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Aiding Russia and Ukraine

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The Consensus in Favor of Aiding Russia and Ukraine

The G-7 summit meeting in Tokyo in July 1993 reaffirmed strong rhetorical support for international aid to Russia and Ukraine. The Clinton administration, like the Bush administration before it, favors foreign assistance to Russia and Ukraine to further their democratization, marketization, and stabilization. And the congressional leadership of both parties has also expressed support for such aid.

Underlying this bipartisan consensus is a sometimes explicit, and always implicit, premise: that Russian and Ukrainian prospects for a less violent and more successful transition to democratic polities and market-based economies will be significantly enhanced by foreign aid. Yet this premise is based as much on hope and good intentions as on evidence, because it can be argued no less plausibly that the prospects for successful transition depend fundamentally on domestic factors and policies in Russia and Ukraine that won't be affected in any predictable way by foreign aid.

Whether or not the premise is valid, there is a strong consensus among the leadership of both parties in the United States in favor of aid. The consensus extends as well to the leadership of the G-7 governments. There is less agreement on the amounts and types of assistance that should be provided.

Among the U.S. general public and among the rank-and-file members of Congress, as distinct from its leadership, there is considerably more skepticism about whether the possible benefits from extending aid to Russia and Ukraine would be greater or less than the benefits forgone by the reductions in other government programs or additions to the budget deficit that would be necessary to finance such aid.

In any event, all sides in the aid debate acknowledge that other domestic and international circumstances and policies, quite apart from foreign aid, will strongly affect Russia's and Ukraine's chances for successful transformation. For example, the course of change will be influenced by domestic policies dealing with macroeconomic stabilization, legal reform, privatization, and property rights. Various non-aid measures by foreign governments, such as opening their markets to exports from Russia and Ukraine, would surpass foreign aid in their effects on the progress of economic change in these countries. Consequently, some of the most important policies the G-7 governments can pursue to help transform the Russian and Ukrainian economies fall outside the domain of what is generally construed as "foreign aid." Nevertheless, this paper proceeds from the belief that assistance by the United States and the other G-7 members is warranted, and that it will be continued. It is thus timely and crucial to address the issue of the types of aid that would be most effective, which is our focus here.

Some General Considerations

In approaching the question of types of foreign aid, several considerations should be borne in mind:

First, prior Western aid has elicited mixed but mainly unfavorable reactions within both Russia and Ukraine. Criticisms, by supporters as well as opponents of Boris Yeltsin, have focused on both the small amounts of aid (far below the $24 billion promised by the G-7 in 1992 and increased to $28 billion in 1993) and the added debt burden that the aid imposes on the already strained Russian economy. Furthermore, Western aid to Russia has elicited even more unfavorable if not bitter reactions in Ukraine. While Russians view Western aid as small or even niggardly, Ukrainians view it as relatively large because of what they see as the West's almost total neglect of their needs and interests.

Second, because of their own budgetary constraints and slow economic growth, the resources that the G-7 countries will have available for aid to Russia and Ukraine are likely to be very limited. These limitations are likely to be more acute with respect to providing new funds than to easing the servicing obligations associated with prior loans made to the Soviet Union.

Third, in the economies that Russia and Ukraine inherited from the Soviet Union, defense industry was so enormously overdeveloped and pervasive that the need for downsizing and converting it should be taken into account in the design of appropriate forms of foreign aid.

Fourth, aid should be *purposeful rather than personal*—that is, it should be designed to advance purposes and policies linked to the fundamentals of transforming the economies and societies of Russia and Ukraine. While Presidents Yeltsin and Kravchuk are surely deserving of encouragement and support, aid policies should not be so narrowly or personally conceived that their rationale lapses if these leaders prove transitory. For example, encouragement of new enterprises and new entrepreneurs (as well as the privatization of "old" state enterprises), legal reform, and housing design and construction are purposes to be sought through foreign aid and especially through technical assistance, regardless of the particular leadership in power in Russia or Ukraine.

Designing a Foreign Assistance Package

A four-part foreign assistance package that comports with the foregoing general considerations would consist of the following:

- Relief, rescheduling, and cancellation of all, or at least some, debt incurred by the former Soviet Union, and swapping some or all of the remaining debt for equities in state enterprises that are undergoing privatization.
- Stimulating foreign direct investment in Russia and Ukraine by galvanizing the presently available OPIC (Overseas Private Investment Corporation) insurance program, as well as by providing a stimulus to increase private insurance available in the commercial market.
- Establishing a "market stabilizing mechanism" for arms sales that would assure Russia and Ukraine a reasonable share of the global arms market.
- Supplementing the $800 million already appropriated for the dismantling of nuclear weapons with additional funds for these and related purposes in Russia and Ukraine.

