Congressional Research Service

Report RL30617

Russia's Paris Club Debt and U.S. Interests

John P. Hardt, Foreign Affairs, Defense, and Trade Division

Updated June 6, 2001

Abstract. Russia faced both fiscal and external debt crises in August 1988. Russia's external debt became unmanageable as the servicing of the debt would have required 80-90 percent of the anticipated federal revenue. Relief came from a new IMF program, a short-term rescheduling "framework agreement" that suspended principal payments for Russian Paris Club debt through the year 2000, and substantial forgiveness of the Soviet era commercial London Club debt.

Order Code RL30617

CRS Report for Congress

Received through the CRS Web

Russia's Paris Club Debt and U.S. Interests

Updated June 6, 2001

John P. Hardt
Senior Specialist in Post Soviet Economics
Foreign Affairs, Defense, and Trade Division

Russia's Paris Club Debt and U.S. Interests

Summary

Russia faced both fiscal and external debt crises in August 1998. Russia's external debt became unmanageable as the servicing of the debt would have required 80% to 90% of the anticipated federal revenue. These crises threatened Russia's ability to govern and to continue a process of transition to a democratic market system. U.S. interests were directly involved because of the danger posed by a potentially unstable Russian economic, political and security system and the possible linkage by policy makers between economics, security, political interests and debt settlement. Relief came from a new IMF program, a short-term rescheduling "framework agreement" that suspended principal payments for Russian Paris Club debt through the year 2000, and substantial forgiveness of the Soviet era commercial London Club debt.

Russia made debt rescheduling a key issue at the Okinawa G-8 meeting on July 21-23, 2000 and in subsequent bilateral and international meetings. When the short term framework agreement ended, Prime Minister Kasyanov announced in January 2001 a policy of partial servicing of their Paris Club debt. Creditor reaction was so strong President Putin reversed Kasyanov and assured creditors that all debt obligations would be met. Later, in early 2001, Russian leadership shifted its concern to an external debt servicing crisis expected in 2003, noting that Russia would then either need debt relief or would face default.

Germany's position as leading Paris Club creditor is that Russia should be able to meet its debt obligations. Germany holds about half of the $42 billion of outstanding Paris Club debts inherited from the Soviet Union. Germany's Paris Club Russian debt rose in 2001 by inclusion of a Russian commitment to pay an earlier debt by the Soviet Union to the German Democratic Republic. The additional $6 billion Russian debt is being given special treatment by Germany. Russia and Germany are discussing debt for asset swaps for this debt.

Improved Russian economic performance has generated additional currency reserves and increased revenue that has eased the burden of servicing their debts and meeting their needs for discretionary spending. Even with substantial reserves in the Russian Central Bank, the Ministry of Finance must either buy the reserves or reduce budget outlays in order to meet Paris Club debt servicing commitments. Without structural reform with changes in the incentive system, the economic upswing may be part of a cycle rather than a new trend line of sustainable economic growth. Reducing the debt service requirements through further rescheduling, limiting subsidies, and containing defense spending may be necessary if Russia is to meet the budgetary needs for implementing the structural reform.

U.S. options in Paris Club Soviet Era negotiations range from no rescheduling to deep debt restructuring and use of debt swaps. The United States gives more explicit attention than Germany and other Paris Club members to the linkage between Paris Club agreements and foreign and security affairs.

Contents

List of Tables

Russia's Paris Club Debt and U.S. Interests

Paris Club: Overview

Russia's serious financial crises were of singular importance to Russia and to the United States in the view of some analysts. Without structural reform, many analysts argued that Russia would regress in future economic performance and governance. The dangers to the United States of a failed Russian Federation would then be great: Possible buildup and use of nuclear and conventional weaponry; return to a more authoritarian government in a weakened federation; increased destabilization of its Eurasian neighbors; aggravation of global economic problems and an inimical foreign policy. On the other hand, the opportunities to the United States of a successful Russia might be substantial: With a transition to a democratic government with a functioning market system, Russia might become an important American business partner. With development of a democratic system, Russia could become a more cooperative ally and a contributor to global stability.

Linkage between Russian performance and the United States interests are less evident to some analysts. Both the dangers and opportunities from Russian developments are considered by some analysts to be of marginal importance to United States interests in maintaining peace and prosperity.

Both the executive and the congressional branches have roles in determining the interests of the United States in debt relief. The Congress of the United States has played a selective role in past Paris Club negotiations. The United States has weighed the importance of the precedents of policies adopted in some past Paris Club negotiations on debt inherited from previous regimes. The United States House of Representatives took a leadership position in the 1992 Polish Paris Club agreement that wrote down over 50% of the debt democratic Poland inherited from its Communist regime predecessor. The underlying assumptions were that the debts were uncollectible and, without relief, they would impede the country's effort to pursue a successful transition to a functioning democratic market system. The United States stressed the importance of structural reform for Russia to make a successful transition to a functioning market economy with sustained growth. American leadership did not explicitly accept the proposition that Russian debt was uncollectible or that debt relief would permit the Russian budget to support the cost of structural reform and serve as leverage to constrain subsidies and defense expenditures.

The Congress has become more involved in all Paris Club negotiations and the linkage of debt relief to foreign security issues has broadened, especially dealing with Russian debt. Since enactment of the Federal Credit Reform Act of 1990, the Congress must be directly involved in any official debt reduction. Official debt forgiveness must be accounted for in the appropriations process. Congress is informed on debt relief even if debt reduction is not involved. The Secretary of State is required to notify the committees of jurisdiction 30 days prior to agreements going into force "with a detailed justification of the interest of the United States in the proposed debt relief" (P.L.95 424, Section 603a). Following the multilateral Paris Club agreement of August 1999, negotiations of the bilateral agreement on rescheduling $485 million of Russian debt were concluded.[1] On May 26, 2000 Congress was notified of the bilateral agreement. On June 16, 2000 the Senate Foreign Relations Committee and House International Relations Committee indicated they would put a hold on this bilateral Paris Club agreement in protest of the Russian actions in Chechnya and aid to Serbia.[2] The same House and Senate Committees passed bills intended to limit bilateral United States rescheduling if progress were not made on limiting missile sales by Russia to China and to encourage closing a foreign intelligence installation in Cuba. (H.R. 4022, H.R. 4118 and S. 2687, S. 2748; see below for details).

On July 1, 2000, a $155 million payment on Russian Lend-Lease debt was due. This payment was included in the $485 million bilateral rescheduling following the August 1999 Paris Club Agreement. If this bilateral Paris Club agreement had been held up, Russia would have been required to make a scheduled payment or run the risk of losing its Most Favored Nation status. The Lend-Lease agreement in 1972 permitted four debt payment deferrals; the allotted postponements in payment have now been used up. The Administration chose to go forward with the bilateral agreement and not follow the wishes of Congress. As the Administration complied with the Paris Club agreement, the payment was not required at that time. Administration officials noted that the agreement on debt relief made in 1999 was based on an established policy of supporting heavily indebted countries with balance of payments crises who had IMF programs. Moreover, they argued, a bad precedent would be set by noncompliance that would weaken the Paris Club in ways adverse to United States interests.[3]

Appropriations to cover possible Russian debt forgiveness may have to compete with developing countries' debt reduction as well as all other appropriations for international affairs. The United States has adopted a policy of debt relief for Highly Indebted Poor Countries (HIPC) countries that draws from the same international

---

[1] The Paris Club "framework agreement" of August 1999 provided for postponement of principal repayment on the debt, but continued the requirement for servicing the interest obligations up to December 31, 2000.

