

# KYRGYZ REPUBLIC

## Macroeconomic Policy Responses to Current External Shocks

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1. **Over the last few years, the Kyrgyz Republic has made considerable economic progress, despite often difficult circumstances.** With the implementation of sound macroeconomic policies, growth accelerated and inflation remained low. Fiscal performance has been impressive, with revenues rising sharply. With firm fiscal policies and aided by strong growth, the country was able to achieve a major improvement in debt indicators. Public debt, largely consisting of external debt, fell to 58 percent of GDP in 2007, from close to 100 percent of GDP in 2004. And most importantly, living standards have improved as well, with average per capita GDP having increased from \$435 in 2004 to \$710 in 2007.

2. **The Kyrgyz Republic's short-term outlook has deteriorated significantly, however, with a more uncertain global and regional economic environment.** As a small and open economy, the Kyrgyz economy is adversely affected by a number of external shocks that threaten to have a considerable effect on poverty, through the erosion of incomes and a reduction in employment opportunities:

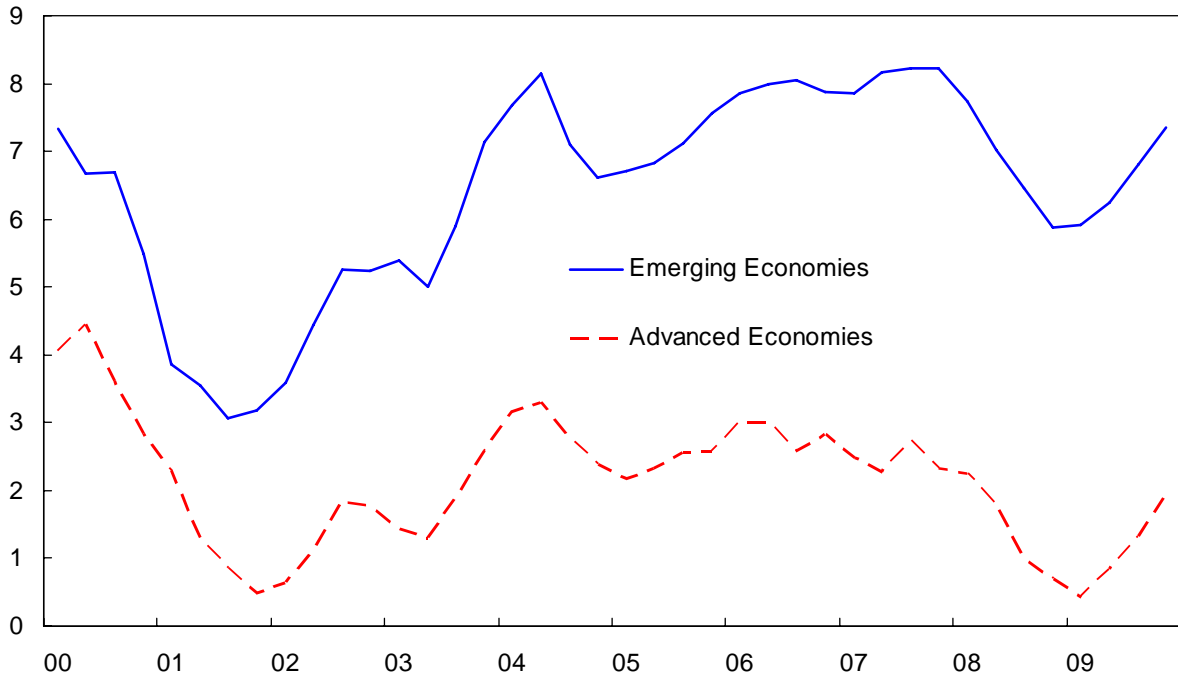
- **After a remarkable five-year span of strong growth, the global economy is slowing in the wake of the financial turbulence that began last summer.** The growth moderation is led by a slowdown in the advanced economies. Expansions in emerging economies, led by China and India, are expected to lose some steam, but to remain relatively strong. More importantly for the Kyrgyz Republic, growth in Kazakhstan is projected to slow to about 5 percent this year, down from 8½ percent in 2007, as a result of the banking sector difficulties.

