THE KYRGYZ REPUBLIC: RECENT ECONOMIC DEVELOPMENTS

FIRST HALF OF 2007

SUMMARY

Political life in the second quarter of 2007 was marked by large scale demonstrations in April 2007 with a call for immediate presidential elections. However, demonstrations were broken up by authorities after a week of tension. Right before these events a key opposition leader, Almazbek Atambaev, was appointed Prime Minister - a step that weakened the opposition. A new Government was formed with most of the ministers retained in their positions. Since April 2007 the country has been enjoying a period of relative political stability.

Despite the political disturbances, macro-economic performance for the first half of 2007 was remarkable. Real GDP grew by 9.2%, the highest growth since 1997, and non-gold GDP by 11.3%. Fixed investment increased by 43%, mainly driven by the domestic private sector. Credit is growing rapidly and has reached 13.5% of GDP. Annual inflation reached 5.6% (June 2006 to June 2007); both nominal exchange rate and REER remained stable compared to end-2006. Current account deficit grew to 12.5% of annual GDP (implying an annualize figure of 24% of GDP) reflecting a 65% increase in imports of goods and services that outpaced exports growth of 31%. The fiscal position stayed strong with positive state budget balance equivalent to 0.7% of GDP thanks to solid growth of revenues and a tight expenditure policy.

1. GROWTH

Real GDP increased by 9.2%, and such impressive growth was possible due to high growth in construction (37%) and commercial services (18%), despite a decline in gold production and slow recovery of agriculture.

Industry grew by 2.5%, with non-gold sectors reaching 14% growth. Major industrial sectors that contributed to the growth were energy (9.6%), food processing, and production of construction materials.

Agricultural output grew by 2.9% thus slowly recovering from the sector's decline in 2005. While the livestock is demonstrating stable growth, there is little growth in crop production where productivity has stagnated.

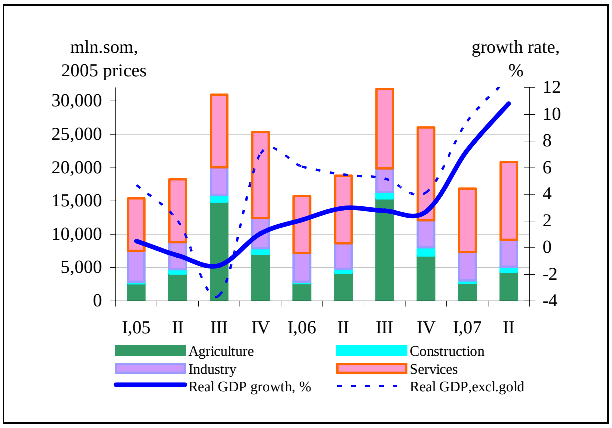
Table 1: Real GDP growth rate

	2005	2006	1hf05	1hf06	1hf07
GDP	-0.2	2.7	-0.1	2.6	9.2
GDP excl. gold	1.9	5.1	3.2	5.7	11.3
Agriculture	-4.2	1.5	-1.1	2.3	2.9
Construction	17.6	8.5	18.0	-12.1	37.1
Industry	-13.4	-9.8	6.4	-6.4	2.5
Industry excl.gold	-6.0	3.7	46.0	-0.6	14.0
Services	8.4	8.4	-3.2	7.9	13.3

Source: NSC

Construction demonstrated a dramatic 37.1% growth. A third of fixed investment was allocated to housing construction, mining (18%), communication (13%) and energy (10%) sectors. Total **fixed investment** grew by 43% in nominal terms, with 45% of total financing originated from companies' funds and 33% from households. However, allocation of fixed investment was more concentrated in the north part of the country.

Figure 1: Real GDP by sectors



Source: NSC

Services grew by 13.3% in real terms, mainly provided by strong growth of trade (13.8%) and transport/communication (34%). In total, real growth of commercial services reached 17.9%, while public services grew by less than 1%.

2. PRICES

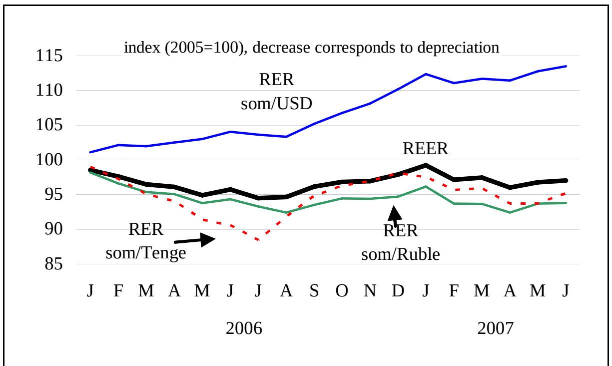
Consumer prices increased by 4.6% (Jun 07 to Dec 06) compared with 4.1% in the first half of 2006, while annual inflation (Jun 07/Jun 06) reached 5.6% due to increased prices for vegetables and fruits, meat and natural gas.

