



KYRGYZ REPUBLIC

SELECTED ISSUES

July 2026

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May 14, 2026

Approved By
**Middle East and
Central Asia
Department**

Prepared By Nasir Rao, Anvar Muratkhanov, and Farid
Talishli (all MCD)

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BEYOND THE POLICY RATE: A BROADER VIEW OF MONETARY AND FINANCIAL CONDITIONS¹

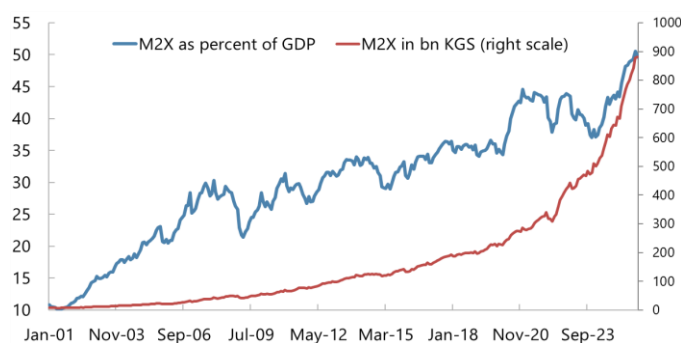
This study assesses the effective monetary stance in the Kyrgyz Republic amid persistent excess liquidity, rapid household credit growth, and elevated inflation pressures. It constructs a monthly Financial Conditions Index (FCI) that captures liquidity conditions, market rates, monetary aggregates, credit dynamics, and external financial factors. The results point to a marked easing in financial conditions since early 2024, driven by strong credit and monetary expansion and declining market rates, despite a relatively tight policy rate. Neutral rate estimates and the real policy rate gap corroborate that monetary conditions have at times remained accommodative in real terms, underscoring the need to complement interest-rate policy with stronger liquidity management, improved corridor operations, and targeted macroprudential tools to safeguard price stability.

A. Introduction

1. The Kyrgyz Republic's post-COVID experience shows why monetary stance must be assessed beyond the policy rate.

Although the National Bank of the Kyrgyz Republic (NBKR) has maintained a relatively tight headline policy rate, the operational stance – captured by short-term market rates – has remained accommodative amid persistent excess liquidity driven by NBKR's domestic gold purchases, capitalization of state-owned banks to support directed lending, and the placement of government deposits in the banking system. As shown in Text Figure 1, broad money growth has accelerated, with M2X reaching 50 percent of GDP, indicating a sizable expansion of system-wide liquidity. Consequently, money market rates (interbank rate) have stayed well below the policy rate, implying looser effective financing conditions despite a restrictive signal. This wedge weakens transmission and complicates interest-rate calibration amid strong domestic demand.

Text Figure 1. Dynamics of Broad Money (M2X)



Source: NBKR and IMF staff calculations.

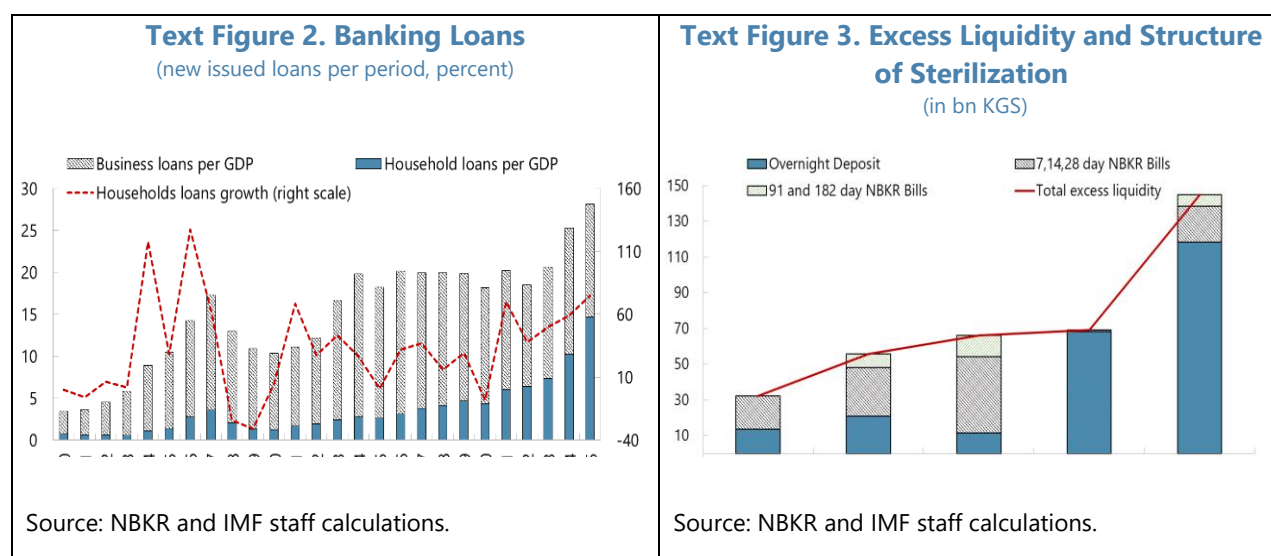
2. Easy liquidity conditions have fueled rapid credit growth, sustaining demand and price pressures.

Following the initial cost-push inflation surge triggered by external shocks in 2020–22, inflation dynamics increasingly reflects domestic demand pressures. Credit growth has outpaced nominal GDP, with households relying more heavily on short-term consumer loans and mortgages. New lending has also shifted sharply toward households, whose share in total new credit reached

¹ Prepared by Nasir Rao and Anvar Muratkhanov (all MCD).

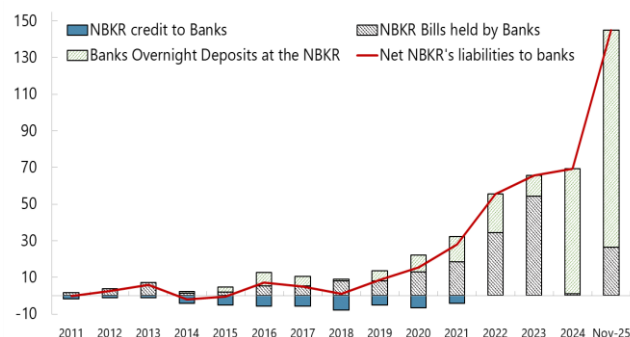
historically high levels in 2024–25, while corporate lending expanded more moderately. As shown in Text Figure 2, total new bank lending now exceeds 25 percent of GDP, underscoring rapid financial deepening but also rising macro-financial vulnerabilities.

3. Credit expansion has been accompanied by a rapid buildup of excess liquidity, which is sterilized primarily through short-term instruments. While the NBKR’s absorption operations have been extensive, heavy reliance on overnight placements makes sterilization highly reversible and vulnerable to shifts in banks’ behavior and market sentiment. Excess liquidity rose sharply during 2021–25, from around KGS 30 billion (3.8 percent of GDP) in 2021 to nearly KGS 150 billion (9.2 percent of GDP) most recently. Although this liquidity is formally absorbed by the NBKR, more than 80 percent is placed in overnight deposits and can quickly re-enter the system through renewed credit expansion (Text Figure 3). This combination can keep financing conditions easier than intended, reinforce demand pressures, and complicate the pursuit of price stability.



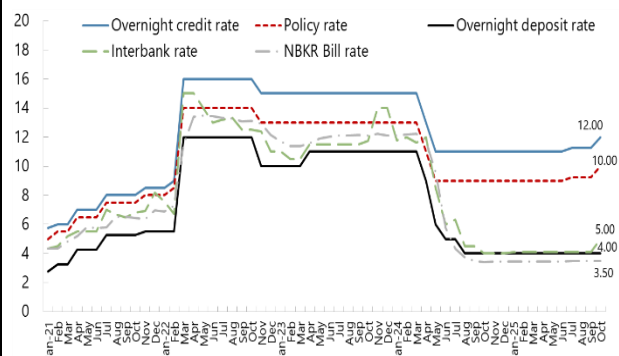
4. These developments highlight the limitations of using the policy rate alone to assess monetary stance. With a persistent structural liquidity surplus, the NBKR has effectively operated as a net borrower from banks, with no refinancing to banks since 2022, underscoring ample liquidity in the system (Text Figure 4). In this environment, the interest rate corridor floor has become the operative anchor for short-term market rates. When the corridor floor was lowered, interbank rates and short-term yields fell even though the headline policy rate was unchanged (Text Figure 5). As a result, the policy signal became divergent from the financing conditions faced by households and firms in practice (Text Box 1), underscoring the need for a broader measure – such as an FCI – that captures liquidity, market rates, credit dynamics, and external financial influences.

