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Minutes of Executive Board Meeting 19/47-2

10:30 a.m., June 7, 2019

2. Kyrgyz Republic—2019 Article IV Consultation

Documents: SM/19/117 and Correction 1; and Correction 2; and Supplement 1; and Supplement 1, Correction 1; and Supplement 2; and Supplement 3 ; SM/19/119; and Correction 1

Staff: Josz, MCD; Porter, SPR

Length: 28 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	K. Obiora (AE)
	O. Diakite (AF), Temporary
	D. Vogel (AG), Temporary
	N. Heo (AP)
	P. Fachada (BR)
	P. Sun (CC)
	A. Arevalo Arroyo (CE), Temporary
L. Levonian (CO)	
	S. Benk (EC)
	L. Van Hoek (FF), Temporary
	I. Fragin (GR), Temporary
	M. Siriwardana (IN)
	M. Psalidopoulos (IT)
	Y. Saito (JA)
	K. Osei-Yeboah (MD), Temporary
	F. Al-Kohlany (MI), Temporary
	D. Cools (NE), Temporary
	J. Sigurgeirsson (NO)
	A. Tolstikov (RU), Temporary
	W. Al Hafedh (SA), Temporary
	K.Tan (ST)
P. Inderbinen (SZ)	
	A. Clark (UK), Temporary
	P. Pollard (US), Temporary

C. McDonald, Acting Secretary
K. Hviding, Summing Up Officer
R. Smith Yee, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Institute for Capacity Development: L. Zanforlin. Middle East and Central Asia Department: A. Alreshan, C. Josz, J. Kahkonen, W. Shi, I. Teodoru. Monetary and Capital Markets Department: A. Marina. Strategy, Policy, and Review Department: B. Csonto, E. Gemayel, N. Porter. World Bank Group: S. Djumena, H. Schrijver.

Executive Director: A. Mahasandana (ST). Alternate Executive Director: J. Di Tata (AG), L. Palei (RU). Senior Advisors to Executive Directors: G. Heim (SZ), S. Potapov (RU), C. Williams (CO). Advisors to Executive Directors: S. Bah (AF), L. Cerami (IT), M. Coronel (BR), D. Crane (US), J. Garang (AE), G. Khurelbaatar (AP), H. Mori (JA), A. Zaborovskiy (EC), K. Lok (CC).

2. KYRGYZ REPUBLIC—2019 ARTICLE IV CONSULTATION

Mr. Inderbinen and Mr. Imashov submitted the following statement:

On behalf of our Kyrgyz authorities, we would like to thank management and staff for their sustained policy dialogue and support of the Kyrgyz Republic, notably in providing technical expertise. The Kyrgyz Republic's economy is growing steadily, benefiting from a benign regional environment. Low inflation, a moderate fiscal deficit, and a stable banking sector point to the success of past stabilization policies. The authorities are pursuing fiscal consolidation to ensure debt sustainability, they are enhancing the legislative and macroprudential frameworks to further strengthen the financial sector, and they are maintaining a flexible exchange rate policy.

The Kyrgyz authorities are aware that preserving macroeconomic stability and putting economic growth on a higher trajectory are essential to sustain social stability and to create fiscal space for investment in human capital and infrastructure.

Recent economic developments

Real GDP growth slowed down to 3.5 percent in 2018, compared to 4.7 percent in the previous year, owing also to the reduction of the fiscal deficit. Nevertheless, growth in 2018 exceeded the IMF's projection of 2.8 percent. Headline average inflation fell to 1.5 percent in 2018, from 3.2 percent in 2017, due to lower core inflation and food prices. Gross official reserves reached 4.5 months of coverage of projected imports of goods and services, well above the relevant benchmarks. Over the last three years, public debt declined by 11 percentage points of GDP, mainly thanks to restraint from new borrowing for large infrastructure projects and a $240 million debt write-off by Russia. The latter contributed to the decrease of debt by 3.1 percent of GDP.

Encouraging trends in the banking sector were sustained in 2018. Banking sector assets increased by over 12 percent, driven mainly by growth in loans, government securities and cash circulation. At the same time, the deposits base rose by 9.5 percent. Also, banking sector performance indicators remain strong. The capital adequacy ratio remained at 23.7 percent, close to double the minimum regulatory requirement of 12 percent. The liquidity ratio stood at 66.9 percent, well above the minimum requirement of 45 percent. Profitability increased, and the non-performing loan (NLP) ratio declined slightly to 7.5 percent in 2018, from 7.6 percent at the end of 2017.

Continued consolidation efforts led to a solid fiscal performance in 2018. The overall fiscal deficit improved significantly in 2018, reaching 1.1 percent of GDP, from 3.1 percent of GDP in 2017. The primary fiscal balance (i.e., the overall balance excluding interest payments) improved significantly, reaching a surplus of 0.2 percent of GDP, from a deficit of 2.0 percent in 2017. The authorities made ad-hoc cuts to goods and services expenditures and re-phased some foreign-financed investment projects. These measures, together with currency appreciation, helped to bring external public debt down to 48 percent of GDP at the end of 2018, from 64.5 percent in 2015.

On the most recent developments, growth recovered this year. As of end-April, GDP growth accelerated to 5.7 percent (y-o-y), driven mainly by industrial production (16.7 percent y-o-y). Headline inflation in the first four months of 2019 is -0.5 percent, well below the inflation target range of 5 to 7 percent. Growth of commercial bank credit to the private sector at end-March was strong at 18.1 percent over the same period last year. The volume of gross international reserves in the first quarter of this year has reached $2,197 million, having increased by $41.7 million, or 2 percent, since the beginning of 2019.

Fiscal policy

The authorities remain committed to continue fiscal consolidation in 2019 and in the medium term, to maintain public debt at a sustainable level. The objectives are: (i) to broaden the tax base, especially to capture the informal economy; (ii) to improve public expenditure efficiency, including compensations, investment management policy, and the rationalization of goods and services spending.

The Kyrgyz authorities are fully aware that improving expenditure efficiency is essential to maintain a sustainable fiscal position. To that effect, they are strongly committed to consolidate all wage-related expenditures, enhance budget transparency, and continue the reform of public wages. The authorities will continue to improve the register of public employees to include their characteristics, corresponding wage information, and performance evaluations, to be able to systematically track employees over time.

The authorities remain committed to developing, with the IMF’s technical assistance, a transparent and actionable financial management information system (FMIS). The latter will provide an anchor for the main functional processes, from medium-term planning and budget preparation to budget execution and accounting. In addition, the authorities intend to review the institutional framework for fiscal policy to increase its effectiveness.

To ensure that debt remains sustainable and that the public debt ratio starts to decline, actions will be taken to sustain the low deficit over the medium term. To this end, the government will refrain from non-concessional borrowing, advance debt monitoring, and minimize fiscal risks stemming from SOEs by enhancing coordination between the Ministry of Finance and line ministries. The authorities will also improve the efficiency of public investment by strengthening project selection.

Monetary, exchange rate, and financial sector policies

The monetary policy stance is appropriate. Both headline and core inflation, 0.4 and 1.6 percent year-on-year in January 2019, respectively, are well below the inflation target range of 5 to 7 percent. Output is estimated to be near potential. The monetary policy stance is on track to keep inflation within the target range over the medium-term.

The National Bank of Kyrgyz Republic (NBKR) is in the process of implementing a new framework for monetary policy. In this regard, the Main Monetary Guidelines were updated to clarify the role of the policy rate for determining values in the money market, and the role of the market interest rate as the operational target of monetary policy. With the aim of gradually adopting an inflation targeting (IT) regime in the medium term, improving the operational framework to support an effective interest rate channel is currently a high priority for the monetary authorities. In the transition towards inflation targeting, the NBKR continues to enhance and strengthen its effectiveness in targeting short-term interest rates, and to fine-tune the available monetary policy toolkit in the process.

A recent MCM TA mission determined that the NBKR's Forecasting and Policy Analysis System (FPAS) has followed most of the best practices implemented among peer central banks. The NBKR will nonetheless continue to improve the monetary policy forecasting framework and the coverage of monetary statistics, and will advance coordination with the Ministry of Finance on fiscal and monetary policy. The authorities will maintain two-way exchange rate flexibility as the key variable to reduce external imbalances, enhance competitiveness, and safeguard reserves. Interventions in the foreign exchange market will be made only to smooth out excessive fluctuations.

Banking sector risks remain moderate. Dollarization in the banking sector has been declining significantly as a result of the NBKR's policy actions. Deposit dollarization increased during 2015, but started to decline over the consecutive years, reaching 43 percent in March 2019, down from 66 percent in 2015. The positive trend reflects the changes in reserve requirements and the ban on new mortgages in foreign currency introduced in February 2016, as well as an increasing level of trust in the local currency. The NBKR's de-dollarization policies have been replicated in other countries of the region.

The withdrawal of the correspondent banking relationships (CBRs) of some banks in recent years has led to the concentration of CBRs and higher transaction costs, further suppressing activity and profitability of the banking system. This mirrors a reality currently faced by many developing countries. The authorities have been addressing the challenges associated with CBR withdrawal through extensive contacts and negotiations at various levels. Even though there is an enhanced understanding of the phenomena and internal legislative procedures are in place, more action at the global level is required. The authorities encourage the IMF to take an active role, in collaboration with other institutions, to assist members in addressing CBR withdrawal. For their part, the authorities will continue their efforts aimed at safeguarding the stability and integrity of the financial sector. The NBKR's regulations were revised to preserve the main requirements for lending to related parties. The threshold amounts of transactions that require the approval of the Board of Directors or shareholders have been adapted. Also, requirements have been established for banks to maintain a register of related parties, and compile information on related and affiliated parties and bank owner schemes to determine ultimate beneficial ownership. In addition, maximum efforts will be made to ensure the passage of the draft AML/CFT law, and to align the framework with international standards.

Structural and institutional reforms

The Kyrgyz authorities are well aware of the importance of institutional and structural reforms to ensure broad-based growth. To achieve high and inclusive growth, structural impediments must be tackled, and the traded goods sectors expanded. In this context, the authorities will work to eliminate the main obstacles to growth, namely by: (i) enhancing labor force participation, including by female labor, addressing skills mismatches, and improving vocational outcomes; (ii) removing market distortions to encourage private investment needed to close infrastructure gaps; (iii) developing the financial market along with improving trade and competitiveness policies; and (v) enhancing governance and tackling corruption.

Reforming the energy sector is essential to ensure better service delivery and to put the sector on a sound economic footing. To this effect, efforts will be pursued to improve the governance aspects of the sector by reducing financial losses attributable to arrears of users and introducing a transparent cash settlement mechanism monitored by pertinent government agencies. The authorities fully recognize the importance of implementing the medium-term tariff strategy to ensure energy sector sustainability, but the decision will be made cautiously considering the current political context.

The authorities view education as a powerful driver of development and one of the most effective instruments for reducing poverty and improving health, gender equality, peace, and social stability. Improving education will be critical to increase employment opportunities and productivity, also in view of the significant gap in quality among urban and rural areas. In addition, the education system needs to ensure that workers acquire the skills necessary to adapt to rapid technological change.

Also, the authorities are well aware that a stable and predictable investment climate with strict contract enforcement, as well as the reduction of red tape, are essential for attracting investment and achieving sustainable, inclusive and private sector-led growth. They recognize that it is vital to strengthen public management and accountability, to improve the governance of SOEs, and to create a business-friendly environment. The authorities also acknowledge the need for a strong improvement of social services, and a strengthening of public institutions.

Nationwide digital transformation is one of the key policy objectives for the upcoming years. Digitalization will create an infrastructure that will significantly enhance governance and reduce corruption. Digitalization also has the potential to help reduce the administrative cost of doing business and improve the delivery of public services.

Conclusion

The Kyrgyz authorities will focus on fostering sustainable growth by strengthening regional cross-border linkages. As a landlocked economy with a limited domestic market, the country would benefit greatly from deeper regional integration, given its important energy export potential, as well as its favorable regional trade and transit position.

The Kyrgyz authorities remain committed to sound macroeconomic policies in order to maintain economic stability and to keep the financial sector on a sound footing. The authorities are aware that key medium-term priorities should include actions to diversify the economy away from gold, reduce dependence on remittances and external support, and create a business environment conducive to private sector-led growth.

Ms. Pollard and Ms. Crane submitted the following statement:

We thank staff for the papers and Mr. Inderbinen and Mr. Imashov for the helpful buff statement. The Kyrgyz economy is stable, aided by benign conditions in the region, but it remains vulnerable to shocks and the structural reform agenda has not advanced much, despite a series of ECF programs. The last ECF program appears to have gone off track at the end, with little visibility for the Board. Could staff comment on what they see as the most important achievements of the last ECF program, and how performance measured up against program objectives? We agree with the thrust of the staff appraisal and urge the authorities to redouble efforts on structural reforms to underpin stronger and more sustainable growth. The Kyrgyz Republic is one of very few countries that chose not to publish its last Article IV report. We strongly urge the authorities to do so this year.

Fiscal Framework and Debt. The authorities have improved fiscal discipline, but further efforts are needed to strengthen the fiscal framework. The establishment of a fiscal rule is a positive step. We encourage the authorities to use the GFSM definition of the fiscal deficit which would include on-lending to loss-making SOE costs. We agree with staff that a more conservative anchor of debt/GDP of 60–65 percent would be preferable, particularly given risks of foreign exchange volatility. We appreciated the analysis in the DSA and concur with staff that the authorities should take a cautious approach to debt and find space for development spending by raising domestic revenues and improving spending efficiency.

