World Bank Country Office in the Kyrgyz Republic

KYRGYZ REPUBLIC: RECENT ECONOMIC DEVELOPMENTS

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SUMMARY

Political life since mid-2008 has been relatively calm in the Kyrgyz Republic. The local elections held in the beginning of October 2008 were preceded by a scandal with the Chair of the Central Elections Committee who left the country due to political pressure. Electricity blackouts that were introduced in the second quarter to save energy power capacities for winter season have been carried out all over the country.

The energy sector has become the top economic and political issue and as a focal point for more active opposition parties which declared to conduct mass protests in nearest months. The global financial crisis has not had an immediate impact on the Kyrgyz economy, but in the medium term it may be affected by lower trade, less remittances and foreign capital inflows. Nevertheless, the overall macroeconomic picture is currently still stable.

Macroeconomic performance for 11 months of 2008 continued to be solid. Real GDP grew by 7.5% thanks to gold, trade and communication sectors. However, non-gold growth reached only 5.4% compared with 8.8% a year ago. Fixed investment declined slightly as a result of sluggish real estate market. Though banking credit grew in nominal terms, its level stayed stagnant at around 15% of GDP. Inflation pressures eased in the second half of the year, which resulted at 19% CPI growth in annual terms (Nov 2008 to Nov 2007), driven mostly by service prices.

In January-November 2008 the Som depreciated by 10.7% against US dollar, the development which started only in October as a reflection of US dollar appreciation internationally. However, real effective exchange rate appreciated by 5% in 10 months as a result of higher inflation rates in the Kyrgyz Republic than in trade partner countries.

The current account deficit is rising due to increased imports. The trade deficit widened to an unprecedented US$1.4 billion in the first 9 months of 2008, which was equivalent to 38% of GDP. The inflow of remittances continues to increase, though it was not enough to compensate increasing current account deficit which is estimated at 12% of (annual) GDP in the first 9 months of 2008. International reserves continued to grow but at a slower rate than in 2007 ($1.28 billion by end-September 2008 or 3.2 months of imports).

In order to support the Kyrgyz Government in addressing several exogenous shocks, IMF has approved in early December 2008 a 18-month program of about US$100 million under the Exogenous Shocks Facility with aim to reduce inflation, maintain an adequate level of foreign exchange reserves, and sustain economic growth.

1. ECONOMIC GROWTH

Real GDP increased by 6.6% in the first nine months of 2007 with the most dynamic sectors being gold (28%), telecommunication (45%) and trade (7.6%). The biggest change since last year has been the end of the construction boom as construction which had previously been growing at about 20% annually declined by almost 4%.

Table 1: Real GDP growth rate by sectors

	2005	2006	2007	9m07	9m08
GDP	-0.2	3.1	8.2	8.4	6.6
GDP excl. gold	1.9	5.7	8.7	9.2	6.1
Agriculture	-4.2	1.7	1.5	2.0	2.2
Construction	17.6	19.1	20.2	19.2	-3.9
Industry	-13.4	-10.9	7.3	7.3	9.0
Industry excl.gold	-6.0	3.6	10.7	12.9	4.0
Services	8.4	9.0	12.4	13.2	10.2

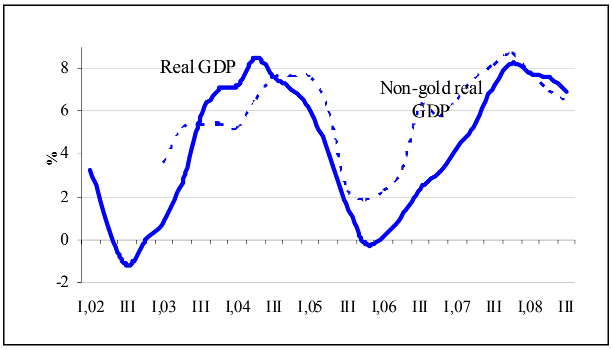
Source: NSC

Non-gold industry **grew only by 4%** mainly due to the reduction in electricity output, but other sectors such as production of textile (28%) and chemicals (18.7%), and oil processing (14.7%) saw strong growth. Gold processing growth was the strongest (28%) induced by improved productivity. Electricity blackouts which started in April 2008 forced firms to reduce production in the textile, glass and tobacco sectors. It is still too early to assess the overall impact of the energy shortages. The decline of construction (both domestically and in Kazakhstan) has also affected production of cement and glass.

