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by

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TABLE OF CONTENTS

	Page
LIST OF ABBREVIATIONS	vii
LIST OF FIGURES	viii
LIST OF TABLES	ix
ACKNOWLEDGEMENTS	xi
ABSTRACT	xii
ÖZET	xiii
1. INTRODUCTION	1
2. LITERATURE REVIEW	5
2.1 Structural Reforms and Economic Performance in Transition Economies	5
2.2 Institutions and Economic Performance in Transition Economies	12
3. THE ESSENTIALS OF TRANSITION PROCESS.....	17
3.1 Two Approaches to Transition	18
3.1.1. The Washington Consensus Approach	19
3.1.2. The Evolutionary-Institutionalist Approach	23
3.1.3. Differences of Two Approaches on Transition Issues.....	25
3.2 Economic Growth in Transition Economies	30
3.3 Explaining Growth Performance: Institutional Framework.....	34
3.3.1 The Concept of Institutions	34
3.3.2 Institution Building in Transition Economies	37
3.3.3 Institutional Trap: Persistence of Inefficient Institutions	43
4. ECONOMY OF KYRGYZSTAN FROM HISTORICAL PERSPECTIVES.....	50

4.1 Economic Structure of Kyrgyzstan before the USSR	51
4.2 Economy of Kyrgyzstan during the USSR.....	55
4.2.1 Establishment of Socialist economy in Kyrgyzstan: 1920s and 1930s	55
4.2.2 Economic System and Economic Development of Kyrgyzstan during the USSR.....	59
4.2.3 Economy of Kyrgyzstan during the “Perestroika”	65
5. INDEPENDENCE OF KYRGYZSTAN AND START OF TRANSITION	73
5.1 In Search of the New Order.....	74
5.1.1 Building New Political System	74
5.1.2 Choice of the Economic Reform Strategy	77
5.2 Liberalization of the Economy	81
5.3 Economic Crisis: 1991-1995.....	83
5.4. Role of the IMF and the World Bank	87
5.4.1 The IMF Programs	88
5.4.2 The World Bank Projects	92
6. STRUCTURAL REFORMS	98
6.1. Privatization.....	98
6.1.1 First Period: 1991-1993	99
6.1.2 Second Period: 1994-1997.....	104
6.1.3 Third Period: 1998-	109
6.2. Reform of Agricultural Sector	112
6.3. Reform of Financial Sector	116
6.3.1. The New Currency and Monetary Policy	116
6.3.2. Restructuring of the Banking System.....	120
6.3.2.1 First Period: 1991-1994.....	120
6.3.2.2 Second Period 1995 -1997.....	124
6.3.2.3 Third Period 1998-	128
6.3.3. Establishment of Non-Banking Financial Institutions.....	130

6.3.3.1 Kyrgyz Stock Exchange	131
6.3.3.2 Credit Unions and Microfinance Organizations	135
6.4. Reform of Public Finance System	139
6.4.1 Establishment of New Tax System.....	140
6.4.2 Fiscal Policy	143
6.5. Reform of Social Welfare System	147
6.5.1 State Social Welfare Payments	148
6.5.2 Health.....	152
6.5.3 Education	156
7. ECONOMIC OUTCOMES OF REFORMS	163
7.1 Progress in Transition Indicators	163
7.2 Economic Growth Performance	167
7.3 Investment Performance.....	171
7.4 Banking Sector Performance	173
7.5 Social Costs of Economic Reforms	178
8. MAJOR REASON FOR INEFFICIENCY OF STRUCTURAL REFORMS –	
 INSTITUTIONAL INFRASTRUCTURE	182
8.1. Evaluation of Institutional Infrastructure in Kyrgyzstan.....	183
8.1.1 Index of Economic Freedom.....	184
8.1.2 Governance Indicators	189
8.1.3 Doing Business.....	191
8.1.4 Business Environment and Enterprise Performance Survey	194
8.1.5 Corruption	196
8.2. Sources of Inefficiency in Institutional Infrastructure	199
8.2.1 Economic Growth Performance	200
8.2.2 Government Efficiency.....	203
8.2.3 Cultural and Behavioral Constraints.....	205
8.3. Perspectives on Improvement of Institutional Infrastructure	20

9. SUMMARY AND CONCLUSIONS.....	211
APPENDIX A: GENERAL INFORMATION ON KYRGYZSTAN.....	216
REFERENCES.....	220

LIST OF ABBREVIATIONS

BEEPS	Business Environment and Enterprise Performance Survey
CIS	Commonwealth of Independent States
EBRD	European Bank for Reconstruction and Development
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
NSCKR	National Statistical Committee of Kyrgyz Republic
NBKR	National Bank of Kyrgyz Republic
SOE	State Owned Enterprises
SPF	State Property Fund of Kyrgyz Republic
WB	World Bank

LIST OF FIGURES

Figure 6.1	Share of listing and non listing sectors in trade volume of KSE	134
Figure 7.1	EBRD transition indicators 2007	164
Figure 7.2	Real growth trends: GDP, industry and agriculture (1991-2007)	167
Figure 7.3	Credits of the commercial banks to sectors of the economy (2003-2007).....	177
Figure 8.1	Corruption as a problem of doing business	194
Figure 8.2	Percent of firms saying bribery is frequent	195
Figure 8.3	Sources of inefficient institutional infrastructure.....	208

LIST OF TABLES

Table 3.1	Washington Consensus: 10 recommendations	21
Table 3.2	Washington Consensus and evolutionary-institutionalist approach	27
Table 4.1	Structure of the production of industry (1970-1990)	60
Table 4.2	Rate of growth of industrial and agricultural sector of Kyrgyzstan and USSR (1913-1986, base year 1913 = 1).....	61
Table 4.3	Annual average rate of increase of some economic indicators of USSR and Kyrgyzstan in five year plans (1961-1990, in per cent).....	62
Table 4.4	Structure of Gross Material Product (GMP) of Kyrgyzstan (1989 -1990, in per cent)	69
Table 4.5	Social expenditures in 1990	71
Table 5.1	Magnitude of production decline (1991-1995, in per cent of 1990 level)	84
Table 5.2	Growth and structure of industrial production by sub-sectors (1991-1995, in percent)	85
Table 5.3	Social outcomes of economic crisis (1992-1995).....	86
Table 5.4	The IMF lending programs in Kyrgyzstan(1993-2008)	88
Table 5.5	The World Bank commitment to projects in Kyrgyzstan (1993-2008)	93
Table 5.6	The World Bank development policy operation projects in Kyrgyzstan (1993-2008)	95
Table 6.1	Privatized enterprises by sectors (1992-2006)	100
Table 6.2	Privatization methods (1992-2006).....	106
Table 6.3	Ownership structure of strategic enterprises	111
Table 6.4	Inflation, M2 and exchange rate (1993-2007)	118
Table 6.5	Number of the non-banking financial institutions (1995-2007)	132
Table 6.6	Activity of Kyrgyz Stock Exchange (2001-2007)	133
Table 6.7	Credits of non-banking financial institutions (2002-2007, in million USD)	137
Table 6.8	Main indicators of the fiscal policy (1991-2007, in per cent of GDP)	144

Table 6.9	General government budget expenditures (1995-2007).....	146
Table 6.10	Social protection system expenditures (1995-2007, in per cent of GDP)	150
Table 6.11	Indicators on health services (1990 – 2007).....	155
Table 6.12	Number of education organizations and students (1990-2007).....	159
Table 6.13	Government expenditure and nominal wage in education sector (1990- 2007)	160
Table 7.1	EBRD transition indicators: Kyrgyzstan 1991-2007	165
Table 7.2	Contribution of sectors of the economy to growth of GDP (1996-2007, in per cent)	169
Table 7.3	Investment activities (1996-2007)	172
Table 7.4	Main indicators of the banking sector activity (1994-2007, in per cent of GDP)	175
Table 7.5	Composition of credits and deposits of commercial banks by maturity (2003-2007, in per cent)	176
Table 7.6	GDP growth, unemployment, poverty and income distribution (1996-2007)	178
Table 8.1	Index of economic freedom: Kyrgyzstan (1998- 2008).....	187
Table 8.2	Governance indicators: Kyrgyzstan (1996-2007).....	190
Table 8.3	Doing Business indicators: Kyrgyzstan (2005-2009)	192
Table 8.4	Transparency International and Freedom House corruption indexes: CIS countries.....	197
Table 8.5	Nominal wage/ minimum consuming budget ratio (1996-2007)	202

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ABSTRACT

Social and economic appearances in transition economies have been unsolved within the initial policy advices based on the mainstream economics. Rapid implementation of mostly advised comprehensive economic reform packages have not been resulted in anticipated outcomes. Most studies on these economies confirm non-existence of the corresponding efficient institutions as one of the major reasons for inefficient outcomes of economic reforms. However, these studies are generally limited by indicating the extent to which institutions important for these economies. While better understanding of the success of economic reforms in transition economies requires further analysis on formation of institutions, sources of inefficiency in institutions and persistence of inefficient institutions in the context of transition economies.

This thesis has attempted to analyse structural economic reforms in transition of Kyrgyzstan to market economy and explain their inefficient outcomes. Particular emphasize is given to analysis of implementation of structural economic reforms and on the efficiency of institutions. Transition process under the research include period of 1991-2007. Analyses are based on interpretation of statistical data, other relevant documents and studies. Results of the thesis are in line with the other studies which conclude that formation of efficient institutions is precondition for successful transition to market economy. Character of implementation of structural reforms along with historical legacies and growth performance are found as major determinants of institutional efficiency in the context of transition. As the primary solution for institutional improvement measures taken by government with focus on administrative reforms are recommended. Also eventual increasing economic growth performances and corresponding behavioral adjustment have potential to contribute to improvements of institutions.

Keywords: Institutions, transition economies, Kyrgyzstan, Washington consensus.

ÖZET

Geçiş ekonomilerinde görülen sosyal ve ekonomik olgular bu ekonomilere genellikle önerilen ve ana iktisadi görüşe dayandırılan ekonomi politikalar çerçevesinde çözülemeyen bir şekilde ortaya çıkmıştır. Hızlı gerçekleştirilmesi tavsiye edilen geniş kapsamlı ekonomik reform programları genellikle beklenen sonuç göstermemişlerdir. Geçiş ekonomileri üzerine yapılan çoğu çalışmalar gerekli etkili kurumların olmaması ekonomik reformların etkisiz sonuçlarının temel nedenlerinden biri olduğunu ıspatlamaktadır. Ancak bu çalışmalar kurumların sözkonusu ekonomiler için ne kadar önemli olduğunu tespit etmekle sınırlı kalmaktadır. Oysa geçiş ekonomilerinde ekonomik reformların başarısını anlamak için kurumların oluşması, kurumlarda etkinsizliğin kaynağı ve etkin olmayan kurumların devam etmeleri konularının da incelenmesi önemli olmaktadır.

Bu tezde Kırgızistan'ın piyasa ekonomisine geçiş sürecinde yapısal ekonomik reformların incelenmesi ve bunların sınırlı kalan sonuçlarını açıklamaya çalışılmıştır. Özellikle yapısal ekonomik reformlar ve kurumsal etkinlik üzerine durulmuştur. Araştırmaya konu olan geçiş süreci 1991-2007 yılları arası periodu kapsamaktadır. Analizler statistiki veriler, ilgili diğer raporlar ve çalışmaların yorumlanması ve açıklanmasına dayandırılmıştır. Araştırma sonuçları ilgili kurumsal altyapının oluşturulması piyasa ekonomisine geçiş için önkoşul olduğunu ileri süren diğer çalışmaların sonuçlarını desteklemektedir. Geçiş sürecinde tarihi özellikler ve ekonomik büyüme başarısı yanında yapısal reformları gerçekleştirme özellikleri kurumsal altyapıda etkinsizliğin nedenleri olarak tespit edilmiştir. Kurumsal iyileşme için öncelikli olarak idari reformlara odaklanan devlet tedbirlerinin alınması önerilmiştir. Bunun yanısıra zamanla ilerleyen ekonomik büyüme başarıları ve davranışsal ve kültürel değişimler kurumsal altyapının iyileşmesine katkıda bulunma potansiyeline sahiptirler.

1. INTRODUCTION

Dissolution of the USSR caused the emergence of countries in transition. In its general meaning the term “transition” can be applied to describe any position which is changing from one to another position. However the concept of transition that we concern here is restricted to the creation of a market economy embedded in a democratic order built on the legacy of an autocratic system with central planning¹. This definition distinguishes transition countries, on the one hand, from developing countries that have already market mechanisms, but lack fast and sustainable modernization and growth and, on the other hand, highly developed countries that have established effective market economies. Therefore, the phrase “transition to a market economy” refers to the countries that belonged to the former Soviet Bloc and focuses on a designed and coordinated shift from a communist to capitalist order. Although according to some considerations transition process is almost finished for most of the Central and Eastern European countries, the process is not completed yet for the Commonwealth of Independent States (CIS) countries.

Dominance of the mainstream economics at the outset of transition brought about the general advice given to transition economies which was based on the Washington Consensus prescription: liberalization, stabilization and privatization. Nevertheless, the same reform packages implemented in different countries have resulted in different outcomes and complexity of socio-economic changes has appeared to be beyond the scope of this prescription. Eventual economic experience of transition economies has revealed the importance of corresponding institutions for economic reforms to be successful. Both of the policy makers and international community have become aware of the significance of institutions building in these economies and have called, especially latter, for second generation reforms where institutions should be of major concern. Although most studies note particular importance of institutions, they do not fully explain the sources of varying

¹ However, the evolutionary economists are against the use of the word “transition”. According to them, the word “transition” means that there is the point of arrival which is certain. But it is not certain what will be outcomes of the reforms launched in countries in transition. Therefore, the evolutionary economists prefer to use the word “transformation” instead of “transition”. But in this work we use these two terms in synonymous meaning being aware of the possible uncertain outcomes of reforms.

efficiency of institutions across countries in transition. Experience of the CIS countries shows that improvement of institutional environment is difficult task and, in contrary, patterns of inefficient institutions have taken systematic character. Therefore, better understanding of institutions building in transition economies requires not only indication to what extent institutions are significant for economic performance, but necessitates further analysis on formation of institutions, sources of inefficiency in institutions and persistence of inefficient institutions. Some studies point out the importance of the historical legacy and general poor economic performance for inefficiency of institutions in these economies. Undoubtedly, historical legacy of the Soviet period has had impact on institutional environment. But it is undeniable fact that conditions appeared during the comprehensive reforms have contributed to situation with institution building too. Therefore, it is important to focus on institution building in the context of implementation of structural reforms, economic performance and heritage of the past.

The principal objective of the thesis is to analyse structural economic reforms in transition of Kyrgyzstan to market economy and attempt to explain inefficient outcomes of these reforms. Under the light of general conclusions of studies on transition economies particular emphasize in the thesis is given to analysis of implementation of structural reforms and on the efficiency of institutions.

Transition of Kyrgyzstan to market economy, as well as other Central Asian countries, generally has been out of the major focus of research papers on transition economies¹. Although Kyrgyzstan as a member of the former Soviet Union in its initiatives of transition to market economy has received considerable support from international community, particularly from the IMF and the World Bank and within their support has implemented radical and comprehensive reforms towards market economy. In 1990s it was considered as one of the most reformist countries in CIS. However, economic performance as an outcome of reforms implemented so far has been remaining weak and country is among the poorest countries in CIS. Problems in attracting investments, recent attempts of Kyrgyzstan government to

¹ According to Kalyuzhnova (2003, p. 437) this is probably because of the geographical remoteness of the region from Europe, a lack of easily available statistical data from the national statistical offices and the perception that the Central Asian transition is one of the most turbulent, with authoritarian methods of management and a mentality among the people that is vastly different from the European.

improve government regulation over business environment and contradicting results of different indicators on institutional environment in Kyrgyzstan confirm the actuality of institutional improvement for economic performance of the country. From this perspective transition experience of Kyrgyzstan constitutes compatible case for analysis of economic reforms, their outcomes and obstacles towards efficiency of these reforms. Results of the study would contribute to better understanding of economic reforms and institutions building in transition economies. It may help to policy makers in carrying out effective economic reforms and in their attempts to improve institutional environment in these economies.

Analysis of transition of Kyrgyzstan includes time period starting from 1991 to 2007. While initial conditions and legacies that the country inherited from the old system is discussed in terms of the historical perspectives till 1990. Statistical data and other relevant information are used in the study. However, it should be noted that statistical data of 1990s, especially of first half of the decade should be treated with cautions. Correctness of statistical data of that period have been questioned because of several issues, including technical problems such as non compatibility of old methods of statistical reporting to international standards; the chaotic economic conditions during the first half of 1990s where old methods of statistical reporting appeared weak; and appeared large scales of underground economic activities that have not been reflected in official statistics. Moreover, so far no more than twenty years passed since the start of transition. This is very short period of time for efficient use of macroeconomic variables of an individual country within quantitative methods. Because of the lack of data possibility of application of quantitative methods to analysis in the thesis is seriously limited. Therefore analyses are based on interpretation of statistical data, other relevant documents and studies.

The study is organized in main six chapters. After literature review third chapter discusses two main approaches in analyzing transition economies, explores general results of the growth experience in these economies and explains growth performance within the institutional framework. Fourth chapter in order to give idea on the initial condition of transition evaluates economy of Kyrgyzstan from historical perspectives. Fifth chapter focuses on the start of transition by analysing choice of economic reforming strategy, magnitude of transformation crisis in Kyrgyzstan and the liberalization policies, which considered as the

starting point of comprehensive reforms in Kyrgyzstan. Sixth chapter analyses structural reforms: privatization, reforms in agriculture, financial, fiscal and social sectors. Seventh chapter evaluates outcomes of economic reforms in terms of the economic growth performance, investment tendencies, banking sector activity and social costs reducing capability of economic performance. Eight chapter evaluates institutional infrastructure as the major reason for inefficient outcomes of reforms in Kyrgyzstan and attempts to explain sources for inefficiency in institutions by taking into account both historical legacies and conditions appeared during the implementation of structural reforms. Finally, ninth chapter presents summary and conclusions of the thesis.

2. LITERATURE REVIEW

Objective of the thesis is to analyse transition of Kyrgyzstan to market economy. Most studies on transition economies investigate economic reforms and economic performance by focusing on economic reforms through general indicators or on specific aspects of reforms. Another part of studies attempting to explain the success in transition have been devoted to institution building and their importance for economic performance. Generally, these studies are based on the analysis made on the sample consisting of several countries in transition. Under the light of these studies particular emphasize in the thesis is made on analysis of implementation of structural reforms and on the efficiency of institutions in Kyrgyzstan.

Therefore, this chapter reviews literature on transition economies in two sections: first section includes studies examining the relation between structural reforms and economic performance, while second section reviews studies on institutions and economic performance.

2.1 Structural Reforms and Economic Performance in Transition Economies

Radulescu and Barlow (2002) evaluate the robustness of the relationship between growth in transition economies and set of variables for economic reforms and macroeconomic stabilization derived from the EBRD indicators, which are used in most of the other studies. For this purpose the study use general to specific procedure and extreme bound analysis on the dataset of twenty five transition economies for 1991-1999. Results indicate robust positive effect of inflation stabilization on growth. A significant long-term effect of liberalization on growth is not found. According to authors this might reflect the fact that liberalization only influences growth after a long lag or benefits of liberalization may be indirect, via reduction of inflation. Effects of fiscal and exchange rate policies on growth are also found as weak. The reform index constructed by inclusion of large-scale privatization, liberalization and restructuring improved the test results, although its robustness is not confirmed. They argue that the reason for this may be imperfections in constructing the reform index, in particular the exclusion of measures of institutional performance.

Lawson and Wang (2004) assess the link between growth and structural reform in 1991-2000 using the panel data of twenty five transition economies. They find that the dominant link between transition indicators and growth is negative. According to the results there is clear evidence that price liberalisation, enterprise reform and competition policies are negatively associated with growth. By contrast, only trade liberalisation has a significant positive association with growth, but no significant link is found between growth and financial sector reforms. However, they note that these results do not imply that there will not be benefits from structural reforms, rather imply that they did not produce positive effects during the first decade of transition.

Falcetti et al. (2006) study the impact of reforms on economic growth in transition economies. As a possible determinant of economic growth are considered: initial conditions, stabilization, reforms and other factors, which had been neglected in most of the previous studies. These factors are: oil prices, as it would have had an impact on some oil-rich countries by the high prices of recent years; recovery from economic downturn, that is, the further a country has fallen in terms of real output, the greater the potential for subsequent growth; and finally, external demand, as transition countries are increasingly integrating into the world economy, it result in increasing external demand from the main trading partners and, therefore, may influence economic growth. The main conclusion of the study is that there is a robust, positive influence of reforms in one period on subsequent growth across transition economies. Growth, in turn, is found to spur economic reforms instantaneously. Their estimations also show that the importance of initial conditions as a determinant of growth has declined over time, and fiscal surpluses are positively associated with higher growth. Other factors such as recovery, oil prices and external growth also drive growth to some extent but do not mitigate the importance of reforms. However, these factors are considered to help in explaining the high growth rates recently appeared in some less reformist countries.

Pelipas and Chubrik (2008) using cointegration and equilibrium correction model for panel data of twenty six post-socialist economies surveys economic reforms and economic growth relation. They found that there is a long-run relationship between them and market reforms have a statistically significant positive influence upon economic growth in the long run. Moreover, a positive influence of market reforms on economic growth in the short run with a

one-year lag is also found. However, concerning the possible feedback between market reforms and economic growth, they did not find such relation both in long-run and short-run that implies economic growth does not influence market reforms.

Bennett et al. (2007) examine how different methods of privatisation might have affected growth for twenty three transition economies. They estimate a cross-country growth model along on Barro (1991) and Mankiw et al. (1992) supplemented with indicators of private sector development, privatisation method, capital market development and government capital expenditure. In particular, dummies for three methods of privatisation are used: privatisation by sale, privatisation MEBO and voucher privatisation. Privatisation by sale includes any method in which ownership in the bulk of enterprises is transferred on the basis of sale at an agreed price to people not previously associated with the firms, including foreigners. Privatisation by MEBO is also a market transaction at a positive price, but the buyers are insiders to the firm – managers or workers. Voucher privatisation entails the transfer of the enterprise at a zero or nominal price, either to insiders. Using several econometric specifications they found that only voucher privatisation have been significantly associated with faster growth. Moreover, neither private sector development, nor capital market development showed significant influence. Therefore it is concluded that mass privatisation is an effective choice in situations where capital markets are highly imperfect and the distribution of wealth is not well correlated with distribution of managerial ability.

Merlevede and Schoors (2005) examine how the choice of reform speed and economic growth affect one another in transition economies. They estimated a system of equations where economic growth, economic reform and FDI are jointly determined for the sample of twenty five transition economies. Their findings show that new reforms affect economic growth negatively, whereas the level of past reform leads to higher growth and attracts FDI. This implies that immediate adjustment cost of new reforms is counterbalanced by a future increase in FDI inflows and higher future growth through a higher level of past reform. Additionally they take into account reform reversals, which found to contribute to lower growth. Testing through simulation the impact of big bang reform and gradualist reform on economic growth in the presence of reform reversals, which requires aggregate uncertainty about the appropriate reform path, they found that for a benevolent policymaker without

reversal, the big bang strategy is advantageous, and conversely, with a reform reversal, the gradualist strategy is preferred. In the presence of uncertainty about the appropriate reform path and hence reversals, relatively small ex ante reversal probabilities in the eye of the policymaker suffice to tilt the balance in favor of gradualism for a benevolent policymaker. However, inclusion of the political motives gives different results. If political cycles force policymakers to be short-sighted, big bang strategies will never be preferred over gradualism. Because of higher initial adjustment costs of a big bang strategy, the potential benefits from reform and FDI only materialize after the elections. However, a countervailing argument arises in the case of voter myopia, i.e. if voters only judge politicians on the basis of whether the economy has yet returned to positive growth, a big bang policy may offer better prospects for re-election. The case for gradualism gains strength if policymakers are short-sighted, but weakens if voters are myopic.

Staehr (2005) studies the effects of sequencing and reform speed on output performance on the sample of twenty five transition countries. By using principal component techniques reform clusters are constructed and effects of speed is tested. The results of the study indicate that broad-based reforms are good for output growth, although have short-term negative effect. Liberalisation and small-scale privatisation even without other structural reforms have positive effect on growth, although with possible early negative effects. Conversely, large-scale privatisation without adjoining reforms, market opening without supporting reforms and bank liberalisation without enterprise restructuring affect growth negatively both in the short-term and medium term. Therefore comprehensive synchronized reforms are beneficial to growth, while unsynchronized reform packages may be detrimental to economic growth. An exception for this synchronization is liberalisation and small-scale privatisation, implementation of which favorable to growth even in the absence of other main structural reforms, then there is no need for postponing these easy components of reforms in the absence of comprehensive reforms strategy. Moreover, the speed of reforms is found to have little effect on growth in the short and medium term. These findings suggest that balanced and wide-ranging reforms are beneficial to growth and in designing reforms packages complex interaction among reforms should be taken into account. Conclusion about little importance of speed of reform favors rapid reform due to benefits of comprehensive reforming. However, the same finding implies

that there is no loss from slowing reforms when it is necessary to get content or sequencing right.

Popov (2006) explaining the transformational recession and the process of economic recovery in transition economies argues that the former can be best explained as adverse supply shock caused mostly by a change in relative prices after their deregulation due to distortions in industrial structure and trade patterns accumulated during the period of central planning, and by the weak institutional capacity, which is treated as the ability of state to enforce rules and regulations. The speed of liberalisation appeared to have negative effect on performance. In contrast, in the recovery period the ongoing liberalisation starts to affect growth positively, while the effect of pre-transition distortions disappears. He relates the negative effect of liberalization at the initial stage of transition with limited ability of the economy to adjust to new price ratios that emerge after rapid liberalisation. In particular, the capacity to transform capital stock from inefficient to efficient industries rapidly and to compensate the fall in output in non-competitive sectors by the rise in competitive sectors was limited. Liberalisation, which have been proceeded much more slowly at the recovery stage have influenced performance positively because it creates market stimulus without causing rapid collapse of output of inefficient industries, which cannot be compensated fully by the rise of efficient industries due to investment constraints. Hence, when reform speed exceeds investment potential of the economy it would have negative consequences on the economy. This argument is considered as advantage of gradual reforming. Institutional capacity and macroeconomic stabilization continue to be important for economic performance. Institutional capacities in turn, depend to a large extent on the combination of the rule of law and democracy. According to his statements both authoritarian and democratic regimes can have strong rule of law and can deliver efficient institutions, whereas under the weak rule of law authoritarian regimes do a better job in maintaining efficient institutions than democracies. In countries with weak democracy, as most of CIS countries, ensuring institutional capacities is worst, which has devastating impact on output. Therefore, as the main finding of the study he notes the importance of preserving of strong institutional capacity for economic performance.

King and Hamm (2005) using cross-national regression technique for thirty two post-Soviet style economies analyse the impact of mass privatization on state capacity. Their

argument is that rapid large-scale privatization in transition economies creates severe supply and demand shocks for enterprises thereby inducing firm failure. The resulting erosion of tax revenues leads to a fiscal crisis for the state, and severely weakens its capacity and bureaucratic character. This, in turn, reacts back on the enterprise sector, as the state can no longer support the institutions necessary for the effective functioning of a modern economy. The result is a vicious cycle of declining state capacity and enterprise failure, resulting in demodernization. Results of the study reveal negative effects of mass privatization on economic growth, state capacity and the security of property rights. They conclude that provision with enough state revenue in order to guarantee bureaucratic stability is important in designing and implementing reforms.

Campos and Horvath (2006) critically evaluating the generally used indicators of reforms in empirical literature attempt to construct the objective reform indicators. In particular, they argue that the measures of reform efforts during the transition from communism have been constructed by international organizations, such as the World Bank and the European Bank for Reconstruction and Development (EBRD) and, hence, are subjective. According to authors being subjective these measures, in particular EBRD transition indicators, have some drawbacks, such as difficulty of determining which are the exact variables underlying each reform measure, underlying measures may include policy inputs as well as outcomes (for instance, for external liberalization, one can find tariff levels as well as trade openness), and these measures are benchmarked against an imprecisely defined reference point (for instance, an “advanced industrial economy”)¹. By noting these shortcomings they construct from forty different variables objective measures of privatization, internal and external liberalization reform across twenty five transition economies countries for 1989-2001. With these new measures they re-estimate various econometric models from the literature on growth and reforms relation in transition economies, and find that the macroeconomic effects of reform (when measured objectively) tend to be larger and more precisely estimated. Along with this

¹ The last argument is related with EBRD transition indicators which take values from 1 to 4, where value 4 is defined as being similar to advanced industrial economies. However, according to Campos and Horvath (2006, pp.10-17) it is an imprecise reference point and even industrial economies are heterogeneous. Moreover, these measures are cumulative and represent reforms as continuous, smooth and uninterrupted and, thus, provide little information about reform reversals.

they study the factors that explain reform dynamics and show that GDP growth determines external liberalization and privatization, concentration of political power drives internal liberalization, and democracy underpins all three.

Iradian (2007b) using panel data approach examines the rapid growth occurred recently in Commonwealth of Independent States (CIS) countries. In particularly the study compares relative contribution of different factors to growth of these economies in two different time periods: 1996-2000 and 2001-2006. The paper finds that output growth in the Commonwealth of Independent States (CIS) has been higher because of the recovery of lost output, progress in macroeconomic stabilization and market reforms, and favorable external conditions. Macroeconomic stabilization and market reforms have had contributions to growth, because of their effect on the overall productivity. Transition countries that experienced larger declines in output during the early 1990s tended to grow at much faster rates. On average, of the eight percent annual average growth rate for the CIS in 2001–06, about two percentage points are concluded to be attributable to the recovery of lost output. Growth acceleration in 2001–06 years was enhanced by the favorable external environment: positive terms-of-trade shock, large increases in remittances and global technological innovation. These factors have accounted for about two percentage points of the annual growth in the CIS. These findings imply that almost half of the total growth in 2001–06 came from the recovery of lost output and a favorable external environment. These two factors are unlikely to continue for a very long time. Therefore, the major conclusion of the paper on growth prospects of CIS countries is further structural and institutional reforms. In particularly it is emphasized to improve the investment climate in the non-primary sectors.

Havrylyshyn (2006) attempting to explain the surge of growth in CIS countries in 2000s argues that according to earlier studies Central Europe and Baltic countries started to recover earlier than CIS because they had more progressed in stabilization, liberalization and institution building. Hence, after 2000s Central Europe and Baltic countries should have had higher growth rates than CIS countries, since latter is still lagging behind Central Europe and Baltics. But CIS countries experienced higher growth and most of the researchers explained it with oil prices, externalities from neighbor countries. However, he states that these arguments only partly explains this situation and argues that such puzzling situation is related with an

existence of a threshold of reforms, achievement of which makes possible to start to recover. For this he compares EBRD reform indicators for Central Europe and Baltics and CIS countries prior their recovery which appeared to be almost at the same level. In this threshold institutional development appeared to be at very low level than of liberalization and, therefore, he proposes hypotheses that the start of recovery is possible even if the process of developing market institutions lags behind that of liberalization and stabilization. He suggests that a most useful option on sequencing of institutions and liberalization would be to begin with a basic and simplified legal-regulatory framework that is comprehensive and but not deep, and follow with refinements of these regulations over time. However, it is admitted that the existence of such threshold of reforms does not imply that growth will continue and be sustained once it is reached; but rather countries should progress further in reforms in order to sustain growth.

2.2 Institutions and Economic Performance in Transition Economies

Moers (1999) performs growth empirics by constructing four institutional measures from few data sources for 25 transition countries over the period 1990-95. These institutional measures are: rule of law, investment law, property rights and civil society. Estimation results suggest that (particularly state) institutions are significant for growth and, especially, foreign direct investment (FDI), the latter in turn being important for the former. These results indicate that quality of institutions is more important than variables that previously considered to have strong effect on growth and investment. Since his estimations show that only inflation and war seem to have been relatively more important for growth performance in transition countries than institutions. This suggests that macroeconomic stabilization and peace should be the main policy priorities in transition, closely followed by institution building.

Crafts and Kaiser (2004) investigate the role of institutions growth of transition economies for medium-term prospect. By taking into account the corresponding literature and the facts of different adherence to the rule of law between transition economies they revised Fischer et al. (1998a) in projecting growth prospects for these economies. Fischer et al. (1998a) used the equation of Levine and Renelt (1992), which did not include institutional quality. However Crafts and Kaiser argue that this approach was too optimistic. Since inclusion of variable for

rule of law considerably decreased the growth prospects. Its importance was such that if, for example, Tajikistan had the same institutional quality with Slovenia, its projected growth would be raised by 2.6 percent. Therefore they conclude that institutional quality is likely to have a substantial effect on future growth performance by raising the quantity and quality of investment and that the prospects for those countries who are not accession candidates to European Union (EU) are much less good than was generally believed in the early days of transition.

Chousa et al. (2004) seeking to evaluate the impact of institutional development on economic growth performances in transition economies suggest methodology of measuring institutional development which is based on the shadow economy and barter trade volume. According to them these indicators are good measure for informal institutions and institutions inherited from soviet period correspondingly. In order to assess the progress in institutional development the average rate of shadow economy for OECD countries are taken as a benchmark. Results of testing on the sample of twenty transition countries show that their proposed indicator for institutional development compared to structural reforms better explains economic growth. It also appears that structural reforms have effects immediately, while the institutional system reform is a matter of permanent improvement.

Susjan and Redek (2008) study the relationship between uncertainty and economic performance in transition economies. According to the authors uncertainty in the transitional economic environment is caused by three groups of factors: institutional and systematic transformation, political and social instability, and legacies of the past. To quantitatively capture this uncertainty they designed the uncertainty index, based on Heritage Foundation and Freedom House data. Results show that high levels of transition-specific uncertainty have negative impact on economic growth. Although analyses indicate negative influence on foreign direct investment, due to the lack of reliable data the results of analysis appeared to be at the intuitive level. However, authors explain the case of oil-rich countries, where recently the high FDI performance occurred, by stating that high uncertainty of the economic environment in these countries has been outweighed by rich natural resources. They argue that regardless of their recent performance, these economies will have to build a reliable institutional framework and reduce uncertainty for further performance.

Pääkkönen (2009) surveys the impact of institutions on economic growth by taking into account human capital, investment and government consumption. Institutions are measured in terms of economic freedom and real GDP per worker is taken as a measure for economic growth. Results from the sample of twenty five transition economies show that in the presence of a high level of human capital institutions promote growth. Moreover, education and skills may not have the desired impact on economic outcomes if there is a lack of proper institutions. Therefore the author concludes that as long as there are insufficient institutions or public capital, human capital is likely to be underutilized. Increasing investments and economic freedom thus allows for more productive use of human capital due to complementarity of skills and capital, and by giving highly skilled labor greater work opportunities in the market economies.

Zeghni and Fabry (2008) examine the role of institutions in human development in two groups of transition economies: new EU member and CIS countries. Infant mortality rate was taken as a proxy for human development and institutional arrangements were analysed by measures for formal and informal institutions. Results of the study showed that human development is more sensitive to institutions in CIS countries than in the new EU members. They explain this different sensitivity by the fact that the in order to join EU new members had to improve considerably their institutions in order to fulfil most of the EU requirements. Such an improvement created an institutional shift towards more stability and transparent rules. Therefore, accession process was an accelerator for institutional building in these countries. While in CIS countries institutional arrangements are seen as immature, unstable and less reliable. CIS countries have deep cultural and ethnical specifications that create conditions for a strong informal institutional pattern which influences the formal institutions building.

Pasquale (2007) analysing institutions, human capital and economic growth chain in twenty six transition economies finds that human development variables are correlated with GDP per capita. Although human development is important for economic growth, human development itself requires appropriate institutional environment. Putting it differently better institutions provide better opportunities for human development, which in turn causes growth. He claims that appropriate institutional policies are crucial to development process.

Bevan et al. (2004) study the impact of different dimensions of the institutional framework in East European transition economies on foreign direct investment (FDI). They find that FDI is positively related to the quality of formal institutions, though an impact from informal institutions are only shown for the special case of Russia, which has large gap between the extensiveness and effectiveness of legal reform. Several specific formal institutions are found to influence FDI: private ownership of business, banking sector reform, foreign exchange and trade liberalization, and legal development. Conversely, domestic price liberalization, non-bank financial sector development and competition policy do not enhance FDI. They explain such situation with the possibility that some foreign investors might have been attracted by the opportunity of earning monopoly rents. However, as a major conclusion authors state that in aggregated level institutions remain important for FDI.

Beck and Leaven (2005) propose the political economy approach in explaining divergence in institution building across transition economies. According to them institution building in transition economies is determined by natural resources and the historical experience of these countries during socialism through their influence on political structure and process during the initial years. They empirically show that countries that are more reliant on natural resources and spent a longer time under communist system are more likely to see former communists remain in power and to start the transition process with less open political systems, which is detrimental to the development of market institutions. Therefore they conclude that the large variation in institution building can be explained by the initial political structure, which is explained by natural resource reliance and years under communist system. Their estimation results confirm the importance of institution building in explaining the variation in economic development and growth across transition economies during the first decade of transition.

Balcilar (2003) using the six governance indicators: voice and accountability; political stability; government effectiveness; regulatory quality; rule of law and control of corruption, examine the impact of governance on different measures for macroeconomic performances on the sample of 25 transition economies and draws conclusions for Central Asian countries. He found that improvements in governance lead to substantial ameliorations of macroeconomic performances: increase of savings and investment, per capita income, level of high education

etc. in these economies. Analogously, improvements in governance would decrease the transformational recession and inflation rate.

Thus, studies on structural reforms and economic performance depending on the aspect of reforming under analyses derive different conclusions. However, general conclusion of studies on the transition economies is that reforms, though might have short-term and mid-term adjustment costs, in the long-term significantly contributes to economic performance. Although there is no consensus on the speed of reforming, most of the researchers agree on the importance of appropriate sequencing of reforms. Studies reviewed in the second section confirm the importance of institutions as one of main the factors for explaining varying economic performance across transition economies and emphasize necessity of corresponding institutional environment for the success of reforms.

3. THE ESSENTIALS OF TRANSITION PROCESS

By launching economic reforms in transition economies the objective is to bring these countries, within appropriate period of time, to high levels of prosperity. Dominant reform prescriptions for this purpose have been based on mainstream economic analysis. However, complexity of social and economic changes has been appeared to be beyond of the general reform prescriptions and their expectations. Magnitude of output collapse, lack of rule of law and lack of other necessary basic institutions have been unexpected by these prescriptions. Then the process of post-communist economic transformation is a complex process of economic change, with important differences between countries, multiple outcomes, and with important differences between actual and intended outcomes (Ellman, 2005, p.612). Moreover, being different both from market and centrally planned economies, transition period does not imply the completed system with strong consistent patterns. Given such complexity analysis of transition economies within a formed theoretical concept in economics has been difficult. As Koldoko (2000, p.340) states:

“The transition process, including the structural and institutional aspects, involves such rapid and frequent shifts that the theoretical generalizations are often of little practical relevance or usefulness. Some situations are in such rapid flux that trying to apply the theory is a little like trying to take a photo of the passing landscape from the window of a speeding train”.

Therefore, it would be consistent to agree with some authors who conclude that under conditions of dynamic change there is no general theory of transition period in economic literature, but there are useful instruments for analyzing issues specific to the transition economies¹. Experiences of transition economies stimulated debates on different aspects of economic reforming. Proceeding from this fact this chapter focuses on three topics. In order to give the general idea on how transition has been treated in economic theory first part analyses two main approaches to transition. Second section outlines major conclusions on economic growth performance in transition economies. Third section includes analysis of institutions and economic growth in the context of transition economies.

¹ For instance, see Portes (1994, p.1179)

3.1 Two Approaches to Transition

Because of the absence of prior deep knowledge on complexities of transition period and dominance of the neoclassical economic theory at the outset of transition much of the advices given to transition economies were derived from the propositions of mainstream neoclassical theory. Consequent failure of these advices and complexity of socio-economic changes of the transition period have brought about different critiques. Initially the debate over transition issues started from focusing on the speed of reforming and was called as “shock therapy (or big bang) versus gradualism (or incrementalism)” debate¹. Shock therapy implied the rapid and comprehensive reform of economic system, whereas gradual strategy meant gradual, by experimenting and launching successful one, reform. However, the pure pattern for this dichotomy can not be found in practice. Since all transition economies to some extent have used both instruments of shock therapy and gradualism². Moreover, continuing debates over the transition issues concerned not only the speed of reforms as in “big bang versus gradualism” debate, but other aspects too. Therefore, in order to understand major views on transition not only in terms of the speed of reforming, but in much more broader framework, it would be consistent to analyze them, as Roland (2003, p. 4) suggests, within the Washington Consensus and the evolutionary-institutionalist approaches. The aim of representing views on transition within such framework is to give a picture of approaches to issues of transition economies in comprehensive way, and not to make the strict distinction between these two views. It should be pointed out that this delineation does not imply the current existence of such strict distinction. But rather experience of transition eventually has lead to consensus in most topics that previously discussed in contrasting visions. Therefore, this representation of

¹ According to Lavigne (1999, p.118), origins of the debate stem from the difference between initial situations of the two first countries following the path of transformation: Poland and Hungary. Reforms launched in Poland were defined as an example for “shock therapy”, while the Hungarian case was treated as gradual.

² Hoen (1996) focuses on the Czechoslovakia and Poland, which are often referred as shock therapist countries, and on case of Hungary that is referred as an instance for gradualism. He argues that shocks versus sequencing debates for these countries only make sense with respect to the stabilization and liberalization. But concerning the institution building and privatization it can be qualified as misleading. Since important elements of a gradual approach such as wage control in labor market, support of banking system with substantial capital injections etc. were also found in Czechoslovakia case, while Hungary applied a tough bankruptcy law, which is considered as shock therapy instrument.

contrasting views is schematic and general. However, it is useful to analyze on the bases of these two approaches in order to understand how the transition have been treated and analyzed in the economic literature and its implication on policy making.

This section focuses on the Washington Consensus and the evolutionary-institutionalist approaches to transition. First and second subsections include explanation of each concept in terms of their roots and their policy implication in the context of transition economies. Final subsection analysis differences of these two approaches.

3.1.1. The Washington Consensus approach

In 1989 at conference devoted to reforms in Latin America countries American economist John Williamson came forward with report that called “What Washington Means by Policy Reform”. This report contained the so called “Washington Consensus”- list from 10 policy recommendations (see Table 3.1). According to Williamson (2000, p.251) the term refers to the lowest common denominator of policy advice being addressed by Washington-based institutions to Latin American countries as of 1989.

The policies of the Washington Consensus initially were not drafted or proposed in order to solve the crisis in post socialist countries entering a period of transition toward a market economy. The consensus was actually aimed at economies which were already market economies, and not in transition. But in 1990s it served as a manual for reforming economies not only in Latin America countries, but has largely influenced policy-making in most of the post-soviet transition economies too. The Washington Consensus view on transition was dominant both in policymaking and thinking of international financial organizations. Naim (1999) explaining this situation states:

“...Because, at the time, it filled an ideological vacuum and it was relatively simple for politicians to understand and use in speeches. It also gave ministers a practical action plan with specific goals; it had the endorsement of prestigious institutions and individuals, last but not least, it had the ring of money...”

Thus, the dominance of theories of the mainstream economics on transition process, need for financial support for implementation reforms and the great enthusiasm for free

market economy after the collapse of communist system contributed to the popularity of propositions of the Washington Consensus both among international organizations and policy makers in most of the transition economies. It is generally argued that the Washington Consensus is based on neoclassical price theory. However, main features of the policies implemented within the consensus shows that it has commitment to such theoretical concepts as supply side economics and monetarism as well. Because of this it would be right to mention its root as heterogeneous with dominance of the neoclassical price mechanism.

Though the list of recommendations accounts for ten main policy prescriptions, experience of transition economies has revealed trinity of policies as important prescriptions of the Washington consensus in transition economies: liberalization, stabilization and privatization.

In neoclassical theory price mechanism is fundamental and rational behavior of economic agents and their promptly reaction to market incentives is assumed. Then, the major concern in establishing market economy should be establishment of the market price mechanism through liberalization and minimum state intervention. Therefore the core element of the Washington Consensus is rapid elimination of domestic price and external trade control of the state. Since economic agents are rationally reacts to current incentives rapid price liberalization would cause rapid receive of incentives for rationality by economic agents. Moreover, price liberalization was essential for macroeconomic stabilization and for microeconomic restructuring of the distorted post-soviet economy: general increase in the price level had to eliminate the monetary overhang, while changing relative prices, and had to improve allocative efficiency.

In order price mechanism to work and give right signal to economic agents, stabilization after liberalization was necessary. Stabilization has been often implemented through restrictive monetary and fiscal policies¹. As soon as the aggregate price level is stabilized the relative price adjustments would lead to efficient allocation of resources. Producers will economize on the utilization of inputs, while consumers are expected to

¹ In most of the literature on transition economies such strict stabilization policy is broadly described as the monetarist approach.

experience welfare gains, because no longer will they be forced to substitute initially for eventually unavailable commodities (Brada, 1993, p.91).

Table 3.1 The Washington Consensus: 10 recommendations

1. *Fiscal Discipline:* Budget deficit should small enough to be financed without recourse to the inflation tax.
2. *Public Expenditure Priorities:* redirecting public expenditure from politically sensitive areas, that receive more resources than their economic return can justify, toward neglected fields with high economic returns and the potential to improve income distribution, such as primary health and education, and infrastructure
3. *Tax Reform:* broadening the tax base and cut of marginal tax rates.
4. *Financial Liberalization:* The ultimate objective of financial liberalization is market-determined interest rate.
5. *Exchange Rates:* unified exchange rate set at a level sufficiently competitive to induce a rapid growth in non-traditional exports.
6. *Trade Liberalization:* Quantitative trade restrictions should be rapidly replaced by tariffs, and these should be progressively reduced until a uniform low tariff in the range of 10 per cent (to 20 per cent) is achieved.
7. *Foreign Direct Investment:* Barriers impeding the entry of foreign firms should be abolished
8. *Privatization:* State enterprises should be privatized.
9. *Deregulation:* Governments should abolish regulations that impede the entry of new firms or restrict competition.
10. *Property rights:* The legal system should provide secure property rights without excessive costs and should make such rights available to the informal sector.

Source: Williamson 1994, pp.26-28.

Along with the liberalization privatization process had to be rapid and comprehensive too¹. High speed of privatization was considered as relevant criterion for the way in which property rights had to be transferred from state to private persons. The device for quick privatization follows straightforward from the Coase theorem: under the zero transaction costs, no matter what the distribution of property rights look like initially, optimal allocation will finally be assured.

Aside of the economic reasons for rapid implementation and comprehensiveness of reforms there was a political economy argument. The argument was to use political window of opportunity and provide irreversibility of reforms. In other words, radical measures in the period shortly after a great change in a country's history (i.e. collapse of USSR) enables one to tap a precious reserve of political capital, that allows for rapid implementation of reforms and thus to provide irreversibility of reforms, that can be caused by opposing political interests eventually².

Thus, the Washington Consensus in reforming post-soviet economies has emphasized three main policies: liberalization, stabilization and privatization. Along with this rapid implementation and comprehensiveness of reforms packages have been favored. After these measures it has been expected that price mechanism will yield in allocative efficiency.

However, in spite of such theoretical expectations failures occurred in transition economies, which have applied prescriptions of the Washington Consensus, have caused different debates about and critiques against it. Thus, for instance, quick and overall liberalization, in combination with restrictive monetary and fiscal policy, have been opposed by argument that it thwarts the importance of certain components of liquidity in the short run (Kregel et al., 1992). Moreover, an immediate and definite exposure of international competition through rapid external trade liberalization may lead to the termination of production which in the long run could have been profitable. But, most of the critiques underlined the argument that the Washington Consensus favored rapid implementation of reforms with universal recommendations without taking into account specific features of transition economies, in particularly institution building. However it would be completely

¹ According to Roland (2003, p.5) one of the roots of Washington Consensus was disappointing experiences with partial reform in Central and Eastern Europe prior to the fall of communism.

² For instance, see Balcerowicz (1993, pp. 30-33).

wrong to state that the Washington Consensus has ignored institutional reform. Indeed, it includes reform items on the introduction of laws: adequate laws to secure private property, rights of shareholders, creditors, absence of corruption etc. But critiques argue that it includes only legal change, whereas for the successful transition conditions of law enforcement, development of self enforcing social norms which support entrepreneurship, trust and respect of legality etc. are required. Supporters of the Washington Consensus argue that the failures raised these critiques are the result of faulty implementation and reluctant reformers. For them policy prescriptions are correct, but the way of their application was wrong.

As mentioned above this presentation of approaches is schematic and over time they have been subject to change. In particular a dominant idea by the end of 1990s became to change the Washington Consensus into the so called Post-Washington consensus. For the supporters of this new version of consensus it differs from original in moving away from the neo-liberal, market-friendly approach and places sustainable, egalitarian and democratic development at the heart of the agenda. Therefore, one considering critiques against the Washington Consensus should bear in mind the changing pattern of the concept. However, in our analysis we focus on conventional version of the Washington Consensus that have had large influence on transition economies, and not on consequent changes made to it.

3.1.2 The evolutionary-institutionalist approach

Another approach to transition is the evolutionary-institutionalist approach. This approach was not dominant at the outset of transition, but gradually has gained more support with transition experience. Intellectual root of this approach consists of the institutional economics (North, 1997) and the evolutionary economics (Murrell, 1992a; 1992b).

The evolutionary economics in its modern interpretation, made by Nelson and Winter (1982), has dynamic micro approach. Application of the evolutionary approach propositions to transition economies' issues has been made by Murrell (1992a; 1992b). He notes elements of the evolutionary economics that are most critical to reforms as:

- The use of routines and the fact that search reflects the historical experience of an organization mean that one should expect much persistence in organizational behavior.

- The evolutionary approach forces one to focus on the concept of the economic environment- the set of external influences that affect an organization's performance, including the set of other organizations in society. Given a stable environment for a long enough period, the types of routines and behaviors that are present in any society will be conditioned by the environment in which society's organizations have survived and adapted. Hence, in an initial period after a change in environment, the types of behavior observed will be to a large extent a reflection of the past environment.
- The evolutionary approach emphasizes the importance of selection processes, or entry and exit, in accomplishing change. Changes within organizations are de-emphasized in favor of a focus on shifts in economic resources from inefficient to efficient organizations or to new organizations better suited to the new environment.
- To aid in the efficiency on the selection process, there is a need to generate variety in the types of organizations that are persistent in society. This is especially the case when a radical change in environment is considered and society's stock of organizations has been honed in a different environment. Moreover, it must also be emphasized that a variety of organizational forms is characteristic of modern capitalist societies.
- The uncertainty and the limits on information processing that are emphasized in the evolutionary approach to organizations must also be acknowledged as elements in the policy-making process. Policy-maker knowledge of the behavior of the economy outside a narrow domain close to past experience will be highly inaccurate.

