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**NATIONAL BANK OF THE KYRGYZ REPUBLIC**

**MAIN MONETARY POLICY GUIDELINES FOR 2011-2013**

**Bishkek  
2010**

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## **INTRODUCTION**

This document specifies the objectives and purposes of the NBKR monetary policy for a medium-term period (2011-2013) including detailed description of monetary policy for 2011 based on the analysis of current economic situation and the forecast of developing the major sectors of economy.

The first chapter of present document covers the analysis of inflation dynamics for 2008 – 11 months of 2010, current state of economy and basic indicators of financial market as well as anticipated results of monetary policy through the end of the current year.

The next chapter describes the prospects of development of the country economy in the medium-term period of 2011-2013 and specifies the external and internal factors and potential risks. Scenarios of economic development and inflation forecast are covered herein as well.

The principles of implementing monetary policy and variants of the monetary program prepared on the basis of potential scenario of the country's economic development are described in the third chapter. The benchmarks for 2011 are defined herein as well as the information about factors that can hinder achievement of the benchmarks provided. This chapter specifies the areas of the NBKR development, which would improve the NBKR opportunities for developing and implementing monetary policy.

For the purpose of preparing this document, there were used the Ministry of Finance's forecast data on the sector of public finances of the Kyrgyz Republic approved by the Government Decree dated December 16, 2010; medium-term forecasts of social and economic development of the Kyrgyz Republic for 2011-2013 dated November 5, 2010, the September-December 2010 Memorandum of Economic and Financial Policy for the Program Supported by the Rapid Credit Facility approved by the IMF Executive Board of Directors on September 15, 2010. The document was based on preliminary data with a considerable share of uncertainty.

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

### 1.1. Review of Economic Conditions Development and Expected 2010 Outcomes

**Real Sector of Economy.** *The year of 2008* was characterized by high growth rates of economy, which made 8.4 percent according to the National Statistics Committee.

*In 2009*, as a result of negative consequences of financial crisis, there was a slowdown in economic growth rates. The decline in economic activity due to a decrease in actual demand in regional economy affected the development of real sector of economy in Kyrgyzstan as well. According to the NSC KR, the GDP volume amounted to Som 196.4 billion in 2009, having increased by 2.3 percent in real terms.

Excluding the Kumtor gold mining enterprises, the growth of real GDP amounted to 2.9 percent against 6.5 percent in 2008.

*In 2010* the Kyrgyzstan economy was in extremely difficult conditions due to the political events and their consequences.

According to preliminary data for 11 months of 2010, the GDP volume decreased by 1.0 percent in real terms against the comparable indicator of 2009 (in January-November 2009 the increase made 1.6 percent); whereas, excluding the Kumtor gold mining enterprises, it decreased by 1.3 percent (for the comparable period of 2009 similar indicator increased by 2.8 percent). As a result of 11 months of 2010, the GDP deflator made 7.6 percent against 1.4 percent in January-November 2009.

As a result of 11 months of 2010, the level of investment in the fixed assets decreased by 2.3 percent against the comparable indicator for 2009; while in January-November 2009 the volume of investment in fixed assets increased by 16.8 percent – this primarily was conditioned by a decrease in investment in energy sector against the backdrop of the finishing construction of Kambar-Ata-2 HES and other large projects.

In the first half of 2010 the level of final consumption increased by 1.7 percent as compared to similar indicator for January-June 2009, which decreased by 9.0 percent in 2009. In many instances, the growth of expenditures for final consumption was conditioned by the low base effect of the previous year. As a whole, a slight increase in consumption is expected as a result of 2010 as compared to the previous year; this will be conditioned by an increase in government expenditures and in remittances of labor migrants. Herewith, the consumption growth will be limited by the continuing negative influence of the decline in economic activity.

According to the forecast by the Ministry of Economic Regulation, a 1.5 percent decrease in the volume of real GDP is anticipated, which will make about Som 210.9 billion in nominal terms. The deflator will amount to 9.0 percent. The shadow sector of economy continues to have a great influence, which is difficult to assess. The assessments of shadow sector are different and may reach about 50% of GDP according to different methodologies.

**Fiscal Policy.** *In 2008-2009* the fiscal policy was, to a greater extent, focused on reforming the tax policy. In 2008 the development and adoption of revised version of the Tax Code of the Kyrgyz Republic was finished, which was put into force on January 1, 2009. The following key changes in the tax legislation can be noted:

- the decrease in value added tax (VAT) rate from 20 to 12 percent;
- the decrease in the total amount of taxes from 16 to 8;
- change in the taxable base for sales tax;
- changes with regard to tax administration, etc.

In 2008-2009 a considerable progress was achieved as to attaining budget balance. For instance,

in 2008 the deficit of state budget made 0.0 percent to GDP taking into account external financing of the SIP (State Investment Program); whereas in 2009 it slightly increased to make 1.5 percent to GDP.

In 2010, as a result of social and economic instability, the economic activity declined in the country, the growth rates of tax revenues slowed down, government expenditures for social protection, peacekeeping and security assurance, for capital construction and repair increased, and, as a consequence, the imbalance of state budget increased significantly. All this has both short-term and medium-term after-effects on economy of the Kyrgyz Republic.

