EFSD Eurasian Fund for Stabilization and Development

Kyrgyz Republic

Recent social and economic trends and short-term prospective *

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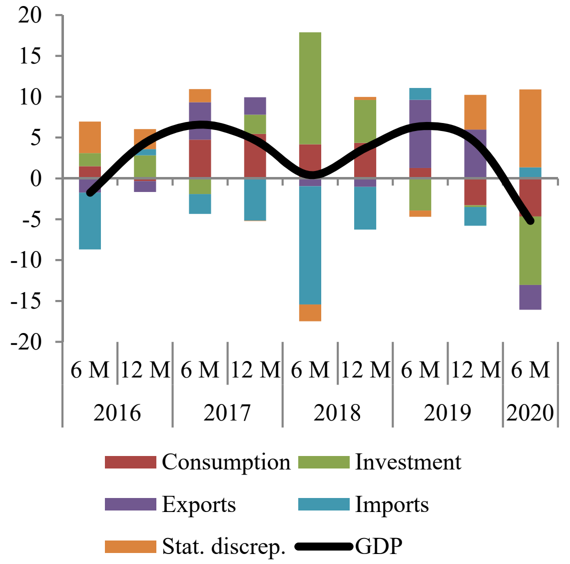
KYRGYZ REPUBLIC: RECENT SOCIAL AND ECONOMIC TRENDS AND SHORT-TERM PROSPECTIVE

Real Sector and Labour Market

Kyrgyzstan's economy was negatively affected by the COVID-19 pandemic and external shocks in the first half of 2020. The impact of the COVID-19 outbreak on the economy of the Kyrgyz Republic started to manifest itself through the foreign trade channel. Lower global demand and output led to declining foreign trade turnover, investments, and remittances that resulted in KGS exchange rate depreciation. The quarantine measures introduced in March 2020 to limit business activity in the context of the spread of the COVID-19 pandemic, combined with mounting uncertainty, caused a dramatic decline in economic activity and growth of prices in the first half of 2020.

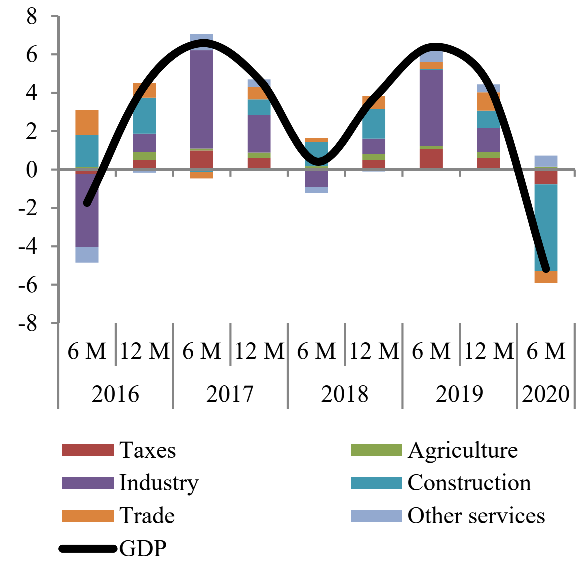
In January-June 2020, the real GDP contracted by 5.3% against growth of 6.4% in the first half of 2019. In terms of final consumption in GDP (Figure 1), the economic recession was associated with lower domestic and external demand. The quarantine measures and border closure resulted in a drop in investments. Investments in fixed assets decreased by 14.8%, mainly due to foreign investments. A 13% decline of remittances, combined with the impact of domestic factors, affected household consumption. At the same time, exports of goods, excluding gold, decreased against the background of lower external demand. In terms of sectors (Figure 2), the shock primarily affected construction (-9.1% against 5.8% a year earlier) and services (-8.2% against 1.5%), such as wholesale and retail trade (-15%), hotel and restaurants (-39.5%), and transportation (-32%). Agriculture and mining showed growth of 1.6% and 9.8% respectively (against 2% and 31.8%). A rise in the output of metallurgy industry, in particular gold at the Kumtor field by 9%, as well as an increase in output of pharmaceutical (by a factor of 2.4) and chemical products (10.9%) supported the performance of the manufacturing sector. In general, the production of manufactured goods grew by 0.1% in the first half of 2020 (against 20.5% growth a year earlier), and excluding gold production at the Kumtor field, the rate of output decline was exacerbated by the impact of the pandemic (-8% against -3.1%).

