

**National Bank of the Kyrgyz Republic**

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**Inflation Report**

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**August 2004**

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**Bishkek**

## ***Inflation Report***

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## **Publications of the National Bank of the Kyrgyz Republic**

### ***Annual Report of the National Bank of the Kyrgyz Republic***

The annual report of the National Bank of the Kyrgyz Republic is a complete report on the work of the National Bank done during the reporting year. It contains a brief description of developments in the real sector of economy, as well as the description of decisions and actions of the National Bank in the monetary sphere. It includes the information on economic development and monetary policy, financial statements, general information about the National Bank, statistical annexes. The report is published in Kyrgyz, Russian and English languages.

### ***Bulletin of the National Bank of the Kyrgyz Republic***

"The Bulletin of the NBKR" contains macro-economic indicators of the Kyrgyz Republic on the real sector, financial sector, external sector, information on prices and social indicators. The bulletin is published monthly in the Kyrgyz, Russian and English languages.

### ***Balance of Payments of the Kyrgyz Republic***

"The Balance of Payments of the Kyrgyz Republic" reflects the latest trends in development of the external sector and contains tables with data in analytical and neutral formats of the balance of payment, the structure of external trade, international reserves, external debt, the methodology and the information base for preparation of the balance of payments, as well as the international investment position of the Kyrgyz Republic. It is published quarterly in January, May, July and October.

### ***Banking System Development Trends***

The purpose of the "Banking System Development Trends" is to study assess the development of the banking system in Kyrgyzstan. It is published on half year basis in Kyrgyz and Russian.

### ***Statutory acts of the National bank of the Kyrgyz Republic***

The purpose of the edition is the official publication of statutory acts of the National bank for informing commercial banks and the public and propagation of the bank legislation of the Kyrgyz Republic. It is published once a month in the Kyrgyz and Russian languages.

### ***Press release of the National Bank of the Kyrgyz Republic***

"The Press-Release of the NBKR" contains the weekly chronicles of the developments in the National Bank and major data of the financial market. It is published quarterly in the Kyrgyz and Russian languages.

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## 1. CURRENT DEVELOPMENTS OF INFLATION

During the first half-year of 2004 gross domestic product gained 9.2 percent basically due to industry and trade made contribution by 3.9 and 2.7 percentage points, respectively. Metallurgy and food-processing industry were in the lead among branches of industry. Agriculture made contribution in growth of gross domestic product by 0.5 percentage points.

For the second quarter of 2004 the negative trade balance developed at the level a little bit smaller in comparison with the corresponding period of the last year, thus volumes of commodity circulation increased more than by 40 percent. High rates of growth were marked on the foreign trade operations with the CIS countries. It is worth to note that growth rates of exports outstripped growth rates of imports, exports in all groups of functional classification increased.

Strong enough fluctuations of exchange rates of the basic currencies in the external financial market did not render essential influence on a rate of a som. The official exchange rate of som against US dollar became stronger by 1.3 percent from the beginning of year, and compared with the corresponding period of 2003 som strengthened by 9.7 percent. The tendency for som nominal and real effective rates to ease was keeping and it made 1.9 and 0.5 percent, respectively, compared with the first quarter of 2004 and 10.6 and 11.8 percent, respectively, compared with the quarter in a year. Dynamics of som effective rates testifies that price competitiveness of the Kyrgyz goods does not worsen.

Growth rates of monetary aggregates compared with the corresponding period of 2003 decreased. In the second quarter, the monetary base grew basically due to operations of the National bank, which intervened in the foreign exchange market and carried out open market operations. The economy was gradually remonetizing that is characterised by the relation of monetary aggregate M2X to gross domestic product. The monetization coefficient made 16.4 percent at the end of the first half-year of 2004. Deposits and credits in the banking system were growing.

Low liquidity in the banking system caused strong demand for refinancing and SWAP operations in the second quarter of 2004. Only 2 out of 13 auctions of notes of the National bank have been taken place. Note yield was formed at 4.86 percent

level that is a little bit lower in comparison to 5.05 percent in the beginning of quarter.