Agricultural output grew modestly by 2.2% (as it has done for the past five years). Wheat production exceeded the level of the same period of 2007 by 6%, which, along with declining international prices, may help to reduce food inflation. Livestock sector growth was also modest, and there are concerns about sufficient availability of fodder in upcoming winter season, which may have impact into rural incomes and productivity.

Construction sector was the first one to be **hit by global crisis** with a decline by almost 4% compared with 20% growth in 2007. Residential housing construction declined most, especially in the capital city Bishkek, reflecting weak demand and coutionary investment decisions. However, housing construction is still represents a large portion of total fixed investment (19%). While mining sector saw substantial decline in investments compare to last two years, manufacturing and, especially, tourism sector, in light of successful 2007 tourism season, were able to increase investments.

Figure 1: Annualized real GDP growth - next downturn?



Source: Calculations based on NSC data.

Total **fixed investment declined** by 2.2% in real terms primarily due to reduced possibilities of domestic businesses to invest own funds (23% decline in nominal terms). In contrast, FDI and foreign borrowing became more important financing sources, jointly providing finance to a third of total fixed investments (17% in 9 months 2007).

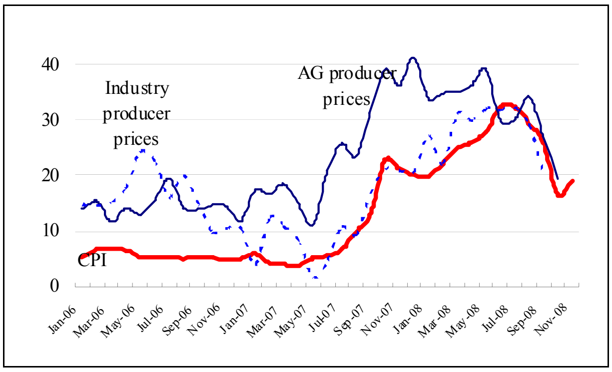
Services at over 47% of GDP, continued growing strongly during the first 9 months of 2008, despite slower growth of trade, which declined to 7.6% compared with average 13% in last two years. Sustained high growth in services was possible due to dynamic growth of transport and communication services (31%), driven primarily by the expansion of mobile telephone services.

2. PRICES AND EXCHANGE RATES

Inflation rate remains high, but has declined from its peak of 32.4% in July 2008. By end-November 2008 the annual inflation rate had fallen to 19% as a result of the stabilization of food prices since June 2008 (reflecting the downward trend of international commodity prices), with a year-to-year increase at 18.4% (compared with 19.5% a year ago). Price of services has grown by 33.5% due to increased tariffs for utilities, transport and education.

As with consumer inflation, producer price inflation has begun to fall. By end-October 2008 agriculture and industry producer prices had increase by 19.5% and 21.4%, respectively. Though producer prices have stabilized in the second half of the year, the price levels of key products (especially wheat, milk and coal) were substantially higher than at the end of 2007.

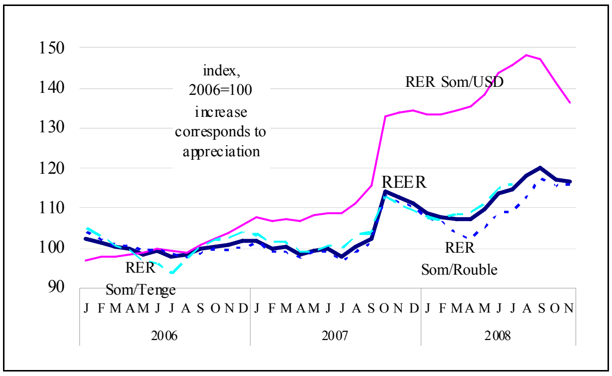
Figure 2: Consumer and Producers Prices



Source: NSC

Despite the high inflation rate, **real wages have still grown by 10%** (Sep08 to Sep07), compared with 38% growth of nominal wages[1] (to reach 155 US dollars). Government efforts to increase wages of public servants resulted in at least 40% wage increases in public administration, healthcare and education. Private sectors wage growth was the highest in trade, agriculture, and construction.

