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Kyrgyz Republic:

Gold Is Not Enough



THE WORLD BANK

Kyrgyz Republic Economic Report No.2
October 2012

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Acknowledgements

This is the second in a series of economic reports on the Kyrgyz Republic. It has been prepared by the ECA PREM team on Kyrgyzstan, which includes Bakyt Dubashov (Economist) and Helen Edmundson (Young Professional), with input from Afsaneh Sedghi (Senior Economist) and Aibek Baigabysh Uulu (Economist). The report also benefited from the guidance of Francisco Carneiro (Lead Economist) and Ivailo Izvorski (Sector Manager). The team would like to acknowledge the cooperation and responsiveness of the Kyrgyz authorities, who found time during September 2012 to discuss the latest economic developments and to share their views on the macroeconomic outlook.

Overview

A new coalition government was formed in September 2012 following the collapse of the previous government at the end of August 2012. The new coalition government includes three of the five main political parties—the Social Democrats, Ar-Namys (Dignity), and Ata-Meken (Fatherland). The remaining two, the Respublika party (the party of the outgoing Prime Minister), and the Ata-Jurt (Homeland) party have now moved into opposition. Commitment to the previous structural reform agenda remains.

The Kyrgyz economy experienced a significant decline during the first half of 2012 caused by disrupted operations at the Kumtor gold mine. Real GDP contracted by 5.6 percent year-on-year (y-o-y) in the first half of 2012, following a 60 percent fall in gold production at Kumtor. Excluding Kumtor, real output grew by 3.9 percent (y-o-y) with positive growth across all sectors. On the demand side, growth was pulled down by net exports. Both consumption and investment made positive contributions.

A decline in gold exports combined with a higher level of imports has increased the current account deficit. The Kumtor gold mine disruption adversely affected total exports, while imports grew faster than expected as a result of higher fuel imports. Improvements in net income (lower outflows) and higher remittances were insufficient to prevent a deterioration of the current account.

Expansionary fiscal policy during the first half of the year along with revenue weakness during the remainder of the year will widen the fiscal deficit to 6.1 percent of GDP in 2012 from 4.8 percent of GDP a year ago. Government expenditures have increased, driven by the higher wage bill, social spending, and a marginal increase in capital expenditures. Despite the gold induced economic contraction, tax revenues during the first half of the year have increased owing to higher customs revenue and a tax advance from Kumtor. The tax advance is spread over the last half of 2012 and 2013, suggesting revenues will be smaller during the rest of the year.

The medium-term growth outlook is favorable although there are significant downside risks. Mining and energy will be the main driving force of economic growth over the next three years. However, there are domestic risks that will need to be managed, such as continued uncertainty around gold production, reduced rainfall affecting agricultural production, and political instability. There are also exogenous shocks that will need to be mitigated, including rising food prices, spillover effects from the Euro zone sovereign debt crisis, and a weak global economy.

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Recent Economic Developments

Political developments—new coalition in place

A new coalition government was expeditiously formed following the collapse of the previous government in August 2012. The parliament signed an agreement formally approving the new coalition government on September 5, 2012, only one week after the resignation of the former Prime Minister. The speed at which the new government was formed is a testament to the country's commitment to its democratic institutions. The new coalition includes three of the five main political parties—the Social Democrats, Ar-Namys (Dignity), and Ata-Meken (Fatherland), with the remaining two moving into the role of opposition.

The new government has reasserted its commitment to the structural reform agenda. The coalition will continue the reforms instigated by the previous government. Institutional knowledge has not undergone too much disruption. Three of the four parties that made up the former coalition are part of the new government and a number of ministers have stayed in their positions. The government will continue to focus on anti-corruption reforms, public finance management, strengthening the business environment and investment climate, energy reform, and development of the financial sector.

Economic growth—golden volatility

Economic activity has fluctuated widely over the last four years due to external shocks and domestic political instability. The economy proved resilient to the global economic downturn in 2009, registering 2.9 percent growth, one of the only positive growth rates in the region. However, this was followed by a 0.5 percent contraction in 2010 as a result of political instability in the country. The troubles in 2010 led to the closure of borders, destruction of private and public infrastructure, weakened consumer and investor confidence, and an increase in poverty.¹ The return to normal economic activity in 2011 boosted economic growth to 5.7 percent. Gold, the mainstay of the Kyrgyz economy, contributed significantly to this growth.²

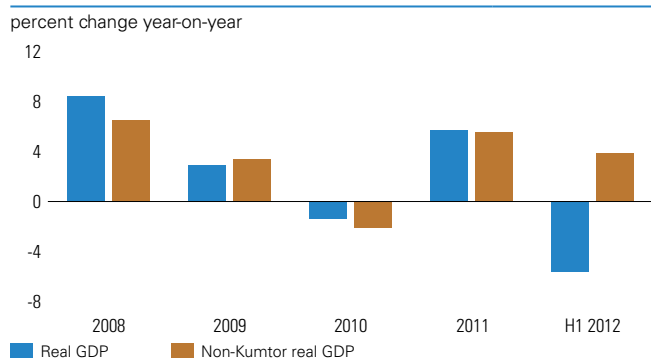
This volatility looks set to continue with large declines in growth during the first half of 2012 following a significant decline in gold production. Real GDP contracted by 5.6 percent year-on-year (y-o-y) during the first half of 2012 following a 60 percent fall in gold production at the country's main mine, Kumtor (Figure 1).³ According to Centerra Gold Company, gold production at Kumtor declined to 125 thousand troy ounces in the first half of this year from 336 thousand troy ounces a year ago.

Excluding gold, real output grew moderately at 3.9 percent (y-o-y) with positive growth across all sectors. The services sector and non-Kumtor industries were the main drivers, contributing 2.3 percentage

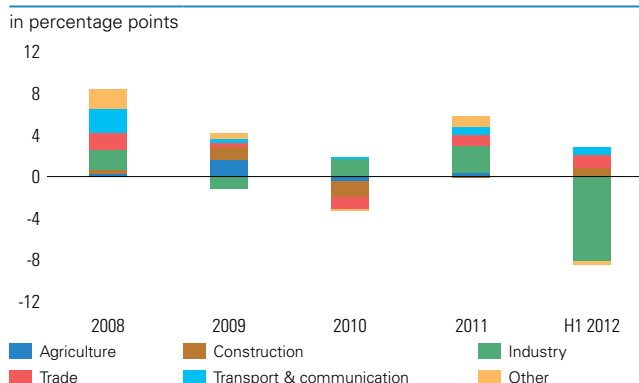
¹ It is estimated that poverty increased by 2 percentage points as a result of the 2010 events (Kyrgyz Republic estimates).