Cost of funds in national currency under REPO agreements increased from 4.2 - 4.3 percent up to 5.6-5.8 percent, and interest rates on credit in the national currency increased up to 5,8-6 percent compared to 4.2-4.5 percent at the beginning of the quarter. For the second quarter of 2004 state T-bills yield with three-month maturity increased by 0.61 percentage points and totalled 5.41 percent. Yield of six-month T-bills decreased by 0.51 percentage points and reached 6.5 percent level. Yield of twelve-month T-bills increased from 9.21 up to 12.69 percent. The weighted average interest rate increased by 0.88 percentage points up to 9.65 percent against the beginning of quarter.

In the second quarter of 2004, according to the data of the National statistical committee decrease in consumer prices by 0.3 percent was observed, whereas it grew by 0.5 percent in the corresponding period of the last year. In third quarter of 2004, the deflation by 1-1.1 percent is expected.

## 2. CONSUMER PRICE INDEX AND ITS COMPONENTS

In the second quarter of 2004, price level decreased as a result of reduction in crop prices, in particular vegetables that is unusual for the given period of year and was never observed. According to the data of the National statistical committee decrease in consumer prices by 0.3 percent was observed, whereas it grew by 0.5 percent in the corresponding period of the last year.

### 2.1. COMPONENTS OF CONSUMER PRICE INDEX

#### 2.1.1. FOOD PRODUCTS

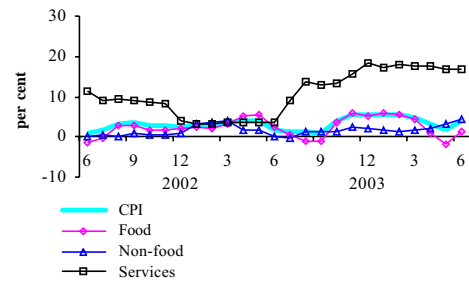
Food prices reduced by 1.2 percent, due to high supply in agriculture crops as a result of the rich crop collected in 2003. In particular, vegetable crop has been collected in 2003 was 1.5 times more, than in 2002 that resulted in reduction of prices on vegetables by 38.5 percent compared with increase by 11.5 percent in corresponding period of 2003. Also seasonal decrease in prices on milk, dairy products, cheese and eggs by 7.4 percent is registered (decrease by 7.7 percent in the second quarter of 2003), oils and fats - by 2 percent.

However, food prices decreased, but there were some kinds of foodstuffs, on which prices continued to raise, for example, the rise in prices on meat is observed since April 2002. Meat for the second quarter of 2004 became more expensive by 3.6 percent (for comparison - the rise in prices on meat in the second quarter of 2003 made 2.1 percent). Seasonal increase in prices on fruits amounted 42.3 percent. The prices on sugar and confectionery products grew by 1.7 percent.

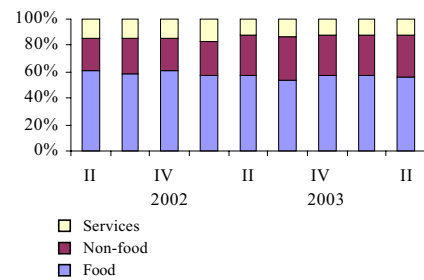
Growth in prices on bread and bakery products by 0.8 percent in the second quarter of 2004 was considerably slower compared to 6.7 percent in the first quarter of 2004. The major reasons for prices to grow were:

- decrease in domestic production of grain crops. So, according to the National statistical committee the wheat crop collected in 2003 was less by 12.8 percent, than in 2002; rise in prices on the food wheat imported from Kazakhstan, which began in September 2003 and proceeded till May 2004 due to strong demand from Ukraine and Russia.

