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NATIONAL BANK OF THE KYRGYZ REPUBLIC

**MAIN MONETARY POLICY GUIDELINES
FOR 2009-2011**

Bishkek

2008

INTRODUCTION

This document determines NBKR's medium term monetary policy objectives (2008-2011), including a detailed discussion of the 2009 monetary policy, as specified on the basis of a current economic analysis and a development forecast for basic sectors of the economy. In the medium term, the monetary policy will be directed to systematically curtail inflation to bring it to single digit numbers by 2011 as one of the basic conditions for maintenance of sustainable economic growth. Meanwhile, the NBKR's task will be that of finding an optimal balance between inflationary pressure and economic growth retardation risks.

In the development of a monetary program, increased uncertainty in the situation in world financial and commodity markets was taken into account, as well as new monetary policy implementation conditions resulting from a burst of a world financial crisis and a high degree of an openness of the Kyrgyz economy of small scale, causing an unstable demand behavior with regard to monetary assets. A floating exchange rate regime, a gradual transition from an exchange rate channel to the interest rate channel of money supply will allow softening a medium term impact of external shocks and will help maintain international reserves at an acceptable level.

The Medium Term Budgetary Framework of the Kyrgyz Republic for 2009-2011 (the Law of the Kyrgyz Republic "On the Republican Budget of the Kyrgyz Republic for 2009 and the Forecast for 2010-2011" as of August 28, 2008), a draft of a Country Development Strategy for 2009-2011 (as of October 10, 2008), and the Medium Term Electricity and Heating Tariff Policy till 2012, adopted by the Government of the Kyrgyz Republic, were used when drafting this document. So far as this document was based on draft strategies, a significant share of uncertainty could impair quality of forecasts presented therein.

1. REVIEW OF ECONOMIC DEVELOPMENT AND MONETARY POLICY THROUGH THE END OF THE CURRENT YEAR

1.1. Review of Economic Developments and Expected 2008 Outcomes

Real Sector. In 2008, one of basic macroeconomic trends was that of growth retardation. According to official data of the National Statistics Committee, the real GDP growth rate in January to October 2008 made 6.9 percent against 8.0 percent in January to October 2007. Excluding enterprises developing a deposit “Kumtor”, growth of GDP was 5.4 percent (against 8.7 percent in January to October 2007). For 2008 as a whole, it is expected that rates of growth of real GDP will come down as compared to 2007.

In comparison with the similar period of the last year, the rates of growth of the economy slowed down and it was caused by a decrease in growth of a value added in construction, trade, and in electricity, gas and water generation and distribution, as well as in transport and communication. Growth in the given sectors was decelerated by crisis phenomena observed in the region, problems in the energy sector that led to an essential reduction of electricity generation and failures in power supply, as well as due to the high rates of inflation and a rise in prices of energy resources thereby detrimentally effecting business of economic entities. Growth of industrial output in manufacturing (due to, mainly, growth of output of gold) resulted in growth of GDP in the period under consideration and allowed to partially offset the decrease in the rates of growth in other sectors of the economy.

Under the circumstances of increasing macroeconomic uncertainty and the decrease in volumes of construction, a negative downward tendency was noted in investments in the current year. According to preliminary estimates, the share of total investments in GDP will decrease from 26.3 percent to 25.5 percent due to, basically, the reduction of private investments in 2008. The largest share in total actual investment falls on housing construction, transport and communication and manufacturing.

The share of expenditures for final consumption in GDP will grow to 122.2 percent in 2008, and its real growth will make 7.8 percent.

Fiscal Policy. The 2008 fiscal policy was, in a greater degree, focused on a tax policy reform. The work to draft and adopt a new version of a Tax Code was complete and it was carried into effect on January 1, 2009. Among the key changes in tax laws, one could single out that of the reduction of the rate of a value added tax (VAT), the reduction of a total number of taxes, an introduction of the retail sales tax, and the changes with regard to tax administration, etc.

Despite increased revenues from profit and income taxes, indirect taxes will continue to be dominating in a tax revenue structure. For instance, the share of VAT and excise taxes is projected to be about 50 percent of a total of tax revenues.

As before, the public expenditure policy was aimed at financing fully and duly social guarantees and liabilities of the government to the population. In view of the essential rise in food and energy prices, special attention was paid to the targeted welfare program for the poor people, pensions were increased (their base part - by 32.5 percent, and insurance part - by 17.0 percent), as well as wages of civil and municipal servants - by 30.0 percent as a minimum.

Regarding the reform of a statistical service system of the sector of public finances, it should be noted that the work continued in 2008 on streamlining a budget classification according to modern international standards.

