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Russia's Role in Evolution of Paris Club*

Those involved in dealing with issues of sovereign indebtedness would agree with us that the 90s had been a defining decade for the Paris Club's current role and functioning. Not only had the "classical" approach of the previous decades been replaced with a "Houston terms" treatment, but also the entire focus of sovereign debt restructuring had shifted from debt collection to finding sustainable solutions to payment difficulties experienced by debtor countries. Thus, the revised approach targeted such conditions of debt restructuring that not only took into account the existing financial environment of the debtor nations but also facilitated the long-term sovereign debt sustainability once the country fulfilled its obligations to the Paris Club.

While many important factors have played a role in this evolution, in this paper we take a detailed account of Russia's unique and significant contribution to these changes.

Russia's Perspective

In retrospect, the swift evolution of the Paris Club's role and its functioning coincided with the development of Russia's closer relationship with the Club. It started in 1991, when after the collapse of the former Soviet Union (USSR), the key outstanding question was the status of its obligations to foreign creditors (about $97 billion), including to the Paris Club (about $48 billion), and its own loans and credits to other countries. The nominal value of those loans and credits at the time was estimated to be about $150 billion, thus, far exceeding the value of the old

* - The opinions expressed and arguments employed herein do not necessarily reflect the official views of the Ministry of Finance of the Russian Federation.

soviet debts. In this paper we examine both aspects of this “soviet inheritance” to shed light on its overall impact on Russia’s and global finances.

Other important milestones of the Russia’s and the Paris Club relationship are as follows:

April 1993: Russia reached a mutual agreement with the Club that the Russian Federation is the sole bearer of the debts and credits owned by the former USSR. This agreement became an important event for the international financial system as it eliminated existing concerns of the possibility of default on the old soviet debt.

April 1996: Russia reached a formal agreement with the Club on the comprehensive restructuring of the nominal $33 billion of the soviet debt. We will address this particular aspect later in the paper as, we believe, the results of this consolidation became a prelude to a new approach that emerged as the “Evian treatment” 5 years later.

September 1997: Russia became a full-pledged member of the Paris Club – the only country that joined the Club since its formation in 1956. During negotiations that lasted over 1 year, the Paris Club, with Russia’s active participation, developed series of unique approaches for solving a number of the Club’s methodological problems. At that point, Russia was the only country that was both a full-pledged member of the Club as well as its client. During 1998-1999, for first time in the history of the Paris Club, one of its full-pledged members had overdue debt obligations to other members.

May 2005: Following intense analytical discussions and numerous unofficial consultations, including critical discussions on the valuation of the Paris Club’s restructured claims on Russia, an agreement on conditions of the early repayment of the $15 billion of Russia’s restructured debt was reached. This outcome laid the foundation for Russia’s concluding its relationship with the Club as a debtor country.

August 2006: Russia prepaid $ 11,1 billion and bought back at the market price $ 10,2 billion of the restructured debt. Thus Russia’s status as a Paris Club debtor ceased to exist any more. We reached one of our aims which had been long ago declared as the most important for our national interests.

Thus, the events of the last 15 years are a clear attestation of a complex and rich relationship between Russia and the Paris Club. Quite significant is the analytical and exploratory work undertaken by various teams to address multiple challenges as this relationship evolved. Among them were various teams formed by the Paris Club Secretariat and several Russian delegations with integral members from “Cleary Gottlieb Steen & Hamilton” and “Houlihan Lokey Howard & Zukin (Europe) Limited”.

USSR’s Heavy Debt Burden

As it often happens with countries facing economic and political challenges, the USSR heavily relied during the mid 80s on external borrowing to finance import of foodstuffs, consumer goods, machinery and equipment. As a result, during the period of 6 years from 1985 to 1991, the USSR’s external debt had more than tripled from $31 to almost $97 billion. As the USSR was borrowing unprudently by the time of its collapse the external debt structure was not sustainable: 30% of the overall debt was short term. Deep economic crisis exacerbated by political challenges put a stop to using external financing for the purposes of rolling over the maturing debt. The last untied loans were grated by Saudi Arabia, UAE, Kuwait, and Republic of Korea. Collapsed Soviet Union was not assumed in bankruptcy only because of the October 1991 memorandum of mutual understanding between the former USSR government and 12 former soviet republics (excluding Latvia, Lithuania and Estonia) to reassure external creditors in their readiness to fulfill the old soviet debt obligations on the solidarity basis.

