

The National Bank of the Kyrgyz Republic

**Inflation Report
Fourth Quarter of 2007**

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February 2008

Bishkek

Kyrgyz Republic Inflation Report

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This issue contains the description of the consumer price trends in the Kyrgyz Republic and its regions, analysis of major inflation factors, informs about decisions made by the National Bank of the Kyrgyz Republic on monetary policy, and also presents inflation forecast for the upcoming period. It is published on a quarterly basis in the Kyrgyz, Russian and English languages.

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Annual Report of the National Bank of the Kyrgyz Republic

This publication is a last year statement of the National Bank of the Kyrgyz Republic (NBKR). It contains brief information about the country's economic development and monetary policy, financial statements of the NBKR, general information about the NBKR, and statistic annexes. It is published in Kyrgyz, Russian and English languages.

Bulletin of the National Bank of the Kyrgyz Republic

This monthly publication contains statistic data for major macroeconomic indicators and sectors of economy of the Kyrgyz Republic. It is published in Kyrgyz, Russian and English languages.

Balance of Payments of the Kyrgyz Republic

Balance of Payments of the Kyrgyz Republic reflects trends of external sector development, data of the payment balance, foreign trade, international reserves, external debt, and international investment position of the Kyrgyz Republic. It is published on quarterly basis in January, May, July, and October in Kyrgyz, Russian and English languages.

Banking System Development Trends

This publication provides an analysis and assessment of the development of Kyrgyz banking system as a financial intermediary, and components of its stability. It is published semiannually in Kyrgyz, Russian and English languages.

Statutory Acts of the National Bank of the Kyrgyz Republic

The objective of this document is to officially publish the statutory acts of the NBKR in order to provide commercial banks and general public with regulatory documents and information about NBKR activities, and to popularize the banking legislation of the Kyrgyz Republic. It is published, as a rule, once a month in Kyrgyz and Russian languages.

Press Release of the National Bank of the Kyrgyz Republic

Press Release of the NBKR contains the description of events related to the National Bank and banking system, major financial market data for the week and other information for mass media, legal entities and individuals. It is published on a weekly basis in Kyrgyz and Russian languages.

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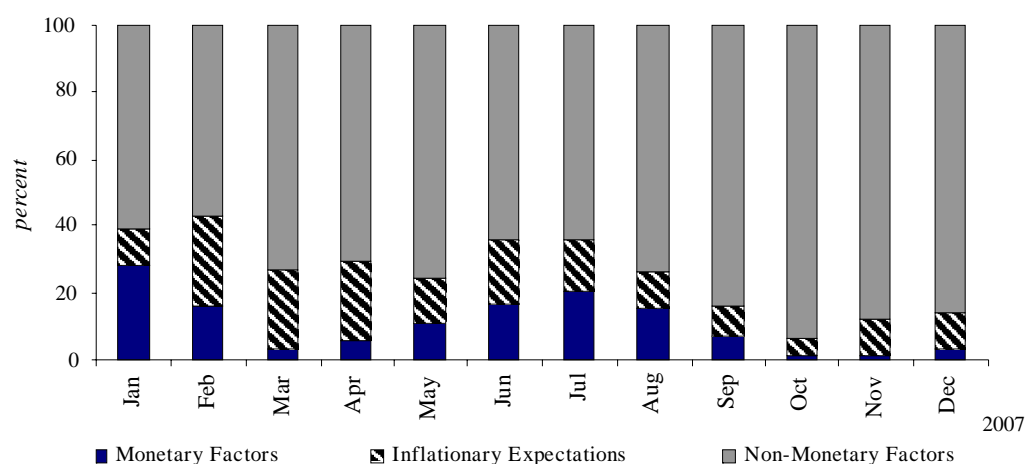
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1. CURRENT TRENDS

At the beginning of the fourth quarter of 2007, the growth of inflation rate kept accelerating to a greater extent due to the external shocks such as growing prices for grain, fuel or some food products at the international commodity markets, and to a less extent due to the growing domestic demand. Subsequently, the growth of prices for main food products slowed down. According to the National Statistics Committee of the Kyrgyz Republic, the inflation¹ for the reporting period amounted to 8.9%, and for the entire year (December 2007 against December 2006) it was 20.1%.

The general inflation rate was formed by monetary² and non-monetary³ factors. According to NBKR estimates, the impact of monetary factors, including changes in volume of currency held by the public and the exchange rate of som, amounted to 3.3%. The impact of inflationary expectations⁴ amounted to 10.7%. The major contribution to the inflation rates – 86.0% – came from the non-monetary factors.

Chart 1.1. Inflation Factors



The dynamics of inflation over the reporting period formed in the context of continued growth of economic activities, abundant supply of foreign currency, low competition in the commodity markets, increased Government consumption expenditures and continued growth of the trade balance deficit.

The National Bank of the Kyrgyz Republic increased the volume of operations to withdraw excess liquidity from the banking system in the context of inflation rate growth. In particular, the volume of NBKR notes increased resulting in the higher yield of 14-day NBKR notes by 5.5 percentage points compared to Q4 of 2006, and 6.5 percentage points increase in the yield of 28-day notes. The average interest rate of repo transactions

¹ Change in the consumer price index (CPI).

² The monetary factors contribution is estimated by assessing the effect of changes in the exchange rate of som and currency held by the public (M0) on the inflation rate, taking into account time lags and seasonality factor.

³ The non-monetary factors contribution is estimated by assessing the effect of changes in manufacturer prices, prices for bread and baked products, alcohol beverages, gasoline, housing and utility services, communication services, and passenger transportation services on the inflation rate, taking into account time lags and seasonality factor.

⁴ The contribution of inflationary expectations is estimated by assessing contribution of the inflationary inertia index, i.e. inflation of the prior period adjusted for the influence coefficient.

increased by 3.7 percentage points, and the average interest rate in the segment of interbank loans in national currency increased by 2.1 percentage points compared to the same period of the previous year.

Increased economic activity and high demand for credit resources resulted in the increased money supply mostly channeled through the foreign currency flows. In Q4 2007, the growth of the monetary base and the M2X monetary aggregate amounted to 15.2% and 11.6% accordingly.