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

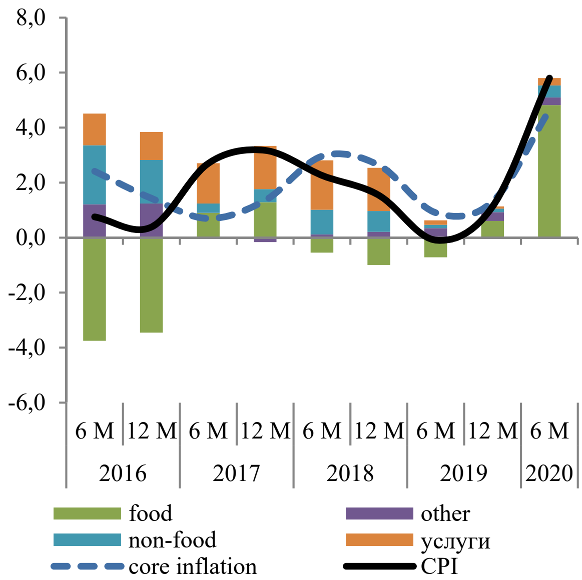
Against the background of the weakening economic activity, employment growth was supported by an increase in the number of employees in the budgetary sector. The growth of the number of employees slowed to 0.1% (against 0.2%) amid a reduction in employment in all sectors of the economy, except for the budgetary sector, which contributed 0.9 p.p. of the total growth. Statistics on real wages of employees indicate an increase in real incomes of the population by 4.4% compared to the previous year, the key contributor again being the budgetary sector (up to 5.9 p.p.), mainly due to last year's increase in salaries and wages.

Inflation and Monetary Policy

The inflation accelerated in the first half of 2020 on the back of local currency depreciation and emerging shortage of consumer goods in the context of difficulties with importing goods and the state of emergency (Figure 3). The consumer price growth accelerated to 8.6% in April 2020 (from 3.1% in December 2019), while the range targeted by the NB KR was 5-7%. The price growth accelerated in all segments of the consumer basket, but the highest rate of growth was registered for food prices, where an additional contributing factor was a sharp increase in demand for food in the face of difficulties with food imports and restricted movement inside the country during the period of the state of emergency. The core inflation accelerated to 6.3% (against 2.4% in December 2019), *inter alia* due to the effect of the local currency depreciation in March. By June 2020, under the impact of weak economic activity and lower demand, the price growth had slowed down to 5.8% (against 0.9% a year earlier). The price level was determined by the food price growth (10.7% against 1.2% a year earlier).

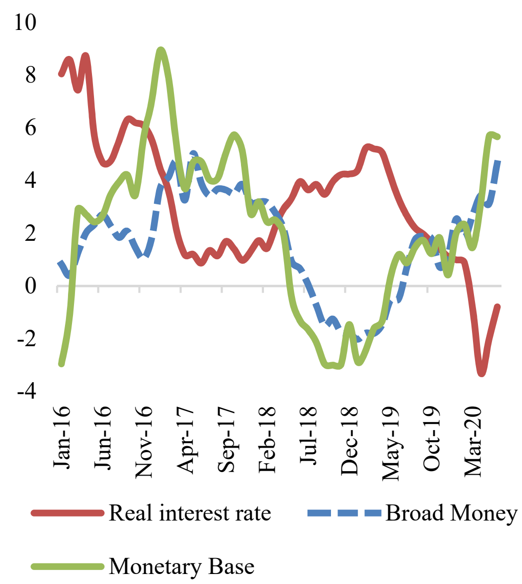
The NB KR maintained its expansionary monetary policies to support the economy at the time of the pandemic (Figure 4). Despite the increase in inflation, the NB KR kept the refinancing rate unchanged at 5% starting from February 2020. Against the background of the accelerating inflation, the real interest rate continued to decline, turning negative in March 2020. The monetary and other financial easing by the regulator contributed to further double-digit lending growth rates (10.7% in June 2020 against 14.5% in December and 15.9% in June 2019). At the same time, the broad money supply growth accelerated (to 21.7% from 12.8% in December and 8.8% in June 2019), which was a result of operations of the general government..

