Kyrgyz Republic

Nearly 2 years after the Tulip Revolution, political stability remains elusive. Although the new Government made real efforts to maintain macroeconomic stability, tensions between the different power centers have distracted the authorities and hampered structural reforms, including the passage of key economic legislation. In addition, an accident at the Kumtor gold mine, the largest industrial contributor, has slowed growth. The medium-term outlook, though positive, is clouded by governance concerns, a poor business climate, and political uncertainty.

Economic performance

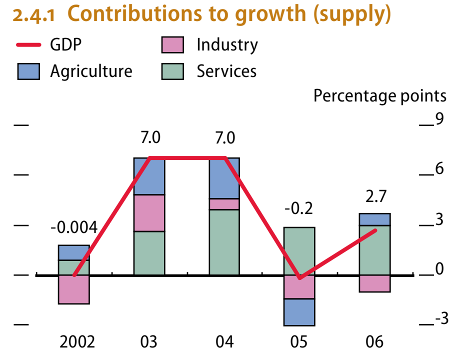
One of the least geographically accessible, and least endowed, countries in Central Asia, the Kyrgyz Republic faces challenging conditions. This partly explains its inadequate physical infrastructure. Recently it has also been buffeted by political turbulence, and almost 2 years after the Tulip Revolution of 2005, political stability has yet to be achieved, which is undermining economic development. A high level of political activity marked 2006, including major protests, government resignation, and two changes of the constitution.

Despite the challenging political environment, the Government managed to maintain macroeconomic stability and keep the Poverty Reduction and Growth Facility (PRGF) program with the International Monetary Fund (IMF) on track. Yet an accident (much less serious than the previous year's) in July at Kumtor—the country's largest gold mine and accounting for about one third of industrial output and 5% of GDP—resulted in gold output falling by about a third, to about 9 tons. This slowed economic growth to 2.7% (Figure 2.4.1), well below the authorities' earlier forecasts of 5–8%. Excluding gold production, GDP grew by about 5%.

On the demand side, private consumption continued to be the driving force of growth, financed by higher incomes (a significant amount of which comes from the shadow economy, with some estimates placing it at up to 60% of recorded GDP); rising workers' remittances from abroad; and higher wages. A positive development was a sizable increase in fixed investment year on year. This stemmed from augmented investment in transport (mainly roads), mining, and construction. Strengthened exports to the traditional destinations of People's Republic of China, Russian Federation, and Kazakhstan provided further impetus.

Sectorally, the drivers were services, construction, and agriculture. Services grew robustly at 8.4%—driven by trade, tourism, catering, and other retail services—and it still has significant room for expansion, given its narrow and low base. Tourism rebounded in 2006 with a record 1 million tourists visiting the Issyk-Kul Lake, the country's main tourist destination. Agriculture—accounting for about a third of the country's GDP and a half of employment—recovered from a fall in output in the previous year, posting a moderate 1.5% expansion. A reported drop

2.4.1 Contributions to growth (supply)



Source: National Statistics Committee of the Kyrgyz Republic.

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in crop productivity together with an outbreak of contagious animal diseases accounted for the sector's modest rebound in 2006. Industry overall experienced a contraction of about 7.4%, reflecting the drop in gold production, but nongold output was encouraging, bolstered by construction (up 8.5%), garments (19%), and some processing industries. The food-processing industry is still undeveloped, with most agricultural output processed in Kazakhstan and the Russian Federation.

Increases in world oil and commodity prices (partly mitigated by a stronger currency) and price hikes of communal services, as well as higher personal incomes and money supply growth, gently stoked price pressures in 2006. Consumer price inflation rose moderately, averaging 5.6% for the year (Figure 2.4.2). Monetary growth, however, expanded by more than 50% (Figure 2.4.3). This came both from a rise in net foreign assets, as a result of higher remittances and increased foreign capital flows, and from more dynamic activity by the private sector, which was reflected in credit expansion of 48%.

The inflationary impact of this large increase in the money supply was partly softened by continuing exchange rate appreciation, by 8.3% against the US dollar (Figure 2.4.4). This occurred despite interventions by the National Bank of the Kyrgyz Republic (NBKR) in the foreign exchange market throughout the year, which lifted gross international reserves by an estimated $205 million. Overall, however, given the low level of monetization of about 22% of GDP, and with adherence of NBKR to a policy of price stability, the monetary expansion experienced in 2006 is unlikely to lead to significant inflationary risks this year.

