

Kyrgyz Republic

The “Tulip Revolution” affected the country’s economic performance during the year significantly, such that several key macroeconomic variables deteriorated from their recent trends. This was mainly due to disruption in economic activity and political uncertainty, and a fall in gold production (gold remains a significant contributor to the economy). The new Government did, though, manage to maintain macroeconomic stability, and declared its commitment to addressing the three main challenges of low living standards, unemployment, and widespread corruption.

Economic performance

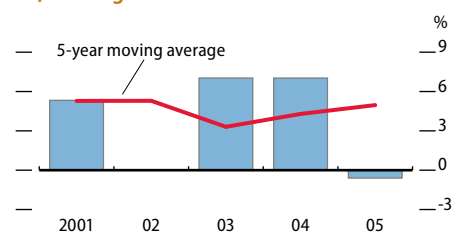
Following the fall of the previous administration and the “Tulip Revolution” of March 2005, the new Government juggled with various crises, which included redistribution of property in a chaotic and at times violent manner as various interest groups, including criminal elements, scrambled for the country’s assets. The Government’s major policy objectives are to improve living standards, reduce unemployment, and root out widespread corruption. It faces serious obstacles in implementing its economic program, partly reflecting internal policy differences.

The unrest and subsequent disruption to economic activity, together with a 24% decline in gold production, caused gross domestic product (GDP) to fall by 0.6%, well below recent trends (Figure 2.4.1). The economy continued to depend on the fortunes of the Kumtor gold mine, which is close to being worked out. The mine’s production accounted for about 6.2% of GDP and 38.5% of industrial output in 2005.

Agriculture, accounting for about half of the country’s GDP, contracted by 4.2%, mainly because of a delayed start to the harvest season, some land disputes, and disagreements over prices between farmers and wholesale purchasers of agricultural crops. The decline in industry and the poor performance of agriculture were partly offset by the activities of small-scale enterprises and services (Figure 2.4.2). Textile and clothing production continued to grow, stimulated by earlier measures to legalize small-scale enterprise activities, including the introduction of a compound tax (called the “patent system”) on small businesses, and by efforts to bring services out of the shadow economy. Growth in construction slowed to 2.1% from 5.4% in 2004. Although the yearly data on the demand-side contributors to GDP are preliminary estimates, it appears that private consumption constituted the main source of demand in 2005.

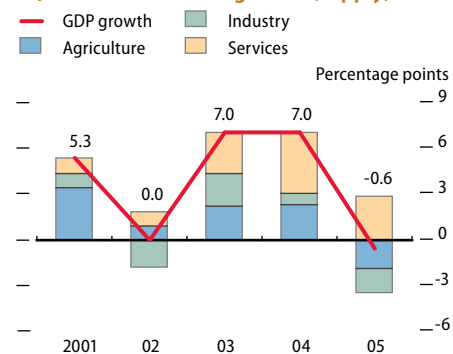
As a result of a continued tight monetary policy, the annual average inflation rate as measured by the consumer price index during the year was 4.4%, slightly below recent trends (Figure 2.4.3). Inflationary pressures stemmed from supply disruptions in the aftermath of the political upheavals, an increase in domestic oil prices, and a delayed harvest.

2.4.1 GDP growth



Sources: National Statistical Committee of Kyrgyz Republic; National Bank of Kyrgyz Republic, available: http://www.nbkr.kg/eu/IR2005Q4_E.pdf, downloaded 18 March 2006.

2.4.2 Contributions to growth (supply)



Source: National Statistical Committee of Kyrgyz Republic.

Despite the predominance of cash transactions, growth of broad money (M2x) decelerated to about 10% in 2005, or much less than recently experienced (Figure 2.4.4), mainly because of decreased economic activity. The level of financial intermediation is still low, though public confidence in the banking sector has improved somewhat in recent years, in part due to the entry of foreign banks, which now own more than half of the country's banking assets.

