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Economic Crisis and the Russian Debt Problem

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Abstract: This paper discusses the debt component of the current global crisis, which has grown in 2011–2012. The Russian economy is reviewed in terms of its debt stability and the key challenges in this area, the latter of which include a high dependence of the public budget on oil prices, too-high public pension liabilities, and high corporate debt. Some measures to address Russian debt policy problems are proposed.

Keywords: financial economy, debt crisis, government and corporate debt, Russia's debt stability, budget deficit, external and internal borrowings, contingent debts

JEL Classification Numbers: E5, F7

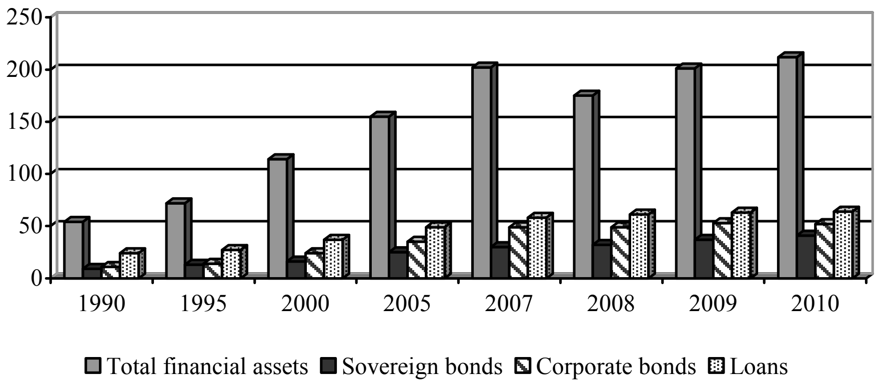
1. A financial economy breeds crises

The formation of the financial economy added many new risks to the development of the real economy. According to the McKinsey Global Institute, the financial depth of the world economy (i.e. ratio of traditional financial assets to GDP) rose from 261% in 1990 to 356% in 2010. With respect to financial assets in recent years, certain shares of government and corporate debt have grown considerably. In 2011, the share of sovereign and corporate bonds and credit commitments amounted to 74.1%; in comparison, on the eve of the first wave of the crisis in 2007, that figure was 67.8% (see Figure 1).

The excessive growth of the financial economy has become one of the most serious risks to modern economic development. It is not accidental that most economic crises over the last 30 years arose from financial turmoil, primarily debt crises like bank defaults, crises in internal and external sovereign debt, and the like[1]; the 2008 global financial crisis, which has grown into a full-scale economic crisis affecting almost four-fifths of the world economy, is no exception. The first wave of this crisis was triggered by a corporate debt crisis. Most countries increased their public expenditures to overcome that crisis and generally assist its economic actors and national economies. In circumstances where market demand narrowed and output dropped, the above measures led to lower earnings and exacerbated budget deficits (see Table 1).

Since the deficit was covered mostly through money issuances and new borrowings, the second wave gave birth to the gravest *public* debt problems[2]. In 2010, the growth of worldwide public

Figure 1 Growth of financial assets and various debt obligations, US$ trillions.



Source: Roxburgh, Ch., Lund, S., and Piotrovski, J., "Mapping global capital markets 2011," McKinsey Global Institute, 2011, p. 2.

Table 1 Deficit (-)/ surplus (+) of the central government budget of some countries, % of GDP

Country groups or countries	2007	2008	2009	2010
OECD countries	-1.3	-3.3	-8.2	-7.7
USA	-2.9	-6.3	-11.3	-10.6
Eurozone as a whole, including	-0.7	-2.1	-6.3	-6.0
Germany	+0.3	+0.1	-3.0	-3.1
France	-2.7	-3.3	-7.5	-7.0
Italy	-1.5	-2.7	-5.3	-4.5
UK	-2.8	-4.8	-10.8	-10.3
Japan	-2.4	-2.2	-8.7	-8.1
Russia	+5.4	+4.1	-5.9	-4.1

Source: OECD (http://www.oecd.org/document/0,3746,en_2649_201185_46462759_1_1 _1_1, 00.htm); Bank of Russia (http://www.cbr.ru).

market debt denominated in bonds amounted to US$4 trillion, while corporate bond debt decreased by US$1 trillion. The bond national debt of all countries, to the beginning of 2011, reached US$41.1 trillion—an increase of nearly US$25 trillion compared to 2000[3]. Ratios of public debt to GDP, by country, are given in Table 2.

For analytical purposes, the International Monetary Fund (IMF) offers the following threshold ratio values (debt/GDP), which match certain degrees of risk inherent in a debt crisis: 30% for low-risk, 40% for medium-risk, and 50% for high-risk. The Stability and Growth Pact (1997)

Table 2 The ratio of central government debt to GDP in some countries, as of the beginning of the year, %

	2007	2008	2009	2010
Australia	5.2	4.9	8.2	11.0
UK	42.7	61.1	75.3	85.5
Germany	39.6	39.6	44.2	44.4
Greece	105.7	110.6	127.0	147.8
Spain	30.0	33.7	48.0	51.7
Italy	95.6	98.1	106.8	109.0
Korea	29.7	29.0	32.6	31.9
USA	35.7	40.2	53.6	61.3
France	52.1	53.4	61.2	67.4
Japan	164.5	180.8	183.5	n/a

