

Environmental Finance



Pre-feasibility Analysis, Project Pipelines and Institutional Support for Debt-for-Environment Swap in the Kyrgyz Republic



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FOREWORD

This report presents the results of a project on Pre-feasibility Analysis, Project Pipelines and Institutional Support for Debt-for-Environment Swap in the Kyrgyz Republic. The study aims to assist the Government of the Kyrgyz Republic in analysing opportunities for, and challenges to, swapping (part of) its external debt for domestic financing of environmental projects. The report suggests that such a swap is likely to be feasible and could be beneficial to both the Kyrgyz Republic and the creditor countries. The pre-feasibility study is only a first step. A lot more remains to be done to convince creditors of the benefits of swapping debt and that the resources could be managed in a transparent and accountable way.

This report was prepared in the framework of the Task Force for the Implementation of the Environmental Action Programme for Central and Eastern Europe (EAP Task Force), whose Secretariat is located in the OECD's Environment Directorate. The project was managed by Nelly Petkova, with support provided by consultants Malgorzata Markiewicz (Public Finance Expert) and Michal Wilczynski (Environmental Expert) from CASE-Poland and Roman Mogilevsky from CASE-Kyrgyzstan. The preparation of this report was financially supported by the EU Tacis Programme.

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The views expressed in this report are those of the authors and do not necessarily reflect those of the OECD or its member countries.

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List of Abbreviations

ADB	Asian Development Bank
CA	Current Account
CAMP	Central Asian Mountain Partnership
CEE	Central and Eastern Europe
CI	Conservation International
CIDA	Canadian International Development Assistance
CIS	Commonwealth of Independent States
CDF	Comprehensive Development Framework
CSAC	Consolidated Structural Adjustment Credit
DANIDA	Danish International Development Agency
DFES	Debt-for-Environment Swap
DFID UK	Department for International Development of the United Kingdom
DSA	Debt Sustainability Analysis
EBRD	European Bank for Economic Reconstruction and Development
EC	European Commission
EECCA	Eastern Europe, Caucasus and Central Asia
ESAF	Enhanced Structural Adjustment Facility
ESMAP	Energy Sector Management Assistance Programme
EU	European Union
FDI	Foreign Direct Investment
FoE	Friends of the Earth
FONAMA	National Fund for the Environment of Bolivia
FONCODES	Social and Poverty Fund (of Peru)
FSU	Former Soviet Union
GDP	Gross Domestic Product
GEF	Global Environment Facility
GHG	Greenhouse Gases
GNP	Gross National Product
HIPC	Highly Indebted Poor Countries (Initiative)
IBRD	International Bank for Reconstruction and Development (World Bank)
IDA	International Development Assistance (World Bank)
IDB	Islamic Development Bank
IFAD	International Fund for Agricultural Development
IFI	International Financial Institution
IMF	International Monetary Fund
IUCN	The World Conservation Union
JICA	Japan International Co-operation Agency
JICB	Japanese International Cooperation Bank
JUMP	Juniper Forests Management Plans
KFAED	Kuwait Fund for Arabic Economic Development
KfW	Bank Kreditanstalt für Wiederaufbau (German Bank for Reconstruction)
KGS	Kyrgyz Som
KICB	Kyrgyz Investment Credit Bank
KIRFOR	Kyrgyz-Swiss Forestry Sector Support Programme
MEE	Ministry of Ecology and Emergencies of the Kyrgyz Republic
MTBF	Medium Term Budgetary Framework
NBKR	National Bank of the Kyrgyz Republic
NDF	Northern Development Fund

NEAP	National Environmental Action Programme
NGO	Non-Governmental Organisation
NPRS	National Poverty Reduction Strategy
NPV	Net Present Value
NTEF	National Trust EcoFund (of Bulgaria)
ODA	Official Development Assistance
ODS	Ozone Depleting Substances
O&M	Operation and Maintenance (Costs)
OECD	Organisation for Economic Co-operation and Development
OPEC	Organisation of the Petroleum Exporting Countries
OPEC Fund	OPEC Fund for International Development
PC	Paris Club
PIP	Public Investment Programme
PPP	Purchasing Power Parity
PRGF	Poverty Reduction and Growth Facility
PROFONAMPE	Protected Areas Fund of Peru
PRS	Poverty Reduction Strategy
RES	Renewable Energy Source
SBA	Standby Arrangement
SDC	Swiss Agency for Development and Co-operation
SDR	Special Drawing Rights
SECO	Swiss Economic Co-operation Office
SFS	State Forest Service of the Kyrgyz Republic
SME	Small and Medium Enterprises
STF	Systemic Transformation Facility
TNC	The Nature Conservancy
ToR	Terms of Reference
UNICEF	United Nations Children's Fund
UNCTAD	United Nations Conference for Trade and Development
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
USD	US Dollar
WB	World Bank
WWF	World Wildlife Fund
WWTP	Wastewater Treatment Plant

List of Physical Units

ha	Hectare
kWh	Kilowatt-hour
m ³	Cubic meter
Mg	Mega gramme
MW	Megawatt (10 ⁶ * watt)
TJ	Terajoule
Toe	Tonne of oil equivalent
TWh	Terawatt-hour (10 ⁹ *kWh)
SO ₂	Sulphur Dioxide
Mg/Nm ³	Milligramme per normal cubic meter

Exchange Rates

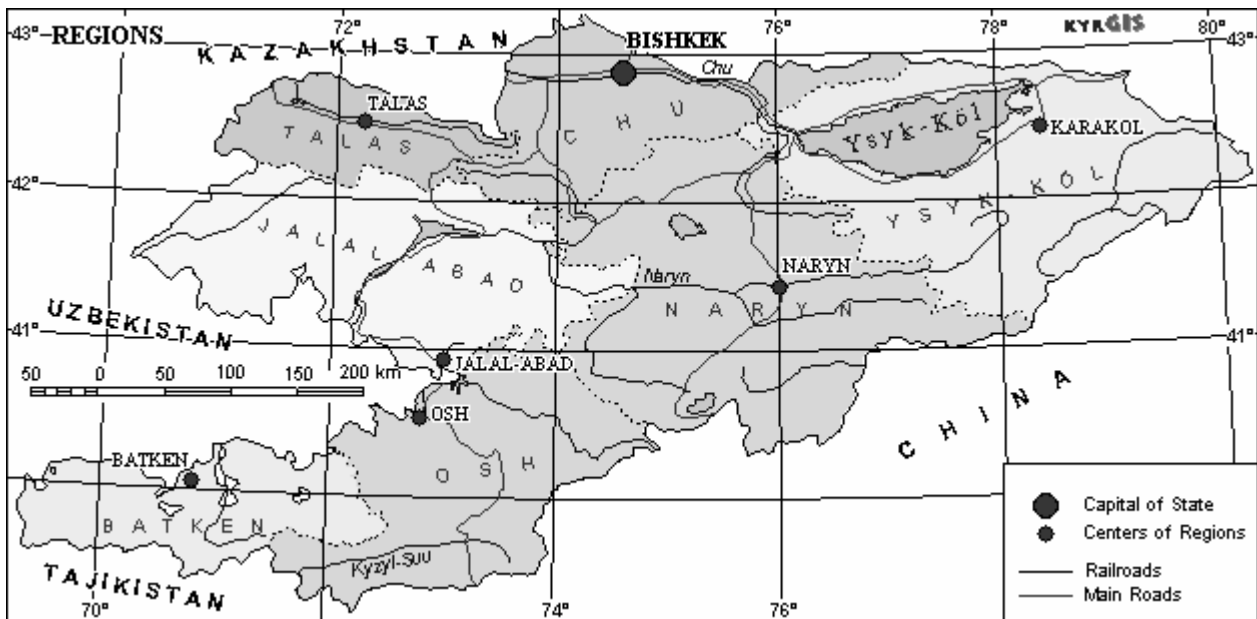
To convert the financial data presented in this report from Kyrgyz Som into US Dollars and EUROS, annual average exchange rates have been used:

Table 1. Exchange Rates, Som/USD, and EURO, Yearly Average

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Som/US Dollar	12.8	17.27	20.84	38.97	47.71	48.45	46.94	43.72	41.51
Som/Euro	-	-	-	41.52	44.14	43.38	44.26	49.27	52.96

Source: National Bank of the Kyrgyz Republic.

Map of the Kyrgyz Republic



EXECUTIVE SUMMARY

Debt-for-environment swaps (DFES) can provide low-income countries with a unique opportunity to link debt reduction with global/regional environmental benefits and poverty alleviation. Projects financed through DFES can aim to foster economic growth and contribute to peace and security in the region by alleviating regional and cross-border conflicts. They can address other internationally-agreed objectives as well, such as the Millennium Development Goals or multilateral environmental agreements. DFES can raise more money for environmental investments than other debt swaps, without adverse budgetary and inflationary consequences. In addition, implementing DFES within a robust institutional framework can help build capacity in managing public environmental expenditure in accordance with international good practices.

At the same time, there are risks involved with DFES. These include risks such as: the country's credit rating being downgraded; distorting more efficient debt treatment operations (restructuring and relief); macro-economic and political instability; inflationary impacts; further deterioration of the fiscal situation; and the possible mismanagement of debt swap funds. The report explores possible ways to mitigate these risks in the case of the Kyrgyz Republic.

International experience with debt-for-environment swaps has shown that preparing, negotiating, and implementing a DFES is a complex, difficult, and lengthy process. First, it is necessary that a sufficient amount of debt be eligible for swapping, so that the swap could generate revenues that more than offset the significant transaction costs involved. A credible fiscal capacity to service the debt swap is also required. Second, to attract creditors' interest, the country seeking a DFES should identify a convincing expenditure programme demonstrating the benefits that would be achieved by the debt swap; in addition, such a programme should be based on transparent and robust project selection criteria and implementation rules and procedures. Third, the country should design an accountable institutional arrangement to manage the associated revenue stream. Full and lasting government backing is also crucial for the success of the debt-for-environment swap implementation.

This Pre-Feasibility study shows that a debt-for-environment swap (DFES) between the Kyrgyz Republic and Paris Club creditors is feasible and could generate benefits for both, and for the international community more broadly.

During the past few years, the overall economic situation in the Kyrgyz Republic has significantly improved. The country has succeeded in achieving stable macroeconomic growth and low levels of inflation; the economy has become more diversified outside of the traditional agricultural and mining sectors. However, in 2003, with a GDP/per capita of 1 808.5 USD¹ compared to an OECD average of GDP/capita of 26 000 USD², the Kyrgyz Republic remains among the poorest countries in the world. Despite the progress made in key economic sectors since 2001, the country still faces significant challenges in servicing its external debt. With the 2005 Paris Club debt stock operation, sustainability of its external public debt was restored but a cautious debt management approach is needed to avoid further debt servicing problems.

¹ Measured in current Purchasing Power Parities (PPPs).

² Measured in current exchange rates and PPPs.

With the 2005 Paris Club arrangement, the government of the Kyrgyz Republic committed itself to not seek further debt relief from the Paris Club. The Government was therefore interested in additional options to limit the debt burden through debt swap operations. Both the 2002 and 2005 agreements with the Paris Club contain a clause on debt swaps allowing creditors to undertake, on a bilateral and voluntary basis, individual debt swaps (debt-for-environment, debt-for-aid, debt-for-equity) with the Kyrgyz Republic. Given the low level of public expenditures allocated to the environment, and the favourable consequences that further investment in the sector could have on economic development and poverty reduction, the Kyrgyz government identified DFES as the preferred option.

The feasibility study shows that the amount available through a potential DFES would be modest and spread over time. The report explains why Germany, France, the Russian Federation and Turkey are creditors that might be potentially interested in DFES with the Kyrgyz Republic. In calculating the potential revenue from DFES, a 20% conversion rate has been assumed. If Germany and France agreed to swap 20% of their annual debt repayments, the available resources in the period 2007 – 2028 are estimated in the range of USD 70-600 thousand annually (Germany's contribution would be about 90% of this amount)³. If the Russian Federation and Turkey (the first and the second largest creditors) joined a programme, this would significantly increase the amount available for DFES and would bring the annual revenue up to almost USD 5 million by 2028. However, there is no indication at the time of writing this report that these countries would be interested in a DFES. A positive track record might generate new swap opportunities in the future, in particular with neighbouring non-Paris Club countries, such as China and Uzbekistan.

These estimates have to be compared with the current level of domestic public environmental expenditure in the Kyrgyz Republic. In 2003, this level was USD 7 million, of which USD 900 000 was for investment. Thus a DFES involving Germany, France, the Russian Federation and Turkey would increase annual environmental expenditure by 70%.

Since DFES can potentially generate sustainable revenues, the report has identified project pipelines which would qualify as an expenditure programme. A review of the Kyrgyz environmental priorities and creditors' preferences suggests that the most promising priority areas could be those which aim at:

- Reducing pollution of regional waters;
- Protecting biological diversity; and,
- Reducing emissions of greenhouse gases.

In the above priority areas, five specific project pipelines were identified in cooperation with Kyrgyz experts and carefully evaluated. Eligibility criteria require that project pipelines achieve environmental benefits along with poverty reduction, local economic development and sustainable growth as well as security in the region. The review suggests that the two most promising project pipelines were biogas production from animal waste, and prevention of irreversible loss of biodiversity.

Given the possible level of revenues that a DFES could generate, local co-financing would be needed for the implementation of any project pipelines. Therefore, careful selection of the most cost-effective projects, and opportunities to co-finance projects from other sources, would need to be the cornerstones of project selection. This is also a prerequisite for creditors to be convinced that the Kyrgyz Republic has the capacity and commitment to manage their funds efficiently. It is worth noting that even if a DFES does not materialise, the project pipelines that have been prepared as part of this work identify cost-effective priority

³ Indeed, such a low level of financial flows might be a disincentive for creditors, who might consider that transaction costs associated with setting and monitoring the swap are relatively high.

projects that could be used by the Kyrgyz Government in discussions with donors when developing technical cooperation.

The Kyrgyz authorities are still considering the most appropriate institutional set-up to manage, monitor and report on the expenditure programme that could be established to manage a DFES. Alternative tools and procedures have to be assessed and discussed with creditors that will take into account the nature of the programme and the institutional capacity in the country.

This report suggests that, if sufficient revenues were generated by a DFES, they could be managed through a local revolving fund (a fund that is replenished at regular intervals from different sources). The final choice, however, would depend on actual negotiated swaps and the resources generated. If the swap amounts are too small, the Kyrgyz Government may consider implementing individual projects rather than establishing an institution. Another option would be to open a DFES window in an existing domestic institution with a proven track record in development finance. If a dedicated institution is established, it should be managed by local staff and contribute to building capacity of both managers and project owners as the best way to ensure sustainability of environmental protection efforts in the country.

Since 2002, representatives of the Kyrgyz Government have been actively promoting the DFES idea in different international forums and have declared their commitment to work for it. Usually, debt-for-equity swaps are the first choice of creditors as they allow them to recuperate more of their assets. Therefore, the Government of the Kyrgyz Republic has to provide creditors with convincing arguments that a DFES would better serve their interests. International experience shows that a strong signal from the government that DFES is a national priority during negotiations with creditors is a crucial factor for success. In addition, in order to be effective, the preparatory process will need a strong, dedicated leader. The Ministry of Finance, supported by and working closely with the Ministry of Ecology and Emergencies, could provide this leadership.

Lessons learned from the Kyrgyz case are relevant for other low-income countries in the region and beyond. Some of the main lessons include:

- Implementing a DFES requires a thorough analysis of the debt portfolio, to assess the magnitude of the swappable debt and of the potential revenue flows;
- The expenditure programme is a key requirement for attracting creditors' interest and eventual commitment. Such programmes should focus on issues of potential interest to creditors, such as international commitments to poverty reduction or environmental issues that are relevant at a global and regional level;
- Another key factor of success is the institutional framework designed to manage, monitor, and account for the implementation of the expenditure programme. Whatever the option, it should guarantee transparent rules of project selection, and accountable management of the revenue flows and expenditures;
- Preparation, negotiation, and implementation of a DFES requires a strong cooperation between the Ministry of Finance, that leads the discussions with creditors, and the Ministry of Environment, that is instrumental in identifying an attractive expenditure programme (project pipelines). Both institutions should be involved in the governance of the entity that will implement the expenditure programme;
- The process takes time to materialise (about 4 years in the case of the Kyrgyz Republic); hence the need for a stable policy and institutional framework, with a strong, lasting commitment.

Harnessing this opportunity will not be easy. However, it is an efficient way to secure additional public finance for environmentally-related projects, in countries where such commitments are fragile and always challenged by strong budgetary pressures.

1. BACKGROUND AND INTRODUCTION

Since its independence, the Kyrgyz Republic has accumulated a substantial amount of foreign debt which it has not been able to service. This is a paradox, as the Kyrgyz Republic began the transition period with no external debt whatsoever⁴. In addition, in the middle of the 1990s, the Kyrgyz Republic was a leader of economic reforms among the former Soviet Union Republics. Currently, in USD terms, the Kyrgyz Republic is among the poorest countries in the world⁵.

In 1993, the Kyrgyz Republic was the first to embark on an IMF support programme aimed at stabilising and transforming its economy. The presence of IMF funding attracted other credit resources from institutional creditors. The discovery of gold fields at about the same time as the implementation of the IMF Enhanced Structural Adjustment Facility (ESAF) programmes brought economic growth at high rates. However, with a hypertrophied public sector, the prospects of economic growth without fiscal adjustments were unrealistic. As an IMF study on fiscal sustainability shows, the actual primary deficits exceeded by almost seven percentage points the level calculated as sustainable (Cottarelli and Doyle, 1999).

The devaluation crisis experienced in the middle of 1996 (by almost 50%) led to an abrupt increase in the public debt expressed in domestic currency. The consequence was an agreement signed with the Russian Federation on debt restructuring. The situation was complicated again by the Russian crisis of 1998. In 2002, there was an agreement with Paris Club creditors resulting in a non-concessional flow rescheduling with the possibility of conducting debt swaps. Following the agreement with the Paris Club, the Kyrgyz authorities successfully completed negotiations with essentially all bilateral creditors on terms comparable to those of the Paris Club. While these agreements significantly lowered the Kyrgyz debt service obligations, the debt stock remained high. Therefore, in March 2005, a debt stock reduction agreement was signed with Paris Club creditors. It brought significant debt relief, however continued fiscal adjustment is critical for maintaining macroeconomic stability.

