

Follow-Up Workshop on Macroeconomic Policy and Mitigating Inflation Pressures

Of the Joint Government/WB/IMF Workshop on “Coping With Short Term Risks and
Vulnerabilities and Accelerating Long Term Growth”

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Bishkek, National Bank of the Kyrgyz Republic

Introduction

Recent global food and energy price surge may undermine poverty reduction efforts of the Kyrgyz Government. Though the Government made some actions (lowered taxes, subsidized food prices for poor, conducted interventions in grain market), external shock gives little room for the Government and the Central Bank to fight with imported inflation. 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. This workshop was intended to serve as a discussion platform to debate on two main policy issues: (i) what are the effective tools to lower inflation, and (ii) how to stimulate growth in a high inflation environment.

Key messages

Presentations of the initial speakers *Yulia Mironova* (World Bank), *Seilbek Urustemov* (National Bank) and *Ron van Roden* (IMF) indicated major problems faced by the country in fighting high inflation.

- Authorities can do little about inflation surge driven by the world food and energy prices increase, but it is crucial to avoid spillovers into broader price and wage pressures.
- Tight monetary and fiscal policies may harm economic growth and the poor, but they play important role in fighting second round effects of the food and fuel inflation.
- High inflation is more dangerous for economic growth than currency appreciation though the later may harm export competitiveness.
- Negative real interest rates are harmful to economy as they encourage pro-consumption behavior – therefore the policy challenge for the National Bank is to turn it to positive.

Main discussion points

The discussion followed by the presentations took place around three major issues: (i) adjustment of domestic prices to international; (ii) policy choice between supporting growth and fighting inflation; and (iii) policy instruments to fight inflation.

- **Domestic prices are eventually adjusting to world prices.** Over last decade Kyrgyz population enjoyed subsidized prices for utilities, for most of which tariffs were on the level lower than cost recovery. Due to deterioration of energy and utilities infrastructure the Government is forced now to make price adjustments and increase the tariffs. Moreover, international commodity price increases are not expected to be temporary and have to be passed on to domestic consumer and producer prices. Full pass-through allows for correct price signals, which help to 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. However, passing international price increase on to consumers can also result in a significant drop in real incomes for households, especially poor. The policy challenge is therefore to ensure economic efficiency and stability while at the same time protecting vulnerable groups.

- **Policy makers face a choice between supporting growth and fighting inflation.** Under strong external price pressure the first question posed by policymakers is to whether fight with inflation or support economic growth with relaxed attention to inflation rate. The workshop participants broadly agreed that bringing inflation down is a policy priority. As experiences of countries that gave priority to bringing inflation down show they were less affected by consequent shocks, while countries that allowed inflation to persist faced greater challenges as inflation expectations had ratcheted upward.

- **Tight monetary policy now dominates over the fiscal policy in bringing high inflation under control.** Up to date, fiscal policy was not helpful due to uneven allocation expenditures with a peak coming by the end of a fiscal year. Interest rate does not work as an effective monetary policy instrument as financial intermediation is very low. Therefore, exchange rate remains the only powerful tool to manage excessive liquidity, though in environment of sizeable capital inflow, appreciation of the som may potentially undermine export competitiveness in short run.

Recommendations

1. **To increase interest rates, which remain negative in real terms.** The National Bank and the Ministry of Finance will need to offer higher yields on the debt instruments they issue and accept the costs arising from this. With high inflation, negative real interest rates, and a weakened currency, economic agents will have little incentive to hold the national currency, risking further pressures on prices and the exchange rate. Temporarily raising reserve requirement ratios or expanding coverage, as some countries have done, would be something to consider, but only if a serious effort to tighten policy through open market operations were not successful.

2. **To allow floating exchange rate regime.** In the environment of net outflows the NBKR is right in resisting the downward pressures on the exchange rate (although there should be a clear exit strategy if these pressures persist and intensify). But when foreign exchange inflows dominate

over outflows, the NBKR should allow the som to appreciate. A nominal appreciation might make Kyrgyz goods and services more expensive on the world market, thereby reducing their competitiveness, but 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.

3. To tighten fiscal policy by restraining spending needs. Non critical recurrent expenditures can be postponed (such as purchase of goods and services, repair of government buildings and etc.), thus restricting domestic spending. Critical and non critical capital expenditures (including PIP) shall be disentangled based on high return outputs, but also on possible inflationary impact. Fiscal pressures due to costs of new policies/programs (e.g. increasing cash transfers to the poor most affected by price increases) and possible drop in revenues from trade taxes, can be accommodated by continuing strong revenue collection from other sources and, if necessary, via external borrowing and grants. Some widening of the fiscal deficit relative to the near-balance achieved in 2007 is therefore appropriate, but not to the extent envisaged in the 2008 State and Social Fund budgets. All efforts shall be done by the government to not allow arrears.

4. To strengthen social safety nets to reduce adverse impact of inflation on poor. An increase in the Unified Monthly Benefit could be considered. This offers solution that can be implemented rather quickly as administration and payment structures are established and functioning. Consideration could also be given to temporarily (further) reducing taxes, including VAT rates and import tariffs, on key food items, especially on foods that are relatively important in the budgets of the poor. Price controls and export bans or taxes should continue to be avoided, as these reduce farmer incentives and will actually reduce the food supply in the long run. The option might be to increase the states reserves of grain and to release these during temporary shortages or sudden price increases, but to avoid subsidizing the general population, release of grain from the state reserves could be combined with existing targeted program.

Possible Donor's engagement

- Adjustment operations, which may include Balance of Payments support to mitigate negative impact of the terms-of-trade-shock or direct budget support.
- Technical assistance in development structural rules for the monetary and fiscal policy, which may include criteria for exchange rate depreciation/appreciation, changing interest rates or establishing sailings for the fiscal balances.
- Technical assistance aimed to strengthen fiscal policy cycle, which may include organizing all exiting fiscal data in a convenient framework and integration this framework in a policy making process.