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Kyrgyz Republic

Economic Update
Fall 2023

Special Topic: Food Price Inflation in the Kyrgyz Republic



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Macroeconomics, Trade & Investment
Global Practice

Kyrgyz Republic Economic Update

**Special Topic: Food Price Inflation in the
Kyrgyz Republic**

Fall 2023

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Currency Equivalent: Exchange Rate Effective as of November 30, 2023
Currency Unit = Kyrgyz Som
KGS 89.0372
Weight and Measures: Metric System

ABBREVIATIONS AND ACRONYMS

BoP	Balance of Payments
COVID	Coronavirus Disease
CPI	Consumer Price Index
DSA	Debt Sustainability Analysis
EMDE	Emerging Market and Developing Economies
ESG	Environmental, Social and Governance
FAO	Food and Agriculture Organization
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
IMF	International Monetary Fund
KGS	Kyrgyz Som
NEER	Nominal Effective Exchange Rate
NPL	Non-Performing Loans
NSC	National Statistical Committee
PPG	Publicly Guaranteed Debt
PV	Present Value
REER	Real Effective Exchange Rate
SDB	State Development Bank
TFP	Total Factor Productivity
UBK	Uy-Bulogo Komok
USD	United States Dollars
VAR	Vector Autoregression
VAT	Value-Added Tax

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FOREWORD

This edition of the Kyrgyz Republic Economic Update was prepared by a team led by Bakyt Dubashov (Senior Economist) that included Gohar Gyulumyan (Senior Economist), David Stefan Knight (Lead Economist) and Marin Brownbridge (Consultant). Antonio Nucifora (Practice Manager) provided guidance and inputs during the preparation of the report. It benefited from Apurva Sanghi (Lead Economist), Sergiy Zorya (Lead Economist) and Nadir Ramazanov (Senior Economist), who served as peer reviewers. Kanykei Temirbekova provided administrative support and helped with report formatting, and Farah Noorali Mohan Manji provided editorial support. The first part of the Economic Update analyzes recent macroeconomic trends and presents the assessment of the short- and medium-term outlook. The Special Focus Section on Food Price Inflation in the Kyrgyz Republic delves deeper into analyzing the drivers of food price inflation and offers policy recommendations for managing it.

EXECUTIVE SUMMARY

Recent Economic Developments and Outlook

1. **In the first half of 2023, real economic growth in the Kyrgyz Republic decelerated to 3.9 percent, down from 6.3 percent in 2022, due to a decline in remittance receipts and a cyclical slowdown in gold and agricultural production.** The slowdown in growth this year has generally mirrored the trends in most other economies in the Caucasus and Central Asia. It is mainly attributable to the reversal of favorable cyclical factors on the supply side of the economy, which had boosted output of agriculture and gold in 2022, and a reduction of 29 percent in remittance receipts (most of which are sourced from Kyrgyz migrant workers in Russia), which constrained household consumption on the demand side. Tourism and the emergence of a substantial transit trade with Russia have supported growth in some of the service industries, and there were also indicators of a recovery of fixed investment expenditures in the first half of 2023.

2. **The huge increase in imports, which began in 2022, continued in 2023 and was likely due to transit trade with Russia.** Imports in the first half of the year were 33 percent higher, in US dollar values, than in the corresponding period of 2022. This is almost certainly attributable to imports which were re-exported to Russia. Imports for re-export to Russia are estimated to have been approximately one third to half of total imports. The re-exports were not recorded in the trade data (filing by exporters of goods traded within the Eurasian Economic Union is not mandatory) and therefore there were large positive errors and omissions in the balance of payment (BoP) estimates. Goods exports (not including the aforementioned unrecorded exports) grew strongly in the first half of 2023, by 41 percent over the first half of 2022, mainly because of the resumption of gold exports which had been suspended in 2022. There was also a large increase of 87 percent in services exports, driven by tourism and also likely by the services component of the transit trade with Russia. The positive impact of the strong export performance on the current account of the BoP was, however, partly offset by the contraction of remittance receipts mentioned above.

3. **The exchange rate came under severe pressure in 2022, and the central bank intervened in the foreign exchange market, resulting in a loss of international reserves.** The BoP deficit declined to 14.2 percent of GDP in the first quarter of 2023, down from 20.4 percent of GDP in the same period of 2022. Full BoP data for the second quarter are not yet available but it is almost certain that the overall BoP remained in deficit. The BoP deficits have been financed mostly from the international reserves of the central bank. The central bank intervened to stabilize the KGS/USD exchange rate, which came under severe pressure in 2022 after Russia's invasion of Ukraine, with the central bank selling USD 457 million in foreign exchange in the first half of 2023 following net sales of USD 225 million in 2022. These interventions depleted international reserves, which fell to a low of 2.6 months of imports in June 2023, down from 2.8 months of imports in June 2022. Despite the interventions, the Kyrgyz Som weakened by 1.1 percent and 1.8 percent against the US dollar in 2022 and the first half of 2023, respectively. At the same time, the Som depreciated by 3 percent against the Russian Ruble in 2022 but then strengthened by 13.8 percent in the first half of 2023.

4. **Headline consumer price inflation began to decline in the first half of 2023 but remains well above the target level.** After peaking at 16.2 percent in February 2023, annual headline inflation fell back to 10.3 percent in June, still well above the central bank's target range of 5-7 percent. Headline inflation was pulled down by sharp falls in fuel and food price inflation, which followed global trends in these prices, and which had been the main exogenous factors driving up inflation since 2020. Nevertheless, non-fuel and non-food goods price inflation, together with services price inflation, proved much stickier in the first half of 2023, with annual increases of 14.1 percent and 11.2 percent, respectively, which suggests that inflationary pressures have become more entrenched. Furthermore, average monthly wages rose by 22 percent in the first half of the year, which was likely to have contributed to rising producer prices; industrial producer prices rose 16.7 percent in the same period despite the fall in fuel prices.

5. **The monetary policy stance may not have been tight enough to restrain the persistence of inflationary pressures.** Although the central bank raised its policy interest rate (its main monetary policy tool) on several occasions since early 2021, to a peak of 14 percent in 2022, in real terms the policy interest rate was consistently negative from 2020 until the second quarter of 2023. In addition, there was a very large expansion of the money supply in the second half of 2022 and the first half of 2023, driven by the central bank's purchase of gold in 2022 whose impact on reserve money was only partially sterilized.

6. **Growth in bank loans accelerated in the first half of 2023.** Bank loans expanded by 20 percent until June 2023 following subdued (and negative real) growth in the previous two years. The financial performance of the banking system continued to be good in 2023, with a capital adequacy ratio of 23.9 percent of risk weighted assets, a very high liquidity ratio of 81 percent, and high profitability as the banks remained risk averse due to high non-performing loans (NPLs) and uncertainty in the economic outlook. Although NPLs as a share of total loans remained relatively high, at 10.1 percent in August 2023, they have decreased by 2.7 percentage points since the end of 2022.

7. **The fiscal outturn in the first half of 2023 was affected by both exogenous and policy factors.** Tax revenue exhibited buoyant growth relative to the performance in the first half of 2022 and is almost certain to exceed budget estimates for the full year. This was mainly because of the buoyancy of indirect taxes, especially VAT, collections of which were 38 percent higher in nominal terms than in the same period in 2022. This outturn is most likely attributable to the VAT levied on the large volume of imported goods destined for re-export to Russia.¹ Developments on the expenditure side of the budget were dominated by an increase of 46 percent in expenditures on wages in nominal terms as a result of the large salary awards made to government employees in mid-2022. This has driven the government wage bill up to more than 13 percent of GDP, by far the highest in the region and amongst the highest in the world. The budget recorded an overall surplus of 2.2 percent of GDP in the first half of 2023 because revenues overperformed whereas expenditures were roughly in line with budget estimates, and this enabled a net repayment of domestic debt. The combination of a negative government

¹ If these goods are not declared for export to Russia or officially declared at the point of exit for the Kyrgyz Republic, companies engaged in re-export trade will not be able to reclaim VAT as they normally would on exports.

borrowing requirement and the increase in nominal GDP led to a fall in the public debt to GDP ratio, down to 47.7 percent in June 2023 from 49.2 percent at the end of 2022.

8. **Short to medium-term prospects for the economy face risks emanating from potential external shocks and internal economic vulnerabilities.** Real GDP growth of around 4 percent per annum is projected for 2024 and the medium term, but in the short term there are external risks to growth, mainly arising from the geo-political situation, the fall in remittances, the threat to the transit trade with Russia stemming from the tightening of sanctions on trade with Russia, and the possible resurgence of global fuel prices. In the medium term, economic growth is impeded by the lack of productivity growth. Total factor productivity (TFP) has been stagnant for more than a decade: output growth has relied almost entirely on factor accumulation, especially fixed investment. Improving TFP, which will require comprehensive structural reforms, is essential to raising the potential growth rate of the economy in a sustainable manner.

9. **Large structural current account deficits are a major vulnerability for the economy.** The outlook for remittances, which are a major source of current account inflows, is uncertain because of geopolitical risks. The recent growth of non-gold goods exports and exports of services offers positive prospects for an improvement in the current account. However, the recent sharp loss of reserves is not sustainable and likely reflects the overvaluation of the real effective exchange rate (REER), which has been exacerbated by the central bank's interventions to stabilize the nominal bilateral KGS/USD exchange rate. Over the medium term, the REER will need to depreciate to strengthen price incentives for exports, put pressure on reducing imports, and to enable the overall BoP deficits to close (because financing these deficits by running down international reserves is ultimately not sustainable).

10. **Consumer price inflation is projected to decline to 5 percent by the end of 2024.** However, there are factors which could impede its decline, including the pace of nominal wage increases, the expansion of the money supply since mid-2022, and the recently implemented power tariff increases, which could be exacerbated if there is a rebound in global fuel prices. The central bank should maintain a strong focus on controlling inflation and avoid reducing the policy rate too quickly.

11. **The improvement in the fiscal balance in 2023 is unlikely to be sustainable.** The increase in the import tax base which boosted indirect revenues is probably a temporary phenomenon, and hence revenues are likely fall back as a share of GDP over the medium term. In contrast, the pay awards to government employees in 2022 have generated a structural expansion of the current budget expenditures which will be difficult to reduce, especially as many other components of current expenditure are non-discretionary. Assuming that the government will not widen the fiscal deficits to unsustainable levels, which would push up the public debt/GDP ratio, this pressure from the wage bill will increasingly constrain the fiscal space for the essential capital expenditures needed to support economic growth and to strengthen resilience to climate change.

Special Topic: Food Price Inflation in the Kyrgyz Republic

12. **Food price inflation is of crucial importance for the welfare of the Kyrgyz population because of the very large share of food in household consumption.** Food items account for more than 60 percent of average household consumption expenditure and up to 74 percent in extreme poor households. Within the food consumption basket, bakery and cereal products, mainly bread, are the most important item, followed by meat, vegetables, and dairy products.

13. **Food price inflation has been volatile over the last 20 years.** There were sharp food price spikes in 2007-2009 and 2010-2011, and a less severe but more prolonged increase in food prices during 2021-2023. In periods of high overall inflation in the Kyrgyz Republic, food price inflation has exceeded inflation of non-food items, sometimes by large margins, whereas during (usually longer) periods of low or moderate overall inflation, food price rises have generally been slightly lower than those of non-food items. The spikes in food price inflation are damaging to the welfare of the poor and the population at large.

14. **The Kyrgyz Republic is a net food importer.** It also imports many of the staple food products consumed by households or the raw materials to make these products (wheat and wheat flour, cooking oil, sugar) and exports non-staple food items such as fruit and vegetables. Hence, imports are essential for food security in the Kyrgyz Republic.

15. **The primary drivers of spikes in food price inflation are food supply shocks.** Both external and domestic shocks have contributed to food price spikes in the Kyrgyz Republic, but external supply shocks – major shocks to global food prices – have been the most important cause. Domestic food price inflation is quite closely correlated with the Food and Agriculture Organization's (FAO) global USD food price inflation, especially in periods of stress in global food markets. In all three episodes of inflationary food price spikes in the Kyrgyz Republic, inflation in the global price of wheat drove up the prices of food items for which wheat is a major raw material, such as bread. For more perishable and less tradeable items, such as vegetables, volatility in supply in the domestic market from local farmers is likely to be an important contributor to price inflation. There is no evidence that demand-side factors, such as those emanating from overly expansionary macroeconomic policies in the Kyrgyz Republic, were drivers of inflationary shocks to food prices.

16. **Public policies to address food price inflation should be informed by a clear understanding of why it is a problem.** High food price inflation is not a chronic feature of the Kyrgyz economy; rather, it mainly occurs in the form irregular, episodic spikes, usually of short duration, interspersed with longer periods of low inflation. These inflationary food price spikes entail a sharp, albeit temporary, cut in the purchasing power of the population, and especially the poor, because food accounts for such a large share of their consumption basket. Moreover, even a temporary cut in household purchasing power could have damaging long-term consequences, for example, if households cannot afford essential medicines because of the temporarily higher outlays required to obtain sufficient food leaving them with insufficient money for other necessities.

17. **International experience has shown that the most effective way to handle price spikes in food items is to introduce an effective system of social protection to protect the poor against the impact of food price shocks (and other shocks).** Policy interventions should mitigate the impact of food price shocks on the population, and especially on the poor. If there were a well-functioning social assistance scheme, with comprehensive coverage of the poor, temporary supplementary payments could be made to the poor to compensate them for the higher food prices they have to pay during periods of food price shocks. The advantage of such an approach is that it is targeted on the segment of the population who suffer the most from the shock, which constrains the fiscal costs. It would entail fewer budgetary resources than more broad-based measures which deliver the same net benefits to the poor, such as a universal food price stabilization scheme in the form of budget subsidies to food producers or creating stocks of basic food products in order to sell them below market prices during the food price spikes. Therefore, countries are generally advised to avoid applying a food price stabilization scheme.

18. **The stabilization of food prices will also benefit from supply-side measures to address market failures and improve the overall performance of the agricultural sector.** These include, among others, improving the functioning of input markets and service provisions (for example, agricultural advice, transport, and marketing services), reducing high transaction costs (associated with access to essential inputs and services such as water, electricity, extension services, and logistics), and addressing information asymmetries leading to weak linkages between small farms and enterprises. Government interventions in these areas are needed to improve small farmers and agri-food processors' access to markets and to create more opportunities to capture value and improve their livelihoods.

