

DYNAMICS OF ECONOMIC REFORM IN POST-SOVIET KYRGYZSTAN

Lyudmila BAUM

*Leading expert,
International Institute for Strategic Studies
under the President of the Kyrgyz Republic
(Bishkek, Kyrgyzstan)*

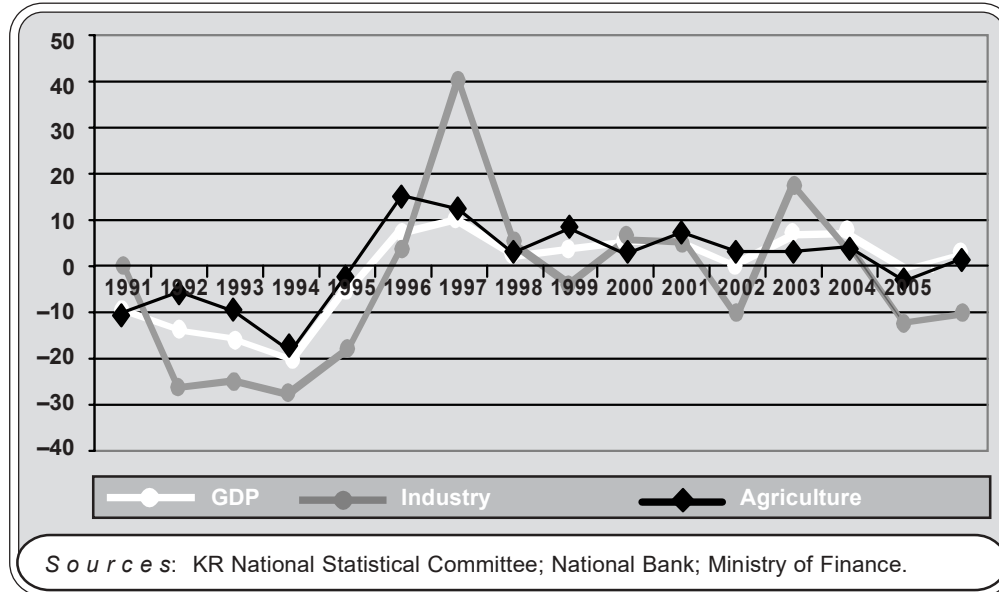
The post-Soviet period in Kyrgyzstan has been marked by dynamic changes. After the breakup of the U.S.S.R., the Kyrgyz Republic (KR) embarked on a parallel transition to a democratic system of governance and a **market economy**. In contrast to other CIS countries with sizeable energy and other natural and labor resources, larger domestic markets and close proximity to transportation arteries, the Kyrgyz Republic lacked such resources and conditions. In this context, its choice of a development option based on the model of a small but “open” economy and highly intensive reforms is quite understandable. The republic was obliged to implement a mixed (convergent) economic system whose basic principles are free enterprise, free market pricing and free competition.

These radical economic transformations were launched and carried out in the conditions of an unprecedented economic crisis. The breakup of the Soviet Union meant a disruption of cooperation ties between economic agents, so that the activities of many enterprises were fully or partially paralyzed. The loss of habitual markets and changes in the structure of domestic demand led to a significant reduction in the gross domestic product (GDP), which fell by over 25%.

In order to overcome the systemic crisis, the republic’s authorities took resolute steps to lay the groundwork for a market economy, which made it possible to create a private sector, set up a basic market infrastructure and liberalize all the key prices (in 1992). Being the first CIS country to introduce a national currency (in 1993), the republic managed to stop hyperinflation and, as a result, to resume economic growth (from 1996).

Figure 1

Economic Dynamics During the Reform Period



An analysis of market transformations in the republic over the past 15 years and of their influence on macroeconomic dynamics allows us to identify a number of stages in the development of the national economy.

Stage one (1991-1995) was marked by a sharp drop in production and household income coupled with a rapid increase in the number of people living below the poverty line (over 50% of the population), with inequality and hyperinflation, followed by initial macroeconomic stabilization, whose first stage was a slowdown in inflation (1992-1995). Macroeconomic and structural reforms in that period laid the foundations for market regulation of the economy. The need to ensure macroeconomic stability was of crucial importance.

This stage was characterized by market transformations which created the institutional, legal and regulatory frameworks for sustainable economic growth.

