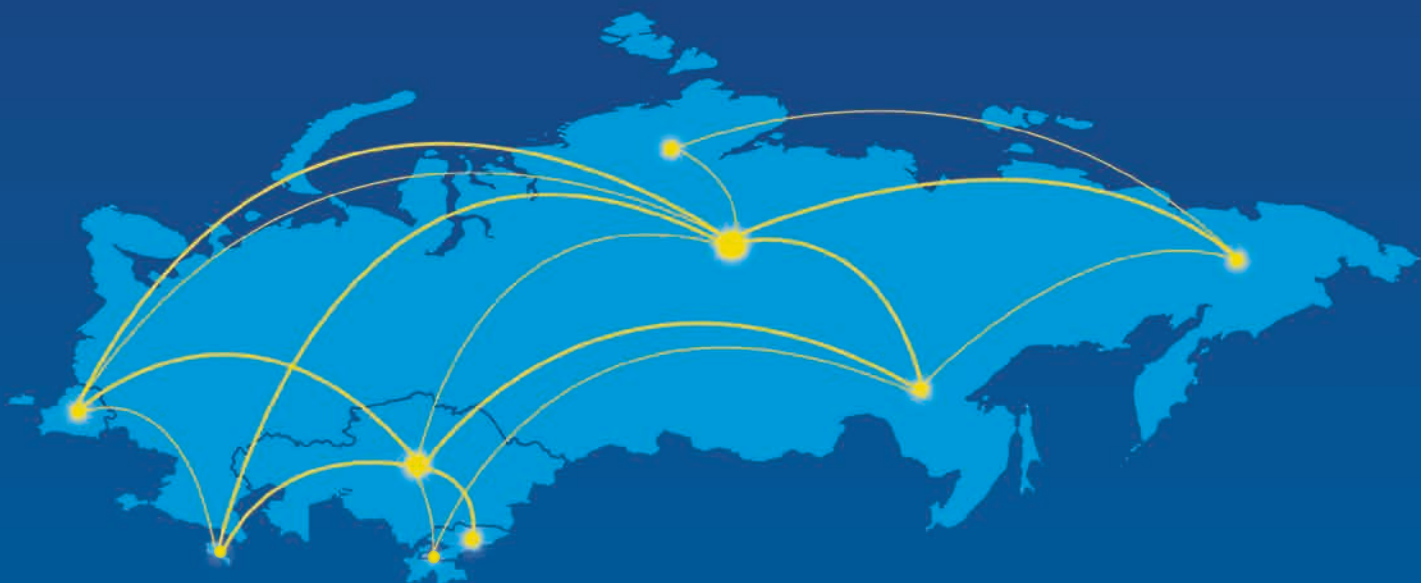


EDB MACRO REVIEW



04'2019

Kyrgyz Republic

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INFORMATION DISCLOSURE

This Review includes a detailed description of the current internal and external macroeconomic setting and an agreed 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

EDB – Eurasian Development Bank

EEC – Eurasian Economic Commission

GDP – Gross Domestic Product

KGS – Kyrgyz som

OJSC – Open joint-stock company

U.S. or **USA** – United States of America

USD – United States Dollar

% – percent

% YoY – Year-on-Year growth rate

SUMMARY

After two years of economic recovery, GDP growth slowed to 3.5% in 2018, from 4.7% in 2017. The economic slowdown was caused by a decline of production at the Kumtor gold mine and stabilization of the growth rates in other sectors at near potential levels. Domestic demand in 2018 showed unstable growth, reflecting the volatility of households' real incomes. A slowdown in lending and remittances inflows growth rates in 2018 compared to 2017, as well as deferred demand of the public sector, also constrained domestic demand.

The deviation of inflation from the target during 2018 resulted from weak prices in the world food markets as well as from the high base effect in the vegetables and solid fuel segments.

The current account deficit expanded as the negative goods and services balance widened, while the net inflow of current transfers remained virtually the same as in 2017.

The state budget posted a deficit of 1.1% of GDP in 2018, down from 3.1% of GDP the year before. The decreased State budget deficit resulted from lower public spending and slightly higher budget revenues. The slower growth in budget revenues was due to lower grants received from other countries' governments and international organizations, while tax revenue growth was unchanged.

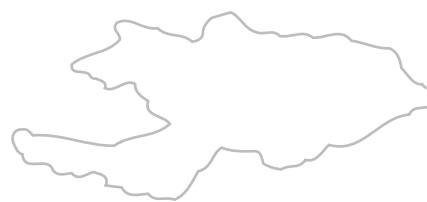
Public debt decreased in nominal terms, mainly on account of the debt to the Russian Federation being written off pursuant to an agreement between the countries.

In May 2018, the National Bank of the Kyrgyz Republic reduced its policy rate from 5.0% to 4.75% as inflation was low, and took a number of decisions concerning the width of the interest band during the year.

In 2019, economic activity in the Kyrgyz Republic is projected to accelerate, largely on account of optimistic assessments of its gold production volumes and moderate expansion of public sector demand. In the medium term the economy is expected to grow steadily at near potential rates.

The inflation trends will depend on the world food market. According to our assessment, world food prices will start recovering in the 1st half of 2019 and stabilize by early 2020, which, in turn, will shape the growth trajectory of the consumer price index in the Kyrgyz Republic.

STATUS OF THE ECONOMY



Economic Activity

GDP growth slows down

After two years of economic recovery, GDP growth slowed to 3.5% in 2018, from 4.7% in 2017. The economic slowdown was caused by a decline in production at the Kumtor gold mine while other sectors' growth stabilized at near potential rates.