- **International fuel and food prices have risen by over 50 percent over the last twelve months.** The rise in oil prices appears initially to have been largely due to a demand-driven tightening of the oil market, particularly reflecting strong demand from emerging economies, with little scope for a short-term supply response. More recently, other factors may have played a role as well, including the financial market turmoil and monetary easing, which may have made oil and other storable commodities more attractive assets to invest in. The boom in food prices partly also reflects tighter market conditions in the context of rapid growth in emerging economies and stronger investor interest, but it has also been driven by food-specific factors, such as biofuel policies, unfavorable harvests for some major crops, and, more recently, trade restrictions. Higher oil prices have raised food prices as well, by boosting the costs of production, through higher farm fuel, transportation, and fertilizer costs.

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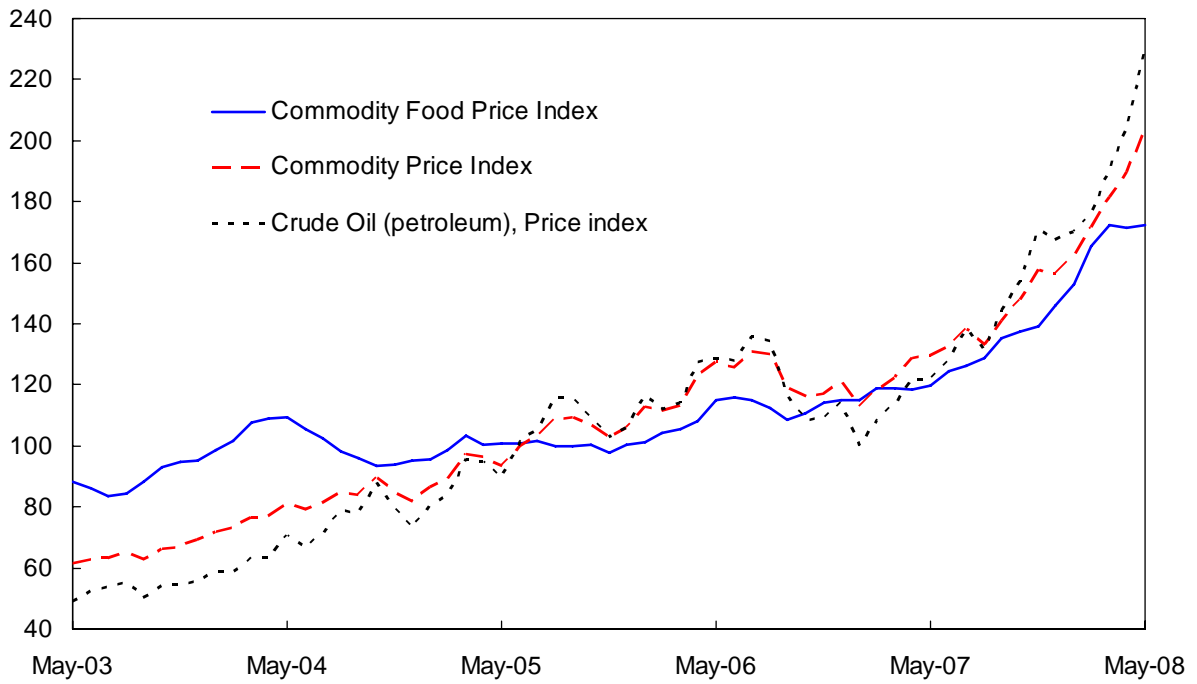
<sup>1</sup> Ron van Rooden is a Deputy Division Chief in the IMF's Middle East and Central Asia Department. This paper represents the views of the author, and not necessarily those of the IMF.

Global Real GDP Growth, in percent



Source: IMF, Global Data Source.