Economic reforms during the first period were mainly geared to:

- curb and stabilize inflation;
- ensure the stability of the national currency;
- reduce the budget deficit;
- restructure large loss-making enterprises;
- demonopolize some sectors of the economy;
- carry out the state privatization program;
- liberalize prices and foreign economic activity.

A liberalization of the domestic market in the republic first began during the existence of the Soviet state, and by mid-1994 it was virtually completed. In that period, most prices were “deregulated” and bread subsidies were abolished. By the end of 1993, price regulation continued only in the

energy industry and public utilities. Such rapid liberalization of prices and foreign economic activity led to an “equalization” of domestic and external prices, and this spurred producers to learn to work in the new conditions of stiff competition and to look for new markets. Price liberalization was accompanied by institutional transformations.

During the transition to a market economy, the question of forming private property came to the fore. A Law on Privatization was adopted on 20 December, 1991, and a State Property Committee was set up for its implementation. All types of property were given “equal opportunities.”

As a result of intensive privatization in 1992 and 1993, by the end of 1998 the share of the private sector increased to 87% in industry, 97% in trade, 57% in construction, and 55% in transport. The modification of state property resulted in the creation of a non-state (non-public) sector as a real basis for the development of market relations in the economy and changes in the economic behavior patterns of business entities. Naturally, at the early stages of privatization it was only possible to accomplish an “intermediate” task: to diversify the forms of property.

Radical changes were also underway in agriculture. The republic’s collective farms proved to be totally unviable in the new conditions, because they were fully dependent on government subsidies. They were reorganized into numerous single and multi-family “farmsteads,” which became the main type of enterprise in Kyrgyz agriculture. Land was distributed among all rural families in proportion to the number of family members.

In May 1993, the Kyrgyz Republic introduced its own national currency (the som) and became one of the first post-Soviet countries to leave the “ruble zone.” This measure enabled it to pursue an independent financial and monetary policy and to control the economic situation. Among the key achievements of this monetary policy was slower inflation and a slower decline in production, which helped the economy to adapt to market conditions.

This went hand in hand with a reform of the banking system, which consisted in the creation of a two-tier banking mechanism and liberalization of the rules for opening commercial banks. In fact, that was when the constructive implementation of economic reforms actually began.

When hyperinflation was brought to an end in 1994, the focus shifted to structural transformation, although the reforms of the fiscal and monetary systems naturally continued. As regards macroeconomic dynamics, 1994 proved to be the most difficult year: there was a significant worsening of the situation in industries geared to meet consumer demand and in areas associated with capital investment. The decline in production was less pronounced in sectors which already had their own markets and were able to find new marketing outlets, both within the country and abroad (electricity industry, nonferrous metallurgy). This resulted in significant changes: an increase in the share of natural resource industries and a reduction in the share of industries producing end products.

By late 1994 and early 1995, the first stage of structural transformation showed that at that time Kyrgyzstan was a leader among the CIS countries in terms of the intensity of change. In international reference books, its efforts in the areas of privatization of state property and liberalization of prices and foreign trade were assessed as significant, and in the areas of governance reform and budget consolidation, as moderate.

The implemented reforms brought about a gradual improvement in the economic situation (from the second half of the 1990s).

The turning point in economic development was reached in 1996, when the republic’s GDP began to grow. In 1991-1996, the trend toward financial stabilization was strengthened, and in 1995-1997 the deep crisis engulfing the Kyrgyz economy was by and large overcome.

Stage two (1996-1999) was a period of economic stabilization, although growth was recorded only in some sectors of the economy (agriculture, gold mining and energy).

Nevertheless, the need to cover the budget deficit made the economy sufficiently vulnerable. The 1998-1999 crisis, largely caused by the “collapse” of the Russian ruble, had its effect as well.

The second stage of economic development proved to be important for strengthening the foundations of the market economy in the country. The pivotal reforms were completed. A consistent monetary policy made it possible (with significant efforts on the part of the fiscal authorities) to reduce inflation from 1,366% in 1993 to 23% in 1997. These successes in curbing inflation were achieved due to the adoption of measures projected in the anti-inflation program, especially a tight monetary policy, an import-substitution policy, etc. The authorities managed to consolidate public finances, reducing the budget deficit to 5% of GDP; they were able to strengthen the som and reduce interest rates.

