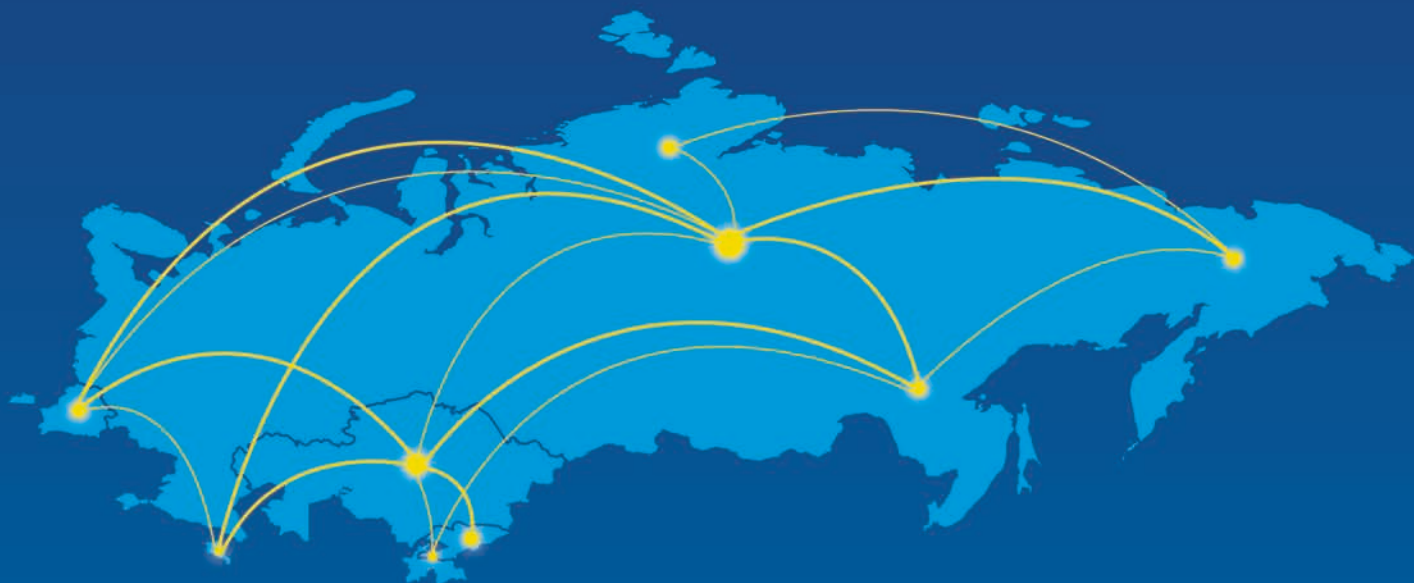


EDB MACRO REVIEW



10'2020

Kyrgyz Republic

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INFORMATION DISCLOSURE

This Review includes a detailed description of the current domestic and external macroeconomic setting and a consistent set of forecasts that takes into account the interrelationships between the economies of the EDB operating region and the external sector.

The forecasts of the main macroeconomic indicators were prepared by the EDB jointly with the EEC using an integrated system of models based on a multi-country structural dynamic macroeconomic general equilibrium model. More detailed information about the structure of the integrated system of models, its main components, and its use for analysis of the macroeconomic situation and forecasting is contained in a joint EDB and EEC report entitled “Forecasting System for the Eurasian Economic Union”.

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LIST OF ABBREVIATIONS

BEA — U.S. Bureau of Economic Analysis

bbl — barrel

CDS — credit default swap

COVID-19 — Coronavirus disease

CPI — Consumer Price Index

ECB — European Central Bank

EDB — Eurasian Development Bank

EEC — Eurasian Economic Commission

ENIA — Euro Overnight Index Average

EU — European Union

EURIBOR — Euro Interbank Offered Rate

Eurostat — The statistical office of the European Union

Eurozone — EU countries, that have adopted the euro as their primary currency and sole legal tender

FLBs — Federal Loan Bonds

FRS — Federal Reserve System of the United States

GDP — Gross Domestic Product

ISM — Integrated System of Models

KR — Kyrgyz Republic

LIBOR — London Interbank Offered Rate

MF KR — Ministry of Finance of the Kyrgyz Republic

MIACR — Moscow Interbank Actual Credit Rate

NBKR — National Bank of the Kyrgyz Republic

NSC — National Statistical Committee

OECD — Organization for Economic Cooperation and Development

OPEC — Organization of the Petroleum Exporting Countries

PMI — Purchasing Managers' Index

pp — percentage point

Q — quarter

RF CB — Central Bank of the Russian Federation

Rosstat — Federal State Statistics Service of the Russian Federation

SSM — semi-structural macroeconomic models

U.S. or USA — United States of America

UK — United Kingdom

USD — United States dollar

% — percent

% YoY — year-over-year growth rate

SUMMARY

The Kyrgyz economy faced challenging external economic conditions in the first half of this year. The COVID-19 pandemic resulted in an unprecedented decline in global business activity and volume of international trade. Lockdown restrictions considerably weakened consumer and investment demand and fostered a slowdown in inflation along with a fall in energy prices. These conditions compelled monetary regulators in both developed and developing countries to ease their monetary policy, while fiscal bodies unveiled large-scale anti-crisis packages to help individuals and business.

June–July 2020 performance indicators communicated the beginning of a recovery in global economic activity amid eased lockdown restrictions and companies resuming work, primarily in the service sector. Due to differences in the epidemiological situation and government support across countries, this process has been gradual and varied. The EDB's baseline scenario assumes a slow recovery of the world's largest economies with unused capacity at production facilities in 2020–2022 to drive only moderate external demand for Kyrgyz exports in the medium term. Under such conditions, inflationary pressure from abroad will remain weak.

The Kyrgyz economy contracted by 5.3% YoY in January–June 2020 in such circumstances. Lockdown within the country, decreasing external demand and challenging transportation situation, as well as reduced remittances from migrant workers were the drivers behind shrinking domestic demand and investment. Due to the borders with China closing at the beginning of the year, a decrease in the inventory of working capital was inevitable, causing an additional reduction in gross accumulation. The aftermath of the coronavirus pandemic is now mostly embodied in a cyclical economic recession, although potential GDP growth rates have also decreased. We believe that the negative output gap amounted to some 4.0–4.5% in 2Q2020.

According to the EDB's baseline scenario, the easing of lockdown measures in the second half of this year and support from expansionary monetary and fiscal policies will generate conditions fostering economic recovery. However, the process is going to be a slow one due to the increased uncertainty, social distancing, moderate external demand, weakened investment and depressed employment market; a return to the pre-crisis production levels is expected in 2021–2022, while the output gap will remain negative throughout the entire forecast period. The GDP contraction is estimated at 5.9% in 2020; its growth rate in 2021–2022 averages about 4.3–4.5% per year.

In the first half of 2020, the Kyrgyz som weakened against the world's key currencies. The highest pressure on the national currency was seen in the second half of March: the coronavirus outbreak grew into a pandemic, while the OPEC+ countries failed to reach an agreement regarding the extension of oil

production restrictions, thus increasing turbulence in global financial markets. In May–June, the som regained some of the lost ground and traded at about 73 soms per U.S. dollar, which was encouraged by the beginning of economic recovery at home and abroad, as well as by the situation in the global financial and commodity markets relatively stabilizing. In the second half of August–early September 2020, volatility rose in the regional financial markets due to increasing geopolitical risks; should these risks remain, the national currency is unlikely to strengthen by as much as its potential. The exchange rate is expected to adjust to an equilibrium level during 2021–2022 if the coronavirus spread slows and geopolitical situation normalizes.

Consumer price growth rates somewhat increased in the first half of this year due to the exchange rate pass-through effect, temporary feverish demand for certain products and increases in prices for grain and grain products. We expect the inflation rate to grow to 5.9% YoY by the end of 2020, mainly due to the depreciation of the national currency and the increase in the cost of food. Restrained domestic and external consumer demand is expected to limit inflationary processes significantly in the medium term. Provided that exchange rates stabilize, the consumer price growth rate will slow down to 4.1% YoY in 2021 and will commence a gradual recovery towards the target of the National Bank of the Kyrgyz Republic (5.0–7.0%), as disinflationary factors weaken.

Inflationary pressure increased in late 2019–early 2020, compelling the NB KR to raise the policy rate to 5.0% from 4.25% in February 2020. In general, we believe the current interest rate policy of the monetary authorities to be of a stimulative nature. We expect the rate to remain at this level up to the end of 2020. As disinflationary factors weaken, the scope of monetary stimulus will decrease and monetary conditions will come close to neutral.

The state budget recorded a deficit of 7.3% of GDP in the first half of this year. The volume of expenditures aimed at containing the coronavirus has significantly increased, while they have been optimized for other budget items. Suspension of business activities and the closure of borders resulted in a significant decrease in tax revenues. The negative budget balance was financed by attracting soft loans and grants from international development institutions, which, in turn, furthered an increase in public debt in the first half of 2020.

Heightened and negatively skewed risks to our forecasts remain, since the anticipated economic recovery is not of a stable nature, on the back of a potential second wave of the pandemic, increased tensions between the USA and China and additional sanctions rhetoric regarding Russia. The latter may translate into a negative effect on the economy of the Kyrgyz Republic through remittances and trade.

EXTERNAL CONDITIONS

Economic Activity

Unprecedented decline in global economic activity

The first half of this year was marked by a huge challenge — the COVID-19 pandemic. As the disease spread, government bodies in the majority of countries responded by taking measures intended to contain it, which then led to a disruption in global supplies and increased volatility in the financial and commodity markets and exerted an overall negative impact on a great number of key economic sectors. Lockdown measures resulted in a reduction of consumer and investment activity, real and business incomes, and increased unemployment.

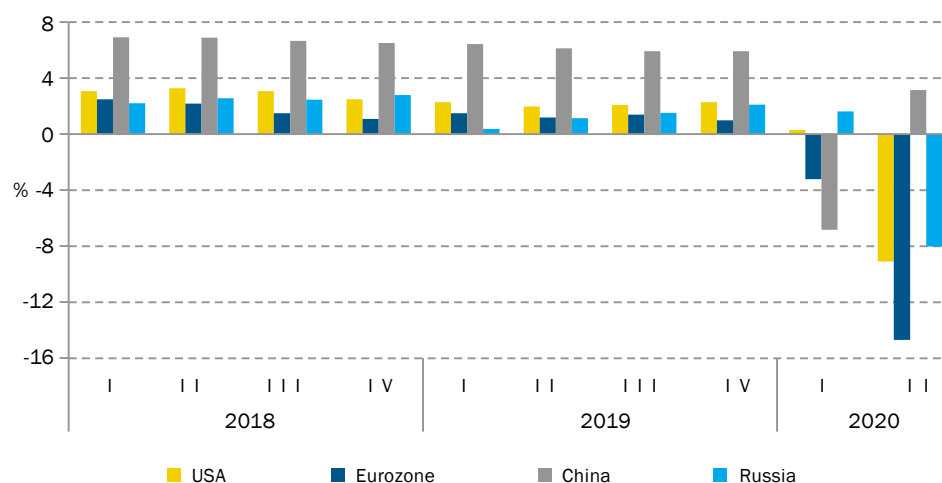
Among the world's largest economies, the biggest decline in business activity in 2Q2020 was observed in the Eurozone, where GDP declined by 14.7% YoY¹ (down 3.2% YoY in January–March 2020), which is the highest drop since the indicator was first calculated in 1995. GDP of the USA decreased by 9.1% YoY² (0.3% growth in Q12020) over the same period, which had not been at this level since 1947. China's GDP showed a positive trend in Q2: it increased by 3.2% YoY (down 6.8% YoY in January–March) upon the restrictions being eased in the spring.