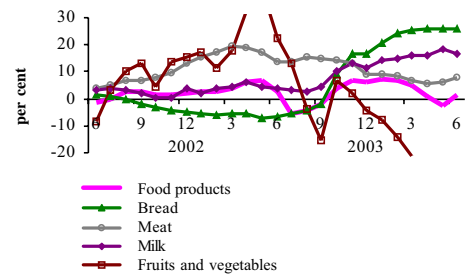
**Chart 2.1: CPI and its components, percentage changes on a year earlier**



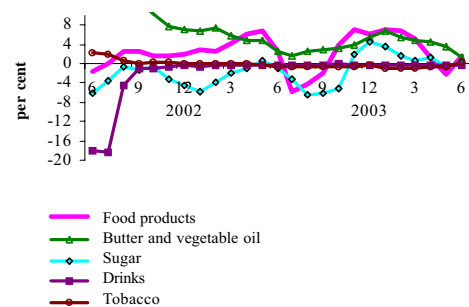
**Chart 2.2: Structure of CPI, per cent**



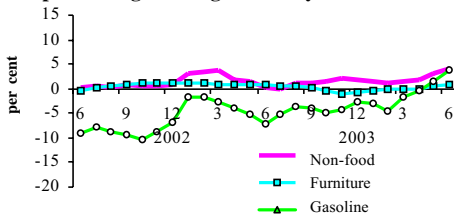
**Chart 2.3a: Food Prices, percentage changes on a year earlier**



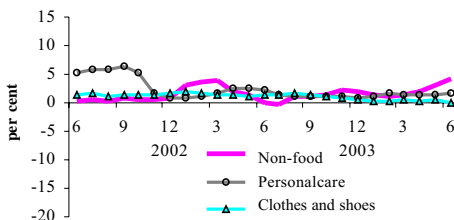
**Chart 2.3b: Food Prices, percentage changes on a year earlier**



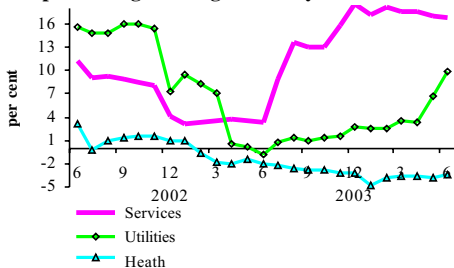
**Chart 2.4a: Non-food Prices, percentage changes on a year earlier**



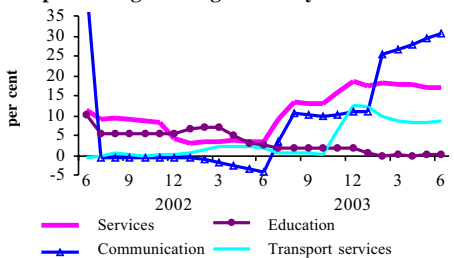
**Chart 2.4b: Non-food Prices, percentage changes on a year earlier**



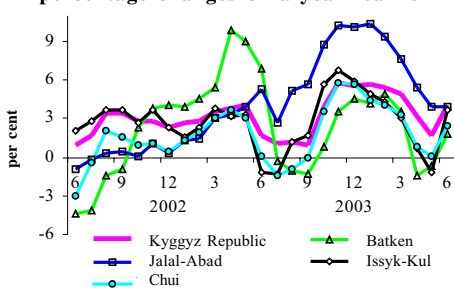
**Chart 2.5a: Services, percentage changes on a year earlier**



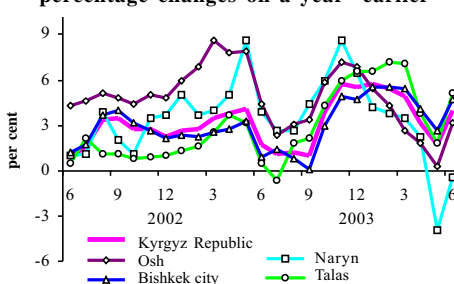
**Chart 2.5b: Services, percentage changes on a year earlier**



**Chart 2.6a: CPI by Oblasts, percentage changes on a year earlier**



**Chart 2.6b: CPI by Oblasts, percentage changes on a year earlier**



**2.1.2. NON-FOOD PRODUCTS**

The non-food prices in the second quarter of 2004 grew by 1.4 percent. Building material prices, being the major factor of growth increased by 35.9 percent. Also, price on tools rose by 2.2 percent, textile products - by 0.5 percent, glass products - by 0.5 percent.

