



## THE KYRGYZ REPUBLIC: RECENT ECONOMIC DEVELOPMENTS

### FIRST HALF OF 2008

#### SUMMARY

The second quarter of 2008 was politically quiet. Several new appointments in the Government were made, including filling a position of Vice Prime Minister on social affairs and the Secretary of State. The resignation of the speaker of Parliament in June 2008 appeared to have political implications.

Curbing high inflation as a result of global increases of food and energy prices became the top priority for the Government. One of the notable reforms the Government made in this period was to loosen business regulations, including banning of tax inspections, simplifying business start-up and licensing procedures, and developing a new liberal tax code. In light of potential energy supply problems, in April 2008 the Government decided to start electricity supply rationing, and at the same time approved medium term tariff increase plan for heating, hot water and electricity, with the latter having wider economic effects on the population.

Drivers of economic growth in the first half of 2008 were different from a year ago. Recovering gold production and communication services made large contribution to 7.1% growth of real GDP (8.8% in H1 2007). Inflation in the first half of 2008 had already reached 15.2% compared with December 2007 (or 32.3% in annual terms) and was driven by prices for food and services. This factor along with the nominal appreciation of the som to the US dollar resulted in real effective appreciation that reached its highest level in July 2008 in last 30 months. Bank credit grew by 18% since end-2007, which looks modest compared with 45% growth a year ago. By preliminary estimates, current account deficit increased to 11.7% of GDP driven by growth of imports, though stock of international reserves continued growing. The fiscal balance for H1 2008 was positive at 0.2% of GDP as a result of continued revenue growth.

#### 1. GROWTH

**Real GDP** grew by 7.1% based on services (8.9%) and the recovery of gold production by 25%. Agriculture and non-gold industry contributed modestly to growth, with overall non-gold real GDP increased by 6.5%.

Table 1: Real GDP growth rate

	2006	2007	1hf 06	1hf 07	1hf 08
GDP	3.1	8.2	3.1	8.8	7.1
GDP excl. gold	16.5	8.7	16.0	11.0	6.5
Agriculture	1.7	1.5	2.5	3.1	3.0
Construction	19.1	20.2	18.4	1.3	7.5
Industry	-10.9	7.3	-7.6	4.7	6.3
Industry excl. gold	94.7	10.7	-0.6	16.7	1.5
Services	9.0	12.4	8.0	13.2	8.9

Source: NSC

**Non-gold industry** increased by only 1.5% in real terms, which was considerably lower than in the previous period. Modest growth was mainly explained by decline in energy and oil-products production, while key driving sectors such as textile, production of construction materials, and the food processing continued to grow.

**Agricultural output** increased by 3%, led mainly by positive developments in livestock sector, and earlier start of the harvest campaign also contributed to better outcome.

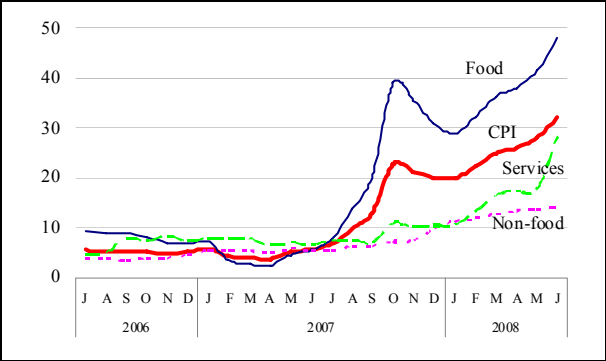
**Construction** was one of the key drivers of growth in the period with real 7.5% increase due to better investment activity in manufacturing, trade and tourism sectors, though private housing construction growth was negative. Overall growth of **fixed investment** was negligible (0.7% in real terms), which was mainly associated with reduction of investments in mining sector and private housing construction. Nevertheless, the latter still constituted a quarter of total fixed investment followed by manufacturing, energy and transport and communication (by 11%). Share of FDI and other foreign sources increased and was 25% of total investments in the period (13% in H1 2007).

