

INTERNATIONAL MONETARY FUND

KYRGYZ REPUBLIC

Ex Post Assessment of Longer-Term Program Engagement

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Approved by the Middle East and Central Asia and the Strategy, Policy, and Review Departments

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ABBREVIATIONS AND ACRONYMS

AUB	Asia Universal Bank
CDS	Country Development Strategy
DSA	Debt Sustainability Analysis
ECF	Extended Credit Facility
ESF	Exogenous Shock Facility
EPA	Ex Post Assessment
HIPC	Heavy Indebted Poor Countries
KRDF	Kyrgyz Republic Development Fund
MDRI	Multilateral Debt Relief Initiative
NBKR	National Bank of the Kyrgyz Republic
NPRS	National Poverty Reduction Strategy
PCs	Performance Criteria
PRGF	Poverty Reduction and Growth Facility
QFDs	Quasi-Fiscal Deficits
RCF	Rapid Credit Facility
TMU	Technical Memorandum of Understanding
VAT	Value-Added Tax

KEY ISSUES

- *During the period 2005–2009, the Kyrgyz Republic experienced several high-impact internal and external shocks.*
- *Despite these shocks, the authorities managed to maintain a relatively stable macroeconomic environment under both Fund-supported programs. However, domestic turmoil in early 2010 adversely affected performance.*
- *Progress in promoting structural reforms and in improving the transparency of government operations has been disappointing. The lack of progress in the latter may jeopardize macroeconomic stability over the medium term.*
- *A new three-year Fund program could be very helpful during the reconstruction period, but structural conditionality needs to be carefully designed.*

I. INTRODUCTION

1. **This report reviews the Kyrgyz Republic’s economic performance under Fund-supported programs from early 2005 to mid-2010.** Two Fund-supported programs are assessed: the March 2005 Poverty Reduction and Growth Facility (PRGF, which expired in May 2008), and the December 2008 Exogenous Shock Facility (ESF, which expired in June 2010). Earlier Fund-supported programs were discussed in the Kyrgyz Republic’s first Ex Post Assessment (EPA), which was completed in November 2004. The assessment does not cover performance under the Rapid Credit Facility (RCF), which was approved by the Executive Board on September 15, 2010.
2. **Fund policy requires that this EPA be prepared in time to be considered by the Executive Board prior to a request for a new arrangement.**² As noted in the Kyrgyz Republic Request for Disbursement under the Rapid Credit Facility (Country Report No. 10/336), the authorities regard the RCF as an opportunity to build a track record to support a new Extended Credit Facility (ECF). The new government has already expressed interest in financial support under a medium-term program with the Fund, and discussions on a future program are expected to start shortly.
3. **The recommendations of the 2004 EPA provide the starting point for this new EPA (Box 1).** The 2004 EPA noted that while Fund-supported programs in the Kyrgyz Republic in the 1990s fell well short of expectations, the 2001–2004 PRGF was more successful. The report also found recurrent problems in Fund program design—in particular a tendency of both the staff and the authorities towards over-optimistic macroeconomic projections, especially regarding exports and government revenue.

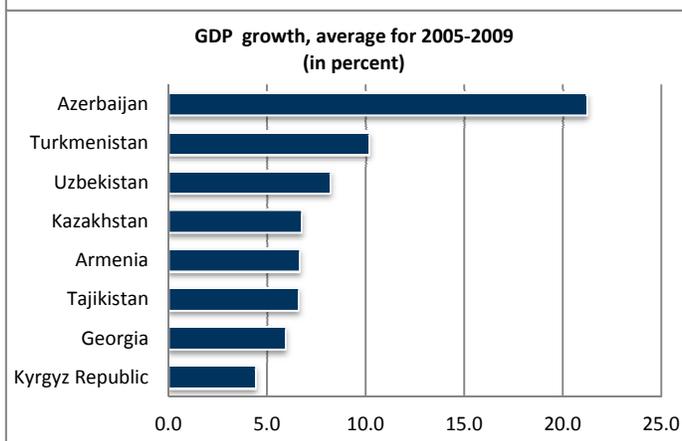
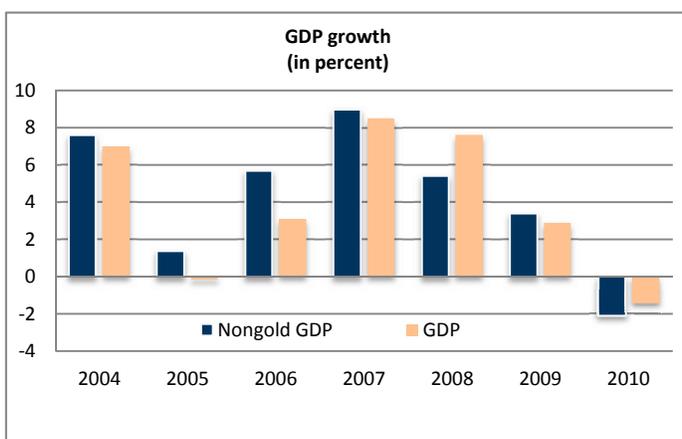
² See *Ex Post Assessments of Members with a Long-Term Program Engagement—Revised Guidance Note* (<http://www.imf.org/external/pp/longres.aspx?id=4427>). An EPA report, rather than an EPA update, is required since during the period relevant for the update, a program—the 2008 ESF—has been cancelled or interrupted for more than six months.

Box 1. Key Recommendations of the 2004 EPA

- (1) Fiscal policy must deliver on its revenue targets.
- (2) Debt reduction must continue to be a main objective of any Fund-supported program. New borrowing needs to be under highly concessional terms.
- (3) Structural reforms—particularly in the financial and energy sectors—must be reinvigorated.
- (4) Closing the ‘implementation gap’—between reform measures and their implementation—is key to sustained success. Tackling problems through issuance of presidential decrees, government resolutions, and legislative amendments does not bring results if enforcement and implementation are neglected. Strong implementation requires a strong and legitimate state. A professional civil service with authority and accountability to civil society is crucial. Stronger program ownership is necessary to alleviate the implementation problem.
- (5) To garner public support for reforms, a tangible reduction in corruption is critical, and in this regard, efforts to increase the transparency of government operations are important.

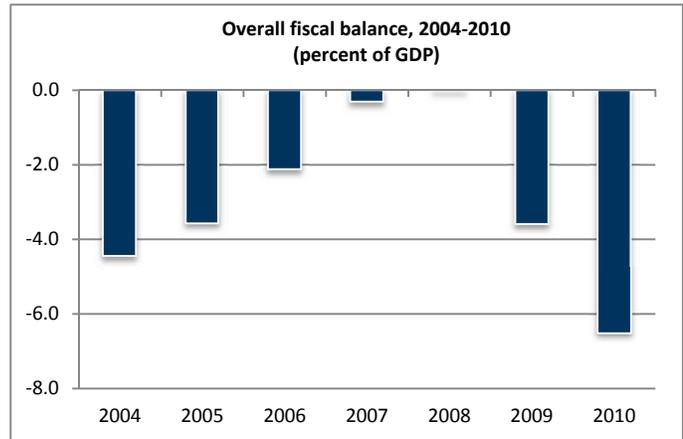
II. SELECTED MACROECONOMIC TRENDS IN THE KYRGYZ REPUBLIC, 2005–10

4. **During the period under review, the Kyrgyz economy experienced several high-impact internal and external shocks.** Domestic political upheaval (the ‘Tulip Revolution’) and associated negative economic growth in 2005 was followed by greater political stability and a favorable external environment in subsequent years, supporting improved economic performance. While the Kyrgyz economy—small and landlocked, with concentrated export earnings—weathered the global economic and financial crisis relatively well, growth decelerated in 2009. The economy had begun to recover in the first quarter of 2010, but the political turmoil in April and the inter-ethnic flare-up in June are expected to result in a contraction in economic activity for the full year. On average, the Kyrgyz Republic’s growth performance over 2005–09 was slightly below that of its regional peers.