Commodity Price Indices, 2005=100

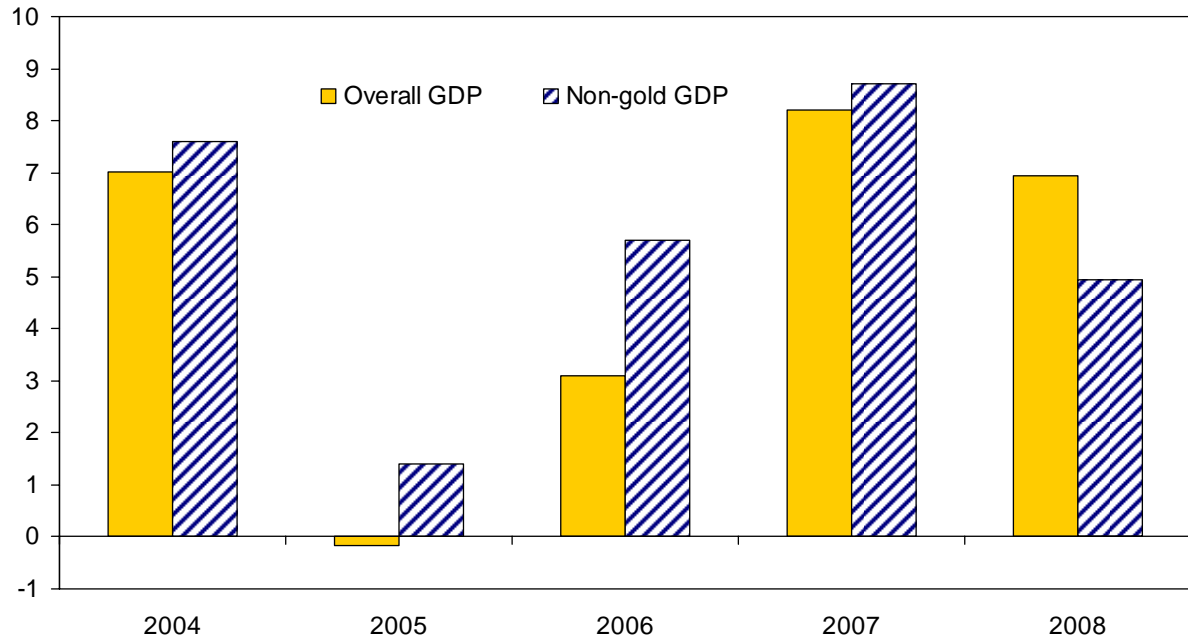


Source: IMF, Commodity Price System.

3. **For the Kyrgyz Republic, the macroeconomic consequences of these external shocks are severe, posing risks to macroeconomic stability and having adverse effects on the poor:**

- **Growth (excluding gold production) is expected to slow to 5 percent in 2008,** mainly due to spillover effects from the banking sector difficulties in neighboring Kazakhstan.

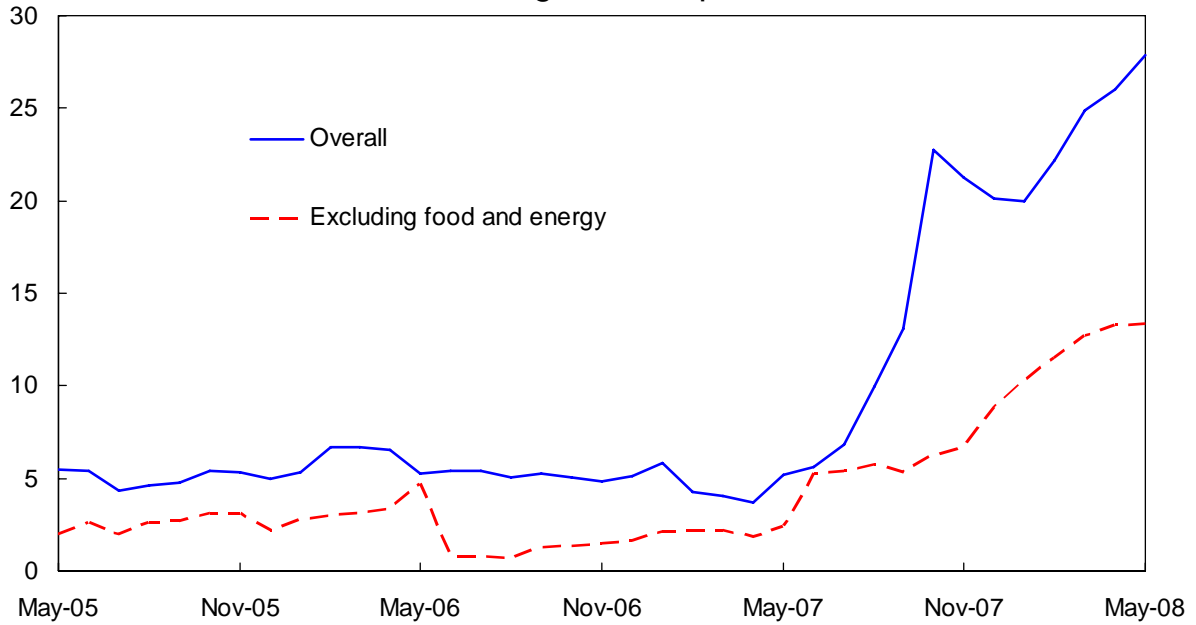
Kyrgyz Republic: Real GDP Growth, in percent



