KYRGYZ REPUBLIC

Social and Economic Development in the First Half of 2023 and Medium-Term Prospective*

October 2023

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LIST OF ABBREVIATIONS
CA – current account
CoM KR – Cabinet of Ministers of the Kyrgyz Republic
CPI – consumer price index
EAEU – Eurasian Economic Union
EFSD Project Unit – Project Unit of the Eurasian Fund for Stabilization and Development
GDP – gross domestic product
GIR – gross international reserves
ILO – International Labour Organisation
KR – Kyrgyz Republic
MF KR – Ministry of Finance of the Kyrgyz Republic
NB KR – National Bank of the Kyrgyz Republic
NSC KR – National Statistical Committee of the Kyrgyz Republic
PIP – Public Investment Programme
RF – Russian Federation
SCNS KR – State Committee for National Security of the Kyrgyz Republic
US – United States of America
VAT – value added tax

Economic growth in the KR decelerated in the first half of 2023 due to lower gold production and a slowdown in agricultural output.

Investment in fixed assets and services remains the key driver of economic growth. Inflation peaked in February 2023 amid rising global prices for non-food products and high transportation costs. In June 2023, consumer inflation decelerated amid a decline in global food prices and the NB KR interest rate remaining at a high level.

The widening current account deficit continued to be financed by unrecorded foreign exchange flows in the balance of payments (item "Errors and Omissions") as evidenced by the lack of strong pressure on the exchange rate.

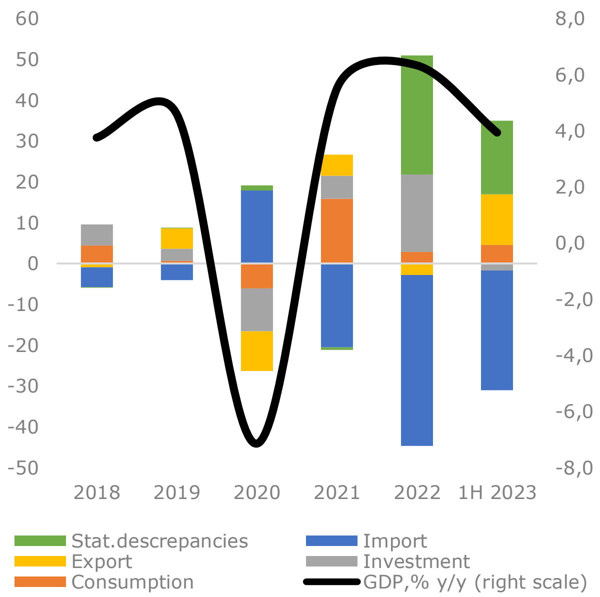
The state budget had a surplus in the context of an increase in revenues from VAT, excise taxes, and import duties. The banking sector continued to show high profitability against the background of credit growth.

Real Sector and Labour Market

In the first half of 2023, real GDP growth decelerated to 3.9%, down from 5.2% in the same period of 2022, amid a decline in gross capital formation. The new external conditions arising due to the sanctions imposed on Russia continued to support private consumption (4.6 p.p.), which in turn influenced the dynamics of the services sector. The resumption of gold exports through a drawdown on last year's inventories helped to increase the contribution of exports (12.3 p.p.) and led to a negative contribution of gross capital formation (-1.7 p.p.). Imports slowed again due to negative base effects (-29.4 p.p.). The significant contribution of "statistical discrepancies" is explained by unrecorded trade flows. Taking into account statistical discrepancies, the contribution of net exports to GDP growth in the first half of 2023 amounted to 1.0 p.p.

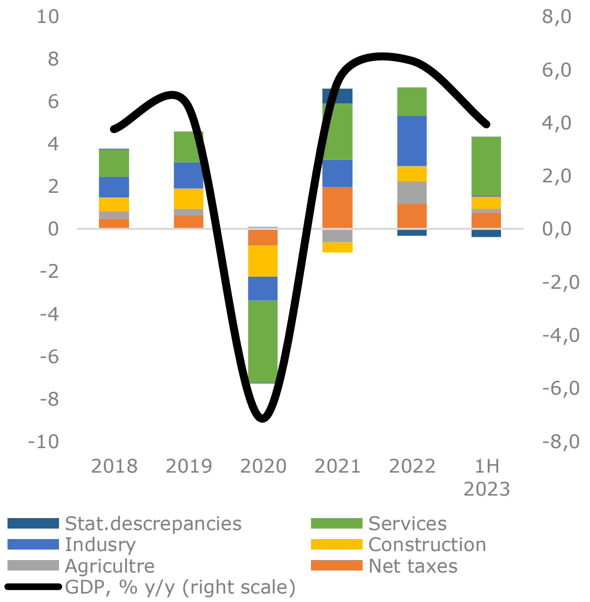
The increase in trade turnover associated with the influx of capital, tourists and migrants observed since March of the previous year influenced economic activity in the first half of 2023 by accelerating production in the textile industry, retail and wholesale trade turnover, and hotel and restaurant services. A deceleration in transport services could be attributed to slower import growth and lower non-gold exports.

