



KYRGYZ REPUBLIC

Highlights

- **Growth in the Kyrgyz Republic is declining.** In the first half of 2016 the economy contracted by 2.3 per cent, compared with growth of 3.5 per cent recorded in 2015. This reflects a difficult external environment, short-term challenges associated with accession to the Eurasian Economic Union (EEU) and back-loaded gold production.
- **Depreciation of the currency has resulted in an increase in banking system vulnerabilities and a higher debt burden.** In 2015 the som depreciated by 22 per cent, putting pressure on borrowers with foreign currency loans. As almost all the public debt is denominated in foreign currency, the depreciation has also led to a higher public debt-to-GDP burden, which in 2016 exceeded 60 per cent.
- **Relations between a major foreign investor, Centerra Gold, and the government deteriorated in the first half of 2016.** The ongoing dispute has resulted in a much lower gold output and has had a detrimental effect on foreign investor sentiment, which has contributed to the economic contraction in the first half of the year.

Key priorities for 2017

- **The government needs to help domestic industries take advantage of the enlarged EEU market.** This includes creating the required infrastructure for certification of veterinary and other quality standards required to export goods to the EEU; improving the capacity of business to reach the required standards; and mitigating the adverse effect on industries as a result of new tariff regulations under the EEU.
- **Obstacles to doing business should be tackled more vigorously.** It is important to enhance access to electricity, reduce barriers to trading across borders and improve access to finance – three areas where the country scores poorly in cross-country comparisons. Other needed improvements include stronger property rights, the establishment of an impartial judiciary and the creation of a stable and transparent tax regime.
- **Banking sector enhancement is critical for developing a more resilient economy.** It is critical to reduce the share of foreign currency lending and funding in the banking sector in light of the significant level of dollarisation and recent increase in exchange rate volatility.

Main macroeconomic indicators %

| | 2012 | 2013 | 2014 | 2015 | 2016 proj. |
|-----------------------------------|------|------|-------|-------|---------------|
| GDP growth | -0.9 | 10.5 | 3.6 | 3.5 | 1.6 |
| Inflation (average) | 2.8 | 6.6 | 7.5 | 6.5 | 3.5 |
| Government balance/GDP | -5.9 | -3.7 | 1.9 | -1.2 | -4.5 |
| Current account balance/GDP | 3.7 | -1.1 | -17.8 | -10.4 | -14.9 |
| Net FDI/GDP [neg. sign = inflows] | -4.4 | -8.5 | -4.7 | -10.6 | -8.9 |
| External debt/GDP | 79.3 | 71.9 | 76.3 | 89.4 | n.a. |
| Gross reserves/GDP | 30.7 | 31.8 | 29.7 | 26.9 | n.a. |
| Credit to private sector/GDP | 12.9 | 15.4 | 18.0 | 14.2 | n.a. |

Macroeconomic performance

The economy started to decelerate in 2016, after already subdued growth at 3.5 per cent in 2015. GDP contracted by 2.3 per cent in the first half of 2016 as a result of low gold production at the Kumtor gold mine and a challenging external environment. GDP growth excluding the Kumtor mine production reached 1.2 per cent in the same period. According to the main investor in Kumtor – Centerra – gold production dropped by 36 per cent in the first half of 2016 year-on-year. However, while remittances from Russia declined significantly in 2015 (25 per cent year-on-year in US dollar terms, 10 per cent in som terms), they have started rising in 2016, up by 7.7 per cent (in US dollar terms) in January to July of 2016 year-on-year.

External and fiscal positions are under pressure. The change in the external tariff structure, enacted since August 2015 as part of EEU accession, together with a slow-down in key trading partners, appears to have negatively affected trade with countries outside the EEU. Total exports decreased by 12 per cent and imports dropped by 28 per cent in 2015 year-on-year, leading to a lower current account deficit of 10.4 per cent of GDP. Trade performance continued to deteriorate in the first five months of 2016, with exports down by 29.3 per cent and imports by 8.2 per cent year-on-year. The fiscal balance reached around 1.2 per cent of GDP in 2015, with a projected rise to 4.5 per cent of GDP in 2016.

The som depreciated significantly during 2015, increasing banking sector vulnerabilities.

