Research Report on Kyrgyzstan

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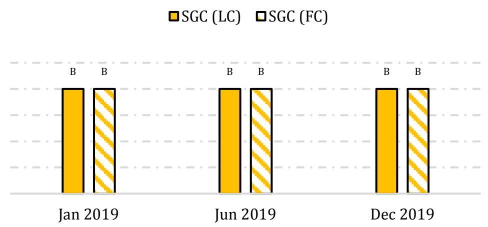
Ratings

Sovereign Government Credit (LC)	B
Sovereign Government Credit (FC)	B
Outlook (LC)	Stable
Outlook (FC)	Stable

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Kyrgyzstan

Macro indicators	2016	2017	2018
Gross gov. debt, KGS bn	281	312	312
Nominal GDP, KGS bn	476	530	557
Real GDP growth, %	4,3	4,7	3,5
Gross gov. debt/GDP, %	59,1	58,8	56,0
Deficit (surplus)/GDP, %	-6,4	-4,6	-1,3
Inflation rate, %	-0,5	3,7	0,5
Current Account Balance/GDP, %			-9,8
External debt, USD bn	-	-	3,8

Development indicators	2019
Inequality adj. HDI	0,61
GDP per capita, USD th	4,1

Source: RAEX-Europe calculations based on data from the IMF, WB, Ministry of Finance of the Kyrgyz Republic and NBKR.

Summary

The confirmation of SGC ratings of Kyrgyzstan at ‘B’ level with a stable outlook reflects the stabilization of macro indicators, recovered fiscal position and adequate monetary policy of the Central Bank aimed to encourage credit growth. Additionally, improved government transparency and incentives available in special economic zones permitted Kyrgyzstan slightly to recover external position and attract foreign investments.

Nevertheless, significant government indebtedness, high level of poverty, heavy dependence on the mining industry and main trading partners continue to restrict the country’s creditworthiness and make Kyrgyzstan’s economy vulnerable to external shocks.

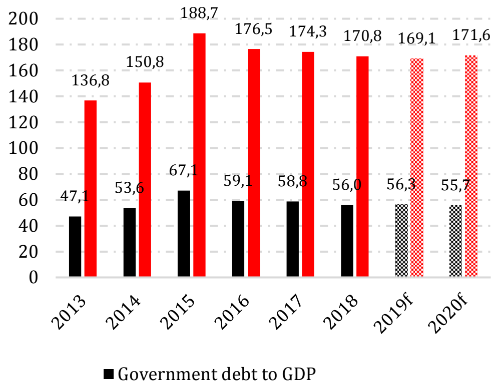
Government debt stabilized, but remained significant. After the last write-off of debt by the Russian Federation in 2018, total government debt to GDP indicator remained stable, around 56% of GDP for the 2018-2019 timeframe (see graph 1). There is a small shift towards internal financing, the share of external debt in total government debt declined by 1p.p. till 83,4% since our previous review. The debt structure is also consistent and favorable as 94% of external obligations have long-term maturity and 98,4% issued on favorable concessional terms (see graph 2).

With the total share of 45,1% as of October 2019, the Export-Import Bank of China continues to be the largest creditor of Kyrgyz Republic. Its main activity is financing the “One Belt One Road” project, in particular transportation links, energy supply development, and mineral resources explorations.

In 2019, a significant share of capital investment was financed by non-repayable grants, 28 % of the total funding. Majority of the grants provided by China, Russia and the European Union as well as international institutions, such as the Asian Development Bank. We anticipate government debt in the mid-term will decline slightly, close to 55% of GDP in 2021 when the substantial principal amount payment is scheduled.

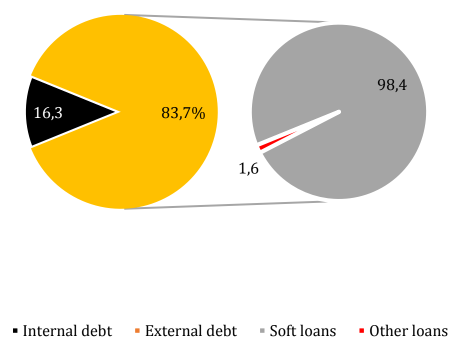
Fiscal policy adequately turned slightly to loosening in 2019. After a very tight fiscal stance in 2018, the government increased budget expenditures in order to maintain social and living standards in the country, causing the budget deficit to GDP ratio to rise by 1,5p.p. until 2,7% in 2019 (see graph 3). Despite the fact that the final number of fiscal