Monetary and Exchange Rate Policy. We appreciate the progress toward strengthening the monetary policy framework, while encouraging greater exchange rate flexibility and attention to removing the multiple-currency practice. Annex II of the staff paper shows that the currency remains over-valued and we join staff in encouraging the authorities to permit two-way fluctuations of the currency. We note that in the last ECF review the authorities were planning to roll out software that would remove the multiple currency practice by mid-2018. Staff comments would be welcome.

Financial Stability. We are disappointed that the NBKR went against staff advice in the prior ECF program by acquiring a troubled commercial bank, and echo staff's call for the authorities to transfer the problem bank to the state as soon as possible. Ownership of the bank creates a conflict of interest, compromises central bank integrity as an impartial regulator, and detracts from its key objective of ensuring macroeconomic stability. The central bank should remove the bank from the NBKR's balance sheet and improve the bank resolution framework, as recommended by staff. We also encourage the NBKR to wind down its quasi-fiscal activities, such as lending to the Russian Kyrgyz Development Fund.

Economic Diversification and Private Sector Growth. We welcome the attention in the staff papers to private sector-led development, and recommendations to focus on energy sector reform, financial sector development, and governance. It will be important for the Kyrgyz economy to develop diverse sources of private sector growth, reducing reliance on gold exports and remittances, as recognized in the buff statement. We were glad to see that the SIP on Constraints to Private Investment references a number of World Bank papers, including the Strategic Country Diagnostic. Can staff comment on the extent of coordination with the MDBs on policy messages and capacity development aimed at removing obstacles to private sector-led growth?

Governance and Anti-Corruption. We note that Kyrgyz Republic lags its peers on governance issues and urge the authorities to place priority on addressing weaknesses in fiscal and financial sector governance, AML/CFT, rule of law and anti-corruption, as recommended by staff.

Mr. Obiora and Mr. Jappah submitted the following statement:

Contrary to staff's appraisal, we think underlying economic conditions in the Kyrgyz Republic merit urgent fiscal consolidation. We commend the authorities for the noteworthy progress in stabilizing the economy and are encouraged by the policy insights and fiscal plans provided in the buff Statement by Mr. Inderbinen and Mr. Imashov. Yet, with widening fiscal deficit, weakening current account balance, elevated debt level, and persisting vulnerabilities to external shocks in the face of continuing global uncertainties, we would have favored fiscal consolidation for 2019 and in the medium term. We think this would allow the authorities build significant buffers and create adequate room for policy flexibility, while ensuring that priority spending in infrastructure and human capital are protected. In this light, we would welcome staff comments on the appropriateness of fiscal expansion under the circumstances outlined above.

We welcome the authorities' efforts to strengthen financial supervisory practices, including through the implementation of macro-prudential measures, risk-based monitoring, and stress-testing of financial institutions. In this connection, we encourage the authorities to further enhance risk-based supervision, and address emerging risks, including from cross-border financial activities. We agree with staff on the need to strengthen the bank resolution framework, including amendments to the banking laws. We believe such updates could give the NBKR better policy handles to deal with troubled banks in the future. Relatedly, we would welcome staff comment on the authorities' difficulties in pursuing a quick resolution of the problem bank? How feasible is the authorities' plan to restructure the bank and list it on a foreign stock exchange within one year?

We are concerned with the reported discrepancy in imports data. Staff indicated that exports to the Kyrgyz Republic reported by the Chinese customs administration were significantly higher than the corresponding imports from China recorded by the authorities in 2016 (See Page 14, Footnote 6 of Staff Report). Given the criticality of reliable data for surveillance, we would appreciate staff update regarding efforts to address this anomaly.

The decisive tackling of outstanding governance deficiencies remains essential to create an enabling environment that attracts private sector investments. We commend the authorities for progress made in the implementation of the AML/CFT legislation by NBKR and activation of the Financial Intelligence Unit to address challenges, which continue to inhibit private sector growth. We urge the authorities to further strengthen judicial independence and enhance the credibility of the arbitration and tax enforcement mechanisms.

Mr. Merk and Mr. Fragin submitted the following statement:

We thank staff for an insightful and candid report, and Mr. Inderbinen and Mr. Imashov for their helpful buff statement.

We welcome the progress made in recent years in bolstering macroeconomic stability, with steady growth, low inflation, and an improved fiscal position. Nevertheless, we note that vulnerabilities remain high and many of the economic challenges faced by the Kyrgyz Republic represent long-standing structural issues. As rightly outlined by staff, the balance of payments position remains somewhat vulnerable due to a strong reliance on inflows from remittances and gold exports, while the economy is also featuring a high current account deficit and a high share of foreign currency denominated debt.

Against this backdrop, we broadly concur with staff's policy priorities and recommendations, and encourage the authorities to make full use of the regained macroeconomic stability to renew the reform momentum. We see merit in allowing for greater exchange rate flexibility with a view to increasing external resilience. We also encourage the authorities to address conflict of interest concerns at the central bank in the context of the take-over of a problem bank in a timely manner. More broadly, we agree with staff that ambitious structural reforms are of the essence in the areas of the financial sector, business environment and governance, as well as the energy sector. Regarding the latter, we encourage the authorities to timely address the structural tariff revenue shortfalls that weigh on the quality of the electricity supply, while also paying due regard to an adequate protection of vulnerable households.

On fiscal policy, we take note that staff assesses the expansionary fiscal stance as adequate in light of the negative output gap. At the same time, we note that growth has been higher than staff's potential growth estimate (of 4 percent of GDP) in 2016 and 2017, and would therefore welcome if staff could provide further details on its output gap estimate. In addition, given that staff's current potential growth estimate is based on an "an increase in gold production" [para. 4], how will potential growth be affected by the projected decline in production in the largest mine?

Lastly, on a specific point, we are somewhat surprised by the strong growth peak projected for 2022 (at 4.6 percent), which appears to be an outlier relative to staff's projections for the preceding and subsequent years. Staff comments would be welcome.

Mr. Benk and Mr. Zaborovskiy submitted the following statement:

We thank staff for the informative set of papers and Messrs. Inderbinen and Imashov for their insightful buff statement. The authorities' commendable efforts, underpinned by several Fund-supported programs, have yielded positive results, including single-digit inflation, enhanced financial stability, and an economic rebound. However, the Kyrgyz economy remains vulnerable to external shocks due to legacies of the past macroeconomic challenges and structural bottlenecks. We agree with the thrust of staff's appraisal and policy recommendations and would like to offer the following comments for emphasis.

Fiscal policy should be geared towards preserving debt sustainability while addressing development needs. We commend the authorities' significant strides to consolidate the budget and put public debt on a firm downward trajectory and urge further efforts on this front. Underpinned by the medium-term budget planning, a robust fiscal rule could significantly strengthen the existing fiscal framework and support the authorities' efforts. Since there are some differences in views between staff and the authorities on the budget deficit and public debt level ceilings, we would have preferred a more nuanced discussion on the fiscal rule design in the report. Could staff further elaborate on their advice on the operational fiscal target, i.e. whether the fiscal target should include or exclude grants, in which cases acquisition of financial assets by the authorities should be recorded "above" and "below" the line. We would also welcome comments on the safe public debt level for the Kyrgyz Republic consistent with the broader fiscal target favored by staff. Going forward, we encourage the authorities to advance fiscal risk management (focusing on risks stemming from the state-owned sector and gold price volatility), public investment management and revenue mobilization. We positively note the measures outlined in the buff statement aimed at creating fiscal space, prioritizing growth-friendly expenditures, and enhancing budget transparency and support the IMF's further technical assistance in this area.

Strengthening the monetary policy framework is essential for allowing greater exchange rate flexibility. We note that staff assessed the monetary policy stance as appropriate and the authorities agreed with this conclusion. Could staff comment in more detail on what underpins this assessment, considering that headline inflation in the first four months of 2019 was -0.5 percent, well below the inflation target range of 5 to 7 percent? Since inflation is subdued and the output gap is slightly negative, some relaxation of the macroeconomic policy mix seems well-justified and we note that staff fully supports the planned fiscal loosening in 2019. For monetary policy to play a more active role in facilitating economic growth while preserving macroeconomic stability, the necessary preconditions should be in place, and we encourage the authorities to move forward with strengthening the monetary policy transmission mechanism by decreasing dollarization, reducing excess liquidity and advancing the central bank's operational framework and independence (in line with the latest IMF Safeguards Assessment). All these measures are critical for a gradual set-up of an inflation targeting framework. We also support staff's call for greater exchange rate flexibility but emphasize the importance of a well-sequenced and gradual transition towards this goal. Staff's comments are welcome.

Decisive actions to advance the bank resolution framework and restore a level playing field in the banking sector are warranted to ensure financial stability. We commend the central bank for the progress made in implementing risk-based supervision, including stress-testing, monitoring and enforcement efforts. However, further efforts are needed to address the existing weaknesses in the financial system, buttress the AML/CFT framework, and strengthen the bank resolution legislation. Regarding the central bank's acquisition of the problem bank, we would welcome staff's estimates of financial costs related to its resolution. Staff's recommendations on deepening financial sector development are very comprehensive and require well-coordinated measures to implement them. We agree with the authorities' remarks that this is quite a difficult task, however, progress on this front is essential to support sustainable growth and gradually wind down the central bank's quasi-fiscal activities. We also sympathize with the authorities' call outlined in the buff statement on the IMF to take an active role, in collaboration with other institutions, to assist members in addressing issues related to the correspondent banking relationships withdrawal.

Promoting private-sector-led growth requires far-reaching structural reforms aimed at strengthening governance and improving the business climate. We encourage the authorities to carefully study the analysis and recommendations outlined in the Selected Issues Papers on economic growth constraints and electricity sector reforms. As theory and practice suggest, significant reform efforts over a prolonged period of time are needed to overcome the structural impediments to growth, such as infrastructure gaps, governance and rule of law issues, and education system performance. In this regard, we encourage the authorities to embark on these reforms with support from the IFIs and other development partners based on a well-designed strategy. Although the electricity sector reform seems justified, we stress the importance of timely expanding a well-targeted social safety net to protect the most vulnerable groups of the population from hikes in energy tariffs, especially considering the elevated poverty level in the Kyrgyz Republic, as well as strengthening the focus on cost-saving measures while moving forward with these reforms. We welcome the authorities' commitments outlined in the buff statement to advance structural reforms, reduce poverty, and ensure social stability. We wish the authorities every success in their reform endeavors.

Mr. Fachada and Mr. Coronel submitted the following statement:

We thank staff for the reports and Mr. Inderbinen and Mr. Imashov for their statement.

We welcome the recent progress in the Kyrgyz Republic towards macro-financial stability and more sustainable growth. Given that the country remains vulnerable to external shocks and that growth has been insufficient to significantly generate jobs and raise income levels—and despite the fact that the Kyrgyz Republic has been under Fund arrangements practically continuously since independence—we fully agree with the focus of this year's Article IV consultation on strengthening the foundations of macroeconomic and financial stability, creating better conditions for private sector led-growth, and generating space to finance long-term development needs.

The authorities' commitment to a market economy and to preserving macroeconomic stability is starting to pay dividends. We welcome recent fiscal outturns and the authorities' assurances that they will continue fiscal consolidation over the medium-term. We also welcome the monetary policy stance and the modernization of the monetary policy framework towards an inflation targeting regime. However, we agree with staff that the large external gap, overvalued real exchange rate, and high FX-denominated public debt pose important sustainability risks. On balance, allowing for greater exchange rate flexibility would help increase resilience. Further, we concur with staff's advice on the transfer of the recently acquired troubled bank from the NBRK to the state. Ownership of the troubled bank tends to create a conflict of interest, putting the NBRK credibility at risk and detracting from its mandate to ensure long-term price stability.

To unleash the country's economic potential, the authorities must accelerate the implementation of reforms. The reforms agenda suggested by staff is certainly ambitious, considering the country's capacity and resource constraints. That said, we welcome that the authorities are well-aware of the importance of institutional and structural reforms to guarantee broad-based growth, according to Messrs. Inderbinen and Imashov statement. We believe that the authorities should adopt a gradual approach to reforms, mainly aimed at enhancing governance, modernizing and deepening the financial system, fostering an improved business climate to attract private sector investment, and developing human capacity and skills.

There is a strong case to promote a gradual economic diversification strategy. The Kyrgyz Republic is a small economy, dependent on gold mining, a few agricultural export products, and remittances from Russia. The lack of economic diversification reinforces the country's vulnerability to external shocks. The immediate potential for diversification seems to lay in both the extractive and the energy sectors, but other sectors also present potential. Increased private sector participation is fundamental to lead the diversification effort.

Mr. Saito and Ms. Mori submitted the following statement:

We thank staff for the comprehensive reports and Mr. Inderbinen and Mr. Imashov for their informative statement. It is welcoming that the economy is growing steadily benefiting from a benign regional environment and that macroeconomic stability has improved reflecting the reforms implemented under past Fund-supported programs. In the meantime, the authorities face challenges such as vulnerability to external shocks, insufficient economic growth to reduce poverty, limited fiscal space to finance development needs to achieve the SDGs, and low financial intermediation. We expect the authorities' continuous effort to preserve macroeconomic stability and put economic growth on a higher trajectory. As we broadly concur with staff appraisals, we would like to offer some comments for emphasis:

Fiscal Policy

Spending composition and execution need to be improved to support the economy's growth and maintain debt sustainability. We welcome the good tax revenue performance reflecting a significant improvement in VAT collection and support the expansionary fiscal stance in 2019 in view of the output gap and the under execution in 2018. The draft fiscal rule presently considered by parliament that caps debt at 70 percent of GDP and the budget deficit at 3 percent of GDP is a welcoming step to maintain fiscal discipline and debt sustainability. In this point, we note that staff recommend deficit of 2.5 percent to build buffers by reducing tax exemptions, better capturing imports and identifying expenditure savings. At the same time, we take note of the authorities' view on the large development needs and the difficulty of tapping the fiscal space identified by staff. Against this background, we would like to hear staff's view about the priorities of fiscal reforms, building buffers, or financing development needs. In the meantime, we encourage the authorities to implement measures to increase domestic revenue and expenditure efficiency and positively take note their commitment to continue fiscal consolidation and improve expenditure efficiency.