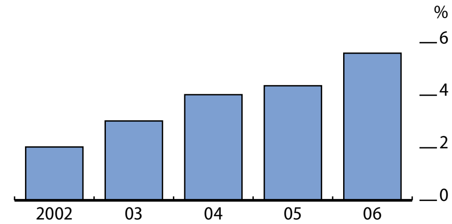
Wages rose by 12% in real terms, with mining seeing the largest gains, but with sizable movements also in public sector wages. Nevertheless, in absolute terms, the average monthly wage (excluding small enterprises) of $76 a month is still low, not much above the government-set minimum consumption budget.

In this low-wage setting, migration has become a growing issue, with estimates of people working abroad varying widely from 0.5 million to 1 million, attracted by the higher incomes in Kazakhstan and the Russian Federation. Increasingly, skilled workers such as doctors and teachers are working abroad, which may lead to a "brain drain" if the issue is not addressed.

According to Ministry of Finance estimates, remittances in 2006 were substantial, in the range of $520 million–750 million, or 20–25% of GDP; the two ex-Soviet countries account for about 80% of the total. Although an important cushion for maintaining living standards and for poverty reduction, migration involves high social costs, as evidenced by the separated families and the children cared for by others than parents.

In 2006, the authorities continued to implement prudent fiscal policy. According to preliminary estimates, all quantitative fiscal performance criteria under the PRGF program were met, including the budget deficit target of 3.2% of GDP (as compared with 4.0% in 2005) (Figure 2.4.5). Although total revenues decreased in relation to GDP (to 22.2% compared with 24.1% in 2005), they increased in nominal terms by about $20 million, mainly as a result of the continued improvements in tax and customs administration and higher import volumes. Revenue performance reflected important tax changes adopted for 2006 to lower

2.4.2 Inflation



Sources: National Statistics Committee of the Kyrgyz Republic; National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg, downloaded 4 March 2007.

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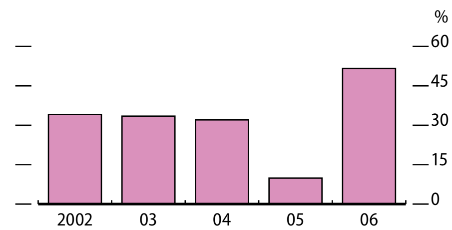
2.4.3 Money supply (M2x) growth



Source: National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg, downloaded 28 February 2007.

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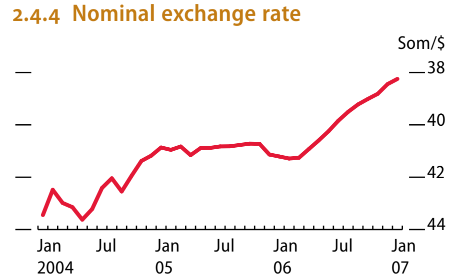
2.4.4 Nominal exchange rate



Sources: International Monetary Fund, *International Financial Statistics* database; National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg; both downloaded 4 March 2007.

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the burden on labor and capital, so as to promote private sector growth and to lessen incentives for taking part in the informal economy. These changes included a flat corporate and personal income tax of 10%, value-added tax exemption for agricultural products and imported basic capital goods, a reduction of payroll taxes from 31% to 29%, and abolition of eight inefficient local taxes.

Total expenditures picked up by about 12% in 2006. However, an important shift took place toward greater social outlays and some economic subsidies. Spending on education, health care, and social security all rose by around a quarter (year on year) in nominal terms, and expenditures on utilities and housing by about a third. Public investments stayed tightly constrained (to 3.1% of GDP) due to limitations on external borrowings for debt-sustainability reasons.

The authorities managed to resist parliamentary pressure to lower the retirement age, and are planning to design a comprehensive pension strategy. Preparatory work has also continued on a transition from a four-tier to a two-tier budgetary system, which would comprise the center and local communities (i.e., bypass the provincial and municipal authorities). The aim is to strengthen decision making at the grassroots level. Introducing the new system will face some challenges in the coming years, and will require simultaneous capacity building in local governments.