Figure 1. *Contribution to GDP growth, by use components (p.p.)*



Source: NSC KR, EFSD estimates

Figure 2. *Contribution to GDP growth, by production components (p.p.)*



Source: NSC KR

On the production side, the main contributors to GDP growth were the services sector (2.6 p.p.) and construction (0.5 p.p.), while agriculture and industry contributed 0.3 p.p. The main drivers of growth in services were foreign trade and domestic wholesale and retail trade thanks to sustained consumer activity and demand for exports transit from third countries to the Russian Federation due to sanctions restrictions. Wholesale trade turnover increased by 31%, retail trade turnover by 7.2%. The growth of tourist flows (exports of tourist services increased by a factor of 2.1) boosted the growth rate of hotel and restaurant services to 29.5%, up from 7.0% a year earlier. From a low base in 2022, there was an increase in construction (11.2% y-o-y) and fixed asset investment (+10.4% y-o-y), mainly related to private construction of mining facilities. Industry experienced a slowdown in growth rates (0.5% against 16.5% in the first half of 2022), associated with a decline in precious metals production (-8.3%) owing to lower gold production at the Kumtor deposit. This was accompanied by a positive trend in manufacturing, particularly in the production of polymers (16%), food (10%), and textiles (38.5%). Agricultural production showed subdued growth (2.5% compared with 4.7% in the first half of 2022) in the context of dry weather and low water levels.

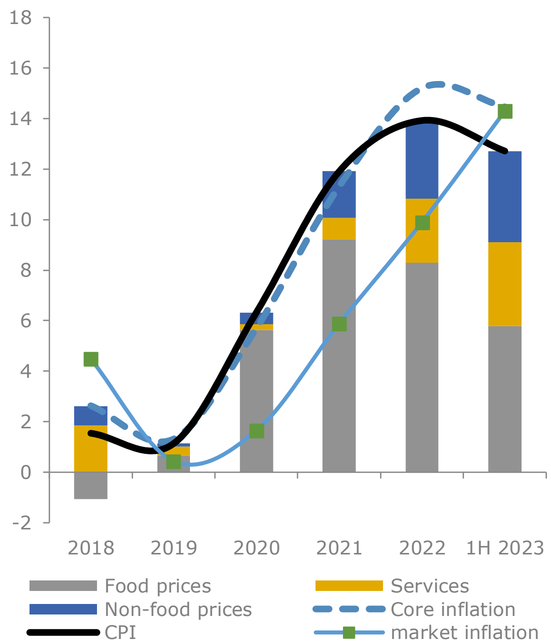
The effect of external and internal factors supported employment growth and a decline in unemployment. According to the NSC KR, the unemployment rate in 2022 decreased to 4.9% (compared with 5.3% in 2021). In the first half of 2023, the officially registered unemployment rate declined to an average of 2.6%. Employment growth in the first half of 2023 was 2.7%. According to our estimates, the number of people employed in manufacturing, finance and tourism increased under the influence of the influx of capital and tourists.

Wage growth, while still at double digit levels, became more subdued due to the slowdown in economic activity. Wage growth for employees decelerated from 22.3% in December 2022 to 11.1% y-o-y in real terms in June 2023. The most significant growth was observed in agriculture (73.3%, y-o-y), public administration (49.5%, y-o-y), information and communication (34.6%, y-o-y), administrative activities (25.9%, y-o-y), tourism (26.5%, y-o-y), and utilities sector (29.1%, y-o-y). At the same time, the main contributors to the growth of real wages were the public administration sector (5.4 p.p.), manufacturing (4.6 p.p.), and agriculture (1.1 p.p.). In addition, the dynamics of the wage growth were influenced by an increase in wages and salaries in transport (0.5 p.p.), retail trade (1.0 p.p.), and tourism (0.2 p.p.) while capital and tourist flows increased.