The fiscal situation remained healthy, and the Government met all International Monetary Fund (IMF) benchmarks, even with increased government expenditure on wages, which grew by about 12% in nominal terms during the year. The Government clearly attaches importance to maintaining IMF targets, mainly because of its reliance on multilateral funding. IMF favorably reviewed the progress being made under the second 3-year Poverty Reduction and Growth Facility arrangement, signed in February 2005.

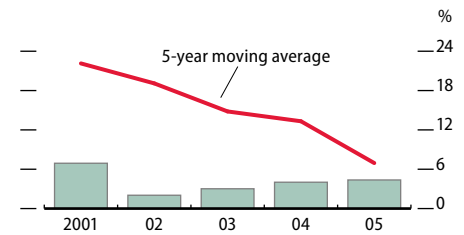
Better tax administration and measures taken to widen the tax base strengthened revenue growth. The fiscal deficit amounted to 4.2% of GDP, slightly above the 4.0% budget target (Figure 2.4.5), and is still financed exclusively by external assistance. The authorities face the challenge of maintaining a balance between meeting the IMF fiscal targets and providing a minimum level of services, such as public health care, education, transport, and utilities.

The external debt burden is large but receding. Total external debt at end-2005 was slightly less than \$2 billion, or 81% of GDP, representing a substantial fall from recent levels. The bulk of external debt (about 94%) is public, and hence the debt situation is an important determinant of fiscal sustainability. A Paris Club agreement in March 2005 improved the prospects for achieving external debt sustainability over the medium term (Box 2.4.1). Currently, the Government is considering use of the Heavily Indebted Poor Countries debt restructuring initiative, under which participating countries may obtain a significant reduction in their external debt.

The current account posted a deficit of \$197 million, equivalent to about 8.1% of GDP (Figure 2.4.6). The trade gap widened to \$435 million during the year, reflecting a significant (40%) decline in gold exports and increases in imports largely due to high oil prices (Figure 2.4.7). The continuing growth of remittances was partly offsetting. (Estimates of the number of people working abroad and annual remittances vary widely, in the ranges of 0.5 million–1 million and \$200 million–\$600 million, respectively.) Gross international reserves remained at a comfortable level of about 4 months of imports. Thanks to monetary prudence, the som remained relatively stable with the nominal exchange rate appreciating slightly by 0.7%, to Som41.3/\$1 at end-2005.

The new Government, despite being fully constituted only in the third quarter of 2005, maintained some reforms, most notably in the area of public expenditure management. These included efforts directed at fiscal decentralization, tax administration, enforcement of the customs code, and preparation of a new tax code that aims to broaden the tax base and lower various taxes to promote entrepreneurship. Overall, however, the budget formulation process has yet to fulfill its role as a tool for effective public service delivery and for efficient resource allocation.

2.4.3 Inflation

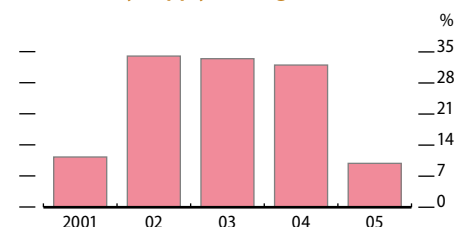


Source: National Statistical Committee of Kyrgyz Republic.

2.4.1 Paris Club debt relief

Following a first round of debt relief on concessional terms in 2002, the Paris Club creditors granted a second round in March 2005. This was based on the “Evian approach,” i.e., writing off 50% of commercial debt and rescheduling the balance over 23 years with a 7-year grace period. The repayment of official development assistance debt has been rescheduled over 40 years with a 13-year grace period. The agreement is expected to provide total cash relief of about \$198 million in 2005–2008. The International Monetary Fund's projections suggest that the agreement will result in the reduction of 36% of the official bilateral debt in net present value terms. In 2005, the Government completed bilateral negotiations with all Paris Club creditors, except Turkey where an agreement was reached in March 2006, and signed debt relief agreements with Japan and the Russian Federation.

