts and creditors either granted restructurings or simply watched arrears accumulate.

It would, with hindsight, have been much more transparent to agree up front on a reasonable amount for Russia to repay on the Soviet-era debts, but there was no political appetite to provide a massive write-off of debts to a superpower nor for the former superpower to ask. The choice of debt strategy (based on simple reschedulings at par) was odd given that at the time most indebted countries in arrears to commercial banks were conducting Brady operations, which greatly reduced the debt burden by granting debt reduction and postponing payments.\(^1\) Similarly, the Paris Club was considering debt reductions for other countries. However, it was politically expedient to the West to have the leverage on the direction of policies in Russia afforded by the ongoing debt issues.

The actual default in August 1998 was somewhat unique in modern economic history. The initial announcement did not include a formal declaration of default on external debts: this came later, although, given the poor record of payments, it can be argued that this is rather a moot point. Rather, the key element in the emergency package of measures was a restructuring of domestic (ruble) debt. No other country has pursued this approach; others simply printed large amounts of domestic currency to clear the domestic debt burden, effectively inflating away the issue.

The authorities did proceed to default on their external obligations but only on Soviet-era debts—the distinction made earlier between Soviet-era debts, which the authorities have frequently been negligent in paying, and Russian-era debts, on which they have not missed a single payment, was preserved. After protracted discussions, partly reflecting the time that it took to reach a domestic consensus on the macroeconomic policy package and subsequently reach a new agreement with the IMF, the authorities were able to obtain new restructuring agreements first with the Paris Club and subsequently with the London Club.

\(^1\)Brady operations involved an exchange of bank claims in arrears (traded in the secondary market at deep discounts just like the Soviet debt) for collateralized bonds (the Brady bonds). The exchange granted debt reduction either on the face value of the new bonds (discount bonds) or on the debt service by paying a below-market interest rate (par bonds). The collateral was financed with loans from the international financial institutions and the reserves of the country. Russia negotiated a Brady-like operation (with no collateral) involving significant debt reduction after the 1998 default.
Aided by the strength of the external position and their determination to come to grips with the underlying fiscal weaknesses, the authorities have subsequently sought to regularize their debts with all creditor groups, using the Paris Club and London Club agreements as frameworks for the negotiations with other creditor groups. The strategy has been largely successful and the bulk of the Soviet-era debts have now been restructured, placing the debt situation on a more transparent and more clearly sustainable footing. This has also served to move Russia away from its focus on constant rounds of negotiations on its debts, enabling Russia to more clearly assume its position as a G-8 country.

**Historical Background**

Upon the split of the Soviet Union, Russia was reborn as a relatively debt-free nation but that was soon to change. After several failed attempts to find a solution to the division of external assets and obligations of the former Soviet Union, the former republics finally agreed, in April 1993, on the “zero option” formula under which Russia acquired all the assets and the liabilities of the former Soviet Union (see Box 7.1). Russia adopted that solution partly at creditors’ request and in exchange for promised financial assistance. As a result, Russia inherited about $100 billion in external debt and acquired about $7 1/2 billion of usable (gross) reserves, as well as a variety of other assets that are difficult to value, including real estate abroad, stockpiles of precious metals, and claims on other countries.\(^2\) Russia’s creditors were mainly industrialized countries (Paris Club), commercial banks (London Club), and other former COMECON countries (see Table 7.1). The burden of debt assumed by Russia is difficult to assess, as measurements of GDP were imprecise at the time and exchange rates were misaligned. Depending on the exchange rate employed, the external debt ratio varied from 15 percent of GDP to 120 percent of GDP. Calculated at the average real exchange rate during 1993, the debt ratio was about 50 percent of GDP.\(^3\)

\(^2\)The value of the stockpile of precious metals was rumored to be quite high. In addition, the Soviet Union had significant claims on a large number of developing countries, although debtor countries disagreed with the valuation and coverage of the debts. In many cases Russia provided generous debt write-offs on the inherited assets and in the event only small payments were received from debtor countries. Valuation and coverage problems were resolved and Russia was invited to join the Paris Club as a creditor country in 1997, having the somewhat unique status of large creditor and large debtor at the same time within the Paris Club.

\(^3\)See Christensen (1994) for a discussion of these valuation problems and a detailed account of the “zero option” proposal.
Box 7.1. Brief History of the Soviet-Era Debt

Relations between the Soviet Union and its creditors were complicated during the course of 1991, as some of the Soviet republics either declared independence or asserted the sovereignty of their laws over those of the Soviet Union. Creditors, concerned about who was ultimately responsible for the outstanding obligations, were reluctant to provide new credits. A temporary clarification was reached in October 1991 when a Memorandum of Understanding between the representatives of the republics of the Soviet Union and the G-7 (Group of Seven industrial countries) was agreed, which specified that the republics were jointly responsible for the external debt. In the event, only 10 of the 15 republics signed the agreement. However, on this basis, the G-7 offered a financial package that included the deferral of amortization payments falling due through end-1992.

An Interstate Agreement was reached in December 1991 that determined each republic’s share of the debt of the Soviet Union (based on population, income, trade, and holdings of convertible currency). Republics were to make deposits at Vnesheconombank (VEB), the foreign trade bank of the former Soviet Union, for the payments to creditors and an Interstate Committee was established to manage the external debts and assets. Only eight republics signed the agreement. During 1992, it became clear that the Interstate Agreement was not working, as only Russia had made payments abroad, and no other republic had deposited any foreign exchange at VEB.

In mid-1992, Russia proposed the zero option at creditors’ request to the other republics. Under this option, Russia would assume the responsibility for servicing the external debt of the former Soviet Union in exchange for the other states agreeing to transfer their share of the external claims of the former Soviet Union. The Interstate Committee was dissolved in November 1992 and Russia declared itself responsible for the entire debt of the former Soviet Union in April 1993.

Russia did not have the luxury of being adequately prepared to face the challenges of transition. Moreover, the evolution of the transition in Russia severely complicated the public debt dynamics.

- **Output was bound to decline rapidly** since the industrial base was concentrated in the military industrial complex, which, following the demise of the Cold War, needed to be reoriented toward the production of consumer goods. Industry was also located based on objectives specified in the state plans rather than on economic criteria, and the substantial change in relative prices (especially energy) required massive investments/restructuring. While it was no surprise that output declined during the early stages of the transition, the magnitude of its decline (by almost
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Sources: Russia's Ministry of Finance; Central Bank of Russia; International Monetary Fund; and author's estimates.

1Preliminary estimates.
one-half between 1991 and 1998) was much more pronounced than anybody had expected.

- **Fiscal policy had to be expansionary**: the significant dislocation produced by the transition required the state to play a more active role than in a typical market economy. Fiscal policy was expansionary but poorly targeted and nontransparent, with large implicit subsidies and arbitrary tax enforcement. For most of the period, the government was running a primary fiscal deficit while the bulk of scheduled interest payments on external debt was rolled over through formal reschedulings or through the accumulation of arrears.

- **Real interest rates were volatile but on average relatively high** because macroeconomic stabilization required high real rates to give credibility to the disinflation efforts and the public sector borrowing requirements were not kept under control.

