

National Bank of the Kyrgyz Republic

Inflation Report

2 (8)

August 2003

Bishkek

Inflation Report

Editorial Board:

Chairman: Abdumanapov E.
Board members: Tsiplakova L.
Abdybaly tegin S.
Isakova G.
Chokoev Z.

Editorial Assistant: Bushman Yu.

On the issues related to the contents of the publication, please, contact:

Bishkek, Umetaliev st., 101.
The National Bank of the Kyrgyz Republic
phone: (996 312) 669 059
fax: (996 312) 610 730
e-mail: ybushman@nbkr.kg

On the issues of dissemination of the publication, please, contact:

Bishkek, Umetaliev str, 101
The National Bank of the Kyrgyz Republic
External and Public Relation Division
phone: (996 312) 669 009
fax: (996 312) 610 730
e-mail: aaibalaeva@nbkr.kg
<http://www.nbkr.kg>

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

The last date of updating of the data in the given publication: July 31, 2003.

Founder: The National Bank of the Kyrgyz Republic.

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

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

720071, Bishkek, Chuy av., 265, rooms 352, 354, 355.

Phone: (996 312) 24-33-35
(996 312) 24-38-01

Fax: (996 312) 24-33-35

Circulation 350 copies.

© National Bank of the Kyrgyz Republic, 2003.

The present publication is not subject to copying and dissemination in any forms and by any means without the permission of the National Bank of the Kyrgyz Republic. When reprinting and translating extracts the reference to “Inflation Report” is compulsory.

Publications of the National Bank of the Kyrgyz Republic

Annual Report of the National Bank of the Kyrgyz Republic

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

Bulletin of the National Bank of the Kyrgyz Republic

“The Bulletin of the NBKR” contains macro-economic indicators of the Kyrgyz Republic on the real sector, financial sector, external sector, information on prices and social indicators. The unit of economic research and analysis of the Economic Department of the National Bank of the Kyrgyz Republic prepare it. Materials of structural subdivisions of the National Bank, as well as of commercial banks, the Ministry of Finance of the Kyrgyz Republic, the National Statistical Committee of the Kyrgyz Republic, the National Commission on Securities Market of the Kyrgyz Republic are used for the purpose of its preparation. It is registered with the Ministry of Justice of the Kyrgyz Republic as of December 27, 1995, registrations certificate № 205. The bulletin is published monthly in the Kyrgyz, Russian and English languages.

Balance of Payments of the Kyrgyz Republic

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

Statutory acts of the National bank of the Kyrgyz Republic

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

Tendencies of the banking system development

“Tendencies of the banking system development” contain the analysis of banking system in the Kyrgyz Republic as the financial intermediary from the point of view of achievement and maintenance stability in banking system. It is published as of January 1 and on July 1 in Kyrgyz, Russian and English languages.

Press release of the National Bank of the Kyrgyz Republic

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

On the issues related to dissemination of the publications of the National Bank of the Kyrgyz Republic, please, contact:

Bishkek, Umetalieva st., 101.
National Bank of the Kyrgyz Republic
External and Public Relation Division
phone: (996 312) 669 009
fax: (996 312) 610 730
<http://www.nbkr.kg>

CONTENTS

1. CURRENT DEVELOPMENTS OF INFLATION	5
2. CONSUMER PRICE INDEX AND ITS COMPONENTS	6
2.1. COMPONENTS OF CONSUMER PRICE INDEX	6
2.1.1. FOOD PRODUCTS	6
2.1.2. NON-FOOD PRODUCTS	7
2.1.3. SERVICES	7
2.2. CONSUMER PRICES BY REGIONS	8
3. INFLATION FACTORS	9
3.1. MONETARY AGGREGATES	9
3.1.1. MONETARY BASE	9
3.1.2. AGGREGATE M2	9
3.1.3. AGGREGATE M2X	9
3.2. INTEREST RATES	10
3.2.1. MONEY MARKET INTEREST RATES	10
3.2.2. STATE TREASURY BILLS	10
3.3. EXCHANGE RATE	11
3.4. DEMAND AND SUPPLY	11
3.4.1. NET EXPORTS	13
3.4.2. DOMESTIC DEMAND	13
3.4.2.1. PRIVATE CONSUMPTION	16
3.4.2.2. PUBLIC CONSUMPTION	16
3.4.2.3. INVESTMENT	16
3.4.3. OUTPUT	16
4. MAJOR DECISIONS OF THE NATIONAL BANK OF THE KYRGYZ REPUBLIC ON MONETARY POLICY ISSUES	17
4.1. MAJOR DECISIONS OF THE NATIONAL BANK BOARD OF THE KYRGYZ REPUBLIC	17
4.2. MAJOR DECISIONS OF THE MONETARY REGULATION COMMITTEE	17
4.3. INFLATION DURING THE SECOND QUARTER OF 2003 AND OUTLOOK FOR THE THIRD QUARTER OF 2003	18

1. CURRENT DEVELOPMENTS OF INFLATION

In the first half-year 2003, gross domestic product gained 2.3% in relation to the first half-year of the previous year. In industry, the value added grew by 2.5%. Without taking into account gold-mine enterprise " Kumtor " its value added increased by 14%. The major contributors were food processing and electric power industries. Output in agriculture reduced by 3.4%.