State budget deficit for January-October 2010 amounted to 3.6 percent to GDP or Som 5.9 billion (for January-October 2009 the budget was implemented at deficit of 6.0 percent to GDP or Som 1.0 billion). Herewith, without regard to the tax on Kumtor gross revenue, the deficit of state budget amounted to 6.0 percent to GDP or Som 10.0 billion.

In the current year the Provisional Government of the Kyrgyz Republic had to adopt a number of decrees for support of aggrieved entrepreneurs and reconstruction of destroyed cities, in particular:

– Decree *On Primary Measures for Reconstruction and Development of Osh and Jalal-Abad Cities* No. 76 dated 19.07.2010;

– Decree *On Fiscal Preferences, Benefits and Delays for Individuals and Legal Entities Aggrieved in the Disorders Period in Osh City, Osh and Jalal-Abad Oblasts and Measures for the Regions Reconstruction* No. 77 dated 19.07.2010;

– Decree *On Tax Exemption of Goods, Works and Services, On a Grant Basis, for Entities Bearing Losses as a result of Circumstances of Insuperable Force* No. 126 dated 07.09.2010

The above mentioned measures coupled with the deceleration of economic activity in the country, closing and tightening control-and-access regime on the borders with neighboring countries resulted in aggravation of balance indicators in the public finance sector. As a result, taking into account the current state of budget indicators implementation, the deficit of state budget is expected at the level of 7.7 percent to GDP in follow-up of 2010.

**Balance of Payments.** The global economic crisis of 2008 had an adverse effect on the balance of payments of the Kyrgyz Republic. Deficit of the current account increased up to 13.6 percent to GDP in 2008. As a result of 2008, the external surplus decreased by 73.0 percent and amounted to USD 83.2 million. The volume of gross international reserves covered 4.0 months of future imports of goods and services as of the end of the year.

In 2009 the current account was formed at deficit of 2.4 percent to GDP. The positive balance of the capital and financial account increased by 2.5 times and made USD 389.9 million in 2009.

Thus, as a result of 2009, the external surplus increased by 2.7 times to make USD 221.9 million. The volume of gross international reserves covered 4.6 months of future imports of goods and services as of the end of the year.

As a result of 2010, the deficit of current account is expected at the level of 9.3 percent to GDP (*taking into account the NBKR calculation, this indicator will make 5.9 percent to GDP*) against 2.4 percent in 2009. The current account trend developed during 9 months of 2010 is expected to continue through the end of the year.

Trade balance deficit will increase by 18.9 percent and amount to USD 1,331.2 million (*taking into account the NBKR calculation, the trade balance deficit will increase by 20.3 percent to make USD 1,177.2 million*). The volume of current transfers will increase by 18.5 percent to make USD 1,431.5 million; this will be conditioned by up to 26.2 percent increase in currency receipts from trade migrants.

As a result of 2010, the capital and financial account is forecasted positive in the amount of USD

127.0 million and will decrease by 67.4 percent as compared to 2009. Meanwhile, the positive balance of financial account will decrease by 52.6 percent and amount to USD 191.4 million. The decrease will be conditioned by 3.6 times increase in the credit balance of capital account, an 8.0 percent decrease in the volumes of direct investments and an 89.5 percent decrease in the receipts from other investments.

Therefore, as a result of 2010, the balance of payments will be formed negative in the amount of USD 87.1 million. The volume of gross international reserves will cover 4.8 months of future imports of goods and services as of the end of the reporting period.

**Indexes of Real and Nominal Effective Exchange Rates of Som.** The REER index increased by 7.8 percent against the comparable indicator of 2007 and amounted to 111.0 *as of the end of 2008*. Despite a decrease in the nominal effective exchange rate (NEER), the lower inflation level in partner countries became a dominant factor for REER formation.

Influenced by the devaluation of nominal bilateral exchange rate of Som against majority of the trade partner countries' currencies, the general index of nominal effective exchange rate (NEER) decreased by 3.7 percent as compared to the similar indicator for 2007 and amounted to 127.9 as of the end of 2008.

*As a result of 2009*, the REER index decreased by 7.2 percent against the comparable indicator of 2008 to make 103.0. The decrease in REER index was conditioned by the devaluation of nominal effective exchange rate (NEER) of Som and by lower inflation level in Kyrgyzstan as compared to the trade partner countries. Thus, NEER index decreased by 2.9 percent and made 124.2 percent. At the same time, the KR inflation level of 2009 made zero percent; whereas the average level of inflation in the trade partner countries amounted to 4.7 percent according to estimated calculations.

According to the preliminary data, the index of nominal effective exchange rate (NEER) of Som decreased by 6.1 percent year to date and amounted to 116.6 as of the end of October 2010. The decrease was caused by a devaluation of Som against the currencies of main trade partners. For instance, average exchange rate of Som in October 2010 as compared to December 2009 devaluated against Kazakh tenge by 6.5 percent, Chinese yuan – by 7.8 percent, US dollar – by 5.7 percent, and Russian ruble – by 3.2 percent. At the same time, strengthening of Som in relation to euro was marked by 0.7 percent.

Despite strengthening of the currencies of main trade partners against Som, the lower inflation level<sup>1</sup> in the partner countries upwardly impacted the index of real effective exchange rate (REER), thus, smoothing the influence of exchange rate. Therefore, Som's REER increased by 3.3 percent year to date and made 106.4 as of the end of October 2010.

