IMPACT OF THE WORLD CRISIS ON THE ECONOMY OF THE KYRGYZ REPUBLIC

For the first time, risks and threats resulting from the negative impact of the world crisis on the economy of the Kyrgyz Republic (KR) were mentioned in the statement of the KR President in January 2008. Among those mentioned were reducing liquidity and increased costs of resources in the international financial system, a noticeable decrease in aggregate demand and global trade, increasing uncertainty and lack of trust experienced in 2008. Alongside these factors the Republic’s economy has also been affected by the influence of domestic factors, in particular, unstable operations of the hydropower sector. In 2008-2009 the management of the Republic has not only taken measures to minimize the mentioned risks, but has also committed to implement serious internal economic transformations and reforms.

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Profile of the Economy of the Kyrgyz Republic

During the five years before the crisis, the Kyrgyz Republic demonstrated a positive overall progress with increasing levels of economic growth and living standards. The average growth of the economy between 2003 and 2007 was about five percent. During this period per capita GDP increased more than twofold reaching 959 dollars in 2008. On the whole this trend can be explained by a favorable external market situation, as well as balanced national fiscal and monetary policies. State budget revenues have increased and fiscal deficit became more sustainable, which constituted 0.1 percent of GDP in 2008. Public debt decreased by practically twofold, to 42 percent of GDP. In recent years one could observe strengthening of the financial and banking sectors of the country, although it is still not sufficiently developed. Total lending to the economy is only about 14-15 percent of GDP.

Economic growth has been mainly preconditioned by domestic consumption growth, which was about 120-130 percent of GDP and was supported by external inflows and transfers. Key sectors of the economy from the added value viewpoint are trade and services, as well as agriculture. Power generating and distribution and gold producing enterprises played a leading role in the industrial output. Effectively, the Republic’s economy entails a small-commodity production, agrarian and trade and service system. There are no established inter-regional and intersectoral economic links within the country.

The Kyrgyz Republic has an open economy. The sustainability of the Kyrgyz economy is very much dependent on economic trends in the regional economy. Trade turnover and foreign investments of Central Asian countries and Russia make up more than 50 percent of the total volume. The most important orientations of regional economic integration are the following three blocks: regional trade, sewing and textile industries, and the electricity sector. In fact, due to the system of regional markets and a liberal trade regime Kyrgyzstan has become a platform for transit of Chinese goods to markets of Central Asia and Russia.

Global Crisis and its Expansion

The current global crisis is one of the largest and deepest financial and economic crises observed in the last 65 years. Current developments in the world demonstrate that the problem is not only lack of funds, but the absence of clear
perceptions and coordination of actions for coming out of the crisis. As it had initially been considered a financial and short-term crisis, it was only in the second half of 2008 that behavior was reassessed and reconsidered in line with the magnitude of the real crisis. The proposed set of anti-crisis measures was based on the available economic theories and past experience, without strategically new ideas. However the reality turned out to be different.

According to the projections of the World Economic Outlook, global growth is expected to slow from just below 3.5 percent in 2008 to about 0.5 percent in 2009 before recovering somewhat in 2010. Output slowdown in developed countries will exceed 1.5 percent, and in the developing ones growth rates will be as low as three percent. Global trade will probably have a downward trend. The above mentioned trends are observed in key trade partners of the Kyrgyz Republic, in particular, in Russia and Kazakhstan. According to various estimates, GDP in Russia is expected to fall by seven percent and in Kazakhstan, about three percent.

World oil prices, which turned out to be lower that the desired pre-crisis levels, have considerably reduced economic opportunities of Russia and Kazakhstan: investment activities and aggregate demand have declined sharply. Economic growth of Russia, notwithstanding all support measures, turned out to be lower than the planned level, likewise in Kazakhstan, which has not come out of the banking crisis yet, aggravated by a decline in energy and metal prices. The Chinese economy also demonstrates growth slowdown: as in the Russian economy, the foreign trade turnover of China decreased. It is important to bear in mind that the struggle for resources and sales markets most probably will become tougher, including extreme forms of protectionism – some of them being observed already today.

