

Kyrgyz Republic

Social and Economic Development in 2021*

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* This Note was prepared by the Financial Credit Project Group, EFSD Project Unit, Eurasian Development Bank, including: Tigran Kostanyan (Director of the Financial Credit Project Group), Natalia Pisareva (Head of the Budget Sector), Elvira Kurmanalieva (Leading Expert), Yaroslav Baklzhansky (Chief Specialist), Alexandr Yanushkevich (Leading Specialist), Dinara Sholanova (Leading Specialist), Liana Harutyunyan (Leading Specialist). The Annex “EFSD’s Approach to Determining the State Budget Balance in the Kyrgyz Republic” 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.

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EXECUTIVE SUMMARY

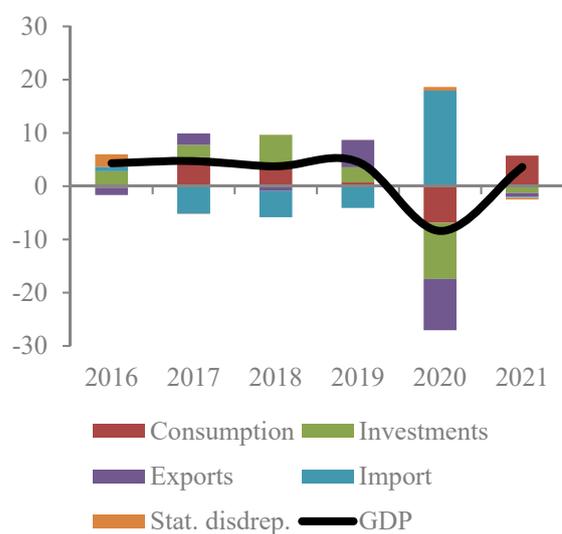
In 2021, in the aftermath of the COVID-19 pandemic with its negative impacts, the economy of the Kyrgyz Republic demonstrated recovery growth of 3.6%. The key drivers of the growth were retail trade, services, and industrial production. At the same time, there was a drop in agricultural production due to a drought and a decline in construction. In addition to the impact of the drought, the shock associated with the world prices for food and petroleum products pushed the growth of inflation. The National Bank of the Kyrgyz Republic responded to that by raising the key interest rate sharply. In the context of growing tax and non-tax revenues and prudent spending policies, the state budget deficit amounted to only 0.2% of GDP. The economic growth and improved fiscal position resulted in the public debt going down to 60.3% of GDP in 2021 from 67.6% a year earlier.

KYRGYZ REPUBLIC: SOCIAL AND ECONOMIC DEVELOPMENT IN 2021

Real Sector and Labour Market

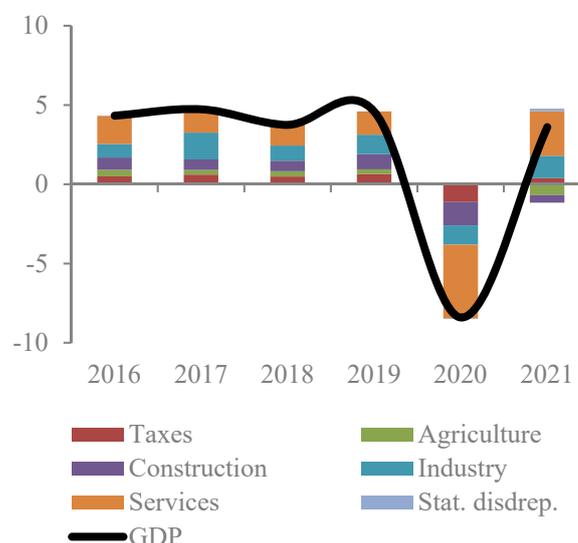
The key driver of the GDP growth in 2021 was a recovery in consumer activity. According to the EFSD, the economic growth in the Kyrgyz Republic, which amounted to 3.6% in 2021, mainly relied on the contribution of private consumption (Figure 1). In turn, the stronger consumer activity of households was facilitated by the lifting of quarantine restrictions, recovery of trade, and resumption of full-fledged economic activity. The remaining components of GDP use made a negative contribution to the economic growth in 2021. In the context of a revision of many regulatory legal documents and persistent uncertainty regarding the doing business environment, there was a weak recovery in investment activity, with capital investments declining at a rate of 5.9%. The contribution of net exports of goods and services, formed as a result of a decline in gold exports and an increase in imports of goods and services, to the GDP growth was also negative.