Text Figure 4. Composition of Net NBKR Liabilities to Banks
(borrowing from banks minus lending to banks, KGS bn)



Source: NBKR and IMF staff calculations.

Text Figure 5. NBKR Interest Rate Corridor
(in percent)



Source: NBKR and IMF staff calculations.

Box 1. Why the Policy Rate Loses Traction Under Surplus Liquidity

In an interest rate corridor system, the policy rate is meant to guide short-term market rates through active interbank trading. This mechanism works best when banks have a structural need to borrow liquidity. When the system is in persistent surplus, banks hold ample reserves and interbank activity becomes thin. Instead of borrowing from each other, banks place excess funds at the central bank deposit facility, earning the corridor floor rate. As a result, money market rates are pulled toward the floor rather than the headline policy rate.

In such conditions, the central bank effectively becomes a net borrower from the banking system and the corridor floor – not the policy rate – anchors short-term pricing. Unless excess liquidity is absorbed durably, policy rate changes may have limited influence on interbank rates, short-term yields, and the financing conditions faced by households and firms. Empirical evidence supports this mechanism, excess liquidity weakens monetary transmission (Saxegaard, 2006), large inflows can delink funding costs from the policy rate (Barajas et al., 2016), and banks with higher reserves may reduce credit supply less after rate hikes (Fricke et al., 2024).

5. This study develops a Financial Conditions Index (FCI) for the Kyrgyz Republic to provide a high-frequency, comprehensive gauge of the effective monetary stance beyond the policy rate. To support and interpret the FCI signals, it also presents an indicative estimate of the real neutral interest rate and compares it with the ex-ante real policy rate. Together, these tools help assess whether overall monetary conditions are effectively restrictive or accommodative in real terms and whether the policy signal is aligned with financing conditions faced by households and firms. This integrated framework is particularly useful in episodes when excess liquidity and strong credit growth weaken the pass-through of the policy rate to market rates and inflation outcomes. By combining a broad conditions-based measure with a real-rate benchmark, it helps identify when tightening “on paper” may not translate into tighter conditions in practice.

B. Methodology and Results

Financial Condition Index

6. The FCI draws on methodologies used in recent IMF analytical work. The index is constructed at monthly frequency and combines indicators covering policy instruments, market interest rates, monetary aggregates, credit dynamics, exchange rate movements, and global financial conditions (Text Table 1).² Each series is transformed so that higher values indicate tighter financial conditions and then standardized using “Z” scores to ensure comparability across variables measured in different units. The resulting FCI provides a consistent measure of how overall financial conditions evolve over time and complements the neutral-rate benchmark in assessing whether the effective monetary stance is restrictive or accommodative in practice.

Text Table 1. Components of Financial Condition Index.

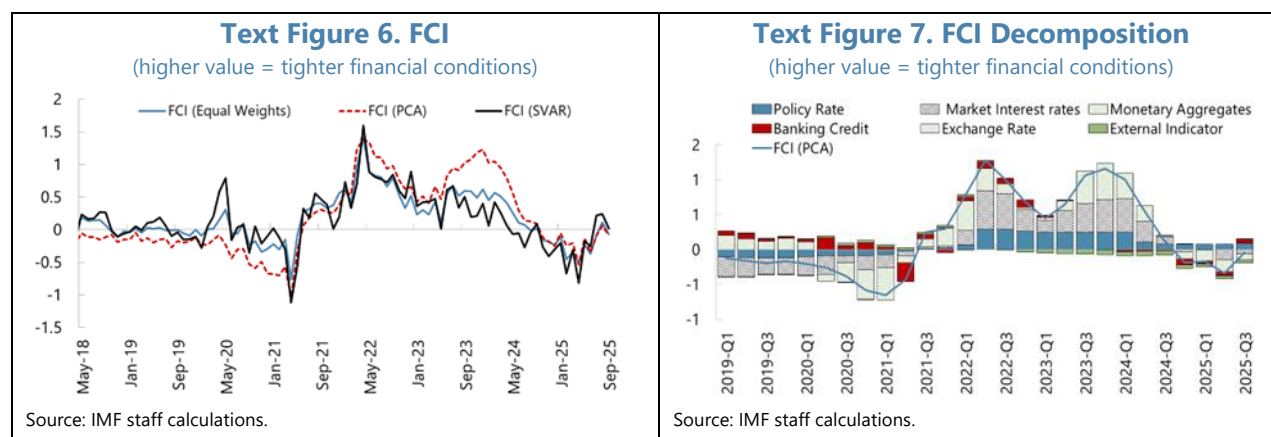
Policy Rate	Market Interest rates	Monetary Aggregates	Banking Credit	Exchange rate	External Indicators
NBKR’s policy rate	NBKR’s interbank rate, government securities rate, banking lending rate, and banking deposit rate	Monetary base and broad money	Business credits and household credits	Nominal effective exchange rate	Fed rate

7. The weights of the FCI components are derived using three complementary approaches. An equal-weight specification provides a transparent baseline, treating each indicator as equally important. Principal component analysis (PCA) is then used to extract the common underlying factor across the data, capturing shared variation in financial conditions. Finally, structural VAR (SVAR) assigns weights based on the cumulative impact of each component on real GDP growth. To keep the SVAR tractable given the large number of underlying indicators, it is implemented in two stages: PCA is first applied within key groups (market interest rates, monetary aggregates, and banking credit) to construct representative sub-indices, which are then included in the SVAR alongside real GDP growth. This multi-method approach enhances robustness by combining a transparent benchmark, a purely statistical summary measure, and an economically interpretable weighting scheme based on the estimated output effects of financial shocks.

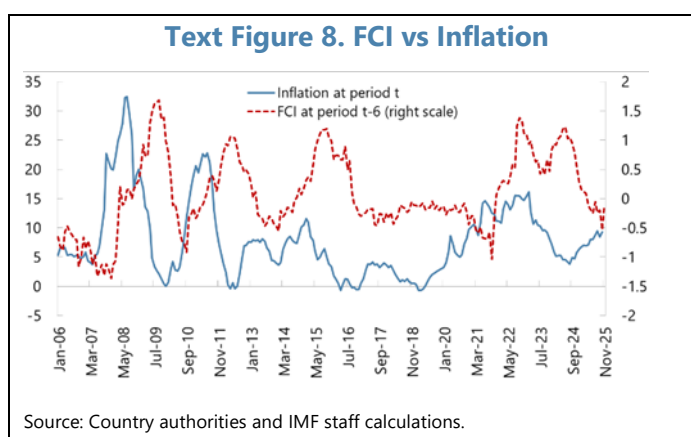
8. Results across all three approaches point to a notable easing in financial conditions from early 2024 (Figure 6). The FCI decomposition suggests that this easing has been driven mainly by faster credit growth and monetary expansion, alongside a decline in market interest rates, even as the policy rate contribution remained tightening (Figure 7). This pattern indicates that the

² Policy rate, market interest rates, and external indicators are expressed in percent levels; monetary aggregates and banking credit are expressed as percent of GDP and measured as year-over-year growth; and the exchange rate is measured as month-over-month growth.

restrictive policy signal was partly offset by liquidity and credit dynamics, leaving overall financing conditions more accommodative than implied by the policy rate alone.



