

KYRGYZ REPUBLIC

Economic Update
Fall/Winter 2018

Weak growth despite emerging regional opportunities

With a special focus on:

agriculture potential for growth and development



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Kyrgyz Republic Economic Update No. 8

Fall/Winter 2018

Government Fiscal Year: January 1 – December 31
Currency Equivalents: Exchange Rate Effective as of October 31, 2018
Currency Unit = Kyrgyz Som (KGS)
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Weights and Measures: Metric System

Abbreviations and Acronyms

EEU	Eurasian Economic Union
GDP	Gross Domestic Product
GoKR	Government of the Kyrgyz Republic
KGS	Kyrgyz Som
NBKR	National Bank of the Kyrgyz Republic
FDI	Foreign Direct Investment
VAT	Value-added tax
GNI	Gross National Income
PIP	Public Investment Project
KIHS	Kyrgyz Integrated Household Survey
IMF	International Monetary Fund
NPL	Non-Performing Loan
ROA	Returns on Asset
ROE	Returns on Equity
REER	Real Effective Exchange Rate

Table of Contents

Foreword	iv
Overview	1
A. Recent Socio-Economic Developments	1
Growth and inflation	1
External sector	3
Financial sector	5
Social sector	5
B. Macroeconomic and Structural Policies.....	6
Fiscal, monetary and exchange rate policies.....	6
C. Economic Outlook and Risks.....	10
Special Focus: Agricultural Potential for Growth and Development	12

Figures

Figure 1: Real GDP Growth	3
Figure 2: Contribution to Growth	3
Figure 3: Inflation (percent)	3
Figure 4: Consumer price index and Exchange rate.....	3
Figure 5: Trade and Current Account Balances (in percent of GDP).....	4
Figure 6: Exports and Imports (in millions of US\$).....	4
Figure 7: Lending Interest Rates	8
Figure 8: Nominal Exchange Rate (KGS/USD).....	9
Figure 9: Nominal Exchange Rate and NBKR Interventions (KGS/USD)	9
Figure 10: Nominal Exchange Rate	9
Figure 11: Nominal Exchange Rate	9
Figure 12: Nominal and Real Effective Exchange Rates (index, 2010=100).....	10
Figure 13: Agriculture Annual Growth Rate and Value-Added Contribution to GDP	12
Figure 14: Growth in Labor Productivity was mainly driven by outflow of farm labor	13
Figure 15: The Depth of the Food Processing Industry (Food Manufacturing/Agriculture Value Added), average, 2006-13.....	14
Figure 16: Fresh fruits and vegetables are major agri-food export.....	15

Tables

Table 1: Key Macroeconomic Indicators, 2014-2018.....	2
Table 2: General Government Fiscal Accounts.....	7
Table 3: General Government Fiscal Accounts.....	11

Annexes

Annex 1: Selected Macroeconomic and Social Indicators, 2014–2020	1
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Foreword

This edition of the Kyrgyz Republic *Country Economic Update* is part of a semi-annual series designed to monitor socio-economic developments in the Kyrgyz Republic. The first part of the Economic Update analyzes recent macroeconomic trends and presents an assessment of the country's short- and medium-term outlook. The Special Focus Section discusses the challenges and the potential contribution of the agri-food production in the Kyrgyz economy.

This edition of the Economic Update was prepared by Bakyt Dubashov (Senior Economist) and Appolonia Mbowe (Senior Economist) with the help of Saida Ismailakhunova (Poverty Economist) on the social sector section. The Special Focus Section was prepared by Appolonia Mbowe and Sergiy Zorya (Lead Agriculture Specialist).

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Overview

Real GDP growth slowed to 3.1 percent in January-November 2018 from 3.7 percent in the same period of 2017. This deceleration was the result of slower growth in both gold production and non-gold industry. Export performance remains weak, largely on account of a sharp slowdown in gold exports, and in spite of trade opportunities within the Eurasian Economic Union. Attracting private investment remains a challenge. Recent developments point to limited progress in addressing structural issues over the past few years. While the Kyrgyz Republic was able to avoid an external shock driven recession in 2014-15, the economy remains vulnerable to external economic shocks given its high dependence on an undiversified export base, workers' remittances, and foreign aid.

The fiscal position has improved with a strong tax revenue performance and cuts to capital outlays. This has helped keeping public debt under control following a sharp increase in 2014-15. With inflation pressures low, the monetary policy stance remains relaxed. The National Bank reduced its policy rate by 25 basis points to 4.75 percent in May 2018 to support economic growth and has maintained a managed float of the exchange rate.

Going forward, real GDP growth is forecast to accelerate slowly to 3.9 percent by 2020 supported by all the major sectors – industry, agriculture, construction and services. On the demand side, growth is projected to be driven by private consumption, investment and exports.¹ The economy will continue to benefit from large remittance inflows and firming external demand. Strong remittances will support average consumption growth of around 3 percent in 2018–20. However, the current account deficit is projected to remain elevated at about 9 percent of GDP, reflecting structural constraints, the significant import content of public investment, and an indirect feed-through effect of remittances via imports. To rebuild fiscal buffers, the authorities are committed to reducing the deficit to 3 percent of GDP by 2020.

A. Recent Socio-Economic Developments

Growth and inflation

Economic growth slowed as gold and non-gold industry output eased

Real GDP growth slowed to 3.1 percent year on year in January-November 2018 down from 3.7 percent during the year earlier period. Output excluding gold production grew by 3.2 percent year on year in this period, down from 3.5 percent a year ago (table 1, figure 1). Overall, growth was supported by a continued increase in remittances inflow through the consumption channel and a relaxed monetary policy.

Gold sector growth entered positive territory only towards the end of 2018. The sector's production volume is driven by production at the Kumtor gold mine, which depends on climatic conditions and geological factors. The 2018 gold production cycle appears to have been backloaded with 2.1 percent annual growth registered for

¹ The contribution from net exports is expected to be negative due to faster growth of imports.

January-November 2018. Nevertheless, this performance was weaker than the 5.2 percent growth rate recorded in the year-earlier period.

Positive growth rates were also recorded across all other sectors over this period. Agriculture grew by 2.4 percent (up from 2.2 percent a year ago), construction – by 8.1 percent (up from 3.4 percent) and the services sector – by 1.7 percent (up from 1.1 percent). However, non-gold industry growth declined to 8.1 percent from 18.5 percent a year ago (Figure 2).

