

Kyrgyz Republic

Despite the global and regional downturns and power supply issues, the economy showed modest growth in 2009 on the back of a fiscal stimulus and strong performance in agriculture. Inflation fell sharply and the external position improved. The outlook is for accelerating, though moderate, growth given the expected recovery in major economic partners and the construction of new power generation capacity. The authorities are pursuing reforms to render the public sector more efficient and to create favorable conditions for private sector development.

Economic performance

Economic downturns in Kazakhstan and the Russian Federation (the major economic partners) and the country's power shortfalls took economic performance in 2009 down to 2.3% from 8.4% in 2008 (Figure 3.5.1). Their difficulties hit the economy through reductions in three channels: remittances from migrant workers (which constituted around 20% of GDP in 2008); inflows of foreign direct investment; and demand for exports.

GDP growth was driven mainly by a robust performance of agriculture (due to favorable weather conditions), which grew by 7.3%. Construction increased by 6.3%, after a 10.8% contraction the prior year, a rebound primarily due to activity in the hydropower generation and mining subsectors, rehabilitation and construction of roads, and residential building. However, industry overall declined by 3.4 because of reduced output in the textile and sewing industry, transport equipment, electric energy, and gas and water distribution. Gold production also declined.

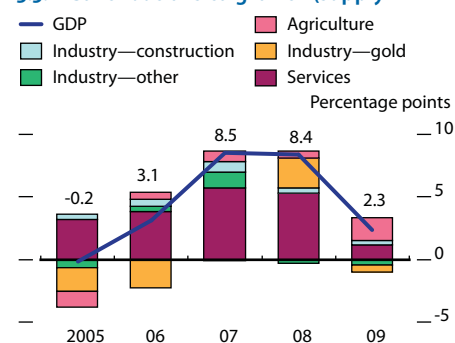
The traditionally high-performing services sectors grew only moderately (2.4%) as the downdraft in workers' remittances crimped consumer expenditure.

Reduced demand, together with sliding world food and energy prices, slashed average consumer price inflation from 24.5% in 2008 to 6.9% in 2009. The rate fell steadily during the year and by December was zero (Figure 3.5.2). The good domestic harvest also helped lower food prices, to 7.4% below December 2009 levels.

Services sector prices also tumbled. Nonfood goods inflation stayed relatively high as depreciation has worked against the decline in global prices of imported commodities and consumer goods.

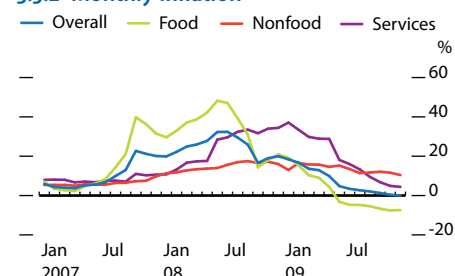
Boosting expenditure on social safety net programs and infrastructure projects, the government took a strong countercyclical fiscal stance: it propelled budget expenditure by 35% (to nearly 38% of GDP). Financial assistance from the Russian Federation, in the form of a \$150 million

3.5.1 Contributions to growth (supply)



Source: National Statistics Committee of the Kyrgyz Republic. <http://www.stat.kg> (accessed 3 March 2010).

3.5.2 Monthly inflation



Source: National Statistics Committee of the Kyrgyz Republic. <http://www.stat.kg> (accessed 3 March 2010).

grant and a \$300 million concessional loan, enabled such a boost. This increase in official transfers—they shot up to seven times the 2008 level—lifted total budget revenue by 25.8%. It also was instrumental in holding the deficit to only 1.8% of GDP in 2009 (Figure 3.5.3) from the original budget plan of 4.6%. The government intends to use the loan to finance infrastructure projects and support small and medium-sized enterprises.

Tax revenue declined by 17.8% in 2009, mainly on a reduction of the average value-added tax (VAT) rate from 20% to 12%, and abolition of some levies such as road and emergency taxes. Customs collection also declined, by around 11%, reflecting weaker trade.

The government forecasts its budget deficit at 5.1% of GDP in 2010. The widening deficit is a result of the increased budgetary allocations for the development budget (mainly infrastructure projects), monetization of benefits, higher pensions, and increased compensation to vulnerable groups (to offset an increase in electricity and heating tariffs).

The National Bank of the Kyrgyz Republic (NBKR) followed an expansionary monetary policy. It reduced banks' reserve requirement from 10% at the start of the year to 9.5% from June; and lowered the discount rate from 14.4% in January to a record low 0.9% at year-end. Although the commercial banks' lending rate remained almost unchanged (at about 20%), credit to the private sector surged by 46.5%. For the year, money supply rose by 20.4%, carried by increased net foreign assets (reflecting the budget assistance) and the expanded credit to the private sector.

The NBKR continued its managed floating exchange rate regime. Following a sharp depreciation of the Russian ruble and Kazakh tenge in early 2009, the NBKR opted for a smooth depreciation of the national currency, the som. Given the large import content of consumption, the NBKR had to sell foreign currency extensively to prevent rapid depreciation of the som in the first quarter. Over the year, the som depreciated by around 15% against the United States dollar (Figure 3.5.4).

