KYRGYZ REPUBLIC

SELECTED ISSUES

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INCOME INEQUALITY IN THE KYRGYZ REPUBLIC

While extreme poverty has declined, overall poverty remains relatively high compared to regional peers. Addressing growth bottlenecks focused on income inequality has been constrained by volatile growth, high population growth, poor infrastructure, and weak institutions. Looking ahead, reducing income inequality would benefit from achieving macroeconomic stability, redesigning fiscal policy, broadening access to finance, improving the business environment, and building human capital.

A. Trends in poverty and income inequality

1. Poverty has considerably decreased over the past decade, but still remains high relative to regional peers. Extreme poverty, defined by poverty at US$1.25 a day, fell below 2 percent in 2008, and increased somewhat afterward, but remains below 5 percent. The overall poverty increased between 2008 and 2012, and then declined marginally in 2013. Nevertheless, still about 80 percent of the population lives below US$5 a day.

2. Poverty is concentrated in rural areas. Almost three quarters of the poor live in rural areas. According to the World Bank, poverty levels vary across region, so called “oblast”, in the country. Poverty across “oblasts” varies a lot, as well as within an “oblast” over several years. Key factors explaining volatility of poverty indicators within an “oblast” over the years are quality of agricultural harvest and remittances flows. Remittances represent a relatively significant share of families’ income—reaching up to 20 percent in southern “oblasts”—and are important for alleviating poverty.

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1 Prepared by Dragana Ostojic and SeokHyun Yoon.

3. **Income inequality improved in the first decade following the independence, but has deteriorated since.** Income inequality improved during the 1990s when there was a strong push for reforms. However, with reform fatigue and deterioration in many governance indicators in early 2000, the inequality trends reversed. Notably, the 2010 civil conflict, political instability, and banking crisis wiped out the bulk of the achievements made in fighting poverty in the early 2000s. The Gini coefficient stood at 33.4 percent in 2011, with the poorest quintile earning 7.7 percent and the richest quintile 41.4 percent of income.

4. **Of additional concern, is land inequality given the importance of the agriculture and mining sector which accounts for 15 percent of GDP.** According to the FAO statistical 2009 yearbook, land GINI in the Kyrgyz Republic was 90 based on their 2002 survey.
5. The relatively poor performance in reducing income inequality is due to the fact that economic benefits from national economic growth have not trickled down to the poor. The growth incidence curve for the Kyrgyz Republic in 2006 and 2011 confirms little improvement in reducing the income gap between the rich and the poor. Real GDP growth rates for the groups in the lower parts of the income distribution are well below the middle part of the distribution.

6. Given the current income inequality level, unemployment is relatively high and concentrated among youth and women. The official unemployment rate currently stands at 8.5 percent, but it is relatively high compared to other countries which have similar income inequality. In particular, unemployment is concentrated among youth and women.

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3 Growth incidence curves identify the extent to which each decile of households ranged by their income level benefited from growth.
7. While the gender-related human development index for the Kyrgyz Republic is relatively high, income disparities between genders are present. According to the latest available data, the ratio of female to male salaries is 74.3 percent, even though women are more educated. Difference in the GNI per capita among genders is even more pronounced (estimated US$2,228 for women vis-à-vis US$3,837 for men).

8. Volatile and nondiversified economic growth and high inflation. The growth in the Kyrgyz republic is very volatile. Episodes of high growth were interrupted by the 2002 natural disaster in the south of the country and the gold production shock, the 2005 tulip revolution, the 2010 revolution, and the 2012 gold production shock. Growth is highly dependent on gold production and trade. These shocks held back progress in fighting poverty. Also inflation is a regressive and arbitrary tax, the burden of which is typically borne disproportionately by those in lower income brackets.
9. **The Kyrgyz Republic has a young population with high growth rates.** The population growth remains strong with 2.5 percent per annum. The population is young with one third below the age of 15 and only 6 percent over the age of 65. According to estimation by the UNICEF, the Kyrgyz Republic is among top 20 countries with the largest youth share in their respective populations. In addition, the average size of the family has increased relative to a decade ago, which would require the creation of more jobs to absorb young job seekers.

10. **Difficulties in the business environment.** The country’s business climate has improved somewhat since 2010. Nonetheless, businesses in the country face burdensome regulations, which discourage new entrants. Despite the government’s efforts, political instability and corruption remain important obstacles in doing business. Also the quality of public service provided to businesses sets unfavorable business climate. Limited reforms against a backdrop of difficult internal and external conflicts have weakened the business environment.

11. **Limited access to finance.** People in remote areas have limited access to banking services, including payment and transfer services and deposit facilities. While the number of accounts increased over the last few years, financial activity remains concentrated in the larger cities (Bishkek, Osh and Jalal-Abad). This is mainly because of the high costs associated with operating branches in rural areas. Limited bank competition; concentration of lending to large established companies; poor financial infrastructure; and limited financial literacy among SMEs are all impediments.

12. **Weak institutions.** Despite some progress, the Kyrgyz Republic ranked in the bottom twenty percentile with regard to the rule of law and control of corruption. Transparency is needed to achieve good governance as it helps reduce opportunities for corruption, cut the cost of government services and reduce inequalities across geographic distances.

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4 Ortiz et al. (2012), "When the Global Crisis and Youth Bulge Collide", UNICEF.
13. **Sizable informal economy.** The large size of the informal economy in the Kyrgyz Republic limits the state capacity to deliver governance and strong institutions, which in turn discourages participation in, and expansion of, the formal economy. Empirical analysis suggests that the size of informal economies is influenced predominantly by the quality of institutions. Not only do informal firms operate without paying taxes, but informal enterprises often have much lower productivity rates. Informal sector workers often have low wages, poor working conditions, and little employment protection or benefits.

14. **Quality of education.** While the government has made some progress in increasing access to education, yet the Kyrgyz Republic remains behind its regional and sub-regional neighbors. For instance, its primary school net enrolment ratio is below the average net enrollment ratio in the region. Over 80 percent of 15 year olds are scored at “functionally illiterate” levels.

**C. Policies to reduce income inequality and promote inclusive growth**

15. **Ensure macroeconomic stability.** A broadly stable macroeconomic environment is a prerequisite for achieving sustained economic growth. The government should implement appropriate policies that would aim to ensure moderate inflation, contain output volatility, and ensure that public debt levels can be sustained over time. High and unstable inflation, sharp fluctuations in domestic demand and risks of a public debt crisis are toxic for longer-term private investment, given the uncertainty and large downside risks that they create.

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6 World Bank (2009), Program for International Student Assessment.
**16. Redesign fiscal policy.** The current social protection scheme is complex and costly, with only one fifth of those in the poorest quintile benefiting from social programs. The authorities’ program should rightly focus on rendering social spending more efficient in tackling poverty. Both tax and expenditure policies need to be carefully designed to balance distributional and efficiency objectives. Options for redistributive policies that help minimize efficiency costs include: (i) consolidating social assistance programs and improving targeting; (ii) expanding cash transfer programs as administrative capacity improves; and (iii) improving access of low-income families to education and health services. To make such options viable, the government should be mindful of: (i) streamlining nonpriority spending; (ii) reducing regressive energy subsidies; and (iii) strengthening public financial management. Importantly, redistributive fiscal policy should be consistent with fiscal sustainability.

**17. Enhance resource mobilization.** A strong domestic revenue base is an imperative if the state is to finance essential public services, including health, education, and infrastructure spending, over the medium term. In this context, a progressive personal income tax could be considered over the medium term by applying it to all labor income above a reasonable threshold, and covering capital income.

**18. Improve the efficiency of the public investment program.** In general a scale-up in the public investment program can help address the country’s development needs and increase the economy’s potential. Given an absorptive capacity constraint, however, the country is already implementing ambitious plans. Against this backdrop, improving the efficiency of the public investment program is crucial. Successful implementation of the program will require ensuring high-quality spending, in particular by addressing potential absorptive capacity constraints and by adopting strong project appraisal and procurement policies.

**19. Broaden access to finance.** A well-functioning financial system is crucial. At a minimum this requires financial stability. Reforms for broadening financial access and supporting financial sector development should focus on increasing competition among banks (thereby incentivizing them to lend more broadly), strengthening financial infrastructure, expanding financial instruments, (e.g., Islamic finance, mobile payments, and microfinance), and providing training to strengthen financial literacy.