We believe that possibly the most important step in Russia’s relationship with the Paris Club came at that time. The Paris Club, using an approach developed joint by the IMF, accepted the USSR’s outstanding debt allocation between the former republics. Same approach was later replicated to allocate external debt burden across the countries that emerged from the former Yugoslavia. Table 1 below summarizes the debt distribution among the former Soviet republics.

Table 1. The Allocation of the former Soviet Debt among former Soviet Republics

	Country	Weight Allocation, %%	Overall Amount ($,bln)
1.	Azerbaijan	1.64	1,6
2.	Armenia	0.86	0,8
3.	Belarus	4.13	4,0
4.	Georgia	1.62	1,6
5.	Kazakhstan	3.86	3,7
6.	Kyrgyzstan	0.95	0,9
7.	Republic of Moldova	1.29	1,2
8.	Tajikistan	0.82	0,8
9.	Turkmenistan	0.70	0,7
10.	Uzbekistan	3.27	3,2
11.	Ukraine	16.37	15,8
12.	Russia	62.32	59,2
13.	Latvia	1.14	1,1
14.	Lithuania	1.41	1,4
15.	Estonia	0.62	0,6
Total		100	96,6

As presented in the Table 1, while the relative debt burden of countries such as Georgia, Republic of Moldova, Tajikistan and some others was relatively small, the absolute debt burden was excessive given the size of the countries' economies, the state of their financial systems and additional burden of their own obligations. Therefore, in 1992 only Russia was in a position to attempt to fully service its debt. Russia, however, managed to pay only 10% of the amount due that year. This situation had a negative impact on the Club's members budgets. The private sector creditors were in challenging circumstances as they were facing a potential $40 billion shock to their balance sheets as a result of USSR's non-payment.

At that historic juncture, we believe, Russia had proved itself as a country with focus on global partnership that was ready and willing to take on the new roles and responsibilities in the global financial system. With that, Russia took the historical decision to unilaterally assume the entire stock of the old soviet debt to avert the severe consequences of a possible debt default and to mitigate the almost certain risk that the earlier signed cooperation agreement among the former soviet republics would not keep up with its obligations.

Quite significant in this process was the Paris Club members' agreement with that decision.

Within a rather short period of time, from March 1992 to March 1993, Russia had signed the so-called "zero-option" agreement with 12 out of the 15 former soviet republics. According to that agreement Russia assumed the obligations for the former soviet debt in exchange for the rights on the soviet financial assets. On April 2, 1993, both Russia and the Paris Club issued mutually agreed statements and entered into a new phase of their relationship: the two sides were ready to start their dialog on the terms of the soviet debt restructuring. The objective of the restructuring was to find a mutually beneficial solution that preserved, to the extent possible, the value of the Paris Club members assets and, at the same time, was not overly burdensome for Russia's fragile economy and financial system.

At first, the negotiations were carried out on the basis of the standard schemes used at the time for middle income countries with moderate debt levels. In 1993, 1994 and 1995, the parties signed multilaterally agreed minutes on consolidation and restructuring of payments due in these years. These agreements carried little financial and political significance internally, as Russia, on the verge of default, struggled to mobilize the $2-4 billions for effecting the required annual payments.

While Russia's struggle to come up with the funds to meet its financial obligations continued over those three years, the Paris Club was making significant changes in its approach to sovereign debt restructuring. Firstly, the Paris Club policy was shifting from "money collectors" approach to the debt crisis prevention. Secondly, issues of the debt sustainability were greatly emphasized leading to creation and adoption of the "Naples terms" and later of the

HIPC initiative. All these new developments were leading to a better framework for more creative solutions for Russia's debt problem. We believe that the LIC and HIPC initiative moved the creditors to the idea of a stock treatment for a middle-income country, which was then applied for the first time in case of Russia.

