EFSD Eurasian Fund for Stabilization and Development

Kyrgyz Republic

Social and Economic Developments in 2020 and Medium Term Prospective *

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*This Note was prepared by the Financial Credit Project Group, EFSD Project Unit, Eurasian Development Bank, including: Tigran Kostanyan (Acting Director of the Financial Credit Group), Natalia Pisareva (Head of the Budget Sector), Elvira Kurmanalieva (Leading Expert), Pavel Biryukov (Leading Specialist), Anatoly Trifonov (Leading Specialist), Alexandr Yanushkevich (Leading Specialist), Dinara Sholanova (Senior Specialist). Analytical box was prepared by Elvira Kurmanalieva. The Group gratefully acknowledges the comments provided by Sergei Ulatov (Advisor to the EFSD Project Unit) and the team of the EFSD Chief Economist

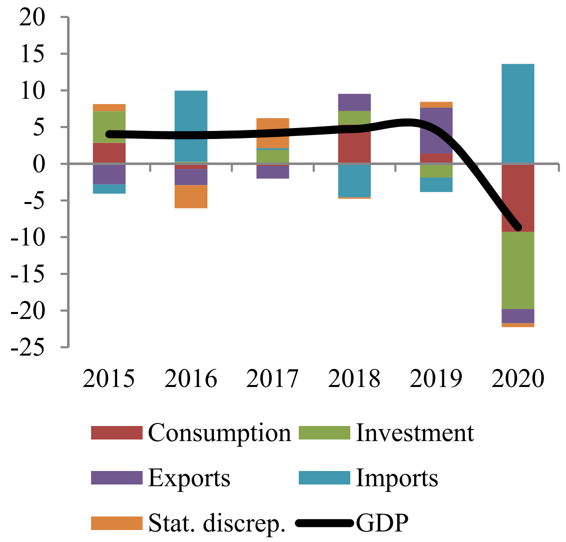
Kyrgyz Republic: Social and Economic Developments and Medium Term Prospective

Real Sector and Labour Market

Kyrgyzstan's economy was negatively affected by the COVID-19 pandemic and external shocks in 2020. The outbreak of the pandemic led to the introduction of quarantine measures in many countries of the world and restrictions on the movement of goods and people across borders. Sluggish global output, lower domestic trade, price volatility in world commodity markets, and depreciation of the currencies of Kyrgyzstan's main trading partners resulted in weaker foreign trade and KGS exchange rate depreciation. The emergency rule introduced in the country in March 2020 and mounting social and political tensions at the end of the year provoked a dip in the economic activity and a rise in prices in the domestic market.

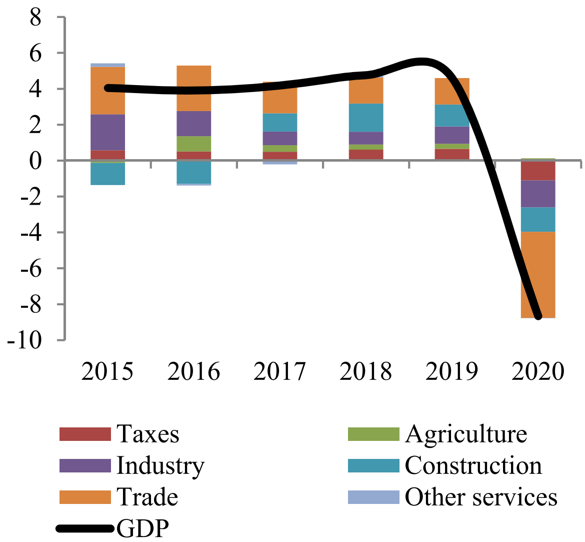
In 2020, the real GDP decreased by 8.6 percent and, excluding gold production at the Kumtor field, it contracted by 9.0 percent. The downturn in the economy was attributed to weaker domestic, as well as external demand (Figure 1). The quarantine measures and the border closure resulted in a drop in private consumption and investments. The volume of investments in fixed assets decreased by 24.7 percent in the context of forced suspension of enterprise activity. Lower foreign direct investments due to the global weakening of investment activity, as well as social and political tensions generated an additional impact. Lower incomes and wages, along with the impact of the quarantine measures, affected the consumer activity of households. A major drop in the contribution of the private sector led to negative GDP developments. The contribution of the government sector was also negative because of consolidation of expenditures on both purchase of goods and services and capital investments. The main factor supporting the economy was net exports of goods and services, whose positive contribution was formed owing to a greater (compared to exports) decline in imports of goods and services, while exports of goods and services also decreased amid the falling external demand.

