Research Report on Kyrgyzstan

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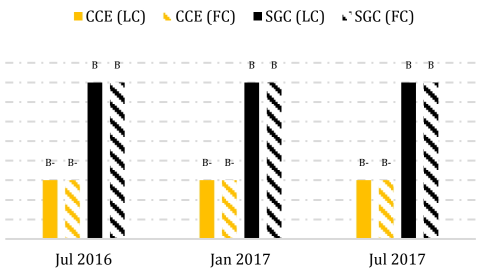
Ratings

Sovereign Government Credit (LC)	B
Sovereign Government Credit (FC)	B
Country Credit Environment (LC)	B-
Country Credit Environment (FC)	B-

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Kyrgyzstan

Macro indicators	2014	2015	2016
Gross gov. debt, KGS bn	209	279	268
Nominal GDP, KGS bn	401	430	458*
Real GDP growth, %	4,0	3,5	2,6*
Gross gov. debt/GDP, %	52,3	64,9	58,5*
Deficit (surplus)/GDP, %	1,0	-1,2	-4,5
Inflation rate, %	10,5	3,4	-0,5
Current Account Balance/GDP, %			-9,4*
External debt, USD bn	-	-	3,7

Development indicators	2016
Inequality adj. HDI	0,58
GDP per capita, USD th	3,5

Source: RAEX (Europe) calculations based on data from the IMF, Ministry of Finance of Kyrgyzstan, NBKR, UN, WB
*Forecast for 2016

Summary

The SGC and CCE ratings of Kyrgyzstan remain constrained by low economic and institutional development, inconsistent fiscal results, as well as limited ability of National Bank of Kyrgyz Republic (NBKR) to sustain price stability.

The absence of a fiscal rule coupled with the continued increase in FX denominated government debt levels, seizing a significant portion of yearly budget expenditure, alongside persistent uncertainty in the stability of the exchange rate, may pose a significant risk in the long-run. However, this risk is currently mitigated by the high amount of concessional debt.

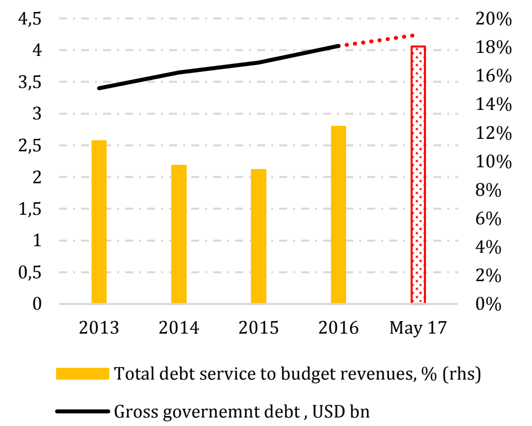
Successful implementation of de-dollarization policies, as well as the new Banking Law strengthens the credit environment. Moreover, advancing recovery of the trading partners, higher remittance inflow and trade turnover will stimulate economic growth.

Debt level remains elevated. Kyrgyzstan continued accumulating debt mainly due to the need to finance multiple investment projects in energy, construction and infrastructure. Hence, absolute levels of gross government debt denominated in USD increased by 7,6% y-o-y by May 2017 (see graph 1). This means that the recent drop in total public debt in KGS terms to GDP ratio by around 3p.p. down to just above 62% was only due to the appreciation of the local currency in 2016. Since 91,2% of the government debt is external we see a significant risk exposure to external shocks and, as a result, unfavorable KGS FX rate developments which, under negative circumstances, may translate into a higher absolute debt level and an increased debt service obligation. The latter has sharply increased in 2016 to 12,4% of budget revenues and was estimated at 18,4% in 1H 2017 (see graph 1) which, in addition to a worsening credit risk position, may put additional pressure on the government's fiscal commitments.

The new Budget Code effective since January 2017 removed a limit on external debt of 60% which will allow the government to determine the maximum external debt threshold in the context of a yearly budget. This, in our view, will elevate credit risks due to overall uncertainty about the government's debt accumulation plan.