Figure 1. Contribution to GDP growth, by use components (p.p., y-o-y)



Source: NSC KR, EFSD estimates

Figure 2. Contribution to GDP growth, by production components (p.p., y-o-y)



Source: NSC KR

In terms of production, services and industry made a positive contribution to the economic growth, while agriculture and construction showed a decline. In terms of sectors (Figure 2), the recovery in trade and consumer activity against the background of a low base of 2020 contributed to an increase in the wholesale and retail trade turnover (+11.4% against a fall by 14.8% in 2020). Industries also showed recovery growth rates (+7.3% against a 6.4% fall in 2020), *inter alia* due to an increase in metal ore production by 22.7%. In manufacturing, the output (in particular, that of food products, non-metallic minerals, and metallurgy) increased by 7.0% in 2021, which ensured practically a full recovery following a 7.1% decline a year earlier. The production of gold at the Kumtor mine also contributed positively to the development of the manufacturing industry and the GDP growth. Agriculture showed a decline of 5.0% (against growth by 0.9% a year earlier) as a result of a fall in crop production in the context of water shortage.

The recovery of the economic activity had a limited effect on the labour market. The number of officially registered unemployed grew on average by 2.3% in the first half of 2021. The labour market conditions improved slightly towards the end of 2021, when the number of officially registered unemployed decreased by 0.9% in annual terms. In general, the employment growth was 1.1% in 2021 (against a 0.2% fall in 2020). It was mainly driven by an increase in the number

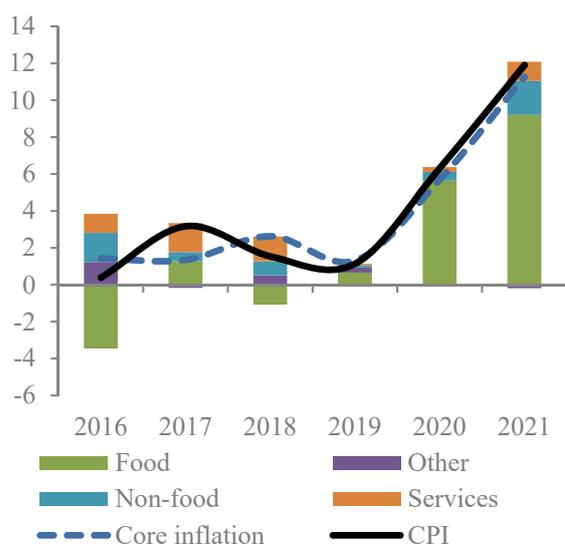
of employees in wholesale and retail trade (a contribution of 0.5 p.p.), and the budget sector – against the background of an increase in the number of employees in healthcare (0.2 p.p.) and education (0.4 p.p.). However, the continued decline in employment in transportation services (-0.1 p.p.) and tourism (hotels and restaurants, -0.1 p.p.) constrained the pace of the recovery in the labour market. Salaries and wages decreased by 2.5% in real terms. Taking into account the growth of inflation, real wages dropped in 70% of economic sectors. Against the background of an increase in the wage bill for medical workers, a positive growth rate of real wages was observed in the health sector (6.2%).

Inflation and Monetary Policy

The acceleration of inflation in 2021 was largely driven by non-monetary factors against the background of water shortage and rising global prices for food and energy. The average consumer price growth was 11.9% in 2021 (against 6.3% in 2020). The main contribution to the accelerated price growth was made by food products (Figure 3). The growth of food prices on world markets affected the growth rates of prices for vegetable oil, sugar, and cereals imported to the Kyrgyz Republic. Inflation accelerated markedly in Q3 2021 as a result of rising prices for food products produced in the Kyrgyz Republic (vegetables, fruit) in the context of a low harvest due to low rainfall and problems with irrigation water. In the second half of the year, the growth of world prices for petroleum products also accelerated, which affected consumer prices for fuels, lubricants, and transportation services. The indicators of inflation, net of the effects of non-monetary factors, also increased. The core inflation, which eliminates the impact of prices for goods and services subject to seasonal fluctuations or administrative interventions, accelerated to 11.3% (against 5.7% in 2020). The market inflation index, which eliminates the impact of food and excisable goods, as well as administratively regulated prices and tariffs, went up to 5.9% (against 1.7% in 2020).