Source: Kyrgyz authorities.

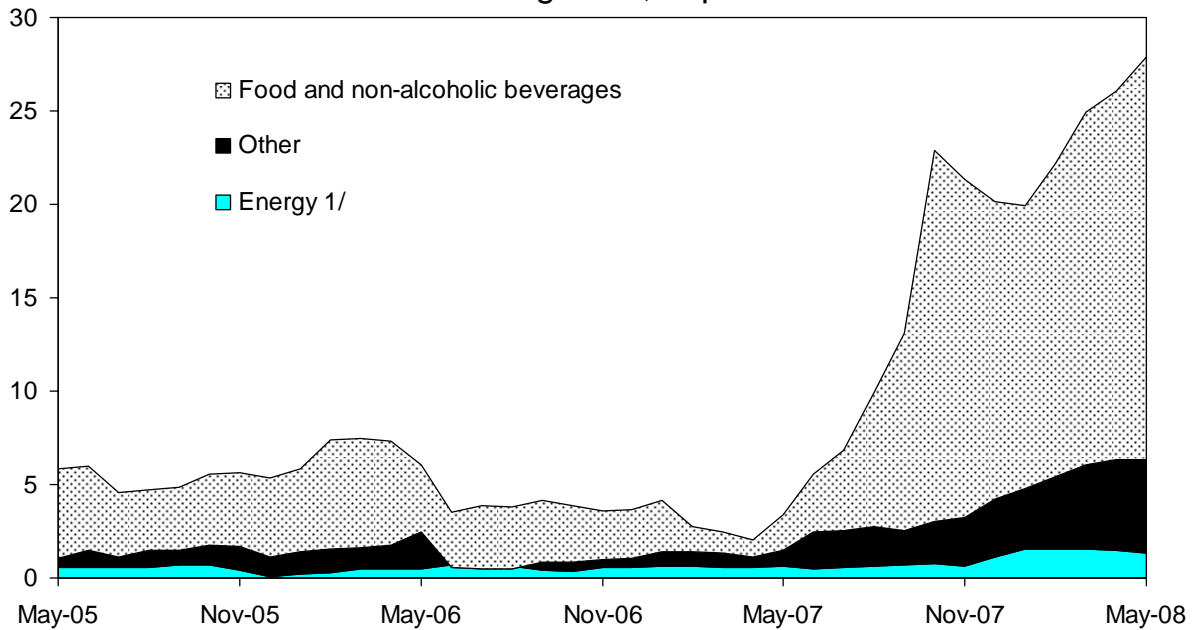
- **Inflation has picked up sharply, reaching almost 30 percent in May this year.** This reflected in large part the higher international food and energy prices, but these higher food and energy prices are also increasingly feeding through to the prices of other goods and services. Non-food, non-energy inflation has risen to almost 14 percent in May, up from 3 percent at end-2006. The Kyrgyz Republic is not alone in this, as average inflation in the region has risen to 17 percent in March, while inflation in Russia has doubled to 14 percent over the last twelve months and in Ukraine exceeded 30 percent in April.

