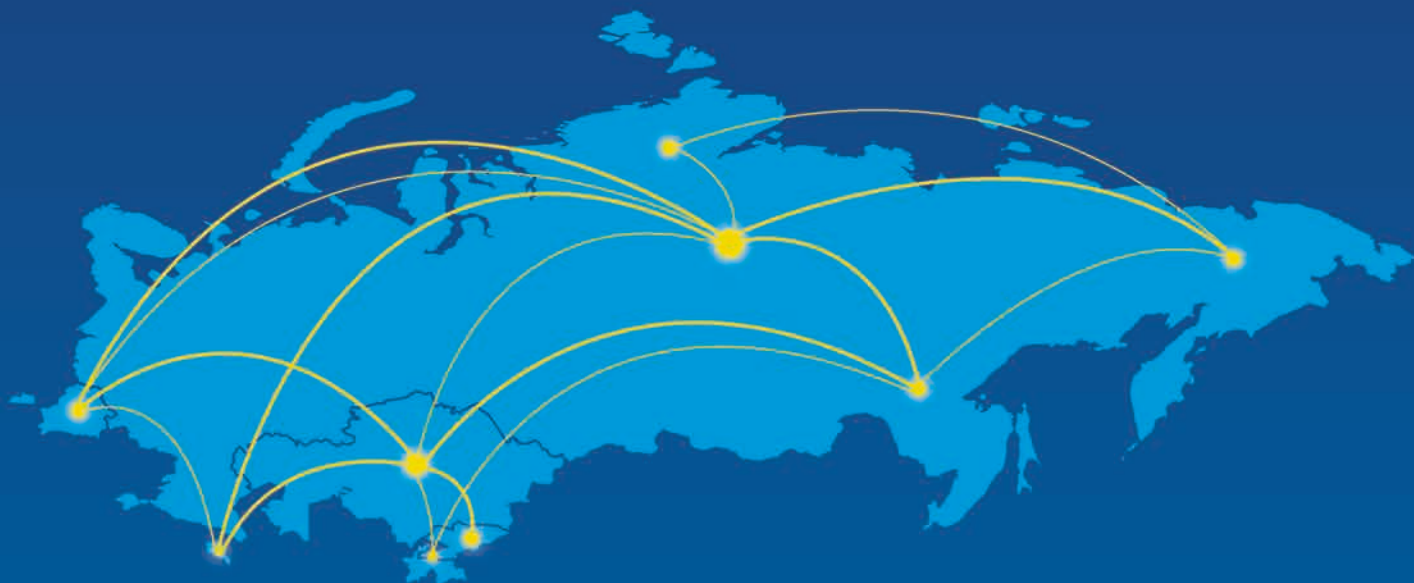


EDB MACRO REVIEW



10'2019

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

KR – Kyrgyz Republic

pp – percentage point

U.S. or USA – United States of America

% – per cent

% YoY – Year-on-Year growth rate

SUMMARY

The acceleration of economic activity in the first half of 2019 resulted from increased production at the Kumtor gold mine. This was also a key factor behind the increase of net physical exports. Rising real household incomes supported domestic consumer demand, while collective consumption¹ limited GDP growth. Investment in fixed capital also promoted the expansion of economic activity, while the decrease of inventory stocks resulted from a high base effect.

The inflation slowdown trend ended in 2Q2019 as world grain and meat product prices grew and the supply of vegetables was limited in the domestic market. The non-food basket price remained virtually the same as in the first half of 2018 as the Kyrgyz som to U.S. dollar exchange rate was stable.

The current account deficit is on a downward trend as exports (mainly gold) grow while imports of goods and services are decreasing. The smaller volume of imported goods partly results from the use of inventory stocks built up a year before.

There was a State budget surplus of 0.1% of GDP in the first half of 2019 after a deficit of 0.2% of GDP a year before. The growth on the income side is outrunning the budget's expenditure increase.

The National Bank of the Kyrgyz Republic reduced its policy rate by 50 basis points in the first six months of 2019, to 4.25% as of end of June 2019, and took a number of decisions to narrow the interest rate band. The main thrust of its foreign exchange policy remained the same, while its interest rate policy became more reserved, which was one of the factors that drew the interbank loans rate closer to the policy rate.

Economic activity is projected to slow down in the second half of 2019, largely due to expected low gold production volumes and the public sector's moderate demand. In the medium term, the economy is expected to continue its gradual growth at near potential rates.

Inflation will be shaped by food price growth. In the medium term, inflation will rise to the target range of 5.0–7.0%.

¹ The National Statistical Committee of the Kyrgyz Republic separates individual and collective consumption in its System of National Accounts. Collective consumption includes the authorities' expenditures on collective services generally provided to the public at no charge, namely general governance, science and science support, agriculture support entities', hydro-meteorological, transport and communication, civil defense, radio and television broadcasting, and publishing services.