**Impact of the Crisis on the Kyrgyz Economy**

Kyrgyzstan is a country with a small and open economy; therefore the world crisis is being imported through several channels: in particular through export and re-export of goods and services, through money supply, including foreign exchange inflows, and through demand for labor force.

The Kyrgyz Republic was demonstrating significant economic growth before the crisis. As noted above, the average annual growth rate was about five percent,
even reaching 7.8 percent in 2008. The majority of macroeconomic indicators had a positive trend. However, in mid-2007 the Kyrgyz Republic experienced a problem with growing prices for hydrocarbon primary products and foodstuff, which triggered an abrupt increase in inflation. By late 2008-early 2009, signs of a negative impact of the world crisis on the Republic became more evident.

According to the figures from the first half of 2009, the economy of the Republic was practically at a level similar to the previous year: economic growth was 0.3 percent. A significant decline of 19 percent was reported in industry due to reduced output by all processing enterprises. A decline in demand in Russia and Kazakhstan affected the Kyrgyz Republic the most, due to a reduction in the output of textile and sewing industries by 40 percent. The crisis, having affected the construction sector of Kazakhstan, had an impact on demand for construction materials produced by Kyrgyz factories. Moreover, due to unfavorable weather conditions the volume of electricity generation, which is a sector that acts as the backbone of the Republic, declined in 2009. Despite the fact that other key sectors of the economy are demonstrating positive indicators, growth rates have overall declined.

It is evident that Kyrgyzstan is experiencing (and is being affected by) the world crisis through an indirect influence of the developments in Russia and Kazakhstan. A key factor was the decline in demand of these countries for exports from countries like Kyrgyzstan. An overall economic slowdown in the world and in the region triggered price reduction, and deflation was observed in certain months of 2009, which, to some extent, had a negative impact on exports. As a result of all of these factors, in 2009, foreign trade turnover of the Kyrgyz Republic dropped by 20 percent. As a result, government revenues from foreign trade were reduced by ten percent.

Another important factor for the economy of the Kyrgyz Republic was a decline in the volume of transfers by labor migrants from Russia and Kazakhstan. According to various estimates there are more than 500 thousand migrants only in Russia and Kazakhstan. On the whole, a reduction in total transfers made up about 30 percent or approximately 300 million dollars, which, in return, was reflected in reduced consumption in the Kyrgyz Republic.

Interest rates between 2007 and 2009 increased from six to 25 percent, which could be observed in the market of state treasury bills. It is worth noting that in
general the Kyrgyz Republic has not experienced any problems with liquidity in the banking system. However, during the crisis, lending to economy as a whole declined. An additional factor, which affected the economy of Kyrgyzstan, was the depreciation of national currencies in Russia and Kazakhstan, which put pressure on the national currency of the Kyrgyz Republic. In 2009, the volume of trading in the capital market decreased by more than 40 percent as compared to the same period of last year.

The situation with the balance of payments is continuing to be relatively stable. The sustainability of the balance of payments is maintained by transfers of labor migrants, inflows of foreign direct investments, as well as financial support of international financial institutions and donor countries — in particular, the timely disbursement of a grant of 150 million dollars and a credit of 300 million dollars by the Russian Federation, as well as financing by the IMF in the amount of 100 million dollars.

The fiscal situation turned out to be noticeably worse than the central government predicted. Given the fact that 2009 was the year of the Presidential Elections, public expenditures are being not only disbursed in full, but have an upward trend, which exceeded more than 30 percent for certain items. With a marked growth in government expenditures, a decline in government receipts resulted in growing budget deficit (without grants) up to seven percent of GDP. In total, tax and non-tax receipts in 2009 make up only 93 percent of last year’s level. One of the reasons for reduced receipts was the introduction of the new Tax Code envisaging a reduction in the VAT rate from 20 to 12 percent, as well as a reduction in tax receipts from external trade. Before receiving grants and credits from Russia, funds in the government accounts tended to reduce.

