Chapter 31

Eastern and Central Europe
Russian Federation

Survivors face the consequences of early excesses and crises, and display newfound discipline.

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Lessons

In the early 1990s regional and local governments in the Russian Federation borrowed heavily and short term to finance their substantial operating deficits. This rush to market occurred in a volatile macroeconomic environment, with heavy spending on subsidies and on the promise of large transfers from the central government. The essentially unregulated financial markets grew rapidly and haphazardly until the crisis of 1998. There also was some foreign borrowing as the cities of Moscow and St. Petersburg, for example, shifted to eurobond borrowings in an attempt to reduce debt service needs. However, this borrowing activity was based on a false premise that the exchange risks could be borne.

The events of 1998 showed the risks of the headlong rush into markets. Foreign borrowing was attractive with the fixed exchange rate, but the devaluation of the ruble in the wake of the

1998 financial crisis dramatically increased debt burdens. Meanwhile, massive defaults on domestic debt occurred among the more remote and dependent Russian regions and cities when they failed to receive anticipated transfers and shared tax receipts from the central government. Moscow and St. Petersburg, however, maintained their debt repayments. The federal government moved to curb local and regional borrowing, but only after recognizing that subnational borrowers were incurring unsustainable risks.

The subnational borrowing experience in Russia points to several lessons. First, foreign borrowing without adequate hedging arrangements in an uncertain macroeconomic environment is very risky and can be extremely costly. Second, centrally enforced prudential rules are needed to discipline borrowing, especially in a newly minted, exceedingly speculative, and unregulated securities market. Third, unfettered market access by subnational borrowers can outpace the development of sound revenue systems and adequate security.

Left largely to their own devices, some subnational borrowers have pulled through the crisis. One of these is St. Petersburg, whose experience shows that an integrated management strategy for domestic and external debt can minimize borrowing costs for the government and keep debt burdens low. It also shows that a debt management strategy must be anchored in a strategy for sharpening the development focus and efficiency of public spending.

For the rest of the Russian subnational sector, which lacks the wealth and sophistication of the major cities and has yet to establish a stable federal-local fiscal framework, the recovery remains slow and arduous.

Borrowing by Russian subnational governments, particularly the city of St. Petersburg, provides a case study of the risks of largely unfettered subnational borrowing in a volatile macroeconomic and political environment. In the early 1990s, facing fiscal imbalances stemming from low and uncertain revenues, a large share of spending on subsidies, and the use of noncash instruments in budget execution, many regional and local governments began to rely heavily on short-term borrowing to finance their spending. As a result, subnational governments, including St. Petersburg, acquired a large share of short-term debt between 1993 and 1996. Regulation of local and regional government debt was erratic and politically influenced, and the regional securities markets springing up were characterized as belonging to the "Wild West." Even in the face of high interest rates, virtually every Russian region and major city was selling bonds in the new and untested markets in a headlong rush to secure cash.

In 1997, as part of a comprehensive plan to improve its financial management, St. Petersburg sought to reduce its debt burden by opting for lower-cost external borrowings from the eurobond market and the European Bank for Reconstruction and Development (EBRD), essentially as a swap for its high-cost domestic borrowings. The city undertook this strategy in an environment of fixed exchange rates. With the 1998 devaluation, however, the city was left with a burden of high-cost external debt. Meanwhile, scores of regional and municipal borrowers, dependent on federal payments that stopped coming, simply defaulted on their domestic debt. Since 1998 St. Petersburg has reduced its debt stock and lowered its borrowing costs through prudent management of its budget and a growing economy that has helped generate greater revenues and budget surpluses. The experience in the Russian Federation has shown the challenges of subnational borrowing in the face of changing rules, market uncertainty, and a volatile macroeconomic environment.

Macroeconomic Context

The Russian Federation, with a population of about 146 million, covers a vast land area almost twice the size of Canada, the next largest country. The federation has 89 subjects—oblasts, republics, krays, autonomous okrugs, and the major cities of Moscow and St. Petersburg. These units vary in description, reflecting differences in the degree of autonomy and the ethnic mix of populations. They form the second tier of government and are referred to generally as regions. (A third tier, the local level of govern-

ment, is made up of the subdivisions of the regions, municipalities, and districts in urban areas and of the rayons in rural areas.) The regions differ widely in climate, ethnic makeup, population density, natural endowments, and economic base.

Although the administrative system inherited from the former Soviet Union is formally a federation, formal relations between levels of government have been effectively based on a highly centralized, one-party, unitary government. Fiscal federalism has developed since independence, however, with important effects on fiscal management. Early efforts at devolution during the transition proved to be much more form than substance, with fiscal autonomy heavily constrained by central government controls over spending norms and the setting of levels of service, rents, prices, and salaries. Tax collection remained decentralized, but tax-sharing arrangements were established by the central government, subject to negotiation, and nontransparent. A study of the Russian Federation's fiscal system in the mid-1990s indicated that its "features render the system of local governance nontransparent and question the degree of accountability of regional and local governments" (Craig, Norregaard, and Tsibouris 1997, p. 698).

