KYRGYZ REPUBLIC
COUNTRY ECONOMIC MEMORANDUM
Executive Summary

Izvorski, Appolienia Mbowe, Bakyt Dubashov, Katharina Gassner, Michael J. Ferrantino, Roumeen Islam, and Tarik Sahovic
Acknowledgements

This is the executive summary of the Kyrgyz Republic CEM. The report was prepared by a World Bank team led by Appolinaia Mbowe and Ivailo Izvorski that comprised: Baky Dubashov, Katharina Gassner, Michael J. Ferrantino, Praveen Kumar, Roumeen Islam, and Tarik Sahovic. Other team members include Emil Abdykalykov, Moritz Meyer, Matthias Timm, Nuradil Raimbekov, Kenan Karakulah, Anna Luisa Paffhausen, Vicky Chemutai, Saumya Mitra, Zhypara Azhykanova, and Sarah Babirye.

The team benefitted from the advice and overall guidance from Sandeep Mahajan (Practice Manager). The team also benefited from inputs from: Aurelien Kruse Jennifer L. Keller, Jeff Chelsky, and Tara Vishwanath. The peer reviewers are: R. Sudharshan Canagarajah, Aurelien Kruse, Paulo Correa, Woori Lee, and Maksudjon Safarov.

The team would like to express its gratitude to authorities of the Government of the Kyrgyz Republic (including the Ministry of Finance and the Ministry of Economy) for their guidance and close cooperation.

The painting on the cover is Kyrgyz mazar. Sanju (Киргизский мазар. Санджу) by Nicholai Roerich, from 1925. The image is in the public domain.
Executive Summary

The Kyrgyz Republic has experienced modest and volatile economic expansion since the economy bottomed out from the transition recession in 1995, when GDP amounted to about half of its pre-independence levels. As a result of structural reforms at the start of transition, the emergence of remittances and commodity exports – largely gold – as powerful new drivers of growth, and improvements in the macroeconomic management in the recent decade, per-capita real GDP grew by 3.1 percent a year on average since 1995. The Kyrgyz Republic is now a lower middle-income economy, as it was in 1990. Economic expansion has benefitted from fixed investment that has risen to 31 percent of GDP, one of the highest in Europe and Central Asia and well-above the threshold of 25 percent reached by the group of successful countries studied by the Growth Commission in 2007.1 Lower fiscal deficits and low inflation indicate the success of recent macroeconomic policies.

These achievements notwithstanding, Kyrgyz Republic’s growth and productivity performance has lagged most relevant comparators, frustrating the needs of the poor and the young. As a result, while per-capita GDP in constant prices has doubled since 1995, it has still not caught up with pre-independence levels.2 Per-capita incomes in the Kyrgyz Republic have increased by 20 percent less than the average of lower middle-income countries since 2000 and 40 percent less than the average for the Caucasus and Central Asia. Productivity increases – proxied by changes in total factor productivity – have averaged half a percent since 2000, leaving largely factor accumulation as the driver of economic growth. And while “Productivity isn’t everything, but in the long run it is almost everything” – highlighting one of the main challenges of the country’s current growth model.3 Poverty has declined, but modest growth has made a modest dent, leaving the poverty rate as high as 31 percent, with a substantial part of the population living in regions with more limited and lower quality government services than in Bishkek.

The country’s growth performance is in stark contrast with the country’s potential and with the promises of the structural reforms and the opening to the rest of the world in the 1990. By 2000, Kyrgyz Republic’s progress in transition was assessed as equal or better than all countries of the Caucasus and Central Asia, Russia, and some economies in Eastern Europe.4 In the following decades, the reform momentum slowed, and implementation weakened. The Kyrgyz Republic was one of the first countries in the region to accede to the WTO after a record-low 2.7 years of negotiations. Nonetheless, after 20 years, the country has implemented just over one-tenth of the WTO trade facilitation agreement and still has not complied with the WTO sanitary and phytosanitary standards that would allow it to export fruits and vegetables to the Eurasian Economic Union (EEU) and China. These are profoundly missed opportunities, especially given the direct borders and huge demand in the EEU and Chinese markets.

2 Data before independence should be interpreted with care because of methodological issues converting data from the national statistics of the former Soviet Union.
3 The quote is from Krugman, Paul. 1997. The Age of Diminished Expectations.
Governance and institutional weaknesses, coupled with an inefficient bureaucracy, are one of the major reasons for Kyrgyz Republic’s growth and jobs underperformance. Since 2011, there have been 10 changes of government; the average tenure of the cabinet of ministers is less than one year. Kyrgyz Republic’s nascent democracy and vibrant political discourse are important assets of the country. Each government, however, has come with a new economic program and team. As a result, the authorities have found it challenging to pursue a consistent economic policy and bring reforms from design to implementation without significant delays or changes.