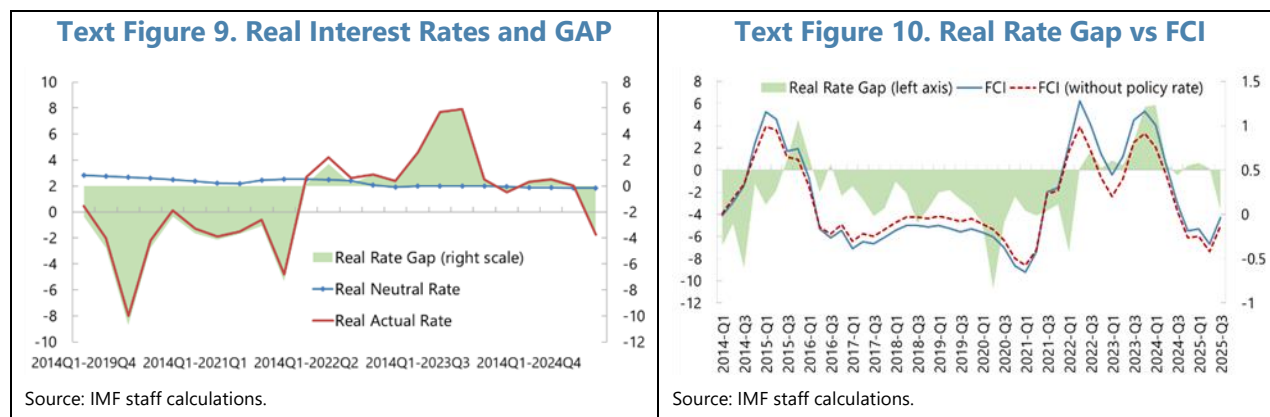
9. Lower FCI values – indicating looser financial conditions – are associated with higher subsequent inflation. With headline inflation already above the NBKR’s medium-term target range of 5–7 percent, this pattern suggests that inflation persistence reflects not only exogenous cost-push shocks but also sustained domestic demand supported by still-easy financial conditions. This is confirmed by both the visual relationship in Text Figure 8 and by a simple regression where the sixth lag of the FCI is statistically significant for inflation. In this environment, excess liquidity and strong credit dynamics can weaken the pass-through of the policy rate to market pricing and borrowing conditions. The FCI therefore provides a useful leading indicator of inflationary pressures and complements the policy rate in assessing the effective monetary stance and near-term inflation risks.



Real Neutral Rate

10. Rolling Taylor-rule estimates suggest that the current real neutral interest rate is around 2 percent. This estimation focuses on the period after the NBKR introduced its medium-term inflation objective of 5–7 percent and strengthened its interest rate based monetary policy framework. Results also suggest that the neutral rate was higher earlier in the sample averaging around 3 percent during 2014–19, before gradually declining in recent years (Text Figure 9). This is broadly consistent with earlier evidence for the Kyrgyz Republic – range of 3.5 to 4 percent at the end of 2019 determined by Teodoru and Toktonalieva (2020).

11. The real policy rate gap, defined as the difference between the ex-ante real policy rate³ and the estimated real neutral rate, is currently negative, suggesting that monetary conditions remain accommodative in real terms despite elevated nominal policy rates (Text Figure 10). Movements in the real policy rate gap closely track the FCI, reinforcing the conclusion that effective financing conditions have loosened at times even when the policy rate signal remained tight. By contrast, the positive real rate gap in 2023–24 coincided with a tightening in financial conditions and a decline in inflation toward its medium-term target, underscoring the effectiveness of a sufficiently restrictive stance when real rates rise above the neutral benchmark.



C. Conclusion and Policy Recommendations

12. Overall, the analysis suggests that financial conditions in the Kyrgyz Republic have been more accommodative than implied by the headline policy rate alone. The constructed FCI indicates that conditions have eased since early 2024 despite a relatively tight policy signal, consistent with the decline in the real policy rate gap toward accommodative territory in real terms. Ample liquidity, declining market interest rates, and rapid household credit growth have supported domestic demand and weakened the pass-through of monetary tightening to market rates and borrowing conditions. In this context, maintaining a sufficiently restrictive real stance remains important to curb inflationary pressures, particularly amid strengthening demand and the announced increases in public sector wages.

13. Strengthening monetary policy transmission will require a multi-instrument policy response that addresses liquidity conditions, operational implementation, and credit dynamics. First, improving the durability of liquidity absorption is critical under persistent structural surplus: greater use of longer-tenor sterilization instruments, stronger liquidity forecasting, and reduced reliance on overnight operations would limit reversibility and prevent excess funds from quickly re-entering the system during demand upswings. **Second,** refining the corridor framework – including a higher corridor floor and a more symmetric design – would help anchor money market

³ The real policy rate is calculated by adjusting the nominal policy rate by the NBKR's one-year-ahead inflation forecasts, which incorporate inflation expectations of domestic households and firms collected by the NSC and subsequently processed by the NBKR. Inflation forecast figures are obtained from the quarterly Monetary Policy Reports published on the NBKR's website.

rates closer to the intended stance rather than the lower bound. **Third**, stronger coordination between the NBKR and the public sector- particularly the Ministry of Finance, given its role in state-owned bank capitalization and fiscal cash management – would reduce autonomous liquidity fluctuations through improved information sharing, more predictable placement of government deposits, and better alignment of fiscal operations with monetary objectives. **Finally**, given rapid household credit expansion, targeted macroprudential measures could complement monetary policy by containing demand-driven pressures and limiting risks to price stability. Together, these measures would narrow the wedge between the policy signal and effective financing conditions, strengthening the overall effectiveness of monetary policy.

Annex I. Methodology

A. Estimating the FCI Weights

Principal Component Analysis (PCA)

1. PCA is used to summarize a large set of financial indicators into a small number of common factors while retaining as much information as possible. Technically, principal components are obtained from the eigen-decomposition of the correlation matrix of standardized variables. The first principal component captures the largest share of common variation across indicators and is interpreted as the PCA-based measure of overall financial conditions.

2. The eigenvalue of the first principal component is 4.22; with eleven standardized indicators, this implies that it explains about 38 percent of the total variance. Text Table 1 reports the corresponding factor loadings, which indicate that the common factor is driven primarily by domestic interest rates and liquidity conditions, reflecting their dominant contribution to overall variation in the data. Credit variables also load positively but play a more secondary role, while the exchange rate and external financial conditions contribute relatively little. Overall, the PCA-based FCI therefore mainly reflects domestic monetary and liquidity dynamics in the Kyrgyz Republic.

Table 1. Kyrgyz Republic: Variables Loadings in PC1.

Indicator	Loadings
Policy Rate	
NBKR's Policy Rate	0.422
Market Interest Rates	
NBKR's Interbank Rate	0.406
Government Securities Rate	0.361
Banking Lending Rate	-0.000
Banking Deposit Rate	0.263
Monetary Aggregates	
Monetary Base	0.415
Broad Money	0.417
Banking Credit	
Business Credits	0.233
Household Credits	0.218
Exchange Rate	
NEER	0.015
External Factor	
FED rate	-0.095

Structural VAR

3. The structural VAR (SVAR) framework is used to derive economically grounded weights of FCI. A two-stage approach is adopted. First, PCA is applied within key blocks to construct composite indicators for market rates, monetary aggregates, and banking credit. These composites are then included in a monthly SVAR together with the policy rate, the exchange rate (NEER), the U.S. federal funds rate, and real GDP growth.

The estimated SVAR has the following form:

$$Ay_t = c + B(L)y_{t-1} + Dx_t + \varepsilon_t,$$

where y_t is the vector of variables in the system, A is the contemporaneous impact matrix, $B(L)$ is a matrix polynomial in the lag operator with six lags, x_t is a vector of exogenous controls, and ε_t is the vector of structural shocks. All variables are expressed in standardized form. The system vector is:

$$y_t = [fed_rate, neer_t, policy, market_rates_t, monet_aggr, bank_credit_t, gdp_growth_t]'$$

The model is estimated over period 2002M01–2025M6 and includes two exogenous dummy variables: (i) a COVID-19 dummy and (ii) a post-2022 dummy capturing the period when the war in Ukraine significantly boosted domestic economic activity through the re-export flows.

Identification and restrictions

4. Identification follows a recursive (Cholesky) structure, with A restricted to be lower triangular with ones on the diagonal (variables ordered from most exogenous to most endogenous):

$$A = \begin{pmatrix} 1 & 0 & 0 & 0 & 0 & 0 & 0 \\ a_{21} & 1 & 0 & 0 & 0 & 0 & 0 \\ a_{31} & a_{32} & 1 & 0 & 0 & 0 & 0 \\ a_{41} & a_{42} & a_{43} & 1 & 0 & 0 & 0 \\ a_{51} & a_{52} & a_{53} & a_{54} & 1 & 0 & 0 \\ a_{61} & a_{62} & a_{63} & a_{64} & a_{65} & 1 & 0 \\ a_{71} & a_{72} & a_{73} & a_{74} & a_{75} & a_{76} & 1 \end{pmatrix}$$

The ordering used is:

1. Fed rate → 2) NEER → 3) Policy rate → 4) Market rates (PCA composite) → 5) Monetary aggregates (PCA composite) → 6) Banking Credits (PCA composite) → 7) Real GDP growth. This implies GDP is allowed to respond contemporaneously to all financial shocks, while external variable is most exogenous.

