

# **Current Account Imbalance of the Kyrgyz Republic**

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## **Abstract**

The given research aims to assess sustainability of the current account deficit of the Kyrgyz Republic that exceeded 20 percent of GDP in the last three years. The evaluation is made through factor analysis proposed by Roubini and Wachtel in 1998 that suggests consideration of sources of the current account deficit, forms of its financing and additional factors such as growth of the economy, real exchange rate and political situation as an assessment method. The study reveals that there are numerous factors that undermine the sustainability of the deficit, including low level of national savings and foreign direct investment, large trade deficit and external debt, as well as political instability. In the final part several policy recommendations are provided that are expected to improve the sustainability of the current account imbalance.

## Acknowledgments

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## List of Abbreviations

ABD	Asian Development Bank
AUB	Asia Universal Bank
BoP	Balance of Payments
CA	Current Account
CIS	Commonwealth of Independent States
EEU	Eurasian Economic Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GNI	Gross National Income
ICOR	Incremental Capital Output Ratio
IMF	International Monetary Fund
KGS	Kyrgyz Som
KR	The Kyrgyz Republic
NBKR	National Bank of the Kyrgyz Republic
NSC	National Statistical Committee of the Kyrgyz Republic
PED	Public External Borrowing
REER	Real Effective Exchange Rate
TED	Total External Borrowing
USD	United States Dollar
WB	The World Bank

## Introduction

Globalization and rapid development of certain less-industrialized economies tend to change the balance of power in the international arena. Such events triggered intensification of competition and increased the barriers for entering the international market for the newcomers. It is believed that the countries which were less steadily integrated into the global trade have limited chances of becoming more competitive and to sustain current account balance. Such problem usually referred to the transitional economies and the countries with limited chances for increasing their exports.

A country's current account is a critical indicator of the economy's health and represents the difference between a nation's savings and investment. Being besides the sum of the balance of trade, current transfers and income factor, a current account has the potential to indicate whether a country relies on foreign savings to fund its operations or exports savings for the same reasons. When economies run large current account deficits for a number of years, concerns often arise about the sustainability of those deficits. Current account is considered to be sustainable if the trade deficit can be turned into the trade surplus smoothly without leading to a financial crisis (Milesi-Ferretti and Razin, 1996). If the country runs unsustainable current account deficit it risks to end up with either currency crisis or external debt crisis. Thus, evaluating the current account sustainability is of high importance.<sup>1</sup>

Alike a lot of countries with transitional economies the Kyrgyz Republic struggles to overcome current account deficit. Moreover, the present indicators reveal that comparing to the previous years, today Kyrgyz Republic suffers from the biggest current account deficit. According to the recent reports, the country had -1821.2 million USD of current account deficit in 2014, which is considered to be the lowest as a percentage of GDP throughout the period of

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<sup>1</sup> Parts of the given thesis initially appeared in the term paper prepared for the course of Economic Policy Seminar Series in December 2014.

2012-2014 (National Bank of the Kyrgyz Republic<sup>2</sup>, 2015). Such figures can have different reasons, for instance, high trade deficit. The Kyrgyz Republic has been experiencing constant trade deficits as the state's exports are much smaller than the imports. According to the NBKR (2015), in 2014 the country had -3435.5 million USD of trade deficit. The country's biggest export resource is gold, while it mostly imports fuel, transport equipment, and machinery.

The Kyrgyz Republic hasn't been able to overcome the current account deficit or trade imbalance for a long time. However, it has to be noticed at this point that not all scholars support the vision of a negative impact of current account deficit on the economy of the country. There are several ways for solving this problem that were used by the other countries experiencing the same situation. For instance, trade deficit problem was addressed by implementing policies that would reduce imports and increase exports. For the same reason, the government spending could be revisited in order to favor local suppliers. There is also a strategy to influence the exchange rates in order to make the exports cheaper for the foreign buyers and to enhance balance of payments. In the critical situation the government can devalue the national currency for the reason of remaining competitive in the international market.

### *Aims and Objectives*

The current research aims to assess sustainability of current account deficit of the Kyrgyz Republic and to determine why it experienced such sharp deterioration in recent years. It is also important to find out what actions the country's policy-makers have to implement in order to improve the situation with current account imbalance. Besides, at present there are no studies that evaluate sustainability of the current account of the Kyrgyz Republic, so the given thesis aims to fill this gap.

The following questions will be answered in the course of the study:

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<sup>2</sup> Further in the text referred to as NBKR.



1. Is current account deficit of the Kyrgyz Republic sustainable?
2. What policies have to be introduced to reduce the deficit?

The thesis is organized in the following way: Chapter 1 makes an analysis of the main sources of the Kyrgyz Republic's current account deficit, namely whether the deficit is a result of a drop in savings or of a decrease in investment made into the economy. Furthermore, the main parts of the current account are examined, that is trade balance, current transfers and income factor. Chapter 2 covers the main sources of the Kyrgyz Republic's current account deficit financing, in other words capital account, external debt and foreign exchange reserves. Chapter 3 studies additional factors that are important to consider while analyzing the current account deficit, specifically, growth of the economy, real exchange rate, financial system and political situation in the country.

## Literature Review

The International Monetary Fund Balance of Payments Manual (1993) defines the current account “as a component of the balance of payment accounts, which systematically summarizes transactions in goods, services, income and transfers between residents of an economy and the rest of the world in a given time period, usually a year” (p. 52). Some scholars consider current account imbalance a serious problem for the country as well as the foreign countries that provide a financial aid for the state. Yet, in some cases, it was reported that the impact of the current account imbalance is exaggerated, as the country have the instruments to sustain it.

Nakunyada & Chikoko (2012) explained that the country which aims to sustain persistent current account imbalance is forced to become a net borrower limiting its further foreign exchange revenues in order to eliminate external debt and to follow obligations before the countries providing the aid. Overall, if the country borrows more than it can return and do not invest it into the long-term ventures that can accumulate long-term sustainable revenues, it leads to the reluctance of the other countries to provide any additional aid. Therefore, in case when the current account experiences ongoing deficit for a prolonged period of time, it becomes a signal for the sustainability concern for the state’s economy.

Maintaining or sustaining balanced current accounts is a common problem that many developing countries face. Such situation happens due to the fact that the majority of developing countries are closely connected to imports of various types of products for the consumption in the reason of intensification of growth of the populations and investment segments (Yol, 2009). At the same time, there is also a possibility that within such economies the exports are uncompetitive in the international market. As the result, the boosting difference between constantly expanding imports and minimized or stagnant exports triggers current account deficits to be unsustainable.

The sustainability of current account has recently become the central focus not only to the academics and policy makers, but also to the central bank and the market analysts of emerging and transitional economies. In a lot of cases the sustainability of the current account is detected through the solvency or inter-temporal analysis. According to intertemporal approach of Milesi-Ferretti and Razin (1996), the sum of funds a certain country borrows or lends in the international market has to reflect the current value of trade surpluses or deficits. In the case when a current account is sustainable, it means that the imbalance experienced by the economy may be returned through the surpluses obtained in future. The approach is usually tested through the econometric models that aim to reveal stationarity of the current account imbalance utilizing specific tests (Yol, 2009).