Figure. 1. *Contribution to GDP growth by the expenditure approach (percentage points, y-o-y)*



Source: NSC KR EFSD estimates

Figure. 2. *Contribution to GDP growth by the production approach (percentage points, y-o-y)*



Source: NSC KR

In terms of sectors, the most significant decline in output was recorded in non-tradeable sectors of the economy (Figure 2). The shock resulted in a downturn in the construction sector (-15.9 percent against 10.7 percent a year earlier), and service sectors (-10.0 percent against 3.2 percent), such as wholesale and retail trade (-15.7 percent), hotels and restaurants (-45.1 percent), and transportation (-30.9 percent). Agriculture demonstrated growth of 1.1 percent (against 2.5 percent). Despite an increase in gold production at the Kumtor field by 7 percent, as well as growth of pharmaceutical (by the factor of 2) and chemical products (by 39.6 percent), the overall fall in the manufacturing industry was 7.2 percent. It was primarily due to a drop in the output of oil products (59.3 percent), textiles, clothing and footwear, leather and leather goods (by 21.5 percent), wood and paper products, and printing (by 13.2 percent). Mining was down by 22.4 percent. Overall, the industrial output decreased by 6.6 percent in 2020 (against an increase of 6.9 percent a year earlier).

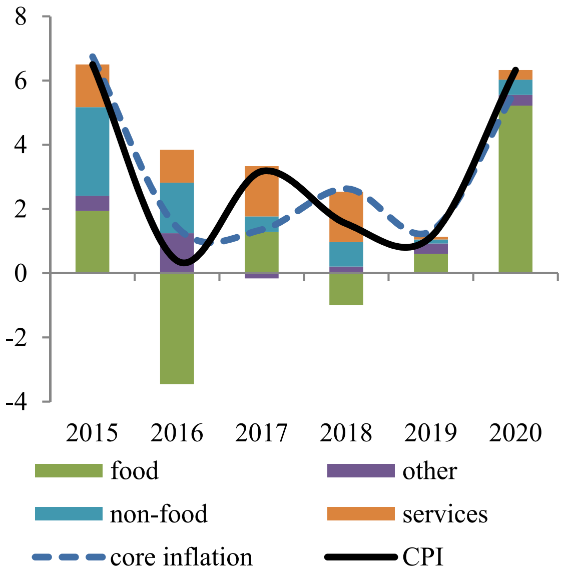
Against the background of the weakening economic activity, employment growth was supported by an increase in the number of employees in the budget sector. Amid the negative impact of the pandemic, the employment in the economy fell by 0.2 percent compared to a 0.5 percent increase a year earlier, which was combined with a slowdown in the real wage growth to 1.3 percent from 4.7 percent a year earlier. In the environment of weakening consumer and investment activity, policy actions of the KR authorities in the budget sector (mainly in the sphere of wages in education) were the key deterrent to negative developments on the labour market. All other industries dominated by the private sector showed a decline starting from Q2 2020 in both employment and real wages relative to 2019.

Inflation and Monetary Policy

The inflation accelerated in 2020 amid local currency depreciation and difficulties with the movement of goods in the context of the emergency regime (Figure 3). The average annual growth of consumer prices in 2020 accelerated to 6.3 percent (from 1.1 percent in 2019), while remaining within the range of 5-7 percent targeted by the NBKR. The core inflation accelerated to 5.7 percent (against 1.3 percent in 2019). The price growth accelerated in all segments of the consumer basket, but food prices rose the most, with the main factor for that being a sharp drop in supply due to difficulties with logistics in the context of the emergency situation regime. An additional driver of the price increase was KGS depreciation during the year by 15.7 percent, which primarily resulted in an increase in prices for imported food products, the share of which in imports is about 15 percent. Thus, the KGS depreciation contributed to inflation acceleration in April (8.6 percent) and October-December 2020 (8.4 percent), while in the middle of the year, the price growth slowed down to 5.4 percent under the influence of the weak economic activity.