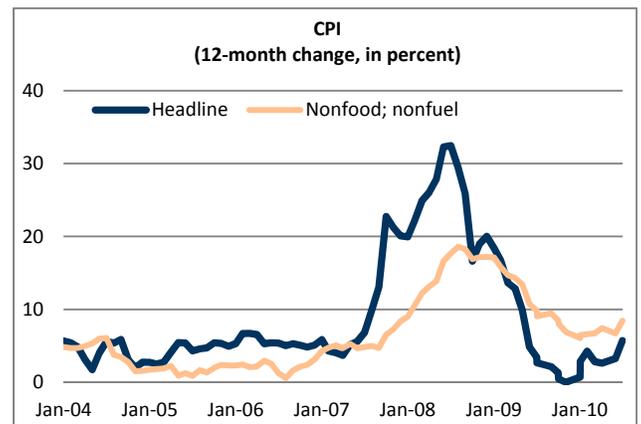
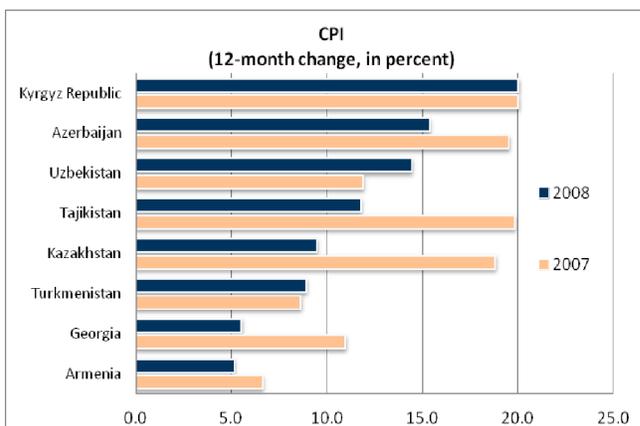


5. **Despite these shocks, the authorities managed to maintain a relatively stable macroeconomic environment up to the 2010 events.** Fiscal policy was prudent, with

increasing government revenue over the period under review supporting balanced budgets by 2007–08 and sharp decline in public debt. This created a buffer that provided crucial room for countercyclical fiscal policies in 2009 and, especially, 2010, with the reconstruction effort expected to lead to a budget deficit of 6 percent of GDP this year. However, the international food and fuel price increases in 2007–08 led to a sharp spike in prices in the Kyrgyz Republic, with inflation more pronounced than in other countries in the region (see Box 2 below).



6. **The impact of the global economic crisis was severe but mitigated by a bumper harvest and countercyclical policies.** The global crisis hurt the Kyrgyz republic mainly through trade and remittance channels. With key economic partners (Russia and Kazakhstan) in recession, Kyrgyz growth slowed down in 2009. The Kyrgyz authorities responded by reducing the value-added tax (VAT) rate, while increasing social and capital spending. These policies were largely financed by timely grant and loan support from Russia. Exchange rate flexibility helped to absorb the impact of the external shock and limit foreign exchange losses, while looser monetary policy supported economic activity. In all, an appropriate macroeconomic policy response helped to limit the impact of the global crisis on the Kyrgyz economy.

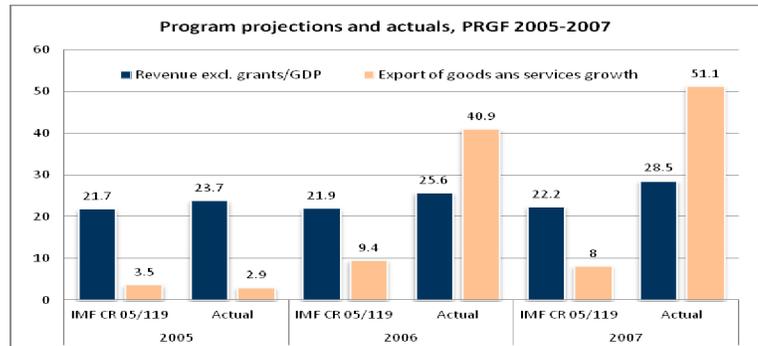


III. IMF PROGRAMS, 2005–10: OBJECTIVES AND ACHIEVEMENTS

A. The 2005–08 PRGF

7. **The 2005–08 PRGF drew clearly and explicitly on the recommendations of the 2004 EPA.** The 2004 EPA suggested a new, low-access PRGF as the most appropriate vehicle for IMF involvement for the next few years.³ The program’s

goals—preserving macroeconomic stability, supported by fiscal consolidation; raising growth prospects and reducing poverty; and structural reform focused on the financial and the energy sectors—were



well aligned with the priorities established in the EPA. Moreover, with conservative projections for key economic variables, a major pitfall identified in the 2004 EPA was avoided. Over much of the course of the program period, export growth and government revenue turned out much higher than programmed at the time of the original program request.

8. **Conditionality under the 2005 PRGF aimed at maintaining macroeconomic stability as well as promoting structural reforms.** The number of quantitative performance criteria (eleven, if zero ceilings on central government budget arrears, Social Fund pension arrears, Social Fund arrears to the Medical Insurance Fund, new nonconcessional external debt, and new external payment arrears are included) was relatively large, but this did not obstruct program performance (see Annex 1 on program performance). The program used structural benchmarks, as well as an indicative target on electricity sector quasi-fiscal deficits, to try to support structural reforms. IMF collaboration with the World Bank was intensive, in light of the heavy structural reform agenda. But the authorities’ ownership of this agenda turned out to be inadequate.

9. **Macroeconomic performance under the 2005–08 PRGF was generally satisfactory.** Six reviews were completed on time, and no waivers for quantitative performance criteria were required. The program’s macroeconomic goals were largely achieved: elevated GDP growth in 2007 and 2008 supported sharp falls in external debt ratios and poverty incidence trends (see Annex 2 on poverty trends). Moreover, fiscal performance was relatively good, with higher government revenue, balanced budgets, and sharp declines in public debt. However, it appears that monetary policy was slightly behind the curve in 2007

³ Access under the original program request in 2005 was 10 percent of quota. This was augmented to 20 percent of quota at the time of the last review, in 2008, in light of the deteriorating external environment. The amount was fully drawn.

and 2008, and that greater exchange rate flexibility could have helped to mitigate the impact of the international food and fuel price increases (Box 2).

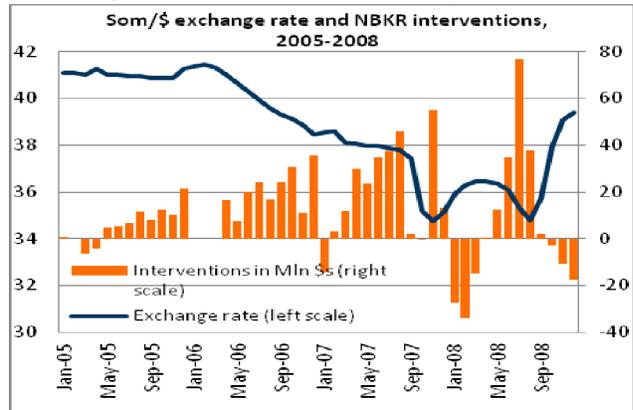
10. **During much of the period covered by the PRGF, political instability made the implementation of a structural reform agenda very difficult.** Following the March 2005 revolution, a July 2005 election confirmed a new President in office. But the next two years were marked by major tensions within the government and between the government and parliament, with political stability reestablished only after the parliamentary elections of December 2007. Moreover, World Bank-supported attempts to reform the civil service had limited success.⁴ Hence the issues identified as the ‘implementation gap’ in the 2004 EPA continued to encumber program implementation. A number of structural benchmarks were missed, including in the financial sector. Attempts to reduce quasi-fiscal deficits in the energy sector had little success (Box 3).

