

Is the Current Account of the Kyrgyz Republic Sustainable?

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Abstract

The given senior thesis research aims to assess the current account deficit of the Kyrgyz Republic in recent years (2010-2018) and analyze the sustainability of the deficit. The Balance of Payments is considered during the research to understand the sources of the current account deficit and its composition, ways of financing the deficit and making conclusions about its sustainability. The examination revealed that the present situation can be kept under control by the government and considered sustainable, even though there are issues with a low level of national savings, decreasing amounts of foreign direct investment, a historically huge trade deficit and external debt. High dependency on foreign remittances remains one of the main challenges for the country, as most of the trade deficit is reduced by the inflow of remittances. The concluding part is dedicated to the policy recommendations that are supposed to enhance the sustainability of the Kyrgyz Republic's current account deficit.

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Introduction

Globalization has accelerated during the last 25-30 years, with significant reform in worldwide political, social and economic institutions. The Kyrgyz Republic is a young democracy and is only at the beginning of a long-term transformation and integration into the global economy. Today, it is widely apparent that this process of reform has generated important outcomes in all countries and continents - largely through the increasing number of international businesses that operate worldwide, global trade networks and labor migration. Historically, free trade and development of trade policies have played a huge role in the balance of power in the world. The collapse of the Soviet Union provided the Kyrgyz Republic a chance to have direct, overseas trade relations for the first time in its history. Consequently, the economic transition period within Kyrgyzstan attempted to keep pace with an accelerating globalization process. However, the rapid and abrupt political and economic transition along with free competition worldwide left Central Asian countries unprepared in the face of such a major challenge (Dikkaya, 2009). It can be tracked in the balance of payments of a country, which includes the nation's current account and its capital and financial accounts.

The current account is a country's trade balance plus its net income and direct payments. The trade balance is simply a country's overall imports and exports of goods and services. In addition to that it measures international transfers of capital. If the country's residents - which includes the business sector, population and government structure itself - can finance all purchases within the country, the current account is considered to be in balance. These purchases can be funded by income and savings and may include such types of spending as consumer spending, business developments and financing of government projects. In general, countries strive for exporting more than they import and aggregate money that way, which is regarded as

trade surplus. Otherwise, if the country's residents import more goods and services than they export, it leads to an overall trade deficit. Economic growth has been seen as one of the most important reasons for current account deficit. The current account deficit is the quantitative difference between national savings and investments. That means, a deficit occurs as a result of either increase in investments or decrease in savings. Economic growth increases confidence in the economy by establishing higher expectations of profit. In this way, investments increase. On the other hand, it decreases savings because of rising demand thus causing the deficit to increase. The economic slowdown caused by the current deficit affects investments and savings in the opposite direction, thereby causing an automatic drop in the current deficit.

The Kyrgyz Republic has been running a current account deficit since 2010, according to the data of the National Bank of the Kyrgyz Republic (hereinafter NBKR). The period 2010-2018 is considered in the current research, and more recent years are examined in the case of missing data. The most recent indicator of the current account deficit states that it was -701.8 million USD, which is -9.827 percent of GDP, according to the World Economic Indicators. The main contributor of the deficit is definitely a significant trade imbalance; and that is another long-time trend in Kyrgyzstan. According to the Balance of Payments (BoP), exports in 2018 were 1815.2 million USD, whereas imports equaled 4594.4 million USD. Thus, the trade deficit was -2779.2 million USD.

Aims and Objectives

The senior thesis is dedicated to examine the sustainability of the current account deficit of the Kyrgyz Republic through an analysis of the main articles of Balance of Payments. It is evident that the country has had a deficit of the current account for many years; that is why the current research aims at answering questions in order to assess sustainability of the deficit and suggest possible solutions for the policy-makers.

The following questions will be answered within the present research:

1. Is the current account deficit of the Kyrgyz Republic sustainable?
2. What are the main reasons of the constant current account deficit?
3. How is the current account deficit financed?
4. What policies have to be introduced to reduce the deficit?

The senior thesis is structured in the following way: Chapter 1 is dedicated to the current account deficit and its main challenges, namely its trade and factor income accounts, where remittances will be regarded as the major driver and economic overview is given. Chapter 2 includes an analysis and overview of the capital account and the ways the current account deficit gets financed - specifically the investment, external debt and foreign exchange reserves. Conclusions and policy recommendations are made at the end of the senior thesis.

Literature Review

In an open market economy, current the account balance consists of the difference between a country's total annual production and total expenditures. In case the total expenditures are higher than the production level, the current account will be negative; meaning it will have a deficit. In general, it is important for a country to have a sustainable current account deficit in order to decrease the negative influence of external economic impacts on the local economy. According to Azgun (2009), even though the current deficit is a final result of private and public deficits, it is mainly defined by the combined budget deficit. Moreover, budget deficits that are not financed by taxes and other public sources are generally covered by foreign incomes and sources.