On the positive side, more than 90% of the gross government debt is concessional, which may give rise to a potential debt roll-over or write-off under adverse circumstances (e.g. Russia has recently written off USD 240 m of Kyrgyz debt which accounted for 5,7% of total debt as of April 2017)[1].

Graph 1: Gross government debt and debt service

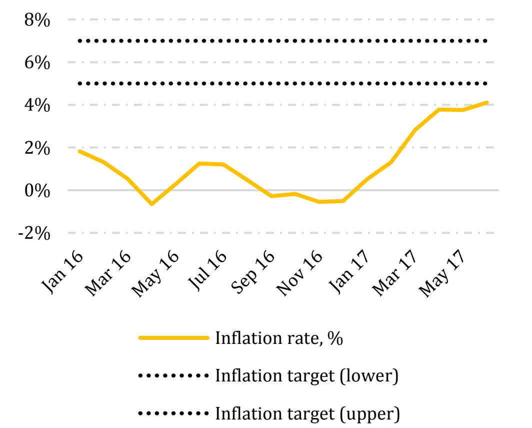


Source: RAEX (Europe) calculations based on data from the IMF and Ministry of Finance of Kyrgyz Republic

Fiscal target was tightened. Following IMF staff recommendations and after posting a deficit of 4,5% in 2016, Kyrgyz authorities have committed to bring the fiscal deficit to a new more sustainable target of 3% in 2017. In order to meet the target, authorities have stated that they will work towards elimination of VAT exemptions, revision of public sector personnel remuneration, as well as reinforcing efficiency of public investment projects and CAPEX in order to avoid an unsustainable debt accumulation. Additional fiscal pressures are expected from the upcoming presidential election in October 2017, which, despite authorities' assurances to refrain from non-budgetary expenditure and populist measures, may become a significant hurdle towards keeping the expenditure down.

In our view, a significant share of the sovereign's credit risk setting will depend on whether the Kyrgyz government sticks to its commitment to develop a credible, transparent and enforceable fiscal rule. The rule would include limits on external debt and fiscal balance, and unlike the recently expired maximum external debt threshold, the new fiscal rule would also incorporate remedial actions in order to ensure compliance.

Graph 2: Inflation vs inflation target band



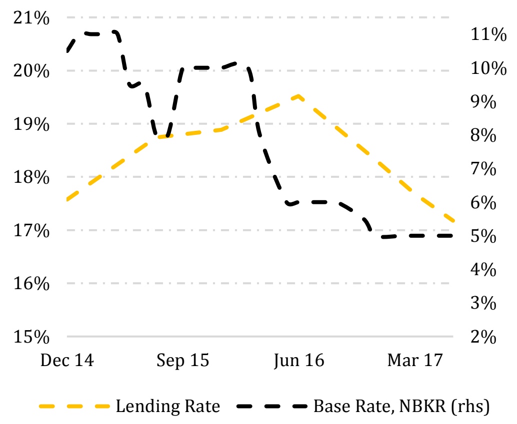
Source: RAEX (Europe) calculations based on data from NSCKR and NBKR

Consumer prices remain unstable. After a recorded deflation of 0,5% as of 2016 the inflation rate has picked up on the wake of increased economic activity and pass-through from higher oil and food prices and reached a level of 4,1% y-o-y as of April 2017 which, however, remains out of the 5-7% target corridor (see graph 2). Nevertheless, the direction of the country's price level dynamics remain largely unpredictable and to a great extent influenced by the uncertainty in the oil market.