Inflation and Monetary Policy

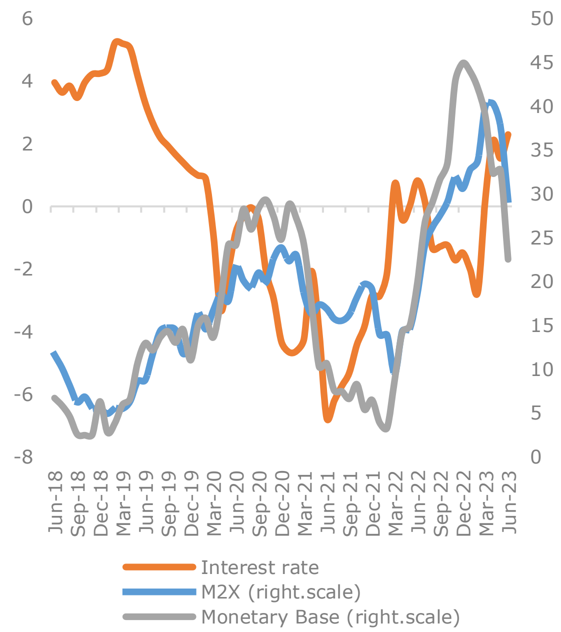
Inflationary pressures had eased by June 2023 as global food prices declined. In June, inflation was 10.5% y-o-y, slowing down from 14.7% in December 2022, against the background of moderately tight monetary policies and the effect of the dynamics of world cereal prices (the FAO cereal price index[1] decreased by 20.8 p.p. compared to the beginning of the year) and prices for non-food products. The contribution of food inflation decreased to 5.8 p.p. (2022 – 7.7 p.p.), while that of non-food products and services increased to 6.9 p.p. (5.1 p.p. a year earlier). There was an acceleration in prices for household items, household appliances (21.6% against 13.8%), cars (19.7% against 7.6%), education services (12.3% against 4.8%), healthcare (20.7% against 12.9%), utilities (8.5% against 6.9%), and restaurant and hotel services (15.6% against 6.3%). This is explained by the high level of consumer activity and demand for tourist services associated with the influx of capital and migrants, as well as the effect of an increase in a number of utility tariffs (electricity, water consumption). Under these conditions, the level of core and market inflation, which excludes the impact of food prices, was higher than CPI inflation (13.7% and 14.3% respectively).

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



Source: NSC KR, EFSD estimates

Figure 4. *Monetary indicators (in %, end of period, y-o-y)*



Source: NB KR, NSC KR

The NB KR kept the refinancing rate at 13% and increased the volume of operations to sterilise excess liquidity in order to contain inflation risks. Despite the slowdown in consumer price growth, the NB KR maintained the

[1] https://www.fao.org/worldfoodsituation/foodpricesindex/en/

refinancing rate at 13.0% throughout the first half of the year in order to curb the growth of market inflation. In April, the NB KR narrowed the interest rate band for overnight deposits, raising the lower boundary to 11.0% and maintaining the upper one at 15.0%. In order to absorb liquidity, open market operations with securities and net foreign exchange sales were made, amounting to USD 456.6 million in the first half of the year (compared to USD 26.9 million in January–June 2022).

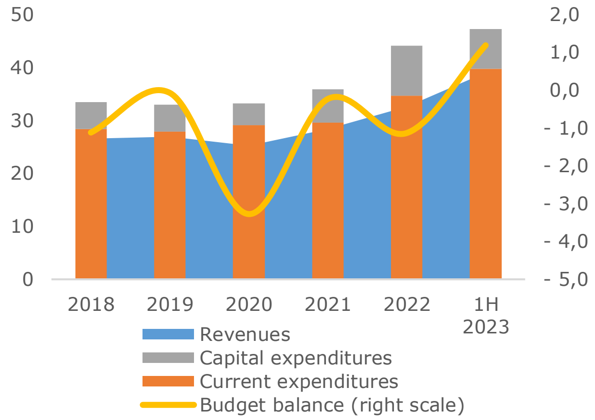
Budget Sector and Government Debt

The state budget surplus decreased due to tax revenues falling faster than expenditures. The state budget had a surplus of 1.2% of GDP, compared with 1.4% in 2022. The decrease in revenues from the Kumtor field was the main reason for the decline in revenues to the state budget. Lower capital investment contributed to a decline in state budget expenditures.

State budget revenues decreased by 1.3 p.p. of GDP to 39.1% of GDP (compared to 40.4% in the first half of 2022). The main contributor to state budget revenues were tax payments at 29.2% of GDP, down from 31.2% a year earlier. The decline in tax revenues was due to lower revenues from the development of the Kumtor field (1.2% of GDP against 6.0%). At the same time, imports rose, resulting in higher revenues from VAT, excise taxes, and import duties (15.4% of GDP against 14.9%), in particular from countries outside the EAEU. The measures implemented to improve tax administration also contributed to better collection of taxes on goods and incomes (VAT and excise taxes on goods, personal income tax, profit tax, etc.) at 12.5% of GDP (against 10.2% in January–June 2022). Grants received amounted to 1.5% of GDP (against 1.7%), while non-tax revenues were 8.4% of GDP (against 7.5%).

