

**THE EFFICIENCY OF MONETARY AND FISCAL POLICIES ON  
SUSTAINABLE GROWTH IN KYRGYZ REPUBLIC**

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**ABSTRACT:** *After the transition period, many countries of Former Soviet Union have advanced in the obtaining of sustainable growth target by means of the macroeconomic stability policies they have put into practice with the help and support of international institutions. One of these countries is the Kyrgyz Republic. The study examines the efficiency of the monetary and fiscal policies that have been applied by Kyrgyz authorities on the abovementioned target. The findings have shown that the target of sustainable growth is not so close though all progresses achieved in the Kyrgyz Republic.*

## **I - INTRODUCTION**

The member countries of the Commonwealth of Independent States (CIS) that gain their independences after dissolving of Soviet Union had experienced a serious economic recession and the inflation and poverty levels in these countries had reached to notably dimensions. These countries targeting the sustainable growth by ensuring macroeconomic stability, in this context, had prepared and brought into force poverty reduction strategies with the help and support of international institutions such as IMF.

Substantial progress has been achieved in transforming the monetary and fiscal systems in the CIS countries into more effective instruments to implement public policy objectives within the framework of a market economy. Today these monetary and fiscal systems are expected to play key roles in ensuring macroeconomic stabilization. These economies desire to obtain development by creating an environment supportive of sustained economic growth based on private sector development, an addressing social needs including poverty alleviation.

In this study, it has been taken up the subject that how much the monetary and fiscal policies which have brought into force by Kyrgyz Republic that has realized courageous reforms towards transition to market economy and the one of important members of CIS countries are effective and sufficient on sustainable growth. In the study, the sustainable growth policy will be examined firstly, which is brought up in the context of “Comprehensive Development Framework of the Kyrgyz Republic to 2010”, and later the efficiency and problems of monetary and fiscal policies that have been put into practice will try to evaluate.

## **II – SUSTAINABLE GROWTH POLICIES**

After dissolving of the former Soviet Union, the Kyrgyz Republic suffered a severe economic shock from the disruption of trade, and it faced the task of developing democratic and market institutions in a vacuum of knowledge and experience. As a result of these difficulties, the Kyrgyz Republic experienced a severe depression. GDP declined sharply from 1990 to 1997, before recovery began. However, the impact of the Russian Crises that erupted in 1998 generated a new contraction, which has affected all aspects of Kyrgyz society. The decline of state enterprises and collective farms has led to widespread unemployment. The social protection system became unsustainable under the deep economic and fiscal crises. The rapid deterioration in economic activity and social sector financing resulted in a loss of prior welfare gains, as shown by the acute rise in mortality, child malnutrition, school dropouts, and unemployment rates.

The government of Kyrgyz Republic addressed the first years of transition by realizing key reforms. These reforms include privatization, corporate governance, bank restructuring, and reforming of the social sectors, which were a necessary but not sufficient condition for recovery. Most importantly, the pattern of economic growth had a limited impact on poverty. Economic growth came about through capital-intensive, foreign investments in mineral extraction, which failed to generate employment on a wide basis and to diversify economic activity. As a result of this pattern of growth, the gap between rich and poor widened; income distribution worsened; and fiscal revenues remained insufficient to meet social needs. A key issue remains to determine a new economic rationale to promote socially inclusive growth in the context of current resource constraints<sup>1</sup>. In response to this situation, the Government decided to have poverty reduction as the predominant element in the first years of its Kyrgyz Republic 2000-2010 Strategy. In the context of the country's participation in the Comprehensive Development Framework, a first workshop for development partners was held in Bishkek during 15-16 February 2000. Detailed discussions were held on the needs for preparing the Interim National Strategy for Poverty Reduction 2001-2003 (NSPR), within close collaboration of IMF, WB, ADB and UNDP.

In according to IMF and IDA staff, NSPR represents an important milestone in the Kyrgyz Republic's ongoing efforts to elaborate a comprehensive, home grown strategy for poverty alleviation<sup>2</sup>. The first aim of NSPR is sustainable growth that recognizes the private sector as the driving force behind sustainable growth. Aim adopted in NSPR is an average annual real GDP growth of about 5 percent over the period 2001-2003. NSPR recognizes that "sound implementation of macroeconomic policies and attainment of macroeconomic stability will be critical if the targeted levels of GDP growth and private investment are to be achieved". Government targets a lowering of the inflation rate from 9.6 percent in 2000 to 6.0 percent by 2003<sup>3</sup>. Two important means of macroeconomic stability policy in Kyrgyz Republic are the monetary policy and fiscal policy.