² On average, gold accounts for up to 10 percent of GDP.

³ The Kumtor gold mine is the largest project in the Kyrgyz Republic, run by Centerra Gold Company. The State has a 33 percent ownership.

Figure 1. A dramatic drop in gold production reduced growth during the first half of 2012

Sources: National Statistics Committee and WB staff calculation.

Figure 2. There has been moderate growth in the rest of the economy

Sources: National Statistics Committee and WB staff calculation.

points and 0.8 percentage points, respectively.⁴ Public investment projects have bolstered construction, which made a healthy contribution of 0.7 percentage points (a 20 percent growth compared to last year) (Figure 2). The growth rate in power

generation was positive but half its rate during the same period last year, dropping to 13 percent. This decline in the growth rate is due to water shortages at the Toktogul reservoir. Growth rates in mining and manufacturing declined to single digits from double digits a year ago, reducing the value added of industry by 32.4 percent and manufacturing by 42.6 percent. It is worth noting, however, that 2011 figures were unusually high, owing to the low base effect of 2010, which may also partly explain the lower growth rates seen during the first half of 2012 (Table 1).

Table 1. Real growth in industry

percent change year-on-year	2008	2009	2010	2011	H1 2012
Industry	14.8	-8.1	10.8	12.1	-32.4
Industry excluding Kumtor	6.5	3.4	11.7	19.3	8.3
Kumtor	85.6	-6.5	8.8	6.2	-60.0

Source: National Statistics Committee and WB staff calculation.

Consumption and investment have been relatively resilient during the first half of 2012. Private sector consumption grew by nearly 13 percent, supported mainly by remittances. A greater inflow of remittances may also be contributing to higher private household investments such as house construction and small business facilities. Public sector consumption growth was moderate at 3.2 percent (y-o-y), and mainly reflects a higher public sector wage bill. Public sector infrastructure investment (e.g., energy investments) is somewhat offsetting a decline in FDI. This decline in FDI is a result of significantly smaller retained earnings of Centerra Gold Company.

The large contraction in 2012 economic growth underscores the need to diversify drivers of growth. Kyrgyzstan, like many of the countries in the Central Asia region, is reliant on its natural resources for growth. With this reliance comes risk and vulnerability, as evidenced by the events of 2012. The collapse of gold production has had a crippling effect on growth, created a challenging fiscal deficit (the highest fiscal deficit projected in the ECA region for 2012), and stymied exports that are projected to create a 12 percent current account deficit by the end of the year. While there are some links between gold production and the rest of the economy (employer of some 2,000 workers, and a source of foreign exchange and revenue), the links

⁴ Non-gold industry includes other mining, food industry, textile and garment production, construction materials, and production and distribution of electricity, gas, and water.

remain weak. Indeed, non-gold growth was relatively resilient in 2012. Facilitating growth in the rest of the economy will help create additional income opportunities while also creating resilience against the supply shock witnessed in 2012.

Non-gold economic growth, however, is heavily concentrated and dependent on export demand. This growth is mainly concentrated in power generation, food processing, textiles, and construction materials, which are considered by the government as the driving forces of growth in the medium-term, however, these sectors need large investments and a significantly improved regulatory framework. Furthermore, it will be critical for the government to reinforce the reform program aimed at improving governance in the power sector while at the same time promoting a transparent and easily navigable environment for private businesses.

Balance of payments—temporarily worse

A decline in gold and electricity exports combined with rapid import growth led to a deterioration of the trade balance during the first half of 2012. The disruption at the Kumtor gold mine reduced gold exports, which fell by 63 percent in real terms during the first half of 2012 from a year earlier. Exports of electricity declined 78 percent in real terms as production fell because of low water levels at the Toktogul reservoir.⁵ Despite growth in non-gold exports (21 percent during the first half of 2012 from a year earlier), total exports declined by nearly 18 percent during the first half of 2012 compared to the same period last year (Figure 3).⁶ Conversely, imports registered strong growth at 35 percent, and fuel imports increased by almost 73 percent (Figure 4). The combination of buoyant imports and depressed exports led to a significant deterioration of the trade balance. The trade deficit widened to 33.3 percent of GDP during the first half of this year from 24.1 percent of GDP during the same period of 2011.

Figure 3. Net exports have driven down aggregate demand

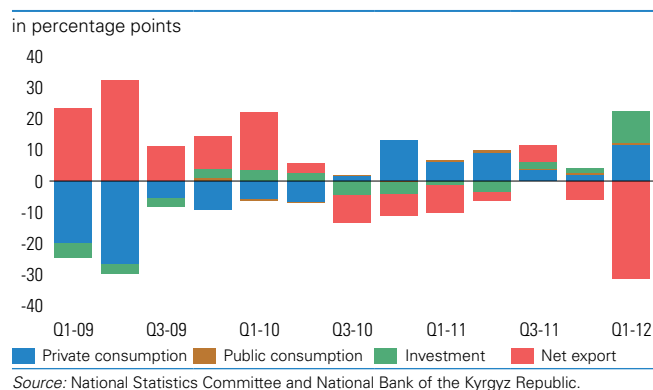
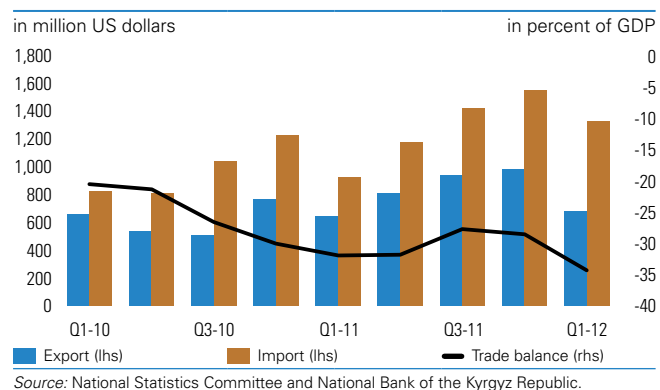


Figure 4. Rapid import growth contributed to a deterioration of the trade balance



Improvements in the income account balance have not been large enough to offset the negative trade balance leading to a current account deficit, which could reach 12 percent at the end of 2012. The current account deficit was 10.5 percent of GDP during the first quarter of this year, increasing from 8.1 percent of

⁵ Exports are not quite as low as they could have been because gold and electricity prices appear to be slightly higher than during the first half of last year.