The Russian economy contracted by 8.0% YoY in 2Q2020 (down 3.4% YoY in the first half of the year). The deteriorating epidemiological situation resulted in a fall in consumer and investment demand, with reduced extraction under the OPEC+ agreement holding back exports further.

¹ Seasonally adjusted data. As per our estimates, the year-on-year decrease compared to the previous quarter (seasonally adjusted) amounted to some 40%.

² Seasonally adjusted data. The year-on-year decrease compared to the previous quarter (seasonally adjusted) amounted to 31.7%.

Figure 1.
GDP of the key trade partners
(Year-on-Year growth rate)



Source: CEIC Data, BEA, Eurostat, Rosstat

Big losses in the service sector

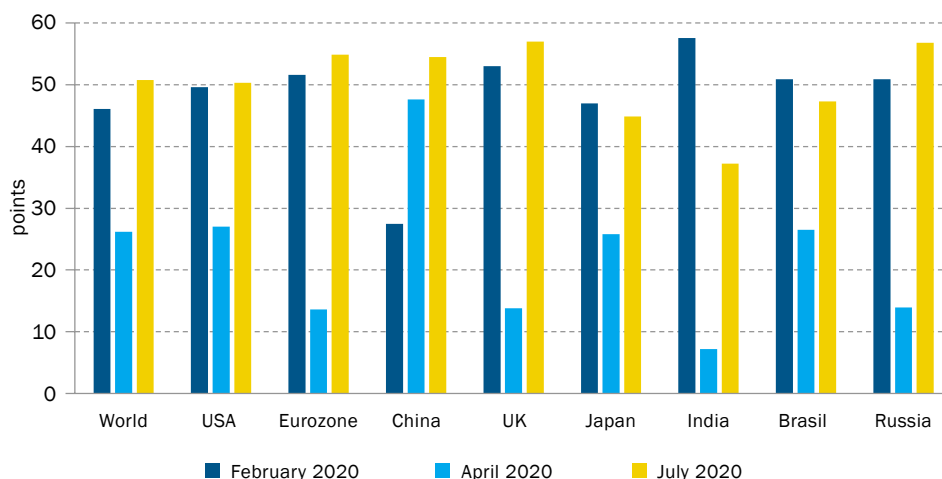
In terms of industry, the largest losses were incurred by businesses providing consumer services. This follows from PMI survey results³, evidencing a significant decrease in business activity in the tourism and significant deterioration in business sentiment hotel industries, as well as in the transport and real estate sectors. A significant deterioration in business sentiment affected technology and financial firms, along with the telecommunications services segment. An output decline was also caused in the manufacturing industry, primarily in mechanical engineering and automobile production. There was a lesser impact of the pandemic on the food and pharmaceutical industries.

Stabilization of the world economy at reduced levels in June–July

The maximum impact of the crisis (barring a second global wave of the disease or provided that its duration and consequences are not overly severe) is likely to have been passed in April–May, with the composite PMI at 26.2 (a record low) and 36.3 points, respectively. In June–July, the indicator increased to 47.7 and 50.8 points, respectively, which attests to a significant slowdown in the economic downturn after lockdown restrictions were eased. The composite PMI for Russia reached 56.8 points in July (13.9 in April 2020), 54.9 in the Eurozone (13.6 in April 2020), 50.3 in the USA (27 in April 2020), and 54.5 in China (27.5 in February 2020).

³ PMI is an indicator describing changes in business activity and the operating conditions of private companies in the manufacturing and service industries. This indicator is based on monthly surveys of purchasing managers. A PMI index reading of over 50 points indicates an increase in economic activity, while readings below 50 indicate a decrease. For more information, please see: <https://www.markiteconomics.com/Public/Release/PressReleases>

Figure 2.
Composite PMI



Source: IHS Markit

Economic sentiment improved in June–July both in the service sector (real estate operations, banking products, telecommunications) and in the manufacturing industry (production of construction materials, automobiles, chemical products, etc.). There was a significant slowing in the decline of new orders volumes, including exports. However, the recovery in global business activity is uneven due to differences in the epidemiological situation, and leading indicators overall signal the stabilization of global output at significantly lower levels than pre-crisis, which indicates the world economy is likely to be slow in returning to its “normal” state.

Inflation

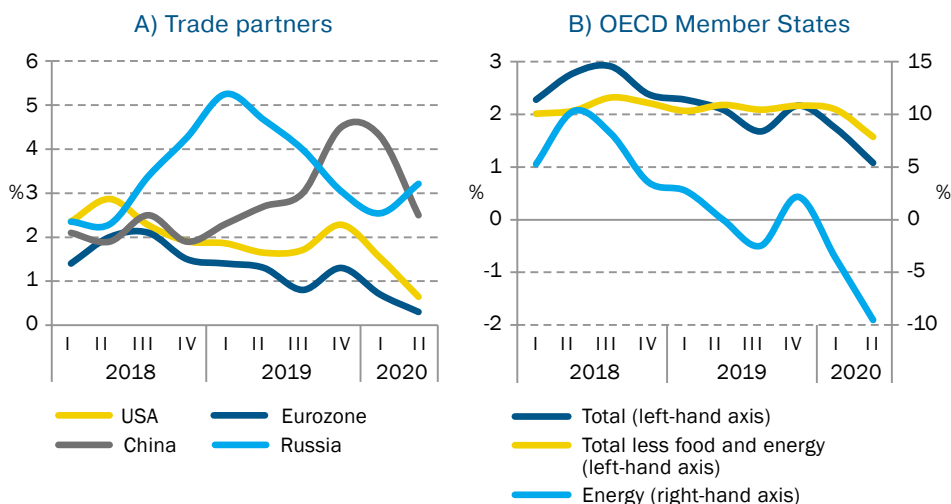
Weak inflation background

The decline in global economic activity resulted in a slowdown in the world’s inflationary processes. Inflation in the OECD countries fell to 1.1% YoY in June from 2.2% in December 2019; in the U.S., it fell to 0.6% from 2.3%; in the Eurozone, it fell to 0.3% from 1.3%; and in China, it fell to 2.5% from 4.5%. The fall in energy costs due to decreased demand acted as an additional disinflationary factor. Accelerated food price growth had an impact on consumer prices despite their decrease in the international market, which might be driven by temporary difficulties relating to transportation and feverish demand for certain products in late March–early April.

Russia retains a moderate price environment: inflation remained below the Bank of Russia’s target (4%) in August, amounting to 3.6% YoY, an increase from 3% YoY in December 2019. The increase in the indicator mainly stems

from the rise in the cost of food products due to the weakening of the national currency, the challenging transportation and logistics situation, as well as the low base effect in the fruit and vegetable segment. Core inflation amounted to 3.1% YoY in August, as in December 2019. Weakened domestic consumer demand curbed its movement.

Figure 3.
Foreign inflation
(the last month in a quarter vs. the last month of the same quarter a year before)



Source: OECD, RF CB

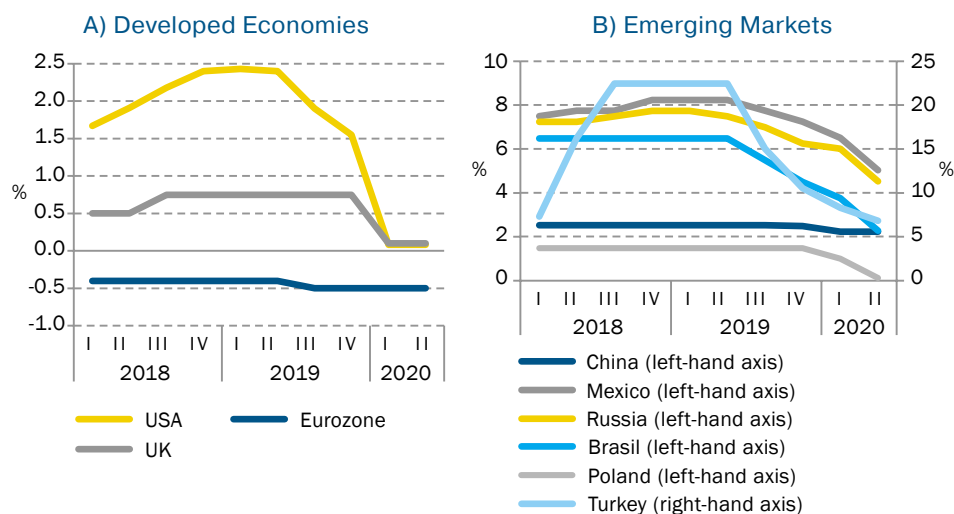
Monetary and fiscal policy

Easing of monetary policy

Active government measures taken to support the population, business and the financial sector were instrumental in limiting the scale of decline of the world’s largest economies. Monetary regulators eased monetary policy significantly in the first half of 2020 by lowering key interest rates and expanding asset purchase programs. In addition, top central banks announced their intention to maintain a soft policy in the medium term.

Monetary regulators in developing countries also lowered key rates, most actively in March–April 2020. As of the end of August 2020, the Bank of Russia key rate amounted to 4.25%, 2 pp lower compared to its level at the beginning of the year. The regulator’s actions are explained by a shift in the balance of risks in 2Q toward disinflation due to a deep drop in both domestic and external demand, which might cause inflation to drop below the 4% target in the medium term. Since the inflationary trend has proven to be rather moderate, we assess the Bank of Russia’s monetary policy as moderately stimulative.

Figure 4.
Key interest rates of foreign countries
(as at the end of period)

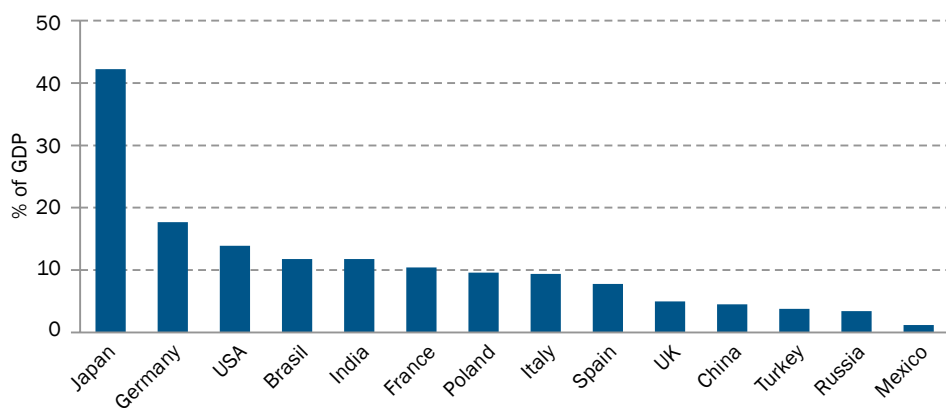


Source: CEIC Data

Stimulative fiscal policy

The volume of fiscal assistance was significantly expanded in the first half of 2020, since a need for anti-crisis measures arose, factoring in support for business and real incomes. According to the COVID-19 Economic Stimulus Index⁴ as of August 25, the volume of fiscal stimulus in Japan amounted to 42.2% of GDP; in the U.S., 13.9% of GDP; in Germany, 17.7% of GDP; in France, 10.4% of GDP; in Italy, 9.4% of GDP; in the United Kingdom, 5% of GDP; in China, 4.5% of GDP; and in Russia, 3.4% of GDP.