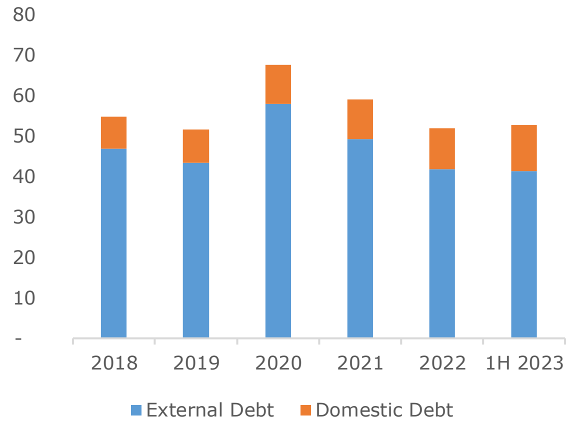
Lower capital investment contributed to a decline in state budget expenditures. The decrease in capital investment by 1.6 p.p. of GDP (7.5% of GDP compared with 9.1% a year earlier) was driven by both lower expenditures under the Public Investment Programme (1.8% of GDP against 2.8%) and lower absorption of domestic investments. Current expenditures of the state budget increased to 30.3% of GDP (compared with 29.9% a year earlier) against the background of higher labour costs (15.3% compared with 14.5%). At the same time, the remaining items of current expenditures were still at the level of January–June 2022. In general, state budget expenditures in the first half of 2023 decreased by 1.1 p.p. to 37.9% of GDP (compared to 39.0% in January–June 2022).

Figure 5. *State budget (in % of GDP)*



Source: MF KR

Figure 6. *Government debt (in % of GDP)*



Source: MF KR

The level of government debt decreased thanks to higher economic growth. The level of government debt decreased from 52.0% at the end of 2022 to 47.7% of GDP in the first half of 2023, while in nominal terms its growth was 5.1%. The external government debt decreased from 41.8% at the end of 2022 to 37.3% of GDP in the first half of 2023 (in absolute terms, the growth was 0.3%). Domestic government debt increased by 0.1 p.p. in the first half of the year to 10.3% of GDP (growth in absolute terms of 15.4%).

External Sector

In the first half of 2023, the trends of widening current account deficits and unrecorded flows ("Errors and Omissions") observed since 2022 continued.

According to the balance of payments data, the current account deficit widened to USD 3.4 billion (64.2% of GDP) in the first half of 2023 against USD 2.3 billion (52.7% of GDP) in the first half of the previous year. This was due to the trade deficit expansion to USD 3.7 billion (71.5% of GDP), against a deficit of USD 2.8 billion (64.7% of GDP) a year earlier, and a reduction in the secondary income surplus to USD 817.6 million (15.7% of GDP), against USD 1.2 billion (26.3%) in the same period of 2022. The primary income deficit was USD 309 million (5.9% of GDP) against a deficit of USD 537.3 million (12.1%).

The expansion of the foreign trade deficit in the first half of the year was driven by faster growth of the value of imports (30.3%) compared with exports (3.4%). The main contributor to export growth was the resumption of gold sales. The growth of the value of non-gold exports slowed down (3.5% compared with 52.6%) due to negative base effects and a decrease in exports to a number of countries. There was a decrease in exports to Russia (-0.5 p.p.) and other countries

(Belgium, Spain, Malta, Lebanon, Syria, India), which had seen an exceptional increase in exports the previous year. Exports of textile products (-8.8 p.p.), food products (-4.8 p.p.), and ferrous metal products (-6 p.p.) made a negative contribution to the growth dynamics. Import growth also decelerated (30.3% compared with 68.7% a year earlier), mainly due to lower imports from Russia, South Africa, and China. The contribution of petroleum products (-4.7 p.p.), textile products (-8.0 p.p.), as well as construction products (-2.3 p.p.), was negative. Growth was mainly supported by imports of passenger cars (17.9 p.p.) and textile materials (4.1 p.p.). The decrease in exports and imports of textile and construction goods may indicate lower demand from Russia, which increased domestic production of clothing by 6%, footwear by 13%, metal structures by 7%, as well as the establishment of transport and logistics chains in Russia.