The som weakened by 22 per cent (against the US dollar) over 2015, notwithstanding tight monetary policy and interventions in the currency market by the National Bank of the Kyrgyz Republic (NBKR). The weakening currency and the overall economic slowdown has contributed to a rise in non-performing loans to 7.1 per cent at the end of 2015, compared with 4.5 per cent at the end of 2014. However, the exchange rate appreciated by 12.5 per cent (against the US dollar) in the first half of 2016; gross international reserves have increased to around US\$ 2.0 billion (covering around three months of imports) in June 2016, up by 12.7 per cent since the end of 2015.

External public debt to GDP rose to around 64.5 per cent in December 2015, above the 60 per cent legal debt threshold. The increase resulted from the depreciation of the som – as around 95 per cent of public debt at the end of 2015 is denominated in foreign currency – and disbursements of US\$ 249 million under the public investment programme. However, debt sustainability is expected to be preserved in the medium term.

Growth is expected to decline to 1.6 per cent in 2016, reflecting a build-up of structural challenges from declining remittances, as well as weaker gold production. Growth in 2017 is projected to improve to 2.6 per cent, helped by the expected gradual improvement in the external environment in 2017. However, the challenges that have been building since 2014-15 will continue to weigh on growth prospects.

Major structural reform developments

The business environment remains challenging despite some improvements in recent years.

The Kyrgyz Republic ranked 75 out of 190 countries in terms of ease of doing business, according to the World Bank *Doing Business 2017* report. The country performs well in areas such as starting a business and registering property, but poorly in paying taxes, resolving insolvency, getting electricity, enforcing contracts and trading across borders. A major issue affecting the attractiveness of the Kyrgyz Republic as an investment destination, particularly for foreign investors, is the lack of a permanent solution to establishing a stable framework for operations and ownership of the Kumtor mine.

Export opportunities provided by accession to the EEU in August 2015 are not being fully utilised.

Changes to the tariff structure enacted as part of EEU accession have negatively affected trade with countries outside the EEU, while potential benefits for Kyrgyz companies from access to the larger (EEU) market are not fully accruing due to insufficient quality of produce and a lack of veterinary and various quality standards that are required to export goods within the EEU. Russia is providing financial support to smooth the short-term negative effects in the accession process.

Relations between the government and Centerra Gold soured in the first half of 2016.

In May 2016 a Kyrgyz court fined Centerra US\$ 98 million for environmental damages; later that month the company announced it had taken its dispute to international arbitration. In June 2016 the company was fined an additional US\$ 220 million for environmental violations and several employees of the company were banned from leaving the country. Despite these negative developments, the government finally approved Centerra's 2016 mining plan on 27 June 2016, and the company plans to increase gold output in the second half of the year.

Dollarisation in the banking sector remains high, but is declining as a result of NBKR policies.

Dollarisation increased during 2015 but has started to decrease in 2016, reaching 54.9 per cent (deposits) and 44.4 per cent (loans) in August 2016, down from 66.9 and 52.2 per cent, respectively, at the start of the year. The positive trend with respect to dollarisation in 2016 reflects the ban on new mortgages and consumer loans in US dollars introduced in February 2016, as well as an increasing level of trust in the local currency.

The Russian-Kyrgyz Development Fund (RKDF) is increasing its activities.

The RKDF, a fund with a charter capital of US\$ 1 billion set up to support the Kyrgyz Republic's integration into the EEU, is significantly increasing its activities by launching a lending programme for small and medium-sized enterprises through Kyrgyz commercial banks, along with numerous other lending projects in 2016. This will improve access to finance in this very challenging environment, but the low cost at which lending is provided could potentially lead to market distortions.

Russia's Gazprom plans to invest US\$ 1.5 billion in the Kyrgyz Republic's energy infrastructure.

The decision was announced in June 2016. The investment programme will run until 2030 and will be implemented by Gazprom's subsidiary, Gazprom Kyrgyzstan. Around US\$ 500 million will be invested in the next two years, leading to the gasification of 411 towns and improving the gasification level to 60 per cent from the current 26 per cent. However, the sector remains largely unreformed; key remaining challenges include continuing the liberalisation process in the oil and gas downstream segment and unbundling the gas supply and distribution company, KyrgyzGaz.