

# **The Kyrgyz Republic: Short Overview of the Recent Increase in Prices**

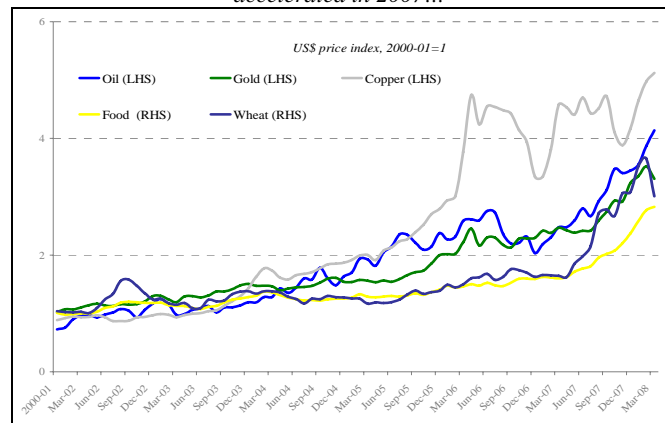
This note has been prepared as a background note for the June 25-26, 2008 CEM follow-up workshop. The note was prepared by the ECA PREM team and it draws on the policy note prepared by PREM, ARD and DEC on Policy options and World Bank Response to Raising Food Prices

## International Context

**1. Last decade were marked by sharp increase in commodity prices, fueled by minerals – crude oil, copper and gold.** Global food commodity prices have been increasing too, but at notably slower speed (see Figures 1 and 2). Situation for selected food crops has changed in 2007, when prices of cereals, dairy, vegetable oils and rice sharply accelerated (see Figure 2) following earlier price increases in the other commodities. This increase has spread to foodstuffs and resulted in high food inflation. Global food prices increased approximately by 80 since end-2006. Many commodity prices, both food and non-food, reached record highs in current US\$ terms in 2007 and early 2008 (see Figure 3). Those commodities include crude oil, tin, copper, nickel, soybeans, corn, and wheat. In real terms, prices of many commodities, particularly foods, remain well below their highs in the early 1970s, but already reached their heights in early 1980s. The major exceptions are crude oil and few minerals which already outpaced their highest levels<sup>1</sup> (see Figure 3 and 4).

Figure 1. International prices for selected commodities in US dollars, 2002-2007

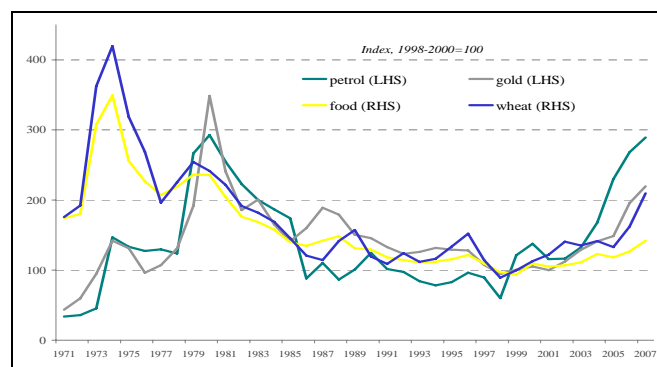
*Following earlier price increases in other commodities food prices accelerated in 2007...*



Source: calculated based on GEM data

Figure 3. International prices in real terms, 1971-2007

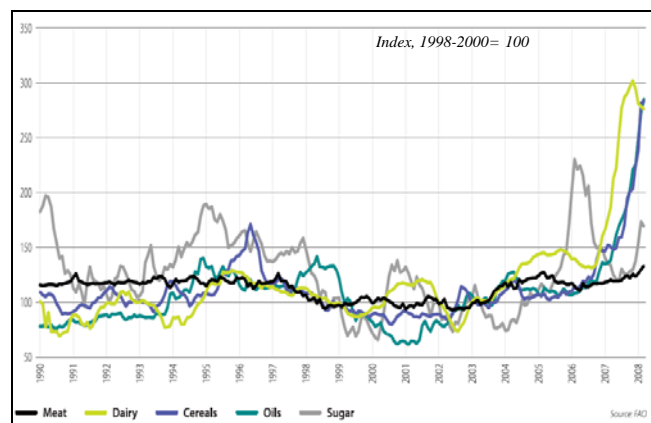
*Still in real terms, global food prices remain well below their highs in the 1970s and early 1980s ...*