In May, the Government of the Kyrgyz Republic accepted resolution to reduce gasoline excise tax rate from 1500 to 1000 soms per ton, however, the given measure did not lead prices on oil products to decline. The prices on gasoline in the second quarter of 2004 grew by 0.1 percent.

There was decline in prices on other non-food items. So, the prices on firm fuel decreased by 3.7 percent, on medicines and medical equipment - by 1.1 percent, on footwear - by 0.8 percent, newspapers, books and the writing goods - by 0.7 percent, clothes - by 0.2 percent.

**2.1.3. SERVICES**

The price index on paid services for households decreased by 0.8 percent due to decline in prices on ritual services by 21.8 percent and tariffs on railway transportation by 1.9 percent.

**2.2. CONSUMER PRICES BY REGIONS**

In the second quarter of 2004, consumer prices were not moving in the same direction. The greatest increase by 1.2 and 1.1 percent due to foodstuff inflation was registered in Issuk-Kul and Batken oblasts, respectively. In Talas oblast, consumer prices grew by 0.6 percent, food prices grew by 1.7 percent, paid services increased by 1.3 percent.

The greatest reduction in consumer prices by 1.6 percent is marked in Jalal-Abad oblast, where prices on food items decreased by 1.6 percent, on non-food items - by 2.2 percent. In Osh oblast, consumer prices decreased by 0.7 percent as a result of reduction in prices on foodstuffs by 1.3 percent. In Bishkek city, consumer prices decreased by 0.2 percent, prices on food items decreased by 1.5 percent, paid services - by 1.4 percent, and prices on non-food items rose by 2.4 percent.



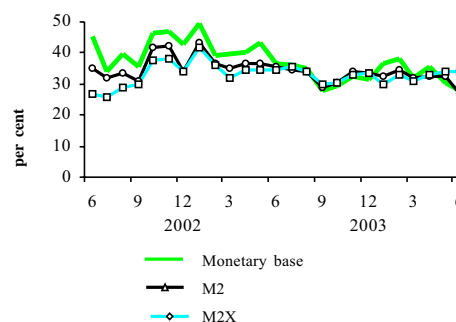
### 3. INFLATION FACTORS

#### 3.1. MONETARY AGGREGATES

##### 3.1.1. MONETARY BASE

The monetary base<sup>1</sup> for the second quarter of 2004 increased by 3.9 percent. Growth rate in a year slowed down and made 28 percent. The monetary base grew by 408.8 million soms, contribution of the National bank and budget operations totalled 377.6 and 31.2 million soms, respectively. The foreign exchange interventions of the National bank and open market operations increased monetary base by 264 and 96.9 million soms, respectively. The money in circulation grew by 4 percent during the second quarter of 2004, and its growth in a year made 27.3 percent.

**Chart 3.1: Monetary aggregates, percentage changes on a year earlier**



##### 3.1.2. AGGREGATE M2

The aggregate M2 grew by 2.7 percent during the second quarter of 2004, and its growth in a year made 26.9 percent. Slowdown in growth was observed compared to 4.3 percent in the first quarter of 2004 and to 6.9 percent in the second quarter of 2003.

##### 3.1.3. AGGREGATE M2X

Monetary aggregate M2X under the current exchange rate increased by 5.7 percent. Its growth was promoted by the rise by 9.5 percent in deposits of commercial banks. Thus, there were essential changes in dynamics of its components in comparison with the first quarter of the current year when deposits in national currency grew by 9 percent, and deposits in foreign currency reduced by 0.6 percent. In the second quarter, deposits<sup>2</sup> in foreign exchange increased by 17.5 percent, while deposits in national currency declined by 2.1 percent.