Altogether, according to the Law of the Kyrgyz Republic “On the Republican Budget of the Kyrgyz Republic for 2008”, revenue and grants (including PIP) are anticipated to total Som 49.1

billion or 26.6 percent of GDP in 2008; expenditure – Som 51.7 billion or 27.9 percent of GDP. The budget deficit will decrease to Som 2.5 billion or 1.4 percent of GDP and will be completely financed through domestic and foreign sources of financing.

Balance of Payments. The current account deficit is expected to increase in 2008 to 12.3 percent of GDP in view of the fact that, as in the previous years, income from current operations (basically, income from export of goods and remittances) does not cover expenses on import and income payments to nonresidents for the attracted financial resources. In view of adjustments to re-exports of goods, the deficit will make 10.5 percent of GDP.

Traditionally, the increase in the current account deficit will be caused by a double import surplus. In addition, exports of goods are growing against the background of high world prices for gold, while imports of goods are growing against the high energy prices.

Economic growth slowed down in neighboring countries and, as a consequence, a diminution in a demand for tourist services will be reflected in the overall balance of international services towards its reduction by 39.5 percent. Despite annual growth of volumes of international services, rendered and received, the overall balance, though remaining positive, turns out to be also insufficient to cover a trade gap.

A shortfall in foreign currency required to cover the current account deficit is covered through a net inflow of capital. The largest share of foreign exchange receipts on the financial account falls on the share of foreign direct investments (credits received from direct investors) and government credits, classified as “Other Investment”. A significant outflow of foreign currency from accounts of commercial banks is observed at the same time with regard to an item “Other Investment”, which would result in the reduction of the positive capital and financial account balance by about 30.3 percent in comparison with 2007.

Expected 2008 REER Index

At the end of 2008, the real effective exchange rate (REER) of the Som will be 110.0 and will increase by 7.4 percent as compared with a corresponding parameter of 2007. The REER average annual value in 2008 will make 104.4 and will be by 100 percent larger than its corresponding value in 2007.

It should be noted that the data on inflation in 10 countries, basic trading partners, as adjusted to their corresponding shares in the foreign trade turnover, are used when calculating inflation in these countries. About 65.0 percent is the share of Russia and Kazakhstan, where inflation for 12 months is estimated to be 14.0 and 10.0 percent, accordingly.

Basic Financial Market Indicators. Participants in the financial market in the Kyrgyz Republic are, basically, represented by commercial banks and other finance and credit institutions. By virtue of its institutional backwardness, the financial market of the country is not integrated into the world financial system, which is currently in a grip of crisis, and continues to gradually build up volumes of operations on the foreign exchange market in a greater degree than on the som market.

In comparison with the similar period of 2007, the volume of operations in the *interbank market of som credit resources* increased by 6.1 percent in January to September 2008 to total Som 6.1 billion. The volume of REPO operations decreased by 26.0 percent, totaling Som 3.5 billion, while that of interbank credits in domestic currency increased by 68.1 percent - to Som 1.7 billion, and the volume of overnight credits made Som 0.9 billion. The average interest rate of REPO operations for 9 months as a whole increased to 7.7 percent ((+) 4.8 percentage points as

against the similar parameter for January to September 2007), the average rate of interbank credits in domestic currency increased to 6.9 percent ((+) 4.2 percentage points), while the average rate of overnight credits made 12.4 percent.

The foreign exchange segment of the domestic interbank credit market displayed the increase in the volume of loans by 36.1 percent or to Som 766.2 million, while their average cost decreased by 0.6 percentage points or to 6.1 percent on impact of, mainly, the reduction in the FRS rate of the USA.

Given the operations conducted by the National Bank on withdrawal of excess liquidity in the banking system, one could assume that interest rates of interbank business transactions will not change significantly despite end-year seasonal growth of excess liquidity.

Within 10 months of 2008, the Ministry of Finance and the National Bank - two emitters of government securities (GS) - carried out the teamwork on coordination of their actions in the GS primary market. As a result, outstanding State Treasury Bills (STB) totaled Som 2.3 billion at the end of September, having thus increased by 30.0 percent for 9 months; the outstanding NBKR Notes totaled Som 1.8 billion, having increased by 23.3 percent, with duration of STB reduced by 50 days down to 183 days. Net financing of the budget through STB totaled Som 406.1 million for January to September. Totally, for January to September 2008, sales of STB for the period under consideration grew by 40 percent up to Som 1.8 billion, with the demand having grown 5 times and totaling Som 2.5 billion as compared with January to September 2007. The National Bank placed its Notes in the amount of Som 12.7 billion during the period of January to September 2008, having thus increased their volume 12.5 times in comparison with the similar period of 2007. The demand grew 9 times in fact and totaled Som 17.3 billion for the period under review.

The average yield of STB made 13.2 percent for January to September 2008, thereby indicating the increase by 6.2 percentage points. In comparison with the corresponding period of 2007, the average yield of NBKR Notes increased by 5.7 percentage points as against the similar period of 2007, having thus made 9.4 percent.