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



Source: NSC KR

Figure. 4 *Monetary indicators (%)*



Source: NBKR, NSC KR

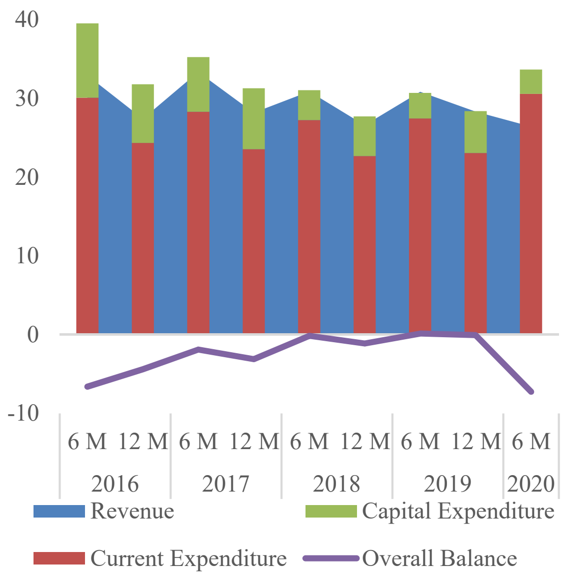
Fiscal Sector and Public Debt Sustainability

The slowdown in economic activity and the decline in imports led to lower State budget revenues (Figure 5). Budget revenues dropped by 4.4 p.p. to 26.4% of GDP, including a 3.5 p.p. decline in import taxes and duties. Domestic tax revenues also decreased (by 0.9 p.p.), except for the personal income tax and profit tax (+0.4 p.p.) and revenues from the Kumtor field development (+0.6 p.p.). The total tax payments amounted to 19.4% of GDP (-3.8 p.p.). In addition, there was a decrease in grants (-0.1 p.p.) and non-tax revenues (-0.5 p.p.).

Budget expenditures increased due to higher current expenditures and spending under the Public Investment Programme (PIP) (Figure 5). Budget expenditures grew by 3 p.p. to 33.7% of GDP mainly due to the budgetary sector payroll going up by 2.9 p.p. to 14.0% of GDP, *inter alia* as a result of an increase in salaries and wages of education workers in October 2019, and additional expenditures on the health sector in the context of the COVID-19 pandemic. Despite an increase in externally financed investments to 1.8% of GDP (+0.6 p.p.), capital expenditures went down (-0.2 p.p.). The decline in capital expenditures financed from domestic sources (-0.8 p.p.) is attributable to a reallocation of budget funds to finance pandemic-related measures.

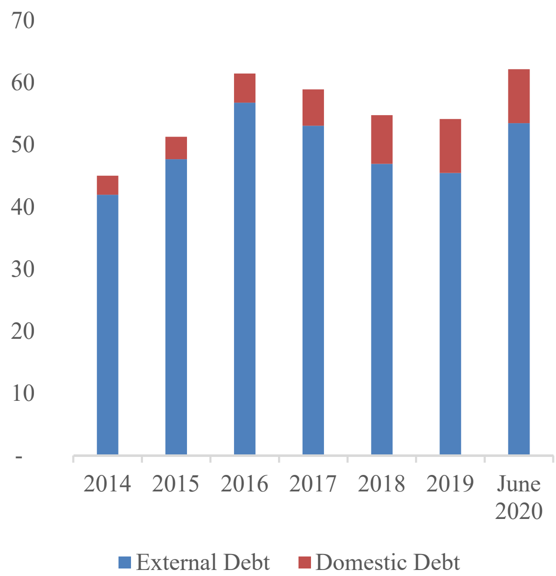
The State budget deficit increased leading to public debt growth. Against the background of a shortfall of tax revenues and expanded spending, the State budget had a deficit of 7.3% of GDP[1] compared to a surplus of 0.1% of GDP a year earlier. The higher state budget deficit was the main factor contributing to the public debt growth, which amounted to 62.2% of GDP as at end-June against 54.1% of GDP in December 2019 (Figure 6). The debt growth was also affected by the weaker economic activity and the local currency depreciation.