STATE OF THE ECONOMY

Economic Activity

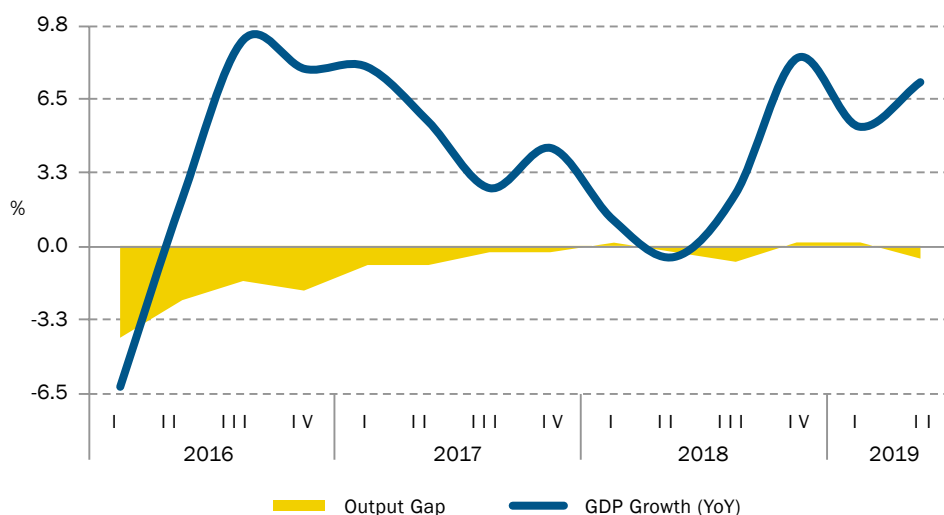
Economic Growth Accelerates

In the first half of 2019 GDP increased by 6.4% YoY against the low base of the first half of 2018, which experienced just 0.3% YoY growth. The acceleration of economic activity results from the expansion of production at the Kumtor gold mine by 63.8% YoY, while in the first half of 2018 it had decreased by 30.8% YoY. Economic activity excluding gold production at Kumtor slowed down from 2.5% YoY in January to June 2018 to 2.1% YoY in the first half of 2019.

Net Exports are a Key Driver of Growth

Greater gold production volumes also had an effect on total exports, which grew by 12.3% compared to the first half of 2018 (2.6% YoY a year before). Imports in real terms decreased by 0.8% YoY in the first half of 2019, which made a positive contribution to net export growth.

Figure 1.
Economic Activity

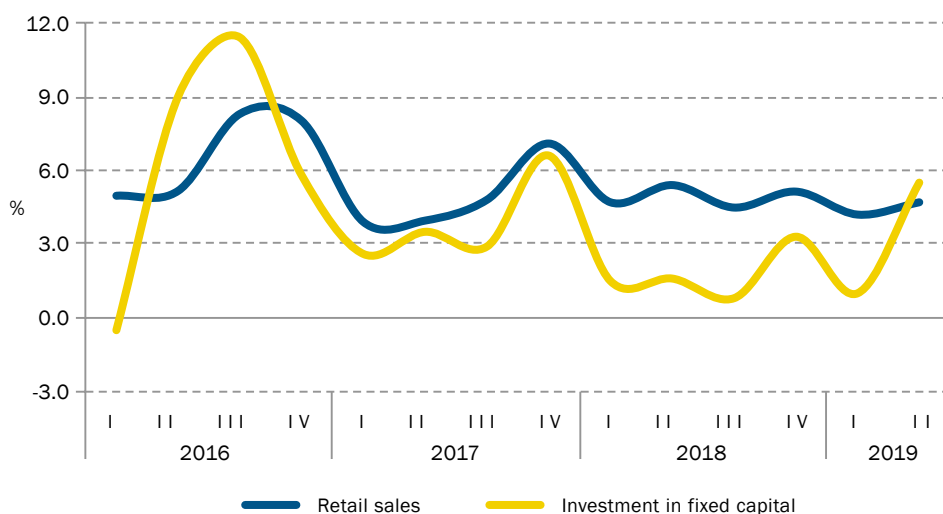


Source: KR National Statistical Committee, calculations by the authors, EEC

Steady Growth of Domestic Demand

Domestic consumer demand increased by 2.0% compared to the first half of 2018, mainly as households’ consumption expanded (+2.5% YoY), while collective consumption decreased by 0.6% YoY. Gross fixed capital formation grew by 5.0%. On the other hand, inventory stocks decreased by 19.1% YoY after growing 2.9-fold a year before.

Figure 2.
Retail Sales and Investment
(period's growth rate year over year, cumulative)

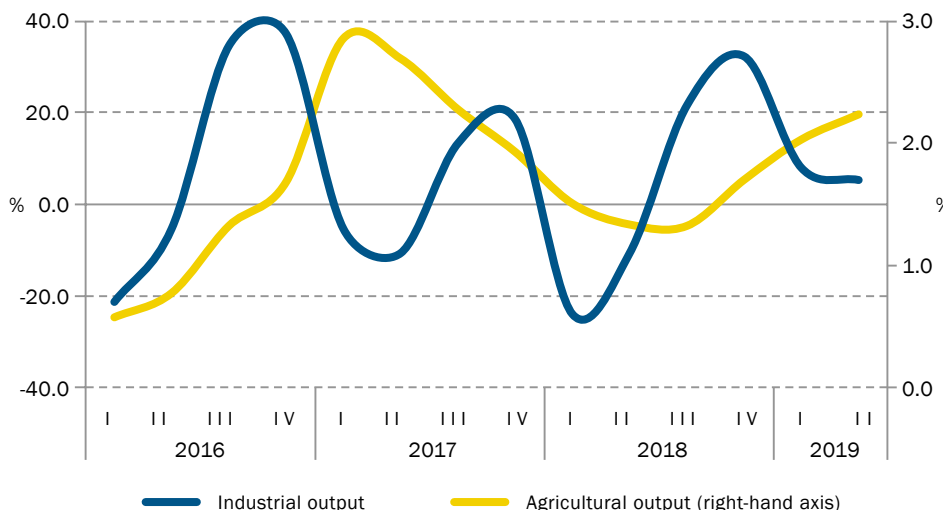


Source: KR National Statistical Committee

Manufacturing was a Key Source of Growth

In the first half of 2019, manufacturing provided 3.9 pp of GDP growth, as gold production increased at the Kumtor mine. A year before, manufacturing had made a negative 1.0 pp contribution. The service sector and agriculture retained their positions in the sectoral structure of GDP growth (0.7 pp and 0.1 pp, respectively). An increased rate of growth in construction works in the first half of 2019 enabled this sector to contribute 0.4 pp to GDP growth (0.2 pp a year before).