[2] Senator Jesse Helms, Chairman of the Senate Foreign Affairs Committee, in a letter to Secretary Albright, moved to block the $485 million Paris Club refinancing package to protest the Chechnya war and a reported $150 million Russian loan to Serbia, June 16, 2000. See also op.ed. Benjamin Gilman, "It's Time Russia Paid Its Debt," *Washington Post*, June 16, 2000.

[3] The Paris Club is an ad-hoc group of creditor nations whose agreement is based on the acceptance of consensus in their process of dealing with debtor nations either in default or in imminent danger of default. Without compliance with these agreements, the Administration argued, the principle of equal burden sharing and the effectiveness of the organization would be imperiled.

affairs budget as potential Russian debt relief.[4] Consideration may be given to criteria measuring need and performance, including the relationship between debt service, exports and gross national products for both HIPC and Russian debt relief. Russia, in 1998, was considered "moderately indebted" with a debt service to export ratio of 12.1.[5] In 1999 Russia's economic performance improved and their estimated GDP was increased, making them a "less indebted country." Proponents of HIPC relief might, therefore, argue that Russia was less qualified for debt relief than many HIPC countries.[6] This comparative need was expected to lead to a shortfall in HIPC financing. The House approved $225 million of the $472 million the HIPC budget requested in FY2000/01; only $75 million was tentatively approved by the Senate.[7] A Paris Club agreement involving 50% reduction of the outstanding Russian debt would have required a budgetary outlay of as much as $455 million.[8] Funding for Russian debt restructuring would have competed with HIPC for these limited funds in the International Affairs Budget. This possible choice between HIPC and Russian debt restructuring did not come to pass, but potential for a trade-off was made evident.

The Paris Club "Framework Agreement" of August 1999 was expected by Russian leaders to be followed in 2001 with a comprehensive Paris Club agreement. This debt issue was raised at the G-8 Okinawa meeting in July 2000.

On July 18, 2000, Senators Jesse Helms, Trent Lott, Mitch McConnell and John W. Warner sent a letter to President Clinton advising him that we "strongly oppose any further debt rescheduling, reduction or relief for the government of Russia absent significant changes in Russian spending priorities."

On the eve of the Okinawa G-8 meeting, Russian Prime Minister Kasyanov observed,

> It is time for the Paris Club to put a financial end to the Cold War by agreeing to a comprehensive solution to Russia's Soviet-era debt comparable to that already

---

[4] CRS Report RL30214, *Debt Reduction: Initiative for the Most Heavily Indebted Poor Countries*, by Larry Nowels.

[5] World Bank, *World Development Indicators 2000.*

[6] Ibid. The World Bank, by applying a more recent year purchasing-power parity calculation, raised the Russian gross domestic product from $605 to $948 million, a 57% increase. Accordingly, Russia's 1998 per capita GDP rose from $4,200 to $6,500. See Roland Gotz, [http://www.biost.de].

[7] FY2000-2001 Foreign Operations bill (S. 2677). The Senate bill also blocks ExIm Bank and OPIC aid to Russia until Serbian assistance is terminated.

[8] The current Paris Club debt to the United States is $2.6 billion (See table 3 below.). One half of that amount would be $1.3 billion, costed at an estimated market price of thirty-five cents on the dollar, would make the necessary appropriations to cover the debt reduction at about $455 million.

> agreed with Russia's London Club creditors A prosperous and democratic Russia is in all of our interests.[9]

The leaders of the Western industrial countries of the G-8 made it clear at the Okinawa Meeting in July 2000 that Russia would be required to go through the usual procedures to qualify for Paris Club debt negotiations: (1) Negotiate a new IMF program; (2) Demonstrate the need for debt relief to avoid default; (3) Make assurance that after debt relief the remaining debt would be collectable.

Prime Minister Kasyanov, on January 9, 2001, announced that Russia could only make a partial payment of $1.6 of the $3.6 billion due on Paris Club, Soviet era debt in 2001. The creditor reaction to Kasyanov's statement on prospective noncompliance was strong and negative:

- The Paris Club secretary took the unusual step of sending an official cautionary letter to Russia counseling full debt service compliance.

- The IMF indicated it would not approve a new program of assistance providing for additional aid and permitting a meeting of the Paris Club without Russian debt compliance.

- Germany indicated that full Russian membership in the G-8 would turn on debt service compliance. Full membership would allow Russia to attend and participate in the economic as well as the political discussions.

- Sweden, occupying the European Union presidency, tied support of Russia's accession to the WTO to debt service compliance.

- Standards and Poors, the leading credit rating agency, indicated it would not consider upgrading Russia's investment credit rating without full debt service compliance.[10]

President Putin then intervened to indicate that Russia would make full payment of all Paris Club obligations. The Duma approved a revised budget for the year 2001 which included necessary additional funds for full debt servicing.

Russian leadership did not give up on the issue of Paris Club Soviet Era debt negotiations, but shifted focus in 2001 to debt rescheduling before the year 2003, the projected peak year of debt servicing. In 2003 total external debt would exceed $18 billion compared to just under $13 billion in 2001. In their total external debt, Paris Club Soviet Era debt alone is projected to rise from $3.2 to $4.7 billion.[11] While

[9] Mikhail Kasyanov, "A Financial End to the Cold War", *Financial Times,* July 20, 2000.

[10] Sergei Blagov, "Moscow Braces for Dispute with Creditors" *Interpress Service,* January 15, 2001.

[11] Michael Marrese, Chase Manhattan International Limited, London, November 17, 2000.

Russians focus attention on the burden of total external debt servicing, the relief they request is centered on Paris Club Soviet Era debt of less than $5 billion.

Russia's External Debt Crisis

Russia inherited close to a $100 billion debt from the Soviet Union in 1991. Russia, as the successor state in the so-called zero solution, proceeded to lay claim to all the foreign assets of the Soviet Union and also assumed its liabilities. From 1991 to 1998 Russia ran budget deficits and partly financed them by borrowing abroad, building up its external debt to over $150 billion.[12] Russia was able to service or meet its debt obligations up to 1998 with the help of several restructurings of its official and commercial debts by its Western creditors. With the financial crisis of August 1998 came an external debt crisis precipitated by its inability to service its $17.3 billion due in 1999. The OECD described the situation as follows:

> Following the dramatic depreciation of the currency, the burden of foreign debt has become so high as to make the servicing of all scheduled payments unfeasible. Indeed, such a strategy would have devoted the equivalent of over 80% of planned federal tax revenue in 1999 to foreign debt service alone. Instead, the Russian government has been following a strategy of servicing only the part of the foreign debt incurred by the Russian Federation itself, as opposed to the inherited debt of the Soviet Union. Negotiations are continuing on debt restructuring agreements that Russia needs to get back on track and boost its credibility in the international community.[13]

The debt crisis of 1998-99 put Russia's leaders in a double bind: either they could choose not to meet their debt obligations by going into default on its inherited debt and suffer lack of support from the donor institutions and loss of access to the international capital markets, or they could meet more of their debt obligations and effectively exhaust the revenue available for discretionary appropriations in their budget. The budgetary restraints faced by the Russians may merit debt rescheduling rather than debt reduction as an option that Congress may consider.

With reduction of the value of Russian securities (GKO/OFZ) to 10% of their cash value, the Western security market was effectively closed to Russia. The GKO/OFZ's are domestic bonds that were primarily held by Russian banks and foreign buyers. Russia had used this security market before August 1998 to finance its substantial budget deficits.[14] Even with limited servicing of its external debts, Russia had substantial arrears or non payments of social expenditures and funding of reform programs. The budgetary squeeze was also exacerbated by increased military claims for financing Chechnya and for military procurement.