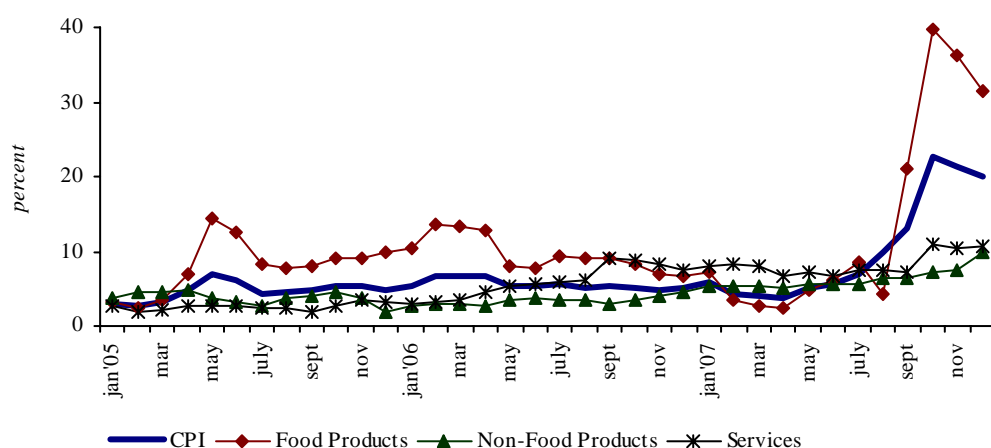
2. CONSUMER PRICE INDEX COMPONENTS

2.1. CPI COMPONENTS

According to the National Statistics Committee of the Kyrgyz Republic, the inflation rate in Q4 2007 amounted to 8.9%, which is an increase by 6.4 percentage points compared to Q4 2006.

The annual inflation rate (December 2007 against December 2006) reached 20.1% with 21.3% increase in prices for goods and 10.6% increase in prices for services. The general level of prices was determined by the high growth of prices for food products such as dairy and bakery products, oil and fats, and meat, and some types of paid services such as educational services and public catering.

Charter 2.1. Annual dynamics of inflation and its components



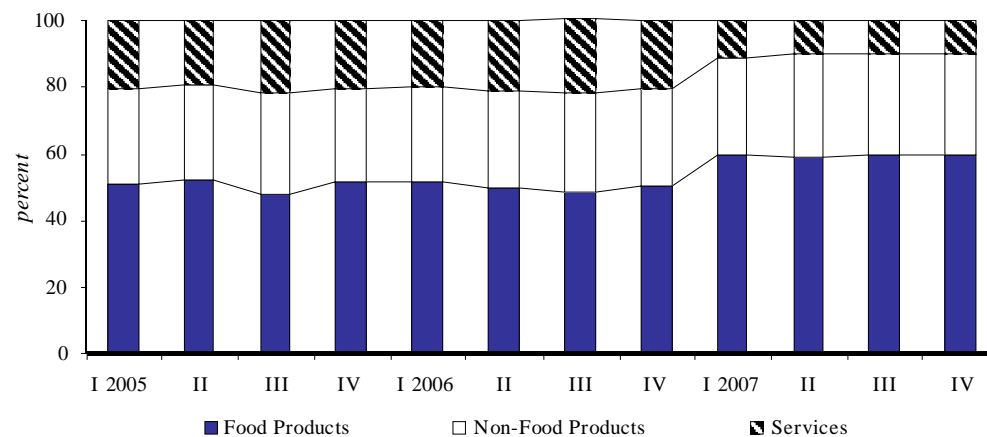
In the dynamics of inflation in Q4 of 2007 a special emphasis should be made on October when the growth of consumer prices reached 9.0% (Kyrgyzstan has not seen such price growth since February 1994). In the period from November to December 2007, the price situation in the food commodity market stabilized after the price spike in October and the growth of prices for main food products slowed down.

In the reporting period, the growth of prices for the group of *food products and soft drinks*, which among other food products constituted about 60% of the consumer basket, became the main reason for the CPI growth. The growth of prices for this commodity group amounted to 12.8%, which is 9.0 percentage points higher compared to Q4 of 2006. The growth of prices for food products, especially for bakery and dairy products, oil and fats, was determined by the increase in prices at the international commodity markets and by the increased domestic demand in the context of limited opportunities for production development.

As a result of decreased yield and planted area under grain crops, in recent years there is a stable trend of reduction in their gross yield. Total grain production (weight after processing) in the country amounted to 1,491.1 thousand tonnes, which is a decrease

by 4.6% compared to the previous year including 15.6% decrease in wheat production. The average yield of grain and legumes, including corn, amounted to 24.3 centners per ha (weight after processing) compared to 24.8 centners per ha in the previous year.

Chart 2.2. CPI Structure



In October 2007, the growth of prices for food products, which began in Q2 of 2007, reached its peak. By December 2006, the growth of prices for *bakery products and grain* amounted to 80.1% with 115.9% and 102.5% increase in prices for the first and high grade wheat flour accordingly and 91.6% increase in the price for bread. In the subsequent months the deflation in this group of products amounted to 9.7%, partially as a result of implemented actions such as de-reservation of food wheat, allotment sales, tax reduction etc. In general, the prices for bakery and grain products in Q4 2007 increased by 19.1% and by 62.6% compared to December 2006. This group's estimated contribution to the general growth of consumer prices accounted for 3.0 percentage points.

The change in the grain market trend had its effect on derivative products. For example, due to rise of grain prices the cost of forage went up, which in turn caused a growth of prices for meat products and eggs. In 2007 Q4, despite some growth in livestock

Reference:

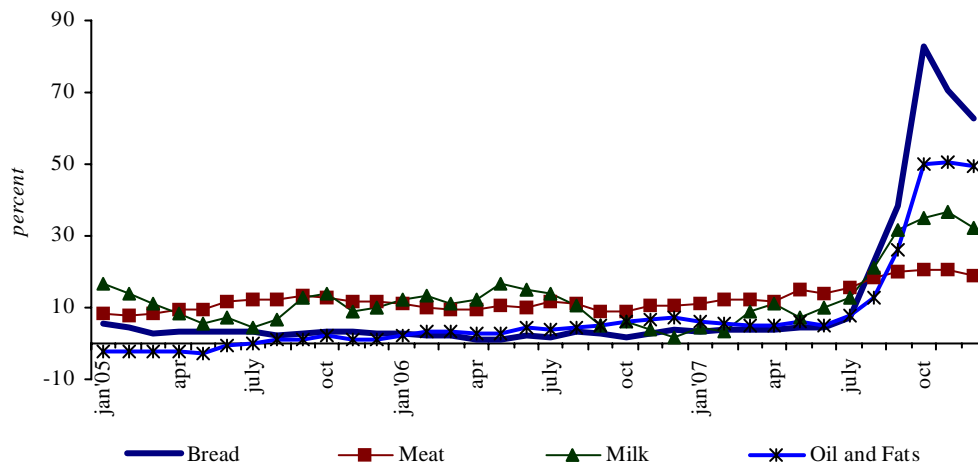
(1) Establishment of large food corporations (holdings) and the national buffer stock of grain crops is planned to facilitate development of the agro-industrial sector in the country. These projects will be part of the three year agro-industrial sector development Program for 2008–2010. National grain stock will be formed under the State Food Corporation with the annual amount of 100–150 thousand tonnes of grain apart from the State Reserve stock.

(2) Due to the forthcoming spring agricultural operations, it is planned to allocate 10,000 cubic meters of diesel fuel and high quality seed from the State Reserve to peasant farms in the form of trade credit. In addition, agricultural machinery in the amount of 200 million soms and fertilizers in the amount of 30 million soms will be purchased. To provide commodity producers with credit, JSC Ayil Bank will lend loans in the amount of 100 million soms at 7% annual interest rate.

production, the prices for meat products increased by 20.0% compared to the same quarter of the previous year.