Figure 3.
Production Activity
(period's growth rate year-on-year)



Source: KR National Statistical Committee

The Labor Market

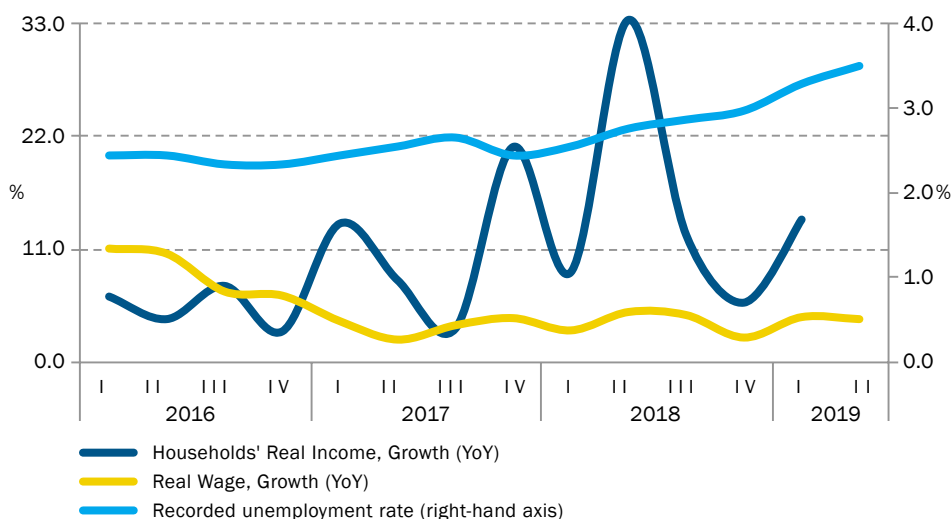
Positive Growth of Household Incomes Continues

Real incomes were on an increase amid their nominal growth and low inflation. The key contributors to growth were employment earnings (8.2 pp) and, to a lesser extent, incomes from personal smallholdings (3.9 pp). Real wages increased by 4.3% YoY in the first half of 2019. Accelerated growth of average monthly nominal wages was observed at enterprises and organizations engaging in most types of economic activity, except wholesale and retail trade, transport and other services.

The highest growth of average monthly wages was observed in the mining sector (12.0% compared to the first half of 2018) and construction (10.9% YoY).

The recorded unemployment level increased from 2.8% of the economically active population at the end of 2018 to 3.3% as of 30 June 2019.

Figure 4. Labor Market Indicators



Source: KR National Statistical Committee, calculations by the authors

Inflation

Consumer Price Growth Recovers in 2Q2019

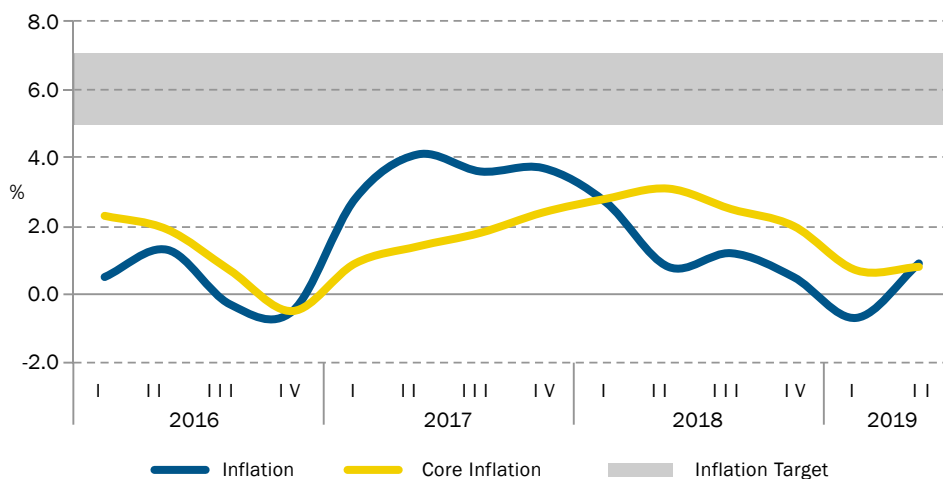
The price growth deceleration trend continued into 1Q2019 amid decreasing food prices and a weak price situation in the service and non-food sectors. This resulted in 0.7% YoY deflation in March. In 2Q2019 food began appreciating, to move the consumer price index into positive growth territory. As a result, inflation reached 0.9% YoY at the end of June 2019.

Food Sector Prices Volatile

The food sector's volatile inflation was shaped by the domestic fruit and vegetables market, where deflation was observed in the first five months of

2019. In June 2019, vegetable prices rose sharply and contributed to a quick recovery of the consumer price index. Another factor behind food basket appreciation was a rise in bread prices as world grain prices increased. The resultant inflation in the consumer sector was 1.5% YoY at the end of June 2019, while 0.7% YoY deflation was recorded in March.

