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Research Report on Kyrgyzstan

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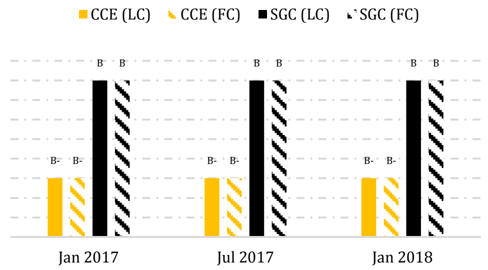
Ratings

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



Main Economic Indicators of Kyrgyzstan

Macro indicators	2015	2016	2017
Gross gov. debt, KGS bn	279	266	280*
Nominal GDP, KGS bn	430	458	489*
Real GDP growth, %	3,5	3,8	3,2*
Gross gov. debt/GDP, %	64,9	58,1	57,2*
Deficit (surplus)/GDP, %	-1,2	-4,5	-3,5*
Inflation rate, %	3,4	-0,5	3,7
Current Account Balance/GDP, %	-	-	-10,0*
External debt, USD bn	-	-	7,9**

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, Ministry of Finance of Kyrgyzstan, NBKR, UN, WB
* Forecast for 2017 ** Figure for 2Q 2017

Summary

The SGC and CCE ratings of Kyrgyzstan continued to be constrained by relatively high and growing debt figures in absolute terms, continuously missed fiscal and monetary targets, as well as by low economic and institutional development. Additionally, the banking sector remained vulnerable; however, the recent sector's profitability increase and ongoing reforms had a noticeable positive effect on the sector.

On the positive side, the smooth recovery of the biggest CIS trading partners, through growing remittances and trading activity supported the output growth. However, a sustained increase in real GDP will continue to depend on the amount of gold production in the country's biggest mines, as well as on the continuous implementation of the key infrastructure projects. Moreover, we anticipate that a sustained decline in dollarization levels, loose monetary policy and a low inflation environment will lead to a further increase in economic activity.

Debt level is on a growing trend. Due to the ongoing need to finance big infrastructure projects, Kyrgyzstan continued accumulating debt indicated by a 9% y-o-y gross government debt (in absolute USD terms) growth as of November 2017. Therefore, despite the fact that gross government debt in KGS terms relative to GDP is expected to continue to decline by 0,9p.p. y-o-y down to 57,2% in 2017 (see graph 1) (mainly due to stabilization of KGS), the current debt level of Kyrgyzstan was assessed as risky due to its composition and the small economy's size. Kyrgyzstan's financial obligations are dominated by debt in foreign currency (91,2% in November 2017) which exposes the government to the exchange rate risks. On the positive side, around 90% of the total government debt was issued under concessional terms, which alongside such benefits as a potential rollover or a write-off, aids relatively low servicing costs (see graph 2).

Fiscal deficit was wider than planned. Despite significant fiscal consolidation commitments over 2018-2019, the government of Kyrgyzstan is expected to miss the fiscal target (deficit at 3% of GDP) once again in 2017, due to additional expenditure the country faced during the presidential election, natural disaster damage liquidation, VAT exemptions and higher than projected expenditure on wages and new social allowances. This has caused the expected deficit to expand to around 3,5% in 2017. However, as a response to the fiscal slippage, the authorities committed to streamline some of the tax, wage and social policy corrective actions in order to stabilize the fiscal performance.

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

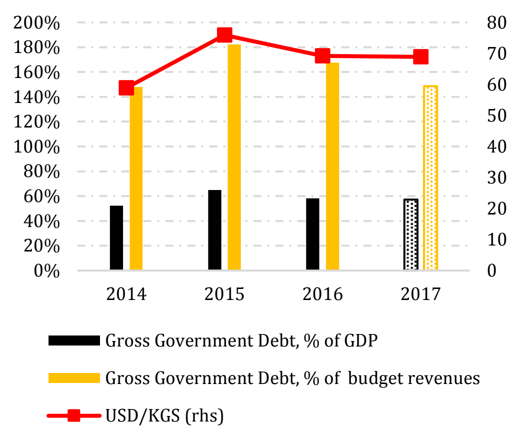
Inflation target was not met once again. The National Bank of the Kyrgyz Republic (NBKR) has managed to keep the inflation positive (it reached 3,7% y-o-y in 2017), however, it missed the inflation target again (between 5% and 7%) (see graph 3). Albeit relative stabilization of core inflation in 2017, the oil market uncertainty remains one of the key sources of price volatility in the economy.