11. **While the program provided the basis for Paris Club debt relief, the Kyrgyz authorities decided in early 2007 not to request further relief under the HIPC and MDRI initiatives** (Box 4). Domestic political positioning played a major role in this decision, with international debt relief—and its conditions—a major issue in parliamentary elections in early 2007. The authorities apparently perceived the proposed triggers to debt relief as more intrusive than ‘regular’ Fund conditionality—especially the measures that aimed to enhance transparency in the mining and energy sectors. Foregoing international debt relief was an important missed opportunity: while debt ratios came down, a successful HIPC operation would have released considerable fiscal space.

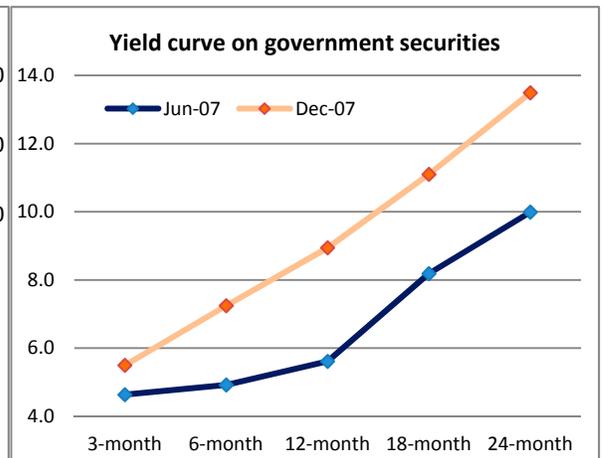
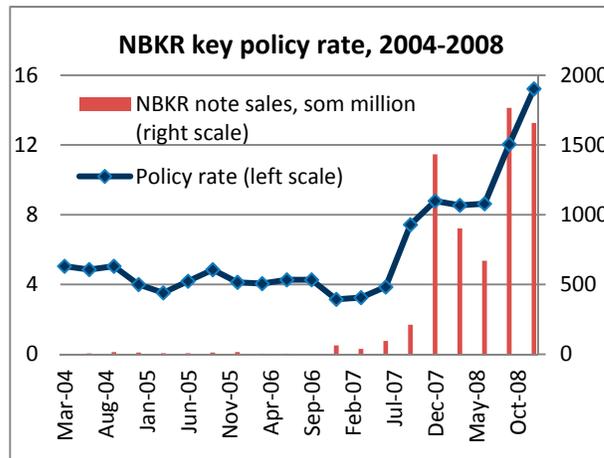
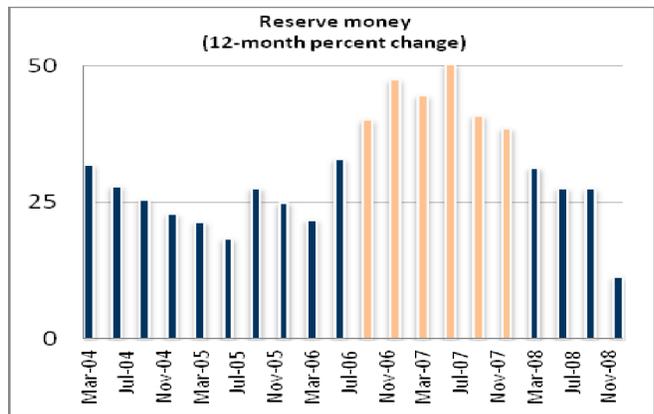
⁴ The World Bank assessed the outcome of its 2003–08 Governance Structural Adjustment Credit as ‘moderately unsatisfactory.’ See World Bank, *Kyrgyz Republic, Governance Structural Adjustment Credit: Implementation, Completion and Results Report*, March 9, 2009, ICR00001017.

Box 2. Monetary Policy in 2007–08: Behind the Curve?

Monetary and exchange rate policies contributed to high inflation in 2007–08. Large foreign exchange receipts (mostly export earnings and remittances inflows) during 2004–07 led to pressures on the domestic foreign exchange market. The National Bank of the Kyrgyz Republic (NBKR) conducted largely unsterilized interventions to avoid excessive appreciation of the national currency. This policy resulted in a large expansion of reserve money, and frequent breaches of indicative reserve money targets under the PRGF program. By end-2006, year-on-year growth in reserve money and broad money reached 48 percent and 52 percent respectively. While this did not lead to immediate repercussions on domestic prices, the sizable monetary overhang created fertile ground for inflation when the international food price shock hit in mid-2007.



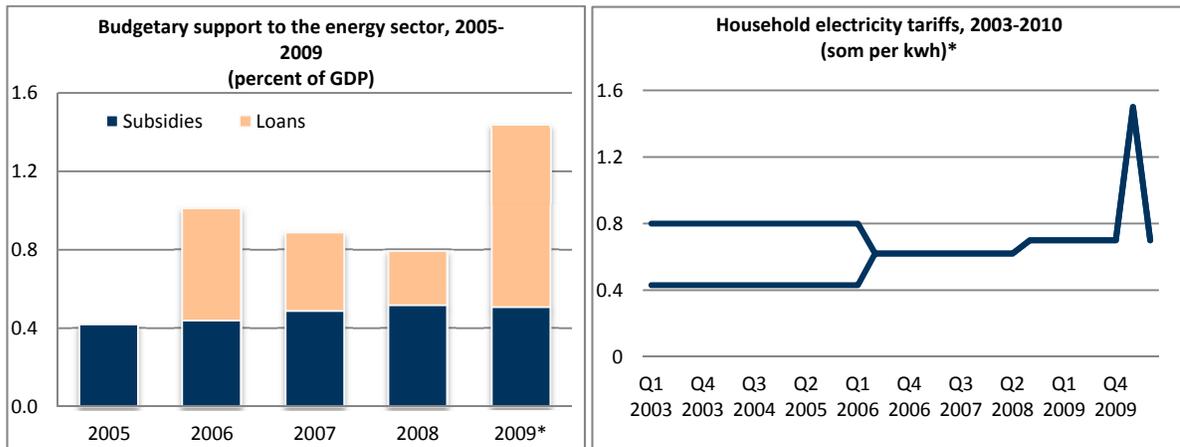
After observing an uptick in inflation in the third quarter of 2007, the NBKR responded by hastily tightening monetary policy and significantly raising exchange rate flexibility. The central bank allowed the som to appreciate against the U.S. dollar by almost 9 percent in three months from September 2007. It increased sales of central bank bills and introduced new 91- and 182-day bills, thereby creating a maturity overlap with the treasury bills. Yields on government securities increased on average by about 3 percentage points from June to December 2007. These measures to tighten monetary policy could have been taken earlier: starting from early 2007, staff had been cautioning the authorities that high international food prices could rekindle inflation, and called on tighter monetary stance.



Box 3. Energy Sector Reform Remains a Key Challenge

The energy sector is a major constraint on Kyrgyz potential for stronger growth. Shortages and volatility in energy supplies, especially during winter, reduce the output of other industries. The government frequently has to resort to electricity rationing.

Energy sector policy is inadequate. Electricity tariffs remain among the lowest in the region and lead to inefficient use. Widespread electricity theft and inadequate metering result in low bill collections. The combination of below-cost-recovery tariffs and poor bill collection leads to high quasi-fiscal deficits (QFDs) in the sector. These are partially financed by the central government through direct subsidies and loans, and partially reflected in inadequate maintenance and underinvestment.



Source: Kyrgyz authorities; Fund staff estimates.

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* Before May 2006 two different tariffs were set for households with below and above 150 kwh monthly consumption.

The PRGF included measures to reform the sector and reduce QFDs, but these had little effect.