Figure 5. Inflation
(last month in quarter vs. last month of same quarter a year before)



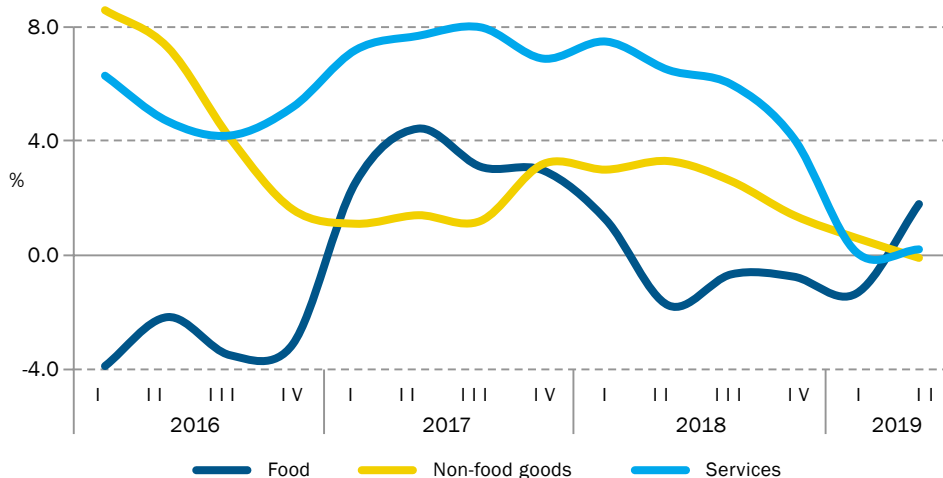
Source: KR National Statistical Committee, KR National Bank

Service and Non-food Sector Inflation Slows Down

Weak inflation in the non-food goods sector resulted from relative stability of the som to U.S. dollar exchange rate together with depreciation of prices for coal and liquid fuel and lubricants – particularly due to weak prices in the world oil market. Deflation was observed in the non-food sector, 0.1% YoY in June 2019.

Service price growth slowed down to 0.2% YoY in the first half of 2019 as the high base effect petered out in the sector and hotel and restaurant service prices decreased.

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



Source: KR National Statistical Committee, calculations by the authors

The External Sector

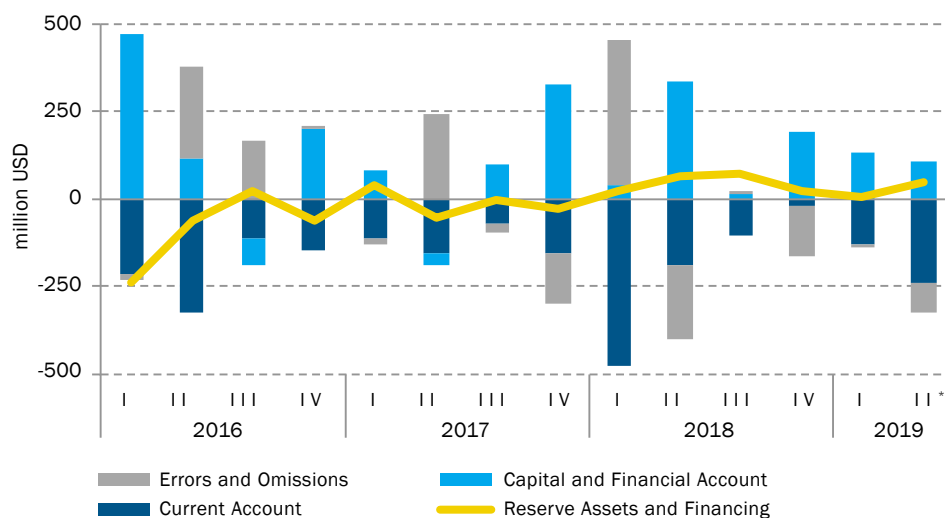
Current Account Deficit Decreases

According to provisional estimates by the KR National Bank, the negative current account balance was USD 370.2 million in the first half of 2019 (vs. USD 804.4 million a year before). The current account deficit decreased as a result of smaller deficits in the goods and services balance and the income account. The Current Transfers item remains in surplus but decreased by 8.2% YoY in the first half of 2019 as labor migrants' remittances fell by 11.3% YoY. In April 2019 the Central Bank of Russia established a limit of 100 thousand rubles a month on money transfers to the KR via remittance systems, which caused the current transfers surplus to decrease.

Positive Capital and Financial Account Balance Expands

In the first half of 2019 the capital and financial account posted a surplus of USD 239.8 million, while a year before it was USD 378.0 million. The capital account surplus decreased to USD 33.4 million from USD 283.1 million in the first half of 2018 when the Russian Federation wrote off a debt of USD 240.0 million. The positive balance² of the financial account was USD 206.4 million, versus USD 94.9 million a year before.

Figure 7.
Balance of Payments



Source: KR National Bank

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

* – provisional estimate

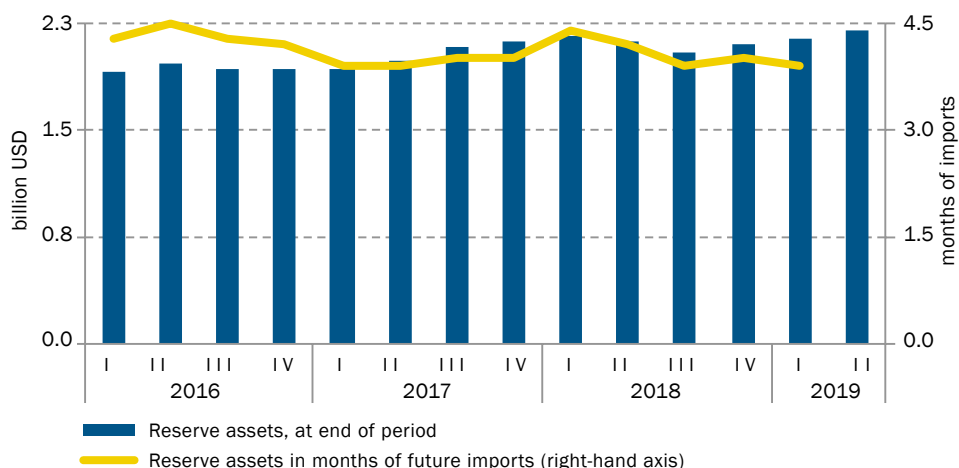
The positive balance on the financial account resulted from an inflow of foreign direct investment and loans attracted by the corporate sector.

