International Monetary Fund

Kyrgyz Republic and the IMF

Press Release:
IMF Executive Board Completes Fifth Review Under the PRGF Arrangement with the Kyrgyz Republic and Approves US$2 Million Disbursement
November 16, 2007

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Kyrgyz Republic: Letter of Intent and Memorandum of Economic Policies

November 1, 2007

The following item is a Letter of Intent of the government of Kyrgyz Republic, which describes the policies that Kyrgyz Republic intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Kyrgyz Republic, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

November 1, 2007

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431

Dear Mr. Dominique Strauss:

Further to our letter of April 24, 2007, reviewing our performance under the program supported by the Poverty Reduction and Growth Facility (PRGF) arrangement approved in February 2005, we are pleased to inform you that all quantitative performance criteria and structural benchmarks for end-June 2007 were met, some with comfortable margins (Table 1). As indicated in Table 2, implementation of some of the end-December 2006 and end-March 2007 structural benchmarks under the program (especially those requiring parliamentary approval) has been delayed. We are now seeking to expedite the passage of key pending economic legislation and to add momentum to financial sector and public financial management reforms. The attached Memorandum of Economic Policies (MEP) describes program implementation to date, sets out the government's economic strategy for the remainder of the program period, and includes program understandings reached with the Fund.

The Executive Board concluded the fourth review under the PRGF arrangement on May 18, 2007. We request disbursement of the SDR 1.27 million tranche upon Board completion of the fifth review, as well as an extension of the arrangement until May 31, 2008 to permit completion of the 6th and final review under the arrangement.

We believe that the policies specified in the MEP provide a strong basis for sustaining growth in a low-inflation environment and alleviating poverty. We stand ready, nevertheless, to take any necessary additional measures to achieve the program's objectives. The government will continue to provide the Fund with the necessary information for assessing progress in implementing our program, as specified in the Technical Memorandum of Understanding (TMU), and will consult with Fund staff and management on any measures that may be appropriate at the initiative of the government or whenever the Fund requests a consultation.

The government intends to make public this letter and the staff report for the fifth review under the PRGF arrangement. Accordingly, it authorizes the IMF to arrange to post these documents on the Fund's website once the Board completes its review.

Sincerely yours,

/s/	/s/
Almazbek Atambaev	Abdybaly tegin Suerkul
Acting Prime Minister	Acting Chairman
Kyrgyz Republic	National Bank of the Kyrgyz Republic

MEMORANDUM OF ECONOMIC POLICIES FOR THE KYRGYZ REPUBLIC

I. RECENT ECONOMIC PERFORMANCE

1. The government's economic program for 2005–08, supported by the PRGF arrangement approved by the Fund's Executive Board in February 2005, aims to achieve sustained and rapid economic and social development in a low-inflation environment. This Memorandum reviews program implementation to date and describes our policies for the remainder of the program period.

2. The government has maintained macroeconomic discipline and adhered to the PRGF–supported program thus far in 2007. All end-June quantitative performance criteria (PCs) were observed, in some cases with ample margins, although the indicative limits on reserve money and the quasi-fiscal deficit (QFD) of the energy sector were missed—the latter mainly because of a postponement of the tariff increases envisaged in the program, more than offsetting ongoing efforts to improve payments discipline and curb technical and commercial losses. Moreover, all end-June and end-September 2007 structural benchmarks (SBs) were met (Table 2), and—as discussed below—we are seeking to fulfill several missed SBs for earlier test dates. In line with our commitment to improve the business climate, we have created a high-level investment council and introduced measures to streamline the regulatory apparatus, simplify business inspections and create an enabling environment for SMEs.

3. Economic activity has continued to rebound in 2007, with year-on-year real GDP growth of 8.5 percent during the period January-September, and non-gold output growth of 9.2 percent. Total and nongold GDP growth in the period October 2006–September 2007 (against the preceding 12 months) were 6.9 percent and 7.8 percent, respectively. Twelve-month inflation rose to 13 percent in September, owing to an easing of liquidity conditions and an externally driven spike in foodstuff prices. The half-year external current account deficit amounted to about $290 million (22 percent of GDP at an annualized rate), with buoyant remittances and sustained export growth moderating the effect of a rapid increase in imports. As the current account deficit was over-financed by rising FDI and other private capital inflows and the NBKR engaged in sizable (mostly unsterilized) intervention in the foreign exchange market, gross reserves increased to $1 billion (3.3 months of projected 2008 imports of goods and services) by end-August.