Source: calculated based on IFS data

Figure 2. International prices for major food commodities, 1990-2008

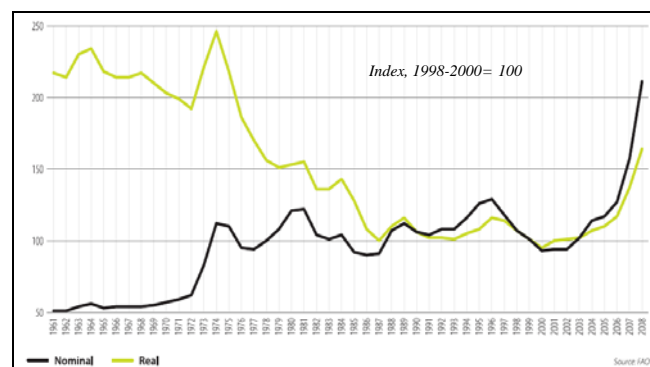
*The surge was led by some major food crops ...*



Source: FAO, *Soaring Food Prices: Facts, Perspectives, Impacts And Actions Required*, June 2008

Figure 4. International food prices in nominal and real terms by FAO, 1971-2008

*Alternative estimates by FAO indicates that food prices even in real term have reached its level in the late 1970s ...*



Source: FAO, *Soaring Food Prices: Facts, Perspectives, Impacts And Actions Required*, June 2008

<sup>1</sup> However, the choice of deflator and price index itself may be important in examining real commodity price movements. Alternative estimates using FAO food price index deflated by the index of unit value of global exports of manufactured goods (MUV) yields different results. It shows that food prices even in real term have almost reached its level in the late 1970<sup>th</sup>

**2. Rapidly growing demand for food crops twinned with continuing depreciation of the US dollar were the major reasons behind the recent food price increase.** High-price events are not rare occurrences in agricultural markets (see Figure 3). However recent global food prices surge can be distinguished by occurrence of the hike in world prices of not just a selected few but, of nearly all major food and feed commodities (see Figure 3). The following factors have contributed to these developments in agricultural markets<sup>2</sup>:

- Rapid economic and population growth in many emerging countries. Demand for food commodities has been growing as income level per capita in many developing countries, particularly in East and South Asia and selected CIS countries, has been increasing in real terms. Many people have been taken out of poverty and could afford higher consumption of food.
- Gradual reduction of world grains stocks. According to FAO, since the previous high-price event in food market in 1995, global stock levels have declined on average by 3.4 percent per year as demand growth has outstripped supply. At the same time production of cereals in major exporting countries has experienced weather-related production shortfalls. Production shocks twinned with low stock levels helped to set the stage for rapid price hikes.
- Increased bio-fuel production. Concerns over oil prices, energy security and climate change have prompted governments to take a more proactive stance towards encouraging production and use of bio-fuels. This has led to increased demand for bio-fuel raw materials, such as wheat, soy, maize and palm oil, and increased competition for cropland. Both WB and IMF assessments have concluded that rising biofuel production is responsible for a significant part of the jump in commodity prices.
- The depreciation of the US dollar against many currencies. Most agricultural commodity prices are quoted in US dollars. Therefore, for those countries which appreciated their currencies against the US dollar, impact of global food price increase on domestic inflation (pass through) was lower. However for these countries commodity imports denominated in the US dollars became cheaper and this could boost demand for food even more.