Graph 1: Government debt dynamics, % of GDP



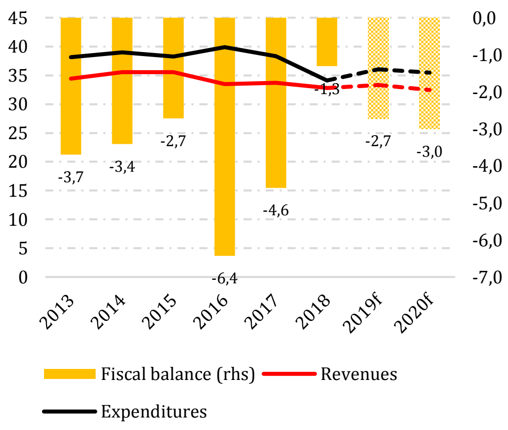
Source: RAEX-Europe calculations based on data from the IMF

Graph 2: Government debt structure as of 3Q 2019



Source: RAEX-Europe calculations based on data from the Ministry of Finance of Kyrgyz Republic

Graph 3: Fiscal budget dynamics, % of GDP



Source: RAEX-Europe calculations based on data from the IMF

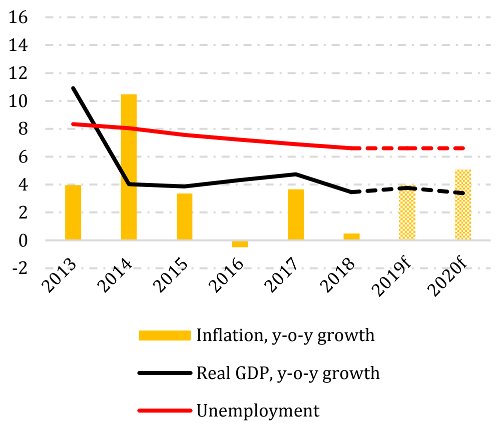
deficit for 2019 will be 1,1p.p. higher than initially planned by the Ministry of Finance, we consider slight loosening of the fiscal policy aimed to fight poverty adequate. According to the new fiscal policy plan, in 2020-2021 the general government fiscal deficit should not exceed 3% of GDP, while gross budget expenditures for 2020 are expected to rise by 7,3% in comparison to the final version of the approved budget of 2019. An increase of the budget is supposed to be covered by higher tax income due to the improvement in tax administration, digitalization and information integration.

Monetary policy remained expansionary. The moderate inflation environment allowed the National Bank of the Kyrgyz Republic (NBKR) to maintain the key policy rate at 4,25% until the end of 2019 after lowering the key rate and overnight credit rate several times in the 1Q 2019. As a result, broad money has increased by 14% and the banking system total loans and financial leasing to clients have increased by 16% since the beginning of the year. In order to control excessive liquidity in commercial banks, the NBKR raised once again the overnight deposit rate from 1,75% to 2% in August 2019. The monetary policy of the NBKR is committed maintaining price stability with a target inflation level of 5-7% in the mid-term. The estimated annual inflation for 2019 is around 4%, only slightly lower than the target interval, and the consumer price index (CPI) growth in 2020 is expected to be sufficient for meeting the objective (see graph 4). Nevertheless, the volatility in food prices remained during 2019. Therefore, the Agency will keep monitoring further NBKR decisions regarding policy adjustment in 2020 and expects inflation for the following year to be close to 5%.

Another direction of the monetary policy is to fight financial dollarization, which despite encouraging dynamics remains high: as of October 2019, 42% of total deposits were denominated in foreign currency. The NBKR uses overnight deposit rate to increase interest rate spread between deposits in local and foreign currency, 0,3p.p. y-o-y growth until 4,9% as of October 2019. Elevated dollarization and high interest rate corridor continues to be wide constraining monetary policy transmission mechanism.

