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**Statement by Mr. Zurbrügg on the Kyrgyz Republic  
Executive Board Meeting  
November 19, 2004**

The discussions in Bishkek and Washington on the 2004 Article IV Consultation and the Ex Post Assessment provided an excellent opportunity to take stock of past and current economic performance in the Kyrgyz Republic. My Kyrgyz authorities thank both teams for the very good papers and the constructive dialogue.

This Board discussion comes at a time at which all of the important macroeconomic indicators have developed more positively than expected. While favourable external economic conditions have contributed to this outcome, a strong track record of economic policy implementation was a key factor. In this context, my authorities are convinced that the Fund's support under the current PRGF program played an important role. Performance under the program has been strong. All program reviews have been completed according to schedule so far. The latest review was completed on a lapse of time basis in June, and current information indicates that all September 2004 performance criteria have been observed. The structural reform efforts have become increasingly effective over the recent past, as noted in the Ex Post Assessment. Moving forward, my Kyrgyz authorities are committed to build on these achievements. In order to maintain macroeconomic stability and secure external sustainability, they look forward to benefit from continued technical assistance and financial support from the Fund and the donor community.

**Recent economic developments**

Following a strong growth performance of 6.7 percent last year, the staff now project real growth for 2004 at 5.5 percent, a full percent higher than at the time of the last review in June. Inflation remains low, compared both to the initial target under the current program and to other countries in the CIS. Fiscal consolidation has continued, with revenue performance again improving and expenditure under control. Also, the share of social spending in total expenditure has increased. The sound macroeconomic management has been conducive to productivity improvements and the diversification of the economy. Manufacturing has developed favourably over the last year, and the contribution of the non-gold and non-energy sectors to overall output growth has increased. This said, my authorities are aware that efforts to further diversify the economy will be necessary to offset the expected decline in gold production over the medium term.

Price stability and productivity gains have also preserved low unit labour costs and external competitiveness. Exports have benefited from rapid growth in the Kyrgyz Republic's main

trading partners. Non-traditional exports, including tourism and other services, have performed strongly. While import growth has also been strong, due mainly to domestic demand, the current account deficit has fallen well below the level anticipated at the outset of the PRGF program. My authorities are confident that the economic outlook for the region will continue to support export performance over the near term. For the longer term, they believe that enhanced economic cooperation within the region would greatly benefit trade and development, not only of the Kyrgyz Republic, but of the region as a whole. For their part, the Kyrgyz authorities remain strongly committed to an open trade regime.

On the structural side, the authorities are committed to continue the reforms necessary for further productivity gains and export diversification. Recent achievements in structural adjustment include the privatization of Kairat bank in early 2004, as recommended by many Directors at the time of the last Board discussion. On governance, the Kyrgyz Republic has adopted the Extractive Industries Transparency Initiative (EITI), which is being implemented with support from the World Bank and the UK's DFID. The authorities are also on track to meet the program targets to reduce the overall quasi-fiscal deficit of the electricity sector.

### **Fiscal policy**

Further consolidation continues to be the main objective of fiscal policy. At the same time, my authorities are aware of the need to increase poverty-oriented expenditure. This is to ensure that the benefits of growth reach the poor and most vulnerable segments of the population. To this end, the higher-than anticipated proceeds from the sale of Centerra shares will allow for more room for social expenditure in the 2005 budget, especially in the health and education sectors. The emphasis will be placed on investment spending.

On taxation, the authorities believe that revenue can be sustained at the present level of 18 percent of GDP. However, they are alert to the need to improve the tax system. This includes improving the incentive structure for businesses to remain within the formal economy. To this end, the payroll tax rate will be successively reduced in 2005 and in the years ahead. To compensate for the effect on revenue, measures to broaden the tax base, to remove tax code inconsistencies, and to improve tax administration are to be implemented. These include measures foreseen under the small business tax reform package, on which agreement has recently been reached with the staff.

### **Monetary and financial sector policies**

Sound policy implementation by the National Bank (NBKR) has been critical to securing overall macroeconomic stability. The monetary authorities are committed to staying this course. In the current context, they believe that the rapid growth in private credit reflects the ongoing remontization of the economy. My authorities are, however, alert to the fact that this will necessitate a careful monitoring of the banks' assets. The NBKR is also aware of the additional demands on banking supervision of the increased participation of foreign-owned banks.

Looking ahead, the financial sector is set to gain further strength through the implementation of the new Law on Bank Bankruptcy and Conservatorship, and the full implementation of the 2003 FSAP recommendations. The authorities are also committed to introducing the measures foreseen to combat money laundering and the financing of terrorism, once the requisite legislation has been passed by parliament.

### **External debt**

Reducing the vulnerability stemming from high levels of public external debt has been a cornerstone of the authorities' economic program. Over the past years, the external debt-to-GDP ratio has fallen to under 100 percent, mainly because of improved debt management and successful fiscal consolidation. Also, the 2002 Paris Club rescheduling has temporarily eased the debt service burden. Gaining external viability will hinge critically on continued growth and prudent balance of payments financing. However, as the staff's debt sustainability analysis (DSA) shows, the debt service will rise rapidly in the years immediately ahead, which would result in considerable fiscal strain in the absence of further rescheduling. It is clear that long-term solvency will only be attained through a concessional debt stock treatment by Paris Club creditors. My Kyrgyz authorities, for their part, are fully aware that reaching and maintaining external sustainability will also require continued implementation of sound macroeconomic policies and structural reforms.

### **Ex post assessment**

My authorities are grateful for the in-depth and candid assessment of policy performance under past Fund-supported programs. The Ex Post Assessment (EPA) illustrates the considerable accomplishments that have been made over the last decade. Price and trade liberalization were undertaken early on, as were the sale of state-owned assets and far-reaching fiscal reforms. Following the backlash suffered in the late 1990s, economic restructuring regained momentum under the current PRGF arrangement. Important reforms of the financial sector were initiated, in the course of which the economy has been largely remonetized. Price stability has been secured by prudent monetary policy. Reforms have helped increase the share of private sector output in GDP, which has more than doubled since 1994. Per-capita income has increased by over a third since 2000. Also, considerable progress has been made in reducing the incidence of poverty, particularly in rural areas.

It is clear from the EPA that the process of transition to a market-based economy has not always followed a linear path. Certain set-backs were due to weaknesses in public administration and governance, which have yet to be fully addressed. Areas in which important further reforms are required include large-scale privatization, corporate governance, and the further deepening of financial markets.

However, it is important to bear in mind that the reforms of the 1990s were undertaken under very difficult and rapidly changing conditions. It took both the authorities and the Fund considerable time to understand the full magnitude of the challenges of transition. Since the difficulties involved were initially underestimated, the targets under past programs were often set at overly ambitious levels. It is also important to note that some of the problems in

implementing reforms only became apparent once the process of structural change was well underway. This particularly pertains to the area of governance, where new challenges emerged with the implementation of market-oriented reforms. It is also noteworthy that the longer-term impact of adverse external developments, in particular of the Russian crisis of 1998, was initially misjudged. Overall, my authorities believe that, given the constraints of a small landlocked economy, they have coped relatively well with the daunting challenges of transition.

Looking ahead, the findings of the EPA contain valuable lessons for the further reform process. My authorities remain committed to further advancing this process, and are confident that lasting effort to close the 'implementation gap' will bear fruit. The Fund's support has been critical throughout the process of transition. The Kyrgyz authorities continue to count on this support, and on that of the international community more broadly, in bringing their reform efforts forward.