There is substantial evidence of governance weaknesses. The World Bank Worldwide Governance Indicators place the Kyrgyz Republic well below the average performance in terms of the rule of law, control of corruption, and political instability. The World Economic Forum's 2017 Executive Opinion Survey placed corruption at the top of business concerns. In a 2015 investor perceptions survey conducted by the World Bank Group, 80 percent of surveyed firms identified corruption, poor transparency, and unpredictability of government decisions as key constraints in operating a business in the country. Doing Business 2020 ranked the Kyrgyz Republic 70th of 190 economies, down from 67th in 2011, because of slower progress compared to other CIS economies. Over the same period, Kazakhstan, Uzbekistan, and Russia all substantially improved their rankings. Almost twice as many firms than in ECA and in lower middle-income countries on average rank corruption and political instability as the top constraints to doing business in the 2019 World Bank Enterprises Survey.

Geography has also been a challenge for the Kyrgyz Republic’s growth prospects. The country is landlocked, with a rugged mountainous terrain – and the fourth highest elevation in the world, just behind the top three.5 Growth spillovers from the country’s neighbors have been negligible, reflecting constrained trade due to limited product complementarity and cumbersome customs procedures, negligible cross-border investment and, until recently, a slow flow of people and ideas.

Macroeconomic stabilization has been effective in recent years, but government spending is high, and the exchange rate appears overvalued, negatively impacting non-resource exports and business development. On the positive side, the fiscal deficit has been reduced to about 2.5 percent of GDP a year over the last several years; the 2010 number was just 0.6 percent because of under-execution of capital spending. It is accompanied with sizable public spending given the Kyrgyz Republic’s stage of development; consolidated expenditures amount to about 37 percent of GDP, well-above the 25-28 percent average for countries with similar levels of income per capita and lower middle-income countries, and the 30 percent average for the Caucasus and Central Asia. Adequate government resources are necessary to provide much needed upgrades to public infrastructure and human capital. But overly high spending levels are counterproductive, especially with governance challenges and weaknesses; this is a topic addressed in the forthcoming World Bank Public Expenditure Review. Government debt amounts to about 55 percent of GDP even after the 2002 and 2005 Paris Club restructuring and the 2018 Russian debt write-off. Prudent fiscal policy that keeps debt at a sustainable level is crucial. Large inflows from remittances and

5 The top three are Bhutan, Nepal, and Tajikistan.
commodity-related revenues appear to have led to an overvaluation of the exchange rate by some 10 percent according to a recent IMF assessment. An overvalued exchange rate saps export growth and nips in the bud the potential new business dynamism.

The answer to the question: Why reforms, large remittances, foreign aid, substantial natural resources, debt forgiveness, and improving macroeconomic management have not resulted in stronger, less volatile, and more inclusive growth? – is simple. The reform momentum has not been sustained in all critical areas and the quality of the country’s institutional framework has not improved substantially. Frequent changes in government and government policies, along with two revolutions and external shocks, have led to macroeconomic volatility, curbing the stability that is needed for sustained increases in private investment. The business environment still does not allow for the private sector dynamism that will transform the economy and the patent regime encourages firms to remain small. Low-hanging fruits, such as setting up the sanitary and phyto-sanitary (SPS) laboratories and policies to allow exports of fruits and vegetables, have not been picked up. Increased outward orientation should allow the Kyrgyz Republic to benefit from foreign knowledge while providing ample opportunities to reinvigorate private enterprise. The electricity sector offers a striking example of how such a strategy can be realized: better regulation and reduced structural impediments for domestic and foreign private investors to build generation capacity, and more efficient and effective public investment.

The simple answer comes with a complex policy dilemma and even more challenging implementation agenda. How should the country reach the consensus needed to reduce policy volatility and adjust its strategies and institutions to revamp the growth model that so far has disappointed? And what should be the priorities in addressing the country’s growth challenges? Sustained macroeconomic stability, lower fiscal deficits and more moderate and more effective spending, and increased exchange rate flexibility are the sine qua non, the necessary condition. The government plans to do exactly this in 2020-2022 according to the recently adopted 2020 budget. Addressing export constraints – including on SPS requirements and completing the implementation of the full trade facilitation agreement with the WTO – is similarly essential and a priority for the authorities. The agenda that will take longer to implement but needs to start without delay has to do with tackling the other constraints to business development, and shifting to a more decisive external orientation of government policies.

Towards a New Growth Model

The existing growth model has not managed to generate the growth in output, exports, and jobs that are consistent with the country’s potential, challenges, and opportunities. This CEM suggests that the authorities should give priority to retooling government policies, strategies, and institutions, and craft a new growth model, more attuned to the population’s needs and the country’s aspirations. The next four sections summarize the key messages of the report and the main recommendations; the detailed analysis and policy options are contained in the main body of the CEM. In brief:

- The authorities need to reduce and manage macroeconomic and financial risks to support investment and growth. Political contestability in the Kyrgyz Republic is a valuable feature of the country’s political system; to prevent it from engendering policy
uncertainty, there needs to be fundamental common agreement on the strategic goals for the country’s development and the policy measures that deliver macroeconomic stability.

