

National Bank of the Kyrgyz Republic

Inflation Report

2 (20)

August 2006

Bishkek

Inflation Report

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The purpose of the publication “Inflation Report” is informing of broad public about the goals and results of the monetary policy. The publication contains the description of inflation developments by its components, by regions, and as a whole, the analysis of inflation factors and inflation forecast for the forthcoming quarter. The report is published quarterly in the Kyrgyz, Russian and English languages.

The last date of updating of the data in the given publication: July 31 of 2006.

Founder: The National Bank of the Kyrgyz Republic.

The publication is registered with the Ministry of Justice of the Kyrgyz Republic, registration certificate of the mass media #628 as of 02.11.2001.

Printed by the printing centre “UnitPrint”.

Circulation 200 copies.

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Publications of the National Bank of the Kyrgyz Republic

Annual Report of the The National Bank of the Kyrgyz Republic

The annual report of the The National Bank of the Kyrgyz Republic is a complete report on the work of the The National Bank done during the reporting year. It contains a brief description of developments in the real sector of economy, as well as the description of decisions and actions of the The National Bank in the monetary sphere. It includes the information on economic development and monetary policy, financial statements, general information about the The National Bank, statistical annexes. The report is published in Kyrgyz, Russian and English languages.

Bulletin of the The National Bank of the Kyrgyz Republic

The publication contains statistics about major macroeconomic indicators and sectors of the Kyrgyz Republic. The bulletin is published monthly in the Kyrgyz. Russian and English languages.

Balance of Payments of the Kyrgyz Republic

The publication reflects the latest trends in development of the external sector and contains tables with data in analytical and neutral formats of the balance of payment, the structure of external trade, interthe National reserves, external debt, the methodology and the information base for preparation of the balance of payments, as well as the interthe National investment position of the Kyrgyz Republic. It is published quarterly in January, May, July and October.

Banking System Development Trends

The publication contains analysis of banking system efficiency as financial intermediary, and developments in financial stability. It is published in Kyrgyz and Russian semi-annually.

Statutory acts of the The National bank of the Kyrgyz Republic

The purpose of the edition is the official publication of statutory acts of the The National bank for informing commercial banks and the public and propagation of the bank legislation of the Kyrgyz Republic. It is published once a month in the Kyrgyz and Russian languages.

Press release of the The National Bank of the Kyrgyz Republic

The Press-Release of the NBKR contains the weekly chronicles of the developments in the The National Bank and major data of the financial market. It is published quarterly in the Kyrgyz and Russian languages.

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1. CURRENT DEVELOPMENTS

Some growth of economic activity was observed in the first half-year of 2006. According to the preliminary data of the National statistical committee the gross domestic product grew by 3.1 percent compared with the corresponding period of 2005. Gross domestic product excluding production of gold-mine enterprise *Kumtor* gained 6.5 percent. Basically, services and agriculture provided increase in value added. Recession in industry slowed down slightly.

The deficit of trade balance for the second quarter increased and totalled 171.2 million US dollars. The external trade turnover in F.O.B. prices increased by 39.7 percent. Thus, CIS and non-CIS countries turnover gained 59.3 and 19.7 percent, respectively. Exports of goods in F.O.B. prices grew by 27.2 percent, and imports of goods surged by 47.7 percent.

The average National bank note yield for second quarter increased up to 4.2 percent, or by 0.7 percentage points. The average interest rates of the interbank credit market did not change and made 3.2 and 3.1 percent for repo and credit in the national currency, respectively.

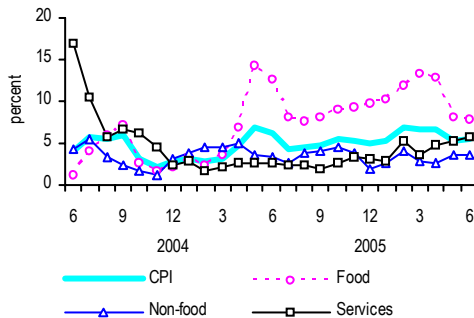
On the end of June the weighted average interest rate on T-bills made 10.8 percent, having raised in comparison with the beginning of the quarter by 4.1 percentage points. Quarterly average of the weighted average interest rate on T-bills increased in comparison with the first quarter up to 8.6 percent, or by 1.4 percentage points.