The macroeconomic environment in Russia was also marked by volatility and uncertainty. The Russian government started implementing a series of economic reforms in 1992 to stabilize the economy and spur growth. By 1997 some elements of stabilization were becoming noticeable as annual inflation fell to around 11 percent, the current account balance showed a surplus equivalent to about 0.5 percent of GDP, and GDP growth turned positive for the first time since the beginning of the transition.

Fiscal adjustment, however, lagged during this period. Even with tight monetary policies and a stable exchange rate (used as a nominal anchor during stabilization), the federal budget deficits remained at 7 to 10 percent of GDP in the second half of the 1990s. The governments started to rely heavily on domestic and external borrowing to fill the budget gap and turned increasingly to accumulation of arrears and massive use of barter and noncash offsets. Estimates suggest that these implicit subsidies reached a size of up to 10 percent of GDP (Pinto, Drebenstov, and Morozov 2000). Moreover, as the global slowdown that started in 1997 gathered steam, petroleum prices, a key factor in government revenues, began to drop with the decline in international demand for oil.

The combination of a tight monetary policy, a loose fiscal policy, a fixed exchange rate regime, and excessive public borrowing—all in a climate of intense currency speculation—led to the macroeconomic and financial cri-

sis of August 1998. The national government defaulted on most of its domestic obligations and was forced to abandon the pegged exchange rate regime. The crisis led to a sharp real depreciation of the ruble, a major banking crisis, a subsequent drop in GDP of 4.9 percent, and a rise in inflation to 84 percent.

Since the disastrous events of 1998 the Russian economy has strengthened. Indeed, as petroleum prices have recovered and the devalued ruble has improved the economy's competitive position in world markets, Russia has emerged as one of the world's fastest growing economies. Real GDP, after falling by more than 50 percent in 1991–98, grew by 5.4 percent in 1999, 8.3 percent in 2000, and 5.0 percent in 2001. Four major factors have helped support the renewed growth: the significant real depreciation following the 1998 crisis, the oil and gas price boom that began in the second quarter of 1999, the reduced crowding out of the private sector resulting from the elimination of the government's market borrowings, and the low real prices for domestic energy.

Average inflation declined from a postcrisis peak of 86 percent in 1999 to about 20 percent in 2001. At the same time external liquidity has improved with substantial growth in the current account surplus—which increased from $1 billion (0.3 percent of GDP) in 1998 to $34 billion (11 percent of GDP) in 2001—driven largely by the export windfall resulting from higher international energy prices. This has allowed the accumulation of gross foreign exchange reserves, up from $12 billion in 1998 to about $37 billion by the end of 2001. However, the growth of the surplus has put upward pressure on the real exchange rate. Real appreciation of about 20 percent in 1999–2001 partly offset the gains from the 1998 devaluation.

The fiscal position also has been strengthened by higher tax revenues and expenditure restraint. Federal revenues increased from 13.5 percent of GDP in 1999 to about 18 percent in 2001. During the same period the primary surplus improved from 2.2 percent of GDP to 4.9 percent. An overall budget surplus was achieved for the first time in 2000 at 1.2 percent of GDP and was estimated at 2.4 percent of GDP in 2001. Moreover, all federal budget revenues raised since early 1999 have been in cash. The ratio of public debt to GDP fell sharply—from 138 percent in 1998 to 52 percent in 2001—as a result of strong growth, appreciation of the ruble, the repayment of debt, the erosion of domestic debt by inflation, and a write-off of $10.6 billion in debt under a London Club restructuring agreement.

Greater liquidity and better fiscal management have led to a significant reduction in noncash offsets on payments to budgets and in noncash

transactions between enterprises. The share of barter transactions declined from 30 percent of all transactions in 1999 to 22 percent in 2001. There also are signs that noncash execution of subnational budgets declined drastically, from about 50 percent of budget revenue in 1998 to about 6 percent in 2000. However, while extrabudgetary funds and overdue payables to suppliers and the budget have been reduced in real terms, they continue to represent a significant source of vulnerability for the economy. These liabilities amounted to 22.2 percent of GDP in 2000.

The macroeconomic improvements have taken place in the context of an improving system of intergovernmental finance and stronger incentives for regional fiscal management. Legislative and administrative initiatives have sought to move fiscal federalism away from a system based on bargaining and special arrangements to one based on rules. These initiatives include tax code reforms, a new local budget code, uniform rates of tax sharing between the center and regions for all major taxes, clarification of expenditure obligations with some reduction in unfunded mandates, the introduction of competitive intergovernmental transfers, and a general tightening of budgetary discipline at the federal level.

Early Adventures in Subnational Borrowing

One casualty of the 1998 crisis and devaluation was the subnational bond market that had sprung up as part of the "shock" movement toward political devolution and a market-based economy. In the wake of the crisis and the defaults of the federal government, nearly all domestically held municipal bonds plunged into default, ending what had been a wild ride to the credit markets by many subnational borrowers.