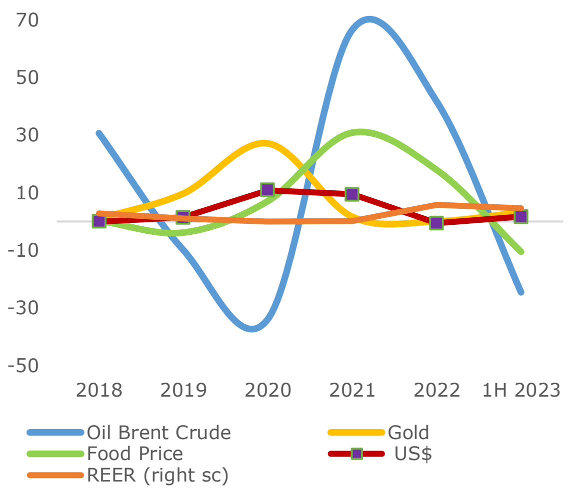
Net remittances decreased by 28.5% y-o-y in January–June 2023 owing to the Russian ruble depreciation against the US dollar. Both inflows and outflows of remittances declined. In terms of countries, Russia was the main contributor to the decline in remittance inflows and outflows, due to both the depreciation of the Russian ruble against the US dollar (by 21.4% since the beginning of the year) and the discontinued capital transit, which had occurred a year earlier.

To prevent the depreciation of the nominal som exchange rate, the NB KR imposed restrictions on exports of cash foreign exchange in March 2023 and sold foreign exchange in the amount of USD 456.6 million in the first half of 2023 (against net foreign exchange sales of USD 26.9 million a year earlier). Against this background, international reserves decreased by 12.8% compared with the beginning of the year, from USD 2.8 billion to USD 2.49 billion, and the nominal effective exchange rate of the local currency depreciated by 1.6% y-o-y in the first half of 2023. At the same time, the index of the real effective exchange rate, which takes into account the difference in inflation between Kyrgyzstan and its trade partner countries, increased by 6.6%, signalling a deterioration in the price competitiveness of Kyrgyz exports.

Net lending under the financial account amounted to USD 2.5 million (0.05% of GDP) in the first half of the year, against net borrowing of USD 212.9 million (4.8% of GDP) a year earlier. The absence of significant pressure on reserves and the exchange rate, which could be expected against the background of such a widening of the CA deficit and financial account outflows, points to the likely unrecorded income from re-exports to EAEU countries, including Russia, in the context of sanctions restrictions[2]. This hypothesis is indirectly confirmed by the fact that in the official statistics, the CA deficit is covered by unrecorded flows under the item "Errors and Omissions", which increased to 57.2% of GDP in the first half of 2023 against 40.4% a year earlier.

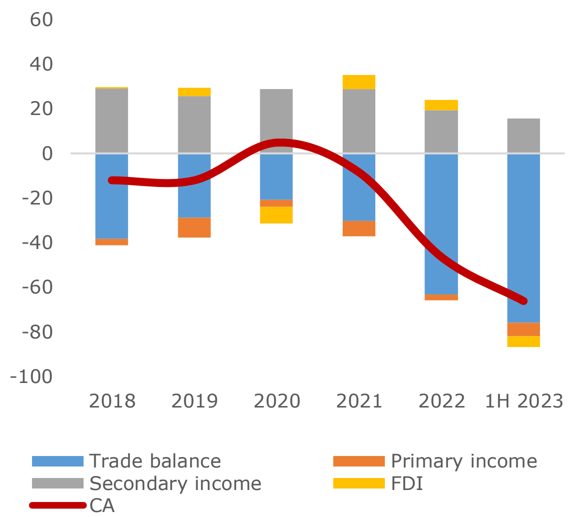
[2] More detailed information can be found in the box in the report "Social and Economic Development in 2022 and Medium-Term Prospective"

