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1998 & 2015 - Déjà vu? Debt Sustainability Assessment in the Kyrgyz Republic.

Based on the research report: Total Public Debt Sustainability: Empirical Assessment of the Solvency Issue in the Case of the Kyrgyz Republic

Moldokanov Daniiar

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Are we going to repeat the same mistake?

The Kyrgyz Republic is the low income emerging market economy, with underdeveloped public institutions, high levels of corruption and a big share of informal economy. It makes it hard to generate sufficient amount of fiscal surplus for the public authorities of the country to cover all the needs that country faces during its development path. The rent seeking problem in the governmental level makes it also tough to rationalize public investments in such way that the investments would potentially contribute to fiscal multiplier, allowing for higher tax revenues in the future. As a result, on the one hand, the country does not have an opportunity to collect taxes due to the week institutions and shadow market, on the other hand the country's public expenditures do not contribute to GDP growth in such manor that they potentially could. This makes the country highly rely on foreign sources of funds such as foreign aid and external debt. First time the country faced debt sustainability problems in 1998 followed by the crisis in Russian Federation.

One of the main trading partners of Kyrgyzstan are Russian Federation and Kazakhstan; and nearly 12% of GDP comes from gold mining sector. In 1998 the default of Russian Ruble influenced negatively its main trading partners including Kazakhstan. As a result, default of Russian ruble, significant devaluation of the Kazakh tenge and the decreasing trends in prices on gold, pressured the national economy of the Kyrgyz Republic. This resulted in negative economic growth in the country and to worsening of the debt position in the country. Debt to GDP in the country increased from 78% in 1998 to 114% in 1999 and became unsustainable. Consequently, the country was forced to have two restructuring agreements with Paris Club. Since these restructuring agreements took place, from 2005 the authorities made a valuable effort to decrease the debt to GDP ratio to 45%. Until the situation with Russian ruble and Kazakh tenge in 2014 and 2015 which frighteningly reminds the events in 1998.

In 2014 the minister of finance of the Kyrgyz Republic Ms. Olga Lavrova said in the interview to Informational Agency "24" that the debt to GDP level in the Kyrgyz Republic is expected to be at the level of 58-59% of GDP, assuming that exchange rate of national currency to 1 US dollar will approximately equal to 60 Som/USD.[1] She said that on 11-th of November 2014, the exchange rate at that time was 57 Som/1 USD, GDP growth of the country was expected to be at 1% and the interest rate on debt averaged not higher than 1.8%. Meanwhile, in the end of the 2015 the exchange rate according to National Bank of the Kyrgyz Republic is approximately 75 Som per1

[1] Kudryavceva, T., "Olga lavrova: in 2015 Public Debt of the Kyrgyz Republic will be at the level of 58-59% to GDP", Informational Agency 24, 11.2014, <http://www.24kg.org/parlament/1394_olga_lavrova_v_2015_godu_vneshniy_dolg_kyirgyizstana_sostavit_58-59_protsentov_vvp/>, (accessed on 01. 12. 2015)

USD, GDP growth is projected by the IMF in the World Economic Outlook (October 2015) at the level of -4% and the interest on public debt is projected to be at 4.4%, and on top of it the prices on gold on average has a decreasing trend. Considering the information described above it becomes clear that the debt to GDP level might appear to be higher or might be much higher than 58-59%.

The main question following up from the information provided above appears as whether there is a risk that the public debt to GDP in the Kyrgyz Republic will become unsustainable as it became in 1999 after the devaluation of Ruble. In order to assess the issue of the debt sustainability, the series of stress tests were performed in the research on which this policy paper bases.

How bad it is now?

There were 3 alternative scenarios constructed for the baseline scenario that was build up based on the projections of the IMF in the World Economic Outlook database (2015): Pessimistic, optimistic and historical average scenarios. Using these scenarios, the main internal and external determinants of the debt to GDP level were stressed in order to assess the risk of debt sustainability concern in Kyrgyzstan. The overall results suggest that there is a significant debt sustainability concern if the country will find itself under the pessimistic scenario of development from 2015 to 2030. For each case with the warning indicators there was a corresponding debt stabilizing primary balance calculated, which shows the level of primary fiscal surplus or primary fiscal net borrowings (i.e. the fiscal financial result minus expenditures on debt interest), that would stop the debt to GDP level at the level of previous period. The results of stress tests are represented in the table below.

