



**WORLD BANK GROUP**  
Macroeconomics & Fiscal Management

## Kyrgyz Republic: Biannual Economic Update

*Resilience amid turbulence*

*Special Focus: Meeting the jobs challenge*

Fall 2015



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The first part of the Economic Update analyzes recent macroeconomic trends and presents the team's assessment of the short- and medium-term outlook. The Special Focus Section delves deeper into an issue of particular relevance, in this case summarizing recent World Bank research on labor market dynamics in the Kyrgyz Republic. The issues discussed in the focus section will be analyzed in greater detail in a forthcoming publication prepared by Jennifer Keller (Senior Economist) and Sarosh Sattar (Senior Economist).

## Overview

**1. Amidst a turbulent economic environment in Central Asia, the Kyrgyz Republic's economy has proven relatively resilient during the first eight months of 2015.** GDP grew at a rate of 6.8 percent, year-on-year (y/y), between January and August, boosted by frontloaded gold production and a strong performance of the agricultural sector. Gold output grew by 46 percent (y/y), while the non-gold GDP growth rate reached 4.5 percent, up 0.9 percentage points from the same period in the previous year. However, gold production is projected to decelerate markedly during the remainder of 2015, while increasingly adverse external conditions and exchange-rate developments are expected to depress domestic consumption and private investment, as well as foreign demand. As a result, the overall growth rate for 2015 is projected to slow to 2 percent. As of August the headline inflation rate had fallen to 5.8 percent (y/y) from 10.5 percent at end-2014, but the combined effect of higher public spending and exchange-rate pressures are expected to drive up prices during the final months of the year, underscoring the importance of maintaining a tight monetary stance.

**2. The government's monetary and fiscal policies have been broadly adequate to mitigate exchange-rate and demand shocks.** Given substantial pressures on the exchange rate in the wake of Kazakhstan's move to a free float, the authorities' adopted a prudent strategy in letting the Kyrgyzstani som (KGS) gradually adjust, while preventing sharp swings in its value. However, this policy also decreased domestic liquidity, and this effect was exacerbated by lower than planned expenditure. Delays in planned investments enabled the government to maintain a budget surplus through the first eight months of 2015. However, spending is expected to increase sharply in the second part of the year. A rise in public investment coupled with increasing recurrent expenditures—including wage adjustments and a significant expansion in public procurement—are expected to contribute to a deficit of 5.8 percent of GDP (including on-lending) and an increase in public indebtedness.

**3. Looking beyond 2015, the Kyrgyz economy is projected to recover over the medium term, and public finances are expected to stabilize, but this generally positive outlook is subject to significant downside risks.** In the baseline scenario, growth is projected to accelerate to 4.2 percent in 2016, driven by higher gold production and an expected acceleration in regional economic activity. Growth in the non-gold sectors should be relatively robust at around 3.7 percent, but a slower-than-anticipated recovery in Russia and Kazakhstan could threaten this projection. Moreover, slower growth in both the domestic and regional economies could complicate the process of fiscal consolidation.

**4. An uncertain external environment will call for increased vigilance, with particular attention devoted to the efficiency and sustainability of public expenditures.** While countercyclical policies will help shore up domestic activity and stabilize employment, the government's limited fiscal space underscores the importance of effective public spending. The government has chosen to continue implementing its ambitious public investment program, but the benefits of these investments will take time to materialize and, in the short run high rates of capital spending will widen internal and external imbalances. Moreover, in 2015, a significant increase in recurrent spending is expected to result in higher deficits, while exchange rate developments have caused the value of Kyrgyzstan's external debt, as a share of GDP, to increase significantly. Improved growth prospects in 2016 and beyond should facilitate consolidation going forward, but the authorities will need to remain vigilant. In any scenario it will be key to ensure that fiscal consolidation is achieved by effectively controlling the growth of recurrent spending, but that this does not negatively impact social programs necessary to protect the most vulnerable. Depreciation pressure on the som is expected to continue over the near term, highlighting the importance of a cautious monetary policy stance underpinned by close attention to inflation and financial sector dynamics.

**5. Over the medium term, establishing the conditions for robust job creation will be a central policy challenge.** The deterioration of labor market conditions in Russia and Kazakhstan underscores the

vulnerability of remittance inflows and the extent to which migration cannot be depended upon to make up for anemic employment growth in the domestic economy. The question of how policymakers can support the development a more vibrant labor market in the Kyrgyz Republic is the theme of the Special Focus Section of this Economic Update.

## **A. Recent Political and Policy Developments**

**6. The political landscape continues to be characterized by policy continuity despite the reorganization of the national leadership.** In April 2015, only a year after his appointment, Prime Minister Djoomart Otorbaev resigned, along with the Cabinet, over disagreements with Parliament regarding a proposal to restructure the Kumtor gold mine. Nevertheless, the three-party coalition that had supported Mr. Otorbaev was able to agree on a new government under the leadership of Mr. Temir Sariev, the former Minister of Economy. This was the fourth Cabinet change since President Almazbek Atambaev took office in December of 2011.

**7. New parliamentary elections were held in October.** The elections are unlikely to result in significant changes in orientation. Rather, elements of uncertainty include the speed at which a new Parliament and coalition government can resume operations.

**8. The accession of the Kyrgyz Republic to the Eurasian Economic Union (EEU) presents new opportunities for regional trade.** Parliament ratified the accession treaty on May 29<sup>th</sup>, 2015, and on August 12<sup>th</sup> the Kyrgyz Republic formally joined Russia, Belarus, Kazakhstan and Armenia as the fifth member of the customs union. Customs controls have already been abolished at the border between the Kyrgyz Republic and Kazakhstan. While accession to the EEU is expected to gradually increase trade with other member states, this impact is likely to be modest in the short run, as the Kyrgyz Republic already enjoyed free access to Commonwealth of Independent States (CIS) markets, and that a transition period has been agreed upon for Kyrgyzstan to adjust (upwards) its customs duties to common EEU levels.

## **B. Recent Economic Developments**

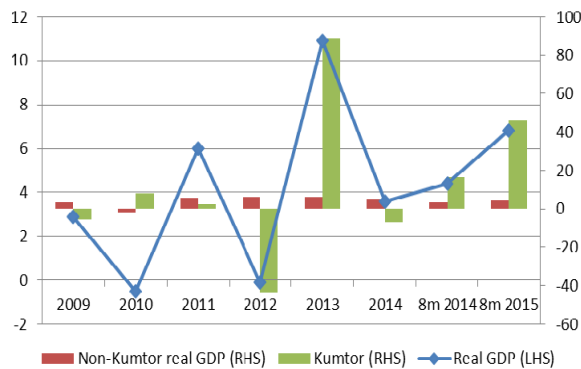
### *Rapid growth through the first half of 2015, supported by frontloaded gold production*

**9. Overall, economic growth was strong during the first eight months of the year, although largely on account of ‘frontloaded’ gold production.** Real output growth reached 6.8 percent (y/y), with the gold sector accounting for nearly half of overall growth (Figure 1). Y/y growth in gold production reached 46 percent, reflecting an inversion in typical production patterns (whereby the bulk of production typically takes place in the second half of each year). In 2015, approximately half of total projected gold production (495,000 troy ounces) happened in the first six months of the year (compared to 2014, when half of the annual output was realized in the fourth quarter), which in turn explains the expected modest outlook for the second half of 2015.

**10. Non-gold GDP growth was also relatively robust at 4.5 percent (y/y) in the first eight months of 2015, thanks to the solid performance of the agricultural sector and, to a lesser extent services.** Favorable weather conditions boosted the agricultural growth rate to 5.3 percent (y/y), compared to a contraction of 1.8 percent a year ago. Service sector growth remained steady at 2.7 percent (y/y) supported by the transportation and communications subsectors. Meanwhile, manufacturing growth slowed to 2 percent (y/y), down from 3.5 percent in the first eight months of 2014. The growth rate of the construction sector fell from 22.2 percent in the first eight months of 2014 to 8.2 percent over the same period in 2015, reflecting both the delayed implementation of the public infrastructure program and weaker demand for residential construction (Figure 2).

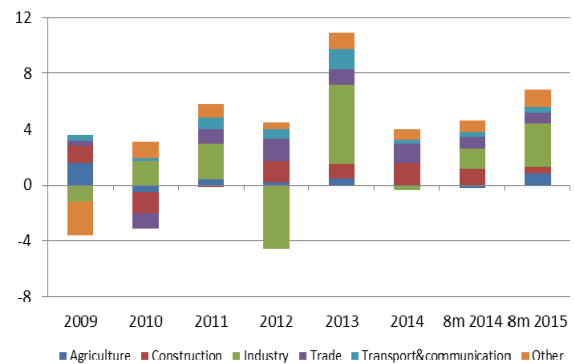
11. **On the demand side, consumption and net exports both contributed positively to growth, offsetting a decline in investment.** Consumption increased by 1.4 percent the first quarter of 2015, down from 3.5 percent in the first quarter of 2014, likely reflecting a significant decline in the dollar value of remittance inflows. Net trade bolstered overall growth through a combination of rising gold exports and a large simultaneous decline in imports. However, investment declined by more than 6 percent, as both public investment and private construction slowed after 4 consecutive years of rapid growth.

