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Transition, Institutions, and the Rural Sector

Edited by Max Spoor



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- Nearly all enterprises are specialized, profit-oriented businesses providing a full income to the entrepreneur and employees.
- The capacity for salaried employment is limited per enterprise to a few employees; but in many cases entrepreneurial income sustains people in and beyond the entrepreneur's household through unpaid labor.
- There are very large variations in the financial features of enterprises, including cost, revenue, and profit levels.
- There are strong links with the agricultural sector through food processing or trade in food products.
- Marketing channels are generally in the local economy and small-scale, with most firms in retail.
- Liquidity and capital constraints are general, and the most important constraint to expansion, or indeed operation, is access to credit.
- The role of public institutions in business support appears very limited, although there is much to be improved in factors that are usually in the domain of public action, such as legal safety and infrastructure quality.

The data are also used to undertake some basic explorations of the determinants of profit, employment, and incomes generated in the enterprises. Profit levels are satisfactorily explained by conventional inputs: labor, fixed capital, and inputs. Of these, employment is of special interest from a rural development point of view. It appears that the size of the labor force, though modest in all cases, is linked to the level of fixed capital, and to access to credit. It is also negatively associated with the share of retail sales, and with capital input expenditures.

There appear to be important regional differences in the relation between employment and income on the one hand, and businesses' capital stock and levels of revenues and expenditure on the other. This confirms the idea that expansion of the rural nonfarm sector is likely to have very different implications for rural employment and rural incomes in different regions. The findings show both how this type of research can be relevant for directing policy on rural development, and the limitations imposed by a relatively small sample.

Notes

The study was prepared as part of the Natural Resources Institute project entitled "Characterization and Analysis of the Nonfarm Rural Sector in Transition Economies" undertaken for the World Bank and Department for International Development (DFID).

1. The communities surveyed were, in Marz Ararat: Hovtashen, Kaghtsrashen, Ajgepar, Mkhchyan, Dzorak, Dashtavan, Ararat. In Marz Siunik: Tolors, Uts, Akhlatyan,

unfortunate geographical location. These constraints—coupled with the economic crises of 1991 and 1992, which led to a sharp reduction in production in industry and agriculture—convinced the government that economic development could only be achieved with foreign aid and investment. It was assumed that rapid adoption of market reforms and the creation of a law-governed democracy would give Kyrgyzstan a head start in a region otherwise rather wary of market reform.

Kyrgyzstan opted for a shock therapy-type of transition strategy and closely cooperated with the IMF and the World Bank. The principles of structural adjustment were laid down in successive agreements, bearing a strong focus on reducing inflation and budget deficits, regulation of the foreign debt, and large-scale privatization of the still sizable state sector (UNDP, 1997: 4-5). These reforms were deemed highly successful and as early as 1994 a representative of the IMF noted that everything was in place at the macroeconomic level—the introduction of the new currency had been successful, inflation had been tamed and trade had been fully liberated.⁵

However, in the middle of the 1990s some observers remarked that the macroeconomic reforms were merely a facade for chaos at the micro level. Spoor (1995) concluded that instead of using the terms “shock therapy” or “fast reformer,” it would be more applicable to speak of “hasty” or “unprepared reforms.” These hasty reforms often had disastrous consequences for the economy. The dismantling of the socialist economy had in fact only been partially accompanied by factual restructuring of the economy. In the course of a few years the entire infrastructure deteriorated, energy distribution became problematic and new laws were not only poorly designed, but also often unknown to those who had to implement them.