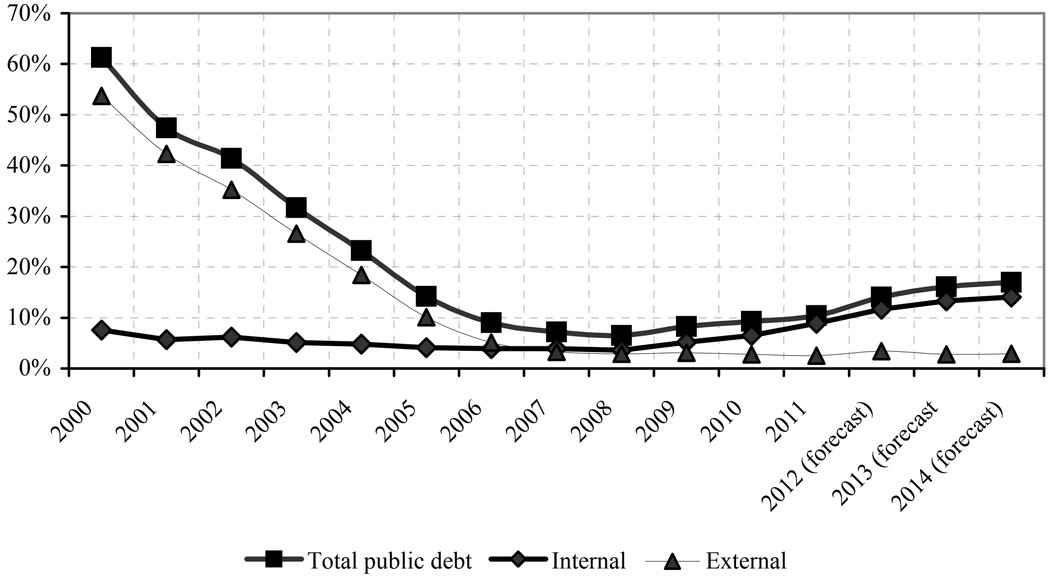
Source: OECD (http://stats.oecd.org)

recommends the following standards, to stabilise the euro: no more than 3% of GDP is to be assigned as an annual budget deficit amount; and sovereign debt should not exceed 60% of GDP. According to Eurostat, over 90% of EU members surpassed these criteria in 2010; in that year, the average budget deficit of the 27 EU countries was 6.4% (6.0% in the EU 17), while public debt was 80% (85.1% in the EU 17) of GDP[4].

The growth of the debt crisis in 2011 led to an exacerbation of the debt problems of many countries. One of the first highlights of the sovereign debt crisis was a heated debate in the United States about increasing the maximum allowable level of public debt, lowering the power of the financial markets, and building up worldwide confidence in the strength of the American dollar as a world currency. In August 2011, referring to the threat of technical default, the maximum allowable level of public debt was raised by US$2.4 trillion to US$16.7 trillion, in exchange for a commitment by executive powers to reduce budget costs over 10 years. However, in January 2012, US gross public debt reached US$15.23 trillion. A particularly acute sovereign debt crisis also emerged in Europe: the OECD estimates that in 2013, the ratio of government gross financial liabilities to GDP in the eurozone will be 98.2% (http://stats.oecd.org/index.aspx?queryid=32442).

Developments in the debt crisis indirectly indicate a reduction in sovereign credit ratings, which in turn assumes the involvement of the leading rating agencies. Standard & Poor's has refused to increase the United States' investment rating, and during 2011, ratings were similarly downgraded in Japan and some developed European countries. In December 2011, Standard & Poor's placed on review the ratings of 15 eurozone countries, and in January 2012 downgraded the ratings of nine states, including that of one of the 'giants' of European integration—namely,

Figure 2 Change in sovereign debt against GDP in Russia, %, as of the end of the year



Source: Bank of Russia (http://www.cbr.ru).

France—and those of three other countries (i.e. Portugal, Spain, and Italy). In February, 2012 after achievement of the arrangement on restructuring of a debt of Greece the investment rating of this country to «selective default» has been lowered (See Appendix 1 for Standard & Poor's ratings).

In this case, the expansion of the sovereign debt crisis may trigger a new wave of corporate debt crisis, especially in the banking sector. The banks in the greatest distress are considered a 'debt scourge', and EU member states are the holders of large blocks of sovereign debt. The growth of banking crises could lead to corporate debt crises—and, in turn, a full-fledged economic crisis.

2. Russia's debt stability

At first glance, the financial position of Russia within the aforementioned context appears to be favourable, especially with regard to its ratio of public debt to GDP. Following the 1998 crisis, this ratio in Russia has significantly improved (see Figure 2).

As of 1 January 2012, the Russian Federation's public debt was 5.1 trillion rubles, comprising 4.0 trillion rubles of internal public debt and US$35.8 billion of external public debt (the latter of which is equivalent to 1.1 trillion rubles). The ratio of public debt to GDP is slightly higher than

10.4%; the Russian Ministry of Finance forecasts that by the end of 2014, that figure will increase—albeit not critically—to 17%.

However, the forecasts of Russia's Ministry of Finance rely on a favourable assessment of world oil price movements. If in 2008, the national budget had been balanced when oil was priced at US$87.5 per barrel, in 2011, a balanced budget would require a price of US$109, while a balanced 2012 budget would require a price of US$117.2 per barrel; clearly, this is not a realistic projection. A price of US$93, as projected for 2012, will lead to a deficit of 1.5% of GDP, and with prices dropping to US$60, the deficit would rise to 5.5%. On average, each time oil prices drop by US$10 per barrel, public revenue will drop by 500 billion rubles and the budget deficit will grow by 1%.

By and large, revenues from oil and oil product production and exports account for over 40% of the total budget revenues from taxes and customs (see Appendix 2). In addition, there are also revenues from the production of natural gas and other mineral resources. In other words, as long as prices for hydrocarbons and other mineral resources remain high, Russia has the good potential to maintain its economic growth. A decline in oil prices to US$80 per barrel, however, may constrain growth, and if prices were to drop below US$60 per barrel, this would spell disaster for the Russian economy. This latter scenario is likely to happen if current declines persist; short-term market price fluctuations, on the other hand, can be covered by financial reserves (i.e. the National Welfare Fund and the Reserve Fund). However, if oil prices continue to decline to US$60, it is estimated that the Reserve Fund will be depleted in about one year. On 1 September 2008, the balance of the Reserve Fund stood at US$142.6 billion, and on 1 January 2012, it was already down to US$25.2 billion—not least of all due to a failure from 1 January 2010 to 1 January 2014 to replenish the Reserve Fund with oil and gas revenues, as a result of a budget imbalance.