**20. Resilient business environment.** Ambitious and decisive structural reforms are necessary for a better business environment and strong private-sector-led growth. Corruption and the lack of infrastructure remain key constraints. In addition, many complain about excessive discretion and nontransparent intervention. Institutional and regulatory reform should aim at ensuring a level playing field that provides equal access to economic opportunities, reducing the scope for discretion (to reduce the likelihood of petty corruption), clearing regulatory barriers to formality, improving transparency, and strengthening institutional autonomy and accountability. In order strengthen the business environment, the country should: (i) continue to streamline the de facto regulatory burden; (ii) monitor the business environment via business surveys to identify the bottlenecks in the implementation of legislation and major constrains for doing business; (iii) improve access to information in general, and in particular, on government operations and contracts to increase
transparency and eliminate perceived corruption; and (iv) streamline bureaucratic procedures in obtaining and registering land titles.

21. **Promote employment.** Labor market policies should promote higher employment and equality of opportunity to work. The authorities should review labor market regulations to reduce distortions that discourage hiring and skills building. They could also change recruitment and compensation policies to ensure that salaries do not bias job-seekers toward the public sector, which would limit economic growth by trapping workers in less productive public-sector jobs and deter investment in the private sector. The government can also consider active labor market policies—in particular vocational training and educational programs for workers—within the envelope of available fiscal resources to facilitate and improve the match of workers to jobs, especially for vulnerable groups.

22. **Address the negative effects of informality.** To reduce the barriers to business and labor formality, policymakers should improve the regulatory framework for business. Entry regulations should be simplified and compliance costs reduced, while at the same time creating an environment that fosters a fairer enforcement of regulation. Simplifying tax regulations would increase formality, and could raise tax revenues. Such reforms will provide incentives for existing informal firms to pay taxes, increase their investments, and ultimately to operate in the formal economy.

23. **Build human capital.** Equipping the current and future labor force with relevant skills is important to increase countries’ productivity and growth, which would, in turn, reduce income inequality. For instance, establishing a national training fund could be considered over the medium term, subject to successful implementation of public finance reforms, particularly by improving tax administration and spending efficiency. Reforming education systems will boost the pool of skilled workers demanded by the private sector and will enhance opportunities for investments in human capital, thereby aiding social mobility. In particular enabling women’s labor market participation—by introducing child-related cash transfer to families with children, public spending on services for families with children and financial support for families provided through the tax system—to reach their full labor market potential can help reduce inequality and vulnerability and raise growth.

24. **Improve data quality and availability.** The limited availability and poor quality of key economic, financial, and social data impede a detailed, realistic assessment of the country’s growth inclusiveness. In particular, the poverty statistics for recent years disclosed by the authorities do not closely match the aggregate consumption inferred from the national account. Strengthened statistical capacity would help identify problem areas and provide an evidence-based analysis, which would allow policymakers to make educated decisions.
POLICIES TO UNDERPIN THE MEDIUM-TERM CONSOLIDATION

With an increased reliance on grants to finance its systemic budget deficit, the Kyrgyz Republic needs to accelerate consolidation by (i) strengthening its revenues by expanding its tax base, transitioning successfully to the EEU accession, and improving performance of corporate and personal income taxes; and (ii) streamlining its expenditure by reducing its public wage bill, rationalizing spending on goods and services, phasing out subsidies, and reforming social benefits.

A. Tax revenues

1. The Kyrgyz Republic still has room to increase tax revenues. Over the past 10 years, tax revenues increased from 12 to almost 21 percent of GDP in 2014, slightly below the regional comparator countries of 23 percent of GDP. Tax capacity is estimated at 22.3 percent of GDP while the realized tax-to-GDP ratio of 16.7 in 2011 implied a tax effort of 74 percent, below the average of comparator countries.

2. Good performance from taxes on goods and services should be preserved. VAT collection has performed about 1 percentage point of GDP above the regional average of comparator countries. However, the Kyrgyz VAT rate of 12 percent remains very low compared to regional comparators, where the average is 18 percent. Another source of concern is the phasing out of the sales tax, currently representing 1.8 percent of GDP in 2014, which will require new measures to compensate for its gradual loss.

3. While the accession to the EEU is expected to have a positive impact on overall tax revenues, the VAT collection is

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1 Prepared by Claire Gicquel and research assistance provided by Mbaye Gueye.

2 S. Caner, R. Krelove, and C. Waerzeggers (2014), The Kyrgyz Republic, Tax policy reforms and capacity building— the tax capacity is based on the latest available data. It is defined as the maximum attainable tax-to-GDP ratio given the economic structure of the country.

3 Armenia, Belarus, Estonia, Georgia, Kazakhstan, Tajikistan, and Russia.
expected to weaken. The accession to the EEU is expected to increase customs revenues by about 1.5 percent of GDP. However, VAT collection on goods and services could decline due to the shift in the VAT collection from the customs services where the VAT was paid at the border, to the state tax services (STS) where the VAT is now paid based on self declaration after the good enters the territory. Recent experience from Armenia shows a drop in VAT because of trade diversion and a shift of VAT accrual reporting after joining the EEU.

4—1. **Personal and corporate income tax performance is poor compared to other countries.** In both categories, the Kyrgyz Republic is on the bottom tier portraying a narrow tax base combined with increase unfairness of the tax system. Rather than improving the revenue performance of broad-based indirect taxes, many special regimes and exemptions were introduced destabilizing the tax system. The exemptions, mostly from agriculture and processing sectors. According to the authorities, tax exemptions represent about 3.5 percent of GDP.

5—2. **Progresses on tax policy and administration to improve corporate income tax and not significant in terms of result.** Some efforts to limit exemptions brought negligible additional revenues and significant measures, such as removing exemptions on agriculture, may be politically difficult to implement. Additionally, the introduction of a simplified system for accounting and reporting and the limitation of the patent system illustrate recent efforts in tax administration. However, the non-observed sector is still important, estimated between 24\(^4\) and 40\(^5\) percent of GDP. Fair taxation could be improved greatly by continuing to reduce exemptions, considering an

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\(^4\) National Statistics Committee.

\(^5\) Shadow Economies All over the World, New Estimates for 162 Countries from 1999 to 2007 Friedrich Schneider, Andreas Buehn, Claudio E. Montenegro.
increase in VAT rate, simplifying the corporate income tax and equalizing the corporate and personal income tax rates.\footnote{A. Jewell, M. Mansour, P. Mitra, and C. Sdralevich, 2015, Fair Taxation in the Middle East and North Africa, SDN/15/16.}

B. Expenditures

6. There is plenty of scope to current expenditures. Both wages and goods and services rank high compared to the sample countries. The issue is not only the level of expenditures but also its inefficiency as it is not supportive of growth. Literature shows that high current expenditures are rarely linked to high growth in low income countries, where corruption and lack of transparency are common.

7. Reducing the wage bill is a wage bill amounts to over 9 percent of GDP while it averages around 6 percent in regional comparators. A review of the wage bill is necessary to identify steps to reduce the bill. The World Bank recommended a reduction of supporting staff with increased role given to local authorities in the decision process and follow up on the implementation of the Program for Enhancing Civil Service Pay for 2013‒20 aiming to improve the fairness, transparency, predictability of civil service salaries and the wage bill. As best practices, the authorities should refrain from ad hoc increase in wages but index wages to inflation.

8. Goods and services never the different crisis the country went through since 2008. Following the injection of the fiscal stimulus in response to the global financial crisis, most of the countries have cut spending, however the Kyrgyz Republic’s spending on goods and services stayed high with the one-off stimuli embedded in current spending. Similarly, ad hoc measures were taken to respond to the 2010 crisis. It is necessary to cut non priority spending and refrain from ad hoc measures becoming permanent.
Social benefits are high but progress in fighting poverty and inequality are limited. Since 2008, poverty has increased to plateau at 37 percent in 2013. Social benefits keep on augmenting and are not well targeted. The pattern of social assistance expenditure still favors richer households. The social assistance system remains complex and fragmented and the pro-poor monthly benefit for poor families (MBPF), which coverage has declined and budget grew at a slower pace than other programs, covers less than a third of the poorest 20 percent. Furthermore, electricity compensations and subsidies are also not targeted to the poorest. The authorities need to work closely with development partners to improve the targeting of social programs, consolidate social benefits to avoid duplicate and reduce administrative costs, and review subsidies, especially by reforming the electricity sector.

