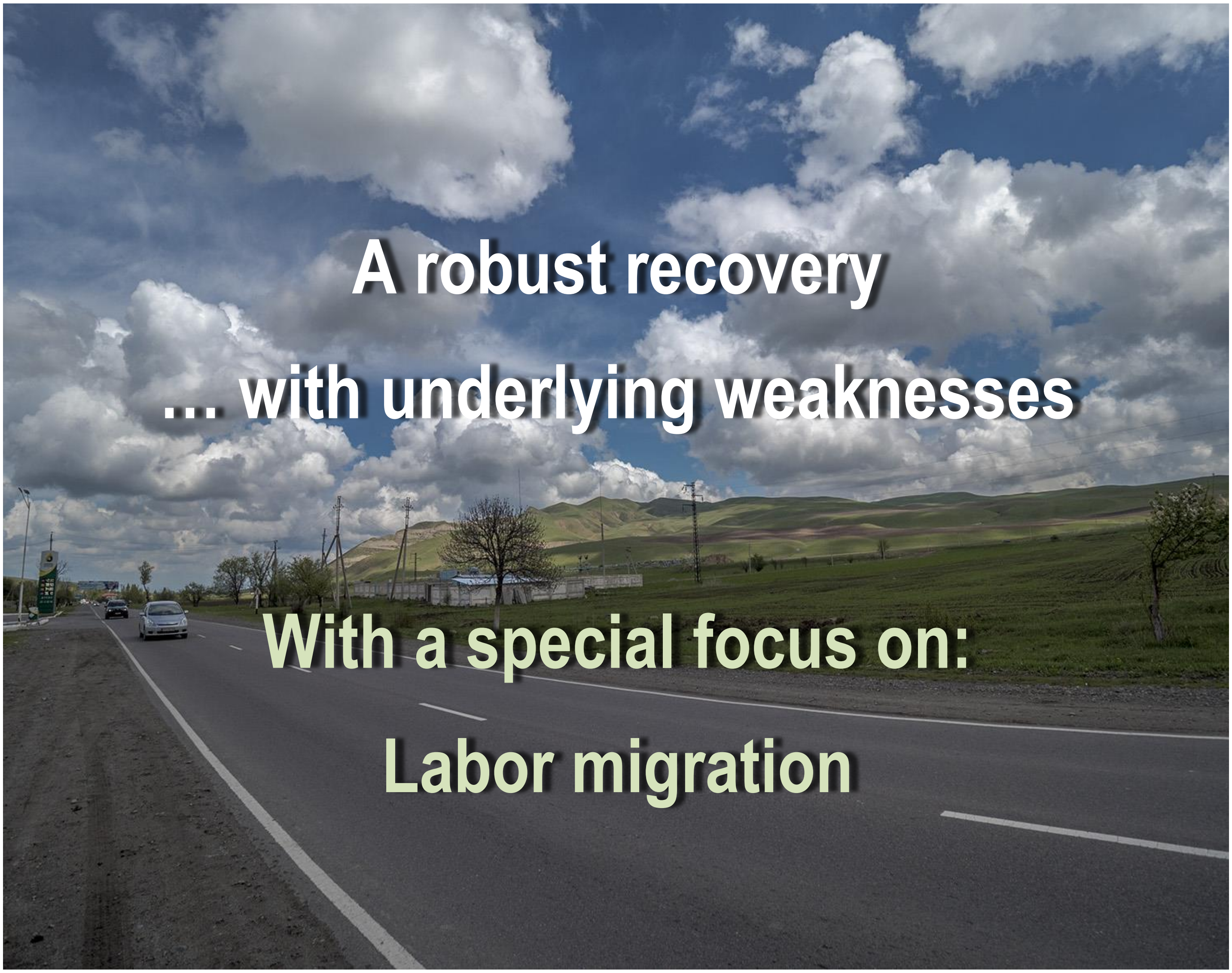
KYRGYZ REPUBLIC

Economic Update
Fall/Winter 2017



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KYRGYZ REPUBLIC:

A robust recovery
… with underlying weaknesses

With a special focus on Labor migration

Kyrgyz Republic Economic Update No. 6

Fall/Winter 2017

Government Fiscal Year:	January 1 – December 31
Currency Equivalents:	Exchange Rate Effective as of September 30, 2017 Currency Unit = Kyrgyz Som (KGS) 68.6069 KGS
Weights and Measures:	Metric System

Abbreviations and Acronyms

EEU	Eurasian Economic Union
GDP	Gross domestic product
GoKR	Government of the Kyrgyz Republic
KGS	Kyrgyz Som
NBKR	National Bank of the Kyrgyz Republic
FDI	Foreign Direct Investment
US dollar	United States dollar
VAT	Value-added tax
TB	Trade Balance
GNI	Gross National Income
PIP	Public Investment Project
KIHS	Kyrgyz Integrated Household Survey
IMF	International Monetary Fund

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Foreword

This edition of the Kyrgyz Republic *Country Economic Update* was prepared by Bakyt Dubashov (Senior Economist) and Aurélien Kruse (Senior Economist) with the help of Saida Ismailakhunova (Poverty Economist) on the Social sector section.

The first part of the Economic Update analyzes recent macroeconomic trends and presents an assessment of the country's short- and medium-term outlook.

The Special Focus Section discusses recent trends in labor migration and the implications of remittance dependence for macroeconomic policies.

The report benefited from comments and guidance by Maria Gonzalez-Miranda (Practice Manager) and Julio Revilla (Lead Economist for Central Asia). Zhypara Azhykanova (Team assistant) provided editorial support.

We hope you find it useful and welcome your comments!

Maria Gonzalez-Miranda

Practice Manager

Macroeconomics, Trade and Investment

Global Practice

Overview

The Kyrgyz Republic has had a peaceful transition of power.

Presidential elections were held on October 15, 2017. Mr. Sooronbai Jeenbekov, the new President, announced that he would extend the reform programs and development strategy of his predecessor—a welcome development that should help ensure continuity in this process. Another notable development was that the amendments to the Constitution that came into force on December 1, 2017 shifted some of the President's power to the Government through the Prime Minister's figure, while the Parliament's oversight role has been strengthened.

The Kyrgyz economy performed robustly over 2017.

The Kyrgyz economy appears to have recovered from the 2014-15 external shocks. Over the first 9 months of 2017, real GDP expanded by 5 percent, year-on-year, thanks to improvements in the external environment and a continued expansionary fiscal policy, which were mirrored by a strong gold production and a strengthening in domestic demand. The current account balance also improved markedly, led by significant gold exports and continued growth in remittances, following a dramatic drop in 2015 mainly as a result of the recession in Russia.

Macroeconomic policies were supportive to growth, but the fiscal stance has deteriorated significantly and inflation has tilted upwards.

Macroeconomic policies have been expansionary, fueling economic activity but coming at the cost of continued fiscal imbalances and increased public debt. The monetary stance remained relaxed. Growth in credit to the economy accelerated, and private sector activity has responded to policy incentives. The exchange rate remained broadly stable, supported by the improved current account balance, while the currencies of neighboring countries continued experiencing depreciation pressures. On the fiscal side, capital spending, as well as recurrent spending continued to be high, especially in the lead-up to the Presidential elections and including one-off emergency expenditures. This means that onward adjustments will need to be higher to rebuild fiscal buffers to withstand future shocks and to maintain debt sustainability. With more buoyant domestic activity and accommodative monetary policy, inflation increased.

Growth is estimated to have decelerated toward the end of 2017, and expected to pick up in 2018.

For 2017 as a whole, growth is estimated at 3.5 percent. With gold production slowing down due to geological factors, economic activity is estimated to have moderated in the second half of the year. Over the medium-run output growth is expected to converge toward potential, slightly above 4.0 percent. This assumes continued inflows of remittances supporting domestic consumption, a moderation of the fiscal expansion and a negative contribution from net exports.

The economy will remain dependent on remittances.

The economy is expected to remain dependent on remittances. Private inflows will continue to support household incomes and boost domestic demand, but they also come with challenges. Indeed, large remittances inflows can undermine the country's competitiveness through a phenomenon similar to that of the well-known as "Dutch Disease", in which the impulse of foreign exchange inflows into domestic demand can generate a significant real exchange rate appreciation, unless macroeconomic policies play a countercyclical role. In addition, the high dependence on remittances heavily exposes the country to external shocks. The Special Focus section of this report examines these issues in greater detail, while highlighting the main policy options available to the authorities.

A. Recent Socio-Economic Developments

Growth and inflation

The Kyrgyz economy performed strongly in the first 9 months of 2017.

An improved external environment, expansionary fiscal policy and a robust performance of the gold sector fueled growth during the first three quarters of the year. Real GDP expanded by 5 percent in January-September, year-on-year (y-o-y) (Figure 1). This solid performance, however, was largely driven by gold production and the improvement in external conditions. Non-gold output expanded more modestly at 3.6 percent, only slightly higher than in the same period of 2016.

Industry drove output on the production side…

On the production side, growth was mainly driven by industry - both gold and non-gold - compensating for a slowdown of agriculture and construction and flat growth in services (Figure 2). Industry grew strongly by 21.2 percent between January and September, y-o-y, (vs. a decline of 14 percent a year before). Gold sector growth reached 18.3 percent, y-o-y, reflecting a front-loaded production cycle compared to the previous year.[1] Non-gold industry growth reached 24.7 percent driven by mining, food industry and electricity generation, which grew by 94 percent, 15.8 percent and 12.3 percent, y-o-y, respectively.