In the second quarter 2003, on the preliminary data there was negative trade balance due to insignificant contraction of exports served basically in the non-CIS countries and some increase in imports. The biggest growth in import share is registered for intermediate and mineral oil products. Consumer goods dominated in import structure.

The tendency of som to strengthen against US dollar still continued. From the beginning of the current year the dollar value decreased by 10.7%. Dollar exchange rate decreased by 9.7% during the second quarter of 2003. Som strengthening occurred as a result of foreign currency inflow, instability in the international financial market and some deficiency of liquidity at banks. The som real effective rate or purchasing power of the national currency did not undergo significant changes. The countries, basic trade partners of Kyrgyzstan, still demonstrated higher growth rates in consumption prices.

Demand for the national currency was steady. Monetary aggregates continued to grow, though a little bit more slowly, than previously. Net purchase of foreign currency by the National bank totalled 9.8 million US dollars.

Yield of instruments of the monetary and the state T-bill markets increased a little. That increase is connected to temporary contraction of liquidity in the banking system. All auctions under notes of the National bank were recognised not taken place as for their carrying out the number of participants was insufficient.

Inflation for the second quarter of 2003 made half of per cent. Some acceleration of consumer prices growth in April - May has been caused by that stocks of vegetables of crop of the last year came to an end, and the new crop was late because of bad weather. The prices for non-food products and services decreased due to reduction in excise rates on oil products and strengthening of the national currency. Development in monetary aggregates and inflation confirms non-monetary character of consumer prices growth.

Inflation for the second quarter of 2003 developed much below, than it was expected. A major reason that forecast deviated from the fact was sharp decline of prices on food products in June. The seasonal factor is subject to the big fluctuations that make its prediction to be hard job. However as a whole inflation remains in margins stipulated in the statement of the National bank for 2003. It is expected that in the third quarter of 2003 the level of consumer prices decrease concerning the second quarter by 1.3-1.5%.

2. CONSUMER PRICE INDEX AND ITS COMPONENTS

Chart 1: CPI and its components, percentage changes on a year earlier

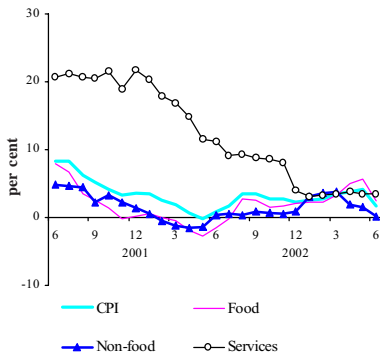
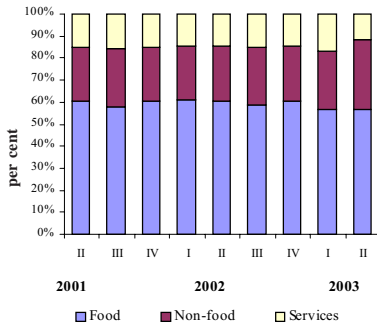


Chart 2: Structure of CPI, per cent



Food products occupy the biggest share in the consumer's basket. Accordingly, fluctuation of the prices on the food products in many respects determines developments of inflation. The foodstuff prices are subject to strong influence on the part of the seasonal factor. In the current year, seasonal upward movement of the food prices was amplified by the relatively poor harvest of fruits and vegetables in 2002 as well the delay of carrying out of sowing works by 15-20 days in 2003 because of adverse weather conditions. So, in April - May, prices accelerated under influence of seasonality and lagging crop of the current year. In June, new crop, which appeared at the market, led to reduction in food prices and to slowdown of growth rate of consumer prices.

The non-food prices and services within the second quarter of the current year decreased. Strengthening of the national currency was one of the factors for non-food prices to fall.

According to the data of the National Statistics Committee for the second quarter of 2003 inflation made 0.5% whereas for the corresponding period of the last year the growth rate of consumer prices achieved 2.2 %.

2.1. COMPONENTS OF CONSUMER PRICE INDEX

2.1.1. FOOD PRODUCTS

Food prices grew by 1.7%. The major source of food inflation was acceleration in fruit-and-vegetable prices. In 2002, decrease in fruit-and-vegetable crop was 3.5%. It caused decline in stocks and supply of fruit and vegetables in the second quarter of 2003 therefore the prices for them jump up by 14.9%. Prices for meat

