

**The National Bank of the Kyrgyz Republic**

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## **Inflation Report**

**4 (22)**

**February 2007**

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**Bishkek**

## ***Inflation Report***

### Editorial Board:

Chairman: Ishenbaev I.  
Board members: Tsyplakova L.  
Chokoev Z.  
Seytkasymova R.

Executive secretary: Kadyrberdieva L.

Please address your questions regarding the content of the publication to:

The National Bank of the Kyrgyz Republic  
at 101 Umetaliev St., Bishkek city

telephone: (996 312) 669 059  
fax: (996 312) 610 730  
email: lkadyrberdieva@nbkr.kg

Please address your questions regarding the distribution of the publication to:

The National Bank of the Kyrgyz Republic  
External and Public Relations Division  
at 101 Umetaliev St., Bishkek city

telephone: (996 312) 669 059  
fax: (996 312) 610 730  
email: pr@nbkr.kg  
<http://www.nbkr.kg>

The publication contains the description of the consumer price trends in the Republic and its regions, analysis of major inflation factors, it also advises of the decisions of the National Bank of the Kyrgyz Republic in the area of monetary policy and presents inflation projection for the upcoming period. It is published on a quarterly basis in the Kyrgyz, Russian and English languages.

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## **Publications of the National Bank of the Kyrgyz Republic**

### ***Annual Report of the National Bank of the Kyrgyz Republic***

The publication is the statement of the National Bank of the Kyrgyz Republic (NBKR) for the past year. It contains brief information on the republic's economic development and monetary policy, also financial statements of the National Bank, and general information about the NBKR and statistic supplements. It is issued in 3 languages: Kyrgyz, Russian, and English.

### ***Bulletin of the National Bank of the Kyrgyz Republic***

This monthly informational publication contains statistic data on major macroeconomic indicators and sectors of economy of the Kyrgyz Republic. It is issued in 3 languages: Kyrgyz, Russian, and English.

### ***Balance of Payments of the Kyrgyz Republic***

«*Balance of Payments of the Kyrgyz Republic*» reflects external sector development trends, data of the payment balance, on foreign trade, international reserves, external debt, and international investment position of the Kyrgyz Republic. It is published quarterly in January, May, July, October in the Kyrgyz, Russian, and English languages.

### ***Banking System Development trends***

This publication provides analysis and assessment of the banking system of the Kyrgyz Republic as a financial intermediary, and also assessment of developments in banking system stability. It is published with a semiannual frequency in Kyrgyz, Russian, and English.

### ***Statutory Acts of the National Bank of the Kyrgyz Republic***

The publication is intended for official publication of the National Bank's statutory acts to provide normative documents and inform commercial banks and the public of the NBKR's activity, and promote banking legislation of the Kyrgyz Republic. It is published, as a rule, once a month in Kyrgyz and Russian.

### ***Press release of the National Bank of the Kyrgyz Republic***

«*Press release of the NBKR*» contains the chronicle of events related to the National Bank and banking system, major data of the financial market for a week and other information for mass media, legal entities and individuals. It is published on a weekly basis in Kyrgyz and Russian.

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## 1. CURRENT TRENDS

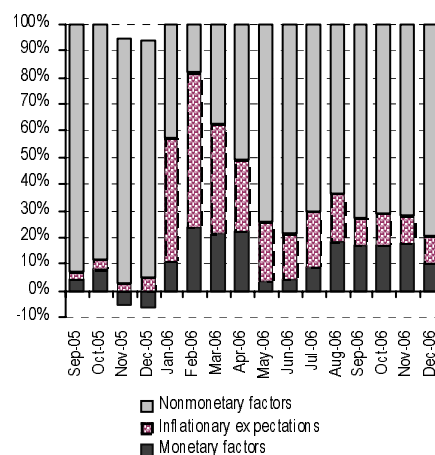
In the fourth quarter of 2006, the overall inflation level<sup>1</sup> was formed under the influence of both monetary<sup>2</sup> and non-monetary factors<sup>3</sup>. According to data of the National Statistic Committee of the Kyrgyz Republic, inflation in the reporting quarter was 2.5 percent and 5.1 percent for 2006.

In the reporting quarter, an economic activity continued to grow. According to the preliminary data of the National Statistic Committee for 2006, the gross domestic product grew by 2.7 percent relative to 2005. Its growth, not taking into account Kumtor gold-mining products, was 5.1 percent (in 2005, the growth of 1.9 percent). The value added increase was mainly provided by services and agriculture. The decline in the industry in 2006 was 11.2 percent. However, not taking into account Kumtor gold-mining products, a growth of 4.2 percent could be observed in the industry, whereas in 2005 the corresponding indicator had been negative (-4.6 percent).

The deficit of the trade balance of the Kyrgyz Republic for the 4<sup>th</sup> quarter of 2006 increased and totaled US\$ 336.8 mln. In comparison with the fourth quarter of 2005, the foreign trade turnover in FOB prices rose by 53.6 percent. The trade turnover with CIS and foreign countries increased by 50.2 and 57.8 percent, respectively. Exports of goods in FOB prices rose by 22.9 percent, with the imports of goods having increased by 71.2 percent.

The growth of the liquidity level in the banking system in the reporting quarter contributed to the increase in the banks' activity at the NBKR banknote market. An average yield on 14-day notes fell up to 2.92 percent, the yield on 28-day notes dropped up to 3.15 percent. The rate on interbank REPO transactions during the reporting quarter remained at the level of 3.5 percent, while the interest rate on interbank

Pic. 1.1. Contribution of factors to CPI



<sup>1</sup> Change of the consumer price index (CPI).

<sup>2</sup> The evaluation of contribution of monetary factors is an assessment of the contribution of a direct effect of changes of som's exchange rate and money outside banks (M0) on the inflation level taking into account time lags and seasonality factors.

<sup>3</sup> The evaluation of contribution of non-monetary factors is an assessment of the contribution of a direct effect of changes of manufacturers' prices, prices for bread and baked products, alcoholic beverages, gasoline, prices for housing and utility services, communication and passenger transportation services on the inflation level taking into account time lags and seasonality factors. The evaluation of contribution of inflationary expectations is an assessment of the contribution of the inflationary inertia indicator, i.e. inflation of the previous period with an adjusted influence coefficient.

loans in the national currency averaged 2.6 percent, which was by 0.3 percentage points less than the rate for the previous quarter.

