

National Bank of the Kyrgyz Republic

**BANKING SYSTEM DEVELOPMENT
TRENDS**

SECOND HALF OF 2004 (6)

BISHKEK, 2005

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Banking System Development Trends

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The NBKR Bulletin contains information on microeconomic indicators of the Kyrgyz Republic on the real, financial and external sectors of the economy, as well as on public finances. Data of the National Statistical Committee of the Kyrgyz Republic, the Ministry of Finance of the Kyrgyz Republic, commercial banks, the National Commission for Securities Market of the Kyrgyz Republic, and the National Bank of the Kyrgyz Republic are used for its compilation. It is published on a monthly basis in Kyrgyz, Russian and English.

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This publication reflects the recent external sector development trends and contains tables with the balance of payments data according to analytical and standard presentation formats, a pattern of foreign trade, international reserves, external debt, as well as information on the Kyrgyz Republic's international investment position. It is published on the quarterly basis in January, May, July and October.

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The "Review of Inflation in the Kyrgyz Republic" contains information on consumer price changes in the republic and its regions, information on decisions of the National Bank of the Kyrgyz Republic in the area of monetary policy and provides an inflation forecast for the forthcoming period. It is published on the quarterly basis in Kyrgyz, Russian and English.

Press Release of the National Bank of the Kyrgyz Republic

The Press Release of the NBKR contains a chronicle of events in the National Bank and the banking system, and operating information on the financial market. It is published on the weekly basis in Kyrgyz and Russian.

Statutory Acts of the National Bank of the Kyrgyz Republic

The "Statutory Acts of the National Bank of the Kyrgyz Republic" is an official publication of the statutory acts of the National Bank to provide the commercial banks and the public with normative documents that form the banking legislation of the Kyrgyz Republic. Tentative periodicity of the Journal - monthly publications in Kyrgyz and Russian.

All publications are disseminated according to lists approved with the orders of the Chairman of the National Bank and are placed on the web-site at the following address: <http://www.nbkr.kg>.

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INTRODUCTION

In the second half of 2004 the banking system of Kyrgyzstan continued increasing lending to the real sector. However a significant reserve of liquidity testifies to the presence of additional capacity of commercial banks for further expansion of financial intermediation.

There is observed some improvements in qualitative characteristics of the credit portfolio of the finance and credit system and an overall reduction in the cost of lending to sectors of the economy. Long-term credits are growing, as well as activities of banking in the area of mortgage lending and lending to construction are increasing, which alongside with an improvement in the aggregate financial performance of the corporate sector can be considered as a proof of further stabilization of the economy.

There is observed some reduction in concentration risk in the deposit market as a result of growth in activity of banks in attracting resources in the domestic currency.

The efficiency of the banking system from the viewpoint of the use of assets and capital continues improving and, as a result, growth in profitability of banking business from major activities is observed.

The loan portfolio of non-banking finance and credit institutions (NBFCI) continues growing, although one can note some deterioration in the quality of the loan portfolio and a reduction in the efficiency of use of NBFCI's assets. Credits of NBFCI are mainly allocated to finance agriculture and trade, which explains their major concentration risks.

Real money income in the sector of households is growing both in nominal and real terms, which can testify to the presence of some potential in the market of resources for the banking system.

Growth of money in circulation is preconditioned by real needs of the economy for cash and reflects an increased demand for cash.

Thus, consolidation of the capital base of commercial banks, significant growth of the loan portfolio of the finance and credit system, reduction in interest rates on assets placed in the domestic and foreign currencies, broadening of the range and improvement of the quality of banking and payment services, as well as an increasing efficiency of the banking business are those factors that promote further stabilization of the macroeconomic situation in the country.

I. STATUS OF THE FINANCE AND CREDIT SYSTEM

As of January 1, 2005 the aggregate loan portfolio of the finance and credit system¹ totaled 9,585.7 million soms, (its structure is reflected in Chart 1.1.). It is worth noting that the banking system continues to gradually strengthen its dominating position and in the second half of 2004 its share increased from 53.9 percent to 60.6 percent in the structure of the aggregate loan portfolio of the finance and credit system. One can observe some reduction in the share of non-banking finance and credit institutions (NBFCI), meanwhile the share of the loan portfolio of bankrupt banks continues decreasing.

In the second half of 2004 the indicator of financial mediation of the finance and credit system in general increased from 8.8 percent to 10.2 percent (see Chart 1.2), while the registered growth in the level of financial mediation of the finance and credit system is exclusively connected to growth in the loan portfolio of the banking system. While the loan portfolio of bankrupt banks and the indicator of financial mediation of non-banking finance and credit institutions remained unchanged in the second half of 2004.

Characterizing the quality of the loan portfolio by the ratio of the amount of reserves to cover loan loss provisions (LLP) to the volume of loan portfolios of the banking system and NBFCI², one can observe a significant reduction in the level of LLP of both the banking system and NBFCI, which, together with growth in repayment of credits of bankrupt banks, can testify to the improvement of the credit portfolio of the finance and credit system as a whole (see Chart 1.3.).

Chart 1.4 reflects the so-called "rose" of the average weighted interest rates of credits extended by commercial banks (in domestic and foreign currencies) and non-banking finance and credit institutions³, which to a certain degree enables to assess the level and the direction of the change in the cost of

Chart 1.1. Structure of the Aggregate Credit portfolio (CP), %

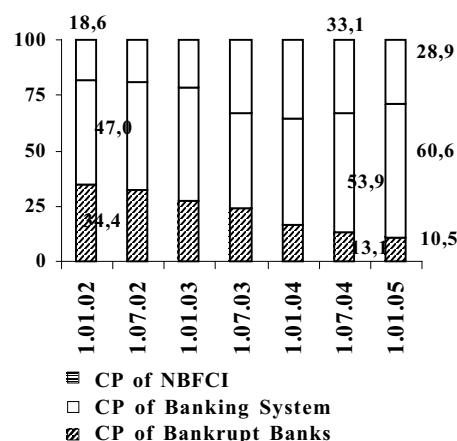
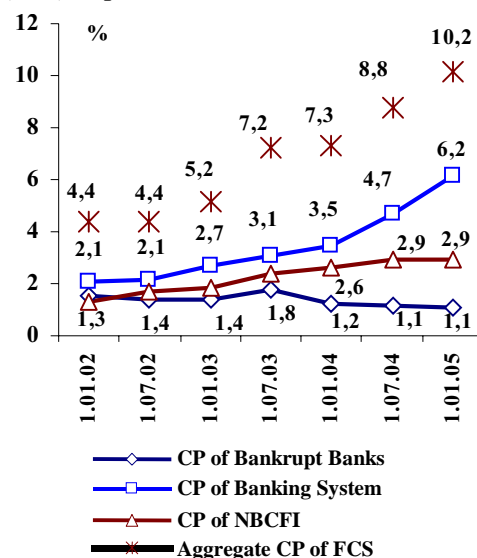


Chart 1.2. Dynamics of Changes in Credit Portfolio (CP) of Finance And Credit System (FCS), in percent to GDP

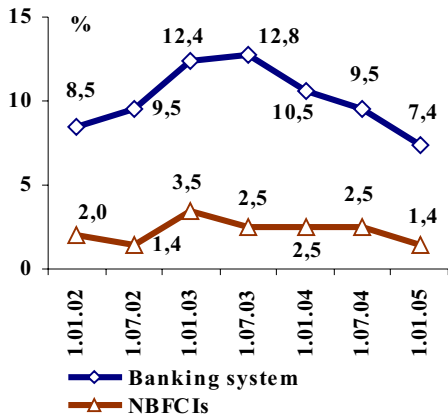


¹ In this case, the operating commercial banks, the commercial banks undergoing bankruptcy proceedings, and non-banking finance and credit institutions licensed by the NBKR are considered as the finance and credit system. Subsequently, upon the receipt of data on other sectors of the finance and credit system the analysis will be expanded.

² In this very case, due to lack of the LLP data for all the NBFCI categories, the KAFC and the FCSDCU data are given at this point to describe the NBFCI loan portfolio.

³ Chart 1.4 does not reflect the average weighted interest rates on pawnshops' credits. As of January 1, 2004 the average weighted interest rate on pawnshops' credits was 164.0%, and as of April 1, 2005 it was 162.0%.

Chart 1.3. Level of Special LLP in Loan Portfolios of Banking System and NBFICs

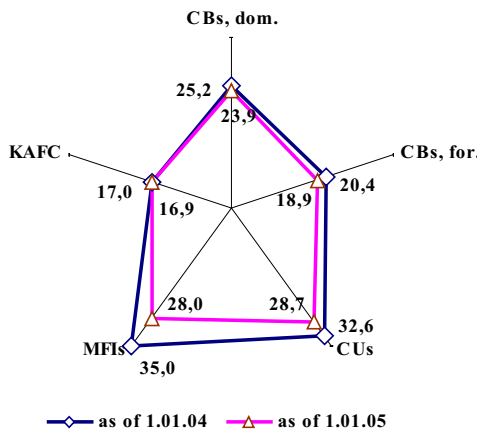


credit resources. Certain "compression" of the considered "rose" of the average weighted interest rates is noted relative to all types of finance and credit institutions under review.

Thus, the status of the finance and credit system of Kyrgyzstan in the current period is characterized by the following:

- the indicator of financial intermediation continues growing and the role of commercial banks in lending to the economy increases;
- Improvements in qualitative characteristics of the loan portfolio of the finance and credit system;
- The overall reduction in the lending costs in the finance and credit system.

Chart 1.4. "Rose" of Average Weighted Interest Rates on Credits of Various FCIs, % *)



*) Abbreviations used in Chart 1.4.: CB, dom. - commercial banks, domestic currency; CB, for. - commercial banks, foreign currency; MFI - micro-financing institutions; KAFC - Kyrgyz Agricultural Financing Corporation.

II. BANKING SYSTEM STATUS

2.1. Banking System Structure

In the second half of 2004 the banking system of Kyrgyzstan was represented by 19 commercial banks (including the Settlement and Savings Company and a branch of the National Bank of Pakistan), including 14 banks with foreign shareholdings, of which 9 banks - with foreign shareholdings of more than 50 percent.

The dynamics of financial intermediation indicates that the banking system continues to gradually increase its presence in the country's economy (see Chart 2.1.1.). For instance, if the degree of financial intermediation relative to the assets was 6.8 percent as of January 1, 2002, by the end of 2004 this indicator increased to 18.6 percent demonstrating that growth was more than 2.5 times. The rate of financial intermediation relative to the credits during this period grew from 1.9 to 6.2 percent, while relative to the deposits - from 3.4 to 11.8 percent. However in the second half of 2004 the rates of growth of financial intermediation relative to the credits decreased from 36.2 percent to 30.7 percent, while the rates of growth of financial intermediation relative to the assets, on the contrary, increased from 4.0 percent up to 30.7 percent (see Chart 2.1.1-a). As a result the factor of growth of financial intermediation in the second half of 2004 was the outstripping growth of cash assets and the security portfolio of the banking system⁴.

The analysis of the banking system structure (Chart 2.1.2.) in terms of the market occupied by groups of large, medium and small banks⁵, indicates a significant reduction in the second half of 2004 in the market share of medium banks (from 30 to 11 percent), and an increase in the market share of large banks (from 57 to 73 percent) and some growth of the share of small banks (from 13 to 16 percent). It should be noted that all loss-making banks are in the group of small banks, with the highest

Chart 2.1.1. Dynamics of Changes in Assets, Credits and Deposits in Percent to GDP

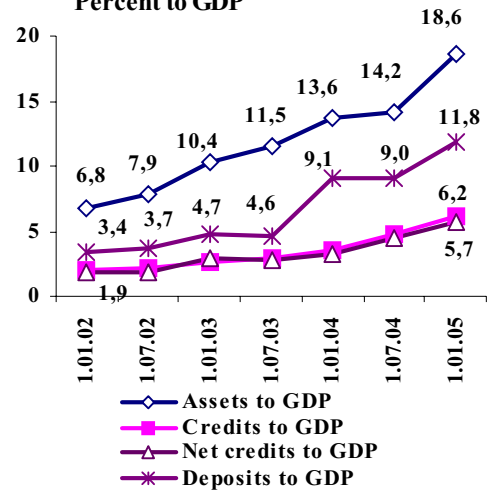
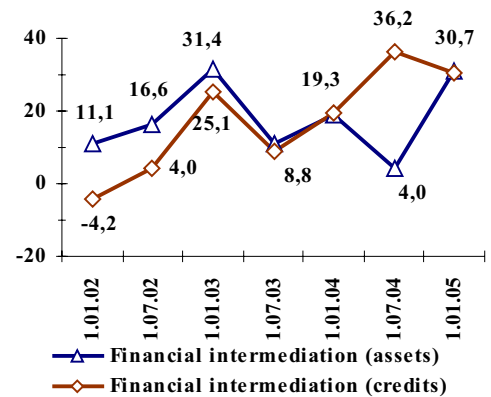


Chart 2.1.1-a. Dynamics of Rates of Growth of Financial Intermediation



⁴ The analysis of the pattern of banking assets is discussed in greater detail in Section "2.2.2. Risks of Financial Transactions".

Chart 2.1.2. Changes in the Structure of Banking System

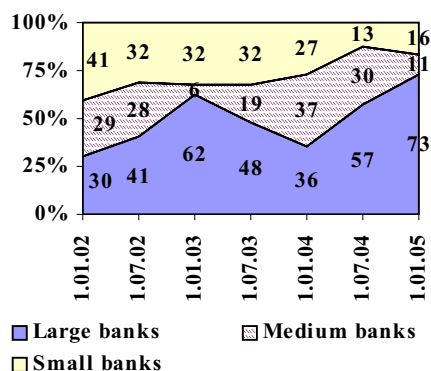


Chart 2.1.3-a. Comparative ROA in Banking System

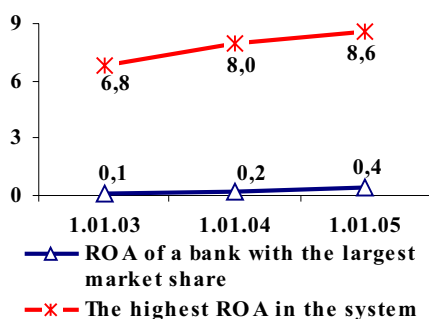


Chart 2.1.3-b. Comparative ROE in Banking System

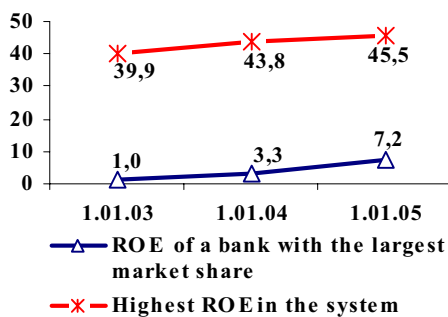
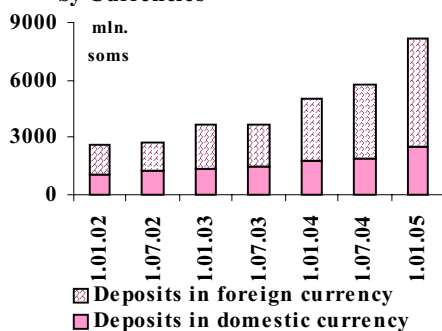


Chart 2.1.4. Changes in Structure of Deposits of Banking System by Currencies



rate of efficiency in the use of both assets and capital displayed also by the group of small banks. One of the operating banks with the largest share in the market of banking services of the republic occupies this niche owing to only growth of its cash assets, at the same time demonstrating the lowest level of efficiency in utilization of both its assets and its capital (See Charts 2.1.3-a, b).

The trends of forming key financial mediation elements - the deposit base and directions of placement of the banking system assets - were considered at this point to characterize financial intermediation of the banking system.