These fundamental elements as: routines, reflection of past in behavior of economic agents, organic development of enterprises, uncertainty and limits on information processing contrast to assumption made in arguments of the Washington Consensus.

Institutional economists argue that functioning of market economy necessitates not only free market prices and minimal state, but it is the corresponding institutions, both of formal and informal, make market mechanism efficient. Efficient institutions provide low cost transacting and credible environment in an economy. On the basis of these propositions it is argued that for successful transition establishment of institutional infrastructure that induces market incentives is essential. But institutional change is not a process of short-term. Effort of

organizations and entrepreneurs in search of profitable potentials through acquiring new skills and learning alter institutions gradually. Institutional change is a gradual process that occurs as a cumulative of short-run profitable opportunities. Moreover, the long-run consequence of institutional change is not certain and may diverge from intended due to the limited capabilities of the individuals and the complexity of the problems to be solved. Under these conditions change of formal rules in transition economies does not necessarily imply the institutional change, since it requires corresponding change in behavioral patterns of individuals, informal rules etc.

Propositions of both evolutionary and institutional roots of evolutionary-institutional approach favor gradual transition emphasizing role of routines, institutions and their change. As we mentioned above, the Washington Consensus and the evolutionary-institutionalist approaches can be represented in their diverging view not only on the speed of reforming, but on other aspects too. These points of debate are discussed below.

3.1.3. Differences of two approaches on transition issues

A fundamental difference of the two approaches is the behavior of economic agents. Neoclassical root of the Washington Consensus allows it to assume that behavior of economic agents is governed by current market incentives (see Table 3.2). Then with right incentives in place reformers can create rational, and convenient to the new system, behavior. But the evolutionary-institutionalist approach along with the current incentives points out the importance of historical and social processes.

Due to its neoclassical roots the Washington Consensus assumes that if price flexibility is provided and government does not intervene, markets will develop spontaneously. However, the evolutionary-institutionalist view focuses on the institutional underpinnings by emphasizing corresponding institutional infrastructure. Therefore, a strong emphasis is put on the general environment of contracting: the minimum legal environment, security of property rights and law enforcement, political stability, the development of business and market networks etc.

Concerning the reform strategy the Washington Consensus supports comprehensive and fast reforming and rejects any partial reform. The idea behind such view is to provide working environment for price mechanism as soon as possible, since in gradual reforming price mechanism may give wrong signal¹. All reforms should be introduced simultaneously and their duration may take different period. For instance, according to Fisher and Gelb (1991, p.102) reforms would be completed in ten years. Moreover, as mentioned above, fast reforming was important to push reforms as quick as possible in order to use political credibility and create irreversibility. With these arguments any partial reform is rejected, since they are perceived as creating rents for given groups that will tend to oppose further reform.

According to the evolutionary-institutionalist approach, in contrary, such strategy may be dangerous and may lead to situations of inefficient economic outcomes. Inasmuch as the existing stock of organizational routines and institutions is a product of the old environment. A radical change in the economic system requires large changes in these elements, which in turn change slowly and lengthy. Hence, slow changes results in better economic performance than does fast reforming. Poor outcomes may break social cohesion and generate important political instability. This implies a more gradual and experimental approach to reforms, relying on the flexibility of experimentation, with an adequate sequencing of reforms with possibility of reversing reforms that do not work.

According to the Washington Consensus with rational behavior of economic agents reforms based on the price flexibility priorities results in sure efficiency gains. Therefore, the models of real existing market economies are matter of coping. Such confidence to the results of the reforms has been reflected to the implicit idea that economic reforms generate transitional costs in the short term before they begin to produce their promised economic gains. The magnitude of these costs is believed to be positively correlated with the comprehensiveness of the reforms adopted. Inefficient enterprises must be closed or restructured, state subsidies and social spending must be reduced, and domestic prices must be raised to world levels - a program that in the short term is expected to generate unemployment, sharp declines in production, and falling living standards. But when the economy begins to

¹ Besides, increased inflation disturbs the correctness of price signal too. Therefore, liberalization and stabilization policies should be implemented simultaneously.

adjust to the new structure of incentives growth and, hence, improvement of the situation expected to appear.

Table 3.2 The Washington Consensus and the evolutionary-institutionalist approach

	Washington Consensus	Evolutionary-institutional approach
Behavior of economic agents	Subject to current incentives and rational under the correct current incentives in place.	Not only current incentives, but historical and social process are important too.
Market mechanism	Under liberal, no state intervention conditions markets will develop spontaneously.	Market mechanisms needs institutional underpinnings. Unless corresponding institutional infrastructure is provided market mechanism is not efficient.
Reforms	No partial reforms. Sequencing of reforms is not important. Instead simultaneous and rapid implementation of all main reforms.	Sequencing of reforms is important. Step by step introduction of reforms, starting from successful one to further.
Outcome of reforms	Efficient results of economic reforms are guaranteed.	Aggregate uncertainty presence.
Institutional change	Emphasize on adoption of laws. Old institutions should be dismantled.	Includes not only adoption of new formal laws, but also law enforcement, reform of organization of government, development of social self-enforcing norms. Use temporarily existing old institutions.
State	Minimal state. Downsize the size of government.	Reform in the organization of government so as to provide law enforcement and secure property rights. Crisis prevention policy.
SOE's and Privatization	Closing down of inefficient SOE's. Quick mass privatization in order to break state power with its bureaucratic rent-seeking consequences and to push up the private sector.	Evolutionary development of private sector

In contrast, the evolutionary-institutionalist perspective emphasizes the aggregate uncertainty of transition outcomes and notes that results may range from positive to very negative. Prerequisites from which existing developed market economies formed out are not unique to all countries. Hence trying to copy the better models of capitalism may not work. Large-scale institutional changes during the reform and coordination problems to be solved among economic agents are sources for uncertainty. Since different outcomes are possible and we do not know which one will be result and there is likely to be important aggregate uncertainty over the outcomes of reforms.

On institutions both approaches agree that institution building takes longer time. But they differ in their vision on how the process of institutional change takes place. Indeed, the Washington Consensus emphasizes need for new institutional infrastructure and focus on the legal changes, such as adoption of adequate laws to secure property rights, provide credible contract environment, to prevent corruption etc. And institutional change is formulated as the need to create *tabula rasa*¹ conditions by breaking as fast as possibly the existing communist state structure. In contrast, evolutionary-institutional approach takes more comprehensive view on institutions and argues for not only legal changes, but also conditions conducive to law enforcement, development of self-enforcing social norms that foster entrepreneurship, trust and respect for law and of commitment. Therefore institutional change is beyond of changes in formal laws. As institutional building is time consuming process, then it is rational to use temporarily existing institutions to prevent economic disruptions and social unrest while developing new institutions. Since leaving old institutions when new ones are not established yet an economy may end up with institutional vacuum, where neither new nor the old institutions exist.

With respect to government, the Washington Consensus argues to prevent intervention in markets, and insists mainly on the need to shrink the size of government and their role in the economy, generally measured through its share in GDP. State role in the economy should be minimal and carry out classical roles. In contrast, the evolutionary-institutionalist view notes that approach to state to be beyond of its downsizing. Such fundamental issues as

¹ Term “tabula rasa” in Latin means “blank state”. In above case it is used to note the conditions where old communist legacies are eliminated.

effectiveness in rule enforcement, secure of property rights, to enforce an adequate competition policy, fights against organized crime and racketeering etc. require adequate government infrastructure (courts, judicial system, tax administration etc). For this the reform of government is needed so that changes in incentives of government bureaucrats do not allow them to predate on private sector or be captured by interest groups.

These two approaches differ in their focus on privatization policy. Washington Consensus stresses the need for a fast transfer of ownership in private hands via mass privatization to break government power and to jumpstart the market economy. Thus, speed is important. The idea is that any privatization is always better than maintaining government ownership so that the benefits of fast privatization outweigh the costs in terms of possible misallocation of assets to private individuals. There is also a strong emphasis on developing stock markets so that efficient resale of assets can take place after privatization. In contrast, evolutionary-institutional approach puts in general less emphasis on the importance of fast privatization of large state owned enterprises (SOE). Without necessary institutional base and capacity to carry out comprehensive and rapid privatization may lead to asset stripping and to unfair distribution of assets. Zero transaction cost assumed in Coase theorem, which is implicitly used as a theoretical argument within rapid privatization supporters is not a case in transition economies. In contrary because of the weak law enforcement evidences transaction cost is very high. Skepticism is also related to the possibility of efficient further re-sales of privatized SOEs given the weak financial institutions and markets at the beginning of transition. Development of financial markets evolves over time and cannot be jumpstarted. Therefore, instead of creating private sector from the SOEs, it is preferred to make emphasize on the organic development of new private sector.

Thus, fundamental differences between two approaches is not only in speed of transition, but rather beyond of it, in their basic assumptions on behavior of economic agents, factors underling market mechanism, reform of state, institutions etc. However, it should be mentioned that despite such differences the final objective of both approaches is transition to market economy.

3.2 Economic Growth in Transition Economies

At the outset of transition expected results from introduction of market reforms in transition economies were very optimistic. The dominant expectation on growth prospects of transition economies was that transformational crisis and economic downturn to some extent would take place and, however, once necessary market reforms implemented they would generate accelerated growth and convergence to the average richer economies.

Such optimistic expectation was the outcome of use of synthesized growth models that were based on the idea of Solow-Swan Neoclassical growth model and Romer (1990), and Barro and Sala-i-Martin (1995). Former model attributed growth to the expansion of capital and labor, augmented by exogenous technological progress. Therefore factor input and factor productivity calculations of the sources of growth are based on this paradigm. Latter models while retaining the role of factor inputs added an explanation of technical progress based on increasing returns, R&D and imperfect competition, human capital, and government policies (Havyrlyshyn et al, 1998, p. 8).

Consequences of application of these models to transition economies were that high growth rates generated from market reforms would be the result of improved technology and efficiency which is conditional on investment in physical and human capital. Thus, restructuring and greater efficiency of privatized and new private firms, employment of high quality human capital, which is considered abundant in post-socialist countries, would be the source of high growth rates. Moreover, as implied by the Solow-Swan model convergence mechanism would move economies towards the steady state path which is globally stable. Economies more distant from this path had higher growth rates and quicker convergence speeds so that the speed of convergence decreased over time. This equilibrium steady state of growth path is generated by the assumptions of well-behaved production functions and preferences, perfect competition, profit maximizing firms and welfare maximizing households. With these theoretical underpinnings transition economies would have high growth rates provided they had implemented market reforms, which dominantly were defined according to Washington Consensus prescriptions, and there would not be large divergences in growth paths of these economies.

From these perspectives central object of most studies became growth prospects and forecasting long run growth in transition economies. Mostly used methodology became Barro (1991) and Levine and Renelt (1992) specifications¹. Barro's specification predicts growth by the initial per capita income, gross primary school enrollment, secondary school enrollment, and the share of government consumption². Levine and Renelt added as an explanatory variable population growth and investment. Investment and human capital are expected to be positively related to growth, while initial income, population growth and government consumption have negative impact on expected growth³.

Coefficients from growth regressions are estimated or taken from specifications in Barro and Levine and Renelt and applied to data of transition economies to estimate their future expected growth rates. Most studies on growth prospects of transition economies used these specifications, for instance IMF (1996), Denizer (1997), and most prominent among them is Fischer et al. (1998a; 1998b). However, Campos (2001, p.674) argues that by imposing these regression coefficients the approach implicitly assumes that the transition economies are structurally identical to market economies at similar level of development. By noting this limitation he re-estimated Barro and Levine and Renelt equations using data for transition economies and concludes that the approach performs poorly in transition economies. In particular, his estimations on Barro's specification showed that initial per capita income, secondary education and government consumption had opposite sign than expected. On Renelt and Levine specifications signs for initial per capita income, secondary education and population growth were opposite to expectations.

Under such analytical framework and expectations most studies during the first decade of transition, i.e. in 1990s, as determinants of growth in transition economies used:

- *Initial conditions*: initial income, over industrialization; war; years under communism etc.;
- *Stabilization*: inflation; fiscal deficit; exchange rate regime dummy;

¹ Brief explanation of these approaches here follows Campos (2001).

² The equation econometrically was specified as: $GDP\ growth = 0.0302 - 0.0075 * Y0 + 0.025 * PRIM + 0.0305 * SEC - 0.119 * GOV$

³ Therefore, equation was specified as: $GDP\ growth = - 0.83 - 0.35 * Y0 - 0.38 * POP + 3.17 * SEC + 17.5 * INV$

- *Liberalization or structural reforms*: EBRD reform index, World Bank index etc.;
- *Factor inputs*: investment; export growth; schooling; population growth etc.

Studies that mention another determinant - institutions- as an explanatory variable started to be widespread by the end of 1990s¹. Two reasons may be referred for the eventual emergence of empirical researches containing institutions. First, data on the institutional quality in transition economies became widely available after the mid of 1990s. Second, difference in economic performance between transition economies led to the recognition of institutions as one of the key determinants of growth performances of transition economies.

In general, incorporation of institutional developments into growth regressions of economies in transition has been performed either through the regressing proxy for institutional quality on growth or to use this proxy in regression equation along with the other above mentioned determinants of growth. Most of these researches are based on institutional development indices that measure structural reform and institutional efficiency, such as the EBRD indicators, the Freedom House index, the Heritage Foundation index, the World Bank governance indicators etc. Such derived proxy for the institutional quality is included in panel data or cross-sectional data regression analysis and generally estimated by ordinary least squares (OLS).

Major concern here is not to review all empirical studies, but rather to figure out general conclusions underling importance of basic factors behind growth performances in transition economies. From this perspective following broad conclusions can be summarized:

- All transition economies, including those of very graduate reformers, experienced an initial steep fall in production – transformational crisis. Hence, reforms alone do not explain the output drop. But the magnitude of output fall was likely affected by policies chosen (Hernández-Catá, 1997; De Broeck and Koen, 2000; Popov, 2006).
- Index for initial conditions, i.e. such factors as the pre-transition structure of the economy, the level of development of the central planning mechanisms, natural resource endowment etc., to some extent explains differences in growth performances

¹ As first empirical studies on institutions in transition economies are considered Brunetti et al. (1997) and Moers (1999).

among transition economies. But over time its impact on growth diminishes (De Melo et al., 1998; Berg et al., 1999; Falcetti et al., 2006)

- Most of the studies confirm that reforms in general are positively correlated with growth. But appearance of these positive effects may take time. Since some studies find an immediate negative effect of liberalisation and structural reforms¹. These negative short-term effects of reforms have been interpreted as the adjustment costs and it is considered that in the long-run positive effect of reforms will appear (Sachs, 1996; Fischer et al., 1996; De Melo et al., 1996; Wolf, 1997; Havrylyshyn et al., 1998; Merlevede and Schoors, 2005; Staehr, 2005; Pelipas and Chubrik, 2008)
- Monetary and fiscal stabilization is necessary, but not sufficient condition for growth. Putting it differently, stabilization is precondition for growth, but is not solely responsible for growth (Fischer et al., 1996; De Melo et al., 1996; Havrylyshyn and van Rooden, 2000)
- Factor inputs, in particularly investment, played insignificant role in explaining growth in transition economies in 1990s (Havrylyshyn et al., 1998; De Broeck and Koen, 2000; Iradian 2007b). A most common explanation for this is that growth in transition economies during the initial phase of output recovery after the transformational crisis came mostly from the efficiency improvements resulted from reorganization of central planned economy. Under the legacy of excessive capital accumulation and inefficient use of resources and, moreover, observed negative investment to GDP ratio during that time did not allow for investment to be the source of growth in this period. However, in recent periods, in particularly starting from 2000s, with the increasing tendency in

¹ There are some non clear moments in some empirical studies in their approximation of structural reforms and institutional developments. Thus, structural reforms in most of the empirical studies are measured through aggregated index derived from the EBRD's transition indicators. While some authors, for instance Sachs (2001), use the same indicators for institutional development too. Such approach causes confusion about distinction between structural reforms and institutions. However, being aware of the strict interrelatedness between these two structural reforms and institutional development we agree with Havrylyshyn and Rooden (2000, p.5), who notes that structural reforms such as price and trade and exchange liberalization as well as privatization, are of a different nature than the development of market-enhancing institutions. Since the former can be introduced within a short time frame, while institutional reforms take longer time to develop and include such categories as legal framework, rule of law, property rights, political and civic freedom.

the investment ratio this factor has contributed to growth considerably compared to 1990s period.

- Institutions considerably explain output variation across transition economies and reforms should be associated with corresponding institutions in order to be successful. (Brunetti et al., 1997; Moers, 1999; Havrylyshyn and Rooden, 2000; Kushnirsky, 2001; Crafts and Kaiser, 2004; Chousa et al., 2004; Redek and Susjan, 2005; Popov, 2005).

Thus, especially during the first decade of transition econometric models inspired by the standard neoclassical growth models got popularity and was the reason for optimistic expectation. But experience of transition economies has shown incapability of such models to fully grasp the nature of growth performances in transition economies. Eventually institutions have been recognized as one of the key determinants of growth in these economies¹.

3.3. Explaining Growth Performance: Institutional Framework

As mentioned above experience of transition economies suggest that better understanding of growth performance in these economies requires its analysis within institutional framework. This subsection provides brief explanation of institutions and their role in economic growth. After that institution building and persistence of inefficient institutions in transition economies context are discussed.

3.3.1 The concept of institutions

Eventual awareness of the importance of institutions in economic performance of transition economies has led to the actuality of such notions as *market enhancing institutions*, *institution building* and *institutional development*. Conventional definition of institutions, widely used in the economic literature, follows North's, which offers the following definition:

¹ For recent assessment of the role of institutions in transition economies in a broad sense, see EBRD (2007)

“Institutions are rules of the game in a society; more formally they are the humanly devised constraints that shape human interaction. In consequence they structure incentives in exchange, whether political, social or economic” (North 1997, p.2).

Most of the definitions used in the economic literature are consistent with the elements of this definition and highlight formal and informal constraints and their enforcement features as the components of institutional framework. Organizations in North’s definition are clearly separated from institutions and defined as the “groups of individuals bound by some common purpose to achieve objectives” (North 1990, p.5). Examples for organizations are political parties, regulatory agency, firms, trade unions, schools, universities etc. According to North (1990) interaction between institutions and organizations causes mutual influence between them. Since the way organizations come into existence and how they evolve are fundamentally influenced by institutions and, in turn, organizations being the agent of institutional change influence how the institutional framework evolves. However, such interaction between these two categories led some authors to include organizations, in North’s sense, into institutional set¹. Within such approach organization entities, regulatory frameworks etc. are also considered as institutions.

There is a common agreement on the above mentioned components of institutional framework. Formal rules contain political (and judicial) rules, economic rules, and contracts, which are enforced by the coercive force of the state. Therefore effective enforcement of formal rules requires impartial system of law and courts. Informal institutions contain conventions, norms of behavior and self imposed codes of conduct. Conventions and self-imposed codes of conduct are self-enforcing, whereas norms of behavior are enforced by the second party (retaliation) or by a third party (societal sanctions or coercive authority). Although formal rules may change overnight as the result of political or judicial decisions, informal constraints embodied in customs, traditions, and codes of conduct are much more impervious to deliberate policies (North, 1990, p.6).

Impact of institutions on the economic growth performance both in theoretical and empirical studies are far from being negligible. According to North (1997, p.1) institutions affect economic performance by determining (together with the technology employed) the cost

¹For instance, see Balzerowicz (2007, p. 12)

of transacting and producing. Most studies suggest that institutions largely affect productivity of resources, incentives to investment, capital accumulation etc¹. Along with the broad conclusion on the importance of institution studies use different categories of institutions that include political, economic and social aspects. In this concern, Rodrik and Subramanian (2003, p. 32) classify institutions necessary for market economy in four groups. First group is market-creating institutions and include secure of property rights and contract enforcement. Second one is market regulating institutions which deal with imperfect competition, externalities, economies of scale etc. Third group includes market stabilizing institutions such as central bank, exchange regimes, budgetary and fiscal rules etc, these institutions ensure low inflation, minimize macroeconomic volatility etc. Fourth group is market legitimizing institutions which provide social protection and insurance, involve redistribution and manage conflict. Examples for these institutions are pension system, unemployment insurance schemes and other social funds. By noting these groups of institutions they state that although market-creating institutions are basic for market economy, for the long-term perspectives economic development requires other three groups of institutions too. Havrylyshyn and Rooden (2000, p.5) propose two distinct categories of market institutions. First one is legal framework for economic activity, which includes establishing legislation for free economic activity, bankruptcy, contract law etc. and enforcement of law. Second category is political and civil freedom. However, along with comprehensive use of the notion of institutions most researchers agree on the fact that economic institutions, such as property rights and contract enforcement, are crucial for market economy and to be perceived primary for functioning of market mechanism. Without property rights, individuals will not have the incentive to invest in physical or human capital or adopt more efficient technologies. Economic institutions are also important because they help to allocate resources to their most efficient use, they determine who gets profits, revenues and residual rights of control. Societies with economic institutions that facilitate and encourage factor accumulation, innovation and the efficient allocation of resources will prosper (Acoemoglu et al., 2004a, p.2). However, this line of

¹For instance, Hall and Jones (1999) use the notion “social infrastructure” which includes institutions and find that its impact on output is through their effect on factor accumulation and productivity. Eicher et al. (2006) show that the largest impact of institutions on output is through the factor productivity. For overview of some studies focusing on growth empirics with different measures of institutions see Moers (1998)

causation is mutual. Since in economies with intensive growth performances there is more prevailing tendency towards efficient institutions and larger opportunities for government to improve institutional environment. Although within econometrical researches determination of this causation line remains as controversial issue¹, the fact that dramatically decreased income during the transformational crisis and issues in sustaining economic recovery in transition economies contributed to the emergence of inefficient institutions in these economies is the commonly accepted one.

Thus, effective or “good” institutions are considered as being conducive to reduction of uncertainty and promotion of productivity through providing low cost transaction and credible environment. Therefore, effective functioning of the market mechanisms necessitates corresponding market supporting institutions, such as property rights and law enforcement.

3.3.2 Institution building in transition economies

Before analyzing the building of institutions in transition economies, it would be useful to list institutions that are considered to be in a typical market economy. Hare (2001, p.7) states that well-functioning market economies are generally found to contain institutions or institutional arrangements to provide for the following key economic functions:

- Private property rights and contracts;
- Banks and other financial markets: existence, functioning and regulation;
 - Reliable access to credit on reasonable terms;
 - Bankruptcy/ liquidation policy in place to facilitate orderly exit;
- Labour market institutions: social policy and the social safety net;
- Clear fiscal environment for firms, perceived as fair, predictable and enforced;
- Institutions dealing with competition policy, industrial policy and trade policy.

¹In fact explanation of this causality line is difficult due to conceptual issues, such as measurement of institutions etc. However various researches are inclined to prefer one causality line for reverse one. For example, Acemoglu et al (2004b); Kaufmann and Kraay (2003) argue that good institutions stimulate growth and development rather than reverse impact. In another study Kaufmann and Kraay (2002) state that quality of institutions impacts on growth, but the opposite effect of growth on institutions depends on the democratization process and on the public governance. In contrary, Gleaser et al. (2004) argue that it is not institutions that cause growth, but human capital.

- Trust between economic agents, trust and honesty in public institutions (lack of corruption, reliable law enforcement, incl. as regards business taxation).

If these institutions are ascribed to typical market economies, then logically this can be considered as the list of institutions that transition economies have to establish in order to be the market economy. Nowadays existence of some of these institutions in transition economies is of no doubt. For instance, banks and other financial markets, bankruptcy and other liquidation policies, labor market institutions etc. But the question of their effectiveness is remaining. In other words, as Hare (2001, p.7) notes, the problem is often not so much to create institutions *ab initio*, but to improve the functioning of those already in place. However among these institutions economic literature and most empirical studies have acknowledged property rights and law enforcement, or first and last item in the above enumeration, as crucial for market economy and consider them as a prerequisite for the successful institution building. While well functioning and, even, existence of these institutions in some transition economies is questioned.

The dominant view on institution building in transition economies in the 1990s expected that the main structural reforms, in particularly liberalization and privatization, would result in the critical mass of the private ownership, which in turn would create demand for the market enhancing institutions: to secure of private ownership, rule of law, transparency etc. Boycko et al. (1995), for example, incorporated such approach into the spontaneous model of establishment of property rights. Model shows that once private sector is dominating in the economy, then private owners would favor security of private ownership rights and press the government for that. Eventually it would result in effective institutions for the market economy.

Such approach to institution-building is consistent with the Washington Consensus prescriptions. Since it emphasized implementation of structural reforms which had to serve as pushing force for private ownership, which in its own turn is the departing point for the emergence of institutions out of demand for them. As we already know within Washington Consensus government had to minimize its intervention into economy and take away its rights on assets. From this point of view mass privatization and rapid liberalization were favored. Moreover, role of the initial allocation of assets during the privatization that could be

inefficient was ignored. Buitter (2000, p. 606) and Polishchuk and Savvateev (2004, p. 105) argue that theoretical basis for such approach to privatization is the proposition of the Coase theorem, which states that it does not matter how the inefficient initial distribution of ownership is, since consequent exchanges in property rights would correct this inefficiency and result in efficient outcome. Thus, within this logic what is required for transition economies is to liberalize, stabilize and privatize. And necessary basic institutions would rise up as a response to the demand of the dominating private sector.

However, experience of transition economies, especially of CIS countries¹, shows that expectation that necessary institutions would rise up, if not immediately then soon after rapidly implemented reforms, have not been fulfilled. Instead, most transition economies, again especially CIS countries, have evidenced weak rule of law, insecure property rights, corruption, state capture and large scale underground economic activity².

These evidences provoked studies attempting to model the failure of emergence of efficient institutions as an aftermath of economic reforms. Thus, Hoff and Stiglitz (2002) show that beneficiaries of privatization may not demand rule of law. Because the uncertainty about the legal regime can lead to asset stripping, which in turn create incentive for agents to favor the absence of the rule of law. Sonin (2003) shows that in societies, where income inequality is high and public protection of property rights is weak, agents have incentives to invest in private protection of property rights. Under these conditions rich agents may benefit from shaping institutions in their own favor and with this ability they preclude demand for development of the market institutions. While for other agents the need to devote substantial resources in private protection reduces attractiveness of production. As a result economy becomes stuck in low growth rates, high inequality of income and widespread rent-seeking. In the same vein, Polishchuk and Savvateev (2004) propose the model where production

¹ It is well known fact that in establishing market economy CIS countries have less progressed compared to Central and Eastern European (CEE) countries in transition. Different studies notes different factors for this, but most studies agree on the fact that CIS countries' initial conditions were mostly common, such as the structure of the economy, interdependency between countries etc., and were less adopted to the market economy, while CEE countries made their first attempts to introduce market mechanisms more earlier and to some extent were much more adjusted to market economy culture.

² For instance World Bank (2000, pp.1-14) provides assessment of the extent and consequences of corruption in transition countries; EBRD (1999, pp.102-129) explores state capture issues and their negative impact on governance; Dabrowski (2008, pp. 21-27) focusing on seven low income CIS countries notes poor investment climate and their institutional roots as one of the policy challenges for these economies.

inefficiency and economic inequality in combination create an environment in which wealthier agents favor less than full protection of the property rights. Therefore, they argue that privatization without providing with efficient system of enforcement of private property rights, and expectation that such a system will emerge subsequently in response to grassroots pressure of private owners is misleading. Havrylyshyn (2004) suggests to group most critical aspects of debates on transition in two groups of thoughts: “transition inevitable” and “transition frozen”. “Transition inevitable” group states that once a minimum of stabilization, market liberalisation, and privatisation is achieved, further progress in transition is inevitable. Since, a major part of assets is in private not state hands, the old-bureaucracy no longer has a power base to oppose reforms, but more, the new capitalists will want to have security of property rights and create a demand for rule of law, transparency, law and order etc. Therefore, critical mass of private ownership and market-based decision-making makes reversal impossible and progress inevitable. The latter group, in contrary, argues that inevitability of transition is conditional. Because the reform process allows vested interests to build up quickly and benefit from rent-seeking opportunities of partial liberalisation, they acquire a concentration of state-assets in an opaque privatisation and finally capture governance of the state. Their interests are not to liberalize or democratize further, rather exactly the opposite. Since capitalists will favor rule of law if it is in their interest. He concludes that contrary to views that after undertaken reforms further progress on liberalisation and democratization is inevitable, ownership concentration and “oligarchs’ capture of the state during the reforms will result in the status quo of partial reforms and a non-transparent political process and, hence, “transition frozen” is possible.

Therefore, experience of transition economies has been contradictory to anticipations on self-emergence of institutions. These evidences have been the result of the factors that are summarized under mutually affecting three groups:

- *Weak government.* Reforms oriented at the minimization of the role of government in economy, drop in budget revenue because of the transformational crisis and lack of concrete view and necessary institutional base on transparent government regulation of ongoing economic processes produced state with limited capacities to enforce law.

And improperly enforced law has been the fertile ground for the emergence of ineffective institutions, such as corruption, tax avoidance etc.

- *Opportunity for extra income deriving and asset stripping.* Under the conditions of systematic vacuum, where the line of continuity between institutions had been broken - old institutions were left without the establishment of new to replace them, and weak law enforcement rapid implementation of reforms resulted in the opportunity for deriving large revenue and asset stripping by small groups of population. Despite expected positive effects from quick privatization, experiences have proved that privatization was opaque process with unfair distribution of assets. Correction to this by the expected eventual exchanges of property rights did not take place. In contrast small groups benefited from such opportunities became to resist further reforms, including secure property rights¹. As these reforms were confronting with opportunities to asset stripping. Such appearance not only resulted in ineffective institutions, but also contributed to their persistence.
- *Weak societal and private sector demand for market enhancing institutions.* There was a little interest of society and newly emerged private sector in demanding efficient market institutions. Despite leave of the communist system, with inertia of the old system societal behavior was continuing on to rely on the state while lacking in the private initiatives for promoting private ownership. From this perspective waiting but not demanding for the efficient market institutions was quite natural behavior during the first years of transition. On the other hand the newly emerged private sector was not strong enough to have serious impact on state and demand for efficient market institutions. One of the reasons for that was the fact that most active private business emerged in trade and service sectors, which are according to Polishchuk (undated, p.3) less sensitive sectors of the economy to the quality of the institutional environment. Since contracts and activities were simple and did not necessitated high demand for protection rights and contract enforcement. Therefore private ownership from these sectors was not keen in developing market enhancing institutions. Beneficiaries of the above mentioned opportunity for extra income deriving and asset stripping may retard

¹ One of the classical examples for that referred in the literature is the emergence of oligarchs in Russia.

private ownership demand for market institutions too. Since under the inefficiency of property rights and law enforcement this opportunity would continue.

Magnitude of these appearances has varied over transition economies, which constitute varying institutions building in these economies. As described above there is a broad consensus that institutions matter for economic growth in these economies. However, most of these studies are limited only by indicating the particular importance of institutions, while sources of varying success in institution building across transition economies are broadly remaining unexplained within current studies. The study of Beck and Leaven (2005) can be considered as an attempt to address this gap. They propose political economy approach and argue that institution building in transition economies is determined by natural resources and the historical experience of these countries during socialism through their influence on political structure and process during the initial years. They empirically show that countries that are more reliant on natural resources and spent a longer time under socialist government are more likely to see former communists remain in power and to start the transition process with less open political systems, with negative repercussions for the development of market-compatible institutions. However, by focusing on initial conditions as the major determinant of institution building, they do not take into account conditions appeared during the implementation of reforms that have influence on efficiency of institutions.

It is evident that establishment of efficient market institutions is difficult task. Indeed, from above mentioned perspective of demand for institutions one may assume that, if not in the medium-term, then in the long-term eventual development of private sector along with social awareness and civil society has potential to rise up demand for institutions. But experience of most transition economies shows that inefficient institutions demonstrate high persistence in these economies. Widespread patterns of weak law enforcement and insecure property rights become rooted and their elimination becomes costly. Therefore, analysis of economic performance within institutional framework in case of transition economies requires analysis of the persistence of inefficient institutions. In the following subsection this persistence is explained with formation of institutional traps.

3.3.3 Persistence of inefficient institutions: institutional trap¹

Institutional trap has been described by Polterovich (1998, 1999, 2008)² in face of the clearly observance of inefficient institutions during the large-scale institutional changes in post-soviet countries. In fact, the concept of institutional trap is closely related to the notion of *lock-in* used by Arthur (1988) and North (1990), which showed that inefficient technical or institutional development can be self-supporting. He attempts to describe the general scheme of appearance and further stability of inefficient institutions, called as “institutional trap”, in a reforming economy³. It is shown that described mechanism successfully explains such phenomena as barter, mutual arrears, tax evasion, and corruption during the reforms in transition economies (Polterovich, 1999, p.4).

Institutional trap is defined as inefficient, but stable norm of behavior with self-supporting mechanisms⁴. In analyzing institutional traps three stages of their existence are important: how do they emerge or which factors contribute to their emergence? ; how do they stabilized and become persistent ?; and, if any, what are the ways out of them ?

A norm is a rule that large groups of people can or must obey. Economic agents face alternative norms of behavior. But their choice among these norms is influenced by several factors. Polterovich (1999, p. 6) classifies these factors as:

- Fundamental – resource and technological opportunities and macroeconomic characteristics of the system;
- Organizational – official rules and law;
- Societal – features of the formed social interaction⁵.

¹ This section is based on articles of Polterovich (1998, 1999, 2008).

² Indeed the concept was further developed by contributions of other authors too. For instance, for mathematical modeling of the concept see Balatsky (2000, 2002).

³ Indeed, as Polterovich (2008, p.1) notes institutional traps have been studied in many papers. As an example he refers to Ickes and Ryterman (1992); Tirole (1996); Bicchieri and Rovelli (1995); Jonson, Kaufman and Shleifer (1997); Uribe (1997). Although some other studies can be added to this list. For instance, Gradstein (2008) and Quy-Toan Do (2004 attempt to analyse “institutional trap” by developing model within political-economy context. Former author analyses institutional trap as bad equilibrium with low-quality institutions and poor economic outcomes, while latter as persistence of inequality and inefficient governance.

⁴ The term “norm” here is used interchangeably with the notion institutions.

⁵ But along with this classification he admits the occasional situation as possible determinant of norms of behavior too.

Depending on these factors, for example, official may choose either corruption or honest service. Factors influencing official's choice may be: fundamental, such as level of salary of servants; organizational, such as existing system of control and punishment; or societal - reaction of collegians and clients to collaboration or resist corrupt behavior.

In analyzing change, or stability, of institutions the role of transaction costs and, along with this, transformation costs are referred as crucial. Transaction costs are well known in the economic literature and permanently incurred by participant of economic exchange processes, firms or individuals. Costs of transition from one norm to another are called transformation costs. Therefore these costs occur not permanently as transaction costs, but in case of change of institutions and may be incurred by firms, individuals and state as well. For a behavioral norm to be stable or to be persistent, individuals should feel that it is unprofitable and disadvantageous for them to deviate from it. This means that the present value of the difference between the transaction cost of a prevailing norm and any alternative norms has to be less than the related transformation cost (Polterovich 2008, p. 3). Stability of norms is provided by the coordination effect, learning, linkage and cultural inertia mechanisms.

- Coordination effect is the main type of mechanism stabilizing norms of behavior. This effect implies that more consistently a norm is observed in a society the greater are the costs incurred by each individual deviating from it. For example, the coordination effect takes place if a personal probability to be punished for a rule-breaking activity decreases with the number of people involved in the activity. This effect has positive inverse relation: more people follow the norm, less advantageous to deviate from it, which in turn causes more people to follow.
- Learning effect is another mechanism that provides stability to a norm. With time as agents learn to operate more efficiently developing more productive technologies within adopted norm of behavior, which in turn reduces transaction cost. For instance, if tax evasion is a norm, the relevant techniques of avoiding taxes develop and widely used by economic agents within that norm.
- Linkage effect. With time an established norm finds itself linked with a multitude of other rules, and becomes part of a system of other norms. Hence, abandoning of this norm causes other norms' transformation, thus leading to high transformation cost and,

therefore, stability too. As a result transformation costs may be so high that even under cease of coordination effect it supports ineffective norm.

- Another norm-fixing mechanism is cultural inertia, which denotes agents' reluctance to review those behavioral stereotypes that have already proven viable.

Thus, due to coordination effect individual or small group looses if deviate from stabilized norm of behavior, which in case of institutional trap is inefficient norm. And other effects: learning, linkage and cultural inertia strengthens prevailed norm. As it can be noted during the norm fixing process transaction costs decrease, while transformation costs increase. Therefore, once inefficient norm of behavior or institution is chosen, the system chooses inefficient path of development and, eventually, return to efficient path may be difficult even if possible. That means system has fallen into an institutional trap.

Polterovich (1998, p.25) argues that institutional traps are often the unexpected results of macroeconomic management during the reform process. In particularly he notes that macroeconomic policies in economies where institutions are in immature position, such as economies in transition, may cause considerable changes in institutions. It may create conditions that facilitate emergence and stability of inefficient institutions. Therefore, during the reforms macroeconomic policies have to be deliberately selected. As an example for institutional trap corruption, tax evasion, barter, arrears and black market activity are referred to.

For instance, for corruption in Russian case Polterovich (2008, p. 6) argues that in Russia jumped income inequality because of uneven transitional rent expropriation, the low salaries of officials, inefficient government policy, inadequate legislation, unclear norms for new market behavior and weak mechanisms of government control contributed to rise of corrupt activities. Larger the scale of corruption, smaller the chances for a bribe-taker to be caught. Corruption technologies were developed with time, corruption hierarchies arose, and corruption activities were closely linked with other shadow economy mechanisms. Corruption turned out to be habitual for both the bureaucrats and the population. The coordination, learning, and linkage mechanisms as well as cultural inertia made the corruption system even more stable.

Analogous example is given for tax evasion. Depending on such factors as the tax policy, state budget expenditure policy, tax administration etc., economic agents decide whether to avoid from tax or not. If these factors are not conducive to create incentives to pay tax, say for example increase of tax burden not associated with the parallel increase in state budget social expenditures and poor system of penalizing for tax avoidance, then, they can serve as fertile ground for the institutional trap – tax evasion. Eventually economic agents will develop appropriate techniques for that, including the development of collaboration with tax officials and their stabilization for avoiding taxes¹. In consequence such behavior becomes systematic and stable.

Stability of the trap does not imply the non existence of ways out of it. An economy or government can develop mechanisms to escape from it. Above outlined role of transaction and transformation costs in individuals' decision to choose a norm of behavior implies that possible ways out of institutional trap should (a) to increase the transaction costs of the prevalent inefficient norm; (b) to decrease the transaction costs of an alternative efficient norm; (c) to bring down the transformation costs of the transition to an efficient norm. As a ways of escaping from the institutional trap the following mechanisms are referred:

- *Measures taken by government.* The simplest measure among them is the introduction of high penalty in order to increase transaction cost. Amnesty of capital is another measure and can reduce cost of transformation to another more efficient norm. In general it is proposed to take into consideration incentives and disincentives for participation in inefficient norms of behavior, say black market operations or corruption, in choosing tax, social or industrial policies.
- *Evolution of civic culture.* As it is noted above remaining in institutional trap is advantageous for each economic agent, but disadvantageous for society as a whole. In this case the root of problem is the lack of coordination of society and in most cases measures taken by government may not be enough for the creation of this coordination. Since emergence of coordination depends on development of civic society. When civic society is developing such tendencies as social activity, political interest of society and

¹ Nevertheless, in this case initiative of developing this kind of collaboration is mutual. Since tax officials try to find ways to take bribes from tax payer in exchange for tax avoidance too.

social trust intensify and contribute to coordination. For instance, emergence of movements of different groups of citizens, businessmen, farmers etc, and their requirement from the government to implement administrative reforms, make transparent business regulation procedures, taxation etc., may finally contribute to the elimination of institutional trap.

- *Systematic crisis.* Sometimes the system fell into institutional trap and could not get out, goes on and may end up with the systematic crisis. And this systematic crisis can be helpful in escaping from an institutional trap. Since crisis changes system parameters and demolishes supporting mechanisms so that an economy may find itself in a new area outside the inefficient norm¹.
- *Spontaneous exit.* Exit from institutional trap may be spontaneous or through the unintended for that tendencies. As an example for that Polterovich (1999, 2008) refers to acceleration of growth. In transition economies where transitional rent large rent seeking activity becomes much more profitable than production. The rate of growth falls, and it makes production even less attractive for investors. Coordination, learning, linkage and inertia mechanism start to work and form institutional traps. However, if substantial increases in growth due to improvements in technology or terms of trade take place, then some agents may decide to increase their investment into production. This supports growth and creates new incentives for the next cohort of agents to switch their efforts from rent-seeking to production. As a result institutional trap may disappear. Growth diminishes the transaction costs of “good” behavior” and facilitates improvement of institutions.

All these four mechanisms represent possible ways out of the trap. However, if to take into account that evolution of civic culture takes place in longer time period and difficulty in determining the precise occurrence and consequences of systematic crisis, then first and last of above described mechanisms can be considered as potential ways where government could take active policy measures in order to facilitate escape from the trap. Among measures taken by government strengthening government law enforcement through necessary reforms is of

¹As an illustration of this statement the author refers to the case of barter trap in Russia, by arguing that it was considerably eliminated due to Russian financial crisis in 1998.

primary importance, since one of the roots of the institutional trap is weak law enforcement. Within the last mechanism - spontaneous exit through accelerated level of growth, government should take comprehensive measures to provide and intensify positive growth tendencies. Especially, if to take into consideration the mutual causation between economic growth and institutions, then under low efficient institutions private sector is likely be unable to provide such positive growth performances. Hence, government has to take leading role and support private sector development through both indirectly – favorable regulative measures over private sector, and directly – making government investments that result in productivity of private sector.

Analysis in this chapter show that despite two main approaches to transition have different visions on transition issues with eventual experience of these economies importance of institutions has become evident. Most theoretical and empirical studies on institutions and economic performance conclude that strong institutional environment is necessary precondition for successful transition to market economy. Although most studies confirm particular importance of institutions for economic performance, there are no large studies attempting to explain varying institutional environment across transition economies. In this concern the concept of institutional trap explains persistence of inefficient institutions in particularly in transition economies context. In the process of comprehensive reforming and large scale institutional changes fundamental, organizational and societal factors become enough to spur up inefficient institutions. Especially, these factors may be the result of macroeconomic policies during the reforms. For an economy once fallen into this trap it becomes difficult and costly to escape from. As many researches and analytical reports show such inefficient institutions as corruption, unofficial economic activity, insecure property rights etc. are widespread in economies in transition and have been admitted as primary goals to be solved in reforms agendas of most of these economies.

The major conclusion from these studies is that analysis of economic reforms in Kyrgyzstan and their outcomes should be based on evaluations of institutional environment. Moreover, it is important to understand the sources of formed institutional environment. Although, historical legacies and initial conditions are considered as major roots of institutions, the concept of formation of institutional trap suggests that conditions appeared

during the reform process play important role too. Therefore, macroeconomic policies and features of implementation of economic reforms may have influence on the formation of inefficient institutions, which in turn negatively affect economic performance.

4. ECONOMY OF KYRGYZSTAN FROM HISTORICAL PERSPECTIVES

History of Kyrgyz people has long roots and according to the recent researches dates back to the third century B.C. Well known facts about the existence and activities of Kyrgyzs reach back to the first Turkic empires of the sixth-eighth centuries A.D. Most of the historians commonly argue that Kyrgyzs lived in southern Siberia and settled along the Yenisey River and subsequently moved into the Tian-Shan mountains starting from the ninth century¹. Eventually by the beginning of 19th century Kyrgyz tribes settled in the valleys in territories of the currently Kyrgyzstan. As the geographical relief is mountainous it served as constraints in communication among tribes settled in different valleys. Government system was a collection of tribes, and there was no single governor, but each tribe has its own leader. In the early 19th century, the southern territory of the Kyrgyz Republic came under the control of the Khanate of Kokand². Leaders of the tribes living in the northern part in order to look for support contacted the Russian tsardom. As a result of its increasing interest in Central Asia region Russian tsardom protectorate was established over the tribes in the Yssyk-Kol and Chatkal, in 1855 and 1864 correspondingly. Later, Russian imperial army collided with the Khanate of Kokand troops. The latter could not offer strong resistance and was defeated in 1876. Thus, some northern parts of the current Kyrgyzstan after joining voluntary and other parts after the collapse of Kokand Khanate were formally incorporated into the Russian Empire³. However, the burden of colonial policy of Russia resulted in the uprising of 1916 which was depressed by Russian army. Further, with 1917 Bolshevik Revolution in Russia, the Soviet power established in the territory of current Kyrgyzstan in 1918. In 1924, the Kara-Kyrgyz Autonomous Oblast was created within the Russian Federal Socialist Republic⁴. In 1926, it

¹ According to historians the process of movement was slow and probably took several centuries, however most scholar state that by 10-11 century AD. Tian Shan area was already inhabited by Kyrgyzs.

² The Khanate of Kokand was a state in Central Asia that existed from 1709-1876 within the territory of modern eastern Uzbekistan, southern Kazakhstan, Tajikistan and Kyrgyzstan.

³ Within the Russian tsardom Kyrgyzstan was in the structure of Turkestan general-region. Territories inhabited by Kyrgyzs were divided into four *oblasts* (regions): Semirechenski, Syrdarinski, Ferganski and Samarkandski. The management system was half-militarian, stardom officials and miliatirans were appointed to the high level government –regions and districts etc., while the lowest level of government were headed by leaders of local tribes.

⁴ The term Kara-Kyrgyz was used until the mid-1920s by the Russians to distinguish them from the Kazakhs, who were also referred to as Kyrgyz.

became the Kyrgyz Autonomous Soviet Socialist Republic. On December 5, 1936, the Kyrgyz Soviet Socialist Republic (SSR) was established as a full Union Republic of the U.S.S.R. With the collapse of the USSR Kyrgyzstan declared independence on 31 August 1991¹.

History of Kyrgyz people before the USSR and history of Kyrgyzstan during the USSR are different in terms of the state order and its social and economic implications. Therefore, in studying the transition period of Kyrgyzstan it is useful to analyze its departure point – features of the economy that had been formed before and during the USSR. These historical aspects of Kyrgyzstan economy are explained in this chapter. The chapter is divided into two main sections. First section focuses on characteristics of the economy of Kyrgyzstan before the USSR. Second section looks at the economic development of the economy during the USSR. In particular, it focuses on the early years of Soviet power, on the development and structure of the economic system that socialist system had formed and on the serious attempt to modernize the Soviet economy within last five year plan (1986-1990).

4.1 Economic Structure of Kyrgyzstan before the USSR

Before the USSR the societal relations of Kyrgyzs had been formed on the tribal divisions and had the patriarchal- feudal features. The Kyrgyz are celebrated mountain livestock breeders, and were largely nomadic until the beginning of the XX century. The nomadic type of life had formed the type of economic activity of Kyrgyz people. For the most centuries Kyrgyz people had practiced the vertical pastoral nomadism, which based on the seasonal migration to the valleys in the lower reaches of mountains during the winter, in the summer they migrated to the valleys in the higher reaches of the mountains. The main type of economic activity was cattle breeding. This nomadic cattle breeding prevented the development of the settled type of economic activity. However, the people of the southern part of Kyrgyzstan were more advanced in husbandry, while in northern part populations were prevailingly employed in cattle breeding. Husbandry had the primitive and routine techniques and was not paid with enough attention by the nomadic Kyrgyz people. In spite of its geographical situation which lies on the trade ways between China and Russia, Kyrgyz were

¹ For more general information on Kyrgyzstan, see Appendix A.

not active participators of the trade. Their international and local trade experiences were limited with the exchange of the necessary everyday stuff against cattle. Since, cattle were often used instead of the money (Usenbaev, 1961, p.83). Hence, under the less developed husbandry and trade, and the dominance of cattle breeding activity, the economic activity of Kyrgyz people was in self-provision character and their production was limited with the aim to satisfy their own local needs.

However establishment of the control of the Russia and beginning of colonial exploitation of the natural resources in the late XIX resulted in some changes in economic and socio-cultural aspects in the life of Kyrgyz people. In order to exploit the new areas and to strengthen its influence Russian stardom stimulated migration of farmers to incorporated territories, hence to Kyrgyzstan territories as well. It brought thousands of peasant families from Central Russia and from Ukraine into new areas¹. They were provided with support and land, which was often seized from the local inhabitants. Most of these newcomers established medium-size farms, specializing in commercial production of agriculture products. With these migrant-farmers husbandry, beekeeping and gardening received large application among Kyrgyzs too.

One of the main consequences of the Russian dominance in the region of that period was increase in trade turnover between Kyrgyzstan and various parts of Central Asia region, Russia and China. Large trade opportunity was stimulated by construction of railway lines: in 1888 Transcaspian railway and in 1905 the Orenburg - Tashkent line was completed. Trade capital started to come to Kyrgyzstan with the aim to realize the industrial goods of Russia and of other foreign production in newly opening markets. This activity began to attract the patriarchal terrain people to the trade-market relations, creating their demands to the new products. Trade was mainly lead by Tatars, Uzbeks and Russians, eventually Kyrgyz people started to be traders too. For instance, during the 1912-1914 years, in Pishpek region there were 1340 traders, of which 440 were from ethnical Kyrgyz nation. At the same time small workshops and plants were opened in major towns and cities, processing agricultural products, like leather, wool, oil etc. New commercial crops were introduced to local farmers, as many

¹ There were migrants of other nationalities such as Dungans and Uygurs that came after the defeat of movement against Tsin Dynasty in China, and Tatars, Germans, as well.

people gradually began to cultivate tobacco and cotton in the Ferghana valley. By 1917 several small mines (lead, copper, coal, etc.) were opened in southern Kyrgyzstan and in some other areas (Koichuev et al., 2003, p. 61).

Increase of trade relations, mass migrant of farmers and of other nationalities, the new administrative order and tendency towards the sedentary type of living among Kyrgyzs resulted in emergence of cities, such as Pishpek (Bishkek), Tokmok, Karakol and other small villages mainly established by migrants.

