Economic and Market Analysis, London EC473
Niclas Sundstrom +44 20 7986 3296
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Russia And External Debt In 2002:
Improving Debt Indicators, More Sovereign Eurobonds – And Corporate Eurobonds In Focus

This note summarizes the recent evolution and the outlook for Russia's overall external debt burden. Against this background, we also outline the main potential issuance patterns in 2002 with regards to Russia and international financial markets, specifically the Eurobond market. In this discussion, special attention is paid to the growing focus on Russian corporate Eurobond issuance.

- **Russia's overall debt burden is set to notably improve further during the course of 2002**. By the end of 2002, sovereign external debt is expected to decrease to some 39% of GDP, from 58% in 2000 and 81% in 1999. Total debt (external and domestic) will fall to no more than 45%, from 66% in 2000 and 93% in 1999. At the same time, the stock of sovereign Eurobonds will most likely increase by up to USD 5 bn in 2002, due to a potential new sovereign Eurobond issue and pending Soviet-era debt exchanges.

- **Russian-related Eurobond issuance in 2002 will be dominated by two aspects. First, 2002 could see the Russian Federation re-enter international financial markets with a full-fledged new issue, 5-10 year, Eurobond of up to USD 2 bn, an event likely to be positively greeted by the markets. Second, having re-started last year, a main focus this year will be an increasing tapping of the international bond markets by Russian corporates and banks.**

- **From the investor perspective, the entering/re-entering of Russian corporates/banks to the Eurobond market after several years of absence is likely to draw quite some interest**. **Selectivity will be a guiding principle, as the list of potential issuer is growing**. A larger universe of Russian corporate Eurobonds would offer credit diversity and yield enhancement to sovereign Russia instruments. An estimated total of potential 2002 Russian corporate/bank Eurobond issuance could amount to around USD 2 bn.

- **Russia's pursuit of debt management reforms might also receive a boost from the increase in corporate Eurobond activity in 2002**. The ambitious program for a new debt management system, worked out by the Ministry of Finance mainly and including establishing monitoring systems/evaluation methodology for Russian sub- and non-sovereign external debt, could elicit more momentum with the reality of a full return of Russian entities to international capital markets.

- **A key, enabling background for the entering/re-entering of Russian corporates to the Eurobond market is the positive dynamics of the Russian economy, the broadening of economic growth, and the ambitious pursuit of structural and institutional reforms by the Russian government**. With the centerpiece of the Russian government's economic strategy being an improvement in the investment climate, a modernizing, restructuring and changing Russian corporate sector will further underpin the interest in these capital market developments.