**Figure 1: The Real GDP Growth Rate, 2009–August 2015 (%)**



Source: National Statistics Committee.

**Figure 2: GDP Growth by Sector, 2009–August 2015 (%)**



Source: National Statistics Committee.

12. **Both non-gold exports and imports fell during the first half of the year in US dollar terms, reflecting the weakening regional economic environment.** The deepening recession in Russia coupled with slowing growth in Kazakhstan significantly decreased export demand, as CIS countries typically account for around 80 percent of the Kyrgyz Republic’s non-gold exports (Box 1). By the same token the worsening external environment also depressed imports via lower remittances, which are estimated to have dropped by about 25 percent (y/y) in dollar terms during the first half of 2015, a decline of US\$255 million.

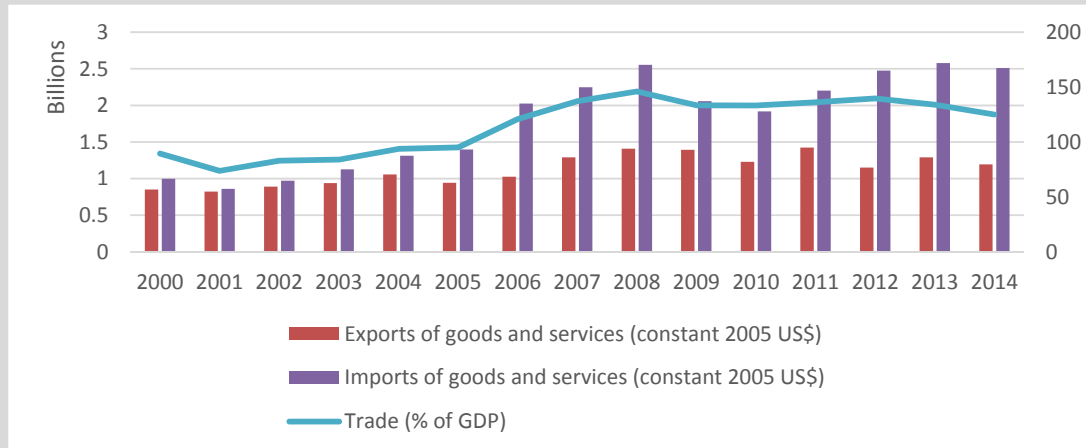
13. **It is not clear to what extent these dynamics may have been influenced by the Kyrgyz Republic’s accession to the EEU.** While EEU membership did not immediately alter trade conditions, there is anecdotal evidence that stricter controls have been imposed on re-exports since 2014 and that traders involved in the re-export subsector have begun closing their operations.



### Box 1: The Economy of the Kyrgyz Republic is Highly Sensitive to External Conditions

The Kyrgyz Republic has become increasingly open to trade over the years, and particularly since the massive emigration of Kyrgyz workers at the turn of the century.

Exports, Imports and Trade Volumes, 2000-2014



Source: World Bank World Development Indicators Database

Gold exports—most of which are bound for Switzerland and the Middle East—account for a significant share of total exports, averaging 27.6 percent during the past three years. However, CIS countries, especially Kazakhstan and Russia, are the main destination for non-gold exports, accounting for an average of 84 percent over the past three years. Rising remittance inflows, which increased to over US\$2 billion in 2014, (equivalent to over 27 percent of GDP and 42.5 percent of the total import bill), have financed a substantial expansion in imports. As a result, the Kyrgyz Republic is significantly exposed to market developments in Kazakhstan and Russia through both trade and remittance channels. While these effects tend to offset one another in terms of their net impact on the current account—as falling export demand tends to be accompanied by a concurrent drop in import-financing remittances—they compound one another in terms of their impact on overall growth.

#### *A worsening external environment is expected to halt progress in poverty reduction*

**14. Agricultural output and remittance inflows have a major impact on poverty in the Kyrgyz Republic.** Agriculture employs a large share of the population, and especially the poor, while remittances play a key role in household consumption. While falling remittance levels affect households almost immediately, the impact of changes in agricultural production on consumption and poverty is typically delayed, as the fall harvest is sold in the early months of the following calendar year.

**15. A rebound in agricultural output in 2013 and rising incomes from farming are believed to have underpinned the substantial progress in poverty reduction observed in 2014.** According to official statistics<sup>1</sup> the absolute poverty rate is estimated to have fallen by over 6 percentage points between 2013 and 2014 to 30.6 percent (see Box 2). As a result, in 2014 around 1.8 million people out of a total population of 5.9 million were estimated to live below the poverty line of KGS 29,825 per year.<sup>3</sup> Meanwhile, extreme

<sup>1</sup> The World Bank does not currently have access to the primary dataset and thus cannot measure the standard errors in official poverty figures.

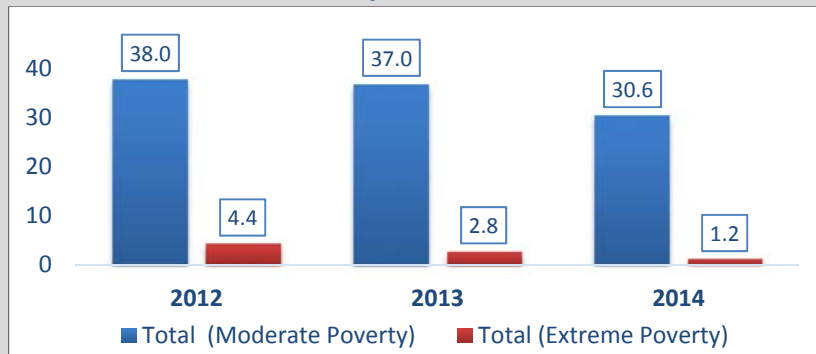
<sup>3</sup> The absolute and extreme poverty lines are based on a basket of essential food and nonfood goods. The absolute poverty line reflects the total cost of the basket, while the extreme poverty line reflects the cost of the food component alone. The cost of the basket was calculated in 2011 and adjusted to account for changes in food and nonfood prices in 2012, 2013 and 2014.

poverty is believed to have decreased by 1.5 percentage points to 1.2 percent of the population, or 71,000 people living on less than KGS 17,588 per year.

**Box 2: Rising Agricultural Incomes Supported Important Gains in Poverty Reduction in 2014**

**Both absolute and extreme poverty are believed to have fallen significantly in 2014 on the back of a good harvest and steady remittance inflows in 2013.** The labor market was the most important factor driving poverty reduction as measured by national poverty line - by almost 4 percentage points- over 2013-2014<sup>4</sup>, with wages (and earnings from sales of agricultural products) remaining the most important drivers of improved living standards along with pensions.

**Absolute and Extreme Poverty Rates, 2012-2014**

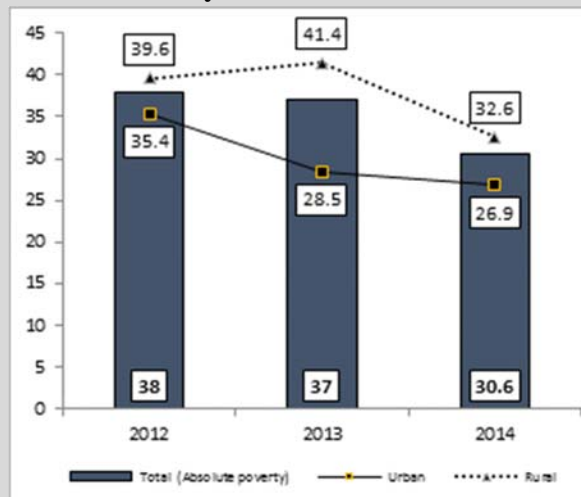


Source: NSC, 2015

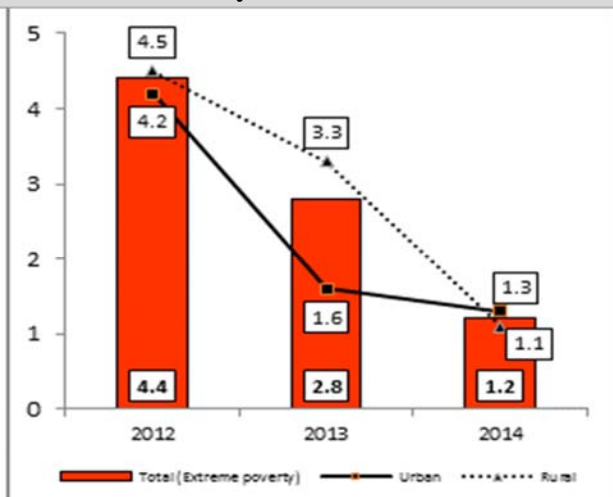
**A sharp decline in rural poverty narrowed the gap between rural and urban poverty rates.** From 2013 to 2014 the rural poverty rate fell by 8.8 percentage points to about 33 percent, (reflecting both income gains and the distribution of households close to the poverty line). By contrast, urban poverty is estimated to have declined by a more modest 1.6 percentage points to about 27 percent. The reduction in poverty was accompanied by a decrease in inequality, and the Gini index slid from 24.0 in 2012 to 22.5 in 2014.