Figure 3. *Terms of trade (in %, y-o-y)*



Source: World Bank, national authorities, EFSD estimates

Figure 4. *Balance of payments (in % of GDP)*



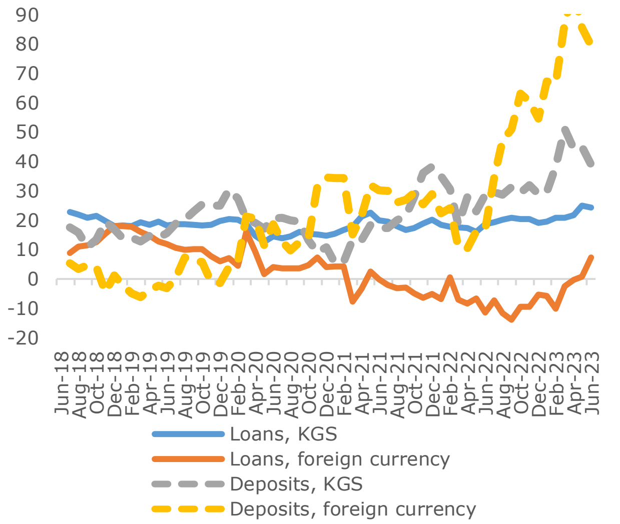
Source: NB KR, NSC KR, EFSD estimates

Net inflows of foreign direct investment (FDI) increased by 80.2% in the first half of 2023 due to a greater decrease in outflows (65.2%) compared with a decrease in inflows (31.7%). Within the FDI composition, the inflow was formed due to an increase in equity capital (73.7%) and a decrease in reinvested profits (34.5%). The outflow of FDI was driven by a decrease in loan repayments (93.9%) and an increase in trade credits (63.1%) and reinvested profits (38.9%). More than half (51.2%) of FDI inflows were directed to the industrial sector (mining and processing), wholesale and retail trade (17%), and financial intermediation (13.2%). The FDI outflow was mainly formed by mining and manufacturing (the shares of 42.2 and 26.1% respectively). The distribution of FDI inflows by country is as follows: China (a share of 23.8%), Russia (20.3%), the US (8.6%), the Netherlands (8.6%), Turkey (7.6%), and Kazakhstan (6.9%). The main contributors to FDI outflows were China (66.8%) and Turkey (7.5%).

Financial Sector

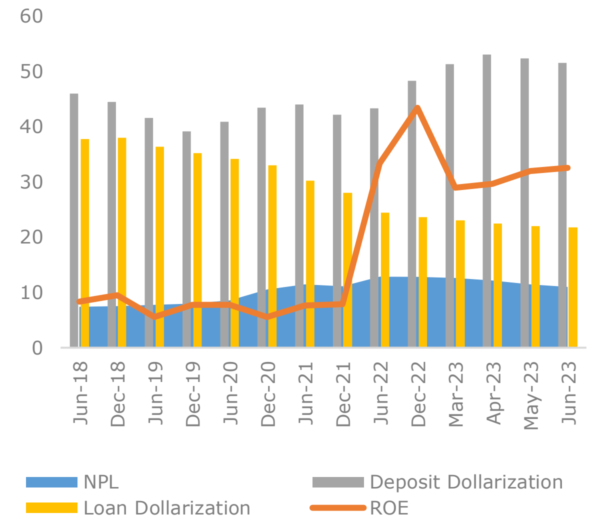
In the banking sector, loans to households increased, mainly due to local currency consumer loans, as well as foreign currency loans to trade. The growth of banks' loan portfolio in local currency accelerated (24.3%, y-o-y, compared with 18.7%, y-o-y, a year earlier). High demand for loans in local currency was observed against the background of excess liquidity in the banking sector. The growth drivers were consumer loans (11.2 p.p.), loans to trade enterprises (5.8 p.p.) and industry (3.1 p.p.), as well as mortgage loans (3.0 p.p.). The volume of loans in foreign currency increased by 7.3% due to loans to trade. The growth rate of deposits accelerated compared to the previous year. The growth of both som (39.0% y-o-y up from 29.5% y-o-y) and foreign currency deposits (79.4% y-o-y in US dollar terms up from 16.8% y-o-y) was mainly influenced by an increase in settlement accounts and term deposits of legal entities, as well as the continued growth of deposits of non-residents in foreign currency.

Figure 9. *Bank loans and deposits (in %, y-o-y)*



Source: NB KR

Figure 10. *Banking sector indicators (in %)*



Source: NB KR

The main prudential indicators of the banking sector remained at a safe level in the first half of 2023. Return on equity and return on assets decreased slightly compared to a year earlier (from 33.3% to 32.5% and from 4.9% to 4.6% respectively), due to lower net non-interest income (by 14.6% y-o-y), while interest income increased (by 54.0% y-o-y). The level of dollarisation of deposits increased, as evidenced by an increase in the share of foreign currency deposits (from 43.3% to 51.5%). At the same time, the dollarisation of loans declined (from 24.4% to 21.8%). The share of non-performing loans decreased to 10.6% (compared to 12.8% in June 2022).

Medium-Term Prospective

Under the baseline scenario, real GDP growth would slow down to 3.7% in 2023, followed by an acceleration in the medium term. The slowdown in economic growth in 2023 is due to weaker consumption and gross capital formation, the latter stemming from lower inventories and government capital spending. . In the medium term, private consumption and exports would support growth. As a result, real GDP growth would be up to 4.9% in 2024, 5.1% in 2025, and 5.5% in 2026.

Inflationary pressures are easing in 2023, and inflation is expected to slow down further in the medium term. According to EFSD estimates, maintaining moderately tight monetary conditions in 2023 (with a slight easing towards the end of the year) would have a dampening effect on inflation, which is projected at 10.0% y-o-y at the end of 2023. In the medium term, monetary policy is expected to gradually become neutral, while the inflation goes back to the medium-term range targeted by the NB KR (5–7%).