4. Year-to-date fiscal performance has been better than envisaged because of buoyant receipts from taxes on imports and under-execution of budgeted spending. As a result, the general government posted an overall surplus of 1.9 percent of GDP at an annualized rate during the first half of the year, compared with a programmed deficit. Parliament passed a supplementary 2007 budget, mainly authorizing one-off outlays for the August 2007 summit of the Shanghai Cooperation Organization premised on an upward revision in revenue, thereby limiting the fiscal deficit to around 3.1 percent of GDP as envisaged in the program.

5. Monetary policy has been conducted lately in an environment of stronger-than-expected foreign exchange inflows and continued remonetization. As a consequence, the NBKR has engaged in significant (mostly unsterilized) intervention in the foreign exchange

market to mitigate the appreciation of the som against the U.S. dollar, sparking a surge in reserve money growth. Moreover, the rebound in economic activity and the entry of new commercial banks have been accompanied by rapid expansion in private sector credit (albeit from a low base) and broad money, partly covered by an increase in short-term foreign liabilities. However, the som has remained broadly stable in real effective terms since end-2006.

6. The NBKR continues to enhance supervision and has established a framework to assess market, operational, country and foreign exchange risks. It has also launched the envisaged independent review of its internal audit function (with assistance from the Swiss National Bank); taken steps to improve the payment system; introduced an enabling legal and supervisory framework for Islamic banking; developed an action plan to align the supervisory framework with the new AML/CFT legislation; and started preparations to introduce mandatory deposit insurance in 2008. A tender for divestiture of two-thirds of the public sector's equity in the Agricultural (*Ayil*) Bank (formerly KAFC) is now poised for submission to parliament. While legislation to enhance the NBKR's legal independence (an end-December 2006 SB) has yet to obtain parliamentary support, the government plans to increase the NBKR's *de facto* autonomy and it has taken steps to enhance coordination between the monetary and fiscal authorities.

II. Program Objectives and Economic Policies for 2007

7. In line with the Kyrgyz Republic's Country Development Strategy (CDS), our economic policy is geared towards poverty alleviation and private sector-led growth in a low-inflation environment. To achieve these objectives, the government will continue to maintain macroeconomic stability, deepen financial sector and public financial management (PFM) reforms, and remove structural impediments to growth, while limiting its direct intervention in the economy.

8. The vigorous economic recovery in the year to date suggests that output growth could reach 7.5 percent during 2007, compared with the original target of 6.5 percent. However, the recent upturn in inflation could make it difficult to achieve the original 5–6 percent target. To dampen inflationary pressures, we are tightening monetary policy and undershooting the program's original fiscal limit. The rebalancing of the macroeconomic policy mix should keep inflation below 9 percent by year's-end and limit the external current account deficit to 18 percent of GDP. Our economic program for 2008 targets output growth at 7 percent and end-year inflation at 7–8 percent, on the strength of fiscal consolidation and economic reforms anchored on the CDS. On this basis, and aided by a recovery in gold exports, the external current account deficit would narrow to 15 percent of GDP and end-year gross reserves would amount to 3.8 months of projected 2009 imports of goods and services.

A. Fiscal Issues

9. Fiscal consolidation will continue to underpin macroeconomic stability. Accordingly, we expect the overall general government deficit to amount to 2.2 percent of GDP in 2007, mostly on the strength of continued revenue gains. To dampen the upturn in consumer prices stemming from higher international commodity prices, we have announced extraordinary public sector imports of grains and fuel amounting to 0.5 percent of GDP. To alleviate the

social costs of higher food prices, we have also announced a 10 percent increase in pensions and selected categories of welfare benefits from October 1, 2007, accompanied by efforts to better target welfare recipients—all of which will be covered by a reassignment of budgetary appropriations already approved by parliament.

10. The 2008 budget sent to parliament in September keeps the general government deficit around 2.2 percent of GDP. This is consistent with an increase in pensions in the order of 10 percent during 2008 and an increase in the public wage bill in the order of 25–30 percent during the year to stem the exodus of qualified personnel and to scale-up social sector spending. To make room for further improvements in remuneration over the medium term while stabilizing the wage bill relative to GDP, we will seek assistance from the World Bank to design a comprehensive civil service reform that would include reductions in personnel; harmonization of pay grades for comparable jobs across the public sector; and introduction of incentives and sanctions geared at enhancing performance management. Continued revenue gains anchored on sustained output growth and further improvements in revenue administration should allow us to eventually reduce the rate of social fund contributions further to 25 percent. We will also seek timely passage of the new tax code, after forging a consensus on the different drafts before parliament.

