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Introduction

During 2014, unfavorable economic growth in the CIS region, depreciation of the national currency (KGS) and slow domestic output growth had dramatic changes in Kyrgyzstan's macroeconomic indicators. The economy can be described as strongly driven by external factors and, thus, very susceptible to outside shocks. This susceptibility was reflected in the increase of government debt to GDP, the considerably high level of inflation and, alongside expenditure-driven fiscal policy, wider budget deficit. Furthermore, high levels of dollarization, amount of money outside banks and imports interfere with the transmission mechanism of the monetary policy. Regarding the financial system, the number of micro finance institutions (MFIs) and underdeveloped markets, complicate and elevate the cost of financing. Moreover, the imminent participation in the Eurasian Economic Union (EEU) and the general business environment in the country, make foreign non-CIS investment complex.

Main Economic Indicators of Kyrgyzstan

Macro indicators	2012	2013	2014*
Gross pub. debt, bill KGS	152	167	215
Nominal GDP, bill KGS	310	350	391
Real GDP growth, %	-0,1	10,5	3,6
Gross gov. debt/GDP,%	49,0	47,7	54,9
Deficit (surplus)/GDP,%	-5,7	-3,8	-4,4
Inflation rate,%	7,5	4,0	10,5
Curr. Account balance/GDP,%	-15,9	-14,8	-14,2
Development indicators	2014		
Inequality adj. HDI	0,51		
GDP per capita (Thou. of USD)	3,4		

Sources: RAEX (Europe) calculations based on data from World Bank, IMF, Bloomberg
 * Assessment of RAEX (Europe) based on current data provided by IMF, the NBKR and the Statistical Committee of the Kyrgyz Republic

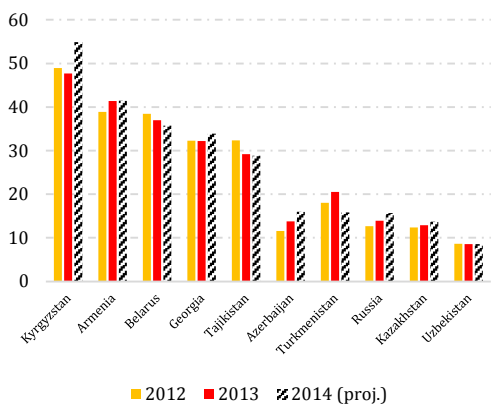
Fiscal policy, along with diminishing revenues and shadow economy participation, will contribute to higher deficit figures. The budget deficit for 2014 has a projected figure of 4,4% of GDP, higher than the one recorded a year earlier of 3,8%. As mentioned before, the fiscal policy of Kyrgyzstan is based on investment to propel growth and, at the same time, these expenditures are financed externally. The government commitment to continue a mid-term investment-driven fiscal expansion, will most certainly widen the fiscal deficit in 2015. Even with a plan strongly based on spending, public expenditure is not coordinated and funds might be misallocated from key sectors of the economy, such as education, energy and healthcare. Moreover, participation in the shadow economy of the country is extremely high and also impacts the fiscal budget. This side of the economy is estimated to be around 40% and programs designed by different administrations to tackle this issue have failed so far.

Government debt, especially external, rose considerably since 2013, however, short-term debt remains bearable. Government debt recorded a substantial hike from 2013 to 2014. It is estimated to grow more than 7% as a percentage of GDP to stay at 54,9% (the highest in the CIS a show in graph 1) and to increase 40% as a ratio of budget revenues to end the year at 180%. These figures summarize the economic activity of the country in 2014. First of all, the economic slowdown in the CIS

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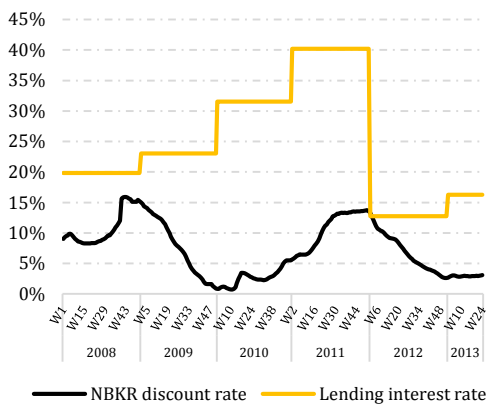
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Graph 1: Gross Government debt in CIS (% of GDP)



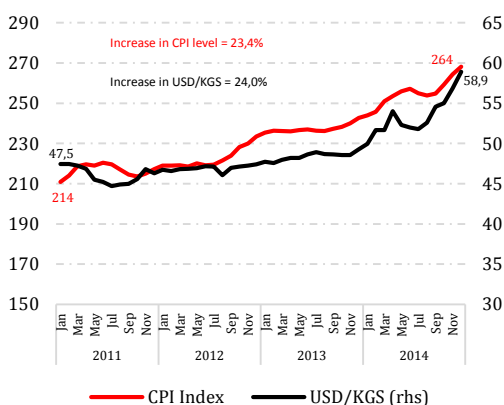
Source: RAEX (Europe) calculations based on data from IMF

