

Approved by the NBKR Board
Resolution No. 48/3 dated
December 12, 2012

**NATIONAL BANK
OF THE KYRGYZ REPUBLIC**

**MAIN DIRECTIONS
OF THE MONETARY POLICY
FOR 2013-2015**

**Bishkek
2012**

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INTRODUCTION

In this document on the basis of analysis of the current economic situation and forecast of the development of the main sectors of economy objectives and tasks of the monetary policy of NBKR are defined for the medium term (2013-2015).

First chapter of this document includes analysis of the dynamics of the inflation for 2010-2012, current condition of economics, main indicators of the financial market, and also expected results of conducting monetary policy until the end of this year.

Second chapter includes the prospects of country's economic development in the medium term of 2013-2015, internal and external factors and possible risks are marked. It also includes the prospects of the development of economic and inflation, built on the basis of official (program) forecasts and current trends.

Principles of implementation of monetary policy and options of the monetary program, prepared on the basis of baseline and alternative scenarios of economic development of the republic, reflected in the third chapter. It also defines targets for 2013, and also information about factors is provided, which may impede achievement of the targets. This chapter provides directions of development of NBKR, which will promote improvement of opportunities of NBKR during the development and implementation of the monetary policy.

During preparation of the document forecast data of the Ministry of finance on the sector of governmental finance in the Kyrgyz Republic were used, approved by the Law of the KR "On Amendments to the Law of the KR "On the republican budget of the KR for 2012 and forecast for 2013-2014" and the Law of the KR "On the republican budget of the KR for 2013 and forecast for 2014-2015"; medium term forecasts of socio-economic development of the Kyrgyz Republic, approved by the Government Decision of the Kyrgyz Republic No. 613 of 12th of September 2012 "On the forecast of socio-economic development of the Kyrgyz Republic for 2013-2015"; foreseen by the project of Sustainable Development Strategy of the Kyrgyz Republic for 2013-2017; Letter of intent prepared by the results of third review of implementation of the economic program for 2011-2014, supported by IMF within the framework of extended credit facility of 13th of November of 2012.

1. REVIEW OF ECONOMIC DEVELOPMENT AND MONETARY POLICY UNTIL THE END OF THIS YEAR

1.1. Overview of the economic conditions in the previous period and the expected results of 2012

1.1.1. Real sector of economy

In 2010 recovery of the business activity in the country's economy was noted after the negative influence of the world financial economic crisis, from one hand, and from another hand, the real sector of economy has experienced internal turmoil due to political instability in the country. Restrictions in the pass control and the temporary or partial closure of the border with Uzbekistan and Kazakhstan has impacted on the reduction in economic activity in the areas of trade and services. This significantly reduced economic activity in the country: the GDP in 2010 amounted to 220.4 billion KGS, having decreased in real terms by 0.5 percent.

In 2011 due to favorable external and internal economic situation there was a recovery of growth in all sectors of economy except for construction. Based on the results of 2011¹ the volume of GDP amounted 273.1 billion KGS, having increased in real terms by 5.7 percent.

In 2012 due to the reduction in production at the gold mining enterprises of Kumtor company, there was a significant slowdown of economic growth. Thus, for 9 month of 2012 the volume of production of gold amounted 125.8 thous. ounces², which is 72.0 percent less than the similar indicator of 2011 (444.4 thous. ounces). Reduction of agricultural production has happened due to the adverse weather conditions which has also negatively affected country's economic growth. According to preliminary data, for nine months of 2012 the volume of GDP in current prices amounted 203.8 billion KGS, having decreased in real terms by 4.6 percent comparing to the similar indicator of 2011 (in January-September of 2011 the volume of GDP has increased by 8.3 percent). Excluding gold mining enterprises of Kumtor company the volume of GDP in January-September of 2012 has increased by 3.8 percent while the comparable figure of 2011 has increased by 6.0 percent. GDP deflator by the results of nine months of 2012 was formed on the level of 10.4 percent against 19.3 percent in January-September 2011.

According to preliminary data for January-October 2012, the volume of GDP in current prices amounted 233598.7 mln. KGS, having decreased comparing to the similar indicator of 2011 by 4.3 percent, while in January-October of 2011 the volume of GDP has increased to 8.8 percent. While excluding gold mining enterprises "Kumtor" company, the volume of GDP in January-October 2012 has increased by 3.6 percent (in January-October of 2011 growth rate of similar indicator amounted 6.0 percent). The volume of industrial production fell by 30.9 percent (growth rate of similar indicator of 2011 amounted 27.6 percent). The volume of agriculture production fell by 0.3 percent (growth rate of similar indicator of 2011 amounted 2.9 percent). GDP deflator was formed at a level of 10.6 percent against 18.6 percent in January-October of 2011.

In the context of branches the decrease of GDP in January-September of 2012 has happened due to the decrease in production in manufacturing enterprises (decrease of deposits amounted -7.7 percentage points), mainly due to the decrease in manufactory on enterprises of "Kumtor" gold field. While the deposit of other sectors of GDP was positive, particularly, services (+2.2 p.p.), construction (+0.6 p.p.) and agriculture (+0.4 p.p.).

In manufacturing, the volume of production has decreased by 44.3 percent compared to the similar indicator of 2011 (+10.2 percent). This decrease has happened due to decrease in metal production and fabricated metal products, textile and clothing production (-21.3 percent). The main contribution to the growth of the service sector made a trade (+73.1 percent), transport and communication (+15.1 percent).

¹ According to preliminary data of the NSC of the KR.

² According to a press release of "Centerra Gold Ink" on November 26, 2012.

In the agriculture sector in January-September of 2012 growth rate amounted 2.0 percent. The positive contribution of the agriculture of GDP was 0.4 percent. This non-significant contribution in GDP is due to the adverse weather condition in 2012.

According to the preliminary data, for the period of January-September 2012, the level of development of investments to the main assets increased by 9.1 percent according to the similar indicator of 2011 and amounted 35.4. billion KGS.

In the structure of sources of investment finance to the main capital, domestic investments continue to hold the major share (72.6 percent of total investments).

In the sectoral structure of investment the major share of investments has mining industry – 27.8 percent, transport and communication (investments to the project on reconstruction of the roads “Talas-Taraz-Suusamir”, “Osh-Irkeshtam”, “Osh-Isfana”, “Bishkek-Naryn-Torugart”, “Sothern transport corridor”, rehabilitation of roads under the project “Improving regional road corridor” – 14.1 percent, manufacturing industry – 12.8 percent.

Table 1.1.1.1. Investments in fixed assets by source of funding

	Jan-Sep. 2011	Jan-Sep. 2012	Jan-Sep. 2012	
	total, mln.soms		share, %	growth rates, %
Total	31 014,6	35 379,8	100,0	109,1
Internal investments	21 952,3	25 674,6	72,6	111,7
Republican budget (including funds intended for emergencies)	3 259,7	1 768,1	5,0	51,9
Local budget	299,6	514,8	1,5	in 1,6 t.
Funds of enterprises and organizations	9 916,2	13 559,3	38,3	130,9
Bank credits	71,2	293,7	0,8	in 3,9 t.
Population funds including welfare aid of KR resident	8 405,6	9 538,7	27,0	108,0
External investments	9 062,3	9 705,2	27,4	102,6
Foreign credits	6 228,4	3 262,0	9,2	50,3
Foreign direct investments	1 987,2	4 697,7	13,3	in 2,3 t.
Foreign grants and humanitarian aid	846,7	1 745,5	4,9	in 2 t.

Source: NSC of the KR

Based on the data of GDP by the method of revenue usage, in the first half³ of 2012, calculated rate of growth of domestic demand (the sum of spending on final consumption and gross capital formation) amounted 122.3 percent compared to 104.8 percent in the first half of 2011. The growth of domestic demand was driven by a positive change of reserved operating assets (2.3 times), accumulation of fixed assets (+16.1 percent) and an increase in the cost of final consumption (+20.4 percent).

In 2012, assuming the situation in the manufacturing industry and agriculture, economic growth will develop slightly negative – within the limits of 1.0 percent. Estimate includes the planned production at the gold mining company “Kumtor” at 360 million ounces, which is almost 40 percent below the 2011 production, as well as slowing the rate of growth of the agricultural sector to zero. A positive contribution to GDP growth in 2012 is expected by the services sector (2.4 percent). The GDP deflator will develop in the range of 8.5 percent, while nominal GDP volume is expected on the level of 293.4 billion KGS.

According to the Resolution of GKR No. 419 of 15th of June 2012 “On amending the Resolution of GKR “On the Forecast of socio-economical development of the KR for 2012 and forecast for 2013-2014” of 13th of September 2011 No.533 in 2012 the GDP growth is expected on the level of 1.8 percent while the GDP deflator is being on the level of 9.9 percent, while nominal volume of GDP in 2012 is projected at the level of 303.5 billion KGS.

³ Here and hereinafter: the reference to earlier periods due to lack of data for the period of 2012.

Labor market and salary

According to the integrated sample survey of household budgets and manpower, conducted by the National Statistical committee of the Kyrgyz Republic, the number of economically active population in 2011 was 2.5 million.