If to compare with the similar period of 2007, deposits of operating commercial banks continued to grow (+13.6 percent) in January to September 2008, though at lower rates (+35.0 percent). The average interest rate of new som deposits increased by 0.4 percentage points and was 2.4 percent in January to September 2008 as compared to the similar period of 2007, while the value of deposits in foreign currency decreased by 0.1 percentage points down to 0.9 percent. The average interest rate of time deposits in soms in comparison with January to September 2007 increased by 0.1 percentage points and made 7.2 percent, while the average rate of time deposits in foreign currency remained at the level below 5.3 percent.

A credit portfolio of operating commercial banks in January to September 2008 grew by 23.5 percent and totaled Som 25.8 billion, however, the rates of growth were much lower (in January to September 2007, the credit portfolio increased by 81.5 percent and made Som 20.6 billion). The average interest rate of newly given credits in soms made 25.9 percent for January to September 2008, having thus increased by 3.1 percentage points in comparison with the similar period of 2007. Having increased by 2.1 percentage points in comparison with January to September 2007, the average interest rate of newly given currency credits made 20.4 percent.

The microfinance sector, which includes the nonbank finance and credit institutions - NFCI (61 percent of the general credit portfolio) and commercial banks (39 percent of the general credit portfolio) engaged in microcrediting, continued to develop in 2008 - in conformity with the Medium Term Microfinancing Development Strategy till 2010. The average annual rates of growth of NFCI assets (for the recent 3 years) made 61 percent, while the rates of growth of the credit portfolio – 58.6 percent. The balance of the credit portfolio of microcredits as of June 30, 2008, was Som 10.4 billion. It should also be noted that about Som 5 billion were received as

part of development projects (under loans of such international organizations, as the World Bank, the European Bank of Reconstruction and Development, and the Asian Development).

1.2. Expected Monetary Policy Implementation Outcome

Review of Monetary Indicators and Current End-Year Forecast. In 2008, the monetary policy was directed to achieve goals and objectives specified in the Basic Monetary Policy Guidelines for 2008-2010 and in the Joint Statement of the Government of the Kyrgyz Republic and the NBKR about Basic Economic Policy Guidelines for 2008, as well as to develop and implement preventive measures in view of the world financial crisis observed in August 2008 in the financial markets of neighboring countries - basic trading partners - Russia and Kazakhstan.

Growth of inflation in one of the scenarios of economic development, presented in the Basic Monetary Policy Guidelines for 2008-2010, is projected to be 22 percent. Due to the continued impact of end-2007 external shocks, accompanied with high inflationary expectations, in 2008, the economy actually developed in a greater degree according to the afore-mentioned scenario.

In this context, in 2008, the NBKR continued implementing the moderately tight monetary policy resulting in the reduction of rates of growth of broad money M2 in January-October 2008 to 13.2 percent (26.3 percent in the similar period of 2007) and of inflation - to 16.6 percent (20.1 in the similar period of 2007).

Credit to the economy in percent of GDP increased by 3.2 percent as of end-October 2008, and grew slightly in comparison with the similar period of 2007 - from 18.0 to 18.3 percent according to the preliminary data. Meanwhile, the rates of growth of som credits (41.2 percent) still exceed significantly the rates of growth of currency credits (23.9 percent), though at the much lower level than in the similar period of 2007 (112.4 and 55.6 percent, accordingly).

Considering the current rate of inflation, risks of significant growth of budget expenditure at the end of the year, and the relatively high level of excess reserves of the banking system, the NBKR will maintain the monetary policy through the end of 2008 as aimed at limiting growth of monetary aggregates. At the same time, the NBKR will monitor the impact of the possible reduction in the net inflow of currency in the banking system on the rates of growth of money in the economy, and the exchange rate policy will be directed not to allow sharp exchange rate fluctuations.

Money Supply Formation Sources. Proceeding from the outcome of 10 months of 2008, the rates of growth of monetary aggregates decreased quite noticeably in comparison with the similar period of 2007 and turned out to be within the range of 11.1 percent – 13.2 percent.

	as of 11/1/2008	as of 11/1/2007
✓ money outside banks M0 –	11.1 percent;	22,2 percent
✓ broad money M2 –	13.2 percent;	22.4 percent
✓ broad money M2X –	12.5 percent;	17.0 percent

The NBKR's net foreign assets (NBKR NFA) for 10 months of 2008 increased to a lesser degree than for the similar period of 2007, and it was due to mainly the more than double reduction of net purchases by the NBKR of US dollars. A contribution of the NBKR NFA to growth of a monetary base for 10 months of 2008 is estimated at (+) 4.4 percent and it is much less than in the similar period of 2007 - (+) 35.4 percent.