Figure 5. *Government budget (% ВВП)*



Source: KR MoF

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



Source: KR MoF

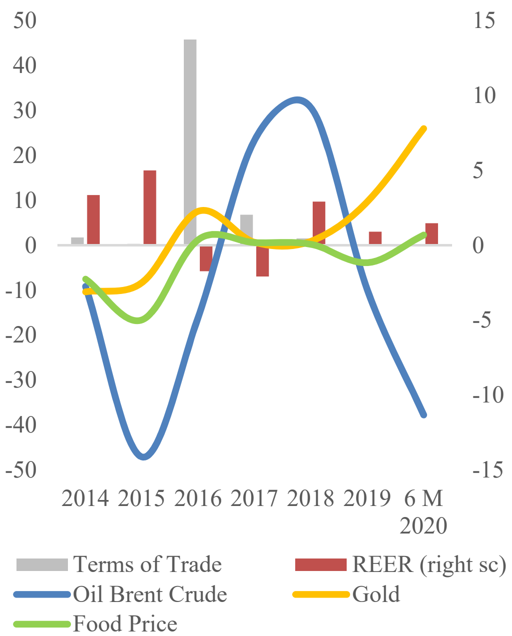
[1] The budget balance, including onlending to state-owned enterprises, amounted to 8.2% of GDP compared to 0.4% in January-June 2019.

External Sector

Despite a fall in incoming remittances, lower imports and higher gold prices resulted in an improvement of the current account balance (Figure 8). The introduction of quarantine measures in many countries across the world triggered a global recession and stronger volatility in global markets. A decline in energy prices (by 37.7% for Brent oil in annual terms) and the subsequent increase in gold prices (by 26.0% in annual terms) resulted in export prices substantially above import ones (Figure 7). Against the background of these changes in the terms of trade, lower imports in volume terms (-32.2%) and higher exports (+2.5%) led to a significant drop of the trade deficit to 21.4% of GDP (against 42.9% a year earlier). Lower imports of footwear, clothing, fabrics, construction products and equipment from China contributed to lower imports. Exports of goods were supported by an increase in gold exports, while exports of footwear and textiles to the EAEU countries decreased. The pressure on the current account was generated due to lower remittances—net incoming remittances amounted to US $763.6 million in the first half of 2020, which is 13.1% lower than in January-June 2019. Thus, according to the EFSD, a strong decline in imports in the first half of 2020 contributed to the formation of a balanced current account (against a deficit of 16.5% in January-June 2019).

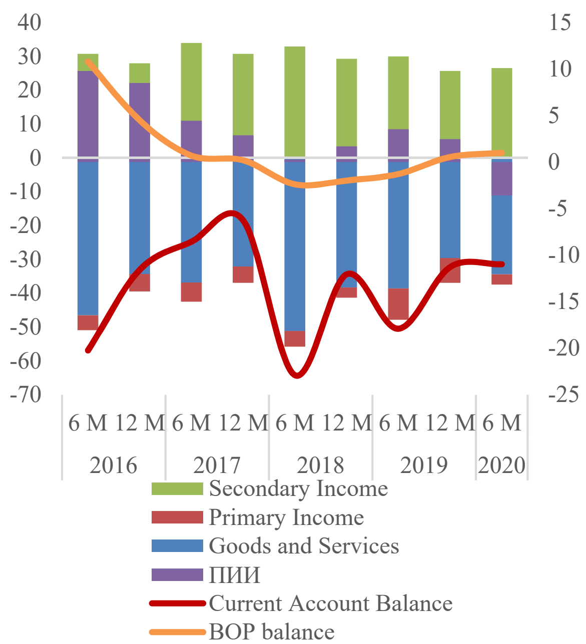
Lower imports and debt-related flows to the public sector were somewhat offset by net foreign direct investment outflows. In the context of the weaker economic activity, capital outflows under the item "Foreign Direct Investments" amounted to US $439.5 million in January-June 2020 (against inflows of US $118.5 million in January-June 2019). At the same time, the public sector borrowed US $296.7 million. Amid the uncertainty about the duration of shock effects, the NB KR engaged in active interventions in the first quarter of 2020 aimed at stabilising the exchange rate. In general, they totalled US $210.4 million for six months of 2020. However, despite net sales of foreign exchange, the gold and foreign currency reserves increased in nominal terms, amounting to US $2.6 billion, which, against the background of a substantial drop in imports, was equivalent to 6.6 months of imports.