There were following changes in M2X structure:

- the share of cash outside of banks was reduced up to 62.3 percent (on 01.01.2004 - 63.6 percent);
- the share of deposits in national currency was reduced up to 11.8 percent (on 01.01.2004 - 12.1 percent);
- the share of deposits in a foreign currency increased up to 25.9 percent (on 01.01.2004 - 24.3 percent).

<sup>1</sup> Excluding foreign exchange deposits in banks.

<sup>2</sup> Including banks, which license is withdrawn, but process of liquidation is no completed yet.

It is worth to note, increase in domestic credit in real sector allows drawing a conclusion that contribution of credit to provide money supply is growing.

### 3.2. INTEREST RATES

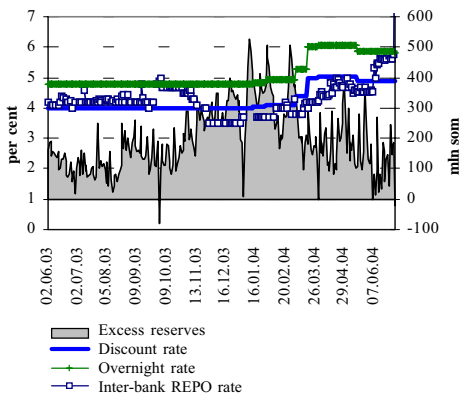
#### 3.2.1. MONEY MARKET INTEREST RATES

In second quarter of 2004, low liquidity in commercial banks caused higher interest rates, than in the first quarter. Cost of funds in national currency under REPO agreements increased from 4.2 - 4.3 percent up to 5.6-5.8 percent, and interest rates on credit in the national currency increased up to 5,8-6 percent compared to 4.2-4.5 percent at the beginning of the quarter.

Commercial banks activity on foreign exchange inter-bank credit market decreased to some extent. On a currency segment of the in the second quarter. Interest rates fluctuated in a range from 6 up to 11 percent compared to 4.5 - 11.2 percent in the first quarter of the current year. Thus, interest rates on credits in foreign exchange traditionally were higher, than interest rates on credits in national currency due to longer terms. The interest rate on SWAP also raised to 5.84 percent compared to 4.85 percent in the first quarter of 2004.

Only 2 out of 13 auctions of notes of the National bank have been taken place. Note yield was formed at 4.86 percent level that is a little bit lower in comparison to 5.05 percent in the beginning of quarter.

**Chart 3.2: Money market interest rates vs. liquidity, per cent**

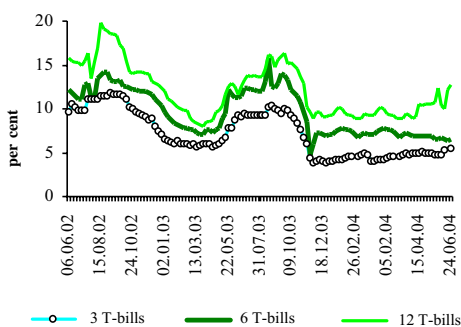


#### 3.2.2. STATE TREASURY BILLS

Decrease in liquidity caused weak demand of commercial banks on T-bills. The Ministry of Finance reduced volumes of issue and changed structure of sales towards bills with the longer maturity.

For the second quarter of 2004 yield of state T-bills with three-month maturity increased by 0.61 percentage points and totalled 5.41 percent. Yield of six-month T-bills decreased by 0.51 percentage points and reached 6.5 percent level. Yield of twelve-month T-bills increased from 9.21 up to 12.69 percent. The weighted average interest rate increased by 0.88 percentage points up to 9.65 percent against the beginning of quarter.