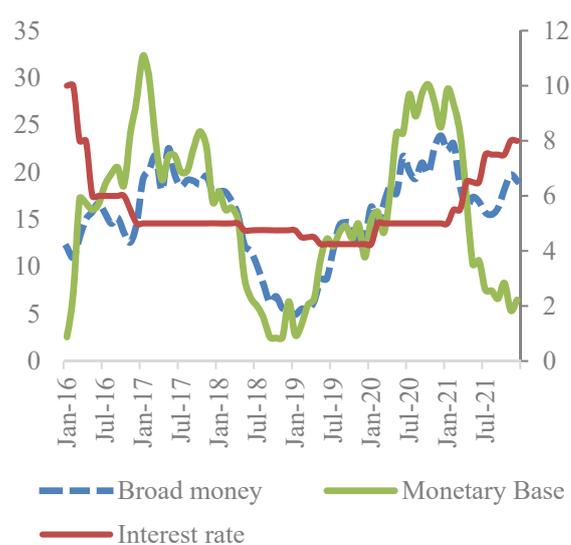
The deceleration of the growth rate of money supply towards the end of the year was facilitated by key interest rate increases by the National Bank of the Kyrgyz Republic along with currency interventions. Due to the growing influence of monetary factors on inflation throughout 2021, the National Bank of the Kyrgyz Republic raised the key interest rate on four occasions (in February, April, July, and November), in total by 300 basis points from 5.0% to 8.0% (Figure 4). The National Bank of the Kyrgyz Republic issued securities, thus sterilising KGS 280 billion. The money supply also decreased owing to net sales of foreign exchange, amounting to KGS 59.3 billion for the year (US \$698.95 million). Against the background of the monetary policy implemented by the National Bank of the Kyrgyz Republic, the base money growth rate had slowed down to 6.5% by end-2021 (against 24.8% in December 2020). The growth of the broad money supply, which includes foreign currency deposits in commercial banks (monetary aggregate M2X), also decelerated to 19.1% (against 23.9%).

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



Source: NSC KR

Figure 4 Monetary indicators (in %, y-o-y)