Economic recovery was very slow and, except for the numerous small-traders, levels of economic initiative were disappointing. Moreover, macroeconomic stabilization did not prevent the further decline of living standards. The percentage of the population living below the poverty line increased from 45 percent in 1993 to 60 percent in 1996 and recent information suggests that the trend is continuing.⁶

Problems in the Rural Sector: Lack of Financial Sources

The privatization of the rural sector is a typical example of the haphazard way the economy was transformed. New privatization laws were adopted quickly—in line with the demands of multilateral organizations—but without having secured consensus within the government. Moreover, the government neglected to provide the population with sufficient information on the reforms. Lack of transparency within the privatization process resulted in great irregularities,

which generally meant that the local elite with access to information and with connections in the administration was able to get hold of most assets.⁷ As a result of the general confusion and as a response to the uncertainty concerning the status of property, many former *kolkhozniki* decided simply to slaughter their own cattle. The half-hearted reforms resulted in dramatic decreases in agricultural production.⁸ A quick recovery of the rural sector did not take place and the rural population returned to subsistence agriculture rather than to produce for the market (Anderson, 1999; Spoor, 1995).

One of the largest problems for renewed rural development was the lack of adequate financial structures that would enable investment in small agricultural farms. Although in the 1990s a multitude of commercial banks were established, their services were mostly restricted to the capital Bishkek and fell short of covering actual demand in the rest of the country. Thus, in 1998, it was estimated that 70 percent of the population did not have access to financial institutions (Wadhwa, 1998: 8).⁹

Moreover, as a result of continuing inflation and high default rates, interest rates remained endemically high. Private lenders asked interest rates of 20 to 30 percent per month, while commercial banks applied rates of 50 to 100 percent per year. Such percentages greatly exceeded the relatively small profit margin of agricultural activities, especially because investments in animal husbandry or crop cultivation only generate profits after a year or longer.

Without a radical change in the financial structure it was improbable that credit services would become accessible to the majority of small farmers. In fact, poor small farmers were simply not interesting clients for commercial banks. Both technical and psychological factors were responsible for this situation. In order to guarantee repayment, banks generally demanded a large number of official documents from their clients, which made the costs of receiving small loans disproportionately high.¹⁰ Small farmers could simply not afford to apply for such credits.

Moreover, under conventional credit practices administrative costs were too high to make disbursement of small credits (of a few hundred dollars) profitable for banks. Another reason that explains the bank's reluctance to grant loans to farmers was a general distrust of poor villagers. They reasoned that since rich clients had so many problems repaying loans, poor villagers would probably not repay at all and enforcing repayment would be either too costly or impossible.

The Participatory Poverty Alleviation Project: Structure, Characteristics, and Goals

In 1998 UNDP and the Kyrgyz Agricultural Finance Cooperation (KAFC) signed a cooperation treaty to jointly provide micro-credit to groups of poor

farmers. The KAFC was responsible for the actual disbursement of loans and had received a long-term interest-free credit from IFAD of 1.5 million dollars for this purpose.¹¹ For its part, UNDP was responsible for the social aspects of the project. In other words, it prepared groups for credit eligibility and monitored the credit process. In order to guarantee the sustainability of the micro-credit approach, the project had to address two major issues. First, it was necessary to design new micro-credit mechanisms that could replace the conventional crediting policies used by the KAFC. Second, in the villages where the project would be introduced, there was a need to create social structures that would facilitate the preparation of credit groups and that would deal with problems of repayment level.

The KAFC was the successor to the Soviet *Agroprombank*, which had collapsed in the beginning of the 1990s. Although the KAFC was an independently operating financial institution, it was closely linked to the Kyrgyz government, which had established the KAFC to address the lack of financing in the rural sector. Given this background, it is not surprising that, until 1998, the KAFC had disbursed credit solely to large agro-business and cooperatives. Nevertheless the bank was selected as a partner in the project for several reasons. It had a relatively young management with a positive attitude towards alternative credit management. In fact, the KAFC had already received technical aid for this purpose from TACIS. Moreover, the bank possessed a large number of branches throughout the country, which was a necessary precondition for micro-credit operations.¹² To allow for the disbursement of credits of 5,000 som per person (approximately US \$150) it was necessary to introduce new credit mechanisms that would minimize both transaction costs and repayment risks. The applied principle was based on social collateral.

To circumvent the need for physical collateral, loans were disbursed to groups of five to twelve people who were responsible for repayment as a group. Moreover, future credit disbursement within a given village was made dependent on the timely and complete repayment of already financed credit groups.¹³ Another measure taken to reduce administrative costs was assessment and approval of the applications by local village associations.