According to the National bank's outlook the consumer price index will decline by 2.5 percent during the third quarter of 2006.

2. CONSUMER PRICE INDEX AND ITS COMPONENTS

2.1. COMPONENTS OF CONSUMER PRICE INDEX

Chart 2.1: CPI and its components, percentage changes on a year earlier

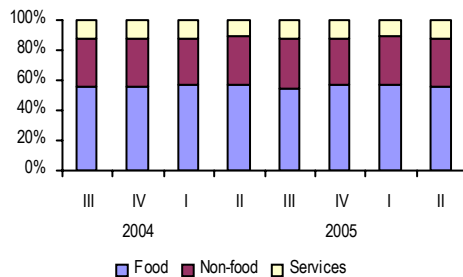


In second quarter, seasonal increase in consumer prices was observed, and according to the National statistical committee inflation made 1.0 percent. The increase in some foodstuff prices contributed strongly to inflation growth. In general, food inflation made 0.7 percent. Non-food inflation and growth rate in services totalled 1.0 and 1.8 percent, respectively.

2.1.1. Food products

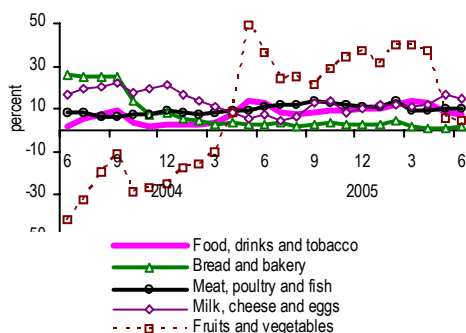
Increase in fruit-and-vegetable, sugar and confectionery, meat, fats and oil prices formed basically dynamics of food inflation in the second quarter of 2006.

Chart 2.2: Structure of CPI, percent



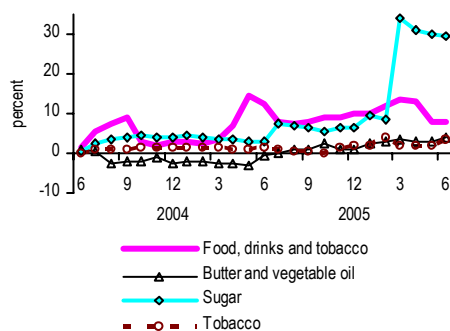
One of the reasons why fruit-and-vegetable prices rose in the first half of 2006 was poor harvest in 2005. So, the fruit-and-vegetable prices in June (by December 2005) have grown by 23.9 percent (but in corresponding period of 2005 it gained 62.0 percent), growth rate on vegetables and fruits totalled 28.8 and 17.6 percent, respectively. Increased production in agriculture in the first half-year of 2006 by 2.3 percent in comparison with the first half-year of 2005 promoted slowdown in growth rate of prices. Grain crop grew by 40.7 percent. In general, vegetable crops rose by 54.5 percent, and potato gathering increased on 13.1 percent.

Chart 2.3a: Food Prices, percentage changes on a year earlier



Slump in production of sugar caused increase in sugar and confectionery prices on 22.2 percent. The prices for meat, oil and fat increased on 6.7 and 5.3 percent, respectively. At the same time, prices on milk and dairy products reduced by 10.7 percent.

Chart 2.3b: Food Prices, percentage changes on a year earlier



2.1.2. Non-food products

The price index on non-food articles in the second quarter of 2006 has grown on 1.0 percent. The biggest increase in prices was fixed on materials for the maintenance and

repair of premises (12.2 percent) and diesel fuel (4.3 percent).

Reduction in prices on such commodity groups as *clothes and footwear* (0.2 percent) and *gas* (0.2 percent) constrained non-food inflation.