I. RECENT ECONOMIC DEVELOPMENTS

Global and Regional Economy

19. **Weaknesses in the global economy have intensified in 2023.** Global real GDP growth is projected to decelerate from 3.5 percent in 2022 to 2.5 percent in 2023. The main headwinds holding back global growth are the erosion by inflation of the real value of household purchasing power, monetary policy tightening, which has raised the costs of borrowing that in turn deters private investment and household spending, and constraints on fiscal space, especially in emerging market and developing economies (EMDEs) as a result of higher borrowing costs and elevated public debt levels.

20. **Real growth in EMDEs is projected at 4 percent in 2023, slightly lower than the 4.1 percent in 2022 but below historical averages.** There is wide divergence within the group of EMDEs with respect to growth performance in 2023, with economies in Asia growing much faster than those in other regions. Growth in Central Asia is projected to increase from 4.1 percent in 2022 to 4.8 percent in 2023 thanks to faster growth in Kazakhstan, while growth in the rest of the region is expected to slow, partly due to the impact of lower remittance inflows on consumption (although demand arising from an influx of people from Russia and increased cross-border trade continues to support growth).

21. **Global growth in 2024 is projected to fall further to 2.1 percent, while growth in EMDEs is projected to decline just slightly to 3.9 percent.** However, the recent rise in long-term interest rates, combined with continued geo-political risks and the fragmentation of global trade patterns, poses serious downside risks to growth. In the Central Asia region, growth is projected to fall to 4.6 percent, and additional downside risks include the imposition of tighter international sanctions on cross-border trade with Russia and lower remittances if the Russian economy weakens.

22. **Inflation eased in 2023 but remains above target levels in most countries.** Global inflation declined from 8.7 percent in 2022 to a projected 6.9 percent in 2023 as the supply-side shocks to fuel and food prices abated (although in EMDEs, the decline in inflation was smaller, from 9.8 percent in 2022 to a projected 8.5 percent in 2023). In Central Asia, average inflation fell from 13.4 percent in 2022 to 9.8 percent in 2023. Measures of core inflation have shown more stickiness and are declining more slowly than headline measures. Global inflation is projected to continue falling in 2024, to 5.8 percent, as monetary policy tightening takes effect, while inflation in EMDEs and Central Asia is projected to decline to 7.8 percent and 9.4 percent, respectively.

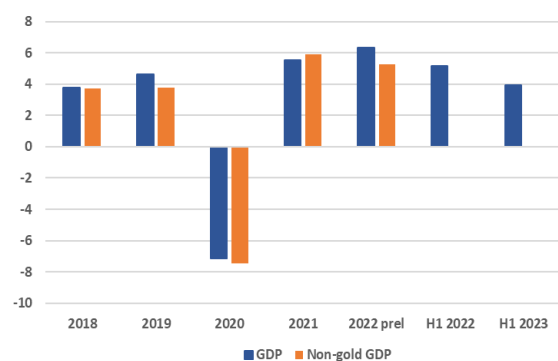
23. **Global commodity prices, in US dollars, declined in 2023.** Oil prices fell by 16.6 percent, albeit after very large rises in the previous two years. Food prices fell by 5.8 percent and those of metals by 4.7 percent. The projections for most commodity prices for 2024 are downwards but with generally smaller declines than in 2023. The average crude oil price is projected to be only marginally lower in 2024, at USD 79.9 per barrel compared to USD 80.5 per barrel in 2023.

Economic Growth in the Kyrgyz Republic

24. **Real economic growth in the Kyrgyz Republic decelerated in the first half 2023 after the partial recovery in the previous two years following the 2020 recession.** Provisional data for the first half of 2023² indicate growth of 3.9 percent over the corresponding period of 2022, which would entail a fall of 1.3 percentage points from the growth rate estimated in the first half of 2022 (Figure 1). The main drivers of growth in the first half of 2023 were some of the service sectors (Figure 2). The service sector in aggregate grew by 4.7 percent, but within the sector there was double digit growth in the hotel and restaurants, communication, and trade subsectors mainly due to increased tourism. Growth in the trade subsector (12 percent), which in the first half of 2023 was more than four percentage points higher than its long-run average, had begun to rise in the second half of 2022 and is mostly likely attributable to the rapid expansion of the re-export trade with Russia.

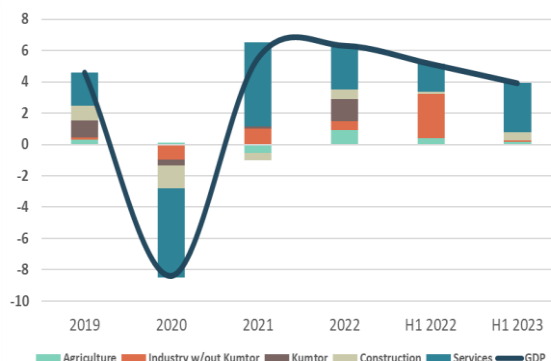
25. **Outside of the services sector, the strongest growth – estimated at 11.2 percent - was recorded by the construction industry.** Construction industry growth is returning to towards its long-run annual average after a severe slump in the pandemic recession of 2020 which continued into the following year. Growth was 8.5 percentage points higher in the first half of 2023 than in the corresponding period of 2022. Manufacturing output stagnated in the first half of 2023 because of lower production from the Kumtor gold mine, whose output is characterized by short-term volatility. Agriculture grew by 2.4 percent in the first half of 2023, but provisional data for the following two months indicate that this may not be sustained in the second half of the year because the favorable weather conditions which boosted agricultural production in the second half of 2022 have not persisted.

Figure 1: Real GDP and non-gold real GDP growth, 2018-2023H1 (percent)³



Source: NSC

Figure 2: Sectoral contribution to growth, 2019-2023H1 (percentage points of real growth)



Source: NSC

26. **A fall in inward remittances is likely to have dampened household consumption demand.** Remittance inflows are estimated to have been 29 percent lower, in US dollar values,

² The provisional data for GDP by production do not include all sectors of the economy.

³ There is no data available for non-gold GDP for H1 2023.

in the first six months of 2023 than in the corresponding period of 2022. That would amount to a fall in household disposable income of approximately 11 percent in real terms and this would unavoidably have adversely affected consumption demand as most households have few buffers to cushion shocks of this magnitude.⁴ Aggregate demand in the first half of 2023 was boosted by a large expansion of exports of goods and services, estimated provisionally at 53 percent in US dollar values compared to the same period in 2022. However, part of the growth of goods exports is almost certainly attributable to the resumption of gold exports from the Kumtor gold mine and will therefore be offset by a fall in inventory investment, which had provided the single largest source of growth in demand in 2022.⁵

27. **Provisional data indicate increased expenditures on fixed investment.** The sharp acceleration in construction industry growth, noted above, suggests that gross fixed capital formation (GFCF) was also much more buoyant in the first half of 2023 than in the corresponding period of 2022, when it had stagnated. A very large increase of 74 percent, in US dollar values, in imports of investment goods in the first quarter of 2023 relative to the same quarter in 2022⁶ also points to a strengthening of GFCF although some of these imports may have been re-exported to Russia.

28. **Real growth appears to be levelling off after the partial rebound from the 2020 recession.** The slowdown from the 6.3 percent recorded in 2022 is partly caused by the reversal of the favorable cyclical factors – good weather for agriculture and the mining of higher grade gold ore at the mining sites of the Kumtor deposit–, which had boosted growth in the previous year. That would suggest that after the partial recovery of output following the recession in 2020 caused by the COVID-19 pandemic, real GDP growth rates are levelling off at around the long-run pre-COVID trend of approximately 4 percent per annum. As such, this would imply that the scarring from the recession has left the Kyrgyz economy around 7-8 percent smaller than it would have been had it continued on its pre-COVID recession growth trajectory from 2020-2023 (Box 1).

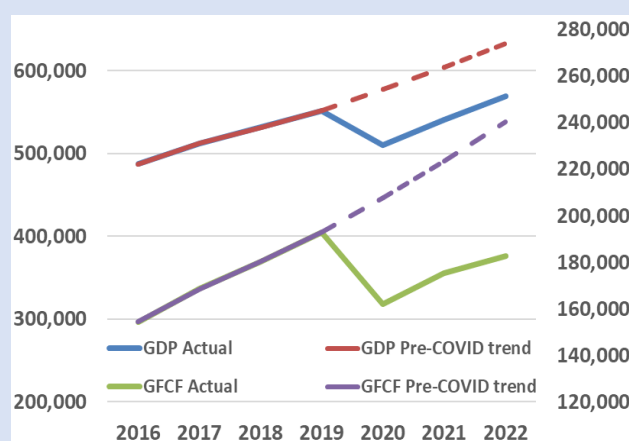
Box 1: The long-term impact of the COVID-19 recession on output and investment

The recession of 2020 has left scars on the economy. Although real GDP growth rates rebounded in 2021 and 2022 following the 2020 recession, this was not enough to fully offset the losses incurred. Had real GDP, excluding Kumtor, maintained its pre-COVID long-term trend in the 2020s (an average growth of 4.9 percent between 2011 and 2019), it would have been around 7.5 percent larger in 2022 than it actually was (Box Figure 1). This represents a semi-permanent loss in output as a result of the scarring left by the large economic shock from the pandemic.

⁴ There is no data yet for GDP by expenditure for 2023.
⁵ Most of the output of gold from the Kumtor mine was sold to the central bank rather than being exported in 2022, and the sales of gold to the central bank were recorded as inventory investment in the GDP by expenditure data.
⁶ There is no data on this variable as yet for the second quarter of 2023.

The most likely cause of the loss in output was a slump in gross fixed capital formation (GFCF). GFCF had been growing strongly in real terms in the decade prior to the pandemic, averaging around 7.5 percent a year, but it contracted by 16 percent in 2020 and was still below its 2019 level in 2022. The cumulative loss in GFCF during the three years, 2020-22, relative to the levels of investment which would have taken place if GFCF had maintained its pre-COVID trajectory during this period, amounted to around 27 percent of 2022 GDP. With a capital stock of around 200 percent of GDP,⁷ the cumulative reduction in GFCF relative to the pre-COVID trajectory corresponds to a reduction in the capital stock of around 12 percent by 2022. Given that the Kyrgyz economy has depended heavily on capital accumulation to drive real GDP growth, it is unsurprising that such a substantial loss of capital would translate into lower output, relative to the counterfactual of the pre-pandemic trend.

Figure B.1.1: Actual GDP, excluding Kumtor, and GFCF relative to pre-COVID trends, 2016-2022 (KGS billions, 2018 prices)



Note: GDP is on the left axis, GFCF on the right axis. The outcomes are shown by the solid lines. The dashed lines show the continuation of the pre-COVID trends (2013-2019) through 2020-2022.

Source: NSC and World Bank

Balance of Payments

29. **Analysis of recent developments in the balance of payments (BoP) is impeded by very large errors and omissions.** These amounted to 37 percent of GDP in 2022 and 54 percent

⁷ Data from the Penn world Tables. The most recent estimate is for 2019. We have assumed that, had GFCF growth been maintained at its pre-COVID level, the capital stock would have increased by 5.5 percent per annum, which is the average rate of increase in the decade prior to the pandemic.

of GDP in the first quarter of 2023.⁸ The errors and omissions were positive, implying that some inflows were unrecorded or under-recorded. The most likely source of these errors and omissions is unrecorded re-exports to Russia (Box 2).

30. **Both exports and imports grew strongly in the first half of 2023.** Goods exports expanded by 41 percent, in US dollar values, relative to their levels in the first half of 2022 (Figure 3). Most of the growth in goods exports took place in the second quarter of the year.⁹ As noted above, the rise in goods exports is most probably due to the resumption of gold exports from the Kumtor gold mine, which had been negligible in the first half of 2022 (because all of the gold produced by the Kumtor gold mine was sold to the central bank rather than exported), and amounted to \$50 million in the first quarter of 2023 (there is no data on gold exports for the second quarter). Goods imports also grew rapidly, by 33 percent in the first half of 2023 compared to the first half of 2022 (Figure 3). However, approximately 40-50 percent of the imports in the first half of the year were most probably destined for re-export to Russia (Box 2). Given that the imports for re-export are such a large share of total imports, and that the estimates of their value are unavoidably very uncertain, it is very difficult to estimate with any confidence whether imports for domestic use were higher or lower in the first half of 2023 than in the corresponding half of 2022. Given the likely magnitude of the imports for re-export, had the re-exports to Russia been fully recorded in the trade statistics, it is likely that the deficit in goods trade would have narrowed from USD 2.9 billion recorded in the first half of 2022 to less than USD 2.5 billion in the first half of 2023. Services exports (imports) grew by 87 (96) percent in the first half of 2023, relative to the first half of 2022, much of which is likely to relate to auxiliary services related to the large increase in goods trade.

Box 2: Estimates of unrecorded re-exports¹⁰

Goods imports (f.o.b.) increased by 70 percent in 2022, from USD 5.2 billion to USD 9 billion. The rise in imports reflected the increased shipment of goods from China, Turkey, and Korea (textiles, footwear, chemical products, construction materials, equipment, machines) as well as higher prices for food, fuel, and some consumer goods (textile, footwear). Goods imports amounted to USD 2.1 billion in the first quarter of 2023 compared to USD 1.7 billion in quarter one of 2022.

A large part of the increase in imports is very likely to be composed of goods which were destined for re-export to Russia. These were not recorded as re-exports. For example, a sizable volume of imports of goods from China, Japan, Korea, Germany, the USA, and the UK are believed to have been subsequently shipped to Russia. How large a share of the USD 9 billion of goods imports comprised goods for re-exports is difficult to estimate precisely; However, prior to 2022, goods imports were equivalent to approximately 41 percent of GDP

⁸ The first quarter is the only quarter of 2023 for which comprehensive BoP data is available so far. However, for some items of the BoP - exports of goods and services, imports of services and remittances – there is Q2 data available.

⁹ The second quarter data may not be reliable.