Unfortunately, due to lack of data the mentioned econometric model cannot be used to assess the sustainability of the Kyrgyz Republic. As an alternative, a factor analysis proposed by Roubini and Wachtel (1998) was implemented in the given thesis which suggests that consideration of sources of the current account deficit, forms of its financing and additional factors (e.g., growth of the economy, political situation, etc.) can be used to examine the sustainability of a current account deficit.

When considering the inter-temporal specifics of the current account and capital account relationship, it is possible to claim that in a strong economy, a trade deficit can be sustained only when the growth rate of national income overwhelms the rate of return paid on the nation's liabilities (Hervey & Merkel, 2000). While it was largely implied by experts that the long-term current account imbalance is a signal of unhealthy economy, there are precedents when the countries tend to sustain them in a short period of time. Rapid and unexpected improvements of economies of the South East Asian countries, like Singapore, Malaysia, or Taiwan showed that it is possible to improve the situation with the appropriate policies.

A study conducted by Mauleon & Larrion (2003) produced the results claiming that the depreciation of the exchange rate of Malaysia and Singapore after the crisis erupted in the region eventually triggered the enhancement of their current accounts. In addition, experiencing trade deficit, the states tended to reduce import, yet, failed to boost the country's international export. Therefore, there is a possibility to bring about sustainability of the current account balance through the traditional methods of dealing with the problem of deficit.

In the analysis of the current account deficit observed in the United States, Mann (2000) underlined that sustainability could be accomplished through structural changes in the economy of the country and in the systematic approach to investment by the government. As the analysis showed, the attraction of the foreign financial injections into the economy may put the country into the dependent position, which in the case of absent long-term revenues can lead to the unsustainable current account imbalance. At the same time, the effectiveness and productiveness of each of policy interventions depends directly on each situation, the structure of economy of the country, the actions made by the government, and the resources obtained by the state.

## Chapter 1. Current Account of the Kyrgyz Republic

Current account (CA) deficit is one of the basic measures of external imbalance of a country. The dynamics of CA balance of the Kyrgyz Republic in the period from 2005 until 2014<sup>3</sup> is illustrated in Figure 1.

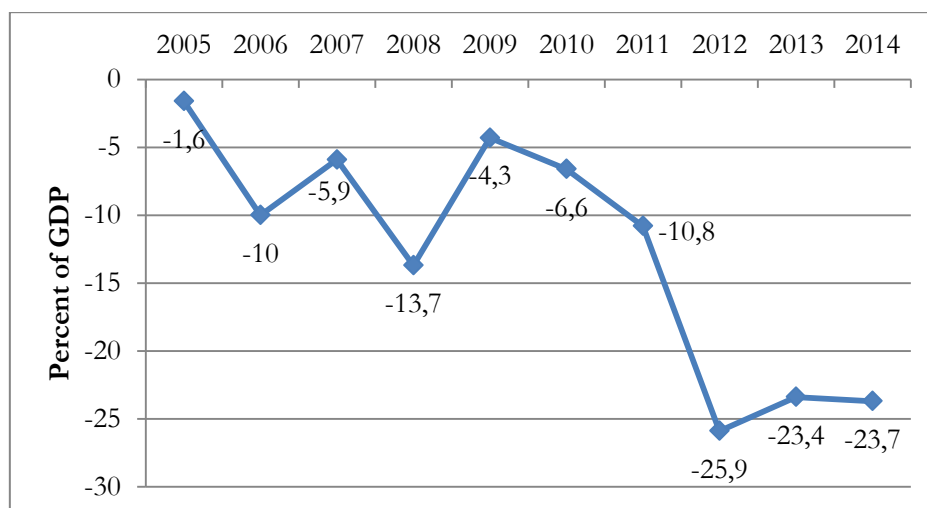


Figure 1. Current account balance of the Kyrgyz Republic.  
Source: National Bank of the Kyrgyz Republic.

We can see that in the last three years the deficit was over 20 percent of GDP. In fact, since 2012 the Kyrgyz Republic has been heading the list of top 10 economies with the largest current account deficits measured as a percent of GDP (IMF, 2015). There are no signs of improvement, as according to IMF projections, current account deficit is going to increase by 3.3. percentage points in 2015 and remain high in 2016. Such situation needs to be a concern for the government, particularly if the deficit is unsustainable.

### 1.1. Savings and Investment

One of the first criteria that should be assessed when evaluating the sustainability of current account deficit is its' *source*. The deficit is considered to be more sustainable if it's caused by increase in investment rather than fall in savings. Figure 2 shows the dynamics of gross national savings and investment into the economy of the Kyrgyz Republic. Current account

<sup>3</sup> The period is chosen based on the data availability for most of the indicators. Data for the year of 2014 is preliminary and is provided throughout the thesis when available in official statistics. Unless otherwise is stated, numbers provided in the thesis are retrieved from the NSC and NBKR.

deficit is supposed to be equal to the savings less investment. However in Figure 2 the difference is not exactly the same as the current account deficit presented in Figure 1. The reason is that the latter is aggregated from the balance of payments. Moreover, there is a methodological issue. The National Statistical office of the country doesn't provide its' estimates of savings, thus it was calculated by the author following the formula used by the World Bank: gross national income less total consumption, plus net transfers.

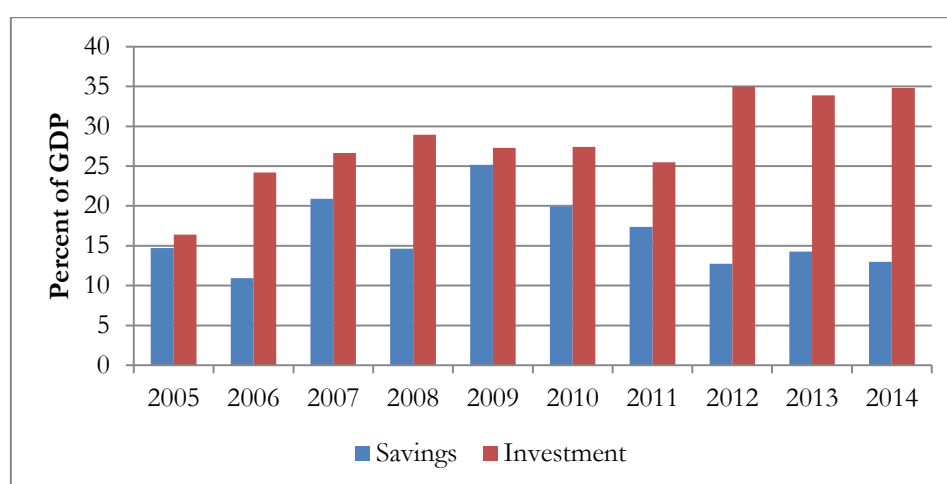


Figure 2. Savings and investment of the KR.

*Source:* National Bank of the KR, The World Bank, author's calculations.

In 2012 both savings and investment contributed to the hike of the CA deficit (Figure 2). Comparing to 2011, investment increased by 49 percent, while savings reduced by 22 percent. The fact that the rise in investment is higher than the decrease in savings seems to be a mitigating factor for current account sustainability, because increasing investment creates more favorable conditions for servicing debts through positive impact on exports of the country (Aristovnik, 2006). However in order to make more accurate conclusions it is necessary to look at the structure of investment as well.

### Investment

According to the NSC (2015), in the considered period domestic funding constituted 65-75 percent of total investment in non-financial assets. Particularly, in 2012 domestic sources funded 67.4 percent of investment. However, such situation doesn't seem to be realistic, because

from Figure 2 we can see that national savings covered not more than 40 percent of investment. Consequently, reliability of official reports appears to be questionable. Nevertheless, official reports in most of the cases are the only source of information, so they had to be used.