In April 1996 took place the longest negotiations in the Paris Club's history that lasted 5 days and 4 nights and ended up in a unique debt restructuring agreement. In our view, the new treatment of Russia's debt could be considered not only as a new phase in Russia's relationship with its creditors, but also as an important contribution towards a sovereign debt restructuring general framework. As a part of the new treatment, the Paris Club members had agreed on the implementation of following new decisions:

Firstly, the Club applied the principle of the comprehensive debt restructuring, which consolidated all scheduled debt payments over the period of 3.5 years, in contrast to the typical 1 year consolidation period. In addition, it was agreed that the consolidation would include both non-consolidated debt payments as well as the earlier restructured amounts. Thus, the Club had modernized its prevailing approach that treated earlier debt consolidations separately. As a result of the new approach, the nominal value of this debt consolidation was a record $33 billion, or about $40 billion including the future interest payments.

Secondly, the Club developed a so-called "exit treatment", which was designed to be the last rescheduling a country would normally get from the Paris Club. The aim was that the debtor country would not need any further rescheduling and would not need to revert back for further negotiations with the Paris Club. As a result of the decisions reached at the G8 meeting in Evian in 2003, the "exit treatment" (along with other approaches to debt restructuring of the middle income countries) was adopted as one of the main tenets of the Paris Club's functioning.

Thirdly, Russia was the first emerging market country that received a non-standard long repayment period of 25 years.

In 1999, building upon the developments of the previous consolidation, Russia and the Paris Club had an easier time agreeing on the 5th and the last multilateral $8.3 billion debt consolidation on the terms similar to that of the 4th consolidation. While Russia was originally asking for more concessions, the Paris Club members were firm in their position as if expecting subsequent improvement in Russia's fiscal situation to allow it to service the restructured debt under the previously agreed terms. Furthermore, continued increase in the world's oil prices allowed Russia to negotiate an early repayment of the restructured debt amounting to $15 billion in 2005 and to 21,6 billion in 2006.

These agreements became the largest financial transactions of this type for the Paris Club. It benefited both sides: Russia was able to realize interest payment savings, while the creditors received an unplanned cash infusion to their budgets. A further significance of this transaction was that for the first time in the Club's history creditors came to a agreement on general principles applicable to early repayment and buy-back of the restructured debt. Russia's important contribution in this area was that it practically stimulated the underlying analytical development and discussions. Not a least significant contribution was that of creditors who, despite potential interests to profit from such transactions, on the one hand, utilized a market based valuation approach and, on the other hand, gave the debtors a choice between a prepayment and a buy-back. In the 2006 transaction Russia used both options at the same time.

We also believe that there are two other instances where Russia, in its dual position as a creditor and a debtor, had influenced both the content and the outcomes of various Club's discussions. One of those contributions relates to developing the Club's methodology dealing with securitization of financial claims on the debtor nations: with Russia's involvement creditors gave debtors a right to receive a notification ahead of the actual securitization operation.

Secondly, Russia as a newly emerged bond issuer (a first eurobond issue took place in 1996) served as a catalyst in the Club's discussion on the methodology to be used in order go guarantee the comparability of treatment principle for various categories of sovereign debt in particular, debts to public and private creditors. The underlying elaborate analysis undertaken by the Secretariat concluded with the Club's acceptance to use the publicly known criteria to assess the outcomes of the debt treatment. For each type of creditor the comparability of treatment includes the calculation of the changes in its nominal debt service, in the net present value of its debt and in duration of the restructured debt. This approach improved transparency in the Paris Club assessment of the comparability of treatment which had a calming affect on criticism arising from the private creditors. Furthermore, the recent Club's discussions with representative of the private sector indicated that both sides were satisfied with the outcomes of the debt consolidations in the cases of the former Yugoslavia, Pakistan, Indonesia, Ukraine and Kenya.

In summary, many policy makers in Russia share the view that the evolution of Russia's relationship with the Paris Club is a success story as it evolved on the basis of transparent and well founded decisions. Going through the difficult and painful process of dealing with Russia's case during the 90s, the Paris Club was not only able to resolve the outstanding issues, but also benefited from the newly developed methodology.

On top of that, Russia's experience with dealing of the Paris Club as a debtor nation had a significant and long lasting impact on many spheres of Russia's financial politics. In particular, from the early 2001, Russia has moved firmly towards replacing external borrowing with an internal borrowing program. In addition, Russia now places a great emphasis on the overall debt structure, in particular, to prevent excessive concentration in certain maturity sectors as it happened during the 1991-1992.

