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**NATIONAL BANK OF THE KYRGYZ REPUBLIC**

**MAIN MONETARY POLICY GUIDELINES FOR 2010**

**Bishkek**

**2009**

## INTRODUCTION

### 1. REVIEW OF ECONOMIC DEVELOPMENT AND MONETARY POLICY THROUGH THE END OF 2009

1.1. Review of Economic Developments and Expected 2009 Outcomes

1.2. Expected Monetary Policy Effects

### 2. ECONOMIC OUTLOOK FOR 2010

2. 1. External and Internal Factors, Contingent Risks

2. 2. Economic Development

2. 3. Inflation Forecast

### 3. ENVIRONMENT FOR IMPLEMENTATION OF MONETARY PROGRAM IN 2010

3.1. Monetary Policy Objective for 2010

3.2. Monetary Program

### 4. CONCLUSION

## **INTRODUCTION**

Based on a current economic analysis and a development forecast for key sectors of the economy, 2010 monetary policy goals and objectives are established for the NBKR in this document, with a detailed presentation of the short-term monetary policy.

The first chapter of this document provides the review of the current economic status by sectors by basic financial market indicators, as well as the monetary policy effects expected by the end of the current year.

The next chapter describes the economic outlook of the country for 2010, with external and internal factors, with contingent risks indicated as well. Economic development scenarios and an inflation forecast are presented here as well.

Monetary policy implementation principles and alternative monetary programs prepared on the basis of the contingent scenario of economic development of the republic are reflected in the third chapter. 2010 targets are also defined here, as well as information is given on the factors, which could hamper achievement of the targets. This chapter provides NBKR development trends that would promote the NBKR's capacity building when developing and implementing the monetary policy.

Statistical information is attached to the document.

Public finance sector projections of the Ministry of Finance of the Kyrgyz Republic for 2010 (as of November 6, 2009), a Country Development Strategy for 2010-2012 (as of March 31, 2009), the Medium Term Electricity and Heating Tariff Policy for 2010-2012 (of November 12, 2009), and a draft memorandum of Economic and Financial Policies for 2009-2010 as edited by the Kyrgyz party and directed to the IMF for consideration. So far as this document was based according to the preliminary data, a significant share of uncertainty could impair quality of forecasts presented therein.

# 1. REVIEW OF ECONOMIC DEVELOPMENT AND MONETARY POLICY THROUGH THE END OF 2009

## 1.1. Review of Economic Developments and Expected 2009 Outcomes

**Real Sector of Economy.** In 2009 a universal crisis situation led to a drastic reduction of an aggregate demand in the regional economy. Under the circumstances, the economy of Kyrgyzstan underwent growth retardation.

Based on outcomes for January to November 2009, the rate of growth of GDP in relation to the corresponding period of the previous year was 2.8 percent against 7.1 percent in January to November 2008. Excluding enterprises, which develop a gold deposit “Kumtor”, growth of GDP was 3.9 percent (in January to November 2008 – 5.0 percent).

At the same time, against the background of a recession in many other countries, including Russia and Kazakhstan, such parameters of growth seem to be quite optimistic.

In a breakdown by sectors, one of the principal reasons for deceleration in growth was that of a significant setback in industrial production due to both gold mining sectors and the sectors not connected with extraction of gold.

Approximately half of growth of the total value added was ensured by agriculture, whose share continues to decrease in the general structure of GDP, having in this regard, made by results of nine months 25.8 percent as against 28.7 percent in the similar period of 2008. The significant part of growth of GDP in the current year fell on the services sectors as well, namely, on trading, transport, and communications. As a result, the share of a sphere of services in total GDP noticeably increased and was 47.3 percent against 42.2 percent in January to September 2008.

Overall, in 2009 it is expected that a volume of real GDP will increase by 2.5 percent and in nominal terms it will be about Som 192.0 billion, in this regard, a deflator will be 1.4 percent.

As compared to the similar period of 2008, investments increased by 30.9 percent in fixed assets in January to November 2009. According to preliminary estimates, the share of gross investment in GDP will increase from 24.8 to 30.6 percent in 2009.

**Table 1. 2009 GDP Forecast by Sectors**

	Facts					Estimates				
	current prices	comparable prices	growth of VA	growth (actual)	deflator	current prices	comparable prices	growth of VA	growth (actual)	contribution to growth
	2007			2008		2009		2009		
Agriculture	38 142.4	38 405.9	263.5	0.7%	24.5%	47 801.4	51 625.5	3 824.1	8.0%	2.1%
Mining	643.7	684.9	41.2	6.4%	21.5%	832.0	873.6	41.6	5.0%	0.0%
Manufacturing	14 074.9	17 395.6	3 320.7	23.6%	19.9%	20 852.2	17 724.4	-3 127.8	-15.0%	-1.7%
Electricity, gas & water generation & distribution	3 882.8	3 591.8	-291.0	-7.5%	14.7%	4 121.2	3 915.1	-206.1	-5.0%	-0.1%
Construction	5 070.4	4 523.2	-547.2	-10.8%	28.0%	5 789.3	7 236.6	1 447.3	25.0%	0.8%
Trade, repair of vehicles	25 445.2	27 788.8	2 343.6	9.2%	24.0%	34 449.9	35 655.6	1 205.7	3.5%	0.7%
Hotels & restaurants	1 707.9	1 933.8	225.9	13.2%	24.3%	2 404.3	2 476.4	72.1	3.0%	0.0%
Transport & communications	10 561.1	13 697.6	3 136.5	29.7%	12.9%	15 458.2	16 231.1	772.9	5.0%	0.4%
Other	23 211.5	23 998.6	787.1	3.4%	20.3%	28 861.7	29 150.3	288.6	1.0%	0.2%
Net taxes on products	19 157.8	20 613.8	1 456.0	7.6%	18.6%	24 443.4	24 736.7	293.3	1.2%	0.2%
<b>GDP</b>	<b>141 897.7</b>	<b>152 634.0</b>	<b>10 736.3</b>	<b>7.6%</b>	<b>21.2%</b>	<b>185 013.6</b>	<b>189 625.5</b>	<b>4 611.9</b>	<b>2.5%</b>	<b>2.5%</b>

A downward tendency in consumption showed up in the context of a decline in economic activity and it is confirmed by the data on expenditures for final consumption in the first half of 2009 and a downward dynamics of import, whose volume from the beginning of the year contracted more than by quarter. Overall, consumption is expected to

decrease by 10.0 percent in real terms in 2009, and its share in total GDP will be about 97 percent. Receipts of remittances are decreasing. At the same time, according to the data for January to August 2009, real growth of monthly average wages was 6.8 percent against 7.2 percent in January to August 2008.