Chart 3a: Food Prices, percentage changes on a year earlier

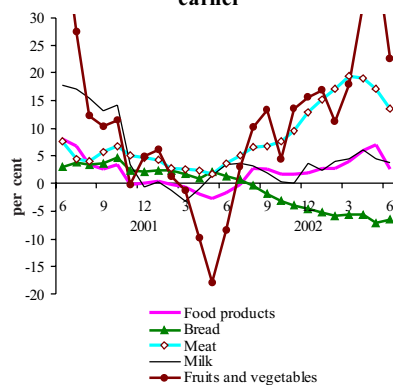
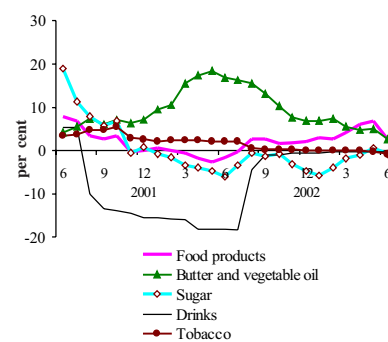


Chart 3b: Food Prices, percentage changes on a year earlier



and meat products increased by 2.1%. Sugar and confectionery products became more expensive by 1.9%. Dairy products, cheese and eggs became cheaper by 7.7%.

2.1.2. NON-FOOD PRODUCTS

The price index on non-food products in the second quarter of 2003 decreased by 1.2%. Decline in excise rates on oil products, som strengthening and increase in imports for some products influenced its developments. The gasoline prices decreased by 11%, while gas and other kinds of fuel, pharmaceutical production became cheaper by 1.1 and 0.8 %, respectively.

Chart 4a: Non-food Prices, percentage changes on a year earlier

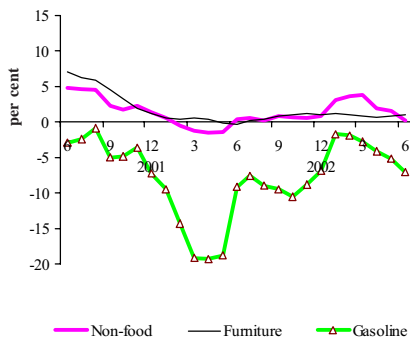
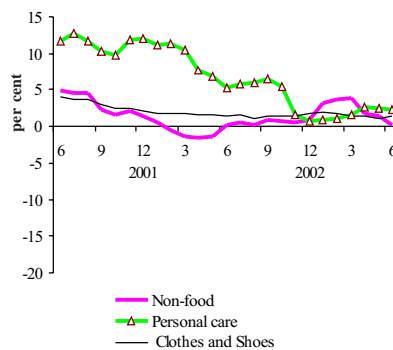


Chart 4b: Non-food Prices, percentage changes on a year earlier



2.1.3. SERVICES

The price index on services decreased by 0.1%. Reduction of prices by 2.9% took place on communication services as a result of som strengthening against US dollar. Hotel service prices declined by 1.2%.

Chart 5a: Services, percentage changes on a year earlier

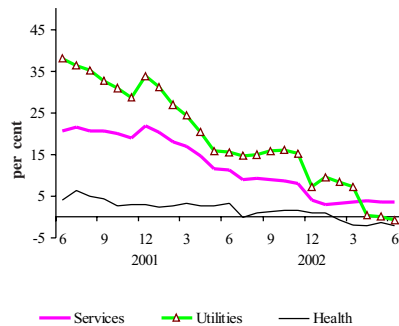
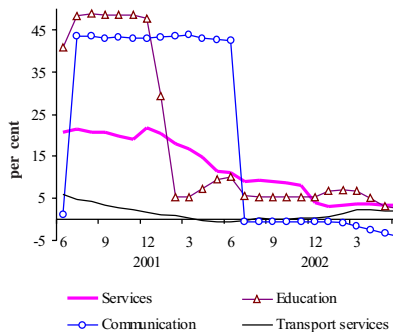


Chart 5a: Services, percentage changes on a year earlier



2.2. CONSUMER PRICES BY REGIONS

In the majority of regions, in the second quarter of 2003 consumer prices grew faster, than inflation. So in Batken, Naryn and Talas

oblasts consumer prices growth exceeded 2.5%. The Osh oblast was the unique region of republic in which consumer prices fall by 1.2%. The biggest weight for inflation falls at the Bishkek. The growth rate of consumer prices in Bishkek almost meet the republican level and made 0.4%.

Chart 6a: CPI by Oblasts, percentage changes on a year earlier

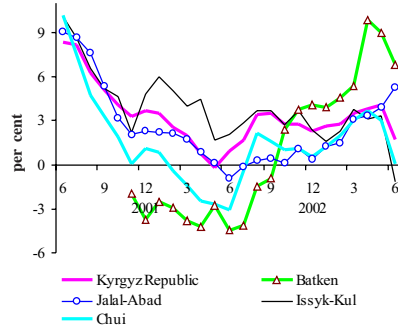
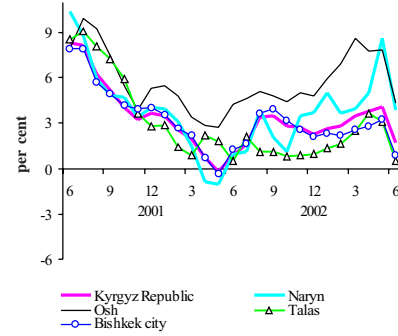


Chart 6b: CPI by Oblasts, percentage changes on a year earlier



3. INFLATION FACTORS

3.1. MONETARY AGGREGATES

In the second quarter of 2003, monetary aggregates were growing. The money supply growth was rendered by foreign exchange interventions of the National bank and budgetary operations. There was decline in banking system deposits. Basically outflow in foreign currency deposits occurred, reflecting negative expectations of investors concerning US dollar exchange rate against som.