**Changes in Poverty Rates by Urban and Rural Sectors, 2012-2014**

**Absolute Poverty Rates**



**Extreme Poverty Rates**



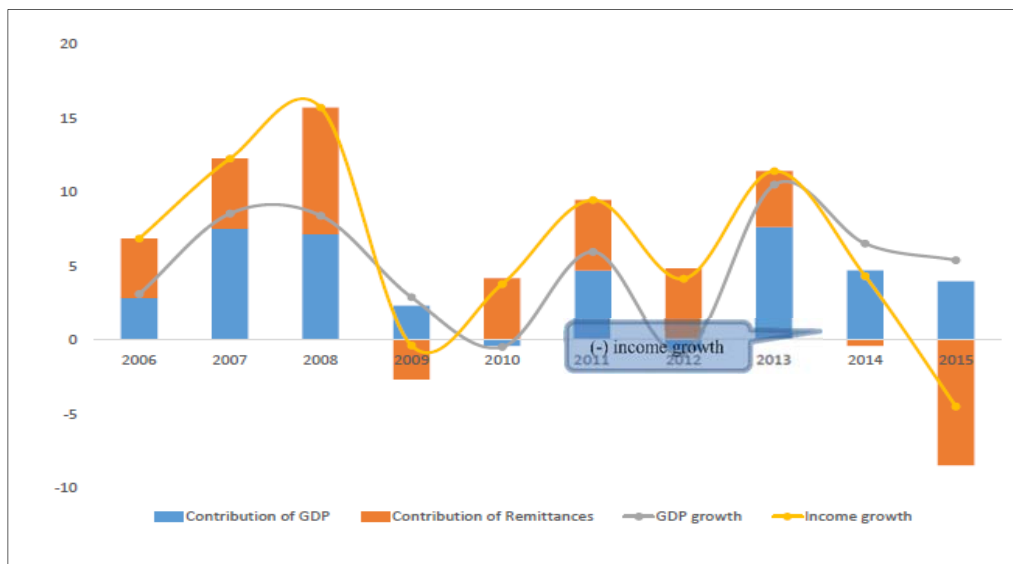
Source: NSC, 2015



16. **However, given the current macroeconomic outlook the country’s prospects for further poverty reduction are less encouraging.** The growth of rural incomes in 2013 appears to have been largely the result of a cyclical increase in agricultural output (+2.7 percent), rather than a structural improvement in productivity, and the sector contracted in 2014 (-0.6 percent). Moreover, remittances, which represent a significant share of the income of about 15 percent of Kyrgyz households, fell substantially in 2014 and continued to slide in 2015. In US dollar terms, private transfers—originating primarily from Russia—fell by 5.2 percent between 2013 and 2014 and are projected to contract by 20 percent in 2015, representing an income loss of over US\$400 million.

17. **Driven by the sharp depreciation of the Russian ruble, declining remittances could result in negative income growth for the first time in years.** While lower remittances will affect growth through their impact on consumption, GDP figures will tend to understate the magnitude of the welfare shock. For much of the past decade income growth has consistently outpaced GDP growth in Central Asia’s poorer countries, including the Kyrgyz Republic, allowing households to expand their consumption well above what would be possible through the growth of domestically generated income alone. However, a sufficiently large shock to remittances could reverse this pattern, and in 2015 the decline in remittances is expected to result in *negative* income growth despite a *positive* increase in domestic economic output.

**Figure 3: Declining remittances driving negative income growth in 2015**



Source: World Bank calculations (Chief Economists’ Office)

*Fiscal indicators have remained in the green, mainly on account of delayed expenditures and one-off revenues*

18. **The fiscal balances improved overall in the first eight months of 2015, as the government slowed its investment program.** As of end-August 2015 the budget recorded a surplus of KGS 2.5 billion, equivalent to 1 percent of GDP, up from a deficit of 3.6 percent at the same time in the previous year (Table 1). However, this was mainly due to a large drop in foreign-financed capital spending as a share of GDP.<sup>1</sup> As a result, government deposits at the central bank rose from KGS 17 billion at end-August 2014 to almost KGS 20 billion at end-August 2015.

<sup>1</sup> These low figures could also reflect delays in reporting, as China-financed investments do not flow through the Treasury, but are reported by the Ministry of Economy to the Ministry of Finance. As a result, detailed activity reports are typically delayed.

19. **Tax revenues fell slightly as a share of GDP, as the decline in trade taxes was only partially offset by strong gains from one-off nontax revenues.** Income taxes from mining companies increased to 1.7 percent of GDP in the first eight months of 2015, up from 1.1 percent during the same period in 2014, as gold mines ramped up production. This partly compensated for falling import-duty collections, which typically account for around 45 percent of total tax revenues. The robust performance of the agricultural sector over the first eight months of the year did not translate into significant fiscal gains, as farmers are exempt from VAT and income taxes. However, nontax revenues increased to 9.4 percent of GDP (versus 8.1 percent a year before) mainly due to a one-off licensing fee of US\$100 million for the development of the Jerui gold mine.

20. **Total spending declined as a share of GDP due to the delayed implementation of public investment projects.** Over the first eight months of 2015 total spending fell to 30.6 percent of GDP, down from 36.2 during the same period in 2014, as the government slowed the implementation of foreign-financed public investment projects and took measures to contain current spending, given (i) the anticipation of future budgetary pressures stemming from the upcoming elections, and (ii) remaining uncertainty over the share from pooled EEU customs revenues that the Kyrgyz Republic would be able to claim under the new arrangement during the second half of 2015,

**Table 1: The Government Budget, January-August 2015 (in % of GDP)**

	Jan-Aug 2014	Jan-Aug 2015
<b>Total Revenues and Grants</b>	32.6	31.6
Total Revenues	29.9	29.8
Current Revenues	29.9	29.8
<i>Tax revenues</i>	21.8	20.4
<i>Nontax revenues</i>	8.1	9.4
Capital Revenues	0.0	0.0
Grants	2.7	1.8
<b>Total Expenditures</b> (including net lending)	36.2	30.6
Current Expenditures	27.2	26.5
Wages and SF Contributions	9.9	9.5
<i>Wages</i>	8.8	8.4
<i>SF contributions</i>	1.1	1.1
Transfers and Subsidies	3.8	3.8
<i>Transfers to SF</i>	4.6	4.4
<i>Interest</i>	0.9	0.9
Other goods and services procurement	8.0	7.9
Capital Expenditures	8.7	4.1
<i>Domestically financed capital spending</i>	1.6	2.4
<i>PIP loans</i>	6.6	1.4
<i>PIP grants</i>	0.5	0.4
<b>Net Lending</b>	0.2	0.0
<b>Overall Balance</b>	-3.6	1.0
<b>Financing</b>	3.6	-1.0
External	6.8	0.8
Domestic	-3.2	-1.8
Source: Ministry of Finance		

**21. With the budget in surplus, public debt fell during the first half of the year.** As of end-June 2015 the total public debt-to-GDP ratio had declined to 53.5 percent, down from 54 percent at the end of 2014. External public debt fell to 50.5 percent of GDP, versus 50.9 percent at end-2014, with the change in the size of the debt stock more than offsetting the price effect of the som's depreciation against the dollar during the first half of the year. Meanwhile, domestic debt declined slightly from 3.1 percent of GDP to 3 percent. However, in the second half of the year a significant acceleration in spending combined with exchange-rate effects is expected to cause a steady buildup in the public debt stock. While the Kyrgyz Republic is expected to remain at moderate risk of debt distress under the World Bank-IMF debt-sustainability assessment (DSA) framework, some indicators will begin to approach the higher risk threshold (Box 3).

### **Box 3: How sustainable is public debt?**

In 2014, a joint World Bank-IMF DSA determined that the Kyrgyz Republic was at moderate risk of debt distress. Under the baseline scenario all present-value based external indicators were projected to stay below their indicative thresholds over the DSA horizon. Meanwhile, debt-service obligations were projected to remain manageable due to the highly concessional nature of the country's external debt. However, stress tests revealed that external public debt indicators could breach their thresholds in the event of a sharp depreciation of the som or a significant reduction in non-debt-creating inflows.

During the first half of 2015 a number of elements of this scenario began to materialize, as the exchange rate depreciated and remittance inflows contracted sharply. While at this point it is unlikely that key indicators will breach their thresholds, or that the Kyrgyz Republic's risk of debt distress will be reassessed as high, the country's debt outlook is clearly worsening.