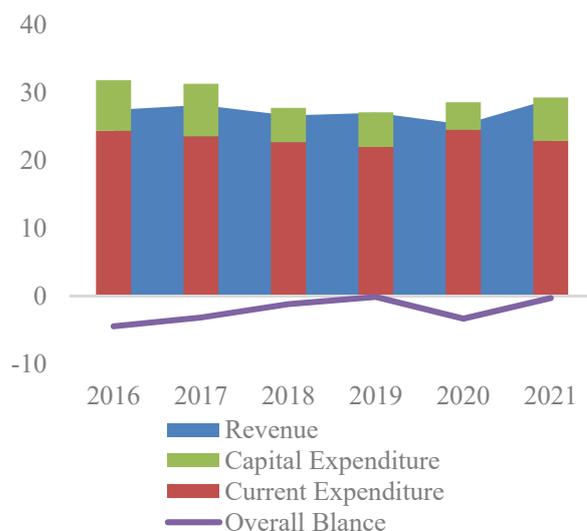


Source: NB KR, NSC KR

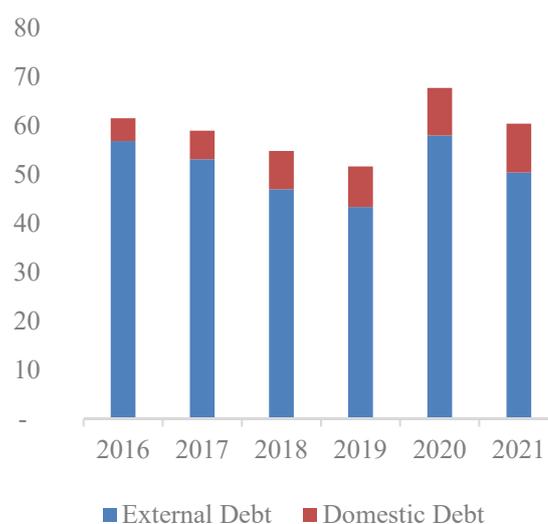
Budget Sector and Public Debt

A recovery of the economic activity and improved tax administration contributed to higher tax revenues, while non-tax revenues increased owing to the provision of paid services and an advance transfer of profits of the National Bank of the Kyrgyz Republic. Tax revenues rose to 20.9% of GDP (17.8% of GDP in 2020; Figure 5) as a result of an increase in revenues from all major taxes except Kumtor mining revenues, which fell by 0.5 p.p. to 1.1% of GDP against 1.6% in 2020. The improvement in tax administration is evidenced by growth of personal income tax and profit tax revenues, as well as revenues from the VAT on imports of goods and services from the EAEU countries in excess of the GDP growth in the absence of nominal tax rate increases. In addition, non-tax revenues also grew (6.2% of GDP against 5.5% in 2020), mainly due to the advance transfer of profits of the National Bank and growth of revenues from provision of paid public services by ministries and agencies. Grants amounted to 1.9% of GDP against 2.0% in 2020.

The expenditure side of the budget grew at a more moderate pace compared to budget revenues. State budget expenditures increased to 29.3% of GDP from 28.6% in 2020 (Figure 5). Higher expenditures are attributable to a recovery of domestic capital expenditures (3.8% against 2.0% in 2020), following a reallocation of budget funds in favour of financing measures to combat the pandemic in 2020, as well as an increase in disbursements under public investment projects (PIP) (2.6% against 2.0%). The level of current state budget expenditures fell to 22.9% of GDP from 24.5% a year earlier due to the high base of 2020, when social payments and transfers were expanded to counter the impacts of the COVID-19 pandemic. In general, over the past two years, there has been growth of such items as the wage bill for budget sector employees, social benefits and transfers to the Social Fund and the Mandatory Health Insurance Fund (MHIF).

Figure 5. State budget (in % of GDP)

Source: MF KR

Figure 6. Public debt (in % of GDP)

Source: MF KR

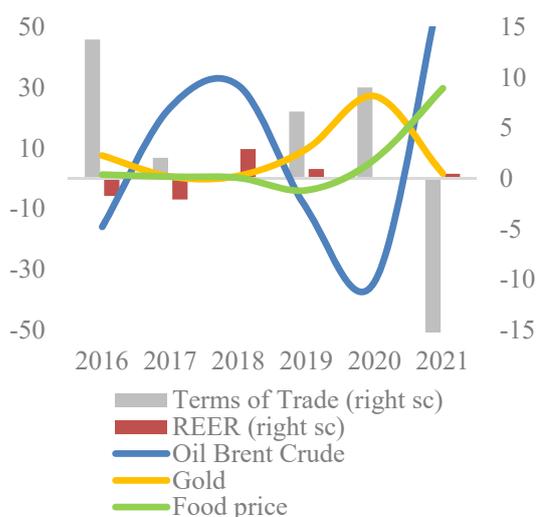
The economic growth and reduction of the state budget deficit contributed to lower public debt. Against the background of revenues growing at a faster pace compared to expenditure items, the budget deficit fell to 0.2% of GDP in 2021¹ from 3.3% in 2020. There was a primary surplus of the state budget of 0.9% of GDP. As a result of the GDP growth, the primary surplus of the state budget, and lower proceeds from external borrowings, the public debt fell to 60.3% of GDP in December 2021 from 67.6% of GDP a year earlier (Figure 6).

External Sector

The growth of imports against the background of higher domestic demand and rising prices for imported petroleum products and food, as well as lower gold exports led to a deficit of the current account. With the economies of trading partners and global trade turnover growing, the volume of foreign trade of the Kyrgyz Republic increased in 2021. Imports of goods grew by 49.8%, reflecting a recovery in domestic demand. Due to the low base of the previous year, almost all categories of imports made a positive contribution to the growth of imports, while the most significant contribution was made by higher imports of petroleum products (7.2 p.p.), as well as clothing and fabrics (11.4 p.p.). Exports declined by 15.9% owing to a decrease in exports of gold and precious metal ores (-34.4%), while exports of other types of goods were growing. Higher import prices, mainly for petroleum products and food, also contributed to a higher foreign trade deficit. The balance of payments was supported by a 16.4% increase in inflows of remittances, the level of which amounted to 25.7% of GDP (against 24.2% a year earlier). According to the EFSD, in 2021, the current account balance had a deficit of 5.5% of GDP (against a surplus of 4.8% in 2020).