3.1.1. MONETARY BASE¹

The monetary base for the second quarter increased by 7.1%. The year-on-year growth rate of the monetary base totalled 36.7%. Money in circulation increased by 8.8%. The monetary base grew due to operations of the National bank and the budget. The biggest growth was marked in April due to plenty of budget expenditures. As of July 1, 2003 gross reserves of the National bank cover 161% of monetary base.

In structure of monetary base, the share of cash in circulation achieved 96% at the end of June, 2003. Accordingly, the share of funds on correspondent accounts of commercial banks in the National bank made 4%.

3.1.2. AGGREGATE M2

Monetary aggregate M2 increased for the second quarter by 6.9%. M2 in year-on-year terms grew by 35.3%. There was reduction of deposits in the national currency by 1.9%, thus the stocks of funds on settlement accounts of legal persons reduced by 3.2%, and time deposits decreased by 0.3%.

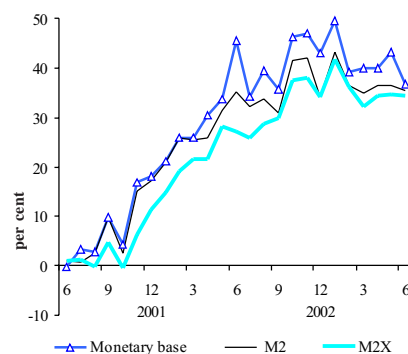
3.1.3. AGGREGATE M2X

The M2X for the second quarter under the current exchange rate increased by 3.6%. Growth of cash outside of banks was accompanied by outflow of deposits from commercial banks by 5.1%. Deposits in foreign currency at the current exchange rate decreased by 7% that is in part caused by strengthening of the national currency against US dollar.

In structure of the M2X (broad money), there were following changes:

- the share of cash outside of banks increased by 1.8 percentage points and made 64.2%;

Chart 7: Monetary aggregates, percentage changes on a year earlier



¹ Without taking into consideration the commercial banks deposits in a foreign currency

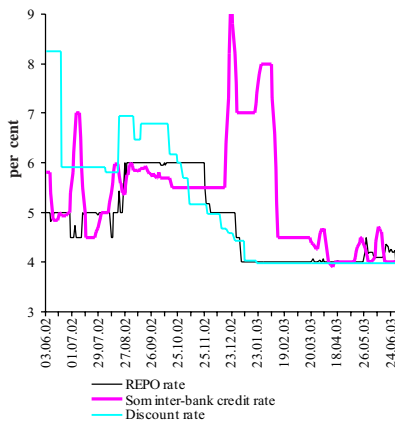
- the share of deposits in the national currency reduced by 0.9 percentage points and achieved 12.5%.

3.2. INTEREST RATES

3.2.1. MONEY MARKET INTEREST RATES

The majority of transactions in the inter-bank credit market from April till last decade of May were conducted under the interest rate of 4%. Acceleration in consumer prices growth rate in May as well temporary reduction in banking system liquidity in June caused certain growth in interest rates. Cost of credit in som on REPO operations increased from 4% by the beginning of the second quarter up to 4.2% for its end, and under credits - from 4 up to 4.4%. Interest rates of the inter-bank credit market in foreign currency fluctuated within a quarter from 4 up to 11% depending on terms and available collateral of the transaction.

Chart 8: Discount rate of the NBKR, inter-bank credit and REPO interest rates, per cent



All auctions on accommodation of notes of the National bank have been recognised not taken place in connection with insufficient amount of participants. Primary dealers did not participate because its yield appreciably conceded yields of instruments at other segments of the financial market. So, discount rate remained constant at the level 3.99% within all second quarter.

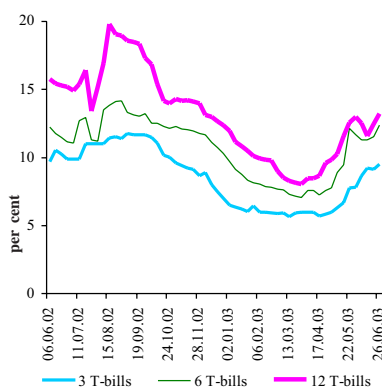
3.2.2. STATE TREASURY BILLS

Demand for state T-bills on the part of commercial banks contracted due to reduction in banking system liquidity. So, average demands on the state T-bills for one auction declined by 25% compared with the first quarter of 2003.

Weak demand and more pronounced inflation in April - May cause gradual growth in T-bill yields. Also, the Ministry of Finance changed in the T-bills sale structure that promoted growth in yields. In the second quarter, issue of the T-bill with 6- and 12 month maturity, which yield is higher than three-month T-bills yield, was increased.