Under these conditions greater vigilance will be required to ensure that spending is allocated efficiently and that fiscal discipline is maintained. The authorities should consider: (i) establishing a transparent mechanism and guidelines for the independent appraisal, monitoring and evaluation of public investments, (ii) consolidating public finances through fiscal adjustment, (iii) borrowing only on concessional terms, and (iv) developing a medium-term debt-management strategy.

Source: Kyrgyz Republic DSA, March 2015.

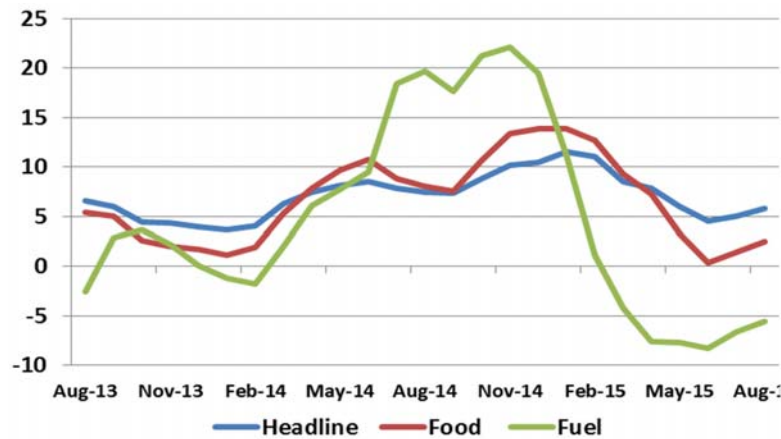
*Rising pressure on the som has thus far had a limited effect on inflation and the financial sector, but it has significantly narrowed the scope for expansionary monetary policy*

**22. Inflation moderated over the first half of 2015.** The headline inflation rate declined to 5.8 percent (y/y) in August 2015, down from 10.5 percent in December (Figure 4). The impact of the som's depreciation on import prices, and its partial pass-through to domestic prices,<sup>2</sup> appears to have been offset by a tighter monetary stance, the impact of lower remittance inflows on household consumption and the government's efforts to contain public spending.

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<sup>2</sup> According to IMF estimates the pass-through effect of a 1 percent depreciation of the som is 0.17 and 0.30 for food and nonfood prices, respectively.

**Figure 4: Inflation slowing down in the first half of 2015**

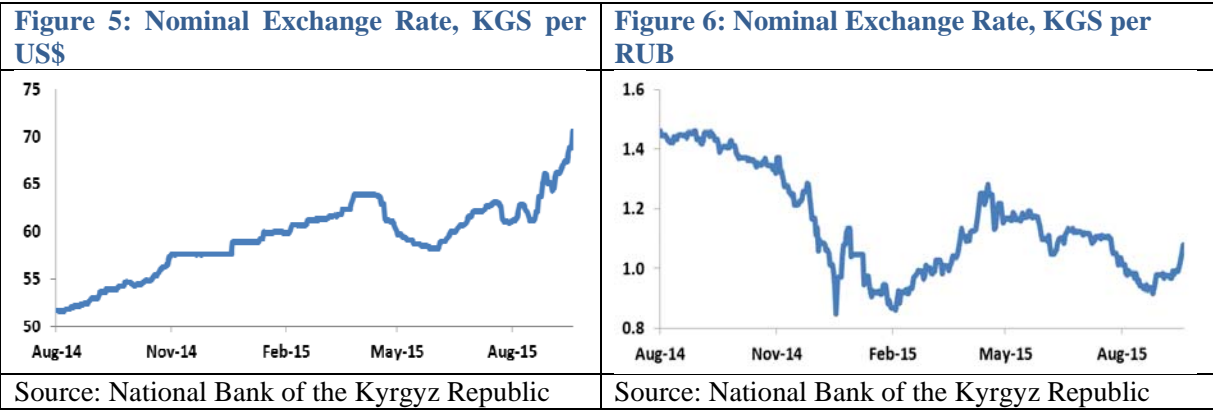


Source: National Statistics Committee

**23. Monetary policy has been broadly accommodative but its effect muted by intervention on foreign exchange markets.** With y/y inflation above the two digit mark at the beginning of the year, the central bank raised its interest rate to 11 percent in late January. It was subsequently reduced to 9.5 percent in May and to 8 percent in July to support domestic activity as inflationary pressures eased. However, in parallel, open market operations by the Central Bank to limit exchange rate fluctuations and the slow pace of public spending contributed to slow money growth, which fell to 7.8 percent (as of end-August) from 12.3 percent a year before. Possibly as a result of tighter liquidity conditions, the growth of credit to the economy declined to 29 percent as of end-August (from 43.6 percent at the end of December 2014).

**24. The depreciation of the Russian ruble (RUB) and the Kazakhstani tenge relative to the US dollar has put considerable pressure on the som.** To mitigate sharp fluctuations in the value of the som relative to the dollar the central bank intervened in the foreign-exchange market, selling US\$215 million in US dollars during the first eight months of 2015. Though this may have helped smooth exchange-rate volatility, it failed to prevent the som from depreciating against the dollar. Between January 1<sup>st</sup> and mid-September the som lost almost 19 percent of its value in dollar terms (Figure 5).

**25. Low inflation and the nominal depreciation of the som vis-à-vis the dollar are bolstering international competitiveness.** After a strong appreciation during 2014 the real effective exchange rate has depreciated significantly since February of this year. As of end-August the real effective exchange rate had fallen by 8 percent, helping to restore the country’s competitiveness.



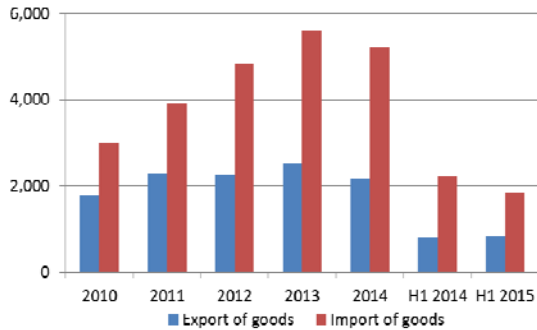
**26. The financial sector has proven resilient to the continued depreciation of the som, but high rates of dollarization are a source of vulnerability.** Financial sector indicators remain broadly sound with only modest deterioration in key indicators. The capital-adequacy ratio of commercial banks fell to 21.2 percent at end-August 2015, down from 23.8 percent the year before. Meanwhile, the return on assets and equity declined from 2.6 to 1.8 percent and from 16.3 to 12.9 percent, respectively. At the same time, NPLs are reported to have slightly declined to 5.6 percent from 5.8 percent over the same period. The weakening of the som against the US dollar is straining bank balance sheet of the commercial banks but an overall long currency position in the sector has been preventing financial distress so far; however by the same token credit risk could increase going forward.

*On the BOP side, “gains” in trade offset by tepid transfers*

**27. The trade balance improved during the first half of 2015, thanks to strong gold exports and a sharp decline in imports.** Gold exports increased by 42 percent in US dollar terms in the first half of 2015 (y/y), more than offsetting a 17.7 percent decline in non-gold exports. As a result total exports grew by 3.5 percent (y/y). At the same time the combined effect of low consumption, declining investment and falling commodity prices caused total imports to drop by almost 18 percent (y/y) in US dollar terms. Overall, the trade deficit contracted to 34.9 percent of GDP (or US\$1 billion) in the first six months of 2015, down from 48 percent of GDP (US\$1.4 billion) in the first half of 2014.

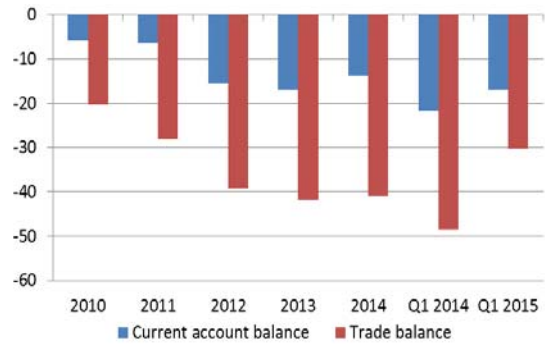
**28. However, this improvement in the traded balance was offset by a decline in transfers, leaving the current-account balance broadly unchanged.** With remittances adversely affected by the sharp depreciation of the ruble (price effect, despite an increase in ruble terms), private transfers declined by USD 136 million relative to the level of 2014 as of end-March. Moreover official transfers also declined. Overall the current account deficit remained stable (at around 17 percent) as a share of GDP, relative to the first quarter of 2014.