2.1.3. Services

The price index on paid services in the second quarter of 2006 has grown on 1.8 percent. In particular, repair of footwear (3.0 percent), services of public catering (2.3 percent), and services on organization of cultural actions (1.3 percents) became more expensive. At the same time, tariffs on communication and transport services decreased on 0.8 percent.

Chart 2.4a: Non-Food Prices, percentage changes on a year earlier

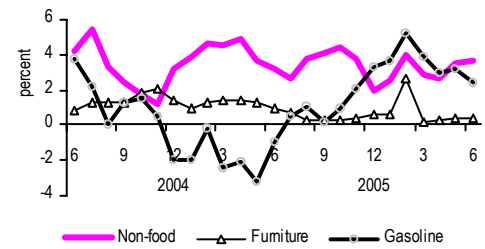


Chart 2.4b: Non-Food Prices, percentage changes on a year earlier

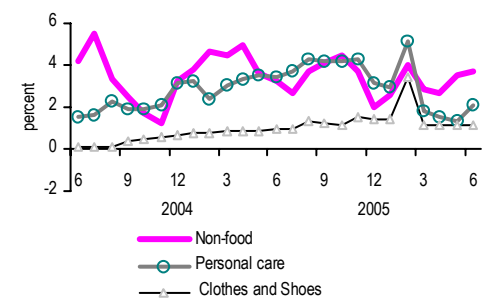


Chart 2.5a: Service Prices, percentage changes on a year earlier

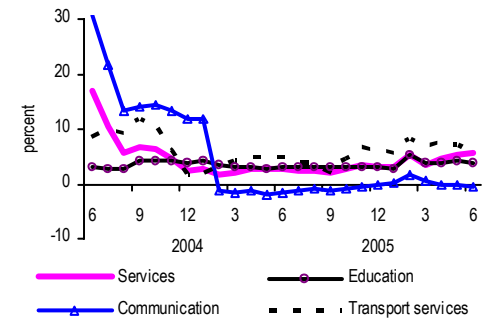
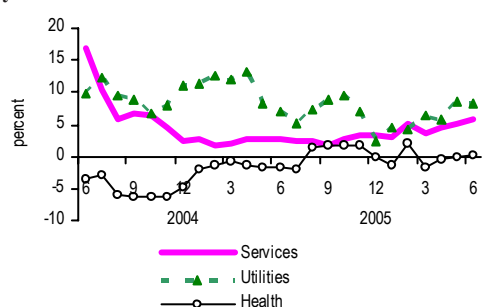


Chart 2.5b: Service Prices, percentage changes on a year earlier



2.2. CONSUMER PRICES BY REGIONS

Chart 2.6a: Consumer Prices by Oblasts (Regions), percentage changes on a year earlier

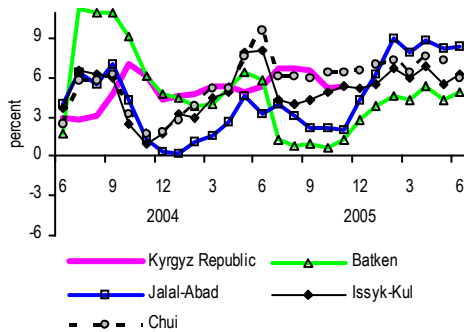
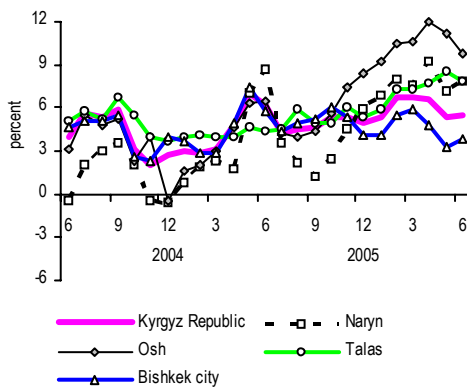


Chart 2.6b: Consumer Prices by Oblasts (Regions), percentage changes on a year earlier



In second quarter, all regions of republic demonstrated growth in consumer prices. The biggest growth rate - 6.8 percent – was registered in Naryn *oblast*, where food and service inflation totalled 18.0 and 2.5 percent, respectively. At the same time, non-food prices decreased by 0.8 percent. Also, consumer prices rose significantly - on 6.2 percent - in Issyk-Kul *oblast*, thus, foodstuffs, non-food articles, and services gained 12.4, 1.6, and 6.1 percent, respectively.