A significant drop in growth rate of trade (from 13.8% in H1 2007 to 6.7%) resulted in slower growth of total **services** that grew by 8.9% in H1 2008 (13.2% in H1 2007). However, other sub-sectors, such as communication, tourism, and financial services continued demonstrating impressive growth rates.

**2. PRICES**

A sustained rise of world energy prices had a negative impact on the inflation rate in the Kyrgyz Republic that has risen to 32% in June 2008 in annual terms. As compared with end-2007, **consumer prices** increased by 15.1%, while in June 2007 inflation was only 4.6% from the end of 2006. Prices for food (20.4% up since end-2007) were the main driver of overall price increase, though prices of services also rose considerably (17.9%).

**Figure 1: Annual inflation, 2006-Jun 2008**



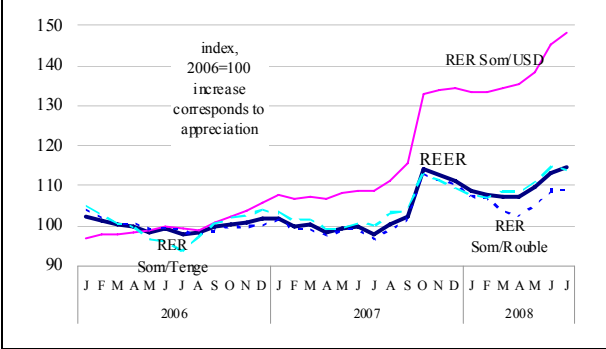
Source: Staff calculations based on NSC data

**Producer prices** in agriculture grew by 12% compared with end-2007 (or 30% in annual terms) reflecting sustained increase of grains and vegetables prices. Producer prices in industry grew by 15.5% since end-2007 (32% on annual basis), mainly due to price increase in mining, food, and energy sub-industries.

**Wages** in June 2008 averaged 5.6 thousand soms (155 US dollars) meaning 32% growth compared with average salaries in June 2007. However, real wages in this period stayed stagnant due to comparable rise of consumer prices.

Real exchange rates appreciated in June 2008 due to nominal appreciation of som and higher inflation rate than in countries - main trading partners. **Real effective exchange rate** index appreciated by 2%. The strongest was real appreciation of the som against US dollar, exceeding its 2006 level by more than 40%.

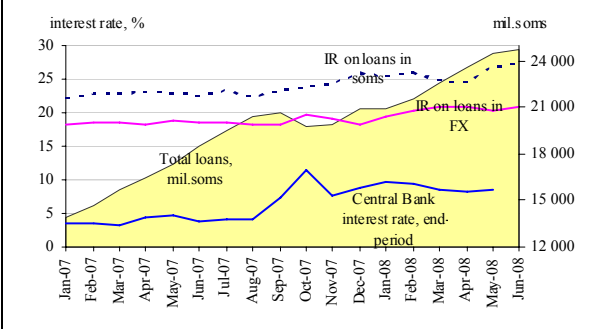
**Figure 2: Real exchange rate**



Source: Staff calculations based on NBKR data

**Interest rate for bank loans** both in national and foreign currencies were adjusted upward to (partially) reflect higher inflation. In end-June 2008 interest rates for loans in soms were high at 27% (compared with 23% in average in 2007), while interest rates for loans in foreign currencies averaged 20% (18% a year ago).

**Figure 3: Bank credit and interest rates**



Source: NBKR

Growth rates of banking lending slowed somewhat (18% growth since Dec 2007) as a result of the impact of slower activity of foreign-owned banks due to sub-prime crisis in international markets. Currency composition and key borrowing sectors remained broadly unchanged with almost half of new loans issued to finance trade and commercial activities (46%). More bank credit was lent to agriculture (9% of total new lending), while mortgage was cut more than twice (from 13% in H1 2007 to 6% in the reporting period).