As of the end of December 2006, a weighted average interest rate on all types of notes was 8.6 percent, having fallen as compared to the beginning of the fourth quarter by 0.4 percentage points. An average level of yield in the fourth quarter in comparison with the previous quarter dropped up to 9.3 percent or by 0.9 percentage points.

As per the National Bank's estimate, in the first quarter of 2007, the consumer price growth is expected at 3.2 percent.

## 2. CONSUMER PRICE INDEX AND ITS COMPONENTS

### 2.1. CONSUMER PRICE INDEX COMPONENTS

In the fourth quarter of 2006, a traditional for this period increase in prices took place. According to the data of the National Statistic Committee of the Kyrgyz Republic, inflation in the period under consideration was 2.5 percent (in the fourth quarter of 2005, this indicator was 2.7 percent). The key factor that determined the price dynamics in the reporting quarter was growth in prices for food products. The increase in prices for food products in the fourth quarter of 2006 was 3.8 percent, the prices for non-food products grew by 1.6 percent and those for paid-services – by 1.1 percent.

In general, inflation for 2006 was at the level of 5.1 percent (4.9 percent in 2005). The overall inflation level was formed under the influence of both monetary and non-monetary factors. According to the NBKR's estimates, the influence of monetary factors including changes in money outside of banks and som's exchange rate was 10.4 percent. The influence of the population's inflationary expatiations was 10.3 percent of total annual inflation level. The biggest contribution into the formation of inflation for 2006 was made by non-monetary factors which made up 79.3 percent.

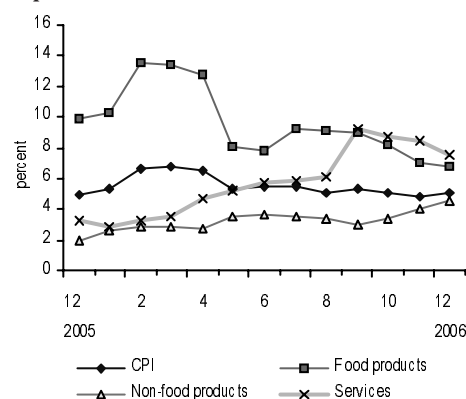
#### 2.1.1. Food products

The price dynamics for food products in the fourth quarter of 2006 was formed under the influence of a seasonal price growth for the following types of products: bread, fruit and vegetable products, and dairy products. Bread rose in price by 5.6 percent, dairy products – by 13.0 percent, fruit and vegetables – by 17.9 percent. Also, among food products, the prices grew for meat by 1.9 percent, vegetable oil and fats - by 1.4 percent. At the same time, the price growth rate for sugar was noted to decline by 9.8 percent.

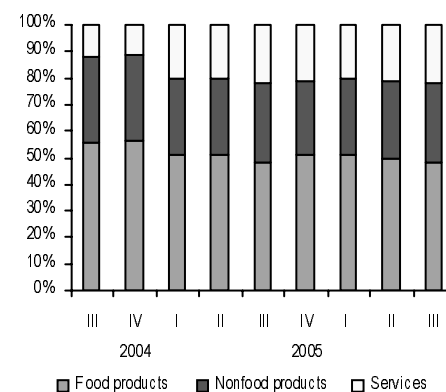
The price dynamics for plant products reflected their production and export volume. Due to a timely beginning of sowing works and good weather conditions, in 2006 we could observe the growth of agricultural crops, except for grain crops and sugar beet.

After a poor crop in 2005, the increase in production of potato, vegetables, melons and gourds, fruit and berries facilitated

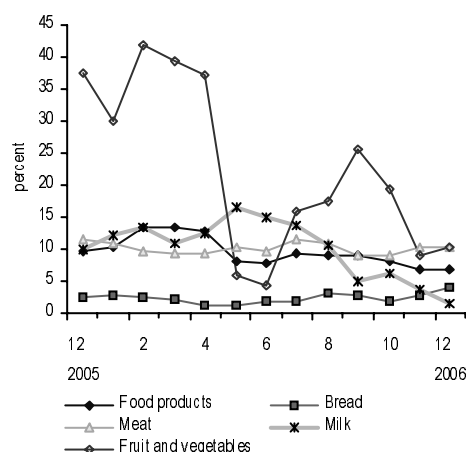
Pic. 2.1. Annual dynamics of CPI and its components

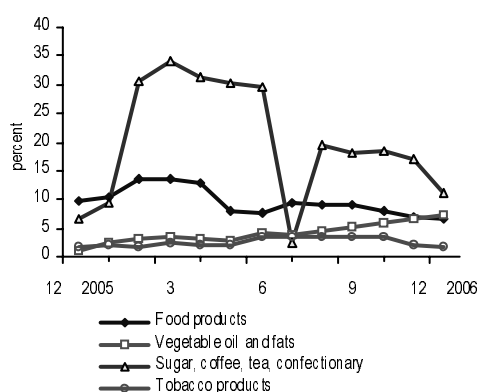


Pic. 2.2. CPI structure

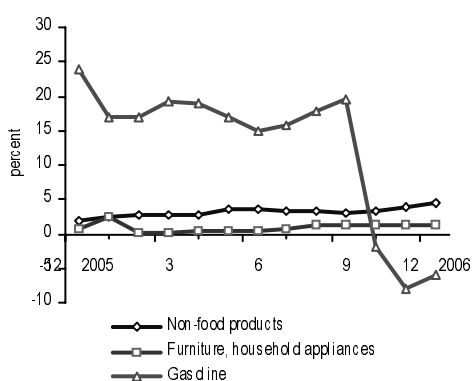


Pic. 2.3a. Annual dynamics of prices for food products



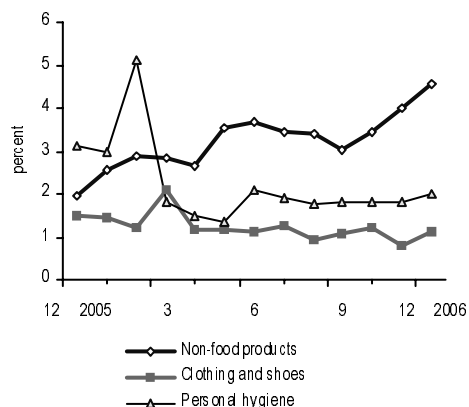
**Pic. 2.3b. Annual dynamics of prices for food products**

lower price growth rates for this group of goods. The prices for “fruit and vegetable” group for 2006 rose by 10.3 percent, whereas in 2005 the increase was 37.4 percent. However, a twofold increase in natural terms of the export of vegetables caused their price growth at the domestic market by 24.7 percent as compared to year 2005, which exceeded the corresponding indicator of 2005 by 10.4 percentage points. The gross output of agricultural, hunting and forestry products in 2006 in comparison with 2005 increased by 1.5 percent, while the production of food industry product grew by 8.2 percent.

