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Research Report on Kyrgyzstan

4 January 2019

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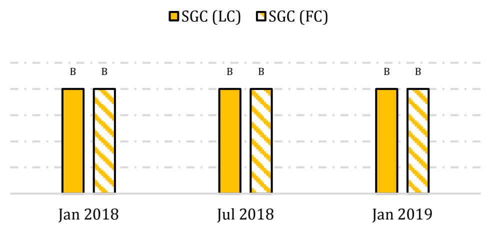
Ratings

Sovereign Government Credit (LC)	B
Sovereign Government Credit (FC)	B
Outlook (LC)	Stable
Outlook (FC)	Stable

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Kyrgyzstan

Macro indicators	2016	2017	2018f
Gross gov. debt, KGS bn	266	292	303
Nominal GDP, KGS bn	476	521	551
Real GDP growth, %	4,3	4,6	2,8,
Gross gov. debt/GDP, %	55,9	56,0	55,0
Deficit (surplus)/GDP, %	-5,9	-4,4	-4,7
Inflation rate, %	-0,5	3,7	4,1
Current Account Balance/GDP, %	-	-	-9,0
External debt, USD bn	-	-	3,8

Development indicators	2018
Inequality adj. HDI	0,672
GDP per capita, USD th	3,8

Source: RAEX-Europe calculations based on data from IMF, NBKR, WB

Summary

The SGC ratings of Kyrgyzstan confirmed at 'B' with a stable outlook reflect an economy which remains heavily dependent on the main CIS business partners and extracting industries. In addition, the lingering high level of indebtedness sensitive to external shocks, low credit to the economy and lack of effective fiscal policy, are the main factors constraining the rating score. Moreover, elevated levels of poverty, high corruption perception and difficulties to trade across the borders, have kept the country with a low competitive position.

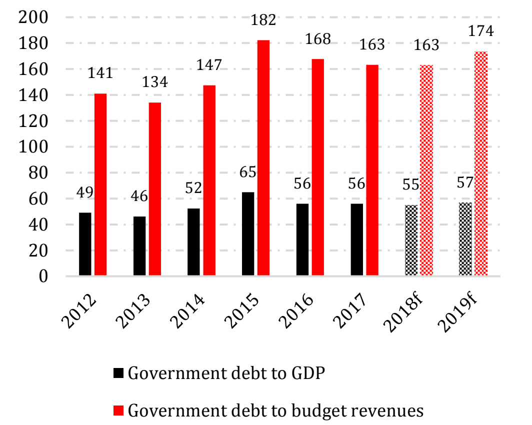
However, the continuous decrease of financial dollarization in the country, higher banking sector profitability and higher remittances inflow, alongside improved export activity, are the most significant factors supporting the output growth.

Government debt is anticipated to decline, but remains high. Government debt to GDP is projected to decrease by 1 p.p. yearly and stand at 55% in 2018 (see graph 1). Such results were mainly driven by the stabilization of the local currency: the KGS lost only 1 p.p. against the USD y-o-y. Nevertheless, such elevated indebtedness rate is one of the highest among the Central Asia region[1] and could be excessive for the country with relatively low GDP per capita. The largest concerns are national currency fluctuations and a possible squandering of external borrowed money during investment projects realization. As of October 2018, more than 40% of total external debt belonged to Export-Import Bank of China issued on substantially generous terms mainly to fund the development of the energy sector. Such significant financial cooperation with the strong neighbor country increases the probability of debt write-offs, while rising foreign aid dependency risks.

Despite the high levels, the structure of external debt remains positive (see graph 2). Short-term debt at the end of 2018 is expected to have been around 0,5% of GDP,80% of which is covered by foreign exchange reserves. More than 50% of the new external debt was issued with fixed interest rate and more than 56% was non-USD-denominated. The concessional origin of the debt in terms of interest rate and grace periods, increases chances of its possible restructuring if such need arises.