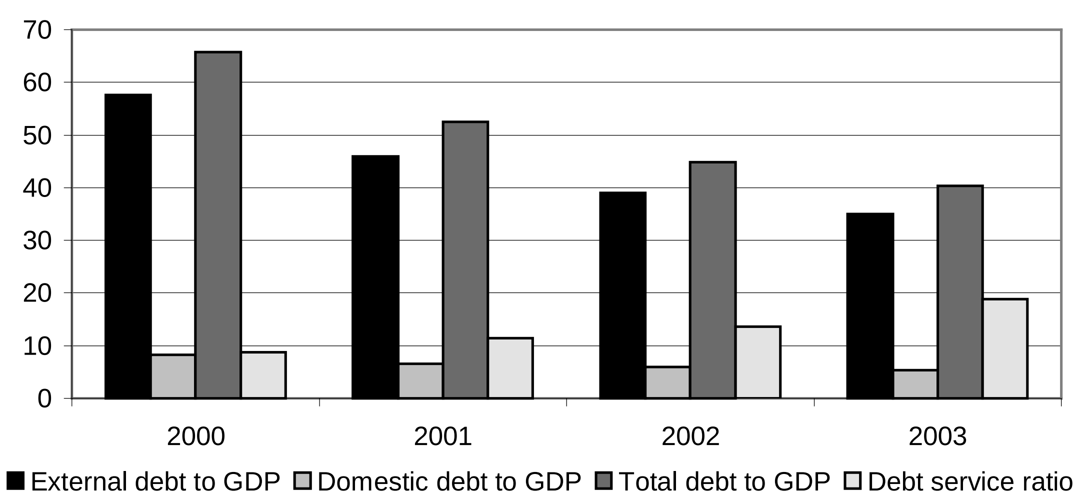
1. Russia's debt indicators

The graph below outlines the evolution of Russia's overall debt indicators over the last years, and how we expect them to evolve over the next couple of years. In 2002, mainly due to the expected conclusion of two pending debt exchanges (the FTO and IIB/IBEC debt exchange), as well as continued IMF debt service without new IMF borrowing and full Paris Club payments, the absolute stock of external debt will decrease[1]. The normalization of the Soviet-era debt categories of FTO and IIB/IBEC debt implies a substantial cut in the nominal, absolute amount of recorded external debt stock, due to a write-off inherent in the exchanges' financial terms, and reconciliation and eligibility rules. This, and the ongoing IMF repayments, outweighs the effects on the stock from potential new sovereign external borrowing. In 2001, Russia paid the IMF about USD 4.3 bn, including ahead-of-schedule repayments, bringing the total stock of Russia's IMF debt down to about USD 7.5 bn. In 2002, Russia will make about USD 1.6 bn in IMF payments. In 2003, we expect the absolute amount of external debt to increase, taking into account the likelihood of new net external borrowing in this year, maybe a resumption of an IMF program.

The debt burden as a share of GDP will continue to decrease throughout the period, By the end of 2002, sovereign external debt is expected to decrease to some 39% of GDP, from 58% in 2000 and 81% in 1999. Total debt (external and domestic) will fall to no more than 45%, from 66% in 2000 and 93% in 1999. By the end of 2003, external debt, while expected to net increase over 2002 in absolute terms, would continue to fall as a share of GDP, down to about 35% of GDP. Total debt would also fall, to some 40% of GDP.

Apart from factors already mentioned, the strongly improving debt indicators are due to a combination of aspects, such as economic growth and real exchange rate appreciation, appropriate fiscal policies and active debt management. Signs are the relevant authorities are keen to stay on this course, as exemplified in the work on a new debt management strategy and system, pursued over the last year. The new debt management strategy, including an overhaul of the debt management system, could be formally approved by the government in February. It should also be noted that there has been a very modest net domestic debt issuance over the last years. Active debt management has been conducted over the last couple of years, particularly with 2003 in mind. As is well-known, year 2003 is the formal near-term debt service peak, per original schedule around USD 18.5 bn. However, active debt management has reduced this, in our estimates, to about USD 14.5-15 bn, and could indeed decrease further by 2003 to the levels paid in annual external debt service over the last couple of years, that is around USD 14 bn.

Russia: Debt Indicators, 2000-2003



[1] In addition, the stock of government guarantees on external debt is expected to decrease somewhat during 2002.

Assumptions		
	2002	2003
Real GDP growth	3.5%	4.5%
RUB/USD, annual average	32.5	34

- *Net domestic borrowing 2002 as per Ministry of Finance plans.*
- *Net domestic borrowing 2003 SSSB estimate.*
- *Note that 2003 external debt service includes full scheduled payments, whereas in practice the major part of the USD 3.5 bn maturing Minfin 4 is probably bought back/retired. Therefore the actual 2003 debt service ratio will most likely be lower than what it appears using the scheduled debt service payments.*

2. International financial markets and Russian-related issuance in 2002

Russian-related Eurobond issuance on international markets in 2002 will be dominated by two aspects. On the one hand, 2002 could see the important event of the Russian Federation re-entering international financial markets with a full-fledged new issue Eurobond. The 2002 budget has a provision for a new such Eurobond of up to USD 2 bn. If such a new Russian Federation Eurobond issue takes place, it would be the first, non-debt exchange related, sovereign new Eurobond issue since June 1998. It could be expected that, should such an issue go ahead, the Ministry of Finance would be interested in a 5-10 year Eurobond, rather than a shorter Eurobond.

