RESTRUCTURING KYRGYZSTAN'S EXTERNAL DEBT: OPPORTUNITY ANALYSIS

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Under the republic's development strategy, by 2010 the annual rate of investment in its economy is to go up to 17% of GDP. This target is to be achieved with a significant reduction in public investment (by more than half) and a much greater influx of private funds. The need to address this complicated task is due to the difficulties of servicing the republic's external debt, which impedes the solution of a number of domestic problems, including problems in the social sphere, since it narrows down the possibilities for state budget spending. So, matters of restructuring and servicing external debt are now among the main problems facing the country's economy.

In the first few years of independent statehood, the country resorted to foreign borrowing in view of the objective need to maintain its economic independence in the conditions of an acute shortage of financial resources caused by the cessation of transfers from the Union center.

The most burdensome commercial loans were received by the republic in the early 1990s from the European Commission, and also from Turkey, Pakistan and Russia. That was also when a part of the debts of state-owned enterprises on correspondent accounts (for 1992-1993) were posted to the country's external debt. It was only after Kyrgyzstan's accession to international financial institutions (1993-1994) that it was enabled to obtain loans from them on preferential terms. At that time, the republic also began to receive aid from donor countries (Japan, Germany, Switzerland and others) within the framework of bilateral cooperation.

In the late 1990s, the problem of servicing external debt took a sharper turn. Although most of the foreign loans and credits had been made available on easy terms, it was time to pay current maturities of principal, so that annual debt service payments, including interest payments, amounted to about 40% of total budget spending.

Most of the external public debt is direct debt, i.e., the republic's net liabilities on loans and credits obtained directly by its government (at the end of 2000, their share was over 95%). This direct debt (according to the breakdown given by the National Bank) has several components: liabilities on program credits (resources going into the government's Counterpart Fund); on project credits within the framework of program-related government investments (PRIs); and on loans and credits outside the PRI framework. The rest of the external public debt is indirect debt consisting of government guarantee obligations on private sector loans.

According to National Bank data (see Table 1), at the end of 2002 the republic's total external debt, including private debt and IMF loans, stood at $1,732.3 million, including a public debt of $1,532.6 million.

Some of the loans that require immediate debt servicing were received on non-concessional terms outside foreign aid programs. But concessional loans may also give rise to serious problems connected with the "resonance" effect: the grace period for many of them is to end within a few years.

Simple calculations based on average interest rates and maturities show that interest payments will reach at least $25 million and principal payments at least $60 million a year, that is, debt service payments will amount to 6-7% of GDP (compared with less than 2% of GDP in 2000).

In addressing this problem, which is to confront the country in the medium term, use should be made (except for a small part of the country's borrowings) of debt restructuring, a method used in recent years for short-term debt relief. Restructuring (rescheduling) means that the original terms of repayment are renegotiated for more favorable terms. However, with regard to loans and credits obtained by way of aid this may not yield any significant effect, because they were initially granted on the easiest possible terms. One should also bear in mind that a temporary softening of the terms of payment in the process of restructuring often leads to a mere deferral of payments until a later date (at an additional charge) instead of an actual reduction in the debt burden.

It is clear that such payments without serious damage to other state budget expenditure items will be possible only given rapid (around 6-8% a year) and steady growth of the country's economy, a radical improvement in tax compliance and a reduction in the scale of the shadow economy. Unless this is achieved, the only way to resolve the problem will be a write-off of debts by creditors. But such a decision depends not so much on Kyrgyzstan as on the creditors themselves.

From the standpoint of aid programs this means that in the structure of allocated funds the share of aid provided in the form of loans and credits should be considerably reduced with a simultaneous increase in the share of grants (grant element).