⁶ Non-gold exports mainly include fruit and vegetables, cotton, construction materials, electricity, and clothing.

GDP a year before (Figure 5). With significantly lower income outflows, the income account deficit declined by almost four times during the first quarter from a year earlier. This was mainly as a result of lower reinvested earnings by Centerra Gold Company (Figure 5). Remittances were higher by \$67 million during the first quarter compared to last year and are expected to grow by 15 percent for the entire year, reaching 30 percent of GDP (Figure 6).

Figure 5. A worsening trade balance has increased the current account deficit

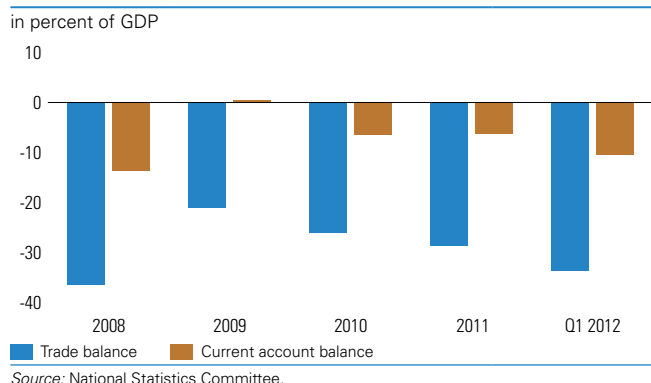
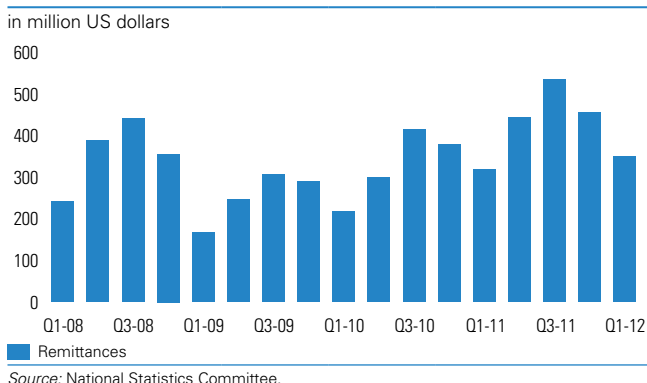


Figure 6. Remittances remain a key capital inflow



This year the current account deficit is largely financed by external borrowing. Compared to last year, FDI during the first quarter of 2012 was just \$45.5 million compared to \$213 million during the same period of 2011 (Figure 7). This left the country's external borrowing by the public and private sectors as the main financing sources for the current account deficit (Figure 8). Borrowing by the public and private sectors was \$155.4 million, 82 percent higher than during the first quarter of 2011.⁷

Figure 7. Inflows of FDI fell significantly

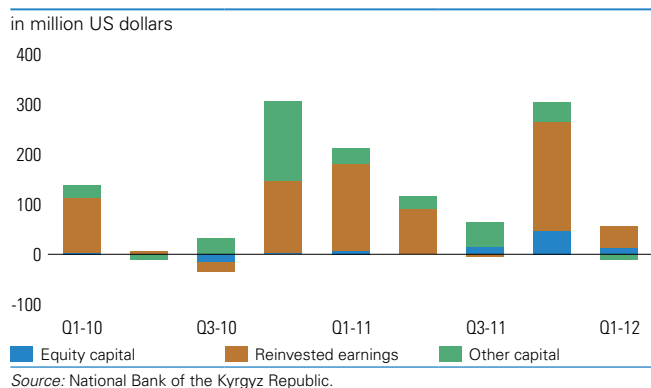
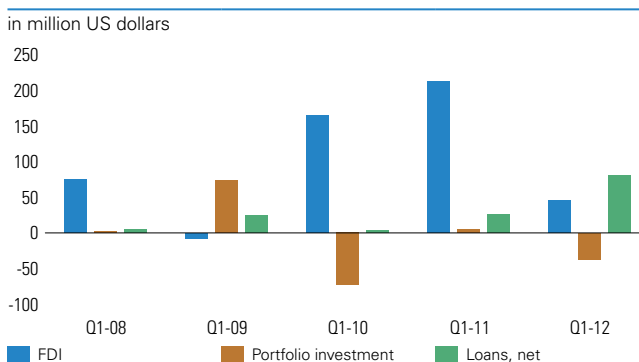


Figure 8. Lower FDI negatively affected the overall capital account



Despite the worsened external position, gross international reserves continued to accumulate. Higher current account deficit and lower capital inflows did not lead to a decline in gross international reserves. As of the end of June 2012, the gross reserves were \$1.90 million, up from \$1.83 million at the end of last year. This difference is explained by a large entry of errors and omissions in the balance of payments attributed to unrecorded exports.⁸

⁷ A significant reduction in the accounts of domestic enterprises abroad has also been observed.

⁸ The authorities have attributed this figure to activity in the shadow economy.

Box 1. Poverty and unemployment (2009–2011)

Poverty

Significant progress was made in poverty reduction from 2006 to 2009, with strong growth helping reduce poverty by 8 percentage points to 32 percent. This trend was reversed following the political disturbances of 2010. According to official statistics, poverty rose to 36.8 percent of the population (more than 2 million people). Perhaps surprisingly, extreme poverty, while rising in 2010, fell in 2011 to 4.5 percent. Within these aggregate figures there are also interesting geographical differences. Urban poverty rates increased by 7.1 percentage points to 30.7 percent in 2011, while rural poverty increased by just 0.9 percentage points to 40.4 percent. Bishkek city, for example, witnessed the largest increase in poverty from 7.9 percent in 2010 to 18.4 percent in 2011 (Figures 9 and 10).