- Renewed private sector dynamism will be needed, along with policy measures to ensure more competitive domestic markets and a level playing field for firms of all sizes.
- Kyrgyz Republic’s future needs to be more firmly anchored in deepening and diversifying integration with external markets: for a small open economy that is often characterized as “land-locked”, more trade and integration should be the foundations of prosperity.
- A reinvigorated energy sector – provided the authorities address regulatory and pricing challenges—will help fuel the domestic economy and support an expansion of exports.

Macroeconomic Stability

Modest per capita growth has been one of the main characteristics of the Kyrgyz Republic’s economic performance since 2000. Whereas real GDP has expanded by an annual average of 4.3 percent since 2000, income per capita has risen by just 2.9 percent over the same period, lifting per-capita GDP from $280 in 2000 to $1,160 in 2018. Average GDP growth since 2000 fell short of the rates recorded in the Kyrgyz Republic’s regional, economic, and structural peers. While the countries of the former Soviet Union experienced similar transitional recessions in the 1990s, economic growth in most of these countries was faster subsequently than in the Kyrgyz Republic.

The volatility of growth has been substantial – even though the volatility of most its peers in the Caucasus and Central Asia has been higher. Frequent swings between periods of expansion and contraction—and deviation in the growth rate between these periods—characterizes the country’s economic performance. Since 2000, the Kyrgyz Republic experienced four one-year contractions (in 2002, 2005, 2010, and 2012). The average deviation in GDP growth from a period of expansion to one of contraction is 5.5 percent, ranging from 3.4 percent to 7.2 percent. Such considerable volatility generates uncertainty and negatively affects investor sentiment and investment.

Three main factors contribute to the growth volatility: political instability, gold, and remittances. Two of the four one-year contractions coincided with the country’s revolutions, which saw major changes in government. Overall, the Kyrgyz Republic has had 15 governments since independence and since 2011, there have been 10 government; the average tenure of the cabinet of ministers is less than one year.

Gold, which plays a significant role in the Kyrgyz economy, has been the main contributor to three of the one-year GDP contractions since 2000. The gold sector’s importance in the economy rose in 1997 with the start of operations at the Kumtor gold mine, the country’s largest mining project. Gold output rose sharply in the early 2000s before falling markedly in 2006 and again in 2012. Gold production and exports have since been on an upward trend. Gold accounts for about 10 percent of GDP, 25 percent of government revenues, 36 percent of exports – but a negligible share of employment.
Remittances have fueled domestic consumption. More than one-fifth of the working-age population works in neighboring countries, mostly Russia and Kazakhstan. Kyrgyz growth performance has benefited as a result, with migrant remittances rising from almost nothing in 2000 to $2.1 billion by 2018, equivalent to nearly 30 percent of GDP. However, the slowdown of the Russian economy in 2009 and the recession in 2014–15—following a sharp decline in oil prices at the end of the commodity super-cycle—resulted in weaker remittance flows. Swings in commodity prices and economic cycles in key trading partners like Russia and Kazakhstan have a significant influence on the Kyrgyz economy, more than doubling the volatility of overall GDP compared to non-gold gross value-added.

The structure of the Kyrgyz economy has changed dramatically since 2000, but the transformation appears to have done little to boost productivity growth. The share of value-added in agriculture fell by 22 percentage points and the sector’s share of employment dropped by 33 percentage points. A similar but less dramatic shift in value-added occurred in most transition economies, with the share of agriculture in both value-added and employment declining by 7 percentage points in Europe and Central Asia (ECA). In the Kyrgyz Republic, firms in the services sector have been the largest employer since 2004, accounting for 55 percent of total employment in 2018, up from 36.5 percent in 2000. Surprisingly, employment in manufacturing has more than doubled since 2000, while its share in GDP has declined modestly, indicating declining productivity. In fact, of all the sectors with an increased share of employment from 2000 to 2018, only retail and wholesale trade experienced increases in sectoral productivity.

Productivity growth – proxied by total factor productivity changes – has averaged half a percent a year since 2000, way too low for the country’s ambitions, challenges, and potential. With low contributions from productivity, factor accumulation accounted for most of the economic growth. Capital accumulation has dominated, as indicated by the surge in fixed capital formation to more than 30 percent by 2018. Fixed capital contributed 2.1 percentage points to the average GDP growth rate of 4.3 percent, labor and human capital added 1.7 percentage points.

TFP growth remained relatively unchanged in the period until the global financial crisis and its aftermath. Structural shifts—away from agriculture to services—dominated during 2000–08, whereas more balanced and modest economic growth across sectors has characterized the period since 2009. Cross-sector resource allocations dominated TFP developments in the first half, but within-sector gains became the dominant force in the second.