As a reference, one should note that the average annual per-barrel oil price in 2001–2010 was about US$60. In the medium term, oil prices are forecast to decline (see Appendix 3), but they are not expected to drop below US$85. In a worst-case scenario (i.e. the development of a full-fledged economic crisis in Europe and the world at large, and a significant drop in oil demand), however, these prices could fall much lower. In late 2008 to early 2009, for example, they fell to US$35–45.

Note that, in terms of the severe debt crisis, EU countries in 2010 purchased more than 50% of all Russian exports. In that year, Russian exports to the 27 countries of the EU represented a value of US$224.7 billion, while EU exports to Russia were relatively small and represented a value of only US$125.6 billion. Nearly four-fifths of Russia's exports are in oil, gas, and energy.

Also note that the European crisis could seriously affect the global economy—especially those countries with which the EU has close economic relations (e.g. the United States). This situation could lead to a global slowdown and a worldwide decline in demand for resources, both of which would have adverse economic consequences for Russian exports.

Potentially, new borrowings, revenues from privatisation, and tax increases may be contemplated as budget revenue sources. However, their use is considerably constrained, both externally and internally. For example, by 2017, the incumbent government is planning to sell or diminish its share in 20–22 strategic companies and privatise almost 5,000 nonstrategic facilities. This could potentially raise funds of US$20–40 billion annually. However, the success of large-scale privatisation will, in many ways, depend on the state of the global and Russian economy. Generally, during a crisis, assets depreciate and proceeds from their sale are expected to be low. As for taxes, any increase may slacken business activity.

IMF Managing Director Christine Lagarde, when delivering a lecture in Moscow on 7 November 2011, recommended that Russia continue to build up its reserve funds (i.e. both the Reserve Fund and the National Welfare Fund). She believes that there are factors in Russia that affect the vulnerability of its economy. Referring to economic vulnerabilities, Christine Lagarde explained that she meant a possible dramatic decrease in world prices for exchange-traded commodities—including oil—and a situation where major European banks may start withdrawing their operations from Russia would result in a liquidity deficit in the market[5].

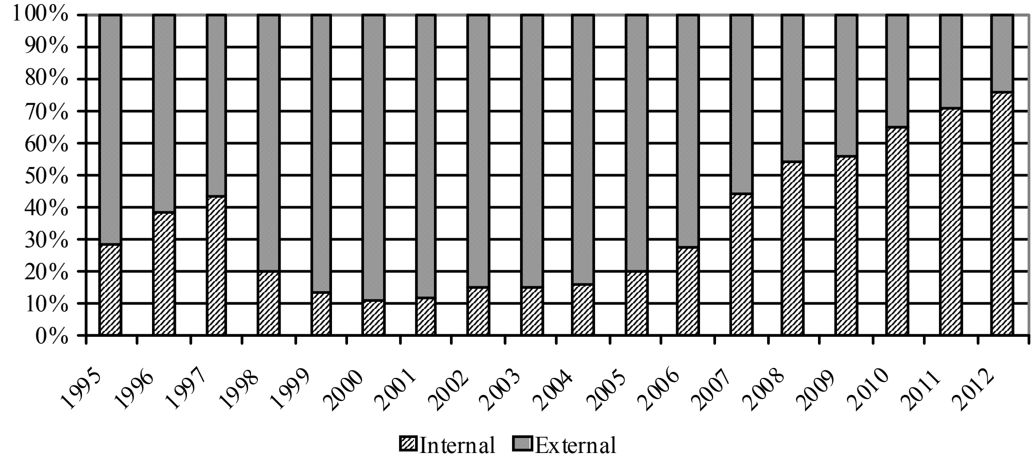
World Bank experts suggest that a possible debt threat looms over the Russian economy. According to S. Ulatov, a World Bank expert on Russia, Russia may face by 2030 a debt crisis similar to what Greece is experiencing now, if the Russian government does not cut public expenditures[6]. World Bank experts also note that there is the risk that global economic growth, including that of Russia, will slow down[7].

In Russia, the provision of new borrowings will also greatly depend on the state of the global financial markets. In fact, according to A. Kudrin, the former Russian Minister of Finance, we are witnessing the unfolding of a large-scale crisis of sovereign debt obligations that 'will paralyse the debt market and close it, first of all, for developing countries'[8]. Therefore, the Russian government's medium-term plans are strongly contingent upon fast growth among internal borrowings; external borrowings will remain at a minimal level, so that Russia can maintain its status as a sovereign borrower from the international capital markets and hence be able to access these markets. For example, in 2012, the upper borrowing limit on foreign markets was US$7 billion.

3. Extreme growth in domestic debt

In recent years, a trend vis-à-vis internal public debt has been increasingly seen, wherein the state of public debt has become more evident. At the beginning of 2012, its proportion of all public debt was 76%, whereas before the 1998 default on internal debt, it was less than 45% (see

Figure 3 Ratio of external sovereign to internal sovereign debt, as at the beginning of the year, %



Source: Russian Ministry of Finance (http://www.minfin.ru)

Figure 3).

For one only 2011 domestic debt increased by 36%, in 2001 - 2011 it had increased more than seven-fold (see Appendix 4). The document entitled *Basic Trends in Public Debt Policy of the Russian Federation for 2012–2014* suggests that in 2012–2014 inclusive, 90% of the budget deficit will be covered by internal borrowings that amount to about 2 trillion rubles[9].

Additional pressure is exerted by the issue of ruble bonds, which have been recently offered on the Russian market, on the markets of CIS countries, and to foreign banks and companies. Several ruble-denominated loans since 2005 have been placed through the European Bank for Reconstruction and Development. In late 2010, Belarus posted a debut issue of ruble bonds, worth 7 billion rubles; they held a maturity period of two years and a coupon rate of 8.7% per annum. In December 2011, the Canadian company Uranium One Inc.—51% owned by Atomredmetzoloto—went on the MICEX Stock Exchange with 10-year bonds worth a total of 16.5 billion rubles. To this is added the risks inherent in the placement of ruble-denominated Eurobonds. In 2011, Russia's Ministry of Finance placed in foreign markets about 90 billion rubles of such securities.