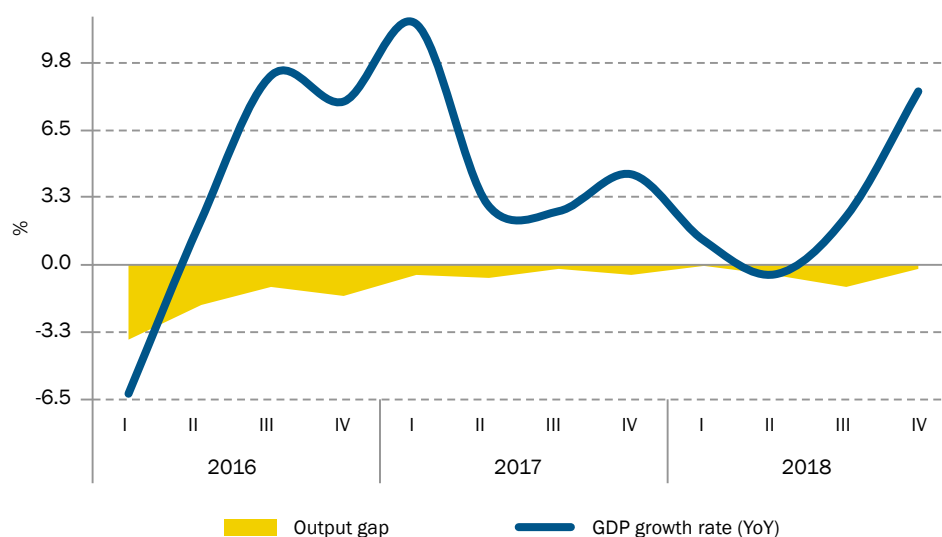
Intra-annual GDP growth remains volatile

Unstable production at the Kumtor gold mine continued to be responsible for volatile intra-annual GDP growth and affected the speed of the economy's progress towards equilibrium.

Domestic demand expands less rapidly

Turning to GDP by expenditure, we estimate that households' demand expanded less rapidly than in 2017. That was partially due to a slowdown in the growth of net inflows of remittances amid increased volatility in the foreign exchange market of Russia, from where 98.4% of remittances were received in 2018. The slowdown in the growth of domestic consumer demand was offset by the acceleration of gross savings, mainly on account of the restoration of inventory stocks.

Figure 1.
Economic Activity

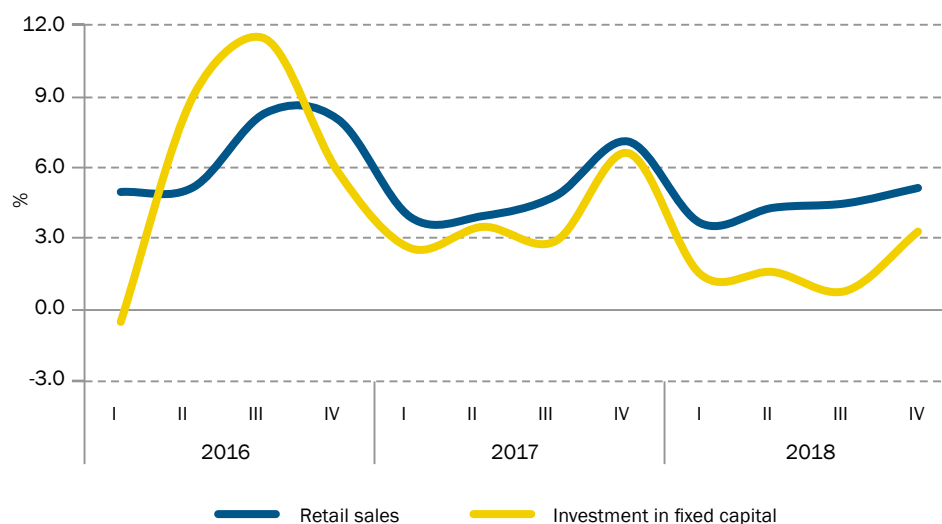


Source: National Statistical Committee of the Kyrgyz Republic, authors' calculations

Foreign trade's negative contribution grows

The replenishment of inventory stocks observed in the 1st half of 2018 was accompanied by faster growth of import volumes, including intermediate goods for the apparel and footwear industries. Export volumes decreased during most of 2018 as gold production declined.

Figure 2.
Retail Sales and Investment
(growth YoY, cumulative year-to-date)

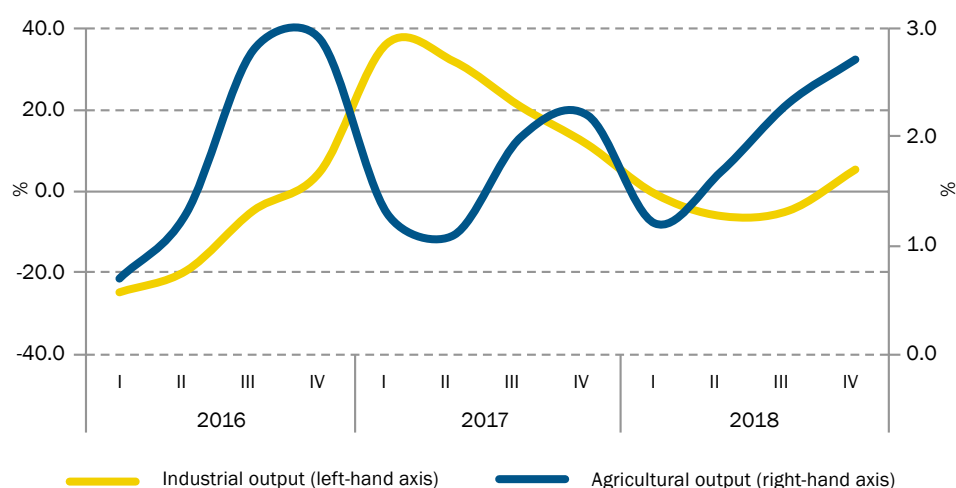


Source: National Statistical Committee of the Kyrgyz Republic

Slower growth in all sectors except agriculture

In 2018, GDP growth excluding Kumtor slowed to 3.5%, from 5.1% the year before, on account of slower growth rates in industry, construction and the service sector compared to 2017. Agriculture was an exception, with its somewhat increased 2018 growth rate that resulted from better output indicators in both crop and livestock farming.