These factors made Russia's ability to service its debts problematic from the very beginning. The transition process dictated a relaxed fiscal stance in the presence of a sharp contraction of output and high real interest rates—precisely the opposite of what was needed to achieve debt sustainability. This fundamental conflict was partially masked by the availability of privatization receipts, the rapid appreciation of the real exchange rate, and access to international capital markets. Furthermore, a relatively large amount of interest arrears was not properly recorded in the debt statistics, in the hope that creditors would agree to further debt reduction at some point in the future.

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4 For the debt to be sustainable and avoid an explosive path, the debt-to-GDP ratio (d) should satisfy the following inequality (an equality is needed for a stable d):

\[ d \leq \frac{1}{(1 + g)/(r - g)} p, \]

where \( g \) is the growth rate of the economy, \( r \) is the real interest rate, and \( p \) is the primary fiscal balance as a ratio of GDP. As an illustration, if the trends observed during the pre-default period 1992-98 were to be applied, the result would be debt unsustainability. The values of these parameters were broadly an annual GDP contraction of about 8 percent, a real interest rate of about 15 percent, a primary deficit of 4 percent of GDP, and a debt-to-GDP ratio of about 50 percent (i.e., \( g = -0.07 \); \( r = 0.15 \); \( p = -0.04 \), and \( d = 0.5 \)). Clearly condition (1) would not be satisfied: the right-hand side implies that the ongoing macroeconomic conditions were consistent with sustainability if Russia were running a primary surplus of 12 percent of GDP rather than the actual deficit of 4 percent. In practice a substantial real appreciation artificially reduced \( d \). Thus, sustainability required a turnaround in the precrisis macroeconomic trends.

5 Interest on Soviet-era debt was rarely paid: Paris Club reschedulings refinanced the bulk of scheduled interest payments; London Club creditors measured past-due interest generously; and interest arrears to COMECON and Foreign Trade Obligation (FTO) creditors were never properly recorded. In the case of COMECON, interest was not recorded as those debts represented mostly trade balances in nonconvertible currencies and there were no provisions for interest charges.
Thus, while the debt statistics do show an increase in debt levels during the early and mid-1990s (Table 7.1), the true state of the fiscal situation was difficult to disentangle.

**Brief Experience with International Capital Markets**

Russia's initial experience with international capital markets was short and ultimately unhappy. Despite concerns that the debt situation would prove to be unsustainable, and in the presence of a sequence of Paris Club restructurings and arrears on various other Soviet-era debts, Russia was able to access voluntary external financing for not only the sovereign, but also several subnational governments (absent a sovereign guarantee) and private enterprises.

From the perspective of fiscal financing and macroeconomic stabilization, gaining access to international capital markets was clearly a positive development, as it promised to lower the cost of financing a given deficit and was a noninflationary source of financing. It was also perceived as an endorsement by the international community of Russia's move toward market-based institutions. The strategy did, however, carry the risk that a reversal of the capital inflows could be painful and it therefore placed an even greater premium on fiscal consolidation and strengthened banking supervision. The authorities were unable to deliver on these, and access to capital markets during 1996–98 was used to permit policymakers to postpone making difficult decisions to tackle the underlying fiscal imbalances. Despite the absence of tangible fiscal adjustment and continuing problems with meeting existing debt commitments, the international ratings agencies maintained a relatively stable outlook on Russia until mid-1998, possibly on the assumption that the international community would never really expect Russia to actually pay on important segments of the Soviet-era debt, that Russia was simply too big to fail (or to be allowed to fail), or that economic growth was going to resume quickly at a very high pace (see Figure 7.1a).

In an attempt to develop domestic financial markets as well as to find alternative sources of financing for the budget, public bonds known by the Russian acronym of GKO were issued for the first time in May 1993. The GKO market developed fast and flourished during 1995–97. GKOs were zero coupon bonds denominated in rubles with maturities of up to one year, sold at a discount, and redeemed at par. GKOs were extremely liquid and were used by the Central Bank of Russia (CBR) to conduct open market operations. Initially, the main
Figure 7.1. Russia: Indicators of Market Access

A. Sovereign Rating
(By Standard & Poors; long-term foreign currency)

B. Foreign Borrowing from International Capital Markets
(Billions of U.S. dollars)

C. Stock Market Developments
(RTS index, U.S. dollar terms)

D. Emerging Market Indices
(December 1993=100)

Sources: Standard & Poors; Capital Data; Bloomberg L.P.; and JP Morgan Chase.
GKO holders were domestic banks but foreign investors soon became an important segment of the market.\textsuperscript{6}

Access to foreign capital was, in the first instance, achieved by relaxing the rules for nonresidents on the trading of GKO\textsuperscript{s} (see Box 7.2). While foreign investors had been rumored to be participating in the GKO market through illegal \textquotedbl grey schemes\textquotedbl for some time, Russia decided in February 1996 to permit foreign investors to participate legally in the GKO market through accounts at the CBR's foreign subsidiaries.\textsuperscript{7} In August 1996, direct participation in the bond market by nonresidents was permitted through special accounts (S-accounts) and with waiting periods for repatriation of funds. The regime was greatly simplified during 1997 and was liberalized by the end of the year. Foreign participation in the GKO market increased rapidly from virtually zero in early 1996 (officially) to about one-third of the market in mid-1998.

Russia formally regained access to international capital markets in November 1996 with the placement of the first Russian-era Eurobond in the amount of $1 billion. Capital flows to emerging markets had been growing for a number of years and investors were eager to gain exposure to Russia. Indeed, the level of investor interest in Russia was such that the first Eurobond was placed despite the fact that Russia was, at the time, in arrears to the London Club—Russia had an agreement in principle with the London Club, but without a definite date for the finalization of the deal (in the event, it took another year to finalize it)—and that the IMF had postponed the completion of a scheduled review under the program supported by the Extended Fund Facility owing to missed macroeconomic targets. Investor interest remained strong in the following years: the stock of Eurobonds reached $16 billion by August 1998 and, at its peak, there were about $17 billion in GKO\textsuperscript{s} placed with nonresidents.

\textsuperscript{6}Another debt instrument known by the Russian acronym OFZ was first placed in June 1995. OFZ\textsuperscript{s} were coupon bonds denominated in rubles with maturities of more than one year and up to two years. The interest coupon was paid quarterly at a variable rate linked to short-term average GKO yields. The principal amount was paid as a bullet on maturity. A fixed-coupon OFZ (OFZ-PD) was introduced in 1997. These instruments were less liquid than the GKO and the size of their market more limited. The 1998 GKO default included a fair amount of these instruments too.