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FINANCIAL STRUCTURE, FINANCIAL INCLUSION, AND CREDIT TRENDS IN THE KYRGYZ REPUBLIC

While the Kyrgyz financial sector remains relatively small and underdeveloped, the recent credit boom and deepening may improve financial inclusion indicators. However, access to credit varies widely across regions. High and increasing dollarization in light of exchange rate volatility and concentration are key sources of vulnerabilities. Prudent monetary and de-dollarization policies, with a set of macroprudential tools, could help mitigate these risks.

A. Financial structure and inclusion

1. The Kyrgyz financial sector remains relatively small and is dominated by banks. The overall level of credit to GDP is low relative to the Caucasus and Central Asia region and Central and Eastern Europe, particularly when compared with the lower middle income country (LMIC) average. The Kyrgyz financial system is a bank-based system, which accounts for 87 percent of financial system assets and provides about 80 percent of credit to the private sector. Nevertheless, Microfinancial Institutions (MFIs) play an important role (Table 1). Up until 2013, MFIs provided about one-quarter of the total credit to the private sector in the Kyrgyz Republic. However, since then MFIs have started to obtain banking licenses (Bai Tuschum in 2013, Finca in early 2015, and Kompanion underway), mostly to overcome hurdles in doing MFI business (including lending in foreign currency, access to the National Bank of the Kyrgyz Republic (NBKR) facilities, and wider range of sources of financing). By contrast, other financial institutions play a marginal role, and capital markets are very shallow, including government securities market.

1 Prepared by Dragana Ostojic.
2 Includes credit union, microcredit companies, microcredit agencies, microfinance companies, credit union, and special financial credit institutions.
3 The stock of government securities is 3 percent of GDP, of which banks hold 1.3 percent of GDP and institutional investors (social fund and deposit protection agency) hold 1.4 percent.
2. The supply of financial services is limited, while the economy remains heavily cash based. Banks offer a few financial instruments (loans/credit cards/leasing), while supply of hedging instruments is very rare. Savings mobilization is still low with deposits accounting for less than 20 percent of GDP. The majority of deposits are demand deposits (about 55 percent) and only 12 percent of total deposits are with maturity of over a year. There are 253 depositors per 1000 adults in the Kyrgyz Republic, as opposed to averages of 115 and 364 for LICs and LMICs, respectively. The average weighted maturity of bank loans is 28.9 months (23.8 and 33.6 months for loans in national and foreign currency, respectively), while for MFIs it is 17 months, which does not provide sufficient support for investment. While the share of cash in the broad money has declined over the past two years, it still remains relatively high at about 40 percent. The five largest banks hold more than half of all deposits and loans, while the ten smallest banks hold about 10 and 12 percent of deposits and loans, respectively.

4 There are a few SWAP transactions, but with short maturity and high interest rates.

5 Currently, the Deposit Protections Agency insures deposits of individuals up to 100,000 som (1.4 percent of GDP per capita), covering 96.5 percent of individual account holders.
3. **Financial inclusion indicators started to improve in 2012, but access to finance still varies across regions.** Credit expansion over the past three years, together with efforts to pay pensions and wages via banking institutions, resulted in an increase in the number of accounts. This included both deposit and credit accounts at banks and MFIs. Similar to the regional income disparity, credit is mostly concentrated in the larger cities (Bishkek, Oss, and Jalal-Abad), while the vast majority of depositors—87 percent—are from Bishkek. In addition, according to the enterprise survey, only a small number of firms—30 percent—use credit lines, and mostly for working capital. Only 8 percent of firms use bank loans for investment.

<table>
<thead>
<tr>
<th>Borrowers by Age and Gender</th>
<th>Percent of total borrowers/ by gender</th>
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<tbody>
<tr>
<td>Age</td>
<td>Female</td>
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<td>&lt;25</td>
<td>5</td>
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<tr>
<td>25-30</td>
<td>9</td>
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<td>31-40</td>
<td>22</td>
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<td>41-50</td>
<td>28</td>
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<td>51-60</td>
<td>27</td>
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<td>60&gt;</td>
<td>9</td>
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<tr>
<td>total</td>
<td>58</td>
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</table>

Source: Ishenim, credit bureau
Note: registry includes data for 23 banks, and 204 MFI.

4. **MFIs provide credit to a wide range of borrowers across the country.** MFIs provided credit to 402 out of 575,000\(^6\) registered borrowers at the credit bureau. Women are more likely to borrow from an MFI than from a bank. About 2/3 of all borrowers are between 30 and 60 years of age.

<table>
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<tr>
<th>Financial Inclusion Indicators</th>
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<tr>
<td>Key Indicators</td>
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<tr>
<td>2009</td>
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<tr>
<td>Accounts</td>
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<tr>
<td>Account at a formal financial institution (% age 15+) /1</td>
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<tr>
<td>Credit</td>
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<tr>
<td>Loan from a financial institution in the past year (% age 15+) /2</td>
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<tr>
<td>Loan from a financial institution in the past year, female (% age 15+) 3/</td>
</tr>
<tr>
<td>The number of women received loans at nonbank finance and credit institutions (person)</td>
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<tr>
<td>Branch Penetration</td>
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<td>Automated teller machines (ATMs) (per 1,000 sq km)</td>
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<tr>
<td>Automated teller machines (ATMs) (per 100,000 adults)</td>
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<tr>
<td>Commercial bank branches (per 1,000 sq km)</td>
</tr>
<tr>
<td>Commercial bank branches (per 100,000 adults)</td>
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</table>

Source: The NBKR data.

1/ Number of adults with age above 15 with an account at a bank includes an amount of deposit accounts of individuals at a bank plus an amount of credits of individual at a bank plus an amount of credits of individual at a non-bank financial institutions

2/ Number of individuals with age above 15 who received credit at a bank

3/ Number of women with age above 15 with received credit at a bank

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6 About 10 percent of population.
B. Credit and NPLs trends

5. **Credit growth started to moderate in 2015, but it remains robust.** Credit growth over the past five years was strong—increasing credit to GDP from 12.5 percent in 2010 to 20.8 percent in 2014. That was accompanied by strong deposit growth, which was financed mostly from internal sources and helped to keep leverage low. Credit growth as of end-September 2015 year-on-year was 27.0 percent. However, the major contributor to the credit growth in 2015 comes from the transition of an MFI to a bank (credit growth without this MFI is just 17.2 percent). Credit growth in real terms is 21 percent, and the constant exchange rate\(^7\) about 13.6 percent over the same period. Loans to agriculture, supported by a government subsidy scheme,\(^8\) along with loans to the trade sector, were the key drivers of this growth. The share of mortgages and construction loans in total loans declined relative to 2009 (Figure 1). The majority of loans to the trade and construction sectors, and for mortgages, are in foreign currency. Mortgages and loans to the trading and construction sectors account for 60 percent of all foreign exchange loans, while agriculture and trade account for 65 percent of all som loans.

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\(^7\) Som exchange rate from December 2013.

\(^8\) Affordable Loans for Farmers was introduced in 2013. The government provides subsidies for interest rates, so they are lower than market rates. The scheme is done via commercial banks, which can opt in or out.
6. **Credit from MFIs started to shrink in the second quarter of 2015.** In addition to one MFI becoming a bank, the main reason behind this was a reduction in the average size of MFI loans—US$100 on average—due to slowdown in the Kyrgyz economy. NPLs are still low, as MFIs mostly lend (about 80 percent) to groups, thus ensuring multiple warrants for their loans. MFIs mostly lend to agriculture (40 percent), consumers (19 percent), and the trade sector (17 percent).

<table>
<thead>
<tr>
<th>MFO Non-performing loans to total loans</th>
<th>3.9</th>
<th>4.6</th>
<th>3.4</th>
<th>4.3</th>
<th>2.8</th>
<th>3.4</th>
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<td>Source: The NBRK data.</td>
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7. **NPLs have been gradually increasing.** They remain low, but could be higher after allowing for restructuring and prolonging loans. With the recent exchange rate volatility and slowdown in the region, the share of restructured loans has increased to 5 percent. NPLs are somewhat higher in the trade, construction, and mortgage sectors. The highest incidence of loan restructuring is in the construction sector. NPLs are sensitive to exchange rate movements, reacting with a one-month lag.

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<tr>
<td>Industry</td>
<td>5.6</td>
<td>5.3</td>
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<td>8.5</td>
<td>8.6</td>
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<td>Agriculture</td>
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Source: Authorities data and IMF staff calculations.

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9 Average size of loan reduced from US$700–800 to US$600–700 for the largest MFI (in a process of obtaining banking license). For the second largest, the average size of loan declined from US$550–600 to US$450–500.

