



**112**

---

**Małgorzata Markiewicz (ed.)**  
*Kyrgyzstan — Economic Reforms in*  
**1996**

Authors: Jacek Cukrowski, Kazimierz Kloc, Jarosław Kuźma,  
Małgorzata Markiewicz, Irena Topińska

*Warszaw, September 1997*

Materials published in these series have a working paper character. They can be subject to further publication. The views and opinions expressed here reflect Authors' point of view and not necessarily those of CASE.

This paper was prepared for the project “Support for Economic Transition in FSU Countries” financed by *the Stefan Batory Foundation*, Warsaw.

Editor *Bartosz Klin*

© CASE — Center for Social and Economic Research, Warsaw 1997

ISBN 83-7178-034-6

Publisher:

CASE — Center for Social and Economic Research  
Bagatela 14  
00-585 Warsaw, Poland

tel.: (48-22) 628-09-12, 629-43-83

fax: (48-22) 628-65-81

e-mail: [case@case.com.pl](mailto:case@case.com.pl)

## Contents

|   |    |
|---|----|
| <i>Jacek Cukrowski</i>  |    |
| 1. Introduction.....  | 4  |
| <i>Jacek Cukrowski</i>  |    |
| 2. Monetary and Exchange Rate Policies .....                      | 6  |
| <i>Małgorzata Markiewicz</i>                                      |    |
| 3. Budget Deficit and Fiscal Reforms.....                         | 10 |
| 3.1. Fiscal Developments .....                                    | 10 |
| 3.2. Institutional Arrangements.....                              | 11 |
| 3.3. Intergovernmental Finances .....                             | 11 |
| 3.4. Tax Policy .....   | 12 |
| 3.5. Revenue Performance .....                                    | 14 |
| 3.6. Expenditure Performance.....                                 | 15 |
| 3.7. Budget Deficit Financing .....                               | 16 |
| <i>Jacek Cukrowski</i>  |    |
| 4. International Trade.....                                       | 16 |
| <i>Kazimierz Kloc</i>   |    |
| 5. The Central Bank and Banking Sector in Kyrgyzstan in 1996..... | 20 |
| 5.1. The Central Bank (NBKR) Credit Policy .....                  | 21 |
| 5.2. Bank Supervision and Prudential Norms .....                  | 22 |
| 5.3. Liquidation of the Commercial Banks in 1996.....             | 24 |
| 5.4. New Banks .....  | 27 |
| 5.5. The Situation in the Banking Sector .....                    | 28 |
| 5.6. New Financial Institutions .....                             | 29 |
| 5.7. The FINSAC Program .....                                     | 32 |
| 5.8. Conclusions.....   | 32 |
| <i>Jarosław Kuźma</i>   |    |
| 6. Privatization .....  | 34 |
| 6.1. Introduction.....  | 34 |
| 6.2. Legislative Framework for Privatization in Kyrgyzstan.....   | 34 |
| 6.3. Methods of Privatization of Enterprises.....                 | 35 |
| 6.4. Privatization Problems .....                                 | 36 |
| <i>Irena Topińska</i>   |    |
| 7. Social Transfers in Kyrgyzstan.....                            | 39 |
| 7.1. Pensions .....   | 39 |
| 7.2. Benefits for the Unemployed .....                            | 44 |
| 7.3. State Allowances and Other Social Assistance Benefits .....  | 46 |
| 7.4. Public Health Care and Education .....                       | 48 |
| 7.5. Concluding Remarks.....                                      | 49 |
| <i>Jacek Cukrowski</i>  |    |
| 8. Economic Policy in 1997 — Plans and First Results .....        | 49 |
| <i>Małgorzata Markiewicz</i>                                      |    |
| 9. Conclusions.....   | 52 |
| Bibliography .....  | 54 |

# 1. Introduction

(Jacek Cukrowski)

In the former Soviet Union the Kyrgyz Republic was considered as one of the poorest republics and its economy was strongly dependent on the center. Nevertheless, the budget of the Soviet Kyrgyz Republic was characterized by a relatively high level of expenditures and, interestingly, by fiscal surplus (due to transfers from the budget of the Soviet Union).<sup>1</sup> The collapse of the USSR and the breakdown of command and control mechanisms of the central planning system, as well as the breakdown of cooperative agreements within the Soviet economic system, was marked by a sharp decline in economic activity, fiscal problems and a rise in inflation rates in independent Kyrgyzstan. Officially recorded output in the Kyrgyz Republic dropped in 1991-1995 by 7.8%, 13.9%, 15.5%, 20.1%, and 5.4% in the respective years (in total Kyrgyz GDP dropped by over 50% in the considered period<sup>2</sup>). Since 1992, fiscal policies have aimed on compensating the loss of external budget support (i.e., transfers from the Soviet budget). Nevertheless, the fiscal deficit increased to 13.4% of GDP in 1992, 13.6% in 1993, 7.7% in 1994, and 11.8% GDP in 1995. As a result, inflation rose to 178.9% in 1991, 1,258.7% in 1992, 1,491.7% in 1993, 87.2% in 1994, 31.9% in 1995.

The significant fall in the rate of inflation observed in 1995 was a direct result of successfully applied market-oriented economic reforms, which included macroeconomic stabilization (restrictive monetary and fiscal policies, coupled with restrictive income policies and adequate exchange rate management policies), market liberalization (removal of price controls, restrictions on private sector development, restrictions on domestic and foreign trade), and institutional reforms (creation of new social, political and economic institutions of the market environment).<sup>3</sup>

As a result of the stabilization program, the growth of broad money fell from 125% in 1994 to 76% in 1995, velocity of broad money decreased by 24% over a year, inflation decreased to a relatively low level (31.9% in 1995), and a relatively stable exchange rate of the national currency (som) was maintained (in 1995 som was moved from 10.45 per USD at the beginning of the year to 11.4 per USD at the end of the year).<sup>4</sup> International trade expanded rapidly. In 1995 exports in USD rose by 20%, while imports increased by 38% (a significant part of the imports was linked with the construction of a foreign financed gold mining project — Kumtor). The current account deficit (excluding imports and services related to the gold project) amounted to about 8% of GDP (i.e., 2% less than in 1994). The overall balance of payments recorded a deficit of USD 79.8 million, and the level of gross reserves decreased from

---

<sup>1</sup> A budget surplus amounted 2.1% of GDP in 1989, 0.3% of GDP — in 1990, and 4.6% of GDP — in 1991.

<sup>2</sup> According to the official statistics, without a shadow economy.

<sup>3</sup> For the analysis of economic reforms in Kyrgyzstan in the period 1991-1995 see: Dąbrowski M., Antczak R., *Economic reforms in Kyrgyzstan*, “Studies and Analyses”, No. 28, CASE, Warsaw 1994 (in Russian), and Antczak R., Markiewicz M., *Economic reforms in Kyrgyzstan in 1994-1995*, “Studies and Analyses”, No. 91, CASE, Warsaw 1996 (in Russian).

<sup>4</sup> The amplitude of the exchange rate fluctuations in 1994 was about 55%, but in 1995 only 9%.

2.5 to 2.3 months of imports, i.e., from USD 94 million in 1994 to USD 111 million in 1995. Significant progress in privatization and restructuring of enterprises has been achieved. By the end of 1995 about 60% of state enterprises existing in 1992 had been privatized. Small and mass privatization processes have practically been completed.<sup>5</sup> Certain progress was also made in the land reform. By the end of 1995, the majority of collective or state farms had been converted to joint-stock farms and land-use rights were extended from 49 to 99 years (land leases can be sold, exchanged, or used as collateral for obtaining bank credits). Overall agricultural output grew by about 4% in 1995 in real terms.

However, despite of apparent achievements in economic restructuring in 1995, there were also serious problems. The crisis in several commercial banks at the end of 1995 (serious solvency problems) destroyed the confidence in the financial system as a whole. As a result of the restructuring program started in 1995, two large commercial banks *Elbank* and *Agroprombank* were closed, further nine of the remaining 14 small private banks were also shown to be in financial distress (according to other estimations about 33% of commercial banks were on the verge of bankruptcy)<sup>6</sup>. Trade deficit increased in 1995 (to USD 179.1 million, or 16% GDP).<sup>7</sup> Foreign direct investment (with the exception of the gold projects) remained low. Total external public debt outstanding at the end of 1995 rose to USD 585 million (36% of GDP). There was still a relatively high level of inflation (31.9%). Average real wages increased in 1995 by only 7% (at the end of 1995 the average wage was about 51% of the average wage in 1992 in real terms), but the minimum wage, to which government wages and pensions are tied, decreased by 5%.<sup>8</sup> In 1995 the average pension was 70% of the average pensioners' consumer budget.<sup>9</sup> At the end of 1995 the amount of unpaid salaries in the government sector and pensions amounted to about 260 million soms.<sup>10</sup> Official unemployment rose to about 3% and started to pose a serious problem (note, however, that a significant number of people, who lost jobs since 1992 were not officially classified as unemployed). The amount of the budget deficit remained on an unacceptable level (11.8% of GDP), and its financing caused serious problems.

These and several other problems faced in 1995 made the successful continuation of market-oriented economic reforms in Kyrgyzstan at least questionable. It became clear that a permanent and high fiscal deficit is a threat for the stabilization program

(i.e., that it cannot be financed without serious inflationary consequences), and can harm economic growth. Nevertheless, the expectations of the government and the

<sup>5</sup> For the analysis of privatization processes see Jermakowicz W., Pańków J., *Ďščárňčřřč' á Kyrgyzstane v 1992-1996 zž.*, "Studies and Analyses", No. 102, CASE, Warsaw 1996.

<sup>6</sup> See Shestakov I., *Crack-down on Corrupt Government Employees*, "Focus Central Asia", No. 18, September 30, 1996.

<sup>7</sup> Note that in order to provide a continuous economic development this figure should not exceed 5-6% of GDP.

<sup>8</sup> See *Kyrgyz Republic, Recent Economic Developments*, IMF Staff Country Report No. 96/98, IMF, Washington, D.C., September 1996, table 10, p. 38.

<sup>9</sup> See Kupuyeva A., *Pension reform model for Kyrgyzstan*, "The Central Asian Post", May 1, 1997, No.17.

<sup>10</sup> See *Социально-экономическое положение Кыргызской Республики*, Национальный статистический комитет Кыргызской Республики, Бишкек, январь 1996 (p. 41).

National Bank of Kyrgyzstan were quite optimistic. In 1996, despite of fiscal problems, further macroeconomic stabilization (i.e., reduction of the annual rate of inflation) and a stable rise of production were expected. However, as it is shown in the analysis below, not all economic targets have been achieved, and stabilization reforms in 1996 should not be considered as very successful (inflation rate increased to 35%, and national currency depreciated by about 50%). On the other hand, another aim — overcoming the slump in production — has been achieved (GDP increased by 5.6%)<sup>11</sup>, and several important socio-economic reforms have been started and continued.

## **2. Monetary and Exchange Rate Policies**

*(Jacek Cukrowski)*

As emphasized in the introduction, several important reforms concerning monetary and exchange rate policies have been completed since gaining independence. New central bank and commercial bank laws were approved in 1992, the national currency (the som) was introduced in 1993. In 1995, the confidence to the national currency was reinforced by a not very high (by Central Asian standards) inflation rate and a relatively stable exchange rate. The year 1996, however, can be characterized as a period of a sharp depreciation of the som (by about 50%) and certain destabilization of the economy as a whole (annual inflation, for example, increased from 31.9% in 1995 to 35% in 1996).

After two years of a relatively stable exchange rate of the national currency, in 1996 the som sharply depreciated (see Chart 2.1). The first crisis in the foreign exchange market was observed in the spring 1996 — over two months (April and May) the som/USD exchange rate increased from 11.35 at the end of March to 12.50 at the end of May. The situation on the foreign exchange market did not improve in summer, although over the last few years the som used to appreciate in those months. A second, deeper exchange rate crisis took place in fall. In September the som/USD exchange rate increased from 12.15 to 13.25, in October — to 15.40, in November — to 16.85 som/USD (after reaching 17.01 som per USD in the first part of December, the exchange rate fell to 16.70 som per USD).

Large exchange rate fluctuations have often been explained (at least till fall 1996) by seasonal factors associated with agricultural production (the share of agricultural production in Kyrgyz GDP amounted to 40% in 1995 and about 60% in 1996), decrease in hard currency income from the export of wool, consequences of an unusually hard winter, or weaknesses of the banking system.<sup>12</sup> However, detailed analysis of macroeconomic data suggests a different explanation.

Dynamics of basic macroeconomic indicators observed in 1996 show that temporary increase in the level of international reserves of the National Bank of the

---

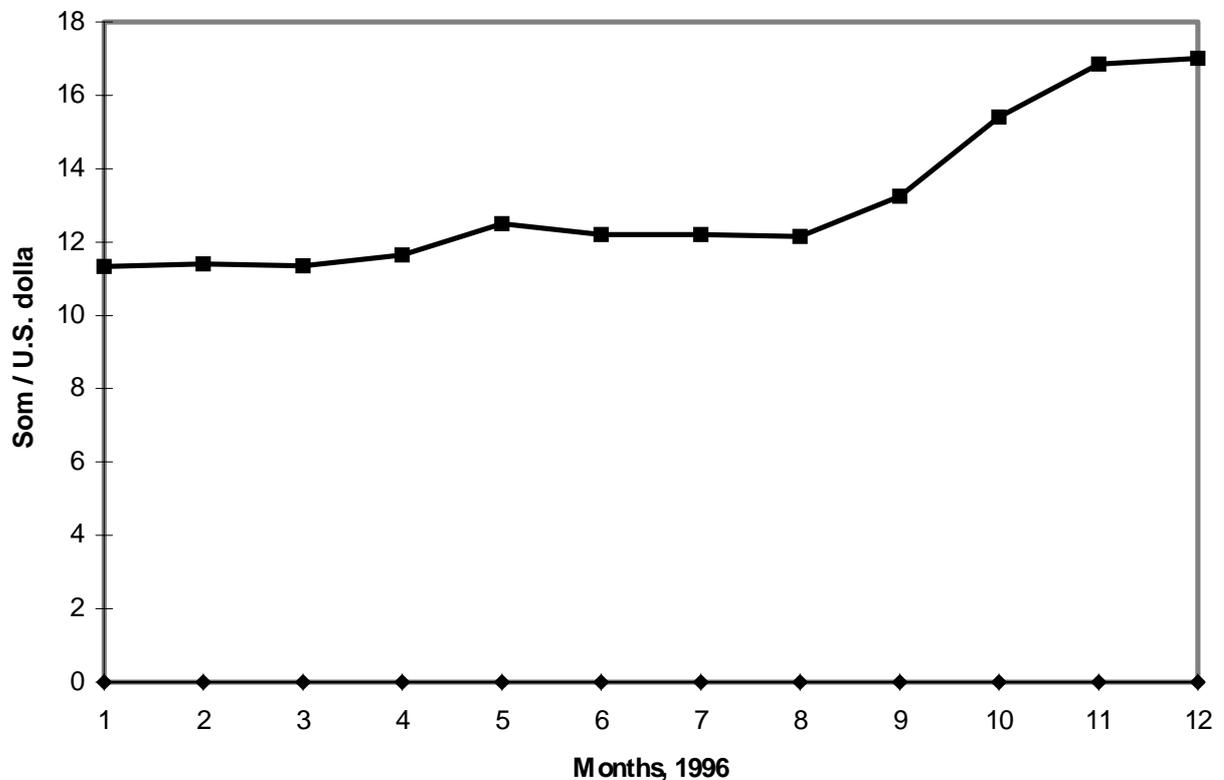
<sup>11</sup> GDP in 1996 was estimated to have been 22,467.8 million som (goods composed 64% of GDP, 30% was made by services and 6% was taxes on products).

<sup>12</sup> See, e.g., *Kyrgyz Republic, Recent Economic Developments*, IMF Staff Country Report No. 96/98, IMF, Washington, D.C., September 1996, p. 2.

Kyrgyz Republic (NBKR) could be one of the reasons of the foreign exchange market crisis. In 1995, exchange rate policy aimed at keeping the som within a narrow band vis-à-vis the US dollar was implemented mainly by varying the amounts of foreign currency the NBKR sold in its twice-weekly auctions. In 1996, this policy was disturbed for the following reasons. Firstly, the increasing volume of import caused a necessity to adjust the amount of foreign reserves kept by the NBKR to the level required by IMF (2-2.5 months of import). Secondly, the deadline to pay off the debt to Russia (USD 132.8 million) at the end of 1996 caused a necessity to increase the amount of foreign reserves in the NBKR (see Chart 2.2). These two reasons caused a sharp decrease of foreign currency supply in the foreign exchange market and as a result the som depreciated (see Table 2.1).

Chart 2.1.

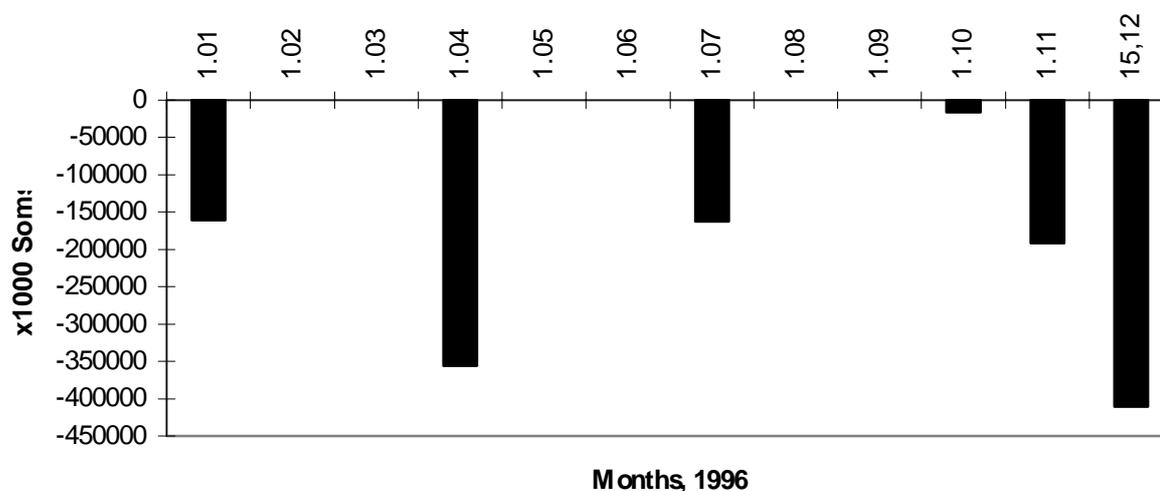
**Som/US dollar exchange rate dynamics in 1996**



Source: the National Bank of the Kyrgyz Republic

Chart 2.2.