**Main Financial Market Indicators.** During 11 months of 2010, the situation was ambiguous in the financial market. The first quarter indicators testified to the return of stability in main segments of the financial market. In the STB primary market the sales volumes increased gradually, while the demand considerably exceeded the supply; the monthly average yield of all STB decreased by 7.32 percent in January down to 4.9 percent in March. The credit in economy from the banking sector increased by 2.9 percent, and the deposit base increased by 2.3 percent<sup>2</sup>. Nevertheless, in the second quarter, the internal shocks caused imbalance in emerging stability. The demand in the STB primary market decreased; whereas the average weighted yield of all STB types jumped up to 10.5 percent in April and continued increasing having reached 15.2 percent in October.

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<sup>1</sup> The inflation level in KR for January-October of the given year amounted to 13.1 percent; whereas the average inflation level of the main partner countries made 2.8 percent according to the preliminary calculations.

<sup>2</sup> In accordance with monetary survey of banking system

Significant changes were marked in the deposit base. As a whole for November 2010, the volume of deposit base made Som 34.4 billion having decreased by 13.2 percent. The average weighted rate for newly accepted Som deposits came down to 2.0 percent (-0.8 p.p), while that for deposits in foreign currency decreased by 0.5 p.p to make 1.2 percent over the period.

The credit portfolio of the operating commercial banks increased by 5.6 percent for eleven months of 2010 and made Som 26.6 billion as of the end of November (in January-November 2009 the credit portfolio decreased by 0.6 percent). The increase in crediting was ensured due to a 22.1 percent increase in Som crediting; whereas the credits in foreign currency decreased by 4.5 percent. Without regard to the US dollar exchange rate, the increase in credit portfolio amounted to 2.9 percent for January-November 2010; at the same time, the decrease in foreign currency credits made 9.8 percent.

The weighted average interest rate for credits in the national currency newly issued by banks amounted to 23,8 percent in January-October 2010 having decreased by 3.0 p.p. against similar indicator for 2009; the rate of foreign currency credits decreased by 1.8 p.p. down to 20.0 percent.

At the same time, the activity of NBFIs in the crediting market remained high. For the first half of 2010 their total credit portfolio increased by 15.2 percent and amounted to Som 10.2 billion, which accounted for 28.3 percent of the total volume of credits in economy (as of the beginning of the year, its share accounted for 26.1 percent).

Till the end of 2010, the increase in crediting will be supposedly continued; this will be ensured due to an increase in the credit portfolio of both bank and non-bank financial institutions. The increase in credits will be ensured only by Som credits; whereas foreign currency credits continued decreasing. The interest rates for new credits in the national and foreign currency will probably trend to downward.

## **1.2. Expected Monetary Policy Implementation Outcomes**

**Review of Monetary Indicators and Forecast through the end of 2010.** In 2008-2010 the world economy experienced a number of disturbances that have a considerable influence on small open economy of Kyrgyzstan. In this conditions, the National Bank conducted monetary policy pursuing its main goal – achieving and maintaining price stability, taking into account the legislative changes of the NBKR primary purpose, that were performed in 2008. In 2008 the main purpose of monetary policy of the National Bank of the Kyrgyz Republic was the reduction of the increased inflationary expectations of the population, achievement and maintaining of stability in the overall level of prices. In 2009 in the process of reducing the adverse effect of the international financial and economic crisis and inflation, the primary purpose of the National Bank was the contribution to economic growth. With view of its attaining, the NBKR established the subsidiary enterprise *LLC Special Fund for Banks Refinancing*; its main area of activity was defined as the provision of financial resources to the banking sector for crediting the real sector. As a result of 2008, the inflation developed at the level of 20.1 percent; in 2009 – 0.0 percent.

According to the preliminary data, on the whole, the inflation in the medium-term period of 2008-2010 will not exceed 12.5-13.0 percent that on the average during the period corresponds to previously declared benchmarks (12-15 percent in 2008, below 15 percent in 2009, 7.5-9.0 percent in 2010).

The “Main Monetary Policy Guidelines for 2010” specified a major task consisted in retention of moderate inflation rates within the range of 7.5 – 9.5 percent. The assumption that inflationary pressure will be increased against the backdrop of large-scale measures of budgetary stimulation required to maintain economic development and strengthen social protection of population as well as increase in the tariffs for electrical and heating energy formed the basis of inflation assessment.

During the first quarter, due to continuation of inflationary risks, the National Bank maintained the volumes of NBKR notes emission at a high level of about Som 1.0 billion. Political events of April and June 2010 and their consequences sufficiently adjusted both the conditions and the nature and areas of conducting monetary policy. In the conditions of systemic crisis, the potential risks in the banking system and the threat of deeper stagnation against the backdrop of moderate rates of inflation during the first months after the April, the National Bank's actions were oriented primarily at ensuring stability in the banking and financial system and facilitating economic development.

Taking into account the decrease in the resource base for economy crediting by the commercial banks, during the second quarter NBKR sufficiently decreased the volumes of excessive liquidity withdrawal through transactions in the open market: the volume of notes in circulation made Som 200 million as of late June against Som 1.0 billion as of late March. The reserve requirements for the commercial banks decreased from 9.5 to 8 percent in May. With view of facilitating economic development, the base rate for operation of the Special Fund for Banks Refinancing (SFBR) was reduced from 8 to 7 percent in May. At the same time, a common adjustment factor was established for the base rate at the level of 1 in order to define the extent of interest rate for the SFBR credit funds.

