

National Bank of the Kyrgyz Republic

Inflation Report

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Inflation Report

Editorial Board:

Chairman: Abdumanapov E
Board members: Tsiplakova L.
Abdybaly tegin S.
Isakova G.
Chokoev Z.

Editorial Assistant: Bushman Yu.

On the issues related to the contents of the publication, please, contact:

Bishkek, Umetaliev st., 101.
The National Bank of the Kyrgyz Republic
phone: (996 312) 669 059
fax: (996 312) 610 730
e-mail: ybushman@nbkr.kg

On the issues of dissemination of the publication, please, contact:

Bishkek, Umetaliev str, 101
The National Bank of the Kyrgyz Republic
External and Public Relation Division
phone: (996 312) 669 009
fax: (996 312) 610 730
e-mail: aaibalaeva@nbkr.kg
<http://www.nbkr.kg>

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720071, Bishkek, Chuy av., 265, rooms 352, 354, 355.

Phone: (996 312) 65-76-93

(996 312) 24-38-01

Fax: (996 312) 65-76-93

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Annual Report of the National Bank of the Kyrgyz Republic

The annual report of the National Bank of the Kyrgyz Republic is a complete report on the work of 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 National Bank in the monetary sphere. It includes the information on economic development and monetary policy, financial statements, general information about the National Bank, statistical annexes. The report is published in Kyrgyz, Russian and English languages.

Bulletin of the National Bank of the Kyrgyz Republic

"The Bulletin of the NBKR" contains macro-economic indicators of the Kyrgyz Republic on the real sector, financial sector, external sector, information on prices and social indicators. The bulletin is published monthly in the Kyrgyz, Russian and English languages.

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"The Balance of Payments of the Kyrgyz Republic" 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, interNational reserves, external debt, the methodology and the information base for preparation of the balance of payments, as well as the interNational investment position of the Kyrgyz Republic. It is published quarterly in January, May, July and October.

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The purpose of the "Banking System Development Trends" is to study assess the development of the banking system in Kyrgyzstan. It is published on half year basis in Kyrgyz and Russian.

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The purpose of the edition is the official publication of statutory acts of 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 National Bank of the Kyrgyz Republic

"The Press-Release of the NBKR" contains the weekly chronicles of the developments in 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 OF INFLATION

The gross domestic product for the first quarter 2004 has grown by 5.7 percent. As a whole growth is marked in the industry and sphere of services, manufacture of an agriculture remained at a level of the similar period of 2003.

For the first quarter of 2004 negative trade balance was registered while exports revealed growth, but imports were growing even faster. The highest growth rates in imports were demonstrated with CIS countries, especially, for mineral oil.

The Som against US dollar become stronger by two percent, for the corresponding period of 2003 Som strengthening by one percent has been marked. It is necessary to note, that high volatility observed in the domestic foreign exchange market was caused by the internal and external reasons. At the same time, the tendency of some easing in Som effective rate in nominal and real terms was manifesting. For the first quarter of 2004 they have decreased insignificantly (0.3 and 1.4 percent, respectively), and it decreased by 6 and 7.5 percent, respectively, since December 2002.

Annual growth rates of monetary aggregates were stable enough. The bank system potential to issue credit is gradually accruing. The structure of monetary aggregates remains constant. Liquidity in banking system grew despite of sharp fluctuations. The discount rate grows on 1.08 percentage points in comparison with the beginning of year. The National bank carried out auctions under notes, thus five of 13 auctions are recognized taken place. Interest rates in the state T-bill market increased somehow, so, the average weighted interest rate increased by 1.15 percentage points.

In the first quarter of 2004, consumer price index was coming back to stable path after surge in prices that was observed in the fourth quarter of 2003. According to the data of the National statistical committee for the first quarter of 2004 inflation made 1.3 percent compared to growth by two percent in the corresponding period of the previous year. The basic risk of inflation outlook is the seasonal factor and a situation in the commodity markets. The inflation outlook for the second quarter of 2004 is 0.7-0.8 percent.