Monetary and Exchange Rate Policy

We agree with the authorities and staff that the monetary policy stance is appropriate given the well below target range headline and core inflation and within the target range projected inflation. We welcome the National Bank of the Kyrgyz Republic's (NBKR) efforts to strengthen the monetary policy framework for moving toward inflation targeting including reducing excess liquidity, dollarization and the width of the interest rate corridor. We agree with staff that the NBRK should limit interventions solely to smooth excessive fluctuation of the exchange rate and allow the exchange rate to work as shock absorber.

Financial Sector

While it is encouraging that the banking system is resilient to substantial credit, exchange rate, and liquidity shocks, the bank resolution framework should be strengthened, and the system's low profitability need to be addressed. As staff point out, removing the problem bank from the NBKR balance sheet is indispensable to eliminate the conflict of interest, restore a level playing field in the banking sector, and protect NBKR's balance sheet. Having said so, we note that NBKR is trying to restructure the bank while ceding the bank to the state property fund includes a possibility of closure of the bank. In this regard, we would like to ask staff about whether the state has a capacity to restructure problem bank and implications of possible closure of the bank on fiscal and financial system. Reducing bank's high operating costs, fostering greater competition, decreasing information asymmetries, and strengthening the rule of low would help address low financial intermediation. On the operating cost, could staff elaborate more on the cause of the high cost and what kind of measures do staff recommend to reduce the cost? On the withdrawal of the correspondent banking relationships (CBRs) in recent years, we note that the authorities expect Fund's role in their buff statement. We would like to ask staff about the current CBRs trend in the country and region, Fund's recommendation to the authorities for addressing this issue in addition to their efforts to safeguard integrity of the financial sector, and Fund's plan to take any action to address CBRs problem in CCA region in collaboration with other institutions.

Structural Reforms

Addressing the most binding constraints to private investment and growth is crucial for improving living standards and achieving sustainable inclusive growth. We appreciate the SIP that identifies constrains such as large infrastructure gaps, weak governance and rule of law, high cost of finance, quality of education and onerous regulations and encourage the authorities' efforts to tackle with these constraints. On the chronic deficit of residential tariffs compared to costs, while recognizing the risks of social unrest, we encourage the authorities to take steps including establishing a comprehensive strategy and implementing information campaign toward future tariffs increases by drawing lessons from international experiences on Reforming Electricity Subsidies.

Mr. Lopetegui and Mr. Vogel submitted the following statement:

We thank staff for the reports and Mr. Inderbinen and Mr. Imashov for their helpful buff statement.

We share the staff's view that the Kyrgyz Republic has made progress toward macroeconomic and financial stability over the past decade, with the support of Fund programs. Indeed, the country has shown interesting growth rates, low inflation, and some advances regarding the stability in the financial system.

At the same time, we observe substantial challenges and risks going forward. Economic growth is still insufficient to meet the country's social needs (poverty rates are high, at about 25 percent); infrastructure also seems to be constrained by a number of obstacles (as rightly underlined in Chapter 1 of the Selected Issues paper) which has to be addressed without delay; the economy exhibits a significant dependence on remittances (29 percent of GDP) and gold; current account deficits have been (and are projected to be in 2019) close to two digits. Improvements in governance and the rule of law should accompany the process to allow the country to enjoy higher economic and social outcomes.

While total state government debt does not seem to be at very high levels, there are some issues in the fiscal area that require urgent consideration. For example, as underlined in the staff report, public debt is mostly denominated in foreign currency; even though the exchange rate has been broadly stable against the dollar, eventual volatility of the currency could generate relevant movements in the public debt-to-GDP ratios. We note staff's comments on the relatively high tax collection observed by Kyrgyz Republic compared to its peers, but the report indicates timely recommendations on different ways for the country to create additional fiscal space, by undertaking both revenue and expenditure reform.

We share staff's recommendation on allowing more exchange rate flexibility. As usual, we understand fears of floating, but it is necessary to consider in the cost-benefits assessment of the system, that for a small economy which is exposed to significant external shocks, a flexible exchange rate can constitute a critical buffer to cushion against them. We are encouraged by Mr. Inderbinen and Mr. Imashov's announcement that "interventions in the foreign exchange market will be made only to smooth out excessive fluctuations". Nevertheless, it is important to keep in mind that, given the possible harmful effects of exchange rate volatility on public and private balance sheets, getting the balance right will be essential. Moreover, we agree with Mr. Benk and Mr. Zaborovskiy in that strengthening the monetary policy framework is critical for allowing greater exchange rate flexibility. We also share staff's consideration on the risk of further increasing the share of gold in official foreign exchange reserves. The level of international reserves is usually seen as a financial buffer to face external shocks, and precisely one of the shocks that the country could face is related to a decline in gold prices, in which case, the level of reserves would also suffer from the same shock.

The high cost of credit is an important deterrent to inclusive and sustainable growth. The report notes that the authorities have subsidized lending to stimulate credit. Even though this could be a temporary solution, the country should try to address the issue more deeply, to tackle the real causes of the high financial costs, which are well-illustrated in paragraph 32 of the staff report, as well as in the above-referred chapter in the Selected Issues paper. Greater competition in the system and, more generally, improvements in governance issues and the rule of law, seem to be essential factors. In this regard, Mr. Inderbinen and Mr. Imashov's remarks are reassuring on the authorities' awareness "of the importance of institutional and structural reforms to ensure broad-based growth".

Regarding financial regulation and supervision, the authorities should evaluate the adequacy of resolution procedures. We would encourage the authorities to avoid direct involvement of the central bank in the management of troubled banking institutions, and to improve bank resolution in general.

With these comments, we wish the Kyrgyz Republic and its people every success in their future endeavors.

Mr. Gokarn and Mr. Siriwardana submitted the following statement:

We thank the staff for their informative set of papers and Mr. Inderbinen and Mr. Imashov for their insightful buff statement. Macroeconomic performance has improved in Kyrgyz Republic, aided by the eight Fund supported programs in the recent past. Growth has been steady, inflation is subdued, and the fiscal deficit has moderated. However, important challenges remain, including insufficient growth to reduce poverty and vulnerability to external shocks, mainly owing to the country's reliance on gold and worker remittances. The substantial decline in gold production and exports starting 2023 looms as a key medium-term factor that could affect growth and revenue. The challenging investment climate continue to affect the progress of private sector-led diversification. Hence, continued efforts are required to diversify the economy, pursue fiscal consolidation to ensure debt sustainability, further strengthen the financial sector, improve governance and fight corruption. Given the vulnerability to external shocks, building up of more reserves is also important. We broadly concur with the thrust of staff's analysis and recommendations, and wish to make following remarks for emphasis.

Efforts to strengthen fiscal consolidation will help to preserve debt sustainability, foster growth and reduce poverty. Hence, authorities are encouraged to speed up the introduction of a fiscal rule to cap the budget deficit and debt in the medium-term, which is a crucial step forward. The authorities' intention to broaden the tax base and improve tax administration, improve public expenditure efficiency, particularly by consolidating all wage-related expenditures, enhance budget transparency and continue the reform of public wages, as well as to refrain from non-concessional borrowings and minimize fiscal risks stemming from SOEs, is important to realize needed fiscal adjustments. However, we note the authorities' view on the difficulty of tapping the ways to create fiscal space, identified by the Fund and the World Bank. Could staff comment? Also, we noted the staff's assessment that there is a high margin of uncertainty around the measure of imports, (footnote 6), possibly affecting the tax revenues. Could staff elaborate more on this with possible corrective measures?

We share staff's view that the current monetary policy stance is adequate. However, we urge the Kyrgyz Central Bank (NBKR) to be vigilant and stand ready to adjust its course if inflationary pressures recur. The ongoing measures, including the improvement of the operational framework and monetary policy forecasting framework in the transition towards inflation targeting, are reassuring. The exchange rate should also be allowed to fluctuate in line with changing economic dynamics while continuing the de-dollarization policies.

On the financial sector, we welcome the progress in strengthening the supervisory and regulatory framework. This should be further strengthened with an effective bank resolution framework. Bank credit remains low and the lending-deposit spread (10 percent) remains among the highest in the world. We would welcome staff's comments on the progress in addressing the high lending-deposit spread and reducing the cost of credit. Like staff, we also emphasize the faster resolution of the unusual situation due to the recent acquisition of a troubled bank by the NBKR, to avoid a conflict of interest, preserve fair supervision and restore a level playing field. Could staff elaborate on plans to achieve this in the near term? Continued efforts are important to preserve correspondent banking relationships (CBRs) in the context of the country's high dependency on remittances. This should be complemented by further strengthening the AML/CFT regime.

Regarding structural reforms, continued progress is needed to unlock the growth potential and make the growth more inclusive. In particular, the improvement of business climate and governance, fighting corruption and strengthening rule of law will help to enhance private sector participation in the economy, attract investors and reduce vulnerability to corruption. Box 1 highlights important challenges related to the rule of law in Kyrgyz Republic. We echo the staff's view on the need for taking steps to make the judiciary more independent and transparent while improving the effectiveness of court proceedings. Could staff comment on the heavy imbalance in the win-loss rate in the courts in favor of state? Addressing the decay in the energy sector also needs urgent attention.

With these remarks, we wish authorities all success in their future endeavors.

Mr. Sun and Ms. Lok submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Inderbinen and Mr. Imashov for the useful buff statement. The Kyrgyz Republic economy is growing at a steady pace amid a benign regional environment, and further progress has been made toward macroeconomic and financial stability following eight successive Fund-supported programs. Going forward, to preserve macroeconomic stability and place growth on a higher trajectory, it is important for the authorities to maintain policy prudence and step up their reform efforts to remove structural obstacles to growth. We broadly share staff's appraisal and confine our comments to the following.

Continued fiscal discipline and efforts to raise expenditure efficiency are essential for maintaining debt sustainability. We welcome the authorities' fiscal consolidation objectives of broadening the tax base while raising the efficiency of public spending and strengthening investment management. Success in raising domestic revenues and rationalizing inefficient expenditures would help create additional space for growth-enhancing investments in infrastructure and human capital.

Banking sector stability has improved as a result of notable efforts by the National Bank of Kyrgyz Republic (NBKR), but more needs to be done to strengthen risk-based supervision and the bank resolution framework. We encourage the NBKR to remove the problem bank from its balance sheet once it is feasible to do so, and welcome the NBKR's measures in the meantime to address the conflict of interest arising from its role as central bank and banking sector supervisor. On the resolution framework, noting the constitutional constraints faced by Kyrgyz Republic, could staff comment on possible actions that can be done to strengthen the current framework within these constraints?

Institutional and structural reforms to eliminate obstacles are essential for promoting private-sector investment and supporting broad-based growth. We take positive note of the authorities' intention to work on various fronts including enhancing labor force participation, removing market distortions, deepening the financial market, as well as strengthening governance and combatting corruption. We welcome the in-depth discussion on constraints to economic growth and ways to unleash the potential of the electricity sector in the Selected Issues Paper and encourage continued close engagement between staff and the authorities to tackle challenges in these areas. In particular, given the difficult political context, the reform of the electricity sector needs to be proceeded with care, with a well-calibrated strategy that includes complementary measures to mitigate adverse social impacts. We encourage staff to continue to provide guidance and assistance to the authorities where needed to help garner sufficient social support for the relevant reforms, so that the authorities can tap the sector's full potential.

With these remarks, we wish the authorities every success in their policy endeavors.

Ms. Levonian and Mr. Williams submitted the following statement:

We thank staff for their comprehensive set of papers and Messrs. Inderbinen and Imashov for their insightful buff statement. While the Kyrgyz economy experienced steady expansion helped by a favorable regional environment, growth continued to lag potential. The economy faces formidable obstacles, not least of which are the high cost of capital, skills gap, and large governance and infrastructure bottlenecks. Moreover, the heavy reliance on remittances and gold exports, and the sizeable foreign currency component of the debt make the economy vulnerable to external shocks. In this context, staff rightly focused policy discussions on macroeconomic consolidation while creating space to address development needs, as well as measures to invigorate private sector-led growth. We broadly concur with staff's assessment and recommendations and offer the following remarks for emphasis.

We support the short-term fiscal expansion followed by a tighter stance from 2020 onwards. The slower-than-planned execution of public investment in 2018 held back growth. Against this backdrop, there is room to scale up capital spending this year without increasing the accumulative deficit, while maintaining debt at moderate levels. Looking ahead, an expenditure-driven consolidation focused on curtailing the wage bill and enhancing the public financial management framework, and supported by rationalizing tax exemptions, will be key to supporting development needs and keeping debt sustainable. Relatedly, we believe the authorities should consider a more ambitious fiscal rule with a lower debt ceiling. A sound fiscal rule would also support the authorities' inflation targeting objectives.

