

National Bank of the Kyrgyz Republic

Inflation Report

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Inflation Report

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

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Annual Report of the National Bank of the Kyrgyz Republic

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

Bulletin of the National Bank of the Kyrgyz Republic

“The Bulletin of the NBKR” contains macro-economic indicators of the Kyrgyz Republic on the real sector, financial sector, external sector, information on prices and social indicators. The 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.

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“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.

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.

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1. CURRENT DEVELOPMENTS OF INFLATION

Reduction in gross domestic product, which began in the first quarter 2002, still kept, though its rate have decreased by the end of year on the preliminary data of the National Statistics Committee up to 0.5 %. Slowdown is basically caused by decrease in output of industry due to bad performance in non-ferrous metallurgy and electric power industry. It is necessary to note that the gross domestic product excluding gold production increased by 3.1 %. The agriculture restored positive growth after reduction marked in the beginning of year. In 2002, the value added of agriculture increased by 3.3 %.

There was registered negative trade balance in the fourth quarter as a well for 2002. Exports increased in comparison with 2001, while imports grew even faster in absolute terms. Exports lost significantly as a result of accident at goldmine enterprise and slowdown in production of electric power. Imports partly increased due to acceleration in financing under the public investment program.

From the beginning of 2002 dollar decreased against som by 3.4 %. During 2002 som nominal effective rate was strengthening. The som real effective rate fluctuated in a narrow range, while purchasing power of the national currency remained roughly stable. Operations in European currency - euro - gradually grew, but their volumes were rather small in comparison with operations with US dollar. Demand for euro may increase if economic relations with the countries of the European Union expand or euro become attractive as an alternative means for savings.

During 2002 monetary aggregates grew with accelerating from quarter to quarter growth rates. Expansion in money supply is caused by operations of the Ministry of Finance and interventions of the National bank in the foreign exchange market. Net purchase in foreign exchange in the fourth quarter made 11.6 million US dollars compared to 4.2 million US dollars in the fourth quarter 2001. Net purchase of foreign exchange by the National bank reached 24.5 million US dollars in 2002 compared to 9.3 million US dollars in 2001. There was some increase in monetization in 2002, while during the period of some years it stays almost unchanged. However, the fact that inflation and monetary aggregates are moving in opposite directions since the end of 2001 manifested that monetary factor in inflation become insignificant.

There were decline in interest rates of money market and yield in the market of the state T-bills during the fourth quarter as well as whole year. Its development was caused by high level of liquidity and favourable macroeconomic situation. At the same time, financial

market depth still small. A number of auctions under notes of the National bank have not taken place owing to insufficient amount of participants.

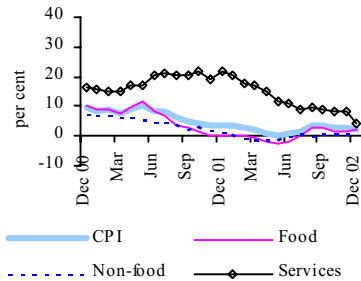
Inflation for the fourth quarter 2002 made one per cent. For a year consumer prices grew by 2.3% that is the lowest rate from the moment of introduction of the national currency. The low inflation in the fourth quarter is explained by that there was no increase of tariffs for utilities, which took place in previous years. The seasonal factor was less pronounced in comparison with previous years. The behaviour of seasonality is connected to specifics of given year or it is possible that seasonality profile is changing. More smoothed pattern of seasonality makes development of inflation to some extent more predictable. It can be connected to reduction in inflationary expectations, that restrains a rise in prices during the winter-spring period when agricultural production of the previous year are consumed.

For 2003 the outlook of inflation makes 4 -5 %. The uncertainty connected to development of economic situation, development of prices for gold and mineral oil, speed in expansion of market economy and money demand, gross domestic product growth and changes in taxation are risk factors of the forecast.

Developments of inflation for 2000-2002 shows the steady tendency of consumer prices to slow down, so there is a question whether deflation is possible or not. The analysis of inflation in the republic shows that the major source of consumer prices growth is administratively regulated prices. In 2003, there is possibility that taxation will be changed, which could affect consumer prices. Inflationary expectations still continue to play an essential role, however, their contribution is decreasing little by little. The tendency of demand for the national currency to strengthen promotes domestic demand. On balance, the National bank did not tightened effective demand. Although, actual inflation in 2001-2002 was less, than it was expected, but balance of risks is skewed towards higher inflation in comparison with 2002. That is why inflation outlook for 2003 is higher, than actual inflation of 2002. Consumer prices are expected to grow by 2.5-2.8 % in the first quarter of 2003.

