Economic Transition in Central Asia: the Lack of Common Sense

by Daniel Kaeser,
former IMF Executive Director
for Azerbaijan, Kyrgyz Republic,
Poland, Switzerland, Tajikistan,
Turkmenistan, Uzbekistan

In the heyday of the Soviet system we made fun of the Soviet Union because they were sending sheepskins and fur hats to Guinea to fit out the tractors they dispatched to this hot part of Africa. This was a nice proof of the nonsense produced by the command economy. With the benefit of hindsight, we have to acknowledge that we made also our mistakes in our efforts to support the transition to the market economy in the former Soviet Republics. I say “we” because as former Executive Director in the International Monetary Fund, I have to bear a tiny part of responsibility.

Nine years after becoming independent, the Central Asian countries and most former Soviet Republics have by far not achieved the transition process to the market economy. In spite of the high education level of the population, of the intensive care provided by the International Financial Institutions (IFIs) and the support of bilateral donors, the growth rates are low, the inflation rates high, the budget unbalanced and the currencies shaky. The poverty line is rising. The foreign direct investments do not meet the expectations, with the exception of the oil, gas and the gold mining sectors. The external debt is growing rapidly.

What went wrong? The cardinal mistake has been to address the economic transition in a dogmatic way, with a ready made solution instead of going in the field to make a comprehensive analysis of the problems at stake. We tried to go too fast. Famous professors of economics claimed that the transition process could be fulfilled within a couple of weeks if the economies of the transition countries were fully liberalized and privatized. Any delay seemed irresponsible or even criminal. Rushing to introduce the free market economics, we did not pay enough attention to different features, whose effects were compounding each other and hampering the success of the transition.

First, we did not recognize that by its size, training and corruption, the administration of the former Soviet Republics was to become a formidable obstacle to the transition process. The civil service, which was in charge in Soviet times of managing the command economy, was and remains grossly overstaffed, especially at the oblast (province) level. Before the collapse of the Soviet Union, Moscow financed between 30 and 40 percent of the budget of the poorest Republics. As the size of the administration has hardly been reduced since independence, the administration is too big not only by international standards but also in relation to the tax paying economy. This has different negative consequences. As the IMF and the other IFIs insist for good reasons on economic stabilization and on the balancing of the budget, the former Soviet

Republics have the tendency to rise their tax rates to a level which contributes to discourage foreign investors and encourages domestic producers to escape taxation by fraud or by seeking refuge in the underground economy. Another consequence is that these countries borrow heavily abroad , notably from the IMF, and become over-indebted, to support their over-sized State machinery. Furthermore, the State budget is usually unable to finance more than two thirds or three quarters of the budgetary allocations of the ministries and State agencies. The remaining part has to be covered by so called "special resources "With other words, the administration, which has been anyway trained to interfere with all aspects of people's life, has to develop its own initiative to finance itself and to round up the insufficient salaries of the civil servants. There are practically no limits when it comes to extract fees and kickbacks from a still fragile private economy.. To give some examples, 244 documents of 64 different types have to be renewed every year with 12 different ministries and State agencies for the industrial production of cheese. Up to 300 permits may be required for the construction of a large building. The formalities for the registration of a small enterprise last more than one year. The conditions prevailing for the transportation of goods, especially to and from neighbouring countries, represent a true return to the middle age in the time of high-tech. The permanent fleecing and harassment of enterprises by various branches of the administration create a poisonous business environment, which discourages the private initiative and deters potential foreign investors. Moreover, a large number of enterprises use kickbacks in order to be able to hide in the underground economy.

A drastic downsizing of the administration is an important precondition of a strong and sustainable growth in Central Asia and in other parts of the former Soviet Union. It would help balance the budget and give room for increasing the salaries of the remaining core of the civil service, thereby eliminating the major cause of petty corruption. It would also help to cut red tape and to improve the business environment. A painless mean to perform such reduction without firing too many people would be to stop for a couple of years hiring civil servants to replace those retiring or leaving the civil service. It is a pity that the IFIs supporting the transition process did not press for a drastic downsizing at an early stage.

Second, the proper functioning of the market economy requires the introduction and the implementation of an economic legislation which is completely different from the Marxist one governing the command economy. As the former Soviet Republics were not able to draft in record time the required laws and regulations from scratch, international organizations and bilateral donors were eager to provide them ready-made. The result was a cocktail from Anglo-Saxon laws blended with Continental ones. When visiting offices of resident representatives of IFIs and Ministries, one can see proudly displayed on one wall an impressive synoptic table of new laws and decrees already passed and on another wall a table of laws, rules and regulations in preparation. But for a long time, nobody did really care about implementation. The top priority was given to the training of economists. It took a long time to realize that the administration and the judiciary have great difficulties in understanding the new legislation, and when they do, they have trouble agreeing with its basic philosophy. The Marxist training of the senior people in the administration and the judiciary explains their reluctance to enforce private property rights and bankruptcy laws.

Laws and regulations which are hardly understandable open the door to arbitrary and erratic administrative decisions. One example is the introduction of international accounting standards, which could be seen as great progress if their rationale could be well understood by all parties involved in their utilization. As this is by far not the case, the new standards lead to permanent squabbling between the tax authorities and enterprises. Another example of a good purpose which turned sour was the introduction of the VAT, which is by far too sophisticated for the Central Asian and most other former Soviet Republics. In many cases, tax inspectors ask enterprises down the processing line to calculate the tax not only on the value added by them, but on the total value of the good, which brings the tax burden to a prohibitive high level. Exporters who are entitled to get the VAT refunded on exported goods can better forget about it, so that the major advantage of the VAT gets lost. To put the top on the nonsense, the Russian Federation retains for the VAT taxation the origin principle, which is serving its own interests, while the other Republics have been advised to adopt the destination principle.