In 1997, Kyrgyzstan was a leader among the Central Asian countries in transforming the economy and introducing market mechanisms. According to such an authoritative publication as *The Financial Times*, in 1997 the republic ranked 14th among the top 20 fastest-growing economies in the world. The macroeconomic stabilization and significant liberalization of the economy achieved by that time enabled the republic to go over to the next stages of the transformation process: privatization of strategic facilities and structural adjustment. It had to restructure large state-owned enterprises and to arrange effective use of mechanisms for reorganizing unprofitable business entities or initiating bankruptcy proceedings.

In that period, as a result of the land reform carried out in Kyrgyzstan, the republic was also able to stop the decline and achieve a certain recovery in agricultural production. It should be noted that the results of transformations in the agricultural sector were at first not very tangible because up to 1997 private commercial and individual farms were "overtaxed"; in view of this, a single tax on land was introduced in 1998. One can say that the agrarian reform initiated in 1991, when collective and state farms were falling apart, was completed by 1997; at that time, a market system for crediting the land reform was introduced in place of the practice of commodity credit.

Growth in agriculture was first recorded in the late 1990s. The reforms carried out in this area have enabled the agricultural sector to increase real production by more than 40% (at an average rate of about 7%), mostly due to growing crop production, which accounts for over half of total agricultural production.

In 1995-1997, state budget revenues remained at 16.8-16.6% of GDP. In order to improve the situation, steps were taken to intensify the tax collection process, establish a treasury service, introduce (in 1996) a new Tax Code, and streamline the tax system. Special funds of public sector organizations and profits from privatization of public housing and other state-owned property were included in budget revenues.

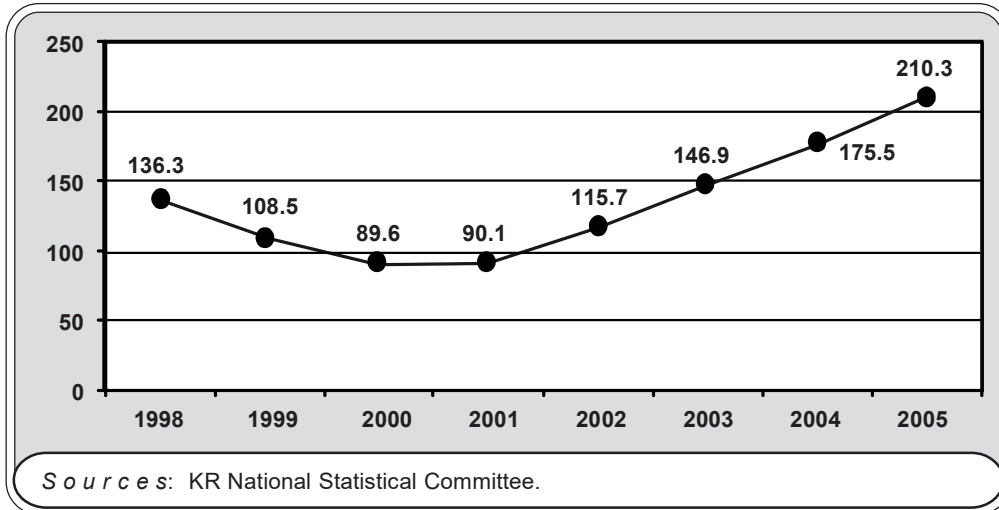
Structural reforms were subsidized on a significant scale by donor countries and international financial organizations. It should be emphasized that macroeconomic stabilization was in large part achieved due to substantial borrowings and donor aid. From 1993 onward, the republic began to receive large amounts of foreign assistance. In the second half of the 1990s, soft loans and grants for maintaining the budget and balance of payments, for structural adjustment, infrastructure projects, technical assistance, etc., added up to about 10% of GDP.

The republic continued to pursue a policy designed to liberalize foreign trade, maintaining low import tariffs and allowing all economic agents to engage in export and import of goods. This policy was underpinned by Kyrgyzstan's accession to the WTO in 1998 (it was the first CIS country to join that organization). As a WTO member, the republic harmonized its national legislation on foreign trade with WTO provisions and upgraded the legal framework that provides a basis for the republic's foreign trade, industrial innovation and investment policy, helps to foster a competitive environment, and determines the interaction of the national economy with the world economy and the degree of the republic's participation in international trade.