**Changes in net foreign assets of the NBKR in 1996**



Source: the National Bank of the Kyrgyz Republic

Table 2.1.

**Results of foreign exchange auctions in 1996**

|           | Amount in USD thousands | Amount in thousands soms | Exchange rate som/USD |
|-----------|-------------------------|--------------------------|-----------------------|
| January   | 17018.637               | 192310.6                 | 11.30                 |
| February  | 10884.657               | 124085.1                 | 11.40                 |
| March     | 8535.533                | 96878.3                  | 11.35                 |
| April     | 10380.515               | 120933.0                 | 11.65                 |
| May       | 6337.742                | 76052.9                  | 12.00                 |
| June      | 5766.885                | 70356.0                  | 12.20                 |
| July      | 5316.228                | 65123.8                  | 12.25                 |
| August    | 6226.156                | 75647.8                  | 12.15                 |
| September | 2830.189                | 37500.0                  | 13.25                 |
| October   | 7099.188                | 109327.5                 | 15.40                 |
| November  | 12982.688               | 218758.3                 | 16.85                 |
| December  | 7583.740                | 126648.5                 | 16.70                 |
| Total     | 100962.156              | 1313261.8                |                       |

Source: *Банковский Вестник Кыргызской Республики*, No. 1, 1997; and computations of the authors.

An agreement on the restructuring of Kyrgyzstan's debt signed in November 1996 changed the exchange rate policy of the NBKR (in November, the NBKR sold approx. USD 13 million, while in September as little as USD 2.8 million)<sup>13</sup> and allowed the som/USD exchange rate to stabilize at the level of 16.70 soms per USD at the end of December 1996 (note that the highest exchange rate in 1996 — 17.01

<sup>13</sup> See Table 2.1.

som/USD was observed in the first half of December).<sup>14</sup> In comparison, in 1995 the NBKR sold on auction about USD 178 million<sup>15</sup>, while in 1996 only about USD 100 million (see Table 2.1).

Another important event, which directly influenced the situation on the foreign exchange market (in particular, the som/USD exchange rate) in the fall of 1996 was the decision to pay off the majority of governmental debts to the population (i.e., unpaid salaries in the government sector and pensions amounting to about 600 million soms). Obviously, this rather significant amount of money placed into the market increased demand for foreign currency, and consequently further increased the exchange rate.

There is also another factor, probably the most important — a permanent budget deficit since 1992 — which in the medium or in the long run always leads to economic destabilization. As emphasized in the introduction, the budget deficit in 1995 was very high (11.8% of Kyrgyz GDP). It was partly financed from foreign credits (42.7% of the total budget deficit), but the remainder (about 7% of GDP) had to be financed from internal sources. In 1996, fiscal deficit decreased, but still remained at a relatively high level of 5.6% GDP (see Chapter 3), and was financed in a significant part (about 41%) by the NBKR credits. Moreover, accumulated hidden deficit in the form of governmental debt (unpaid salaries in the state sector and pensions) could also cause problems (as mentioned above the decision to repay this debt was the impulse that started the foreign exchange market crises in the fall of 1996).

Obviously, a sharp depreciation of the national currency caused a significant rise in the price level. The exchange rate depreciation observed in 1996 affected particularly the level of inflation, rising prices of imported goods and decreasing demand for the national currency (i.e., increasing the velocity of money). Therefore, the rise of the monthly rate of inflation to 6.6% in November (and to 4.5% in December) was not surprising. The dynamics of the monthly rate of inflation is presented in Chart 2.3. In total, the inflation rate in 1996 reached about 35%, and exceeded that of 1995 (31.9%).

Note that significant increase of the exchange rate (depreciation) always rises inflationary expectations and decreases confidence in the national currency. The existence of these relationships is confirmed by monetary data of the NBKR. In the third quarter of 1996 velocity of broad money (i.e., an aggregate M2) equaled 10.6 and 12.7 for the monetary base, while in the same period of 1995 these indicators were 8.6 and 11.8 respectively (for the whole year the velocity of broad money was equal to 8.8 in 1996, as in 1995, however, the velocity of the monetary base increased from 7.2 in 1995 to 10.8 in 1996). In the first half of 1996 the growth of broad money was quite low (in some months — negative). However, starting from July the situation changed drastically, and over the following few months broad money expanded at significantly higher rates (the highest rate being 13.6% in October). At the end of the year the

---

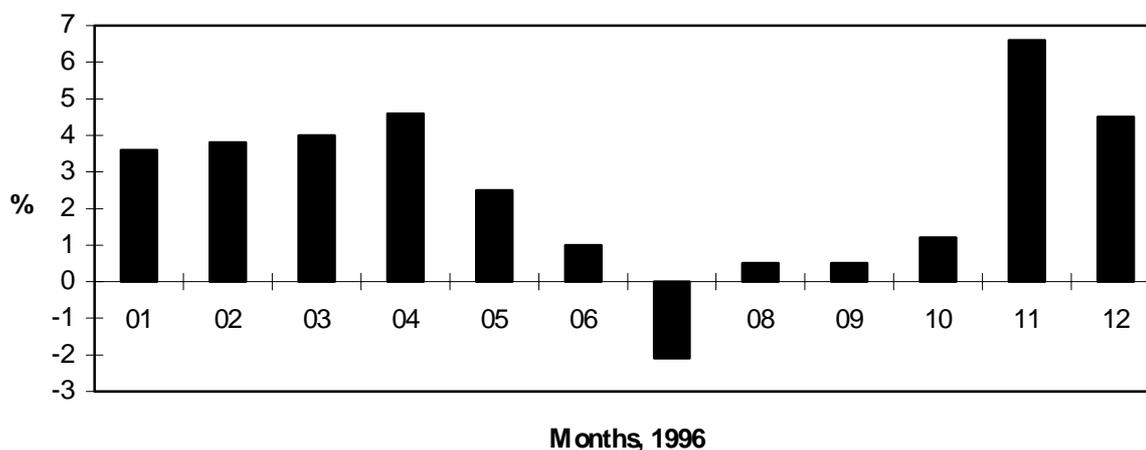
<sup>14</sup> According to this agreement, Kyrgyzstan's debt was deferred for 14 years. For the first 4 years, beginning on 1997, Kyrgyzstan will pay only interest. Payments on the principal will be made in the period from 2000 till 2009. The debt will be paid off partially in cash, goods, and with shares of enterprises.

<sup>15</sup> See *1995 year report*, National Bank of Kyrgyz Republic, Bishkek, April 1996 (in Russian).

expansion was reversed (in November a negative growth of broad money of -5.0% was observed, in December it rose by 3.2%).

Chart 2.3.

**Dynamics of monthly rate of inflation in 1996 (percentage changes with respect to the previous month)**



Source: the National Bank of the Kyrgyz Republic

It should be stressed, however, that there was a single driving force behind the monetary expansion in 1996 — the growth in credit to the Government<sup>16</sup> (credit to banks fell in nominal terms, and net international reserves decreased during the year). As a consequence, one can expect to observe similar macroeconomic problems in the future, if the size of the fiscal deficit is not decreased.

### 3. Budget Deficit and Fiscal Reforms

(Małgorzata Markiewicz)

#### 3.1. Fiscal Developments

The stabilization experience of the Kyrgyz Republic was similar to other transition economies. Fiscal developments were dominated by the shortfall of budget revenues, cuts in expenditures and high budget deficit. The destruction of the previous economic system, output decline and weak tax administration caused a decline in revenue. The revenue shortfall was much more severe than the fall in expenditure. As a result the budget deficit increased, equaling 13.4% GDP in 1992, and 13.6% GDP in 1993. In 1994 the consolidated budget deficit was reduced to 7.7% GDP, but in 1995 it increased to 11.8% GDP. The government bears in mind the necessity of lowering

<sup>16</sup> In 1996 the National bank credit to government amounted about 509 million soms.

budget deficit, but the results of such policy are not impressive. In 1996, the fiscal year was closed with the deficit of 5.6% GDP. In medium term high budget deficit can undermine achieved stabilization, especially when it is financed mainly with central bank credit. At the beginning of transition a substantial part of budget deficit was financed with foreign loans. However, the government has financed a big part of its deficit inflationary, including monetary creation. The collection of inflation tax induced price increase, as the result of price adjustment to money growth. The law on the central bank defines its independence from the government. According to these regulations, the central bank can finance budget deficit maximally up to 5% of GDP. Practically, this ratio was higher until 1995. A high inflation rate was the immediate result of liberalization, decreasing from 1,491.7% in 1993 to 35% in 1996. High inflation had a negative impact on real tax revenue and resulted in collection lags. Another problem concerned the persistence of budget arrears.

The Kyrgyz government underwent major changes in 1996 and their evaluation is presented below.

### **3.2. Institutional Arrangements**

The Kyrgyz Republic's consolidated budget consists of the central budget, local budgets and one extrabudgetary fund. There are seven local budgets: Chuj, Osh, Dzalal-Abad, Issyk-kul, Naryn, Talas and one municipality of Bishkek. Local budgets consist of 47 regions, the lowest level of administration structure. The extrabudgetary Social Fund was created in December 1993, combining three existing funds: the Pension Fund, the Employment Fund and the Social Insurance Fund.

In 1994 the National Treasury was established. From that time government accounts were shifted from the central bank to the Treasury, which is responsible for realizing all payments. The National Bank serves the accounts of Treasury sections only. From the beginning of 1995 the national budget has been presented using a classification based on the Government Financial Statistics System (GFS)<sup>17</sup>. Presently, the budget is presented on cash basis. The goal is computerization and introduction of commitment based accounting system.

### **3.3. Intergovernmental Finances**

Special attention must be paid to issues such as persistence of local budget arrears. The central budget has weak control over local budget expenditures. More than 80% of local government spending covers health, education and wages. Revenue sharing arrangements between the central and local governments are adjusted every year. However, some local budgets retain a larger than adjusted share of revenue collected and transfer less to the central budget due to weak control. Such practices result in the cumulation of arrears. The existing regional structure reflects political pressure and is not supported by economics. There are big differences in the level of economic development of different areas, not fully reflected in intergovernmental finances. As mentioned above, they result in expanding budgetary arrears and an

---

<sup>17</sup> see *Kyrgyz Republic, Recent Economic Developments*, IMF, July 5, 1996.

increased need of transfers from the central budget. A negative correlation between the amount of revenues and expenditures per capita on local level has been observed. Such system of intergovernmental finance does not justify an increase in revenue and efficient expenditures policy on local level. The reform of this system has become one of the most important programs in the fiscal area. The Ministry of Finance, with assistance of the World Bank, has started to prepare a program of reforms of the intergovernmental finance system, with plans to introduce medium term stabilized normatives (the share of revenues that could be kept by local budgets) and to implement the correlation between level of incomes and outlays per capita. The implementation of this program was planned for the beginning of 1997.

### **3.4. Tax Policy**

The Kyrgyz Republic, as all countries that have taken the road toward market economy, has witnessed a fall in tax revenue. The decline was neutralized by major restructuring of the tax system. However, such changes inevitably take time, so the results were observed with lag.

The tax system was created step by step from the beginning of independence, and profit tax, personal income tax, excise tax and VAT were introduced. Existing regulations were not transparent and included many releases. In 1995 the government submitted a new tax code for parliamentary consideration. The perspective of the creation of a custom union with Russia, Belarus and Kazakhstan delayed approval of the new tax regulations. Finally, in June 1996 the Parliament approved the new law.

In the middle of 1995 agricultural production was excluded from profit tax. The tax code decreased profit tax rate from 35% to 30%. Previously, there were different rates for different types of economic activity, for example: the banking sector was taxed with a rate of 45%, insurance companies 55%, cooperatives 10%. Presently, all types of activities are taxed with one rate. Additionally, the definition of tax base has been changed in some cases. For example, banks were allowed to form special funds for outstanding credits and to exclude their value from profit tax. This way banks were obliged to pay taxes only on the top of de facto earned profits.

On introduction the VAT tax rate was 28%. At the beginning of 1993 the rate was decreased to 20%. The common feature of VAT tax in new independent Soviet countries is creating obligation when the payment is done, and not when the goods are delivered, as in other countries. This construction of VAT tax caused big payment arrears and brought about barter transactions. The tax code introduced in 1996 changed the situation, setting the payment of VAT to be realized at the time of delivery.

According to the practice of CIS countries, the source VAT principle exists in the Kyrgyz Republic. Taking into consideration a negative trade balance record (especially with Russia, Kazakhstan and Uzbekistan) this practice decreased the net inflows to the budget from VAT. The tax code changed the rule to destination principle with exemption for imports from CIS countries. Other changes involved the introduction of invoices including VAT calculations, tax payer registration, tax collection on the custom border. On one hand, all changes have been increasing tax base for VAT, extending the tax obligation to the sectors previously excluded from

taxation, such as public budgetary organizations, municipal companies, education. On the other hand, tax base decreased as a result of deductibility of VAT paid with the purchase of production goods.

In Soviet Union times, the average citizens were never confronted by the tax system. They never had to file a return and, in most cases, were not even aware of the existence of taxes. Introduction of personal income tax has changed this situation. From the beginning of 1995 workers have the obligation to pay taxes on the top of all money and non-money incomes and to prepare a tax declaration every year. Personal income has been taxed increasingly with rates according to the tax brackets from 10% to 40%. The value of two minimum wages was tax exempt. A group of incomes, such as allowances, pensions, scholarships was excluded from personal income tax. The changes introduced in the tax code strongly affected budget revenues. This regulation increased burdens on persons with higher incomes. Tax base definition was changed and aimed at decreasing tax base.

As of the beginning of 1992 the excise tax was introduced. Initially, this tax was collected on domestic production only. In 1994 the list was extended to imported goods. The government signed agreements with neighboring countries on the exclusion of import from custom duties. The tax rates were different in all these countries. As a result, the Kyrgyz Republic, with relatively high tax rates, collected low incomes from this tax. The introduction, by the end of 1994, of tax rates equal to these in neighboring countries solved this problem. As of January 1996 excise marks on taxed goods are obligatory. The tax code introduced some changes to the excise tax formula, the most important being the exclusion from taxation of domestically produced goods destined for export. A wide range of goods was excluded from import excise tax, causing a decrease of revenues (i.e., oil products). The remaining major problems include too frequent changes in tax rates and low collection on the border.

The 5 per cent retail sales tax adopted in July 1994 was abolished with the introduction of the tax code. The purpose of its existence had been to attract small private enterprises to the tax system and to increase budget revenue.

Special export taxes were laid on the trade of a small group of goods. All export taxes were abolished as of February 1996. Custom duties regulations were changed very often. In 1996 an import duty on oil products and electronics was introduced. These taxes are not regulated by the tax code. The custom duty was scheduled to be eliminated with the introduction of the destination principle VAT, but it was retained for maintaining the source principle of VAT for imports from CIS countries (see *Kyrgyz Republic...*, IMF, 1996)<sup>18</sup>.

Another important change concerns the land tax. Previously, this tax was not an important source of budget revenue. The situation changed in 1995, when agricultural production was excluded from profit tax, road tax and extraordinary tax. Since then, land tax rates have been increased (rates are nominal amounts per hectare that vary to reflect the quality and location of the land). In 1996 land tax was included in the tax

---

<sup>18</sup> Nowadays the agreement with Kazakhstan about destination principle of VAT has been signed, but doesn't act yet because such change need to introduce changes in existing tax code. Similar regulation is discussed with Uzbekistan, the debate is proceeding. Kazakhstan, Uzbekistan and Russia are the main trade partners of Kyrgyz Republic, so such change is extremely important for the purposes of increasing the budget inflows.

code and in this way its significance has increased. The tax code does not indicate rates; they are defined by special regulations.

In December 1996 the Parliament approved changes to the tax code. The general direction was to squeeze the tax base and to introduce tax releases. Firstly, the level of income excluded from personal income tax was increased from two to four minimum wages. Such correction would cause lower income from this tax. The most numerous group of people pays tax according to the lower rate. Such amendment would apply to a wide range of taxpayers. Secondly, agricultural production has been excluded from VAT tax. Under the previous regulations VAT was calculated on top of border value of goods increased by all duties, excise and other border taxes. The introduction of changes meant that VAT would be calculated on top of custom value of goods, and that the level of budget income from VAT could decline. Agricultural production would also be excluded from personal income tax. All releases and amendments could change the structure of budget tax income, shifting the main source from indirect to direct taxes. Furthermore, the tax system lost its transparency. All these changes must be viewed as being against a broad strategy of tax reform. The results will be visible at the budget revenue record in 1997.

### **3.5. Revenue Performance**

The budget deficit reported surplus up to 1991. From 1992 government performance deteriorated. The deficit of the Kyrgyz Republic amounted to 13.4% of GDP in 1992, 13.6% in 1993, 7.7% in 1994 and 11.8% in 1995. The deep macroeconomic disequilibrium hurt the budget. Fall in GDP had direct impact on the income side of budget revenue. The drop in revenue was also caused by high inflation recorded in 1993 (1,491.7%) which was favorable for delaying tax payments (Tanzi effect). As mentioned before, a comprehensive tax reform had been implemented, resulting in tax base changes and regulation changes. Time was needed for necessary adjustment of payers and administration structures. A lot of enterprises started to act in underground economy, using the situation of weak control. Rampant corruption in tax collecting bodies appeared, with the allowance of non-payment of taxes by firms and enterprises.

High budget deficit had a destabilizing effect on macroeconomic stabilization. In 1996 the consolidated budget deficit equaled 5.6% of GDP. The relatively good performance of the budget deficit was achieved by reduction of expenditures. The level of revenues was quite stable and increased from 16.5% of GDP in 1995 to 17.6% of GDP in 1996. Such results were achieved due to the increase of GDP and the increase of tax collection. In 1995 the level of collected tax revenues amounted to 74.4% of planned revenues, in 1996 this rate increased to 84.8%. In 1994-1996 the rise in tax revenue appeared in the first quarter due to the tax regulation system, which imposed the payment of taxes (the difference between what should be paid and was paid) for the previous year in the first quarter of the following year.