In the medium term, the CA deficit is expected to decrease due to higher non-gold exports and lower imports. The gradual adaptation of the economy to changing external conditions would form new logistics channels and production links, with a positive effect on export volumes, which would go up to 46.5% of GDP by 2026, mainly due to an increase in other (non-gold) exports. Remittances are expected to decrease to 14.8% of GDP in 2026 due to the depreciation of the Russian ruble against the US dollar, which may lead to the return of some migrant workers. High import volumes and peak payments under foreign debts would worsen the vulnerability of the balance of payments – the level of gross international reserves would decrease to 2.3 months of imports by 2026, compared with 3.2 months in 2022.

The fiscal position is expected to improve in the medium term. The state budget deficit at 2.4% of GDP in 2023 is projected to have some boosting effect on the economy. Despite the reduction in capital expenditures, state budget expenditures would be higher in 2023 than in 2022 owing to an increase in current state budget expenditures. The implementation of measures to automate fiscal procedures and the continuing high volumes of imports would help maintain a moderate upward trend in tax collection. Owing to a reduction of budget expenditures, by 2026 the state budget may have a small surplus close to a balanced value (0.9% of GDP).

The KR economy is exposed to significant risks, both external and internal. The main risks include fluctuations in world prices for food and raw materials and a slowdown in the Russian economy. High prices for food and raw materials may have a negative impact on the dynamics of inflation, energy security, and employment in the agricultural sector. A slowdown in the Russian economy, depreciation of the ruble exchange rate, risks of secondary sanctions – all this can lead to lower remittances from Russia and re-exports to Russia, resulting in weaker domestic and external demand and economic growth in the KR. In the medium term, the process of import substitution in Russia (localisation of production), as well as the potential relocation of Russian production to neighbouring countries (Kazakhstan, Uzbekistan, Belarus) may also negatively affect the KR export potential. In the long term, the risks associated with natural and climatic phenomena (drought, low water levels) should be highlighted as they are likely to have a negative impact on the energy and agricultural sectors, which can significantly affect the country's economy.

Table 1. Forecast of key macroeconomic indicators

	2022 Actual	2023 Estimate	2024 Forecast	2025 Forecast	2026 Forecast
National accounts and prices (in %)					
Real GDP growth	6.3	3.7	4.9	5.1	5.5
CPI (December, y-o-y)	14.7	10.0	8.0	6.6	6.4
Money and credit (in %)					
Broad money supply growth (y-o-y)	30.6	15.3	23.1	13.4	10.3
Policy interest rate	13.0	12.0	10.0	8.0	8.0
Public finance (in % of GDP)					
Budget revenues and grants	32.7	32.1	32.9	32.4	31.9
Budget expenditures	33.8	34.5	32.8	31.3	31.0
Budget balance	-1.1	-2.4	0.1	1.1	0.9
External Sector					
Net remittances (in % of GDP)	19.4	19.2	17.7	15.7	14.8
Current account* (in % of GDP)	-46.5	-28.2	-16.9	-15.8	-13.3
Net foreign direct investment (in % of GDP)	4.7	4.7	6.4	6.5	6.5
Gross reserves, in months of imports of goods and services	3.3	2.9	2.6	2.4	2.3