---

[12] Herman Clement, *The Indebtedness of the CIS Nations,* Osteuropa Institut, Munich, December 1999. Prepared for the German Ministry of Finance.

[13] John Litwack et al. OECD, *Russian Federation, 1999-2000,* Paris, France, March 2000.

[14] Michael Marrese, *International Fixed Income Research Report of Chase Manhattan Bank, London*, Dec. 1998. (Hereafter Chase Report)

While Russia had been seeking debt relief after the 1998 financial crisis in order to help resolve its external debt crisis, debt restructuring was sought solely on the official and commercial debt Russia inherited from the USSR. This inherited debt represented close to two-thirds of Russia's debt in 1998, i.e., $59.5 billion of official debt and $35.2 billion of commercial debt. (See Table 1.) The part of the official and commercial debt eligible for inclusion in Paris and London Club rescheduling were debt obligations in imminent danger of default. The Paris Club debt for 1999 was $42.0 billion; the London Club debt was $31.8 billion in that year.

Table 1. Russian External Debt
(Billion dollars)

	1991	1992	1993	1994	1995	1996	1997	1998
Federal Government	96.8	107.7	112.7	119.9	120.4	125.0	123.5	147.1
Former USSR Debt	96.8	104.9	103.7	108.6	103.0	100.8	91.4	95.2
To Official Creditors	62.2	69.2	69.1	69.9	62.6	61.9	56.9	59.5
To Commercial Creditors	32.9	34.0	34.0	37.0	39.3	38.8	33.9	35.2
Bonds	1.7	1.7	1.6	1.7	1.1	0.1	0.1	0.0
Russian Federation	0	2.8	9.0	11.3	17.4	24.2	32.1	51.9
To Multilateral Creditors	0	1.0	3.5	5.4	11.4	15.3	18.7	26.0
To Official Creditors	0	1.8	5.5	5.9	6.0	7.9	7.6	9.7
Bonds	0	0	0	0	0	1.0	4.5	16.0
Sub-national Governments	0	0	0	0	0	0	1.1	2.2
Total	**96.8**	**107.7**	**112.7**	**119.9**	**120.4**	**125.0**	**124.6**	**149.3**

Source: OECD, Russian Federation, 1999-2000, March 2000, including data from Russian Ministry of Finance and IMF Data.

Debt Relief Provided to Date

To obtain debt relief, Russia had to first reestablish itself again with the IMF and agree to a new assistance program before beginning discussions with the Paris and London Clubs on debt restructuring. By agreement with Russia, the IMF, Paris Club and London Club provided some debt relief to Russia:

- In July 1999 a Russian/IMF agreement was signed because Russia was in default. This agreement reopened the process of servicing the $26 billion multilateral institution debt. The $4.5 billion provided by the IMF was to be used primarily to service the debt to that multilateral organization. After the first installment of $640 million was disbursed, further funding was held up until significant structural reform was undertaken as agreed to by Russia.[15]

- In August 1999, the Paris Club provided a “framework” agreement on the $42 billion debt.[16] The terms provided postponement of principal repayment on the debt, but continued servicing interest obligations. A bilateral Paris Club agreement between Russia and the United States covering Soviet era debt payments due from August 1999 to December 2000 was transmitted to the United States Congress on May 26, 2000. This bilateral agreement on debt rescheduling was put on hold by the Chairmen of the Senate Foreign Affairs and House International Relations Committees on June 16. The Administration put the agreement into force before July 1, 2000.

- In February 2000, the London Club provided for substantial forgiveness in the Russian commercial debt. The London Club agreed to an exchange of the $31.8 billion of claims held by the commercial creditors for $20.3 billion in new Eurobonds. This debt reduction translates into 36.5% debt forgiveness. The full debt forgiveness was raised to 52% by providing a lower interest rate and a grace period on principal payments of eight years. This multilateral agreement of the London Club was finalized by a lengthy process employing a bank advisory committee to reach bilateral commercial debt agreements with individual banks represented in the London Club.[17]

Russian leaders, Putin and Kasyanov, made clear that this London Club debt relief was welcomed and necessary but not sufficient. They called for the same 50% degree of forgiveness in the comprehensive Paris Club negotiations based on the terms of the February London Club agreement.[18]

A Russian Paris Club debt to Germany of 17.6 billion marks, not included in the Paris Club negotiations in 1999, is a debt the Soviet Union owed to the German Democratic Republic.[19] President Boris Yeltsin and Chancellor Helmut Kohl agreed in a Joint Declaration on December 16, 1992 to the following:

- The Russian government could assume the role of legal obligator to unified Germany for the Soviet debt to the German Democratic Republic;

---

[15] Russia-IMF Agreement, July 1999.

[16] Chase Report, September 1999.

[17] Chase Report, March 2000. Kasyanov op. cit.

[18] ITAR-TASS, February 15, 2000

[19] *Declaration by President Yeltsin and Chancellor Kohl on Moscow Meeting of December 1992*, Europa-Archiv, May 1993. Original text in German.

- An interest-free payment on the 17.6 billion marks Paris Club debt could be deferred to the year 2000.

With this new debt coming into force, an increase of about one fifth of the Paris Club debt would have to be serviced beginning with 2001. The dollar value of the debt, estimated to be as much as $6 billion, was determined by exchange rate calculations agreed to by German and Russian financial authorities. Prime Minister Kasyanov did not include the old GDR obligation in his pre-Okinawa debt statement.[20]

Potentially offsetting to Russia's debt burden are their claims on debts owed to them by other countries and assets abroad inherited from the Soviet Union. The bulk of the enormous official debts owed to Russia, especially debts for military equipment sales, may be largely uncollectible. Russian estimates, however, consider $25 billion of the debts as collectable. The value of Soviet assets abroad inherited by Russia in the zero solution has not been subjected to objective inventory. Estimates range widely from $2.0 to $600 billion. Whatever the accurate amount, neither the collectable outstanding debts nor assets abroad have yielded appreciable inflow of funds to Russia to date.[21] There is little evidence of Russian plans to exploit these potential sources of funds to relieve their debt burden.

Russia's Economic Growth Prospects and Debt Management

There are two competing views on current Russian economic growth prospects. One perspective, articulated by the World Bank, IMF and OECD, is that the present upsurge in Russian economic growth is fragile and that sustained growth requires significant structural changes that need to be initiated soon. If not under way in the near term, the upsurge of growth may provide, at best, an economic breathing space followed by a return to financial and debt burden crises resulting from another down-cycle. More expenditures for reform would be needed, in this view, to bring about structural reform and attain sustainable growth and increased revenue.

The second perspective held by some economists and bankers judges the current improvement in economic performance as having staying power and that necessary structural changes are now taking place during this improvement in performance. In this view the economy is seen to be already on a new trend line of sustained and rising growth. Those who stress the rich natural resource potential of Russia that ought to be able to support sustained growth reinforce this view.

Bearish Outlook. Under the first broadly held view, the size and distribution of the Russian budget is important to success in generating sustained growth, providing an increased revenue stream, and managing the external debt. Structural reform requires increased expenditures for recapitalizing working banks and pension

---

[20] Kasyanov, op. cit. He said "Russia has also agreed to be responsible for the $38 billion of Soviet debt owed to official bilateral creditors organized as the Paris Club." Why Kasyanov used $38 billion rather than the $42 billion figure the Paris Club creditors used, is not clear. Moreover, the prime minister did not mention the Paris Club GDR debt.