The early market had been dominated by regional governments (oblasts), which not only were the larger subnational units but also enjoyed federal tax exemption. Regional governments started issuing bonds in 1992 (despite high inflation), and by 1997 most were using borrowed resources.[1] Several types of bonds quickly emerged, including bonds much like the federal government's treasury bills, or GKOs (short-term zero-coupon notes used primarily to cover operating deficits), housing bonds (essentially used to sell off publicly owned housing), and arbitrage bonds (which allowed governments to borrow and invest proceeds in the high-yielding federal bonds). Much of the borrowing of the era, all of which was short term, was undertaken to cover operating deficits or invest in higher-yielding assets. Little of the borrowing was done to finance capital projects.

The municipal bond market in Russia started up virtually free of any meaningful central regulation, and governments began issuing bonds under a number of laws. The tax-exempt status and what some saw as an implied federal guarantee soon became an issue for the federal authorities. The Ministry of Finance in 1995 attempted to deny tax-exempt status to all subnational bonds but relented for the regions. Requests for tax exemption subsequently were handled on a case-by-case basis.

From the outset it was clear that the fiscal capabilities of subnational borrowers varied enormously. Moscow, a relatively well-off government that ran surpluses, did not borrow until relatively late, and then only sparingly. In contrast, St. Petersburg was an avid issuer that used the proceeds of its borrowing to cover operating deficits.[2] Both cities also borrowed in the international markets in 1996.[3] Meanwhile, smaller regions and cities sold a rapidly swelling volume of bonds on the many regional stock exchanges that had sprung up overnight. In 1992–95 the Russian Ministry of Finance registered some 43 subnational bond issues. In 1997 alone some 309 issues were registered for local exchanges and another 3 were destined for the euro markets, totaling more than $5 billion in value (Tchepournykh and Simonsen 1999). These bonds, usually with maturities of a year or less and yielding as much as 95 percent in interest by mid-1998, were seen as entailing significant credit risks. It was a prediction they did not fail to fulfill when the August 1998 crisis and devaluation struck.[4]

The ensuing collapse of the subnational bond market was by no means unexpected. The World Bank, noting the lack of effective central oversight, had cautioned in a 1996 report:

> The legal framework for subnational borrowing in Russia is more permissive than in many countries. Although significant problems have not yet arisen, there is a real possibility of uncontrolled borrowing for the wrong purposes, including financing operating deficits, propping up local enterprises, and investing in activities best left to the private sector (World Bank 1996, p. 42).

There was a precipitous slide in bond ratings, reflecting the crash in the credit of subnational borrowers (table 31.1). Only a few subnational borrowers had received international credit ratings before the crisis of 1998. In late 1997 all Standard & Poor's ratings of subnational governments were speculative (in the BB category) but not overwhelmingly so. How the cities and regions responded to the financial crisis had an effect on their ratings.

Moscow and St. Petersburg were put on the "pending default" list (CCC category) at the outset of the crisis, but they managed to pull out of the nose-

Table 31.1. Standard & Poor's Credit Ratings of Subnational Borrowers, Russian Federation, 1997–2002

Borrower	December 1997	June 1998	August 1998	December 1999	January 2002
Moscow	NR	BB–	B–	CCC–	B+
St. Petersburg	BB–	B+	B–	CCC–	B+
Novograd	BB–	B+	CCC	SD	NR
Samara	BB–	B+	CCC	SD	B
Sverdlovsk	BB–	B+	CCC–	CCC	CCC+
Tartarstan	BB–	B+	CCC–	SD	CCC+
Yamal-Nenets	NR	BB–	B–	CCC–	CCC+
Irkutsk	NR	B+	CCC	CCC–	CCC+

Note: The table shows the foreign currency ratings for approximately the dates shown. NR indicates that the issuer is not rated. BB is a speculative grade just below the lowest investment grade (BBB). B is highly speculative, and CCC indicates pending default. Plus and minus signs indicate where the credit falls within each rating band. SD is selective default.

Source: Standard & Poor's, various issues.

dive by continuing to honor their contracted debts. Other Russian cities and provinces went into selective default (SD), but one of these (Samara) later managed to restore its rating. Overall, however, the early batch of credit ratings had clearly overvalued the creditworthiness of Russian subnational borrowers. Only a few could muster internationally acceptable credits, and in early 2002 none was considered investment grade, though Moscow and St. Petersburg managed to keep their ratings above pending or selective default.

After the municipal and regional defaults of 1998, Russia disallowed subnational borrowing from abroad except in limited circumstances for refinancing outstanding debt. Debt service is generally limited to 15 percent of operating expenditures, and subnational borrowing is restricted to capital investment. In addition, municipally owned banks are prohibited, and the federal government does not guarantee local bonds (World Bank 2001). Russian localities continue to rely heavily on shared taxes (for about 50 percent of revenue) and transfer payments (30 percent), with own-source revenues accounting for around 20 percent of revenue. The subnational governments in the more rural and remote regions of the federation depend even more on central transfers and shared taxes.

