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External Borrowing in the Baltics, Russia, and Other States of the Former Soviet Union - the Transition to a Market Economy

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Abstract

The external debt of many countries of the Baltics, Russia, and the former Soviet Union has been growing rapidly in recent years and has played an important part in the transition process. However, it is vital to strike a balance between financing transition and ensuring that the external debt is not used to finance wasteful expenditures or delay the transition process. This is especially important since the rising stock of external debt makes the borrowing countries increasingly vulnerable to changes in perceived creditworthiness. Accordingly, countries must adopt policies, including pressing ahead with structural reforms, to ensure that the borrowing is used to promote sound growth.

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External Borrowing in the Baltics, Russia, and Other States of the Former Soviet Union - the Transition to a Market Economy[1] [2]

The external debt of many countries of the Baltics, Russia, and the former Soviet Union region (hereafter BRO)[3] has been growing rapidly in recent years. Although not especially high by the standards of most developing countries, the current level of debt in some countries is nevertheless remarkable, given that it was zero or close to zero less than seven years ago.

This paper discusses the role that external borrowing has played in the transition process and some of the risks it poses. On the one hand, it clearly makes sense to borrow abroad to help finance the difficult transition period. On the other, there is a risk that the option of borrowing abroad will weaken efforts to transform the economy and its institutions, including governments. A balance must therefore be struck between taking advantage of growing external borrowing opportunities and not allowing such borrowing to finance wasteful expenditures or delay the transition process. The paper therefore focusses attention on the supreme importance of maintaining the momentum of structural reforms (including strengthening the intermediation role of the financial system) and fiscal consolidation, while at the same time controlling and containing the growth of external indebtedness. It is concerned

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[1]This paper draws heavily on a similarly titled paper presented at the Third Dubrovnik Conference on Transition Economies (June 25–27, 1997) and which will appear in the proceedings of that conference to be published by the National Bank of Croatia. We are grateful to Ishan Kapur, Jorge Márquez-Ruarte, and Emmanuel van der Mensbrugghe for many helpful comments.

[2]The concept of external debt in this paper embraces debt financing from all foreign sources, including from other BRO countries.

[3]The BRO region includes fifteen countries: Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. The reason for treating them as a group rather than, say, also including transition countries in central Europe or, alternatively, excluding the Baltics is that—apart from Russia—they share the common characteristic of zero or close to zero external debt at the end of 1991.

primarily with debt-creating capital inflows. Foreign direct investment, although sometimes associated with a simultaneous deterioration in the current account, does not give rise to the same difficulties; indeed, it is highly desirable in these economies because of its implications for the transfer of technology and management and financial skills, and for integration into the world economy.

What Has Happened in the BRO Countries?

Since the dissolution of the Soviet Union in late 1991, virtually all the new independent states on its territory have obtained substantial foreign financing from multilateral, official bilateral and private creditors. The character and amounts of such financing were determined by the different stages of transition, success in achieving macroeconomic stabilization, medium-term growth prospects, endowments of natural resources, and perception of relative creditworthiness by the international investment community.[4]

Total external finance of BRO countries during 1993–1997 from all identified sources (including flows between BRO countries) amounted to about US$200 billion.[5] [6] There were wide differences between countries in their reliance on different sources of external financing. In general, countries more advanced in the transition process have been more successful in mobilizing private capital flows while countries less advanced have relied more on official

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[4]For a more detailed analysis of external financing developments in the BRO as well as a discussion of selected policy issues, see WP/97/72, *External Borrowing by the Baltics, Russia, and Other Countries of the Former Soviet Union: Developments and Policy Issues*, by Ishan Kapur and Emmanuel van der Mensbrugghe (June 1997).

[5]Including Russia.

[6]Most of the data cited in this paper are subject to wide margins of error, and can be used only to indicate broad orders of magnitude.

disbursements. Countries also differed in the extent to which they accumulated arrears as a form of financing, with the great bulk of arrears being to other countries within the region.[7]

There are several features of debt-creating flows and the resulting debt that are worthy of note:

- Immediately after the breakup of the Soviet Union, most BRO countries resorted to external borrowing to meet their financing needs and in some cases this led to a rapid increase in external debt.[8] By the end of 1993, the median external debt/export ratio had reached 36 percent, and it continued to rise to 59 percent at the end of 1996 (Table 1) and an estimated 70 percent at the end of 1997.