**Fiscal Policy.** The promotional fiscal policy of Kyrgyzstan during the world financial crisis led to a deterioration of equilibrium parameters of the public finance sector, because a need for additional budget expenditures stumbled across essential restrictions on the part of tax revenue in the light of a general business loss in the country, the reduction in the volume of imports, and amendments made in tax laws.

By end-2009, consolidated<sup>1</sup> budget revenue is expected to grow by 16.1 percent, of which state budget revenue – by 17.1 percent, and Social Fund budget revenue (including budget transfers) – by 13.4 percent. In this regard, the positive rates of growth of state budget revenue will be, largely, ensured by receipt of official transfers from foreign organizations and states (a grant of the Government of the Russian Federation), while tax revenue will decrease by 2.4 percent.

The public expenditure policy in 2009 was aimed at financing social guarantees and obligations of the state to the population fully and timely, rendering support to the most vulnerable layers of the population, and capital expenditure for an infrastructure (including construction of the Kambarata-2 HES). As a result, the increase is projected in the consolidated budget expenditures by 26.3 percent in comparison with 2008.

Among the key factors in a system of mandatory state insurance, we would note the following changes:

1. Introduction of a funded pillar at the rate of 2.0 percent of a wage fund. In this regard, the rates of employer's insurance contributions decreased by 2.0 percent (from 19 to 17 percent), while the rates of employee's insurance contributions increased from 8.0 to 10.0 percent, of which 8.0 percent is still the conventional funded part, and 2.0 percent will be directed to exactly the funded part of a pension (becomes effective as of January 1, 2010);
2. Establishment on July 1, 2009, of the Worker Recreational Fund, whose funds will be directed to pay for sanatorium-resort treatment vouchers for workers and members of their families, as well as for maintenance of sanatoria and preventoria and children's recreational centers. The rate of insurance collected for the Worker Recreational Fund is established at a level of 0.25 percent of all types of payments accrued in favor of workers or executors of works/services;
3. Starting from 2010, a financing of the base part of pensions will be phased in the republican budget – 20 percent of an annual financing requirement on the accrual basis to achieve the level of 100 percent by 2014;
4. The increase in the size of pensions: the base part – to Som 800 (by Som 170 or 27.0 percent), and the insurance part – by 40.0 percent.

As a whole, considering the current status of budget execution, the consolidated budget deficit is expected at the level of Som 4.2 billion or 2.2 percent of GDP.

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<sup>1</sup> The consolidated budget means the aggregate data of the State Budget and the Social Fund budget.

**Balance of Payments.** In 2009, the current account deficit is projected to decrease to 2.0 percent of GDP (in 2008 the given parameter was 11.9 percent of GDP).

The economic recession in the developed countries and the decrease in the world prices in primary markets will affect foreign trade operations of the Kyrgyz Republic. For instance, a foreign trade turnover of the country in 2009 will decrease by 17.4 percent and will total US\$4 649.6 million. The deficit of trade balance will be US\$ 1 220.6 million and will decrease by 35.0 percent.

Based on performance in 2009, export is projected to decrease by 8.5 percent to US\$ 1 714.5 million. The major factor influencing a drop in export deliveries is that of the business loss in the trading partner countries of Kyrgyzstan. In this regard, the increase is expected in export of gold by 11.9 percent due to both growth of world prices, and the increase in output.

In 2009, the decrease by 21.8 percent is projected in the volume of products imported in the republic – to US\$ 2 935.1 million. The decrease in the volume of imports will be basically caused by the decrease in import of energy resources and consumer goods.

The volume of current transfers will be US\$1 245.9 million and will decrease by 15.6 percent conditioned by the 26.3 percent reduction of the volume of foreign exchange receipts from labor migrants. The reduction of remittances of labor migrants will be connected, first of all, with the deterioration of the economic situation in Russia and Kazakhstan<sup>2</sup>, where the basic part of labor migrants from Kyrgyzstan is concentrated. Alongside with this, the reduction of foreign exchange receipts as remittances is offset by receipt of grants from the Government of the Russian Federation totaling US\$ 150.0 million.

The capital and financial account is projected to be positive of US\$ 417.2 million in 2009 as against its negative value in 2008 equal to US\$ 7.6 million. By end-2009, it is proposed a write-off of US\$ 193.6 million of the debt of Kyrgyzstan to Russia and in this connection the capital account is projected to be positive in the volume of US\$ 214.4 million. On the financial account, the 5.4 times increase is projected in its positive balance – to US\$ 202.8 million, while the volume of direct investments will be reduced from US\$ 232.4 million to US\$ 33.8 million and a net inflow in an item “Other Investment” will be US\$ 186.9 million against a net outflow of US\$ 169.4 million.

The net inflow in the item “Other Investment” will be ensured by the public sector external receipts. As a whole, a slowdown is expected in growth of assets of residents abroad and growth of liabilities of residents to the external world. In this regard, an excess of debt servicing over debt attraction is expected in the private sector.

This being the case, the total balance of payments will develop positive at the rate of US\$ 154.9 million. The volume of total international reserves at the end of the accounting period will cover 3.7 months of future imports of goods and services.