The stock of bank deposits grew by 14% and reached 17% of GDP. Currency structure of deposits was equally represented by foreign and domestic currencies. Despite negative return from deposits due to high inflation, banks demonstrated some progress in bringing more deposits with longer maturity (half a year and longer).

### 3. EXTERNAL SECTOR

The **current account** deficit increased to 11.7% of GDP in H1 2008 compared with 6.2% in the same period of last year, reflecting strong increase in imports. Despite recovery of gold exports, strong growth of import resulted in widening trade deficit that was partially offset by inflow of workers' remittances.

**Table 2: Current account, mln.USD**

	2006	2007	1hf 06	1hf 07	1hf 08
Current account	-282	-232	-44	-193	-500
as % to GDP	-9.9	-6.2	-1.7	-6.2	-11.7
Exports (fob)	906	1 337	431	607	746
Gold	206	225	123	107	167
Imports (fob)	1 792	2 635	1 171	1 113	1 689
Exports of services	379	684	186	242	406
Imports of services	461	582	278	283	424
Net income	-43	-56	-55	-38	-64
Interest payments	-20	-26	-15	-11	-14
Current transfers	730	1 020	356	398	526
Remittances inflow	762	1 065	370	418	534

Source: NBKR preliminary data

**Merchandise exports** grew by 23% driven mainly by gold that exceeded its value in H1 2007 by 56% due to both price and quantity factors. Among non-gold items agriculture and textile export continue to demonstrate positive performance, while energy export growth was moderate.

**Merchandise imports** (fob) increased by 52% due to continued rapid growth of energy, food and non-food consumer goods, as well as intermediate and investment goods. Both rising world energy price and sustaining domestic demand resulted in increased import bill for energy only equivalent to 5.4% of GDP. Some portion of growing import probably can be explained by better statistical recording as evidenced by some items such as textile and shoes that grew 4 and 7 times as much comparing to H1 2007.

As preliminary data suggest FDI became the main financing BOP item among other categories of financial account. 'Errors and omissions' remain large, but given premature nature of data, it may decrease.

**Table 3: Financial account, mln.USD**

	2006	2007	1hf 06	1hf 07	1hf 08
Financial account	328	334	216	86	157
FDI, net	182	208	124	46	129
LT loans, net	66	44	16	17	19
Public sector	54	28	15	4	7
Private sector	12	16	1	13	12
ST flows, net	79	82	77	23	10
Errors & Omissions	187	276	-123	70	377
Internation.reserves	817	1 177	651	939	1 231
in months of imports	3.0	3.4	2.8	2.9	3.0

Source: NBKR preliminary data

The stock of international reserves rose modestly (by 4.6%) due to FX selling interventions of the central bank in the first quarter of 2008, and was equal to 3 months of imports. Total external debt was estimated at US\$ 2.4 bln (the same level as in end-March 2008), or 51% of GDP. External debt service was modest, absorbing about 7.6% of exports.

### 4. GENERAL GOVERNMENT BUDGET

As preliminary data indicate, the general fiscal position stood balanced with the surplus equivalent 0.2% of GDP, though there has been some tendency of expenditure to outstrip revenue growth during last 12 months. Thus, in January-June 2007 a budget surplus was recorded at 0.7% of GDP, in first quarter of 2008 – at 0.4%, and in second quarter of this year the budget recorded a deficit of 0.2% of GDP.

**General government revenue** reached 13.9% of GDP, which was the highest level recorded during last 4 years. Compare to H1 2007, nominal revenue increased by Som 7.5 billion, or by 42%, while real growth rate was at around 8% with tax collections increased by modest 3.6%. The major contribution to the growth of latter was done by VAT and custom duties collections reflecting notable import growth.

**General government expenditure** reached 13.6% of GDP. Nominal expenditures of the State budget increased by Som 6.5 billion compare to the previous period. The government notably increased resources to such items as salaries (to fulfill the Presidential decree requiring a 60% increase for civil and municipal servants in 2008); social transfers (including allowances for poor, stipends and transfers to the

Social Fund), public debt service (according to schedule), and investment projects funded from local sources. Besides this, the continuing inflation of consumer and energy prices caused a quite significant growth of subsidies and credits to state enterprises (including communal utilities and State Reserve Fund) and some categories of population (e.g. farmers).