- Available evidence suggests that the overwhelming proportion of borrowing during this period was undertaken by public or publicly guaranteed debtors.

- Most borrowing was contracted on market terms. A number of low-income countries in the region[9] also had access to concessional financing (mainly from the IMF), which mitigated somewhat the servicing burden of their external debt.

- Analysis of the public expenditure record of borrowing countries indicates that most spending, irrespective of how it was financed, was for current rather than capital purposes, including the settlement of arrears on wages and pensions.

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[7] Arrears were a larger problem than indicated in the table because those that were subsequently consolidated into intergovernmental loans appear as official loan disbursements rather than accumulation of arrears.

[8] From early 1992 most countries incurred monetary obligations to the Central Bank of Russia through their positions in the correspondent accounts of their central banks. For most countries, these obligations were converted into government debt to Russia.

[9] Mainly Armenia, Georgia, Kyrgyz Republic, and Tajikistan.

- Available evidence indicates that a number of countries have also resorted to the use of instruments that are not formally included in the definition of external debt, but nevertheless create potential servicing liabilities, especially for the public sector. These include the guaranteeing by governments of debt to government agencies, municipalities, and enterprises, as well as agreeing to long term lease agreements (e.g., for aircraft). All too often, the monitoring of such operations is haphazard with no centralized coordination of the total contingent liabilities being incurred or their repayment profile.

- As overall debt levels increased, the sovereign direct external borrowing of a number of BRO countries has been characterized by a shift towards private market financing, particularly through Eurobond issues. These developments have been facilitated by the fact that a number of BRO countries, including Estonia, Kazakhstan, Latvia, Lithuania, Moldova, Russia, and Turkmenistan have obtained country ratings (as of December 1997).[10] However, towards the end of 1997 access to external finance became tighter again as markets reassessed emerging markets in the wake of the Asian crisis.

- In almost all cases disbursements by the IMF and the World Bank have represented a significant proportion of total external financing flows. Agreement with the IMF on financial and structural reform programs has often been an important catalyst in mobilizing both private and public financial flows.

Motivation for Borrowing Abroad

There are several important reasons for this build-up of external debt and its concentration in the government sectors of the BRO countries.

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[10]However, only the Baltic countries have investment grade ratings.

- A key factor was the emergence of large government budget deficits. As a result of the substantial and prolonged contraction of output—in most cases a cumulative decline in the order of 25–50 percent of GDP relative to 1990—there was a sharp fall in government revenues. This was combined with substantial pressures for maintaining spending levels, not least because industrial restructuring was placing strains on social safety net expenditures. The response of government in the early years was to finance them by central bank credits, but the experience of hyperinflation soon persuaded the authorities to reduce deficits and to look for noninflationary external and domestic non-bank financing.

- Borrowing abroad has appeared to be cheaper in the short run than borrowing from domestic financial markets, and longer maturities have been available on foreign loans. Monetary stringency and uncertainties causing residents to hold savings in foreign currency rather than in the banks or in domestic securities tended to keep domestic interest rates high. Moreover, the trend toward greater stability in exchange rates that accompanied the decline in inflation implied that the advantage of lower nominal interest rates abroad was not fully offset by exchange rate depreciation.

- While the need to finance budget deficits was a major cause of the external debt build-up, the proximate cause of much debt was the need to finance imports. This was especially true in the case of financing energy imports from Russia and Turkmenistan by other BRO countries. Sometimes, the government or energy producers of Russia extended loans to partner countries to enable them to import energy. More often, the imports took place without full payment being made, and the resulting arrears were in many cases subsequently converted into intergovernmental loans.[11]

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[11]Up to mid-1993 a similar mechanism, which also generated external debt, was the debiting of liabilities for imports to the correspondent accounts between central banks.

- The needs of the borrowers has been matched by the growing enthusiasm on the part of the international financial community to lend to BRO countries, at least until the final months of 1997. Initially, this reflected a perception that these countries had lower external indebtedness than most developing and transition economies and were therefore worthwhile risks, especially as substantial margins could be picked up relative to traditional sovereign borrowers. At the same time, medium-term bond yields in many traditional markets—though not in other emerging markets which have also experienced increasing market interest—have either stabilized at relatively low levels or have fallen. This prompted many international investment managers to try to enhance performance by increasing the weight in their portfolios of higher-yielding sovereign instruments in the BRO region and elsewhere. Strenuous efforts were made by investment houses to obtain a foothold in a number of these countries, even if it meant cutting their management fees or otherwise absorbing the costs of placing loans. Since the Asian crisis of late 1997, markets have become more discriminating. While terms and conditions, especially interest rate spreads over LIBOR, have hardened sharply for countries that are seen as higher risk, there has been little change for countries perceived as good risks (e.g., Estonia)