Figure 9. Overall poverty rates

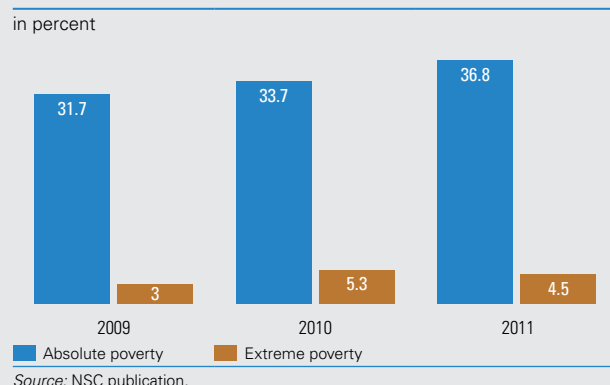
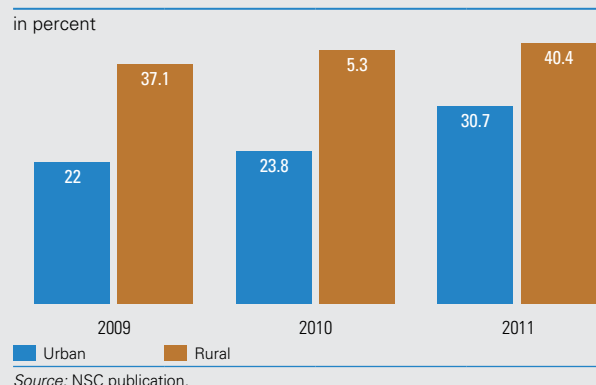


Figure 10. Urban/Rural Poverty rates

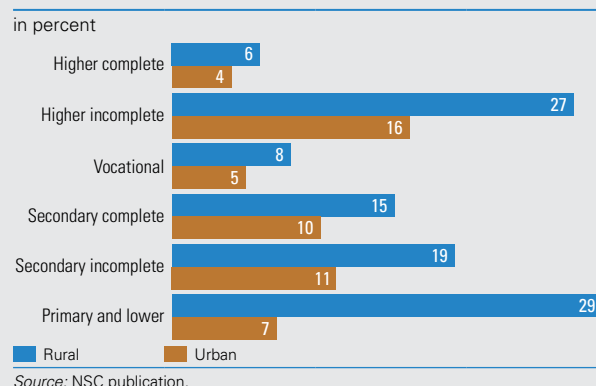


The food price inflation witnessed in 2011 had a heterogeneous effect on households which may partly explain both the fall in absolute poverty and the apparent convergence of rural and urban poverty rates. While higher food prices generally have a negative impact on poverty rates in the Kyrgyz Republic owing to a fall in real incomes and the high share of food in a household's consumption basket, food producers may benefit. The Kyrgyz Integrated Household Survey (2010) estimated that 21 percent of rural households grow wheat, the main food staple. Rural wheat producing households therefore have a source of income and food that is unavailable to households in urban areas.

Unemployment

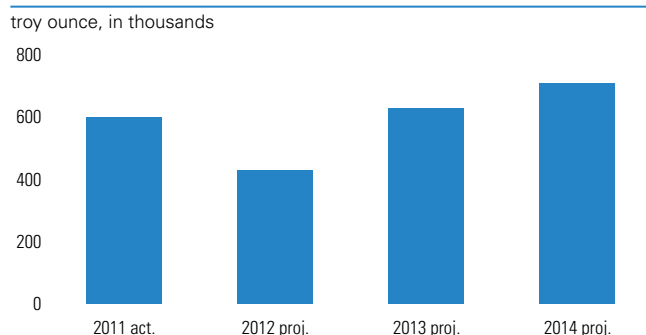
Unemployment levels have remained relatively stable over the past three years despite fluctuating growth levels. People losing formal or better-paid informal jobs are likely to have slipped into self-employment in agriculture (where labor is usually underutilized) and into services. Higher educational attainment increases the probability of employment as evidenced by the lower unemployment rates of people with higher education. There are, however, pronounced differences across urban and rural areas. The premium on education is much lower in rural areas because of the high level of informality in the rural labor market. The unemployment rate among low-skilled people (primary education or below) in urban areas is four times higher than the rate among this same demographic living in rural areas.

Figure 11. Unemployment, by education and location



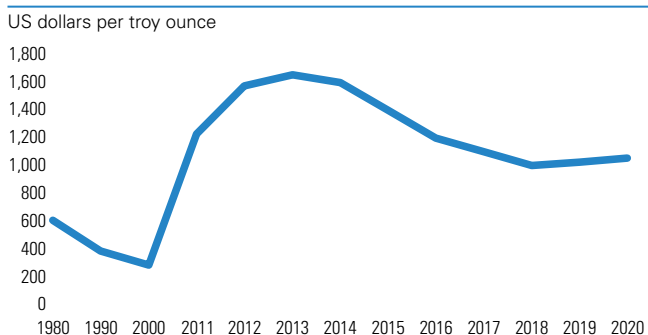
As gold production increases over the next two years, the trade balance and the overall current account balance will improve. In addition to Kumtor, there are a number of other gold producers that are scheduled to start producing in the next two to three years (Figures 12 and 13). Furthermore, trade in services may also grow following a recently adopted law that cancels visa requirements for some middle- and high-income countries. If Russia and Kazakhstan expand at 4–6 percent annually, then remittances to Kyrgyzstan are expected to continue growing at a moderate rate. However, these developments are subject to risks (e.g. political stability and the Euro zone debt crisis, which may affect Kyrgyzstan's main trade partners) and so uncertainty remains about the sustainability of the external account.

Figure 12. Gold production should record moderate growth in the coming years



Source: World Bank Commodity price forecasts as of September 2012.

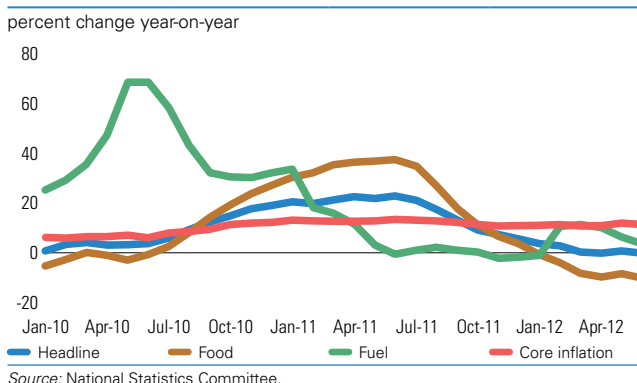
Figure 13. Gold price forecast



Inflation and monetary policy—interest rates come down

Headline inflation has come down as the pressure from international food prices eased. Core inflation remains high, however, prices fell 0.5 percent (y-o-y) in June after rising 5.7 percent during the 12 months through December 2011 (Figure 14). Deflation was led by lower food prices, which account for 58 percent of the consumer price basket. Food prices fell 10.3 percent (y-o-y) in June after rising 3.5 percent (y-o-y) in December last year. Fuel prices, however, have increased following price hikes in Russia, the main exporter of gasoline and diesel to the Kyrgyz Republic. As of the end of June, 12-month core inflation was 11.4 percent, a slight increase by 0.5 percentage points from December 2011 (Figure 14).