The NBKR's net domestic assets (NBKR NDA) for 10 months of 2008 also had their impact on growth of the monetary base - (+) 7.1 percent, unlike their reducing impact by (-) 15.2 percent in January to September 2007. Other items had their basic impact on growth of the NBKR NDA - (+) 7.2 percent – due to mainly the change in reserves for revaluation of gold, foreign currency, as well as the changes in emission of Notes (statistical appendix 5.1 table 1).

In view of maintaining the current monetary policy, receiving grants and credits from the international financial institutions scheduled for quarter IV of 2008, growth of the monetary base projected for 2008 will make about 16 percent. The actual rate of growth of the monetary base as of end of 2008 will depend in many respects on total expenditure of the Government of the Kyrgyz Republic by end-December alongside with actual receipts of external grants and credits.

The net foreign assets of the banking system (BS NFA) for January-October 2008 had the reducing impact on broad money M2X – by (-) 0,1 percent, unlike their positive impact - (+) 9.2 percent - in the similar period of 2007. The NFA of the commercial banking system had their basic impact on the reduction of the BS NFA (CBsNFA), with the NBKR NFA increasing. The reduction in the CBsNFA for January-October 2008 is connected with outstripping growth of liabilities to nonresidents – 35.9 percent (growth for the similar period of 2007 was 54.0 percent), in comparison with growth of claims of the commercial banking system to nonresidents – 24.7 percent (with the reduction for the similar period of 2007 by 14.8 percent).

The net domestic assets of the banking system (BS NDA) for 10 months of 2008 increased broad money, and the BS NDA contribution to growth of broad money M2X is estimated at (+) 12.6 percent. The basic impact was that of growth of credits to the economy, which is estimated at (+) 14.9 percent. In comparison with the similar period of 2007, the capital account changed positively, the impact of this item is estimated at +1.8 percent.

The rates of growth of M2X in January to October of 2008 were at the level of 12.5 percent, a multiplier M2X slightly increased from 1.61 to 1.63. In this regard, the impact of money outside banks on the change of broad money M2X is estimated to be 6.9 percent (in 2007 – 13.3 percent), and the impact of deposits as part of broad money M2X to be 5.6 percent (3.6 percent - in 2007). It should be noted that in 2008 the rates of growth of money outside banks (11.1 percent) for 10 months turned out to be lower in comparison with the rates of growth of deposits as part of broad money (14.7 percent). At the same time, the structure of deposits as part of broad money, indicates that other deposits in domestic currency grew at the highest rates (29.0 percent).

For 10 months of 2008, lending to the economy from the banking system increased by 30.4 percent, and by end-2008 the rates of growth of the credit portfolio of commercial banks will presumably remain at the same level, with its quality slightly worsening due to maturing of credits received in the previous years. As a whole, growth of broad money M2X is anticipated at the level of 12 percent.

Inflation Factors and Monetary Policy Target Implementation. According to the National Statistics Committee of the Kyrgyz Republic, the rate of growth of the consumer price index since the beginning of the year made 16.6 percent in October 2008 (in 2007 – 20.1 percent).

Two periods could be conventionally singled out in inflation developments in 2008. In the first half of 2008 inflation was observed to be accelerating in the republic as a result of continued

growth of global food and energy prices since 2007. As a consequence, the domestic consumer market showed growth of food and oil prices, gas and electricity tariffs, and those of other types of fuel and transport services. The rise in prices of basic raw material resources was reflected in the cost of derivative goods, thereby forming the general high inflationary background in the economy - inflation was 15.2 percent in the first half of the year, of which just in June it was 4.3 percent.

Starting from the second half of the year, a process of stabilization and the reduction of prices of basic foodstuffs and petroleum products is observed in the world. For this reason and because of the seasonal factor, the rates of growth of consumer prices also slowed down in the republic. Meanwhile, since the beginning of the year, the high prices still continue to have the increasing impact on pricing in Kyrgyzstan. The additional factors of an inflationary pressure during this period were those of also problems in the energy sector of the country through their indirect impact on the producer price index and the rise in prices of services (trade, services of restaurants). As a result of this, the evolving inflationary processes are accompanied with a slowdown of economic activity, which limits economic growth in the country in general.

The measures undertaken by the NBKR for tightening the monetary policy and by the Government of the Kyrgyz Republic in the area of fiscal policy, as well as improvement of the price situation in the food and primary markets, did not allow a more significant surge of inflation caused by the essential rise in prices of basic food stuffs and the energy resources. They also allowed to reduce a potential of price growth and limit a monetary component of inflation at the end of October of the current year within the range of 9.0 percent. The nonmonetary factors most significantly contributed to growth of the general price level in the accounting year – 81.6 percent.

Strong dependence of the domestic economy on the world price situation and limited opportunities of the country to resist the external and internal shocks conditioned still high rates of inflation in Kyrgyzstan and it is expected that the rate of inflation will develop at about 20 percent in 2008 (December 2008 to December 2007).