The labor market in Kyrgyzstan in the last five years (2007-2011) is characterized by the tendency of reducing the number of newly created jobs. In 2011, 106.6 thous. jobs were created, which is 4.6 percent lower than in 2010.

The unemployment level was formed at a level of 2010 and amounted 8.5 percent. The major share of unemployed country's population (20.0 percent) take young people at the age from 15 to 24 years, but in 2011, there was a decrease of this group of unemployed by 0.8 percentage points compared with 2010. With increasing age of the population unemployment rate tends to decrease, however, it is necessary to note, that by the results of 2011 increase in the proportion of unemployed people was noted at the age from 50 to 65 years by 1.0 percentage points.

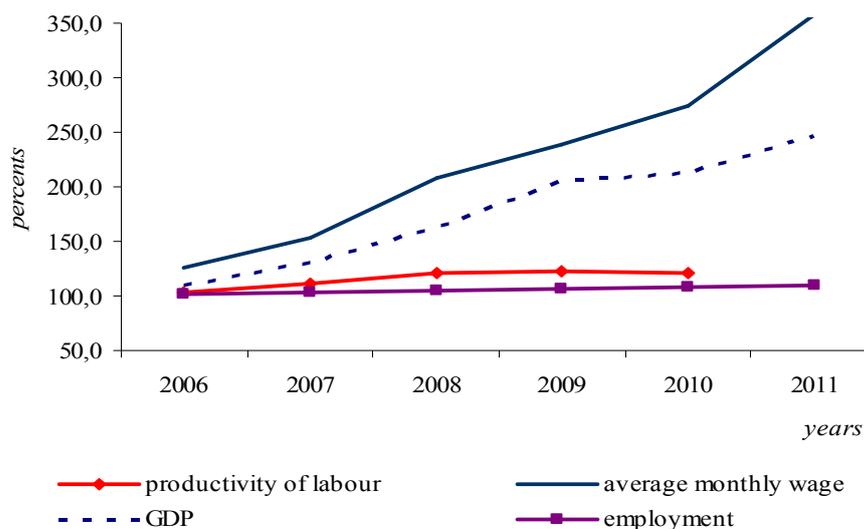
According to the inspection of the NSC of the KR in recent years men are more active on the labor market: the proportion and the number of economically active men is significantly higher than women – 58.2 percent of men of the total number of economically active population, against 41.8 percent of women.

Distribution of unemployed by education shows that more than half of unemployed have secondary (complete) education, although the share of this group in 2011 decreased by 4.8 percentage points compared to 2010 and amounted 51.7 percent. At the same time there is an increase of unemployed, having higher professional education, from 10.2 percent in 2010 to 13.2 percent in 2011.

The average monthly salary⁴ in 2011 increased by 30.8 percent compared to the similar indicator of 2010 (an increase of the average real wage amounted 12.2 percent). The growth rate of wages is largely achieved by its increase in the public sector by 1.5 times, which is confirmed by the data on the state budget for the period under review. Thus, the major share of spending in 2011 was the cost of labor, which increased by 40.9 percent compared to the indicator of the previous year.

Index of labor productivity, is characterized by the ratio of the index of gross value added to the index of labor costs, in 2010⁵ decreased by 1.6 percent compared to the previous year. In general, the dynamics of labor productivity and wages confirms a higher rate of salary growth, which could lead to an increase in production costs, and as a result, negatively impact inflation processes in the country.

Graph 1.1.1.1. Dynamics of GDP, productivity, levels of employment and wages
(2005 =100 percent)



⁴ Excluding small business.

⁵ Reference to an earlier period of time due to lack of date for the year of 2011.

According to a conducted study of 2012, which was made by the experts of German Society for International Cooperation (GIZ) “The labor market and employment policy in the Kyrgyz Republic”, the main characteristics of the labor market in Kyrgyzstan are:

- higher rates of growth of the economically active population in comparison to the growth of employed on the labor market;
- reduction in the share of employed population in the agricultural sector and corresponding increase in services sphere;
- continued growth of the gap in employment level among men and women;
- high level of economic activity of the rural population compared to urban;
- a significant proportion of employed in the informal sector of economy (about 70 percent) of the total number of people employed;
- high level of external labor migration.

1.1.2. Fiscal policy

The unstable socio-political situation in the country in 2010 led to a decrease in revenues for the state budget, including the revenues of official transfers (a decrease of 30.9 percent compared to the similar indicator of the previous year). Along with this, the Government has increased spending on social protection, economic issues and the sphere of defense, public order and safety. As a result, there has been an increase in the level of the budget deficit to 4.9 percent to GDP.

In 2011, the state budget’s imbalance remained – the budget deficit amounted 5.0 percent to GDP. The policy of rising living standards of population by raising wages of public sector and pensions has increased the budget deficit.

In 2012, the loss of tax revenue from gold mining enterprises of Kumtor company on the background of the production decrease, and also a reduction in revenues of official transfers resulted the loss of income in the resource part of the budget. At the same time, an improvement in tax administration and a series of regulations that promote the growth of tax revenue, as well as the down payment from gold mining enterprises of Kumtor company in the amount of 1.4 billion KGS, helped to keep the rate of growth of tax revenues. Total revenues of the state budget in January-September of 2012 amounted 62.8 billion KGS or 30.8 percent to GDP (compared to similar indicator of January-September of 2011 an increase amounted 13.4 percent), including income of tax revenues which amounted 45.6 billion KGS or 22.4 percent to GDP.

This year, the Government continued to expand budget spending for labor payments, for purchase of goods and services, as well as costs associated with the implementation of the public investment program. However, costs were reduced by non-priority budget items to 3.4 billion KGS. Total expenditure of the state budget in January-September of 2012 amounted 74.4 billion KGS or 36.5 percent to GDP, increased by 23.6 percent compared to the similar indicator of January-September of 2011.

As a result, indicator of balance of the sector of the governmental finance has reduced. Thus, the budget deficit for the first nine months of 2012 amounted 11.6 billion KGS or 5.7 percent to GDP, while in the same period in 2011 budget ran a deficit of 2.5 percent to GDP. Excluding official transfers received the state budget’s deficit amounted 15.1 billion KGS or 7.4 percent to GDP.

Total revenues of the state budget in January-October of 2012 amounted 69.7 billion KGS or 29.9 percent to GDP. Total spending amounted 82.2 billion KGS or 35.2 percent to GDP. The budget deficit was formed at a level of 12.5 billion KGS or 5.3 percent to GDP (in January-October of 2011 budget ran a deficit of 2.8 percent to GDP).

The state budget deficit by the end of 2012 is expected to reach 21.7 billion KGS or 7.1 percent to GDP.

1.1.3. Balance of payments

In 2010, there was an increase of the trade deficit by 7.3 percent, to 1202.2 mln. US dollars. In addition to this size of the negative balance of “services” and “income” has increased to 231.1 and 305.3 mln. US dollars, respectively. As a result, the current account deficit in 2010 increased from 2.2 to 7.3 percent to GDP, despite the receipt of funds on current transfers in the amount of 1391.3 mln. US dollars. The balance of capital account and financial transactions as a whole decreased from 585.1 to 484.2 mln. US dollars. Thus, in 2010 the overall balance of the balance of payments was positive in the amount of 65.5 mln. KGS, and the level of international reserves covered 4.1 months of future import of goods and services.

2011 was characterized by the activation of foreign economic activity of the country. On the increase of the volume of trade transactions affected both external factors, such as rising prices for gold and crude oil, as well as internal growth – volume of production. However, the higher rates of growth of import of goods over their export led to an increase in the trade deficit by 38.5 percent, to 1664 mln. US dollars. Volume of current transfers increased by 32.2 percent and reached a record value of 1838.7 mln. KGS, which led to reduction of current account deficit to 6.3 percent to GDP. The balance of the capital and financial transactions account increased by 612.5 mln. US dollars. Consequently, the surplus of balance of payments increased by 61.7 percent and amounted at 105.9 mln. US dollars, at the same time the volume of gross international reserves at the end of the year covered 3.7 months of future import of goods and services.

By the results of 2012 deterioration of the current account deficit is expected, deficit of which will rise to 9.7 percent to GDP (excluding revaluation – to 13.7 percent to GDP). This tendency is due to the deterioration of condition of the trade balance, the negative balance will increase by the results of the year by 30.2 percent, to 2166.9 mln. US dollars. Cash inflow on current transfers will be small and its growth will be 6.6 percent, which is to some extent is due to denunciation in March of 2012 of Russian-Kyrgyz Agreement on the facilitation of the Russian Federation citizenship by citizens of the Kyrgyz Republic.

The balance of the capital account and financial transactions has increased by 52.1 percent, to 931.9 mln. US dollars by attracting by companies of capital, situated in foreign accounts, in the amount of 158.1 US dollars, saving inflow of foreign direct investments at a level of the annual average of the last 3 years (428.6 mln. US dollars) and proceeds from external loans for the amount of 136.2 mln. US dollars.