…and consumption and exports on the demand side.

On the demand side, private consumption and net exports were the main contributors to output. The former was supported by continued growth in remittances inflows, and the latter reflected high gold exports, increased external demand and progress made by Kyrgyz producers in complying with Eurasian Economic Union (EEU) standards. Meanwhile, investment growth is estimated to have been positive, thanks to continued increases in public investment (Table 1).

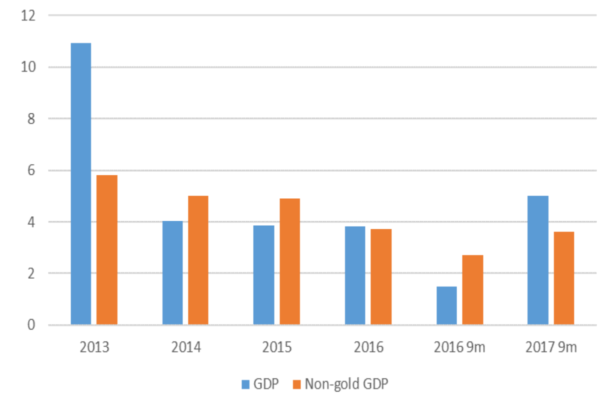
Table 1: Key macroeconomic indicators, 2014-2017

	2014	2015	2016	2016 (9m)	2017 (9m)
Real GDP (growth in percent)	4.0	3.5	3.8	1.5	5.0
Non-gold real GDP (growth in percent)	5.0	4.5	3.7	3.1	3.6
Real gold sector (growth in percent)	-5.8	-8.3	5.0	-28.3	18.3
Consumption (growth in percent)	2.4	-0.7	1.9	2.1	2.2
Investment (growth in percent)	15.7	-2.3	0.4	-0.4	0.1
Inflation (eop, in percent)	10.5	3.4	-0.5	-0.3	3.3

Source: National Statistics Committee and Bank staff estimates.

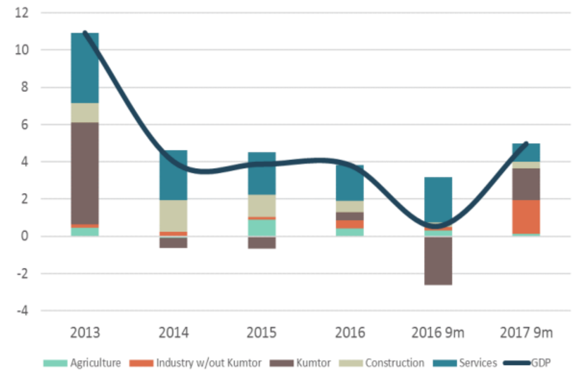
[1] Unlike its usual production cycle, gold production in 2017 was front-loaded due geological factors at the Kumtor gold mine.

Figure 1: Real GDP growth (percent)



Source: National Statistics Committee.

Figure 2: Contribution to growth (percentage points)

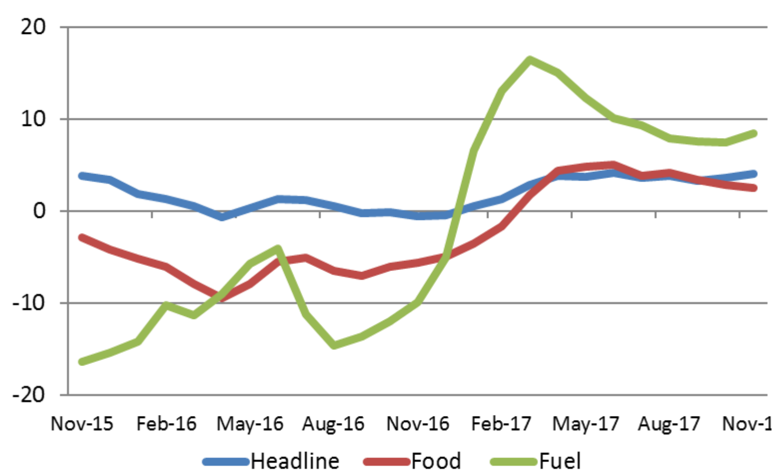


Source: National Statistics Committee.

Inflation returned to positive territory with economic activity rising.

Increased domestic demand fueled by remittances, jointly with loose monetary and fiscal policies, put pressure on consumer prices. In the first half of the year, this was compounded by an increase in exports of fruit and vegetables that limited domestic supply. As a result, 12-month inflation rose to 4 percent as of end-November 2017, following a deflation of 0.5 percent at the end of 2016 (Figure 3). While consumer prices rose across the board, the more noticeable increases were seen in food and fuel prices, which rose by 2.5 percent and 8.4 percent, respectively.

Figure 3: Inflation (percent)



Source: National Statistics Committee.

External sector

External trade volumes increased…

Following a fall in 2016, exports generally performed strongly in 2017. Exports in US dollar terms increased by almost 15 percent in the first 9 months of 2017 compared to a 3.1 percent decline in the same period the previous year (Figure 4). While the recovery was mainly driven by gold (contributing to about 60 percent of total export growth), non-gold export performance also improved. Specifically, food and textile exports grew, reflecting a pull effect from increased external demand and a push effect, as Kyrgyz producers stepped up compliance with EEU quality standards.

… with growing exports to regional markets.

Exports have increased to Russia (by 48 percent), Uzbekistan (by17 percent), Kazakhstan (by 16 percent), China (by 83 percent) and Switzerland (by 11 percent, gold); although they have fallen to Turkey (by 10 percent).

At the same time, the increase in imports was more moderate.

Total imports rose by 8.1 percent (in US dollar terms) in the first 9 months of 2017, y-o-y, albeit slower than might have been expected given the rebound in remittances and high levels of public investment. Significant import increases were seen from Russia (6 percent), Uzbekistan (159 percent), Turkey (21 percent) and South Korea (151 percent). While the import structure remained broadly unchanged, there was an increase in imports of food, consumer goods, medication and used cars.

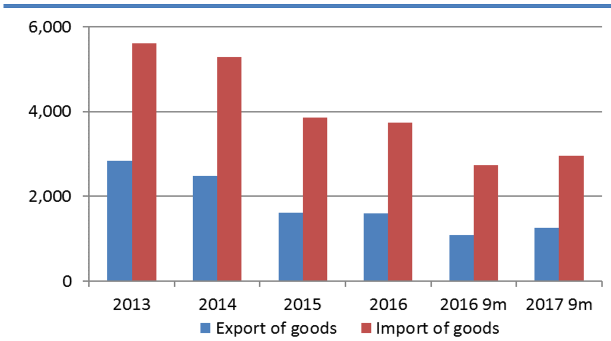
The trade balance improved slightly…

The trade deficit (annualized) declined to US$2.1 billion in June 2017 from US$2.3 billion a year before, as export growth outpaced the increase in imports. As a share of GDP, the trade deficit shrunk more noticeably - to 32.8 percent of GDP from 36.7 percent a year before (Figure 5).

… and the current account deficit narrowed significantly.

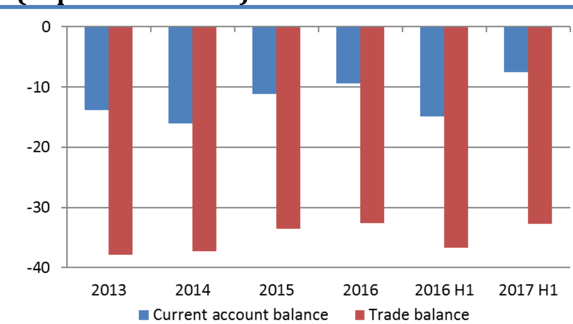
Reflecting the lower trade deficit and, to a larger extent, the continued recovery of remittances, the current account deficit narrowed significantly. It shrank to 7.6 percent of GDP (annualized), from 14.9 percent a year before (Figure 5); private transfers (mostly remittances) grew by about 30 percent in US dollar terms. The current account deficit was financed by foreign direct investment (FDI) and public borrowing; FDI (annualized) amounted to US$428 million and public borrowing was US$181 million in June 2017.

Figure 4: Exports and Imports (in millions of US$)



Source: National Bank.

Figure 5: Trade and Current Account Balances (in percent of GDP)



Source: National Bank.

Financial sector

The banking system is strengthening.

The banking system continued to expand reflecting increased activity in the real economy. The banking sector dominates the financial system in the Kyrgyz Republic, accounting for almost 90 percent of total loans, mainly concentrated in trade and agriculture (29 percent and 22 percent, respectively). As of end-September 2017, the nominal assets of the banking sector expanded by 6.9 percent, y-o-y, to 190.7 billion soms (while remaining unchanged at 40 percent as a share of GDP). This was mainly driven by loans, which grew by 15.6 percent, y-o-y, reflecting high demand for real sector activity financing. The banks also increased their holdings of government papers (reaching 18.6 billion soms) in response to increased supply by the government. The increase in assets was counterbalanced mainly by growth in deposits (18.6 percent, y-o-y), settlement accounts (23 percent, y-o-y) and capital (9.6 percent, y-o-y). [2]

Dollarization decreased slightly.

The dollarization level of loans and deposits declined slightly, though remained significant, suggesting that confidence on the local currency could be strengthened. Loan dollarization stood at 41.6 percent as of end-September 2017, down by 2.6 percentage points in the previous year; and deposit dollarization fell to 45.2 percent, down by 5.9 percentage points.

Banking stability indicators remained robust.