However, the cost of these borrowings, along with the capacity and weakness of the domestic financial market infrastructure, considerably constrains such debt policy. Moreover, public loans will substantially increase the cost of borrowing among private borrowers, who may as a result be squeezed out of the internal borrowings market. The key point is that the capacity of the internal debt market depends greatly on the ability of the monetary authorities to keep the inflation level low and the exchange rates relatively stable. If the ruble depreciates considerably, internal borrowings will not be able to meet completely the corporate needs related to the service of external debt and imports.

All these developments suggest the need for a more balanced approach to government borrowing in the domestic market, compared to the policy pursued in the present day and planned for the future.

4. Contingent debts

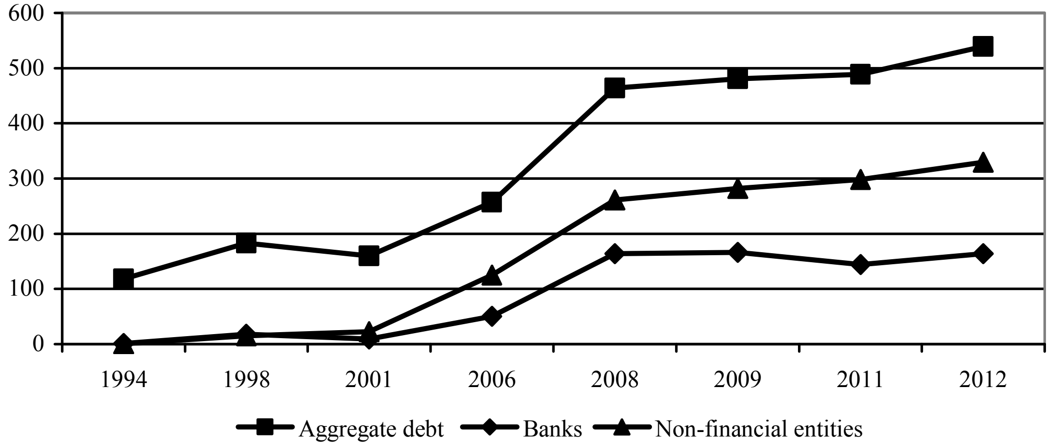
An in-depth analysis of the debt stability of the Russian economy reveals a number of other grave risks arising from Russia's national debt policy; those risks also comprise so-called contingent debts. Some experts believe that public debt, apart from traditional kinds of public indebtedness, should include government obligations, already assumed, to pay pensions (i.e. the debt of the social guarantee system), to provide tax and customs privileges, and to grant various state guarantees, etc. These are the so-called contingent debts.

For Russia, the payment of pensions is the most critical obligation. In accordance with applicable pension laws and assumptions regarding Russia's demographics, the deficit of the Russian Federation Pension Fund in 2012 will double to 1.75 trillion rubles, or 3% of Russia's GDP. As a point of comparison, in 2011, the Pension Fund deficit was 875 billion rubles[10].

Standard & Poor's states that it has a serious negative outlook for Russia in this area. According to this agency, Russia's public debt in the long term could grow substantially owing to such democratic issues as a diminishing working population and an increased number of pensioners, coupled with higher expenditures relating to healthcare, long-term care, and the like. Standard & Poor's experts predict that by 2050, Russia's ratio of public debt to GDP may range between 124% and 585%, depending on the development of scenarios for the situation in that country. The severity of this indicator is likely to become apparent across all scenarios, as early as just after 2015[11].

This challenge calls for radical reforms to Russia's pension system. All attempts in the 2000s to meet the challenge failed; at present, various options are being proposed, from the use of revenues from privatisation and excess earnings from oil, to raising the retirement age and introducing additional taxes. At the same time, many of these changes may give rise to grave social and economic risks, which are unacceptable in the 2011–2012 election period. In any case, such reforms need to start in the near future, and because no one measure suffices, solving this complex problem will demand a comprehensive approach.

Figure 4 Aggregate external debt, external debt of banks and non-financial entities, as at the beginning of the year, US$ bn



Source: Bank of Russia (http://www.cbr.ru)

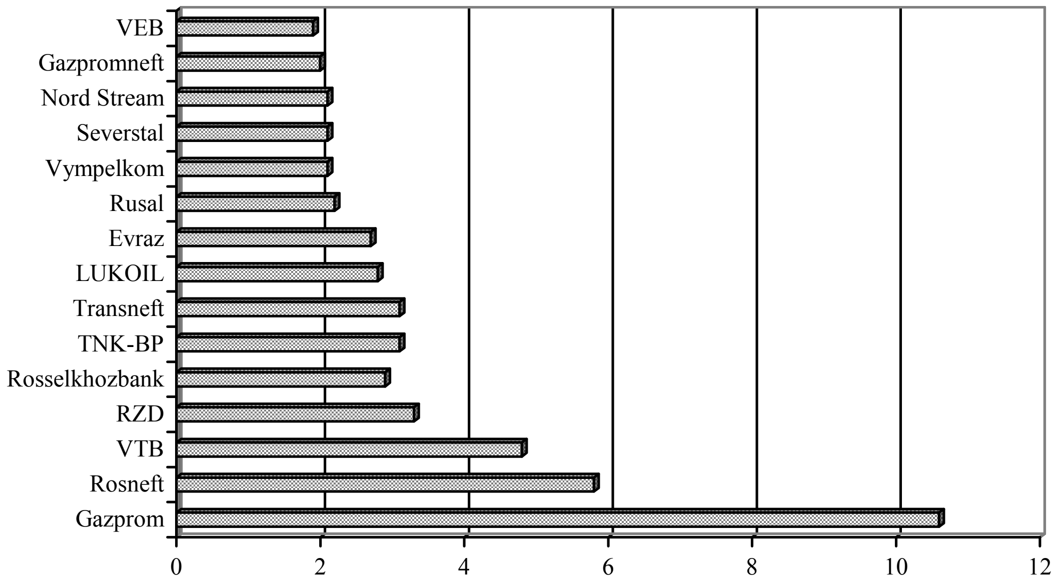
5. Corporate debts

Corporate debts may also be attributed to contingent debts. Under certain circumstances, the state must bear partial responsibility, as these debts pose a threat to the stability of national economic development. The 2008–2009 crisis and 2011 debt crisis in Europe have validated these assertions, and it is why substantial state financial aid was provided to corporations and banks—many of which were in developed countries—that faced an acute liquidity shortage.