Along with these changes during the early XX century there was a rise in literacy compared with the previous periods. Since, changes in the market and in the economy demanded new skills and new knowledge. Local communities needed more literate people who could help them to calculate taxes, read official documents, and write letters or other documents. Meanwhile, tsardom needed more educated native administrators who would be able to handle the increasingly complex issues of local governance. This led to an increasing number of schools and consequently a rise in the literacy rate among the indigenous population. By the middle of the XIX century a network of *medrese* (religious schools) had developed mainly in the areas with a traditional sedentary population. This network generally did not cover areas with a traditionally pastor-nomadic population. In the late XIX century tsardom attempted to establish a primary education network for the Russian population as well as for Kyrgyz children (*Russko-Tuzemnyie shkoly*). At the beginning of the XX century there was an attempt to establish a network of secular schools- *maktabs*- to promote primary education in Russian among Kyrgyz children as well as among the adult population. According to official reports on Semirechie oblast, by 1912-1913 the literacy rate among Kyrgyz males increased to 8.2 per cent, among Kyrgyz women to 0.2 per cent, although only 2.20 per cent of the Kyrgyz population could read and write in Russian. However, the efforts at increasing in literacy rate were quite inadequate as tsardom provided rather limited funding for education (Abazov, 2004, p.17).

Despite all of these new introductions, there were not significant changes in economic structure and improvements in economic conditions of the people. Industry, construction and transportation sectors were still less developed. There were only few industrial enterprises, which generally were based on primitive techniques, and the main production was the

processing of the agricultural products. The construction sector was more undeveloped. The main construction activities had been launched in developing city location. But all of them were individual and the old construction method had been used. The same can be said for the transportation. With the completion of the Transcaspian railway and of the Orenburg-Tashkent line, railway included only the Jalal-Abad region (in south part of Kyrgyzstan). However, the main transportation was still being implemented by the primitive tug transportation.

In spite of the fact that during the Russian dominance in Kyrgyzstan the creation of small size enterprises in industrial processing of agricultural products was launched, most of the household needs were still being satisfied by the own family production based on self-provision, and only the small parts of the production were used for selling in the market. This was typical, in particular, for the ethnical Kyrgyz people. According to the data before the World War First (1913) approximately 96 per cent of production of the country was produced in agriculture, while only 2-3 per cent was produced in industry. In economic activity prevailing operations were operated on the bases of the barter system, and the money exchange system involved only one third of the GDP (Koichuev et al., 2003, p.61).

Thus, for a long time Kyrgyz people were nomadic and were living on the feudal-patriarchal relations. The main economic activity was nomadic cattle breeding on principle of self-provision. However, with the Tsarist Russian colonialism new industrial productions emerged, husbandry received wide application and trade relations increased. By these changes production started to be based on private ownership with profit incentives. However, these effects were limited and the socio-political relation remained as the patriarchal- feudal one. Since Russian colonial attitude in governing the region did not intervene deep in rooted order of governing the local population. Feudal was going to govern, but on the behalf of Russian Tsarist administration, and to keep formed traditional structure of the society.

Notwithstanding the deep history backing to the more than two thousands years, Kyrgyz people in the last years of the XIX century and at the beginning of the XX century was in low level of the economic development. Economic structure of the Kyrgyzstan before the USSR was the backward agriculture with the dominance of nomadic cattle breeding.

4.2 Economy of Kyrgyzstan during the USSR

With the 1917 Bolshevik Revolution the Socialist power started to be established in Central Asia region too. But during the first years people of Central Asia were not ready to accept the new order. Throughout 1919 and 1920 many groups within Kyrgyz society vigorously resisted the establishment of the new political regime. In 1922 the establishment of the USSR was declared and the policy for creating the socialist economy began. In 1922 the *New Economic Policy* was adopted and was abandoned in 1928 by the introduction of five year plan practice. In 1936 with the adoption of new Constitution of USSR it was declared that economic base for socialist economy was established.

This section divided into three subsections. First includes the period of making socialist economy in Kyrgyzstan: 1920s till the end of 1930s. Second focuses on the general observation of economic development of Kyrgyzstan during the Soviet period and on the explanation of the basic features of the economic system. Third subsection includes the period of serious attempt on modernization of economic and, consequently, political system – period of “Perestroika”.

4.2.1 Establishment of socialist economy in Kyrgyzstan: 1920s and 1930s

The World War I and Civil War seriously destroyed economies on which the USSR was established. Dissatisfaction of some part of population with introduced new order of the Soviet power, weak industrial sector and underdeveloped agricultural represented unstable base for realization of the idea of socialism. Backwardness of the economy of USSR necessitated the newly established Soviet government to take urgent measures. This measure was adopted as the New Economic Policy (*NEP*) which was decided in the course of the 10th Congress of the All-Russian Communist Party in March 1921. *NEP* was interpreted as a temporary deviation from the intended socio-economic structure of the society that had to be based on communist principles and was seen as a necessary policy for creating the base for socialism (Koichuev et al., 2003, p.76). In fact, within this policy it was supposed to maintain the state leading role in the economy, but along with this, to allow partly private property rights in agriculture, in small and medium industrial, trade, transportation and construction

enterprises. According to this policy industrial sector of the USSR had to be developed within the single plan lead by the *Gosplan*¹, which was formed in February of 1921. To create stimulus for production, especially for peasants, it was allowed to lease and hire labor for peasants and they were allowed to keep a surplus after paying a certain tax to the government. This has also led to the Fundamental Law of the Exploitation of Land by the Workers, which ensured that the peasants have a choice of land tenure. Cooperatives were entitled to establish the price according to the market conditions. All of these measures provided quick economic recovery after the devastating effects of the World War I, the October Revolution and of the Civil war. By 1928 agricultural and industrial production had been restored to the pre-war period.

Realization of the NEP in Kyrgyzstan was associated with the help, both material and financial, to return of emigrated Kyrgyz people during the 1916 rebellion against the Tsarist colonization, and with the land reform. The land reform was supposed to balance the land tenure of Russians and indigenous people by confiscating lands that had been seized and given to migrants from Russia and Ukraine during the Tsarist colonization, and give them to landless indigenous people. Starting in 1920 and 1922, migrants were settled back to their old areas and on their place the new families of Kyrgyz people were sedentarized.

These acts contributed to the start of mass sedentarization of Kyrgyz people. However, the lack of knowledge on husbandry, the lack of agricultural techniques and dominance of nomadic tradition prevented the complete sedentarization of Kyrgyz. In 1927 year 62 per cent of 1 451 114 Kyrgyz families were nomadic and semi-nomadic. Activities of mass sedentarization of nomadic people continued until the end of 1930s. Together with the land reform activities on irrigation increased and cooperatives among peasants developed. As a result of changes in 1920s the agricultural production increased. In 1926-1929 years production of agriculture was increased by 1.5 times (Ploskih et al., 2003, p.212).

Thus, in years of the *New Economic Policy* the new economic structure and the new order in economic activities of indigenous people emerged. Although the *NEP* allowed some market elements, which induced the private interest in economic activity, these measures were not fully realized among Kyrgyz people, since the main population had just obtained the

¹ Gosplan was the state planning committee responsible for the central economic planning in the USSR.

property rights on lands and, moreover, most of them were still nomadic. The *NEP* was abandoned by Joseph Stalin in 1928 in favor of First Five Year Plan (1928-1932). The idea behind this plan was the rapid industrialization to the level of capitalist countries in the West. In all of its following existence the growth and development of the economy of USSR was based on the adoption of Five Year Plans, which was containing the centrally planned activities and parameters to be achieved in each following five years by using centrally determined resources. The format of this Five Year plan changed the approach of *NEP*. Since, this policy within five year plan aimed at the total leading role of the state in the economy and abandonment from partial private ownership rights on factors of production introduced during the *NEP*. From this perspective mass collectivization was seen as an instrument for establishing collective ownership in agriculture.

In 1929 the Soviet authorities launched a campaign of collectivization and incorporated, often forcibly, most of the Kyrgyz peasants into *kolkhozs*¹. By 1 July 1935 by incorporating 70.8 per cent of farmers and 84.7 per cent of irrigated lands into *kolkhozs* Kyrgyzstan almost completed collectivization. In spite of the common view that mass collectivization contributed to the high growth rates of the agriculture, the results of the mass collectivization before the World War II were negative: peasants, who were forcibly involved into collective farming were not showing interest in increasing the productivity, hence, the production of the agriculture decreased compared to 1928 level. For example, the number of cattle was at 77 per cent of 1928 level and meat production was low by 8 per cent. Moreover, positive consequences that are ascribed to collectivization were rather related with other serious changes, such as land reform, large scale activities on irrigation, mass sedenterization, implementation of which coincided with collectivization period (Ploskih et al., 2003, p.216).

The development of the industrial sector did not reach the set aims in plans. In December 1925 during the 14th Congress of Communist Party of the Soviet Union six main elements of industrialization were defined: development of large scale industry, metallurgy, development of fuel industry, development of railway transportation, support in developing

¹“Kolkhoz” was a form of collective farming in the Soviet Union that existed along with state farms (sovkhoz). The word is a contraction of “*kollektivnoe hoziastov*” or “collective economy”. In a kolkhoz, a member was paid a share of the farm’s product and profit according to the number of workdays, while a sovkhoz employed salaried workers. In addition the kolkhoz was required to sell their crop to the State which fixed prices for the grain.

local industry and education of necessary staff. Only on two of them (fuel industry and the support in developing of local industry) the substantial progress was done, although less than aims set in plans (Ploskih et al., 2003, p.217). Most activities of five year plans before World War II were financed at considerable low level than planned; hence, most of planned activities remained unrealized. For instance first five year plan was financed at 46.2 per cent of planned and planned construction of 150 km of rail roads was realized only as 10 km. According to the results of the implementation of pre World War II five year plans (first (1928-1932), second (1933-1937) and third (1938-1942)) the most of the set aims on industrial sector were not realized. For instance, in 1940 production of local industry was implemented at 66.7 per cent of planned, on construction sector it was 38.1 per cent. Unsolved problems of each five year plan transferred to be solved to the next plan period. In other words, before World War II period, the rate of growth of the industrial sector of Kyrgyzstan did not correspond to the set indicators in plans.

One of the positive consequences of establishment of the Soviet power in Kyrgyzstan was the liquidation of illiteracy. This concerned both the liquidation of general illiteracy and educating of the necessary staff for the economy. In the 1920s and 1930s the Soviet modernization policy aimed to create a large intelligentsia and working class among the Kyrgyz. But the reality was that most of them lacked the skills and education necessary for working in newly created factories and enterprises as only 15.1 per cent of the Kyrgyzs were literate in 1927. In response the government launched a “*vyjdvichenstvo*” program (promotion campaign) that aimed at intensive training of locals and promoting them to managerial positions and giving them priorities during recruitment to the newly created factories. Yet Kyrgyzstan still experienced shortage of skilled labor that was often filled by migration of people (voluntary and forcibly) from European part of the USSR. According to official statistics, number of ethnic Russians in Kyrgyzstan increased from 116,000 in 1926 to 302,000 in 1939 and Ukrainians from 64,000 to 134,000 in the same period (Abazov, 2004, p.26). For the preparation of highly qualified specialists young people were sent to universities in Tashkent, Moscow and Leningrad. In 1937 in medium and large industrial enterprises the percentage of Kyrgyz workers was only 20 per cent (Ploskih et al., 2003, p.220). Therefore, despite the activities for liquidation of illiteracy, because of the lack of educated staff from the

local people the worker class was growing slowly. By the end of 1930s the general liquidation of the general illiteracy of the population was almost achieved. The tendency of the high level of education had been preserved during the all of the existence of Soviet Union.

Thus, with making socialist economy in Kyrgyzstan in 1920 s and in 1930 s the state ownership rights on all production were established. And country started to operate in one unified administratively distinguished territory and traditionally nomadic society was sedentarized. The mass collectivization in 1930s did not result in rapid growth of agriculture and did not reach the 1928 level. Despite the announced accelerated industrialization policy in Kyrgyzstan industrialization was limited in its scope and rate. Problems concerning the transportation, large scale industrial production and education staff from local people remained unsolved.

In 1936 with the adoption of new Constitution of Soviet Union, it was declared that the transition from capitalism to socialism is completed, all elements of capitalists were deleted and the necessary economic base of socialism is established. However, above mentioned facts on Kyrgyzstan's development at that time show that the level of economic development was not enough in proving the "strong economic base of socialism".

4.2.2 Economic system and economic development of Kyrgyzstan during the USSR

During the first years of USSR its economy had very low developed industrial and agricultural sectors. For the operation of member countries as a whole system of socialist economy it was necessary to integrate them with common economic interest and include them into modern industrial and state controlled agricultural sectors. Because of this Soviet government used large amount of investments into construction of big industrial enterprises and in agriculture based on large scale centrally controlled farming.

Industrialization of Kyrgyzstan during the Soviet power took place in main three waves. Industrialization began in the 1930s with large investments into the production of heavy and agricultural machinery, electric motors and light manufacturing, and also mining. These investments were primarily financed by the Central Soviet budget, For example, according to statistics in 1928-1932 years share of the general USSR budget and of the

Russian Federation budget in constructions of the new industrial enterprises in Kyrgyzstan was 90 per cent. During and after the World War II there was a second wave of industrialization: industrial plants were reallocated to Central Asia along with their workers, engineers, and technical staff from the European part of the USSR, where their functioning was threatened by military actions and postwar turbulence. These factories and plants remained in the republic after the war, and they became the backbone of Kyrgyzstan's heavy industry.

Table 4.1 Structure of the production of industry (1970-1990)

	1970	1980	1985	1990
Total	100	100	100	100
Heavy Industry	34.4	42.4	43.7	45.6
Fuel-energy	5.6	4.4	4.8	5.1
Machine building	17.6	24.5	25.6	25.7
Chemical-wood Processing	3.1	2.3	2.3	2.4
Production of materials for construction	6.2	4.8	4.4	4.8
Light industry	36.6	32.4	28.9	28.8
Processing industries in agricultural sector	27.2	21.2	23.2	22.3

Source: NSCKR, 1992; Statistical Committee of Kyrgyz SSR, 1987.

Third wave of industrialization occurred in the 1960s and 1970s, when Moscow allocated large investments to the republic's hydroelectric power-producing sector, and to mining and metallurgy plants, although due to construction delays some of them could not operate in full scale until the late of 1980s (Abazov, 2004, p.23). The structure of the industrial sector was formed with the high share of heavy industry. The share of which increased by 10 per cent from 1970 to 1990 and correspondingly of other two, light industry and processing industries in agriculture, decreased. Among the components of heavy industry machine building had the leading share (see Table 4.1).

The machine building sector had priority in developing enterprises specializing in electronic products, such as, physical, electronic-estimating machines, construction of staff for

space industry etc. In other words, machine building was one of the most progressive and perspective sectors for Kyrgyzstan's economy. Since, it presented the basics for further steps toward the new developments in industrial development and technological progress. Along with this sector, one of the important contributions of the soviet investment was construction of hydroelectric power stations. Since Kyrgyzstan has a large potential in producing hydro energy.

Table 4.2 Rate of growth of industrial and agricultural sector of Kyrgyzstan and USSR (1913-1986, base year 1913 = 1)*

	1913	1940	1960	1970	1980	1985	1986
Production of industrial sector of USSR	1	7.7	40	92	163	195	205
Production of industrial sector of Kyrgyzstan	1	9.9	61	188	362	457	480
Production of agricultural sector of USSR	1	1.4	2.2	3.1	3.4	3.8	4.0
Production of agricultural sector of Kyrgyzstan	1	2.0	3.6	5.7	7.2	7.7	8.3

* Rate of growth is given in terms of the fold increase taken 1913 as the base year. It may be misleading to present the economic growth in such measure. However, these data are available official statistics from the USSR period that make possible to compare development of Soviet period with pre-Soviet era.

Source: Statistical Committee of Kyrgyz SSR, 1987; USSR State Committee of Statistics, 1987

Analogous description can be given to agriculture sector - modernization of production techniques brought about changes in the structure of the agricultural production, where along with the tradition animal husbandry, plant breeding had been developed. In Soviet labor division Kyrgyzstan had its own specialization in agricultural production and was the big producer of the animal husbandry products. The leading role in animal husbandry was sheep breeding, whose share in income of *kolkhozs* and *sovkhozs* was 34 per cent. Kyrgyzstan was in leading third place in USSR (after Russia and Kazakhstan) on production of sheep breeding products in absolute values (Ploskih et al., 2003, p.285).

These contributions provided the high rate of growth of the economy of Kyrgyzstan under the Soviet system. Compared to pre-soviet period, development of Kyrgyzstan economy

during the soviet period is significant. Rate of growth of both agriculture and industry compared to pre soviet period in Kyrgyzstan was faster than average for the USSR (see Table 4.2). Especially industrial sector was growing fast and in 1986 it was 480 times higher than in 1913. In the late 1980s it was considered that Kyrgyzstan, which was less developed agricultural country at the beginning of XX century, became a country with industrial-agricultural economy.

Table 4.3 Annual average rate of increase of some economic indicators of USSR and Kyrgyzstan in five year plans (in per cent, 1961-1990)

	1961-1965	1966-1970	1971-1975	1976-1980	1981-1985	1986-1990
<i>GDP</i>						
USSR		7.4	6.3	4.2	3.5	4.3
Kyrgyzstan	8.6	9.3	6.4	4.2	4.3	3.1
<i>Industry production</i>						
USSR		8.5	7.1	4.4	3.7	4.9
Kyrgyzstan	10.8	13.0	8.7	4.8	4.8	4.7
<i>Agricultural Production</i>						
USSR		3.9	2.5	1.7	1.0	5.3
Kyrgyzstan	5.2	4.2	2.9	1.7	1.5	2.8
<i>Real per capita income</i>						
USSR		5.9	4.4	3.9	2.1	2.5
Kyrgyzstan	...	5.5	4.5	2.4	2.3	2.7
<i>Public Labor Productivity*</i>						
USSR		6.8	4.5	3.3	3.1	3.8
Kyrgyzstan	6.9	5.2	2.2	2.1	1.9	5.2

*In Soviet statistics the public labor productivity was estimated as produced national income per worker employed in sectors of material production.

Source: Chotonov, 1995; Statistical Committee of Kyrgyz SSR, 1987.

The soviet economic system demonstrated its effectiveness at the period when weak economic base needed mobilization of resources in establishing material and technical base of the economy. For the short period before the World War II it created gigantic industrial enterprises in electricity, machinery production etc.

However, starting from 1960 and 1970s economy of the USSR began to show its inefficiency. Almost all main economic indicators were decreasing. As it can be seen from

Table 2.3 all indicators both in USSR and in Kyrgyzstan were decreasing starting from the mid of 1960s. During the period of the last five year plan (period of 1986-1990) rate of growth of production in industry and agriculture was almost two times low compared to the first half of 1960s. Rate of growth of GDP in the late 1980s was more than two times lower than it was at the beginning of 1960s. The public labor productivity also shows that effectiveness in production was decreasing. Growth of the real per capita income decreased. Moreover, in Kyrgyzstan the rate of produced national income was almost at half than average level for the USSR. But it was not reflected in living standards of the population, since government received a huge amount of subsidies from the USSR central government budget. Such eventual inefficiency of the Soviet economy system was predetermined by features of the system under which economy operated.

The main feature of the economy of USSR was that it was constructed on the state monopoly. While private ownership in factors of production was not practiced, and management and control of enterprises was implemented by the state bureaucracy. Ideologically the socialist society was perceived as owners of the socialist property, but not each member individually. And socialist society was presented by the socialist state. Therefore, all the factors of production were in the state property. The method of deciding key economic questions in the Soviet Union- that is, what should be produced, how much, where, how and to whom it should be distributed- was to be by no means of a broad national economic plan (Kalyuzhnova, 1998, p.6). This plan was prepared by the government of each member republic of USSR and Gosplan of the USSR. All resources were allocated centrally according to these five year plans that included economic and social indicators to be achieved in each following five years. State-owned enterprises covered all the key sectors of the economy. The disposal of their residual income was given into the central state budget and right of control over the activity of the enterprises was being exercised by the state bureaucracy. Along with the state owned enterprises, formally, there also was the cooperative-socialist type of enterprises, in particularly in agriculture, which was perceived to operate on the basis of the cooperative principles. But it was only formally, since members were not free to join or leave the cooperative, leaders of cooperatives were not elected, and most often they were appointed by the state authorities. Under these conditions, as the central government of

USSR was entitled to reallocate resources among member countries, the state budget of member country was strictly related to central government budget¹. Prices were not determined as the consequences of demand and supply conditions, on contrary it was determined by the state. External trade also was under the control of the central state and the main trade pattern was the inter-republican trade between member countries of the USSR.

Another feature was that the system of production of the USSR economy presented high interdependence of member republics. This meant that the infrastructure of production was spread out across the territory of the former Soviet Union (FSU), with each of the former republics representing a link in the chain. Generally speaking the division of labor within the USSR republics was not connected to comparative advantage, but rather to a centrally devised plan. All the republic economies were part of the general system *Edinyi Narodno Khozyaistvennyi Komplex* (Integral Economic Complex), which was a system of a collective production. Therefore, the economic regions represented the interest of the USSR's economic system as a whole. The *Territorial Concept of Labor Division* was very active in Soviet economic science. According to this concept every region (member republic) had to have a particular area of specialization (Kalyuzhnova, 1998, p.11). Traditionally, in this labor division Kyrgyzstan had its own specialization in agricultural production and was the bigger producer of the animal husbandry products.

With these features the Soviet economy was a lack of incentives for efficiency. For instance, in preparation and implementation of five plans in Kyrgyzstan, the government of Kyrgyzstan was trying to increase the indicators on investment, wages, expenditures on production, quantity of workers, etc. in order to get more financial resources from the Central Government and Gosplan of USSR, but by doing so it was not trying to increase indicators on profit, deductions to central budget, produced goods etc, so that it would be easy to implement the plan. The same was for managers. As managers were neither the owners of enterprises nor entrepreneurs they were not motivated to achieve the set aims in plans. Moreover, the Soviet economy in almost all of its existence had generated capacity of production extensively, and not intensively. Emphasize was made on the increase of investment into all sectors of the

¹ The available official statistics of the Kyrgyz SSR do not show the level of subsidy of the central USSR budget to Kyrgyzstan's state budget. However, according to some sources, after the World War II till the end of 1980s level of central budget subsidy in Kyrgyz state budget was varying between 8% and 12 %.

economy, and not on economic return. This fact caused not only decreasing effectiveness, but also ecological problems. Especially, it was evident in agriculture where the irrational increase in animal density without taking into account the limit of potentials of natural pastures appeared. This density in Kyrgyzstan highest in USSR - 119 sheep for 100 hectares of pasture, while average for USSR was 45 sheep for 100 hectares. Because of this by 1985 about 60 per cent of pastures in Kyrgyzstan had become little in use (Ploskih et al, 2003, p.286).

Therefore, the economic mechanism in Soviet economy was in cost-inducing (*zatratnyi*) character which orientated industries and enterprises to increase costs. In other words: the structure predetermines excessive costs. Large investments have been wasted, and the prioritizing of development of machine-building in investment did not materialize (Kalyuzhnova, 1998, p.21). The quality of products was low compared to international standards, attempts to achieve high growth rates were associated with extensive exploitation of resources, and, hence, the cost of production was rising. Thus, socialist economy of USSR showed its effectiveness in mobilizing resources for weak economy, eventually, the state monopoly in all aspects of the economy caused decreasing effectiveness that started explicitly demonstrated starting from the mid of 1960s.

4.2.3 Kyrgyzstan economy during the “Perestroika”

The debates on the inefficiency of socialist economic system in USSR started in 1950s, when the leader of communist party was N. Hrushev and during the leadership of every new leader of communist party, there was an attempt to increase the effectiveness of the socialist economic system.

During the period of Hrushev’s leadership there was an attempt to increase efficiency by changing the organizational structure of managing the economy. This attempt was that to establishment *sovnarkhoz* (regional economic board) and thus to create the territorial system of managing the economy. Another reform attempt was suggested by Kosygin, who was the prime-minister of the USSR government during the Brejnev’s period (1964-1982). This reform package was supposed to increase effectiveness by posing the final financial results as new indicators to measure the effectiveness of enterprises, and not only produced output, by

allowing enterprises to create special funds to use in stimulating workers. At the beginning of 1980s the new leader of the communist party Andropov was trying to increase disciplinary responsibility of officials and workers in order to decrease the bureaucratic inefficiency.

But none of these reforms could solve the problem of socialist economy and stop the decreasing effectiveness. Because all of these attempts excluded any possibility to introduce the market mechanisms and all of these reform attempts proceeded from the state monopoly in the soviet economy. The more active searches for restructuring of the soviet economy started in the mid of 1980s, during the period of leadership of M.Gorbachev. This period in the history of USSR is called as “Perestrioka”. This period started with five year plan for 1986-1990, which was defined as a concept of intensification (*uskorenie*) or acceleration of economic growth by scientific-technological progress, by the new technical equipment of production and by stirring up “human factor” (Ploskih, 2003, p.291).

Within this five year plan Kyrgyzstan had to achieve new level of technical improvements in production and to increase the output level and labor efficiency. In industry the main emphasize was made on machine building whose product had to be increased by 1.4 times, growth of the over all industry had to be 24 per cent and of agriculture 15 per cent. For motivation in agriculture for *kolkhoz* and *sovkhos* contract with individuals and families was allowed and this form of activity was considered as one of the collective activities.

But the first years this five year plan did not include serious reform programs for intensification of the Soviet economy, and the economy was operating in the same mechanisms. Without restructuring the economic system it was impossible to reach the intensification of the economy. The situation changed starting from June 1987, when the plenum of the Central Committee of the Communist Party of USSR decided to start economic reforms aimed at the restructuring of the economic system.

During this plenum it was also decided to introduce the principle of self-financing (*khozraschot*). This principle was introduced at the enterprise level through the newly adopted The Law on Enterprises. According to this law all state enterprises were free to determine output levels based on demand from consumers and other enterprises. Enterprises had to implement state orders, but they could dispose of the remaining output as they saw fit. Enterprises bought inputs from suppliers at negotiated contract prices. Under the law,

enterprises became self-financing; that is, they had to cover expenses through revenues. It was a year when the notion of “*republic khozraschot*” became the part of economic life of the republics. According to this notion, republics had to be given more independent powers, including the authority to manage their own finances (Kalyuzhnova, 1998, p.21).

The Law on Cooperatives, enacted in May 1988, permitted private ownership of businesses in the services, manufacturing, and foreign-trade sectors. The law initially imposed high taxes and employment restrictions, but it later revised these to avoid discouraging private-sector activity. Under this provision, cooperative restaurants, shops, and manufacturers became part of the Soviet scene.

For the short period, as a result of these new changes, in Kyrgyzstan there were some progresses that exceeded the previous five year plan level. For instances, in 1988 the average rate of growth of the produced national income was 5.9 per cent, against 4.3 per cent in 1981-1985 period. Compared to 1985, the production of industry increased by 13.6 per cent and of agriculture by 14 per cent. However, the new imbalances emerged in the economy. In particular there was a deficit of consumer goods. With the introduction of republican *khozrachyot* the disturbances in implementing contracts between enterprises emerged. This fact very negatively influenced the metal processing sector of Kyrgyzstan, since it was highly dependent on the raw materials imported from other Soviet republics. In 1988 year 15 per cent of industrial enterprises did not implement their contract obligations. In agriculture the practice of leasing and cooperation was progressing very slowly.

In 1989, after the short period of upward trend the crisis started. Decrease in industrial production started in December of 1989, was continuing and accelerated in 1991. The deficit of union budget reached 10 per cent of GNP. Each fourth enterprise was not implementing contract obligations. The main focus of resources on industry brought about the lack of the resources in social sector, in particular there was a substantial gap in providing with houses and household services. Even at the beginning of 1990s each sixth family of the urban population of Kyrgyzstan was in a queue for house, of them 36 per cent had to wait from 5 to 10 years, and 14 per cent - above 10 years. All population, especially rural, were facing difficulties in taking household services and most of them was complaining about the low quality and delays in providing with services. By 1990 the government had virtually lost

control over economic conditions. Government spending and inflation increased sharply as an increasing number of unprofitable enterprises required state support, and consumer price subsidies continued

Despite taken measures for the modernization of the Soviet economy, structure of the economy remained as cost-inducing (*zatratnyi*). Taken measures were not enough for building the new structure of the economy. Since all of the economy was remaining to work under the command system with its central planning, private property rights were limited and workers and managers were not motivated. In many respects, enterprise law and *khozraschyot* contradicted each other. While enterprises received more freedom in economic decisions, they still remained dependent on the state. However, *khozraschyot* could only function if enterprises were independent; that is, had property rights. In Soviet society ownership belonged to people, and nobody felt responsibilities for *narodnuyu* (publicly owned) property (the property of these people). So the basic premise of this law on enterprise failed to satisfactorily account for the logical consequences of the state enterprise's to this scheme. Given the freedom to decide on the distribution of their production funds (the income of enterprises), they focused strongly on the wage base (Kalyuzhnova, 1998, p.22). While the introduction of the latest machinery and technology was neglected.

Economic changes undertaken during the perestroika did not improve decreasing effectiveness of the economy. Although reforms promoted decentralization to some extent, most government control over the means of production and over the price remained. Therefore, the economic changes alone without changing political system could not be resulted in new effective economic order. The new political appearances and accelerating democratic movements in Soviet republics in the late 1980s resulted in the collapse of the USSR and in emergence of new independent states¹.

Thus, during the soviet power economic structure of Kyrgyzstan had been formed as the typical Soviet socialist economy together with its own specifics. These main features of pre-transition socio-economic structure of Kyrgyzstan are summarized below.

¹ Although we are well aware of the importance of the political aspect we omit this aspect as this is beyond the content of the research. However, in next chapter on the start of transition taking into account the importance of political conditions under which economic reforms have been implemented, brief explanation of building new political system is given.

- Structure of production. Agricultural-industrial economy - it was the definition given to the Kyrgyzstan economy at the end of 1980s. The definition emphasized that during the soviet period along with developed agriculture Kyrgyzstan achieved considerable developments in industrial sector. Indeed in 1990 share of industry and agriculture in GMP was 33 and 40 per cent respectively; while in employment their shares were 28 and 33 per cent (see Table 4.4).

Table.4.4 Structure of Gross Material Product (GMP) of Kyrgyzstan (1989 -1990, in per cent)¹

	1986	1987	1988	1989	1990
GMP	100	100	100	100	100
Agriculture	37	38	37	39	40
Industry	34	36	36	35	33
Construction	13	12	13	12	12
Transport	6	6	6	5	6
Other	10	8	8	9	9

Source: Calculated on the data of World Bank, 1993b, p. 177.

In spite of the relative importance of industrial sector in the structure of the GDP, agriculture remained to play key role and dominant activity in the economy. As already mentioned in soviet labor division Kyrgyzstan had its own specialization, it was the main producer of the animal husbandry production and in industrial sector the main proportion had heavy industry, in particular machine building which was largely dependent on the integrated Soviet production chain. Generally, the Central Asian republics' place in the Soviet system was mainly as producers or processors of raw materials. The latter activities could be especially vulnerable as either input supply or

¹ Soviet statistics used to calculate Net Material Product (NMP) for monitoring growth. Although NMP conceptually was equivalent of Gross Domestic Product (GDP), numerically the two measures were different in calculation. MP excluded most of the service sectors, which was classified as non-material product. Although, according to the source used here, data used in this table were prepared for the IMF by Kyrgyzstan Statistical Committee and, therefore, includes some adjustments to GDP estimation. But again GDP by sectors are given under the headline of gross material product and calculations in the table are based on them. Therefore one should be aware that GMP is not the same as GDP in calculation, but available Soviet statistical indicator that conceptually equivalent to it.

access to market breaks down, or the entire Soviet production chain could prove uneconomic at world price (Pomfret, 1995, p.37).

- **Foreign Trade.** Because of the considerable degree of regional specialization of output among the republics of the Soviet Union almost all of the trade was inter-republican. For instance in 1988 year 86, 9 per cent of Kyrgyzstan total trade was with other the USSR member republics. Moreover, the low competitive structure of the economy compared to the world standards, low efficiency of production and the absence of large oil and petroleum reserves could negatively affect the trade balance of the country in the future.
- **Social security and social services.** The social expenditures on social services were extremely expensive for Kyrgyzstan budget. However, Kyrgyzstan benefited from large transfers from the Union and these permitted the country to have an overall budgetary surplus. Of the Government's expenditure, a large proportion was devoted to social security and social services. In 1990 the proportion was about 60 per cent, equivalent to about 23 per cent of GDP. Health services accounted for about 4.1 % of GDP and education for about 8.2 per cent (see Table 4.5). According to the World Bank report social spending in Kyrgyzstan in 1990 was than twice the average of the some lower-income and lower-middle income countries. Kyrgyzstan had a relatively well-developed infrastructure of social services (World Bank, 1993, p.4). This infrastructure contributed to the strong system of healthcare and general education that caused the expansion of access to these services.

Probably the most positive contribution of the Soviet period was the liquidation of illiteracy and maintained high level of general literacy. In 1989-1991, the level of secondary school enrollment was 99 per cent. But, at the end of 1980's there was a problem concerning the education of staff. The problem was that in 1970-1980s the disproportion in educating specialists emerged. Since young native Kyrgyz people was more attracted in humanitarian fields and after graduating they were trying to find job in civil services or in nonmaterial production spheres while in industrial sector the need for specialists with technical knowledge was growing. Therefore, industries of strategic importance such as machine building, instrument building, electronics and

even light industry were provided mainly with the specialists-Europeans. This situation created the dependence on these specialists (Djakishev, 2007).

Table 4.5 Social expenditures in 1990

	% of total government expenditure	% of GDP
Pension Fund	17.0	6.7
Family Allowances	9.3	3.5
Food Subsidies	17.0	6.5
Non-food Subsidies	1.0	0.4
Health services	10.9	4.1
Education	21.6	8.2
<i>Total Government Social Expenditure</i>	<i>59.9</i>	<i>22.7</i>
<i>Total Social Expenditure</i>		<i>29.4</i>
<i>Total Government Expenditure</i>	<i>100</i>	<i>38.2</i>

Source: World Bank, 1993, p.5.

Despite these relatively high level of social expenditures, income level of population of Kyrgyzstan, and almost in all Central Asia countries, at the end of 1980 was lower compared to other countries of USSR. For instance in 1989 more than 35 % of population of Kyrgyzstan had a per capita income monthly income below 75 rouble, which was considered as a line below which families were considered as “*maloobespechennye*”, referring to those who live poorly and are lacking in supplies¹. That means in spite of the high level of total social expenditure the level of income of the population in Kyrgyzstan was low compared to the average level for USSR.

- Absence of market experience. As it can be noted from previous parts historically Kyrgyz society had partially practiced the private ownership in production only for very short period of time - during the Tsarist colonization and partially in years of *NEP*. Moreover, in more than 70 years of its existence Socialist regime formed the society type which almost did not have knowledge and practice on private ownership

¹ This information is taken from World Bank (1993, p.9). In this report it is mentioned that the yearly survey, that these data are based on, in USSR was conducted on sample based on the sample with non random bases. Nevertheless, it sheds some lights on the living standards of people at that time.

rights on factors of production. Probably it would be important behavioral and institutional constraints in future reforms towards the market economy.

Thus, before the USSR historically Kyrgyzs were actively using nomadic cattle breeding. Changes occurred during the Russian Tsarist colonial dominance in the late of XIX century did not result in large improvements and the economy remained as backward agriculture with the dominance of nomadic cattle breeding. However, with establishment of the USSR considerable large investments were used to develop industry and agriculture. Kyrgyzstan had its own specialization in Soviet labor division - it was specialized on the animal husbandry production, and in industrial sector the main proportion had heavy industry, in particular, of the machine building which was heavily dependent on the integrated Soviet production chain. As a result by late 1980s structure of the economy was characterized as agricultural-industrial. By the beginning of transition period Kyrgyzstan had inherited both advantageous and disadvantageous from the Soviet experience. Advantageous was that it had relatively good base for further development of industrial production and developed human capital. On the other hand disadvantageous was that it was highly dependent on other member republics within the integrated system of production and on the financial support of central budget of the USSR in providing welfare services, and market experience after more than 70 years under the Soviet system was almost absent. These initial constraints might to make difficult transition of Kyrgyzstan to market economy.

5. INDEPENDENCE OF KYRGYZSTAN AND START OF TRANSITION

1991 year is known in history as the year of collapse of the USSR. The sign of the agreement between Russia, Belorussia and Ukraine on dissolution of the USSR on 8 December 1990 resulted in emergence of the new 15 independent states, member republics of the former USSR. At the same time signed new agreement between former USSR countries (excluding Baltic countries) created the Commonwealth of Independent States (CIS). CIS being different from the USSR was not supposed to represent all these republics as one state, but as the type of cooperation on different aspects on the basis of equal rights. After this event the declaration of independence of Kyrgyzstan was adopted in 31 August 1991. From this date officially starts the history of the new independent Kyrgyzstan¹.

From the outset of the transition period Kyrgyzstan has been recognized as a most liberal reformist country in Central Asia. It caused the substantial support from international community, in particularly from international financial organizations. Therefore, in preparing and implementing economic reforms substantial role was played by the International Monetary Fund (IMF) and the World Bank (WB).

This chapter is focused on the start of transition in Kyrgyzstan and consists of four sections. First section analyses the search for the new political order and the choice of the economic transition strategy during the first years after the dissolution of USSR. Second section is on the first step of radical economic reforms - liberalization of prices and trade. In analyzing economic reforms economic crisis, or as generally noted in the literature transformation crisis that took place during the first half of 1990s should be taken into account. Therefore, third section describes the magnitude of economic crisis in Kyrgyzstan in 1991-1995 years. Last section includes role of the IMF and the World Bank in economic

¹ It should be noted that legislative preconditions for the sovereignty started in 1990. Thus, on 15 December 1990 in third session of Supreme Council Declaration of State Sovereignty of Kyrgyz Republic was adopted. But this declaration defined principles of the sovereignty of Kyrgyz Republic, however, within the USSR. Law of USSR "On distinguishing power between USSR and member republics" and "On economic situation in country and transition to regulated market economy" adopted in 1990 gave some autonomy to member republics in economic and cultural aspects. Therefore, adoption of programs on reforming economy in Kyrgyzstan started before the official date of sovereignty.

reforms in Kyrgyzstan. Their role explained in terms of the content of their programs in Kyrgyzstan.

5.1 In Search of the New Order

Transition period has two main goals: a democratic country and market economy. Hence launching economic reforms was to be done in parallel with the creation of new political institution. Creation of both of the new political and market institution is difficult for transition economies which more than 70 years were under the totalitarian political system with planned economy. These two goals are interdependent and success in realization of each has an impact on another. Since, political forces in the new order can resist or can accelerate launched economic reforms. And economic reforms with its successful results can find further support from the society. Therefore it is useful to look at the creation of political system. In this section the process of building new political system is analyzed by focusing on the changes made to constitution of the country and balance of power till the 2000¹. After this the choice of the economic reform strategy is discussed in terms of the economic programs.

5.1.1 Building new political system

One of the legacies of the USSR was the old political system. Launched reforms faced the resistance of the old procommunist parliament and the officials of the old *nomenklatura*. This Soviet type of political structure was unable to carry out the programs of reforms that needed for transformation. Therefore, transformation of the political system along with the economic reforms was one of the important tasks of the country.

By the time of declaring of the independence societal consciousness had been formed under the Soviet system and the civil society had not been developed, because of this, conducted reforms and their outcomes were seen as the responsibility of the government, and

¹ Indeed, we are aware of the fact that political changes always affect economic reforms. However, in order to understand the political context of implementation of comprehensive economic reforms, which took place mainly in the 1990s, description of changes in political system is limited up to 2000 year.

society did not consider it as a societal task. Hence, the process of democratization had to be launched from top to down.

In October 1991 Askar Akaev was elected in national election as a president of Kyrgyz Republic¹. Akaev soon after was recognized as a supporter of political and economic reforms. In speech delivered in December 1991 Akaev argued that the only way forward was through “the development of private interest, private life and private property” based upon the strong civil society, guarantees of civil and political rights, ethnic harmony, and social protection of those likely to find the transition period difficult. Simultaneously he claimed that the reality of the situation, and the complexity of the tasks faced, required that there be strong executive power capable of pushing through reform against the resistance of vested reforms (Anderson, 1999, p.24).

However, with the election of president, country was continuing to live under the old constitution adopted during the Soviet order and the uncertainty regarding the power system remained. Therefore, the next step towards the new political order was the adoption of the new Constitution which was approved by parliament of Kyrgyzstan on 5 May 1993. In this Constitution Kyrgyz Republic was described as “a sovereign, unitary, and democratic republic built upon the basis of legal and secular government” and “the carries of sovereignty were the people of Kyrgyzstan”. Power of the legislative, executive and judicial body was defined. For the structure of the parliament the number of deputies for future elections was defined as 105 and called as *Jogorku Kenesh* (Supreme Council of parliament). This body was entitled to approve key presidential appointments, to legislate, and over-ride presidential vetoes in certain circumstances. President was given the power to appoint the prime-minister and other key officials with the approval of parliament. President was to be selected by the people.

Nevertheless, tensions between parliament and president were going on. The Soviet-style single-chamber 350 seat Supreme Council was still operating and was not effective in terms of the progressive passing laws under the picture of ongoing radical economic reforms. Akaev, in his turn, decided to reinforce his legitimacy by referendum held at the end of January 1994. This referendum asked people whether they supported the policies of the

¹ However, first time he was elected as a president by the parliament of Kyrgyz SSR before the declaration of independence in October 1990, when the institute of presidency was introduced in USSR.

president and wanted him to remain in office until the scheduled end of term in October 1996 year. 95 per cent of voters said yes. After this event Akaev supported the early dissolution of the parliament and it was dismissed by the president decree in October 1994 and another referendum was proposed to be held on 22 October. In this referendum electors were asked to affirm constitutional changes would be made by referendum rather than parliament and approve the creation of a new, two chamber parliament: the upper house, or the People's Assembly, was made up of 70 deputies who would meet several times in a year to discuss the general direction of Kyrgyz policy, and the Legislative Assembly consisting of 35 deputies focusing on the law making process and meeting regularly. This referendum's propositions were affirmed by the 72.1 per cent of the electors and the new two chamber parliament election held on 9 February 1995. In the same year in 24 December, presidential elections were held, where Akaev was again selected by receiving 71.6 per cent of votes. After renewing his legitimacy president concentrated on further extension of presidential powers through the amendments to the Constitution. Akaev's suggestions for constitutional changes included: to give the right to president to appoint and retire members of the government, to appoint judges at all levels and with the approval of *Jogorku Kenesh* to make other key appointments. Prime-minister had to be appointed with the approval of parliament of the suggested candidate by president. Even the parliament approval was still required for the appointment of prime-minister, if parliament rejected three times president could dissolve parliament. On 10 February 1996 these propositions were affirmed by voters in referendum. An October 1998 referendum approved constitutional changes that increased the number of deputies in the upper house, reduced the number of deputies in the lower house, rolled back Parliamentary immunity, reformed land tender rules, and reformed the state budget. In other words, this time also changes were made to the extension of presidential power.

Political pluralism was one of the components of the political doctrine for the democratization and different parties with different ideological principles and agendas have been established. But political parties did not emerge as a political force. Often parties were based upon personalities and regions, and have not paid sufficient attention to nation-wide

organization. Most of the authors as one of the main reasons for that refer to the existence of regional patronage networks and tribalism¹.

Thus, during the first decade of independence formation of political system took place in favor of the president's power, by that strengthening executive organ's power. Implication of these changes for economic reforming is that under conditions of weak political party system and undeveloped civil society, the strong presidential power allowed to conduct economic reforms without strong political resistance. Therefore initiatives of the president in reforming economy have played substantial role.

5.1.2 Choice of the economic reform strategy

Disintegration of the USSR posed question of choice of transition strategy towards the market economy. The common point of that period was that the centrally planned economy was not considered as an efficient economic system any more and private ownership and market mechanism was seen as a necessary condition for establishing the new economic order. However, there were different approaches in answering the question on how to achieve them. Some policy makers had conservative approach and argued for gradual way of implementing economic reforms, some showed the liberal economic adherence with radical economic reforms arguments and other part were in moderate approach by arguing for comprehensive economic reforms with the active state intervention (Abazov, 1999, p.202).

President Akaev's administration called for radical and deep changes in the economy of the republic. Despite this willingness the new administration did not have a whole picture of transition path, concerning the speed and directions of the economic changes. One of the reasons for that was the non existence in the history of such experience that could give some lessons and shed some lights on the reforms to be implemented. Nevertheless, the new administration showed the great enthusiasm for market oriented reforms and inclined to the radical implementation of reforms. In particularly it should be noted that during the first years of independence there was a widespread societal euphoria that the fact of independence itself would bring the prosperity and growth. This was a natural view of the society where the

¹ For instance, see Anderson (1999, p.39)

paternalistic expectations were very strong. Therefore, the “loyalty” of the society to undertaken reforms gave a kind of support for radical reforms. However, the strong adherence to the market oriented reforms of the new administration faced some criticism on the part of the old communist administration representatives. Along with these approaches there was a third approach, which emerged among the supporters of the market oriented reforms. Their view had being formed during the reform process and mostly was supported by local economists. They argued for economic reforms with active role of the government and called for better analysis of local specificities in launching reforms.

In January 1991 The New Economic Course was developed and approved by Kyrgyzstan authorities¹. This program included:

- the new agrarian policy oriented at the improvement of the social infrastructure, development of small industrial enterprises in rural area;
- review of legislative base, creation of organizational and legislative conditions for attracting foreign investment, credit and new technologies;
- privatization of small enterprises in trade, social services and local industrial sectors; establishment of relations with the foreign countries;
- review of personnel policy, not only renewing of personnel, but also review of the education system;
- creation of financial-credit institutions.

Thus program focused on the main directions that important for establishing market economy. However, it lacked of detailed practical plan for implementing reforms.

¹ Indeed, the first program that intended comprehensive reforming of the economy was adopted in last year of the Soviet period. “Program of Stabilization of National Economy and Transition to the Market Economy” was prepared by the State Commission on the Economic Reforms, which was established following establishment of the analogous commission on the Soviet level, and adopted by Primary Council of the Kyrgyz SSR in 22-23 October 1990. Program was based on the ideology of market economy with their basic principles such as free competitive markets, free prices, and different forms of ownership. However, market was to be regulated by the state in case of some negative appearances such as unemployment, high income differentiation, instability in production, uneven development of regions etc. Program was comprehensive and included almost all the aspects of the economy: privatization, money and credit policy, fiscal policy, external trade policy etc. In other words by its content it was a concept rather than a program. But in 1991the USSR dissolved and possibility of implementation of this program within the USSR ceased.

Realization of the new course began with the program titled as “The Forecast of Socio-Economic Development of the Kyrgyz Republic in 1991” and approved by parliament in 7 February 1991. This forecast mentioned the unavoidable increase of prices through either liberalization of prices or by state directives. The forecast envisaged reorientation of machine building enterprises to the production of consumer goods; financing of capital construction by the country stabilization fund and by savings of the population and enterprises, in other words by internal resources; the program also gave the more authorities to the local councils in solving social and economic problems. However, economic crisis was going on and as another attempt to formulate anti-crisis economic policy with the directions of the major economic reforms president Akaev decreed message to Supreme Council “On Transition to the New Economic Policy (NEP)” on 26 June 1991. In the message directions of the NEP were emphasized as: privatization with necessary social provisions, development of entrepreneurship and the strengthening of estate responsibility, prohibition of monopolistic actions and unfair competition, necessity of integration of the country into the world economic community.

Though in all above mentioned programs main directions of the economic reforms (such as privatization, deregulation of the economy etc.) were defined, there was no practical program with detailed actions for implementing reforms. While deteriorating economic situation necessitated decisive actions. More decisive was the “Program of Economic Reforms for 1992-1995” approved in July 1992 by parliament.

The program’s main directions proceeded from the previous programs’ ambitions. However, the government developed concrete programs: program of privatization, program of agrarian reforms, program of social protection and program of state investments. The aim of the program was defined as: “To reach the acceleration of the process of systematic changes, macroeconomic stabilization, curbing the collapse of output and creation of conditions for the start of economic growth” (Chotonov, 1995, p.100). In essence it was the program of the first stage of economic reforms. President Akaev himself was a supporter of this comprehensive approach. He was in favor of implementation within one reform package all the market oriented reforms: privatization, liberalization of prices, abolishment of state intervention into the economy, introduction of the private ownership institutions, free trade, elimination of

restraints on import and export, unified credit, finance, monetary and tax policy. Moreover, he stated that these changes should be done in a radical way. The main reason for the radicalization of economic reforms according to him was the legacy of the USSR that left Kyrgyzstan highly vulnerable to its dissolution, as Kyrgyzstan was receiving substantial subsidies from central union budget and was highly integrated into the union economy. While, economic crisis was continuing vulnerability of the country was rising and necessitated urgent measures. Another reason was the geographical characteristics of Kyrgyzstan: small, landlocked without large opportunities to the entrance of the international transport corridors¹, and being different from some other transitional countries it does not have any large oil or natural gas reserves, that could allow to derive addition financial resources and restrain the deficit of the balance of payments (Akaev, 2001, p.38-45).

The basic idea behind the model of economic reforming in Kyrgyzstan was to implement comprehensive economic reform package, which would result in effective establishment of market mechanisms. For this liberalization of the economy, stabilization policies and structural reforms had to be realized. For the emergence of entrepreneurship and development of private sector they had to be given with freedom, hence the state intervention into the market should be reduced together with the reduction of bureaucratic inefficiency. Among structural reforms privatization was seen as the necessary prerequisite for the change of ownership relationships, development of market structure and acceleration of competition.

It was expected that the radical way of reforming would have result in high social cost expressed by unemployment, poverty and low income level. But these costs were supposed to emerge for the short term. Since radical economic reforms were thought to lead to growth that would address the social cost issues². However, minimization of the social cost of reforms was necessary to maintain the popular support for the reforms and social stability that is precondition for the successful implementation of economic reforms.

Institutional change was considered to take place in the long-term. Because adjustment of behavioral pattern of the society that support new laws can emerge only in long period of

¹The railway system was connected to the Soviet system, but within the country railway track is small, and most domestic transportation is made on highways. The country does not have the direct access to sea ports. For some implications on being landlocked and their costs on Central Asian case, see Raballand (2003)

² For instance, see World Bank (1993, p. 24)

time. Meanwhile, the role of the state was in formulating new legislative base. Thus, new laws were adopted and decrees issued, including liberal legislation on investment, customs regulation, insurance of private business, mortgage of real estate, privatization of enterprises and a legal basis was prepared for land reforms and the creation of a new banking system. To strengthen the institutional basis of the reforms of 1992, the structure of state management was reorganized. The previous 41 ministries were transformed into 12 ministries and 7 commissions. On the basis of the merged Ministry of Finance and the State Planning Committee, the Ministry of the Economy and Finance was created and tax inspection was formed. At the same time, the number of vice-prime ministers was reduced from six to three: for social policy, foreign affairs and economic policy (Vassiliev, 2001, p.253).