A Survivor: The City of St. Petersburg

St. Petersburg was one of the few survivors of the carnage in the subnational bond market. It is the second largest metropolis in Russia (after Moscow),

with a population of about 4.6 million. St. Petersburg and Moscow are the only two Russian cities that are also subjects of the federation, giving them the status of regions. As a result of this status, St. Petersburg has some political and fiscal characteristics that differ from those of other municipalities. The city has more powers to enact legislation on economic issues and budgets than do third-tier municipalities. It also enjoys greater fiscal autonomy, since it is only dependent on changes in federal tax legislation (unlike the municipalities that are subject to regional laws) and is allowed to levy higher tax rates than other municipalities.

The center of gravity for all of northwest Russia, St. Petersburg is considered the unofficial second capital of the country. It is one of the most advanced regions of Russia, accounting for about 3.2 percent of the country's GDP and 2.7 percent of its industrial production. In 2000 St. Petersburg's gross regional product amounted to 232.8 billion rubles (Rb), about $8 billion. The economy's strengths lie in its food processing industry; high-technology machine building and shipbuilding; and transport, financial, and telecommunications services. St. Petersburg is a global tourist attraction and an important center of education, health care, and fundamental research. It is also the second largest financial center in Russia (after Moscow), and its stock exchange is the leading subnational bond market.

During the past decade of transition to a market economy, the city experienced a dramatic decline in industrial output. The collapse in output was more pronounced than that for the Russian economy as a whole, because the city does not have developed oil, gas, and metallurgy sectors, which helped offset the fall in output in other parts of the country.[5] However, the city's growth pattern mirrored that of Russia—with growth declining until 1996, slightly positive in 1997, dropping in 1998, and then recovering in 1999–2001. The city's recovery has been stronger than the national average, with the gross regional product growing by 6.8 percent in 1999 and 10 percent in 2000, thanks to the import substitution effect following the 1998 devaluation. Major engines of economic recovery have been the chemical and petrochemical industry, food processing, and machine building and metal processing. The city's share of the foreign investment in Russia grew from 5.3 percent in 1995 to 11 percent in 2000, when it amounted to $1.14 billion.

The city ran budget deficits until 2000, when a surplus of 4.1 percent of budget revenue allowed it to repurchase part of its eurobonds. Another surplus of about 2.4 percent of budget revenue was expected in 2001. The city made substantial efforts to phase out noncash budget execution, and the

noncash share of its own budget revenue fell from 17.4 percent in 1997 to 4.7 percent in 2000. Unlike many other regions, St. Petersburg has no wage arrears in its budget.

Trends in City Borrowing

St. Petersburg started borrowing domestically in 1994 to cover its budget deficit. Its leading creditors during this period were commercial banks, which provided financing through loans and purchases of city government bonds. The city's domestic borrowings increased rapidly, from Rb 212.5 million in 1994 to Rb 3,298.5 million in 1996 (table 31.2). A growing share of the portfolio was in short-term commercial bank loans and short-term municipal bonds (with average maturities of less than five months). These rose to 90 percent of total debt in 1996 (loans were about 30 percent of total debt, and short-term bonds about 60 percent). During this time external borrowing became attractive as a result of the longer maturities provided by foreign loans, the high domestic and low international interest rates, and the low perceived exchange rate risk (due to a fixed exchange rate with the U.S. dollar).

In 1997 the city decided to lengthen the maturity of its debt, diversify its financial risks, and refinance its high-cost short-term domestic commercial bank loans and short-term municipal bonds through a five-year eurobond placement of $300 million. In 1998 the city took out a $100 million credit line from the European Bank for Reconstruction and Development (of which $40 million was drawn in 1998), whose ruble proceeds would also be used to reduce domestic debt. As a result, the share of foreign currency borrowings jumped from 1 percent at the beginning of 1997 to 45 percent at the beginning of 1998 (table 31.3).

Circumstances changed dramatically in 1998 with the unfolding of the Russian financial crisis and the sharp devaluation of the ruble. St. Petersburg had no cover for foreign currency risks (such as through hedging operations or own sources of foreign exchange earnings), and the devaluation caused a sharp increase in the ruble amount of its foreign currency debt and in its debt service expenditures (table 31.4). The city continued to pay its creditors on time and in full, even as many other Russian regions defaulted on their obligations, but the debt service imposed a heavy burden on the city's finances.

