

Kyrgyz Republic

The economy has faced significant external and domestic shocks in the last year, including high food and energy prices, power shortages, natural disasters, and downturns in the economies of Kazakhstan and the Russian Federation. As a result, economic growth decelerated. Continued prudence in macroeconomic management will be critical for addressing macroeconomic imbalances in the near term. Structural reforms, including in the energy sector, are needed to support growth over the medium term.

Economic performance

From the third quarter of 2007, the small, open Kyrgyz economy has faced significant shocks, including global inflation of food commodities and oil products, a sharp widening of the current account deficit (the country is a net fuel and food importer), severe power shortages, an earthquake, and the spillover effects of an economic slowdown in Kazakhstan and the Russian Federation (with which it has extensive trade and financial links). High inflation is reversing gains made in poverty reduction. In response, the country became one of the first to access the new International Monetary Fund Exogenous Shocks Facility. A recovery in gold production helped maintain respectable growth of 7.6% in 2008 but growth will slow markedly to 4.0% in 2009 as the full impact of the shocks plays out.

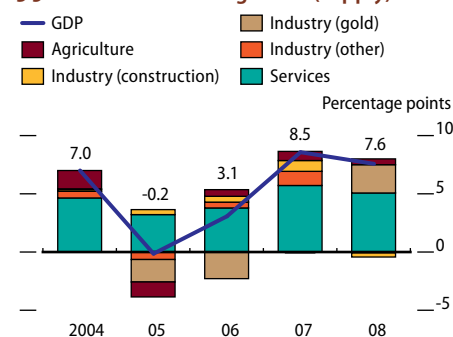
Economic growth was driven by expansion of the services sector and by gold production, with a recovery in production at the Kumtor gold mine from earlier accidents (Figure 3.5.1). (Excluding gold, the economy grew by 5.4%, well below the prior-year 9.0% rate.) A striking difference from previous years was a 10.8% contraction in construction, which had grown at double-digit rates after 2005. This had follow-on effects in supporting industries, such as glass and cement. A 20% drop in hydropower generation (Box 3.5.1) was deleterious for all economic activity and led to a 2% decline in industrial production (excluding gold).

Services growth slowed to 10.7% in response to the weakening economy but continued to make the largest sector contribution to growth. Agriculture, which suffers from low productivity, expanded by only 0.7%.

From the second half of 2007, inflation accelerated sharply: the overall consumer price index was up 20.1% year on year in December 2007, and climbed further to a peak of 32.4% in July 2008 (Figure 3.5.2). Food prices, particularly for bread and cereals, have a heavy weight in the index, and were the dominant factor in the price spike, which reflected mainly the sharp run-up in global wheat prices and the country's heavy dependence on imports.

After July, inflation subsided to 20.0% year on year by end-December 2008. In this period food inflation came down, benefiting from a

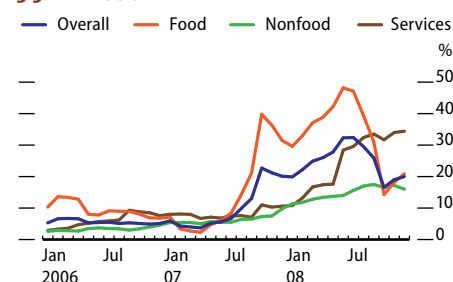
3.5.1 Contributions to growth (supply)



Sources: National Statistics Committee of the Kyrgyz Republic; National Bank of the Kyrgyz Republic, available: <http://www.nbkr.kg>, downloaded 3 March 2009.

[Click here for figure data](#)

3.5.2 Inflation



Sources: National Statistics Committee of the Kyrgyz Republic; National Bank of the Kyrgyz Republic, available: <http://www.nbkr.kg>, downloaded 3 March 2009.

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3.5.1 Energy shortages

Last year saw electricity generation and exports tumble by about 20% and 75%, respectively. The cause was a very low water level in Toktogul reservoir, which provides about 90% of national power output. The level had fallen to an unprecedented 7 billion cubic meters because of a severe winter in 2007 that led to greater demand for electricity. About 13 billion cubic meters is necessary for winter needs.

Structurally, the main reasons for the energy shortage are overdependence of the economy on hydropower and the chronic lack of investment in basic energy infrastructure. These are largely explained by an inappropriate pricing policy that imposes heavy financial losses on the sector. Management weaknesses also play a part, as does the lack of coordination in—and friction stemming from—regional energy and water use among the Central Asian republics.

The Government has adopted emergency measures to

save water at Toktogul dam, including significant limits on electricity consumption, cuts in electricity exports, a ban on electrical heating systems in private homes, and a prolongation of the winter secondary-school holiday in the regions. Heating and electricity tariffs have been increased, but are still way below cost-recovery levels.

The National Energy Program (adopted in 2008) allows for the privatization of some segments of the state-owned energy sector and private entry into new power generation.