¹⁰ The source of data and information used in this Box are from the central bank's BoP publication.

plus remittance receipts on average,¹¹ which would imply that imports for domestic use amounted to just under USD 6.1 billion in 2022 and that around USD 2.9 billion was re-exported to Russia but not recorded as re-exports (official re-exports were only USD 151 million). In the first quarter of 2023, applying the same methodology would imply that out of the total recorded goods imports of USD 2.1 billion, just under USD 1 billion were imports for re-export and just under USD 1.2 billion were imports for domestic use.

Including estimated re-exports substantially reduces the current account deficit. The goods imports are recorded on an f.o.b. basis. Hence, the actual value of the imports destined for re-export would have been higher due to the cost of insurance and freight, which is recorded in the BoP as a services import. If the cost of insurance and freight amount to 10 percent of the f.o.b. value of the imports, around USD 300 million of the total services imports of USD 1.4 billion in 2022 pertained to the imports for re-export. Similarly, around USD 100 million would have comprised the services component of imports intended for re-export in the first quarter of 2023. The cost of these services would have been recouped as part of the price of the re-exports transported to Russia, but not recorded in the BoP. Hence it is likely that the value of unrecorded re-exports was approximately USD 3.2 billion in 2022 and USD 1.1 billion in the first quarter of 2023. That would account for a substantial share of the USD 4.3 billion of positive errors and omissions in 2022 and of the USD 1.2 billion of errors and omissions in the first quarter of 2023. It would also imply that the actual current account deficit in 2022 was around USD 1.9 billion or 17 percent of GDP, an increase of USD 1.2 billion compared to 2021 which was mainly accounted for by the suspension of gold exports in 2022. In the first quarter of 2023, the inclusion of the estimated re-exports would reduce the current account deficit to around USD 400 million (17 percent of GDP), which is lower than the deficit of USD 1.1 billion recorded in quarter one of 2022.

31. **Remittances fell sharply in the first half of 2023.** Remittance inflows were 29 percent lower in the first half of 2023 than in the corresponding period of 2022. The source of most of the remittances is Kyrgyz workers employed in Russia.¹² Remittances had initially held up well in 2022, and were six percent higher in 2022 than in 2021, but they began declining in late 2022 as the depreciation of the ruble reduced the value of remittances in US dollars.¹³ The decline has since flattened out but if the trends in monthly inflows recorded in the first seven months of 2023 continued through to the end 2023, remittances for the full year are likely to be lower by around 35 percent than in 2022, which would amount to a loss in current account inflows of approximately USD 1 billion.

32. **There were also substantial outward remittances in the first half of 2023, estimated at USD 257 million.** This was actually lower than the total in the first half of 2022, of USD 362 million; the latter had increased dramatically in the second quarter of 2022. The main destinations of outward remittances were Russia and Turkey and these remittances are possibly

¹¹ This average excludes 2020, when imports fell sharply because of trade disruptions as well as the recession.

¹² Remittances from Russia comprised 95 percent of total remittance inflows in 2022.

¹³ Remittances from countries other than Russia, although small in magnitude, increased by over 40 percent in the first half of 2023 compared to the first half of 2022, to USD 90 million.

related to the movement of Russian citizens to the Kyrgyz Republic since Russia's invasion of Ukraine, but they may also include (mis-recorded) payments for small scale imports.

33. An overall BoP deficit led to further depletion of the central bank's international reserves. The financial account recorded a deficit of USD 129 million in the first quarter of 2023 compared to a surplus of USD 167 million in the first quarter of 2022. The deficit appears to have been mainly attributable to reduced external borrowing. The overall balance in the first quarter of 2023 was a deficit of USD 326 million, which was financed by a reduction in the central bank's international reserves. The overall BoP deficit was USD 365 million in quarter one of 2022 and USD 292 million for the whole of 2022. As a result of these overall BoP deficits, the central bank's official international reserves have fallen from three months of imports at the end of 2022 to 2.6 months of imports at the end of the first half of 2023, which is below the IMF's adequate level of international reserves for a credit constrained economy such as that of the Kyrgyz Republic.¹⁴

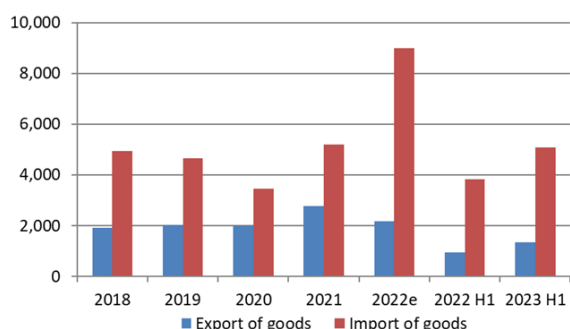
34. The central bank intervened heavily in the foreign exchange market to support the exchange rate.¹⁵ The central bank sold USD 457 million in the foreign exchange market in the first half of 2023 following net sales of USD 225 million in 2022 (Figure 4).¹⁶ This brought some stability to the nominal KGS/USD exchange rate (the average level of which in the first half of 2023 was only 1.6 percent lower than in the first half of 2022), but it was at the expense of the depletion of the foreign exchange reserves (and an appreciation of the real effective exchange rate which is discussed in the Outlook and Risks section). Had the central bank not intervened to support the exchange rate by selling foreign exchange, the exchange rate would have depreciated, forcing the overall BoP deficit to close.

¹⁴ The adequate level of reserves for credit-constrained economies is estimated at 3 months of imports (IMF, 2015, Assessing Reserve Adequacy – Specific Proposals).

¹⁵ The managed floating exchange rate is the officially declared regime and according to the central bank, it intervenes only to avoid sharp fluctuations in the foreign exchange market. However, the central bank has been intervening heavily to support the exchange rate, and as a result, the exchange rate is perceived to be overvalued.

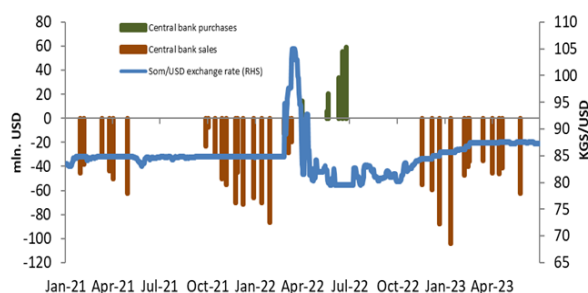
¹⁶ As an additional measure intended to support stability in the foreign exchange market, the central bank banned commercial banks and other financial organizations from taking cash US dollars out of the country as Russia began to import cash US dollars from neighboring countries in response to sanctions. The ban was lifted in December 2022.

Figure 3: Exports and imports, 2018-2023 H1 (USD millions)



Source: Central Bank

Figure 4: KGS/USD Exchange rate and central bank interventions, January 2021-June 2023



Source: Central Bank

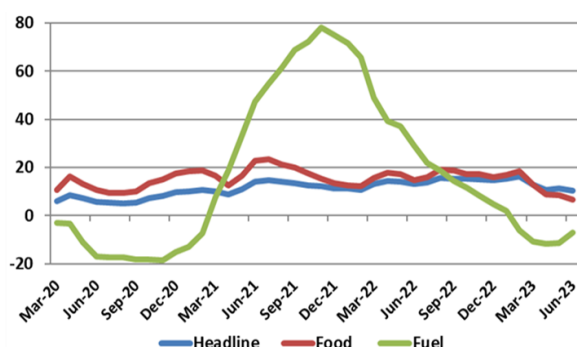
Inflation and Monetary Policy

35. **Inflation eased in the first half of 2023 but remained above the central bank’s target range and it is amongst the highest in the region.** Annual headline consumer price inflation fell back to 10.3 percent in June 2023, down from a peak of 16.2 percent in February 2023 and 13.2 percent in June 2022. The central bank’s target range is 5-7 percent but inflation has been consistently above the target range since October 2020. However, the fall in inflation in the six months since February 2023¹⁷ has been the largest and most sustained over the last three years, and it suggests that the rising trend in inflation that characterized this period has finally begun to reverse.

36. **Inflation was pulled down by the abatement of supply price shocks.** Since 2020, headline inflation had been driven up by food and especially fuel price shocks (Figure 5), which were primarily caused by international factors; e.g., higher global food and fuel prices (Figure 6). The exogenous shocks began to abate in 2022, enabling domestic fuel price inflation to begin falling in 2022 and food price inflation to fall in early 2023, which in turn has fed through to the lower headline inflation recorded since February 2023. Food price inflation fell to 6.7 percent in June from a peak of 18 percent in February 2023, while fuel price inflation fell even more steeply, to negative 4.7 percent from a peak of 78 percent in November 2021. In 2022 and projected in 2023, inflation in the Kyrgyz Republic is the second highest of the seven countries in Central Asia and the South Caucasus, behind only Kazakhstan (Figure 7).

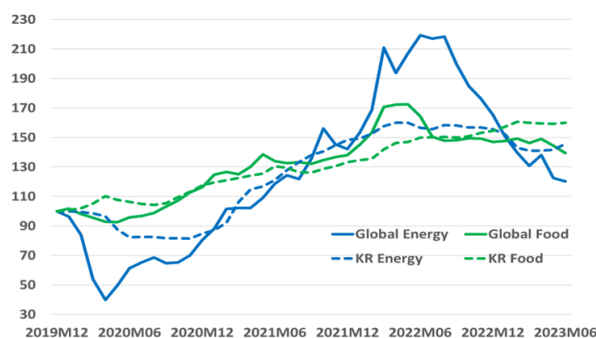
¹⁷ The most recent headline inflation data available are for August 2023, when it was 9.5 percent.

Figure 5: Annual headline, food and fuel inflation, January 2020-June 2023 (percent)



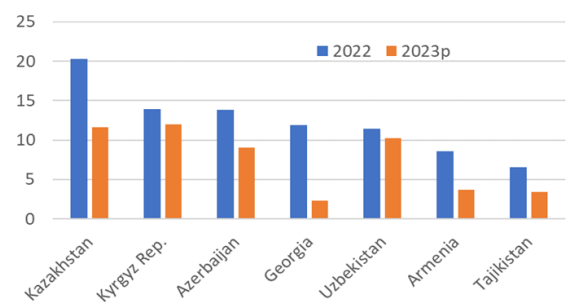
Source: NSC

Figure 6: Global energy and commodity price indices and Kyrgyz fuel and food price indices; Dec 2019-Jun 2023 (Dec 2019 = 100)



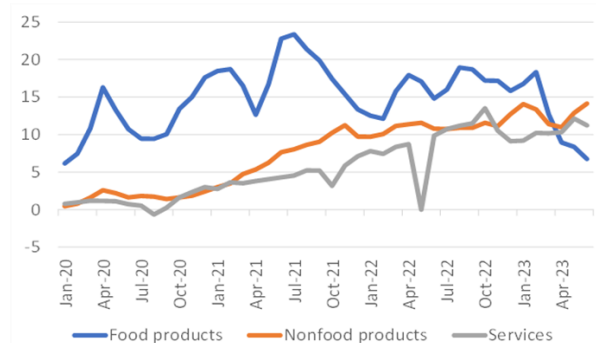
Source: NSC and World Bank

Figure 7: Inflation rates in the Caucasus and Central Asia, 2022 actual and 2023 projections (percent)



Source: World Bank

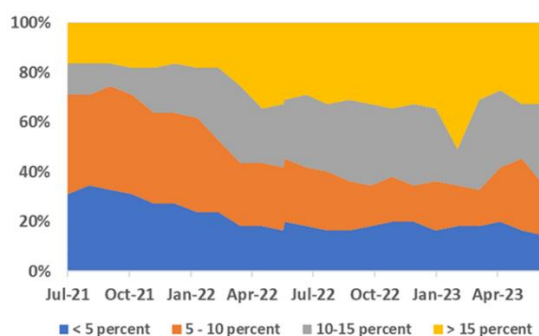
Figure 8: Annual food, non-food goods and services price inflation, January 2020 - June 2023 (percent)



Source: NSC

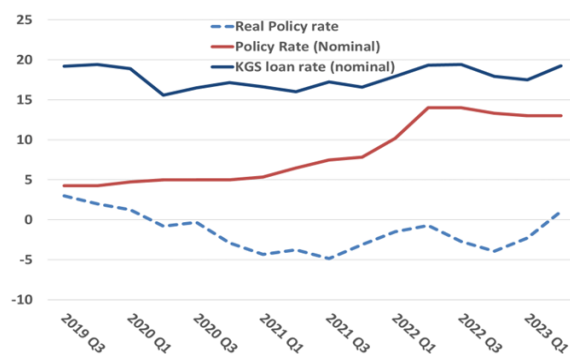
37. **Non-food goods and services price inflation are proving more persistent.** The downward trends in fuel and food price inflation were not matched by inflation in other components of the consumer price index (CPI). Non-food goods price inflation was 14.1 percent in June 2023, having risen by three percentage points in the second quarter of the year and it was 3.3 percentage points higher than in June 2022. Similarly, services price inflation rose by 2.1 percentage points in the first half of 2023, to 11.2 percent, and was 1.4 percentage points higher than in June 2022 (Figure 8). The share of items in the CPI consumption basket for which higher rates of annual inflation were recorded has been increasing since 2020 and flattened out during the first half of 2023 (Figure 9). This would suggest that inflationary pressures have become more entrenched over the last 12 months, most likely emanating from the demand side of the economy.

Figure 9: Percentage share of items in the CPI grouped by their annual price changes, June 2021-June 2023



Source: NSC

Figure 10: Nominal and real central bank policy rate and nominal bank KGS loan rate, Q3 2019-Q2 2023 (percent)



Source: Central Bank

38. **Inflationary pressures also fed through to the labour market.** Average monthly wages rose by 22 percent in nominal terms between June 2022 and June 2023 following a rise of 41 percent in the previous 12 months, well above CPI inflation and also higher than nominal GDP growth in 2022. Wage increases are likely to have exerted upward pressure on producer prices which in turn feeds through, with lags, to prices of consumer goods and services.