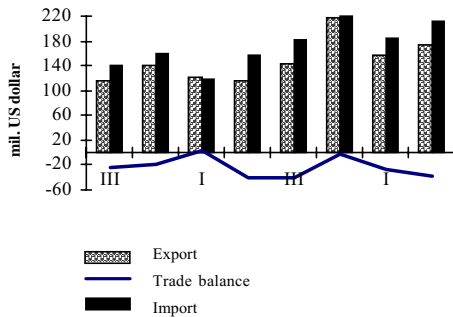
**Chart 3.3: T-bill yields**





Turnover with CIS and non-CIS countries increased by 48.6 and 34.8 percent, respectively.

Chart 3.6: Trade balance



Exports of goods in F.O.B. prices made 173.8 million US dollars and increased by 50.6 percent in a year. Exports in CIS and non-CIS countries grew by 61.7 and 45 percent, respectively. Gold export volume increased from 46.4 million US dollars up to 71.4 million US dollars, basically due to increase in price of gold. Exports excluding gold grew by 48.4 percent caused by the increased deliveries of sugar, inorganic chemical substances, fresh vegetables, building materials, including, glass.

There was growth along all functional groups of exports. Share of intermediate goods increased to 50.1 from 49.3 percent out of total exports in a year. Share of consumer goods amounted 21.5 percent, energy products - 11.2 percent and investment goods - 4.6 percent out of total exports. Growth in exports of consumer goods by 79.1 percent took place as a result of increased deliveries of garments, fresh vegetables, milk and dairy products. Exports in energy products grew by 33.2 percent due to higher deliveries of kerosene and electric power. Exports of intermediate goods grew by 48.4 percent in a year due to increased deliveries of gold, spare parts and building materials, mainly, slate, cement and glass.

In geographic distribution, exports of goods to non-CIS countries were dominating and its share totalled 63.9 percent out of all exports. The biggest volume, besides the United Arab Emirates and Switzerland, where gold is delivered, mainly fell to Canada, China and Turkey. Exports to Canada made 11.5 million US dollars, where 98 percent out of total amount are submitted by aviation kerosene. Exports to CIS countries increased by 61.2 percent and made 62 million US dollars. CIS countries occupied 36.1 percent. The major partners among CIS countries Russia, Kazakhstan, Uzbekistan continues to remain. Exports of goods to Tadjikistan increased by 51.1 percent basically caused by growth in deliveries of building materials, in particular, slate. Export deliveries to Kazakhstan grew by 90.8 percent because of increased deliveries of building materials (cement, slate and glass).

Imports of goods in F.O.B. prices on preliminary data totalled 210.5 million US dollars and grew by 34.6 percent in a year. Imports from CIS and non-CIS countries rose by 43 and 22.8 percent, respectively. All groups of functional classification demonstrated growth. The biggest items of import were consumer goods and energy products, which shares totalled 32.9 and 24.5 percent, respectively. Imports of intermediate

goods increased by 32.8 percent in a year and it amounted 75.9 million US dollars. Growth of deliveries in intermediate goods took place for pharmaceutical production, fabrics synthetic, beer and cars. Imports of energy products grew by 42.7 percent.

In geographic distribution, 60.6 percent out of total imports fell at CIS countries. Russia and Kazakhstan occupied the biggest shares. Imports from Russia grew by 42.9 percent due to increase in deliveries of automobile gasoline, aviation kerosene, paint and varnish production and saw-timbers. From Kazakhstan imports increased by 46 percent because of increased growth in deliveries of mineral oil, trunks, beer and vegetable oil. China, Germany, Turkey and the USA are major trade partners, as before, among non-CIS countries.

### **3.4.2. DOMESTIC DEMAND**

Steady growth of monetary aggregates was supported by high demand on national currency. Strengthening in business activity is characterised by expansion in amount of new registered legal persons and credit to real sector of economy. Creation of new production potential is reflected with statistics of gross domestic product. Gold-mine enterprise "Kumtor" being still high significant for economy ceased to bring the greatest contribution to growth of gross domestic product.