2. CONSUMER PRICE INDEX AND ITS COMPONENTS

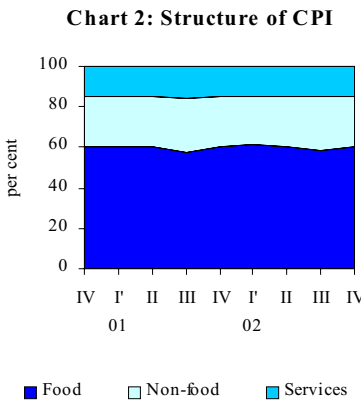
Chart 1: CPI and its components, percentage changes on a year earlier



In the fourth quarter 2002, consumer prices growth was unusually small for this period of year. The seasonal factor and increase in tariffs for services of housing and communal services were major reasons in previous years why consumer prices rose in the fourth quarter. However, there were not any movements in tariffs in 2002, so it was the reason why consumer prices grew insignificantly. According to the National Statistics Committee consumer prices rose by one per cent. Food inflation made 1.2 %, prices for non-food products increased by 0.9 %, and services became more expensive by 0.3 %. For comparison, in 2001, inflation totalled 2.2 % for the corresponding period.

2.1. COMPONENTS OF CONSUMER PRICE INDEX

2.1.1. FOOD PRODUCTS



The prices for foodstuffs grew because of seasonal rise in prices on fruit-and-vegetable and dairy products. Fruit and vegetables became more expensive by 24.4%. Dairy product and eggs, meat products rose by 13.3 and 5.2 %, respectively. Reduction in prices on bread and bakery, which occupies the major share among food stuffs, by 2.7 % made essential contribution in food inflation and total inflation to slow down. Prices on bread fell due to high yield of grain cultures. Also, prices in sugar, coffee, tea, and confectionery products reduced by 7 % as a result of growth in sugar production.

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

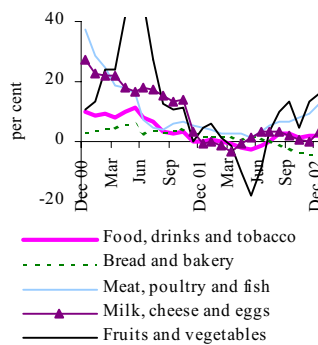
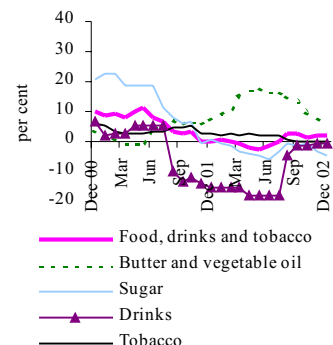


Chart 3b: Food Prices, percentage changes on a year earlier



2.1.2. NON-FOOD PRODUCTS

Developments of non-food prices characterised by more or less stability, as there were no sharp fluctuations in some exchange rate. It is worth to note growth in some kinds of fuel prices by 2.1 %, as a result of seasonal increase in demand.

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

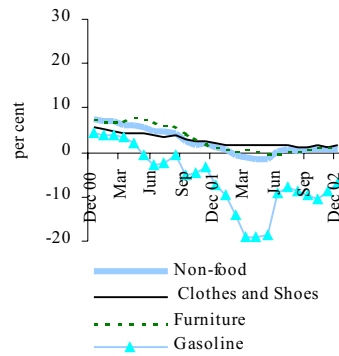
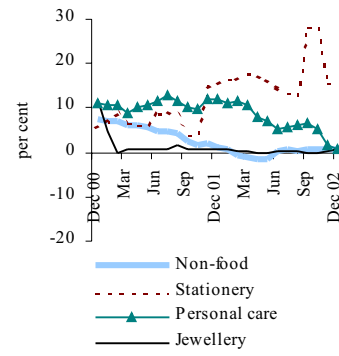


Chart 4b: Non-food Prices, percentage changes on a year earlier



2.1.3. SERVICES

Price policy of natural monopolists is the main contributor for service prices. In the fourth quarter, there were no any changes in tariffs. Minor growth in service prices registered.

