



Sustaining the momentum of growth in the context of global food and energy price increases

World Bank PREM team

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***“COPING WITH SHORT TERM RISKS AND VULNERABILITIES &
ACCELERATING LONG TERM GROWTH”***

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Main Messages:

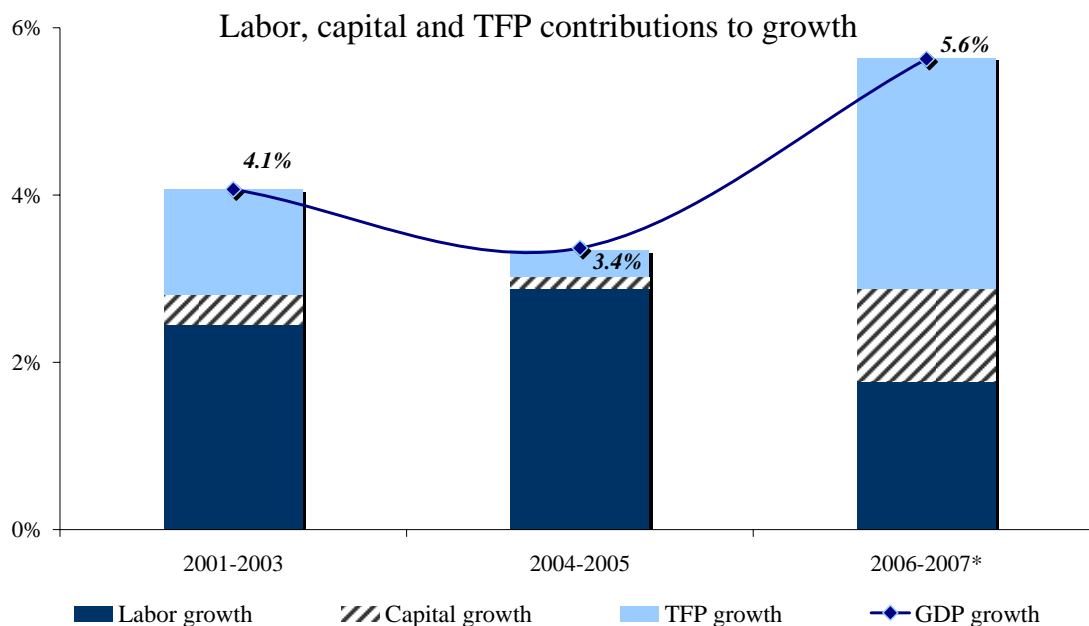


- Kyrgyzstan has tapped opportunities of regional growth
- Liberalization has paid off and put economy on a new trajectory
 - Some barriers hampering allocation of capital to activities yielding highest returns have been lowered
 - and investment (both foreign and domestic) has responded
- Growth depends on investment and higher productivity
- Higher food and fuel prices threaten growth through higher costs and reduced incomes
- The biggest risk to growth now is a poor policy response to higher prices
- The challenge is to ensure that responses to the crisis do not inhibit allocation of capital to productive activities

Growth investment and productivity



- Productivity growth requires investment
- Recent growth has been driven by productivity increases based on new investment
- Effective investment will be guided by market signals and profitable opportunities