Table 3.1 shows the proportion of various types of budgetary revenues in tax inflows in 1995-1996.

Table 3.1.

**The proportion of various types of budgetary revenues in tax inflows in 1995-1996**

|            | 1995 | III  | VI   | IX   | XII 1996 |
|------------|------|------|------|------|----------|
| Profit tax | 17.8 | 17.1 | 14.8 | 13.4 | 12.6     |
| Income tax | 11.5 | 9.0  | 9.0  | 9.5  | 9.2      |
| VAT        | 30.4 | 34.3 | 35.0 | 38.2 | 42.3     |
| Excise     | 12.7 | 10.5 | 11.5 | 9.8  | 8.6      |
| Duty       | 5.5  | 6.3  | 6.0  | 6.1  | 6.7      |

Source: the Treasury

The above data indicate that VAT was the most important source of budgetary tax revenues. Since 1993 the share of VAT revenue in tax revenue has been quite stable and amounted to 30.3% in 1993 and 30.4% in 1995. In 1996 the share of VAT revenue in tax revenue increased to 42.3%. The most important conclusion from Table 3.1 is the shift of the most important source of tax revenues from direct to indirect taxes. In 1995 profit and income taxes provided 29.3% of all tax revenues, in 1996 their share equaled 21.8%. On the other hand, indirect taxes (VAT, excise, duty) amounted for 48.6% of tax revenues in 1995, and in 1996 for 57.6%. The decreasing role of profit tax as the most important source of government tax revenue is a common feature of tax reform in transition countries. The share of profit tax inflow in percent of GDP declined from 4% in 1993 to 2.7% in 1995 and 1.7% in 1996. The following drop in share of profit tax in GDP in 1996 (the first year of real GDP growth) with the new changes in tax code (one rate for all types of activities) could signal the increasing share of underground economy. It could also be the result of the exclusion of agricultural production from profit tax. Thirdly, tax collection from the private sector is weak.

### 3.6. Expenditure Performance

As a result of revenue decline and limited access to non-inflationary sources of budget financing big pressure was made on decreasing expenditure. In 1992 budget expenditures were at the lowest level (12.7% of GDP). Since then the analyzed item has been characterized by high variability. In 1996 the share of expenditures in GDP was reduced to 23.2%. Unfortunately, decline in budgetary outflows was connected with increase in governmental arrears in wages and allowances. In the fourth quarter of 1996, the government decided to pay all obligations due to outstanding salaries and pension payments. It has caused big pressure and instability on the currency market (see Chapter 2).

The medium term tendency was growth of social expenditures. In 1996 the outlays for social insurance equaled 3.9% of GDP (decline from 5.7% in 1995). The most important item of social expenditures are pensions. The reform of the pension system is imminent to keep social expenditures in balance in the long run. Lately there were visible attempts to keep the real value of expenditures unchanged. On the other hand, comprehensive reform of education and health system has not been implemented yet. According to the forecasting calculation (see Cukrowski, Markiewicz,

Mogilewski, 1996) an unchanged situation in expenditure system can jeopardize budget stability in the medium term.

### **3.7. Budget Deficit Financing**

Budget deficit was financed mainly from foreign borrowings. In 1993 foreign financing accounted for 60% of general government deficit, in 1994 — 80%, in 1995 — 42.7% and in 1996 — 53.6%. Monetary financing (the emission of central bank credit) was the second source. The Treasury bond market was established in 1993. From the beginning of 1995 revenues from the issue of Treasury bonds were treated as income of the state and were used to finance the budget deficit. Unfortunately, the market for Treasury bonds is flat and the level of spending and liquidity of commercial banks made possible the financing of 6% of deficit in 1995 and 5.4% in 1996. High rate of inflation and small competition on the Treasury bond market influence the real rate of return. Hence, it has increased the cost of internal financing. As a result, revenue obtained from the new issue of bonds was transferred to pay off old obligations. In 1996 82.1% of income gained from issuing of new bonds was used to pay off old obligations (in 1995 this ratio amounted to 39%).

In transition countries, the budget deficit is a closely watched economic barometer. The decrease of this measure in 1996 was offset by the increase in commitments, which would have to be paid in future. This would increase the pressure on the budget. The medium term stabilization can not be achieved without increase of tax system efficiency, control over tax collection and tax system transparency and simplicity. Most of the changes introduced in the tax code in December 1996 have taken a wrong turn. On the other hand, structural reforms on the expenditure side (reform of pension system, social spendings, health and education expenditure) must receive the full attention they deserve. Without such measures budget position can hamper economic growth and destroy the still weak macroeconomic stabilization.

## **4. International Trade**

*(Jacek Cukrowski)*

Current international trade arrangements in the Kyrgyz Republic are considered as the most liberal among countries of the former Soviet Union.<sup>19</sup> Not surprisingly, therefore, the volume of foreign trade has grown permanently during last six years (dynamics of the main international trade indicators: volume of international trade, volume of export, volume of import, and trade deficit, are presented in Table 4.1). Moreover, after a certain stagnation in 1994 with the economic recession in the CIS area (in 1994 international trade turnover amounted USD 744.4 million)<sup>20</sup> external

---

<sup>19</sup> For details see: Antczak R., Markiewicz M., *Экономические реформы в Кыргызстане в 1994-1995 годах*, “Studies and Analyses”, No. 91, CASE, Warsaw 1996.

<sup>20</sup> There are certain differences between National Statistical Committee estimates and National Bank of Kyrgyz Republic data. All data quoted in the present section (if not indicated explicitly) come from National Statistical Committee of Kyrgyz Republic reports (see *Кыргызстан в цифрах*

trade expanded rapidly in subsequent years (USD 967.8 million in 1995 and USD 1,397.3 million in 1996). In 1995 exports increased by about 20% (to USD 408.9 million) and in 1996 by about 23.5% (to USD 505.4 million). At the same time imports jumped by about 38% in 1995 (to USD 558.9 million) and 59% in 1996 (to USD 891.9 million).<sup>21</sup> As a result, trade deficit more than doubled in both 1995 and 1996 (USD 150 million in 1995, and USD 386.5 million in 1996).

A major shift in trade away from former Soviet Union republics (CIS countries) to non-CIS partners, which started in 1991, seems to have slowed down (see Table 4.2). The share of CIS countries in foreign trade of the Kyrgyz Republic declined from over 80% in 1992 to about 65% in both 1995 and 1996. For exports, the share of CIS countries declined from over 95% in 1989-1993 to 66% in 1995 and 77% in 1996. Similarly, the CIS share of imports into the Kyrgyz Republic fell from about 80% in 1989-1993 to 54% in 1995, and so it remained in 1996. As a result, trade deficit with CIS countries increased from USD 84.4 million in 1995 to USD 93.5 million in 1996, while trade deficit with non-CIS countries more than tripled (increased from USD 65.6 million in 1995 to USD 293.0 million in 1996). As already mentioned, a significant increase in imports from non-CIS countries reflects mainly imports to the Kumtor gold project.

In 1996, Kyrgyzstan was engaged in export and import trade with 62 countries, usually divided in two groups: CIS and non-CIS countries. Among the CIS countries, the main trade partners are traditionally Russia (25.3% of total exports, and 19.6% of imports), Kazakhstan (21.2% of total exports, and 15.5% of imports) and Uzbekistan (22.1% of total exports and 22.1% of imports). Together they account for over 90% of Kyrgyzstan's exports and imports to CIS countries and 71% of total Kyrgyzstan's exports and about 50% of imports (note that the custom union with Russia, Belarus and Kazakhstan did not start to operate in 1996).<sup>22</sup> The main trade partners from outside of the CIS are the US (3.5% of total exports and 4% of imports), Turkey (1% of exports and 5.3% of imports), China (7.2% of exports and 0.9% of imports), and Germany (0.6% of exports and 3.6% of imports). We should mention a significant jump in foreign trade with the US in 1996 (export increased from USD 4.0 million in 1995 to USD 17.6 million in 1996, and import from USD 19.1 million to USD 35.7 million, respectively).<sup>23</sup>

---

1996, *Краткий Статистический Сборник*, Национальный Статистический Комитет Кыргызской Республики, Бишкек, 1997).

<sup>21</sup> Significant increase in import is usually explained by a surge in capital goods import by the Kumtor gold mining project.

<sup>22</sup> Only at the end of May 1997 an agreement concerning custom union was ratified by Kyrgyz Parliament.

<sup>23</sup> Humanitarian aid was a large part of imports from US.

Table 4.1.

**Foreign trade of the Kyrgyz Republic in 1992-1996 (main indicators in USD millions)**

| Indicator       | 1992  | 1993  | 1994  | 1995  | 1996   |
|-----------------|-------|-------|-------|-------|--------|
| Volume of trade | 737.7 | 808.0 | 744.4 | 967.8 | 1397.3 |
| Export          | 317.0 | 360.2 | 340.1 | 408.9 | 505.4  |
| Import *        | 420.7 | 447.8 | 404.3 | 558.9 | 891.9  |
| Trade deficit   | 103.7 | 87.6  | 64.2  | 150.0 | 386.5  |

\* Starting from 1994 non-organized import is included.

Source: Кыргызстан в цифрах 1996, Краткий Статистический Сборник, Национальный Статистический Комитет Кыргызской Республики, Бишкек, 1997.

Table 4.2.

**Foreign trade with CIS countries in 1992-1996 (main indicators in USD millions)**

| Indicator       | 1992  | 1993  | 1994  | 1995  | 1996  |
|-----------------|-------|-------|-------|-------|-------|
| Volume of trade | 590.7 | 583.9 | 432.5 | 622.8 | 880.3 |
| Export          | 240.5 | 248.1 | 223.0 | 269.2 | 393.1 |
| Import *        | 350.2 | 335.8 | 209.5 | 353.6 | 486.9 |
| Trade deficit   | 109.7 | 87.7  | -13.5 | 84.4  | 93.5  |

\* Starting from 1994 non-organized import is included.

Source: Кыргызстан в цифрах 1996, Краткий Статистический Сборник, Национальный Статистический Комитет Кыргызской Республики, Бишкек, 1997.

As far as export and import nomenclature is concerned, significant changes were not observed in 1996. The main exports groups consist of: food (35% of exports), machinery and equipment (15%), textiles (14%), and electricity (13.8%). Imports include mainly energy (natural gas, diesel fuel, mazout, gasoline) — about 12.3% of total imports, electric machinery (mainly for the Kumtor project) — about 7% of imports, food (raw sugar — about 9.3% of total imports, wheat — about 2.5% of imports), and ferrous metals (about 2.5% of total imports).

The developments of the total record of all transactions with foreign countries (the balance of payments) in 1996 were dominated by a rapid expansion in trade and by a foreign-financed investment associated with the Kumtor gold mining project. The developments of balance of payments in 1994-1996 are presented below (see Table 4.3). Data reported show that the current account deficit increased from USD 242.3 million in 1995 to USD 428.1 million in 1996. The overall balance of payments recorded a deficit of USD 16.8 million (USD 79.8 million in 1995). Gross official reserves increased by USD 20 million. The balance of payments deficit was financed mainly by IMF loans of USD 19.6 million and debt conversion and rescheduling of USD 58.2 million.

Table 4.3.

**Consolidated Balance of Payments of the Kyrgyz Republic (in USD millions)**

|                                       | 1993          | 1994        | 1995         | 1996         |
|---------------------------------------|---------------|-------------|--------------|--------------|
| <b>CURRENT ACCOUNT</b>                | -66.5         | -89.3       | -242.3       | -428.1       |
| Goods and non-factor services         | -175.7        | -130.3      | -287.5       | -476.6       |
| Trade balance                         | -166.8        | -116.7      | -179.1       | -362.6       |
| Exports                               | 339.6         | 340.0       | 408.9        | 531.2        |
| CIS countries                         | 227.5         | 222.8       | 269.2        | 393.9        |
| Non-CIS countries                     | 112.1         | 117.1       | 139.7        | 137.3        |
| Imports                               | 506.4         | 456.7       | 588.0        | 893.7        |
| CIS countries                         | 316.7         | 260.5       | 346.4        | 484.9        |
| Non-CIS countries                     | 189.8         | 196.2       | 241.6        | 408.9        |
| Non-factor services                   | -8.9          | -13.6       | -108.4       | -113.9       |
| Transportation                        | -6.3          | 9.5         | 5.3          | -4.3         |
| Travel                                | 0.3           | 0.8         | -1.1         | -0.1         |
| Others (excluding TA)                 | -0.5          | 7.7         | -64.3        | -64.8        |
| Technical assistance (TA)             | -2.5          | -31.6       | -48.3        | -44.7        |
| Income                                | -5.5          | -20.8       | -33.4        | -35.5        |
| Income on portfolio investment        | 0.0           | 0.0         | 0.0          | 0.0          |
| Income on other investment            | -4.5          | -17.5       | -24.7        | -28.5        |
| Interest payments                     | -4.5          | -17.5       | -28.4        | -32.6        |
| Other income on other investment      | 0.0           | 0.0         | 3.7          | 4.1          |
| Compensation of employees             | -1.0          | -3.3        | -8.8         | -7.1         |
| Current transfers                     | 114.7         | 61.8        | 78.7         | 83.1         |
| <b>CAPITAL AND FINANCIAL ACCOUNT</b>  | -52.2         | 53.6        | 238.0        | 318.4        |
| Capital account                       | -107.1        | -62.4       | -29.0        | -15.9        |
| Capital transfers                     | -107.1        | -62.4       | -29.0        | -15.9        |
| Financial account                     | 54.9          | 116.0       | 267.1        | 334.3        |
| Foreign direct investment             | 10.0          | 38.2        | 96.1         | 42.5         |
| Portfolio investment                  | 0.0           | 0.0         | 1.7          | -1.7         |
| Other investment                      | 44.9          | 77.8        | 169.3        | 293.5        |
| Assets (- increase)                   | -53.0         | -43.2       | 10.4         | 1.5          |
| Commercial banks                      | -13.4         | 1.3         | -1.2         | 1.6          |
| Other assets                          | -39.6         | -44.5       | 11.6         | -0.1         |
| Liabilities (+ increase)              | 97.9          | 121.1       | 158.9        | 292.0        |
| Commercial banks                      | 5.7           | 3.6         | -3.3         | -2.1         |
| Loans                                 | 71.1          | 105.8       | 200.0        | 285.1        |
| Disbursement                          | 71.1          | 106.5       | 272.4        | 335.6        |
| Amortization                          | 0.0           | -0.6        | -72.4        | -50.4        |
| Other liabilities                     | 21.1          | 11.7        | -37.9        | 8.9          |
| Errors & Omissions                    | -17.4         | 59.9        | -75.5        | 93.7         |
| <b>OVERALL BALANCE</b>                | <b>-136.1</b> | <b>24.2</b> | <b>-79.8</b> | <b>-16.8</b> |
| Financing                             | 136.1         | -24.2       | 79.8         | 16.8         |
| Reserves of the NBKR                  | -35.1         | -32.1       | 0.3          | -20.0        |
| IMF loans                             | 62.1          | 13.7        | 46.6         | 19.6         |
| Other foreign liabilities of the NBKR | 17.9          | -17.7       | 0.2          | 0.2          |
| CIS correspondent accounts            | 88.1          | -0.2        | -0.3         | 0.0          |
| Accumulation of arrears (net)         | 3.0           | 12.1        | 30.8         | -41.2        |
| Debt conversion or rescheduling       | 0.0           | 0.0         | 2.2          | 58.2         |

Sources: 1996 *годовой отчет НБКР*, Национальный Банк Кыргызской Республики, Бишкек, май 1997; and *Кыргызстан в цифрах 1996, Краткий Статистический Сборник*, Национальный Статистический Комитет Кыргызской Республики, Бишкек, 1997.

To summarize: in 1996 Kyrgyzstan managed to increase its foreign trade by more than one-third (to 29% of GDP), and, importantly, improved the character of its

exports in that the share of exports accounted by raw materials declined (e.g., wool exports dropped by 80%, and tobacco exports by about 40%). Export of finished goods increased; in particular, the volume of cigarette exports increased 15 times; beer exports 6 times; sugar 5 times; vegetable oil 2.8 times. On the other hand, in 1996 Kyrgyzstan actively increased imports (to about 50% of GDP), importing mainly machinery and equipment products from countries outside the CIS. As a result, a large trade deficit has been observed (exceeding 20% of GDP). Note that it is widely recognized that in order to provide continuous economic development this figure should not exceed 5-6%. Thus, the huge trade deficit observed in 1996 (as well as in 1995, see Table 4.3) confirms that the government did not have, and still does not have (see Chapter 8) a clear export oriented economic policy.

The task to radically resolve the exports problem was posed over and over again in recent years, however, no solution has been found. The export potential of the country is obviously much higher than it follows from the results of the year 1996. There is a long list of potential export resources (electric power, antimonite and mercury, electric motors for home appliances, electric bulbs, Portland cement, vodka, mineral water, sugar, cotton fiber, raw leather and silk products), although custom tariffs and high transportation costs make the products non competitive. There is hope that the development of Kyrgyzstan's export opportunities could be facilitated through a custom union with Russia, Belarus and Kazakhstan and through entering the World Trade Organization (WTO). However, the process will not be short and surely it will be very difficult. Firstly, expectations that the custom union will start to work efficiently in near future are quite low, and secondly, to enter WTO Kyrgyzstan will have to fulfill many formal requirements.

## **5. The Central Bank and Banking Sector in Kyrgyzstan in 1996**

*(Kazimierz Kloc)*

Fundamental institutional changes which occurred in the banking sector in Kyrgyzstan in 1996 involved liquidation of the largest commercial banks. Their audit had been carried out and more stringent prudential norms introduced to control that part of the financial market. The liquidated banks were replaced by new financial institutions. The changes were linked to the recently launched restructuring program FINSAC. It is aimed at reconstruction of that sector and creating conditions conducive to its further development. One of the important objectives of the program involves promoting new legislation concerning the Central Bank and banking system. The draft bills, however, had not been approved neither by the Parliament nor the President by the end of March 1997.