**3. The most projections suggest that food prices are likely to remain high, although the food market situation remains uncertain.** It means that an observed increase in food prices is not a temporary phenomenon, but is likely to persist in the medium term. Food crop prices are expected to remain high in 2008 and 2009 and then begin to decline as supply and demand respond to high prices; however, they are likely to remain well above the 2004 levels through 2015 for most food crops. Forecasts of other major organizations (FAO, OECD, and USDA) that regularly monitor and project commodity prices are broadly consistent with these projections. However, further patterns of food prices will highly depend on the following factors: (i) further population and income growth in developing countries; (ii) the price of crude oil, i.e. whether it continues to increase and whether policies supporting the biofuels are maintained; and (iii) ability to increase agricultural supply given land/technology constraints and climate change impacts.

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<sup>2</sup> Drawing from work across the Bank

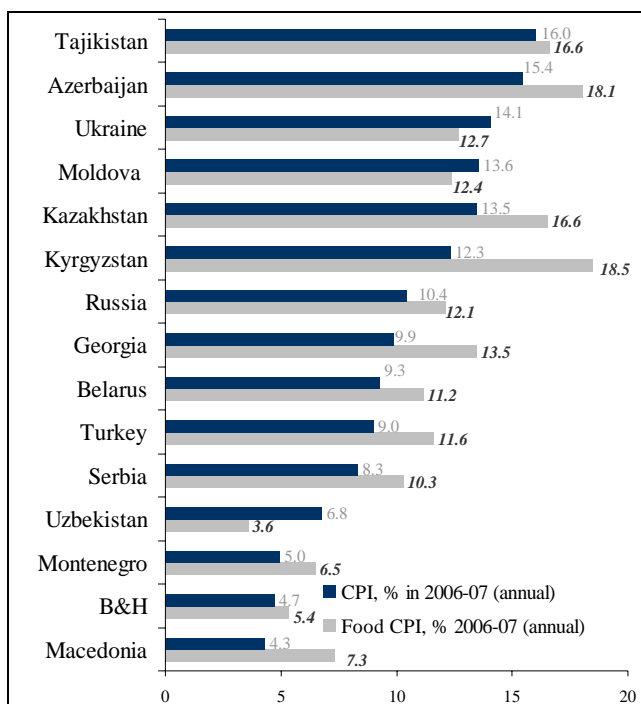
## Impact of the food prices increase on Kyrgyzstan

### 4. Rapidly rising global food and energy prices exerted upward pressures on domestic prices in many low and middle income ECA countries in 2006-2007.

Overall inflation in Europe and Central Asia averaged 6 percent in 2006 and 10 percent in 2007). Countries from low and lower middle income groups on average faced higher inflation. Higher inflation in the countries from lower income groups is partially explained by the higher weight of food items in their overall CPI (see figure 5). Overall price level over 2006-2007 dramatically increased in Tajikistan (by 16 percent), Azerbaijan (by 15.4 percent), Ukraine (by 14.1 percent), Kazakhstan (by 13.5 percent), and Kyrgyzstan (by 12.3 percent). In the most countries from ECA region, food price inflation triggered by the global food price increase was higher than aggregate inflation and provided major contribution to underlying inflationary pressures. For instance, food prices increased by approximately 18 percent in Kyrgyzstan and Azerbaijan and by 16 percent in Tajikistan and Kazakhstan over 2006-2007 (see figure 6). In 2007 food prices increased the most in Kyrgyzstan (31.5 percent), Kazakhstan (26.6 percent) and Ukraine (22.9 percent).

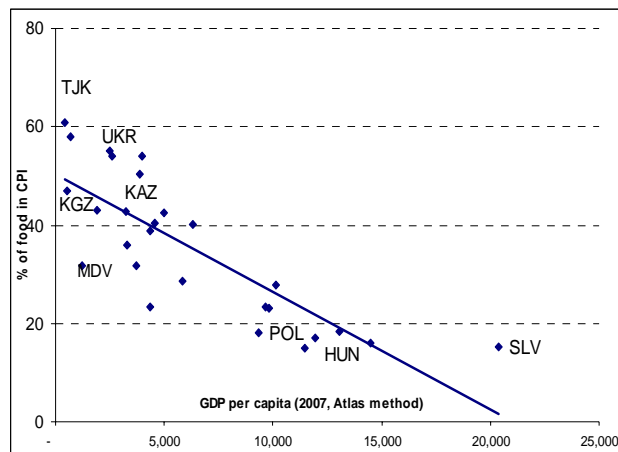
Figure 5. Inflation and food inflation in ECA countries, 2006-2007