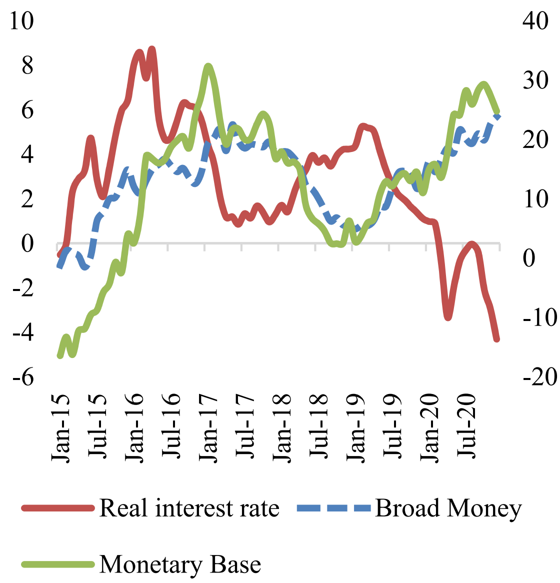
On the one hand, the NBKR sought to contain inflation, on the other hand, its aim was to provide liquidity to the banking system to stimulate the economy in the context of the COVID-19 pandemic (Figure 4). Against the background of the announced package of measures to support the economy in the context of the pandemic, the NBKR maintained the refinancing rate at 5 percent, unchanged since February 2020. The real interest rate in the face of the accelerating inflation turned negative in March 2020, indicating an easing of the monetary conditions. Along with other financial reliefs granted by the regulator, such as a reduction of the standard reserve requirement ratio, provision of liquidity to banks through credit auctions led to continued double-digit growth rates of lending (11.7 percent in December 2020 against 14.5 percent in December 2019). At the same time, the broad money supply growth accelerated (up to 23.9 percent from 12.8 percent in December 2019) starting in March 2020 under the influence of large amounts of government budget spending associated with measures to mitigate the negative effects of the pandemic. The factors deterring an increase in excess liquidity included higher demand for cash and foreign exchange interventions (net sales of foreign exchange) by the NBKR to smooth out fluctuations of the exchange rate.

Figure. 3. *Inflation (eop, in %, y-o-y)*



Source: NSC KR

Figure. 4 *Monetary indicators (%)*



Source: NBKR, NSC KR

Budget Sector and Public Debt

The weaker economic activity and lower imports led to lower State budget revenues (Figure 5). Against the backdrop of the falling economic growth rates and restrictions related to imports of goods, the revenue part of the budget declined by 1.6 p.p. to 25.4 percent of GDP. The main contributors to that were lower revenues from taxes and duties on imports, which decreased by 2.2 p.p. The State budget was supported by revenues from operations of the Kumtor field, while revenues from other domestic taxes remained at the level of 2019 (7.2 percent of GDP). Shortfalls of domestic VAT and sales tax revenues were offset by an improvement in the collection of the personal income and profit taxes. The share of all tax payments in the GDP was 17.9 percent of GDP (-1.8 p.p.). In addition, there was a decrease in grant revenues (-0.2 p.p.).

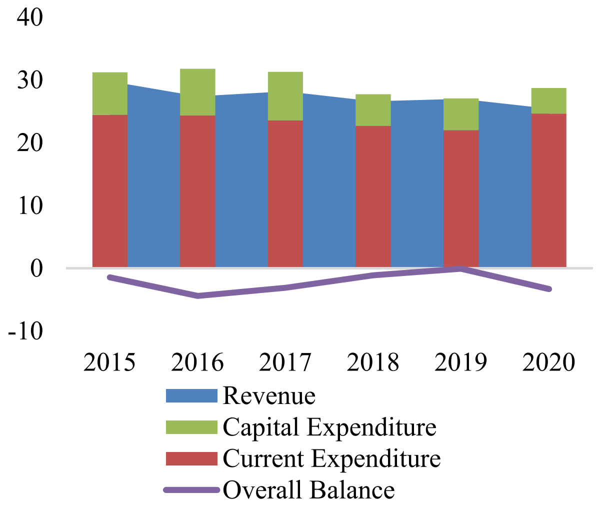
An increase in the expenditure part of the budget was caused by higher current expenditures while capital expenditures decreased (Figure 5). The expenditure part of the budget grew by 1.7 p.p. to 28.7 percent of GDP mainly due to an increase in current expenditures (by 2.7 p.p.), including the wage bill for budget sector workers, which reached 10.3 percent of GDP, *inter alia* because of a wage raise for education workers in October of the previous year, and additional health spending in the context of the COVID-19 pandemic. At the same time, lower priority consumer spending to purchase goods and services were cut. Capital expenditures also decreased (by 1.0 percent of GDP) amid lower domestic investments due to the need to reallocate budget funds to finance measures to combat the pandemic, while external capital expenditures under the state investment programme remained at the level of 2019 (2.0 percent of GDP).