A complete picture of the debt situation in Russia cannot be obtained without a consideration of corporate debt. Russia's external corporate debt amounted to US$494 billion on 1 January 2012 (see Figure 4), a figure almost 16 times higher than that at the beginning of 2001 (US$31 billion). In 2000, the corporate external debt accounted for less than 20% of Russia's aggregate external debt, versus 91% in 2011. This figure is much higher than that of many other countries, where corporate debt levels also substantially rose in the 2000s; at the beginning of 2011, some of those figures, as a percentage of aggregate external debt, were as follows: Germany, 72%; France, 70%; the United Kingdom, 94%; Japan, 67%; the United States, 67%; Canada, 75%; India, 74%; and Brazil, 82% (Bank of Russia (http://www.cbr.ru) or (http://www.cbr.ru/statistics/print.aspx?file =credit_statistics/debt_countries.htm&pid=svs&sid=ITM_8395).

The Bank of Russia estimates that as of the beginning of 2011, the country's aggregate external debt level, including corporate debt, was at 33% of GDP. This number is not critically high, but when internal corporate borrowings are brought into consideration, it is estimated to be actually

Figure 5 Fifteen largest corporate borrowers as a percentage of total corporate debt, as of 1 July 2010, %



Source: Arakelyan, M. and Nestmann, T., "Russia's quasi-sovereign debt. A sizeable contingent liability," Deutsche Bank Research, 2011 January No. 27. p. 4.

2–2.5 times higher. In 2010, annual payments related to aggregate external debt represented 9% of GDP and 28% of exports. Of special concern is the fact that the latter percentage is higher than that defined by IMF as being high-risk (i.e. 25%).

The risks related to external corporate debt are associated with certain circumstances. First, companies and banks that feature state participation account for a considerable part of all corporate debt; that relating to banks can be considered *quasi-sovereign* debt. The Bank of Russia estimates the external debt of enterprises and banks that feature state participation, as of 1 October 2011, to be US$163.3 billion, or an amount representing just over 34% of total corporate debt; in comparison, those figures at the beginning of 2006 were US$68.7 billion and 27% (Bank of Russia (http://www.cbr.ru) or (http://www.cbr.ru/statistics/print.aspx?file=credit_statistics/debt_an_det.htm&pid=svs&sid=ITM_29204).

Corporate external debt in Russia is highly concentrated. According to Deutsche Bank analysts, as of 1 July 2010, 12% of all companies accounted for 80% of Russia's total corporate debt, which included only bonds and syndicated loans (US$277 billion); internal bonds, meanwhile, accounted for more than 30% of these debts (see Appendix 5). State-run companies like Gazprom, Rosneft, and VTB accounted for 30% of all corporate debt. Among the six largest debtors are state-run RZD, Rosselkhozbank, and Transneft (see Figure. 5).

Second, in Russia, major private companies receive strong paternalistic support from the state. In the autumn of 2008, the Russian government launched a special US$50 billion fund to help companies that were facing difficulties in repaying their external debts. Under the Federal Law of 13 October 2008, No. 173, *On Additional Measures to Support the Financial System of the Russian Federation*, Vnesheconombank (VEB) was assigned to manage this fund. The bulk of this money was granted to private companies such as Rusal (US$4.5 billion), Alfa Group (US$2 billion), Evraz Group (US$1.8 billion), PIK (US$262 million), and Sitronix (US$230 million). In total, in dispersing that fund's money, VEB has loaned out US$14.33 billion, but in 2009, such funding was discontinued.

By and large, Russian companies have drawn lessons from the 2008 crisis; most noteworthy is the fact that, in the two years immediately preceding the crisis, the Russian corporate sector had almost doubled its debt load. During the acute phase of the crisis, the sector almost completely lost its access to the world financial markets; only government aid helped it survive and preserve its assets held in foreign banks.

In recent years, major private corporate borrowers have been vigorously restructuring their external debts. They were assisted in their efforts by banks that feature state participation—like VEB, VTB, Sberbank, Gazprombank—and large private Russian and foreign banks. To obtain access to new loans some corporate borrowers were given state guarantees. Other measures to help reduce debt included the sale of some assets, the institution of various swaps, and the issuance of floating new bond loans, among others.

Thus, in 2009, Sitronix borrowed US$230 million from the Bank of Moscow, to repay its debt to VEB; for exactly the same purposes, PIK borrowed from Nomos Bank. A pipe-rolling company borrowed US$200 million from EBRD to settle its Eurobonds, as well as US$1,750 million from Gazprombank, Sberbank, and VTB to repay its short-term debts. Vimpelcom redeemed its own Eurobonds, worth US$320 million, using a loan obtained from Sberbank in December 2009.

In September 2011, Rusal performed one of the last major reschedulings of debt (US$9.3 billion). On 23 September 2011, an additional agreement with Sberbank on a loan of US$4.58 billion was signed and came into force. The agreement extended the loan repayment schedule until September 2016 and cancelled the VEB guarantee. On 29 September 2011, an agreement involving 13 international and Russian banks—namely, BNP Paribas (Suisse) SA, ING Bank N.V., Commerzbank Aktiengesellschaft, Credit Agricole Corporate and Investment Bank, Gazprombank, Natixis, Nordea Bank AB (publ), The Royal Bank of Scotland Plc, Sberbank Russia, Sumitomo Mitsui Banking Corporation, SCGIB, UniCredit Bank AG, and WestLB AG—was signed and came into force on a US$4.75 billion syndicated loan that will also be used

Table 3 Structure of the Russian Federation external debt by maturity, %

	1 Jan 2006	1 Jan 2008	1 Jan 2011	1 Oct 2011
Aggregate public debt of RF, including	100	100	100	100
short-term	16.9	21.5	13.3	13.7
long-term	83.1	78.5	87.7	86.3
External debt of private sector, including	100	100	100	100
short-term	21.2	30.2	15.2	16.7
long-term	78.8	69.8	84.8	83.3

Source: Bank of Russia (http://www.cbr.ru)

to meet Rusal's repayment obligations under the International Override Agreement signed on 7 December 2009. Following the syndication of this loan, a number of international banking institutions are expected to join the primary pool of banks.