The slowest pace in consumer price growth - 3.1 percent – was marked in capital (Bishkek) where foodstuffs, non-food articles, and services gained 4.4, 2.8, and 1.9 percent, respectively.

3. INFLATION FACTORS

3.1. MONETARY AGGREGATES

3.1.1. Monetary base

The monetary base during the second quarter of 2006 increased on 10.5 percent. In a year, it gained 32.9 percent. Out of increase in the monetary base on 1614.5 million Soms transactions of the National bank contributed 1414.5 million Soms. Operations of the Ministry of Finance increased reserve money further by 199.7 million Soms. Money in circulation increased on 12.3 percent. In a year, money in circulation rose by 28.9 percent.

The share of cash in circulation increased on 1.4 percentage points and has made 88.3 percent on the end of June. Accordingly, the share of commercial banks' balances on correspondent accounts in the National bank reduced up to 11.7 percent.

3.1.2. Aggregate M2

The money aggregate M2 (broad money in national currency) increased by 13.9 percent during the second quarter. In a year, it gained 32.1 percent.

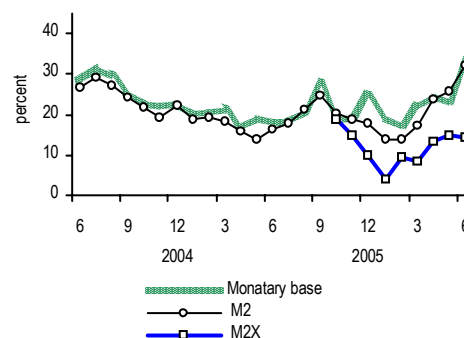
Deposits in the national currency increased by 20.9 percent, growth in transferable deposits and other deposits made 22.3 and 18.0 percent, respectively. In a year, it gained 45.5 percent.

3.1.3. Aggregate M2X

The monetary aggregate M2X (broad money including deposits in a foreign currency) increased by 11.8 percent. At the same time, deposits¹ of commercial banks and cash outside of banks rose by 11.1 and 12.2 percent, respectively. Foreign currency deposits increased by 5.5 percent.

Basically, the increase in net domestic assets in the banking system due to extension of domestic credit determined

Chart 3.1: Monetary Aggregates, percentage changes on a year earlier



¹ Including deposits of commercial banks which license is withdrawn, but process of liquidation is not completed yet.

dynamics of M2X. The broad money multiplier amounted 1.42.

| | Share |
|-------------------------------|--------------|
| Cash outside of banks | 60.0 |
| Deposits in national currency | 15.4 |
| Deposits in foreign currency | 24.6 |
| Monetary aggregate M2X | 100.0 |

Velocity of broad money $\dot{M}2X$ totalled 4.7 turnovers. The monetisation of economy designed on monetary aggregate M2X made 21,1 percent.

3.2. INTEREST RATES

3.2.1. Money market interest rates

In second quarter, decrease in banking system liquidity did not affect practically money market interest rates in national currency because there was not any deficit in money resources at the interbank credit market. So, within April repo interest rate was 3.0 percent, and only in May-June its level and volatility increased somewhat due to strengthening in demand and extending in transactions' maturity. As a result on the end of quarter repo interest rate rose up to 3.3 percent.

Interest rate on interbank credit in national currency corresponded with fluctuations in the interbank interest rate on repo. Some transactions settled under non-cash US dollar collateral and 2.0 percent interest were carried out.

At the same time, because of liquidity reduction the activity of banks on the market of notes of the National bank decreased - half out of declared auctions has not taken place. Note yield was fluctuating within 3.7-4.5 percent due to variations in liquidity. The gap between the discount rate and money market interest rate increased at the end of the first quarter, and it has been unchanged during the second quarter staying at 1.0 percentage point level.