The investment rate hike of 2012 mainly came from an increase in fixed capital investment (by 35.2 percent comparing to 2011). This type of investment constitutes more than 90 percent of total investment in nonfinancial assets. The breakdown of fixed capital investment by the type shows that the major part was directed to non-residential building construction (49.5 percent) and purchase and installation of machinery, equipment and inventory (30.7 percent) which is a positive factor in terms of the sustainability of the current account deficit, because such types of investment add to the productivity unlike investment in residential building.

Breakdown of investment by sectors presented in Figure 3 reveals high concentration of investment in two sectors, mining and construction which together make 46.7 percent of total investment. Such pattern is understandable because of gold being country's main exporting product and large infrastructural projects going on.

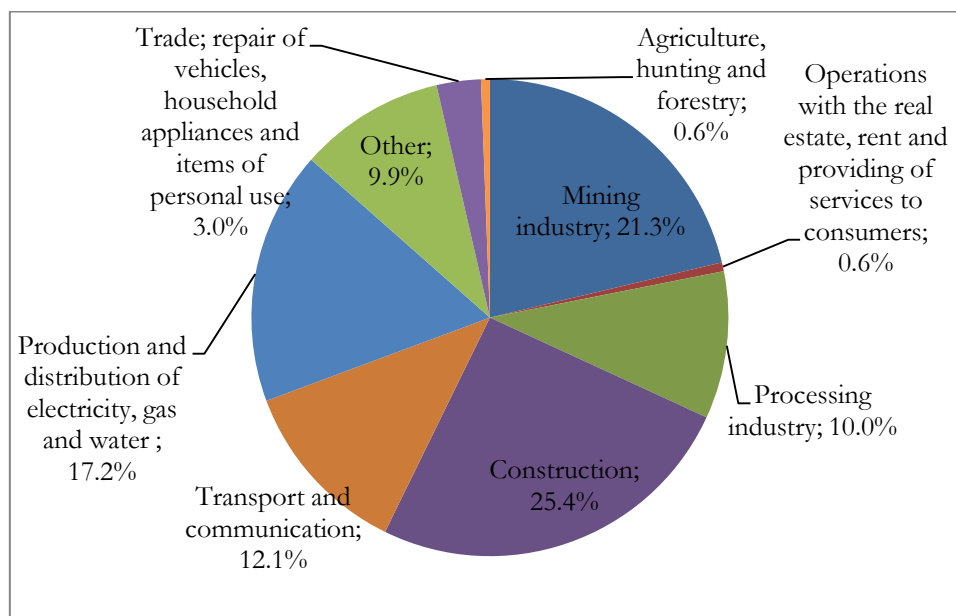


Figure 3. Used investment of the KR in 2014.<sup>4</sup>  
*Source:* National Statistical Committee of the KR.

<sup>4</sup> Similar breakdown has been observed since 2010, mining and construction sectors have been representing the greatest shares.

Nevertheless, low diversification of investment might undermine longer term development prospects. Moreover, investment in mining sector highly depends on the world prices for gold. According to the Prime Minister of the country, lower gold prices in 2014 resulted in lower investment in mining sector which dropped by 13 percent which is another source of vulnerability (Tazabek, 2015).

Another point to be made regarding sector breakdown is that only 0.6 percent of investment was used in agriculture which is too little for the country where this sector has one of the biggest shares of GDP (17 percent in 2012 and 15 percent in 2013 and 2014), moreover agricultural products are one of the main items to be exported. Thus, attention of the government should be drawn for attracting more investment into this sector which can help to improve the trade balance by both increasing earnings from exports and reducing imports.

Public share in fixed capital investment for 2009-2013 was 15.2 percent on average with the greatest share in 2011 (almost 25 percent). The main investment types are infrastructure projects in energy sector (49.7 percent of all investment programs in 2012) and roads (24.5 percent) that are mainly financed by donors. One of the biggest problems of public investment that negatively affects current account sustainability is poor management. Assessment of public investment management implemented by Harnett et al. in 2014 revealed that few projects go through the process of rigorous appraisal. Moreover, implementation progress is not monitored properly which leads to retardation of projects or even coming to a full, and eventually to cost over-runs. It was also noted that in face of increased investment in infrastructure projects, social sector investment, such as in education and rural development, reduced sharply. So, it was suggested that “given the importance of investments in sectors such as education, rural development and agriculture for long-term growth, the government should agree on a systematic approach to maintaining its investment in these critical areas” (WB, 2014, p. 7)



Poor investment management is expected to lead to efficiency concerns. In 2014 Asian Development Bank estimated the efficiency of investment of the Kyrgyz Republic through the computation of the incremental capital output ratio (ICOR), which measures the ratio of investment to the overall growth. The ICOR is also used in evaluating how efficiently the capital is employed in the economy. Most nations have a ratio of 3.0, while the Kyrgyz Republic between the years of 2003 and 2013 observed a measurement of 6.3. This fact implies that in order to generate the same level of growth, it had to seek for higher amounts in terms of investment than most of other countries of the region. In fact, statistical data indicate that the ICOR of the Kyrgyz Republic shifted from 3.8 experienced between the years 2000 and 2005 to 5.4 during the years 2006 – 2011 (ADB, 2014). Thus, the efficiency of the country's investment has deteriorated which is an additional threat for the sustainability of the current account.

### **Savings**

The level of *national savings* of the country is relatively low. The average rate of the considered period is 16 percent of GDP while in the neighboring Kazakhstan it's 28 percent. Moreover, the measured indicator includes net transfers. Gross domestic savings (indicator that doesn't include transfers and is calculated as GDP less total consumption) has been always negative except for the year of 2009. Milesi-Ferretti and Razin (1996) by making international comparison showed that low and falling level of national savings makes the current account less sustainable, thus structurally low savings rate is one of the main issues that need to be addressed.

In 2012 national savings continued to decline (the trend started in 2009). We see from Figure 4 that it happened because of increase in both private and public consumption; in total they reached 116 percent of GDP.

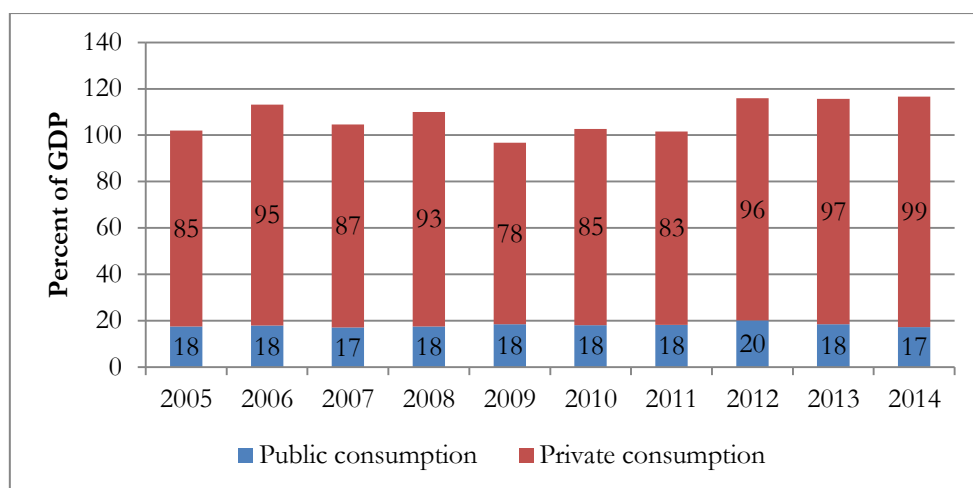


Figure 4. Public and private consumption of the KR.