#### **A - MONETARY POLICIES**

After independence in 1991 and the introduction of a domestic currency, the som, in May 1993, the Kyrgyz Republic rapidly adopted a reform and adjustment strategy to transform the economy to a market system. Supported under various IMF programs, the government pursued generally tight monetary policies, which over time helped reduce the annual inflation rate to single-digit levels.

Government's monetary targets are quite standard in the Kyrgyz Republic. Generally, performance criteria are set on net international reserves and net domestic assets, with indicative targets on base money and net credit to government. In all cases, the criteria are specified with an eye to achieving a certain rate of expansion of the money supply, and thereby a target for inflation.

NSPR also adopted that a tight stance monetary policy and the continued implementation of a flexible exchange rate mechanism will be key to the achievement of the inflation and international reserve targets. The broad money projections of The National Bank of Kyrgyz Republic (NBKR) are important in monetary policy. NBKR expected that broad money growth would be maintained at 16.8 percent in 2002 and at around 10 percent in 2003. The NBKR will continue to implement a flexible exchange rate regime, with interventions in the foreign exchange market directed only to maintaining the level of reserves at their targeted levels and to smoothing out temporary fluctuations in the exchange rate. In this regard, the NBKR is prepared to allow a depreciation of the som if unanticipated pressures on the currency threaten to lower significantly the level of reserves. In this case, the NBKR will seek to restore confidence in the som by tightening further the stance of monetary policy<sup>4</sup>.

#### **B - FISCAL POLICIES**

<sup>1</sup> Asian Development Bank, "Technical Assistance to the Kyrgyz Republic for Support to the National Strategy for Poverty Reductions", TAR: KGZ 34107, June 2000, pp.1-2.

<sup>2</sup> IMF and IDA, "Joint Staff Assessment of Poverty Reduction Strategy Paper", January 24, 2003, p.1.

<sup>3</sup> Kyrgyz Republic, Interim National Strategy for Poverty Reduction, 2001-2003, prepared by Kyrgyz authorities, June 13, 2001, p.12.

<sup>4</sup> See, NSPR, p.12.

NSPR recognizes that tight fiscal policies lie at the heart of government's program of macroeconomic stability policies. The government have introduced a considerable projected reduction of the primary deficit not only to allow for the substantial debt service costs, but also to ensure that NBKR is able to pursue tight monetary policies while leaving room for the growth of credit to the private sector. For this reason, a key aspect of the fiscal adjustment is the projected reduction in the Public Investment Program (PIP) in order to put a brake on the accumulation of external debt. The overall fiscal deficit is targeted to decline from 9.7 percent of GDP in 2000 to 4.4 percent in 2003.

***Tax Policy:*** The NSPR targets an increase in the central government tax revenue to GDP ratio to at least 15 by 2005, mainly through a broadening of tax base, reduction of marginal tax rates, and an improvement in the tax administration. Tax administration reform has mainly focused on enactment of necessary legislation, establishment of organizational structures, development of systems and procedures.

The changes that realized in tax system from the first years of transition period until today are shown in Table 1 below. As it can also be seen clearly in Table 1, the supply side economics view of Arthur Laffer is dominant in the tax reform realized in Kyrgyz Republic.

**Table 1: Tax Reform in Kyrgyz Republic**

Name of Tax	Year	Explanation
<b>Personal Income Tax</b>	1992	progressive tax with top marginal rate of 40% and 5 brackets, applied only to monetary income
	1995	new law, base extended to in-kind income
	1996	new tax code, deductions were limited, tax exempt threshold increased
	1997	tax exempt threshold abolished 6 brackets
	1999	top marginal rate reduced to 33% and number of brackets to 4
	2001	2 brackets with 10% and 20% rates
<b>Enterprise Profit Tax</b>	1992	tax simplified, rate reduced from 45% to 35%, alternative rates for specific activities
	1994	rate reduced to 30%
	1995	new law, specific rate for agriculture raised to 25%, fewer exemptions and deductions
	1996	new tax code, presumptive taxes on small retailers introduced, rate unified at 30%
	1997	rates on dividends and interest income reduced to 5%
	1999	rate on dividends reduced to 0%
	2001	rate reduced to 20%
<b>Value Added Tax</b>	1992	tax introduced at 28%
	1993	rate reduced to 20%
	1996	new tax code, coverage extended to imports, gradual shift to destination principle, custom duties and excises removed from VAT base
	1999	destination principle applied for all countries except Russia
	2001	some exemptions eliminated

**Source:** Vahram Stepanyan, "Reforming Tax Systems: Experience of Baltics, and other Countries of the Former Soviet Union", IMF Working Paper, No.03/173, September 2003, p.27.