## 5.1. The Central Bank (NBKR) Credit Policy

In 1996 the Central Bank was carrying out monetary and credit policies which had been initiated in May 1993 with the introduction of national currency. In the following years it lent to commercial banks less and less money for specific purposes, but increasingly introduced the system of credit auctions and foreign exchange auctions. In order to reduce inflationary deficit financing of the budget the market of government securities was created. As production remained depressed for several years, and some elements of the policy consisting in granting credits for specific purposes were continued, “bad debts” cumulated in the credit portfolios of commercial banks. Their overdue payments to the Central Bank (the so-called overdraft) were transformed into medium-term credit. As a result, since the beginning of 1995, the NBKR was reducing refinancing credit offer, which given high profit margins of the commercial banks and lasting recession led to the actual “freezing” of the credit policy of commercial banks.

Since the beginning of 1996 the NBKR's lending was more and more limited: in January it equaled 6 million soms, by mid-year fell to less than 1 million soms per month, in November amounted to 360,000 soms. The amounts lent by the Central Bank for refinancing credit were much lower than the ones lent to commercial banks trying to improve its liquidity. The purpose was served by the so-called lombard credit ranging from 2 to 8 million soms in the second half of the year. The largest credits extended by the NBKR were extraordinary credits meant to help banks in emergency. Those credits ranged from 3 to 25 million soms per month. Mutual proportions of refinancing credit, lombard credit and extraordinary credit granted by the Central Bank indicate that the condition of the whole banking sector was very poor.

The inter-bank market was not in a better condition. At the beginning of 1996 monthly turnovers represented only a half of the figures recorded at the end of 1995 — they fell from 15 million soms to 8 million and subsequently to 7 million soms per month). In the second half of 1996 the figure oscillated between 9 and 1 million soms per month. It follows from the data that lending by commercial banks came to a halt.

As commercial banks could not, as a matter of fact, provide credit to the economy, they engaged in foreign exchange and securities operations. The latter could be carried out as the market of government securities developed. The securities, issued by the Ministry of Finance, were sold by the NBKR at weekly auctions. The Regulation of March 1996 set the principles regarding functioning of the market of Treasury Bills, and the commercial banks' activity in the capacity of dealers on the primary market. At the beginning of 1997 nine out of the 18 commercial banks complied with the requirements of the Central Bank and started to act as dealers at that market. In June 1996 the NBKR management decided that since that date Treasury Bills would be available for private persons not only through commercial banks, but also at regional branches of the Central Bank. In August 1996 a simplified procedure was introduced for institutional investors i.e., pension funds, insurance companies, etc. participating in the Treasury Bills auctions. The new regulations provided incentives for investors on the Treasury Bills market, and reduced profitability fluctuations. As

for most of the year the real exchange rate was positive, market participants could earn high profits, but the cost of internal debt service was pushed up.

Foreign exchange policy was the area where the problems encountered in 1996 were the greatest. The NBKR sold foreign currencies at weekly auctions, where the demand for foreign exchange ranged from USD 20 to USD 7 million per month. The sales in the first quarter of 1996 represented about 80-90% of the demand. In the second and third quarters of the year, although the demand was falling, the sales to demand ratio was even lower and oscillated between 50 and 70%. At the same time the proportion of cash deals dropped nearly to nil. The auction sales of foreign exchange went up in the last quarter of 1996, after the dollar exchange rate had sharply gone up (see Chapter 2).

## **5.2. Bank Supervision and Prudential Norms**

In 1996 the greatest changes occurred in the sector of commercial banks. They resulted from the policy of the bank supervision department of the Central Bank. The requirements of the NBKR towards commercial banks grew restrictive; they concerned the minimum own capital, observation of the norms set by bank supervision authorities, and the level of obligatory reserves which should be raised.

The minimum value of the starting capital set by NBKR regulation issued in August 1995 amounted to 10 million soms for the banks with national capital and 20 million soms for the banks with foreign capital participation (a bank with foreign capital participation was a bank with the foreign partner's share of 20% or more). In August 1996 out of 15 commercial banks in the country five failed to raise their starting capital to the required minimum level. In September 1996 the management of the Central Bank decided that the deadline for replenishing the capital to the required level should be postponed until 1 January 1997. At the same time the banks were forbidden to accept payments, both in national currency and in foreign currencies, until the required norm was met. (“Слово Кыргызстана”, September 19, 1996). By December 1996 only three banks had not been able to meet the requirement concerning the capital minimum.

According to the same regulation, the minimum starting capital required from commercial banks should be systematically raised every year. For the already operating banks with national capital the minimum starting capital would be raised by 5 million every year to reach 30 million soms late in the year 2000. For the newly established national banks the annual increment in minimum starting capital was set at 10 million soms, and was assumed to reach 50 million soms by the year 2000. The adopted regulation on the increase of the minimum starting capital — if observed — should contribute to stabilization and consolidation of the banking sector in Kyrgyzstan. Small banks and the banks that failed to replenish their capital by the time required would be liquidated or forced to merge to form larger financial institutions.

Apart from raising requirements concerning starting capital, the banking supervision of the NBKR began to demand that prudential norms should be rigorously observed by the banks. The norms introduced in 1992 regard control of the bank assets quality, particularly the security of credit portfolio, bank liquidity and currency risk.

The first prudential measure, designated by the symbol K1, sets the upper limit to the value of credit for an individual borrower. The maximum credit ratio for an individual borrower was set at 30%, and 15% for a shareholder or a bank employee. In 1994 the amount of credit was measured against own resources of the bank. In 1995 after the indicator had been changed, credit was related to the capital of the bank. At the beginning of 1995, that requirement was fulfilled by 7 banks only (out of 21 banks in operation). At the end of 1996, after the liquidation of 5 banks, half of all commercial banks in operation exceeded that indicator.

The second prudential norm, designated as K2, is a solvency coefficient, or capital adequacy coefficient. It is a relation of the bank assets weighted by the risk factor to own sources of the bank. The capital of the bank was divided into two grades. Grade I included only the stocks or shares, with no additional liabilities, and undivided profits from the past years. The solvency coefficient for the capital with grade I should not be lower than 4%. The capital identified with grade II included stocks or shares with additional liabilities, 5 years government bonds as well as the accumulated reserves. In the second case, solvency coefficient should not be lower than 8%. From the data on ten banks published at the end of 1996 it followed that only two of them failed to attain the required norms. The lack of data on the remaining five banks may indicate that some of them — probably three — also failed to fulfill that condition.

To control liquidity of banks the K3 norm was introduced. It is a relationship of liquid assets (cash, government securities and other liquid assets) to short-term liabilities of the bank. The coefficient was set at 30%. It follows from the data published on ten commercial banks that in 1996 all of them met the required norm. Other banks may not have fulfilled that criterion.

The fourth standard obligating commercial banks was aimed at reducing the exchange rate risk. It defined the gap between assets and liabilities for each currency. In the case of “hard currencies” its size could not exceed 20% of the total capital. With regard to “soft currencies” the indicator was set at 15%. It follows from the published data for ten commercial banks that none of 10 the banks which had licenses for foreign exchange operations exceed the norm.

Obligatory reserves are an important tool of monetary policy of the Central Bank. Until March 1996 the required standard indicator of the reserves for commercial banks was 15%. In March 1996 that indicator was lowered to 13.5%. As the som exchange rate fell and inflation began to grow faster in the autumn, the NBKR issued the Decision (“About the change of norms concerning obligatory reserves”). The reserves were set at 15% as of 1 December 1996 and at 20% as of 1 January 1997. Two facts were quoted to provide official justification of that decision: one was the increase of deposits in the banking systems, the other was lack of insurance legislation concerning those deposits.

In 1995, general assessment of the situation in the banking system became possible due to improved operation of the supervision department of the Central bank. As a consequence it was recognized that immediate action had to be taken in the four large commercial banks. The first steps conducive to the solution of their problems were taken in 1996. It was then that banking supervision authority tightened control over the banks which failed to meet the capital and prudential norms. Three of the former state-owned banks were put under interim administration. The rule was that in

spite of some attempts at restructuring liquidation of the banks occurred after several months.

### **5.3. Liquidation of the Commercial Banks in 1996**

At the beginning of 1996 there were 19 commercial banks in Kyrgyzstan. One of them — a savings bank — was state-owned. Eleven banks had mixed-capital (with the state participation), and seven banks were private. Four out of 19 banks originated from the financial institutions of the old system (Elbank, Agroprombank, Promstrojbank and AKB Kyrgyzstan). They provided services to various sectors of economic activity (agriculture, industry) or played a definite role (of population savings repositories or provided services to different sectors e.g., connected with central budget, social expenditure, local administration). At the end of 1995 three of these banks joined the group of banks found to have negative capital and failing to conform to obligatory economic norms. A much greater proportion than 50% of their portfolios contained credits classed as dubious or lost (nine banks were in that position, i.e., half of the number of commercial banks in Kyrgyzstan). The situation of large banks, burdened with bad credits portfolios, adversely influenced the situation of the whole banking system. Its improvement required first and for most the resolution of the problems concentrated in those few banks. They were radically resolved in 1996. Two of the four banks were liquidated (Elbank and Agroprombank).

The decision about the liquidation of Elbank (savings bank) was taken on 14 February 1996. That repository of the population savings was the first to be liquidated in any of the states created after the disintegration of the USSR. The bank's condition was bad from the very beginning. With low starting capital of 2.7 million soms (1995 end-year data) it was at the very bottom of the list of the 18 commercial banks operating in Kyrgyzstan. The amount of its starting capital turned out to be nearly four times less than the statutory minimum set for commercial banks in September 1996 at the level of 10 million soms. With its 49 branches the bank — according to this criterion — took the second place in Kyrgyzstan. Agroprombank with its 50 branches took the first position.

The NBKR justified its decision about liquidation of the bank by its very poor condition. The blame was put on its old management. It exceeded the range of its statutory competence. The accumulated assets were not invested in state securities only. A substantial part of these resources was lent through the inter-bank market to different borrowers, including banks in poor condition. Later, some of those banks came to be liquidated. The bank also granted credits at low interest rate to economic subjects, and — as a consequence — incurred considerable losses. Apart from that, most credits granted in that form proved to be uncollectable. The interest rate at that bank was lower than in other commercial banks.

The bank management also pursued a hazardous policy of attracting deposit by high deposit rate. Although the inflation rate fell in 1994 the deposit rate was maintained at nearly 250% annually. As a result, the bank managed to collect a large proportion of the population savings, but — unlike other banks — it failed to make gradual adjustment to the falling rate of inflation. It continued that policy even in the final year of its operation. Up to the end of the first quarter of 1995 the deposit rate on

short notice deposits was the same as in other banks (60%). On the other hand, the deposit rate on long-term deposits was much higher than the rate offered by other commercial banks. In the second and third quarters of that year, as the inflation rate was falling, the deposit was diminishing in all banks except for the savings bank. It offered a much higher rate, especially on one year deposits (50-80%). In mid-year the Central Bank demanded from the management of the savings bank to change its policy of deposit rate. As late as in the last quarter of the year the bank lowered its deposit rate to 10% on short-time deposits and to 30% on long-term deposits. In that way it brought down its deposit rate to the level of average deposit rate used by other banks. It turned out, however, that the action was performed too late. Under the circumstances liquidation of the savings bank was considered to be more reasonable than, for instance, change of management and reconstruction of the bank.

The issue of returning the money repositied by individuals was posed at the moment of liquidation of the bank. The savings bank was the only bank in Kyrgyzstan where deposits were guaranteed by the state. Strictly speaking, the guarantee covered only the deposits repositied by 11 December, 1992 (on that date bank operations were resumed as the period of “freeze” of the savings which had been repositied by the Soviet *Sbierkassa* came to an end). As the bank was state-owned, its status obligated both the government and the Central Bank to take over the responsibility for the people's money repositied with the bank also after that date. At the moment of liquidation of the bank it owed physical persons 122 million soms. At the beginning of February 1996 decisions were taken on the principles, amounts and the procedure of returning deposits. Small amounts, up to 3,000 soms, became payable on the date of the liquidation of the bank. The deposits of 3 to 5,000 soms became payable in April 1996, and the deposits of 5 to 10,000 soms — in May of that year. A promise was given to make deposits exceeding 10,000 soms payable after smaller amounts had been paid off. The interim administration established by the Central Bank took steps to recover the resources lent through inter-bank market and to institutionalized borrowers. As the recovered amounts proved to be too small to make the promised repayment of the deposits possible, the Central Bank earmarked 50 million soms from its own reserves for this purpose.

Another crucial step in the restructuring program of the banking sector was made in June 1996 when Agroprombank, the second of the large banks with the preserved state majority participation (54%) was liquidated. That bank operated in the sector of agriculture. A very poor condition of the kolkhozes and sovkhoezes, the policy of fragmenting collective farms into small farms without having solved outstanding debt problems deteriorated the situation of the bank even further. Agroprombank had a large number of branches (50) and a small starting capital of 15 million soms. Over several years, starting in 1989, it granted loans according to central plans. At the moment of the bank's liquidation the loans it had granted amounted to 1.5 billion soms (as it follows from the 1995 audit report, most of the loans — 90% were classed as dubious or lost). According to the initial concept, “bad loans” were to be consolidated into a separate portfolio managed by an agency which would be set up at the Ministry of Finance. Thus, the Agroprombank, free from the burden of bad credits, could have continued to operate. And yet, the NBKR took a different decision. The main

reason behind this was very poor quality of the bank's management which would not have been able to reconstruct the bank even under special supervision.

The decisions of the liquidation of the two out of four large banks was unprecedented in the states created after the disintegration of the Soviet Union. In the case of the remaining two large banks — the AKB Kyrgyzstan and the Promstroibank — the Central Bank set a deadline — end of March 1997 — by which their financial position should have been improved. In case of failure, the NBKR did not rule out decisions of liquidation. In the beginning of 1997, the Central Bank staff believed that the position of Promstroibank could be improved, but the AKB Kyrgyzstan was considered to be on the verge of bankruptcy.

The decisions on liquidation of the banks in 1996 were not confined to the group of former state banks. Decisions on liquidation of small banks and the commercial banks established in the nineties had already been taken over the previous two years. In 1994 three commercial banks were liquidated: Ch.B. Zhyrgal, KB. Urmatbank, AKB Saturn. In 1995 two banks were liquidated: AKB Adil, AK Kyrgyzdyikanbank. The main reason for their liquidation was permanent loss of liquidity resulting from the fact that they based their lending on the refinance credit obtained from the Central Bank. Its relation to total lending in the liquidated banks ranged from 48 to 72%. The loans granted by those banks were largely lost. To sum up, the banks liquidated in 1994 and 1995 had extremely poor performance records, lacked professionalism or served purposes which could not be identified with normal banking activity.

In 1996 another three banks were liquidated: Hen-Fen Bank, Orient Bank and Kyrgyz-Zher Bank. The reasons for their liquidation differed from the reasons behind liquidation of the banks in the previous years. These three banks were either in major part or totally foreign-owned. In the case of the Hen-Fen Bank the ratio was 100%, for the Orient Bank — 70%, and for the Kyrgyz-Zher Bank — 97.5%. The position of those banks was not particularly bad. The Orient Bank was even said to be one of the best banks in Kyrgyzstan.

The Central Bank withdrew the license for the German-Kyrgyz Orient bank on the grounds that it “failed to comply with the NBKR instructions, and revealed some compromising facts concerning the bank's shareholders” (“Pres-Reliz NBKR”, No. 19, May 1996). Moreover, as it followed from press reports, the main shareholder — a German citizen of Kyrgyz or Uzbek origin was accused of criminal offenses. Another factor which contributed to the shareholders' decision about liquidation of the bank was the shareholders' own conflict. The bank was able to pay all its liabilities proving that its actual position was rather good.

The situation of the Hen-Fen bank was much more complex. It was set up in 1992 on the basis of an agreement between two private companies from Hong-Kong and the government of Kyrgyzstan. The license was withdrawn on the grounds that its founders submitted forged documents to obtain the banking license. It also turned out that the starting capital of the bank amounted to USD 430,000 only, whereas the declared amount was USD 1 million. Furthermore, the source of the money was not documented. The audits carried out by the bank supervision authority at the Hen-Fen bank showed that the main shareholder used the loan obtained in the bank to finance his firms to a much higher extent than permitted by existing norms. As the Hen-Fen bank failed to comply with other NBKR norms, in autumn 1995 the Central Bank put

it under interim administration. The final decision to withdraw the banking license was taken in May 1996 (“Press-Reliz NBKR”, No. 19, May 1996).

In the case of the Kyrgyz-Zher Bank the license was withdrawn in December 1996. The causes given by the NBKR were as follows: failure to meet the requirement concerning the minimum starting capital, violation of the prudential norms set by the banking supervisory authority and loss of liquidity.

As the liquidation of the three banks with a considerable share of foreign capital shows, banking sector in Kyrgyzstan was “purged” of the banks with capital of dubious origin, and on the other hand, of the banks whose founding institutions proved unable to meet the required standards.

## **5.4. New Banks**

The liquidated banks were replaced by a Russian bank *Rossiysky Kredit* which obtained license for banking operations in autumn 1996. It was also expected that in the beginning of 1997 a Turkish bank — the Demirel's Bank would also be granted a license, its head office in Bishkek already being under construction since 1996. These two foreign banks — which have already entered or are to enter the Kyrgyz market of banking services — have a remarkable and strong position in their respective countries, which provides a guarantee that banking services in Kyrgyzstan will be upgraded.

Apart from the new foreign banks, two banks with national capital obtained licenses in 1996: AKB Toluby and AKB Eridan. In total, from mid-1994 to the end of 1996 four banks obtained licenses. In the case of an already registered bank major changes were allowed within the group of the shareholders (i.e., foreign capital was allowed to have share in a bank in poor condition). The new banks that came into operation in 1995 and 1996 were as follows: Joint-Stock-City Bank (AGB) Bishkek, Akylinvestbank, AKT Tolubaybank, AKB Eridan.