[21] Keith Bush, *The Russian Economy in March 2000.*

systems, restructuring bankrupt state enterprises for sale to private owners, improving transport and communications infrastructure, and providing at least minimum outlays for health, environment and education. Without debt restructuring that reduces the debt servicing burden, limits subsidies, and restrains military outlays, these claimants may continue to squeeze out budgetary outlays necessary for reform. Even with debt relief, overly ambitious military programs might draw down funds released by debt relief. Paris Club creditors would likely be especially concerned if they perceived their debt relief funds would be used to fuel military budgets designed to strengthen military programs that would threaten the security of creditor countries.

The international institutions, especially the World Bank, IMF and OECD, find that institutional changes in the Russian economic incentive system are critical to attaining sustained growth and an increased and reliable stream of revenue for government financing. The critical problem identified in World Bank analyses is that of changing the nonpayment system in Russia.[22] Without an efficient tax code, a working banking system, and a bureaucratic system that regulates competitive enterprises with a hard budget constraint, Russia will not be able to effectively gather taxes, generate investment, pay wages and pensions, and manage debt. Uneconomic subsidies to housing and utilities do not improve the quality of living spaces and absorb 4% of the GDP. The World Bank views the present Russian economic system as a disincentive system based on rent seeking rather than profit maximization and, therefore, persistently hostile to the development of sustained solvency and economic growth. With the introduction of a working institutional infrastructure in Russia, sustainable growth may be assured.

International financial institutions view repatriation of some of the over $150 billion capital flight as a necessary contributor to the success of Russian fiscal and monetary reform. Export earnings returned to Russia rather than retained abroad in flight capital might then pay taxes and contribute revenue for needed domestic investment.[23] Without these comprehensive structural reforms called for by the World Bank, even debt relief under the favorable terms set up by both the London and Paris Clubs may not be sufficient for Russia to attain the threshold of sustained economic growth and effective future debt management.

The OECD points to the same structural requirements needed to effect Russian reform. In stressing the need to address the demonetization of the economy, the OECD also calls for reworking the entire fiscal relationship between the federal and regional governments with more local mandates that may be funded through additional regional tax authority.[24]

---

[22] Bryan Pinto et al., *Dismantleing Russia's Nonpayment System: Creating Conditions for Economic Growth,* World Bank, December 1999. Lev Freinkman et al., *Russian Federation Housing and Utility Services: Policy Priority for the Next Stage of Reform,* World Bank, February 1998.

[23] CRS Report RL30394, *Russian Capital Flight, Economic Growth, and U.S. Interests: An Analysis*, by William H Cooper and John P. Hardt.

[24] OECD, *Russian Federation 1999-2000, op cit.*

The International Monetary Fund now shares the World Bank view on the need for comprehensive structural change in order to develop a productive economic incentive system. The IMF views the delay in reforming the fiscal infrastructure as a special deterrent to the development of a productive economic incentive system.

> Perhaps a main internal factor contributing to the Russian crisis was the persistent failure to bring fiscal problems under control. Lack of commitment for fiscal reform at the highest political levels, political opposition to such reforms, lack of cooperation by regional governments, and the emergence of influential oligarches unwilling to share the tax burden all helped stifle the base of fiscal reform. On the expenditure side, control over spending in the military area was particularly lax.[25]

Russian expenditures for military and security forces in Chechnya led to concerns by the IMF that the military budget increases would exceed the approved budget or be hidden off budget. In either event priority military claims would absorb or delimit revenue that was planned and needed for social welfare expenditures and funding institutional reform measures. Alexei Arbatov, Deputy Chairman of the Defense Committee in the Duma, projects an increase in defense spending if Putin follows current military doctrine.[26] Current military doctrine, he notes, rests on two pillars: Nuclear deterrence and preparation for local wars, including the need for peacekeeping forces. Under discussion in Russian military circles is a proposed third pillar for defense planning that would provide for forces that might counter those of NATO. To fund the first two pillars of current military doctrine, the military budget would have to increase to 3.5% of GDP from the present 2.5%. This increase may allow for a 50% increase in military procurement; an increase from close to zero procurement budgeting for most of the decade.[27] Arbatov strongly supports the increased budget for military reform and professionalization of forces, "We will be able to reach a new level in the course of three years to preserve the most advanced defense industries, double the wages of soldiers and officers, and place the army on a fully professional level." These steps, albeit expensive to implement, would provide for adequate nuclear deterrence and reformed military forces prepared to fight small wars. However, Arbatov strongly opposes the third pillar, the so-called Balkan scenario for countering NATO.

> Here we face a fundamental question: If the Balkan scenario suddenly becomes the prevailing one in our military doctrine, and there are many forces, including in the general staff who are insisting on this, then nothing will come out of our cooperation with the West. This will contradict our foreign policy ties and our external economic tasks. We simply cannot shift the ascent in our defense policy to confrontation with NATO in the field of conventional armed forces and armaments and at the same time hope for development of cooperation with the

---

[25] Donal McGettigan, *Current Account and External Sustainability in the Baltic, Russia, and other Countries of the Former Soviet Union,* Appendix 1, "Russian Crisis," Washington IMF, March 2000.

[26] Alexei Arbatov, *The Future of Russian Policy,* Federal News Service Conference, March 29, 2000.

[27] Russian Military Faces up to Aging Armaments, *Defense News,* May 1, 2000.

> European Union, count on getting new credits and honor restructuring of our debt. This will collide. This is something that cannot be combined.[28]

A military "two-pillar" reform policy described by Arbatov would lead to increased claims on Russian revenue, but still might be manageable in budgets with increased revenue supporting reform. However, United States negotiators may find some of Arbatov's proposals unacceptable. American specialists on the Russian military find the increase of 50% in military procurement "difficult, controversial and costly," setting back economic reform.[29] The Balkan scenario of countering NATO, if adopted, would likely be both budget breaking, threatening to United States-Russian relations and, therefore, unacceptable for any financing from the United States' international affairs budget.

Bullish Outlook. An alternative view on Russian economic performance finds necessary institutional changes under way and economic growth already more sustainable. Accepting this view might make substantial debt relief and structural reform less urgent. Anders Åslund of the Carnegie Endowment for International Peace articulated this assessment of increased growth in the year 2000 representing a new trend in growth.[30] Åslund and other analysts bullish about rapid growth do not highlight the need for structural reform as a prerequisite for attaining sustained growth.

Peter Boone, a prominent American financial specialist at Brunswick Warburg brokerage firm in Moscow, projected a 5% to 8% GDP growth rate for 2001 and 2002. According to this view, high growth would not only be sustained in the next five years but possibly surge to higher levels. Åslund found that "the previous vicious circle of decline in the former Soviet Union might be turning to a virtuous circle of growth. Something fundamental has changed in the Russian economy. It changed the whole mentality."

The Putin leadership projected an increase in Russian economic growth but tied it to structural reforms featuring fiscal, financial, enterprise and administrative system changes. Putin spelled out some principal aspects of his new economic strategy: a strong central government supported by a broad political consensus; a smaller, more efficient, better-paid, less corruption-prone bureaucracy; and improved state regulation to develop an incentive based system to counter control of the oligarchs.[31] Economic strategy papers prepared by advisory groups to Putin provided more details on an economic strategy for supporting structural reform.[32]

---

[28] Arbatov op. cit.

[29] Stuart Goldman, *Russia*, CRS Issue Brief 92089, updated May 2000.

[30] Anders Åslund,, *After a Decade of Chaos, the Russian Economy is Finally Starting to Boom*, Presentation to U.S.-Russia Business Council, March 21, 2000 and in *Nezavisama Gazeta*, April 4, 2000. Heinrich Vogel, *The Russian Economy Under Putin: Doomed to Boom?* [http://www.biost.de/preswahl/vogel.htm]

[31] V. Putin, *Izvestia*, February 25, 2000.

