

**National Bank of the Kyrgyz Republic**

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**Inflation Report**

**3 (13)**

**November 2004**

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**Bishkek**

## ***Inflation Report***

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The purpose of the publication "Inflation Report" is informing of broad public about the goals and results of the monetary policy. The publication contains the description of inflation developments by its components, by regions, and as a whole, the analysis of inflation factors and inflation forecast for the forthcoming quarter. The report is published quarterly in the Kyrgyz, Russian and English languages.

The last date of updating of the data in the given publication: October 31 of 2004.

Founder: The National Bank of the Kyrgyz Republic.

The publication is registered with the Ministry of Justice of the Kyrgyz Republic registration certificate of the mass media №628 as of 02.11.2001.

Prepared for publication and printed by the printing center of the magazine "Banking Herald of the Kyrgyz Republic".

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Circulation 350 copies.

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### ***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.

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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

On the preliminary data of the National statistical committee for 9 months of 2004 gross domestic product gained 7 percent. Excluding production of gold mine "Kumtor" the gross domestic product rose by 6.9 percent. Trade, agriculture and industry were the major contributors to that growth.

The external trade turnover grew by 43 percent in comparison with the corresponding period of 2003. Imports increased by 42 percent, exports gained 45 percent. Trade turnover in goods grew by 51.8 and 35.2 percent with the CIS countries and non-CIS countries, respectively. Trade turnover in goods increased by 46.5 percent with EvrAsEC countries.

For the third quarter Som exchange rate became stronger by 0.43 percent against the US dollar compared to 3.2 percent for the correspondent period of the last year. The official exchange rate of euro become stronger by 0.71 percent and the rate of sale of euro in exchange bureaux increased by 0.22 percent.

On the end of September of 2004 index of Som nominal effective exchange rate decreased by 1.2 percent in comparison with the beginning of year that corresponds to strengthening of national currency. But its average value for 9 months of 2004 increased by 7.9 percent compared with the corresponding period of 2003. The index of the Som real effective exchange rate grew by 3 percent from the beginning of 2004, while average value of considered index increased by 7.8 percent.

Year-on-year growth rates of monetary aggregates fluctuated in 25-30 percent range. The monetary base in the third quarter grew due to operations of the National bank. The deposits in commercial bank grew by 13.3 percent concerning the second quarter. Thus deposits in national currency increased by 7.3 percent, and deposits in a foreign currency - by 14.8 percent.

In third quarter, banking system liquidity increased in comparison with the second quarter, accordingly, demand for refinancing and operations the SWAP on the part of commercial banks was reduced. So average level of interest rates in the monetary market declined. The cost of credit in the national currency reduced from 5.8-5.9 to 5.4-5.5 percent, while interest rates under agreements on conditions REPO decreased from 5.8-7 to 5.4 percent. Six out of 13

declared auctions on the National bank notes are taken place. Note yield reached 5.05 percent at the end of the corresponding period.

Yield of 3-month's treasury bill increased by 0.2 percentage points and made 5.62 percent. Yield of 6-month's treasury bill decreased to 5.8 percent or by 0.69 percentage points. Yield of 12-month's treasury bill reduced from 12.69 to 10.08 percent. The average weighted interest rate decreased to 8.16 percent or by 1.5 percentage points.

In third quarter, according to the data of the National statistical committee decrease in consumer prices was 0.7 percent compared to 2.5 percent at the corresponding period of the last year. Inflation by 3.5 percent is expected for the fourth quarter of 2004.

## 2. CONSUMER PRICE INDEX AND ITS COMPONENTS

In third quarter, seasonal decrease in consumer price index was observed. According to the data of the National statistical committee, consumer prices decreased by 0.7 percent (in the third quarter of 2003 deflation made 2.5 percent). Seasonal reduction in foodstuff inflation was the major factor of deflation.

### 2.1. COMPONENTS OF CONSUMER PRICE INDEX

#### 2.1.1. FOOD PRODUCTS

Food deflation made 2.3 percent. Food items occupying the greatest share in consumer's basket structure are usually characterised by significant seasonal fluctuations. However, in the current year seasonal fluctuations have been smoothed by a good harvest of agricultural crops in 2003, in particular, vegetables has been collected in 1.5 times more, than in 2002 that has caused a low price level on them within the first half-year of the current year. Accordingly, seasonal deflation on fruit-and-vegetable was not so significant as the last years and made 28.8 percent in the third quarter compared to 53 percent for the corresponding period of the last year. Oil and fat prices decreased also as a result of the seasonal factor by 2.1 percent.