	2015	2016		2017	
Internal determinants of debt to GDP	debt to GDP	debt to GDP	DSPB	debt to GDP	DSPB
Pessimistic scenario	68.0%	74.1%	1.68% vs -4.9%	79,4%	1,7% vs -0,4%
Stress on GDP growth	68.4%	76.80%	1.75% vs -4.9%	82%	-0.49% vs -3.9%
Stress on Interest rate	68.5%	76.40%	1.71% vs -4.9%	82.10%	-0.4% vs -3.9%
Stress on Primary balance	68.1%	76.30%	1,7% vs -4.9%	81.70%	-0.4% vs - 3.9%
Multiple stress of internal determiants	73.50%	82%	1.88% vs -4.9%	87.00%	
	2015	2016		2017	
External determinants of debt to GDP level	debt to GDP	debt to GDP	DSPB	debt to GDP	DSPB
Stress on gold prices	69%	78.00%			
Stress on Ruble	71%	79.2%	1.8% vs -4.9%		
Stress on Kazakh tenge	68%	76%	1.74% vs -4.9%	81.70%	-0.4% vs -3.9%
Multiple stress on external determiants	78%				

Following the results, it can be seen that in the majority of the cases debt to GDP becomes unsustainable mainly in 2017. For these cases debt stabilizing primary surplus was calculated at the level 1.68% - 1.75% vs predicted primary net borrowing of -4.9%. In other words, the method recommends the tightening of the fiscal policy in 2016. However, for these cases it is also possible to run the primary net borrowing at -4.9% and then try to stabilize the debt level in 2017 at the levels of 2016. The logics behind this policy decision is that in this case the public sector would rely on the fiscal multiplier effect in 2017 as a result of high public expenditures, which will cause higher GDP growth and would theoretically allow to generate higher tax revenues. This strategy might work only if the public expenditures would be effective and will stay in the country, creating the additional value.

Unfortunately, due to the corruption issues the effective public investments are questioned and due to the week institutions and shadow economy aspects, it is doubtful that the public sector would be able to generate significantly higher revenues in order to stabilize debt to GDP. Moreover, even if the strategy will work, the debt to GDP level will be stabilized at the level of 74% - 76%, which are not far from unsustainable level which is 78%, so any shock might easily bring the debt position to unsustainable level. Therefore, the recommendation will be to tighten the fiscal policy in 2016, by stabilizing the debt to GDP ratio at the level of 68%

The stress test also indicates that there are cases when the debt to GDP level might become unsustainable in the case of pessimistic scenario in 2016 (multiple stress on internal factors, stress on gold prices and stress on ruble). Following these results, it might be concluded, that in these cases debt to GDP level is more vulnerable to shocks. Unlike to previous stress test results, these cases indicate that there is no one-year room for fiscal authorities to run the deficit and stabilize the debt position later in 2017. In fact, if the fiscal policy would not be tightened, the debt level will reach the threshold line. The debt stabilizing primary balance technique indicates that for these cases the primary surplus should result in 1,74 - 1,88% of GDP.

And lastly there is one more interesting case, when the debt to GDP level becomes unsustainable already in 2015, which is the multiple shock on external factors. In this case, possibly the public sector would have no other choice rather than having a debt restructure agreement with Paris Club or/and attempting to negotiate main creditors to transform substantial amount of debt to the foreign aid or grants. This will mean the debt distress for the country, and might result in decreasing of foreign direct investments to the country, and slow economic growth in the midterm perspective.

All in all, the conclusion from the results of the stress tests suggest to tighten the fiscal policy. The question is whether the government could commit to such a fiscal path both from economic perspective and political. Historical evidence shows, that the country was able to generate net primary surplus at 1,7% of GDP once in 2001, when the GDP growth was 11%. Now it is required to generate the approximately the same or even bigger amount of surplus at the very time, when the economy has negative growth and needs in stimulations of aggregate demand much. It is hard to say, whether it is economically feasible to generate such a high primary surplus, although theoretically it is possible.