Indicative targets on QFD were met in 2005–2006, but missed during 2007. A commitment to raise electricity tariffs during the PRGF period was not met. The authorities prepared an action plan to reduce the energy sector's QFD (in compliance with a structural benchmark); however, the plan lacked details. Electricity tariffs for households were raised by 13 percent in 2008, but they remained far below cost-recovery level. An independent electricity regulatory agency was downgraded to become a department in a reorganized Ministry of Energy, thereby weakening the governance of the sector.

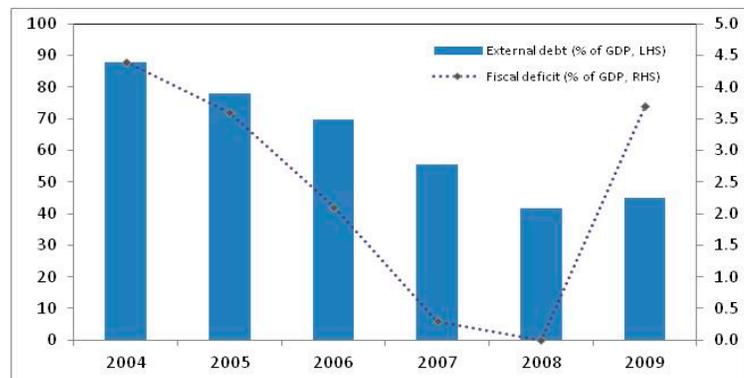
Starting from 2009, the authorities initiated comprehensive reforms in the energy sector that failed due to improper implementation and poor public communication. A two-round increase in electricity tariffs for all end-users that was planned for 2010 would have resulted in a cumulative increase in household electricity tariffs of no less than 171 percent. However, the first round of increases triggered an outpouring of public discontent that led to the fall of the government, and the new interim government reversed it. Likewise, the privatization of two distribution companies in 2009 was annulled by the interim government in 2010, in light of shortcomings in the tender process.

Box 4. HIPC Initiative and External Debt

From February 2006 to February 2007, the World Bank and IMF staffs worked with the Kyrgyz authorities on the HIPC process. Even after 2002 and 2005 Paris Club relief operations, the Kyrgyz Republic's external debt remained high, with sustainability vulnerable to shocks. In early 2006, the country met all eligibility criteria for the enhanced HIPC Initiative: it was IDA-only and PRGF-eligible; had established a track record of reforms under IMF and IDA programs; and its NPV of debt to revenue ratio exceeded the relevant HIPC threshold. Staff calculations indicated that the Kyrgyz Republic would have needed an estimated total assistance of US\$397 million in end-2004 NPV terms (equivalent to 18 percent of GDP) to bring its debt-to-revenue ratio to the HIPC threshold. Annual debt service savings over the medium term would have lowered the debt service-to-revenue ratio by 6½ percentage points. Combined with possible subsequent debt relief under the MDRI, this would have created important additional fiscal space for spending on priority social sectors and infrastructure.

However, in February 2007, the government decided to forego HIPC debt relief. Support for the initiative among the general public and civil society was limited, with participation seen by some as a national humiliation. In addition, vested interests saw their rents threatened by the focus of the proposed completion point triggers on transparency, particularly in the energy and mining sectors. The country's participation in the HIPC process became an emotional issue entangled with other political debates, rendering it a political liability for the government.

Meanwhile, the country started to grow out of its debt problem. Real GDP growth picked up, and fiscal discipline resulted in much reduced deficits. The authorities also adhered to the continuous PRGF and ESF conditionality to refrain from contracting or guaranteeing nonconcessional external borrowing. As a result, debt indicators improved significantly, bringing the country's debt profile to below the relevant HIPC eligibility thresholds. The Kyrgyz Republic remains potentially eligible for HIPC debt relief though: if debt ratios were to increase substantially and exceed HIPC thresholds, the country could still request debt relief under the initiative.



The recent Debt Sustainability Analysis (DSA) update concludes that the Kyrgyz Republic faces a moderate risk of debt distress (Country Report No. 10/336). External debt is now increasing again, owing to substantial fiscal expansion in 2009 and 2010 and planned borrowing related to energy investments over the next few years. While investment needs are huge, medium-term fiscal consolidation is needed to avoid a new cycle of debt build-up, along with prudent debt management and structural reforms to sustain economic growth.

B. The 2008–10 ESF

12. Unlike the 2005 PRGF, the 2008–10 ESF was not explicitly linked to the 2004 EPA.

The objective of an ESF is to provide assistance to address a temporary balance of payments need whose primary source is a sudden and exogenous shock. In the Kyrgyz republic's 2008 request for an ESF, no less than five such shocks were identified: (i) the rise in international food and fuel prices; (2) the global economic crisis, and in particular its impact on Russia and Kazakhstan; (3) banking sector difficulties in Kazakhstan; (4) a shortfall in hydropower capacity, owing to insufficient water levels; and (5) an earthquake in a remote border region.

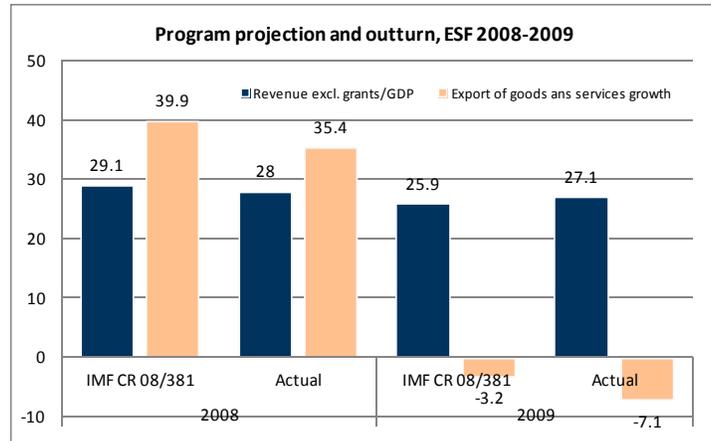
13. Conditionality under the 2008 ESF was more streamlined than under the 2005 PRGF.

On the quantitative side, the program had performance criteria (PCs) on net international reserves and net domestic assets of the NBKR, and on the cumulative overall deficit of the general government, as well as indicative targets for reserve money and tax collection. While performance on these was initially strong (with all end-December 2008 and end-June 2009 PCs met), two December 2009 PCs were missed (on both NBKR net domestic assets and on the general government's cumulative overall deficit)—these would have required waivers for subsequent reviews to be completed. The 2008 ESF had a less ambitious structural reform agenda than the 2005 PRGF, as would normally be the case given the different nature of the two instruments. After careful consideration, the authorities opted for the ESF (as opposed to a successor PRGF) precisely for this reason. The streamlined approach allowed Fund staff to increase their focus on macroeconomic policy (leaving structural issues in the purview of the World Bank) and also facilitated program ownership.

14. Performance under the Kyrgyz 2008–10 ESF was weak. Only one review was completed, out of the envisaged three, and of the program's three main goals, 'reduce inflation, sustain growth, protect the poor', only the first was achieved (although of course the deteriorating global economic environment was a key factor in this).⁵ Governance concerns led to delays in the completion of the second review—in particular the government's decision to place a substantial portion of saved bilateral assistance in investments overseas. Structural benchmarks were missed in the area of governance and transparency of government operations (Box 5). An effort to try to bring the program back on track was overtaken by events in 2010.

⁵ Access under the program was 75 percent of quota, of which half was drawn.

15. **As under the 2005 PRGF, macroeconomic policy under the ESF was generally appropriate.** The authorities continued to deliver on revenue targets—a key recommendation of the 2004 EPA—and thereby provide a solid basis for macroeconomic policy. With a new tax code introduced in January 2009, staff projected a drop in tax revenue from 23 percent of GDP to



19 percent—but it did not materialize (Box 6). Improvements in tax administration and increased gold-related tax receipts largely compensated for lower VAT revenues. The sharp increase in gold prices also supported exports, with the value of gold exports in 2009 more than double that in 2007.