Maintaining balanced current accounts is a significant challenge that faces many developing countries in general, and the Kyrgyz Republic in particular. In fact, as noted by Hopkins and Mansbach (2008), the general factors of globalization affect people all over the world. In the first period of independence and the transition process, Central Asian countries faced the globalization process and experienced dramatic setbacks in basic public services, a huge decline in production and an abrupt rise in unemployment and other inequalities. However, while the process of globalization initially caused trouble for countries of the region, it also changed their position after many years -from one of isolation to full participation with the outside world. Most economies depend largely on imports of goods and services, while their own production and export sectors lack development and are not competitive in the global markets. Consistent growth of imports and stagnation of exports leads to a current account deficit, which is not sustainable, as it measures the ability of a domestic economy resource inflow and accrued debt that cannot be paid off in the long term.

Aristovnik (2006) mentions the necessity of current account sustainability by highlighting that emerging market economies have been involved in a catching-up process, which includes financing a vast amount of productive investment without harming their external sustainability and external debt. Due to the fact that such economies typically have low levels of domestic savings rates, they do not have much choice but to use foreign savings that lead to even higher current account deficits. Current account deficits can be short- and long-term, as some countries have floating situations and indicators. Temporary current account deficits may not be as negative and harming since they can only mean a transfer of capital to more capital intensive and productive economies (Wu, 2000). However, constant deficits may have more serious consequences and influence on the local economies; for instance, higher internal interest rates compared to the external ones, so accumulation of more debt leads to increased interest payment requirements and become a public burden. In that case, an imbalance of the current account shows a necessity for changes in macroeconomic policies if a country cannot meet its deficit. Important steps, which would be helpful to deal with such situations could be: decreasing public deficits, drastic depreciation of exchange rates and increasing the level of savings to balance the current account.

Even though a current account deficit can be sustained by foreign debt in a short period of time, external lenders can doubt the ability of an economy to meet its obligations in case of persistent deficits. That is why such a trend can lead to negative outcomes - as loss of foreign exchange, decreased amount of reserves, net outflow of capital, etc. In contrast, a stationary current account may mean there is no incentive for a country to default on its external debts (Holman, 2001). Moreover, stationarity is consistent with the intertemporal model of the current account sustainability, which proves its validity. This may contribute to potential unfavorable

policy scenarios (e.g., temporary trade deficits can become major problems in the future, especially if the trade accounts are stationary. On the other hand, if the trade accounts are not stationary, trade accounts may become unsustainable and require certain policies to mitigate further growth of imbalances.

It is apparent that most of the economies in the world are interconnected. That is why countries with large current account deficits are monitored by other countries to make sure the deficits will be under control and sustainable in the long term. To support this view, Milesi-Ferretti and Razin (1996) offered a threshold level of the current account deficit to gross domestic product (GDP) as 5 percent to be considered by the decision-makers as important. Definitely this threshold is not a one-way ticket, because there have been examples of Australia, Israel, and South Korea that have managed to sustain significant current account deficits without major currency issues or related crises. On the other hand, countries such as Mexico, Chile, the Philippines, and Thailand went through a major crisis in 1997.

Frankel and Rose (1996), argued in their research that large deficits did not necessarily cause currency crises in developing markets. However, Frankel and Saravelos (2010) claimed that the current account could predict currency crashes, but to a lesser degree, compared to such indicators as international reserves and real exchange rates.

Roubini and Wachtel (1999) stated that there should be a clear separation between current account deficits that initiate from capital inflows and current account deficits, which lead to unsustainable amounts of debt. Following the reasoning of the authors, a current account is sustainable, if it can be maintained without any of the crises.

As Benjamin Franklin wrote in the Principles of Trade in 1774, “No nation was ever ruined by trade.” All of the modern history of the Kyrgyz Republic has been marked by market-

oriented transformations. Despite some obstacles that stand in the way of becoming a democratic country, as well as difficulties in reforming market institutions, it is still an attractive country for foreign investment. As for the Government of the Kyrgyz Republic, it is constantly working on improving the country's investment environment and understands that it is also necessary to improve public service. By emphasizing the BoP accounting identities in this thesis, I aim at supporting the general view that trade and current account deficits are financed by surpluses on the capital account (e.g., Fisher, 1990). According to Fisher, since savings are often low in countries with developing economies, capital inflows supplement private savings and promote capital accumulation, which fosters economic growth. The highlighted idea is that trade and current account deficits are temporary conditions and will be adjusted through future surpluses of high capital inflows, higher investment and faster economic growth.

Chapter 1. Current Account of the Kyrgyz Republic

2010	2011	2012	2013	2014	2015	2016	2017	2018
-7%	-8%	-15%	-14%	-17%	-16%	-12%	-6%	-9%

Table 1. Current Account as % of GDP, Source: National Bank of the Kyrgyz Republic

The Table 1 shows the current account balance of the Kyrgyz Republic as percent of GDP during the period from 2010 to 2018. Data was taken from the open sources of World Bank and National Bank of the Kyrgyz Republic.