An increase in the State budget deficit, along with the exchange rate depreciation, led to growth of the public debt. Against the background of falling tax revenues and expansion of spending, there was a deficit in the 2020 State budget of 3.3 percent of GDP[1] (compared to a deficit of 0.1 percent of GDP in 2019). Against the background of the weaker economic activity and local

[1] The budget balance, which includes the funds on-lent to state-owned enterprises, amounted to 3.9 percent of GDP compared to 1.0 percent in 2019.

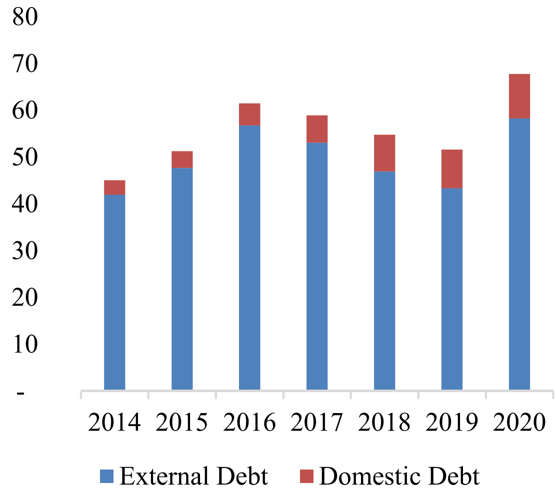
currency depreciation, the public debt, characterised by a high share of foreign exchange borrowings in the portfolio, rose from 51.6 percent of GDP in December 2019 to 68.1 percent of GDP in December 2020 (Figure 6).

Figure 5. *Government budget (% ВВП)*



Source: KR MoF

Figure 6. *Public Debt (% of GDP)*



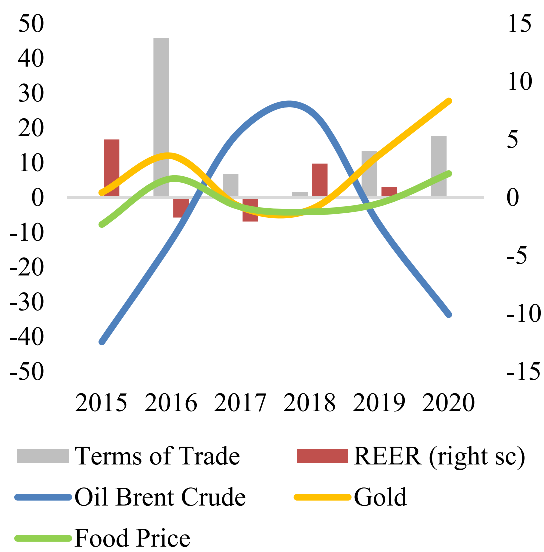
Source: KR MoF

External Sector

According to EFSD estimates, a sharp drop of the volume of imports of goods and the rate of export price growth exceeding that of import price growth led to a CA surplus in 2020 (against a deficit of 12.1 percent of GDP in 2019). The introduction of quarantine measures and the closure of borders due to the COVID-19 pandemic in many countries of the world resulted in lower international trade, global recession, and stronger volatility across the world markets. In Kyrgyzstan, it caused a significant decrease in imports of goods (by 26.2 percent), the main contributors to which were lower imports of footwear, clothing, fabrics, construction products, and equipment from China. Amid the decline in the volume of exports of footwear and textiles to the EAEU countries, exports of goods also decreased (by 1.09 percent). Lower energy prices in global commodity markets—the Brent oil price decreased by 33.6 percent in annual terms—led to a decrease in nominal volumes of petroleum product imports, and higher gold prices (up by 27.8 percent in annual terms) resulted in a significant increase in nominal volumes of precious metal exports. Against the background of such changes in the terms of trade (Figure 7) and lower physical volumes of imports, the trade deficit decreased to 18.4 percent of GDP (against 29.6 percent a year earlier). An additional contribution to the formation of the current account surplus (Figure 8) was made by growth of remittances, net inflows of which amounted to US $1.89 billion in 2020, which is 1.8 percent higher than in 2019.