The authorities have made notable progress toward safeguarding financial sector stability, but further efforts are needed. Implementation of risk-based supervision is a good step forward. So is the implementation of stress testing of financial institutions. We take note of the divergent views between staff and the authorities on the approach to adequately address various factors that may pose risks to financial stability, including proposals to strengthen the banking resolution framework and to phase out quasi-fiscal activities of the central bank. Given the referenced constitutional restrictions on bank resolution decisions, can staff comment on what alternative options are feasible? The cost of credit remains quite significant and is a key obstacle to financial inclusion and, by extension, economic diversification. Against this backdrop, we encourage the authorities to prioritize actions geared at improving financial intermediation along the lines recommended by staff.

A profound reform of the energy sector is integral to boosting potential growth. Inefficient operations led by below-cost tariffs continue to weigh on the electricity sector and stymie growth prospects across the wider economy. The existing tariff regime compromises energy security and reliability. We can sympathize with the authorities' aversion to increasing tariffs given past experience. Nevertheless, we urge them to find a way to meaningfully engage key stakeholders, particularly the households, on the benefits of overhauling the tariff structure. In this context, we find staff's presentation on reform in the SIP quite compelling, with some useful international experiences that Kyrgyz can draw on.

Ms. Mahasandana, Mr. Psalidopoulos, Mr. Rashkovan, Ms. Cerami, Mr. Cools and Ms. Yoe submitted the following joint statement:

We would like to thank staff for the well-written set of reports and Mr. Inderbinen and Mr. Imashov for their informative buff statement.

The Kyrgyz economy has made significant progress toward macroeconomic and financial stability, helped by the support from Fund programs and the successful implementation of stabilization policies by the authorities. That said, the country remains vulnerable to external shocks, given its still-high reliance on remittances and gold exports as well as high dollarization. While the gross official foreign exchange reserves were adequate based on reserve adequacy metrics, we encourage the authorities to diversify the economy and further reduce dollarization to address the vulnerabilities. Continued efforts to cement macroeconomic and financial stability and accelerate structural reforms to unleash private sector growth are essential to put the economy on a sustainable growth path.

Fiscal policy

We note positively the authorities' commitment to fiscal discipline and welcome the expected approval of the draft fiscal rule, which sets a budget deficit ceiling of 3 percent of GDP. At the same time, we echo staff recommendations for the authorities to put in place further measures to build up fiscal buffers to weather future shocks.

Chief among the measures to create fiscal space is the need to reduce the government wage bill which stood at 10.2 percent of GDP in 2018. The authorities highlighted plans to improve the register of public employees so as to better track employees over time. However, we encourage the authorities to go beyond process improvement and focus on reforms to target public sector wage bill spending so as to reduce government expenditure. This could be more impactful in terms of freeing up significant fiscal resource that can be channeled to meet its large development needs. Equally important would be stepping up efforts to increase revenues. In this regard, staff suggest reducing tax exemptions and we seek staff comments on the specific tax exemptions that can be rolled back to achieve growth-friendly fiscal consolidation.

In addition to measures to increase revenue mobilization and expenditure efficiency, the authorities could also consider encouraging private investment for infrastructure development. Staff comments on how to promote private sector participation in infrastructure projects are welcome.

Finally, we note that to be in line with GFSM, staff recommended for on-lending to loss-making SOEs to be recorded as capital grants contributing to the deficit rather than as a financing item. Can staff provide an estimate of the size of the on-lending to SOEs, and how would the budget deficit change if the on-lending is recorded as a deficit item instead of a financing item?

Monetary and exchange rate policy

The National Bank of Kyrgyz Republic (NBKR) is on track to maintain price stability and continues to make good progress in strengthening the monetary policy framework in preparation to move toward inflation targeting. However, notwithstanding the importance of exchange rate stability to the Kyrgyz economy, we reiterate the importance that foreign exchange interventions should be limited solely to smoothing out excessive fluctuations. In this regard, NBKR noted that it had reduced the frequency of its intervention sharply and their aim was to smooth excessive fluctuations. Greater exchange flexibility would strengthen the resilience against external shocks and support export diversification.

Financial stability

Banking sector stability has improved, as evidenced by the resilience shown in the bank stress tests. However, there is room to further safeguard financial stability. We agree with staff recommendations that the NBKR should remove the problem bank from its balance sheet as soon as possible and that the authorities should strengthen the bank resolution framework. Doing so would ensure that bad debt in the banking sector can be swiftly and resolutely resolved without allowing these risks to become entrenched. With regard to the protracted liquidation of four insolvent banks, can staff elaborate on the impediments to the liquidation process? In addition, we welcome staff comments on the plan to strengthen bank resolution framework, including which legislative changes should be prioritized and the recommended timeframe.

Promoting private sector-led growth

To put the economy on a higher growth trajectory, the Kyrgyz authorities must strengthen their resolve to tackle structural and institutional impediments to private sector growth.

Notwithstanding implementation difficulties, the authorities must address the root causes of low financial intermediation, including reducing high operating costs at commercial banks and enhancing bank resolution framework to foster greater competition. In this regard, we suggest that staff could provide some specific and practical measures for authorities to consider. We take note from the buff that high banking costs also reflect, in part, difficulties in maintaining correspondent banking relationships and we support the authorities' call for a more active role of the Fund in this area.

We note that staff highlights the urgent need to address underinvestment and under-maintenance in the energy sector to improve the business climate. However, the authorities contend that staff recommendation for an increase to residential tariff is not socially acceptable anytime soon. We share the advice to increase residential tariffs, and we invite the authorities to address governance problems in the energy sector head-on in order to gain political buy in to effect the needed tariff increases. Given the high potential of the energy sector, it is regretful that exports are projected to decline in the medium term and cannot make a significant contribution to closing the cash deficit of the sector. Could staff elaborate on the reasons for the projected decline in energy exports, and how would the projected decline affect the external position? What measures could be taken to attract foreign investments especially from importers of Kyrgyz energy?

With these comments, we wish the authorities success in their future endeavors.

Mr. Mouminah, Mr. Alkhareif and Mr. Keshava submitted the following statement:

We thank staff for the well-written set of reports and Mr. Inderbinen and Mr. Imashov for their helpful buff statement. We are in broad agreement with staff's analysis and policy recommendations and would like to limit our remarks to the following issues.

The Kyrgyz Republic's economy is growing steadily, but it remains vulnerable to external shocks. While macroeconomic and financial stability has improved, helped by successive Fund-supported programs, we note that the economy remains highly dependent on remittances and gold, and the public debt is high and mostly denominated in foreign currency. Moreover, the economy is not growing enough to make sufficient inroads into poverty. It is therefore important to step up reform efforts to achieve higher and more inclusive growth to sustain progress on poverty reduction and raising living standards.

We take positive note of the agreement between the authorities and staff to maintain fiscal discipline and enhance public investment management. Here, the focus should be on reforming the public-sector wage bill, rationalizing other nonpriority spending, and boosting priority infrastructure and social expenditures while broadening the tax base and strengthening tax administration. We also look forward to progress in implementing a comprehensive Financial Management Information System (FMIS).

We commend the NBKR for the progress made toward strengthening the monetary policy framework as well as improving banking sector stability. In this connection, we welcome the decline in loan and deposit dollarization and we encourage the NBKR to continue implementing the de-dollarization policies. In paragraph 17, it is recommended to decrease dollarization by implementing prudential rules and developing hedging instruments for foreign exchange risk. We would welcome staff elaboration especially on prudential rules, which can help accelerate the process. We are encouraged to note the authorities' view that AML/CFT legislation has been strengthened with Fund assistance, and implementation by the NBKR and the Financial Intelligence Unit has started, and we would encourage continued progress in this regard.

Finally, staff has rightly placed emphasis on steadfast implementation of reforms to promote private sector-led growth and diversify the economy. In this context, we agree that priorities include accelerating financial sector development, reforming the energy sector to make it financially self-sustainable, addressing skills gap, and strengthening governance. Notably, continued improvement in the business environment will help in diversifying exports, which will become important after the main gold mine closes in a few years.

With these remarks, we wish the authorities further success.

Mr. Mozhin and Mr. Palei submitted the following statement:

We thank staff for a set of papers on the Kyrgyz Republic and Mr. Inderbinen and Mr. Imashov for their informative BUFF statement. We broadly agree with staff's conclusions that, after the end of the ECF program in April of last year, the authorities continued to conduct prudent policies and were successful in implementation of important structural reforms.

Economic developments since the previous Article IV consultation and the last program review bode well for the continuing good performance of the Kyrgyz economy in the future. In the beginning of 2017 staff were wary of possible slippages related to the challenging political cycle and warned about the risk of a permanent increase in fiscal expenditures in the amount of about two percentage points of GDP. The authorities, however, managed to significantly reduce the overall fiscal deficit and to maintain 2017 growth at a high level of 4.7 percent. In 2018, the authorities further cut the deficit to only 1.3 percent of GDP in the staff's definition. We agree with staff that, in 2018, the change in deficit was too sharp and probably contributed to slower growth of 3.5 percent. The reduction in deficit was largely due to a very good tax revenue performance. We also note that the delays in implementation of publicly financed projects may be detrimental to the medium-term growth. Hence, we agree with staff that, in 2019, some fiscal relaxation is warranted.

The introduction of the fiscal rule was an important structural reform in the Kyrgyz Republic. Importantly for the Kyrgyz Republic, the authorities have already put public debt on a declining path, and the baseline scenario points to its continuing decline in the medium-term. Currently public debt amounts to 56 percent of GDP, well below the 70 percent level stipulated under the introduced fiscal rule. We agree with staff that the introduction of the fiscal rule with the debt and deficit limits was a significant structural reform. We also agree with staff that additional fine-tuning with respect to the deficit definition, escape clause and other features is advisable. The authorities may wish to consider the experience of other countries with excessively rigid rules. We note that the authorities completed the work with the Fund on public investment management and continue building a comprehensive Financial Management Information System, despite difficulties with financing this project.

The authorities' monetary policy was successful in many respects. Inflation remained well under control, and price stability, together with policy measures, contributed to substantial and necessary de-dollarization of the economy. The exchange rate remained appropriately flexible, while the authorities maintained an adequate level of foreign exchange reserves. Given that a large share of the public debt is denominated in foreign currencies, we welcome the ongoing transition to a more resilient monetary policy framework. At the same time, we note that, according to staff estimates, the som may be somewhat overvalued, and encourage the authorities to remain vigilant against the risks to competitiveness.

Over the past several years the Kyrgyz authorities adopted an important banking law, which was extensively discussed with staff under the EFF program. While we note that staff pushed for a few additional improvements, we believe that the adoption of this law reflects the authorities' continuing commitment to deep structural reforms. The circumstances which led the Central Bank to take over a private bank are not entirely clear to us, and we ask staff to provide additional explanation on this matter. Overall, according to the report, the banking system appears to be well capitalized and healthy. Therefore, the double-digit credit growth over the past two years should not be a concern.

We were surprised by the lack of balance in the staff report in describing the risks to the outlook in paragraph 3 and the Risk Assessment Matrix (Annex 3). First, in paragraph 14, staff referred to the slowdown in Russia and Kazakhstan due to lower oil prices. However, as it is correctly stated in Annex 3, "the risks to prices are broadly balanced". We do not see how staff can simultaneously say that the risks to oil prices are balanced and, at the same time, label them as "downside' with a medium probability. We request an explanation and corrections.

Second, while in paragraph 14 and in other parts of the report staff did mention the risk of the dollar strengthening, they failed to mention it in the RAM. Perhaps, indirectly this risk could be found in the section on the low/medium probability of a sharp tightening of global financial conditions. What would be the possible impact on the Kyrgyz Republic in case of substantial dollar appreciation? We would appreciate staff's more explicit description of the risks stemming from possible U.S. dollar appreciation, as it was one of the two main shocks experienced by the Kyrgyz economy in 2014-2015, in addition to the shock from the lower oil prices transmitted through remittances.

We agree with Ms. Pollard that most of the time the Board is not properly informed about off-track programs. Like many other colleagues, on multiple occasions we called for more clarity on the definition of the program being off-track and on monitoring these programs in a systematic manner. We look forward to a Board meeting on this issue.

However, in the case of the Kyrgyz Republic, if we recall correctly, the Board approved the last ECF review in December2017, and, according to staff, the program naturally expired in April. We ask staff to clarify the timing and to explain whether it is appropriate to refer to such situations as the program going off-track? We believe that this unfortunate misunderstanding is yet another illustration of the need for a more general Board discussion.

We also have a question about the authorities' decision not to publish the 2017 Article IV report. Did staff discuss the reasons for the authorities' change of heart, as previously they had an enviable and consistent track record of publishing staff reports? Also, over the past two years did the Kyrgyz authorities publish any TA reports, such as the one on the PIMA?

Mr. Heo and Mr. Khurelbaatar submitted the following statement:

We thank staff for the informative report and Mr. Inderbinen and Mr. Imashov for their insightful buff statement. The economy of the Kyrgyz Republic is stabilized, and the economy is growing steadily. We commend the authorities for their efforts in reducing inflation, lowering public debt, stabilizing the economy and banking sector. However, the economy is still vulnerable to external shocks, debt is still high, and structural reforms are needed to alleviate macroeconomic imbalances. We broadly agree with the report and have the following comments.

We welcome the authorities' fiscal consolidation efforts aimed at keeping public debt at sustainable level. The recent fiscal consolidation efforts provided positive results, deficit is reduced, and public debt is on a downward trajectory. The introduction of fiscal rule and a debt ceiling are positive steps towards more disciplined fiscal policy. At the same time, we are concerned about the sharp increase of domestic debt in recent years and we would call on the authorities to carefully analyze this trend.