2. MEDIUM TERM ECONOMIC OUTLOOK

2.1. External and Internal Factors, Contingent Risks

The 2009 monetary policy will be complicated by the significant degree of uncertainty connected both with external macroeconomic factors in the region, and with a progress in structural reforms implemented in the Kyrgyz Republic.

The high level of uncertainty as to the impact of the world financial crisis on the economy of the Kyrgyz Republic and the countries – its basic trading partners, as well as the following factors could be classified as *external risks* that might affect the macroeconomic situation in the republic:

- volatility of energy and gold prices;
- the reduction in the demand for domestic products in the region;
- the reduction of workplaces in Russia, Kazakhstan and a number of other countries;
- the reduction of investment in capital of local commercial banks from parent banks;
- problems of global food security still in suspense.

Internal Risks:

- persistency of problems in the energy sector;

- uncertainty with regard to the impact of the new version of the Tax Code on the economy and state budget revenue;
- the rise in the gas tariff due to expected growth of procurement gas prices;
- non-implementation of projections in the fiscal sector;

2.2. Economic Development

In case the current year trend are still there and the situation in the commodity markets and the energy sector stabilizes, *the possible scenario of macroeconomic development* in 2009 assumes maintenance of rates of economic growth at the level of 2008. Despite growth retardation and a general business loss, still, there are preconditions for growth, and this will allow providing for real growth of GDP at about 5.0 percent. Further development of key sectors in the sphere of services, such as transport, communication and trade will be instrumental in maintenance of projected economic growth. The continuance of steady extraction of gold at the Kumtor deposit will allow ensuring the appreciable contribution of the manufacturing sector. The situation in the energy sector should be stabilized with the lapse of time.

It is assumed that in 2009 there will still be ascending flows of income of the population, despite the slowdown of their growth. It is expected that money income of the population will increase in real terms to 6 percent. The size of the average wage will grow in real terms to 6-7 percent.

Real growth of total investment in 2009 is projected at the level of 8.2 percent, and their share in the structure of GDP on the use of income will make 25.2 percent. Both the capital base of enterprises and the population, and the state budget resources will become the basic sources of investment of funds in fixed capital. In this case, industry, construction and services will be priority directions of investment.

Additionally, sustainable development of the agrarian sector, whose share in GDP is significant, is expected to remain. The rate of growth of gross output in agriculture in 2009 is expected at the level of 2 percent. Such growth is assumed to be ensured by, basically, the increase in plant growing output.

Growth of industry in 2009 will make about 11 percent and in many respects will be caused by growth of production of basic gold mining enterprises. Industrial buildup in other sectors of manufacturing will continue. Excluding Kumtor enterprises, industrial production will increase by 10 percent in real terms.

Real growth in the sphere of services will make about 8 percent in 2009 and will be provided by trade, transport and communication, as well as by tourism.

In the medium term, the rates of economic growth will go up due to stabilization of the macroeconomic situation both in the country and abroad, and will make about 6 percent in 2010 and 2011.

According to the Medium Term Country Development Strategy, the sphere of services will still show the tendency of high rates of growth in the domestic market – by 10 percent a year on the average, with their share in GDP increasing to 43 percent. This will be largely caused by development of trade, transport and communication and tourism.

Under favorable climatic conditions, teal annual rates of growth of gross agricultural output will make about 3 percent.

In industry, medium term growth is projected to be 10 percent a year on the average, basically, resulting from growth of gold production as a result of development of a southwest site of the Kumtor deposit and commissioning of Taldy-Bulak Levoberezhny and Jerui gold mines. In other

sectors of industry (excluding gold mining), the average annual rate of real growth is also projected to be at the level of 10 percent.

The basic preconditions of sustainable industrial development will be: attraction of investments, anticipated reforms in the energy sector in order to rehabilitate this sector, legalize the shadow economy, restore and put into operation idle enterprises, and to increase volumes of processing of agricultural produce, and others.

In 2009, according to the Law of the Kyrgyz Republic “On the Republican Budget of the Kyrgyz Republic for 2009 and the Forecast for 2010-2011”, the state budget deficit in the fiscal sector will be Som 3.5 billion or 1.5 percent of GDP to be financed through the domestic and foreign sources in the amount of Som 1 511.5 million and Som 1 977 million, accordingly.

Total state budget revenue and grants are projected at the level of 22.4 percent of GDP, expenditure – 23.7 percent of GDP in 2009. As in the previous periods, the basic share of state budget revenue will fall on tax collection. Meanwhile, with the implementation of the new version of the Tax Code, some shortfall is expected in VAT collection in the short-term perspective, for the VAT the budget-forming tax.

The KR balance of payments forecast for the nearest three years is based on the slowdown of economic growth in the neighboring countries - basic trading partners of the republic in 2009 and gradual improvement of the situation by 2011. It is expected that the measures undertaken by governments of developed countries to neutralize consequences of the world financial crisis will help prevent the avalanching fall of world stock exchange and commodity indexes in 2009-2010.