Overall, banking sector performance indicators remained robust, suggesting a healthy financial system. The capital adequacy ratio declined slightly to 23.8 percent as of end-September 2017 from 24.5 percent a year before, but still well above the statutory requirement of 12 percent. The liquidity ratio also declined to 65.8 percent from 77 percent a year before, but remained in excess of the required level of 45 percent. Both returns on asset (ROA) and returns on equity (ROE) appear to have risen to 1.1 percent (0.3 percent a year before) and 7.2 percent (1.9 percent a year before). The non-performing loans ratio improved slightly to 8.1 percent as of end-September, 2017, down from 9 percent a year earlier, but still high compared to pre-2016 levels.

Social sector

Poverty declined due to low food prices and remittances inflows.

According to official statistics, the absolute poverty rate was 25.6 percent in 2016 (the latest available estimate) (Figure 6). Lower food (domestic and external) prices in 2016 positively impacted the purchasing power of households, especially those at the bottom of the income distribution. Real labor incomes per capita grew by about 8 percent and, with higher remittances inflows boosted households' consumption. Significant spatial disparities existed in poverty reduction. The poverty rate declined significantly in cities such as Bishkek and Jalal-Abad due to stronger economic growth and more buoyant trade activity, while it increased in Chui oblast.

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[2] The corresponding accounts with commercial banks abroad appear to have fallen by one-third due to a delay of the Kyrgyz Republic to implement the Financial Action Task Force (FATF) recommendations—in line with the phenomenon known as "de-risking".

While poverty is falling, about 1.6 mln. people are still poor.

Around 1.6 million out of a total population of 6 million lived below the poverty line of 31,151 soms per year per capita.[3] Extreme poverty continues to be low and was equal to 0.8 percent of the population, corresponding to about 49 thousand people unable to afford a minimum basket of food (estimated at 17,052 soms per year per capita). Eight people out of ten extreme poor live in rural areas.

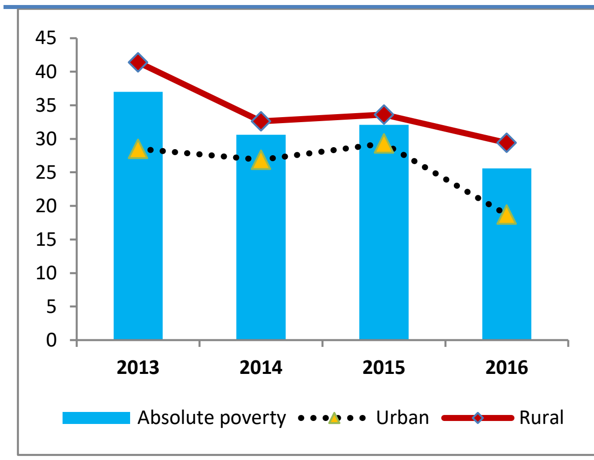
Growth was pro-poor and prosperity was broadly shared.

Prosperity was broadly shared and accompanied by a decline in inequality. In 2016, the Gini coefficient decreased from 0.24 to 0.21, largely due to an improvement in urban areas. Over the same period, the consumption growth of the bottom 40 (B40) percent averaged more than 5 percent, compared to 3 percent for the population as a whole, and was therefore much faster than that of the top 60 percent (T60) (Figure 7).

Agriculture and services continue to be main employment sectors

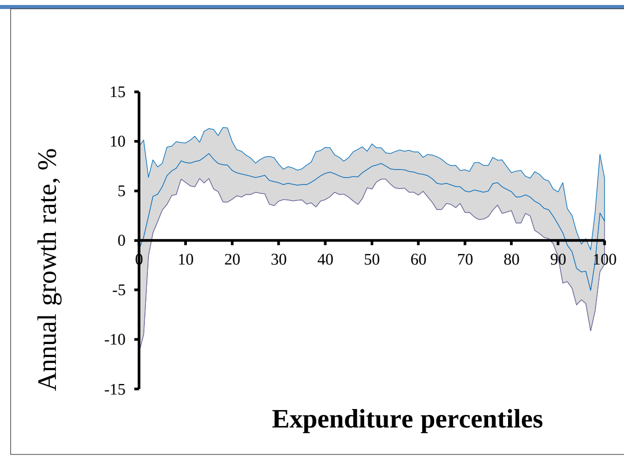
The employment rate in the Kyrgyz Republic was equal to 57.1 percent in 2016. Agriculture and services continue to be main economic sectors for employment. One third of population, and about 36 percent of individuals in the bottom 40 percent of the income distribution, worked in the agricultural sector. Poor households with a higher share of members working in agriculture are seen to experience a relatively higher likelihood of persisting in poverty.

Figure 6: Absolute poverty, 2013-2016



Source: NSC

Figure 7: Growth Incidence Curve, 2015/2016



Source: KIHS

[3] The poverty line was calculated using the "cost of basic needs" approach in 2011 and subsequently inflated to account for food and non-food price changes in 2012, 2013, 2014, 2015 and 2016. Thus, the poverty lines are in nominal Kyrgyz soms.

B. Macroeconomic and Structural Policies

Fiscal, monetary and exchange rate policies

The government continued to pursue an expansionary fiscal policy…

Fiscal policy remained significantly expansionary, despite the improvement in the external environment. The general government ran a budget deficit of 4.4 percent of GDP in January-September 2017, down from 5.8 percent in the same period a year before, but significantly above the levels of previous years (Table 2). This deficit was mainly driven by significant capital spending, albeit partially mitigated by increases in tax and non-tax revenues, as well as grant support.

… partly matched by higher revenues.

Total revenues for the same period, including grants, amounted to 36.9 percent of GDP, up from 34 percent a year ago. This was thanks to tax and non-tax revenues, as well as grant support including unbudgeted Russian grant. Tax revenues increased to 27 percent of GDP, from 26.1 percent a year earlier, largely on account of increased international trade receipts (customs revenues, VAT and excise taxes on imported goods). Improved domestic activity, as well as higher rates for excises for tobacco and alcohol also boosted tax revenues. Non-tax revenues rose to 7.4 percent of GDP from 6.0 percent a year before, thanks to higher profits from state-owned enterprises.

Expenditures increased considerably.

Total expenditures grew by 1.6 percent of GDP, to 41.4 percent of GDP from 39.8 percent a year earlier. This increase was mainly due to capital outlays (8.8 percent of GDP, up from 7.7 percent) for foreign-financed infrastructure projects. Meanwhile, current expenditures increased slightly as a share of GDP (32.6 percent vs. 32.4 percent of GDP).

The fiscal deficit was mainly financed by borrowing, both external and domestic (T-bills). In particular, a large part of capital spending was supported through external public investment project (PIP) loans (amounting to 3.3 percent of GDP, net of debt amortization). Despite the fiscal deficit, government deposits (in soms and foreign currency) increased by more than 10 percent over the first 9 months of 2017 due to external borrowing and additional grant support (from Russia).

A policy tradeoff is necessary.

Fiscal policy expansion boosted domestic demand and helped sustain economic recovery. However, this came at a potentially high cost; the annual-level deficit is projected to have remained elevated at 4.7 percent of GDP (including on-lending) for the year as a whole, mainly due to government's commitment to keep high levels of public investment, expenditures associated with the Presidential elections and one-off emergency spending after landslides affected the southern part of the country. Indeed, the fiscal headroom to respond to future possible crises is now significantly eroded. This means that adjustment going forward will need to be sharp and steadfast.

Table 2: General Government Budget
(in percent of GDP)

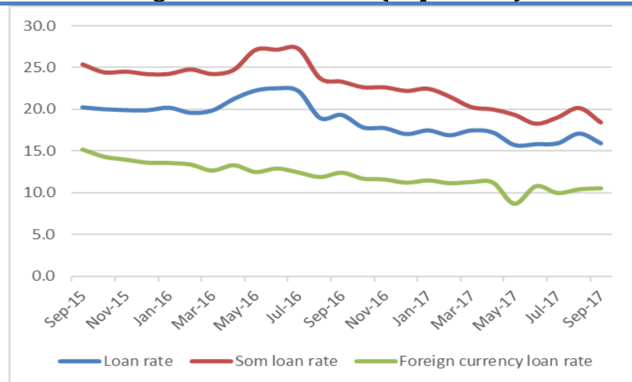
	2014	2015	2016	2017 Proj.	2016 Jan-Sep	2017 Jan-Sep
Total revenues and grants	34.4	34.4	33.3	33.5	34.0	36.9
Total revenues	31.9	32.2	31.1	30.8	32.1	34.4
Current revenues	31.8	32.1	31.0	30.8	32.1	34.3
Tax revenues	25.1	24.2	25.2	26.1	26.1	27.0
Non-tax revenues	6.7	7.9	5.9	4.6	6.0	7.4
Capital revenues	0.1	0.1	0.1	0.1	0.1	0.1
Grants	2.5	2.2	2.2	2.6	1.8	2.5
Program grants	1.9	1.7	1.4	0.7	1.2	1.3
PIP grants	0.6	0.5	0.7	1.9	0.7	1.2
Total expenditure (incl. net lending)	38.5	37.4	39.8	38.2	39.8	41.4
Current expenditure	29.3	30.1	31.4	30.4	32.4	32.6
Wage	7.8	8.1	8.7	8.4	8.8	8.6
Transfer and subsidies	3.4	3.4	3.5	3.4	3.7	3.7
Social Fund expenditures	9.2	9.0	9.0	3.5	9.5	10.1
Interest	0.9	1.0	1.1	1.3	1.3	1.3
Purchase of other goods and services	8.1	8.6	9.2	7.8	9.1	8.8
Capital expenditure	8.4	7.2	8.3	8.4	7.7	8.8
o/w foreign financed	6.1	4.5	5.3	5.7	4.7	5.9
Net lending	0.6	0.1	0.0	-0.5	-0.4	0.0
Overall balance	-4.1	-3.0	-6.6	-4.7	-5.8	-4.4
Financing	4.1	3.0	6.6	4.7	5.8	4.4
External	5.5	3.8	4.2	3.8	3.2	3.3
Domestic	-1.4	-0.8	2.4	0.9	2.6	1.2

Source: Ministry of Finance

A relaxed monetary policy also contributed to strong growth performance.