The structure outlined above enabled the KAFC to apply relatively low interest rates. The rates of 28 percent and 32 percent per year covered inflation and the administrative costs of the financial institution but did not include a profit margin. The KAFC expected that if clients were successful, they would take out larger follow-up loans and that these loans would generate profit.

The implementation of such a financial structure strongly depended on a social network that could guarantee the coordination and functioning of the implicated activities. The task of the UNDP staff was to establish such structures in designated pilot villages and small towns. Their work started at grassroots level by initiating or strengthening informal groups made up of former

colleagues, neighbors, or, for example, ex-classmates. Participants received short courses in bookkeeping, and marketing and financial mechanisms. Potential credit groups were also required to attend workshops and informal meetings to develop their group structure and to write a business plan.

This preparation phase lasted six months on average. The goal of the preparations was not simply to teach practical skills—some of them were quite redundant—but rather to enhance and test group cohesion. During this period special attention was given to the obligatory informal savings funds that were set up within the groups. The savings funds were meant to create an internal emergency fund and more importantly, the way a group managed these funds served as a reliable indicator of their relative cohesion.¹⁴

A crucial and tricky element in the project design was to organize village associations in order to regulate coordination between the various groups. These associations consisted of representatives of each group and several respected community-members, usually elderly men (*aksakals*). In due course the village associations were expected to take over the coordination of credit disbursement in their villages by forming a link between the affiliated farmers and the financial institutions. Credit services would be sustainable after a period of four years—the life span of the UNDP project—only if these structures operated well.

The model outlined above was not an externally prescribed blueprint, but instead evolved from discussions between the various groups involved and was repeatedly adjusted during the first year of the project. However, this does not mean that it was successful in all cases. Problems frequently arose during application. These problems can best be illustrated by reference to specific cases, showing progress and setbacks in a small industrial town and in a more or less typical rural setting. The town of Kok-Jangak and the village of Bai-Munduz are both located in Jalal-Abad province in Southern Kyrgyzstan, where the project was initiated in fourteen villages and small towns.

Surviving in Kok-Jangak

The economic decline that followed the disintegration of the Soviet Union turned Kok-Jangak into a ghost town. By 1998 approximately 3,000 miners had already lost their jobs in the destitute coal mine, while the textile and radio factories had long closed their gates. Of the 25,000 people that had inhabited Kok-Jangak at the end of the 1980s, approximately 16,000 had left the town for good. Because of the deplorable living conditions Kok-Jangak quickly attracted the attention of aid agencies. They tried to alleviate the problems with grant and emergency aid, but they had very little lasting effect. In fact, the combination of severe economic decline and an overwhelming amount of uncoordinated and ill-prepared aid projects turned out to be a dangerous mix. Within a few years a wide variety of local NGOs had been set up in Kok-Jangak. They were hardly

known by the majority of the population, but they received one grant after the other from international donors.¹⁵ The leaders of these newly established NGOs often saw foreign aid agencies as a lucrative source of income that—with some ingenuity—could easily be tapped.¹⁶

Given these circumstances, it is hardly surprising that the implementation of the *Poverty Alleviation Project* was problematic in Kok-Jangak.¹⁷ Various NGOs and influential people tried to advance their own interests. In fact, at one point the police commander visited the regional UNDP office, and demanded that a special credit group be set up for his men.¹⁸ Eventually the project started to work with eight groups. Six were formed after several informal visits to two neighborhoods, during which the mechanisms of the project were explained and discussed. The other two groups, in contrast, were nominated by local NGOs. These two groups were initially accepted because they genuinely consisted of poor inhabitants and seemed to meet the criteria of the project—but also because the UNDP fieldworkers did not want to strain relations with local NGOs.

