

Kyrgyz Republic

Despite continuing political tensions, the economy grew strongly in 2007, driven by services, construction, and manufacturing. Inflation, particularly for food products, jumped in the second half of the year. The authorities resumed their efforts to improve the business environment and to attract foreign investment. Prudent macroeconomic management will be critical for continued rapid growth, especially in light of the economy's vulnerability to external shocks from commodity price swings and to economic developments in Kazakhstan and the Russian Federation.

Economic performance

The political situation has been volatile since the Tulip Revolution of March 2005, when protesters ousted the long-time leader and brought a new president to power. Since then, the president's stand-off with Parliament, packed with deputies from the former era, has fueled political instability: for example, the period since the revolution has seen four prime ministers. In the parliamentary elections of December 2007, the newly formed pro-presidential party, Ak Zhol, obtained a majority of seats. This may provide the Government with a base on which to advance economic reforms.

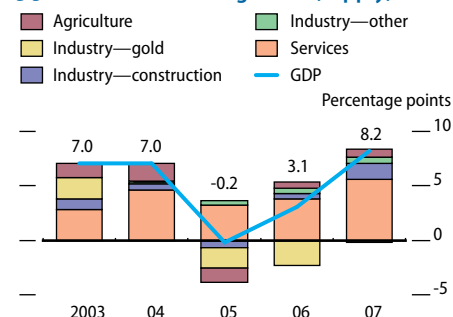
In the economic sphere, and for the first time since March 2005, the economy has resumed its dynamic growth. According to preliminary data from the National Statistics Committee, GDP grew by 8.2%, well above the recent trend (Figure 3.5.1). The strong performance is all the more encouraging because the Kumtor gold mine—the largest single contributor to GDP—has not fully recovered from an accident in 2006 and operational problems in 2007, which led to a marginal fall in output. Excluding gold, the economy grew by 8.7% in 2007.

The strong performance was driven by a 12.4% expansion in services, which contributed about two thirds of GDP growth. Buoyancy in the sector was due to gains in the trade subsector, as well as large gains for some of the smaller subsectors, especially communications. Industry (excluding gold) grew by 12.5%, contributing about one quarter of GDP growth and reflecting a marked 20.2% expansion in construction activity and gains in processing industries and utilities.

Agriculture, which suffers from weak productivity, continued to expand at a muted 1.5%. According to the National Statistics Committee's preliminary figures, the overall economy recorded more vibrant growth in the first half of the year (up 9.2% year on year), with a lower grain crop and, perhaps, higher producer prices affecting output in the second.

On the demand side, private consumption in 2007 continued to be the main engine of growth, invigorated by rising real incomes, including

3.5.1 Contributions to growth (supply)



Source: National Statistics Committee of the Kyrgyz Republic.

[Click here for figure data](#)

those from remittances (Box 3.5.1) and from the shadow economy, which is estimated at around 50–60% of official GDP. Although anecdotal evidence suggests a strong expansion in fixed investment (in roads as well as in mining, construction, and energy) and data show a healthy net inflow of foreign direct investment (FDI), the preliminary official data on fixed investment estimated growth to be only 3.7% for the year.

Inflation accelerated, notably in the second half (Figure 3.5.2). From an average of 4.0% over the last 5 years, it averaged 10.2% for the whole year, soaring to 20.1% at end-2007, the highest rate since 2000. October saw a 9% month-on-month increase in inflation.

For food products, particularly bread and cereals, the largest rise in prices was seen in October–November 2007. The continued decline in the area planted to grain (estimated at around 20% over the last 7 years), falling yields, together with unfavorable weather conditions in 2007, lowered domestic grain production, of which wheat production fell by 16%. The country imported approximately 360,000 tons of wheat in 2007 (the equivalent of nearly half domestic production), with most of that coming from Kazakhstan. As bread and other wheat-related products make up a large share of the consumption basket, the sharp rise in global wheat prices has boosted inflation. Other price increases were also important, notably for natural gas, with supplies from Uzbekistan almost doubling in price to \$100 per 1,000 cubic meters in 2007.

While external factors played the major role in high inflation, other elements such as the rapid growth in the country's monetary aggregates in recent years; wage increases of about 30%; and, possibly, escalating price expectations by producers late in the year, as well as agriculture's supply constraints, also had an impact.

With about 40% of the population living below the poverty line, and bread accounting for about a third of spending on food, the rising prices of wheat hit hard the population's poorer groups. The authorities have responded with a combination of administrative and economic policy measures under the direction of a newly established Food Security Council, chaired by the prime minister. They released wheat from strategic reserves, cut value-added tax for producers and importers of food products from 20% to 10%, and tightened monetary policy. They plan to develop a food security strategy that envisages stockpiling grain reserves of 100,000–150,000 tons, protecting the most vulnerable groups of the population, improving the provision of agricultural inputs, and enhancing the incentive structure for farmers.