Figure 3.
Production
(growth YoY)



Source: National Statistical Committee of the Kyrgyz Republic

Growth slowing in extraction industries and manufacturing

Growth slowed in the extraction industries to 8.1% in 2018, from 58.4% in 2017, due to the decrease in metallic ore mining volumes against the high base of 2017. Manufacturing industries, except gold production, grew more slowly in 2018 than in 2017, as they approached their potential growth rate. Growth in the services sector also reflected the economy's gradual approach towards equilibrium. Amid more moderate growth in consumer demand and activity in the industrial sectors, retail sales and transport services decelerated.

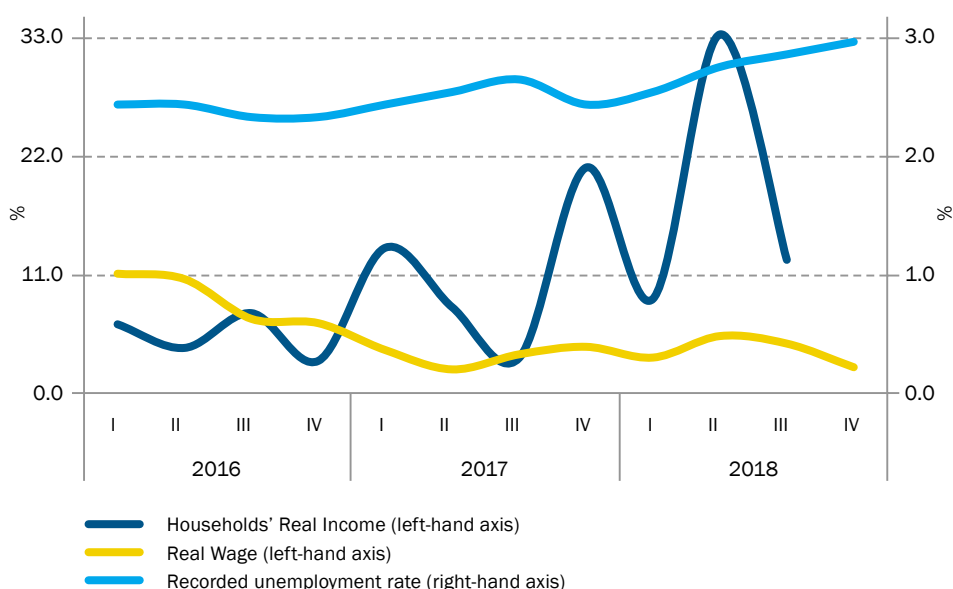
The Labor Market

Intra-annual real income growth partly driven by temporary factors

Real incomes were highly volatile in 2018, which in turn affected domestic consumer demand. The real income growth spurt in 2Q2018 resulted from increased entrepreneurial incomes and incomes from sales of personal smallholdings' produce. Wages and social benefits growth had a more moderate effect on the increase in incomes in 2Q2018. Later in 2018, the contribution of incomes derived from individual activities decreased considerably – to slow down the rate of growth of real incomes.

The recorded unemployment level increased in 2018 to reach 2.8% of the economically active population at the year's end. The increase may partly be attributable to more active registration with the employment service.

Figure 4.
Labor Market
Indicators



Source: National Statistical Committee of the Kyrgyz Republic, authors' calculations

Inflation

Inflation farther away from target in 2018

The deviation of inflation from its 5.0–7.0% target range grew in 2018 as prices remained weak in the world food markets as well as due to the high base effect in the vegetables and solid fuel segments. Inflation decelerated to 0.5% in December 2018, from 3.7% the year before.

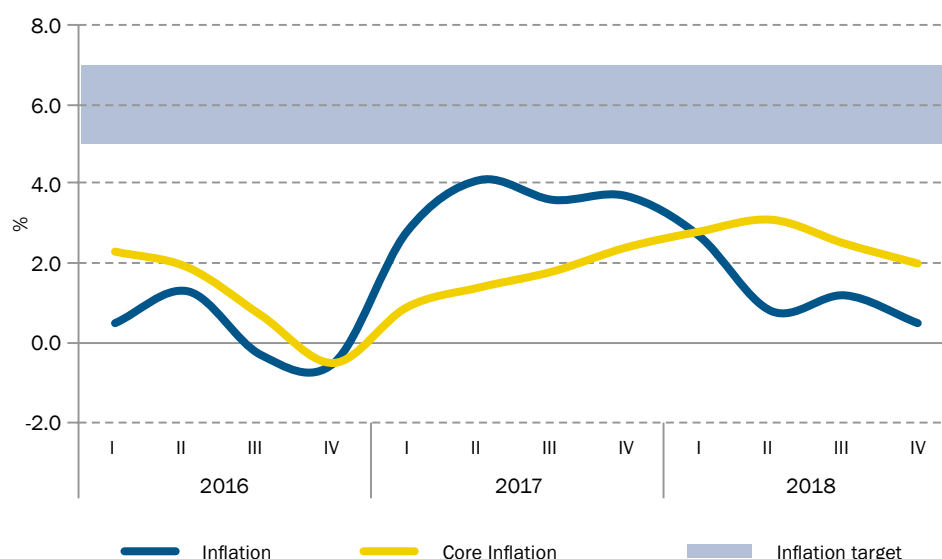
The upward trend in core inflation was interrupted in the 2nd half of 2018 as non-food prices and tariffs slowed down.

Deflation in food sector

Deflation in the food sector, observed for most of 2018, resulted from decreasing prices of vegetable produce. The decrease of prices in the regional grain markets and of world sugar and vegetable oil prices was an additional factor behind the decline in the food price index. Food prices fell by 2.6% during the year.

