THE KYRGYZ REPUBLIC: RECENT ECONOMIC DEVELOPMENTS

NINE MONTHS OF 2007

SUMMARY

The relative political calm of 3rd quarter of 2007 was disrupted by the decision of the Constitutional Court in September 2007 to nullify two constitution amendments made in end-2006. As a result, President Bakiev called for a national referendum in October 2007 to vote for a new edition of the Constitution. The new constitution was supported by population and following its approval, the President dismissed Parliament and called for a new parliamentary election in mid-December 2007.

Macroeconomic performance for nine months of 2007 continued to be solid. Real GDP grew by 8.5% and non-gold GDP by 9.2%. Fixed investment increased by 39%, mainly driven by the domestic private sector. Banking credit grew rapidly to reach 14% of GDP. However, inflation grew rapidly up to 13% in annual terms (October 2006 to September 2007), and had reached 22.7% by October 2007, driven mostly by food prices. Both the nominal exchange rate and REER remained stable compared to end-2006. The current account deficit for nine months of 2007 grew to 9.5% of annual GDP (implying an annualized figure of 18.7% to GDP) reflecting a 47% increase in imports of goods and services that outpaced export growth of 37%. Preliminary data indicate that fiscal position for the nine months of 2007 stayed strong with state budget surplus equivalent to 1.6% of GDP thanks to solid growth of revenues and a tight expenditure policy[1].

1. GROWTH

Real GDP increased by 8.5% in nine months of 2007 with key driving sectors being construction (39%), commercial services (17%) and non-gold industry (11.6%). This high growth occurred despite a decline in gold production and slow recovery of agriculture.

Industry (including gold) grew by 6.3%. Most of the industrial sub-sectors demonstrated strong growth this year, with major contributing sectors being energy (9%), food processing (7.6%), textile (23%) and production of construction materials. The third quarter of 2007 was a turning point for recovery of gold production, which increased by 47 percent compared with third quarter of 2006.

Table 1: Real GDP growth rate

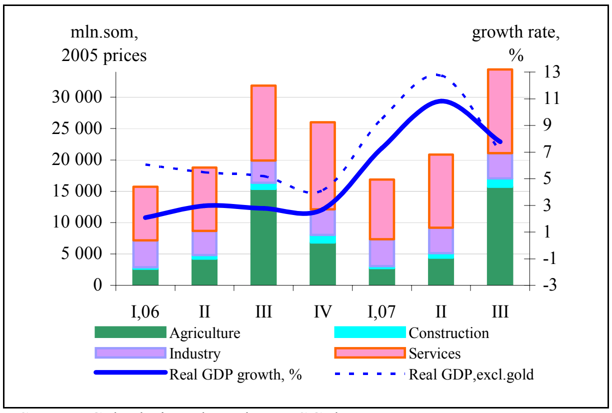
	2005	2006	9m05	9m06	9m07
GDP	-0.2	2.7	-0.7	2.7	8.5
GDP excl. gold	1.9	5.1	-0.2	5.5	9.2
Agriculture	-4.2	1.5	-4.7	2.9	2.2
Construction	17.6	8.5	25.4	-5.5	39.2
Industry	-13.4	-9.8	-12.5	-9.5	6.3
Industry excl.gold	-6.0	3.7	-15.2	6.9	11.6
Services	8.4	8.4	7.7	8.5	12.6

Source: NSC

Agricultural output grew modestly by 2.2%. Livestock is demonstrating stable growth, while crop production growth was slow and unstable due to declining productivity of grains and reduced allocation of land to key export crops.

Construction demonstrated a dramatic 39% growth. Housing construction took 28% of total fixed investment followed by mining (16%), communication (13%), manufacturing (11%), and energy (8.5%).

Figure 1: Real GDP by sectors



Source: Calculations based on NSC data.

[1] Detailed fiscal data for 9 months of 2007 are not presented in this note.