Therefore, during the first year of the independence, Kyrgyzstan government could not form the practical program of reforms for transition to the market economy. However, with the decisive measures taken in 1992 the radical way of reforming was selected. The first step in this was the liberalization of prices

5.2 Liberalization of the Economy

Liberalization of the economy started at first with the liberalization of prices and further was accompanied by the liberalization of foreign trade.

Liberalization started with the removing of state control over the prices, which was a precondition for introduction market mechanism. Therefore it can be argued that radical economic reforms in Kyrgyzstan started in 1992 with the liberalization of prices. Indeed, the first sign of liberalization of prices in Kyrgyzstan appeared before the independence, on November 1990 within the introduction of free retail prices in USSR for both of nationally produced and imported luxury goods. In January 1991 on industrial products, transport and communication and publishing services the so called “utmost of efficiency” was introduced. The rate of which was 25-30 per cent, 35 and 40 per cents correspondingly. These were maximum limits within which prices could be changed according to the market conjuncture. Actually with these measures government tried to stop increase of wholesale prices, which was the result of the monopoly of state enterprises in the market. Therefore, these changes in price formation did not result in comprehensive introduction of market prices.

The real step in price liberalization was done in 1992 with the issue of President's decree "On Substantial Changes of State Policy in Price Sphere" from 3 January 1992. According to this decree goods and services had to be realized on the basis of free market prices, and state control over the prices in terms of the maximum limit of changes in prices, could be used on the products of the technical-production importance, basic consumer goods and services that have social importance (such as bread, meat, coal and public transportation). This meant elimination of the majority of state subsidies. Till the end of 1995 price of other basic consumer goods (such as bread) were liberalized. Nowadays prices in the domestic market is fully liberalized, excluding control over the prices of some goods that present public interest, such as products of the natural and allowed monopolies.

Along with internal price liberalization there was significant external trade liberalization. Before the end of 1993 external trade policy was determined by high rate of tariffs on imported goods and limitations on export. Thus, in April 1992 quantitative limitations and tariffs on exported goods to non CIS countries introduced, and on borders of the country custom posts established. In October of the same year Kyrgyzstan introduced the obligatory licensing for the export to CIS countries too. Such a limiting trade pattern at the initial years of transition period was the result of the attempt to meet the demand in the domestic market.

In autumn of 1993 government ratified the list of tariffs for import and export goods, the maximum level of export tariff reached 70 per cent. At the end of 1993 list of goods subject to export tax was shortened and for some goods tariffs were decreased. It was the first step towards the external trade liberalization. In 1994 government introduced temporarily 10 per cent tariff for all imported goods, tax on exported goods were removed excluding 9 goods (sugar, bread, metals etc), all the requirements on the licensing of export and import were also eliminated. And to the end of 1995 last taxes on export were abolished. Starting from the 1995 Kyrgyzstan actively worked on the membership to World Trade Organization (WTO) and became a member of this organization in 1998. Nowadays, Kyrgyzstan does not use any quantitative restrictions on external trade and taxes on export, and the only instrument is the taxes on import, the average rate of which is decreasing every year, according to the WTO membership obligations.

As a result, starting from 1992 to 1998 Kyrgyzstan liberalized both of the internal market price control and external trade. This process can be considered as radical, since within the short period of time government substantially removed its control over prices and fully liberalized its trade regime, which end with the membership to the WTO. These changes were associated with other macroeconomic challenges such as rocketing inflation and radical drop in GDP.

5.3 Economic Crisis: 1991-1995

Almost all economists studying transition economies and policy makers of the former USSR countries agree upon the fact that magnitude and duration of economic recession appeared in transition economies right after the dissolution of the USSR was unexpected. Though, the economic stagnation and decrease of economic activity in some sectors of the economy, to some extent, was seen as unavoidable process because of the some objective factors that left Soviet system.

Transformational crisis is explained by both of the objective and subjective reasons. Objective reason was that economies of member republics were highly integrated into economic system of the USSR and undoubtedly its dissolution caused collapse of this system with its negative consequences on former member countries. Subjective reasons are often explained as the features of reform policies. Depending on the existence of the objective and subjective reasons different CIS countries experienced economic crisis after 1991 at different magnitudes¹.

Economic crisis in Kyrgyzstan started in 1991 and ended in 1995 with the positive GDP growth rate 7.1 per cent in 1996. The main reason for the deep fall of output in Kyrgyzstan, as in other CIS countries, was the heritage of USSR, in other words economic structure with dependence to the centre and high mutual dependence on economic relations between member republics. The direct subsidies received by Kyrgyzstan from central union budget accounted approximately for 10-12 per cent of GDP, and moreover, there were

¹As one of the successful examples among CIS countries can be referred to Uzbekistan, which, according to CIS statistics, in 2000 reached 99 per cent of 1991 GDP level, while the performance of, for example, Tajikistan and Moldova for the same period was 40.5 and 42.1 per cent correspondingly.

significant subsidies in indirect form in terms of the low price of oil and gas compared to international levels. With collapse of the USSR Kyrgyzstan was deprived from these advantages. Moreover deterioration of old economic relation contributed to the deprivation of markets for export, as external trade mainly was inter-republican. As a consequence domestic production faced double problem: high prices for and deficit of raw materials and loose of consumer markets.

Generally it is considered that one third of causes of economic crisis in transition economies was the break of old economic relations, and in Kyrgyzstan the share of this factor in economic crisis can be regarded more than that, as 40 per cent (Koichuev et al, 2003, p.83). Along with these objective reasons, surely, there were other subjective factors related with character and implementation of economic reforms. Although it was expected that the recession in the economy because of the transition period to some extent would take place, the crisis in the economy of Kyrgyzstan was deeper than it was anticipated.¹

Decline of output during the first five years of 1990s was so deep that GDP in 1995 was only at 50.3 per cent of 1990 (see Table 5.1). In other words in 5 years economy decreased by half and went back to its 1970s level.

Table 5.1 Magnitude of production decline (1991-1995, in per cent of 1990 level)

	1991	1992	1993	1994	1995	Share in GDP 1991	Share in GDP1995
GDP	92.2	79.4	67.1	53.6	50.3	100	100
Industry	99.7	73.0	55.0	39.0	35.0	27.5	12
Agriculture	90.0	85.0	77.0	63.0	57.0	35.5	40.7
Capital investments	87.0	57.0	39.0	23.0	37.0	n/a	n/a

Source: IMF, 1998; Koichuev et al, 2003, p.85.

In particularly, the fall of the production of industry was deep - almost 65 per cent. Capital investments also showed substantial drop by decreasing over the 60 per cent. The share of industry in GDP in 1995 decreased to 12 per cent, while share of agriculture to 40.7 per cent. Deep economic crisis changed the structure of industrial production (see Table 5.2).

¹ According to the New Economic Policy 1993 had to be the year of end of output collapse.

All sectors of the industry showed the decline, however, sectors producing finished products experienced substantial fall. For instance sectors such as machine building and metalworking and light industry in 1995 had a substantial small portion in all production compared to the level in 1991. While share of sectors producing products of raw material category, such as electricity and ferrous and nonferrous metallurgy, increased.

Output collapse was also associated with the hyperinflation and deteriorating finance and credit system. Liberalization of prices in 1992 significantly contributed to the rocketing inflation rate that in 1992 reached to 1259 per cent, and in 1993 accelerated to its highest level of the crisis period – 1366 per cent.

Table 5.2 Growth and structure of industrial production by sub-sectors*
(1991-1995, in percent)

	1991	1992	1993	1994	1995	Share in total production 1991	Share in total production 1995
All industry	-0.3	-26.4	-25.3	-27.9	-12.5	100	100
Electricity	5.1	-13.5	-9.4	7.5	1.0	4.44	19.19
Fuel Industry	-6.2	-38.3	-24.9	-31.7	-25.7	0.83	2.05
Ferrous and nonferrous metallurgy	0.5	-10.6	-22.7	-0.2	-16.9	4.52	10.22
Machine building and metalworking	3.2	-35.2	-39.4	-54.3	-15.3	26.79	10.23
Forestry, woodworking, pulp and paper industry	12.0	-12.1	-35.2	-57.8	-29.3	1.97	0.67
Construction materials	-2.0	-33.6	-54.6	-39.8	-19.9	4.66	4.19
Light Industry	5.0	-11.6	-12.0	-36.8	-35.7	30.03	17.62
Agriculture/Food processing	-9.9	-42.8	-28.6	-31.5	-21.5	20.00	20.1

* Production of chemical and petrochemical industry and other industries are not included

Source: IMF 1998; NSCKR 1998; World Bank, 1993.

However, inflation at the initial periods of transition was not only a phenomenon following price liberalization, but also the consequence of the structure of production inherited from the Soviet era. During the Soviet era industrial sector of the republic was concentrated on heavy machinery building, while consumption goods producing sectors were stagnating. Because of this production disproportion during the last years of the USSR deficit of goods

with the instability of consumer markets emerged and the use of consumer-coupons or consumer-cards, which were disseminated among people for buying goods in limited amount, started. Thus, inflationary pressure in USSR period was hidden and after its dissolution with liberalization it accelerated and took open form.

Rocketing inflation and high interest rates was making it hard to make an investment, purchasing power of consumer was continuously falling down by reducing aggregate demand. Increasing unbalance in consumer markets, sharp decline of output and continuing deterioration of economic relations together with the hyperinflation undermined any start of implementation of economic reforms. It caused the uncertainty in the economy, devaluation of income and the reduction of incentives to invest into real sectors of the economy. In response to this, government of Kyrgyzstan after the introduction of national currency on 10 May 1993¹ started to implement restrictive money-credit policy together with the limiting budget expenditure that aimed at: restrain the growth of the money volume in circulation, limit of the money emission, restraining the social expenditures, decrease of the budget deficit, cut of the subsidies and other financial supports to the real sector of the economy from the state budget². This policy was successful in reducing inflation rate from four digit rates to two digit rates in short period of time: consumer price index (CPI) in 1994 and 1995 was 87.2 and 31.9 per cent correspondingly.

Table 5.3 Social outcomes of economic crisis (1992-1995)

	1992	1993	1994	1995
Unemployment level*	0.1	0.2	0.7	2.9
Poverty	n/a	40	n/a	49.2
AP/ Minimum Consuming Budget**	66	12.8	20.1	51.5
AW/ Minimum Consuming Budget***	86.9	68.4	56.5	96.0

* Estimation of unemployment was based on the officially registered unemployed population

** Ratio of average pension to the minimum consuming budget for pensioners

*** Ratio of average wage to the minimum consuming budget for able to work individuals.

Source: Calculated on data of NSCKR 1996, 1998; World Bank, 1993.

¹ Detailed analyses of introduction of national currency unit are given in section on financial sector reforms, in chapter on structural reforms.

² Indeed, this anti inflationary policy was supported by IMF's credits after the introduction of national currency unit. This is discussed in section on the role of IMF and World Bank.

As a consequence of deep economic crisis living standards and the purchasing power of population declined. Economic recession caused the rise of unemployment. However, official data for that period show the extremely low level of unemployment (see Table 5.3), since it was based on the estimation of officially registered unemployed individuals. While with non registered unemployment it was at substantial high levels.¹ Situation of lowered individual income is more evident in case of comparing the average pension and average wages to the income needed for minimum consumption (in table it is noted as minimum consuming budget or in abbreviated form MCB). Both of these ratios indicate that individual with average pension or wage could not afford even the minimum consuming budget and almost half of the population was living under the poverty.

Therefore, economic crisis had damaging social and economic outcomes. Within five years economy of Kyrgyzstan turned to agricultural from industrial-agricultural country as it was considered at the end of 1980s.

5.4 Role of the IMF and the World Bank

Reforms in transition of Kyrgyzstan to market economy have been actively supported by international organizations. As Kyrgyzstan became a member of the IMF and of the World Bank at the early beginning of transition, on 8 May 1992 and on September of the same year correspondingly. Cooperation of Kyrgyzstan with these two organizations has been very comprehensive and almost all the main structural economic reforms have been realized with their commitment. This section, at first, focuses on the features of the IMF programs and their implications on economic policy, then analysis projects of the World Bank in Kyrgyzstan.

¹ For instance, in 1995 number of officially registered unemployed individuals was 50.4 thousand, while according to non official estimations including non registered unemployed individuals it was around 200-300 thousand.

5.4.1 The IMF programs

As mentioned above history of financial arrangements between the IMF and Kyrgyzstan programs dated to the introduction of the national currency unit¹, after which the IMF provided immediate financial support. Initially, the IMF assistance was provided under the Stand-by facility to counter strong inflationary pressures, deterioration in the balance of payments, and the collapse of output. Following this stand-by arrangement since July 1994 Kyrgyzstan has been receiving the IMF assistance under the medium-term adjustment programs, at first within Enhances Structural Adjustment Facility (ESAF) and later within Poverty Reduction and Growth Facility (PRGF)². So far three PRGF arrangements are completed by Kyrgyzstan government (see Table 5.4).

Table 5.4 The IMF lending programs in Kyrgyzstan (1993-2008)

Type	Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-by	05.12.1993 - 04.11.1994	27.09	11.61
ESAF	07.20.1994 - 03.31.1998	88.15	88.15
ESAF/PRGF	06.26.1998 - 07.25.2001	73.38	44.69
PRGF	12.06.2001 - 03.14.2005	73.40	73.40
PRGF	02.23.2005 – 05.31.2008	8.88	7.61

Source: IMF 2001, 2008

Implementation of these medium-term arrangements are based on the quantitative targets and structural benchmarks. During the last three PRGF arrangements the following targets were included:

- Floor on the accumulation of international reserves of the National Bank of Kyrgyz Republic;
- Ceiling on the domestic assets of the National Bank of Kyrgyz Republic;
- Ceiling on reserve money;
- Ceiling on the size of the fiscal deficit of the Kyrgyzstan government budget;

¹ Introduction of national currency unit is discussed in the section on financial sector reforms of next chapter.

² In the IMF system of assistance ESAF was replaced by PRGF in 1999.

- Floor on state government tax collections in cash;
- Cumulative floor on payroll collections in cash of the Social Fund;
- Ceiling on new non concessional external debt.
- Ceiling on the quasi-fiscal deficit of the electricity sector¹;

As it can be noted the first three criteria are related to the Central Bank activity and have influence on monetary, exchange rate policy and balance of payments. The remaining criteria have an implication for fiscal policy and external debt. Apart from these quantitative targets the IMF loans are given under the condition of implementing structural reforms that mostly focused on the development of the financial system, privatization and improvements in governance. It should be mentioned that structural reforming is the area of joint programs of the World Bank and the IMF, and sometimes of other donor institutions too. Therefore conditionality of the IMF programs has direct implications on macroeconomic policy and structural reforms. Components of macroeconomic policy and structural reforms are briefly described below.

Fiscal Policy

Fiscal policy is characterized as strict and oriented at the decrease of the budget deficit through increasing revenues and containing expenditures. On revenue side it is emphasized to take measures that result in increase of the tax revenues, such as reforms of the taxation directed at the improvements in tax administration etc. Also within the IMF programs it is generally recommended to avoid tax rate reductions unless it is provided with broad tax base or additional revenue sources that can replace the possible loss of the tax rate reduction².

On budget expenditure side policy is concluded in restraining them. In particularly it attempted to reduce government investment expenditures and improve their effectiveness³. The same emphasize valid for current expenditures. It should be mentioned that the spending on health and education starting from 2001 approved to grow at slow rate.

¹ It should be mentioned that these are targets included in the last three PRGF arrangements and some of them were not used in some periods. For instance limit on the new non concessional external debt is not included in last IMF staff review from June 2008, while it is used for June and July 2001. However, these differences are small in sense and do not imply the substantial changes in setting quantitative targets.

² In 2001 President signed the Law that reduced rate of profit tax to 10 per cent from 30 per cent. However, IMF staff that observed program implementation insisted on the cancellation of the law.

³ Government investment expenditures are reflected in the government budget of Kyrgyzstan as Public Investment Program (PIP).

Monetary and Exchange Rate Policies

Monetary policy is also tight and aims at the low inflation rate through limiting money supply. Exchange rate policy is also directed at the reduction of inflation rate. Generally exchange rate regime in Kyrgyzstan is considered as flexible. Interventions in the foreign exchange market by NBKR are directed at the accumulation of reserves and smoothing temporary market fluctuations. In case of the unexpected supply of foreign exchange that threaten stability of the exchange rate NBKR generates reserves, and in case of the unanticipated outflows tightens monetary policy through open market operations. However, if pressures on the nominal exchange rate persist depreciation or appreciation in gradual manner is allowed. Control over the nominal exchange rate and attempts to smooth fluctuations are explained with the fact that under the condition of the low monetization of the economy and large import content in consumer basket exchange rate is effective tool to influence on inflation.

External Trade and Debt Management

Within its loan programs the IMF supports Kyrgyzstan's activities towards the liberal trade regime. On this direction membership of Kyrgyzstan to the WTO and measures taken within this membership, such as reduction of tariffs and remove of other barriers, are supported by the IMF.

Another area for economic policy discussions on the IMF programs became external debt of the country. Heavily reliance on external financing in undertaking comprehensive reform programs and ineffective use of these resources resulted in high external debt burden that critically peaked in the late 1990s. This situation posed the question of the debt sustainability¹. It has been reflected in PRGF programs with caution to reduce external debt burden through restructuring, receiving new loan primarily on concessional terms and improvement of debt management.

¹ By taking into account external debt burden IMF and World Bank suggested Kyrgyzstan government to join HIPC (Heavily Indebted Poverty Countries) initiative that represented the opportunity of debt relief under the condition of further implementation of PRGF, effective debt management and reforms in sectors of the economy. According to Ministry of Finance of Kyrgyzstan information after the completion of the external debt of Kyrgyzstan could be reduced by 915 million USD or almost 50 per cent of the total external debt. Question on entering into this initiative was hotly debated in 2006 year among the society and could not find the absolute support, hence, was not accepted.

Structural Reforms

The most focus areas of structural reforms of the IMF are: privatization, financial sector reform, energy sector reform targeted at the reduction of quasi-fiscal deficits, and improve of governance.

Privatization has been remaining as one of the core elements of the IMF programs. Following mass privatization campaigns that were completed by 1998, privatization of large state owned strategic companies, such as “Kyrgyztelecom”, “Kyrgyz Airlines”, “Kyrgyz Gaz” and four power distribution companies became the main topic for privatization. According to the IMF experts their privatization would improve their financial performance, increase the allocative efficiency in the economy and reduce the external debt.

Financial sector reform emphasizes importance of the strengthening banking sector, in particularly strengthening banking supervision and capitalization of banks. Energy sector reform aimed at the reduction of the quasi fiscal deficit would improve fiscal stability. For that improvement in bill collection, elimination of some tariff discounts and increase of prices for electricity most part of which is considered as below cost and world prices are envisaged.

As the weak governance is considered as the major reason for poor business climate and, therefore, impediment to economic growth, it is recommended to improve public governance. But it should be mentioned that though the IMF takes into account this problem active support on this aspect is provided by projects of other donors mainly of the World Bank and the Asian Development Bank (ADB).

Thus, quantitative targets and structural benchmarks defined in the IMF programs contribute to the formulation of economic policy and structural reforms. The main principal target is to achieve low inflation through the tight monetary and fiscal policies. Along with these measures the IMF lending programs require adoption of liberal economic reforms within structural benchmarks, such as liberalization of trade, privatization of SOEs, decrease of state intervention in the economy.

5.4.2 The World Bank projects

The World Bank, as well as the IMF, has been contributing to the reforming of the economy of Kyrgyzstan since the very beginning of transition. First assistance programs were launched during the periods of undertaking rapid economic reforms programs. Generally projects are multi-sectoral and cover different sectors of the economy: agriculture, financial sector, health, education, trade, governance etc. Therefore, it is useful to analyze projects in terms of the types of lending (see Table 5.5).

According to the World Bank classification there are two types of lending operations: investment operations and development policy operations. Investment operations focus on the long-term (5 to 10 years) and provide funding to projects that involves broad range of sectors, such as agriculture, urban development, rural infrastructure, education and health etc. Development policy operations run from one to three years, and provide untied, direct budget support to governments for policy and institutional reforms. These loans more focus on structural, financial sector and social policy reforms, for instance, the management of public resources, the functioning of the judiciary, good governance etc.

As can be seen total commitment through all the projects that has been provided by the World Bank so far accounts for about 850 million USD.¹ Approximately 60 per cent of total provided as the investment operations, absolute majority of which consists of the specific investment loans². Credits received under the investment operations has been used in infrastructure, such as irrigation, water supply, rural finance, district heating, road rehabilitation, education, health, etc. Undoubtedly, under the conditions of the decreased public investment this support of infrastructure is important.

For structural restructuring and reforming of the economy development policy operations are important by their content. Table 5.6 shows that all of these projects are completed and not active more. These projects mainly focused on: privatization and

¹ It includes both of completed and currently active projects. Value of the projects are given in terms of the commitment made by the World Bank, and the total value is just the sum of these commitments without including other disbursement or repayments related with given loans and credits.

² Specific investment loans (SILs) support the creation, rehabilitation, and maintenance of economic, social, and institutional infrastructure. In addition, SILs may finance consultant services and management and training programs (see <http://go.worldbank.org/QHKM6QB1H0>)

restructuring of industrial enterprises (PESAC), agriculture (APEAC), financial sector (FSAC), public sector (PSRMAC), social sector (SOSAC), private sector development (CSAC) and governance (GSAC). In other words almost all the major sectors of the economy were under the influence of these structural reform projects which are discussed in more detailed in previous part. Though each of the projects had its own component, it is possible to figure out the general framework.

Table 5.5 The World Bank commitment to projects in Kyrgyzstan (1993-2008)

Lending Instrument Type	Value (in million USD)
Investment operations	507.63
Specific Investment Loan	413.85
Technical Assistance Loan	33.18
Financial Intermediary Loan	30
Emergency Recovery Loan	18
Sector Investment and Maintenance Loan	11.6
Adaptable Program Loan	1
Development Policy Operations	345.5
Sector Adjustment Loan	141.5
Structural Adjustment Loan	144
Rehabilitation Loan	60
Total	853.13

Source: World Bank projects database. Available on site:
<http://web.worldbank.org/WBSITE/EXTERNAL/PROJECTS>

Firstly, emphasize was made on the reduction of the role of the state in the economy through the restructuring and privatization of major industrial enterprises within PESAC program, demonopolization of the agriculture within APEAC, and restructuring of the utility sector, such as telecommunication and energy sector (gas, electricity and district heating) within CSAC. Secondly, effectiveness of the state and use of the government resources through the improvements in budget management, reform of the intergovernmental fiscal relations, tax reform, civil service reform etc, was the topic of PSRMAC, CSAC and GSAC projects. Thirdly, development of the emerging private sector, apart other factors, required

corresponding support from the finance sector. In this concern, reforming of the finance sector was designed within FSAC project, where strengthening of regulatory and supervision system, development non-banking financial institutions and liquidation of insolvent two large state banks were the main components. Fourthly, all these structural changes required the new approach to the social policy, in particularly in pension benefits. Therefore, within SOSAC project it was intended to create the new pension scheme and support new employment law and social assistance law.

However, not all the projects have been considered as successful. In particularly, PESAC program was one of the hotly debated themes among domestic economists and specialists. This program mainly was designed to restructure and privatize large state enterprises in manufacturing sector in order to adopt them to the new market conditions. In fact scope of the production of these enterprises was important for the whole manufacturing sector and, hence, for the economy of Kyrgyzstan. But the results of the project did not meet expectations and was criticized. One of the main critiques was the method of evaluation of enterprises' values.

Idinov and Abdugarimova (2001) state that the method of evaluation of enterprises proposed by the World Bank, and indeed applied, underestimated the real value of assets. The proposed method was that the value was estimated as a difference between assets and liabilities. However, economic crisis of that time resulted in such situation that enterprises had a large amount of receivable accounts, the return of which was hopeless, and, at the same time, had large amount of payable accounts that was rising because of the credits from the government budget. As a result receivable accounts were being deleted, while payable was rising. It affected the estimated value to be below of the real value.

Table 5.6 The World Bank development policy operation projects in Kyrgyzstan (1993-2008)

Project Name	Lending Instrument	Approval Date- Closing Date	Value	Main Components
Rehabilitation Project	Rehabilitation Loan	13.05.1993 - 31.12.1996	60	n/a
Privatization & Enterprise Sector Adjustment Credit (PESAC)	Sector Adjustment Loan	29.6.1994 - 31.12.1995	60	Reduction of economic and financial costs to the economy of large and inefficient SOEs through liquidation, restructuring and privatization.
Agricultural Privatization & Enterprise Adjustment Credit (APEAC)	Structural Adjustment Loan	28.6.1995 - 28.2.1997	45	i) Rationalization of, and elimination of distortions in, the system of agricultural marketing, pricing, and trade; ii) demonopolization and privatization of trade, transport and marketing institutions for major commodities; iv) continued support toward restructuring and liquidation of major loss making state enterprises.
Financial Sector Adjustment Credit (FINSAC)	Sector Adjustment Loan	25.6.1996 - 30.6.1998	45	i) Liquidation of two insolvent state-owned banks; ii) creation of regulatory and supervisory framework; iii) creation of temporary debt resolution agency (DEBRA).
Public Sector Resource Management Adjustment Credit (PSRMAC)	Structural Adjustment Loan	16.4.1997- 30.6.1999	44	Reform of budget management, processes to rationalize expenditure, and intergovernmental finance.
Social Sector Adjustment Credit (SOSAC)	Sector Adjustment Loan	10.12.1998 - 30.6.2000	36.5	i) establish a fiscally sustainable pension scheme; ii) improve the efficiency of active labor market interventions; iii) implement effective, well targeted and fiscally sustainable programs to alleviate poverty
Consolidation Structural Adjustment Credit (CSAC)	Structural Adjustment Loan	14.9.2000 - 31.12.2004	35	i) tax reform; ii) reduction of regulatory burden on business environment; iii) utility reform: energy (electricity, natural gas, and district heating) and telecommunication sector reforms; iv) social protection: mitigating the social impact of the utility reform.
Governance Structural Adjustment Credit (GSAC)	Structural Adjustment Loan	15.5.2003 - 30.6.2008	20	i) Civil service reforms; ii) transparency in income and assets of senior officials; iii) reform of external audit, the chamber of accounts, public procurement, financing of health and education.

Source: The World Bank projects database. Available on site: <http://web.worldbank.org/WBSITE/EXTERNAL/PROJECTS>

For example, total stock value of the state enterprise restructured into the joint stock company “Maily-Suu Electro Light Bulb Factory” was estimated as 1780 som, while only in 1997 its revenue was 56 116,4 million som. In other words infrastructures of the former large state manufacturing enterprise have been privatized for the value that considerably below of the real. Among other factors affecting the failure of the project Idinov and Abdukarimova (2001) note the corruption among officials.

The scope of above projects shows that commitment of the World Bank to the main structural reform packages implemented in Kyrgyzstan is important. As already noted structural reforms are objects of the joint initiatives with the IMF. From these perspectives programs of the IMF and the World Bank projects are mutually complementary. At the same time most of the World Bank projects are provided as investment operations in sectors, such as health, education, agriculture etc, which are important in terms for sustaining infrastructure of the economy.

Therefore contents of the IMF and the World Bank programs show that they have influence on structural economic reforms and economic policy of Kyrgyzstan in transition to market economy. Economic policy has been featured by the tight monetary and fiscal policies, while structural reforms have been comprehensive and radical. Kyrgyzstan in its own turn has been the most active partner of these two institutions in the Central Asia region during the first decade of transition and is involved in both long-term and medium term development programs within the IMF-World Bank initiatives¹.

¹Comprehensive Development Framework and National Strategy of Poverty Reduction are examples for that CDF initiative was proposed by the World Bank in early 1999. According to the World Bank it is based on the long term vision and prepared by the country through a participatory national consultation process and balances good macroeconomic and financial management with sound social, structural and human policies. CDF emphasizes partnerships between government, civil society, the private sector and external assistance agencies. National government with the participation of domestic and external partners prepares the Poverty Reduction Strategy Paper (PRSP) based on the long run principles of the CDF. PRSP represents a medium term economic policy framework and broadly endorsed by the IMF and the World Bank as the basis of concessional assistance from these two institutions. Thus, in 2001 Kyrgyzstan government approved the Comprehensive Development Framework (CDF) till 2010 and became one of 13 pilot countries for the CDF initiative. Principle objective under the CDF in Kyrgyzstan was to reduce poverty in Kyrgyzstan by half by 2010¹. Realization of the CDF goals had to be achieved through medium term strategies. The first phase of this was the National Poverty Reduction Strategy (NPRS) for 2003-2005. On the experience of this NPRS the new medium term strategy - Country Development Strategy for 2007-2010 build and currently is under implementation.

Thus, in Kyrgyzstan comprehensive and radical reforming was favored by policy makers. Collapse of the integrated economic system between the former USSR member republics, lack of large oil and gas reserves compared to some other neighboring countries, remote geographical location of the country – all of these factors had been noted as reasons for such approach. Comprehensive and radical economic reforms in Kyrgyzstan started with price liberalization in 1992. Because of its reformist activities during the first decade of transition Kyrgyzstan was considered as one of the fast reforming transition countries and has been involved in active partnership with the IMF and the World Bank. Activities of these two organizations in Kyrgyzstan were also important determinant of features of economic reforms. The magnitude of transformational crisis in Kyrgyzstan within first five year of transition was so deep that the economy recessed almost by fifty percent and brought about high social costs. Although by proponents of the comprehensive and radical reforms it was expected that emerged social costs are for short term and they would be eliminated by positive results of reforms in future perspectives.

6. STRUCTURAL REFORMS

As noted in the preceding chapter comprehensive reforms started with the radical liberalization of the economy launched in 1992. However, liberalization of the economy does not imply the fully-fledged introduction of market mechanisms into the economy. Under the conditions of burst of inflation after the liberalization bringing inflation under the control and lowering it over time through tight monetary and fiscal policies was considered important for further economic improvements. But most importantly functioning of the economy had to be in accord with market mechanisms, which required large-scale structural reforms in sectors of the economy. Firstly, as the centrally planned economy was based on state ownership, these structural changes had to concern, primarily, with transfer of state ownership to private sector – privatization. Secondly, construction of the new financial system that provide with financial resources on the bases of the market mechanism was needed. Thirdly, public - private sector relationship was to be build and the role of the government in economy had to be defined, which has implication in public finance system. Finally, renew of approach in provision of social services, such as education and health, and social protection, were necessary in order to establish the new form of social services different from the all encompassing old system and to overcome the social consequences of transition. Therefore, for comprehensive and radical reforming liberalization of the economy had to be accompanied by stabilization policies and structural reforms.

This chapter analyses structural reforms in Kyrgyzstan by focusing on the privatization process, reforms in agriculture, financial, fiscal and social sector reforms. Also monetary and fiscal policies as instruments of stabilization policy are described in sections on financial sector and public finance system reforms correspondingly.

6.1. Privatization

In the former USSR economic system state had monopoly power over the economy and, therefore, privatization and reduction of state control over the economy had to be primary measures for making and development of private sector.

Privatization and de-nationalization in Kyrgyzstan process started with the adoption of Law “On General Principals of Denationalization, Privatization and Entrepreneurship” on 20 December 1991. This Law defined general principals of privatization as basics for free entrepreneurship in competitive environment. The meaning of privatization was treated as the acquisition of the objects of the state property and of the state share in joint stock companies by private and nongovernmental parties. Denationalization was clarified as a reorganization of state enterprises into joint stock companies or into other forms of commercial companies in order to reduce direct state control.¹ For implementation of privatization and governing state property the State Property Fund of Kyrgyz Republic (SPF) was created in February 1992. For the certain periods special privatization programs was to be prepared, which included objectives, priorities, scope, methods and revenue and investment forecasts.

Privatization in Kyrgyzstan according to their main characteristics can be divided into three main periods: first period including 1991-1993 years, second period 1994-1997 years, and third starting from 1998 to nowadays. These periods are analyzed below.

6.1.1 First Period: 1991-1993

In this period two privatization programs (of 1991-1992 and 1992-1993) were undertaken. Privatization process started to be comprehensive from 1992, while in 1991 its scope was insignificant. First period of privatization focused on the quick privatization of small and medium enterprises in trade and catering and other consumer services sectors. Because of this the first period is known as “small privatization”. The reason for giving relative priority to small enterprises for the start of privatization was that they were comparatively less complex in organizational and technical aspects. In privatization program for 1992-1993 objectives of the privatization were defined as:

“...implementation of the comprehensive privatization of enterprises of all sectors of the economy and speed up small privatization in service sectors in order to create conditions

¹ For details, see The Law of Kyrgyz Republic “On General Principals of Denationalization, Privatization and Entrepreneurship”, article 1 and 2, from 20 December 1991.

for the emergence of different ownership structures, competitive environment and making and development of market relations in the society” (Panorama, August, 1992).

Therefore, the aim of privatization was to serve as a start point for the creation of different ownership forms in the economy, and it was believed that consequently it would contribute to the development of market relations in the economy. Moreover, the speed of privatization was emphasized. It was planned to privatize 35 per cent of the all state properties in two years.

Table 6.1 Privatized enterprises by sectors (1992-2006)

Sectors	1992-1993	%	1994-1997	%	1998-2006	%
Total	6786	100	1947	100	837	100
Industry	376	5.5	272	14	11	1.3
Agriculture	288	4.2	119	6.1	30	3.6
Construction	312	4.6	195	10	13	1.6
Transport	98	1.4	72	3.7	23	2.7
Public Services	3042	45	540	27.7	188	22.3
Trade and Catering	2437	36	268	13.8	22	2.6
Others	233	3.4	481	24.7	550	66

Source: Calculated on the data of Ministry of Finance of Kyrgyz Republic and NSCKR, 1998.

Results of this program showed that by the end of 1993 year 6786 enterprises were privatized, their total value accounted for 33 per cent of all state properties, or 94 per cent of planned in the program. Privatization results by sectors were varying. As mentioned, during the first period emphasize was made on public services and trade, and catering (see Table 6.1). Hence, by the end of 1993 shares of privatized enterprises in these two sectors were 92.4 and 71.6 per cent correspondingly. Privatization in other sectors was as following: in industry 40.1 per cent, 33.7 per cent in agriculture, 55.3 per cent in construction and 18.1 per cent in transport sector¹. Such different results by sectors are explained by the general strategy

¹ This information is taken from “The Concept of Denationalization and Privatization of State Property in Kyrgyz Republic for 1994 -1995”, p.12.

adopted in program and varying attractiveness of enterprises offered to privatization. Enterprises that did not require large capital and were elastic in adoption to market conditions were more attractive for private parties. Especially it concerns enterprises in service and trade sectors.

Privatization methods used in the first period varied according to sectors. In industry, construction, and transport sectors conversion to joint stock companies was prevailing (of privatized enterprises 79 per cent, 72 and 87 per cent correspondingly). In contrast, in trade and catering sector sale to workers' collectives (30 per cent of privatized enterprises) and sale through commercial competition (32 per cent of privatized enterprises) were mostly used.¹ However, in total, if to account in terms of the total number of privatized enterprises, then, sale through commercial competition, sale to workers collectives and to private parties were mostly used methods (see Table 6.2). Therefore, the quantitative targets of the first period were achieved.

Within the program of privatization for 1992-1993 Kyrgyz government launched the voucher system (it was named in Kyrgyzstan as *Special Payment Means* or *SPM*) which was undertaken by most of the countries in transition. Idea behind the introduction of voucher was to give a kind of start opportunities to citizens for participation in privatization process. Vouchers (or *SPM*), with the value written on it, could be used in purchase of any state properties, including participation in sale through commercial competition and auctions. Generally, the main difference of the start of privatization in transitional economies from other developed market economies was the egalitarian approach. This approach of giving equal opportunities to be the owner of property to some extent stems from the perceived idea of establishing Soviet economy, where it was argued that the property is societal and, therefore, every member of the society contributed to the development of wealth of the country. Hence, the argument here was that if society was the owner of the all the property, then each member should get his own part in state property.

Every citizen had a right to receive *SPM* by their personal application and each given *SPM* had values expressed in national currency unit - som (before the introduction of som in rubles). Value of *SPM* given to workers and pensioners was defined by their level of salary

¹ These estimations are based on the data of Ministry of Finance of Kyrgyz Republic

and years spent for working, other parts of population could get *SPM* with nominal value 1000 thousand ruble. *SPM* could be used for purchase in privatization of state property, in buying stocks and in privatization of houses and they could not be sold or given to others (excepting close relatives). As a result by the end of 1993 year $\frac{3}{4}$ of population received *SPM*. Its total value in circulation was approximately 40 million som¹. It can be defined as a demand for property. At the same time the total value of stocks issued for this purpose was only 13 million (or 2.13 million USD). Hence, demand for property was three times higher than the supply. Moreover, mechanism for exchange *SPM* for stock through auctions was not created yet. As a result by the end of 1993 only 5 per cent of owners of *SPM* used them in privatization of houses and enterprises where they worked (Pankuv, 2001, p.25). Additionally the disadvantage of *SPM* was that being defined by nominal value it was not protected from inflation, which was rocketing at that time. Therefore, its value was decreasing in high inflationary environment.

Thus, limited supply stocks for exchange to *SPM*, non existence of the mechanism for exchange and, also, limits posed on circulation of *SPM* (could not be sold and delegated) retarded the wide participation of population in privatization and its intention to be mass privatization was not realized. Besides, priority given to workers' collectives posed other parts of the population in unequal position. The first period of privatization did not result in the effectiveness of privatized enterprises and in making of effective private ownership. There were some reasons for that.

Main reason for that was "subjective" approach in implementation of the program that was sourced from the authority given to the State Property Fund (SPF). According to the Law "On State Property Fund" the SPF was entitled to adopt normative documents and prepare legislative projects concerning the privatization, to distribute proceeds from privatization and was accountable to Supreme Council (parliament) of Kyrgyzstan. This given authority allowed the SPF to act independently from other governmental bodies by causing distortion of unity in economic policy.² With such authority the final decision on the privatization of every concrete

¹ If to convert to US dollars on the bases of annual average exchange rate of that time, according to the EBRD data it was 6.1 som per one US dollar, then it accounts for 6.55 million of USD.

² For detailed discussion of the SPF authority at that period and their consequences, see Koyçuev (2002, pp.76-79)

enterprise had to be made by the SPF. Decisions on the value of each enterprise, payment methods, ownership structure and amount of shares passed to employees were very subjective. This brought about the loss of control over the privatization process. As a consequence most of the enterprises were sold with high privileges to buyers. Thus, according to the SPF data by 06.06.1994 out of the total value of the all privatized enterprises by selling stocks only 43 per cent had to be paid, in other words applied discounts were higher than the valued paid. The same can be seen in policy of defining the price to be paid by workers' collectives and private individuals, where the workers' collectives had to pay 71 per cent of estimated values and private individuals only 23.5 per cent. Indeed, in most of the attractive enterprises the considerable shares were obtained by their directors. For instance the share of director of the trade centre "Aychurok" was 20 per cent or 44 million som, this share in joint stock company "Alamedinmeh" (specialized in processing of fur) was 51 per cent or 69 million som, in joint stock company "Suusar" (specialized in production of leather) 70 per cent or 140 million som¹. Such a situation again proves that privatization in this period in most cases was uncontrolled (Koyçuev, 2002, pp.77).

Methods of privatization used in this period did not promote emergence of effective private owners. Since by the end of 1993 in total ownership structure of the country 59 per cent belonged to government, 14.5 per cent was in joint ownership of state and workers' collectives, 9 per cent was in hand of workers' collectives, and only 0.5 per cent was in hand of private parties². In case of ownership of workers' collectives they did not play active role, the real owners were managers of enterprises, which had been staying on the same position since the Soviet period. In such situation the old administration of enterprises remaining on the position did not have any initiative in restructuring and adaptation of enterprises to market realities.

Conversion to joint stock companies without stock market practically lead these companies to be closed to the society and to foreign investors. In most cases used method of conversion into closed type joint stock companies limited free circulation of stocks. Most of

¹ These high values of shares pose the question about the legality of income of managers of that time. Since, with the normal level of salary of manager it was practically impossible to be the owner of these shares.

² This information is taken from "The Concept of Denationalization and Privatization of State Property in Kyrgyz Republic for 1994 -1995", p.13.

the small stockholders did not know their rights. The right of governing of the remaining state share in conversion into joint stock companies usually transferred to related sector ministries, which in turn did not change method of management and was continuing to use the old approach to management.

Significant contribution to such results was made by weak legislative base. Non-existence of the prior experience on privatization and need to create corresponding legislative base for planned rapid privatization was difficult for Kyrgyzstan. Most of the legislative documents were adopted by Kyrgyz authorities during the process, and not before launching the privatization program. Most of the decisions to be made in order to correct the process did not have enough law bases.

During the first period of privatization, starting from 1992 the comprehensive privatization program started which aimed at creation of the economy with the variety forms of ownership. In generally, the objective of privatization in terms of number of privatized enterprises was achieved. However, serious mistakes made during the process practically lead to inefficiency of privatization that contributed to further deterioration of economic activity and crisis.

6.1.2 Second period: 1994-1997

Having evaluated the lessons of the first period government of the country launched the second period of privatization process which included two privatization programs for 1994-1995 and for 1996-1997 years. The aim of this period was the same as in the previous period and was defined as “the formation of large group of private owners in population”. It was believed that emerging private owners would be interested in profitable functioning of enterprises and, thus, would lead to stabilization and growth of the economy¹. Totally according to these programs the share of privatized enterprises (compared to the total number of state enterprises at the beginning of 1991) by the end of 1997 was planned to account for 65

¹ For details, see “The Concept of Denationalization and Privatization of State Property in Kyrgyz Republic for 1994 -1995”, pp.14-15.

per cent. In contrast to first period this period was characterized by mass privatization and reorganization of medium and large enterprises. Other strategic directions of this period were:

- attraction of foreign investment;
- introduction of new methods of managing state properties including management contracts;
- active application of methods of denationalization and liquidation to insolvent enterprises.

In the second period policy concerning the methods of privatization was changed.

Firstly, in this program methods of privatization were clearly defined depending on the size of enterprises. While in previous period it was left to subjective decisions of State Property Fund (SPF). For small enterprises auctions were to be applied as a basic method and only in exceptional cases through the commercial competition. Medium enterprises were planned to be converted into joint stock companies and after that to privatize through selling stocks. Large enterprises at first were to be governed by managerial groups, which were responsible for preparing an individual plan for privatization of that enterprise. Part of this large enterprises were to be privatized through selling stocks, part that was not included for this program of privatization would be denationalized by introducing them corporate governance through establishing management organs as in joint stock companies¹.

Secondly, in program of privatization for 1994-1995 there was a second attempt to implement mass privatization. In light of lessons of the previous period privileges to workers of enterprises was limited, according to the program workers' collectives were able to take 5 per cent of stocks without charge². Instead of giving advantages to workers it was decided to start mass privatization by attracting wide participation of population. For this it was planned to correct voucher system by replacing *SPM* introduced in first period by coupons. With introduction of coupons values of vouchers were transformed into scores (it was called "*upai*"), one som value of voucher was exchanged to 100 *upais*. Coupons were intended for the exchange to the stocks of privatized enterprises in coupon auctions. But being different

¹ In the program classification of "large", "medium" and "small" was made according to amount of workers employed: large enterprises - more than 1000 workers, medium from 100 to the 1000, and small – less than 100.

² In "The Program of Denationalization and Privatization of State Property in Kyrgyz Republic for 1996-1997" it was allowed for this limit to be lower than 5 per cent.

from the *SPM*, it was allowed to sell and buy them within expire date. Thus, newly introduced coupons by converting their values to scores were protected against inflation and also offered opportunity for the creation of the stock exchange market. For this purpose 25 per cent of stocks of enterprises converted to joint stock companies had to be reserved¹. Together with coupon auctions it was planned to implement money auctions (purchasing stocks for money).

Table 6.2 Privatization methods (1992-2006)

Methods	1992-1993	%	1994-1997	%	1998-2006	%
Total	6786	100	1947	100	837	100
Rented to subsequently purchase	135	2	31	1.6	66	7.9
Conversion to joint stock company	1059	15.6	862	44.3	26	3.1
Auctioned	520	7.7	204	10.5	156	18.6
Sale through commercial competition	1897	28.0	83	4.3	120	14.3
Unrequited transfer	1	0.0	0	0	10	1.2
Direct sale*	928	13.7				
Sale to private parties	924	13.6	376	19.3	303	36.2
Sale to workers' collectives	1223	18.0	293	15	109	13
Conversion to limited joint stock company	99	1.5	97	5	28	3.3

*Available data for 1992 do not give detailed information on sales to private parties and to workers' collectives, but classify them under the direct sale category. While from 1993 data include sale to private parties and workers' collectives.

Source: Calculated on data of Ministry of Finance of Kyrgyz Republic and NSCKR 1998.

For the elimination of issue related with supply of stocks for mass privatization, as was in first period, conversion of enterprises into joint stock companies took place. At the same time conversion of joint stock companies in closed form into open form was implemented². Together with creating supply of stocks it was expected that this approach would create

¹ However, later according to "The Program of Denationalization and Privatization of State Property in Kyrgyz Republic for 1996-1997" this limit could be lower than 25 per cent.

² In Kyrgyzstan legislature joint stock company of closed type is characterized by the limitation of circulation of stocks, in other words for the operation with stocks approval of stockholders is necessary. However, in open forms there is no such limitation.

stimulus for secondary stock exchange market. Additionally laws on investment funds and on their functioning were adopted. More than 20 investment funds received license and it was thought that they would play substantial role in promoting exchange of coupons to stocks. All of these preconditions would create environment for development of capital market.

Result of this period was that 1947 enterprises were privatized and by the end of 1997 year amount of privatized enterprises accounted for 63 per cent of total amount enterprises by the beginning of 1991. Being different from the previous period, most of them were converted into joint stock companies - 44.3 per cent (see Table 6.2). At the beginning of 1998 share of privatized enterprises in the economy by sectors was as following

- in industry sector 81.6 per cent;
- in transport 51.5 per cent;
- in construction 57 per cent;
- in trade and catering 97.2 per cent;
- in household services 100 per cent.

SPM was changed to 3.5 billion *upais* through the branches of the Kyrgyzelbank were distributed free to the people, as a result of which 75.5 per cent of population received coupons. The period of official usage of coupons was 1.02.1994 – 30.06.1997. Thus, in 1997 mass privatization was completed. Within this period stocks of 1056 joint stock companies were offered in 237 stock auctions. Out of total number of received coupons by people two third were used. 98 per cent of coupons were used for purchasing stocks of enterprises. Only 20 per cent of coupons were used through the investment fund mechanism and remaining 80 per cent were used directly in stock auctions. Thus, new mechanism of mass privatization introduced in this period by replacing *SPM* with coupons had advantages in terms of the flexibility, liquidity and protection against inflation. Results of money auctions were limited: stocks of 1125 enterprises were offered, but only stocks of 410 enterprises were fully realized (or 36.4 per cent), and stocks of 168 enterprises (15 per cent) were partially realized. Together with mass privatization the State Property Fund focused on individual privatization projects for medium and large enterprises. As a result in August 1996 profiles for 100 large and medium enterprises were published which could serve as a basis for individual projects.

Although, quantitative targets of programs were realized, not all objects were fully achieved:

- Expectation that the introduction of investment funds and free circulation of privatization coupons would promote development of capital market was not realized. As mentioned above small share of coupons used through the investment funds supports this result.
- Mechanism of exchange of coupons to stocks that had to bring about private ownership forms was not effective. In often cases population did not use it consciously. Representatives of enterprises were actively buying up coupons from population and, thus concentrating coupons became the owner of stocks of enterprise where they work.
- Demand for stocks was ineffective. Because, the value of coupon was low¹ and as the economic downturn during the five years substantially diminished purchasing power of population, it was considerably reflected to the demand for stocks in money auctions. Another factor contributed to the weak demand for privatized enterprises were their non attractiveness. Since most attractive enterprises already were privatized during the first period and most of the remaining enterprises were in crisis situation.
- In most cases management of enterprises were passive. They did not take active measures in restructuring, privatizing and adapting of enterprises to market conditions.

Despite the intentions to introduce corporate governance in state owned enterprises and promotion of foreign investment these objectives remained unachieved.

Thus, second period of privatization was characterized with mass privatization and privatization of medium and large enterprises. Despite the achievement of quantitative targets, objectives of making effective private system and capital market did not materialize. In implementing privatization programs serious accusations of mismanagement and corruption revealed. After which the president of Kyrgyzstan temporarily suspended privatization program by a decree on 27 May 1997.

¹ As noted above value of *SPM* was determined by the workers' salary, for pensioners according to their year of work before retirement, and for other parts of population value was 1000 rubles. But workers' salary itself were low, therefore value of *SPM* was low too. Later in replacing with coupons their value were changed to scores, which was still representing weak purchasing power.

6.1.3 Third period: 1998-

Third period of privatization started from 1998 and is continuing to nowadays. This period encompasses privatization of strategic sectors of the economy (such as fuel and energy, communications, transportation), privatization of rehabilitation centers and other institutions of this group and privatization of remained block of shares not sold at previous periods. Programs of privatization implemented during this period (1998-2000, 2001-2003, 2004-2006, currently program for 2008-2012 is being carried out) had the same objectives as in previous periods - making of effective ownership structure. Along with this general objective the strategic directions were emphasized as attraction of investment, introduction of corporate governance into governing of state shares in enterprises and contribution to development of stock market. This period is characterized as case by case privatization with developing individual privatization project for each enterprise.

According to the information of SPF by the beginning of 2009 year 7284 enterprises privatized, which accounted for 73 per cent of total state enterprises in 1991. Prevailing method in third period is selling to private parties. Privatization in strategic economic sectors started with conversion of monopoly enterprises into joint stock companies and, in some cases, with their further reorganization. Reorganization in energy sector was associated with the emergence of new joint stock companies on the bases of their old structure. Objectives of such reorganization were de-monopolization of this sector and introduction of market mechanisms in their functioning.