In addition to the contemporaneous recursive structure, we imposed a block-exogeneity restriction reflecting the small-open-economy assumption. Although included in the system vector to capture external financial shocks, the U.S. federal funds rate is treated as strictly block-exogenous: its equation contains only its own lags (and a constant), while coefficients on all lagged domestic

variables and dummy variables are restricted to zero. This ensures that innovations to the Fed rate reflect purely external financial shocks, with no feedback from the domestic economy on any horizon.

SVAR-based weights are obtained from the 12-month cumulative impulse response of real GDP to a one-standard-deviation shock in each financial indicator. This assigns larger weights to indicators whose shocks have a stronger cumulative impact on real activity over one year.

The SVAR results indicate that banking credit is the dominant driver of real activity, receiving the largest weight in the FCI. The policy rate and the exchange rate play a secondary but still important role, while market interest rates and external indicator contribute more moderately. The market rates show the lowest effect.

Table 2. Kyrgyz Republic: SVAR-based weights.

Indicator	Weight
Policy rate	0.263
Market rates Indicator	0.016
Monetary aggregates Indicator	0.082
Banking credit indicator	0.403
NEER	0.132
Fed rate	0.099

B. Estimating Real Neutral Rate

The estimation is based on a standard inertial Taylor rule in which the policy rate responds to deviations of inflation from its target and output from potential, while also displaying interest-rate smoothing. The rule is specified as:

$$i_t = \rho i_{t-1} + (1 - \rho)[r^* + \pi^* + \alpha(\pi_t - \pi^*) + \beta \tilde{y}_t] + \varepsilon_t,$$

where i_t denotes the nominal policy rate, π_t the inflation rate, π^* the inflation target, and $\tilde{y}_t$ the output gap. The parameter ρ captures policy inertia, while α and β measure the response to the inflation gap and the output gap, respectively. The real neutral interest rate r^* is defined as the real rate that prevails when inflation is at its target and the output gap is closed.

Under these neutral conditions, $\pi_t = \pi^*$ and $\tilde{y}_t = 0$, the steady-state policy rate satisfies

$$i^* = r^* + \pi^*.$$

This identity forms the basis for recovering the neutral rate from the estimated policy rule. Assuming a constant inflation target, the Taylor rule can be rewritten in a form suitable for estimation:

$$i_t = k + \rho i_{t-1} + \gamma(\pi_t - \pi^*) + \delta \tilde{y}_t + u_t,$$

Where:

$$k = (1 - \rho)(r^* + \pi^*), \gamma = (1 - \rho)\alpha, \delta = (1 - \rho)\beta.$$

The real neutral interest rate is obtained from the estimated coefficients as

$$r^* = \frac{k}{1 - \rho} - \pi^*$$

According to the approach proposed by Tiedemann, Bizimana, and Arzoumanian (2025), the model is initially estimated by ordinary least squares for the sample period 2014Q1–2019Q4. To allow for time variation in the neutral rate, the Taylor rule is subsequently estimated recursively using an expanding-window approach. In each step, one additional quarterly observation is added to the sample, and the model is re-estimated. This procedure continues until the final estimation window 2014Q1–2025Q3. For each estimation window, the real neutral interest rate is recovered using the coefficient mapping described above, generating a time series of neutral-rate estimates.

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INFORMAL ECONOMY IN THE KYRGYZ REPUBLIC¹

A. Introduction

1. Informality is very common in developing countries. According to World Bank research, in developing countries, 70 percent of workers and 30 percent of production are concentrated in the informal economy (The World Bank 2018). The literature indicates that informality results from a combination of factors. Although informality exists everywhere, it is more prevalent in low-income and developing countries and is mainly driven by suboptimal education systems, gaps in tax and social protection system design, deficiencies in labor market regulations, limited access to finance, and weak institutions and governance (IMF 2021).

2. Informality has a negative effect on economic development through several channels. Firms in the informal sector tend to be small, as they have limited access to credit, advanced technologies, and international markets. High levels of informality narrow the tax base, limiting government resources for investment in human capital and public infrastructure—both important for long-term economic development. In addition, high informality creates distortions in taxation, as formal firms and workers are excessively taxed.

3. People working in informal sector are more prone to poverty rather those working in the formal sector. Empirical research suggests a significant correlation between informal employment and poverty or vulnerability (ILO, 2014). Most people working in the informal economy have low literacy levels, limited skills, and inadequate training opportunities. They typically lack state-provided protection and security—such as minimum wages, social protection, and job stability—which makes them highly vulnerable to poverty and economic shocks.

4. At the same time, informality in low-income and developing economies provides employment opportunities and income for individuals in contexts where formal jobs are scarce. Many studies suggest that policy should not focus on eliminating informality immediately, but rather on gradually making formality more attractive by improving institutions, reducing regulatory burdens, and expanding access to social protection (World Bank 2018). Blunt efforts to eliminate informality may instead lead to higher unemployment, increased poverty, and rising crime.

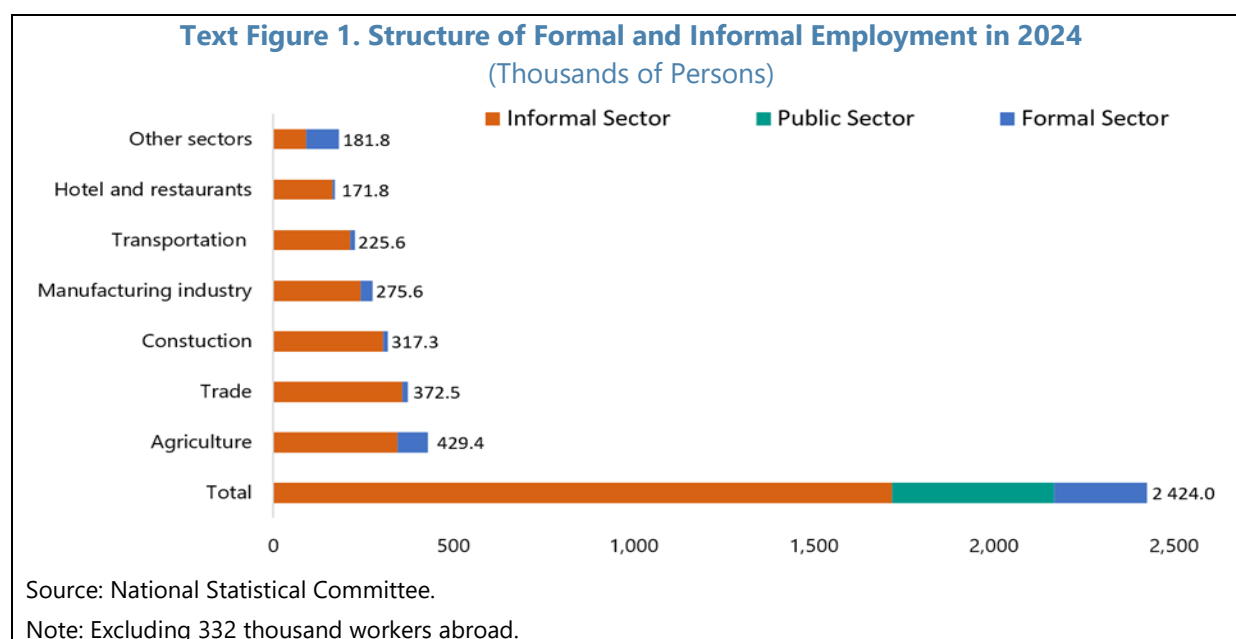
B. Labor Market and the Main Drivers of Informality in Kyrgyz Republic

5. Informality in Kyrgyzstan is a complex phenomenon driven by multiple, interrelated factors. As in many developing and transition economies, low educational attainment is strongly associated with informal employment. Global evidence shows that around 45 percent of informal workers have only primary education or less, compared with about 7 percent of formal workers (OECD, 2024), a pattern that is also relevant for Kyrgyzstan given the concentration of low-skilled labor in informal activities, particularly in agriculture, trade, and services. In addition, the role of