In the second half of 2004 *the deposit base*⁶ continued growing and made up 141.5 percent, and the rate of financial intermediation in terms of the deposit base increased from 9.0 to 11.8 percent. A significant part of deposits is that of deposits of legal entities (74.6 percent) and deposits in foreign currency (70.0 percent) (see Chart 2.1.4). At the same time due to the significant share of deposits in foreign currency, the activities of commercial banks are still vulnerable to external factors.

One should note growth of *the loan portfolio of the banking system* by 39.3 percent in the second half of 2004. In addition growth of the long-term credits was registered: their share in the second half of 2004 increased from 25.4 to 27.5 percent, and it could be considered as one of the factors indicating certain stabilization in the economy. Although the significant share is still that of the short-term credits (72.5 percent) with some decrease in their share (see Chart 2.1.5).

Growth of credits in foreign currency resulted in growth of "dollarization" of the loan portfolio of the banking system, their share in the second half of 2004 increased from 63.6 to 70.3 percent, which is the largest value for the period since 2000.

Such characteristics as the variation coefficient of credit interest rates, the average and average weighted credit rates were considered to estimate the cost of intermediation.

⁵ For the analysis purposes in this edition, the banks, whose share in the banking market (the averaged share in total assets, liabilities, credits and deposits) is more than 10%, are considered to be large banks, those within the range of 5% to 10% - medium banks, and less than 5% - small banks.

⁶ The analysis is based on the data of operating banks.

Thus, the following was noted as the positive factors: (1) the average weighted rate of credits, both in foreign and in domestic currencies, continues to remain below the average rate and proves that lower-than-average rate lending exceeds higher rate lending; (2) both the average and average weighted rates of credits in domestics and foreign currencies were gradually declining in the second half of 2004 (see Chart 2.1.6-7).

The variation coefficient was noted to decline for credits both in foreign and domestic currencies, that is, the reduction in the spread of interest rate on certain credits relative to the average price of credits, which testifies to strengthening of competition and deepening of the market of credits.

Thus, in fulfillment of its intermediary function the banking system is characterized by the following positive trends:

- the indicator of financial intermediation of the banking system increased significantly;
- growth of long-term credits to some extent reflects stabilization in the economy;
- interest rates on credits continue decreasing, and they have been evened up to a certain degree compared to the level of the average interest rate in the market of credits.

Chart 2.1.5. Changes in Structure of the Consolidated Loan Portfolio of Banking System by Maturity

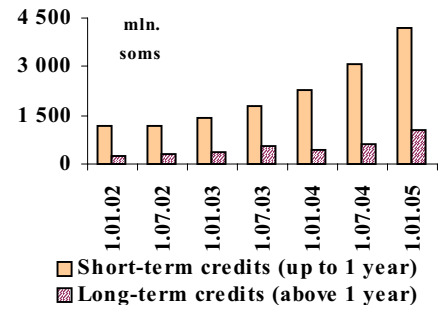


Chart 2.1.6. Changes in Interest Rate on Credits in Domestic Currency

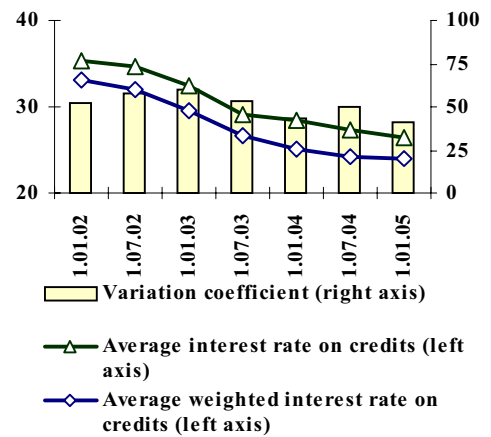
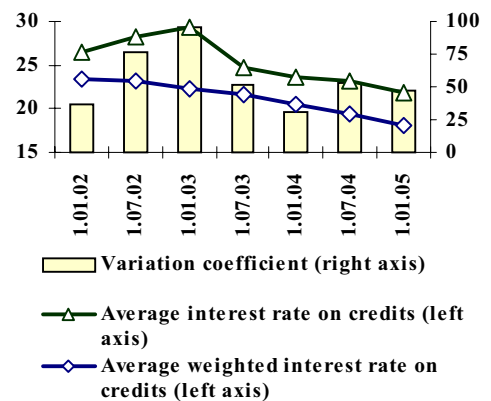


Chart 2.1.7. Changes in Interest Rate on Credits in Foreign Currency



2.2. Risks

2.2.1. Credit Risk

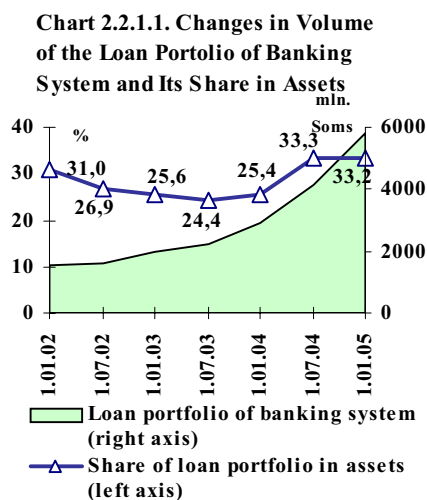


Chart 2.2.1.2 Changes in Share of Non-Performing and Past Due Credits in Bank's Loan Portfolio

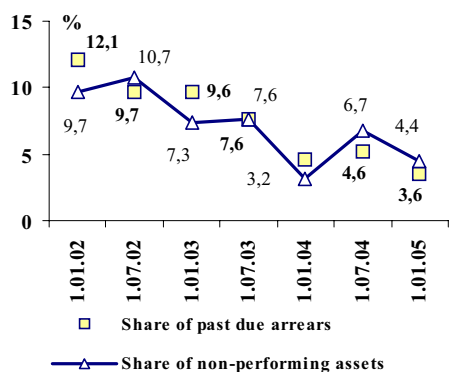
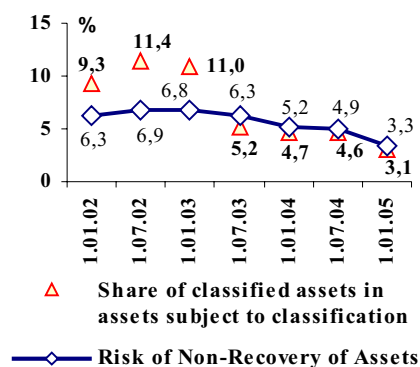


Chart 2.2.1.3 Changes in the credit risk in assets of the banking system



Credit risk is one of the major risks in banking. This section discusses all active operations of a bank exposed to credit risk.

As evident from Chart 2.2.1.1. the loan portfolio of the banking system in absolute terms continued growing in the second half of 2004, and its share in assets remained practically un-changed, which testifies that the rates of growth of the loan portfolio are comparable to the rate of growth of assets of the banking system.

When analyzing quality of the loan portfolio maximum attention should be given to non-performing and past-due assets demonstrating first signs of deterioration of the loan portfolio. Chart 2.2.1.2. shows that both non-performing and past-due assets share is decreasing with general growth of lending, that demonstrates improvement of banking credit portfolio quality in the second half 2004.

The system of assets classification is used to determine the quality of assets (see Chart 2.2.1.3). Classification of assets enables to determine the level of risks, related to active banking operations, That is, the bank's loan loss provisions are determined according to "viability" of credits. Consequently, the classification of assets reflects various degrees of one factor - the risk of non-repayment⁷. Thus, with the growth of total assets, subject to classification, the share of classified assets in them, the most exposed to loss, continued to decrease. In Chart 2.2.1.3. one could also see that the risk of non-repayment of assets continued de-creasing during the period under consideration.

To analyze risks, accompanying placement of other assets, except credits, a general pattern of banking system assets is con-sidered (see Chart 2.2.1.4). So, somewhat qualitative change in banking system assets pattern is observed.

⁷ The risk of non-repayment of credits is calculated as the ratio of the volume of special LLP and the aggregate loan portfolio of the banking system; The term "special LLP" means the recourses, reserved by the finance and credit institution to repay the potential loan and lease losses.

If earlier developments were mainly related to growth of the volume and the share of money recourses and credit portfolio of banking system, then in the second half of 2004 with invariable level of the share of money and credits the growth of the securities share from 6.6 to 9.5 percent is observed.

Considerable share of money resources in banking system assets pattern (49.1 percent in the second half 2004) is still the subject of separate consideration. So, the pattern of "cash" of the banking system more than 70 percent is continuing to be "nostro" accounts of one bank. It should be stated, that the increase of cash on the "nostro" accounts of the banking system, excluding this bank, is not significant (reflected in Chart 2.2.1.5. by a dotted line).

Thus, in general, the considered indicators reflect some re-reduction of the credit risk in the banking system with simultaneous expansion of active operations diversification that was reflected in the growth of the share of the securities in assets pattern of the banking system.

2.2.2. Liquidity risk

Confidence of the population in the banking system depends on timely fulfillment by the banks of their commitments, that is provided by sufficient liquidity level. For regulatory purposes the risk of liquidity is measured by means of economic norm of liquidity⁸. The level of this norm, maintained by the banking system, is still rather high. On the average it made 91.1 percent for the whole banking system in the second half 2004, having thus increased by 5.4 percentage points as against the previous period. The reason for its growth was that of outstripping of growth of short-term liquid assets compared to the rates of growth of liabilities. On the other hand, considerable excess of liquidity ratio testifies that banks did not use the opportunity to increase financial mediation.

As the liquidity ratio is the most generalized feature of the liquidity risk of the banking system, other estimated figures should be considered. In Chart 2.2.2.1. one could note a continued tendency of the overall liquidity reduction (the share of liquid assets in total assets), that also reflects growth of income generating assets.

Chart 2.2.1.4. Changes in the share of credits, securities, funds and other placements of commercial banks in assets

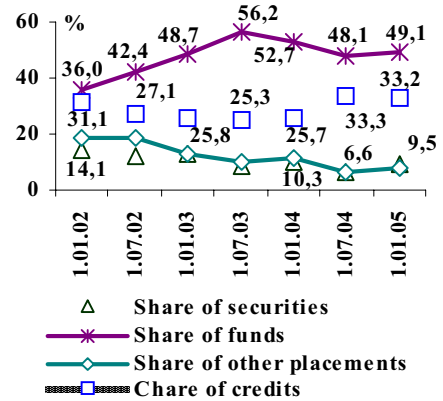


Chart 2.2.1.5. Impact of operations in "nostro" accounts of a certain bank on operations in "nostro" accounts of banking system

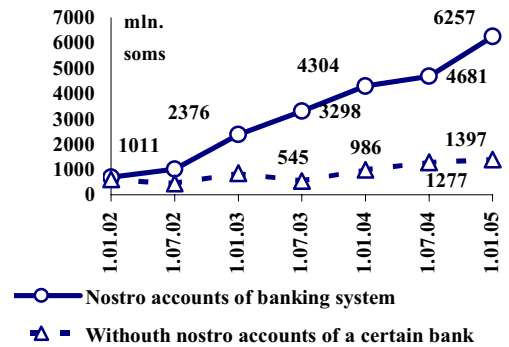
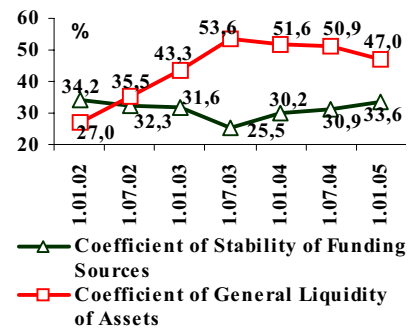


Chart 2.2.2.1. Evaluation of Stability of Funding Sources and General Liquidity of Assets of Bnking System



⁸ The liquidity ratio is one of the mandatory norms to be observed by a bank, established by the NBKR at the level of not less than 30 percent.

Chart 2.2.2.2. Dynamics of changes in duration of credits and deposits of banking system months

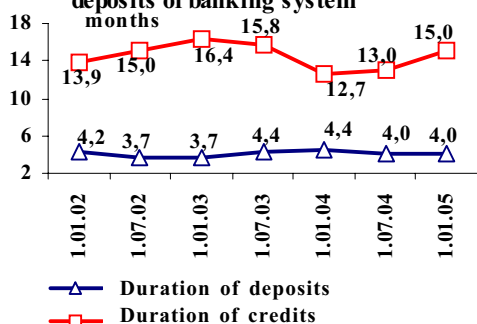
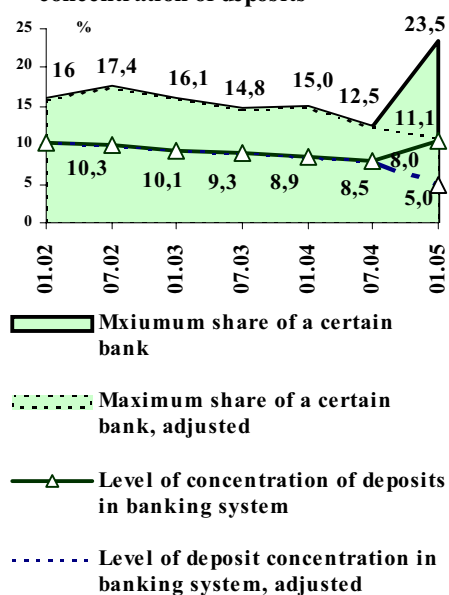


Chart 2.2.3.1. Changes in concentration of deposits



Developments of another indicator, the stability ratio of sources of financial assets⁹, reflects some deterioration in the pattern of sources of the banking system assets. In connection with this, the growth of a gap between duration of deposits and credits in the second half 2004 also indicates some misbalance between assets and liabilities of the banking system by terms (see Chart 2.2.2.2).

By and large, despite of some deterioration of the developments of the considered liquidity indicators of the banking system, there are no reasons to conclude on the growth of the liquidity risk in the banking system.

2.2.3. Risk of Concentration

Characteristics of Deposit Concentration. As evident from Chart 2.2.3.1 a maximum share of an individual bank in the deposit market sharply increased in the second half of 2004. It should be stated, that just the same bank whose growth of "nostro" accounts had an impact on the growth of the banking system assets (that was discussed in section 2.2.1), holds deposits of foreign counteragents, who balance with "nostro" accounts of this bank. When considering the developments of deposits concentration by types of currencies (see Chart 2.2.3.2) growth of deposits concentration in foreign currency is observed, that is caused by growth of deposits in foreign currency with the same bank, mentioned above.

If to except deposits of this bank, for the period under consideration from 01.01.2002, both maximum share of deposits and the level of deposit concentration in the banking system trend to decline (reflected in Chart 2.2.3.1. by a dotted line), that signifies some growth of competition in financial resources market and reduction of the risk of deposit concentration in the banking system.

Estimation of the level of concentration in the banking system by means of other indicator "The share of four largest banks by the level of deposits" in the first and the second 2004 also testifies the growth of deposit concentration from 45.2 to 52.0 percent.

⁹ The ratio of stability of financial assets' sources is characterized by the share of instable deposits in the total sum of liabilities.

At the same time composition of banks remained stable, but if in the first half of the year these four banks had approximately the same shares, then in the second half of the year almost half share of these four banks belongs to one bank.

Characteristics of Credit Concentration. Growth of the laon portfolio of the banking system is accompanied with somewhat increase in the level of credit concentration (see Chart 2.2.3.3.). At the same time the maximum share of an individual bank in the credit market of commercial banks' system grew slightly.

If to consider the indicator "The share of four largest banks by the level of credits", one should note, that it actually remained unchanged having made 56.0 percent. At the same time the composition of these banks did not change either (the same three banks out of four), but the distinctive feature is that only one bank from the group "Four largest banks by deposit level" is included in the group "Four largest banks by the level of credits".