Producer prices in agriculture grew by 16.4% over the same period of 2006, reflecting sustained internal and foreign demand for vegetables, milk and meat. Producer prices in industry grew by 5.7% since December 2006, mainly due to price increase in chemical, energy and textile sub-industries.

Average **wages** increased to 3680 soms per months compared to 2911 in the first half of 2006, with real wage growth exceeding 20%. The Governments decision to increase salaries of teachers, medical staff and other social workers (by 30%) was one of the reasons of rapid growth of average wages.

The real effective exchange rate as well as nominal rates remained relatively stable. Though the som continued to appreciate in real terms against US dollar, it was more stable compared to the currencies of Russia and Kazakhstan.

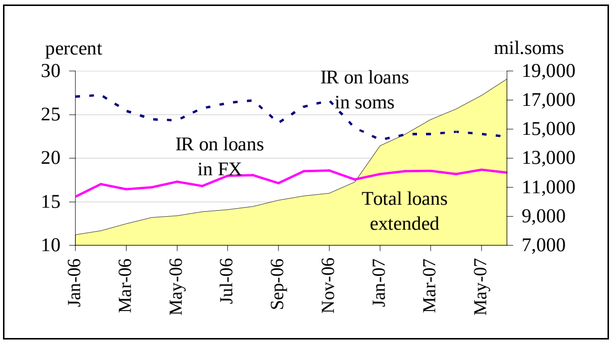
Figure 2: Real exchange rate



Source: Staff calculations based on NBKR data

Despite improved macroeconomic performance and availability of resources, **interest rates** for bank loans remain high with an interest rate spread up to 21% for funds in national currency and 18% - in foreign currencies. The average weighted interest rate on bank loans in national currency declined to 23% against 26% recorded in the first half of 2006. However, interest rates for loans in FX increased to 19% in June 2007 compared with 17% a year ago due to depreciation of the US dollar. Banking lending continued to grow with rapid pace (62% growth compared to end-2006[1]) to reach 13.5% of GDP, of which two-thirds were provided on a long-term basis mainly due to increased housing lending. Traditionally, leading sectors to get most of the banking credit were trade (37% of total credit stock), followed by mortgage (15%), agriculture (13%) and industry (8%).

Figure 3: Bank credit and interest rates



Source: NBKR

The stock of deposits grew 20% by end-June 2007 (to reach 14.8% of projected 2007 GDP). Two third of the deposit stock were demand accounts, thus not providing a stable basis for banking lending, given that deposits with maturity 1 year and more accounted only for 11% of all deposit stock. There is a steady trend for de-dollarization of deposits due to the depreciation of the US dollar (share of deposits in foreign currencies stood at 57% of total against 69% by end-2006).

3. EXTERNAL SECTOR

The current account deficit was at 12.5% of annual GDP (equivalent to 24% of GDP on an annual basis) due to rapid growth rate of imports of goods and services (by 65%). Export performance was also solid with 31% increase driven by non-gold items.

Merchandise exports increased by 34% over first half of 2006, with non-gold and non-oil exports' growth at 36%. Gold exports declined by 13% driven by a 22% decline in volume.

Merchandise imports (cif) increased by 55%, reflecting strong growth of energy, capital and intermediate goods. Import of oil products

[1] 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 45%.

increased by 48% driven mainly by growth in volumes – 52%, About 40% of imported oil products are re-exported, which is a new phenomena. The VAT exemption on the import of fixed assets induced strong growth of technological equipment and machines with increased import of investment goods by 76%.

Table 2: Current account

	2005	2006	1hf05	1hf06	1hf07
Current account	-29	-400	-18	-92	-448
as % to GDP	*-1.2*	*-13.7*	*-0.7*	*-3.3*	*-12.5*
Goods Exports (fob)	687	811	329	383	515
Gold exports	231	206	125	123	107
Goods Imports (fob)	1,106	1,797	480	691	1,171
Exports of services	256	374	112	153	186
Imports of services	291	456	128	187	278
Net income	-75	-48	-43	-35	-55
Interest payments	-36	-32	-19	-8	-15
Current transfers	500	716	192	286	356
Remittances inflow	514	749	197	301	370

Source: NBKR

International reserves rose to US$ 939 million (3.2 months of imports). Conservative borrowing policy kept external debt at US$ 2,173 mil (end-June 2007), which is equivalent to 60% of projected 2007 GDP. External debt service was modest, absorbing about 8.4% of exports.

4. GENERAL GOVERNMENT BUDGET

As preliminary data indicate, the general fiscal position stood balanced with the surplus equivalent 0.7% of GDP (compared with negative 0.9% in January-June 2006) due to continued growth of budget revenues and tight spending policy.