In the 3<sup>rd</sup> quarter a considerable enhancement of inflationary processes began, which manifested itself in a rise of internal prices for food products and was coupled with enhancement of inflationary expectations of the population due to external price shocks provoked by climatic cataclysms in large countries producing cereal crops against a rise of prices for energy carriers. Whilst on the whole for the 1<sup>st</sup> half-year the inflation amounted to 4.1 percent, in the 3<sup>rd</sup> quarter its value was 5.9 percent.

The NBKR discount rate increased from 0.9 percent to 5.32 percent for 11 months of 2010. The volume of issued overnight credits increased by almost 4 times against 2009 and amounted to Som 2529.0 million (Som 635.8 million for 2009).

From August 2008 the National Bank started performing swap transactions for the US dollars purchase with the commercial banks in order to provide Som liquidity for filling MFO requests, the accounts of which had been blocked in OJSC AUB. The total amount of these transactions amounted to USD 14.65 million or Som 683.5 million in equivalent for August-November.

In the domestic foreign exchange market there was a considerable increase in demand for foreign currency due to an outflow of foreign-currency deposits, a decrease in the inflow of foreign currency from export revenues, increased devaluation expectations, and strengthening of dollar positions in the international markets. With view of preventing any sharp fluctuations of the USD exchange rate, the NBKR increased the sales volume of cashless dollars in the foreign exchange market. The NBKR net sales of US dollars made USD 218.9 million for 11 months of 2010, the US dollar exchange rate increased by 6.28 percent (the NBKR net sales of US dollars made USD 134.65 million in the comparable period of 2009, the dollar exchange rate increased by 11.43 percent).

As a result of 11 months of 2010, the monetary base increased by 8.7 percent, mainly due to the growth of state budget deficit.

**Money Supply Formation Sources.** The National Bank took a number of measures for maintaining economy crediting. In particular, the Special Fund for Banks Refinancing intensified its activity; the National Bank started concluding swap transactions with the commercial banks for providing them with Som liquidity upon the requests of microfinance organizations. The Government increased the expenditures of state budget including the expenditures for social support of the population, reconstruction of destroyed objects in the south, conducting a referendum and parliamentary elections. As a result of 11 months of 2010, the growth rates of monetary aggregates accelerated against the comparable indicator for January-November 2009:

	for 11 months of 2010	for 11 months of 2009
✓ money outside banks M0 –	14.0 percent;	3.5 percent
✓ broad money M2 –	13.8 percent;	4.1 percent
✓ broad money M2X –	10.9 percent;	7.2 percent

Contribution of the NBKR net foreign assets (NBKR NFA) to the monetary base increase amounted to 27.0 percent (38.8 percent in the comparable period of 2009). The main contribution to the NBKR NFA was made by the increase in foreign assets (+20.2 percent).

The NBKR net domestic assets (NBKR NDA) for 11 months of 2010 decreased the monetary base, and the NBKR NDA contribution to its reduction was estimated at (-) 18.1 percent (in January-November 2009 the NBKR NDA contribution to the monetary base decrease made (-) 28.9 percent).

Net foreign assets of the banking system (NFA BS) for January-November 2010 influenced the increase in broad money M2X with contribution of (+) 16.2 percent, whereas in the comparable period of 2009 the contribution made (+) 41.2 percent.

Net domestic assets of the banking system (NDA BS) for 11 months of 2010 decreased the broad money, and the NDA BS contribution to the change in broad money M2X was estimated at (-) 5.3 percent (33.6 percent in the comparable period of 2009).

As of the end of November 2010, the structure of broad money M2X changed as compared to the beginning of the year as follows:

- the share of money outside banks increased from 59.3 percent to 61.0 percent;
- the share of deposits of other deposit corporations decreased from 40.7 percent to 39.0 percent.

Herewith, the deposit structure changed towards an increase in the share of transferable deposits in the national currency (from 27.1 to 30.5 percent) under more sufficient decrease in the share of foreign currency deposits (from 58.7 to 56.1 percent) against that of the national currency (from 14.2 to 13.4 percent).

On July 27, 2010, the International Donor Conference “Emergency Assistance to KR: Reconstruction and Harmony” was held in Bishkek, which addressed the problem of allocating funds to Kyrgyzstan for the country reconstruction. As a result of the International Donor Conference, there was agreed to allocate USD 1.1 billion during 30 months for reconstruction of the Kyrgyz Republic economy. The expenditures of state budget in the light of the April and June events and Parliamentary elections will influence a growth of monetary aggregates in the medium-term period as well as will exert pressure on the exchange rate dynamic and, subsequently, on the inflation.

**Inflation Factors and Monetary Policy Benchmark Implementation.** Strong dependence of the domestic economy from the international pricing environment and limited capacity of the economy to stand against external and internal shocks conditioned maintaining the high inflation rates in 2008, when inflation annual value (December 2008 against December 2007) amounted to 20.0 percent.

There can be conventionally marked two periods in the 2008 inflation dynamic. In the first half-year there was observed an acceleration of inflation rates in the country as a result of a rise in world prices for food products and energy carriers that continued since 2007. As a consequence, there was a rise in prices for food products, petroleum products, in tariffs for gas, electric power and other types of fuel as well as for transport services. Growing prices for main raw material resources impacted on the value of derivative goods, thus, forming general high inflationary background in the economy.