As can be seen, the current account has been constantly negative during the studied period. The highest levels of deficit were in 2014 and 2015, after that the trend was decreasing, but in 2018 the current account deficit showed a change back to an increase and was 9 percent of GDP within persisting positive growth in money transfers and increase in trade balance deficit.

1.1 Trade Deficit

The current account imbalance is an important economic indicator that reflects the real state of the trade balance. As Kyrgyzstan is an active member of the World Trade Organization (WTO) and Eurasian Economic Union (EAEU), it is essential to analyze the imbalance and reasons behind the phenomenon. The Kyrgyz Republic became a member of the World Trade Organization on December 20, 1998 – being the first post-Soviet Union country to be accepted into the organization (Ismailova, 2017). However, it turns out that membership in the WTO or EAEU automatically does not provide economic growth. For the whole time of Kyrgyzstan's membership in both organizations, there have been many disputes, what consequences it has brought and what advantages Kyrgyzstan has received from it. There are certain costs and requirements that come with the membership in such big organizations. It helps to strengthen the foundations of long-term growth, but at the same time worsens certain problems of national development.

Kyrgyzstan is a signatory to 27 international conventions, including most recent Russian-led Eurasian Economic Union. The Kyrgyz Republic is still vulnerable to the influence of its larger neighbors. At all times its strategy has been a multi-vector approach, balancing its dependence on China, Russia, Kazakhstan and the US. The Kyrgyz Republic has moved back into Russia's sphere of influence by signing the agreement to join EAEU. Trade benefits in 2016-2018 were negligible, however, because demand for Kyrgyz exports suffered as regional currencies weakened, and recession persisted along with low oil prices. This compounded the effect of lower demand from China and other trading partners outside the EAEU.

According to Ismailova (2017), "the entry of Kyrgyzstan into the WTO had no significant impact on the dynamics of national production, the growth rates of foreign trade turnover also largely depended on the conjuncture of the world economy", which indicates that there was no real positive effect on the GDP growth rates.

Table 2 indicates that the external imbalance has been declining not only due to the reduction of the trade deficit in goods but even more so in services. However, for a country with a small economy external imbalance is a concern, especially considering the international monitoring by the creditors and partners.

(millions of USD)	2010	2011	2012	2013	2014	2015	2016	2017	2018
Current account	-317.1	-479.3	1,020.4	1,016.1	1,269.4	1,058.6	-792.0	-477.4	-701.8
Goods and services	-	-	-	-	-	-	-	-	-
	1,403.4	1,658.9	2,912.6	2,831.1	3,138.0	2,428.7	2,340.0	2,475.3	2,914.6
Trade balance	-	-	-	-	-	-	-	-	-
	1,202.2	1,555.2	2,576.8	2,780.4	2,807.5	2,240.8	2,136.5	2,383.3	2,779.2
Export (FOB)	1,778.7	2,380.7	2,588.3	2,833.2	2,482.7	1,619.0	1,607.9	1,813.9	1,815.2
CIS countries	784.2	1,133.3	1,760.0	1,810.7	1,480.6	711.5	638.5	771.7	837.3
Foreign countries	994.5	1,247.4	828.3	1,022.4	1,002.1	907.4	969.4	1,042.2	978.0
Import (FOB)	2,980.9	3,935.9	5,165.1	5,613.6	5,290.2	3,859.8	3,744.4	4,197.2	4,594.4
CIS countries	1,590.2	2,018.3	2,689.4	2,787.1	2,580.4	2,078.7	1,638.8	1,940.7	1,867.8

Foreign countries	1,390.6	1,917.7	2,475.7	2,826.5	2,709.8	1,781.1	2,105.6	2,256.5	2,726.6
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Table 2. Trade Balance & Current Account Deficit, Source: National Bank of the Kyrgyz Republic

As can be seen in Tables 2 and 3, overall export and import have been decreasing in absolute terms since 2014. Even though in 2017 and 2018 there was an upward trend, the economy is not developing vividly. This confirms the fact that Kyrgyzstan's membership in the WTO has no significant influence on the growth rates of GDP, exports and imports of goods and services of the country, because as percent of GDP exports and imports have decreased drastically since 2013.

Percent of GDP	2013	2014	2015	2016	2017	2018
Export of goods and services	54.0%	45.9%	37.9%	35.7%	34.3%	32.8%
Import of goods and services	93.2%	88.6%	75.1%	69.8%	66.4%	68.8%

Table 3. Exports & Imports as % of GDP, Source: National Bank of the Kyrgyz Republic