11. The phased three-year reduction in the retirement age through 2009 enacted by parliament entails significant near-term costs. While we continue to seek political support for reversing this fiscally unsustainable initiative, we will cover its immediate costs by (a) broadening the social fund revenue base and stepping up its collection efforts; and (b) providing central government transfers as needed, including to permit the further step-wise reductions in the rate of social fund contributions mentioned earlier. To put the social fund finances on a sound longer-term footing, we will forge a domestic consensus for designing a comprehensive pension reform with World Bank assistance. Key elements under consideration include a streamlining of social benefits and a broadening in the coverage of social safety nets, as well as introduction of fully funded private pension funds within a few years—premised on creating an appropriate legal and regulatory framework for these funds and developing suitable asset classes for them to invest their resources.

12. We have embarked on donor-assisted PFM reforms, especially to strengthen budgetary design and implementation and direct pro-poor spending to priority sectors identified in the CDS. We will also seek timely passage of the Internal Audit Law submitted to Parliament in September. Moreover, we are implementing the new Public Procurement Law, which entails multi-year procurement planning and prohibits the State Agency on Public Procurement and Material Reserves from participating directly in the procurement process. In keeping with the phased move to a three-tier government and budgetary structure (comprising central, regional and local governments), we will continue to help local authorities in their efforts to build capacity and will clearly demarcate revenue and expenditure competencies at each tier.

13. The new Medium-Term Budgetary Framework (MTBF) includes a new classification of poverty reducing spending and the tracking of pro-poor spending in the monthly budget reports. It also outlines a strategy for developing health, education, social protection, agriculture, and transport and communication, along with criteria for identifying sectoral priorities and deepening fiscal decentralization. We will update the MTBF in the coming months to reflect the tightening of the fiscal stance mentioned above and the envisaged fiscal

consolidation through 2010. The updated MTBF will include sectoral ceilings directly and transparently linked to annual budgets, starting with the 2008 budget. Further, the annual budget process is being strengthened with the inclusion of functional, economic and administrative summaries in the budget bill.

B. Monetary and Financial Sector Policies

14. To dampen inflationary pressures, the NBKR has begun to tighten liquidity conditions, seeking to slow reserve money growth to about 34 percent by end-2007 (from nearly 40 percent in the 12 months to September 2007) and about 21 percent by end-2008. In this vein, it has also outlined indicative limits for end-2008 on its net domestic assets and reserve money and an indicative floor on its net international reserves (see Table 1). To achieve these goals, the NBKR will operate its managed exchange rate float more flexibly, limiting its intervention in the foreign exchange market to smoothing short-term fluctuations and sterilizing any residual intervention. This will, in turn, be accompanied by improvements in its indirect monetary control instruments and more flexible pricing of these instruments. We will take measures by end-December 2007 to simplify the structure of long-term government securities held by the NBKR, without adverse effects on the value of the NBKR's balance sheet. This should give greater scope to the NBKR for conducting open market operations.

15. We have introduced several measures in recent years to strengthen the financial system, especially regarding supervision, the payment system, and curtailment of money laundering and the financing of terrorism. Going forward, we will deepen these reforms and focus on introducing mandatory deposit insurance for small depositors in early 2008 and on stepping up supervision (including through strict enforcement of procedures for tracking market, operational and country risks) in light of the rapid expansion in private sector credit. The State Service for Financial Reporting and Monitoring will further strengthen supervision in the main areas under its purview (insurance companies and financial institutions operating in the stock exchange), and will enhance information sharing with the NBKR.

16. To upgrade the payment system, the enhanced real-time gross settlement system will become fully operational early next year, and we will submit legislation adding flexibility in the use of bank accounts for settlement purposes. Moreover, to ensure finality of bank resolution, we will seek approval of amendments to the bank bankruptcy law modifying provisions introduced last September that allowed reinstatement of banks that are insolvent and in the process of liquidation. Furthermore, to foster mortgage and other term lending, we have secured passage of amendments to the civil code which—together with amendments to the land code before parliament, as well as amendments to the laws governing collateral and a new housing code to be proposed—are expected to strengthen the legal foundation for the use and for the seizure of collateral in cases of default. Further, we will continue to enhance consolidated bank supervision regulations to adequately monitor risks.