Since then, improved public finances have allowed the city to reduce its debt burden and refrain from new borrowing. Both the level and the composition of its debt stock have changed substantially. Foreign debt fell from a peak

Table 31.2. Debt by Type, St. Petersburg, 1994–2001 (millions of rubles)

Type of debt	1994	1995	1996	1997	1998	1999	2000	2001
Domestic debt	212.5	1,275	3,298.5	2,352	1,692.1	1,579.2	3,089.7	5,091.4
Bank loans	109.4	414.0	993.8	71.0	262.2	71.1	0	—
Other loans	78.4	0.4	0.4	0	0	0	0	—
Bank veksels	0	77.0	19.9	0	0	0	0	—
CoF veksels	0	95.0	307.6	79.1	0.2	0.2	0.2	—
Municipal bonds	0	647.4	1,976.4	2,165	1,417.8	1,391.5	2,636.8	—
Other	24.7	41.3	0.4	37.8	11.9	0	0	—
Ruble guarantees	0	0	0	0	0	116.4	452.7	—
Foreign debt	0	0	24.0	1,951.5	7,683.3	13,227.8	9,488.4	6,794.3
Eurobonds	0	0	0	1,776.2	5,521.5	8,016.0	6,117.2	—
Loans from international financial institutions	0	0	0	130.4	2,063.7	2,167	2,398.2	—
Loans	0	0	24.0	44.9	98.1	0	0	—
Currency guarantees	0	0	0	0	3,044.8	973	—	
Total debt	212.5	1,275.1	3,322.5	4,303.9	9,375.4	14,807.0	12,578.1	11,885.7

— Not available.

Note: Data for 2001 are not broken down by type of debt instrument.

Sources: St. Petersburg Committee of Finance; World Bank staff estimates.

Table 31.3. Structure of Debt, St. Petersburg, 1994–2001 (percentage of total debt)

Type of debt	1994	1995	1996	1997	1998	1999	2000	2001
Domestic debt	100.0	100.0	99.3	54.7	18.0	10.7	24.6	42.8
Bank loans	51.5	32.5	29.9	1.6	2.8	0.5	0	—
Other loans	36.9	0	0	0	0	0	0	—
Bank veksels	0	6.0	0.6	0	0	0	0	—
CoF veksels	0	7.5	9.3	1.8	0	0	0	—
Municipal bonds	0	50.8	59.5	50.3	15.1	9.4	21.0	—
Other	11.6	3.2		0.9	0.1	0	0	—
Ruble guarantees	0	0	0	0	0	0.8	3.6	—
Foreign debt	0	0	0.7	45.3	82.0	89.3	75.4	57.2
Eurobonds	0	0	0	41.3	58.9	54.1	48.6	—
Loans from international financial institutions	0	0	0	3.0	22.0	14.6	19.1	—
Loans	0	0	0.7	1.0	1.0	0	0	—
Currency guarantees	0	0	0	0	0	20.6	7.7	—
Total debt	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

— Not available.

Note: Data for 2001 are not broken down by type of debt instrument.

Source: Table 31.2.

Table 31.4. Debt Indicators, St. Petersburg, 1997–2001 (percent, except where otherwise indicated)

Indicator	Limits set by federal law	1997	1998	1999	2000	2001
Total debt (millions of rubles)		4,303.9	9,375.4	14,807.0	12,578.1	11,885.7
Debt/budget revenue	100	29.15	54.93	56.80	33.46	24.00
Debt service/budget expenditure	15	—	7.8	7.9	8.5	4.1
New borrowings/budget revenue	30	18.02	12.49	12.68	16.72	8.80
Debt/gross regional product		5.68	10.44	9.57	5.40	—
Foreign debt/total debt		45.3	82.0	89.3	75.4	57.2
Short-term debt/total debt		33.35	24.37	13.45	15.50	51.12
Average yield of open market bonds, year-end		33.27	77.12	50.7	30.98	19.65
Average duration of open market bonds (days)		325	168	305	620	796

— Not available.
Sources: St. Petersburg Committee of Finance; AVK Securities and Finance; World Bank staff estimates.

of 89 percent of the total at the beginning of 2000 to only 75.4 percent at the end of that year, with eurobonds accounting for 48.6 percent of the total.

Instruments for Domestic Borrowing. The city has used several instruments for domestic borrowing, including the following:

- *Open market bonds.* Among Russian regions, St. Petersburg is the largest issuer of open market bonds, city bonds of variable maturity that are placed on the open market and traded. Secondary trading is also permitted. The St. Petersburg bond market is among the most liquid in the Russian financial market. Different market and design options are available for trading in open market bonds, including forward contracts, repurchase operations, fixed coupon bonds, and floating coupon bonds. At the end of 2001 the city's outstanding open market bonds totaled Rb 5 billion.
- *Savings bonds.* One- to five-year bonds issued since 1999, savings bonds are targeted to both individual and institutional investors. Effective demand for such bonds has been low. At the end of 2000 the city's outstanding savings bonds amounted to Rb 70 million.
- *Special-purpose bonds.* Introduced in 1999, special-purpose bonds were provided to city enterprises as a means of offsetting their tax arrears

to the city. Holders of such bonds used them to settle two-month arrears due to the city budget for certain taxes.[6] These bonds have not been used since 2001, since all city budget revenue is now raised in cash. At the end of 2000 the city's outstanding special-purpose bonds totaled Rb 102 million.

- *Commercial bank loans*. A significant instrument in the early years, bank loans are now used by the city administration only to support short-term cash management needs.