In order to support real sector growth, monetary policy remained relaxed, with no major changes in the use of policy instruments by the National Bank (NBKR). The NBKR kept its interest rate unchanged at 5 percent since the start of the year. Similarly, the Bank's overnight interest rates for loans and deposits remained unchanged at 6.25 percent and 0.25 percent, respectively. This, together with regulations limiting foreign currency borrowing for a broad group of consumers, led to a gradual decline of the interest rate in the loan market (Figure 8). As a result, the monetary base grew by 22.6 percent, y-o-y, and money supply increased by 19.1 percent, y-o-y, in September 2017. Moreover, inflation picked up, and is estimated to reach 4 percent by end-year. While still below the NBKR's target of 5-7 percent, this increase suggests that the space for accommodative policies is running its course.

Figure 8: Loan rates (in percent)



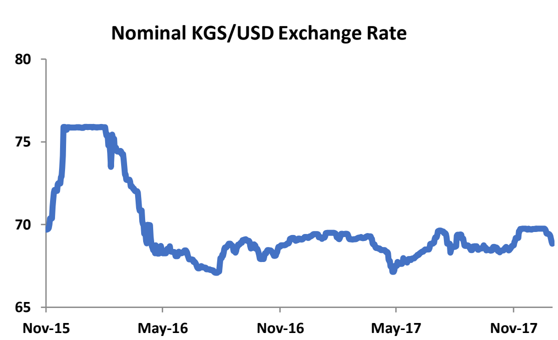
Source: National Bank.

A credit expansion resumed.

On the demand side, there was a gradual increase in credit growth, from a contraction at the beginning of the year; as of September 2017, credit to the economy[4] increased by 15.2 percent, y-o-y. Moreover, the figure is an under-estimate of overall credit growth, as it does not include direct lending by the Kyrgyz-Russian Development Fund.

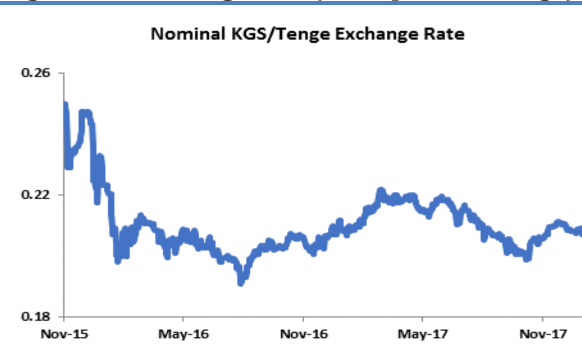
The NBKR maintained a managed float for the exchange rate, broadly allowing market forces to determine the exchange rate, while intervening to smooth short term fluctuations.[5] Overall, this flexibility allowed to preserve competitiveness and safeguard international reserves. The som appreciated slightly (0.8 percent) in the first 9 months of the year against the US dollar (Figures 9, 10,) and somewhat more strongly relative to the tenge (3.2 percent). However, the som depreciated against the ruble (3.7 percent) (Figure 11), given the ruble's appreciation relative to the US dollar, as well as increased demand for rubles stemming from bilateral trade activity.

Figure 9: Exchange rate (soms per US$1)



Source: National Bank.

Figure 10: Exchange rate (soms per one Tenge)

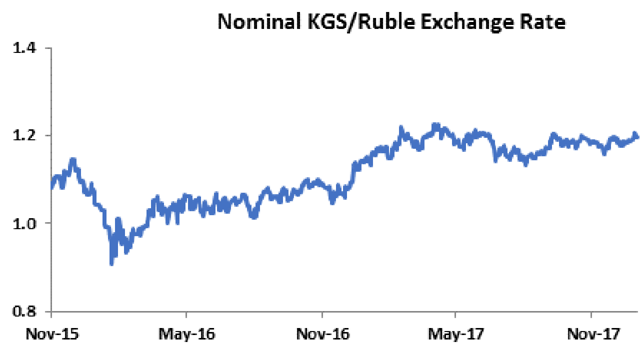


Source: National Bank.

[4] Not including non-banking financial institutions

[5] The NBKR interventions are decided based on developments in the foreign exchange market.

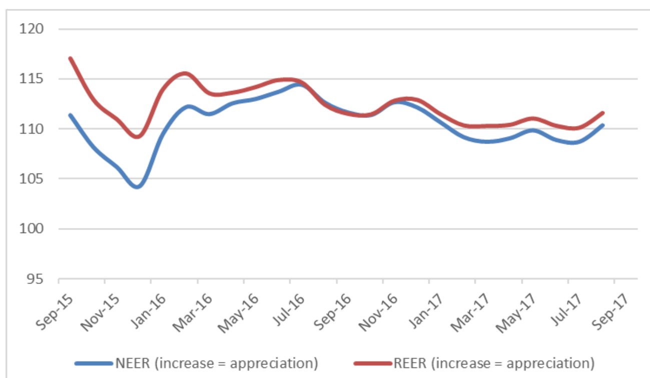
Figure 11: Exchange rate (soms per one Ruble)



Source: National Bank.

The real effective exchange rate remained broadly stable most of the year with a slight appreciation in recent months (Figure 12), but depreciated by about 5 percent since early 2016, improving slightly competitiveness of Kyrgyz exports. International reserves grew by 7.4 percent amounting to US$2.1 billion, or more than 4 months of imports as of end-September 2017 and are expected to stay at this level by end-year. This increase is welcome given the significant dollarization of the economy and its vulnerability to external shocks.[6]

Figure 12: Nominal and real effective exchange rates (index, 2010=100)



Source: National Bank.

C. Economic Outlook and Risks

Growth is estimated to have decelerated slightly for 2017 as a whole …

Macroeconomic conditions generally remained favorable in the last quarter of 2017, an annual growth is estimated at 3.5 percent in 2017. A significant deceleration in gold production in the last months of the year would have been partly offset by more robust non-gold growth -expected to reach 4.1 percent for the full year-, as high remittances inflows translate into higher demand.

[6] During the latest Article IV consultations, the IMF staff highlighted the importance of maintaining flexibility of the exchange rate and advised that the authorities continue to buildup international reserves.

This scenario, however, does not take into account the impact of the recent border issues with Kazakhstan that have constrained the flow of people and goods across the border. With the issues finally resolved, it is estimated that they had a short-term one-off impact, mainly on the performance of services in the fourth quarter of 2017.

... and to recover in 2018.

In 2018, overall growth is expected to increase to 4.2 percent owing to remittance supported-consumption – as Russia and Kazakhstan continue to recover, further boosting Kyrgyz exports. Specifically, export growth is likely to be supported by:

(i) further progress by Kyrgyz Republic producers in upgrading their standards and procedures to EEU norms, freeing-up latent supply in agro-products;

(ii) further financing from the Kyrgyz – Russian Development Fund targeting access to EEU markets;

(iii) additional production from new gold mines expected to come online, and

(iv) improved relations with Uzbekistan that are expected to spur cross-border trade.

A core challenge continues to be the need to accelerate the process of convergence of local production to EEU standards. It is expected that this will help the Kyrgyz producers to utilize the already existing capacities to boost exports of agricultural and textile products in the short and medium run.

Ambitious fiscal consolidation is expected.

On the fiscal front, the authorities aimed at closing 2017 with a deficit target of 4.7 percent of GDP (3 percent excluding on-lending), supported by measures agreed under the ongoing IMF-related program. Going forward they have committed to reduce the deficit to 3 percent by 2019 (baseline scenario) mainly through measures to increase tax revenues and curtail current spending, while capital expenditures would remain high.

Over the next few years, tax revenues should increase as a share of GDP, supported by measures that: (i) expand the tax base by encouraging businesses to formalize, (ii) improve the administration of taxes, (iii) reduce overall tax exemptions, through canceling existing exemptions and streamlining policies for granting new ones, and (iv) increase some tax rates, such as excise tax rates on alcohol and tobacco products[7]. Over the same period, expenditures are targeted to decline by over 3 percent of GDP as a result of efforts to: (i) streamline non-priority purchases of goods and services; (ii) reduce the wage bill as a share of GDP, by implementing the recently adopted action plan for the reform of the public sector personnel and remuneration policy and by carrying out functional reviews of the civil service; and finally, (iii) strengthen public procurement to ensure value for money in public contracts.

[7] In 2018, the new tax measures are estimated to increase total revenues by 0.9 percent of GDP.

The sustainability of these commitments would be buttressed by the adoption of a fiscal rule. Such rules are now increasingly being adopted worldwide to ensure that fiscal policy remains consistent with clear debt sustainability objectives. The Kyrgyz Republic has committed to introducing such a rule in 2018 to become fully operational by 2020. Together with other changes to the legal framework for budgetary operations, this would go a long way towards strengthening fiscal discipline.