The authorities have restored fiscal prudence since independence, underpinning macroeconomic stability, a sine qua non for economic growth. The overall balance shifted dramatically from a deficit of nearly 11 percent of GDP in 2000 to a surplus of nearly 2 percent in 2008, supported by strong revenue performance and in line with the government’s program to restore and maintain macroeconomic stability. The deficit widened again in 2009–10, as automatic stabilizers played their role following a weakening of output, and large donor support to address urgent social needs supported the authorities. In recent years, the deficit has fluctuated in a range outside the limits of the proposed fiscal rule. The authorities plan to sustain fiscal consolidation and limit the fiscal deficit to 1.8 percent of GDP by 2022. This is a commendable ambition that will require substantial efforts to reduce oversized spending and sustain robust growth in revenues.
External grants, *ad hoc* efforts, and revenue administration measures helped boost government revenues from 20 percent of GDP in 2000 to 33 percent on average in the last several years. The authorities need to rely more on improvements in the tax regime, broadening the tax base, reducing exemptions, and strengthening revenue administration. Widespread tax exemptions—amounting to roughly 4.4 percent of GDP—present substantial room for increasing revenues. Another option is increasing the rate of VAT from its current level of 12 percent, one of the lowest rates among the Kyrgyz Republic’s comparators. The VAT rate in the CCA, for example, is in the 18-20 percent range.

**While revenues could contribute modestly to the fiscal adjustment needed to reduce debt to lower levels, the main contribution needs to come from spending.** Public spending is high and above the levels of relevant comparators (see the forthcoming World bank Public Expenditure Review). Government spending increased from 30 percent of GDP in 2000 to 37 percent on average in recent years, excluding the one-off lows in 2018. Government spending is now on par with levels immediately following independence. The surge since reflects increases in both current and capital expenditures, the 2018-19 drop in the latter notwithstanding.

**The quality and effectiveness of public spending, essential to support growth and poverty reduction, appear to be sub-standard.** Spending on wages and salaries is much higher than in comparable countries, for example, driven to a large extent by higher public employment. Partly for countercyclical reasons, compensation has grown rapidly over the past five years. A rationalization of the wage bill should be achieved by a thorough review of total employment and efficiency gains followed by reform of the civil service pay system. Measures approved for rationalizing the wage bill have not been fully implemented, including differentiated pay scales in public services such as education and health, an increase in the share of base pay in total pay, and the elimination of the 13th-month salary and some performance-linked bonuses.

**Improved public investment management is also needed.** The Kyrgyz Republic spends substantial resources on public infrastructure, but project selection, execution, and monitoring will require strengthening given the country’s significant needs, especially in energy.

**Government debt has declined from its highs in 2000, thanks to Paris Club restructuring in 2002 and 2005 and the 2018 debt write-off by Russia.** General government debt fell from 123 percent of GDP in 2000 to about 55 percent in 2019. The proposed fiscal rule plans to limit debt to GDP to 70 percent. This is a very high level for a country at Kyrgyz Republic’s state of development; a more conservative rule, perhaps with limits not higher than 60 percent will be more conducive to fiscal sustainability.

**Monetary policy in the Kyrgyz Republic targets inflation.** The central bank’s indicative target for inflation is in the range of 5-7 percent using a broad money aggregate as the intermediate target. Several factors complicate the conduct of monetary policy. First, the financial system is shallow. Bank deposits and loans are substantially dollarized, even though the extent of dollarization has declined since 2016 to 36 percent for loans and 45 percent for deposits. Second, there is a weak relationship between monetary aggregates and inflation. Furthermore, open market operations are hampered by the small volume of securities available. In an environment of substantial excess
liquidity, limited bank competition, and high bank operating costs, the policy rate is still not fully effective in influencing bank lending rates.

**The exchange rate has remained little changed against the US dollar since 2016.** This stability followed the sharp depreciation of the nominal exchange rate by nearly 40 percent against the dollar in 2015 and of the real effective exchange rate by about 12 percent in 2015, following the sharp drop in oil prices and remittances at the end of the commodity super-cycle.

**The exchange rate is assessed to be overvalued by 10-15 percent, according to the latest calculations by the IMF.** A more flexible exchange rate should help the economy react better to external shocks, minimize shocks to its buffers and foreign exchange reserves, and limit losses in external competitiveness for its non-commodity exports.

**We invite the authorities to consider the following policy options:**

- Plan for lower fiscal deficits and lower debt levels relative to GDP. Fiscal deficits should be consistent with public debt to GDP ratios that are well within debt sustainability thresholds to ensure there is fiscal space to respond to adverse fiscal shocks.

- Formulate budgets with an explicit countercyclical objective to strengthen macroeconomic stability. Countercyclical policy must operate both in good and bad times.

- Raising real GDP growth rates over the medium to long term will require a stronger growth orientation of fiscal policy, notably in improving the effectiveness of spending on education and investment.

- Improve the quality of public investment by focusing on project selection, execution, and monitoring. Only on this basis, gradually increase budgetary allocations to investment.

- Broaden the VAT base by reducing exemptions and consider raising the VAT rate.

- Allow for more exchange rate flexibility and do not allow an overvaluation of the currency. An overvalued exchange rate saps the country’s competitiveness and curbs the ability of companies to export.