**Figure 7: Exports and Imports, 2010 – H1 2015, (in US\$ millions)**



Source: National Bank of the Kyrgyz Republic

**Figure 8: Trade and Current-Account Balances, 2010 – Q1 2015 (in % of GDP)**



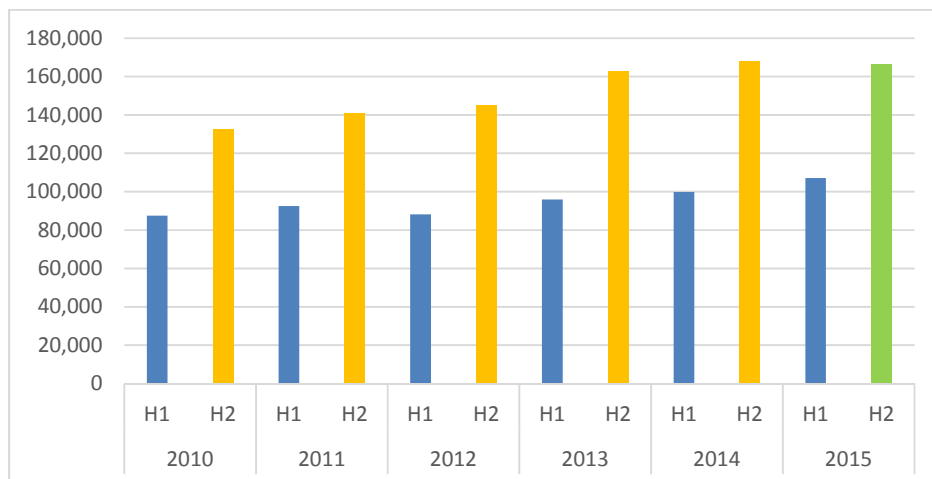
Source: National Bank of the Kyrgyz Republic

### C. Outlook: Maintaining a Cautious Policy Stance in a Difficult Climate

*Growth is expected to slow in the second half of the year despite increased public spending*

29. We project overall economic growth to moderate to 2 percent for 2015 as a whole, and then improve gradually over 2016-2018. The year-on-year increase in output observed over the first half of 2015 largely reflected the frontloading of gold production. Output during the second half of the year is projected to decline marginally from the same period in 2014 (Figure 9). Total gold production in 2015 is expected to be lower than in previous years, and the impact of increased public spending (both recurrent expenditures and investment) will be more than offset by the anemic growth of private consumption and a decline in private investment, coupled with weakening external demand. Developments in Russia and Kazakhstan underpin these projections; both countries have recently revised their growth projections downward, lowering anticipated remittances and intensifying risks to the exchange rate.

**Figure 9 Sluggish growth in the second half of 2015 should result in a modest overall performance.**



Source: Official statistics and WB projections for 2015



**30. In a context of lower growth, the government's planned fiscal expansion will increase pressure on both domestic and external balances.** Higher recurrent spending on wages and procurement coupled with slower revenue growth will significantly reduce the gross operating balance as a share of GDP (assuming only modest increases in social benefits). Moreover, with public investment projected to pick up during the second half of the year, the budget should shift from a net lending position (+0.2 percent of GDP) in 2014 to a net borrowing position (-2.4 percent) in 2015. Due to increased spending and further exchange-rate depreciation the value of the public debt stock (to GDP) is expected to rise sharply.

**31. The resulting deterioration in the savings-to-investment ratio will also be reflected, mechanically, in the balance of payments.** The trade deficit is expected to fall during 2015 (both in nominal terms and as a share of GDP) due largely to favorable terms-of-trade developments. Although exports are projected to decline faster than imports (by volume), the significant drop in import prices should help narrow the trade deficit from 39.6 percent of GDP in 2014 to an estimated 35.8 percent. However, a significant drop in remittance inflows is expected to widen the current-account deficit from 16.8 percent of GDP to 18.5 percent.

**32. Financing this current-account deficit will require the government to draw down its US dollar reserves.** Although loan disbursements and foreign direct investment are both projected to increase in 2015, the government will still need to use a portion of its international reserves to meet its external financing obligations. As a result, total international reserves are projected to decline to approximately US\$1.7 billion, or 3.4 months of imports, down from 4.5 months in 2014.

**33. The government's ambitious program to develop critical infrastructure should bolster growth in the medium term, but at the cost of increased vulnerability; vigilance and flexibility will be required to adapt to changing external and domestic circumstances.** On the fiscal side, even under a fairly optimistic growth scenario, particular caution will be needed to control and streamline current expenditures, while ensuring that measures taken are not regressive from a social point of view (such as counterbalancing the higher civil service wage bill by reductions in social protection outlays). Low hanging fruits (although politically difficult) include streamlining energy subsidies and adjusting energy prices and mobilizing grant support (through accelerating structural reforms). On the BOP side, it will be key for the Kyrgyz Republic to fully leverage the potential for EEU integration to boost exports, by investing in upgrading the national framework for quality controls and certification to EEU standards and accelerating the harmonization of norms and standards.

*The medium-term outlook is generally positive, but subject to significant downside risks*

**34. Economic growth is expected to modestly accelerate in 2016, reflecting higher gold production and exports, as well as a gradual improvement in regional conditions.** The GDP growth rate is projected to reach 4.2 percent in 2016 and 3.4 percent in 2017, with non-gold output expected to gradually return to trend, expanding at a rate of 3.7 and 4.2 percent in 2016 and 2017, respectively. This forecast assumes: (i) rising gold exports in 2016, as increased production more than offsets lower global prices, and (ii) improving conditions in Russia and Kazakhstan,<sup>3</sup> which will allow exports and remittance inflows to gradually recover.

**35. On the external side, the current-account balance is expected to improve as private transfers recover.** After two consecutive years of declines in both exports and imports, an improving external environment is projected to support renewed export growth, while stronger domestic conditions and rising public investment levels should cause a countervailing rise in imports. After falling by almost 20 percent in 2015 in US dollar terms, remittance inflows are projected to grow by over 10 percent in 2016 and 2017.

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<sup>3</sup> Under the baseline scenario the Russian economy is expected to contract by 0.6 percent in 2016 before expanding by 1.7 percent in 2017. Meanwhile, Kazakhstan's growth rate is expected to rise from 1.5 percent in 2016 to 3.3 percent in 2017.

As a result, the current-account deficit is projected to improve significantly as a share of GDP, narrowing from 18.5 percent in 2015 to 13 percent by 2017.

**36. However, significant downside risks threaten this outlook, particularly the possibility of adverse developments in Russia and Kazakhstan.** If global oil prices were to fall below the baseline projection of US\$53 per barrel, the Russian economy could contract by as much as 2.8 percent in 2016, while growth in Kazakhstan would slow substantially. Worsening conditions in Russia and Kazakhstan would reduce demand for Kyrgyz exports and diminish the value of remittances inflows. A further depreciation of the som could fuel inflationary pressures, necessitating tighter monetary controls, and depress domestic demand, with negative implications for growth.

**37. Even in a more optimistic scenario fiscal consolidation will be needed in order to maintain debt sustainability and alleviate pressure on the exchange rate.** In light of the government's ambitious public investment, improvements in tax collection and tight control over recurrent spending will be necessary to ensure fiscal equilibrium. The authorities will need to enhance the efficiency of the tax administration, with the goal of increasing tax revenue from 20.4 percent of GDP in 2015 to 22 percent by 2017. In addition, the government will need to control the growth of recurrent spending, cutting total public expenditures from 30.5 percent of GDP in 2015 to 28.3 percent by 2017.

### Special Focus: Meeting the Jobs Challenge

**38. Providing access to more and better jobs to its citizens is arguably the most pressing and fundamental challenge facing the Kyrgyz government.** In a constrained fiscal environment (limiting the scope for social transfers to increase) and given uncertainties surrounding the economic fortunes of Russia (and its continued ability to absorb foreign labor), domestic job creation constitutes the principal channel through which the welfare of Kyrgyz citizens will improve in the medium-to-long run. However, the recent track-record in the Kyrgyz Republic points to important constraints. Not only is the rate of job creation too low, but productivity and wage growth (i.e. the quality of jobs) have declined in recent years.

**39. A jobs agenda must include overall economic growth but additional considerations as well.** While economic growth is a necessary condition for more and better jobs to materialize, understanding the demographic, geographic and skills dimensions of the employment challenge can help devise policies that increase the elasticity of jobs creation to overall economic expansion.

**40. In this context the following Special Focus Section presents the main findings of a forthcoming World Bank report entitled "Transitioning to Better Jobs in the Kyrgyz Republic."** The report is expected to be launched and publicly disseminated in 2015. Interested parties are welcome to contact the World Bank office in Bishkek to obtain more detailed information on the upcoming launch.

**41. A successful strategy for promoting strong and sustained job creation in the Kyrgyz Republic should be based on three pillars.** These include: (i) support for private sector development, with a particular focus on small and medium enterprises, (ii) the alleviation of binding constraints on export growth, and (iii) leveraging remittance income to expand domestic economic activity.

### Changing patterns of employment across space and occupation

**42. Patterns of employment in the Kyrgyz Republic have evolved considerably since the dissolution of the Soviet Union with two major shifts:** (i) initially, after the dissolution of the Soviet system of production, a major 'return to the land', then followed by; (ii) gradual re-urbanization –however with jobs mostly in services- and mass outmigration of Kyrgyz workers.