On the demand side, growth was driven by private consumption and investment while the contribution from net export was negative. Private consumption is estimated to have strengthened by about 4 percent year on year during the first nine months of 2018, supported by an increase in remittances (about 7 percent year on year in US dollar terms) and real wage growth (up 4.4 percent year on year). Investment growth is estimated at 5.4 percent during this period, reflecting increased company self-financing, bank lending, households’ resources, and foreign grants.

Unresolved structural issues are constraining growth

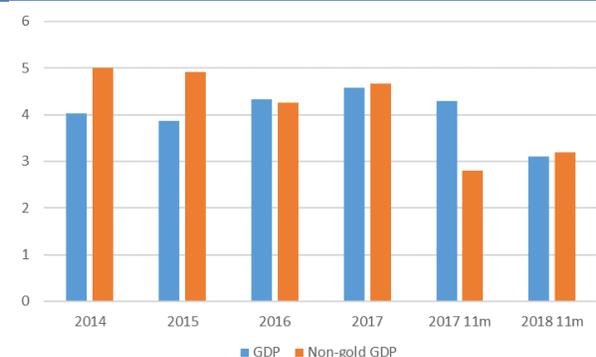
The Kyrgyz economy faces major structural constraints related to low agricultural productivity, a weak business environment, inefficiencies in the energy sector, and transport connectivity, among others. Export growth is low and attracting more private investment remains a challenge. As a result, economic growth continues to be heavily dependent on the gold sector (on the supply side) and remittance inflows (on the demand side). New opportunities associated with the accession to the Eurasian Economic Union (EEU) are yet to be fully exploited, mainly due to institutional constraints. For example, many Kyrgyz agricultural produce exporters fail to meet the EEU’s technical and quality standards resulting in limited growth of agricultural and food exports.

Table 1: Key Macroeconomic Indicators, 2014-2018

	2014	2015	2016	2017	2017 11m	2018 11m
Real GDP (growth in percent)	4.0	3.9	4.3	4.6	3.7	3.1
Non-gold real GDP (growth in percent)	5.0	4.9	4.3	4.7	3.5	3.2
Gold sector real GDP (growth in percent)	-5.8	-8.3	5.2	3.8	5.2	2.1
Consumption (growth in percent)	2.4	-0.7	-0.3	3.1
Investment (growth in percent)	15.7	-2.3	8.1	3.9
Inflation (end of period, in percent)	10.5	3.4	-0.5	3.7	4.0	0.5

Source: National Statistics Committee and Bank staff estimates.

Figure 1: Real GDP Growth (percent)



Source: National Statistics Committee.

Figure 2: Contribution to Growth (percentage points)

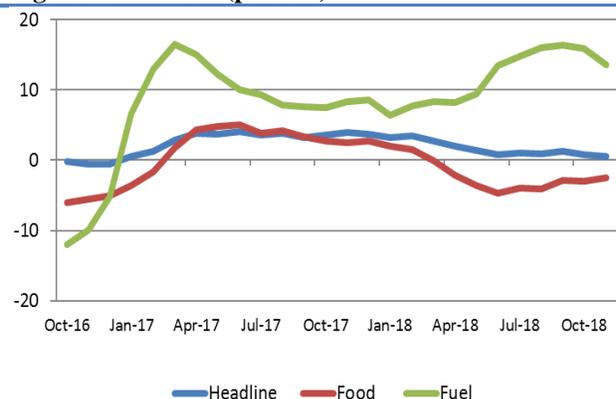


Source: National Statistics Committee.

Price pressures remains subdued

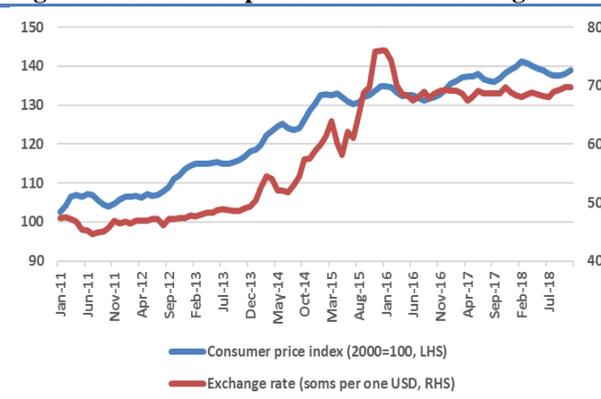
Inflation eased in 2018 reflecting a decline in food prices. The 12-month rate of inflation declined to 0.5 percent in November 2018, down from 3.7 percent at the end of 2017 (figure 3). Food prices dropped by 2.6 percent as a result of an excess of supply over demand. Counterbalancing this, fuel prices rose by 13.6 percent due to an increase in import prices and prices for tobacco by 18.8 percent following an increase in excise taxes. While consumer price dynamics are affected by seasonal factors, the exchange rate remains an important determinant owing to the openness of the Kyrgyz economy and its high propensity to import (figure 4).

Figure 3: Inflation (percent)



Source: National Statistics Committee.

Figure 4: Consumer price index and Exchange rate



Source: National Statistics Committee.

External sector

External sector indicators deteriorated ...

Developments in external trade and financial transactions were driven by a fall in gold export earnings, a robust rise in import spending, and slower growth in remittance inflows. Following an improvement in 2017, the external position

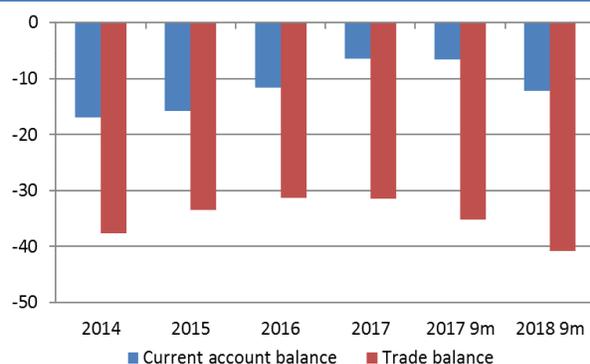
worsened during January-September 2018. The current account deficit increased to 12.2 percent of GDP from 6.6 percent in the same period last year primarily reflecting a widening of the trade deficit (which rose to 40.9 percent of GDP in the first nine months of 2018 compared to 35.3 percent of GDP in the same period of 2017) (figure 5). The current account deficit was mainly financed by a US\$240 million write-off of Kyrgyz debt with the Russian Federation and a reduction of assets abroad. While inflows of foreign direct investment (FDI) also financed the current account deficit in the first nine months of 2018 these were significantly reduced compared to 2017 (1.5 percent of GDP compared with 3.7 percent previously).