***Public Expenditure Policy:*** The reform of expenditure programs in Kyrgyz Republic are becoming a priority, in part because of their impact on the prospects for sustainable growth, and also given commitments made in NSPR. As part of macroeconomic stability policies, Kyrgyz Republic was forced to cut significantly public expenditures. Cuts from expenditures were often made where the resistance was left or where priorities were less immediate.

The Kyrgyz authorities have introduced a comprehensive debt strategy to alleviate the debt burden and to restore debt ratios to sustainable level over time. One of the means of this strategy is a gradual reduction of the PIP from 6 percent of GDP in 2001 to 3.8 percent GDP in 2005. NSPR recognizes that such decline in public investment will be compensated by higher private investment fostered by the macroeconomic stability and other structural measures.

### **III – THE EFFICIENCY OF MONETARY POLICIES**

While tight monetary policies in Kyrgyz Republic achieved a decline in inflation and a slowdown in the depreciation of exchange rate, still there are some issues affecting monetary policy management. These issues are the dollarization and the weakness of financial system.

#### **A – THE ISSUE OF DOLLARIZATION**

Notwithstanding the progress made in macroeconomic stabilization, the Kyrgyz Republic has experienced persistently high and increasing currency substitution ratios. The process of restoring growth and inducing disinflation in the Kyrgyz Republic is far from over. The impact of the Russian financial crises on Kyrgyz economy is likely to have delayed this process further<sup>5</sup>.

Dollarization process began at the time when the country lifted restrictions on foreign currency holdings as a part of their efforts to liberalize its economy. It reflects a choice by household and firms to protect themselves from recurrence of high inflation by diversifying their assets. Dollarization of assets is particularly widespread, be it in the form of dollar-denominated bank deposits or dollar bills under the proverbial mattress. Payment dollarization is prevalent for large household transactions involving apartments or cars or illegal and gray market transactions<sup>6</sup>.

While dollarization was not an obstacle to the impressive reduction in inflation rates, it has increased the vulnerability of the financial system and the economy to large exchange rate changes and contributed to a fear of floating. Dollarization increases the default risk for banks' assets and liabilities makes exchange rate adjustments more costly. Knowing that the authorities might therefore be hesitant to adjust the exchange rate can create a moral hazard and encourage firms to borrow excessively and cheaply in foreign currencies rather than in domestic currency<sup>7</sup>. In this respect, there may, in principle, be room for monetary policy to induce a reversal in the portfolio allocation in favor of domestic currency by fostering a sufficiently large real interest rate differential vis-à-vis the dollar and targeting a greater stability in the exchange rate.

#### **B – THE WEAKNESS OF FINANCIAL SYSTEM**

In 2002, the CIS countries recorded the lowest monetary depth, as measured by the average ratio of M2 to GDP, and the lowest depth of bank intermediation activity, as measured by the ratio of total banking sector assets, deposits, and credit to the private sector, to GDP. In fact, the gap between the CIS countries and the best performing transition economies (CEE-B) has widened since 1995<sup>8</sup>.

The root of the problem lies in weakness in their institutional infrastructure, which hampers their ability to intermediate savings between lenders and borrowers. Banks in the Kyrgyz Republic might incur higher operating costs because they are not large enough to exploit of scale. As a result, borrowers would pay higher lending rates. Banks also might incur higher regulatory costs that they pass on the borrowers. Credit risk is also high because of macroeconomic uncertainty and structural factors including the lack of a credit culture. In underdeveloped financial market system, interest rates and other policy instruments play at best a secondary role. As a consequence of all these reasons net credit to economy of banking sector in Kyrgyz Republic is the lowest level in transition economies.

**Table 2: Banking Sector Net Credit to Economy**

<sup>5</sup> Joannes Mongardi, Johannes Mueller, "Ratchet Effects in Currency Substitution: An Application to the Kyrgyz Republic", IMF Staff Papers, Vol.47, No.2, 2000, p.226.

<sup>6</sup> Peter M. Keller, Thomas Richardson, "Nominal Anchors in the CIS", IMF Working Paper, No.03/179, September 2003, p.19.

<sup>7</sup> Keller and Richardson, p.20.