### Kyrgyz Republic: Inflation Developments 12-month growth, in percent



Source: Kyrgyz authorities.

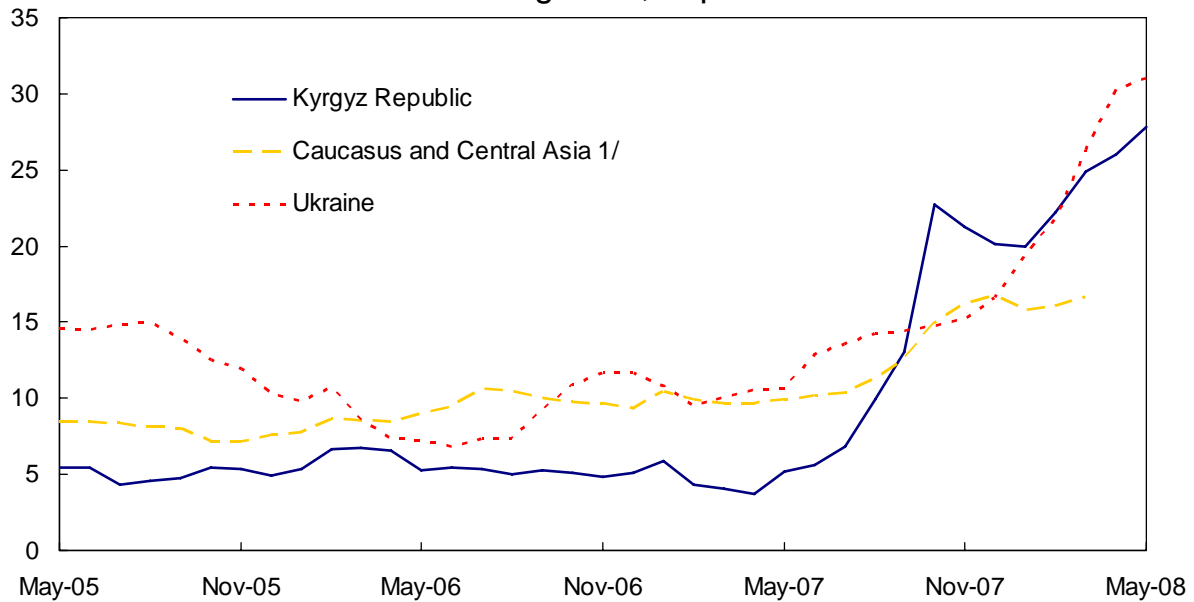
### Kyrgyz Republic: Contribution to Inflation 12-month growth, in percent



Source: Kyrgyz authorities.

1/ Electricity, gas, and other fuels.

### Consumer Price Index 12-month growth, in percent



- The balance of payments is expected to worsen substantially this year.** The import bill for food and energy products is projected to be around \$300 million higher this year than last, equivalent to some 6 percent of GDP, due to the full-year effect of higher world prices. In this regard, the rise in oil prices is expected to have a much larger effect on the balance of payments than the increase in food prices. Inflows, including from exports, remittances and other private (capital) flows, are expected to slow due to the regional slowdown. To some extent, the negative effects of higher food and fuel prices on the current account will be offset by higher prices and volumes of gold exports. However, the impact on the overall balance of payments is expected to be limited, as much of the higher gold export earnings are expected to flow out, reflecting higher production costs and repayments of intracompany loans following several years of below-cost-recovery production.
  - For the impact on inflation, household incomes, and poverty, the rise in food prices is a greater concern than the oil price increases.** The share of household expenditure spent on food far exceeds the share of oil-related products and services. The urban poor are likely to be the most affected by the rising prices, as the rural poor may be at least partially self-sufficient in food supplies. In the Kyrgyz Republic, the effect on poverty is likely to be large, given the high import dependence combined with a still high incidence of poverty. Many near-poor could fall below the poverty line, threatening to undo much of the gains in poverty reduction achieved in the last five to ten years.
4. **In dealing with these shocks, policies will need to walk a fine line between tackling high inflation and protecting growth and the poor.** As the international