Figure 5.
Scope of fiscal support measures



Source: COVID-19 Economic Stimulus Index

⁴ For more information, see: Elgin C., Basbug G., Yalaman A. 2020. Economic Policy Responses to a Pandemic: Developing the Covid-19 Economic Stimulus Index. CEPR. Covid Economics, Vetted and Real-Time Papers. No 3. PP. 40–53.

Commodity markets

Low oil prices

The prices of most key commodities were driven largely by global demand and expectations of its recovery. After falling in March and April, prices for oil, metals and food began to recover in the face of a revival in economic activity. The OPEC+ agreement also had a positive impact on oil prices, providing for a large-scale reduction in raw materials extraction from May 2020. As a result, the price of Brent rose to USD 42.8 per barrel in July (Urals rose to USD 43.9) from a multi-year low of USD 23.3 in April (Urals: USD 18.2), but remained much lower than before the crisis.

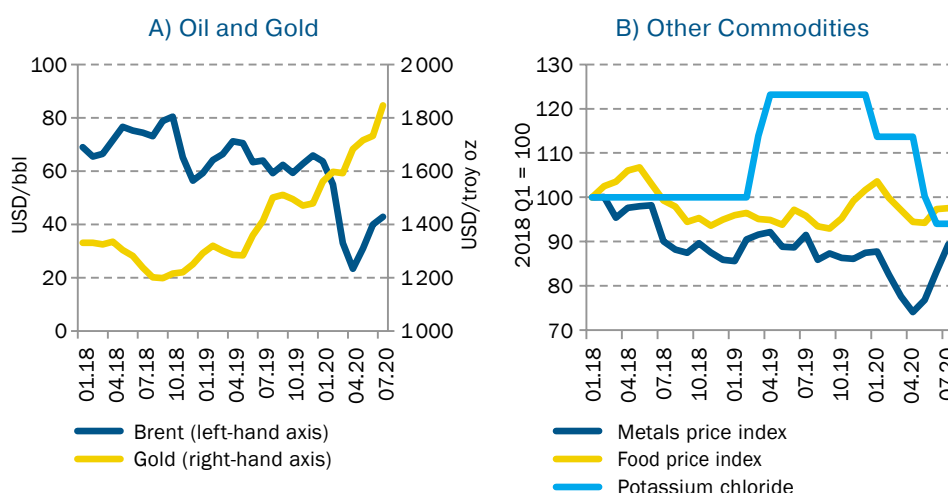
Resumption of growth in metal prices by the end of the first half of the year

The metal price index increased by 20.7% in July versus the April minimum, and exceeded the level of December 2019. This was largely influenced by the revival of economic activity in China. The weakening of the U.S. dollar against key world currencies, as well as the risk of reduced supply of industrial metals, including copper, caused by the spread of coronavirus in Latin America, also affected the rapid growth of the indicator in June–July. The food price index showed a similar trend: after falling in April–May, there was a recovery in June–July. The market for potash fertilizers and coal remains weak.

Increase in gold prices

Amid increasing global uncertainty in the first half of this year, there was a significant increase in demand for protective assets such as gold, with its prices reaching an all-time high in July 2020, being almost 25% higher than in last December. The soft policy maintained by major central banks furthered the increase, accompanied by large-scale injections of liquidity.

Figure 6. Commodity prices



Source: World Bank

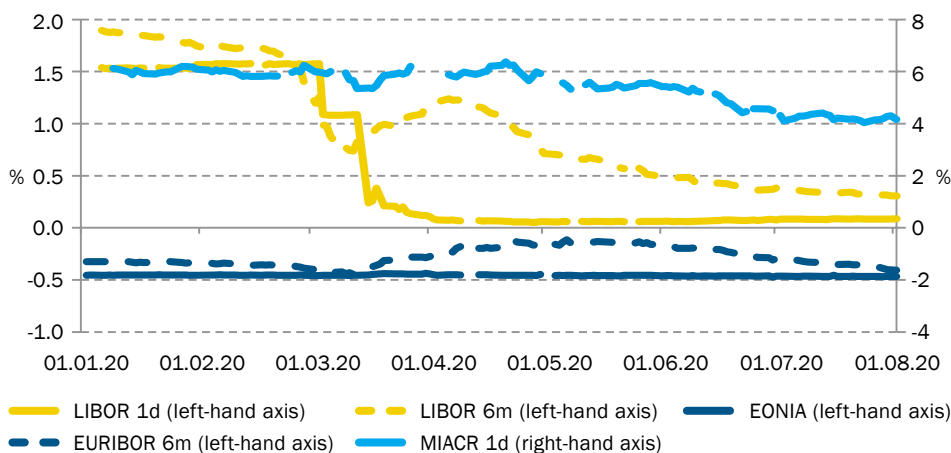
Financial markets

Lowering of interbank market rates

LIBOR rates in U.S. dollars, as well as indicators of the Eurozone money market, decreased in 2Q2020 after monetary regulators opted to ease monetary policy. Central banks' efforts to maintain financial markets liquidity and somewhat improved business sentiment amid stabilizing economic activity were instrumental in reducing spreads between rates on one-day and longer interbank loans, which had returned to pre-crisis levels after an upsurge in March.

The short-term interbank loan rates decreased in Russia over January–July 2020, staying near the policy rate, with a small negative spread resulting from a structural surplus of liquidity remaining in the banking sector. The yield on ruble FLBs also significantly decreased in April–July after an increase in March, propelled by the expectation of a key rate adjustment and the stabilization of the financial market after a period of increased turbulence around the middle of March.

Figure 7.
Money market rates

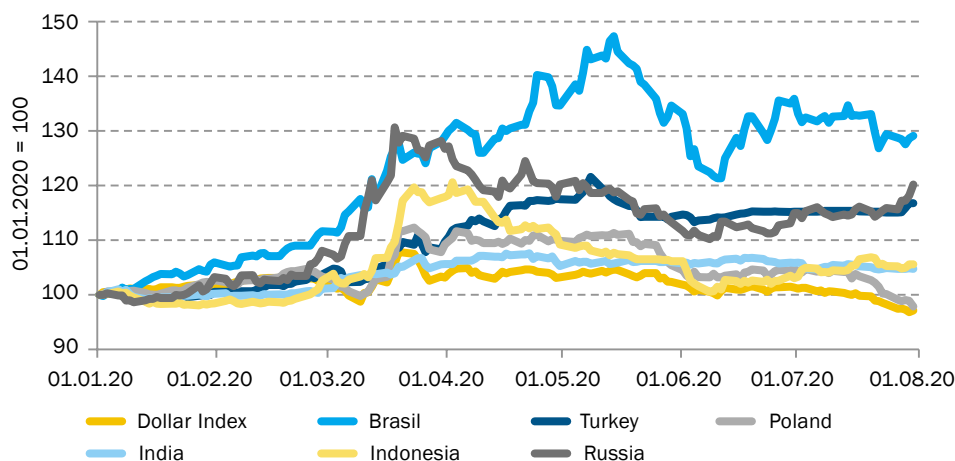


Source: CEIC Data

Weakening of the U.S. dollar against the currencies of developed countries

The U.S. dollar exchange rate against key world currencies weakened markedly in June–July after strengthening in March–April, when investors were exiting from risky assets. The decline in the value of the U.S. currency was caused by a number of factors, including the FRS's statements about its intention to support an extremely soft monetary policy in the medium term, a still high rate of coronavirus disease spread in the USA, and the EU countries' agreement to issue common bonds in July.

Figure 8.
Exchange rates
against the U.S. dollar



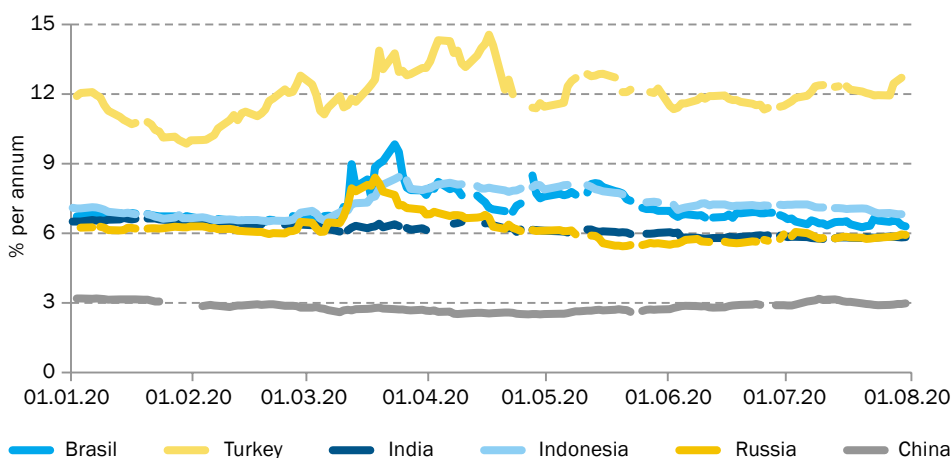
Source: CEIC Data, Investing.com

Volatility in emerging market currencies

The currencies of emerging market countries regained in 2Q2020 some of the ground lost against the U.S. dollar in March, largely driven by signs of recovery in economic activity. In addition, these movements were largely corrective, since the currencies were oversold amid the March panic. However, exchange rates remain volatile. In the wake of new COVID-19 outbreaks in late June and July and a deterioration in China–United States relations, emerging market currencies were again pressurized by increased concerns about a second wave of the pandemic and a decrease in investor interest in risky assets.

The yield on long-term government bonds of emerging market countries decreased in April–July after a significant increase in March; it basically returned to the levels observed prior to the start of the pandemic, if not lower. Both the reduction in key interest rates of central banks and the beginning of recovery processes across economies played a crucial role in this.

