

INTERNATIONAL MONETARY FUND ASSESSMENT LETTER

The Kyrgyz Republic—Assessment Letter for the Asian Development Bank September 18, 2017

This note provides IMF staff's assessment of the Kyrgyz Republic's macroeconomic developments and prospects as background for the Board of the Asian Development Bank. This assessment updates the macroeconomic situation presented in the Staff Report of the Third Review under the Extended Credit Facility, and is based on the most recent information obtained in a staff visit during September 7–13.

Recent Developments and Outlook

The economy is gradually recovering from the external shocks it endured starting in 2014 due mainly to the effect of low oil prices on its main trading partners. Counter-cyclical fiscal and monetary measures and a relatively flexible exchange rate helped mitigate some of the impact of the external shocks, but they left a legacy of financial and debt vulnerabilities. The recovery currently underway is helped by a rise in remittances, and a good gold production and trade performance. In 2017, non-gold growth is expected to recover to 3.8 percent. Inflation remains subdued but is expected to gradually rise to 4.8 percent at end-2017 as food prices normalize. Barring substantial structural reforms, however, medium-term growth is expected to remain modest, reflecting gaps in skills, infrastructure, and institutions that are constraining productivity growth.

Imbalances are building up in the fiscal sector, despite the relief provided by recent exchange rate appreciation. Meeting the 3 percent of GDP fiscal deficit target under the authorities' program for 2017, and the further decline to below 2 percent of GDP in the medium term, will be challenging owing to spending pressures (see below). Rising spending, coming on top of the large public investment program (PIP), planned to be the equivalent of 25 percent of GDP in 2014–18¹, will drive the current account deficit to around 12 percent of GDP during 2017–18. Public debt levels reached around 65 percent of GDP in early 2016, approaching the high risk of debt distress. Although subsequent exchange rate appreciation

as well as the rephasing of some PIP projects helped bring debt back to moderate risk of debt distress (58 percent of GDP as of end-2016), this episode highlights fiscal vulnerabilities and the risk posed exchange rate volatility.

The financial sector, although well capitalized, remains vulnerable, due to weak profitability, dollarization, a relatively high level of non-performing loans, and concentration of correspondent banking relationships. After a year of negative credit growth reflecting weak economic recovery and competition from the Russia-Kyrgyz Development Fund, banking sector credit recovered in early 2017, posting a 12.7 percent

¹ Financing mainly comes from external creditors, especially China, and is largely provided on concessional terms.

(yoy) growth by June. However, profitability remains weak due to the legacy of the shocks, modest demand, and competition from the RKDF. NPLs including prolonged loans remain relatively elevated at 13 percent as of June 2017 due mainly to the impact of the recent crisis on the private sector and high level of dollarization. Growing reliance on the Russian and Kazakh banks for U.S. dollar transactions after the withdrawal of the correspondent banking relationships by U.S. banks in 2016 creates additional concentration and country risks, putting further pressure on the activity and profitability of the Kyrgyz banks.

Macroeconomic Policies

Consolidation efforts initiated in 2016 are undermined by spending pressures in the run up to the October presidential elections. A number of policy slippages occurred since the beginning of the year, which if not reversed could undermine the fiscal position, including: (i) the adoption of a universal child allowance; (ii) ad-hoc measures to increase pensions and wages for certain categories of public sector employees; (iii) VAT exemptions on flour and for private schools, interest rate subsidy for export producers, and a tax holiday for capital investment in remote areas; and (iv) one-off expenditure measures in 2017 including disaster relief, housing for police, and road building. The combined annualized fiscal cost of these measures could exceed 3 percent of GDP.

Monetary policy has been prudent, and the exchange rate is allowed to float and serve as shock absorber. With inflationary pressures subdued, the National Bank of the Kyrgyz Republic (NBKR) reduced the policy rate by 5 percentage points over the course of 2017 to 5 percent, but the weak monetary transmission mechanism limited the impact of the policy easing on commercial bank activities and the real economy. The NBKR is working on adopting an inflation-targeting framework over the medium term.

The NBKR succeeded in containing banking sector risks, through a combination of macro-prudential measures and robust supervision. The minimum capital was raised to 500 million soms in July 2017, reinforcing the capital buffers held by banks. The NBKR is refining regulations on asset classification, to bring more clarity to the classification of restructured loans. Transition to risk-based supervision, as well as the operationalization of the crisis preparedness framework, are underway. However, the recent announcement of the

NBKR's intention to assume an equity position in a commercial bank yet to be established raises concerns over conflict of interests and integrity of the NBKR as supervisor and regulator.

Progress on reforms has been mixed, and structural issues remain an impediment for more sustained and inclusive growth. The authorities are currently working on the next national strategy for sustainable development, with a focus on human development. To achieve this goal, significant efforts are needed to improve the business climate, to upgrade the health and education sectors, and to enhance governance. Reforms are being carried out in the financial sector to modernize the banking legislation and to strengthen the NBKR's supervisory capacity and its authority in the resolution process. Public financial management

(PFM) reforms are ongoing though at a slow pace. The draft AML/CFT law, which benefited from extensive Fund technical assistance, was sent to Parliament in June 2016 but has not been acted on. In the meantime, amendments, which substantively weaken the public procurement law are progressing through parliament. An agreement was reached recently with Centerra, the operator of Kumtor, the largest gold mine in the country, to resolve some outstanding issues, which could herald an improvement in the investment climate.

Staff's Assessment

After following broadly sound macroeconomic policies in response to external shocks, fiscal policy has been relaxed and reforms have slowed in 2017. As the economy gradually recovers, the authorities were due to resume fiscal consolidation to rebuild depleted buffers. Weakening fiscal discipline and reform fatigue are complicating these efforts. Given the lack of fiscal space, as well as the elevated debt level, the authorities should adhere to their consolidation plan and pursue reforms of public sector wages and energy subsidies. The NBKR should stay vigilant and stand ready to adjust the monetary policy stance as needed. It should exert additional efforts to strengthen the monetary transmission mechanism and increase the traction of the policy rate. It should continue to strengthen supervision. Additionally, it should focus on its core role of impartial regulator and guardian of macroeconomic stability. Accelerating PFM reforms, safeguarding the procurement law and strengthening the monetary policy framework will be essential in the period ahead.

Status of IMF Relations with the Kyrgyz Republic

The 2017 Article IV consultation with the Kyrgyz Republic is expected to be concluded in October 2017. The third review of a three-year arrangement under the IMF's Extended Credit Facility was completed in December 2016, leading to a disbursement of SDR 9.514 million. The fourth review under the program could not be completed on time because the prior action on reversing the VAT on flour did not pass the second reading in Parliament, and the slippages discussed above. Discussions on the review could continue after the October elections.