2. CONSUMER PRICE INDEX AND ITS COMPONENTS

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

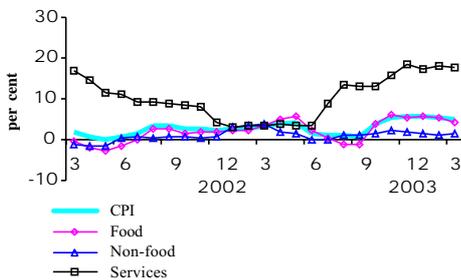
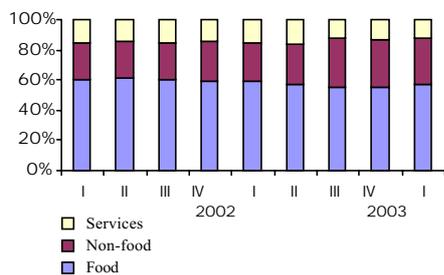


Chart 2.2: Structure of CPI, per cent



In the first quarter of 2004, consumer price index was coming back to stable path after surge in prices that was observed in the fourth quarter of 2003. According to the data of the National statistical committee for the first quarter of 2004 inflation made 1.3 percent compared to growth by two percent in the corresponding period of the previous year.

Food items dominate in the consumer's basket structure. Accordingly, changes in food prices determine consumer price dynamics. The rise in bread and the bakery products prices started in the fourth quarter of 2003 was continuing. A high crop of vegetables, however, in the current year smoothed the foodstuffs growth in prices being traditional for this period due to the seasonal factor, in 2003. In the first quarter of 2004, decline in non-food prices restrained inflation.

2.1. COMPONENTS OF CONSUMER PRICE INDEX

2.1.1. FOOD PRODUCTS

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

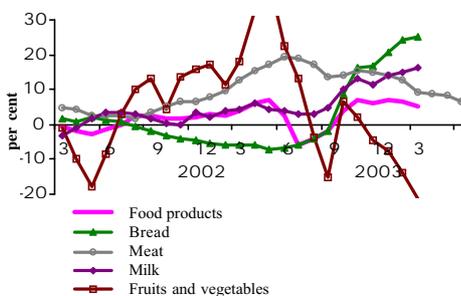
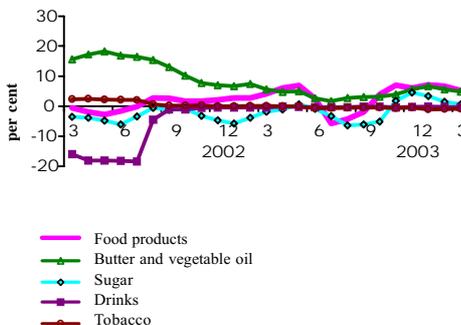


Chart 2.3b: Food Prices, percentage changes on a year earlier



Food inflation gained 2.8 percent basically due to growth in bread and bakery products prices by 6.7 percent, while in the first quarter of 2003 decrease by 0.6 percent was observed. The reasons for specified increase were bad grain crops in 2003, which according to National statistical committee was reduced by 12.8 percent concerning 2002 level and increase in prices for grain imported from Kazakhstan - a sole grain exporter in region, because of high demand on Kazakhstan wheat on the part of Ukraine and Russia.

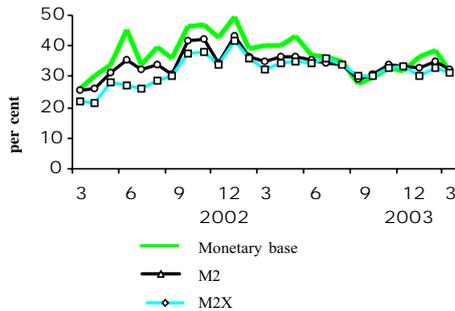
Seasonal increase in agriculture products prices being traditional for this period was smoothed by good harvest of vegetables which was collected by 1.5 times more than in 2002. In particular, fruit-and-vegetable prices grew by 4.3 percent while in the first quarter of 2003 its growth made 26.6 percent. Prices for milk, dairy products, cheese and eggs increased by 5.3 percent, and oil and fats prices grew by 1.8 percent. The rise in prices on meat and meat products observed since April 2002 was still continuing and made 1.8 percent.

3. INFLATION FACTORS

3.1. MONETARY AGGREGATES

3.1.1. MONETARY BASE

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



During the first quarter of 2004 monetary base¹ increased by three percent. The gain in monetary base compared with corresponding period of 2003 made 31.8 percent. Growth in monetary base due to operations of the Government made 322.8 million Soms. Operations of the National bank reduced monetary base by 20.9 million Soms. The structure of monetary base has not practically changed, cash in circulation and commercial banks balances at the National bank shares totalled 95.4 and 4.6 percent, respectively.

As a whole, during the report period money in circulation grew by 2.9 percent, and by 33.2 percent compared with the corresponding period of 2003, that is a little bit lower than corresponding rates in 2003 (5.3 percent for the first quarter and 38.9 percent in annual expression).