\textsuperscript{7}The CBR's foreign subsidiaries are Moscow Narodny Bank (London), Eurobank (Paris), Ost-West Handelsbank (Frankfurt), Donau Bank (Vienna), and East-West United Bank (Luxembourg). In each case the banks were established during the Soviet era to undertake financial operations (such as trade financing) between clients in the Soviet Union and the rest of the world. Each bank is regulated by the respective national supervisory agency.
Box 7.2. Foreign Participation in the GKO Market and the S-Accounts

In response to pressure from foreign investors and in an attempt to increase its level of reserves, Russia opened the domestic government bond market—principally GKO (short-term zero coupon bonds denominated in rubles)—to foreign participation in February 1996. Foreign investors were not permitted direct access to the market (and were not allowed to repatriate proceeds) but were instead offered the ability to place deposits at a foreign subsidiary of the Central Bank of Russia (CBR) for a guaranteed return in dollars (initially 19 percent and less thereafter). The CBR foreign subsidiary converted the funds to rubles and purchased GKO, incurred foreign exchange risk, and, at maturity, converted the principal plus interest to dollars and paid the investor. The exchange rate was relatively stable and GKO yields were relatively high so that, in the end, the scheme was profitable for the foreign subsidiaries. At the time, the transactions were perceived to be increases in net international reserves, though they were in effect short-term borrowing by the CBR's foreign subsidiaries.

Foreign investors were permitted to participate directly in the GKO market in August 1996. The ruble counterpart of the foreign exchange proceeds was deposited in specially created accounts for nonresidents called "S-accounts." Nonresidents were allowed to trade in GKO and OFZ (longer-term variable coupon bonds denominated in rubles), but their funds could not be repatriated on demand.

Repatriation from the S-accounts required a cooling-off period. Investors who wanted to repatriate their funds had to notify the CBR a few months in advance and at that time trading on securities stopped and the foreign investor had to enter into a forward contract (part of it with the CBR and the other with a local bank), which guaranteed a dollar yield fixed by the CBR. Ostensibly, the procedure was designed to develop the forward market for the ruble. Initially, the cooling-off period was 6 months and the yield on the forward contract was 19 percent. Subsequently, the waiting period was reduced, as was the yield on the forward contract.

Restrictions on repatriation were progressively relaxed and eventually removed in December 1997. All transactions were still done through S-accounts, but there was neither a waiting period nor the need to have forward contracts during the first seven months of 1998. In the event, holdings in S-accounts were frozen after the default in August 1998 and remain frozen to this day, although repatriation rules have been relaxed.

Russian corporates (and subnational governments) were also able to access international capital markets. While access was initially fairly modest, there was a substantial increase in demand for Russian exposure during 1997 leading to a large inflow of funds to Russian corporates and a sharp run-up in the stock market (see Figures 7.1b, c, and d).
As expected, following the August 1998 crisis Russia lost all access to capital markets. A few selected corporates (mostly in the energy sector) were able to place modest amounts in 2000 and 2001, but it was only in 2002 that the market's appetite for Russian paper clearly reemerged.

**Default and Resolution Strategy**

The debt situation deteriorated from late 1997 and continued to worsen in 1998. GKO yields remained unusually high (over 50 percent) while the exchange rate regime imposed a relatively stable exchange rate, against the background of a severe financial crisis in Asia that threatened contagion in other regions, further deteriorating market sentiment. In an attempt to ease pressures in the GKO market and to reduce interest costs, the government announced a large swap of GKOso for Eurobonds in mid-July 1998. About $40 billion in face value (ruble-denominated) GKOso were eligible to be exchanged for 7-year and 20-year (dollar-denominated) Eurobonds at market prices and a spread on the Eurobonds quoted by GKO holders, determined in a modified Dutch auction mechanism. In the event, the authorities accepted a maximum spread of 940 basis points over the relevant U.S. treasury bonds and about $4 billion worth of GKOso were tendered. The swap was immediately perceived to be a failure (see Box 7.3).

Pressures mounted and a default on GKOso was announced on August 17, less than a month after the swap was completed. The ministry of finance and the CBR declared their intention to unilaterally restructure all ruble-denominated debt falling due through end-1999 and imposed a three-month moratorium on external private debt obligations (including margin calls) to ease the pressures on the exchange rate and the banking system. The exchange rate regime was abandoned in favor of a more flexible regime and eventually the ruble was floated.

When the default was announced, Russia did not have an overwhelming level of public debt (less than 60 percent of GDP). External debt amounted to about 45 percent of GDP (about $145 billion)—of which about one-third was contracted by Russia and the rest was Soviet era. Domestic debt amounted to about 15 percent of GDP,

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8See Aizenman, Kletzer, and Pinto (2002) for a description of the GKO swap. They argue that under certain conditions the GKO swap may have accelerated the August 1998 crisis.
Box 7.3. The GKO-Eurobond Swap

A bond swap operation was launched on July 14, 1998 in which the authorities offered:
- to exchange its outstanding GKO's maturing prior to July 1, 1999 for new 7-year and 20-year U.S. dollar-denominated Eurobonds; and
- a new money option in which up to $500 million of new bonds were offered to investors for cash. The transaction was designed to lengthen debt maturities and reduce pressures in the GKO market. Participants in the GKO exchange were to specify principal amounts and whether the offer was competitive (and at what spread) or noncompetitive. The coupon of the U.S. dollar bonds was at a fixed rate and paid semiannually. The prices for the U.S. dollar bonds were fixed by a modified Dutch auction.

In the event, only a small amount of cash was raised and about $4 billion worth of GKO's were converted at a maximum spread of 940 basis points over the relevant U.S. bonds.

Under the auction, participants specified:
- GKO series and amounts offered; and
- whether the offer was competitive (and the acceptable spread) or non-competitive.

An appointed agent sorted offers in ascending spread order and in increasing maturity order, and set a single clearing spread of 940 basis points. Offers were accepted in the following order:
- all noncompetitive exchange offers, and
- all competitive offers in order of increasing GKO maturities at or below the clearing spread of 940. Investors could scale multiple offers at different spread levels. All competitive exchange offers that were at or below the clearing spread were pro-rationed.

The nominal amount of GKO's exchanged was to be divided equally between the new 7-year bonds and the new 20-year bonds. The currency conversion rate was the average spot ruble/U.S. dollar exchange rate for the period of the exchange offer as reported by MICEX (the Moscow Interbank Currency Exchange). Investors were offered prices for their GKO's in excess of the levels prevailing before the invitation to offer, with a large premium for very short maturities, and the premium declining progressively as the maturity of GKO's increased.

U.S. treasury benchmarks were the yields on July 17 of (1) the U.S. treasury bond due May 2008 (for the 7-year bond), and (2) the U.S. treasury bond due August 2027 (for the 20-year bond).

consisting mostly of short-term GKO's. By international standards, the level of public debt was not high; in fact, it was similar to that of most Western European countries and well below the level of Turkey at

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9Because of the absence of relevant data, the breakdown between external and domestic debt is based on the currency criterion rather than the residency criterion. Thus, external debt refers here to debt denominated in foreign currency and domestic debt refers to debt denominated in rubles. In practice, residents held some foreign currency debt and nonresidents held significant amounts of ruble-denominated debt.
end 2001. That said, what became a problem was the massive rollovers needed on ruble short-term debt (GKOs) and uncertainties about the future exchange rate regime—a similar problem to that in Argentina in 2000/01, where the level of debt was also not high by conventional measures (see Figure 7.2).  