10 According to regulation restructured loan should be classified as substandard until regular payments are received for 180 days. However, that is not the practice as at the moment.
C. Dollarization trends

8. Dollarization has been declining since 2010, but the depreciation of the som over the past two years has started to reverse the trend. Dollarization of deposits fell below 50 percent in 2012, but increased sharply in 2014 and 2015. Even if dollarization is calculated at the constant exchange rate, deposit dollarization increased between 2014 and 2015, reflecting confidence effects of developments in Russia and Kazakhstan. The foreign currency loan-to-deposit ratio stabilized below 100 in June 2015, suggesting that dollar amounts of loans and deposits are similar. The limit on the net open foreign currency position is 15 percent of capital for a single currency, and 20 percent of capital in total. The foreign currency exposure for the banking system is negative as of end-July.

D. Key vulnerabilities in the financial sector

9. Given its structure and recent trends, key vulnerabilities in the Kyrgyz financial system are emerging from:

- **Exchange rate related risks and dollarization.** Even though foreign currency liabilities, upon which interest is paid, are similar to the foreign currency interest bearing assets, foreign liabilities...
may rise much faster than assets if the som depreciates due to developments in the region. In addition, a large depreciation may affect the ability of clients with unhedged banks to service loans, leading to a run on deposits. While unlikely to materialize, this would create a large currency mismatch for banks and diminish their capital. Stress tests conducted by the authorities at the end of August suggest that in the case of a 30 percent depreciation in the som, the capital position of the banking sector would weaken.

- **Concentration of lending in key industries, namely trade and agriculture.** Given that more than 50 percent of loans are concentrated in these industries and key bank clients may be connected, this may be a source of vulnerabilities for banks in the case of a further slowdown to the economy and exchange rate vulnerabilities. Large exposure are not yet an issue (the five largest exposures account for 56 percent of equity in the system and 80 percent for the five largest banks at end-July).

- **Credit risks mostly stem from currency-induced risks at the moment, but new ones may emerge.** Loans, including consumer loans (except credit card), are collateralized and 90 percent of collateral is made up from real estate. The value of collateral varies across banks and types of projects, but usually exceeds value of loans as the haircut of value of collateral is applied. Some banks revise collateral with the fall of real estate prices, and occasionally ask borrowers to pledge additional collateral or repay the loans. However, the value of collateral may become an issue in the case of a real estate market crash and in the case of a severe slowdown in the economy, collateral may become illiquid, meaning a shortage of buyers for real-estate. Given small market and connected businesses, illiquidity or bankruptcy on one client can quickly transmit to the other clients.

- **A liquidity ratio** of about 50 percent does not signal issues for concern, but maturity mismatches may give rise to new problems. Tight monetary policy to offset exchange rate and inflationary pressures may squeeze liquidity in banks too much. Liquidity stress test suggests that with an 18 percent deposit withdrawal, the liquidity ratio would fall by 2 percent for the largest banks.

- While there is no evidence of weakening lending standards, the strong pace of credit growth suggests it is likely. Increased incidence of restructuring and prolonging (revolving credits) may mask the extent of the problems manifested in the balance sheet of borrowers.

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11 While there is limited information on corporate and household balance sheets, anecdotal information suggests it takes a longer time to pay claims. The average time for accounts receivable has been extended from two weeks to two months.

12 Real estate market statistics are scarce. While some statistics suggest declines in real estate prices in Bishkek and Osh, it is difficult to assess the appropriate changes in prices.

13 Liquid assets over short-term liabilities.
• Cross-border contagion is not a source of problem at the moment, due to limited integration in the international financial system. The role of Kazakh banks diminished following the 2009 crises, and these banks barely do any lending. However, following the Kyrgyz Republic’s accession to the Eurasian Economic Union (EEU), new banks could come to the Kyrgyz market and expand access to markets of other members of the EEU, which could in turn increase risks of cross-border contagion. Moreover, a number of banks have corresponding accounts in Russian and Kazakh banks, so if those banks encounter difficulties, Kyrgyz banks may face liquidity problems.

10. **The pace of credit growth is not yet a concern.** The BIS based credit-to-GDP gap suggests that credit is only 2 percent above the long-term trend and within normal range. The macro-financial forecast consistency check suggests that credit growth forecasts and economic dynamics are consistent. Despite being strong, the pace of credit growth may rather signal financial deepening than just a pre-crisis expansion.

11. **Developing the financial sector will be critical for promoting growth, increasing financial inclusions, and providing a shock absorber.** To address the above mentioned vulnerabilities, it is important to:

• Maintain a stable macroeconomic environment and an appropriate policy mix that increases confidence in the banking system, including the NBRK, and lowers inflation. In this context, it is important to increase the traction of monetary policy and strengthen the interest rate channel. A symmetric and narrower corridor around the policy rate can help to increase its signaling power, while higher variety and volume of securities available for collateral can stimulate bank intermediation. In addition to measures aimed at strengthening the interbank market, it will be crucial to pass the draft banking code, which will help increase the autonomy of the NBKR, and consequently confidence in the banking system. Moreover, such measures would help attract additional bank deposits, and enable a healthy and balanced expansion of the sector. This would require the NBKR to balance the trade-off between exchange rate flexibility and the impact on the financial sector. In the event of exchange rates reaching the threshold for more serious
problems in the banking sector, the NBKR should offer additional liquidity and SWAPs to banks. Moreover, the NBKR will need to balance the trade-off between the impact of tight liquidity on the banking sector, while curtailing the demand for foreign currency.

- Implement market-driven and gradual de-dollarization policies aimed at building trust in the financial market. De-dollarization measures that have failed in the past in other countries include the forced conversion of foreign currency deposits and the suspension of access to foreign currency deposits. Therefore, such measures should be avoided. Similarly, forced conversion of loans is likely to create currency mismatches in banks, putting them in difficulty with servicing their loans, and distort market trends and interest rate structure, further impeding monetary policy transmission. Creating a market for local currency-denominated government securities—currently very shallow as parliament imposes a limit on these securities—would be an initial step. In addition, the securities market would help strengthen the transmission mechanisms and increase the effectiveness of monetary policy.

- Develop financial hedging instruments. The NBRK should work with banks to develop hedging instruments, including SWAPs to enable banks’ clients to protect themselves against risks. Given the limited availability of SWAPs, their short maturity and high cost, an intervention by the regulator is needed. Thus, while protecting itself from foreign currency risk, the NBKR should begin to serve as a market maker and match banks with opposite SWAP demands. Ahead of any such measures, an intensive campaign aimed at educating the market about hedging instruments and forward exchange rates may be needed.

- Strengthen the supervision of banks and regulations. In particular, rules on net open foreign exchange positions, classification of loans, provisioning, and restructuring should be carefully monitored and enforced. Moreover, continuing to strengthen banking sector supervision by developing a strategic plan to build supervisory capacity—and to provide for a robust supervisory program, including risk based supervision—will be crucial.

- Design a complete macroprudential tool kit that enables the NBRK to react promptly when required. Such a kit should build on existing macroprudential measures introduced for different provisioning and reserve requirements for foreign currency assets and liabilities, and debt-to-income (DTI) ratios for consumer lending in foreign currency. The kit could for example include: (i) provisions for prohibiting lending in foreign currency to unhedged borrowers or for a particular sector; (ii) include higher provisioning for loans to the most vulnerable sectors (like mortgages, trade and construction); (iii) loan-to-deposit ratio for foreign currency; and (iv) DTI for mortgages and consumer lending in domestic currency etc. In designing such rules, the stability of the financial sector should take priority over pursuing government strategies to develop certain sectors/services (like provide affordable housing and affordable lending for productions).

- Develop options for the NBRK to provide emergency loans in foreign currency to ensure that the DPA can pay out deposits on time and allow the government to become involved in times of systemic banking problems. A crises preparedness framework would ensure timely and
coordinated action, as would a communication plan in the case of such problems, which would help to contain consumer panic.
## Table 1. Financial System Structure

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<td>37.4</td>
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<td>Locally incorporated</td>
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<td>Credit-unions</td>
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<td><strong>Other financial institutions</strong></td>
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<td>Securities companies</td>
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<td>23.7</td>
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<td>2.4</td>
<td>3.6</td>
<td>3.6 na</td>
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<td>Broad money, percent of GDP</td>
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<td>25.8</td>
<td>28.4</td>
<td>31.4</td>
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<td>63.6</td>
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<td>Credit to private sector, percent of GDP</td>
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<td>17.5</td>
<td>16.9</td>
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<td>21.6</td>
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<td>of which:</td>
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<tr>
<td>Banks</td>
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<td>13.6</td>
<td>12.5</td>
<td>12.5</td>
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<td>13.8</td>
<td>16.1</td>
<td>20.7</td>
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<td>Non-bank credit institutions</td>
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<td>4.4</td>
<td>4.0</td>
<td>5.5</td>
<td>5.1</td>
<td>5.5</td>
<td>5.9</td>
<td>3.6</td>
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</table>

Source: Kyrgyz authorities.
Figure 1. Credit Trends and Structure by Sector

Sources: The NBKR data.