For the first half-year yield on three month T-bills increased from 7% by the beginning of one year up to 9.5% for the end of the first half-year, on six-monthly T-bills - from 10.3 up to 12.4%, and on twelve-month T-bills - from 12.4 up to 13.2%. The weighted average interest rate increased from about 9.9% by the beginning of year up to 12.8% by the end of June.

Chart 9: T-bill yields



3.3. EXCHANGE RATE

In April - May, the national currency has strengthened against US dollar in the foreign exchange market. Dollar was promptly declining due to excess foreign currency supply at the market during the first week of April and at the middle of May.

From the middle of June strengthening of the national currency stopped due situation at the world financial markets have changed and foreign currency stocks in banks have decreased. During this period the National bank carried out sales of the US dollars. For the second quarter the US dollar against som became weaker by 9.7%, while for the first half-year it depreciated by 10.7%. For the corresponding period of the previous year dollar weakened by 3.8 and 3.3%, respectively.

The total amount of operations at the inter-bank foreign exchange market totalled 26 million dollars in the second quarter or 49% more in comparison with the corresponding period of the previous year. Thus transactions between commercial banks occupies 53% out of total. In the first half-year, the stocks of Euro in commercial banks and exchange bureaux grew by more, than three times in comparison with the beginning of 2003. Euro exchange rate, especially in the second quarter, has been subject to the significant fluctuations connected to changing preferences of investors in the global and domestic markets. For the second quarter the official exchange rate of euro reduced by 3.9%. The exchange rate of euro in exchange bureaux decreased by 2.1%.

The som nominal effective rate became stronger by 5.5% during the second quarter of 2003. From the beginning of the current year the som nominal effective rate strengthened by 6.5%. An explanation is (1) weakening of US dollar against the basic currencies in the international financial market; (2) seasonal reduction in demand for foreign currency in domestic market; (3) inflow of foreign currency. The som real effective rate became stronger during the first half-year by 4.4%. Som strengthening in real terms made 4.6% during the second quarter of 2003. Stability of som real effective rate is characterised by the fact that som purchasing power increased only by 3.2% from the beginning of 1997 till the end of the first half-year 2003. Purchasing power of som, excluding sharp fluctuations of real effective rate during financial instability of 1998-1999, fluctuated within following margins: low bound reached 8% (decrease) and high bound achieved one per cent (increase) around mean². So purchasing power of the national currency is returning to pre-crisis conditions. Real effective exchange rate keeps stability and does not render negative influence on competitiveness of economy.

² Purchasing power fluctuated in a range from 15 per cent (decrease) up to 22 per cent (increase) around mean including instability period.

Chart 10: Cumulative change in exchange rate (Som per US dollar)

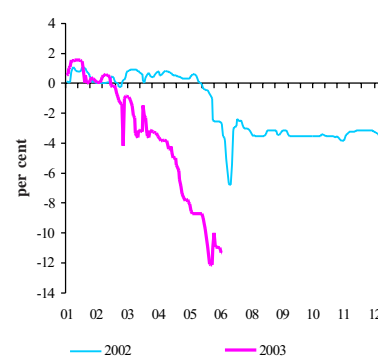
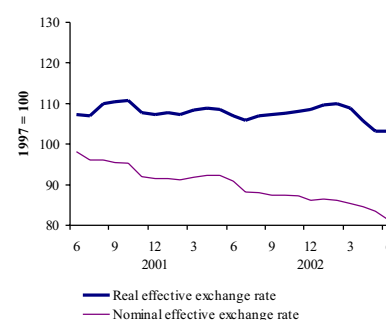


Chart 11: Som effective exchange rate indices



3.4. DEMAND AND SUPPLY

In the second quarter, inflation and the exchange rate returned to normal path: some strengthening was corresponded with decrease in inflation. It is necessary to note that stable demand for the national currency is kept. Exchange rate and inflation acts as the basic indicators of money demand. The exchange rate characterises external balance of economy or balance in the foreign exchange market. Inflation reflects domestic balance or balance in commodity market. Strengthening of the national currency and low inflation testify to prevalence of non-monetary factors of inflation. In previous years, tariffs for municipal services, first of all the electric power brought the major contribution in inflation. In 2003, seasonal factor determined by a leakage in foodstuffs supply played crucial role, while tariffs for electricity have not been changed.

Non-monetary character of inflation and steady demand for the national currency allow to draw a conclusion that aggregate demand to some extent is restrained by the level of wages. The wages in republic are at low level among the countries CIS. The current level of monthly average wages in republic makes about 34-35 US dollars. For comparison at CIS leaders, Kazakhstan and Russia, the given parameter totalled 130-140 US dollars. So, some increase in wages in budgetary sphere under current conditions does not threaten inflation. Other fear connected to deterioration of price competitiveness of exports has no grounds also. Production prices of Kyrgyzstan has the significant competition reserves in labour unit cost in comparison with the trading partners even in conditions of existence of trading barriers.