Graph 2: Monetary Policy transmission mechanism effectiveness



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

Graph 3: Exchange rate pass-through



Source: RAEX (Europe) calculations based on data from the Statistical Committee of the Kyrgyz Republic and the NBKR

region (driven mostly by the downturn of the Russian economy) and a decline in gold production¹ halted GDP growth and, more deeply, budget revenues. Additionally, debt (mainly external and from international organizations – 94% of total debt), increased due to the expenditure-driven fiscal policy. However, short-term debt presents no risk as it is low representing only 0,78 % of GDP and well covered accounting for 2,6% of FX reserves and 2,5% of budget revenues.

Monetary policy efficiency is restricted by high levels of financial dollarization, dependence on imports and the amount of money outside banks. According to the National Bank of the Kyrgyz Republic (NBKR), the objective of monetary policy is “focused on achieving and maintaining price stability” as well as “to support purchasing power of the national currency, to provide efficiency, safety and reliability of the banking and payment system”. This means that the NBKR is focused on targeting inflation (current target between 5% and 7%). In order to enact the aforementioned objective, the NBKR uses tools such as the discount rate, NBKR notes auctions and sporadic interventions in the FX market. So far, this objective has not been achieved and the transmission mechanism of monetary policy is non-existent. As it can be seen in graph 2, interest rates do not respond to changes in the discount rate set by the NBKR. The failure of the transmission mechanism can be explained mainly by three phenomena: financial dollarization, substantial imports and the amount of cash outside banks. First of all, the levels of dollarization in the Kyrgyz economy are high and rising (58,0% of total deposits and 55,4% of total loans). This, combined with the fact that Kyrgyzstan relies heavily on imports, reduce the ability of the NBKR to control money supply and, thus, inflation. Instead, the level of prices is determined by the exchange rate (see graph 3), revealing the high exchange rate pass-through. This explains how the devaluation of the KGS, among other factors, spurred inflation to 10,5% in 2014. Secondly, the amount of money outside banks is another factor which limits the effectiveness of the transmission of monetary policy, i.e. people who do not use banks, do not react to changes in rates. However, in recent months the levels of deposits have started to climb (see graph 4), a sign that financial intermediation is starting to develop and the private sector trust in the system is improving.

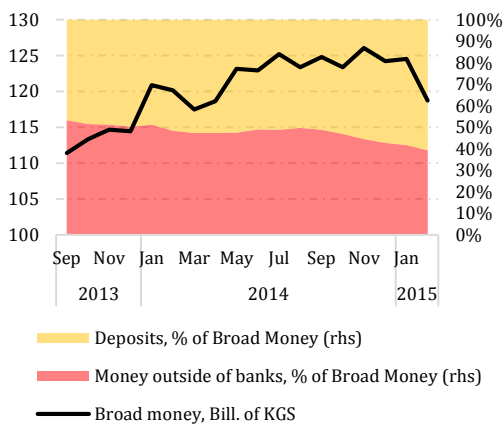
The financial sector has a profitable banking system, however, the proliferation of MFIs and the underdevelopment of financial markets, limit development of SMEs. The banking system seems to be healthy and profitable. ROA for 2014 was 2,6% and the capital adequacy ratio showed a figure as high as 16,2%, additionally, NPLs were only 5,5% of total loans. These figures show that the banking system is in a stable

¹ According to the latest data from Centerra Gold, the production in 2013 was 600 000 ounces and 567 693 ounces in 2014.

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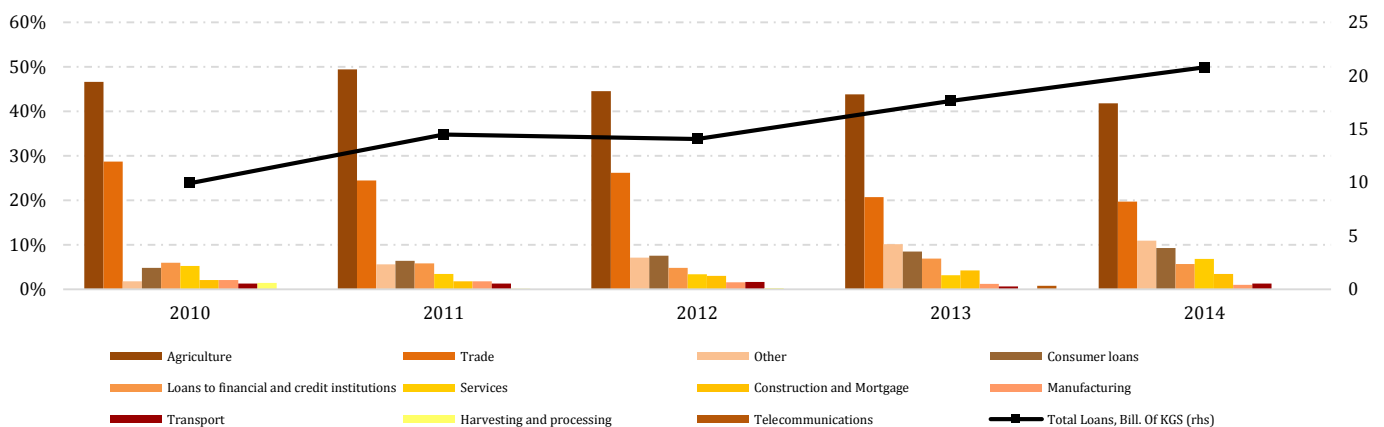
Graph 4: Money outside banks