Source: National Bank of the KR.

Total consumption as a fraction of GDP has been fluctuating because of differences in rates of growth, while the value of consumption has been always increasing except for the year of 2009 (consequence of the global crisis). Year on year change in total consumption was higher in 2011 (28 percent) rather than in 2012 (22 percent), however because of slowdown in nominal GDP growth the fraction increased by 14 percentage points. The average growth rate of private consumption for the considered period was 19 percent, while of public consumption 15 percent.

Deterioration of the state budget balance since 2009 has been contributing to the decrease in the level of national savings (Figure 5).

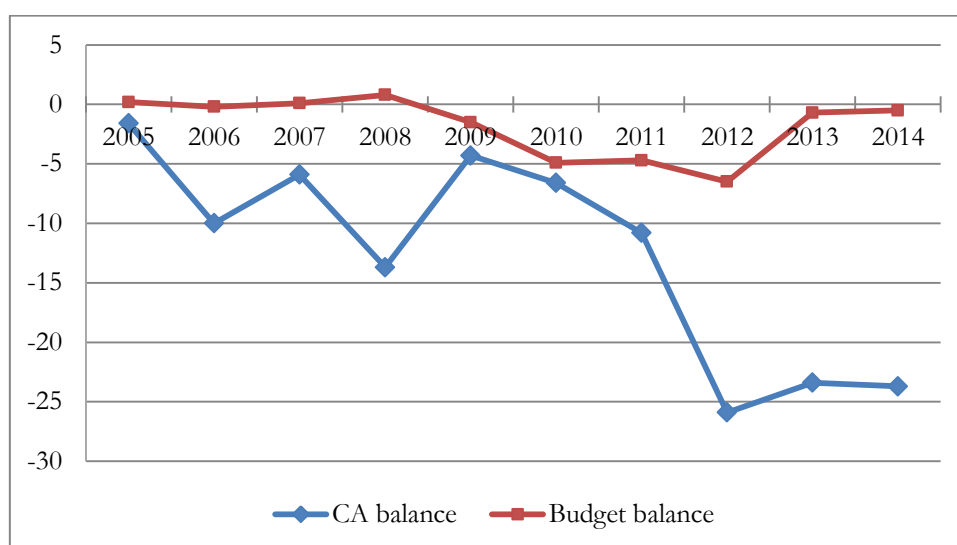


Figure 5. State budget balance of the KR.

Source: Ministry of Finance of the KR.

Deterioration of the budget deficit was caused by several factors:

- In 2009 a new Tax Code was introduced that abolished some taxes (e.g., resort, advertising), introduced other taxes (e.g. turnover, property), but most importantly, the rate of the biggest item in country's tax revenues (Value Added Tax) was reduced from 20 to 12 percent.
- In 2011 a number of legal acts were adopted that increased social spending (e.g. salaries in healthcare and education, pensions and subsidies).
- Large-scale projects in power industry and transport were initiated (e.g., modernization of power lines in the south of the country, reconstruction of the road connecting the north of the country and China in the south).

Consequently, budget revenue growth rates slowed down while expenditures increased. As a result, budget deficit reached 6.5 percent of GDP in 2012. The situation improved in 2013, however not as a result of better management, but mainly thanks to increase in official transfers (by 60 percent) and decrease in expenditures on economic issues (by 82 percent) primarily, due to change of methodology. According to the Ministry of Finance of the Kyrgyz Republic, in 2015 budget deficit is expected to increase to 3.3. percent of GDP as a result of increase in expenditures. Increase in budget deficit would imply lower level of national savings and increase in external borrowing to finance the deficit. As a result, fiscal imbalance of the Kyrgyz Republic contributes to persistent current account deficit.

## ***1.2. Trade Deficit***

Current account deficit of the Kyrgyz Republic mainly comes from the deficit of the trade balance which adds to the unsustainability because such situation indicates the problems in structural competitiveness. According to the Global Competitiveness Report of the World Economic Forum (2014), the country ranked 108 out of 144 which suggests that local products

can poorly compete on the international markets. The country's total exports have never been higher than its imports.

The transition after the dissolution of the Soviet Union followed by subsequent political and economic instabilities was a challenging process for the country. The country has chosen a rather liberal trade regime strategy on its' path to development. On December 20th, 1998, the Kyrgyz Republic has become the first former Soviet Republic to enter the World Trade Organization. The lowest trade barriers in the region and the fact that the country shares borders with China has led to large inflow of goods from abroad. Additionally, the collapse of the Soviet Union had broken most of the economic ties, which stopped large amounts of local production. It took time to adjust infrastructure and overcome political problems to initiate exports to countries outside the post-Soviet territory (Kurmanalieva, 2008).

In the considered period export and imports of the country as a percentage of GDP increased from 95.1 percent in 2005 until 143.1 percent in 2013 (WB, 2015). Figure 6 illustrates the evolution of the trade deficit of the country.

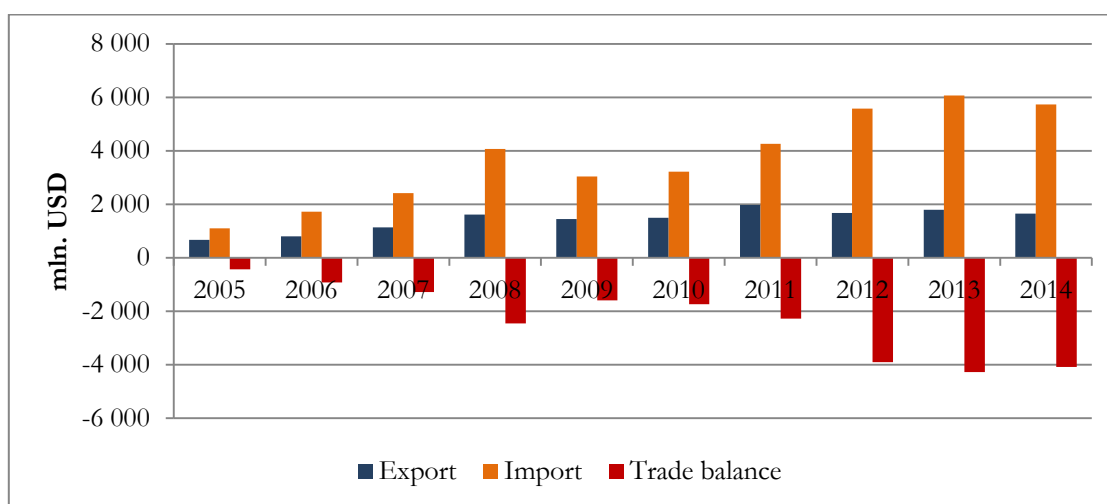


Figure 6. Export, import and trade balance of the KR.  
Source: National Statistical Committee of the KR.

The gap between export and import has been widening since 2010 and somewhat declined in 2014, but remained big. The hike in trade deficit of 2012 was caused not only by large

import demand which increased by 26.1 percent in that year, but also by insufficient export growth. In fact, exports decreased by 14 percent in 2012 comparing to 2011 as a result of drop in gold production. In 2013 thanks to improvements in gold production exports increased by 5 percent compared to 2012.