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

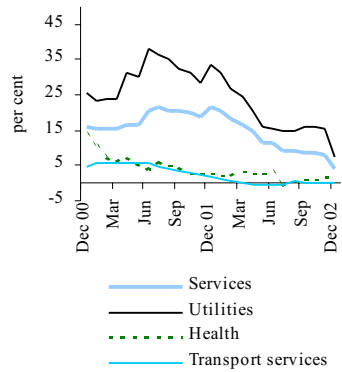
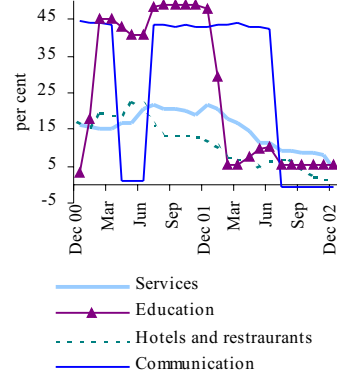


Chart 5b: Services, percentage changes on a year earlier



2.2. CONSUMER PRICES BY REGIONS

Growth in prices in the majority of regions outpaced republican level. The biggest growth rates as much as 4 and 3.5 % were registered in Naryn and Jalal-Abad region, respectively. In Osh region, consumer prices grew by 2.9 %, in Talas and Issyk-Kul region inflation made 1.9 and 1.2 %, respectively. The food stuffs prices, which increased from 2.6 to 5.6 % in different regions, got major contribution to inflation. In Naryn and Osh region, growth in food prices was supplemented by acceleration in non-food prices by 3.9-4.9%.

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

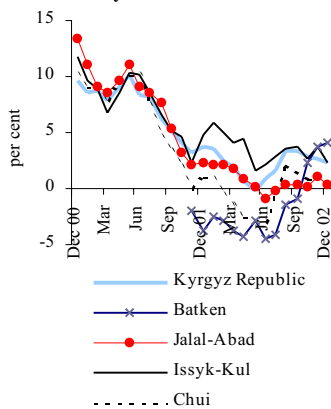
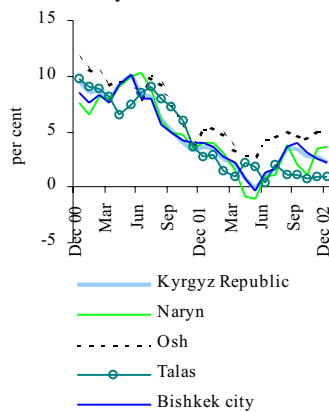


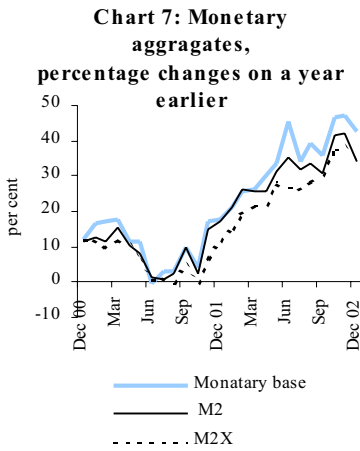
Chart 6b: CPI by Oblasts, percentage changes on a year earlier



3. INFLATION FACTORS

3.1. MONETARY AGGREGATES

In the fourth quarter, the tendency of money supply to accelerate still kept. Expansion in money supply was supported with money demand. The monetary aggregates grew basically due to operations of the Ministry of Finance and increase in net international reserves owing to interventions of the National bank.



3.1.1. MONETARY BASE¹

The monetary base for the fourth quarter increased by 12.9 %. In 2002, the monetary base rose by 42.9 %. Net purchase of foreign currency by the National bank made 11.6 million US dollars. As of January 1, 2003 gross reserves amounted 316.7 million US dollars and it covers 194.4 % of monetary base.

There was decline in share of cash in circulation from 94.4 % on the end of September to 92.2 % on the end of December. The money in circulation rose by 10.2 %.

3.1.2. AGGREGATE M2

The monetary aggregate M2 increased by 10.3 %. In 2002, monetary aggregate M2 rose by 34.2 %. The tendency of depository base to grow still kept in the fourth quarter. Deposits in the national currency increased by 4.7 % due to growth in balances on settlement accounts of legal persons by 15.3 % as well time deposits by 4.8 %.

3.1.3. AGGREGATE M2X

The monetary aggregate M2X under the current exchange rate increased by 11.4 %. Growth in broad money occurred due to following sources: cash outside of banks increased by 10.2 %; accelerated inflow of deposits to commercial banks by 13.4 %. Growth rates for cash in circulation outstripped rates of growth for deposits, while deposits in foreign currency increased by 15 %. There were following changes in the structure of broad money M2X:

- share of cash outside of banks reduced from 63.2 up to 62.5 %;
- share of deposits in foreign currency increased from 23.7 up to 24.5 %.