**Table 4: General government budget (% of GDP)**

	<b>January-June</b>			
	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
<b>Total revenue</b>	<b>11.2</b>	<b>11.9</b>	<b>12.6</b>	<b>13.9</b>
Taxes	9.3	9.6	10.0	10.6
Income and profit tax	1.6	1.4	1.5	1.5
VAT	3.1	3.4	3.8	4.2
Excises	0.6	0.5	0.5	0.4
Customs	0.6	1.0	1.1	1.2
Payroll	1.9	1.9	1.8	1.8
Others	1.4	1.5	1.4	1.6
Non-tax and Capital	1.7	2.0	1.9	2.6
Grants	0.3	0.3	0.6	0.7
<b>Total expenditure</b>	<b>13.5</b>	<b>12.8</b>	<b>12.2</b>	<b>13.6</b>
Current	11.6	11.2	10.6	11.9
Wages	2.5	2.6	3.4	2.9
Transfers&subsidies	3.7	3.5	4.0	3.7
Interest	0.9	0.8	0.3	0.5
Goods and services	4.5	4.3	2.9	4.8
Capital	1.9	1.6	1.6	1.7
Foreign financed PIP	1.6	1.3	1.1	0.7
Net lending	-0.2	-0.1	-0.3	0.1
<b>Balance</b>	<b>-2.1</b>	<b>-0.9</b>	<b>0.7</b>	<b>0.2</b>

Source: the MEF and WB staff calculations

## **5. MAIN LEGISLATIVE CHANGES WITH AN ECONOMIC IMPACT IN APR-JUN 2008**

### ***1. The Decree of the President of KR "On Tax Inspection examinations Moratorium", April 22, 2008, # 145***

The Decree imposes a moratorium on tax inspection examinations with the exception of tax payments on a voluntary patent basis, statements on of business eliminations, as well as on request of tax authorities of other countries. Authorized regulatory bodies, with the exception of the Tax Inspection of the Kyrgyz Republic are to reduce the number of tax examinations. The decree is valid from the date of publication until December 31, 2008.

### ***2. The Resolution of the Government of KR "On the Concept of "single window" principle introduction in foreign trade of the KR", June 19, 2008, # 315***

This Resolution approves the Concept of introducing the "single window" principle in foreign trade in the Kyrgyz Republic. The "single window" principle in foreign trade is a mechanism that allows interested parties to submit standardized documents through a single channel in order to meet all regulatory requirements concerning import, export and transit, including borders that operate in accordance with "One stop shop" principle. The "single window" principle in foreign trade allows to submit information only once in a unified form and all state bodies and organizations involved receive a copy in electronic format.

### ***3. The Resolution of the Government of KR "On the Medium-Term Electricity Tariff Policy for 2008-2012", April 23, 2008, # 164***

By this Resolution the Government of the Kyrgyz Republic approves the Medium-Term Electricity Tariff Policy for 2008-2012. Tariffs on electrical energy will be increased step by step during 2008-2012. The first increase is on July 1, 2008, and then annually on 1 April, according to the schedule. With the proposed tariff increases fees rate will rise from 0.70 som (from July 1, 2008) to 1.45 som in 2012 for the population, from 0.96 to 1.60 som for industry, respectively.

### ***4. The Decree of the President of the KR "On additional measures of social support to vulnerable groups of population in the face of sharp food price increase", June 4, 2008, #191***

This Presidential Decree requires the Government to open a dedicated account for social support of vulnerable groups of population; to identify sources of their origin and size of annual replenishment; to develop a mechanism to support socially vulnerable groups of population.