Restructuring and Swapping Foreign Debt

Russia, Ukraine, and six other republics agreed, upon dissolution of the Soviet Union at the end of 1991, to assume "joint and several" responsibility for servicing the entire Soviet external debt, much of which was accumulated before and during Mikhail Gorbachev's 1985–1991 tenure. This debt, together with additions to it incurred in 1992 and 1993, is currently about $80 billion. Russia is the only republic that has attempted to meet this extremely onerous servicing obligation. During the next three years, from 1993 to 1995, the annual burden represented by servicing long-term, hard-currency debt alone will be from $10 to $14 billion, thereby preempting between one-third and one-half of Russia's annual hard-currency foreign exchange earnings.

Two measures can greatly help ease this burden. The first would have the Western creditors (Germany, Italy, and the other West European countries are collectively owed 70 percent of the total, the United States only 5 percent) forgive all or most of the debt incurred before the formal dissolution of the Soviet Union on January 1, 1992. Most of the creditors' public and private banking institutions have already built up loss reserves in anticipation of this prospect, thereby lessening the financial impact of any such debt forgiveness. Moreover, by linking the debt cutoff to the historic date of the Soviet Union's dissolution on December 31, 1991, this policy of debt forgiveness can be pursued without creating a precedent that other debtor countries might invoke in seeking to obtain equal concessions for themselves.

The second measure is to swap the remaining sovereign debt for equities in state enterprises undergoing privatization in Russia and Ukraine. Under the Russian privatization law adopted in 1992, 35,000 state enterprises are being privatized over the next three years; more are supposed to follow. The privatization process that is now actively under way calls for 25 percent of the shares to be given to enterprise workers and managers, 30–35 percent to be auctioned to Russia's 150 million citizens in exchange for ruble vouchers previously distributed to them, and the remaining 40–45 percent to be retained by the state. If some of these government-held shares were swapped for debt liabilities, the economic burden of meeting the fixed servicing obligations of debt would be replaced by more flexible servicing obligations that depend instead on the economic performance of the equities that have been acquired. Concerns about selling off Russia's patrimony to foreigners would be allayed because the swapped shares would not, in general, constitute majority ownership.

Moreover, foreign creditors who acquire these equities will have incentives to enhance their stakes by adding management skills, technology, and improved access to Western markets, as well as by new investments. As the value of the existing debt declines on the secondary debt market, creditors' incentives to engage in such swaps will increase. (Significantly, medium-term Soviet debt that carried a 20 percent discount in the fall of 1992 carried a 50 percent discount in the spring of 1993!)

Encouraging Foreign Investment by Expanding Risk Insurance

The U.S. government, as well as the private insurance markets, provides insurance against the political risk of violence or expropriation that may discourage potential investors in Russia and Ukraine. The U.S. government's longer-term investment guarantees are offered through the Overseas Private Investment Corporation (OPIC). Several private commercial insurers in the United States and in the United Kingdom offer the same types of insurance as does OPIC, but at twice its subsidized rates.[1]

In the spring of 1993, OPIC had 256 unapproved insurance applications with a total face value of potential private investment in Russia of $22 billion, compared to only seven approved applications with a face value of less than $200 million. The corresponding figures for Ukraine were 39 applications with a face value of $1.7 billion of potential investment, and no approvals by OPIC. Expansion of insurance in the private market to meet this backlog of demand is constrained by the unwillingness of private underwriters to assume additional risk exposure in Russia and Ukraine without substantially raising the premiums charged to those seeking insurance.

The limited scale of OPIC approvals of insurance applications is due to many factors, including its understandable reluctance to increase the risks that American taxpayers would be exposed to if turmoil actually ensued in Russia or Ukraine and compensation to insured investors were required. It is also possible that the subsidized price at which OPIC offers political risk insurance, as well as its screening of applications, have the effect of "creaming" the less risky applications for risk insurance, diverting the riskier ones into the private insurance market. This adverse selection may distort the commercial side of the political risk insurance business, since the private market becomes the market of last resort for those unable to obtain the subsidized rates offered by OPIC.

Foreign aid that is directed toward encouraging private direct investment is a high-leverage form of aid for furthering market-oriented economic reform in Russia and Ukraine. The "leverage" results from several sources: First, it is likely that aid for this purpose would be more productive than other forms of aid, because it is presumably linked to the provision of management, technology, and training. As Anatoly Sobchak, the mayor of St. Petersburg, has observed: "Russia and the other former Socialist countries don't need humanitarian aid. They need direct investment in concrete projects . . . Political guarantees of Western investment would help."[2]

Second, the amount of the insurance subsidy, if prudently managed, is typically a very small fraction of the total foreign direct investment that the insurance guarantees are underwriting. And third, there is probably a scale effect associated with the writing of political risk insurance: If and as the quantity of direct investment increases, prospects for successful marketization and transformation will improve, the outlook for reasonable stability in Russia and Ukraine will brighten, and the dangers of violence and expropriation will recede.