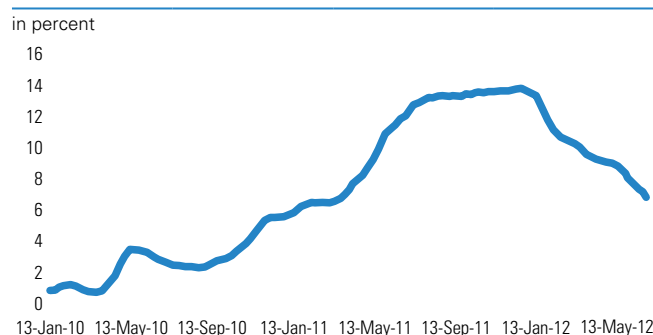
Figure 14. Core inflation remains high, rising international food prices have yet to affect Kyrgyz inflation



Source: National Statistics Committee.

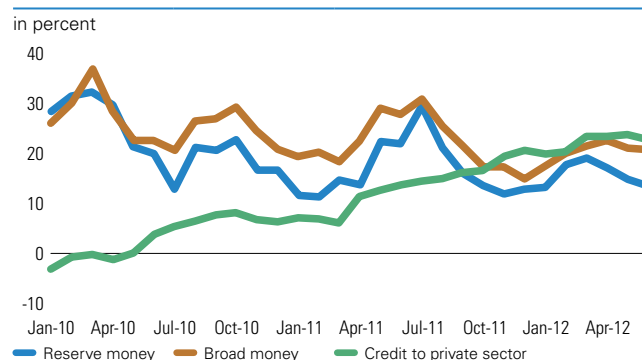
Lower inflation and a broadly stable exchange rate provided the Central Bank with some room to ease monetary policy. The Central Bank lowered its key policy interest rate to 6.8 percent in June from 13.6 percent in December 2011 (Figure 15). Money supply growth peaked to 22.7 percent (y-o-y) in April, declining to 20.9 percent in June 2012 (Figure 16). Higher liquidity in the banking system provided more resources to the private sector—lending growth peaked at 23.8 percent in May and declined to 22.8 percent in June.

Figure 15. The interest rate is declining after peaking at 13.7 percent



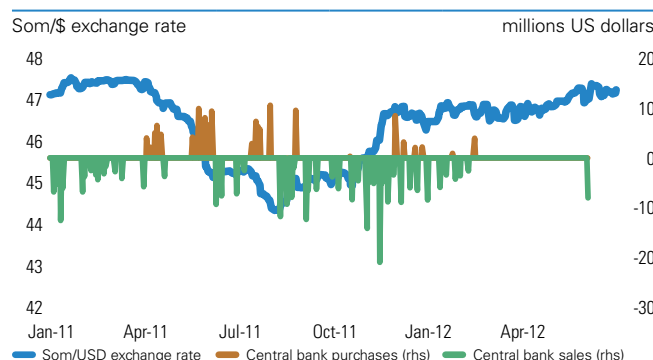
Source: National Bank of the Kyrgyz Republic.

Figure 16. Leading to the private sector has been steadily growing since 2010



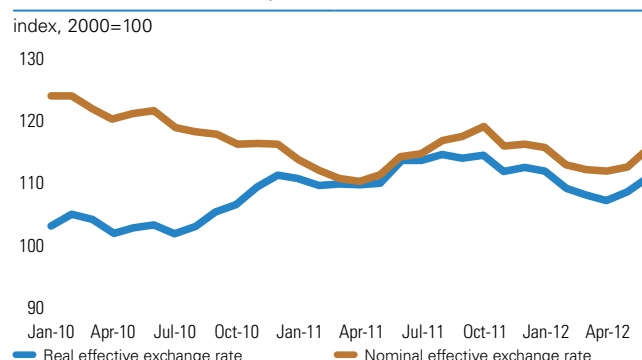
Central Bank interventions in the foreign exchange market were limited in 2012. The Central Bank continued to pursue a managed floating exchange rate regime, aimed at smoothing sharp fluctuations. This ensured a stable nominal Som/U.S. dollar exchange rate during the first quarter of this year (Figure 17). The Central Bank did not intervene in April–May, allowing the Som/U.S. dollar rate to slightly depreciate, which may be a result of the slower growth in exports and weak capital inflows.

Figure 17. The Central Bank's market interventions were minimal in 2012



Source: National Bank of the Kyrgyz Republic.

Figure 18. Real and nominal exchange rate movements (2010–April 2012)



The recent shift in the real effective exchange rate may affect the country's competitiveness. The real effective exchange rate (REER) depreciated by 5 percent from December 2011 until April before resuming an appreciating trend in line with higher inflation (Figure 18). These movements were driven by changes in the nominal effective exchange rate. A relatively lower domestic inflation rate compared to trading partner countries contributed to the depreciation of the real exchange rate through April. The REER has been resisting appreciation since then.

Fiscal policy—expansionary response

The 2012 fiscal stance remains expansionary, increasing the fiscal deficit to more than 6 percent by year end. The government ran a deficit of 2.8 percent of GDP during the first half of 2012 compared to a surplus

of 0.8 percent of GDP a year ago; 6.1 percent of GDP is projected for the end of the year (Figure 19). This is driven mainly by increasing expenditures from wage increases introduced in May 2011, and higher Social Fund expenditures. To contain expenditure growth, the government intends to keep spending in goods and services and capital expenditures at the same level as last year, and to reduce transfers and subsidies. Total revenues are projected to decline compared to last year because of significantly lower grants, although tax revenues are expected to increase by 1.3 percentage points. This growth comes from an advanced tax payment of \$20 million from Kumtor for this year (although there is some uncertainty as to whether this money will have to come from end of 2012 payments rather than 2013), and strong import revenue growth (particularly oil) (Table 2).