Another possible way of resolving the problem is to launch large-scale interstate projects in the territory of the republic. This will enable Kyrgyzstan to repay its debts in the form of reinvestment in joint

Table 1

Kyrgyzstan's External Debt

	1997	1998	1999	2000	2001	2002
Total external debt						
TED[1] at end of period (*$m*)	1,356.1	1,480.3	1,647.4	1,703.8	1,677.7	1,732.3
TED at end of period[2] (*% of GDP*)	76.7	90.6	134.4	124.6	109.6	107.5
TED at end of period[3] (*% of exports*)	200.7	247.6	312.3	297.5	299.2	276.1
Scheduled debt service on TED[4] (*$m*)	81.1	130.2	137.1	160.8	172.5	129.2[6]
Actual debt service on TED[4] (*$m*)	78.2	118.4	111.4	154.7	171.1	120.8
Debt service ratio for TED (*% of exports*)						
— scheduled	12.0	21.8	26.0	28.1	30.8	20.6[6]
— actual	11.6	19.8	21.1	27.0	30.5	19.3
Public external debt						
PED[5] at end of period (*$m*)	951.5	1,093.3	1,314.4	1,399.2	1,441.5	1,532.6
PED at end of period[2] (*% of GDP*)	53.8	66.9	107.2	102.3	94.2	95.1
PED at end of period[3] (*% of exports*)	140.8	182.9	249.2	244.8	257.0	244.3
Scheduled debt service on PED[4] (*$m*)	43.4	55.8	53.4	77.6	71.7	84.0[6]
Actual debt service on PED (*$m*)	41.2	51.4	30.4	48.1	71.7	74.0
Debt service ratio for PED (*% of exports*)						
— scheduled	6.4	9.3	10.1	13.5	12.8	13.7[6]
— actual	6.1	8.6	5.8	8.4	12.8	11.8

[1] Total external debt (including private debt and IMF loans).
[2] As a percentage of projected annual GDP.
[3] As a percentage of projected annual exports of goods and services.
[4] Includes principal and interest payments.
[5] Public external debt.
[6] Without regard for bilateral debt rescheduling within the Paris Club framework.

Sources: KR Ministry of Finance and KR National Bank.

Note: Debt is calculated based on the amounts received and/or repaid in foreign currencies at face value and converted into U.S. dollars at the IMF exchange rate in effect at the end of the reporting period.

projects, which will eventually become a source of foreign exchange earnings. Yet another and no less effective source of budget revenue for debt repayment could be successful privatization of large state-owned enterprises.

The amount of contracted foreign loans and credits should not exceed the amount of principal payments on the republic's external debt. In order to make efficient use of the funds obtained, they should not be spent on current consumption or budget deficit financing, but mostly on investment in production, including the construction of new enterprises. Income from investment in these areas is a source for repayment of the loans and credits received. The external debt is repaid from the budget either out of international reserves and property or out of new borrowings. Such borrowings should be made only for top-priority programs and projects serving to promote economic growth and to reduce poverty.

Repayment of external debt is made in foreign currency, whose main source is a trade surplus. So, economic resource flows should be altered in order to ensure an increase in exports. But the level of exports in relation to debt is very low. For example, in 1997 export earnings came to 44.5% of total debt, and in 2002 the figure was down to 28%. In other words, the republic's ability to service its external debt leaves much to be desired, since about 40% of export earnings are reserved for external debt service payments.

As regards the "quality" of external debt, the republic applies the following system of threshold values developed by the World Bank:

(a) the ratio of the present (discounted) value of accumulated external debt to GDP—not higher than 80%. Present value is the principal amount of external debt with interest due on it for the entire maturity period minus actual repayments;

(b) the ratio of the present value of external debt to annual exports—not higher than 200-220%;

(c) the ratio of annual debt service payments on external debt to annual exports—18-25%.

Debt is regarded as moderate if the first indicator is within the limits of 18%-80% or the second indicator is between 132% and 220%. Higher figures are an indication of the country's low debt servicing capacity, which points to an unsustainable debt burden.

The ratio of the present value of external debt to annual exports (debt to exports ratio) gives a good idea of the state's ability to put into effect the classical scheme of external financing, when debt service payments are met out of foreign exchange earnings from national exports. In countries that have no difficulty in meeting such payments the debt to exports ratio is around 10-20%, whereas traditionally problem debtors have a ratio of over 500% (in Kyrgyzstan, the figure is 299.3%).