One of the poorest credit groups in Kok-Jangak had adopted the name *Yntymak* ("friendship"). The group consisted of eight female neighbors who had already developed close contacts of mutual aid. As single or divorced mothers they barely survived the economic changes. They relied on irregular and insufficient state allowances and poorly paid administrative jobs for their income. In terms of the project *Yntymak* formed the ideal group. The group cohesion was strong, the members were highly motivated and they freely expressed their ideas during noisy group discussions. As was pointed out before, the project demanded that the groups established their own internal savings fund. Although in principle, they were free to define the terms of such a fund, like most groups, *Yntymak* set up a rotating savings fund. The women borrowed the accumulated sum in turn, but only after having written down how the money would be used. Every two weeks the women discussed the results and the amount—with 5 percent interest added—was allocated to the next member in line. During one of these discussions a woman said that she had used the money to make pastries and sold these on the market, but that she had hardly made any profit. The other women were ready with advice and discussed innovative ways of producing cheaper pastries without incurring complaints from customers.

Nevertheless, application for credit turned out to be problematic. In their business plans, the majority wished to use the credit for the purchase of cows. The reason for their choice was understandable. Having young children at home, fresh milk was a desirable addition to the sober diet. However, simple profit analysis showed that keeping a cow would not be profitable in their case. The application that the KAFC eventually accepted was a compromise. The women collectively bought one cow, but used the bulk of the loan for the purchase of poultry. The remaining 25 percent of the loan was set aside to enlarge their internal rotating fund for individual trading activities. Repayment of the credit

did not raise any real problems and at the end of the year the group had a net profit of one cow and 120 chickens.

Not all credit groups were equally successful. Nurlan Kabaev was the leader of a group of former miners and in all modesty he had given the group his own first name. The group enrolled in the project on the recommendation of a local NGO, of which Nurlan's wife was an active member. Whereas most groups had difficulties in formulating their future economic activities, the *Nurlan* group already possessed a solid business plan, which contained detailed calculations and timetables on the management of a beef and poultry farm, and the organization of corn and potato cultivation. Stables for the animals had already been arranged, consisting of an abandoned apartment complex that the local authorities had allocated "free of cost" to Nurlan.

On paper everything looked fine, but in practice problems quickly rose. After the group had met a few times, it turned out to be virtually impossible for Nurlan to get all his members together. Likewise, the set up of an informal savings fund turned out to be problematic for the group. Although amounts were meticulously written down in a log, in reality no money was saved. Eventually the credit application was turned down by the KAFC. The main problem was that the majority of the members showed little interest or initiative. The group was constructed on the principle of patronage that resembled the Soviet way of doing things. One person takes the initiative, gathers a number of people and of course also receives the bulk of the profit. Because the KAFC granted the loans on the basis of social collateral, this hierarchical structure involved a high risk as it prohibited strong internal group cohesion.

Joint Effort in Bai-Munduz

Bai-Munduz is a small rural community with approximately 200 houses, located along the edge of the Ferghana Valley. Most of the local people used to be employed in the local collective farm (*kolkhoz*), whose administrative buildings were located in the neighboring village. The dismantling of collective agriculture had harsh consequences for the village. Because most farmers had no financial reserves, dependency on costly agreements with brokers greatly increased. Generally, these agreements meant that the broker financed fertilizer, pesticides and transport on condition that the farmer would sell the harvest at a greatly reduced price. Even those villagers who had no need to enter in such unequal relations, still had great difficulty in improving their economic position. The limited diversification of Kyrgyz agriculture, the lack of storage facilities and the fragmented character of markets, resulted in extreme fluctuations in the prices of the most important crops. Villagers without sufficient financial resources were forced to sell their produce at the moment that prices were

lowest, while agricultural inputs like fertilizer, seeds, pesticides and petrol were bought when prices were highest.

In spite of these problems the prospects of the inhabitants of Bai-Munduz seemed promising. The village was located along the main transit road, not far from one of the bigger regional markets. The fields were fertile, allowing the cultivation of cotton and tobacco, both relatively profitable crops. In several respects Bai-Munduz was the opposite of Kok-Jangak. The former *kolkhozniki* had been left alone since the *kolkhoz* was disbanded, which meant that daily life was less interwoven with bureaucratic structures. Although there were several "rich" villagers, the difference in living standards was much less pronounced than in Kok-Jangak. Moreover, the villagers had no experience with aid organizations, which paradoxically eased the implementation of the project.