The clause on the debt swaps, included in the 2002 agreement with the Paris Club, opened a window of opportunity for the Kyrgyz Republic. Following the Paris Club agreement, at the initiative of the Ministry of Ecology and Emergencies, the Kyrgyz Government established an inter-ministerial working group, to discuss and develop modalities for utilising the opportunity presented by the debt-for-environment swap (DFES). At present, there seems to be a greater willingness among the international community to consider debt-for-environment swaps than there has been in the past. There is also an opportunity for the Kyrgyz Republic to link the debt-for-environment swap initiative with the existing CIS-7 Initiative. The Kyrgyz Government is also trying to advance and link the DFES idea to a UN initiative on Poor Mountainous countries.

In addition, the Ministry of Ecology and Emergencies requested that the EAP Task Force Secretariat (OECD) assist in establishing a framework for bilateral negotiations of debt-for-environment swaps with creditors, similar to the assistance that the EAP Task Force had earlier provided to Georgia. The project on “Pre-feasibility Analysis, Project Pipelines and Institutional Support for Debt-for-Environment Swap in the Kyrgyz Republic” was formalised and officially launched in November 2004.

⁴ This is so because as soon as after 1991, the Russian Federation, as agreed with the creditors, offered the other EECCA to take over all official foreign liabilities of the former Soviet Union.

⁵ According to the World Bank definition (World Bank Global Development Finance, 2004), a country is classified as low-income when the annual GNP per capita is equivalent to or less than USD 735 (in 2002 prices). There are about 60 low-income countries in the world, including 8 EECCA countries: Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, Ukraine and Uzbekistan.

The study undertaken in the course of this project has focused on three major issues: debt profile and sustainability, identification of project pipelines for the expenditure programme to be financed by potential DFES resources and governance issues.

Part 1 of this study sets the stage for the subsequent analysis. It introduces different debt treatment operations and models of swap transactions and discusses advantages and disadvantages related to each of these options. It presents some lessons learnt from international experience with DFES implementation.

Part 2 focuses on debt profile and sustainability issues. The data collected are grouped and analysed by creditors as not all of them are potential candidates for debt-for-environment swaps. The report examines external public and publicly-guaranteed long-term debt owned to official bilateral creditors. Taking into account existing experience with debt-for-environment swaps (DFES) (mostly, Poland and Bulgaria) and assuming that all identified creditors participate in the DFES scheme, flows of potential revenues are calculated and conclusions made. Then, the current level of environmental expenditure is discussed and the role that environmental objectives play in the Public Investment Programme is identified.

Part 3 presents an analysis of national environmental priorities and project pipelines suggested for inclusion in an expenditure programme to be co-financed by potential DFES resources. To this end, a number of strategic documents have been reviewed. The main priorities of the Kyrgyz Republic include sustainable economic growth and reduction of poverty. This report looks at three priority areas eligible for financing from potential DFES resources, namely: water resources protection; climate protection; and biodiversity protection. In addition, focus is placed on problems common to all of Central Asia, i.e. soil desertification and erosion and their relation to climate change, plant life degradation and deforestation. Five potential pipelines are identified, of which two are recommended for further detailed economic evaluation.

Finally, Part 4 discusses institutional options for governance and management of the expenditure programme with special attention to the local legal and regulatory framework and issues related to project cycle management. The conclusions of this analysis and further actions are presented in Part 5.

The results of this report were presented and discussed at a multi-stakeholders' meeting held in Bishkek on 28 June 2005.

1.1 Possible Debt Treatment Operations

The international community has long recognised the potential of debt swap operations for raising capital in low-income countries. As such, debt swap operations have received particular attention over the past 20 years. This section looks at different debt treatment operations and models of swap transactions. It draws some lessons from international experience with DFES implementation.

A **debt swap** (or conversion) is defined as the cancellation of (part of the) external debt of a country in exchange for the debtor government's commitment to mobilise domestic resources (local currency or another asset, such as bonds, privatised public assets) for an agreed purpose at agreed terms. The cancellation of external debt usually comes at a discount from the face value⁶.

There are several major debt swap transactions:

Debt-for-aid (development) swap – the cancellation of external debt in exchange for local currency paid for development projects (e.g. health, education) in the debtor country;

⁶ Definitions and examples presented in this chapter are mostly based on a UNDP Guide for DFES for National Desertification Funds (1998).

Debt-for-equity swap – the cancellation of external debt in exchange for local currency invested in equity (shares) in a domestic firm or privatised public enterprise but also in natural resource stocks;

Debt-for-nature (environment) swap – the cancellation of external debt in exchange for local currency used to finance conservation (“green”) or environmental protection (“brown”) projects, i.e. pollution abatement, development of environmentally-related infrastructure, preservation of biological diversity. Debt-for-environment should also be designed to alleviate poverty and foster economic development.

The international debt crisis of the 1980s led to the introduction of the debt swap mechanism for conversion of debt owed by developing countries which were unable to service their external debt. The first swap operation was applied by Chile in 1985 as a debt-for-equity swap. The first debt-for-nature swap was concluded in 1987 between the government of Bolivia and *Conservation International (CI)*. As a result, USD 650 thousand in debt was cancelled in return for the establishment of the *Beni Biosphere Reserve* in north-eastern Bolivia and the creation of a small endowment to cover its operation costs. Other swaps followed the same year in Costa Rica and Ecuador. Since then, the DFES have been used in low income countries to capitalise environmental trust funds or endowments (see Annex 6). It has also been common in those African countries that have been most severely affected by desertification⁷. DFES have been also implemented in many Latin American countries (e.g. Argentina, Bolivia, Chile, Colombia, El Salvador, Jamaica and Uruguay) or transition countries (Poland, Bulgaria, Georgia (in progress)). It is estimated that over 30 countries have benefited from DFES, which have generated over USD 1 billion in funding for the environment.

The economic rationale of debt swaps is based on the willingness of creditors to accept less than the face value of debts and of the debtor government to make payment at a price higher than the reduction agreed by the creditor in exchange for cancellation of the debt. DFES can bring multiple benefits: creditors can be relieved of an asset that might never be repaid in full, and debtors can reduce the external debt burden without drawing down scarce foreign reserves and may even gain considerable debt relief (GEF, 2002).

The transaction of debt swap is **feasible** if:

- A creditor is willing to donate or sell debt at a discount from face value. The debt must be available and eligible for conversion. The creditor is willing to do this, if the benefits of reducing debt through debt swap outweigh the benefits of waiting for future repayment. In order to swap debt, the creditor government should recognise the positive development impact of debt relief combined with increased social or environmental investment. In the case of commercial creditors or government export agencies, their primary motivation is based on the desire to recover some debt that they perceive as unlikely to be repaid at full face value.
- A debtor government is interested in and able to provide local currency or another commitment in support for the environment. The intention of a debtor government is to retire its debt at the highest possible discount from face value. The debtor government has to appreciate the positive impact of debt reduction at low cost combined with increased investment in priority sectors. Another motivation may be the scarcity of foreign exchange reserves – in case of debt swap the payment is made in local currency. In order for a debt swap to be realised, the debtor government has to perceive the benefits of a swap as more advantageous than future debt relief that may be obtained through debt rescheduling agreements.

Some of the potential advantages of debt conversion are (after Moye, 2001, UNDP):

⁷ Some experience of African countries in the context of potential DFES has been amply summarised in a report of UNSO on *Mobilizing Resources for National Desertification Funds through Debt-for-Environment Swaps* in 1997.

- Debt swap retires debt at a discount from face value. The government chooses a debt swap operation only when repayment terms for debt conversion are more favourable than anticipated renegotiated terms;
- By reducing debt service payments in foreign currency debt swaps can have a positive impact on a country's balance of payments;
- Debt swap may favour investment in priority sectors which are defined by government;
- Debt-for-equity swaps may be used as an incentive to encourage privatisation or to facilitate the return of flight capital by their nationals;
- Debt swap may increase funding for development programmes. In many countries, debt swaps have stimulated the creation of local currency environmental funding mechanisms that have often been new to these countries. Debt swaps lead to greater participation by civil society, including NGOs, in implementing development projects;
- Initial capital granted through debt swaps can also be used to attract matching contributions from other donors. In the case of the Mexican debt-for-nature swap, the GEF (see: Box 6) made a major contribution to a protected area. Debtor governments usually try to estimate the degree of additionality offered by debt swap operations by determining the likelihood of the foreign investment or development assistance entering the country in the absence of debt conversion.

Some of the disadvantages related to debt swaps are:

- Lack of fiscal resources to make a prepayment may be a constraint to debt swap operations. Hence, some co-financing may be also necessary. It is believed that the budgetary impact can be managed, if payments are made over time;
- Debt swap means injection of excessive amounts of local currency into the economy that may result in inflation. In order to mitigate inflationary impact, debtor governments may structure payments in instalments or bonds. By issuing securities in local currency, the government is able to contain any potential inflationary impact of the swap. Debt-for-equity swap has no adverse monetary impact;
- Debt swap transactions are time-consuming and complex, usually requiring the use of specialised advisors which increases the cost of operations;
- There is a risk of corruption and round-tripping (investors transfer local currency generated through conversion out of the debtor country for illegal gain). In order to limit these risks strict reporting requirements should be put in place;
- In the absence of additionality, the debtor government may be subsidising investment that would have occurred anyway. This risk is highest in the case of debt-for-equity swaps with major incentives for foreign investment.

Below, we discuss some of the major debt swaps and their advantages and disadvantages as well as their relevance for the Kyrgyz Republic.

*1.1.1 Debt-for-Aid Swaps*⁸

Debt-for-aid swaps offer creditors an attractive opportunity of swapping the debt without significant net additional flow of financial resources to the debtor country. Debt-for-aid often means financial transfers between various agencies within the creditor country government, i.e. outstanding receivables on foreign official loans are financed by decreasing, or not increasing, the foreign aid budget. Such swaps would reduce the budget available for other official assistance programmes, and for this reason can be more easily accepted by the creditor country government.

Debt-for-aid may be attractive for creditors as a transparent transaction and usually one-time only financial transfer. Managing related expenditure can be easily incorporated into an established programming framework of bilateral official development co-operation agreements. This gives creditors direct control over disbursement and enables a partial recuperation of financial benefits through a reduction of the baseline aid budget and through tied procurement (swapped debt used to purchase goods and services from the creditor/donor country).

For the same reasons, the Kyrgyz Republic may find debt-for-aid swap less beneficial. From the Kyrgyz perspective, the major question is the value added that such a transaction would provide compared to the aid-as-usual scenario. A legitimate expectation of the Kyrgyz Republic would be that debt-for-aid should not substitute for the baseline official development assistance but would mobilise "new" and "additional" resources. Unfortunately, such an expectation would most likely be difficult to meet if debt were swapped for aid. Even if it may not affect already committed bilateral assistance, it is very likely that such a swap would influence the allocation of foreign assistance budgets in the future.

Debt-for-aid swap could in principle be used for environment and development purposes. However, as described earlier, such a transaction is usually a one-time transfer as opposed to diverting the debt repayment flows over a longer period of time. The commitment periods of official assistance budgets are not longer than one to two years. Indicative programming may sometimes stretch up to three years, but not more. Because of its short term, the value of transactions cannot be very large. This is so because if a significant amount of future liabilities is swapped for domestic expenditure on aid over the maximum period of two to three years, this could be fiscally impossible for the Kyrgyz government and could distort its foreign exchange regime. A government can bypass this constraint by issuing bonds to raise the necessary amount of resources up-front and smooth payments to the scheme over a longer period of time. Such an action would also "sterilise" potential distortions to monetary policy, which could be caused by pumping large amounts of domestic currency into the economy in a short period of time. But it would involve the additional cost of bond issuance and servicing. It would also compromise the sovereign borrowing capacity, hence may not be a feasible option for the Kyrgyz Republic in the short to medium term.

As international experience shows, debt-for-environment swaps can be designed so as to mitigate these problems and to redirect many more resources to the local economy in a way that does not create macroeconomic distortions and does not affect creditworthiness. Moreover, the expenditure programme under the debt-for-environment swap can be made fully compatible with the objectives of official aid programmes. Environment and development goals are often synergistic.

⁸ The detailed analysis of different debt swaps is mostly based on a forthcoming OECD publication *Debt Swap for Environment and Development in Georgia: Pre-Feasibility Study, Institutional Option*.

1.1.2 Debt-for-Equity Swaps

The crucial difference between debt-for-equity and other debt swaps considered here is that under this scheme the creditor can recapture more of his assets. It is therefore no surprise that 98-99% of all debt conversions world-wide have been swaps for equity⁹. Debt-for-equity swaps have been quite successful in solving some of the liquidity problems in a number of the Latin American countries¹⁰. Debt-for-equity swaps are often preferred by creditor governments as *ad hoc* measures to compensate their domestic financial institutions affected by debt conversion. Some creditors also use this instrument to take over strategic assets in debtor countries, e.g. energy infrastructure or strategic industrial sectors.

A debt-for-equity swap would be attractive to creditors strictly on financial terms if the value of the swap was smaller or equal to the market value of the equity. Market value, in turn, is equal to the risk-adjusted present (discounted) value of the future flow, net of tax profits from the assets acquired through a swap.

Unlike a foreign firm, which is interested exclusively in financial returns, some creditor governments are also interested in environmental and social benefits that cannot be captured in monetary terms by a private investor. If this is the case, a creditor government might be willing to accept a swap value that is larger than the market value of equity. The difference would be the actual debt relief or the price that the foreign government would pay for producing local social and environmental benefits, some of which are trans-boundary or global. The market value of environmental assets must, however, be greater than zero. Otherwise, no foreign firm would be willing to accept the assets, even free of charge.

For the same reasons, the Kyrgyz Republic would benefit from swapping debt for assets that would not have found buyers otherwise, i.e. whose market value is zero. Swapping debt for assets that have a positive market value would not always yield benefits to the Kyrgyz Republic. Selling assets on the market, through competitive sale is likely to yield more revenue than swapping these assets for debt reduction with a single creditor under a very limited competition. Unless the creditor buys assets through competitive bidding (a rather unlikely arrangement under the swap), the purchase price is likely to be lower than the market value (Zylicz, 1998).

Debt-for-equity swaps also cannot contribute to capacity building in the debtor country as much as the more long-term and comprehensive approaches to the debt-for-development and debt-for-environment swaps discussed below.

A transaction beneficial to the Kyrgyz Republic on economic grounds is unlikely to attract creditors' interest, unless the assets in question yield some non-market services of a public goods character that a creditor government is interested in. Therefore, the optimum strategy for the Kyrgyz Republic would be to sell on the market any asset which has financial value and swap the debt for the economic value of non-market services. These non-market services may include services provided by improved environmental assets (water, air, soil), such as reduction of premature mortality and morbidity, flood protection or support of sustainable agricultural and forest output.

1.1.3 Debt-for-Environment Swaps

A debt-for-environment swap is among the very few mechanisms that can provide sustainable support for local economic development and at the same time mobilise domestic spending to protect purely public and common goods (such as biodiversity) or pure externalities (such as trans-boundary or global pollution) in low-income countries. These basic goods and services that nature provides are the essential basis for subsistence, social welfare and sustainable growth of local communities. They are also common global

⁹ UNCTAD (United Nations Conference on Trade and Development) (1992), *Conversion of Official Bilateral Debt*, GE.92-55494, Geneva.

¹⁰ UNCTAD. 1992, pp. 38-42.

assets that sustain life on earth and determine the future growth of the world economy, as recognised by numerous international environmental conventions and treaties. The tragedy of common goods, such as most services provided by pristine nature, stems from the fact that they can yield only limited cash revenue to their owners or users. Therefore, they are bound to be depleted (many irreversibly), because of the inability for owners and users to co-operate. This depletion is exacerbated by the immediate pressure of poverty and the need for cash (e.g. in order to service foreign debt).

A debt-for-environment swap can be used to finance "green" public goods (nature reserves, sustainable tourism or sustainable agricultural practices) or to finance abatement of industrial pollution externalities – the so-called “brown” projects (improving energy efficiency, reducing pollution from the power and district heating sector or in selected industrial facilities). Debt-for-environment swaps can also be used to finance development of collective environmental infrastructure, such as wastewater collection and treatment systems, handling of accumulated toxic waste. In particular, development objectives can be facilitated by financing access of the poor to essential infrastructure services, such as water, sanitation and energy. Many services of such infrastructure can also yield trans-boundary or global benefits. In the absence of a financial incentive, a low-income country usually cannot realistically be expected to finance the full costs of the projects, which partly benefit downstream or downwind countries. By the same token, immediate and local needs of a low-income country usually crowd out projects that would generate purely global returns, such as prevention of climate change, protection of international waters or biological diversity.

The majority of such projects would also yield important economic benefits to poor local communities, which depend on environmental goods and services for subsistence and sustainable growth. For example, treating discharge of wastewater into the Issyk-Kul Lake from the coastal villages and cities would not only prevent eutrophication of this sensitive water reservoir, but would also help increase the attractiveness of the area for tourists. Harvesting local renewable energy sources, such as rivers or biomass, would not only benefit the global climate, but could also provide access to cheap and sustainable energy for the local communities, which do not have access to or cannot afford electricity and heat produced from imported fossil fuels. Therefore, **debt-for-environment swap can be viewed as a mechanism that blends local and foreign financing to implement projects that support local economic development and poverty reduction that otherwise would not have been financed because of their public goods character, or because their benefits are shared by many countries.**

For the Kyrgyz Republic, swapping debt for environment is an attractive option for a number of reasons:

- It provides new and additional local currency expenditure that does not replace other public spending.
- It can leverage additional local expenditure on environmental public goods that are highly important as the foundations of the country’s sustainable development, but are typically not urgent because of the immediate pressures to provide food and security to poor people, even if this undermines the long-term, sustainable basis for local food supply.
- It offers opportunities to integrate environmental quality improvements with poverty reduction, social well-being and economic recovery through protecting public health, creating new jobs and harvesting local resources and skills to generate sustainable revenues to local communities.
- It provides a unique opportunity to move towards fulfilment of international environmental agreements (such as the Climate Change Convention, the Convention on Biological Diversity).
- It can contribute to the alleviation of regional and cross-border conflicts related to the management of trans-boundary natural resources (e.g. surface waters, forests).
- It is a practical and effective instrument to mainstream the environment in the social and economic growth agenda of the Kyrgyz government. As Polish experience has shown, by raising environmental issues at the debtor country's government forum, swap negotiations, elevate the status of environmental departments, and make them partners with financial and industrial agencies.

- If properly designed, it can contribute to the improvement of the institutional capacity to develop and implement result-oriented environmental programmes, to prepare projects and to manage public expenditure in a transparent, accountable and efficient manner.