There is little hope to have conflicts between enterprises or between an enterprise and the State properly settled in court. In an interview given to a Western newspaper the Kazakh President jokingly suggested that it would take 40 years to eradicate Marxism and to re-educate the courts. We cannot wait for so long if we wish to secure the success of the transition. The market economy can only work if contracts can be enforced by legal means and if enterprises can be protected against arbitrary administrative decisions.
As the difficulty of introducing a new legal system in the former soviet Republics has been grossly underestimated at the outset, a special effort has to be made and a large amount of resources should be devoted by the international organizations, by bilateral donors and by the concerned countries to improve the professional qualification of the civil servants- notably in the tax and customs administration - of the private tax advisors, of the lawyers, and last but not least of the judiciary. The transparency and the accountability of the judicial system should be enhanced, for instance through the publication of all laws and by-laws, as well as of the upper court's decisions. The salaries of the judges should be high enough to prevent corruption.

Third, the functioning of a market economy requires also a well performing banking system. The banking system should be able to collect the savings of the population and, in turn, to extend credits to viable enterprises, thereby expanding the money supply in line with the growth potential of the economy. Unfortunately, the hyperinflation that followed the breakdown of the Soviet Union left the banking system of the Republics in shambles. The population became extremely reluctant to deposit money on bank accounts and recurring banking failures confirmed the people's mistrust. They prefer to keep its savings in dollar notes under one's pillow or to buy durable goods produced abroad, which is not supporting the development of the domestic economy! Collecting only little money from the population, the banks cannot satisfy the normal credit demand of a market economy. The total amount of credit is small, the credit maturity does usually not surpass 3 to 6 months and the real interest rates (after deduction of inflation) fluctuates between 20 and 30 percent. Only very short -term operations (shuttle business) and the State deficit can be financed on such terms! Enterprises which would be able to process the national production of cotton, wool, skins, tobacco etc. cannot afford to do so, because the financing of the crop would carry prohibitive terms. Viable enterprises are standing idle because they cannot afford to borrow working capital. While the money supply M2 is about the size of the GNP in most market economies, it rarely surpasses 13 percent in the Central Asian Republics. These extremely tight monetary conditions keep the development of these countries well below its potential. They have also other negative consequences. The payment system is in a state of catalepsy. What has been called the “non payment culture ”of these countries is at least partly due to a general lack of money. The same can be said concerning the permanence and omnipresence of the barter trade.

This problem has been recognized at an early stage. The IFIs which are monitoring and supporting the transition process urge the Republics to do the utmost to improve the organization and the supervision of banks as well as the professional qualification of bankers. Yet this will take time and once these betterments are achieved, it will take again a relatively long probation period without failures to regain the public confidence in the banking system. What should be done in the meantime to mobilize the savings of the population and to recycle them in the economic circuit? The IFIs are adamantly against solutions which would run against the liberal orthodoxy, like the creation of postal banks with State guaranty.

Fourth, an important statutory purpose of the International Monetary Fund is “to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy”. It seems that the IMF has forgotten this purpose. If not how could one explain why the Fund is advising and supporting Central Asian countries which are fighting a tireless trade war against each other? Trade and transportation between the different republics sharing the Fergana Valley have come to a complete standstill. Elsewhere, goods passing the border have to be unloaded and reloaded, they are subject to arbitrary and erratic decisions by customs officers. A Kyrgyz truck with perishable goods will have to pay 100 dollars at each of the five Kazakh checkpoints established on the road to Siberia and to wait for one day at each checkpoint before being escorted in convoy to the next one. One usual form of extortion is to ask truck drivers to produce additional documents or photographs and to charge 125 dollars for requesting them by fax and 25 dollars for receiving them. These are only a few examples of the trade hampering, always changing , practices introduced after the collapse of the Soviet Union either by government decision or on the own initiative of local authorities.

The strengthening of the regional cooperation should be made a major condition set by the IMF and the other IFIs for supporting these countries, if only because the mutually beneficial impact of the development of regional relations would reduce the need for external assistance. Unfortunately, the IFIs are overcautious in addressing this issue, partly because they fear to interfere with the sovereignty of member States, partly because it is extremely difficult to gather reliable information on the multiplicity of ever changing trade hampering measures.

I do not think necessary to discuss the disappointing results of the forced privatization imposed on the countries in transition, because this topic has been extensively dealt with in the media, but I would like to stress that this is a good example of a policy based on dogmatism rather than on common sense.

It is time to conclude. On the one hand, we did realize that the IFI's bear a large part of responsibility in the creation of the major problems which are now hampering the success of the transition process. They did err in their assessment of the situation, as this was the case for the need of drastically downsizing the civil service and for the difficulty to introduce a new, market based legislation. They did err by an excess of dogmatism in the field of financial sector rehabilitation and of forced privatization. They showed too much respect for the sovereignty of member States as in the case of regional trade war. On the other hand, we have to admit that the IFIs responsibility was more pronounced for the creation of those problems than for their perpetuation. These problems could at least to a large extent be solved by the concerned countries themselves. Why are they shying away from doing it? Partly because the monitoring of the transition process by the IFIs and the assistance provided by bilateral donors weaken the sense of responsibility of the national authorities. Partly because the decision process in these young democracies is still shaky. Partly because the civil society (NGOs, pressure groups) are not yet developed enough.