The more buoyant economic activity of recent years and large foreign exchange inflows—especially in the form of remittances and foreign capital or due to tourism—led the National Bank of the Kyrgyz Republic (NBKR), the central bank, to ratchet up its purchases of foreign exchange in order to limit the nominal appreciation of the som. Since these operations were mostly unsterilized, broad money (M2) increased by an average of 30% annually from 2002 to 2006, recording 52% growth in 2006 (Figure 3.5.3). (However, as M2 was only about 15% of GDP in 2002, some of the rapid growth reflects the economy's monetization.)

Concerned with inflation pressure in the second half of the year, the monetary authorities sharply reduced their interventions in late 2007, allowing a notable nominal appreciation of the som against the United

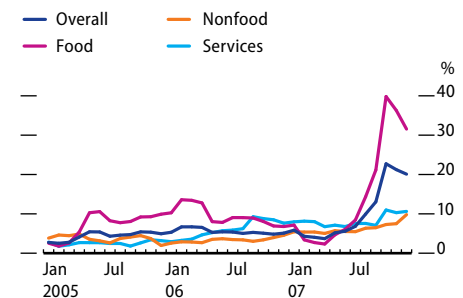
3.5.1 Remittances

Preliminary findings of a recent study on remittances by the Asian Development Bank in the region suggest the need for further refining the country's balance-of-payments (BOP) remittance calculation methodology and its BOP data.

It is estimated that around 16% of households received remittances in 2006, at an average of \$1,331. Remittance inflows in 2006 were estimated at \$615 million (22% of GDP); official estimates put the total at \$730 million. This may suggest that transactions of different natures (such as revenues from exports of goods and services, and trade credits) are being counted as remittances in the BOP accounts.

Remittances were found to be important for the welfare of households, lifting many of them out of poverty, and generally having a positive impact on personal consumption, imports, and informal employment.

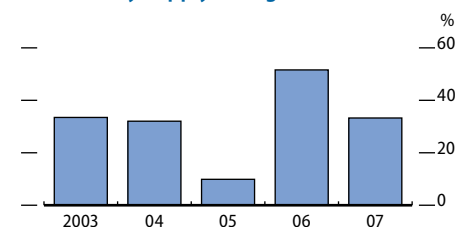
3.5.2 Inflation



Sources: National Statistics Committee of the Kyrgyz Republic; National Bank of the Kyrgyz Republic, available: <http://www.nbkr.kg>, downloaded 3 March 2008.

[Click here for figure data](#)

3.5.3 Money supply (M2) growth



Source: National Bank of the Kyrgyz Republic, available: <http://www.nbkr.kg>, downloaded 3 March 2008.

[Click here for figure data](#)

States dollar—by about 9% between September and November—with some retracement in the rate by January 2008 (Figure 3.5.4). NBKR's preliminary estimates put broad money growth for the year at 33%, and net purchases of foreign exchange at \$240 million, taking the level of international reserves beyond the \$1 billion mark (Figure 3.5.5).

In addition to changes in foreign exchange operations, NBKR almost tripled its policy discount rate (from 4.0% in August to 11.5% in October), and aggressively increased issuance of NBKR notes to reduce commercial banks' excess reserves. Banks recorded a slight slowing in credit growth after September, though this may also be attributable to a credit crunch experienced by the Kazakh parent banks of local subsidiaries, which account for about half of all outstanding loans in the domestic banking system.

According to preliminary data, the fiscal deficit was 2.2% of GDP in 2007, or about 1 percentage point below the originally planned target (Figure 3.5.6). This performance is mainly the result of underspending in the first half of the year, emanating from, on the one hand, delays in budgetary approval and, on the other, better than expected growth in budget receipts, itself mainly due to higher import duties, stronger value-added tax receipts, and some improvement in revenue administration.

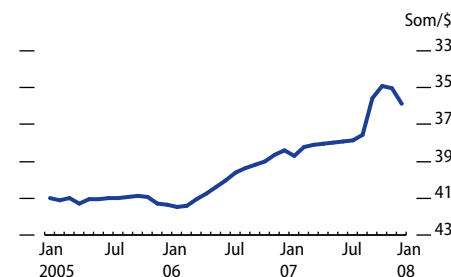
The strong revenues allowed for additional fiscal expenditures to finance construction activities for the Shanghai Cooperation Organization Summit held in August 2007; the cost imposed by a March 2007 bill on the lowering of the retirement age; policy measures aimed at tackling the inflation pressure in the second half, such as emergency grain imports and a 10% increase in pensions and selected welfare benefits from October 2007; and early costs associated with construction of the Kambarata-2 hydropower project.