Value (or Lack Thereof) of USSR's Financial Claims

At the time of the Soviet Union collapse, its external financial assets were estimated to be at about $150 billion, of which $112 billion were claims on developing countries. Based on these figures, one would conclude that Russia was well compensated for assuming the former soviet debt by getting the assets estimated to be 1.5 times bigger. This interpretation, in fact, has been consistently used by some nations to accuse Russia in profiteering from assuming the old soviet debt. Closer evaluation of the quality of these assets and attempts to claim them have demonstrated that their actual value was just a fraction of the nominal figure. Many factors have contributed to this result.

1. About $14 billion of the soviet assets that represented financial claims on eastern European countries, including the former Yugoslavia, were offset by the financial claims of those countries on Russia. While the old Soviet credits extended to those countries were denominated in hard currency, their claims on Russia were denominated in clearing currencies used for settling cross-country trade balances. After the Soviet Union collapse, this balance shifted toward the Eastern countries. This negative impact for Russia's financial position was caused by the increase of the import prices from Eastern Europe, decrease in world's oil prices and Russia's economic and financial challenges that reduced its capacity to increase its oil exports to offset this impact. For example, in a single case of Poland, this resulted in a $8.6 billion reduction of the value of Russia's financial claims from the early 80s.

2. 26 out of 67 countries-debtors of the former Soviet were African countries, with 8 being HIPC countries. 12 other countries were classified as low income countries. Nominal amount of those countries' debts to Russia was estimated to be about $15.5 billion and had a very low likelihood of recovery.

3. More than half of all outstanding credits were extended to the countries with special political relationship with the former Soviet Union. These countries (such as Algeria, Afghanistan, Cambodia, Cuba, Iraq, Laos, Libya, Mongolia, Nicaragua, Democratic People's Republic of Korea, Syria and Vietnam) accounted as of the end 1996 for a nominal of about $70 billion debt to the former Soviet Union. Moreover these countries took a firm position that any debt restructuring should take into account political factors, practically asking for 100% debt forgiveness. The situation was further complicated by the fact that some of those countries did not had any relationship with the IMF, nor the Paris Club. Therefore Russia had to conduct case by case bilateral negotiations.

4. The structure of the old Soviet credits was predominated by the credits linked with export of arms and military machinery to the developing countries and in majority of these cases the Soviet Union being the only supplier. As the world's political situation and regimes changed, many debtors were not willing to address the debts accumulated during the preceding political regime.

5. The currency composition of the old Soviet debts had a further negative impact on the value of the Soviet assets. Only 5% of the overall assets were denominated in hard currency, while the remaining 95% was denominated in either the old Soviet Rubles or the transferable Rubles used by the Counsel for Mutual Economic Assistance. As they ceased to exist after the collapse of the former Soviet Union, some debtors intentionally attempted to use the newly revalued 1996 Ruble that was worth about 1000 units of 1992 Rubles as the basis for their debt valuation.

6. Another factor underlying in the poor quality of the old Soviet assets was the fact that the majority of the extended credits were structured either in the way that allowed borrowing nations to pay back their debts by deliveries of certain goods (not necessarily of a good quality) or by effecting payment in specially designed currencies to the accounts opened in dully

authorized government banks. Later on this "money" was used by soviet foreign trade organizations to finance the import of certain goods to the former USSR. In retrospect these financing mechanisms could only function in the conditions of the planned centralized economy of the former Soviet Union and was guaranteed only by the goodwill of the trade partners. This mechanism vanished in the early 90s when Russia moved towards the market oriented economy.

As a result of the above factors, in the early 90s Russia was receiving only about 1-2% of the overall amounts due which mostly came from trade-based debt with India. Thus, while the original schedule of debt payments implied about $10 billion payments to Russia in 1992, only $120 million, including in kind, was actually received.