Figure 19. The fiscal deficit is projected at more than 6 percent in 2012, the highest in Europe and Central Asia

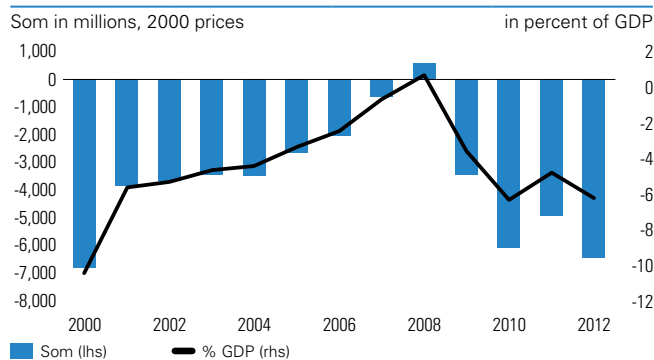
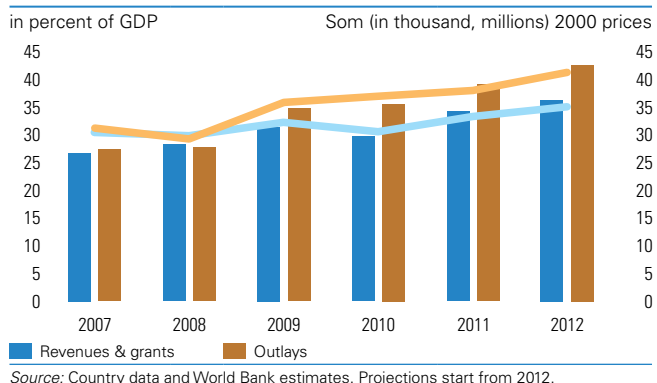


Figure 20. Expenditures increased by 10 percentage points of GDP from 2008 to 2012



The Government has highlighted the need for fiscal consolidation. Total government outlays have increased by 10 percentage points of GDP between 2008 and 2012 (Figure 20). Wages and social assistance expenditures account for the largest share of this growth following the wage increases in 2011 (particularly in the education and health sectors) and the additional benefits introduced following political unrest in 2010. Pension payments are also putting a strain on Government accounts, estimated to reach 9.8 percent of GDP in 2012. The Government has indicated that it wants to undertake fiscal consolidation reform, but there are several political sensitivities to do so. For example, wages in the education and health sector have increased to help attract and retain better qualified staff. Both areas were struggling to fill vacancies and retention of staff was low. Making cuts to recently increased wages will not be politically possible in the near future.

Table 2. Fiscal consolidation will need to target current expenditures

in percent of GDP

	2011 Jan-Jun Act.	2011 Year Act.	2012 Jan-Jun Act.	2012 Year Proj.	2013 Year Proj.	2014 Year Proj.
Total revenues and grants	39,1	33,3	41,8	32,8	31,1	30,5
Total revenues	35,5	30,2	40,1	31,1	29,9	29,6
Current revenues	35,2	30,0	39,8	30,9	29,7	29,4
Tax revenues	27,1	24,2	32,1	25,5	25,1	24,8
Non-tax revenues	8,1	5,7	7,8	5,3	4,6	4,7
Capital revenues	0,3	0,3	0,3	0,3	0,2	0,2
Grants	3,6	3,2	1,7	1,7	1,2	0,9
Program grants	1,7	1,5	0,2	0,5	0,5	0,3
PIP grants	1,9	1,7	1,5	1,1	0,7	0,6
Total expenditure (incl. net lending)	38,2	38,0	44,6	38,9	35,9	33,9
Current expenditure	33,4	32,4	39,7	33,5	29,6	27,4
Wage	9,0	8,7	11,5	9,4	8,1	7,5
Transfer and subsidies	4,9	4,0	4,6	3,1	3,0	2,6
Social Fund expenditures	9,6	8,7	12,7	9,8	9,3	9,1
Interest	1,5	1,0	1,1	1,0	1,0	0,9
Purchase of other goods and services	8,4	10,0	9,8	10,1	8,1	7,3
Capital expenditure	5,7	5,8	5,6	5,7	6,3	6,5
Domestically financed	0,6	1,0	0,5	0,6	1,0	1,8
PIP loans	3,3	3,1	3,6	3,9	4,6	4,1
PIP grants	1,9	1,7	1,5	1,1	0,7	0,6
Net lending	-0,9	-0,1	-0,7	-0,3	0,0	0,0
Overall balance	0,8	-4,8	-2,8	-6,1	-4,8	-3,4
Primary balance	2,4	-3,8	-1,6	-5,1	-3,8	-2,5
Financing	-0,8	4,8	2,8	6,1	4,8	3,4
External	3,0	3,4	3,3	3,8	4,8	4,2
Domestic	-3,9	1,4	-0,6	2,3	0,0	-0,8

Source: Ministry of Finance of the Kyrgyz Republic and World Bank projections.

Macroeconomic and Fiscal Outlook and Debt Sustainability

Growth outlook—a bumpy road ahead

We have revised the growth projection for 2012 to 0.9 percent from 5 percent expected in April.⁹ This reflects a significant drop in gold production at the Kumtor mine. Performance in the agricultural sector has also been somewhat subdued after lower than expected rainfall. However, other non-gold growth is projected to grow by 4.5 percent, driven mainly by the services and construction sectors. The contribution of the power sector, an important source of growth in 2011, is expected to be much less in 2012, partly because of the exceptionally high energy growth in 2011 following the disturbances in 2010.

Over the next two years growth is likely to pick up as gold production rebounds and new projects in the mining and energy sectors are launched. The resumption of gold production and stronger investment will help growth of 8 percent in 2013 moderating to 7.1 percent in 2014. Kumtor's current projections suggest it will grow at 30 percent annually during 2013 and 2014. Meanwhile, new gold mining projects, (Ishtamberdi, Bosumchak, and Kara-Kazyk gold mine) are likely to affect growth, both in the short term through investment and its associated multiplier, and in the medium term once production begins. Similarly, investment in energy projects, the Datka-Kemin transmission line;¹⁰ additional investment targeted towards the Datka power substation project; and the possible construction of the Kambar-Ata 1 and Upper Naryn hydropower plants¹¹ will positively contribute towards Kyrgyz GDP growth in the coming years.