Figure 5. Inflation

(the last month in the quarter vs. the last month of the same quarter the year before)



Source: National Statistical Committee of the Kyrgyz Republic, National Bank of the Kyrgyz Republic

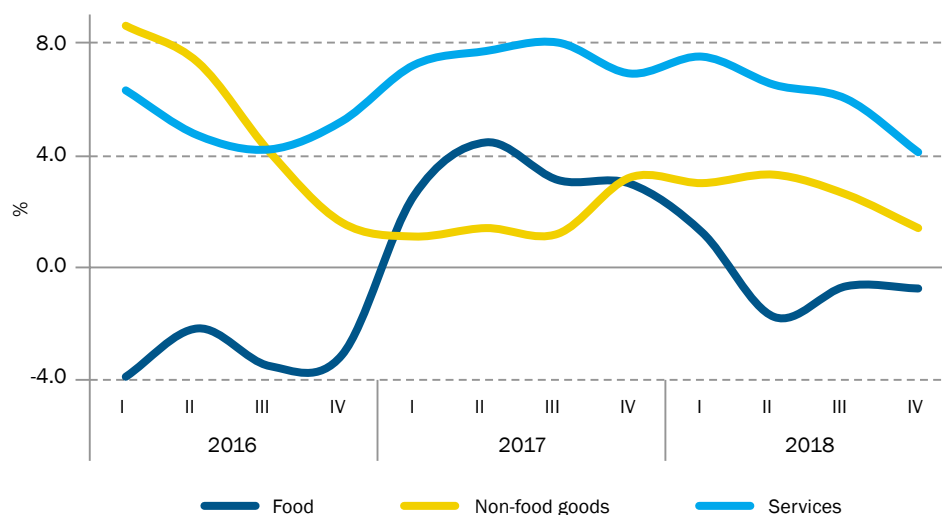
Deflation in the food sector more than compensated for the accelerated alcohol and tobacco price growth caused by the increased tobacco excise base rate and by higher prices of some alcoholic beverages. The annual alcohol and tobacco price growth rate accelerated to 6.4% in December 2018, from 4.0% the year before.

Slower inflation in service and non-food sectors

Consumer goods prices grew moderately as the Kyrgyz som to U.S. dollar exchange rate was relatively stable. The less intensive slowing of inflation in the non-food sector resulted from accelerated growth of energy prices, partially due to higher prices in the world oil market. Non-food goods appreciated by 1.4% in 2018 (by 3.2% the year before).

The prices of services grew by 4.1% in 2018 after 6.9% the year before, contained by lower growth in education services and public catering prices and tariffs in 2018 than in 2017.

Figure 6.
Inflation Components
(last month in the quarter vs.
the last month of the same
quarter the year before)



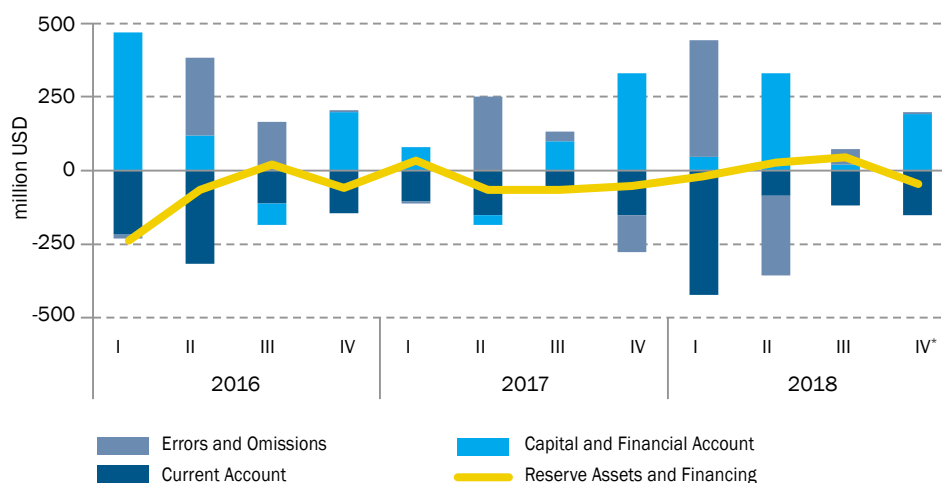
Source: National Statistical Committee of the Kyrgyz Republic, authors' calculations

The External Sector

Current account deficit expands

The current account deficit expanded as the negative goods and services balance widened, while the net inflow of transfers remained virtually the same as in 2017.

Figure 7.
Balance of Payments



Source: National Bank of the Kyrgyz Republic

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

* – provisional estimate

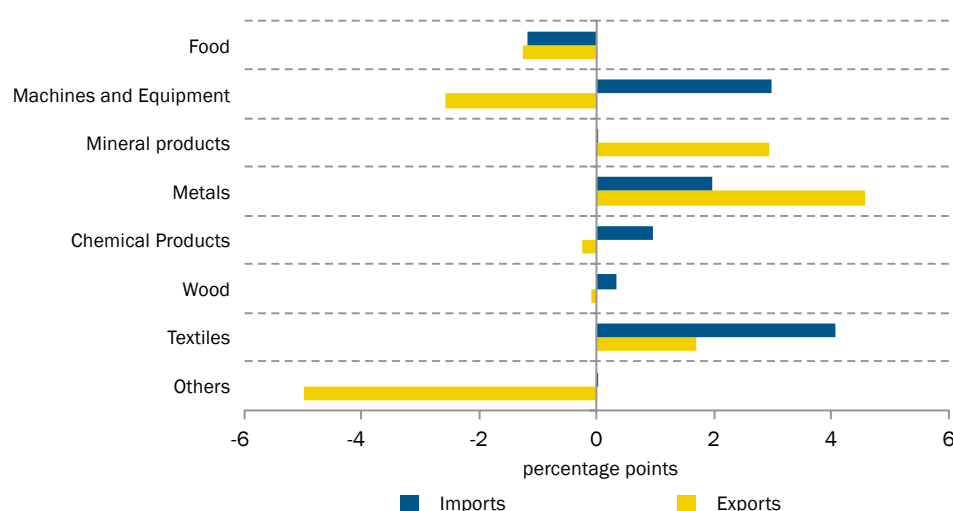
Trade balance deficit grows

According to provisional data from the National Statistical Committee of the Kyrgyz Republic, the greater negative trade balance in 2018 resulted from increased imports while exports remained at their 2017 level.