39. **The monetary policy stance may have allowed inflation to become more broad-based and persistent.** Although the primary drivers of inflation have undoubtedly been supply shocks, the pass-through of these shocks to a broader range of prices and the persistence of elevated inflation may have been enabled by loose monetary policy in 2022, although it tightened in 2023 (Figure 10). The central bank raised its policy rate gradually in 2021, from 5 percent in January to 8 percent in December, and then much more sharply in March 2022 when it was raised from 8.5 percent to 14 percent. It was then reduced to 13 percent in November 2022, and it has since remained at this rate. However, the increases in the policy rate lagged behind the rise in inflation. In real terms, the central bank policy rate (i.e., the nominal rate adjusted for annual consumer price inflation) was positive in 2019 and the first quarter of 2020, but it was consistently negative in every subsequent quarter until quarter two of 2023. The increase in the policy rate was only partially passed through to the interest rates on KGS denominated bank loans. There was almost no increase in the nominal loan rate in 2021 despite the 300-basis point rise in the central bank policy rate that year, and a rise of only around 300 basis points in the loan rate in the first three quarters of 2022, which is only half the size of the increase in the policy rate and indicative of a weak monetary policy transmission mechanism (Figure 10).¹⁸

¹⁸ Like in other countries in the region, the characteristics of the Kyrgyz economy influence the monetary transmission mechanism. These include the structural excess liquidity resulting in a limited impact on commercial banks' willingness to adjust their lending volumes in response to changes in the central bank policy rate; weak competition among commercial banks allowing them not to pass on policy rate changes to their market rates; and the high exchange rate pass-through and the large share of imported goods and foods in the CPI basket reducing the ability of monetary policy to influence inflation.

Financial Sector

40. **The financial sector is dominated by banks, which hold 92 percent of financial sector assets.** The banking sector, which comprises 23 licensed commercial banks, holds assets equivalent to 50 percent of GDP, and 56 percent of these assets are held by the five largest banks in the country. Total bank lending amounted to 23.1 percent of GDP in 2022. While the credit-to-GDP ratio increased over the last decade from 13.4 percent in 2012, it is still significantly lower than the average of the Europe and Central Asia region (excluding high-income countries) of 53.3 percent.

41. **Growth in bank lending was subdued in 2022 but picked up in the first half of 2023.** The growth in bank loans was 12.2 percent in 2022, only marginally higher than in 2021 (11.8 percent) and 2020 (11.0 percent) and lower than the annual growth rates of 14.5-18 percent in the three years before the pandemic. Commercial lending grew by 7.4 percent in 2022. Bank deposits have risen much faster than bank loans, by 39.5 percent in 2022, and bank liquidity has been rising.¹⁹ Private sector credit growth is therefore more likely constrained by limited demand or weak intermediation functions rather than by any shortage of resources. Bank lending rates for KGS loans averaged 19.4 percent in June 2023, slightly higher in nominal terms than the 19.1 percent in June 2022 but higher in real terms because of the 2.6 percentage point fall in inflation in this period.

42. **The banking system retained its resilience in 2023.** At the end of August 2023, the banking system's capital adequacy ratio was 23 percent, almost double the statutory minimum ratio of 12 percent (Table 1). The non-performing loans to total loans ratio, which rose during the pandemic and continued rising through 2022, fell back by 2.7 percentage points by end-August 2023 to 10.1 percent. Although the share of deposits in foreign currency in total deposits declined slightly in 2023 following an increase during 2020-22, it remained high at 50.3 percent as of August 2023. At the same time, the share of loans in foreign currency in total loans continued to fall partly due to measures aimed at de-dollarization of the economy. The banks have also been very profitable, earning a return on assets of 5.9 percent and 4.6 percent in 2022 and the first eight months of 2023, respectively, partly benefiting from the exchange rate volatility. The central bank introduced temporary regulatory forbearance measures at the onset of the pandemic, as did many other countries, but they remained in place due to the war in Ukraine, and the Kyrgyz Republic was one of the last countries to withdraw the temporary measures in late 2022. Nevertheless, the provision of regulatory forbearance for more than two years has not adversely affected the financial soundness of the banking system.

Table 1: Banking sector indicators (2018–2023)

	2018	2019	2020	2021	2022	2023 August
Capital adequacy (%)	23.7	24.0	24.9	22.2	25.6	23.9
NPLs/total loans (%)	7.5	8.0	10.5	11.1	12.8	10.1

¹⁹ The loan to deposit ratio of the banking system fell from 103 percent in December 2019 to 65 percent in December 2022.

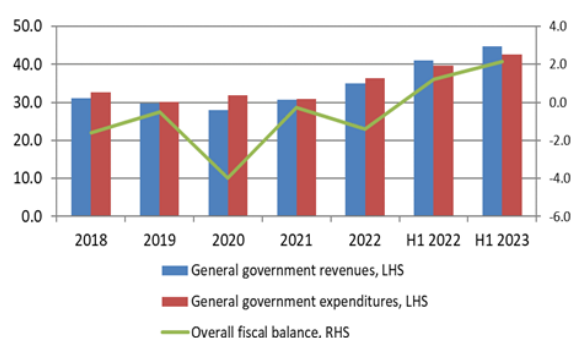
	2018	2019	2020	2021	2022	2023 August
Liquidity ratio (%)	66.9	64.0	64.9	71.3	82.8	80.9
Loan to deposits ratio (%)	101.0	103.0	95.9	80.3	65.0	69.6
Return on equity (%)	9.5	7.7	5.5	7.8	43.4	33.2
Return on assets (%)	1.4	1.2	0.9	1.4	5.9	4.6
Deposits in foreign currency (%)	44.5	39.1	43.4	42.2	51.4	50.3
Loans in foreign currency (%)	38.0	35.2	33.0	28.0	23.5	21.4

Source: NBKR

Fiscal Performance

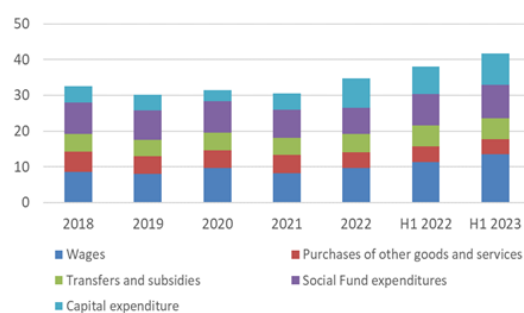
43. **Fiscal revenues and current expenditures both grew strongly in the first half of 2023.** Following a 41 percent growth in 2022, total revenues continued to grow rapidly in the first half of 2023, rising by 31 percent in nominal terms compared to the corresponding period of 2022 to 42.9 percent of the estimated GDP in the first half of the year (Table 2 and Figure 11). The revenue increases in the first half of 2023 were mainly composed of indirect taxes, especially VAT, but there was also a large increase in non-tax revenue. As was the case in 2022, the buoyancy of indirect taxes in the first half of 2023 was in large part attributable to the strong expansion of imports, which include the imports for re-export to Russia.²⁰ Income taxes, however, fell by 14 percent, which was surprising given the robust wage growth in both public and private sectors, and this suggests that there was a sharp reduction in tax paid on profits (Figure 12).

Figure 11: Government revenues, expenditures, and deficit (percent of GDP)



Source: Ministry of Finance

Figure 12: Expenditure composition (percent of GDP)



Source: Ministry of Finance

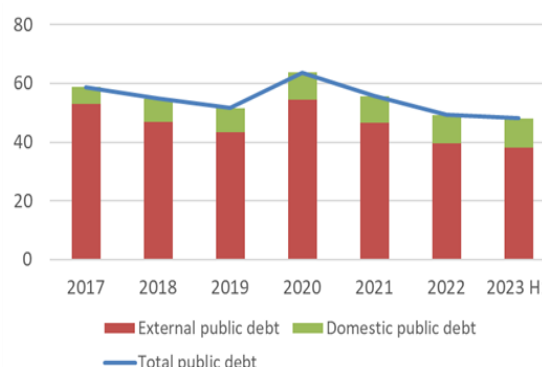
²⁰ If these goods are not declared for export to Russia or officially declared at the point of exit for the Kyrgyz Republic, companies engaged in re-export trade will not be able to reclaim VAT as they normally would on exports.

Figure 13: Income tax and VAT (KGS billions)



Source: Ministry of Finance

Figure 14: Public debt: External and domestic (percent of GDP)



Source: Ministry of Finance

44. **Public sector salary awards boosted current expenditures.** Current expenditures rose by 27 percent in the first half of 2023 compared to the first half of 2022 because of a 46 percent increase in the government wage bill due to salary awards (Box 3). The wage bill, excluding the Social Fund Contribution (which is allocated to government revenue) amounted to 13.6 percent of GDP of the first half of the year compared to 8.2 percent in 2021. This is a far higher level of wage expenditure, as a share of GDP, than other countries in the South Caucasus and Central Asia, none of which have government wage bills exceeding 8 percent of GDP. Wages comprised more than a third of total expenditures in the first half of 2023 (Figure 12). Similarly, pension spending rose to 7.8 percent of GDP in the first half of 2023 compared to 6.4 percent of GDP in 2021 following the increases in pension entitlements which took effect in 2022. There were also increases of 22 percent in other social fund expenditures and of 33 percent in transfers and subsidies. Consequently, current expenditures rose to 34.4 percent of GDP in the first half of 2023 compared to 31.9 percent of GDP in the first half of 2022. Capital expenditures (domestic and external) also increased in the first half of 2023 to 8.7 percent of GDP from 7.6 percent in the previous year.

45. **Driven by the very buoyant revenue performance, the budget recorded an overall surplus of 2.2 percent of GDP in the first half of 2023.** This enabled a net repayment of domestic debt, amounting to 2.7 percent of GDP, combined with a relatively small amount of external financing. However, it is likely that the overall fiscal surplus will be reversed in the second half of the year as the pace of spending accelerates. The negative government borrowing requirement in the first half of 2023, combined with fairly robust growth in nominal GDP, pulled down the public debt-to-GDP ratio to 47.7 percent in June 2023 compared to 53.1 percent in June 2022 (Figure 14). The interest costs of public debt are low, amounting to only 3.4 percent of total budget expenditures in the first half of 2023, because almost 80 percent of public debt is concessional external debt.

Box 3: Increase in the public sector wage bill

The public wage bill in the Kyrgyz Republic averaged 9.2 percent of GDP during 2017-21. It increased to 11.6 percent of GDP in 2022 after the President signed two decrees raising the salaries of public sector employees.

- The salaries of workers in education and science, healthcare, culture, information and sports, and the social protection sector were increased by 50 percent to 100 percent in nominal terms on April 1, 2022. Specifically, the salaries of school and kindergarten teachers increased by 80 percent, faculty staff of universities and colleges by 50 percent, researchers by 50 percent, medical personnel by 50 to 100 percent, cultural workers by 75 to 100 percent, social workers by 50 to 100 percent, administrative and managerial staff by 50 to 75 percent, and technical and junior service personnel by 50 to 100 percent (all in nominal terms). According to the Finance Ministry, the total cost of these wage increases amounted to 26 billion Som.
- The salaries of public servants were increased by 50-70 percent in nominal terms on August 1, 2022. This included central government and municipal employees. The total cost of these salary increases amounted to 7 billion Som.

Table 2: General government finances (percent of GDP)

Table 2: General Government Finances (percent of GDP)

	2021	2022	2022 H1	2023 H1
Total revenues and grants	30.7	35.0	41.0	44.7
Total revenues	28.9	33.0	39.5	42.9
Current revenues	28.9	33.0	39.4	42.8
Tax revenues	23.2	27.6	32.7	34.4
Non-tax revenues	5.7	5.4	6.7	8.4
Capital revenues	0.1	0.0	0.1	0.1
Grants	1.8	2.0	1.5	1.8
Program grants	0.4	0.8	0.3	0.1
PIP grants	1.3	1.2	1.2	1.7
Total expenditure (incl. net lending)	31.0	36.4	39.8	42.5
Total expenditure	31.7	35.9	39.5	43.1
Current expenditure	27.0	27.7	31.9	34.4
Wage	8.2	9.7	11.4	13.6
Transfer and subsidies	4.8	5.1	6.0	5.8
Social Fund expenditures	7.8	7.3	8.8	9.4
Interest	1.1	1.1	1.4	1.4
Purchase of other goods and services	5.1	4.5	4.2	4.2
Capital expenditure	4.7	8.2	7.6	8.7
o/w foreign financed	3.4	3.3	3.6	3.9
Net lending	-0.7	0.5	0.3	-0.6
Overall balance	-0.3	-1.4	1.2	2.2
Financing	0.3	1.4	-1.2	-2.2
External	1.6	2.8	0.6	0.6
Domestic	-1.3	-1.4	-1.8	-2.7

Source: Ministry of Finance.

Institutional and Structural Reforms

46. **The government increased electricity tariffs in 2023 for first time since 2015.** Starting on May 1, 2023, the government increased electricity tariffs for different segments of consumers. For the residential sector, which accounts for almost two-thirds of total domestic consumption, the electricity tariff was increased by 30 percent in nominal terms (from 0.77 to 1.00 KGS/Kwh). For agriculture, industry, and some other sectors electricity tariffs were adjusted by the rate of CPI inflation. The government kept an unchanged tariff of 0.50 KGS/kwh for the beneficiaries of the social safety net system to protect vulnerable households. In addition to tariff adjustments, the authorities implemented the first phase of the debt-for-equity swap for energy companies in July-August 2023, which replaced part of their debt liabilities to the government (arising from on-lent external finance) with government equity in the companies. These measures are expected to contribute to a reduction of the quasi-fiscal deficit of the energy sector, which was estimated at 18 percent of GDP in 2022. These initial steps should be continued and supported by systematic actions to ensure the sector's financial viability and the reliability of its services. The government is discussing the long-term National Program for the Energy Sector Development for the period up to 2035, which includes continued tariff adjustments to achieve the cost recovery tariff levels by 2030.

47. **Benefits under social assistance programs were raised.** To mitigate the impacts of multiple crises on the poor and vulnerable, the government increased the monthly benefit amount of the Uy-bulogo komok 21 (UBK) program by 50 percent from KGS 810 (approximately US\$10) to KGS 1,200 (approximately US\$15) starting June 1, 2022. Around 350,000 children and 105,000 families currently benefit from the UBK program. In 2022, the government launched a pilot cash grant program named "Social Contract" that aimed to provide a one-time payment of KGS 100,000 (equivalent to US\$1,100) to help eligible poor and vulnerable households receiving UBK payments to engage in income-generating activity. Following the pilot stage, the government has scaled up the program targeting some 10,000 families across the country. In 2023 the Government approved the State Program on "Accessible Country" for 2023-2030, which focuses on creating an enabling environment for developing employment opportunities for people with disabilities.