..... with weak growth in exports and a robust increase in imports

Export earnings were disappointing due to weak volumes of gold exports. Export earnings are estimated to have fallen by 3 percent year on year in US dollar terms in January-September 2018 as gold exports declined by about 16 percent (figure 6).² This decline was the result of a fall in volumes – gold prices were up by 6 percent during the period. At the same time, non-gold exports increased by around 4.5 percent reflecting greater shipment to both the EEU and non-EEU markets. Among EEU economies, Russia and Kazakhstan continued to be the primary destinations of the Kyrgyz goods accounting for about 98 percent of exports to the EEU and 40 percent of total exports. Exports to Russia increased by more than 50 percent year on year while exports to Kazakhstan remained flat. Among the non-EEU countries, exports increased to Uzbekistan and Tajikistan but declined to China and Turkey. The United Kingdom appears to be the largest export destination due to gold exports.

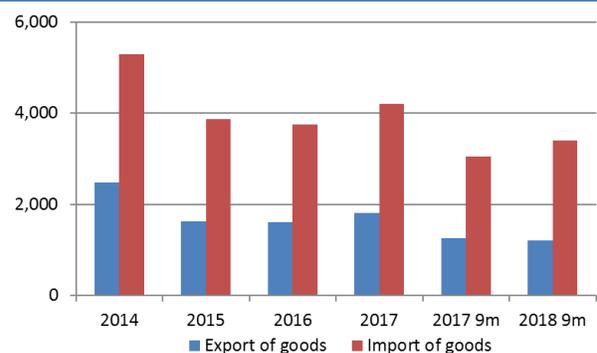
Import spending rose by 11.5 percent year on year in US dollar terms in the first three quarters of 2018, reflecting higher domestic demand (supported by remittances) and higher prices for oil products (figure 6). This increase was largely driven by increased imports of consumer goods, machinery and equipment, and intermediate goods for manufacturing. While the volume of oil products imported fell during the period, the oil import bill increased owing to higher prices. As in the past, the key source economies for imports were China, Russia, Kazakhstan and Turkey.

Figure 5: Trade and Current Account Balances (in percent of GDP)



Source: National Bank.

Figure 6: Exports and Imports (in millions of US\$)



Source: National Bank.

² Positive growth in gold production reported during January-November 2018 is expected to lead to an increase in gold exports towards the end of the year.

Financial sector

Financial sector indicators remain solid

Positive developments in the banking sector continued in 2018. By October 2018, banking sector assets had increased by 9.3 percent since the start of the year. This was driven by growth in loans (15.5 percent), government securities (16.9 percent) and cash (15.8 percent). On the liabilities side, deposits rose by 7.6 percent in January-October 2018.³

Banking sector performance indicators remain robust. The capital adequacy ratio remained high at 23.5 percent, almost twice as high as the minimum regulatory requirement of 12 percent. The liquidity level stood at 64.8 percent, down slightly from 65.1 percent at the end of 2017 but still well above the minimum requirement of 45 percent. Both returns on assets (ROA) and returns on equity (ROE) rose in January-October 2018 to 1.4 percent (from 1.2 percent at the end of 2017) and 9.2 percent (from 7.6 percent at the end of 2017), respectively. The non-performing loan (NLP) ratio declined to 7.4 percent in October 2018 from 7.6 percent at the end of 2017.

Social sector

Stagnation in poverty reduction is associated with labor market performance

The Kyrgyz Republic's poverty rate remained unchanged in 2017 at 25.6 percent. At the same time, the employment rate declined by 1.8 percentage points over two years to 55.9 percent in 2017. Agriculture and services remain the economy's main employers. Indeed, about one-third of employment and 28.6 percent of employment of individuals in the bottom 40 percent in terms of income distribution is in the agriculture sector.

Self-employed individuals increasingly dominate the labor market. These are people that are likely to be working in an informal setting. Informality is a complex phenomenon and there are variations in defining what informality constitutes. In general terms, informal employment can be viewed as labor employed outside of incorporated enterprises (organizations and establishments) or without a formal contract. Based on this definition, Labor Force Survey (LFS) data show that total informal employment over three years has been largely stable, accounting for 59 percent of total employment. The pattern of informality is different in urban and rural areas. While the level of informality is inherently higher in rural areas, in urban areas, informal employment has been increasing. The formal non-agriculture labor market is structurally constrained to accommodate increasing low skilled rural labor.

Labor income plays an essential role

Labor income (wages and agricultural incomes) represents more than 77 percent of total income for both poor and non-poor households in the Kyrgyz Republic. For poor households, the share of incomes from work to total incomes was 68.8 percent, reflecting higher unemployment rate or inactivity among the poor. Agricultural incomes play a more important role for the bottom 40 percent in rural areas reflecting higher employment in the agriculture sector. While both wage and agricultural

³ Demand deposits and time deposits.

incomes are earned by labor, agricultural income is more vulnerable to exogenous shocks, such as changes in commodity prices or adverse weather conditions.

Access to jobs is a critical factor for economic mobility. Those moving out of the bottom 40 percent and those staying out of it tend to have a relatively higher employment rate. At the same time, the percentage of non-employed people (including both the unemployed and the inactive) is relatively higher in those households, which either persist or fall into poverty. Households either persisting or moving down into the poverty status tend to have a relatively higher share of income deriving from household enterprises or self-employment. By contrast, households that are either moving out or staying out of poverty tend to resort to income from wage employment.

B. Macroeconomic and Structural Policies

Fiscal, monetary and exchange rate policies

The fiscal position improved owing to higher tax revenue and reduced capital spending

The fiscal accounts strengthened significantly in 2018. Strong tax performance, coupled with a sizeable cut in capital spending helped to reduce the deficit to 1.6 percent of GDP over January-November 2018 from 4.2 percent a year ago (table 2). Excluding on-lending, the budget ran a deficit of 1.0 percent of GDP compared to a 2.4 percent GDP a year earlier.

Tax revenue rose to 26.6 percent of GDP during the first eleven months of 2018 from 25.0 percent a year earlier, driven mainly by import tax collections. Specifically, revenue from value-added tax (VAT) on imports increased by 25.5 percent year on year (compared with a 5.2 percent decline in VAT revenue associated with domestic goods and services) and excise tax on imports by 10.5 percent (compared with a 4.6 percent increase on domestic goods). Collections of customs duties grew by 11.3 percent.