Structural reforms to create a fiscal space for development needs are necessary, mobilizing the budget revenue and increasing expenditure efficiency are vital to achieve public debt sustainability. Public wage and energy tariff reforms, moving from more universal to targeted social spending, reducing tax exemptions and strengthening public investment management could be priority areas where additional fiscal space can be created.

The energy sector has a big potential to boost the country's economy. The authorities are aware of the need to reform the energy sector, including the implementation of a medium-term tariff strategy, but are cautious and worried about the impact of such a reform would have in the current political context. Tariff reform is ambitious in any country, affecting significant part of the population. Could staff explain more on what the authorities can do to lessen the impact of energy reforms on vulnerable parts of the population?

Inflation in the Kyrgyz Republic has been well stabilized, and it is one of the lowest in the region. We commend the Kyrgyz Authorities for stabilizing inflation and we further encourage the authorities to gradually adopt "inflation targeting".

For the Kyrgyz Republic, addressing CBR withdrawal may be one of the urgent matters. Could staff elaborate more on what should be done by the Kyrgyz authorities and what can be done by the Fund to support the authorities with this matter?

Staff suggests that to increase the credibility of the budget, additional spending should be approved by the parliament rather than a subcommittee of the parliament. Could staff elaborate more on what is the size of additional spending approved by the subcommittee of the Parliament in recent years?

With these comments, we wish the Kyrgyz authorities every success in their future endeavors.

Mr. Mojarrad and Mr. Osei Yeboah submitted the following statement:

We thank staff for the well-written papers, and Mr. Inderbinen and Mr. Imashov for their insightful buff statement. We concur with the thrust of the staff appraisal and make the following comments for emphasis.

The Kyrgyz authorities' prudent macroeconomic policies, aided by an enabling regional environment, are helping to consolidate economic gains post the 2014-2015 oil price shock. Inflation is also low, fiscal deficit is declining and the banking sector is stable. That said, however, the heavy dependence on gold production, external assistance and remittances, and the large share of foreign currency denominated debt leave the economy vulnerable to external shocks. To contain downside risks, while placing the economy on a higher sustainable growth trajectory, macroeconomic policies and structural reforms need to be strengthened, and skills, infrastructural and institutional gaps be addressed.

Maintaining debt sustainability should remain the prime focus. We agree that the 2019 budget's expansionary stance is appropriate as the risk of debt distress is moderate. While encouraging, the authorities need to exercise caution in adding new debt and continue to enhance the efficiency of public investment management. We welcome the improvement in revenue collection and the expected strengthening of tax administration, but with an elevated wage bill, we stress the need for building sufficient fiscal buffers to accommodate additional spending on infrastructure and human capital to raise the living standards, generate jobs and reduce poverty, in line with the authorities' commitment to SDGs (Annex IV).

The monetary and exchange rate policies are appropriate and supportive of economic recovery and low inflation, as well reducing excess liquidity and dollarization. While NBKR loosened monetary policy, as output gap remained slightly negative, we are encouraged by the authorities' preparedness to tighten policy if warranted, especially in the event of higher food prices or EEU related spillovers. We commend the authorities' efforts to strengthen monetary policy implementation, and with plans to adopt an inflation-targeting framework, we encourage the authorities to draw on Fund TA at an early stage. Staff indicates a weakening in external position in 2018 but gross official foreign reserves remain adequate. Can staff elaborate on the appropriate mix of monetary gold in NBKR reserves (para 19)?

We recognize the progress being made by NBKR in strengthening its supervisory capacity and prudential framework, as well as increasing the banking system's resilience to exchange rate and liquidity shocks. Like staff, we encourage a speedily resolution of the four insolvent banks to bolster market confidence, and the transfer to central government of liabilities of the troubled bank taken over by NBKR.

Accelerating structural, institutional and governance reforms—notably in the energy sector SOEs and financial institutions—will be instrumental in removing obstacles to private sector participation in the economy. We agree with staff that strengthening the financial oversight of public entities will mitigate risks of contingent liability to the government, while buttressing anti-corruption and AML/CFT measures will bolster investor confidence and unlock the economy's growth potential. In the labor market, we welcome the authorities' initiatives to address skills mismatch, encourage women participation, and address market distortions in general, as reflected in Mr. Inderbinen and Mr. Imashov's statement.

With this, we wish the authorities success in their endeavors.

Mr. Sigurgeirsson and Mr. Gade submitted the following statement:

We thank staff for their reports and Mr. Inderbinen and Mr. Imashov for their informative BUFF statement. Aided by a series of ECF arrangements with the Fund and benign conditions in the region, progress has been made in recent years in ensuring macroeconomic stability. The economy remains vulnerable due to the high degree of reliance on remittances, the concentration of exports on gold, a fiscal and current account deficit, and the level and composition of public debt. Also, reforms to strengthen the business climate and governance should continue, along with efforts to raise living standards and lower poverty. We broadly agree with staff's appraisal and offer the following points for emphasis.

The authorities should take a cautious approach to debt and focus on raising domestic revenues, improving public financial management, as well as public spending efficiency. We welcome the adoption of a fiscal rule and agree with staff that credibility in the budget process can be further strengthened through the approval of any additional spending ex-ante and in a supplementary budget. We agree that creating additional fiscal buffers would be useful given risks around the outlook. With adequate social safeguards, we see merit in staff's recommendations of reducing tax exemptions, possibly lowering the pubic-sector wage bill, and adopting a reform strategy to ensure that the energy sector has full cost recovery. Reforming the energy sector would also bring substantial positive structural effects through ongoing maintenance and renewal of energy production facilities.

Financial sector reform and development is of key importance to improve financial sector intermediation and private-led investments and growth. We agree with staff the there is a need to promote a more efficient financial system, including through creating a level playing field, decreasing information asymmetries, strengthening the rule of law and reducing governance-related vulnerabilities, transferring or resolving the recent acquisition of a problem bank by the NBKR, and ending the NBKR's quasi fiscal activities. It will also be important to allow the NBKR to focus on its core mandate. We welcome progress in strengthening the supervisory and regulatory framework, which should be further strengthened with an effective bank resolution framework. We encourage and support close collaboration with Fund staff and other international institutions on these important efforts.

Finally, we encourage the authorities to consent to publication of the Article IV report.

Mr. Raghani and Mr. Diakite submitted the following statement:

We thank staff for the set of comprehensive reports and Mr. Inderbinen and Mr. Imashov for their insightful buff statement.

The Kyrgyz Republic has made good progress in achieving macroeconomic and financial stability in recent years. Real GDP growth has averaged more than 3 percent during the last decade and inflation was significantly reduced to stand at 1.5 percent in 2018. We also note that under steadfast implementation of Fund-supported programs, the fiscal deficit, public debt and current account deficit have also been lowered. Nonetheless, given the current global environment, further efforts are needed to strengthen macroeconomic stability and address the vulnerabilities stemming from high reliance on remittances and gold exports and from the composition of public debt. In addition, stronger economic growth will be necessary to significantly reduce poverty. We broadly concur with staff’s appraisal and policy recommendations and would like to offer the following comments for emphasis.

Financing pressing needs in the social and infrastructure development sectors require the creation of significant fiscal space. While the risk of debt distress is moderate, we note that the level of public debt in 2018 stood at 56 percent of GDP. Therefore, we agree that creating fiscal space through measures to enhance domestic resource mobilization and improve expenditures efficiency should be considered to help achieve Kyrgyz’s development objectives, including the sustainable development goals (SDGs) in the six major areas identified in annex IV of the staff report. In this regard, better assessing the import base, notably from China, and reducing tax exemptions would help to raise revenue. In particular, we encourage the authorities to carefully balance the costs and benefits of tax exemptions with the view to mobilize sizeable fiscal revenue. On the expenditure side, reforming energy tariffs, rigorously selecting public investment projects, better controlling SOEs, and containing the wage bill by reforming the management of public sector employees should carry significant savings for the State. Staff elaboration on additional measures to achieve a budget deficit of about 3.3 percent of GDP in 2019 and 2.5 percent in 2020 will be appreciated.

While the current monetary policy stance remains appropriate, the authorities should stand ready to shift direction in case of mounting and strong inflationary pressures and continue to enhance policy transmission mechanisms. We commend the authorities for the progress made in strengthening the monetary policy framework and maintaining inflation within the target range. However, they should be prepared to tighten monetary conditions should inflationary pressures arise. We welcome the central bank's move toward inflation targeting. In this context, we encourage the authorities to increase their efforts in strengthening the independence and governance of the central bank and reinforcing the interest rate as an operational tool for monetary policy transmission. We also concur with the need to pursue the de-dollarization process, mop out excess liquidity, develop a domestic security market and further deepen the financial sector. We agree with staff that there is a need for the central bank to transfer the recently acquired bank to the state to avert conflict of interest given its mandate of banking supervision. We also see merit in limiting the interventions of the central bank in the foreign exchange market to reducing excessive volatility. The authorities have rightly highlighted the challenges of the withdrawal of correspondent banking relationships (CBRs), and we support their call for an active role of the Fund and other institutions to foster a global action to address this issue.

We encourage continued implementation of structural reforms to reinforce the development of the private sector and foster stronger growth. Further efforts should be made to increase financial sector deepening, reform the energy sector and improve governance with the view to create an enabling business environment for the private sector. On financial sector development, we consider reducing operating costs, promoting competition and addressing the asymmetries of information as essential ingredients to achieve efficiency and we encourage the authorities to step up their efforts in this regard. We also urge for a deep reform of the energy sector to unleash its growth potential while taking account of the need to strengthen social protection programs given the importance of lessening the impact of the adjustment in energy tariffs on the most vulnerable.

With these remarks, we wish the authorities of the Kyrgyz Republic continued success in their endeavors.

Mr. de Villeroché, Mr. Castets and Ms. Van Hoek submitted the following statement:

We would like to thank Staff for their comprehensive set of documents and Mr. Inderbinen and Mr. Imashov for their helpful buff statement. We agree with the thrust of the Staff's appraisal and would like to make the following comments for emphasis.

The Kyrgyz authorities have made great progress under successive Fund-supported programs towards macroeconomic and financial stability. Average inflation was reduced to 1.5 percent in 2018 and the general government deficit declined to 1.3 percent of GDP. Excess liquidity, the NPL ratio and the dollarization of the economy were reduced. The NBKR monetary stance is appropriate and it is on the right path to strengthen the monetary policy framework for moving toward inflation targeting. The banking sector is well capitalized, thanks to the NBKR's enforcement of prudential norms. It is also resilient to substantial credit, exchange rate and liquidity shocks. Generally, the soundness of the banking sector has improved, although we agree with Staff on the need to gradually wind down the NBKR's quasi-fiscal activities, especially its lending to the Russian Kyrgyz Development Fund (RKDF), and to remove the problem bank it recently acquired from the NBKR balance sheet. We urge the central bank to sell said bank as soon as possible without restructuring it. Finally, fiscal consolidation has been successfully implemented and we share Staff's view that the expansionary fiscal stance implied by Kyrgyz Republic's 2019 budget is appropriate. Over the medium term, we concur with Staff on the need to limit the general government deficit at no more than 2.5 percent of GDP while maintaining escape clauses in scenarios of major shocks, and to approve all supplementary budget ex-ante. The current situation where a sub-committee of the Parliament regularizes them ex-post is detrimental to the credibility of the budget.

The economy remains vulnerable, especially to external shocks. The external position weakened in 2018, with a widening of the current account from 6.2 percent of GDP in 2017 to 8.7 percent in 2018. In addition, most of the public debt (79 percent) is denominated in foreign currency. The Kyrgyz Republic's growth is also very dependent on remittances (29 percent of GDP) and gold exportations (37 percent of exports of goods and 9 percent of GDP). The negative impact on remittances of a possible decrease in global growth and the projected closure of the main goldmine in 2026 call for a diversification of the sources of growth.

Growth has also been insufficient to significantly raise living standards and continue to reduce poverty. The quality of public services suffers from weaknesses in public financial management. Additionally, untargeted social transfers and energy subsidies reduce the space for investments in human capital and infrastructures. As there is limited room to take on more debt (given the already high level of the public debt at 56 percent of GDP), it is crucial that the authorities create more fiscal space. Reducing tax exemptions and energy subsidies should be the first steps in that direction, provided they are accompanied by transparent communication and are compensated by social safety net measures towards the more vulnerable. We note with regret the authorities' refusal to increase energy prices and urge them to reexamine their position.

Structural challenges that constraint private investment and economic growth include large infrastructure gaps, gaps in skills, low female labor participation, high cost of finance and the low quality of governance and respect of the rule of law. In addition to investing in human capital and infrastructures via an increase in domestic revenue and more expenditure efficiency, it is essential to deepen the financial sector development by reducing banks' high operating costs and fostering greater competition. Strengthening the rule of law would also participate in promoting financial deepening. We commend the authorities for their progress in implementing AML/CFT legislation with the IMF's assistance. But, as shown in Box1, market participants have low trust in courts and the legal enforcement system, which hinders business development. Making the judiciary more independent and transparent and pursuing efforts regarding the fight against corruption are essential reforms to develop private market development.

Mr. Villar and Mrs. Suazo submitted the following statement:

We thank staff for their comprehensive report and Selected Policy Issues (SIP) and Mr. Inderbinen and Mr. Imashov for the helpful buff statement. Benefiting from a benign regional environment, the economy has recently shown steady growth however insufficient to raise living standards and continue to reduce poverty. To achieve this, structural reforms are needed to address gaps in skills, infrastructure and institutions.

Since we broadly agree with the thrust of the staff's appraisal, we would just offer the following comments:

Kyrgyz has benefited from eight successive Fund supported programs, the last one ending in April 2018. Although staff mentions some of the benefits achieved through these programs, such as low inflation, lower fiscal deficits, and a capitalized banking sector, results nevertheless seem to have been mixed, with the last program ending unsuccessfully. Through such a long engagement with the Fund, what would staff considered to be the main lessons learned.