commodity price increases are not expected to be just temporary, these price increases should be passed on to domestic consumer and producer prices. Full pass-through allows for correct price signals, which help ensure allocative efficiency by encouraging producers to increase supply and consumers to decrease demand. This also alleviates balance of payments pressures and shields public finances from excessive costs. But passing these price increases on to consumers can also result in a significant drop in real incomes for households, especially poor households. The policy challenge is therefore to ensure economic efficiency and stability while at the same time protecting vulnerable groups.

5. **The best option, from experience worldwide, to address the adverse impact on low-income households and other vulnerable groups is through well-targeted direct cash or in-kind transfers.** These support the purchasing power of the poor, without distorting domestic incentives to produce more food. Examples include cash or in-kind transfers that are conditional upon meeting a requirement, such as low income, social or economic status (elderly, children, disabled, or unemployed), or engaging in mandatory behavior (attending school, immunization of children). In the Kyrgyz Republic, an increase in the Unified Monthly Benefit could be considered, or a targeted program of food stamps. Already, the budget envisages an increase in resources for providing food to children and the elderly. Transfer programs in low-income countries, however, often suffer from weaknesses, particularly with regard to targeting efficiency and administrative capacity that could take considerable time and effort to overcome.

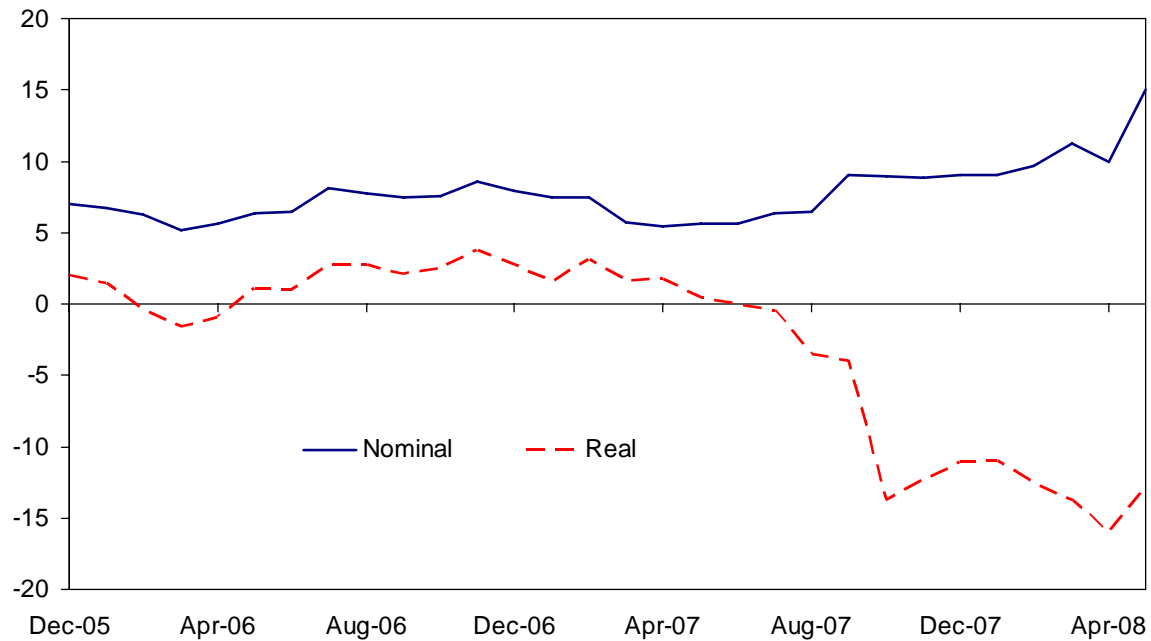
6. **While transfer programs are developed or improved, second best measures that can be effective in the short term could include the temporary reduction of taxes and tariffs and/or introduction of subsidies on the one or two products that are most vital for the poor.** However, as these policy responses are likely to result in higher fiscal costs and are distortionary, they should be reassessed, with a view to being eventually reversed, as direct transfer programs are strengthened. Price controls and export bans or taxes should be avoided, as these export hunger from one country to another and reduce farmer incentives, thus actually reducing the food supply in the long run. Grain could be released from the state reserves during periods of temporary shortages or sudden price increases, although it might be difficult in practice to distinguish between temporary and permanent shocks. To avoid subsidizing the general population, release of grain from the state reserves could be combined with a food stamp or other targeted programs.