**Pic. 2.4a. Annual dynamics for non-food products**

In 2006, the wheat production substantially declined –the fall of 11.6 percent (in 2005, the decline was 4.8 percent). Due to this, the prices for bread, baked products and cereals increased by 4.0 (the price growth for bread was 5.7 percent), whose contribution to an annual inflation level made up 0.4 percentage points (this group accounts for more than 10 percent of total consumer expenses). In addition, the latest data on Kazakhstan and Russian markets reflected the trend towards the price growth for grain crops, which creates a risk of price increase for imported wheat and flour in the first half of 2007.

The price growth for sugar in 2006 was 15.6 percent. The contribution of this factor to the inflation level for the year was estimated at 0.54 percentage points. The first quarter of 2006 accounted for the major price growth (by 39.9 percent), which was conditioned by a substantial price increase for sugar in the producing countries. However, by the end of the year, due to the beginning of the domestic harvest of sugar beet, the price growth for sugar slowed down. The prices for meat products tended to grow. In 2006, the prices for meat increased by 10.4 percent, vegetable oil and fats- by 7.2 percent.

**Pic. 2.4b. Annual dynamics for non-food products**

### 2.1.2. Nonfood products

The price index for nonfood products in the fourth quarter of 2006 was 101.6 percent. The biggest price increase was recorded for housing services- by 5.2 percent, including prices for electric power, gas and other types of fuel- by 4.7 percent. This particular factor gave rise to the current price level for nonfood products. As for the remaining groups of goods, the price growth was moderate. As for instance, the prices for clothing and footwear rose by 0.8 percent, while that of household items increased by 0.2 percent.



The price index for nonfood products in the 2006 grew by 4.6 percent. Housing services, electric power, gas and other types of fuel whose prices increased by 11.5 percent, including materials for maintenance and repairs of housing facilities, and gas which grew by 19.3 percent and by 10.5 correspondingly, accounted for the major growth. The prices for household items increased by 1.3 percent, including furniture and floor coverings – by 3.1 percent, glassware and houseware – by 2.4 percent. The decline in prices for fuels and lubricants in 2006 made up 2.6 percent, including the price for gasoline - by 5.8 percent. However, the diesel fuel rose in prices by 6.4 percent.

### 2.1.3. Services

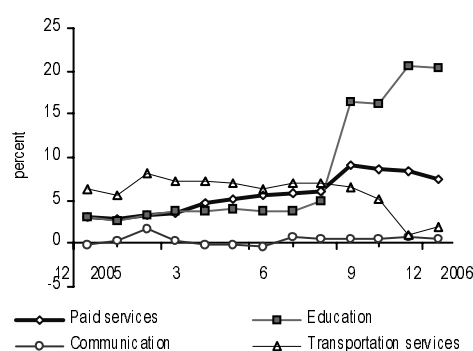
The price index for paid (fee-based) services in the fourth quarter of 2006 grew by 1.1 percent (the growth rate in the fourth quarter of 2005 was 2.7 percent). Under this group, the price growth was moderate and was mainly formed due to the increase in educational prices which grew by 3.8 percent. In 2006, the index for paid services provided to population grew by 7.5 percent (in 2005, it grew by 3.2 percent). The major reason for the price increase for a group of paid services was the increase in prices for educational services by 20.5 percent. In addition, the prices for restaurant and hotel services increased by 2.7 percent, as well as the prices for recreational and cultural services which grew by 1.8 percent.

## 2.2. CONSUMER PRICE DYNAMICS IN THE REGIONS

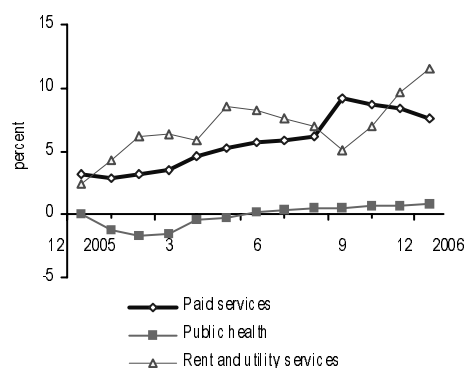
In the fourth quarter of 2006, there was a price growth noted in all the regions of the republic. The biggest price growth was observed in Talas, Jalalabat and Naryn oblasts, where the growth rates were 4.2, 3.3 and 2.9 percent respectively. The major price growth factor in the above oblasts was a considerable price increase for food products. In Bishkek city, in the fourth quarter of 2006, the prices went up by 2.4 percent. At the same time, the prices for food products rose by 4.0 percent.

If we break down by regions, then Jalalabat, Talas and Osh oblasts were noted to experience the biggest price growth- by 9.0, 7.2 and 6.9 percent respectively.

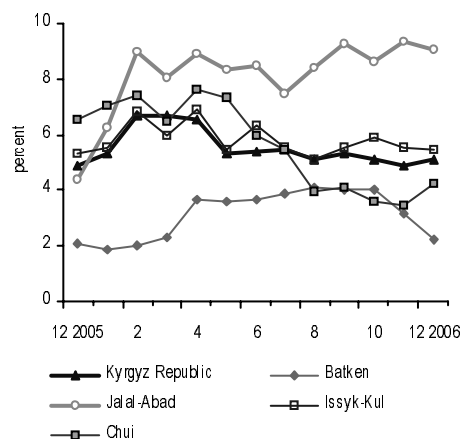
Pic. 2.5a. Annual dynamics of prices for paid services



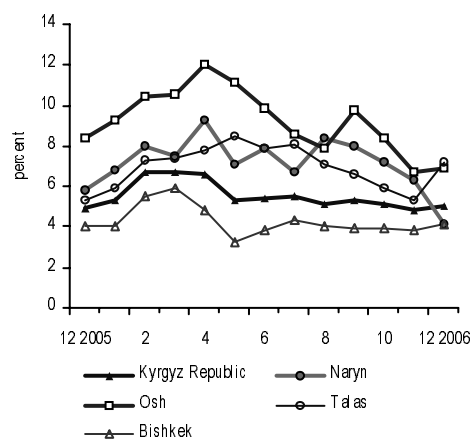
Pic. 2.5b. Annual dynamics of prices for paid services