On the other hand, a main focus this year will be the return (and debut for many) to the international bond markets of Russian corporate and banks. With the broadening of Russian economic growth, the Russian corporate sector has seen a dramatic increase in overall investment growth over the last years. Such investments have been two-way, in the sense that not only have some entities in the Russian corporate sector looked at overseas investments, but there have been increasing signs of a return of previous Russian capital outflows/moderating capital outflows, to be invested in mainly domestic Russian sectors. As indications of this encouraging capital flow trend, one can point to the expansion into the Russian food industry by Interros, as well as by some oil companies, including an interest in Russian retail networks, and also the expansion into the Russian automotive industry pursued by large Russian metals companies[2].

At the same time, the structural reform agenda at the heart of the government's economic strategy is gradually transforming the institutional framework and incentive set-up facing the corporate sector. This is contributing to laying the medium- to long-term foundations for an improving investment climate, both for domestic and foreign companies. The table below summarizes some of the key institutional changes affecting the corporate sector, approved over the last year and coming into effect during this year[3]. To this one could add the various WTO-related reforms, part of Russia's WTO accession process, to be pursued this year. Russia's eventual membership in the WTO will act as a powerful integration- and restructuring boost to Russian business. There are also a number of further corporate governance-related reforms which are to be approved this year, some of which are nearing full approval already in the first quarter (e.g. further amendments to the law on securities markets, to the law on joint-stock companies and to the law on the protection of investors' rights).

[2] An interesting observation regarding the focus on the Russian food industry and retail networks is the interaction between the observed expansion of Western retail chains and Russian investments in domestic food production. Western retail chains such as Metro and EuroSpar, which have opened in Russia (in the Moscow area), have indicated that they are mainly looking at securing a predominantly Russian-supplied product line. For example, in press reports, the recently opened Metro supermarket in Moscow indicated it will carry some 40-45 000 product lines, with the aim of having the vast majority of such product lines supplied locally.

[3] See seminar reports *Zakony prinyaty. Chto dalshe?* (Professor Evgeny Yasin) Fond Liberalnaya missiya, December 2001., and *Ot sluzheniya gosudarstvy k obsluzhivaniya obshestva*, Fond Liberalnaya missiya, January 2002.

Table 1. Russia: The Corporate Sector – Institutional Changes In Effect 2002

Reform	Implementation	Comment
De-bureaucratization reforms	In effect from January 1, 2002	The first wave of these de-regulatory reforms, including licensing, inspection and registration, was approved in 2001. A second wave of further de-regulatory reforms, and possibly a third wave, will follow in 2002. Also, the government will this year engage in the formulation and initiation of administrative reforms, reforms of Russia's vast bureaucracy. A draft strategy in this regard is basically concluded, and is awaiting further instructions from President Putin.
New profit tax	In effect from January 1, 2002	The new corporate profit tax, lowered to 24% as of this year, could be accompanied by a lowering of the unified social taxation this year.
Code of Corporate Governance	Expected to be published by February 2002	Fully drafted, discussed and approved by the FSC/government in 2001, the Code of Corporate Governance is expected to be formally concluded early this year. While the real effects of this Code will take some years to evaluate, there are already signs the focus on drafting this Code has had an impact, and the introduction of the Code could imply the emergence of an increasingly accepted benchmark.
Amendments to the law on joint-stock companies	In effect from January 1, 2002	These amendments, signed by Putin in August 2001, represent corporate governance-related improvements of existing legislation.
Start of pension reforms	During 2002	The first, basic, package of enabling pension reform laws was approved last year, and the key law on investing pension assets is expected to be approved in the first half of this year. This will initiate the practical phase of pension reforms, a process, which will see private pension funds fully take part in the management of pension assets from at least 2004.
New Labor Code	In effect from January 2002	Approved in late 2001, the new Labor Code represents an important part of the modernization process of Russia's corporate sector institutional infrastructure. The new code will make labor relations more flexible.
Natural monopoly reforms	Throughout 2002	For UES, continued gradual implementation of restructuring program approved in 2001 and continued approval of necessary legislation, for Gazprom continued strive to establish transparency, for the Railways Ministry possibly new momentum behind reform efforts.
Legal reforms	In effect from January 2002	First wave of legal and judicial system reforms approved last year, further reform phases expected in 2002.