2.4.4 Money supply (M2x) growth



Source: National Bank of Kyrgyz Republic, available: http://www.nbkr.kg/web/interfeis.builder_frame?language=ENG, downloaded 14 March 2006.

The political uncertainties and the transitional challenges prevented the new Government from focusing on some crucial reforms to improve growth prospects, such as diversifying the economy away from gold production; improving governance, clarity in property rights, and the regulatory framework; ensuring a favorable climate for private sector development; and carrying out major sector reforms.

Indeed, there are some examples of reforms being undone. In energy, for example, with the dissolution of the State Energy Agency, the sector currently has no government body responsible for policy, strategy, or regulation. In agriculture, the Government issued a decree assigning a state enterprise to undertake procurement, processing, and marketing of agricultural produce. Privatization has made no significant headway, except for preparatory activities for the Kyrgyz Agriculture and Finance Corporation, which should be taken private late this year.

Economic outlook

The following discussion on the outlook and the baseline assumptions takes, as its starting point, government data and sources, information received from meetings with the Government and international organizations, and forecasts for the economy used in the Poverty Reduction and Growth Facility to which the Government and IMF agreed.

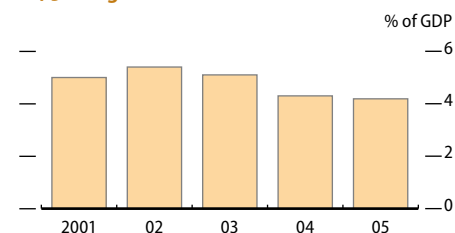
The assumptions used for the short- and medium-term economic outlook for the country are that: the political situation stabilizes through effective constitutional reforms to restore the power balance between the executive, judicial, and legislative branches of government; law and order improve; the Government continues to demonstrate its commitment to announced economic policy goals and reforms; the depletion of Kumtor gold mine is partly counterbalanced by the commissioning of two new gold mines (Jerui and Taldy-Bulak); the world price of gold does not decline; growth stays strong in Kazakhstan and the Russian Federation; and cooperation with the People's Republic of China continues, with planned large regional infrastructure projects going ahead.

Prospects for 2006 and 2007

In his recent speeches, the country's president has instructed the Government to target real GDP growth of 8% in 2006, mainly through reactivation of old factories and increased production at existing ones. Even if the above assumptions hold, it is not clear that investor interest and financing will be available in the amounts needed to ensure the old factories' competitiveness.

Based on a review of the Poverty Reduction and Growth Facility arrangement in November 2005, the Government's economic program forecasts GDP growth of 5.0% in 2006 and 5.5% in 2007. It targets average inflation of 4.5% and 4.3%, and a fiscal deficit (excluding grants) of 2.9% and 2.6%, in 2006 and 2007, respectively. With full implementation of the program's economic policies, these macroeconomic objectives are within reach.

2.4.5 Budget deficit



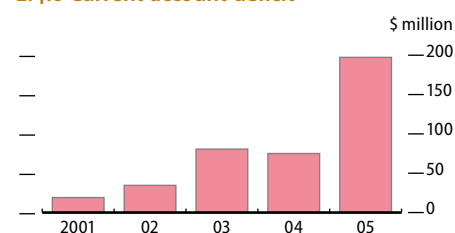
Source: National Statistical Committee of Kyrgyz Republic.

2.4.1 Selected economic indicators

	2006	2007
GDP growth	5.0	5.5
Inflation	4.5	4.3
Current account balance (% of GDP)	-4.7	-4.0

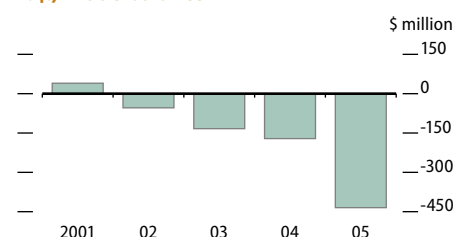
Sources: Government and International Monetary Fund estimates.