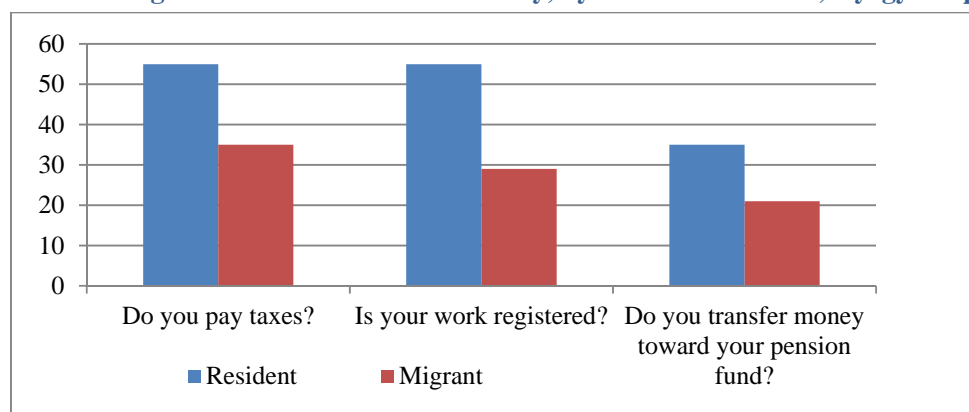
43. **The unravelling of the soviet system of production translated into a decline of industry and “re-ruralization” of the population.** In the early 1990s, the Kyrgyz industrial sector<sup>4</sup> contracted sharply –by almost three quarters-, with sizeable jobs losses. At the same time, the dismantling and privatization of large public farming entities encouraged previously urban workers to take advantage of the newly created agricultural plots as a livelihoods strategy. As a result, by the early 2000s agriculture had become the main sector of employment (for about half of the labor force).

44. **In parallel the nature of employment also changed: from guaranteed wage employment to predominantly informal and irregular occupation.** Employment outside of registered establishments came to account for 70 percent of total employment, with predominant informality in agriculture, construction and services.

45. **The lack of prospects and mobility offered by this ‘model’ eventually triggered massive internal and external migration.**

- **Internal migration mostly from the rural south to northern urban oblasts.** Between 2005 and 2010 it is estimated that some 7-9 percent of the rural population moved to urban areas, where complex and discretionary registration procedures (in addition to weak demand for formal labor) have tended to confine internal migrants to informal activity.

**Figure 10 Differences in Formality, by Residential Status, Kyrgyz Republic, 2010**

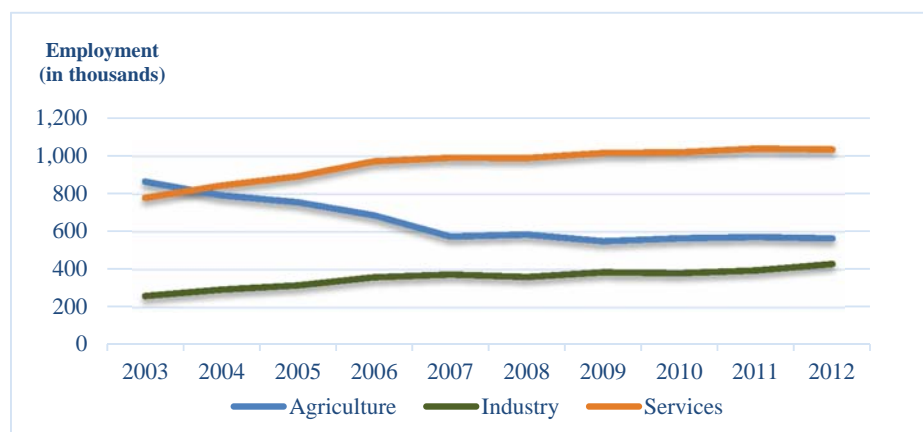


Source: Nasritdinov et al. 2010.

- **External migration predominantly to Russia and Kazakhstan.** Starting in the early 2000’s, massive in- and outmigration has absorbed excess rural labor, while remittance income has boosted domestic consumption and demand for urban services. Within the span of a decade, the Kyrgyz Republic became the second remittance-receiving economy (as a share of GDP) after Tajikistan. In turn, remittance income boosted domestic consumption manifested in a significant rise in imports, falling poverty and shift in GDP and employment from agriculture to services.

<sup>4</sup> The soviet-era industrial sector was dominated by power generation, engineering, and metal, fuel and chemical production.

**Figure 11 Total Domestic Employment, by Sector, Kyrgyz Republic, 2003–12**



*Source:* Estimates based on data of the Kyrgyz Labor Force Survey.

**Table 2 Changes in the Structure of GDP, Kyrgyz Republic, 2000–13**

	2000	2004	2009	2013
Average annual real GDP growth	--	5%	4%	4%
(from prior year shown to year)				
Share of GDP (current LCU)				
Agriculture	37%	33%	21%	17%
Industry	31%	24%	27%	29%
Manufacturing	19%	17%	16%	18%
Construction	4%	3%	8%	7%
Mining	1%	1%	1%	1%
Gas/elec/water	7%	4%	2%	2%
Services	32%	43%	52%	54%

*Source:* Kyrgyz Republic, World Bank Development Economics LDB Database, 2015.

**46. Though out-migration acts as a safety valve for a constrained domestic labor market, there are risks involved in this dependence, as well as possible negative effects; moreover demographic pressure will also require domestic alternatives to emigration.** First, the ability of the Russian economy to continue to absorb foreign labor cannot be taken for granted and risks exist, ranging from limited additional job creation in Russia to the large scale return of migrants. Second, the inflow of remittances has possibly undermined the competitiveness of the domestic economy through real effective exchange rate

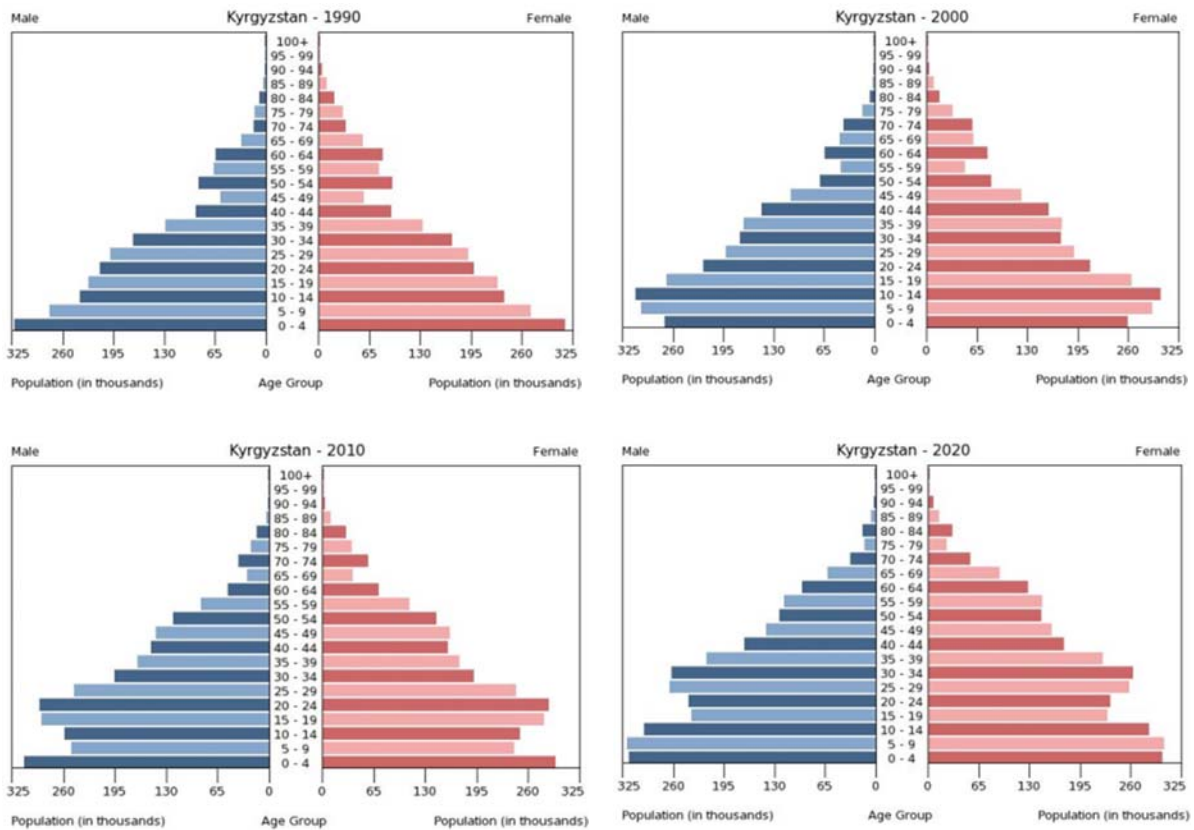
appreciation and rising labor costs. Finally, the demographic structure of Kyrgyzstan is such that job creation will remain a central challenge for years to come.