For creditors, a debt-for-environment swap has a number of attractive characteristics:

- For creditors that are concerned with global environmental problems (climate change, biodiversity), it offers an opportunity to "purchase" global environmental benefits more cheaply than at home. This benefit is proportional to the scale of potential global benefits that can be produced in the Kyrgyz Republic (e.g. the potential reduction of emissions of greenhouse gases, the size of potential carbon sinks, and the size and diversity of endemic natural ecosystems).
- For creditors concerned with international security, a debt-for-environment swap offers an opportunity to foster cross-border co-operation and confidence building between (potentially) antagonistic countries. Such measures may include protecting common natural biological resources, e.g. nature reserves, endangered species, rivers or lakes. A debt-for-environment swap can also help uproot sources of international/regional conflicts, e.g. by improving the management of water resources in trans-national rivers or by reducing pollution loads that affect the quality of life in neighbouring countries.
- For creditors concerned with poverty reduction, a debt-for-environment swap offers various win-win opportunities to eradicate poverty while enhancing environmental sustainability. In low-income countries, such as the Kyrgyz Republic, a large share of the population depends heavily on natural ecosystems for daily subsistence. Sustainable management of natural resources, such as water, soil, forests, is a solid source of food, energy and income to many local communities.
- A debt-for-environment swap may also have a positive effect on a creditor country's environmental and political image in light of the increasing political promotion of debt forgiveness to the poorest countries (e.g. the CIS-7 Initiative, see Box 3) and global co-operation for environmental protection.

Debt-for-environment swaps have a number of advantages over alternatives, such as debt-for-aid and debt-for-equity swaps. Debt-for-environment swaps can be designed as effective swaps for poverty eradication and sustainable development. This could be done by developing an expenditure programme that addresses international/regional and global common goods while eradicating local poverty, improving regional security, enhancing infrastructure for the poor and strengthening the environmental foundations of sustainable development. Therefore, **it is recommended that the Kyrgyz Republic pursue the comprehensive debt-for-environment swap scheme.**

1.2 Models of Swap Transactions

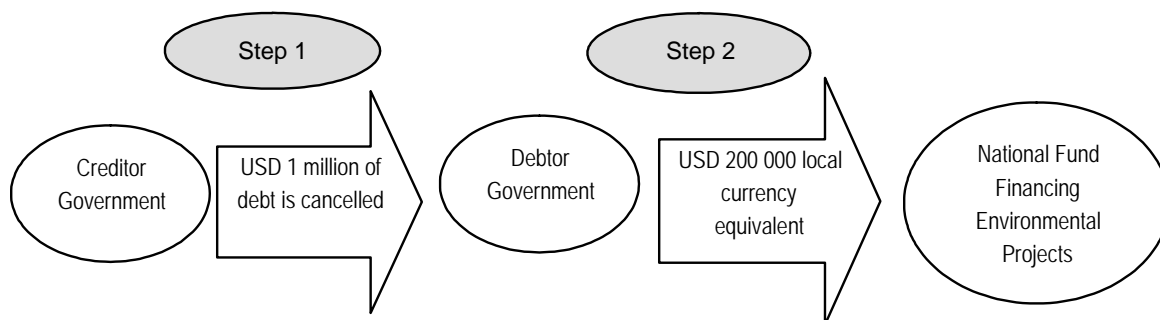
Two main models of debt swaps, depending on the number of negotiating parties in a transaction, have been used so far:

- Bilateral (direct) swaps; and,
- Third-party - trilateral or multilateral - swaps (through an intermediary).

Bilateral, direct swaps - When the swap is bilateral, the creditor government cancels debt owed by the debtor government in exchange for the debtor setting aside an agreed amount of counterpart funds in local currency for an agreed purpose. This model is used mostly in official (government to government) debt swaps. The bilateral model has been used to convert Official Development Assistance (ODA) debt and publicly guaranteed export credits. The best known and advanced case of bilateral debt-for-environment swap is the swap that Poland made with Paris Club creditors in 1991-2000 (see section 1.3 below). In addition, bilateral swaps can also be made through a multilateral swap facility, which gives the debtor a standardised framework for swapping several bilateral debts for one expenditure programme.

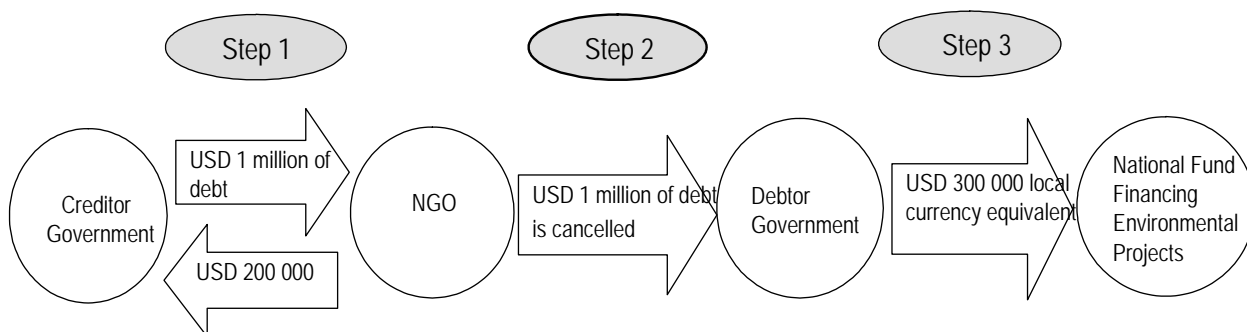
The amount of local currency may or may not reflect a discount, relative to the present face value of the original debt, and this discount can be subject to negotiations between the two countries. Another variable that needs to be negotiated is the exchange rate at which local currency payments are made, a schedule of payments (one-time transfer or instalments as repayments are due), and the mode of payment (e.g. cash, government bonds or in-kind contributions). All these variables determine the rate of debt forgiveness, or relief, embedded in a transaction. Figure 1 below presents the schematic model of a standard bilateral swap transaction.

Figure 1. Model of Bilateral Swap



Third-party swaps – A transaction can also be concluded with the participation of a third-party. The difference between the purchase price of debt and its redemption price (face value; nominal value of debt) in local currency is the gain from debt conversion, which can be invested in environmental projects. An organisation (e.g. an NGO) solicits debt donations or purchases debt at a secondary market at a discount from face value from a creditor and negotiates separately with the debtor government the cancellation of the debt in exchange for project funding. Debt for nature swaps that have been negotiated by conservation NGOs such as *Conservation International (CI)*, the *Nature Conservancy (TNC)* and the *World Wildlife Fund (WWF)*, have mostly been three-party swaps. Figure 2 below presents the schematic model of a standard trilateral swap transaction.

Figure 2. Model of Trilateral Swap



Note: Assumptions: 20% debt purchase price, 30% payment in local currency.

The converted debt is usually deposited in the form of local currency denominated government bonds in a conservation trust fund that disburses the funds (derived from interest and amortisation of the bonds) for conservation purposes agreed upon in advance with the creditor.

It is worth noting that Paris Club rules envisage the possibility of selling debt by the creditor government to an investor who in turn sells the debt to the debtor government in return for shares in a local company or

for local currency to be used in projects in the country (www.clubdeparis.org – debt swap provision). Thus, the third-party swap may be also applied under Paris Club arrangements.

Examples of trilateral swaps have been more common in Latin America, Asia and Africa since the 1980s. Through trilateral swaps, both official and non-official debt can be converted.

Box 1: Example of a Trilateral Swap

The first debt-for-environment swap was implemented in Bolivia in 1987, where USD 650 000 of Bolivia's debt (a fraction of a percent of the country's substantial indebtedness) was bought by Conservation International for USD 100 000 (roughly 15 cents in the dollar) in the secondary financial market and retired. In exchange, the Bolivian government agreed to expand protected areas around the Beni Biosphere Reserve by 1.5 million hectares. The Bolivian government contributed USD 100 000 to the protection programme and also received a USD 150 000 grant from the United States Agency for International Development.

Trilateral swaps usually involve relatively small amounts and one-off financial transfers to create an endowment of a trust fund. Trilateral swaps are usually used to finance a portion of running costs of nature protection areas or small NGO non-investment projects. Trilateral swaps rarely have potential to generate a critical mass of resources to support investment projects, e.g. in rehabilitation of deteriorated environmental infrastructure. They also introduce an additional constraint into expenditure planning – interests of the NGO intermediary must be taken into consideration. This may or may not be compatible with the preferences of creditors and/or the Kyrgyz government.

Trilateral swaps have been the remedy in countries with corrupt, dictatorial governments, which could not be trusted. One can argue that the progress that the Kyrgyz Republic is making in building democracy, civil society and improving governance may not make it necessary to take expenditure management out of the hands of the institutions controlled by the government and put it into the hands of an international NGO. Domestic NGOs can and should play the role of watchdogs, but not necessarily intermediaries. International environmental NGOs have so far shown little interest in the Kyrgyz Republic and in other smaller, low-income countries of the former Soviet Union. It is less likely that, in the foreseeable future, they will be willing and able to raise funds to buy the official debt of the Kyrgyz Republic from its creditors.

International experience summarised in Annex 6 speaks for itself. The most sizeable swaps have been bilateral swaps of government debt without intermediaries. A single bilateral swap of Polish debt diverted more debt money for environmental purposes than all trilateral swaps world-wide taken together. Bilateral swaps can generate a critical mass of predictable environmental financing over a longer period of time.

The important progress, which has been achieved already in opening the window for bilateral swaps with Paris Club creditors, makes such transactions feasible in the near future. It should be noted, however, that bilateral transactions can be designed in a way that could accommodate any number of one-time transfers from single swaps of public or private debt facilitated by potential intermediaries. They can also encourage other (non-swap) donations if the facility established for DFES purposes proves to be efficient and reliable.

Typically, bilateral debt reduction programmes result in the creation of institutional structures such as counterpart funds or environmental funds that monitor grant-making programmes. It should be noted that the creation of such an institution is not necessary, especially when the debt swap amount is limited and would not justify the institutional costs.

To date, several developed countries have established special programmes for a debt reduction under the DFES arrangements in different countries in the world. In the case of the Kyrgyz Republic and given the structure of its creditors, two programmes are important:

French Programme – In 1992, France announced the creation of the *Fonds de conversion de créances pour le développement*, (“Funds for Debt-for-Development Swap”) the so-called *Libreville Fund*, created with FF 4 billion owed to France by four middle-income countries – Cameroon, Congo, Ivory Coast and Gabon. The Fund provides for conditional debt cancellations on a bilateral basis in exchange for the debtor government setting aside counterpart funds for development projects. The French Treasury is responsible for debt sales subject to a bilateral debt conversion framework established between France and the debtor country.

German Programme – The German government established a debt-for-environment programme after the Rio Summit in 1992. In 1997, the German government set aside USD 160 million to fund cancellation of ODA debt via debt swaps. The bilateral programme is administered by the German Ministry for Economic Cooperation and Development. Debt sales are authorised on a case-by-case basis upon application to the Ministry of Finance of Germany.

1.3 Lessons Drawn from Existing Debt-for-Environment Swaps

A number of countries have implemented debt-for-environment swaps. To date, the largest environmental swap involving conversion of bilateral debt has been concluded by Poland. The mechanism has proven to be valuable and thus deserves special attention.

1.3.1 The Polish EcoFund

In 1991, Poland concluded an agreement with the Paris Club on debt restructuring assuming cancellation of 50% of its debt to Paris Club creditors providing the remaining part be paid off by 2010. Although Poland had the possibility to negotiate different debt swaps within the framework of the Paris Club agreement with creditors, it was the Polish Government decision to insist that only DFES would be requested while some creditors expected debt-for-equity swaps too. In exchange for cancelling an additional 10% of each participating creditor’s claims, Poland proposed to finance a local fund with an equivalent amount of hard currency. The Paris Club accepted the proposal to implement a mechanism of allocating up to 10% of debts for the purposes specified in bilateral agreements signed with individual creditor countries.

By 2000, the Polish EcoFund had mobilised resources equivalent to USD 571 million through swaps with creditors and grants from donor countries. This is roughly equal to the value of all other debt-for-nature and debt-for-environment swaps world-wide so far.

In June 1991, the US government, as first, assigned 10% of the Polish debt (about USD 370 million) for the DFES scheme. This allowed the establishment of a special institution that would administer the resources made available through the swap.

In April 1992, the Polish Minister of Finance, acting on behalf of the State Treasury, established the EcoFund with the status of an independent non-profit foundation. The first tranche of money was transferred to the EcoFund’s bank account in November 1992. This permitted the employment of the first three staff members, the renting of offices and the start of regular operations. The first grants were awarded by the EcoFund to five projects as early as 1993.

Starting in 1993, the following agreements were concluded: in June 1993, France agreed to swap 1% of its debt, in December 1993, Switzerland agreed to swap 10% of its debt, in 1997, Sweden agreed on 4%, in 1998, Italy on 2% and in 2000, Norway on 10% of the debt conversion.

The amount treated by the Paris Club agreement was equal to USD 29 871 million. Half of this amount was cancelled and an additional 10% was able to be exchanged into swap operations. The 6 agreements with Paris Club creditors already signed have provided USD 571 million available for EcoFund grants in 1992-2010. This represents an average swap rate of 1.9% (the amount of agreements signed divided by the amount treated by the debt agreement of USD 29 871 million). The US contribution was the first and the largest and accounted for 72% of the total.

The money is paid in annual tranches from the state budget to the EcoFund's bank account as Poland's commitment towards the creditor countries. The relevant funds are provided every year in the budgetary act as 'servicing of foreign debt'.

The EcoFund finances private sector investment projects within five priority environmental protection sectors:

- reduction of transboundary air pollution of sulphur dioxide and nitrogen oxides and elimination of the low sources of such emissions;
- reduction of pollutant and eutrophying flows into the Baltic Sea and protection of drinking water resources;
- reduction of emissions of gases causing global climate change (global warming and stratospheric ozone);
- protection of biological diversity; and,
- promotion of waste management and contaminated soil reclamation.

One of the major objectives of the EcoFund is to support the transfer of the best engineering and technological environmental protection solutions from the creditor countries to Poland.

Over the period 1992-2003, the EcoFund awarded grants to over 1000 projects. Usually, the average grant covers about 20% of the project cost. Grant disbursement is followed by strict monitoring procedures during and after project implementation in order to ensure that the beneficiary uses the grant for the agreed purpose and agreed results are achieved. Every project is divided into a number of stages approved on the basis of technical and financial inspections. The grant funds are transferred only after the specific stage is completed and approved by the Fund.

A good indicator of EcoFund's efficiency and credibility is the fact that donors have agreed to provide the Fund with additional grants. So far, two grants of the equivalent of USD 3.9 million have been entrusted to the EcoFund to manage. They were awarded by the government of Norway in 1997 and the government of Switzerland in 2000 (www.ekofundusz.org.pl).

The Polish example shows the importance of clear and credible commitment to economic and governance reforms in winning the interest and trust of creditors. It shows how a concerted effort of the whole government and a smart negotiations strategy combined with a very attractive expenditure programme and a good design of the transaction and institutions can bring spectacular results.

In 1996, the OECD EAP Task Force conducted a performance review of the EcoFund. The report concluded that the EcoFund is best known throughout the region for its rigorous project cycle management procedures, its leveraging of additional financial resources, and its objective and transparent decision-making process (www.oecd.org).

1.3.2 The Bulgarian EcoFund

The National Trust EcoFund (NTEF) of Bulgaria is a legal entity established pursuant to the DFES agreement between the governments of Switzerland and Bulgaria in 1995. As of now, Switzerland is the only source of financing. The Swiss representative, sitting on the Supervisory Board of the Fund, has an

absolute veto right on projects proposed to be financed with funds provided by this source of financing (www.ecofund-bg.org).

The priority areas, financed by the Fund, comprise:

- clean-up of past pollution;
- reduction of air pollution;
- clean water protection; and,
- protection of biodiversity.

By July 2003, the Fund had approved financial support for 58 environmental investment projects; 40 of these have been fully implemented and 18 under implementation. The financial support provided by the Fund had amounted to approximately USD 11 million, while the total cost of the projects supported by the Fund had totalled about USD 60 million. The Fund's share of financing in overall project costs had averaged about 19%. Out of 58 projects approved, 30 are related to air pollution reduction, 15 to water pollution protection and 10 to protection of biological diversity. The greatest number of projects is proposed by municipalities (71% of approved projects; 43% of awarded finance). (REReP, 2003).

Support by the NTEF is provided in the form of grants or loans. In both cases, there are requirements for co-financing by beneficiaries. If the NTEF financing is in the form of grants, the Fund requires co-financing from other sources in the share of 70% of the project value. If the NTEF financing is provided as a loan, it requires a co-financing of 50% of the project value. Cancellation of the above requirements is possible upon a special decision of the Board of Directors after a preliminary consultation with the Swiss Government.

1.3.3 Other

Beside the Polish and Bulgarian experiences, some lessons may be drawn from other countries. The Senegal swap undertaken in 1993 with a third-party participation of UNICEF (Moye, 2001) provides an interesting example. This case study stresses the importance of macroeconomic risks for the success of debt swap arrangements. With the assistance of the ING Bank, UNICEF purchased USD 24 million face value of bilateral debt owed by Senegal to Argentina for a purchase price of USD 6 million (25% of face value). The Government of Senegal agreed to pay UNICEF the equivalent of USD 11 million over three years to support UNICEF projects in Senegal related to development (education, health, sanitation, and water projects). The payment had to be done in domestic currency. However, one month after the debt swap agreement was signed the local currency devalued by 50% doubling the government obligation. Subsequently, the Government and UNICEF agreed to re-negotiate the terms of the transaction. The objective was to balance between the budgetary impact of increased payments in local currency and the need to provide sufficient financing of the programmes. An additional benefit resulting from the debt swap arrangement was Senegal's renewed eligibility for new Argentinian credits.

2. EXTERNAL PUBLIC DEBT PROFILE OF THE KYRGYZ REPUBLIC

This chapter focuses on the analysis of the debt profile and external public debt structure of the Kyrgyz Republic. Most of the Kyrgyz foreign debt is official - borrowed from foreign governments or from state institutions with sovereign guarantees. Thus, this chapter does not discuss debt owed to private creditors in detail. Swapping private debt can always be negotiated on commercial terms with any single creditor.

The chapter also analyses alternative scenarios for potential debt swap revenue under different assumptions of creditors' participation. In addition, the chapter discusses the fiscal capacity of the Kyrgyz Republic to service potential DFES schemes. The chapter ends by identifying priority creditors for potential bilateral DFES negotiations that the Kyrgyz Government could consider approaching with a request for a DFES.