The August 17, 1998, default was unprecedented, as it included a default on local currency-denominated debt instruments that at some point were perceived to be the “risk-free asset” in the economy. The government’s decision to default initially on GKOs and OFZs (and only subsequently on most Soviet-era debt) was clearly controversial, as no country in modern history had defaulted on a bond that was denominated in its local currency and was subject to its local law. In the past, all countries facing the dilemma that Russia faced in August 1998 had chosen the option of eliminating their domestic currency debt problem by printing money, generating an extraordinary outburst of inflation. The government’s decision to default led to major losses in the banking sector and severely impaired both the balance sheet and income position of the CBR, as well as causing substantial losses for foreign investors.

It is difficult to understand the authorities’ motivation for the default when other options were available. Perhaps the negative experience with high inflation, depreciation, and economic contractions of the not so distant past imprinted an anti-inflationary bias that influenced the authorities to declare default. The spectacular financial collapse in Indonesia at the time could have also made an impression on the authorities.

The decision to default may have also been influenced by concerns about the lack of private sector involvement in Russia. The debate about private sector involvement in crisis resolution had already begun: there was a perception that the private sector had not contributed adequately in other crises and that the “big packages” from the IMF to Thailand, Indonesia, and Korea during the Asian crisis had only served to bail out private investors. Many investors, though, appeared to base their risk assessments on the premise that Russia was “too big to fail” and that the

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10 One often overlooked factor that may explain the crisis is the possibility of having a debt trap, where a mixture of a loose fiscal policy and a strict monetary policy lead to large debt accumulation and eventually a collapse (see Sargent and Wallace, 1981).

11 The distinction between instruments issued subject to local law and instruments issued subject to international law is significant in that holders of instruments subject to international law can pursue litigation in international courts in the event of default.

12 See Kharas, Pinto, and Ulatov (2001) for a detailed description and analysis of this episode.

13 See Thornhill (1998), who argues that there was a strong anti-inflationary bias by the authorities at the time the decision was made.
Figure 7.2. Russia: Public Debt Indicators, 1994–2002

A. Total Public Debt
   (Billions of U.S. dollars)

B. External Public Debt
   (Billions of U.S. dollars)

C. Domestic Public Debt
   (Billions of U.S. dollars)

D. Composition of Public External Debt
   (End-1998)

Sources: Russian Ministry of Finance; Central Bank of Russia; International Monetary Fund; and author’s estimates.
international community would rescue Russia. They were proved wrong. While this debate raged, in Russia’s case it made little difference whether the contribution from the private sector took the form of reduced private sector claims on Russia in real terms (because of inflation and the exchange rate depreciation) or because the default forced a debt-reduction operation. Whatever the motivation, the default certainly prevented a much larger inflationary outbreak and, in this sense, tilted the burden of the adjustment to bondholders (principally banks and nonresidents) rather than cash ruble holders (principally residents).

After a period of confusion, compounded by poor and erratic communications with the public and bondholders, the authorities announced a strategy for resolving the debt problem. The strategy consisted of restructuring virtually the entire stock of domestic debt and applying differentiated treatment to holders of external debt—the external debt contracted by Russia (post-1991) was to be serviced in full, but Russia was going to seek restructuring of the stock of Soviet-era external debt. The above strategy involved a variety of creditors: financial institutions; the Paris Club; the London Club; the COMECON countries; and uninsured suppliers. Given the scale of the problem, the Russian proposal clearly spelled hard work for the ministry of finance and its debt negotiator, Mr. Mikhail Kasyanov. By and large, the strategy worked and the Russians were able to restructure almost the entire stock of domestic debt, as well as the bulk of the Soviet-era external debt.

A key component of the debt-resolution strategy was the negotiation of a new arrangement with the IMF in order to signal to the international community that a credible macroeconomic framework was in place to provide a basis for the discussions with creditors. Moreover, this leg of the strategy was key to unlocking an agreement with the Paris Club. Negotiations with the IMF—suspended after the crisis—began in late 1998 and continued until July 1999, when a new Stand-By Arrangement was approved by the IMF’s Executive Board.

**Domestic Debt Resolution: The Novation Scheme**

Domestic debt holders were given the option of participating in a bond restructuring known as “the novation scheme” or having their holdings frozen. The restructuring covered GKOs and OFZs maturing through end-December 1999 (that is, obligations falling due in the 16½ months after the default), which constituted almost the entire outstanding stock of GKOs and the majority of the outstanding stock of OFZs. The novation scheme did not cover government debt held either by the CBR or by individuals or agencies, such as private pension
funds that were required by law to hold government securities, whose holdings were restructured subject to separate conditions. It is estimated that about Rub 190 billion in GKOs/OFZs was affected by the restructuring, of which over Rub 80 billion ($13 billion at the August 1, 1998 exchange rate) was held by nonresidents.

In addition, nonresident investors were faced with new restrictions (imposed under the private debt moratorium) on payments by Russian banks to nonresidents toward the settlement of forward foreign exchange contracts. Attempts by creditors—resident and nonresident—to pursue these claims in the Russian court system were largely unsuccessful.

The GKO/OFZs were held by a diverse group of bondholders who often displayed deep disagreements among themselves. A restructuring offer was announced in mid-September 1998, but creditors refused the offer. An agreement was ultimately reached in March 1999, after months of often difficult negotiations, and accepted by an overwhelming majority of bondholders. Under the terms of the novation scheme, most resident and nonresident bondholders received a package, including quasi-cash, medium-term bonds, and long-term bonds (see Box 7.4).

All proceeds received by nonresidents under the scheme, including the up-front cash payment, coupon, or principal, as well as proceeds from secondary market trading in GKO/OFZs, were deposited into S-accounts (special ruble-denominated accounts that are not freely convertible into foreign exchange or cash rubles). These “restricted rubles” could then be used for purchases of additional government domestic debt instruments or certain Russian corporate bonds and equity. Nonresidents wishing to convert and repatriate “restricted rubles” initially had two options: (1) deposit the funds in a non-interest-bearing transit account for one year, after which repatriation would be allowed at market exchange rates; or (2) purchase foreign exchange through a special auction at a more depreciated exchange rate.

In view of the complexity of the package, it is difficult to obtain reliable estimates of the loss suffered by investors. At the time, market analysts estimated that, under the restructuring, returns to investors would amount to only 5 cents on the dollar. It should be noted, however, that much of the losses suffered by the GKO/OFZ investors were

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14 In mid-2002, the waiting period for repatriation was reduced from 12 months to 4 months.

15 This scheme was liberalized in July 2001, when nonresidents were allowed to repatriate interest income derived from their trading in securities with ruble funds in S-accounts, but as of mid-2003 nonresidents are still unable to freely repatriate the amounts in their S-accounts.
Box 7.4. The Novation Scheme of 1999

Terms for Investors Who Participated in the Novation Scheme

Investors who participated each received, in compensation for their GKOs, a package with the following assets in the proportions mentioned below. The flow of defaulted payments in the period August 1998–December 1999 was recalculated as a stock at the time of default using a discount rate of 50 percent a year.