Foreign direct investments attracted mainly in manufacturing industry and to conduct operations with real estate⁶, the share of those is 50 and 30 percent of the total volume of direct foreign investments. The main share of inflows of Public Investment Program (PIP) is loans issued by the Government of China, for the past 3 years. Forecast foresees debt write-off according to the entry into force of the agreement on debt relief for Turkey and ratification of the Agreement by the Kyrgyz Republic to settle the debt of the Kyrgyz Republic on previously issued loans to the Russian Federation.

It is expected, that in 2012 the balance of payment will not change significantly compared to 2011 and amounted 105.7 mln. US dollars and the volume of international reserves will cover 3.8 months of future import of goods and services.

Indexes of real and nominal effective exchange rate of the som

Nominal effective exchange rate (NEER) of the som at the end of 2010 compared to the previous indicator of 2009 decreased by 6.5 percent. At the same period the index of real effective exchange rate (REER) increased by 8.1 percent. Despite the strengthening of currencies of major trading partners to the som, lower inflation rate in the partner countries (3.2 percent) comparing to the inflation rate in the Kyrgyz Republic (19.2) percent put pressure on the REER index towards the increase, thus, smoothing the effect of the exchange rate.

⁶ According to the methodology of NSC geological prospecting relates to transactions with real estate.

NEER index of some at the end of 2011 compared to similar indication of 2010 has not changed. At the same time REER index under the reviewed year increased by 1.1 percent. The main reason for the increase of REER index is the low level of inflation in the partner countries compared to the indicator in the KR: in December of 2011 compared to December of 2010 inflation in the Kyrgyz Republic amounted 5.7 percent, in the countries of main trading partners – 4.6 percent.

According to preliminary data, the NEER of som for 9 months of 2012 has decreased by 2.9 percent. Decrease was due to the depreciation⁷ of the som in September of 2012 compared to the average rate for December of 2011 in relation to other foreign currencies.

Despite the lower level of inflation⁸ in the partner countries, the depreciation of NEER index of som caused the decrease of REER index by 2.2 percent by the results of September of 2012.

Table 1.1.3.1. Main indicators of the exchange rate

	<i>to the end of year (at the end of month)</i>						
	December 2009	December 2010	%	December 2011	%	September * 2012	%
REER	103,0	111,3	8,1	112,5	1,1	110,1	-2,2
NEER	124,2	116,2	-6,5	116,2	0,0	112,8	-2,9
RBBER to Chinese yuan	141,7	147,5	4,1	144,2	-2,3	144,1	-0,1
NBER to Chinese yuan	89,4	81,6	-8,7	78,4	-3,9	77,6	-1,0
RBBER to euro	109,4	133,8	22,3	140,1	4,7	144,9	3,4
NBER to euro	67,9	70,8	4,3	71,6	1,1	73,1	2,0
RBBER to Kazakh tenge	103,0	111,3	8,1	112,5	1,1	110,1	-2,2
NBER to Kazakh tenge	113,6	105,4	-7,2	106,5	1,0	107,2	0,7
RBBER to Russian ruble	70,1	75,0	7,0	76,6	2,2	74,2	-3,2
NBER to Russian ruble	114,5	111,8	-2,3	114,7	2,6	113,7	-0,9
RBBER to Turkish lira	104,2	109,8	5,3	131,5	19,8	125,0	-5,0
NBER to Turkish lira	262,1	246,4	-6,0	308,5	25,2	295,1	-4,3
RBBER to USD	162,4	178,8	10,1	184,4	3,1	185,3	0,5
NBER to USD	108,4	101,6	-6,3	102,3	0,7	101,7	-0,6

* preliminary data

" - " Som depreciation, improvement of competitiveness

" + " Som appreciation, deterioration of competitiveness

1.1.4. Key indicators of the financial market

Negative socio-political events in the country and their impact brought an imbalance to the process of the development of the financial market in 2010. Particularly, the influence of the internal shocks manifested as a reduction in the volume of deposit base⁹. Despite that, the total loan portfolio of commercial banks continued to grow due to the stability in the banking sector of the country. Som to US dollar in 2010 has depreciated by 6.8 percent due to the high demand for foreign currency, due to an increase in the deficit of the current account. Unstable political situation in the country also provided additional pressure on the exchange rate. Also, under the influence of negative expectations and growth of risks decrease of issued STB was observed on the market.

In 2011, stable situation remained on the financial market, due to the economic growth in the countries – which are main trade partners of the Kyrgyz Republic, and also growth of lending of the economy. The Government has launched the program “Affordable loans to farmers”, created as a tool of governmental support for agricultural sphere. With increasing liquidity in the banking system main indicators of the market have demonstrated modest growth. In all segments of the government securities market the increase of the yield was noted, with the greatest demand for treasury bills of the Ministry of Finance and notes of the National Bank. Thus, in 2011 the volume of STB in circulation increased by 26.0 percent, to 3.6 billion KGS, and volume of notes – in 2 times, reaching 1.4 billion

⁷ The data on the nominal bilateral exchange rate of some, as the base period used to calculate the index of 2000.

⁸ Inflation in the KR for January-September of 2012 amounted 3.1 percent, while the average inflation rate of inflation of major trading partner countries according to preliminary calculations amounted 1.9 percent.

⁹ Excluding the adjustment data on the performance of “AUB”

KGS. During the year the course trend of the US dollar was multidirectional, however by the results of 2011 the national currency slightly strengthened its position in relation to the US dollar.

Saving a relatively stable social and political environment in the country and the increase of business activity on the domestic market helped to keep the upward tendency on the market of deposits and loans in January-September 2012. In addition, in the beginning of 2012 the second phase of the project "Affordable loans to farmers" has started with the same volume of governmental financing as in a previous year (1 billion soms). At the same time indicators of the interest rates have not changed significantly, remained in whole at a level of values of the comparable period of the last year. Improvement of quality of credit portfolio of the banking system was observed, thus, indicators of arrears have decreased from 3.9 percent in the beginning of 2012 to 3.4 percent by the results of September, the share of extended loans was 4.1 percent (at the beginning of 2012 – 4.7 percent).

The volume of the deposit base of the commercial banks at the end of September 2012 amounted 50.8 billion KGS, increased from the beginning of the year by 31.4 percent. This increased happened due to the growth of deposits both in national (by 28.7 percent, to 24.8 billion KGS), as well as in foreign currency (by 34.2 percent, to 26.0 billion KGS in equivalent).

The monthly average interest rate on newly taken som deposits compared with the similar indicator for 9 month of 2011 increased to 2.3 percent (+0.2 p.p.), on foreign currency deposits – decreased by 0.1 percentage points, amounted 0.8 percent.

In January-September of 2012 acceleration of dynamics of credit portfolio of the bank system was observed compared to similar indicator of the previous year, due to a relatively active increase in its foreign currency component. The credit portfolio of commercial banks for 9 months of 2012 increased by 15.8 percent and amounted 36.1 billion KGS at the end of September (in January-September of 2011 credit portfolio increased by 13.9 percent). Growth of crediting has been provided by the expanding of crediting both in soms by 13.3 percent, as well as in foreign currency by 17.8 percent. Excluding the impact of exchange rate of som the loan portfolio for January-September of 2012 was formed in amount of 14.8 percent, at the same time increase of foreign currency loans was 16.1 percent.

The weighted average interest rate on newly issued bank loans in the national currency in January-September of 2012 amounted 22.9 percent, decreased compared to the similar indicator of the previous year by 0.6 percentage points, the rate on foreign currency loans decreased by 0.5 percentage points, to 19.1 percent.

On the market of government securities the increase of demand was noted in all of the market segments which led to reduction of monthly average indicators of yield.

In January-September of 2012 Ministry of Finance placed STB for the total amount of 2.0 billion KGS. As a result of a considerable growth of demand for these securities on annualized basis, the yield of STB decreased and amounted to an average of 15.0 percent for the period, having decreased in comparison with the similar indicator of 2011 by 3.9 percentage points. Volume of STB in circulation at the end of September amounted 4.1 billion KGS exceeded respective indicator at the beginning of the year by 34.8 percent.

For 9 months of 2012 the Ministry of Finance placed STB for the total sum of 3.9 billion KGS which is 21.7 percent higher than the similar indicator of 2011. At the same time supply of STB ranged from 330.0 to 565.0 mln KGS in a month having reached the maximum value in May. At the end of September of 2012 the volume of STB in circulation amounted 3.8 billion KGS, having increased from the beginning of the year by 5.7 percent. Average monthly yield on all types of STB amounted 10.2 percent, having decreased in comparison with January-September of 2011 by 6.0 percentage points.

In January-September of 2012 on the primary market of notes the NBKR supported volume of monthly average emission in the amount of 2.5 billion KGS in accordance with the objectives of monetary policy. In most of conducted auctions the volume of demand exceeded volume of supply and yield of securities decreased. In the period under review of 2012 the National Bank placed notes on the total sum of 21.2 billion KGS, having increased their volume compared to the similar indicator of 2011 by 32.9 percent, and volume of demand for the period amounted 28.5 billion KGS, having increased by 48.9 percent. The weighted average yield for the period amounted 7.3 percent which is 1.1 percentage points lower than the similar indicator of 2011. At the end of September the volume of

notes of the NBKR in circulation amounted 1.8 billion KGS, increased by 29.9 percent compared to the indicator on the beginning of the year.