Despite of decrease in food prices there were some foodstuffs, which prices were continuing to rise. Price on dairy products, cheese and eggs has raised in by 3.7 percent, sugar and confectionery products - by 2.6 percent, tobacco products - by 0.9 percent. The rise in prices on meat made 0.7 percent.

#### 2.1.2. NON-FOOD PRODUCTS

In third quarter, non-food prices grew by 0.5 percent, which major reason was growth in oil products prices; in particular, the prices for gasoline increased by 27.2 percent. It was caused by growth in the world prices for oil and prices increased by oil refining factories in Russia and Kazakhstan. Also, there were increase in prices for firm fuel (2.2 percent), building materials (1.7 percent), gas (1.1 percent), newspapers and

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

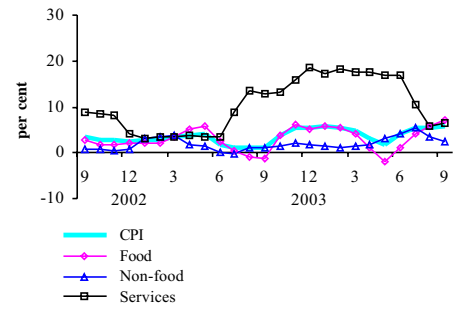


Chart 2.2: Structure of CPI, per cent

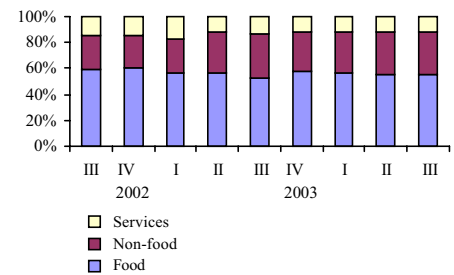


Chart 2.3a: Food Prices, percentage changes on a year earlier

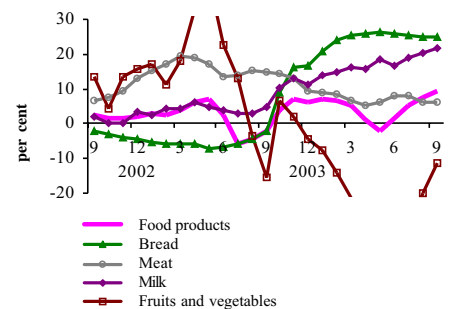


Chart 2.3b: Food Prices, percentage changes on a year earlier

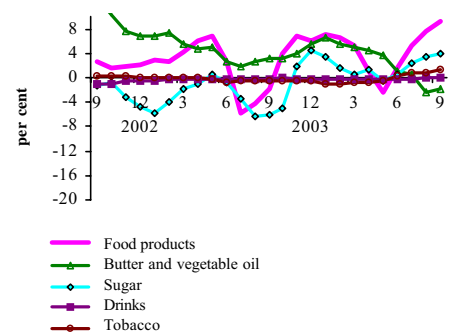
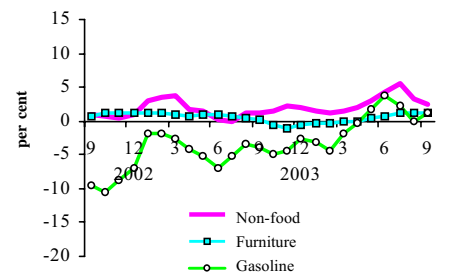
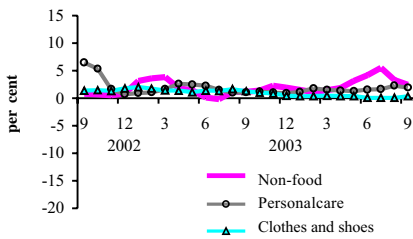


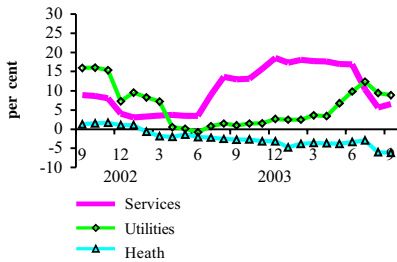
Chart 2.4a: Non-food Prices, percentage changes on a year earlier



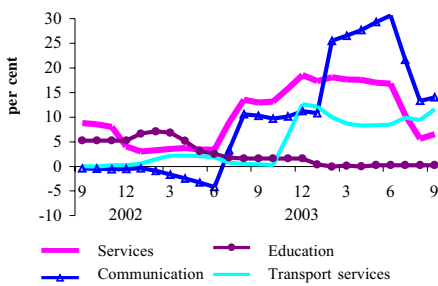
**Chart 2.4b: Non-food Prices, percentage changes on a year earlier**