Thus, in energy sector Kyrgyzenergo was created as joint stock company in 1998 and 94 per cent of its capital was owned by state, and 6 per was in hand of individuals. Eventually reorganization of this enterprise implemented by creating new joint stock companies on the basis of the “Kyrgyzenergo” structure. Creation of these companies was based on the principle of distinguishing transfer and distribution functions from production functions of “Kyrgyzenergo”. Starting from 1 July 2001 function of distribution electro energy was separated from production of energy. Thus, joint stock companies “Bishkekteploset” - specialized in heating infrastructure of the capital city Bishkek, and four electro distributing companies (“Severelektro”, “Vostokelektro”, “Oshelektro” and “Jalal-Abadelektro”)

specialized in distribution of electric energy in regions of Kyrgyzstan were established from the structure of “Kyrgyzenergo”. The control share of stocks of these companies is in state property. Further, starting from 1 November 2001 “Kyrgyzenergo” was separated into two joint stock companies: “Elektricheskie Stantsii”(“Electrical Stations”) and “Natsionalnaia Elektricheskaia Set (NES) Kyrgyzstana” (“National Electrical Network of Kyrgyzstan”). The former one is specialized directly in production of electro energy and includes hydro energy stations, heating centers (HEC) of Bishkek and Osh city. The latter one is focused on the transmission of electric energy from producer to distributors and comprises electrical substation with lines of electro energy transmission. Condition of delivery and transmission of electro energy to distributing companies and consumers are agreed in the contract signed between production, transmission and distribution companies. License for distributing energy can be obtained by private parties. These evidences show that there is an effort to introduce market mechanism into energy sector.

Joint stock companies appeared in other basic sectors also. In air transportation sector state company “Kyrgyzstan Airlines” (“Kyrgyzstan Aba Joldoru”), in 2001 it was reorganized into two joint stock companies: “International Airport Manas” and “National Air Company Kyrgyzstan Airlines”¹. In communication sector “Kyrgyztelecom” and in energy sector gas supplying enterprise “Kyrgyzgas” were created as a joint stock companies.

Eventually their stocks were partially sold to private parties. Table 6.3 includes data on ownership of these enterprises. As it can be noted with the dominant state position some portion of ownership was given to Social Fund of Kyrgyz Republic, this was done to support to sustain payments of Social Fund², and participation of private sector is very limited.

¹ Kyrgyzstan Airlines on 11 September 2007 was announced as bankrupt. The new air company “Kyrgyzstan” is established with 100 per cent of state ownership.

² However, its share also can be considered as a state ownership, since it is a state organization.

Table 6.3 Ownership structure of strategic enterprises

Name of joint stock company	Sector of production	Share (in per cent)		
		State	Social Fund	Private
Electrical Stations	Energy production	80.49	13.6	6.35
NEG of Kyrgyzstan	Energy transmission	80.49	13.6	6.35
Electro distributing companies*	Distribution of electro energy	80.49	13.6	6.35
Kyrgyzgas	Provision with natural gas (transportation, distribution and sale)	87.9	5.37	6.73
Kyrgyztelecom	Communication	77.84	12.51	9.85
Kyrgyzstan Airlines	Air transportation	81.3	8.4	10.1
International Airport Manas	Airport	81.3	8.4	10.1

* includes four distribution companies

Source: State Property Fund of Kyrgyz Republic.

(http://spf.gov.kg/index.php?option=com_content&task=view&id=94&Itemid=86)

Thus, privatization process in Kyrgyzstan till 1998 is characterized by mass privatization and high dynamics, and after 1998 to nowadays the process, generally, is focused on the strategic sectors of the economy, which is not completed yet. Many times programs of privatization of these enterprises were the topics of debates between government and parliament.¹ Besides, technical equipment of these enterprises has not been renewed for a long time and requires large investments for their further effective functioning. Because of this the primary objective of privatization programs is becoming attraction of strategic investor. In this concern, particular importance has the energy sector, especially hydro energy sector. Since water reserves for production of hydro energy is considered as one of the potentials of Kyrgyzstan economy. Moreover, development of the economy and growing energy consumption requires enlargement of energy production capacities.

¹ Thus, in 2004 it was planned to sell as a result of tender 51 per cent of stocks of Kyrgyztelecom to Arextech Ltd./DeTeCon for 16.2 million USD. However, parliament found this price low and rejected this selling operation.

6.2 Reform of Agricultural Sector

Particular importance of agriculture sector for Kyrgyz economy is caused by its dominance in the economy both in terms of the production and employment. At the beginning of transition agriculture accounted for one third of GDP, about 60 per cent of population was living in rural areas, and almost 35 per cent of workers were employed in this sector. Private ownership as a productive force did not exist. Before the land reforms launched during the transition 45 per cent of land resources belonged to state agricultural enterprises – *sovkhos*s and institutions; 36.58 per cent to collective farms - *kolkhos*s¹; and only 00.01 per cent to private farms. Therefore, *kolkhoz* and *sovkhos* system in agriculture did not correspond to the principles of market mechanism. Reforming of agriculture in Kyrgyzstan has been characterized by privatization of state and collective agricultural enterprises and introduction of private ownership on land.

Being different from other sectors the specificity of agriculture sector was that it was important to find an optimal form of farming. Since, productivity and competitiveness of emerging private sector in agriculture depended on the optimal size of enterprises and technical infrastructure, which in the USSR system was developed on the bases of collective usage, and not on individual farming. This issue caused some debates which resulted in two main opinions. Supporters of the collective farming offered to improve technical base of existing agricultural enterprises and were arguing for large agricultural enterprises. Another group was arguing for full “farmerization” of agriculture, i.e. to create individual private farms instead of large collective enterprises. Among the supporters of this view, B.Talgarbekov, for instance, referred to the model of land relations used in Norway, where the number of population was similar to Kyrgyzstan’s. According to him, in this country about 80 thousand individual farms were working effectively and were providing this country’s demand for agricultural products (Stepanenko, 1997). Indeed, the first initiative of privatization in agriculture began in earlier 1990s when Kyrgyz Government embarked on a program of restructuring and privatizing state and collective farms. Loss making farms in particular were

¹ Despite their name “collective farmers”, de facto, as it was mentioned in first part, they were under the state authority, therefore, can be regarded as state enterprises too.

encouraged to reorganize their ownership and management structure. However, this program resulted in limited success - only two state farms comprising 600 families were privatized by November 1991.

Agricultural reform virtually started in spring of 1991 with the adoption of Law on Farms, on Land Reform and Land Code. These laws defined land relations, legislative, organizational and economical aspects of organizing and functioning agricultural enterprises with different ownership rights. In particular, it was noted that land is the property of Kyrgyz nation and it is in state ownership. Private parties could get the right to use land, and not the land itself. The date for use of this right in Land Code was defined as a life time of the owner. According to the Law on Land Reform” as a priority ineffectively working *kolkhozes* and *sovkhoses* should be denationalized and privatized.

Proceeding from these normative documents, to speed up and encourage the process of privatization in this sector, President of Kyrgyzstan issued decree in November 1991. This decree was about distribution of land area to people:

- for establishment of farmers, agricultural cooperatives for organization of medium and small enterprises
- kitchen gardens for food cultivation, livestock pasture and hay
- for individual gardens and collective gardening

Also, it was planned to reorganize *kolkhozes* with profitability between 15 and 25 per cent into agricultural cooperatives to 1 February, and starting from 1992 privatization and denationalization of *sovkhoses* and other state agricultural enterprises.

It was planned to establish special land fund on account of ineffectively used lands with 1.5 million hectare to 1 February 1992. For members of *kolkhozes* and *sovkhoses* land areas were distributed from lands of their enterprises, and other parts of the population were given with land areas from the stock and special land fund. Moreover, citizens of Kyrgyz nationality could obtain land area from National Land Fund (NLF) which was established with 50 per cent, or 422 thousand ha, of all irrigated arable lands. Lands of this fund were designed to be distributed to citizens with Kyrgyz nationality.

By the end of 1993 year 173 *kolkhozes* and *sovkhoses* had been reorganized and 17.5 thousand private farms, 197 cooperatives, 120 small enterprises, 199 associations and 9 joint

stock companies had been established. Planned formation of special land fund was implemented with 1.12 million hectare, of which 145 thousand hectare or, approximately, 10 per cent was given to farms, while remaining part was still being used by *kolkhozes* and *sovkhozes*. Implementation of programs and plans of agrarian and land reforms stipulated in adopted normative documents faced weak support from officials and managers of the state agricultural enterprises. In distributing land areas bureaucratic processes became complicated and use of informal relations was often.

Thus starting from 1991 till 1994 structural reforms in agricultural sector was concentrated on breaking of large state enterprise into small farms. However, this privatization process was uncoordinated and brought about chaotic emergence of individual farms that was not productive and most of their production have been limited to their own consumption, and not to further market sales. In such a situation debates on the optimal structure of farmers appeared. Supporters of further realization of reforms had both “moderate” and “radical” views.

According to moderate reformers the course adopted in agricultural sector had to be corrected in terms of the increasing effectiveness of emerging private farmers. Their argument was results of the reforms implemented so far. Since, by the beginning of 1994 in Kyrgyzstan over 20 000 farmers were officially registered, but according to experts only 2000 of them could effectively function in market conditions. Therefore, according to them, it was necessary to make revision of all the landowners and farmers and liquidate unproductively functioning farmers and enterprises. After this examination only 10-12 per cent of registered farmers would remain. Further, agricultural policy should promote increase their amount. In this manner by the end of 1990s in Kyrgyzstan would function not 80 000 as it was expected at the beginning of reforms, but 10-12 thousands farmers. By decreasing amount of farmers it would be easy to carry educational training programs for farmers and it would be possible to give them credits in significant amount. However, this approach would not solve the problem of the possible societal discontent. Since under the procedure of liquidation of unproductive farmers and further limiting the number of farmers meant deny of distributing land to some part of population. And in second article of Land Code it was written that “...each citizen of Kyrgyz

Republic has right for land area”. Moreover, within this view the question of further modernization of legislative base was not concerned.

It could be argued that such selective approach to farmers could result in their effectiveness. However, according to the existing law rights given to individuals to be the owner of land did not give the full right for land. In other words, this right was limited with the usage of land and duration of owning was the lifetime of the owner. But they could not sell and use it in other operations. These restrictions posed limits on the emergence of the land market and consolidation of farmers. Therefore, “radical” reformers insisted on further modernization of legislative base of land reforms with the introduction of full institution on land owning, development of land market and non-government credit system for agriculture.

President of Kyrgyzstan of that time A. Akaev in his speech “On strategy of socio-economic development of Kyrgyz Republic and urgent measures” noted not to prioritize further only private farms, but to provide optimal structure between collective farms and individual farms. In this work Akaev emphasized that because of the fact that most of farmers were not ready, both economically and psychologically, for independent functioning and, moreover, infrastructure of agriculture had been formed under the collective system of farming, it was offered to separate *kolkhozes* and *sovkhazes* into small private enterprises and use common infrastructure on the cooperative and rental principals. Generally, in 1995 agrarian reform was implemented in this manner.

In February 1994 President issued decree “On measures for deepening land and agrarian reforms in Kyrgyz Republic”. This decree redefined the right of land use by introducing the opportunity of disposing them: to sell this right, to exchange, give as heritage, use for deposit and rent. Date of right was limited by 49 years. However, it was not a real ownership right, but just right entitled to use land, and not to own the land. President’s decree issued in November 1995 prolonged this date to 99 years. With the same decree NLF was reorganized into the Fund of Redistribution of Agricultural Lands. In national wide reform in 1998 question of private ownership on land was posed and results were positive. Thus full private ownership on land was realized. After the adoption of Law “On Management of Agricultural Lands” limitations on the realization of all type operations with land were eliminated. Therefore, starting from 01.09.2001 buy-sell, exchange and other operations are

being realized. With these changes privatization and reorganization activities and distribution of land areas in agriculture were continuing. To 1 January of 2001 year 509 out of 561 *kolkhoz* and *sovkhoses* had been reorganized, on the bases of which 71163 individual farms, 573 collectives farms and 281 associations and joint stock companies created. Eventually number of individual farms increased. For instance number of individual farms in 2005 was above 300 000. To the beginning of 2002 year 72.5 per cent of agricultural lands were distributed to about 3 million citizens of the country.

Therefore, starting from 1991 land and agrarian reform aimed at introduction of market mechanisms in the agriculture focused on the creation of private farms with private ownership right in land. The virtual result of reorganization of the old system has been the dominance of small scale private family farms.

6.3 Financial Sector Reform

Transition to market economy required the establishment and development of financial system through creating both of banking and non-banking financial institutions. This section includes analysis of the establishment and development of the financial system of Kyrgyzstan in transition to market economy. However, before that, it is useful to describe the introduction of the national currency and the relevant monetary policy of the central bank, since in general they are part of changes in financial system too.

6.3.1 The new currency and monetary policy

Kyrgyzstan, as other Central Asia countries, right after the independence was continuing to use Russian ruble as a currency. Continuation of functioning within ruble zone meant the preservation of existing system of economic cooperation. Moreover, by doing so Kyrgyzstan could use Russian subsidies in terms of the low prices for oil, gas etc. However, increasing unbalance in consumer markets, sharp decline of output and continuing deterioration of economic relations together with the hyperinflation undermined any start of implementation of economic reforms. It caused uncertainty in the economy, devaluation of income and reduction of incentives to invest into real sectors of the economy. Under the

hyperinflationary pressure demand for the cash money rose up quickly, in order to meet these needs within ruble zone Russian Central Bank used emission of ruble, which in turn was provoking high rate of inflation. This situation can be characterized by two main circumstances for money-credit policy. Firstly, in ruble zone Kyrgyzstan was unable to run independent money-credit policy for stabilizing inflationary environment. Absence of independent money policy was making country to be more vulnerable to external financial crisis. Secondly, confidence of population and entrepreneurs on existing money system was decreasing. Obviously, under these circumstances it was necessary to introduce the new national currency. Primary objectives of introducing new currency were to run independent monetary-credit policy and stabilize inflationary environment.

At the beginning of 1993 Kyrgyz government informed the republics of the former Soviet Union about its intention to introduce a new national currency. In May, Parliament approved the project and created special committee for introduction of currency. On 7 May 1993, it was announced that on 10 May the new national currency unit -“som” - would be introduced. Official rate of exchange was determined as: 1 som- 200 ruble; 1 USD – 4 som; 1 English pound – 6.11 som. These rates were determined only for five days, then, exchange rates were left to be determined by market conditions. For the population’s deposits in saving institutions (*sberkassy*), as compensation for inflation in previous years, exchange rate was higher 1 som – 150 ruble. Official period of exchange of currency was 10-14 May¹. Thus, after official period, starting from 15 May som became the currency unit of Kyrgyzstan²

¹ Indeed exchange of currency held in three periods: 1) official period (10-14 May); 2) additional week (14-21 May) was given for those who because of the some objective reasons could not change rubles for som. This period was allowed only for exchange of ruble; 3) In final period (3-4 June) only citizens of Kyrgyz Republic could change, but according to market exchange rate 1 som -260 ruble.

²According to specialists’ evaluation monetary mass in use in Kyrgyzstan at that moment was about 50-53 billion rubles. During all the periods of exchange 14 billion rubles or about 25 per cent of total rubles in circulation were collected. This was the consequence of the low confidence of population in the new national currency. But, at the same time, Kyrgyz citizens could use non exchanged rubles in other former Soviet Union republics, where ruble was continuing to be used as currency.

Table 6.4 Inflation, M2 and exchange rate (1993-2007)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Consumer Price Index (CPI)*	1366	87.2	31.9	34.8	13	16.8	39.9	9.6	3.7	2.3	5.6	2.8	4.9	5.1	20.1
M2*	100	118.3	77	23	25	17	34	12	11	34	33	32	9.9	51.6	33.3
Coefficient of Monetization**	13.5	12.8	17.1	14.3	13.8	14.4	13.5	11.9	11.1	14.6	17.4	20.5	20.5	28.5	31.2
Exchange rate Som/ USD***	5.04	10.84	10.82	12.84	17.37	20.77	39.02	47.72	48.45	46.94	43.72	42.67	41.3	40.16	37.30

*Changes from the previous year in per cent.

** Ratio of M2 to GDP

*** Average per year

Source: Calculated on data of IMF, 2008; NBKR, 2008 (3); NSCKR, 1996, 1998, 2001, 2001 (b), 2006a, 2006 (b)

After introduction of the national currency, first aim of the policy of National Bank of Kyrgyz Republic (NBKR, or Central Bank of Kyrgyzstan) was to achieve price stability in order to ensure macroeconomic stability and conditions for economic growth. Exchange rate policy was determined as a floating managed rate. It was obvious that deteriorating economy could not serve as a reliable and sufficient base for price stability. Assistance on this case came from IMF, which two days after the introduction of the national currency, on May 12 approved a SDR 16.125 million loan under the Systematic Transformation Facility (STF) and a SDR 27.09 million of stand-by credit. In all following years monetary policy of Kyrgyzstan was the subject of various IMF programs. Kyrgyzstan government jointly with NBKR in order to cope with inflation started to implement restrictive monetary policy aimed at restraining the growth of the monetary mass. In other words, criteria of the monetary policy were specified with the certain rate of expansion of money supply, and, thereby, target for inflation. As a result monetization of the economy was decreased, which reached its lowest level in 2001, and only starting from 2002 showed upwards progress (see Table 6.4). The policy was successful in reducing inflation rate from four-digit rates to two-digit rates in short period of time. Inflation was reduced to 87.2 in 1994, from 1366 in 1993, and starting from 2000 its level was reduced to single-digit level. Concerning the exchange rate NBKR continued on flexible exchange rate regime, with interventions directed to smoothing out temporary fluctuations and to maintain the level of reserves at their targeted levels.

Therefore with introduction of the national currency Kyrgyzstan received independence in running monetary policy, which is being the subject to the various IMF programs is generally characterized as a tight monetary policy. Besides of running monetary policy and beginning of making national monetary system, introduction of national currency is also regarded as catalyst of other changes, such as banking sector, tax system, currency regulations etc.

6.3.2 Restructuring of the banking system

Establishment and development of the banking system in Kyrgyzstan since independence took place in three main periods: first period from 1991 to 1994, second period from 1995 to 1997 years, and third period from 1998 to nowadays.

6.3.2.1 First period: 1991-1994

The first task in reforming banking system after the independence was dismantling the monopoly in the sector and establishment of two-tiered banking system with the central bank and commercial banks. Since in the Soviet system there was a system based on a “monobank” endowed with all the banking functions: it was issuing money acting as the Treasury of the state, and as the sole source of credit for the economy. Hence it was necessary to develop the system with a central bank and commercial banks.

The reform of banking system in Kyrgyzstan began before the official date of independence¹ with the passage of the Law on the State Bank and the Law on Banks and Banking Activity in June 1991. In February 1992, the former republican branch of the State Bank of USSR was transformed into the National Bank of Kyrgyzstan, which inherited legal rights and responsibilities of the State Bank and took the role of the central bank of the country.

¹ However, it should be mentioned that the first attempt of reforming banking system was made during the USSR, in 1987. Before that the State Bank of USSR allocated financial resources through its branches over all the union according to economic plan and banking system consisted of the State Bank, *StroiBank* (Construction Bank), *Vneshtorgbank* (EximBank) and *Sberkassa* (saving institutions). However, at that time as increased autonomy was given to enterprises and cooperatives, there was a corresponding need to change the banking system. The new system included: *GosBank* (State Bank), *Sbergatelnyi Bank* (Savings Bank, based on the previous saving institutions) and banks, specialized on financing particular sectors of the economy (industry-construction, external economic affairs, social development etc). These specialized banks were entitled to give long and short-term credits. This scheme was adopted on the level of member republics too. Another innovation was the adoption of laws that allowed for creation of banks with various forms of ownership. It made possible the creation of commercial banks, which were established at first through the commercialization of regional branches of specialized banks. Thus, in 1989 in Kyrgyzstan specialized state banks began to be restructured into commercial banks, but privatized starting from 1992. In other words this new structure of banking system created during the last years of USSR was, to some extent, close to two-tiered system: with Central Bank and other specialized banks. But this system was not effectively functioning one, it was rather precondition for further reorganization and development of two-tiered banking system in transitional period.

First commercial banks in Kyrgyzstan arose during the Soviet Union in last 1980s¹. Thus, in Kyrgyzstan about ten commercial banks had already been established before the announcement of independence. After independence the existing banks registered anew according to new banking legislation of the country. Therefore, commercial banking sector in Kyrgyzstan was formed by two types of banks: created on the bases of the previous large specialized banks and new commercial banks established by private initiative.

By the time of declaring independence there were four large specialized banks: Agroprombank (Agricultural-Industrial Bank), Promstroibank (Industrial-Construction Bank), Jilsotsbank (Housing-Social Bank) and Sberbank (Savings Bank).² The three largest banks (excluding Savings Bank) dominated in the commercial banking sector with the following approximate shares in activity: 94 percent of branches, 95 per cent of total staff, 94 per cent of loans and 90 per cent of deposits.³ Under the light of this dominance the emerged new commercial banks were very small in capital and banking activities. They did not have large amount of branches, even some of them, such as Saturn, Kyrgyz Djer, Adyl etc, did not have them at all. By the beginning of 1995 year 18 commercial banks were functioning. Most of the new commercial banks were created by the largest and most powerful enterprises from certain branches of the economy.⁴ Some banks were created with the participation of foreign capital.⁵

Economic crisis of that period characterized by the sharp output decline and high inflation rate negatively affected development of banking sector. Generally, in 1993

¹ Thus, following the practice of creation of commercial banks through the commercialization of regional branches of specialized banks in Russia, republican bank branches were transformed into independent banking units. At the same time they were converted into joint stock companies in which their previous clients (state enterprises and collective farms) became shareholders. This was the result of the situation where there were no other potential buyers, and no other organization to arrange the sale of banks' shares, and therefore the shares were offered to each bank's main customers. On the basis of these new legislations at the last years of USSR new banks with various forms of ownership began to be established.

² Sberbank at that time did not start for normal functioning, since Central Bank did not approve its statute because of its transfer of the money (3 billion rubles) for deposition in Moscow Savings Bank before declaration of independence. First three were converted into joint-stock banks. Their shares were held mostly by enterprises that were their clients. However, in Kyrgyzagroprombank the state preserved control share -54 per cent, while in two other banks² its share were less - 29 and 13 per cent correspondingly.

³ The Savings Bank was also large with its 58 branches and 2000 employees and with 3 billion ruble deposits (at that time more than 70 per cent of the total for all commercial banks).

⁴ For example, the founders of AKB Kyrgyzvneshbank were enterprises engaged in export activity, and the shareholders of AKB Kyrgyzenergobank include power plants.

⁵ For example, AKB Adil, with Swiss capital, and KB Chen-Fen LTD, with capital from Hong-Kong. Banks were organized in the form of joint stock companies, Russian abbreviation of which is AKB (or sometimes referred as AK) or in the form of commercial bank, that in abbreviation is KB.

commercial banks' credit policy were based on the high inflationary environment by charging high price for credit explaining it by high rate of inflation. However, their expectation on further continuation of high inflation was not realized and in following year inflation rate fell. But banks were not ready to operate in low inflation conditions. They decreased interest rate on credits, while still keeping it the same on deposits. It brought about sharp decline of credit profitability. Moreover, the lack of adjustments in inflationary environment resulted in the fact that rate of interest was below the rate of inflation. Population and enterprises withdrew large amount of money from banks. The majority of banks lacked funds for implementation credit operations.

At the same time because of the general tendency of declining production in the economy enterprises that were the receivers of banks' loans showed negative performance. Consequently, quality of banks' credit portfolios worsened, where the share of lost and doubtful loans increased. This kind of situation concerned all commercial banks, including the largest banks.¹ Along with this because of the high inflationary pressure decapitalization of banks occurred. In 1993 inflation rate rose up to 1465, while totally all commercial banks' capital base increased only sixfold.

Significant influence on the situation had government intervention into banking activity. At the beginning of independence the large banks continued for planned crediting of the sectors of the economy, later, in place of the planned allocation mechanism refinancing credits of the central bank was introduced. Until the end of 1993 refinancing credit from central bank to commercial banks virtually was the sole source of their credit funds and the main instrument of the central bank's influence on the money supply². This credit on the basis of instructions from the parliament and the government was extended to credit for specific purposes or to specific sectors of the economy³ through commercial banks according to the government and parliament instructions. These credits used not only through commercial

¹ It was difficult to determine the exact share of these loans in credit portfolio of banks. But some surveys showed that in some cases their share reached almost 90 per cent.

² Changes in minimum reserve requirements constituted a further instrument for the central bank to influence on commercial banks' credit action. In 1993 the reserve requirement was raised from 15 to 20 per cent of deposits. At the same time the central bank paid the commercial banks a market rate of interest on these reserves. In 1994 intending to reduce the credit activity of commercial banks, raised the minimum reserve requirements to 30 per cent of deposits of all types.

³ Mainly for agricultural and processing sectors.

banks, but also used for the government itself. Especially, credits for the government were extended on preferential terms. In case of financing sectors of the economy resources were allocated according to government instructions. For example, in 1993 year 60 per cent of all credit funds of the central bank were used either to satisfy the needs of the government (almost 14 per cent) or used in the economy according to the instructions of the government (46 per cent). In addition to these credits, as an attempt of the central bank to control market rate of interest, another method of distributing refinancing credits - irregular credit auctions - was introduced. In 1993 year nine such auctions were organized.

The major executors of the government and parliament instructions concerning the allocation of financial resources to the sectors of the economy were above mentioned three largest commercial banks. According to the government and parliament instructions these banks had higher limits and lower rates of interest in receiving refinancing credits than other banks.¹ Significant decline or completely stop of production of these bank's creditors posed their payments on loans under suspicion and, practically, led to the default of the enterprises. Consequently, position of three largest banks significantly worsened in 1993. In 1994 a presidential decree forbade the practice of these preferential credits.

Besides these reasons, the weaknesses in running banking activity of banks itself played significant role. Management was not effective and did not correspond to market realities. Especially in case of the new banks, credits were given without proper analysis of clients' activities and financial situations. In some cases, when accepting securities for loans, banks accepted insurance from insurance firms chosen by them. In particular cases, this was the only means of security for up to 90 percent of all loans (for example in Energobank or Mercuribank).

Because of such situation debts of commercial banks to the central bank increased. In response to these, the central bank cut off refinancing credit for commercial banks. NBKR funds were distributed solely on the instruction of the government and parliament. For the first time NBKR accepted decisive measures and in 1994 three banks were stripped of their license

¹ For example, in 1993 the share of refinancing credit in the total sum of credit approached 74 per cent. The three largest commercial banks were the main recipients. In Kyrgyzzagroprombank this credit made up almost 94 per cent of the entire sum of the bank's credit funds, in Kyrgyzpromstroibank 66 per cent, and in AKB Kyrgyzstan 63 per cent.

because of their low level of capital. After these cases, NBKR posed the question of increasing starting capital. On 7 April this requirement was set as 5 million soms, at the same time for foreign banks was set at one million dollar¹. Nevertheless, by the end of 1994 only 12 out of 18 commercial banks corresponded to this requirement.

Therefore, during the first period two-tiered banking system was formed in Kyrgyzstan. However, the practice of allocation of financial resources according to instructions of the government with the provision of various types of preferences, lack of modern banking management and market experiences of staff and economic crisis characterized by deep output fall and high inflation resulted in default of most commercial banks. It meant that after forming two-tiered banking system it was necessary to change principles of operation in banking system, to create and strengthen supervision organs and further restructuring of financial system.

6.3.2.2 Second period: 1995-1997

Tendency towards the macroeconomic stability, further reforming attempts in the economy and difficult situation in banking system of the country occurred by the mid of 1990th necessitated the further decisive reform measures in the banking system.

In October 1995 in Washington the meeting of specialist of working group on program FINSAC (Financial Sector Structural Adjustment) took place, where representatives of the National Bank and Ministry of Finance of Kyrgyzstan, IMF and World Bank participated. The topic of the meeting was the strategy of further reforming in financial sector. As a result official memorandum on preliminary agreement was signed. This agreement implied the main elements of financial sector reform strategy that can be summarized as following:

- Creation of corresponding conditions for development of healthy competitive private banking system;
- Transformation of existing banking structure through reorganization;

¹ In 1993 with the introduction of new currency minimum required starting capital set at one million soms and for foreign banks was set at one million dollar.

- Creation of temporary mechanisms aimed at penalitation of overdue payments and, thus, speeding up of restructuring or liquidation of insolvent enterprises;
- Creation of corresponding legislative base for development of non-banking financial institutions and capital market.

For the realization of the program FINSAC between Kyrgyz government and International Association of Development (IDA) was signed credit agreement for 45 million dollar on 3 July 1996 and officially program was closed on 30 June 1998.

As it can be noted the program was intended for overall financial sector including both banking and non banking financial institutions. Proceeding from the strategy directions restructuring process in banking sector was focused on three main points: amendments to existing legislature on banking activity and banking system, strengthening of supervision and control of banking system, and transparency in banking operation.

Strengthening of banking supervision and control of the banking system was associated with the radical policy of NBKR in banking sector that resulted in liquidation of some banks¹.

As mentioned above in Kyrgyzstan from the Soviet period four large state banks (Elbank, Agroprombank, Promstroibank and AKB Kyrgyzstan) were inherited. Because of the reasons explained above their situation worsened off. 50 per cent of their credit portfolio consisted of the lost and doubtful credits. Such a situation was negatively affecting all banking system. As a cure for solving the problem was selected the radical way – liquidation of two of them: Elbank and Agroprombank.

Both of these banks were largest in the country by their branches². It was decided to liquidate Elbank in February 1996. At the end of 1995 it has low starting capital- 2.7 million som, while the minimum requirement set in September 1996 was 10 million som. It was the first time among the former USSR countries when such a large bank, that was depositing the savings of the population, was liquidated. During the liquidation problem of paying back of

¹ Following the liquidation of three banks in 1994, two banks were liquidated in 1995 (AKB Adil and AK Saturn Kyrgyzdyikanbank). The main reason for their liquidation was the lost of the liquidity. In 1996 three banks with foreign capital participation (Hen-Fen, Oreint and Kyrgyz-Jer) and two large state banks were liquidated. Being different from the previous cases the reason for liquidation of the banks with the foreign capital included not only financial problems, but also reasons in crime character.

² Elbank had 49 branches over the country, while Agroprombank being the first in the country had 50 branches.

deposits of individuals arose. Its predecessor – Savings Bank (*Sberbank*) was the only bank in Kyrgyzstan that had the state guarantees on deposits¹. By the time of liquidation the bank's debts to individuals accounted for 122 million som. Funds of the bank were not enough for paying back them and NBKR must give special reserves 50 million som for that purpose.

In June 1996 it was decided to liquidate Agroprombank. This bank was financing mainly agricultural sector and gave credits on governmental program. By the time of liquidation sum of given credits by the bank was 1.5 billion som and according to the auditing results 90 per cent of them were classified as lost and doubtful credits. Initially it was thought to exempt from the bank's portfolio "bad" debts and to transfer them to the special agency created by the Ministry of Finance of the republic. Being free from the problematic components of its portfolio the bank could continue to function. However, NBKR concluded that even with such approach the bank would not be able to improve its situation and made final decision to liquidate it. Following the close of the Agroprombank branches a Settlement and Savings Corporations (SSC) was established to provide payments system services and a saving outlet, especially for rural areas.

Together with liquidation of these banks, NBKR hardened banking supervision activities by developing normative policy aimed at the stability of the banking system and limiting of appearance of small banks. For limiting the emergence of small banks with small capital NBKR increased the requirement on minimum starting capital². Besides, in the same period, for the financial stability of commercial banks NBKR developed other normative requirements to be implemented. These norms are:

¹ Officially this guarantee was over the savings deposited in the bank before 11 December 1992, when the Savings Bank began its activity after the temporarily suspension by the central bank. However, the state status of the bank was making government responsible for the all savings in the bank.

² Thus, NBKR in 1996 set minimum size of starting capital for existing commercial banks to be reached to the end of 1997 – 15 million som, and for the banks with the foreign capital (more than 20 per cent) 30 million som. At the same time starting from 1997 NBKR obligate commercial banks with domestic capital to increase starting capital by 5 million som per year, and the banks with the foreign capital by 10 million som per year, and, thus, by the end of 2000 the minimum starting capital would be 30 million som, and in banks with foreign capital 50 million som. The new banks that received their license after the introduction of this order were obligated to increase their starting capital by 10 million som each year. Banks that could not correspond to this requirement were to be liquidated or merged with other banks.

- Maximum limit of risk on one borrower or one group of borrowers related with each other. This norm was defined as the ratio of given credits to the own capital of bank. The limit was set as 25 and 15 per cent, correspondingly.
- Maximum limit of large credit risks, that is defined as the ratio of large risks¹ on own capital of bank.
- The standards of defining the sufficiency of capital of banks were introduced².

Another innovative case of this period in supervision of banking system was the organization of the Agency of Reorganization of Banks and Restructuring of Debts (DEBRA). It was provided with two main functions: the role of liquidator and offset of debts. In realizing them DEBRA acts on the behalf of the NBKR and governs assets and liabilities of reorganized banks.

Concerning the legislative base, legislature on banking system that adopted in first years of independence had general meaning and left the room for different interpretation. Moreover, existed laws on banking activity did not give the full independence of the central bank of Kyrgyzstan (NBKR). Hence, for further reforming of the banking sector and effective introduction of market mechanisms, it was necessary to redesign them corresponding to market mechanisms. Thus, in July 1997 the new Law on Central Bank and Law on Banks and Banking Activity were adopted. These changes filled out missing elements in previous legislature. In particularly, the objective and principles of functioning of the central bank was defined clearly and in character to provide with significant independence.

The objective of NBKR was defined as “...achievement and maintenance of the stability of prices through carrying out of corresponding monetary and credit policy...” (The Law on Central Bank, article 2). Such defined formulation of the objective excludes out possibility of giving different additional functions to the central bank. Definition and development of the monetary policy is defined as the prerogative of the management of the central bank, it should coordinate and implements this policy together with the government. Intervention of state organs into central bank’s activity is not accepted, and central bank on its

¹ According the NBKR normative as a large risks are considered the credits for one client exceeding 5 per cent of own capital of bank.

² These standards were introduced according to the recommendations of Basel Committee on Banking Supervision, the member of which Kyrgyzstan became in November 1995.

own side annually has to give report to the parliament of the country. At the same time the new Law forbids crediting of government and other state organs by the central bank. In other words, changes made to legislature of the banking system in 1997 constituted the new legislative approach to both of governing and functioning of the banking system, making it closer to principles of the market economy. During the same period, reform of accounting and auditing system took place and the international standards of accounting were introduced. All of these changes together with the macroeconomic stabilization in 1995-1997 years contributed to the positive developments in the banking system.

6.3.2.3 Third period 1998-

After the short period of stabilization banking sector of Kyrgyzstan faced the crisis in 1999, which occurred following influence of the Russian crisis in 1998. However, after overcoming consequences of the crisis banking sector showed dynamic growth in terms of the capitalization and total assets. Hence, the third period of development of banking sector in Kyrgyzstan can be considered as started in 1998 and continuing to nowadays.

After three years of stabilization macroeconomic situation starting from 1998 started to worsen. Russian crisis in 1998 reflected in poor macroeconomic indicators of the Kyrgyz economy – devaluation of the national currency, acceleration of inflation, decreased rate of growth and worsened balance of payments¹. This resulted in the deterioration of real sector production and, further, had impact on the banking sector. It worsened credit portfolio of banks: short term obligations increased and the problem of liquidity in banking sector appeared².

Negative impact of the Russian crisis was accelerated by issues of ineffective credit policy and management. These effects resulted in banking crisis in 1999. In 1999 year 11 banks reported the total loss for 368 million som, total capital of the banking sector by the end

¹In 1998 the rate of growth was 1.8 per cent, without the gold mining production 0.3 per cent only, industrial production was 4.5 per cent, but without gold mining it was decreased by 6 per cent and inflation rate was 18.4 per cent.

²NBKR in order to help with liquidity started to give “lombard” and emergency credits to commercial banks. Along with this in October 1998 NBKR introduced the new instrument called K5 that concerned the maximum size of money deposited in correspondent accounts in banks abroad.

of 1999 accounted for 1.3 per cent of GDP, while in 1998 it was 2.7. Also situation was complicated with facts of financial machination related with the state oil and gas enterprise “Kyrgyzgazmunaizat”, which resulted in the lost of given credits with value about 30 million USD. Consequently, two banks (Bank Mercury and KramdsBank) became insolvent in 1999 and at the beginning of 2000 another one (Bishkek Bank) - went bankrupt¹. These facts on the bankruptcy together with inflation and devaluation of the national currency decreased total capital base of the banking system in real terms. The crisis revealed the weaknesses of the banking system of Kyrgyzstan, in particularly: wrong credit policy, which was over concentrated on the one sector of the economy and did not adhere to the principles of limiting credit risk, and ineffective system of the management, which without stockholders control over bank managers were inclined to affiliated operations².

In its own turn, NBKR’s focused on hardening supervision requirements and increased norm of security. For instance, the norm of obligatory reserves increased to 20 per cent, the share of credits that could be given without the guarantee decreased from 70 to 50 per cent of the portfolio. At the same time, previously announced minimum requirement on the starting capital was replaced by the new program of increasing it³. NBKR started to apply tough measures for those who did not fulfill its requirements. Thus, four banks (Bank Insan, KyrgyzKramdsBank, Kurulusbank and Akyl Bank) did not meet requirements on increasing starting capital and were liquidated in 2001. After such radical decisions NBKR announced that those banks that would not implement requirements on starting capital would be able to work only within limited functions, and not as universal bank. NBKR argued that these

¹ The first bank went bankrupt was the Bank Mercury. Till 1998 it was one of the fast growing banks of the country and auditing of the bank since 1996 was resulting in positive evaluations. However, as the reason for the bankruptcy it was emphasized that the bank was over concentrated on the one sector of the economy – oil and gas, which was in state dominance. In this sector only one state enterprise – Kyrgyzgazmunaizat was functioning. Under the guarantee of Ministry of Finance the enterprise received credits mainly from the Mercury Bank and from other two banks. Prevailing part of these credits were given to the imaginary firms created by the Kyrgyzgazmunaizat. Eventually, 30 million som and 30 million dollar were transferred abroad, in other words were stolen. Ministry of Finance rejected guarantee. As a result, given credits found out lost. Next two banks liquidated – Kramdsbank and Bank Bishkek- also gave the credits to Kyrgyzgazmunaizat. Besides, their assets deteriorated under the light of the general macroeconomic situation destabilized by the Russian crisis.

² After the scandal of swindle of the head of Kyrgyzgamunaizat it was found out that the several banks were firmly affiliated with each other, and firms that received credits on the behalf of Kyrgyzgazmunaizat were faked.

³ The set new requirement constituted minimum requirement of starting capital as 300 million som (about 6 million dollar). Existing banks had to increase their starting capital to 100 million som by the mid of 2001, eventually by the beginning of 2002 to 150 million, and gradually increase it to the determined level.

measures would strengthen the banking sector, decrease the risk of bankruptcy and bring about the public confidence. Banking sector ended 2000 year with negative result and reported lost for about 53 million som, only starting from 2001 its activity resulted in positive balance. In following years NBKR has been continuing to emphasize tough requirements on commercial banks, in particularly on increasing capital¹. Further reform measures in the banking sector according to the official reports focuses on improvement of supervision of the banking system; introduction of the mandatory deposit insurance scheme for all small depositors and enhance the payment system.

6.3.3 Establishment of non-banking financial institutions

Development of the financial system necessitates the establishment and development of the non-banking financial institutions too. Non-banking financial institutions represent supplementary mechanisms for accumulation and distribution of financial resources.

Different institutions can be regarded under this category: insurance companies, investment funds, pension funds, credit unions, specialized credit institutions, stock exchanges, exchange offices and lombards² and other financial organizations. The important component of financial system is security market that represents one of the main sources of finance in market economy. Therefore, emergence and development of the organized market of security trade, or stock exchange, in transition economies is important. Obviously, these non banking financial institutions are inter-related in their development. Development of financial institutions of collective investing (such as pension funds, investment funds and insurance companies) represents resources that can participate in stock exchange as demand for securities. Moreover, all financial institutions depend on general factors: development of market relations, level of income, strengthening of private sector, development of corporate governance, public confidence on financial system etc. In this section the general overview of

¹ It was increased for existing banks to 60 million som (\$1.5 million) in 2006, to be further increased to 100 million som in 2008. The floor for new banks remained at 300 som million. In February 2008 NBKR announced about increase on the minimum requirements on starting capital for new banks at twice and set at 600 million som.

² Lombards are financial institutions that are entitled to give credits under the pledge of the properties of clients, in case of the non-payment of given credits they can sell the pledged properties.

the development of non-banking financial institutions is provided. However currently non-banking financial sector in Kyrgyzstan is undeveloped and some of the non - banking institutions are still in immature state. Therefore, this section particularly focuses on development of the Kyrgyz Stock Exchange (KSE) and on institutions that have shown relatively fast growing performance: credit unions and microfinance organizations.

6.3.3.1 Kyrgyz Stock Exchange

Stock exchange represents alternative to the banking system. Therefore, its development is one of the important tasks for transition economies. However, it takes a time, since it depends on the development of the private sector and corporate governance in transition economies. Moreover, if some roots of the banking system were existed, though not in market terms, in Soviet period, then any bases and roots of stock exchanges and security markets did not exist¹.

¹ However, it does not imply that in USSR there was no security, since securities existed as state securities issued to finance government expenditures and thus borrowing from the people.

Table 6.5 Number of the non-banking financial institutions (1995-2007)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Insurance companies	144	47	37	35	36	29	24	23	15	12	11	12	16
Investment funds	24	17	n/a	16	14	14	8	11	6	5	5	5	5
Stock exchanges	1	1	1	1	1	2	2	2	2	2	2	2	3
Lombards	78	75	53	55	49	57	64	85	108	116	141	145	180
Exchange offices	355	368	307	340	267	290	271	234	261	266	263	269	308
Pension funds	18	2	2	2	2	2	2	2	2	2	2	2	2
Specialized credit institutions *	n/a	n/a	n/a	4	4	4	10	2	2	2	2	2	1
Credit unions	n/a	n/a	n/a	83	169	191	279	349	303	305	320	308	272
Microfinancial organizations	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	72	104	136	164	229
Other financial organizations **	n/a	37	61	56	68	55	53	58	62	63	58	79	n/a

* KAFC, Financial Credit Union Support Company (FCUSC), State Small and Medium-Size Business Support Fund attached to the Government of the Kyrgyz Republic, "Kyrgyzaiyltrast", "Mercy Corps International", Civil Fund of Microcrediting "Meerim", Finance Fund "Bai-Tushum", Centers for microcrediting of unemployed residents, FINCA-Kyrgyzstan (Foundation for International Community Assistance), Central Asian and American Fund of support of small and medium business (CAAF). This category does not include operating financial institutions, for which the lending is not a major activity. KAFC – Kyrgyz Agricultural Financial Corporation. KAFC was organized with the state ownership on the credit of World Banks for 12 million USD after the liquidation of Agroprombank. KAFC was announced as the universal financial-credit institution for financing agricultural sector of the economy. As it is noted above, in December 2006 KAFC was reorganized into Aiyl Bank (Rural Bank). FCUSC- Financial Credit Union Support Company was established according to the NBKR decree issued on 25 February 1997 as a Limited Joint Stock Company for support and contribution to the development of credit unions.

** Specialized registrars, central depository, financial brokers and dealers, investment consultants, managers of investment companies, legal entities, who have legal rights to activities on trust securities.

Source: NBKR, 2003, 2008.

Start of mass privatization campaign with the use of “coupons” and conversion of enterprises into joint stock companies, necessitated establishment of organized security market so that securities could be traded at market prices. Thus, on 25 May 1995 the Kyrgyz Stock Exchange (KSE) was officially opened¹. KSE was organized as trade board for securities in a form of non commercial organization, and had 15 members, which were banks and broker companies. In 2000 the KSE was reorganized into joint stock company of closed type². Initially the KSE was functioning as the Centre of Trade with Coupons (CTC) that was issued for mass privatization programs. And starting from January 1995 the KSE began to listing of enterprises in order to give information on firms for investors. Till 2001 the main instrument in stock exchange corporate security market was stocks, and only in 2001 another instrument - corporate bonds started to operate.

Table 6.6 Activity of Kyrgyz Stock Exchange (2001-2007)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Trade Volume (in million of USD)	0.4	1.0	1.6	5.4	22.5	19	24.1	11.5	52.8	30.1	102.7	146,18
Quantity of deals	1570	1126	2519	2614	10798	6552	3112	1865	2305	1745	2284	4092
Stock market capitalization (in percent of GDP)	n/a	0.5	0.8	0.4	0.3	0.3	0.5	1.6	1.5	1.7	3.1	3.1

*Trade volume estimations are converted to USD from som by using nominal exchange rate for each year and rounded.

Source: EBRD database (www.ebrd.com/country/sector/econo/stats); KSE database (ww.kse.kg/archive); NBKR, 2008.

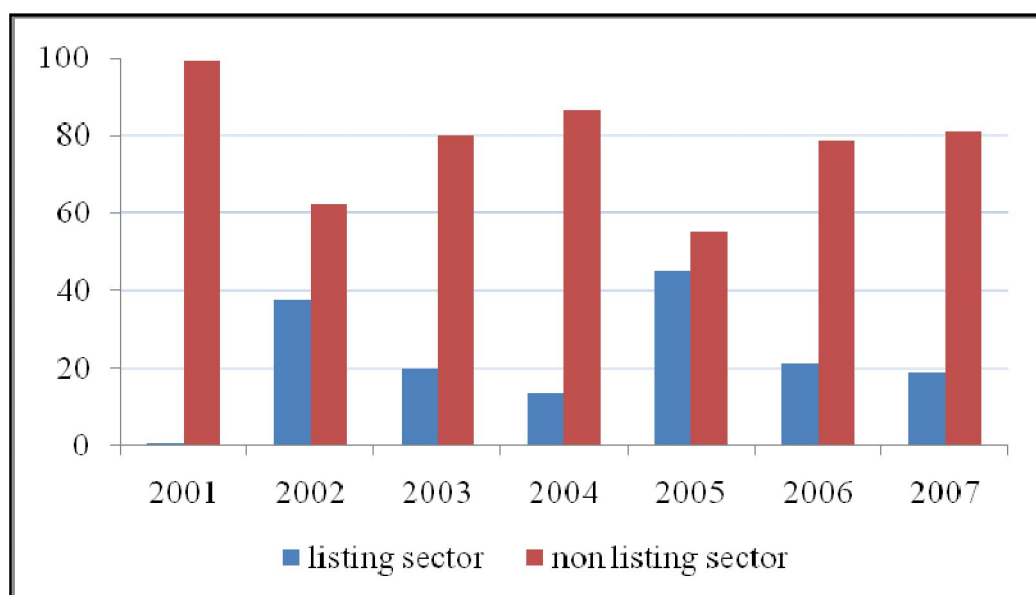
Table 6.6 shows that generally till 2000 the volume of trade in the KSE was relatively very low and only in 1998 it reached the level of 1 million USD. However the main share of trade with corporate securities was processing out of the stock exchange, directly between buyers and sellers. However, starting from May 1999 presidential decree obligated all the

¹ On 2 October 2000 another board of trade with securities in the south part of the country was established closed type Joint Stock Company “Stock Exchange Trading System”. The aim of establishing it was to involve in security market companies of south region of the country.

² Currently there are two foreign stock holders of KSE: Istanbul Stock Exchange (27.51 per cent of share) and Kazakhstan Stock Exchange (10.58 per cent of share).

market operations with corporate securities to be processed at trading boards, in other words to trade at the stock exchange only. After this event, increase in the volume of trade is observed. In 2006 trade volume reached 102 million USD from 5.43 million USD in 1999. However, despite this slight increases, activity of the KSE is remaining very low- level of capitalization is only three per cent of the GDP.

Figure 6.1 Share of listing and non listing sectors in trade volume of KSE (in percent) 2000-2007



Source: KSE database (www.kse.kg/archive)

The KSE includes two markets: state security markets and market of corporate securities. The latter consists of trading with securities of the two types companies: listing and non listing companies. Listing companies those that were registered by the KSE in order to give about them the full information to investors, while non listing companies do not have such procedure and expected to have less advantages in attracting investment. In 2003 the KSE shortened the list of listing companies because of amendments made to conditions of listing that increased requirements. In 2000 year there were 69 companies in listing, while in 2007 it decreased to 9. In total trade volume the share of trade with securities of non listing companies is dominant (see Figure 6.1). It means that about 80 per cent of companies

participating in the KSE do not have stimulus to be processed through listing and give full information and closed to the potential buyers. This fact implies that low potential for accumulating financial resources in stock exchange and desire of companies to keep their strategic share of management and their less interest in speculating with corporate securities do not stimulate companies to be listed (Abdynasyrov, 2005, p. 248).

Trade volume at the KSE is low and most of the deals include stocks only of some large companies. Moreover, trades in secondary market¹ are generally made to obtain strategic share of stocks of companies, while trade with the speculative aim is not developed. Under these conditions the stock exchange mainly serves for changing of ownership, and cannot be considered as the active mechanism of meeting financial needs of the private sector. It is obvious that development of stock exchange is firmly related with development of over all private sector and other financial institutions of collective investment such as pension funds, investment funds and insurance companies etc, that give the possibility to accumulate free financial resources.

6.3.3.2 Credit unions and microfinance organizations

Since the beginning of the independence with the liberalization and de-monopolization attempts quantity of non-banking financial institutions started to grow. However, as can be seen in Table 6.5, number of insurance companies, investment funds and pension funds decreased. Nowadays, there are only two pension funds, of which only one is the private pension fund. In 2007 there were five investment funds and sixteen insurance companies. They have little volume of operation in financial system. It can be explained by various reasons, but main factors are: low level of income of population and low confidence of population to financial system. Relatively fast developing non-banking financial institutions in Kyrgyzstan are credit unions and microfinance organizations.

Credit unions are credit organizations concentrated on giving small credits for farmers and entrepreneurs, especially in trade sectors. The base for their capital is volunteer unions of

¹ In the structure of total trade volume share of secondary market is increasing in recent years. According to the data of KSE in 2007 share of secondary market trade in total trade volume was 54.6 per cent.

members aimed at mutual financing of their financial needs. In other words, credit unions are specific financial institutions and they have their specific way of capitalization. Their functioning is based on members' contribution and crediting and accumulating of capital in credit unions take place within the union. At the same time, credit unions have elements of civil organization. In particular, being different from commercial banks, they do not have commercial aim to profit and directed at satisfaction of financial needs through the system of mutual assistance and lending small credits. However, world experience shows that with eventual progress credit unions overcome their traditional border of activity and takes the form of the typical market institutions – commercial banks. Credit unions eventually become participant of open financial market and adapt to the market conditions. Together with this, they still preserve elements of mutual financing of members and, hence, do not represent the fully matured banking structure. Therefore, they are non-banking financial institutions (Bektenova, 2003, p.196). Though became to function only recently credit unions have received widespread usage in Kyrgyzstan. In 2007 year 272 credit unions were functioning and gave credits almost for 22 million USD (see Table 6.7).