In January-September of 2012 activity of the credit market of NBFI was on the level of dynamic of development of the banking sector. For 9 month the growth of gross loan portfolio of NBFI amounted 15.1 percent, having reached in quantitative terms 18.1 billion KGS. At the same time the share of loans of NBFI in the total indicator of loans volume in economy decreased by 0.1 percentage points, to 33.4 percent.

1.2. Expected results of the monetary policy

1.2.1. The analysis of monetary indicators in the previous period and the forecast for the end of 2012

In 2010 and in the first half of 2011 the National Bank in order to avoid deep recession of the country's economy due to external and internal shocks supported lending of the economy by the banking sector through a custom tool of monetary policy – loans of LLC “Specialized fund for bank refinancing” (SFBR). Creation of SFBR was one of the measure, taken to protect economy from negative effects of the world financial crisis, by providing additional resources of refinancing of the banking sector to support and provide assistance of the entities. The SFBR provided financial resources to the banking sector for refinancing of real sector at a rate, equal to the base rate, adjusted by a correction factor for corresponding industry. In 2010, the NBKR gradually reduced the base rate on the SFBR loans to 7 percent, setting a single industry coefficient at a level of 1 (one). The volume of the SFBR loans issued in 2010 amounted 1.6 billion KGS.

Taking in account the decrease of a resource base for lending of the economy the National Bank from May of 2010 reduced the amount of reserve requirement for commercial banks from 9.5 to 8 percent. Also volume of withdrawal of excess liquidity through operations on the open market was significantly reduced.

In 2011, considering the encouraging signs of economic growth, the NBKR held a moderately strict monetary policy, by taking a number of measures in response to the rising inflation. The National Bank during 2011 increased the volume of liquidity sterilization: the volume of notes of the NBKR in circulation increased from 669.2 mln. KGS on the beginning of the year to 1.4 billion KGS at the end of the year; the volume of repo-operations on withdrawal of liquidity increased from 70.8 mln. KGS in the beginning of the year to 206.8 mln. KGS at the end of the year. To limit the monetary component of inflation on the background of high excess reserves of the banking system in March of 2011 the NBKR increased the size of required reserves for commercial banks from 8 to 9 percent of the calculated base, and also increased base rate for lending purposes of the SFBR to 10 percent in July of 2011. However, taking into consideration the robust signs of economic recovery, and due to the implementation of the main task to solve it the SFBR was created, the National Bank took a decision to stop its activity. At the start of the liquidation process, on 1st of August of 2011, the volume of distributed funds of the SFBR amounted 2.6 billion KGS.

On the domestic interbank currency market the National Bank in 2010 and 2011 conducted mainly operations of selling US dollars, the volume of net sales amounted 234.8 and 160.7 mln. US dollars, respectively. The growth rates of the monetary base in 2010 and 2011 amounted 18.4 percent and 12.8 percent, respectively.

In the “Main guidelines of the monetary policy for 2012-2014” the main objective of the monetary policy in 2012 the retention of moderate rates of inflation, contributing implementation of Government's plans for sustainable economic growth, was defined.

During 9 months of 2012, taking into account the persistence of high inflation background, evidence of which is the preservation of core inflation at a level of 9-10 percent and also due to the significant increase of state budget's deficit, the NBKR increased the volume of sterilization of excess liquidity: the volume of NBKR notes in circulation amounted an average of 2.0 billion KGS, having increased by 1.3 times from 1.4 billion KGS at the beginning of the year to 1.8 billion KGS at the end of September of 2012; the volume of repo-operations increased in 2.4 times from 206.8 mln. KGS at the beginnings of the year to 500 mln. KGS at the end of September of 2012.

Discount rate of the NBKR for 9 months of 2012 decreased from 13.61 percent to 4.25 percent. The volume of issued “overnight” loans decreased and constituted 1.9 billion KGS against 3.9 billion KGS in similar period of 2011.

During 9 months of 2012 on the domestic currency market relatively stable situation has remained, correspondence of supply and demand was observed. In this regard the NBKR took restrained part on the currency market conducting currency interventions only to prevent sharp fluctuations of the exchange rate in January-February and in June. Net sales of foreign currency 9 months of 2012 amounted 38.3 mln. US dollars, when in the same period of 2011 – 65.9 mln. US dollars. The exchange rate of US dollar in relation to som increased by 1.4 percent from 46.4847 to 47.1484 for 1 US dollar (in similar period of 2011 decrease of the exchange rate by 4.5 percent was observed).

By the results of January-September of 2012 money base has increased by 9.8 percent, mainly, due to the deficit increase of the state budget. In January-September of 2012 broad money M2X increased by 18.9 percent, loan to the economy from the banking sector increased by 16.5 percent.

Until the end of 2012 the NBKR will keep the accepted direction of monetary policy, which should allow keeping the growth rate of the monetary base not higher than 17 percent, with an expected substantial increase in Government spending at the end of the year.

Sources of formation of the money supply

As part of the implementation of the project “Affordable credits to farmers” Government in 2012 has launched the second phase of the project with a volume of government financing in the amount of 1 billion KGS. Actual settlement by the Government of funds in terms of this project was 700.4 mln. KGS (as of 01.12.2012). Government increased the state budget expenditures, including expenditures for social support (including social protection, salaries for employees of the public sector and pensions), the restoration of damaged facilities in the south.

As per results of 9 months of 2012 the growth rate of monetary aggregates were as follows compared with the similar indicators for January-September of 2011:

	<i>for 9 months of 2012</i>	<i>for 9 months of 2011</i>
- money outside banks M0	7,1 percent;	6,7 percent
- broad money M2	14,5 percent;	9,2 percent
- broad money M2X	18,9 percent;	10,5 percent

The contribution of net foreign assets of the NBKR (NFA NBKR) for 9 months of 2012, the growth of the monetary base grew by 15.0 percent (in the similar period of 2011 – 8.6 percent). The main contribution to the increase of the NFA NBKR made foreign assets (+10.4 percent) and growth of the gold price (+3.3 percent). From domestic sources of increase of the NFA NBKR the large ones are proceeds from gold mining companies for the total amount of 75.5 mln. US dollars, the Transit Center in the amount of 45 mln. US dollars, and lease of the Russian military base in the amount of 15.5 mln. US dollars. The volume of external financing for January-September of 2012 is 19.2 mln. US dollars.

Net domestic assets of the NBKR (NDA NBKR) for 9 months of 2012 reduced the monetary base, and the contribution of the NDA NBKR is estimated in (-) 5.2 percent (in January-September of 2011 the contribution of the NDA NBKR to reduce the monetary base amounted (-) 3.2 percent). The major impact on reducing of the NDA NBKR made operations of the NBKR on the open market with the contribution of (-4.0 percent), the decrease in accounts “capital accounts and other items (net)” with the contribution of (-2.1 percent) due to the revaluation of currency assets as a result of exchange rate changes. Operations of the Government brought positive contribution to the change of NDA (+0.8 percent).

Net foreign assets of the banking system (NFA BS) for January-September of 2012 influenced the increase of the broad money M2X with the contribution (+) 12.8 percent, when in the similar

period of 2011 their contribution amounted (+) 7.6 percent. Major contribution in the increase of the NFA BS made “requirements for nonresidents” (+) 12.4 percent.

Net domestic assets of the banking system (NDA BS) for 9 months of 2012 increased broad money. Contribution of the NDA BS in the change of broad money M2X is evaluated (+) 6.1 percent (in the similar period of 2011 the increase amounted (+) 2.9 percent). On increase of the NDA BS articles “requirements to other sectors” have affected with the contribution of (+) 6.9 percent and operations of the Government with the contribution of (+) 1.1 percent with a decrease on “Others” articles with contribution of (-) 0.9 percent and “capital accounts” with contribution of (-) 0.9 percent.

At the end of October of 2012 the structure of the broad money M2X comparing to the beginning of the year has changed as follows:

- share of money outside banks decreased from 59.4 percent to 53.5 percent;
- share of deposits of depository corporations increased from 40.6 percent to 46.5 percent.

The structure of deposits, including to M2X, practically has not changed. Share of deposits in nation currency was 46.6 percent and currency deposits 53.4 percent.

Accordingly the multiplier of M2X increased from 1.45 at the beginning of 2012 to 1.57 at the end of September of 2012. It is expected that the growth rate of broad money M2X at the end of 2012 will not increase 20 percent, mainly due to the increase of money outside banks in the result of expected significant spending of the Government of the Kyrgyz Republic.

In January-November of 2012 the monetary base increased by 10.2 percent. Broad money M2X increased by 19.2 percent, by the preliminary data. Money outside banks increased by 5.6 percent and deposits of commercial banks by 39.2 percent, including deposits in national currency – by 47.1 percent, and in foreign currency – by 32.4 percent. Credit to the economy grew by 26.7 percent.