Figure 9.
Ten-year government
bond yield in emerging
markets

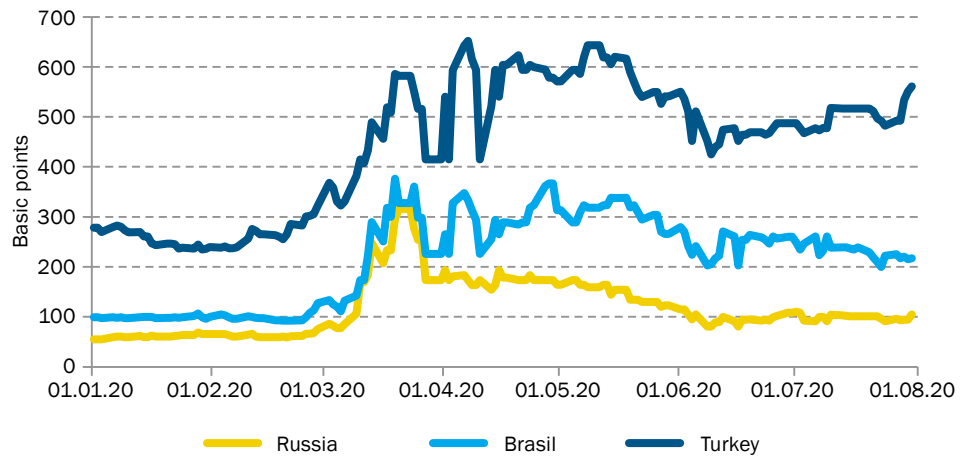


Source: Investing.com

Risk premium has stabilized at a heightened level

Risk premiums for developing economies in 2Q2020 decreased against the highs of March–April, as indicated by the CDS trends. Nevertheless, their indicators stabilized in June–July, at levels higher than those before the crisis, which might be driven by the remaining high uncertainty about the global economic outlook. Country risk premiums will likely remain high until the spread of coronavirus slows in a sustained fashion.

Figure 10.
Five-year CDS in emerging markets



Source: Investing.com

STATE OF THE ECONOMY OF THE KYRGYZ REPUBLIC

Economic activity

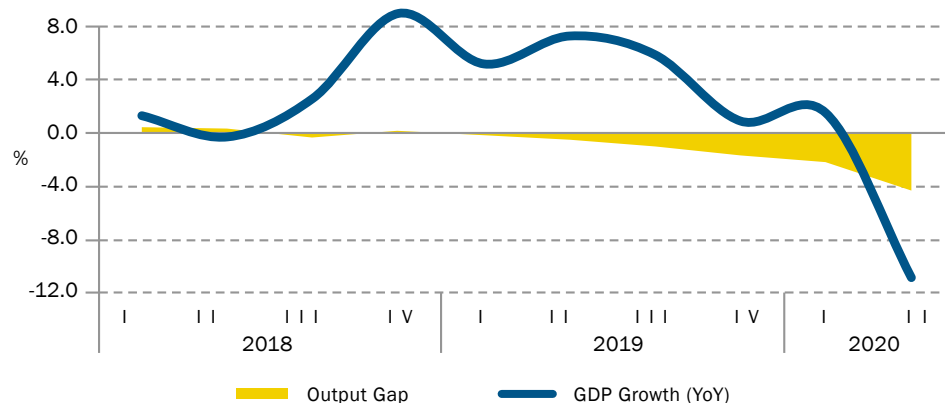
Widespread decline in economic activity In the first half of 2020, the economy of the Kyrgyz Republic took a big hit caused by the COVID-19 pandemic. The country's GDP decreased by 5.3% YoY in January–June 2020. The outbreak has affected business activity in the country via two main channels.

- A deterioration in external economic conditions driven by lower demand for Kyrgyz exports (except gold), decreased budget revenues and the disruption of global value chains.
- Health measures introduced in the country, primarily a lockdown imposed from mid-March to mid-May 2020, resulted in consumer and investment demand shrinking on a large scale.

The biggest shock from the pandemic was felt in Q2, with output dropping by 10.7% YoY. We believe that the negative impact was mostly embodied in a cyclical decline, although the potential GDP growth rate also decreased (according to the EDB's estimates: by 0.3–0.6 pp versus pre-crisis indicators to reach 3.2–3.6% YoY) (*Box 1*).

State fiscal, monetary and macroprudential support measures were instrumental in mitigating the negative economic and social impact of the worsening epidemiological situation.

Figure 11.
Economic activity



Source: NSC, EDB and EEC calculations

Box 1. Impact of the COVID-19 pandemic on the Kyrgyz Republic's potential and cyclical economic growth

The fallout from the coronavirus pandemic may have a significant impact on trends in unobservable macroeconomic variables, such as potential GDP and the output gap. Whether monetary and fiscal policies are effective is largely determined by several aspects: the correct identification of the state of the business cycle, the nature of monetary and fiscal policies, as well as the drivers of economic processes.

The EDB uses its integrated system of models (ISM)⁵ as the main tool for analyzing and forecasting the macroeconomic situation in the Bank's operating region. The system uses semi-structural models with monetary and fiscal sectors that permit an assessment of non-observable variables.

The Bank has developed a semi-structural macroeconomic model (SSM)⁶ in order to verify ISM-based findings for the Bank's every operating region. It is distinguished from the SSM mainly by the method of determining the equilibrium interest rate: the level (instead of the ISM-based uncovered interest rate parity) is linked to the growth of potential GDP, which is adjusted for the change in the real equilibrium effective exchange rate. This makes it possible to directly factor in how the impact of the production profit rate on the equilibrium rate, the impact of the economic convergence process and the return on foreign currency investments influence its movements.

The findings obtained show that the COVID-19 pandemic resulted in a large cyclical downturn in the economy of the Kyrgyz Republic: the negative output gap, which shows the deviation of actual real GDP from the equilibrium (potential) level, was some 5–10% in 2Q2020. This trend can be attributed to such key factors as the reduction in external demand and the flow of remittances sent by migrant workers, as well as the effect of domestic restrictive measures aimed at curbing the spread of coronavirus. The influence of the latter on the decompositions shown (figure B.1) is indicated in the contribution of other factors (demand shock). State support measures and an increase in global gold prices have served to contain the decline of business activity.

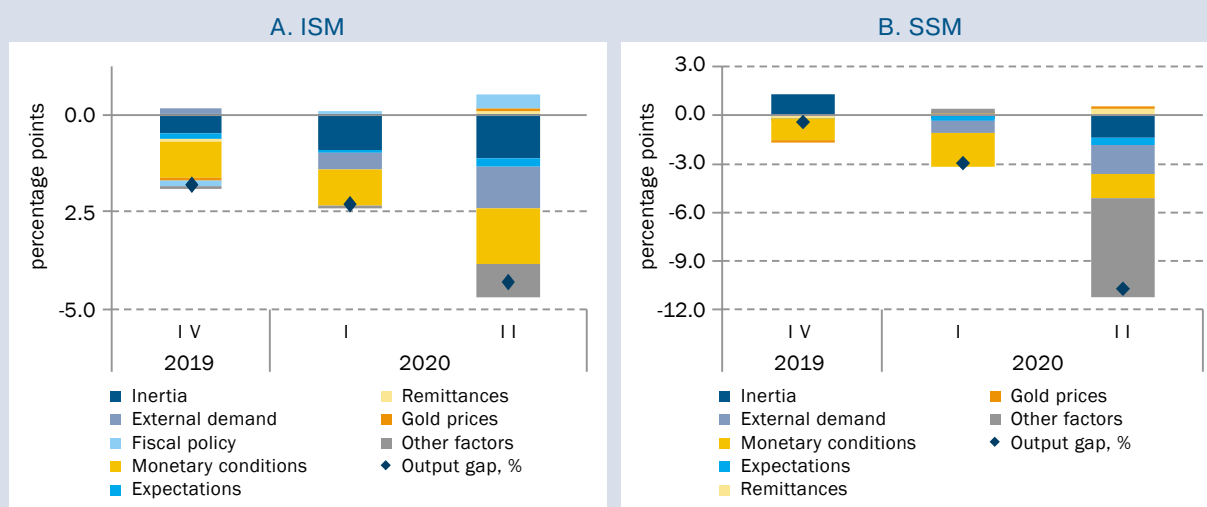
The growth rate of potential output decreased by 0.3–0.6 pp to 3.2–3.6% YoY, which can be attributed to some enterprises closing down, to shrinking investment activity and increased uncertainty. It should be noted that the COVID-19 pandemic may affect potential Kyrgyz economic growth significantly more than the findings show, which will much depend on how the epidemiological situation further develops.



⁵ For more information, see the Joint EEC and EDB Report entitled 'Forecasting System for the Eurasian Economic Union' (2016).

⁶ For more information, please see the EDB special report entitled 'Estimation of Non-Observable Economic Variables in EDB Member Countries' (August 2020).

Figure B.1. Decomposition of the output gap in the Kyrgyz Republic



Note: the ISM shows the GDP gap excluding the gold sector, while the SSM refers to the impact of gold production on GDP as “other factors”.

Source: EDB and EEC calculations

Contraction in the service sector

In terms of industry, large losses in the first half of 2020 were incurred by companies in the service sector, with the negative GDP contribution amounting to 4.0 pp. A large-scale reduction in activity in the hotel and restaurant business, the sphere of leisure and recreation and retail trade in non-food products was attributed to lockdown measures and the suspension of the work of businesses with activities involving direct contact between the producer and the consumer of the service, as well as significant gatherings of people. The weakening of aggregate demand led to a considerable decline in wholesale trade, transportation and warehousing services.

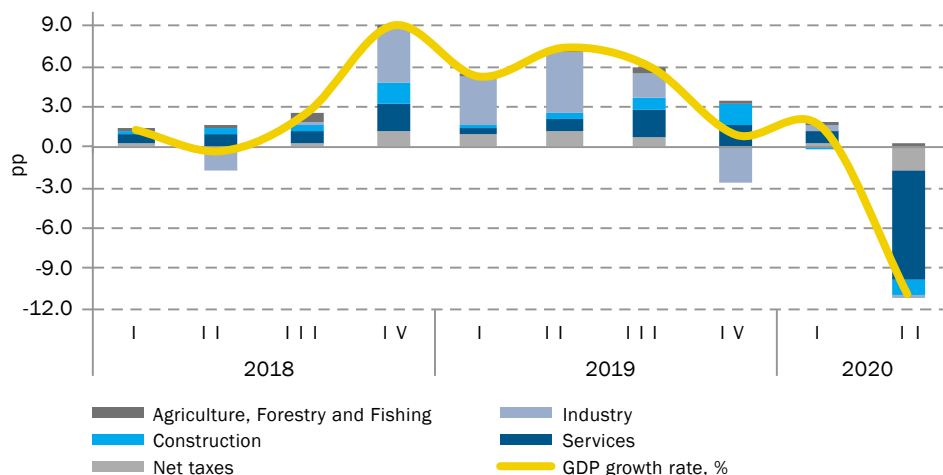
Contraction in construction volumes

The construction sector also saw a significant output reduction, contributing an approximately 0.6 pp to the GDP reduction in January–June 2020. For instance, the construction volume of residential buildings and social facilities decreased by 26.2% YoY. In addition, lockdown measures and border closure were the drivers behind the suspension of infrastructure projects in April–May.