Pic. 2.6a. CPI annual dynamics by oblasts



Pic. 2.6b. CPI annual dynamics by oblasts

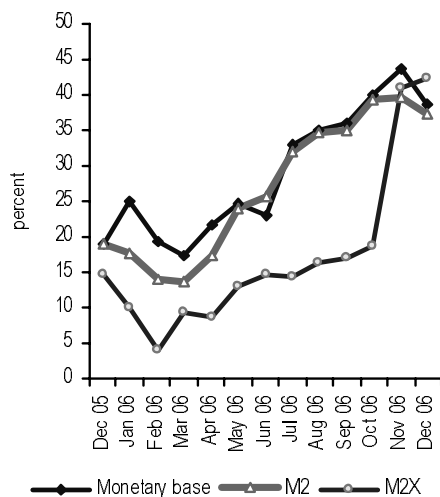


### 3. INFLATION FACTORS

#### 3.1. MONETARY AGGREGATES

##### 3.1.1. Monetary base <sup>4</sup>

**Pic. 3.1. Annual dynamics of monetary aggregates**



The monetary base for the fourth quarter of 2006 increased by 17.2 percent in nominal terms, and by 14.4 percent in real terms. The monetary base as of end of 2006 totaled 22798.8 mln. soms.

If broken down by transactions, the National Bank's transactions exerted the major influence on the change in the monetary base for the reporting quarter (+3344.3 mln. soms), which increased the monetary base by 3034.6 mln. soms mainly due to the foreign currency interventions made by the NBKR, which was caused by an increased inflow of foreign currency into the Republic and weakening of the US dollar's rate at the world market.

The Government transactions increased the volume of reserve funds by 309.7 mln. soms which was due to an excess of state budget expenses over revenues.

In the monetary base structure, there was a slight reduction in the share of cash in circulation from 87.9 percent as of the end of September 2006 to 87.3 percent as of the end of December 2006 and consequently an increase in the share of funds on correspondent accounts of commercial banks placed with the NBKR from 12.0 percent to 12.1 percent.

In general, the nominal growth of the monetary base for 2006 was 47.4 percent and 40.2 percent in real terms.

Money in circulation in the reporting quarter rose by 16.5 percent (by 9.5 percent in the fourth quarter of 2005) and as of January 1, 2007 it totaled 19909.7 mln. soms. An annual growth of money in circulation was 48.4 percent, which noticeably exceeded their growth rates for the previous year (17.4 percent in 2005).

##### 3.1.2. M2 Aggregate

The growth in the M2 monetary aggregate- broad money in

<sup>4</sup> Not taking into account the commercial banks' deposits in the foreign currency with the NBKR.

the national currency- was 15.0 percent in the fourth quarter of 2006. In 2006, M2 monetary aggregate in nominal terms showed an increase of 51.1 percent and as of the end of the year it totaled 24108.1 million soms.

In the reporting quarter, deposits in the national currency increased by 8.2 percent, including the growth in transferable deposits, which made up 5.4 percent and other deposits – 15.4 percent. In general, in 2006, the increase in the deposits in the national currency was 62.3 percent, which exceeded by 3.4 times their growth rate in 2005 (18.4 percent).

### **3.1.3. M2X Aggregate**

M2X monetary aggregate, which includes M2 money supply and deposits in the foreign currency, grew by 18.2 percent for the reporting period. At the same time, commercial banks' deposits<sup>5</sup> and cash outside banks rose by 20.3 and 16.8 percent respectively. Deposits in the foreign currency showed an increase of 28.6 percent.

In the reporting quarter, the share of deposits in the foreign currency increased in the M2X monetary base structure versus reduction in the share of money outside banks and deposits in the national currency.

| <b>Structure of M2X monetary aggregate</b> | <b>Share, percent</b> |                   |
|--|-----------------------|-------------------|
|  | <b>III quarter</b>    | <b>IV quarter</b> |
| Cash outside banks                         | 59.9                  | 58.9              |
| Deposits in the national currency          | 15.6                  | 14.2              |
| Deposits in the foreign currency           | 24.5                  | 26.9              |
| <b>M2X Monetary aggregate</b>              | <b>100</b>            | <b>100</b>        |

The analysis of sources of formation of M2X broad money showed that the major influence on its change was continuously made by the increase in net foreign assets of the banking system, first of all, due to the increase in the NBKR's net international reserves, and also increase in net domestic assets of the banking system caused by the growth in loans granted to the economy.

The broad money multiplier that characterizes the level of financial intermediation practically did not change in the fourth

<sup>5</sup> Taking into account the data of commercial banks whose licenses were revoked, however, the liquidation process has not been completed.

quarter of 2006 in comparison with the third quarter of 2006, and as of end of year it was 1.406 (1.404 as of September, 1 2006).

As of end 2006, the circulation velocity of M2X which included deposits in the foreign currency at a fixed exchange rate made up 4.5 (as of October 2006, it was 4.8).

The economy monetization ratio, calculated based on M2X monetary aggregate, was 22.4 percent as of end of the year (20.7 percent as of October 1, 2006).

## 3.2. INTEREST RATES

### 3.2.1. Money market

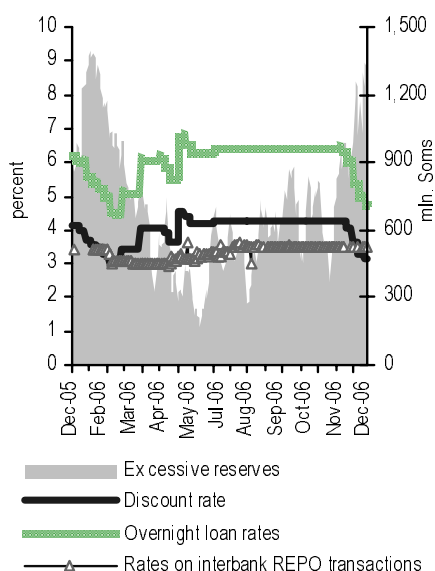
The fourth quarter of 2006 was noted by a characteristic for this period liquidity growth in the banking system. At the same time, in the reporting period, the cost of borrowed resources remained unchanged at the interbank credit market. The interest rate on interbank REPO transactions remained at the level of 3.5 percent during the reporting period, while the rate on the interbank credits in the national currency continued fluctuating within the same range of 0.0 to 3.5 percent depending on the nature of the pledged security.

On average, the rate of interbank loans in the national currency was 2.6 percent, which was by 0.3 percentage points lower than that of the previous quarter. As compared to the fourth quarter of 2005, the cost of interbank credits in the national currency rose by 0.6 percentage points due to the increase in the share of unsecured transactions, with the rate on REPO transactions remaining unchanged.