² According to the 5th Edition of the International Monetary Fund's Balance of Payments Manual, a positive financial account balance means a capital inflow.

International Reserves Grow

Gross international reserves amounted to USD 2.2 billion as of end of June 2019, a 4.1% increase from the beginning of the year. The share of monetary gold increased to 26.7%, from 21.4% over the same period.

Figure 8. International Reserve Assets



Source: KR National Bank

Trade Balance Deficit Decreases in First Half of 2019

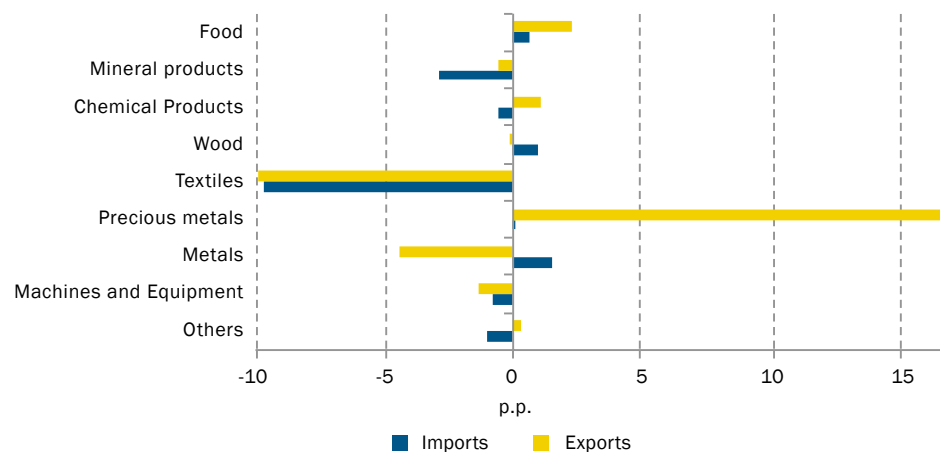
According to provisional data of the KR National Statistical Committee, the trade balance deficit decreased as a result of the increase in exports while imports fell compared to the first half of 2018.

Export revenue grew in the first half of 2019, mainly on account of a 1.5-fold increase in gold exports compared to the first half of 2018. Exports excluding gold decreased by 17.4% YoY, mainly as exports of textiles fell by a factor of 2.3 [SHOW AS A%]; non-precious metal exports declined by 46.3% YoY; and machine and equipment exports declined by 42.2% YoY.

Imports decreased in the first half of 2019, largely resulting from smaller volumes of imported textiles (-41.9% YoY), footwear (-33.1% YoY), and mineral fuel (-18.5% YoY).

Figure 9. Product Groups' Contribution to Goods Export and Import Growth

(January to June 2019 vs. January to June 2018)



Source: KR National Bank, calculations by the authors

The Fiscal Sector

State Budget in Surplus

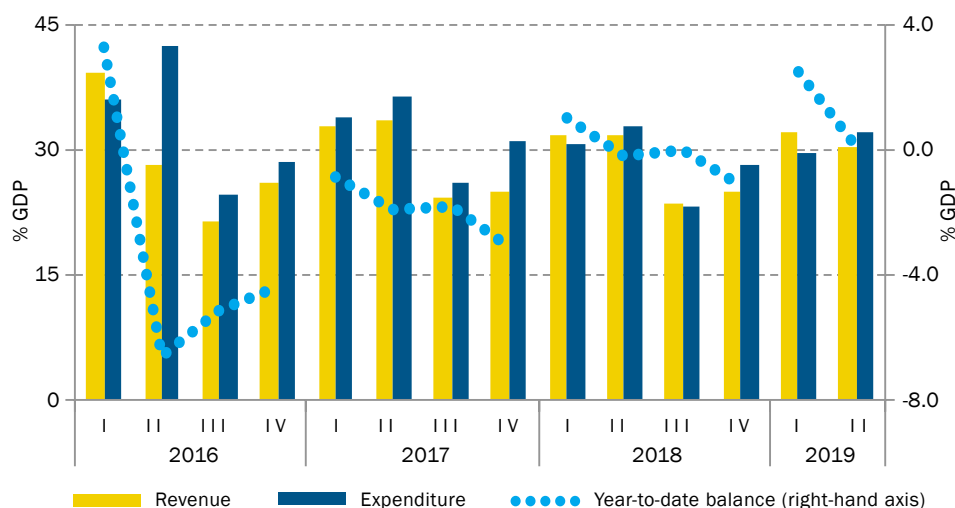
The state budget surplus was 0.1% of GDP in the first half of 2019, versus a deficit of 0.2% of GDP a year before. The budget's income side is outrunning expenditure growth.

Budget Income Growth due to Non-Tax Revenues

The budget's income, including revenue from the sale of non-financial assets, grew by 2.6% YoY on account of growing non-tax revenues and official transfers. Tax revenues decreased by 1.9% compared to the first half of 2018, mainly as income from value added tax on goods imported into Kyrgyzstan decreased.

Expenditures Increase The budget's expenditures, particularly on the purchase of non-financial assets, grew by 1.6% YoY. Since 1 January 2019, changes have been made in the functional classification of its expenditure side, which largely determined some items' movements. Thus, transfers to the budgets of the Social Fund and Compulsory Social Insurance Fund have been classified since 2019 as 'General Purpose Public Services' (2.8 fold growth YoY), while last year they were included under Social Security and Health (61.9% YoY and 80.7% YoY decreases, respectively). In the first half of 2019 expenses on the purchase of non-financial assets were 11.7% lower than in the same period last year.