If to consider the concentration of credits by types of currencies, then some revival is observed in the foreign currency credit market (see Chart 2.2.3.4.).

Based on the data from table 2.2.3.5, one could state, that in the period under consideration quite different situation was observed in the breakdown of credits by sectors of the national economy as compared to the previous period.

The analysis of the risk of credit concentration by sectors of the national economy reveals preservation of the estimation of credit concentration level by all sectors from "close-to-high" to "high"¹⁰. At the same time the decline of the level of credit concentration in two interrelated sectors "construction" and "mortgage" is observed, that is caused by a definite revival in these sectors of the national economy. Taking into account the fact that the year 2005 is declared "The year of housing constriction and social mobilization" as well as considering governmental support of initiatives in this sphere, one could assume that the decline of credit concentration in the subject sectors will continue.

Chart 2.2.3.2. Concentration of deposits by types of currencies

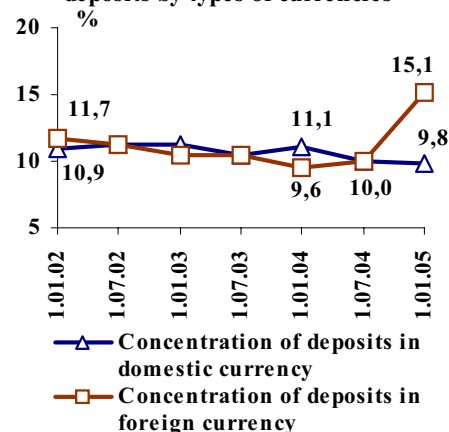
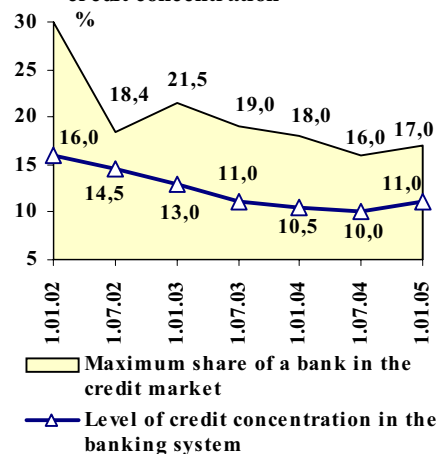
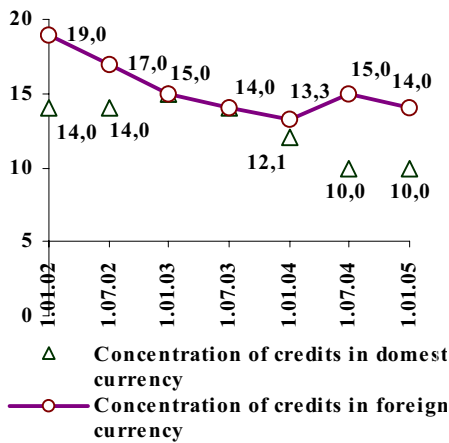


Chart 2.2.3.3. Changes in credit concentration



¹⁰ Appraisal of the risk of concentration as high, moderate, and low is based on the common scale of levels of risk of concentration. So, the concentration risk is considered to be low, if the level of concentration is below 10 percent, moderate- from 10 to 20 percent or high- above 20 percent.

Chart 2.2.3.4. Concentration of credits by types of currencies (%)



Thus, the analysis of risks of concentration shows that:

- Banks expanded their activities in placing loans in foreign currency and in lending of such sectors as "construction" and "mortgage";
- Changing of deposit concentration indicators testifies on some raise of banks' activity in the financial resources.

Table 2.2.3.5. Bank Credit Concentration by Sectors of National Economy*
(In percent)

	01.01.02	01.07.02	01.01.03	1.07.03**	1.01.04	1.07.04	1.01.05
Industry	23,2	18,9	20,3	13,7	17,1	19,1	20,8
Agriculture	21,7	22,7	33,7	39,9	29,2	29,1	25,9
Transport	39	41,5	51,7	33,2	31,2	45,6	31,9
Communications	31,6	44,2	34,6	62,6	26,9	37,2	34,7
Trade	19,3	17,4	14,3	12,3	13,4	11	12,0
Procurement and processing	30,3	29,2	28,8	27,9	19,7	25,2	28,8
Construction	24,3	18,6	17,9	17,8	23,7	33,6	28,8
Mortgage	-	-	-	61,6	27,7	21,7	16,3
Households	-	-	-	45,8	13,4	15,6	16,0
Social services	-	-	-	16,6	67,7	71	44,3
Other	22,7	20,9	25,8	12	12,5	12,2	13,6

* Concentration is determined based on the Herfindale index, which is calculated as the sum of squared shares of banks in total lending to the sector. The concentration index equal to 100 percent means complete monopolization of the market, 50 percent- 2 participants with equal shares, 33 percent - 3 participants, and so on.

** Before July1, 2003 the categories "mortgage", "households" and "social services" were unified in one category "individuals".

2.3. Capital Adequacy

The key indicator of the bank's solvency is adequacy of its capital to the scale and nature of operations conducted by the bank. Sufficient capital forms a peculiar "cushion", which enables the bank to remain solvent and maintain confidence of the population in the bank. The optimal policy of the bank in the sphere of capitalization should be aimed at maintaining the acceptable risk level by maintaining sufficient level of its own capital.

Taking into account the fact that the minimum capital adequacy ratio is established at the level of 12 percent, the average capital adequacy ratio of the banking system, despite of its decline (see Chart 2.3.1), remains rather high - 23.0 percent, that enables one to conclude on the opportunity to increase the volume of risk assets almost by one and a half without exceeding of acceptable level of risk in banking system's activity as a whole. The above stated reflects the availability of certain potential to expand the level of financial mediation of the banking system.

Chart 2.3.1. and Table 2.3.1. illustrate, that starting from the second quarter 2003 the rates of growth of both assets and own capital were positive. At the same time one could note the following feature - the rates of growth of own capital were lower, than the rates of growth of assets. Such situation may be treated as acceptable one, because, as it was mentioned above, there is a sufficient "reserve" in the size of the capital adequacy ratio.

Chart 2.3.1. Changes in Capital Adequacy Ratio of Banking System

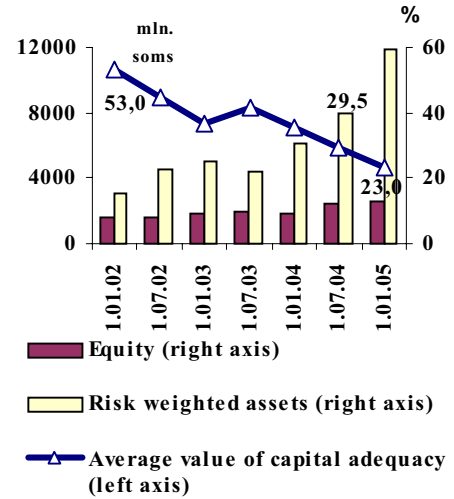
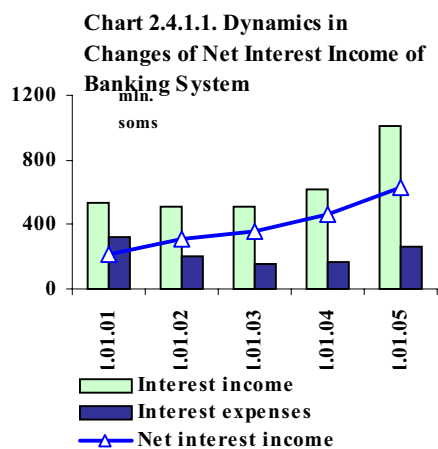


Table 2.3.1. Time History of Rates of Growth of Risk Assets & Net Total Capital in Banking System

INDICATOR	01.01.02	01.07.02	01.01.03	01.07.03	01.01.04	01.07.04	01.01.05
Rates of growth of risk assets in the banking system as a whole, percent	50,8	16,7	8,6	-11,4	39,3	30,4	49,4
Rates of Growth of NTC of the banking system, percent	100,3	4,4	-8,7	2,7	17,9	7,7	4,6

2.4. Financial Data

2.4.1. Yield



Due to specificity of banking operations, interest income, which characterizes profitability of active operations, is the traditional source of income.

With the growth of loan portfolio, which comprises the main share of income-generating assets of the banking system, a steady growth of net interest income for the period from 2001 is observed. At the same time more than doubled growth (or by 62.4 percent) of interest income of the banking system is marked in 2004 as compared with the similar period of the last year (see Chart 2.4.1.1.).

Developments of indicators, characterizing the rate of return of the banking system - the ratio of net interest income and non-interest income to gross income (see Chart 2.4.1.2.) - demonstrates formation of trend of the rate of return growth from main activities in the banking system.

A *yield of spread* is another attribute of profitability of the banking system, which helps to assess how effectively the function of the intermediary between the investors and the real sector. For instance, the situation, which occurred in the second half 2004, i.e. some decline of the revenue base of assets with invariable spread level may testify that return indicators of the banking system in the second half 2004, at least, did not worsen (see Chart 2.4.1.3.). And unchanged level of spread from January 1, 2003 and as of each January 1 of the next year in combination with the descending trend of the yield spread¹¹ illustrates insignificant competition among commercial banks for revenue assets.

Chart 2.4.1.2. Changes in Profitability of Banking System

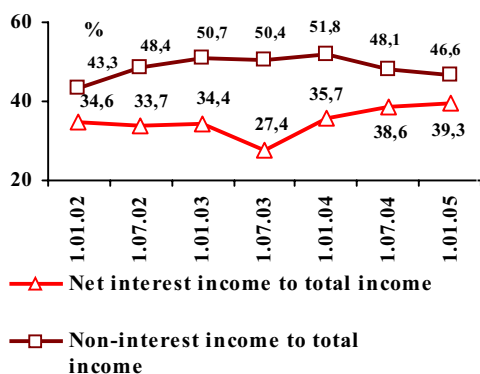
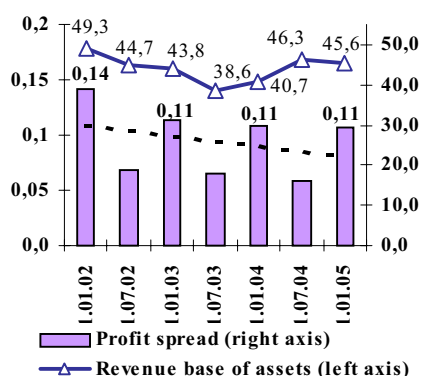


Chart 2.4.1.3. Dynamics of quality indicators of profitability of the banking system (%)



¹¹ Taking into account the cyclical nature of *Profit* and all its derivatives (for instance, the Yield spread), the dotted line indicates the trend of the *Yield spread*.

2.4.2. Net Income

Significant growth of net income of the banking system is observed in 2004 as compared to the corresponding period of the last year - by 164.6 percent (see Chart 2.4.2.1), at the same time income and expenditures grew almost equally having made 166.2 and 166.5 percent, accordingly.

Taking into mind, that growth of income of the banking system occurred not due to growth of the yield rate of banking operations (as it was stated in section 2.4.1), but mainly due to growth of banking activity volumes, it is necessary to note, that this did not impact growth of indicators, characterizing expenses of the banking system (see Chart 2.4.2.2.).

2.4.3. Effectiveness

Such indicators as return on assets (ROA) and return on equity (ROE) (see Charts 2.4.3.1, 2.4.3.2.) were used to evaluate the effectiveness of the banking system. In the second half of 2004 the rate of return on assets grew having made 2.4 percent. As compared to the similar period of the year 2003, growth of this indicator made 84.6 percent, and the rate of return on equity for the period under review was 15.5 percent, with growth rate 93.7 percent.

Thus, the considered indicators of effectiveness of the banking system reflect positive developments as a whole. At the same time comparison of the rates of growth of ROA and ROE, as well as high average figure of capital adequacy ratio in the banking system signifies, that expansion of active operations of banks was conducted somewhat less efficiently against opportunities, given by the size of own capital of the banking system.

Chart 2.4.2.1. Formation of Net Income of Banking System

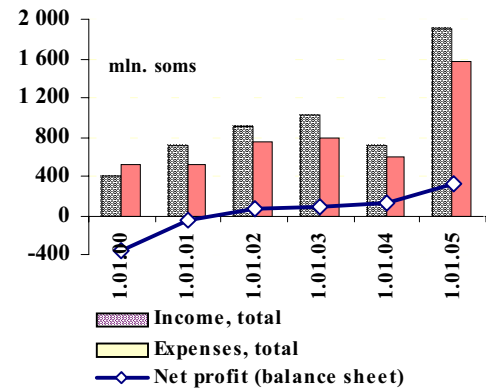


Chart 2.4.2.2. Changes in Profitability of Banking System

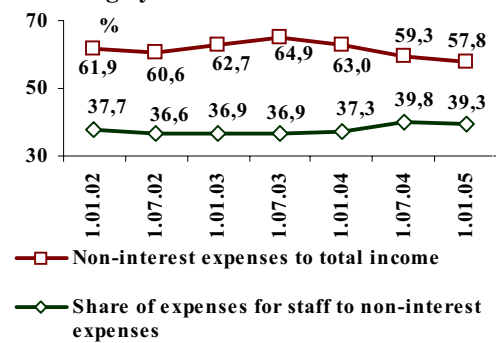


Chart 2.4.3.1 Changes in Return on Assets (ROA)

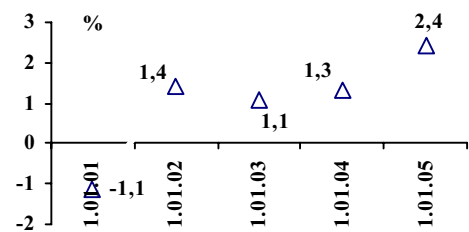
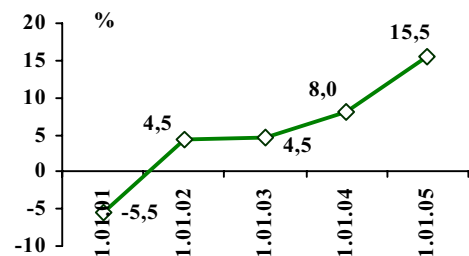


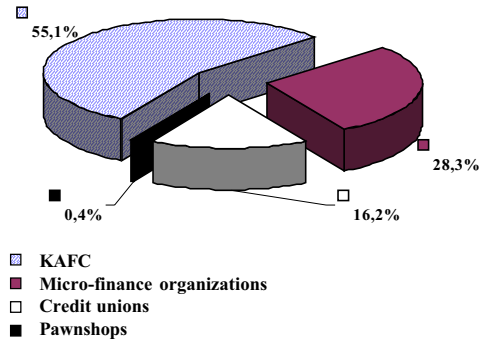
Chart 2.4.3.2 Changes in Return on Equity (ROE)



¹² When analyzing such indicator as Profit and its derivatives, it is necessary to bear in mind, that reporting reflects it on the accrual basis for the period from the beginning to the end of the year. This explains the use in charts of the separate value as of the beginning of the year and as of the end of the half of the year.

III. NON-BANK FINANCE AND CREDIT INSTITUTIONS

Chart 3.1.1. Aggregated Loan Portfolio as of 01.01.05 by Types of Non-Bank Finance and Credit Institutions



As of January 1, 2005, the system of non-bank finance and credit institutions (NFCI) comprised: the Kyrgyz Agricultural Financial Corporation (KAFC), the Financial Company on Support and Development of Credit Unions (FCSDCU), 305 credit unions (CU), 26 micro-credit companies (MCC), 78 micro-credit agencies (MCA) and 116 pawnshops. No one micro-finance company (MFC) was registered as of January 1, 2005.