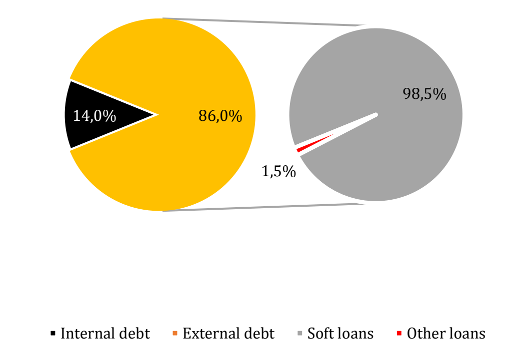
[1] Estimated debt to GDP for 2018: Kazakhstan – 17,8%, Tajikistan – 52,7%, Turkmenistan – 30,9% and Uzbekistan -19,2%.

Graph 1: Government debt dynamics, %



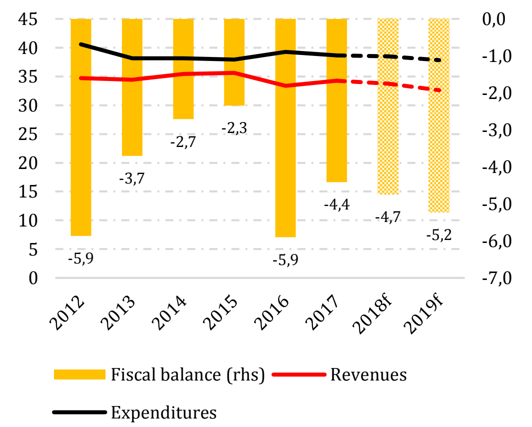
Source: RAEX-Europe calculations based on data from the IMF

Graph 2: Government debt structure as of 3Q 2018



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

Graph 3: Fiscal budget dynamics, % of GDP



Source: RAEX-Europe calculations based on data from the IMF

Fiscal deficit keeps the quality of the government's fiscal policy at a moderate level. The fiscal deficit to GDP is expected to decrease by 0,6 p.p. y-o-y and to be around 4,7% (see graph 3). Despite this, we consider the overall fiscal policy to be insufficient as the initial deficit target of the authorities for the year was 1,6%. Albeit parliamentary approval to cut domestically financed capital expenditures in order to meet the primary objective, the government continued with an expansionary policy increasing social benefits. Such measures were taken mainly to support poverty reduction under the weaker than expected economic environment.

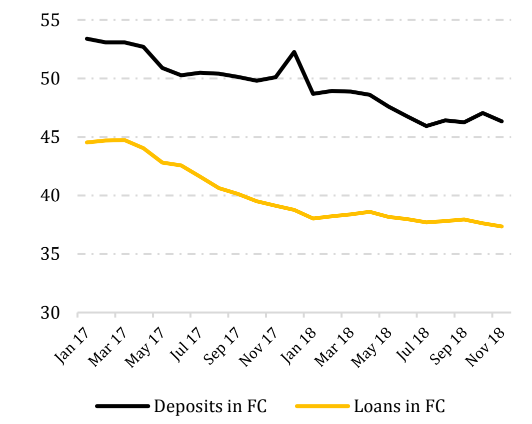
For 2019, the Ministry of Finance of the Kyrgyz Republic announced a budget deficit cut to 1,7% of GDP, justified by lower social expenditure and higher projected tax income. However, we still anticipate the deficit to increase

Inflation contained at low levels, while dollarization keeps declining. The moderate consumer price index growth didn't allow to meet the National Bank of Kyrgyzstan's (NBKR) mid-term target band within 5% and 7%. Low inflationary expectations (estimated inflation rate for 2018 is 4%), permitted to continue monetary expansionary policy and keep the base interest rate at the level of 4,75%. The response for the interest rate easing was a decrease of the average commercial banks' lending rate in national currency by 0,73p.p to 18,04% and an increase of total volumes of loans by 18p.p. y-o-y. Financial dollarization dynamics continue to be encouraging, as the amounts of FX loans to total loans and FX deposits to total deposits ratios decreased by 1,8p.p. and 3,8p.p. y-o-y down to 37,4% and 46,3% as of November 2018 respectively (see graph 4). Further monetary policy success will for the most part continue to rely on the de-dollarization development and inflation target commitment.

Currency in circulation increased by 8% since the beginning of the year, driven by measures of the NBKR aimed at preventing local currency rapid appreciation caused by higher foreign currency inflows. Such increase in the money supply, together with increased price volatility on food (specially granulated sugar) and oil keeps pro-inflation risks elevated.