[32] German Gref, "Strategy for the Development of the Russian Federation up to 2010," (continued...)

An American banker, Michael Marrese of Chase Manhattan Bank, London, projected positive growth on the condition that "Russia would receive 50% forgiveness from the Paris Club and flight capital would be reversed."[33] If the Marrese scenario proves to be accurate, substantial debt relief might be necessary and sufficient to provide funds for sustainable debt servicing and budgetary support to reform programs spurring sustained growth. The scenario is especially dependent on Russia's leadership adopting structural changes that alter their economic incentive system and encourage domestic and foreign investment. The German finance ministry also considers the Russian economy capable of increased growth and able to meet its debt payments.[34] The skeptical view on the need for debt forgiveness has been supported by many of the finance ministers of Paris Club member countries.[35]

Renewed economic growth and favorable commercial environment responsible for building up foreign currency reserves would facilitate servicing the Russian external debt, but not without possible consequences for funding reform. To service the external debt Russia needs to have foreign currency available and the means to buy the foreign currency. The Central Bank of Russia has built up substantial foreign currency reserves of $28 billion by December 2000.[36] The Ministry of Finance may buy the necessary currency to pay the debt by either printing money or borrowing from abroad. Neither of these options is attractive: The first is inflationary; the second would create very expensive debt. The third option for providing foreign currency is to shift expenditures in the budget from non-debt service spending to debt service. The discretionary spending squeezed out of the budget may have been ticketed to fund reforms, e.g., recapitalizing working banks and pension funds. Putin's personal economic advisor, Alexei Illarionov, has favored this fiscal option but it may not be used without possible effects on reform.[37]

Strong Russian growth without significant structural reform may contribute to more capital flight abroad and increased dollarization of savings in Russia. Reform of the financial system, a key part of Putin's structural reform, may lead to a reversal of capital outflow from Russia and dollarization of savings within Russia but not immediately.

---

[32] (...continued)
Kommersant, May 12, 2000. Andrei Illarionov, "Long Term Strategy for Russia," Working Paper, April 2000. Prime Minister Kasyanov's interview in *Kommersant*, "Parameters of Eighteen Months and Ten Year Socio-Economic Policy," June 29, 2000.

[33] Chase Report, March 2000. C.f. *Commercial Issue Briefs* prepared for Clinton-Putin Presidential Summit, June 3-5, 2000 by American Chamber of Commerce in Russia and U.S.-Russian Business Council in Washington.

[34] German Ministry of Finance Press Release "Reason Why Not to Give Russia Debt Reduction," February 18, 2000.

[35] Group of Seven meeting leading up to a G-8 Okinawa meeting, *Agence France Presse,* July 8, 2000.

[36] CRS Report RL30879 "Russian Economic Development and Prospects: Implications for Russia and the United States" by William H. Cooper, May 9, 2001.

[37] "Russia: Debt Debate," *Oxford Analytic Briefs*, January 22, 2001.

Western Debt Relief Options

Debt relief by the creditors to heavily indebted countries has historically been the exception rather than the rule. The Paris Club established in 1956 a rationale of need and likely performance for providing debt rescheduling or debt forgiveness: Need has been established by imminence of default; performance has been measured against compliance with the debtor countries' IMF programs. The London Club of commercial creditors was constituted with similar criteria of need and performance. The London Club meetings characteristically followed the Paris Club. The creditor countries may view Russia's debt status as meriting or not meriting rescheduling. The no relief option is exercised by not convening the Paris Club members.

Russia's official debt is owed to eighteen Paris Club member countries. The major creditor is Germany with 48% of the debt. The second tier of Paris Club creditors is led by Italy, followed by other members of the G-7. The third group all have smaller claims than most of the G-7 Paris Club members. (See Table 2.) The United States holds $2.6 billion Paris Club debt inherited by the Russian Federation from the Soviet Union. This Russian debt to the United States, inherited from the Soviet era, is divided between agricultural and lend-lease debts (See Table 3).

Table 2. Paris Club Debt Inherited from the Soviet Union, December 31, 1999

Creditor Countries	Debt ($ billion)	Percentage
Germany	20.2	48
Italy	7.0	17
United States	2.6	6
France	2.0	5
Japan	2.0	5
Canada	0.8	2
United Kingdom	0.6	1
Other Countries	6.8	16
Total	**42.0**	**100**

Source: "The Secretariat of the Club de Paris does not maintain an up to date data base on the debt of debtor nations. Precise figures will be gathered from each country once negotiations are to begin. Even then data can only be obtained from the creditor countries." Francois Perol, Office of the Secretary General of the Paris Club, made this response to a query from Professor Marie Lavigne of the Institute for Scientific, Mathematical and Economic Research (ISMER), Paris. These estimates made from official sources were confirmed by the Department of Treasury as reasonable on March 9, 2000.

Table 3. United States Paris Club Soviet Era and Russian Era Debt
($ billion)

Responsible Agency	Paris Club Soviet Era	Russian Era	Total
Department of Agriculture	2.0	1.2	3.1
Export Import Bank	–	0.9	0.9
State, Lend Lease	0.6	–	0.6
Total	**2.6**	**2.1**	

Source: Communication from the Department of Treasury, June 9, 2000. Paris Club debt is debt incurred prior to the debt cutoff date for rescheduling, which in the Russian case was January 1992, not long after the creation of the Russian Federation. The agricultural debt for Paris Club Soviet Era is from the Commodity Credit Corporation debts: The Russian Era debt is under Public Law 480. The Lend-Lease debt incurred in World War II was renegotiated in 1972.

Russia, under President Putin, made his Paris Club negotiations a centerpiece of his new economic relations with the West and the United States in particular, even elevating his finance minister and debt negotiator, Mikhail Kasyanov, to prime minister. All high level fora, such as the Okinawa G-8 on July 21-23, 2000, presented opportunities for the Russian President and Prime Minister to present their view that rescheduling in line with the London Club agreements were necessary and appropriate. Prime Minister Kasyanov argued that debt relief was appropriate in line with historical precedents such as our United States Marshall Plan Assistance, estimated at $88 billion in current dollars, and the annual transfer of $70 billion from western to eastern Germany after the 1990 German unification. Debt relief is necessary, he claimed, because it is essential to successful reform and because Russia would then be able to meet its remaining commitments to the creditor countries. The required extensive structural reform essential for long-term growth would not be possible without substantial debt relief.

> It will be very difficult for Russia to succeed in transforming its economy, or at a minimum, a successful reform will be seriously delayed without significant Paris Club debt relief ... Russia is prepared to agree to mutually acceptable conditionality appropriate to the debt relief provided by the Paris Club.[38]

The Paris Club agreement of August 1999 was a short term, framework agreement to provide some relief on servicing the debt by deferring payments on principal to the end of 2000. The West, after looking critically at the new Putin economic strategy and weighing its prospects for sustained economic growth and improved debt management, may opt for either no debt negotiations or some degree of debt rescheduling. Evidence to date from official statements from Western creditors shows little support for substantial debt relief. Germany, owning at least

[38] Kasyanov, op. cit.

half the Paris Club debt, strongly supports a strict no debt relief policy.[39] The Paris Club Advisory Committee may face difficult choices on debt rescheduling. Either outcome could have risks and costs for the creditor countries.