In Q4 2007, the price growth trend continued for dairy products, oil and fats. Prices for this group of food products increased by 13.8% and 19.9% accordingly. The group's contribution to the general price growth accounted for 0.9 percentage points.

Chart 2.3. Annual dynamics of prices for food products



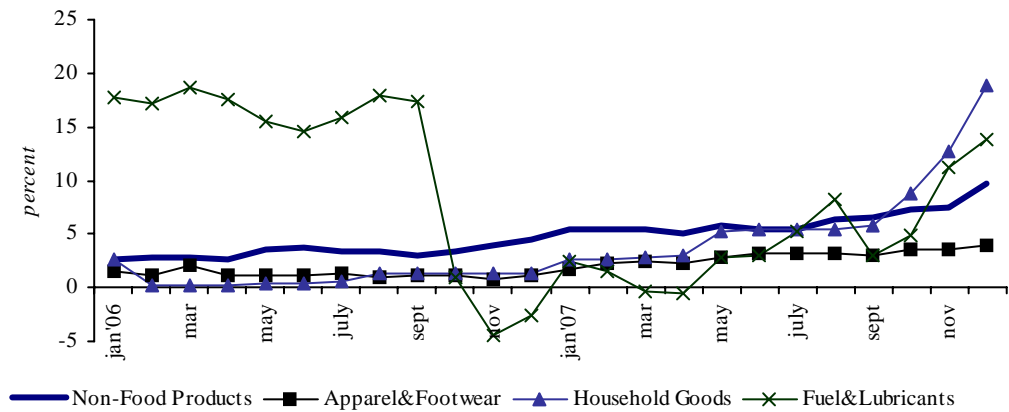
After the seasonal reduction of prices for fruit and vegetables in the third quarter, the growth of prices for this commodity group from October to December of 2007 amounted to 21.2%. Considerable growth of fruit prices amounted to 55.5% compared to the same period of the previous year. One of the causes of fruit price increase was a growing demand from the neighboring countries. According to the preliminary data, the fruit export increased in 2007 2.1 times in volume and 2.9 times in value terms. This group's estimated contribution to the general growth of consumer prices accounted for 1.8 percentage points.

In Q4 2007, the growth of prices for alcohol and tobacco products amounted to 6.3% (0.6% in Q4 2006).

In Q4 2007, the price index for non-food products increased by 4.8%. A trend of rising prices for fuel and lubricants was observed from May 2007. The growth of prices for this group amounted to 4.9% in Q4, including 5.3% growth of gasoline prices, and 3.4% growth of prices for diesel fuel. The price rise for fuel and lubricants was caused by an increase in the prices of a major domestic wholesale supplier; the retail prices were also affected by the rise in the sales prices of petroleum refinery.

After the growth trend in the first half of 2007, the correction of prices for construction materials took place in the reporting period. In Q4 2007, the deflation amounted to 3.2%, but compared to the same period of 2006, the prices rose by 28.4% due to the high internal and external demand. According to the National Statistics Committee of the Kyrgyz Republic, the total volume of gross product in the construction sector in 2007 was 20.2% higher than in 2006; the preliminary data shows 52.8% increase in construction materials export.

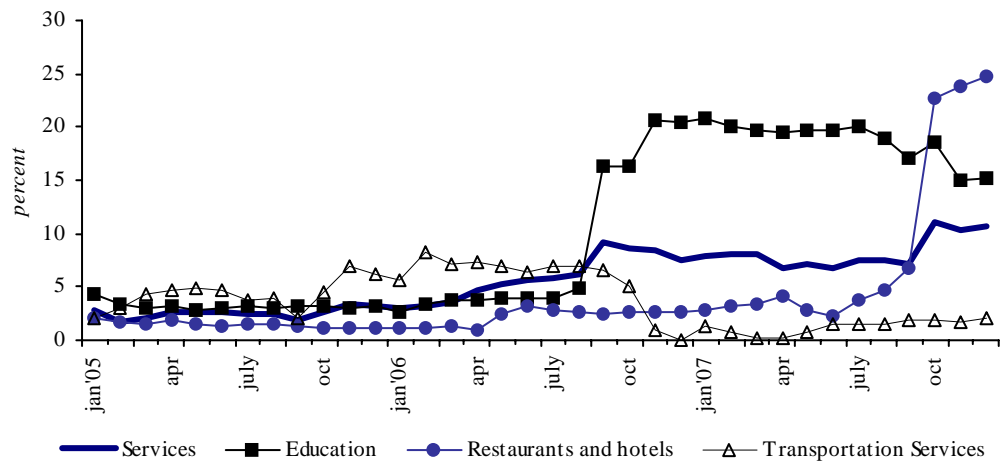
Chart 2.4. Annual dynamics of prices for non-food products



The CPI for paid services grew by 4.5% in Q4 2007 (against 1.1% in Q4 2006). The dynamics of prices and tariffs in this group was affected by the 17.9% growth of prices for public catering services. The cost of services in the education and health sectors went up by 2.2% and 0.6% accordingly.

On an annualized basis, the CPI for paid services grew by 10.6%, including 25.9% increase in prices for public catering services.

Chart 2.5. Annual dynamics of prices for paid services

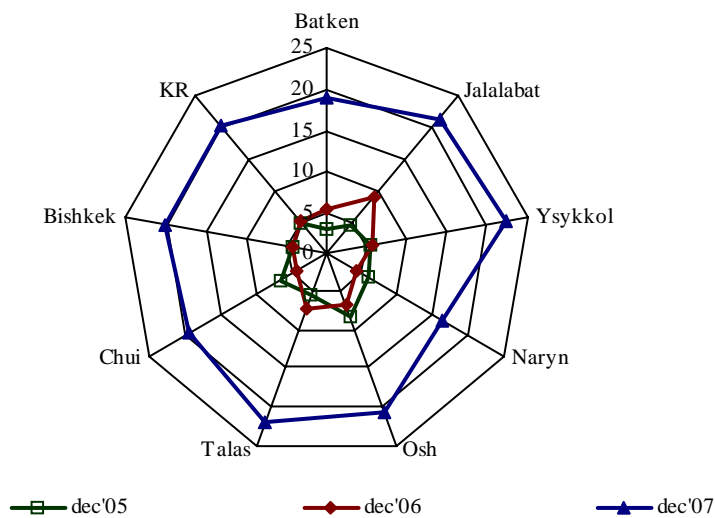


2.2. CONSUMER PRICE DYNAMICS IN REGIONS

Over Q4 2007, the consumer price growth in all KR regions was considerably higher than the growth in the same period of the previous year. The highest rise occurred in Talas (14.6%) and Ysykkol (10.2%) oblasts. Despite of the price rise in all the oblasts as the main factor of price increase for food products, the average food prices in the regions varied. For example, food prices rose by 20.6% in Talas oblast, while the prices rose by 7.6% in Osh oblast.