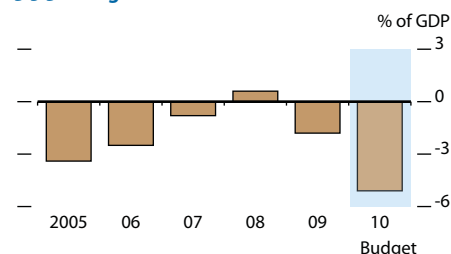
The economic downturn in the country's main partners cut their demand for products from both the Kyrgyz Republic and the People's Republic of China (PRC), the latter product reexported to neighboring countries. Preliminary data indicate that exports fell by 11.3% in 2009, mainly due to weaker demand for domestic textile exports and the PRC's reexports.

At the same time, imports decreased by 24.3% owing to the slowdown in the economy and the drop in imports for reexport. As a result, the trade deficit decreased by about 37% to \$1,203 million and the current account deficit to an estimated 10% of GDP from around 12% (Figure 3.5.5). A capital account surplus more than fully financed the deficit, and reserves increased by about \$364 million to \$1.6 billion at end-2009.

A new tax code, in effect from 1 January, cut the number of taxes (as well as reducing the VAT rate). To offset the revenue losses, the authorities introduced new taxes on owners of automobiles and property. Overall, many of these changes were welcomed by large businesses. The authorities also introduced a new "tax contract" scheme under which businesses pay a fixed amount indicated in the contract and are not subject to further tax inspections.

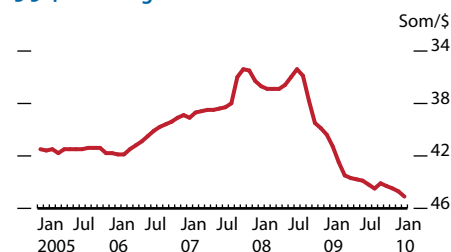
Among financial reforms, a deposit insurance scheme was launched

3.5.3 Budget balance



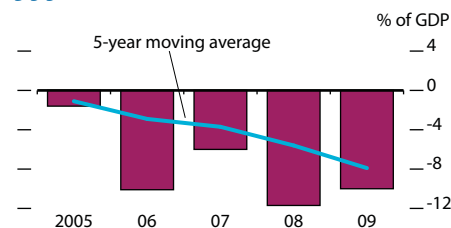
Sources: International Monetary Fund, 2008. *Exogenous Shocks Facility-Staff Report*, December, 2009, Article IV Consultation, July. <http://www.imf.org>; Ministry of Finance.

3.5.4 Exchange rate



Source: International Monetary Fund. International Financial Statistics online database (accessed 22 March 2010).

3.5.5 Current account balance



Source: National Bank of the Kyrgyz Republic. *Balance of Payments of the Kyrgyz Republic*. Various issues. <http://www.nbkr.kg>

in April 2009, covering deposits up to Som100,000 (\$2,290). All banks are required to participate. A new law under which agricultural land can be used as collateral for loan receipts was adopted on 29 June 2009.

In the energy sector, the government believes that the new tariff will bring the sector to cost-recovery levels and attract private investment. It has no plans for any further tariff increases this year.

The PRC made a preliminary agreement to grant a \$342 million loan for a power transmission line, which would help the country ensure energy security. Construction is expected to start in 2011 and finish 2 years later.

In October 2009, the country embarked on a government sector reform under which the number of ministries and agencies has been reduced. The reform also envisages cutting the number of government employees by 30% and aims to streamline the work of government and cut other costs.

Economic prospects

GDP is projected to grow at 5.5% and 6.0% in 2010 and 2011, respectively. The expansion is mainly due to the expected recovery of Kazakhstan and the Russian Federation, boosting demand for exports, foreign direct investment inflows, and migrants' remittances—the last of which will directly bolster private consumption. Foreign-financed hydropower projects should carry on underpinning strong construction growth, but until all those projects are brought into commission (the first is scheduled for May), power shortfalls will continue to hamper manufacturing.

The government will also provide impetus to growth as it is planning to raise spending on wages and pensions and on infrastructure, the latter with financing assistance from development partners.

The expected increase in global food and oil prices will exert upward pressure on prices, though the contracted import price for natural gas will fall by about 10%, as will stronger workers' remittances. These forces will push up inflation in 2010 and 2011, to 8.5% and 9.0%, respectively.

Given the large import share in the consumer basket, the NBKR will use the exchange rate to mitigate inflation. Credit growth will remain subject to the bottlenecks that face Kazakh banks (which account for half the banking sector) in supplying capital to their subsidiaries in this country. However, increased foreign exchange inflows may allow the NBKR to adopt an accommodative credit policy.

The expected regional economic revival is expected to increase demand for Kyrgyz exports by about 10% in the forecast period, while workers' remittances will increase, though not dramatically. The expected recovery of the Kyrgyz economy and continued project implementation will increase demand for imports by an estimated 15%. The current account deficit is projected at 12% in 2010 and 2011.

3.5.1 Selected economic indicators (%)

	2010	2011
GDP growth	5.5	6.0
Inflation	8.5	9.0
Current account balance (share of GDP)	-12.0	-12.0

Source: ADB estimates.

3.5.1 Development challenges

The government recognizes that in order to achieve a sustainable growth path it has to push through institutional reforms and changes in key areas such as energy, trade facilitation, and customs administration. It has undertaken major administrative and government reforms to make public-sector decision making more efficient. In addition, it is revising its long-term development strategy with a key focus on the business investment environment.

Complementing these moves, it has to design and implement mechanisms to substantially raise the level of private domestic saving and investment. Success is essential both to lay the foundation for sustainable, inclusive, private sector-driven growth and to strengthen the country's ability to resist external shocks.