Toward these ends, foreign direct investment in Russia and Ukraine can be encouraged in several ways:

- OPIC's existing activities can be galvanized by reducing the bureaucratic bottlenecks that impede it, by removing the present $200 million limit that applies to insurance for any single company's investment, and by enabling OPIC to securitize the insurance portfolios that it accumulates (for example, in the manner of GNMA and FNMA),

[1]Willis, Faber & Dumas Limited, insurance brokers in London, cited 2 percent of the market rate for such insurance in Russia and Ukraine in March 1993. The OPIC 1992 rate is less than 1 percent of the face value of insurance covered.

[2]Interview quoted in *Chief Executive*, May 1993, p. 37.

thereby spreading risk and tapping resources in the private capital market.

- Incentives can be provided to the private commercial insurance market through allowance of a tax credit of, say, 50 percent of the premiums private insurers receive from issuing political risk insurance to U.S. investors in Russia and Ukraine, thereby increasing the after-tax profitability of privately written political risk insurance, and making the private insurance market more directly competitive with insurance written by OPIC.

Of course, these measures will not be a panacea. The climate for foreign investment in Russia and Ukraine depends on a wide range of political, legal, and economic considerations that political risk insurance doesn't address. And the distinction between normal (and perhaps even abnormal) business risks and the particular limited types of political risk (against turmoil or expropriation) that OPIC insurance is intended to cover may not always be clear in practice.

Assuring Russia and Ukraine a Reasonable Share of the World Arms Market

One of the salient characteristics of the militarized economy of the former Soviet Union is that the military sectors comprised something over 25 percent of the country's gross national product. Thus, reform of the Russian and Ukrainian economies clearly requires shrinking, converting, and privatizing major parts of the former defense industry. Reductions of over 60 percent in defense procurement spending in Russia, and probably similar or greater reductions in Ukraine, are already forcing the shrinking to take place, providing strong incentives for converting equipment and skilled manpower to other productive activities.

However, it should be recognized that Russia and Ukraine have a critical need for hard-currency exports, and their comparative advantage for realizing them unfortunately lies in arms sales. In the last half of the 1980s, international weapons sales accounted for about 20 percent of the former Soviet Union's export earnings, compared to less than 4 percent for the United States. The problem this poses is how to reconcile the shrinking of Russia's and Ukraine's military industry with access to a share of the international arms market sufficient to help them acquire foreign exchange needed for their internal development and economic reform.

Ongoing RAND research is trying to provide a way of squaring this circle, through something we are calling a "market-stabilizing mechanism," though others might label it a cartel (although a beneficent one). The MSM envisaged in this work would be established by the United States, Russia, and the other principal weapons exporters (France, Britain, China, and Germany) to prohibit or control exports of potentially destabilizing weapons (such as submarines, cruise missiles, or advanced sea and land mines) to such areas as the Persian Gulf and Middle East, while allowing Russia and Ukraine an appreciable share (perhaps as large as 15 percent) of the $30 billion annual weapons market in these and other areas. To be sure—even excluding the most destabilizing weapons—such a scale of conventional arms exports still involves enormous potential lethality. Consequently, prudent efforts should be made to reduce it. However, these efforts should proceed while Russia and Ukraine receive ample opportunities to realize a reasonable share of the international weapons market. Where restraint or prohibitions of weapons sales are accepted in the MSM, and where Russia and Ukraine are therefore obliged to forgo an otherwise bona fide sale, a modest aid fund might be established to compensate them for the lost revenues.

Although the aim of this measure is to assure Russia and Ukraine a major stake in the tightening weapons market, they should be under no illusion that this stake will do more than ease somewhat the pace of decline of the military industry and the resulting economic strain.

Dismantling Nuclear Weapons and Retrofitting Nuclear Reactors

In 1992, the United States authorized $800 million in Defense Department appropriations for dismantling tactical nuclear weapons in Russia and Ukraine. As of the middle of 1993, less than 10 percent of these Nunn-Lugar funds have been spent, owing to logistical, contracting, and organizational delays on both the U.S. and Russian sides and to a hardening of the Ukrainian position with respect to removal of nuclear weapons from its territory. It would be worthwhile to expedite the effective use of these funds, and also to increase the amounts provided for the dismantling of additional nuclear weapons, including strategic ones. Funding from this source should also be used to retrofit with radiation-containment structures the several dozen Chernobyl-type nuclear reactors located in Russia, Ukraine, and other former Soviet states, and to dismantle the 300 power reactors on Russian nuclear submarines that are to be decommissioned under existing arms control agreements.

In some respects, financial assistance for the tasks of dismantling weapons and retrofitting nuclear facilities is analogous to the compensation fund discussed above in connection with establishing an MSM to ameliorate the effects of forgone weapons sales. Both devices are intended to move the Russian economy toward a more "normal" and less militarized structure, while recognizing the realities of the distorted economic structures the republic has inherited.

In sum, the four-part aid package outlined above would advance reform and marketization in Russia and Ukraine, consistent with: (1) the sharp limitations on the resources available from the G-7 countries; (2) reasonable balance in aid policies toward Russia and Ukraine; (3) emphasis on providing incentives for foreign direct investment; and (4) awareness of the importance of linking the provision of foreign aid to reductions in the military sector and the progress of economic reform.

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