As noted above, the republic is now faced with certain problems in duly servicing its foreign liabilities. A special point to note here is that there are credits whose inefficient use is already putting great pressure on the state budget. These include credits received from the government of Turkey, the government of Pakistan and other credits, and also from CIS countries (Russia, Uzbekistan and others), with payments on these reaching a peak in 2000-2005. The main feature of these credits is that they were extended to the republic on non-concessional terms.

One should note that external debt adjustment (settlement) and external debt management are different concepts. The former is a matter of tactics and means a search for ways of resolving a concrete situation. The latter is of a strategic nature and is designed to normalize debt relations over the long term. Unfortunately, Kyrgyzstan's efforts have so far been concentrated exclusively on problems of settling its external debt. This task has to be addressed in the overall context of long-term external debt management, which is closely connected with further economic development, with efforts to enhance the republic's reputation in the world economic arena and, consequently, with its relations with Western investors and credit agencies.

As we saw above, effective opportunities for settling the external debt problem could be provided by large-scale interstate projects in the territory of the republic. Kyrgyzstan could meet its debt service payments by reinvestment in joint projects, which would not only enable it to solve this problem but would eventually become a source of foreign exchange earnings. Yet another and equally effective source of budget revenue for meeting debt service payments could be successful privatization of large strategic state-owned enterprises. The third way is to reduce the outflow of capital from the country by creating favorable conditions for direct and portfolio investments. In this context, the key question today is a further improvement of the investment climate. This includes not only deregulation of the economy, but also a whole complex of general confidence-building measures aimed at balancing the budget, ensuring efficient operation of the banking sector and protecting investor rights.

In order to reduce the debt burden, it is necessary, in our view, to go over to multiyear restructuring agreements with Western creditors.

Today there are seven methods of debt conversion used at the international level:

1. "Debt for financial instruments" (debt for bonds, bills of exchange, etc.) swaps in the form of one-time deals or in tranches.
2. "Debt for legislative, economic or other reforms" swaps, under which debt is cancelled in exchange for the implementation (or alteration) of economic, social or other policies by the debtor government.
3. "Debt for local currency" swaps. In this case, debt is not purchased at a discount from face value, but is cancelled in exchange for the establishment by the debtor country of a fund in local currency, which is then used to allocate resources to local and international development agencies for carrying out socioeconomic projects approved in the debtor country. The governments of such countries may be faced with the problem of allocating already scarce local resources for the aforesaid fund, and the governments of the creditor countries, with legal problems in effecting such debt conversion. Another point to note is that the establishment and management of such funds is a delicate and lengthy process with the participation of representatives of the creditor and debtor governments, bilateral and multilateral organizations.
4. "Debt for development" swaps. These are usually aimed to finance projects in the field of education, health care, support of small and medium business, urban and rural development, and environmental protection.

   Debt for development swaps are an instrument enabling the debtor country to achieve its long-term goals in traditionally underfunded areas. That is why the initiative here should be taken by the debtor. In a sense, the mechanism of this exchange is a form of project co-financing without external obligations for the country. A well-functioning project could attract additional support from sponsors not connected with the debts in question.
5. "Debt for equity" swaps. Such transactions (in their present form) were initially performed in the Latin American countries in the 1980s in response to the debt crisis that had broken out in the region. In debt for equity swaps, the investor acquires a part of the government debt in the secondary market and then exchanges it (at a discount) for the debtor country's currency, investing these funds in shares of enterprises undergoing privatization.
6. Debt buyback, which is a transaction in the debt market or, less frequently, with the creditors themselves. For this purpose, the debtor country usually has to negotiate a debt restructuring agreement with foreign commercial banks and get their approval. However, projects of this kind meet with particular resistance on the part of banks, since the buyback mechanism implies forgiveness (write-off) of a significant part of the debt and encourages financially unscrupulous governments. In other words, instead of servicing its foreign debt and paying interest on it, a state can declare a moratorium on debt service payments and then, taking advantage of the sharp drop in the price of the debt in the secondary market, buy back its own liabilities. Sometimes the fall in the market price of the debt is so great that the amount of interest due for two years is sufficient to buy back the entire debt. Moreover, the foreign investor does not acquire any equity positions in national assets, as in the case of debt for equity swaps.
7. "Debt for nature" swaps, which are aimed at promoting environmental protection projects. Although these swaps can be regarded as a variety of debt conversion, there is an essential distinction: they are not meant to make profit. Moreover, they do not provide for any transfer of ownership or repatriation of capital to the foreign investor.