We welcome the expected approval of the fiscal rule, but we suggest, as staff recommends, that the deficit be measured as advised by the IMF Government Finance Statistics Manual (GFSM), including lending to loss-making SOEs as capital grants contributing to the deficit rather than as a financing item. We also urge authorities to cap the debt ceiling at 60-65 rather than 70 percent of GDP. Related to SOE's, can staff clarify if the government has a complete picture of SOE debt and/or fiscal contingencies and if these are adequately reported in government statistics?

Access to finance in Kyrgyz is significantly worse than the EMDE average, with very low financial deepening. Because of this, we urge authorities to take note of staff recommendations to reduce the cost of financing, strengthening the legal framework for the enforcement of collateral, as well as taking advantage of Fintech and mobile payment systems to foster financial inclusion.

Staff mentions in their risk assessment matrix tensions between the government and one of the major gold mining companies, which could adversely impact growth if unresolved and affect investor confidence. Can staff provide an update on this issue, if it is likely to be repeated among other mining investors and quantify the probable impact on growth.

We congratulate staff on their SIP and hope that authorities could draw helpful policy actions from the implications related to private investment constraints that have restricted growth, particularly related to governance and the high cost of finance relative to peers. This is markedly important in the case of the Kyrgyz Republic which is highly dependent on gold and remittances. We also urge authorities to evaluate the case studies regarding the transformation of the energy sector, and to gradually increase residential tariffs, using cash transfers to compensate the poor.

The Acting Chair (Mr. Furusawa) made the following statement:

The Kyrgyz Republic has experienced steady growth and improved macroeconomic and financial stability but remains vulnerable to external shocks, and growth has been insufficient to meaningfully reduce poverty. In their gray statements, Directors recognized the need to ensure continued macroeconomic and financial stability through measures to strengthen the fiscal and monetary policy frameworks. As Directors noted, strong efforts are required to create space for development needs, for private sector-led growth, and to reduce poverty.

Mr. Inderbinen made the following statement:

I would like to provide some additional context on three topics. One is on the intervention of Rosinbank. The other is on the expiration of the Extended Credit Facility (ECF)-supported program last year and the related issues surrounding the publication of the 2017 Article IV report. The last one is the multiple currency practice (MCP). At the outset, I would like to thank colleagues for the interest they have taken in the Article IV consultation for the Kyrgyz Republic and the Acting Chair for the introductory comments.

In Directors' gray statements, there was considerable commentary on the National Bank of the Kyrgyz Republic's (NBKR) intervention of a troubled bank. The bank came under considerable pressure as its liquidity was constrained following an audit and subsequent additional charges and penalties imposed by the state tax service as well as the indictment of a former bank official on criminal charges. Financial recovery plans agreed on by the NBKR were not successful, and the central bank then made the determination to take over a majority stake in the bank in order to protect depositors and safeguard the stability of the financial system.

There were many comments on the possibility that ownership of Rosinbank could conflict with the exercise of the central bank's powers as a supervisory authority. The authorities would like to emphasize that measures have been taken since then to ensure that management of the bank is separated from the NBKR's supervisory functions in a similar way that has been done in other countries in our membership.

Second, on the last ECF arrangement and the question of whether and to what extent the program had veered off track at the time, the last review of the program could not be completed prior to the expiration of the arrangement in April last year due mainly to the rejection by parliament of legislation to introduce a non-executive board of the central bank, which was a structural benchmark under the program. The staff suggested at the time that passage by parliament be a prior action for the final review under the arrangement but could at the time not offer more than a six-month extension. This was deemed too short by the authorities for two reasons. One is parliamentary procedure, which prohibits resubmission of a piece of legislation before a six-month period. The second was the difficulties involved due to the near unanimous rejection of the law by parliament and its reading earlier in the year, the reason for which was mainly the administrative costs associated with the changes in the legislation in the central bank.

Discussions on these issues were quite intense at the time, and the authorities did offer suggestions for alternate measures, and the focus was very much on program negotiations and on the question of publishing the surveillance report. This being said, it is important to note that the staff report for the fourth and fifth reviews under the ECF that took place two months after the 2017 Article IV consultation in December 2017 was published, and

Mr. Mozhin and Mr. Palei do remark in their gray statement that the Kyrgyz Republic does have a strong record of publication of Fund documentation.

Finally, on the MCPs, there was a question by Ms. Pollard and Ms. Crane on the practice described in the informational annex. The staff will comment on this as well, but I believe the broader point is that the official and the market rates have actually stayed within the 2 percent band since early 2018, and the MCP is based on potentiality, which will be eliminated in the course of the ongoing review of the Fund's policy on MCPs, which we all hope will be concluded in the course of the year.

Ms. Pollard made the following statement:

I want to start by thanking Mr. Inderbinen for his opening remarks and answers to our question on the MCP. It is incredibly helpful in also giving some context as to why the program was not completed. We just want to make a few points based on some of the questions and answers in the gray statements.

With regard to the answer to our question on the accomplishments of the last program, we find that the outcome of the program was rather disappointing. The answer to another question on the lessons learned said that the authorities have not demonstrated the ownership necessary to achieve meaningful progress in many structural areas. Based on Mr. Inderbinen's comments on the issue that led to the program going off track last time, I would like to get the staff's sense of whether there was anything else that could be done or whether they see this as a lack of the authorities' commitment. Looking for any future ECF request, our sense would be that there should be a relatively high bar, but I want to get some more context on whether there is a problem with authorities' interest in economic reforms or whether there were just some issues that prevented things from being accomplished.

On the issue of publication, we would still be interested in learning whether the authorities have agreed to publication of this year's report.

Finally, on the issue of the central bank acquisition of the problem bank, we agree fully with both the Fund's and World Bank's recommendation that the authorities proceed with the disposition of the problem bank based on an independent expert evaluation.

The staff representative from the Middle East and Central Asia Department (Mr. Josz), in response to questions and comments from Executive Directors, made the following statement:[1]

> We have addressed all the technical and factual questions in our answers circulated to the Board yesterday and have left a few policy questions for our intervention in the following areas: monetary policy, fiscal policy, banking resolution, and at the end I will address the question posed by the U.S. chair on the impediment to complete the review of the last program.
>
> On monetary policy, we were asked what underpins our assessment that the monetary policy stance is appropriate considering that headline inflation in the first four months of 2019 was -0.5 percent, well below the inflation target range of 5 to 7 percent. The central bank has been lowering its policy rates over the last year, lastly on May 27, when the policy rate was reduced by 25 basis point to 4.25 percent. The staff reports this loosening of the monetary policy stance, given that the projected path of inflation is on track to move to the target range within 12 to 18 months. This projection takes into account the negative output gap and the lagged effects of the cuts in the policy rates.
>
> On fiscal policy, we were asked about the priorities of fiscal reforms, building buffers or financing development needs, given our advice to limit the budget deficit to 2.5 percent of GDP in the medium term while creating fiscal space for development needs. The staff thinks it is possible to both keep the budget deficit within 2.5 percent of GDP and clear fiscal space for development needs. Indeed, reducing tax exemption alone has the potential to increase revenue by 4 percent of GDP. Increasing residential energy tariffs would free another 2 percent of GDP for development spending. Progress in wage bill management, starting with setting up a comprehensive database to track the relatively high wage bill equivalent to 10 percent of GDP, would also help identify additional expenditure savings.
>
> The same is true for implementing a comprehensive financial management information system to inform budget preparation and execution. It would help identify additional savings for development needs.
>
> On banking resolution, we were asked to comment on the authorities' difficulties in pursuing a quick resolution of the problem bank and the feasibility of the authorities' plan to restructure the bank and list it on the

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[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

foreign stock exchange within one year. With the financial difficulties of one small bank, the authorities decided to save rather than close it. As we explained in the staff report, the staff thinks that the state rather than the central bank should bear the financial consequences of that decision. This is why we recommend that the state rather than the central bank should own the bank, the other key reason being to end the conflict of interest for the central bank of implementing monetary policy and banking supervision and owning a commercial bank.

As to the feasibility of the central bank's plan to restructure the bank, together with the World Bank, we have recommended to conduct an independent expert evaluation to highlight restructuring options. We need such evaluation to form a view on the central bank's plan.

The staff's views were sought on the risk that oil prices pose to the outlook considering what we wrote in the Risk Assessment Matrix and in the relevant paragraph of the staff report. I would like to start by noting that oil price fluctuations do have an important impact on the Kyrgyz Republic and, hence, warrant elaboration in the risk paragraph of the staff report and the Risk Assessment Matrix. But since it impacts the Kyrgyz economy mainly indirectly, it is important to explain the transmission channel, which is what the text does. Specifically, in the Risk Assessment Matrix, we highlight that even though risks to oil prices are broadly balanced, lower oil prices could have a negative impact on Russia and Kazakhstan. In the relevant paragraph of the staff report, we highlight the risk that a slowdown in Russia or Kazakhstan due to lower oil prices could have negative implications for the Kyrgyz Republic through the remittances, trades, foreign direct investment, and aid channels.

Lastly, on the question on what precluded the conclusion of the last review of the program, the Director reminded us that the main issue was the approval of the change of the banking law to implement an executive board with a majority of non-executive directors, as recommended by the Fund's safeguard assessment of 2015. The draft law including these changes was rejected by parliament in December 2017 for cost reasons. The staff at the time proposed to extend the program to give an opportunity to the authorities to complete the last review. Approval of the law was a prior action to complete the final review. It is the staff's understanding that with a better explanation to parliament, it would have been possible to explain the rationale of that change. It is true that parliament rejected that change out of concern that it would increase the administrative costs of the central bank, but with the amendment of staff, the board would have to have a majority of non-executive directors that would not be paid a full-time salary. Non-executive directors would be expected to meet only a few times per year. They have non-executive responsibility and therefore would not have a full salary; and therefore we believe that basically parliament rejected the amendment on the belief it would increase the administrative costs of the central bank more than it would in reality.

Mr. Palei made the following statement:

I would like staff to elaborate a bit more on that issue. We had a successful review on December 15, and then the program was expiring in the beginning of April, so there was a window of about three months. As I understand it, there was no way for the authorities to complete the program without extension, and the staff insisted on this prior action of the adoption of the banking law. As I understand it, the authorities did not see that it was feasible even under the extension of the program, and that is why they were reluctant to go along with the proposal to extend the program. It could be interpreted as a very high degree of ownership of the program. If they feel that they cannot fulfill these prior actions, they just say that they cannot go along with the extension. From our point of view, it was difficult to see how we can say that the program was off track or the program was unsuccessful, as some other Directors said. It was a three-year program, and the last completed review was at the very end of the program, so most of the program was successful. Then there are these three months that are foggy, and we do not know what really happened. I appreciate comments from the staff's point of view. Maybe Mr. Inderbinen could say a few words how the authorities saw it, but all of us should be careful in assigning various labels to the program given the lack of information. I do support Ms. Pollard's point that we need more information about off-track programs when we have them in place, and I look forward to the staff coming back to the Board with a more general discussion on these issues. But I do not believe it applies in the case of the Kyrgyz Republic. We see it as a successful program.

Mr. Inderbinen made the following concluding statement:

I thank Directors again for their comments and advice, and we will duly pass these on to the Kyrgyz authorities.

The Kyrgyz Republic is experiencing a broad recovery, but sustained structural reforms are critical to building economic resilience and higher and more inclusive growth over the medium term. The authorities are well aware that fiscal consolidation and public financial management reforms are necessary to sustain macroeconomic stability and a strong institutional framework in the Kyrgyz Republic. Thus, the strengthening of public financial management remains a top priority for the government. I would like to emphasize that given the nature of the country's challenges, advancing structural reforms is key to achieving economic diversification and unleashing faster potential growth over the medium to longer-term. In this context, the authorities recognize that further efforts are needed to improve the business climate, develop human capital, and upgrade infrastructure, which will also be important to enhance cross-border connectivity, as well as strengthening cooperation with the international and regional partners.

We take good note of the importance underlined by many chairs of energy tariff reform, also against the background of the high potential the sector has, as laid out in the helpful supplement to the staff's paper. At the same time, we are grateful for the understanding that these reforms are socially challenging given the history of unrest in the country, and as stated in our buff statement, the authorities deem reform of the energy sector to be essential. They recognize the importance of implementing the medium-term tariff strategy, but they will be proceeding with due caution.

The Kyrgyz Republic will continue to avail itself of the many benefits of the membership in the Fund and the dialogue with and knowledge transfer from the Fund will continue to provide support for their important reform agenda. The technical assistance provided over the years by the relevant departments is highly valued.

On the question of publication, the authorities will review the corrections that have been made to the reports, and once they have the time to give due consideration to the changes and match these with the requests they made under the Transparency Policy, they will proceed to a determination of whether to publish the report.

At the outset I elaborated on the reasons for the program going off track last year. But to underline, Mr. Palei's assessment is correct that much of the program was implemented, and it did hinge on this structural measure. I believe it is important to underline that the macroeconomic stability did not suffer from the non-completion of the last review, and macroeconomic stability has been maintained since then.

With this, I would like to sincerely thank Directors, management, and the staff for their comments and advice on the Kyrgyz Republic, which as I said, we will be conveying duly to the authorities.