The unaccomplished structural reforms especially in housing and communal services are preventing aggregate demand to grow. On the one hand, producers of electric power are subsidising the rest of economy. According to experts quasi-fiscal deficiency of electric power industry exceeds 10% of gross domestic product. On the other hand, the high level of technical losses and non-payments are kept. The vicious circle turns out, when low wages are consequence of administrative price control. At the same time, administrative price control is preserving in order to meet social stability. The true as always is in the middle.

It is obvious, that simple increase of tariffs does not solve that problem. For this reason there is necessity to carry out deep structural reforms. Tariffs should inevitably cover costs, but expansions in market sector to rise incomes are crucial too. Thus, structural reforms should affect both parties - the aggregate supply and aggregate demand. Non-inflationary expansion in aggregate supply and demand is one of reserves to achieve steady economic growth.

3.4.1. NET EXPORTS

The trade balance of the Kyrgyz Republic, on the preliminary data, in the second quarter developed negative at the rate of 34.5 million US dollars. On the corresponding period of 2002 its value developed positive at the rate of 0.6 million US dollars. The foreign trade turnover amounted 279.1 million US dollars or by 11.9% more in comparison with the second quarter of 2002. Trade with the CIS countries increased by 25.1%, and with the non-CIS countries - by 2.2%.

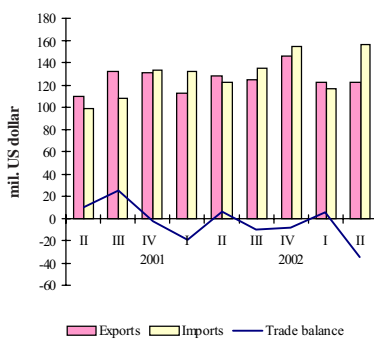
Exports of goods in F.O.B. prices reduced in comparison with a corresponding period of the previous year by 2.1%. Exports in the CIS countries increased by 9.6%, while in the non-CIS countries it decreased by 7%. Exports of gold grew insignificantly from 45.8 up to 46.4 million US dollars. Exports excluding gold reduced by 4.1% that is caused by falling exports of raw materials.

There was growth on all functional groups, except raw materials, in the functional structure of exports. There was an increase in exports of garments, sports stock, milk and dairy product that caused growth of exports of consumer goods by 33.5%. Exports of oil products grew by 30.8% that is caused by satisfaction of requirements on aviation kerosene for military base of coalition. The increase in exports of intermediate products by 12.5% is connected to increase in exports of gold, silver, non-ferrous metals and construction products like glass, slate and cement.

According to geographic distribution in export of goods the non-CIS countries continue to prevail, whose share occupies 66.9%. The biggest exports besides United Arab Emirates where gold is exported fell to Canada, Switzerland and China. The basic export partners among the CIS countries are Russia, Kazakhstan, and Uzbekistan. Exports of goods to Tadjikistan increased more than two times basically due to increase in deliveries of the electric power. Export deliveries to Kazakhstan grew by 33% owing to expanding in exports of construction products (cement, slate and glass), dairy product and ice cream.

Imports of products in F.O.B. prices on the preliminary data grew by 26%. The import growth took place from the CIS countries as well non-CIS countries by 33.4 and 16.9%, respectively. In absolute terms biggest amount of imports fall to consumer goods. Growth in all functional groups of imports took place, except raw materials. The highest rates of growth revealed by intermediate and oil products. Imports of intermediate products increased more than twice and totalled 59 million US dollars. Imports of hire of ferrous metals, trunks for lorries, nitric fertilisers, paint and varnish production increased. In geographic distribution, the CIS countries occupy 54.7% out of

Chart 12: Trade balance



imports. Russia and Kazakhstan hold the biggest share. Imports from Russia grew by 50.8% due to increase in deliveries of automobile gasoline, aviation kerosene, paint and varnish production, chocolate products and saw-timbers. Imports from Kazakhstan increased by 56.2% due to growing deliveries of sugar, cigarettes, vegetable oil, hire of ferrous metals and beer. Among the non-CIS countries the basic suppliers of products, as before, were China, the USA, Germany and Turkey.

3.4.2. DOMESTIC DEMAND

Domestic demand has heterogeneous character. There is significant difference between incomes of various categories of the population. As is known, categories of the population with low incomes use practically all income and do not save anything. The significant part of the population has the limited opportunities to consume within narrow set of products. As is known from the economic theory, consumption can cause effect of multiplication. It means that consumption being increased by one unit of money results in effective demand amplified by several times. In other words, if you spent one som to purchase any product, aggregate demand will be increased by more, than one som.

The mechanism of multiplication is closely linked to investment activity. To satisfy growing aggregate demand, investments are required. More investments in turn promote multiplication of aggregate demand that lead to expansion of output and finally income, which is a result of the previous investments. Multiplication occurs unless output and demand achieve an equilibrium level.

The multiplication is supplemented with acceleration. As far aggregate demand and output is growing, income is expanding too. The greater income is the more additional consumption is, that is acceleration supplements and strengthens multiplication.