Source: SSSB, the Russian government, the Federal Securities Commission (FSC).

To support the real economy expansion associated with the current Russian growth recovery, Russian corporates/banks/regions started already last year to look for financing opportunities in the Eurobond market[4]. The first one out among the non-sovereigns was the (sub-sovereign) City of Moscow, bringing a 3-year, 350 mn euro Eurobond in October 2001 – the first post-1998 new Russian Eurobond any category (the city issued subsequently yet another one in November). In November, this was followed by the first post-1998 new corporate Eurobond, issued by Rosneft (a 5-year, USD 150 mn bond), a state-owned company. Then, in December, Gazprombank and MTS followed with their respective issues, the former the first post-1998 Eurobond from a Russian bank, and the latter one the first post-1998 Eurobond from a private Russian company.

This activity brought total corporate/regional Russian Eurobond issuance in October-December 2001 to the equivalent of USD 1.2 bn. The table below summarizes these Eurobond issues. In terms of issue spread, the experience proved mixed across the issuers, but all offers a premium over the Russian Federation sovereign curve. While state-owned Rosneft curiously had to issue at a high 937 bps, established names such as MTS and Gazprombank (Gazprom) issued at 757 bps and 606 bps over respectively. (Issue spread over respective major market benchmark.). In secondary market trading, the issues offer notable yield enhancement over the sovereign Russia curve. In mid-January, the Russian Federation 2003 Eurobond

[4] This can also be tracked in domestic capital markets, where rouble corporate bonds is the fastest (from a low base) growing Russian financial market segment. However, domestic maturities are still too short, and for longer-term financing Russian corporates often have to look abroad. Nevertheless, some Russian corporates with plans/intentions to access international capital markets, have also expressed an interest in issuing/continuing to issue benchmark rouble corporate bonds in 2002. Indeed, most of the leading entities on the rouble corporate bond market have plans to access international markets. In terms of transparency and information, this could have positive spillover effects on the rouble corporate bond market (the Eurobond road shows raising the profile of such companies). Furthermore, it could be mentioned that more Russian companies are exploring the possibilities of ADR listing/IPO on the NYSE. The first ADR level 3 introduction for a long time from a Russian company is expected in the first quarter this year, from Wimm Bill Dann, and there are indications of other Russian companies looking into this as well. All of these activities will serve to further highlight developments in the Russian corporate sector.

yielded around 6%, with the Russian Federation Eurobond 2005 at some 8.3%. For comparison, the Rosneft 2006 Eurobond yielded 12.39%, the MTS 2004 Eurobond yielded 10.54%, and the Gazprombank 2003 Eurobond yielded 9.14%.

Table 2. Russia: New Eurobond Issues, Corporate/Bank/Regional 2001

	Issue date	Amount, currency	Maturity	Coupon
City of Moscow 2004	October 25, 2001	350 mn euro	3 year (Oct 25, 2004)	10.25%
Rosneft	November 12, 2002	150 mn US	5 year (Nov 20, 2006)	12.75%
City of Moscow 2006	November 29, 2001	400 mn euro	5 year (April 28, 2006)	10.95%
Gazprombank	December 21, 2001	200 mn euro	2 year, (Dec 22, 2003)	9.75%
MTS	December 21, 2001	250 mn US	3 year, (Dec 21, 2004)	10.95%

Source: Bloomberg, company announcements. The Gazprombank bond was initially 150 mn euro, with 50 mn euro added on December 18, 2001. The City of Moscow 2004 was initially 300 mn euro, with 50 mn euro added on December 14, 2001.

The list of other Russian corporates/banks, interested in issuing Eurobonds, grew all throughout last year. The table below attempts to give a snapshot picture over the potential Russian corporate Eurobond issuance in 2002, using news reports, company statements, interviews, and other official, mass media sources, to track down entities which have indicated plans/interest in entering/re-entering international bond markets.