Figure 10.
The State Budget

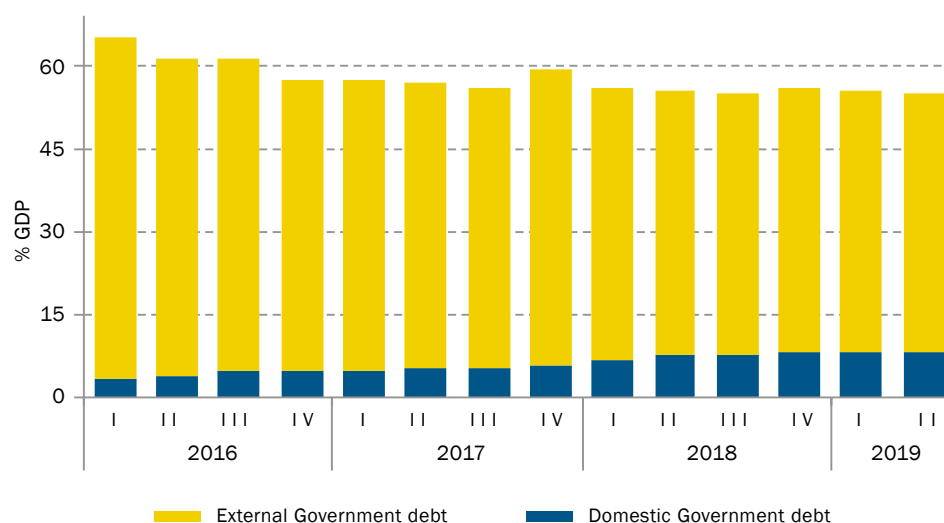


Source: KR National Statistical Committee, calculations by the authors

Public Debt Decreases

Public debt decreased in absolute terms, mainly as debt on external loans decreased by 0.9% compared to early 2019. The trend of a gradual increase in domestic debt's share through the placement of treasury securities in the domestic market continued in the first half of 2019.

Figure 11.
Public Debt



Source: KR Ministry of Finance, calculations by the authors

Monetary Conditions

Policy Rate Reduced Against a low inflation background, the KR National Bank reduced its policy rate on two occasions during the first half of 2019: from 4.75% to 4.5% in February and by another 25 basis points in May. Also in May 2019 the interest rate band was changed, with the overnight deposit rate raised to 1.75% and the overnight loan rate lowered to 5.75%.

Interest rates in the interbank market point to an excess of liquidity in the banking system, which makes the rates fluctuate near the lower limit of the interest rate band.

Reserved Borrowing Policy In the first half of 2019 the National Bank's borrowing policy was more reserved than in the same period of 2018. The number of credit auctions decreased as commercial banks' demand declined. On the other hand, the KR National Bank made no moves to lend to the Russian-Kyrgyz Development Fund in the first half of 2019.

Kyrgyz Som Stable The domestic foreign exchange market was fairly stable during the first half of 2019. With demand for foreign exchange exceeding supply, the KR National Bank made selling interventions whose net volume was USD 68.6 million in the first half of 2019 (vs. USD 13.6 million a year before).

The som to U.S. dollar exchange rate fluctuated between 69.5 and 69.9 KGS per USD during the first half of 2019, while its average rose by 1.9% YoY. The real effective exchange rate strengthened by 3.0% compared to the first half

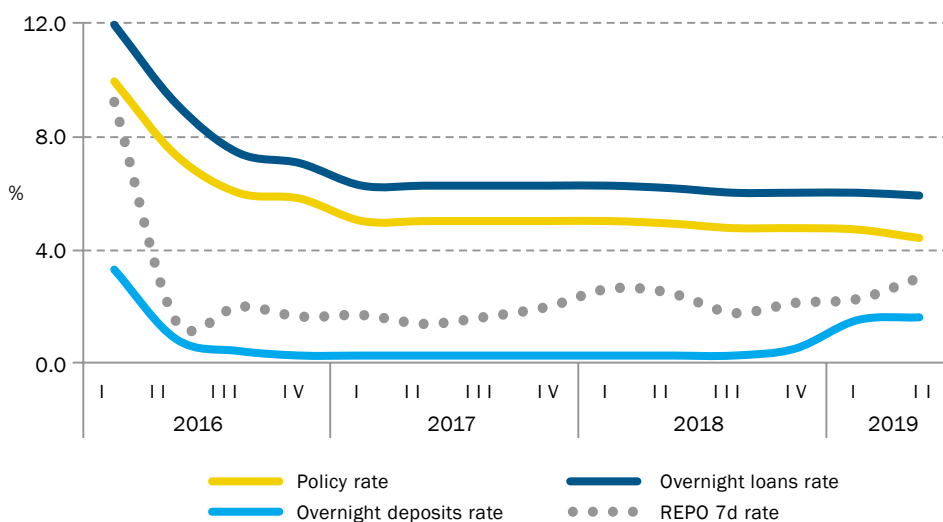
of 2018. Against the currencies of the main trade partner countries, Russia and Kazakhstan, the som's exchange rate strengthened by 3.2% and 8.6%, respectively, over the year.

Interest Rates Decline in Loan and Deposit Markets

The price of loans provided by commercial banks decreased from 16.6% in January to 16.1% in June 2019. The volume of loans issued in the first half of 2019 grew by 8.8% YoY, mainly as lending to agriculture increased (19.0% YoY) and more consumer loans were issued (by 27.8% YoY).

The volume of newly attracted deposits grew in the first half of 2019 by 20.6% YoY, and the six months' average interest rate was 0.93% (vs. 1.67% in the first half of 2018).