The current energy insecurity in a potentially hydropower-rich nation highlights the need to accelerate structural reforms in energy—including institutional arrangements, tariffs, and financing—to attract private investment. If these energy shortages persist, serious consequences could ensue, not just for social welfare and economic growth but also for the country's fragile political stability.

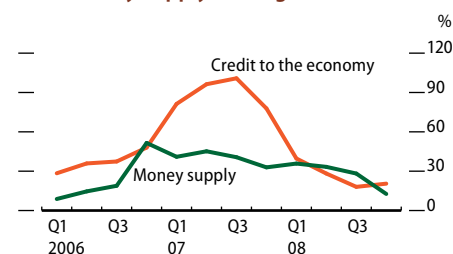
marked drop in global wheat prices; however, a pickup in the services index as the Government raised electricity tariffs limited the fall in overall inflation. For 2008 inflation averaged 24.5%, compared to 10.2% in 2007.

Monetary policy was tightened substantially in 2008 as reflected in the Treasury bill rate climbing to 20% by end-December from 5.7% a year earlier. Growth in the money supply was markedly reduced to 12.6% from 33.3% in 2007 (Figure 3.5.3). Expansion in credit to the economy fell even further, to 20.5% from 80.1% a year earlier. This slowdown resulted from a crimping in funding from head offices to Kazakh-owned banks in the country, which account for about half the banking system. While no outflow of funds is apparent, Kazakh parent banks continue to suffer from their own financial pressures and may not roll over funding to their subsidiaries when liabilities fall due this year.

The National Bank of the Kyrgyz Republic, the central bank, allows the exchange rate to adjust and intervenes only to smooth sharp movements. The som has depreciated by almost 12% against the United States dollar since August 2008, reflecting the dollar's appreciation internationally. Given the large import content of consumption, the central bank has supported the rate to limit inflation pressures by sales of foreign exchange, and official reserves fell by nearly 5% in the fourth quarter. The real effective exchange rate appreciated by 7.9% in 2008, as a result of higher inflation in the Kyrgyz Republic than in trading partner countries (Figure 3.5.4).

Fiscal performance in 2008 was relatively strong despite increased spending pressures for wages and energy. The budget deficit was contained at around 1.9% of GDP (or about 4.8% of GDP if grants are excluded) (Figure 3.5.5). This was due to better than expected revenue collections and cuts in nonpriority spending. The authorities increased assistance to the poor in October 2008 by raising the main targeted social

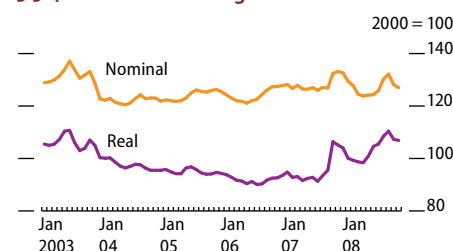
3.5.3 Money supply (M2x) growth



Sources: International Monetary Fund, *International Financial Statistics* online database; National Bank of the Kyrgyz Republic, available: <http://www.nbkr.kg>, downloaded 3 March 2009.

[Click here for figure data](#)

3.5.4 Effective exchange rates



Source: National Bank of the Kyrgyz Republic, *Balance of Payments of the Kyrgyz Republic* (various issues), available: <http://www.nbkr.kg>, downloaded 3 March 2009.

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benefit, from an average of \$3 per month per recipient to \$4. Donor grants covered this increase initially, and government resources will do so later.

Higher fuel and food import bills widened the current account deficit to an estimated 10.5% of GDP in 2008 (Figure 3.5.6); their net annual import cost is estimated to have risen by almost \$300 million in 2008. Exports recorded robust growth of about 39.0%, driven by gold and other items such as textiles, mineral products, and precious and semiprecious stones. Imports grew by about 38.4%, but from a larger base, expanding the trade deficit by nearly \$500 million. Remittances as a share of GDP stayed at around 25%, representing an increase of about one fifth compared to the previous year.

Foreign direct investment flows were largely unchanged in 2008, though other capital and financial flows accelerated to finance the larger current account deficit and provided for an increase in reserves. Gross official reserves increased by \$48 million to about \$1.2 billion at end-December (Figure 3.5.7), equivalent to around 4 months of imports.

Good progress was made in the business environment, as seen in the country's much improved ranking in the *Doing Business 2009* report to 68, from 99. The Kyrgyz Republic improved investor perceptions by amending a law to allow minority investors to take legal action as shareholders. A one-stop shop was established to ease business registration. The Pledge Law and the Civil Code were amended to allow for out-of-court procedures to seize collateral. Finally, the Civil Code was amended to allow the sharing of borrower information with third parties, including credit bureaus.

In 2008, the Government further intensified efforts to reduce hindrances to open trade. It is also pressing ahead with public financial management reforms. A new law governing internal audits of government agencies and institutions establishes a framework for conducting audits in line with international best practice. In the financial sector, Parliament has approved a plan for privatizing Aiyl Bank, the largest nonbank financial institution, and introducing a deposit insurance scheme, which will come into effect next year.