One of the main export issues is that Kyrgyzstan depends on gold – 30 percent of all exports - and as the “Kumtor” gold mining company decreases the production levels, it inevitably hurts the local economy. According to the BoP, the products of processing industry (metallurgical, textile and garment industry) and agriculture conventionally prevail in exports of the Kyrgyz Republic. 15.3 percent of exports are metalliferous ores and metal scrap, almost 10 percent belongs to the articles of apparel and clothing accessories, other items in the list of major export goods have a share of 3 percent and less. In 2018, production output of base and finished metal products decreased by 8.8 percent, which influenced the overall gold export, so it decreased by 16 percent compared to the levels of 2017. During 2018, there was an increase in the output of the textile sector by 17 percent mainly due to increased production of clothes and textile output; growth of production output led to an increase in exports of apparel and clothing accessories by 36.2 percent (by USD 32.1 million). As far as the agriculture sector, which engages most of the local population, even though it lacks investment and support of the

government, there was growth in the crop output of agricultural products in 2018. The goods of crop-growing sector prevailed in the commodity structure of agricultural exports. Thus, among large commodity items, there was an increase in the export supplies of cotton (by 2 times) and the products from cereals, flour or starch (by 42.6 percent). However, there was a decrease in exports of vegetables (by 27.2 percent), fruit (by 22.9 percent), and oil (by 32.8 percent)

Moreover, there is a location factor, as the actual trade and economic relations are concentrated on cooperation with only a few countries, mainly neighbors, which makes Kyrgyzstan exposed; for example, products of textile and agricultural sectors were mainly exported to Russia (55.1 percent) and Kazakhstan (43.6 percent). Even though the share of Non-EAEU countries is 63.5 percent of the geographic structure of exports, the share of Great Britain is more than 50 percent in the total exports to non-EAEU countries. Turkey, China and Uzbekistan are other significant trade partners outside the EAEU, out of which two are neighboring countries.

As for the imports, in absolute terms they have been increasing, as can be seen in the table, but the shares of GDP are falling. As for the geographic structure of imports, non-EEU countries increased their share up to 65.2 percent. China has a share of 62 percent in the total value of goods imported from the non-EAEU region. Dependence on the fuel and energy goods implies a strong position of the Russian Federation as the major supplier of energy products in the EAEU area.

Joining the EAEU had major economic implications for Kyrgyzstan, a small economy in which foreign remittances and profits from re-export trade generate almost a third of the national income. The overall analysis of the current account imbalance indicates that accession has reduced national welfare, because falling profits from re-exporting outweigh higher migrant

remittances and tariff revenues. The Kyrgyz Republic should decrease its dependency on imports and diversify exports product-wise and geographically, increase the amount of national savings and foster foreign direct investment inflow into the country to make the current account more sustainable.

1.2 Factor Income Account

The current transfers – the second largest part of the current account after the trade balance – include mainly remittances from the citizens working in foreign countries. Kyrgyzstan remains one of the countries with the highest dependency on remittances in the world, as they constitute more than 30 percent of GDP. Remittances cover around 40 percent of the trade deficit, which is a risk signal, as there is no guarantee that the resources will be available in the long-term, even though most of the remittances come from Russia and Kazakhstan - members of the EAEU – as Russia is under strict economic sanctions by the Western countries, which negatively affects all central Asian region and employment opportunities of the migrants.

According to the statistical data of NBKR, overall inflow of remittances doubled since 2010 to 2018. It is evident that the dependency of the Kyrgyz Republic on remittances is helping to close the gap between trade imbalance, however, it is also an indicator that the local economy cannot provide enough jobs for the population and people do not have much choice but to work abroad. In the table, we can see that no matter political and economic situations in Russia and Kazakhstan, they are still remaining almost only resources of remittances inflow in the Commonwealth of Independent States (CIS) region. Table 4 shows that the amount of financial inflows from Kazakhstan has been constantly falling from a maximum of 41.2 million USD in 2011 to 2.2 million in 2018. This trend can be explained by the EAEU integration and preference of labor migrants to work in Russia, where payment levels are higher. It is proved statistically,

because the amount of remittances has been growing surely with only a significant downfall in 2015, when the net inflow was 1,622.3 million USD, which can be explained by the effect of the political and economic sanctions by the Western countries that influenced the Russian economy and required most of the sectors to tighten and reorganize the structures. However, right after 2015 the amount of remittances from Russia has been only growing and reached a historically maximum amount of 2,640.6 million USD in 2018.

As for non-CIS countries, most of the remittances' inflow comes from the United States of America. If compared with the levels of 2010-2011, there is a decreasing trend in amount of remittances of about 45 percent, as in 2010 the Kyrgyz Republic received 41.7 million and in 2018 only 26.7 million. Most probably the decreasing trends of remittances from the USA can be related with the political agenda of the current Presidential administration regarding the working migrants in the USA. Actually, the net inflow of transfers from Great Britain and Germany have fallen even more and now represent amounts close to 0 million USD, while remittances from other countries have been increasing up until 2014 and started steadily decreasing afterwards.