<table>
<thead>
<tr>
<th>Type of payment/security</th>
<th>Percentage of adjusted holdings</th>
<th>Coupon (percent)</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash payment</td>
<td>3½</td>
<td>None</td>
<td>Funds must be deposited in “restricted” ruble accounts.</td>
</tr>
<tr>
<td>3-month GKO (maturity March 1999)</td>
<td>3½</td>
<td>None</td>
<td>Funds must be deposited in “restricted” ruble accounts.</td>
</tr>
<tr>
<td>6-month GKO (maturity June 1999)</td>
<td>3½</td>
<td>None</td>
<td>Funds must be deposited in “restricted” ruble accounts.</td>
</tr>
<tr>
<td>Cash-value OFZ</td>
<td>20</td>
<td>None</td>
<td>Funds must be deposited in “restricted” ruble accounts. Can be used, at par, to pay tax obligations that were in arrears as of July 1, 1998; purchase newly issued shares of Russian banks. Any sales receipts must be deposited in “restricted” ruble accounts.</td>
</tr>
<tr>
<td>OFZs with maturities ranging from four to five years</td>
<td>70</td>
<td>30, 25, 20, 15 and 10 each year, respectively</td>
<td>Funds must be deposited in “restricted” ruble accounts.</td>
</tr>
</tbody>
</table>

Terms for Investors Who Did Not Participate in the Novation Scheme

The three main groups were treated as follows:

- **Central Bank of Russia.** Defaulted GKOs/OFZs were restructured at par with six equal tranches of government securities maturing between 2013 and 2018, each bearing an interest rate of 5 percent a year.
- **Russian investors required by law to hold securities.** These investors received slightly better terms than the novation scheme. In particular, this group received 30 percent quasi-cash (10 percent cash, 10 percent three-month GKO; 10 percent 6-month GKO; 20 percent zero-coupon medium-term bonds; and 50 percent fixed-coupon long-term bonds.
- **Nonresident creditors who did not participate in the novation scheme.** These investors were paid according to the original terms of their holdings but proceeds were deposited in S-accounts that were effectively frozen.
related to the depreciation of the ruble and only smaller amounts were related to the restructuring. The ruble, however, soon stabilized (although at a much depreciated rate) and Russia has made all payments under the novation scheme (although the funds were kept partly frozen in the S-accounts subject to strict repatriation rules). Consequently, the value of the novation scheme was significantly higher than expected when the scheme was announced.

External Debt Resolution: A Differentiated Approach

A key element in the external debt strategy was a differentiated and discriminatory treatment of creditors depending on who the original debtor was. Creditors that signed contracts with the Russian Federation (Russia-era debt) were to receive preferential treatment in that their payments would be made on schedule, whereas those that signed contracts with the former Soviet Union (Soviet-era debt) would be subject to restructuring. This approach also mimicked the Paris Club rules of establishing a cutoff date for future reschedulings, which coincided with the rebirth of Russia on January 1, 1992. Thus, the Russian strategy for servicing its external debt was, in a sense, based on an accepted Paris Club principle to all classes of creditors.16

Russia-Era Debt

Consistent with the debt strategy, Russia remained current on all Russia-era official debt. At the time of the default, Russia-era debt amounted to some $60 billion, of which about one-third was owed to the IMF, one-third was in the form of Eurobonds, and the remainder was owed to the World Bank and other official creditors. Despite the lack of access to capital markets and limited new disbursements from official creditors, the strength of the macroeconomic recovery in the postcrisis period enabled the authorities to meet the scheduled payments on Russia-era debt in 1999 in a timely manner, including heavy repurchases to the IMF. As a result, the stock of Russia-era debt declined by about one-fourth to $39 billion at end-2001 (excluding the Eurobonds issued as part of the London Club restructuring) with

16 An exception to the rule was the payment of interest to all MinFin bonds in May 1998, some series of which were perceived to be Soviet-era debt. However, the authorities preferred to pay the 3 percent contractual rate rather than face a higher litigation risk. It was perceived that any restructuring would entail a higher interest rate than the 3 percent in the MinFin bonds. In the event, the principal of the MinFin (series III) was restructured.
Russia’s debt to the IMF reduced by almost two-thirds (in part reflecting repayments ahead of schedule). The first Russia-era Eurobond placed in November 1996 was paid in full in November 2001.

**Soviet-Era Debt**

Soviet-era debt stood at about $100 billion at the time of the default in August 1998, of which 40 percent was held by Paris Club creditors and about 30 percent by London Club creditors. Payments on Soviet-era debt were largely halted and arrears accumulated to all creditor groups. The accumulation of arrears was not out of the ordinary for several classes of creditors—only ad hoc payments had been made in the past to COMECON and non-Paris Club official creditors, while no payments had been made to uninsured suppliers (also referred to as Foreign Trade Organization or FTO debt).

Final agreement on restructuring terms for all categories of the Soviet-era debt has yet to be reached. However, considerable progress has been made with several groups of creditors that together represent over 90 percent of the Soviet-era debt, namely, the Paris Club, the London Club, MinFin bondholders, several COMECON countries, and the first tranche of the FTO creditors. Negotiations with the remaining creditors are also at an advanced stage.

**Paris Club Debt**

Prior to the 1998 crisis, Russia had benefited from four Paris Club reschedulings (in 1993, 1994, 1995, and 1996) that provided for a restructuring of principal payments and the recapitalization of the bulk of scheduled interest payments (see Box 7.5).

Despite the limited payments due in 1998 and 1999, arrears quickly emerged. Reflecting the drawn-out discussions with the IMF on a new arrangement, it was only in August 1999, a year after the crisis had erupted, that a fifth rescheduling 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 addition to the direct contribution of this restructuring, the agreement provided a framework for negotiations with other creditors since, as is typical in Paris Club agreements, there is a formal understanding that other creditors will not be granted better payment terms than those provided to the Paris Club.

While the agreement covered the flow problems of near-term debt service and regularizing the arrears, there was some sentiment among major creditors for offering a stock of debt operation to provide a formal
Prior to the 1998 crisis, Russia had received Paris Club reschedulings in 1993, 1994, 1995, and 1996. The first three of these agreements had consolidation periods of 12 months, while the fourth agreement, in support of a 3-year arrangement with the IMF, had a consolidation period of over 3 years. In each agreement, principal was restructured and interest payments were, for the most part, capitalized by including rescheduled interest payments in consecutive reschedulings. In the first three reschedulings, the amounts rescheduled averaged $9.4 billion. Because of the comprehensive nature of the fourth rescheduling, the 1996 agreement restructured about $40 billion of debt.

The fourth Paris Club rescheduling (the 1996 agreement) covered principal and interest payments falling due in the period January 1996–March 1999 and a subsequent stock treatment (reprofiling) of previously rescheduled debts. It was designed to be an “exit strategy” for Russia. This was the largest amount rescheduled for a single debtor (about $40 billion) in the Paris Club’s 40-plus-year history.

Agreement on the fifth Paris Club rescheduling was reached on August 1, 1999. The agreement covered both arrears and maturities falling due on Soviet-era debt between July 1999 and December 2000. The agreement covered an estimated $8.1 billion in the following manner:

- $6.7 billion was rescheduled over 20 years with a grace period of 1½ years and graduated payments;
- $0.8 billion was deferred over 6 years with a grace period of 1 year; and
- $0.6 billion of up-front payments compensated creditors who received lower payments relative to other creditors in the last 5 months of 1998 (Russia had made varying amounts of partial payments to various creditors in the postcrisis period).