In the domestic foreign exchange segment of the interbank loan market in the fourth quarter of 2006, the range of fluctuations of rates remained quite high –from 0.0 to 8.5 percent reflecting the dependence of the rate on the character of the security and maturity of transactions. At the same time, due to higher quality of the security (pledged collateral) and reduction of maturity of transactions, an average cost of borrowed resourced fell by 1.2 percentage points and made up 4.4 percent.

A high liquidity level in the banking system at the end of November and December 2006 contributed to an increased

Pic. 3.2. Dynamics of money market rates



activity of banks in the NBKR banknote market. At the end of November, after a long break<sup>6</sup>, an action was held on trading in NBKR banknotes. In addition to issuance of traditional 28-day NBKR notes, the National Bank renewed the placement of 14-day NBKR notes. The yield on the above securities at the last auction held in November 2006 was formed at the level of 4.3 and 4.2 percent respectively. In December, the demand for notes continued growing, which caused the reduction in their yield. As a result, by the end of the quarter, the value of the discount rate pegged to the yield of 28-day NBKR notes, was 3.15 percent having declined as compared to the beginning of the quarter by 1.12 percentage points. At the same time, the interest rate on «overnight» loans, which is equaled to the discount rate of 1.5, as of the end of December was 4.73 percent, which was by 1.68 percentage points lower than the rate at the beginning of the quarter.

Due to the acceleration of the growth rate of the monetary base, the National Bank increased the volume of transactions on withdrawal excessive liquidity from the banking system mainly through conduction of reverse REPO transactions at the open market. The volume of the above transactions as compared to the third quarter doubled and totaled 1073.4 million soms. An average interest rate on REPO transactions in comparison with the third quarter dropped by 0.4 percentage points up to 4.3 percent. The maturity of transactions was 47 days.

In addition, in order to sterilize an excessive liquidity in the banking system, the National bank increased the volume of a weekly issue of NBKR notes from 4 to 24 million soms. The total amount of notes placed in the fourth quarter was 108.0 million soms.

For the same purpose, the National Bank conducted SWAP foreign currency transactions on sale of US dollars, the volume of which for the fourth quarter of 2006 totaled US\$ 1.5 mln. or 58.5 million soms. An average maturity of SWAP transactions worked out at 67 days.

Also, it should be mentioned that in the fourth quarter of 2006, the National Bank started applying a new instrument for sterilization of an excessive liquidity— deposit transactions. As for instance, at 2006 year-end one transactions was conducted

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<sup>6</sup> The last auction on sale of the NBKR notes was conducted in June 2006.

on attraction of deposits for a period of 1 month with a total amount of 50.0 million soms at a 2.0 interest rate.

### 3.2.2. State treasury bills

In the first half of the fourth quarter of 2006, the yield of notes slightly increased due to the reduction in the demand structure at the STB market. The worsening of the market situation affected to a greater extent the 18-month notes segment. However, in the second half of the reporting quarter, with a growth of excessive reserves in commercial banks, the situation at the STB market stabilized: the demand for notes was started growing, due to which there was a dominating trend towards the yield reduction till the end of the quarter. At the same time, at the beginning of December 2006, a considerable drop of rate up to 3.0 percent was noted at the 6-month STB segment, which, however, did not reflect the market conditions and was connected with a technical mistake made by one of the bidders.

As of the end of December, a weighted average interest rate on all types of STB was 8.6 percent, having fallen as compared to the beginning of the quarter by 0.4 percentage points. However, an average level of STB yield in comparison with the previous quarter fell up to 9.3 percent or by 0.9 percentage points.

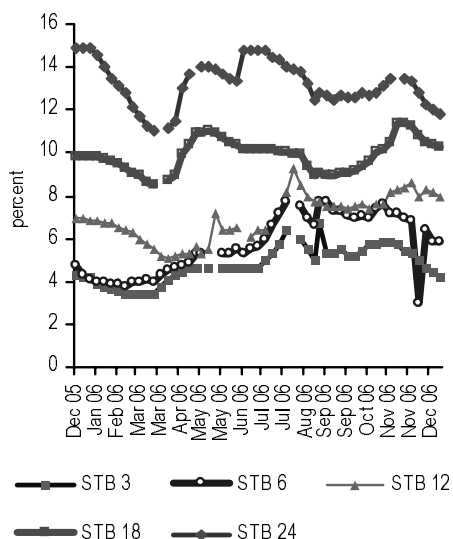
In comparison with the fourth quarter of 2005, an average level of yield increased in all the segments except for 24-month STB. An overall yield on all the STB rose by 1.3 percentage points.

### 3.3. EXCHANGE RATE

In the fourth quarter, at the domestic foreign currency market, there was a stable trend towards strengthening of the national currency's rate. The drop in the dollar's exchange rate was under the influence of an excessive supply of the foreign currency due to its inflow in the form of investments in the real sector and banking system, and also in the forms of deposits and money transfers from abroad and as a result of proceeds from sale of agricultural products.

As of end of the fourth quarter of 2006, a weighted average dollar exchange rate in foreign exchange biddings was 39.0452

Pic. 3.3. Dynamics of STB yield



som/US dollar having dropped by 2.9 percent for the quarter. The dollar selling rate in exchange bureaus fell up to 37.6938 som/US dollar as of end of December or by 3.7 percent as compared to the beginning of the reporting quarter.

The US dollar discount rate as of the end of the reporting period amounted to 38.1238 som/US dollar having dropped for the fourth quarter by 2.8 percent. For comparison: in the similar period of 2005, the dollar's discount rate rose by 1.1 percent and amounted to 41.3011 som/US dollar.

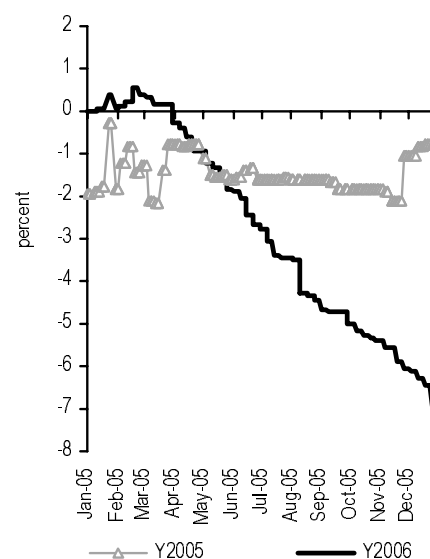
The euro's exchange rate in the cash segment of the domestic foreign exchange market, as before, was changing in accordance with its fluctuations at external markets. After certain decline in the first half of October 2006, euro's rate was rising until the beginning of December. Euro's selling rate in exchange bureaus as of end of December 2006 amounted to 49.86 som/euro having fallen for the fourth quarter by 0.4 percent. At the same time, the discount rate as of end of 2006, was 50.18 som/euro having dropped for the fourth quarter by 0.3 percent.