Figure 12.
Monetary Policy Rates
(the period's average)



Source: KR National Bank, calculations by the authors

ECONOMIC OUTLOOK

Background

Decrease in External Demand

Economic activity in the world's major economies slowed down in the first half of the current year. The growth slowdown in the Eurozone, the USA and China largely resulted from the negative effect of world trade tensions on net exports and investment. Mounting global uncertainty and trade wars are worsening sentiment in traded sectors (mainly manufacturing industries).

The projection's base scenario assumes the global trade tensions to persist at their level prevailing in September 2019, with no additional protectionist measures anticipated (besides those announced). In this situation, the increasingly uncertain outlook for the global economy will keep hindering investment activity in the USA, Eurozone and China in the medium term, which will lead to a gradual slowdown of their potential growth. Stimulative monetary policies will keep supporting the world's major economies by means of monetary and fiscal easing.

Commodity Price Estimates Reduced, Higher Gold Price Projected

Economic activity in Russia is expected to slow down in 2019 and to gradually reach its potential levels in the medium term. In Kazakhstan, GDP growth will accelerate over 2019 and slow down to its potential rate in the medium term.

The external sector's inflationary pressure on the Kyrgyz economy is expected to be low. The projection's base scenario assumes a gradual decrease of oil prices relative to their average level of 2019 as world demand growth slows down. Low and inertial expectations, in conjunction with the projected reserved economic activity and depreciation of energy commodities, will continue to restrict price growth in the Eurozone and the USA. In this connection we project inflation to be below the ECB and FRS targets in 2019–2021. In China, inflation is expected to accelerate in 2019 as food prices grow. In 2020–2021, the pressure on consumer prices will ease as economic growth slows down, which will be reflected in their slower growth.

A sharper than expected slowdown of world economic growth and a weak price situation in the oil market have manifested themselves in a lower food price index projected. We expect it to be 87.6 in 2021, which is 6.7 points below the April forecast.

Table 1. Projected Main 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	63.6	1402.5	86.7	1.1	4.2
2020	60.7	1539.8	87.3	1.8	3.5
2021	58.9	1561.6	87.6	2.0	3.4

Source: calculations by the authors, EEC

The deterioration of growth prospects has boosted investors' interest in risk-free assets, with a positive effect on gold, whose value has been growing steadily since April 2019. A USD 1,562 price per ounce of gold is thus expected, while our April review was predicting USD 1,386 per ounce.

Economic Policy to Retain its Main Thrust

The base scenario assumes economic policy to retain its main thrust. In the medium term, the KR National Bank is expected to continue lending operations in order to stimulate the real sector of the economy under State programs aiming to develop agricultural sectors and regions of the country. Foreign exchange policy is expected to continue unchanged in the medium term.

According to estimates by the KR Ministry of Finance, the budget deficit is to be reduced from 1.7% of GDP in 2019 to 1.3% of GDP in 2021. The nominal growth of current expenses is to continue while movements in investment expenses will depend on the volumes of funding from external sources.

Main Indicators: Forecasts

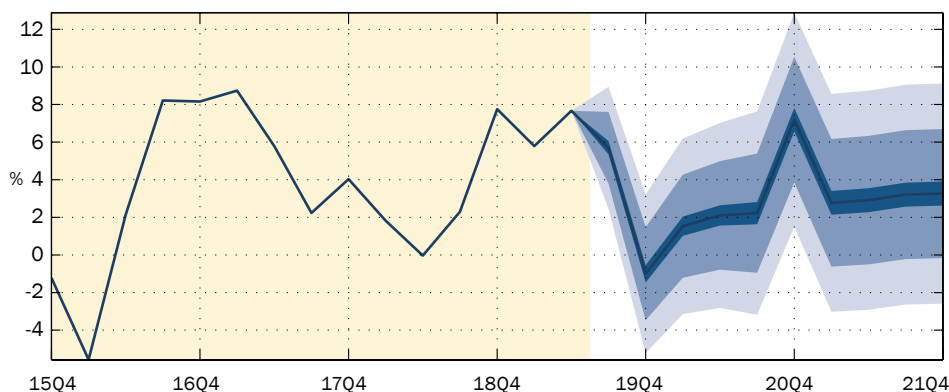
Growth to Slow Down in Medium Term

Notwithstanding the high growth indicators of the first half of 2019, economic activity in the KR will moderate in the second half. We expect the Kumtor mine to produce 33.4% less gold in the second half of 2019 than a year before, which will be reflected in a slowdown of GDP growth. In the following

years, the mine's output is expected to gradually decline. Given Kumtor's significance for the economy, its performance will be a key factor in determining the country's GDP growth.

Sustained positive rates of growth in the main trade partner countries will support growth in the medium term via the remittance and export revenue channels. The decrease of remittances from Russia, resulting from the 100 thousand rubles' limit on the dispatch of money to the KR imposed by the Bank of Russia, is expected to be short-lived. Foreign currency inflow to the KR from labor migrants working in Russia will recover in the medium term as alternative ways of remitting cash are mastered.

Figure 13.
Real GDP³
*(period's growth rate,
year-on-year)*



Note: seasonally adjusted data.