The London Club precedent, if adopted by the Paris Club Advisory Committee, would lead to acceptance of some form of debt relief writing down both principal and interest payment obligations. This policy, proposed by Russian leaders, would result in immediate costs and future risks to the creditor countries once the principal and interest were reduced. In most creditor countries the debt written off would have to be offset in the creditor country's budget. If Russia's commitment to meet the conditions of the restructured debt obligations were not being followed, then the creditor countries would have limited future leverage needed to assure collectability of the remaining debt in the long run.[40] The debt relief policy implies a substantial degree of trust in Russia's future credit worthiness and the acceptance of the risk of a future noncompliance with newly negotiated debt terms. All creditors supporting relief may need to have confidence that Russia would follow its commitments to structural reform, and thereby assure a prospect of sustainable economic growth, increased revenue and sustained debt management. Finally, political benefits in security and foreign policy matters may not accrue even if linked directly to debt relief.

Accepting the German negotiating position, the Paris Club would not support Russian debt rescheduling. Without rescheduling of debt, Russia may be unable and unwilling to sustain its commitments for debt servicing. Russia may be less able and willing to adopt structural reform programs necessary to ensure sustainable future growth, increased revenue, and improved capability for future debt management. Without some reduction in the servicing requirements, Russia may go into default again for some part of their inherited debt. Without reduction in the debt servicing requirements, the creditor countries may not enjoy the benefits of future repayments, increased trade, investment and cooperation in foreign security policy. Potential security and political benefits may then not be forthcoming through cooperative arms agreements and foreign policy cooperation accompanying a debt rescheduling policy.

The announced German position of no debt reduction may represent the starting point of Paris Club discussions. The Schroeder-Putin summit on June 17 did not change Germany's negative debt relief policy.[41] However, Chancellor Schroeder reportedly reached an agreement with President Putin on rescheduling $3.8 billion of Soviet era debt due in 1999 through 2016 at a significantly reduced interest rate.[42] The French finance minister at the Okinawa meeting said "Cancelling the debt is not

[39] German Ministry of Finance, Press Release, "Reason Why Not to Give Russia Debt Reduction," February 18, 2000.

[40] Under HIPC terms debt relief requires at least a three year period of performance under IMF and World Bank sponsored programs. While meeting the conditions of these agreements a country that can demonstrate that it is still unable to service the debt may receive debt relief. Without an acceptable track record, relief is not forthcoming. Larry Nowels, op. cit.

[41] *Financial Times*, June 19, 2000.

[42] *Handelsblatt* (German Trade Newspaper), July 22, 2000.

on our minds."[43] The policy debates may continue to be lively because of the importance placed on debt relief by Russia. These discussions may focus on four issues that have been under consideration in past Paris Club negotiations: Precedents from past agreements, cost of forgiveness to creditor countries, sustainability of Russian economic growth and debt management, and strategic and political benefits linked to debt agreements. Each of these will be discussed with the current German position in italics.

Precedents for Paris Club Debt Relief

Russia has cited a number of precedents when the United States has supported debt relief, especially for inherited debt.[44] United States officials have not recently discussed these precedents as relevant to current debt discussions. The German position is that past London Club and Paris Club agreements *do not prejudge any Paris Club agreement*. There are two types of precedents that have been under discussion. The first has to do with the order in which debt settlements are negotiated as between multilateral entities, e.g., IMF, Paris Club and London Club. The second is related to the status of debts inherited from previous regimes.

The precedents for time sequencing of past debt agreements have been that the Paris Club follows the IMF and precedes the London Club and each sets precedents for the other. Germany made clear that the London Club Agreement of February 2000, featuring 50% reduction in debt and a clearer acceptance by Russia of its obligation for paying debt inherited from the Soviet Union, was not acceptable as a starting point for Paris Club negotiations. Russia and some Paris Club members may still raise the London Club outcome as a precedent.[45] Although Russia in the zero solution agreement accepted responsibility for Soviet debts, the Russian government did not accept the role of principal obligator of the inherited debt.[46] The old Soviet foreign economic bank (Vnesheconombank, owned by the Central Bank of Russia) continued to be the principal obligator for inherited Paris Club Soviet debt. This ambiguity on debt obligations was cited by Russia as a reason for defaulting on Soviet debt while continuing payment of Russian Federation debt obligations after the August 1998 financial crisis. This ambiguity was resolved in the London Club Agreement when the Russian government accepted the position of principal obligator for payment of the new Eurobonds. The commercial debt was converted at a discounted rate to the newly issued Eurobonds, replacing Soviet era commercial debt instruments.[47]

The second precedent that has been considered in past negotiations is the standing of debts inherited from old regimes. Responsibility for inherited debt in

[43] Minister Laurent Fabrius, *Agence France Press*e, July 8, 2000 from Okinawa, Japan.

[44] Kasyanov op. cit.

[45] John Thornhill, *Financial Times,* May 25, 2000 quoting favorable comments on debt relief position by the French Foreign Minister.

[46] Clement, op.cit.

[47] Chase Report, February 21, 2000

official and commercial negotiations has a relevant history in debt relief for Germany, Poland, Egypt and Russia. The United States played a proactive role in the Polish and Egyptian Paris Club agreements based on the assumption that the debts were uncollectible and the new regime merited support because of its overall policies. For example, the Foreign Operations Subcommittee of the Appropriations Committee of the U.S. House of Representatives "after using the initial FY 1991 United States contribution to the European Bank for Reconstruction and Development to encourage the international recognition of the uncollectability of the Polish debt, the subcommittee was supportive of funding for the bank"[48] The United States debt reductions from 1989 to 1998 totaled $14.5 billion with two-thirds concentrated in two debt reductions: Egypt, $7.0 billion in 1990, and Poland with about $2.5 billion in 1991.[49]

The Polish debt inherited from the Polish Communist government was accepted as the obligation of the Post-Communist government in Poland.[50] A Polish Paris Club debt negotiation, including a 50% forgiveness was consummated in 1992. Russia and some Polish leaders point to the Polish debt settlement as a precedent for deep restructuring in Russian Paris Club negotiations. The United States led the effort for Polish debt relief in 1992. The bilateral United States-Polish agreement allowed for 10% additional forgiveness than the multilateral agreement. This debt relief was to provide funds for supporting mechanisms for converting Polish debts to environmental projects, the Polish Ecofund.[51] By October 1997, $370 million had accrued to the Polish Ecofund from conversion of Polish Paris Club debt owed to the United States.[52]

The Polish Paris Club negotiators, in turn, had cited the German debt settlement of 1953 as a precedent for their substantial relief of inherited debt obligations.[53] A large debt inherited from the pre-World War II Reich was taken over by the Federal Republic of Germany. The London agreement of 1953 involved a 60% cut in inherited German debt. The United States drew lessons from the prewar debt policy of the western governments dealing with the fledgling German democratic government that preceded the Nazi regime. The heavy debt burden, resulting from the reparations in the Versailles Treaty following World War I was not forgiven. Some critics of this Western debt forgiveness policy implemented in the Dawes Plan, associated that policy with the German depression followed by the accession of Hitler

---

[48] William Schuerch, op.cit.

[49] Nowels, op.cit.

[50] William Schuerch, "The Congressional Role in United States Assistance Policy," *Central-East European Economies in Transition*, Joint Economic Committee, March 1994. Patricia Wertman, CRS Report 91-474, *The Polish Official Debt Accord: A Problem of Containment*.

[51] OECD, *The St. Petersburg Guideline on Environmental Funds in the Transition to a Market Economy*, Paris 1995. *Swapping Debt for Environment: The Polish Ecofund*, Paris, France, March 1998.

[52] Ibid.