In addition to the above-mentioned proposals, a necessary condition for successful repayment of external debt is the "transfer problem." This problem has three key aspects. First, a fiscal aspect: state budget revenues must exceed expenditures, which will make it possible to accumulate resources for debt service payments. Second, a resource aspect: external debt is repaid in foreign currency, whose main source is a trade surplus, so that economic resource flows must be redirected in order to increase the mass of commodities designed for export. And third, a systemic aspect: an increase in the physical volume of exports must lead to a corresponding increase in their value.

There are different strategies for overcoming external indebtedness whose main purpose is to expand national exports. This can be done by taking measures to limit the capacity of the domestic market and to create a "surplus" of traditional export products for increasing sales in the foreign market, and also by stimulating the production of traditional export products through the attraction of domestic and foreign investments.

Kyrgyzstan's current debt service policy is designed to reduce the debt burden by prepayment of non-concessional loans and a rescheduling of bilateral debt through the Paris Club. Clearly, without a rescheduling of its accumulated debt (in terms of maturities and payment amounts) the republic would have experienced serious difficulties in the economic and social sphere and in implementing many programs, including poverty reduction programs.

In 2001, the republic managed to reschedule its overdue debt owed to such creditors as Russia, Tureximbank (Turkey), Kazkommerzbank (Kazakhstan), Berliner Bank (Germany) and Hoechst Schering – Aventis Corporation (Germany), with the result that debt service was reduced to $57.2m, including $37.5m worth of principal and $19.7m worth of interest.

In March 2002, Kyrgyzstan and the Paris Club held negotiations on rescheduling the republic's external debt, which stood at around $1.5 billion. As a result of these negotiations, the Paris Club decided to accord to our country the so-called Houston Terms of debt relief enhanced by a commitment to consider the question of a significant reduction in the stock of debt under what is known as a goodwill clause and capitalization of so-called moratorium interest.

The Houston Terms of debt rescheduling include two important points:

(1) capitalization of moratorium interest falling due within the consolidation period, i.e., payment of this interest is deferred until a later date as follows: 50% of the interest amount in 2002, 60% in 2003, and 70% in 2004;

(2) a goodwill clause, which means that upon the successful completion of the PRGF Program[1] (by December 2004) the republic will be entitled to even more favorable restructuring terms, with a significant reduction not only in debt service amounts, but also in the total debt stock. A precedent was created when a first-time applicant to the Paris Club secured a goodwill clause for its debt stock. This is a good incentive to continue rescheduling external debt and to obtain credits on favorable terms.

By 30 June, 2003, bilateral debt rescheduling agreements within the framework of the Paris Club had been concluded with France, Denmark, Germany, Japan, Russia, Turkey, Uzbekistan and Korea. Agreements with India and Pakistan were at the signature stage, and negotiations on the loan from the Kuwait Fund for Arab Economic Development (KFAED) were still in progress.

The rescheduling agreement signed with the Paris Club is expected to reduce debt service payments due to Paris Club creditor countries for 2002-2004 from $101m to $5.6m. And if all bilateral creditors, including non-members of the Club, agree to extend to the republic terms of rescheduling identical to the terms provided by the Club, the overall reduction in debt service payments due to all bilateral creditors for that period will amount to $122.75m, including $44.69m in 2002, $37.52m in 2003 and $40.54m in 2004 (see Table 2).

As noted above, talks are underway with non-members of the Paris Club: the KFAED, India, Pakistan, China, Uzbekistan and Korea.

[1] IMF program for reducing poverty and fostering economic growth.