Instruments for Foreign Borrowing. The city uses three types of instruments for foreign borrowing—commercial bank loans, eurobond issues, and borrowings from international financial institutions.

- *Commercial banks*. Commercial banks were the first source of external borrowing for the city. It borrowed $10 million under a 1995 loan agreement with the German Dresdner Bank, repaying the loan in December 1999. In 2001 the city negotiated a $35.9 million syndicated loan from a consortium of Italian banks, guaranteed by the federal budget, for repairing damage to the subway.
- *Eurobonds*. The eurobonds issued in 1997 make up the largest part of St. Petersburg's foreign currency debt. On 18 June 1997 the city placed its first issue of $300 million, with a maturity of five years and a coupon rate of 9.5 percent—a spread of 312 points over the benchmark U.S. treasury bond. The lead manager for the issue was Salomon Brothers International. With the 1998 financial crisis, the spreads rose to 800 basis points. Recent spreads have been much smaller, at about 300 basis points over the benchmark U.S. bond, but are still close to precrisis levels. In 2000 the city started a buyout of these bonds from its own budget proceeds. At the end of 2001 the outstanding amount was estimated to be about $108 million, due in June 2002.
- *International financial institutions*. The city has received several loans from the European Bank for Reconstruction and Development and the World Bank. The $100 million EBRD loan in 1997, to support the city's creditworthiness enhancement program, financed the redemption of short-term municipal bonds. The loan is only partially disbursed—the city received the first installment ($30 million) in August 1998 and the second ($10 million) in November 1998. This five-year loan carries a floating interest rate.[7] In November 2001 the city

signed an agreement with the bank converting $16 million of the loan into rubles. Borrowings from the World Bank have been for two projects—the Russian Federation's 1995 Housing Project, under which a subloan of $33.5 million was made to the city, and the 1997 City Center Reconstruction Project, involving a loan of $30 million. Disbursements under these loans totaled about $50 million by the end of 2001.

Structure of the St. Petersburg Bond Market. The St. Petersburg bond market involves the following participants:

- *Issuer:* the Committee of Finance of the St. Petersburg administration.
- *General agent:* an authorized financial institution—AVK Securities and Finance—acting as the market on account of, and on behalf of, the issuer.
- *Exchanges:* authorized institutions acting as the trading, registration, and clearing system for the primary and secondary markets and for repayment. There are two exchanges in St. Petersburg—the currency exchange and the stock exchange.
- *Settlement depository:* an authorized institution—the St. Petersburg Settlement Depository Center—carrying out a centralized accounting of operations with bonds and performing depository services.
- *Settlement center:* an authorized credit organization—the St. Petersburg Settlement Center—providing settlement services for bond transactions.
- *Depository deponents:* professional securities firms providing depository services for market participants.
- *Bond dealers:* professional securities market dealers providing services to investors. At the end of 2001 the city had 34 bond dealers, representing most of the biggest banks and financial companies operating in Russia.
- *Investors:* corporate and private clients investing in bonds.

Credit Ratings. The three major international credit rating agencies—Fitch Ratings, Moody's, and Standard & Poor's—rate the city's foreign currency debt. Credit ratings have improved in recent years, reflecting in part the improvement in sovereign ratings (table 31.5). In 1999 St. Petersburg became the first Russian region to receive a local currency rating from Standard & Poor's and Fitch Ratings.

Table 31.5. Credit Ratings, St. Petersburg, 1998–2002

	Fitch Ratings		Moody's Investors Service		Standard & Poor's	
Date	Foreign currency	Local currency	Foreign currency	Local currency	Foreign currency	Local currency
1 January 1998[a]	BB+	NR	B1	NR	BB–	NR
1 January 1999	CCC	NR	Caa1	NR	CCC–	NR
1 January 2000	CCC	CCC	Caa1	NR	CCC	CCC
1 January 2001	CCC+	CCC+	B3	NR	B–	B–
1 January 2002	NR	NR	NR	NR	B+	NR

Note: For an explanation of the ratings and other abbreviations, see table 31.1.
a. First-time rating.
Source: Credit rating agency reports.

Experience with Guarantees. St. Petersburg uses guarantees mostly for loans for commercial investment projects. Before 1997 it used guarantees for funding deferred investment. But since then it has issued them for concrete investment projects with business plans. The city has declared principles for the selection of borrowers: the borrower must have sustainable finance and no tax arrears and must provide 100 percent liquid collateral. In practice, however, the city also provides guarantees to commercially nonviable but socially important projects, such as a hospital and a research institute.

Executed guarantees amounted to Rb 258.6 million (1.5 percent of total expenditure) in 1998, Rb 2,023 million (7.7 percent) in 1999, and Rb 2,027 million (5.7 percent) in 2000. According to the city Committee of Finance, the guarantees issued in these years were concentrated in utilities, transport, construction, and the food industry. Few city-provided guarantees have been called, and the amount of outstanding guarantees has fallen, declining from Rb 3.2 billion (21.3 percent of total city debt) on 1 January 2000 to Rb 1.4 billion (11.3 percent) on 1 January 2001.