According to the preliminary data for the fourth quarter of 2006, the nominal efficient exchange rate<sup>7</sup> strengthened by 1.3 percentage points as compared to the corresponding period of 2005. In comparison with the previous quarter, it strengthened by 2.6 percentage points. As of end of December 2006, the nominal efficient rate index was 127.8. In general in 2006, an average index of the nominal efficient rate remained at the level of 2005.

The real effective exchange rate in the fourth quarter of 2006 fell by 2.3 percentage points as compared to the fourth quarter of 2005 and strengthened by 2.2 percentage points relative to the previous quarter of 2006.

As of end of December 2006, the index of the real effective exchange rate fell by 3.8 percent which was caused by an actual drop in the som's exchange rate relative to the Russian ruble and Kazakh tenge.

Pic. 3.4. The US dollar discount growth rate



<sup>7</sup> In May of the current year, the methodology for calculation of the efficient exchange rates was changed. The National currency was expressed in the foreign currency units. E.g. the index growth means strengthening of the national currency, whereas its reduction means weakening of the national currency. The year 2000 is used as a reference period for the formation of indices. Historical values of indices have been recalculated.

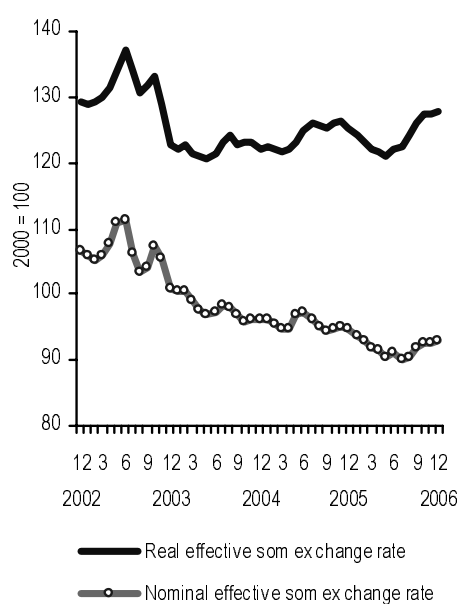


### 3.4. SUPPLY AND DEMAND

#### 3.4.1. External demand

According to the current data, the Kyrgyz Republic's trade balance in the fourth quarter 2006 was negative and equaled to US \$336.8 million against US \$143.1 million for the similar period in 2005. In general, based on the 2006 year-results, the trade balance more than doubled and amounted to US\$920.7 million against US \$418.7 million in the previous year.

Fig. 3.5. Indices of effective som's rate



The foreign trade turnover in FOB price in the fourth quarter of 2006 totaled US\$804.0 million, which was by 53.6 percent more than the similar indicator for 2005. Besides, during the reporting period the trade volume increased by 57.8 percent with foreign countries and by 50.2 percent with CIS countries. Based on the 2006 data, the volume of the foreign trade turnover in FOB prices amounted to US\$2,544.3 million, which was ensured by 31.6 percent by volumes of this indicator in the fourth quarter of 2006.

In the fourth quarter of 2006, the exports of goods in FOB prices totaled US \$233.6 million, which was by 22.9 percent more than the exports volume for the previous year. The growth in exports in the fourth quarter of 2006 took place due to an increased volume of supply of goods to foreign countries (by 24.4 percent) and to CIS countries (by 21.2 percent). As for foreign countries, there was a growth in exports to Afghanistan, Great Britain, USA and Turkey, while the volume of exports to UAE, Canada and Germany decreased. With regards to the CIS countries, the volume of exports to Kazakhstan significantly increased in the fourth quarter of 2006 (by 74.1 percent compared to the same period in 2005) and to Russia (by 10.1 percent) due to increased exports of energy products and consumer goods. At the same time, the volume of exports to Uzbekistan, Ukraine, Tajikistan and Turkmenistan has reduced. Thus, the share of exports to foreign countries increased from 51.5 percent in the fourth quarter of 2005 to 52.1 percent in the fourth quarter of 2006, while the share of exports to CIS countries reduced from 48.5 percent to 47.9 percent.

In the reporting quarter, export of gold retained the trend towards reduction and fell by 17.3 percent in value terms and



by 61.7 percent in natural terms as compared to the fourth quarter of 2005. The volume of exports net of gold increased by 35.5 percent. Based on the preliminary data for 2006, the growth was 32.8 percent.

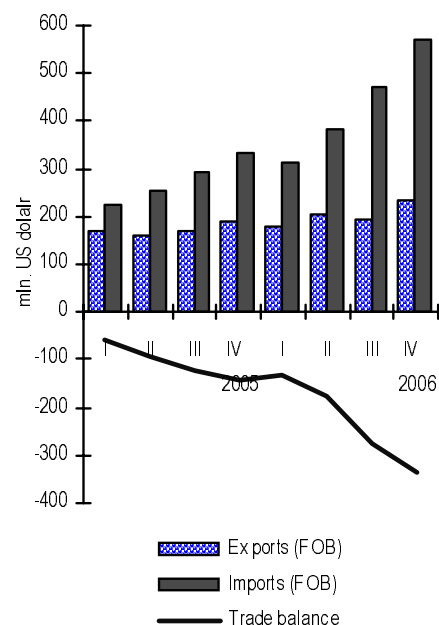
In the fourth quarter of 2006, the supply of the intermediate goods and raw materials tended to reduce (by 20.3 percent and 2.3 percent respectively). The intermediate goods and raw materials that exerted a significant influence on the reduction in exports, included gold, cotton and rawhide. During the reporting period, the volume of the exported energy products significantly increased (more than threefold) compared to the same period in 2005. The exports of the investment and consumer goods also increased. In 2006, the growth in the volume of export supplies of energy products, investment and consumer goods was 91.6 percent, 83.6 percent and 29.2 percent respectively.

According to the preliminary data for the fourth quarter of 2006, the import of goods<sup>8</sup> (in FOB prices) retained the trend towards an increase and totaled US\$570.4 million, which was by 71.2 percent more than the corresponding indicator for 2005. Based on the 2006 year-results, the import of goods<sup>9</sup> (in FOB prices) amounted to US\$1 732.5 million, having exceeded by 56.7 percent the similar indicator for the previous year.