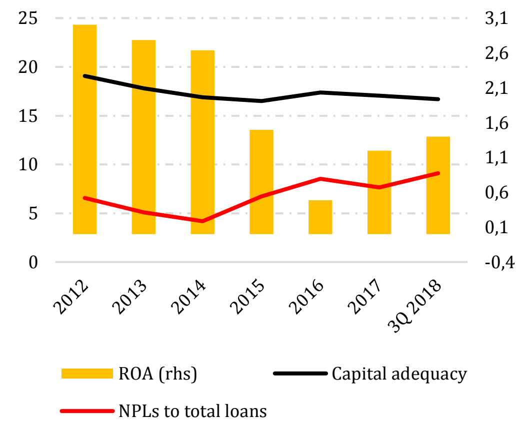
Banking sector showed positive profitability dynamics but remained underdeveloped and fragile. The profitability of commercial banks has been enhanced as ROA and ROE indicators increased up to 1,5% and 9,5% in October 2018 from 1% and 6,7% respectively for the same date a year earlier (see graph 5). Bank`s assets to GDP ratio is forecast to increase by 2,3 p.p. y-o-y in 2018, while domestic credit to GDP only by 1,4 p.p. up to 24%. Even though the share of non-performing loans to total loans decreased by 0,4 p,p yearly and stood at a level of 7,6% as of 3Q 2018, it was mainly driven by a higher pace of total loans growth rather than real

Graph 4: Financial dollarization, % of total



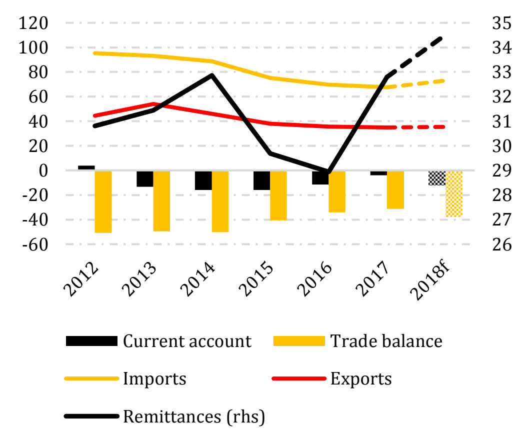
Source: RAEX-Europe calculations based on data from the NBKR

Graph 5: Financial soundness indicators, %



Source: RAEX-Europe calculations based on data from the NBKR

Graph 6: External sector indicators, % of GDP



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

qualitative changes. As a result of the preferential lending policy and lingering currency risks, the share of NPLs could potentially increase further. The capital to asset ratio remained at 16,7%, unchanged from the year before, demonstrating satisfactory capitalization levels while liquidity conditions slightly weakened.

Starting from 2017, some of the U.S. banks in order to lower the risks of AML/CFTE (anti-money legalization/laundering and counter-financing of terrorism or extremism) closed correspondent accounts in Kyrgyzstan, contracting the funding channels. In order to be in line with the international standards on AML, in August 2018 the new law came into force, implication of witch should be a driver of banking system development.

Institutional development remained low. In 2018, the Kyrgyz Republic improved from 100th till 97th place out of 140 countries in WEF global competitiveness index. Despite improvements driven by recovering macroeconomic indicators, low infrastructure quality, innovation capacities and a small market share continue to restrict the total score. Moreover, unclear tax regulations, high corruption perception, difficulties with electricity access as well as complications to trade across the borders restrained Kyrgyz Republic`s position in Doing Business Ranking (77th out of 190) in 2018.

External sector continues to recover. Real GDP is expected to grow by 3% in 2018 mainly due to the increase of incoming remittances from workers (more than 34% of GDP) and local currency stabilization. On the other hand, the trade balance remains negative with an estimated deficit of 36% of GDP at the end of 2018 (see graph 6). The country relies heavily on imports for the most required goods mainly from China (40% of gross import). Revenues from export are very concentrated in gold (more than 38% in 2018) and around 44% is coming from Great Britain. Kyrgyzstan's output growth continue to be determined by remittances inflows, market prices on gold, Kumtor's performance (the country's largest gold mine) and main trading partners conditions. Such a high dependence on a limited number of trade partners, export goods and remittances restrain the rating assessment.

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:

https://raexpert.eu/reports/Press_release_Kyrgyzstan_04.01.2019.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.