**The demographic challenge: curse or blessing depending on job outcomes**

**47. Job creation is lagging labor force growth.** Between 2009 and 2013, job growth averaged only 0.9 percent per year or roughly two thirds the pace of expansion of the labor force. The relative stability in official unemployment, therefore, was achieved through increased out migration and exit from the labor force.

**48. Population dynamics are such that the jobs challenge will be magnified in years to come.** As can be seen from the shape of the population pyramid, not only will the bulk of today’s active population remain in the labor force in the near future, but the number of new entrants will also swell.

Figure 12 Population Dynamics, Kyrgyz Republic, 1990–2020

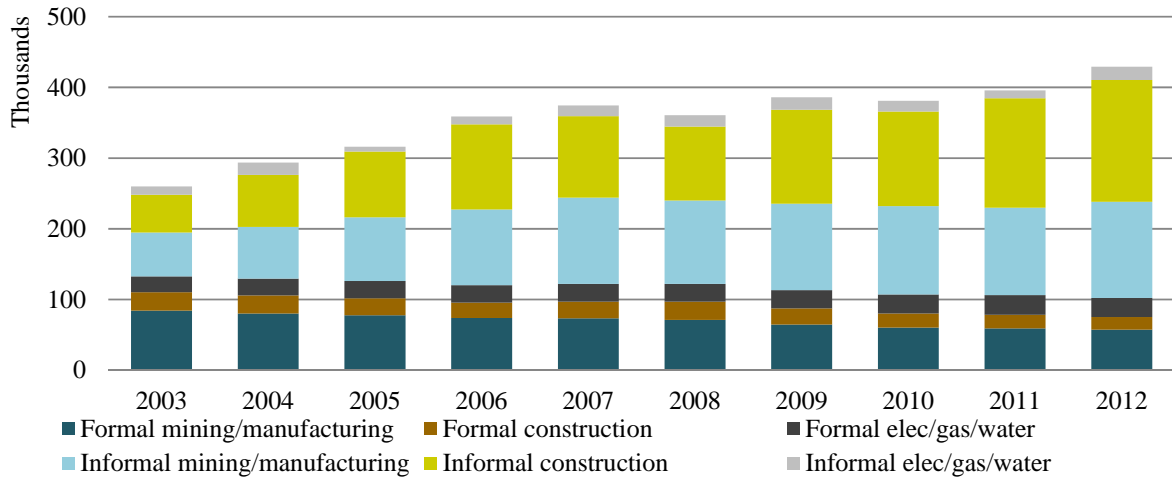


*Sources:* World Population Prospects: The 2012 Revision (database), Population Division, Department of Economic and Social Affairs, United Nations, New York, <http://esa.un.org/unpd/wpp/index.htm>.

**49. Job quality is also an issue.** The Kyrgyz Republic has the second-lowest level of output per worker in Europe and Central Asia. Since 2005, output per worker has increased by 4.3 percent per year, which is significantly below the rates observed in other (including poorer) CIS countries. Moreover productivity growth has been declining over the years, from an average of 7 percent per year in 2005-09 to 0.7 percent per year in 2009-12. The decline in productivity has gone hand in hand with an explosion of informality in

non-agricultural non-state sectors: with the formal private sector accounting for only 11% of total employment.

**Figure 13 Composition of Industrial Sector Employment, 2003-2012**



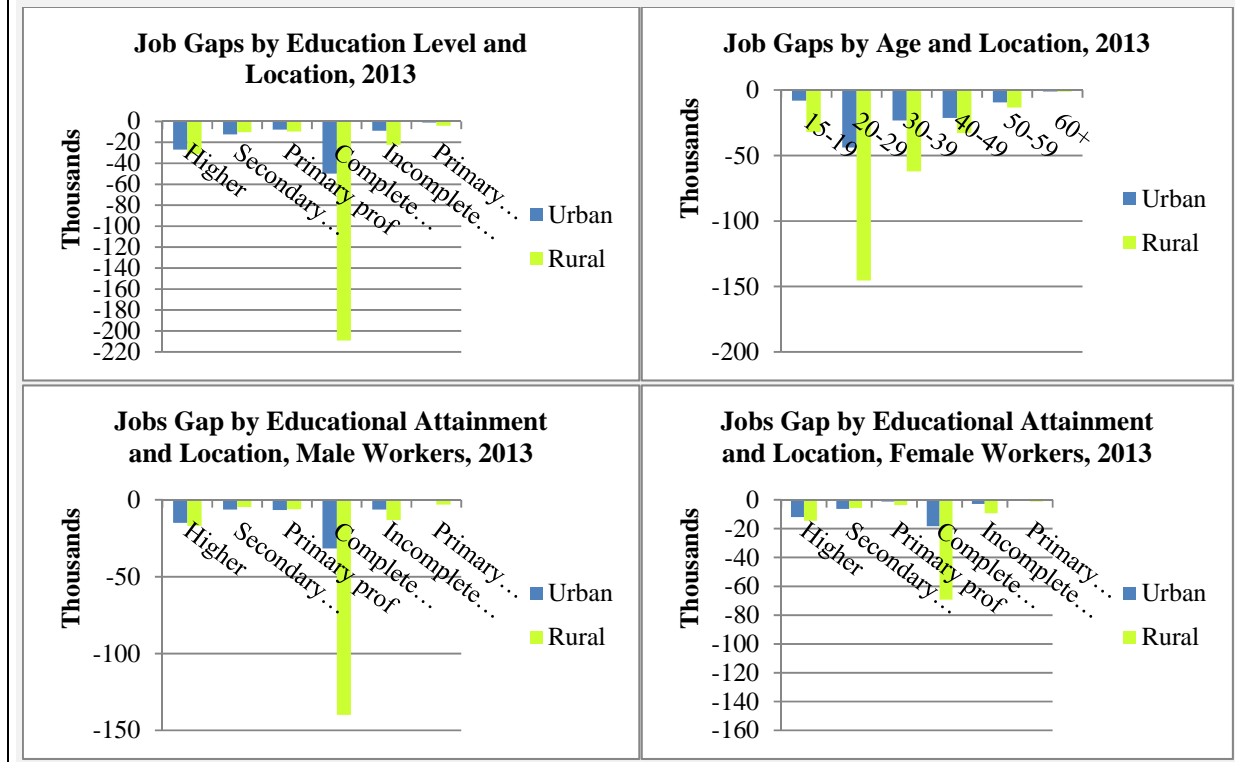
Sources: Formal employment: estimates based on establishment reports collected by the National Statistical Committee of the Kyrgyz Republic. Total employment: estimates based on data of the Kyrgyz Labor Force Survey.

Note: Informal employment is estimated as the difference between overall employment in the sector as reported by households in the Labor Force Survey and the employed reported by registered establishments through the KER.



#### Box 4: Job Deficit Highest for Rural Youth with Limited Education

Another approach to illustrating the quantity and quality deficit of jobs is to look at jobs gaps, which are larger for young rural males with only complete secondary education. Precisely the segment of the population that is expected to grow in the future.



#### Economic Dualism: Understanding the productivity/employment asymmetry

50. **The Kyrgyz economy is characterized by dualism, with particular implications for quality job creation:** while production and productivity growth are overwhelmingly driven by the small formal sector, job creation has occurred primarily in the large informal economy. Between 2009 and 2012, value added growth in formal establishments averaged 6.6 percent per year, but job growth was less than 0.4 percent (much of it, moreover, in non-profit entities or state-owned enterprises). Specifically, while manufacturing contributed the most to output growth in this period, the sector actually shed jobs.

51. **The formal sector is dominated by a small number of large conglomerates, while new firms struggle to survive and expand.** These conglomerates face limited competitive pressures and do not create jobs. While employment creation is most likely to come through entry and expansion of new, initially small firms, this prospect appears constrained in the Kyrgyz Republic. Data from the Kyrgyz Establishments Report (KER) suggests that considerable churning (entry and exit) occurs for small and medium firms with considerable barriers to expansion for those that survive.

52. **Few of the firms that manage to grow and create employment are export oriented.** Among the top quintile of establishments in terms of job growth in which value added was positive, only about 15 percent of value added derives from tradables (whether in fact traded or not), which suggests that job creation is dependent on the continued inflow of remittances and subject to the limits of a narrow domestic market.

### *Policy Challenge 1: Addressing barriers to private sector development*

**53. Good formal jobs will need to come from the private sector through firm creation, survival and expansion.** Good jobs also tend to be formal jobs. In the Kyrgyz Republic, however, the bulk of employment creation has taken place in the informal economy, in which productivity and wage growth have been anemic. The Kyrgyz Republic has one of the smallest formal private sectors in the region in terms of employment (it accounts for only 11 percent of overall employment against 70 and 18 percent in the informal and public sectors respectively). Moreover the small formal sector has not created jobs: although it grew at about 6.6 percent a year in terms of output between 2009-2012, job creation growth averaged less than 0.4 percent. Understanding and addressing the constraints to formal private sector development *and* employment creation, therefore is central to the jobs agenda.