However, such actions might be stopped by political representatives. It is very likely that majority of the deputies in the parliament would not approve the budget that does not satisfies the interest groups that they are representing. Otherwise, these deputies might lose political points, that are so important during the election and pre-election times. That is a classic conflict of politicians and policymakers. Luckily, the election already took place in 2015, so the politicians might not have to concern that much about their points, therefore, there is a hope for tight fiscal policy actions. On top of it, if the country will develop in pessimistic scenario, the politicians would not have any other choice, because unsustainable debt levels is most likely will negatively impact their political points just by the time of the reelections after 4 years from now. Therefore, it is the high chance that there will be some tightening of fiscal policy in the case of pessimistic scenario development, however might be not at the sufficient level for preventing the debt to GDP from growing, at least there will be a compromise between politicians and policymakers.

Now what?

Whatsoever, it is important to point out that all these cases of unsustainable debt to GDP might appear only in pessimistic scenario, while the other scenarios indicate, that the debt to GDP level is controllable at 60% level. However, the negative scenarios and the stressing of the determinants indicates, that there is a concern, and taking into account the fact that OPEC announced about increasing the quotas on crude oil extraction, it is most likely that oil prices would continue to fall in 2016 pressuring the Russian ruble and Kazakh tenge towards further depreciation. This would result in depreciation of Kyrgyz national currency too, due to the fact that both Russian Federation and he Republic of Kazakhstan are both one of the main trading partners of Kyrgyzstan. And this in turn might lead to significant increase in prices of imported goods. Kyrgyzstan is a net importer, which means, that there will be negative effect on aggregate demand, which in turn will result in slowdown of GDP growth, and this in turn might result in the worsening of the debt position of the country.

In addition to that the US FED announced about the increasing of the interest rates. This will push US dollar towards appreciation, and will make the import for Kyrgyz consumers even more expensive. Moreover, the prices of gold have been gradually decreasing from 2012, and considering that 12% of GDP comes from gold mining, this will also negatively affect GDP growth and will worsen the debt position of the country.

Summing up all concerns that were listed, one might make a conclusion that the likelihood of pessimistic scenario development is solid. And hopefully, the fiscal apparatus is ready to do something about the situation. Otherwise the situation in 2015 – 2017 will repeat the period of debt distress form 1998 – 2005.

As a general long term recommendation, probably the most important thing would be increasing the quality of institutions for better capability to generate fiscal revenues, and take some actions towards decreasing the level of shadow market in the country, which were estimated at the level of 40% in 2006 by UNDP. There would also be some warning signs for government to take some actions in order to soften the external effects on debt to GDP position in the country. Obviously, the public sector should be cautious, when it comes to the changes in Oil prices, gold prices ruble and tenge exchange rates. Particularly, if there is a probability of simultaneous shocks of these factors, it is important not to run expansionary fiscal policy. In the case of bad institutions and high probability of ineffective government investments, it is better to save funds in order to be able to meet the obligations, when the crisis appears.

And final recommendation is to keep each year the interest rate on public debt under the preferential levels at the point not more than the GDP growth of the country. In fact, in March, 2015, the Kyrgyz Republic applied for a 3-year arrangement with the IMF through the Extended Credit Facility (ECF) with access equivalent to SDR 66.6 million (or 75 percent of quota). This might be considered as a preferential loan from IMF at a 0% interest with the grace period of 5.5 years and final maturity 10 years2. It is certain that any borrowings of Kyrgyz government in the situation when the debt to GDP position is close to the unsustainable levels, might worsen the debt position. Nevertheless, in the critical situation, the funds under the ECF might be used in order to cover the existing liabilities on debt, which can stabilize the situation in the short term.

[2] "Request for a Three-Year Arrangement Under the Extended Credit Facility – Stuff Report; and Press Release" in *International Monetary Fund Country Report* № 15/113, IMF (2015); <https://www.imf.org/external/pubs/ft/scr/2015/cr15113.pdf>, (Accessed 05.01.2016)

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