One of the groups in Bai-Munduz had adopted the name *Maksat* ("hope"). The members were of the same age group and had known each other since childhood. They had already applied for credit through the KAFC once before, but this attempt had failed because of their inability to provide sufficient collateral. The men stressed that the main reason for the refusal to grant them credit was that corrupt bank employees would only provide a loan in exchange for the payment of an additional 10 percent on top of the regular interest rate.

Maksat's business plan was very simple. They intended to rent four hectares of land to cultivate cotton. During the assessment of their plan a KAFC credit specialist asked them whether they understood that they had to pay interest on the credit. After all, they would receive money in January, but the bulk of expenditures would be made in April or May. This meant that during the first three months—according to their business plan—interest would accumulate on unused credit. This question started a heated discussion, which showed that the group had planned in detail how to invest the money. From January to April they would raise young bulls and sell these again around the time that agricultural inputs for the cultivation of cotton had to be purchased. The group knew exactly how to proceed, but it had been too difficult for them to translate this formally into writing. The KAFC decided nevertheless to grant them the credit on the basis of their simple business plan. After four months of buying and selling cattle, the group had already made enough money to repay the bank, but preferred to stick to the repayment schedule in order to be able to further expand their economic activities.

In Bai-Munduz, as in every village where the project was operating, a village association was created, consisting of representatives of the credit groups and respected elderly men. The effectiveness of this specific village association became clear when a conflict arose in one of the groups. This group had already received credit, but decided at the last minute not to trust one of its members. This member made his dissatisfaction clear to one of the representatives of village association, who in turn demanded a special meeting. The association

decided that the group did not have to give the money to the distrusted member, but instead had to return the money to the KAFC within a week in order to prevent problems of future financing in the village.

The creation of village associations filled a social vacuum that was created after the collapse of the FSU. In several villages, including Bai-Munduz, these new village associations became active in addressing village problems. Access to credit was only one of the issues that could be handled collectively. In the course of the project several village associations started to coordinate other economic issues and activities. The association in one village bought an oil-press for the production of sunflower oil; elsewhere a plan was developed for the renovation of the village waterworks. In Bai-Munduz the association focused on marketing services and aimed to solve some problems with regard to the purchase and sale of agricultural assets. By organizing these transactions collectively they were able to reach more profitable markets (in Uzbekistan as well as Northern Kyrgyzstan), which reduced their dependency on disadvantageous agreements with rich middlemen.

Analysis of Problems and Successes

The mining town of Kok-Jangak and the rural community of Bai-Munduz differed in many respects and the problems of implementing micro-credit services varied accordingly. The former miners and civil servants in Kok-Jangak obviously had more difficulty in setting up viable businesses than the farmers in Bai-Munduz, not only because of their professional background, but also because of the differential access to markets, the fertility of the soil and the availability of land. Moreover, the pervasiveness of bureaucratic and hierarchical structures in Kok-Jangak made the implementation of a project based on horizontal grassroot initiatives more problematic than in Bai-Munduz. However, these are differences more of scale than of nature, and therefore make a comparison possible. By pointing at both similarities and differences in the implementation of the project, it will be possible to acquire further insights into the wider process of economic reform and the collision of international agencies and local circumstances.

A first obstacle in the implementation of the PPAP, for both the financial institution and the recipients, was unfamiliarity with the credit mechanisms. The initial designs of projects were regularly not economically viable. Members of potential credit groups were often motivated by the daily needs of their families, such as milk, or by concerns originating from social status, for example to own cattle, rather than profit margins. This problem was particularly urgent in small industrial towns, where until recently inhabitants had the security of monthly wages and for whom private economic activities had mainly meant additional

income and less dependency on inadequate distribution systems. More often though, the difficulties of business planning were related to the problem of translating complex thoughts into flat black and white paper. As such it reflected the difficulty of *planning* activities in an environment of uncertain and changing economic opportunities and bureaucratic restrictions, rather than a lack of knowledge among the villagers.