*Inflation in many low and middle income countries accelerated over 2006-2007...*



Source: ECA regional data on food prices

Figure 7. Food weight in CPI vs. 2007 GDP per capita



Source: ECA database

Figure 6. Food inflation in ECA countries, 2006-2007

*Food prices increased the most in Kyrgyzstan ...*

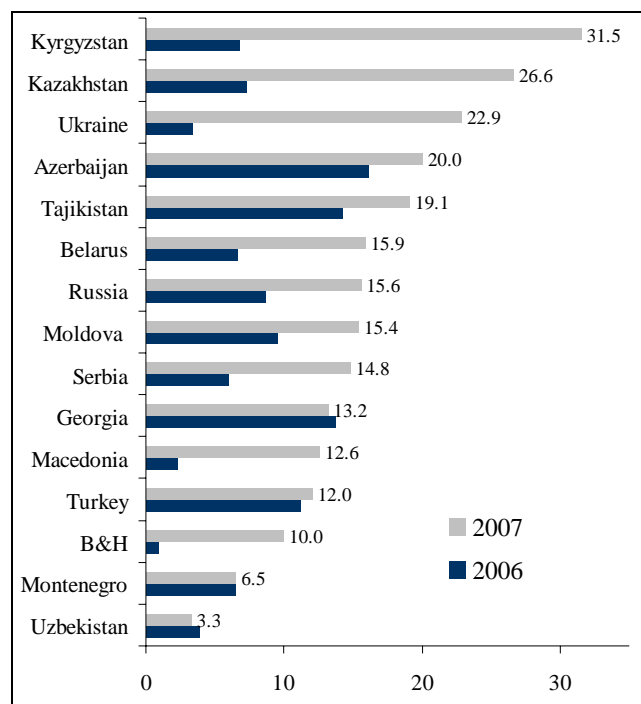
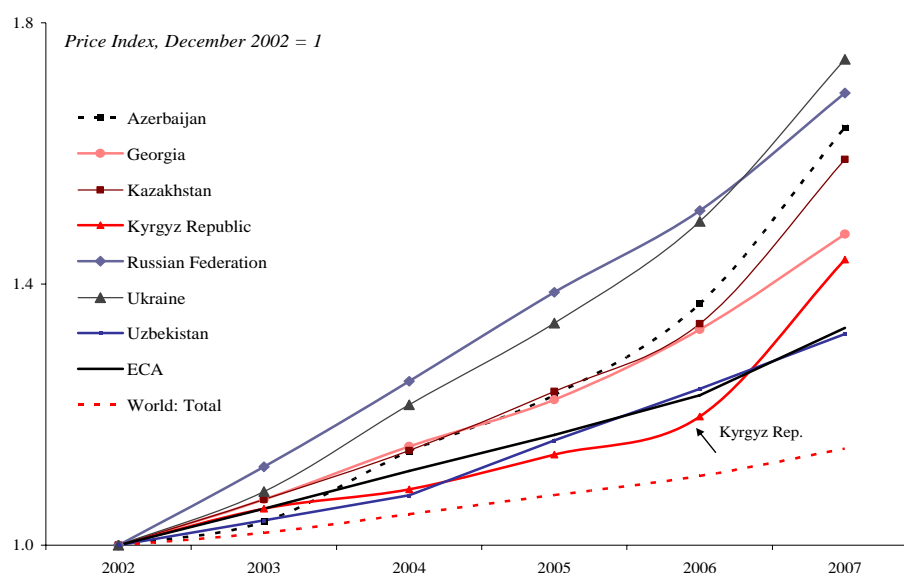