After much debate across the country, the Government decided in early 2007 to withdraw its decision to take part in the Heavily Indebted Poor Countries Initiative led by the International Monetary Fund (IMF) and the World Bank. Since then, it has updated the medium-term public debt management strategy for 2007–2010, which continues the 45% minimum grant element required on any new public borrowing and aims to strengthen supervision of public enterprises' external borrowing. Due to a combination of rapid output growth, the som's strengthening, and prudent debt management, the external public debt burden fell from over 100% of GDP in 2003 to around 60% in 2007 (Figure 3.5.7). The latest country debt-sustainability analysis, undertaken jointly by IMF and the World Bank in November 2007, lowered the country's risk of debt distress from high to moderate.

The country continues to run a trade deficit, estimated at \$1.6 billion in 2007, despite rapid export growth (up by about 41%, driven by mineral products and other non-gold items). Strong demand for imported consumer and investment goods, as well as higher import prices (for gas, oil, and food products in particular), propelled an estimated 52% import growth. Figures 3.5.8 and 3.5.9 show the composition of exports and imports.

Although the expanding trade gap was partly offset by the rise in workers' remittances from abroad, estimated to have increased to \$800 million, the current account deficit widened to \$600 million or 16%

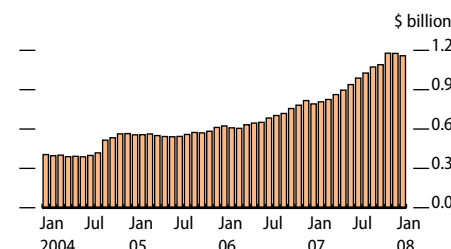
3.5.4 Nominal exchange rate



Sources: International Monetary Fund, *International Financial Statistics* online database; National Bank of the Kyrgyz Republic, available: <http://www.nbkr.kg>; both downloaded 4 March 2008.

[Click here for figure data](#)

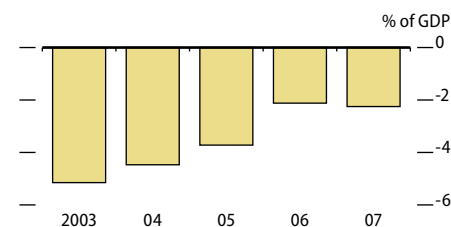
3.5.5 Gross international reserves



Source: National Bank of the Kyrgyz Republic, available: <http://www.nbkr.kg>, downloaded 4 March 2008.

[Click here for figure data](#)

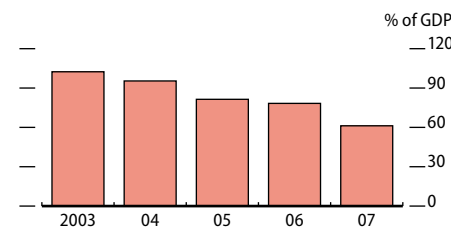
3.5.6 Fiscal balance



Source: National Statistics Committee of the Kyrgyz Republic.

[Click here for figure data](#)

3.5.7 External debt



Source: National Statistics Committee of the Kyrgyz Republic.

[Click here for figure data](#)

of GDP, according to preliminary estimates (Figure 3.5.10). The number, however, is being revised to account for the informal sector's reexport trade in consumer goods.

Estimates for the capital and financial accounts showed robust growth in FDI inflows, which amounted to more than \$480 million, much from Kazakhstan, with investments going primarily into finance and manufacturing. Together with other recorded inflows and private short-term flows (reflected in the sizable, positive errors and omission rubric), the overall balance of payments was comfortably in surplus, with international reserves rising.

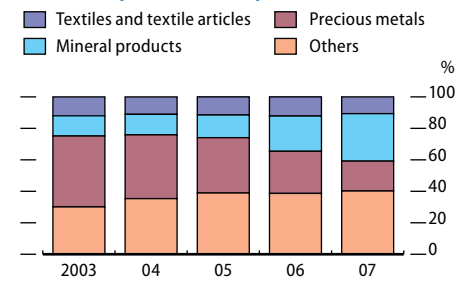
Although the authorities were preoccupied with political issues and with addressing the inflationary surge, some progress was noted in implementing sector and structural reforms. The Government has adopted a strategy for 2007–2010 to facilitate private sector-led growth and diversify the economy. It has also created a high-level investment council that promotes private sector development by facilitating dialogue among government agencies, private sector participants, and the donor community. Laws on streamlining inspections and on a regulatory framework for business activity were also adopted. In addition, Parliament passed legislation allowing the privatization of key assets of the Kyrgyz energy sector. In the financial sector, the privatization strategy for the Aiyl Bank was approved by the Government, and submitted to Parliament. However, the new tax code is still awaiting approval by Parliament, and action needs to be taken on the large quasi-fiscal deficit in the important energy sector to enhance its efficiency.