**Renewed Private Sector Dynamism**

The share of private sector activity in the Kyrgyz Republic is larger than in most other countries in the region because of early economic liberalization, rapid privatization, and new firm entry. The private sector is reported to account for more than 75 percent of GDP in the Kyrgyz Republic compared to 60 in Kazakhstan and less in the other countries of Central Asia. In contrast to comparators, however, Kyrgyz firms face substantial constraints to expansion and their productivity growth appears to be lagging many comparators. The public sector includes 23 joint stock companies and 104 state enterprises, or unincorporated legal entities. The largest SOEs are in energy (the only loss-making sector), mining, transport, and banking.
Economic activity is spatially concentrated around the capital, Bishkek, where 37 percent of value-added is produced. Bishkek also accounts for half of the registered workers and firms in the country. In terms of the spatial concentration of economic activity, the Kyrgyz Republic is above the average of countries in its income group. About 38 percent of value-added in produced in Bishkek, above comparators with similar incomes and double the level in Kazakhstan. The advantages of locating in Bishkek far outweigh those found elsewhere, particularly given the condition of supporting infrastructure, more reliable electricity, and logistics for business.

High agglomeration of firms and people – or spatial concentration – is an important precondition for the country to reap benefits from the Belt and Road Initiative (BRI); but it will not be enough. It will require complementary policies, such as measures to advance the country’s trade and investment with neighbors, steps to strengthen the legal protection of investment, efforts to address labor displacements and the territorial inequality and labor mobility, and, most importantly, a determined agenda to support private sector development.

The Kyrgyz Republic is a story of the “missing middle” – unlike many relevant comparators, medium-sized firms are largely missing in terms of their contribution to output and employment. Medium-size firms comprised less than 0.1 percent of the total number of firms (just 769 of 856,549 firms) in 2018, 4.6 percent of GDP and 3.7 percent of employment. Not only is their contribution low, but it has declined since 2001 both in number and their share of employment, while the share of small and large firms has increased. Large firms contribute the most to value-added (60 percent) – similar to Kazakhstan, and employment (80 percent), similar to Azerbaijan and Uzbekistan. In this regard, the country differs from most other economies, in which small – and medium-size enterprises dominate. Employment data indicate that the number of workers in very large firms has risen only slightly over time, but the most significant increase has been in micro and small-size firms. In terms of the sectoral distribution of employment, agriculture's share has declined substantially, to 21 percent by 2018 from 54 percent in 2000, with wholesale and retail trade rising the most, and manufacturing and construction also showing increases.

The “missing middle” indicates that firms face substantial constraints to expanding. In part, this reflects low productivity and financial constraints to support scaling up production and employment. It also reflects the burdensome regulatory environment and a playing field that is tilted against small companies. Firms single out unfair competition from informal companies as an important obstacle to doing business, but informality is an outcome that reflects the various limitations and policies in the economy. Informal companies are typically small and micro in size and, like formal companies, face obstacles to expansion. As a result, both the missing middle and informality are indications of what needs to change to allow for a more dynamic private sector.

The government should follow no-regrets policies concerning informality. Policy makers should not place unnecessary pressure on informal firms to formalize. Instead, policy should focus on improving the business and regulatory environment, and ensuring taxes are fair and collection is even-handed. As the business, regulatory, and macroeconomic environments improve and incomes per capita rise, more firms will formalize.
Labor productivity and labor costs also set the Kyrgyz Republic apart. Relative to comparators, the growth rate of labor productivity is more modest (except Azerbaijan, Belarus, and Moldova). At the same time, unit labor costs have increased substantially since 2000 because of the appreciated exchange rate and wage increases. Unit labor costs are twice as high in 2018 as in 2000. Tajikistan, another large recipient of remittance inflow, has also experienced such doubling of unit labor costs over the same period, while the other countries in the Caucasus and Central Asia have had more moderate increases or even declines, as in Kazakhstan.

Besides policy instability and governance weaknesses – as highlighted earlier – the main constraints to business development in the Kyrgyz Republic are in the areas of business inspections, licenses and permits, taxation and financing.

Business inspections: In 2012, the government reduced the number of state inspectorates from 21 to 12 and made fewer administrative bodies responsible for inspections. The scope of inspections narrowed, the number of inspections has been reduced by 30 percent, and businesses have saved about $5 million in compliance-related expenses. More challenges remains. There is little incentive for the state inspectorate to move away from a penalty-based approach to a compliance and awareness-building approach.

Licenses and permits: Firms must comply with 800 different administrative procedures (including permits) according to a recent OSCE survey. In comparison, Moldova has 155 such procedures, and Kosovo has approximately 480 that have a direct relation to the regulation of business. Obtaining permits is a major obstacle for businesses in terms of time and cost. The existence of multiple permits—each with its own process—has facilitated corruption and reduced the transparency of the system. Plans to simplify the system are in development; digitalization and automatization should help.

Investment protection and foreign direct investment (FDI): The Kyrgyz Republic is the lowest-ranked country in Central Asia on investor protection. Doing Business, for example, ranks the Kyrgyz Republic below the regional average across most indicators. The country scores particularly low on resolving insolvency and enforcing contracts.