3.1.2. AGGREGATE M2

The increase in monetary aggregate M2 made 4.3 percent, and on year-on-year basis M2 increased by 32.1 percent confirming that money demand is stable and high. Deposits in national currency gained 9 percent, including demand deposits² growth by 8.2 percent.

3.1.3. AGGREGATE M2X

Monetary aggregate M2X under the current exchange rate increased by 2.5 percent. Growth in cash outside of banks and deposits³ in commercial banks by on 3.5 and by one percent, respectively, caused broad money gain.

Deposits in national currency increased by 9 percent, while deposits in foreign currency reduced by 0.6 percent that is explaining why M2 growth was outstripping M2X growth and confirming strengthening of trust to the national currency.

There were following changes in M2X structure:

¹ Without taking into account deposits of commercial banks in a foreign currency.

² Deposits poste restante.

³ Including deposits of banks under liquidation.

share in cash outside of banks increased to 63.8 percent (on 01.01.2004 - 63.6 percent);

share in deposits in national currency increased to 12.8 percent (on 01.01.2004 - 12.1 percent);

share of deposits in foreign currency reduced to 23.4 percent (on 01.01.2004 - 24.3 percent).

The analysis of M2X components confirms that contribution in money supply from credit is still growing.

3.2. INTEREST RATES

3.2.1. MONEY MARKET INTEREST RATES

In the first quarter of 2004, liquidity in commercial banks was at higher level in comparison with the fourth quarter of 2003, therefore, the average level of interest rates on all segments of the monetary market was lower. However, during report period cash balances were gradually decreasing, that led to some increase in interest rates by the end of quarter. So, REPO interest rate by the beginning of current year were from 3.5 up to 3.7 percent, whereas by the end of quarter they reached 4.2-4.3 percent, and on credits in national currency - 4.2-4.5 percent.

The interest rates in foreign exchange in the inter-bank credit market fluctuated more significantly from 4.5 to 11.2 percent, and its average level increased within quarter also. Credits in foreign exchange had higher costs in comparison with credits in the national currency due to its longer terms.

Gradual increase in interest rates on the National bank notes within a quarter was observed. On the end of quarter its value made 5.05 percent and rose by 1.08 percentage points in comparison with the beginning of current year. There was some reduction in demand for notes was marked on the part of commercial banks: only 5 out of 13 declared auctions have been recognized taken place.

3.2.2. STATE TREASURY BILLS

High liquidity in the banking system maintained stability at the primary market despite of sharp fluctuations in supply of T-bills. At the same time, in January yields were gradually growing due to substantial growth in T-bills supply. So, for 3-month T-bills yield increased from 3.79 up to 4.12 percent, 6-month T-bills yield - from 6.94 up to 7.73 percent), 12-month

Chart 3.2: Money market interest rates vs. liquidity, per cent

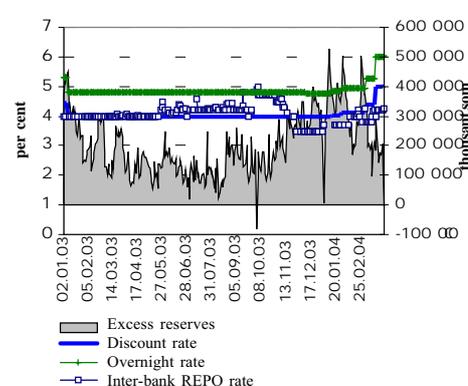
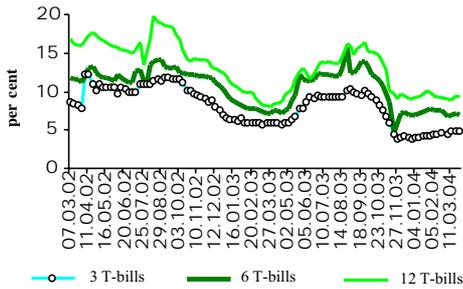


Chart 3.3: T-bill yields

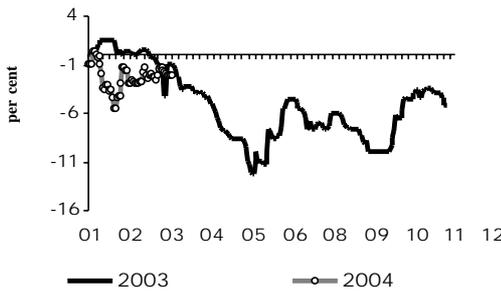


T-bills yield from 9.1 up to 9.91 percent. However, in February and March 6 and 12-month T-bills yields were decreasing, while 3-month T-bills yield continued to grow gradually. Banks revealed strong demand for long-term securities that is explaining the favourable price developments for 6 and 12-month maturities, while only one - two banks revealed demand for 3-month T-bills.