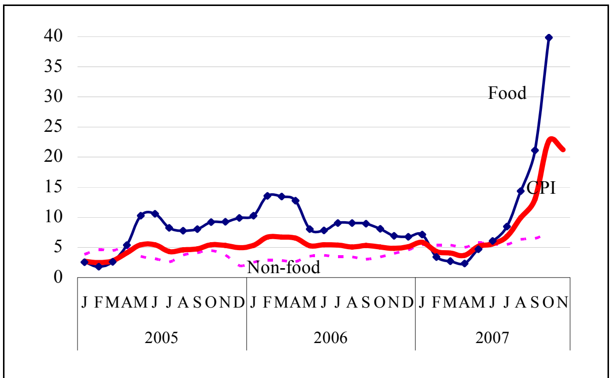
Total **fixed investment** grew by 39% in nominal terms, with 40% of total financing originated from companies' funds and 26% from households. However, allocation of fixed investment was more concentrated in the north of the country (80%).

Services grew by 12.6% in real terms, mainly provided by strong growth of trade (12.6%) and transport/communication (39%). In total, real growth of commercial services reached 17%, while public services stayed stagnant.

2. PRICES

Sharp increase in consumer prices became a notable feature of the third quarter 2007. **Consumer prices** increased by 10.3% (Sep 07 to Dec 06) compared with 2.5% in nine months of 2006, while annual inflation (Sep 07/Sep 06) reached 13.1% due to increased prices for food products (bread, flour, cooking oil, meat, vegetables) and some services.

Figure 2: Annual inflation, 2005-Oct 2007



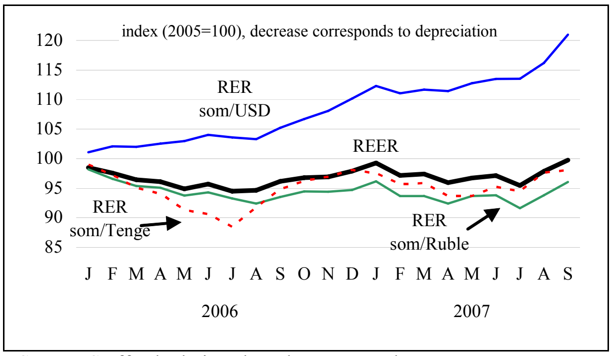
Source: Staff calculations based on NSC data

Producer prices in agriculture grew by 19.7% over the same period of 2006, reflecting sustained internal and foreign demand for bakeries, vegetables, milk and meat. Producer prices in industry grew by 14.3% since December 2006, mainly due to price increase in chemical, energy and textile sub-industries.

Average **wages** in nine months of 2007 increased by 31% over the same period of 2006 to reach the equivalent of 100 US dollars per month. The Government decision to increase wages for public servants resulted in sizable wage increases in healthcare (50%) and education (40%). In the private sector the highest wage increases have been in strongly growing sectors such as trade, communication and transport.

The real effective exchange rate as well as nominal rates appreciated somewhat in September 2007 as the NBKR abandoned the almost fixed nominal rate policy maintained since March 2007. Real appreciation of the som against US dollar was the strongest, while it was more stable compared to the currencies of Russia and Kazakhstan.

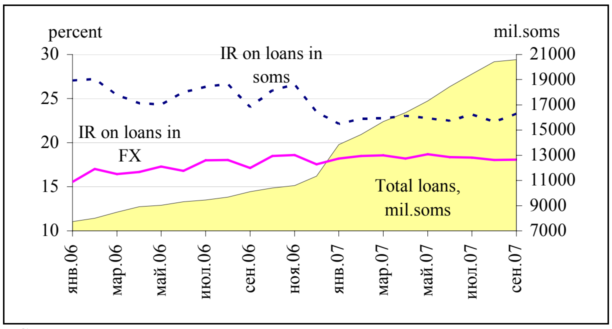
Figure 3: Real exchange rate



Source: Staff calculations based on NBKR data

Although still high, the average weighted **interest rate for bank loans** in national currency declined to 23% against 26% recorded in nine months of 2006. Interest rates for loans in FX averaged 18% in 9 months of 2007, which is slightly higher than a year ago. However, banking lending continued to grow rapidly (81% growth compared to end-2006[2]) to reach 13.8% of GDP, of which 69 percent were provided on a long-term basis mainly due to increased housing lending.

Figure 4: Bank credit and interest rates



Source: NBKR

Nevertheless, lending appeared to be slowing in August and September as a result of the impact of the sup-prime crisis in international markets. Distribution of the banking credit among sectors didn't change much with trade taking 37% of

[2] The numbers are exaggerated since Ayil Bank (which specializes in agricultural credit) was granted a banking license at the end of 2006. Without Aiyl Bank loans increased by 62%.

total credit stock, and followed by mortgage (17%), agriculture (12%) and industry (7%).