Taxation: The effective tax burden on firms is modest and not a significant concern for the private sector. Tax compliance, by contrast, is burdensome, particularly for micro, small, and medium enterprises (MSMEs), owing to a plethora of complex tax regimes and rules that lack clarity. There are six national taxes (the sales tax overlaps with the VAT, but existing fiscal constraints prevent a rapid phase-out), and two local taxes. In addition to the general tax regime, there are six other specialized tax regimes for distinct categories of companies. Recent reforms include consolidating the tax on interest income with the corporate income tax and the establishment of an online platform for filing and paying taxes. If implemented well, these reforms should make paying taxes easier.

Patent system for small business: Most small businesses prefer to apply for patents. In addition to the low cost of entry, the patent regime offers a very generous threshold of KGS 8 million ($116,000), among the highest in Europe and Central Asia. Business owners under the patent regime pay about one-seventh of the social insurance contributions paid by those under the general
tax regime. Some enterprises abuse the patent system and grow much larger (as informal entities) than allowed by the system. Others stay small and forego expansion that would raise their taxes and social security contributions and increase their interactions with regulators. This may be an important explanation of why so few enterprises in the Kyrgyz Republic grow into medium-size firms.

Finance: Access to finance is one of the top constraints to doing business in the Kyrgyz Republic. About 26 percent of Kyrgyz MSMEs identified access to finance as a major constraint compared to 16.6 percent of firms in ECA on average, and 8.8 percent in Kazakhstan. Credit to the private sector reached about 24 percent of GDP at end-2018 compared to over 40 percent in lower-middle-income economies on average. Only 9 percent of the population borrowed from a financial institution in 2017, and even fewer saved or took out a loan for opening a business. Agriculture is one sectors that would benefit substantially from improved access to credit. Over the last two years, the situation in the banking sector has improved, with financial sector growth accompanied by declining interest rates. The transformation of major microfinance organizations (MFOs) into banks may have influenced these rates by increasing competition in the market. The establishment of the Russia-Kyrgyz Development Fund (RKDF) also had an impact on lending rates as it provided a new source of financing. However, private sector financing through the development fund cannot and should not substitute for a commercially-viable financial sector that can provide business and household credit.

Reform to the tax and business regulatory frameworks is needed to facilitate rather than constrain firm growth, competition in markets, and ease in resource reallocation. Input markets—whether in finance, labor, energy, or other services (not all covered in this chapter)—will need attention if they are to support firm development. In addition to horizontal regulatory reform, focused sectoral initiatives (in agriculture or tourism, for example) could add additional momentum so firms can best compete in global markets in non-commodity sectors.

We suggest the government consider the following main policy actions; more details can be found in Chapter 2 of the main report:

• As a priority, implement sanitary and phytosanitary requirements by the WTO and the EEU and build the needed infrastructure to unlock export markets and support domestic businesses.
• Move to a more transparent and simplified tax and social insurance administration, including a lower threshold in line with the Kyrgyz Republic’s GDP per capita, and establish unified taxpayer IDs for business. Small businesses—including those on the patent regime—should be properly registered as such.
• Simplify and make more transparent the licensing and inspection regime.
• Develop risk-based inspection checklists and dynamic risk models.
• Deal with other cumbersome procedures limiting firm growth, such as access to land, construction permits or energy.
• Streamline oversight of foreign investment disputes.
• Move faster with e-government and a one-stop shop to reduce opportunities for corruption.

• Improve the availability of information about borrowers and collateral; avoid subsidizing finance

Increased Trade and Regional Integration

A small and open economy like the Kyrgyz Republic needs increasing trade and integration with its neighbors and the world economy. Such an ambition is well placed: the Kyrgyz Republic’s exports of goods and services have barely changed in U.S. dollar terms since 2008, while global exports and exports from lower middle-income countries have risen by 26 percent and 53 percent, respectively. As a share of GDP, exports of goods and services in the Kyrgyz Republic have fallen by 36 percent of exports, and half during this period to 33 percent in 2018. This is below that in countries with similar levels of GDP per capita and—owing to Kyrgyz Republic’s commodity exports—just above the average of lower middle-income countries. For a country that was the region’s first to join the WTO, this poor export performance is diminishing the scope for boosting output, income, and wages.

The Kyrgyz Republic is not resource abundant, but commodities dominate its exports. The Kyrgyz Republic, together with Tajikistan, is the least abundant in natural capital in ECA and is in the bottom 20 percent of all countries in the world by natural capital per capita. Nonetheless, gold, other metals, and minerals account for 63 percent of exports, a share unchanged since 2000. Together with fuels, these exports account for 72 percent of the country’s total – similar to the share of commodities in the exports of the six most resource-rich countries in Europe and Central Asia. Like other countries with natural resource endowments, the Kyrgyz Republic has integrated into the global economy via its commodity exports: more than one-third of the country’s total exports (primarily gold) goes to Switzerland and the United Kingdom. The Russian Federation and Kazakhstan purchase a further 30 percent. But commodities have created little backward linkages in the economy and account for less than 3 percent of the jobs. Commodity production is operated as an enclave, an economy within the economy. It is imperative for the authorities to reinvigorate the export engine of growth and jobs.