Starting from the second half-year there was marked a stabilization process and a decrease in main food products and petroleum products in the world. Measures undertaken by the NBKR allowed to decrease the potential of price growth and considerably limited monetary factors of inflation; this, in addition to the world prices stabilization, insured moderate growth of consumer prices in Kyrgyzstan in the second half of 2008.

In 2009 a considerable deceleration of economic development and negative processes related to it, such as low growth rates of population income and decrease in consumer demand became one of the main factors for disinflation in Kyrgyzstan. Besides, in 2009 the situation in the international markets of food products and energy carriers was characterized by stability that facilitated price adjustment towards their decrease and, as a consequence, the decrease in prices in the Kyrgyzstan domestic consumer market, in particular, in those for imported products. As a result of 2009 (December 2009 against December 2008), the inflation amounted to 0.0 percent. The deflation process was observed for almost all groups of food products.

In the first half of 2010 there were marked rather moderate growth rates of consumer prices (in June 2010 the annual value of inflation made 3.6 percent against 4.8 percent in the comparable period of 2009). However, from July 2010 there was an acceleration of inflation rates conditioned primarily by a rise in the value of fuels and lubricants in connection with introduction of export customs duties and an increase in prices in the international petroleum product markets as well as with a rise in prices for primary commodities.

According to NSC KR preliminary data, as of November 30, 2010, the annual inflation made 17.5 percent. In annual terms, the prices of food products increased by 23.7 percent, for alcoholic and tobacco products – by 11.6 percent, for non-food products – by 14.1 percent as well as prices and tariffs for paid services rendered to the population – by 11.0 percent.

On the whole, the existing level of prices was formed under influence of such factors as:

- change in tariff policy for electric and heating energy;
- change in prices for main food products including change influenced by prices in the international markets;
- the growing price for fuels and lubricants in the domestic market due to the introduction, from April 1, 2010, of export customs duties for petroleum and petroleum products exported from Russia to Kyrgyzstan and to the rise in the world prices;
- tightening of control-and-access regime on the borders with neighboring countries due to the start of operation of the Customs Union;
- worsening of trading conditions within the country and closure of borders with trade partner countries due to instable social and political situation in the country
- considerable increase in the expenditures of state budget, which act as one of the main sources of money supply growth.

Subject to the actual data for the previous period as well as to the forecasts of further price dynamic for different groups of goods, the inflation was estimated to make 19.0-19.5 percent in annual terms (December 2010 against December 2009).

From April 2010 the National Statistics Committee of KR initiated the calculation of core inflation applying a method of simple exclusions (according to the approved methodology No. 9 dated April 29, 2010). The calculation excluded such goods as milk, sugar, separate types of fruit and vegetables and alcoholic-tobacco products, fuels and lubricants, commodity group “electricity, gas and other types of fuel”, services of passenger transport, communication and etc. On the whole, the share of excluded goods accounted for 25 percent of the total consumer goods basket.

According to the NSC KR methodology, the value of core inflation, as a result of October 2010,

was lower than the existing CPI, but insignificantly. For instance, according to the NSC KR methodology, the core inflation amounted to 14.1 percent in annual terms, whereas the “uncleaned” inflation – 14.9 percent. These figures of the core inflation indicated that the inflation dynamic had a stable upward trend, and on the whole for Kyrgyzstan there was formed general high inflationary background.

## **2. PROSPECTS OF ECONOMIC DEVELOPMENT FOR 2011-2013**

### **2.1. Internal and External Factors and Possible Risks**

The *external factors*, which can impact on the macroeconomic situation in the country, include:

- failure to receive planned volumes of foreign investment;
- reduction of investment activity.

The *internal risks* include the following:

- structural vulnerability of the country’s economy;
- unsolved problems of food safety;
- uncertainty in tariff policy;
- low level of labor efficiency;
- slow recovery of economic activity in the country;
- structural vulnerability of the country’s economy both to internal and external shocks.

### **2.2. Development of Economy**

In 2011 the GDP growth is expected at the level of 5.8 percent against the recession in the previous year; in nominal terms the GDP volume will make Som 241.4 billion. Against the backdrop of the economic activity recovery, a considerable growth of agriculture and construction is forecasted in the south of the country, conditioned by the recovery of economic activity in the country. In many aspects, economic development in 2011 will depend on external factors: trading conditions with main trade partner member-countries of the Customs Union and pricing environment in the international food products and raw materials markets.

As to 2012 and 2013, the GDP real growth rate calculated based on the estimates of the long-term capabilities of economic development will be formed at the level of 5.0 percent (on the assumption of shocks and other disturbances absence) that in nominal terms will make Som 274.6 and 309.0 billion accordingly.

It must be taken into account that the economic situation within the country will largely depend on economic development of the neighboring countries (Russia, Kazakhstan), which economies, in their turn, are influenced by the conjuncture of world prices for petroleum. According to the practice, the periods of high prices for energy carriers give high-power impulse to economic development in the whole region. The positive effect of such expansion will touch the Kyrgyz economy as well through inflow of capital, growth of trading activity and increase in income.

In compliance with the Kyrgyz Republic Law *On the Republican Budget for 2011 and Forecasts for 2012-2013*, the GDP real growth rates are forecasted at the level of 4.8 percent in 2011, 6.0 percent in 2012, and 6.3 percent in 2013. The amount of budget deficit will make 7.7 percent to GDP in 2011. Thus, the problem of attracting additional financial resources becomes one of the most topical in 2011.