Figure 3: Real exchange rate

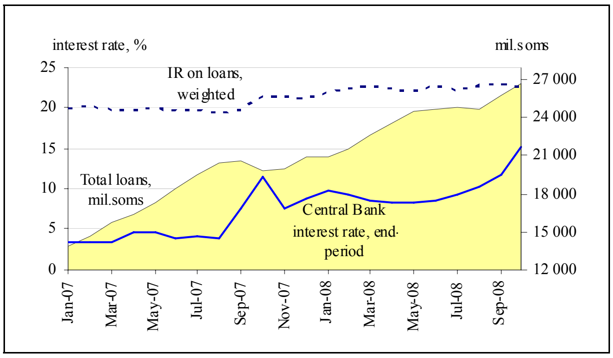


Source: Staff calculations based on NBKR data

The Kyrgyz Som depreciated by 10.7% against the US dollar in 11 months of 2008, mostly during October and November, reflecting the general appreciation of the US dollar. However, the real effective exchange rate appreciated by 5% in the first 10 months of this year as a result of higher inflation rates in the Kyrgyz Republic than in its trade partners. During the last two years there has been a strong debate at the highest policy making levels on whether to use the exchange rate to support growth (by avoiding nominal appreciation), or to allow a tightening of monetary policy through appreciation to diminish inflation. This has led to apparent inconsistencies in exchange rate policy as policy makers have tried to respond to rapidly changing economic conditions.

In the midst of global financial crisis, the Kyrgyz banking system seems to be relatively unaffected at this point. However, reflecting cautious lending policy of the banks (and the rise in inflation), the average weighted **interest rate for bank loans** increased from about 21% at end-2007 to 23% since middle of this year. Banking lending has continued to grow solidly (by 28% since end-2007), so that credit remains at about 15% of GDP. However, a sectoral breakdown of new loans extended shows that banks are cutting back longer term lending, such as mortgages and to industry, and putting more emphasis on short term lending and higher returns to sectors such as trade (47% of all new loans) and consumer credit (11%).

Figure 4: Bank credit and interest rates



Source: NBKR

The growth of deposits was also sound at 16%, though lower than credit growth.

3. EXTERNAL SECTOR

Preliminary BOP data indicate that the **current account** deficit for nine months of 2008 grew to

[1] These numbers, however, should be interpreted with caution, since they do not cover the informal sector.

12% of GDP on annualized basis[2] due to continued rapid growth of imports in goods and services (by 54%). Exports performance was impressive at 37% growth, though contribution of more than 60% increase in gold export contributed significantly. Remittances continued demonstrating strong growth (46%), which is helping to counterbalance the widening trade deficit.

Merchandise exports increased by 35% in 9 months of 2008, with non-gold exports growing at a slightly lower rate. Gold exports benefited from higher world prices, as well from increased production. Among non-gold items raw materials and energy re-export saw the highest growth (at least 50%).

Table 2: Current account, *mln.USD*

	2005	2006	2007	9m07	9m08
Current account	-29	-282	-232	-159	-485
as % to GDP	*-1.2*	*-9.9*	*-6.2*	*-4.2*	*-10.4*
Exports (fob)	687	906	1 337	961	1 294
Gold	231	206	225	169	271
Imports (fob)	1 106	1 792	2 635	1 753	2 707
Exports of services	256	379	684	348	654
Imports of services	291	461	582	395	707
Net income	-75	-43	-56	-50	-95
Interest payments	-36	-20	-26	-16	-22
Current transfers	500	730	1 020	729	1 075
Remittances inflow	514	762	1 065	759	1 109

Source: NBKR preliminary data

Merchandise imports (cif) increased by 72%, reflecting tripled import of non-food consumer goods and of energy (78%). Import of oil products increased by 82%, driven mainly by increased prices (by 57%). In overall, volume effect was dominating factor for commodity import growth, though import prices have risen considerably for critical items such as oil products, natural gas (45%), sugar (31%), and grains (2 times).