One of the main export problems is its high concentration on gold which constitutes one third of total exports and decline in gold production is the foremost reason of contraction of exports. Other main exporting items of the country are mineral and energy products which on average constituted 16.7 percent of total exports in the last 10 years, textile and textile products accounted for 10 percent and vegetable products – for 7 percent. Thus, the country highly depends on the volume of gold production as well as on the world prices for this commodity. As a result, existing trade situation makes the country extremely vulnerable.

The Kyrgyz Republic has a problem of not only product concentration of export, but also geographical concentration. Even though the Kyrgyz Republic has trade relations with more than 140 countries, the biggest parts of certain products are exported to a single or a couple of countries. For example in 2013, 97 percent of the main exports item (gold) was exported to Switzerland and United Arab Emirates; 75 percent of vegetables – to Turkey and Kazakhstan, 75.7 percent of motor vehicles – to Uzbekistan, 76.9 percent of fruits and nuts, 96.1 percent of articles of apparel and clothing accessories, 100 percent of inorganic chemicals, 99.9 percent of electric current and 92.1 percent of ores and concentrates of precious metals – to Kazakhstan; 95 percent of cotton – to Russia and Turkey. Such high geographical concentration makes the country dependent on the economic situation and trade policies of those individual countries.

In the considered period imports of the country increased by five times, primarily because of increase in commodity prices. The main import sections are petroleum products (29 percent of total imports, mainly gasoline, gas oils and kerosene), machinery and transport equipment (27 percent), manufactured goods (19 percent), and food and live animals (11 percent

of total imports). Russia has the biggest share in imports of the country (33.6 percent of total imports in 2013), followed by China (23.9 percent) and then Kazakhstan (9.4 percent). Thus, Russia, China and Kazakhstan being the main trade partners of the Kyrgyz Republic is consistent with the Gravity Model of trade which assumes that size and distance are important for the trade between countries (Krugman et al, 2015).

Export of the country is considerably dependent on the import, as required equipment, supplies and raw materials are either not produced domestically or produced in limited amount, namely petroleum products, electrical machinery and equipment, plastics, rubber, ferrous metals, ground transport means, fabrics, fertilizers and others. Therefore, the share of such import items is about 70 percent. Such situation makes it difficult to increase export without increasing import correspondingly. So, this interconnectedness should be taken into great consideration when addressing the trade deficit of the country.

### ***1.3. Remittances and Income Factor***

The second largest part of the current account after the trade balance is current transfers, 94 percent of which are *remittances*. The Kyrgyz Republic is second most remittances-reliant country in the world<sup>5</sup>, as they make up more than 30 percent of GDP. Table 1 shows that flow of remittances increased by more than five times in the period from 2005 till 2013. A significant surge has been caused by the growing flow of migrants, mainly to Russia.

Year	2005	2006	2007	2008	2009	2010	2011	2012	2013
<b>Net inflow</b>	448.7	686.7	951.4	1392.4	990.3	1243.8	1661.4	1951.1	2101.3

Table 1. Net inflow of remittances of the KR, mln. USD

Source: National Bank of the KR

Remittances cover approximately 50 percent of the trade deficit which might seem to negatively affect the sustainability of the current account, because future availability of those resources heavily depends on the economic situation of countries-originators. Nevertheless,

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<sup>5</sup> Tajikistan is the first.

reduction in remittances is expected to lead to decrease in imports because of a self-reinforcing mechanism: Kyrgyz people receive money from their relatives abroad and spend them for buying imported goods. Thus, overall effect of high remittances on current account sustainability is unclear.

According to the NBKR, remittances from Russia increased by 4 percent in 2014 when estimated in local currency, Kyrgyz som. However, supranational organizations such as the World Bank report that remittances have decreased in 2014 and that it is the main channel of spillover from economic problems of Russia (Trilling, 2015). Considering the depreciation of Kyrgyz som and Russian ruble against US dollar, remittances might have decreased in USD values which is the most likely explanation for contradictions.<sup>6</sup>

Analysis of remittance inflows by quarters reveals that the Kyrgyz Republic started feeling the economic slide of Russia in the end of 2014, as volume of remittances estimated in Kyrgyz som started decreasing in fourth quarter of 2014 (by 8.8 percent comparing to the similar period of 2013) and in the first quarter of 2015 there was a 9.5 percent decrease comparing to the first quarter of 2014. As economic slowdown in Russia is not over, remittances are expected to keep decreasing.

The Kyrgyz Republic is a net foreign borrower; as a consequence, the third (smallest) component of the current account – *income factor* – has been always negative and averaged at 235 million USD in the considered period. This item constituted 10 percent of the CA deficit in 2012, but it increased to 22.9 percent in 2013 mainly due to increase in repatriated income of foreign direct investors. In 2014 income account made 12.5 percent of CA deficit. It would be extremely useful to look at the way the given item is created in order to make some conclusions, for example, to see whether it's mainly repatriation of profits of foreign investors of gold mining sector. Regrettably, there's no detailed data regarding this issue in the official publications.

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<sup>6</sup> The NBKR's estimates of remittances in USD for 2014 haven't been published yet.

## Chapter 2. Sources of Current Account Deficit Financing

### 2.1. Capital Flows

Analysis of the volume and structure of external capital inflows is vital for assessment of current account sustainability as various types of foreign investment have different sustainability implications. Current account deficit is more sustainable if it is financed by Foreign Direct Investment that does not generate debt and it is less volatile source of financing (Aristovnik, 2006). Figure 7 shows that in 2012 there was a substantial drop in net inflows of FDI; it reduced by 58 percent in year on year terms and covered just 17 percent of the CA deficit. The biggest inflow of capital was in the form of net external borrowing (26 percent of the CA deficit) which makes the deficit unsustainable as the country accumulates external debt.

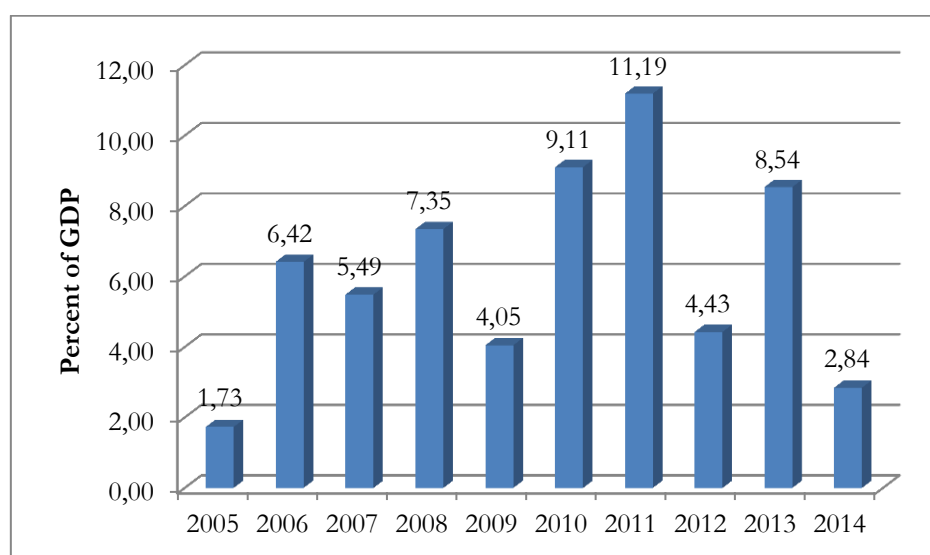


Figure 7. Net foreign direct investment into the KR.  
Source: United Nations Conference on Trade and Development.