The restructuring of corporate debt has improved the duration (i.e. weighted average time to maturity) of corporate external debt. The long-term liabilities of the private sector, as a proportion of total external liabilities, rose from 69.8% at the beginning of 2008 to 83.3% on 1 October 2011 (see Table 3).

In general, many Russian experts believe that the acute corporate debt crisis of 2008–2009 is unlikely to recur. For example, according to A. Pestova and O. Solntsev from the Centre for Macroeconomic Analysis and Short-Term Forecast, although the second wave of bad debt is likely to hit the Russian economy in 2012, it will not be as large as the first one. It will simply sweep out the players who use risky strategies—those who have built proverbial financial houses on sand[12].

At the same time, the growth of external corporate debt has accelerated: in 2011 alone, it increased by more than US$50 billion (up 11.5%, from the previous year). By the beginning of 2012, the total amount of external corporate debt was close to its maximum level on 1 October 2008 (i.e. US$505 billion).

If the global crisis is exacerbated in 2011–2012, the Russian government promises financial support to businesses, but only to efficient ones. V Putin said at the VTB Capital 'Russia Calling!' Investment Forum that 'if there is a need, we [the government] will lend a shoulder to help, but of course [it will help] only those who work efficiently and whose economic and corporate policy is not too risky'[13].

Another manifestation of state paternalism with respect to the debt problems inherent in certain corporate structures is the growth of government guarantees in the aggregate structure of sovereign debt. In 2008, government guarantees backed 3.4% of corporate debt; but in 2010, that number reached 10.2%. At the same time, guarantees in foreign currency accounted for

Table 4 Annual growth of external debt of Russian non-banking corporations by countries, %

	2008	2010
UK	14.4	32.8
Cyprus	28.0	22.5
Germany	5.7	6.4
Netherlands	18.7	6.2
Luxembourg	6.0	5.4
China	0.1	4.5
France	5.2	4.2
British Virgin Islands	3.6	2.8
Ireland	3.5	3.4
Austria	2.0	1.5

Source: Bank of Russia (http://www.cbr.ru)

28% of all warranties in 2010; the remaining 72% were ruble-denominated guarantees. By 2013, it is expected that the share of state guarantees in state debt will increase to 18–20%.

The state is indirectly responsible for corporate debt, as major companies and banks—and not merely those that are state-owned—have investment ratings at the level of RF sovereign ratings. For example, both state-owned companies like VEB, VTB, Gazprom, Rosneft, RZD, and Transneft, and private companies like Lukoil, TNK-BP, and NLMK receive, as the Russian Federation does, from Standard & Poor's the same foreign currency long-term rating of the issuer (i.e. BBB), with an outlook of 'stable'. This rating enables such companies to borrow from international financial markets at lower rates than companies with lower ratings.

At the same time, a review of external corporate debt suggests that, to some extent, this is an *artificial* construct. Many Russian companies take capital out of Russia and then repatriate it in the form of credits and loans; this is often known as 'round-tripping capital'. Compared to investing the capital, round-tripping provides for businesses better insurance against noneconomic risk, as it can give rise to arbitrage in international institutions. This means that these loans are often in-house postings. In this case, the real value of corporate external debt may be 25–40% lower than estimated.

The experience of companies affiliated with the Yukos Oil Company, which went bankrupt in Russia, may exemplify the success of such an investment strategy. Since 2007, Yukos Capital S.a.r.l, a Dutch subsidiary of Yukos that is controlled by some former Yukos managers, has been involved in litigation with Rosneft. Yukos Capital claimed ownership of four loans with an aggregate value of 12.9 billion rubles that it had extended to Yugansneftegaz in 2004.

Table 5 Structure of current foreign investment in Russia by types, %

	1995	2000	2005	2007	2010	2011
Foreign investment, including:	100	100	100	100	100	100
direct investment, out of which:	67.7	40.4	24.4	23.0	12.1	9,7
capital contributions	48.8	9.7	19.3	12.2	6.7	4,8
borrowings from foreign co-owners of entities	11.4	25.0	4.0	9.7	4.1	3,9
other direct investment	7.5	5.7	1.1	1.1	1.2	0,9
portfolio investment, out of which:	1.3	1.3	0.8	3.5	0.9	0,4
equities	0.4	0.6	0.6	3.4	0.3	0,3
debt securities	0.9	0.6	0.2	0.1	0.6	0,1
other investment, out of which:	31.0	58.3	74.8	73.5	87.0	89,9
trade credits	6.3	14.1	11.2	11.6	15.3	14,6
other credits	16.5	43.2	62.9	61.0	69.0	73,4
other	8.2	1.0	0.7	0.9	2.7	1,9

Source: Russian Statistics Agency (http://www.gks.ru)

Afterwards, Yugansneftegaz, following Yukos' bankruptcy, was acquired by Rosneft, but no funds were repaid to Yukos Capital. Yukos Capital was not even registered as a creditor of the bankrupt Yukos. After failing in Russian courts, Yukos Capital went to the appeal court of Amsterdam, which granted a judgment for the plaintiff. Rosneft attempted to appeal the decision with the Supreme Court of the Netherlands, but the appeal was dismissed. Eventually, in the summer of 2010, Rosneft paid Yukos Capital about US$400 million, which is the equivalent of the claimed 12.9 billion rubles.