The decline of gold export revenues in 2018 (as both volumes and world prices decreased) was compensated for by increased sales of textile products, onboard jet fuel and non-precious metals.

The imports increase in 2018 resulted from greater imports of machines and equipment.

Figure 8.
Product Groups'
Contribution to
Growth of Exported
and Imported Goods
in 2018



Source: EEC, authors' calculations

Current transfers balance still positive

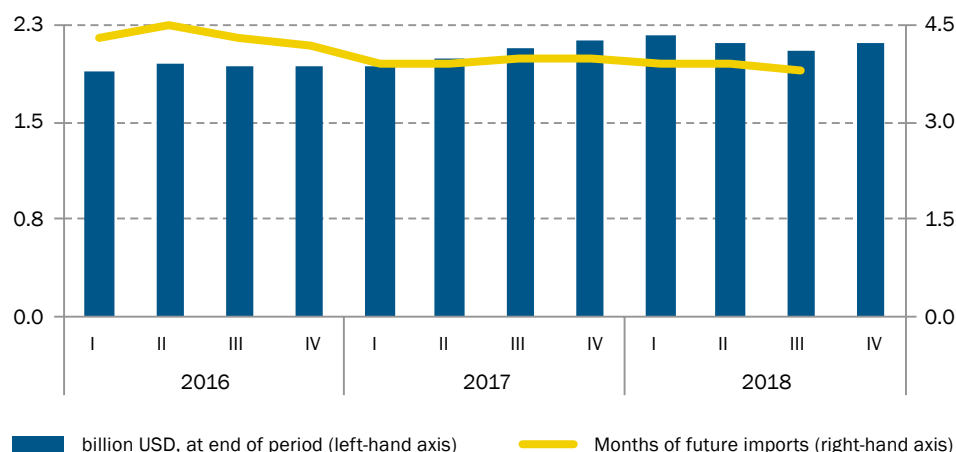
The services balance and the income balance were negative as usual. However, unlike the services balance, the negative income balance contracted as payments to foreign direct investors and interest income paid to foreign lenders decreased.

As provisionally estimated by the National Bank of the Kyrgyz Republic, the growth of net inflows of remittances in dollar equivalent slowed to 5.5% in 2018, from 24.2% the year before. As more than 98% of the remittances came from Russia, the situation in the Russian domestic market affected the volume of remittances in dollar equivalent, as the Russian ruble to U.S. dollar exchange rate decreased from its 2017 level. Further, official transfers received by the public sector from international financial institutions decreased.

Capital and financial account in surplus

The capital and financial account remained in surplus largely on account of the write-off of foreign debt and the recovery of net inflows of foreign direct investment. At the same time, the public sector increased its payments on previously raised foreign loans.

Figure 9.
International
Reserve Assets



Source: National Bank of the Kyrgyz Republic

The Fiscal Sector

State budget deficit lower

The State budget deficit was 1.1% of GDP in 2018, down from 3.1% of GDP the year before. The main factor behind this was less public spending.

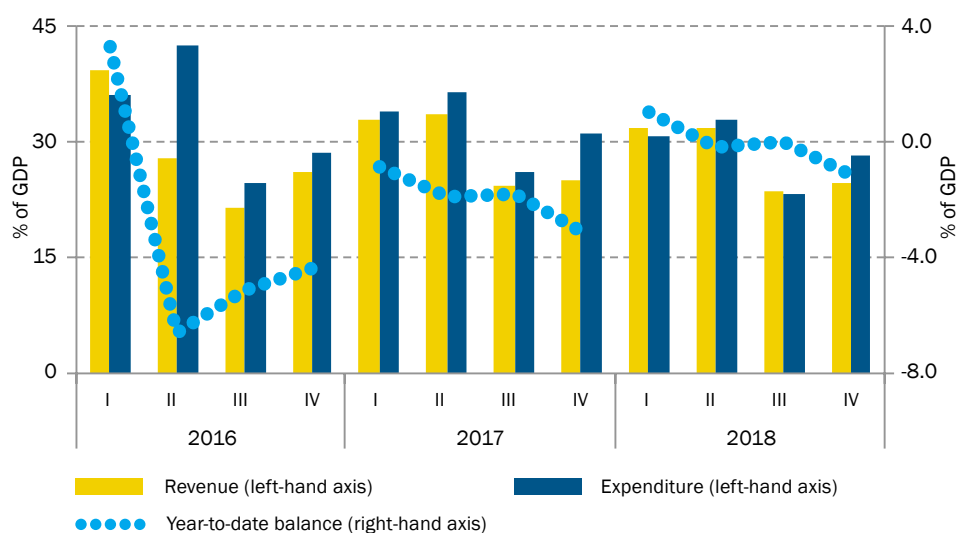
Tax revenues are now the core of budget revenues

In 2018, there was a larger share of tax revenues, including value added tax, in the budget's income structure. Non-tax revenues and official transfers decreased in 2018 against the high base of 2017.