However, the strong tax performance was outweighed by a decline in non-tax revenue and lower grant support during the January-November period. Non-tax revenue declined to 4.7 percent of GDP from 6.5 percent of GDP in the year-earlier period, the result of 2017's high base of comparison when the budget received a one-off dividend payment from a nationalized mobile operator and a license fee from a gold company. At the same time, grant support fell by almost half to 1.2 percent of GDP from 2.1 percent of GDP in the same period of 2017.

Total spending was reduced to 34.2 percent of GDP in January-November 2018 from 37.8 percent a year earlier as both foreign- and domestically-funded capital outlays were cut by nearly half. On the current spending, while it remained the same as a share of GDP, there were some noticeable changes in the composition – transfers and subsidies increased by 2.0 percentage points of GDP while purchasing goods and services fell by 2.5 percentage points. These changes were mainly due to a shift of budget transfers to the Medical Insurance Fund between these two expenditure items. At the same time, the wage bill increased by 0.1 percentage points of GDP as the government increased compensation for government and municipal servants in

the lowest pay scale. Social spending also rose with the introduction of a universal child birth support.

Table 2: General Government Fiscal Accounts
(in percent of GDP)

	2014	2015	2016	2017	2017 Jan-Nov	2018 Jan-Nov
Total revenues and grants	34.4	34.4	32.0	33.2	33.6	32.7
Total revenues	31.9	32.2	29.9	30.6	31.5	31.4
Current revenues	31.8	32.1	29.8	30.6	31.5	31.4
Tax revenues	25.1	24.2	24.2	24.3	25.0	26.6
Non-tax revenues	6.7	7.9	5.6	6.3	6.5	4.7
Capital revenues	0.1	0.1	0.1	0.1	0.0	0.1
Grants	2.5	2.2	2.1	2.6	2.1	1.2
Program grants	1.9	1.7	1.4	1.5	1.0	0.2
PIP grants	0.6	0.5	0.7	1.1	1.1	1.1
Total expenditure (incl. net lending)	38.5	37.4	38.3	37.9	37.8	34.2
Current expenditure	29.3	30.1	30.2	29.9	29.8	30.0
Wage	7.8	8.1	8.3	7.9	7.9	8.0
Transfer and subsidies	3.4	3.4	3.4	3.3	3.3	5.3
Social Fund expenditures	9.2	9.0	8.6	8.9	9.3	9.6
Interest	0.9	1.0	1.1	1.1	1.2	1.4
Purchase of other goods and services	8.1	8.6	8.8	8.6	8.1	5.6
Capital expenditure	8.4	7.2	8.0	8.3	8.2	4.4
o/w foreign financed	6.1	4.5	5.1	5.3	5.4	2.7
Net lending	0.6	0.1	0.0	-0.2	-0.2	-0.1
Overall balance	-4.1	-3.0	-6.3	-4.7	-4.2	-1.6
Overall balance excluding on-lending	-0.2	-1.0	-4.0	-3.2	-2.4	-1.0
Financing	4.1	3.0	6.3	4.7	4.2	1.6
External	5.5	3.8	4.0	3.4	3.1	0.1
Domestic	-1.4	-0.8	2.3	1.3	1.1	1.4

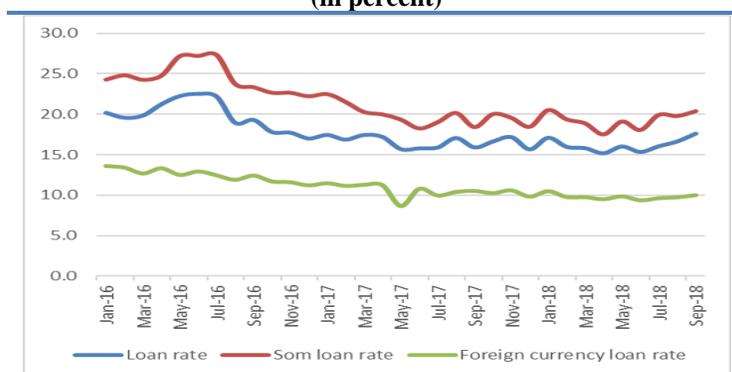
Source: Ministry of Finance

Monetary policy remains relaxed

With inflation well below the target range of 5-7 percent, monetary policy remained relaxed in 2018. The National Bank cut its policy interest rate by 25 basis points to 4.75 percent in May 2018 to promote economic activity in the context of fiscal tightening.⁴ The overnight interest rate for loans was also cut to 6 percent while the rate on deposits remained unchanged at 0.25 percent. However, the immediate reaction from the market was not as expected - interest rates for som-denominated loans have risen in recent months reversing a gradually declining trend since early 2016 (figure 7).

⁴ The promotion of economic activity is indicated as one of the tasks of the National Bank in the Main Directions of the Medium-Term Monetary Policy.

**Figure 7: Lending Interest Rates
(in percent)**



Source: National Bank.

While the money supply growth decelerated loans continued to grow at a robust rate supported by high liquidity

The monetary base expanded by 2.1 percent year on year in October 2018, a much slower pace than the 22.8 percent increase recorded a year earlier. Similarly, money supply rose by 3.7 percent year on year, decelerating from 19.6 percent in the year-earlier period. These developments reflect fiscal tightening as well as fewer interventions by the central bank in the foreign exchange market. At the same time, commercial bank loans grew by 17.2 percent year on year, up from 15.2 percent a year earlier, suggesting a gradual strengthening of confidence in the economy.

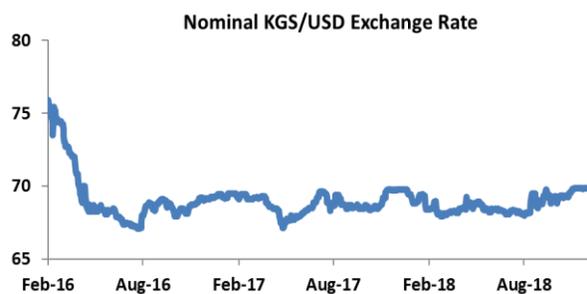
In response to high liquidity in the banking system, the National Bank continued to offer 91-day notes along with 28-day and 7-day notes. As a result, the volume of notes in circulation rose by 65 percent to KGS 8.7 billion in the first eleven months of 2018.