48. **The Kyrgyz Government established its first State Development Bank (SDB) in late 2022 to mobilize financing for diversifying and stimulating the economy.** The SDB can potentially play a catalytic role; however, the global experiences of development banks show that such policy financial institutions need to attract talented professionals, make independent decisions for their operations, and be well managed and run in a prudent manner.

49. **Policy measures have been taken to promote "green" financing.** The central bank has drafted a guideline on integrating environmental, social, and governance (ESG) risk assessment in the banking sector. The Kyrgyz Stock Exchange has joined the Sustainable Stock Exchange Initiative and has issued Sustainable Reporting Guidelines for listed companies. The State Guarantee Fund is also developing green credit guarantee products for local banks. Over

²¹ Translated as 'Family assistance for children'.

the past year, one green bond and one gender bond have been issued by two local commercial banks and listed on the Kyrgyz Stock Exchange.

II. OUTLOOK AND RISKS

Growth

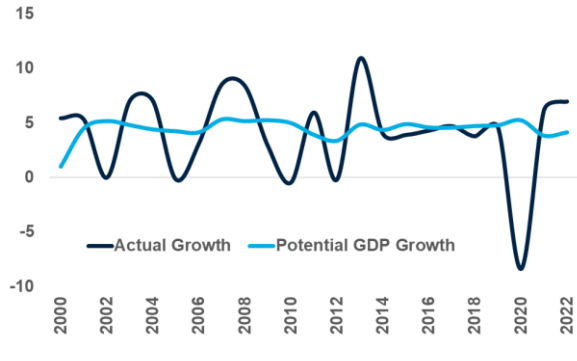
50. **Real GDP growth is forecast to decelerate to 3.5 percent in 2023 before rising to 4 percent in 2024.** There is, however, considerable uncertainty over the short to medium-term growth prospects and the balance of risks lies on the downside, with most of these risks emanating from external factors. A major cause of uncertainty are spillovers from the war in Ukraine, which could be transmitted to the Kyrgyz economy through multiple channels. The baseline scenario assumes that the international sanctions on trade with Russia will have only a limited adverse impact on economic activity, partly because the Kyrgyz Republic and Russia are expected to increase the use of domestic currencies in bilateral trade in lieu of US dollars, but the degree to which sanctions constrain the business activities of Kyrgyz companies is inherently difficult to predict. A risk to the short to medium-run outlook is the tightened implementation of existing international sanctions on Russia and the adoption of proposals to impose further sanctions on countries that may be transit routes for goods to Russia, as announced under the European Union's (EU) 11th round of sanctions. The United States has recently imposed sanctions on several businesses registered in the Kyrgyz Republic involved in re-exporting sanctioned goods to Russia.

51. **Lower remittance flows from Kyrgyz workers in Russia, already evident in 2023, will have an adverse effect on domestic demand and the balance of payments.** As discussed above, a lower level of remittance inflows going forward is expected to translate into lower levels of household disposable income, which would lead to lower output, especially in the domestic non-traded goods sectors which supply these goods. It is likely to have a disproportionate impact on the construction sector, as households scale back expenditures on house building to prioritize basic necessities. It would also affect the BoP, as discussed below. If sustained for any length of time, the recent strengthening of oil prices in global markets will raise supply costs in the Kyrgyz economy and have a dampening effect on economic growth. Risks in the BoP, discussed below, could also undermine macroeconomic stability and raise the domestic cost of essential imports into production, which would adversely affect business confidence, investment and economic growth.

52. **In the medium term, the economy is projected to grow at an annual average of 4 percent, constrained by feeble total factor productivity growth (TFP).** This is in line with the pre-pandemic average growth rate and is the best estimate of the current medium-term potential rate of growth (Figures 15 and 16). Growth in potential output is constrained by the lack of growth in TFP. For around two decades, real growth in the Kyrgyz economy has been driven mainly by factor accumulation. In the ten years prior to the pandemic, the growth of the capital stock averaged 4.9 percent per annum, while the number of people employed rose by

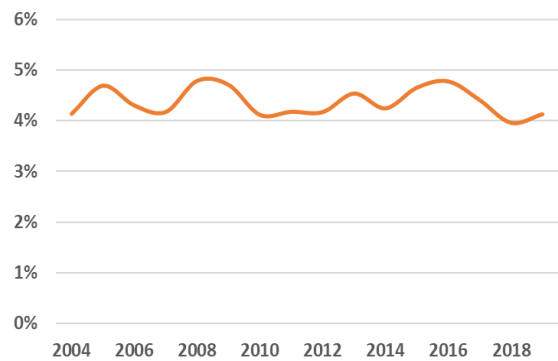
1.7 percent per annum and there was a 1.3 percent per annum increase in the human capital index. In contrast, annual growth in TFP was negative 0.1 percent.²² That implies that capital accumulation contributed around 60 percent to the real growth of output during 2009-2019 with the growth in the number of people employed and the improvement in their human capital contributing the other 40 percent. Including the post-COVID period as well, over the 2009-2022 period, capital accumulation and labour contributed 97 percent and 11 percent to the real growth, respectively, while the contribution of TFP was negative 7 percent.²³ Going forward, it will be very difficult to raise the potential rate of real GDP growth above the current rate of around 4 percent per annum if the economy continues to rely primarily on factor accumulation to drive growth. If the potential real GDP growth rate is to be raised, it will require sustained improvements in TFP, something which the Kyrgyz economy has not achieved in the last two decades.

Figure 15: Actual vs. potential GDP growth (percent)



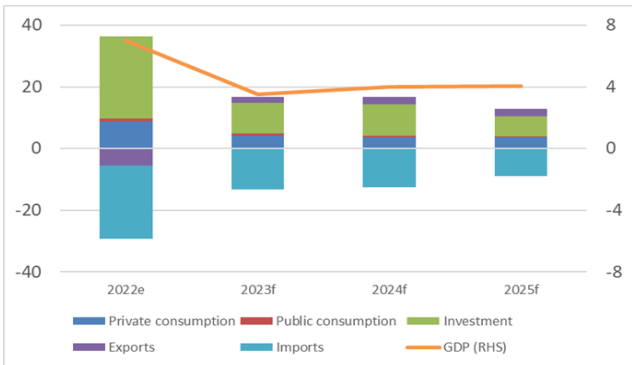
Source: World Bank

Figure 16: Rolling 10-year average GDP growth



Source: World Bank

Figure 17: Real GDP growth: 2022 outturn and 2023-25 projections by components of aggregate demand (percent)



²² Data from the Penn World Tables, 2023. There is no data for years after 2019.

²³ World Bank estimates.

Note: The large contribution of investment to growth in 2022 was mainly due to inventory investment. The negative contribution of the external components of demand in that year is overstated because of the under-recording of re-exports.

Source: World Bank

53. **Comprehensive structural reforms across multiple sectors of the economy are a pre-requisite to improving the performance of TFP.** These include reforms to boost efficiency in state-owned enterprises, to improve the business environment in order to reduce the costs of and the risks involved in doing business, to strengthen competition in markets, and reforms to encourage the modernization of agriculture.

Balance of Payments

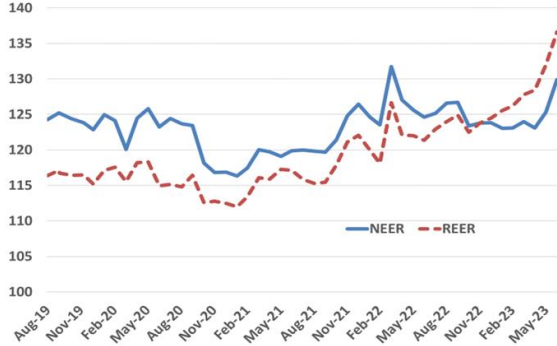
54. **The resumption of gold exports is expected to strengthen the current account in 2023.** After two years of weak export performance, exports (excluding estimated re-exports) are projected to grow by 23 percent, driven by gold exports, while increasing food, textiles, and construction material exports should support non-gold export growth. The services export performance is also projected to improve as a result of tourism. Imports, excluding those destined for re-export, are projected to increase on account of higher imports of food, other consumer goods, chemical products, machinery, and equipment.

55. **There are major risks to the balance of payments.** Although the recent strong growth in exports of services and non-gold goods offers positive prospects for the balance of payments, these could be offset by the loss of remittance inflows if the reduction observed in the first seven months of 2023 is not reversed. That would almost certainly lead to a significant depreciation in the exchange rate as it is unlikely that the central bank could continue to support the exchange rate with the levels of foreign exchange market intervention that occurred in 2022 and the first half of 2023 because that would further deplete its international reserves. A gradual depreciation of the exchange rate, in real effective terms, would be beneficial for the external sector, as discussed below, but a rapid and large adjustment would be very disruptive as many major components of the BoP are unlikely to be price elastic (e.g. gold exports, fuel imports, remittances), and hence a larger burden of the adjustment would occur expenditure reduction; i.e. a contraction of demand and thus of output.

56. **The large-scale interventions in the foreign exchange market by the central bank to support the exchange rate in 2022 and 2023 has led to an appreciation of the REER.** Although these interventions stabilized the nominal KGS/USD exchange rate after the sharp depreciation which took place in March 2022 following Russia's invasion of Ukraine, this was at the expense of the REER, which appreciated by 17 percent between July 2021 and July 2023 (Figure 18). The external sector assessment, which was part of the 2022 IMF Article IV consultation, provided mixed indicators as to whether the REER was overvalued but the assessment of the Fund staff was that the exchange rate was overvalued in the range 5-10 percent (IMF, 2022). That is likely to be an underestimate of the current level of overvaluation because the REER has appreciated by a further nine percent since October 2022, which was the last date for which data was available for the external sector assessment.

57. **An overvaluation of the REER is conducive neither to a more sustainable current account nor to the growth of non-traditional exports, for which profit margins are often small.** The development of dynamic export industries is essential if the Kyrgyz economy is to become more externally oriented and more productive given that it is mostly traded goods industries which drive productivity growth in developing economies. Furthermore, gold production is expected to decline after the mid-2020s as deposits of the mineral are depleted, and thus it will be imperative for the Kyrgyz economy to develop other types of export industries which can replace gold exports over the medium to long term. That will be harder to achieve if the real effective exchange rate remains overvalued.

Figure 18: Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) indices; August 2019-July 2023, 2010 = 100



Source: World Bank
 Note: An upward movement denotes an appreciation

58. **Gross international reserves fell by more than USD 700 million from their peak of USD 3.2 billion in September 2021 to USD 2.5 billion in August 2023.** This decline was due to the substantial sales of foreign currency by the central bank referred to above; had the central bank not intervened in the foreign exchange market to this extent, the exchange rate would have depreciated to narrow the overall BoP deficits. The projections made for the Article IV consultation show gross international reserves falling further over the medium term, to USD 1.6 billion by 2027, which is equivalent to the value of only two months of the subsequent year’s imports. That is not a sufficient buffer to support the BoP, especially in view of the volatility of the current account balance. It would be more prudent if the central bank were to refrain from intervening in the foreign exchange market to support the exchange rate, except in the few cases where it may be necessary to dampen excessive exchange rate volatility, and instead allow the market to determine the level of the exchange rate while gradually rebuilding international reserves over the medium term. The central bank could also sell its holdings of non-monetary gold on the international market and use the proceeds to rebuild its international reserves.

Inflation

59. **Headline consumer price inflation is projected to decline to around 10 percent by the end of 2023 and to average just over 5 percent in the medium term.** Weaknesses in consumer demand resulting from the contraction of remittance inflows, together with the fall of global food prices, should help to dampen inflationary pressures in 2023. There are, however, downside risks to these forecasts as there are factors which could impede the decline in inflation in either 2023 or the following year. First, electric tariff increases for households, announced by the government earlier this year, will directly raise the fuel price component of the CPI and feed through into headline inflation. This could be exacerbated by the recent rebound in global oil prices which will further raise domestic fuel prices. Second, the recent large increase in average monthly wages, of 21 percent from June 2022 to June 2023, may not yet have fed through fully into producer prices, but if it were to do so it would be likely to force firms to pass on their higher production costs to consumers by raising the prices at which they sell their products. Third, there is a danger that the rapid build-up of currency in circulation in the second half of 2022 and of bank deposits, which continued expanding in the first half of 2023, has not yet fully fed through to consumer spending and therefore demand-side pressures on inflation, but will do so later in 2023 or in 2024.

60. **There is also a risk that the persistence of inflation above the central bank's target range of 5-7 percent for more than three years has affected expectations as to how assertively the central bank will act to control inflation.** That could induce the private sector to expect that inflation will remain higher than its target in the future, with consequences for price and wage setting. If expectations of higher inflation become entrenched, it would make it harder for the central bank to bring down inflation and maintain it within the target range, especially given that the monetary policy transmission mechanism is weak. Inflationary expectations can be influenced downwards by the central bank through both its monetary policy actions and its communications with the public. The central bank should remain firmly focused on bringing inflation back within its target range through an appropriately tight monetary policy stance, which should include maintaining the policy rate at a positive real level as well as controlling the growth of reserve money.