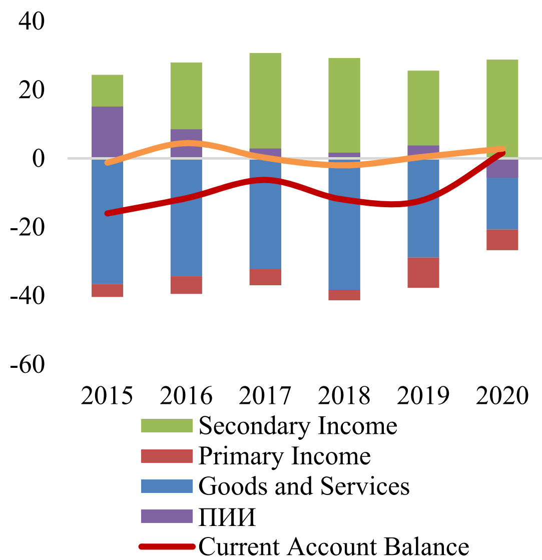
The CA surplus, flow of donor aid to the public sector, and the increase in the price of gold contributed to growth of the gross international reserves despite a decline in foreign direct investments and foreign exchange interventions of the NBKR. In 2020, there were net outflows of foreign direct investments (-US $330.5 million) because of lower investment inflows, outflows of reinvested profits, and payments to repay corporate loans. Against the background of the foreign economic volatility, the NBKR made intensive interventions in 2020 aimed at smoothing sharp fluctuations in the exchange rate. Overall, its net sales were US $466.0 million during the year. The inflow of international assistance in the fight against the COVID-19 pandemic amounting to US $366.8 million, together with the CA surplus, contributed positively to the evolution of the gross international reserves (GIR). The GIR growth was further supported by higher gold prices and an increase in volumes of gold reserves of the NBKR. Thus, the GIR increased by US $384 million in 2020, amounting to US $2.8 billion, which is equivalent to 7.5 months of imports, considering the significant drop of import volumes in 2020.

Figure 7. *Terms of trade (%, y-o-y)*



Source: World Bank, NBKR, NSC KR

Figure 8. *Balance of payments (% of GDP)*



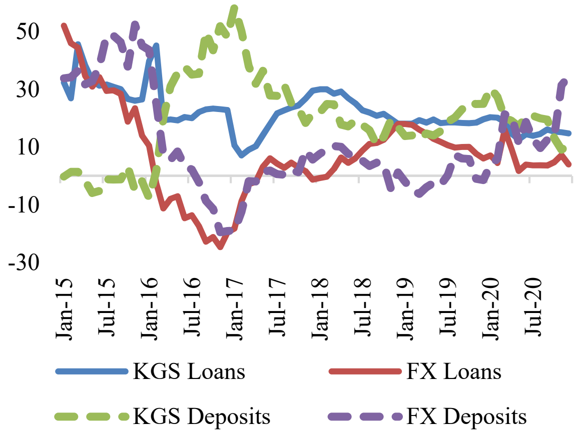
Source: NBKR, NSC KR

Financial Sector

In 2020, banks' loan portfolio continued to grow at a double-digit rate amid excess liquidity. The growth of lending amounted to 11.0 percent in December 2020 (up from 14.5 percent a year earlier) (Figure 9). The growth of loans is to some extent explained by the efforts taken by the NBKR to support the liquidity of the banking sector. The weighted average interest rates on loans continued to demonstrate a downward trend, amounting to 16.1 percent (compared to 17.5 percent a year earlier) in local currency and 9.3 percent (9.7 percent) in foreign currency in December 2020. The drivers of credit growth in local currency (by 14.8 percent in annual terms in December 2020 against 19.7 percent in December 2019) included loans to agriculture (3.0 p.p.), trade enterprises (4.8 p.p.), and mortgage loans (2.3 p.p.). Loans in foreign currency grew in KGS terms by 4.0 percent due to loans to other sectors (1.7 p.p.), and industry (2.6 p.p.). Considering the nominal exchange rate depreciation by 15.7 percent, the volume of foreign currency loans, net of the currency revaluation effect, decreased.