3.2. INTEREST RATES

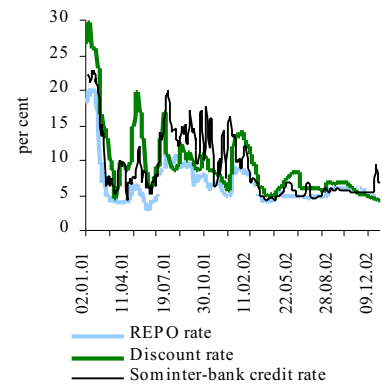
3.2.1. MONEY MARKET INTEREST RATES

The level of excess reserves in banking system during fourth quarter remained high and stable enough, therefore fluctuations of rates in the inter-bank credit market were insignificant: from 4.5 up to 6 %.

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

Thus, in the inter-bank market, interest rate of 6 % predominated from October till November, however, the significant increase in liquidity at the end of November led to decrease in interest to 5 %. At the end of December, traditionally, there are pronounced contraction in excess reserves in commercial banks, which caused growth in costs of som funds, in connection with necessity of carrying out payments to budget. However, December 2002 is an exception: banking system liquidity remained high and interest of som resources fell up to 4.5 %. It is worth to note two transactions, which have been carried out at the end of December in the inter-bank credit market in the national currency. Interest rates of these transactions were unusually high as much as 7 and 10 % because of they were not backed by collateral.

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



Situation with notes of the National bank improved to some extent in comparison with the third quarter, but competition was still low enough, so only 8 out of 14 auctions were recognised as taken place. At the same time, it is necessary to note, that growth in banking system liquidity was manifested by tendency of the National bank’s note yields continuously to decrease, though demand for given securities was rather unstable.

So discount rate reduced from 6.8 up to 4.4 %; the interest rate on REPO operations decreased from 6 up to 4.5 %, while the interest rate on inter-bank credits in the national currency, on the contrary, increased from 5.5 up to 7 %.

The National bank significantly reduced operations in the open market in the fourth quarter in connection with high and stable banking system liquidity. So, there was two times reduction in overnight credit, and SWAP operations on purchase of foreign exchange decreased by 7 times comparing with the third quarter. The National bank suspended REPO operations with commercial banks in the fourth quarter. It is necessary to note, in 2002, interest rates in money market were characterised by lower level and volatility in comparison with previous years.

3.2.2. STATE TREASURY BILLS

Average level of excess reserves in the fourth quarter increased from month to month. The high level in liquidity caused the demand for the state T-bills by commercial banks to increase. So, average demand for one auction grew by more than 64 % during the fourth quarter. The high level of demand in conjunction with low inflation predetermined continuous decrease in yields for all types of the state T-bills. Three-month state T-bill yield reduced from 11.7 to 7 %; six-month paper yield decreased from 13.2 to 10.3 %; yield of papers with term of the maturity one year decreased from 17.3 to 12.4 %. The weighted average interest rate decreased in 2002 from 15.3 to 9.9 %.

Chart 9: T-bill yields

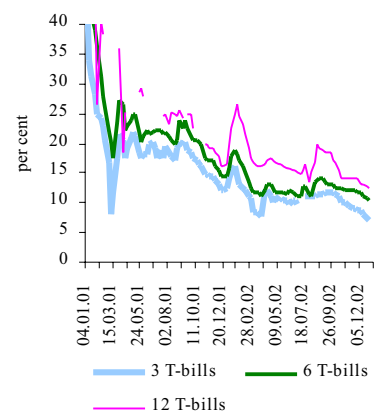
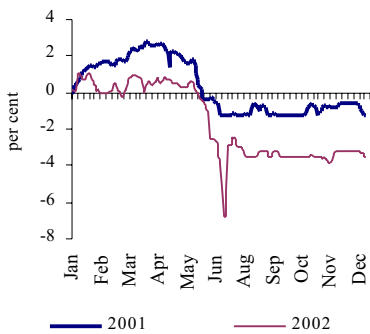


Chart 10: Cumulative change in exchange rate (Som per US dollar)



3.3. EXCHANGE RATE

In October, the situation in the inter-bank foreign exchange market kept stable enough, and fluctuations of dollar were insignificant. Thus, the supply of foreign exchange by commercial banks exceeded demand for it, so the National bank actively intervened by purchasing foreign currency.

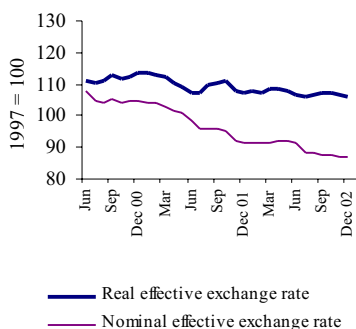
In November, fluctuations of dollar were insignificant, and the National bank was continuing to purchase foreign exchange, but volumes of transactions have decreased in comparison with September.