In the medium term period, the Kyrgyz Republic will, still, import goods more, than export them. This being the case, the rates of growth of both export and import deliveries will be halved on the average in 2009-2011 in comparison with the rates, which are expected to be 19.5 and 19.2 percent, accordingly, by the end of 2008.

It is expected that the average annual rate of growth of remittances will be reduced to 9.6 percent, whereas for the recent three years it was not less than 35.0 percent due to the prospective reduction of workplaces in Russia, Kazakhstan and a number of other countries. Such a situation will lead to growth of the current account deficit by 2011 to 18.9 percent of GDP.

As in the previous years, the current account deficit will be covered through mainly private and public investments. The average annual value of the capital and financial account will make US\$286.0 million that will allow maintaining the balance of payments positive in 2009-2011.

If the external environment impact turns out to be stronger and longer against global growth retardation, energy sector problems will not be fully resolved, economic activity will continue declining, and an investment climate will deteriorate. This will reduce the rate of real GDP growth in 2009 as compared with 2008 and is expected to be at the level of about 4 percent.

Serious fears are caused by an emergency in the energy sector. It is obvious that it will take several years to correct problems in this sector. This development creates the risk of further deceleration in growth of the economy, considering the high rate of dependence of the latter on electricity consumption. The essential factor of growth retardation is that of diminution in the demand of countries - basic trading partners - owing to deterioration of the economic situation in the whole region.

Nevertheless, in industry, as a whole, a loss of production will be comparatively insignificant, because of, basically, maintenance of steady gold extraction at the Kumtor deposit. Growth of the value added in industrial production will make about 5.0 percent in 2009.

The risk of inflation and the rise in the producer prices could become the additional factor of the falling rates of economic growth. In this case, the reduction in the value added of construction

will be about 5 percent in the period under consideration. Following the reduction of the building activity one should expect the reduction of investments in fixed capital, whose volume will, presumably, decrease by about 3.0 percent in comparison with 2008.

Agriculture will not undergo essential changes. The increase in the total value added is projected at the level of 2.0 percent.

Against the background of weakening business activity, the increased price level and the expected decrease in remittances of migrant workers, income of residents can be noticeably reduced, that in turn will lead to the reduction of the size of domestic consumption, whose tendency revealed itself in the current year. In this connection, the incentive public expenditure policy becomes topical and here emerges the question as to growth of income with the view of maintaining economic growth under the circumstances of the worsening economic situation.

In the ensuing years, as the macroeconomic situation stabilizes and the domestic development sources become more active, the basis will be established for consistent growth. In this context, the average annual growth rate of real GDP will make 4-5 percent.

In the fiscal sector, as the situation develops this way, a pattern of expenditures is expected to change: additional revenue will be directed to increase consumption and finance operating expenditures, which do not decrease in view of structural problems, as well as to support the most vulnerable layers of the population in connection with the rise in prices of foodstuffs and public utilities. The budget deficit in relation to GDP could increase at the same time.

When developing the forecast it was anticipated that the medium term fiscal policy will be aimed at expanding the taxable base, full and timely financing social guarantees and liabilities of the state to the population, and at improving the budgetary legislation. Serious attention will be paid to public expenditure management issues in order to more effectively finance the priority programs under the Country Development Strategy, therefore, state budget formulation will be still based on programs.

As a whole, average annual growth of total state budget revenue in 2010-2011 is projected at the level of 10.7 percent, whereas average annual growth of expenditures – at 8.3 percent. So far as the medium term fiscal policy is oriented to outstripping growth of the revenue part of the budget, in contrast with the expenditure part, this will become the basis for the gradual reduction of the budget deficit down to Som 1.5 billion or 05 percent of GDP in 2011.

2.3. Inflation Forecast

The rate of growth of the general price level is expected below 15 percent in 2009. However, deceleration in economic growth in the region and the reduction in income of the population indicate that the rates of growth of the general price level in the region could be lower. It will be connected with the sales slowdown with regard to domestic products from Kazakhstan and Russia and, as a result, - saturation of the domestic market with the goods, whose prices will change at lower rates.

Inflation, as earlier, will be determined by, mainly, the behavior of food prices, with the share of food products in consumer spending being more than 50 percent.

For instance, in the first half of 2009 the rate of inflation will be, basically, formed on impact of 2008 carry-overs and a harvest in agriculture in 2009 that would directly affect food prices.

It is expected that meat prices will continue showing the upward trend observed since 2002. The rise in meat prices in 2009 is projected at the level of 20 percent. Due to the essential rise in forage prices, growth of milk prices is projected to be about 15 percent. The rise in fruit-and-vegetable prices will presumably make about 20 percent in 2009 provided the current trend in production, export and import of fruit and vegetables is still there.