The average note yield for second quarter increased up to 4.2 percent, or by 0.7 percentage points. The average interest rates of the interbank credit market did not change and made 3.2 and 3.1 percent for repo and credit in the national currency, respectively.

Interest rate on domestic interbank credit market in foreign currency in the second quarter varied from 5.5 up to 8.0 percent depending on maturity of transaction. The average interest rate has made 6.7 percent, that is 0.9 percentage points higher than the first quarter level.

3.2.2. State treasury bills

In second quarter, the primary market of T-bills revealed simultaneously reduction in banking system liquidity, and decrease in demand for all kinds of T-bills, and increase in yield. 18- and 24-month bills – the bills with the longest maturity demonstrated increase in interest rate in April. Later, 18-month bills’ interest rate decreased, while 24-month T-bill yield, after some correction, raised again due to reduction in price bids of auction participants at the end of quarter. Because of weak demand some auctions have been recognised not taken place.

On the end of June the weighted average interest rate on T-bills made 10.8 percent, having raised in comparison with the beginning of the quarter by 4.1 percentage points. Quarterly average of the weighted average interest rate on T-bills increased in comparison with the first quarter up to 8.6 percent, or by 1.4 percentage points.

3.3. Exchange rate

Because of strong supply of cash and non-cash US dollar and US dollar weakening against basic currencies during the second quarter the exchange rate of the US dollar against som decreased steadily. The reasons of strong supply of foreign currency at the interbank currency tenders were reduced payments carried out by banks on behalf of the clients; increased inflow of foreign currency in the banking system, basically, investments, as well as deposits and transfers (including remittances from abroad).

For the quarter the weighted average US dollar exchange rate formed at the foreign exchange tenders decreased by 2.4 percent, and the US dollar exchange rate of sale in exchange bureau reduced by 2.3 percent. The official exchange rate for the second quarter decreased on 2.8 percent. The official exchange rate decreased by 0.8 percent for the corresponding period of 2005.

Chart 3.2: Money Market Interest Rates vs. Liquidity

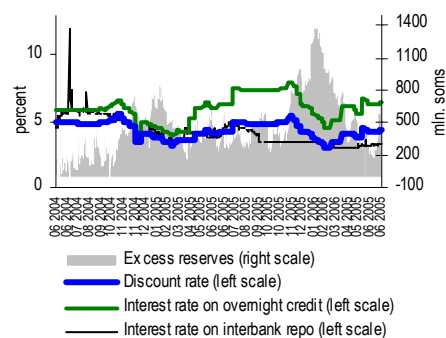


Chart 3.3: T-bill Yields

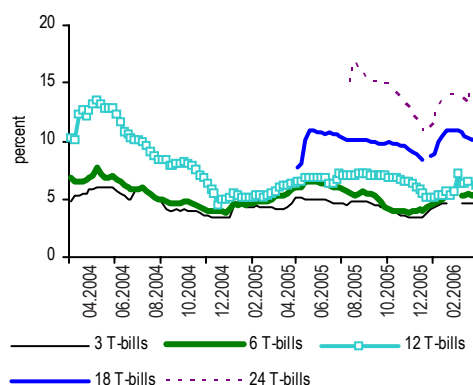
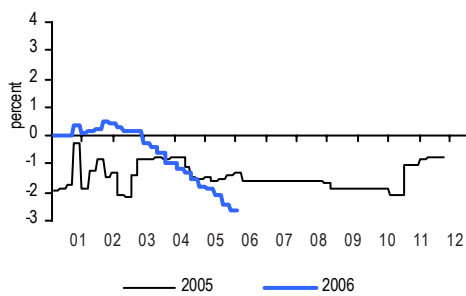