The deadline for signing bilateral agreements was originally set for end-March 2000, but had to be extended a few times due to reconciliation problems and disputes about the terms of the rescheduling. Eventually, all 17 bilateral agreements were signed with the participating countries.

Box 7.5. Paris Club Reschedulings

exit from such restructurings and deal once and for all with the Soviet-era debt issue in a comprehensive manner. To this end, a goodwill clause was included in the 1999 Paris Club agreement whereby official creditors expressed their readiness to further consider the situation of the Soviet-era obligations at a later stage, once conditions were established for the implementation of a more ambitious economic reform
program. This was interpreted by the Russians as meaning that discussions for a comprehensive solution would begin during the fall of 2000 to coincide with the end of the 1999 Stand-By Arrangement with the IMF, and likely transition to a multiyear arrangement with the IMF with an accompanying agreement on the reform strategy.

As it happens, this scenario did not evolve as envisaged. First, despite strong macroeconomic performance, the program with the IMF quickly went off track owing to a lack of progress with structural reforms. Some observers interpreted the interruption in IMF disbursements as politically motivated. This made the transition to a multiyear arrangement with the IMF difficult, but not impossible. Indeed, given that the Russians had, as discussed in Chapter 3, developed in the first half of 2000 an ambitious medium-term structural reform program and had proceeded to implement it, the Russian authorities felt that they had done enough to demonstrate that they had the foundations for an ambitious economic reform—as had been specified by the Paris Club. However, the rapidly improving balance of payments outlook led key creditors to question whether Russia actually needed a new restructuring agreement or whether it should be expected to meet its payment obligations. Thus, Russian advances to the Paris Club met with strong resistance on the part of key official creditors.

As 2000 progressed, and the magnitude of the oil price increase became clear, the basis for a rescheduling became more and more tenuous. The current account surplus reached $45 billion (17 percent of GDP) for the year as a whole, of which $16 billion was reflected in an increase in gross reserves—dwarfing the approximately $3 billion reduction in debt service that would have been made available following a restructuring on terms similar to the 1999 agreement. Indeed, the main macroeconomic challenge faced by the authorities was how to respond to the enormous inflows of foreign exchange that were generated by the energy sector, and the situation was not expected to deteriorate dramatically in 2001—hardly a situation that can be characterized as representing an immediate balance of payments need. In all likelihood the authorities were not that interested in the debt relief of a flow rescheduling for $3 billion but rather were keen on obtaining some debt reduction in a subsequent restructuring of the entire stock of debt of almost $40 billion.

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17 Similar language is found in the Cologne G-8 Communiqué of June 1999.
However, the economic situation remained vulnerable to a sudden deterioration in the external environment. Thus, Russia opted to initiate negotiations on a precautionary arrangement with the IMF, which they hoped would be sufficient to unlock a new Paris Club restructuring. The motivation for the authorities was twofold: first, to line up financing that would be available in the event of a sudden downturn and, therefore, to avoid another crisis situation; and second, to ensure early on that a sharp spike in scheduled debt service in 2003 (the year before the next presidential election) would not generate substantial budgetary complications.

The strategy was risky, as few countries have been able to secure a Paris Club restructuring based on a precautionary arrangement with the IMF. The reason is that a logical leap needs to be made: a precautionary arrangement with the IMF signals the lack of an immediate balance of payments financing need, whereas a Paris Club restructuring is provided to finance just such a need. As it became clear that key creditors remained unconvinced of the need for additional financing—in part due to the continued buildup of reserves—the Russians began to explore other alternatives.

At the end of 2000, there was an exchange of letters between the ministry of finance and the Paris Club secretariat, which clearly demonstrated how far apart the two sides were. The Russian position continued to be that a comprehensive restructuring was required as envisaged in the agreed minute to the 1999 Paris Club agreement; indeed, the 2000 budget had been approved on the assumption that debt relief would be forthcoming, whereas the Paris Club secretariat insisted that Russia had graduated from reschedulings and that full payments should start immediately. Russia made some partial payments to the Paris Club in early 2001 and then began to accumulate arrears. At the same time, negotiations on a precautionary IMF-supported program continued, and the two sides were close to an agreement at end-February 2001 prior to the G-7 meeting in Palermo. At Palermo, the Russian delegation presented its case for debt relief, but official creditors remained unpersuaded. Once Russian policymakers realized that virtually no room existed to garner

19 Under a precautionary arrangement, the member expresses its intention not to use the IMF money. However, the funds are made available to the country in the event that a balance of payments need materializes as long as the member continues to observe the conditions of the arrangement.

20 At some point the proposal of having a precautionary Paris Club restructuring was mentioned, presumably to work in a similar fashion to a precautionary arrangement with the IMF. Such an arrangement was unprecedented, and it was unclear how it could be implemented or what would trigger the provision of debt relief.
London Club Debt

An agreement, in principle, on a rescheduling of the London Club debt (in default since 1992) was reached in November 1995 and completed at end-1997. The agreement contained three main elements:

• cash payments;
• an exchange of loans for principal bonds (PRINs); and
• issuance of special interest arrears notes (IANs) to cover past-due interest.

The Vnesheconombank (VEB) was the issuer of the bonds. While there was no element of debt reduction in this deal, the bonds did have favorable terms: PRINs had 7 years of grace and a 25-year maturity with graduated payments, whereas IANs had 7 years of grace and a 20-year maturity with graduated payments and favorable interest rates. A year after its issuance, PRINs and IANs were in default.

A debt and debt-service reduction operation was agreed with the London Club in February 2000. The agreement restructured the entire stock of debt to the London Club, estimated at $31.8 billion and included three kinds of claims held by the London Club:

• PRINs ($22.2 billion);
• IANs, ($6.8 billion); and
• past-due interest arising from the nonpayment of PRINs and IANs since late 1998 ($2.8 billion).

The interest rate on PRINs was 13/16 over LIBOR capped at 8 percent in the first 6 years and (semiannual) interest payments were partly capitalized. Cash interest payments on PRINs of 25 percent of the due amount were to be made in 1996, increasing to 40 percent in 1997, 50 percent in 1998-99, 60 percent in 2000, and 85 percent in 2001 with full cash payment thereafter. IANs were used to capitalize the unpaid part of the interest due. The interest rate on IANs was also 13/16 over LIBOR with no cap and the full (semiannual) interest due was to be paid in cash.

Further debt relief, Russia accelerated payments immediately and by the end of the second quarter of 2001, Russia had cleared almost all arrears to Paris Club creditors. In April 2001, Russia decided not to request the precautionary arrangement with the IMF.