During the second half 2004 NFCI continued to grow in number. The most active growth of NFCI quantity was observed among the micro-finance organizations MFO - 30 percent and MCA - 18.2 percent. The number of pawnshops increased by 7.4 percent, and the number of CU remained unchanged (14 licenses were issued during the period, 11 licenses were recalled and 3 licenses were cancelled).

The number of NFCI borrowers as of January 1, 2005 in breakdown by regions is as follows: Bishkek - 15 407; Batken oblast - 7 446; Jalal-Abad oblast - 11 997; Issyk-Kul oblast - 16 624; Naryn oblast - 7 675; Osh oblast - 26 109; Talas oblast - 8 576; Chui oblast - 8 917.

By and large, dynamics of the quantity of NFCI demonstrates saturation of the market by such type of institutions as CU, which is connected with rather long term of the project on creation of CU system. Thus, from 1997 to 2002, state agencies actively performed in terms of popularization of the framework on rendering bank services by means of establishment of CUs. Besides, according to estimations, conducted by international experts, in 1996, market demand of the Kyrgyz Republic in such institutions made about 280 CU, that is less of the current number CU. On the other hand, dynamic increase of MCA and MCC shows demand for their services and flexibility of regulatory frameworks proposed by the state.

3.1. Loan Portfolio Structure

According the data of regulatory reports, aggregate assets of non-bank finance and credit institutions for the second half 2004 increased by 8.8 percent, and as of January 1, 2005 totaled Som 3 321 million.

The main share of aggregate assets of NFCI is in the loan portfolio - 83.7 percent. As of January 1, 2005, the loan portfolio of NFCI was Som 2 772 million¹³.

As of January 1, 2005 the number of active loans of NFCI totaled 102.8 thousand.

In the aggregate NFCI loan portfolio structure (see Chart 3.1.1) 55.1 percent is that of the KAFC, 28.3 percent - loans of micro-credit organizations (MFO) - MCA and MCC, 16.2 percent - loans of CU and 0.4 percent - loans of pawnshops.

In the second half of 2004 the largest volume of NFCI loans was directed to lending to agriculture - 59.4 percent and trade 27.9 percent.

Such distribution of loan resources could be explained by specificity of operation of KSFC and micro-credit organizations. Thus, KAFC, having the largest share in the aggregate loan portfolio NFCI, directs 84.9 percent of its loans to agriculture, and MFO directed 66.1 percent of their loans to trade.

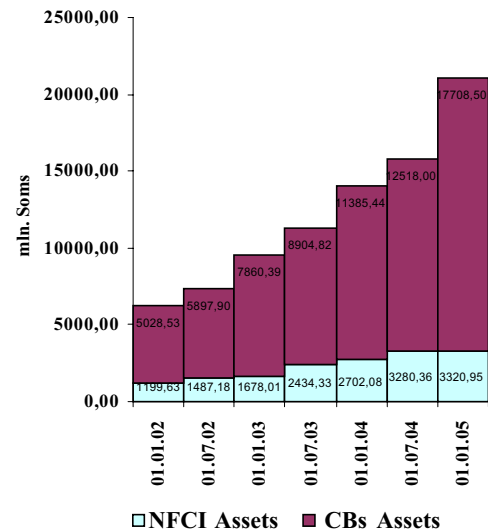
The largest volume of loans was extended in Osh oblast - 27.3 percent, Djalal-Abad oblast - 16.4 percent, Chui and Issyk-Kul oblasts - per 12.6 percent and in the Bishkek city - 11.1 percent.

Dynamics of volumes of the loan portfolio by sectors and regions demonstrates sustainable preferences in lending - the main niche of NFCI is agriculture and trade, and regional activity is the most high in the south of the country due to higher population density and economic activity.

3.2. Loan Portfolio Dynamics

Growth of NFCI assets was 8.8 percent since July 1, 2004. As of January 1, 2005, the assets of these institutions totaled Som 3 321 million (Chart 3.2.1). The largest share in the NFCI assets is that of the KAFC - 48.4 percent, micro-credit organizations - 29.1 percent (MCA - 12.2 percent, MCC - 16.9 percent). The MFOs and pawnshops showed the highest rate of growth (31.1 and 12 percent, correspondingly), while the lowest rate of assets was that of KAFC - 3.8 percent. Growth of NFCI assets is caused, first of all, by the growth of assets of large MFOs and by establishment of new pawnshops and MFOs.

Chart 3.2.1 Share of assets of NCFI and CBs



¹³ Hereinafter, when considered separately (without calculation of the share in assets and other), the loan portfolio of NFCI is indicated without FCSDCU, as its portfolio is already included in CU assets.

Chart 3.2.2 Dynamics of loan portfolio of NBFIs and CBs

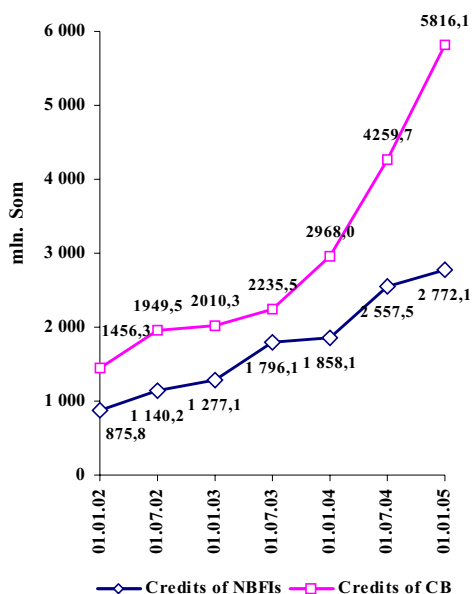
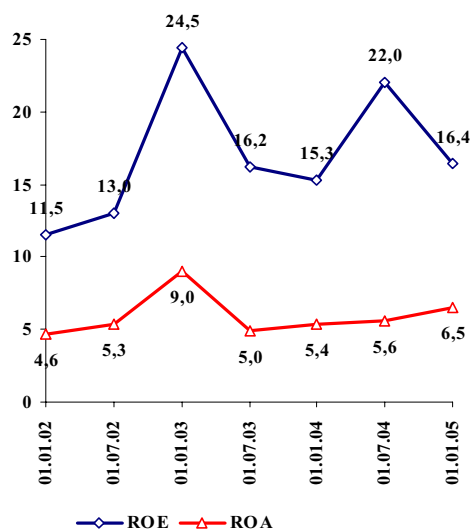


Chart 3.2.3 Changes in ROA and ROE Indicators of NBFIs



The share of NFCI assets in the total assets of finance and credit institutions¹⁴ decreased from 20.8 percent to 20.3 percent for the second half of the year 2004.

In the second half 2004 growth of assets of commercial banks continued to maintain the outstripping rates (the rate of growth is 29.3 percent) as compared to NFCI (the rate of growth is 8.8 percent).

With the growth of NFCI system's assets by 8.8 percent, their loan portfolio increased by 7.8 percent. It should be noted, that the share of the loan portfolio in NFCI assets for the last two years, as a rule, increased during the first 6 months and decreased by the end of the second 6 months. Such cyclic dynamics resulted from the evident seasonal nature of the majority NFCI performance and relation of the borrowers' business to agricultural cycle.

The aggregate loan portfolio of NFCI totaled Som 2 772 million as of January 1, 2005. By and large, the loan portfolio of NFCI for the last three years bears steady upward tendency that confirms that services of such institutions are in demand (see Chart 3.2.2).

The analysis of NFCI loan portfolio indicators showed, that its quality changed insignificantly. For instance, although the rates of growth of special loan loss provision (LLP) for the second half 2004 was 8.3 percent (20.9 percent in the first half of the year), the share of LLP in the loan portfolio increased only by 0.05 percent and was 2.4 percent as of January 1, 2005. The outstripping rates of growth of special LLP, as compared to growth of the NFCI loan portfolio (8.3 and 7.8 percent, accordingly) resulted from some deterioration of micro-finance organizations' and credit unions' loan portfolio quality.

By and large, the relative stability of quality and apparent growth tendency of the loan portfolio enable to expect that the role of NFCI will increase in rendering definite bank services to the population of the Kyrgyz Republic with full coverage of the regions.

The analysis, taken on the ROA and ROE basis showed, that the effectiveness of NFCI activity increased in the second half of 2004 (see Chart 3.2.3). ROA indicators for about one and half year have steady and positive dynamics, and income

¹⁴ Total assets of finance and credit institutions mean the assets of commercial banks and the assets of non-bank finance and credit institutions.

growth rates (the rates of growth for the six-month period - 23.2 percent) significantly exceed the assets growth rate of NFCIs (the rate of growth for the six-month period is - 8.8 percent). In terms of ROE it should be noted, that apparent decline relates to the outstripping rates of growth of NFCI capital. For instance, for the second half 2004 the rates of growth of the aggregate NFCI capital was 52.1 percent.

So, one could state, that despite of some deterioration of the loan portfolio quality, the rate of return had an upward tendency.

3.3. Primary Risks

NFCI activity is accompanied with the high risks of loan concentration, because their activity is directed to mainly lending to agriculture and related business, located in rural areas. As it is known, lending to this sphere is attended with high risks, related to weather-climatic conditions and relatively insignificant income of the rural population.

In addition to agriculture, lending covers trade and catering. The turnover of resources is larger in the sphere of trade than in agriculture, however, the risks related to pricing and keen competition reduce economic efficiency of utilization of the received loans.

Interest rates of loans extended by NFCIs remain quite high and it is due to the NFCI's strive for covering their high risks resulting from specificity of their activity as well as permanently high demand for these types of credits on the side of the population. At the same time, the interest rates of the NFCI credits show the sustained downward tendency. For instance, since the beginning of the six-month period the majority of the NFCIs reduced their interest rates due to the general reduction of interest rates and keener competition. The average interest rate of the NFCIs credits for the reporting period was that of MFO - 28.0 percent, in CU - 28.7 percent, in KAFC - 16.9 percent and FCSDCU - 17.1 percent.

IV. PAYMENT SYSTEM

4.1. Bank Tariffs and Services

As a whole, the tariffs for the basic banking facilities changed insignificantly during the second half of 2004. Commercial banks establish the tariffs for rendered services in accordance with their internal policies. The range of prices for certain types of services varies by commercial banks. There are banks, oriented to providing services to broader strata of the population and legal entities at lower and more accessible tariffs and banks preferring to serve larger customers.

The tariffs for settlement and encashment servicing, including the tariffs for a remittance of funds in regional branches of banks depend on how far the branch is located and whether there are banks-competitors in the region and, as a rule, are higher than in head offices and banks' branches located in Bishkek. At the same time the second half of the year 2004 showed the tendency of equalization of the size of the tariffs in the regions with the tariffs of head offices.

The tariffs of commercial banks for the remittances of funds in foreign currency outside Kyrgyzstan (dollars, euro, marks, rubles, tenge and others) did not change on the average in the banking system as compared to the second half of 2003 and were 0.2 percent of the remitted funds. At that, the majority of commercial banks differentiate their payments depending on the currency and the volume of payment. A number of banks raise the fees for the remittances of foreign exchange. The minimal payment makes US\$ 5 and the maximum one -US\$ 500 irrespective of the amount of the remitted funds.

As of January 1, 2005 money was transferred outside the republic via the international systems of remittances: West-ern Union, MIGOM, Money Gram, Contact, VIP Money Transfer, Anelik, Express Money, Unistream. The banks continue developing the international remittance services.

In addition to the earlier existing systems, functioning in the second half of 2004, two new systems of money transfer Kyrgyzstan - Sibcontract and Travels.

The tariffs for international remittance are standard within each system.

New instruments on conducting payments appeared in the second half 2004 in the market of retail and regular payments. Particularly, prepayment cards in the domestic currency with various denominations at Som 250, 500, 1500, 3000, which are further planned to be utilized for making utility payments were realized among the population to conduct payments for mobile and fixed communication.

4.2. Cash and Non-Cash Turnovers

The money turnover has cash and non-cash forms, with the cash and non-cash turnovers depending on the economic pattern, the preference of the population for consumption, and on development of the banking and payment systems. The steps, taken by the National Bank of the Kyrgyz Republic are aimed at stabilizing the rates of growth of cash and at reducing the share of cash in the currency mix.

As of January 1, 2005 *money in circulation* made Som 11, 425.1 million. Growth of money in circulation in the second half of 2004 as compared with the first half of 2004 made Som 850.7 million, the rate of growth - 8.0 percent.

Som 298.2 million or 3.7 percent of the total sum of money in circulation were in the cash offices of commercial banks.

The pattern of money in circulation is shown in Chart 4.2.1.

The growth factors of money in circulation are related to the increase of the payments of the state social package, the demand for cash on the part of developing small and medium businesses, and insufficient development of non-cash payments.

The rate of return of cash to the cash offices of commercial banks and the NBKR is the basic indicator characterizing the level of development of the cash turnover. For the second half of 2004 the *rate of return of cash to the cash offices of commercial banks* made 98.4 percent, which is 1.1 percentage points more than in the first half of 2004. The dynamics of the rate of return is reflected in Chart 4.2.2.

The highest rate of cash return for the second half 2004 was registered in the Chui oblast - 115.3 percent, the lowest - in the Batken oblast - 33.2 percent. In the Bishkek city the rate of cash return was 110.2 percent. Such high rate of return of cash in many ways relates to concentration of banking and finance institutions, trade and industrial enterprises in the capital of the republic and in the Chui oblast.

Chart 4.2.1. Structure of money in circulation

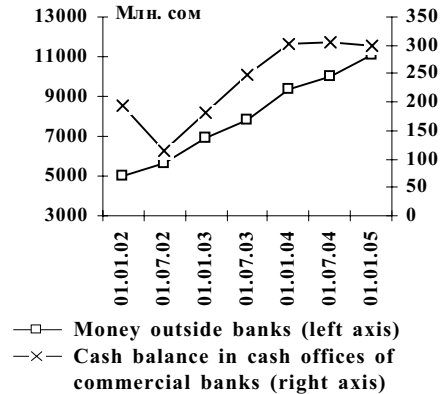


Chart 4.2.2. Dynamics of changes in cash return to commercial banks (%)

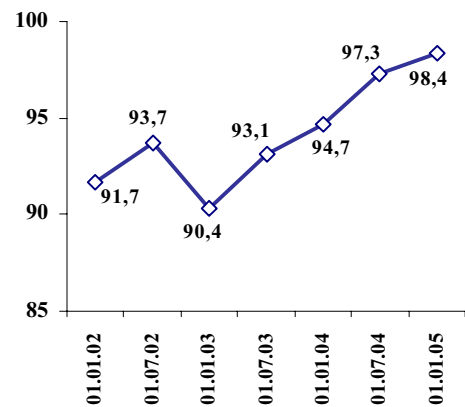


Chart 4.2.3. Indicator of return of cash to cash offices of commercial banks (%)

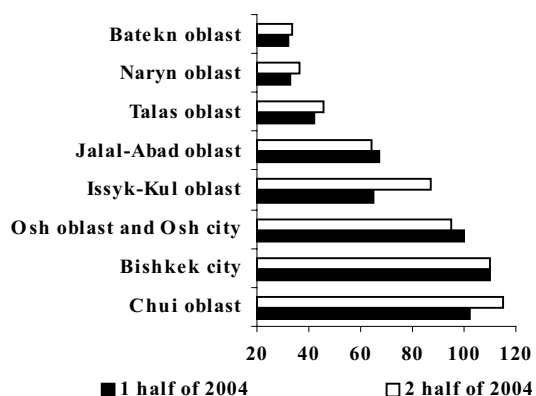
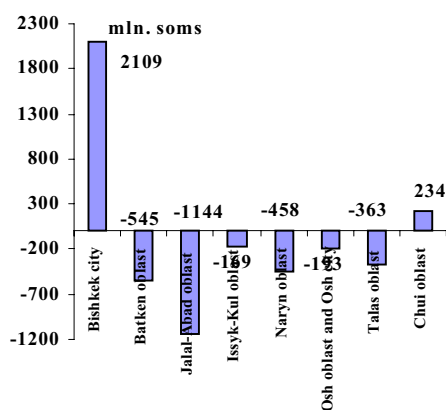


Chart 4.2.4. Increase in cash receipts compared to cash issues from cash offices of commercial banks for 2 half of 2004



At the same time, the rate of return of cash to the cash offices of commercial banks in the Bishkek city remained at the same level as compared to the first half of 2004. As a whole, in the republic by regions the rate of return of cash increased significantly. Growth of the rate of return of cash caused by the growth of receipts of cash in cash offices of commercial banks. The rate of return of cash for the second half 2004 as compared to the first half in breakdown by regions is presented in Chart 4.2.3.