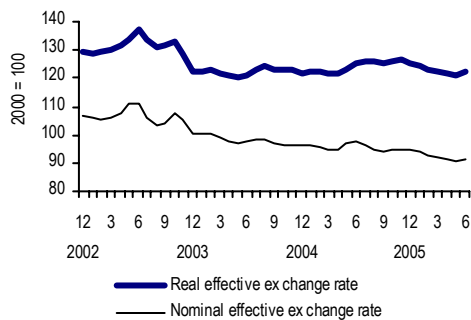
Chart 3.4: Cumulative Change in US dollar Exchange Rate, percent



In the first half of the second quarter Euro exchange rate grew, while in second the half of quarter it decreased. The pattern of the Euro exchange rate coincided with its fluctuations on international markets, however, volatility of the Euro exchange rate at domestic market was lower appreciably. During the second quarter the exchange rate of sale in exchange bureau raised by 2.3 percent, and the official exchange rate grew by 1.1 percent.

According to the preliminary data for the second quarter nominal effective exchange rate¹ decreased by 1.7 percentage points in comparison with a corresponding period of 2005. The real effective exchange rate decreased by 5.3 percentage points in comparison with the second quarter of 2005.

Chart 3.5: Effective Exchange Rate Indices



3.4. DEMAND AND SUPPLY

3.4.1. External demand

According to the preliminary data the trade balance deficit of the Kyrgyz Republic for the second quarter of 2006 amounted 171.2 million US dollars. The external trade turnover in F.O.B. prices grew by 39.7 percent in comparison with the corresponding period of 2005. The turnover with CIS and non-CIS countries increased by 59.3 and 19.7 percent, respectively.

Exports of goods in F.O.B. prices increased by 27.2 percent. Exports rose due to increase in deliveries of goods in CIS and non-CIS countries by 43.9 and 15.3 percent, respectively. Value and volume of gold exports increased by 6.3 and 28.8 percent, respectively. Exports excluding gold grew by 29.5 percent.

All items of the National bank's classification of export demonstrated growth. The most considerable growth - more than 3 times - revealed investment goods' deliveries (mining equipment, spare parts and the equipment for automobiles, other equipment).

¹ In May the methodology of calculation of effective exchange rates has been changed. Now, the unit of the national currency is expressed in units of foreign currency, that is the index increase means strengthening the national currency, or index decrease means easing of the national currency. As the base period for construction of indexes 2000 is used. Historical values of indexes are re-estimated.

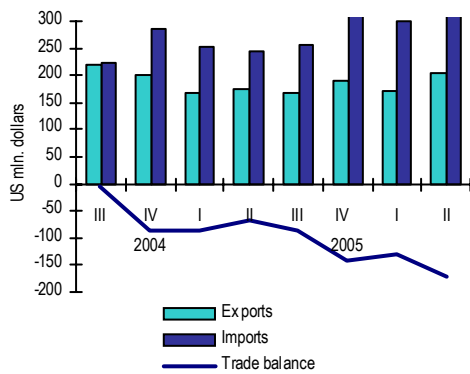
Due to outstripping growth of exports to the CIS countries their share increased by 5.3 percentage points in comparison with the corresponding period of 2005. Accordingly, the share of the non-CIS countries reduced. Among the CIS countries export deliveries increased to the greatest degree to Uzbekistan - more than 2 times. At the same time, there was a reduction in exports to Belarus, Turkmenistan, and Ukraine. Deliveries of lamps, tobacco, cotton, non-ferrous metals, sugar beet to these countries reduced. Export deliveries increased considerably to Switzerland and Afghanistan – non-CIS countries. Exports to Switzerland grew due to gold deliveries. Exports to Afghanistan increased 10.5 times due to re-export of mineral oil.

Imports of goods (in F.O.B. prices) increased by 47.7 percent comparing with the corresponding period of 2005. Imports from the CIS and non-CIS countries increased by 66.5 and 23.4 percent, respectively.

All items of the National bank import classification revealed growth. The biggest growth rate by 90.9 percent gained energy deliveries. Traditionally the basic share among energy products is occupied by mineral oil which imports increased 2 times in value. Its volume increased by 60.9 percent.