The som strengthened against the currencies of main trade partners

The NBKR maintained a managed floating exchange rate regime in 2018, broadly allowing market forces to determine the market exchange rate, while intervening to smooth short term fluctuations.⁵ The som has been broadly stable against the US dollar since the second quarter of 2016 reflecting a recovery of remittance inflows and a stabilization of the Russian ruble and Kazakh tenge (figure 8). In 2018, the som experienced some fluctuations against the US dollar mainly driven by seasonal factors. The NBKR intervened in the foreign exchange market both as a buyer and seller with net sales of USD134 million during the year. Compared to 2017, this represents almost twice as much intervention (figure 9). At the same time, the som strengthened against the Russian ruble and Kazakh tenge during this period as these currencies depreciated against the US dollar (figure 10, figure 11).

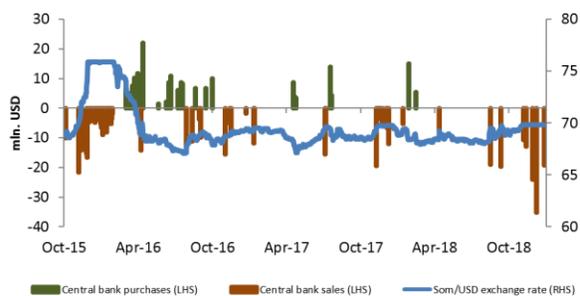
⁵ The NBKR interventions are decided based on developments in the foreign exchange market.

Figure 8: Nominal Exchange Rate (KGS/USD)



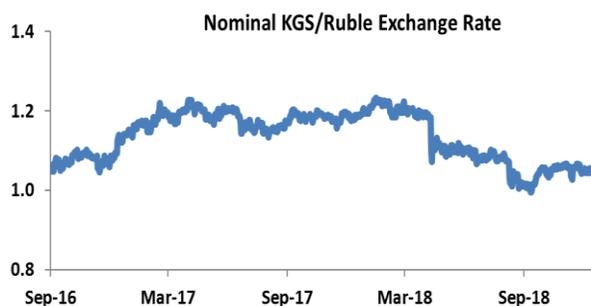
Source: National Bank.

Figure 9: Nominal Exchange Rate and NBKR Interventions (KGS/USD)



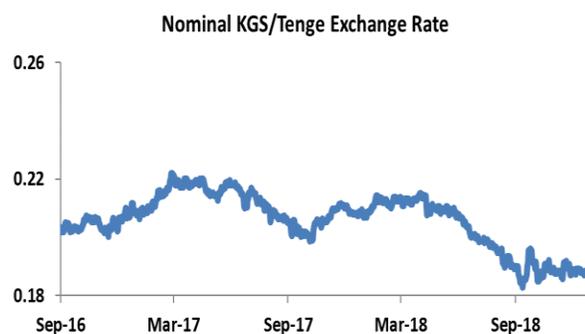
Source: National Bank.

Figure 10: Nominal Exchange Rate (KGS/Russian ruble)



Source: National Bank.

Figure 11: Nominal Exchange Rate (KGS/Kazakh tenge)



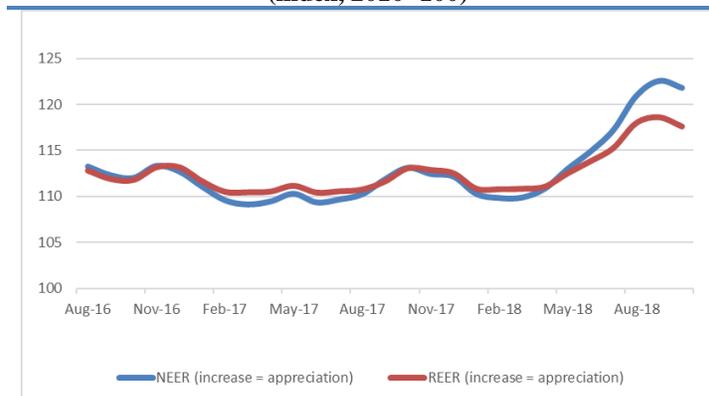
Source: National Bank.

Following two years of broad stability, the real effective exchange rate (REER) has been on an appreciating trend since the second quarter of 2018 (figure 12). The REER strengthened by 4.5 percent since the beginning of the year eroding the competitiveness of Kyrgyz exports. This change mainly reflects a nominal appreciation of the som against the currencies of its main trade partners, Russia and Kazakhstan, in particular, underscoring the importance of these currencies to maintaining competitiveness.

Gross international reserves stood at US\$2.11 billion in November 2018 (down by 3.2 percent compared to US\$2.18 billion at the end of 2017).⁶ In spite this decline, gross reserves remain at an adequate level of 4 months goods and services imports.

⁶ Source: NBKR.

**Figure 12: Nominal and Real Effective Exchange Rates
(index, 2010=100)**



Source: National Bank.

C. Economic Outlook and Risks

Real GDP growth is projected to accelerate over the medium-term

Real GDP growth is estimated to have decelerated to 3.5 percent in 2018 from 4.6 percent in 2017 as a result of slowing gold production growth. Economic growth is forecast to accelerate to 3.8 percent in 2019 and 3.9 percent in 2020. This scenario assumes moderate economic growth in Russia and Kazakhstan, which will benefit the Kyrgyz economy via the traditional remittance and trade channels. Export earnings are expected to provide an additional boost to growth as Kyrgyz Republic's market access to the Eurasian Economic Union expands and bilateral relations with Uzbekistan continue to improve, leading to greater trade flows.

Average consumption growth is projected at around 3 percent in 2019–20, mainly reflecting rising remittance inflows. Investment is forecast to grow at about 8 percent annually as public capital outlays remain high and private investment increases. The volume of exports and imports is projected to expand, with net exports making a positive contribution to GDP growth.

Inflation is expected to stay below the NBKR's targets

Average inflation is estimated at 1.5 percent in 2018. But inflationary pressures will intensify in 2019 due to rising fuel prices. Over the medium term, inflation will remain below the central bank's target range of 5-7 percent, assuming exchange rate stability and no significant shocks to global food prices.

Import growth will sustain a large current account deficit

While remittance inflows are expected to rise further, the current account deficit is projected to remain elevated at about 9 percent of GDP, reflecting structural constraints, the significant import content of public investment, and an indirect feed-through effect via imports.

The fiscal position is set to improve further

To rebuild fiscal buffers the authorities are committed to reducing the deficit to 3 percent of GDP by 2020 (table 3). In 2018–20, tax revenues in nominal terms are projected to rise on account of the government’s commitment to implement policy measures to expand the tax base by addressing constraints to private sector growth, reducing tax exemptions, and raising excise tax rates. However, as a share of GDP, tax revenues are expected to increase in 2019 and decline in the following year. Meanwhile, expenditure is projected to decline following efforts to streamline non-priority purchases, reduce the wage bill as a share of GDP, and strengthen public procurement.