Given description led to some conclusions. First, if autonomous consumption, is low, the multiplication is absent. Second, if imports occupy significant share in consumption structure, the multiplication is essentially small. Third, if for any reasons savings of the population are not transformed into investments, the multiplication is absent also. Fourth, goods being produced should be sell, otherwise resources used in production are lost irrevocably.

Hence, in order multiplier - accelerator mechanisms start to work some conditions are necessary. First, increase in autonomous consumption level or poverty decline is required. As the poor

population prevails, the biggest effect can give stimulation of the population with low-income demand. Second, development of the domestic production supported with demand promotes multiplication. It is obvious, that stimulation of demand for domestic products is impossible to achieve by administrative measures. If demand exists, but domestic products do not satisfy preferences of population, the only result will be an escalating of imports. It means, that stimulation of demand should be supported with structural reforms, which promote development of market sector of economy. Third, the reliable and advanced financial market is necessary.

Savings are not used in full, if investments are insufficient, so resources are simply removed partly from circulation. Abundant savings over investments means insufficient aggregate demand and as consequence lower income, than potential.

The rate of unemployment in republic by estimation of some experts is about 20% out of labour force. The reasons for such high rate of unemployment are deficiency of the capital, productive and financial, and insufficient development of the financial market. The low financial intermediary limits transformation of savings into investment.

It is worth to note, that the most part of investments went to the industry whereas in an agriculture it was put much less funds. However the agriculture continues, excluding the current year, to be major contributor into growth of gross domestic product. This means, that industry remains to be low productivity sector.

The public investment program, foreign direct and portfolio investments and investments out of domestic funds of population and enterprises are three major sources of investments now. Resources of public investment program are basically used on development and maintenance of an economic and social infrastructure. The rest two sources of investments directed to production of goods and services.

The conclusion is that it is desirable to stimulate consumption of low-income population and to apply savings efficiently as more as possible.

3.4.2.1. PRIVATE CONSUMPTION

On the preliminary data of the National Statistics Committee incomes of the population for the first half-year grew by 6.3% in comparison with the corresponding period of 2002. Thus the real disposable income grew by 2.7%. A monetary outlay of the population increased by 7.4%. Retail trade grew by 10.1%.

3.4.2.2. PUBLIC CONSUMPTION

Revenues of the state budget grew by 15.2% in comparison with the first half-year of 2002. Expenditures of the state budget increased by 7%. Wage expenditures grew by 2.8%. Subsidies to the state enterprises, both capital investments and repair underwent out of means of the budget were significantly reduced. Subsidies to the state enterprises decreased almost by 21%. On capital investments and repair it has been directed by 0.9% means less, than for the corresponding period of 2002.

3.4.2.3. INVESTMENTS

According to the preliminary information of the National Statistics Committee capital investments for the first half-year reduced by 6.4% in real terms relative to the corresponding period of 2002. The major sources to finance investments are funds of the enterprises, population and external resources.

3.4.3. OUTPUT

The gross domestic product for the first half-year increased by 2.3%. In agriculture, there was decline by 3.4%. Industry gained 2.5%. Without taking into account manufacture gold-mine enterprise "Kumtor" industry grew by 14%. Revival in manufacture is connected to the food-processing and electric power industries. According to the National Statistics Committee in first half-year of 2003 is registered 16.3 thousands new of businesses. There are 62.6% out of new businesses in agriculture. The share of trade makes 15.9%, services and manufacturing industry occupies 6.2 and 4.2%, respectively.

4. MAJOR DECISIONS OF THE NATIONAL BANK OF THE KYRGYZ REPUBLIC ON MONETARY POLICY ISSUES

4.1. MAJOR DECISIONS OF THE NATIONAL BANK BOARD OF THE KYRGYZ REPUBLIC

The board of the National bank in the second quarter accepted the resolution " About the exchange rate of dollar used for calculation of obligatory reserve requirements " №16/3 as of May 27, 2003. Exchange rate, effective from June 2 till September 28, 2003, is established at 41.4 soms per US dollar for calculation of required reserve level.

4.2. MAJOR DECISIONS OF THE MONETARY REGULATION COMMITTEE

The monetary regulation committee carries out decision-making on operational level. The committee based decisions on assessment of financial markets on weekly basis. Operations take into account developments in the banking system, budget, and aimed to meet monetary policy target established within the framework of social-economic programs and directions of monetary policy for 2003.

In the second quarter of 2003, decrease in banking system liquidity, in particular in April, was marked. The National bank increased refinancing of commercial banks. So, "overnight" credit totalled 1192,4 million soms or by 41% more in comparison with the first quarter. Reduction in banking system liquidity caused contraction in REPO operations with commercial banks. Their volume decreased in comparison with the previous quarter from 309.3 up to 20 million soms.

Interventions of the National bank occupy 47% out of total amount of operations in the foreign exchange market. The National bank carried out SWAP operations with foreign currency by amount of 850 thousand US dollars that by 85% more than, in the first quarter. Net purchase of foreign currency in the second quarter of the current year totalled 9.8 million US dollars.