Sources: Authorities data.

Sources: NBKR and IMF staff calculations.

Sources: NBKR and IMF staff calculations.

Sources: Authorities data.
REAL FINANCIAL LINKAGES IN THE KYRGYZ REPUBLIC:

The financial sector in the Kyrgyz Republic has been in an expansionary phase since 2010, reflecting mostly the recovery from the 2008–09 global financial and 2010 domestic banking crises. The business cycle reached its peak in late 2013/early 2014 before the regional slowdown. The exchange rate appears to be a nexus between the real and financial sectors, and at the same time, a key source of vulnerabilities due to high dollarization. Addressing these vulnerabilities will require credible monetary and exchange rate policies aimed at the increasing confidence in the banking sector, as well as efforts aimed at deepening the domestic market.

A. Background

1. The still underdeveloped financial system and frequent structural brakes, distort the analyses of linkages between the financial and real sectors of the economy. The level of credit-to-GDP was very low prior to the 2010 political crises and, at 21 percent of GDP as of August 2015, remains relatively low despite the recent credit boom. The correlation between credit and GDP growth is positive, having exhibited increasing strength after 2010. However, due to the 2005 and 2010 political upheavals, and the 2009 global financial crisis, it is difficult to find a statistically meaningful relationship between the business and financial cycles. In addition, the high presence of the informal economy—estimated between 24 and 40 percent—further blurs the trends in the business cycle. A weak interest rate channel also hampers the analysis.

B. Trends in credit and business cycles

2. With data caveats in mind, the following trends in the credit and business cycle can be observed:

- The credit growth trend suggests that the financial cycle has been in an expansionary

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1 Prepared by Dragana Ostojic.
phase since 2010, reflecting mostly the recovery from the 2008–09 global financial and
2010 political/banking crises. Exchange rate volatility also affected the pace of growth of
foreign currency loans, which accounted for about half of the overall credit growth. Demand for
loans in foreign currency has significantly subsided with the recent sharp depreciation of the
som, mostly as a reaction to the devaluation of the tenge. As of September 2015, foreign
currency credit growth in dollar terms had fallen to below 1 percent, partly due to monetary
policy tightening (via an increase in the policy rate and foreign exchange rate interventions as a
sterilization tool). Also, macroprudential measures introduced in May 2015 may have also
contributed to the slowdown in the pace of credit growth. That said, September credit growth,
at 13 percent in the constant exchange rate, remains strong.

- The business cycle reached its peak in late 2013/early 2014, with nongold growth pace starting
to slow down during 2014 as a result of adverse developments in the region. However, the
strong credit growth of previous years, coupled with strong government investments, has
prevented the nongold growth from contracting.

- The exchange rate appears to explain the nexus between the real and financial sectors. Given the
high dollarization of the banking sector, the exchange rate movements strongly affect the
demand for credits. In addition, the trade and construction sectors, both key drivers of the
economy, are sensitive to exchange rate movements. Given the sharp depreciation of the som,
NPLs have increased from 4.5 percent of total loans at the end of 2014 to 6.0 percent at
end-September 2015. In addition, the share of restructured loans at end-August
reached 5 percent, as opposed to 2.2
percent at the end of 2014, when the
share of prolonged loans stayed at
around 3 percent of total loans. This
explains why NPLs remain relatively low.
The authorities’ stress test in August
suggested that a 30 percent exchange
rate depreciation would weaken the
capital position of the banking sector.

- The link between credit and growth in the
individual sectors of the economy is more pronounced than the link between overall credit and
growth (Figure 1). In particular:
  (i) agriculture growth in 2015 has been strong, reaching 5.3 percent at end-August, partly due to

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2 The micro-finance institution FINCA obtained a license in March 2015, otherwise the peak would have happened in late 2014.
3 Approximated by the nongold growth trends.
a government subsidized lending program (credit to agriculture contributed, on average, about 9.5 percent to overall credit growth); (ii) trade sector growth has started to slow from 8.6 percent in 2014 to 4.5 percent (year-on-year) on average in 2015, while loans to trade started to slow at the same pace; and (iii) construction sector growth has shown signs of a slowdown in the first half of the year. Although intensive public investment kept construction growth at 8 percent, the majority of banks stopped or significantly downsized mortgage lending, in addition to cutting lending to construction.

C. What needs to be taken into account when analyzing real-financial linkages?

While gold and remittances are important for the Kyrgyz economy, their relevance to the financial sector is less so. Given limited sovereign-banking linkages and monetary policy traction, changes in financial sector policy have a limited effect.

3. Key factors to be considered in real financial linkages in the Kyrgyz Republic include:

- **Remittances.** Given their high share in the economy, a decline in remittances can significantly affect the real sector. A decrease in demand can result in a drop in growth prospects (while, conversely, a rise in demand will boost growth prospects). A remittance decline would decrease disposable income, and may indirectly affect the ability of clients to service their loans. In particular, remittances are important factors for servicing Microfinance Institution (MFIs) loans. While there is no evidence of problems in MFIs, their balance sheets may deteriorate if the slowdown in Russia, a key source of remittances, continues for a longer period. However, the majority of MFIs have stopped counting remittances as a source of income when providing loans. According to anecdotal information, remittances are commonly used for the purchase of real estate and their slowdown, therefore, decreased demand for property, as well as growth in the construction sector.

- **Gold.** While relevant for the economy as a source of budget and export revenues, gold does not have the same importance for other industries or the financial sector. Gold production has relatively few connected industries (even transportation is handled “in-house”). The whole output is exported, while the majority of investment and maintenance is mostly done via importing goods. Kumtor, an open-pit gold mine in the country’s north-east corner, has only recently started purchasing materials from the domestic market. However, the company’s financial flows are more relevant for the banking system than they are as a source of deposits and demand for loans from Kumtor employees.

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4 With remittances accounting for 30 percent of GDP, the Kyrgyz Republic’s economy is one of the most remittance-dependent economies in the world.
KYRGYZ REPUBLIC

- **Weak sovereign banking linkages.** Fiscal slippages and increases in public debt have an indirect impact on the financial sector through negative spillovers on overall macroeconomic stability. The stock of T-bills and T-bonds to GDP is about 3 percent, while banks' gold constitutes about 1.3 percent of GDP. The scope for a sudden increase in domestic debt is limited due to a parliamentary-imposed ceiling. Thus, the risk of crowding out private sector credit is minimal, as is the risk of a spike in interest rates. However, fiscal slippages may destabilize the economy through inflationary pressures, weakening demand for credit.

- **Limited traction of monetary policy.** The policy rate is mostly impacting the interbank interest rate, with only marginal effects on deposits and lending rates. Due to weak interest rate channels, monetary policy is currently focused on controlling liquidity (for example, tightening the stance via decreasing the amount of som offered). This could, however, lead to a decrease in demand for the som.

D. **Going forward: linkages between real and financial sector?**

4. **Medium-term growth projections forecast the strong credit growth of previous years to partly offset the negative spillovers from the region.** Nongold growth is expected to moderate to 3 percent in 2015, and gradually pick up thereafter. While 2015 credit growth is expected to slow down relative to 2013–14 trends, it is expected to remain relatively strong in the period ahead. This is justified by: (i) an additional MFI in the process of obtaining a banking license; (ii) a new bank in the process of registration; and (iii) the onset of Russian-Kyrgyz Development Fund operations, which will be done via banks. These trends indicate that there is still demand for credit. However, in the case of the credit crunch during the next year, growth may slow slightly, especially in the trade and construction sectors. But strong government investments are another source of impetus for the economy, which can offset negative spillovers from the financial sector to the real sector.

5. **Adverse risk from the slowing economy would mainly affect the financial sector via increasing exchange rate and concentration risks.** As discussed, the authorities’ stress test results suggest a 30 percent depreciation would weaken the capital position of the banking sector. Moreover, given that the economy is not diversified and that the majority of lending is concentrated in a few industries, a risk of contagion between banks’ clients could be likely. While large exposures are not yet an issue (the five largest exposures account for 56 percent of equity for the system and 80 percent for the five largest banks).