AGB Bishkek was registered in October 1995 with the starting capital of 5 million soms. The bank assumed the form of a closed joint stock company. Out of the 27 founders of the Bishkek Bank eight are legal persons contributing 47% of the total amount of the starting capital. The bank intends to cooperate with selfmanagement authorities and administration of the capital city by serving both communal and municipal needs with branches opened in every district of the city etc. In the proposed activities the bank is to become a coordinator of the credit and investment projects in Bishkek, aimed at solving the city's problems. (“Банковский Вестник”, No. 10, 1995, p.10).

Another commercial bank, the Akylinvestbank, was also registered in 1995 with the starting capital of 5 million soms. The share of artificial persons in the starting capital amounted to 93%. The last of the recently established banks — Tolubay Bank — obtained a license in January 1996. It was created in the form of a closed joint stock company with starting capital of 5 million soms. It was established by 14 individuals intending to engage banking activity of various kinds. AKB Eridan Bank was registered in December 1996. Its starting capital at the outset amounted to 10 million soms.

Apart from the newly listed commercial banks, in December 1995 the NBKR changed the legal form under which it had been recognized into an open Russian-Kyrgyz joint-stock company, called Amanbank. The Russian share in the starting capital of the bank amounts to 35%.

As it follows from the above, the Central Bank granted banking licenses with caution. Between January 1994 and October 1995, i.e., over nearly two years, no banks were established. As the situation in the banking sector deteriorated, and the already operating banks proved hard to control, the caution of the Central Bank was understandable.

## **5.5. The Situation in the Banking Sector**

Although in the first half of 1996 four banks were liquidated, later in the same year some new licenses for banking operations were granted. In September 15 banks were operating in Kyrgyzstan. Some of them were under direct supervision of the banking authority. Between the beginning of the year and September the assets of the banking sector decreased from 1,660 million soms to 1,146 million soms. The share of loans in the banks' assets fell considerably during that period (from 1,710 million soms to 643 million soms respectively). This was a direct result of closure of some banks. It was particularly true about the Agromprombank, with the share in the total banking sector's lending amounting to 52%.

The decisions about liquidation remarkably improved the condition of the credit portfolio of commercial banks, as the greatest part of credits ranked as either unrecoverable or dubious was in the credit portfolio of Agromprombank. The composition of the credit portfolio of the whole banking sector in Kyrgyzstan improved considerably due to the liquidation of that bank and to passing over the responsibility for debt recovery to a specialized agency. The data on the situation are as follows:

*Table 5.1.*

### **The composition of the credit portfolio of commercial banks**

| Category / Year                       | January 1995 | January 1996 | September 1996               |
|---------------------------------------|--------------|--------------|------------------------------|
| Normal                                | 1.3          | 4.7          | 12.4                         |
| Satisfactory                          | 7.8          | 9.9          | 31.0                         |
| Supervised (in effect since mid 1995) | ---          | 3.9          | 9.3                          |
| Sub-standard                          | 13.1         | 8.6          | (including the dubious) 33.7 |
| Dubious                               | 15.0         | 9.5          |                              |
| Lost                                  | 63.8         | 63.4         | 13.6                         |

Source: NBKR Report for 1996, and *Current tendencies in the activity of commercial banks as for 1 September 1996* "Банковский Вестник", No. 10/1996, p. 13.

Short-term loans, granted mainly to industrial and commercial enterprises, constituted, as in the previous years, a dominant part (90%) of all provided loans. The nominal value of deposits in the commercial banks rose by about 10% over 1996, which — given the inflation rate — implied a fall in the value of deposits in real terms. By the end of the year, as the exchange rate of the som to the dollar dropped, the value

of deposits fell by 4-5%, whereas the ratio of foreign currency proportionately increased (from about 20% in mid-year to 30% at the end of the year). Current accounts of economic subjects represented a major part of deposits. The loan rate was twice to three times higher than the deposit rate throughout the year.

Also in 1996 commercial banks were obligated to create special funds for unrecoverable and dubious loans. According to the tax regulations in force, however, only after-tax profits could be used to build reserves. Moreover, the new Tax Code, passed in mid-1996, contained discrepancies which rendered the problem even more difficult. According to the article No. 104 of that Code the banks' cost accounts could be debited with the total amounts of reserves, whereas according to the article No. 105 the amount in question could not be larger than 10% of the insured resources. With this constraint, the banks could hardly attain the required level of resources within the given time limit, the date was extended and the process was broken up into stages. Under the circumstances commercial banks practically did not earn any profit.

## **5.6. New Financial Institutions**

The three financial institutions — none of them being a commercial bank — established in Kyrgyzstan in 1996 were meant to help to improve performance of the banking sector. After the liquidation of two big commercial banks with extensive branch networks the shortage of banking services made itself felt and had to be filled. The major problems to be solved were as follows:

- securing payments in budgetary sector,
- maintaining a repository of the population's savings,
- setting up an institution for providing loans to reformed agriculture,
- creating an institution for settling accounts and recovery of the debts incurred by the liquidated banks.

In order to attain the first two objectives the Central Bank set up the so-called Savings and Accountancy Company, with starting capital of 1 million soms. It is not assumed to be a banking institution — it neither has the minimum required capital nor fulfills prudential norms. It is not authorized to lend money, and can invest resources only in Treasury bonds.

The new financial institution was primarily obligated to help the budgetary sector with payment of salaries and pensions. The Company was able to secure settling of budgetary accounts on the country-wide scale by using the 50 branches of the liquidated Agroprombank, scattered all over the territory of Kyrgyzstan. At the end of 1996 it had effected 20% of all budgetary payments. In the first quarter of 1997 the proportion of the payments rose to 50%. According to the assigned role the Company runs accounts of many state institutions. Thus, the resources on current accounts of its clients rose to 20 million soms at the beginning of 1997. The Company intends to streamline budgetary payments by introducing some new operational techniques — new accountancy system, computerized operations — to achieve time and cost economics.

Another reason for establishing the Savings and Accountancy Company was attracting deposits of private persons after the liquidation of the Savings Bank. The Company offered the population an opportunity to open both current and long-term

accounts. As a rule, its deposit rate is linked to the return rate on the Treasury bonds at the auctions organized by the NBKR. Deposit rate at the Company is lower than the rate at commercial banks, but safety of deposits is believed to be greater in the former. It plans to set up a network with a data base which will enable cashing of bills at any of the Company's branches. Eight counters accepting deposits from individuals were opened over the first six months of activity and 500,000 soms were accumulated. The amount represents a small fraction of the population savings that could be attracted. The deposits of the liquidated savings bank amounted to 100 million soms. That is why the prospects for that line of the Company's activity can be viewed with optimism, as it keeps opening new branches.

The Company's operations on State Treasury bonds are an important part of its activity — it has become a significant participant on the secondary market. During three months at the turn of 1996 it conducted sales and redemption operations of the state bonds of 40 million soms worth.

The Savings-Accountancy Company also became a participant of the inter-bank market. For the first half of the year of its activity it placed 3 million soms through that market. It lent to banks on 100% pledge of the liquid assets to protect itself. This caution is justifiable by the hazards of the situation in the banking sector and poor legal protection. Given very limited turnovers on the inter-bank market, the Company has a relatively significant position with a 50% share of the market. It hopes that inter-bank loans and secondary securities will be the main market of its capital assets operations. At the same time, at the beginning of 1997 the Company applied to the Central Bank for a license for foreign exchange operations. The number of its clients and its turnover are steadily growing. Given the rapid development of the Company's operations it would be important to answer some questions concerning the future course of its transformation.

Further course of the Company's development has not been clearly defined. As its starting capital is limited, and its scope of operations on the short-term financial markets is wide, the supervisory banking authority was confronted with the necessity to prepare a special instruction and introduce norms binding for the institutions of this kind. On the other hand, the management of the Company aims at setting up a bank with state institutions as founders and stockholders. It would be a clearing bank for all the non-bank participants of the short-term financial markets. Among the concepts there is one that involves transformation of the Company into a savings bank. In that case, however, the FINSAC program would be an obstacle as there were no plans to create such a company or transform it along those lines.

Another specialized financial institution created in 1996 is the Kyrgyz Agricultural Corporation. It was established on the basis of joint decision of the Kyrgyzstan government and the World Bank. That institution earmarked USD 12 million for that project. Its main objective is to provide financial aid to private and newly created farms operating on market principles and to the so-called agribusiness. It was created as a typical credit and finance organization which might be transformed into a bank. From the outset its starting capital amounted to 150 million soms. Although the new corporation is government-owned, also private sector representatives are in the management. In the future shares are to be sold to private sector and foreign banks. Financial assistance to agriculture will include short-term,

medium-term and long-term loans. Those credits may be used for different purposes (purchase of agricultural raw materials, remuneration of hired labor, construction and repair of the buildings used for production purposes, development of animal husbandry, leasing of machinery and agricultural equipment, etc.) The statutory activity of the Corporation has not started yet. For the preceding half of the year its operation principles (methods of assessment of the prospective borrowers, methods of securing loans, monitoring principles) have been worked out. The European Union and the Swiss government promised to provide technical and educational aid. Lending is to start in the second half of 1997.

The third financial institution created in May 1996 by the Central Bank was the Agency for Bank Reorganization and Debt Recovering — DEBRA. It was a component of the program of reform in the banking sector — FINSAC. The envisaged time horizon of the Agency's activity was three years. Its main objective is to consolidate debts of enterprises which had been contracted by the liquidated banks. According to the program debt recovery may take any form of the restructuring, sale or bankruptcy procedures. The Agency is to get resources from the NBKR, which in turn is to obtain long-term, 15-20 years government bonds. In part the resources are to be raised by the Agency through recovery or sale of debts (5% of the resources the Agency will manage to mobilize itself are to be booked to its credit). The main emphasis in the Agency's activity will be on bad loans recovery. A special instruction has been prepared, in which debt recovery procedures are thoroughly reviewed (the instruction is discussed in “Слово Кыргызстана”, September 5, 1996, p.8).

A debt may be written off only after using every possible procedure of recovery. The Agency is authorized to write off a debt, provided the amount of credit concerned did not exceed 50,000 soms. Higher amounts can be written off only by the State Committee for Restructuring Finance and Banking. It is headed by the Prime Minister; the Minister of Finance, the Minister for Economic Affairs, and the President of the Central Bank are among its members. (*Time to Consolidate Debts*, “Áříęâńęćé Ářńńíčę”, No. 10/1996, pp. 8-11).

The first credit portfolio the Agency dealt with was the one of the liquidated Agroprombank — 3,655 cases of bad loans amounting to 1,400 million soms total. It took half a year to analyze indebtedness and to sign the agreements on debt restructuring and repayment with all the major borrowers. In most cases, the deadline for debt repayment was extended. The interest that had been charged by the bank was partly canceled to make the repayment of the main amount of the loan possible. By mid-February 1997, 15 million soms of debt had been recovered. The Agency has also organized four auctions to sell pawns. But out of the 83 objects put on sale only 19 were sold for 1,250,000 soms. At the end of 1996 the Agency filed two bankruptcy petitions in court. As a result of the pressure exercised by the Agency the two enterprises concerned reached an agreement on the conditions of debt repayment. The example proved instructive for other sluggish debtors.

By virtue of the President's Decree, the control over the repayment of the money borrowed from the state over the past years by the producers operating in the nationalized sector of agriculture was transferred from the Ministry of Agriculture and regional administration bodies to the Agency. The very hard task it has to complete has been compounded by poor documentation, the lack of pawns and the liquidation of

some kolkhozes and sovkhoses concerned. Moreover, the Agency is expected to recover debts from the portfolio of the liquidated savings bank.

## **5.7. The FINSAC Program**

On 3 July 1996 an agreement was signed in Washington between the Republic of Kyrgyzstan and the International Development Agency (IDA — an organ of the World Bank). It envisaged that the government of Kyrgyzstan would be granted a credit of USD 45 million to help with restructuring of the financial sector (FINSAC).

The aid program to the financial sector in Kyrgyzstan has three main parts:

1. The first part deals with legislation and organization. In the first instance this concerns the laws on the Central Bank and banking system. Apart from that the program includes changes in legislation concerning bankruptcy, pawns and their registration, mortgage and changes in taxation. It is assumed that new legislation should upgrade organizational and economic capacities of the banking sector operating in the conditions of market economy.

2. The second component of the program involves restructuring of the former state banks. In fact, it accepts liquidation of two of them and approves of restructuring of the two that have remained. In order to solve the problem of unrecoverable debts remaining after liquidation of the most heavily indebted banks, the program has envisaged that a special Agency will be set to deal with the problem.

3. The third group of problems concerns creation of conditions for development of financial institutions such as investment funds, insurance funds and pension funds. As legislation in that area is lacking and non-banking institutions of the financial market are in the embryonic state, a broad educational program has been envisaged.

The management of the Central Bank considers the implementation of the FINSAC program as delayed. It should have been started earlier, at least as early as the PESAC program aimed at restructuring of the largest industrial enterprises in Kyrgyzstan. The problem of indebtedness of those enterprises has not been solved under the program. As the debts have only been frozen, it has only deteriorated the financial condition of the three big banks where the debts were concentrated.

## **5.8. Conclusions**

Throughout 1996 and in the first quarter of 1997 the banking sector in Kyrgyzstan was facing serious problems. They resulted from small capital base of the banks, low level of savings and deposits, a large portfolio of non-performing credits, limited range of banking services and low staff qualifications. Poor condition of the national economy had an immediate adverse effect on the banking sector and its performance. Lending by commercial banks was very limited and confined mainly to short-term loans provided to the services sector.

The problems mounting in the banking sector made necessary its immediate restructuring. It can be expected that the steps undertaken in 1996 will help to improve its performance considerably. This should be an important factor in realizing Kyrgyzstan's potential for economic growth. It may prove to be even faster, if banking sector is ordered and consolidated without delay. Consistent observation of the NBKR

instructions should result in the growth of capital and its security connected with the level of reserves. Mergers of smaller units involving creation of bigger entities are also encouraged. The policy of attracting new foreign capital to the banking sector should improve the capital “quality”, and contribute to growth of competition in the sector of commercial banks in general.

Further objectives are as follows:

- providing a legal framework for the Central Bank and the activity of the banking sector,
- providing for the tax regulation conducive to the increase in the capital and the required reserves of the banking sector,
- elaboration of a long-term program of further development of banking sector.
- preparing a clear program of setting up new banks or consolidation of the old banks with special attention given to the savings bank,
- promoting further consolidation of the banking sector, promoting development of two or three leading institutions in that sector, able to compete with foreign banks,
- promoting specialization branch-wise and regional specialization of the banks which had been created as universal banks,
- raising competition by stimulating cost reduction, use of new techniques and introduction of new banking services,
- launching of a broad program of upgrading qualifications of the banking staff.

Table 5.2.

**NBKR auctions in 1996**

|           | Credit auctions    |               | Foreign exchange auctions |                             | Treasury bonds auctions |                      |                      |               |               |
|-----------|--------------------|---------------|---------------------------|-----------------------------|-------------------------|----------------------|----------------------|---------------|---------------|
|           | value in '000 soms | interest rate | value in '000 soms        | Exchange rate to the dollar | value in '000 soms      | Including            |                      | Simple yield  |               |
|           |                    |               |                           |                             |                         | 3 month in '000 soms | 6 month in '000 soms | 3 month bonds | 6 month bonds |
| January   | 6000               | 46.80         | 192311                    | 11.30                       | 5000                    | 5000                 | -                    | 29.59         | -             |
| February  | 4000               | 37.80         | 124085                    | 11.40                       | 14000                   | 14000                | -                    | 32.08         | -             |
| March     | 2500               | 36.20         | 96878                     | 11.35                       | 18000                   | 17500                | 500                  | 35.53         | 52.20         |
| April     | 2500               | 36.20         | 120933                    | 11.65                       | 21500                   | 20500                | 1000                 | 37.27         | 48.93         |
| May       | 745                | 36.70         | 76053                     | 12.00                       | 31500                   | 26500                | 5000                 | 36.14         | 46.16         |
| June      | 480                | 36.70         | 70356                     | 12.20                       | 32000                   | 24000                | 8000                 | 34.03         | 41.12         |
| July      | 630                | 40.04         | 65124                     | 12.25                       | 33000                   | 24000                | 8000                 | 36.18         | 46.13         |
| August    | 480                | 40.04         | 75648                     | 12.15                       | 44000                   | 29000                | 14000                | 29.55         | 39.03         |
| September | 480                | 40.04         | 37500                     | 13.25                       | 37500                   | 20500                | 16000                | 54.15         | 68.42         |
| October   | 540                | 45.90         | 109328                    | 15.40                       | 40000                   | 20500                | 19000                | 50.65         | 63.88         |
| November  | 360                | 45.90         | 218758                    | 16.85                       | 44000                   | 19000                | 25000                | 48.30         | 62.60         |
| December  | 60                 | 45.90         | 126649                    | 16.70                       | 51000                   | 26500                | 24500                | 52.32         | 63.19         |
| TOTAL     | 18775              |               | 1313623                   |                             | 371500                  | 247000               | 121000               |               |               |

Source: “Банковский Вестник”, No. 12/1996, p. 21

## 6. Privatization

(Jarosław Kuźma)

### 6.1. Introduction

In the market economy, there are two basic types of enterprise property: private and state-owned. A private firm is almost always more efficient than an analogous state company. This is due to profit maximization by the private contractor. A public enterprise does not have a real, responsible owner. The supervisor of a state-owned firm is not personally interested in efficiency. He/she maximizes not profits, but political power or other non-pecuniary benefits. Hence, the public sector of the economy is ineffective and usually not competitive. It is therefore desirable to minimize its role. Besides, the main task for the government is to provide public goods to the society. Taking care of enterprises is an additional, useless task for the authorities.

In the centrally governed (socialist) economy there is no real market and no private ownership of the means of production, so talking about efficiency is useless. Privatization is one of the most important elements of transition from planned to market economy. Privatization means sale by the state of state property units and stocks to private legal entities and individuals. The transfer of state enterprise supervision to a Board of Directors in post-Communist countries is called denationalization. 1996 was the first year of the third stage of privatization and denationalization processes in Kyrgyzstan.

The privatization process in Kyrgyzstan started in January 1992. A radical change of property structure in all branches of the Kyrgyz economy was planned for the first, two-year stage. The reform covered 33% of state fixed assets. Most of the enterprises were only denationalized. Employees seized 80% of privatized companies. The structure of the economy hardly changed and there was no significant increase in efficiency. "Small privatization" of tiny enterprises proceeded successfully.