However, expenditure tensions will need to be tackled.

Some of the trends observed in 2017, including due to the adoption of new policies that will have spending implications for 2018 (including a universal extension of the previously income-targeted *Monthly Benefit for Low Income Families with Children* program, as well as increases in civil service compensation and pensions) are likely to make these objectives difficult to abide by, bringing more rigidity to the budget (increasing the structural component of the deficit). In turn this will imply the need to make significant reductions in capital spending and goods and services purchases.

Poverty is expected to decline.

Modest increases in growth projections for agriculture and construction, and further increases in remittances, are likely to support rural poverty reduction during 2017-18. Private sector real wages are expected to rise slowly, resulting in a slight reduction in urban poverty, where wage employment is more prevalent. Social transfers will continue to play an important role in driving poverty reduction in both urban and rural areas. A scheduled increase in pensions should also benefit poor households given that pensions represent close to 15 percent of income among the poor. The poverty rate is projected to decline to 22.6 percent in 2017 and 22.2 percent in 2018.

D. Special Focus: Migration, Remittances and Dutch Disease; Policy Options

Starting in the mid-2000s, the Kyrgyz Republic has experienced an explosion of migration, principally to Russia. These massive outflows of labor and corresponding financial inflows have profoundly re-shaped the domestic economy, with tangible short-term gains but also challenges. This Special Focus *seeks to shed light on the phenomenon, analyze its features and consequences, and draw lessons for policy.*

Benchmarking migration and remittances in the Kyrgyz Republic

The Kyrgyz Republic is one of the most remittance-dependent

The magnitude of out-migration from the Kyrgyz Republic has been massive. A lower-bound figure - derived from the labor force module of the Kyrgyz Integrated Household Survey - suggests that the number of Kyrgyz migrants abroad is around 200,000. However, statistics from the Russian State Migration Services report a number of 710,000 for that destination alone[8]. Even the lower-bound estimate is

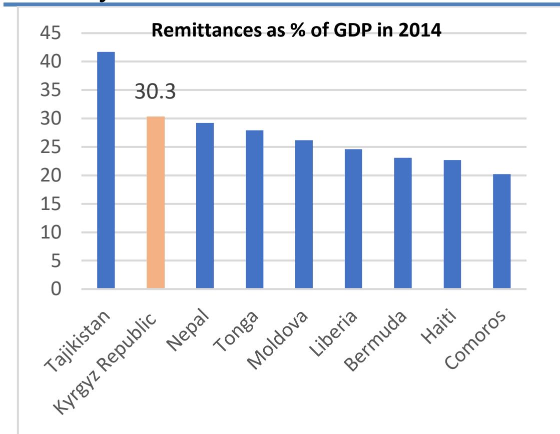
[8] There are a number of possible explanations for this discrepancy. First, numbers extrapolated from household surveys fail to capture long-term migrants or cases in which entire households migrated. Second, Russian statistics also include Kyrgyz nationals who hold Russian citizenship as well as Kyrgyz nationals registered with the Russian migration office, but residing in the country for purposes other than work (such as studies).

countries in the world.

considerable: equivalent to 3.3 percent of the total population in Kyrgyzstan or 10 percent of the working age population.

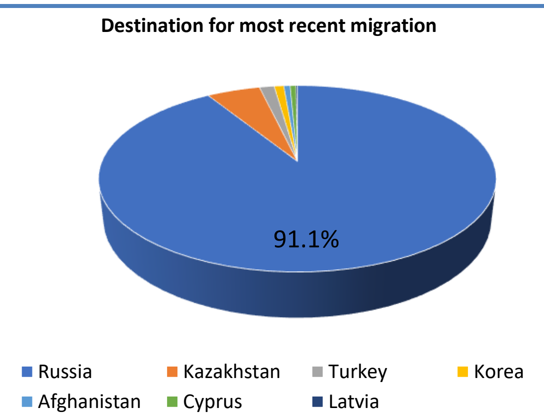
In terms of remittances to GDP, the Kyrgyz Republic is among the most remittance-dependent economies in the world. In 2014, the remittances sent home by Kyrgyz migrants crossed the US$ 2 billion mark, an amount equivalent to 27.4 percent of GDP, and almost 9 times greater than FDI inflows. This made the Kyrgyz Republic the second most remittance-dependent economy in the world as a share of GDP that year, after Tajikistan and before Nepal, Tonga and Moldova (Figures 13 and 14).

Figure 13: The second most remittance-dependent country in the world



Source: WB, Migration and Remittances Factbook 2016

Figure 14: ...with migrants overwhelmingly in Russia



Source: KIHS migration module

Young men chose emigration to make up for poor domestic prospects

Migrants tend to be educated and young, driven to leave the Kyrgyz Republic for lack of domestic opportunities and by economic deprivation (Figures 15 and 16). They are predominantly young males, often from the poorer regions of the South, who leave agricultural work or unemployment to supplement insufficient household income. Men, typically around 18-35 years old, make up some 75.6 percent of the total migrant population. 89 percent of migrants have completed secondary schooling or more. A significant fraction was unemployed prior to departure or engaged in agriculture or urban services (sales, construction) (Figures 17 and 18).

Figure 15: Most migrants are (young) men…

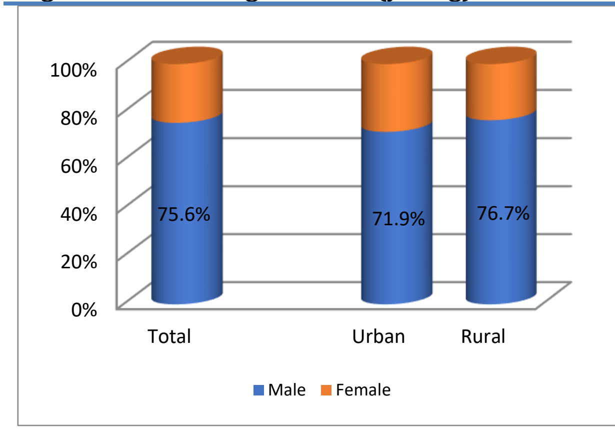
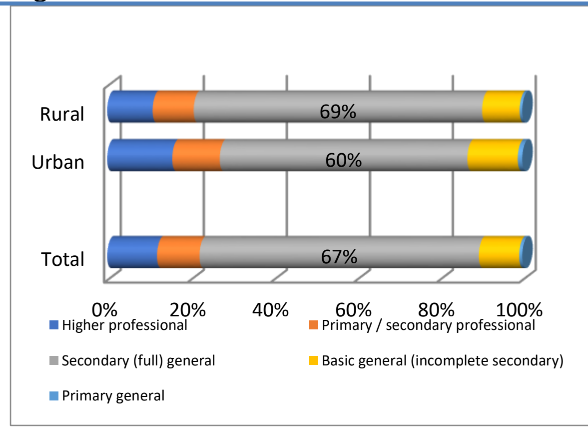


Figure 16: … who tend to be well educated



Source: KIHS migration module

Figure 17: Many migrants left un- or underemployment…

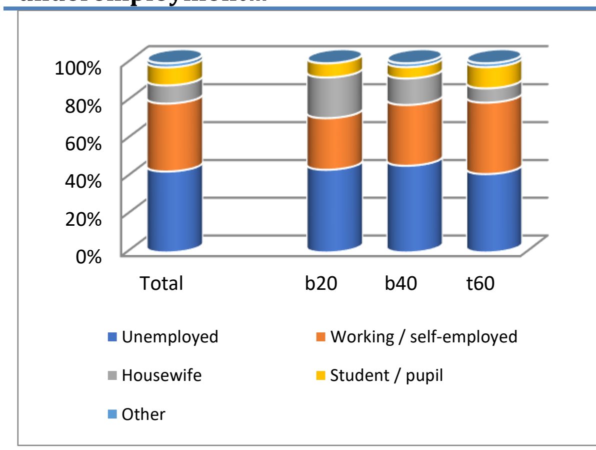
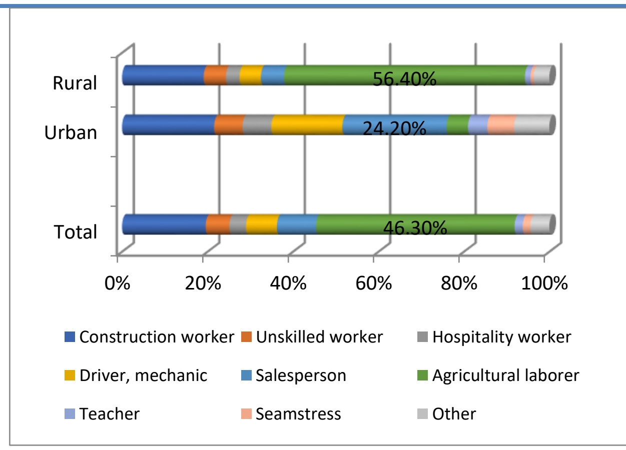


Figure 18: … often in agriculture



Source: KIHS migration module

Migration is a bi-product of poverty

As expected, migrants tend to come from poorer households (pre-remittance income). While migrant households are better-off than average, this is overwhelmingly as a result of these transfers, which on average constitute over half of their total earnings. Consequently, it is not surprising that the primary motivation for migration is to find alternative means of income to cater to daily needs. In surveys a majority of migrants indicate that they had left because their household needed money (55 percent) or for lack of domestic employment opportunities (16 percent). By contrast, the savings-investment motivation appears less significant and mostly geared to providing for family events and property purchases (Figure 19). This is reflected in the reported use of remittances, channeled largely to food purchases (35 percent) and housing improvements (21 percent) as opposed to children's education (8 percent) (possibly reflecting state provision), business investments (3 percent), or savings (9 percent) (Figure 20).