In the medium term a gradual decrease in deficit is forecasted, by the year of 2013 the state budget deficit will decrease down to 3.4 percent to GDP. However, the average level of state budget deficit is expected to be rather high; this can entail the problems of debt and general

macroeconomic nature.

With view of ensuring macroeconomic stability in the medium and long term, the budgetary policy will be oriented at creation of the conditions for enhancing efficiency and competitiveness of the economy and at improvement of investment climate as well as achievement of macroeconomic goals.

In the medium-term period the fiscal policy will be oriented at addressing the following problems:

- ensuring macroeconomic stability, which provides for, among other things, gradual decrease in budget deficit;
- proceed with implementing close coordination of monetary and fiscal policies in the medium-term period;
- reduction of government debt to GDP.

The most essential factors influencing the balance of payments of the Kyrgyz Republic in the medium-term period, along with the consequences of the occurred political events, are the changed conditions in the external trade caused by creation of the Customs Union and pricing trends developed in the goods and raw materials international markets. Taking into account the particular features of export and import operations performed in the country, the activity of the Customs Union will cause a decrease in imports in terms of re-exported positions as well as of export supplies of the goods of textile and clothing manufacture due to worsening the conditions of trade. This decrease, to Some extent, will be compensated by maintaining high prices for petroleum and oil in the international markets. At the same time, it's noteworthy that the volume of remittances made by the trade migrants will be maintained at a high level in the medium-term period.

The balance of payments forecast for 2011 was developed on the suggestion of gradual revitalization of the country's economy, inflow of tangible financial resources both to the public and private sectors as well as the growth of world prices for petroleum and gold.

Therefore, in 2011 the deficit of current account is forecasted at the level of 4.1 percent to GDP (taking into account the NBKR final calculation, the surplus of 2.5 percent to GDP is anticipated). Due to the economy revitalization, an increase in foreign trade turnover is forecasted, which nominal growth will make 8.5 percent; the imports growth will be at the level of 5.9 percent, while export growth will make 13.0 percent. As a result, the trade deficit will decrease by 3.5 percent and make USD 1,284.8 million (taking into account the NBKR final calculation, the 2011 trade balance deficit will decrease by 19.3 percent to make USD 949.8 million). As before, gold will be the main export item, which cost volume will increase by 24.3 percent; this will be conditioned by a 0.2 percent increase in production of gold industry and by a 22.0 percent<sup>3</sup> increase in the world price. At the same time, taking into account the forecasted growth of agriculture and industry of the country, an increase in export supplies of agricultural and industrial products is forecasted. As to the goods imports, a 15.3 percent increase in supplies of energy products conditioned by a 15.0 percent rise in prices for petroleum in the international markets is forecasted.

A stable growth trend for currency receipts from the current transfers will continue at the level of 23.7 percent; a 27.1 percent<sup>3</sup> increase in remittances of labor migrants is expected.

Insufficient currency resources required for financing the current account deficit will be covered due to financial support from KR donors by means of government credits and grants in the overall amount of USD 665.9 million, due to credits attracted by the private sector up to USD 44.9 million as well as due to direct foreign investment for the amount of up to USD 270.0

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<sup>3</sup> Averaged data from different Internet sources: [www.oecd.org](http://www.oecd.org) , [www.imf.org](http://www.imf.org) , [www.rbk.ru](http://www.rbk.ru) , [www.ereport.ru](http://www.ereport.ru)

million.

Thus, the total balance of payments will be formed positive in the amount of USD 164.7 million. The volume of gross international reserves will cover 4.2 months of future imports of goods and services as of the end of the reporting period.

The forecast of balance of payments of the Kyrgyz Republic for 2012-2013 was developed based on the following suggestions:

- GDP<sup>4</sup> annual average growth of 5.0 percent, which will make it possible to ensure export growth by 12.0 percent on average;
- decrease in the cost volume of gold exports conditioned by the decrease in the world prices for this precious metal<sup>3</sup>;
- fall in world prices for petroleum<sup>3</sup>
- deceleration in growth rates of migrants' remittances, which will make 3.3 percent on average;
- attraction of external financial resources by the private sector;
- decrease in the volume of financial resources attracted by the public sector under maintaining a high servicing level for previously attracted credits.

The above mentioned prerequisites will cause an increase in the trade turnover of up to USD 6.4 billion by 2013. At the same time, a decrease in the trade balance deficit is forecasted, which, first of all, will be conditioned by higher growth rates of export supplies as compared to the imports supplies. For instance, the annual average exports growth rate will make 12.0 percent in the reporting period, whereas the comparable indicator of imports will make 8.9 percent.

A gradual decrease in inflow of foreign currency from the current transfers by 5.2 percent on average is forecasted in the period.

As a whole, the described trend will lead to formation of the current account deficit at the level of USD 516.6 million as a result of 2013, that will correspond to the level of 7.7 percent to GDP (*taking into account the NBKR final calculation, this indicator will make 6.5 percent to GDP*).

As in the previous years, coverage of the current account deficit will be implemented primarily due to the private and government investments. At the same time, a decrease in external borrowings to the public sector is forecasted under maintaining rather high servicing level for previously attracted credits. The decrease in investment to the public sector will be compensated by a considerable increase in the volumes of direct foreign investments to the private sector. As a result, the capital account and financial account will be formed with surplus at the level of USD 422.0 million as a result of 2013.