2.1 External Debt

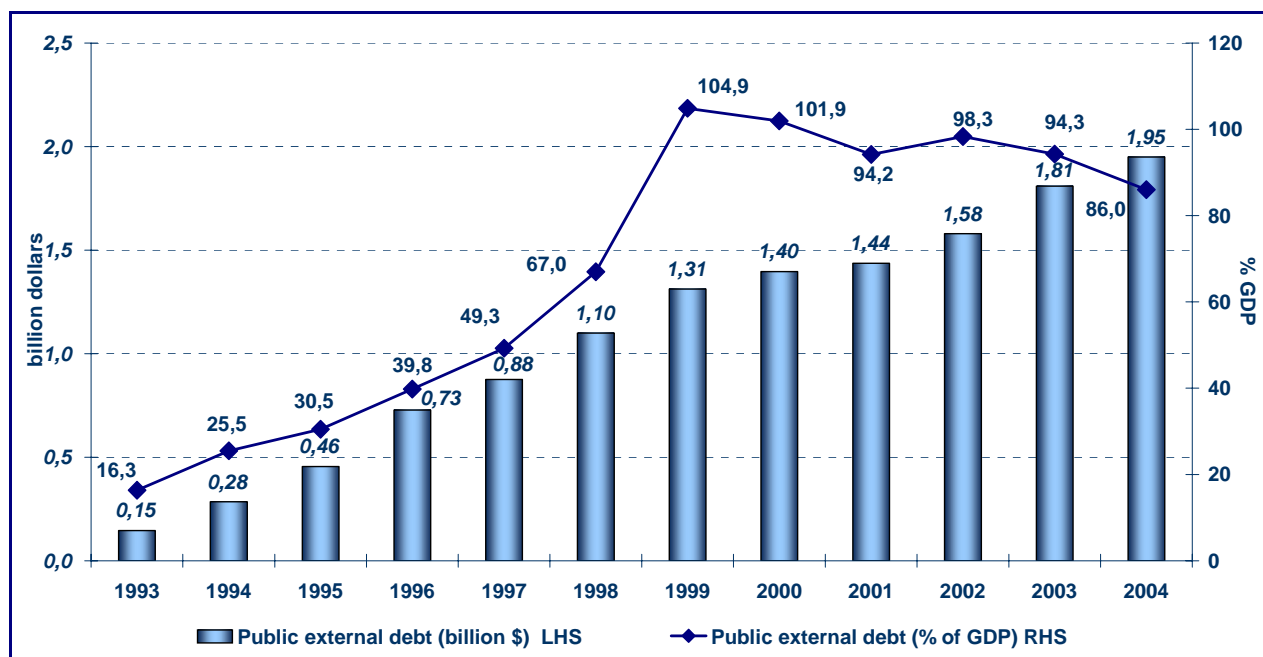
Since its independence, the Kyrgyz Republic has accumulated a substantial amount of foreign debt which it has not been able to service. This is a paradox, as the Kyrgyz Republic began the transition period with no external debt whatsoever¹¹. Between 1995 and 1997, the dollar value of its external public debt doubled and by the end of 1999 it had tripled.

2.1.1 External Debt Accumulation

In 1999, the external debt (both public and private) was equal to 134.4% of the Gross Domestic Product (GDP), with an 80% share of its public debt. The stock of public external debt was systematically growing. The ratio of public external debt to GDP increased rapidly in 1999 due to an exchange rate fall after the Russian crisis (Chart 1). Although economic growth was sustained, the nominal exchange rate depreciation of Som/USD by 21% in 1998, 87% in 1999 and 22% in 2000 led to a sharp increase in the domestic currency denominated foreign debt. Hence, the lack of a national debt strategy (created only in 2001) and a reliable monitoring system obscured the costs of the rapid debt accumulation. Therefore, the Kyrgyz Republic faced liquidity problems and debt restructuring was unavoidable. The 2002 Paris Club rescheduling of the Kyrgyz external debt temporarily eased the pressure on managing the external public debt.

¹¹ This is so because as early as after 1991, the Russian Federation, as agreed with the creditors, offered the other EECCA to take over all official foreign liabilities of the former Soviet Union.

Chart 1. Public External Debt – Stock and Share in GDP



Source: www.minfin.kg

Debt owed or guaranteed by the Kyrgyz Government is mostly concessional¹²: almost all multilateral debts and over half of bilateral debts are of such nature.

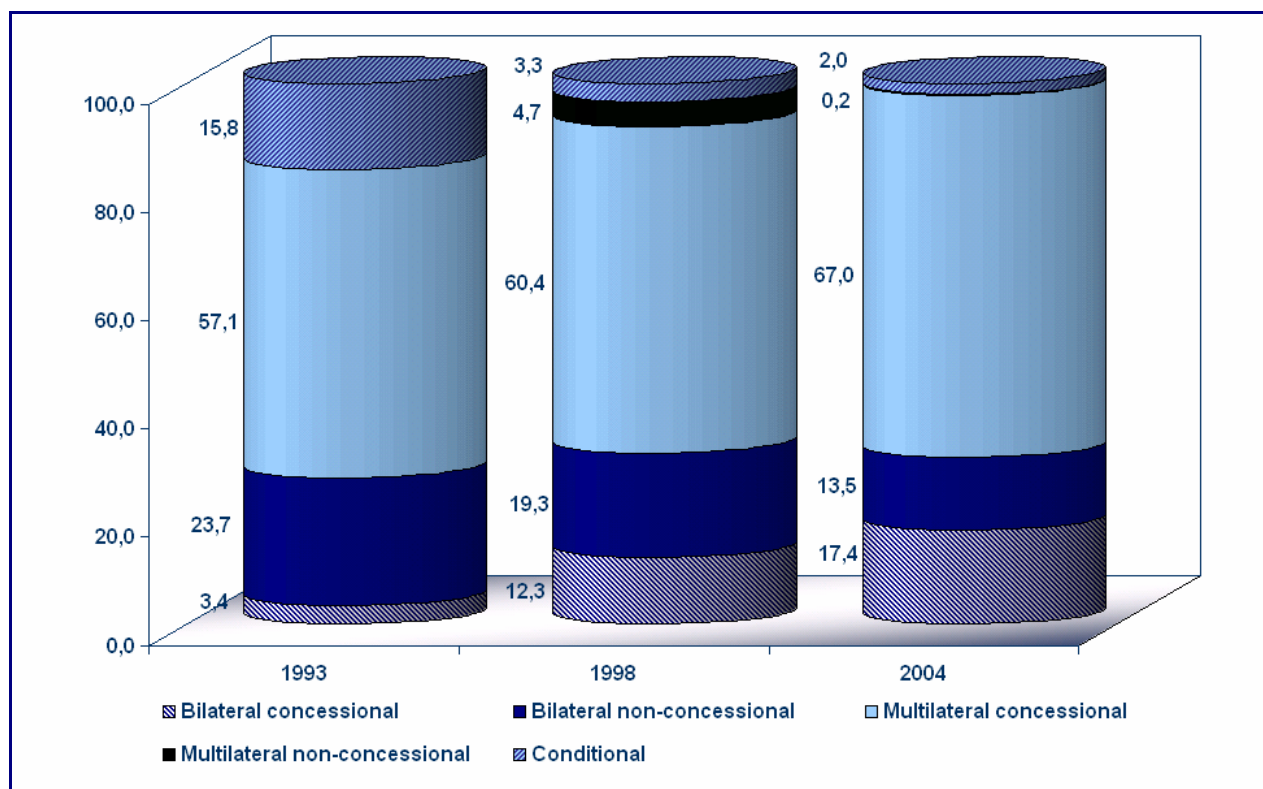
The Kyrgyz Republic is highly dependent on multilateral concessional loans whose share in the public external debt is growing and reached 67% in 2004 (Chart 2). Concessional loans reduce their share in net present value¹³ (NPV) terms to less than 55%. Multilateral non-concessional loans extended since 1995 were limited after the Russian crisis and currently their share is decreasing. However, even in 2000, some non-concessional borrowing was made. It was only in 2000 that the IMF programme introduced a limit on cash fiscal deficit, including the Public Investment Programme (PIP), set zero ceilings on non-concessional borrowing and required submission to the Parliament of a law on contracting new external debt (IMF Country Report 05/32). The share of bilateral debts in 2004 remained at 30% but its composition, compared to 1998, changed as the concessional component grew (Chart 2). The share of contingent liabilities fell to 2% of all public external debt obligations at the end of 2004.

The main declared goal of debt accumulation was to facilitate economic growth and protect declining living standards. Loans were extended to support the balance of payments and finance the PIP.

¹² Considering concessional or official development assistance (ODA), the OECD definition is applied. This implies a loan carrying a grant element of at least 25%.

¹³ The NPV of debt is the sum of all future debt service obligations (interest and principal) on outstanding debt discounted at the market interest rate.

Chart 2. Composition of Public External Debt by Creditor Type



Source: www.minfin.kg

Large current account deficits are the most important factor contributing to the increase in external debt (Chart 3). The break-up of the former Soviet Union resulted in a sharp increase in current account deficits, which hovered at around 10-20 percent of GDP in the first half of the 1990s (IMF Country Report 05/32). In the second half of the 1990s, these deficits further increased exceeding any safety thresholds. The current account deficits were covered through external borrowing implying a rapid increase in external debt.

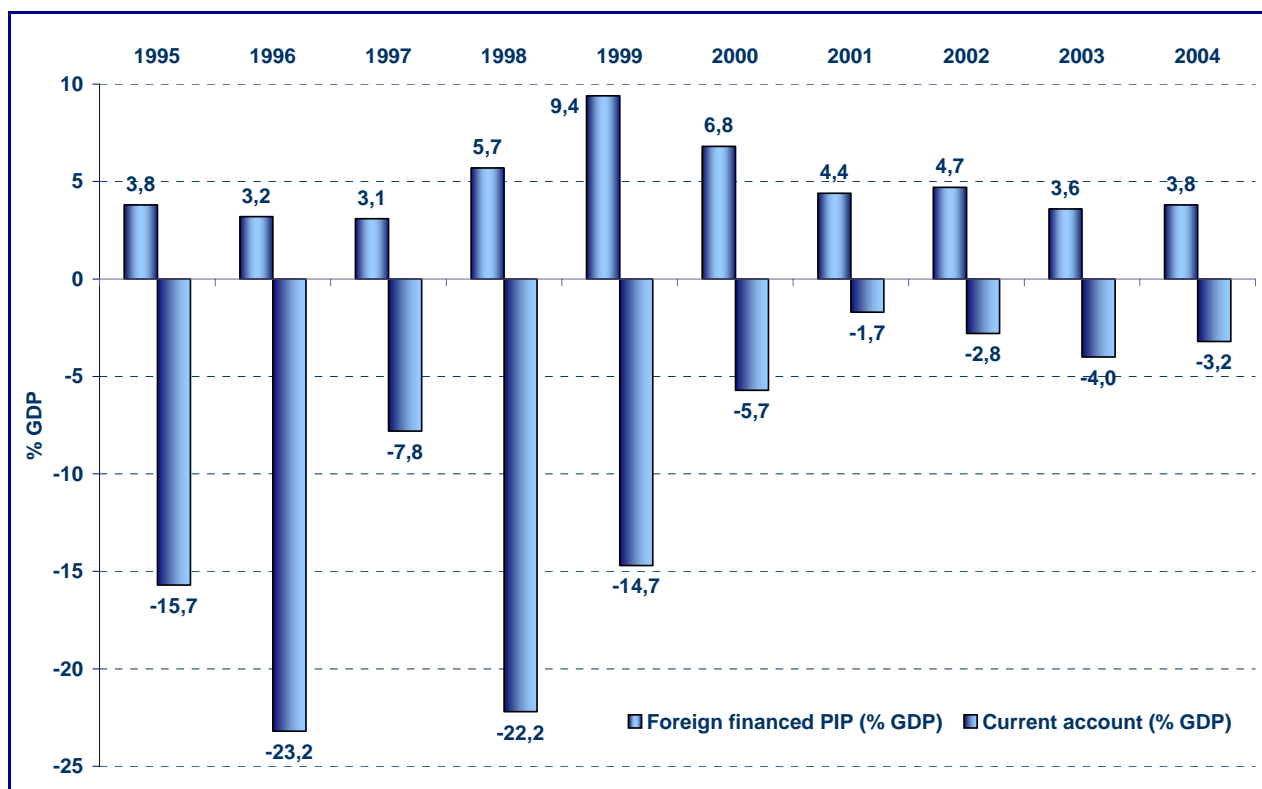
The second factor explaining the dynamics of public external debt was the Public Investment Programme (Chart 3, for more information on PIP see 2.4.1). At the end of 2003, loans from multilateral and bilateral creditors under the PIP were close to 50% of the nominal debt stock (IMF, Country Report 05/32). The PIP externally financed of about 3% of GDP annually in 1995-1998 increased to 9.4% of GDP in 1999 and only since then has it been systematically streamlined. It suggests that coordination within the donor community which financed the public investments was not sufficient to provide safe debt accumulation.

Until the Russian crisis, the stock of the Kyrgyz external debt rose by less than programmed in IMF arrangements but the dollar GDP was far below projections, reflecting slow recovery and sharp depreciation in the exchange rate (IMF, Country Report 05/32). It is admitted that projections were by and large optimistic. Current account deficits exceeded projections because of imports associated with the Kumtor mine construction¹⁴ and the large PIP. The decline in exports to the Commonwealth of Independent States (CIS) and the depreciation of the som against the dollar as a result of the Russian crisis led to an increase in the external debt stock and the debt to GDP ratio far above projections.

¹⁴ Gold related imports were partly financed with Foreign Direct Investment (FDI).

To summarise, at the beginning of the transition period, the debt dynamics were caused by the collapse of trade relations and the negative terms of trade shocks. Then, two factors became more important: fiscal reforms and growth revival took longer than expected and excessive optimism by multilateral investors contributed to the high debt levels (IMF WP/04/93).

Chart 3. Current Account Deficit and PIP External Financing as a Share of GDP



Source: IMF Country Report 05/31.

Note: Current account in 2004 – 9 months only.

2.1.2 Debt Reduction Strategy

In response to the debt problem, in 2001, the Kyrgyz Republic adopted a Debt Reduction Strategy¹⁵ based on the following objectives of the National Development Strategy:

- (i) sustainable economic growth;
- (ii) institutional development; and,
- (iii) social policy and human development.

The Debt Reduction Strategy states that sustainable external debt is a precondition for a macroeconomic stability. The medium-term strategy of the borrowings assumed budgetary capital outlays expressed as a share of GDP to decline, including the PIP. The foreign-financed PIP was expected to be reduced from around 7% of GDP in 2000 to 3% in 2005 - the amount could be higher given the intention to attract grants instead of loans to finance the PIP. The priorities of budgetary capital expenditures are to be formulated

¹⁵ Decree of the Government of the Kyrgyz Republic N 284 on the Mid-Term External Debt Reduction Strategy of 19 June 2001.

based on the potential influence on growth, export and poverty reduction. The strategy assumed the approval of a 5-year PIP updated annually. The bulk of the fiscal adjustment would come from restraining the foreign-financed PIP while at the same time achieving an increase in the state budget primary fiscal surplus (excluding the PIP) from 0.3% of GDP in 2000 to 3.5% of GDP in 2004 and 3.7% of GDP in 2005. To sustain this adjustment, the government intended to increase the tax revenue of the state budget from 13% of GDP in 2001 to more than 15% by 2004. The current expenditures were supposed to decrease from 15.2 to 13.9% of GDP, although the social expenditures were to grow in real terms. The strategy assumed privatisation of the following state companies: the KyrgyzTelecom, Kyrgyz Airlines, KyrgyzGaz and power distribution companies spun off from the KyrgyzEnergo before the end of 2005. The privatisation receipts would be deposited into a special account at the National Bank of the Kyrgyz Republic and at least 75% of these funds would be available for debt reduction only, with the remaining amounts allocated for restructuring of outstanding state enterprises and counterpart funding of foreign financed investment projects. The strategy assumed further debt restructuring following the progress achieved with Russia and Turkey. Non-concessional public debt would be repaid ahead of schedule, if possible, hence shares of state enterprises would be offered to creditors or debt would be bought off at a discount.

As of the end of 2004, the performance against the quantitative targets under the debt reduction strategy was mixed. Capital budgetary outlays as a share of GDP were falling, except in 2002, mainly due to the growth in the foreign-financed PIP component. The PIP was approved with a 3-year perspective only. Progress with the primary balance improvement (excluding the PIP) was sluggish as a result of growing current expenditures, contrary to the debt strategy assumption. The progress with privatisation of big state companies was limited. The privatisation process was weakened as a result of significant revenues generated by the sale of Kumtor gold mine shares (gold layers were transferred to Centerra¹⁶ following an agreement between Cameco (a Canadian company previously operating the Kumtor gold mine) and the Kyrgyz government) which were much higher than expected. As a result, the overall willingness of the Kyrgyz Government to proceed with privatisation decreased. In general, although some improvement was recorded, the privatisation pace was slower than expected.

2.1.3 Debt Sustainability

There are a number of indicators used to measure and analyse debt sustainability: they are all related, but the relationship is not straightforward. The major indicators include: external debt to GDP ratio, debt service to GDP ratio, debt service to exports ratio, debt service to fiscal revenue ratio, NPV of debt. Each of these indicators captures different elements of debt sustainability. It is customary to use the ratio of external debt to GDP rather than the debt stock in nominal terms to assess the burden that external debt can impose on the economy. Broad indicators, such as the debt to GDP ratio and the debt service to GDP ratio compare the debt burden to the ability of the economy as a whole to generate income. The debt service to export ratio links the level of debt service to the availability of foreign exchange earnings in the economy as a whole. The debt service to fiscal revenue ratio links the debt service to the ability of the public sector to generate income. The net present values of debt are used to capture the concessionality of the debt stock and compare debts among creditors with different repayment schedules.

There are some thresholds on ratios derived from empirical analysis conducted as part of the Highly Indebted Poor Countries (HIPC) Initiative (see: Box 2). The original targets were subsequently reduced to provide more of a cushion from exogenous shocks and free up additional resources for poverty reduction. The amended sustainability thresholds are (Press Release No.02/23, Andrews et.al., 1999):

- NPV of debt-to-export ratio of 150%; and,

¹⁶ Centerra is a Canadian gold-mining company which owns 100% of the Kumtor gold mine through its wholly owned subsidiary Kumtor Gold Company.

- NPV of debt-to-revenue ratio of 250%.

Box 2: The HIPC Initiative

The Heavily Indebted Poor Countries (HIPC) Initiative is a coordinated approach to debt reduction launched in 1996 by the IMF and the World Bank. To date, debt reduction packages have been approved for 27 countries, 23 of them in Africa, providing USD 32 billion (net present value terms) in debt service relief over time.