Figure 19: Migration stems from desperation

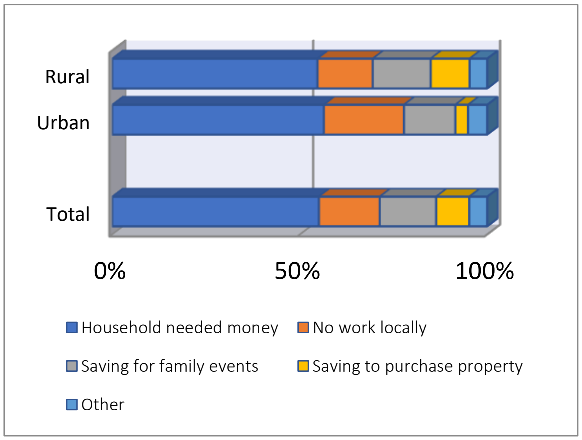
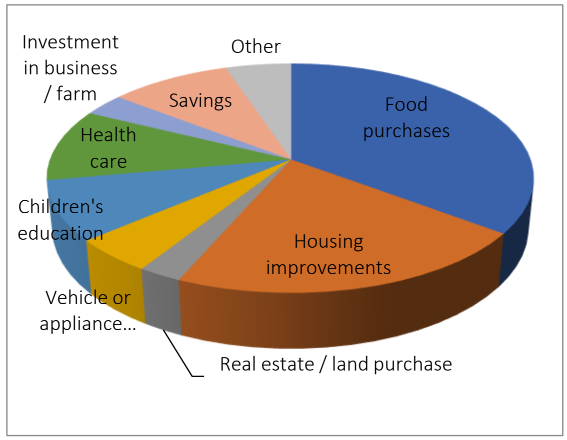


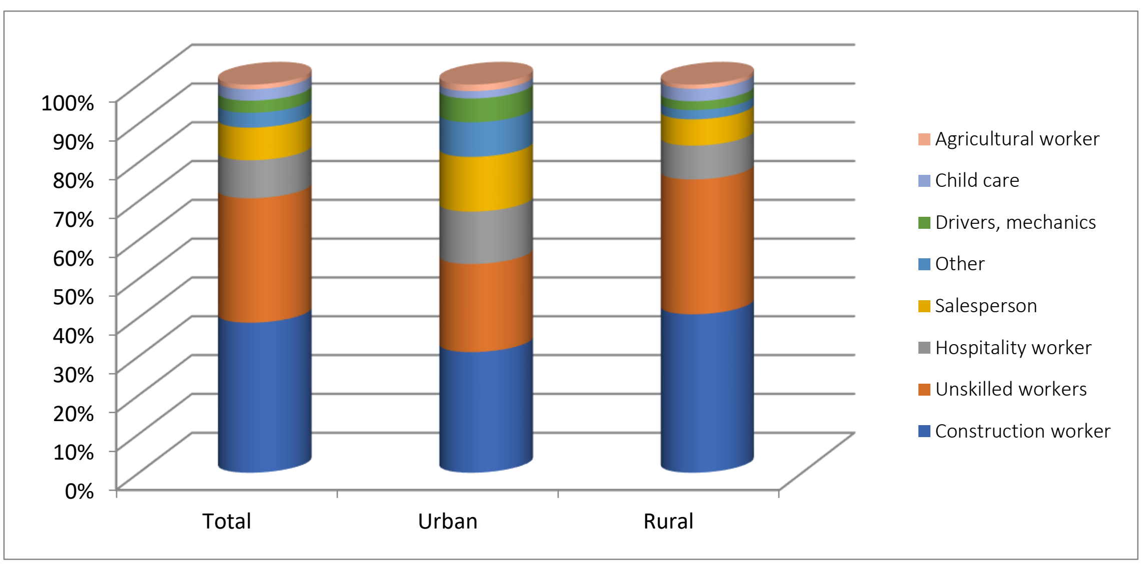
Figure 20: Remittance income is channeled to basic needs



Source: KIHS migration module

Most migrants are employed in low skill services at destination. The most significant professional transition appears to be from agricultural labor at home, toward urban construction or services employment at destination, with otherwise limited apparent skills upgrading, although the relative crudeness of the data probably understates the extent to which such upgrading may be happening within broad fields of occupation (Figure 21).

Figure 21: Occupations at destination in construction and un-skilled services



Source: KIHS migration module

Some insights on impacts

Remittances generate short term gains…

In the short run, remittances inflows tend to be associated with lower poverty levels and higher growth rates. For households, migration helps relieve un/under-employment pressures. For the economy, the capital inflows ease external financing constraints, allowing for higher savings to spur investment (either directly by households of intermediated by the financial sector). More directly, remittances help to boost economic growth in the short run through the consumption multiplier effect (Figure 22).

…but undermine competitiveness over time.

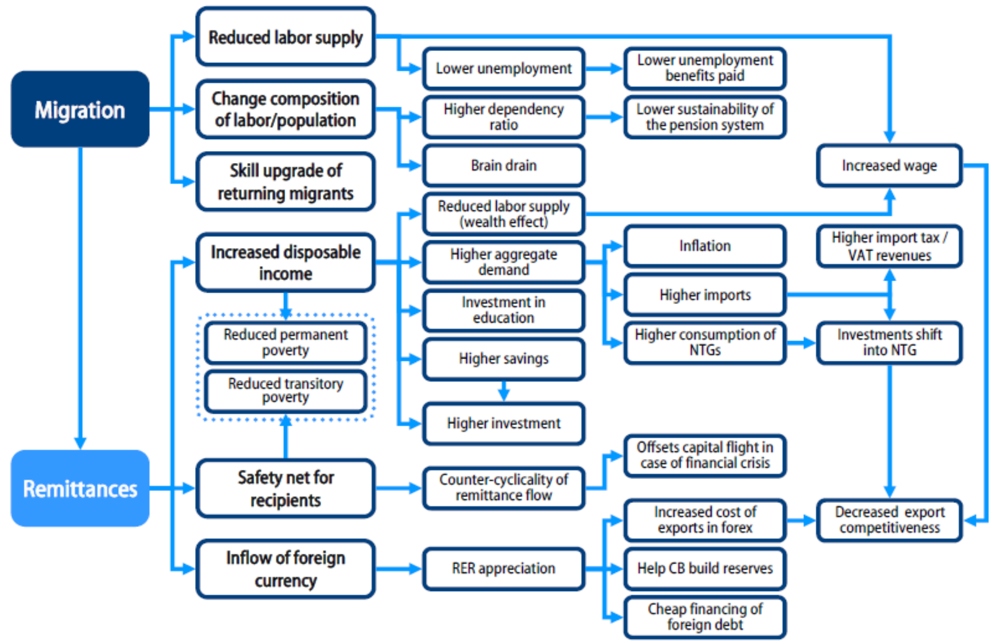
At the same time, over the medium to long run, remittances may impact macroeconomic stability and translate into Dutch Disease-type phenomena. The mechanism and transmission channels are well known. The positive income shock boosts consumption of tradable and non-tradeable goods, but because the prices for the former are given, growing overall demand translates into relatively higher prices for non-tradables. In turn, this dis-incentivizes investment and labor movements into export oriented (or import competing) sectors, and vice versa. Seen otherwise, the large capital inflows result in real exchange rate appreciation. These effects are exacerbated when non-labor income growth (such as results from remittances) puts pressure on wages, intensifying the effects of real exchange rate appreciation and dampening international competitiveness (Figure 22).

In turn this translates into:

A key impact is depressed export performance.

- Adverse effects on the tradeable sectors of the economy, with lower export sales and higher import demand, all else equal. Fundamentally, this implies lower long run growth prospects, especially for small economies for which accessing foreign markets is the only option that provides ample and sustained room for increasing output.
- A widening of trade imbalances, to the extent that some of the remittances-induced consumption is directed toward imports and exports are depressed.
- Increased pressure on prices (as monetary aggregates expand) and a rise in financial asset prices - particularly real estate, possibly leading to over-investment in this sector.

Figure 22: Impacts of migration and remittances



Source: Culiuc, A. Integrating Migration and Remittances in a Development Strategy

Application to the Kyrgyz Republic

Remittances played a key role in supporting income and GDP growth, ...

The onset of migrations and remittances in the Kyrgyz Republic has been associated with relatively robust growth driven by consumption. The growth rates of consumption and remittances have been highly correlated such that we can safely conclude that economic growth has been largely tributary to remittances (Figures 23 and 24).