C. External Debt Issues

17. The updated low-income country debt sustainability analysis (LIC DSA) prepared jointly by Fund and World Bank staff shows that the Kyrgyz Republic's debt burden remains

relatively heavy and that the country remains vulnerable to external shocks and natural disasters, despite the improvement in key debt indicators stemming mainly from significant gains in domestic revenue mobilization, rapid output growth and a strengthening of the currency. To put the debt sustainability ratios on a steady downward path, we are consolidating the fiscal position (as noted above) and improving public debt management with Swiss technical assistance; in this connection, we plan to adopt a best-practice external debt management strategy (a missed program benchmark) by end-2007. In addition, the program will continue to prohibit public or publicly guaranteed external borrowing on nonconcessional terms and adhere to a minimum 45 percent grant element on any concessional loans.

D. Other Structural Reforms

18. To help deliver reliable energy supplies for the domestic and external markets and curtail the sector's quasi-fiscal deficit (QFD) over time, we have updated the energy sector action plan discussed earlier with the World Bank. In this connection, we have launched a feasibility study for construction of the Kambarata I and II power generation complex and plan to gradually privatize the power distribution system. In addition, we are intensifying our actions to stamp out corruption in the sector, boost utility bill collections and reduce technical losses and theft, which are already showing encouraging results. Furthermore, in the coming months we will announce phased semi-annual adjustments in electricity tariffs beginning in April 2008, cushioned by social safety nets provided in the budget, with a view to reaching cost-recovery tariffs by 2010. On this basis, we expect to meet the end-2007 indicative limit on the electricity sector's QFD (5.1 percent of GDP), and to reduce it further to 4.8 percent in 2008.

19. To bolster the prospects for rapid, sustained private sector-led growth, we will continue to fight corruption, improve the business climate and strengthen property rights. These actions will be supported by financial and technical assistance from the U.S. Millennium Challenge Corporation, the World Bank and other donors. We plan to introduce a number of measures through end-2008 to foster SME development and private sector-led growth more generally, including sunset ("guillotine") clauses for the elimination of redundant regulations and steps to further reduce government intervention in the economy and to attract foreign direct investment.

E. Program Monitoring

20. The program will continue to be monitored through semi-annual reviews. In keeping with our determination to dampen inflationary pressures, we will make every effort to undershoot the program's original fiscal limits and to significantly slow the growth of reserve money in Q4 2007, as mentioned earlier. Moreover, we will strive to comply with the missed structural benchmarks for end-December 2006 and end-March 2007 (see Table 2), and we have outlined the broad parameters of our 2008 macroeconomic program (including indicative targets), which will be updated at the time of the sixth and final review under the arrangement in early 2008. Completion of that review will hinge on observance of the end-December 2007 quantitative PCs outlined in Table 1 and satisfactory progress in implementation of the program's structural benchmarks. Detailed definitions and reporting

requirements for all quantitative PCs and data sources are presented in the Technical Memorandum of Understanding attached with the Country Report 07/195.

Table 1. Kyrgyz Republic: Quantitative Program Targets for 2006–08 1/

(In millions of soms, unless otherwise indicated; eop)

	2006		2007					2008
	December PCs		March	June PCs		September	December	Dec.
	Program	Actual	Actual	Program	Actual	Indicative Targets	PCs	Indicative
I. **Performance criteria**								
1. Floor on net international reserves of the NBKR in convertible convertible (eop stock, in millions of U.S. dollars)	457	606	656	658	764	862	787	1,105
2. Ceiling on net domestic assets of the NBKR (eop stock) 2/	-1,469	-2,559	-2,944	-1,094	-3,830	-4,484	-1,769	-5,361
3. Ceiling on cumulative primary deficit of the general government 3/	3,701	2,459	…	1,130	…	…	…	…
4. Ceiling on cumulative overall deficit of the general government	…	…	-657	1,665	-962	687	3,937	3,009
5. Cumulative floor on state government tax collections in cash	17,650	19,981	5,253	10,246	11,517	21,763	23,141	30,955
6. Ceiling on the stock of central government budget arrears	0	0	0	0	0	0	0	0
7. Ceiling on the stock of Social Fund pension arrears	0	0	0	0	0	0	0	0
8. Cumulative floor on payroll collections in cash of the social fund	4,823	5,528	1,508	2,864	3,271	4,798	5,738	6,751
9. Ceiling on the stock of Social Fund arrears to the Medical Insurance Fund	0	0	0	0	0	0	0	0
10. Ceiling on contracting or guaranteeing by the state government, NBKR or any other agency acting on behalf of the state government, of new nonconcessional external debt with maturity of less than one year (continuous, in millions of U.S. dollars)	0	0	0	0	0	0	0	0
11. Ceiling on contracting or guaranteeing by the state government, NBKR, or any other agency acting on behalf of the state overnment, of new nonconcessional external debt with maturity of one year or more (millions of U.S. dollars)	0	0	0	0	0	0	0	0
12. Ceiling on accumulation of new external payment arrears (continuous, in millions of U.S. dollars)	0	0	0	0	0	0	0	0
II. **Indicative targets**								
1. Ceiling on reserve money (eop stock)	17,708	22,806	22,177	24,177	25,496	28,617	28,499	37,100
2. Ceiling on the cumulative quasi-fiscal deficit of the electricity sector (in millions of soms)	6,509	6,127	…	3,822	4,171	…	6,633	…
3. Ceiling on contracting or guaranteeing by the state government or NBKR of new concessional external debt (in millions of U.S. dollars) 4/			(as specified in the TMU attached to EBS/07/46)					