**54. Small and medium enterprises face few barriers to entry, but limited prospects for survival or expansion (possibly reflecting negative incentives to do so).** Small firms have the potential to create jobs but face negative incentives to grow or formalize. Indeed, the transition from small to medium size implies higher taxes and payments for labor insurance and social security, more burdensome regulatory requirements and increased formal and informal payments. A starting point, therefore, is to ensure that the burden of informal payment and bribes is decreased. Another priority is to understand which of the various costs associated with formal operation (from taxes to social security contributions and labor regulations) are the most binding for informal operators, understanding that a reduction in the rate of collection can be compensated by an expansion in the base of contributors.

**55. Moreover, it is believed that competition is undermined by advantages given to a handful of large firms which don't create employment:** just over 40 firms account for more than half of output growth (among growing establishments) and appear to enjoy privileged access to bank lending, government budgetary financing and imported inputs. In turn, the limited competitive pressures faced by these large conglomerates reduce business dynamism in the private formal sector and constrains the entry and growth of firms that would be more likely to create jobs.

**56. While good jobs tend to be created in export-oriented manufacturing, growth in this sector is constrained by poor logistics and RER appreciation.** Given the shallowness of the domestic market, manufacturing can only prosper in the Kyrgyz Republic if it has credible options to tap into foreign markets. Prospects for exports, however, are depressed *inter alia* by (i) real exchange rate appreciation, (ii) the sorry state of logistics, and (iii) regulatory hurdles to leveraging the EEU market. Improvements in infrastructure and trade logistics should therefore be prioritized while maximizing the potential to leverage the EEU market for exports will require significant efforts to (i) harmonize domestic rules and regulations with EEU ones and (ii) investments into testing and certification infrastructure.

### *Policy Challenge 2: Addressing supply-side barriers to formal employment*

**57. Despite revisions in the law on internal migrations, there is evidence that the registration system for employment remains cumbersome and opaque.** Because of higher utility fees and associated fees, there are incentives for landlords not to provide tenants with the documentation necessary for migrant registration and legal employment. Between 2003 and 2012, there was a fivefold increase in the share of industrial employment outside the construction sector held by workers from other oblasts, and, among these internal migrants, the proportion working without a contract rose from 28 percent to 47 percent. In construction, a similar trend occurred whereby internal migrants accounted for 11 percent of construction jobs by 2012 (up from 3 percent), and, among these internal migrants, the share working without a contract increased from 36 percent to 81 percent. Without registry in the city, migrants not only have more limited access to higher-value formal sector employment, they also have more limited access to medical treatment, education, and other basic services.

*Policy Challenge 3: Leveraging remittances*

58. **While remittance receiving countries face many of the similar challenges that natural-resource exporting countries do, the options to manage associated Dutch Disease effects are more limited.** This is because the financial flows associated to foreign labor are essentially private and therefore out of the control of policy makers (remittance income cannot be parked into a sovereign fund and invested abroad, nor can it be used to draw down public debt). The most practical response therefore consists in ensuring that the right incentives are in place for remittances to support financial intermediation and private investment in productive ventures. In that respect, experience from other countries (particularly in Latin America) could be instructive.

<b>PROMOTE PRIVATE SECTOR DEVELOPMENT</b>	
Reduce constraints to SME growth and formalization	Reform the patent and regulatory system to reduce costs faced by formal SMEs Address explicit and implicit protection of large incumbent firms Reduce barriers to entry for firms
Promote export-oriented manufacturing activity	Invest in transport and logistics infrastructure development Accelerate the pace of reforms to ensure compliance with EEU rules and regulations for export
<b>LEVERAGE MIGRATION AND REMITTANCES</b>	
Maximize the value of remittance income to households and economic multipliers	Strengthen financial intermediation of remittances to (i) improve the mobilization / investment of savings and (ii) allow timelier macro-monitoring of flows

## Appendix 1 –Economic and Social Indicators – Kyrgyz Republic 2010-2017

Selected Indicators	2010	2011	2012	2013	2014	2015	2016	2017
					Prel.	Projections		
<b>Income and Economic Growth</b>								
GDP (current LCU, billions)	220.4	286.0	310.5	355.3	397.3	436.3	498.3	550.8
GDP (current US\$, millions)	4,793.5	6,199.0	6,605.1	7,333.0	7,404.4	6,777.1	7,514.3	8,063.9
GDP Growth (% change, y-o-y)	-0.5	6.0	-0.1	10.9	3.6	2.0	4.2	3.4
GDP Per Capita (US\$)	880	1,125	1,186	1,282	1,295	1,177	1,290	1,370
Gross Investment ( % of GDP)	28.1	24.0	26.1	26.2	26.9	27.9	28.2	28.8
Public ( % of GDP)	7.0	5.5	7.7	7.0	8.4	11.1	11.1	10.8
Private ( % of GDP)	21.1	18.5	18.5	19.0	18.5	16.8	17.0	18.0
<b>Money and Prices</b>								
Inflation, Consumer Prices (% change, y-o-y, end of year)	19.2	5.7	7.5	4.0	10.5	8.6	7.0	7.0
Inflation, Consumer Prices (% change, y-o-y, period average)	7.8	16.6	2.8	6.6	7.5	9.4	8.7	6.6
Nominal Exchange Rate (LCU/US\$, end of period)	47.10	46.48	47.40	48.44	53.7			
Real Effective Exchange Rate Index (2000=100)	111.3	112.5	112.6	113.3	128.8			
M2 (% GDP)	31.4	27.8	31.7	34.0	31.3	30.7	31.3	31.4
<b>Fiscal (% of GDP, unless otherwise indicated)</b>								
Revenues	30.5	31.8	33.8	33.4	34.7	35.2	34.6	35.4
Expenditures (incl. net lending)	36.8	36.4	39.1	37.3	38.8	41.0	40.0	39.1
Current	31.4	30.9	31.8	30.1	29.5	29.9	28.8	28.3
Capital	5.4	5.5	7.7	7.0	9.3	11.1	11.1	10.8
Overall Fiscal Balance	-6.3	-4.6	-5.3	-3.9	-4.1	-5.8	-5.3	-3.7
Primary Fiscal Balance	-5.4	-3.6	-4.4	-3.0	-3.3	-4.8	-4.5	-2.7
Total Public Debt	59.7	49.4	49.0	46.1	53.0	60.0	62.0	62.3
External Public Debt	56.8	46.2	46.9	43.7	51.0	58.1	60.3	60.9
<b>External Accounts (% of GDP, unless otherwise indicated)</b>								
Export growth, f.o.b (nominal US\$, % yoy)	8.2	23.7	-0.9	19.9	-19.0	1.3	8.9	7.6
Import growth, c.i.f (nominal US\$, % yoy)	5.9	32.0	31.2	8.7	-5.8	3.9	5.5	7.5
Merchandise exports	38.2	36.6	34.0	36.9	31.8	32.2	31.5	31.3
Merchandise imports	62.4	63.5	73.2	76.6	71.5	73.2	70.8	70.5
Services, net	-4.8	-1.7	-5.4	-0.7	-4.5	-4.5	-4.3	-3.7
Workers' Remittances, Net (US\$, millions)	1,244	1,662	1,952	2,101	1,993.4	1,694.4	1,948.5	2,240.8
Current Account Balance	-6.4	-6.5	-15.6	-15.0	-16.8	-18.5	-16.6	-11.1
Foreign Direct Investment, net inflows	9.1	11.2	4.4	8.7	2.8	7.2	6.7	6.6
External debt, total	88.4	76.7	78.6	72.9	81.2	88.3	89.1	87.0
<b>Population, Employment and Poverty</b>								
Population, Total (millions)	5.4	5.5	5.6	5.7	5.8	5.8	5.9	5.9
Population Growth (% change, y-o-y)	1.2	1.2	1.7	2.0	1.1	1.0	1.0	1.0
Unemployment Rate (% of labor force)	8.6	8.5	8.4	8.3				
Poverty Headcount Ratio at National Poverty Line (% of population)	33.7	36.8	38.0	37.0				
Poverty Headcount Ratio at US\$1.25 a day (PPP) (% of population)	6.7	5.03	...	...				
Poverty Headcount Ratio at US\$2 a day (PPP) (% of population)	22.9	21.64	...	...				
Inequality - Income Gini	36.51	33.38	...	...				
Life Expectancy	69.3	69.6	70.0	70.2				
<b>Other</b>								
CPIA (overall rating)	3.7	3.6	3.6	3.6	3.6			
Economic Management	4.2	4.2	4.0	3.8	3.8			
Structural Policies	3.8	3.7	3.7	3.7	3.7			
Social Inclusion and Equity Policies	3.6	3.6	3.6	3.6	3.5			
Public Sector Management and Institutions	3.0	3.0	3.1	3.1	3.2			

Source: Kyrgyz authorities and Bank staff estimates and projections

".." indicates not available.