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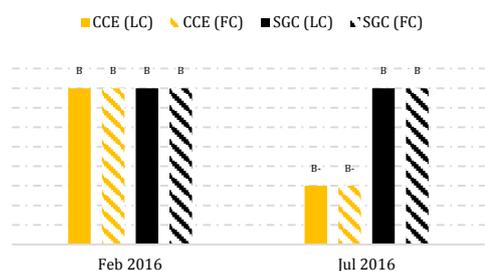
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## Ratings

Sovereign Government Credit (LC)	<b>B</b>
Sovereign Government Credit (FC)	<b>B</b>
Country Credit Environment (LC)	<b>B-</b>
Country Credit Environment (FC)	<b>B-</b>

\* These ratings are unsolicited

## Ratings dynamics



## Main Economic Indicators of Kyrgyzstan

Macro indicators	2013	2014	2015
Gross gov. debt, KGS bn	164	211	280
Nominal GDP, KGS bn	355	401	424
Real GDP growth, %	10,5	3,6	3,5
Gross gov. debt/GDP, %	46,1	52,6	66,0
Deficit (surplus)/GDP, %	-3,7	-3,1	-1,2
Inflation rate, %	4,0	10,5	3,4
Current Account Balance/GDP, %	-	-	-17
External debt, USD bn	-	-	3,7
Development indicators	2015		
Inequality adj. HDI	0,66		
GDP per capita, USD th	3,4		

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

## Summary

The SGC ratings of Kyrgyzstan continue to be constrained by the limited competitiveness of the economy, volatile inflation and exchange rate, as well as strong dependence on external financial aid.

The increasing level of government debt remains a negative factor, however it does not represent an imminent risk, as it mainly consists of external long-term concessional loans. Moreover, real GDP growth is expected to slow down in 2016 mainly due to the weak RUB, reduced trading activity and declining gold production.

High and volatile real interest rates, increasing NPLs and narrowing capital to assets ratio combined with the losses in the underdeveloped banking sector contributed to our decision to downgrade Kyrgyzstan's CCE ratings.

**Debt load is building up.** Recent expenditure on construction and maintenance of infrastructure, as well as on the National Sustainable Development Strategy plan 2013-2017 has led to a sharp increase in gross government debt. It reached 66% of GDP and 173,4% of budget revenues in 2015 which is a 19,9p.p. and 39,9p.p. respective increase from 2013 (see graph 1). The new legislation which allows the public external debt to GDP threshold level (currently 60%) to be reviewed on an annual basis, could reduce certainty around government's mid- and long-term fiscal plans.

In spite of the debt increase, the debt's structure and diversification are satisfactory. Most of the long-term debt is concessional and the short-term debt was just 1,1% of GDP and 2,8% of budget revenues in 2015, hence we foresee no substantial credit risk to the economy in the short run. The investors' long-term negative credit risk perception is becoming more pronounced as the 5Y government bond yield grew by 2p.p. from November 2015 up to 19,7% in May 2016.

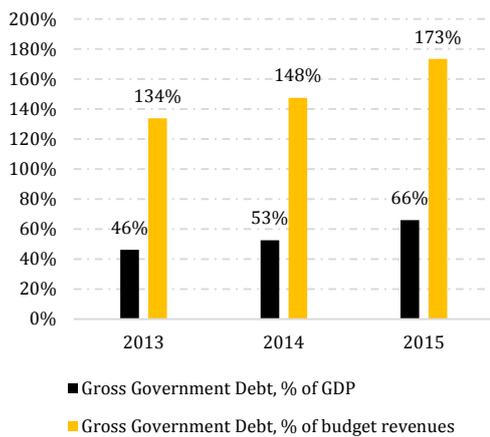
**Fiscal balance is improving.** The fiscal deficit has narrowed by 4,7 p.p. since 2010 and by 1,9 p.p. from a year ago to reach 1,2% in 2015. However, the positive dynamic was a result of one-off non-tax revenues and the delay in some major capital expenditure and investment projects. In general, tax revenues decreased from 20,6% of GDP in 2014 to 20% of GDP in 2015 (estimated by the IMF) as trading activity slowed down and the