There are, however, significant downside risks to these projections. First, while Kumtor's forecasts for the rest of 2012 and 2013 are broadly optimistic, there is still a degree of uncertainty surrounding how much gold it will start producing. The risk of a Kumtor breakdown over the next 12 months has not been completely eliminated. Second, agriculture might perform below an already lowered forecast in 2012. A second year of low rainfall would also lower production in 2013, putting a strain on their irrigation capabilities. The third risk relates to political stability. The new coalition government is working hard to get the country back on track but concerns regarding its stability remain.¹²

Rising international food and fuel prices and a protracted sovereign debt crisis in the Euro zone may also impact the Kyrgyz economy. Given the high dependency of domestic consumption on imports, food and fuel price increases in world markets will continue to drive up domestic prices, putting pressure on the real incomes of the poor. We projected that 12-month inflation will reach 12 percent at the end of 2012, with further increases likely in 2013. Without any additional price shocks, medium-term inflation should return to 6–8 percent. The second major international risk stems from the Euro zone. While Kyrgyzstan's direct interaction with the Euro zone is limited, its main partners (Kazakhstan, Russia, and Turkey) could be adversely affected by the lack of

⁹ World Bank estimates, Kyrgyz Republic Economic Report, Number 1, 2012. The Ministry of Economy in the Kyrgyz Republic has a higher revised estimate of 1.8 percent, down from 7.5 percent.

¹⁰ To be implemented by Chinese contractors under a loan agreement signed between the Kyrgyz Republic and China this year.

¹¹ Russia has recently agreed to finance these projects.

¹² A recent protest led by opposition leaders demanding nationalization of Kumtor turned into a call for the seizure of power and ended with a clash with the police.

demand in the Euro area. This would affect Kyrgyzstan through lower remittance flows, and lower demand for their exports.¹³

The IMF has assessed that the implementation of short term economic policies under the Extended Credit Facility program is on track. The recent IMF mission assessed the government's economic policy performance as satisfactory given the shock of lower gold production and the difficult political environment.¹⁴ The government met all the quantitative targets as of end-September 2012. For structural benchmarks, the government still needs to implement measures related to strengthening the financial sector (Banking Code and Zalkar bank privatization). The IMF Board is expected to complete the third review of the ECF-supported program in December 2012.

Commitment to the structural reform agenda, however, will be essential for stronger medium-term growth, including support for policies to:

- Enable investments in agriculture and agro-processing to improve lagging productivity and to generate income opportunities for the rural poor;
- Support growth of the garment and textile industries, taking advantage of their access to the key export markets of Russia and Kazakhstan;
- Encourage further investments in infrastructure and the development of new services;
- Secure stability of the banking sector and promote adequate access to finance for SMEs, and other entrepreneurial activity; and
- Improve governance and enable private investments in new mines, both gold and non-gold commodities. The business community is calling for enhanced transparency of the government and strengthening of overall governance. The recently adopted anti-corruption strategy is the first step towards addressing these concerns.¹⁵

Fiscal consolidation—key policy challenge

The government is committed to fiscal consolidation, however, design and implementation is delayed. On the financing side, the Kyrgyz Republic has become increasingly reliant on external sources of financing to fund the budget deficit. This remains, however, a volatile source of funding and ultimately adds to their stock of public debt. Revenues have played their part, increasing as a share of GDP, predominately due to tax administration reforms. However, at over 25 percent of GDP it is unlikely that tax revenues will increase much more since most of the gains from the reforms have already materialized. On the expenditure side, short term remedial measures such as cuts within the goods and services category, and cuts to capital maintenance have been adopted. These types of expenditure cuts are not, however, sustainable in the medium to long term. The government therefore intends to reduce the fiscal deficit through structural reforms of spending policies. They have targeted an annual reduction in the primary fiscal deficit of 1.3 percentage points over the next two years

¹³ To date remittances have proved to be fairly resilient and are forecast to grow by 15 percent in 2012.

¹⁴ October 2012.

¹⁵ See, for example, results from business surveys such as the World Bank's Doing Business survey and the Global Competitiveness Index that suggest that government instability and corruption are the top two barriers to investment and business activity.

(Annex). Events in 2012 such as the change in government and fall in gold production have made it difficult for the government to push ahead with these sensitive reforms, delaying fiscal consolidation to 2013.

The World Bank is supporting government thinking on fiscal consolidation through a Public Expenditure Review (PER). The review examines certain sector and specific issues, (health, education, the wage bill, pensions, social protection, energy, public financial management), alongside a macro fiscal overview of the government's accounts. The analysis and subsequent recommendations are focused on a medium-term agenda, addressing what structural reforms may be necessary to help the government reduce the fiscal deficit.

Initial analysis from the PER suggests that implementing fiscal consolidation over the next 3–4 years will require shifts in medium-term expenditure policy to contain underlying pressures. Some preliminary findings include:

- **Education**—The number of schools has been growing, however, but some are not only under capacity (i.e. low enrollment rates), but are also in close proximity to other schools. Providing the issue of transportation can be resolved, there may be savings from consolidation.
- **Social protection**—While the Kyrgyz Republic spends a relatively high proportion of GDP on social assistance (close to 3 percent of GDP in 2011), most benefits are categorical and not explicitly targeted to the poor. The sole explicitly targeted program (monthly benefit for poor families with children) covers less than one-third of the poorest 20 percent of the population and provides only about 6 percent of their total consumption. This suggests that there may be savings from refocusing the overall package of social assistance on those most in need.
- **Pensions**—Consolidated public pension spending has grown considerably in recent years, with further pressure on pension spending likely in the future due to demographic pressures, growth of social pensions to the uncovered population, and a projected fall in replacement rates. This suggests that pension reform can help put the system on a sustainable footing while also generating savings.
- **Wage bill**—Public sector salaries are currently negotiated in an ad hoc manner, with recent large increases in education and health raising the wage bill to 11.5 percent of GDP during the first half of 2012 from 9 percent of GDP the year before and under 8 percent in 2010. A coherent system to manage public wages is needed for the medium term, where gradual increases in wages are tied to productivity improvements and any bonuses are tied to measurable performance. Such a system is expected to lead to savings compared to ad hoc increases.

