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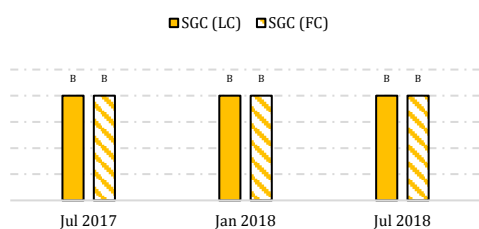Rating-Agentur Expert RA GmbH
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Ratings

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

* These ratings are unsolicited

Ratings dynamics

□ SGC (LC) ▨ SGC (FC)

Jul 2017   Jan 2018   Jul 2018

Main Economic Indicators of Kyrgyzstan

Macro indicators	2015	2016	2017f
Gross gov. debt, KGS bn	279	266	292
Nominal GDP, KGS bn	430	458	493
Real GDP growth, %	3,9	3,8	4,5
Gross gov. debt/GDP, %	64,9	58,1	59,1
Deficit (surplus)/GDP, %	-1,2	-4,6	-3,3
Inflation rate, %	3,4	-0,5	3,7
Current Account Balance/GDP, %	-	-	-7,8
External debt, USD bn	-	-	8,2

Development indicators	2017
Inequality adj. HDI	0,58
GDP per capita, USD th	3,7

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

Summary

The SGC rating of Kyrgyzstan confirmed at 'B' with a stable outlook reflects declining dollarization levels, favorable banking sector dynamics and moderate inflation postings. The continued recovery of the main CIS trading partners, through growing remittances and trading activity, expansionary monetary and fiscal policies supported the output growth. However, it remains heavily dependent on the amount of gold production in the country.

At the same time, the rating level was constrained by the still high government debt levels vulnerable towards exchange rate volatility and absence of a credible fiscal rule. Moreover, continuously missed fiscal and monetary targets, low institutional and economic development, as well as still low levels of credit to the economy restrained the rating further.

Government debt level improved, but vulnerabilities remained. The amount of government debt relative to GDP has declined since the beginning of the year down to 56,7% in May 2018 resulting from the write-off of the debt to Russia, KGS appreciation and rephasing of investment projects (see graph 1). However, the level of this metric remains a concern as it was the highest among the regional peers[1] in that period. The debt level is expected to stay at around 55% of GDP for the next two years, provided the appropriate policies for fiscal stabilization are adopted and the new fiscal rule is introduced. Nevertheless, the debt sustainability remains vulnerable to the exchange rate volatility, fiscal overspending and the government's policy to finance infrastructure projects with external debt. On the positive side, around 98% of external debt is of a concessional nature, which increases the chance of a potential restructuring and decreases the servicing cost (see graph 2).

Fiscal deficit target missed once again keeping the quality of the government's fiscal policy at a moderate level. As a result of increased social expenditure and one-time disaster relief measures the initial 2017 deficit target (3% of GDP) was missed and revised at the level of 3,5% of GDP (see graph 3). In 2018, the fiscal budget is expected to continue being characterized by large expansionary measures and great dependence on external sources of financing. Unless revised or cancelled, these measures may affect the 2018 budget deficit target sustainability of 2,8% committed
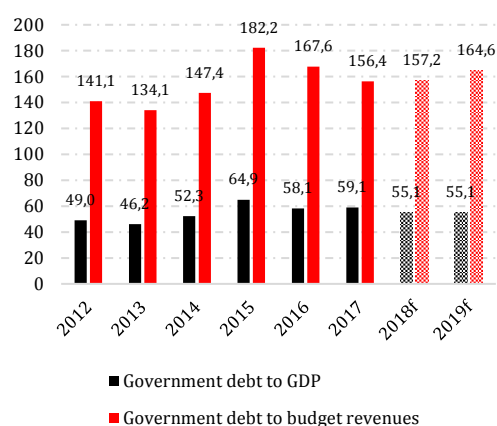
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[1] Here Kazakhstan, Tajikistan, Turkmenistan and Uzbekistan