In December, the National bank continued to carry out interventions in the foreign exchange market. During the first three weeks the National bank sold foreign exchange, while last week of December was accompanied by purchasing of foreign exchange. The net position developed with advantage for sales against purchases.

Thus, for the fourth quarter the som exchange rate depreciated by 0.2 %. In 2002, US dollar depreciated against som by 3.4 %. For comparison, the fourth quarter 2001 som exchange rate against US dollar almost unchanged, while in 2001 dollar weakened against som by 1.2 %.

Som nominal effective rate appreciated by 5.2 % in 2002. Som real effective exchange rate strengthened by one per cent due to development of som nominal effective rate and slower growth of consumer prices in republic in comparison with the major trading partners.

Chart 11: Som effective exchange rate indices



3.4. DEMAND AND SUPPLY

There is an opinion that in republic significant funds are spent for carrying out structural reforms, while output is low. The sense of these statements is reduced to idea that structural reforms give nothing for increasing output and that more funds is necessary to allocate for crediting of real sector instead of carrying out structural reforms. In this case, there are expectations of growth in output and improvement in economic situation. It seems that it not quite correct to oppose structural reforms and credit to real sector.

It is hardly possible to argue that idea that credit facilities is insufficient is deprived the reasons. At the same time, judgements that any increase in credit automatically conducts to expansion of output and improvement of condition in economy are unduly simplified. It goes from the point of view that any production is good or in other words production exists for the sake of production. Actually it not so.

In any economy, there are three independent blocks: real sector, demand and financial intermediary. Activity concerning with any production should meet the requirements of efficiency, income should cover costs, in other words it is presupposed that there is demand on given production. If any of these conditions - demand or efficiency -

is not carried out, production becomes unprofitable. In this case credit is capable to support the given activity only for some time. The financial intermediary provides economy with credit and investment resources, moving capital in the most effective spheres. Hence, there is need for consumer demand, effective manufacturers and financial intermediaries. Structural reforms are of vital need to provide it.

Other important problem from the point of view of steady development of economy is a balance between domestic and external demand. As it is already marked, demand is prerequisite condition for sustainable development of economy. Earlier, in the previous releases of the *Inflation Report* it was marked that level of low marketability in republic means that there are significant reserves for expansion of domestic demand. At the same time, it is necessary to take into account natural restrictions of domestic demand: population and its incomes. The current consumption competes with consumption of the future periods. In other words, is it better to consume products (to spend money) today or to invest them? The unique answer does not exist to the given question. There is point of view that the current consumption is better promoter of development in low-income economy. The reason is that savings in such countries, as a rule, are small and scattered, the financial system is undeveloped, and therefore savings are not transformed to investments. However, it is meant implicitly that there are free capacities in economy, which are not used by virtue of low demand, so it is necessary to stimulate demand. Another condition for such statement is presence of sufficient scale of economy.

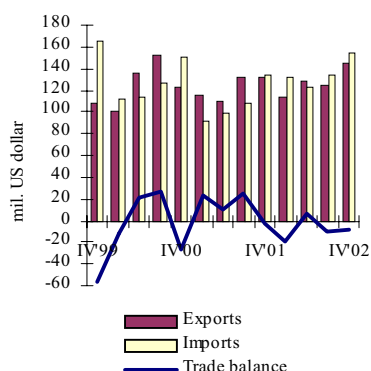
These conditions are not quite adequate for economy in Kyrgyzstan. Formally, it seems that there are free capacities owing to sharp slump in production during first years of transformation. However, actually equipment either is worn physically out, or is morally obsolete. Opportunities of import substitution appeared rather limited even after the Russian crisis when local manufacturers have got competitive advantage in prices of goods.

When financial intermediary is poorly advanced, savings are not transformed to investments, it is necessary to apply either state, or private investments. Although public investment program has great significance, to attract direct foreign investments, to promote domestic investments and venture business is high priority.

Decline in gross domestic product in 2002 can be attributed to unexpected events. The main reason is accident at the large gold-mine enterprise, which negatively affected output up to the end of year. Slump in production of electric energy was the second serious reason. Events of 2002 reveal problem how to increase robustness of economy and to decrease dependence on externalities.

It is necessary to note that policy of weak som to stimulate exports is inappropriate. This conclusion is based on export structure, which consists primarily of raw material, and there is no hi-tech production in it.