Table 3: Fiscal Performance

	2005	2006	1hf'05	1hf'06	1hf'07
Revenues and grants	24.7	26.8	11.3	11.9	14.0
Grants	1.0	0.8	0.3	0.3	0.7
Taxes, incl.social	20.0	21.6	9.3	9.6	11.2
Expenditures	28.5	29.8	13.2	12.8	13.3
Current	22.6	24.6	10.6	10.5	11.8
Capital	4.8	4.5	1.9	1.6	1.8
Fiscal balance (accr)	-3.8	-3.1	-1.9	-0.9	0.7

Source: MF, Treasury, NBKR

General government revenue increased to 14% of annual GDP compare with 11.9% in the first half of 2006. This growth was driven by growth of VAT and import duties collection, mainly as a result of rapid growth of goods import.

General government expenditure was 13.3% of GDP compared to 12.8% of GDP in Jan-June 2006. Funding increased as a proportion of GDP in education and social sectors, while defence and public order seen declined.

5. Main legislative changes with an economic impact in Apr-Jun 2007

1. **The Law of the KR "On amendments to the Law "On State Social Retirement Insurance**", *April 18, 2007, # 43*
According to the Law starting from January 1, 2007 till December 31, 2007 61 years old men and 56 year old women have a right for retirement due to their age, starting from January 1, 2008 – 60 and 55 years olds appropriately.

2. **The Law of the KR "On entrepreneurs inspections procedure"** *May 25, 2007 #72*
The Law determines the procedure for conducting inspection of entrepreneurs by the authorized bodies, determines rights and obligations of the authorized bodies and entrepreneurs in terms of inspections implementation, as well as entrepreneurs rights protection from illegal interference in their activities.

3. **The Law "On government support of small enterprises**", *May 25, 2007 #72*
This Law determines general regulations in the field of Government support and small enterprises development, identifies methods and forms of state stimulation and small businesses activities regulation for all small businesses regardless of patterns of ownership and organizational form.

4. **The Decree of the President "On National Council on Kyrgyzstan Strategic Development",** *April 5, 2007, #157*
To ensure work coordination on Kyrgyzstan strategic development issues according to the principals of constructive partnership of all levels of state authorities and civil society this Decree resolves to establish the National Council on Strategic Development of Kyrgyzstan (the list of member is enclosed to the Decree), approve attached Regulation on National Council. Ministry of Economic Development and Trade of the Kyrgyz Republic is determined the National Council's working agency. In this connection all previous Decrees of the President concerning National Council on CDF implementation are declared invalid.

5. **The Decree of the President "On Country Development Strategy for 2007-2010",** *May 16, 2007 #249*
This Decree approves the Country Development Strategy for 2007-2010 in accordance with received comments and proposals. The Government of the Kyrgyz Republic, administrative and other agencies, as well as local governments are delegated to take all measures on Strategy implementation including finding budget and non-budget means.

6. **Regulation of the Jogorku Kenesh of the KR "On approval of quota for labor migration by economy sectors and regions of the Kyrgyz Republic for 2007**", 3 April, 2007 #1769-III
The quota for labor migration was approved. It determines the maximum number of foreigners and those without citizenship coming into the Kyrgyz Republic with the aim to make labor activities (by economy sectors and regions of Kyrgyz Republic) for 2007. The Government was delegated to consider the issue of increasing patents fees for individual foreign entrepreneurs up to KGS100 000 per month. Herewith, when determine a quota to provide for the job places for at least 80% of Kyrgyz citizens.