1.2.2. Factors of inflation and achieving quantitative targets of monetary policy

By the results of 2010 acceleration of inflation was noted (December of 2010 to December of 2009) to 19.2 percent compared to the similar indicator of 2009. Moderate growth rate of consumer prices in the first half of 2010 (annual value of inflation amounted 3.6 percent) has changed by inflationary surge in the second half. Thus, due to the external price shocks for consumer goods, rising cost of fuel due to the export duties and rising prices on the world markets for oil, prices for domestic consumer goods have significantly increased.

Inflation inertia of 2012 continued during the first quarter of 2011. However, in April on world commodity markets, and then on domestic market of Kyrgyzstan, first signs of price stabilization for food have started to appear, including due to seasonal factors. High yield in the agricultural sector contributed for seasonal deflation, which continued for four month for the first time, beginning from July. By the results of 2011 inflation in the annual terms amounted 5.7 percent, including rise in food prices amounted 3.5 percent.

First half of 2012 was characterized by the decrease in the overall price level in the Kyrgyz Republic on the background of falling world prices for major food goods. In June of 2012 information about adverse weather conditions started to appear, and therefore production targets for certain crops have decreased, market of wheat and corn began to demonstrate significant price increase. Change of the world prices for wheat reflected on the domestic prices for bakery products. Internal reason have made the situation more complicated, also due to the poor grain harvest. Additional factor of increase of inflation in the country became the increase of population’s income (net inflow of money transfers of migrants increased by 19.9 percent; real salary increased by 20.5 percent).

According to preliminary data of NSC, in November of 2012 inflation in the annual terms amounted 7.0 percent, on the background of slowing of price growth rates for consumer goods. From the beginning of the year inflation amounted 5.9 percent with the increase of prices in November by 0.8 percent.

In general, the current dynamic of consumer prices is determined by following factors:

- volatility of prices for consumer goods;

- unstable macroeconomic situation in the country;
- high rate of spending of state budget for current consumption, as well as irregular expenditure of budget funds during the year.

Considering the actual data for the past year, and also assumptions about future dynamics of consumer prices, inflation by the results of 2012 (December of 2012 to December of 2011) is expected to be on the level of 8.5 percent.

2. PERSPECTIVES FOR ECONOMIC DEVELOPMENT IN 2013-2015

2.1. Internal and external factors, possible risks

The *external risks* that could have an impact on the macroeconomic situation in the country include:

- instability of the world economy:

Fundamental suspense of financial problems in some countries of European Union, economic slowdown in U.S.A and China are the factors of uncertainty of the global economic system.

- deterioration of terms of trade with countries major trading partners:

Negative effects of deterioration of conditions of trade with countries major trading partners may appear in the form of decline in production volume in export-oriented sectors of economy (industrial and services sphere), which will lead to additional pressure on the national currency due to decrease of inflow of foreign currency through export. With the growth of import cost additional inflationary pressure on the economy will happen.

- shortfall of planned volume of foreign investments:

In the medium-term the most part of the state budget's deficit will be covered by external lending. In the case, if external lending will not go to the full extent, there will be a risk of failure to comply by the state of spending commitments.

Internal risks include following:

- instability in the fiscal sector:

The coming period will be stressful and requiring special attention from the fiscal authorities in the effective management of public finances. Continued high level of deficit over a long period is bad for economy, inflation growth can be a real obstacle in achieving stabilization of inflationary process in economy. It is also important to comply principles of budget consolidation and optimization.

- the unresolved problem of the high import dependency of the economy and provision of food security:

According to the data of food balance for many main foodstuffs the low domestic production is noted, which covers consumption in a limited way that leads to an increase of import dependency. Prices for imported goods are characterized by high uncertainty of future development and also cannot be regulated by internal instruments. In this case domestic price dynamics is more vulnerable to external shocks.

- uncertainty regarding tariff policy

At this moment the position regarding medium rate tariff policy remains uncertain. The quarterly increase of the purchase prices for gas from Uzbekistan as well as maintaining a high level of losses in the energy sector create conditions for tariff increase for industrial and private sector.

2.2. Development of economy

Forecast of development of economy is developed on the basis of basic and alternative scenarios. According *basic scenario*, the GDP forecast for 2013 provides recovery of economic growth after the recession of 2012. The main assumptions are:

- recovery of gold mining volume at the gold deposit Kumtor to the level of 2011 (about 580 thous. ounces)¹⁰;
 - the growth rates in the agricultural sector and services will be higher than the average annual values;
 - steadily developing trade-economic relations with trading partners of the country.
- Also, the effect of the low base of 2012 should be considered.

In 2013 economy will resume its growth and the real GDP growth will be on the level of 8.3 percent. The largest contribution to the GDP growth is expected from the industry (3.9 p.p.), service industry (2.4 p.p.) and agriculture (0.5 p.p.).

The GDP deflator is projected at a level of 12.0 percent which corresponds to the forecast of average annual inflation. Thus, the volume of GDP in the nominal terms will be 355.9 billion. KGS.

GDP growth from the usage side will be provided by the growth of consumption and investments in the country's economy. Inflow of monetary funds of individuals will continue to contribute to the stable growth of the domestic demand. Investments in the sphere of rehabilitation of roads and in the energy sector are expected.

For 2014 and 2015 real growth rate of GDP, calculated on the basis of estimates of long-term growth potential of the economy and in the condition of absence of shocks and other disturbances, is set on the level of 5.0 percent, in the nominal expression the GDP volume is projected at a level of 407.5 and 466.4 billion KGS, respectively.

Table 2.2.1. Estimate of GDP growth in the medium term

	fact	forecast			
	2011	2012	2013	2014	2015
Agriculture	2,3	0,0	2,5	2,0	2,0
Industry	12,1	-17,5	22,8	5,6	9,0
Construction	-3,9	8,0	9,0	11,5	8,0
Services	5,2	5,2	5,2	5,2	4,0
Net tax on products	5,7	-1,0	5,0	5,0	5,0
GDP, percent	5,7	-1,0	5,0	5,0	5,0
Deflator, percent	17,3	8,5	12,0	9,0	9,0
Nominal GDP, million KGS	273 107,8	293 377,4	355 930,4	407 489,9	466 372,1

According to the medium-term strategy of fiscal policy among the most important prerequisites for macroeconomic stability are:

- socio-political stability in the country;
- conducting of coordinated monetary and fiscal policies;
- carrying forward of structural reforms in priority areas of economic development;
- reducing the burden of external debt and expansion of foreign economic cooperation;
- creation of favorable investment climate for inflow of private investments.

Basic assumptions of development of fiscal policy in the years of 2013-2015 are:

- financing of secured budget items in the full volume;
- conducting of budget consolidation in the medium term.

Based on the practice of following years, the actual execution of state budget in average is 90 percent of the budgeted amount, and average actual income from the resource part is about 70-80 percent from the budgeted amount. These estimates have been considered during preparation of indicators of fiscal sector shown below.

State budget revenues including PIP grants in 2013 are projected in the amount of 93.4 billion KGS or 26.2 percent to GDP. For the period of 2014-2015 the total volume of revenues will increase to 97.0 billion KGS and 105.2 billion KGS, respectively.

In 2013-2015 the systematic reduction of expenditures relative to GDP is expected. The state budget expenditures in 2013 are projected in the amount of 104.9 billion KGS or 29.5 percent to GDP,

¹⁰ According to the forecast published in the press release of Centerra Gold Inc. on November 7, 2012.

in 2014 – 108.0 billion KGS or 26.5 percent to GDP, in 2015 – 112.4 billion KGS or 24.1 percent to GDP.

In order to enhance the investment component of public expenditures and curb the growth of consumer spending, it is assumed that in 2013 current expenditures, including salary, it will be kept on the level of 2012. This in turn will allow increasing the volume of funds directed from the budget to improve the real sector of economy, which will eventually have a positive impact on the economic growth of the country.

The budget deficit in 2013 is projected on the level of 11.5 billion KGS or 3.2 percent to GDP, in 2014 – 10.9 billion KGS or 2.7 percent to GDP, in 2015 – 7.2 billion KGS or 1.6 percent to GDP.

In 2013, improvement of condition of the country's trade balance¹¹ is projected, the dynamic growth of export deliveries will contribute to it, comparing to the growth of import revenues. Thus, the recovery of gold mining at the “Kumtor” gold field, in addition to maintaining of demand by trade partner countries for domestic goods will provide export growth by 17.3 percent. At the same time, the growth of economy of the Kyrgyz Republic and trade partner countries will help to maintain demand for imported goods volume of which will increase by 5.2 percent. Price decrease of Urals oil by 11 percent will reduce the volume of oil imports by 7.5 percent.

Along with the positive dynamics in foreign trade, deceleration of the growth rate dynamics of monetary funds in the form of transfers is expected, they will be provided by remittances of migrant workers. Particularly, from 1st of December of 2012 law of the RF comes into force which requires migrant workers to pass the exam on knowledge of Russian language. In whole, the improvement of the current account is projected, deficit of which will decrease to 5.4 percent to GDP (excluding adjustment – to 8.2 percent to GDP).

Financing of deficit of the current account will be conducted by inflow of direct foreign investments (459.2 mln. US dollars) and credits in the governmental sector (295.0 mln US dollars).