London Club Debt

These claims stem from commercial bank loans granted to the Vnesheconombank of the USSR (VEB) that were defaulted on in 1992. After almost six years of negotiations and partial payments of interest and various payment deferrals, the London Club debt was formally rescheduled for the first time at end-1997 (see Box 7.6). The agreement contained three main elements: (1) up-front cash payments; (2) securitization of the principal of the loans (into bonds known as PRINs); and (3) issuance of special interest arrears notes (IANs) to cover past-due interest.
The claims to the London Club were exchanged for new Eurobonds issued by the Russian Federation (instead of the VEB) that in principle have similar status as previously issued Eurobonds. PRINs and IANs were consolidated and were subject to debt reduction. PRINs were exchanged for New Eurobonds in the amount of 18 1/4 billion after a 37.5 percent write-off and IANs, after a 33.0 percent write-off. The issued Eurobond has a grace period of 7 years and a maturity of 30 years featuring graduated payments and a frontloading of interest reduction. New Eurobonds in the amount of $18 1/4 billion arising from the PRIN and IAN exchange were issued.2

Past-due interest was not subject to debt reduction. Past-due interest was exchanged for a special Eurobond at par (i.e., without debt reduction) with a grace period of 6 years and a maturity of 10 years with equal semiannual payments and a fixed interest rate of 8.25 percent paid semiannually.3 The amount exchanged was equal to the outstanding amount of past-due interest minus a cash payment of 9.5 percent (about $0.3 billion). PDI (past-due interest) Eurobonds were issued in the amount of $2 1/4 billion.

The necessary critical mass of participation required to complete the operation was achieved in August 2000 and the new Eurobonds were issued in September 2000.

Payments are to be made semiannually at the end of March and September of the corresponding year. There are 47 semiannual amortization payments after the 7 years of grace; payments 1-4 and 37-47 will be for 0.5 percent of the original principal; payments 5-7 and 33-36 will be for 2.0 percent; payment 8 for 2.5 percent; payments 9-24 and 29-32 for 3.0 percent; and payments 25-28 for 4.0 percent.

Semiannual interest payments are to be made at different rates in year 1 (2.25 percent for the first payment and 2.5 percent for the second); 5.0 percent in years 2-7; and 7.5 percent in years 8-30. 3 There are 9 semiannual equal amortization payments after the 6 years of grace for 11.11 percent of the outstanding amount after the cash payment.

Within a year, however, Russia was back in arrears to the London Club creditors. Interest payments were made on time until the August 1998 crisis, but the interest payment in December 1998 was missed. While the authorities paid interest due on the IANs, cash interest payments on the PRINs were not made in the hope that bondholders would accept an amendment to the terms of the 1997 exchange that would allow Russia to fully capitalize the interest due. In the event, the critical mass needed to amend the bond contract (95 percent) was not reached and Russia missed the next scheduled payments (June 1999 and December 1999) on both PRINs and IANs.

In February 2000, a comprehensive stock of debt operation was agreed in principle at a meeting of Russia’s Bank Advisory Committee. The operation involved debt and debt-service reduction through an exchange of PRINs and IANs for new Eurobonds and an upgrade in the
seniority of the debt: the new Eurobonds were issued by the Russian Federation rather than VEB.\textsuperscript{21}

The London Club deal was finalized in August 2000 with an overwhelming participation of creditors. There were three elements of debt reduction in the operation.

- A reduction in the face value of the bonds of about $10\frac{1}{2}$ billion from almost $32$ billion before the exchange to $21\frac{1}{4}$ billion after the exchange.
- A reduction, in present value terms, of about $2\frac{1}{2}$ billion, due to the use of below-market interest rates embedded in the graduated interest payments with low rates at the beginning of the restructuring period.
- A reduction of about $1\frac{1}{2}$ billion reflecting the up-front cash payments, consisting of prepayment on past-due interest.

All in all, the debt reduction involved in this deal amounted to about $13\frac{1}{2}$ billion, equivalent to almost 40 percent of the London Club debt or 5 percent of GDP.\textsuperscript{22} The deal provided considerable debt relief in the servicing of London Club obligations over the medium term: it is estimated that Russia saved about $2$ billion in debt-service payments a year.

The terms of the London Club agreement, including the debt reduction component and the replacement of Soviet-era claims on VEB by a Eurobond issued by the Russian Federation, became the model for subsequent agreements with other commercial Soviet-era creditors.

**MinFin Bonds**

MinFin bonds originated from foreign currency deposits of companies trading with the Soviet Union that were held at the VEB and frozen in 1991. The deposits were securitized in two stages in 1993 and in 1996 into a series of bonds with maturity dates ranging from 1994 through 2011. Each series is foreign currency–denominated and pays an annual interest rate of 3 percent. Despite their not having the same legal status as the Eurobonds, there is an active secondary market in the MinFin bonds, which are also known as Taiga bonds or by the Russian acronym OVVZ.

\textsuperscript{21}Despite the formal change in issuer, there is still some debate as to whether the new Eurobonds are Soviet-era or Russia-era debt. In the view of some official creditors these Eurobonds should be treated as Soviet-era debt whereas investment bankers treat them as Russia-era debt. The Eurobonds related to the London Club deal trade at a small discount over Eurobonds issued voluntarily by the Russian Federation.

\textsuperscript{22}The debt-service reduction is calculated against the counterfactual of a simple rescheduling at 13/16 over LIBOR. If the calculations are made at Russian yields on Eurobonds at the time of the agreement in principle, the debt reduction would be about 67 percent.
In May 1999, while accumulating arrears to Paris and London Club creditors, and absent an imminent agreement with either group, Russia defaulted on MinFin series 3 bonds using the argument of the need to preserve the comparability of treatment of creditor groups. Somewhat paradoxically, interest payments on all series of MinFin bonds continued to be paid on schedule. In November 1999, following the agreement with the Paris Club and in the midst of intense negotiations with the London Club, Russia announced a bond exchange to reschedule the MinFin series 3 bonds that was subsequently amended in January 2000 to allow greater flexibility to investors (see Box 7.7). The overwhelming majority of the defaulted MinFin series 3 debt was restructured by end-2000.

All other series of MinFin bonds (i.e., series 4 to 7) continue to be serviced—the MinFin series 4 was paid in full in May 2003—and the government has announced its intention not to seek additional restructurings of MinFin bonds despite the fact that another outstanding series is regarded as Soviet-era rather than Russia-era debt (series 5). The MinFin bonds trade at a discount relative to Eurobonds of similar maturity, reflecting some pricing by investors of a higher-risk premium.

**Foreign Trade Organization Debt**

The debt originated from amounts owed to uninsured suppliers—that is, private sector companies that extended trade credit to the former Soviet Union without a guarantee from an export credit agency in their home country. The main parameters for a rescheduling had been agreed in October 1994, along the lines of the deal under discussion with the London Club at the time. In the event, no agreement was finalized and no payments have been made since the early 1990s.

In August 1998, the stock of foreign trade organization debt stood at about $4 billion. An agreement in principle was reached with the Forum of Trade Creditor Group Representatives in April 2001, on similar terms to the London Club deal. A formal proposal was articulated by the ministry of finance in November 2001, which, in essence, treats creditors as “late arrivers” to the series of London Club deals. A formal bond exchange offer (to be completed in several tranches) was made available to foreign trade organization (FTO) creditors in November 2002, with closing and settlement by mid-December 2002. Only holders of verified debt were eligible. This posed a problem, as verification requires documentation of the original trade deals with the relevant Soviet organization. The first tranche of the exchange was successfully finalized although participation was low (just over $1 billion). Holders of as-yet unverified debt will be given an opportunity to apply for the bond exchange scheduled for July 2003.
Box 7.7. The MinFin Series 3 Bond Restructuring Deal of 1999

A bond exchange scheme was announced in November 1999 and modified in January 2000. The exchange is open ended as no deadline for participation has been announced.