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



Source: World Bank, NBKR, NSC KR

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



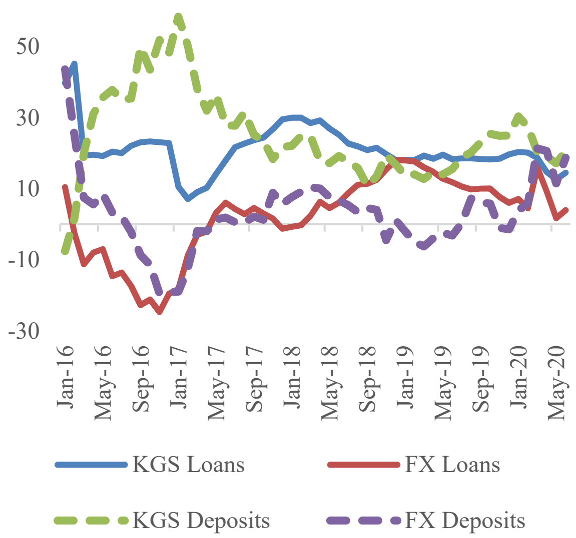
Source: NBKR, NSC KR

Financial Sector

In the first half of 2020, the growth rate of the loan portfolio slowed down, still remaining, however, at a double-digit level (10.7% compared to an increase of 15.9% previously) (Figure 9). This was largely due to the continued excess liquidity in the banking sector and the KGS exchange rate depreciation—the effect of the latter amounted to about 3.2 p.p. of growth of the loan portfolio. As to local currency loans (up by 14.5%), loans to agriculture (3.0 p.p.), trade enterprises (3.3 p.p.), and mortgage loans (3.0 p.p.) were the key drivers of growth. The stock of loans in foreign currency increased by 4.0%—taking into account the exchange rate depreciation, they decreased by 4.9%—due to loans to other sectors (2.8 p.p.), as well as social services (1.4 p.p.), and industry (1.6 p.p.). The dollarization of loans declined from 36.4% in June 2019 to 34.2%. The weighted average lending interest rates continued to be on the downward trend, making 16.9% (down from 17.6%) in local currency and 9.5% (down from 9.9%) in foreign currency.