In general, by the results of 2013 the positive balance of payment balance is projected on the level of 160.1 mln. US dollars, and the cover level by international reserves of future volume of import of goods and services will increase to 4.0 months.

In 2014-2015, the account deficit of current operations will have a decrease tendency, and by 2015 the negative balance on the current account will be reduced to 1.3 percent covering reserves in months of import will be in average 4.4 months.

Alternative scenario of economic development is based on forecasts and targets of the Government programs and the Strategy project of sustainable development until 2017. Alternative forecast of GDP foresees economic recovery to the level of 7 percent annually over the medium term, after its downturn in 2012:

The main assumptions are:

- increase of investment activity and implementation of major national projects in the sphere of gold mining, energy, agricultural sector,
- resumption of gold mining at the “Kumtor” gold field in accordance with plans of gold mining company,
- positive growth in agriculture and service,
- active foreign economic activity,
- steadily developing trade and economic relations with trading partners countries.

Economic development in 2013 is based on a forecast of Government's economy, reflected in the Government's Instruction “On the Forecast of socio-economic development of the Kyrgyz Republic for 2013 and forecast for 2014-2015” No.613 of 12.09.2012. In this case the real rate of GDP growth in 2013 will be positive on the level of 7.0 percent. Projected growth will be provided by the contribution of all sides of the economy. The greatest contribution will be provided by service industry sector. GDP deflator in 2013 is projected on the level of 8.4 percent. Thus, the volume of GDP of 2013 in nominal term will be 354.4 mln. KGS.

¹¹ In the forecast of 2013-2015 the impact of external factors is not foreseen, related to the entry of the KR to the Customs Union (CU), as the conditions and terms of joining of the country to the CU are not defined.

In the period of 2014-2015 economic development will correspond to the quantitative targets, laid down in the project of Strategy of sustainable development for the period of 2013-2017. Thus, economic growth averaging 7 percent and by 2015 in nominal expression of GDP will reach the level of 470.2 billion KGS.

In an alternative scenario development of fiscal sector corresponds to parameters laid down in the Law “On republican budget for 2013 and the forecast for 2014-2015”. In addition, it is assumed:

- financing of protected budget items in the full volume;
- conducting of budget consolidation;
- inflow of planned grants and loans.

According to the Law “On republican budget for 2013 and forecast on 2014-2015” the state budget revenues including PIP grants in 2013 will amount 98.5 billion KGS or 27.8 percent to GDP. State budget expenditures will amount 115.4 billion KGS or 32.6 percent to GDP.

For a period of 2014-2015 the total volume of the state budget revenues including PIP grants will increase to 102 913.4 mln. KGS and 111 811.1 mln. KGS, respectively; and the total expenditures to 119.1 billion KGS and 122.9 billion KGS, respectively.

Budget deficit in 2013 is projected on the level of 16.9 billion KGS or 4.8 percent to the GDP, in 2014 – 16.2 billion KGS or 4.0 percent to GDP, in 2015 – 11.1 billion KGS or 2.4 percent to GDP.

In accordance with alternative scenario the decline of the deficit level of current operations is expected to 2.8 percent of GDP (excluding adjustment – to 5.7 percent to GDP), due to increased export of gold. Capital inflow to the country will not have big changes and balance of the capital and financial transactions account will be 950.1 mln. US dollars. Total balance of payment balance is expected to be positive (184.1 mln. US dollars), and international reserves will cover 4.0 months of import.

It is expected, that dynamics of growth of export and import revenues to 2015 will grow about the same. The average annual growth rate of current transfers will be at the level of 8-9 percent. The average annual growth rate of current transfers will be at the level of 8-9 percent. This, deficit of account of current operations at the end of 2015 will decrease to 1.5 percent to GDP.

Implementation of the Strategy of sustainable development of the country until 2017 will contribute to growth volume of external financial flows will provide growth of direct foreign investments on the level of 500-550.0 mln. US dollars. Along with this, the volume of credits in public sector will decrease to 124.3 mln. US dollars, which will lead to decrease, in general, the volume of operations with capital and financial operations to 765.0 mln. US dollars.

Thus, by 2015 the positive balance of payments will be projected at the level of 162.5 mln. US dollars, and the coverage level of international reserves of future volume of import of goods and services will be in the range up to 3.8 months.

Table 2.2.2. Key assumptions (alternative scenario)

	source	2012	2013	2014	2015
GDP growth, %					
Kyrgyz Republic	NBKR, SED	-1,0	7,0	7,0	7,0
Countries major trading partners	data: IMF, MoE of RF and RK	4,2	4,6	5,0	5,7
Gold (mln. S)		629,9	1090,8	1167,5	1298,6
volume of export (thous. troy ounce)	by data of SED and NBKR	382,5	661,1	753,2	837,8
price for troy ounce in \$US	by data of NBKR and expert data	1650,0	1650,0	1550,0	1550,0
Oil products (mln. \$US, at CIF prices)		983,4	862,5	934,0	1000,6
volume of import (thous. ton.)	expert estimate	1301	1352	1407	1463
price for ton., \$US	data: MoE of RF	756,1	637,8	664,1	683,8
Adjustment on reexport of fuels and lubricants, mln. SUS	expert estimate	211,9	-	-	-
Public finance, SUS	by the RB data				
exchange rate of som to US dollar		47,0	47,5	47,5	47,5
Receipt of credits	by the RB data	384,0 *	406,6	286,2	202,9
Program credits (forecast include 90% of built in the RB)		41,6	95,4	35,0	1,4
Credits of PIP included in BoP (forecast include 90% of built in the RB)	expert estimate	342,4	311,2	251,2	201,5
Credits of PIP included in the RB		342,4	311,2	251,2	201,5
Debt service	by MoF data (DTS)	73,8 *	92,1	105,6	125,8
percents		32,8	42,2	45,2	46,7
depreciation		41,0	49,9	60,4	79,1
Receipt of grants	by the RB data	129,9 *	158,2	116,7	73,6
Program grants		17,7	43,7	21,5	8,4
Grants of PIP included in BoP (forecast include 90% of built in the RB)	expert estimate	112,2	114,5	95,1	65,2
Grant of PIP included in the RB		112,2	114,5	95,1	65,2

* as per preliminary data

- Republican budget (RB) for 2013 and forecast for 2014-2015 approved by the Resolution of KR Government No. 726 of 18.10.2012 r.

2.3. Inflation forecast

Prices for non-food products, alcoholic beverages, tobacco products, and also services for a number of years keep stable positive dynamics on the level of 10 percent, which generally forms the basic level of inflationary background in economics. Traditionally large fluctuations of inflation are the reason of volatility of the prices for consumer goods, depending from the prices for imported goods on the domestic market.

In 2013, with a moderate growth rate for consumer goods, reducing the accumulated inflation expectations of population and absence of any significant external and internal shocks of demand and supply, the inflation value with the expert assessments is expected on the level of single digit. Inflation forecast on the basis of technical calculations by various methods is show below.

Method	Meaning
1 Forecast by average	9.0
2 Consecutive mean	8.0
3 Componentwise model (by CPI basket)	10.0
4 Factor model (regression)	5.7 ¹
5 New system model (approbation)	10.4
Consensus-forecast (average)	8.6

¹ – under the baseline scenario

Inflation for 2014-2015, in the absence of shocks, is estimated in the range of 6-8 percent.

This forecast is basic and relies on the forecast indicators of the monetary component. Uncertainty remains on the planned medium-term period of Government's tariff policy and effectiveness of implementation of Government's program in the agricultural sector.

In whole, in the short-term and medium-term perspective the price situation will be predetermined, to a large extent, by such factors as the saturation of the domestic market by goods and services, conditions of trade and price conjuncture on the commodity market of main imported goods by the republic, implementation of fiscal policy and administratively established tariffs by the

Government. It should be noted, that the equal expenditure of the state budget during the fiscal year will contribute to the risk decrease of inflation growth.

Dynamics of the inflation will also depend from the degree of price correction for the imported goods on the domestic market and assessments of the dynamics of exchange rate.

3. CONDITIONS FOR IMPLEMENTATION OF MONETARY PROGRAMS IN THE MEDIUM-TERM

3.1. The goal of monetary policy

The main goal of the monetary policy is to keep inflation within the single digits in the medium-term.

To achieve the set goals the NBKR will use its available monetary policy instruments. In the event of the inflationary pressure, caused by the price shocks, and if the shocks will be continuous, the NBKR will tighten monetary policy.

In the conditions of pro-cyclical fiscal policy, as well as the expected inflow of foreign currency into the country in the form of remittances and receipts from foreign organizations and donor countries, monetary policy of the NBKR in the medium-term will focus on the achievement and maintenance of price stability and will contribute to the implementation of Government's plan directed on recovery of macroeconomic stability and creation of basic conditions for economic and social development in the medium-term.

One of the main medium-term tasks of the National bank is to further increase the effectiveness of the monetary policy, including by improvement of work interest rate channel of the transmission mechanism, expanding the instruments of the monetary policy, the development of financial markets and strengthening of competition in the banking sector.