(in millions of USD)	Total 2010	Total 2011	Total 2012	Total 2013	Total 2014	Total 2015	Total 2016	Total 2017	Total 2018
Net inflow	1,124.9	1505.4	1,768.5	1,908.2	1,811.9	1,344.4	1,634.3	2,030.5	2,143.0
Inflow	1,252.6	1695.4	2,017.9	2,268.2	2,235.9	1,683.6	1,991.3	2,482.4	2,685.3
CIS countries	1,199.3	1639.4	1,980.4	2,245.0	2,188.3	1,630.8	1,942.0	2,439.3	2,640.6
Kazakhstan	35.0	41.2	33.8	25.4	20.1	8.3	3.5	4.2	2.2
Russia	1,164.3	1597.5	1,946.2	2,219.1	2,167.9	1,622.3	1,938.5	2,435.1	2,638.3
Others	0.0	0.7	0.5	0.5	0.4	0.1	0.0	0.0	0.1
Foreign countries	53.3	56.0	37.5	23.2	47.5	52.8	49.3	43.1	44.7
Belgium	0.2	1.4	0.0	0.1	0.1	0.0	0.0	0.0	0.0
Great Britain	1.4	1.5	1.2	1.5	1.5	0.1	0.0	0.0	0.0
Germany	9.9	15.7	9.5	1.8	0.1	0.2	0.1	0.0	0.0
USA	41.7	36.1	25.0	16.6	12.0	30.5	38.2	24.2	26.7

Others	0.1	1.3	1.8	3.1	33.8	22.0	11.0	18.9	17.9
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Table 4. Remittances inflow to the Kyrgyz Republic, Source: National Bank of the Kyrgyz Republic

As Akmoldoev (2012) indicates in his research, “most of the incoming remittances are being used for consumption by the local population instead of investment, which leads to a bigger trade deficit, as more imported goods are being consumed”. Basically, higher rates of consumption rather than investment tend to reduce economic effectiveness.

Due to the fact that the Kyrgyz Republic is a net foreign borrower, the income factor of the current account has been a deficit in the analyzed period since 2010 with an average amount of -339.6 million USD. The indicator mainly consists of the income of foreign direct investors, so in 2011 there was a maximum of -659.1 million USD of negative income factor, due to the fact that 610.7 million USD was repatriated by the investors. The income factor is an important contributor to the current account deficit of the Kyrgyz Republic.

(in millions of USD)	2010	2011	2012	2013	2014	2015	2016	2017	2018
Income	-305.1	-659.1	-169.3	-423.0	-307.1	-257.9	-355.6	-371.6	-208.1
Income on Direct investments	-247.9	-610.7	-110.8	-348.1	-223.2	-191.0	-276.6	-295.9	-150.8
Income on Portfolio investments	0.2	0.1	0.0	0.0	0.0	0.9	0.0	0.0	0.0
Income on Other investments	-25.1	-19.2	-29.7	-53.0	-60.6	-49.1	-62.7	-56.9	-43.3
Interest payments (chart)	-35.8	-39.7	-46.8	-70.0	-78.6	-66.5	-67.6	-76.2	-74.9
Other income on other investments	10.7	20.4	17.1	16.9	18.0	17.4	4.9	19.3	31.6
Compensation of employees	-32.3	-29.4	-28.8	-21.8	-23.3	-18.7	-16.3	-18.8	-14.0

Table 5. Income factor of the Balance of Payments of the Kyrgyz Republic, Source: National Bank of the Kyrgyz Republic

1.3 Economic overview

The GDP of the Kyrgyz Republic has been rising gradually in the local currency. The main sectors that contribute to the GDP are shown in Table 6. The most important contributor is

the services sectors with its share of 46.8 percent in 2018 and it has never been below 45 percent of GDP, as the country orients itself as one of the major destinations in Central Asia with its main attraction – the Issyk Kul lake. Such events as “World Nomad Games” help attracting foreign tourists and their financial resources into the local economy. Industry is mainly represented by the “Kumtor” gold mining company, agricultural sector is the most important in terms of human population working in the sector. The recent construction boom is generally supported by the financial inflows from migrants, as their relatives purchase real estate.

Sectors	2010	2011	2012	2013	2014	2015	2016	2017	2018
Industry	20.7	22.5	15.8	18.6	16.5	16.7	18.2	18.7	18.6
Agriculture	17.4	16.6	16.6	14.6	14.7	14.1	12.8	12.5	11.6
Construction	5.5	4.9	6.5	6.3	7.4	8.3	8.4	8.6	8.8
Services sector	46.1	45	48	46.6	47.4	49.1	47.5	47.1	46.8
Net National Product	10.3	11	13.1	13.9	14	11.8	13.1	13.1	14.2

Table 6. Structure of GDP by Sectors for 2010-2018, in % of the total, Source: National Bank of the Kyrgyz Republic

Economic situation of the country plays a significant role in the current account balance. In general, the real GDP growth decreased to 3.5 percent in 2018, compared to 4.7 percent in 2017. Gold production was still growing, but the general output level decreased to 3.5 percent from 5.1 percent in 2017. According to the World Bank data, the growth was reinforced by consumption, which was supported by large inflows of remittances, investment, also a negative balance from overall exports. The current account deficit was financed by foreign direct investment (FDI), a debt write-off by the Russian Federation, and foreign exchange reserves.