Sources: Kyrgyz authorities; and Fund staff estimates and projections.

1/ Definitions are provided in the TMU.

2/ The target excludes medium- and long-term central bank liabilities (i.e.the loan by the Eximbank of Turkey and the EBRD/IDA enterprise loan channeled through the NBKR).

3/ Ceilings on the primary deficit are not performance criteria after Dec. 2006.

4/ New concessional loans during the year.

Table 2. Kyrgyz Republic: Structural Conditionality, 2006–07

I. September–December 2006

Structural benchmarks for end-September 2006

- Prepare an action plan to reduce the energy sector's quasi-fiscal deficit in close cooperation with World Bank staff, addressing problems of transmission and distribution losses, payment indiscipline, and tariff adjustment. [Observed]

- Expand the operation of the Large Taxpayers Unit to cover at least 60 percent of tax revenues. [Observed]

Structural benchmarks for end-December 2006

- Conduct an independent review of the NBKR's internal audit function. The review could be performed by the internal audit department of another central bank, and should include a review of the capacity of the NBKR's internal audit division, as recommended by the Safeguards Assessment Report conducted by Finance Department in 2005. [Not observed]

- Bring KAFC to the point of sale and issue a privatization tender for the company. [Not observed]

- Submit to IMF staff a report prepared by the ministry of labor and social protection recommending measures to improve labor market flexibility. [Observed]

- Secure approval of legislation that has been already sent to parliament to enhance the NBKR's legal independence and ensure legal protection of its employees in performing official duties. [Not observed]

II. March–December 2007

Structural benchmarks for end-March 2007

- The government will submit to parliament amendments (drafted by the NBKR) to the civil, housing and land codes, as well as to all the laws governing collateral, in order to harmonize provisions on collateralized lending by financial institutions and facilitate collateral seizure in cases of default. [Not observed]

- Approval of the tax code bill that is before parliament. [Not observed]

- The government will adopt a new medium-term external debt management strategy aimed at ensuring external debt sustainability, as described in paragraph 24 of the MEP for the third review under the arrangement. [Not observed]

Structural benchmarks for end-June 2007

- The NBKR will implement regulations for consolidated supervision to monitor risks faced by financial institutions, in line with the recommendations of the 2005 Basel Core Principles for Effective Banking Supervision Assessment. [Observed]

- The government will introduce a new and detailed budget classification, based on the best practice reporting of government finances (GFS 2001), which will permit monitoring of poverty reducing expenditures in the monthly budget execution reports. [Observed]

Table 2 (Concluded). Kyrgyz Republic: Structural Conditionality, 2006–07

Structural benchmarks for end-September 2007

- Submit to IMF staff a written Memorandum of Understanding agreed between the NBKR and the State Agency for Financial Supervision and Reporting (SAFSR), delineating the specific supervisory responsibilities of the SAFSR and establishing modalities for information-sharing between them, as recommended by the FSAP update mission. [Observed]

- Submit to parliament an internal audit law for government agencies in line with best international audit practices, in order to establish an appropriate framework for internal public sector controls. [Observed]

Structural benchmarks for end-December 2007

- To ensure finality of bank resolution, the government and the NBKR will secure parliamentary approval of further amendments to the bank bankruptcy law modifying the provisions introduced in September 2006, which allowed reinstatement of banks that are insolvent and in the process of liquidation.

- Submit to IMF staff a best-practice, time-bound action plan to modernize customs administration, including greater selectivity of customs control based on risk criteria and expanding post-clearance audits.

- Submit to parliament enabling legislation to enhance flexibility in the use of bank accounts (including demand deposits) for settlement purposes by legal entities and physical persons.