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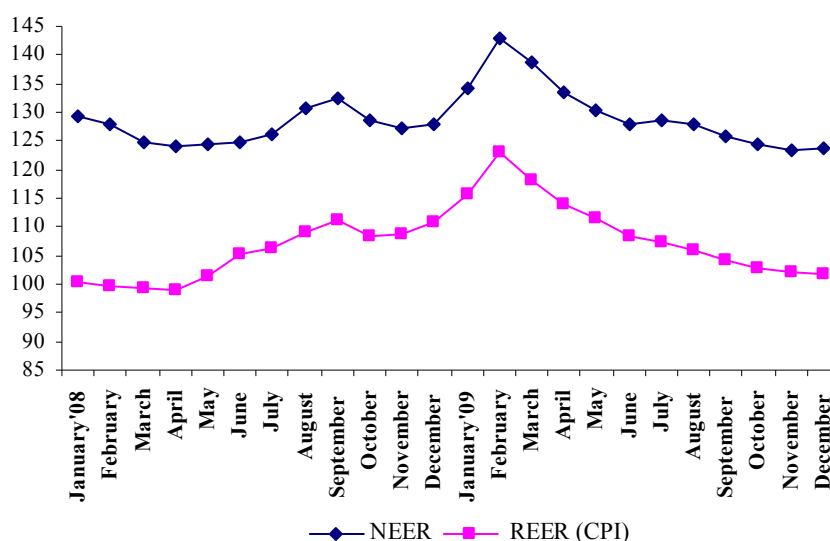
<sup>2</sup> According to the IMF data, an economic slack in Russia will be 8.5 percent in 2009, economic growth in Kazakhstan will be at the level of 0.1-0.4 percent. The situation is expected to deteriorate in the market of construction and in the sphere of trade and services. These spheres provide for the basic share of workplaces for the labor migrants.

## Expected 2009 REER Index

At the end of 2009 the real effective exchange rate (REER) index of the Som will be 101.9<sup>3</sup> and in comparison with the 2008 corresponding parameter will decrease by 8.2 percent. The decrease in the REER index will be influenced by both a strengthening of the nominal bilateral exchange rates currencies of a majority of basic trading partners vis-à-vis the Som<sup>4</sup>, and the rate of inflation in the Kyrgyz Republic lower than in the countries trading partners<sup>5</sup>.

In 2009 inflation in the Kyrgyz Republic is projected at the level of 0.5 percent, whereas the corresponding parameter of the key trading partner countries is tentatively estimated be 6.4 percent.

**Chart 1. REER and NEER Index Movement (2000 = 100)**



**Basic Financial Market Indicators.** A list of participants in the financial market of the republic expanded in the current year – the public special funds started to operate in Kyrgyzstan: the Kyrgyz Republic Development Fund (KRDF), the Special Fund for Banks Refinancing (SFBR).

Based on the outcome of 11 months of 2009, the volume of SFBR operations was Som 566.6 million. To determine the value of SFBR resources, “the base rate” was introduced and it is established by the NBKR on the monthly basis, taking into account

<sup>3</sup> The nominal exchange rate of the Som in relation to the currencies of basic trading partner countries effective in October was applied for the REER forecast.

<sup>4</sup> The US dollar average exchange rate in October 2009 as against the average exchanger rate for December 2008 appreciated with regard to the Som by 9.8 percent, the Russian Ruble – by 5.0 percent, the Chinese Yuan – by 10.1 percent, the Euro – by 17.9 percent, the Japanese Yen – by 10.9 percent, the Uzbek Sum – by 1.7 percent, and the Turkish Lira – by 13.5 percent.

<sup>5</sup> The price level in the Kyrgyz Republic for nine months of 2009 decreased by 1.7 percent, while the corresponding indices of basic trading partner countries grew by 3 percent according to preliminary calculations

rates of the money market of the republic. In September 2009, the base rate for crediting the SFBR was established at 8.0 percent of the annual interest rate and maintained at the given level in the ensuing months. With this level of the base rate, the maximal value of resources for a sub-borrower was within a range of 13.4 percent (industry, agriculture) to 21.0 percent (microfinancing), taking into account a margin of a commercial bank or a microfinance organization.

In January to November 2009, the volume of operations *in the interbank market of credit resources in national currency* in comparison with the similar period of 2008 increased by 33.1 percent – to Som 10.1 billion. In this regard, the average level of rates of interbank credits in national currency grew by 1.2 percentage points and was 8.3 percent, and the average rate of “overnight” credits was 8.8 percent.

The volume of loans *in the domestic interbank credit market in foreign currency* decreased by 27.3 percent – to Som 711.2 million, and their average value increased by 0.1 percentage points to 6.0 percent.

*Foreign Exchange Market.* The weakening tendency of the Som vis-à-vis the US dollar that started at the end of the third quarter of 2008 practically remained during the period of January to November 2009. This dynamics was caused by the reduction of the inflow of foreign exchange: the receipts from export of goods and services and the remittances of labor migrants. Furthermore, this tendency was encouraged by also expectations of market participants as a result of a significant weakening of national currencies of key trading partner countries of Kyrgyzstan. For instance, a one-stage devaluation of the Kazakh tenge by the National Bank of Kazakhstan had a significant impact on developments in the domestic foreign exchange market in early-February, being instantly reflected in the exchange rate changes in the domestic foreign exchange market: – the dollar and Euro exchange rates jumped and the rate of the Kazakh tenge decreased in relation to the Kyrgyz som. Under the circumstances, the NBKR took measures to prevent sharp exchange rate fluctuations of the national currency, caused by the keen demand for foreign exchange, acting as a seller of non-cash and cash US dollars in the market, as well as conducting the operations on cashing the US dollars. As a result, NBKR’s sales of US dollars amounted to US\$ 215.2 million in January to November 2009.

On the aggregate, for January to November 2009, the official dollar exchange rate increased by 11.4 percent, to Som 43.9220/US\$ 1.00 (for comparison: the official US dollar exchange rate for the corresponding period of 2008 increased by 11.0 percent, to Som 39.2956/US\$ 1:00).

In the short-term period, the fluctuating world currencies, influencing the domestic interbank market situation, is supplemented by uncertainty related to insufficiency of information on financial plans of the Development Fund, which accumulates essential volumes of foreign currency. An upswing of demand for foreign currency by the end of the year could strengthen pressure towards the moderate US dollar rate increase vis-à-vis the national currency.