Legal Framework for Subnational Borrowing

In the Russian Federation, as in most other transitioning economies with a federal structure, federal legislation sets out the basic principles for debt management by St. Petersburg, limits the volume of new issues, and outlines some qualitative parameters for debt, such as the possible types and purposes of borrowings. The main federal laws that define these rules are the Budget Code of the Russian Federation, the Law on Budget Accounting

and Standards, and the Law on Terms of Issue and Turnover of State and Municipal Securities. Uniform standards for debt accounting form a core element of the federal legislation.

The Budget Code of the Russian Federation defines debt obligations as including loan agreements and contracts, government securities, and government guarantee agreements. Before the adoption of the Budget Code in 1999, the government guarantee agreements were not included in the city's debt. The federal legislation requires that the accounting of foreign debt in local currency be carried out at the current exchange rate (the exchange rate at the date of valuation). It also requires that the regional budget law list domestic and foreign borrowings (and guarantees) for the corresponding financial year. All borrowing proceeds and debt repayments are reflected in the budget.

The federal legislation is complemented by the annual St. Petersburg budget law, which establishes the borrowing program for the year and provides information on debt operations for policymakers. The city's budget—along with the federal legislation—establishes constraints on budgetary expenditures:

- The ratio of debt outstanding to revenues (excluding transfers) is limited to 100 percent.
- Debt service expenditures may not exceed 15 percent of total budgetary expenditures.
- The budget deficit may not exceed 15 percent of budget revenues, excluding transfers from the federal budget.
- Borrowing may be used only to finance investment expenditures; current expenditures may not exceed revenues.
- Foreign borrowing is permissible only to refinance maturing external loans.
- The annual budget must specify limits on the amount of budget guarantees outstanding for the year.

These prudential limits are an attempt by the federal government to prevent regional governments from developing large deficits or building up unmanageable debt burdens. Some of these limits, such as those on external borrowing, may limit access to new investment finance and may need to be relaxed as the national debt burden declines. The legal framework for debt management appears to be broadly satisfactory for monitoring purposes and provides for integrated debt management. In time, however, it

will need to be strengthened to allow more sophisticated risk management, such as for contingent liabilities arising from financial transactions of city-owned enterprises.

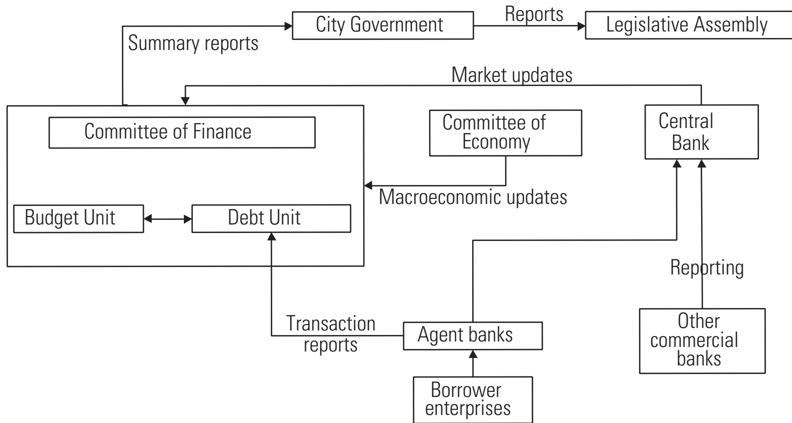
Institutional Framework for Subnational Borrowing

Management of St. Petersburg's debt is centralized in the Committee of Finance, which formulates the debt strategy, provides systemic portfolio analysis and decision support, and handles investor relations and public disclosure. A special unit is responsible for debt management. This debt unit is led by the deputy head of the Committee of Finance, who reports directly to the head of the committee (figure 31.1).

Debt Management Strategy. The city has a medium-term debt management strategy covering all domestic and external debts that it contracts as well as guarantees, also treated as debt. The debt management strategy has evolved with economic circumstances and now includes policy for the long-term development of domestic capital markets and a notion of risk exposure. The current strategy emphasizes:

- Minimizing the cost of financial resources to the city budget through integrated debt management and improvement of the city's credit rating.
- Reducing exposure to foreign currency risk by extending the maturity structure of foreign debt, lowering the cost of foreign borrowing, and reducing the share of foreign currency debt.
- Lessening the burden of domestic borrowings by extending the maturity of domestic bonds and reducing yields.
- Ensuring the effective use of guarantees to promote capital investment.

The debt unit of the Committee of Finance supports the implementation of this strategy through debt analysis and risk assessment. It issues periodic reports and makes them publicly available; it also makes information available on the Committee of Finance Web site. The unit actively manages risk, although its ability to do so is now limited as the repurchase of eurobonds and domestic municipal bonds reduces the share of marketable instruments in St. Petersburg's public and publicly guaranteed debt portfolio. The debt unit uses quantitative benchmarks to measure and limit specific risks and, importantly, consolidates data on external and domestic debt to create a comprehensive view of the public debt portfolio.