Graph 1: Government debt dynamics, %

- ■ Government debt to GDP
- ■ Government debt to budget revenues

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

Graph 2: Government debt structure

- ▪ Internal debt ▪ External debt ▪ Soft loans ▪ Other loans
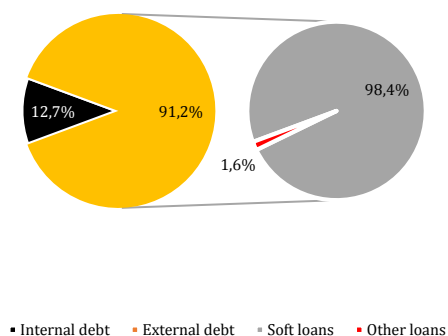
Source: RAEX-Europe calculations based on data from the Ministry of Finance of Kyrgyz Republic

Graph 3: Fiscal budget dynamics, % of GDP

- ▮ Fiscal balance (rhs) —— Revenues
- —— Expenditures
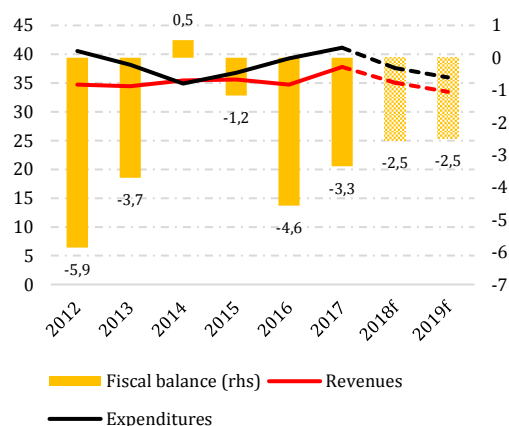
Source: RAEX-Europe calculations based on data from the IMF

by the government. Kyrgyz officials, at the same time, acknowledged the problem and prepared a list of measures to increase budget revenue, cut expenditure and, if needed, potentially revise tax exemptions.

One of the top priorities for the government in 2018 will be the adoption of a credible, effective and enforceable fiscal rule, which would be able to act as an anchor and safeguard against further fiscal slippages. Once in place, the fiscal rule would be able to create more certainty over the government's mid and long-term fiscal plans and whereby would prevent additional uncertainty around the sovereign's credit risk setting.

Inflation contained at low level, but remains volatile. On the backdrop of rising food prices, the National Bank of the Kyrgyz Republic (NBKR) has managed to keep the headline inflation down for the third consecutive year, as it reached 3,7% in 2017 (see graph 4) and was estimated at just 1,4% in May 2018. Despite being relatively low in value, both recordings were well outside of the NBKR's inflation target band between 5% and 7%, with oil and food price volatility remaining one of the main sources of overall price uncertainty in the economy.

As a result of the successful de-dollarization policy measures and KGS appreciation, the dollarization levels have continued their favorable trend, as the amounts of FX deposits relative to total deposits and FX loans to total loans decreased by 3,3p.p. and 4,6p.p. y-o-y down to 47,6% and 38,2% as of May 2018 respectively (see graph 5); however, they remain rather high which continues to restrain the effectiveness of the monetary policy transmission mechanism. Nevertheless, on the backdrop of the low inflationary environment the NBKR has relaxed its policy rate down to 4,75% in May 2018, which contributed to the average lending rate decreased by 1,8p.p. y-o-y down to 15,4% in May 2018. The future effectiveness of the monetary policy transmission will largely depend on de-dollarization developments, as well as other monetary policy advances e.g. gradual movement toward inflation targeting, which the current Kyrgyz government is committed to.