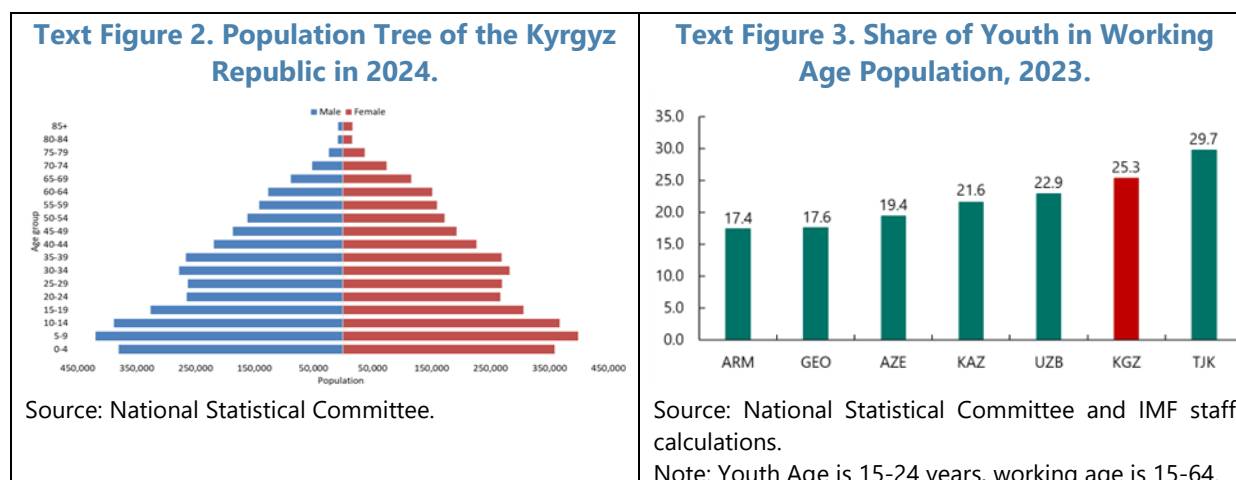
¹ Prepared by Farid Talishli and Anvar Muratkhanov (all MCD).

structural and institutional factors—such as tax policy, labor market rigidities, weak institutional capacity, and regulatory and financial market constraints—in sustaining high levels of informality. These factors are particularly salient in the Kyrgyz context, where small firms and self-employed workers often face significant barriers to formalization.

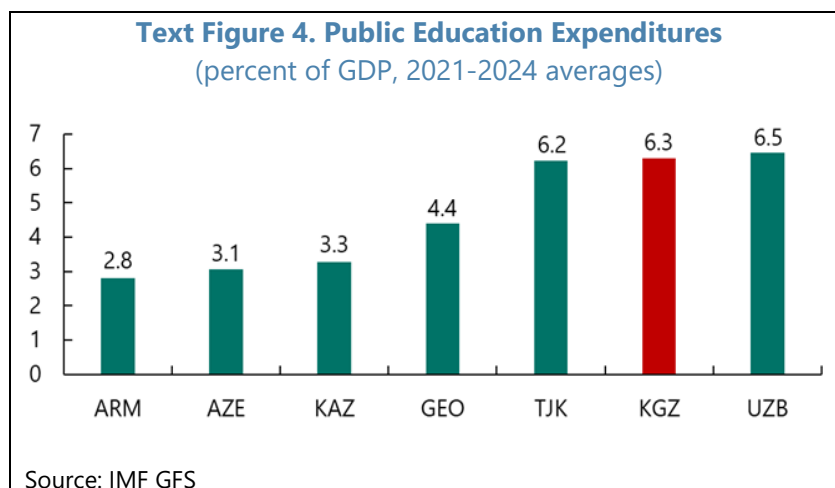
6. The economy of the Kyrgyz Republic is characterized by a high level of informality and informal employment. The informal economy employs about 65 percent of the workforce and accounts for an estimated 19 percent of GDP. Informal activity is mainly concentrated in trade, construction, and services (Text Figure 1). It is associated with limited social protection, low wages, minimal job security, and an uneven tax burden between formal and informal businesses.



7. The Kyrgyz Republic has a young and growing population, with one of the highest shares of youth in the region (Text Figures 2-3). While this demographic trend represents potential for economic growth, most new entrants to the labor market end up in the informal sector. According to the World Bank, about 50,000 people enter the labor market every year.



8. The weak quality of education in Kyrgyz Republic limits human capital development and contributes to high informality in the labor market. Although the Kyrgyz Republic spends one of the highest shares of GDP on education in the region (around 6 percent, Text Figure 4), outcomes remain weak (World Bank, 2021). Government funding covers 11 years of schooling, but learning-adjusted years of schooling average only 8.4 years.² Moreover, 64 percent of primary school graduates are not proficient in reading comprehension, and the primary completion rate is 93 percent—both below regional averages (World Bank 2019). Limited access to quality vocational training and higher education worsens skills mismatches, as young people often lack the qualifications demanded by employers.



9. Many young people in the Kyrgyz Republic still face difficulties when moving from school to higher education and work because of weak learning outcomes. Although NEET rates have declined since 2021 and remain one of the lowest in the CCA region, it is still relatively high with 16.7 percent of youth aged 15–24 disengaged from productive activities³⁴. While the government is investing in youth education, employment, and entrepreneurship, mismatches between curricula and labor market continue to hinder transitions into work. Limited access to inclusive and effective career guidance and skills training constrains opportunities for upskilling and reskilling (World Bank, 2024; International Labor Organization, 2023; ADB, 2023).

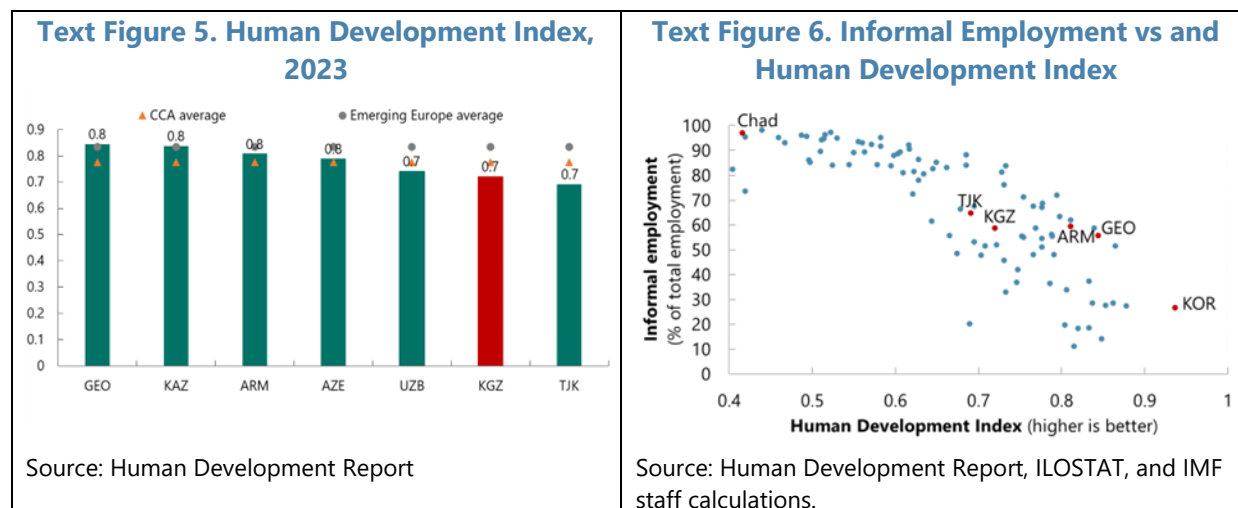
10. Weak education outcomes are also reflected in the Kyrgyz Republic's lower performance on the Human Development Index compared with both CCA and Emerging Europe countries (Text Figure 5). Low human development is strongly associated with high informality, as limited education and skills reduce both workers' and firms' incentives and

² The Kyrgyz Republic began transitioning to a 12-year schooling system in 2025 under the national education transformation program "Altyn Kazyk".

³ NEET (Not in Education, Employment, or Training) is an indicator that measures the share of young people (15–24 years) who are not engaged in formal education, paid work, or job-related training. It is widely used to assess the degree of youth disengagement from learning and the labor market.

⁴ <https://sustainabledevelopment-kyrgyzstan.github.io/en/8-6-1/>

opportunities to operate in the formal sector. As shown in Text Figure 6, countries with lower Human Development Index scores tend to have higher levels of informal employment⁵.