A country is eligible for assistance, if it faces an unsustainable debt burden, beyond available debt-relief mechanisms, implements IMF and World Bank – supported programmes and has developed a Poverty Reduction Strategy Paper (PRSP). If a country's external debt ratio, after traditional debt relief mechanisms, is above a threshold for the value of debt to exports (or, in special cases, the value of debt to fiscal revenues), it qualifies for assistance under the Initiative.

The Kyrgyz Republic does not qualify for the HIPC Initiative.

Countries that qualify are: Benin, Bolivia, Burkina Faso, Cameroon, Chad, Congo, Ivory Coast, Ethiopia, Gambia, Ghana, Guinea, Guinea-Bissau, Guyana, Honduras, Kenya, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, Sao Tome and Principe, Senegal, Sierra Leone, Tanzania, Uganda, Yemen, Zambia.

Source: www.imf.org

For the group of CIS-7 (see: Box 3), IMF applies less strict thresholds: external debt sustainability problems are signalled by ratios of the NPV of future debt service to exports in excess of 200-220%. Fiscal sustainability problems are indicated by ratios of NPV of debt to central government revenue in excess of 250-280% (Odling-Smee et.al, 2001). It should be stressed that these ratios cannot be directly compared with the HIPC thresholds, since the Kyrgyz Republic has not rescheduled its bilateral debt on Naples terms (see: Box 5), which is a prerequisite for a HIPC treatment.

The public debt burden in the Kyrgyz Republic was relatively high in comparison with the other CIS-7 countries. Table 2 below shows basic data on external debt for this group of countries. Before the 2002 Paris Club restructuring, the level of the Kyrgyz external debt (in net present value terms) was higher than those in the other CIS-7 countries.

Table 2. Basic Data on External Debt for CIS-7 Countries

	2000	2001	2002	2003	1999	2000	2001	2002	2003
	Present Value of Debt/GDP				Debt Service (% Exports)				
Armenia	31.3	30.9	31.5	26.1	12	8	8	8	9
Azerbaijan	18.8	17.4	17.8	19.0	6	8	5	6	8
Georgia	41.7	33.2	40.6	38.1	12	13	8	10	12
Kyrgyz Republic	102.6	87.0	82.6	83.0	20	27	30	25	16
Moldova	88.3	76.1	74.3	92.1	29	18	18	20	10
Tajikistan	94.9	78.3	72.7	60.4	11	8	12	11	9
Uzbekistan	30.5	39.0	44.9	47.9	18	26	27	25	21

Source: World Bank Database: <http://devdata.worldbank.org/data-query>

The debt situation has improved since the 2002 Paris Club flow rescheduling. However, it remained unsustainable at the end of 2003: NPV of debt to export was 186% and NPV of debt to revenue was 342% (far above the threshold). The last Debt Sustainability Analysis (DSA) done by the IMF suggested that

without further debt rescheduling, debt service to fiscal revenue would increase to levels beyond those before the 2002 Paris Club flow rescheduling (IMF, 2005, 05/47). Therefore, in 2005, a stock operation was applied by the Paris Club and sustainability was restored (Table 3).

Table 3. Debt Sustainability Indicators under the London* Terms Applied in the 2005 Paris Club Agreement

	2005	2010	2015	2023
PV of Debt-to-GDP	49	40	36	30
PV of Debt-to-Exports	138	121	131	132
PV of Debt-to-Revenues	267	195	170	136

*See: Box 5.

Source: Ministry of Finance.

Although the Kyrgyz Republic does not qualify for the HIPC Initiative, it was included in the CIS-7 Initiative (see: Box 3), where under defined conditions the possibility of multilateral debt restructuring was considered. As stressed in CIS-7 Initiative statements, these countries have the option of requesting multilateral debt relief, relying on existing frameworks, if the full range of traditional debt relief mechanisms employed by commercial and bilateral creditors still leaves some of them with debt levels above the HIPC thresholds (IMF, PR no.02/23). However, at this stage, it seems that the Kyrgyz Republic, due to the recently executed Paris Club debt stock restructuring, does not qualify for this benefit.

Box 3: The CIS-7 Initiative

The CIS-7 Initiative is a common framework for seven low-income countries of the CIS – Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan and Uzbekistan – to accelerate poverty reduction and economic growth, while ensuring sustainable fiscal and external debt positions. The initiative was launched in 2002. The role of Initiative participants is to extend support to those countries implementing significant reforms. Assistance could take the form of:

- More concessional financial support, and debt restructuring or relief where needed, in conjunction with strong reform programmes;
- Increased access for CIS-7 countries to industrial countries' markets and promotion of Foreign Direct Investment (FDI);
- Improved coordination between development agencies;
- Support through technical assistance, policy advice, and concessional financial assistance (including grants) in support of the reform efforts.

In addition, bilateral debt restructuring or debt relief should rely on existing frameworks, such as the Paris Club.

Source: www.imf.org

2.1.4 IMF Programmes

The Kyrgyz Republic has received relatively constant net inflows of IMF resources. The presence of IMF funding has been crucial in attracting other credit resources from institutional creditors. The decisions of the Paris Club on debt restructuring were conditional on the existence of an appropriate programme supported by the IMF, which would demonstrate the need for debt relief. Therefore, it seems reasonable to

analyse how this cooperation has been proceeding and to what extent the potential debt burden was forecasted.

In 1993, the Kyrgyz Republic launched its cooperation with the IMF and in 1994, it was the first among the former Soviet Union countries to sign an Enhanced Structural Adjustment Facility (ESAF)¹⁷ programme that aimed at providing a basis for stabilisation and long-term growth. As of May 2005, there were five arrangements signed with the IMF, two of which were not completed (see Table 4). Fiscal policy and debt accumulation were important reasons behind this non-compliance (IMF Country Report 05/32). In completing the first review in 1993, waivers were required for some performance criteria, including public sector and central bank contracting or guaranteeing new medium and long-term external debt. In 2000, quarterly performance criteria were introduced. However, the final reviews were not completed due to many reasons, including the lack of external debt strategy. The external debt strategy, approved in 2001, facilitated application for IMF funds and permitted the country to regain credibility. Hence, the arrangements approved with the IMF facilitated the negotiations and debt restructuring with the Paris Club as the IMF programmes demonstrated the need for debt relief. In order to ensure that the external debt ratio would be reduced, the last programme introduced a target for concessional public borrowing.

Table 4. Financial Arrangements with the IMF

Facility	Date of Arrangement	Date of Expiration or Cancellation	Amount Approved (SDR* million)	Amount Drawn (SDR million)
Standby Arrangement	May 12, 1993	April 11, 1994	27.09	11.61
PRGF Commitments	July 20, 1994	March 31, 1998	88.15	88.15
PRGF Commitments	June 26, 1998	July 25, 2001	73.38	44.69
PRGF Commitments	Dec 06, 2001	March 14, 2005	73.40	73.40
PRGF Commitments	March 15, 2005	March 14, 2008	8.88	1.26

Note: * The SDR serves as the unit of account of the IMF and some other international organisations. Its value is based on a basket of key international currencies.

Source: www.imf.org

2.1.5 Debt Treatment Operations

The Kyrgyz Republic has rich experience in debt restructuring. Since 1995, it has repeatedly signed bilateral rescheduling agreements. For example, the Kyrgyz Republic has rescheduled parts of its debt owed to Russia five times since 1994 (Odling-Smee et al, 2001). The devaluation crisis experienced in the middle of 1996 (by almost 50%) led to an abrupt increase in the public debt denominated in domestic currency. As a consequence, there was another agreement signed with Russia on debt restructuring. While providing temporary liquidity relief, these rescheduling operations were typically on non-concessional terms with little attention paid to the country's repayment capacity or comparable treatment of creditors.

On March 7, 2002 the Kyrgyz Republic signed an external debt rescheduling agreement with Paris Club creditors resulting in a non-concessional flow restructuring of USD 102 million out of USD 451 million (see: Annex 2). Following the agreement with the Paris Club, the Kyrgyz authorities successfully completed negotiations with essentially all bilateral creditors on terms comparable to those of the Paris Club. While these agreements significantly lowered the Kyrgyz debt service obligations, the debt stock remained high and negatively affected the economic prospects of the country. The agreement with the Paris Club included an explicit clause on debt swaps to be undertaken on a voluntary and bilateral basis with individual creditors. The swap operations may be debt-for-nature/environment, debt-for-aid, debt-for-equity swaps or other local currency debt swaps.

¹⁷ Later transformed into Poverty Reduction and Growth Facility (PRGF).

The 2002 Kyrgyz Republic agreement with the Paris Club was a standard agreement restructuring flows. It referred to the period when the IMF programme showed a financing gap that could only be covered by debt rescheduling (consolidation period). Payments due to Paris Club creditors in this period were covered by the Paris Club agreement and the payments of these debts were then made on a new schedule.

Box 4: What is the Paris Club?

The Paris Club is an informal group of creditor governments from major industrialised countries (i.e. OECD, including also the Russian Federation) set up in 1956. The Chairman and the Secretariat are provided by the French Treasury. The participation of creditor countries is voluntary. The group meets on a monthly basis in Paris with debtor countries in order to agree on debt restructuring. Rescheduling is a means of providing a country with a debt relief through a postponement and, in the case of concessional rescheduling, a reduction in debt service obligations.

The Paris Club has no legal basis or status. Agreements are reached following a number of rules and principles agreed by creditor countries. The Paris Club framework allows the treatment of the debt issue of developing countries in a co-ordinated way.

There are 19 permanent members of the Paris Club. Other creditors are invited on a case-by-case basis. Any country that has granted government loans or guaranteed credits by the Government or its official agencies to a debtor country which presents a request for a debt restructuring can attend a Paris Club meeting.

The outcome of the negotiation is not a legal agreement but an Agreed Minute signed by creditor countries which is a recommendation to their governments to sign bilateral agreements with the debtor country.

Source: www.clubdeparis.org

Some Paris Club treatments apply to the entire stock of debt from which payments fall due. The intention of a stock agreement is to provide a country with a final treatment called an *exit rescheduling*. Such agreements are implemented in the context of the HIPC Initiative and in other cases for countries having established a satisfactory track record with the Paris Club and the IMF and for which there is sufficient confidence in their ability to respect the debt agreement (www.clubdeparis.org). It is important that stock treatments generate interest payments on the consolidation that are larger than those resulting from flow treatments. As a result, stock treatment provides a long-term debt relief, but debt service relief is smaller in the short-term than for a flow treatment.

While the 2002 Paris Club rescheduling agreement reduced the liquidity problem, it did not provide a lasting relief. With successful implementation of the Poverty Reduction Strategy, the Kyrgyz Republic was given the right to apply to the Paris Club again in 2004 for cancellation of 67% of its bilateral debts on Naples terms (see: Box 5). Stock rescheduling was assumed as a goodwill clause on concessional terms.

In mid-March 2005, the Kyrgyz Republic held another round of negotiations with Paris Club creditors. Paris Club creditors agreed on restructuring the stock of the public external debt of the Kyrgyz Republic (see: Annex 3). The agreement also included a clause on debt swaps. The Paris Club applied the Evian approach with treatment comparable to the London terms (see: Box 5). The 2005 agreement with the Paris Club ensures long lasting external debt sustainability.

Box 5: Paris Club Approach to Debt Treatment

In 2003, Paris Club creditors agreed on the **Evian approach** to deal with non-HIPC countries. It is provided only in case of default and aims at ensuring long lasting debt sustainability. Therefore, debt treatment is adjusted to individual needs of the country. For countries that face liquidity problems but are considered to have sustainable debt, the Paris Club designed debt treatment on the standard terms presented below.

In 1991, Paris Club creditors implemented a new treatment of the debt of the poorest countries called **London terms**. This new treatment raised the level of debt cancellation to 50%. 23 countries benefited from this treatment in 1991-1994, when these terms were replaced by Naples terms.

In 1994, the Paris Club agreed to implement new concessional debt reduction terms for the poorest and most indebted countries, called **Naples terms**. Eligibility assessments consider the track record of cooperation with the Paris Club and the IMF, a high level of indebtedness, eligibility only for International Development Assistance (IDA) financing and low GDP per capita (USD 755 or less). Under such conditions, stock treatment may be implemented. The level of cancellation is 67% of eligible non-ODA credits (in NPV terms).

Houston terms apply for highly indebted lower-middle-income countries. Non-ODA repayment periods are extended to or beyond 15 years and ODA repayment periods are extended up to 20 years with a maximum of a 10-year grace period; ODA credits are rescheduled at a concessional rate.

Source: www.clubdeparis.org

Apart from the Paris Club arrangement, there is also a political effort to limit the Kyrgyz Republic debt burden within the framework of *mountain countries*. In line with a draft UN resolution of 10 December 2004, there is a possibility of writing off credits incurred by the poor mountain countries under the framework of debt-for-development swap (Annex 4).

2.1.6 Public Debt Structure

At the end of 2004, public and publicly-guaranteed debt of the Kyrgyz Republic amounted to USD 2.1 billion, with only 8.4% share of domestic debt (the Kumtor mine is excluded¹⁸). The Kyrgyz Republic has had little success in developing the domestic debt market. The stock of external debt amounted to **USD 1.9 billion**. Most of the foreign debt is official – borrowed from foreign governments or from state institutions with sovereign guarantees and multilateral creditors. Of this external debt, **67.2%** was owed to multilateral institutions, with the remaining **30.8%** of bilateral debt and **2%** of contingent liabilities. Table 5 below presents the volume and the structure of public debt as of the end of 2004.

The public external debt is mostly long term in nature. The average interest rates are comparable to rates found in heavily indebted low-income developing countries. External debt consists of multilateral, bilateral and contingent liabilities.

¹⁸ Sometimes the debt of the state-owned Kumtor gold mine was included. The Kumtor gold mine was a joint stock company. Two-thirds of equity was held by the state-owned KyrgyzAltyn JSC. The remaining one-third was held by Cameco of Canada. As Cameco guaranteed Kumtor's external debt, it was decided to omit these liabilities. In 2004, the ownership of the Kumtor mine was transferred to Centerra, a new company listed on the Toronto Stock Exchange. Through the state-owned KyrgyzAltyn, the state took 1/3 of the equity in Centerra and declared to decrease its share to 20%, which happened in 2004.

Table 5. Public Debt of the Kyrgyz Republic as of 31 December 2004

Debt Category and Creditors	Amount, Thousand USD
INTERNAL	178 612
EXTERNAL	1 949 769
Bilateral	600 779
Concessional	338 395
China (Export-Import Bank)	13 633
France (Natexis Banques Populaires)	5 684
Japan (Japan Bank for International Development)	248 185
Germany (Bank Kreditanstalt für Wiederaufbau)	38 817
Korea (Export-Import Bank)	16 505
Kuwait (Fund for Arab Economic Development)	15 571
Non-concessional	262 384
Debis	350
Denmark (Danish International Development Agency)	5 885
Germany (Hermes Kreditversicherungs-Aktiengesellschaft)	6 715
India	1 024
Pakistan	9 214
Russia	181 817
Turkey (EximBank)	46 267
Uzbekistan	11 112
Multilateral	1 310 480
Concessional	1 306 740
IMF	206 936
OPEC	6 820
ADB	477 165
IDA/WB	574 220
IDB	25 493
IFAD	9 223
NDF	6 883
Non-concessional	3 740
EBRD	3 740
Contingent Liabilities	38 510
TOTAL PUBLIC DEBT	2 128 381
<i>Notes:</i>	
Paris Club	487 103
Paris Club and Turkey	533 370
Paris Club and Turkey without Japan	285 185
Paris Club and Turkey without Japan and Russia	103 368

Source: Ministry of Finance www.minfin.kg

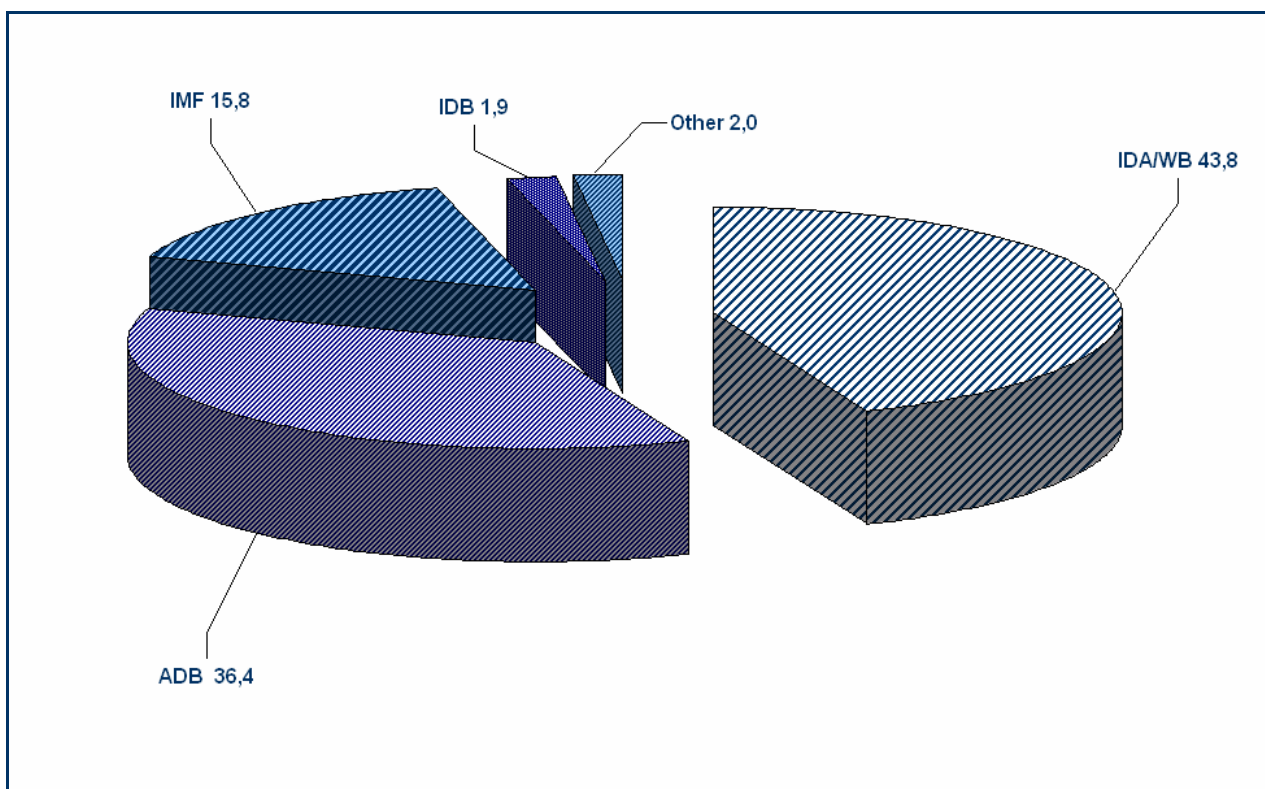
The government extended guarantees to the EBRD and the *Gesellschaft Berlin Bank* to cover the risk connected with credits provided by these two institutions. The EBRD contingent liabilities consist of credits to: *Kyrgyzenergo*, *Kyrgyztelecom* and the *National Bank of the Kyrgyz Republic*. The *Gesellschaft Berlin Bank* extended credits to a company called *Zhildiv-Shparta*. The government guarantees that these two banks will receive the payments that the Kyrgyz enterprises and the National Bank owe them. This obligation may occur in case of default or liquidity problems of the enterprises.