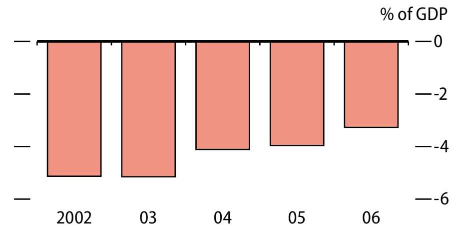
The current account deficit increased sharply (Figure 2.4.6) from 8.3% of GDP in 2005 to an estimated 14.7% in 2006 (or $414 million), mainly due to the widening trade gap (although improvement in the statistical coverage of the significant "shuttle trade" may also have played a part). Imports of investment goods increased as a result of value-added tax exemption of basic capital assets; other factors were rising energy prices, stronger domestic demand, and speculation (e.g., reexports of fuel resources).

Import growth vastly outpaced that of exports, largely due to decreased production of gold at Kumtor. However, gold remains the largest export item (with about one quarter of the total). Nongold exports were underpinned by greater sales of fruit and vegetables, reexported oil products, and construction materials, spurred by robust demand in neighboring countries.

The trade gap was partly offset by inflows of remittances. The current account deficit was financed by a rise in net foreign direct investment (FDI) and by foreign loans. These capital account inflows have allowed a strong buildup of gross official reserves to $817 million at the end of December (Figure 2.4.7). FDI expanded rapidly after the 2005 revolution, and was estimated at $109 million (for the first 9 months of 2006), directed mainly into finance, telecommunications, and food-processing. The largest inflows came from Kazakhstan (30%), UK (19%), Canada (7%), and Turkey (6%).

Though coming down (Figure 2.4.8), the country's external debt is still the highest relative to GDP among the Commonwealth of Independent States countries, at about 70% of GDP. The 2002 and 2005 reschedulings of the country's debt by the Paris Club of official creditors has not alleviated the external debt burden. As part of the debt-reduction strategy, the authorities refrained from borrowing or guaranteeing external loans

2.4.5 Budget balance



Source: National Statistics Committee of the Kyrgyz Republic.

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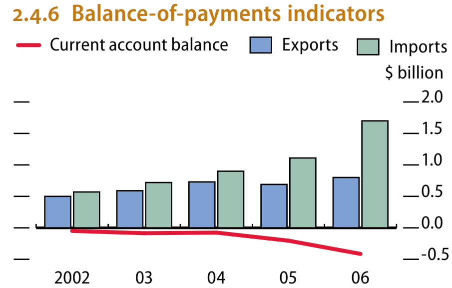
2.4.6 Balance-of-payments indicators



Source: National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg, downloaded 30 January 2007.

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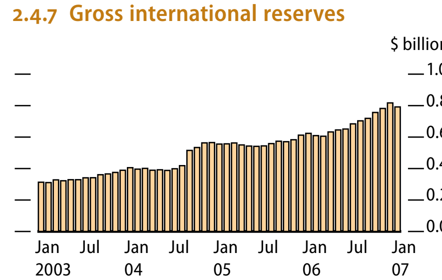
2.4.7 Gross international reserves



Source: National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg, downloaded 10 March 2007.

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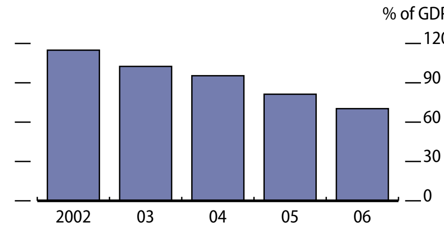
on nonconcessional terms. In mid-October 2006, IMF formally declared the country eligible to participate in the enhanced Heavily Indebted Poor Countries initiative. This prompted national debate and general public and political resistance, in view of what was taken to be loss of "face" and erosion of the country's sovereignty. In February 2007, the new Government made a decision not to pursue further interest in the initiative.

Progress on structural reforms has been uneven (Box 2.4.1). Delayed passage of key legislation hampered several government initiatives. For example, the new tax code and regulations on enhancing central bank independence, among others, are still awaiting parliamentary approval. The slow pace of reform largely stems from preoccupation with political issues, but also reflects weakened coordination between the different branches of government in implementing core reforms.

Banking sector reforms remained largely on track, except for the delays with privatization of the Kyrgyz Agricultural Finance Corporation. The central bank made some progress in modernizing the payments system; upgrading its accounting and internal controls; and enhancing bank supervision, with the creation of the Agency for Financial Surveillance and Reporting to assess market, operational, country, and foreign exchange risks. Parliament passed legislation to combat money laundering and terrorism financing. To improve stability in the banking system, the central bank upped the minimum capital requirement for banks to $1.5 million, which is to be raised further to $2.5 million by the end of this year.

2.4.8 External debt



Source: National Statistics Committee of the Kyrgyz Republic.