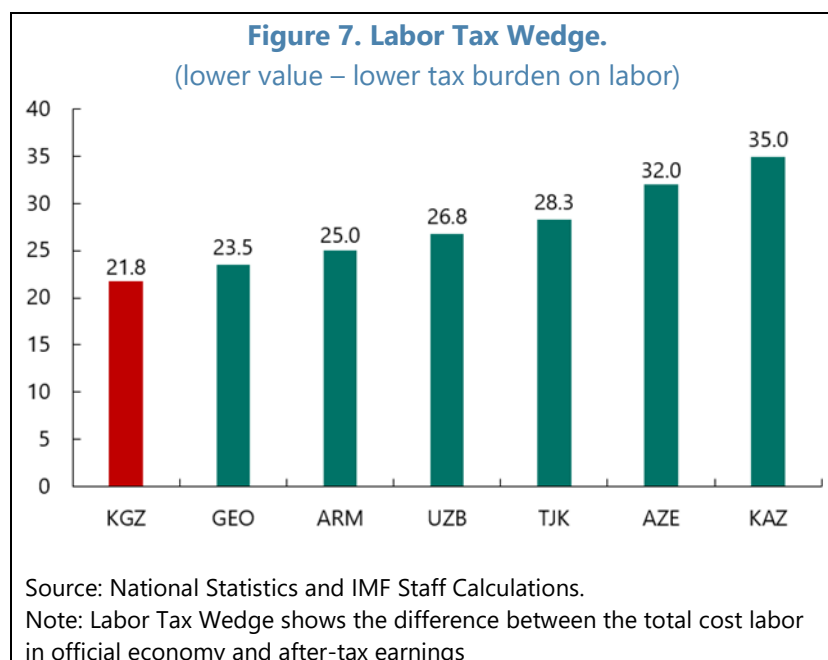
11. The tax regime in the Kyrgyz Republic is broadly competitive. Tax rates and social contributions rates are relatively low compared to regional peers (Text Tables 1-2), yet tax revenues amount to roughly 20 percent of GDP, reflecting good tax administration.

Text Table 1. Tax Rates in CCA Countries, in percent.							
	ARM	AZE	GEO	KAZ	KGZ	TJK	UZB
VAT	20	18	18	12	12	18	15
Corporate Income Tax	18	20	15	20	10 (general regime) or 2-	15	15
Personal Income Tax	20	14	20	10	10	13	12
Source: National Statistics.							
Text Table 2. Social Contributions Rates in CCA Countries, in percent.							
	ARM	AZE	GEO	KAZ	KGZ	TJK	UZB
Employee	5	3	2	12	10	2	6
Employer	5	22	2	13	2.25	20	12
Total	10	25	4	25	12.25	22	18
Source: National Statistics.							

12. The Kyrgyz Republic's labor tax wedge – defined as the difference between the total cost of labor to employers and worker's after-tax earnings – is the lowest in the region (Text Figure 7). It indicates that compared to most neighboring countries, a smaller proportion of labor costs is taken through taxes and social contributions, making transition to formal employment

⁵ Cross-country empirical analysis suggests that an additional year of expected schooling is associated with an estimated 8-percent decline in the share of informal employment.

relatively less costly. As a result, the overall tax burden on labor is not excessive and is unlikely to constitute a significant obstacle to labor formalization.



13. Notwithstanding the overall competitiveness of the tax regime, it remains highly fragmented and has been subject to frequent changes in recent years. This has created uncertainty for businesses and weakened incentives for formalization. As discussed in the box below, the system includes multiple special tax regimes that increase compliance costs. Although recent reforms were intended to strengthen tax administration, the introduction of new procedures initially raised compliance costs and proved burdensome for businesses. Some of these procedures were later softened or eliminated.

Box 1. Tax Fragmentation and Compliance Costs in the Kyrgyz Republic

The Kyrgyz tax system is highly fragmented. In addition to the main national taxes—personal income tax, corporate income tax, VAT, excises, and the sales tax—there are numerous special tax regimes, including the patent regime, single tax regime, free economic zones, high-technology park regime, crypto-mining regime, electronic commerce regime, gambling activity regime, and trading zones regime (IMF, 2024).

Businesses may operate under the patent, simplified, or general tax regime, but complexity goes well beyond this choice. Within each regime, tax obligations vary depending on several factors, including the type of activity, whether transactions are cash or non-cash, whether the final consumer is a registered taxpayer or an anonymous end-user, and whether the business operates in a special tax zone. This layered structure increases compliance complexity and raises administrative costs for firms.

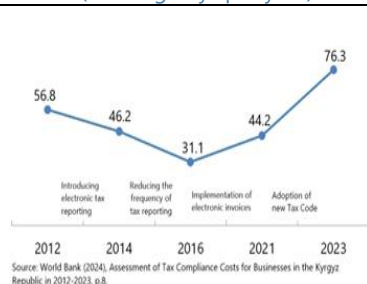
The parallel operation of simplified and general corporate income tax regimes creates particularly strong distortions. While simplified regimes are intended to ease compliance and promote formalization among small businesses, they are widely used in sectors such as trade that already have high levels of informality. This encourages firms to remain small, split operations, or underreport turnover to stay below eligibility thresholds. As a result, incentives to move into the general tax regime remain weak, constraining productivity growth, distorting competition, and limiting the tax base. Over time, this fragmentation undermines full formalization and reinforces persistent informality, despite the overall competitiveness of the tax system.

Box 1. Tax Fragmentation and Compliance Costs in the Kyrgyz Republic (concluded).

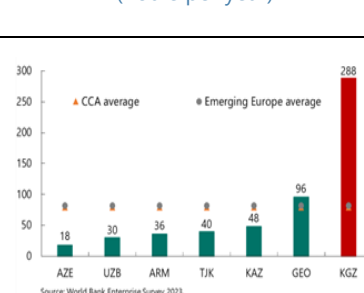
In addition to fragmentation, the tax system is subject to frequent changes. The adoption of the new Tax Code in 2022 introduced important reforms, including expanded electronic reporting, a higher VAT registration threshold (from KGS 8 million to KGS 30 million), and a stronger legal framework to broaden the tax base. However, the transition also increased administrative burdens, as taxpayers had to adapt quickly to new rules, reporting formats, and accounting procedures. According to the World Bank's tax compliance cost survey, the average time legal entities spent on tax accounting rose from 44.2 working days in 2021 to 76.3 working days in 2023 (Box Figure 3). The 2023 World Bank Enterprise Survey shows that firms in the Kyrgyz Republic spend more than 280 hours per year preparing and paying taxes—more than twice the average in the Caucasus and Central Asia and Emerging Europe (Text Figure 11). About 25.8 percent of firms identify tax administration as a major constraint (Text Figure 12). High compliance costs, especially for small and medium-sized enterprises, weaken the perceived benefits of formality and reinforce incentives to remain outside the tax system.

A major driver of the increase in compliance time in 2023 was the introduction of electronic consignment notes to improve the traceability of goods. While this measure was intended to strengthen oversight, it substantially increased the time required to meet tax reporting obligations. The government has since streamlined the requirement, which now applies only to selected goods such as alcohol, tobacco, and petroleum products. Together with ongoing efforts to digitalize tax administration, compliance time is likely to decline relative to 2023, even though updated survey data are not yet available.

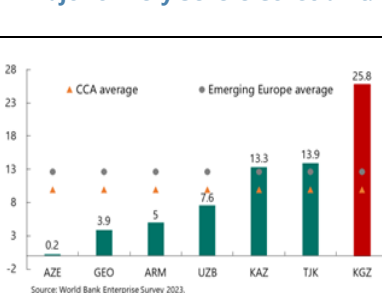
Box Figure 1. Time Cost of Tax Accounting for Legal Entities in the Kyrgyz Republic.
(working days per year)



Box Figure 2. Time to Prepare, File, and Pay Taxes.
(hours per year)



Box Figure 3. Percent of Firms Identifying Tax Administration as a Major or Very Severe Constraint.



14. Social safety net programs play a limited role in the Kyrgyz Republic.

In countries with weak social safety net where unemployment insurance, health coverage, pensions, and other benefits are limited or unreliable relative to the costs of formal contributions, workers generally prefer informal employment because formality does not significantly improve their income security or reduce risk (OECD 2025). The average unemployment benefit coverage in the Kyrgyz Republic is 0.3 percent, compared to 5.4 percent in other CCA countries and 20 percent in EMEU (Table 3). Unlike advanced economies, where these benefits

Text Table 3. Unemployed Benefit Coverage.