*GS Primary Market.* In January to October 2009, the demand in the primary market of Government securities was outgrowing a supply by two emitters: the National Bank (NBKR Notes) and the Ministry of Finance (GT-Bills). The higher demand in this segment of the market, as well as the persistently high level of excess liquidity in the banking system speaks for a preference of banks to invest their assets in highly liquid financial tools during the periods of crisis. As a result, despite the increase in the monthly average volumes of issue of NBKR Notes by 14.0 percent and of MFKR GT-Bills by 58.6 percent



in January to November 2009 in comparison with the similar period of 2008, a yield of GS in the period under review of the current year essentially decreased (from the second half of 2008, the yield in the primary GS market showed the upward tendency). The monthly average yield decreased in November in comparison with January 2009: with regard to all of the GT-Bills from 19.3 to 4.5 percent; with regard to all of the Notes – from 12.4 to 1.4 percent.

The given segment of the market was concordantly divided in the current year between the two emitters. As a result, the NBKR acts as the emitter in shorter segment of the GS market with one month maturity that conforms more to the money market. The MFKR is the emitter of GS<sup>6</sup> with maturity of 3 months and more than one year. In this regard, the MFKR divided emitted papers by maturity, having left the GT-Bills as short-term, one year GSs, and having started issuing GT-Bonds – midterm GS for over one year. Accordingly, for January to November 2009 duration of GT-Bills was reduced from 214 days to 180 days.

The total amount of *the deposit base* of operating commercial banks for January to October 2009 increased by 17.2 percent and was Som 34.6 billion at the end of the period (for January to October 2008, the volume of deposits grew by 15.5 percent). The average interest rate of newly attracted deposits in national currency grew by 0.3 percentage points in January to October 2009 in comparison with the similar period of 2008 and was 2.8 percent, and the value of currency deposits – by 0.8 percentage points, to 1.6 percent, of which the average interest rate of time deposits in national currency increased by 2.0 percentage points and was 9.1 percent, and the average rate of time deposits in foreign currency grew by 2.4 percentage points, to 8.0 percent.

*The loan portfolio* of operating commercial banks for ten months of 2009 was reduced by 0.2 percent and was Som 25.6 billion at the end of October (for January to October 2008 the loan portfolio increased by 28.2 percent). The average interest rate of newly extended credits in national currency for January to October 2009 was 26.8 percent, having thus increased in comparison with the similar period of 2008 by 0.9 percentage points. The average interest rate of credits in foreign currency was 21.7 percent, having thus increased by 1.3 percentage points.

At the same time, lending to the real sector from NFCI continued to grow in the period under review. For the first half of 2009 their cumulative loan portfolio increased by 12.8 percent and was Som 8 329.8 million that makes 24.7 percent of total lending to the economy (at the beginning of the year its share was 22.4 percent).

## **1.2. Expected Monetary Policy Effects**

**Review of Monetary Indicators and 2009 Year End Forecast.** In 2009 the monetary policy was directed to minimize consequences of the financial crisis and maintain stability of the financial system not to allow stagnation in economic development of the republic. The goals and objectives connected with this were reflected in the Main Monetary

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<sup>6</sup> Placement of 18- and 24-month GT-Bills was cancelled on October 23, 2008, with the Resolution of the Government of the Kyrgyz Republic No 556 of October 2, 2008.

Policy Guidelines for 2009-2011 and in the Joint Statement of the Government of the Kyrgyz Republic and the NBKR about Main Economic Policy Guidelines for 2009.

Damping of aggregate demand owing to growth retardation coupled with downward adjustments of world prices of basic commodities lessened the inflationary pressure in the republic. As a result, inflation started to go back in 2009 to its average level of previous years. In order to form the adequate business-community expectations promoting economic activities alongside with the anti-crisis measures of the Government and the National Bank of the Kyrgyz Republic, in August the National Bank revised the earlier stated quantitative monetary policy criterion (below the level of 15 percent) downward to the level of no more than 7.5 percent (December 2009 against December 2008).

As was assumed, growth retardation was accompanied with the essential reduction in the rates of growth of monetary aggregates. For instance, the rates of the change of broad money M2 in January to November 2009 were (+)4.1 percent, broad money M2X grew by 7.2 percent.

The ratio of monetization of the economy by broad money M2 decreased from 19.9 percent to 18.5 percent (at the end of November 2008 and 2009, accordingly). According to the preliminary data, credit to the economy in percent of GDP decreased from 16.5 percent at the end of November 2008 to 15.0 percent at the end of November 2009. In this regard, the rates of the decrease in credit to the economy in soms and in foreign currency from the beginning of 2009 are at the level of 2.4 percent and 3.1 percent, accordingly<sup>7</sup>. Thus, in spite of the fact that the safety factor in the banking system of the Kyrgyz Republic was quite sufficient, the world financial crisis had a negative impact on the economy. Namely, lessening of consumer demand on the part of key trading partner countries of Russia and Kazakhstan affected the reduction of consumption that, in turn, alongside with growth of uncertainty concerning the US dollar exchange rate and the situation in the world markets was conducive to the reduction of lending to the economy from the banking system. Furthermore, the reduction of remittances of labor migrants by 26.3 percent, which are a significant component of the demand for cash in national currency, also contributed to the decrease in the rates of growth of money in the current year.

In the context of low inflation by end-2009, the NBKR will continue implementing the measures directed to stimulation of lending to the economy, considering at the same time the risks of significant growth of budget expenditures at the end of the year and essential uncertainty in the operations of special funds, as well as the permanently high level of excess reserves of the banking system.

***Money Supply Formation Sources.*** Implementing a task of “...finding an optimal balance between inflationary pressure and the risk of no economic growth...”, stated in the Main Monetary Policy Guidelines, for 2009, in the context of disinflation, the National Bank undertook a number of measures for maintenance of the volumes of lending to the economy. In particular, the Special Fund for Banks Refinancing was established; reserve requirements were lowered; a list of collateral is expanded by the refinancing tools. However, despite the listed monetary policy measures, there are signs of credit stagnation that influence the supply of money. The NBKR’s monetary policy measures directed to

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<sup>7</sup> According to the monetary survey data of the banking system.

stimulation of the banking system to maintain growth of lending to the economy, are hampered by the cautious policy of banks, which, being market agents, behave according to market laws during periods of crisis and surmounting them. Under the circumstances, direct government support of priority directions of economic development could yield the essential results – China is an example of such a policy.