A review of the geography related to corporate debt suggests the significant role of round-tripping capital (see Table 4). Table 4 shows that a considerable proportion of debt (i.e. in excess of 70%) was generated by flows of loans from offshore or related jurisdictions, where the corporate laws are favourable for setting up holding centres that concentrate financial resources and control the assets in Russia.

It is not accidental that in 2011, the proportion of foreign direct investment within Russia's current foreign investment structure dropped to 9.7%, compared to 67.7% in 1995 and 40.4% in 2000. Accordingly, the proportion of loans of various types has increased (see Table 5). It is typical that in the corporate private debt structure loans and credits dominate, leaving securities far behind. It is especially typical that among nonfinancial entities, as of the beginning of 2011, loans and credits accounted for more than 90% of the total external debt load (see Table 6).

The credit form of reinvestment in Russia, of course, is also used for other reasons. One is the related tax savings: interest payments to 'foreign' creditors reduce the taxable income of

Table 6 Structure of private sector external debt as of the beginning of 2011, %

	Loans	Debt securities	Other debt obligations
Total private debt	62.1	4.8	33.1
Banks	59.2	3.9	36.9
Non-financial entities	91.4	7.5	1.1

Source: Bank of Russia (http://www.cbr.ru)

companies registered in Russia.

The aforementioned developments and circumstances call for the creation and use of special approaches to the regulation of corporate debt.

6. Outlook for debt

On the whole, focus is better placed on the efficiency of macroeconomic policy—especially budgetary policy—than on debt policy challenges; although the latter are critical, the former are more instrumental. Here, in my opinion, the core objective should be to reduce budget deficits and attain deficit-free budgets. Although Russia's debt burden is low by international standards, the risks inherent in Russian debt policy cannot be left unmitigated.

Even as oil prices continue to climb, it is not necessary for Russia to take the most simplistic route in reducing its budget deficit—namely, to rely unduly on oil and gas revenues and postpone making allocations to reserve funds. It is particularly important that Russia place emphasis on making maximum reductions to its deficits, without allowing oil to enter the picture.

Naturally, it will not suffice to merely tighten fiscal policy, if the goal is to prevent an economic recession. Moreover, such policy can lead to reduction of rates of increase. In the conditions of global debt crisis which can be tightened for the long period of time, only the state with its financial resources can really stimulate economic development. Falling of budgetary incomes may require changes in how financial reserves are evaluated, in terms of their sufficiency and the rationality of their structure. Some of those reserve funds could be used more efficiently in investment, and using the funds in this way would contribute to the structural and technological modernisation of the Russian economy.

More broadly, improving debt sustainability involves the creation of a new global trend that, furthermore, involves stable sources of economic growth, thus improving the living standards of Russian citizens. Such change is associated with major institutional reforms, without which there can be no 'normal' investment climate or inflows of foreign or Russian capital into the Russian economy. In terms of doing business in Russia, Russia's 2012 ranking by the World

Bank and International Finance Corporation was only 120th out of 183 tested countries; in 2011, it was 123rd. Clearly, Russia is behind many countries in the emerging markets, including many sovereign nations rising out of the former United Soviet Socialist Republics.

Indicators of an unfavourable investment climate are aggravated during a crisis, and capital tends to flow out during those times. If the precrisis 2007 net capital inflow to Russia amounted to nearly US$82 billion, in 2008–2011, the capital outflows exceeded US$300 billion, including US$84.2 billion in 2011. Therefore, improving Russia's investment climate is a prerequisite for improving the debt sustainability system within the Russian economy.

There are plans to set up the Russian Financial Agency, a dedicated market institution, to enhance the efficiency of Russia's debt policy. In general, the decision to set up this institution was made as early as 2008. Similar institutions have shown strong performance in some countries. The importance of a dedicated debt agency is especially clear now, for example, that the proportion of debts traded in financial markets has reached 80% of Russia's external sovereign debt, compared to 32% in 2000. However, we should not impose upon such an agency excessive expectations, as it would only be considered an organ by which the operational management of public debt can be undertaken. It cannot solve problems that are dependent on macroeconomic, fiscal, monetary, fiscal, or monetary policy. This agency, together with the Bank of Russia, can play an important role in the control of foreign corporate debt obligations, primarily those of state-owned companies. A new wave of global debt crisis, however, could create grave problems in this area.

In this context, the need to elaborate and implement real-world policy has given rise to new proposals, including one to limit the growth of corporate debt. The most promising include suggestions to improve the monitoring of the external borrowings of the corporate sector, establish a mechanism of efficient control over the borrowing policy of Russian corporations and banks that feature strong state participation, prohibit loans to companies located in offshore and competing offshore jurisdictions, limit the share of foreign loans within liabilities, and more closely examine the required reserves, etc.

An effective policy vis-à-vis corporate debt includes not only a tightening of regulations on foreign lending to Russian businesses, but also the setting forth of criteria for use in granting state-sourced aid. In this context, the granting of such aid so would require not just the monitoring of the volume of new corporate borrowings, but also identifying the ultimate beneficiaries of such assistance. This will allow a more reasonable policy for the provision of possible state support to enterprises in financial difficulty. If the creditors are the real owners of Russian companies, such loans can be worked out through special methods involving tax policy, which should in turn encourage the refinancing of corporate profits in Russia.

Moreover, it is important to create institutional conditions where the owners of the company are accountable for their management decisions with regard to all its assets, including offshore assets, expensive real estate, and transportation assets. They cannot assume that there will be unconditional financial support from the state, nor that they will have the right to exercise unreasonable investment expansion or make other inefficient management decisions. Businesses cannot be allowed to 'blackmail' the state into making such concessions, by cutting manufacturing jobs and thus promoting social unrest or protest. The use of such public policy would severely limit the use of 'artificial bankruptcy', which is often used to obtain additional financing on favourable terms. Such changes would create an effective and legitimate system of bankruptcy, which would in turn allow for the subsequent reprivatisation of bankrupt companies.

Notes

[1] These matters are discussed in detail in Reinhart, C. and Rogoff, K., "This time is different: A panoramic view of eight centuries of financial crises," *NBER Working Paper*, No. 13882, 2010, pp. 86–88.