Figure 23: Private consumption driving growth

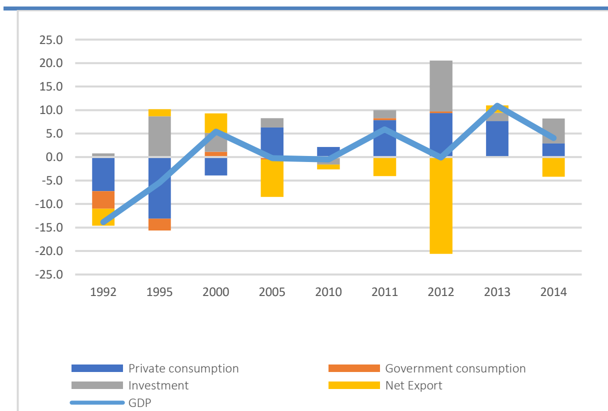
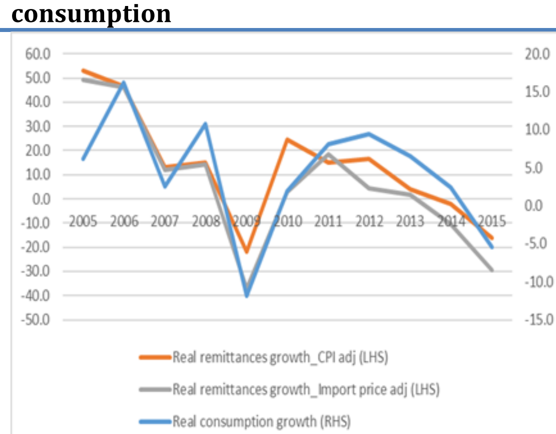


Figure 24: Remittances driving private consumption



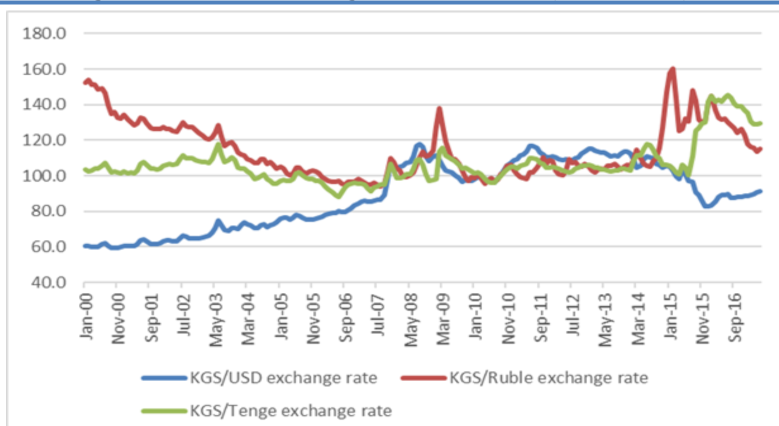
Source: KIHS migration module

…. but they may also have had undesirable effects.

Some characteristic symptoms of a Dutch Disease-type of episode have been observed.

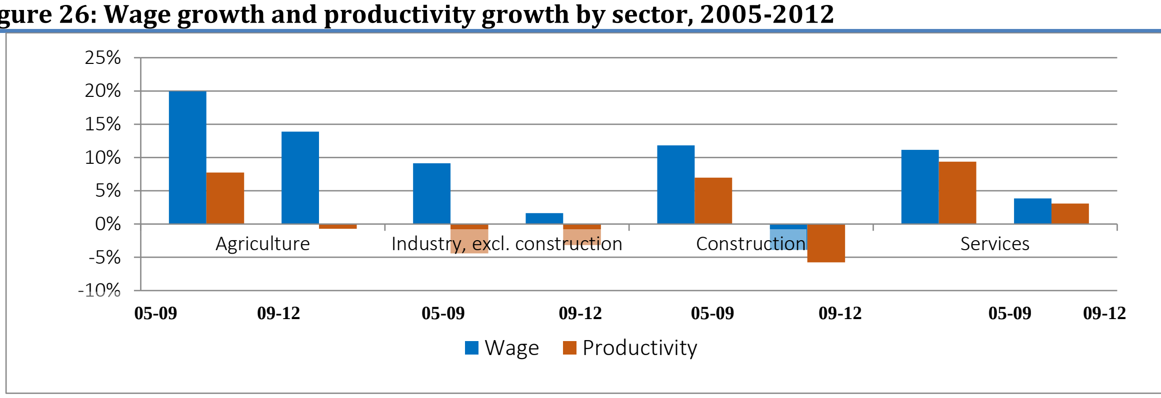
- <u>Loss in competitiveness through real exchange rate appreciation and a tilt in production structure favoring non-tradeables/services and commodity exports:</u> The channel of transmission operated through foreign exchange revenue inflows (from commodity revenues and remittances) that boosted household incomes, generating an expansion in private consumption—and an increase in the prices of domestically produced goods (particularly services). This increase in prices would bring about a real exchange rate appreciation of the Kyrgyz som that amounts to a loss of external competitiveness (Figure 25); in addition, these prices signals tend to reinforce the reallocation of resources into further commodity and non-tradeable output, thus raising the economy's exposures to commodity prices shocks (and correlated shocks to remittances).
- Wage effects: Real wages rose by almost 9 percent annually between 2003-12, significantly outpacing productivity growth, particularly in tradables (agriculture and industry) (Figure 26).

Figure 25: Real exchange rate 2000-16 (2010=100)



Source: National Bank.

Figure 26: Wage growth and productivity growth by sector, 2005-2012



Source: Kyrgyz authorities and WB staff

- Trade effects: Non-gold exports have suffered while imports surged. Goods and services export growth, in US$ terms, averaged 12 percent over 2000-2016, albeit with a significant deceleration (to about 4 percent) over 2008-2015. Moreover, this performance was made possible by a significant rise in gold prices and services exports (whose share in total exports rose from 11 percent in 2000 to 34 percent by 2016), implying a decrease in the value of otherwise exported goods. By contrast, import growth averaged 15 percent over 2000-2015, resulting in a clear deterioration of the trade balance (Figures 27 and 28).

Figure 27: Remittances driving the TB deficit

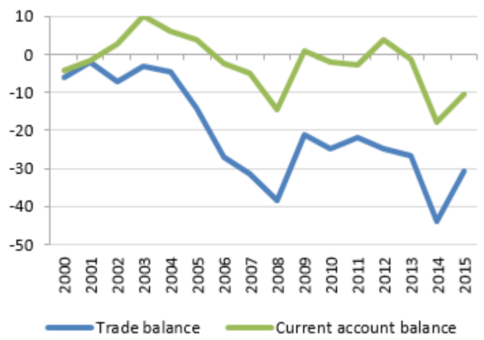
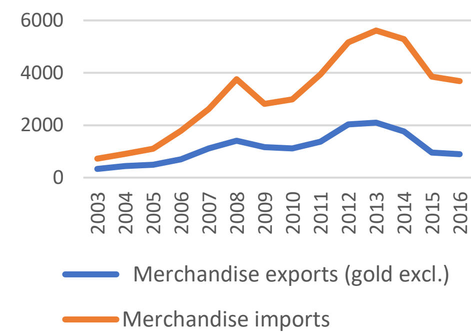


Figure 28: Import growth outpacing non-gold export growth



Source: Kyrgyz authorities and WB staff

- Exports have become more concentrated. Another clear symptom of Dutch Disease is the reduction in the number of goods produced by the country. Not only has gold gradually increased its share in the export basket, but indexes of product concentration show increased concentration starting around 2007 (Figures 29 and 30)

Figure 29: Gold exports vs. other merchandise

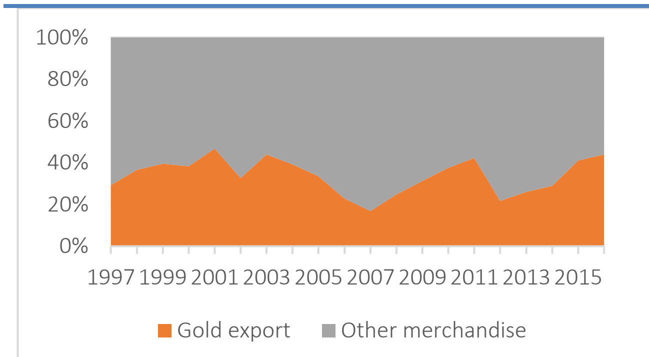
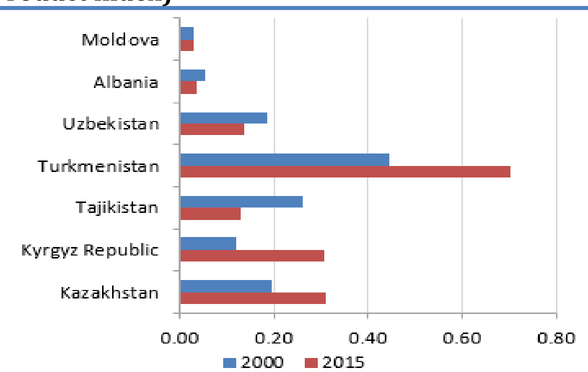


Figure 30: Growing product concentration (HH Product index)



Source: Kyrgyz authorities and WB staff

- <u>Financial intermediation.</u> With a savings rate of over 20 percent of GDP in 2015 the Kyrgyz Republic ranks relatively high in the region (Figure 31). We also see, as of 2007 especially, a dramatic increase in bank credit to the economy (Figure 32). However, starting from very high levels, interest rate spreads have remained very constant (mostly over 20 percentage points) indicating persistent bottlenecks in the intermediation of these savings (Figure 33).