Figure 8. Inflation in selected ECA countries, 2002-2007



Source: WB GEM

**5. Overall price level in Kyrgyzstan has been increasing much slower than in other ECA countries until 2006.** It can be partially explained by slower adjustment of overall domestic price level to the international prices. Overall price level in Kyrgyzstan has increased the least among selected CIS countries and less than average increase for all ECA region over 2002-2006 (see Figure 8). The following factors helped to keep overall inflation in the country at relatively low level up to 2006:

- Cheap electricity - below the cost electricity. The budget suffers substantial quasi-fiscal deficit caused by below the recovery cost electricity tariffs (see table 1). In addition to relatively low tariffs [for example, electricity tariff in Georgia was 4.6 times higher in 2006, and 6.2 times higher in 2008], energy distribution suffers from big losses and arrears.
- Cheap wheat – below the world market price of imported Kazakh wheat. Production of wheat in Kazakhstan is very efficient. Good land, economy of scale and modern equipment make this sector very productive and allow producing wheat at relatively low cost. Lacking access to the European market Kazakhstan supplied wheat to the regional markets at relatively low price.
- Cheap labor – relative wages well below the most of CIS countries. Economic growth after transition was not very diversified. It came mostly from labor intensive and low productive agriculture and few mining projects. Excessive labor force and low productivity did not exert upward pressure to real wages growth.

Table 1. Quasi-fiscal deficit, 2001-2007

	2001	2002	2003	2004	2005	2006	2007 (est.)
QFD (mln KGS)	9,192.0	8,780.9	9,193.3	8,867.0	9,204.1	7,808.9	7,615.2
QFD (mln US\$)	189.7	187.1	210.3	207.8	224.4	194.3	195.5
QFD (% GDP)	12.4%	11.7%	11.0%	9.4%	9.2%	6.9%	5.5%

Therefore on average Kyrgyz producers faced lower input costs and one of the major commodities from the consumption basket – bread – was implicitly subsidized through cheap imports of Kazakh wheat. This two factors were likely to play the key role in slow relative price adjustment process.

**6. Increasing inputs costs and relaxed monetary policy speeded up inflation in 2007 when it reached 20.1 percent.** It is likely that outstanding growth performance in 2007 (8.2 percent) contributed to inflationary developments. Close location to other landlocked booming economies has become the source of big economic benefits, but at same time increased pressure on prices:

- Relatively low input cost and liberal business environment attracted considerable FDI in selected labor intensive sectors (e.g. textiles).
- The country has engaged in large re-export activities between China and selected CIS countries, which increased real incomes of large number of people involved in trade operations.
- Large labor migration from Kyrgyzstan to Kazakhstan and Russia brought big inflows of remittances, but at the same time reduced labor supply on domestic market that exerted upward pressure on domestic real wages.

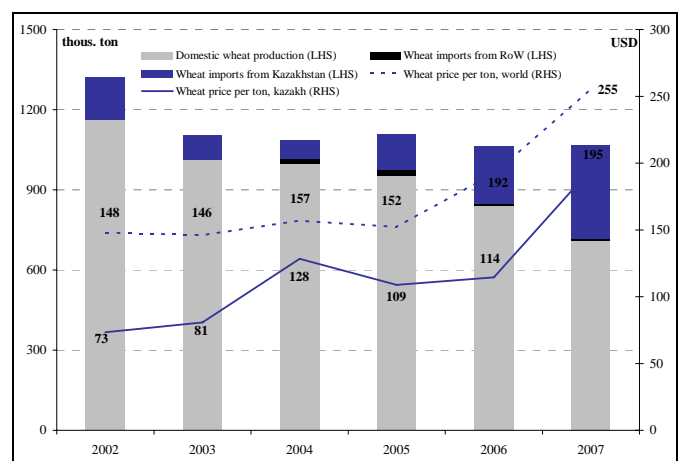
Higher wages twinned with growing energy prices (e.g. fuels) increased input costs for producers. FDI, remittances and re-exports' receipts brought considerable inflows of foreign exchange in the country that pushed real exchange rate to appreciate. However not to harm competitiveness of the Kyrgyz goods National Bank conducted unsterilized foreign exchange purchases resisting appreciation. As a result rapid monetary growth and growing real wages seem to have added to inflationary pressures in 2007.