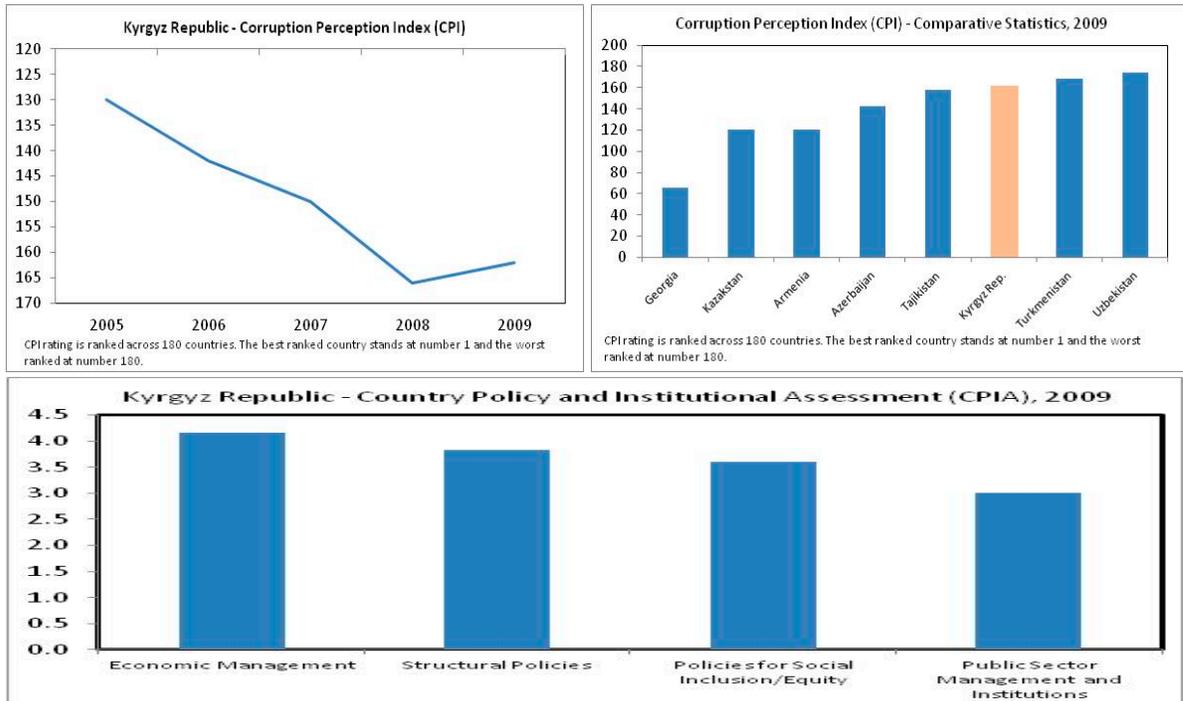
16. **The Kyrgyz banking system weathered the global financial crisis well, but the 2010 domestic upheaval exposed weaknesses that threatened systemic stability (Box 7).**

A spillover of the Kazakh banking crisis into the Kyrgyz republic was avoided, and with the global financial crisis abating, financial soundness indicators began to show gradual improvement in early 2010. But the April and June 2010 events took a significant toll on the sector. While most banks were adequately liquid and capitalized, there were problems at some banks, including Asia Universal Bank (AUB)—the largest, with nearly 50 percent of system deposits prior to the crisis. The crisis led to the loss of some assets due to fraud and a rapid deterioration in loan quality, owing to connected and insider lending and exposure to the south. After a significant non-resident deposit outflow, AUB was first put under conservatorship and subsequently nationalized. Following a good-bad bank model, the authorities have made some progress, but the resolution process remains incomplete. The systemic risks, however, appear to have dissipated.

17. **Most of the problems that the ESF program could face were well identified at the time of the initial program request.** A possible further deterioration in the international economic environment and possible energy shortages were clearly flagged, along with political and social tensions and administrative capacity constraints. However, governance concerns were not identified as a source of program risk. Possible risks in the financial sector were presented as stemming from the region (i.e., Kazakhstan)—weaknesses in domestic financial sector supervision were not identified.

Box 5. Governance Issues

Governance problems in the Kyrgyz Republic remained widespread throughout the life of the 2005–08 PRGF and the 2008–10 ESF. The March 2005 revolution provided an opportunity to address entrenched governance problems, but the country’s Corruption Perception Index rating deteriorated significantly in the following years. The main problems were in the areas of public sector management and institutions (as evidenced by the Country Policy and Institutional Assessment ratings below) and the energy and mining sectors. Weaknesses in governance not only hampered the evolution of an effective and efficient public sector, but also stood in the way of private sector development. Improvements in the country’s ‘Doing Business’ score—with the Kyrgyz Republic ranked 44 in the *Doing Business 2011* report, much better than most of its regional peers—are yet to produce a major impact on economic activity.

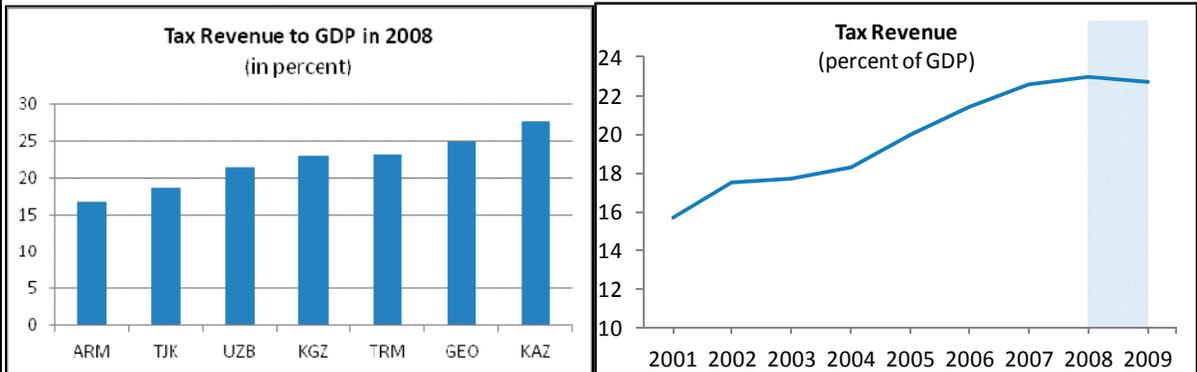


Both IMF-supported programs emphasized building fiscal institutions and promoting fiscal transparency as a means to strengthen governance in the public sector. A number of structural benchmarks measures were put in place, especially under the PRGF, but many were either not observed or met with delays. Proposals to tackle corruption were not translated into tangible and decisive measures.

During the period covered by the 2008–10 ESF, the lack of transparency in the management of donor funds created additional risks. The ESF program emphasized the importance of integrating the operations of the Kyrgyz Republic Development Fund (KRDF, set up to channel privatization revenues and bilateral donor assistance into development projects) into the general government framework, and also aimed to improve the KRDF’s reporting and auditing. Conditionality put in place during the ESF helped safeguard the KRDF’s assets, and following the April 2010 events the new authorities decided to liquidate the KRDF.

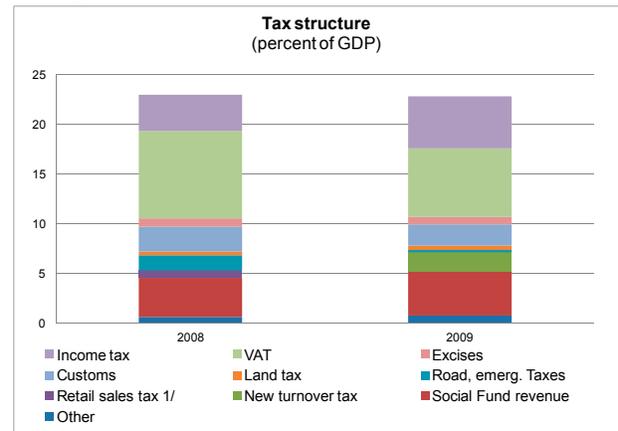
Box 6. The 2009 Tax Reform

Tax collection in Kyrgyz Republic increased steadily until 2008, comparing favorably with that in the region. During the period of the PRGF, tax revenues increased by 5 percentage points, to 23 percent of GDP in 2008. Improved customs administration, streamlined tax procedures, and effective arrears management contributed to improved revenue collection.