Current account deficit was dominantly financed by long term financial items such as FDI and long term borrowing both by public and private sectors. There is some indication of short term capital outflow in the period analyzed, which is mainly presented by items, like trade credits and changes in account balances. As it was case in recent years, 'Errors and omissions' were considerably high, reflecting unresolved issue of poor statistical recording of external trade.

Table 3: Financial account, *mln.USD*

	2005	2006	2007	9m07	9m08
Financial account	21	328	334	241	185
FDI, net	43	182	208	191	266
LT loans, net	18	66	44	41	50
Public sector	17	54	28	24	20
Private sector	1	12	16	18	30
ST flows, net	-39	79	82	9	-132
Errors & Omissions	67	187	276	143	444
Internation.reserves	612	817	1 177	1 073	1 283
in months of imports	*3.3*	*3.0*	*3.4*	*3.0*	*3.2*

Source: NBKR preliminary data

International reserves rose to a historical high US$ 1.28 billion at end-Sep 2008, to cover 3.2 months of imports. A prudent borrowing policy keeps external debt at US$ 2.3 bln level (end-Aug 2008), which is equivalent to 48% of annualized GDP. External debt service was modest, absorbing about 4% of exports.

However, expecting some BOP financing problems due to potential spillovers from the international financial crisis, the Government has agreed an economic program with IMF with a focus on reducing inflation, supporting economic growth, and protecting the poor. This economic program will be supported by an 18-month arrangement under the Exogenous Shocks Facility, providing financial support of about US$100 million, and was approved in December 10, 2008.

4. GENERAL GOVERNMENT BUDGET

The general fiscal position in January-September continued to be strong enough with the surplus equivalent 0.7% of GDP.

General government revenue reached 22.2% of GDP, mainly due to impressive growth of tax revenues, which increased over the period by 1.3 percentage points (more than Som 8 bln in nominal terms). The major contribution to the tax growth was made by increased collections of

[2] The National Bank adjusts BOP data by estimates of unrecorded export and re-export at the end of the year, so the current account deficit for 2008 will probably not be so high.

VAT, which ensured 36% of tax growth, income and profit taxes (23%), and payroll tax (15%).

General government expenditure was recorded at 21.4% of GDP. Nominal expenditures of the state budget increased by Som 9.6 billion compare to the previous period. The government notably increased funding to such items as salaries, social transfers, public debt service, 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)

	January-September			
	2005	**2006**	**2007**	**2008**
Total revenue	**17.3**	**18.8**	**21.3**	**22.2**
Taxes	14.2	15.1	16.2	17.5
Income and profit tax	2.4	2.1	2.1	2.7
VAT	4.9	5.6	6.4	6.7
Exices	0.8	0.8	0.8	0.6
Customs	1.1	1.7	1.8	1.8
Payroll	2.8	2.8	2.8	2.9
Others	2.2	2.2	2.4	2.7
Non-tax and Capital	2.5	3.0	3.5	3.9
Grants	0.5	0.6	1.5	0.7
Total expenditure	**20.5**	**20.5**	**20.0**	**21.4**
Current	17.1	17.5	17.1	18.7
Wages	4.2	4.1	4.8	4.7
Transfers&subsidies	5.6	5.6	5.2	5.7
Interest	1.0	0.9	0.4	0.6
Goods and services	6.3	7.0	6.5	7.7
Capital	3.4	3.0	3.0	2.7
Foreign financed PIP	2.8	2.3	2.0	1.3
Net lending	-0.3	-0.1	-0.1	0.1
Balance	**-2.9**	**-1.6**	**1.4**	**0.7**

Source: the MEF and WB staff calculations

4. Main legislative changes with an economic impact in July-November 2008

1. The Law of the Kyrgyz Republic «On the state social order», Jul 21l, 2008, # 162
Regulates general principles, legal and organizational basis for the formation, allocation and execution of public social orders in order to implement social programs. The Law is aimed to increase the efficiency of using state budget funds allocated to address social and economic problems and to improve the quality of social services.