[53] Patricia Wertman, CRS Report 90-335, *The German Debt Settlement: An Overview of the London Agreement of 1953.*

to power.[54] Debt relief to the post-Nazi government strengthened the Federal Republic politically for its cold war conflicts and facilitated the subsequent economic miracle.

Another example of successor country precedents of relevance to Paris Club negotiators is the previously discussed debt inherited to and from countries that no longer exist, specifically from the Soviet Union to the German Democratic Republic.[55] Boris Yeltsin and Helmut Kohl agreed in a joint declaration of December 16, 1992 to acceptance of Soviet debt obligations to unified Germany along with a number of other political and security obligations. The Russian government in the Yeltsin-Kohl agreement assumed the role of legal obligator for the Soviet debt to German enterprises taken over by the unified Germany. Germany agreed to support Russia in obtaining more favorable terms for the debt than the Paris Club was offering in November 1992; the German government acknowledged awareness of Russia's "limited ability to service the debt" at that time. The declaration also stated that the Paris Club debt was not to be a topic of discussion for eight years; both sides were to resume discussions in 2000. This debt is being treated in a special way at the Paris Club, it is "round fenced" or set aside for special bilateral negotiations. In his summit with President Putin, Chancellor Schroeder suggested this debt be handled by debt for asset swaps Little progress to date has been reported on development of these debt conversion negotiations.

Soviet Lend-Lease debt for economic assistance during World War II was accepted by Russia for repayment to the United States. The Lend-Lease debt was renegotiated in an agreement in 1972 that wrote down 90% of the debt, based on the precedent set by the earlier British settlement of their Lend-Lease debt.[56] Debt relief of the major part of Lend-Lease obligations may be considered another precedent for upcoming Paris Club negotiations. Postponements in payments were allowed but, "there will not be an extension of time allowed past July 1, 2001." Some $600 million of this debt is still outstanding. (See Table 3.)

These precedents may not be considered persuasive as Russia's current situation is different from that of Poland, Egypt or Germany in previous years. The United States policy for most of the period treated debt relief on a case by case basis.

Cost of Forgiveness to Creditor Countries

The United States position has been considerably influenced by the passage of the Federal Credit Reform Act of 1990 that required that relief of official debt be counted against appropriations.[57] Debt taken off the United States books would

---

[54] Hans Mommsen, *The Rise and Fall of Weimar Democracy*. Chapel Hill, North Carolina Press, 1996.

[55] Yeltsin Kohl Joint Declaration, op.cit.

[56] White House Fact Sheet on U.S.-U.S.S.R. Agreement Regarding Settlement of Lend-Lease, November 20, 1972.

[57] Patricia Wertman, *U.S. Government Foreign Loans and Loan Guarantees: Managing*
(continued...)

require either new appropriations or reduction in the appropriations of responsible departments. The German position is strongly opposed to reduction of their Russian Paris Club debt, on grounds of cost of debt relief in the German budget. They made this clear in rejecting the London Club forgiveness as a precedent. "*For one thing, the private banks involved have partly bought German debt at a discount, so they retain a profit under this scheduling agreement. For another thing, tax laws generally allow banks to write off their losses (e.g., through unpaid Russian debt service) as tax deductible; this also means a decline in tax revenue of the concerned countries. Both considerations do not apply to official creditors.*" Germany owns the largest percentage of debt and therefore would incur the greatest cost from debt relief.. The former Soviet GDR debt of estimated $6 billion added to more than $20 billion Paris Club debt would increase the Russian debt to Germany to some $28 billion, more than the total IMF disbursements to Russia since 1991.[58] Some Germans note, however, that the United States may take a favorable view toward debt relief since the American debt is small compared to the German debt.[59] Based on Paris Club principle of equal burden sharing, the cost of debt relief for the German budget would be approximately eight times that for the United States. (See percentage shares in Table 2.)

The same requirement for compensating for official debt relief in the budgetary process of the United States and Germany applies to other countries in the Paris Club, notably Japan.[60] Japan would likewise have to compensate for Paris Club reductions in their General Account Budget by using public funds; Japan considers foreign assistance preferable to debt reduction.[61] When the Federal Credit Reform Act of 1990 went into force, it raised a new budgetary constraint on forgiveness. The Polish-Paris Club Agreement dealt with debt incurred before the passage of the Federal Credit Reform Act. Current United States law governing reduction of non-concessional debt in Section 557 of FY2000 Foreign Operations Bill makes debt such as Commodity Credit Corporation debt accountable in the Department of Agriculture appropriations. (See Table 3.) Paris Club debt reductions require that appropriations be supplied in advance. When debt reduction is involved, the Administration must ask the Congress separately for appropriation power to precede the debt agreement.

---

[57] (...continued)
Subsidies. CRS Report 95-151.

[58] In pre Paris Club discussions with German and American officials, it is clear that the declaration of Yeltsin/Kohl in 1992 is in force and some settlement is anticipated in the Paris Club context. However, some question is being raised on the appropriate exchange rate from the German mark denominated agreed debt and the debt that might be under negotiation in the Paris Club. The fact that the original debt was in nonconvertible, transferable rubles is responsible for the uncertainty in determining the exchange rate of this debt.

[59] Clement, op.cit.

[60] This issue is examined in detail in CRS Report 95-151E, *U.S. Government Foreign Loans and Loan Guarantees: Managing Subsidies.*

[61] Michiyo Nakamoto, "Forgiving Debt is OK–But Not for the Biggest Donor" *Financial Times,* June 23, 2000.

Debt relief for HIPC provides precedents for Russian debt restructuring and competition for available funds. Before the HIPC initiative, poor country debt reduction appropriation had been running around $20 to $33 million per year. HIPC is expected to cost less than $1 billion over four years.[62] If debt relief for Russia requires appropriations in future fiscal years, there may be competition between HIPC and Russian debt relief. If 50% reduction were granted to the Russian Paris Club debt, following the London Club precedent, appropriations of over $400 million might be involved. (See footnote 8 above.) These appropriations may have to be reduced in either the State or Agriculture Department accounts in the United States budget.

Offsetting factors to the cost of Paris Club debt reduction could be developed in the State and Agriculture Department budgets through debt swaps. Other Paris Club countries have shown little enthusiasm for debt conversion or debt swaps. Russia, itself, pursues debt to asset conversion as a vehicle for converting Russian gas export debts of Ukraine, albeit with little success.[63] In the early 1990s the United States was one of the leading proponents of debt for nature and other debt conversion mechanisms for countries in transition.[64] The burden of debt relief may be ameliorated by Paris Club debt swaps that require purchases of debt by a third party at the present market value of the debt. If the market value of Russian debt were calculated at $35 per $100 of debt, then that would be the price for third party purchase. This debt might then be converted to ecological purposes as was done in the Polish Ecofund.[65] Lend Lease debt might be a logical candidate for debt swaps as all payments have to be made not later than July 1, 2001.[66] Debt swaps might be attractive to the Russian government for debts not likely to be forgiven. Even then, the Polish conditions making for success of the Ecofund may be different from those in Russia.

Sustainability of Economic Growth and Debt Management

The German position is *"Russia is rich in natural resources and with high world oil prices and the upsurge of economic performance, Russia has the ability to sustain its debt obligations and maintain an adequate budget. … If it were not for the high level of capital flight from Russia, the balance of payments would not be a serious strain on its debt service*."

The continued upswing in Russian economic performance noted by some Western economists, such as Anders Åslund, strengthens this view of German spokespersons that Russian performance is not contingent on monitored structural

[62] Nowels, op. cit.