Uneven trend in industrial sectors, continued growth in agriculture

A great number of Kyrgyz industrial enterprises were affected by the adverse effect of the pandemic. The output in industries with an economic downturn decreased by 25% YoY in the first half of 2020. Output in mining (9.8% YoY), base metals (9.0% YoY), pharmaceutical products (143.7% YoY) and chemical products (10.9% YoY) was instrumental in supporting the industrial sector. This resulted in industrial production staying at the January–June 2019 level (0.1% YoY). Agriculture proved to be less affected by the COVID-19 pandemic. Its output increased steadily in the first half of 2020 (1.6% YoY).

Figure 12.
GDP growth rate decomposition
(Year-on-Year)



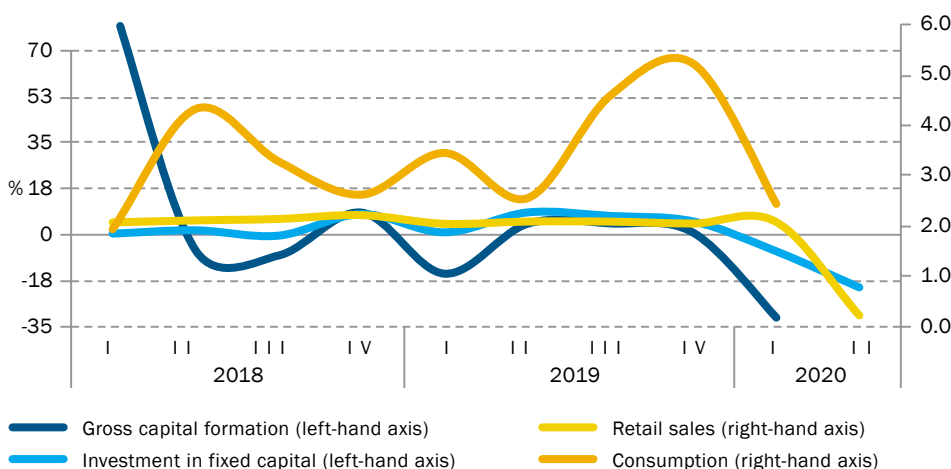
Source: NSC, EDB calculations

Weakening domestic demand

Domestic demand has been significantly affected by the lockdown restrictions introduced at the end of March. Consumption growth slowed to 2.4% YoY in 1Q2020, from 5.2% YoY a quarter before. In 2Q2020, consumer activity decreased, evidenced by a 30.7% drop in retail turnover compared to the corresponding period in 2019.

Borders with China closed in 1Q2020 and increasing difficulties in international transport services resulted in a 76.3% YoY decrease in inventory stocks. This translated into gross capital formation falling by 31.5% YoY. In 2Q2020, investment activity retained its negative character, while capital investment decreased by 20.0% YoY. Most industries experienced a decline in investment activity (excluding agriculture, mining companies and organizations providing electricity, gas and steam). In the water sector, the drop in investment was set against high volumes of capital investments made a year earlier.

Figure 13.
Domestic demand indicators
(Year-on-Year growth rate)



Source: NSC, EDB calculations

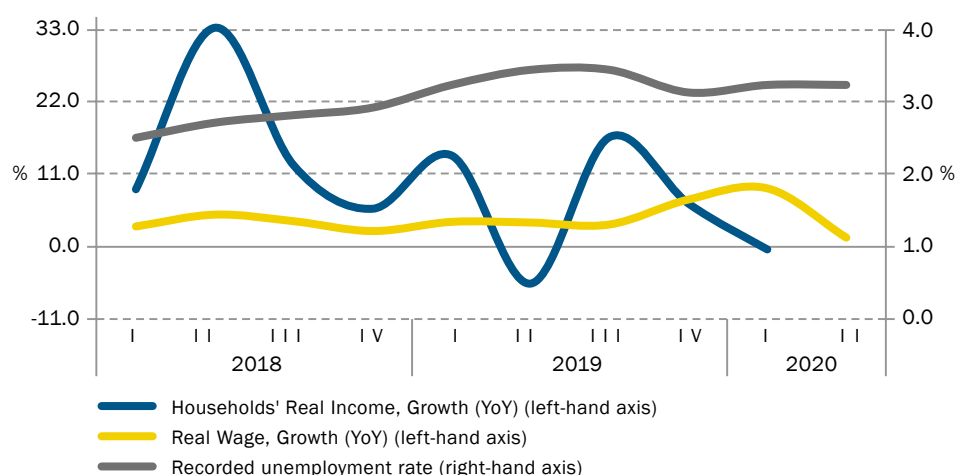
The labor market

Real disposable income has changed little

Wages continued to rise in real terms in the first half of this year (4.4% YoY after 4.7% YoY in 2019). The trend was largely determined by the wage increase in budget-funded organizations (education and law enforcement agencies). Companies engaged in the mining, water supply and service industries also indicated a double-digit wage growth rate in January 2020. Nevertheless, real household income decreased by 0.4% YoY compared to 1Q2019, primarily on account of a drop in other revenue and profit received from subsistence farming. Household income from work and the amount of social transfers received have changed little in real terms compared to 1Q2019.

Official unemployment was 3.1% as of the end of the first half of 2020 (3.0% in 2019).

Figure 14.
Labor market indicators



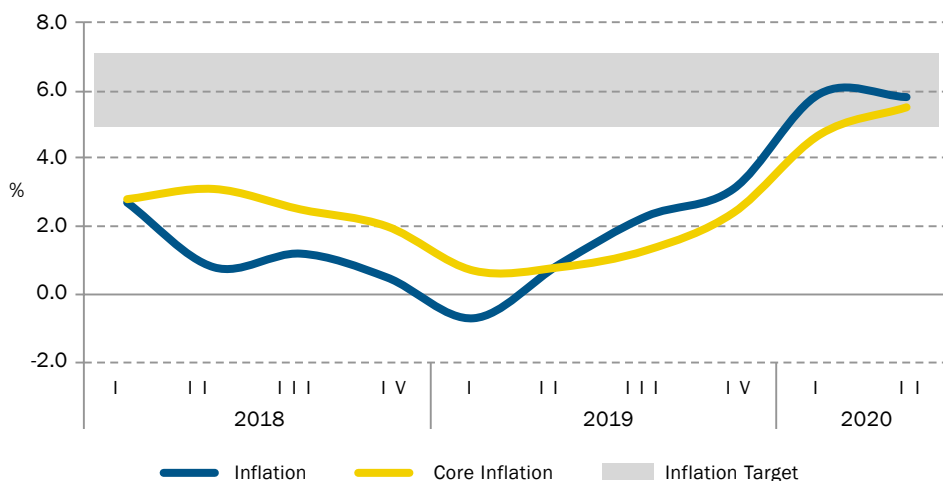
Source: NSC, EDB calculations

Inflation

Inflation in target range

Inflation accelerated to 5.8% YoY in June 2020, from 3.1% YoY in December 2019, as core inflation rose to 5.5% from 2.4% YoY in the same period. In April and May, the annual CPI growth rates amounted to 8.6% and 7.2% YoY, respectively, thus exceeding the target corridor of 5.0–7.0%. The indicator's trend was largely determined by food prices (including alcoholic beverages and tobacco products), with their contribution increasing to 5.7 pp in June 2020 from 3.1 pp in December 2019.

Figure 15. Inflation
(last month in quarter versus last month of same quarter the year before)



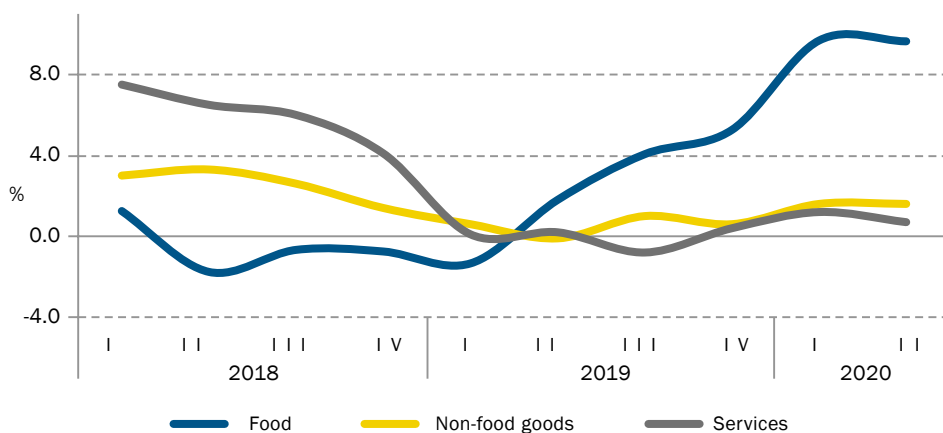
Source: NSC, NB KR

CPI was affected by both external and domestic shocks

In early 2020, inflation accelerated as tobacco excises were raised in February. Prices for bread products in the country were driven by the rise in the grain price in regional markets observed from the end of 2019 to April 2020. Frenzied demand exerted additional pressure on the domestic food market in March–April on account of the lockdown restrictions imposed and the som exchange rate depreciating dramatically. In May, as social distancing requirements were eased and regional grain prices declined, food inflation began to slow down.

The trend in the non-food component of CPI was limited by the national emergency in the country, the decline in world oil prices and the weakening of domestic demand for durable goods. The growth rate in the value of the basket of non-food products increased to 1.6% in June 2020 from 0.6% YoY in December 2019; while in services it rose to 0.7% from 0.4% YoY over the same period.

Figure 16. Inflation components
(last month in quarter versus last month of same quarter the year before)



Source: NSC, EDB calculations

The external sector

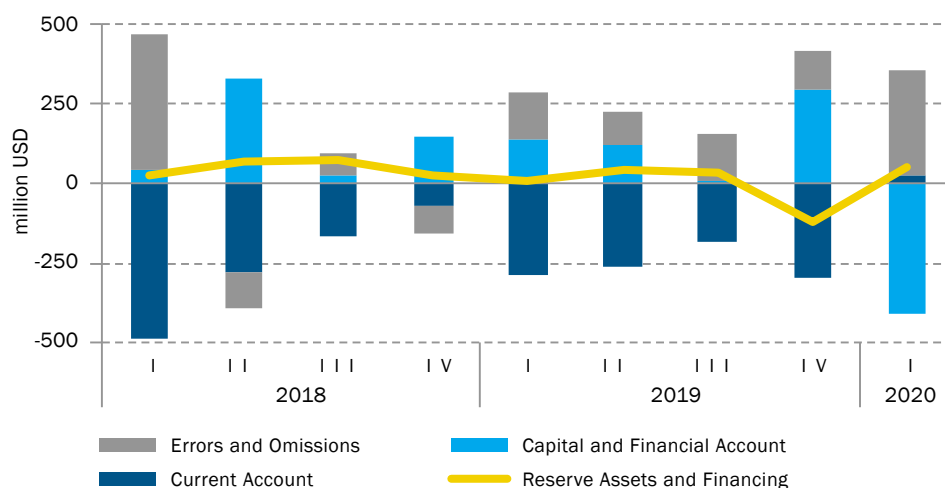
Current account balance in surplus

The current account surplus amounted to USD 21.7 million in 1Q2020 versus a deficit of USD 289.9 million the year before. The indicator was driven by a decrease in the negative balance of goods and services and an income balance surplus. A decline in imports versus a marginal increase in exports caused trade turnover to experience a downturn. International services observed a significant decrease in nominal volumes in transport services and travel. A reduction in the net inflow of remittances from migrant workers curbed the current account surplus.