(percentage of unemployed receiving unemployment benefits)

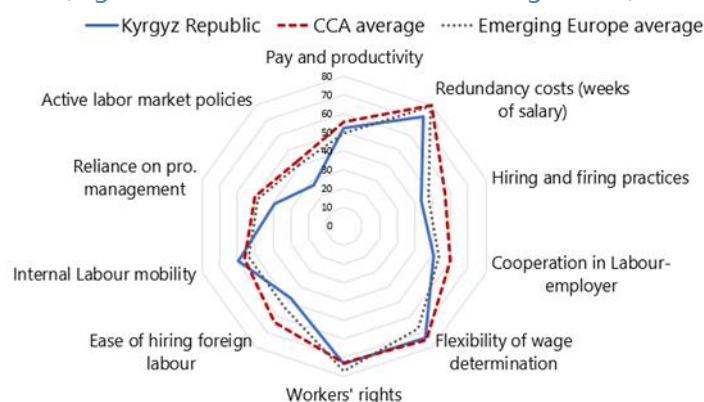
ARM	0.0
AZE	1.6
GEO	0.0
KAZ	23.2
KGZ	0.3
TJK	6.5
UZB	6.0
CCA average	5.4
Emerging Europe average	20.0

Source: ILOSTAT.

automatically expand during economic shocks to stabilize household income and consumption, they are static in the Kyrgyz Republic⁶.

15. Labor market rigidity is another key factor increasing the incentives for informal work. Based on the World Economic Forum's Global Competitiveness Index, the Kyrgyz Republic ranks below its regional peers on most labor market indicators, including active labor market policies, reliance on professional management, ease of hiring foreign labor, and hiring and firing procedures (Text Figure 8).

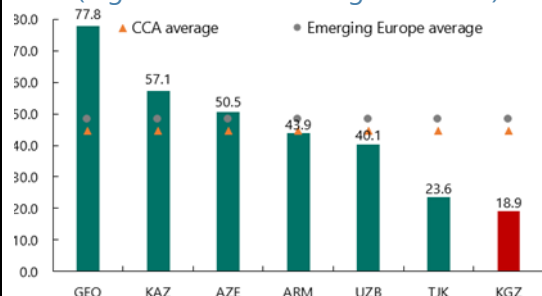
Text Figure 8. Labor market regulation indicator.
(higher the score the better market regulation)



Source: 2019 Global Competitiveness Report of World Economic Forum.

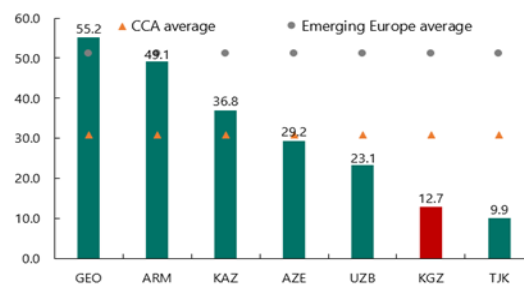
16. Institutional quality is closely tied to the extent of informal employment. Weak governance, poor rule of law, low regulatory quality, and high corruption incentivize firms and workers to operate outside the formal sector. The Kyrgyz Republic performs below most of its CCA peers on governance indicators (Text Figures 9-12), highlighting challenges in public service delivery, contract enforcement, regulatory predictability, and perceptions of corruption. These factors weaken trust in institutions and reduce incentives for formalization.⁷

Text Figure 9. Government Effectiveness.
(higher value – better governance)



Source: World Bank Government Indicators 2023.

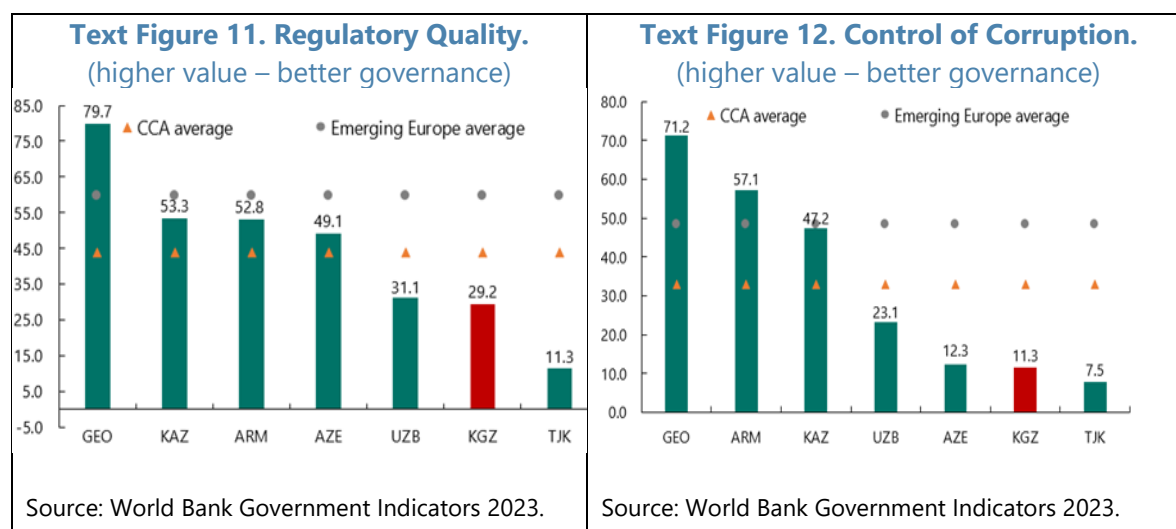
Text Figure 10. Rule of Law.
(Higher value – better governance)



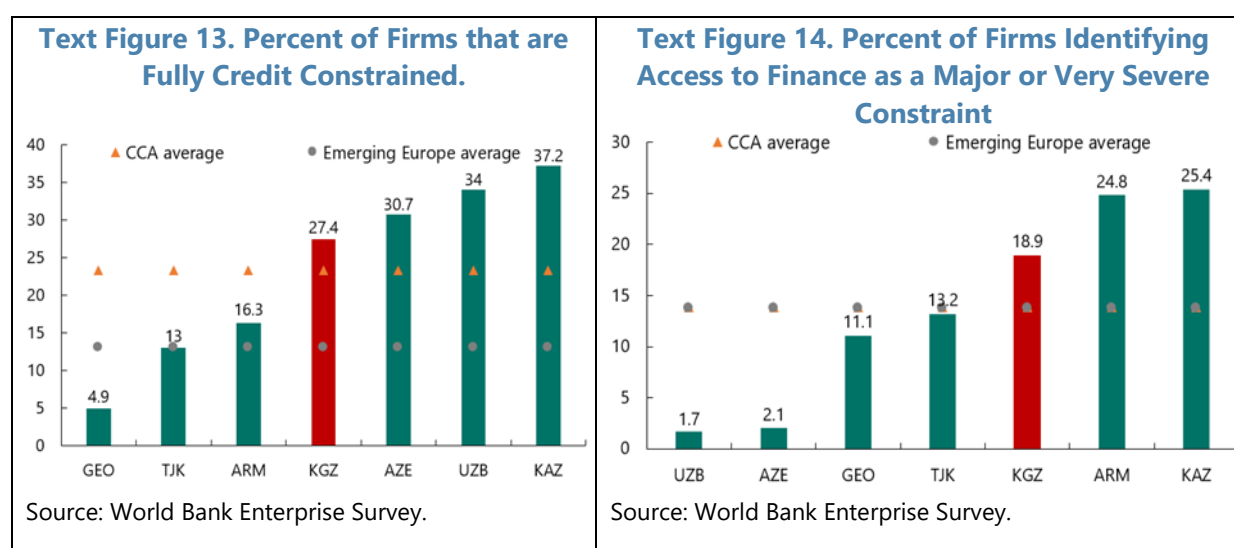
Source: World Bank Government Indicators 2023.