Chart 12: Trade balance



3.4.1. NET EXPORTS

On the preliminary data, the trade balance in the fourth quarter of 2002 was slightly negative. The foreign trade turnover increased by 13 % in a year. Thus, growth in turnover is marked with the countries of a non-CIS and CIS by 3 and 23 %, respectively.

Exports of goods in F.O.B. prices grew in comparison with the corresponding period of the 2001 by 16 %. There was growth in exports to the CIS, while non-CIS exports reduced slightly.

Consumer goods, raw materials and energy products rose actively, while exports of intermediate products contracted. Raw material exports increased basically due to cotton, tobacco and tanning raw material. It is worth to mention growth of kerosene deliveries in the USA, skins of animals to China, the equipment of communication to Turkey, the electric power to Uzbekistan and a cotton fibre to Russia. Reduction in tobacco delivery to Russia and gold to the Great Britain is marked.

Non-CIS countries still prevails in geographical structure of exports. Among them biggest share has United Arab Emirates (34 %), Switzerland, China and the USA (17, 10 and 9 %, respectively). The main partners among CIS are Russia and Kazakhstan.

In the fourth quarter of 2002, imports in F.O.B. prices increased by 11.3 %. The growth in imports from CIS and non-CIS were 9.4 and 14 %, respectively. One of the largest import items is consumer goods. Also, imports of investment products considerably grew. The share of mineral oil occupied quarter out of total amount of imports. Gasoline and diesel fuel deliveries rose in physical terms, but import prices of gasoline unchanged. Imports of raw products in the fourth quarter 2002 remained on the same level. In commodity structure of imports growth of deliveries of coal and mineral oil, in particular, kerosene from Kazakhstan is marked. Imports of medicines, optical devices from the USA strongly increased. But at the same time, there was a significant curtailment in imports of such products as gasoline, organic chemical compounds, medicines, cars from Russia. Imports from China reduced almost by 1.5 times. Deliveries of plastic products, furniture, building constructions, the special equipment from Turkey reduced. The geographic distribution of imports still unchanged: the biggest share as much as 54 % falls on the CIS. Share of Russia and Kazakhstan increase and reached 20.8 and 20.2 %, respectively, against 16.8 and 18.2 % in the fourth quarter 2001. Also, the share of imports from Ukraine increased, while Uzbekistan's share dropped from 24.8 to 15.5 %. The USA and Germany are main sources of import among non-CIS.

3.4.2. DOMESTIC DEMAND

Domestic demand consists of state and private demand. Domestic demand is subdivided on consumer and an investment demand.

According to the economic theory the state demand is one of instruments of economic policy. Regulations existing in economy and individual preferences determined private demand. Positive or negative gap between supply and domestic demand is possible. Positive gap means that some surplus of goods is present, which is transformed to net exports. Negative gap manifests that deficient products compensate by imports.

Current account deficit is neither good nor bad by itself. If there is need in modernisation for sake of economic development, expansion in imports of investment products is almost inevitable. Another case is, if imports consist of primarily consumer goods. The consumer, who receives cheaper or better products, gains, however, imports predominated with consumer goods gives nothing for development of economy. In addition, consumption amount and structure has essential influence on inflation, output and employment, money demand.

During transformation the mechanism, which regulates total amount of domestic demand, managed to create. But the question what structure of domestic demand in medium term should be remains open. The economy of republic cannot be closed, as it does not possess sufficient resources, at the same time, it is impossible to lean extremely on external sources.

Republic is in a process of clarifying state functions: structure, quality and volumes of given state services. This process is far from end that is caused by transitive character of economy. More specific state functions have allowed to decrease burden on budget and to balance aggregate supply and demand.

In the medium term, amount and structure of the state demand can be specified. Minimal wages and an employment policy will be of more importance. Certain kinds of the state support for population with low incomes will be preserved as far reforming of housing-and-municipal sphere, state participation in production and other reforms are far from end. Probably, investment activity will be changed in process of development of capital market and, in particular, bond market.

Condition and prospects of final consumption and investment activity in private sector are major determinants of economy development. The greater consumption is the fewer saving and investments are, and vice versa. It seems that acceleration of investment activity has a little bit greater value nowadays. The reason is necessity to restore and modernise fixed capital. Output growth applying old industrial base has the limited potential and a short-term positive effect.

Improvement in macroeconomic situation during last two - three years promoted formation of savings. However, savings not automatically transform in investments. The outlined tendency to increase monetization of economy has not got new quality yet, because more money does not mean more capital. Capitalisation of economy means formation of the capital, including financial which is interested in search

of the most favourable spheres. Creation of conditions to accelerate capitalisation of economy should be one of priorities of economic policy. The emphasis on updating and modernisation of industrial potential does not mean that development and stimulation of domestic demand is a task of second importance. This direction of activity also means necessity of expansion of market sector of economy. Development of trade and credit are important factors of increasing in final consumption. In this connection it is worth to pay attention to consumer credit as well as housing and land mortgage.