OpEx grows while infrastructural CapEx decreases

The State budget's expenditure decreased in 2018 as allocations for the purchase of non-financial assets declined. The public sector's capital expenditures on the development of infrastructure fell below the 2017 level, which partly resulted from some delay in the implementation of public investment projects co-funded from external sources. The operating expenditure growth rate decelerated from its 2017 level, mainly on account of a smaller volume of State subsidies and public procurement of goods and services. Interest payment expenses and social expense items continued to grow.

Figure 10.
The State Budget

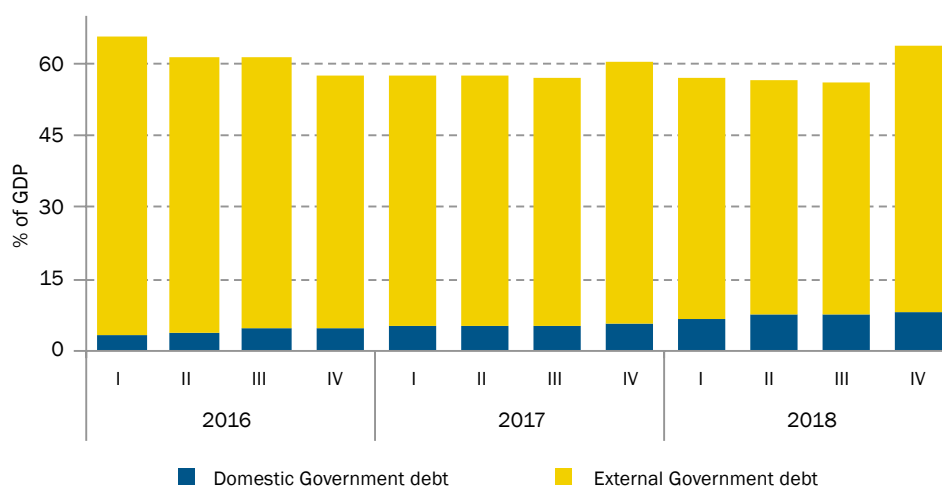


Source: National Statistical Committee of the Kyrgyz Republic, authors' calculations

Public debt decreases

Public debt decreased in absolute terms, mainly as debts owed to Russia were written off. Within external public debt, 98% of the loans were raised on concessional terms. The trend towards a gradual increase in domestic debt through placing treasury securities in the domestic market continued in 2018. At the same time, the share of short-term instruments within the structure of public securities decreased, and 7 and 10-year State treasury bonds were introduced to circulation.

Figure 11.
Public Debt
(at end of period)



Source: Ministry of Finance of the Kyrgyz Republic, authors' calculations

Monetary Conditions

Policy rate reduced by 25 basis points to reach 4.75% as of end 2018

Against a low inflation background, the National Bank of the Kyrgyz Republic reduced its key rate from 5.0% to 4.75% in May 2018. At the same time, it lowered the upper limit of the interest rate band, the rate on overnight loans, from 6.25% to 6.00%, while its lower limit, the rate on overnight deposits, remained at the same level of 0.25%. In the following months of 2018 the policy rate did not change but the interest rate band was gradually narrowed as the rate on deposits was raised in stages to 1.5% by the end of 2018.

7-day REPO rate fluctuates near lower limit of interest rate band in 2018

Interest rates in the interbank lending market testified to an excess of liquidity in the banking system, which made the rates fluctuate near the lower limit of the interest rate band. Against the low base of 2017 the volume of deals in the interbank lending market grew in 2018 but still remained below the level of 2014, when the seven-day REPO rate was close to the policy rate of the National Bank of the Kyrgyz Republic amid widespread interbank lending.

In 2018 the National Bank's credit policy was tighter than in 2017. The volume of credit auctions decreased as commercial banks' demand declined. On the other hand, the National Bank of the Kyrgyz Republic increased lending to the Russian-Kyrgyz Development Fund.

Foreign exchange market stable

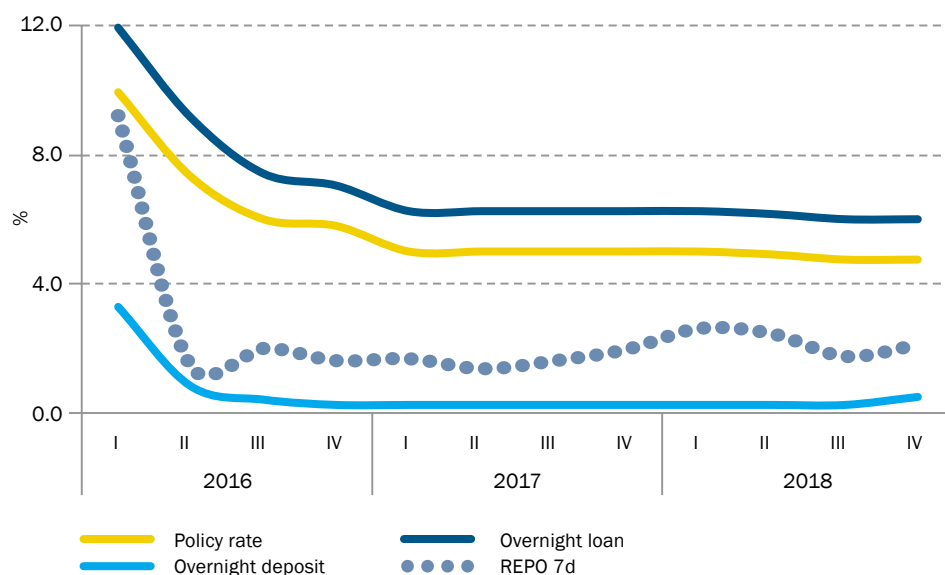
The domestic foreign exchange market was fairly stable in 2018, which was partly due to the National Bank. The pressure in the domestic currency market that increased in April and the 2nd half of 2018 amid high volatility in regional financial markets was smoothed by National Bank interventions. For most of 2018 the National Bank was a net seller of foreign currency. The Kyrgyz som to U.S. dollar exchange rate varied between 67.94 and 69.85 KGS per USD, while its average annual value remained at the 2017 level. Compared to 2017, the real effective exchange rate of the Kyrgyz som strengthened by 2.8%. Against the currencies of the main trade partner countries, Russia and Kazakhstan, the som's exchange rate strengthened by 5.3% and 6.6%, respectively.