Fiscal Policy

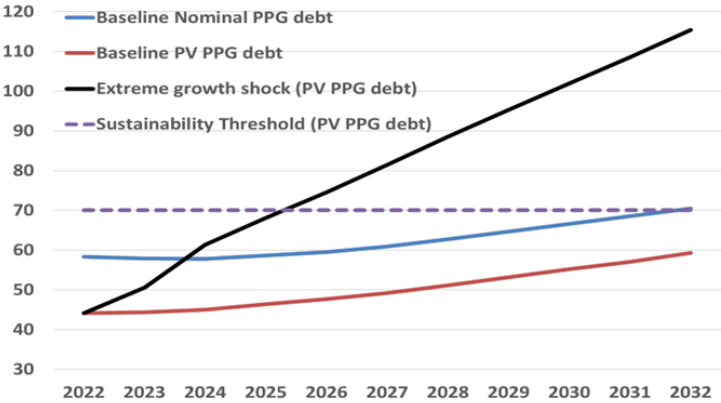
61. **Buoyant revenues are likely to strengthen the fiscal outturn in 2023.** Revenues are likely to exceed budget estimates because of the buoyancy of tax revenues. Tax collections had already reached 54 percent of the budget estimates after the first six months of 2023 compared to a historical average of 45-47 percent. If the buoyancy of tax revenues is maintained in the second half of the year, they are likely to exceed the budget estimates for 2023 by around 4 percent of GDP. Non-tax revenues were also very strong, relative to the budget estimates, in the first half of the year, but these revenues include major items which are irregular in terms of timing and so the first half collections do not offer a reliable guide for the rest of the year. On the expenditure side of the budget, the implementation of current expenditures is not out of line

with historical patterns (44 percent of the budgeted current expenditures took place in the first six months of 2023) but capital expenditures were running ahead of schedule. That would indicate that any expenditure overruns for the full year are likely to be relatively small as a share of total budgeted expenditures and are likely to be exceeded by the overperformance of revenues. In terms of shares of GDP, if expenditure outturns are roughly in line with budget estimates, as seems likely, current expenditures would amount to about 34 percent of GDP and capital expenditures to 6-7 percent of GDP. Total revenues would be in the region of 40-42 percent of GDP provided that the buoyancy of tax revenues does not subside in the second half of the year. Consequently, the overall fiscal balance is likely to be higher than the 1.2 percent of GDP deficit implicit in the budget estimates and may even be a surplus.

62. Over the medium term, the salary increases for government employees will constrain fiscal space. The policy changes implemented in 2022 to public sector salaries and social security entitlements will have a significant structural impact on the budget, raising current expenditures on a permanent basis. Furthermore, spending on goods and services in the recurrent budget, which provides the materials which public servants need to deliver public services, was squeezed in 2022 and in the first half of 2023, falling by nearly one percentage point of GDP to 4.2 percent of GDP, and that may not be sustainable without damaging the quality of public services. Hence it is likely that current expenditures over the medium term will be at least 32 percent of GDP. In contrast, it is likely that that the recent strong growth in revenues will not prove permanent because it has mainly resulted from one-off revenue payments (the arrears payments by Kumtor) and an expansion of the tax base, a large part of which is likely to be temporary (the imports for re-export to Russia). Hence, revenues and grants are likely to subside over the medium term to around 36 percent of GDP. That would leave very limited fiscal space for capital investment needed to support economic growth without a marked widening of overall fiscal deficits. For example, if capital expenditures plus on-lending average around 8 percent of GDP over the medium term (which has been the average over the last 10 years, excluding the pandemic year when construction activity was interrupted), overall fiscal deficits would be at least 4 percent of GDP and deficits of that magnitude would not be consistent with a stable public debt/GDP ratio (i.e. it would gradually push up the ratio).

63. The latest joint World Bank-IMF debt sustainability analysis (DSA) of November 2022 assessed the Kyrgyz Republic's risk of public and external debt distress to be moderate. All public and external debt ratios remain below their respective sustainability thresholds in the baseline trajectory. However, a customized stress test on exports causes a sustained breach for the debt-to-exports and debt service-to-exports ratios. Public debt is vulnerable to a growth shock. Under this shock, the debt-to-GDP ratio breaches the threshold in 2026 and continues a persistent upward trajectory. Moreover, the baseline projections include a steady rise in the nominal public debt/GDP ratio over the long term, to 71 percent of GDP by 2032, although the present value of public debt/GDP remains below the sustainability threshold (59 percent of GDP compared to a threshold of 70 percent). The main driver of the rise in the public debt-to-GDP ratio over the long term is the projected fiscal deficits of 4.6-5.5 percent of GDP. The DSA projections, up to 2032, for the nominal value and the present value (PV) of publicly guaranteed debt (PPG), along with the projected trajectory of the PV of PPG debt in a scenario involving an extreme shock to GDP growth modelled in a stress test (Figure 19).

Figure 19: Projections of nominal and PV PPG debt, baseline and extreme growth shock, and threshold for sustainability, 2022-32 (percent of GDP)



Source: Joint Fund/Bank DSA, 2022

64. **The structure of public debt is projected to change markedly over the next decade.** Slightly more than 80 percent of the nominal value of PPG debt at the end of 2022 was external debt, all of which was concessional. Over the long term, the government is expected to mobilize a larger share of its public borrowing requirement from the domestic financial market. As such, the share of domestic debt in the nominal debt stock is projected to rise from 20 percent in 2022 to almost 56 percent in 2032. Because domestic debt is mobilized on commercial terms and external debt is concessional, the shift in the composition of the PPG debt will lower its average grant element from 24 percent at the end of 2022 to 16 percent in 2032. From the fiscal standpoint, the shift in the composition of the public debt has both advantages and disadvantages. The main advantages are that it reduces the foreign exchange risk of the public debt portfolio, and it also gives the government more control over the mobilization of the finance needed to meet its borrowing requirement. The disadvantages are that it will raise the average interest rate on the debt, and thus the burden of interest payments to the budget, and it is likely to increase roll-over risk because the maturity of domestic debt instruments (treasury bills and treasury bonds) is mostly much shorter than that of concessional external loans.

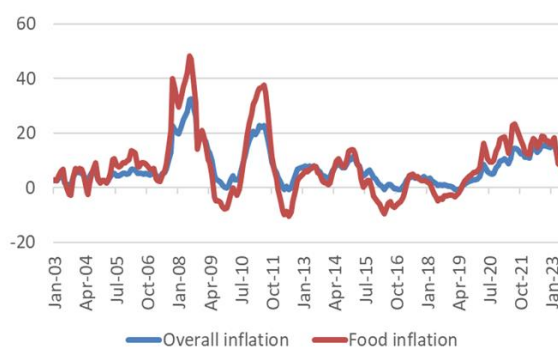
III. SPECIAL TOPIC: FOOD PRICE INFLATION IN THE KYRGYZ REPUBLIC

Introduction

65. **This part of the Economic Update provides an in-depth look at food price inflation.** Food prices have been a cause of serious concern in the Kyrgyz Republic in recent years, with the domestic food price index rising by a cumulative 57 percent in the three years to February 2023, after which it began to edge downwards.

66. **Food price inflation is an important issue for several reasons.** First, food prices have a major impact on household welfare because food comprises a substantial part – 63 percent on average – of the household consumption basket. Moreover, food comprises a larger share of the consumption basket of poorer households, hence the prices of food have a larger impact on the welfare of the poor than on non-poor households.²⁴ Second, food prices are a major driver of overall consumer price inflation. Third, food price inflation has historically been more volatile than non-food price inflation. This volatility mainly arises because food prices have been subject to severe, albeit infrequent, upward shocks; there have been three such shocks during the last 20 years including the latest episode referred to above (Figure 20).

Figure 20: Overall inflation and food inflation



Source: NSC

67. **The argument expounded in this special topic is the following.** Over the long term, the trend in food prices has not been problematic; average food price inflation over the last 20 years has been like that of non-food prices in the Kyrgyz Republic. However, food price inflation has caused severe short-term problems because it has been concentrated in episodic upward shocks or spikes, interspersed with generally longer periods of relative calm. These inflationary spikes are driven by supply-side shocks, mainly global food price shocks, although domestic supply shocks have probably been the cause of spikes in prices for some food products

²⁴ In addition, the poor have fewer savings or other liquid assets than the non-poor with which to cushion their welfare from food price inflation. Consequently, food price inflation matters greatly for the welfare of the poor and is likely to be a significant determinant of poverty, and especially the depth of poverty, at least in the short term. Hence, it is important to understand the drivers of food price inflation and to design policies which can help to control it, and, in particular, to dampen inflationary shocks to food prices.

which are not easily tradeable. Mitigating the adverse impact of these food price shocks on the welfare of the population will require some form of targeted social assistance.

68. **The rest of the special topic is organized as follows.** Section 2 discusses why food price inflation is so important in the Kyrgyz Republic. Section 3 examines the key trends and characteristics of food price inflation. Section 4 outlines key trends in the production and international trade of agricultural products. Section 5 analyses the main causes and drivers of food price inflation and especially the inflationary spikes. Conclusions and policy implications are discussed in section 6.

The Importance of Food Price Inflation in the Kyrgyz Republic

69. **Food price inflation matters crucially for the population of the Kyrgyz Republic given that food comprises a very large share of the household consumption basket.** On average, households allocate almost 63 percent of their total consumption expenditure to food items (Table 3). Furthermore, because food is a basic necessity and a minimum food intake is essential for human life, food consumption is income inelastic; hence, the poor have to allocate a much larger share of their total consumption to food than the non-poor. Food comprises 71 percent and 75 percent of the total consumption of the extreme poor in urban and rural areas, respectively, and 64 percent and 71 percent of the total consumption of the poor in urban and rural areas. For the non-poor in urban and rural areas, food accounts for 60 percent and 62 percent of their total consumption, respectively (Table 3).

Table 3: Percentage of food in total consumption and of individual food items within the total food basket

	Kyrgyz	Extreme poor		Poor		Non poor	
		Urban	Rural	Urban	Rural	Urban	Rural
Food consumption (% of total consumption)	62.7	70.9	74.6	63.5	70.7	59.9	62.3
Food consumption	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Bread and bakery foods	25.3	30.0	34.4	29.2	31.5	21.2	25.4
Milk and dairy produce	8.4	6.6	3.6	6.5	5.8	8.7	9.3
Meat and meat foods	22.4	25.5	24.2	23.9	21.2	24.0	21.4
Fish and fish foods	0.7	0.1	3.3	0.3	1.3	1.0	0.4
Vegetable oil, margarine and other fats	4.4	6.2	8.6	5.6	5.9	3.9	4.1
Eggs	2.2	2.7	2.6	2.6	2.2	2.4	2.1
Potatoes	3.8	4.9	4.7	4.8	4.6	3.3	3.7
Vegetables, melons and gourds	9.4	8.3	6.1	9.0	8.1	9.8	9.5
Fruits and berries	5.5	4.4	3.1	4.5	4.2	5.9	5.9
Sugar	6.0	4.4	4.0	5.1	5.6	6.1	6.1
Tea, coffee, cacao	1.5	2.3	1.5	2.1	1.4	1.9	1.2
Non-alcoholic beverages	0.8	0.4	0.1	0.3	0.4	0.7	1.1

Other food products	4.1	2.4	1.5	3.2	4.1	4.0	4.3
Alcoholic beverages	0.2	0.0	0.0	0.0	0.2	0.2	0.3
Tobacco	0.9	0.2	0.3	0.4	0.6	0.9	1.0
Eating out	4.4	1.7	2.1	2.8	3.1	6.0	4.1

Source: Kyrgyz Integrated Household Survey

70. **Food price increases severely affect the poor.** The large share of food in household consumption means that food price shocks unavoidably impose a significant cut in living standards, especially for the poor. In addition, food price shocks are relatively more harmful to the living standards of the poor and extreme poor because these groups of households do not generally have significant savings with which to cushion price shocks. Hence, most have no alternative but to reduce their consumption in real terms in response to a food price shock. For people already living in poverty, that imposes severe hardship.²⁵

71. **Food price inflation is an important contributor to overall price inflation through two channels, direct and indirect.** Because food has the largest share of the consumption basket from which the CPI is composed,²⁶ movements in food prices have a direct impact on the CPI. Second, food price inflation may indirectly affect that of other prices in the CPI, especially through its cost push impact on wages and thus on the producer prices of non-food product and services industries. Given that food prices matter so much for living standards, it is inevitable that rises in food prices will lead to demands for higher wages from workers, although how successful these demands will be in securing higher wages is likely to depend crucially on conditions in labor markets. For net food importer countries, food price shocks caused by aggregate supply shocks drive inflation and output in opposite directions (Adam, 2011). Hence, a supply shock which raises food prices is likely to pull output down. That would weaken demand for labor and thereby dampen the pass-through of food prices to wages and then to prices of non-food products and services.

72. **Bread and bakery products are the most important in the household consumption basket.** To understand the consequences of food price inflation for consumers, it is also pertinent to examine the composition of the overall food consumption basket in terms of the most important individual food items (Table 3). The most important item in the food consumption basket is bread and bakery products, which on average, accounts for around 25 percent of total food consumption expenditure for all households, and because it is the main staple food in the country, it accounts for a much larger share of the food consumption of the poor and extreme poor. The latter two groups allocate between 29 percent and 35 percent of

²⁵ Compton et al. (2010) reviewed the evidence of over 60 field studies on the impact of the 2007-09 global food price spike on poverty in developing economies. A key finding is that the main poverty impact of higher food prices was to intensify the poverty of households already living below the poverty line rather than to increase the numbers below the poverty line. The worst affected households were the poor in rural areas and those whose income was derived from the informal sector. There was strong evidence (e.g., from anthropometric measures) of increased malnutrition among the worst effected groups. Dorward (2012) found that increases in staple food prices have serious impacts on very large numbers of poor people in developing economies and on the depth of poverty as well as its incidence.

²⁶ The share of food and soft drinks in the CPI is 45.5 percent. This is almost 17 percentage points lower than the total for food consumption for all households shown in Table 3. Some of the difference is due to the fact that Table 3 includes some items—alcohol, tobacco and eating out—which are not included in the CPI weights, but these items together only account for 3.5 percent of total consumption. It is not clear what explains the remaining 13 percentage points of the difference between the data in Table 1 and the CPI weights.

their total food consumption to bread and bakery products, respectively, which is approximately 10 percentage points more than the non-poor. Because bread and bakery products are the single most important food item in the consumption basket, and even more so for the poor and extreme poor, we focus on this item in sections 3 and 4 of this report.

73. **The second most important food item in the household consumption basket is meat and meat foods, which accounts for between a fifth and a quarter of total consumption.** There are no major differences between income groups in terms of the share of their total food consumption allocated to meat and meat foods. The third and fourth most important items in the food basket are vegetables and milk and dairy produce, with overall shares of around 9 and 8 percent, respectively. For both of these products, the share in total food consumption is larger for the non-poor than for either the poor or extreme poor.