In Bishkek, the prices grew by 9.5% with a 14.3% increase in food prices.

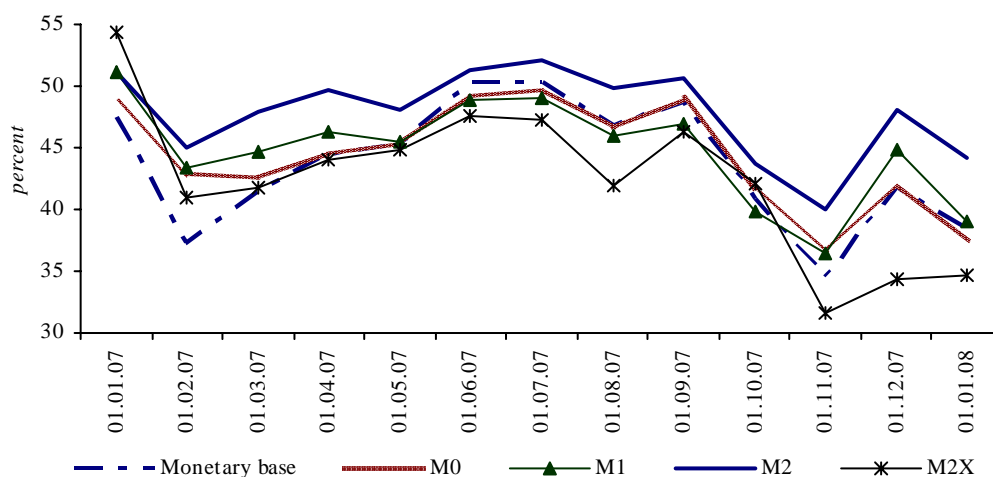
Chart 2.6. Annual dynamics of inflation by oblasts



3. INFLATION FACTORS

3.1. MONETARY AGGREGATES

Chart 3.1. Annual nominal growth rate of monetary aggregates



3.1.1 Monetary base

As of January 1, 2008, the monetary base amounted to 31,575.9 million soms. In Q4 2007, it grew by 15.2% in nominal terms and by 5.7% in real terms. The annual growth of the monetary base amounted to 38.5% in nominal terms and 15.3% in real terms.

Analysis of sources of monetary base formation indicates that the monetary base growth in 2007 was affected by the increase in NBKR net foreign assets by 45.4% (their contribution to the monetary base change was 49.7%) due to the 48.6% increase in net international reserves.

The impact of the change in volume of net domestic assets on the monetary base growth was negative in the reporting period (-11.2%), which was mostly due to the increased volume of Government deposits and, as a result, a decrease in net liabilities of the KR Government to the NBKR.

Change in the monetary base in the context of operations (in the reporting period the growth amounted to 4,141.5 million soms) was related to the operations of the KR Government, mostly due to the excess of the government budget expenditure over income by 3,144.8 million soms. The National Bank operations increased the reserve money volume by 996.8 million soms, mostly due to the NBKR currency interventions (1,814.9 million soms). At the same time, NBKR open market operations with the KR Government securities (REPO) and NBKR notes partially reduced the monetary base by 1,006.2 million soms.

Over Q4 2007, the monetary base structure changed in the following way: the share of cash in circulation decreased from 88.8% to 87.3%. Therefore, the share of commercial banks' funds in correspondent accounts with NBKR increased from 11.2% to 12.7%.

In the reporting period, money in circulation increased by 13.3% and totaled 27,561.9 million soms as of January 1, 2008. The growth rate of money in circulation for 2007 amounted to 38.4%, which is lower than the previous year growth rates (48.4% for 2006).

3.1.2. M2 aggregate

As of January 1, 2008, the M2 monetary aggregate in the national currency totaled 34,768.7 million soms. The increase of M2 aggregate in Q4 2007 amounted to 15.4% in nominal terms and 5.9% in real terms. On the annualized basis, the M2 monetary aggregate increased by 44.2% in nominal terms and by 20.1% in real terms.

The increase in M2 monetary aggregate in the reporting period was caused by the growth of currency held by the public by 13.2% and deposits in the national currency by 23.3%. The growth of transferable (demand) deposits and other (time) deposits amounted to 20.9% and 27.2% accordingly. In 2007, the growth of deposits in the national currency accounted for 72.3%, which exceeds the growth rates in 2006 (62.3%).

The M2 broad money multiplier increased compared to the beginning of the year and as of January 1, 2008 amounted to 1.101 (as of October 1, 2007 it was 1.099).

3.1.3. M2X aggregate

The M2X monetary aggregate which includes deposits in foreign currency increased by 11.6% in the reporting period and totaled 43,018.0 million soms as of January 1, 2008 (against 38,537.3 million soms as of October 1, 2007).

The growth of broad money was caused by the growth of the deposit base of commercial banks¹ by 9.1% and the growth of currency held by the public by 13.2%. At the same time, deposits in foreign currency decreased by 1.9%, and their annualized volume went up by 0.9% (December 2007 against December 2006). In Q4 2006, these deposits increased by 28.6% and on the annualized basis they increased by 53.1% (December 2006 against December 2005).

Compared to the beginning of 2007, the structure of M2X monetary aggregate changed as follows:

- the share of currency held by the public increased from 60.0% to 61.2% (60.8% as of October 1, 2007);
- the share of deposits in the national currency grew from 14.5% to 18.6% (17.0% as of October 1, 2007);
- the share of deposits in foreign currency reduced from 25.5% to 20.2% (22.2% as of October 1, 2007).

The analysis of M2X broad money formation sources indicates that the major impact on its change, since the beginning of 2007, was made by an increase in net foreign

¹ Including the data of commercial banks which had their licenses revoked but which are still going through the liquidation process.

assets of the banking system, mostly due to increase in the net foreign reserves of the National Bank and the net domestic assets of the banking system due to the 79.7% growth of credits in the economy.

The broad money multiplier decreased compared to the beginning of 2007, and amounted to 1.362 as of January 1, 2008 (against 1.406 as of October 1, 2007).

The circulation rate of M2X broad money including deposits in foreign currency at the fixed exchange rate amounted to 4.0 as of January 1, 2008 (it was 4.0 as of October 1, 2007). The economy monetization ratio calculated based on M2X monetary aggregate amounted 25.3% (against 25.2% as of October 1, 2007).

3.2. INTEREST RATES

3.2.1. Money market

In Q4 2007, interest rates at the interbank market of credit resources were affected by fluctuations of the liquidity level and its concentration in the banking system as well as the measures taken by the National Bank on tightening monetary policy in the context of accelerated inflation rates.