Investors were provided the option of exchanging their defaulted bonds for combinations of
- new eight-year bonds similar to the MinFins (foreign currency-denominated with an interest rate of 3 percent); and
- four-year OFZs (ruble-denominated) bonds at an interest rate of 15 percent the first year and 10 percent thereafter (paid semiannually) and bullet principal payments.

The ministry of finance continued to be the guarantor of the new bonds. The bulk of the MinFin series 3 has been successfully exchanged. Investors have preferred, by an overwhelming majority, the foreign currency bond over the OFZ.

The proposed debt exchange entails a two-step procedure: first, all calculations would be made as if FTO creditors had joined the 1997 London Club deal; and, second, calculations would have to be made as if FTO creditors joined the 2000 London Club deal including debt reduction. FTO creditors ultimately receive a package similar to the London Club creditors including Eurobonds that mature in 2030, Eurobonds that mature in 2010, and some cash payments.23

International Bank for Economic Cooperation/International Investment Bank Debt

The International Bank for Economic Cooperation (IBEC) and the International Investment Bank (IIB) were the multilateral financial institutions of the former COMECON trading block. Both IBEC and IIB became inoperative shortly after the dissolution of the Soviet Union. While most members covered their obligations with some assets, only Cuba and Russia have not done so, leaving Russia with an outstanding obligation of about $1 billion. Effectively, the obligations are to the original creditors of IBEC/IIB since both institutions are closed. The Russian ministry of finance reached an agreement in principle with IBEC/IIB and their creditors (represented by Lloyds TSB Bank) on

23The calculations are complicated by the fact that the FTO debt is denominated in more currencies than is the London Club debt and agreement needs to be reached on conversion rates as well as on interest rates on arrears. Current rates of participation suggest payments of about $0.16 billion and issues of 2030 Eurobonds of $1.1 billion and 2010 Eurobonds of $0.16 billion.
September 2001, with the aim of replicating a “virtual” London Club deal similar to that of the FTO creditors described above.

**COMECON Debt**

The COMECON debt comprises intergovernmental obligations to eight countries: former GDR, the Czech Republic, the former Yugoslavia, Slovakia, China, Hungary, Bulgaria, and Romania. At the time of the 1998 crisis, debts to COMECON countries amounted to $15 billion, subject to some disagreement on the exchange rates to be used in converting the debts. Payments to all COMECON creditors had been irregular and ad hoc and had, at times, been made in kind.

While negotiations had been proceeding in an on-again, off-again fashion for many years, discussions were approached with a new intensity following the post-1998 Paris Club and London Club restructurings. Agreements on the bulk of the debts owed to the Czech Republic and Germany were reached in late 2001 and early 2002, respectively (see Box 7.8). The terms of the restructuring appear, at least in the case of Germany, to be significantly more generous than the terms provided by Paris Club and London Club creditors. Discussions with the other creditors are still ongoing.

The strategy for other COMECON countries involves the implementation of the “virtual Paris Club” deals. This idea is based on the concept of comparability of treatment, and ensures that no creditor be allowed to get a better deal than was offered by the Paris Club in the past.

**Other Debts**

In addition to the debts detailed above, Russia has outstanding obligations to a number of official creditors that do not belong to the Paris Club, including South Korea. The stock of such debts amounted to almost $5 billion at the time of the crisis and only ad hoc payments have been made since (as was also the case prior to the crisis). While little progress has been made with this group of creditors, the idea is to offer them a “virtual” Paris Club deal once amounts are reconciled, which is similar to that envisaged for other COMECON countries. In the event that there are other unresolved debts, the strategy is to offer

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24 There were three main categories of obligations: (1) transferable ruble loans (German Democratic Republic); (2) balances on bilateral clearing accounts (Yugoslavia and China); and (3) hard currency debts (the rest). Interest on these balances was not accrued and was usually repaid in kind. These claims were mostly trade related and based on nonmarket terms of trade. Some have argued that if the transactions that gave rise to these balances were to be measured at market prices Russia would be a net creditor rather than a net debtor, which may explain some of the generous terms in the negotiations.
Russia's debt to Germany was frozen, without interest, by Germany in 1992 for a period of 10 years as a gesture of goodwill toward Russia. In April 2002, Germany and Russia agreed on a simple debt-reduction operation whereby the debt of about $6.5 billion will be discharged by cash payments of about $0.45 billion. Of this amount, about 70 percent was paid in 2002 and the rest will be paid in two equal annual installments in 2003 and 2004. This payment stream implies a debt reduction of 93 percent of the eligible debt. The representatives of Germany and Russia noted the irony of the fact that the debts of a country that no longer exists (the Soviet Union) were restructured by a creditor country that also no longer exists (the former German Democratic Republic).

The Czech deal involves a complex and nontransparent operation. In 1994, this debt—amounting to $3.4 billion—was rescheduled for 20 years, involving equal principal payments and increasing interest payments. During the second half of 2001, Russia and the Czech Republic announced a scheme covering 80 percent of the debt, which also involved debt reduction for Russia. Under this scheme, a Czech financial institution bought $2.5 billion in Russian debt from the Czech government at a discount of about 80 percent, and traded this debt with the power company RAO UES (the electricity monopoly) in return for the supply of electricity. In turn, RAO UES used the claim to clear its arrears with the government. The transaction can be broken into two steps:

- the Czech financial institution sells its claims on Russia to RAO UES in exchange for deliveries of prespecified amounts of electricity to the Czech Republic for the next 10 years; and
- RAO UES pays tax arrears to the budget for $1.35 billion with the claims on Russia given by the Czech financial institution with a face value of $2.5 billion.

“virtual” Paris Club deals for official creditors and “virtual” London Club deals for commercial creditors.

Concluding Remarks

The Russian experience shows that while external borrowing may ease the transition costs, it needs to be utilized effectively. There is no question that access to capital markets (including by allowing nonresidents to trade with GKOs) permitted the laxity of fiscal policy in Russia to continue at a time when fiscal consolidation (which would have strengthened the debt dynamics) was urgently needed.
In much the same way that debt dynamics looked problematic at the beginning of the transition, they look very solid now. As mentioned in the introduction to this chapter, a combination of negative growth, high real interest rates, and primary budget deficits did not augur well for sustaining the inherited Soviet-era debt. However, 10 years after the transition, following a series of IMF-supported programs to stabilize and reform the economy (largely repaid by now), and a chaotic debt default, the situation looks quite encouraging. The strategy for debt crisis resolution following the default worked well and achieved its objectives. At end-2002, the stock of public external debt is estimated at about $140 billion or about 40 percent of GDP.\(^{25}\) There is no doubt that today Russia is in much better shape to confront the remaining challenges of transition, and debt sustainability is not such a binding constraint. As structural reform continues and productivity improves, the equilibrium real exchange rate will appreciate, further lowering the debt burden as measured by the debt to GDP ratio.

References


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\(^{25}\)In addition, on the asset side, the CBR has gross reserves of about $50 billion or 15 percent of GDP, implying net public external debt of about $90 billion or 25 percent of GDP at end-2002.