Interest rates falling on both loans and deposits

The price of loans provided by commercial banks decreased from 17.11% in January to 15.85% in December 2018. Lending growth rates decelerated in 2018 as new mortgages decreased and volumes of new loans to industry continued to decline. On the other hand, lending to agriculture and new consumer loans increased.

The volume of deposits opened grew by 14.0% in 2018, while the interest rate decreased from 1.69% in January to 0.93% in December 2018.

Figure 12.
Monetary Policy Rates
(period average)



Source: National Bank of the Kyrgyz Republic, authors' calculations

ECONOMIC OUTLOOK

Background

Decreased external demand

In the world economic growth forecast, the balance of risks has shifted towards deceleration. The main factors that may constrain future growth of the world economy include mounting tension in world trade and uncertain economic prospects in major economic centers of Europe and Asia. On the other hand, a switch to smoother tightening of financial conditions in developed economies may support the world economy. In Russia and Kazakhstan, the main trade partner countries of the Kyrgyz Republic, economic activity is also expected to decelerate in 2019, and in the medium term the potential levels will gradually be reached.

Mixed trends in world commodity markets

In 2019, oil prices are expected to regain some of the ground lost in late 2018: the average Urals price is expected to be some USD 65 per barrel and then decline smoothly. In world food markets, a price spurt is a low-probability event in the projection period, so a slow price recovery trajectory is expected. Positive gold prices movements are projected.

Economic policy to retain its main thrust

The projection scenario assumes no additional stimulation of the economy through fiscal or monetary policy measures. Fiscal policy is expected to remain focused on keeping both the budget and public debt sustainable. Monetary policy will pursue the mid-term inflation target of 5.0–7.0%.

Table 1. Forecast 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, %
2019	65.0	1269.3	91.6	1.5	3.3
2020	64.7	1350.7	92.9	2.0	3.4
2021	63.4	1385.7	94.3	2.2	3.5

Source: authors' calculations, EEC

Economic Activity

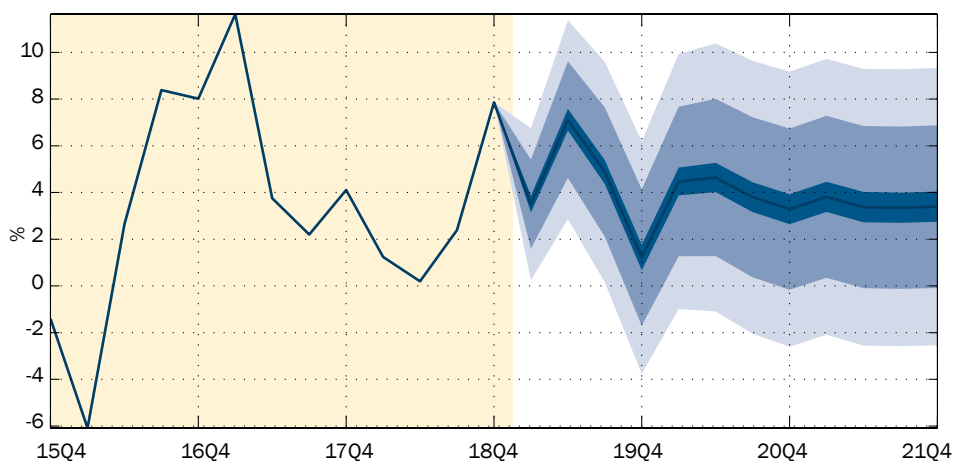
Growth to slow down in medium term

In 2019, economic activity in the Kyrgyz Republic is expected to accelerate, largely on account of optimistic expectations of gold production volumes. As projected by Kumtor Gold Company OJSC, in 2019 their output is to reach some 535–565 thousand ounces¹, vs. 535 thousand ounces produced in 2018. This suggests a production increase of up to 5.7% according to provisional estimates. In the following years, the enterprise's output is expected to decrease gradually. Given the enterprise's significance, its production numbers will largely determine the GDP growth trajectory.

Fiscal policy may give the economy an additional growth impetus in 2019. In 2018, the State budget posted a deficit of 1.1% of GDP, while the Republic's budget for 2018–2020 had envisaged a 2018 deficit of 3.6%, to decrease to 1.2% of GDP by 2020. The expected increase of the budget's deficit in 2019 (the approved limit of the deficit in 2019 is 1.7% of GDP) may additionally support economic growth.

Continued positive growth rates in the Kyrgyz Republic's main trade partner countries will support growth in the medium term via the remittance and export revenue channels.

Figure 13.²
Real GDP³
(growth YoY)



Source: authors' calculations, EEC

¹ <https://www.kumtor.kg/ru/> [Viewed on 19.03.2019].

² Here and elsewhere the fan chart ranges correspond to the 10%, 50% and 75% confidence intervals.

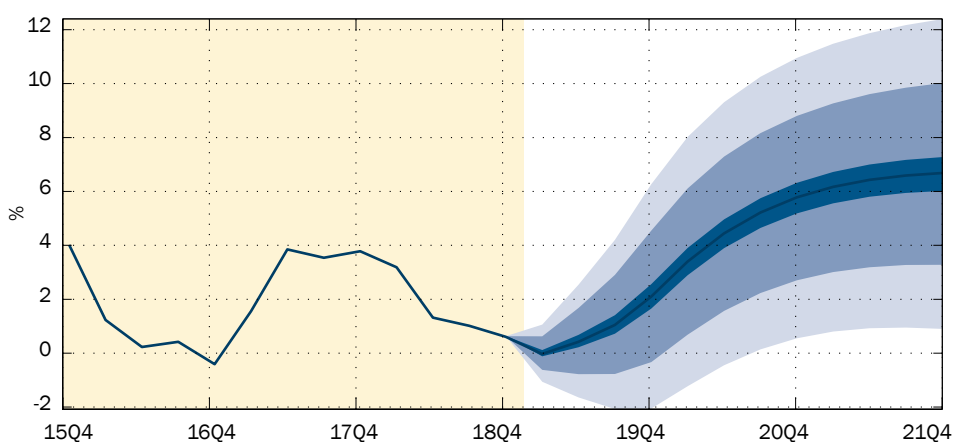
³ Seasonally adjusted data.