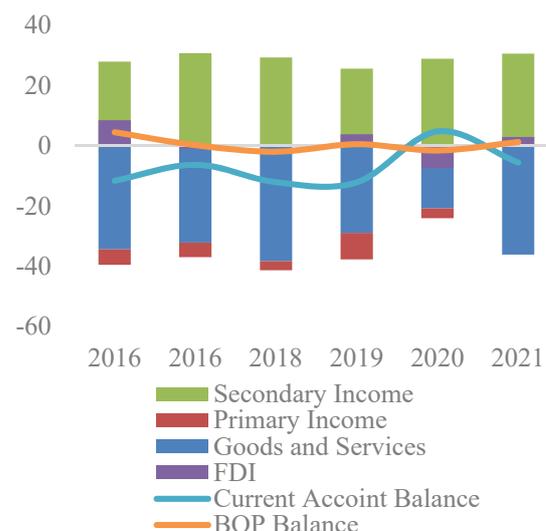
¹ The republican budget balance, including the funds on-lent to energy companies, amounted to 1.3% of GDP compared to 3.8% in 2020.

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



Source: World Bank, national authorities, EFSD estimates

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



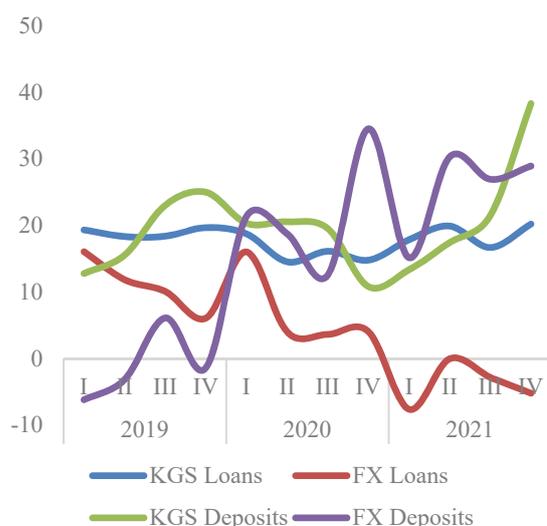
Source: NB KR, NSC KR, EFSD estimates

An additional quota allocation by the IMF and a rise of the price of gold contributed to an increase in international reserves, despite a decline in foreign direct investments and currency interventions of the National Bank of the Kyrgyz Republic. In 2021, there was a net inflow of foreign direct investments (US \$247.5 million against an outflow of -US \$582.4 million in 2020), formed as a result of an increase in inflows of investments by 29.9% and a decrease in repayments of reinvested profits and payments under inter-company loans by 52.0%. In 2021, the National Bank of the Kyrgyz Republic engaged in intensive interventions aimed at smoothing out sharp fluctuations in the exchange rate (US \$698.95 million against US \$465.95 million in 2020). In 2021, the KGS exchange rate against the US dollar depreciated in nominal terms by 8.6%, while in real terms it appreciated by 0.5%. Despite the interventions of the National Bank of the Kyrgyz Republic, due to an additional quota allocation by the IMF, the gross international reserves had increased to US \$2.97 billion by end-2021 (against US \$2.8 billion as at end-2020), making 6.6 months of imports of goods and services.

Financial Sector

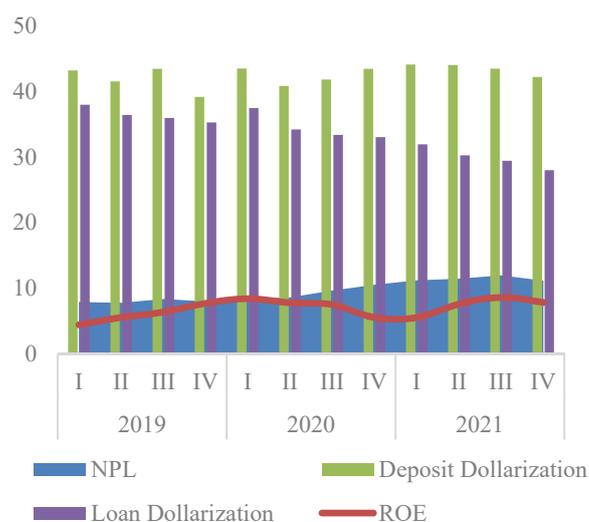
In 2021, the loan portfolio of banks continued growing at double-digit rates due to an increase in lending in the local currency. The growth of lending was 11.8% in December 2021 (up from 11.0% a year earlier) amid a recovery in the economic activity (Figure 9). The weighted average lending interest rates continued to be on the downward trend, making 16.1% (down from 17.5%) in the local currency and 9.3% (down from 9.7%) in foreign currency. The drivers of growth of lending in the local currency (by 20.2% against 14.8%) were loans to trade enterprises (7.1 p.p.), agriculture (2.4 p.p.), consumer loans (4.5 p.p.), construction (1.4 p.p.), and mortgage (2.7 p.p.). Loans in foreign currency decreased by 5.2% due to lending to other sectors (-3.4 p.p.), construction (-3.2 p.p.), mortgages (-0.4 p.p.), and industry (-0.8 p.p.). The rate of dollarisation of loans decreased from 33.0% in December 2020 to 28.0% as at end-2021.