The WTO, the Eurasian Economic Union, and the BRI are three of the most important avenues for strengthening Kyrgyz Republic’s regional and global integration. The country acceded to the WTO in 1998 – the first in Central Asia – after completing its accession process in just 2.7 years, the shortest on record. Despite the early accession, the Kyrgyz Republic has yet to take full advantage of its WTO membership. For example, the country has implemented just 12.2 percent of its commitments under the WTO Trade Facilitation Agreement, and the government plans to implement another 16.4 percent by the end of 2020 without external assistance. Such assistance will be needed, however, to implement the remaining 71.4 percent of the country’s commitments. Specifically, the Kyrgyz Republic has requested assistance and support for a total of 26 TFA measures,6 the most pressing of which concern the legislative and regulatory framework. Other major needs include developing appropriate information and

6 See the WTO’s TFA website at https://www.tfadatabase.org/members/kyrgyz-republic/category-c-analysis for a full list of the 26 measures.
communication technology (ICT), human resources and training, institutional procedures, awareness-raising, and carrying out diagnostics and needs assessments. While the Kyrgyz Republic is committed to adhering to the provisions of all related WTO agreements on standards, implementation has fallen short.

Several donor agencies and international organizations have been providing dedicated technical assistance on trade facilitation, although gaps remain. In particular, the Central Asia Regional Economic Cooperation (CAREC)’s trade facilitation programs (under the Asian Development Bank) have been guided by several strategies, including the Transport and Trade Facilitation Strategy 2020 and the Common Agenda for Modernization of Sanitary and Phytosanitary Measures for Trade (CAST). The Regional Improvement of Border Services (RIBS) project, for example, coordinates infrastructure improvement and the simplification of border crossing clearance procedures in select border crossing points in the Kyrgyz Republic, Mongolia, Pakistan, and Tajikistan. An emerging suggestion is that the Kyrgyz Republic accedes to the Simplification and Harmonization of Customs Procedures (Revised Kyoto Convention, RKC).7

Kazakhstan has filed several sanitary and phytosanitary emergency measures against the Kyrgyz Republic. These include temporary restrictions on the import of Kyrgyz potatoes due to the “systematic identification of pests in quarantine products.” Procedures are slow owing to a lack of infrastructure, and, as a consequence, Kazakhstan again introduced a temporary ban—on the import of Kyrgyz meat—in October 2018.8 A 2015 study of the procedures required to export processed fruit from the Kyrgyz Republic to Kazakhstan indicated that procedures are slow and cumbersome. The total time for processing documents and delivering fruit in 2015 ranged from 30-45 days, with the highest percentage of time spent on obtaining a phytosanitary certificate (27 percent).9 Limitations in the Kyrgyz Republic’s infrastructure are directly affecting its competitiveness. In addition, these limitations have limited its ability to notify trading partners. For example, Kyrgyzstan, while notifying TBT measures as early as 2007, only submitted its first SPS notification in 2015, the year of EEU accession.

The Kyrgyz Republic is still in the process of adapting its economic and regulatory structure to the Eurasian Economic Union; as such, it may be too soon to predict long-term impacts. The Kyrgyz Republic joined the Eurasian Customs Union, the predecessor of the EEU, in 2015. With a nascent regulatory standards structure, the Kyrgyz Republic was granted an exemption to distribute products not in compliance with EEU standards (within its domestic market only) until August 2019. Export to other EEU member states has remained a challenge, primarily owing to the Kyrgyz Republic’s failure to comply with WTO SPS requirements and World Organization for Animal Health standards for slaughter, regular vaccination, and animal identification. To reap the full benefits of EEU membership, however, the Kyrgyz Republic will need to do more than harmonize regulations; it should build the necessary infrastructure for testing and certification. Currently, only some facilities, including food testing laboratories, have the capacity for sample analysis, and several are not internationally accredited.

---

7 The RKC is considered the 21st-century blueprint for modernized customs procedures and complements the WTO TFA.
9 UNESCAP 2018.
The EEU’s common external tariff (CET) is significantly higher than those of several of its member countries before accession. As all of Kyrgyz Republic’s external tariffs need to align with the CET by 2020, the country’s average duty will rise to 8 percent from 5 percent in 2016. Negotiations with the WTO members on compensation for increased EEU tariffs present an additional challenge. When the Kyrgyz Republic acceded to the WTO, it committed only to impose tariffs that conform with relevant WTO provisions\(^\text{10}\) in the event that it joined a free trade or customs union agreement. Because nearly 50 percent of tariff rates under the new EEU-tariff structure do not comply with the country’s WTO commitments, the Kyrgyz Republic will be required to renegotiate and provide compensation to other WTO member states.

To make the best of its membership in the EEU, however, the Kyrgyz Republic needs to improve its institutional infrastructure to support its exports to EEU countries. Requirements for stricter sanitary and phytosanitary standards need to be met, more laboratories – including for food testing – need to be internationally accredited and better linked to exporters. Trade facilitation should be rapidly improved to allow seamless border crossing with Kazakhstan that will reduce substantially the time trucks spent at customs.