During the reporting period, there was an increase in proceeds from imports by all items of the functional classification. The energy products and investment goods, with 29.3 percent and 27.3 percent share, respectively, were the biggest import items during this period.

The volume of imports both from foreign and CIS countries increased by 122.1 percent and 60.0 percent respectively in the fourth quarter of 2006 compared to the same period in 2005. Besides, the share of imports from the CIS countries reduced from 62.3 percent to 54.4 percent, while the share of imports from foreign countries increased from 37.7 percent to 45.6 percent. The import growth from foreign countries

Pic. 3.6. Trade balance



<sup>8</sup> CIF imports (for the fourth quarter of 2006) taking into account "shuttle" trading and revaluation, was US \$615.4 million while the trade balance deficit was US\$381.8 million.

<sup>9</sup> CIF imports (for 2006) taking into account "shuttle" trading and final appraisal, totaled US \$1869.3 million while the trade balance deficit amounted to US\$1057.5 million.

was mainly due to the increased imports from Switzerland, USA and China. In general, the major import growth in 2006 was imports from such countries as China (more than twofold), UAE (more than twofold), Canada (more than twofold), and USA (an increase of 57.1 percent). China and the USA were again the main suppliers of goods with 36.6 percent and 21.9 percent share, respectively, of the total volume of imports from foreign countries.

### 3.4.2. Domestic demand

#### 3.4.2.1. Private consumption

According to the preliminary data for January-November 2006 provided by the National Statistics Committee, the salaries and wages increased by 18.2 percent and by 11.9 percent in real terms. Thus, the increase in real income of the population facilitated the growth of individual consumption. The volume of retail turnover increased by 15.1 percent in 2006, while the volume of services provided by hotels and restaurants grew by 19.7 percent.

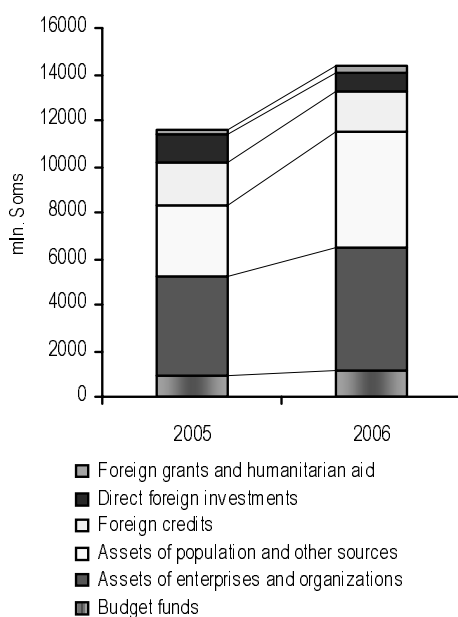
#### 3.4.2.2. Public expenses

A restrained policy of the state budget expenses during the reporting period was the main constraint to the increase of an excessive liquidity thus contributing to less pressure on the consumer prices growth.

The state budget income in January-November 2006 increased by 23.5 percent compared to the same period in 2005, while the expenses for payroll payment grew by 6.1 percent. The current expenses of the state budget increased by 21.5 percent, while subsidies to public enterprises rose by 11.1 percent. Funds provided for capital investments and repairs exceeded by 14.7 percent the amount provided during the same period in 2005.

During the two months of the reporting period, the surplus of 386.2 million soms was due to the excess of the budget revenues over the expenses (not taking into account the State Investments Program) (against 224.2 million soms in the third quarter of 2006). It is forecasted that this fact would enable to cover the 2006 deficit and keep it within the fixed index in spite of some increase in budget expenses in December 2006.

Pic. 3.7. Structure of capital investments



### 3.4.2.3. Investment

According to the preliminary data provided by the National Statistic Committee, in the fourth quarter of 2006, the capital investments (including the investment in facilities' construction, reconstruction, expansion and reequipping) increased by 33.1 percent as compared to the fourth quarter of 2005 and totaled 5 619.9 million soms.

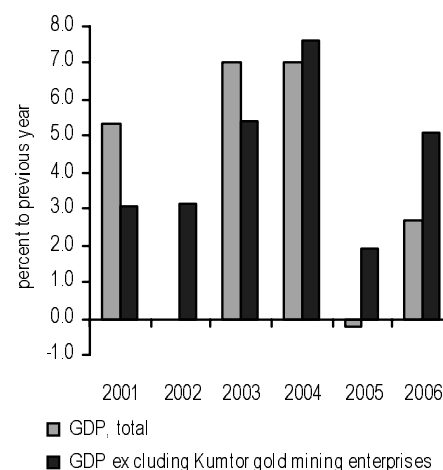
In general, the capital investments increased by 18.2 percent in 2006. The investment structure reflects a sharp growth of the share of investments made by the population from 26.6 percent in 2005 to 35.4 percent in 2006. The investment activity of the population was supported by a rapid rate of housing construction (8.5 percent). At the same time, the share of the investments from the external sources reduced from 28.4 percent in 2005 to 19.5 percent in 2006.

### 3.4.3. Gross domestic product (GDP)

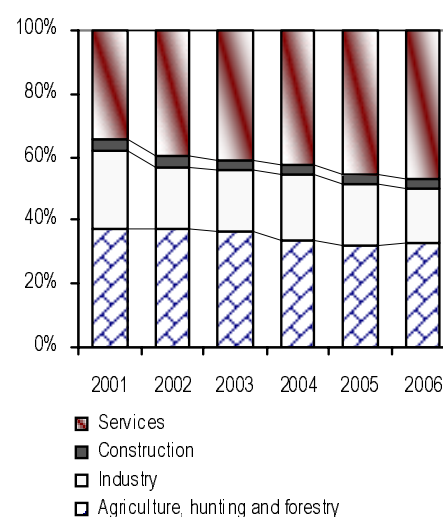
According to the preliminary data provided by the National Statistic Committee, the GDP increased by 2.7 percent in 2006 (it fell by 0.2 percent in 2005). In 2006, there was a revival of economic activity observed in spite of an insignificant growth rate. Thus, the GDP growth without taking into account Kumtor gold-mining enterprises was 5.1 percent (an increase of 1.9 percent in 2005). The gross value added in trade increased by 14.4 percent, in construction – by 8.5 percent and by 1.5 percent in agriculture. The gross value added in industry dropped by 11.2 percent in 2006, although the growth in industry sector was 4.2 percent not taking into account Kumtor as compared to its decline by 4.6 percent in 2005.