A more urgent problem was the inclination towards hierarchical group formation, with persons with a higher social and economic status being chosen as chairmen, as was the case in the *Nurlan* group. This tendency is understandable, as such leaders have better access to local authorities and can therefore ease operations in the economic and political arena. However, these vertical group structures increased the possibility of power abuse and unequal profit sharing, and proved disastrous in a credit scheme based on social collateral because they undermined the principle of shared responsibility. Moreover, they did not correspond to the ideal of poverty alleviation of the aid organization.

As the *Maksat* group made clear, not all groups trusted the KAFC—or any official financial institution for that matter—and accusations of corruption were frequently expressed. Although such allegations have to be understood in the context of a widespread tendency to attribute all kinds of problems to “the Mafia” or to corruption in official institutions, the charges were certainly well-founded in a number of cases. The problem of corruption is of course not new in this part of the world, but one has to be careful in seeing it automatically as a legacy of the Soviet past. On the contrary, the involvement of donor organizations and the implementation of aid projects have to be considered. The dilemma was very visible in the implementation of the PPAP. On the one hand the project aimed to “empower” local communities, so that their dependency on authorities and other influential people would be lessened. On the other hand, the interference in the financial flows meant an increased risk of corruption. Because the credits had been partially subsidized, the KAFC could apply lower interest rates than commercial banks. This difference in interest rates put local bank employees in a tempting situation, because they were able to capitalize on the difference. The KAFC attempted to restrict corruption among its staff by adopting a rule that employees were not allowed to work in the same district for longer than two or three years. This would prevent their personal networks from becoming too large. UNDP adopted a similar policy and sent its Kyrgyz employees to regions where they had no relatives. In addition, the modest size of the loans and the involvement of several organizations in realizing the projects provided a certain guarantee that bribing and corruption remained on a fairly low level.

Despite the problems outlined above—or perhaps because they were not ignored—the PPAP has a fairly good reputation within the ‘aid world.’¹⁹ The

latest reports indicate that the project is successful in its own terms. Contrary to expectations and fears, repayment did not pose serious problems at the end of the first credit cycle. At the end of 2000, the repayment rates were still very high (99.92 percent), and micro-credit had become one of the KAFC's major activities. Meanwhile, over a thousand credit groups totaling 6,500 members were receiving credit. At least as important is that in a number of pilot villages the village associations have taken over UNDP's role and mediate directly with the KAFC to streamline credit services in their villages. This provides reasonable hope that the established financial structure will also prove sustainable after UNDP's planned retreat in December 2002 (UNDP, 2000: 50).

The unexpected but nevertheless understandable conclusion that can be drawn from this project is that farmers' unfamiliarity with economic principles forms a relatively small obstacle. They only had difficulties in places where people lacked experience with market forces, such as in Kok-Jangak, whereas in Bai-Munduz it was mainly an issue of teaching farmers to speak the "right" language. Indeed, most farmers quickly picked up the principles of micro-credit and applied inventive strategies to deal with the new economic realities. However, long-term success is certainly not guaranteed. One of the main issues to be confronted in the future is how to elude established power structures and to prevent local authorities and elite groups from interfering with financial institutions and aid projects. Authorities in the post-socialist era are accustomed to having influence on economic initiatives, and since the political chaos that arose after 1991, both the possibilities and the wish to do so (lack of resources) have grown. No development project can harbor the illusion of fully circumventing these problems, and dangers of nepotism and corruption form a continuing threat.

Another consideration is how this bottom-up approach relates to the general development of the rural economy in Kyrgyzstan. One reason for the success of the PPAP was its limited scale. Because of the general deficit of financial resources among small farmers, providing loans to a limited number of people automatically gives them an advantage over others. This advantage disappears when a larger percentage of the population gains access to credit facilities. Although even in this scenario the establishment may still have the effect of reducing independence on local elite groups and brokers, sustained development can only be achieved if the rural market overcomes its present isolated and local character.

Aid Organizations, the Rural Sector, and the Transition

Considering the number of projects that fail or turn out to be counterproductive, one may well question the value of development aid in general. This issue is not