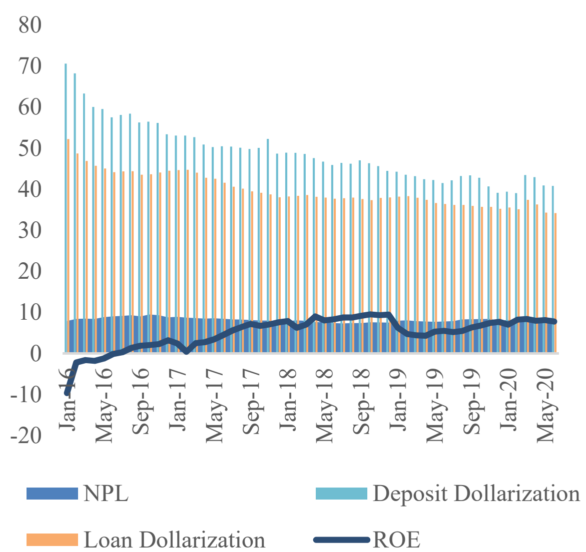
The rate of deposit growth accelerated significantly compared to the previous year (19.8% against 7.1% a year earlier), partly due to the depreciation effect—with the latter netted out, the increase was 15.6% (Figure 10). The main contribution to the acceleration of deposit growth was a sharp increase in deposits of legal entities. The weighted average deposit interest rates continued to be on the downward trend, making 5.8% (down from 6.1%) in local currency and 1.3% (down from 1.4%) in foreign currency. The local currency deposit portfolio increased by 20.5% (against 15.5% a year earlier), and the growth was generated equally by deposits of households and those of legal entities. The growth of foreign currency deposits was mainly due to the value effect of the KGS exchange rate depreciation (10.1 p.p. of 18.1%). Foreign exchange deposits of legal entities increased by 20.6%, taking into account the depreciation effect, with the key contributors being settlement accounts and demand deposits. The growth of foreign exchange deposits of households, taking into account the depreciation, amounted to 1.1%. Against the background of low interest rates for foreign exchange deposits, they were getting less attractive. In addition, a decline in foreign exchange deposits was associated with continued slowdown in the pace of foreign exchange lending, which generally contributes to the continued trend of the economy de-dollarization—the dollarization of deposits went down from 41.5% to 40.8%.

Figure 9. *Bank Lending (%, 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). The share of classified loans in total assets increased from 4.7% to 4.9%, which may be a consequence of the economic shutdown during the quarantine. The share of non-performing (classified) loans rose to 8.6% (against 7.8% in June 2019). However, the return on equity and the return on assets increased compared to the previous year (from 5.6% to 7.8% and from 0.9% to 1.2% respectively), with a dramatic improvement in these indicators launched in 2020. It is explained by low profits of banks in the first half of last year.

Short-Term Outlook and Risks

Should there be no new wave of the COVID-19 pandemic, a gradual recovery of the economy is expected starting from the autumn. During the remainder of the year, the economy of the Kyrgyz Republic will be impacted by uncertainties regarding the likelihood of another wave of the COVID-19 pandemic and the pace of the economic recovery. If a recovery of the world economy, including Russia, begins, the negative impact of the lower external demand transmitted through the channels of trade, investments, and remittances could be expected to diminish. Against the background of an economic recovery in Russia, the rate of the fall in remittances would decrease. Amid high world prices, gold exports would support the dynamics of exports. Improving domestic demand would lead to a recovery of imports, resulting in rapid growth of the current account deficit. With restrictions gradually shifted in Kyrgyzstan and measures of financial support implemented by the Government, the private sector would be able to reduce the pace of investment activity deceleration by end-2020 and to move to a positive rate of recovery growth in 2021. Higher expenditures of the State budget supported by international donor programmes, including the EFSD financial credit (see the Box), would support domestic demand. The State budget will have a deficit of 4.6% of GDP in 2020. And in 2021, as the tax collection recovers, the State budget deficit would decrease to 1.3% of GDP. As a result, the EFSD forecasts a 4.6% real GDP contraction in 2020, and the recovery growth is expected to be 5.1% in 2021. Having accelerated in early 2020 and slowed down on the back of the weakening economic activity in Q2, the inflation will be 5.8% in December 2020. In subsequent years, the inflation will remain within the range targeted by the NB KR.

The emergence of another wave of the COVID-19 pandemic, against the background of gradual lifting of restrictive measures in Kyrgyzstan and its major partner countries, is a major risk factor for the economic development pattern in the last months of 2020 and in 2021. Repeated COVID-19 outbreaks in many countries across the world entail the risk of that scenario unfolding in Kyrgyzstan. If this scenario materialises, new outbreaks of the COVID-19 pandemic will delay the economic recovery. Against the background of the current weak domestic and external demand, another sharp increase in the number of people affected by the COVID-19 pandemic will have a strong impact leading to a deterioration of the financial condition of businesses. That would have a negative effect on tax payments to the budget, and the need for higher spending on treating those infected and supporting the economy would result in additional expenditures of the State budget. In case of a high-poverty economy, limited savings of most of its households would not be able to fully offset a continued decline in real incomes of the population. A deterioration of the balance of payments would result in further local currency depreciation, adding to foreign exchange risks to the public debt sustainability and the banking system.