Since the NBKR has put its de-dollarization policy plan into action in 2016, restricting banks from issuing some loans in USD, together with forcing conversion of existing loans into KGS and limiting indication of prices and payment execution to KGS only, the deposit and loan dollarization levels have fallen significantly down to 52,3% and 38,8% in November 2017. Nevertheless, dollarization remains rather high, restraining transmission mechanism of the monetary policy. However, reinforced by the subsequent policy rate cuts down to 5% in 2017 and relatively low inflation environment, the average lending rate has decreased by 2,5p.p. down to around 16% in November 2017 from a year ago. Nonetheless, future sustainability of the de-dollarization advances and strengthening of the inter-bank market will determine the effectiveness of the monetary policy transmission.

Banking sector risk stabilized. The banking sector remains underdeveloped with bank's assets and volume of private credit to GDP expected to remain low at around 41% and 22% in 2017 respectively. Risk accumulation of the banking sector has stabilized, evidenced by slightly decreasing (1,3p.p. change y-o-y) NPLs down to around 8% as of November 2017. Bank's capitalization remained solid, displayed by slightly shrinking, but still high, net total capital to risk-weighted assets at 23,9% as of November 2017. Accelerating profitability at 6,8p.p. y-o-y up to 7,1% in November 2017, was another positive sign to the banking sector which, if sustained, may contribute to the sector's recovery (see graph 4).

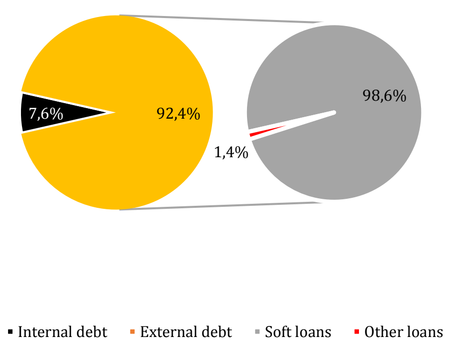
The new Banking Law was a very important step towards improving the banking sector regulatory framework. Whereby clear rights, duties and responsibilities of all participants in the banking business were established, as well as timeliness and efficiency of banking supervision

Graph 1: Government debt metrics



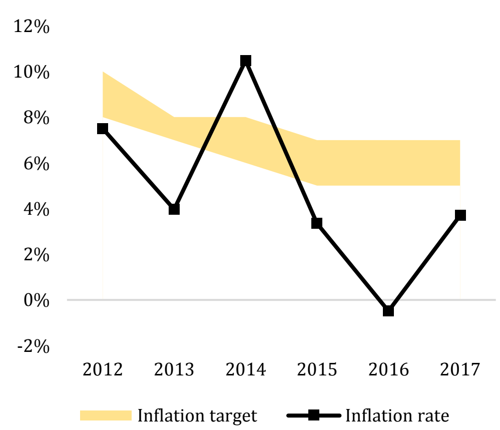
Source: RAEX-Europe calculations based on data from IMF and NBKR

Graph 2: Government debt structure



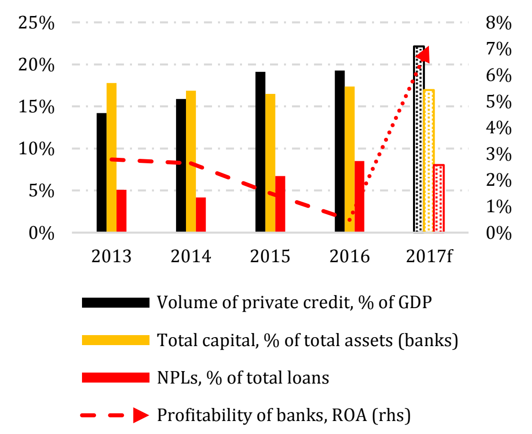
Source: RAEX-Europe calculations based on data from the Ministry of Finance of Kyrgyz Republic