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

position in the country. However, the amount of money outside banks, dollarization and, to a greater extent, proliferation of MFIs, blur the real picture of the financial system. MFIs are a very important source of financing in Kyrgyzstan with current outstanding debt at 20 billion KGS representing 5% of GDP and 25% of total loans, and it is still growing (see graph 5). Loans provided by these institutions are extremely expensive (the average lending rate is 30%). Nonetheless, the average lending rate from banks is 20%, also substantially high. Therefore, the access to financing from small or medium businesses is practically unattainable. Thus, reducing the potential for growth and competitiveness globally, especially in such an open economy. In addition, the underdeveloped financial markets also limit financing for the private sector.

Graph 5: Structure of MFIs (% of Total loans from MFIs)



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

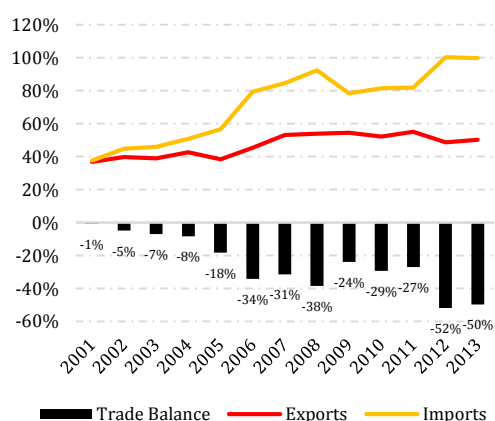
The future participation in the EEU along with political instability pose a risk to foreign non-CIS investors. On December 2014, president Almazbek Atambayev signed the agreement to join the EEU, an agreement where, besides free trade, financial system, labour markets and industrial and agricultural policies will be coordinated. The recent economic slowdown in Russia along with the accession to the Union will further spread the contagion of the weak economic activity. Besides, this agreement has not been well received by Chinese investors, a relationship that has been beneficial for Kyrgyzstan and that has strengthen and grown sharply². The sentiment of Chinese investors started to show in 2014 when FDI dropped 35% due to the fact that a potential accession to the EEU will allow Russia have more economic control. Nonetheless, the EEU membership is not the only factor driving away investment, the political

² Kyrgyzstan imports 33% of its products from China (already more than from Russia) and exports 4,4%. In addition, Chinese foreign direct investment (FDI) is one of the largest in the country.

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Graph 6: Imports and exports (% of GDP)



Source: RAEX (Europe) calculations based on data from the United Nations Conference on Trade and Development

climate and future parliamentary elections are also a concern. A recent report by «Minchenko consulting», ranked Kyrgyzstan in the second to last place regarding political risk for investors.

Exposure to external factors alongside dependency on remittances, low labor productivity and unfriendly investment atmosphere will continue to limit economic development. As mentioned along this report, Kyrgyzstan is a country which relies heavily on external factors. Levels of dollarization, the amount of government external debt, dependence on remittances and the substantial amount of imports, are some of the determinants that exposes the country to external imbalances. The Kyrgyz current account is heavily supported by remittances³ and imports are continuously growing while exports have remained flat opening a huge gap in the trade balance (50% of GDP) (see graph 6). If these factors remain constant, the development of a domestic market will be hard to achieve. In addition to this, labor is concentrated in the agricultural sector and investments in these areas is insignificant. Combined with the flawed educational system, skilled labor is hard to come by. Finally, as mentioned in the previous section, political conditions halt investment. However, on top of this, the taxation system in the country is not the most favorable for private businesses. The latest *Doing Business* report by the World Bank stated that the total share of taxes as a percentage of profit in the country is as high as 68,9%.

Conclusion

The external exposure of the Kyrgyz economy along with a weak domestic market, high dollarization levels and political instability, are the factors that summarize the state of an underdeveloped economy. The considerable changes that the economy suffered in 2014 (substantial increase in government debt, inflation and diminished output) due to a slowdown in the CIS region economies, are cause for concern. At the same time, the inefficiency of the monetary policy transmission mechanism and the possible retreat of foreign investment due to the participation in the EEU, raise questions on the future development of the economy.

³ The current account presents a deficit of 14% of GDP in 2014. If remittances are excluded, the deficit soars above 40% of GDP.

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