Table 3: General Government Fiscal Accounts

	2018 approved	2019 approved	2020 approved
Total revenues and grants	33.9	34.0	32.1
Current revenues	31.2	32.0	30.6
Tax revenues	27.1	27.8	26.8
Non-tax revenues	4.1	4.2	3.8
Capital revenues	0.1	0.1	0.1
Grants	2.6	1.9	1.4
Total expenditure (incl. net lending)	38.8	37.2	35.1
Current expenditure	29.7	29.2	27.9
Capital expenditure	9.1	8.1	7.3
o/w foreign financed	6.7	5.3	4.9
Overall balance	-4.9	-3.2	-3.0
Financing	4.9	3.2	3.0
External	3.3	2.2	2.2
Domestic	1.6	1.0	0.8

Source: Ministry of Finance

Growth and microframework risks are associated with developments in the region

The growth performance of the Kyrgyz Republic will remain vulnerable to developments in its major trading partners in the region. Specifically, a slowdown in Russia (as US sanctions intensify) and Kazakhstan could negatively impact the baseline scenario through remittances and trade. Fluctuations in commodity prices could have a mixed impact on export receipts and the import bill. A continuous real appreciation of the som against trade partner currencies will deteriorate the competitiveness of Kyrgyz goods and services in the domestic and EEU markets.

A central challenge will continue to be the acceleration of the process of convergence of local production to EEU standards and the improvement in the business environment. This would help Kyrgyz producers to boost agriculture and textile exports in the short and medium term.

Special Focus: Agricultural Potential for Growth and Development

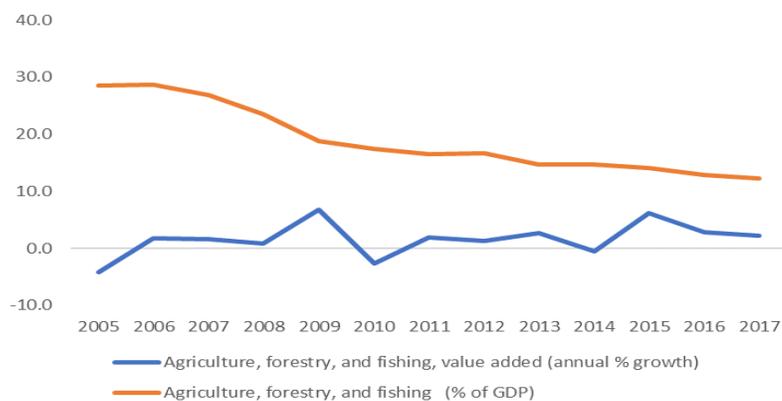
Realizing the potential of high-value agri-food exports is the cornerstone of the new government's policy objectives for agriculture development. The new government has declared that its priorities for agriculture sector development will be promoting high-value agri-food production and organic agriculture, improving the quality and safety of agri-food and orienting assistance to producers of those groups of agricultural products (selected fruits and vegetables, legumes, dried fruits, and so on) that have potential to generate high value added in export markets.

To realize the government's objectives the following three-track approach is appropriate: (i) expanding markets for agri-food products and improving competitiveness; (ii) linking small enterprises and farmers to market and promoting value addition; and (iii) creating enabling business environment for agri-food production. This approach would require a more proactive government that would address constraints faced not only by farmers but also by agri-food processors and exporters that is, addressing market failures along the entire food value chains. Doing so would help overcome the fragmented and small-scale structure of farms and agricultural firms, bringing the Kyrgyz agri-food sector to a new level of development.

Agriculture can support employment growth and poverty reduction

The Kyrgyz Republic's agriculture sector accounted for just over 10 percent of GDP in 2017, compared to close to 46 percent in 1996 and 27 percent in 2007 (figure 13). Agriculture grew at an annual average of 2.1 percent during 2007-17, a slower pace than the non-agriculture sectors and with large fluctuations. The underperformance of agriculture has been largely attributed to uncoordinated and inefficient public policies and external shocks.

Figure 13: Agriculture Annual Growth Rate and Value-Added Contribution to GDP



Source: World Bank Development Indicators

Because most of the poor are directly and indirectly employed in the agriculture sector, addressing the constraints to sector productivity and diversification will go a long way in accelerating the pace of poverty reduction as well as reducing food insecurity, boosting GDP growth and creating jobs.

Agri-food processing can generate off-farm

Agri-food products have considerable market potential and can be competitively positioned in both traditional and non-traditional markets with targeted public-sector assistance. Even domestically, agri-food products can be positioned to perform better and compete with imported food products. Agri-food processing also provides a natural

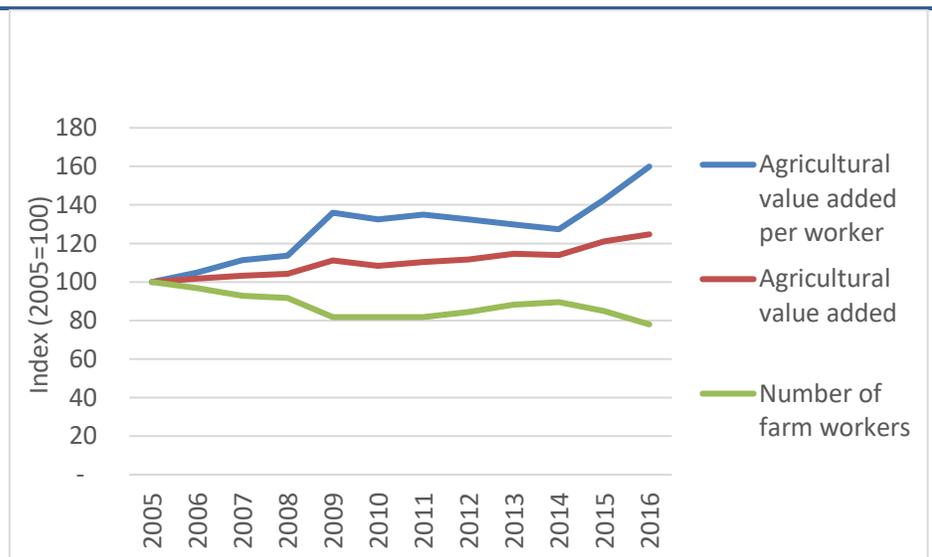
jobs and reduce poverty

entry point for the country to create much needed off-farm employment and poverty reduction in rural areas through the multiplier effect.⁷ Such potential can be realized in a conducive policy environment with proactive government support through the export of value-added food products such as dairy and meat products, fruit, nuts and vegetables, among others.

