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Ratings

Sovereign Government Credit (LC)	**B**
Sovereign Government Credit (FC)	**B**
Country Credit Environment (LC)	**B-**
Country Credit Environment (FC)	**B-**

* These ratings are unsolicited

Ratings dynamics

■ CCE (LC)   ◣ CCE (FC)   ■ SGC (LC)   ◪ SGC (FC)
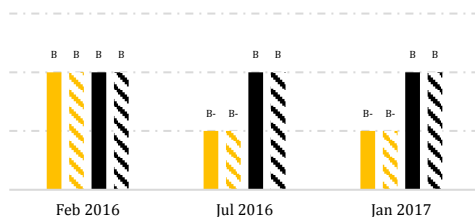
Main Economic Indicators of Kyrgyzstan

Macro indicators	2014	2015	2016
Gross gov. debt, KGS bn	210	280	281*
Nominal GDP, KGS bn	401	424	452*
Real GDP growth, %	4,0	3,5	2,6*
Gross gov. debt/GDP, %	52,3	66,0	62,1*
Deficit (surplus)/GDP, %	1,9	-1,2	-4,4*
Inflation rate, %	10,5	3,4	-0,5
Current Account Balance/GDP, %	-	-	-9,6*
External debt, USD bn	-	-	3,7*

Development indicators	2016
Inequality adj. HDI	0,56
GDP per capita, USD th	3,5*

Source: RAEX (Europe) calculations based on data from the IMF, Ministry of Finance of Kyrgyzstan, NBKR, UN, WB
* Forecast for 2016

Summary

The sovereign rating of Kyrgyzstan is curbed by the excessive reliance on external financial aid, further widening of the fiscal deficit as well as the inability to sustain price stability. The banking sector remains vulnerable, as banks' profitability continues to sink. Fiscal deficit is expected to expand as Kyrgyzstan has missed tax and non-tax revenue targets. Government debt levels have decreased mainly due to a steep appreciation of the KGS along 2016. However, these levels remain a negative factor due to uncertainty regarding potential shocks on the exchange rate – given the high share of FX denominated debt – and future debt accumulation plans.

Sharp decline of dollarization levels caused by the implementation of new de-dollarization policies and cuts in the policy rate have caused lending rates to decrease. Furthermore, high external exposure have limited output growth; however, provided further smooth recovery of the biggest CIS partners, would propel economic growth.

Debt load continues to expand. In order to finance an increased expenditure on construction and maintenance of infrastructure as well as investments in the energy sector, the gross government debt (denominated in USD) continued its upward trend (it grew by 10% y-o-y as of November 2016). However, government debt levels denominated in KGS were estimated by the IMF to have decreased by 3,9p.p. and 10p.p. y-o-y down to 62,1% of GDP 163,4% of budget revenues in 2016. The above was mainly caused by a total KGS appreciation of 8,8% against the USD in 2016 (see graph 1). Since the Kyrgyz currency is volatile and dependent on external factors, we still consider debt levels a risk for the economy in case external shocks are exerted on the exchange rate.

The legislation allowing government to review the debt threshold level on an annual basis has come into force in January 2017, effectively removing the administrative constraint for the amount of government debt (previously 60% of GDP).

Despite a still acceptable debt structure -with most of the long-term debt being concessional (see graph 2) and short-term debt expected to stay at very low level of 1,02% of GDP and 2,7% of budget revenues in 2016 - the debt service (estimated at 12,1% of budget revenues in 2016) continues to increase limiting budget flexibility. A continued increase in the volume
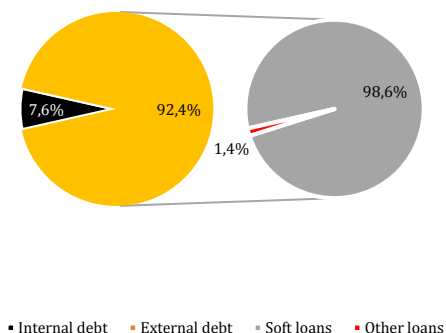
Graph 1: Government debt metrics