In the second stage (1994-1995) conclusions were drawn from the mistakes of the first stage. Present privatization legislative framework was elaborated and introduced. Privatization methods and rules were made easier. Employee privileges were decreased. Coupon privatization was launched. About a half of the enterprises was privatized.

### 6.2. Legislative Framework for Privatization in Kyrgyzstan

The process itself is regulated by the law *On Denationalization and Privatization of State Property in the Kyrgyz Republic* (January 1994). Every second year the parliament elaborates detailed *Concepts of Denationalization and Privatization in the Kyrgyz Republic*. The State Property Fund prepared, by government order, *Programs of Denationalization and Privatization* for the years 1994-1995 and 1996-1997. Private and public entrepreneurship activity is legislatively regulated by the Civil Code (May 1996). The government is charged by the Constitution and acting legislation to

guarantee the rights of private investors. All necessary legal protection, such as protection against unfair expropriation and nationalization are obliged.

State owned enterprises and organizations, their structural departments, objects in the social and cultural sector and state owned stocks are designated for privatization. Objects not to be privatized include: widely considered public goods and their providers, land, natural and water resources, forests, rail transport, historical monuments. Privatization of objects in some sectors (e.g., mining) requires special licensing.

The state is able to hold the “golden share” of a privatized enterprise. In such cases the state officials have not only the “veto” right, but even the right to influence important strategic decisions. Hence, the other share-holders are not sovereign. It is an obvious restriction of the right of possession. On the other hand, the state takes over a part of responsibility for a given enterprise. This involves some kind of gratis state guarantee for the company activity (e.g., credit guarantees).

Purchasers of state owned objects can be either Kyrgyz or foreign individuals or legal entities, unless the state share in their assets exceeds 25%. The only condition is the preparation of a privatization project.

There exist state provided facilities for privatization of objects at high altitudes. Such objects operate in much more difficult environmental and climatic conditions.

**Organization Structure.** Every privatization project is analyzed by the State Property Fund, created in 1992. The Fund is subject to the Parliament, although its chairman has the rank of deputy prime minister. The Fund prepares projects of privatization laws, elaborates and implements policy and strategy of privatization. It represents the state as an owner. The State Property Fund organizes coupon auctions for mass privatization. From 1996 the Fund's new duty is to draw foreign direct investments. All revenues from the Kyrgyz privatization go to the Fund, and 93% of them are then transferred to the state budget. The rest 7% covers Fund's internal expenditures.

### **6.3. Methods of Privatization of Enterprises**

The method of privatization depends on the size of the company, evaluated by the number of employees. All privatized Kyrgyz enterprises were divided into three groups. Firms employing less than 100 persons are to be auctioned with a tender process used in certain specific cases. This is the so called “small privatization”.

Bigger enterprises are firstly denationalized, then transformed to joint stock companies. Their stock is divided into three parts.

Maximum 5% of shares are given to employees free of charge. Presently, the number of employees' free shares in newly privatized enterprises is decreasing.

25% of shares was set aside for the mass privatization program. Since June 1997 this program has been completed. Undistributed shares magnified the remaining third part.

The remaining minimum 70% shares of Kyrgyz companies is to be privatized in the following manner: medium size enterprises (100 to 1000 employs) are sold entirely or partly to the investor with the best privatization project. The structure of large

enterprises (over 1000 employees) is transformed to corporate system. Blocks of their shares can be sold in several ways: through the stock exchange, cash or coupon auctions, to the winner of privatization project competition, to direct investors, to cooperating firms and finally to employees. Worker crews usually try to take over 50% shares of enterprises. Sometimes they unlawfully restrict rights of external investors. Over 10% of privatized enterprises is fully owned by their employees. In 28% of privatized companies the workers possess more than 50% shares.

In some cases a firm can be leased or even handed over free of charge.

**Mass (coupon) privatization.** 25% of shares of 985 state enterprises were designated to this program. According to the acting regulations, every citizen of Kyrgyzstan was entitled to a certain amount of coupons enabling him/her to take part in the mass privatization process. Over 76% of population participated in coupon privatization. Coupons were securities that could be used in four ways. If a coupon holder did not want to invest his/her coupons, he/she could use them on purchasing lodgings or simply sell them on the market. The investor could also exchange coupons to company shares during special auctions. These auctions were organized by the State Property Fund for individuals and special investment funds. The funds invested on behalf of the citizens, who in exchange retained a share in the investment fund. One-fifth of the coupon holders decided to avail of such funds. Shares of all enterprises covered by the mass privatization program were offered on auctions till 30 June 1997. Presently, mass privatization is finished. During 41 coupon auctions individuals purchased 50% of the offered shares of enterprises. Funds invested in 10% of shares. More than 14% of shares were purchased by other legal entities. A significant quantity of coupons was not realized in any of the possible ways and lost its value.

## **6.4. Privatization Problems**

At the first glance privatization carries only undoubted economic advantages. The process should have social support, as citizens' welfare would increase. Nevertheless, privatization meets some resistance and objections wherever it is implemented. Kyrgyzstan is not an exception.

At the beginning of the privatization process employees had a privileged position. A part of shares was given out to them free of charge. This discriminated citizens who did not work in the privatized companies. Employees should work for their salaries, and not for shares of their companies. Besides, the worker crews are often dominated by the boards of the enterprises, facilitating the takeover of control by former soviet directors (privatization by propertization).

Coupons were not distributed equally to all citizens in the mass privatization program. The quantity obtained depended on salary and work period of the employee. This could have been considered by some people as unfair discrimination.

State property is being sold by a state organization (the Fund). In the setting of high inflation and absence of efficient capital markets it is hardly possible to estimate the real value of the enterprises. Suspicions arise of bribe-taking. Officials are accused of purposely underestimating the prices of privatization projects. In the post-

Communist countries it is called “sale of the common social property for almost nothing”.

The problems mentioned above retard the realization of privatization goals.

**Privatization goals for the year 1996.** The main purpose of reform was to start changes in large state-owned monopolist enterprises and holdings. They were supposed to be denationalized and transformed into joint-stock companies. Due to their influence on the national economy, they shall not be fully privatized. The state is going to keep control packets of their shares. Other aims were to finish the mass privatization and to increase of direct foreign investment attraction. Economy was estimated to be private in over 65%. Budget privatization revenues should have amounted to 160 million soms (about USD 9.5 million).

**Results of privatization in 1996.** According to the State Property Fund by January 1997 the reform had covered over 6200 out of 10,000 primarily state owned enterprises (excluding the agricultural sector). In 1996, 327 enterprises were transformed. Their book value amounted to 1479 million soms (USD 87 million). Among them, 65% were privatized, and 23% changed to joint stock companies. Privatization revenues amounted to 111 million soms (USD 6.5 million). Only 70% of the plan. Since the beginning of the program, privatization ratios in different sectors are as follows:

- industry — 81%,
- trade — 98%,
- construction — 58%,
- transport — 48%,
- public services — 100%.

Obviously, the education system and health services were not considered to be public services. Low ratio of privatization in the transport sector is explainable in the light of legal regulations.

Results of privatization seem to be satisfactory. However, all data relate to the quantity of enterprises, and not their aggregated value. This can be misleading, because in the beginning the program covered enterprises that were easier to privatize, mostly small or medium size. Their aggregated value is not very high. Most of fixed assets are still controlled by the state.

**Foreign direct investments.** The legislative environment for foreign investors is very favorable. Regulations provide guarantees for investments that are at least as favorable as those for citizens. Prior to July 1997 foreign investors had additional tax benefits.

In January 1997 total foreign direct investments (FDI) amounted to USD 544 million. In 1996 there was a foreign investment capital inflow of over USD 350 million, 1.9 times more than in the preceding year. The dominating foreign investor in Kyrgyzstan is Kumtor Operating Company (gold mining enterprise). It has invested USD 450 million (83% of total FDI), including USD 322 million (92% of total FDI) in the year 1996. The rest of FDI is negligible, making it difficult to consider the results of attracting foreign investments to the privatization program as a success. (On the

other hand, Kumtor gold production is supposed to increase Kyrgyzstan's GDP by 30%!)

***Agricultural reform.*** Unfortunately, plans of land privatization in Kyrgyzstan are still non-existent. All agricultural land belongs to the state. In 1994 the President of the Republic issued a Decree *On Measures of Development of Land and Agricultural Reform in the Kyrgyz Republic*. According to the Decree, citizens and enterprises of Kyrgyzstan are able to possess only the right to use land, especially for agricultural production. The right may be granted for the period of 49 years, with a possible extension to a maximum of 99 years. Agents can sell, change, transfer, lease and pledge only this right to the land, not the land itself. This rather discourages peasants from long term planning and investment. Until the end of 1996 151 agricultural enterprises were denationalized in Kyrgyzstan (18 state farms — *sovkhoses*, 19 collective farms — *kolkhozes* and 101 other large farms). They were transformed to 13,265 independent farm households and 717 agricultural cooperatives. The number of independent farms increased to 30,989. The number of cooperatives accrued to 1,063. At the beginning of 1997 53 large state-managed agricultural enterprises remained, including 12 *sovkhoses* and 14 *kolkhozes*.

***Residence privatization.*** In 1996 only 9600 lodgings were sold to its inhabitants and 5600 were given free of charge. (This discrimination seems to be unfair and unintelligible.) The amount of coupons used in residence privatization was negligible. People preferred to spend their coupons on privatized enterprises with hope for possible future benefits from share ownership. Perhaps the inhabitants do not find advantages in residence ownership. The conditions of state-owned houses are bad. Dislodging is hardly possible because of legal and social reasons. Most of the privatized flats are found in the two largest Kyrgyz cities: the state capital Bishkek and Osh.

***Privatization in 1997.*** In 1997 government officials were accused in many cases of purposely underestimating the prices of privatization projects. These charges led to a Decree of Kyrgyzstan's President stopping privatization in the Republic. A board of inquiry led by the national prosecutor was appointed. At the same time Kyrgyzstan's Parliament Jogorku Kenesh has been working on detailed projects of privatization of the nine “natural” monopolists like Kyrgyzstan Airlines Aba Joldory, Kyrgyz Telecom and Kyrgyzneft Oil Company. Because of their size and importance to the whole national economy, every project is considered separately. A transfer of 8% shares of these huge companies to transfer takers is planned. Pensioners, war veterans and the handicapped will obtain nominative shares that give the share-holders a right to take dividends, but not the right to sell the equities. One of the largest enterprises, Kyrgyz State Energy Holding Company, is going to be privatized in four stages that will last till the end of the century.

## 7. Social Transfers in Kyrgyzstan\*

(Irena Topińska)

Kyrgyzstan entered the year 1996 with a high level of social transfers, accompanied by a serious deficit of the consolidated state budget. In 1995, total spending on social protection — including pensions, unemployment, sickness, maternity, state allowances and related benefits — amounted to 1,900 million soms, i.e., to almost 12% of GDP (see Table 7.1). Adding health care, education, housing and communal sectors, public spending reached over 3,700 million or 23% of GDP. At the same time, state budget deficit was dangerously high, amounting to 11.8% of GDP, while that of the Social Fund — the fund paying pensions, unemployment and all other social insurance benefits — was much lower, but still significant. These figures alone reveal problems of financing social transfers faced by the Kyrgyz government at the beginning 1996.

In terms of total spending, the situation looked better in 1996. Over the year, all social transfers took less than 4,500 million soms, or less than 20% of GDP (see Table 7.1). Also, the budget deficit was much lower (5.6% of GDP), and the deficit of the Social Fund stabilized as compared to the GDP. This resulted, it seems, from the GDP growth (5.6% in 1996) rather than from deliberate and effective policy measures.

This is not to say that the government has completely avoided to transform the social sector. On the contrary, many efforts were made to prepare new reform proposals which could have improved financing and administration of social transfers. In 1996, special attention was paid to pensions and to health care. Profound systemic reforms were intended in each case, but unfortunately reform implementation had limited success.

Reforming pensions seems to be especially important, given the amount spent and the number of beneficiaries affected. Therefore, the description of Kyrgyz social transfers of 1996 starts with the pension system. Then, benefits for the unemployed and state allowances are discussed. Issues concerning health care and education come at the end of the section.

### 7.1. Pensions

From the point of view of the pension system, demographic composition of the Kyrgyz population is favorable. The number of people in pensionable age (women 55+, men 60+) remains below 10% of the total (9.8% in January 1, 1995 and 1996) or less than 20% of the population in the working age (19.5% at the beginning of 1995, 19.4% a year later). Moreover, these indices may improve in the future: according to the forecast of the National Statistical Committee the population in the working age

---

\* These notes have been written as a result of three short-term missions of the author in Kyrgyzstan, in April - May 1996, in August 1996, and in May 1997. Detailed reports from these missions are available at CASE (see: Topińska I., *Расходы на содержание социальной сферы Кыргызстана в 1994-1995 годах*, CASE, November 1996, and Topińska I., *Sfera socjalna w Kirgistanie: przewidywane zmiany organizacji i finansowania*, CASE, memo, August - September 1996).

will grow at the annual rate of 2.9% in 1995 - 2005, while that in pensionable age at a very low rate of 0.3%.<sup>24</sup> Nevertheless, the system is in financial crisis, and the situation may worsen, if profound changes are not introduced.

*Table 7.1.*

**Social transfers in Kyrgyzstan, 1995-1997**

| Main items                              | 1995           | 1996 <sup>a</sup> | 1997 <sup>b</sup> | 1995           | 1996 <sup>a</sup> | 1997 <sup>b</sup> |
|---|----------------|-------------------|-------------------|----------------|-------------------|-------------------|
|   | million soms   |                   |                   | percent of GDP |                   |                   |
| Pensions                                | 1,208.8        | 1,781.9           | 2,085.2           | 7.49           | 7.93              | 7.37              |
| <i>of which: worker pensions</i>        | <i>1,095.6</i> | <i>1,617.7</i>    | <i>1,849.4</i>    | <i>6.79</i>    | <i>7.20</i>       | <i>6.54</i>       |
| Sickness, maternity & other SI benefits | 103.0          | 105.8             | 206.0             | 0.64           | 0.47              | 0.73              |
| Benefits for the unemployed             | 33.7           | 59.0              | 104.0             | 0.21           | 0.26              | 0.37              |
| <i>of which: unemployment benefits</i>  | <i>20.0</i>    | <i>34.4</i>       | <i>43.0</i>       | <i>0.12</i>    | <i>0.15</i>       | <i>0.15</i>       |
| State allowances                        | 428.8          | 404.0             | 391.7             | 2.66           | 1.80              | 1.38              |
| Other SA benefits                       | 126.5          | 115.1             | 237.0             | 0.78           | 0.51              | 0.84              |
| Housing & communal sector               | 183.3          | 131.2             | 195.8             | 1.14           | 0.58              | 0.69              |
| Public health care                      | 593.9          | 654.6             | 817.0             | 3.68           | 2.91              | 2.89              |
| Education                               | 1,041.1        | 1,187.8           | 1,471.5           | 6.45           | 5.29              | 5.20              |
| <b>TOTAL</b>                            | <b>3,719.1</b> | <b>4,439.4</b>    | <b>5,508.2</b>    | <b>23.04</b>   | <b>19.76</b>      | <b>19.46</b>      |
| <i>Memo:</i>                            |                |                   |                   |                |                   |                   |
| GDP                                     | 16,145.1       | 22,467.8          | 28,298.1          | 100.0          | 100.0             | 100.0             |
| Social Fund deficit                     | 55.8           | 79.4              | 185.3             | 0.35           | 0.35              | 0.65              |
| State budget deficit                    | 1,864.6        | 1,376.1           | 1,612.0           | 11.55          | 6.12              | 5.70              |

Notes: a — preliminary, b — budget. Pensions — spending of the Social Fund on all types of pensions, including administration costs. Sickness, maternity and other SI (social insurance) benefits — total spending of the Insurance Fund (a part of the Social Fund). Benefits for the unemployed — total spending of the Employment Fund. Sickness, maternity, unemployment in 1997 — including health care contribution for pensioners and unemployed persons. State allowances — 'unified' family allowance (income tested) and social allowance (formerly social pension) paid out of the state budget. Other SA (social assistance) benefits — special allowance (reduced tariffs, credits, etc.) for selected groups of population (veterans, rescue team members from Chernobyl etc.). Housing and communal sector — subsidies and other spending.

Source: GDP — NBKR 1996 Годовой отчёт, 1997 estimated from the Ministry of Finance data. Pensions, other SI benefits, and benefits for the unemployed — *Проект бюджета Социального Фонда на 1996 и 1997 года*. State allowances, other SA benefits, housing and communal sector, health care, education — data from the Ministry of Finance (*Аналитическая таблица доходов и расходов госбюджета КР за 1994 - 1997 годы*).

**Current system.** At present, pensions (old age, invalidity and survivor) are financed on the PAYG basis from the Social Fund. Contribution is levied on the wage bill at the following rate (in percent):

<sup>24</sup> In 2005-2015, this tendency will be reversed. It is predicted that the rate of growth of the number of the elderly will be higher than that of the number of people under a pensionable age.

Table 7.2.  
**Contribution on the wage bill (in percent)**

| Contribution financing:                              | Employer contribution | Employee contribution | TOTAL contribution |
|--|-----------------------|-----------------------|--------------------|
| pensions, sickness, maternity and related benefits   | 33.0                  | 2.0                   | 35.0               |
| unemployment benefits & active labor market programs | 1.5                   | 0.5                   | 2.0                |
| health care (since 1997)                             | 2.0                   | x                     | 2.0                |
| TOTAL  | 36.5                  | 2.5                   | 39.0               |

The main benefit paid by the Social Fund — and the one the most discussed — is the old age or retirement pension. Eligibility to this pension is not restrictive. Old age pensions are paid to women over 55 (minimum length of service 20) and to men over 60 (length of service 25), so both requirements are rather loose. Moreover, there are many cases — listed in the so called *Ňd'čnîę* 1 and 2 — in which these requirements are not binding. As a result, the number of old age pensioners is rather high (see Table 7.3), and over 17% of them receive benefits at a lower age and/or length of service than indicated by general regulations. It should be noted, however, that recently the number of old age pensioners has been declining slightly, from 450 thousand at the beginning of 1995, down to 444 thousand in 1996, and 440 in 1997 (see Table 7.3).<sup>25</sup> One of the reasons for this decline might have been an intense emigration process.<sup>26</sup>

Pension level is not related to the contribution. Retirement pension is paid at a rate of 55% of the average wage of a pensioner (computed on a five year basis, selected out of the last fifteen years of work) plus 1% of this average for each year of work above the minimum requirement. A higher rate is set for those listed in *Ňd'čnîę* 1 and 2. Pensioners are also entitled to various supplements and/or allowances. According to the regulations, pensions should be indexed with inflation (strict rules). In fact, occasional presidential decrees fix exact dates and rates of benefit re-evaluation.