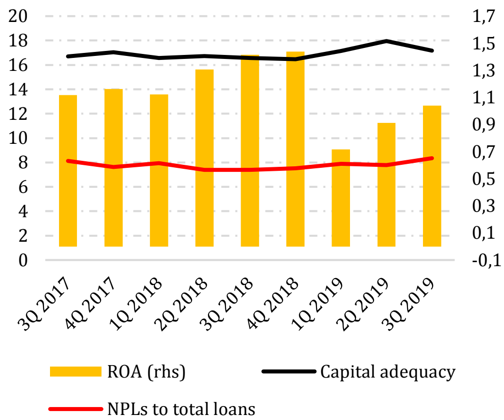
Major banking soundness indicators deteriorated. Financial indicators of the banking system slightly deteriorated as ROA and ROE indicators annually decreased by 0,3p.p. and 2,7p.p. respectively as of October 2019 (see graph 5), due to the reduced interest rate income and operating costs' 7% increase y-o-y in October 2019. Asset quality also continues to decline as share of non-performing loans reached 8,4% (0,8p.p. annual increase) and amount of loans classified as doubtful doubled. The real worsening of loans' quality could be even higher, as the

Graph 4: Macroeconomic indicators, %



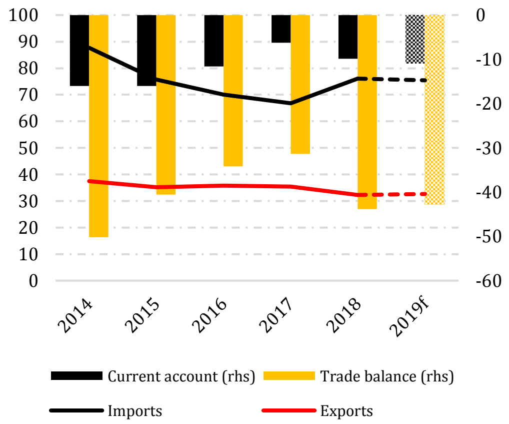
Source: RAEX-Europe calculations based on data from the IMF

Graph 5: Financial soundness indicators, %



Source: RAEX-Europe calculations based on data from the WB and NBKR

Graph 6: External sector indicators, % of GDP



Source: RAEX-Europe calculations based on data from the IMF and NBKR

effect was partially offset by total loan growth and reclassification of the troubled loan of the Rosinbank acquired by NBKG in 2018. On the other hand capitalization level remained satisfactory with the ratio of total capital to total assets at 17,2% as of October 2019. Consolidated assets of commercial banks increased by 10% by October 2019 since the beginning of the year with estimated total banking assets to GDP ratio at the level of 43%. The growth is fully attributed to consumer loans, as the growth of loans to corporates is restricted by extremely high interest rates, and banks are trying to keep the spreads to maintain profitability and lack of long term funding (maturity mismatch of loans and deposits). Moreover, there is a significant concentration of loans portfolio in agriculture and trade. For 2020, we expect similar growth in credit to the economy.

Implemented in 2018 AML/CFTE (anti-money legalization/laundering and counter-financing of terrorism or extremism) legislation was considered as a significant improvement by Financial Action Task Force (FATF). Although Kyrgyzstan is no longer on the FATF red list, a large shadow economy, high remittances inflow, and narcotics trafficking keep financial crimes risk elevated. Kyrgyz Republic still does not comply with FATF 40 + 9 Recommendations.

The economy growth slowing down while the external position slightly recovers. The real economy expanded by 3,8% in 2019, which is 0,3p.p. higher than in 2018 driven by mining activity and manufacturing industry associated with precious metals. The life of the largest mine of the country Kumtor (approximately 10% of GDP), is estimated until 2023, though it might be extended further if current exploration research is successful. Trade deficit and current account remained negative in 2019 at a similar level as in the previous year, 42,8% and 10,9% of GDP respectively (see graph 6).

The structure of cross-border remittances, import and export remained highly concentrated on major partners. The reliance on the main export product also continues to be high, precious metals account for 40% of total exports. Kyrgyzstan currently does not have real benefits of "GSP+"[1] scheme due to the lack of necessary laboratory equipment in order to meet EU standards, as well as the existence of a sufficient amount of trading intermediaries and excessive regulatory environment.

Foreign direct investment inflow in 2019 increased by 4p.p. until 5% of GDP, nevertheless its growth remains constrained by the quality of logistics, continued obstacles to trade, high corruption perception and mistrusts to the court system. Free economic zones tax regulations is a

[1] "GSP+" - Generalised Scheme of Preferences Plus. The scheme allows eligible developing countries to pay fewer or no duties on exports to the European Union.

good sign for investment growth, however, while the tax rates are low, their regulations and administration have a room for improvement.

Important note for sovereign ratings

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

https://raexpert.eu/reports/Press_release_Kyrgyzstan_27.12.2019.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the Agency.