Domestic prices of specific goods will be largely determined by their world production and consumption. This is related to grain, sugar and petroleum pricing. For instance, according to world forecasts, grain crop (wheat and rice, in particular) is expected to be above the level of the previous years in 2008-2009, thereby leading to larger carry-overs and fixing prices, accordingly, at the current level or, may be, the reduction of prices in the forthcoming year.

Despite the increase in domestic grain production, the republic will import the essential share of grain to cover the deficit. The expected rise in prices of bread and bread products and cereals in 2009 will not be more than 12 percent.

There are risks of the slight rise in sugar prices in the world in connection with the loss of its production in Cuba, Brazil and India. As part of this dynamics the rise in sugar prices is projected within the range of 15 percent in 2009.

The petroleum price behavior will remain volatile. Unstable energy price developments will depend on a large number of factors, both economic, and geopolitical, in the countries-exporters of oil.

According to the Tariff Policy Plan for 2008-2012, electricity, heating and gas tariffs are expected to be administratively increased, with electricity tariffs for the population to be increased by 20 percent. Due to expected growth of procurement prices of gas from Uzbekistan, the disbursing gas prices for the population are expected to grow in 2009.

The money supply trend in 2009, which reflects the impact of various supply and demand factors, will correspond to the goals of maintenance of macroeconomic stability and rate of growth of GDP at the specific level.

In the medium term perspective, as the general economic situation stabilizes and the balanced monetary and fiscal policy implemented, the rate of inflation will not be more than its single digit value by end-2011.

3. ENVIRONMENT FOR IMPLEMENTATION OF MEDIUM TERM MONETARY PROGRAM

3.1. Medium Term Monetary Policy Objective

The objective of the NBKR fixed by the Law “On the National Bank of the Kyrgyz Republic” - achievement and maintenance of price stability in the country as one of the basic conditions of sustainable economic growth - will predetermine the development and implementation of the NBKR’s monetary policy. The medium term monetary policy will be aimed at bringing the rates of inflation down to single digit parameters by 2011.

In this regard, there are significant risks for achievement of this level in view of the stronger impact of factors of uncertainty. The impact of external price shocks that started influencing the situation in 2007 and resulted in the burst of inflation in the country continued showing up during 2008. The tightening of the monetary policy in response to the price shocks accompanied with the measures of the Government of the Kyrgyz Republic allowed to restrain inflation, however, stability is not achieved yet. The crisis phenomena in the world financial system introduce additional risks in the world economy as a whole and in the economy of our country in particular. Economies of some leading countries in the world that entered into a phase of recession, an expected sub-cycle both in developed, and developing countries, including the countries-trading partners of the Kyrgyz Republic, will affect the rates of economic growth in our country as well. Coupled with domestic structural problems, it generates uncertainty as to

both the direction, and the rates of development of the national economy, that essentially complicates any possibility of forecasting the medium term outcome.

In this connection, the primary short-term monetary policy goal will be that of not to allow acceleration of inflation in the economy, because inflation at the current level of two-digit numbers can have the negative impact on economic growth in the long-term perspective. On the other hand, the excessively tight monetary policy could also be undesirable in case if sub-cycle risks in economic growth turn out to be essential. Thus, the NBKR will monitor macroeconomic developments to strike the optimal balance between the risk of inflationary pressures and the risk of absence of economic growth.

The 2009 quantitative monetary policy benchmark will be aimed at bringing inflation down to the level below 15 percent (December 2009 to December 2008) - this will establish the basis for attainment of the medium term monetary policy goal.

The economy of the republic is still subject to the impact of shocks, which were aggravated by the crisis phenomena in the world financial markets. The monetary policy targets could be adjusted under the circumstances of significant world market developments, the increase in tariffs and prices administratively set for goods and services, and in case of revisions made in official macroeconomic performance forecast data, including the republican budget forecast.

3.2. Monetary Program

If the economy develops according to the favorable scenario, the monetary policy will be implemented in 2009-2011 by the NBKR based on the anticipated development trends in the real, fiscal and external sectors of the economy and will be directed to observe the inflation target set below 15 percent for 2009, with its subsequent reduction to the single digit level.

The forecast of required money supply for projected medium term growth of GDP is complicated by a need for bringing down the general price level in the economy and the unstable external environment influencing the exchange rate of the Kyrgyz Som. In this context, the currency mix will change towards growth of the share of net domestic assets (NDA) due to implementation by the NBKR of the weighed interest rate policy while reducing the share of net foreign assets (NFA), which will be determined by the inflow of funds from external economic operations and the volume of net external financing.

Medium term developments in the NBKR's net foreign assets (NFA), as a result of, mainly, National Bank's interventions, will not be unidirectional because of an increased volatility of the US dollar and Euro - basic reserve currencies. As before, the NBKR NFA will grow on essential impact of current transfers, whose rates of growth will be essentially reduced in 2009-2011, though their nominal volume will remain at the high level of about US\$1450-1780 million.