Public Debt Owed to Multilateral Creditors

Most of the Kyrgyz external debt is owed to multilateral creditors. With the exception of the EBRD credits, all multilateral loans are concessional. The largest creditor is the IDA/World Bank, followed by the Asian Development Bank (ADB) and the IMF (Chart 4). Although this is the biggest component of the external debt, it is not available for conversion as multilateral claims are not subject to rescheduling. Multilateral creditors have a preferential status and, until recently, they have refused to consider any reduction in debt claims (the exception is the HIPC Initiative). The main argument is that multilateral creditors provide financing on concessional terms and offer new lending to debtor countries that would otherwise have no or limited access to credit. Therefore, multilateral creditors argue that multilateral debt should be serviced first when a debtor country experiences difficulties in servicing its debts. It has also been argued that cancellation of multilateral debt would jeopardize the multilateral institutions' ability to raise new financing for lending to low-income countries, if their credit ratings were harmed (UNDP, 1998).

So far multilateral debt has not been subject of debt swap transactions. However, this is not completely impossible. A swap involving multilateral debt could take place in the future but even if it happens, it would probably concern the HIPC countries only. Therefore, the Kyrgyz official debt to IFIs cannot be considered as a candidate for debt-for-environment swaps which significantly reduces the potential swap amount. Nevertheless, IFIs do not oppose swapping bilateral debts.

Chart 4. Composition of Multilateral Debt by Creditors as of End-2004 (%)



Source: Ministry of Finance of the Kyrgyz Republic.
Note: IDB – Islamic Development Bank.

Public Debt Owed to Bilateral Creditors

Until the beginning of 2004, bilateral debt rescheduling agreements were completed as committed under the 2002 Paris Club agreement. Agreements with Denmark, France, Germany, Turkey and the Russian Federation were signed in 2002, with Korea, Japan, China and Uzbekistan in 2003, and with Pakistan and India in 2004. Negotiations with the Kuwait Fund have, however, been unsuccessful [Letter of Intent, 15 December 2003]. As a result of debt restructuring within the Paris Club protocol, the credit payments were delayed to 2006-2023. Hence, the debt servicing payments (principal and interest) decreased by USD 46.9 million in 2003 and by USD 54.2 million in 2004.

In 2005, there was another agreement signed with Paris Club creditors. However, at the time of writing of this report (June 2005) no bilateral agreements have been signed yet. Once such agreements are signed, the detailed description of the credits presented below will change.

China – two credits were extended for the construction of the Kyrgyz-Chinese paper producing factory in the town of Tokmok. Debt was consolidated on 11 July 2003 within the Paris Club protocol of 7 March 2002. The new repayment period is 20 years.

France – In 1996, the French Natexis Bank extended a concessional loan of Euro 3.8 million for 15 years for the rehabilitation of the airport in Osh. The purpose was the purchase of equipment and services for the reconstruction of the control center for managing air transportation at the Osh airport. The outstanding loan was consolidated in June 2002 within the Paris Club protocol of 7 March 2002. The new repayment period was 20 years.

Japan - there were six loans extended by the Japanese Bank for International Development during 1993-1999 for 30 years. The loans were provided for: balance of payments support, technical assistance defined as a component of critical import, support for different sectors of the economy (fuel and energy sector, transport, telecommunications, social and agricultural sectors), reconstruction of the *Manas* airport in Bishkek, reconstruction of the automobile road Bishkek-Osh, and the development of the social sector. In May 2003, an agreement on debt consolidation was signed within the Paris Club protocol of 7 March 2002. The new repayment period was 20 years.

Germany – 10 concessional credits were extended by the KfW Bank (the German Bank for Reconstruction) between 1994 and 2001. The loans were provided for: support for agriculture (with a repayment of 30 years), support to private entrepreneurship (three projects) (40 years), support to the textile industry (30 years), two projects for procurement of buses and materials for printing textbooks (40 years), reconstruction of a hotel and the *Ala-Too* restaurant complex (10 years), mother and child protection (40 years) and a share participation of the Kyrgyz Republic in equity of the KICB Bank (40 years). In June 2002, an agreement on debt consolidation towards KfW within the framework of the Paris Club protocol of 7 March 2002 was signed. The new repayment period was 20 years and the amount of consolidated debt was Euro 738 thousand.

In July 2001, an agreement on assignment of liabilities between the Ministry of Finance of the Kyrgyz Republic and Berliner Aktiengesellschaft Bank was signed (on a non-concessional loan). The agreement assigned the right of charging liabilities from AGB Bishkek (bankrupt) to the Ministry of Finance; restructuring of the non-repaid amount on interest and payments on the principal loan amount within the Loan Agreement No.1 of 28.08.1997 concluded between AGB Bishkek and the Berliner Aktiengesellschaft Bank. The repayment period is 10 years.

In June 2002, an agreement was signed between the government of the Kyrgyz Republic and the government of Germany on the external debt restructuring, consolidating debts for 10 years within the framework of the Paris Club protocol of 7 March 2002.

Korea – credit extended in 1998 by the Export-Import Bank of Korea for 30 years for the development of a quality telecommunications network in the Chui region, providing assistance during the transition to

digital communications and procurement of telecommunications equipment. The loan was consolidated on 20 May 2003 within the Paris Club protocol of 7 March 2002. The new repayment period is 20 years.

Kuwait – two loans were extended by the Kuwait Fund for Arabic Economic Development. First, in 1997, for 18 years for financing the reconstruction and modernisation of the telecommunication network in Osh, and for the installation of digital telephone stations. Second, in 1997, for 20 years for the construction of 150 km of high-voltage lines of 220 kW from the Alai sub-station to the newly-projected Batken sub-station, and for the construction of a new sub-station in Batken. An agreement on the consolidation of these credits has not been achieved.

Denmark – there is one loan from Denmark on the external debt stock extended for *Rehabilitation of Electric Power Supply and Central Heating Systems* by DANIDA (Danish International Development Agency). The agreement was signed in 1998 for USD 7.1 million with a repayment period of 5 years. The outstanding credit was consolidated on 28 May, 2002 within the framework of the Paris Club protocol of 7 March 2002. The new repayment period was 20 years.

India – a credit of USD 5 million was extended in 1995 with a repayment period of 12 years. The purpose was: modernisation and reconstruction of operating industrial enterprises, establishing Indian-Kyrgyz joint ventures and organisation of small industrial enterprises. The outstanding credit was consolidated in 2004 within the framework of the Paris Club protocol of 7 March 2002. The new repayment period was 20 years.

Pakistan – in 1993, a loan of USD 10 million was extended for 7 years for financing the procurement of machinery and technologies for production of medical drugs at the *Aiodan-Pharma* pharmaceutical company. This loan was restructured in October 2000 for 6 years and subsequently consolidated in January 2004 within the Paris Club protocol of 7 March 2002. The new repayment period was 20 years.

Russian Federation – A credit of USD 132 million was extended in 1996 for a period of 13 years. This was a consolidation of previously extended credits in 1992-1993. There was also a loan of USD 6 million extended in 1997 for a period of 10 years for the purchase of raw materials by enterprises from the energy sector, TV and railway companies and by the Ministries of Agriculture and Education. Another loan of \$59 million was extended in 2001 for a period of 15 years to restructure the debt of the Kyrgyz Republic to the Russian Federation. In December 2002, an agreement on debt consolidation of USD 63 million for 20 years within the Paris Club protocol of 7 March 2002 was signed.

Turkey – in 1993, the EximBank of Turkey extended a loan of USD 75 million for a period of 20 years for financing the construction of fur and furniture factories, the construction of the Ak-Keme-Pinara Hotel, financing of equipment, purchases of cars and veterinary medication. The outstanding credit was consolidated in October 2002 for a period of 20 years within the Paris Club protocol of 7 March 2002.

Uzbekistan – a loan of USD 16.3 million was extended in 1996 for a period of 15 years. The loan settled trade and economic relations prior to the introduction of correspondent accounts between the National Banks of Uzbekistan and the Kyrgyz Republic. In July 2003, the outstanding loan was consolidated within the Paris Club protocol of 7 March 2002. The new repayment period is 20 years.

There was also a credit extended on a commercial basis by the private company Debis. However, the amount was small and the repayment was completed in February 2005.

2.2 Revenues Forecast from Debt-for-Environment Swap Scheme

In order to assess the feasibility of implementing a DFES, it is necessary to identify the sources of DFES as well as estimate the expected revenue flows that could be generated through the swap scheme. Bilateral debt is the most promising source of DFES. The revenue forecast developed below takes into account existing experience with bilateral debt-for-environment swaps between the Paris Club and debtor countries and is based on assumptions laid down in the 2005 agreement between the Paris Club and the Kyrgyz Republic.

2.2.1 Bilateral Candidates for Debt Conversion

Most of the bilateral obligations of the Kyrgyz Republic are accrued towards Paris Club members (81.1%). Bilateral debt to Paris Club countries (including France, Japan, Germany, Denmark, and the Russian Federation) amounted to USD **487.1** million (Table 5). The biggest creditors are Japan and the Russian Federation, which account for 71.6% of the bilateral debt. There is also Turkey, which is not a permanent Paris Club member but in the case of the Kyrgyz Republic was invited and participated in rescheduling sessions. The share of Turkey in bilateral debt is 7.7%. Bilateral debt to Paris Club countries and Turkey equals USD 533.4 million.

Japan, Denmark and South Korea are not candidates for DFES. These countries rejected such proposals in the past claiming that they do not have any legal basis to conduct debt swap programmes (for example, in Indonesia).

The Russian Federation is a potential candidate, although its record of debt swaps is limited. It seems that Russia would be more interested in debt-for-equity swaps. The Russian Federation has experience with a debt-for-equity swap conducted with Tanzania in 1994 and converting Tanzania's obligations into Russian investment in Sheraton Hotel (Moye, 2001). However, it is not impossible that Russia could join a DFES arrangement. Thus, of the group of countries participating in the 2002 debt rescheduling, the four most promising candidates for swaps are: **Germany, France, Russia and Turkey**.

Paris Club members have agreed on and apply some common rules when they deal with debt swaps. These rules were introduced in 1990. Since then, Paris Club creditors have incorporated debt swap clauses into agreements with low-income and lower-middle-income countries that allow part of the debt covered by Paris Club agreements to be converted through debt swaps on a voluntary basis. These common rules, applied in the case of the Kyrgyz Republic, stipulate that **all Kyrgyz ODA debts are eligible for swaps and non-ODA loans are eligible for conversion of up to 20% of the amounts of outstanding credits as of 6 December 2001 or up to an amount of 5 million Special Drawing Rights (SDR,) whichever is higher** (Agreed Minutes of 2002 and 2005).

Kuwait is the only country which did not agree to consolidate credits extended to the Kyrgyz Republic. The agreement considering the Paris Club protocol has not been signed. Therefore, this debt is not considered available for conversion.

Apart from the above mentioned creditors, there are also bilateral credits extended by non-Paris Club members, namely Uzbekistan, China, Pakistan and India. Uzbekistan and China could potentially have some trans-boundary environmental interest in the Kyrgyz Republic as neighbouring countries. In the case of China, India and Pakistan credits were used for building factories. If any swap with these countries is considered, their first choice would rather be a debt-for-equity conversion. It should be stressed that in general all creditors would be more interested in debt-for-equity than debt-for-environment swaps, for reasons discussed earlier. It can only result from a firm decision of a debtor that a creditor agrees to DFES (Zylicz, 1998). However, under certain conditions, the debtor country itself might be more interested in debt-for-equity swaps (which is also true for the Kyrgyz Republic in some cases), particularly when credits have been extended for purposes which have not resulted in economically successful investments.

Therefore, it seems that liabilities of China, India and Pakistan are not good candidates for DFES. As for Uzbekistan, it may be interested in some swap but probably only after some successful arrangements with other creditors are conducted.

There has been a preliminary agreement concluded with the Turkish EximBank on the debt issue. The proposal is to convert one-third of the debt into grants and the outstanding amount into equity shares. The final decision is still pending.

In conclusion, Germany, France, the Russian Federation and Turkey are the countries that make up the group of potentially good candidates for DFES. They owned **USD 279.3 million** of the Kyrgyz debt at the end of 2004. Debt towards Russia accounts for 65% of this amount.

Germany and France are particularly promising with regard to DFES arrangement due to the presence of special programmes for debt reduction under the DFES arrangements and a track record in such operations. However, France seems to be more willing to conduct such swaps with highly-indebted African countries rather than with countries of the former Soviet Union. As for Germany, there is already one swap discussed between Germany and the Kyrgyz Republic. In 2004, Germany declared that it would write off Euro 750 thousand of ODA debts conditional on the requirement that Euro 350 thousand should be spent on fighting tuberculosis. However, by May 2005, the agreement between the two governments had still not been signed.

2.2.2 Potential DFES Flows

The group of potential creditors that could agree on debt swap arrangements with the Kyrgyz Republic includes: Germany, France, Russia and Turkey. The credits extended by France and Germany (partly) are concessional, therefore are fully eligible for swaps. In the case of non-concessional credits extended by Russia, Turkey and Germany (partly) up to 20% of the amount may be swapped.

Taking into account the existing experience of countries that have conducted DFES arrangements, it is assumed that about 20% of the debt can realistically be expected to be reduced through the swap mechanism¹⁹. For the Kyrgyz Republic, one scenario of a 20% debt swap has been considered, as this is the maximum settled by the Paris Club for non-concessional loans. Achieving a 20% conversion (on average) would be a great success. The analysis assumes equal conversions in every year which simplifies the calculation but probably is not a realistic scenario. It should rather be expected that allocations will be made in increasing shares which on average would only equal 20%. Table 6 below presents the potential revenues which could be generated through a swap, assuming a 20% swap rate on all repayments until the year 2028 and a few alternative scenarios of participation of creditors. The first swap is expected in 2007.

Calculations presented in Table 6 are based on the assumption that bilateral agreements following the 2005 Paris Club agreement on public debt reduction are signed before the first swap takes place. The ODA credits of Germany and France are to be repaid over 40 years of which 13 years are a grace period at interest rates as favourable as the concessional rates applying to these loans. It is assumed that the non-ODA credits of Germany, Russia and Turkey are to be cancelled by 50% and the remaining 50% are to be repaid over 23 years of which 7 years are a grace period at an appropriate market rate. The first payment on non-ODA credits shall be made in 2012 and the last one in 2028. It means that the more preferential scenario of a stock cancellation is assumed for the creditors holding non-concessional debt (they have also a choice to apply 100% of debt repayment). Therefore, the calculations presented here constitute an optimistic scenario (see Annex III – the 2005 Agreement with the Paris Club).

¹⁹ Bulgaria made a swap with Switzerland reducing its debt by 23%. In Poland, the highest share was 10% for USA, Sweden and Norway (however, in the case of Poland there was an upper limit of 10% altogether), but the share of conversion to potential bilateral debt stock is 1.9% only.

Table 6. Annual Flow of Revenues under Alternative Scenarios of Creditors' Participation (Assuming a 20% Swap of Total Annual Repayments until 2028 or 2045), Thousand USD

	France	Turkey	Russia	Germany 1)	Germany 2)	All	All w/o Russia	Turkey & Germany	France & Germany
2007	10.6	29.1	388.7	50.6	14.9	493.8	105.1	94.5	76.1
2008	12.9	35	485.9	60.8	18.3	612.9	127	114.1	91.9
2009	28.1	78.2	1 003.1	114.2	31.9	1 255.5	252.4	224.3	174.2
2010	35.3	98.6	1 240.8	139.5	49.3	1 563.4	322.7	287.4	224.1
2011	35.3	98.6	1 240.8	169.4	49.3	1 593.4	352.6	317.3	254
2012	35.5	112.4	1 300.1	170	89.8	1 707.9	407.7	372.2	295.3
2013	36.1	140.6	1 417.3	171.5	128.5	1 893.9	476.6	440.6	336.1
2014	36.4	160.3	1 494.5	172.5	126.1	1 989.9	495.4	459	335.1
2015	36.8	182.6	1 578.9	173.7	123.9	2 096.0	517	480.2	334.4
2016	37.3	207.4	1 670.0	175.1	121.7	2 211.4	541.4	504.1	334
2017	37.7	233.6	1 762.7	176.5	119.5	2 330.1	567.3	529.6	333.8
2018	58.4	264.1	1 869.1	314	117.4	2 622.9	753.8	695.4	489.7
2019	78.1	297.9	1 983.9	448.3	115.4	2 923.7	939.7	861.6	641.9
2020	77.5	331.9	2 093.5	446	113.4	3 062.3	968.8	891.3	636.9
2021	77.1	375.9	2 239.2	444.3	111.6	3 248.1	1 008.9	931.8	633
2022	76.7	420.9	2 380.9	442.7	109.8	3 431.0	1 050.1	973.5	629.2
2023	76.3	470.8	2 534.9	441.5	108.1	3 631.6	1 096.7	1 020.4	625.9
2024	76.1	527.4	2 707.9	440.7	106.6	3 858.6	1 150.8	1 074.7	623.4
2025	75.9	588.6	2 889.6	440.2	105.2	4 099.5	1 209.9	1 134.0	621.3
2026	75.9	660.6	3 106.0	438.6	104	4 385.0	1 279.1	1 203.2	618.5
2027	76.1	740.7	3 342.6	439.4	103	4 701.8	1 359.2	1 283.2	618.5
2028	68.5	400.9	1 757.3	412.5	51.1	2 690.2	933	864.5	532.1
						56 403.0	15 915.4	14 756.8	9 459.5
						62 770.3	22 282.6	20 391.5	15 826.7

Notes: ¹⁾ Concessional debt, creditor KfW, ²⁾ Non-concessional debt, creditor BAB (Berliner Aktiengesellschaft Bank).
Source: Ministry of Finance data, own calculations.