7. **Longer term measures to reduce the vulnerability to international food and fuel price shocks would need to focus on encouraging the expansion of domestic agricultural production and improving energy efficiency.** Absent sufficient infrastructure to increase cultivation, boost productivity and to bring agricultural products to the market, the supply response to higher prices may remain elusive. Thus, policies should aim to upgrade infrastructure, distribution, and storage systems; increase competition; provide a stable regulatory environment and access to financing; and remove remaining trade barriers. Fuel imports could be reduced by moving ahead forcefully with energy sector reforms to attract much-needed investment. Crucial to all of this is a further improvement in the overall business environment.

8. **How these measures are paid for—through higher revenues, a higher deficit, increased grants, or reductions in other expenditures—will need to be based on a country’s specific macroeconomic and fiscal circumstances, as well as financing options.** Given the Kyrgyz Republic’s income and poverty levels, and the size of the external shocks, increased international assistance would be warranted and some assistance has already been forthcoming. Some widening of the budget deficit relative to the near-balance achieved in 2007 would be appropriate in light of the need to protect growth and the poor. However, with debt levels still relatively high and to avoid fueling inflationary pressures through an expansionary fiscal policy at a time when inflation is already high, the widening of the budget deficit relative to last year’s stance should remain limited to a level of about 1½ percent of GDP. Thus, to create room for additional social transfers and to reduce the fiscal deficit relative to the approved budget, non-priority spending will need to be curtailed, while revenue collection should be strengthened further.

9. **Monetary policy will need to focus on bringing inflation back under control.** The first-round effects of higher food and fuel prices—an adverse terms-of-trade shock that the authorities can do little about and to which the country will need to adjust—should generally be accommodated. If, as a result, inflation objectives are missed, the central bank should explain to the public that achieving these targets in the face of such profound supply shocks would require an overly tight monetary policy and, hence, lead to an unnecessary further slowing in economic activity. However, even though the higher inflation may be driven initially by rising world food and energy prices, this can quickly spill over into broader price and wage pressures. It is important for monetary policy to fight these second round effects, to prevent high rates of inflation from becoming entrenched. As mentioned, in the Kyrgyz Republic, the pace of non-food, non-energy inflation has been steadily increasing. A further tightening of monetary policy—including a more substantial rise in interest rates (which remain negative in real terms)—is therefore urgently needed. With high inflation and negative real interest rates, economic agents will have little incentive to hold the national currency, risking further pressures on prices and the exchange rate.