The situation did not improve in the subsequent years. All attempts to collect the claims have been thwarted by the countries-debtors that were using ongoing financial weaknesses and changes in the political and ideological systems to refrain from paying the debts. By the end of 1996, the nominal amount of overdue debts had risen to about $82 billion. In some cases, the governments kept on questioning the legal basis of Russia's financial claims towards them. For example, such position was quite often assumed by Ukraine at the time of the negotiations on the distribution of non-financial assets, when Ukraine kept on proclaiming its rights to the financial assets as well. The still outstanding refusal by Ukraine to ratify the so-called "zero-option" agreement had further confused Russia's relationships with its other debtors.

Taking into account the difficult situation with regard to Russia's outstanding credits, as well as the legal implications of its relationship with the countries-debtors, the Russian government took the decision to join the Paris Club as a creditor. It is important to re-emphasize that this was a difficult decision as general public and some lawmakers even today strongly believe that Russia was and still is in a position to collect these debts.

Thus, in early 1997, the Paris Club faced an unprecedented situation. The Club had to admit not only a new member, but also a creditor whose claims on many countries that were clients of the Paris Club exceeded the claims of most members of the Club. As of January 1, 1996, Russia's claims on 27 countries, that had already reached agreements on their debt restructuring with the Club, stood at about $37 billion or 30% of the overall Paris Club's claims on those countries. Furthermore, Russia was one of the most difficult Club's clients, with a convoluted structure and nature of its financial claims.

Entering such a "non-institution", Russia, with its non-performing financial assets, could have become "an elephant in a china shop" by destabilizing the 50-years old functioning of debt policies that were established by the Paris Club, the IMF, the IBRD and other multilateral institutions. At the same time the world community realized the need to support and assist Russia in its attempts to deal with the former soviet financial assets. The solution of such a difficult case was found through development of a new special methodology that later defined the conditions of Russia's joining the Paris Club.

First of all, Russia had to understand the rules and principles of being the Club's member. As a result, for the first time in its history, the Club put on paper principles, on which its work was organized. For many years they were refereed to as "unwritten rules" of the Paris Club: case by case treatment, consensus, conditionality, solidarity, comparability of treatment.

With Russia's membership, the Paris Club itself had entered a new phase after almost 40 years of its history.

The next step for Russia was to establish the comparability between the old Soviet credits and the claims of the Paris Club members towards the debtor countries. Addressing this question required three key resolutions. First, to establish fair USD exchange rates for various currency units. Second, to determine the appropriate treatment for the credits used to finance arms trade. Third, to reflect the fact, that while from 1991 to 1997 Russia did not participate in debt relief operations, Paris Club member countries granted this relief to many Russians' debtors. The solution to this complex problem was found after an extensive and comprehensive analysis of the quality and the quantity of the outstanding credits and of the mutual interest of creditors and debtors.

The found solution was as follows. The exchange rates were established at 0.6 Soviet Ruble for 1 USD and 1 Transferable Ruble for 1 USD. Next, different rates of the upfront discount were established for the Russian claims and set at 0.35, 0.65, 0.70 and 0.80 for the four distinct groups of debtor countries. The largest discount was to be applied to the countries with debts accumulated as a result of the Soviet monopoly on the arms supply to the country. Table 2 below presents the impact of the described treatment on the former Soviet assets.

Table 2. Impact on the nominal amount of Russian claims towards
HIPC Countries after a first Paris Club treatment

	Country	**Original amount of credits outstanding in original currency**		**Original amount of credits outstanding, in USD equivalent, mln**	**Amount after application of the upfront discount, mln**	**Amount outstanding after a first Paris Club based bilateral agreement, mln**
		Currency	Amount, mln			
1	Benin	SUR	37.98	61.63	18.49	6.10
2	Burkina Faso	SUR	5.67	9.45	2.83	0.93
3	Burundi	SUR	13.40	22.33	6.70	2.39
4	Cameroon	SUR	1.20	2.01	0.60	0
5	Chad	SUR	2.57	4.28	1.28	0.42
6	Congo, Republic of	FRF SUR USD	5.13 250.97 5.98	425.27	127.58	54.91
7	Ethiopia	SUR USD	3,537.04 8.34	5,873.04	1,180.81	497.09
8	Guinea	SUR USD	298.77 2.87	500.82	172.70	110.74
9	Guinea-Bissau	SUR USD	105.62 2.48	178.52	35.71	17.34
10	Guyana	USD	16.58	16.58	4.97	1.22
11	Madagascar	SUR USD	145.47 314.47	556.92	171,06	121.95
12	Mali	SUR	343.30	572.17	114,43	40.93
13	Mozambique	SUR USD	1,068.71 764.27	2,545.46	509,46	186.33