The Acting Chair (Mr. Furusawa) noted that the Kyrgyz Republic is an Article VIII member and maintains a multiple currency practice subject to Fund approval under Article VIII, Section 3.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the improved macroeconomic and financial conditions but noted that the economy remains vulnerable to external shocks and that risks are tilted to the downside. Continued stability-oriented macroeconomic policies and further policy reform is therefore needed to create the necessary buffers and to generate increased inclusive growth.

While stressing the need to ensure long-term debt sustainability, a modest expansionary fiscal stance, as implied by the 2019 Budget, was considered appropriate. Given the negative output gap and tighter than anticipated fiscal stance in 2018, an increase in the deficit could be helpful without jeopardizing long-term sustainability. To create the appropriate fiscal buffer, the fiscal deficit should, however, remain below 2.5 percent of GDP from 2020 and beyond, allowing the stabilization of public debt.

Directors saw the need for heightened efforts to increase fiscal space for development needs by improving domestic revenue mobilization and expenditure efficiency. They called for reducing tax exemptions, the high public-sector wage bill, and energy sector subsidies, and to strengthen public financial management. They emphasized that the general government budget deficit should be measured in line with the Government Financial Statistics Manual to include on-lending to loss-making state-owned enterprises.

Directors considered the monetary policy stance as appropriate but saw merit in greater exchange rate flexibility. They welcomed steps taken to move toward inflation targeting, including reducing excess liquidity, dollarization, and the width of the interest rate corridor. To help this transition and allow the economy to adjust to shocks through the exchange rate channel, Directors recommended that the National Bank of the Kyrgyz Republic (NBKR) maintain two-way exchange rate flexibility and limit interventions solely to smoothing excessive fluctuations.

Directors stressed the importance of implementing risk-based supervision and strengthening the bank resolution framework. Directors urged the NBKR to transfer the recently acquired problem bank to the state as soon as possible, to eliminate conflict of interest with its role as central bank and banking supervisor, to protect the central bank’s balance sheet, and to allow it to better focus on monetary policy formulation and implementation and banking supervision. Directors noted the challenge of maintaining correspondent banking relationships (CBRs) and supported the call for an active role of the Fund in assisting members to address CBR withdrawal.

Directors emphasized the importance of structural reforms to increase income and reduce poverty. The reform should focus on enhancing financial sector development, restructure the energy sector, and improve governance. A gradual increase in residential tariffs, with cash transfers to compensate the poor, is necessary to increase capacity and to unleash the growth potential of the energy sector. Strengthening the fiscal framework, improving financial sector oversight, further bolstering the AML/CFT framework, and buttressing the rule of law should help improve governance and reduce vulnerabilities to corruption.

It is expected that the next Article IV consultation with Kyrgyz Republic will be held on the standard 12-month cycle.

APPROVAL: April 16, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. ***We take note that staff assesses the expansionary fiscal stance as adequate in light of the negative output gap. At the same time, we note that growth has been higher than staff's potential growth estimate (of 4 percent of GDP) in 2016 and 2017. Could the staff provide further details on its output gap estimate?***

- The output gap has been estimated at minus one percent of potential output in 2018, and it should be closing in 2019. Potential growth may decline in the medium term if other mining or other activity are not going to compensate the loss in gold production at the main gold mine.

2. ***Given that staff's current potential growth estimate is based on an "an increase in gold production" [para. 4], how will potential growth be affected by the projected decline in production in the largest mine?***

- The closure of the main mine will reduce potential growth by about 0.7 percent. However, new activity could emerge to compensate such as new gold mines, other minerals, such as rare earths, or hydropower, for which only 10 percent of the potential has been exploited so far, or other sectors spurred by progress in structural reforms and improvement in the business environment.

3. ***Lastly, on a specific point, we are somewhat surprised by the strong growth peak projected for 2022 (at 4.6 percent), which appears to be an outlier relative to staff's projections for the preceding and subsequent years. Could the staff comment?***

- The growth peak in 2022 is due to a significant increase in gold production in other gold mines than the main one.

4. ***We were surprised by the lack of balance in the staff report in describing the risks to the outlook in paragraph 3 and the Risk Assessment Matrix (Annex 3). First, in paragraph 14, staff referred to the slowdown in Russia and Kazakhstan due to lower oil prices. However, as it is correctly stated in Annex 3, "the risks to prices are broadly balanced". We do not see how staff can simultaneously say that the risks to oil prices are balanced and, at the same time, label them as "downside' with a medium probability. We request an explanation and corrections.***

- Staff will respond to this question during the Board meeting.

5. ***Second, while in paragraph 14 and in other parts of the report staff did mention the risk of the dollar strengthening, they failed to mention it in the RAM. Perhaps, indirectly this risk could be found in the section on the low/medium probability of a sharp tightening of global financial conditions. What would be the possible impact on the Kyrgyz Republic in case of substantial dollar appreciation? We would appreciate staff's more explicit description of the risks stemming from possible U.S. dollar appreciation, as it was one of the two main shocks experienced by the Kyrgyz economy in 2014-2015, in addition to the shock from the lower oil prices transmitted through remittances.***

- Substantial dollar appreciation (or depreciation of KGS relative to USD) would affect the economy through the trade and balance sheet channels.

- **Trade channel**. The depreciation of KGS would improve country's competitiveness by making local goods cheaper for foreign buyers and foreign goods expensive for local buyers. As a result, the trade balance is expected to improve, contributing to reduction of the current account deficit.
- **Balance sheet channel**. Public and banking sector balance sheets would deteriorate given the still high dollarization and large share of foreign currency-denominated public debt in total. For instance, foreign-currency denominated debt as of Q1-2019 is 47.5 percent of 2018 GDP. The depreciation of KGS relative to USD by 20 percent (like in 2014) would mechanically increase the public debt-to-GDP ratio by about 10 percentage points. Similarly, large exchange rate depreciation would lead to higher NPLs due to a high share of loans to unhedged borrowers (about 25 percent of loans). The experience from the 2014-15 shock supports this, when exchange rate depreciation by 20 percent in 2014 and 29 percent in 2015 was accompanied by a doubling of NPLs to 9.5 percent of total loans in 2016. Higher NPLs would adversely affect bank capitalization and would slow down the growth of credit to the economy, with adverse repercussions for the real sector.

6. ***Staff mentions in their risk assessment matrix tensions between the government and one of the major gold mining companies, which could adversely impact growth if unresolved and affect investor confidence. Can staff provide an update on this issue, if it is likely to be repeated among other mining investors and quantify the probable impact on growth.***

- An agreement between the state and Kumtor, the main gold mine and largest foreign investor, appears to have been reached, and gold production is expected to operate at full capacity in 2019.

Fiscal policy

7. ***With widening fiscal deficit, weakening current account balance, elevated debt level, and persisting vulnerabilities to external shocks in the face of continuing global uncertainties, we would have favored fiscal consolidation for 2019 and in the medium term... In this light, could the staff comment on the appropriateness of fiscal expansion under the circumstances outlined above?***

- Staff supports an expansionary fiscal position in 2019 in view of the output gap and the unexpectedly tight stance in 2018. For 2020 and the medium term, staff recommended keeping the general government deficit not higher than 2.5 percent of GDP build buffers needed in view of the relatively high public debt, the downside risks on the horizon, and the unknown cost of the NBKR's takeover of a problem bank.

8. ***Could staff further elaborate on their advice on the operational fiscal target, i.e. whether the fiscal target should include or exclude grants, in which cases acquisition of financial assets by the authorities should be recorded "above" and "below" the line. We would also welcome comments on the safe public debt level for the Kyrgyz Republic consistent with the broader fiscal target favored by staff***.

- In line with the IMF Government Finance Statistics Manual (GFSM), any transfer of loans to state-owned enterprises that have a low likelihood of being repaid should be recorded above the line.

- On the safe debt level, staff prefers a tighter debt limit (60–65 percent of GDP) considering the external vulnerabilities to which the economy is exposed. Holding the fiscal deficit at 2.5 rather than 3.0 percent of GDP beyond 2020 would reduce the debt to 50 rather than 54 percent of GDP by 2024.

9. ***We note that staff recommend deficit of 2.5 percent to build buffers by reducing tax exemptions, better capturing imports and identifying expenditure savings. At the same time, we take note of the authorities' view on the large development needs and the difficulty of tapping the fiscal space identified by staff. Against this background, we would like to hear staff's view about the priorities of fiscal reforms, building buffers, or financing development needs***.

- Staff will respond to this question during the Board meeting.

10. ***Staff elaboration on additional measures to achieve a budget deficit of about 3.3 percent of GDP in 2019 and 2.5 percent in 2020 will be appreciated.***

- In 2019, staff encourages the authorities to continue improving revenue administration, including by enhancing custom control and procedure, automating VAT reporting/invoicing, etc, which is expected to yield higher revenue. On the expenditure side, staff considers an expansionary position which compensates the under-execution of investment in 2018 is appropriate.

- In 2020 and beyond, staff recommends reducing tax exemptions, the relatively high public-sector wage bill, and energy sector subsidies, and implementing a computerized Financial management Information System (FMIS) to inform budget execution, which would improve public financial management and help identify additional expenditure savings.

11. ***We note the authorities' view on the difficulty of tapping the ways to create fiscal space, identified by the Fund and the World Bank. Could staff comment?***

- Gradually reducing the relatively high public-sector wage bill and energy sector subsidies requires careful planning and communication considering their social impact. However, reducing tax exemptions, improving public investment management and implementing a computerized FMIS should be less challenging.

12. ***We noted the staff's assessment that there is a high margin of uncertainty around the measure of imports, (footnote 6), possibly affecting the tax revenues. Could staff elaborate more on this with possible corrective measures?***

- Currently, the Kyrgyz authorities along with other countries in the Eurasian Economic Union are actively working with the Chinese authorities to understand what cause discrepancies in trade flow statistics between the two countries. The results of this analysis will determine the corrective measures.

13. ***Equally important would be stepping up efforts to increase revenues. In this regard, staff suggest reducing tax exemptions and we seek staff comments on the specific tax exemptions that can be rolled back to achieve growth-friendly fiscal consolidation.***

- A first step would be to provide more transparency in the budget on the list of tax exemptions and their beneficiary and to submit the approval of tax expenditure to budget approval, as for other budget expenditure.

14. ***In addition to measures to increase revenue mobilization and expenditure efficiency, the authorities could also consider encouraging private investment for infrastructure development. Staff comments on how to promote private sector participation in infrastructure projects are welcome.***

- Implementing the staff report recommendations to remove obstacles to private-sector led growth (see ¶¶31-37 of SM/19/117) will also be helpful to encourage private investment for infrastructure development.

15. ***Staff suggests that to increase the credibility of the budget, additional spending should be approved by the parliament rather than a subcommittee of the parliament. Could staff elaborate more on what is the size of additional spending approved by the subcommittee of the Parliament in recent years?***

- In 2018, given the better-than-expected VAT collection, the subcommittee authorized additional spending of 0.9 percent of GDP in September. In 2017, it approved additional spending of 3.7 percent of GDP.

16. ***Can staff provide an estimate of the size of the on-lending to SOEs, and how would the budget deficit change if the on-lending is recorded as a deficit item instead of a financing item?***

- Total loans to loss-making energy companies averaged 1.7 percent of GDP per year during 2014–18. Recording these loans as transfers above the line, as done by staff in this staff report in accordance with GFSM, increases the deficit by the same amount compared to the authorities' fiscal accounts that record these loans below the line as acquisition of financial assets.

17. ***Can staff clarify if the government has a complete picture of SOE debt and/or fiscal contingencies and if these are adequately reported in government statistics?***

- There is no single government body that monitors and keeps record of all SOEs debt. The most recent data on the SOE debt stock can be provided by individual SOEs upon request from the State Property Fund but with a substantial time lag.

- There is no single government body quantifying and monitoring contingent liabilities either. It is useful to distinguish between explicit and implicit contingent liabilities. On explicit contingent liabilities, government's 2007 medium-term debt strategy introduced moratorium on the issuance of state guarantees and this moratorium later became an integral part of the Budget Code. On implicit contingent liabilities, staff is not aware of an assessment already conducted by the authorities.

Monetary and exchange rate policies

18. ***We note that staff assessed the monetary policy stance as appropriate and the authorities agreed with this conclusion. Could staff comment in more detail on what underpins this assessment, considering that headline inflation in the first four***

months of 2019 was -0.5 percent, well below the inflation target range of 5 to 7 percent?

- Staff will respond to this question during the Board meeting.

19. ***In paragraph 17, it is recommended to decrease dollarization by implementing prudential rules and developing hedging instruments for foreign exchange risk. We would welcome staff elaboration especially on prudential rules, which can help accelerate the process.***

- Prudential measures include the prohibition of foreign exchange-denominated mortgage and consumer loans and the tailoring of more onerous provisioning and capital requirements for banks for foreign currency-denominated loans, especially those to unhedged borrowers, i.e. borrowers who get their revenue in KGS but carry debt in foreign currency.

20. ***Can the staff elaborate on the appropriate mix of monetary gold in NBKR reserves (para 19)?***

- Since gold price volatility is one of the main external shocks the Kyrgyz economy is exposed to, further increasing the share of gold would increase the exposure of the economy to the volatility of gold prices through both the export and reserve channels.

21. ***We support staff's call for greater exchange rate flexibility but emphasize the importance of a well-sequenced and gradual transition towards this goal. Could the staff comment?***

- The top immediate priorities for the NBKR in the monetary and exchange rate policy field are: (i) development of a strategic plan for the transition to inflation targeting for internal use, with key elements made public; (ii) articulation of a foreign exchange intervention strategy and a policy for the provision of foreign exchange to the market; and (iii) reduction of excess liquidity in the banking system to achieve closer alignment between the policy rate and other money market rates.