Moreover, the fiscal accounts improved in 2018 due to higher tax collections and reduced the deficit to 1.6 percent of GDP in 2018 (this indicator was 4.6 percent in 2017). Tax revenue increased to 25.4 percent of GDP in 2018, which was a slight improvement compared to the previous year and consisted of higher collections of import taxes.

With inflation well below the target range of 5-7 percent, monetary policy was loosened to a certain extent in 2018. The local currency Som – KGS – went through certain fluctuations against the U.S. dollar in 2018, mainly because of seasonal factors. In order to manage the situation, the National Bank intervened in the foreign exchange market with net sales of 134 million USD during the year. Banking sector consists of 26 banks and their performance remains healthy with the key indicators well above the required levels. The World Bank foresees an average annual consumption growth to be approximately 3 percent in 2019–21, mainly based on the increasing remittance inflows. Investment is expected to grow at around 10-12 percent per year. In case the economic activity improves and stabilizes, inflation will be kept under the NBKR target range.

The current account of the Kyrgyz Republic will keep having a deficit of around 10 percent of GDP due to structural deficiencies of the economy, dependence on imports even in terms of investment. The deficit will be financed by foreign resources through remittances, creditor's money and FDI.

Chapter 2. Capital Account

The Capital Account of the Kyrgyz Republic has been formed with a positive balance during the reviewed period. In 2018, the Russian Federation fulfilled the protocol to the agreement between two governments about a write-off of the debt in the amount of 240 million USD, which was one of the reasons positive balance in the Capital account, as stated by the World Bank (2018).

The current account sustainability depends on the structure of external capital flows, as it is more sustainable to finance it by foreign direct investment that does not generate debt (Aristovnik, 2006). The recent contraction of the economy, decrease of the exports and budget deficit negatively affect the sustainability of the debt burden. Financial system stability and political situation in a country have a great influence and importance on the sustainability of the external imbalance, because investors want to be confident in the system in order to enter the country and finance the deficit. The financial sector of the Kyrgyz Republic is dominated by banks, which is characterized as sound and stable. However, the political situation of the country has a negative effect on the independence of the National Bank of Kyrgyzstan and overall banking system. Moreover, high dollarization of the economy is another threat for the financial stability of the country, even though legislative proposals and enactments have been introduced to change the accounting and payment practices to use only local currency – KGS – majority of the people still prefer and trust USD much more than the local medium of exchange, especially for significant purchases and transactions.

2.1 Capital Flows

Analysis of the capital flows structure into the economy of the Kyrgyz Republic is necessary to understand the peculiarities of the current account deficit financing. Ideally, most of

the financial flows would be in the form of FDI. According to the International Debt Statistics (IDS, 2019), FDI is direct investment flows and is “the sum of equity capital, reinvestment earnings, and other capital”. Most of the investment resources are allocated in the capital of the Kyrgyz Republic – 49 percent of the total investment in 2018 and have been constantly growing from 1 billion USD in 2010 to 2.6 billion in 2018. Bishkek is located in the Chui Oblast that received 8% of investment in 2018. Most of the production sites and business sectors are founded in the Chui region and Bishkek. According to the National Statistical Committee, Issyk-Kul Oblast received 35 percent of investment in 2018, which is about 2 billion USD, for tourism sector development, so that people come in summer to the lake Issy-Kul and in winter to the ski resorts. This is another challenge for the local government, as 92 percent of investment is allocated in the Northern part of the country and other regions lack financial resources for development.

Year	Total (thsd. USD)	Direct foreign investments	Portfolio investments	Other
2010	3,572,451.0	666,086.0	94.3	2,906,270.7
2011	4,947,985.9	849,201.1	5,475.1	4,093,309.7
2012	4,335,854.0	590,733.3	12.6	3,745,108.1
2013	5,487,045.7	964,507.1	2,463.1	4,520,075.5
2014	5,415,672.0	727,091.2	68.0	4,688,512.8
2015	5,615,352.8	1,573,243.7	437,807.2	3,604,301.9
2016	5,335,050.4	813,960.7	367,513.8	4,153,575.9
2017	5,219,899.8	616,793.1	815.6	4,602,291.1
2018	5,352,636.3	569,790.5	2,446.0	4,780,399.8

Table 7. Structure of Investments into the Kyrgyz Republic, Source: National Bank of the Kyrgyz Republic

% of Total Investment	Direct foreign investments	Portfolio investments	Other
2010	18.65%	0.00%	81.35%
2011	17.16%	0.11%	82.73%
2012	13.62%	0.00%	86.38%
2013	17.58%	0.04%	82.38%
2014	13.43%	0.00%	86.57%
2015	28.02%	7.80%	64.19%
2016	15.26%	6.89%	77.85%
2017	11.82%	0.02%	88.17%
2018	10.65%	0.05%	89.31%

Table 8. Structure of Investments as % of Total, Source: National Bank of the Kyrgyz Republic

The tables 7 and 8 shows that, on the other hand, direct investment into the Kyrgyz Republic collapsed in the last few years, falling from 1.573 bln USD in 2015 to 569.79 mln USD in 2018. In 2018, the main investment volume of more than 90 percent was directed towards manufacturing – 48 percent, financial and insurance activities received 29 percent of investment, wholesale and retail trade – 8.2 percent and the rest were related with professional, scientific and technical activities – 3.8 percent, etc. The volume of investments in the sphere of financial intermediary and insurance increased from 87 million USD in 2010 up to 1.5 billion USD in 2018, which proofs trust in the soundness of the financial sector of the Kyrgyz Republic. It is necessary to note low levels of portfolio investment, so it does not finance the current account deficit in a feasible manner.