Capital outflow

Net lending to other countries was recorded in the financial transactions account (IRA excluded) in 1Q2020 in the amount of USD 418.0 million, while net borrowing equaled USD 120.8 million the year before. Capital outflows were recorded for foreign direct investment; they were also attributable to assets placed by banks in foreign accounts and an increase in accounts receivable of companies.

Figure 17.
Balance of payments



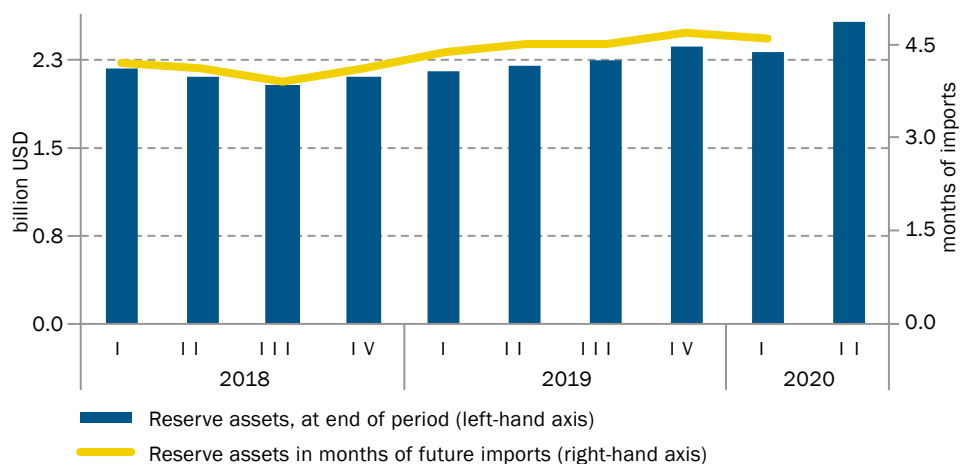
Note: the balance of payments was compiled in accordance with the International Monetary Fund's Balance of Payments Manual, 5th Edition.

Source: NB KR

Gross international reserves grow

The gross international reserves of the Kyrgyz Republic amounted to USD 2.6 billion as of the end of June 2020, a 9.0% increase compared to the beginning of the year. The increase in this indicator was mainly due to an upswing in investments in foreign financial assets. The physical volume of monetary gold fell by 18.0% compared with the beginning of the year.

Figure 18.
International reserves



Source: NB KR

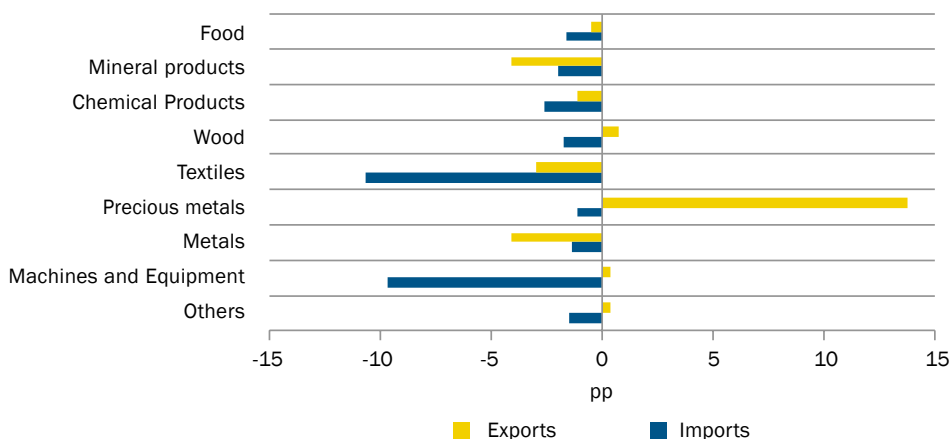
Trade balance deficit decreases in first half of 2020

According to the customs statistics, the trade deficit equaled USD 0.7 billion in January to June 2020, USD 0.8 billion less than in the same period last year. The reduction in imports of goods by 1.5-fold YoY was the key factor in the decline in the foreign trade balance.

There has been a decrease in the import volume of all enlarged commodity items. A decrease in the total worth of machinery and equipment, as well as textiles, which is largely due to the closure of borders, primarily with China, a key importer of these goods, largely affected the indicator. The fall in the volume of imported fabrics partially limited the clothing exports of the Kyrgyz Republic. Exports of clothing and accessories decreased by 36.9% in dollar terms compared to the first half of 2019. The quarantine measures, challenging transportation situation and border closure have affected most of the product range supplied abroad. Exports excluding gold decreased by 21.1% YoY. Revenue from the export of precious metal increased by 29.8% YoY, mainly on account of the world price increase. In general, the total value exported increased by 2.4% YoY.

Figure 19.
Groups' contribution to goods export and import growth

(January–June 2020 against January–June 2019)



Source: NB KR, EDB calculations

The fiscal sector

Budget deficit increase in the first half of the year

In January to June 2020, the state budget posted a deficit of 16.6 billion som, equivalent to 7.3% of GDP, while a year earlier there was a surplus of 0.3 billion som, or 0.1% of GDP. An 8.4% YoY increase in spending, accompanied by a 16.7% YoY drop in revenue, caused the public finance sector to deteriorate.

Revenue drop for all key items

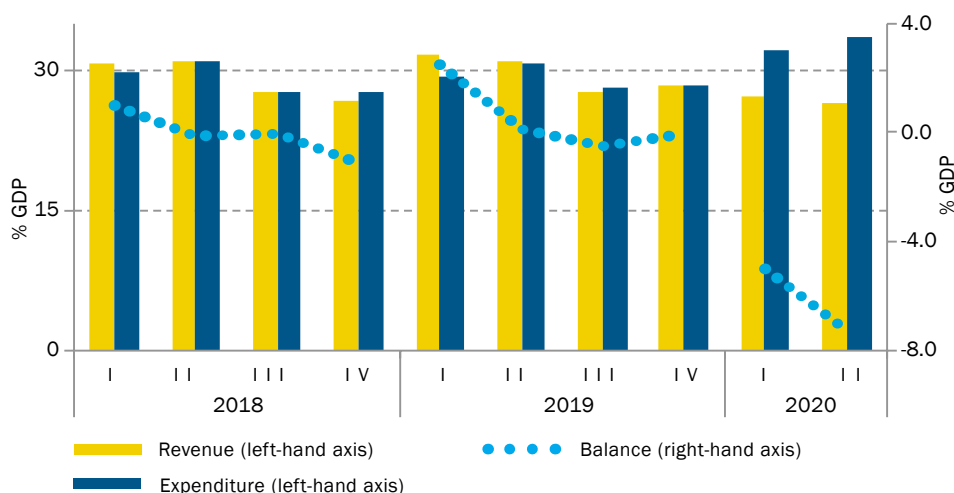
There was a decrease in revenues for all enlarged items of the state budget's revenue. Tax collection shrank largely due to most companies suspending their work during the national emergency. Income and value-added tax returns fell by about 30% compared to the first half of 2019. The closure of borders put additional pressure on the functioning of organizations involved in foreign economic activity, which reduced transfers of customs duties to the budget by 86.0% YoY. Non-tax revenues and official transfers also made a negative contribution to budget revenues.

Increased costs due to COVID-19 prevention measures

Public spending in the first half of 2020 was primarily aimed at financing measures to contain the coronavirus, including sanitary and disinfection measures, equipping hospitals, providing additional payments to the staff involved, purchasing medical supplies, making payments to citizens in need outside the country and providing food to people in difficult circumstances during the lockdown. Wages for teachers and law enforcement officers were increased at the beginning of the year, serving as an additional factor causing budget expenditures to increase.

Budget expenditures were optimized in order to make state-guaranteed payments on the back of the limited resource base. The amount allocated for housing and utilities, recreation, culture and religion, economic issues and environmental protection was reduced.

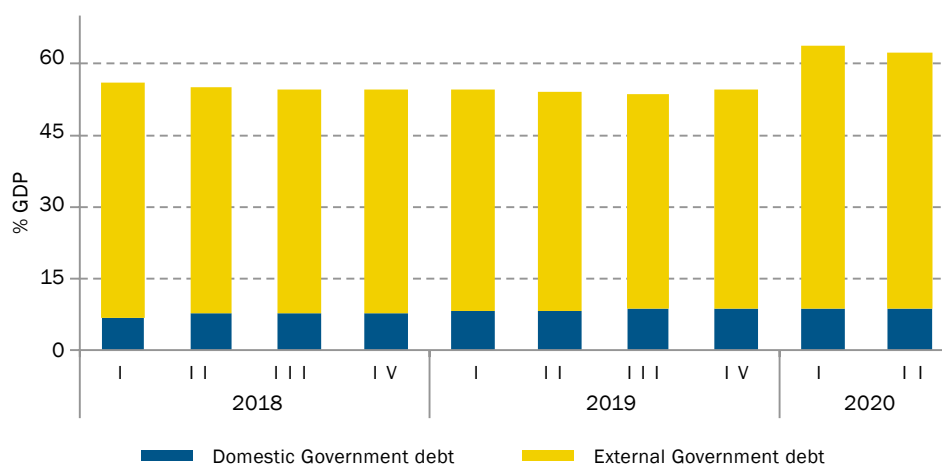
Figure 20.
The state budget
(year-to-date)



Source: MF KR, EDB calculations

Public debt increases Public debt increased to 62.2% of GDP as of July 1, 2020, from 54.3% of GDP as of the beginning of this year. The increase is accounted for by external debt amid the decreased tax returns and increased current expenditures. For instance, as part of emergency assistance to finance the urgent balance of payments needs arising from the COVID-19 pandemic, the IMF allocated two concessional loans to the Kyrgyz Republic totaling USD 242 million. There has also been an increase in debt to a number of international development institutions, as their financial resources were provided to the country on concessional terms. A reduction in debt on state treasury bills drove domestic debt for the first half of the year to decrease in nominal terms by 1.2%.