In result, as a whole for 3 months of 2004 3-month T-bills yield increased by 1.01 percentage points and reached 4.8 percent, 6-month T-bills yield grew by 0.06 percentage points and made 7 percent, and 12-month T-bills yield rose from 9.1 to 9.2 percent. The average weighted interest rates increased by 1.15 percentage points in comparison with the beginning of current year and reached 8.77 percent.

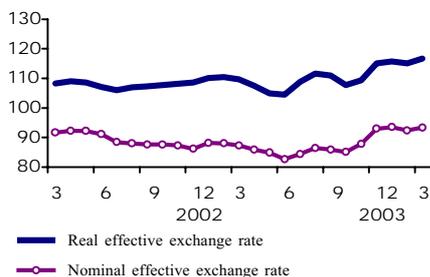
3.3. EXCHANGE RATE

Chart 3.4: Cumulative change in exchange rate (Som per US dollar)



In the first quarter of 2004, high volatility in foreign exchange market was caused, mainly, by effects of internal factors, and to a lesser degree by developments in global financial markets. So, appreciation of US dollar in the beginning of current year was due to seasonal increase in monetary base, and depreciation of US dollar in the second decade of January was caused by significant foreign exchange inflow in the form of receipts of large industrial enterprises and investments into the capital of domestic banks. In the beginning of February, banks manifested strong demand for foreign exchange, so US dollar started to strengthen fast enough, and by the end of the first decade it increased by 4.5 percent in comparison with the beginning of the month. However, foreign exchange inflow to banks, begun in the second decade of February, caused US dollar exchange rate to decrease. In the beginning of March, US dollar manifested short-term appreciations followed with corrections. Thus, Som appreciated against US dollar by 2.18 percent (for comparison: for the similar period of the 2003 year the Som strengthen by 1.1 percent).

Chart 3.5: Som effective exchange rate indices



The operations at the inter-bank foreign exchange in the first quarter of the current year amounted 22.28 million dollars, having increased in comparison with the similar period of the last year by 12.4 percent or on 2.49 million dollars. Thus, transactions between commercial banks made 20.28 million dollars or 91 percent out of total, and operations of the National bank on purchase / sale of currency - 2 million dollars or 9 percent. At the same time, the National bank carried out SWAP on purchase of US dollars totalled one million US dollars. Net

purchase of US dollars for three months of 2004 made 800 thousand US dollars (for the same period of 2003 the similar operations totalled 844 thousand US dollars).

Euro developments were basically affected by situation on the world markets. Thus, euro revealed decreasing, while there were some periods (first half of January or the first decade of February) when euro was strengthening. In exchange bureaus, euro depreciated against Som by 4.1 percent, official rate of euro against Som eased by 4.78 percent.

Developments in nominal effective rate of Som in the first quarter of 2004 changed compared with the corresponding period of 2003, so, there were easing and strengthening, while in the first quarter of 2003 nominal effective rate manifested steady strengthening. In average, index grew by 5.9 percent in comparison with the corresponding period of 2003 year.

Som real effective index in average rose by 5,5 percent that corresponds to some easing of Som, which was caused by lower inflation in republic in comparison with inflation in the basic trade - partners. Som real effective rate was easing against Russian rouble and Kazakh tenge by 9 and 4 percent, respectively. Though, exports of goods increased due to strong demand (building materials, agricultural production and sugar) and favourable prices for some domestic goods rather than developments in real effective exchange.

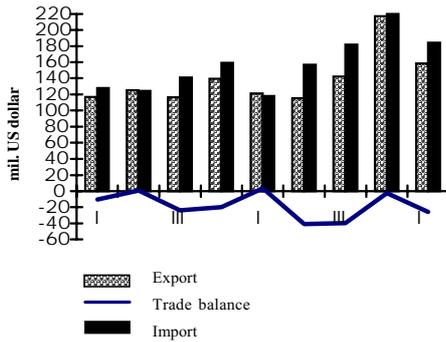
3.4. DEMAND AND SUPPLY

3.4.1. EXTERNAL DEMAND

On the preliminary data in the first quarter of 2004 of trade balance of the Kyrgyz Republic developed negative and totalled 26.1 million dollars compared to positive balance at amount of 3.4 million US dollars in the first quarter of 2003. The trade turnover made 342.5 million dollars or 43.2 percent compared with corresponding period of 2003. Turnover with the CIS countries amounted 170.6 million dollars, having increased by 63.8 percent; with the non-CIS countries turnover grew by 27.4 percent and totalled 171.9 million US dollars.