In terms of financing the situation improved in 2013. FDI inflows increased by 160 percent and made up 45 percent of the CA deficit, however in 2014 the rate dropped by 66 percent and covered only 11.6 percent of the deficit. Thus, low and unstable inflow of FDI puts the current account deficit in a fragile position.



Major part of FDI (67.8 percent on average for the period in consideration) comes in a form of loans, either received from foreign co-owners or trade loans, 20.7 percent is reinvested income, and 11.2 percent is equity investment.

Foreign direct investment is concentrated in the sector of operations with real estate, rent, and services provision to consumers (42 percent of total FDI in 2013) and in processing industry (32.9 percent). More than 90 percent has been going only to four territories<sup>7</sup>: the capital of the country Bishkek (45 percent), Chui (18.5), Issyk-Kul (17 percent), and Jalalabad (10.7 percent). As we can conclude, providing incentives for diversification of FDI by sectors and regions is another area for development.

Major inflow of FDI is from non-CIS countries which in the last ten years accounted for 72 percent of total FDI on average. Foreign direct investment from China has been rapidly increasing, if in 2005 it accounted only for 2 percent of total FDI, by 2013 its' share increased until 49 percent. The second largest investor is Canada (11 percent of total FDI in 2013) followed by United Kingdom (8 percent). The main CIS investors, as can be expected, are Russia (7 percent) and Kazakhstan (5 percent).

One of the mitigating factors for the sustainability of the current account in terms financing is low level of portfolio investment as such type of investment can be reversed easily. In the last three years portfolio investment financed just 0.3 percent of the CA deficit.

Capital transfers item of the capital account financed 10 percent of CA deficit in 2012, the main contributors were debt relief by Turkey (49.2 million USD)<sup>8</sup> and grants within the framework of the government investment program (100.5 million USD). In May 2013 Russia wrote-off 188.9 million USD of Kyrgyz debt in return of 48 percent of shares of a torpedo

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<sup>7</sup> The Kyrgyz Republic is divided into 7 regions that are named oblasts.

<sup>8</sup> No official conditions for the debt write off were set; however, there were concerns that Turkey has interests in some strategic objects of the Kyrgyz Republic. (De facto, 2012)

producing plant (The Moscow Times, 2013)<sup>9</sup>; as a result capital transfers item reached its historic maximum (280.3 million USD) and covered 17 percent of the current account deficit. In 2014 current transfers dropped by 77 percent comparing to 2013 and financed 3.5 percent of CA deficit.

It has to be noted that there is a problem of incomplete registration of capital inflows as in the last three years Errors and Omission item of Balance of Payment made up around 50 percent of current account deficit. Another point to make is that in 2014 for the first time in the considered period BoP had a negative balance which was mainly financed by NBKR reserves.

## 2.2. External Borrowing

*Debt burden* of the country has been problematic. In the beginning of the century public external debt fluctuated around 100 percent of GDP. The country was suggested to join the HIPC initiative (Heavily Indebted Poor Countries). Within the framework of that initiative debt of the country would had been cancelled. However the initiative faced fierce opposition from the society, because participation in the initiative was perceived as losing the control of the power by the state, so the government had to refuse to join the initiative (Liebert et al., 2013).

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
TED, % of GDP	81.4	79.4	93.0	66.6	84.6	88.7	80.0	80.2	83.3	86.4
PED, % of GDP	75.6	69.4	54.3	40.6	53.7	55.4	47.5	46.3	43.8	46.7

Table 2. Total (TED) and public (PED) external debt of the KR.  
Source: National Bank of the KR.

Debt restructuring (in 2002 and 2005) and debt forgiveness as well as better economic growth, nominal exchange rate appreciation and fiscal consolidation helped to bring down the public debt till 75.6 percent of GDP by 2005 which kept decreasing until the Global Financial Crisis hit the world (Table 2).

<sup>9</sup> In the end, the deal was not finished. By 2014 Russia lost its interest in the factory. (Kucera, 2015).

Assessment of the debt sustainability performed by IMF in 2011 concluded that “[t]he baseline scenario points to a *cautiously* favorable improvement in the external debt outlook over time” while “[s]tress tests and alternative scenarios show that the Kyrgyz Republic’s external debt is vulnerable to large shocks or substantially less favorable assumptions” (IMF, 2011, p. 5).

A year after the mentioned assessment was performed there was a contraction of the economy, reduction in exports and high budget deficit which added to the unsustainability of the debt burden. Moreover, total external debt to GDP ratio has been larger than the acceptable level of 80 percent (threshold suggested by the World Bank) most of the years which is also challenging. Furthermore, according to the International Debt Statistics of the World Bank (2015), ratio of external debt stock to exports of goods and services reached 217.3 percent in 2013 which is really close to the threshold of 220 percent to become classified as highly indebted. In 2014 as a result of increased capital investment in infrastructural projects, the public external debt increased by almost 3 percentage points.

However, there are two mitigating factors. First, is that 90.6 percent of total external debt is long-term. Second, is that majority of loans are concessional from donors, so they are less reversible in the short run. The main creditors of the country are The Export-Import Bank of China which currently holds 32.5 percent of total external debt, International Development Association (The World Bank group, 19.5 percent) and Asian Development Bank (17 percent).

The fact that external debt is taken in foreign currency poses additional risks. According to the Ministry of Finance of the country (2015), depreciation of the Kyrgyz som by 19 percent in 2014 increased country’s external liabilities by 30 billion KGS which is 7.5 percent of GDP. Thus, existence of large amount of debt whose sustainability is vulnerable to shocks makes the current account deficit less sustainable as well.

### 2.3. Foreign Exchange Reserves

In the period between 2005 and 2014 capital account was less than the current account in 5 years; nevertheless international reserves have been steadily increasing up until the year of 2013 (Table 3). Presence of Errors and Omissions item of the Balance of Payments contributed to this. It indicates incomplete statistical registry of transactions related to either inflow of capital into the country or undercount of the exports. In 2014 the stock of international reserves reduced for the first time in the considered period as a result of active NBKR interventions directed to support rapidly depreciating domestic currency.

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Stock of reserves, billion USD	0.6	0.8	1.18	1.2	1.6	1.7	1.8	2.07	2.2	1.9
Reserves in months of future import	3.2	3.0	3.0	4.1	5.0	4.2	3.4	3.7	4.1	3.9

Table 3. Foreign exchange reserves of the KR.  
*Source:* National Bank of the KR.

Table 3 demonstrates that reserves of the country are adequate when evaluating according to the benchmark of covering 3 months of future imports. However, deeper assessment of adequacy performed by IMF (2013) revealed that buffers are limited and that existing level of international reserves might not be adequately resilient to gold production disruptions similar to the one experienced in 2012 and to external shocks. Since the time the mentioned assessment was performed, the situation got worse as NBKR has been using up reserves to reduce the volatility of the exchange rate. That is why questionable adequacy of foreign exchange reserves adds to unsustainability of the current account deficit.