- Sustaining growth will require sustaining investment

Private investments flow to activities that show positive returns

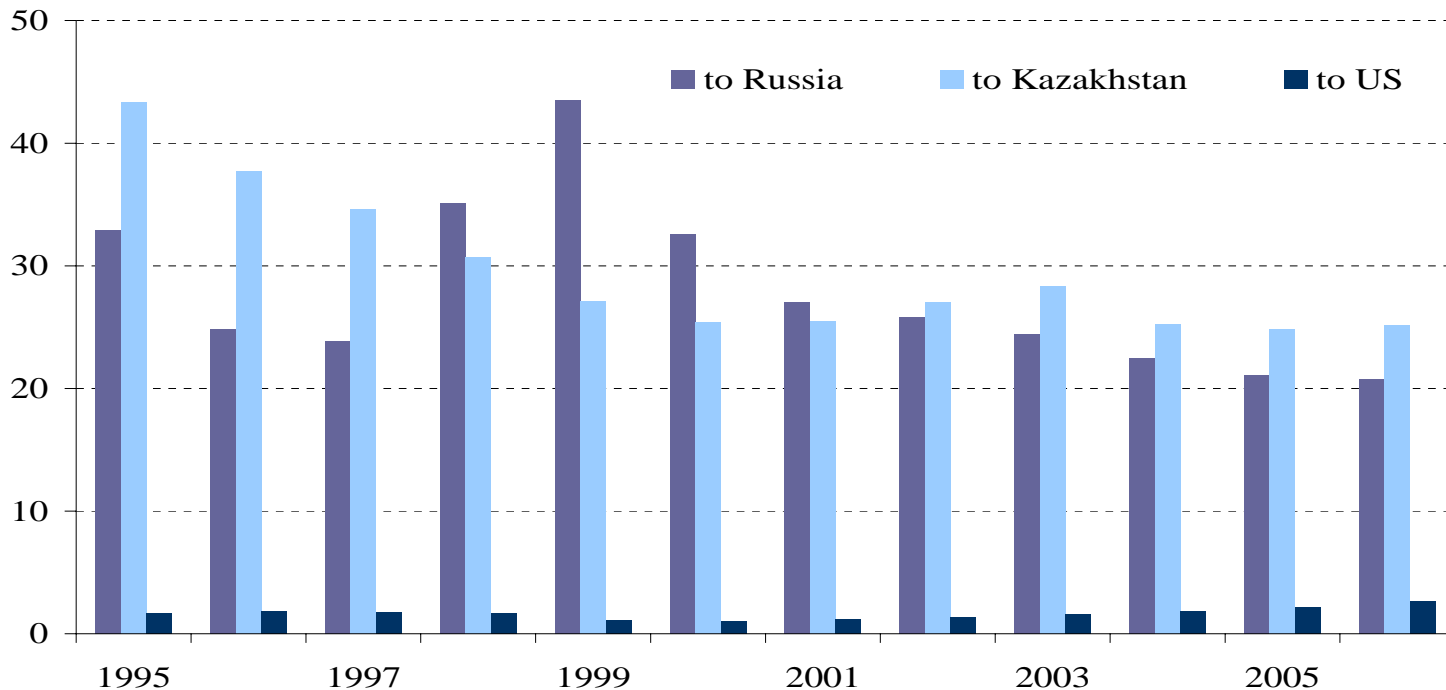


- Sectors that have had an opportunity to be liberalized and exposed to a free market competitive environment
 - Textiles
 - Construction
 - Services
 - Mobile telephones and internet
 - Transit trade
- Relative price changes now favor both agriculture and energy, but for investment to take place policies should:
 - Assure investors (particularly farmers) that they will be able to benefit in the future from higher prices
 - Allow farmers to benefit from economies of scale in production and marketing
 - Ensure energy investors a transparent and stable regulatory regime
- Public policies which have contributed to recent growth should continue
 - Liberal trade regime
 - Presumptive taxation for small business
 - Further actions on Doing Business easing are on agenda
- Unless growth of employment continues outside agriculture it will be difficult to improve agricultural productivity and output



Kyrgyz wage costs are still competitive

Wage costs are still relatively low in KR and serve as a magnet for attracting Investments



And government can help to reduce other costs such as transactions costs of doing business to increase both productivity and profitability

Costs are exacerbated by recent increase in food and fuel prices



Macro impact of higher food and energy prices

	Net imports, % GDP	Price nominal increase, 2006-2008	Real price increase (short term)	Real price increase (long term)	Impact on real incomes	
					short	long
Food	4.5	82.3	73.6	33.6	-3.3	-1.5
Energy	12.4	62.2	54.5	18.8	-6.8	-2.3