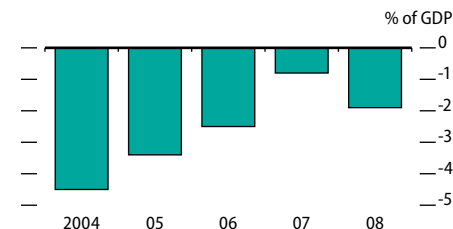
Structural reforms could be advanced further in other key areas such as energy, pensions, trade facilitation, customs administration, and property rights. In addition, rules-based governance is weak. Transparency International's 2008 Corruption Perceptions Index shows that corruption remains a challenge, too: the country's performance deteriorated from 2.1 in 2007 to 1.8 in 2008 (on a scale of 0 to 10).

Economic prospects

The global financial crisis and economic downturn, as mediated through the sharp deceleration of the economies of Kazakhstan and, especially, the Russian Federation, have hit this poor economy through a range of channels. Combined with weaker domestic demand, the effects are expected to slow GDP growth to 4.0% in 2009, with some pickup to 6.0% in 2010, provided that the global economy (including these two countries) recovers a little.

Although monetary policy aims to cut average consumer price inflation to single digits, given the need to support economic growth, it

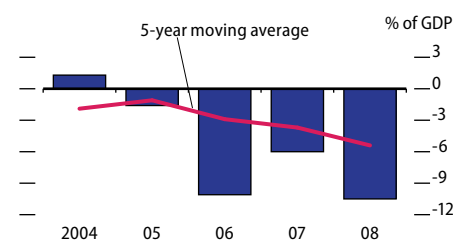
3.5.5 Budget balance



Source: International Monetary Fund, *Country Reports* (various issues), available <http://www.imf.org/external/country/KGZ/index.htm>.

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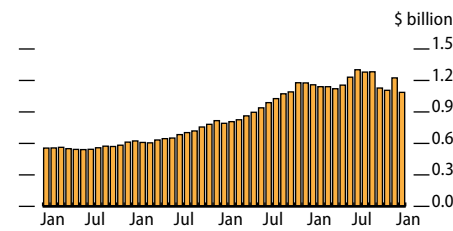
3.5.6 Current account balance



Sources: National Bank of the Kyrgyz Republic, *Balance of Payments of the Kyrgyz Republic* (various issues), available: www.nbkr.kg; International Monetary Fund, *Country Reports* (various issues), available: <http://www.imf.org/external/country/KGZ/index.htm>, both downloaded 4 March 2009.

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3.5.7 Gross international reserves



Source: National Bank of the Kyrgyz Republic, available: <http://www.nbkr.kg>, downloaded 4 March 2009.

[Click here for figure data](#)

is unlikely to be lower than 15.0% in 2009 and 12.0% in 2010. To foster macroeconomic stability, the central bank and the Ministry of Finance are reinforcing coordination, especially regarding domestic debt issuance and liquidity management.

With a large import element in the consumer basket, the authorities will use the exchange rate channel, to the extent possible, to deflate inflation pressures. They also aim to contain the overall budget deficit. They will make any needed spending cuts to offset the net revenue loss due to the introduction of a new tax code, which among other things lowered the value-added tax rate from 20% to 12%. They intend to make up that revenue loss by bringing in property and turnover taxes, which will replace the existing sales, road, and emergency taxes.

The current account deficit is projected to remain large in the period ahead at about 10.0% of GDP, as external demand weakens and remittance inflows slow due to adverse conditions in the country's main trading partners. The price of imported natural gas from Uzbekistan was increased early this year from \$145 per cubic meter to \$240, which will boost imports, though slower economic growth will provide something of an offset. Three agreements signed with the Russian Federation early this year will add to the financing already arranged elsewhere to cover the deficit.

A range of risks looms over the medium-term outlook, including a more severe than expected economic downturn in Kazakhstan and the Russian Federation, worsening infrastructure constraints (mainly power shortages), and vulnerability to natural disasters. Still-higher inflation plus deteriorating economic conditions may spur public discontent and protests.

Development challenges

In addition to the challenges from the global and regional downturns, the spike in global food prices in 2008 showed that food security is an issue for the country, as a net importer of food. Internally, the long-standing water-energy problem resulting from a lack of investment and poor management has further undermined the economy.

Perhaps the main issue currently facing the Government is to minimize the damage done by the global financial crisis and economic downturn, including job and income losses, and the erosion of the impressive poverty reduction of the past few years. This will not be easy, especially in light of considerable pressure on public financial resources in a weakening economy.

The Government recognizes that sustainable inclusive growth is not only key to raising people's living standards and poverty reduction, but also to building up the economy's resilience to external and internal shocks. It has recently reaffirmed its focus on long-term growth despite urgent short-term difficulties. In this respect, further structural reforms in the energy (and other) sectors, along with continued efforts to improve investment and the business environment, are essential.

3.5.1 Selected economic indicators (%)

	2009	2010
GDP growth	4.0	6.0
Inflation	15.0	12.0
Current account balance (share of GDP)	-10.0	-10.0

Source: Staff estimates.