Relatively to the wage rate pension level is not high, but this ratio has increased recently: from 45.9% in January 1995, up to 46.6% in 1996, and 47.3% in January 1997 (see Table 7.3). Also, it should be noted that the share of pensions in GDP has actually increased — from 7.7% in 1995 up to 7.9% in 1996 (see Table 7.1) — revealing a tendency opposite to most social transfers.

***Crisis of the pension system.*** Main symptoms of the crisis are as follows. First, the Social Fund — since its establishment in 1993 — has been in deficit. In fact, it refers to that part of the Fund which may be called “the Pension Fund”, while two other parts i.e., “the Social Insurance Fund” (financing sickness, maternity and other short term benefits) and the Employment Fund (financing unemployment benefits and active labor market measures) both produce a surplus. The deficit remains substantial (see Table 7.1), despite a considerable state budget subsidy (see Table 7.3). The state subsidy amounted to 182 million soms or 4.0% of the total state budget spending

<sup>25</sup> At the same time, the number of invalidity pensioners (small compared to the number of the old age pensioners) has been increasing from 45 thousand in 1995 up to 50 thousand in January 1997.

<sup>26</sup> Net emigration was equal to 51 thousand in 1994, 19 thousand in 1995, and 13 thousand in 1996.

(15.1% of total pensions) in 1995, rose significantly in 1996, i.e., 314 million soms or 6.4% of the budget (17.6% of pensions), and was planned at 280 million soms (3.4 and 13.4% respectively) for 1997.<sup>27</sup> Moreover, the state budget also covers pensions for the military and special pensions. This transfer is not treated as a subsidy; nevertheless it shows additional expense for the budget.

*Table 7.3.*

**Pension system in Kyrgyzstan: main indicators, 1995-1997**

| Main items  | 1995    | 1996 <sup>a</sup> | 1997 <sup>b</sup> |
|---|---------|-------------------|-------------------|
| Number of pensioners, Jan 1 (thousand)                                    |         |                   |                   |
| old age   | 449     | 444               | 440               |
| invalidity  | 45      | 48                | 50                |
| Ratio of the average pension (all types) to the average wage, January (%) | 45.9    | 46.3              | 47.3              |
| State Budget total spending (million soms)                                | 4,610.5 | 4,899.3           | 6,301.5           |
| Social Fund total spending (million soms)                                 | 1,345.5 | 1,946.7           | 2,489.2           |
| of which: pensions (million soms)   | 1,208.8 | 1,781.9           | 2,085.2           |
| State Budget subsidy to the Social Fund (million soms)                    | 182.0   | 314.0             | 280.0             |
| as % of the total State Budget spending                                   | 3.95    | 6.41              | 4.44              |
| as % of the total pensions  | 15.06   | 17.62             | 13.43             |
| Unpaid contribution cumulative, Jan 1 (million soms)                      | NA      | 724.0             | 329.0             |
| as % of the total spending of the Social Fund                             | NA      | 31.19             | 13.22             |
| as % of the total pensions  | NA      | 40.63             | 15.78             |

Notes: a — preliminary, b — budget. Pensions — spending of the Social Fund on all types of pensions, including administration costs. In 1995, State Budget subsidy to the Social Fund include payments of supplements and compensations.

Source: Pensioners, pensions, Social Fund spending, and personal communications — *Проект Бюджета Социального Фонда на 1996 и 1997 года*. State Budget spending and subsidy — data from the Ministry of Finance. (*Аналитическая таблица доходов и расходов госбюджета КР за 1994 - 1997 годы*).

Second, contribution collecting by the Social Fund is very ineffective. This certainly affects mostly pensions, since other benefits financed by the Fund (sickness, maternity, unemployment) constitute altogether 10 to 15% of the total Fund expenditure. There are two problems involved here: (i) the shrinking number of contributors resulting from breakdown and transformation of the economy, and (ii) delays of contribution payments partly reflecting monetary constraints faced by enterprises and institutions during the transition period. The Fund points out that these problems originate mostly in the private sectors (agricultural for instance), but at the end of 1996 the largest debtors — in terms of contribution due — could be found in energy, manufacture and public service sectors. In order to make payments easier for contributors, the Fund occasionally accepted contribution payments in kind (rice, tobacco etc.), but this measure has not solved the problem.

<sup>27</sup> Data of the Social Fund. In 1995 the amount reported (182 million soms) included 100 million of “pure” subsidy and 82 million of supplements and compensations for pensioners.

Both in 1995 and in 1996, the current non-compliance rate (ratio of contribution paid to the amount due) was 89% — and this result was achieved after the first quarter of the consecutive year. At the beginning of 1996, the total unpaid contribution (cumulative) amounted to 724 million soms, or 37.2% of the total Fund expenditure (see Table 7.3). At the beginning of 1997 this amount was much lower: 329 million soms, or 13.2% of spending. This considerable decline — by 395 million soms — was due to debt repayment (225 million soms) and canceling (170 million soms). This decline might have reflected a more lenient monetary policy of the government in the second half of the year.

Third, the Social Fund has been paying benefits with a huge delay. At the end of April 1996, the total debt amounted to 206.8 million soms, or 400.3 soms per one pensioner. In other words, the debt was equal to a two-month pension payment. At that time the Social Fund tried to solve the problem by occasionally paying pensions in non-monetary form (tobacco, flour, rice etc.). The amount paid in kind was small (about 2% of the total at the beginning of 1996), and in fact this has not helped in diminishing the Fund debt. Only at the end of 1996 had the situation improved; the total of the unpaid pensions had been curbed down to about 80 million soms, or less than one-month pensions due. This decline, many believe, has been rather temporary than stable.

**Proposed reform.** The government started work on reforming the pension system several months ago. The intention was to design a new system allowing to balance the “Pension Fund” in the long term. Given the circumstances, it was clear that more attention should have been paid to lowering pension expenditure or adjusting the amount spent to the contribution collected than to raising the Fund revenue. Thus, the government opted for a contribution defined, one pillar system, financed on the PAYG basis.

As a first step, a new law was implemented in the middle of 1996<sup>28</sup> that allowed to keep individual record of contributions paid for each person covered by social insurance. Within this legal framework, individual records are now being established (this process will continue possibly until the end of 1998). Also, the position of the Social Fund, as an independent agency in charge of designing and implementing social insurance policies, has been strengthened.

A project of the main bill concerning the pension reform, introducing new eligibility rules and pension provisions, was submitted to Jogorku Kenesh in fall 1996.<sup>29</sup> The parliamentary debate concerning this project has not ended yet.

Under the new system, eligibility is to be restricted to those with a record of at least 25 (women) or 30 (men) years of employment. Retirement age is to be kept unchanged, despite former proposals to raise it by 5 years. Supplements are to be curbed down and paid by the state budget (at present they are financed by the Social

<sup>28</sup> See Закон КР *О государственном социальном страховании* No. 222 от 3 июня 1996; see also *Социальное страхование*, “Слово Кыргызстана”, 8 августа 1996 года.

<sup>29</sup> See Постановление Правительства Кыргызской Республики от 31 октября 1996 года No. 509: *О проекте Закона Кыргызской Республики 'О государственном пенсионном социальном страховании'*; see also Sukrowski J., 'Предложения по реформе пенсионной системы кыргызской республики', первая рабочая версия, CASE, 11 декабря 1996 г.

Fund). Early retirement is to be limited considerably. Also, pension is to be partially suspended, if the pensioner resumes work.

Pension provision would be changed substantially. In the near future, a retirement pension would consist of two parts: the “old” pension, corresponding to the employment period (before the end of 1995) with no individual contribution record, and the “new” one based on already established contribution records. The first part of the pension would be recalculated according to the new formula: it would be equal to the sum of the “base pension” (fixed by the government as a certain amount of soms) and of the so called “insurance pension”, adding 1% of the average individual wage for each contributory year.<sup>30</sup> The second part of a retirement pension (and the only one in the future) would be set on the basis of “collected”, registered individual contributions, corrected by an actuarial factor fixed each year by the Social Fund.<sup>31</sup> Thus, pensions would be fully contribution defined in the future.

Simulation results show that the new pension system would be more expensive than the present one. This is mostly due to the assumed ratio of the average pension to the average wage — higher than the current one. Despite this feature, the reform proposal is widely criticized. Many solutions — mostly those restricting eligibility, limiting supplements or pension rates — have already been questioned by deputies. By now it is clear that the legislation procedure for the new pension law will be rather long and difficult, and substantial modifications may be expected.

## **7.2. Benefits for the Unemployed**

*Unemployment figures.* The number of registered unemployed has been growing recently at a high rate. At the beginning of 1995, the number of unemployed was less than 13 thousand, and the unemployment rate did not reach 1%, while at the beginning of 1997 these figures amounted to over 77 thousand and 4.5% (see Table 7.4). Moreover, according to the ILO definition, the unemployment rate reached almost 8%. This shows that at present unemployment has become a real problem in Kyrgyzstan, and possibly it will become even more pronounced in the future. This is the case despite the GDP growth and the increase of the number of employed persons.

The main reason for the recent unemployment growth seems to be the decline of hidden unemployment. In Kyrgyzstan, as in many other post-Soviet economies, hidden unemployment — very large in the past — has taken two forms: (i) forced unpaid leave, (ii) forced reduction of working hours.<sup>32</sup> In the last quarter of 1995, there were 65 thousand workers on unpaid leave, while a year later this number went down to 50 thousand. At the same time, the number of those with reduced working hours

---

<sup>30</sup> For farmers covered by social insurance, each contributory year would add only 0.7 percent of the declared income.

<sup>31</sup> The actuarial factor would reflect current demographic situation (as usual). But at the same time, it would be set in a way allowing to control the ratio of the pension level to the wage rate, being a measure of the cost containment.

<sup>32</sup> Also, workers may not receive their remuneration for months. This is quite common in Kyrgyzstan: the total cumulative debt equals more than two-month wage payments. But these unpaid workers are treated as employed persons.

decreased from 29 to 20 thousand (see Table 7.4). Some of these people might have moved to the group of fully paid workers, but certainly not all of them.

Another reason of growing unemployment might have been the process of migration. As it was already mentioned, net external emigration has dropped down. On the other hand, internal migration — mostly from the countryside to urban areas — has been continuously increasing. New immigrants are rather young and uneducated, and it is very hard for them to find a job in the city.

Table 7.4.

**Unemployment in Kyrgyzstan: main indicators, 1995-1997 (in thousands)**

| Main items                      | 1995    | 1996    | 1997    |
|---------------------------------|---------|---------|---------|
| Total population                | 4,483.4 | 4,546.8 | 4,604.9 |
| Labor force                     | 2,261.1 | 2,290.0 | 2,300.0 |
| Employment                      | 1,645.3 | 1,641.0 | 1,650.0 |
| Unemployment                    |         |         |         |
| registered as looking for job   | 42.2    | 98.2    | 119.0   |
| registered unemployment         | 12.6    | 50.4    | 77.2    |
| receiving unemployment benefits | 7.9     | 28.9    | 25.2    |
| Unemployment rate (%)           | 0.7     | 2.9     | 4.5     |
| Workers                         |         |         |         |
| on forced leave (unpaid)        | NA      | 65      | 50      |
| forced to work reduced hours    | NA      | 29      | 20      |

Notes: Upper panel figures: as of January 1, reported year, or December 31, previous year. Lower panel figures: monthly averages, last quarter of the previous year. At the end of 1996, unemployment rate according to the ILO definition was equal to 7.8%.

Source: *Рынок труда, Информация 4*, Январь 1996 и 1997. ГУЗН 1996 и 1997. *Статистический Бюлетень* 1 (481), Нацстатком 1996, ст.89.

**Benefits.** Social protection for the unemployed was established in 1991, but it was seriously modified in 1994. In 1995, changes were introduced with regard to the administration.<sup>33</sup>

Support for the unemployed includes unemployment benefit, and various benefits in kind (training and retraining, job placement, public works etc.). Unemployment benefit is set at a flat rate on the basis of minimum wage ( $w$ ), a parameter remaining under full control of the government, and widely used to fix various social benefits (pension supplements, social assistance benefits etc.). Benefit is paid either at a level of  $1.0 \times w$ , or  $1.1 \times w$ ,  $1.2 \times w$ , or  $1.5 \times w$ , depending on the situation of the unemployed (low rate for school leavers, high for older persons etc.). Supplements for dependent family members may also be received. Unemployment benefit is usually paid for 6 months.

In 1996, the minimum wage was equal to 75 soms (the rate set in November 1995). As a result, the average unemployment benefit amounted to about 100 soms, or

<sup>33</sup> See Закон о занятости населения, January 14, 1994; Положение о порядке и условиях выплаты пособий по безработице (утверж. постановлением Правительства КР от 19 августа 1994, No 626), and other regulations.

24% of the average wage in January 1996 (11% of the average wage in December). Obviously, unemployment benefit has been very low.

All benefits are financed by the Employment Fund (contribution is shared by the employer paying 1.5%, and the employee 0.5%). Since 1994, this Fund is a part of the Social Fund, while employment policy making, remains with the separate department of the Ministry of Labor. Such a solution was intended to lower overall administration costs. However, it soon revealed a serious disadvantage: the Social Fund, being constantly in deficit, suppressed the much smaller Employment Fund, simply by delaying contribution transfers. In 1996, new solutions were implemented to make these transfers strict and regular. But it does not seem that the position of the Employment Fund has been strengthened sufficiently.

The share of the Employment Fund in total spending of the Social Fund is very small, although recently it has increased: from 2.5% in 1995, to 3.0% in 1996, and a further increase to over 4% is planned for 1997. The same refers to the share of this Fund in GDP: it has been small, but on the rise (see Table 7.1). Certainly, this has been the result of growing unemployment (the average benefit, for instance, has actually decreased).

Contrary to the pensions, there is no intention to introduce substantial changes into the system of social protection of the unemployed. In general, more attention is paid to improving administration and implementation of new active labor market measures, than to redesigning benefits in cash.<sup>34</sup> In 1995 and 1996, monetary benefits alone accounted for over 50% of total spending on unemployment protection (a higher share in 1996). The budget for 1997 sets this expenditure at only 41% of the Employment Fund spending. Such low level of spending will certainly be very hard to sustain.

### **7.3. State Allowances and Other Social Assistance Benefits**

**State allowances.** Two types of state allowances were introduced in 1995: the so called “unified” allowance, which replaced seven types of formerly paid family allowances, and the “social” allowance, which replaced the former social pension. Both allowances are financed by the state budget, and administered by the Ministry of Labor. The former is especially important, given its formula and the number of beneficiaries.

The unified allowance is directly targeted at the poor. It is income tested, with the minimum wage set a poverty line. Eligibility covers children under 16, students under 21 (taking courses free of charge), non-working pensioners, people who for some reasons cannot work, the unemployed not receiving unemployment benefit. The benefit rate is declining with per capita household income as follows:

---

<sup>34</sup> There are officials who would like to solve labor market and growing unemployment problems by encouraging emigration (to Malaysia for instance). It does not seem, however, to be an serious option.

Table 7.5.

**The per capita income and benefit rate.**

| per capita income              | benefit rate |
|--------------------------------|--------------|
| in percent of the minimum wage |              |
| up to 25%                      | 60%          |
| 25% - 50%                      | 50%          |
| 50% - 75%                      | 40%          |
| 75% - 100%                     | 30%          |

The social allowance is not income tested. It is paid in the case of invalidity to those disabled who have never worked, to the elderly with no source of income, to orphans and to mothers of more than ten children. The rate of social allowance is usually higher than that of “unified” allowance, and is equal to 30, 50, 100 or 150% of the minimum wage. In April 1997, the average “unified” allowance was equal to 33 soms, and the average social allowance to over 70 soms. It should be remembered, however, that social allowance provides an income to those, who are usually in the worst situation, being unable to work, while “unified” allowances supplement most incomes.

The number of beneficiaries receiving “unified” allowance is very high. In April 1996, it amounted to 1257 thousand. This number declined very quickly over the year: in April 1997, the number of beneficiaries was only one-half of the previous number (640 thousand). This was due mainly to an inflationary increase of incomes, while the poverty line was kept unchanged. Social allowance is paid to about 32 thousand people, and this number has remained stable over time. As a result of a decreasing number of beneficiaries of the first benefit, total expenditure on state allowances has declined considerably, from 2.7% of GDP in 1995, down to 1.8% in 1996 (see Table 7.1). Further decline of this expenditure was planned for the 1997 budget.

Unified allowance, in a sense very modern and often suggested by international experts, does not work properly in Kyrgyzstan. The problem is at least twofold. First, it is very difficult to evaluate the total income in most households, for a large part of income comes in natural form (from agriculture). Second, the poverty line is set in a way which may be easily questioned, for it has no relations whatsoever to the subsistence minimum.<sup>35</sup> Other problems involved are well known. They refer to any targeted benefit which is usually hard to administer, reduce work incentives, introduce implicitly a very high tax rate etc.

Kyrgyz officials are familiar with these problems. They try to improve “unified” allowance by putting more attention on indicative targeting (i.e., by poverty indicators other than income), differentiating eligibility rules by regions, working on concepts of the total household income (including income in kind) and the poverty line. Also, in order to recognize poverty, and thus for better targeting, special surveys monitoring

<sup>35</sup> Each month, subsistence minimum is evaluated by the National Statistical Committee. But its level is so high that it is irrelevant for social policy purposes.

poverty have been conducted.<sup>36</sup> They should certainly be repeated on a regular basis in the future.