Trends and Characteristics of Food Price Inflation

74. **Food price inflation has been volatile compared to non-food and services prices inflation.** Over the long term, food price inflation rates have not, on average, differed much from non-food price inflation. The average rate of annual food price inflation during the last 10 years, July 2013 to June 2023, was 6.1 percent compared to 5.8 percent for non-food products and 5.1 percent for services in the same period. In the previous 10-year period, from 2003-2013, the average annual inflation rates for food, non-food products, and services were 10.3 percent, 8.1 percent, and 11.3 percent respectively (Table 4). However, food price inflation has been much more volatile than non-food inflation (Figures 20 and 21). The standard deviation of annual food price inflation during 2003-2013 was 13.7 percentage points compared to 5.3 and 8.1 percentage points for non-food products and services, respectively. Volatility of food price inflation was lower in the second 10-year period, from 2013-2023, with the standard deviation falling to 8.2 percentage points, although this was still double the standard deviation of non-food product inflation (4.1 percentage points) and more than double that of services inflation (3.1 percentage points). Most of the volatility was caused by three very prominent surges in food price inflation in the last two decades; from late 2007 to early 2009, when the peak was 48.2 percent, from late 2010 to late 2011, when the peak was 37.5 percent, and a less dramatic but more prolonged surge from late 2020 to the first half of 2023, during which the peak was 23.4 percent.²⁷

Table 4: Long-term average annual inflation rates and standard deviations: Food, non-food, and services, July 2003-June 2013 and July 2013-June 2023 (percent)

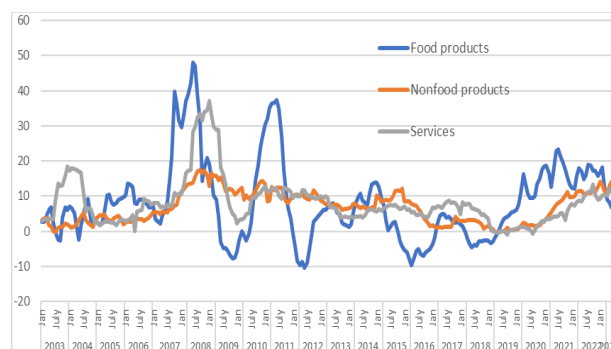
	July 2003-June 2013		July 2013-June 2023	
	Annual average	Standard deviation	Annual average	Standard deviation
Food	10.3	13.7	6.1	8.2

²⁷ The peaks in annual food price inflation occurred before the peaks in food prices in absolute terms. This is because after annual inflation had peaked, food prices continued rising in absolute terms, albeit at a decelerating pace, before prices began to fall and annual inflation turned negative.

Non-food products	8.1	4.6	5.8	4.1
Services	11.3	8.1	5.4	3.1

Sources: NSC and World Bank

Figure 21: Annual inflation rates of food products, non-food products and services, June 2003-June 2023 (percent)



Source: NSC

75. **It is worth noting that it is the spikes in food price inflation, which greatly exacerbated the impact of higher non-food inflation, that are so damaging to the welfare of the poor.** Over the last two decades, a characteristic of inflation in the Kyrgyz Republic is that during periods of high inflation, such as the late 2000s, early 2010s, and early 2020s, food price inflation has exceeded that of non-food products and services, sometimes by very wide margins. But during the generally much longer periods of low or moderate inflation, such as from 2015 to 2019, food price inflation has been lower than non-food price inflation (Figure 21).

76. **Vegetable prices are highly volatile.** It is also worth noting that vegetable inflation rates exhibit very high volatility (Figure 22 and Table 4). In fact, while the inflation rates for bakery and cereal products, meat, and dairy products, cheese and eggs show some co-movement through time, there appears to be very little correlation between the inflation rates of vegetables and the other three groups of food items. This observation might suggest that the primary drivers of vegetable price inflation are different from those of the other three groups of food items.

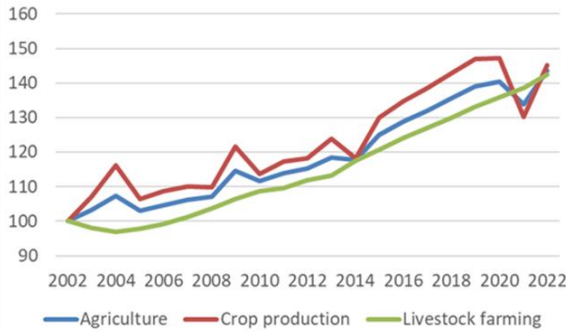
Food Production, Exports, and Imports of Food Products

77. **The Kyrgyz Republic’s food production systems satisfy the needs of only some of the country’s food demand.** Agriculture and the food industry are important sectors of the Kyrgyz economy, contributing to overall growth, and providing jobs and food security. These sectors produce both unprocessed and processed food products. The country’s major agricultural food products include grains (wheat, barley, corn), meat (lamb, beef), milk, eggs, fruits (apples, apricots, and others), berries, and vegetables (potato, onion, tomato, and others). Agricultural production increased by 43.5 percent over 2003-2022, with crop production and livestock farming increasing by 45 percent and 42 percent, respectively (Figure 22). In the last

ten years, there were sustained increases in annual production of vegetables, corn, meat, milk, eggs, fruits and berries, while production of potatoes, barley, and melons remained largely unchanged, and production of wheat declined (Figure 23a-23d). Moreover, crop production has been very volatile. There were sharp drops in output in 2005, 2010, 2014, and 2021. Production of wheat, barley, sugar-beet, fruits and berries and melons was especially volatile.

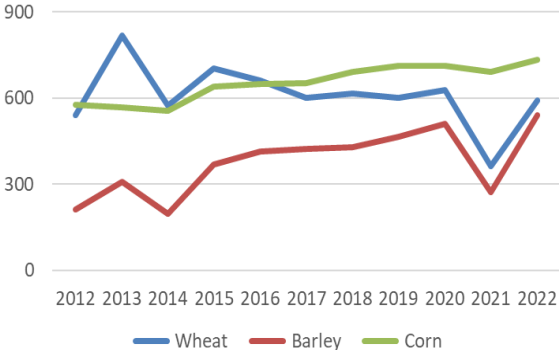
78. The Kyrgyz Republic relies on food imports, but it also has substantial food exports. With arable land comprising only 7 percent of total land area and low agricultural productivity, the Kyrgyz Republic is a consistent net food importer with imported food products accounting for about 60 percent of the consumer food basket (Figure 24). The composition of food exports and imports differs fundamentally. In essence, the Kyrgyz Republic imports a large share of the staple items, or the intermediate inputs needed to make them in the household food consumption basket (wheat, wheat flour, cooking oil, and sugar), while it produces domestically non-staple items (fruit and vegetables) which comprise a smaller share of the food consumption basket but which comprise the largest items in its food exports; in most years, vegetables and fruit comprise around half of total food exports by value.

Figure 22: Agricultural production volume index, 2002=100



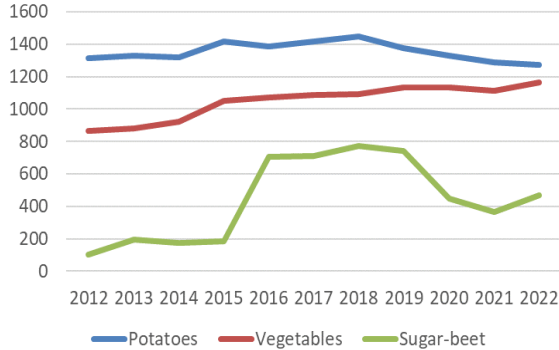
Source : NSC

Figure 23a: Production volume of wheat, barley and corn (thousands of tons)



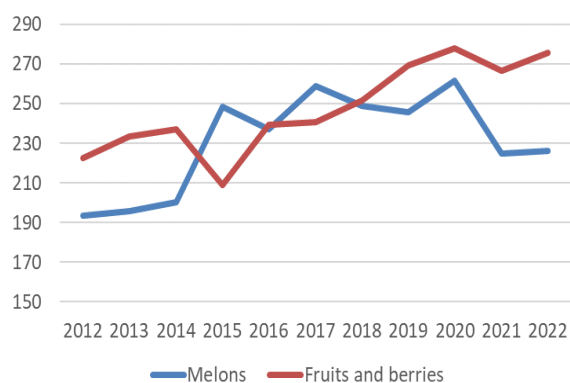
Source: NSC

Figure 23b: Production volume of potatoes, vegetables, sugar-beet (thousands of tons)



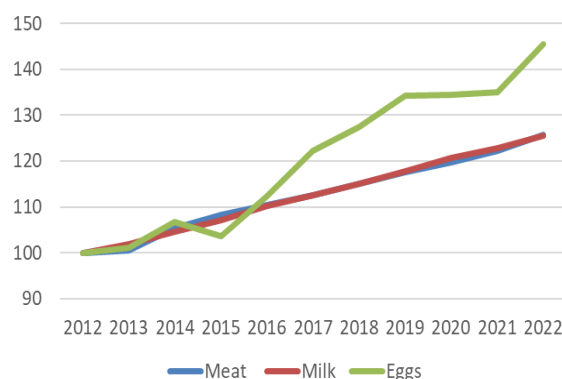
Source: NSC

Figure 23c: Production volume of melons and fruits and berries (thousands of tons)



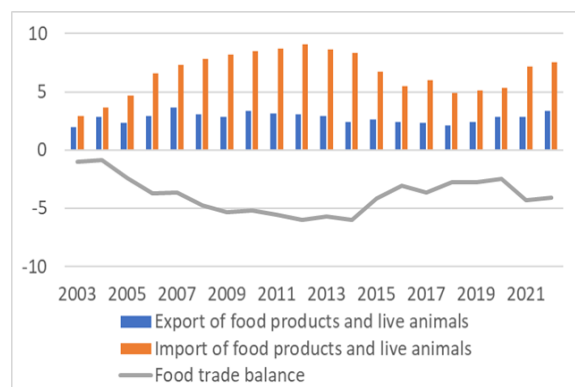
Source: NSC

Figure 23d: Production growth indices for meat, milk and eggs (2012=100)



Source: NSC

Figure 24: Exports, imports, and trade balance of food and live animals, 2003-2021 (percent of GDP)



Sources: NSC and NBKR

The Causes of Food Price Inflation

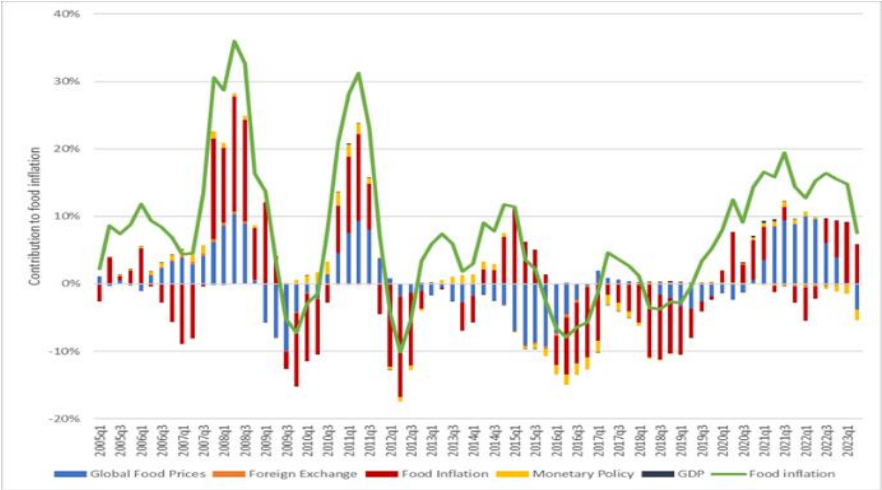
79. **Food price inflation has been driven by a range of factors, with supply-side shocks being the dominant factor.** This section analyses the likely determinants of food price inflation. As with most macroeconomic variables, it is unlikely that a single factor is driving food price inflation in the Kyrgyz Republic; rather, there are likely to be multiple factors influencing it. However, it is very likely, given the characteristics of food price inflation in the country (with inflation concentrated in episodic, relatively short periods of upward price shocks, in which food prices have risen much faster than the prices of most non-food goods and services), that the primary cause lies on the supply-side of food markets; i.e. the inflationary spikes are the consequence of supply-side shocks.

Estimates of the causes of food price inflation

80. **We estimate an econometric model to capture the impact of global food price inflation, inflation inertia, the monetary policy stance, exchange rate, and aggregate demand on domestic food inflation.** Specifically, we estimate a Vector autoregression (VAR)

model of the determinants of domestic food price inflation from the first quarter of 2005 to the second quarter of 2023. The explanatory variables considered were global food price inflation, four-quarter lagged food price inflation, changes in the nominal exchange rate, changes in GDP, and domestic monetary policy. The results of the analysis suggest that the most important determinants of domestic food price inflation are the global food price inflation rate and four-quarter lagged food inflation, especially during both high inflation periods of 2007-2009 and 2010-2011 and negative inflation periods of 2009-2010, 2015-16, and 2018-19 (Figure 25). The contribution of lagged food inflation and global food price inflation are estimated at 5.8 percentage points and 3.8 percentage points, respectively. The impact of nominal exchange rate movements appears to be neutral (which could be related to the central bank’s interventions to maintain the exchange rate stable during global price shocks). The central bank’s monetary policy appears to have had little impact for the most of part except during 2016-17. Overall, this decomposition of food price inflation suggests that the food price inflation spikes were mainly driven by supply shocks while demand factors, expressed as nominal GDP, were a much smaller factor.

Figure 25: Decomposition of the determinants of food price inflation, Q1 2005 – Q2 2023



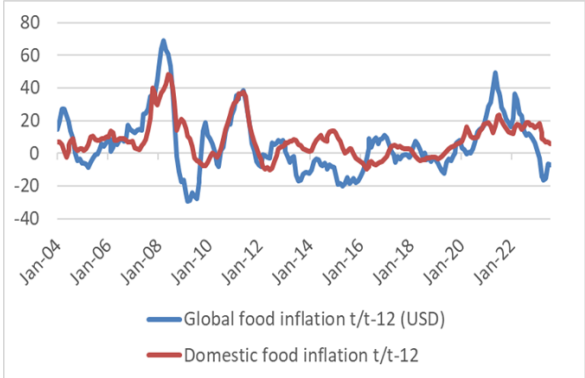
Source: WB staff

Note: The decomposition is derived from a sign-restricted Bayesian VAR model with normal diffuse priors that includes real GDP, lagged domestic food price inflation, global food price inflation, policy interest rates, and the nominal exchange rate. Shocks are as expressed as deviations from a model-determined initial condition. All variables are expressed as growth rates; i.e. difference of logs. Nominal exchange rates are expressed in terms of quarterly growth rates. GDP and inflation growth rates are expressed as year-on-year changes. The global food price is IMF global food price index and expressed as year-on-year inflation rate.