Therefore, the total balance of payments will be formed negative in the amount of USD 63.6 million. The volume of gross international reserves will cover 3.4 months of the future imports of goods and services as of the end of 2013.

### **2.3. Inflation Forecast**

The 2011 inflation forecast is varied heavily as currently there is no relevant information about economic program of the government, tariff policy, fiscal policy, and investment policy; the stability in the domestic policy has not been achieved. On the whole, the inflation dynamic will directly depend on the measures taken by the government in the food products market. In the case of failure to undertake timely and sufficient measures, a significant threat to price stability will emerge.

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<sup>4</sup> NBKR assessment

In this connection, the forecast of 2011 inflation level was developed in two scenarios taking into account different ranges of price fluctuations. According to the core scenario, which implies a moderate growth of tariffs for housing and public utilities and undertaking some measures for maintaining balance between the demand and supply in the food products market, the inflation is forecasted within the range of 8.00-10.00 percent. The alternative way of macroeconomic situation development, which suggests continuation of high inflationary expectations and continuation of imbalanced fiscal policy, greater increase in tariffs for housing and public utilities and price rise for energy carriers as well as slow recovery of favorable external and internal trading conditions, makes prerequisites for inflation growth up to the value of about 18.5 percent.

As a whole, in the short-term and medium-term periods, the pricing environment will be predetermined, to a greater extent, by such factors as structural reforms of agricultural sector, enhancement of production capacity, changes in foreign economic environment, balance between the demand and supply of goods and services, tariffs prescribed by the Government in administrative manner, changes in the indicators of state budget, and seasonal fluctuations for agricultural products.

In other words, besides the external shock risks typical for small open economy, the problems of the very internal risk factors influence on the economy of our country are extremely acute.

Balance between the demand and supply of goods and services plays a key role in forming the general level of consumer prices in the medium-term period. Actual data from 2009 as well as forecasts demonstrate that the internal demand in Kyrgyzstan is starting to be recovered.

Constraining effect on the part of aggregate demand will be taken by social and political instability of the last months and consequences of business activity slowdown in the country as well as by worsening the investment climate and decrease in the trade turnover.

Taking into account the fact that the major part of population income is spent for consumption, one can suggest the formation of high inflationary potential in the economy as the growth of consumer demand occurs against the decrease in production or deceleration in growth rates in almost all the sectors of economy. For instance, according to the NSC KR data, in January-September 2010 there was a decrease in growth rates of the following products: flour, bread, vodka, gross output of agricultural products, concrete, and asbestos slate; taking the current agricultural crops was passing at a slower pace as compared to the previous year. There was a slight increase in many other types of products (for example, meat, sausage products, milk, cigarettes, and sand block); however, the growth rates decelerated considerably.

The inflation dynamic will also depend on the degree of price adjustment for imported goods in the domestic market in connection with fluctuations of the national currency exchange rate and expectations as to its further dynamic.

In the absence of shocks, the 2012 inflation is estimated within the range of 7.5-8.5 percent; for 2013 – below 7.0 percent.

### **3. ENVIRONMENT FOR IMPLEMENTATION OF MEDIUM-TERM MONETARY PROGRAM**

#### **3.1. Monetary Policy Objective**

Development and implementation of monetary policy in the forthcoming period will be predetermined by the necessity of finding the way out of the difficult macroeconomic situation, in which the country got in 2010. The slump in gross domestic product, on the one part, and inflationary boom, on the other part, raised a difficult problem for the NBKR to balance between the objective of stabilizing pricing environment and the problem of facilitating economic

development. In order to limit monetary component of inflation, the NBKR will regulate monetary base applying standard monetary policy instruments, increasing the operations for excess liquidity sterilization in response to the increase in budget expenditures. The National Bank will proceed with ensuring money supply by means of the substandard monetary mechanism through the SFBR activity; however, with occurrence of the stable signs of economic recovery, the application of this mechanism will be restricted. For this purpose, the NBKR will focus on price stabilization; thus, hardening the monetary policy where appropriate. Achievement and maintenance of price stability in the medium-term period is the main objective of the NBKR monetary policy; in such a case, the primary task is the reduction of the increased inflationary expectations.

The policy of floating exchange rate will remain unchanged. The NBKR will continue the practice of currency interventions that would support flexible adjustment of the exchange rate and allow to prevent its sharp changes. In the case of an increase in the pressure on the exchange rate, the NBKR will avoid deep reduction of international reserves and harden the monetary policy.

The NBKR will proceed with the activity on improving the operation of interest channel mechanism, which creates orienting points for the financial market, in particular through enhancing the role of base rate for the Special Fund for Banks Refinancing.

Taking into account the significance of coordination and responsiveness of the KRG and the NBKR to ensure macroeconomic stability, a great attention will be paid to activity of the interdepartmental coordination board of the MFKR and the NBKR.

Economic research remains to be the area of the National Bank interest. Within creation of the macroeconomic model of the economy there will be continued the work on research of the transmission mechanism channels, on assessment of inflationary expectations as well as on expanding the inflation model with applying new approaches.

With view of maintaining the stability and integrity of the banking system, the NBKR will proceed with the work on strengthening banking supervision and improving legislation in the area of enhancing the supervision over banks and regulation of their activity. At present, the 2011-2015 Micro-Financing Development Strategy is developed. The work on development of the 2011-2013 Banking System Development Strategy has been started.