14	Nicaragua	SUR DEM USD	1,896.60 358.90 251.20	3,444.30	1,033,29	344.40
15	Sao-Tome and Principe	SUR	6.55	10.92	3.28	1.08
16	Tanzania	SUR USD	351.99 0.21	586.85	117.37	73.23
17	Zambia	SUR GBP	414.80 3.57	696.86	139.38	138.61
Total				15,507.59	3,639.94	1,597.67

Note: the data is presented under the Debt Reduction (DR) scheme even though in some cases the Debt Servicing Reduction (DSR) was actually used.

The data in the Table 2 vividly illustrate the quality and the resulting quantity of the Russia's "inheritance" from the former USSR with respect to its claims on developing countries. After a debt treatment within the Club's framework, the old Soviet assets were reduced by almost 90%, resulting in the assets valued at only 1/10 of the value of the overall liabilities assumed by the Russian Federation. This is in stark contrast to the original expectations that Russia was inheriting Soviet assets far in excess of its assumed liabilities.

Not without its challenges, the 9-year history of Russia's role as a Paris Club member-creditor has been a convincing proof that the 1997 decision to join the Club was correct and well founded. Neither Russia, nor the Paris Club have been disappointed in their expectations. During its tenure with the Club Russia has proven its willingness and ability to take into account interests of both the Club members and its debtors. Notable examples of this are Zambia (special debt restructuring for the "post cut-off date debt"), Serbia and Montenegro (application of a special "cut-off" date), and Iraq (Russia was the largest creditor, with the debts denominated in USD rather than in exotic currencies and is subject to the conditions of its joining the Club, as well as the multilateral protocol of Iraq's debt restructuring).

From their side, the Paris Club members in general provide their support to Russia in cases with "uncooperative" debtors. In particular, at the time of Russia's negotiations with Vietnam, the Paris Club sent to Vietnam a number of letters underscoring the importance of maintaining the comparability of treatment principle for the entire stock of debt including the debt to Russia. Similar letters were sent to Algeria, Pakistan, Ethiopia and other countries. As a result, as of March 1, 2006, Russia has reached bilateral agreements with 29 countries-clients of the Paris Club. In addition Russia has re-established its rights to debts arising from almost 1000 bilateral credit agreements, some of which, for example, with Albania were signed 50 years ago.

Russia as a creditor has benefited financially from its membership in the Club. Since joining the Club, payments from the debtor-nations in excess of $1.5 billion were transferred to Russian's federal budget. However, more significant for Russia was the normalization of the financial relations with many of its debtors in the process of debt restructuring, which was based on multilateral and fair negotiations rather than one-sided concessions. Consequently, these countries are now more open to renew their credit cooperation to re-establish trade and other relationships with Russia that broke down in the 90s.

With respect to Russia's own debt burden, in 2006, the year of Russia's chairing the G8, our position became even more geared toward the interests of the G8 and the Paris Club members. This year, for the first time, in accordance with the Federal Budget Code the Russian Government approved to write off $700 million of debts to 16 enhanced HIPC countries. We hope that the freed-up funds will be used by these countries in their development efforts towards achieving of the Millennium Development Goals.

Conclusion

In a relatively short period of 10-15 years from a "de-facto" bankrupt debtor with sizeable but illiquid claims on many developing countries Russia has evolved to a thriving economic power house. We reduced our sovereign (mostly external) debt from 180% of GDP in 1992 to less than 10% in 2006, prepaid or bought back at market price most of our foreign financial obligations, including all (!) loans, restructured under the Paris Club agreements, changed our borrowing policy, which now relies on ruble denominated bonds, received investment ratings from all three leading international Rating Agencies. Now Russia is able to deal with generosity and compassion with its poorest debtors.

Russia's membership in the Paris Club has made the Club a more universal multinational instrument to deal with debt crises. We benefited from the debt relief on FSU debts, a transfer of financial "know-how" an a strengthened ability to collect our claims on other debtors.