One could also note here, that exceeding of issues of cash from cash offices of commercial banks over receipts of cash in cash offices of commercial banks in the second half 2004 was Som 529.3 million, that is by Som 101.5 million or by 19.2 percent less than for the first half 2004. The excess of cash issues over receipts is caused by low rate of return of cash in commercial banks in regional divisions, as the receipt of cash in cash offices of commercial banks in the Bishkek city and in the Chui oblast exceeds their issue. For instance, exceeding of receipts over issues in the Bishkek city totaled Som 2 108.9 million, that is by Som 495.3 million or by 30.7 percent more than that for the first half 2004, by Chui oblast - Som 233.5 million, that is by Som 208.4 million or by 92.8 percent more than for the first half 2004. The excess of receipts of cash over issues for the second half 2004 by regions is presented in Chart 4.2.4.

In the second half 2004 the issue of cash from the cash offices of the NBKR as a whole in the republic exceeded their receipt by Som 1 129.6 million, which is by Som 452.2 million, or by 66.8 percent less, than for the first quarter 2004. Exceeding of receipts of cash in the cash offices of the NBKR over their issues is caused by the increase of cash issues by commercial banks.

The rate of return of cash to the cash offices of the NBKR as a whole in the republic for the second half 2004 was 82.4 percent, having decreased by 3.7 percentage points as compared to the first half 2004.

Issues of cash from the cash office of the NBKR. For the first half 2004 the cash office of the NBKR issued Som 6 436.9 million, which is by Som 1 562.5 million or by 32.1 percent more than for the first half 2004. At this, it was issued Som 873.4 million for payment of wages to the budgetary entities, cash issued to pay pensions and allowances totaled - Som 619.9 million, to pay wages to economic entities - Som 731.6 million, for other payments - Som 4 162.9 million¹⁵. Dynamic of issues of cash from the cash office of the NBKR is demonstrated in Chart 4.2.5.

¹⁵ Issues for other payments represent payments to legal entities to conduct their activity.

According to the data from the Ministry of Finance, the Social Fund and the Ministry of Labor and Social Protection of the Kyrgyz Republic the overdue arrears as of January 1, 2005 amounted to Som 23.5 million and as compared to July 1, 2005 it decreased by Som 89.3 million or by 79.2 percent. Reduction of the overdue arrears is related with the repayment of budgetary debt on wages and social payments, that resulted in the evident growth of cash in the second half of 2004. The pattern of issues of cash in percentage is demonstrated in Chart 4.2.6.

Receipts of cash by the cash offices of the NBKR. In the second half of 2004 the cash offices of the NBKR, as a whole, in the republic, received Som 5 308.3 million, that is by Som 1 111.3 million or by 26.5 percent more than for the first half of the year 2004. Growth of receipts of cash to the cash offices of the NBKR in the republic, in general, is caused by the increase of cash receipts by cash offices of commercial banks. Developments of receipts, issuers of cash and their return to the cash office of the NBKR as a whole in the republic is presented in Chart 4.2.7.

In the second half 2004 it was issued from the *cash offices of commercial banks* Som 32 829.2 million, which is by Som 7 857.6 million or by 31.5 percent more than for the first half of 2004. The increase of cash issues took place under the following expenditure items:

- "for payment of wages to budgetary organizations" it was issued by Som 452.9 million or by 14.4 percent more than for the first half 2004;

- "for buying of foreign currency" it was issued Som 1000.8 million or 65.6 percent;

- "for other expenses" it was issued Som 5 795.0 million or by 31.6 percent more than for the first half of 2004.

The item of issues for "payment of pensions and allowances" showed the decrease by Som 22.0 million or by 1.0 percent; Reduction in payment of pensions and allowances is caused by complete repayment of overdue debt on pensions. Issuance of money recourses for payment of pensions from 2003 is made in time without any debt on payments.

Som 32 299.9 million was received by *cash offices of commercial banks* in the second half of 2004, which is by Som 6 697.5 million or by 26.2 percent more than for the first half of the 2004. The increase of receipts was observed by all items of receipts:

- "receipt of taxes and duties" increased by Som 376.9 million or by 15.4 percent;

- "receipts from selling of foreign currency" - by Som 686.3 million or by 42.0 percent;

- "other receipts" - by Som 6 265.1 million or by 30.0 percent.

The change in the receipt of cash, issue of cash and their

Chart 4.2.5. Time history of cash issues

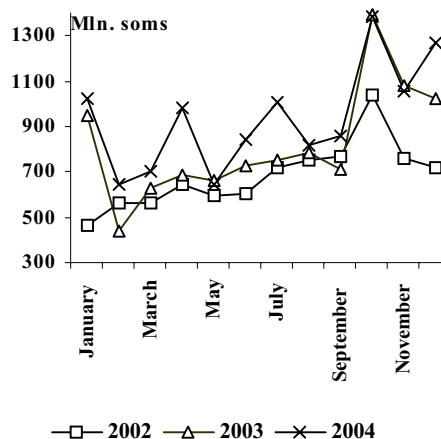


Chart 4.2.6. Structure of Issue of Cash in 2 half of 2004

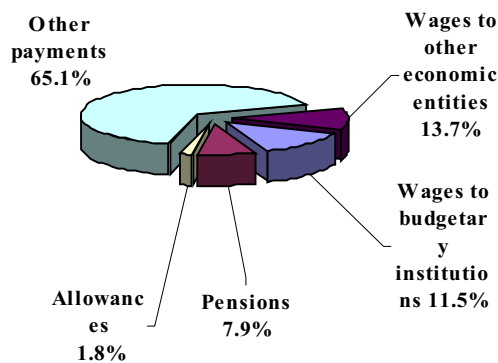


Chart 4.2.7. Changes in receipts, issues and return of cash to the NBKR

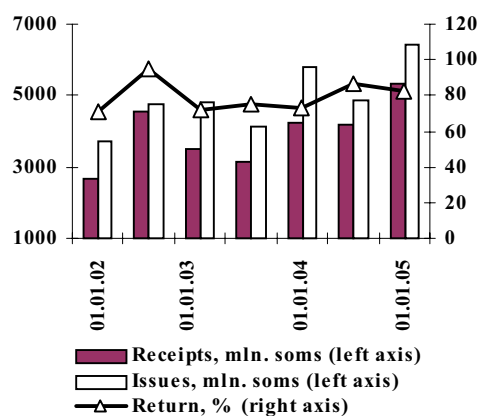


Chart 4.2.8. Receipts, issues of and return of cash to cash offices of commercial banks

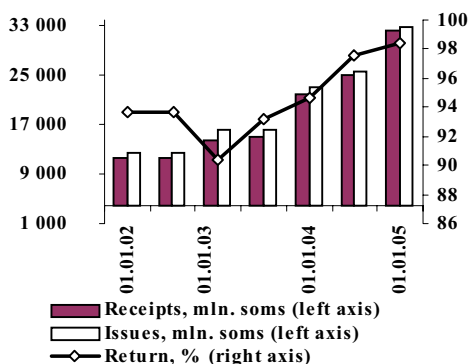


Chart 4.2.9. Dynamics in the volume of payments in clearing and gross systems

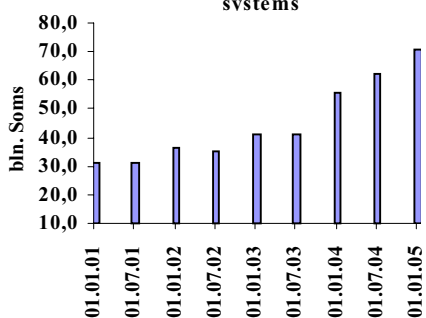


Chart 4.2.10. Changes in volume and number of payments made through clearing and gross systems

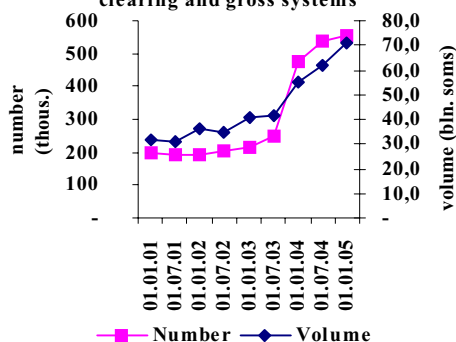
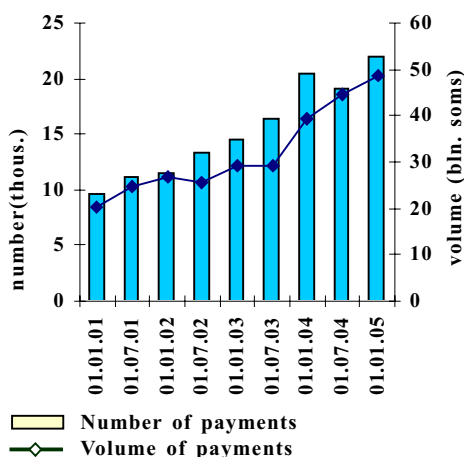


Chart 4.2.11. Changes in volume and number of payments made through gross system



rate of return to the cash offices of commercial banks is illustrated in Chart 4.2.8.

So, the growth of cash in circulation is caused by the sustained growth of the demand for cash on the part of economic entities as well as by expansion of the market of goods and services, served by cash.

Non-cash Turnovers. The analysis of indicators characterizing the volumes of non-cash payments in the payment system evidently indicates their sustained growth. The volume of payments made through the interbank system in the second half of 2004 totaled Som 70 950 million and it is by Som 15 633 million or 28.3 percent more than in the corresponding period of 2003 (see Chart 4.2.9).

The growth tendency of the volume of the interbank payments is explained by strengthening of the economic situation, improvement of the financial system that promoted growth of production in all of the economic spheres, the increase in income of the population and the increase confidence of the population in banking system. One should add that the rate of growth of the volume of payments, made through the interbank payment systems, is accompanied by the growth of payments in their number (see Chart 4.2.10). For the period under review it was made 552.2 thousand of payments, which is by 15.6 percent more that for the second half 2003 (478 thousand payments).

System of Gross Settlements. For the second half 2004 the total volume of the interbank payments made through the gross system of settlements increased as compared with the relative period of the last year by 24.3 percent and amounted to Som 48.8 billion. The number of payments was 22 thousand, which characterized by 8.1 percent growth as compared to the respective period of 2003 (Chart 4.2.11).

530 thousand payments totaling Som 22 billion were made in the same period through the system of retail payments, being characterized by growth by 16.0 and 37.1 percent correspondingly in comparison with the similar period (Chart 4. 2.12).

The volume of retail payments in breakdown by regions of the republic is noted to be increased in all regions (Chart 4.2.13). Traditionally the largest share of payments in the volume of payments of the republic is that of the Chui oblast and the Bishkek city - 84.3 percent. As the same time it is necessary to note, that during the last two years the growth of volumes of payments by other oblasts outstrips the growth of volume of payments in the Chui oblast and in the Bishkek city. Thus, the volume of payments, made through banks of the Chui oblast and the Bishkek city increased by 35.2 percent as compared with the similar period of 2003 while the rate of growth of the volumes by other regions made from 49.7 percent (Talas oblast) to 77.9 percent (Issyk-Kul oblast) that characterizes active development of bank services in the regions of the republic.

Cross-Border payments, Including SWIFT remittances.

Within the frameworks of activities, carried out by SWIFT community, works have been done on transition to new technology of data transfer arrangement SWIFTnet. Transition to SWIFTnet enables commercial banks render additional services (direct connection to SWIFT network of their large customers, exchange with the secured finance messages in the real time mode and soon). In the second half 2004 works have been performed on connection of two commercial banks to the collective utilization center SWIFT (CUC SWIFT) and as of January 1, 2005, 18 banks became the users of SWIFT system in the Kyrgyz Republic, of them the NBKR and 12 commercial banks operate via CUC SWIFT of the National Bank of the Kyrgyz Republic.

Due to the increase in the number of participants in the SWIFT system, the number of transactions conducted through the international SWIFT network (Chart 4.2.14) was noted to have increased. For instance, for the second half 2004 the number of outgoing transactions via CUC SWIFT thousand payments, which is by 24.2 percent more as compared to the similar period of the last year. The number of incoming transactions as compared with the similar period of the year 2003 increased by 54.2 percent having made 68 thousand payments.

International remittances in the republic are conducted by means of postal remittances and via international remittances systems, which services are provided by banks.

Traditionally, the figures reflecting the volumes of international remittances to the Kyrgyz Republic significantly exceeded the volumes of remittances from the Kyrgyz Republic. The volume of remittances to the republic for the second half 2004 totaled USD 55.0 million, the volume of remittances from the republic - USD 8.7 million. As compared to the corresponding period of the year 2003 the volume of remittances increased by 42.4 and 70.7 percent, accordingly.

Labor migration of the population of the republic and development of banking services on remittances contributed in considerable growth of the volume of international payments via bank remittances systems. At this, the share of remittances through the postal system, which volume made only 3 percent of the total volume of remittances, considerably decreased. Increasing volume of remittances via banking systems for the last 3 years more than 7 times is explained by the development of banking services both in the Bishkek city and in the regions, as well as by growth of remittance systems, which render more acceptable services in terms of price, in number.

Systems of Payments by Plastic Cards.

In the second half 2004 acquiring and settlement and cash services to customers with the use of bankcards were provided by 15 finance and credit institutions with 8 out of them

Chart 4.2.12. Changes in Volumes and Number of Payments in Clearing System

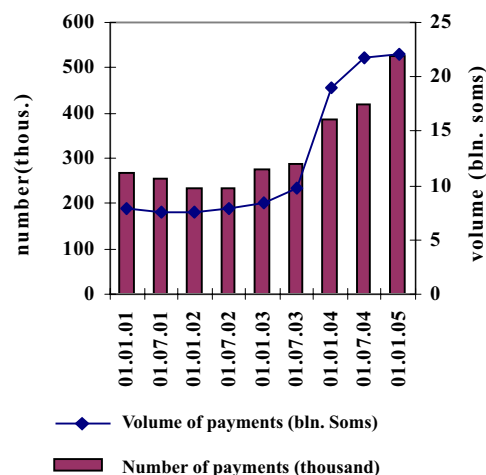


Chart 4.2.13. Volumes of Payments in Clearing System by Regions

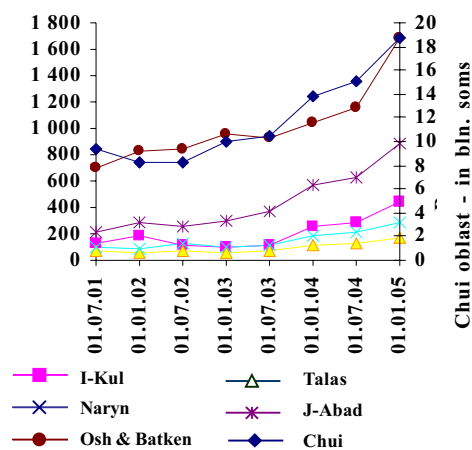


Chart 4.2.14. Dynamics of transactions through SWIFT network (thous. units).