Among the main reasons for the republic's accession to the WTO is open access to foreign markets and export advantages.

Since 2000, there has been an increase in foreign direct investment, a significant part of which goes into industry.

Figure 2

Gross Foreign Direct Investment (*million dollars*)

In 1999-2000, upon the completion of small privatization, the authorities launched a campaign to privatize strategically important industries: the energy industry, mining and telecommunications. At that time, the non-public sector accounted for over 79% of the total number of employed persons, but there was still no “effective” owner. The republic introduced private property in land. As the bulk of the population was drawn into the market economy, employment and, consequently, the economy in general were “ruralized.” In 1991-2001, the share of people employed in agriculture increased from 34.5% to 52.9%, while the share of those employed in industry fell from 18.1% to 8.2%.

In the period from 1996 to 2000, the average rate of economic growth in Kyrgyzstan was 5.5%, one of the highest figures among the CIS countries.

Stage three (from 2000 to March 2005) brought continued growth, a reduction in the budget deficit and stabilization of exchange rates, but compounded the problem of external debt. From 2002 to 2004, the average rate of economic growth was around 5%, reaching 7% in 2003 and 2004 due to progress in some sectors, primarily an increase in gold exports and in agricultural production.

During the third period, reforms revolved around deregulation problems: the need to remove administrative barriers to business, reduce the number of state control and authorization agencies, and enhance investment activity. Concrete measures to deregulate the economy were designed to create conditions that would encourage investment in priority sectors and improve the investment climate in the republic.

An improvement in the economic situation made it possible to increase budget revenues from 16% of GDP in 2000-2001 to 19% in 2003-2004. The budget deficit fell from 11.9% of GDP in 1999 to 5.7% in 2002. Inflation slowed down significantly: from an annual average of 12.6% in 2000-2001 to 3.4% in 2002-2005. The national currency strengthened as well.

Within a few years, certain changes took place in the structure of Kyrgyzstan’s GDP. The agricultural and service sectors, whose contribution to GDP was on average around 70%, remained dominant and ensured economic growth. The share of the service sector gradually increased and, starting from 2002, exceeded the share of agriculture, reaching 38.3% in 2004. The shares of industry and agriculture tended to decline: in 2000-2005, the share of industry fell from 23.3% to 16.1%, and that of agriculture, from 34.2% to 30.5%.

Table 1

GDP Composition (in current prices; as % of total)

	2000	2001	2002	2003	2004	2005	2006
Total	100	100	100	100	100	100	100
Industry	23.3	23.1	17.9	17.3	19.2	16.1	14.9
Agriculture	34.2	34.5	34.4	33.6	29.9	30.5	28.9
Construction	3.8	3.8	3.4	2.9	2.5	2.5	2.7
Services	31.7	31.4	35.6	36.8	38.3	40.2	41.2

Source: KR National Statistical Committee.

Rapid progress in the service sector was due to successful reforms and an expansion of market services. In recent years, this expansion was mostly ensured by an increase in the volume of trade and paid services, driven by domestic demand associated with rising household income.

From 2000, active work was underway to privatize strategic industries such as the power industry and telecommunications. The level of privatization in that period was as follows: 88.6% in industry, 97% in trade and public catering, and 99.85% in consumer services. These figures show that most enterprises are now in the non-public sector and their activities are regulated by market relations. On the whole, roughly 90% of all industrial and agricultural products are produced in the private sector of the economy. Since 1991, more than 7,000 economic entities have changed their form of ownership. The private sector, mostly represented by micro, small and medium enterprises, has become a leading force, looking for new markets, enhancing product quality, raising management standards, and investing in human capital. Small and medium businesses operating in the light and food industry and in the service sector are an important and dynamic sphere of the economy. Today these enterprises provide most of the jobs in urban areas, but many of them operate in the “shadow” economy, which limits their opportunities to develop and to take part in creating public goods.

Consistent measures taken in that period by the National Council on Good Governance markedly improved the investment climate, which promoted a steady annual increase in investment in the economy. True, during the years of reform the republic has been unable to attract the expected amounts of foreign capital or to ensure its proper quality. These failures are mostly due to political and macroeconomic conditions (sociopolitical instability), mistakes in implementing market reforms and their incompleteness; in large part these “setbacks” are connected with flaws in the policy designed to attract foreign direct investment. The situation is also complicated by excessive bureaucratization of the economy and related corruption problems.