**Other social assistance benefits.** They include benefits granted in the form of nursery homes for the elderly and the disabled, and various privileges (tariff reduction, occasional lump sum benefits etc.) for selected groups of the population: veterans, rescue team members from Chernobyl etc. The second type of benefits, so called *ëüãññü*, is quite common, costly, and not well controlled. They do not remain within one and stable legal framework, being rather discretionary. Also, they are very inefficient, going to those who are not the most needy.

Total expenditure on these benefits, although lower than 1% of GDP, is much higher than total spending of the Employment Fund or of the Social Insurance Fund (see Table 7.1). Possibly, not all *ëüãññü* are included in this amount, some of them being hidden as an expenditure of the Social Fund or the ministries on pension or wage supplements. There is a need to curb *ëüãññü* down as much as possible, saving money for other social purposes.

## 7.4. Public Health Care and Education

Financing, organizing and administering public health care and education is a challenge in Kyrgyzstan. These sectors call for fast and profound reforms.

Until the end of 1996, health care and education were financed by the state budget, the central and local budgets. In both cases, considerable — legal or not — co-financing has occurred by individual households. Services granted were of a very poor quality, and shortages of equipment were visible in both the health and the education sectors. At the same time, remuneration of employees in these sectors was inadequate.

Total expenditure on health care has been very low, too low by international standards (less than 4% of GDP, see Table 7.1). Moreover, in 1996, this expenditure decreased down to 2.9%. Additional financial resources were needed in the health care sector, and the government decided to find them by introducing compulsory health insurance. The reform was announced in 1992<sup>37</sup>, but was introduced in 1997. An additional contribution of 2% (6% was discussed in the past) has been recently imposed on the wage bill, payable by the employer exclusively (or by the state budget, if needed). At present, this contribution is collected by the Social Fund. It is hard to say at the moment, how new solutions really work, but the reform looks very limited. Contribution is simply too small to really help financing medical services, and health administration is not ready yet to work efficiently within the health insurance system.

Contrary to health care, expenditure on education is high: over 6% of GDP in 1995, 5.3% in 1996 (see Table 7.1). This ratio may partly be explained by the population structure in Kyrgyzstan: people under 19 account for over 45% of the total population. Keeping this in mind, the government has opened the way to marketization

---

<sup>36</sup> There were two surveys of this type, in 1993 and 1996, both conducted jointly by the World Bank and national experts. Also, National Statistical Committee conducts household budget surveys which may be useful as well.

<sup>37</sup> See Закон РК Об охране здоровья народа в Республике Кыргызстан, July 2, 1992 and Закон РК О медицинском страховании граждан Республики Кыргызстан, July 3, 1993.

of educational services. This refers, first of all, to universities: public universities have introduced tuition fees, at the moment paid by a half of the students. Also, private schools have been founded at university level. Their number is rather small, and the quality of service often questioned. As for elementary or middle schools, other solutions have been discussed to curb down public expenditure, such as lowering the number of teachers, increasing their working hours, increasing the number of students in classes etc. On the other hand, better equipment for schools would be needed to out-balance the possible decline in the labor force in the education sector.

## **7.5. Concluding Remarks**

In 1996, the share of GDP spent on all social transfers declined. However, this was not true for every single transfer. Actually, the expenditure on pensions and unemployment benefits increased: in the case of pensions due to the increase of the benefit rate relative to the average wage, in the case of unemployment — due to the growth of the number of beneficiaries. The government should certainly pay more attention to pension expenditure control. However, the recent version of reform proposal, which is under discussion, does not assume cost containment.

The decline of spending was more pronounced in housing and communal sectors than in social assistance. Social assistance benefits went down mainly as a result of inflation, i.e., stable poverty threshold (in nominal terms) over months. However, targeting is still ineffective and should be improved.

The decrease of expenditure on health care is alarming. Government efforts of financing changes — by the introduction of health insurance in 1997 — will not necessarily provide enough resources to this sector. Decreasing expenditure on education should be carefully examined to evaluate, whether it is accompanied by higher private spending and better efficiency of teaching, or only by a decline of quality of services granted.

One should remember, however, that these results were achieved in the year of considerable GDP growth and high inflation rate. The situation may change with changing economic conditions, and also with the reforms still waiting for implementation.

## **8. Economic Policy in 1997 — Plans and First Results**

*(Jacek Cukrowski)*

The economic policy of the Kyrgyz Republic bases on the development strategy of the state to the year 2005, and the indicative social economic plan for 1996-1998. These documents provide full information about socio-economic programs related to investments, privatization and restructuring of state enterprises, reorganization of bankrupt enterprises, market securities, structural banking reform, social reforms, etc., which are planned for realization in 1997.

According to these documents, the real increase of GDP is planned at about 6%. Industry production is intended to increase by 24%, while agricultural production is expected to stay at the level of 1996. In the macroeconomic sphere the government has announced its aim to hold inflation at the level of 17%. Two basic targets: the size of the budget deficit of about 5.7% and curbing debts on wages and social payments will be in the center of macroeconomic policy. In this aspect a number of reforms is planned, particularly budget law improvement, inclusion in the budget of all special funds (in order to avoid expenditure of state means without corresponding legislative approval), establishing strong budget limitations for branch ministries and departments, improving budget procedures, etc. On the other hand, some reduction of the share of tax receipts in GDP is expected.<sup>38</sup> In monetary policy, the government and the NBKR plan limitation of the increase of monetary aggregates to 20% (it is expected that direct financing of the budget deficit by the NBKR will decrease).

In the banking sector, the realization of the restructuring program supported by a Financial Sector Adjustment Credit (FINSAC) will be a priority task.

Structural transformations will also remain in the center of economic reforms. It is planned that 499 medium and large state enterprises with capital funds of more than 433 million soms will be reorganized. It is expected that the process of privatization will almost be completed.

Foreign trade policy intends to reduce the balance of payments deficit mainly through stimulation of export and import substitution (a 25% increase in export and 19% reduction in import is expected). Moreover, there are plans to continue work within the Custom Union on the formation of a single custom territory. Entering the World Trade Organization will be a priority task.

Social reforms are aimed at maintaining minimum social standards. In particular, an increase of the minimum wages from 75 to 100 soms (in the second part of the year) and equalization of pensions among pensioners (the differences in pensions received before and after 1994) are planned. However, legislation of the new pension law will be the main problem in the social sector in 1997 (see Chapter 7).

Many of the plans and targets presented above are clearly very ambitious, but should be considered rather as wishes or hopes than realistic plans to be realized in a single year. Data coming from the first and second quarters of 1997 fully confirm this opinion. For example, to fulfill the annual plan, industrial output would have had to grow by 24.5% during the first two months, but it grew only by 5.4%.<sup>39</sup> Similarly, agriculture failed to make expected gains. Finally, the GDP increased by 0.6% instead of the projected 7.2%. Also, efforts to stabilize the exchange rate and to slow down inflation are far from being successful. Consumer prices in the first half of the year increased by over 10%<sup>40</sup> (note that in this situation inflation can reach 17% in

---

<sup>38</sup> The fall in the tax receipts expected in 1997 is being explained by a structural changes in the economy, in particular, by the rise in production at enterprises, with respect to which a preferential taxation is foreseen (e.g., the gold mining project - Kumtor).

<sup>39</sup> See Blum Y., *1997 economy off to sluggish start*, "The Central Asian Post", No. 14, April 10, 1997.

<sup>40</sup> Statistical Committee estimates inflation in the first half of the year at the level 11% (see *Социально-экономические положение Кыргызской Республики, Оперативная информация, I полугодие*, Национальный Статистический Комитет Кыргызской Республики, Бишкек 1997) while Economic Institut of Ministry of Finance estimates it at the level 13.6% (see Мониторинг

September 1997, i.e., the annual inflation level planned for 1997, and about 23% at end of the year) and the som lost its stability in the foreign exchange market. While the US dollar exchange rate was about 16 soms at the beginning of the year, after the first quarter of 1997 it fluctuated at about 18 soms per dollar (i.e., rose by about 8% since the beginning of the year) and then decreased in July to the level of 17 soms per dollar. The high inflation rate observed at the beginning of the year is explained by a significant increase in the US dollar exchange rate, but, as we already emphasized in the previous sections, the reasons for inflation might have been much more complex. The export facilitation program developed by the Government still remains on paper and the balance of trade remains negative (in January-May, foreign trade totaled 338.6 million dollars including 129.7 million in exports and 208.9 million dollars in imports).<sup>41</sup> Taking into account that in the present situation export opportunities are very limited, one can hardly expect the growth of export. Finally, it is worth mentioning that, according to data provided by the National Statistics Committee of Kyrgyzstan, in April 114 enterprises (21% of the total) were idle due to lack of funds and marketing problems. 180 enterprises (33% of the total) failed to reach the level of production of April 1996. By June 1, unpaid salaries in the public sector totaled 23.3 million soms, and unpaid pensions totaled 144.3 million soms. As of May 1, the number of officially registered unemployed was 70,000 persons and remained unchanged throughout the last half of 1996 and the first four months of 1997.<sup>42</sup> In addition, it is estimated that about 60,000 to 70,000 employees were on unpaid leave during the first four months of 1997.<sup>43</sup>

On the other hand, during the first months a few positive results were recorded. The most promising data came from the Ministry of Finance and the National Bank for the first quarter 1997: (i) the volume of the money supply significantly decreased (1.1% in January, 0.0% in February and 1.2% in March 1997)<sup>44</sup>, and (ii) in the same period budget revenues totaled 900.8 million soms (19.5% greater than in the same period of 1996). However, it should be mentioned that in the first quarter the national budget operated with a deficit of 65.1 million soms (i.e., 1.6 % of GDP).

To summarize, economic results for the first months of 1997 show that the achievement of economic targets will be rather difficult, although in several cases not impossible. Much will depend on the willingness and the determination in the realization of economic reforms in the second half of the year.

---

экономической ситуации в Кыргызской Республике, Мин. Финансов Кыргызской Республики, Научно-Исследовательский Институт Экономики, Выпуск 4, Бишкек 1997).

<sup>41</sup> In comparison with the corresponding period of 1996 foreign trade turnover decreased by 25%, volume of export decreased by 12%, and import fell by 31%.

<sup>42</sup> This is connected rather with strengthening criteria for receiving unemployment benefits, and with the withdrawal from the records of persons who have land, than with successful employment policy.

<sup>43</sup> See *Kyrgyzstan's economy continues progress*. "The Central Asian Post", No. 22, June 12, 1997.

<sup>44</sup> In April 1997 money supply decreased by additional 0.8%.

## 9. Conclusions

*(Małgorzata Markiewicz)*

The evaluation of the progress in transition presented in this paper gives signals about the deterioration of the economic situation in the Kyrgyz Republic in 1996. The most unfavorable indicators are as follows: high inflation rate (on the increase since 1995), high trade deficit, instability of the domestic currency exchange rate, fiscal problems. The results for the first months of 1997 confirm the necessity of more restrictive macroeconomic policy.

Special attention must be paid to fiscal issues. The continuing relatively high level of budget deficit and its monetary financing undermine the stability of the economic situation. Internal financial markets are shallow and can not be expected to further serve high budget deficits without the danger of currency destabilization and inflation growth. A structural reform of public expenditures, especially the withdrawal of exemptions<sup>45</sup> and conducting the pension reform is the only way to improve fiscal balance. Tax law amendments directed at squeezing the tax base and introducing tax exemptions implemented in December 1996 should be abolished. If the government fails to curb the fiscal imbalance, decrease in the balance of payments deficit, stability on the currency market, fall in interest rates and growth of savings can not be expected. Furthermore, it could reduce the long term growth rate. The results in attracting foreign investments are also not very impressive. Most of the cumulated inflow relates to the gold mining project of *Kumtor* company. Macroeconomic stability is the precondition for foreign investor activity in the Kyrgyz Republic.

The positive value of the “errors & omissions” item in the balance of payments could be explained by unrecorded export of goods and services by natural persons and legal entities. In comparison with the previous years this item provides proof of the increasing share of the shadow economy. Future improvements of the government policy toward the private sector could cause an increase of budgetary tax inflows and lower the share of underground economy. In 1996 recorded trade deficit amounted to over 20% of GDP. In order to provide continuous economic development the admissible level for this figure should be approximately 5-6%. Persisting current account deficit could undermine economic stability and cause depletion of foreign reserves.

Regarding big enterprises, the results of privatization seem to be unsatisfactory. Without the transfer of property to the private sector, efficient management of these entities can not be expected. Given that the state owned majority stakes in many partially privatized companies, the size of the private sector amounted to about 50% in mid-1996 (EBRD calculations). Enterprise restructuring and formation of new private entities was hampered by a lack of finance and inadequate infrastructure.

In 1996 a broad reform was implemented in the banking sector. Due to the crisis of the commercial banks the central bank made some strategic decisions. Some of the banks were liquidated and banking supervision over the remaining banks was

---

<sup>45</sup> There are different exemptions: tax and for social and municipal services.

strengthened. New financial institutions were created and a program of help for the financial sector (FINSAC) was launched. All these measures improve the prospects for progress of the financial markets, and indirectly for the whole economy.

Incoming data for the first half of the 1997 are rather disturbing. The economic policy and the pace of reforms stray from the long-term strategy. Without strong determination in decreasing the fiscal deficit, inflation rate and exchange rate volatility, in improving the balance of payments record and in structural reforms the situation may even worsen. It should be noted that social approval for the reforms is declining and a collapse in the macroeconomic situation would undermine the credibility of the government. There is hope that the determination in the realization of economic reforms is sufficiently strong to improve the prospects for progress on the path toward a market economy.

## Bibliography

- Antczak R., Markiewicz M., *Экономические реформы в Кыргызстане в 1994-1995 годах*, "Studies and Analyses", No. 91, CASE, Warsaw 1996.
- Antczak R., Cukrowski J., Dąbrowski M., Markiewicz M., *Перспективы финансирования бюджетного дефицита Кыргызской Республики в 1997-2000 гг.*, "Studies and Analyses", No. 106, CASE, Warsaw 1997.
- Blum Y., *1997 economy off to sluggish start*, "The Central Asian Post", No. 14, April 10, 1997.
- Cukrowski J., *Предложения по реформе пенсионной системы кыргызской республики*, CASE, 11 December 1996.
- Cukrowski J., Markiewicz M., Mogilewski R., *Государственные расходы Кыргызской Республики: перспективы на 1997-2000 гг.*, "Studies and Analyses", No. 108, CASE, Warsaw 1997.
- Dąbrowski M., Antczak R., *Economic reforms in Kyrgyzstan*, "Studies and Analyses", No. 28, CASE, Warsaw 1994.
- Jermakowicz W., Pańków J., *Приватизация в Кыргызстане*, "Studies and Analyses", No. 27, CASE, Warsaw 1994.
- Jermakowicz W., Pańków J., *Приватизация в Кыргызстане в 1992-1996 гг.*, "Studies and Analyses", No. 102, CASE, Warsaw 1996.
- Kupuyeva A., *Pension reform model for Kyrgyzstan*, "The Central Asian Post", No. 17, May 1, 1997.
- Kumtor Gold Project the Biggest in Independent Kyrgyzstan's History*, "Kyrgyzstan Chronicle" weekly newspaper, July 2-9, 1997.
- Kyrgyzstan's economy continues progress*, "The Central Asian Post", No. 22, June 12, 1997.
- Kyrgyz Republic, Recent Economic Developments*, IMF Staff Country Report No. 96/98, IMF, Washington, D.C., September 1996.
- Kyrgyzstan Investment Guide*, State Commission Foreign Investments and Economic Assistance (Goskominvests), Directorate General, 1994.
- Markiewicz M., *Перспективы развития рынка ценных бумаг в Кыргызской Республике*, "Studies and Analyses" No. 107, CASE, Warsaw 1997.
- Shestakov I., *Crack-down on Corrupt Government Employees*, "Focus Central Asia", No. 18, September 30, 1996.
- Topińska I., *Sfera socjalna w Kirgistanie: przewidywane zmiany organizacji i finansowania*, CASE, memo, August - September 1996.
- Topińska I., *Расходы на содержание социальной сферы Кыргызстана в 1994-1995 годах*, CASE, November 1996.
- 1995 year report*, National Bank of Kyrgyz Republic, Bishkek, April 1996 (in Russian).
- Банковский Вестник Кыргызской Республики*, No. 1-12/96.
- Закон РК Об охране здоровья народа в Республике Кыргызстан, July 2, 1992.

Закон РК О медицинском страховании граждан Республике Кыргызстан, July 3, 1993.

Закон о занятости населения, January 14, 1994; Положение о порядке и условиях выплаты пособий по безработице (утверж. постановлением Правительства КР от 19 августа 1994, No. 626).

Закон КР ‘О государственном социальном страховании’ No. 222 от 3 июня 1996.

*Кыргызстан в цифрах 1996, Краткий Статистический Сборник*, Национальный Статистический Комитет Кыргызской Республики, Бишкек, 1997.

*Мониторинг экономической ситуации в Кыргызской Республике*, Мин. Финансов Кыргызской Республики, Научно-Исследовательский Институт Экономики, Выпуск 4, Бишкек 1997.

Постановление Правительства Кыргызской Республики от 31 октября 1996 года No. 509: О проекте Закона Кыргызской Республики “О государственном пенсионном социальном страховании”.

Постановление правительства Кыргызской Республики: О программе разгосударствения и приватизации государственного имущества в Кыргызской Республике на 1996-1997 годы.

*Социальное страхование*, Слово Кыргызстана, 8 августа 1996 года.

*Социально-экономические положение Кыргызской Республики, Оперативная информация, I полугодие*, Национальный Статистический Комитет Кыргызской Республики, Бишкек 1997.

*Социально-экономические положение Кыргызской Республики*, Национальный статистический комитет Кыргызской Республики, Бишкек, январь 1996.

*Социально-экономическое положение Кыргызской Республики, 1996 год*, Национальный статистический комитет Кыргызской Республики, Бишкек 1996.

*Социально-экономическое положение Кыргызской Республики в I квартале 1997 г.*, Национальный статистический комитет Кыргызской Республики, Бишкек 1997.

*Уровень жизни населения Кыргызской Республики, статистический сборник*, Национальный статистический комитет Кыргызской Республики, Бишкек 1996.