Another type of non-banking financial institution that has shown fast growing performance in Kyrgyzstan is the microcredit and microfinance institutions. Their primary object is to contribute to decrease poverty and increase living standard through the entrepreneurship, in particularly small entrepreneurship. Generally, their resource base is accumulated from grants, credits and security issues. Grants are given by donors, they can be programs of bilateral and multilateral assistance, by governments of donor countries, private sponsors etc. Eventually with their stable capitalization credits become the main source of their resource and in some cases credits are given under privileged conditions, i.e. on non market interest rates. Generally, one of the features of microfinance organizations is that credits are given to group of individuals which has the mutual responsibility and, hence, responsible for taken credit as a group. In this case deposit for given loans is not needed, and in practice these credits have high rate of reimbursement.

Since the independence, especially starting from 1998, several state and non state microcrediting organizations have been established, majors of them are:

- Kyrgyz Agricultural Financial Corporation (KAFC)¹;
- Financial Credit Union Support Company;
- State Small and Medium-Size Business Support Fund under the Government of Kyrgyz Republic;
- “Mercy Corps International”;
- Finance Fund “Bai-Tushum”;
- Centers for microcrediting of unemployed residents,
- FINCA-Kyrgyzstan (Foundation for International Community Assistance), etc.

However, legislative base of microfinance organizations was created only in 2002 with the adoption of “The Law on Microfinance Organizations”. According to this law microfinance organizations are entitled to give credits, both of provided with guarantee and not provided, and receive time deposits; have right to run factoring and leasing activities. Advantage of microfinance organizations is that with its specificity of microcrediting they involve rural population and part of population that do small business. Since, usually these parts of the population do not have large opportunity to apply to the commercial banks for loans.

Table 6.7 Credits of non-banking financial institutions
(2002-2007, in million USD)

	2002	2003	2004	2005	2006	2007
KAFC	21.7	28.9	36.7	44.5	54.2	n/a
FCUSC	2.3	3.4	5.8	7.7	9.2	10.2
Microfinancial organizations	n/a	9.8	18.9	36	53.9	114
Credit Unions	5.4	6.5	10.8	14	17.8	22
Lombards	0.146	0.182	0.263	0.334	0.519	0.876
Total	29.6	48.9	72.3	102.6	135.6	147

*Estimations are converted to USD from Som by using nominal exchange rate for each year and rounded

Source: Calculated on the data of NBKR 2003, 2008

¹ KAFC on 27 December 2006 was reorganized into *Aiyl Bank* (Rural Bank).

Microcrediting has a high volume of crediting among non-banking financial institutions. As it can be noted from table 6.7 at least two third of all credits belongs to the microfinancial institutions.

Thus, the system of non-banking financial institutions in Kyrgyzstan is still in immature position. Institutes of collective investing such as insurance companies, pension funds and investment funds are represented by the small quantity and insignificant volume of operation. Organized market of security trade – the KSE is also characterized by small volume of trade and most of the deals do not have the aim to trade with securities, but simply expresses the formal change in ownership. Most developing non-banking financial institutions in Kyrgyzstan are credit unions and microfinancial organizations that have the feature of social mobilization and the instrument for fighting against poverty. However, it should be mentioned that along with this progressive experience these non-banking institutions do not provide with long-term financial resources.

Creation of the new financial system in Kyrgyzstan resulted in establishment of the two tier banking system. Structural reforming of the financial sector in Kyrgyzstan involved the restructuring and radical liquidation of the previous large state banks. Further emphasize has been made on the strengthening of the supervision mechanisms of the banking system. Among non-banking financial institutions credit unions and microfinancial organizations have received wide practice. However, financial resources accumulated by both of the banking and non-banking system are not enough for sustainable development of the private sector. Financial resources are prevailingly characterized as a short term and inaccessible to the wide part of the private sector. Moreover, financial system lacks of the other type of institutions: stock exchange, private insurance and pensions organizations, investment funds etc. These forms of the financial institutions in Kyrgyzstan are underdeveloped and have low scope of the activity. Therefore, financial system of Kyrgyzstan is weak and currently does not provide with enough financial resources for sustainable development of private sector.

6.4 Reform of Public Finance System

Transition to the market economy requires adoption of new role of state in economy, which is reflected in changes of the budget system, taxation and overall fiscal policy.

Reorganization of the budget system in accord to the market principles started from the beginning of independence. Generally changes made to the budget system of the country by mid of 1990th resulted in setting up of the general bases of government budget¹. However, set new legislative were not enough for effective budget system. There were deficiencies in the capacity of budget planning and execution. One of the main problems was in intergovernmental fiscal relations: intergovernmental expenditure and revenue responsibilities were not clearly defined, moreover, local governments were not stimulated in saving and accumulating own revenue sources. Because at that time local budget revenues were mainly formed by subventions from the central budget and the share from the central budget tax revenues, the rate of which was determined differently for each region on the region's revenue potential. Such situation did not promote local governments to accumulate revenues and they just heavily relied on the central budget. As a response to this government with support of the World Bank launched program Public Sector Resource Management Adjustment (PSRMAC). Implementation of the program made treasure system operational in 1996 and integrated into the budget execution process in 1997. But, the main result was the development of project of "The Law on Principles of the Budget", which passed parliament in May 1998. This amendment significantly contributed to modernization of budgeting process. This law being different from previous legislatives defined budgeting procedures in details and set new norms in fiscal relation between central and local budgets. In particularly the latter innovation was important for fiscal decentralization. Since set new norms clarified distribution of public services and revenues between central and local budgets. On expenditures side, three

¹ The first legislative base for government budget in independence was the Law on State Budget adopted in 1991. Later on 10 January 1994 was adopted another law - Law on Principles of the Budgeting Rights. As a result of these legislative amendments system of government budget obtained general characteristics: the system of government budget started to include three components: republican budget, local budgets and extrabudgetary funds¹; standard procedure of approving republican budget by parliament, and local budgets by local governments, and obtaining the power of law after signing by the president. Another institutional arrangement was the establishment of the National Treasure in 1994, which consisted of a central treasury department in the Ministry of Finance and 65 regional offices.

categories of expenditures were defined: those to be delivered by the central budget (security, justice etc), local budget (local services) and mixed services (education, health etc.). On revenue side local budgets' revenue was categorized by three main sources: their own local revenue (local taxes etc.), share from the central budget's tax revenues and transfers from the central budget¹.

This is a generally tendency of the changes in government budget system. However, as a part of the fiscal changes from the beginning of the independence establishment of new tax system has been the important object of reforming. This section is focused on establishment of new fiscal system in Kyrgyzstan. At first, the process of making the new tax system is described. Finally, as a component of the fiscal policy developments in revenue and expenditure side of Kyrgyzstan government budget are discussed.

6.4.1 Establishment of new tax system

Reforming of the tax system of Kyrgyzstan started with adoption of the first Tax Code on 17 December 1991 and put in implementation starting from January 1992. The objective of new tax code was not only to introduce tax system corresponding to the market principles, but also it had to result in maintaining revenue level of government budget under the rapidly recessing economic situation of that time and, hence, narrowed tax base. Indeed, in changing tax sphere with this tax code it was attempted to copy models of tax system of developed market economies.

First feature of the code was that it defined general principles of taxation such as: responsibilities and rights of tax bodies and tax payers, bases of the taxation and tax penalties etc. Secondly, the novelty of the code was the introduction of income tax, the rate of which was set as progressive between 12 and 40 per cent, and corporate tax, the rate of which was also set as progressive between 15 and 50 per cent. Besides these tax types, the code involved regulations concerning the local taxes, obligatory payments and nontax revenues. Following these changes value added tax (VAT) and excise tax was introduced with another amendment

¹ There are 5 taxes that are shared between central and local budgets are: income tax, corporate tax, excise tax, obligatory patenting tax and the unified tax from small enterprises. The rate of share is specified as 35 (for local budget) and 65 per cent (for the central budget).

in March 1992. Rate of VAT was 28 per cent, while the rates of excise tax were determined differently depending on the type of product. In general, reforming of the tax system at this stage helped to reorganize the tax system according to the principles of market economy.

However, despite these novelties the tax system did not correspond to changing economic conditions of that time, radical economic reforms in other sectors and further development of emerging private sector required the new approach in taxation. Because of this the new tax code was prepared with the assistance of World Bank and IMF and put in implementation on 27 June 1996.

New tax code simplified the tax legislation and administrative procedures, and improved internal consistency of the tax system. It incorporated the revised VAT legislation where destination principle was adopted. Also it stipulated new provisions for the income and profit tax, excise taxes and tax administration. According to this code the rate of corporate tax was set as unified at 30 per cent. Income tax's maximum rate was reduced from previously 40 per cent to 33 per cent and was based on the global income together with limitations on deductions and new accounting rules. Excise taxes were changed so that rates on domestic and imported goods were harmonized for most commodities.

In following years Kyrgyz tax system was the object of continuous amendments¹ that in turn was raising the problem of inconsistency and complication in the system. For instance only in 1997 three amendments were made: on 18 March, 7 April and 19 December, which resulted in increase of number of exemptions.

In 2002 maximum rate of income tax and corporate tax rate was decreased to 20 per cent. In the same year, on insist of the IMF about the persistence of revenue level of the government budget, VAT on agricultural lands started to be used. This amendment was hotly debated and finally approved with the limit of being the taxpayer of the tax only up 300 000 som (or about 6 800 USD²). In the same year tax on real estate was introduced³.

The new government formed after the so called "Tulip revolution" of 24 March 2005, declared to take measures to reduce the size of the underground economy. These measures in

¹There are no exact estimations on the number amendments made to the tax system. However, according to some evaluations only by 2001 there were made more than 1000 changes, while others argued about 600.

² Estimated according to the nominal exchange rate in 2003

³ However, it is still not applied to practice, because of the issues on evaluation of value of the object of the tax.

taxation resulted in the amendment made to the tax code in February 2006. It decreased the rates of income tax and corporate tax¹ to 10 per cent and defined them as non progressive. This rate is considered as the lowest among CIS countries. Social insurance tax rate was also decreased to 29 per cent. The reason for such decrease in rate of main taxes is the aim to decrease tax burden and to legalize the underground economy. Changes concerned also local taxes by abolishing some local taxes that were found ineffective².

However, in spite of these measures the tax system is remaining as the object of debate and Kyrgyz government starting from 2000 has been announcing its intention to reform the tax system through different concepts and projects. Almost in all debates on further reforming of the tax system the following points are agreed as the major objectives to be achieved in the new tax code:

- Increase of tax base and decrease of tax burden on private sector so that to provide the favorable environment for private sector development;
- Legalization of the underground economy, the size of which is approximated as above 50 per cent of GDP³.
- Creating stimulus for attracting investment into the economy;
- Improvement of tax administration.

As a result the new tax code was adopted and is under implementation since 1 January 2009. The new code included some novelties: rate of VAT decreased to 12 per cent, number of taxes reduced from 16 to 9, rate unified tax for small enterprises was decreased from 10 to 6 per cent, and tax on real estate is introduced⁴. Along with these novelties some other measures to reduce tax burden on mining and agricultural production, foreign investment are introduced⁵. Moreover, the new code envisages the new regulations on control of taxpayers. In

¹ This 10 per cent rate of corporate income is valid only for residents of Kyrgyzstan, while for foreigners the rate remaining at 20 per cent.

² These local taxes are fees on owners of dogs, on use of local symbols, on right to realize local lottery and auctions, on right for hunting and fishing etc. Instead of these taxes the rate of tax on owners of transport vehicles was increased

³ According to the last evaluation made by UNDP on 2004 data, scale of the underground economy is estimated as 53.5 per cent of GDP.

⁴ However, because of some objections on set rates application of this tax was postponed to 2010 with corrections to rates.

⁵ For example, enterprises working on processing agricultural products, in case of processing their own agricultural products, are not obligated to pay VAT on agriculture. Moreover, part of profit of agricultural

particularly according to official press-releases number of monthly and quarterly inspections is decreased by three times.

Thus, tax system of Kyrgyzstan since independence already passed two periods of reforming in 1992 and 1996, and third period of its development can be considered as started with the recent new tax code. During these changes the tax system in Kyrgyzstan has been constructed according to the basic principles of market economy. Within latest developments government of Kyrgyzstan took serious measures to reduce tax burden and improve environment for private sector developments. One of the important remaining issues is effective tax administration. It is the problem of dialog between public and private sector and, moreover, it needs the corresponding behavioral adjustment of taxpayers. This situation necessitates improvement of not only of the tax administration, but also needs for overall administrative reform in the public sector objected at the efficient contact between private and public sector.

6.4.2 Fiscal policy

In carrying out fiscal policy, as a component of the stabilization policy, the attention has been paid on the reduction of budget deficit through increasing tax revenue and decreasing or maintaining expenditures. This approach is explained by the general framework of stabilization policy, which emphasizes, along with the strict monetary policy, restrictive fiscal policy too.

During the first half of 1990th tax revenue of the budget declined almost twice, whereas expenditure did not decrease at the same magnitude (see Table 6.9). If to take into account the level of central union budget transfer that Kyrgyzstan budget was receiving during the USSR, construction of the new tax system and drop in economic activity, then it was quite expected that revenues would decrease sharply. Increase of tax revenue in ten years, from 1995 to 2005, accounted only for one per cent of GDP, but in last two years tax collection relatively

enterprises that is used in reinvestment is not obligated by profit tax. For enterprises in mining productions accelerated mechanism of amortization is envisaged. Dividends received as a result of investing into national companies are not taxed by income tax. Income tax rate for foreigners' profit that received as a result of serving domestic enterprises is decreased from 30 to 10 per cent.

improved reaching 20 per cent of GDP. However, despite this improvement there is still large gap between potential revenue sources avoiding state budget, which is proved by high rate of unofficial economic activity, and actually collected revenues.

Table 6.8 Main indicators of the fiscal policy (1991-2007, in per cent of GDP)¹

	1991	1995	2000	2001	2002	2003	2004	2005	2006	2007
Tax Revenue	17.5	15.0	11.7	12.4	13.9	14.3	14.8	16.3	17.7	20.0
<i>Of which (in %)</i>										
Direct Taxes	n/a	46.7	34.1	35.5	36	37	35.6	35.8	30.2	27.6
Indirect taxes	n/a	53.3	65.9	64.5	64	63	64.6	64.2	69.8	72.4
Total Tax Burden	n/a	21.9	16.1	16.8	18.6	18.9	19.3	21.2	22.6	24.8
Total Expenditure	31.1	29.7	25.4	22.8	24.8	24.5	24.2	25.2	25.4	29.0
<i>Of which</i>										
Current Expenditures	29.8	25.0	17.2	17.5	18.9	19.6	19.7	21.0	21.0	23.6
Capital Expenditures	1.3	4.8	8.1	5.3	5.9	4.8	4.5	4.2	4.3	5.5
<i>Of which</i>										
Domestically financed	n/a	1.0	1.4	0.9	1.2	1.2	1.1	1.0	1.1	2.0
Foreign financed	n/a	3.8	6.8	4.4	4.7	3.6	3.4	3.2	3.2	2.5
Deficit (-) surplus (+)	4.6	-13	-10.2	-5.9	-5.7	-5.7	-4.7	-4.8	-2.8	-2.5
Tax Revenue/ Total Ex.	0.56	0.5	0.46	0.54	0.56	0.58	0.61	0.64	0.69	0.69
External Debt/GDP	n/a	51	124.6	109.6	114.3	102.6	95	81.4	77.5	63.9
External Debt/Export	n/a	170.5	297.5	299.2	288.3	264.8	223.5	212.5	185.3	137.6
Debt service-to-Export	n/a	10.9	27.0	30.5	20	7.2	6.5	6.4	5.3	4.4

Source: Dombrowski and Antczak, 1994; IMF 1998, 2005, 2007.

In the structure of tax revenues (see Table 6.8) there is a tendency of increasing share of indirect taxes, while direct income taxes have about 30 per cent of total. Such appearance is deteriorating for equity principle in taxation. Indeed, it is the general feature peculiar to most

¹ It should be mentioned that in relation to some weaknesses in statistical data mentioned in introduction in some cases different sources give different statistical data on the economy of Kyrgyzstan. It concerns, especially, the period before 1995 when it was difficult to get reliable data on GDP and other economic indicators in chaotic economic environment and unreliable statistical monitoring. The same issue is valid for public finance data: the IMF reports give different data while NSCKR data are different. For instance, data of the NSCKR show low budget deficit compared to the IMF data. Therefore, in order to give more reliable data it is preferred to use the IMF reports that have two data versions on public finance: state government budget, that includes central and local budget, and general government budget that includes additionally social fund budget, which is extra budgetary fund. This table is constructed on state government budget data of the IMF which is currently available from 1995, while next table 4.9 is based on the general government budget expenditure data.

of the developing countries where indirect taxes contribution to the total tax revenue prevails. It is explained by the fact that the administration of indirect taxes is easier than of the direct taxes, and level of per capita income is not so high in order to bring about significant contribution to total revenue. Additionally, in Kyrgyzstan case numerous exemptions in applying direct taxes, close or bankruptcy of the large enterprises of the Soviet period, high rate of underground economy are also reasons for low rate of direct tax revenues.

Despite recent attempts to increase tax revenue its level remains insufficient. Ratio of tax revenue to budget expenditures is only at 69 per cent. That means fiscal system is not based on the stable taxation system, and other non tax revenues play significant role in financing government expenditures.

On the expenditure side fall continued till 1996 and was followed by the upward fluctuation which in 2007 reached 29 per cent of GDP. Economic classification of expenditures shows that current expenditures are prevailing in the budget – more than 80 per cent, whereas capital expenditures has performed slowly increasing tendency. But most part is financed by external sources. For instance, in 2006 approximately only one fourth of total capital expenditure were financed domestically. In other words state capital investment intervention has been limited. Functional classification of the budget expenditure (see Table 6.9) shows that about 50 per cent of budget expenditure in all observed periods is used on social sphere: education, health, social protection etc. But as per cent of GDP spending on education and health decreased compared to 1991 level, while spending items on general public services and sectors of the economy increased. It shows that the government to some extent could sustain the relative level of social expenditures.

Attempts to restrain budget expenditures have been realized mainly through contraction of wages and transfers. Undoubtedly, contraction of these expenditure items during the first years of transition occurred under the conditions of economic decline. However in following years among other factors the most important one was decrease of real value of these expenditures. Real value of public wages and transfers decreased due to the insignificant increases of wages which were not matched with annual inflation rates. It created situation of very low salary of public servants, and in particularly of education and health

sectors, which consequently had an impact on outflow of staff and deteriorating quality of these services.

Table 6.9 General government budget expenditures (1995-2007)

	1995		2000		2005		2007	
	% of GDP	% of total	% of GDP	% of total	% of GDP	% of total	% of GDP	% of total
Total Expenditures *	30.2	100	29.9	100	28.4	100	32.3	100
General Public Services**	5.8	19.1	6.0	20.0	6.1	21.5	7.5	23.2
Social Spending	15.8	52.3	12.2	40.0	14.5	51.0	17.0	52.6
<i>Education</i>	6.5	21.5	3.5	11.7	4.9	17.3	5.9	18.3
<i>Health</i>	3.7	12.1	2.1	7.0	2.3	8.0	3.0	9.3
<i>Social Security and Welfare Affairs</i>	5.6	18.4	1.9	6.4	2.1	7.4	2.5	7.7
<i>Pension Fund</i>	n/a	n/a	4.8	16.0	5.3	18.7	5.7	17.6
Sectors of the economy***	1.9	6.1	8.2	27.4	5.7	20	6.0	18.6
Other****	6.8	22.5	3.5	11.7	2.0	7.0	1.7	5.3

* Includes PIP (public investment program) and net lending

** Includes following items given in source: general public services, defense and public order and safety affairs.

*** Comprises the following expenditure items: energy complex; agriculture, water resources and forestry; mining and mineral resources; transport and communication; and other economic affairs and services.

**** This item consists of the three main items from original classification: original item called "other" and other two items - housing and community services, recreational, cultural and religious activities - are added.

Source: IMF 1998, 2004, 2007.

Decrease of budget deficit were realized successfully only after 2000 and was reduced to one digit rate reaching 2.5 per cent of GDP in 2007. However, implementation of stabilization policy along with the economic reform programs in other sectors was associated with increasing external debt which in 1999 reached its highest rate - 134 per cent of GDP. But in following years this rate sharply decreased. In spite of this considerable decrease, service of these debts still preserves burden on the government budget.

Analyses show that fiscal policy of Kyrgyzstan as one of the components of the stabilization policy has been used to decrease budget deficit through attempts to increase budget revenue and decrease expenditures. This policy objective to attain low budget deficit was achieved after 2000. But along with this achievement the government budget is remaining weak in terms of the stimulating economy. In particularly the taxation system, as noted above,

heavily relies upon the indirect taxes, tax revenues is not enough to cover government budget expenditures. On the expenditure side state investment capabilities are limited and most parts of the capital expenditures are financed by external sources. Moreover, restraining budget expenditure has been mainly realized through keeping salary in public sector at low rate, which in turn has negatively affected the quality of basic public services, such as health and education. Launch of comprehensive and radical economic programs and implementation of stabilization measures required corresponding financial support that Kyrgyzstan received from international financial organizations and donors. It has resulted in high external debt burden, which at least at medium-term perspective will be additional burden on the government budget.

6.5 Reform of Social Welfare System

Overcoming social costs appeared because of the structural adjustments in the economy during the transition and need to redesign of state approach in providing social services require reforms in sector of social services. Success of these reforms is important because it has political-economy implication, since society unsatisfied with an extent of social costs appeared in transition may block further reforms and, thus, pose under the question successful continuation of reforms to be implemented. Moreover, rising poverty together with deterioration of basic social services results in low quality of human capital, which in turn is detrimental to growth perspectives.

This section focuses on the social protection system and education and health services. We are well aware of that fact the specific research of social sector requires the detailed analysis on each of these topics. However, our object on the social sector is to give a picture of the social sector during the transition so that to understand social implications of economic reforms implemented so far.

6.5.1 State social welfare payments

Under the Socialist system state was considered as responsible for all social guarantees and social protection was universal in its criteria and wide in scope. Moreover, as the system itself was “socialists” such component of the social protection as the social assistance to vulnerable part of population did not exist, and the system was rather focused on managing social risks: retirement, maternity, sick etc. Undoubtedly, universality and wideness of social protection were expensive in terms of budget expenditures. For instance, in Kyrgyzstan in 1990 pensions paid accounted for 6.7 per cent of GDP and family allowances for 3.5 per cent. In contrast, the country’s entire tax and non-tax revenues only amounted to an average 30 per cent of GDP. However, Kyrgyzstan benefited from large transfers from the Union and these permitted the country to have an overall budgetary surplus (World Bank, 1993, p.4).

These large scales of social protection did not correspond to state capabilities under transition period circumstances. Fiscal constraints appeared due to economic downturn, high inflationary and sharp income fall consequences did not allow for state to maintain the previous level of social protection. On the other hand rising unemployment, per capita income drop and increasing poverty level required social support of the government. Under these conditions the priority of social protection policy became to prevent households from falling to poverty level and provision with targeted social protection services.

These new realities for social protection policy were adopted in government strategy by the end of 1992, while before that in 1991 and 1992 government, though started to adjust public spending on income support and social services according to new fiscal situation, did not have clear strategy for protecting social groups during the transition period yet. At the end of 1992 Government drew up Resolutions 539 and 608 setting out some bases for policy towards social protection. For instance, in the former resolution government commits itself to define a minimum poverty line, to carry out regular surveys of the living standards of vulnerable groups, to establish a special service of economic support to the poor and to rationalize cash benefits (World Bank, 1993, p.34).

Introduction of new types of spending items on social protection and redesign of previously existing ones in terms of the eligibility criteria and size of benefits resulted in

nowadays existing social protection system. In a broad sense system of social protection in Kyrgyzstan consists of two components: social insurance system and system of social assistance¹.

System of social insurance helps to mitigate social risks such as unemployment, casualty, retirement or other cases. Therefore, it includes pensions, other social insurance payments (sick pay and maternity benefits), and benefits in case of unemployment. However, among them pensions dominate (see Table 6.10) and issues of pension system are remaining as crucial for social protection as a whole.

Kyrgyzstan inherited a pensions system with low age for retirement (60 for men and 55 for women) that was universal and benefits were enough to meet the minimum consuming budget. Pension system was financed by general government budget. But with fiscal constraints faced during the transition to market economy payment of pension benefits levied burden on the government budget and real values of pension benefits decreased². Moreover, lags in payments and use of goods instead of cash benefits in paying pensions got widespread practice. For achieving financial stability of the pension system it was necessary to introduce the new mechanisms of financing that would be primarily based on the private individual contributions, and not only on the government budget. However, under the low income level and undeveloped financial market conditions private sector participation in pension system was limited. Therefore it was impossible to create the “funded pension system” where pension benefits depend on contributions paid by workers or to rely on appearance of private pension funds formed by voluntary individual contributions.

Because of these reasons Kyrgyzstan chose the so called “conditional funded system”. According to this system contributions paid by workers are accumulated in the individual account of workers. However being different from “full funded system” contributions are not saved, but used for paying current pension benefits, the value of pension, in turn, is determined proceeding from the sum of accumulated contributions. Kyrgyzstan began to realize this system by the adoption of the Law on Pensions in 1997. The law increased

¹ Some analysis note quasi-fiscal social transfers related with the electricity consumption as a third component of social protection.

² For instance, nominal value of average pension benefit paid in 1995, the year of lowest point of fall of GDP, accounted only for 51 per cent of minimum consuming budget.

retirement age¹ and eliminated some privileges, in particular the early retirement right for some occupations.

Table 6.10 Social protection system expenditures (1995-2007, in per cent of GDP)*

	1995	2000	2001	2002	2003	2004	2005	2006	2007
Social Insurance	8.1	4.8	4.6	5.26	5.23	5.04	5.27	5.28	5.04
Pensions	7.2	4.4	4.39	5.0	4.98	4.82	5.04	5.05	4.86
Unemployment Benefits	0.2	0.2	0.05	0.05	0.04	0.19	0.03	0.03	0.03
Other Social Insurance Exp-es	0.7	0.2	0.17	0.21	0.21	0.03	0.2	0.2	0.14
Social Assistance	4.0	0.4	1.25	1.74	1.48	1.36	1.38	1.48	1.23
Total	12.1	5.2	5.85	7.0	6.71	6.4	6.65	6.76	6.26

*Includes expenditures from government budget and social fund

Source: NSCKR 2008a, 2008c, 2008d; World Bank, 2004.

Results of pension reforms made so far is financial stabilization of the system and reduction of government debt on pensions, payments has been stabilized by abolishing lags in payments and practice of non cash payment. At the same time expenditure on pensions as a percentage of GDP decreased from 7.2 per cent in 1995 to 4.86 per cent in 2007. However, reforming of the system did not result in effectiveness and in increase of the average pension value that is still below the minimum consuming budget². Pension contributions paid by individuals are not enough for financing pension benefits and government budget transfers are used systematically. Additionally, employed labor force in unofficial economy and migrants

¹ Retirement age was set as for men from 60 to 63, and for women from 55 to 58. However in March 2007 another amendment was made which decreased retirement age to 60 for men and 55 for women again starting from 2008. But government officials worry about the potential increase of burden on Social Fund, which is responsible for pension benefits, and consequent misbalance in the pension system and now there is debate on back to the old age of retirement that is 63 for men and 58 for women. Also the law defined pension benefits with three components: 1) Granted basic pension for each pensioner which should not be less than 12 per cent of average wage. This component has the feature of social protection; 2) Second component of pension is designed for transition from old system to the new system by being based on the wage rate and estimated as the one per cent of wage received before 1996; 3) Third component is completely based on the “conditional funded system” principles, in other words value of pension depends on the contributions accumulated in account of pensioners

² For instance in 2007 the average monthly pension covered only 46 per cent of minimum consuming budget for pensioners.

working abroad¹ are not involved in the pension insurance that means not only loss of financial resources but also unrealized social insurance for future pensioners.

Second component of social protection is the social assistance programs that imply support for vulnerable parts of population. Being different from the social insurance the system of social assistance during the Soviet period was not developed. Since, real hardships were rare and resources were ample to enough to ensure assistance (World Bank, 1993, p.88). Social assistance system came to play important role with transition when with the economic downturn groups of population needed for social assistance emerged. In other words, system of social assistance in Kyrgyzstan formed during the transition and, nowadays, comprises cash benefits, subsidies and price exemptions with the aim to support low income part of population². System of social assistance compared with the social insurance programs is devoted with less share of GDP which in 2007 was 1.23 per cent (see Table 6.10). Analysis of World Bank shows that the system is poorly targeted and unduly low. Most extremely poor families receive no help and much help goes to non poor families. Additionally benefits are typically small and administrative costs per som of targeted assistance delivered appear high (World Bank, 2004, p.101).

Thus, during the transition of Kyrgyzstan to market economy the new expenditure items have been introduced within social assistance program. However, the social welfare payments system currently is not considered effective in terms of both value of paid benefits and quality of targeting social assistance. Correspondingly, in further perspective improvements in this aspect require increase of financing of the system and rationalization of benefits that should take into account better targeting of social payments.

¹ There is no exact data on the number of migrants working abroad, but according to unofficial assessments they vary from 500 000 to 1 000 000 or from about 10 per cent to 20 per cent of population of Kyrgyzstan.

² There are two types of cash benefits: Unified Monthly Benefit (UMB) and social benefits. UMB was introduced in May 1998 with adoption of The Law on State Benefits as the basis for a simplified and unified cash social assistance policy. UMF is designed to guarantee a minimum income under means testing, and is to be adjusted annually in line with an assessment of needs and available fiscal resources. While social benefits are cash allowances paid for defined category of disables (such as invalids, families with invalid children, orphans etc). In addition to these payments there are two kinds of subsidies. First one is called “scheme of socially protected prices” and used to protect low income families living outside of the capital city against price increases in gas, heating and water supply services, entitled families pay discounted price and remaining part is paid from the state budget. Second one is called “housing subsidies” and used for families in capital city, for which cost of housing services accounts for more than 27 % of total income. There are other subsidies for some categories of population in terms of the price exemptions in buying drugs, communication, medical and transport services.

6.5.2 Health

It is undeniable fact that the Soviet system had the strong infrastructure of education and health care system. Equitable access to health and education services for all the population was one of the main priorities of social policy during the Soviet period. These services were provided free of charge and, at the same time, ample system of social transfers existed. But functioning of the system, as all other sectors of the economy, was based on central planning principles. Such approach resulted in structural problems that did not match with an idea of market economy and caused difficulties in carrying out health services in transition period. The World Bank report (2004, p.60) points out the following structural problems of the health system that Kyrgyzstan inherited from the Soviet period:

- Excessive reliance on specialized hospital care, which was expensive sector of the health care system, while primary and preventive health care services remained weak;
- Health care system was unbalanced with too many hospitals and too few general practitioners and primary care facilities;
- Most health programs were structured vertically and were poorly coordinated;
- The perverse incentive in allocation of resources that lead to the wasteful and uneven allocation of resources among regions. At first, sum of resources to be received by hospitals depended on the number of registered beds that they had. This created incentives to retain unnecessary beds and to allocate not on actual needs but on input needs of existing health facilities. Under these circumstances hospitals with large facilities received large amount of resources, while with limited inputs received relatively less resources, hence causing uneven allocation of resources.

With such properties health system became ineffective under the conditions of transition to market economy and narrowed state revenue capacity made it unsustainable in terms of the fiscal resources. In order to reform health care sector Kyrgyzstan government adopted comprehensive program “Manas” in 1996, which was developed with contribution of international donors, such as the World Health Organization (WHO) and United States Agency for International Development (USAID), and was implemented with the main financial support of the World Bank. The program was projected for 1996-2006. Currently

another program “Manas Taalimi” is under the implementation, which is projected for 2006-2010 period and was prepared on the principle of succession of the previous program. Components of the reform implemented so far can be analyzed in two aspects: changes in the organization of health services and changes in methods of financing the system.

First measures of the program were focused on the reduction of number of facilities and staff. It was noted as a “rationalization” of excessive capacity. This brought about reduction of number of beds and medical staff (see Table 6.11). But it should be mentioned that decline in number of medical staff was partly occurred due to volunteer dismissal caused by low salary in the sector.

However the main concern of structural changes within the health care system was strengthening of preventive and primary care, since according to analysis the previous system with concentration on specialized hospital care was too costly. This concern resulted in creation of family group practices (FGPs) that provide integrated primary health care services. FGPs were designed to replace the former network of separate polyclinics for woman, children and adults and reduce the fragmentation and duplication of these services. All citizens of the country are entitled to free primary care as long as they seek primary care from an FGP with whom they are enrolled (World Bank, 2004, p.63).

On part of financing health care the main novelty was introduction of the Mandatory Health Insurance Fund (MHIF) as an off budget agency in 1997. It was designed to mobilize additional resources for health services and to institute an insurance basis for the risk pooling of health user charges. The MHIF derives revenue from a 2 percent payroll tax for most employees, paid by employers and collected by the Social Fund. The MHIF works on the basis of contract agreement made with the medical organizations. Nowadays it includes all the FGPs and most part of the drugstores. According to the MHIF report (2007, p. 1) almost 99 per cent of population of Kyrgyzstan have access to medical services governed by the MHIF.

However role of the MHIF is not limited with providing additional source of financing, with introduction of the so called “Single Payer”¹ system in health care role of the MHIF as an administrator of health care funds became important. Under the “Single Payer” system the

¹Although this system involves several new features compared to the previously existing system, it is named as “Single Payer” after one of the principal characteristics of the new system that pool all local funds for health in one source – MHIF.

health sector was divided into “providers” – those who give health services: hospitals, FGPs etc, and “payers”- those who pay for services. In this case the main “provider” is the Ministry of Health and the main payer is the MHIF. All funds from local budgets for health are pooled within the MHIF, which in turn uses output-based purchasing (capitation for primary care and case-based payment for inpatient care) to contract with health care service providers. Providers on their own part have more flexibility in the use of funds. In other words, it was an attempt to introduce principles of payments that create incentives for health service providers to be effective and cut costs.¹

All of these changes have been implemented under the decreasing public financing for health sector. If in 1990 expenditure from the government budget on health services was 4.1 per cent of GDP, then in 1995 it was lowered to 3.7 per cent, period from 2000 to 2005 was very critical in terms of the level of government financing (see Table 6.11). Despite the increases of last two years it did not attain even the level of 1995. The MHIF, which had to serve as an alternative source of financing, have not fulfilled that task yet. Level of the MHIF financing did not reach even 1 per cent of GDP. Under decreasing public expenditure conditions inevitably rises the share of private expenditures on health care. The World Health Organization (2009, p.110) data show that in Kyrgyzstan the share of private expenditure on health has increasing tendency and in 2006 accounted for 57 per cent of total expenditure on health. Moreover, 94 per cent, of this private expenditure on health in Kyrgyzstan consists of the so called “*private out-of-pocket*” spending that refers to the direct outlays of households and includes official co-payments and informal charges, such as gratuities other in-kind payments, paid by users of health services. These payments levy high financial burden on low income households².

Low level of public financing resulted in low wages for health personnel which has the lowest average level among sectors of the economy. Table 6.11 shows that the average wage

¹Another important change under the “Single Payer” system is the formalization of co-payments paid partially by consumers, for drugs and food during the inpatient care and for some medical services. With this formalization it was tried to reduce informal payments that became important and widespread in paying for medical services by population.

² Though, there is no time series data on the correlation between the private payments on health services and financial burden on the low income part of population, most of the observations and indirect data agree on this conclusion. For instance World Bank (2003, p. 128) notes approximately 33% of people in the Kyrgyz Republic borrowed money, or sold livestock or produce (in rural areas) to finance the cost of receiving inpatient care.

in health care accounts for only 60 per cent of general average wage in the economy, in particularly this situation worsened in years between 2000 and 2005, in last two years there is small improvement but it is still considered very low¹. Under the low wage medical staff began to rely on informal payments of patients or leave the job, which in turn reflected in corruption and deficit of staff, especially in rural parts. Also renewing of basic medical supplies and equipments is seriously delayed. All of these negative appearances resulted in decreasing quality of health services.

Table 6.11 Indicators on health services (1990 – 2007)

	1990	1995	2000	2001	2002	2003	2004	2005	2006	2007
Government Budget ¹	4.1	3.7	2	1.9	2	2	2	2.3	2.7	3
MHIF ²	n/a	n/a	0.2	0.2	0.2	0.3	0.3	0.2	0.5	0.4
Nominal wage ³	n/a	0.8	0.5	0.5	0.5	0.5	0.5	0.5	0.6	0.6
Hospital Beds ⁴	118	91	74	66	58	56	54	54	54	54
Doctors	34	33	29	28	27	27	27	26	25	25

¹ Ratio of general government budget expenditures on health services to GDP.

² Ratio of the Mandatory Health Insurance Fund expenditures financed by revenues received from the Social Fund to GDP.

³ Rate of nominal wage in health to average nominal wage in the economy

⁴ Number of both of hospital beds and doctors are given per 10 000 individuals of population.

Source: IMF 1998, 2004, 2006, 2007; NSCKR 1996, 1998, 2006, 2008(c); NSCKR database (<http://www.stat.kg/rus/part/zdrav.htm>); World Bank 1993, 2004.

Thus, reform in health care system of Kyrgyzstan that started in 1996 was designed to change the system according to the new economic realities. Comprehensiveness of the reform package and its implementation was considered by international donors as a possible future model for health reform of other economies in transition. However, despite these quite positively expected prospects health system of Kyrgyzstan did not meet all expectations and health services' quality has deteriorated. One of the main reasons for that has been lack of state financing which in observed period decreased².

¹ According to the NSC data in 2007 average nominal wage in health sector was 2489 som or about 68 USD.

² Also there is a critique of the new system. It is argued that the introduced new system of Family Group Practices (FGP) did not take into account the local specific of Kyrgyzstan. Since FGP assumes practices to have knowledge not only in one of health care such as at the same time in therapy, pediatrics and cardiology, while

6.5.3 Education

During the Soviet period Kyrgyzstan achieved significant results in education that brought about high literacy rate. Education was free at all levels and was mandatory up to grade 11. Higher education students were provided with jobs after graduating and they could expect to keep these initial jobs through their working lifetimes. Access to higher education was limited, with fewer than one-fifth of secondary school graduates going on to higher education. Correspondingly, such system of education was provided by large state expenditure that, for instance, in 1990 accounted for about 8 per cent of GDP (see Table 6.13).

Education system of Kyrgyzstan, as a heritage of the Soviet system, comprises pre-school education for children, between 1 and 6 of age, basic education school (grades 1 through 11) and higher education. Basic education in turn consists of: primary education (grades 1 through 4), lower secondary education (grades 5 through 9) and upper secondary education (grades 10 through 11). Also after grade 9 the system includes professional technical schools (PTUs) and special secondary schools (*technicums*). PTUs are vocational schools that offer skilled worker qualifications, while *technicums* offer high-level training for master craftsmen.

Transition to market economy brought about new challenges for education system. Education system needed to adapt to new environment, where new areas of employment were emerging. For example, in particularly in higher education it was necessary to expand in new areas required by the new realities of the economy, such as business administration, economics, foreign languages etc¹. Another challenge was related with financing education sector. In a situation of decreasing state revenue and large-scale of state education system inherited from the Soviet period it became difficult to sustain the previous level of financing. Moreover, transition to market economy implied the possibility of introduction of market

medicine system of Kyrgyzstan had been focused on qualifying doctors specialized in one area, for instance only in pediatrics, and an attempt to re - qualify them into family group doctors in short period of time by training this staff inevitably results in low quality of health services.

¹Also there was methodological challenge in education. In other words education system inherited from Soviet period was criticized as not being conducive to development of critical thinking capacity and rather was based on the specific occupation skills. Therefore it was considered that with transition to market economy one of the challenges was to change content of education programs.

mechanisms in education services too. However, the major challenge was to retain achieved quality of education services and to develop it further.

The first step of reforming in education system was an adoption of the Law on Education in 1992. The law introduced considerable changes to the previous system. In particular, supply of education services by private sector and different sources of finance, other than government budget resources, were allowed. Kyrgyz government launched several programs to modernize the education system and to improve education services. First and most comprehensive among them was the national educational program “Bilim” implemented in 1996-2000 years. The program was supported by the Asian Bank of Development (ADB) and was oriented at the creation of necessary normative-legislative base for education system for its development in market economy conditions, to sustain common access to basic education, provision with the sustainable financial resources, to maintain quality of education services etc. Another program - the Presidential program “Staff of XXI century”, launched in 1996 too, was designed to train and prepare new generation of specialists that are required by new conditions faced by the country and attraction of alternative sources, i.e. international donors, to education sector through implementing educational projects. Also some other programs were launched such as: “Jetkinchek” (1999) oriented at improvement of access to education and support of socially vulnerable parts of population to benefit from education services; objective of the program “Rural Schools” (2003) was to develop basic education in rural parts of the country. Additionally, programs launched in other fields of social development included some aspects of education too. For instance, such programs as: “Aialzat” (1996-2000) for gender development, “Araket” (1998) for poverty decrease, “Jany Muun” (2001) oriented at issues of child rights etc., covered issues of improvement of basic education, access to education services and nurture.

Under the light of social and economic changes of transition period education system has had considerable changes. At first there have been significant changes in the number of educational organizations. Table 6.13 shows the number of education organizations and number of students in 1990-2007 years period. Number of pre-school organizations reduced about threefold, from 1696 in 1990 year to 474 in 2007 year. In the Soviet system pre-school organizations generally were attached to public enterprises and in early transition as these

enterprises faced financial pressure most of them were closed. In contrary to this, number of universities and basic education schools increased. Increase of basic education schools is result of the demographic growth and, hence, additional demand for basic education services. However increase in number of universities is significant: in 1990 there were only 9 higher education institutions that in 2007 reached 49, of which 16 are private. Such growth in number of universities was achieved due to new private universities and branches of different universities with the new areas of studying. These changes in number of educational organizations have been reflected in education coverage. Number of children covered by the pre-school education by the end of 2007 was low almost four times compared to 1990. In contrary to this, in the same period number of high education students significantly increased (see Table 6.12). Such appearance in high education might have been expected to positively contribute to enlargement of education programs in new areas, in particularly in social sciences, increase in high education rate in general and potential competitive environment among universities.

Private education services started to grow since the mid of 1990s and got relatively large application in higher education, covering 10 per cent of higher education students. However, generally the share of private education organizations in terms of the number of students is remaining low, in pre-school accounting for almost 1 per cent only and in basic education 1.5 per cent of total students. But it should be noted that such relatively small share of private education organizations does not imply absence of any fee payments by students for education services in public (or state) education organizations. Under the conditions of decreasing public financial support public education organizations became to rely on formal and informal payments. Basic education schools also have been authorized to charge money for the rental of facilities and other activities, pupils have been required to purchase or rent textbooks, which previously had been provided free. The government also instituted a system of contracted, fee paying education within public universities and specialized upper secondary schools (World Bank, 2004, p.80). In particularly in higher education along with the public education departments financed by government budget there is a system of “contract education”. Students of this system pay per year fee and about 75-77 per cent of students in higher

education study by contract¹. Therefore, along with private education mechanism of fee payment for education services has been introduced in public education too.

Table 6.12 Number of education organizations and students in Kyrgyzstan (1990-2007)

	1990	1995	2000	2001	2002	2003	2004	2005	2006	2007
Number of education organizations:										
Pre-school education	1696	456	416	407	416	417	440	448	465	474
of which private	n/a	n/a	6	5	5	5	5	5	6	6
Basic education schools	1759	1886	2005	2048	2052	2073	2104	2137	2149	2168
of which private	n/a	19	27	31	20	25	35	50	56	55
Higher education	9	32	45	48	46	47	49	51	47	49
of which private	n/a	10	15	16	15	16	16	18	15	16
Number of students* :										
Pre-school education	486	102	94	92	92	95	100	106	114	120
of which private	n/a	n/a	0.9	0.9	0.7	0.8	0.8	0.7	1.0	0.9
General education schools	2164	2153	2302	2285	2342	2292	2224	2173	2110	2067
of which private	n/a	0.2	0.4	0.3	0.3	0.4	0.6	0.9	1.3	1.5
Higher education	135	143	388	423	399	403	429	450	457	479
of which private	n/a	11.5	7.6	7.5	7.2	7.4	7.2	7.6	8.8	9.9

* Number of students are given per 10 000 individuals of population. "Of which private" refers to the per cent of students of private educational organizations in total number of students of relevant category.

Source: Calculated on the data of NSCKR database (www.stat.kg/rus/part/obr.htm).

Public financial resource devoted to education was declining almost all the first decade of transition and reached to its critical point in 2000 year - 3.5 per cent of GDP (see Table 6.13). In spite of the appreciable increase in government expenditure on education in last recent years situation in education system is remaining critical. Decline of public finance in education caused deficit of elementary equipments, in particularly in basic schools, such as

¹ Although there is no available data from the National Statistical Committee of Kyrgyzstan on students of contract education, World Bank (2004, p.96) and National Report on Higher Education (http://educasia.net/educ_ca/kg/reports_kg/natotchet_kg/) refer to this rate.

textbooks¹ and other educational materials, along with the practically insignificant level of capital expenditure, lead to the physical deterioration of schools. Also low public financing resulted in low salaries of teachers that in relative terms decreased to 60 per cent of average wage in the economy². It led to lack of motivation and demoralization of teachers and non perspective popularity of teacher profession among the new generation. The latter effect particularly has negative impact on pre-school and basic education schooling and has caused the deficit and aging of staff³. Most of the young people do not prefer this profession and, moreover, most of the graduate students of this specialization do not work on their specialty. In higher education low salaries have contributed to a serious problem of corruption that got widespread usage where bribes are often paid for admission or for grades to teachers.

Table 6.13 Government expenditure and nominal wage in education sector (1990- 2007)

	1990	1995	2000	2001	2002	2003	2004	2005	2006	2007
Government Budget ¹	8.2	6.5	3.5	3.6	4.2	4.2	4.6	4.9	5.6	5.9
Nominal Wage ²	n/a	0.8	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.7

¹ Ratio of general government expenditures on education to GDP

² Rate of nominal wage in education to average nominal wage in the economy

Source: IMF 1998, 2004, 2006, 2007; NSCKR 1996, 1998, 2006; World Bank 1993.

All of these negative appearances resulted in decreasing quality of education services. Although there are no systematic criteria and data on the quality of education in Kyrgyzstan, most analysis, reports and observations agree upon this fact. For instance, according to Minister of Education report performance of general education schools' pupils in last six years decreased sharply, in particularly of primary schools in twice and of secondary schools three times⁴. Lack of pre-school organizations in most regions, especially in rural parts, brings about

¹ For instance recently Minister of Education reported that level of provision of general education schools with textbooks is ranging from 39 to 52 per cent of needed.

² Average nominal wage in education according to NSCKR data in 2007 was 2959 som or about 80 USD.

³ For instance, according to the Ministry of Education and Science in pre-school education half of the teaching staff is in age above of 45 year, and about 28 per cent is above 64 year.

⁴ (<http://www.24.kg/community/2008/03/26/80253.html>)

the low level of preparation of children for education¹. Large number of universities under the conditions of low level of financing and weak regulative approach of the state became to work without corresponding equipment and staff, resulted in the low level of higher education services. Moreover, such large number of high education institutions and universities with low quality of education and corrupt activities brought about the low public consideration of the significance of higher education diplomas.

Therefore, along with changes in number of education organizations and in coverage with education services method of financing has changed. However, all of these programs were undertaken under the low public financing conditions and, hence, number of launched programs did not result in significant positive results. In contrary education system deteriorated with low quality of education services. Undoubtedly, low quality of education services has deteriorating effects on human capital of the country that has long lasting consequences on economic development of the country.

Analysis in this chapter shows that structural reforms have received comprehensive feature along with the liberalization of the economy. First and second periods of privatization process described in the chapter have been featured with mass privatization programs. In the same manner agricultural reforms were comprehensive and included privatization of the *kolkhozes* and *sovkhozes* and land reform. In particularly, in both of the privatization programs generally and in reforms of agriculture as one of the strategic objectives was mentioned creation of private ownership. Such objective in the comprehensive reforms is explained, to some extent, with an idea of creating critical mass of private owners that would provide base for market economy. Financial sector reforms associated with reorganization of large state banks resulted in the establishment two tier banking system, emergence of some non-banking financial institutions and central bank regulative instruments have been set. Public finance system changes have been mostly related with novelties introduced in taxation and government budget system. Also analysis of reforms in financial and public finance system demonstrates that monetary and fiscal policies have been tight in order to control inflation. Changes in

¹ According to Timothy Shuffter, the UNICE representative in Kyrgyzstan, in rural parts only 4.1 and in urban 4.8 per cent of children of pre-school age come to school as prepared for education (<http://www.24.kg/community/2008/05/14/84559.html>).

social welfare payments introduced new types of social protection expenditure items and redesign of previously existing ones in terms of the eligibility criteria and size of benefits. Comprehensive health reforms launched in 1996 and several programs were undertaken in education aimed at modernization of education system and education services. However, the common issue for almost all reform attempts in sector of social services has been the lack of government finances.

Therefore, economic reforms in Kyrgyzstan have followed the advices of supporters of radical and comprehensive reforming that emphasized liberalisation, stabilisation and privatisation. Expectation from such reforms was economic recovery, if not in the short term than in the medium term, and further economic performance with the dominance of effective private ownership. Next chapter analysis how much this expectation has been fulfilled.