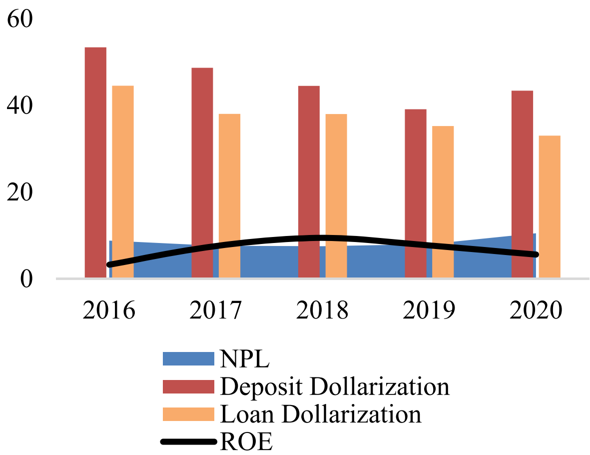
The rate of deposit growth accelerated compared to the previous year (19.9 percent against 13.4 percent in 2019), which is mainly due to the impact of the KGS depreciation (Figure 9). The main contribution to the faster deposit growth was made by an increase in foreign currency deposits (by 34.5 percent), which was mainly caused by the KGS exchange rate depreciation. The growth of foreign currency deposits was accompanied by a decrease in local currency deposits: settlement accounts of legal entities and demand deposits of households in foreign currency grew amid a decline of local currency term deposits under the influence of the sharp local currency depreciation in March and October-November 2020. Overall, the local currency deposit portfolio growth slowed down to 10.8 percent (against 25.0 percent a year earlier), which was secured equally by deposits of households and legal entities. The weighted average deposit interest rates continued to be on the downward trend, making 5.7 percent (down from 6.0 percent) in local currency and 1.2 percent (down from 1.4 percent) in foreign currency.

Figure 9. *Bank Lending and Deposits (%, y-o-y)*



Source: NBKR

Figure 10. *Banking sector performance (%)*



Source: NBKR

The quality of assets in the banking sector deteriorated under the influence of the pandemic (Figure 10). With the economic activity dropping sharply during the quarantine and the instability in Q4 2020, the share of non-performing (classified) loans rose to 10.5 percent (compared to 8.0 percent in December 2019). Against the background of shrinking interest margins and fees from other services, the profitability of the banking sector declined. Its return on equity decreased to 5.6 percent (against 7.7 percent a year earlier) and that on assets – to 0.9 percent (against 1.2 percent a year earlier). The KGS depreciation led to an acceleration of the rate of deposit dollarization to 43.4 percent against 39.1 percent a year earlier. At the same time, the dollarization of loans decreased (from 35.2 percent in December 2019 to 33.0 percent at end-2020) against the background of the prudential restrictions on foreign currency lending issued by the NBKR.

Medium-Term Prospects

Under the baseline macroeconomic outlook, the economic growth is expected to recover in 2021-2022, followed by a slowdown to its potential rate (Table 1). The recovery of consumer activity in 2021 would be mainly supported by growth of public spending, combined with continued implementation of the anti-crisis measures, while the investment activity of the private sector would remain relatively weak. At the same time, the stronger economic activity and increasing income of the population would lead to a recovery of the delayed demand for imports of goods and services in 2021. In the medium-term perspective (starting from 2022), the private sector investments and external demand for exported goods and services associated with a recovery of the world economies and those of the major trading partners, following the relaxation of the restrictive measures taken in response to the COVID-19 pandemic, would generate a higher contribution to the economic growth.

The fiscal and monetary policies are expected to be based on the priority of ensuring a macroeconomic equilibrium. The monetary policy would aim at keeping the inflation within the targeted range of 5-7 percent. The inflation is projected to be above the upper limit of the targeted range in 2021, influenced by rising food prices, and in the medium term, it would be within 6-7 percent. The efforts of the NBKR in the medium term are also expected to focus on maintaining the stability of the banking system, reducing the share of non-performing loans, and improving the performance of banks. As estimated by the EFSD Project Unit, despite stable economic growth in 2022-2024, the pressure on the fiscal sector would persist in the medium term due to the presence of fiscal and quasi-fiscal risks. At the same time, the fiscal policy would be aimed at improving the collection of tax revenues and streamlining expenditures by improving the public finance management mechanism.

Shortfalls of tax revenues and customs duties and continued high levels of current expenditures could be the main causes of fiscal gaps. The reason for the fiscal gap in 2021 is the likely shortfall of tax revenues and customs duties because of a slower recovery of the economic activity and trade, and the slow effect of the fiscalisation measures introduced in tax procedures. In addition, lower balances in budget accounts, compared to those planned in the approved budget, contribute to the formation of the gap in 2021. At the same time, the presence of risks, associated with budget loan repayments, changes in donor plans to provide budget support, as well as the Government's plans to raise salaries in the health sector, may further impact the size of the gap in 2022-2024.