The GDP structure changed in the following way in 2006: the share of industry reduced significantly and reached the lowest level during the last 6 years and it was equal to 14.9 percent, while the share of the services sector reached its maximum and made up 41.2 percent, which was, first of all, due to high growth rates of the trade turnover.

Pic. 3.8. Real GDP growth



Pic. 3.9. GDP structure



## **4. KEY DECISIONS ON MONETARY POLICY**

### **4.1. KEY DECISIONS OF THE BOARD**

On November 29, 2006, the Board of the National Bank of the Kyrgyz Republic reviewed and took into consideration «Monetary Policy Report for 9 months of 2006» (NBKR Board Resolution # 37/2).

On November 29, 2006, the Board of the National Bank of the Kyrgyz Republic adopted Resolution “On Attraction of Funds for Time Deposit Accounts of Commercial Banks” (#37/4 of November 29, 2006), in accordance with which the NBKR started conducting transactions on attraction of commercial banks’ funds in the national currency for fixed-term deposit accounts with the National Bank on a contractual basis. These transactions are one of the monetary policy instruments and are applied with a view to regulating monetary aggregates and formatting the interest rate corridor in the money market. Introduction of the depository transactions by the NBKR will enable to increase the monetary policy efficiency aimed at the creation of favorable conditions for the development of economy. The major parameters of the NBKR’s deposit transactions (volume, period and interest rate) are established by the Monetary Regulation Committee on a weekly basis.

On December 15, 2006 the Board of the National Bank of the Kyrgyz Republic adopted Resolution # 40/2 «On the Statement of the National Bank of the Kyrgyz Republic on Monetary Policy for 2007». The major purpose of the NBKR’s monetary policy in 2007 will be maintaining the overall price level stability as the condition for the economic growth. The NBKR jointly with the Government of the Kyrgyz Republic will undertake required coordinated measures to retain the consumer price growth at the level of no more than 5.0-6.0 percent.

On December 27, 2006 the Board of the National Bank of the Kyrgyz Republic adopted Resolution # 43/4 «On Major Directions NBKR’s of the Monetary Policy for 2007-2009». This document specifies the NBKR monetary policy targets for a medium-term period (YY2007-2009). The major goal of the NBKR monetary policy in a medium-term period will

be maintaining the price stability as one of the most important condition for a sustainable economic growth. The document presents information on the monetary policy instruments, which the NBKR intends to use to achieve the stated objectives.

#### **4.2. KEY DECISIONS OF THE MONETARY REGULATION COMMITTEE**

In the reporting quarter, the Monetary Regulation Committee (further referred to as Committee) developed and took prompt decisions in the monetary and credit area based on the situation evaluation findings at the monetary market taking into consideration the status of the banking system and tax and budget areas, and also based on the monetary policy deliverables established within the programs aimed at the poverty reduction and promotion of economic growth and stipulated in the major directions of the monetary policy for 2006.

In the fourth quarter of 2006, the sales of NBKR notes were renewed with the maturity of 14 days. 5 auctions were recognized as valid on sale of 14-day notes as well as 5 auctions on sale of 28-day NBKR notes. Six actions on sale of 14-day notes and eight auctions on sale of 28-day notes were declared void due to an insufficient number of bidders. To withdraw an excessive liquidity from the banking system, the Committee recommended that the securities should be sold under REPO terms. The sales volume of STB(r)<sup>1</sup> in the reporting quarter doubled and as compared to the third quarter of 2006, it amounted to 1073.4 million soms.

In the fourth quarter of 2006, in order to increase the NBKR's capabilities on a prompt and efficient regulation of the banking system liquidity level, the Committee made a decision on the introduction of a new instrument for regulating interest rates and withdrawal of an excessive liquidity- fixed term deposit accounts of commercial banks with the NBKR. In December 2006, one transaction was made amounting to 50.0 million soms at a 2 percent interest rate with a maturity of 30 days. The National Bank made interventions on purchase of the foreign currency at the internal market aimed at smoothening of sharp fluctuations of the som's exchange rate relative to the US dollar, with their volume amounting to US\$77.65 million.

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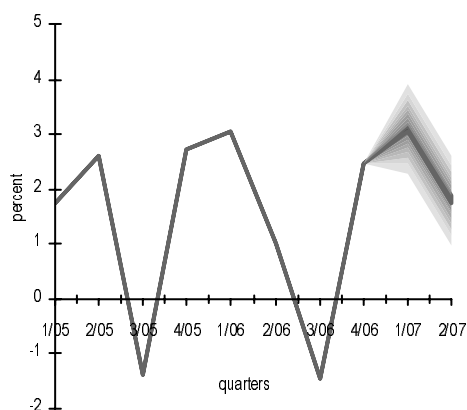
<sup>10</sup> Renewable state treasury bills (for regulation) (STB) are state securities issued by the MFKR on a regular basis.

With a view to regulating liquidity in the banking system, the Committee recommended that reverse SWAP transactions with the foreign currency should be conducted provided that there was demand on the part of commercial banks. The volume of purchase transactions in the reporting quarter totaled 58.5 million soms, while the repurchase volume amounted to 127.7 million soms.

#### 4.3. INFLATION EVALUATION FOR THE FIRST QUARTER OF 2007

As per the National Bank's estimates, the consumer price index growth is expected in the first quarter of 2007 within the range of 3.2 percent. The growth in the first quarter of 2006 was 3.0 percent.

Pic. 4.1. Inflation projection



In addition to influence of seasonal factors, the consumer price index growth in the first quarter of 2007 will be additionally affected by an administrative increase in tariffs for electric power and natural gas. Due to rise in purchase prices for gas from Uzbekistan, the gas selling prices for population will be increased in 2007 in the Republic. The gas rates will increase from 3.7 to 5.7 soms per cubic meter, i.e. the growth will be about 52 percent. The direct contribution of the gas tariff growth to the CPI is evaluated at 0.3 percentage points.

The increase in agricultural crops in 2006 after a decline in 2005 will enable to ensure supply at a sufficient level. However, the risk of an additional pressure on the CPI growth is possible on the part of prices for bread and baked products, whose share in the consumer basket is more than 10 percent. A substantial reduction in the wheat production in 2006 (by 11.6 percent), decrease in the winter crops in the first half of 2007 (by 12.3 percent) in the republic, and also the trend toward the growth in grain-crop prices in Kazakhstan and Russia create risk of price rises for wheat at Kyrgyzstan's domestic market.