Kyrgyz Republic: Key macroeconomic indicators

	2002	2003	2004	2005	2006	2006	2006	2006	2006	2007	2007
						I	II	III	IV	I	II
GDP and prices											
GDP real growth (%)	0.0	7.0	7.0	-0.2	2.7	2.1	3.0	2.8	2.7	7.3	10.8
GDP, mln soms	75,367	83,872	94,351	100,899	113,176	18,857	23,350	39,021	31,948	21,119	28,205
GDP, mln US$	1,606	1,919	2,212	2,460	2,818	456	578	984	821	550	742
GDP per capita dollar (at avg exchange rate)	322	381	434	478	543	..	..	..	..	..	..
Poverty headcount (% of population)[4]	55	50	46	43	..	..	..	..	..	..	..
Extreme Poverty headcount (% of population)[4]	23	17	13	11	..	..	..	..	..	..	..
GDP per capita, 1990=100	62	65	69	68	70	..	..	..	..	..	..
GNI per capita dollar (Atlas)	290	340	400	450	500	..	..	..	..	..	..
Inflation (% beginning-to-end of period, CPI)	2.3	5.6	2.8	4.9	5.1	3.0	1.0	-1.5	2.5	2.0	2.5
Inflation (% average, CPI)	2.1	3.1	4.1	4.4	5.6						
Deflator GDP (% to prev.period)	2.0	4.0	5.1	7.1	9.2	4.7	8.7	12.5	8.5	4.4	9.0
CPI index, average 2000=100	109	113	117	122	129	..	..	..	..	..	..
Wage, average (soms per month)	1,684	1,916	2,203	2,570	3,059	2,661	2,911	2,881	3,059	3,448	3,678
Wage, average (US$ per month)	36	44	52	63	76	64	72	73	79	90	97
Pension, average (soms per month)	561	647	709	791	906	843	871	915	906		
Exchange rate (som/US$, end of period)	46.1	44.2	41.6	41.3	38.1	41	40	39	38	38	38
Exchange rate (som/US$, avg of period)	46.9	43.7	42.7	41.0	40.2	41	40	40	39	38	38
REER (2000=100, end-period, up=appreciation)	107	101	96	95	94	92	91	92	94	93	93
Unemployment rate (% of labor force)	12.5	9.9	8.5	8.1	..						
M2 (e.o.p as % of GDP)	15	17	21	21	29	19	21	24	29	22	26
External Sector											
Current account balance (% to GDP)[3]	-1.9	-2.2	1.3	-1.2	-13.7	-1.5	-1.7	-1.1	-9.3	-4.6	-7.8
Exports (mln US$, fob)	498	588	733	687	811	178	205	195	233	253	261
Power	22	19	22	21	25	2	4	17	2	5	8
Gold	163	260	287	231	206	62	61	45	37	51	56
Other	313	312	424	435	580	114	140	132	193	198	198
Imports (mln US$, cif)	640	716	941	1,101	1,723	304	371	449	599	488	555
Food	64	78	110	140	211	39	54	50	68	60	65
Other consumer goods	130	178	194	211	287	53	62	81	90	71	90
Energy	152	180	256	314	507	101	112	123	171	180	147
Other intermediate goods	125	152	217	245	332	54	75	97	106	87	125
Capital goods	116	128	163	191	386	57	67	98	164	91	128
External Debt (mln US$)	1,785	2,018	2,100	2,024	2,197	1,988	2,130	2,132	2,197	2,172	2,173
Public External Debt (mln US$)	1,579	1,809	1,949	1,883	1,980	1,870	1,920	1,924	1,980	1,977	1,989
External Debt (% to GDP)	111	105	95	82	78	71	76	76	78	60	60
Total debt service to exports (%)	21	22	14	12	8	5	12	5	10	8	9
Public external borrowing (excl. IMF, mln US$)	88	75	95	92	76	9	13	24	30	7	24
Worker's remittances (inflow, mln US$)	79	143	307	514	749	122	179	223	224	171	199
Foreign direct investments (net, mln US$)[1]	5	46	175	43	182	11	113	-15	74	46	32
International reserves (mln US$, end period)	317	389	565	612	817	605	651	719	817	825	939
General Government Budget (% of GDP)[2]											
Revenues and grants	22.7	22.9	23.4	24.7	26.8	5.4	6.5	6.9	8.0	5.7	8.3
Grants	1.1	0.6	1.4	1.0	0.8	0.1	0.2	0.3	0.2	0.1	0.6
Tax	13.9	14.2	14.8	16.2	17.7	3.6	4.1	4.6	5.3	3.9	7.3
Social fund contributions	4.2	3.5	3.5	3.8	4.0	0.9	0.9	1.0	1.1	0.9	..
Nontax and capital	3.5	4.6	4.0	3.7	4.3	0.7	1.3	1.0	1.3	0.8	..
Expenditures	27.9	27.6	27.4	28.5	29.8	5.5	7.2	7.6	9.5	5.2	8.1
Current (other than interest)	20.7	21.7	21.1	22.6	24.6	4.7	5.8	6.1	8.0	4.7	7.1
o.w. transfers & subsidies	9.4	8.7	8.4	8.7	8.8	1.9	2.1	2.3	2.4	1.8	..
wages & salaries	5.4	5.7	5.8	6.3	5.9	1.2	1.4	1.4	1.9	1.4	..
Interest payments	1.9	1.6	1.9	1.5	1.3	0.1	0.7	0.1	0.5	0.3	..
Capital	6.0	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	4.7	3.7	3.8	3.8	3.4	0.5	0.8	1.0	1.1	0.4	0.4
Net lending	-0.6	-0.5	-0.5	-0.4	-0.2	0.1	-0.2	-0.1	-0.1	-0.1	-0.1
Fiscal Balance (accrual)	-5.2	-4.7	-4.0	-3.8	-3.1	-0.2	-0.8	-0.6	-1.5	0.5	0.2
Memo:											
Primary Balance (w/o interest and PIP)	1.4	0.5	1.6	1.5	1.6	0.5	0.7	0.5	0.0	1.1	..
Primary Balance (w/o interest)	-3.3	-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.