The Future

The prognosis for BRO countries is that external borrowing will continue, although the rate of growth may be tempered by a reassessment of the attractiveness of emerging market debt following the turbulence in Asian capital markets in late 1997. The expectation is also that the principal borrowers will remain governments and other governmental entities. This is mainly because, despite considerable progress in macroeconomic stabilization, the fiscal position of many BRO governments is expected to remain under significant pressure over the medium-term, especially as repayments of existing domestic and external public sector debt is expected to be bunched over the next 2–3 years. At least for the countries which are seen as good risks, a greater proportion of external borrowing over the next few years will come from private

sources, especially international bond issues and commercial bank credits, and a smaller share from the international financial institutions (IFIs).

What further increase in indebtedness would be in the interests of BRO countries? The case for continuing to contract external debt is clear. It expands a country's opportunity set, thereby enabling it to finance in a non-inflationary fashion (assuming appropriate macroeconomic policies are implemented) more consumption, more investment, or both. Given the decline in consumption which has already occurred in most countries, and the need to maintain political support for continued reforms, resources which enable consumption to be higher than it would otherwise be are desirable. Moreover, the resumption of growth requires an adequate amount of investment.

As for the relative amounts of additional consumption and investment that more external borrowing permits, what really matters is that any additional consumption now should not be at the expense of a major reduction in future consumption (when the time comes to service the external debt). This does not necessarily mean that additional borrowing should mainly finance investment spending directly. It could finance it indirectly, for example by reducing the need for the government to borrow on domestic credit markets thereby providing more room for these markets to finance private investment.

The key thing, however, is to ensure that the breathing space afforded by the borrowing is used to press ahead with structural reforms. With greater macroeconomic stability becoming widespread in BRO countries, the emphasis now must be on speeding up the structural reform program, including liberalization, privatization, legal reform, tax reform, banking sector reform, loosening trade barriers, and deregulation. The aim must be to create an environment which encourages private economic activity and investment, thereby permitting an early resumption of rapid and sustainable growth, which in turn will enhance the ability to service the external debt. Yet the temptation will often be in the opposite direction: borrowing abroad to avoid making the difficult structural and fiscal reforms. This must be resisted at all costs.

In some cases external borrowing will be directly linked to the implementation of structural reforms, as with the conditional lending of the IMF and the World Bank. It is often believed that there is less conditionality attached to borrowing from markets than from the IFIs and the shift in this direction in some countries in 1997 may have resulted in a lessening of the pressure for structural reform. However, the Asian experience shows that markets can be unforgiving over the medium run and many BRO countries may have correctly drawn the conclusion that reforms need to be pursued energetically whatever the source of financing.

Meanwhile, the cost advantage of borrowing abroad over borrowing domestically can be expected to decline over time. First, the real interest rate differential will narrow as confidence in the domestic currency and domestic financial institutions returns, and the financial system becomes more efficient and reduces its bad debts. Second, the real exchange rate appreciation will not continue indefinitely, although there are few signs in any country that it has reached its limit. The main threat to the cost of foreign borrowing in these countries may be a sharp depreciation of the currency because of a loosening of monetary and/or budgetary policies, or a loss of confidence for other reasons. Any such developments must be avoided if foreign borrowing is to remain the cheaper option.

Since much of the external borrowing has been undertaken by governments, special emphasis must be given to reform of the public sector. Tax structures and tax administration in most BRO countries need to be strengthened so as to improve tax compliance, including by encouraging the shadow economy to come out into the open, and reduce the tax burden on compliant taxpayers. On the expenditure side there remains much room for rationalizing the structure so as to streamline the administration, reform health and education services, target the social safety net to the most needy, and eliminate subsidies for economic activity. Budget deficits must be reduced and turned into surpluses as growth accelerates so that the government does not preempt domestic savings and external borrowing that would be better employed financing private investment.