The recovery of the world economy, in particular the economies of Russia and Kazakhstan, would contribute to growth of foreign trade operations and stable inflows of remittances to the KR in 2021. The projected growth of gold prices would have a positive impact on the growth of exports in value terms and the gross international reserves. However, against the background of a recovery of imports of goods and services, the current account would have a deficit of 0.8 percent of GDP in 2021, and remittances would grow to 25.3 percent of GDP. In 2022-2024, the current account deficit would remain at the level of 0.5-1.5 percent of GDP, which would result in moderate exchange rate depreciation. However, it should be noted that the current GIR volume allows seeing them as a source of financing the balance of payments gap, which, along with smooth exchange rate depreciation, would help maintain them at a sufficient level to ensure financial stability (Table 1).

Risks under the Outlook

- ✓ **Deterioration of the epidemiological situation (the third wave of the pandemic) and slower recovery of the economies of the trading partner countries.** Repeated COVID-19 outbreaks in many countries across the world entail the risk of that scenario unfolding in Kyrgyzstan. It could delay the economic recovery. In the current environment of weak domestic and external demand, another sharp rise in the number of victims of the COVID-19 pandemic would negatively affect the real sector and budget revenues, as well as call for additional spending to support the health sector. A deterioration of the balance of payments would result in accelerated local currency depreciation, adding to foreign exchange risks to the public debt sustainability and the banking system.
- ✓ **Mounting social and political tensions.** The suspension of activity of mining enterprises amid the social and political unrest in October 2020 already resulted in a sharp reduction in the contribution of this industry to the economic growth. Mounting domestic social and political tensions in 2021 may affect the pace of recovery of domestic demand, especially that of investment activity, as well as recovery of confidence of foreign direct investors.
- ✓ **Easing of macroeconomic policies to stimulate the economic growth.** The authorities may review their plans to reduce the budget deficit and resort to a stronger economic stimulus package, including, for example, expansion of capital investments and on-lending instruments not supported with additional measures to mitigate fiscal and quasi-fiscal risks, or maintenance of wage growth in the economy at a pace above that of productivity. Such policy changes may break the macroeconomic equilibrium principles that would accelerate and boost the size of the financing gaps.

Table 1. Kyrgyz Republic: Key Macroeconomic Indicators and Medium Term Prospective

	Actual		Forecast*			
	2019	2020	2021	2022	2023	2024
National Account and Prices (in %)						
Real GDP growth	4,6	-8,6	4,1	5,2	4,4	4,8
GDP Deflator	3,9	5,8	4,2	4,9	4,4	5,1
CPI (Dec, y/y)	3,1	9,7	8,3	6,8	6,3	6,0
Money and Credit (end-of-period)						
Broad Money, % change	12,8	23,9	11,0	10,3	9,0	10,1
Key Policy Rate	4,3	5,0	5,50	5,50	5,50	5,50
Public Finance (in % of GDP)						
Revenue and Grants	27,0	25,4	28,5	26,8	25,9	25,9
Tax Revenues	19,6	17,9	20,9	21,1	21,2	21,7
Expenditure	27,1	28,7	31,0	28,6	27,4	27,4
Overall Balance ("-" deficit / "+" proficit)	-0,1	-3,3	-2,5	-1,8	-1,5	-1,5
External Sector (in % of GDP)						
Current Account Balance	-12,1	2,0	-0,8	-0,5	-0,5	-1,5
Exports of goods and services	35,2	37,0	36,3	35,4	34,6	32,7
Imports of goods and services	64,1	57,7	60,4	59,0	58,3	56,5
Remittances	20,9	24,4	25,3	25,6	25,0	24,1
Foreign direct investments	3,8	-4,3	0,6	0,6	0,5	0,5
Gross International Reserves, in months of imports of goods and services	5,1	7,5	7,6	7,6	7,6	7,3

Source: national agencies, EFSD estimates

MEDIUM-TERM PRIORITIES OF STRUCTURAL AND INSTITUTIONAL REFORMS IN THE KYRGYZ REPUBLIC

Structural and institutional constraints do not enable an environment for sustainable economic growth in the KR and cause its high volatility. Over the past 20 years, the economy of the Kyrgyz Republic has shown volatile growth rates, the main drivers of which were remittances of migrant workers and gold exports. Pro-cyclical macroeconomic policies, against the background of structural and institutional challenges, led to the accumulation of macroeconomic imbalances. Among the key challenges are low diversification of exports and economic activity; a large informal sector; fiscal and quasi-fiscal risks associated with insufficient efficiency of the public sector; inadequate road infrastructure; and poor access to financial services in regions of the country.