4.3. INFLATION DURING THE SECOND QUARTER OF 2003 AND OUTLOOK FOR THE THIRD QUARTER OF 2003

Slump in economy achieved the lowest point in 1995. Since 1996 growth, which was slowed down after crisis 1998 restored. Structural reforms resulted in private sector of economy start to exist, so

recession halted. Initially those developments took place in services, and later processes of private sector formation spilled over agriculture. It is connected to land and agrarian reforms. Investments were additional reason why recession finished and output started to rise. Investments promoted formation of the new productive capital, which is connected to new technologies. Basically they had the form of direct and portfolio foreign investments. Investments within the framework of the public investment program were aimed to maintain and to develop industrial and social infrastructure, to improve quality of the government services. Simultaneously, private sector accumulated capital from domestic sources. Private sector and investment in combination with contracted employment led to productivity growth.

Productivity is increasing though from a low level especially in agriculture basically from the farmers' side. In 2003, there was contraction in agriculture in connection with adverse weather conditions, nevertheless, the industry and services have compensated it.

The essential contribution to growth in gross domestic product brings gold-mine enterprise "Kumtor". In 2002, slump in Kumtor's production led to curtailment of gross domestic product. Nevertheless, it is possible to note that for the period since 1999, except for 2000, rate of growth of gross domestic product without taking into account the added value of gold exceeded the general growth rate. It is worth to note development in services, in particular, trade though the services is hardly covered by statistics due to small turnover and large number of the physical persons rendering them.

Demand for the national currency proves to be steady as far expansion of trading and industrial activity exists. That is why new products are occurring at the market and monetary transactions spread across economy. So, as an example it is possible to note the formation of land market. Development of micro credit and micro finance promotes expansion of aggregate demand also. People, who are involved in commodity production, receive some income that can be used on consumption.

Aggregate demand is determined by two different groups of consumers. Consumption of majority barely increased. Imports start to grow especially consumer goods. Probably, demand of consumers with higher incomes was strengthening to some extent. Now it does not represent any threat, but there is need to stimulate production and consumption of domestic goods by market methods. The distribution of micro credits by kinds of activity is worth to examine. The biggest share has been credited in trade. There is nothing bad as the given tendency reflects the remonetization of economy. Development of

trade testifies that monetary transactions and market economy to expand.

Strong som against US dollar manifested that demand for the national currency to strengthen and economic situation to improve. Som nominal appreciation is due to foreign currency inflow and relative deficiency of the national currency. Generally speaking, the stronger national currency corresponds with healthier economy.

Nominal appreciation of the national currency is compensated by higher inflation in countries, basic trade partners. The som real effective rate remained stable enough though and it appreciate a little in the second quarter. Low elasticity of Kyrgyz exports against real effective som explains why exports practically did not sensible to it. Imports on some commodity groups are more sensitive to changes in purchasing power of the national currency. First of all, it concerns to consumer goods. In fact, imports of consumer goods start to increase.

The money supply continued to increase, though more slowly, than earlier. Cash in circulation growth resulted because budget expenditures were outstripping revenues as well the National bank intervened on foreign exchange market. In the second quarter, there was some growth in credits in the national and foreign currencies. Thus in June credit growth rates in the national currency, considerably exceeded credit growth rates in foreign currency. It is worth to note, growth in the consumer credit, in particular, on purchase and construction of housing. Construction of dwellings is one of powerful instruments to develop economy.

Instability in the foreign exchange market expressed by constant and fast enough reduction in dollar exchange rate caused certain outflow of deposits in foreign currency. Apparently, investors were afraid of the further easing of dollar. Nevertheless, the dollar still keeps position as means of savings.

In the second quarter of 2003, consumer prices growth slowed down. It is caused by the delivery of the new crop at the market. The non-food prices and services in many respects were determined by developments in the exchange rate. As it was supposed in the previous *Inflation Report*, surge in inflation in the first quarter has short-term seasonal nature. The macroeconomic situation continues to remain stable, there are no preconditions for sharp fluctuations.

The analysis of quarterly forecasts of the National bank and actual values of inflation shows, that, as a rule, the forecast exceeds the fact. It can be connected to the certain degree with overvaluation of negative and underestimation of positive factors. It means,

overvaluation of inflationary expectations. Really, in the past any acceleration in inflation immediately transformed into steady inflationary expectations. Now robustness of economy against negative shocks increased to some extent, so inflationary expectations stabilised at lower level. Short-term surge in inflation at the end of the first and the beginning of the second quarter of the current year did not accelerate expectations.

Number of factors affects inflation. As it was marked above, in economy there were positive changes: the private sector of economy emerges, productivity start to rise. The increase in productivity due to investment inflow, introduction of new technologies and contraction in employment was underestimated by the National bank.

Productivity growth other things being equal bring about decrease in price level. In the first years of transformation, inflation was restrained basically due to applying of nominal anchor and contraction of aggregate demand, while currently expansion in aggregate supply makes possible to increase aggregate demand. In other words, higher productivity allows increasing wages without pains.

The major risks of inflation forecast are seasonal factor depth and developments in external trade. Consumer prices are expected to decrease by 1.3-1.5% during the third quarter.