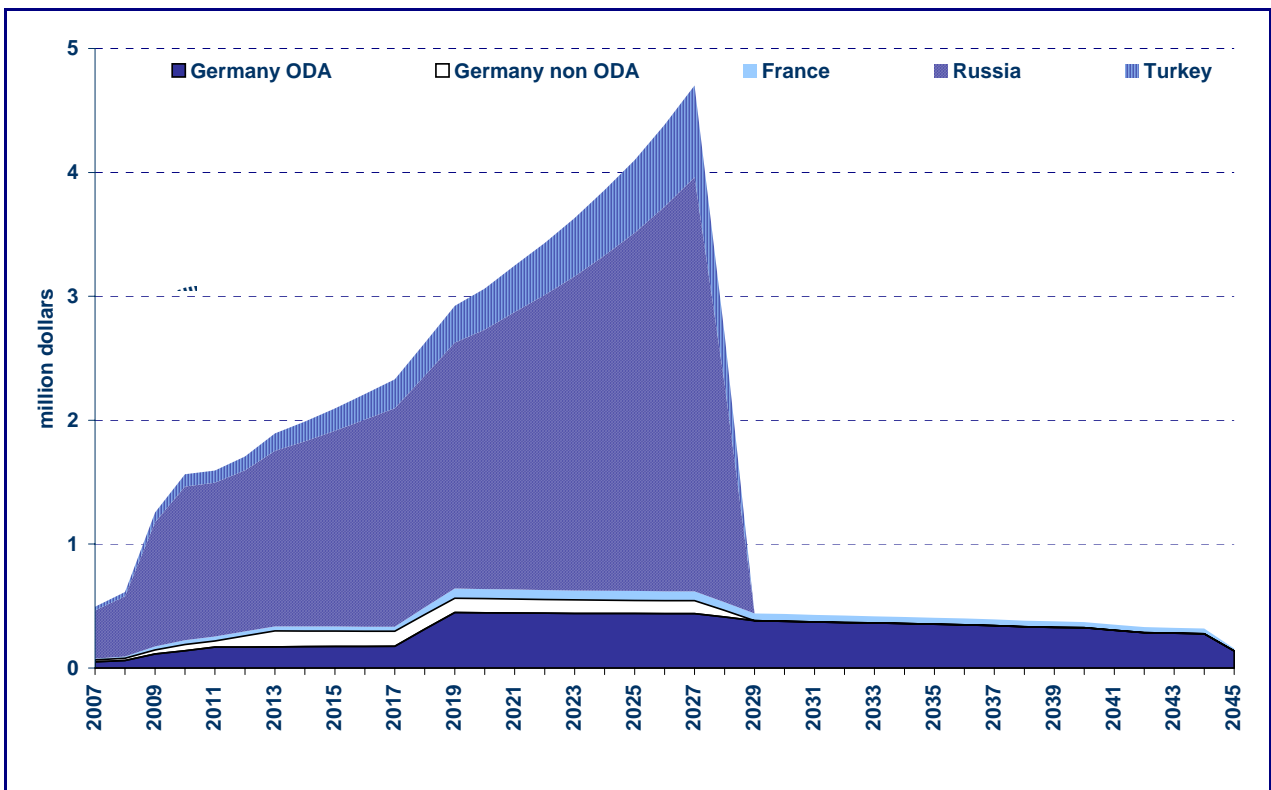
It is assumed that two time frameworks are potentially feasible: (1) 2007-2028 and (2) 2007-2045. It will take time to sign all bilateral agreements and prepare the first swap transaction; therefore, it is assumed that the first swap could take place in 2007 at the earliest. The non-concessional debts of Germany, Russia and Turkey will be paid off in 2028. Therefore, this year is set as the upper limit for the first scenario. With application of the 2005 Paris Club agreement, all concessional debts are supposed to be paid off by 2045, thus this is the second upper limit considered.

Annual flows presented in Table 6 are calculated on a gross basis, that is they do not consider institutional costs connected with servicing the swap operation. If an institution to service swap operations is set up (such as in Poland or Bulgaria), additional calculations should be made to account for the costs of running an institution (for more information on this issue, see Section 4.2).

Probably not all potential creditors would agree to swap their credits. Those who agree would do it at different times and in different amounts, therefore the real flows would differ from the calculations presented above. Nevertheless, the **main conclusions** emerging from the above analysis show that:

- The largest creditor in the group of potential candidates for DFES is Russia but it is also probably the least interested in a DFES. Russia might be more interested in a debt-for-equity swap. Therefore, the potential Russian participation remains a question mark. Without the Russian presence, the potential flows decrease to USD 16 million.
- The next largest creditor in this group is Turkey, which is also not particularly interested in debt conversion operations and has not undertaken such swaps in the past. A swap with Turkey could generate about USD 6.5 million until 2028. Without Turkish participation, there are only France and Germany which could be expected to become interested in swapping debt. Swaps with France and Germany could generate about USD 9.5 million until 2028 (when all German non-concessional debts are paid off) or USD 15.8 million until 2045.
- The 2005 Paris Club agreement resulted in changing the pattern of the debt repayment into a progressive one. With the participation of the four selected countries, the amount available annually will increase from USD 0.5 million to almost USD 5 million. Most realistically however, with the participation of France and Germany only, the available amount will grow from USD 76 thousand in 2007 to about USD 400 thousand annually in 2011-2020 and above USD 600 thousand in 2021-2028. If on the other hand, only Turkey and Germany participate, this would generate amounts growing from around USD 100 thousand in 2007 to over USD 1 million in 2023-2028. Taking into account that this is the likely maximum (20% swap of total repayments) and comparing these numbers with the value of the projects financed within the Public Investment Programme in the Kyrgyz Republic, these are not significant amounts.

Chart 5. Schedule of Potential Revenue of a 20% Debt Swap for the Kyrgyz Republic for 2007-2045 (in Million USD)



Source: Ministry of Finance. Own calculations.

The potential revenue flows from debt swap could additionally decrease, if the Kyrgyz Republic chooses to set up a special financial institution, such as the EcoFund in Poland or Bulgaria to manage the swap resources. The operational costs could consume a significant part of available funds, especially in the first years of operation. Therefore, given the limited potential flows available for swaps, different institutional options should be considered (see: Section 4.2).

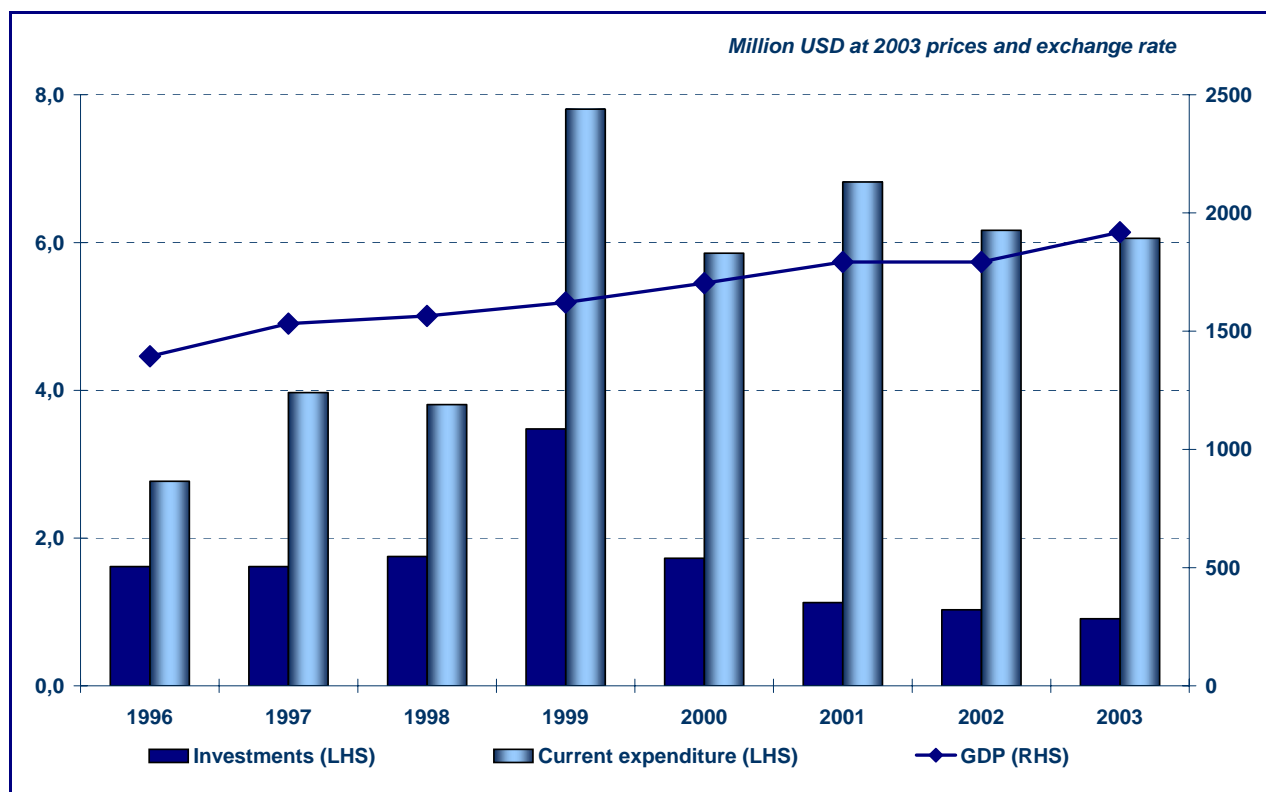
There is a chance though that potentially available revenue would be supplemented by donors through technical assistance or additional grants. However, such a situation could be more likely only after the mechanism applied gains sufficient reputation and credibility, as evidenced by international experience from Europe and from well performing debt-for-environment swap funds in Latin America, Africa and Asia.

In conclusion, a **DFES scheme is feasible and relevant for the Kyrgyz Republic**. However, the situation is not comparable with that of Poland or Bulgaria, and not even with Georgia. Yet, there is some debt which could realistically be considered for a swap. Although, the potential resources are limited, given the low level of domestic public environmental expenditure in the Kyrgyz Republic (see Section 2.3.), any additional resources, if appropriately targeted, could bring benefits to the country. Given the above revenue forecast, it seems that the necessary financing which would be needed by the Kyrgyz Republic would be in the range of its financial abilities. Due to the relatively small amounts of DFES, the potential inflation risk is also limited.

2.3 Present Environmental Expenditure

Environmental expenditure consists of two main components: capital and current expenditure. Capital expenditure includes investment expenditure and expenditure on measuring, monitoring and control equipment. Current expenditure, classified by the European Union as administrative costs, include such items as personnel costs, operation and maintenance costs, transport, spare parts, chemicals.

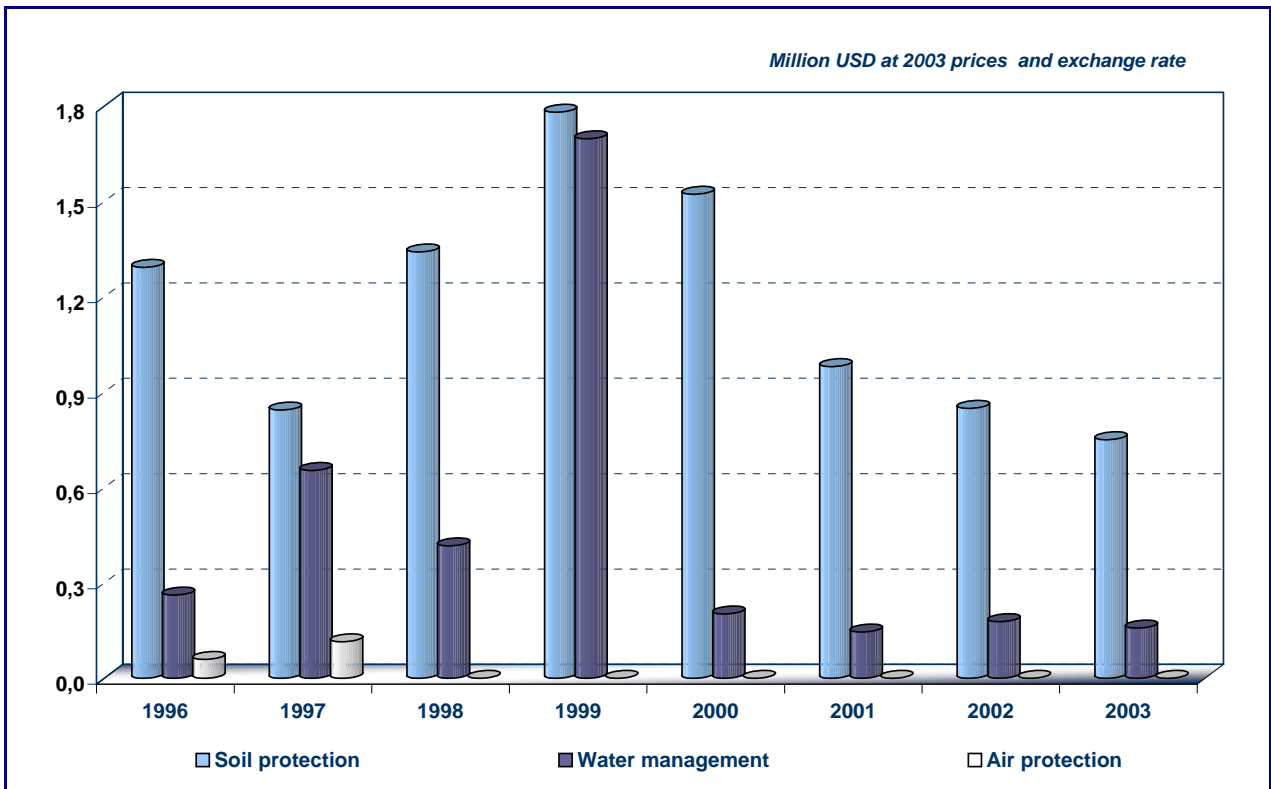
Chart 6. Environmental Expenditure in the Kyrgyz Republic, 1996-2003



Source: National Statistics Committee.

According to the most recently available data for 2003, the total environmental expenditure in the Kyrgyz Republic amounted to about USD 7 million, of this about USD 900 000 was spent on investments and the rest on current expenditure. In recent years, capital investment expenditure for the environment in the Kyrgyz Republic have constituted as little as 0.048% of GDP. Moreover, as a share of total investments (or gross fixed capital formation) in the country in 2003, environmental investments constituted about 0.3%. This is a critically low level. Over the past years, the Kyrgyz Republic has experienced significant difficulties in financing environmental expenditure, and particularly investments in environmental protection projects. There are a number of reasons for this situation, among others: the consequences of the financial crisis in Russia and difficulties in reducing public expenditure in other domains. As a result of these factors, the country practically ceased to finance new environmental investment projects and considerably reduced the number of modernisation projects in the late 1990s. In practice, only the current expenditures of the Ministry of Ecology and Emergencies have been financed from the State budget. In the Public Investment Programme for 1999-2001, the share of environmental expenditure in total expenditure was 3.8%. Since 2000, investment expenditure for environmental protection projects has been steadily decreasing (see Chart 6) while current expenditure remains high. The rapid increase in current expenditures recorded in 1999 is presumably related to the fact that expenditure to counteract the effects of emergency situations was included in the environmental protection sector. When analysing the reasons for the decrease in investment expenditure in different sectors, it might be helpful to use Chart 7.

Chart 7. Capital Environmental Investment Expenditure by Sectors, 1996-2003



Source: National Statistics Committee.

Enterprises that finance air protection investments have stopped any investments in this field since 1998. Investment expenditure for water protection dropped from a record-breaking level of USD 3.4 million recorded in 1999 to USD 0.9 million in 2003.

Table 7. Breakdown of Environmental Capital Investment Expenditure, 1996 - 2003

	1996	1997	1998	1999	2000	2001	2002	2003
Capital Expenditure (Thousand USD at 2003 Prices and Exchange Rate)	16 14.3	1 612.5	1 752.5	3 477.2	1 724.8	1 126.2	1 027.7	908.7
Water Management	262.1	6 54.0	416.4	1 697.0	202.6	145.6	178.4	157.9
<i>Wastewater Treatment</i>	226.4	584.1	393.5	163.0	202.6	145.6	178.4	157.9
<i>Other Expenditure for Wastewater Systems</i>	35.7	69.9	22.9	1 533.9	0.0	0.0	0.0	0.0
Air Protection	59.6	114.8	0.0	0.0	0.0	0.0	0.0	0.0
Soil Protection	1 292.7	843.7	1 340.7	1 780.2	1 522.2	980.6	849.3	750.7
<i>Landslide and Erosion Protection</i>	1 185.4	698.9	1 272.1	332.7	60.2	0.0	95.2	244.9
<i>Slope Consolidation</i>	107.2	109.8	68.6	1 294.4	1 300.5	662.6	585.2	350.2
<i>Anti-erosion Afforestation</i>	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Soil Reclamation</i>	0.0	30.0	0.1	0.0	0.0	0.0	0.0	0.0
<i>Anti-erosion Activity</i>	0.0	0.0	0.0	0.0	0.0	0.0	0.0	91.6
<i>Hydropower Station Protection</i>	0.0	0.0	0.0	1 53.1	161.5	318.0	168.9	59.5

Source: National Statistics Committee.

The details on the allocation of funds by individual sectors, presented in Table 7 above, show that almost 83% of investment expenditure is assigned to measures aimed at counteracting the effects of emergency situations, i.e. "soil protection". Undoubtedly, this function is very important for the country; however, it has dominated the environmental protection sector, in the strict sense of the word.

One source of financing environmental expenditure in the Kyrgyz Republic is the Environmental Funds (one Republican and 9 local funds). The system of environmental funds in the Kyrgyz Republic was established by a Presidential Decree of 12 July 1992 and 21 July 1992 (with subsequent amendments). Environmental Funds are capitalised through pollution charges and fines. The revenue generated by these charges is allocated between the 2 levels, with 25% of the revenue transferred to the Republican Fund.

Table 8. Revenue and Capital Investments Expenditures of the Kyrgyz Environmental Funds, 2001- 2003

	2001	2002	2003
Total Revenue (USD)	565 554	490 206	484 493
Capital Investment Expenditures (USD)	246 914	285 472	314 232
<i>% of the Revenue</i>	43.7	58.2	64.9

Source: Ministry of Ecology and Emergencies.