Figure 21.
Public debt



Source: MF KR

Monetary conditions

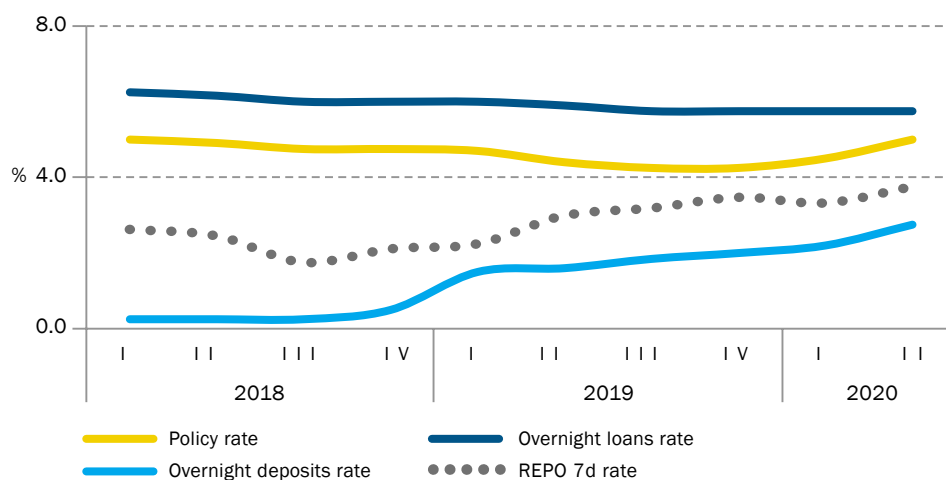
Policy rate increased Inflationary pressure increased in late 2019–early 2020, compelling the NB KR to raise the policy rate to 5.0% from 4.25% in February 2020. In early March, the lower limit of the interest rate range was adjusted: the rate on overnight deposits was raised to 2.75% from 2.0%. Such monetary conditions were in force till the end of June 2020.

Interest rates in the interbank money market increased by the beginning of July 2020 The interest rate in the interbank market for seven-day REPO operations increased to 3.8% in June 2020, from 3.4% in December 2019. A decrease in surplus liquidity in March–April was a key factor in the indicator’s trend, on the back of NB KR foreign exchange interventions and the growth of money outside banks during the lockdown.

Lending rates lower... Interest rates on new loans issued by commercial banks decreased by the end of the first half of 2020 on account of soft loan programs introduced by the government and the NB KR⁷. The volume of new loans issued by commercial banks in the first half of 2020 decreased by 14.2% YoY, with a decline in most industries. The share of non-performing loans in the banks' loan portfolio was 8.6% as of July 1, 2020, up from 8.0% at the end of 2019.

...with growth of interest rates for deposits in soms The increase in the policy rate in February led to an increase in the interest rates paid by banks for accepted deposits, thus encouraging people to place new deposits in soms, whose volume increased by 13.1% YoY in the first half of the year.

Figure 22.
Interest rates
(the period's average)



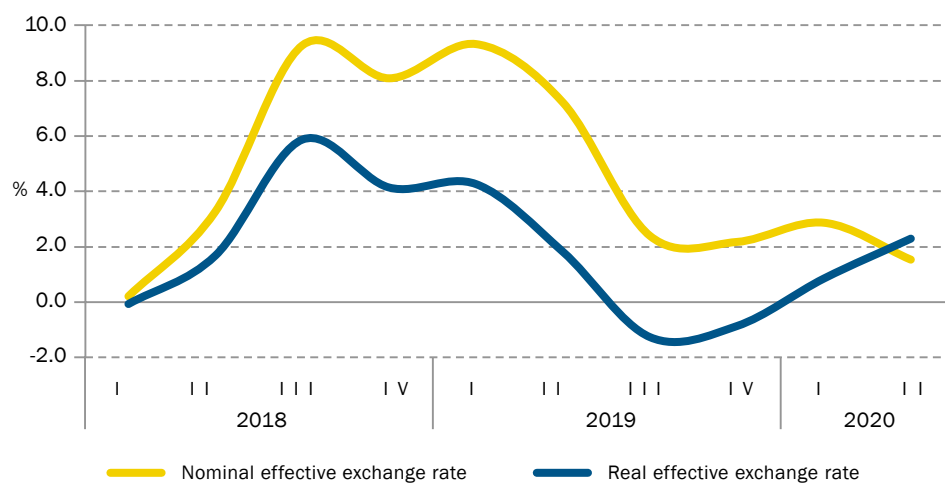
Source: NB KR, EDB calculations

Som weakens against U.S. dollar The Kyrgyz som exchange rate decreased significantly against the world's major currencies in the first half of 2020. The main blow was seen in the second half of March: the national currency rate came close to 85 soms per U.S. dollar amid increased turbulence in the global financial markets. The NB KR conducted currency interventions in the net amount of USD 210.4 million in 1Q2020 in order to ease the pressure in the domestic market.

National currency undervalued in real terms The som's real effective exchange rate weakened following the nominal rate in the first half of the year. We believe that this resulted in the undervaluation of the national currency. On the one hand, inflation was affected, but on the other, the price competitiveness of domestic producers was maintained. According to our calculations, the coronavirus pandemic has led to faster depreciation of the equilibrium real effective exchange rate of the Kyrgyz som.

⁷ In particular, "Financing of Agriculture 8", "Financing of business entities", as well as lending to commercial banks and microfinance organizations in order to smooth the negative economic consequences of the spread of COVID-19.

Figure 23.
Som exchange rate
(Year-on-Year
growth rate, + = som
strengthening)



Source: NB KR, EDB calculations

KYRGYZ REPUBLIC ECONOMIC DEVELOPMENT OUTLOOK

Background

Gradual recovery of trade partner countries' economies in the mid term

The baseline scenario involves a slowdown in the development of the COVID-19 pandemic in the second half of 2020 and the prevention of a global second wave of the disease. The further easing of lockdown restrictions is expected in the world's largest economies (the US, the Eurozone and China) in the second half of 2020, which, along with stimulative fiscal and monetary policies, will be instrumental in a gradual recovery in consumer and investment activity, as well as international trade. However, due to the increased uncertainty, deterioration of the labor market, disruption of existing value chains, and anticipated changes in consumer habits (social distancing, higher savings rates, etc.), the return to pre-crisis production levels will be slow and is unlikely to be completed until 2022.

External demand constrained

Negative output gaps in the trade partner countries of the republic will gradually close, remaining in negative territory over the entire projection horizon (2020–2022) owing to the restrained economic activity recovery. As a result, external demand for Kyrgyz exports is expected to stay depressed in the medium term.

Moderate oil price growth

Under the EDB baseline scenario, oil prices will grow at a moderate pace in 2020–2022, encouraged by a recovery in global business activity. Nevertheless, we are quite conservative in our expectations of the increase in energy commodity prices, which will continue to be affected by the uncertain global outlook.

Low foreign inflation

A weak external inflation background will remain in the medium term. We expect the growth rate of the consumer price index in Russia, the Eurozone and the USA to remain below the RF CB, ECB and FRS targets in the wake of moderate demand.

The country risk premium for Russia will remain heightened in 2020–early 2021 due to high uncertainty about the development of the pandemic and the global economic recovery, as well as a geopolitical factor (the threat of

anti-Russian sanctions expanding). In the future, as the situation normalizes, we expect it to return to pre-crisis values.

Fiscal policy revised

In June 2020, the budget of the Kyrgyz Republic for 2020 was revised as the economic situation deteriorated on account of the adverse effect of COVID-19. The new version factored in reduced tax revenues and optimization of non-priority expenditure items. The amount of funding for protected budget items will not be affected by the reduction in state payments. Supplementary allocations have been made for law enforcement agencies, food security measures and the health sector. The budget of the Kyrgyz Republic will post a deficit of 27.7 billion som, or 4.7% of GDP, in 2020 (versus 8.0 billion som, or 1.2% of GDP that was planned previously). In the medium term, the negative balance of the public finance sector is expected to decrease.

The volume of state support for business in 2020 was approved in the amount of 14 billion som (2.4% of GDP); in 2021, 40 billion som are planned to be allocated for concessional loans.

Potential growth will begin to gradually recover in 2021–2022; however, it will be slow due to high uncertainty in the external environment, as well as weak domestic economic conditions.

Table 1. Forecasts of Key Foreign Economic Indicators

| | Average annual Urals oil price (USD per barrel) | Average annual gold price (USD per ounce) | Food prices, 2010 index = 100 | Russia's real GDP growth rate, % | Kazakhstan's real GDP growth rate, % |
|-------------|---|---|-------------------------------|----------------------------------|--------------------------------------|
| 2020 | 42.4 | 1779.0 | 88.0 | -4.2 | -2.5 |
| 2021 | 48.9 | 1842.1 | 88.0 | 3.2 | 4.6 |
| 2022 | 52.7 | 1658.1 | 88.3 | 2.7 | 4.8 |

Source: EDB and EEC calculations

Economic activity

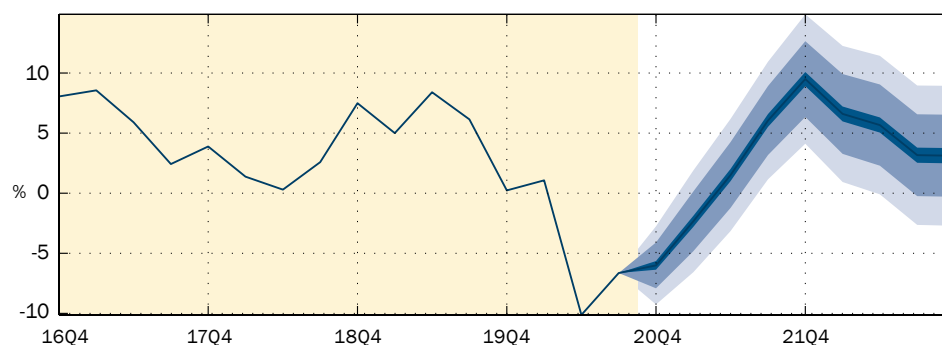
Economic activity to recover gradually in second half of 2020

Foreign economies adapting to the consequences of the pandemic are creating conditions for the recovery of business activity in the country. We expect a gradual recovery in both consumer and investment demand, which will continue to be supported by stimulative monetary and fiscal policies in

2020. A recovery of heightened economic activity abroad and the weakening of the national currency will help limit the decline in export volumes (excluding gold). The concessional lending program of the Kyrgyz government will give support to export-oriented companies, small and medium-sized businesses, as well as the service sector.

Restrictions on economic activity re-introduced in early July 2020, as well as a number of companies suspending their activities out of their own volition due to a dramatic upturn in the number of COVID-19 cases, have had a restraining effect on the pace of economic recovery in the country. A projected decline in gold production and a reduction in the inflow of remittances will serve as an additional negative factor. The GDP contraction rate over 2020 is estimated at 5.9%.

Figure 24.
Real GDP⁸
(Year-on-Year growth rate)



Note: seasonally adjusted data.

Source: EDB and EEC calculations

Risks of aggravation of economic situation

Compared to the previous projections, the assessment⁹ has been downgraded by 5.8 pp, thus factoring in the longer-term effect of lockdown measures and their slower easing than that expected in early April¹⁰, as well as the stronger negative impact of the pandemic on economic activity abroad.