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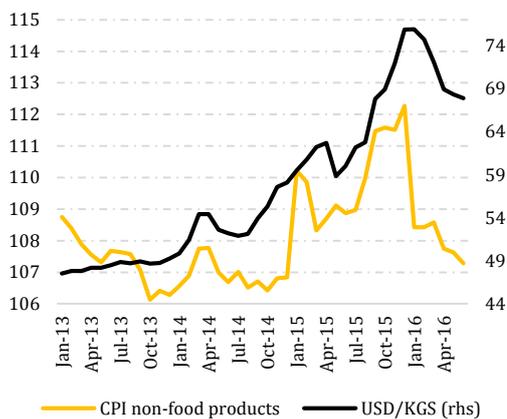
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**Graph 1: Government debt metrics**



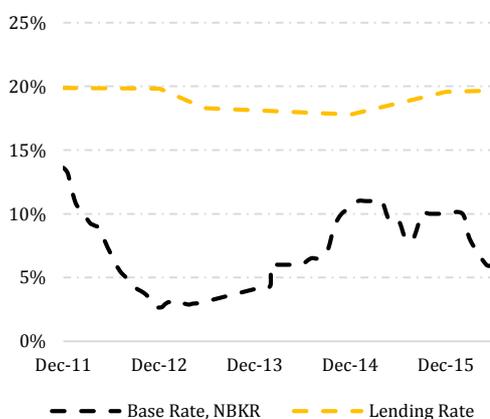
Source: RAEX (Europe) calculations based on data from IMF

**Graph 2: Exchange rate pass-through**



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

**Graph 3: Monetary transmission mechanism, %**



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

fact that the shadow economy still represents a big part of the economy (between 24% and 40% of GDP), thus, the sustainability of such a tight fiscal deficit is under question.

In our view, maintaining a stable balance will largely depend on the quality and intensity of tax collections and further materialization of the privatization plans.

**Monetary targets are not met.** The National Bank of the Kyrgyz Republic (NBKR) continues to miss its inflation target set at 5-7% in the medium term. The CPI index grew by 10,5% in 2014, by 3,4% in 2015 and, as of June 2016, it only increased by 1,5% y-o-y driven by the decrease in international food prices.

However, when controlling for food prices, the strong influence of the exchange-rate pass-through on the price level is even more evident (see graph 2). Non-food inflation at year-end 2015 (12,3%) reflected the steep currency depreciation in the second half of last year and lower non-food inflation at mid-2016 (7,3%) is a result of an appreciating KGS (11,3% against the USD from January to July 2016) which, at the same time, translated into lower import prices (imports represented 87,68% of GDP in 2014).

Furthermore, the transmission mechanism of the NBKR monetary policy remains hampered by the still high dollarization levels which stood at 63,3% and 46,9% of total deposits and loans respectively in June 2016 (see graph 3).

**Risk exposure of the banking sector has increased.** Average ROA of the banking sector turned negative (-0,2%) in 1Q 2016 and NPLs increased to 8,8% in May 2016 from 7,1% at year-end 2015. Despite this, banks' capital to assets ratio reached a level of 16,3% as of May 2016 (see graph 4).

In general, the banking sector remains underdeveloped with bank's assets and credit to private sector relative to GDP at 42% and 22,7% respectively in 2015. Furthermore, access to banking institutions is limited to larger cities and only a few financial instruments are available.