The stock of deposits grew by 35% in nine months of 2007 (to reach 15.2% of projected 2007 GDP). Two third of deposits were demand accounts, which is not a stable basis for long term banking lending. It should be noted that banks are making some progress in attracting savings of the population, which is shown by increased deposits of individuals by 52% in nine months 2007. About 59% of deposits were in foreign currency by end-September 2007, though de-dollarization of deposits is taking place due to the depreciation of the US dollar.

3. EXTERNAL SECTOR

Preliminary BOP data indicate that the **current account** deficit for nine months of 2007 grew to 9.5% of GDP (or 18.7% of GDP on annualized basis) due to continued rapid growth of imports in goods and services (by 47%). Export performance was also solid with a 37% increase driven by non-gold items. The growing trade deficit was counterbalanced with increased inflow of migrants' remittances (by 30%).

Table 2: Current account, *mln.USD*

	2005	2006	9m05	9m06	9m07
Current account	-29	-400	-7	-124	-376
as % to GDP	*-1.2*	*-13.7*	*-0.3*	*-4.4*	*-9.5*
Goods Exports (fob)	687	811	497	578	822
Gold exports	231	206	186	169	169
Goods Imports (fob)	1 106	1 797	772	1 157	1 753
Exports of services	256	374	185	275	348
Imports of services	291	456	208	303	395
Net income	-75	-48	-54	-21	-54
Interest payments	-36	-32	-23	-12	-21
Current transfers	500	716	346	504	656
Remittances inflow	514	749	352	525	683

Source: NBKR preliminary data

Merchandise exports increased by 42% over January-September 2006, with non-gold and non-oil exports growing with similar rate. Gold exports started recovering since Q3 2007 and for nine months of 2007 value of exported gold was at the same level as in comparable period of 2006. Among non-gold items consumer goods have shown strongest performance (40% growth).

Merchandise imports (cif) increased by 49%, reflecting more than 50% growth of energy, capital and intermediate goods. Import of major oil products increased by 53%, driven solely by growth in volumes. About 30% of imported oil products were re-exported, mainly to Afghanistan. Import of investment goods by 56% was significantly induced by VAT exemption on the import of fixed assets in form of technological equipment and machines.

In financial account FDI and long term loans played main role in financing the current account deficit. Foreign borrowing of the private sector was notably higher in the reporting period than that of the public sector. However, reflecting problems in statistical coverage, 'Errors and omissions' were on the rise and were similar to the current account deficit.

Table 3: Financial account, *mln.USD*

	2005	2006	9m05	9m06	9m07
Financial account	21	323	-2	233	269
FDI, net	43	182	47	109	85
LT loans, net	18	62	12	42	100
Public sector	17	54	15	31	27
Private sector	1	8	-3	11	74
ST flows, net	-40	79	-61	83	84
Errors & Omissions	58	289	37	23	404
Internat.reserves	612	817	574	719	1 073
months of imports	3.3	3.1	3.7	2.9	3.4

Source: NBKR preliminary data

International reserves rose to a historical high US$ 1073 million at end Q3 2007, which covered 3.4 months of imports. A conservative borrowing policy kept external debt at US$ 2294 mil (end-September 2007), which is equivalent to 67% of annualized GDP (Q4 2006-Q3 2007). External debt service was modest, absorbing about 6.2% of exports.

4. Main legislative changes with an economic impact in July-September 2007

1. **The Law of the KR "On Development Fund of the Kyrgyz Republic**", *August 6, 2007, # 135*

Development Fund is to be developed to stimulate the prioritized and strategic economic sectors of the Kyrgyz Republic through the public finance effective corporate management. The Law determines the following Fund's functions: selection of projects in the real sector and providing them with the loans; projects implementation monitoring; assessment of financial situation of the partcipating banks. This Law determines a legal and organizational foundation for Development Fund establishment and its further activities.

2. **The regulation of the Government of the KR "On National Program of the Kyrgyz Republic on migration processes regulation for 2007-2010**", *September 25, 2007, #433*

By this regulation the Government approves the National Program on regulation of migration processes for 2007-2010 and implementation. The program goal is to achieve the migration flows controllability in the volumes and directions expedient to the state. The main objectives are the legislation improvement, regulation of external labor migration, internal migration stabilization, migration registering improvement, etc.