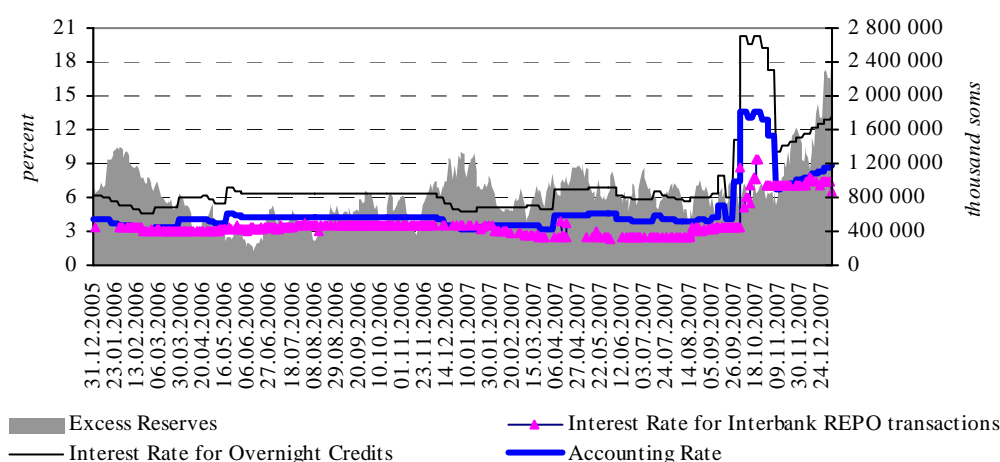
Using the NBKR notes as an instrument of excessive liquidity withdrawal, the National Bank continued to increase the volume of issues of 14 and 28-day NBKR notes, and starting in November it commenced issuing 3 and 6-month NBKR notes. The volume of notes offered by NBKR on a weekly basis increased from 150 million soms to 460 million soms. At the end of December, additional notes in the amount of 520.0 million soms were placed outside the auctions. At the beginning of October, the demand for notes grew slower than their supply, and the declared volume of issues at the auctions in the same period significantly exceeded the volume of bids, which affected their yield increase. Later on, the market adapted to the new conditions facilitated by the seasonal growth of excessive liquidity in the banking system: the demand for 14-day and 28-day notes significantly increased, while their yield went down, and by the end of the year the figures reached 8.0% and 8.4%, accordingly. The demand for 3-month and 6-month NBKR notes remained low due to their novelty in the market as well as the short-term nature of excessive liquidity of commercial banks. On average for Q4, the yield of 14-day NBKR notes grew by 5.4 percentage points compared to Q3 2007 and amounted to 9.3%. The yield of 28-day notes increased by 6.1 percentage points and amounted to 10.3%. The average yield of 3-month NBKR notes for the period amounted to 9.6%. Compared to Q4 2006, the yield of 14-day NBKR notes increased by 5.5 percentage points and the yield of 28-day notes grew by 6.5 percentage points.

Starting on November 8, the interest rate initially pegged to the current yield of 28-day NBKR notes began to be estimated as an averaged value of 28-day NBKR notes formed over the last 20 auctions. By the end of the period, the interest rate rose by 1.4 percentage points compared to the beginning of the period and amounted to 8.8%. At the end of the period, the interest rate for overnight credits set to 1.5 times discount rate amounted to 13.2%. The NBKR performed no transactions for refinancing commercial banks by means of overnight credits in the reporting period.

The cost of interbank credits in the national currency as well as its volatility at the beginning of the reporting period significantly rose, affected by the increased yield of NBKR notes in the market. Further on, the situation stabilized and the interest rates for interbank credits fluctuated within narrower range. The average interest rate of repo transactions for the reporting period increased by 4.4 percentage points compared to the previous period and amounted to 7.2%. The cost of interbank credits in the national currency rose by 2.3 percentage points up to 4.7%. Compared to Q4 2006, the average interest rate of repo operations increased by 3.7 percentage points, and the rate of interbank credits in the national currency grew by 2.1 percentage points.

Interest rates in the foreign exchange segment of the domestic interbank credit market fluctuated within the range of 2.8% and 6.0% depending on transaction term. In the reporting period, the average cost of foreign exchange interbank credits increased by 0.1 percentage points compared to the previous period and amounted to 6.5%. In comparison with the corresponding quarter of 2006, the interest rates of these credits increased by 2.1 percentage points, mostly due to the extension of credit terms.

Chart 3.2. Interest Rates in Monetary Market



In Q4 2007, in order to withdraw excessive liquidity out of the banking system, the National Bank announced repo auctions on STB(s) sales, making reverse repo contracts with the commercial banks for the amount of 745.5 million soms. In comparison with the previous quarter, the volume of NBKR repo transactions decreased by 62.4%, their weighted average rate rose by 2.5 percentage points up to 6.7%, and the maturity of transactions increased from 30 to 40 days. Also in the reporting period, the transaction on placing commercial banks' funds in NBKR time deposit accounts was executed in the amount of 80.0 million soms at the rate of 1.8% for a term of 7 days.

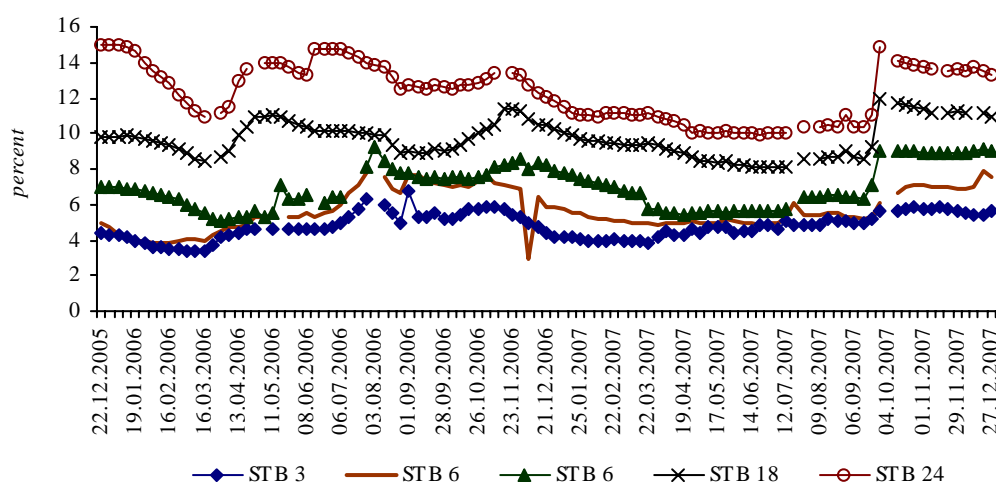
NBKR managed to withdraw 1,212.1 million soms of excessive bank liquidity through reversed swap transactions in the amount of USD 34.5 million in Q4. The average maturity of these transactions amounted to 50 days.

3.2.2. State treasury bills

In the first week of October, bids for all types of STB in the primary STB market were considered void due to the high yield volatility. Later on, the situation in the market

stabilized, and the yield of bills in Q4 2007 fluctuated within a narrow range. The yield of 18-month and 24-month bills went down, while the yield of 6-month STB went up.

Chart 3.3. STB Yield



The total weighted average yield of STB in Q4 amounted to 8.9%, having increased by 1.8 percentage points compared to the previous quarter. The yield growth was observed in all the segments of STB market.