**7. Nevertheless, the biggest contribution to the dramatic increase of Kyrgyz CPI in 2007 came from the global food prices pressure.** Foodstuffs which contribute approximately 46.6 percent to the Kyrgyz CPI basket saw the highest surge among all ECA countries in 2007 (31.5 percent). This means that approximately 14 percent (out of 20.1) of increase in price level can be directly attributed to the food items. The highest increase among food items was provided by bread and bakery products which contribute approximately 1/3 to the CPI food basket Bread process increased by 62.6 percent in 2007, i.e. it was comparable with the increase of world wheat prices for the same period – 63.6 percent. However bread inflation in 2006 was much below the world level. This can be explained by maintaining by Kazakhstan wheat import price at below the world price level up to 2007.

**8. The sharp increase in Kazakh wheat prices was one of the major factors which triggered big increase in Kyrgyz bread prices in 2007.** Most of the domestically produced wheat is of soft sorts, while bread and flour production requires hard wheat. Kyrgyz farmers have gradually stopped producing hard wheat as economically it was more efficient to import wheat from Kazakhstan. Indeed over 2002-2006 Kyrgyzstan benefited from the low price of Kazakh wheat which was approximately 30-35 percent below the world price (see figure 9). Kazakh wheat was much cheaper because the country was too far from European and other big markets to trade its wheat at world prices. However situation has changed in 2007. Excessive demand in the world resulted in larger engagement of alternative markets (namely Kazakhstan, Ukraine and Russia) to the world trade of wheat. Prices of wheat increased twice over 2007 - from US\$ 176 in January to 345 in December. As a result it became very profitable to export wheat to remote markets even despite high transportation cost. This changes in trade patterns had a few major consequences:

- Kazakhstan has diverted large share of its wheat supply from the regional and domestic markets towards Europe;
- Differential between world and domestic price of wheat in Kazakhstan decreased;

Figure 9. Wheat production and imports in KR, 2002-2007

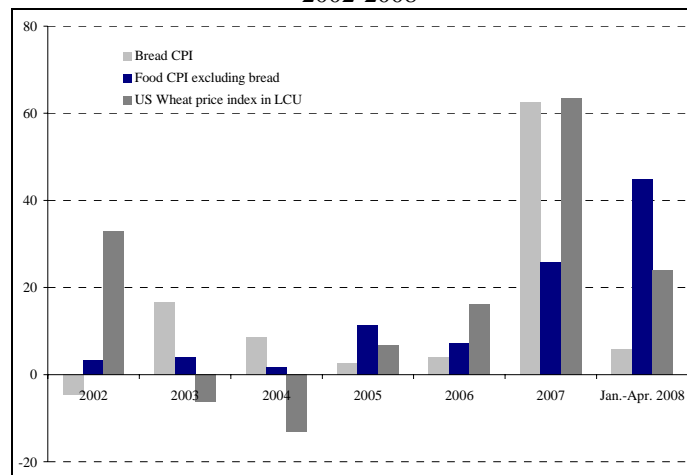


Source: NSC, COMTRADE, WB GEM

- Kazakh Government introduced additional export duties for grain to slow down increasing exports of wheat and to insure domestic food security.

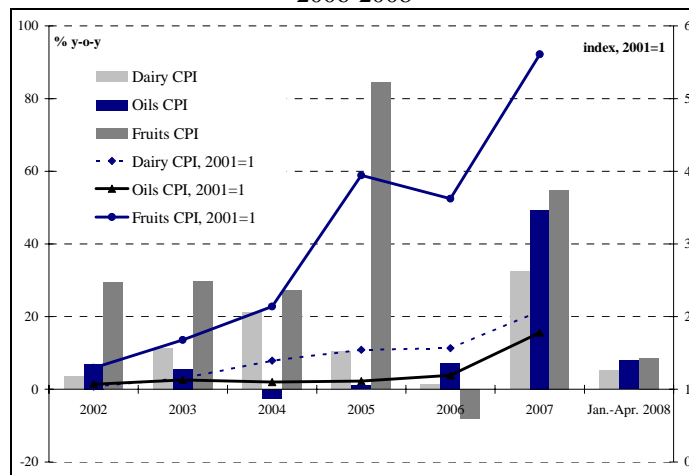
As a result import price of Kazakh wheat for Kyrgyzstan went up. On average it increased by 70 percent in 2007. An increase in the price of Kazakh wheat immediately translated into domestic prices of bread (see figure 10).