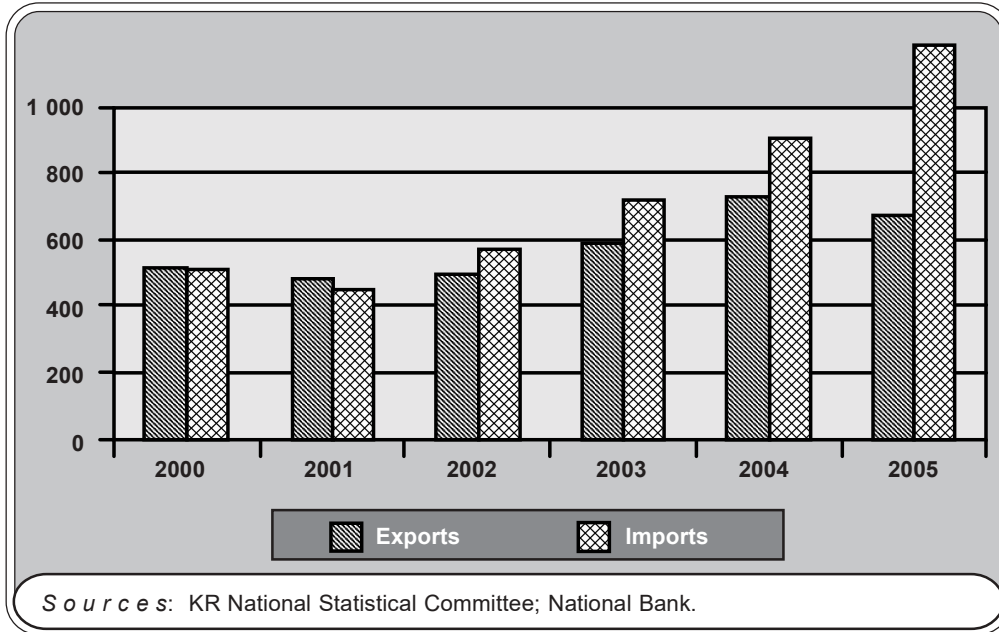
In the period under review, significant changes took place in Kyrgyzstan’s foreign trade. Thus, the decline in trade recorded from 1999 to 2001 was reversed in 2002, when the trade turnover began to increase. This increase in commodity flows was in large measure due to rising imports (see Fig. 3).

During the past years, the country’s trade balance was negative, with the exception of 2001. Incidentally, this was the second time (after 1994) during the years of independence when the balance was positive, constituting \$8.9 million. Nevertheless, in 2002 the situation changed once again: the trade deficit began to increase, reaching \$429.3 million in 2005.

About half of the republic’s trade is carried on with member countries of the following regional associations, of which the Kyrgyz Republic is a member:

Figure 3

Exports and Imports in 2000-2005 (million dollars)



- Commonwealth of Independent States (CIS);
- Eurasian Economic Community (EurAsEC);
- Shanghai Cooperation Organization (SCO);
- Economic Cooperation Organization (ECO).

Since 1999, the geographical composition of exports and imports has changed significantly. In exports, the share of non-CIS countries has increased with a reduction in the share of CIS countries, and in imports, on the contrary, the share of the former has declined from year to year with an increase in the share of the latter. This reorientation of the Kyrgyz market and trade with non-CIS countries can be explained by the fact that trade relations with WTO states are based on the most favored nation (MFN) principle. In 2005, 52.3% of Kyrgyz exports went to WTO countries.