Source: calculations by the authors, EEC

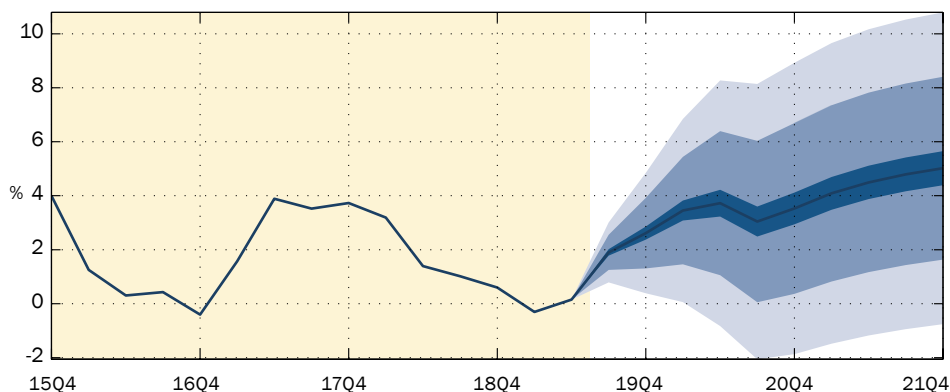
Inflation to Reach Bottom of Target range in Early 2020

According to EDB projections, in the medium term inflation will continue to approach the KR National Bank's target range. A brisker rise in grain prices is expected as cereals imported from Kazakhstan appreciate after a lower harvest in 2019. The appreciation of meat prices amid the spread of swine fever in China and the rise of excises in early 2020 and 2021 under the EAEU's mid-term plan to harmonize their tobacco excise policies will contribute to inflation. We expect the increase in customs tariffs on imports of personal vehicles from 1 January 2020 as part of the unification of the KR tariff policy with the EAEU Customs Code to have a limited effect on the consumer price index in the KR.

Inflation will be held back by cheaper oil and a weak inflation background in the trade partner countries. No shocks that might accelerate domestic price growth are expected from the foreign exchange channel, either.

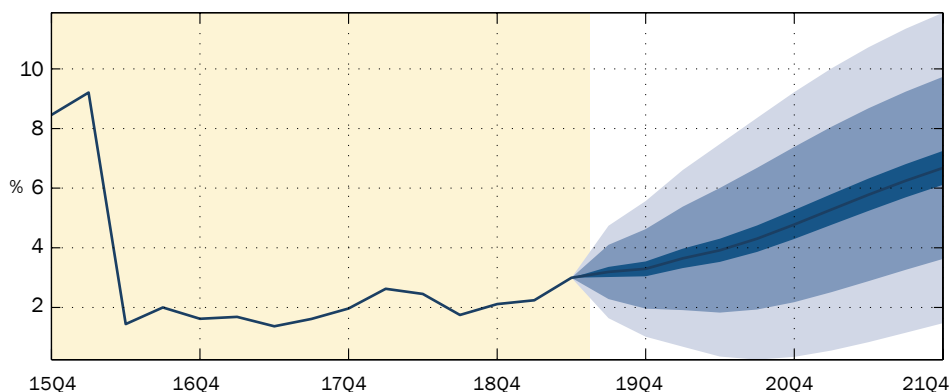
³ Here and elsewhere the chart ranges correspond to the 10%, 50% and 75% confidence intervals.

Figure 14.
Inflation
(last month in quarter vs. last month of same quarter a year before)



Note: seasonally adjusted data.
Source: calculations by the authors, EEC

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



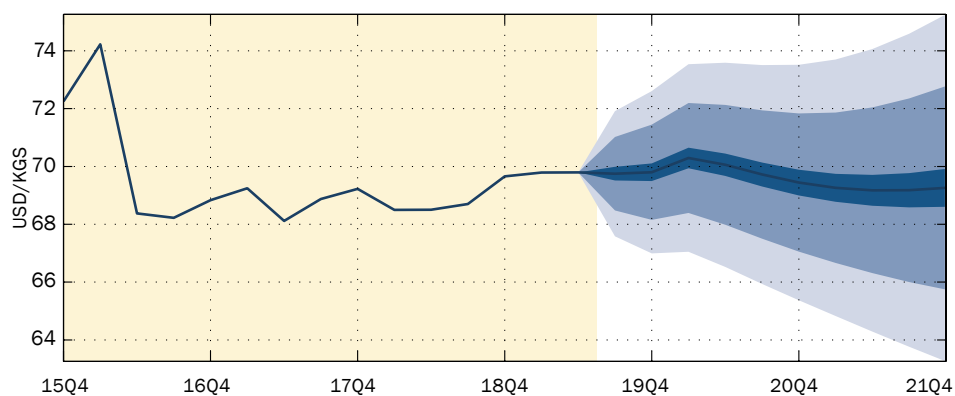
Source: calculations by the authors, EEC

Exchange Rate to Be Stable

In the projection period, the National Bank is expected to keep to its foreign 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 69–70 KGS per USD range.

With an excess of liquidity existing in the banking system and the National Bank’s interest rate policy remaining the same, the 7-day interbank REPO rates will remain in the lower segment of the interest rate band over 2019. The interbank loan rates are expected to rise as inflation approaches the target in the medium term.

Figure 16.
Nominal Kyrgyz
Som to U. S. Dollar
Exchange Rate
(KGS per USD)



Source: calculations by the authors, EEC

Table 2. Main Macroeconomic Indicators of the Kyrgyz Republic

	2016	2017	2018	2019P	2020P	2021P
Consumer price index <i>(% growth December to previous year's December)</i>	-0.5	3.7	0.5	2.6	3.5	5.9
GDP in constant prices (% growth YoY)	4.3	4.6	3.5	4.0	3.6	3.1
Interbank repo rate 7d <i>(the year's average % per annum)</i>	3.7	1.7	2.2	2.9	4.2	6.0
Nominal Kyrgyz Som to U. S. Dollar exchange rate, KGS per USD <i>(the year's average)</i>	69.9	68.9	68.8	69.8	69.9	69.9

Note: P = Projected

Source: calculations by the authors, EEC



Eurasian Development Bank

**RESEARCH DEPARTMENT,
EURASIAN DEVELOPMENT BANK**

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