The National Bank will retain the policy of floating exchange rate, and if necessary will implement currency interventions in order to avoid sharp fluctuations in the exchange rate. Management of international reserves will be based on the basic concepts of liquidity and safety of reserve assets. In order to replenish the volume of gold reserves the NBKR will buy gold for the national currency on the country domestic market, taking into account the situation on the world financial markets.

In order to further improve the functioning of the banking system and maintenance of the competitive environment the NBKR will continue work to strengthen the banking supervision and improvement of the legal base in the sphere of regulation and supervision of activity for commercial banks, and also development of the Banking Code.

Work will be continued on further integration of principles of the system of early intervention and implementation of the complex assessment of commercial banks activity including assessment of management quality and internal system control. There will also be activities on financial health of the banks, which are on the conservation regime, to solve problems with the banks which are in the regime of bank direct supervision.

The National Bank in 2013 paid special attention to the development and improvement of legal acts in the field of regulation of activity of non-bank financial institutions including matters of the establishment of requirements for credit risk management, expanding the list of operations carried out in accordance with the Islamic principles of banking and financing, protection of the rights of consumers of financial services and antimonopoly regulation. Implementation of the Strategy for Microfinance Development on 2011-2015 will be continued.

The National Bank will continued to work on improvement of the legal base for the regulation of banks and non-bank financial institutions in the area of fighting financing of terrorism (extremism) and legalization (laundering) of income received from crime, protection of deposits on the matters of conducting of financial inspections.

Economic research in the area of the monetary policy and macroeconomic modeling including modeling of inflation and usage of the monetary instruments, including the assistance of international financial institutions, will be conducted with the purpose of improvement of short-term and medium-term inflation forecast, strengthening monetary policy transmission mechanism, and also improvement the NBKR possibilities to achieve the goals and intermediate targets of the monetary policy.

In the framework of the State Program on increasing the share of non-cash payments and settlements in the Kyrgyz Republic for 2012-2017¹² the National Bank will continue to ensure control of implementation of measures to gradually shift the salaries of civil servants and other employees of the public sector, scholarships, pensions, social benefits, to receive payments to the state budget, as well as payments for goods and services in non-cash form.

In order to protect consumers and reducing of financial risks in the payment system the National Bank will conduct activities for supervision of functioning of the payment system of the country and provision of control for correspondent relationship and technical infrastructure of the payment system of the Kyrgyz Republic. Policy in the area of supervision (oversight) for the payment system will be improved with the emerging market of innovative technologies. In the conditions of development and implementation of innovative forms of activity in the sphere of payments and settlements the National Bank will continue to work on improvement of the legal regulation of payment services.

In 2013, the NBKR plans to complete the project of the Main book directed on providence of full automation and interaction in real time between all components of the payment system, internal systems of the National Bank, system of international payments, trade system and other business-applications. Also in 2013 it is planned to finish the project on integration of automated trade system intended to automate transactions on the financial market, as well as to reduce the risks and increase reliability of conducting the transaction on the government securities market, currency and monetary markets.

In order to provide macroeconomic stability Government and the National Bank will take a coordinated measures on the development of macro economical forecasts within the framework of Interagency Working Group and coordination of monetary and fiscal policies in the framework of Interagency Coordinating Council of the Ministry of finance and the National Bank.

3.2. Monetary program

To conduct the monetary policy in the medium-term of 2013-2015, the NBKR will rely on the expected trends of the development of real, fiscal and external economic sectors and will focus on the inflation value on the level of 8-9 percent in average for the period in the absence of shocks.

The medium term monetary program was developed by the baseline and alternative scenarios.

Baseline scenarios was developed on the basis of the NBKR's assessments which takes into account the economic downturn in 2012 to the level of -1.0 percent due to a significant reduction in the forecast of gold production. This scenario considers reduction of the gold mining by the results of 2012 to the level of 360 thous. ounces, in accordance with an updated press-release of "Centerra Gold Inc" of 7th November 2012 (a decrease of almost 40 percent of the actual value for the year of 2011). In 2013, the economic growth is projected at 8.3 percent in 2014 and 2015 – within 5.0 percent. For the sector of governmental finance the NBKR assessments are used suggesting in 2013 the government deficit budget of 3.2 percent to GDP, the deficit value of following years are also adjusted downward. In this case, the growth rate of the monetary base in 2013 will be around 16.7 percent and inflation in 2013 will be 9.0 percent.

In the medium-term the main contribution to the increase of the monetary base will make net foreign assets (NFA NBKR). Thus, the average contribution for 2013-2015 NFA NBKR will be (+) 13.5 percent, the contribution of net domestic assets (NFA NBKR) is projected on the level of (+) 1.3 percent with the deficit of the current account on the level of 3.6 percent to GDP, deficit of the government budget on the level of 2.5 percent and an average annual economic growth of 6.1 percent. The growth rates of the monetary base will gradually decline to 11.6 percent by the end of 2015, the inflation rate in 2014-2015 is estimated between 6.5 and 6.3 percent, respectively.

The rate of growth of M2X in the medium-term will amount in average 15.1 percent.

Velocity of broad money M2X during the forecast period will remain at an average of 3.4.

¹² Approved by the Joint Resolution of the Government of the Kyrgyz Republic and the National Bank of the Kyrgyz Republic No. 289/5/1 of May 14, 2012.

Alternative scenario of economic development is based on projected data in the framework of the program of the Government of the KR, as well as the project of Sustainable Development Strategy of the Kyrgyz Republic to 2017. For the sector of government finance the forecasts are used indicated in the Law of the KR “On republican budget of the KR for 2012 and forecast for 2013-2014” and “On republican budget of the KR for 2013 and the forecast for 2014-2015”. This scenario implies the economic downturn in 2012 to the level of -1.0 percent and economic recovery in the medium-term to the level of 7 percent annually after its downturn in 2012. In the sector of government finance there will be expected the slight decrease of the governmental budget from 7.4 percent to GDP by the results of 2012, in the medium-term perspective – from 4.8 to 2.4 percent to GDP. It is assumed, that the growth rate of the monetary base in the medium-term will be around 18-20 percent, the level of inflation amounted 8.0; 9.0 and 7.0 percent in 2013, 2014, 2015, respectively.

In an alternative scenario the contribution of NFA NBKR to the growth of the monetary base in average amounted (+) 18 percent, and NDA – to (+) 1.0 percent with the deficit of the current account on the level of 2.4 percent to GDP, deficit of the government budget on the level of 3.7 percent and the average rate of economic growth of 7.0 percent.

The rate of growth in the medium term M2X will amount in average 25.2 percent and the rate of circulation of broad money will be in the range of 3.2-3.7.

At the *baseline* and *alternative* scenarios on the change of net foreign assets of the NBKR will influence operations to maintain the external debt, the proceeds of the external credits and grants, proceeds from the Transit Center of the U.S. Ministry of Defense and the gold mining companies, as well as the volume of the NBKR gold purchases on the domestic market. If necessary the NBKR will act both as a seller and as currency buyer on the interbank currency market in order to smooth the sharp fluctuations in the exchange rate of the som to the dollar.

3.3. Conditions to achieve the goals of the monetary policy

Achieving of estimated rates of inflation will largely depend on the fundamental factors, and factors of a seasonal nature.

Stability of socio-political situation in the country, unchanging terms of trade and a moderate price dynamics on the world commodity markets, as well as the commitment of the National Bank and the Government on conducting of the collaborative macro-prudential measures, will be decisive for the achievement of the monetary policy targets.

The impact of structural reforms of the Government in the agricultural sphere will be a significant factor in the formation of the internal saturation of market by goods. Low yield of agricultural products in 2012 led to a significant increase of import dependency of the republic, and as a consequence, high inflationary background until the middle of 2013.

Fiscal policy in the medium-term is aimed at the fiscal consolidation, however it is still soft. Thus, the projected deficit of the state budget of 2013 is 4.8 percent to GDP, which is 2 times higher than the average value of budget deficit for the last 5 years (2.5 percent, 2007-2011). Continued high level of deficit over a long period of time is bad for economy due to the inflation growth and can be a real obstacle for achieving of stabilization of inflationary processes in the economy.

In the medium term perspective achievement of objective of the monetary policy will be possible if success in following areas is achieved:

- 1) reducing of import dependency on the main food staples;
- 2) preventing of the formation of deficit and speculative surges of prices for socially important goods;
- 3) conducting structural reforms, proactive steps in the development of agriculture in the republic;
- 4) strengthening measures on providing sustainability and stability of inflow of the state revenues and the uniform distribution of state expenditures during the financial year in conjunction with measures for fiscal consolidation;
- 5) regulation of tariffs for housing and communal services, transport, education and communication, in order to avoid their unreasonable growth on the basis of principle of transparency, economic efficiency and social justice;
- 6) regulation of tariffs for housing and communal service, transport, education and reduction of losses in the energy sector as fast as possible.

4. CONCLUSION

Socio-political stability in the country is one of the important prerequisites for conduction of macroeconomic policy in the medium-term.

Monetary policy in the medium-term will be directed at keeping of inflation within the single digits in the absence of shocks and at facilitating for implementation of Government's plans to restore macroeconomic stability.