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



Source: NB KR

Figure 10. Banking sector indicators (in percent)



Source: NB KR

The path of the deposit base is explained by a recovery of the economic activity and growth in the number of settlement transactions. The rate of growth of deposits significantly accelerated compared to the previous year, amounting to 34.3% against 19.9% a year earlier (Figure 9). The growth of the deposit portfolio in the local currency (by 38.3% against 10.8% in December 2020) was supported by an increase in settlement operations of legal entities, as well as demand accounts and term deposits of households in the local currency. Against the background of a slowdown of the exchange rate depreciation, the level of dollarisation of deposits decreased (42.2% against 43.4% a year earlier) and the growth rate of foreign currency deposits in the KGS equivalent slowed down (28.9% against 34.5% a year earlier). However, the growth of foreign currency deposits in their dollar equivalent accelerated (to 25.7% against 13.3%). The weighted average deposit interest rates continued to be on the downward trend, making 5.61 percent (down from 5.67%) in the local currency and 0.92% (down from 1.22%) in foreign currency.

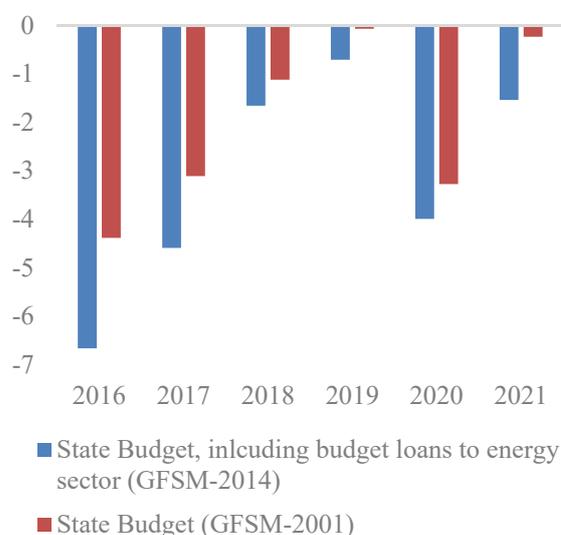
The quality of assets of the banking sector continued to deteriorate, while its profitability indicators improved. The share of non-performing loans in the total loan portfolio of banks increased to 11.1% (against 10.5% in December 2020), reflecting a delayed effect of the pandemic on the business activity (Figure 10). However, there was an improvement in key profitability indicators: the return on equity increased from 5.5% to 7.8%, and the return on assets – from 0.9 to 1.2%.

EFSD'S APPROACH TO DETERMINING THE STATE BUDGET BALANCE IN THE KYRGYZ REPUBLIC

The Ministry of Finance of the Kyrgyz Republic calculates its fiscal parameters using the methodology described in the Government Finance Statistics Manual 2001 (GFSM 2001). However, the current approach to accounting for certain transactions of the republican budget results in distorted understanding of the fiscal position of the Kyrgyz Republic. In particular, according to the GFSM 2001, all domestic lending operations are recorded “below the line” as budget financing operations. It also applies to budget loans to state-owned energy companies, which account for the majority of all liabilities of state-owned enterprises to the budget.