In comparison with Q4 2006, the overall yield of STB went down by 0.4 percentage points due to the decreased ratio of long-term bills (from 80.2% down to 53.7%), while the yield went up in all segments of STB market.

3.3. EXCHANGE RATE

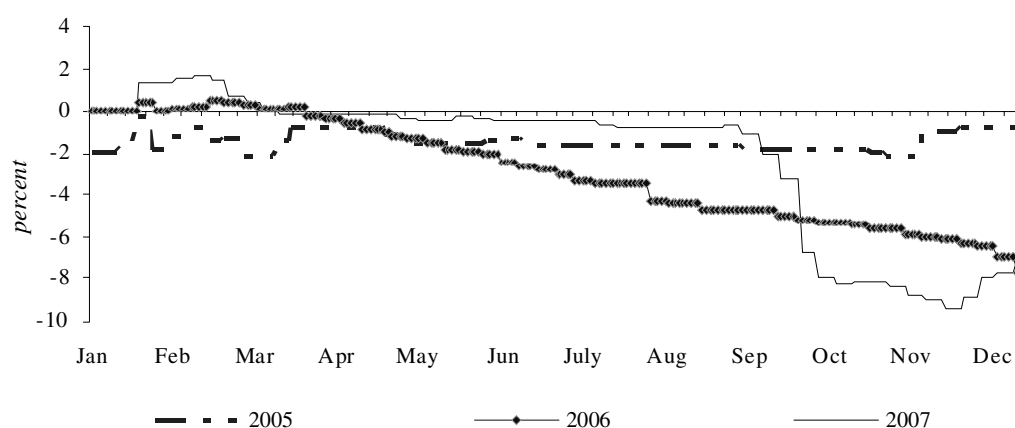
From October to November 2007, the situation in the currency exchange market developed in the context of excessive supply of foreign currency in the domestic market as a result of labor migrants' money transfers, a seasonal influx of income from sales of agricultural produce as well as the National Bank's actions on tightening monetary policy. At the beginning of October, the US dollar exchange rate continued to drop followed by the decrease in fluctuations of the range. Starting at the end of November, the US dollar appreciated due to the increased demand for the foreign currency from some commercial banks and the growing US dollar exchange rate against the main world currencies in the international markets. The dollar started to go down again only at the end of December. In the context of increased US dollar volatility, in the reporting period the National Bank conducted transactions on both buying and selling US dollars in an attempt to smooth its violent fluctuations.

At the end of the reporting period, the weighted average dollar exchange rate amounted to 35.2709 soms per US dollar, having decreased by 4.1% over the quarter. The dollar selling rate in exchange offices decreased by 1.9% and amounted to 35.5361 soms per US dollar by the end of December.

At the end of the reporting period, the official exchange rate of US dollar amounted to 35.4988 soms per US dollar, having decreased by 3.8% over the quarter. For

comparison, in the same period of the last year, the dollar official exchange rate went down by 2.8% over the quarter and amounted to 38.1238 soms per US dollar.

Chart 3.4. USD Exchange Rate



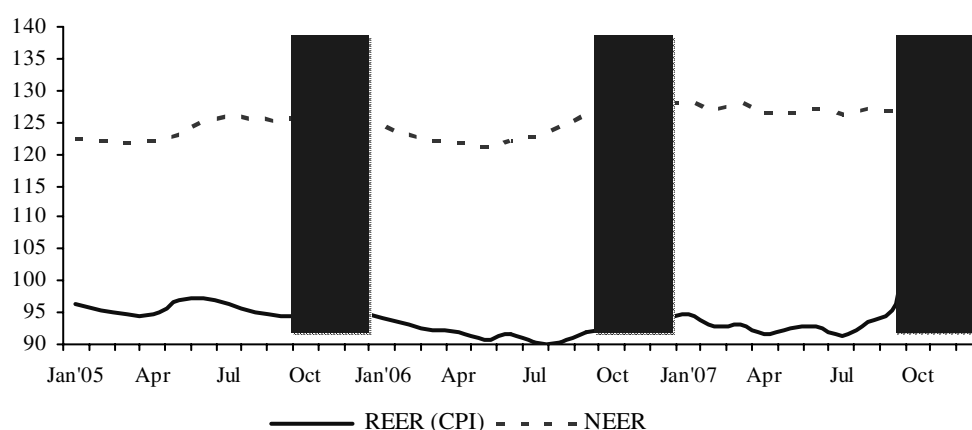
The dynamics of euro exchange rate, as usual, was mostly affected by its fluctuations in the international markets as well as changes in the som exchange rate against the US dollar in the domestic market. At the beginning of October, euro maintained the downward trend, which started in December, followed by its appreciation until the end of the quarter. There were no significant changes of euro selling rate in exchange offices over the quarter, and by the end of December it amounted to 52.1993 soms per euro. The official exchange rate amounted to 52.0111 soms per euro at the end of the period, having decreased by 1.0% over the quarter.

According to the preliminary data, the average nominal effective exchange rate (NEER) of som increased by 4.7% in Q4 2007 compared to the previous quarter, and by 4.0% compared to the corresponding period of 2006. At the end of December 2007, the NEER index amounted to 132.4, having increased by 3.6% compared to December 2006 due to the decreased exchange rates of US dollar, Russian ruble and Kazakh tenge against the som.

In Q4 2007, the average real effective exchange rate (REER) of som increased by 12.6% compared to the previous quarter, and by 13.3% compared to the corresponding

Chart 3.5. Indices of Real Effective Exchange Rate (REER) and Nominal Effective Exchange Rate (NEER)

Index 2000=100



period of 2006. At the end of December 2007, the REER index amounted to 104.1, having increased by 11.4% compared to December 2006. The major factors of REER index growth in 2007 included a decrease in the exchange rates of major currencies against the som observed from the end of Q3 and escalation of the inflation rate in Kyrgyzstan.

In Q4 2007, the inflation rate in the Kyrgyz Republic amounted to 8.9%, while according to the preliminary estimates, the inflation rate of the main trade partner countries amounted to 4.3%. By the end of 2007, inflation in the Kyrgyz Republic reached 20.1%, while it amounted to the average of 12.0% in the major trade partner countries.

3.4. DEMAND AND SUPPLY

3.4.1. External demand

According to the preliminary data, the trade balance of the Kyrgyz Republic in the fourth quarter of 2007 was negative, and the deficit growth trend maintained due to the excess of the growth rate of imports over exports.

3.4.2. Internal demand

3.4.2.1. Private consumption

A significant increase of consumer activity was noted in 2007. The consumption structure of GDP observed a trend of accelerated growth in household expenditures for final consumption. Such dynamics of private consumption is the evidence of growing disposable income of citizens due to an increase in labor migrants' remittances for the last few years. The wage push also makes a significant impact on the growth of income. In 2007, the nominal month wages (excluding small enterprises) rose by almost one-third compared to the previous year, and in real terms, the growth amounted to 19.0%.