Low agriculture sector productivity is symptomatic of ineffective public policies

The agriculture sector is characterized by low productivity (of both land and labor) which in turn results in low production volumes, constraining the growth of the agri-food processing sector. Low agricultural land productivity has contributed to low yields, stalling poverty reduction and propelling food insecurity. According to World Development Indicators data, the agriculture value added per worker in constant 2010 U.S. dollars – a proxy for farm labor productivity - increased by 167 percent between 2000 and 2014, from \$721 to \$1,200. However, this increase was mainly owing to the decline in the number of agricultural workers, not productivity growth *per se* (figure 14). Low farm productivity has been the result of a mix of ineffective policies to support productivity growth, low investments in research and development, weak extension services to support agriculture growth, and inadequate attention to promote market linkages and develop value chains between farms and agri-processors.

Figure 14: Growth in Labor Productivity was mainly driven by outflow of farm labor



Source: World Bank Staff calculations

Proactive public policies are crucial

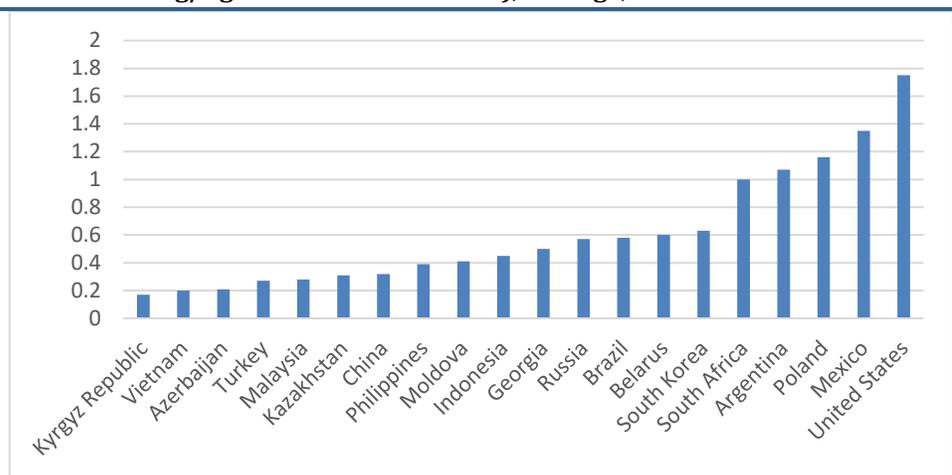
Proactive public policies are needed to promote higher-value crop production, niche marketing and quality improvement to help small farms maximize their limited resources. Policies are required not only at the farm level, which has been the case historically, but also along the various stages of food value chains. Most farms and agri-food firms in the Kyrgyz Republic are small, while the transaction costs for linking them and developing a strong agri-food sector are high. Without the expansion of the agri-food sector, the demand for domestic raw agricultural materials will remain low. The government has a role to play in addressing these market failures.

⁷ Agriculture is the primary source of employment for the bottom 40 percent of the population.

Farm structure is a barrier to realizing agri-food processing potential

Small farmers and small-scale agri-food processors make up the bulk of farming enterprises in the Kyrgyz Republic, and this has a negative impact on the proper functioning of modern value chains. Small-scale agri-food processors are rarely successful in establishing sustainable partnerships with small farmers unless there are strong market signals that facilitate such partnerships. Strong partnerships are typically found in niche and premium products that require specialized and labor-intensive agricultural production. When the above preconditions are absent, however, there is a need for public sector assistance to facilitate the establishment of such partnerships.

Figure 15: The Depth of the Food Processing Industry (Food Manufacturing/Agriculture Value Added), average, 2006-13



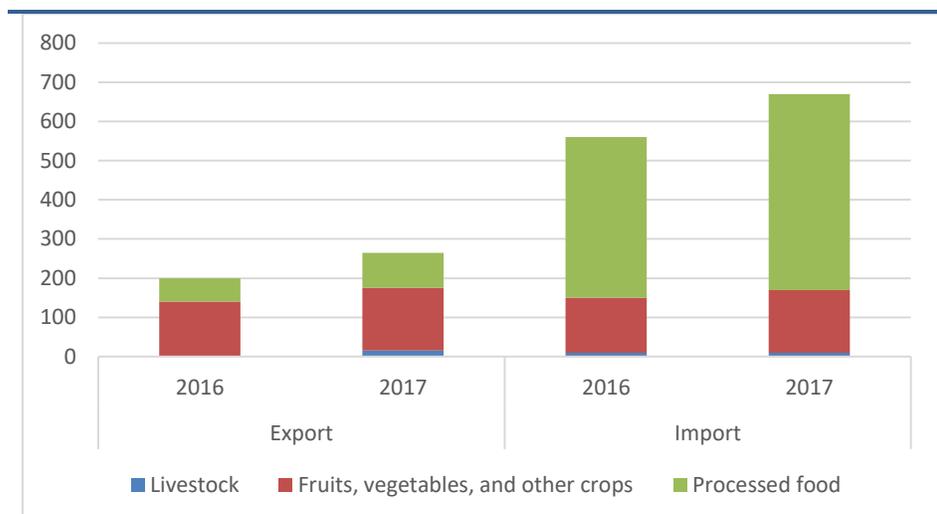
Source: World Bank Staff calculations

Import of food products currently exceeds exported food products. Should the balance shift?

Fresh fruits and vegetables constitute a large share of Kyrgyz agricultural exports, comprising around 15 and 41 percent of total agri-food exports, respectively in 2017 (World Bank 2018) (chart 4).⁸ Almost half of the Kyrgyz Republic’s \$264 million in agri-food exports in 2017 went to Russia, Kazakhstan and other former Soviet Union economies. At just \$8.4 million, agri-foods exports to China were negligible. In 2016 and 2017, the aggregate monetary value of imported and exported primary agriculture products was roughly equal, but the value of imported food items exceeded exported food items by four times in 2016 and by five times in 2017. A market opportunity exists in the Kyrgyz Republic for processed and high-value domestically-produced food products.

⁸ Kyrgyz National Statistics Committee.

Figure 16: Fresh fruits and vegetables are major agri-food export



Source: Kyrgyz authorities

Seizing upon growing demand in the region for agri-food products

In addition to the growing domestic market for food products, the increasing demand for high-value agricultural products and food-driven by rising population incomes in Kazakhstan, China, and Russia, the country’s main regional trading partners - creates opportunities for the Kyrgyz Republic to realize higher and sustainable economic growth by expanding and diversifying its agri-food exports.