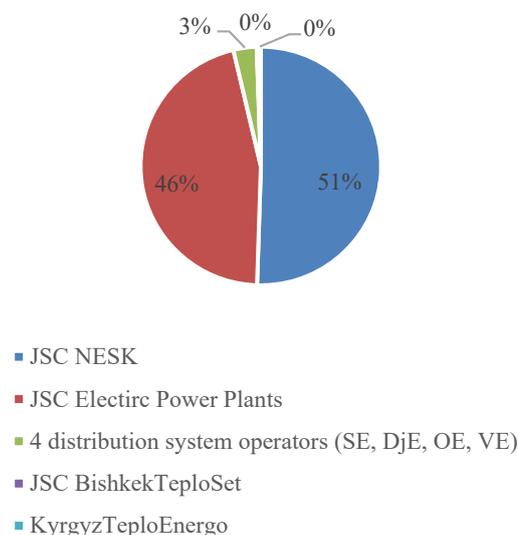
Most of the state-owned energy companies are loss-making. The main reasons for the high losses include subsidised electricity tariffs that do not cover the costs. Due to insufficient financing of capital investments, *inter alia* for the reason of maintaining a low level of cost recovery through tariffs, the energy companies have to cover part of their costs by expanding their borrowing from the republican budget. The Government Finance Statistics Manual 2014 (GFSM 2014) recommends recording operations of the Ministry of Finance under budget loans/credits, which are unlikely to be repaid, as expenditure items of the budget. Figure A-1 shows the path of the state budget balance based on the GFSM 2001 and taking into account loans to the energy sector. In 2016–2021, loans to the energy sector contributed to an increase of the state budget deficit by 0.6–2.4% of GDP annually.

Figure A-1: State budget balance (in % of GDP)



Source: MF KR, NSC KR

Figure A-2: Budget loans to the energy sector (2021 in %)



Source: MF KR

The main source of budget loans to the energy sector is the on-lending of loans and grants received from bilateral and multilateral donors for the implementation of investment projects. The Ministry of Finance of the Kyrgyz Republic additionally allocates budget loans, including those to cover operating expenses, which ultimately affects the formation of financing needs of the budget. As at end-2021, the total debt of the energy sector to the budget amounted to KGS 137.8 billion (19% of GDP), most of which are debts of the JSC NESK and the JSC Electric Power Plants (Figure A-2). Of this amount, the on-lent funds amount to KGS 127.6 billion (92.5%), and the remaining debt (KGS 10.2 billion) is other budget loans.

It should be noted that from the point of view of statistics, on-lending operations do not lead to a higher deficit or an increase in the public debt. However, the provision of budget loans carries

significant fiscal and quasi-fiscal risks, which, in the absence of tariff adjustments, may add to the loan repayment risk, and, thus, the execution of liabilities under mobilised external loans may be shifted to the budget. Since these funds are on-lent in the currency of the loan agreements between the Kyrgyz Republic and creditors, depreciation of the local currency, not accompanied by an adjustment of tariffs, may result in debt growth. During the period of the past six years, 2016–2021, the stock of debt increased by KGS 50.9 billion, of which budget loans extended to the energy sector amounted to KGS 41.2 billion, and the remaining increase in the debt stock includes, among other things, the effect of exchange rate depreciation. However, the stock of overdue debt remains relatively low (0.05% of GDP, or 0.1% of the current debt), which is explained by the fact that the Ministry of Finance of the Kyrgyz Republic routinely restructures these loans, granting deferred payments. In particular, in 2016–2021, the debts of the two major recipients of budget loans and the largest state-owned enterprises were restructured on several occasions (deferred payments were granted) for the amount of about KGS 19.4 billion, which is 14.1% of their current debt.

Guided by the principles of the GFSM 2014, the EFSD Project Unit includes operations of the Ministry of Finance under budget loans and credits to the energy sector in the state budget balance. The EFSD's approach to calculating the state budget balance is primarily justified by the fact that it enables a more comprehensive assessment of the scale of fiscal risks arising at the issuance of budget loans to financially fragile energy companies, as well as quasi-fiscal risks associated with the materialising of contingent liabilities, which may contribute to an increase of the level of debt and financing needs of the budget. The paper, prepared by the EFSD Project Unit in 2021² to assess the potential risks of contingent liabilities of the EFSD recipient countries materialising and their impact on the countries' fiscal and debt positions, finds that budget loans are the main source of fiscal risks associated with the probability of default of enterprises on budget loans and credits. If the financial position of strategically important energy companies worsens, the government will have to support these companies. As a result, the country's needs for financing and mobilising borrowed funds may increase. Quasi-fiscal risks, which scale is potentially even larger, arise from long-term underinvestment by energy companies, leading to equipment wear and gradual degradation of the infrastructure.

² EFSD (2021) "Total Debt is So Much More Than Just Sovereign Debt. Contingent Liabilities in Armenia, Belarus, Kyrgyz Republic, and Tajikistan". EFSD Working Paper WP/21/2