Financial sector

22. ***Could the staff comment on the authorities' difficulties in pursuing a quick resolution of the problem bank? How feasible is the authorities' plan to restructure the bank and list it on a foreign stock exchange within one year?***

- Staff will respond to this question during the Board meeting.

23. ***Regarding the central bank's acquisition of the problem bank, we would welcome staff's estimates of financial costs related to its resolution***.

- The costs of the NBKR's acquisition of the problem bank have been about 0.8 percent of GDP and include: (i) NBKR's emergency liquidity assistance that was not reimbursed by the bank (KGS 0.9 billion or 0.2 percent to GDP) in 2018, and (ii) total recapitalization made by the NBKR following the takeover since October 2018 (KGS 3.7 billion or 0.7 percent to GDP).

24. ***We note that NBKR is trying to restructure the bank while ceding the bank to the state property fund includes a possibility of closure of the bank. In this regard, we would like to ask staff about whether the state has a capacity to restructure problem bank and implications of possible closure of the bank on fiscal and financial system***.

- For staff, the authorities have both the technical and financial capacity to restructure that problem bank. The World Bank and the IMF have been providing extensive technical assistance that resulted in substantial improvement in the banking law, including in banking resolution. Implementing the existing provisions allows the closure of banks, even though there is need for improving banking resolution as explained in ¶26 of SM/19/117. The problem bank that the NBKR took over is a mid-sized bank: its assets constituted 2.5 percent of total banking sector assets at end-2018 and its deposits 2.6 percent of total deposits (equivalent to 0.6 percent of GDP). World Bank and IMF staff have recommended an independent expert valuation based on which the future of the problem bank should be decided.

25. ***Reducing bank's high operating costs, fostering greater competition, decreasing information asymmetries, and strengthening the rule of low would help address low financial intermediation. On the operating cost, could staff elaborate more on the cause of the high cost and what kind of measures do staff recommend reducing the cost?***

- The reasons for the high operating costs need to be further studied. They could reflect operational inefficiencies that translate in high personnel costs, costs of the branch network, high funding costs, and high credit risk. Measures to address them could include: (i) fostering greater competition by: actively encouraging the entry of new banks and the exit of failed ones, through improving the bank resolution process; and identifying and addressing constraints to the development of capital markets; (ii) mitigating credit risks by strengthening the rule of law; and (iii) reducing information asymmetries by developing the infrastructure for local ratings and expanding the coverage of credit registries.

26. ***Like staff, we also emphasize the faster resolution of the unusual situation due to the recent acquisition of a troubled bank by the NBKR, to avoid a conflict of interest, preserve fair supervision and restore a level playing field. Could staff elaborate on plans to achieve this in the near term?***

- World Bank and IMF staff have recommended an independent expert valuation based on which the future of the problem bank should be decided.

27. ***We would like to ask staff about the current CBRs trend in the country and region, Fund's recommendation to the authorities for addressing this issue in addition to their efforts to safeguard integrity of the financial sector, and Fund's plan to take any action to address CBRs problem in CCA region in collaboration with other institutions.***

- The CBR data published in May 2019 by the Bank of International Settlement's Committee on Payments and Market Infrastructures indicates that the total number of correspondent banking relationships is declining globally and that the correspondent banking network is increasingly concentrated. This trend is consistent with the status of CBRs in the Kyrgyz Republic. There are increasing concerns in the Kyrgyz Republic about the fragility of USD access corridor as all banks lost direct access to the US clearing system and need to rely on non-US based intermediary banks. The authorities have been encouraged to better monitor the status of CBRs, effectively communicate efforts to address perceived risks to correspondent banks and foreign regulators and strengthen and effectively implement the AML/CFT regime.

- Staff have been supporting the authorities in this respect through technical assistance on the drafting of the recently adopted AML/CFT law and regulations and efforts to establish a risk-based approach to AML/CFT supervision of banks by the NBKR. At the regional level, Staff organized a workshop on the withdrawal of CBRs in the Caucasus and Central Asia (CCA) region in April 2018 which was attended by representatives of correspondent and respondent banks, regulators from home and affected jurisdictions, and regional and international organizations. It also participated in a CBR workshop organized by the authorities of the Swiss Confederation in February 2019 to discuss recent trends and support. Staff continue to monitor the situation in the context of Article IV Consultations and technical assistance support.

28. ***For the Kyrgyz Republic, addressing CBR withdrawal may be one of the urgent matters. Could staff elaborate more on what should be done by the Kyrgyz authorities and what can be done by the Fund to support the authorities with this matter?***

- Please see answer to previous question.

29. ***Bank credit remains low and the lending-deposit spread (10 percent) remains among the highest in the world. We would welcome staff's comments on the progress in addressing the high lending-deposit spread and reducing the cost of credit.***

- Work is being done to improve the coverage of credit registries, the scoring of borrowers, and corporate ratings, and to extend collateral beyond real estate assets. However, issues highlighted in para 32 of the SM/19/117 are pending and require a wholistic/integrated approach encompassing measures to reduce banks' high operating costs, foster greater competition, reduce information asymmetries, and strengthen the rule of law.

30. ***Notwithstanding implementation difficulties, the authorities must address the root causes of low financial intermediation, including reducing high operating costs at commercial banks and enhancing bank resolution framework to foster greater competition. In this regard, we suggest that staff could provide some specific and practical measures for authorities to consider.***

- Staff plans to continue to elaborate its advice as part of surveillance and technical assistance in collaboration with other donors.

31. ***On the resolution framework, noting the constitutional constraints faced by Kyrgyz Republic, could staff comment on possible actions that can be done to strengthen the current framework within these constraints?***

- The authorities' constitutionality concerns relate to the judicial review limitations (i.e., non-suspension and non-reversal of bank resolution decisions). No such constraints have been raised by the authorities in relation to the other potential improvements in the resolution framework. Three areas can be mentioned as regards such improvements:

- ***The NBKR's independence and governance:*** The recent takeover of a failing bank by the NBKR raises questions regarding the independence of the NBKR, and the strength of its governance arrangements, which can be critical in implementing the existing resolution powers decisively. Improvements in that regard should follow the recommendations of the latest IMF Safeguards Assessment;

- ***Clarifying the status of the Banking Law provisions vis-à-vis other "codes":*** While the banking law provides a specific resolution and liquidation framework, the hierarchy of norms under the Kyrgyz legal system gives priority to Civil Code and other codes in case of conflicts. The protracted liquidation of banks is to an extent attributable to this situation. Addressing this issue would increase the ability of the NBKR to exercise its resolution powers more effectively. Considering that the original staff proposal of adopting the "Banking *Law*" as a "*code*" was rejected during the parliamentary stage, an alternative could be introducing into the Civil Code or the Civil Procedure Code provisions that state that the Banking Law will prevail in case of any conflicts; and

- ***Safeguarding the use of NBKR and public funds:*** While there are limitations in relation to the use of NBKR and public funds in resolution, the recent acquisition of a failing bank by the NBKR indicated some gaps in the framework about the use of such funds outside resolution. This appears to undermine the integrity of resolution framework as well. To that end, staff recommendations aim at tightening the standards for the provision of ELA by seeking MoF guarantees if ELA is provided to a bank whose viability is in question, and by preventing the NBKR ownership in banks (i.e., bank shares cannot be taken as collateral by the NBKR, and NBKR ownership in entities should be limited to thoroughly circumscribed circumstances, such as operating payment and settlement systems).

32. ***We take note of the divergent views between staff and the authorities on the approach to adequately address various factors that may pose risks to financial stability, including proposals to strengthen the banking resolution framework and to phase out quasi-fiscal activities of the central bank. Given the referenced constitutional restrictions on bank resolution decisions, can staff comment on what alternative options are feasible?***

- Please see answer to previous question.

33. ***With regard to the protracted liquidation of four insolvent banks, can staff elaborate on the impediments to the liquidation process? In addition, we welcome staff comments on the plan to strengthen bank resolution framework, including which legislative changes should be prioritized and the recommended timeframe.***

- Ineffective bank resolution process and ongoing lawsuits have delayed the liquidation of four insolvent banks. On the proposed legislative changes, the ones noted above and in para 26 of the staff report with respect to the banking law and the fiscal code should be prioritized and passed in the near term.

External sector

34. ***Could staff elaborate on the reasons for the projected decline in energy exports, and how would the projected decline affect the external position? What measures could be taken to attract foreign investments especially from importers of Kyrgyz energy?***

- The projected decline in exports reflects the structural bottleneck in electricity supply as the generation capacity is constrained by the ageing infrastructure, which is becoming more and more difficult to meet domestic demand rising along with economic growth. According to World Bank estimates, under current tariff policies, the declining exports will lead to a widening of the cash deficit to over 1 percent of GDP in 2023 from 0.3 percent of GDP in 2017. To attract foreign investment, the authorities would need to reform existing tariff policies to restore the financial sustainability of the energy sector.

Structural reforms

35. ***Can staff comment on the extent of coordination with the MDBs on policy messages and capacity development aimed at removing obstacles to private sector-led growth?***

- The IMF is coordinating closely with bilateral and multilateral donors active in the country through the Development Partners Coordination Council (DPCC). The Council meets once a month and IMF's resident representative actively participates in these meetings, provides regular updates on Fund activities, and shares views on policy initiatives discussed in the meetings. The Council provides a platform for sharing information about donor activities and developing coordinated positions on policy issues of common interest. Most of the donors are active in the areas of sustainable, private sector-led growth, which is documented in their recent country partnership strategies. Examples include: DFID (regional project on SME support), EBRD and USAID (SME support), EU (regional project on support to private sector), SECO (global project on trade promotion), World Bank (investment in human capital, building greater connectivity), ADB (economic diversification program).

36. ***We echo the staff's view on the need for taking steps to make the judiciary more independent and transparent while improving the effectiveness of court proceedings. Could staff comment on the heavy imbalance in the win-loss rate in the courts in favor of state?***

- The imbalances in the win-loss rate in all categories of cases in the courts (debt enforcement, tax and administrative) reinforce the lack of trust of the market in the formal enforcement system, which is not viewed as a neutral arbiter between state and private interests. This imbalance is particularly striking in tax cases and may help explain the sharp drop of cases filed by taxpayers into the courts, almost halving in three years. The replacement of the professional tribunal for tax disputes by state courts contributed to creating that imbalance. The general absence of market trust results in high transaction costs, reduced FDI, reduced access to credit and sub-optimal growth. It has a delegitimizing impact on public authority. One key cause is that governance structures manifestly allow for government interference in the judiciary, and in cases by extension. Persistent allegations of corruption aggravate the situation. The response should be for the authorities to take structural measures, identified in the box, which aim to reinforce the role of courts as neutral arbiters, and inform the market of such measures.

37. ***Could staff explain more on what the authorities can do to lessen the impact of energy reforms on vulnerable parts of the population?***

- International experiences on tariff reforms point to various options to protect vulnerable populations from tariff increase, namely (1) providing financial support such as the targeted cash transfers to the poor/vulnerable households; and (2) maintaining a lifeline with subsidized tariff to poor/vulnerable households, among others. It is also important for the authorities to communicate clearly the planned tariff path and implement it in a smooth manner so that the population have time to make necessary adjustments to their consumption pattern.

Fund issues

38. ***Could staff comment on what they see as the most important achievements of the last ECF program, and how performance measured up against program objectives?***

- Progress was made in reducing the budget deficit and inflation and strengthening the monetary and fiscal frameworks. However, performance was mixed with respect to reducing tax exemptions, implementing a comprehensive Financial Management Information System, improving wage bill and public investment management, raising energy tariffs, strengthening the banking law and liquidating insolvent banks.

39. ***Kyrgyz has benefited from eight successive Fund supported programs, the last one ending in April 2018. Although staff mentions some of the benefits achieved through these programs, such as low inflation, lower fiscal deficits, and a capitalized banking sector, results nevertheless seem to have been mixed, with the last program ending unsuccessfully. Through such a long engagement with the Fund, what would staff considered to be the main lessons learned?***

- As first lesson is that, in response to external shocks, it is important to allow for some flexibility, especially in the fiscal area, to mitigate the adverse impact on growth, as the programs did. However, to make lasting progress on structural reforms, ownership of the authorities is indispensable, as the mixed results on the banking law, liquidation of banks, implementation of PFM measures, public investment management recommendations, and energy sector reform illustrate.

40. ***In the case of the Kyrgyz Republic, if we recall correctly, the Board approved the last ECF review in December2017, and, according to staff, the program naturally expired in April. We ask staff to clarify the timing and to explain whether it is appropriate to refer to such situations as the program going off-track?***

- There is no precise legal definition of what constitutes an off-track program. As noted in the context of the Work Program discussion, staff is consulting internally on how best to take forward the work to improve Board monitoring of off-track programs, leveraging the more easily accessible information on program review delays from the recently launched MONA-Tableau pages.

41. ***We also have a question about the authorities' decision not to publish the 2017 Article IV report. Did staff discuss the reasons for the authorities' change of heart, as previously they had an enviable and consistent track record of publishing staff reports? Also, over the past two years did the Kyrgyz authorities publish any TA reports, such as the one on the PIMA?***

- Staff will leave the Executive Director elaborate on the reasons for not publishing the 2017 Article IV report or TA reports over the past two years.

42. ***Staff indicated that exports to the Kyrgyz Republic reported by the Chinese customs administration were significantly higher than the corresponding imports from China recorded by the authorities in 2016 (See Page 14, Footnote 6 of Staff Report). Given the criticality of reliable data for surveillance, we would appreciate staff update regarding efforts to address this anomaly***.

- Please see answer to question 12.