Banking sector showed positive risk dynamics but remained vulnerable. Albeit improving indicators, the banking sector remains underdeveloped with bank's assets and volume of private credit standing at around 40% and 20% of GDP in 2017 respectively. Risk accumulation of the banking sector has stabilized further (see graph 6), evidenced by the NPLs to total loans ratio decrease of 0,9p.p. y-o-y down to 7,7% in May 2018. This, however, resulted mainly from the base effect, as the nominal amount of NPLs has been growing slower than total loans, on the backdrop of the ongoing increase in credit to the economy. Bank's capitalization remained solid, as net total capital to risk-weighted assets was at a favorable level of 24,2% in May 2018. Sector's profitability picked up as
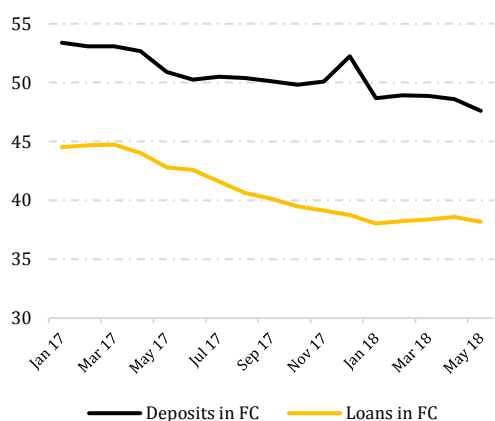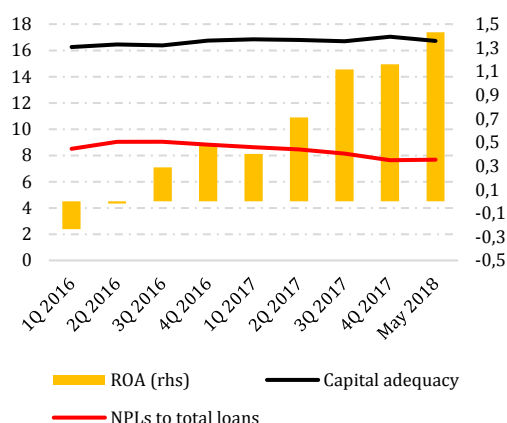
Graph 4: Macroeconomic indicators, %
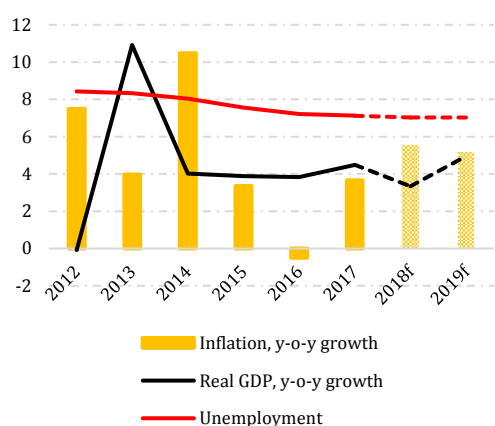
Source: RAEX-Europe calculations based on data from the IMF

Graph 5: Financial dollarization, % of total

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

Graph 6: Financial soundness indicators, %

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

ROA increased up to the level of 1,4% in May 2018, posting a 1p.p. y-o-y growth. Responding to the NBKR's expansionary monetary policy, the banking sector indeed showed some signs of recovery, but the embedded vulnerabilities remain, as banks are still exposed to currency and policy risks.

The new Banking Law introduction was a very important step towards improving the banking sector regulatory framework and stability. However, as the IMF pointed out, further progress is needed to strengthen the NBKR independence and governance. The Kyrgyz government is committed to resubmit key additional Banking Law provisions on governance and lending to non-supervised institutions. Furthermore, the government remains committed to make every effort to streamline submission of the remaining banks to the court of liquidation. The above will effectively drive the sector's credit risk developments.

Institutional development remained low. It was reflected in high corruption perception, low government effectiveness and political stability index, inadequate rule of law, as well as low position in the Doing Business Ranking (77th out of 180) in 2017. The economy's competitiveness stayed narrow, evidenced by a rather low competitiveness index at 3,9 from the WEF in 2017, ranking the country 102nd out of 138 countries – very well behind its regional peers[2]. Nevertheless, the transparency of the government reporting is historically at acceptable levels, thanks to a long-lasting cooperation with international organizations.

External environment improved further. The World Bank claimed the country's economy to have recovered from the external shocks of 2014-2015, with real output growth accelerating up to 4,5% in 2017, as opposed to 3,8% in 2016, on the backdrop of recovering key partner economies and expansionary fiscal and monetary policies. A downside pressure on the real GDP growth dynamic may come from the conflict involving Centerra Gold Inc. and the Kyrgyz government over Kumtor's (the country's largest gold mine) environmental disputes, as the former PM Mr. Isakov, who agreed on the deal back in September 2017, has been already arrested for corruption. The real GDP growth is expected to decelerate in 2018 down to 3,3% and pick up to 4,5% in 2020, as the economy is expected to be supported by increased remittance inflow, as well as additional export boost due to improved access to the Eurasian Economic Union market. Output growth will remain dependent on international gold prices, continued politicking around the country's largest mines, recovery of the main trading partners as well as efficient implementation of the country's key infrastructure projects.

[2] Here Kazakhstan and Tajikistan, as Turkmenistan and Uzbekistan are not included in the competitiveness report by WEF.

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_13.07.2018.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.