Structural and institutional reforms are needed to improve the potential and sustainability of economic growth in the KR, the main ones including:

(1) Economy digitalisation to reduce the share of the informal sector.
(2) Improvement of the tax administration.
(3) Improvement of the public sector efficiency.
(4) Enhancement of the transparency and accountability of the energy sector.
(5) Improvement of the quality of road infrastructure management.

Reforms in economy digitalisation are aimed at diversifying the economy, improving the access of the population to basic infrastructure and financial services. The KR Government has developed and adopted the National Digital Transformation Strategy, including the digitalisation of government services, e-commerce development, efforts aimed at piloting and implementing innovative banking services. If implemented successfully, with balanced allocation of financial and human resources, the strategy would facilitate both the development of those industries, where the KR has natural advantages (agriculture, tourism), and discovery of new niches. For a landlocked country, for example, exports of digital services bear great potential. Measures to digitalise government services and the development of innovative banking products would help expand the access of the population to basic education, health, and other social and financial services.

Opitmizing tax preferences based on an assessment of their effectiveness, supplemented by fiscalisation and other measures to improve the tax administration, should give added impetus to the private sector development and reduce the share of the informal economy. The private sector, which is mainly represented by small and medium-sized businesses, generates about 40-45 percent of the country's GDP. It is represented in the retail and wholesale trade sectors, hotel and restaurant services, agriculture, and transportation. However, a large part of it is involved in informal economic activities. The existing gaps in public administration and corporate governance, lack of access to financial services and credit resources, and frequent changes in business regulations hinder the growth of the private sector and force it to remain “in the shadow”. Competition development, formalisation, and growth of private enterprises, as well as improved conditions for its development would be facilitated by measures of fiscalisation of tax procedures, streamlining numerous tax preferences and benefits, and other important measures, including digitalisation of government services and improvement of legislation in the tax administration.

The efficiency of the public sector can be enhanced through a combination of transition to a new public administration strategy and mitigation of fiscal and quasi-fiscal risks. The public sector is predominantly represented by State budget operations. Current expenditures of the State budget make about 24 percent of GDP, of which about 10 percent of

GDP is wages and salaries of budget sector workers. At the same time, low wages of employees in social sectors indicate the need to audit and optimize the wage bill in the State budget. An additional measure to integrate databases of the staff size in the public sector with the budget execution system would lead to efficient allocation of funds to finance the current expenditures of the State budget. Public investments average at about 8 percent of GDP and are mainly funded by foreign loans and grants under the State Investment Programme (SIP), some of which are on-lent in the form of budget loans to state-owned enterprises. The current debt of state-owned enterprises under budget loans amounted to about 20 percent of GDP in August 2020, posing significant quasi-fiscal risks. The quantification of these and other fiscal and quasi-fiscal risks, as well as the elaboration of measures to mitigate them, are needed in preparing and forecasting budget parameters. Further promotion of transparency principles in programme-based budgeting at ministries and agencies, combined with evaluations of budget programme implementation, would enable effective creation of reliable databases on performance indicators and enhance the capacity of ministries to improve the efficiency of the public sector.

A package of measures with different execution periods will be needed to improve the efficiency of energy sector operations. The energy sector, mainly represented by large hydroelectric power plants, is constrained due to enterprise financial difficulties and deteriorated infrastructure. The sector depends on substantial direct and indirect subsidies in an environment where the existing tariffs do not ensure its financial sustainability and the tariff policies have not changed over a long period. Short-term measures include ensuring transparency and financial accountability of energy sector enterprises. Public availability of energy companies' financial statements, as well as forecasts of electricity generation and consumption would improve the transparency of the energy sector and contribute to its financial rehabilitation. Longer term measures should include tariff policy reforms, accompanied by assistance to vulnerable households.

Institutional reforms in the road sector to improve the quality of road maintenance and the efficiency of budget expenditures on current maintenance of roads would improve the transport and logistics connectivity of the country. The road transport services almost the entire domestic passenger and freight traffic and most of the foreign trade. However, because of the high terrain and harsh climate in winter, road pavements require regular maintenance. The introduction of a tool to control the road maintenance quality and enhancement of the financial framework for resource allocation would help ensure sustainable operation of the road sector and improve the country's transit capacity in future.