Region-wise overview shows that historically non-CIS countries have been investing more into the local economy, even though there was a drop of investment in 2018 compared with 2010 by 15 percent of the total annual investment share, as can be seen in Table 9.

(thsd. USD)	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total	3,572,451 .0	4,947,985 .9	4,335,854 .0	5,487,045 .7	5,415,672 .0	5,615,352 .8	5,335,050 .4	5,219,899 .8	5,352,636 .3
non CIS	2,746,646 .3	4,091,413 .3	3,414,807 .1	4,286,505 .0	3,666,045 .4	3,275,934 .4	3,343,454 .2	3,793,760 .1	3,331,940 .3
CIS	825,804.7	856,572.6	921,046.9	1,200,540 .7	1,749,626 .6	2,339,418 .4	1,991,596 .2	1,426,139 .7	2,020,696 .0
non CIS	77%	83%	79%	78%	68%	58%	63%	73%	62%
CIS	23%	17%	21%	22%	32%	42%	37%	27%	38%

Table 9. Entrance of foreign investment by regions, Source: National Bank of the Kyrgyz Republic

At the country level, Canada remains the main investor that increased the amount of resources since 2010 from 429,426.8 million USD to 1,918,689.6 million USD in 2018, which is 35.85 percent of the total investment into the local economy. Other major countries are USA (3.38 percent in 2018) and China with its 8.24 percent in 2018 and a general trend of decreasing the investment level. It is related with the entrance of the Kyrgyz Republic into the EAEU and certain political issues between the countries. In 2015, CIS region – mainly Russian Federation and Kazakhstan – invested 42 percent of the total investment volume, which then slightly decreased to 38 percent in 2018.

2.2 External Borrowing

According to the IDS of the World Bank (2019), “Total external debt shown in the IDS is the sum of long-term external debt, short-term debt, and IMF credit. Long-term debt has an original maturity of more than one year”, so the ability of a country with an open economy to borrow abroad generally allows a country to receive credits at lower interest rates, with less pressure on the exchange rate and therefore on inflation, than if it was financially closed (Obstfeld, 2012).

According to the World Bank IDS, ratio of international debt stock to exports of goods and services was 325.8 percent in 2016 and 313.3 percent in 2017, which is much more than the acceptable threshold of 220 percent that is already considered as a high indebtedness. The reserves to total debt ratio in the same years were 22.7 and 23.1 percent accordingly. Fortunately, prevailing amount of foreign debt is long-term – more than 90 percent, which definitely supports sustainability of the debt.

The Kyrgyz Republic needs to consider ways to decrease its dependency on imports and diversify exports product-wise and geographically. Imports started increasing in 2017, and their increase was offset by a corresponding increase in remittances that finance the imports to a wide extent. One of the main concerns is the existing fiscal deficit and external debt that should warn the government from borrowing more, so other sources of financing should be used more as private sector investment and FDI.

According to the NBKR and Table 10, the total external debt has been kept almost on the same level since 2014 with some fluctuations between being 6.3 and 6.9 billion USD. The public debt has been increasing since 2010 with the biggest overall amount of 4 billion USD in 2017.

	2010	2011	2012	2013	2014	2015	2016	2017	2018
TED¹, end of period (millions of USD)	4,209.4	4,730.7	5,229.4	5,929.6	6,370.5	6,670.1	6,830.1	6,997.5	6,684.1
TED as of the end of period to GDP ¹ (%)	90.0	80.5	81.0	83.4	94.4	119.5	103.2	90.8	83.8
PED² end of the period (millions of USD)	2,615.7	2,802.6	3,031.9	3,158.7	3,437.1	3,601.1	3,742.7	4,089.8	3,825.7
PED as of the end of period to GDP ¹ (%)	55.9	47.7	47.0	44.4	50.9	64.5	56.6	53.1	48.0

Table 10. Total (TED) & Public (PED) external debt of the Kyrgyz Republic, Source: National Bank of the Kyrgyz Republic

¹ Total External Debt is the outstanding amount of actual current liabilities on loans and borrowings (include liabilities of all sectors of economy)

² Public External Debt is outstanding amount of actual liabilities on loans and borrowings by General Government and Monetary Authorities

China remains the main creditor of the Kyrgyz Republic and has increased its share in the overall debt of the country from 727.5 million USD (24.8 percent) in 2014 to 1,267.4 million USD (43.2 percent) in 2018. The Russian Federation is another important creditor with its average share of 9 percent of the external debt. Kazakhstan (average of 3.3 percent) and Turkey (average of 3 percent) are also in the list of main lenders. As Athukorala (2018) mentions, in the first decades after the transition into an open economy grants and “soft loans” helped the Kyrgyz Republic to deal with consumption and delivered required resources for stabilizing the revenues with expenditures. However, slowly but surely the composition of capital inflows was changed from concessionary to credits at commercial market rates, which is a huge burden for the country. The credit and economic ratings of the Kyrgyz Republic are not promising better conditions to be offered any time soon, which is influencing the amount of FDI – the most beneficial form of capital flows – which has not become a significant form of capital inflows, as can be seen in Tables 7 and 8.