2.4.6 Current account deficit



Source: National Bank of Kyrgyz Republic.

2.4.7 Trade balance



Source: National Bank of Kyrgyz Republic.

Medium-term outlook

The Government has initiated the preparation of the National Poverty Reduction Strategy for 2006–2010, for which international financial institutions pledged coordinated assistance. This coordinated assistance is part of the overall harmonization of activities by international donors in the country. Given the Government's ownership and commitment to the strategy, its timely preparation, including its linkage with the budgetary process, and maintenance of the country baseline assumptions, achieving the strategy's medium-term objectives for the economy appear solid.

A preliminary assessment by international financial institutions for the medium term suggests that the economy will grow at an average of 5.5%. If the country baseline assumptions hold and structural reforms continue, domestic private and foreign direct investment are projected to increase, respectively, to over 19% and 2.5% of GDP in the medium term.

Government efforts to pursue prudent monetary and fiscal policies are expected, in the medium term, to keep inflation at about 4% and the fiscal deficit below 4% of GDP. Improving revenue mobilization will be a major task for addressing increasing priority social and infrastructure maintenance expenditures. Therefore, the Government should continue reforms for eliminating deficiencies in tax and customs administration, especially in the areas of goods subject to excise duty, value-added tax, and personal income, profit, and property taxes. Despite some opposition, the Government is expected to push ahead with power sector reforms, which should result in lower quasi-fiscal deficits and financial sustainability of the sector. Efforts to expand regional trade will be continued (Box 2.4.2).

Given the favorable external environment, trade flows are forecast to increase at rates higher than GDP, with average non-gold export and import growth of 8.4% and 7.3%, respectively, over 2006–2010. These will help maintain the current account deficit at about 4% of GDP over the medium term. If the business climate improves significantly, the share of foreign direct investment inflows will increase as a source of financing. International reserves will be kept at around 4 months of imports in the medium term.

Poverty reduction will remain an important challenge for the Government. Although poverty is declining, it remains a major problem in rural areas, where some three quarters of the country's poor live.

The risks of continuing political instability remain, stemming from preparations for a referendum on constitutional reform (scheduled for late 2006); the associated debates on, and possibly the actual redistribution of power between, the different branches of government and possibly between the north-south centers of power; the deteriorating law-and-order situation; and the continuing redistribution of state assets. Significantly, the unsettled political situation has diverted the Government's attention to urgent, short-term goals related to maintaining its power, and away from strategic, long-term issues.

2.4.2 Removing behind-the-border barriers

The Kyrgyz Republic was the first in Central Asia to join the World Trade Organization, in 1998, and it enjoys one of the most liberal trade regimes in the region. With no significant nontariff barriers (except those required for regulatory and public health and safety purposes), the Trade Restrictiveness Index of the International Monetary Fund places the country in the most open category. However, trade is restricted by unfavorable trade and transit regimes in the region, including physical and nonphysical barriers.

Trade with immediate neighbors and transit facilitation are vital for the country because of its relatively small economy, landlocked nature, and long distances from large potential markets. About 40% of goods are exported to the People's Republic of China, Kazakhstan, Russian Federation, and Uzbekistan. It is estimated that over the medium term the economy has significant potential to expand exports by reducing nonphysical barriers related to trade and transit. These issues also cloud the investment climate. Unfortunately, the multilateral and bilateral agreements on transit and customs that the country has signed have been largely ineffective, and so regional bodies need to defend nondiscriminatory transit. The trade and transit agenda for the subregion should stress organizational, institutional, and technical rationalization aspects allowing for better use of available infrastructure. The Government is encouraging its neighbors to allow free transit through their accession negotiations to the World Trade Organization.