Despite the expected recovery in 2021, the economy of the Kyrgyz Republic will remain vulnerable, as indicated by the State budget deficit still combined with the balance of payments deficit. In the face of the uncertainty, continued significant structural and institutional challenges, and the high vulnerability of the economy to external shocks, the EFSD plans to maintain an active dialogue with the Kyrgyz authorities, and further coordinate with donors its support to important structural transformations in the framework of the EFSD budget support programmes. In this regard, the EFSD will continue its on-going monitoring of macroeconomic developments and a coordinated dialogue with key donors on the need to provide budget support in 2021 (see the Box).

Box: Budget Support Provided by the Eurasian Fund for Stabilization and Development to the Kyrgyz Republic in the Context of the COVID-19 Pandemic

In 2020, as part of concerted efforts of key donors to support the Kyrgyz Republic in mitigating the impact of the COVID-19 pandemic on the country's economy, financial and social sectors, the EFSD Council approved the extension of budget support to the Kyrgyz Republic in the amount of US $100 million. The key objective of the loan is to assist the country in financing measures to mitigate the effects of COVID-19 in order to ensure a recovery of its economic growth and avoid worsening of the living standards of the population, including support to the health sector, vulnerable groups of the population, and main sectors of the economy, as well as responsible fiscal and monetary policies, and sustainability of the banking sector.

Given the high uncertainty regarding the impact of the COVID-19 pandemic on the global, regional economy, and that of the Kyrgyz Republic, as well as the high vulnerability of the Kyrgyz economy to external shocks, the key objective of the EFSD is to continue its on-going monitoring of macroeconomic developments.

Starting from 2021, once the COVID-19 pandemic is over and a strong revival of the Kyrgyz economy begins, the EFSD will focus on supporting strategic priorities of the Government of the Kyrgyz Republic, aiming at structural and institutional reforms, as well as further active implementation of projects related to basic infrastructure modernisation and human capital development. If the Government of the Kyrgyz Republic is interested in a medium-term EFSD financial credit programme, the work will be focused on supporting macroeconomic, fiscal and financial stabilisation measures with a view to ensuring the prerequisites for recovering sustained economic growth rates

Kyrgyzstan: Main Macroeconomic Indicators

	Actual					Forecast*	
	2017	2018	2019	1 H 2019	1 H 2020	2020	2021
National Account and Prices (in %)							
Real GDP growth	4,7	3,8	4,5	6,4	-5,3	-4,6	5,1
GDP Deflator	6,3	3,4	-0,8	-3,5	2,7	12,0	5,4
CPI (Dec, y/y)	3,7	0,5	3,1	0,9	5,8	5,8	6,8
CPI (average)	3,2	1,5	1,1	-0,1	5,8	5,5	6,4
Money and Credit (end-of-period)							
Broad Money, % change	17,9	5,5	12,8	8,8	21,7	16,4	10,8
Broad Money Multiplier	1,8	1,9	1,8	1,9	1,9	1,9	1,9
Velocity	2,7	2,8	2,6	2,7	2,2	2,4	2,4
Key Policy Rate	5,0	4,8	4,3	4,3	5,0	5,0	5,0
Public Finance (in % of GDP)							
Revenue and Grants	28,2	26,6	28,3	30,9	26,4	26,1	27,6
Expenditure	31,3	27,7	28,4	30,7	33,7	30,7	28,9
Overall Balance ("-" deficit / "+" proficit)	-3,1	-1,1	-0,1	0,1	-7,3	-4,6	-1,3
External Sector (in % of GDP)							
Current Account Balance	-6,3	-12,1	-12,3	-16,5	0,0	-13,7	-9,2
Remittances	26,4	25,9	21,9	26,1	24,9	17,0	19,9
Gross International Reserves, in months of imports of goods and services	5,1	4,4	5,2	4,8	6,6	5,2	5,0

Source: national agencies, EFSD estimates