### ***5. The Decree of the President "On compensatory payments to pensioners because of electricity prices increase", June 5, 2008, # 193***

In order to provide social support for pensioners in connection with approval of Medium-Term Electricity Tariff Policy for 2008-2012 and an increase in electricity tariffs accordingly starting July 1, 2008 this Decree sets up monthly compensation payments to pensions, appointed in accordance with the Law of the Kyrgyz Republic "On state social pension insurance" up to 1500 soms in accordance with specially designed scale.

### ***6. Resolution of Jogorku Kenesh of the KR "On adopting the Law of the Kyrgyz Republic" On Food Security of KR", June 19, 2008, # 516-IV***

According to the Law the main directions of state support are: guarantees for payment prices announced in advance to agricultural food products producers; subsidies for the production of basic food products; development of leasing activities aimed strengthening material and technical base of rural producers; funding research programs. In case of food crisis or its threat the Government of the Kyrgyz Republic establishes normative distribution of basic food products for a certain period for socially vulnerable groups of population; identifies limit market prices for basic food products for socially vulnerable groups of people; sets guaranteed prices for raw materials purchased for state material reserves; imposes state regulation for certain goods (works, services) by setting a threshold of profitability and trade margin; establishes a list of controlled goods and limits the profitability of trade margins; regulates food exports and imports through seasonal duties in accordance with the Kyrgyz Republic legislation; organizes operational procurement, delivery and distribution of basic food products for socially vulnerable groups of population.