2. The Resolution of the Government of the Kyrgyz Republic «On the Development Fund of the Kyrgyz Republic», Aug 25, 2008, # 469
The main objectives of the Fund are to promote priority and strategic economy sectors, to establish an efficient and stable financial base to support the development of the real sector; to accumulate funds from different sources, to provide an access to medium-and long-term credits for economic entities; to attract investments for domestic enterprises.

3. The Law of the Kyrgyz Republic «On Food Safety », Aug 4, 2008, #183
The Law establishes the basic directions to provide food security in the Kyrgyz Republic for an access to adequate amounts of food in accordance with minimum standards of food consumption, based on their availability, accessibility and security. In case of food crisis, or its threat, the Government upon the recommendation of the Council on Food Safety establishes a special regime to ensure food security for a certain period. Availability of food is determined by combination of stocks of state material reserves, imports, food aid and own production.

4. The Presidential Decree «On measures for introduction fully funded scheme to the pension system», Sep 24, 2008, # 339
Approves the Concept of introducing fully funded scheme into the pension system of the Kyrgyz Republic and approves Action Plan for its introduction in order to raise pensions, to achieve financial stability of Pension Fund in the medium and long term perspective, to attract financial resources to the Social Fund of the Kyrgyz Republic as investments to the economy.

5. The Law on Introduction of the Tax Code, Oct 15, 2008 # 231

The draft of the new Tax Code of the Kyrgyz Republic was approved on October 2008 by the Parliament of the Kyrgyz Republic to be come into force from January 1, 2009.

New Tax Code describes in detail taxation principles, types of taxes, rights and responsibilities of taxpayers and tax authority. As a whole the bill essentially differs from the existing Tax Code of the Kyrgyz Republic given reduction of number of taxes from 16 to 8, simplification of tax procedures and methods of tax calculations. Among notable changes: 1) property tax with certain rates has been included; 2) sale tax was imposed (1.5 % to 3.5 % volume of the realized goods, works and services), 3) VAT rate to be lowered from 20% to 12%, 4) excise tax rates are reconsidered;