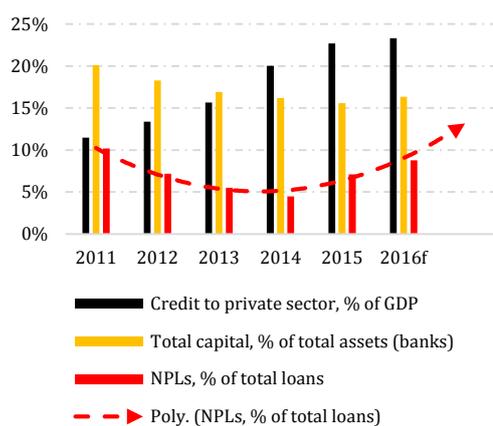
In addition, the industry is highly concentrated with the five largest banks holding more than half of all deposits in 2015. Loans are usually issued in the trade and agriculture sectors (with 50% of loans in these industries), which may promote vulnerability in the case of further economic slowdown, exchange-rate volatility and decline in the quality of collateral.

**Credit environment quality deteriorated.** Volatile interest rates alongside underdeveloped financial markets and increasing corruption have further hurt the country's credit climate.

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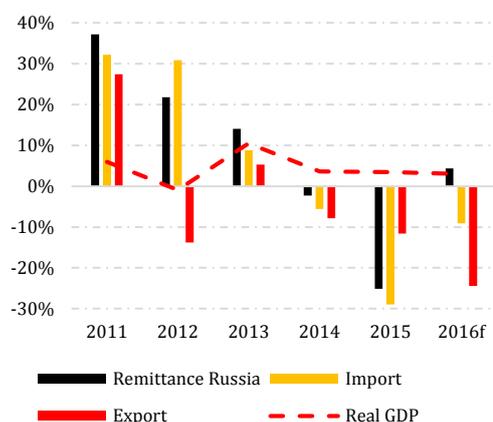
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**Graph 4: Banking system indicators**



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

**Graph 5: External sector and real GDP, % growth**



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

The Kyrgyz bank-based financial system is characterized by very high and volatile levels of real interest rate (12,9% in 2014 and 21,6% in 2015) and rather high spread between deposit and lending rates of around 7,1% by November 2015. In regard to financial markets, despite a significant increase in the Kyrgyz Stock Exchange (KSE) index (20% since the start of the year), these remain small-scaled and concentrated which harms the prospects of growth, especially for SMEs.

Moreover, national savings to GDP ratio of 14,2% in 2015 is a proxy for the low investment potential in the country. Likewise, the economy lacks competitiveness as shown by a low (the lowest among CIS peers) competitiveness index (from the WEF) in 2015 and a very high dependence on imports and concentration on gold exports. Furthermore, Kyrgyzstan is defined by a substantial level of corruption.

**Exposure to external shocks continues to be a problem.** Kyrgyzstan, to a very large extent, depends on remittances from neighboring countries which have declined by 4,3p.p. from 30% of GDP in 2014 to 25,7% of GDP in 2015. This is mainly explained by the steep slowdown in the Russian economy and the substantial depreciation of the RUB since Russia accounted for 97% of net remittances inflow (according to 2015 data).

Kyrgyzstan's trading activity is greatly exposed to the CIS region. Imports from and exports to CIS countries constitute 54% and 50% respectively according to the NBKR. Nearly 37% of exports and 10% of GDP constitute gold exports leaving the country greatly exposed to the fluctuating market prices of gold, as well as to the operations of Kumtor, the country's biggest gold miner.

**Real GDP expected to slowdown in 2016.** The Kyrgyz nominal GDP growth was negative as of June 2016 at -2,3% and real GDP growth is projected by the IMF at 3% for 2016; 0,5p.p less than the 3,5% figure posted in 2015.

The slowdown will be mainly caused by a decrease in remittances and trading activity (as a result of depreciation of RUB and economic instability in the region) (see graph 5), as well as due to current and expected low oil prices.

It is worth mentioning that whereas overall GDP contracted in the first half of the year, non-gold GDP stayed flat, as gold production by Kumtor decreased, and is projected to be 2,9% (contracting from 4,5% in 2015) by the end of 2016.

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

[http://raexpert.eu/reports/Press\\_release\\_Kyrgyzstan\\_29.07.2016.pdf](http://raexpert.eu/reports/Press_release_Kyrgyzstan_29.07.2016.pdf)

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

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