7. ECONOMIC OUTCOMES OF REFORMS

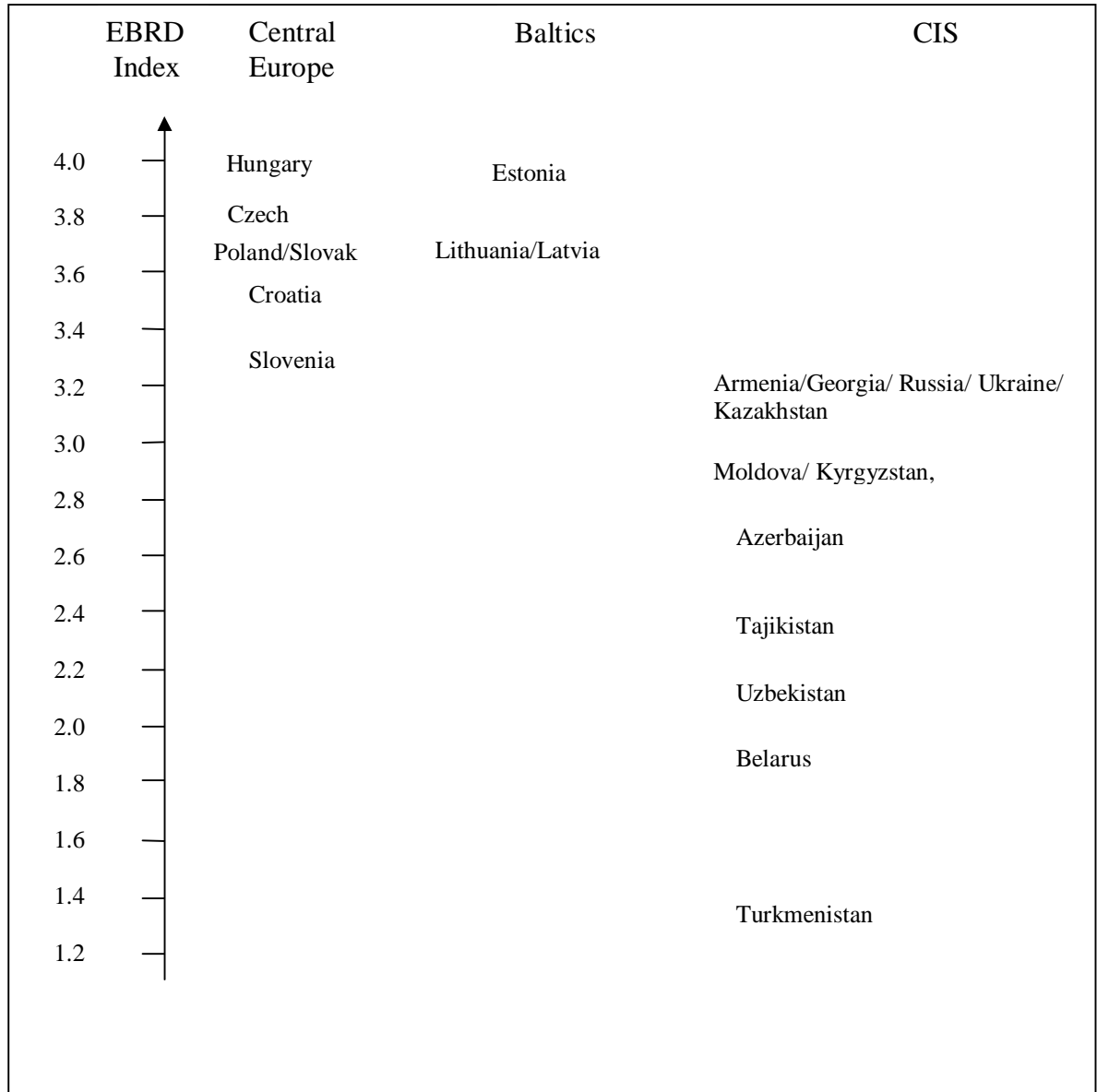
As mentioned previously expectation from economic reforms was that it would result in early recovery of the economy from transformational crisis and further strong economic performance with effective private ownership. Though transition to market economy in Kyrgyzstan is not completed yet, it is possible to evaluate economic performance expected from the main structural reforms implemented so far. This chapter focuses on the economic performances in Kyrgyzstan since 1996. At first growth in terms of sectors of the economy is analysed. Then investment activities, in particularly FDI, and the banking sector activity are analysed. Finally, scale of social costs and the capacity of economic performance in their reduction are examined. However, before that in order to give the general comparative picture of Kyrgyzstan with other transition economies in implementing structural reforms it is useful to look at the EBRD transition indicators.

7.1 Progress in Transition Indicators

Principally the appraisal of transition to market economy may require individual approach to each economy and may differ in used quantitative and qualitative measures. Transition indicators reported by the European Bank of Reconstruction and Development (EBRD), which is specialized on transition economies, represents measures of transition indicators for 25 transition countries on the main areas of reforming. Therefore, this is convenient in terms of the sector based analysis and international comparisons.

Figure 7.1 presents average of the indicator for CIS, Baltic countries and for some Central Europe transition economies. Indicator ranges from 1 to 4 and over, 1 indicates low performance, while 4 and upper points note the typical standards and performance of advanced economies. Putting it differently, generally low performance is characterized as little introduction of market mechanisms with heavy state control, while high performance is conceived as large commercialization and decentralization with driving force of private entrepreneurship.

Figure 7.1 EBRD transition indicators 2007¹



Source: EBRD database (www.ebrd.com/country/sector/econo/stats)

As shown Central Europe and Baltic countries show high performance, compared to CIS countries, and some of them, such as Estonia and Hungary have almost reached the high performance – “4”. Most of the CIS countries are ranked between 2.8 and 3.10 and can be

¹Motivation of this figure is Havrylyshyn (2004, p. 40)

considered as moderately progressed. Position of Kyrgyzstan with its 2.93 average point is moderate as well. Among Central Asian countries it has high points together with Kazakhstan, while Tajikistan, Uzbekistan and Turkmenistan performed low level of progress, in particularly the latter. In other words, Kyrgyzstan under the light of the progress of non - CIS transition economies is moderate, nevertheless, among Central Asia countries its position is quite distinct. Details of this indicator for Kyrgyzstan in terms of the main reforming sectors are given in Table 7.1.

Table 7.1 EBRD transition indicators: Kyrgyzstan 1991-2007*

	1991	1995	2000	2007
Enterprises				
Large scale privatisation	1.00	3.00	3.00	3.67
Small scale privatisation	1.00	4.00	4.00	4.00
Enterprise restructuring	1.00	2.00	2.00	2.00
Markets and Trade				
Price liberalisation	1.00	4.33	4.33	4.33
Trade & Forex system	1.00	4.00	4.33	4.33
Competition Policy	1.00	2.00	2.00	2.00
Financial Institutions				
Banking reform & interest rate liberalisation	1.00	2.00	2.00	2.33
Securities markets & non-bank financial institutions	1.00	1.67	2.00	2.00
Infrastructure Reform**	1.00	1.33	1.33	1.67
Telecommunications	1.00	2.00	2.33	3.00
Railways	n/a	n/a	1.00	1.00
Electric power	1.00	2.00	2.33	2.33
Roads	1.00	1.00	1.00	1.00
Water and waste water	1.00	1.00	1.00	1.67

* EBRD index classification is as following: "1" is a little private ownership or progress in enterprises, extreme state control in market and trade, and little progress in financial institutions. While "4+" is typical of standards and performance of advanced industrial economies.

** Infrastructure reform rating is calculated from the five infrastructure reform indicators covering electric power, railways, roads, telecommunications, water and waste water.

Source: EBRD database (www.ebrd.com/country/sector/econo/stats)

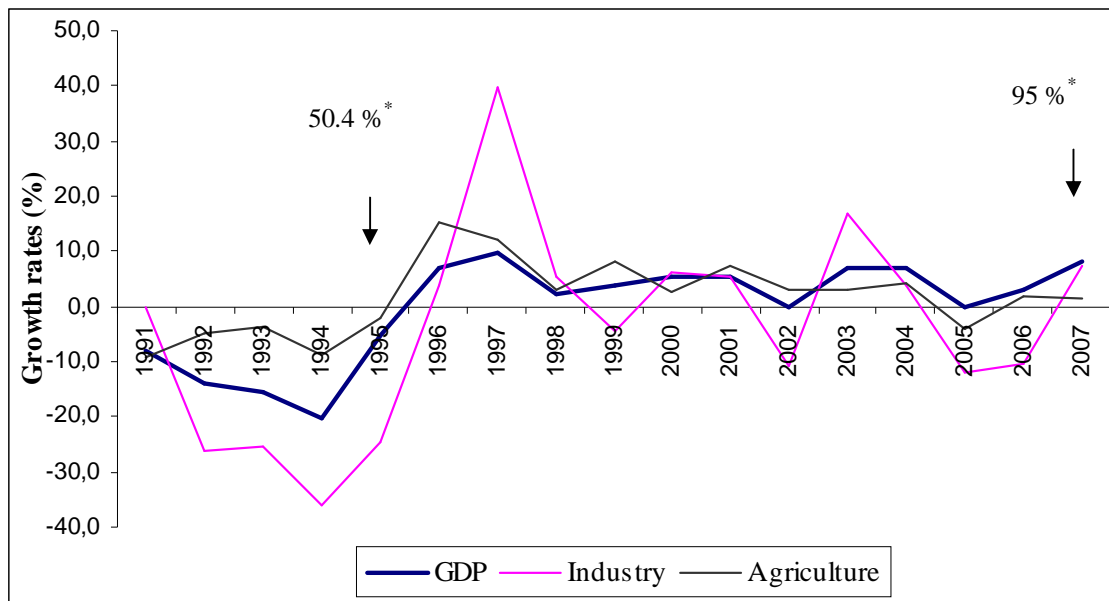
According to these data by 2007 sector of enterprises is characterized as progressed in terms of the privatization, especially in small scale privatization, while lacking in effective governance and restructuring. This explained with weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance. Trade and price liberalization is considered as complete and rated as typical standards and performance of advanced industrial economies. Competition policy is characterized with set up legislation and institutions, but there are no significant enforcement actions to reduce market power and to promote competitive environment. Financial institutions are also rated at medium level. Which state that, though basic elements for the establishment of effective financial institutions such as liberalization of interest rate and credit allocation, required formal legislative and formation of securities exchange, are implemented, there are still missing points in the necessary regulatory framework and legislatives, and capacity of the financial system is weak . Among the given sectors infrastructure in general received the lowest rate. It is described as low commercialized with the dominance of the state and its direct regulation. However, telecommunications differ with its substantial progress in commercialization and liberalization in mobile segment. In electric power sector, though the power company is distanced from the government, it is featured with weak management, little institutional reform and minimal private sector involvement. Remaining sectors, roads and railways, show little progress.

Thus, there are two main conclusions from these indicators. First, advanced progress is achieved in privatization and trade and price liberalization areas. However, in other spheres, namely in competition policy, banking sector, securities markets, non-bank financial institutions and in objects of infrastructure rate of progress of transition is slow. Since progress in these areas requires not only the deregulation or minimization of the state involvement as in the privatization and liberalization, but also institutional restructuring that takes longer time. Second, first five years of reforming were effective in terms of the rate of growth of indicators. For instance, in five years small scale privatization and liberalization indexes achieved high performance rate, while rates achieved by other sectors did not change substantially in later periods. It proves again that Kyrgyzstan implemented rapid privatization and liberalization program packages.

7.2. Economic Growth Performance

Transformational economic crisis in Kyrgyzstan which prolonged for five years was so severe that in 1995 the economy reached its lowest level of downturn. GDP in 1995 year accounted for 50.4 per cent of its 1989 level (see Figure 7.2). 1996 year was breaking point from recession to recovery showing 7.0 per cent of growth rate. Since this year to onwards growth performance is characterized by slight ups and downs. In particularly, in 1998 because of the Russian crisis growth rate slowed down, in 2002 it showed zero performance due to the accident in *Kumtor* gold mining enterprise, and political instability in 2005 resulted in negative growth rate. During 1996-2007 the economy was growing by 4.9 per cent per year in average. Such tempo made possible to increase GDP in 2007 to 95 per cent of its 1989 level, i.e. pre-transition level was not attained yet.

Figure 7.2 Real growth trends: GDP, industry and agriculture (1991-2007)



* Estimated level of real GDP in 1995 and 2007 in per cent to its 1989 level

Source: ERBD database (www.ebrd.com/country/sector/econo/stats); Fisher and Sahay, 2000, p.34.

In order to understand origins of growth in this period it is useful to look at performance of two main sectors of the economy. Comparison of growth tendencies of agriculture and industry sectors shows that the agriculture performed more stable growth (Figure 7.2). In particular, in 1995-2001 years agriculture appeared as a driving force of growth of the economy and recovered from transformational crisis decreases¹. However, in following years rate of growth of agriculture slowed down, and even in 2005 showed negative performance. Such two staged growth of agriculture is explained with impulse for growth created by the reforms in agricultural sector in 1990s: restructuring of agricultural enterprises and land reform. The newly created private ownership in agriculture increased productivity of land by using labor-intensive techniques. However, these effects were not long lasting. Under the conditions of rising unemployment farming became the option to be employed for most of the citizens². High concentration of employment in agriculture sector³ productivity of labor started to decrease. Improvement of such situation requires investments into new technologies and renew of technical infrastructure. But agriculture has faced the problem of lack of investments, limited access to financial resources, markets for sale of products and non existence of developed agricultural product processing industrial enterprises. Furthermore, small scale farmers – the main type of farming in Kyrgyzstan – do not promote application of mechanization and technology in agriculture that could rationalize production. Most small-scale farmers are characterized as subsistence agriculture where much of the output is not marketed, but consumed by farmers themselves or used for barter deals. This production structure contrasts sharply against corporate or commercial farming, where all outputs are sold at market prices, and the owners use farm proceeds to purchase food and shelter separately. The resulting business structure is one of limited risk-taking. Because small-scale, subsistence farmers face greater risks (e.g., starvation) by growing new crop types or experimenting with different inputs, these farmers choose the least risk, even if it implies lower household income (Light, 2007, p.20).

¹ Production of agriculture sector exceeded 1991 level in 2001 by accounting for 102.8 per cent.

² Light (2007, p.12) argues that agriculture in Kyrgyzstan de-facto became the country's welfare system. Since for most of the unemployed agriculture became the only source of living and workers decided that it was better to farm on a small peasant parcel, eating part of the output and selling the surplus, than to remain unemployed.

³ According to the NSCKR data for 2006 year 36.2 per cent of total employment was employed in agriculture.

Industrial sector suffered deeply from recession of the economy reaching its highest level of decrease at 36 per cent in 1994. In post crisis period the highest rate of growth of this sector was 39 per cent in 1997. This jumping performance in industry was the result of introduction of *Kumtor Gold Mining* project, production of which became important component of industrial production, export and, therefore, of growth of the economy¹. In following years there were no such large investments into industrial sector. In general growth of industrial sector in post-recession period was unstable compared to agriculture and several times resulted in negative growth (Figure 7.2). As a result structure of industrial production which was distorted by economic crisis in favor of raw materials production did not change substantially. Large portion of production still belong to the metallurgy, especially to the non-ferrous metallurgy after the start of *Kumtor Gold Mining* project, and electricity production. While shares of sectors producing finishing products, such as machine building, light industry and food manufacturing are insignificant. According to the data of NSC for 2007, metallurgy and manufacture of fabricated metal products has 29.5 per cent of total industrial production, and production and distribution of electricity gas and water 20.6 per cent. In other words, almost half of the industrial production produced by these two sectors. However, machine building produced only 1.5 per cent of total and light industry and food manufacturing about 10 and 15 per cent correspondingly. These variations in sectors' production defined their extent of contribution to growth of GDP during this period (see Table 7.2).

Table 7.2 Contribution of sectors of the economy to growth of GDP
(1996-2007, in per cent)

	1996-2001	2002-2007	1996-2007
GDP (average rate)	5.6	4.2	4.9
<i>Sectors(in % of total)</i>			
Industry	29.9	-9.83	10.0
Agriculture	46.6	14.96	30.8
Trade and Catering	13.9	58.12	36.0
Other services	9.7	36.75	23.2

Source: Mogilevsky 2002, p.1; Calculated on the data of NBKR database.

¹Sensitivity of the economy to only this project is such that official statistics on the GDP are recorded specifically with the gold production and without it.

For the period 1996-2001 the leader contributor to economic growth was agriculture and, then, industry. But these effects diminished substantially in following six years. Share of agriculture in total growth contribution was only 14.96 per cent. Primary positive effects of reforms in agriculture appeared as short-term and stable growth of this sector required solutions to new problems faced by agriculture. Contribution of industry had even negative sign. Impact of gold mining production of *Kumtor* project on GDP is eventually decreasing¹. Under these conditions leading contributor to growth became sector of services.

Within these tendencies the role of the private sector in economy has significantly increased. According to the EBRD data share of private sector in GDP of Kyrgyzstan in 1990 was 5 per cent, while in 2007 it was 75 per cent. However, these growth tendencies did not change structure of the economy inherited from the economic crisis and the economy still remains as agricultural. As the EBRD data show in 2007 share of agriculture in GDP was 29.0 and of industry 16.4 per cent, while in 1990 their share were 47.3 and 37.9 per cent correspondingly. Such structure of real production in the economy predetermined composition of export where raw goods are leading. In 2007 articles of export goods that include gold and electricity² accounted for 49.1 per cent of total export volume³.

Therefore, growth of the economy after transformational recession at first was provided mainly by agriculture and gold mining (*Kumtor*), and, later with the decrease of their contribution, by sector of services. Economic recovery from transformational crisis did not result in change of structure of the economy, which is still preserving its agricultural and raw material exporting features. Although recovery started in 1996, achieved growth performances have not been enough to compensate for its decline during the transformational crisis. Full recovery of the economy and achievement of sustainable growth require corresponding level of investments. Therefore, it is useful to observe investment tendencies, in particularly foreign direct investments.

¹ For instance, in 2004 the share of value added of *Kumtor* project enterprises in total value of GDP was 8 per cent, while in 2007 its share decreased to 2.5 per cent.

² These articles in external sector statistics of NSC are named as “Mineral products” and “Natural or cultured pearls, precious or semiprecious stones, precious metals and products, coins”

³ However, it should be pointed out that in earlier years their share were larger. For instance in 2000 only non-ferrous metallurgy products made 45.8 per cent of total export, while electricity 15.6 per cent.

7.3 Investment Performance

Creation of corresponding investment climate has been one of the most discussed priorities of economic policy in Kyrgyzstan. Despite recent attempts to improve investment climate level of investments in the country has not increased substantially. In post-transformational crisis period level of total investment has not been stable and even was decreasing in some periods despite positive growth rates of the economy¹. In general starting from 2000 growth of investment is observed as relatively stable and with slight improvements (Table 7.3). But level of investment in Kyrgyzstan is remaining lower than average for CIS countries. For instance, in 2007 the average level of investment in CIS countries 27, 33 per cent of GDP, and in Kyrgyzstan was 22 per cent. In average for 2000-2007 years level of investment in Kyrgyzstan was 21 per cent of GDP. It is the lowest rate together with Tajikistan among CIS countries². For instance in the same period investment rate in Belarus, Moldova and Kazakhstan was above 27 per cent, in Azerbaijan 34, 8 per cent, and in Uzbekistan 25, 2 per cent of GDP³.

Increase of investments by domestic sources is limited due to the low rate of domestic savings. Indeed in the economy where the per capita GDP is low and poverty level is substantial, high rate of consumption and low rate of savings are quite expected. Approximation of propensity to save in Kyrgyzstan economy in Table 7.3 shows that final consumption of the economy is high and even resulted in negative saving propensity. Another reason for retardation of financing investments by domestic sources, as described in the previous chapter, is weak financial system that is not efficient in transferring existing financial resources into investment projects. In such situation external debt represents alternative source

¹ It was common tendency in transition economies. As noted in third chapter (Section 3.2) generally in transition economies investment played insignificant role in growth of transition economies in 1990s and its growth rate was negative. A most common explanation is that growth in transition economies during the initial phase of output recovery after the transformational crisis came mostly from the efficiency improvements resulted from economic reforms.

² This information is based on own calculations on the data of the EBRD. In calculating data for CIS countries, because of incomplete data Georgia, Armenia and Turkmenistan were not included.

³ For example, according to Fischer et al (1998) estimations under the Levine-Renelt specification with an investment ratio 22 per cent it would take transition economies an average of 45 years to catch up to current average OECD per capita income levels, and if investment is raised to 30 per cent of GDP catch up time in average falls to 30 years.

of financing investments. However, recent situation with high rate of external debt and its burden on the economy seriously limits use of this source of finance. Therefore, foreign direct investment (FDI) becomes one of the potential sources of finance of investments.

Open economy with liberalized trade regime, relatively developed human capital, existence of some natural resources (hydro energy, tourism, gold and other resources for mining industry etc) and geographical location between Russia, China and Kazakhstan have been considered as the major potential advantages of Kyrgyzstan in attracting FDI. Also there has been a common agreement that macroeconomic stabilization and improvements in investment climate would promote realization of these potentials.

Table 7.3 Investment activities (1996-2007)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Investment (in % of GDP)	25.2	21.7	15.4	18.0	20.0	19.6	20.3	20.5	20.8	21.8	22.9	22.0
Propensity to save (in % of GDP)*	-0.6	13.8	-6.1	3.2	14.3	17.7	13.8	5.3	5.8	-2.1	-13.1	-18.9
<i>FDI:</i>												
In million USD**	31	83	87	38	-7	-1	5	46	132	43	182	208
In % of GDP*	1.7	4.7	5.3	3.1	-0.5	-0.1	0.3	2.4	5.9	2.7	6.4	6.0
Share in total capital investment	56.5	59.8	25	5.0	12.9	7.4	10.9	8.9	6.2	11.2	8.0	6.9

*Indeed common approach in estimating propensity to save is identification of saved part of disposable income in the structure of GDP. However, for a lack of data on disposable income in our case propensity to save is approximated by using the data on final consumption in the structure of GDP. Therefore used formula is: $(GDP - Final\ Consumption / GDP) * 100$

**Expressed as net inflows recorded in the balance of payments

Source: Calculated on the data of EBRD database (www.ebrd.com/country/sector/econo/stats); NSCKR 1998, 2001, 2006b, 2008d.

As it can be noted FDI inflows in 1996-2007 years were not stable and even showed in 2000 and 2001 year negative performance. Net inflows of FDI in absolute terms (in USD) started to reach relatively significant amounts only after 2003. However, despite these positive developments in recent years general volume of the FDI is not large enough to be the source for investment expansions.

According to the EBRD data FDI inflows in Kyrgyzstan is one of the low performing among CIS countries. Cumulative FDI inflow for 1989-2007 years in Kyrgyzstan is 961 million USD. Together with Tajikistan this is the lowest performance among CIS countries. In terms of the per capita cumulative FDI inflows Kyrgyzstan below the average level for CIS countries, this parameter for Kyrgyzstan is 183 USD, while in average for CIS is 428 USD. The same situation with annual data, for instance, in 2006 and 2007 average per capita FDI for CIS were 90 and 87 USD, in Kyrgyzstan 35 and 40 USD correspondingly.

Another parameter of the importance of FDI volume is its share in total capital investment. Capital investment is important with its investment in fixed assets with long-term use and not in day-to-day expenses. This parameter also shows low level and indicates that with its current volume FDI in Kyrgyzstan does not represent serious source for capital investment.

Thus, volume of investment and FDI in Kyrgyzstan is not enough to provide sustainable growth. Poor investment climate and limited domestic finance capacities are considered as the main factors retarding investment. Along with this effective banking system is required to provide the flow of financial resources from savings to investment.

7.4 Banking Sector Performance

As known from the section on financial sector reforms after the banking crisis in 1999, stabilization of macroeconomic conditions in 2000s contributed to the positive developments in banking sector: number of profiting banks and capitalization level increased, and emerging new banks with foreign capital started to strengthen competition among commercial banks. The pre-crisis level of main indicators of the banking sector activity was reached by the end of 2003 and 2004. Especially in recent four years the banking sector showed relatively fast growing performance. Total capital base of banking sector increased almost by threshold compared to 2000 level, assets also showed rapidly growing performance by reaching in 2007 about 30 per cent of GDP (see Table 7.4). Large foreign capital has been invested in the banking sector, mainly from neighbor Kazakhstan. Nowadays, about 60 per cent of the total banking capital belongs to the foreign investors. Prevailing presence of foreign capital

undoubtedly contains positive moments, such as improvement in corporate management and in customer services standards, and increasing resource potential of the banking sector. However, at the same time it bears the potential risk of being sensitive to external shocks.

Despite these achievements banking sector in Kyrgyzstan is still remaining weak and insufficient in terms of the mobilization of financial resources and crediting the economy. Level of mobilization of financial resources measured as the ratio of total deposits volume to GDP is low. In 2007 it was 16.5 per cent, though in earlier years it was even lower, for instance in 2001 it was only 3.5 per cent (see Table 7.4). Low level of deposits in commercial banks can be viewed as the low public confidence to the banking sector and preference of private sector to implement transactions outside of banking sector. Moreover, it is related with the large extent of underground economic activities. On this case, another ratio – ratio of money outside banks to deposits can be used. High ratio implies high share of money circulating outside of banking sector. The ratio in analyzed period had always values above 1. In other words, money circulating outside of the banking sector was always higher than deposits. In 2007 the ratio accounted for 1.6. That means the volume of money outside of banks is higher for 60 per cent compared to money deposited at the banking sector. Crediting the economy- ratio of credits to GDP - does not represent high level too. It should be noted that the rate of credits always was low than the rate of deposits and only in 2007 this tendency changed.

Table 7.4 Main indicators of the banking sector activity (1994-2007, in per cent of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Number of Banks *	18	17	15	19	22	21	21	18	19	20	19	19	20	22
Assets	15.7	10.3	5.6	9.0	12.3	8.6	7.2	6.8	10.4	13.6	18.8	21.7	24.9	30.0
Capital	1.2	1.2	0.9	2.0	2.7	1.3	1.5	2.1	2.4	2.5	2.9	3.4	4.5	6.4
Currency outside banks/Deposits	n/a	2.4	2.5	1.8	1.4	1.2	1.3	1.6	1.7	1.7	1.3	1.6	1.5	1.6
Deposits **	4.7	4.8	3.8	4.9	6.2	5.4	4.3	3.5	4.8	6.0	8.7	12.9	14.8	16.5
Credits ***	15.7	9.9	2.63	5.08	9.4	2.9	3.4	3.7	4.5	5.9	8.9	10.5	14.3	17.3

* Includes Settlement and Savings Corporations (SSC)

** From 1996 does not include deposits from banks, other financial-credit organizations and government organs.

*** From 1996 does not include credits given to banks and to other financial-credit organizations and corresponding discounts.

Source: IMF 2003, 2005; NBKR 2002, 2009.

In other words not all accumulated resources were used for crediting. High share of currency outside banks, insufficient resources for banking sector, high rate of interest and short terms features of bank crediting restrain use of bank credits by main sectors of the economy. In their own turn banks seek for sectors of crediting that have quick rate of return, such as trade, and remaining resources have been used in investment into government bonds, in inter-bank credit market or simply held as liquid assets.

Table 7.5 Composition of credits and deposits of commercial banks by maturity (2003-2007, in per cent)

	2003	2004	2005	2006	2007
Credits	100	100	100	100	100
Less or equal 1 month	5	3	6	2	1
1 month to 12 month	73	69	59	45	31
More than 1 year	22	28	35	53	68
Deposits	100	100	100	100	100
Less or equal 1 month	9	14	8	13	8
1 month to 12 month	53	49	59	65	62
More than 1 year	38	37	33	22	30

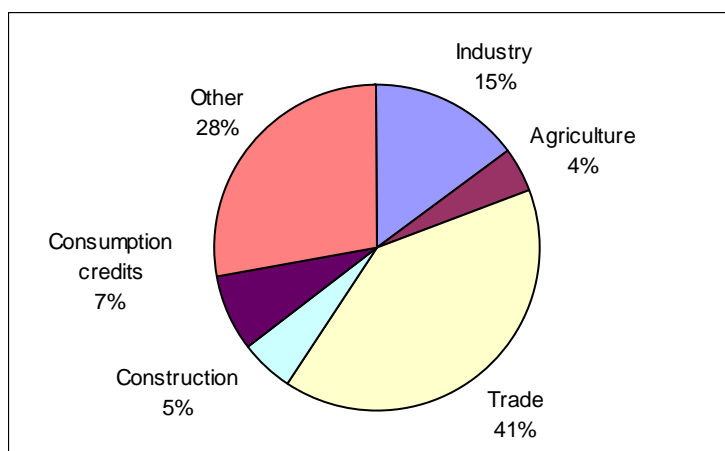
Source: Calculated on the data of NBKR 2008.

Short- term feature of bank credits and deposits is proved by the data given in Table 7.5. Though both share of credit and deposits given for more than 1 year has increasing tendency over the observed last five year period, still share of short-term credits and deposits high, in 2007 year 31 per cent of credits was given for period till 1 year, and in deposits 70 per cent¹. In other words there is a deficit of the long term financial resources. All above mentioned characteristics of the banking sector activity affected on the crediting sectors of the economy. Banks seek for sectors that can provide with returns in short period of time under the high interest rate conditions, while enterprises of real sector of the economy do not have opportunity for that. Because of this, among the sectors of the economy received commercial

¹ It should be noted that the classification in the Table 7.5 made only on the official data of NBKR that show credits and deposits till 1 year and more than year, while for the clear distinction between short term and long term activities it should include periods more than year: 3 year, 5 year periods. However, relevant data of IMF that is available till 2003 shows that the long term credits and deposition, that are given for more than 3 years have the lowest share in the structure. For instance, data for December 2003 shows that the share of credits given for the period more than 3 year was 8.4 per cent of total (see IMF 2005, p. 40)

banks' credits trade is leading – as average from 2003 to 2007 year 41 per cent (see Figure 7.3). While the share of real sectors of the economy is low, for instance agriculture in average received only 4 per cent. In other words, use of the commercial banks' financial resources by real sector of the economy is limited.

Figure 7.3 Credits of the commercial banks to sectors of the economy (2003-2007)



Source: Calculated on the data of NBKR 2008.

There is relative stabilization in the banking sector activity in Kyrgyzstan. Especially recent improvements in volume of its activities have allowed for increase of deposits and credits to considerable levels compared to 1999 and 2000 years. However, in spite of such rising activity the banking sector with current position is not strong in providing private sector with necessary financial resources. Both of deposits and credits are given prevailingly for short term. Consequently, sectors that possess high rate of return in short term, such as trade sector, are appeared to be advantageous in using banking sector lending, while real sectors of the economy still lack of financial resources.

7.5. Social Costs of Economic Reforms

Commonly accepted argument on consequences of rapid and comprehensive economic reforming was that its social costs appear to be high: rising poverty and inequality, inability of state to sustain previous rates of social provisions due to the decreasing revenue capacities and, as a result of these, decreasing quality of human capital. However, it was also expected that post-recession economic recovery and further economic performance would reduce these costs. Indeed, reduction of social cost and maintaining it at manageable level are important in terms of the social and political stability and sustaining support for further economic reforms. Therefore, it is useful to look at the general indicators of social costs under the light of economic growth tendencies.

Economic crisis till 1995 considerably decreased per capita GDP level¹, and growth tendencies of post-crisis period were reflected correspondingly in per capita GDP. In particular, since 2001 stability in increase of nominal per capita GDP is observed. But despite doubling of per capita GDP at nominal values since 1996, Kyrgyzstan with 729 USD per capita in 2007 is still remaining among the low income level countries and pre-transition level is not attained yet.

Table 7.6 GDP growth, unemployment, poverty and income distribution
(1996-2007)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
GDP growth rate	7.1	9.9	2.1	3.7	5.4	5.3	0.0	7.0	7.0	-0.2	3.1	8.2
GDP per capita (in US dollars)	399.4	382.3	349.1	256.7	279.2	309.3	322.1	381.4	434.5	479.6	552.0	729.8
Poverty level	43.5	42.9	54.9	55.3	52.0	56.4	54.8	49.9	45.9	43.1	39.9	35
Gini Coefficient (on income)	0.391	0.453	0.447	0.443	0.449	0.441	0.419	0.407	0.422	0.433	0.446	0.442
Unemployment (end-year)	n/a	n/a	5.9	7.4	7.5	7.8	13.5	10.4	8.8	8.8	9.0	8.9

Source: EBRD database (www.ebrd.com/country/sector/econo/stats); Mogilevsky, 2002, p.6; NSCKR, 1998, 2001b, 2006b, 2007, 2008a, 2008b

¹ According to the EBRD data in 1989 per capita GDP of Kyrgyzstan was 2768.5 USD, while in 1995 it was 330.6 USD.

If to compare growth trends and poverty level differing correlation is revealed. Increased poverty level during the economic crisis continued to do so even under positive growth rates in post-crisis period and peaked in 2001 by reaching 56 per cent of population as living under poverty line. Such controversial situation was partly result of the fact that the base of growth of the economy was narrow, mainly agriculture, gold mining and energy. In other words poverty reduction capacity of growth was limited. Another important factor was inequality that rose rapidly from 0.39 per cent in 1996 to 0.45 in 1997. Poverty level started to decrease only starting from 2002 and, in particularly recent three years resulted in relatively fast decrease. Official data for 2007 estimated poverty level as 35 per cent of population, while in 2001 it was 56 per cent. Despite these recent developments poverty level at 35 per cent is still high. This reduction of poverty has not been associated with obvious improvements in inequality. The Gini coefficient despite slight falling during 2000-2005, in general remained at the rate above 0.44.

Level of unemployment in last ten years showed increasing, at least not decreasing substantially, trend despite positive growth rates during this period. There are two main probable explanations of such non-parallelism between unemployment and growth.

First, growth of the economy has been limited being unable to absorb rising labor supply and leading sectors of the economy have not been efficient in employment generating. Employment generating of sectors of the economy have not been proportional to their growth performance. For instance, McKinley (2004, p.14) states that in contrary to the cumulative growth of manufacturing and mining over 49 per cent in 1996-2000 years, it was associated with a cumulative decline of employment of almost 20 per cent. While in the same period in agriculture with 30 per cent of cumulative growth, employment increased by 21 per cent. The same positive trend was in trade, hotels and restaurant sector which grew by over 36 per cent, its employment grew by over 21 per cent. While positive correlation between growth and employment is quite expected, negative one, as in manufacturing and mining, is paradoxical case. However, if to take into account the fact that source of growth of the economy has been narrowly based this paradoxical case can be explained. Especially as we know gold production only became important contributor to growth.

Second, one should be aware of the fact that the data on unemployment may vary considerably and is not certain. Reasons for that are poor data on general unemployment level, since most part of unemployed are not officially registered, and high rate of employment in unofficial economy. Official data of Kyrgyz authorities on unemployment based on officially registered number of unemployed people is considerable low and does not reflect the real level. For instance, by April 2008 this rate of unemployment was estimated as 3.2 per cent. Size of the unofficial employment is not known certain. But according to the United Nations data in Kyrgyzstan informal employment together with general informal economic activities is increasing and approximated as up to 67 per cent of total employment. And the general level of unemployment estimated by international experts to be considerably higher, from 8 to 15 per cent of the economically active population¹. Therefore, generally data the on real rate of unemployment does not yield to the concrete estimations and, to some extent, approximated.

In addition to these appearances for the full evaluation of social tendencies migration processes should be taken into account. Since during the recent years in Kyrgyzstan the scale of migrant workers and remittances has reached considerably large numbers. Although data on them are not concrete and varies, according to the Kyrgyz authorities number of worker migrants in Russia from Kyrgyzstan are about 300 000 and in Kazakhstan between 50 000 and 100 000, however unofficial evaluations state them to be high – between 500 000 and 1 000 000². If to rely on these data then approximately share of migrants in total economically active population of Kyrgyzstan varies between 15 and 45 per cent. Migration in such scale correspondingly reflects in amount of remittances. World Bank data on remittances for Kyrgyzstan show that in 2006 its volume was 27.4 per cent of GDP³. With this rate Kyrgyzstan together with Moldova and Tajikistan is ranked in triple of leaders of remittance receivers among CIS countries. Undoubtedly by these scales money transfers from abroad and unofficial earnings have become important source of income of population.

Thus, first decade of transition period was featured with the rising poverty and inequality in income distribution. Post-recession economic performances contributed to reduction of poverty, in particularly starting from 2002. However, existing level of poverty

¹(http://www.un.org.kg/index.php?option=com_content&task=view&id=142&Itemid=65#_ftn1)

²(<http://www.for.kg/goid.php?id=66306&print>)

³(www.worldbank.org/prospects/migrationandremittances)

remains high and income level is low. Employment generating effect of economic performance during this period appeared low. Together with the rise of unofficial economic activities employment in informal economy has achieved substantial level. Part of economical active population leaving the country and getting migrant worker is increasing. Such situation results in double effect: on the one hand it contributes to decreasing of social tension, on the other hand, large scale of this appearances cause loss of most active part of labor force. Moreover, money transfers of migrant workers, which recently achieved large amounts, are not generated into investment. Therefore, economic growth performances after the economic crisis have not been efficient in reduction of social costs and under the current social conditions potentiality for social instability and tensions remains.

Economic outcomes of reform packages concentrated on the rapid privatization, liberalization and stabilization in Kyrgyzstan have not been effective. During the first six years of post-crisis period growth of the economy was provided mainly by agriculture sector growth and gold mining production. In 2002-2007 years effectiveness of agriculture and contribution of gold mining production to the growth of the economy decreased, while contribution of services increased. Structure of the economy did not change substantially and remains agricultural with raw material exporting structure. Moreover, the sources of growth have been narrowly based, which had an implication in low capacity of employment generating and poverty reduction. Despite recent considerable increase volume of investment in Kyrgyzstan is remaining insufficient for strong economic performance. Attraction of foreign investment is below of average for CIS countries. Accumulation of internal financial resources of the country is limited by weak banking sector and low rate of savings. Banking sector is generally characterized by short term operations, though recently started to show increases in both of credits and deposits.

8. MAJOR REASON FOR INEFFICIENCY OF STRUCTURAL REFORMS - INSTITUTIONAL INFRASTRUCTURE

Rapidly implemented comprehensive structural reforms with the aim to create private sector dominance and market mechanism were expected to result in recovery of the economy. Indeed, economy of Kyrgyzstan after five years of transformational crisis entered in the process of recovery with positive growth rates in 1996. But as analysis in the previous chapter show issue of full recovery of the economy and provision with further sustainability is still remaining. As discussed in the third chapter most empirical studies found institutions as one of the determinants of varying economic performances in transition economies.

Almost all studies empirically analyzing institutions and economic performance include large sample of countries and use cross-sectional or panel data approach and derive some comments on the role of institutions. However, such general conclusions on the importance of institutions do not give insights on their scope and sources in case of individual country. In particular, data availability limits effectiveness of quantitative examination of importance of institutions for individual country. Most commonly used indicators on institutions available since the mid of 1990s. For example, currently available data of governance indicators start only from 1996 and by now there exist only 8 years available for analysis. And economic freedom index includes most of the former Soviet Union countries, including Kyrgyzstan, only since 1998. This is very short period for time series analysis and not enough for empirical testing the relation between institutions and growth performances for individual country case. By taking into account these issues this chapter attempts to evaluate institutional infrastructure in Kyrgyzstan comprehensively and to identify main factors for its inefficiency. By institutional infrastructure is meant the set of institutions that makes market mechanisms to function and be efficient, such as rule of law and secure of property rights, and effectiveness of state in law enforcement and in regulatory policies over business environment.

This chapter consists of three sections. First section evaluates institutional infrastructure in Kyrgyzstan. Second section focuses on factors that have influenced on current

situation in institutional infrastructure in Kyrgyzstan. Third section discusses perspectives on improvement of institutional infrastructure.

8.1 Evaluation of Institutional Infrastructure in Kyrgyzstan

One of the main issues in analysis of institutions is related with used proxies for institutional development. In existing literature on the relation between economic performance and institutions, the quality of the latter is measured by some indices, results of the questionnaire-based survey or by some other relevant indicators.

Mostly used indices to approximate quality of institutions in transition economies are: the EBRD transition indicators, the Heritage Foundation index of economic freedom and the World Bank governance indicators. Of these three the EBRD transition indicators have been extensively used by some studies for approximating institutional development, while most of the studies use them to measure structural reforms too. Such application of the same indicator for two different categories causes misinterpretation and constitutes unclear distinction between structural reforms and institutions. Indeed, as shown in the previous chapter, EBRD transition indicators measure the progress of transition economies in implementing structural reforms towards market economy, and not the institutional development. Therefore, it would be consistent to agree with some authors who state that structural reforms and institutional development are different and should be distinguished in analysis¹. As the EBRD indicators are not appropriate measure of institutional development, remaining two - index of economic freedom and governance indicators are more appropriate to explore quality of institutional infrastructure in Kyrgyzstan.

Apart of these indices some authors use existing surveys based on the business environment assessments, such as *Business Environment and Enterprise Performance Survey*

¹For instance, Havrylyshyn and Rooden (2000, p. 5) state that structural reforms are of a different nature than the development of market-enhancing institutions. The former captures mostly measures that can be introduced within a short time frame. Institutional reforms on the other hand, by their very nature, take much longer time to develop. While Chousa et al. (2005) suggesting to use as a measure of institutional development size of underground economy state that it is inappropriate to use index on structural reforms as a measure of institutional efficacy. Since their estimations on institutional efficacy show that some transition economies where market reforms were minimal still have high efficacy of institutions.

(BEEPS) of the World Bank and EBRD and Doing Business report of the World Bank, to approximate institutional development. While some studies exploring institutional quality across countries use indicators on corruption perception.

Therefore, institutional quality in economic literature is measured by different aspects, ranging from political stability to business environment. However, all these approaches in measuring institutions have their own limit. For instance, these indices are generally based on experts assessments and, hence, may be subjective and contain perception bias. While the approach based on questionnaire-based surveys is limited by problems, such as lack observations and other sampling issues etc. By taking into account these practices we do not rely on one particular indicator, but rather use different available measures to explore the quality of institutional infrastructure in Kyrgyzstan. First and second subsections include analysis based on the index of economic freedom and governance indicators correspondingly. Third and fourth subsections evaluate institutional infrastructure from the perspectives of business environment and include BEEPS and “Doing Business” report correspondingly. Finally, fifth subsection focuses on indexes and reports on corruption issue in Kyrgyzstan.

8.1.1 Index of economic freedom

Development of market enhancing institutions is associated with fewer constraints in front of the private sector, small and supporting state, strong judicial system and property rights. Therefore in most studies indicators on economic freedom that include these components are used as a measure for institutional development. Correspondingly here “Index of Economic Freedom” published by the Heritage Foundation and the Wall Street Journal is used.¹

Economic freedom in Index of Economic Freedom (2008, p.40) is explained as to encompass all liberties and rights of production, distribution, or consumption of goods and

¹ Also “Economic Freedom of the World” annual report of the Fraser Institute represents measurement for economic freedom. Being different from the Heritage Foundation index it assesses economic freedom on five main categories: size of government, legal structures and security of property rights, access to sound money, freedom to trade internationally and regulation of credit, labor and land. Its data from 1970 to 2000 are given in five year averages. For these reasons we prefer to use the index of Heritage Foundation.

services. The highest form of economic freedom provides an absolute right of property ownership; fully realized freedoms of movement for labor, capital, and goods; and an absolute absence of coercion or constraint of economic liberty beyond the extent necessary for citizens to protect and maintain liberty itself. In other words, individuals are free to work, produce, consume, and invest in any way they please, and that freedom is both protected by the state and unconstrained by the state. The index classifies and assesses economic freedom in terms of the ten components of freedom:

1. *Business freedom* is the ability to create, operate, and close an enterprise quickly and easily. Burdensome, redundant regulatory rules are the most harmful barriers to business freedom.
2. *Trade freedom* is a composite measure of the absence of tariff and non-tariff barriers that affect imports and exports of goods and services.
3. *Fiscal freedom* is a measure of the burden of government from the revenue side. It includes both the tax burden in terms of the top tax rate on income (individual and corporate separately) and the overall amount of tax revenue as a portion of gross domestic product (GDP).
4. *Government size* is defined to include all government expenditures, including consumption and transfers. Ideally, the state will provide only true public goods, with an absolute minimum of expenditure.
5. *Monetary freedom* combines a measure of price stability with an assessment of price controls. Both inflation and price controls distort market activity. Price stability without microeconomic intervention is the ideal state for the free market.
6. *Investment freedom* is an assessment of the free flow of capital, especially foreign capital.
7. *Financial freedom* is a measure of banking security as well as independence from government control. State ownership of banks and other financial institutions such as insurer and capital markets is an inefficient burden, and political favoritism has no place in a free capital market.
8. *Property rights* is an assessment of the ability of individuals to accumulate private property, secured by clear laws that are fully enforced by the state.

9. *Freedom from corruption* is based on quantitative data that assess the perception of corruption in the business environment, including levels of governmental legal, judicial, and administrative corruption.

10. *Labor freedom* is a composite measure of the ability of workers and businesses to interact without restriction by the state

Each of these components is graded within 0 and 100 scale, where 100 represent the maximum freedom. Average of these grades expresses the total score and, according to the given score a country is ranked among total number countries included in the report.

Kyrgyzstan included in the index starting from 1998. In terms of the total score Kyrgyzstan improved for about ten points in last ten years (see Table 8.1). Compared to 1998 scores relatively improved in business, trade, fiscal, monetary freedom and government size. In particularly, first three freedom components improved their position notably after 2005. As it is known in 2005 the political and societal tensions after the parliamentary elections of February 27 and March 13 resulted in the overthrow of the president and became to be called as “*Tulip Revolution*”. The new government declared as one of its priorities in the economic policy to decrease regulative and other state burden on the private sector. As a result rate of some taxes were decreased and directives to reduce regulative burden on business environment were adopted. Probably assessment of these economic policy measures of the new government caused improvement in business, trade and fiscal freedom in the index. Despite these positive developments other components of freedom: investment and financial freedom and property rights did not change, while freedom from corruption substantially worsened compared to 1998.

Thus, score of Kyrgyzstan in the economic freedom index in observed period was improved by first five components, while another aspect did not change. However, one in interpreting developments in this index should take into account the nature of these components. Measurement of those five aspects of freedom that improved during the observed period is based on quantitative measures. Changes in these measures are very often and may appear in short period of time. Therefore, these variations in used quantitative measures may not necessarily imply fundamental institutional changes.

Table 8.1 Index of economic freedom: Kyrgyzstan (1998- 2008)

	Ranking	Score	Business Freedom	Trade Freedom	Fiscal Freedom	Gov't Size	Monetary Freedom	Investment Freedom	Financial Freedom	Property Rights	Freedom from Corruption	Labor Freedom
2008	70	61,1	60,4	81,4	93,9	76,1	75,6	50	50	30	22	72,0
2007	75	60,3	59,9	81,4	92,7	77,1	77,1	40	50	30	23	71,9
2006	69	61,0	60,7	76,4	90,0	81,3	77,9	50	50	30	22	72,2
2005	89	57,0	55	69,4	85,1	81,5	78,8	30	50	30	21	68,9
2004	86	58,0	55	69,4	85,5	84,4	76,2	50	50	30	22	n/a
2003	98	56,8	55	69,4	76,5	90,3	67,6	50	50	30	22	n/a
2002	122	51,7	55	65,0	72,5	61,1	60,0	50	50	30	22	n/a
2001	110	53,7	55	65,0	68,7	86,8	55,7	50	50	30	22	n/a
2000	102	55,7	55	65,2	69,3	86,8	65,0	50	50	30	30	n/a
1999	103	54,8	55	65,0	72,7	83,7	56,9	50	50	30	30	n/a
1998	110	51,8	55	65,0	72,3	72,6	41,1	50	50	30	30	n/a

Source: Heritage Foundation. Available on site: <http://www.heritage.org/Index/>

For instance, in estimation of trade freedom average tariff rate and non-tariff barriers are used. In fiscal freedom top tax rates on individual and corporate income and the rate of government tax revenue to GDP is used, analogously government expenditure is used in assessment of government size. For monetary freedom average of inflation rate and existence of price control is used. If to take into account the efforts of Kyrgyzstan in trade and price liberalization explained in the fifth part of the thesis, attempts to decrease budget deficit and inflation rate as priority within stabilization policy and decreases in tax rates and amendments made to government regulation procedures over the business environment within the economic policy of government since 2005, then it is not surprising that the components of economic freedom based on these measures are improved.

However, situation is different for other components that did not improve: investment freedom, financial freedom, property rights and freedom from corruption. Estimation of these components in the index is based on evaluations of different institutions and organizations and qualitative by their nature. For instance property rights scores the degree to which laws protect property rights and the degree to which government enforces those laws, independence of the judiciary, ability of individuals and firms to enforce contracts etc. Investment freedom is based on assessments of countries' policies towards the foreign investment, capital flows etc. In financial freedom extent of government regulation and intervention in financial services, government influence on credit allocation is evaluated.

Therefore, first group of components is primarily based on the quantitative measures and "nominal" in terms of reflecting institutional changes. They are sensitive to changes in used units of measures, which do not necessarily represent fundamental institutional change. For instance, decrease of rate of government expenditure to GDP does not necessarily imply institutional improvements. Second group of components is mostly qualitative evaluations. Thus, economic freedom index gives mixed results on institutional infrastructure: although the economic freedom is considered as improved in trade, monetary, fiscal and business freedom aspects, no improvements have been observed in other aspects such as property rights and control of corruption. Hence, despite improvements in terms of the total of score of the index institutional infrastructure in Kyrgyzstan cannot be evaluated as efficient. Since aspects that

are fundamental institutions for enhancing market mechanism did not change or even worsened.

8.1.2 Governance indicators

Another commonly used index for institutional development is governance indicators based on works of Kaufmann, Kraay and Mastruzzi and issued by the World Bank. In this index governance is defined as the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them (Kaufman et al., 2008, p.7). In this index governance is measured by following six aspects:

1. *Voice and Accountability* – measuring perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.
2. *Political Stability and Absence of Violence* – measuring perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism.
3. *Government Effectiveness* – measuring perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
4. *Regulatory Quality* – measuring perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.
5. *Rule of Law* – measuring perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.

6. *Control of Corruption (CC)* – measuring perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests (Kaufman et al., 2008, p.7).

These definitions show that some components of governance indicators measure political perceptions concerning freedom of expression, media, political stability etc., while others measure perceptions about quality of public services, government regulations in promoting private sector development, rule of law and corruption. For evaluation of development of institutions enhancing market economy this content of the index is quite applicable. Although in our analysis the notion of institutions is not primarily concerned with political component, the remaining aspects of governance indicators are of particular importance. Since rule of law and control of corruption give some idea on the basic market enhancing institutions such as law enforcement and property rights, while government efficiency and regulatory quality expresses the government efficiency in law enforcement and regulatory policy.