Legend:
- Gross Government Debt, % of GDP
- Gross Government Debt, % of budget revenues
- USD/KGS (rhs)
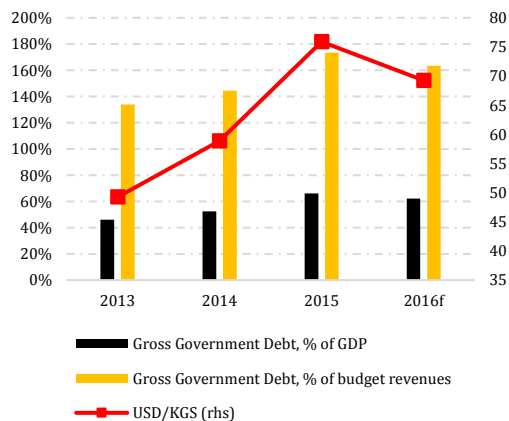
Source: RAEX (Europe) calculations based on data from the IMF and NBKR

Graph 2: Government debt structure

- Internal debt
- External debt
- Soft loans
- Other loans

Source: RAEX (Europe) calculations based on data from the Ministry of Finance of Kyrgyz Republic

Graph 3: De-dollarization and monetary policies

- Base Rate, NBKR
- Lending Rate
- Foreign currency loans, % of total loans (rhs)
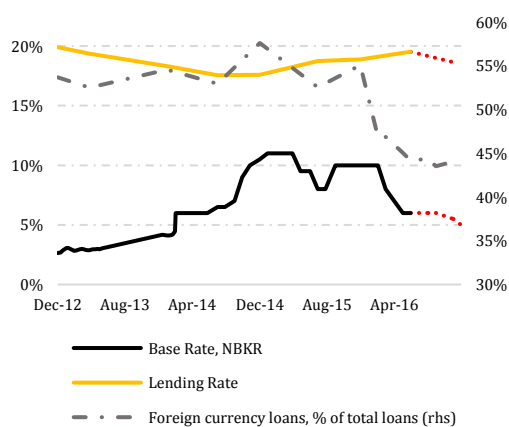
Source: RAEX (Europe) calculations based on data from the NBKR

of debt service, may worsen the credit risk position of the sovereign, decreased level of which is already reflected by the market in rather high 5Y government bond yield of 18,1% in November 2016.

Fiscal imbalance is developing. The IMF has estimated the fiscal deficit at 4,4% in 2016 (against 4,5% budgeted), which represents a 3,2p.p. expansion since the end of 2015. On the revenue side, the government has collected 7,6% less in taxes and 23,6% less in non-tax revenues by November 2016 compared to what has been budgeted. This can be explained by a decrease in the levels of production growth, reduction of the trade turnover, new tax exemptions, as well as non-reception of instalments from network operators. At the same time, the government has expended only 80% of what had been budgeted by November 2016. In our view, the degree to which the budget revenue collection measures are exercised, including improvement of the tax collection policy, will be of a paramount importance in order to sustain the budget deficit at minimum levels.

Monetary targets have not been met. The National Bank of the Kyrgyz Republic (NBKR) has not managed to stabilize inflation (it reached -0.5% y-o-y in December 2016) and missed its inflation target (between 5-7%).

The negative inflation has been a result of decreasing food prices (food products deflation reached 5% in December 2016) and very low increase in prices of non-food products, which have been strongly impacted by the exchange-rate pass-through. The effect of the latter is dominated by lower price of imports (imports estimated at 55,9% of GDP in 2016), controlled by stronger KGS, which appreciated by 8.8% y-o-y against the USD in 2016, contributing to a 10,6p.p. lower y-o-y non-food inflation of 1,6% in 2016.