Based on the outcome of 11 months of 2009, the below given rates of change of monetary aggregates reflect the slowdown in comparison with the similar period of 2008:

	as of 12/1/2009	as of 12/1/2008
✓ money outside banks M0 –	3.5 percent	6.6 percent
✓ broad money M2 –	4.1 percent	9.5 percent
✓ broad money M2X –	7.2 percent	11.6 percent

In this regard, excluding growth of the US dollar exchange rate, growth of broad money M2X was lower and made 4.5 percent.

The NBKR's net foreign assets (NBKR NFA) for 11 months of 2009 increased substantially in comparison with the similar period of 2008 due to, mainly, the Russian credit and grant, whose total volume more than offset the NBKR's net sales (-)US\$ 148.4 million (in 2008, NBKR's net purchases were (+)US\$ 70.6 million).

The NBKR's net domestic assets (NBKR NDA) for 11 months of 2009 reduced the monetary base and the contribution of the NBKR NDA to its decrease is estimated at (-)28.9 percent, (in January to November 2008 the NBKR NDA did not affect the monetary base). The NBKR NDA decreased on impact of basically activities of special funds. The net foreign assets of the banking system (BS NFA) for January to November 2009 had the upward impact on broad money M2X, with their contribution being equal to (+)41.2 percent as against (+)5.7 percent in the similar period of 2008.

The net domestic assets of the banking system (BS NDA) for 11 months of 2009 reduced broad money, with the BS NDA contribution to the change of broad money M2X estimated at (-)33.6 percent.

The rates of growth M2X in January to November 2009 developed at the level of 7.2 percent, a multiplier M2X decreased from 1.41 to 1.35. In this regard, the contribution of money outside banks to the change in broad money M2X is estimated at 2.1 percent (in January to November 2008 – 4.1 percent), while the contribution of deposits included in broad money M2X was 5.1 percent (in 2008 – 7.5 percent).

Credit to the economy from the banking system decreased by 2.8 percent for 11 months of 2009. The rates of growth of the loan portfolio of commercial banks will presumably increase in the short-term period due to activity of the special funds. Considering the aforesaid, the NBKR NDA contribution to the supply of money will be more essential than in 2008 because of SFBR activity, while the BS NFA contribution will be predetermined by activities of the KRDF.

**Inflation Factors and Monetary Policy Target Implementation.** Essential deceleration in growth and the related negative processes, such as the low rates of growth of money household income and the reduction of the consumer demand became one of the major factors of disinflation in Kyrgyzstan.

The situation in the world markets of food products and energy resources slightly stabilized in 2009 and also led to the price adjustments downwards and, as a consequence, to the reduction of prices in the domestic consumer market in Kyrgyzstan, in particular, with regard to the imported products.

According to the National Statistics Committee of the Kyrgyz Republic, year-over-year growth of the consumer price index was 0.4 percent in November 2009 (in the similar period of 2008 it was 19.0 percent).

The price reduction was observed with regard to practically all of the basic groups of food products. In particular, annualization of price changes showed that the prices of breadstuffs decreased by 15.6 percent, of oil and fats – by 16.6 percent, and those of fruit and vegetable – by 19.9 percent.

However a continued rise in the prices of nonfoods and services bears some risks from the point of view of stabilization of the general price level in the country and uncertainty of inflation forecasts.

Proceeding from the actual data and estimates of further development trends under the program monetary policy scenario, it is projected that inflation in 2009 will be lower than 0.5 percent (December 2009 by December 2008).

## **2. ECONOMIC OUTLOOK FOR 2010**

### **2. 1. External and Internal Factors, Contingent Risks**

The 2010 conditions of monetary policy implementation were characterized by a high degree of uncertainty, which is dictated by not only the external macroeconomic factors in the region, but also by the aggressive investment policy of the public sector of the Kyrgyz Republic.

First of all, the high level of uncertainty concerning the rates of revival of the regional economy after the world financial crisis could be referred to the *external risks*, as well as the following factors:

- Unresolved issues of food security;
- Continued low demand for domestic product in the region;
- Shrinkage of workplaces in Russia, Kazakhstan and a number of other countries;
- Non-delivery of scheduled public investments.

#### Internal Risks:

- Uncertainty of behavior of economic agents in connection with the tariffs increases;
- Instability of tax treatment;
- Non-achievement of growth in agriculture;
- Non-implementation of projected targets in the fiscal sector;
- Incomplete disbursement of capital assets;
- Energy sector problems.

## 2. 2. Economic Development

Further improvement of the economic situation in the region and the more dynamic process of overcoming the consequences of the crisis due to successful use of capital assets formed the basis of the program scenario of macroeconomic development of the republic.

Despite the general business loss, there are preconditions for growth that would allow providing for real growth of GDP at the level of about 5.0 percent.

Activities of such sectors in the sphere of services, as transport and communications and trade will play the determining role in maintenance of projected economic growth. Growth of a trade turnover will be caused by the positive economic development trends in the key trading partner countries. In this regard, the slowdown will be observed eventually in the sectors of transport and communications, one of the key industries of the sphere of services, because a growth potential in the given sector is exhausted.

The manufacturing sector will be, most likely, in stagnation and will start recovering only in the second half of 2010. Investments in the industrial sector should play the important role in a step-up in production. No appreciable changes are expected in extraction of gold at the Kumtor deposit.

The situation in the energy sector will stabilize eventually. Launching of the first turbine unit of the Kambarata HES-2 scheduled for December 2009 will substantially contribute to economic development of Kyrgyzstan in 2010 and will ensure intensive development of the electricity, gas and water generation and distribution sector.

Moderate growth is anticipated in agriculture. Considering high productivity in the current year, growth of the total value added in this sector is projected in 2010 at the level of 1.0 percent.

The major factors supporting growth of economic activity in the country will be those of active investment activity, including public investments and a recovery of the consumer demand, caused by growth of household income in the republic.

The consumption trend, as well as economic activity as a whole, will be determined in many respects by growth of income of citizens and will coincide with the dynamics of import with a certain time lag. Some increase in final consumption is expected in 2010 after the appreciable reduction in 2009, therefore, the volume of consumption will grow by about 4 percent, and its share in relation to GDP in comparison with 2009 will decrease amounting to 90.9 percent.