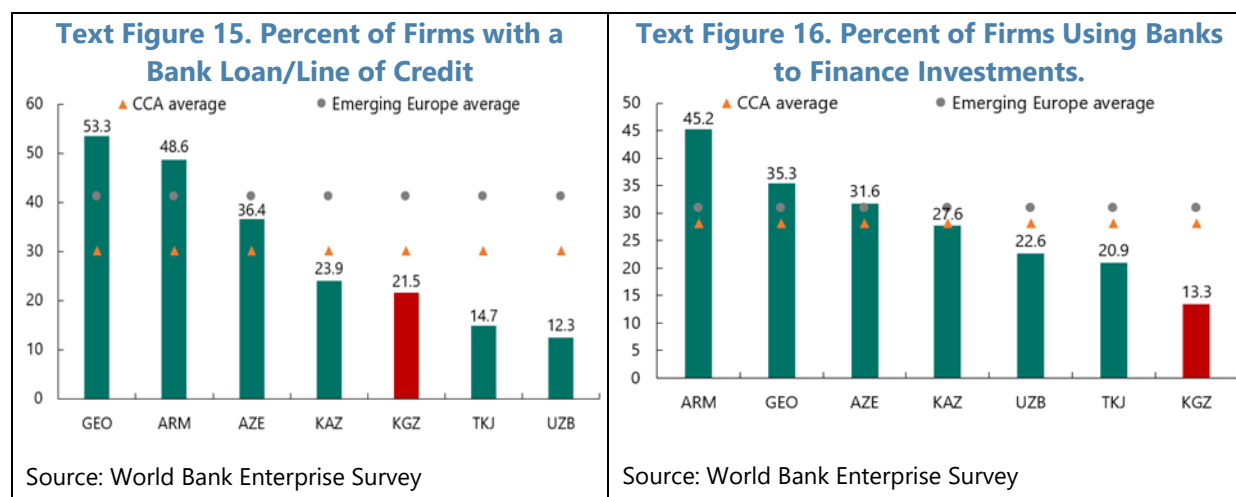
⁶ Kyrgyz republic faces challenges in determining and verifying eligibility for unemployment benefits (IMF 2025). Tracking informal workers and their pay is difficult, which increases the risk of ineligible claims for unemployment benefits (Brollo, Ibarra, and Campante Vale, 2024). Further complications arise from limited technical and administrative capacity to provide job search assistance and training, which are essential elements of an efficient unemployment benefit scheme.

⁷ Cross-country empirical analysis suggests that 10-point improvement in governance indicators is associated with an estimated 8.4-percent reduction in informality.



17. Low affordability and limited accessibility of financing is important factor of informality. Restricted access to finance discourages business expansion, constrains productivity-enhancing investment, and reduces incentives for firms to formalize, as informal operations often depend on alternative, non-bank financing arrangements that may be easier to obtain in the short term but ultimately limit long-term growth potential. According to the World Bank Enterprise Survey 2023–2024, the share of Kyrgyz firms that are fully credit constrained and identify access to finance as a major obstacle is higher than the CCA and Emerging Europe averages (Text Figures 16–17). Access to formal credit is particularly limited: only 21.5 percent of firms have a bank loan or line of credit and just 13.3 percent use bank financing for investment — one of the lowest shares in the region (Figures 13–16). These patterns suggest that most firms rely heavily on internal funds to meet both working capital and investment needs, reflecting limited availability of affordable formal credit.





C. Discussion and Policy Recommendations⁸

18. Kyrgyz Republic is prone to informality due to a combination of weak human capital outcomes, institutional constraints, and limited incentives to formalize. Despite relatively low labor taxes, poor education quality, skills mismatches for a young and rapidly growing workforce, fragmented and frequently changing tax regimes, weak social protection, and rigid labor market regulations push many workers and firms into informal activity. Limited access to finance and weak governance further reinforce informality by raising the costs and lowering the perceived benefits of operating in the formal sector.

19. Reducing informality remains a key policy objective for the Kyrgyz Republic, given its implications for productivity, medium-term inclusive growth, revenue mobilization, and inequality. A comprehensive policy approach is needed, encompassing measures to foster private-sector-led growth, strengthen labor market institutions, improve tax and social safety net design, enhance governance, expand access to finance, and upgrade human capital. Reforms should be carefully designed and implemented gradually, given the importance of informal activities for the livelihoods of many households. Abrupt or poorly targeted efforts to eliminate informality could increase unemployment, poverty, inequality, and social tensions.

⁸ The conclusion and results of this work are aligned with the strategic priorities outlined in the National Development Program of the Kyrgyz Republic until 2030 (NDP), which emphasizes improving human capital, reducing informality, increasing employment, and strengthening institutional quality. The NDP sets explicit targets—such as reducing informal employment to 58 percent, improving the country's Human Development Index ranking, and expanding access to quality education and vocational training—that directly correspond to the main determinants of informality highlighted by our empirical findings. The NDP also prioritizes modernizing the education system (including transitioning to a 12-year school model, strengthening teacher qualifications, aligning curricula with labor-market needs, and expanding STEM and vocational education). Additionally, NDP commitments to improving public administration, reducing bureaucratic barriers, modernizing tax administration, and enhancing governance transparency.

20. A growth strategy centered on formal job creation would support reductions in inequality, poverty, and vulnerability over the medium term. In this context, reducing the state's footprint in the economy and creating greater space for private-sector activity would facilitate economic formalization. Continued efforts to improve the business environment—through clearer and more predictable regulations, lower administrative burdens, and stronger governance—would encourage firm growth and participation in the formal economy.

21. Labor market policies. Greater labor market flexibility, including through more adaptable employment contracts and streamlined hiring and firing procedures, could help reduce incentives for informal employment. These reforms should be complemented by stronger social protection and active labor market policies—such as job search assistance, vocational training, and reskilling programs—to support worker transitions and mitigate adjustment costs.

22. Tax policy and administration. Frequent changes to the tax system often create uncertainty and send wrong signals to businesses, weakening incentives to operate formally. A predictable and stable tax policy framework that balances simplicity with fairness is essential. While the tax system has improved in recent years, further reforms aimed at enhancing tax policy and administration could help strengthen compliance and incentives to formalize. Priority areas include simplifying and further digitizing tax administration, reducing compliance costs, and rationalizing the use of simplified tax regimes—particularly in sectors with high informality. Over time, greater convergence between simplified and general regimes would help reduce distortions and broaden the tax base.

23. Social protection and active labor market policies. Stronger and more modern social protection systems are essential for reducing informality and supporting inclusive labor market transitions. Expanding budget allocations for unemployment insurance, health coverage, and pensions would help ensure broader, more reliable coverage and reduce households' reliance on informal work as a coping strategy. Designing benefits to operate countercyclically—automatically expanding during economic downturns—would strengthen income stabilization and social resilience. At the same time, greater investment in active labor market policies, including job search assistance, vocational training, and reskilling programs, would facilitate mobility from informal to formal employment. These measures should be complemented by reforms that enhance labor market flexibility, such as more adaptable employment contracts and streamlined hiring and dismissal procedures, alongside the development of portable benefits systems to encourage formalization while protecting workers⁹.

24. Education and skills. Reforming education financing and strengthening skills development are critical for reducing informality over the medium term. Rather than focusing solely on increasing education budgets, greater emphasis should be placed on improving the efficiency and targeting of spending—particularly through investments in teacher training, curriculum modernization, and digital learning infrastructure. Expanding vocational and technical education, especially in close

⁹ Portable benefits are social protection benefits—such as health insurance—that stay with workers when they change jobs, helping protect them while supporting more flexible employment.

partnership with private sector employers, would help address persistent skills mismatches and facilitate smoother school-to-work transitions. Introducing performance-based budgeting that links funding to measurable improvements in learning outcomes and employability could further enhance impact. In addition, increasing support for disadvantaged groups through targeted scholarships, career guidance, and skills training programs would help reduce disparities in access to formal employment.

25. Governance and institutions. Strengthening governance and institutional capacity is central to reducing informality in the Kyrgyz Republic. Increased investment in public administration reform, digitalization of government services, and anti-corruption measures would improve regulatory quality, enhance transparency, and reduce compliance costs for formal firms. Strengthening contract enforcement, property rights, and the consistency of regulatory application would build trust in institutions and incentivize participation in the formal economy. At the same time, upgrading monitoring and data systems—particularly payroll and employment databases—would enable more regular, evidence-based reviews of public sector wages and employment trends, improving fiscal management and labor market oversight. Together, these reforms would support a more predictable business environment and reinforce incentives for firms and workers to operate formally.

26. Access to finance. Expanding access to finance would support the growth of small and medium-sized enterprises and facilitate their transition to the formal sector. Improved access to credit would lower barriers to formalization and increase its net benefits for both firms and workers. These measures should be implemented cautiously to avoid undermining financial sector stability.

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