**Kyrgyz Republic: Key Macroeconomic Indicators, 2003 - Q2 2008**

	2003	2004	2005	2006	2007	2007	2007	2007	2007	2008	2008
						I	II	III	IV	I	II
<b>GDP and prices</b>											
GDP real growth (%)	7.0	7.0	-0.2	3.1	8.2	8.5	9.0	8.0	7.7	6.1	7.9
Non-gold GDP growth (%)	5.4	7.6	1.9	5.7	8.7	10.9	11.0	7.2	7.5	5.8	7.0
GDP, mln soms	83 872	94 351	100 899	113 800	139 749	22 242	27 626	48 687	41 195	28 144	37 193
GDP, mln US\$	1 933	2 218	2 461	2 855	3 764	580	727	1 278	1 180	779	1 024
GDP per capita dollar (at avg exchange rate)	384	436	478	550	718						
Poverty headcount (% of population) <sup>1</sup>	50	46	43	40	35						
Extreme poverty headcount (% of population)	17	13	11	9	7						
GDP per capita, 1990=100	65	69	68	70	75						
GNI per capita dollar (Atlas)	340	400	450	500	600						
Inflation (% beginning-to-end of period, CPI)	5.6	2.8	4.9	5.1	20.1	2.0	2.5	5.5	8.9	6.1	8.6
Inflation (% average, CPI)	3.1	4.1	4.4	5.6	10.3						
Deflator GDP (% to prev.period)	4.0	5.1	7.1	9.4	13.5	5.3	6.9	18.7	17.2	19.3	24.7
Wage, average (soms per month)	1 916	2 203	2 570	3 270	3 976	3 404	3 904	3 958	4 637	4 658	5 288
Wage, average (US\$ per month)	44	52	63	81	106	89	103	104	133	129	146
Exchange rate (som/US\$, end of period)	44.2	41.6	41.3	38.1	35.5	38.1	38.0	36.9	35.5	36.4	35.9
Exchange rate (som/US\$, avg of period)	43.7	42.7	41.0	40.2	37.3	38.4	38.0	38.1	34.9	36.1	36.3
REER (2000=100, end-period, up=appreciation)	101	96	95	94	102	92	92	94	102	99	104
Unemployment rate (% of labor force)	9.9	8.5	8.1	9.3	11.5						
M2 (e.o.p as % of GDP)	17.5	20.5	21.1	28.4	30.8	26	29	29	31	28	30
<b>External Sector</b>											
Current account balance (% to GDP) <sup>2</sup>	-2.2	1.3	-1.2	-9.9	-6.2	-4.4	-2.0	2.3	-3.1	-6.5	-5.7
(mln US\$)	-42	29	-29	-282	-234	-131	-62	77	-118	-256	-244
Exports (mln US\$, fob)	588	733	687	906	1 337	300	308	354	376	318	428
Power	19	22	21	25	32	5	8	19	1	1	0
Gold	260	287	231	206	225	51	56	62	55	74	93
Imports (mln US\$, cif)	716	941	1 101	1 723	2 417	488	555	628	746	788	997
Food	78	110	140	211	251	46	55	61	89	77	92
Other consumer goods	178	194	211	287	306	54	70	78	104	198	243
Energy	180	256	314	507	740	179	147	189	225	249	303
Other intermediate goods	152	217	245	332	722	128	171	184	240	179	218
Capital goods	128	163	191	386	397	81	112	116	88	85	141
External Debt (mln US\$)	2 018	2 100	2 024	2 184	2 282	2 172	2 216	2 269	2 282	2 408	2 383
Public External Debt (mln US\$)	1 809	1 949	1 883	1 980	2 077	1 977	1 989	2 052	2 077	2 188	2 162
External Debt (% to GDP)	104.4	94.7	82.2	76.5	60.6	73	71	66	61	61	51
Actual debt service to exports (%)	12	9	12	6	5	7	10	4	5	4	3
Public external borrowing (excl. IMF, mln US\$)	75	95	92	76	59	7	20	23	8	8	13
Workers remittances (inflow, mln US\$)	113	285	482	731	1 065	162	256	341	307	227	307
Foreign direct investments (net, mln US\$)	46	175	43	182	178	46	34	79	20	75	54
International reserves (mln US\$, end period)	389	565	612	817	1 177	825	939	1 073	1 177	1 140	1 231
<b>General Government Budget (% of GDP)<sup>3</sup></b>											
Revenues and grants	22.9	23.4	24.7	26.6	30.8	5.7	8.3			6.0	7.9
Grants	0.6	1.4	1.0	0.8	2.3	0.1	0.6			0.0	0.7
Tax	14.2	14.8	16.2	17.6	19.0	3.9	7.3			4.2	4.7
Social fund contributions	3.5	3.5	3.8	3.9	3.9	0.9	..			0.9	0.9
Nontax and capital	4.6	4.0	3.7	4.3	5.6	0.8	..			1.0	1.6
Expenditures	27.6	27.4	28.5	29.7	30.9	5.2	8.1			5.6	8.1
Current (other than interest)	21.7	21.1	22.6	24.4	30.2	4.7	7.1			4.8	7.0
Transfers & subsidies	8.7	8.4	8.7	8.7	8.5	1.8	..			1.8	1.9
Wages & salaries	5.7	5.8	6.3	5.9	7.1	1.4	..			1.1	1.9
Interest payments	1.6	1.9	1.5	1.3	0.6	0.3	..			0.1	0.4
Capital	4.9	4.9	4.8	4.5	7.3	0.7	1.1			0.5	1.2
o.w. foreign financed PIP	3.7	3.8	3.8	3.4	2.7	0.4	0.4			0.3	0.4
Net lending	-0.5	-0.5	-0.4	-0.2	0.1	-0.1	-0.1			0.3	-0.1
Fiscal Balance (accrual)	-4.7	-4.0	-3.8	-3.1	0.0	0.5	0.2	1.0	-1.8	0.4	-0.2
Memo:											
Primary Balance (w/o interest and PIP)	0.5	1.6	1.5	1.6	3.3	1.1	..	..	..	0.7	0.6
Primary Balance (w/o interest)	-3.2	-2.1	-2.3	-1.7	0.6	0.7	..	..	..	0.5	0.2

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

<sup>1</sup> Poverty data is consumption based.

<sup>2</sup> Preliminary data from the National Bank

<sup>3</sup> The state budget consolidates central and local budgets and includes the foreign-financed public investment program and the deficit of the social fund.