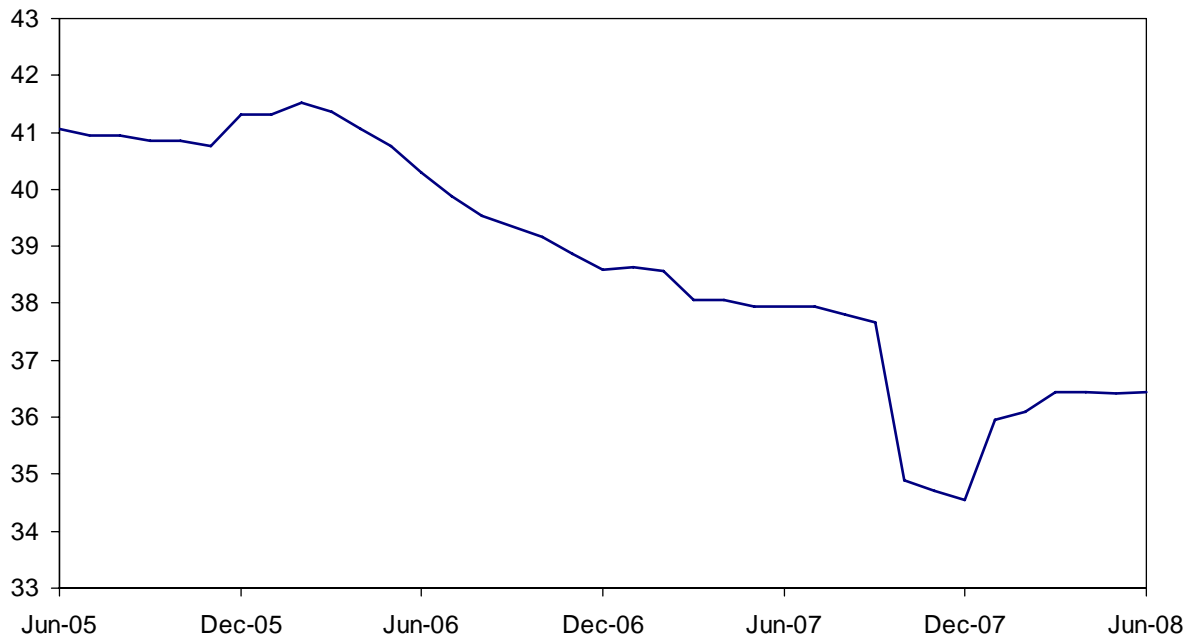
### Kyrgyz Republic: Nominal and Real Interest Rates



Source: Kyrgyz authorities.

10. **In countries particularly hard-hit by high food and fuel prices, there may be a tradeoff between exchange rate adjustment and higher inflation.** In principle, to the extent that the price increases are considered permanent, the food and fuel price shocks call for a real effective exchange rate depreciation for net importers. But in some countries, a depreciation may quickly feed through into even higher domestic inflation, while having only a limited effect on the trade deficit, as the price elasticity for food and fuel imports is low. In those cases, and the Kyrgyz Republic appears to be one of them, there would be a strong case to avoid an exchange rate depreciation and to finance the higher balance of payments need by utilizing the country's foreign exchange reserves, mobilizing concessional financing, or a combination thereof. In the Kyrgyz Republic, the central bank has therefore been right in resisting the downward pressures on the exchange rate that emerged in the beginning of this year. It should continue with this policy, although it should also have an exit strategy (i.e., allowing the rate to depreciate) to avoid large losses in reserves if downward pressures were to re-emerge and persist or intensify. If, on the other hand, foreign exchange inflows resume, the central bank should allow the som to appreciate to help bring down inflation faster. A nominal appreciation might make Kyrgyz goods and services more expensive on the world market, thereby reducing their competitiveness, but this fear may be exaggerated. Over time, a nominal appreciation of the som would be expected to result in a lower domestic price level, thereby leaving the real exchange rate—which is key for competitiveness—broadly unchanged. More importantly, while an appreciation may affect some businesses in the short term, the high rates of inflation affect the entire economy and particularly the poor.

Kyrgyz Republic: Exchange rate (Som/US\$, period average)



Source: Bloomberg.

11. **Reducing inflation while protecting growth and the poor will be a very tough challenge.** Looking back at the experience of other countries with episodes of higher inflation triggered by commodity price shocks shows that to prevent inflation from rising even higher and to bring it down successfully to single digits decisive action is required. Countries where bringing down inflation was given priority were typically less impacted by future shocks, while countries that allowed inflation to persist faced greater challenges from subsequent shocks as inflation expectations had ratcheted upward. In the latter group of countries, when they eventually undertook measures to bring down inflation, this could only be achieved at the expense of considerably higher output losses. It is therefore crucial that the authorities move decisively to address the current challenges, with the support from the international community.