



Kyrgyz Republic

For the second consecutive year, economic performance in the Kyrgyz Republic was modest. The government must persevere in reforms to push the economy toward more rapid and sustainable growth and higher living standards.

RECENT TRENDS AND PROSPECTS

Real GDP grew by 3.6 percent during 1999, higher than the 2.1 percent in 1998 when the Russian crisis broke out. As in 1998, the agriculture sector produced the best performance, and grew by 8.7 percent. Production of all major crops increased, except for grain and wheat, which decreased slightly. The service sector edged up 1.8 percent. Industrial production declined by 2.4 percent, and gold production at the Kumtor mine also decreased.

The weak fiscal situation continued during 1999. Total government revenue as a percent of GDP increased slightly to 18.1 percent. However, taxes fell short of the planned level, due mostly to the slowdown in imports caused by the steep depreciation of the som. The tax revenue collection relies heavily on industry, and the poor industrial performance also contributed to the shortfall in tax revenue. Nontax revenue and grants remained weak. Total expenditure fell about 1 percent of GDP to 28.3 percent, higher than planned because of unanticipated spending related to a foreign terrorist incursion in the southern

province of Osh. The total fiscal deficit remained high, at more than 10 percent of GDP. Because of the weakened fiscal situation, both budget and pension arrears rose steeply.

The money supply (M2) rose at a slightly higher rate in 1999 than in 1998, and inflation more than doubled from 16.8 percent to nearly 40 percent. Inflation had been rising since the fourth quarter of 1998, primarily because of the weakness of the som, caused by a continued lack of public confidence triggered by the Russian crisis of August 1998. During 1999, the som lost another 35 percent of its value to the dollar, after a 32 percent loss between end-August and end-December 1998. Public confidence was further shaken by a major financial fraud involving most of the largest commercial banks. A swift and satisfactory resolution would help restore public confidence in the financial sector and the currency.

Total external trade in 1999 declined by about 25 percent compared with the previous year. Imports declined by nearly 30 percent and exports around 19 percent. Consequently, both trade and current account balances improved, with the latter at 12 percent

of GDP, nearly half the deficit of 1998. The savings rate was negative for the second year in a row, while the investment rate was around 12 percent. The resource gap of more than 12 percent of GDP mirrors the current account deficit and reflects a lack of domestic savings in a weak economy. International reserves rose to a level equivalent to more than four months of imports as inflows of concessional assistance exceeded the current account deficit. External debt (public and publicly guaranteed) stood at about \$1.3 billion at the end of 1999, an increase of about \$150 million from December 1998.

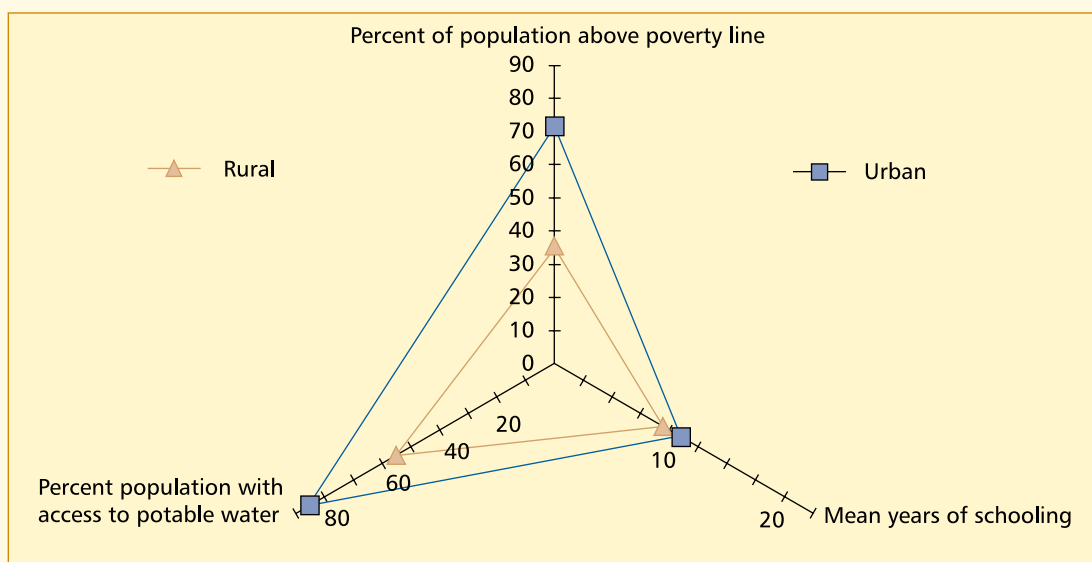
While the economy is capable of growing 4-5 percent per year, the unfavorable domestic and external conditions will likely slow growth to within 2-3 percent in 2000 and 2001. Tighter monetary policy will cut inflation in 2000 by half to about 20 percent, and reduce currency depreciation. If measures designed to enhance revenue and reduce expenditures are followed consistently, the overall fiscal deficit could decrease to about 7.4 percent of GDP. Both imports

and exports are expected to grow moderately, with the current account deficit projected to decrease to 10.5 percent of GDP for 2000. With weak foreign investments, both direct and portfolio, the country will continue to rely on foreign official assistance, mostly on concessional terms, and public and publicly guaranteed debts will accumulate to about \$1.5 billion by the end of 2000.