<sup>8</sup> Gianni De Nicolo, Sami Geedah, Dmitriy Rozkhov, "Poorly Developed Financial Systems in the CIS-7 Countries May Jeopardize Their Sustained Growth", Finance & Development, December 2003, p.42.

Country	1999	2000	2001	2002
Armenia	8.6	9.5	8.0	7.2
Azerbaijan	11.9	9.4	6.9	7.2
Belarus	15.0	16.5	14.9	16.0
Georgia	7.0	8.6	8.6	9.8
Kazakhstan	8.2	11.6	16.7	19.5
Kyrgyz Rep.	5.0	4.1	3.8	4.2
Moldova	13.3	14.3	16.3	18.9
Russia	12.2	13.1	16.5	18.4
Tajikistan	13.5	19.2	22.9	18.8
Turkmenistan	64.2	62.5	51.1	--
Ukraine	5.7	12.2	14.5	19.9
Uzbekistan	21.4	27.9	36.9	33.9

Source: IMF, European II Department Database, quoted by Peter M. Keller and Thomas Richardson, p.27.

The conduct of monetary policy is hampered by a number of factors. Chief among these are (i) difficulties in forecasting money demand, due to rapid changes in financial market, re-monetization and dollarization, (ii) shallow financial market, (iii) banking sector that are weak or in which public confidence is only gradually increasing, (iv) external shocks (e.g., oil prices or weather/drought)<sup>9</sup>.

#### IV – THE EFFICIENCY OF FISCAL POLICIES

Tight fiscal policy, which has been put into practice to realize macroeconomic stability and sustainable growth in Kyrgyz Republic, is far from being effective due to some issues. These are the quasi-fiscal activities, the decrease of tax revenues, and the insufficient reaction of economic agents to tax stimulations.

##### A – THE ISSUE OF QUASI-FISCAL ACTIVITIES

Quasi-fiscal activities and deficits born by certain state enterprises in the industrial sector, however, are still quite large, especially in the energy, water, housing, communal services, and transport sectors<sup>10</sup>. Quasi-fiscal activities are a major problem in Kyrgyz Republic. IMF and WB staff estimates suggest that quasi-fiscal activities are about 10 percent of GDP in Kyrgyz Republic<sup>11</sup>.

Quasi-fiscal activities divert public resources in an inefficient and nontransparent manner, undermining accountability. These quasi-fiscal activities and deficits imply a laxer than apparent fiscal stance. In spite of the tight fiscal policy implemented, to be secured of fiscal discipline may deteriorate because of quasi-fiscal activities. They also jeopardize the foundation for sustainable economic growth.

##### B – THE DECREASE OF TAX REVENUES

<sup>9</sup> Keller and Richardson, p.24.

<sup>10</sup> M.Petri, G.Taube, A.Tsyvinski, “Energy Sector Quasi-Fiscal in the Countries of Former Soviet Union”, IMF Working Paper, No.02/60, pp.5-6.

<sup>11</sup> IMF and WB, Poverty Reduction, Growth and Debt Sustainability in Low-Income CIS Countries, February 4, 2002, p.13.



The tax reform implemented in Kyrgyz Republic faced a number of difficulties. These are stemmed from; (i) the tax administration capacity has not been adequate to handle the significant increase in the number of taxpayers and the different types of taxpayers; (ii) planned economy typically were concentrated in a state-owned industrial sector, while the transition to a market economy assumed more taxpayers and growing share of private sector; (iii) old traditions and attitudes – the tradition of negotiation and bargaining in taxation – needed to be broken and taxpayers’ attitudes towards tax evasion and voluntary payments changed<sup>12</sup>.

**Table 3: Tax Revenue in Kyrgyz Republic (as percent of GDP)**

Name of Tax Revenue	1993	1994	1995	1996	1997	1998	1999	2000	2001
<b>General Government Tax Revenue</b>	25.1	20.8	15.0	12.7	12.5	14.2	12.3	11.7	12.4
<b>Personal Income Tax Revenue</b>	1.3	1.9	1.8	1.2	1.0	1.2	1.1	1.3	--
<b>Enterprise Profit Tax Revenue</b>	4.3	3.5	2.6	1.6	1.1	1.3	1.2	0.9	--
<b>Value-Added Tax Revenue</b>	4.4	4.3	4.4	5.3	5.6	5.8	4.1	4.8	--

**Source:** IMF, quoted by Vahram Stepanyan, “Reforming Tax Systems: Experience of Baltics, and other Countries of the Former Soviet Union”, IMF Working Paper, No.03/173, September 2003, p.14-20.