**Policy Measures under Implementation**

By the end of 2008 the central government developed an anti-crisis program aimed at minimizing the negative impact of the global crisis on the republic. The Government has been focusing efforts on six blocks: (i) maintaining macroeconomic stability; (ii) ensuring banking sector stability; (iii) ensuring food and energy security; (iv) promoting and supporting local economic activities; (v) improvement of the investment environment; (vi) targeted support to socially vulnerable groups.
Maintaining Macroeconomic Stability

A significant political and economic step was the Intergovernmental Agreement on the Russian grant totaling the amount of 150 million dollars and the credit for 300 million dollars. Thanks to this decision, the Government resolved one of its most important problems of budget liquidity. In particular, in response to Russian loan, net domestic assets of the Government increased 18 times. Moreover, this step coupled with the decision of the IMF to allocate 100 million dollars under the ESF enabled Kyrgyzstan to maintain international currency reserves at a high level of 1,600 million dollars, which is close to four months of import.

Given the continuing world financial and economic crisis, the exchange rate is still under pressure. It should be noted that in relation to the exchange rate the National Bank pursues the policy of restricting abrupt fluctuations in the exchange rate of the Kyrgyz som and maintaining sufficient international reserves. At the same time, notwithstanding the devaluation in key trade-partner countries, until the end of quarter one of 2009 the National Bank maintained the exchange rate of the national currency at a stable level, which required using some portion of its international reserves. As a result, the National Bank had to ease the policy in relation to the stability of the national currency.

Stabilization of the situation in world food and energy markets accompanied by downward price adjustments in the markets, as well as anti-inflationary measures taken by the National Bank and the Government triggered a slowing down of inflationary processes in the economy. Thus, a reduction in prices for foodstuff and moderate growth in prices for non-food products and services have been reported. At the same time, the situation was aggravated by the governmental decision to increase budget expenditure financing. On the whole, this situation required active actions to be taken by the National Bank to constrain an abrupt growth in money supply and restrictions for additional inflationary pressures.

Ensuring Stability of the Banking System

One of the first steps to ensure the stability of the banking system was the requirement to increase the equity of commercial banks. Along with that, the Deposit Insurance Fund has been established, which brings the insurance of deposits up to 2,300 dollars, thus enabling the guarantee 95 percent of the population’s deposits. The establishment of the Deposit Insurance Fund, on the other hand,
allowed reducing the mandatory reserve requirements from ten to 9.5 percent. In 2009 the Bank Refinancing Fund has been established in control of an amount of 100 million dollars, however, it has not issued a single credit. In addition to the above mentioned measures, the National Bank reduced the discount rate to just below five percent, probably signaling a reduction in inflationary expectations of market participants.

Ensuring Food and Energy Security

Taking into account that the agriculture and energy sectors are the backbone for the Kyrgyz Republic, the Government continually supports them. To prevent a food crisis in 2008, the Government took all measures to organize for sowing agricultural crops and to provide support to farmers. In addition to increasing financing for agriculture, an agro-industrial corporation has been established, the key objective of which is to ensure food security. The state provides soft lending to agricultural producers through the Agricultural “Aïylbank”.

In the energy sector, along with the largest national project Kambarata-2, construction of new sub-stations Datka and Kurshab, rehabilitation of the Uchkur-gan HPP, construction of new electricity transmission lines have been initiated. Due to unpopular but necessary measures of limiting electricity consumption last year, the threat to energy security of the country has been reduced considerably.

Promoting and Supporting Local Economic Activities

Despite of the current complexity of the economic situation, the Kyrgyz Republic has made a decisive step of adopting the new Tax Code, which was discussed for over seven years. The majority of provisions have been aimed at promoting local economic activities. In particular, a decision has been made to reduce the VAT rate from 20 to 12 percent. The total number of taxes has been reduced from 12 to eight. At the same time, a sales tax has been introduced to take a significant share of retail sales and services out of the shadow. VAT and profit tax for processing and agricultural machinery manufacturing enterprises have been put off. Strong efforts are exerted to simplify fiscal administration. In 2008 the government reduced inspections of businesses by 70 percent.