Kyrgyz Republic: Key Macroeconomic Indicators, 2005 - Q3 2008

	2005	**2006**	**2007**	2007	2007	2007	2007	2008	2008	2008
				I	II	III	IV	I	II	III
GDP and Prices										
GDP real growth (%)	-0.2	3.1	8.2	8.5	9.0	8.0	7.7	6.1	7.9	6.2
Non-gold GDP growth (%)	1.9	5.7	8.7	10.9	11.0	7.2	7.5	5.8	7.0	5.6
GDP, bln soms	100.9	113.8	139.7	22.2	27.6	48.7	41.2	28.1	37.2	65.9
GDP, mln US$	2 461	2 855	3 764	580	727	1 278	1 180	779	1 024	1 866
GDP per capita dollar (at avg exchange rate)	478	550	718							
GNI per capita dollar (Atlas)	450	500	600							
Poverty headcount (% of population)[1]	43	40	35							
Extreme poverty headcount (% of population)	11	9	7							
Inflation (% beginning-to-end of period, CPI)	4.9	5.1	20.1	2.0	2.5	5.5	8.9	6.1	8.6	1.9
Inflation (% average, CPI)	4.4	5.6	10.3							
Deflator GDP (% to prev.period)	7.1	9.4	13.5	5.3	6.9	18.7	17.2	19.3	24.7	27.5
Wage, average (US$ per month)	63	81	106	89	103	104	133	129	146	154
Exchange rate (som/US$, end of period)	41.3	38.1	35.50	38.1	38.0	36.9	35.5	36.4	35.9	36.7
Exchange rate (som/US$, avg of period)	41.0	40.2	37.3	38.4	38.0	38.1	34.9	36.1	36.3	35.3
REER (2000=100, end-period, up=appreciation)	95	94	102	92	92	94	102	99	105	110
Unemployment rate (% of labor force)	8.1	9.3	11.5							
M2 (e.o.p as % of GDP)	21.1	28.4	30.8	26	29	29	31	28	30	29
External Sector										
Current account balance (% to GDP)[2]	-1.2	-9.9	-6.2	-4.4	-2.0	2.3	-3.1	-6.4	-4.6	-0.7
Exports (mln US$, fob)	687	906	1 337	300	308	354	376	318	428	548
Power	21	25	32	5	8	19	1	1	0	23
Gold	231	206	225	51	56	62	55	74	93	104
Imports (mln US$, cif)	1 101	1 723	2 417	488	555	628	746	786	1 019	1 092
Food	140	211	251	46	55	61	89	77	92	93
Other consumer goods	211	287	306	54	70	78	104	198	243	225
Energy	314	507	740	179	147	189	225	246	303	371
Other intermediate goods	245	332	722	128	171	184	240	179	240	263
Capital goods	191	386	397	81	112	116	88	85	141	142
External Debt (mln US$)	2 024	2 184	2 282	2 172	2 216	2 269	2 282	2 408	2 392	2 340
Public External Debt (mln US$)	1 883	1 980	2 077	1 977	1 989	2 052	2 077	2 188	2 162	2 110
External Debt (% to GDP)	82.2	76.5	60.6	73	71	66	61	61	56	48
Actual debt service to exports (%)	12	6	5	7	10	4	5	4	3	3
Public external borrowing (excl. IMF, mln US$)	92	76	59	7	20	23	8	8	19	13
Workers remittances (inflow, mln US$)	482	731	1 065	162	256	341	307	224	387	497
Foreign direct investments (net, mln US$)	43	182	208	56	57	78	18	74	65	54
International reserves (mln US$, end period)	612	817	1 177	825	939	1 073	1 177	1 140	1 231	1 283
General Government Budget (% of GDP)[3]										
Revenues and grants	24.7	26.6	30.8	5.5	7.1	8.7	9.5	6.1	8.1	8.0
Grants	1.0	0.8	2.3	0.1	0.5	0.9	0.8	0.0	0.7	0.0
Tax	16.2	17.6	19.0	3.8	4.5	5.2	5.6	4.2	4.8	5.6
Social fund contributions	3.8	3.9	3.9	0.9	0.9	1.0	1.1	0.9	1.0	1.1
Nontax and capital	3.7	4.3	5.6	0.8	1.2	1.6	2.1	1.0	1.7	1.3
Expenditures	28.5	29.7	30.9	5.1	6.9	8.0	10.9	5.7	8.3	7.5
Current (other than interest)	22.6	24.4	30.2	4.3	6.0	6.3	6.3	4.9	6.8	6.5
Transfers & subsidies	8.7	8.7	8.5	1.7	2.3	1.3	3.3	1.9	1.9	2.0
Wages & salaries	6.3	5.9	7.1	1.3	2.0	1.5	2.3	1.1	1.9	1.7
Interest payments	1.5	1.3	0.6	0.2	0.1	0.1	0.2	0.1	0.4	0.1
Capital	4.8	4.5	7.3	0.6	0.9	1.4	4.3	0.5	1.2	0.9
o.w. foreign financed PIP	3.8	3.4	2.7	0.4	0.7	0.9	0.7	0.3	0.4	0.6
Net lending	-0.4	-0.2	0.1	-0.1	-0.2	0.2	0.2	0.3	-0.1	-0.1
Fiscal Balance (accrual)	-3.8	-3.1	0.0	0.4	0.2	0.7	-1.4	0.4	-0.2	0.5
Memo:										
Primary Balance (w/o interest and PIP)	1.5	1.6	3.3	1.1	1.0	1.6	-0.5	0.7	0.6	1.2
Primary Balance (w/o interest)	-2.3	-1.7	0.6	0.7	0.3	0.8	-1.2	0.5	0.2	0.6

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

[1] Poverty data is consumption based.

[3] The state budget consolidates central and local budgets and includes the foreign-financed public investment program and the deficit of the social fund.