3.4.2.2. Government expenditures

In the reporting period, the current consumption constituted a major share in the expenditures, which affected changes mostly in the cash segment of money supply in the country. Following the results of the 2007 government budget implementation, wage expenditures and transfers to the Social Fund of KR constituted 39.7% of the total government expenditures, having increased by 30.0% in real terms² compared to 2006. In 2007, the government budget income grew in real terms¹ by 28.5% compared to the previous year. The surplus of funds within the reporting period (excluding Public Investment Program) totaled 130.0 million soms, which constituted 0.1% of GDP.

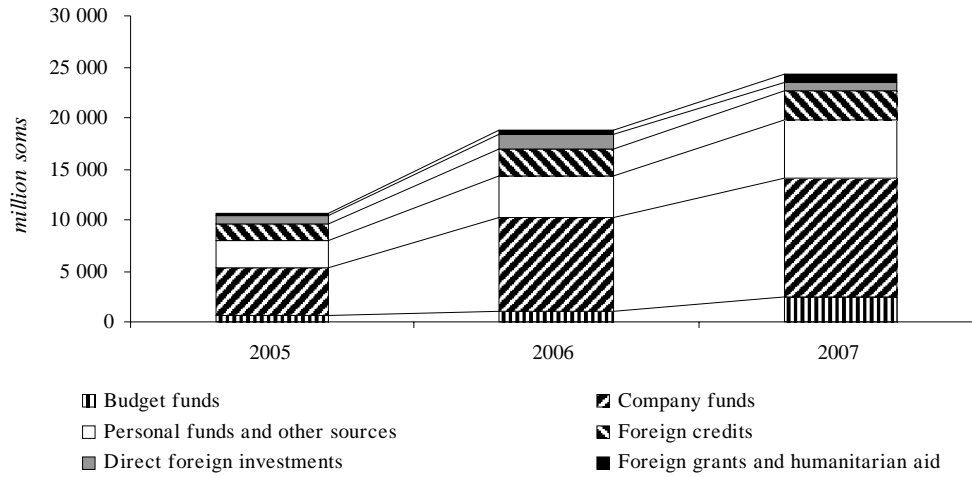
3.4.2.3. Investments

In 2007, capital investments growth in real terms amounted to 3.7% against 54.6% in 2006 (including adjusted data and review of capital investment volumes in 2006). In Q4 2007, the level of assimilation of capital investments increased by 5.7% compared to the corresponding period of the previous year and amounted to 9,842.4 million

² Adjusted to CPI.

soms. As before, the major share belonged to subcontract works amounting to 16,373.5 million soms. The capital investments were mostly financed by the companies' equity and personal funds.

Chart 3.6. Structure of Capital Investments

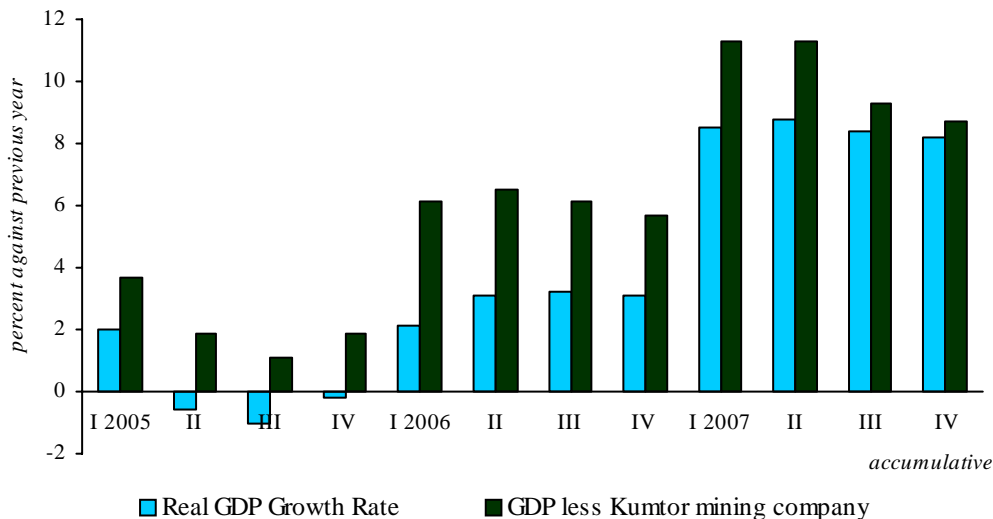


The largest share in the total volume of realized investments belonged to housing construction (23.0%), mining industry (15.7%), processing (10.0%), electric power, gas and water production and distribution (7.6%), and transportation and communications (12.7%).

3.4.3. Gross domestic product

In 2007, there was a significant surge of economic activities in KR. According to the preliminary data by the KR National Statistics Committee, the growth rate of real GDP amounted to 8.2% in 2007 (against 3.1% in the period from January to December 2006, according to the updated data). The real GDP grew up due to an increase in production volume in the following economic sectors: transportation and communications – by 44.4% (3,058.8 million soms); retail – by 11.2% (2,340.9 million soms); industrial production – by 7.3% (1,233.5 million soms); and construction – by 20.2% (614.5

Chart 3.7. Real GDP Growth



million soms). The growth in agriculture sector maintained; in the reporting year, the GDP share of this sector increased by 1.5% or 505.4 million soms. The growth of GDP (net of Kumtor gold mining company) in real terms amounted to 8.7% against 6.1% in 2006.

In the industry structure of GDP, the agriculture had the largest share which in 2007 decreased by 1.8 percentage points down to 26.9%. The share of the service sector increased by 2.0 percentage points up to 8.1% due to the dynamic growth of transportation and communications sector and the share of the retail sector grew from 18.4% up to 18.9%. The industrial production did not change much in the reporting period compared to 2006 and constituted 14.8% of the GDP. The share of taxes on food products remained at the level of 12.5%.

4. MAJOR DECISIONS ON MONETARY POLICY

4.1. MAJOR DECISIONS OF THE BOARD

The following is the list of decisions made by the NBKR Board during the fourth quarter of 2007:

1. On October 30, 2007 revisions and amendments to the *Regulation on Issuing, Placing, Circulating, and Repaying NBKR notes* approved by the NBKR Board Resolution 42/1 dated September 19, 2007 (KRMJ Registration No 95-07 as of October 17, 2007) came into effect. These revisions and amendments were made to expand instruments of regulating liquidity levels in the banking system.
2. According to the NBKR Board Resolution 42/3 dated September 19, 2007, *On the NBKR Discount Rate*, from November 8, 2007 the NBKR discount rate is estimated as the average yield of 28-day NBKR notes over the last 20 auctions on NBKR notes placement.
3. On November 30, 2007, the new edition of the *Regulation on the Procedure for Holding Auctions on Placement of the Kyrgyz Republic State Treasury Bills via the NBKR* approved by the NBKR Board Resolution 42/4 dated September 19, 2007 (KRMJ Registration No 102-07 as of October 26, 2007) came into effect.
4. On November 30, 2007, the NBKR Board reviewed and adopted *The Report on Monetary Policy for Nine Months of 2007*. (NBKR Board Resolution No 51/1)
5. On December 20, 2007, the Board of the National Bank of the Kyrgyz Republic reviewed and approved the following:
 - *Major Guidelines of the NBKR Monetary Policy for 2008 – 2010* (Resolution 54/1). This document sets medium-term target milestones of the NBKR monetary policy. The main goal of the NBKR monetary policy in the medium term is maintaining price stability as the most important condition for sustainable economic growth.
 - *Statement of the National Bank of the Kyrgyz Republic on the Monetary Policy for 2008* (Resolution 54/2). The main goal of the NBKR monetary policy in 2008 is to lower public expectations of growing inflation and to achieve and maintain stable general price levels as one of the main conditions for sustainable economic growth in the medium term. The NBKR jointly with the KR Government will take appropriate coordinated steps to keep consumer price growth within 12–15%.

