Executive Memorandum

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RUSSIA'S BORROWING SPREE: A LOOMING FINANCIAL CRISIS

The Yeltsin administration has been digging itself a financial hole, and Western attempts to solve the problem by allowing Russia's federal and local governments to borrow billions of dollars are likely to backfire. The Russian Federation's borrowing spree—reminiscent of pyramid schemes that have plagued Russia and other countries in Central and Eastern Europe—could leave millions of investors holding worthless Russian debt securities and cause a financial and economic crisis requiring a Mexico-style bailout by international financial institutions like the International Monetary Fund (IMF), with guarantees provided by the United States, the European Union, and Japan.

To help ensure this does not happen, the Clinton Administration needs to act now to persuade the Kremlin to pursue more financially responsible policies. Instead of going further into debt and leaving itself unable to repay its obligations, the Kremlin should diminish its rate of borrowing, lower interest rates on government bonds, and place Russia's natural resources in escrow for the bond debt.

A Soaring National Debt. During the Soviet era, the Kremlin ran up a debt of close to $150 billion—over one-third of Russia's yearly gross national product—which Russia assumed after the collapse of the Soviet Union. Even worse, Russia's tax collection structure is near collapse—a condition that led the government to issue bonds in a desperate attempt to raise funds. Taxation accounted for less than 16 percent of government revenues last October.

With no viable revenue base, Russia's state apparatus, including such vital functions as law enforcement and nuclear weapons and reactor security, is grinding to a halt. Workers, soldiers, and pensioners have not been paid for months: As of February 1997, the Russian government owed $7 billion in belated salaries, $2.7 billion in pensions, and over $10 billion to government contractors. Yet Russia's largest corporations, such as the Gazprom natural gas monopoly, continue to get away with failing to pay their taxes.

Inflated Bond Ratings. Strapped for cash, the Kremlin implemented a disastrous borrowing scheme in 1995 and 1996. Russia's Treasury floated short-term treasury bills called GKOs and federal bonds (OFZs) with interest rates of up to 240 percent per year—twice as high as the rate of inflation. In a move similar to a Ponzi scheme, the Russian government boosted interest rates on bonds ever higher to attract more funds to repay past debts and attempted to pay off its multibillion dollar salary debts before the presidential elections in 1996. Russians and Westerners alike rushed to cash in on the government paper. In 1996, $6 billion in Western investment capital (three times the amount in 1995) flowed into Russia's securities market. These debts also will need to be repaid, and soon, and this means even more borrowing.

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Complicating the situation is the fact that the soundness of the Russian bonds tends to be overrated by Western rating agencies. Accountants and risk analysts look only at the budget and debt figures but ignore the political, social, and economic morass in Russia. For example, Moody's Investors Service gave the Kremlin a rating of "BA2," higher than the state bonds of Brazil, Turkey, Argentina, and Venezuela, and on par with Hungary, India, and Mexico; and *International Bank Credit Analyst* rated Russia a "BB+," which may allow pension plan and portfolio managers to hold Russian bonds. This would put Russian paper into the hands of millions of small investors worldwide and create a political lobby for bailing Moscow out in case of default. Western investors should recognize that the Russian financial track record is far from perfect. Russia is still in default on the tsarist debt accumulated before World War I and the Soviet debt for U.S. lend-lease programs during World War II.

Heavy Borrowing by Cities. Russia's cash-strapped cities have followed the government's lead. Moscow and St. Petersburg, for example, will offer their own Eurobonds for $500 million and $300 million, respectively. St. Petersburg is offering its projected accounts receivables as collateral even though the city's debt is approaching $1 billion and millions of taxpayers and thousands of businesses are defaulting on their city taxes. Moscow, with a mushrooming debt close to $1.7 billion, is offering assets owned by the government of Mayor Yurii Luzhkov as collateral even though Luzhkov's administration is mired in allegations of rampant corruption. Russian municipal debt does not appear to be sufficiently collateralized.

An Issue for the Group of Seven (G–7) Summit. The Clinton Administration has supported Russia's profligate borrowing. It has endorsed continuation over the next two years of IMF and World Bank loans to Russia amounting to more than $15 billion. The U.S. government-run Export–Import Bank and the Overseas Private Investment Corporation will offer taxpayer-supported loans and insurance worth billions of dollars to U.S. firms that otherwise would be reluctant to invest in Russia. Thus, the Administration is distorting the investment environment and interfering in private-sector investment decision making. In addition, it plans to provide Russia with an assistance package worth over $225 million in fiscal year 1988. Such an approach neither protects Western investors nor solves Russia's economic woes.

The Clinton Administration should pursue a different course. President Yeltsin is scheduled to participate in the Denver G–7 summit in July. This will be an excellent opportunity to put the Russian government on notice that, in order to continue the flow of Western credits, the federal government and Russian cities should (1) curb their pace of borrowing significantly; (2) come up with a realistic schedule to explain how the existing debt is going to be repaid; and (3) put the country's natural resources, such as oil, gas, diamonds, and other minerals, in escrow as collateral. Otherwise, Russia will continue to bury itself in debt it ultimately will be unable to repay. Moreover, before the G–7 summit, Congress should hold hearings into Russia's looming financial crisis and the Administration's response to this situation.

Without a sound financial base supported by economic growth, Russian state and municipal bonds could become extremely risky for investors. U.S. financial market regulators should examine Russia's offerings with extreme caution. The U.S. and other G–7 governments should instruct their representatives in the IMF, the World Bank, and other multilateral financial institutions to condition further credits to Russia on the success of the Kremlin's efforts to slow down borrowing. Western investors and U.S. taxpayers should not become hostage to Russia's irresponsible borrowing practices.

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