#### **3.4.2.1. PRIVATE CONSUMPTION**

According the preliminary data of the National statistical committee household incomes for the first half-year of 2004 grew by 10.7 percent in comparison with the corresponding period of 2003. Thus the real disposable income grew by 6.4 percent. Household outlays increased by 12 percent, and retail trade turnover grew by 16 percent.

#### **3.4.2.2. PUBLIC CONSUMPTION**

State budget revenues for the first half-year of 2004 grew by 15.2 percent in a year. Accordingly, state budget expenditures increased by 15.7 percent. Wage bills gained 17.9 percent. Grants to state enterprises practically unchanged. Capital investments and repair increased by 34.3 percent in a year.

### **3.4.2.3. INVESTMENT**

According to the preliminary information of the National statistical committee investment for the first half-year of 2004 increased by 23.1 percent in a year.

### **3.4.3. OUTPUT**

The gross domestic product for the first half-year of 2004 on the preliminary data of the National statistical committee increased by 9.2 percent. The industrial output gained 18.1 percent, 5.9 percentage points out of total industry growth belongs to Kumtor gol-mine enterprise. The greatest growth is marked in a manufacturing industry in which the determining role is played with production of metallurgical manufacture and manufacture of foodstuff. Processing industry was the biggest contributor into growth in gross domestic product, which made 3.9 percentage points due to metallurgy and food industry production. There was increase in electric energy, gas and water manufacturing of increased and certain revival in construction. Agriculture production also increased and provided 0.5-percentage point in growth of gross domestic product by. The amount of registered legal persons were growing, it increased by 5.1 percent during the first half-year of the current year.

## **4. MONETARY POLICY DECISIONS**

### **4.1. BOARD DECISIONS**

Statement № 7/4 as of March 31" About the Annual report of the National bank of the Kyrgyz Republic for 2003." Annual report containing description of the National bank activity in the accounting period and the financial reporting confirmed by the independent auditor was authorised.

Joint statement of the Government and the National bank of the Kyrgyz Republic as of April 9, 2004 "On the basic directions of economic policy for 2004".

Statement № 12/3 as of May 19, 2004 "About the exchange rate of dollar used for calculation of obligatory reserve requirements." Exchange rate as 42.5 soms per US dollar was established for calculation of required reserve requirements from May 31 till October 3.

### **4.2. MONETARY REGULATION COMMITTEE DECISIONS**

The monetary regulation committee makes decisions on weekly basis.

1. The volume of 28-day maturity notes of the National bank placed on auction has been established at 4 million soms (April - May) and 2 million soms (June) level.
2. The National bank issued overnight credits, which totalled 3416.4 million soms .
3. REPO operations on purchase which volume made 238.7 million soms were carried out to increase liquidity of commercial banks. Open market operations to withdraw liquidity were made in amount 55 million soms.
4. Net purchase of the National bank in foreign exchange market made 4.49 million US dollars. The SWAP operations in foreign exchange between the National bank and commercial banks totalled 2.29 million US dollars.

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<sup>1</sup> Imports in C.I.F prices in the first quarter 2004 made 196,5 million US dollars, thus deficiency of trading balance made 38,2 million US dollars.

### 4.3. INFLATION OUTLOOK FOR 2005

Macroeconomic situation in the Kyrgyz Republic economy improved and favourable tendencies is still remaining till nowadays. Average growth rate for gross domestic product reached 4.8 percent during 2000-2004, thus, its growth rate gained more, than 6 percent in last two years. The increase in trade turnover, including exports, basically, to Russia and Kazakhstan is observed. Nominal effective rate of some strengthened by 14.6 percent during 2000-2004. However, purchasing power of national currency at foreign market did not increase, moreover, it decreased by 4.8 percent, so price competitiveness of Kyrgyz goods did not decrease, while inflation pressure from abroad was restrained.