Table 3. Russia: Estimated Potential Corporate/Bank Eurobond New Issues 2002, USD mn

	Estimated possible size
Gazprom	5-750
Sibneft	150-200
MMK	150-200
Tatneft	200
Severstal	150
TNK	3-500
MDM-Bank	100
Vimpelkom	n.a
Alfa-Bank	n.a
Slavneft	n.a

Source: Russian news reports, company announcements, Bloomberg, Reuters

Based on above estimates, and assuming a USD 150 mn issue size for those where we have no public communication available as to potential size, one gets a total of over USD 2 bn in possible 2002 Russia corporate Eurobond issuance. Of course, these are very rough estimates, and should not be taken literally. Some names may fall away, and some may be added to the list of interested issuers.

Based on the above, one can estimate the potential total Russian-related Eurobond issuance in 2002, that is, Eurobonds from all the different categories such as sovereign, debt exchange-related and corporate/bank and regional. The table below summarizes the estimates. In a net sense, that is after maturing 2002 Eurobonds in the various categories, total new Russian issuance could be some USD 5.9 bn. It is important to stress that we have included in the table below the two debt exchanges which are likely to take place this year, the so-called FTO and IIB/IBEC debt exchanges. Specifically, it is important to consider that while the stock of Russian Federation Eurobonds will increase during 2002 as a result of these debt exchanges and a potential new issue, Russia's overall stock of external debt will decrease.

Table 4. Russia: Estimated Total Russian Eurobond Issuance 2002, All Categories (corporate/bank, regional, sovereign new issue, debt exchanges), USD bn

	Gross	Net
Corporate Eurobonds, new issues	2	1.5
Russian Federation Eurobond, new issue	2	2
Regional Eurobonds, new issues	0	-0.326
FTO debt exchange – additional Russian Federation Eurobonds (2030s and 2010s)	2	2
IIB/IBEC debt exchange – additional Russian Federation Eurobonds (2030s, 2010s)	0.7	0.7
TOTAL	**6.7**	**5.9**

Source: SSSB, the Ministry of Finance. There are no sovereign Eurobonds maturing in 2002. In 2002, a Tatneft corporate Eurobond of USD 300 mn is maturing in October, as is a USD 200 mn Mosenergo corporate Eurobond. Among the regions, the St.Petersburg Eurobond of USD 300 mn is maturing in June, and no refinancing in the Eurobond market is expected. In addition, the amortizing note from the Yamal-Nenets region is scheduled to execute the final payment in 2002, of some USD 26 mn. The City of Moscow will not be able, due to Budget Code regulations, to issue further Eurobonds in 2002, and for Nizhny Novgorod re-entering the markets with a new issue is not on the table at the moment. However, should the Budget Code be amended in 2002 – and there are some discussions in the Ministry of Finance regarding this – external borrowing constraints on regions could be relaxed. Finally – note that it is assumed the two debt exchanges will involve the issuance of additional 2030s and 2010s, and not involve, e.g., 2030s and 2010s the Ministry of Finance might have bought back in the market over the last year. If a portion of the distributed 2030s and 2010s as part of the two debt exchanges are bonds which the Ministry of Finance has bought back previously, this will not increase the stock of existing Eurobonds.

On January 1, 2002, the stock of Russian Federation Eurobonds was some 35.2 bn, decreasing by some USD 1 bn in 2001 due to the repayment (out of fiscal means, no refinancing) of the 2001 Eurobond. If taking into account the FTO and IIB/IBEC debt exchanges in 2002, and a potential new Russian Federation Eurobond, the stock of Russian Federation Eurobonds in 2002 would go up to USD 40 bn approximately. However, it is important to understand that this does not translate into an increase in Russia's overall external debt. This is because the FTO and IIB/IBEC events are debt exchanges, and not new Eurobond issues per se. These two Soviet-era debt categories will be restructured through a debt exchange into Russian Federation Eurobonds, a debt normalization which will decrease the stock of Russia's Soviet-era commercial debt by about USD 4 bn through the combined effects of the write-off involved and the reconciliation and eligibility criteria. It is also important to note that the Russian Federation Eurobonds which the FTO and IIB/IBEC debt will be exchanged into are not bullet Eurobonds, but amortizing bonds, spreading the payments over a long time period. Thus, these exchanges can not be said to suddenly increase notably maturing Eurobond payments in any one particular year.