6. **Spillovers from the financial sector to the economy are still limited, given the relatively small financial sector and high presence of cash in the financial system.** In general, negative spillovers from the financial sector could result in higher volatility for both the exchange rate and inflation, hampering growth prospects. Problems in the financial sector would most likely result in a withdrawal of some deposits from banks and further increase dollarization, causing
negative effects on credit growth. As a result, exchange rate pressures may rise, leading to inflationary pressures. Consequently, this would slow down the payment system and settlement of transactions between businesses. However unlikely it might be, a combination of all of these factors would hamper growth prospects.

E. What can be done from the policy side?

A stable macroeconomic environment with credible monetary and exchange rate policies is a precondition for addressing key vulnerabilities in the financial sector. They should be supplemented with macroprudential policy kits and efforts to deepen the domestic financial market.

7. To address risks stemming from exchange rate volatility, it is important to pursue a balanced set of monetary, exchange rate, and de-dollarization policies. The recent IMF working paper and examples from other countries suggest that credible monetary and exchange rate frameworks, low inflation, and deep domestic financial markets are essential for the success of any de-dollarization policy. While the NBKR has successfully established a credible monetary framework, it should continue to increase its traction and pursue a flexible exchange rate policy. Such policies, together with a prudent fiscal policy, will create the foundations for a stable macroeconomic environment. Also, the NBKR’s macroprudential policies—aimed at making assets and liabilities in dollars more expensive than som assets and liabilities—are another step in the right direction. Measures to limit foreign currency lending to unhedged borrowers or a loan-to-deposit ratio for foreign exchange rate loans should be introduced when required. Strong banking supervision is needed to ensure that banking risks are properly monitored, so increasing the supervisory capacity and moving toward a risk-based supervision model is required.

8. In developing new de-dollarization policies, it is important to encourage market-based solutions as opposed to forced de-dollarization. De-dollarization measures that have failed in the past include the forced conversion of foreign currency deposits and the suspension of access to foreign currency deposits. Therefore, such measures should be avoided.

9. Developing a market for domestic securities would be a first step toward deepening domestic financial markets, and should be done in consultation with the Ministry of Finance and the NBKR. A deeper market for government securities would enable banks to increase intermediation between themselves, as it would create a higher volume of securities for collateral. In this context, the NBKR should allow its notes to be used as collateral for transaction purposes at the interbank market level. Moreover, hedging instruments and markets should be developed to enable clients to protect themselves against risks, particularly exchange rate risks.

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5 Pass through from the exchange rate depreciation to inflation is estimated at 0.27.

10. Limiting concentration risks will require a mix of macroprudential measures in the short term and, in the medium term, macro-structural reforms for diversifying the wider economy. Macroprudential measures could involve debt-to-income ratio and increased provisioning loans to the most vulnerable sectors—mortgage, construction, and trade. While a diversified economy requires a complex set of policies, a combination of quality infrastructure, a stable and conducive business environment, and strong governance would be a good start.
Figure 1. Credit Trends and Structure by Sector

Contribution to the Credit Growth by Sector
(In percent)

Sources: NBKR and IMF staff calculations.

Contribution to the Credit Growth by Currency
(In percent)

Sources: NBKR and IMF staff calculations.

Loans by Sector
(June 2009)

Sources: Authorities data.

Loans by Sector
(June 2015)

Sources: Authorities data.
IMPACT OF WORKER’S REMITTANCES ON KYRGYZ ECONOMIC GROWTH

A. Stylized facts

1. Worker’s remittances have represented by far the most important financing flow in the balance of payments of the Kyrgyz Republic in recent years but they remain quite volatile. Representing on average about 29 percent of GDP over the past five years they have covered a wide part of the large trade and service balance deficit. However, since they are almost entirely originating from Russia and widely denominated in rubles, they are quite sensible to Russian economic development. In particular, the marked slowdown that Russia experienced since the end 2013 has resulted in a significant drop in remittances inflows since the beginning of 2015.

2. The significant decline in remittances inflows since the beginning of the year seems to be essentially due to the large ruble depreciation, the volume of transfers remaining broadly constant. Indeed, while about 25 percent of remittances originating from Russia are denominated in dollars, the rest is denominated in rubles which have depreciated by about 42 percent since the end 2013. In 2014, the evolution of the ruble has been widely compensated by an increase in the volume of remittance leading to only a marginal decrease of their inflows of about 2 percent. The relative resilience of remittances inflows can probably be explained by the sectoral repartition of Kyrgyz workers in Russia. Indeed most of them work in the sector of trade and services which have been comparatively less affected by the economic slowdown than sectors such as construction which employs a more marginal part of Kyrgyz workers. However since expatriate workers cannot indefinitely compensate for the ruble depreciation, the drop in remittance appears much more marked since the beginning of the year: they have declined by 28 percent by the end of September on a year-on-year basis.

Sources: Authorities data and IMF staff calculations.

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1 Prepared by Veronique Salins.
2 About 97 percent of remittances inflows in the Kyrgyz Republic come from the Russian Federation.
3. The magnitude of remittances coming from Russia makes the evolution of the som highly correlated with the evolution of the ruble but the som recent depreciation has been much less pronounced than the ruble one. The coefficient of correlation between the evolutions of the two currencies vis-à-vis the dollar reached 90 percent over the past 10 years. In this context, the Kyrgyz Republic nominal effective exchange rate has decreased since the end of 2013 (by 5.6 percent by the end of July 2015) albeit in a significantly lesser extent than the Russian one which declined by about 30 percent over the same period. The Kyrgyz Republic real effective exchange rate, on the other hand, has remained more stable since the end of 2013 reflecting only a depreciation of 1.5 percent (versus 18 percent for the ruble). This recent appreciation in real term of the som vis-à-vis the ruble could harm the country competitiveness at a time when the country just joined the Eurasian Custom union.

4. In view of the magnitude of the remittances inflows and their volatility, the long-run impact of remittances on the domestic economy warrants investigation. On the one hand, remittances are expected to alleviate poverty, smooth consumption and allegedly reduce the financial constraints for underserved segments of the population and such favoring small-scale investments projects. On the other hand, beyond being volatile and rather unpredictable, remittances can support excessive private demand during an extended period of time distorting prices and preventing an efficient allocation of labor, undermining the country’s competitiveness and its potential growth.

B. Macroeconomic impact of remittances: some hints from the literature

5. The literature on the macroeconomic impact of remittances is well furnished but remains an open field. In particular, their effects on long term growth remain controversial. On the one hand, remittances may enhance investment in physical capital thus increasing economic growth. The effect is expected to be all the more so big face significant financial constraints that the remittances may ease. Moreover, remittances can also facilitate human capital formation either through higher spending in education or, more indirectly, through improved nutrition and shelter. However, the effects on growth will crucially depend on the economic conditions that prevail in the country and in particular in the share of remittances which will be actually invested rather than consumed. And on the other hand, remittances can, independently on these specific circumstances, have negative effects on growth through a Dutch disease effect. Indeed remittance inflows can
generate an appreciation of the real exchange rate that could harm the tradable good sector and the country competitiveness.

6. **Empirical findings show little evidence of a long term impact of remittances on growth but support the idea that remittances tend to reduce output volatility.** Most cross country and panel analysis find no or at best a mild impact of remittances inflows on growth, conditioned on the degree of financial development and the improvement of business environment. Guilanao and Ruiz-Arranz (2009) for instance, argue, using a panel of about 100 developing countries, that remittances boost investment and long term growth in economies with underdeveloped financial sectors by helping local entrepreneurs circumvent collateral constraint due to inefficient credit market. This result is somewhat confirmed by Chami et al (2008) whose results albeit not supporting any positive impact of remittances on growth highlight the negative interaction between remittances and financial deepening on growth. Controlling for a various set of institutional variables, Catrinescu and others (2006) using both cross-sectional and panel regressions, find a significant, albeit mild, positive relationship between remittances inflows and GDP growth. The impact of remittances on output volatility appears to be more conclusive. Both cross section analysis (see for instance IMF 2005 or Chami et al 2008) and panel regressions (World Bank 2006) find a negative correlation between output volatility and remittances inflows. This result can be explained the desire among migrants to compensate their relative for negative impact of economic fluctuation in the home country enabling the recipient households to smooth consumption. As mentioned in Chami et al (2008), this result could also comes from smoother investment if the remittances flow through the financial system making it easier for them to borrow and hence easier to smooth their investment expenditures.