Real growth of gross investment in 2010 is projected at the level of 20 percent, and their share in the structure of GDP on the use of income will be 34.6 percent against 30.6 percent in 2009. The basic sources of fixed asset formation will be both own means of enterprises and households, and public funds. In this regard, the priority directions of investments will be those of industry, construction, and the key sectors of the sphere of services.

**Table 2. GDP Forecast by Use for 2010**

	2009		2010			
	Value (mln soms)	Share (percent)	Deflator (percent)	Real growth (percent)	Value (mln soms)	Share (percent)
Consumption	186 010	96.7	9.8	4.2	210 960	90.9
Investment	58 821	30.6	13.7	20.0	80 385	34.6
Export	84 514	44.0	13.1	7.3	104 486	45.0
Import	137 051	71.3	7.0	11.7	163 795	70.6
<b>GDP</b>	<b>192 294</b>	<b>100.0</b>	<b>14.9</b>	<b>5.0</b>	<b>232 037</b>	<b>100.0</b>

Total household income will be growing modestly in 2010, being caused by, mainly, the gradual recovery of general business in the neighboring countries. Growth of income, calculated on the basis of projections of consumption and investment, will be about 8 percent in real terms in the year under review.

In 2010, according to *the program scenario* of fiscal policy development, the consolidated budget deficit will be Som 15.7 billion or 6.7 percent of GDP and will be completely covered, including through direct budget support by donors, including the IMF, as well as due to the use of Government deposits.

The state budget will be executed with the deficit of Som 14.3 billion or 6.2 percent of GDP. The total amount of state budget revenue and grants is projected at the level of 25.0 percent of GDP, and expenditure – 31.1 percent of GDP. Current expenditure is expected to increase by about 14 percent in 2010, while capital expenditure – by 57 percent. As in the previous periods, the basic share of revenue will fall on tax revenue. Though the state budget will continue to lack the resources and, as a result, the budget deficit will be still at quite a high level. The increasing role of the state in support of the most vulnerable layers of the population due to the increase in electricity and heating tariffs is the certain risk for budget stability. The need for attraction of external sources to cover the state budget deficit also becomes the key factor of the budget balance.

The gradual recovery of the world economy<sup>8</sup>, including the recovery in the key trading partner countries<sup>9</sup>, which is expected since 2010, created a foundation of the forecast of balance of payments of the Kyrgyz Republic for 2010.

The following developments are expected to take place in 2010:

- The increase in the volume of exports of gold as a result of development of new deposits, with the average world price of gold at the rate of US\$ 955 for a Troy ounce;
- The level of the world prices of oil at about US\$ 76.5 for a barrel;
- Attraction of foreign lending by the public sector totaling US\$ 900 million;
- Growth of remittances of migrants;
- Growth of direct foreign investments;
- Continued attraction of external financial resources;

<sup>8</sup> According to the IMF projections, real growth of the world GDP will be 3.1 percent, including 1.3 percent in the developing countries.

<sup>9</sup> According to the IMF projections, real growth of GDP in Russia in 2010 will be 1.5 percent, and in Kazakhstan – 2.0 percent.

- Maintenance of international reserves NBKR at the level of not less than 3 months of import.

The above-listed preconditions will serve for growth of the commodity turnover up to US\$ 5.8 billion in 2010. The rate of growth of export of goods for the year under review is projected at the level of 8.9 percent, the similar parameter of import of goods – at the level of 35.0 percent.

In general, the reported tendency will lead to growth of the current account deficit up to US\$ 1.1 billion US dollar, thereby corresponding to 22.3 percent of GDP.

As in the previous years, the current account deficit will be mainly covered by the inflow of foreign investments and attraction of loans.

Thus, the general balance is expected to be still positive in 2010 – at the rate of US\$ 81.7 million.

The alternative forecast assumes development of the domestic economy in the context of the long economic recovery in the region. According to this scenario, real growth of GDP in 2010 is expected at the level of 3.3 percent, and the nominal volume of GDP will be Som 227.0 billion, with the deflator of GDP increasing by 9.2 percentage points. The sphere of services, industrial and construction sectors will be the sectors forming the basis of economic growth.

The most significant contribution to economic development in 2010 will be made by the sphere of services, whose rate of growth is expected at the level of 4.1 percent. Activity in key industries of the sphere of services will be maintained by inertial development of trade and economic relations.

In 2010, growth of industrial production is expected at the level of 3.2 percent, the basic contribution to growth of industrial production will be made by such sectors, as manufacturing and electricity, gas and water generation and distribution. The high rates of growth of generation and distribution of electricity, gas and water will be ensured provided the Kambarata-2 HES is put into operation.

On the part of agriculture, this sector will not make any essential contribution to economic growth. The increase in the total value added in this sector is projected at the level of 1.0 percent.

Real growth of gross output in construction is expected at the level of 10.0 percent by results of 2010. The priority directions will be those of energy, transport and mining sectors. In addition, a startup of new projects, both at the national and regional levels, will create an additional impetus for development of the construction sector.

The share of final consumption in the structure of GDP by use will be 110.0 percent in 2010. The volume of consumption in real terms will increase by 5.7 percent.

Implementation of measures for improvement of an investment climate will allow increasing the rate of real growth of gross investment up to 8.5 percent in 2010 due to the inflow of both private and public investments. As a result, the share of gross investment in GDP will be 27.7 percent.

Cash household income will grow by 7.1 percent as a result of growth of the monthly average wage by 9.8 percent and the increase in the size of pensions by 15.0 percent.

### **2. 3. Inflation Forecast**

The uncertain outlook of the economic recovery and macroeconomic imbalances in the economy of basic trading partner countries bring uncertainty in the short-term and midterm forecasts of macroeconomic parameters of the republic.

The economic picture for the forthcoming year of 2010 assumes gradual restoration of business activity both in the world, and in the region. Owing to stabilization of the world economy, the upward price tendencies are expected in the markets of food products and energy resources, for instance, the rise is expected in prices of grain, energy resources, sugar, and other secondary goods.