ISSUES IN ECONOMIC MANAGEMENT

While the country made major efforts in reaching agreement with the International Monetary Fund to start the enhanced structural adjustment facility program in 2000, it faces serious challenges in implementing macrostabilization and structural reforms. Besides a continued tight monetary policy, the government must make extra efforts to cut spending while increasing revenue collection. On the revenue side, the focus should continue to be on broadening the tax base and increasing tax compliance for better tax collec-

Figure 2.4 Welfare Status by Geographic Location, Kyrgyz Republic, 1997



Source: World Bank.

tion. Frequent changes to the tax code and ambiguous interpretation of the tax law discourage business activity and encourage tax evasion. It is essential, therefore, to maintain a stable tax environment. The current system of interpreting the tax code and granting arbitrary exemptions creates more uncertainty, especially among small and medium-size enterprises. It also discourages risk taking by both domestic and foreign entrepreneurs and reduces the incentive to invest. Indirect tax collections have improved, but revenues from direct taxes remain low and below target. Because about one fourth of the working population pays little or no tax, the potential payoff from increased tax efforts is high, particularly regarding direct taxes.

On the expenditure side, efforts should be concentrated on cutting subsidies, especially indirect ones, and shifting expenditures to sectors that are likely to contribute to strong long-term growth. Direct subsidies to state-owned enterprises (SOEs) should be phased out as well as indirect subsidies for gas and electricity consumers. Existing utility tariffs do not reflect full costs and are not designed to absorb shocks such as exchange rate depreciation. Losses by utility companies also contribute to the government's weak fiscal position.

Fiscal management also needs to be improved. In particular, better coordination between the Treasury and the Ministry of Finance is required. Efforts to reorganize the fiscal management system are under way. These include strengthening linkages between the Treasury, the Ministry of Finance, and the National Bank of the Kyrgyz Republic, and they should be monitored for effectiveness.

On the structural side, progress in promoting private sector development has been slow, and privatization of large SOEs continues to lag. Major government efforts, including privatization and restructuring of the SOEs, will be needed to develop the private sector. Changes may be difficult to implement, considering that both the parliamentary and presidential elections occur in 2000.

POLICY AND DEVELOPMENT ISSUES

Historically, the Kyrgyz Republic was one of the poorest regions in the former Soviet Union, and in the

five years following independence in 1991 cumulative output fell by about 50 percent. As a result, in 1997 an estimated one half of the population lived below the official poverty line, the equivalent of less than \$0.75 per day.

The economic recovery that began in 1996 was robust. However, it has lagged since the Russian currency crisis of August 1998, and real wages are likely still lower than they were in 1992. Due to the depth and severity of poverty, a significant improvement in living standards will require a sustained and broad-based effort by the government and long-term sustained economic growth. The fundamental picture of poverty is unlikely to have changed substantively in the last two years.

Although on national average one in two persons is poor, 80 percent of the poor live in rural areas. The degree of poverty in rural areas has also deteriorated relative to urban areas. While extreme poverty decreased from 19.1 percent of the population in 1996 to 14.8 percent in 1997, most of this resulted from a targeted poverty reduction program in urban areas only. Poverty also appears to affect more women than men.

Realizing that widespread poverty is the main obstacle to improving the welfare of the people, the government has an ongoing national initiative, the Arakat program. The government is waging major efforts to revamp its poverty-fighting strategy and related policies in coordination with major donors, including the Asian Development Bank and the World Bank. It must consider carefully three issues.

First, because poverty is most severe in the rural areas, lifting rural and agriculture development above the current level of subsistence farming must be the core in formulating an effective poverty reduction strategy (see figure 2.4). Some farm households apparently engage in both agricultural and nonagricultural wage labor, which suggests a range of income-generating activities. Policy may need to pay more attention to promoting off-farm employment and secondary (nongrain) food crops, livestock, and horticulture.

Second, policies should aim to increase the quality of life as well as income. Social infrastructure spending needs to be increased, especially in rural areas. About 45 percent of the rural population has no access to potable water versus only 15 percent in urban

areas. About 95 percent of those in rural areas still use latrines, compared with 47 percent in urban areas. Centralized systems for heating, water supply, and gas distribution are lacking in rural areas, and the quality and reliability of electric power supply and distribution is much lower than in urban areas.

Third, private sector development efforts should be strengthened. Substantial progress has been made in adopting markets and stimulating the private sector since independence, including price and trade regime liberalization and substantial privatization. By the end of 1997, the private sector accounted for about 65 percent of GDP, the highest private sector share among former Soviet republics. Nevertheless, the government should strengthen its role in creating an environment

that encourages private sector growth, and in establishing and enforcing transparent rules and simple procedures. For example, despite decrees and resolutions, small and medium-size enterprises still require 27 clearances to register a business.

The role of the government is still evolving and facing many questions. What are the functions of the government in this era of transition? How can the government optimally participate in building and maintaining a legal and regulatory framework for economic development and poverty reduction? Answers to these questions will guide the government in reorganizing its structure and staffing and making it more suited to meet the long-term challenges of reducing poverty and promoting economic growth.