[2] See Roxburgh, Ch. et al., "Debt and deleveraging: The global credit bubble and its economic consequences," McKinsey Global Institute, 2010 January (http://www.mckinsey.com/mgi); Reinhart, C. and Rogoff, K., "From financial crash to debt crisis," *American Economic Review*, Vol. 101, August 2011.

[3] Roxburgh Ch., Lund S., and Piotrovski, J., Op. Cit, 2011, p. 21.

[4] EU Statistics and opinion polls (http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-21102011-AP/EN/2-21102011-AP-EN.PDF).

[5] "IMF managing director Christine Lagarde urges Russia, emerging Europe to guard against global economy risks," IMF Press Release No. 11/400, 7 November 2011 (http://www.imf.org/external/np/sec/pr/2011/pr11400.htm).

[6] "Russia may face debt crisis like Greece" (http://www.bloomberg.com/news/2011-06-23/russia-may-face-debt-crisis-like-greece-by-2030-world-bank-says.html).

[7] "Growing risks," The World Bank in Russia, Russian Economic Report, No. 26, September 2011, p. 4.

[8] Kudrin A. (2011) "Broadside to the wave," *Kommersant*, 18 November 2011.

[9] "Basic trends in the state debt policy of the Russian Federation for 2012-2014," Russian Ministry of Finance, August 2011 (http://www.minfin.ru/common/img/uploaded/library/2011/08/Dolgovaya_politika_na_sayt.pdf), p. 6.

[10] Russia will fall in a pension pit in a year (http://www.interfax.ru/business/txt.asp?id=214766).

[11] "Ageing of the general public — 2010: The Russian Federation" (http://www.standardandpoors.com/ratings/articles/ru/ru/?articleType=HTML&assetID=1245318586827).

[12] Pestova A. and Solntsev O., "Bad debts: Whom will 'a second wave' hit?" (http://expert.ru/2011/11/7/plohie-dolgi-kogo-mozhet-zahlestnut-vtoraya-volna/).

[13] Putin V.V. Speech at the ‘Russia Calling!’ VTB Capital Investment Forum 2011 6 October (http://premier.gov.ru/events/news/16653/).

Annex 1 Lowering of long-term credit ratings of some countries in 2011-2012 by Standard & Poor's

	Previous rating	Date of appropriation of the new rating	New rating
Portugal	BBB	2011 March	BBB-
Japan	AA	2011 April	AA-
USA	AAA	2011 August	AA+
Italy	A+	2011 September	A
Spain	AA	2011 October	AA-
Greece	CCC	2011 November	CC
Belgium	AA+	2011 November	AA
Hungary	BBB	2011 November	BBB-
France	AAA	2012 January	AA+
Spain	AA-	2012 January	A
Italy	A	2012 January	BB+
Portugal	BBB-	2012 January	BB
Austria	AAA	2012 January	AA+
Cyprus	BB+	2012 January	BB
Malta	A	2012 January	A-
Slovakia	A+	2012 January	A
Slovenia	AA-	2012 January	A+
Greece	CC	2012 February	SD

Source: Standard & Poor's (http://www.standardandpoors.com)

Annex 2 Share of oil and oil products in Russia's national budget revenues, % of GDP

	2005	2006	2007	2008	2009	2010
Revenues, total	39.7	39.5	39.9	38.8	35.1	35.3
Tax revenues and payments	36.5	36.1	36.2	36.2	31.0	31.7
Revenues from oil and oil products related tax and duties, including	9.2	10.0	8.1	9.7	6.0	8.3
Oil export duties	4.0	4.5	3.5	4.3	2.7	3.8
Oil import duties	0.9	1.2	1.0	1.3	0.9	1.4

Source: "Guidelines for the Tax Policy of the Russian Federation for 2012 and projections for 2013 and 2014," Russian Ministry of Finance, 2011 (http://www.minfin.ru/ru/)

Annex 3 Crude oil price forecast (US$/barrel)

	2010	2011	2012	2013	2014	2015
Average price	79.0	103.0	94.7	92.5	90.5	88.5
Brent	79.6	110.6	101.2	98.0	95.2	91.5
WTI	79.4	93.2	86.7	86.0	85.2	86.5
Dubai	78.1	105.2	96.2	93.5	91.0	87.5
Urals	78.3	108.7	99.0	95.5	92.7	89.0

Source: World Bank (http://www.worldbank.org)

Annex 4 The volume of domestic government debt, bn rubles.

At the beginning of the year	Total	In Securities	The state guarantees of the Russian Federation in rubles	The share of government guarantees in all domestic debt,%
1993	3.57	0.09	0.08	2.2
1998	490.92	451.05	3.47	0.7
2000	578.23	529.90	0.82	0.1
2008	1301.15	1248.89	46.68	3.6
2009	1499.82	1421.47	72.49	4.8
2010	2094.73	1837.17	251.36	12.0
2011	2940.39	2461.59	472.25	16.1
2012	4003.32	3546.44	459.36	11.5

Source: Russian Ministry of Finance (http://www.minfin.ru/ru/)

Annex 5 Structure of quasi- sovereign debt (bonds and syndicated loans) by economic sectors, as of 1 July 2010, %

	Domestic bonds	Eurobonds	Syndicated loans
Oil and gas production	9	55	35
Finance	29	59	12
Transport	71	15	14
Mining and metallurgy	41	42	17
Other sectors	83	0	17

Source: Arakelyan, M. and Nestmann, T., "Russia's quasi-sovereign debt. A sizeable contingent liability," Deutsche Bank Research, 2011 January No. 27, p. 5.

Annex 6 Net capital exports (-)/ imports (+) in the private sector, US$ bn

	2006	2007	2008	2009	2010	2011
Total	+41.4	+81.7	-133.9	-56.3	-35.3	-84.2
Banks	+27.5	+45.8	-56.9	-31.4	+15.9	-26.2
Non-financial entities	+13.9	+35.9	-77.0	-25.4	-51.2	-58.0

Source: Bank of Russia (http://www.cbr.ru)