Exports of goods (in F.O.B. prices) totalled 158.2 million US dollars, having increased by 36.9 million dollars. Exports of goods excluding gold increased by 34.3 percent, while exports of gold amounted 67.3 million US dollars and increased by 25.6 percent due to growth in gold price from 357 up to 405.6

Chart 3.6: Trade balance



US dollars per troy ounce. Exports of goods in the CIS countries rose by 37.6 percent that was caused by increased deliveries of sugar, some kinds of garments, slate and cement or from 5.7 to 15.8 million US dollars.

Significant growth in exports of raw materials amounted 9.7 million US dollars was caused by deliveries of cotton, tanning raw material, and also non-ferrous metals.

On the preliminary data imports of the goods¹ (in F.O.B. prices) in the first quarter of 2004 totalled 184.3 million US dollars that by are 56.4 percent higher than in corresponding period of 2003. The significant gain in imports by 80.1 percent manifested trade with CIS countries, basically through aviation fuel and the automobile gasoline, imported, from Russia and Kazakhstan.

The consumer goods and oil products being the largest items of imports in the first quarter of 2004 occupied 35.7 and 30.3 percent, respectively. Increased inflow of pharmaceutical production, fabrics and automobiles automobile caused the growth in consumer goods imports. Besides, growth in imports spares parts for machines and the equipment, hire of ferrous metals and asbestos caused increase in imports of intermediate goods to 28.7 million US dollars against 17.8 million US dollars in the corresponding period of 2003.

Russia occupied 30.4 percent, the biggest share out of CIS countries imports, which totalled 61 million US dollars, in geographic distribution. Imports from Russia excluding kerosene and automobile gasoline increased for such items as pharmaceutical production, other inorganic and saw-timbers goods. The imports of goods from Kazakhstan increased by 55 percent due to deliveries of oil, waste products and a breakage copper, asbestos, wheat and beer. Among the non-CIS countries the basic suppliers of the goods, as before, were China, the USA, Germany and Turkey.

3.4.2. DOMESTIC DEMAND

Domestic demand was sufficiently balanced. Steady growth in monetary aggregates accompanying with low inflation. Emerging real estate market and increasing capitalization of

¹ Imports in C.I.F prices in the first quarter 2004 made 196,5 million US dollars, thus deficiency of trading balance made 38,2 million US dollars.

stability is the optimum objective for monetary policy as all negative phenomena connected to consumer prices growth disappear. The most essential drawbacks are decrease in low-income households purchasing power, deterioration of conditions for business, deterioration of an investment climate. Practically, there are difficulties such as measurement mistakes and other to maintain zero inflation in practice. Chairman of Federal Reserve System in the USA argue that price: stability exists, if current inflation does not render influence on decisions of economic agents concerned with future. Thus, there is some growth rate in prices, which does not distort economy.

The monetary policy serves as aggregate demand regulator. In 50-60 years of the last century, the monetary policy had mainly short-term anti-cyclic character, but the modern tendency is lengthening in horizon of decision-making. There are thousands, dozen thousands of various goods, which are circulating in economy simultaneously, and on which prices constantly change. However, there are goods, the prices on which steadily correlate with developments of general price level. Monitoring this set of goods allows judging to what degree inflationary processes are caused by monetary policy. The given parameter is known as base inflation, which is estimating in many countries. But, there are the certain technical problems connected with designing procedure for base inflation in order to preserve maximum of helpful information and to make it clear for public.

In Kyrgyzstan, consumer prices managed to decrease inflation substantially. Why this is so important The reason is household income structure. There is big differentiation in incomes, while average level is low. Inflation to the greatest degree affects households with low incomes, therefore, the well known expression that: inflation is the tax on poor is true.

The current inflation target established by the National bank and the Government level will not exceed 4.5 percent. The inflation target is based existing structure of economy and its transition character. The higher inflation is undesirable as far poverty and unequal distribution of incomes will expand.