Thanks to the Russian credit the recently established Development Fund of Kyrgyzstan will start its operations. The Government plans to allocate 300 million
dollars to finance real sector projects. Most probably, the priority areas for financing will be: geologic exploration, upgrading oil and gas and electric power complexes, mining industry and agricultural processing.

New steps continue to be taken to implement important infrastructure projects. One of the largest of these projects is the completion of HPP Kambarata-2, as well as HPP Kambarata-1 which are planned to be launched in cooperation with the Russian Federation. The state allocates significant resources for public procurement. Measures have been taken to provide advantages to local producers participating in bidding.

*Improvement of the Investment Environment*

A lot has been done by the Government to improve the investment environment. Firstly, in 2008 after time-consuming and concerted work of all branches of power, with the involvement of the business community, the new Tax Code bringing numerous innovations, as noted above, has been signed. One should specifically mention the achievements of Kyrgyzstan in improving its ranking in the international “Doing Business” rating. According to the World Bank Doing Business rating, Kyrgyzstan is among the three of the top ten most active countries-reformers, which enabled the country to move from 99th position to the 68th in the world rating, allowing it to skip 31 countries. A number of regulatory and legal acts aimed at property protection, as well as legalization of capital and property have also been adopted.

*Targeted Protection of Socially Vulnerable Groups*

In 2008 and 2009 sufficient measures have been taken to support socially vulnerable groups in the population. Pensions have been increased in several phases, funding has been allocated to increase government benefits, certain expenditures have been indexed in social welfare institutions all for supporting the vulnerable population. The Development Fund of Kyrgyzstan is expected to launch a comprehensive program for social housing construction. The budget of the country will allocate at least 250 million dollars for this purpose.
Prospects for Development of the Economy of the Kyrgyz Republic

A significant amount of time will be required for a considerable improvement of the situation in Russia and Kazakhstan in 2009. A further prospect for economic development is unclear, and one should not count on any significant positive developments until the middle of 2010. The internal capacity to promote growth is limited. Therefore, in 2009 economic growth in Kyrgyzstan will range within 0.5 to one percent, while the budget has been formed based on six percent growth. The general trend in key sectors of the economy will continue for one year ahead. By the end of the year, one should expect a 15 percent decline in industrial output. Agriculture and services will grow at insignificant rates. Better growth, given a low baseline of 2008, will be demonstrated by construction, including construction stimulated by government expenditures.

The most serious risks are related to the lack of fiscal sustainability of the budget. Budget forecasts have been based on the economic growth rate of six percent. Meanwhile, as mentioned above, growth would not exceed one percent. Russian grant and credit in principle will resolve the 2009 budget problem. However, one should understand that growth in budget expenditures would not be supported in the future, and would become critical in 2010. It is important to note, that a reduction of the output by large taxpayers, whose share is about 50-55 percent of all tax payments, will be an important factor of fiscal sustainability. On the whole, the deficit of the state budget will grow in a short-term run, which will require searching for additional sources to close the gap.

The banking system as a whole will be stable. But some indicators are expected to deteriorate in 2009, in particular, credit repayment rates. It should be noted that one can already observe a trend of bad credits and non-repayments. This is especially visible in trade and services. The worsening situation in industry will also result in bad debts. But the critical period probably will be in 2010.

The economic slowdown in developed countries and reduction of prices at primary markets will have an impact on external operations of the Kyrgyz Republic in such a way that the external trade turnover of the country in 2009 will decrease by 15 percent. Export is projected to fall down as a result of weak demand for construction materials, textile products and primary products. The volume of goods and services imported to the Republic is expected to decrease, which will be preconditioned by reduced domestic demand.
The trend of falling foreign exchange flows from labor migrants is expected to continue. The reduction of transfers by labor migrants will first of all be related to the worsening economic situation in Russia and Kazakhstan, where the major share of labor migrants from Kyrgyzstan work. Given the crisis, it is assumed that the state policy of Russia and Kazakhstan will be tightened with the aim of reducing unemployment, which will then have a negative impact on the situation of labor migrants.