The NBKR will take measures for stabilization of the IPC and payment system operation.

Reformation of the payment system will promote the development of new mechanisms, convenient for population and economic entities, of making payments through accounts in the commercial banks. The central and other public authorities and local government bodies are supposed to receive and make all types of payments, to draw salaries and other fees through accounts and cash departments of the commercial banks and divisions of the Public Enterprise *Kyrgyzpochtasy*. It is intended to develop the infrastructure for receipt and service of payments using modern banking innovative services and technologies (internet-banking, mobile banking, prepaid cards, etc); the bank card payment systems will be further developed all over the country. With view of risks decreasing and consumer protection, the measures for payment system supervision and control will be enhanced.

### **3.2. Monetary Program**

Implementation of monetary policy by the NBKR in the medium-term period will rely upon the forecasted development trends in the real, fiscal and external sectors of economy and will be oriented at inflation value of 8 percent on the average for the period on the assumption of shocks absence.

The monetary program was developed based on the presumption that external financing of USD

1.1 billion specified at the donors' conference will be allocated evenly within the period of 2010-2013. Due to uncertainty as to the sources of financing the state budget deficit in 2011-2013, it is supposed that the budget deficit will be covered primarily out of the external sources. The broad money M2X and monetary base are expected to be increased with almost similar rates – within the range of 16-20 percent annually.

A change in the NBKR net foreign assets (NBKR NFA) will be essentially influenced by currency supply from the Transit Traffic Center of the US Department of Defense and from gold-mining companies, in addition to the standard transactions for external debt servicing and supplies of external credits and grants. Taking into account the unevenness of the interbank foreign exchange market, the NBKR will serve as a seller and as a purchaser of foreign currency, thus, implementing the exchange rate policy.

Structural weakness and dependence of the economy of our country from prices in the international goods and raw materials markets, instable internal political situation, incomplete works on developing the economic program, as well as investment and tariff policies of the government oriented at reforming the real and external trade sector of economy aiming at enhancing the domestic production capacity, improving the balance between demand and supply of goods and services; each of these factors can considerably change the conditions of monetary program and monetary indicators as well as require significant adjustments of indicators assessments for all sectors of economy including inflation assessment.

### **3.3. Conditions of Monetary Policy Objective Achievement**

Achievement of the indicated values of inflation will largely depend on fiscal policy pursued by the Government, structural reforms and economic activity in the country and in the region as well as on joint activities of the Government and local authorities for preventing short-term speculative surges of prices for primary commodities.

Achievement of the monetary policy objective in the medium-term period will become possible only in the case of observing the following conditions:

- 1) prevention of deficit and speculative surges of prices for socially significant goods at the local level;
- 2) the value of consumer goods, in particular that of primary goods, will be formed strictly based on the competitive price formation rules;
- 3) there will be conducted structural reforms and taken the proactive actions for agricultural development of the country within the activity of the existing organizations, such as Kyrgyz Agro-Food Corporation, etc;
- 4) in the process of pursuing fiscal policy there will be enhanced the measures for ensuring sustainability and balance of the state revenues receipts and even allocation of government expenditures during financial year as well as for their optimization and target use with further decrease in budget deficit;
- 5) tariffs for housing and public utilities, transport, education and communication must be regulated based on the principles of transparency, economic efficiency and social justice in order to prevent their unreasonable growth. It is also necessary to decrease losses in energy sector as quickly as possible.

## **4. CONCLUSION**

The NBKR monetary policy in the medium-term period will be oriented at maintaining moderate inflation rates and facilitate implementation of the Government's plans focused on return of macroeconomic stability.

The expected high budget deficit in the medium-term period implies that money supply will be

ensured mainly by the public finance sector. In these conditions, coordination of the Government and the National Bank actions will be of special significance. Coordination of the measures of monetary and budget policy will be implemented operatively within the interdepartmental coordination board.

Researches in monetary policy and macroeconomic simulation including those in cooperation with central banks of other countries and international financial institutions will be conducted aiming at improving the NBKR capability to achieve goals and intermediate targets of monetary policy.

To improve interest transmission channel, the NBKR will proceed with the work on enhancing the role of interest rates of the instruments of monetary policy including base rate for the SFBR.

With view of tempering the impact of US dollar exchange rate fluctuations in the foreign markets, diversification of the risks of worsening the value of the NBKR reserve assets as well as meeting the demand of the commercial banks, the NBKR will continue developing the segment of transactions with currency assets other than US dollar in the interbank foreign exchange market.

Observing the principles of maintaining the liquidity and safety of reserve assets, the international reserves are planned to be maintained at the level of covering at least 3 months of critical volume of goods and services imports in the medium-term period.

The NBKR will continue maintaining active cooperation with international financial organizations (the International Monetary Fund, the World Bank, the European Bank for Reconstruction and Development, the Asian Development Bank, the Islamic Development Bank and other organizations).

As to the payment systems, there will be taken measures for enhancing the availability (and penetration to the distant districts of the country) of bank payment services, on improving the servicing level, development and introduction of innovative systems to make retail payments such as Internet banking, mobile banking, etc.

The main objectives of the banking sector in the medium-term period will include maintaining the integrity and sustainability of the banking system and recovery of confidence of the population, which will be reflected in the increase of the financial intermediation level.