Figure 10. Kyrgyz bread CPI vs. international wheat prices, 2002-2008



Source: NSC KR, WB GEM

Figure 11. Kyrgyz CPI for selected food staffs, 2006-2008

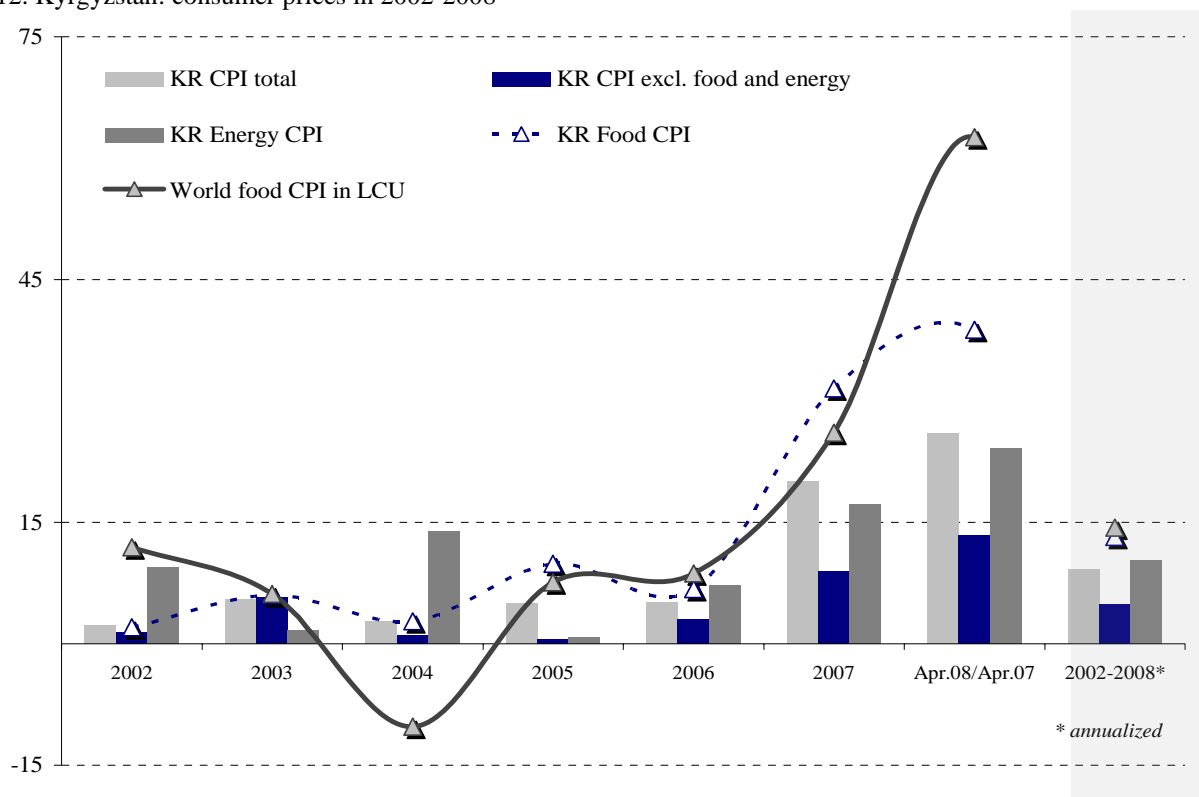


**9. Food inflation was mainly driven by the rapidly growing bread prices, but even excluding bread it was relatively high.** Taking into account, that more than 40 percent of the Kyrgyz population lives in poverty and 7.2 percent in extreme poverty, and therefore bread is one of the major commodities in consumption basket, fast and large transmission of bread prices increase into food and overall inflation was expected. Food inflation even excluding bread reached 26 percent in 2007 (see figure 12) while it averaged 5.5 percent over 2002-2006. The other foodstuffs which saw considerable price increase in 2007 were dairy - 32.4 percent, vegetable oils - 49.3 percent and fruits - 54.9 percent (see figure 13). Partially it was explained by the transmission mechanisms from the bread prices. However, growing regional demand from Kazakhstan, Russia and China could have contributed to this increase, particularly for dairy products and fruits. Dairy price almost doubled and price of fruits increased six times over 2002-2007.

**10. In addition to the global food prices pressure it is likely that speculative behavior of the traders contributed to the domestic food inflation.** Kyrgyz retail trade of food products features oligopolistic practices and collusion at certain stages. This is particularly the case for foodstuffs sales which take place at two major food markets (bazaars) – in Bishkek and Karasu. It means that a small group of people, owners and closely affiliated parties, can control wholesale food prices in the country. Therefore the prices at the domestic market could have been increased at higher extent than the import prices.

**11. Oil price increase transmitted to the domestic prices of energy products and pushed energy inflation up to 17.3 percent in 2007.** Energy products saw the second largest increase in prices after the foodstuffs in 2007. The highest increase was attributed to fuels (36.7 percent). Prices of natural gas went up by 21.8 percent. Electricity tariffs have not been increased yet and therefore did not provide any inflationary pressures. Given low weights of energy products in the Kyrgyz CPI basket it did not have big direct impact on overall CPI increase in 2007. However, planned by the Kyrgyz Government increase in electricity tariffs by 10 to 20 percent in 2008 can only aggravate the situation and accelerate overall inflation further.

Figure 12. Kyrgyzstan: consumer prices in 2002-2008