It is important to mention that in 2016 the NBKR has put its de-dollarization policy plan into action, banning commercial banks from issuing mortgage and consumer loans in USD and forcing the conversion of existing loans into KGS-denominated. Coupled with low inflation and a lower and more stable exchange rate, this has led to a sharp y-o-y decline in dollarization levels by 15,7p.p. and 12,2p.p. down to 56,2% and 44,1% in deposits and loans respectively by November 2016. This de-dollarization policy, has also forced the foreign currency lending rate to drop by 2,2p.p. y-o-y in December 2016. This, together with subsequent policy rate cuts from 10% (beginning of the year) down to 5% in December 2016 led to average lending rates decreasing by 1,3p.p. down to 18,32% in 2016. The future effectiveness of the monetary policy
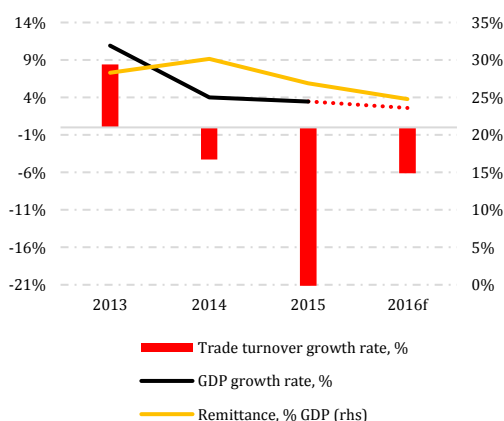
Graph 4: Banking system indicators
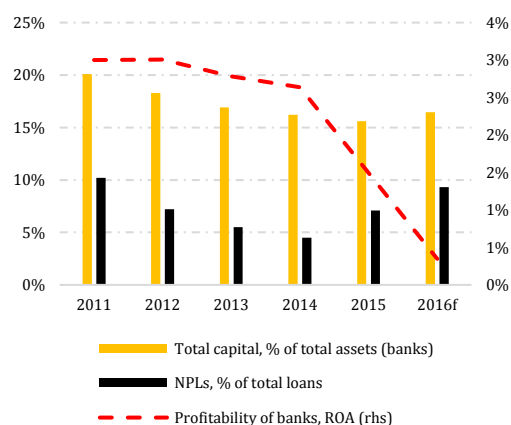
Source: RAEX (Europe) calculations based on data from the NBKR

Graph 5: Output growth

Source: RAEX (Europe) calculations based on data from the IMF and NBKR

transmission mechanism will largely depend on how well the country sustains the de-dollarization policies' implementation (see graph 3).

Banking sector remains weak. Financial intermediation in Kyrgyzstan continues to be dominated by an underdeveloped banking system which is still concentrated in large cities. Bank's assets and credit to private sector relative to GDP are expected to be at very low levels of 39,4% and 20,7% respectively in 2016.

Bank's profitability has been decreasing since 2013 and was significantly hurt during the latest period of instability. Bank's ROA is expected to shrink by 1,1p.p. y-o-y down to 0,3% in 2016, as the quality of the credit portfolio deteriorates and a need for more reserves emerges. Thus, NPLs grew by 2,2p.p. y-o-y up to 9,32% in 2016 coupled with a capital to asset ratio increase of 0,9p.p. up to 16,5% in 2016 (see graph 4).

Credit environment remains unfavorable. Country credit environment continues to be constrained by the high and volatile real interest rate estimated at 19,1% in 2016, as well as by the average level of development of the country's institutions. The Kyrgyz financial market remains underdeveloped with only 26 companies listed on the Kyrgyz Stock Exchange (KSE). Nevertheless dynamics of the KSE index are rather positive, as in 2016 it has grown 45,8% y-o-y and 86,5% in the last three years.

External shocks remain significant. Due to the current economic slowdown in Russia and Kazakhstan, remittances in relation to GDP from the CIS countries, which accounted for 97% of all remittance inflow in 2016, have declined by 2p.p. down to 24,8% in 11M 2016. Meanwhile, the Ministry of Economy reports a downward trend in trading activity, with total and CIS countries trade turnover decreasing by 1,3% and 7% y-o-y in October 2016 respectively. The above is expected to translate into slower real GDP growth of 2,6% and 2,3% in 2016 and 2017 respectively (from 3,5% in 2015) (see graph 5). Output growth recovery will depend on stability of gold prices and how smooth Russia and Kazakhstan recover.

Important note for sovereign ratings

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

http://raexpert.eu/reports/Press_release_Kyrgyzstan_27.01.2017.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the Agency.