

Will the West Reduce Russia's Debt?

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Having successfully rescheduled its debt to foreign commercial banks through the London Club last fall and obtained a reduction of principal and interest rates, Russia now turns to the Paris Club of government creditors. What are the prospects for a similar agreement in the next year? How should we understand the politics of international debt?

The Economics of Debt

Creditor nations have certain resources with which they can compel debtor nations to repay their debts: indeed, if they did not, debtor countries would never pay, and consequently lenders would never lend. These resources exist outside of the debt contract itself. Most frequently, the argument for repayment of debts is cast in terms of future access to international capital markets. Those who fail to pay damage their reputations as borrowers and reduce their ability to draw on foreign capital in the future. With large players in international relations, such as Russia, there can be no other credible means of enforcing repayment.

Debt is worth no more than can be collected, which depends upon the value of the future stream of benefits that the debtor can hope to obtain through access to global capital markets. No sensible creditor will knowingly extend loans beyond this point of no return, but unforeseen circumstances can and do arise (wars, droughts, terms-of-trade shocks, or macroeconomic mismanagement), which turn sound investments sour. When this happens, the market value of debt no longer bears much relationship to its nominal value, and consequently, debt forgiveness does not necessarily imply any sacrifice on the part of creditors. Indeed, when it is contemplated, it is usually mutually beneficial. This is because 1) debt forgiveness increases the feasibility of repayment, which increases the value of the debt that remains to be repaid; 2) debt forgiveness or rescheduling is linked to a package of macroeconomic adjustment measures that further increase the probability that debt will be repaid; and 3) each creditor loses only the market value of the debt it forgives, but benefits from the effects of concessions made by all of the other creditors. Indeed, when repayment is unlikely *ex ante*, a substantial debt reduction may increase the value of the portfolios that the creditors hold. So why is debt forgiveness not contemplated more often?

The Politics of Debt: The International Debt Regime

The lending business is only profitable if borrowers can be compelled to repay their loans. When it becomes a widely accepted principle that loans can be renegotiated--as has sometimes been the case--debtors find compelling reasons to feign distress, the supply of credit quickly dries up, and even reputable borrowers are compelled to pay very high interest rates. When the creditors are national governments, of course, the loans are made for political reasons that have nothing to do with making a profit. Nevertheless, the ability to extend aid in this way in the future, like the supply of commercial loans, depends upon the credibility of repayment. Consequently, although creditors typically face short-term incentives to forgive debt to individual countries, they often resist the temptation in order to protect their long-term interest in maintaining the credibility of international debt collection.

This is the context for the current arguments about whether Russia's case for debt reduction is compelling: debt relief is a matter of making pragmatic exceptions to rules, and the exceptions have to be well justified if they are not to become the rule. The Germans take the pragmatic view that Russia is flush with foreign earnings from high energy prices, and the current account and the state budget have record surpluses, so this is a poor time to reduce the pressure on Russia to repay its debts. Meanwhile, the last two years have provided an unprecedented opportunity for the Russian government to implement far-reaching structural reforms while the economy is growing and the public coffers are full, but there is little evidence of a commitment to do so. A debt-reduction agreement linked to a credible strategy of adjustment that would finally bring Russia into the global economy might be a good gamble for Russia's creditors; a debt-reduction deal that promises more of the same is not.

None of this should be taken to mean that debt forgiveness is not politically motivated. Indeed, since debt forgiveness is a matter of making exceptions, it is intensely political. For example, Poland's landmark debt reduction agreement in 1991 was made possible by its maverick role in bringing down the Soviet bloc; Egypt's debt reduction in the same year was a side-payment for its support for the US-led coalition in the Persian Gulf War.

The best time to renegotiate the Soviet-era debt would have been the spring of 1996. The change of administrations in the United States, furthermore, makes it much more difficult for Russia to achieve a favorable outcome: debt reduction in general was part of the Clinton agenda, and it is not part of the Bush agenda. The Bush administration will view proposals for debt reduction as dubious giveaways. Bush himself made it clear on the campaign trail that he does not trust the Russian leadership and does not approve of economic aid to Russia in any form, including IMF loans; the budget proposal he submitted in March cut funds from even the most popular aid-to-Russia program in Washington, which bolsters the security of Russian nuclear stockpiles. Consequently, we should not expect to see any significant initiatives on the debt reduction front from the United States for the next four years.

A Quid Pro Quo for CIS-Area Debts to Russia?

Russia has long insisted that an equitable treatment of its debt should take into account the fact that it is a substantial net creditor to the countries of the CIS, and indeed, to several developing countries as well. This raises the prospect of a deal that reduces both Russia's debts to the West, and the CIS countries' debts to Russia. Moral arguments aside, this is a bargain that Western creditors are unlikely to make.

Western creditors are unenthusiastic about forgiving debt to Ukraine and other Russian debtors because their economic management has been even worse than Russia's. Ukraine has been able to mismanage its economy for so long in large part because it has been able to rely upon Russian subsidies and cheap credits. Forgiving those debts now would reward the poor corporate governance that led Gazprom to extend the credit in the first place, and would allow Ukraine to put off economic adjustment and start the cycle again.

In addition, a transaction of this sort would effectively transfer lending power from the Western countries to Russia. The key here is that while debt flows are a political resource for the lender, debt stocks are not. In accounting terms, debt is an asset to the lender and a liability to the borrower, but in political terms, the relationship is reversed: debts that a creditor has to collect are a political liability, and the borrower's ability to disrupt payments of principal and interest is a potent source of political leverage. It is not Ukraine's debt that makes it vulnerable to Russian pressure at present, but its dependence upon Russian gas, and that dependence would remain if the debt were liquidated. While nullifying Ukraine's debts to Russia would be an economic boon to Ukraine, it would increase rather than decrease Ukraine's dependence upon Russia. First, it would decrease Ukraine's leverage as a debt payer; second, it would increase the attractiveness to Russian companies of extending credit to Ukraine in the future. Since the new Bush administration is pessimistic about Russia's intentions, it is unlikely to pursue a policy that amounts to subsidizing Russia's subsidies to its neighbors.

A great deal can happen in two years, and it seems quite probable that Russia will come to some arrangement with the Paris Club before its debt payments become unmanageable in 2003. One can hope that the deal that is struck becomes an impetus for far-reaching reform in the Russian economy, as was the case in Poland, rather than an occasion for exerting leverage over foreign policy, as was the case in Egypt. In the near term, however, an agreement appears unlikely.