Source: NSC KR, WB GEM

**12. While much of increase in inflation reflects higher international and food prices, the Government needs to tighten monetary and fiscal policies to fight second round effects of the food and energy prices increase.** Price level considerably increased not only for foods and fuels. Non-food and non-energy inflation, which averaged 2.4 percent over 2002-2006, speeded up in 2007 and reached 9 percent. Situation did not improve in the first four months of 2008. Overall inflation (on annual basis) reached 26 percent, inflation excluding food and energy - 13.4 percent, energy prices went up by 24.1 percent and food prices increased by 38.8 percent (see figure 9). Therefore there is a serious threat to the overall macroeconomic stability if inflation continues to increase. Moreover there is a serious risk of poverty increase given adverse impact of inflation on real incomes and threats for the food security. Whether the country will be able to sustain momentum of economic growth and maintain overall macroeconomic and social stability will depend on the following factors:

- Dynamics of the global food and energy price. Recent developments indicate slowdown in world price of wheat - in April 2008 it went down by 17 percent in nominal terms from US\$ 440 to 362, but still it remains at higher level that 2007 average. However, oil price according the WB projections has not reached its peak yet and is expected to slow down not before 2010 (see Para 3).
- Response of the Kyrgyz agricultural producers to the opportunities provided by the new food prices. Agriculture was one of the major drivers of growth over 1996-2000, but it has been stagnant afterwards. Given new conditions (i.e. high prices on agricultural products) Kyrgyzstan's agricultural engine for growth may drive the economy once again. But unless Kyrgyz farmers can expand operations and access regional markets, the sector will remain in its secondary role – as a social safety net.
- Government policies. Given increasing real wages and domestic prices converging to international, increase in the core inflation (i.e. excluding energy and food) may reflect healthy for economy process of relative price adjustment. However the Government needs to tighten monetary and fiscal policies to fight second round effects of the food and energy prices increase and to prevent price expectations from being adjusted upwards. At the same time the fiscal policy will needs to strike a balance between reducing inflation and protecting growth and poor in the face of adverse impact of recent food price increase on the poor.