Table 8 shows the total revenue of the Regional Funds and the Republican Fund taken as aggregate. On the revenue side for 2004, the revenue of the Environmental Funds was estimated at USD 470 thousand (according to data available from the Ministry of Ecology and Emergencies). Preliminary data show an increase in the share of investment expenditure of all Environmental Funds, although current expenditure remains very high in comparison with similar funds in other countries, such as Poland, for example. Polish

environmental funds spend not more than 5% on current expenditure. Until the year 2000, the Kyrgyz funds practically did not finance investments in environmental protection projects; they only covered current expenditure, particularly those of the local administration of environmental protection (nearly 50% of the total), and provided some small amounts for training and education.

Data on investment expenditure of the Regional Environmental Funds (excluding the Republican Fund) were obtained for 2004 only. In most cases, financial support was provided for tree planting and for creating urban greenery, which represents 46% of total Funds' expenditure. The second largest group of investment expenditures was dedicated to municipal landfills (26%). Next come air protection (13%), improvements of operations of wastewater treatment plants (10%), and improvements of sewerage systems (8%).

In November 2004, a new system of pollution charges was introduced by a resolution of the Cabinet of Ministries of the Kyrgyz Republic. Pollution charges have been diversified depending on the natural value of the area affected and the impact on transboundary pollutant transport (location of the area affected in relation to state borders). If a pollutant concentration exceeds the maximum allowable limit, the charge is increased fivefold. The Ministry of Ecology and Emergencies expects the revenue from pollution charges to double in 2005.

Foreign aid is a very important source of financing of environmental protection projects. According to data obtained from the Ministry of Finance, foreign donors have provided or will provide an amount of over USD 147 million in 1996-2007 for projects already agreed upon. Of this amount, USD 69 million is allocated for water supply, irrigation systems, and modernisation of sewerage systems. The projects related to energy supply and renewable energy sources will receive USD 69.7 million. Relatively high foreign aid funds have been allocated for biological diversity protection projects and programmes. The aid programmes are discussed in detail in the chapter on the expenditure programme for the potential DFES.

In conclusion, environmental investments in the Kyrgyz Republic have been extremely low over the past years and have been steadily decreasing. In 2003 (the baseline year), the level of environmental investments was less than USD 1 million. If contrasted with the level of revenue that can be generated by potential DFES, under the most optimistic scenario, the DFES resources could make a significant additional source for environmental protection in the Kyrgyz Republic. Under the pessimistic (as well as the most realistic) scenario however, the expected annual flow of DFES resources will remain at levels lower than the baseline investment expenditure. However, given that a number of important but not urgent environmental projects have remained unfunded over the years (due to other social priorities or because of the fact that environmental projects are often of regional or global public goods character and do not get financed in the absence of international transfers), the availability of DFES resources could help such projects get implemented. In either case however co-financing will be required.

2.4 Fiscal Capacity to Service a DFES Scheme

In order to assess the fiscal capacity of the Kyrgyz Republic to service a DFES scheme, we need to answer a few questions:

- Is there any risk for external debt sustainability caused by public investments?
- Is there an environmental component in the PIP?
- Is there a possibility to redirect investments in the medium term to environmental projects?
- What is the scope for budgetary co-financing of investments financed with DFES, given the current investment policy?

In this section, we look at the current public investment policy as a source of insight as to the capacity of the Kyrgyz Republic to find resources to service obligations under a potential DFES. In answering the above questions, it should also be noted that there already exist a certain number of constraints, which cannot be changed even in the medium term. In the first place, there are a number of investment projects

already implemented which incur operational and maintenance costs which will have to be financed in the future. Second, the scope for co-financing from the budget is constrained by already accrued investment obligations, social expenditure and debt servicing. These and other constraints need to be clearly accounted for in the analysis of the debt servicing capacity of the Kyrgyz Republic.

2.4.1 Current Public Investment Projects

In the past, the majority of public investments was externally financed, mainly with foreign loans. Domestically-financed public investments include: (i) co-financing of externally financed programmes; and, (ii) capital expenditures not connected with foreign credits and their objectives.

The Kyrgyz government annually spends about USD 80-95 million within the PIP (Table 9). Annual disbursements of external finance on the PIP averaged over USD 70 million. Over 80% of the PIP was financed by external sources with an increasing share of grant financing (from 1% in 2001 to 10% in 2003), still below the 50% threshold set by both creditors and the Kyrgyz Government. The sources of external PIP financing include funds provided by multilateral donors (69%) and bilateral donors (31%) (MoF, Investment Policy). The main donors are the ADB, the World Bank and the German and Japanese governments.

Table 9. Public Investment Programme – Scope and Structure

	2001	2002	2003	2004	2005F	2006F	2007F	2008F
PIP mln KGS	3 893.1	4 462.1	3 850.0	4 203.8	5 250.0	5 640.2	5 560.1	3 399.1
PIP mln USD	80.4	95.1	88.1	101.3	119.3	128.2	126.4	77.3
Structure %								
External Sources	83.5	82.5	80.6	84.2	85.7	84.5	82.8	77.6
Internal Sources	10.9	10.4	6.8	6.1	8.5	9.8	10.8	10.9
Capital Expenditure	5.7	7.1	12.6	9.7	5.9	5.7	6.4	11.5

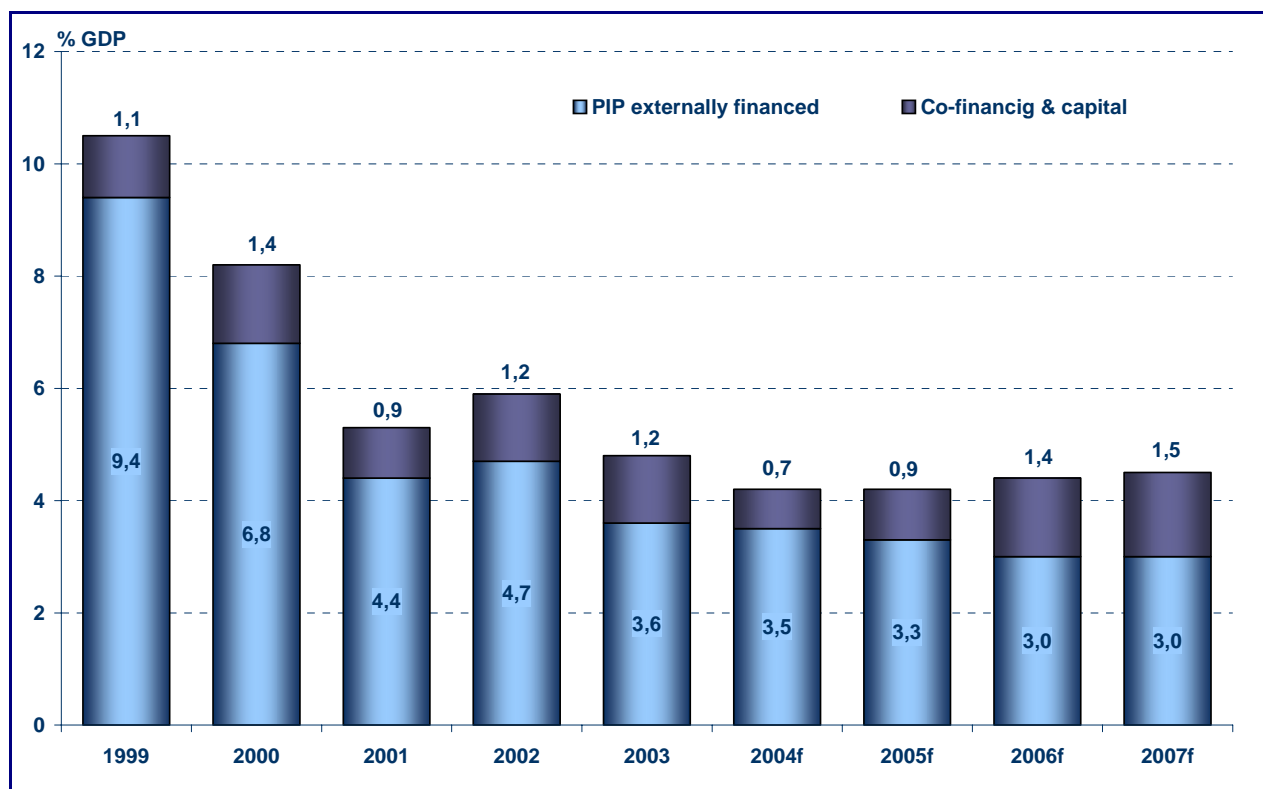
Note: F- forecast.

Source: Report on Official External Aid to the Kyrgyz Republic for the Period 2002-2004, I 2005 p. 25, MTBF 2005-2007, MTBF 2006-2008.

The main areas financed by the PIP are: infrastructure, social infrastructure and private sector financing. The division of the PIP along these strategic priorities reflects the objectives of the National Poverty Reduction Strategy (NPRS).

At the end of the 1990s, the scope of the PIP had been systematically increasing. The PIP reached its maximum of 10.5% of GDP in 1999 (including 9.4% of GDP externally financed) and led to an IMF programme suspension. As a result, special limits were set in the next arrangement. The PIP was projected to streamline to a targeted 5.5% in 2002 and 3% in 2005 (Mathieu, 2004). Since then, the PIP has crossed the planned limits and was supposed to be equal to 4.2 % of GDP in 2004. Some further streamlining of the externally financed PIP is planned, whereas the domestically financed public investments are expected to grow. Progress should be facilitated by medium-term budgetary planning and the IMF arrangement. Nevertheless, some risk for debt sustainability from public investments remains and has to be permanently monitored.

Chart 8. Public Investment Programme Components as a Share of GDP



Source: *Report on Official External Aid to the Kyrgyz Republic for the Period 2002-2004, I 2004.*

Note: f- Forecast.

In 2004, for the first time the government prepared a Medium Term Budget Framework (MTBF) for the period 2005-2007 with a detailed description of planned developments in the PIP and external debt. The main assumptions were as follows:

- Over the medium-term, the target of the government policy is to seek borrowing on concessional terms, to increase the share of grants, to remain below the Poverty Reduction and Growth Facility ceilings and to prioritise investment expenditures towards the National Poverty Reduction Strategy (NPRS) areas.
- During 2005-2007, the disbursement of external PIP financing is expected to average USD 95 million annually, including credit financing which will average USD 77 million.
- In 2005-2007, external credit financing of planned new public investment projects is USD 104 million. For the same period, grant financing of the PIP is planned at USD 51 million.
- The share of the PIP co-financing from the budget is expected to grow, so are capital expenditures.

Recently, some public investments have been made off-budget. The 2005-2007 Medium Term Budgetary Framework includes grant-financed capital expenditures, and it is assumed that an increasing share of all external project financing will be included in the Annual Budget Law in 2005-2007.

The projects under implementation were signed a few years ago and the major share of the public investment spending over the next three years will be on projects which are either on-going or for which funding commitments have been negotiated or are in the process of negotiation. The share of new projects financed through the PIP will grow from 2.4% in 2004 to 44.5% in 2007. The planned project portfolio in

2004-2007 includes 25 new projects, with 18 projects financed through credits and 7 through grants. Thus, the project portfolio is already defined.

Although many projects are being concluded, the value of new projects externally financed through credits will grow from about 74.3 mln USD in 2004 to 83 mln USD in 2007. Therefore, donor financing of the PIP is not decreasing over the medium-term. Domestic financing of the PIP is also planned to grow. Considering fiscal difficulties, the shortage of resources to meet the domestic financing requirements may affect the timely completion of projects and cause arrears on co-financing. Another risk is the extension of budgetary guarantees to avoid limits on external PIP financing.

The IMF programme assumed that the streamlining of existing projects and inclusion of new projects under the PIP will also take into account the ability to cover the operation and maintenance costs once these investments mature (Letter of Intent Nov 16, 2001). Thus, PIP financing should include expenditure for the maintenance and depreciation of new infrastructure. To date, such a use of funds has not been included in overall project expenditure (MoF, Investment Policy). Within the 2005-2007 MTBF, for the first time, the Ministry of Finance has calculated the recurrent cost implications of the PIP projects. Although calculated, these costs have not been incorporated into the annual recurrent budget yet. With the majority of PIP expenditure in recent years spent on infrastructure (particularly transport) adequate resources allocated to maintaining this infrastructure in the future will be necessary.

It should be stressed that this strategy of public investments remains beyond the fiscal capacity of the Kyrgyz Republic. Only with the last Paris Club debt relief did it become possible to close the financing gap.

In prioritising alternative investments, it would be necessary to analyse the impact of the PIP on economic growth, poverty reduction and labour. Currently, there is no quantitative method to evaluate these relationships and clear guidelines are still not available. This is a critical issue as the government admits that the rapidly expanding foreign borrowing to finance the PIP did not generate sufficient growth to avoid the external debt problem. To date, it is not clear to what extent the PIP attracts private investment and stimulates economic growth. It is only believed that interrelated projects stimulate development of the economy but this theory has not been verified. In the long run, the PIP definitely stimulates growth, especially those investments in social infrastructure such as education and health. In the short term however, the result is debt accumulation and high dependence on external borrowing. Actually, economic research is also inconclusive in this respect²⁰.

Assuming the lack of access to credit on the financial markets, concessional credits remain the only available option for public investment financing.

2.4.2 Project Portfolio

In 2002-2004, 38 projects were implemented within the PIP, including 33 financed through credits and 5 through grants. Table 10 below presents the list of these projects.

The PIP project portfolio is formulated in advance. The current portfolio was formulated mainly for the period 1998 and 2001. In 2002, two projects were launched, in 2003 – three new projects and in 2004 – five new projects started. As a result of concluded agreements, seven new PIP projects will start in 2005 (Table 11). The number of newly-launched projects is growing along with their total value.

²⁰ There is even no agreement on the public infrastructure investments and economic growth relationship. The impact is positive in OECD countries, but the relation is not significant for developing countries [i.e. Sala-I-Martin (1996), Devarajan et.al. (1996)].

Table 10. Public Investment Programme in 2002-2004

Donor	Project Title
CREDITS	
World Bank	<ol style="list-style-type: none"> 1. Registration of rights on real estate 2. Consolidated structural adjustment credit (CSAC) 3. Health care sector development 2 4. Financing of rural development 2 5. Rehabilitation of irrigation systems 6. In-farm irrigation 7. Emergency actions in case of flooding 8. Sanitation and water supply in rural areas [started in 2002] 9. Electric energy supply and central heating systems rehabilitation (additional loan) 10. Municipal transport 11. Support to private businesses 12. Technical assistance under the CSAC programme [started in 2003] 13. Technical assistance for financial sector reforms 14. Modernization of the payment and banking system [started in 2004]
WB/ IFAD	<ol style="list-style-type: none"> 15. Support to ancillary services in agriculture 16. Sheep breeding development
ADB	<ol style="list-style-type: none"> 17. Regional development of agriculture 18. Bishkek – Georgievka motorway reconstruction 19. Provision of infrastructure services at municipal level 20. Technical assistance in corporate governance and introduction to bankruptcy procedures 21. Rural financial institutions 22. Mitigation of floods effects and rehabilitation works performance in Osh and Jalal-Abad regions 23. Development of junior-age children at a community level [started in 2004] 24. Mitigation of natural calamities effects [started in 2004]
ADB/ OPEC	<ol style="list-style-type: none"> 25. Provision and funding of social services 26. Development of the education sector
ADB/ JICB/ IDB	<ol style="list-style-type: none"> 27. Bishkek – Osh motorway reconstruction [started in 2002]
IDB/ KFAED	<ol style="list-style-type: none"> 28. Batken region electrification
IDB	<ol style="list-style-type: none"> 29. Taraz – Talas – Suusamyр motorway reconstruction [started in 2003]
Germany	<ol style="list-style-type: none"> 30. Private sector development credit line 31. Establishment of the Kyrgyz investment and credit bank 32. Maternity and childhood protection – reproductive health [started in 2003]
China	<ol style="list-style-type: none"> 33. Paper mill construction
GRANTS	
World Bank	<ol style="list-style-type: none"> 34. Central Asian biodiversity conservation transboundary project [GEF] 35. The Aral Sea basin water resources and environmental management [GEF] 36. Rural investments [started in 2004] 37. Prevention of natural calamities (Maili-Suu) [started in 2004]
Germany	<ol style="list-style-type: none"> 38. TB prevention and treatment programme

Source: Report on Official External Aid to the Kyrgyz Republic for the Period 2002-2004, I 2005.

Table 11. Externally Financed Public Investment Programme Launched in 2005

Donor	Project Title	Credit Amount	Grant Amount
ADB	Development of the education sector 3	---	15 mln USD
WB	Rural education	---	15 mln USD
ADB	Modernization and development of customs service infrastructure	7.5 mln USD	---
ADB	Kyrgyz transportation corridor motorway project, Phase 1	32.8 mln USD	---
Germany	Funding of local government infrastructure	6 mln Euro	2 mln Euro
WB	Agribusiness and marketing	8.1 mln USD	4.75 mln USD
WB	Small towns infrastructure and capacity building	12 mln USD	3 mln USD

Source: Report on Official External Aid to the Kyrgyz Republic for the Period 2002-2004, I 2005.

Describing the PIP portfolio, it should be stressed that only few of the implemented projects could be classified as environmental (Table 10). These refer to water sanitation and flood protection projects (No. 7 and 8) and electric energy supply and rehabilitation of central heating systems (No.9). The two GEF grants also finance environmental investments. However, there are many projects implemented by governmental agencies which are not listed in the PIP programme (all omitted projects are financed through grants only). All other identified environmental projects are presented in Chapter 3 in the expenditure programme.

The project portfolio planned for 2004-2007 includes 25 new projects and consumes the limits of new debt growth. Thus, the room for manoeuvring is limited, but given the potential volume of DFES flows it should not be difficult for the Kyrgyz Government to find potential co-financing within the PIP.

Box 6: GEF – the Global Environment Facility

Established in 1991, GEF helps developing countries to fund projects and programmes that protect the global environment. GEF grants address six global environmental issues: biodiversity, climate change, international waters, land degradation, the ozone layer, and persistent organic pollutants.

GEF funds are contributed by donor countries. Since 1991, the GEF has provided USD 4.5 billion in grants and generated \$14.5 billion in co-financing from other partners for projects in developing countries and countries with economies in transition. GEF projects are managed by three implementing agencies: (1) the United Nations Environment Programme (UNEP), (2) the United Nations Development Programme (UNEP), and, (3) the World Bank.

In the Kyrgyz Republic, GEF financed 5 country projects and 7 regional and global projects. In 2002-2004, two GEF projects were included in the PIP: (i) Water and Environmental Management in the Aral Sea Basin; and (ii) Central Asia Transboundary Biodiversity Project.

Source: www.gefweb.org