Source: St. Petersburg Committee of Finance.

Figure 31.1. Administrative Structure for Executing the Debt Strategy, St. Petersburg

The city has been successful in recent years in implementing its debt strategy. The amount of debt outstanding has declined (see table 31.2), average borrowing costs have fallen, the maturity structure of loans has been extended, and the portfolio is more diversified. In addition, the debt service burden has lessened. Diversification has been achieved primarily through domestic issues of open market bonds of variable maturity (including long-term coupons of 5 to 30 years) and the issue of new instruments such as savings bonds and special-purpose bonds. The city also repaid one of its foreign currency loans from Dresdner Bank early, in 1999, and repurchased about $190 million in eurobonds. The extension of the maturity structure has been facilitated by the long-term borrowings from the World Bank. The city undertakes medium-term debt sustainability and economic forecasts that are adequate for its current needs.

While the debt strategy has been effectively implemented, it does not capture hidden debt, such as that of unitary enterprises, and this may cause problems with the expected restructuring of these enterprises. Addressing this issue would be a welcome move toward developing an asset and liability management approach to debt.

Information and Disclosure. Disclosure of information on the public debt portfolio of St. Petersburg is complete and timely. The Committee of Fi-

nance publishes information on total debt monthly on its Web site and in the local press. It also publishes detailed annual debt management reviews. Market prices of open market bonds are published daily in information bulletins issued by the general agent, on the agent's Web site, on electronic trading sites, in local newspapers, on business Web sites, and by information agencies such as Bloomberg and Reuters. The transparency in disclosure has been a critical element in the city's progress toward creditworthiness.

From Crisis toward Recovery

The unfettered market access of subnational governments contributed to the speculative bubble in Russian financial markets that burst in 1998. Only a few survivors emerged from the wreckage of widespread defaults—most important, the great cities of Moscow and St. Petersburg. The past five years have been a period of disciplined recovery for the survivors of the great crash.

St. Petersburg has followed a strenuous fiscal path. In the early years of the transition the city borrowed short term to finance structural budget deficits in a volatile macroeconomic environment and with heavy subsidy spending. As this strategy became clearly unsustainable, the city shifted to using eurobonds and EBRD borrowings to reduce its debt service needs. As it phased out subsidies and strengthened budget and cash management, the city hoped to improve its liquidity and its creditworthiness. However, while foreign borrowing was attractive with the fixed exchange rate, the devaluation of the ruble in the wake of the 1998 financial crisis strained the city's fiscal accounts. The city maintained its debt repayments in the face of the shock and worked to develop an integrated debt management strategy. At the same time it sought to restructure its expenditures by expanding its investments in human and physical capital.

The experience of St. Petersburg teaches several lessons:

- Foreign borrowing without adequate hedging arrangements in an uncertain macroeconomic environment is very risky.
- Prudential rules for borrowing can help discipline borrowing.
- A diversified borrowing strategy helps mitigate risk.
- An integrated management strategy for domestic and external debt provides the best means to minimize borrowing costs for the government and keep debt burdens low.

- A debt management strategy must be anchored in a strategy for sharpening the development focus and efficiency of public spending.

St. Petersburg and Moscow, borrowers with ample resources and sophistication, have been able to retain access to the markets. However, the fate of other Russian subnational borrowers remains precarious. Future subnational borrowing will depend on a reliable intergovernmental revenue system and stronger own-revenue systems.

Notes

1. It was estimated that these "municipal bonds" represented about 3 to 4 percent of all market debt outstanding in the Russian Federation in 1997.
2. Together, Moscow and St. Petersburg represented 68 percent of the bonds outstanding in 1997.
3. Moscow borrowed $500 million in the euro market and was rated Ba2 by Moody's and BB– by Standard & Poor's. St. Petersburg borrowed $300 million and was rated Ba3 and BB–. The ratings were capped by the Russian Federation's rating of Ba2.
4. Expected transfers backed most of the borrowings from the central government. When these payments failed to materialize, borrowers quickly defaulted on the bonds.
5. In 2000 industrial production in St. Petersburg was about 42 percent of the level in 1991, while that in Russia was about 62 percent of the 1991 level.
6. These taxes were the land tax, profit tax, transport tax, property tax, educational institutions tax, housing and social infrastructure tax, and tax for law enforcement activity.
7. Originally the interest rate varied with changes in the London interbank offered rate (LIBOR) and the spread of Russian Federation bonds. With the 1998 crisis, the debt service on the EBRD loan became onerous, and the terms of interest calculation were renegotiated in 1999. Under the new terms the rate is LIBOR plus a fixed margin, and the margin can be reduced by meeting certain targets for financial management performance and improvements in credit ratings. The new terms have reduced debt service expenditures and the risk of interest rate fluctuations. The loan is being repaid in semiannual installments.