While the risk that the reform effort could be undermined by foreign borrowing is the main one, it should also be noted that, as the stock of external debt grows, countries will be increasingly vulnerable to changes in perceived creditworthiness on the part of the international financial community. This is especially the case in settings where data dissemination is poor and shifts in macroeconomic policy, and public policy in general, may not be well articulated by the authorities and thus easily misunderstood abroad, resulting in a loss of international confidence to a sufficient degree that it may curtail further access to external credits. Such changes in sentiment can also trigger precipitous outflows of portfolio investment and a withdrawal of overdraft and other short-term inter-bank credit facilities (e.g., as in the case of Mexico in 1994–95 and Thailand and Korea in 1997), which could have serious implications for the stability of otherwise viable domestic financial institutions.

All of these risks arise in most developing and transition countries to some degree. The main factors that distinguish many BRO countries include:

- *the scope and difficulty of the fiscal and structural reforms* that are needed, and hence the risk that mistakes will be made, or reform fatigue will set in, especially if money can be borrowed to postpone implementation of essential reforms;

- *the uncertainty* associated with the unprecedented transition from planned economies to market economies, the paucity of information about the economy, the persistence of various forms of nonmarket behavior (e.g., nonpayments), and the inexperience of economic agents in transition economies with the functioning of market economies;

- *short-sighted attitudes toward borrowing* due to a combination of Soviet experience where defaults by governments on domestic loans were not uncommon and limited experience of sovereign borrowing. The early consequences have been the frequency with which BRO countries have incurred arrears in servicing external debt (mainly among themselves); and

- *weak systems for monitoring and managing government debt and new borrowing, including government guaranteed debt.* Government borrowing programs at both central and local government levels are typically not integrated into a medium-term framework that takes explicit account of exchange rate risk, interest rate risk, and the overall maturity structure of both domestic and foreign debt.

In conclusion, the special characteristics of BRO countries point to the policies that are needed to ensure that external borrowing promotes sound growth and ultimately guarantees the medium-term sustainability of their borrowing programs. Macroeconomic stabilization is vital, both to encourage investment and growth and to contribute to price and exchange rate stability. Also crucial is rapid progress with structural reforms to help accelerate the return of sustainable output growth; such reforms need to include liberalization, privatization, legal reforms, banking sector reforms, loosening of trade restrictions, tax reform, and deregulation, among other things. It is especially important to reform taxation and government expenditures so as to contain the budget deficit and hence the need to borrow at all, whether abroad or domestically (which diverts domestic savings away from domestic investment). Finally, the government's external borrowing strategy must be better coordinated and managed, including by setting it within a medium-term financing strategy to ensure that debt service payments can be made without undue burden on the rest of the budget. If progress is made in all these areas, BRO countries should find over time that their present and prospective levels of debt do not prove unduly burdensome because they will achieve sustainable growth.

Table 1: Baltic States and Commonwealth of Independent States
External Debt/Exports 1/ 2/
(In percent)

	1993	1994	1995	1996
Advanced Reformers				
Estonia	12.3	9.2	8.8	9.4
Latvia	15.3	23.5	19.6	18.5
Lithuania	18.9	26.9	29.3	34.7
Intermediate Reformers				
Armenia	76.3	77.9	121.6	168.0
Georgia	4.4	204.4	258.8	255.5
Kazakhstan	38.7	73.2	59.8	55.8
Kyrgyz Republic	86.6	105.1	135.0	128.0
Moldova	56.7	82.3	90.8	102.5
Russia	181.6	152.6	122.6	126.4
Late Reformers				
Azerbaijan	6.0	51.9	69.8	67.1
Ukraine	32.9	59.2	59.6	58.6
Uzbekistan	36.1	37.7	44.1	56.7
Others				
Belarus	36.1	47.4	32.7	16.3
Tajikistan	111.6	136.1	124.4	186.0
Turkmenistan	6.2	12.7	26.4	39.5
Memo item:				
Croatia	46.2	53.2	70.8	69.5
Czech Republic	54.2	64.6	61.0	60.3
Hungary	267.2	319.8	206.1	201.4
Poland	276.1	183.8	122.7	111.5
Argentina	442.0	430.1	361.9	357.2
Mexico	341.5	330.0	361.6	402.8
Brazil	308.1	286.8	245.9	194.9

Source: IMF staff estimates.
1/ Exports of goods and services except for Latvia, Lithuania, Belarus, Kyrgyz Rep., Tajikistan, and Turkmenistan which are exports of goods only.
2/ External debt includes public and private sector borrowing from multilateral and bilateral lenders as well as private sources (mainly commercial banks); except for Estonia and Russia which is only public and publicly guaranteed debt. Debt also includes rescheduled debt service and arrears accumulations.