7. **The literature provides a broader evidence of the impact of remittances inflows on the equilibrium real exchange rate.** The conventional view that higher remittance receipts is associated with an appreciation of the real exchange rate has been confirmed by Bourdet and Falck (2003) for Cape Verde over the period 1980–2000, by Hyder and Mahbood (2005) for Pakistan over 1978–2005 or by Saadi-Sedik and Petri (2006) for Jordan over 1964–2005. Amuedo-Dorantes and Pozo (2004) found similar results using a panel of 13 Latin American and Caribbean countries over 1978–98. So, if the literature is far from having studied all single country cases, most of the research to date seems to confirm that higher remittances tend to appreciate the real exchange rate. So if this appreciation indeed implies Dutch disease effects, harming the competitiveness of the tradable sector, large remittances inflows could have negative effects on the long term growth. Thus if remittances are not sufficiently oriented toward investment their beneficial short run effects on the recipient country welfare through higher and more stable consumption and poverty reduction could come at the expense of long-term growth.

C. **Macroeconomic impact of remittances: an empirical analysis**

8. **We use a VAR model for our analysis of Kyrgyz’s remittances.** We estimate an unrestricted vector autoregression (VAR) in which real GDP, remittances inflows and the real effective exchange rate evolve jointly and endogenously of the form:
\[ Y_t = \beta_0 + \beta_1 Y_{t-1} + \beta_2 Y_{t-2} + \epsilon_t \]
\[ \epsilon_t \sim iid(0, \sigma) \]

Where \( Y_t = \text{[Real GDP growth; Remittance inflow growth in dollar; Real effective exchange rate growth]} \) and all growth rate are month over month of the preceding year. The data span covers the period 2006M03 to 2015M06. Lags criterion criteria being rather inconclusive, we choose to have 2 lags included, striking balance between higher complexity and better fit of the model.\(^3\) Our results are displayed in Table 1.

<table>
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<th>Kyrgyz Republic – VAR model</th>
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<td>L2.REER</td>
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<td>L1.Remit. Inflows</td>
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<tr>
<td>Sample</td>
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* \( p < 0.1; \) ** \( p < 0.05; \) *** \( p < 0.01 \)

Source: IMF staff calculations.

9. **Our results appear to be in line with the literature on the macroeconomic impact of remittances.** In column (1), it is worth noting that as various empirical studies we do not find any evidence of a positive impact of remittances on growth suggesting that these flows are probably not enough oriented toward investment. However, in column (2) our results highlight a positive and very significant impact of remittances inflows on appreciation of the real effective exchange rate in

\(^3\) However, it is worth noting that we obtain similar results using alternatively one lag or three.
Kyrgyz Republic supporting the idea the higher flows of remittances receipt could generate Dutch disease effects. A careful analysis of the impact of remittances on tradable industries in the manufacturing sector would however be necessary to confirm these preliminary findings.

D. Policy implications and recommendations

10. **The results of our empirical analysis suggest that a higher mobilization of remittances flows toward investment would be growth enhancing.** One way that governments can use public expenditures to enhance remittances’ growth impact is to improve public infrastructure, both physical infrastructure and public institutions. This recommendation echoes the migration and development literature which finds that poor physical infrastructure and poor governance discourage private investment. And because they typically support household incomes the receipts of remittances exacerbate the negative impact of poor infrastructure. The more remittances a country receives, the higher the quality of the country’s public investment must be in order to induce a given amount of investment from individuals. According to the last World Economic Forum’s Global competitiveness report government instability, corruption, policy instability and inefficiency government bureaucracy are majors impediments for doing business in the Kyrgyz Republic. Working on these institutional weaknesses would help orienting remittances toward private investment. Moreover the same report notes that the Kyrgyz Republic tends to lag behind other CIS countries in terms of infrastructure: in this context the launch of the large PIP program, if well implemented, appears welcome.

11. **With regard to tax policy, empirical studies suggest that a shift toward consumption based taxation may provide the correct incentive to increase private savings and investments.** On the other hand, it is not recommended to tax directly remittances that could cause a decline of remittances activity and induce a migration of the flow from formal to informal channel (Chami et al 2008). If the Kyrgyz Republic already taxes consumption through VAT, increasing its coverage through the reduction of the informal economy would help create savings incentives. According to Abdih and Medina (2013), the informal economy represented about 26 percent of the Kyrgyz GDP in 2008 and was mainly driven by the regulatory burden in financial and products markets. In this context, it would be beneficial to increase the availability and affordability of financial services while rising local competition and reducing regulations burdensome in doing business.

12. **In particular, increasing the formality of transfers is important for leveraging remittances. It can make the process more easily monitored potentially make access to finance more effective.** Ultimately the securitization of remittances inflows could be considered: it

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4 These regulatory burden can be defined as burdensome regulations in the product markets, in the form of procedures for starting business, registering property and dealing with construction permits, as well as difficulties in the credit market (such as availability and affordability of financial services). On the other hand, any legislation aiming at increasing local competition, and reducing monopolies and the extent of market dominance would contribute to reduce the size of the informal economy.
would be an efficient way to combine relatively small amounts of personal savings into larger flow of capital to finance public investment. Such diaspora bonds have already been used to finance public investment in several countries such as India, Israel, Sri Lanka, Ethiopia, or Zimbabwe. Moreover, improving statistics on remitters will help in the analysis and policy making decision process.

13. Finally, governments can mitigate the effects of the real exchange rate appreciation linked to large remittances inflows by implementing reforms that favor the manufacturing sector competitiveness. Increased spending in education, reforms to make the labor market more flexible for instance should improve labor productivity and enhance external competitiveness. The last World Economic Forum global competitiveness report points in particular an inadequately educated workforce as a significant impediment of doing business in the Kyrgyz Republic.
References


IMPACT OF THE ACCESSION TO THE EURASIAN ECONOMIC UNION

Following its accession to the Eurasian Economic Union (EEU), the Kyrgyz Republic could benefit from deeper integration across a broad range of areas, including an enhanced access to EEU markets, higher customs revenue, and more secure access to the Russian labor market. Given the current Kyrgyz trade structure, however, the initiatives pose a risk to divert trade and weaken the economic prospects, and the authorities have sought to mitigate trade diversion and adverse impacts. Reaping the full benefits of the EEU strengthens the case for upgrading technical standards and improving macroeconomic policies and undertaking structural reforms, so that the Kyrgyz economy can become more competitive not only within the EEU but also vis-à-vis non-EEU countries.

A. Background

1. In August 2015 the Kyrgyz Republic officially became a member of the Eurasian Economic Union (EEU), which comprises Russia, Kazakhstan, Belarus, and Armenia. The EEU is a customs union and “single economic space” that calls for free movement of goods, services, capital, and people within its borders. With a total GDP of nearly US$2.5 trillion in 2014, and more than 170 million people, EEU membership provides an opportunity for the Kyrgyz Republic to expand its exports and deepen integration, particularly with Russia.

2. The EEU can bring multiple benefits through a deeper integration across a broad range of areas. Greater diversification and larger markets would increase domestic competition, facilitate innovation, and contribute to building cross-border production chains. These, in turn, would increase exports outside the region and enhance job opportunities. The Kyrgyz Republic is a member of the Free Trade Agreement of Common Independent States (CIS FTA), however, the EEU membership is expected to eliminate the need for customs declarations and inspections, thus reducing nontariff barriers and delays. Strengthened financial linkages would provide better opportunities for consumption smoothing (trade finance) and efficient capital allocation (foreign direct investment). With a substantial number of migrants from the region seeking employment in the better-off economies, economic cooperation and integration could contribute to the reduction or removal of informal and institutional barriers to labor migration. Also economic cooperation could reinforce economic reforms towards greater unification of standards and political commitment to anti-corruption and good governance. In addition, the EEU membership can bring the Kyrgyz Republic financial assistance from the Eurasian Fund for Stabilization and Development for dealing with external shocks and implementing large investment projects. Although little progress has been made for integrating the financial sector and exchange rate policies, a single

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\[1\] Prepared by SeokHyun Yoon.
financial market is the ultimate goal, with mutual recognition of banking licenses as an early step and joint financial supervision targeted by 2025.