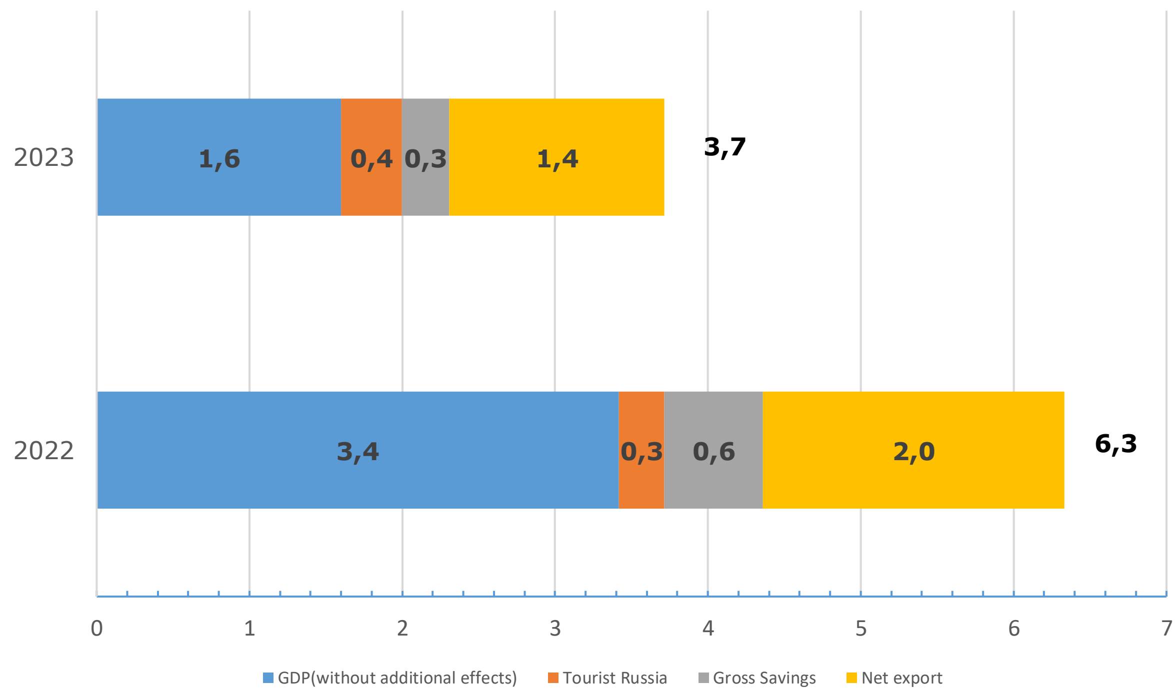
Source: NSC KR, NB KR, MF KR

*Unrecorded export flows are partially reflected under the item "Net Errors and Omissions".

Annex: "**Assessment of the Impact of Sanctions against Russia, the Influx of Russian Financial and Human Capital on the Economy of Kyrgyzstan"**

In 2022, the economies of the EFSD member states were influenced by new external conditions related to sanctions pressure on Russia, as well as the outflow of financial and human capital from Russia to the EFSD member states. These conditions influenced the economies of the EFSD member states in different ways and through different transmission channels. This analysis focuses on assessing the impact of these effects on the Kyrgyz economy in 2022 and 2023. The methodology used in a similar analysis for the Republic of Armenia was taken as a basis[3]. The impact of additional effects on certain GDP components was assessed. In order to assess the impact on GDP, the "overhang above natural levels" of the inflows of tourists, foreign direct investment, exports and imports from the RF was calculated by assessing the deviations of their actual values from the average level of previous years (the "natural level").

Figure 1.1. Assessment of the contribution of the influx of financial, human capital, and higher foreign trade with the RF to the KR GDP growth rate in 2022–2023 (in %)



Source: NSC KR, EFSD estimates

[3] "Assessment of the impact of the influx of Russian capital and Russian citizens on the economic growth of the Republic of Armenia" (EFSD, 2022).

Preliminary estimates made in 2022 showed that the contribution of the impact of new external conditions on the growth of the KR economy was 2.9 p.p. out of 6.3%. The main effect was an increase in trade turnover with Russia. Against the background of the sanctions imposed on Russia, there was an increase in the flow of consumer goods from Kyrgyzstan to Russia, most of which were imported from China. The increase in trade turnover with Russia and China contributed to the growth of domestic trade and transport services. In addition, there was an influx of Russian foreign direct investment in 2022, which facilitated a higher contribution of gross capital formation to economic growth. The additional influx of citizens from Russia in 2022 amounted to 313,600 people (93.3% above the "natural level"). Most of those people visited Kyrgyzstan for the purpose of tourism, which contributed to an increase in tourist services and stimulated consumption.

According to EFSD estimates, in the first half of 2023, the growth of the Kyrgyz economy, net of the influence of Russian capital and tourists, slowed down to 2.6%, which means that the positive contribution from the RF was 1.3 p.p. According to EFSD forecasts, economic growth in 2023 would be 3.7%. The decomposition of GDP shows that the contribution of tourists from Russia to GDP dynamics would be 0.4 p.p. At the same time, a lower level of foreign direct investment from Russia would reduce the contribution of gross capital formation (to 0.3 p.p. against 0.6 p.p. in 2022) to the growth of the KR economy. According to our estimates, net exports to Russia (1.4 p.p.) would continue to make the main contribution to GDP growth, which would also decrease. As a result, net of the influence of externalities from Russia, the growth of the national economy would be 1.6%.

It is worth noting that the GDP statistics by use components show a substantial increase in the item "Statistical Discrepancy" in 2022 and 2023, which, we assume, represents unrecorded re-exports to Russia[4]. Therefore, the value of net exports was adjusted for the amount of the "Statistical Discrepancy".

One of the initial hypotheses was that the effects of the new economic conditions would be short-term. However, preliminary estimates show that the positive effects on the economy are expected to persist in 2023 and to be felt in 2024. This allows us to assume that these trends may persist in the medium and long term, depending, however, on the adaptation of the Kyrgyz economy to the new economic conditions. Further research is needed to assess structural changes and their effects on the Kyrgyz economy.

[4] Macroeconomic review for the KR for 2022.