3. **The regulation of the Government of the KR "On approval the Minimum Consumer Budget Calculation Methodology for the main social demographic groups of population and per capita in the KR**", *August 15, 2007, #333*

The Government of the Kyrgyz Republic approved methodology for calculation of the minimum consumer budget for the main social demographic groups of population and per capita in the KR. The Methodology includes the principles and order of minimal consumer budget calculation. The structure of minimal set of nutrition is determined in accordance with scientific recommendations on minimal volumes of nutrition consumption needed to ensure people vital functions.

4. **The resolution of the Government "About amendments to the resolution of Government of KR "On VAT registration threshold**", *September 06, 2007, #394.*

This resolution increases the VAT registration threshold from 2.5 mln. Soms up to 5 mln Soms for the flour, bread and bakery producers and sellers. Thus, the flour, bread and bakery producers and sellers with an annual turnover less then 5 mln. som are not VAT payers. (Memo: the threshold for the rest VAT payers is 2.5 mln.soms).

5. **The resolution of the Government "On Program on the legalization of shadow economy for 2007-2010",** *September 6, 2007, #395*

The Government approved the Program on the legalization of shadow economy in KR for 2007-2010 and Action Plan on the legalization of shadow economy in KR for 2007-2010. The Action Plan consists of such steps as strengthening a business society "voice", decreasing of doing business expenses, tax regimes simplification, wages expenses decreasing, and business environment improvement.