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Economic prospects

The underlying assumptions for economic projections are as follows: the political situation stabilizes as both the Government and Parliament make headway to resolving the prolonged standoff; key legislation is passed quickly; structural reforms are carried out soon; two promising gold deposits, Jerui and Taldy-Bulak, start mining production; growth stays strong in People's Republic of China, Russian Federation, and Kazakhstan; the price of gold stays favorable; and, importantly, the new Cabinet will demonstrate commitment to announced economic policy goals and reforms.

In this scenario, GDP growth is projected to be around 4% in 2007 and 5% in 2008 (Figure 2.4.9), underpinned by the rebound in Kumtor gold output and the launch of the new mines, and by a sustained increase in nongold industry and services. Needless to say, this scenario will only unfold if the political situation stabilizes, before all else.

With continuing government efforts in improving the tax administration, and greater compliance encouraged by reduced tax rates and some "formalization" of the shadow economy, it is expected that the fiscal balance will remain within limits agreed with IMF—3% of GDP and to be covered by external resources and privatization proceeds. The draft state budget for 2007 envisages a further reduction in the payroll tax from 29% to a medium-term target of 25%, with the associated revenue losses to be offset by the results of greater efforts to curb tax and customs evasion.

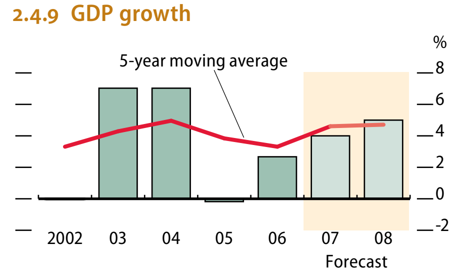
Given the currently low levels of public salaries, and in its efforts to

2.4.1 Selected economic indicators

	2007	2008
GDP growth	4.0	5.0
Inflation	5.0	5.0
Current account balance (% of GDP)	-12.2	-10.7

Source: Staff estimates.

2.4.9 GDP growth



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

Click here for figure data

deliver the promised improvement in living standards, the Government plans in the coming year to lift state sector wages and pensions by a further 10%, and social spending to about 16% of GDP. These moves are to be funded from public services and administration streamlining, and cuts in the number of public officials. Other priorities in the fiscal area include passage of the tax code, further improvements in tax and customs administration, a strengthening of the Large Taxpayers' Unit, enhanced public financial management, and increases in nonagricultural land taxes.

Inflation should remain manageable. Further gains in remittances, as well as the increase in the price of gas imports from Uzbekistan (to \$100 per 1,000 cubic meters, from \$55 previously) may exert additional price pressures in 2007. However, continued prudence in monetary and fiscal policies is expected to keep inflation at about 5%. The current account deficit is estimated to narrow to around 10–12% of GDP in the next 2 years, aided by an upswing in export volumes. The deficit is to be financed by FDI, other private inflows, and concessional assistance. The domestic currency is set to appreciate in both nominal and real terms in the medium term.

The overriding risk to the economic outlook is continued political uncertainty. Another relates to evolving intentions of the authorities to boost development spending to seek higher rates of investment and employment creation to meet the expectations—still largely unrealized—brought about by the March 2005 revolution.

The second Cabinet, formed in February 2007 after a long bout of political horse-trading, faces a formidable task of stimulating aggregate demand while maintaining high-quality standards for investment, and keeping inflationary pressures in check. This task is exacerbated by the current context of widespread governance issues, and a strong public resistance to foreign-funded aid. Policy stimulation for economic growth is understandable, but entails the risk of excessive state intervention, including through aggressive industrial policy.

2.4.1 Reforming the business environment

The new Government announced improvement of business environment and combating corruption as priority issues. A Country Development Strategy for 2007–2010 was submitted to Parliament for consideration.

The authorities' efforts to stimulate the economy and attract FDI include, for example, cuts in profit and income tax rates and efforts to establish a national development fund. However, tangible advances in improving the investment climate and the business environment, and in fighting corruption, is less evident. Poor public and corporate governance, bureaucratic and administrative constraints, a weak financial sector, and a pliable judiciary remain major obstacles to private business activities.

The country continues to face major challenges in resolving governance weaknesses and stamping out bribery, both of which have diverted scarce resources and depressed productivity growth over the years.

Although the Government has kept the macroeconomic backdrop stable, attracted certain foreign investment over the past year, and announced and initiated wide-ranging reforms, progress in actually pushing through reforms has been slow, again because of political diversions.