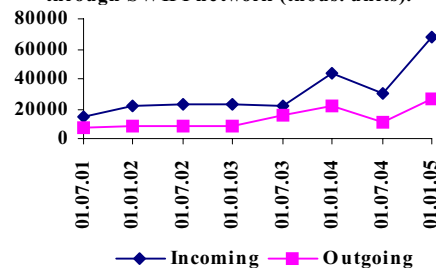


Chart 4.2.15. Changes in postal money remittances

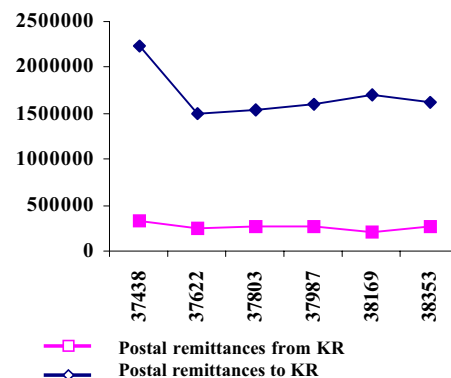


Chart 4.2.16. Dynamics in Money Remittances

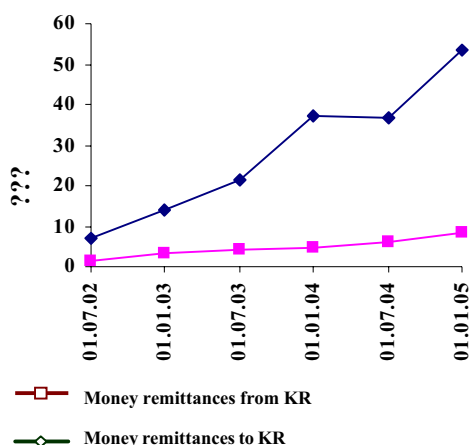


Chart 4.2.17. Changes in the volume of transactions

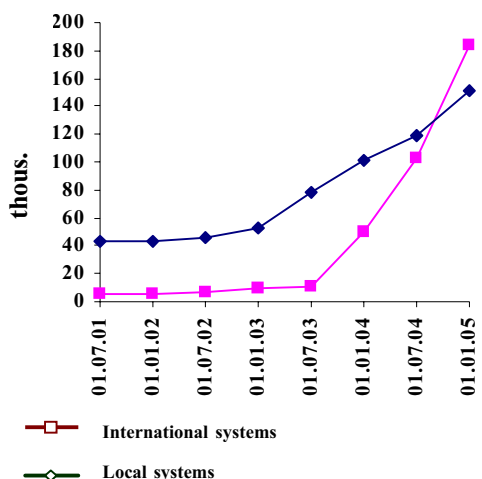
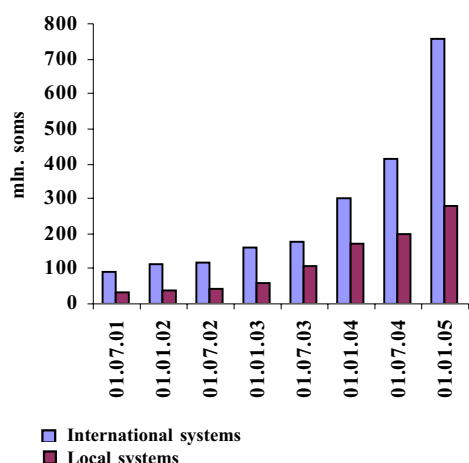


Chart 4.2.18. Changes in Volumes of Transactions



being the issuers and issue cards of international (7 banks) and local systems (3 banks).

By and large, the banks are observed to become more active in the market of payments cards, which is confirmed by increasing number of the issued cards and operations with their use.

In the second half of 2004 funds movement was with the use of the following types of cards: Visa, Master Card, Alai-Carrd, Demir- 24 and Union Card.

The total number of issued cards as of January 1, 2005 was as follows:

Via international systems

- Visa - 2 293 (14 corporate);
- Master Card - 1 327 (524 corporate);

Via local systems

- Alai-Card -6 437 (119 corporate);
- Demir- 24 -3 479;

The number of transactions made through the local systems was 151 746, of which though the Alai-Card system it was done 88 274 transactions (58.1 percent of the total of transactions), through Demir 24 - 63 409 (41.7 percent) and through Union Card - 63 transactions (0.04 percent). As for international systems the number of transactions makes 183 491 transactions. Via the Visa and Master Card- 112 133 and 71 358 transactions respectively (61.1 and 38.9 percent of the total number of transactions).

The volume of transactions made through the local systems totaled Som 280.3 million, of which though the Alai-Card system - Som 161.6 million (57.6 percent of the total of transactions), Demir 24 - Som 117.1 million (41.8 percent), Union Card - Som 1.6 million (0.5 percent). As for international systems the volume of transactions amounted to Som 759.6 million, of which: via the Visa and Master Card systems it was Som 484.6 million and Som 275.0 million or 63.8 and 36.2 percent, respectively.

Commercial banks installed 30 trade and cash POSs in the second half 2004. So, the number of POSs in the Alai-card system is 73 POSs (5 of them in the Gold Crown system) and 3 ATMs, Demir 24 - 35 POSs and 12 ATMs, and in the international systems - 184 POSs and 6 ATMs.

The market of banking cards continues to develop, commercial banks vividly act in the sphere of infrastructure de-velopment for acceptance and servicing of international and local systems' cards.

As a whole, sustainable upward dynamics of non-cash payments is caused by the real need of the economy, on the one hand, and by expansion of the range of banking and payment services, more active banking both in the capital and in the regions of the republic, on the other hand.

V. REAL SECTOR STATUS

5.1 Households

Total money income of the population for 9 months¹⁶ 2004 amounted to Som 47.2 billion, with growth being 9.4 percent in nominal expression and by 4.3 percent in real expression as compared to the respective period 2003.

The composition of money income for this term indicates the tendency to growth of the share of income from entrepreneurial activities, which made 35.4 percent of total money, and it is by 8.7 percentage points more than in January to September of 2003. Growth of income from entrepreneurial activity was, first of all, caused by the sustained high rates of growth of servicing sphere, with the largest share being that of individual businessmen. For instance, the annual average growth of trade turnover, repairs of cars, household products and articles for personal use for the last 3 years made 116 percent.

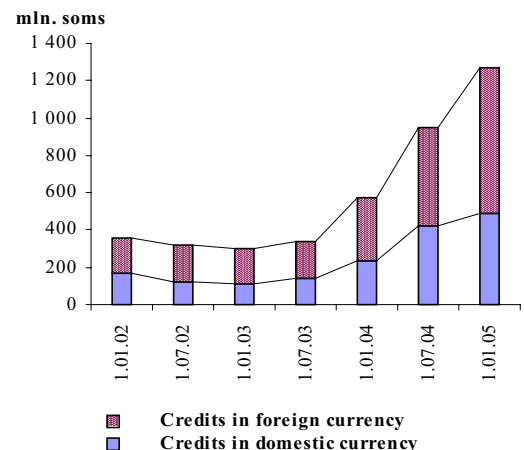
The share of wages payment, although decreased by 1.7 percentage points as compared to the similar period of 2003, remained significant making 24.9 percent in the structure of money income formation sources of the population for 9 months of 2004. The share of pensions and various social transfers was 7.9 percent.

The nominal average monthly salary in the year 2004 was som 2202.9 having increased by Som 14.7 in nominal expression and by 10.2 percent in real expression in comparison with the year 2003. In its turn, the cost of the minimum consumption budget was Som 1725.9 in 2004.

5.1.1 Liabilities to Finance and Credit Institutions

As of January 1, 2005 the liabilities of the household sector to the banking system totaled Som 1.2 billion having increased by 3.6 times for the last 3 years. At the same time, growth for the year 2004 was 2.2 times. The liabilities structure shows the tendency of growth of loans in foreign currency (see Chart 5.1.1.1).

Chart 5.1.1.1. Liabilities of Individuals to Commercial Banks



¹⁶ Annual data is missing due to changing of examination methods of households, conducted by NSC KR.

The liabilities in the domestic currency as of January 1, 2004 totaled Som 487.4 million having grown 2.9 times for the last 3 years and in 4.2 times in foreign currency, amounting to Som 781.8 million. As a result the structure of loans was as follows: 38.4 percent in the domestic currency and 61.6 percent in foreign currency (as of January 1, 2002 - 47.4 and 52.6 percent, accordingly).

A rapid growth of consumer expenses, revival of investment activity of corporate sector and households during the last three years caused changing of the pattern of extended credits. For instance, for the period since 2001 the following types of credits have considerably increased: for construction and acquisition of the real estate -11.9 times, for trade - 7.6 times, for agriculture- 5.4 times, as well as for industry - 2.9 times. The share of the above stated credits in the second half 2004 in total of the extended credits made 78.2 percent, including trade - 53.4 percent, industry - 14.8 percent, construction - 10 percent.

The volume of credits, extended to individuals increased 1.6 times in 2004 as compared with the year 2001, but its share in the total of extended credits decreased gradually from 16.9 to 9.0 percent. The total amount of the newly disbursed consumer credits was Som 761.5 million for the year 2004. The average weighted rate under credits extended to private persons in 2004 in domestic currency was 29.3 percent, in foreign currency - 22.1 percent.

Growth of lending to the population was preconditioned by the positive influence of a number of factors, the major one being that of economic growth, reduction of inflation rate and stabilization of macroeconomic situation.

On the other hand, the low level of income of households hampers further development of mutual relations of the banking system and households. Thus, for 9 months of 2004 the average monthly level of money income made Som 1031.4. At this, the share of expenses in the pattern of money income of households to buy goods and to pay for services in 2004 made 87.9 percent, which is higher as compared to the relative period of 2003 by 10.1 percentage points, to pay taxes and contributions - 5.6 percent (by 2.0 percent).

5.1.2. Savings of the Population

Despite the fact, that the largest share of expenses of the population is that of consumption expenses (90.8 percent), the savings of the population increased due to macroeconomic stabilization, reduction of the inflation rate, growth of households' revenues. Thus, for the last three years, the volume of deposits and savings of individuals in commercial banks according to the regulatory reports of operating commercial banks increased 2.3 times (see Chart 5.1.2.1) totaling Som 2081.2 million as of January 1, 2005, for comparison: Som 916.6 million as of January 1, 2002.

The pattern of deposits changed as well: the deposits in foreign currency were registered to increase. Thus, if as of January 1, 2002 only a half of deposits were placed in foreign currency, their share increased to 65.5 percent as of January 1, 2005.

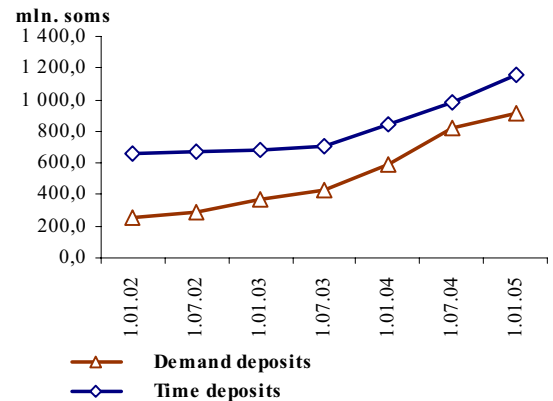
Growth of economic activity of the population, including in external economic activity resulted in increasing of funds on current accounts of individuals and, consequently, increased the intermediary role of banks in conducting payments.

The volume of deposits of individuals in commercial banks grew by 45.6 percent in 2004. At this, deposits in foreign currency increased by 54.5 percent, in domestic currency - by 31.3 percent.

The largest growth was registered as of January 1, 2002 with regard to demand deposits in foreign currency - 3.9 times, in domestic currency - 2.8 times. As for the time deposits in foreign currency, their growth rate was 2.4 time, and in domestic currency - 1.3 times.

Changes in the pattern of deposits and savings were accompanied by changes of rates. Thus, the rates for demand deposits were characterized by insignificant growth: in foreign currency from 0.11 to 0.80 percent, in domestic currency - from 1.11 to 1.69 percent.

Chart 5.1.2.1. Deposits of Individuals



By and large, despite of the growth of the volume of households' deposits, their share in the pattern of deposits of the banking system decreased from 59.3 percent as of January 1, 2002 to 40.6 percent as of the beginning 2005.

5.2 Corporate Sector

5.2.1 Liabilities to Finance and Credit Institutions

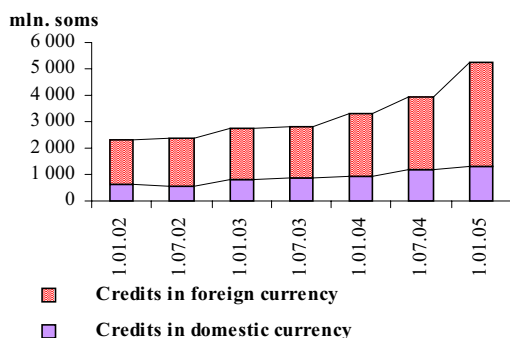
AS of January 1, 2005 the number of legal entities was 60.5 thousand agents and it increased by 9.2 percent in 2004. Of the total number of legal entities, the significant share was registered in the sphere of trade, car repairs and repairs of household appliances - 28.1 percent, the utilities and social services - 17.9 percent, and in industry - 11.4 percent. The majority - 86.7 percent of total legal entities is privately owned. According to the size, the enterprises and entities are divided into small businesses¹⁷, whose share was 88.0 percent as of January 1, 2005, medium - 8.3 percent and large - 3.8 percent.

Total arrears of enterprises and to the operating commercial banks for the last three years bear an increasing tendency. AS of January 1, 2005 the arrears totaled Som 5298.6 million, having increased by Som 1952.3 million or 1.6 times over the year 2004 (see Chart 5.2.1.1). During three years, the arrears to the banks increased 2.2 times. As a result of faster growth of credits in foreign currency, their share increased by 3.3 percentage points and was 74.5 percent of the total liabilities of enterprises by the end of the period under review.

As of January 1, 2005 the average weighted interest rates of credits in domestic currency were for industry 19.8 percent per annum, for agriculture - 26.2 percent, for transport and communications - 20.1 percent and for trade - 25.0 percent.

The average weighted interest rates of credits extended in foreign currency as January 1, 2005 were for industry 16.4 percent, for agriculture - 20.7 percent, for transport and communications - 18.1 percent and for trade - 18.4 percent.

Chart 5.2.1.1. Dynamics of Arrears of Corporate Sector to Commercial Banks



¹⁷ Small enterprises are those which staff is less than 50 persons, medium - 51-200 persons, large - more than 201 person.

During the last three years one could note a downward tendency of interest rates under newly extended credits. General reduction of the rates on deposits is caused by decreasing of inflation rate, stabilization of macroeconomic situation, strengthening of the financial sector in the recent years and keen competition in the lending market, including competition among bank and non-bank institutions.

5.2.2 Accounts Receivable and Payable

During the last three years the enterprises of the national economy demonstrate the growth tendency of accounts receivables and payables (see Chart 5.2.2.1).

In terms of absolutes, the accounts receivable of enterprises and entities totaled Som 25690.5 million as of January 1, 2005, having thus grown by 3.8 percent within a year. The share of domestic accounts receivable made 81.1 percent, with the share of CIS countries in the accounts receivable being 11.8 percent.

In the total amount of accounts receivable the largest share is that of the enterprises of the industrial sector - 62.2 percent, including the enterprises generating and distributing electricity - 38.0 percent; trading companies, those of car repairs, repairs of household appliances and items of personal use - 17.0 percent, transport and communications - 9.0 percent, and the construction entities - 5.7 percent.