Despite the fact, that in the medium-term the gradual reduction of the budget deficit is expected, nevertheless, the money supply will be conducted mainly by the public finance sector. In these conditions, special importance will have coordination of activity of the Government and the National Bank. In this case, coordination of measures of the monetary and fiscal policies will be conducted in an operating manner within the framework of the Interagency Coordinating Council.

Economic researches in the sphere of the monetary policy and macroeconomic modeling will be conducted to improve the possibility of the NBKR to achieve the objectives and intermediate targets of the monetary policy.

The NBKR plans to buy gold for the national currency on the domestic market in order to mitigate the impact of fluctuations of the US dollar rate on the external markets, risks diversification of deterioration of the NBKR's reserve assets value, accumulation of gold-value reserves,.

In the medium-term, international reserves will be maintained on the level of coverage within the 4 months of critical volume of import of goods and services, following the principles of liquidity and safety of reserve assets.

Active cooperation of the NBKR with international financial organizations (International Monetary Fund, World Bank, European Bank for Reconstruction and Development, Asian Development Bank, Islamic Development Bank and others) will be continued.

Implementation of the project on the Main book will give a possibility to integrate accounting, treasury and financial informational systems of the National bank to meet the ever-growing needs for the implementation of business operations in all areas. Completion of the project on the implementation of an automated trade system will let to automate transactions on the financial market, and also to reduce the risks and increase reliability of the transactions on the government securities market, exchange and monetary markets.

In the area of payment systems the NBKR will continue systematic work to develop the retail payment market in the republic, improvement of quality of the banking services. In the conditions of development and application of innovative forms of activities in the sphere of payments and settlements the National Bank will continue the work on improvement the legal regulation of the payment services market. Implementation of the State program to increase the share of non-cash payments and settlements in the Kyrgyz Republic for 2012-2017 will be continued.

The main objectives of the banking sector in the medium-term will be to maintain the integrity and stability of the banking system, which will be reflected in the increase of level of financial intermediation.

5. STATISTICAL APPLICATION

5.1. Individual indicators of the monetary market (fact)

SURVEY OF THE NBKR (in thousands of soms)						
	31.12.2010	30.09.2011	31.12.2011	29.09.2012	contribution to the growth of MB, %	
					30.09.2011	29.09.2012
NET FOREIGN ASSETS	65 126 684,0	69 305 554,6	71 419 514,2	79 617 017,0	8,6	15,0
NET INTERNATIONAL RESERVES	73 474 891,9	77 365 236,3	79 628 953,4	87 962 181,4	8,0	15,2
GOLD	5 500 433,0	6 091 097,8	6 139 818,4	7 922 791,5	1,2	3,3
FOREIGN CURRENCY (ASSETS)	75 315 745,3	76 800 268,0	78 980 660,4	84 701 994,5	3,1	10,4
FOREIGN CURRENCY (LIABILITIES)	-7 341 286,4	-5 526 129,5	-5 491 525,5	-4 662 604,6	3,7	1,5
NET DOMESTIC ASSETS	-16 529 383,4	-18 092 082,3	-16 616 288,3	-19 442 312,4	-3,2	-5,2
NET DOMESTIC CREDIT	-2 489 155,0	-6 694 068,6	-1 712 670,4	-3 413 956,7	-8,7	-3,1
NET CLAIMS ON GENERAL GOVERNMENT	-2 052 629,3	-4 718 687,6	-1 158 332,7	-729 792,0	-5,5	0,8
NET CLAIMS ON GOVERNMENT	-1 982 454,7	-4 648 545,4	-1 143 284,3	-729 792,0	-5,5	0,8
TOTAL GOVERNMENT DEPOSITS	-7 242 533,9	-9 273 440,8	-6 479 727,8	-5 623 112,6	-4,2	1,6
NET CLAIMS ON SPECIAL FUNDS	-70 174,6	-70 142,2	-15 048,4		0,0	0,0
NET CLAIMS ON ODC	86 758,4	-1 552 092,0	-398 016,8	-2 605 036,4	-3,4	-4,0
LOANS	342 657,9	323 461,6	1 664 836,5	1 333 262,3	0,0	-0,6
SECURITIES	-738 666,3	-1 650 549,7	-1 566 629,1	-2 273 960,2	-1,9	-1,3
Of which: Securities Issued by the NBKR	-667 860,2	-1 361 601,2	-1 359 218,7	-1 772 663,7	-1,4	-0,8
Securities under REPO-agreements	-70 806,1	-288 948,4	-207 410,4	-501 296,5	-0,4	-0,5
DEPOSITS	-207 236,5	-225 004,0	-496 224,2	-1 664 338,5	0,0	-2,1
Of which: DEPOSITS IN FOREIGN CURRENCY	-207 236,5	-225 004,0	-496 224,2	-1 664 338,5	0,0	-2,1
FINANCIAL DERIVATIVES	690 003,3				-1,4	0,0
NET CLAIMS ON OFC	-523 284,1	-423 289,0	-156 320,9	-79 128,3	0,2	0,1
CAPITAL ACCOUNTS and OTHER ITEMS (net)	-14 040 228,4	-11 398 013,8	-14 903 617,9	-16 028 355,7	5,4	-2,1
RESERVE MONEY	48 597 300,6	51 213 472,2	54 803 225,8	60 174 704,6	5,4	9,8
CURRENCY IN CIRCULATION	43 290 296,2	46 567 810,5	49 866 936,3	53 562 416,2		
RESERVES OF DEPOSITORY CORPORATIONS	5 307 004,4	4 645 661,8	4 936 289,5	6 612 288,4		

Kyrgyz Republic: Monetary Survey of Banking System (in thousands of soms)

contribution to the growth of M2X, %						
	31.12.2010	30.09.2011	31.12.2011	29.09.2012	30.09.2011	29.09.2012
Net Foreign Assets	71 424 835,8	76 686 449,1	77 213 850,7	87 426 802,6	7,6	12,8
Net International Reserves	79 773 043,7	84 746 130,8	85 423 289,8	95 771 967,1	7,2	13,0
Claims on Non-Residents	93 732 031,1	96 692 472,2	98 591 252,3	108 440 557,7	4,3	12,4
Liabilities on Non-Residents	-13 958 987,3	-11 946 341,4	-13 167 962,5	-12 668 590,6	2,9	0,6
Other Foreign Assets	134 261,3	153 598,5	135 027,0	141 712,3	0,0	0,0
SDR Allocation	-6 096 397,1	-5 959 958,9	-6 030 054,8	-6 152 625,0	0,2	-0,2
Long-term Foreign Liabilities	-2 386 072,1	-2 253 321,3	-2 314 411,4	-2 334 251,8	0,2	0,0
Net Domestic Assets	-2 217 108,8	-228 097,0	2 313 946,1	7 166 582,8	2,9	6,1
Net Claims on General Government	-4 195 406,1	-6 050 996,2	-3 028 729,6	-2 167 023,7	-2,7	1,1
Net Claims on Government	-3 039 215,5	-5 100 848,7	-1 333 681,3	-487 023,7	-3,0	1,1
Loan to Government in Foreign Currency	2 333 073,2	2 215 203,4	2 288 249,7	2 320 920,9	-0,2	0,0
Government Securities	6 835 858,7	6 998 849,5	7 618 894,0	8 163 671,2	0,2	0,7
Counterpart Funds	0,0	0,0	0,0	0,0	0,0	0,0
Government's Deposits	-12 208 147,4	-14 314 901,6	-11 240 825,0	-10 971 615,8	-3,0	0,3
of which: Social Fund's Accounts	-3 144 984,3	-2 905 212,1	-2 287 076,0	-2 282 133,9	0,3	0,0
Net Claims on Special Funds	-1 156 190,6	-950 147,5	-1 695 048,4	-1 680 000,0	0,3	0,0
Development Fund	-1 156 190,6	-950 147,5	-1 695 048,4	-1 680 000,0	0,3	0,0
Claims on Other Sectors	27 574 725,9	32 015 720,6	33 321 887,1	38 806 487,5	6,4	6,9
Domestic Currency Credits	12 975 625,2	15 765 720,3	15 811 790,7	18 167 114,3	4,0	3,0
Foreign Currency Credits	14 599 100,7	16 250 000,3	17 510 096,4	20 639 373,2	2,4	3,9
Other Items	2 654 614,3	-2 304 760,0	594 755,9	-147 089,5	-7,2	-0,9
Capital Accounts	-28 251 042,9	-23 888 061,4	-28 573 967,3	-29 325 791,6	6,3	-0,9
Broad Money	69 207 727,0	76 458 352,2	79 527 796,8	94 593 385,4	10,5	18,9
Money Outside Banks	41 471 151,7	44 235 966,0	47 219 565,7	50 577 178,7		
Deposits of Other Depository Corporations	27 736 575,3	32 222 386,1	32 308 231,1	44 016 206,7		
Transferable Deposits in National Currency	8 621 691,0	9 736 095,3	9 726 697,8	13 471 291,9		
Other Deposits in National Currency	3 652 585,9	4 708 578,4	5 179 063,6	7 055 006,0		
Deposits in Foreign Currency	15 462 298,4	17 777 712,4	17 402 469,7	23 489 908,8		