Despite the above efforts, the implementation gap in adopting structural reforms remains a serious issue, as evidenced by the country's low scores on transparency, governance, and other indicators related to the business environment. The country's ranking in *Doing Business 2008* worsened by six places, from 88 to 94 out of 178 countries and areas. Transparency International's *Corruption Perceptions Index 2007* ranked the country 150 out of 180 (a worsening from 142 out of 163 the previous year). The continuing uncertainty with the revision of the terms of the agreement with the Cameco Corporation of Canada, the country's leading foreign investor, and ambiguities surrounding other agreements in mining, industry, and tourism, will not help the business climate.

Economic prospects

Apart from the impact of world prices on its major imports, the Kyrgyz Republic has so far been little affected by adverse global economic developments. However, the world and the region have entered a challenging period, where growth forecasts are being revised downward for major economies, oil prices are at record highs, food and raw material prices are escalating, and major financial markets appear mired in difficulty. For this small open economy, economic developments in its large regional partners, such as Kazakhstan and the Russian Federation, become of particular importance, and are a potential source of risks. The adverse effects would be felt through weaker exports, slower capital inflows and investment activity, and potentially lower employment opportunities for Kyrgyz workers (Box 3.5.2) and weaker remittance inflows.

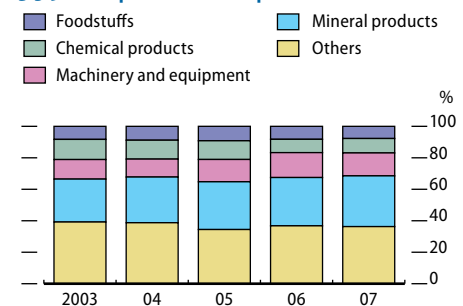
3.5.8 Composition of exports



Sources: National Statistics Committee of the Kyrgyz Republic; staff estimates.

[Click here for figure data](#)

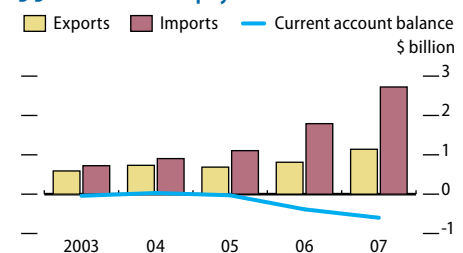
3.5.9 Composition of imports



Sources: National Statistics Committee of the Kyrgyz Republic; staff estimates.

[Click here for figure data](#)

3.5.10 Balance-of-payment indicators



Sources: National Bank of the Kyrgyz Republic, available: <http://www.nbkr.kg>, downloaded 3 March 2008; staff estimates.

[Click here for figure data](#)

Three years after the Tulip Revolution, the country is still vulnerable to political instability. However, the current Government has a “window of stability” because of its control of Parliament and because the public has grown weary of protests in any form. The challenge for policy makers is to use this period for uniting the various factions and to prevent vested interests from derailing the reform agenda.

The Government is fully aware of the problems it faces. For the forecast period, it envisages various scenarios (baseline, optimistic, and pessimistic) depending on global and regional conditions and domestic developments. Assuming no major political disruptions, sustained regional economic growth, and continued high world gold prices, the baseline forecasts adopted here are attainable. In domestic economic policy, keeping inflation in check through adequate monetary and fiscal policy action, but without undermining growth prospects, is a major concern. In this respect, strengthening central bank independence is important.

Development challenges

Improving the business and investment environment is perhaps the most crucial task for invigorating private investment, attracting FDI, and ensuring solid economic growth. With a less fortunate natural resource endowment and a smaller market than those of its neighbors, the Kyrgyz Republic needs not only to continue developing highly educated and professional human resources. It also needs to have an investment climate that is superior to that of its neighbors, in order to be able to compete for FDI flows into Central Asia. To achieve this, and to create foundations for the economy’s diversification, the following minimal list is suggested: transparent conduct of privatization, strict enforcement of contracts, effective and efficient public services and administration, and improvements in economic policy making and management.

The authorities face demanding times ahead, and a prudent policy response to the potential deterioration of external conditions will be critical for sustaining economic growth.

3.5.1 Selected economic indicators

	2008	2009
GDP growth	7.6	7.6
Inflation	12.0	10.0
Current account balance (% of GDP)	-14.6	-17.0

Source: Government of the Kyrgyz Republic.

3.5.2 Unemployment

According to the National Statistics Committee, unemployment was stable at around 8% in 2006 (the last full year for which data are available). However, the true level of unemployment is higher, given that official statistics regard all people with a piece of land as “employed.” In reality, people formerly working on large collective farms in the Soviet regime were left unemployed after the collapse of the Soviet Union.

Agricultural activities have not been able to feed the growing rural population, which constitutes two thirds of the total. Many employed people work in the country’s sizable informal sector. Absence of jobs in rural areas has led to mass migration of mainly young people to urban areas, and, increasingly, abroad.