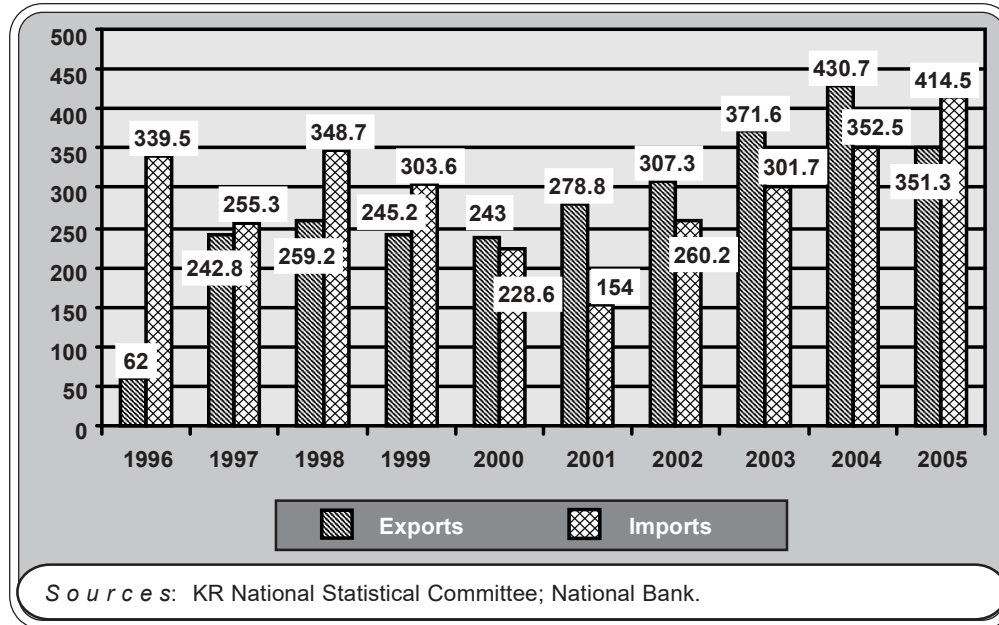
Overall, the Kyrgyz Republic today maintains trade and economic ties with almost over 100 countries in the world, including 11 CIS countries and more than 90 WTO states (see Fig. 4). The republic's WTO membership creates stable and liberal conditions for access to the markets of WTO countries in view of MFN treatment accorded to Kyrgyz exports, which means guaranteed compliance by WTO members with generally accepted commercial practices, without any restrictive measures in the form of bans or quotas.

In October 2006, Kyrgyzstan's first trade policy review (performed by each WTO member in order to ensure transparency in commercial and investment policy) took place at the WTO headquarters in Geneva. During this event, the WTO states gave a positive assessment of the republic's economic reforms designed to liberalize trade and attract investment to the economy, noting that Kyrgyzstan was performing its obligations.

In the period from 2000 to March 2005, inflation slowed down while GDP growth somewhat accelerated, but it was too early to talk about macroeconomic stability. The situation in the republic

Figure 4

Trade with WTO Countries in 1996-2005 (million dollars)



remained insufficiently stable. This lack of macroeconomic stability and sensitivity to “external shocks” were due to the following factors:

- the persistently large budget deficit, which has traditionally been one of Kyrgyzstan’s main economic problems;
- an external debt in excess of annual GDP, with the burden of debt service weighing heavily on the budget; markedly reduced foreign aid was used entirely to overcome these difficulties and maintain the stability of the national currency;
- the shadow sector of the economy, which in 2000 accounted (according to statistical data) for about 25% of GDP.

The underlying causes of the above problems were incomplete reforms, ineffective functioning of the financial market, and an insufficiently favorable climate for the development of private enterprise and for attracting foreign direct investment. The republic reached a point where a consistent and active renewal process could only be achieved based on a long-term strategy designed to resolve existing problems and meet the people’s basic needs.

At this stage, Kyrgyzstan became a pilot country for the introduction of a Comprehensive Development Framework Until 2010 (CDF), which projected the strategic goals of socioeconomic progress for 10 years ahead. In this process, the Millennium Development Goals (MDGs), including a twofold reduction in poverty by 2010, were “extended” to the republic. The CDF was based on an approach known as “pro-poor growth” and a development strategy oriented toward economic progress. By means of distribution mechanisms ensuring such growth and in accordance with its main purposes, the CDF was to benefit the poor and most vulnerable strata of the population. The overall CDF goal had three major components:

- enhancing effective and transparent governance;
- building a fair society;
- ensuring sustainable economic growth.

In 2003-2005, the National Poverty Reduction Strategy (NPRS) spelled out and gave substance to the CDF through various practical measures and programs. The NPRS was developed with broad participation of civil society and donor organizations, and was completed at the end of 2002. Among its merits one can include a sober assessment of the current poverty situation, an orientation toward transition to a market economy (with due regard for the need to protect the poor and to promote the private sector), an urge to ensure the harmonious development of rural areas and branches of the economy, and—last but not least—an awareness of the need to fight corruption.