While all these difficulties have been prevailing, in the late 1990s, Kyrgyz Republic had lower income tax rates and continued the rate reductions through 2000-2001, leading to a situation where further reduction in marginal rates have caused negative revenue effects. As it can be seen from the table 3, both the overall tax revenues and the shares of personal income and enterprise profit taxes within GDP had decreased. Another factor behind reduction of tax revenue is low income per capita in Kyrgyz Republic. Low income per capita countries are often with relatively larger agricultural and informal sectors which have traditionally difficult been to tax<sup>13</sup>.

Decreasing of tax revenues has negatively affected the ensuring of budget balance, which is the most important tool of macroeconomic stability. Along with the decrease in tax revenues, cutting down of public expenditures has become inevitable for ensuring budget balance. The decreases that appeared particularly in health, education and infrastructure investment expenditures make hard to obtain the aim of long-term economic growth.

### **C – THE INSUFFICIENT REACTION OF ECONOMIC AGENTS TO TAX STIMULATIONS**

In tax reform that has been realized at Kyrgyz Republic, it had been aimed that private savings and investments will increase by means of tax rates’ reduction. Thus, it has been expected that private sector will play a pioneer role in sustainable growth. The fact that sustainable growth depend on the reaction of economic agents to the tax reform; and such changes may or may not be substantial, depending on whether there is a large elasticity in the behavior of economic agents, in particular with respect to work, saving and investment.

<sup>12</sup> Vahram Stepanyan, “Reforming Tax Systems: Experience of Baltics, and other Countries of the Former Soviet Union”, IMF Working Paper, No.03/173, September 2003, p.10; Liam Ebrill, Oleh Havrylyshyn, and others, “Tax Reform in the Baltics, Russia, and other countries of Former Soviet Union”, IMF Occasional Paper No.182, July 27, 1999.

<sup>13</sup> Henri Lorie, “Priorities for Further Fiscal Reforms in the Commonwealth of Independent States”, IMF Working Paper, No.03/209, p.20.

The elasticity of economic agents' behavior in Kyrgyz Republic, in terms of labor supply, saving and investment with respect to tax rates is not large. The reduction of tax rates is unlikely to lead to a notable expansion of economic activity. Saving rates declined as the population experienced a substantial decline in living standards, with a greater share of national income being spent on consumption. Therefore, aggregate savings will not increase much when personal income tax rates are reduced, and hence the investment levels will not be affected substantially through this channel.

A decrease in the enterprise profit tax rates, *ceteris paribus*, is likely to lead to larger investment volumes, both domestic and foreign. Given the short period for which data are available, and the weakness regarding data on business investment in Kyrgyz Republic, it is difficult to assess with any certainty whether business investment has increased in response to tax reductions. Despite its efforts to implement market-oriented reforms, the Kyrgyz Republic received inward net Foreign Direct Investment (FDI) flows of only 3 percent of GDP on average in 1996-2001<sup>14</sup>.

## V – CONCLUSION

The tight monetary and fiscal policies which have been put into practice within the National Strategy for Poverty Reduction, though they are successful in the decrease of inflation, are sufficient partly in obtaining of macroeconomic stability due to some structural and cultural issues remaining from planned economy era and the partly established market economy system. The most important problems lessening the efficiency of monetary policy followed are the dollarization and the weakness of financial system. The problems affecting negatively fiscal policy are the quasi-fiscal activities, the decrease in tax revenues and the low adoption level of society in tax reform. The basic reason for these issues is the very quick efforts in market economy reforms, but slower change in mentality infrastructure.

The monetary and fiscal policies, which have been put into practice, though they contribute partly to the realization of macroeconomic stability, are not sufficient in obtaining of sustainable growth policy followed. It has been observed that the saving and investment levels of private sector, the leading sector in development, have not attained the desired level though the subvention measures in the monetary and fiscal policies.

Finally, it can be said that negative economic shocks can lead to a severe deterioration of macroeconomic stability, even with tight monetary and fiscal policies. The skeleton of Kyrgyz economy that has great importance is come into existence agriculture, hydropower and mining sectors. These sectors have proven vulnerable to weather related developments and natural disasters. In the light of the risks described above, however, the path to success is narrow. Policy slippages could easily lead to a low-growth trap with a deteriorating external debt position and macroeconomic imbalances.

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<sup>14</sup> Clinton R. Shields, "FDI and the Investment Climate in the CIS Countries", IMF Policy Discussion Paper, No.03/5, November 2003, p.13.

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