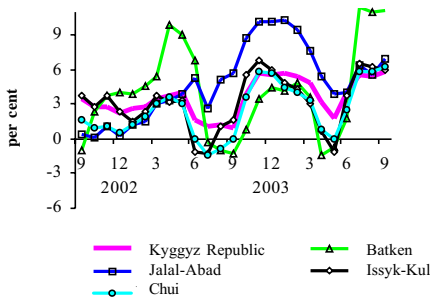
**Chart 2.5a: Services, percentage changes on a year earlier**



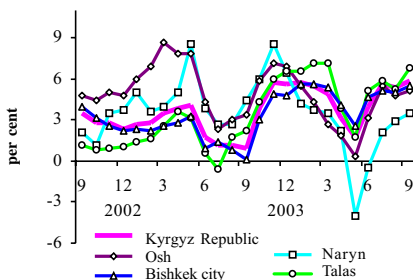
**Chart 2.5b: Services, percentage changes on a year earlier**



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



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



stationary (2.3 percent), while medicine prices decreased by 4.4 percent.

**2.1.3. SERVICES**

Services became dear by 1.4 percent. So, there was increase in prices on transport services by 2.6 percent, education (2.5 percent), wealth care (one percent), services of public catering (0.9 percent).

**2.2. CONSUMER PRICES BY REGIONS**

In third quarter, prices in regions were moving in opposite direction. The greatest deflation has taken place in Talas oblast and made 2.1 percent, thus the prices for foodstuffs decreased by 6.4 percent, and food and services have risen in price by 2.3 and 1.9 percent, respectively. Also, the prices decreased in Bishkek (1.5 percent), Naryn (one percent) and Issyk-Kul oblasts (0.6 percent).

In Batken oblast, there was the greatest rise in prices by 2 percent a result of growth in food inflation by 5.8 percent. In Chui oblast, goods and services became more expensive by 0.7 percent, service price increased by 3.8 percent. The inflation in Osh and Jalal-Abad oblast made 0.2 percent.



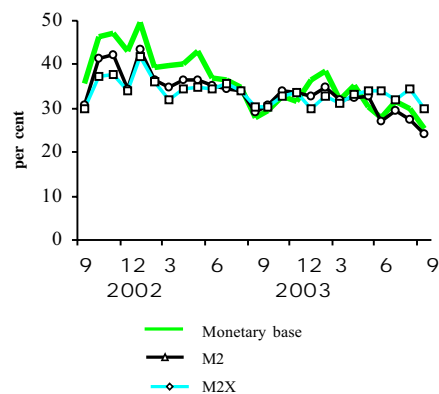
### 3. INFLATION FACTORS

#### 3.1. MONETARY AGGREGATES

##### 3.1.1. MONETARY BASE

In third quarter, the monetary base<sup>1</sup> increased by 0.9 percent. Year-on-year growth rate gained 25.5 percent. Thus, operations of the National bank promoted growth in monetary base by 528.7 million Som, while budget operations contracted it on 433.7 million Som. The money in circulation grew by 0.3 percent and by 23.3 percent on year-on-year basis that growth rates have decreased in comparison with 2003 (3.5 percent and 30.7 percent, respectively). In structure of monetary base, there was some reduction in cash in circulation share from 95.5 to 94.9 percent at the end of September.

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



##### 3.1.2. AGGREGATE M2

In third quarter, growth rate of monetary aggregate M2 made 1.5 percent and was slowed down compared to 3.8 percent for corresponding of the last year and to 2.7 percent for the second quarter of the current year. Year-on-year growth rate made 24.1 percent that was basically caused by increase of deposits in national currency by 7.3 percent which taken place as a result of growth in demand deposits by 10.8 percent and time deposits by 0.8 percent.

##### 3.1.3. AGGREGATE M2X

In third quarter, monetary aggregate M2X under the current exchange rate increased for the accounting period by 4.8 percent. Deposits in foreign currency rose by 14.6 percent (in second quarter, 16 percent). The deposits<sup>2</sup> of commercial banks increased by 12.3 percent. In structure M2X structure, there were following changes:

- share of cash outside banks reduced to 60.1 percent (as of 01.07.04 - 62.76 percent);
- share of deposits in national currency rose to 12.15 percent (as of 01.07.04 - 11.87 percent);
- share of deposits in foreign currency increased to 27.75 percent (as of 01.04.04 - 25.37 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.













### 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.