[63] PlanEcon, *Review and Outlook for the Former Soviet Republic*, October 1998.

[64] Seed Act of 1989, P.L. 101-179 and Freedom Support Act of 1992, P.L. 102-511 provided authority for debt swaps.

[65] OECD, Ecofund, op.cit.

[66] Lend Lease Agreement, op.cit. This cutoff may be reinterpreted if the Lend Lease debt was considered to be rescheduled rather than deferred.

reform.[67] Indeed, the IMF has told Paris Club creditors that there is no need to forgive any of Russia's $42 billion debt.[68] The IMF position may continue to be that no debt rescheduling is required to facilitate reform and that adequate budget outlays would be forthcoming if the costs of Chechnya and other defense spending were reduced.

U.S. negotiators may consider the relationship of debt relief to the prospect for generating structural change to be a positive incentive in reducing Russian debt. Former Secretary of Treasury, Lawrence Summers, made the general case for debt relief in promoting reform: "We saw in Poland and Egypt that debt relief, which won strong bipartisan support here in the United States, could provide vital early momentum to reformers and help countries with decades of economic failure behind them. With the enhanced HIPC, we have a chance of seeing this happen in Africa."[69] At the same time, Secretary Summers considered economic improvement under way in Russia and the buildup of more foreign exchange reserves might make it possible to support the debt service burden without debt relief.[70]

However, the sufficiency of revenue and increased reserves are not enough to provide the necessary government expenditures to support the required reform. Revenue for covering costs of structural reform, such as outlays needed to recapitalize reformed commercial banks and pension systems, is necessary but may be squeezed out of future budgets by requirements to service debt, provide subsidies and satisfy the fiscal needs of military reform. The United States stressed the importance of structural reform for Russia to make a successful transition to a functioning market economy with sustained growth and the necessity of reversing capital flight. American leadership has not explicitly accepted the proposition that debt relief is currently necessary to permit the Russian budget to support the costs of structural reform and serve as leverage to constrain subsidies and defense expenditures.

Creditor Benefits from Security and Foreign Policy Linkage

German policy discussions on Russia do not specifically relate debt negotiations to security negotiations fostering political settlement in Chechnya, and improvements in foreign policy cooperation dealing with rogue states. Nor has Germany been explicit in linkage of military doctrine, defense spending, and arms sales to debt relief. Earlier German policy on Paris Club debt, laid out in the Yeltsin-Kohl agreement of December 1992, directly linked debt management to security issues, e.g., removal of troops from Germany and dismantling of nuclear and chemical weapons. Current German discussions on Paris Club debt do not link debt relief to security and foreign policy issues.

---

[67] German Ministry of Finance Press Release, op. cit.

[68] Stanley Fischer, Deputy Executive Director, IMF, "No Need to Forgive Russian Paris Club Debts," *Financial Times,* May 5, 2000.

[69] Lawrence Summers, "Debt Relief: A Fresh Start," op.ed. *Washington Post*, November 3, 1999.

[70] At the Group of Seven Meeting, Secretary Summers commented on the favorable developments in the Russian economy. *Agence France Presse*, July 8, 2000.

The United States has made explicit the importance of Russian compliance with arms reduction, limited arms sales, and cooperative foreign policy for support of debt restructuring and forgiveness. Eligibility for debt relief for poor countries is barred to those who spend too much on defense, support terrorists, contribute to the drug trade, violate human rights, and expropriate American-owned property (Section 557 of FY2000 Foreign Operations Bill). This legislation has special relevance to Russia in relation to arms sales to unfriendly states, commercial relations with Iran, loans to Serbia, Iraq, or other rogue states, or lack of control of nuclear weaponry. Linkage between debt restructuring and foreign security policy cooperation was included in appropriation bills:

- The International Relations Committee approved H.R. 4022 (the Rohrbacher Bill) on April 14. This bill is designed to prohibit any United States forgiveness of bilateral debt with Russia until the President can certify the Russians have permanently ceased any sale or transfer of Moskit, Sunburn Anti-Ship Missiles to countries that threaten the United States, primarily China. (S. 2687 is a comparable Senate bill.)
- The International Relations Committee on May 4, 2000, approved H.R. 4116 prohibiting the rescheduling or forgiveness of any outstanding bilateral debt owed to the United States by Russia until it has closed its intelligence facility at Lourdes, Cuba. The measure was approved by voice vote after it was amended to include a presidential national interest waiver. (S. 2748 is a comparable Senate bill.)

U.S. Congressional Options in Debt Negotiations

The U.S. Congress may choose to support one of several options on Russian debt management: *No Paris Club debt negotiations based on Russian economic needs and foreign and security policies; debt restructuring negotiations based on need resulting from imminence of default; substantial rescheduling negotiations based upon merit from commitment to structural reform and more cooperative foreign and security policies*.

The U.S. Congress may influence the Paris Club Soviet era debt agreement between Russia and the United States in several ways: Congress may influence the multilateral Paris Club agreement by indirect and direct expressions of concern. In the FY1991 budget, final support for the EBRD was held up by the House of Representatives until the Paris Club agreed to 50% forgiveness on Poland's debt. The bilateral agreement between Russia and the United States must be referred to Congress as that body must appropriate funds in response to Paris Club debt forgiveness in conformance with Federal Credit Reform Act of 1990. Congress in the appropriations process may also attach amendments that make funding conditional on compliance with United States policy on arms control, arms sales, and selected foreign policy issues. Congress may also indicate its strong concern that Russia not give budgetary support to military spending increases that reflect developments inimical to U.S. interests. Congress may make its wishes known even if debt relief did not involve appropriations by calling for a hold on a U.S.-Russian bilateral agreement, as was the case on June 16, 2000, by the Chairmen of the Senate Foreign Affairs Committee and House International Relations Committee.

The United States' choices on debt rescheduling of Paris Club debt may turn on whether it is perceived as an economic or political decision, or both. In either case, Russian progress toward a democratic government with a functioning market economy may be crucial. Economically, the United States may decide that Russia, with the current economic upsurge and serious steps toward structural reform, will accumulate enough foreign exchange reserves to sustain the current or restructured levels of debt servicing. Or the United States may decide that structural reform to be successful may require more expenditures for introducing market reform, meeting needs of social welfare, and managing appropriate military expenditures that require debt restructuring to reduce the debt burden. Politically, the United States may decide that current progress on arms negotiations, cooperation in the Balkans and elsewhere is managed sufficiently well without rewarding Russia with debt restructuring. Or, the United States may decide that each criterion controlling our assistance in arms control, arms sales, foreign policy issues such as trade and investment with rogue states, require special legislation and agreement that must be monitored to accompany or bar debt relief. In addition to the specific linkages, the United States may tie debt relief to an over-arching agreement on missile policy including acceptance of the United States National Missile Defense (NMD) and a revised Anti Ballistic Missile (ABM) treaty.

Glossary

PARIS CLUB is an ad hoc group of creditor nations that meets in Paris with debtor countries that are in a condition of default or imminent default to negotiate rescheduling of outstanding debt and that have approved programs with the International Monetary Fund. There are currently eighteen countries in the Club including all members of the G-8. Staff is provided to the Club by the French Ministry of Finance. The Paris Club Advisory Committee makes recommendations for a multilateral policy on bilateral debt settlements. Debt relief is formally provided by bilateral agreements between each creditor and debtor country.

LONDON CLUB is a parallel group of commercial banks that meets in London to negotiate rescheduling of outstanding commercial debt of countries in a condition of imminent default. After agreement on the multilateral rescheduling, each creditor bank may enter a bilateral agreement with the principal obligator bank in the debtor country.