2.3 Foreign Exchange Reserves

According to the IDS (2019), “international reserves constitute the sum of a country’s monetary authority’s holdings of special drawing rights, its reserve position in the IMF, its holdings of foreign exchange, and its holdings of gold (valued at year-end London prices)”. International reserves of the Kyrgyz Republic have been kept in the range of 1.72 billion USD in 2010 and highest amount of 2.24 billion USD in 2013. As can be seen in Table 11, most of the reserves are liquid.

(bln. US dollars)³	2010	2011	2012	2013	2014	2015	2016	2017	2018
Gross international reserves	1.72	1.83	2.07	2.24	1.96	1.78	1.97	2.18	2.16
Liquid part of reserves	1.70	1.83	2.06	2.23	1.85	1.68	1.88	2.09	2.07

Table 11. International Reserves of the Kyrgyz Republic (end of period), Source: National Bank of the Kyrgyz Republic

The evaluation of the reserves in months of import of goods and facility is positive and covers the overall benchmark of 3 months – since 2014 the indicator has not been lower than 4.3 months of future imports. As Athukorala (2018) states, “a comparison of changes in foreign exchange reserves and the Som-Dollar exchange rate suggest that the National Bank of the Kyrgyz Republic intervened in the foreign exchange market only to avoid excessive volatility”, so the levels of international reserves mainly stay in the same range. However, in case of external shocks as disruptions of the gold production, etc. there may be certain risks.

³ In accordance with the IMF methodologies, the international reserve assets comprise the assets only in convertible currencies (US dollar, Euro, British pound sterling, Japanese yen, Swiss franc, Australian dollar and Canadian dollar).

Conclusion and Policy Recommendations

The persistent current account deficit of the Kyrgyz Republic has been analyzed in the current thesis paper. As was expected, the main issues and challenges of the country regarding the sustainability of the current account are related to its historical, geographical and human factors. The participation of Kyrgyzstan in the WTO does not affect much the growth rates of GDP, exports and imports of goods and services of the country and has acquired more drawbacks than advantages. In general, in combination with EAEU political and economic realities, this is an infringement of domestic producers, support of Russian and foreign suppliers, which is tied with an increase in price of imported goods from non-CIS countries. In the long term, from membership in the WTO Kyrgyzstan should benefit by actively integrating the service sectors, food and light industries into the world market and realizing its competitive advantages - cheap labor and low costs.

The example of Kyrgyzstan clearly shows that membership in the WTO automatically does not provide economic growth. It helps to strengthen the foundations of long-term growth, but at the same time exacerbates certain problems of national development. Therefore, in the long term, expectations from participation in the WTO should be more moderate and objective, especially considering the role of country under the Russian, Kazakh and Chinese pressure.

The Kyrgyz Republic remains a dependent state, just as it was during the Soviet rule, where most of the decisions were implemented from above. It is clear as the country cannot make decisions contradicting to the will of the Russian Federation. Kyrgyzstan needs to find a way to balance its dependence on foreign debt and help of the neighbors and introduce strategic steps to integrate the local economy into the EAEU system and then actively use the WTO opportunities. Contradicting interests of the organizations do not make the situation any easier,

but if there is no choice, the country needs to choose the most effective option to keep moving forward by enhancing the business environment aimed at attracting foreign direct investments.

In order to reduce the vulnerability and prevent the external crisis, it is extremely important to increase the level of national savings. Domestic savings could be a major decrease the country's dependency on foreign capital. Sound banking system of the Kyrgyz Republic should be a corner stone for development of the whole financial system in the country and create a precedent in the region.

The country's debt servicing commitments remain within manageable limits, but the government needs to make sure to keep major part of debt in long-term loans and liabilities, make the investment climate in the country friendlier through law enactments that would prove openness of the Kyrgyz Republic for flows of FDI by modernizing the economic system, promoting investment into different sectors of the economy, decreasing the natural and artificial barriers for businesses. As was seen, the share of direct investment into the economy is too low. Moreover, the dependence on the major regional partners as Russia, Kazakhstan and China and foreign remittances serves as a basis for stagnation rather than development and remains a vivid risk in case of issues in the neighboring economies. Remittances are not really directed towards investment, even though they play an important role in reducing poverty in the country, as the financial transfers are dispersed all over the country. However, we should understand clearly that remittances are not a development strategy, they are rather a direct proof of the lack of development in the country.

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