B. Fiscal impact

3. The government would benefit from higher customs revenue. The Kyrgyz Republic has secured 1.9 percent of the EEU common customs pool, which is expected to result in an increase in customs revenue annually (1.5 percentage points of GDP for 2016, according to the authorities’ estimates). In addition, the country would receive a small increase in tariff revenues (0.1 percent of GDP), since non-EEU common external tariffs (CET) are higher than the current preferential tariff (US$0.2 per kg of imported goods) between the Kyrgyz Republic and China, which accounted for 55 percent of Kyrgyz imports in 2014.

4. The customs revenue structure is not expected to change. Joining the EEU is not expected to cause a significant change in tariff revenue from these countries, since goods traded among these countries are either not taxed at the border or are taxed at very low rates as a result of agreements among CIS countries. Under the current tariff regime, about 80 percent of the customs revenue is generated from imports from the rest of the world.

5. The positive effects on customs revenue would be partially offset by a VAT revenue loss because of a likely increase in administrative costs of revenue collection. Following accession to the EEU, collection of VAT and excises on EEU imports should be done on the basis of declaration of taxpayers rather than payments collected at border crossings. Therefore, the government shifted the responsibility of VAT and excise collections for imported goods from customs services to the state tax services. However, the Kyrgyz importers include many small traders, most of whom are unlikely to be registered VAT payers. This might result in loosing VAT or excise tax collection on EEU imports. The authorities estimate this revenue loss from small traders at approximately som 1 billion annually, which is about 2.5 percent of total VAT and excise collections.

In addition, the accession to the EEU comes with the abolition of simplified customs procedures whereby several neighboring countries, including China, had their customs duties calculated based on the volume of trade rather than value. As a result, a potential under-reporting of the value of imports, if significant, could negatively affect revenues.

\[2\] IMF, Fiscal Affairs Department (2015), "Impact of Accession to the Eurasian Economic Union".

\[3\] Ibid.
C. External trade impact

6. The transition from the current customs regime to the EEU would generally impose higher costs on Kyrgyz importers, which would, in turn, negatively affect exports. The weighted average EEU CET rate is higher (10.4 percent) than the current Kyrgyz weighted average tariff rate (5.1 percent). Both exports and imports are expected to decelerate as the transit trade declines due to higher external tariffs. An average 5 percentage points increase in import duties in excess of Kyrgyz WTO commitments may result in worsening terms of trade, estimated in the range of US$100 to US$300 million annually (1.5 to 4.5 percent of GDP). Export price competitiveness would be negatively affected as well. For instance, the higher CET would increase production costs of garments and textiles in the country, which employ 150,000 people and account for more than 15 percent of total exports, by 4 to 8 percent. \(^5\)

7. However, a gradual reduction in the EEU CET rates over the medium and longer term would mitigate such negative impact. The EEU CET rate schedule will decline over the medium term, reducing risks of trade diversion. With Russia’s accession to WTO, the average weighted tariff of the EEU CET rate would go down to 7.8 percent by 2017. Following its accession to WTO in June 2015, Kazakhstan is committed for lowering its tariff to an average of 6.1 percent, which would, in turn, require adequate downward adjustment to the EEU’s CET. Meanwhile, Kazakhstan’s WTO Accession is adding to challenges: the Kazakhstani government has recently requested the Eurasian Economic Commission (EEC) for CET exemptions of more than 3,000 goods to meet their WTO

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\(^4\) Eurasian Development Bank Yearbook (2012), “Assessing the Economic Effect of Kyrgyzstan’s Accession to the Customs Union.”

\(^5\) World Bank (2015), Competitiveness of the Kyrgyz economy in the wake of accession to the Eurasian Customs Union: Select issues and opportunities.

\(^6\) The adjustment to CET is calculated as an average of the tariff rates of the member states on the basis of their share of the total EEU market.
accession commitments. If the EEC accepts the request from Kazakhstan, the Kyrgyz Republic is expected to receive similar treatments.

8. **By contrast, the benefits of removing non-tariff barriers in the EEU will take time to materialize.** The EEU, which envisages free trade within the region, has made it more difficult for individual members to introduce unilateral nontariff measures for the regional trade. However, these benefits may be slow to materialize, given the lack of physical infrastructure and institutional capacity in member states. According to the 2015 World Bank Doing Business Report, the Kyrgyz Republic is ranked near the bottom globally with regard to trade across borders (183 out of 189 countries). This reflects exceedingly high intra-regional trade costs resulting from the geographic disadvantages, but also from cumbersome procedures and red tape in the processing of import and export documents. Meanwhile, uniform minimum health, safety, and quality standards on the intra-EEU trade are likely to restrict trades by increasing the cost and delays of obtaining certifications.

D. **Other impact**

9. **The higher CET will negatively affect the local industry.** Re-exports would be affected on account of an increase in input costs. As the re-export sector employs over 20 percent of the working population, the drop in re-exports is likely to have far-reaching repercussions throughout the economy. Also the high CET implies a rise of the consumer price inflation, because of a substantial import share of consumer goods.

10. **The permanent opening of the Kazakh-Kyrgyz border would avert economic shocks.** Temporary closure of this border in the past has resulted in a disruption of economic activity. In April 2010, The Kazakh border was unilaterally closed, which resulted according to the authorities, to a decline in exports of about US$0.4 billion (or 5 percent of the 2010 GDP), notably affecting the agricultural, clothing, and construction material industries.

11. **The sanctions and counter-sanctions between Russia and some other countries have presented an opportunity for the Kyrgyz agriculture sector.** As a result, Kyrgyz exports of fruits

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7 Ministry of Economic Regulation (2012), “Economic Consequences of the Customs Union for the Kyrgyz Republic” as an USAID Regional Trade Liberalization and Customs Project.

8 Earlier this year, this border was also closed. As a result, hundreds of trucks transporting fuel to, and from, Kazakhstan and Russia were blocked at the Kyrgyz/Kazakh for several weeks. Reportedly, it made a significant disruption in economic activities.
and vegetables, dairy, and meats substantially increased. The EEU membership would give the Kyrgyz Republic much easier access to the Russian market than imports from other different regions.

12. **The Kyrgyz labor is expected to have a more secure access to the Russian market.** There are currently about one million Kyrgyz migrants in Russia, but only half of them have work permits. The EEU membership has simplified employment procedures, abolished mandatory quotas to the labor market, and improved social conditions for migrant workers and their families except for pension and health insurance. As a result, Kyrgyz labor migrants will no longer have to obtain work permits and do medical exams and language tests prior to seeking a job in any EEU member state. Since the country joined the EEU, the monthly flow of the Kyrgyz migrant workers to Russia has reportedly increased by about 20 percent (to 44 thousand people from 36 thousand people).

E. **Authorities’ efforts to maximize the economic impact of the EEU**

13. **Ensuring macroeconomic stability is key to maximizing the positive effect of the EEU.** While deeper economic and financial cooperation can yield substantial benefits, it also poses macroeconomic challenges and vulnerabilities. Limited trade diversification of exports and imports make the country particularly susceptible to sudden external shocks. Also an asymmetry in the economic size of the member states makes it more difficult for member countries to reap the full benefits of the customs union and enhanced economic integration. Kazakhstan’s GDP is about one-tenth of Russia’s, and the Kyrgyz Republic’s GDP is one-thirtieth of Kazakhstan’s. As a result, the Kyrgyz republic will be prone to more shocks, and sudden changes in the direction of capital flows may induce boom-bust cycles. In particular, exchange rate policy may become more challenging as integration with the EEU advances, particularly if more transactions are settled in rubles. Strengthening and modernizing macroeconomic frameworks and prudential regimes in tandem with increased openness and integration is important.

14. **The Kyrgyz authorities have been identifying measures to mitigate short-term negative effects.** During the accession negotiation, the government has secured transition periods to the EEU CET rates up to 2019 for about 1,500 products (including food products, cars, and machinery) out of about 6,400 commodities, for which the Kyrgyz’s current tariffs are lower. Also the government has been modernizing the existing test laboratories to meet the EEU sanitary and veterinary requirements. In connection with EEU membership, the Kyrgyz Republic has obtained a Russian grant of US$200 million to help it meet the EEU requirement of customs and border controls.

15. **The US$1 billion Russia-Kyrgyz Development Fund (RKDF) is expected to mitigate the short-term negative impact of the EEU accession by contributing to growth.** The priorities of the fund include infrastructure investment for the implementation of technical regulatory compliance in the agribusiness, garments and textile, and services sectors. The success of the fund will hinge on ensuring that it operates under a transparent and accountable governance framework in line with the international best practices. Also, clear delineation between the fund’s activities and public finances will be critical.