The authorities introduced a new tax code in January 2009. The new code included a large cut in the VAT rate (from 20 to 12 percent), while introducing a new turnover tax to offset some of the expected revenue loss. Fund staff advised against this package, as the new turnover tax “cascades” when goods pass from one enterprise to another in the production and distribution chain, and therefore results in distortions in economic activity.

As expected, the share of VAT in total tax revenue dropped sharply in 2009. However, the sharp drop in overall revenue projected by staff did not materialize, with tax to GDP declining from 23.0 percent in 2008 to 22.7 percent in 2009. Tax revenue in 2009 was boosted by strong gold-related tax receipts from the Kumtor mine, and strengthened tax administration, including tax arrears clearance.

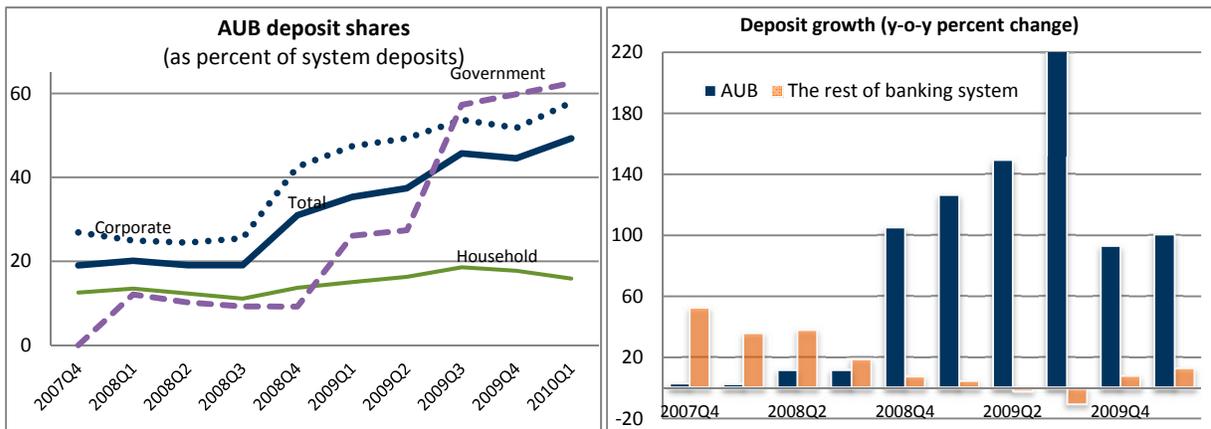


Despite political turmoil and ethnic conflict, tax collection performed adequately in 2010. Fiscal revenue performance has held up well despite the crisis, largely as a result of strong gold-related tax receipts—both from higher prices and output—and continued emphasis on tax administration. While the authorities have generally avoided using tax breaks as a crisis response, they have provided relief to businesses in the south until 2012; the impact of these measures on tax collection is likely to be small as the south has a small share of national tax receipts.

Box 7. The Financial Sector: Flaws Exposed by the Crisis

The 2010 political upheaval exposed weaknesses in the Kyrgyz financial sector and its supervision.

Following the change in government in April, the central bank introduced temporary administration in 7 out of 22 commercial banks (with more than 60 percent of the system deposits). While these were soon lifted for several banks, the resolution of the remaining ones and especially the largest bank, Asia Universal Bank (AUB), turned out ineffective and protracted. Meddling from law-enforcement agencies was common, limiting the supervisors' ability to effectively perform their duties. Lack of qualified supervisors also had an adverse effect on the resolution process. Moreover, court rulings, frequently overriding the decisions of the central bank, significantly undermined its ability to achieve one of its core objectives—financial stability. Fortunately, despite the precarious situation, major bank runs were avoided. The creation of deposit insurance system in the second half of 2008 (a structural benchmark under the ESF) likely contributed to this.



A politically favored bank emerged as a champion of the Kyrgyz financial sector in a short time span.

AUB's overall deposit share increased from 19 percent at end-2007 to almost 50 percent at end-March 2010, mostly in corporate and government deposits. Deposits in the rest of the banking sector barely grew. State capture was behind the AUB's unrivalled success during 2008-10. Acquisition by the AUB of one of the largest commercial banks—PromStroiBank—in November 2008 marked the beginning of AUB's transformation. Companies were reportedly coerced to move their deposits to AUB, while all main government entities also shifted their cash balances there. In 2008, AUB also acquired a majority share in the Interbank Processing Center, the country's main card processing center. Competition in the banking sector was restricted, including by discouraging qualified entrants.

AUB's growing dominance and its unusual operations should have raised regulatory concerns and triggered actions. The bank contributed little to domestic financial intermediation, with loans representing less than 16 percent of the bank's total assets. It focused on investments abroad, mainly corporate debt and equity securities in Russia and Ukraine. External audit of the bank's activities was performed by a little known Moscow-based company. Weak supervision, limited central bank independence, and poor transparency standards led to systemic vulnerability.

A new Fund-supported program in the Kyrgyz Republic should include financial sector reform, and aim to find lasting solutions. Central bank independence, both legal and actual, needs to be reinforced. Particular attention must be paid to strengthening the central bank's supervisory capacity, and safeguarding its autonomy and legal immunity. The financial sector's legal and regulatory framework could be further improved, especially by expanding the discretionary role of the central bank, and reducing that of the courts in financial stability matters. Corporate governance practices should be raised to improve financial sector transparency and accountability. The bank resolution framework needs to be strengthened, and the government's responsibilities clearly defined.

IV. CONCLUSIONS AND OPTIONS FOR FUTURE IMF INVOLVEMENT

18. **Macroeconomic performance under Fund-supported programs in the Kyrgyz republic in the period under review (2005–10) has been generally satisfactory.** Prudent fiscal policy in the good years provided crucial space for countercyclical policies in 2009 and 2010. Revenue targets were met, often with wide margins; and external debt was reduced significantly, despite the missed opportunity of forgone HIPC/MDRI debt relief. Monetary policy was also generally appropriate, although the central bank could have tightened policy earlier in 2007 to address inflationary pressures at an earlier stage. In sum, in the macroeconomic area, key objectives identified in the 2004 EPA were achieved.

19. **However, progress in promoting structural reforms and in improving the transparency of government operations has been disappointing.** Lingering weaknesses in the energy and financial sectors came clearly to the fore in the 2010 crisis, had large macroeconomic implications, and appear to have their root cause in more general economic governance problems. Neither the ‘structural benchmarks’ approach taken in the 2005–08 PRGF, nor the hands-off approach under the 2008–10 ESF, had much impact in these areas.

20. **The lack of progress in economic governance may jeopardize macroeconomic stability over the medium term, and exposes the Fund to reputational risk.** The delay (and eventual noncompletion) of the second and third review under the ESF owing to governance concerns have greatly helped maintain Fund credibility. If governance issues are not addressed, problems in key sectors are likely to recur, with macroeconomic ramifications.

21. **A new three-year Fund program could be very helpful during the reconstruction period.** Given the Kyrgyz Republic’s protracted balance of payments need, an ECF that helps to finance this need, catalyzes support from other donors and addresses structural issues could play a key role in supporting macroeconomic management over the next few years. Such a program should ensure fiscal consolidation over the medium term to avoid a renewed build-up of government and external debt, and rebuild macroeconomic policy buffers.