The monetary policy is carried out in conditions of uncertainty; the economy is subject to various internal and external shocks. To determine shocks nature is very important for monetary policy formulation. There are demand and supply shocks. In another way, they are known as nominal and real shocks, which can have positive and negative effects. As an example

of nominal shock change in money demand is. If money demand grows more slowly, than their supply, result will be inflation and deterioration of trade balance. The real shock is connected to production sphere, increase in productivity can be considered as positive shock. The bigger productivity means, that one unit of labour is producing more units of goods, accordingly, increase in wages other things being equal does not conduct to accelerating in inflation.

In the fourth quarter of 2003, as well the first quarter of the current year the economy was affected by negative real shocks from commodity side. In the first case the republic was affected by deficiency of some goods such as grains, flours and oil products that led to acceleration in inflation. In the first quarter of the current year, as a result of high vegetables crops inflation decreased compared with the corresponding period of 2003.

The monetary policy should not react to supply shocks. Misbalance in the separate market does not mean that aggregate demand or the aggregate supply has been changed. In case of negative real shock the increase in money supply will mean unreasonable expansion of aggregate demand, and, on the contrary, toughening of monetary policy at time of positive real shock conducts to excessive restriction of aggregate demand. For this reason central banks prefers to use base inflation indicator in order shocks do not distort monetary policy the. Now, the National bank assumes to develop methodology for estimation of base inflation for its application in practice in future.

The basic assumptions of inflation outlook for the second quarter of 2004 are:

- oil prices, grain and flour will not grow strongly;
- international financial market will be characterised by high volatility and tendency of the US dollar to strengthen. The high oil and gold prices will be kept. Som purchasing power will be stable enough;
- money demand remains steady.

The basic risk of inflation outlook is the seasonal factor and situation in some commodity markets. For the second quarter of 2004 the inflation outlook based on specified assumptions is 0.7-0.8 percent.

In spite of low growth rates in consumer prices the inflationary potential is still exists connected with likelihood of external shocks and incompleteness of transformation processes. That statement could be proved by the situation in 2003 when the price shock in the fourth quarter led to sharp increase in inflation.

External factors of inflationary potential are connected to high share in consumption of imports, for example, oil products, the investment and consumer goods. Low elasticity of substitution tends to high sensitivity of price level on development of prices for imported goods.

Development in the national currency exchange rate, which depends on trade balance, flows of foreign currency, situation in the international financial market, has a great value for inflation. Unpredictable financial flows, strong volatility in the international financial markets causes high risks for transition economy, where deep and advanced financial market is absent.

Internal factors of inflation are connected to the current condition of economy. In spite of price liberalisation is carried out, there are several goods, which pricing is still not quite market because of incompleteness of structural reforms. In particular, there is an administrative pricing on some kinds of the goods, the monopoly pricing for some goods is not overcome.

Inflation is maintaining on low level in conditions of carrying out of structural reforms and acceleration of economic growth. In order economic growth not to create inflationary pressure outstripping creation of modern production capacities and growth of productivity is prerequisite.

Expectations are one of the major factors that influences inflation developments in the transition countries. The economic theory and practice of the central banks shows that inflationary expectations is capable to undermine trust to monetary policy and to cause destabilisation of economy. Reduction and maintenance on low level of inflationary expectations cause the slowdown in consumer price growth.

In 2004, inflation developed at 2.8 percent level, and development of inflationary processes does not cause fears now. It is possible to speak that macroeconomic environment is favourable for low inflation stance, at the same time, it is necessary to trace carefully inflationary potential and to hold it under the control in republic.

The monetary policy of the National bank is carried out taking in account these and many other factors, it is directed on maintenance of positive changes in economy of republic. The basic directions of monetary policy in 2005 are development of payment system, strengthening of bank supervision, further development of microfinancing and its institutes. The development of financial market is crucial for further economic development, poverty reduction and increase of monetary policy efficiency.

The National bank established inflation target at a level not exceeding 4 percent for 2005. The inflation forecast for 2005 take into account current and expected development of economy and prospective economic policy. So, it is expected that growth in gross domestic product will approximately correspond with current tendency. Thus, expected curtailment in production of gold mine Kumtor will be compensated due to growth in manufacturing of other goods. The increase in growth of trade turnover is expected. Price competitiveness on foreign markets will be provided by lower inflation in republic compared with inflation in the trading partners from CIS countries. The money supply will meet demand, the tendency of financial intermediation is expected to strengthen through attraction of deposits and expanding credit to real sector. Also, expected increase of tariffs for electric power and communication services was taken into account. Forecasted growth in consumer prices is 2-2.2 percent for first quarter of 2005.