81. **At the aggregate level, external supply price shocks appear to be the dominant driver of domestic food price shocks.** Supply-side shocks to food prices can entail both domestic and external supply shocks. Which particular type of shock is the most prominent will usually be determined by the characteristics of the specific food item, especially whether or not it is a tradeable good. The prices of non-tradeable food items are much more vulnerable to fluctuations in domestic production of these items whereas the prices of tradeable food products are heavily influenced by the international prices of these products (unless they are subject to

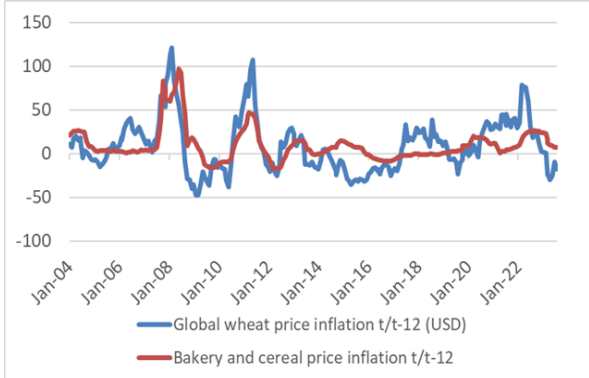
stringent import and export controls, which is not the case in the Kyrgyz Republic). In the Kyrgyz Republic, although both domestic and external price shocks have affected domestic food prices, the dominant factor has been external supply price shocks. Domestic annual inflation rates were quite closely correlated with inflation in the FAO’s USD global food price index, especially during periods of stress in global food markets when global food price inflation was very high (Figure 26). During the first of the three food price spikes that have occurred in the last 20 years in the Kyrgyz Republic, annual food inflation peaked at 48 percent in June 2008; at the same time, the annual inflation in the FAO global USD food price index was 61 percent. During the second domestic food price spike, annual food price inflation peaked at 37 percent in June 2011 compared to an annual rise in global USD food prices of 38 percent. In the final domestic food price spike, in the early 2020s, domestic food price inflation peaked at 23 percent in July 2021 compared with a global USD food price inflation rate of 37 percent at the same time. Over the entire 20 year period of 2003-2023, the correlation between annual changes in the FAO’s global USD food price index and the domestic food price index is quite high; the correlation coefficient is 0.71.²⁸ The strong correlation between global food price inflation and domestic food inflation, and to a slightly lesser extent headline inflation, is a feature of other Central Asian economies as well as most other EMDEs (Al-Eyd and others, 2012).

Figure 26: Annual inflation rates for global USD food prices and Kyrgyz domestic food prices, January 2004-June 2023 (percent)



Source: FAO and NSC

Figure 27: Annual inflation rates for global USD wheat prices and prices of bakery and cereal products in the Kyrgyz Republic, January 2004-June 2023 (percent)



Source: FAO and NSC

82. **Exchange rate depreciation was not a major driver of domestic food price shocks.** Depreciation of the nominal exchange rate made very little, if any, positive contribution to the pass-through from USD global food prices to KGS domestic food prices. In the first two episodes of food price spikes the nominal KGS/USD exchange rate actually appreciated over the 12-month period leading up to the peak in annual domestic food price inflation. In the most recent episode, there was a depreciation of the nominal KGS/USD exchange rate of 9.5 percent in the 12 months prior to the peak in domestic prices, but that is not large enough to account for

²⁸ The global USD food price annual inflation rate was lagged by two months to derive the correlation co-efficient in order to allow time for the pass-through of changes in global food prices to domestic food prices. The correlation coefficient with a two-month lag is higher than that without a lag and that with a lag of one month.

most of the domestic food price inflation and is only slightly more than one quarter of the magnitude of the change in USD global food prices.

83. **Next, we look in more detail at the probable causes of price inflation of two of the most important food items in the consumption basket: bakery and cereal products, and vegetables.** There is considerable difference between these two groups of items with respect to the characteristics of the items or the raw materials needed to produce the finished product and the structure of the domestic market. These features influence the causal factors of price inflation of these items.

Bakery and Cereal Products

84. **The main ingredient of bread, the main staple food in the Kyrgyz Republic, and other bakery products is wheat.** Wheat is a highly tradeable product with import prices determined on the international market plus a markup for logistics costs. Wheat is grown in the Kyrgyz Republic but domestic supplies must be supplemented by imported wheat (which is milled in the Kyrgyz Republic) and, to a lesser extent, imported wheat flour for two reasons: First, the quantity of wheat grown domestically is not large enough to fully supply the domestic market; and second, the quality of the wheat flour obtained from domestically grown wheat is generally poor and as a consequence it must be blended with flour from imported wheat in order to bake bread. During 2016-22, the quantity of wheat imported comprised around 29 percent of the wheat (domestically grown and imported) processed in the Kyrgyz Republic for use in bakeries and by households, and this was also supplemented by imported wheat flour. The combination of these three factors – the international tradability of wheat, the necessity to blend flour from imported wheat with flour from domestically grown wheat, and the role of imported wheat in ensuring that the domestic market is fully supplied – suggest that the price of wheat imports will be a major factor determining the producer price of bread in the Kyrgyz Republic and through that the price of bread charged to the consumer.

85. **Domestic consumer prices for wheat-based items were correlated with global wheat prices but were less volatile in periods of global stress on wheat prices.** The trends in the annual inflation rates of global USD wheat prices and of domestic consumer prices for bakery and cereal products are quite closely correlated with a two-month lagged correlation coefficient of 0.68 but the Kyrgyz consumer price inflation series is less volatile than that of global wheat prices inflation (Figure 27). In particular, although there were spikes in bakery and cereal product price inflation in 2008 and 2011, and a much shallower one in 2021-22, they were far less severe than the global wheat price spikes. In the periods of very high global wheat price inflation, the pass-through to consumer prices on the domestic market for items for which wheat is an input was partially muted.

86. **Two factors probably account for the partially muted pass-through of global wheat prices to domestic consumer prices of wheat-based products during periods of global wheat price stress.** First, wheat is not the only element in the cost function for bread, although it is undoubtedly one of the largest. Millers and bakeries incur the costs of energy and capital as well as the wages of their workers, and these costs do not necessarily move in tandem with global wheat prices, especially in periods of severe shocks to the latter. Second, there were

some administrative controls on the price of bread sold in the Kyrgyz Republic alongside temporary measures to reduce the producer price of bread, and these will have constrained upward movements in consumer prices during periods when global producer wheat prices were rising sharply.²⁹ Hence it is reasonable to conclude that while global wheat price inflation has a major influence on the domestic consumer price inflation of wheat-based products through its impact on input costs, it is not the only factor determining domestic inflation.

Vegetables

87. **Domestic factors may be the most important determinants of vegetable price inflation.** Vegetable price inflation has been more volatile than that of other major items in the food consumption basket and the former is only weakly correlated with that of other major items, suggesting that factors specific to the growing or marketing of vegetables are the primary determinants of vegetable price inflation. Vegetables are grown domestically and exported as well as consumed domestically; exports comprised 30 percent of domestic production on average during 2012-2021 whereas imports were negligible.

88. **Sales of vegetables on the domestic market have been more volatile than production.** The annual volume of sales of vegetables to the domestic market was quite volatile during 2012-2021, with a standard deviation of 18 percent, which was higher than the standard deviation of annual vegetable production. It is likely that vegetables for export are mainly grown on modern commercial farms that have the capacity to comply with the required rigorous standards for quality and reliability of supply to secure export contracts, while much of the domestic supply of vegetables is grown by smaller farms with less advanced technology, which impedes reliability of supply (e.g. they do not use irrigation). That could explain why annual sales to the domestic market are more volatile than total domestic production of vegetables. Annual data may also mask within-year volatility and so may underestimate the actual volatility of supply to the domestic market.

89. **Volatile supplies to the domestic market could explain the very high price volatility exhibited by vegetables over the last two decades.** Vegetables are perishable goods which are costly to store and preserve. Demand for vegetables, like that of other food items, is relatively price inelastic, hence any significant over or under supply of vegetables to the domestic market should generate price falls or rises, respectively, given the limited opportunities to export surpluses or cover deficits with imports. It is difficult, however, to demonstrate empirically that this is the case. This is because there are only annual data available on the production and sales, by quantity, of vegetables, whereas much of the vegetable price inflation swings are of short duration and masked to some extent by the annual inflation data. Consequently, the correlation between output and inflation data, at the annual level, is correctly signed (i.e. negative) but the correlation coefficient is only 0.28. The two years when there clearly was a strong negative correlation were 2015 and 2021. In the former, the quantity of sales to the domestic market increased by 39 percent and average vegetable price inflation

²⁹ Administrative measures to control food inflation during 2007-2008 included the following: i) the VAT threshold for flour and bread producers and importers was increased; ii) profit margins for large flour producers were monitored by public regulators; iii) there were sales from the State Grain Reserve Fund; and iv) bread was sold to pensioners at subsidised prices (Al-Eyd et al., 2012, Annex 2, Table A2.1).

during the year was negative 10 percent. In the latter year, the quantity of sales to the market fell by 12 percent and average vegetable price inflation was 33 percent. In contrast, there were price spikes in 2014 and 2017 (with average inflation of 18 percent and 37 percent, respectively), but in both years sales to the domestic market actually increased, by 10 percent and 8 percent, respectively. Hence, while economic theory indicates that domestic supply factors should be a major driver of vegetable price inflation, the empirical evidence to demonstrate this is not conclusive.

IV. POLICY RECOMMENDATIONS

90. **International experience has shown that the most effective way to handle price spikes in food items is an effective system of social protection to protect the poor.** Policy interventions should aim to mitigate the impact of unmanageable food price shocks on the poor especially without attempting to control prices. With a well-functioning social assistance scheme and comprehensive coverage of the poor, in addition to regular targeting, temporary supplementary payments could be made to more rapidly and adequately compensate the poor during periods of food price shocks (Amaglobeli and others, 2023). Another option might be a subsidized school feeding program, which could help to protect children from lower-income families.

91. **An effective social assistance scheme needs to be put in place and be well-functioning before the next food price crisis occurs.** This would require both a comprehensive database of poor households to determine eligibility and the administrative structures to reach all poor families, including those living in remote areas.³⁰ Adequate funding from the central government budget will also be needed, with contingency funds of sufficient magnitude made available in the event of a severe price shock.

92. **Focusing policy support on targeted social assistance is less fiscally costly than alternative policy measures.** Because focusing the policy response to a food price shock on targeted social assistance is, by definition, targeted, it will entail fewer budgetary resources than more broad-based measures which deliver the same net benefits to the poor, such as a universal food price stabilization scheme. The latter would require budget subsidies to food producers, such as bakers and traders, together with some form of retail food price control or creating stocks of basic food products in order to sell them at prices below market prices during the food price spikes. It would not necessarily be effective in delivering subsidized food to the poor, especially in remote areas, and would offer incentives for the smuggling of subsidized food across borders. Therefore, countries are generally advised to avoid subsidizing food companies or stockpiling basic food products to stabilize food prices.

93. **Notwithstanding protection for vulnerable groups, allowing economic agents to adjust to the price shock avoids risks of compounding problems.** Targeted social assistance programs, unlike broad-based price stabilization schemes, allow domestic relative prices to adjust to the food price shock. This gives economic agents – producers and consumers – incentives to adjust production and consumption decisions. Although the extent to which such adjustments are possible in the short term is limited – food demand is price inelastic and food production is mostly very inelastic in the short term – even limited adjustments are of value. For example, for a net food importer such as the Kyrgyz Republic, when faced with a global

³⁰ In the Kyrgyz Republic, almost half of the population live in households receiving at least one type of social transfer (including pensions). The share of transfer recipients is the largest among the poorest 20 percent of the population – more than two thirds of them benefit from a transfer. Pension coverage is almost universal with very few of the elderly depending on social pensions (i.e. those with no contribution history). In social assistance, only 12.5 percent of the bottom quintile of households benefited from the monthly benefit for poor families program and an estimated 60 percent of children in the poorest quintile were not covered. Further, the program only covers 5 percent of consumption expenditures of households in the bottom quintile, one of the lowest adequacy levels in East Europe and Central Asia.

wheat price shock, allowing the higher global wheat prices to feed through to domestic prices would encourage consumers to substitute wheat-based products with alternative staples, thereby reducing the impact of the price shocks while allowing domestic wheat farmers to benefit from higher prices.

94. **Stabilizing inflation following a major food price shock may call for monetary policy tightening.** By raising prices, food supply shocks may necessitate tighter monetary policy to avoid inflation becoming more generalized. Monetary policy cannot prevent a rise in food prices because it is caused by supply-side factors rather than those on the demand side of the economy,³¹ but it can dampen the pass-through to other prices. Food price shocks are usually temporary because the supply-side factors are generally of short duration (e.g., bad harvests in major global grain exporters), but if food inflation is passed through to core inflation, inflation can be more persistent, hence calling for a monetary response. This is all the more pertinent for a country like the Kyrgyz Republic where food accounts for a large share of consumption and price increases may lead to immediate upwards pressure on wages.

95. **The stabilization of food prices can benefit from supply-side measures to address market failures and improve the overall performance of the agricultural sector.** These include, among others, improving the functioning of input markets and service provisions (for example, agricultural advice, transport, and marketing services), reducing high transaction costs (associated with access to essential inputs and services such as water, electricity, extension services, and logistics), and addressing information asymmetries leading to weak linkages between small farms and enterprises. Government interventions in these areas are needed to improve the access of small farmers and agri-food processors to markets, to create more opportunities to capture value, and to improve their livelihoods. In the medium to long term, the policy focus should be on promoting private investments in cold storage chains and other logistics infrastructure, which would reduce the seasonality and volatility of vegetable and other food prices. To crowd in more private investment, the government can provide matching grants and/or long-term credit lines.

³¹ The same principle applies if the economy suffers a fuel price shock. The core items of the CPI are usually defined to exclude items whose prices are volatile and mainly determined by supply-side factors, especially food and fuel. Inflation in the prices of the core items of the CPI is termed “core inflation”.

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