Deposit and loan dollarization levels were down by 15,2p.p. and 6,3p.p. y-o-y to 50,9% and 42,8% as of April 2017 respectively. The favorable dynamic is connected to the regulation banning commercial banks from issuing mortgage and consumer loans in USD, forcing conversion of existing loans into KGS, as well as prohibiting indication of prices for goods and services in foreign currency and making compulsory payments only in KGS. Reinforced by low inflation environment and stronger KGS, foreign currency interest rate went further down by around 3p.p. to 12,4% as of May 2017. Combined with currently relaxed monetary policy (the base

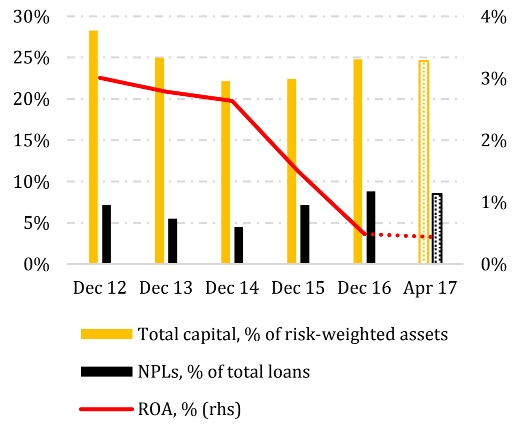
[1] Subject to parliamentary ratification.

Graph 3: Transmission mechanism effectiveness



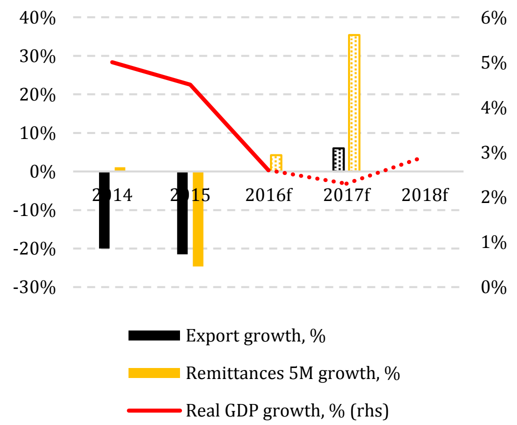
Source: RAEX (Europe) calculations based on data from NBKR

Graph 4: Banking system indicators



Source: RAEX (Europe) calculations based on data from NBKR

Graph 5: Output growth



Source: RAEX (Europe) calculations based on data from NBKR

rate was slashed down to 5% in 2016) the average lending rate is decreased further by 2,5p.p. y-o-y in May 2017 (see graph 3).

Successful advances in the de-dollarization policy and strengthening of the interbank market will determine the enhancement of the monetary transmission mechanism and the monetary policy overall.

Banking sector remains vulnerable. Despite recent positive dynamics the banking sector remains concentrated and underdeveloped with banks' assets to GDP low at around 39% in 2016. The sector has been accumulating additional risks evidenced by NPLs reaching 8,51% of total loans by April 2017. This promoted the accumulation of additional capital reserves which translated into a higher net total capital to risk-weighted assets at 24,6% as of April 2017. The above kept ROA at low levels from the second half of 2016 onwards, amounting 0,4% in April 2017 (see graph 4).

The banking sector regulatory framework is on track to be further enhanced with the new Banking Law being passed in November 2016 bringing in some key improvements. These include establishing clear rights, duties and responsibilities of all participants in the banking business, as well as ensuring timeliness and efficiency of banking supervision. Although the IMF points out that some key postulates were left out of the new law, the Kyrgyz authorities have committed to work towards addressing the shortcomings of the law in 2017.

Successful adoption and enhancement of the new Banking Law will be of paramount importance to the credit risk developments in the country.

Credit environment quality stayed at low levels. The financial market remains largely underdeveloped with small-scale and concentrated stock-exchange and very high and volatile levels of real interest rate. Moreover, the institutional development is curbed by a very high corruption perception, low government effectiveness, lack of rule of law, as well as fairly low ranking for doing business. At the same time, the country exhibits a good investment potential evidenced by very high net foreign direct investment to GDP at 7,5% in 2016.

External shocks eased. Real output grew at 2,6% in 2016, as the biggest regional partners' recovery was rather slow. Moreover, we anticipate growth levels to remain subdued in 2017. However, we expect real GDP to grow at a faster pace from 2018 as a result of increasing real income through low inflation environment and higher remittances inflow (grew by 35% y-o-y in April 2017), which resulting into stronger domestic consumer demand. Greater production of gold, as well as rising exports will contribute to gradual output recovery (see graph 5).

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_21.07.2017.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.