3.4.2.1. PRIVATE CONSUMPTION

On the preliminary data of the National Statistics Committee monetary incomes of population rose 3.4 % in a year. Thus the real disposable income increased by 0.7 %. Monetary expenditures of population grew by 3.5 %. Retail turnover rose by 9.8 %.

3.4.2.2. PUBLIC CONSUMPTION

Incomes and expenditures of the state budget increased by 14.7 and 23.9 %, respectively, in a year. Growth in salary and wages made 17.7 %. Capital investments and repair from budget increased by 27.8 %. Grants to the state enterprises began rose by 28.3 %.

3.4.2.3. INVESTMENTS

According to the National Statistics Committee capital investments for 2002 reduced by 12.3 % in a year. The major sources of capital investments are funds of enterprises, population and external resources.

3.4.3. OUTPUT

The gross domestic product reduced by 0.5 %. Agriculture gained 3.3 % that is not compensated recession in industry, which made 13.1%. Situation in non-ferrous metallurgy and electric power industry determined decline in industry production. Value added in non-ferrous metallurgy declined as a result of accident at the large gold-mine enterprise. Output in non-ferrous metallurgy and electric power industry reduced by 33.2 and 11.7 %, respectively.

In 2002, according to the National Statistics Committee 23.8 thousand new legal and physical persons were registered. Agriculture share is 56% out of total. The trade share makes 19.3%, services and manufacturing occupies 6.5 and 5.3%, respectively.

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

4.1. MAJOR DECISIONS OF THE BOARD

The Board of the National bank in the fourth quarter 2002 has accepted number of decisions:

- The resolution of Board № 46/1 as of November 27, 2002: Statement of the National bank of the Kyrgyz Republic on monetary policy for 2003 is declared that monetary policy goal - inflation - will not exceed 4 - 5 %;
- The resolution of Board № 48/1 as of December 11, 2002: Major directions in monetary policy for 2003 contain the description of conditions and tendencies, which influence monetary policy goal. There is emphasising how to strengthen and to increase an efficiency of the banking and payment systems. To promote savings alongside with mentioned above activities is a priority. Also, this document contains the forecast of the basic macroeconomic variables;
- The resolution of Board № 50/1 as of December 20, 2002: the Additional Agreement to the General Agreement № Д-3-2 / 659 as of June 21, 2002 is directed to settle financial relationships between the Government of the Kyrgyz Republic and the National bank of the Kyrgyz Republic concerning financial conditions and legal base for circulation of T-bills (settlement);
- The resolution of Board № 51/6 as of December 25, 2002: new edition of Provision “ On limits for management by investment asset of the international reserves of the National bank of the Kyrgyz Republic ” and new edition of the Policy of risks management at management of the international reserves of the National bank of the Kyrgyz Republic prohibits to apply international reserves of the National bank as collateral, guarantees or any other contingent obligations connected to obligations of the third parties. The powers of participants who involved in process of risk management were clarified. New editions are coming into force since March 1, 2003.

4.2. MAJOR DECISIONS OF THE MONETARY REGULATION COMMITTEE

Under the recommendation of the committee monetary regulations (CMR) in October operations in purchase of foreign currency were actively carried out. From the middle of November CMR

recommended to limit operations on purchase of foreign exchange in order to restrain money supply growth. In December, net sale of foreign currency is marked. In the fourth quarter, net purchase made 11.6 million US dollars and increased in comparison with the fourth quarter 2001, when the net purchase made 4.2 million. SWAP operations in the fourth quarter 2002 with foreign exchange were considerably reduced

In the fourth quarter 2002, REPO operations with the state securities were not carried out as financial relations between the Government and the National bank were carried out at the end of December 2002. A number of auctions in notes of the National bank have not taken place as amount of participants was under required limit.

4.3. INFLATION DURING THE FOURTH QUARTER OF 2002 AND OUTLOOK FOR 2003

Inflation for the fourth quarter 2002 made one per cent. In 2002, consumer prices grew by 2.3 % that is the lowest rate from the moment of introduction of the national currency. The low rate of inflation in the fourth quarter is explained by the fact that tariffs for municipal services did not raise whereas it took place in previous years. The seasonality was less pronounced than in previous years. There are probably two possible reasons: the seasonality pattern was specific for given year, or the seasonality pattern start to change. Smoothed seasonality pattern, which may be connected to decrease in inflationary expectations, makes inflation more predictable.