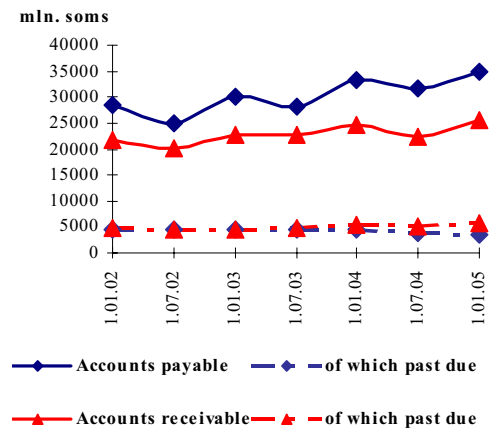
The volume of accounts receivables increased by 8.7 percent in 2004 having totaled Som 59199 million as of January 1, 2005 or 23 percent of the total accounts receivables. 58.8 percent of the accounts receivables were that of the enterprises generating and distributing electricity, gas, steam and water, 15.2 percent - processing industry entities, 12.1 percent - trading companies, those of car repairs, repairs of household appliances and items of personal use.

The accounts payables grew over three years having amounted to Som 34858.5 million as of January 1, 2005. The share of domestic accounts payables made 74.7 percent, to the CIS countries - 10.1 percent.

In general, for corporate sector the ratio of accounts payable to the total accounts payable decreased somewhat from 15.9 percent as of January 1, 2002 to 9.9 percent as of January 1, 2005. The highest level of this ratio as of January 1, 2005, according to the NSC KR data and the NBKR estimates, is registered with regard to the enterprises, entities involved in the following types of activity:

- state administration - 38.3 percent,
- mining - 34 percent.
- rendering of utilities, social and personal services - 21 percent.

Chart 5.2.2.1 Dynamics of Accounts Receivable and Payable of Corporate Sector



5.2.3 Financial Data

In 2004 growth of balance profit of the real sector enterprises grew 8 times in comparison with the year 2003, having totaled Som 10399 million. The basic impact on its formation was that of growth of profit from non-operational activities, gained by metallurgic industry enterprises. The profit from operational activities, as compared to the previous year, increased by 62 percent and made Som 7641.7 million.

The major share of the balance profit in 2004 and the growth of its volume in comparison with the last year is observed on metallurgic industry enterprises - Som 7860.5 million, communications - Som 1058.6 million, wholesale trade organizations and trading though agents - Som 561 million, enterprises on manufacturing of other non-metal products - Som 484.9 million, transport - Som 398.4 million. Balance losses in 2004 were sustained by enterprises generating and distributing electricity, gas and water - Som 789.5 million that is lower by 18 percent as compared with the year 2003.

In 2004 the share of unprofitable enterprises was 40.6 percent of the total number of the reported entities.

As a whole, the year 2004 showed improvement of financial indicators of enterprises after recession of 2002 when the real sector entities received balance profit 18.9 times less than that of the year 2001 due to, first of all, recession of metallurgic industry caused by the breakdown in "Kumtor" mine.

VI. DEVELOPMENT TRENDS

Economic development to a great extent depends on efficient financial intermediation and the level of development of the financial market as a whole. Economic growth significantly depends on stimulation of investments from various money recourses. With the developed exchange market there exist a lot of opportunities for direct investment of resources to the economy through buying the securities. Presence of large number of institutional participants of the financial market also expands alternative opportunities of investing in the economy.

As the economy is growing and steadiness is reached, ensuring of further dynamics objectively requires attraction of huge financial resources. With this regard, the influence of non-bank financial intermediaries on the real sector development is increasing with appearing of the most various forms of financial resources attraction.

Two aspects of further development of the financial system of the republic become to be more urgent: to increase the effectiveness of the intermediary activities of commercial banks and strengthen the role of non-bank financial intermediaries. Ensuring of transformation of savings into investments by means of other financial intermediaries' activity - is also the subject of analysis.

Institutional participants of the financial market as a whole act as intermediaries between creditors and borrowers, they are: commercial banks and non-bank finance and credit institutions, licensed by the NBKR and other finance institutions (investment and pension funds, stock exchanges, insurance companies and other).

Institutional participants of the financial market accumulate savings of the population and of the entities and place received resources into economy by means of lending, investing in finance assets. This is the way a fundamental function of financial intermediation is performed - reallocation of capital, in this case of money one, thus, ensuring overflowing and transformation of capital within the system of sector, inter-sector and inter-regional reallocation.

The nature of mechanisms, which transform savings into investments depend, first of all, on the level of financial markets maturity.

The share of commercial banks in financial intermediation is insignificant in the developed countries. For instance, in the mid of 80-ties of XX century 35 percent of money resources was reallocated by commercial banks, and in the 90-ties this indicator fell more. The prevalent place in reallocation of money resources in transition economy countries is taken by banking sector. Our republic in not an exception.

About 80.1 percent of the total assets of financial system of the country are that of the banking system in the Kyrgyz Republic.

Commercial banks are practically the only finance institutions in the lending and deposit markets, except non-bank finance and credit institutions, licensed by the NBKR.

Chart 6.1. Changes in assets, liabilities and equity of commercial banks

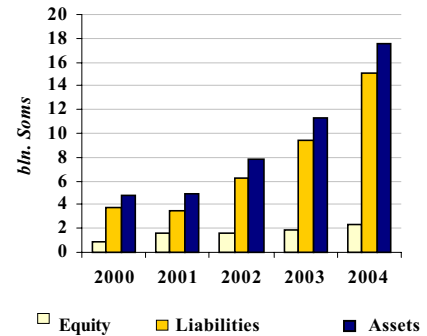


Chart 6.2. Structure of credits of commercial banks by sectors of economy

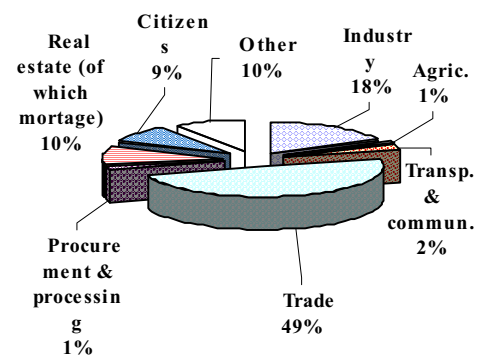


Chart 6.3. Structure of credits of commercial banks by maturity

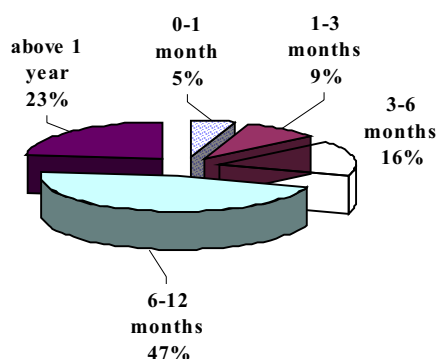


Chart 6.4. Structure of financial market of the Kyrgyz Republic

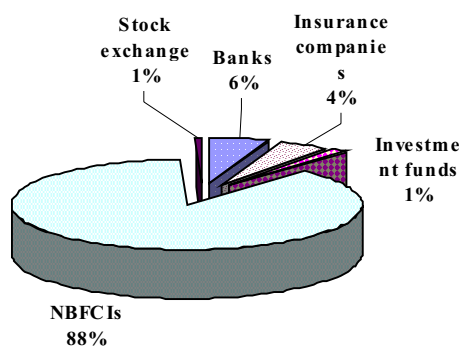


Chart 6.5. Structure of financial market by assets (without securities market)

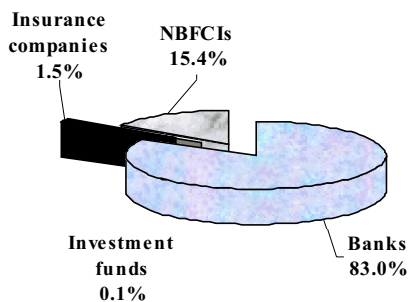
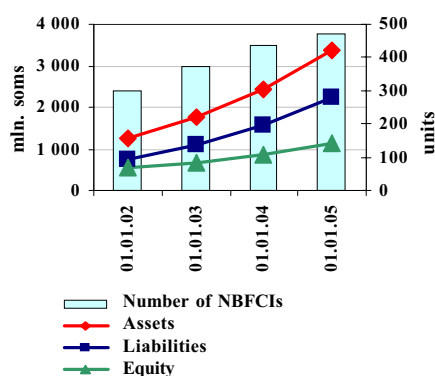


Chart 6.6. Changes in assets, liabilities and equity of non-bank finance and credit institutions



When performing functions of financial intermediary, commercial banks successfully mobilize and reinvest considerable financial resources. For instance, the banking system assets for the last years (2000-2004) increased by Som 12.7 billion or more than 3.5 times. The ratio of the assets share to GDP grew as well from 7.2 percent to 18.6 percent. Growth of banks' liabilities more than 4 times and of the capital 2.5 times was observed (Chart 6.1). Increasing of bank resources resulted in significant growth of the volume of loans, issued to the economy, by Som 6.2 billion (274.7 percent).

The largest share of the total volume of loan portfolio in 2004 is that of the loans to trade - 49.2 percent and industry - 17.7 percent. Loans to construction and acquisition of the real estate made 9.6 percent, to private persons - 9.0 percent, to transport and communications - 2.3 percent, while to procurement/processing and agriculture - only 1.4 and 1.3 percent, respectively (Chart 6.2).

If to consider the composition of loans of commercial banks by their term, one could see that the volume of long-term loans is still insignificant (Chart 6.3) with their share 23 percent.

One of the developing segments of the financial market is non-bank sector, including non-bank finance and credit institutions, licensed by the NBKR and other institutional participants (Charts 6.4 and 6.5).

Non-bank finance and credit institutions, along-side with the banking sector, start playing more significant role. They are organized, as a rule, by entrepreneurs themselves, by farmers by means of uniting common efforts and establishing credit institutions enabling to invest their joint and individual projects on development of own business.

These credit institutions serve not the national economy as a whole, not individual sectors, but locally specific entrepreneurial structures in the regions, villages. That is, they service local territorial development, thus, bearing self-running character. Such form of lending is close to the borrowers, accessible and supposes obtaining a loan under simplified scheme. Therefore, analysis of development and functioning of non-bank finance and credit institutions, in order to estimate their current status and determine their prospective support policy, is of great interest.

As of the end of 2004 the share of KAFC in the aggregate loan portfolio of non-bank finance and credit institutions was 55.1 percent, the share of micro-finance organizations - 28.3 percent, the share of credit unions - 16.2 percent, the share of pawnshops - 0.4 percent. The assets of non-bank finance and credit institutions totaled Som 3 366 million or 3.6 percent to GDP, having increased by 39.0 percent as compared to the last year. For comparison: as of the end of 2001 the total assets were Som 1 260 million. The own capital grew by 112.0 percent in comparison with the year 2001. As of the end of 2004 the liabilities of non-bank credit institutions made Som 2 243.1 million, having increased by 42.8 percent. The statutory capital for 2001-2004 grew by 192 percent (Chart 6.6).

By lending terms the largest share (50.2 percent) was that of the medium-term loans with the maturity from 1 to 3 years. Short-term and long-term loans made 38.7 and 11.0 percent, respectively. The share of long-term loans, like in the banking sector, is not large.

In breakdown by sectors the composition of loans, like in the previous years, remains almost un-changed. 56.7 percent of loans, issued by the credit un-ions, is used in agriculture, 25.6 - in trade, 3.3 percent - in industry, 3.1 - in construction and acquisition of the real estate, 1.8 - in procurement and processing of products, 1 - in transport and communications and 8.7 percent is taken by other types of activities, works and services (Chart 6.7).

The capital of credit unions increases from year to year, and, most likely, such tendency will be kept. Growing attention is paid to development of credit unions in the republic as it is just through them additional sources of funding of agricultural production can be obtained. Small and medium businesses develop in rural areas with the help of credit unions; the volume of both produced and processed agricultural products is growing.

Such segments of the financial market as stock and insurance markets, investment funds and other require not less thorough attention.

In recent years, insurance companies, pension funds and various investment funds play an increasing role in the global financial markets. Especially in the USA, where the share of non-bank finance organizations in the total of assets attracted from the population exceeds 50 percent already. The aggregate assets of these organizations are estimated at US\$ 28 trillion. More than 90 percent of their investments are directed to stock markets¹⁸.

As of the beginning of 2005 the assets of insurance companies to GDP, as well as insurance contributions made 0.36 and 0.18 percent, accordingly (Table 6.1). The receipts of contributions by insurance organizations for the period from 2001 to 2004 grew by 14 percent. If in 2000 it was Som 25.45 of insurance contributions per capita, then in 2004 this sum was Som 64.37 (grew 2.5 times).

Total distribution between voluntary and mandatory insurance makes on contributions - 90 percent against 10 percent respectively, on payments - 71 percent against 29 percent.

Despite of progressive growth of total indicators, the national insurance market of the Kyrgyz Republic currently can not play an important role in the economy as it is only at the beginning stage of its development. Therefore its results, as compared to the banking sector, are not so noticeable and still its indicators do not meet the scale of the economy.

The securities market is one more important segment of the financial market. The estimation of development of this financial market sector is ambiguous. The primary market,

Chart 6.7. Lending to Sectors of Economy by Credit Unions

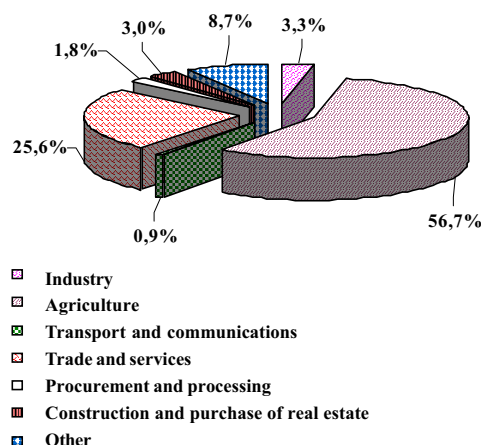
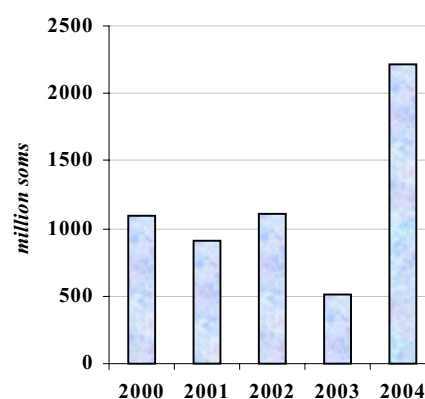


Table 6.1. Ration of Performance Indicators of Insurance Companies to Macroeconomic Indicators

(as of end-of-year)

	2000	2001	2002	2003	2004
Assets, mln. Soms	124,90	132,20	176,20	339,45	335,39
Assets, in % to GDP	0,19	0,18	0,23	0,40	0,36
Insurance contributions received, mln. Soms	149,90	131,10	143,00	154,90	171,08
Insurance contributions received, in % to GDP	0,23	0,18	0,19	0,18	0,18
Insurance contributions received per capita, soms	25,45	26,73	35,35	67,39	64,37
Insurance contributions/insurance payments	2,90	1,90	2,30	2,60	5,63

Chart 6.8. Changes in volumes of trading at the Kyrgyz Stock Exchange



¹⁸ Alexander Movsesyan, Modern trends of global financial system development.