Figure 31: Gross Savings as share of GNI (2015 or latest)

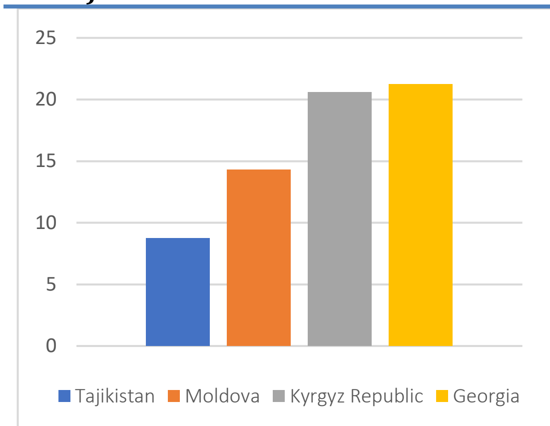
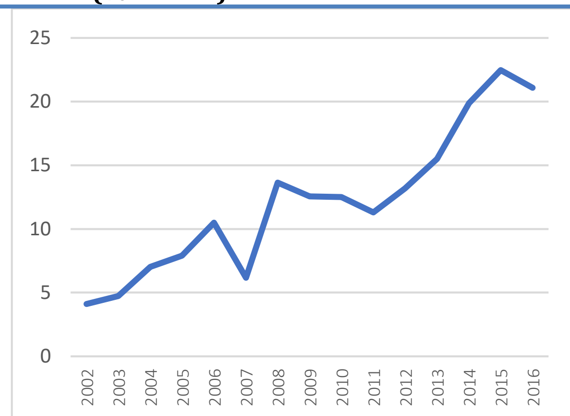
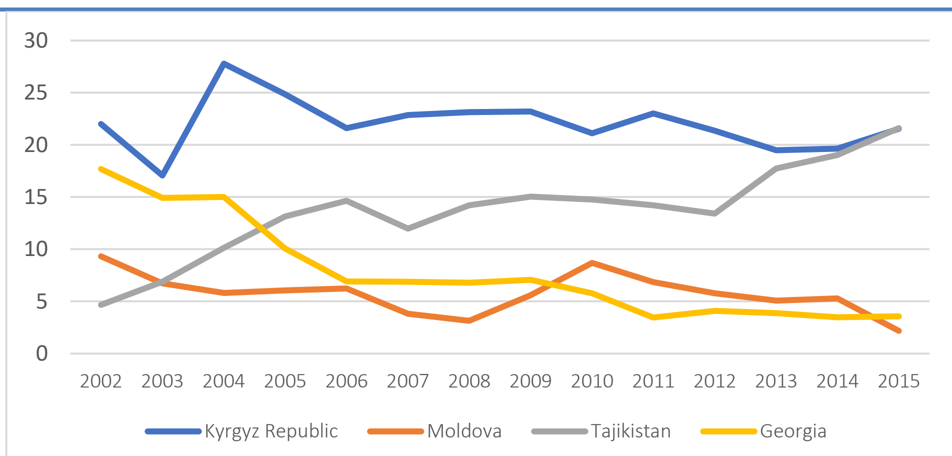


Figure 32: Domestic credit to private sector by banks (% of GDP)



Source: Kyrgyz authorities and WB staff

Figure 33: Interest rate spreads (lending rates minus deposit rates)



Source: Kyrgyz authorities and WB staff

What can policy do?

Managing the consequences and reinforcing the positive effects of migration are the main policy challenges. The range of policy options includes cyclical / macro actions, structural policies to build the resilience of the economy, as well as targeted initiatives to leverage remittances for investment.

Macroeconomic policies should be counter-cyclical.

Maintaining exchange rate flexibility is key…

- As far as monetary policy is concerned, the main focus should be on maintaining inflation under control, while keeping the flexibility of the exchange rate regime. On the downside (when remittances inflows drop) allowing the currency to depreciate may hurt consumers, but it can immediately help improve the competitiveness of exports. On the upside (when remittances increase), attempts to sterilize the capital inflows (to counter appreciation pressures) via monetary policy can only be a temporary remedy, and sterilization costs could rise quickly.

…as its ensuring that counter-cyclical fiscal and monetary policies are properly implemented

- There is also an important role for fiscal policy. Specifically, counter-cyclical policies (saving during booms, loosening during downturns) help prevent some of the harmful effects from Dutch Disease from taking hold. In particular, fiscal restraint can help prevent overheating, mitigating wage pressures and dampening the real exchange rate appreciation. In Kyrgyz Republic, the observation is the opposite, with the pursuing of pro-cyclical policies, and boosting spending (including on wages) at the time when remittances inflows and export revenues were peaking. Going forward adopting a fiscal rule that explicitly factors in remittances would be a significant step forward to entrench healthier counter-cyclical policy making in the economy.

Structural policies should be geared at ensuring that asset diversification can take place

In parallel to calibrated macro policies, structural reforms should be focused on helping the non-commodity tradable sector become more productive. This would include the following:

Complementary structural reforms should be geared towards increasing productivity of non-commodity tradeable goods and services

- ***Building competitive and efficient markets,*** including through better understanding barriers to entry, the role of public enterprises, their impact on competition and on sector price dynamics, and the presence of additional distortions.
- ***Developing competitive sectors with clear (market-based) growth potential.*** This includes agriculture, certain types of manufacturing and export-oriented services.
- ***Enhancing connectivity.*** Natural asset transformation into high-quality connectivity infrastructure is key to foster diversification.

- ***Reducing informality,*** allowing medium and small enterprises to scale up, generate jobs and have incentives to invest, innovate and increase productivity."

And financial intermediation could work better

While remittances can help alleviate credit market inefficiencies (by loosening the liquidity constraints for entrepreneurs that cannot access credit due to the absence of collateral or high lending costs), they do so in ways that are suboptimal relative to a well-functioning financial market that can channel resources to the most productive uses[9]. In the Kyrgyz Republic, a low level of effective competition in the financial sector is probably driving high interest spreads signaling opportunities for improvement. Moreover, the reliance on subsidized finance to promote private investment (such as via the Russian Kyrgyz Development Fund) introduces distortions in the market which could hurt both system stability and inclusion.

Improvements in the investment climate is the most effective solution in the long run.

Eliminating rigidities in labor and product markets as well as all other measures to make the economy otherwise more competitive could partly offset the negative appreciation shock. Moreover, improvements in the investment climate are the most straightforward way to effectively promote more productive uses for remittances via investment as opposed to consumption.

Government programs can work where strong community institutions exist.

An alternative to system-wide reform of the financial sector consists in mobilizing remittances via community programs, typically for local infrastructure projects and micro-entrepreneurship and savings. There is significant experience with such programs in Latin America (including with matching grants from the central government and/or support from development partners) yet their applicability to the Central Asian context probably deserves further examination to the extent that such programs (i) typically mobilize savings from well-established diaspora networks migrants (whereas Kyrgyz emigration is more recent and temporary in nature) and (ii) require very strong community institutions. Nonetheless this could be an avenue for development partners' engagement, in the context of Social Investment programs, to which remittance-supported components could be added.

[9] For reasons including lack of entrepreneurial skills or expertise or the absence of complementary factors in the areas where recipients are located

Annex 1: Selected Macroeconomic and Social Indicators, 2014–2019

	2014	2015	2016	2017	2018	2019
			Prel.	Projections		
National Income and Prices	(Percent, unless otherwise indicated)					
Nominal GDP (bln. of soms)	400.7	430.5	458.0	493.0	541.7	599.6
Nominal GDP per capita (US$)	1,266	1,109	1,073	1,138	1,162	1,215
Real GDP growth	4.0	3.9	3.8	3.5	4.2	4.8
Real non-gold GDP growth	5.0	4.9	3.7	4.1	5.2	5.2
Private consumption growth	3.0	-6.0	2.2	2.5	3.2	3.5
Gross investment (percent of GDP)	29.2	29.4	30.1	32.1	32.5	31.5
Consumer price inflation, year-end	10.5	3.4	-0.5	4.0	5.0	5.0
Consumer price inflation, period average	7.5	6.5	0.4	3.6	4.5	4.8
Real effective exchange rate (2010=100)	120.2	109.3	112.9			
External Accounts	(Current US$ millions, unless otherwise indicated)					
Merchandise exports, *of which:*	2,483	1,619	1,594	1,659	1,717	1,837
Gold exports	717	665	771	732	696	751
Merchandise imports	5,290	3,860	3,680	3,957	4,185	4,324
Current-account balance	-1,191	-742	-616	-848	-855	-773
as percent of GDP	-16.7	-15.9	-9.6	-8.0	-7.1	-6.1
Foreign direct investment, net	233	1,009	430	489	519	554
Total official international reserves	1,958	1,778	1,969	2,089	2,217	2,383
External debt, as percent of GDP	80.5	94.5	92.6	91.8	90.9	88.9
Consolidated Fiscal Accounts	(Percent of GDP, unless otherwise indicated)					
Revenues	34.4	34.4	33.3	33.5	31.9	31.0
Expenditures	38.5	37.4	39.8	38.2	36.1	34.1
Overall fiscal balance	-4.1	-3.0	-6.6	-4.7	-4.1	-3.0
Primary fiscal balance	-3.2	-2.0	-5.4	-3.5	-2.9	-1.8
Total public debt	53.6	67.3	61.6	62.9	63.3	63.5
Monetary Accounts	(Percent, unless otherwise indicated)					
Base money growth	-11.9	4.0	27.6	11.1	10.3	9.9
Real growth of credit to the private sector	43.6	17.2	-0.8	12.7	12.3	13.0
Policy rate	10.5	10.0	5.0			
Social Indicators						
Population, total (millions)	5.8	6.0	6.1	6.1	6.2	6.3
Population growth (percent)	2.0	2.1	2.1	1.1	1.1	1.1
Unemployment rate (percent of labor force)	8.0	7.6	7.6			
Poverty rate, international (percent of population)	29.2	32.9	32.8	31.7	30.2	28.3

Sources: World Bank staff calculations and estimates based on official data published and provided by the authorities.