Existing market failures need to be addressed urgently

Several market failures hamper the development of the agri-food sector. These include, among others, inefficient functioning of input markets; a lack of service provision (for example, agricultural advice, transport, and marketing services) and high transaction costs (associated with access to essential inputs and services such as water, electricity, extension services, logistics, and so on); and information asymmetries leading to weak linkages between small farms and small enterprises. Government interventions in these areas are needed to improve small farmers and agri-food processors’ access to markets, create more opportunities to capture value and improve their livelihoods.

Lessons learned from investments in rural infrastructure

While substantial support has been directed toward rural infrastructure development - including roads, water and irrigation networks, and connectivity the absorption capacity of the benefits of those investments has been low. This is mainly because (i) those investments were predominantly donor-financed and, as such, their benefits have not been fully captured; and (ii) those investments have not yet incorporated market pull and push mechanisms that could have augmented their results.

Investments in agricultural research and extension, rural infrastructure, and large irrigation networks are all critical but need to be complemented by market pull and push mechanisms that help farmers and small-scale processors link to markets. Strong partnership between the government and the small farmers and agri-food processor will go a long way towards unlocking the country’s agri-food potential.

Supportive government policy for the agri-food sub-sector critical

Realizing the potential of high-value agri-food exports is also the cornerstone of the new government’s policy objectives for agriculture development. Policy consistency, political stability and the enabling business environment are critical for the success of the agri-food sector and the government’s growth and poverty reduction policies more broadly.

The government would need to foster the appropriate environment by encouraging greater private sector participation by strengthening farmers' organizations, developing small and medium-size agricultural enterprises, designing appropriate financial instruments (including for supply chain finance, rural credit, and crop insurance), and investing in storage and distribution.

Public assistance will assist in promoting the agri-food industry

Such an approach requires the establishment of policies, appropriate standards, and a conducive environment for the private sector to invest in the agri-food sub-sector. It also involves raising government awareness of modern food safety management systems and strengthening capacity for food safety at the food enterprise level. This may include the provision of necessary support to improve compliance, for example, with phytosanitary requirements in food processing enterprises and enhance food safety management processes.⁹ Addressing issues related to inefficient and inadequate processing, packaging, and marketing - which limits the transition from localized production and consumption to international competition - will also be required.

Three strategic reform options appear most appropriate¹⁰

The government's vision for agriculture sector development is anchored in two policy objectives. The first is to increase exports and expand markets for agri-food products with a focus on ecologically clean and organic production. The second is to increase the value addition in the agri-food sub-sector while promoting coordination and cooperation and strengthening market linkages. To address these two policy objectives, the following three strategic reform options appear most appropriate: (i) expand markets and improve competitiveness; (ii) link small enterprises and farmers with markets and promote value addition; and (iii) create an enabling environment.

⁹ FAO <http://www.fao.org/documents/card/en/c/I9242EN>

¹⁰ World Bank, 2018. Kyrgyz Republic: Developing Agri-Food Value Chains

Annex 1: Selected Macroeconomic and Social Indicators, 2014–2020

	2014	2015	2016	2017	2018	2019	2020
				Prel.	Projections		
(Percent, unless otherwise indicated)							
National Income and Prices							
Nominal GDP (bln. of soms)	400.7	430.5	476.3	521.0	550.4	593.5	644.8
Nominal GDP per capita (US\$)	1,279	1,121	1,078	1,109	1,139	1,178	1,222
Real GDP growth	4.0	3.9	4.3	4.6	3.5	3.8	3.9
Real non-gold GDP growth	5.0	4.9	4.3	4.7	3.5	3.8	3.8
Private consumption growth	3.0	-0.9	-0.6	3.4	2.7	3.1	3.4
Gross investment (percent of GDP)	29.2	29.4	30.1	32.1	32.5	31.5	31.5
Consumer price inflation, year-end	10.5	3.4	-0.5	3.7	1.5	3.8	4.0
Consumer price inflation, period average	7.5	6.5	0.4	3.2	1.7	3.1	3.5
Real effective exchange rate (2010=100)	120.2	109.3	112.9				
(Current US\$ millions, unless otherwise indicated)							
External Accounts							
Merchandise exports, <i>of which:</i>	2,483	1,619	1,608	1,840	1,944	2,168	2,314
Gold exports	717	665	702	700	679	713	749
Merchandise imports	5,290	3,860	3,744	4,196	4,729	5,204	5,522
Current-account balance	-1,191	-742	-792	-306	-727	-822	-836
as percent of GDP	-17.5	-17.1	-15.0	-6.6	-9.2	-8.8	-9.0
Foreign direct investment, net	233	1,009	579	123	450	503	568
Total official international reserves	1,958	1,778	1,969	2,089	2,217	2,383	2,394
External debt, as percent of GDP	80.5	94.5	90.3	88.5	87.7	85.6	85.4
(Percent of GDP, unless otherwise indicated)							
Consolidated Fiscal Accounts							
Revenues	34.4	34.4	32.0	33.2	33.0	31.3	29.7
o/w Taxes	25.1	24.2	24.2	24.3	25.1	25.6	26.4
Expenditures	38.5	37.4	38.3	37.9	37.0	35.7	32.7
Overall fiscal balance	-4.1	-3.0	-6.3	-4.7	-4.1	-4.4	-3.0
Overall fiscal balance excluding on-lending	-0.2	-1.0	-4.0	-3.2	-2.5	-2.5	-2.3
Primary fiscal balance	-3.2	-2.0	-5.2	-3.6	-3.0	-3.2	-1.9
Total public debt	53.6	67.2	59.1	59.9	60.0	60.2	59.3
(Percent, unless otherwise indicated)							
Monetary Accounts							
Base money growth	-11.9	4.0	27.6	11.1	10.3	9.9	8.7
Real growth of credit to the private sector	43.6	17.2	-0.8	12.7	12.3	13.0	10.2
Policy rate	10.5	10.0	5.0	5.0			
Social Indicators							
Population, total (millions)	5.8	6.0	6.1	6.1	6.2	6.3	6.3
Population growth (percent)	2.0	2.1	2.1	1.1	1.1	1.1	1.1
Unemployment rate (percent of labor force)	8.0	7.6	7.6				
Poverty rate, international (percent of population)	29.2	32.9	32.8	31.7	30.2	28.3	27.2

Sources: World Bank staff calculations and estimates based on official data published and provided by the authorities.