Chart 6.9. Changes in volume of trading in primary and secondary markets of the KSE

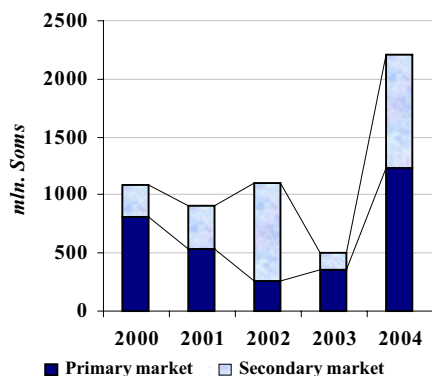
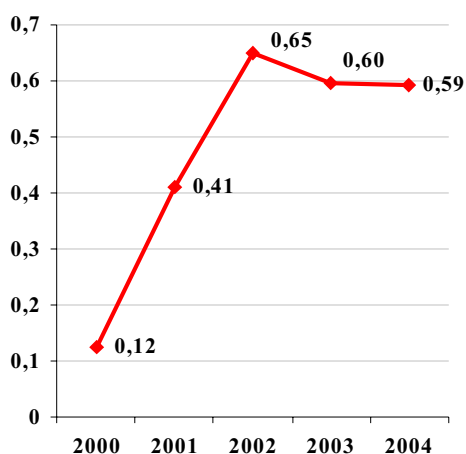


Table 6.2. Ratio of Performance Indicators of Investment Funds to Macroeconomic Indicators

(as of end-of-year)	2000	2001	2002	2003	2004
Assets, mln. Soms	45,2	23,8	21,8	16,1	14,7
Assets, in % to GDP	0,069	0,032	0,029	0,019	0,016
Revenue of investment funds		5,3	1,1	1,4	1,5
Revenue of investment funds, in % to GDP		0,007	0,001	0,002	0,002
Investments made by investment funds, mln. Soms	39,2	36,8	14,8	11,2	11,8
Investments made by investment funds, in % to GDP	0,060	0,050	0,020	0,013	0,013
Investment made by investment funds per capita, soms	8,0	7,4	3,0	2,2	2,3

Chart 6.10. Share of financial activities in GDP, percent



through which the securities are placed in the market, is of greatest interest (Chart 6.8). On the background of significantly developed market of the state securities a weakness of the corporate securities market is especially noticeable. Nevertheless, significant positive changes are lately observed in this segment of the market.

3 licensed organizers of trades act in stock market, thus, the volume of trades of the Kyrgyz Stock Exchange (KSE) made more than 86 percent of the total volume of trading with the securities in the republic.

For then years of KSE's operation 34 145 deals with the securities have been concluded on its trading platform with total volume Som 6.3 billion. Over the last five years (2000-2004), despite decreasing of the concluded transactions in number, their volume in som equivalent grew twofold, having reached Som 2 209.3 million, which is the highest indicator for the whole pe-riod of KSE's existence (Chart 6.9).

The indicators of the investment funds' activities illustrate their insignificant influence on the economy of the republic. In 2004 the assets and investments of the investment funds to GDP made 0.016 and 0.013 percent, respectively. The income of the investment funds to the income of the republic is also extremely low - 0.002 percent. Activities of the investment funds declined for the period 2000-2004 which is confirmed by decreasing of assets, income as well as investment contributions of the investment funds (Table 6.2).

As of the beginning of 2005 the investment port-folio of funds was Som 11.8 million, having decreased within five years by 70 percent. Long-term investments (66.8 percent of the assets composition) remain the basic direction of placement of resources in the composition of decreasing assets. At this, their significant reduction is observed from Som 32.4 million in the year 2000 to Som 9.8 million in 2004. Short-term investments in the assets pattern also born downward tendency between 2000-2004 from 6.8 to 2 million of soms. Liquid assets, whose share is about ? of the total assets, decreased 2.5 times. Since 2003, net income of investment funds became negative that resulted in decreasing of own resources. Insignificant rate of return testify on rather law effectiveness of investment funds' activity.

Thus, when analyzing the contribution of financial activities to GDP of the republic in terms of value added, one may note, that the share of financial intermediation in the economy, as a whole, remains low (Chart 6.10). Still, the banking sector plays a leading role in the financial market both on mobilizing of money resources and their placement in the economy.

The impact of stock, investment and insurance markets on composition of allocation of resources in the economy is rather insignificant. With this regard, it is worth noting, that conducting of complex measures of the state in the sphere of development of stock and investment markets will enables in the near future to attract reliable investors to the financial market of the republic, that will result in expansion of the reproduction process in the real sector of the economy aimed to stimulate sustainable economic growth.

VII. SPECIAL ISSUES

Cash Turnover Development Trends

(Based on the materials of Cross Conference - 2005, High Security Printing Conference)

International conference on highly-secured printing was held in April 2005 in Kiev. 330 delegates from 26 countries participated in the conference:

- Representatives from the central banks of Austria, Albania, Bulgaria, Indonesia, Kazakhstan, Canada, Kyrgyzstan, Latvia, Lithuania, Poland, Russia, Uzbekistan, Ukraine and other (14 percent of participants);
- Representatives from the governmental organizations and commercial banks, as well as representatives of the Parliament of the Ukraine (7 percent);
- From commercial printing companies (32 percent),
- Manufacturers of the secured printing equipment (14 percent),
- Manufacturers of the secured printing materials (27 percent),
- Representatives from the specialized mass media (3 percent),
- Consulting companies representatives (3 percent).

All in all 28 reports were delivered in the conference, including the report of the NBKR "The strategy of the national currency development: retrospective and plans for the future":

The conference was dedicated to future trends of the secured printing, manufacturing of banknotes, as well as cash turnover in the conditions of accelerated development of information technologies, changes in global political and economic situation.

1. Security of banknotes

The key moments in the development of industry in conditions of more active international terrorism are the accents on new tools to provide the security of banknotes from unauthorized reproduction. With this regard, the issue of implanting microprocessors (chips) in banknotes, which will allow tracing of monetary flows and transactions, is actively discussed.

The development trends of banknotes elements security are in growing of OVI (colourchangable paints) efficiency as optical protection means and felling reliability of holograms' protection due to wide spread of holographic images reproduction techniques.

Widespread of vending machines, ATMs and depositories requires including a device-readable elements into the substratum (paper mixture, water signs, taggants), paints and applied elements (threads, holograms and other).

In his report the representative of the National Bank of the Ukraine made assessment of the efficiency of visual security elements of the Ukrainian grivna, the US dollar and the Euro. In the opinion of the author, the most efficiency is noted for such security elements as, the orlov offset printing, security threads with the orlov colourchangable lengthwise effect (GOZNAK production), OVI paint, micro-perforation and iridescent paint. The frequency of imitating one or another security element on counterfeit banknotes, detected in the territory of the Ukraine, was used as criteria of efficiency of that security element.

2. Extension of banknotes life cycle

A new direction in banknotes improvement is the search of long-living substratum and techniques to prolong the serviceability of banknotes with a high quality of money in circulation. There exist two principal approaches: manufacturing of special wear-resisting paper and after-printing covering with a protective layer. Both types of banknotes are in the cash turnover of Kyrgyzstan: one batch of banknotes was produced with application of the after-printing covering with a protective varnish, and another one was printed on a paper with improved wear-resistance. The NBKR experts currently conduct analysis of statistical indicators of cash turnover of banknotes of both types and their comparison with the similar indicators of those banknotes, produced on a traditional banknote paper. As it turned out, this subject is interesting not only for the National Bank of the Kyrgyz Republic. The European Central Bank is also engaged in studying the conduct of various substrates in circulation conditions. The Central Bank of the Russian Federation arranged an investigation, having modeled in the laboratory a real circulation conditions, aimed to study the impact of one or another factor on wearing of banknotes and define basic reasons of their dilapidation.

As the research showed, the main reason of wearing banknotes is their surface dirtying. So, after-printing security of banknotes may contribute in prolongation of the service life of banknotes. The experts believe as well, that use of two-sided intaglio not only ensures prolongation of banknotes serviceability, but also increases the safety of banknotes from counterfeiting.

3. Strategic approach - multilateral consideration

Banknotes are not only printing product, and not simply a payment means. Banknotes are a piece of art in a sense, a politicized art. Therefore designing of banknotes is connected with multilateral discussion of esthetic, technological, financial and, surely, political aspects.

The National currency, cash circulation pattern must also improve in accordance with changing external conditions. Any changes, even the most favorable ones, must serve a subject of strategic planning. What does the strategic planning of cash circulation changes means?

The national currency development strategy must be built on the following determinants: 1) the reasons for changes; 2) time framework; 3) the subject of changes. In other words, it is necessary to define, WHY, WHEN and WHAT must be changed in banknotes.

The reasons of planned changes dictate choosing of this or that mechanism to implement the plan. Potential reasons of changing denomination row or appearance of banknotes and coins can be divided in three groups:

1) Political

The example may serve an introduction of Euro in EU countries, issuance of new dinars in Iraq or Afghanistan, changing of banknotes of Nepal after the king's death. As a rule, political reasons require crucial changes of banknotes' appearance and sometimes of the design concept itself. Since, national currency is a visiting card of a country.

2) Economical

These reasons are often related to economic expediency of "hardening" of a monetary unit. For instance, the Turkish lira lost six zeros in 2005, and denomination of the Romanian national currency -lei will take place in the year 2006. According to the Central bank of Turkey the economic effect from introduction of the new lira by reducing the cost of production, transportation and processing of the new cash will total about \$1.5 billion per year¹⁹;

3) Technological

Scientific and technical revolution and accelerated development of information technologies incorporate their requirements in strategic planning of banknotes. Being governed by the principle "to be one step ahead of potential counterfeiters in technological contest", the central banks must from time to time renew the security concept and design of the banknotes row. According to the resolution of the International conference of the INTREPOL (Amsterdam, 1997) the system of banknotes' security must be renewed each 5-7 years, since during this term commercially accessible equipment and techniques create new opportunities for reproduction of even those elements, which earlier ensured high level of security from copying and unauthorized reproduction.

The process of reproduction as well as of pre-printing preparation of banknotes, not to mention the decision making process with regard to design and protective features of the national currency requires -is a time consuming process. That is why, when planning to incorporate changes in cash circulation, the central banks must, first of all, to precisely estimate a "starting point" for project implementation.

Actually, two basic approaches can be distinguished here: "evolutionary" one - gradual renewal of banknotes features and "revolutionary" one - complete replacement of the banknotes row. As a rule, economical and political changes require crucial changing of the banknotes row, while strengthening of the banknotes security from counterfeiting can be realized in the evolutionary way. Kyrgyzstan has an experience of both complete replacement of the banknotes row and gradual improvement of the national currency.

Introduction of the national currency 12 years ago became a revolutionary change for Kyrgyzstan, when according to proposal of the Government of the Republic of Kyrgyzstan on the necessity to introduce the national currency for further implementation of the economic reform Program and conducting the independent economic policy by the Supreme Soviet of the Republic of Kyrgyzstan a historical Resolution

¹⁹ Currency News Vol 3 No1, p.10. The New Turkish Lira - Restoring the Country's Price in its Money.

was adopted on May 3, 1993 "On Introduction of the National Currency". At 4:00 a.m. on May 10, 1993 the Kyrgyz som was issued in circulation and became the official payment means in the territory of the Kyrgyz Republic. Parallel circulation of soms and rubles was allowed only between May 10 -14, 1993. At 6:00 p.m. on May 14, 1993 som became the only lawful payment means in the territory of the republic.

The national currency improvement was carried out in compliance with the stepwise strategy:

- The first Kyrgyz banknotes, the so-called "money of economy in transition" to be produced in a short space of time and on the rims - the 1st issue banknotes- appeared in 1993. In 1995 the so-called "soft" method of the withdrawal of the 1st issue banknotes from circulation was adopted (cash offices surplus, received from commercial banks, contained the 1st issue banknotes was exchanged for the 2nd issue banknotes).

- In 1994 the banknotes of the stabilization period were issued to satisfy the principle of the reasonable combination of the low price and security features.

- In 1997 the first banknotes of the next series, bearing high security features, were issued. Introduction of other value banknotes of this series into circulation was carried out step by step upon the necessity to replenish the stock of one or other value banknotes.

According to the concept of design and security the series of the 3rd generation banknotes should be safely secured against counterfeiting and being adequate to the modern level of development of copying and printing equipment. The key aspects of the mentioned concept will be as follows:

- The comprehensive approach, that allows to combine effective security of banknotes from counterfeiting with the aesthetic design of the notes that reflects the national features of the historical and cultural heritage of Kyrgyzstan;

- Conformity of the security requirements level to the level of development of copying and printing equipment;

- Three-level security of banknotes from counterfeiting that ensures the opportunity to check banknotes authenticity at three various levels:

By the population - without any equipment

By cashiers - with the help of simple detectors

By the central banks' experts - by using a special equipment

- The possibility of automated handling the banknotes;

- Optimal quality for the reasonable price.

The banknotes, manufactures according to this concept, first of all should be comfortable for various categories of users. Banknotes have their individual dimensions that simplify recognition of the notes denominations, individual watermarks hamper counterfeiting, individual colors, special elements enable people with the weak eyesight to define denomination of the notes and other security elements are also available. Additionally to security elements, used for production of the 2nd issue banknotes, the banknotes of the 3rd generation contain more than 17 new and improved elements of protection.

However, development of science and technique requires uninterrupted improvement of protective and user features of the banknotes. Any changes, not only negative, but positive as well, need thorough preliminary preparation, while decisions need not emotional but rational approach. This becomes more important when one speaks about such spheres as civil self-consciousness, state symbols to which the national currency is referred as well.

4. Optimization of cash handling cost - rational approach

The rational decision supposes comprehensive considering of the number of criteria and well-grounded choosing of the optimum option, accepted with recognition of the alternative opportunity cost. Thus, cost evaluation of the project should be done based on the production cost, transportation and handling cost, but not just based on the cost of banknotes production. As they say, the cost of a banknote is defined by the factor of what point of circulation cycle you are in. In other words, for the user a banknote is just a carrier of information on buying capacity and on the amount of goods and services this note can be exchanged into. For retail trading company each note is connected with additional expenses for labor payment to cashiers, acquisition of cash machine, and arrangement of cashier's workplace. For commercial bank these expenses increase significantly since cash flows require more sophisticated equipment, large number of workplaces, which, in addition, are distant from each other, and consequently there is a necessity to collect valuables and sustain transportation expenses. Expenses of the central bank increase more for the cost of production, storing and

destruction of banknotes. Payment Committee of the European central bank estimates annual expenses for handling of cash at the amount of Euro 50 billion, which is 0.4 percent - 0.6 percent of GDP, with Euro 37 billion to be expenses of banks and Euro 13 billion - expenses of economic entities. Therefore it is extremely important to arrange cash circulation so that to minimize production and cash handling costs, sustained not only by one of the payment system participant - the central bank, retail trading entities or commercial banks, but by all cash circulation agents in the republican scale. In some countries it is achieved by means of incorporating entities, specialized on handling and collecting of cash, which render such services to commercial banks on chargeable basis. This enables commercial banks to reduce their staff expenses, as well as expenses for transportation, packaging of banknotes and the equipment to handle cash. For instance: annual expenses of the NBKR only for packaging of tyiyn denominations total more than som 52 thousand.

As a whole, at the time being, the evolution of money circulation is carried out with the effect of two tendencies - (1) broad expansion of the automated cash services both in the retail trade and in the banking sector (introduction of slot machines, ATMs and depositaries) and (2) outsourcing of operations on handling of cash. The central banks reduce their participation in handling banknotes, being limited only by defining the principles of building the banknotes and coins row, production and destruction, thus, assigning the function of sorting and changing money to commercial banks and entities - intermediaries (collection firms, cashier centers). Accordingly, such changes influence the requirements to banknotes. The importance of hidden machine-readable features of banknotes' and coins' authenticity, so, increases. Hence, the concept of the banknotes security and design needs to be changed. The circle closes...