The major factor of inflation developments in 2010 will be that of the increase in the electricity, hot water and heating tariffs. In turn, one could expect that growth of the cost of public utilities will cause a downward redistribution of expenditures of the population towards purchases of other goods and services, thereby constraining the general rate of inflation in the country.

The fiscal policy measures are another important factor that essentially affects inflation and the monetary policy. The reduction in tax revenue collection and simultaneous growth of public expenditure are observed in the current year and entail growth of the budget deficit and the increased needs for its financing. There could also be the increase in excises in 2010, which, undoubtedly, could cause the short-term inflationary fluctuations. In this regard, uncertainty in the midterm fiscal policy bears the certain risks for the projected rate of inflation.

In addition, in the short-term period (up to one year), some volatility of values of inflation is expected, as a result, of the impact of so-called “base effects”. In particular, the cumulative value of inflation during 2009 was all-time low and owing to this development one could expect, other things being equal, some growth of inflation in the first half of 2010, taking into account the low base.

As a whole, considering all the afore-mentioned factors, the rate of inflation is projected to be within the range of 7.5-9.5 percent in 2010.

The dynamics of the general price level in the economy will be defined by the significant share of food products in consumer spending. According to the estimates of foreign experts, the global food prices in the nearest 15 years will grow by 15-20 percent a year owing to growth of the population, the energy price increase, as well as a diversion of part of agricultural raw material for biofuel production. The behavior of prices of specific goods in the republic will depend on growth of producers’ costs because of the increase in the tariffs, saturations of the domestic market with these commodities, a competitiveness of the specific commodity market, the US dollar exchange rate developments, the energy prices, and the value of these goods in the markets of countries-exporters of products in the Kyrgyz Republic.

Overall, the following assumptions are taken with regard to the basic items of consumer expenditures for the forecast of inflation:

- In 2010, the developments in the world grain market will start up the upward price behavior. Despite the increase in domestic grain production, the republic will remain wheat dependent on imports of grain from the CIS countries. The saturation of the domestic grain and flour market, including stability of import deliveries and the actions on maintenance of state strategic stocks at the sufficient level will have the essential impact on the general price level,



considering also their indirect effect on other consumer expenditures. The forecast of inflation for 2010 was based on the assumptions that growth of prices in this group, considering the previous years' dynamics, might be about 15 percent.

- The market of animal production shows the increase in production of meat, poultry and milk. This circumstance, as well as the average prices that developed in the market of meat production, allows assuming that in 2010 the rise in the meat prices will not exceed 10 percent, and this fact was taken into consideration for the forecast of inflation. The price situation in the market of meat and milk products will depend, mainly, on the prices of forage and petroleum products, as well as on the external supply and demand from the trading partner countries. The rise in the forage prices and the increase in export of products, as a result of the restored consumer demand in the neighboring countries, could lead to a narrowing of the domestic supply and as result – to the greater price rise.
- The behavior of domestic prices of agricultural output will be determined by the rate of saturation of the domestic market, which, in turn, depends on the volume of external demand for products of plant growing and on the natural and climatic factors. Taking into account the behavior of fruit-and-vegetable prices for the previous years, the forecast of inflation for 2010 was based on the rise in the fruit and vegetable prices of about 5 percent.
- After the sharp rise in the fat and oil prices in 2008, the long period of their decrease is noted in the current year. In 2010, because of the decrease in world production of sunflower oil, the forecast of inflation was based on the average rate of growth of prices on the given group until the period of their sharp rise in prices – up to 10 percent.
- Lack of domestic raw material for production of domestic sugar was covered by import of ready sugar. The measures of the Government for development of the domestic sugar industry to restrict import could lead to the narrowing of the domestic supply of imported sugar and cause the rise in prices. In addition, the supply deficit is expected in the world markets of sugar till September 2010 and the forecast of inflation for 2010 was, therefore, based as taking into account the rise in the sugar prices by 20-25 percent.
- The gradual economic recovery in 2009-2010 will affect the market of hydrocarbons through the increase in the demand and price of oil, thereby creating the preconditions for the rise in the price of mineral oil in the domestic market as well. Furthermore, the export duty on oil is established by the Government of Russia proceeding from the average price of oil for the period of monitoring. Accordingly, this expected price growth will entail also the increase in the export duty. In the light of these factors, the forecast of inflation for 2010 was based on growth of petroleum prices of about 10 percent (the rise in prices is expected at the level of the global prices).

### **3. CONDITIONS FOR IMPLEMENTATION OF THE MONETARY PROGRAM IN 2010**

#### **3.1. Monetary Policy Objective in 2010**

Efforts of the authorities of the Kyrgyz Republic, directed to counteract the consequences of the impact of the external shock that shows itself in growth retardation in the current year and predetermine the monetary policy for 2010. The planned scale budget stimulation measures to maintain economic growth and strengthen social protection of the population, the increase in the electricity and heating tariffs predetermine, as the priority monetary policy objective, the moderate rates of inflation of about 7.5-9.5 percent.

The basic tool of regulating money supply will be that of the open market operations in 2010, with, largely, a withdrawal of liquidity: the NBKR Notes and the REPO operations and in case of need - a deposit attraction mechanism. The NBKR and the Government of the Kyrgyz Republic will study ways of transforming the non-marketable Government securities into market instruments that will allow to increase the volumes of reverse REPO operations in the money markets. Though the effect of the mechanism of the interest rate that forms itself in the money market is complicated by backwardness of the domestic financial market, the NBKR will continue promoting a practice of fixing the interest rates when forming a comprehensible yield curve to provide the market with the guidelines.

An emergence of new financial institutions in the form of specialized funds in the domestic market and no clear forecasts of their financial activity is the essential structural factor that brings in uncertainty from the point of view of achieving the monetary policy objectives. On the other hand, the special funds, increasing a competition in the financial market, will help to narrow the spread in the interest rates of money and financial markets. Credit extension by the special funds directed to stimulate growth of the economy will require accounting of this activity when formulating the monetary policy and exercising appropriate risk controls.

The flexible exchange rate, which is adjusted by NBKR interventions in order to avoid its sharp fluctuations, was quite an acceptable regime during the recent crisis, and will remain effective in the midterm perspective to sterilize any serious external shocks and restrict losses in reserves. In case of any pressure or strengthening of the pressure on the exchange rate, the NBKR will avoid any large reduction of international reserves and will ensure a conduct of the tightened monetary policy.