Inflation

Inflation to reach the lower limit of the target range in early 2020

In 2019, decreasing world food prices and moderate domestic demand will continue to shape a low inflation background. As currently estimated, world food prices will start recovering in the 1st half of 2019, and by early 2020 their trend will stabilize and impact the growth trajectory of the consumer price index in the Kyrgyz Republic. Lower expected oil prices will have a somewhat limited effect on inflation in the projection period. Among domestic factors, the annual tobacco excise increases planned for the medium term may exert pro-inflationary pressure.

Figure 14.⁴
Inflation
(period, YoY)



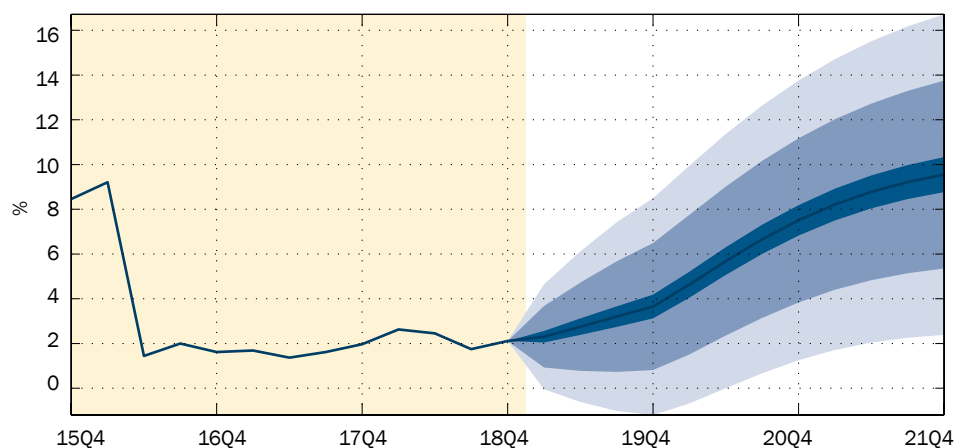
Source: authors' calculations, EEC

Monetary Conditions

With an excess of liquidity existing in the banking system and the vector of the National Bank's credit policy remaining the same given the low inflation, the 7-day interbank REPO rates will remain in the lower segment of the interest rate band in 2019. An increase of inflationary risks as world food prices recover may require a certain increase in rates in the interbank credit market.

⁴ Seasonally adjusted data.

Figure 15.
7-Day REPO Rate
(period average)

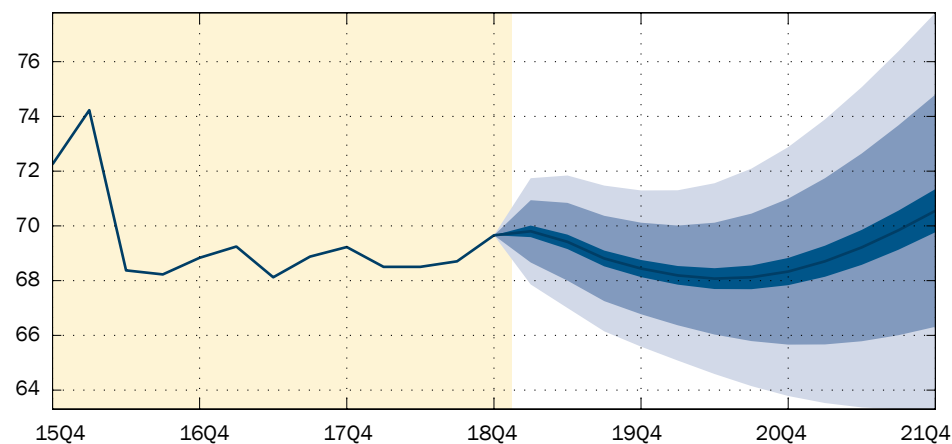


Source: authors' calculations, EEC

Exchange rate to stabilize

In the projection period, the National Bank is expected to maintain its exchange rate policy, including the smoothening of sharp fluctuations of the Kyrgyz som to U.S. dollar exchange rate. Consequently, barring additional shocks, the exchange rate will probably keep within the 68-69 KGS per USD range.

Figure 16.
The Kyrgyz Som's Nominal Exchange Rate vs. the U.S. Dollar
(KGS per USD)



Source: authors' calculations, EEC

Key Macroeconomic Indicators of the Kyrgyz Republic

Indicator	2016	2017	2018	2019F	2020F	2021F
GDP in constant prices (% YoY)	4.3	4.6	3.5	4.0	3.9	3.5
Consumer price index (% growth in December to previous year's December)	-0.5	3.7	0.5	2.1	5.8	6.6
Interbank REPO 7d rate (the year's average % per annum)	3.7	1.7	2.2	3.0	6.1	8.9
Nominal Kyrgyz Som to U.S. Dollar Exchange Rate, KGS per USD (the year's average)	69.9	68.9	68.8	69.1	68.2	69.6

Source: authors' calculations, EEC. F – forecast



Eurasian Development Bank

RESEARCH DEPARTMENT, EURASIAN DEVELOPMENT BANK

Your comments and suggestions
concerning this review are welcome at:
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