Current economic development (since March 2005). The relatively stable growth of the Kyrgyz economy was disrupted by the events that followed in the wake of 24 March, 2005. As a result, economic growth that year fell to -0.6% (compared to 2004). Out of the three main sectors of the economy, production fell in industry and agriculture, whereas the service sector held its ground, posting growth of 5.7%. Accordingly, there was a decline in real household income and in domestic and foreign investment, coupled with a worsening of social indicators. As regards fiscal policy, it was aimed, as in previous years, to broaden the tax base and ensure priority financing of the social sector. Thus, improvements in tax policy (including the enactment of a new Customs Code and enhanced tax administration) made it possible—against the background of slowing economic growth—to meet the target figure for budget revenues.

Let us once again turn to the past. In the early 1990s, Kyrgyzstan became a member of the World Bank, and in 1993 it signed the first agreement with this financial organization on a so-called rehabilitation loan designed to pay for food imports in that difficult post-Soviet period. That was when it became fashionable to borrow money abroad instead of learning how to work properly and to collect taxes. Needless to say, at the early stages of the transition period—in view of limited budget resources and low levels of domestic investment—the attraction of foreign capital and its effective use were the crucial factors of economic growth in Kyrgyzstan. At that time, our economy could not do without dollar “infusions” and grants from abroad. Of course, foreign loans enable the recipient country to invest and consume more than its own economy produces, but piling up external debt has a depressing effect on its fledgling financial and economic systems, destabilizes the general economic situation and leads to malfunctions in the development process.

At the same time, foreign loans have been unable to ensure (because of low efficiency) the rate of growth in production and exports required for their own redemption. In recent years, the republic has come up against an urgent need for restructuring its external debt, caused by the lack of domestic sources for its redemption.

It is no secret that the republic’s external debt is regarded as “excessive.” The main question of 2006 was whether to join the HIPC. This option came under consideration because this could ease Kyrgyzstan’s debt burden within the framework of the Multilateral Debt Relief Initiative (MDRI). At the same time, in order to obtain debt relief the republic will have to meet sufficiently severe conditions, including invitation of international experts to take part in reforming the key sectors of the economy: energy and mining.

The question of joining the HIPC met with a mixed response in Kyrgyz society.

The development of the necessary reform programs was somewhat delayed in view of the complicated situation. The CDF-2010 goals turned out to be hardly attainable. The question of carrying the projected reforms to their logical conclusion remained high on the agenda. By the end of 2005, the government produced its Program of Concrete Actions to Accelerate Economic Growth in 2006. The

tax reform was continued. From January 2006, the rate of profit tax was reduced by 10%, and income tax was switched to a flat rate of 10%.

In 2006, a draft Country Development Strategy (NDS) was formulated in Kyrgyzstan. It charts the main lines of the republic's progress and activity for 2006-2010. Its main goal is to raise the level and quality of life in the country by means of sustainable economic growth, a proper employment market, high and stable income, access to a wide range of social services, and high living standards in a healthy environment. According to the NDS, in 2010 per capita GDP is to reach \$728 (for developed countries, this figure is at least \$1,000), the average wage is to increase by 60%, while the budget deficit is to be reduced to 2.6% of GDP.

From 2007, the republic is to go over to a two-tier budget consisting only of the national and local budgets (the regional and district levels are abolished). A legal framework for the new arrangement was provided by the Law on the Principles of Budget Law. The switch to such a system should do away with the transfer of funds from local budgets to the national budget, so encouraging local government bodies to increase their revenue-raising capacity.

Having gone through a change of power in 2005, Kyrgyzstan has got a chance to move into a qualitatively new phase of progress.

We have got an opportunity to overcome the accumulated negative consequences of various undesirable phenomena. For this purpose, the country should revise certain elements of its system of governance and its economic development strategy, and should strictly implement the projected plans. Current economic policy should be focused on the main goals.

At the present stage of progress, we have to take an objective view of the republic's prospects, with a sober approach to the realities we will have to face in the near future and in the longer term. Another thing we have to do is to remove the organizational and legal obstacles to future growth.

A dawning awareness of these imperatives supported by concrete actions holds out hope of positive changes.