Debt sustainability—moderate risks remain

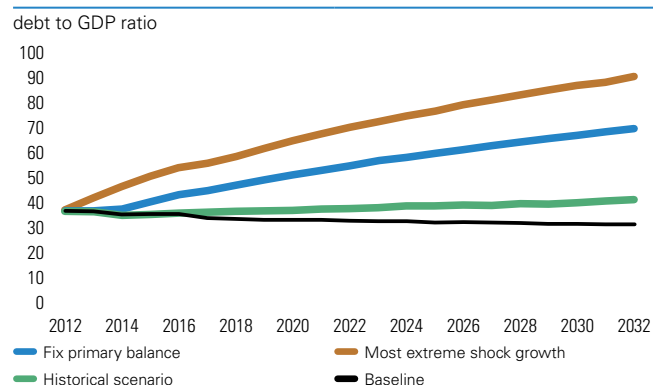
The Kyrgyz Republic has been assessed to be at a moderate risk of debt distress. The debt service burden is projected to stay below indicative debt thresholds, in part due to the heavily concessional nature of the debt.¹⁶ However, external public debt thresholds could be breached if they are subjected to a prolonged shock, negatively effecting real GDP growth. Public sector debt seems somewhat more manageable, but this sustainability is subject to the absence of the same shocks. The assessment includes the recently agreed loans

¹⁶ The present value of public sector debt is projected to be 37.1 percent in 2012, dropping to 33.4 percent in 2020, under the assumption of a 5 percent long term GDP growth rate.

from China for much needed energy infrastructure, which could contribute a quarter of a percentage point of GDP from increased domestic consumption. It does not, however, include the September 20, 2012 debt relief agreement between Kyrgyzstan and Russia.¹⁷

This assessment is based on key assumptions about the government's structural reform agenda and commitment to fiscal consolidation. Under different scenarios, the present value (PV) of public debt could rise to as much as 51.4 percent of GDP in 2020 if the primary deficit witnessed in 2012 is maintained, compared to 33.4 percent under a baseline scenario.¹⁸ A long term GDP growth shock scenario projects a PV public debt burden of 41.9 percent of GDP by 2020 (Figure 21). These scenarios underscore the necessity of the structural reform agenda and action to reduce government expenditures to contain the fiscal deficit.

Figure 21. Extreme fiscal and growth shocks would raise the ratio of the present value of public debt to GDP to more than 40 percent



Source: World Bank and IMF estimates of public debt.

¹⁷ Russian and Kyrgyzstan have recently come to a preliminary agreement on debt relief of up to \$490 million. The first tranche (approximately \$190 million) will be forgiven over the next two years. The second tranche of debt relief (\$300 million) will start in 2016.

¹⁸ Under the baseline scenario, the average yearly primary deficit is assumed to be 2.2 percent of GDP between 2013 and 2020. The fiscal shock scenario assumes a primary deficit of 5.3 percent over the same period, the same rate as projected for 2012.

Annex

Annex 1. Selected Economic Indicators (2005–14)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
				Act.					Proj.	
Nominal GDP (in billions of soms)	100.9	113.8	141.9	188.0	201.2	220.4	273.1	308.6	360.0	404.8
Real GDP (growth in percent)	-0.2	3.1	8.5	7.6	2.9	-0.5	5.7	0.9	8.0	7.1
Nongold real GDP (growth in percent)	1.4	5.7	9.0	5.4	3.4	-2.1	5.6	4.4	3.9	5.0
GDP per capita (in U.S. dollars)	478	546	726	972	864	875	1,070	1,109	1,241	1,370
Consumer prices (12-month percent change, eop)	4.9	5.1	20.1	20.1	0.0	18.9	5.7	12.0	7.0	6.0
Consumer prices (12-month percent change, average)	4.3	5.6	10.2	24.5	6.8	7.8	16.6	5.6	8.0	5.5
Investment and savings (in percent of GDP)										
Investment	21.8	22.8	21.3	20.3	23.0	23.9	24.3	25.0	25.0	25.4
Public	4.8	4.3	4.8	4.1	5.0	5.4	5.8	6.1	6.3	6.5
Private	17.0	18.5	16.5	16.2	17.9	18.5	18.6	19.0	18.7	18.9
Savings	24.6	19.8	21.0	12.3	23.6	17.5	18.1	12.3	19.8	21.3
Public	1.0	1.6	4.1	5.1	3.8	-0.4	1.0	-1.2	1.4	2.9
Private	23.6	18.2	16.9	7.2	19.8	17.9	17.1	13.5	18.4	18.4
Savings-investment balance	2.8	-3.1	-0.2	-8.1	0.7	-6.4	-6.3	-12.7	-5.1	-4.1
General government finances (in percent of GDP) 1/										
Total revenue and grants	24.7	26.4	30.3	29.9	32.1	30.5	33.3	32.8	31.1	30.5
Of which: Tax revenue	20.0	21.4	22.6	23.0	22.2	22.3	24.2	25.5	25.1	24.8
Total expenditure (including net lending)	28.1	28.9	31.0	29.2	36.1	36.6	38.0	38.9	35.9	33.9
Of which: Current expenditure	23.7	24.8	26.2	24.8	28.4	31.0	32.4	33.5	29.6	27.4
Capital expenditure	4.8	4.3	4.8	4.2	5.0	5.4	5.8	5.7	6.3	6.5
Overall fiscal balance	-3.6	-2.1	-0.3	0.0	-3.5	-6.3	-4.8	-6.1	-4.8	-3.4
Primary balance	-2.0	-1.2	0.3	0.8	-2.7	-5.4	-3.8	-5.1	-3.8	-2.5
Total public debt	84.2	72.3	57.0	48.6	58.5	60.3	52.4	54.6	52.6	50.7
External sector										
Current account balance (in percent of GDP)	2.8	-3.1	-0.2	-8.1	0.7	-6.4	-6.3	-12.7	-5.1	-4.1
Export of goods and services (in millions of U.S. dollars)	1,053	1,485	2,244	3,037	2,695	2,526	3,482	3,255	3,883	4,440
Export growth (percent change)	2.9	40.9	51.1	35.4	-11.3	-1.1	37.9	-4.1	19.3	14.3
Import of goods and services (in millions of U.S. dollars)	1,397	2,253	3,218	4,747	3,683	3,917	5,160	5,858	6,204	6,917
Import growth (percent change)	23.9	61.3	42.8	47.5	-22.4	6.0	31.7	15.5	5.9	11.5
External public debt outstanding (in percent of GDP)	78.0	69.8	54.6	41.2	52.8	55.1	48.1	48.4	45.8	44.6

Sources: Kyrgyz authorities, and VWB staff estimates.

1/ General government comprises State Government and Social Fund finances. State government comprises central and local governments.

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