Graph 3: Actual vs. target inflation rate,%



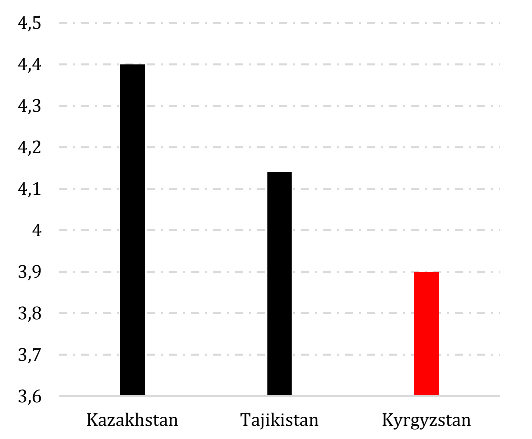
Source: RAEX-Europe calculations based on data from the IMF and NBKR

Graph 4: Banking system indicators



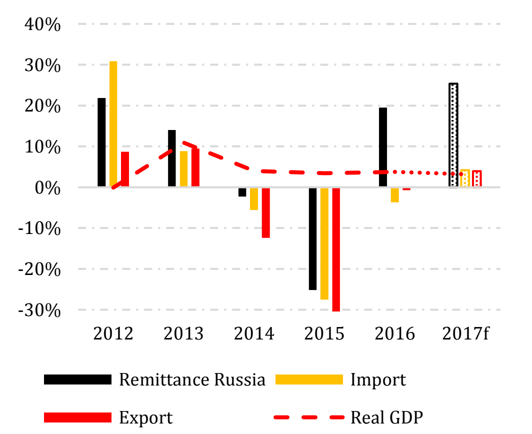
Source: RAEX-Europe calculations based on data from IMF and NBKR

Graph 5: Global Competitiveness Index in 2017



Source: RAEX-Europe calculations based on data from WEF

Graph 6: External sector and real GDP, % growth



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

and a clearer roadmap for dealing with problem banks were enacted. However, the IMF pointed out that further progress is needed to strengthen the NBKR independence and governance. Moreover, the Agency on Banks Reorganization and Debt Restructuring (DEBRA) was discovered to have a significant exposure to corruption risks, which is going to be addressed and removed by the joint working group of DEBRA and the Security Council. Hence, the extent to which the authorities will be able to further enhance the banking policy will drive the sector's credit risk developments.

The quality of the credit environment is restricted. Institutional development of the country remained constrained by a 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[1] (see graph 5). The financial market continues to be rather underdeveloped with small-scale and concentrated stock exchange and very high and volatile levels of real interest rate. However, the transparency of the government reporting is historically at acceptable levels, thanks to a long-lasting cooperation with international organizations. Furthermore, the country is characterized by a favorable investment potential, evidenced by a high-expected net foreign direct investment to GDP at 6% in 2017.

External environment improved. Real output grew at a slightly lower pace in 2017 than a year ago, expected at 3,2% y-o-y in 2017 as opposed to a 3,8% figure from 2016. The dynamic of real GDP still highly depends on the level of production of gold on the country's largest field Kumtor (approx. 40% of industrial sector), which is expected to slow extraction in 2018 putting additional negative pressure on the output growth figures. At the same time, relative stabilization of the Russian economy has pushed the remittances figures further up, which were expected to grow by 25,7% y-o-y in absolute figures as of November 2017. The latter, as well as, picking up trading activity, evidenced by the 8,65% y-o-y international trade turnover growth as of October 2017 acted as an additional support factor for the economic growth (see graph 6). Sustainability of the output surge will highly depend on the international gold prices including continued politicking around the country biggest gold mines, recovery of the biggest regional partners, as well as smooth implementation of the key infrastructure projects in the country.

[1] Here Kazakhstan and Tajikistan.

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_19.01.2018.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.