Table 8.2 Governance indicators: Kyrgyzstan (1996-2007)

	Voice and Accountability	Political Stability and Absence of Violence	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
2007	37,2	27,8	35	42	26,3	28,3
2006	35,8	24,4	34,6	38	25,5	27,9
2005	34	27,2	32,6	35,6	28,4	28,5
2004	30,2	26,8	35,8	43,2	33,5	29,9
2003	28,4	25	37	45,6	33,6	33
2002	30	26,6	37,2	46,2	34,6	33
2000	26,6	40,4	39,8	45,4	32,7	32,6
1998	35,4	50,2	44	43,4	35,8	35,8
1996	36,2	51,4	40,2	39,6	37,2	33

* Data for 1999 and 1997 do not exist.

** Governance indicators are based on several individual variables measuring perceptions about indicators, which are represented in different data sources and constructed by different organizations. The six governance indicators are measured in units ranging from about -2.5 to 2.5, with higher values corresponding to better governance outcomes, i.e. as scores move from negative to positive the underlying component of governance improves. In order to make them simple for our analysis in Table 8.2 data on Kyrgyzstan are converted into 100 score system so that 2.5 to be the upper bound or 100 and -2.5 the lower bound or 0.

Source: Governance indicators. Available on site:
<http://info.worldbank.org/governance/wgi/index.asp>

Governance data on Kyrgyzstan show that except some improvements in voice and accountability and regulatory quality, remaining components are worse off compared to 1996. Score of government effectiveness that measure perceptions of the quality of public services and policy formulation and implementation decreased in five units. Almost the same level of reduction in score is observed for control of corruption. In case of rule of law decrease in score is higher - almost nine units. Hence, according to these indices in observed period perceptions about confidence in rules, quality of property rights, contract enforcement, court etc. decreased. Overall level of governance is low, none of the components reached the 50 score, or in original scoring system positive side of the measurement scale is not achieved yet.

Thus components of the governance indicators for Kyrgyzstan show that despite the slight improvements in regulatory quality, situation in market enhancing institutions such as rule of law and effectiveness of government did not show progress.

8.1.3 Doing Business

Another data source is “Doing Business” report of the World Bank. This report helps us to evaluate development of market institutions from the perspectives of quality of government regulation over the business environment. The particular interest of analyzing Kyrgyzstan within this report is that government of Kyrgyzstan considers this report as a measurement of effectiveness of government regulations and declared intention to improve investment climate within the Doing Business ratings starting from 2007.

The report represents quantitative indicators on business regulations since 2003 and currently includes 181 countries. It focuses on domestic small and medium-size companies and measures the regulations applied to them through their life cycle. This lifecycle is defined by 10 aspects: starting a business, dealing with construction permits, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and closing a business. Measurement of most of these aspects is based on number of necessary procedures to be implemented for that aspect, days for its realization and its cost for firm. The percentile rankings of these ten categories are averaged in the aggregate index of ease of doing business, according to which an economy is ranked among countries

involved in the report. According to the Doing Business (2009, p.vii) these indicators are mostly based on reading and surveying official laws and regulations in a country and also on information of practitioners with experience in measured aspect of regulation. To observe developments of Kyrgyzstan's position within the Doing Business five indicators measured by the number of procedures and time required for that and index of investor protection are given in table 8.3. These six indicators are given for Kyrgyzstan for 2005-2009 years period and in the last column 2009 year average of five countries comparable with Kyrgyzstan referenced in the index: Kazakhstan, Moldova, Russian Federation, Tajikistan and Ukraine, is given¹.

Table 8.3 Doing Business indicators: Kyrgyzstan (2005-2009)

	2005	2006	2007	2008	2009	2009*
Ease of Doing Business	n/a	84	90	94	68	
<i>Starting Business</i>						
Number of procedures	8	8	8	8	4	9.6
Time (days)	21	21	21	21	15	28.2
<i>Dealing with construction permits</i>						
Number of procedures	n/a	n/a	22	22	13	36.8
Time (days)	n/a	n/a	332	332	159	409.8
<i>Registering property</i>						
Number of procedures	7	7	7	7	7	6.6
Time (days)	15	10	8	8	8	54
<i>Trading across borders</i>						
Documents for export(number)	n/a	n/a	13	13	13	8.2
Time for export (days)	n/a	n/a	64	64	64	54
Documents for import(number)	n/a	18	13	13	13	10.6
Time for import (days)	n/a	127	75	75	75	53.2
<i>Enforcing contracts</i>						
Number of procedures	46	46	39	39	39	34
Time (days)	492	492	177	177	177	305
Investor protection index	n/a	5.7	6	6	7.7	4.5

*Refers to average of five countries that in the Doing Business (2009) are given as comparable with Kyrgyzstan. These countries: Kazakhstan, Moldova, Russian Federation, Tajikistan and Ukraine.

Source: Doing Business 2005, 2006, 2007, 2008, 2009

¹Note that the data of report "Doing Business" for particular year belongs generally to previous year. For instance 2009 report data are current as of June 2008. But to be consistent with release date of the report they are given in the table as in original reports' title. Therefore, it would be consistent to treat these indicators to some extent as an assessment of previous year results.

According to the “Doing Business 2009” position of Kyrgyzstan is significantly improved in last two years. In 2009 report its rank is 68, while in 2006 it was 84. Considerable improvements are observed in starting business, dealing with construction permits and in protecting investor. Currently in order to start business four procedures are to be done instead of eight that was in 2005, analogously procedures to deal with construction permits decreased from 22 to 13. Also in case of contract enforcement considerable improvement achieved in days required for its implementation. Investor protection index have increased by more than two units. Due to these improvements according to 2008 report Kyrgyzstan was defined in top three reformist countries in ease of doing business. However there are no changes in registering property and trading.

There are differences between Kyrgyzstan and of average of five comparable countries in observed six indicators. In Kyrgyzstan less number of procedures and days needed for starting business, dealing with construction permit and enforcing contracts, and investor is better protected than in average of five countries. In registering property entrepreneurs spend eight days, while in comparable countries in average have to spend 54 days, while there is no large difference in number of procedures for that. However, in case of export and import Kyrgyzstan is disadvantageous both in terms of number of procedures and time.

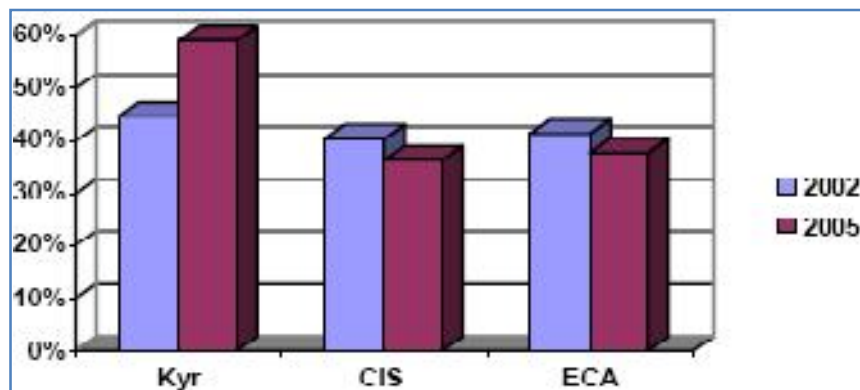
Thus, according to the Doing Business indicators considerable improvements in regulations over private sector is achieved especially in last two years. So far progress is achieved in regulations on starting business, dealing with construction permit and on investor protection. According to the Kyrgyzstan government statements it will further extend the scope of reforms within the report and particular emphasize will be on registration of new enterprises, dealing with construction permits, protecting investors, getting credits, trading across borders, paying taxes, employing workers and registration of property. However, it should be noted that the report is mostly based on regulations written in formal laws, while their de-facto implementation may considerably differ. Moreover, as mentioned above the report primarily reflects government regulatory policy on business environment, while institutional infrastructure wide in scope and includes other factors, such as security of property, the transparency of government procurement etc.

8.1.4 Business environment and enterprise performance survey

Business Environment and Enterprise Performance Survey (BEEPS) of the World Bank and the EBRD is another data source that used to assess institutional infrastructure in transition economies from business environment perspectives. It is a questionnaire based survey of managers and owners of firms in 26 transition economies and Turkey. So far BEEPS was implemented in three rounds in 1999, 2002 and 2005. The survey's questionnaire focuses on analyzing eight major issues as doing business in a country. These are: unofficial payment and corruption; crime; regulations and red tape; customs and taxes; labor issues; firm financing; legal and judicial issues and infrastructure. Of these measures results on unofficial payments and corruption; regulations and judiciary system are relevant for assessing institutional infrastructure.

According to the results of BEEPS 2005, percentage of firms indicating corruption as a problem of doing business in Kyrgyzstan was about 60. This rate was higher compared with 2002 survey results and in both periods corruption was indicated by firms in Kyrgyzstan higher than average of CIS countries and Europe and Central Asia countries (see Figure 8.1).

Figure 8.1 Corruption as a problem of doing business

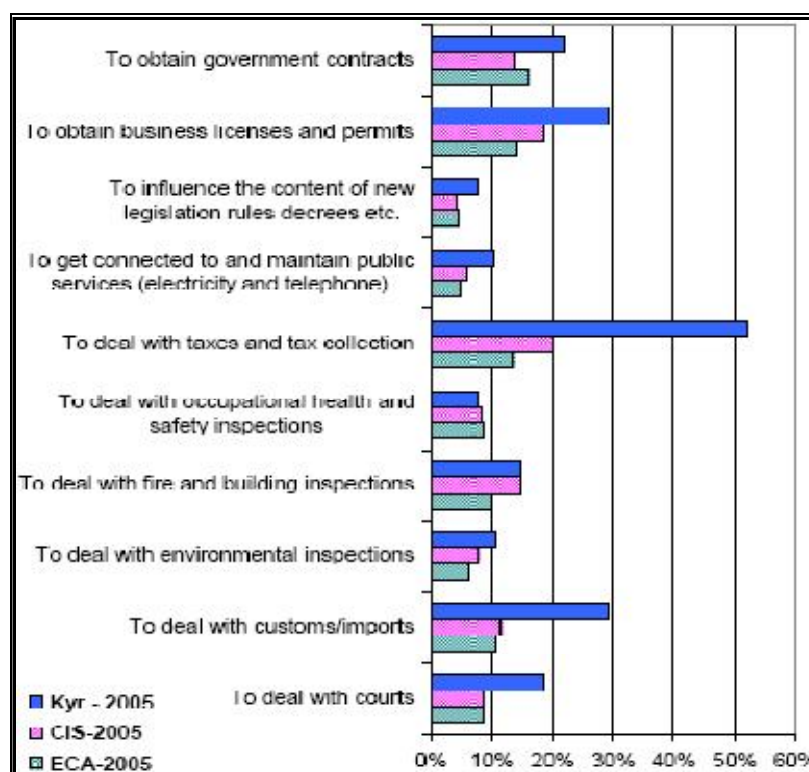


Source: BEEPS 2005

Analogously, regulatory policy and functioning of judiciary as a problem of doing business was defined higher than in 2002 survey. If in 2002 survey almost 55 per cent of interviewed firms indicated regulatory policy as a problem, then in 2005 survey almost 70 per cent. Judiciary system was defined as a problem by about 28 per cent of firms in 2002, while

this share increased to about 35 per cent in 2005. Again these rates in both 2002 and 2005 year surveys are higher than average of CIS and Europe and Central Asia countries. However, despite this slight increase in the share of firms negatively assessed judiciary in 2005 compared to 2002, at the same time firms positively assessing functioning of judiciary in terms of its ability to enforce its decision and its affordability increased. For instance if in 2002 the share of interviewed that indicated judiciary is able to enforce its decisions was almost 25 per cent, in 2005 this share increased to about 45 per cent.

Figure 8.2 Percent of firms saying bribery is frequent.



Source: BEEPS 2005

One of the major consequences of inefficient institutional arrangements over the business environment is an extent of practice of bribery. In the same survey results of the answers to questions on the frequency of bribes for different processes are given (see Figure 8.2). It was indicated that percent of firms saying that bribes are frequent in dealing with taxes

and tax collection - above 50 per cent; to obtain business licenses and permits and to deal with customs – 30 per cent; and to obtain government contracts – 20 per cent. Almost in all measured aspects frequency of bribery is higher than average of CIS and Europe and Central Asia countries. In particularly large difference is evident in dealing with tax and customs. Such appearance may have consequences in high rate of underground economy and loose of large revenues for government budget.

Thus, according to the results of BEEPS corruption, regulatory policy over the business environment and functioning of the judiciary system are defined as one of most problems of doing business and frequency of bribery or unofficial payments are defined as high. These perceptions are higher than in the previous survey and situation of Kyrgyzstan is worst than average of CIS and Europe and Central Asia countries involved in the survey.

However the results of the survey should be treated taking into consideration possible issues associated with questionnaires, such as sampling and observation issues etc. Moreover, the last survey of BEEPS was in 2005, and by taking into account some differences appeared in results of 2005 survey compared to 2002, there is a high possibility that survey on current dynamics would reveal different results from 2005 survey. Nevertheless, despite such possible shortcomings the survey's results support the fact that in Kyrgyzstan institutions that enhance market mechanism are not efficient.

8.1.5 Corruption

One of the appearances of inefficiency of institutions is corruption. Different analytical reports and studies confirm the pervasiveness of corruption in Kyrgyzstan and note weak rule of law and widespread corrupt activities in Kyrgyzstan as one the main obstacles for economic sustainability. Commonly used index on corruption - Transparency International Corruption Perception Index (CPI) and corruption indicator in Nation in Transit (NIT) report of the Freedom House for CIS countries are given in the Table 8.4. According to these indices generally level of corruption in CIS countries is perceived as high. In CPI Kyrgyzstan along with Turkmenistan and Uzbekistan is ranked below the average for CIS countries. Analogously in case of the NIT report Kyrgyzstan is considered as more corrupted than

average for CIS countries. Surely, these indices are evaluations of experts that main contain biases. However, apart from these indices other surveys confirm existence of widespread corruption in Kyrgyzstan. For instance, according to the results of National Interview of Kyrgyzstan (2006) 61 per cent of respondents asserted that corruption in Kyrgyzstan is high. Moreover, custom, internal affairs and police, courts and tax offices are perceived by respondents as more corrupt institutions.

Table 8.4 Transparency International and Freedom House corruption indexes: CIS countries

	CPI*	NIT**
Armenia	2.9	5.75
Azerbaijan	1.9	6.25
Belarus	2.0	6.25
Georgia	3.9	5.00
Kazakhstan	2.2	6.50
Kyrgyzstan	1.8	6.25
Moldova	2.9	6.00
Russia	2.1	6.00
Tajikistan	2.0	6.25
Turkmenistan	1.8	6.75
Ukraine	2.5	5.75
Uzbekistan	1.8	6.50
Average	2.31	6.10

* Corruption Perception Index (CPI) of Transparency International ranks countries by scores ranging from 10 (low level of perceived corruption) to zero (high level of perceived corruption).

** Corruption rating of Freedom House International within its Nation in Transit Report is based on scale of 1 to 7, 1 representing the progressive level and 7 representing the most regressive level.

Source: Freedom House, 2008; Transparency International, 2008.

One of the negative consequences of bribe taking practices is their usage in education and healthcare system. Though there is no concrete data on the scale of corruption in these sectors, different evaluations conclude that their extent is considerably large. Nowadays most people in Kyrgyzstan agree that admission, grading, and even getting diploma in higher

education are sometimes subject to corruption¹. Such situation with basic public services results in low quality of these services and, therefore, poor human capital².

Apart of above used indices and surveys extent of underground economy is one of the appearances of inefficient institutions. As Chouse et al. (2004, p. 16) argue underground economy is the best reflection of institutional inefficiency. Underground economy can be seen as an indicator of a deficit of legitimacy of the present social order and the existing rules of official economic activities. Indeed, under the weak rule of law, inefficiency of regulatory policy over business environment and frequency of bribe practices high rate of underground economy is quite expected. According to the results of the survey of the UNDP (2006) share of underground economy in Kyrgyzstan was about 53 per cent of GDP. According to another estimations made by Ministry of Economic Development underground economy is about 80-100 billion som, while GDP in 2008 was 185 billion som (i.e. the rate of underground economy was between 43 and 55 per cent of GDP). The large scale of underground economy once again confirms inefficiency of institutional infrastructure in Kyrgyzstan.

Thus, different indicators and data support the argument that institutional infrastructure for market economy in Kyrgyzstan is not efficient. Inefficiency of institutional infrastructure seriously retards economic activity. For instance, because of the weak law enforcement and insecure property rights the so called practice of corporate “raiding” recently has become popular in Kyrgyzstan. The practice refers to the case of violation of private ownership rights by one person of another person, or being more precisely takeover of the ownership despite the unwillingness of the owner by other person³. As analytical reports and experts evaluations show “raiders” use non complete law base, weakness of the corresponding state administrative bodies and corruption among officials. According to the analytical report of the Institute of Constitutional Policy corporate “raiding” is becoming kind of business and has achieved large scales. Qualified specialists are hired and considerable amount of money is devoted, large part

¹ For instance, for analytical report on corruption in higher education in Kyrgyzstan see Mambetalieva (2008).

² Moreover, the problem has moral and ethical aspect. Since corruption in education system contributes to the increasing of tolerance to corrupt behavior as a usual evidence and preparation of youth ready to use their dishonest skills in their future career.

³ It should be mentioned that generally in developed market economies the term “corporate raid” refers to the official buying a large interest in a corporation and then using voting rights to enact measures directed at increasing the share value. However, in CIS countries the term is associated with practices of the violation of ownership rights with force or by some other unfair techniques.

of which is used to give bribe to officials (Karimov, 2009). Undoubtedly, such practices detrimental to security of property rights and causes uncertainty in business environment. Another example of weaknesses in rule of law in Kyrgyzstan and its consequences is given by Light (2007) for agricultural sector. He states that in traditional agriculture markets, purchase agreements for inputs and outputs allow farmers and agro-processors to plan ahead during the crop-cycle. But during his interviews with vegetable drying and pickling companies in Kyrgyzstan producers complained that they cannot plan ahead more than six months. According to these businesses, farmers simply do not honor agreements. If the price at a local market is higher than the contracted price – then farmers simply sell on the market, ignoring the contract. This wait-and-see approach makes it impossible to make contracts with international buyers and it makes planning and expansion difficult. Likewise, some businesses have confessed that they also breach contracts. They buy inputs on the spot market if they are cheaper, leaving the farmers to sell their outputs at lower prices as well. The result of contract failure is that neither farmers nor factories can plan ahead.

Inefficient institutions cause uncertainty and, hence retard investment. Moreover, under the weak rule of law conditions corruption issue and unofficial economy activities have reached large scales, and, in turn, have damaging impacts on poor human capital formation. Despite recent efforts made to improve regulatory policy over business environment situation with property rights and rule of law is still remaining unchanged.

8.2 Sources of Inefficiency in Institutional Infrastructure

Proceeding from the analysis of structural reforms and economic performance in previous chapters, inefficiency of institutional infrastructure in Kyrgyzstan is explained with three groups of factors: growth performance, weak government and cultural and behavioral constraints. Each of them discussed below.

8.2.1 Economic growth performance

As mentioned above good market institutions accelerates economic performance, and at the same time high economic growth performance itself may serve as a base for institutional improvements, i.e. there is a mutual causation between growth and institutions. Indeed, low quality of institutions with high transaction costs and uncertainty retards growth, while low and unsustainable growth performance represents low income level and less resource available for institutional improvement and, therefore, is favorable to emergence of inefficient institutions. However, this causation line in economic literature dominantly analyzed as being primarily from institutions to economic performance and reverse causation is considered as the process of long term. Although, it is undeniable fact that income decline in transition economies as a result of the transformation crisis and consequent difficulties in recovery of the economy served as fertile ground for emergence and intensity of inefficient institutions.

As explained previously, during the transformational crisis in Kyrgyzstan (1991-1995) output fell by more than 50 per cent in real terms and growth performance of Kyrgyzstan economy after the crisis was not strong and the process of full recovery of the economy has long lasted. Magnitude of output fall in crisis was partly related to objective reason USSR heritage: the economy was highly integrated into USSR economic system and its dissolution caused collapse of economic relation within that system. However, along with such objective factors there have been subjective factors - features of carrying out economic reforms that have had negative impact on growth performance.

As analysis in chapter six show privatization programs in Kyrgyzstan were comprehensive. However, by emphasizing speed in implementation privatization programs transfer of state properties to private sector as fast as possible turned out to be priority. Thus other aspects which are important for achieving effective functioning of enterprises after privatization have been implicitly ignored. Without provision of conditions for improving efficiency such as competitive environment, availability of financial resources and other public services, change of ownership form was not a guarantee for making effective private enterprises.

During the mass privatization programs fast implementation turned into an object to achieve planned quantitative targets and low pricing and large discounts were practiced. Consequences were that most of the state properties were sold under their real values. Thus, according to the State Property Fund (SPF) data by 06.06.1994 out of the total value of the all privatized enterprises by selling stocks only 43 per cent had to be paid, in other words applied discounts were higher than the valued paid. These selling prices were so low that passing short time after their privatization, prices of construction materials of these properties and different other components, such as sheep enclosure of farms, objects of social infrastructure in countryside, considerably exceeded their privatized values. Aftermath, there were widespread practices of selling them further on demolition, while metal components were sold as a scrap and exported to China. Moreover, there was a lack of strong legislative base which left important procedures none answered thus allowing for different interpretation and misuse. Such tendency did not create incentives for improving efficiency, and in contrary was aggravating crisis of the economy.

Attempts of comprehensive and rapid reforming created the issue of complementarities between sectors of reforms. This problem was evident between financial sector and real sector. As known prevailing part of trade and price liberalization and mass privatization programs was already completed by the mid of 1990s and quick recovery of emerging new private sector in new market conditions required corresponding response from financial sector, in particularly from the banking system. But as we know from the analysis of reforms on financial sector despite the establishment of two-tiered banking system and other new settings, the banking system started to operate relatively stable and efficient only after 2000s. Evidently it was impossible to rely on increase of population savings because of dramatic decline in income and weakened confidence of population after the liquidation of largest state banks¹. Thus, complementary link between real sector and financial sector reforming was not provided, emerging private sector was not supported by financial flows. This break of link between sectors of the economy aggravated the crisis position of enterprises.

¹ On this case Pirimbaev (2003, p.373) criticizing FINSAC program states that liquidation of the “Elbank” without taking into account the interest of depositors on indexing their deposits, and liquidation of the “Agroprombank” , the main financial source of agriculture sector, without replacing it with another financial mechanism, considerably undermined public confidence to the banking sector.

The same issue was evident in restructuring of agriculture sector where the creation of small farmers became priority as well. Along with privatization of *kolkhozes* and *sovkhozes* state organizations responsible for provision with machines and technical spare parts and with fertilizers were privatized. But these organizations during the USSR were formed under the principle of common use and after their privatization newly emerged small farmers were in lack of necessary technical facilities. This situation along with lack of financial resources left agriculture farms without machine and technical support and resulted in the dominance of small family farms primary focused on self provision with products, rather than effective agricultural producers.

Thus, both of the objective reason and subjective reasons appeared during the implementation of reform programs impacted on the magnitude of transformational crisis and long lasted process of recovery, which in turn resulted in sharp income decline, increased poverty level and inequality. These social consequences became favorable ground for inefficient institutions, such as corruption. Low level of real income level is directly reflected in the salary of workers and state officials, which in turn considered as one of the incentives for bribe-taking. To explore the level of salary of officials Table 8.5 shows average nominal wage of government officials, education and health sectors as the ratio to minimum consuming budget.

Table 8.5 Nominal wage / minimum consuming budget ratio (1996-2007)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total average wage	78	83	89	82	86	93	102	106	111	123	125	129
Government officials	110	110	118	99	117	146	146	154	156	166	143	145
Education	55	50	57	48	50	56	59	62	67	76	75	87
Health care and other social services	52	47	48	40	40	44	49	52	56	65	67	82

*In NSC estimations minimum consuming budget represents the price value of minimum basket of consumption products and payments for other services and goods necessary for individual to stay healthy, and taxes and obligatory payments.

Source: Calculated on the data of NSC 2001, 2008a.

These data show that income of state officials and workers of education and health care services are not high enough. Though compared to average wage for the whole economy state officials receive relatively higher salary, its level not enough to indicate their compatibility with non-corrupt behavior, when one takes into account comparison to minimum consuming budget. Position of education and health is worse. They are among the sectors with the lowest wage rate and, though last three years show some increases, did not reach even the minimum consuming budget rate¹. Obviously, under these low wages bribe taking and state capture attempts are expected to be very often. Under low growth performance government budget is also limited, while state needs revenue opportunities both to sustain quality of public services and to finance projects for improving institutional environment.

Thus, comprehensiveness and emphasize on speed of reforms were not characterized by efficiency. In most cases the speed of implementation became the objective, and not the quality. Priority of rapid reforming without analysis on sequencing reforms and local specifics of the economy, and absence of prior experience brought about aggravation of collapse of the economy and retarded the recovery of the economy. Consequences of low and unsustainable growth performance in turn have contributed to the inefficiency of institutions through sharp income decline.

8.2.2 Government efficiency

Creation of conditions for emergence of inefficient institutions during the implementation of structural reforms has been mainly associated with inefficiency of government. In order to adopt effective transformation policies government needs to provide public goods, enforce laws and regulations, and more effective bureaucracy independent from different interest groups. Implementation of these functions is important for establishment and effective functioning of market institutions. Since as explained in the third chapter expectation that institutions for market economy evolve automatically, or spontaneously, as a response to the demand of private owners in economy has not been fulfilled. Therefore, they need to be

¹ According to NSC latest data average nominal wage average in 2008 was 134,4 USD; government management – 160 USD ; and education – 85, 63 USD, while minimum consuming budget was 89,7 USD (www.24.kg/economics/2009/03/30/110413.html).

designed and enforced by the government. However, at the same time government in transition economies is required to be minimized: to reduce the scope of its activities, to solve the issues of overstaffing etc. Therefore, government in transition economies needs to be not only small, but at the same effective: able to run solid macroeconomic policies, to effectively enforce formal rules and have strong monitoring institutions.

In Kyrgyzstan minimization of state activity in the economy has been mostly realized through cut of government budget and elimination of financial support to private sector of the economy. However, such emphasize on fiscal aspect of downsizing state and absence of substantial administrative reforms under the conditions of decreasing fiscal resources lead to the lack of administrative capacity to enforce formal laws and regulations. Systematic control of government officials through government monitoring institutions was weakened that result in weak capacity of preventing public officials from corruptive behavior and influential pressure groups from rent seeking.

Such situation was detrimental to carrying out comprehensive privatization programs. Programs on transferring wealth from state to private sector have appeared to be lucrative opportunity for pressure groups and under inefficient government monitoring institutions have become object of vast misuse. Therefore, as noted in part on structural reforms, privatization was associated with cases of accusations of mismanagement and corruption. Weak monitoring on the process has resulted in lack of transparency in realization of privatization programs. Although it is difficult to explicitly determine the extent of these appearances, most of the researchers and experts agree on this fact¹. Thus, Koychuev, head of the State Commission on Economic Reform of Kyrgyzstan (1990-1993), pointed out one of the shortcomings of privatization as:

“...de facto pressure of officials and authorized individuals on the State Property Fund decisions. Their requests were so often that they formed policy of the SPF. Such pursue of private interest promoted elements of corruption” (Koychuev, 2003, p.112).

Non transparent realization of privatization programs along with other factors has lead to inefficient outcomes. For instance, as a result of mass privatization program most of the

¹ Indeed, in most of the studies transfer of property from state to private ownership is recognized as being accelerator for rise of corruption and state capture, for instance see World Bank (2000, p.32)

enterprises were sold with high privileges to buyers. Though, low paid value for privatized enterprises were the outcome of other factors as well, such as application of large discounts mentioned in the previous subsection, there is no doubt that non transparent attempts contributed to low pricing. Moreover, considerable share of most of the attractive enterprises was obtained by its directors. For instance the share of director of the trade centre “Aychurok” was 20 per cent, this share in joint stock company “Alamedinmeh” (specialized in processing of fur) was 51 per cent, in joint stock company “Suusar” (specialized in production of leather) 70 per cent (Koyçuev, 2002, p.77).

Such negative appearances in realization of privatization programs brought about corresponding perception of society. The questionnaire-based survey carried out by Osmonalieva (2002) showed that despite 77.5 per cent of respondents indicated that they knew the word “privatization”, only 2.9 per cent defined process as a real chance to be the owner. In contrary 15.3 per cent of respondents negatively perceived privatization process and defined as “*prihvatizatsia*” – the slang converted from Russian language that has meaning synonymously with the word “grabbing”.

Thus, under the conditions of weak government influential pressure groups could benefit from buying state properties. These new owners in order to continue profitable activities were going on to attempt to avoid laws thus causing state capture, erosion of rule of law and property rights.

8.2.3 Cultural and behavioral constraints

Changes in informal institutions take place in long period of time. Society of the most transition economies, especially of CIS countries, longer time stayed under the communist regime where the paternalistic behavior was dominant. Society had to pass through learning process in order to leave the old stereotypes of behavior and show those corresponding to the market relations. Therefore, to rely on quick formation of critical mass with highly entrepreneurial skills was wrong at least because of needed behavioral adjustment. Because of this, neither new directors of privatized enterprises that in most cases were de facto remaining old administration, nor the society after having been long period under the socialist system

were able to show entrepreneurial initiatives right after the mass privatization. It was obvious that it would appear gradually.

Apart from communist stereotype of behavior there are cultural features of societal behavior that promote inefficient institutions. Example for that is the corruption issue. Cultural structure of a society is considered as one of the roots of such inefficient institution. Strong traditional links among families and, more often, kinship relations among groups create the atmosphere for accepting the misuse of public power as a normal and, moreover, as obligated acts. On these constraints, study of Kuehnast and Dudwick (2004) is relevant. They surveyed the social network in Kyrgyzstan and changes in it during the transition. They indicate that during the USSR period informal social networks were the most important mechanisms for getting things done, obtaining access to “deficit” goods and services, acquiring accurate information about events and opportunities etc., and status and power depended less on income than on the extent to which one’s informal networks included people with *blat* (pull or influence). In the context of Central Asian countries such informal network had also roots in the traditional kinship ties. In these countries, in particularly in Kyrgyzstan, historically tribal and clan relations constituted the basis for economic and political structure prior to USSR. The influential kinship relations persisted during the Soviet regime despite attempts to weaken them. Moreover, practice of Soviet collectivized agriculture often grouped extended families and clan groups together, thereby reinforcing kinship networks by ensuring that their members lived and worked in the same location. Therefore, informal networks of Soviet type integrated with Central Asian countries’ specifics thus reinforcing the mutual support among kinship groups, friends, neighbors, and colleagues.

In post-socialist period together with drastic decline in real income social network changed in character. In contrast to the situation in Soviet period, money started to play a central role in networks. The importance of social networks for regulating access to public institutions and services has increased since the collapse of USSR. Respondents of the survey asserted that *blat* (pull or influence) had become essential for finding job, gaining admission to competitive university department, or resolving a traffic dispute. The non-poor in urban communities and, to a lesser extent, in rural communities, started to move to more “modern,” interest-based networks through which they successfully exploited access to resources (for

example, “insider” information, credit, preferential treatment by government offices) (Kuehnast and Dudwick, 2004, pp. 2-15).

Thus behavioral and cultural constraints naturally have been the legacy of long period under socialism and their changes take time. Therefore it can be assumed that in the long run with development of private sector and social awareness the role of such informal institutions as constraints to institutional development will ease.

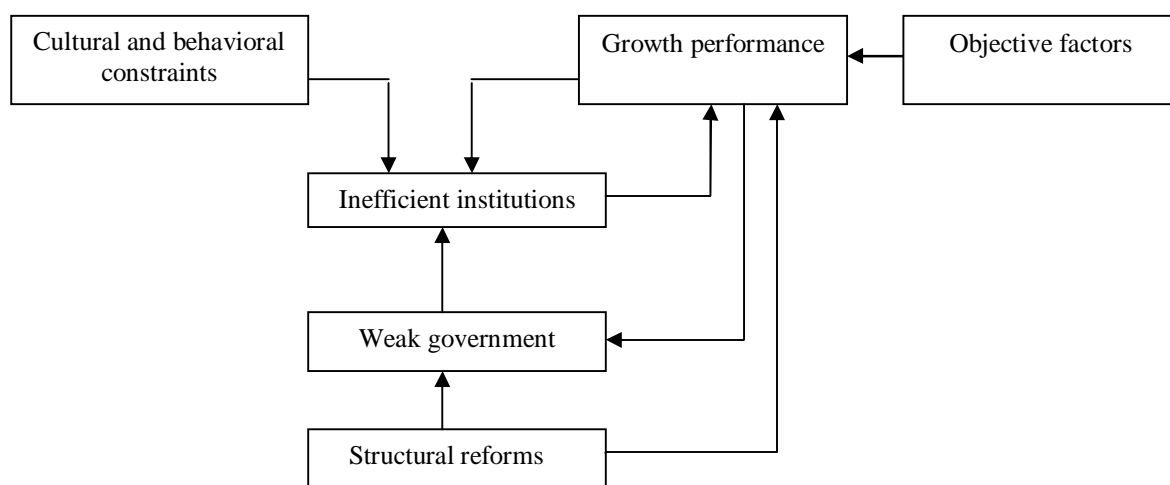
8.3. Perspectives on Improvement of Institutional Infrastructure

Three factors are identified as major sources of inefficient institutional infrastructure: economic growth performance, weak state and behavioral and cultural constraints. Mechanism of impact of these factors on inefficiency in institutional infrastructure is given in Figure 8.3. Growth performances have direct impact on inefficiency of institutions. Factors behind such growth performance have been not only objective, but subjective as well. Objective factors were related with dissolution of the USSR that caused unavoidable fall in output during the transition. Subjective factors have been appeared as consequences of implementing structural reforms. In particular, emphasize on speed in realization of reform programs caused the issue of non synchronic reforms in different sectors and ignorance of other important aspects of reforming. These features of implementing structural reforms aggravated transformational crisis and restrained recovery of the economy. But causation line between growth performance and institutional infrastructure is mutual - inefficiency of institutions is one of the major constraints of growth of the economy too.

Another source of institutional inefficiency - weak government, indeed, has been the result of character of implementation of structural reforms too. During the comprehensive structural reforms role of state in economy was particularly considered to be minimal. It resulted in minimization of state mainly through restraining government budget expenditures. Meanwhile, less priority were given on administrative reforms to adjust government to new economic conditions. This fact along with fiscal contraction resulted from unstable growth performance created weak governance. Thus, structural reforms influenced on emergence of inefficient institutions in two ways: through creating weak state and via negatively impacting

on growth performance of the economy. Behavioral and cultural constraints have also direct impact on inefficiency of institutions. This group of factor is related with an appearance of corresponding behavior of the society, such as entrepreneurial initiatives, development of civil society etc., which is the subject of long term changes¹.

Figure 8.3 Sources of inefficient institutional infrastructure



One may argue that if these are factors that have promoted inefficient institutional infrastructure, than despite such inefficiency eventually it will improve. Since comprehensive and rapid structural reforms are in past and enough time elapsed for behavioral and cultural adjustments to new conditions. But evaluation of institutional infrastructure shows that most of the data on such fundamental institutions as rule of law and property rights show that inefficiency of these institutions has been showing persistence and even have a negative tendency. Such inefficiency of institutions as corruption, weak rule of law, tax avoidance etc., have taken systematic character.

¹It should be mentioned that this described mechanism is schematic and there may be other ways of interactions between factors, for instance there is a quite possibility that weak government has an impact on growth performance, or behavioral and cultural constraints have an impact on weak government formation. However, we limit objective in this mechanism to show forming of inefficiency institutions and to aggregate interaction of factors.

Under this persistence main instrument on improving institutional infrastructure are measures taken by government. As the analysis reveal the fundamental problem is weak government that do not allow for efficient law enforcement. For instance, under the inefficient state an attempt to strength control cannot be achieved and rule enforcement will remain unchanged. Therefore, more fundamental solution is the administrative reform. Scope of this reform needs to be comprehensive, but as primary goals should be provision of efficiency of juridical system; changes of organizational structures to better suit the new conditions; and human resource development via improving the staff and training officials to work efficiently in new conditions with an increase in wage level of officials etc.

Along with government measures, growth performances and development of civic culture have potential to contribute to institutional improvements. Accelerated growth performance creates incentives for efficient institutions. Indeed this option can be seen as the positive feedback from economic growth to institutions or as the causality line from economic performance to institutions. But in this case economic growth should be successive in order to be able to provide with opportunities for institutional improvements. Although in the short and mid-term cultural and behavioral norms are considered as fixed, in the long-run they are subject to change. By now almost twenty year passed from the beginning of transition process, which is likely to be sufficient for behavioral adjustments. In Kyrgyzstan where democratic reforms, especially in 1990s, have been regarded more progressed in comparison with some other CIS countries, there is a high potential for the development of civic culture and their demand for improving institutional infrastructure.

Thus, evaluation of institutional infrastructure in Kyrgyzstan using different commonly used measures reveal two contradicting results: while measures on government regulatory policies over business environment show improvement in recent years, no progress indicate measures on other aspects such as rule of law, corruption and property rights, even in case of corruption negative tendency is observed. Also some other analytical reports emphasize large scale of underground economy and insecure property rights in Kyrgyzstan. Therefore, despite some improvements in regulatory policy, in general institutional infrastructure in Kyrgyzstan is inefficient. Three major factors are identified as sources for this inefficiency: growth performance, weak government and behavioral and cultural constraints. In perspectives

priority in improving of institutional infrastructure in Kyrgyzstan should be related to government measures, in which strong government should be the objective. Also stable growth performance and development of civic culture have potential to play important role in improving institutional infrastructure.

9. SUMMARY AND CONCLUSIONS

The principal objective of the thesis is to analyse structural economic reforms in transition of Kyrgyzstan to market economy and explain their inefficient outcomes. With this objective after analyzing structural economic reforms and evaluation of their outcomes, institutional infrastructure is explained as the main determinant of the success of economic reforms.

On policy debates how structural reforms in transition economies should be implemented Washington Consensus approach has been dominant. Within this approach institution building was not emphasized. However, growth experience of transition economies has caused eventual recognition of institutions as one of the key determinants of economic performance in these economies. Dominant view on institution building in transition economies in 1990s was that it would emerge spontaneously. Rapid liberalization and privatization would create critical mass of the private ownership, which in turn would create demand for the market enhancing institutions: to secure private ownership, rule of law, transparency etc. But experience shows that expectation of spontaneous emergence of institutions has not been fulfilled. Inefficient institutions such as corruption, underground economic activity, insecure property rights etc. are widespread in economies in transition and have been admitted as primary goals to be solved in reform agendas. Moreover, the persistence of inefficient institutions appeared as major issue for transition economies. Such persistence of inefficient institutions is explained with the formation of institutional trap. Institutional trap concept suggests that comprehensive economic reforming itself may create conditions that facilitate emergence and stability of inefficient institutions.

Evaluation of economy of Kyrgyzstan from historical perspectives shows that before the USSR historically Kyrgyzs were actively using nomadic cattle breeding. Changes occurred during the Russian Tsarist colonial dominance in the late of XIX century did not result in large improvements and the economy remained as backward agricultural country with dominance of nomadic cattle breeding. However, with establishment of the USSR considerable large investments were used to develop industry and agriculture. Kyrgyzstan had its own specialization in Soviet labor division – it was specialized in animal husbandry production and in industrial sector the main proportion had heavy industry, in particular, machine building

which was heavily dependent on the integrated Soviet production chain. As a result by late 1980s structure of the economy was characterized as agricultural-industrial. By the beginning of transition period Kyrgyzstan had inherited both advantages and disadvantages from the Soviet experience. Advantages were that it had relatively good base for further development of industrial production and developed human capital. On the other hand, it was highly dependent on other member republics within the highly integrated system of production and on financial support of central budget of the USSR, and market experience after more than 70 years under the Soviet system was almost absent.

Kyrgyzstan government chose the radical way of economic reforming that started with liberalization of prices in 1992. Selection of radical way was outcome of political and economic motives – to provide irreversibility of economic reforms under the light of remaining old communist political elite; economic motives – small and landlocked economy without large natural resources compared to some neighboring countries, inherited economic structure that was highly integrated into the Soviet system; and of large international community support, in particular of the IMF and the World Bank. Especially, activities of the IMF and the World Bank have played the important role in economic policy of Kyrgyzstan that has been featured by the tight monetary and fiscal policies. Transformational crisis in Kyrgyzstan was associated with rocketing inflation and sharp decline in GDP till 1995. Within five years economy of Kyrgyzstan turned into agricultural country from industrial-agricultural country as was considered at the end of 1980s. The magnitude of decline were determined both by dissolution of the old system and by consequences of economic policies.

Analysis of structural reforms shows that they have been comprehensive and radical. Privatization programs were implemented in mass character till 1998, from that to nowadays the process, generally, includes strategic sectors of the economy, which is not completed yet. Reforms in agricultural sector aimed at creation of private ownership forms virtually have resulted in the dominance of small individual farmers. Structural changes in the financial system have brought about establishment of the two-tiered banking system and restructuring and liquidation of the previous large state banks. Among non-banking financial institutions, credit unions and microfinancial organizations, have received wide practice. Reform of public finance system brought about the new budget and tax system, and fiscal policy has been

oriented at decreasing budget deficit. Changes in social welfare payments introduced new types of social protection expenditure items and redesign of previously existing ones. Comprehensive health reforms launched in 1996 and several programs were undertaken in education aimed at modernization of education system and education services. However, the common issue for almost all reform attempts in social sector has been the lack of government finances that has resulted in deteriorating quality of social services.

Economic outcomes of structural reforms have been weak. During the first six years of post-crisis period growth of the economy was mainly provided by agricultural sector growth and gold mining production. Growth of the agriculture was due to increases in productivity that resulted from structural reforms in this sector. But in 2002-2007 years this reform-induced effect was limited and effectiveness of agriculture decreased. Structure of the economy did not change substantially and remains as agricultural and raw materials exporting economy. Investment activities in Kyrgyzstan, despite the recent considerable increase, are limited too. Banking sector is generally characterized by short term operations, though recently started to show increases in both of credits and deposits.

Different indicators and data support the argument that there is a lack of necessary institutional infrastructure for market economy in Kyrgyzstan. Rule of law and property rights have obtained systematic weak character. This situation has serious damaging impact on the economy. According to the results of analysis made in the thesis, inefficiency of institutional infrastructure in Kyrgyzstan is explained with three groups of factors: growth performance; weak government; and cultural and behavioral constraints.

As analysis show economic growth performance of Kyrgyzstan has not been strong and this has negatively affected institutions. In particularly, sharp income decline during the transformational crisis and weak growth performance in post-crisis period have served as fertile ground for emergence and acceleration of inefficient institutions. Reasons for weak growth performance are not only objective, such as collapse of the previous integrated system within the USSR, but also subjective factors related with the character of implementation of structural reforms. In implementation privatization programs transfer of state properties to private sector as fast as possible turned out to be priority. However, without provision of other conditions for improving production efficiency simple change of ownership form is not a

guarantee for making effective private enterprises. Privatization programs have not resulted in establishment of effective private ownership and capital market. Reforms in agriculture virtually have brought about small family farmers primary focused on subsistence production, rather than being effective commercial producers. Overemphasize on speed of reforms and issue of complementarities between parts of reform has retarded the economic growth performance.

Comprehensive structural reforms have been implemented under the condition of weak government, therefore - weak rule enforcement. Weak government has been the result of attempts to downsize the government in order to achieve fiscal prudence and minimal state in the economy without corresponding administrative reforms to increase its effectiveness. Thus, although mass privatization programs achieved their quantitative objectives, privatization of state properties under the insufficient state institutions and absence of monitoring institutions turned into vast misuse. Such practices weakened rule of law and undermined further economic reforms.

Communist stereotype of behavior which had been based on paternalism was absolutely different from market behavior that required entrepreneurial initiatives. Moreover, strong traditional links among families and, more often, among groups with kinship relations have created the atmosphere for accepting the misuse of public power as a normal and, besides, as obligated acts. Adjustment of these behavioral and cultural constraints to market conditions has required longer time period.

With these mutually affecting three factors one may assume that inefficient institutions will improve. Since comprehensive and rapid structural reforms are in past and enough time elapsed for behavioral and cultural adjustments to new conditions. But the problem is that once emerged inefficient institution has deeply rooted and has taken systematic character. As analyses demonstrate inefficient institutions in Kyrgyzstan have been showing persistence. Although some indicators on government regulation over business environment show improvements, most of the commonly used indicators on property rights and corruption show no improvements in last ten years. Primary solution to these issues should be measures taken by government, in particularly administrative reforms that would provide juridical system with efficiency; changes of organizational structures that better correspond to new conditions;

human resource development via improving the staff and training officials to work efficiently in new conditions etc. Besides, eventual increasing economic growth performances and corresponding behavioral adjustment have potential to contribute to improvement of institutional infrastructure too.

Thus, effects of structural reforms in Kyrgyzstan without corresponding institutional environment have not been long lasting and inefficient institutional infrastructure is the major constraint for efficiency of structural reforms in Kyrgyzstan. Character of implementation of structural reforms contributed to the extent of inefficiency of institutions. In particular, downsizing of government within stabilization policies have not resulted in efficient and strong government. Comprehensive reforms under weak rule of law have been detrimental to consequent institution building.

These findings support the conclusion of other studies that institution building is precondition for successful transition to market economy. Evaluation of institutional infrastructure and results of analysis on sources of inefficiency in institutional infrastructure suggest that character of implementation of structural reforms, including macroeconomic policies, are important for efficiency of institutions too. This conclusion is in line with the propositions of institutional trap concept which note that macroeconomic policies in economies where institutions are in immature position, such as economies in transition, may create conditions that facilitate emergence and stability of inefficient institutions. Therefore, this study shows that variety of success in institution building of transition economies are not outcome only of historical past, but also of the conditions emerged during the reforms. However, these results are derived from the case of Kyrgyzstan and their generalization requires further possible research over several countries. But taking into account some common specifics of the CIS countries, such as initial conditions, behavioral patterns of society, macroeconomic policies etc., it may be expected that arguments of the study on importance of the institutional infrastructure and sources for its inefficiency have a high possibility to be valid for other CIS countries too.

APPENDIX A: GENERAL INFORMATION ON KYRGYZSTAN¹

Kyrgyzstan, officially named the Kyrgyz Republic (Kyrgyz Respublikasy), is a landlocked republic in the eastern part of Central Asia which is bordered in the north by Kazakhstan, in the east by China, in the south by China and Tajikistan, and in the west by Uzbekistan. Bishkek is the capital and largest city.



Map 1. Central Asia.

The total area of Kyrgyzstan is 198,500 sq km (76,640 sq mi). The country is almost completely mountainous. More than half of Kyrgyzstan lies at an elevation higher than 2,500 m (8,200 ft), and only about one-eighth of the country is lower than 1,500 m (about 4,900 ft). Glaciers and permanent snowfields cover more than 3 percent of Kyrgyzstan's total land area. An underlying seismic belt causes frequent earthquakes.

Kyrgyzstan is located at the juncture of two great Central Asian mountain systems (the Tian-Shan and the Pamir). These two systems are geologically separated from each other in

¹ Based on information on Kyrgyzstan from site: <http://www.kyrgyzstan.orexca.com/>

southern Kyrgyzstan, between the Alai Mountains of the Tian-Shan and the Trans-Alai Range of the Pamir. The Trans-Alai Range, which is the northernmost part of the Pamirs, forms part of Kyrgyzstan's southern border with Tajikistan. The main ridge of the Tian-Shan extends along Kyrgyzstan's eastern border with China, on a northeastern axis. Victory Peak (known as Pik Pobedy in Russian and Jenish Chokosu in Kyrgyz) is the highest peak in the Tian-Shan system at an elevation of 7,439 m (24,406 ft). The Fergana Valley in the west and the Chu Valley in the north are among the few significant lowland areas in Kyrgyzstan.

The Naryn River, Kyrgyzstan's largest river, originates in the mountains in the northeast and flows westward through the middle of the country. The Naryn then enters the Fergana Valley and crosses into Uzbekistan, where it joins with another river to form the Syr Darya, one of Central Asia's principal rivers. Due to its water reserves Kyrgyzstan is considered as having large potentials in producing hydro energy. Yssyk-Kul, the largest lake in Kyrgyzstan and one of the largest mountain lakes in the world, is located at an altitude of 1,607 m (5,273 ft) above sea level in the northeastern portion of the country.

The country's climate varies by region. The climate is subtropical in the Fergana Valley and temperate in the northern foothill zone. The lower mountain slopes have a dry continental climate, as they receive hot desert winds from Kazakhstan and Uzbekistan, whereas the highest mountain elevations have a polar climate. In the valleys, the average daily temperature in July is 28° C (82° F). In January daily averages are as low as -14° C (7° F). Conditions are much colder at high elevations, where in July the average daily temperature is 5° C (41° F) and in January, -28° C (-18° F). Precipitation is between 100 and 500 mm (4 and 20 in) in the valleys and from 180 to 1,000 mm (7 to 40 in) in the mountains.

Kyrgyzstan's natural resources include significant deposits of gold and other minerals. Also present are deposits of coal, uranium, mercury, antimony, nepheline, bismuth, lead, and zinc. Exploitable but small reserves of oil and natural gas also exist. The country's fast-flowing rivers provide hydroelectric power. Only 7 percent of the total land area is cultivated.



Map 2. Kyrgyzstan

Summary Information:

Area: 198,500 sq km (76,640 sq miles).

Land boundaries: Uzbekistan - 1,099 km, Kazakstan - 1,051 km, Tajikistan - 870 km, China - 858 km.

Climate: dry continental to polar in the high Tien Shan; subtropical in the southwest (Fergana Valley); temperate in northern foothill zone.

Money: National currency is the Som = 100 tyin

Government type: Republic

Administrative divisions: 7 regions. Batken Region, Chuy Region (Chuy Oblasty), Jalal-Abad Region (Jalal-Abad Oblasty), Naryn Region (Naryn Oblasty), Osh Region (Osh Oblasty), Talas Region (Talas Oblasty), Issyk-Kul Region (Issyk-Kul Oblasty).

Capital: Bishkek.

Independence: 31 August 1991 (from Soviet Union)

Population: 5,067,000 (2002)

Ethnic groups: Kyrgyz 65%, Russian 12.5%, Uzbek 13.8%, Dungan 1.1%, Ukrainian 1%, Uygur 1%, other 5.7%

Religions: Muslim 75%, Russian Orthodox 20%, other 5%

Languages: Kirghiz (Kyrgyz) - official language, Russian - official language (since 1996)

Flag of Kyrgyzstan



Emblem of Kyrgyzstan



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