The increase in share of the CIS countries in import deliveries and, respectively, reduction of non-CIS countries' share was continuing. The share of the countries CIS totalled 62.6 percent and increased by 2.1 percentage points. The biggest growth rate fell on imports from Russia (93.7 percent) and Belarus (104.6 percent). Imports from Russia rose basically due to increase in mineral oil deliveries, which comprise about 60.0 percent out of total imports from Russia. Imports from Belarus were promoted by increase in deliveries of sugar and trunks. Canada, Switzerland, and China demonstrated the biggest growth rate of imports among the non-CIS countries. Imports from Canada increased more than 3 times due to deliveries of mining equipment and various tools. Traditionally, imports from China were growing due to deliveries of consumer goods having almost 60.0 percent out of total imports. At the same time, imports from the USA and Netherlands reduced as a result of decrease in deliveries of commodity

Chart 3.6: Trade Balance



grants from the USA, and reduction in deliveries of mining equipment from Netherlands.

3.4.2. Domestic demand

3.4.2.1. Private consumption

According to the preliminary data of the National statistical committee for January - May the wages increased on 15.9 percent. In real terms it gained 10.8 percent. The turnover of trade for the second quarter grew by 15.9 percent.

3.4.2.2. Public consumption

While state budget revenues for the first half-year rose by 20.4 percent comparing with the corresponding period of 2005, salary payments increased by 16.7 percent. Expenditures of the state budget grew by for 21.0 percent. Subsidies to the state enterprises increased by 11.0 percent. Capital investments grew by 39.9 percent.

3.4.2.3. Investment

For January - June, according to the operative information of the National statistical committee the investments into fixed capital (construction, reconstruction, expansion and modernisation of objects) increased by 18.4 percent.

3.4.3. Output

According to the preliminary data of the National statistical committee for the first half-year the gross domestic product rose by 3.1 percent comparing with the corresponding period of 2005. It gained 6.5 percent excluding production of gold-mine enterprise *Kumtor*. The value added in industry reduced by 0.8 percent. The value added in agriculture and construction gained 2.4 and 9.5 percent, respectively. In trade the value added increased by 14.5 percent.

4. MONETARY POLICY DECISIONS

4.1. BOARD DECISIONS

The *Procedure of repo auctions carrying out by the National bank of the Kyrgyz Republic* was considered and authorised (statement #10/1 as of April 12).

The procedure is aimed to the further development of the monetary policy tools, strengthening of secondary market transparency for state securities. The document determines rules for repo operation carrying out and the mechanism for price calculation of state securities tradable on repo auctions.

The joint statement of Government of the Kyrgyz Republic and the National bank of the Kyrgyz Republic *On the basic directions of economic policy for 2006* is approved (Joint statement of Government of the Kyrgyz Republic and the National bank of the Kyrgyz Republic #308 as of April 28).

The *Report on monetary policy for 1st quarter 2006* is considered (statement # 14/2 as of May 17).

The exchange rate - 40.5 Soms per US dollar - is established for calculation of obligatory reserve requirements since June 5 till October 1 (*About the exchange rate of dollar used for calculation of obligatory reserve requirements*, statement # 16/3 as of May 31).

The draft of the Kyrgyz Republic Law *About protection of deposits* is approved (statement # 19/5 as of June 28).

4.2. MONETARY REGULATION COMMITTEE DECISIONS

Seven auctions on sale of 28-day's notes are recognised taken place. Four auctions are recognised not taken place owing to insufficient amount of participants of these tenders, one more auction did not take place due to unsatisfactory price conditions of bids.

Aimed to liquidity withdrawal out of banking system, the Committee recommended carrying out repo operations on

sale of securities up to 2-month and 5 or 6-month maturity using 3- and 6-month T-bill yields as price benchmark, respectively. So, the sale of T-bills(s) totalled 112.5 million Soms.

The National bank carried out interventions purchasing foreign currency in order to smooth fluctuations in US dollar exchange rate against Som, the interventions totalled 44.1 million US dollars.

4.3. INFLATION OUTLOOK FOR THIRD QUARTER OF 2006

According to the National bank's outlook the consumer price index will decline by 2.5 percent during the third quarter of 2006.