Table 2

Debt Service in 2002-2004 (*$m*)

	2002	2003	2004
Total debt service payable from the budget before Paris Club rescheduling (1)	58.55	59.66	59.32
including principal	31.69	33.42	36.64
interest	26.86	26.24	22.68
Total debt service payable from the budget after Paris Club rescheduling (2)	13.86	22.14	18.78
including principal	2.45	4.59	4.88
interest	11.41	17.55	13.9
Debt service reduction: (1) – (2)	44.69	37.52	40.54

In 2002, budget expenditures connected with payment of principal on public debt amounted to 1,138.9m soms (currency unit in Kyrgyzstan), or 89.8% of the scheduled figure. Of these, 80.8m soms went to repay external debt and 1,058.1m soms went to service domestic debt, including government treasury bills (642.4m soms), government restructured loan bonds (277.2m soms), government short-term obligations (96.6m soms), savings loan bonds (30.0m soms), and temporary borrowings (11.9m soms).

Table 3

2002 Budget Execution for Public Debt
(*mill. soms*)

Items	Scheduled	Actual	Deviation	%
1. Domestic debt stock	1,183.1	1,058.1	–125.0	89.4
2. External debt stock	84.7	80.8	–3.9	95.4
Total public debt	1,267.8	1,138.9	–128.9	89.8

Payments of principal on public debt in 2002 constituted 8.5% of the republic's total budget expenditures and 1.5% of GDP, whereas in the preceding year the figure was 28.5% of total expenditures. In view of the republic's application to the Paris Club and rescheduling of debts owed to bilateral creditors, the amount of external debt payments for the 12 months of 2002 was 3.8 times less than for the respective period of 2001.

Debts owed to other countries and foreign organizations should be seen not as some kind of mechanism limiting the country's economic potential, but as an external financial resource promoting national economic growth. But if these borrowings, which augment domestic resources, are to promote a further influx of investment, they should be used exclusively for investment purposes. If these resources are used to import consumer goods, the aforesaid function loses its significance and the aggregate external debt can then be regarded as "net external debt," i.e., its importance amounts to payment of interest.

The extent to which external borrowing has been used to finance real investment determines the possibility of economic growth. From the positions of the developing countries, external debt performs the important function of covering the "foreign exchange deficit" and markedly restrains economic growth. By covering this "deficit" it gives an opportunity to acquire foreign machinery and equipment, raw materials and special products not produced in the country. From this it follows that such debt, on the one hand, stimulates the conversion of domestic resources into investment and, on the other, raises the technological level of the economy through imports of machinery that is not produced at home. So, a "foreign exchange shortage" has an even more negative effect on economic development than a shortage of domestic resources.

As mentioned above, the ratio of external debt to GDP is a major indicator of the impact of debt service obligations on the national economy. The republic's debt for 2002 amounted to 108% of national income. If its economy is analyzed from the standpoint of external debt figures, Kyrgyzstan can be ranked among the problem countries, since it has been unable to increase its foreign exchange reserves in due time, which has created difficulties in debt service. In order to halt the growth of external debt and make this process manageable, we must concentrate on domestic capital formation and on investment in export-oriented industries. At the same time, it is necessary to establish proper control over the target use of funds from foreign sources so as to raise the republic's repayment capacity, which will help to build a system for managing its external debt.

In conclusion, we would like to draw attention to the need for an adequate assessment of the effects of Kyrgyzstan's external debt on its foreign economic orientation.

First, in order to resolve its debt servicing problems the republic has to expand its cooperation with Russia and other countries to which it is most heavily indebted. Russian businessmen will probably make more active efforts to penetrate into the republic's business environment, including incorporation and acquisition of large industrial enterprises in settlement of debt.

Second, the question of how to raise foreign exchange for debt service payments could come to the fore in the very near future, which puts the problem of finding ways to expand exports among the top priorities. Its solution depends directly on an improvement of transit across the territories of neighboring countries, primarily Kazakhstan. Despite the understandings reached in this area, there are still many barriers to be surmounted. A solution of these problems, including the need to harmonize economic relations and identify interests, is undoubtedly one of the keys to the country's future economic development.