Inflation in 2002 basically had non-monetary character. Developments of inflation and monetary aggregates start to diverge since the middle of 2001. Monetary aggregates grew steadily, while inflation slowed down.

Usually, rigid correlation between inflation and money in transition economies is connected with underdevelopment of the financial market and rigid structure of economy. As a rule, lack of financial instruments and low credibility in financial intermediary undermines stimulus to savings, so incomes are almost entirely spent for consumption. But potential to expand or to converse production towards best-selling goods is limited, so demand which is not covered by supply, results in inflationary pressure. This situation is bright expression of monetary inflation, which was frequently observed in recent times, however, as it was marked above, situation in 2002 is not the case.

The service prices rose most rapidly, so non-monetary factors became the major factors causing inflation. That is why regulated tariffs are the most important factor of inflation.

Inflationary expectations are another factor, which is worth to mention. In transition countries, inflationary expectations that are strongly persistent easily and quickly arise, but it is very difficult to reduce it,

and it takes a long time. The economy of Kyrgyzstan in this sense is not an exception. Though it is rather difficult to measure inflationary expectations, it is possible to note that the current inflation is under affect of inflation with two years lag. The level of expectations was reduced and it is one of explanations why consumer prices growth in republic slowed.

Slowdown in inflation was promoted by strengthening of som nominal effective rate. National currency starts to strengthen since the middle of 2000. The tendency of the national currency to strengthen and economy to monetise reflects the processes occurring in economy. Expansion in market sector led to growth in money demand. Decline in gross domestic product is registered in 2002, but developments of other major macroeconomic variables leads to conclusion that there were actually no any falling in gross domestic product taking in account grey economy.

Monetization and money demand are the interconnected processes. For a long time monetization fluctuates in a narrow range 10 - 15 % of gross domestic product. It is low even for transition economy, but as long as monetization reflects intrinsic features of economy, it cannot be increased artificially. Another specific feature of Kyrgyz's economy is that demand for money is satisfied not only by the national currency, but by the US dollars too. It is difficult to estimate what place in economy of republic will occupy by euro, it is obvious that operations with this currency is increasing. Positive tendencies for demand in national currency to grow and economy to monetise were revealed, however, these changes for the present did not lead to new quality of economy yet.

The monetary policy in 2002 was not aimed to artificial strengthening of the national currency. Moreover, the National bank prevented excessive strengthening som against US dollar. The monetary policy also was not restrictive, developments of monetary aggregates prove that fact. In other words, the National bank is guided by current and expected money demand; the most important factors, influencing decision-making by the National bank, are: performance of monetary policy goal, competitiveness of economy and external debt servicing.

It is expected that inflation in 2003 will not exceed 4 - 5 %. There are main assumptions: growth of monetary aggregates will be slowed down; the real effective rate of som will keep stability. Various parameter serves as risk factors. There is uncertainty connected to development of economic situation in the world. Sharp fluctuations in oil prices and measures of economic regulation in the basic exporters of mineral oil - Russia and Kazakhstan - are capable to affect prices significantly. Different outlooks for oil prices strongly differ of each other. One of them predicts growth in prices, while others expect their sharp drop. Gold occupies an essential share in exports of republic, so prices for gold will play certain role. Among domestic factors it is

necessary to note the following: money demand; economic development; changes in the taxation.

Money demand depends on how fast will grow market sector in economy, what rates of growth of economy will be. With the high degree of probability it is possible to expect, that gold mine and electric power production will be restored. Though development of situation in 2002 has shown, that slump in production in these branches has not negatively affected money demand. The expected changes in taxation could affect inflation, while there is some uncertainty.

Development in inflation during 2000-2002 reveals the steady tendency in consumer prices to slow, so there is a question whether deflation is possible. The analysis of inflationary processes in republic shows that the administrative increase in utility tariffs is the main source of inflation. In 2003, changes are possible in the field of the taxation that, in case of acceptance of these changes, will affect consumer prices. Inflationary expectations continue to play an essential role, however, their contribution decreased slightly. The tendency of demand for the national currency to strengthen promotes domestic demand to sustain. On balance, the National bank does not tighten effective demand.

In spite of the fact that actual inflation per 2001-2002 developed below, than it was expected risks of higher inflation in 2003 in comparison with 2002 are high, therefore the outlook for 2003 is higher, than actual inflation in 2002. Growth in consumer prices for the first quarter 2003 is predicted at a level of 2.5-2.8 %.