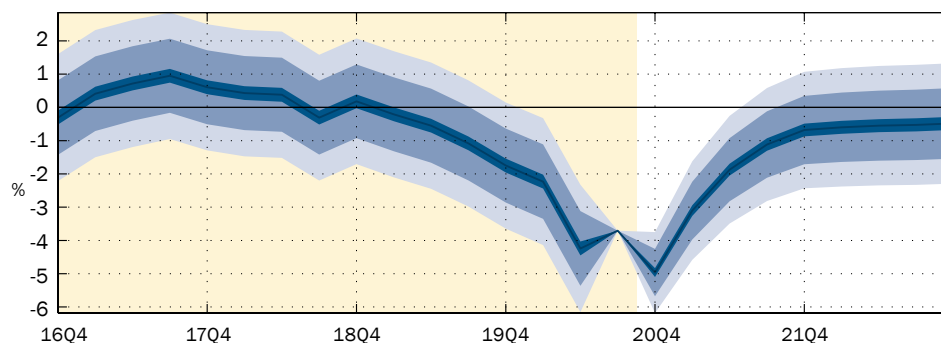
The short-term risks are shifted towards a larger reduction in GDP due to the ongoing challenging epidemiological situation in the world and an anticipated large second wave of the pandemic in the fall and winter, along with the increased geopolitical risks. Should they materialize and new restrictions be imposed similar to those introduced in 2Q2020, a deeper and longer recession is to be expected.

⁸ Here and elsewhere the chart ranges correspond to the 10%, 50% and 75% confidence intervals.

⁹ Please see EDB Macroreview. April 2020. Updated Projections.

¹⁰ In our April projection, we assumed a month-long lockdown with no restrictions re-introduced or companies suspending their activities in July 2020.

Figure 25.
Output gap



Source: EDB and EEC calculations

Gradual recovery of economic activity in 2021–2022

In the 2021–2022 base case, we expect GDP growth to continue to recover by 4.3–4.5% per year as the situation in the global economy and commodity markets stabilizes and fiscal policy support continues. An increase in global gold prices in 2021 will set the stage for increasing exports, just as the normalization of the situation in Russia will foster the inflow of remittances of migrant workers. However, the EDB forecasts assume that this will be a slow process due to the long-term weakening of investment activity amid the increased uncertainty, a number of service-related organizations closing down and changing consumer habits (social distancing, a weak travel industry and air transportation).

As a result, we believe that the pre-crisis level of GDP (4Q2019) will be reached only in the second half of 2021. A slow recovery will result in a negative output gap remaining throughout the forecast period, indicating that the economy will operate with unused production capacity.

Lingering risks to economic growth

The risks to the medium-term forecasts have shifted to the downside. The future development of the epidemiological situation is still uncertain. Should it worsen, we might expect greater losses of potential economic growth than those built into the base case due to a continuous decline in investment and innovation activity. There is still a high chance of geopolitical tensions increasing both within the country and abroad and stricter anti-Russian sanctions being imposed; this might have a significant negative effect on the economy of the Kyrgyz Republic through trade and remittances. In addition, there is also an increased risk of global trade protectionism growing, which may hinder global economic recovery.

Inflation

Inflation within the target range in 2020...

The EDB projects inflation to amount to 5.9% YoY at the end of 2020, remaining within the National Bank's target (5.0–7.0%). Increased volatility in the regional financial markets will put pressure on prices in the second half of the year amid increased sanctions rhetoric against the Russian Federation, as well as rising regional prices for grain and meat. Moderate domestic demand will be instrumental in limiting the scale of inflation acceleration.

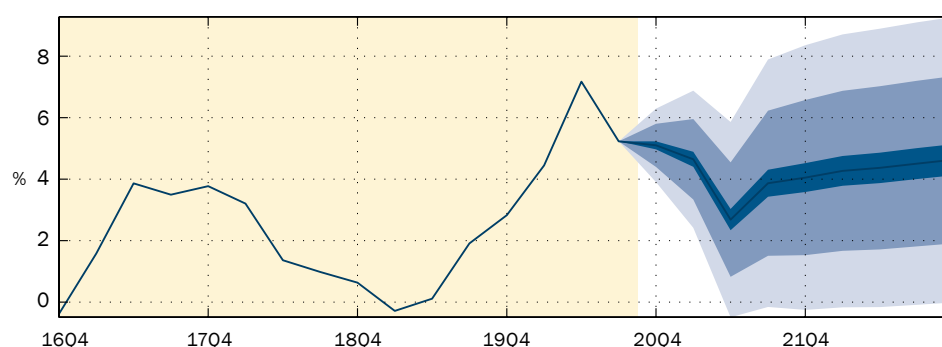
...and below it in 2021–2022

The latter will exert its biggest impact on CPI in 2021, which, together with the weak price situation in the major trading partner countries and the decrease in inflationary pressure in the global commodity markets, will cause the consumer price growth rate to slow down to 4.1% YoY in 2021.

A gradual recovery in economic activity will help reduce the disinflationary impact of domestic demand during 2022, thus making the return of the CPI indicator to the lower threshold of the target more sustainable.

Figure 26. Inflation

(last month in quarter versus last month of same quarter the year before)



Note: seasonally adjusted data.

Source: EDB and EEC calculations

Risks are shifted towards proinflationary

Currently, the risks of accelerating inflation predominate; this is primarily attributable to the som weakening in the wake of increased volatility in the regional markets, the cost of grain increasing and external demand for meat from Kyrgyz producers growing.

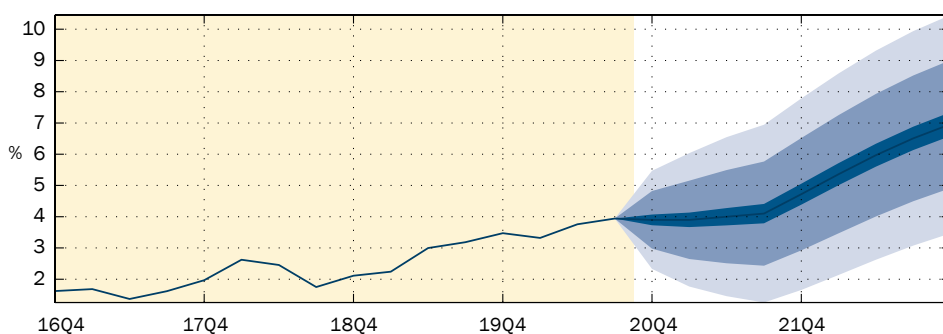
Disinflationary risks are driven by a likely slower recovery of the economy of the Kyrgyz Republic and its trade partners than that projected in the EDB baseline scenario.

Monetary conditions

Stimulative monetary policy

We believe that the policy rate of the NB KR will remain at 5.0% until the end of this year, while rates in the interbank lending market will continue to remain below the key rate until the end of 2021. The weakening of the stimulative interest rate policy and the convergence of the key rate towards its equilibrium level will increase in 2022 on account of inflation returning, as expected, to the target range.

Figure 27.
7-day REPO rate
(the period's average)



Source: EDB and EEC calculations

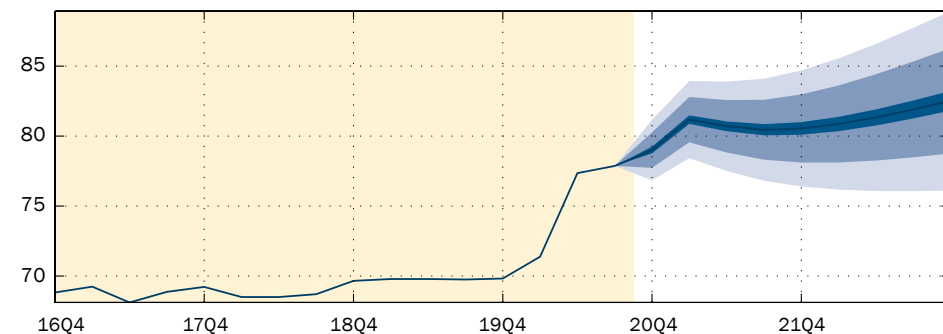
Geopolitical risks limit leeway for som to strengthen in second half of 2020

In the second half of August–early September 2020, volatility in the regional financial markets grew due to harsher anti-Russian sanctions rhetoric, resulting in the national currency weakening to about 80 soms per U.S. dollar. This factor is likely to remain key during the rest of the year, which will hinder the full strengthening of the KR currency. Consequently, we expect its average annual exchange rate to amount to 77 soms per U.S. dollar in 2020.

Correction of exchange rate to equilibrium level in 2021

The exchange rate is expected to adjust to an equilibrium level during 2021 assuming a slowdown in the coronavirus spread and normalization of the geopolitical situation. In this scenario, the devaluation rate of the national currency will not cause an imbalance in the economy in 2021–2022. The weakening of the exchange rate in nominal terms will be due to a higher growth trend of consumer prices in the Kyrgyz Republic compared to the USA.

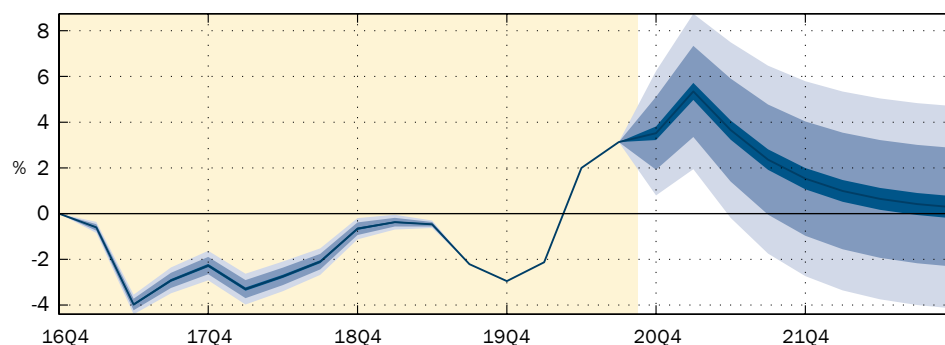
Figure 28.
Nominal som exchange rate
(KGS per USD)



Source: EDB and EEC calculations

The main risks to the exchange rate emanate from the external sector. Negative trends in the world's economy might trigger a drop in global commodity prices and increased turbulence in the financial markets. This, in turn, may provoke a reduction in investor demand for emerging market assets. Sanctions imposed by Western countries against Russia also remain a risk factor, which can translate into a negative effect on the economy of the Kyrgyz Republic through remittances and trade.

Figure 29.
Real Kyrgyz Som
Exchange Rate to USD
Gap
(+ = the som is undervalued)



Source: EDB and EEC calculations

Table 2. Key Macroeconomic Indicators of the Kyrgyz Republic

| Indicators | 2017 | 2018 | 2019 | 2020P | 2021P | 2022P |
|---|------|------|------|-------|-------|-------|
| GDP in constant prices (% growth YoY) | 4.7 | 3.8 | 4.5 | -5.9 | 4.5 | 4.3 |
| Consumer price index (% growth in December to previous year's December) | 3.7 | 0.5 | 3.1 | 5.9 | 4.1 | 4.6 |
| REPO 7 day rate (the year's average % per annum) | 1.7 | 2.2 | 2.9 | 3.7 | 4.2 | 6.2 |
| U.S. Dollar Exchange Rate, KGS per USD (the year's average) | 68.9 | 68.8 | 69.8 | 76.4 | 80.7 | 81.7 |

Note: P = Projected

Source: EDB and EEC calculations



Eurasian Development Bank

**RESEARCH DEPARTMENT,
EURASIAN DEVELOPMENT BANK**

Your comments and suggestions concerning this review
are welcome at: pressa@eabr.org