## Chapter 3. Additional Factors Affecting the Sustainability of the Current Account Deficit

### 3.1. Economic Growth

One more factor that should be estimated in terms of current account sustainability is *GDP growth* of the country (Figure 8). “Higher growth rates are related to more sustainability of the current account deficit because, everything else equal, higher growth will lead to a smaller increase in the foreign debt to GDP ratio and make the country more able to service its external debt.” (Roubini and Wachtel, 1998, p.6).

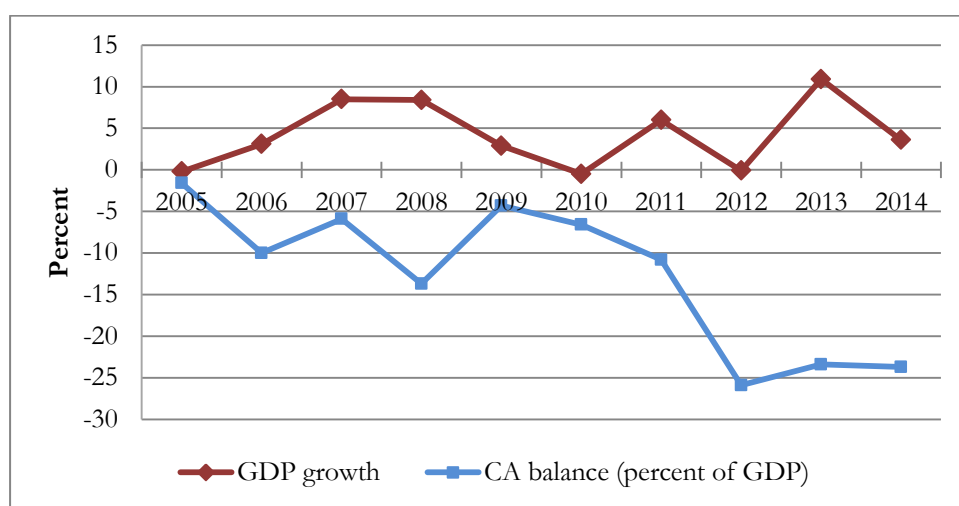


Figure 8. GDP growth and current account balance of the KR.  
Source: National Bank of the KR.

Since 2005, GDP growth has been varying between -0.5 and 10.9 percent (Figure 7). In the last ten years the average growth rate was 4.3 percent which is the lowest in the region (The World Bank, 2015). If we look at both GDP growth and CA balance over the years, no distinctive common trend can be observed. GDP was growing at a higher rate until 2007-2008, but then we see a rapid fall in the indicator. That is probably the consequence of the world financial crisis on the economy. However, after that, instead of stabilization of economic growth one can observe further decline until 2011. In 2010, GDP contracted by 0.5 percent. The main

reason is obviously the political downturn and subsequent instability that took place in the country during that year which had a negative effect on all sectors of the economy.

In 2011, the economy started to stabilize, reaching higher than 5 percent growth. However, in 2012 the economy was in a bad shape again, and hike in current account deficit was not associated with real growth of the economy. In fact, GDP contracted by 0.1 percent as a result of the drop in gold production. In 2013 the growth was reported to be 10.9 percent, however such impressive number can be attributed not only to rehabilitation of gold production, but also to low base of 2012.

The data for 2014 shows that GDP growth constituted only 3.6 percent. One of the main reasons of the slowdown is decrease in gold production. Projections of 2015 are even more pessimistic. According to the Ministry of Economy (2015), real GDP growth is expected to be only 2 percent as a result of regional slowdown, electricity shortage, low level of investment climate, and potential adverse effects of upcoming Parliamentary elections. Hence, absence of stable economic growth and its high dependence on gold production exacerbates concerns regarding the sustainability of the current account deficit.

### ***3.2. Real Exchange Rate***

*Real exchange rate* has to be also considered when evaluating the current account deficit. Real exchange rate appreciation might contribute to unsustainability of the deficit as it might bring to increase in imports of consumer goods and capital goods for investment (Roubini and Wachtel, 1998). The transmission mechanism would be the following: appreciation of the local currency (which is reflected as a decrease in REER index) will make imported goods cheaper comparing to domestic goods. As a result, increase in imports would be observed which will lead to deterioration of the trade balance and increase in current account deficit.

The Kyrgyz Republic has been maintaining floating exchange rate regime since the introduction of its own currency – Kyrgyz som in 1993. The National Bank of the country makes interventions in the foreign exchange market in case of sharp fluctuations in order to smooth them out.

In 2013 IMF implemented a quantitative assessment of Kyrgyz real exchange rate using various econometric methodologies. The first one, equilibrium real exchange rate approach (ERER) model takes into account terms of trade, government consumption, productivity and initial foreign assets. The model estimates equilibrium exchange rates and then differences with the actual data are calculated. The smaller the difference, the more real effective exchange rate values are in line with fundamentals. The resulting estimated disequilibrium of this approach was about -7.7, indicating undervaluation.

The next approach is called macroeconomic balance (MB) approach, which models equilibrium value of the current account balance to output ratio. The disequilibrium is then calculated as a change in REER, which is required to achieve the estimated current account norm. The closer the actual and estimated current account levels, the more REER are in line with fundamentals. The result of this estimation was similar to the previous one pointing at 8 percent undervaluation.

The last approach, external sustainability (ES), is rather similar to the previous one. It equates the current account norm to the current account balance to output ratio that is needed to achieve the net foreign asset to output ratio norm, which is the most recently observed value. The estimation with this method showed overvaluation disequilibrium of about 9.4 percent. The average of all the three methods was -2.1. Overall, the conclusion is that REER is generally in line with its fundamental values (IMF, 2013).

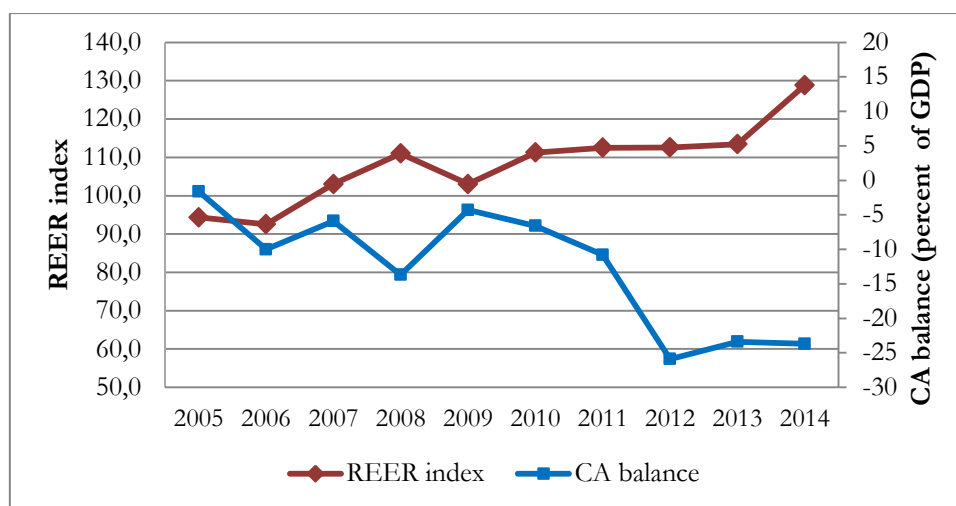


Figure 9. Real effective exchange rate index and current account balance of the KR.  
*Source:* National Bank of the KR.