22. **Under a possible new ECF-supported program, structural reform of key sectors will need to be addressed head-on.** Structural conditionality will need to be carefully designed, be based on a homegrown development strategy, take into account implementation capacity, and be coordinated with other donors, in particular the World Bank. It must be meaningful without being perceived as intrusive—ownership of reforms remains crucial. In the financial sector, a level playing field needs to be maintained, including by strengthening the central bank’s independence and supervisory capacity. The rule of the courts in financial stability matters should be reduced, and financial sector transparency and accountability standards raised. In the energy sector, the QFD will need to be brought under control, with a targeted safety net to compensate for higher prices. A very good communication effort is needed to explain why electricity price increases are necessary, and any increase in tariffs should be embedded in an overall reform strategy for the sector, focusing on improving

transparency and governance. Given the Fund's limited expertise in energy issues, close cooperation with key donors will be especially important in this area.

23. **The risks associated with renewed engagement under a possible ECF arrangement will need to be carefully managed.** A solution of security issues, especially through a reconciliation in the south, is a precondition for sustainable economic development. Weak governance remains a key concern—while reducing corruption and the perception of corruption will likely be a top priority for the new government, progress in the area has proven elusive in the period under review in this assessment. Program design and monitoring of implementation will need to be mindful of the risks associated with weak governance. In addition, exogenous shocks will likely continue to effect program performance. A solid performance under the RCF would provide some comfort, but no guarantees.

Table 1. Kyrgyz Republic: Selected Economic Indicators, 2004–10

	2004	2005	2006	2007	2008	2009	2010
	Act.	Act.	Act.	Act.	Act.	Prel.	Prel.
Nominal GDP (in billions of soms)	94.4	100.9	113.8	141.9	188.0	201.2	212.2
Nominal GDP (in millions of U.S. dollars)	2,215	2,460	2,837	3,805	5,131	4,683	4,615
Real GDP (growth in percent)	7.0	-0.2	3.1	8.5	7.6	2.9	-1.4
Non-gold real GDP (growth in percent)	7.6	1.4	5.7	9.0	5.4	3.4	-2.1
GDP per capita (in U.S. dollars)	435	478	546	727	972	880	863
Consumer prices (12-month percent change, eop)	2.8	4.9	5.1	20.1	20.1	0.0	18.9
Consumer prices (12-month percent change, average)	4.1	4.3	5.6	10.2	24.5	6.8	7.8
Investment and savings (in percent of GDP)							
Investment	20.8	21.6	22.5	21.0	20.3	22.9	24.7
Public	4.9	4.8	4.3	4.8	4.2	5.0	5.6
Private	16.0	16.9	18.2	16.3	16.2	17.8	19.1
Savings	25.8	24.4	19.5	20.9	12.3	24.9	21.2
Public	-0.1	1.0	1.6	4.1	5.1	4.0	-0.4
Private	25.9	23.5	17.8	16.7	7.1	21.0	21.7
Savings-investment balance	4.9	2.8	-3.1	-0.2	-8.1	2.0	-3.5
General government finances (in percent of GDP) 1/							
Total revenue and grants	23.3	24.7	26.4	30.3	29.9	32.3	31.7
of which: Tax revenue	18.3	20.0	21.4	22.6	23.0	22.2	23.2
Total expenditure (including net lending)	27.7	28.1	28.9	31.0	29.3	36.1	38.1
of which: Current expenditure	23.3	23.7	24.8	26.2	24.8	28.4	32.2
Capital expenditure	4.9	4.8	4.3	4.8	4.2	5.0	5.6
Overall fiscal balance	-4.4	-3.6	-2.1	-0.3	0.0	-3.6	-6.5
Primary balance	-3.1	-2.0	-1.2	0.3	0.8	-2.8	-5.6
Primary balance excluding grants	-4.1	-3.0	-2.0	-1.9	-1.1	-8.1	-8.6
Total public debt	92.9	85.9	72.5	56.8	48.5	57.9	65.1
Banking sector 2/							
Reserve money (percent change, eop)	22.9	24.9	47.4	38.5	11.3	18.3	18.4
Broad money (percent change, eop)	33.6	25.5	51.6	33.3	12.6	17.9	20.2
Credit to private sector (percent change, eop)	67.7	20.5	48.6	79.7	26.4	-2.8	4.2
Credit to private sector (in percent of GDP)	7.0	7.8	10.3	14.9	14.4	12.9	11.7
Velocity of broad money 3/	5.6	4.7	3.5	3.3	3.9	3.4	3.2
Interest rate 4/	24.3	4.3	4.2	5.6	19.2	1.9	5.5
External sector							
Current account balance (in percent of GDP)	4.9	2.8	-3.1	-0.2	-8.1	2.0	-3.5
Export of goods and services (million USD)	1,024	1,053	1,485	2,244	3,037	2,821	2,794
Export growth (percent change)	24.2	2.9	40.9	51.1	35.4	-7.1	-0.9
Import of goods and services (million USD)	1,127	1,397	2,253	3,218	4,747	3,680	4,015
Import growth (percent change)	27.7	23.9	61.3	42.8	47.5	-22.5	9.1
Gross International reserves (million USD)	544	608	814	1,194	1,222	1,584	1,700
Gross reserves (months of next year imports, eop)	4.7	3.2	3.0	3.0	4.0	4.7	4.0
External public debt outstanding (in percent of GDP)	88.5	78.0	69.8	54.6	41.2	52.8	59.5
External public debt service-to-export ratio (in percent)	5.9	6.5	4.0	2.9	2.4	3.2	3.5
Memorandum items							
Exchange rate (soms per U.S. dollar, average)	42.6	41.0	40.1	37.3	36.6	43.0	46.0
Real effective exchange rate (2000=100) (average)	99.6	100.0	101.7	108.3	121.7	117.7	...

Sources: Kyrgyz authorities; and Fund staff estimates.

1/ General government comprises State Government, Social Fund and Development Fund (starting from September 2009) finances. State government comprises central and local governments.

2/ At actual exchange rates 2004-2009, at program exchange rates (KGS 38.21 per 1 U.S. dollar) for 2010.

3/ 12-month GDP over end-period broad money.

4/ Interest rate on 3-month treasury bills.