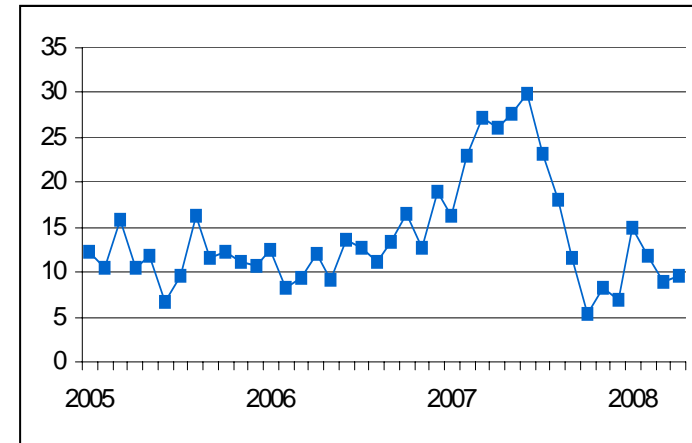
- Cost of production are increasing considerably
 - implies income reduction for producers (if costs not passed on to prices) or consumers (if costs are passed on)
- Direct short term BOP impact of up to 10 % of GDP
 - partly offset by supply and substitution responses
- Higher food and energy prices create new opportunities
 - High food prices - for producers
 - High energy prices - for energy investors

Price shock also erodes real incomes and wages



- High food and fuel prices lower national incomes
 - fuel prices will have a bigger impact on national income than food prices
 - so far it only led to reduction in growth of real wages

Annual growth of real wages



- Food prices increases imply redistribution of income
 - from net consumers to net producers

Reaction to high food and fuel prices



- Short term impact can be offset by 18 months of growth
- Initial impact of higher food and energy prices will be to reduce growth of real incomes/wages (if not, inflation will become entrenched)
 - therefore likely increase of competitiveness vis-à-vis Kazakhstan and Russia
- If investment is maintained and productivity continues to increase real wages should continue to increase subsequently
- However slowdowns in the Kazakh and Russian economies could lead to (i) reduction in FX inflows from remittances and transit trade and (ii) return of migrants
 - both these phenomena could reduce real wages (through exchange rate depreciation or competition in labor markets)

Criteria for policy responses



- No policy response can change the loss to national income (people will on average be worse off in the short term)
- Offsetting some of the distributional impact of food price increase is essential (both for social justice and to preserve human capital)
 - Redistribution should be transparent, not reduce or threaten future incomes of those gaining from change in prices (e.g. agricultural sector)
- Short term policy response should almost certainly include some additional borrowing to finance additional targeted social spending, without cutting back on investment and maintenance in infrastructure, and to cushion the temporary increase in the external deficit
- Monetary policy should seek to gradually squeeze inflation out of the system and prevent it being permanently entrenched – but it can never undo the permanent real rises in food and energy prices
- Above all policy should avoid directing investors and producers, but should provide a stable and transparent framework for investment in newly emerging profitable areas
- Key issue is to ensure that policy response allows investment and growth to continue

Short term policy versus long term growth



- Fiscal pressures will increase – greater need for social spending – possible tax losses from exemptions. This should not be at the expense of investment and maintenance
- Focused Public Investment Policy, particularly infrastructure (energy and transport) development, will reduce costs for the private sector
- Important to ensure that tighter monetary policy does not squeeze credit too far
- Policy makers should seek the ways of reducing unnecessary transaction costs - hence higher profits/margins and more attractive for investment
- Education Reform may need to accelerate to support productivity

Some thoughts for policy-making



- Nominal wages are likely to increase further given low starting point but real wage growth may slow for a period
- Sustainable growth depends upon productivity gains
 - Economy diversification and job creation will bring labor reallocation and boost productivity
 - Reduction of costs of doing business, i.e. reducing policy induced transaction costs, is likely to increase productivity as well
 - Commodity prices boom offer opportunity to recover agriculture, but reducing economic distance to regional markets is crucial
 - Though real appreciation is a concern for competitiveness, productivity gains and sector diversification will partially offset some real appreciation
- Maintaining macroeconomic stability is important given high exposure to external shocks and need to maintain investment

Conclusion



- Some reduction in real income is unavoidable in the short term
- Fuel prices may be a greater challenge than food prices
- Policy can help to redistribute adjustment of income, but cannot eliminate it
- Supporting investment and productivity, and allowing resources to flow to sectors of high return is critical