As we can see from Figure 9, in the period between 2010 and 2013 REER index stayed on the same level (around 112), so it did not contribute to the hike of the current account deficit in 2012. Since 2014 the NBKR has been actively intervening the foreign exchange market in order to support rapidly depreciating som. Last year it made 45 interventions and in total sold 516.3 million USD.

In 2014 Kyrgyz som depreciated by 19 percent, thus sharp increase in REER index is observed. Imports reduced by 5.8 percent, but not only as a result of currency depreciation, but also lower oil prices. However, exports contracted as well, by 9.5 percent as a result of lower gold prices. Consequently, increase in REER didn't lead to reduction in CA deficit. High current account deficit not being accompanied by real exchange rate appreciation is a mitigating factor for its sustainability.

### 3.3. Financial Stability and Political Situation

*Financial system stability* and *political situation* in the country have a great influence on the sustainability of the CA imbalance, because investors need to have confidence in the system in order to be willing to become a part of it while financing the deficit (Corsetti et al., 1999). Like in most of the developing countries, the financial sector of the Kyrgyz Republic is dominated by



banks. The country's banking sector has considerable liquidity reserves and high level of capital adequacy (21.8 percent in 2014 while the minimum requirement is 12 percent). Moreover, the major source of banks' financing are funds of domestic households and enterprises rather than foreign borrowings. Furthermore, the system withstood the global economic crisis well. So it might seem that this sector of the country is stable<sup>10</sup>, however political turmoil of 2010 made explicit the weaknesses in the bank supervision and limited independence of the National Bank of the Kyrgyz Republic.

Up to 2010 the banking sector was dominated by Asia Universal Bank (AUB). According to IMF (2011), AUB held around 50 percent of all the deposits and managed to acquire such big share of deposits just in 3 years (in 2007 it had no more than 19 percent). "Companies were reportedly coerced to move their deposits to AUB, while all main government entities also shifted their cash balances there. In 2008, AUB also acquired a majority share in the Interbank Processing Center, the country's main card processing center. Competition in the banking sector was restricted, including by discouraging qualified entrants." (IMF, 2011, p.16)

At the same time AUB's main income generating activity was not giving out loans (loans represented just 16 percent of total assets) but investing in Russian and Ukrainian corporate debt and equity securities. All these factors as well as the fact that external audit was made by little known company in Moscow should have raised regulatory concerns. One of the chairmen of the National Bank was forced out of the job by the President of that time when expressing concerns regarding the way AUB was run and trying to help the Central Bank of Russia with investigation on the doubtful transactions between AUB and Russian banks (Global Witness, 2012). This fact demonstrates that politics has a great influence on the performance of the National Bank of the Kyrgyz Republic which is a weakness for the financial stability of the country and a matter of

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<sup>10</sup> This is exactly what the NBKR (2014) claims in its Financial Sector Stability Reports.

concern for the sustainability of the current account imbalance. Fortunately, vulnerability of that time didn't end up with a banking crisis.

Another threat for the financial stability of the country, and thus for current account sustainability, is imposed by high dollarization of the economy that is continuing to increase. According to the NBKR (2015), the level of dollarization of the economy in 2014 reached 58.2 percent which is by 14.6 percent higher than in the previous year.

Though the Kyrgyz Republic hasn't had any banking crises in its short history of independence, it had political ones. For more than 20 years, much has been achieved in the Kyrgyz Republic in terms of democratic transformation. For the first time in the political life of Central Asian region, presidency changed through free elections in the Kyrgyz Republic, suggesting that the country has become the pioneer of democratic transformation. The Kyrgyz Republic is considered to be the most democratic state of the Central Asia. Put it differently, the country and its nation aspires for a full-fledged democracy.

However, such image came at a high cost: there were two revolutions in the past decade that resulted in the overthrows of presidents. In March 2005, the Tulip revolution started out of discontent with the undemocratic tendencies of President Askar Akayev. During the revolution, when the opposition marched to the government building demanding the resignation of the President, he fled the country. Subsequently, the opposition leader, Kurmanbek Bakiyev was elected President but was also ousted after he was accused of nepotism and corruption in April 2010. On June 27, 2010, the current constitution of the Kyrgyz Republic was passed by referendum. The constitution replaced the previous immediately upon publication of voting results, although limited sections did not come into force until later. The document introduced the principles of parliamentary form of governance in the country.

According to the World Governance Indicators of 2014, only 19.4 percent of countries rank lower than the Kyrgyz Republic on political stability. Ministry of Internal Affairs of the country (2015) reported that 849 protests took place just in the year of 2013; out of them 519 were political ones. Even though the overall number of protests in 2014 reduced to 448, the year of 2015 is expected to be politically active as parliamentary elections are scheduled for the coming autumn. Thus, the political environment of the country can certainly be classified as unstable which makes the current account deficit less sustainable.

## Conclusion and Policy Recommendations

Since 2012 the Kyrgyz Republic has been leading the list of top ten countries with largest current account deficits measured as a percentage of GDP. As large current account deficit implies high consumption and investment it might be good for growth, but the disadvantage is that it depends completely on importation of foreign savings. It makes the country too reliant on the rest of the world and as a result vulnerable to external shocks; moreover it makes foreign creditors doubt that the country will be able to repay its debts, as a result can make them stop lending causing a financial crisis.

Factor analysis implemented in the given research revealed that there are numerous factors that make the existing current account imbalance of the Kyrgyz Republic unsustainable, namely low level of national savings and foreign direct investment, large trade deficit and external debt, questionable adequacy of foreign exchange reserves and financial stability, volatile growth and unstable political situation. The country has a lot of areas for improvement; however following are policy recommendations that in the author's point of view are the most imperative for the enhancement of the current account sustainability.

In order to reduce the vulnerability and prevent the external crisis, it is certainly important to raise the level of national savings. It is the main policy recommendation that can decrease country's dependency on foreign capital. Domestic savings could be promoted by introducing a tax system directed towards long-term asset accumulation through pension and investment funds. It should be admitted that it would be effective only if transparency in funds management and overall trust in domestic financial institutions is achieved.

Another recommendation is to attract foreign direct investment. As FDI does not generate debt, this source of financing current account deficit makes the latter more sustainable. In 2014 FDI inflows to the country constituted just 2.84 percent of GDP, this number should be increased by creating a stable and predictable investment climate, strengthening property rights,

reducing red tape and addressing corruption. The main advantages of larger FDI are that it is expected to trigger technology spillovers, assist human capital formation, help create a more competitive business environment and enhance enterprise development, which will eventually contribute to higher private sector-led economic growth.

Finally, Kyrgyzstan should reduce its dependency on imports and diversify exports, both the product base and geographically. In the current list of imported food products there are items that could be produced domestically. For example, vegetable oils, some types of tobacco products, fruit juices, flour, pastries, etc. If Kyrgyzstan were able to develop the food and textile industries and restore processing enterprises, it could also help re-direct the export attention towards sectors that are not natural resource-based, such as fruits and vegetables (fresh and processed), meat (raw and processed), milk and dairy products, bottled water, clothing and others. The main concern is the existing fiscal deficit and external debt that should withhold the government from borrowing and increasing spending, so alternative sources of financing should be addressed, such as private sector investment and foreign direct investment.

The main goal of provided recommendations is restoration of financial sustainability without jeopardizing the growth in the long-term.

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