Kyrgyz Republic: Key macroeconomic indicators

	2003	**2004**	**2005**	**2006**	2006	2006	2006	2006	2007	2007	2007
					I	II	III	IV	I	II	III
GDP and prices											
GDP real growth (%)	7.0	7.0	-0.2	2.7	2.1	3.0	2.8	2.7	7.3	10.8	7.8
Non-gold GDP growth (%)	5.4	7.6	1.9	5.1	6.1	5.5	5.2	4.1	9.5	12.7	7.0
GDP, mln soms	83 872	94 351	100 899	113 176	18 857	23 350	39 021	31 948	21 119	28 205	49 537
GDP, mln US$	1 933	2 218	2 461	2 839	456	578	984	821	550	742	1 300
GDP per capita dollar (at avg exchange rate)	384	436	478	547	..	..	..	..	..	..	..
Poverty headcount (% of population)[4]	50	46	43	40	..	..	..	..	..	..	..
Extreme Poverty headcount (% of population)[4]	17	13	11	9	..	..	..	..	..	..	..
GDP per capita, 1990=100	65	69	68	70	..	..	..	..	..	..	..
GNI per capita dollar (Atlas)	340	400	450	500	..	..	..	..	..	..	..
Inflation (% beginning-to-end of period, CPI)	5.6	2.8	4.9	5.1	3.0	1.0	-1.5	2.5	2.0	2.5	5.5
Inflation (% average, CPI)	3.1	4.1	4.4	5.6							
Deflator GDP (% to prev.period)	4.0	5.1	7.1	9.2	4.7	8.7	12.5	8.5	4.4	9.0	17.8
CPI index, average 2000=100	113	117	122	129	..	..	..	..	..	..	..
Wage, average (soms per month)	1 916	2 203	2 570	3 059	2 661	2 911	2 881	3 059	3 448	3 678	3 746
Wage, average (US$ per month)	44	52	63	76	64	72	73	79	90	97	98
Pension, average (soms per month)	647	709	791	906	843	871	915	906	..	..	1 120
Exchange rate (som/US$, end of period)	44.2	41.6	41.3	38.1	41	40	39	38	38	38	37
Exchange rate (som/US$, avg of period)	43.7	42.7	41.0	40.2	41	40	40	39	38	38	38
REER (2000=100, end-period, up=appreciation)	101	96	95	94	92	91	92	94	93	93	95
Unemployment rate (% of labor force)	9.9	8.5	8.1	..							
M2 (e.o.p as % of GDP)	17	21	21	29	21	23	25	29	26	29	29
External Sector											
Current account balance (% to GDP)[3]	-2.2	1.3	-1.2	-13.6	-1.5	-1.7	-1.1	-9.2	-4.2	-4.1	-0.9
Exports (mln US$, fob)	588	733	687	811	178	205	195	233	253	261	318
Power	19	22	21	25	2	4	17	2	5	8	19
Gold	260	287	231	206	62	61	45	37	51	56	62
Imports (mln US$, cif)	716	941	1 101	1 723	304	371	449	599	488	555	628
Food	78	110	140	211	39	54	50	68	60	65	71
Other consumer goods	178	194	211	287	53	62	81	90	71	90	106
Energy	180	256	314	507	101	112	123	171	180	147	189
Other intermediate goods	152	217	245	332	54	75	97	106	87	125	133
Capital goods	128	163	191	386	57	67	98	164	91	128	128
External Debt (mln US$)	2 018	2 100	2 024	2 184	1 997	2 048	2 127	2 184	2 172	2 261	2 294
Public External Debt (mln US$)	1 809	1 949	1 883	1 980	1 870	1 920	1 924	1 980	1 977	1 989	2 052
External Debt (% to GDP)	104	95	82	77	80	80	78	77	74	73	67
Actual debt service to exports (%)	12	9	12	4	5	12	5	10	8	12	3
Public external borrowing (excl. IMF, mln US$)	75	95	92	76	9	13	24	30	7	20	23
Worker's remittances (inflow, mln US$)	113	285	482	731	122	179	223	224	171	264	248
Foreign direct investments (net, mln US$)[1]	46	175	43	182	11	113	-15	74	46	34	5
International reserves (mln US$, end period)	389	565	612	817	605	651	719	817	825	939	1 073
General Government Budget (% of GDP)[2]											
Revenues and grants	22.9	23.4	24.7	26.8	5.4	6.5	6.9	8.0	5.7	8.3	
Grants	0.6	1.4	1.0	0.8	0.1	0.2	0.3	0.2	0.1	0.6	
Tax	14.2	14.8	16.2	17.7	3.6	4.1	4.6	5.3	3.9	7.3	
Social fund contributions	3.5	3.5	3.8	4.0	0.9	0.9	1.0	1.1	0.9	..	
Nontax and capital	4.6	4.0	3.7	4.3	0.7	1.3	1.0	1.3	0.8	..	
Expenditures	27.6	27.4	28.5	29.8	5.5	7.2	7.6	9.5	5.2	8.1	
Current (other than interest)	21.7	21.1	22.6	24.6	4.7	5.8	6.1	8.0	4.7	7.1	
o.w. transfers & subsidies	8.7	8.4	8.7	8.8	1.9	2.1	2.3	2.4	1.8	..	
wages & salaries	5.7	5.8	6.3	5.9	1.2	1.4	1.4	1.9	1.4	..	
Interest payments	1.6	1.9	1.5	1.3	0.1	0.7	0.1	0.5	0.3	..	
Capital	4.9	4.9	4.8	4.5	0.6	1.0	1.4	1.5	0.7	1.1	
of which, foreign financed PIP	3.7	3.8	3.8	3.4	0.5	0.8	1.0	1.1	0.4	0.4	
Net lending	-0.5	-0.5	-0.4	-0.2	0.1	-0.2	-0.1	-0.1	-0.1	-0.1	
Fiscal Balance (accrual)	-4.7	-4.0	-3.8	-3.1	-0.2	-0.8	-0.6	-1.5	0.4	0.2	1.0
Memo:											
Primary Balance (w/o interest and PIP)	0.5	1.6	1.5	1.6	0.5	0.7	0.5	0.0	1.1	..	..
Primary Balance (w/o interest)	-3.2	-2.1	-2.3	-1.8	-0.1	-0.1	-0.6	-1.1	0.7	..	..

Sources: Ministry of Finance, National Statistical Committee, Social Fund, National Bank and World Bank staff calculations.

[1] Includes repayment of FDI related debt

[2] The state budget consolidates central and local budgets and includes the foreign-financed public investment program and the deficit of the social fund, which became an extrabudgetary Fund in 1991. The quarterly data are on cash basis and based on the Treasury reports.

[3] Source: NBKR

[4] Poverty data is consumption based. Poverty data for 2003-05 are based on the Kyrgyz Integrated Household Survey and are not comparable with earlier year data.