4.2. MAJOR DECISIONS OF THE MONETARY REGULATION COMMITTEE

The Monetary Regulation Committee (hereinafter – “the Committee”) develops and adopts current decisions required for monetary regulation. The Committee makes decisions based on monetary market situation assessment on a weekly basis. The Committee determines volumes of transactions considering the situation in the banking system and in the fiscal area as well as the monetary policy targets in the framework of programs aimed at poverty reduction and facilitation of the economic growth. These targets are specified in the *NBKR Statement on Monetary Policy for 2007* and *Major Guidelines of the Monetary Policy for 2007-2009*.

The following are the Committee recommendations:

1. In order to regulate liquidity in the banking system, it is recommended to hold auctions on securities sales under REPO terms. The sales of STB(s) in the reporting period amounted to 745.5 million soms, and the volume of repurchases amounted to 1,025.2 million soms.

2. Considering the overall liquidity of the banking system and the growing demand on the part of commercial banks, the NBKR increased the recommended volume of sales of 14-day notes at weekly auctions from 75 to 160 million soms and of 28-day notes – from 75 to 320 million soms. From November in the reporting period, the NBKR introduced into circulation 91-day and 182-day notes.

In the reporting period, 12 out of 13 announced auctions on the NBKR 14-day notes sales took place and one auction was recognized void due to the high yield volatility. The demand slightly exceeded the supply, while the number of participants grew from 5 (at the end of September) to 7–8 (at the end of December 2007). All 14 announced auctions on the NBKR 28-day notes sales were recognized as effective. In addition, at the end of December, the NBKR conducted two additional placements of the NBKR 28-day notes. The demand was twice as much as the volume of sales and the number of participants varied from 4 to 9. Out of 9 announced auctions on the NBKR 91-day and 182-day notes only 5 auctions on 91-day notes sales took place, while the rest were recognized void due to insufficient number of participants and/or high yield volatility.

A weighted average yield of 14-day notes increased from 6.10% as of the end of September 2007 up to 7.95% as of the end of 2007 (against 2.92%, as of the end of December 2006), while the yield of 28-day notes increased from 7.43% as of the end of September 2007 up to 8.37% as of the end of 2007 (against 3.15% as of the end of December of 2006), and the yield of 91-day notes decreased from 9.94% as of the beginning of November 2007 down to 9.52% as of the end of 2007.

The NBKR discount rate used to define refinancing rates and as the benchmark for formation of market rates amounted to 8.79% by the end of December 2007.

3. In order to regulate excessive liquidity of the banking system, it is recommended to take time deposits from commercial banks for the period of 7 days and 1 month at the rate of 1.8% and 2.0%, accordingly. The minimal deposit volume is set at 10.0 million

soms. In the reporting period, one deposit transaction was made with a commercial bank in the amount of 80.0 million soms with the maturity of 7 days. In total for 2007, the National Bank made 45 transactions for the total amount of 1,664.0 million soms.

4. In Q4 2007, there were no significant fluctuations of yield in the STB market, while the demand considerably exceeded the supply. By the end of 2007, the 3-month STB yield did not change compared to the end of September and remained at the level of 5.62%. The fluctuation range was not high between 5.41% and 5.9%. The yield of 6-month STB increased from 6.05% up to 7.49% with 6.05%-7.88% change range. Interest rates on long-term securities went down. The yield of 12-month STB came down from 9.06% to 9.05%, 18-month STB – from 11.91% to 10.96%, 24-month STB – from 14.82 to 13.35%.

5. Following the policy of floating exchange rate, the NBKR is recommended to aim its activities in the foreign exchange market at smoothing drastic fluctuations of the exchange rate of som to US dollar.

Accordingly, in Q4 2007, the NBKR conducted transactions on both buying and selling foreign currency in the domestic foreign exchange market. The volume of purchases (USD 89.0 million) significantly exceeded the volume of sales (USD 21.2 million). The National Bank's volume of net purchases from October to December 2007 totaled USD 67.8 million.

There were no transactions with cash foreign currency.

In Q4 2007, the official exchange rate of som to US dollar went up by 3.8% and by 6.9% compared to the beginning of 2007; by the end of December it amounted to 35.4988 soms per US dollar (against 38.1238 soms per US dollar as of the end of December 2006).

6. In order to control liquidity in the banking system, in the event of demand on the part of commercial banks, it is recommended to conduct reverse swap transactions with foreign currency. The total volume of swap transactions conducted by the National Bank in the reporting period amounted to USD 34.5 million with USD 48.9 million for the year.

7. In order to regulate liquidity in the banking system, it is recommended to start transactions on euro sales in the inter-bank currency market via the NBKR Electronic Trading System with the set limit on sales in the amount of 1 million euro per week. One sales transaction in the amount of 200.0 thousand euro was conducted in the reporting period.

4.3. INFLATION PROJECTIONS FOR THE FIRST QUARTER OF 2008

Monetary policy target guidelines of the National Bank of the Kyrgyz Republic and measures for their achievement are presented in the *Major Guidelines of the NBKR Monetary Policy for 2008–2010*.

In 2008, the NBKR jointly with the KR Government will take required concerted steps to keep consumer price growth within 12–15% (December against December of the previous year). In 2008, inflation dynamics will be affected by the existing risks of external shock impact on the country's macroeconomic situation as well as by such factors as growing internal and external aggregate demand, changes in the external business environment, expected increase of natural monopoly tariffs, growth of wages in the government sector, growing volatility of the som exchange rate, and decreasing dollarization of the economy as well as seasonal fluctuations of prices for agricultural produce.

In Q1 2008, the inflation is expected to be affected by the seasonal factor, growing average prices for dairy, meat, fruit and vegetable products, as well as natural gas tariff rise due to the increased purchasing price for natural gas from Uzbekistan from January 1, 2008.

Based on these assumptions, it is expected that in Q1 2008 inflation will be at the level of 4.4%.

Chart 4.1. Inflation Dynamics