The monetisation characterises a degree of a saturation of economy with money resources. Since 2002, monetisation increased by 7,5 percentage points and it reached 17.5 percent of gross national product on the end of 2004. Though, being the greatest level of monetisation since the beginning of transformation, it remains low in comparison with the developed countries level.

The structure of money supply has a great value. Currency dominance in the money supply structure characterises weak opportunities of financial institutions to attract savings and to transform them into credit and investments. In 2004, the tendency of currency to grow faster, than inflow of deposits into banking system stopped.

The velocity of money is characteristic of money demand. Thus, the velocity of money is depending on macroeconomic situation and financial sector development. High velocity can be caused by low trust to national currency, for example, as a result of inflation. This situation was observed in many transition countries at the initial stage of transformation. But, also velocity is influenced by characteristics of payment system, degree of financial market development. Development and expansion of financial market, payment system promotes increase in velocity.

Since 2001, the tendency of velocity to decrease, which is caused by reduction of inflationary expectations, is observed. Money aggregate M2X velocity contracted from 9.4 turnovers on the end of 2000 to 5.7 turnovers by the end of 2004. The consumer prices growth rate did not exceed 10 percent level during 2000-2004, thus in three out of last five years inflation did not exceed 5 percent.



In spite of low growth rates in consumer prices the inflationary potential is still exists connected with likelihood of external shocks and incompleteness of transformation processes. That statement could be proved by the situation in 2003 when the price shock in the fourth quarter led to sharp increase in inflation.

External factors of inflationary potential are connected to high share in consumption of imports, for example, oil products, the investment and consumer goods. Low elasticity of substitution tends to high sensitivity of price level on development of prices for imported goods.

Development in the national currency exchange rate, which depends on trade balance, flows of foreign currency, situation in the international financial market, has a great value for inflation. Unpredictable financial flows, strong volatility in the international financial markets causes high risks for transition economy, where deep and advanced financial market is absent.

Internal factors of inflation are connected to the current condition of economy. In spite of price liberalisation is carried out, there are several goods, which pricing is still not quite market because of incompleteness of structural reforms. In particular, there is an administrative pricing on some kinds of the goods, the monopoly pricing for some goods is not overcome.

Inflation is maintaining on low level in conditions of carrying out of structural reforms and acceleration of economic growth. In order economic growth not to create inflationary pressure outstripping creation of modern production capacities and growth of productivity is prerequisite.

Expectations are one of the major factors that influences inflation developments in the transition countries. The economic theory and practice of the central banks shows that inflationary expectations is capable to undermine trust to monetary policy and to cause destabilisation of economy. Reduction and maintenance on low level of inflationary expectations cause the slowdown in consumer price growth.

In 2004, inflation developed at 2.8 percent level, and development of inflationary processes does not cause fears now. It is possible to speak that macroeconomic environment is favourable for low inflation stance, at the same time, it is necessary to trace carefully inflationary potential and to hold it under the control in republic.

The monetary policy of the National bank is carried out taking in account these and many other factors, it is directed on maintenance of positive changes in economy of republic. The basic directions of monetary policy in 2005 are development of payment system, strengthening of bank supervision, further development of microfinancing and its institutes. The development of financial market is crucial for further economic development, poverty reduction and increase of monetary policy efficiency.

The National bank established inflation target at a level not exceeding 4 percent for 2005. The inflation forecast for 2005 take into account current and expected development of economy and prospective economic policy. So, it is expected that growth in gross domestic product will approximately correspond with current tendency. Thus, expected curtailment in production of gold mine Kumtor will be compensated due to growth in manufacturing of other goods. The increase in growth of trade turnover is expected. Price competitiveness on foreign markets will be provided by lower inflation in republic compared with inflation in the trading partners from CIS countries. The money supply will meet demand, the tendency of financial intermediation is expected to strengthen through attraction of deposits and expanding credit to real sector. Also, expected increase of tariffs for electric power and communication services was taken into account. Forecasted growth in consumer prices is 2-2.2 percent for first quarter of 2005.