Annex 1. Kyrgyz Republic: Observance of Program Conditionality, 2005–2008

			Reviews						ESF
			PRGF *						
			First	Second	Third	Fourth	Fifth	Sixth	
Quantitative Performance Criteria	Monetary	Net International Reserves	✓	✓	✓	✓	✓	✓	✓
		Net Domestic Assets	✓	✓	✓	✓	✓	✓	✓
	Fiscal	Fiscal Deficit	✓	✓	✓	✓	✓	✓	✓
		Tax Revenues **	✓	✓	✓	✓	✓	✓	✓
		State Budget Arrears	✓	✓	✓	✓	✓	✓	...
		Pension Arrears	✓	✓	✓	✓	✓	✓	...
		Payroll Collections	✓	✓	✓	✓	✓	✓	...
		Medical Insurance Fund Arrears	✓	✓	✓	✓	✓	✓	...
	Debt Sustainability	Short-term Nonconcessional Borrowing	✓	✓	✓	✓	✓	✓	✓
		Long-term Nonconcessional Borrowing	✓	✓	✓	✓	✓	✓	✓
External Payment Arrears		✓	✓	✓	✓	✓	✓	✓	
Indicative Targets	Monetary	Reserve Money	✓	✗	✗	✗	✗	✗	✓
	Energy	Electricity Quasi-Fiscal Deficit	✓	✓	✓	✓	✗	✗	...
Structural Benchmarks	Fiscal	Structural Benchmark 1	✓	...	...	...	...	...	...
		Structural Benchmark 2	✓	...	...	...	...	...	...
		Structural Benchmark 3	✓	...	...	...	...	...	...
		Structural Benchmark 4	✓	...	...	...	...	...	...
		Structural Benchmark 5	✓	...	...	...	...	...	...
	Fiscal/Financial	Structural Benchmark 6	✓	...	...	...	...	...	...
	Monetary	Structural Benchmark 1	...	✓	...	...	...	...	...
		Structural Benchmark 2	...	✓	...	...	...	...	...
	Financial	Structural Benchmark 3	...	✓	...	...	...	...	...
	Monetary/Financial	Structural Benchmark 4	...	✓	...	...	...	...	...
	Fiscal	Structural Benchmark 1	...	...	✓	...	...	...	...
		Structural Benchmark 2	...	...	✗	...	...	...	...
	Monetary	Structural Benchmark 3	...	...	✓	...	...	...	...
		Structural Benchmark 4	...	...	✓	...	...	...	...
	Energy	Structural Benchmark 3	...	...	...	✓	...	...	...
		Structural Benchmark 4	...	...	...	✓	...	...	...
	Financial	Structural Benchmark 5	...	...	...	✗	...	...	...
		Structural Benchmark 6	...	...	...	✓	...	...	...
	Fiscal	Structural Benchmark 1	...	...	...	...	✓	...	...
		Structural Benchmark 2	...	...	...	...	✗	...	...
		Structural Benchmark 3	...	...	...	...	✗	...	...
	Financial	Structural Benchmark 4	...	...	...	...	✓	...	...
		Structural Benchmark 5	...	...	...	...	✓	...	...
	Fiscal	Structural Benchmark 1	...	...	...	...	...	✓	...
		Structural Benchmark 2	...	...	...	...	...	✓	...
	Financial	Structural Benchmark 3	...	...	...	...	...	✓	...
		Structural Benchmark 4	...	...	...	...	...	✓	...
		Structural Benchmark 5	...	...	...	...	...	✗	...
	Monetary	Structural Benchmark 1	...	...	...	...	...	...	✓
		Structural Benchmark 2	...	...	...	...	...	...	✓
	Financial	Structural Benchmark 3	...	...	...	...	...	...	✓
		Structural Benchmark 4	...	...	...	...	...	...	✓
	Monetary	Structural Benchmark 1	...	...	...	...	...	...	✓
Structural Benchmark 2		...	...	...	...	...	...	✓
Financial	Structural Benchmark 3	...	...	...	...	...	...	—
	Structural Benchmark 3	...	...	...	...	...	...	—

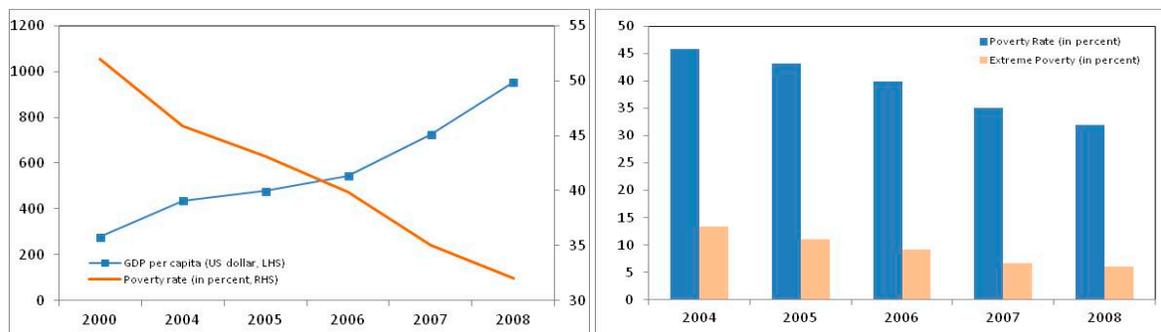
✓ observed, ✗ not observed, — observed with delay.

* The PRGF also included an indicative target on contracting or guaranteeing by the state government or NBKR of new concessional debts, agreed separately in the TMU. These targets have all been met.

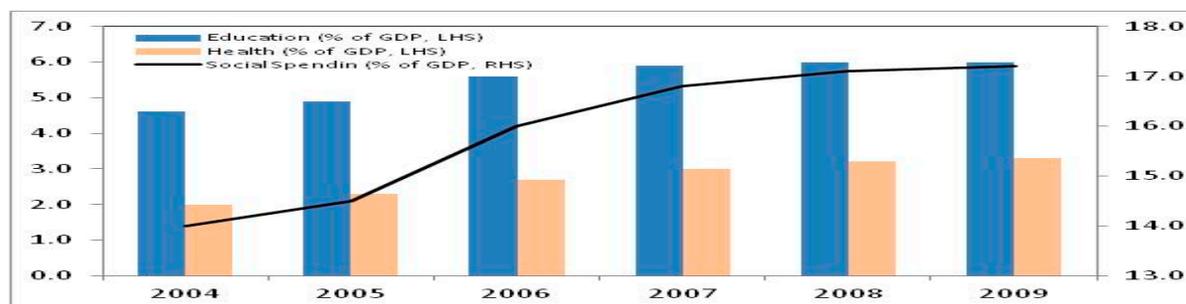
** Was made an indicative target under the ESF.

Annex 2. Kyrgyz Republic: Poverty Trends

The Kyrgyz Republic entered its 2005–08 PRGF-supported program with considerable strides made towards reducing poverty. Relatively robust economic growth over the period 2000 to 2004 resulted in an over 50 percent increase in per capita GDP and a decline in the poverty rate from 52 percent to 46 percent over the same period. During the program period, the poverty rate fell further to 35 percent by end-2007, with much of the decline driven by an increase in private consumption and high inflows of workers' remittances.



The 2005 PRGF was based on the authorities' National Poverty Reduction Strategy (NPRS) and the Country Development Strategy (CDS). At the onset of the program, additional budgetary resources were allocated to poverty-reducing spending on investments in health and education, as well as increased pension benefits to the poorest segment. Special emphasis was also placed on a campaign against corruption, especially in the tax and customs administrations that would increase revenue and create room for an increase in social spending. Fiscal reforms under the program aimed at improving public expenditure management, focusing on steps to strengthen budget credibility and transparency, and to enhance the tracking, monitoring, and reporting of poverty-related spending.



Over the life of the PRGF program, macroeconomic conditions improved, growth was robust, social spending increased, and poverty rates were reduced. However, inequality remained high, owing to a lack of labor-intensive growth and continued weak governance.

In contrast, during the period covered by the 2008–10 ESF, earlier gains in poverty reduction may have been partially reversed. Several shocks undermined macroeconomic stability and led to lower economic growth, a reduction in employment opportunities, weakened inflows of workers' remittances, and lower real incomes.

Annex 3. The Authorities' Views

A draft EPA report was discussed in Bishkek on January 31 and February 1, 2011 in meetings with the First Deputy Prime Minister, Mr. Babanov; the Acting Governor of the NBKR, Mrs. Jeenbaeva; and the Minister of Economic Regulation, Mr. Tashbaev.

- The authorities broadly agreed with the conclusions of the EPA report, and considered that it provided a balanced assessment of the Kyrgyz Republic's performance under the 2005-08 PRGF and the 2008–10 ESF. However, they had a few specific comments which are detailed below.
- The authorities considered that the maturity overlap between NBKR notes and treasury bills discussed in Box 2 of the report did not result in competition between the two instruments, as total sales of NBKR notes were small.
- They considered that consumer price inflation in 2007 was driven by a sharp increase in food prices, and hence essentially non-monetary in nature. Combating this inflation with monetary policy alone would have been costly and ineffective.
- They also noted that if the August 2009 mission had been able to complete the second review under the ESF, performance criteria for end-December 2009 would have been modified. Two of these criteria were eventually missed, as noted in paragraph 13 of the report.