Economic research works and the analysis of the economic situation remain an area of NBKR's interest, with the certain resources directed there to help resolve the issues of better opportunities for the NBKR in achievement of monetary policy objectives and medium-term targets. The research works are scheduled to be carried out jointly with the National Bank of Switzerland to assess the NBKR's information policy as the indirect monetary policy tool. In addition, the work will be done to study the monetary policy transmission mechanism in the Kyrgyz Republic, to assess inflationary expectations, and to develop a methodology of calculating the base inflation rate, with other works to be done as well.

The work will also continue to develop the payment system, optimize the legal and regulatory framework, and strengthen supervision over the payment system with a view of maintaining a timeliness of settlements on large payments and final settlements for the

retail payment systems. In addition to the external shocks that influence the economy of the republic, the planned reforms in the financial sphere (a transfer of a trading platform of GT-Bills and foreign exchange from the NBKR to a stock exchange) will bring in uncertainty of forecasts of developments in the domestic financial market.

In case of any essential change in the world markets, a revision of the tariff policy of the Government, the significant changes in the investment policy and in the public finance sector, the estimates of inflation and its range could be reconsidered.

### **3.2. Monetary Program**

Should the economy develop according to the program scenario, the NBKR's monetary policy will be implemented in 2010 proceeding from the expected development trends in the real, fiscal and external sectors of the economy, and will be directed to maintain the inflation target within the range of 7.5-9.5 percent in 2010.

The expected inflow of foreign investments, including public investment, will increase credit to the economy. In this regard, the moderate rates of growth of broad money will be provided by growth of net domestic assets of the banking system (BS NDA), with the decrease at the same time in the net foreign assets (BS NFA).

In addition to the standard external debt service operations and receipt of external credits and grants, the receipts from the Transit Center at Manas of the US Defense Ministry and from Kumtor will have the essential impact on the change in the net foreign assets of the NBKR (NBKR NFA) in 2010. In this regard, investment activity of the Development Fund of the Kyrgyz Republic will presumably put additional pressure on the interbank foreign exchange market regarding the supply of US dollars that will in turn make the NBKR increase the operations on purchases of US dollars. However, considering a heterogeneity of the interbank foreign exchange market (IFEM), the NBKR will act both as seller and as buyer of foreign exchange, pursuing the objective of avoiding the sharp fluctuations in the exchange rate.

The special funds created in response to the world financial crisis of 2008 are the significant factor of the domestic nature in the short-term monetary policy implementation. In case of the successful sale of investments in the economy of the planned volumes of resources by these funds in 2010, growth of the monetary base will be at the level of 27 percent, and broad money M2X will increase by 27 percent. However, inertia, currently existing alongside with the current objective factors in the banking sector of the republic, hampers the implementation of measures of the Government and the National Bank for stimulation of lending to the economy. Taking this into account and proceeding from the assumption that the KRDF and the SFBR will not be successful in placements of the planned volumes of investments in the domestic market, and with other things being equal in the alternative monetary policy scenario, growth of monetary aggregates will be more constrained.

### **4. CONCLUSION**

In 2010, the NBKR's monetary policy will be aimed at maintaining the moderate rates of inflation and promoting the implementation of the Government's plans directed to stimulate economic growth. In this regard, there are certain risks connected with the stronger impact of external and internal factors of uncertainty which could make it difficult to reach the targets.

The cautious credit policy of banks will help maintain excess liquidity in the banking system, though expansion of a spectrum of highly liquid assets due to the Government securities will lower its level a little. It is expected that essential injections in the economy by the Government through the banking system will help reduce the value of loans for the real sector. This will allow to contract the intermediary spread in the interest rates of attracted and placed resources and will simultaneously promote the reduction of the spread between the rates of NBKR and real sector tools.

Under the circumstances, to successfully regulate liquidity, the NBKR will have to do the comprehensive work in 2010 on modernization of available components of the information and technological and legal and regulatory base, as well their elements under development.

Realization of the Government's decision to restructure the non-marketable Government debt instruments in the NBKR's portfolio into the marketable tools will allow to increase capital of the NBKR that will, in turn, lower the risks of impact of external shocks on the banking system, as well as promote development of the market of Government securities.

Monetary and fiscal policy measures with regard to the issues of regulation of liquidity and issue of securities will be coordinated by an interdepartmental council.

The monetary policy and macroeconomic modeling research works, including the joint works with the central banks of other countries, and the international financial institutions will be done to enable the NBKR to achieve its objective as well the medium-term monetary policy targets.

In order to regulate the rates of fees in the financial market, the NBKR will establish the base rate for the SBRF, which, alongside with the open market operations, will serve as a reference point with regard to the value of financial resources.

With a view of mitigating the impact of the US dollar exchange rate fluctuations on the foreign markets, diversifying the risks of deterioration in value of the NBKR's reserve assets, as well as satisfying the demand on the part of commercial banks, the NBKR will continue developing the segment of operations with the assets different from those in US dollars in the interbank foreign exchange market.

It is projected to maintain the international reserves it at the level of cover of not less than 3 months of the critical volume of import of goods and services in the midterm period, with the principles of liquidity maintenance and safety of reserve assets observed at the same time.

The NBKR will continue to actively cooperate with the international financial organizations (International Monetary Fund, World Bank, European Bank of Reconstruction and Development, Asian Bank of Development, Islamic Bank of Development and others).

The work will continue to further develop the payment system, optimize the regulatory and legal framework, and strengthen supervision over the payment system with a view of maintaining the timeliness of settlements on large payments and the final settlements for the retail payment systems.

The basic goals of further banking sector development conforming to the NBKR's strategy of banking system development for the period till 2012 are those of further growth of financial intermediation, enhancement of the role of the banking sector in the economy of the Kyrgyz Republic, and maintenance of efficiency, safety, and reliability of banking.

The significant factor to enhance confidence in commercial banking is that of activity of the Deposit Insurance Agency.

In 2010, the further measures for improvement of the legal and regulatory environment will be taken in the microfinance sector of the republic in order to enlarge access to the financial services of this sector.