If the current schedule of public debt service is observed, volumes of external debt service will be observed to annually grow by 8.5 percent on the average in 2009-2010 as against the previous year. Volumes of medium term and long-term credits and grants to be disbursed by the international financial institutions and private investors are not determined yet. These factors, alongside with the reduction of the inflow of investments in the banking sector from parent companies, will become the additional constraining factor of growth of net foreign assets of the banking system (BS NFA) in 2009-2011. The essential factor of changes in the BS NFA is still that of the NBKR's interventions, whose development trends and volumes remain uncertain because of the consequences of the world financial crisis that force the financial markets in the Central Asian region.

Growth in the economy projected for 2010-2011 will be ensured by, mainly, the net domestic assets of the banking system BS NDA. Expansion of financing of the banking system through the domestic sources will demand a speed-up in modernization of the NBKR's trading system in order to diversify the assets acceptable in the domestic interbank market. The deposits of the population, whose growth is expected due to the increase in their interest rates and introduction of the system of protecting the deposits of the population, will become the important source of financing for the banking system.

Expected medium term growth of the deposit base of the banking system, the further deepening and expansion of the payment system, alongside with the weighed policy implemented by the NBKR will result in growth of a multiplier effect.

In case if growth slows down to the level of 4 percent against the background of the global financial and economic crisis, there will be the more essential reduction of rates of growth of monetary aggregates in the monetary program. Such a development could be possible (besides the external shocks) in case of inefficient spending of scarce domestic resources, and a diffusion or the non-targeted use of external financing. From the point of view of monetary policy implementation under these circumstances, the inevitable component of such a situation will be that of the need to increase the impact of net domestic assets of the banking system on growth of broad money and to reduce the rates of growth of gross reserves. In this context, a tightened budgetary discipline and a broader spectrum of government securities will be required, as a minimum, to bring the basic macroeconomic parameters to the acceptable level, for this will allow to count on the renewed investment inflows to the republic for growth recovery.

4. Conclusion

Given the need for lending aid to economic growth, the monetary policy of the NBKR will be targeted to consistently reduce the rates of inflation in order to achieve single digit numbers by 2011. In this case, there are certain risks entailed by the stronger impact of external and internal factors of uncertainty, which could hamper achievement of targets.

As a result of a restraint of external loans of commercial banks and the increase in interest rates of mobilized resources in the domestic financial market, it is assumed that the level of excess liquidity in the banking system will go down in the medium term period as compared with 2008. To maintain the level of liquidity at the acceptable level, the NBKR will use the available monetary policy tools, while continuing its work on improvement of the information-technological and regulatory-legal framework.

The work to convert non-marketable state debt instruments in the NBKR's portfolio into the marketable instruments will be completed in order to increase the capacity of the domestic financial market and expand the list of securities, which could be used for conducting open market operations. This will also promote government securities market development.

An interdepartmental coordination council will be responsible for coordination of monetary and fiscal policy measures and issues of regulating liquidity and issuing securities.

The NBKR will continue developing the interest rate channel of the monetary policy to have an opportunity to re-direct the supply of money from the exchange rate channel to the interest rate channel in the medium term perspective. Along this direction, the NBKR will carry out applied research works in the monetary policy sphere and macroeconomic model building, including the joint work with central banks of other countries and the international financial institutions.

The basic tools to adjust rates of compensation in the financial market and to sterilize excess liquidity of banks for a short-term period will be those of open market operations, with the NBKR notes used as the structural tool for sterilization of excess liquidity.

To mitigate the impact of dollar exchange rate fluctuations on the foreign markets, to diversify risks of deterioration of the value of the NBKR's reserve assets, as well as to satisfy the demand in the commercial banking system, the NBKR will continue developing that segment of the interbank foreign exchange market that deals with the transactions with foreign exchange holdings, which are different from those in US dollars.

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

The measures will be taken in the area of payment systems to enhance efficiency and security of payment systems, create the conditions for increasing the share of clearing settlements in the economy, and to increase the number and improve the payment services.

In accordance with the NBKR's Banking System Development Strategy that covers the period till end-2011, the basic goals of further development of the banking sector are that of further growth of financial intermediation, enhancement of a role of the banking sector in the economy of the Kyrgyz Republic, and maintenance of efficiency, security and reliability of banking are.

The deposit protection system, whose introduction will guarantee refunds of certain amounts of money to investors (physical persons) becomes the significant factor of increasing confidence in commercial banks.

The microfinance sector of the republic will continue its development and, given the current trends, the overall size of the credit portfolio in microfinancing will make Som 8-9 billion, while the number of borrowers will presumably increase to 250 thousand people by end-2011.