The need to improve behind the border trade facilitation and sanitary and phytosanitary standards has acquired a new urgency because of the dramatic reforms in Uzbekistan. Many of Uzbekistan’s exports compete directly with those of the Kyrgyz Republic – and while that will not improve trade between the two countries, it will pose substantial challenges for Kyrgyz exports of fruits, vegetables, and textiles, to name just a few, in EEU countries.

The Kyrgyz Republic stands to become one of the biggest beneficiaries of the BRI. A recent study finds that the BRI could boost the Kyrgyz Republic’s GDP by 9-32 percent over the long term; the higher impact is estimated based on combining BRI improvements in infrastructure with ambitious complementary policy reforms on trade facilitation, logistics, and other steps to reduce border-crossing delays by half. That is, infrastructure alone cannot deliver large gains: policy reforms are an essential part of the package needed to benefit substantially from improved connectivity. The completion of BRI transport projects is forecast to increase Kyrgyz Republic’s exports by 7.3 percent. This improvement reflects a sizeable reduction in the time to trade and an associated decline in trade costs. If complementary reforms that reduce border crossing delays by half across all countries combine with the transport infrastructure improvements, Kyrgyz exports could rise by almost 22 percent.

In summary, we suggest the government consider the following main policy actions; more details can be found in Chapter 3 of the report:

- Urgently upgrade the country’s sanitary and phyto-sanitary capacity to support exports of fresh fruits and vegetables.
- Complete all remaining commitments under the WTO TFA. Seek donor support.
- Advance compliance with the EEU’s other technical regulations and standards.

\(^{10}\) These relevant provisions include Articles I and XXIV of the General Agreement on Tariffs and Trade 1994.
• Work deliberately on tackling trade facilitation challenges. The World Bank is providing technical assistance in this area.

• Buoyant exports require a buoyant private sector, with reduced obstacles to the mobility of capital and labor, business entry, and innovation (Chapter 2).

**Reinvigorated Energy Sector**

The energy sector has the potential to provide the (hydro) fuel for Kyrgyz Republic’s new growth model by reinvigorating the domestic industry and boosting exports. The country’s strong comparative advantage in hydropower offers a transformative opportunity to raise the country’s economic growth potential in a sustained manner. Electricity exports to Kazakhstan and Uzbekistan have traditionally generated revenues for the country, although trade is highly cyclical and dependent on hydrological patterns. In recent years, however, the country has imported electricity to meet its domestic needs. There is potential to increase the revenue stream as regional demand increases. The CASA 1000, the transmission line connecting the Kyrgyz Republic and Tajikistan as exporters of clean power with South Asia’s growing markets of Afghanistan and Pakistan, is expected to start operations in 2023. Exports via the new high-voltage line can generate an estimated $90 million annually during the spring and summer months when there is surplus generation in the Kyrgyz Republic.

More abundant hydro energy will also help private companies expand. Private sector employment, especially in the formal economy, is likely to increase and wages rise in line with higher productivity. Inclusion will also depend on the new energy-related fiscal revenues used to support investments in human capital, skills, and infrastructure.

With its rich endowment of natural water reserves in mountainous terrain, particularly in the Naryn River basin, the Kyrgyz Republic’s untapped hydropower potential is enormous. The country’s installed capacity of 3.1 gigawatts (GW) places it 40th globally. Hydropower potential, which exists for small, medium, and large generation plants, is estimated at 140-170 terawatts (TW), the 56th largest in the world. The country uses just 10 percent of its existing hydropower potential. With the cost of generation relatively low, the country enjoys a strong comparative advantage in hydropower.

Economic growth and social development are driving an increase in electricity demand that outstrips the currently installed generation capacity. Although the number of residential electricity consumers rose by 16 percent in 2007–18, consumption jumped by 71 percent. Compounding the challenge of rapid demand growth is the very high seasonality of demand—winter consumption was 2.6 times greater than summer consumption in 2017, posing a challenge for system planning, considering peak demand. Between 2014 and 2016, the Kyrgyz Republic imported power from neighboring countries for the first time to supply peak demand during the winter months. The authorities have announced they expect electricity imports in 2020 as well.

---

11 International Hydropower Association 2018.
12 The cost of generation in the Kyrgyz Republic is variable, but averaged KGS 1.7 per kilowatt-hour in 2014 and KGS 2.8 in 2015.
13 As cited in March 2019 by Praveer Sinha, CEO of Tata Power, at the World Bank’s Energy and Extractives learning week, the “top 10 percent of capacity is needed only 1 percent of the time.”
The risk of unmet winter demand is projected to rise if current growth trends continue. During low hydrology cycles, imports have become a new reality.

**More generation capacity is sorely needed.** However, for this to materialize, the country will need to foster an environment conducive to the large-scale private – both domestic and foreign – investment required to expand hydropower generation capacity. While private investment will be important, public investment will remain critical, with a renewed effort to improve the efficiency and value for money of public expenditures. Investments cannot be delayed; neighboring countries are already adding capacity, for example, the Rogun hydropower plant in Tajikistan14 and solar capacity in Uzbekistan.15 In addition to its hydro resources, the country has significant amounts of coal, moderate amounts of oil and natural gas, and renewable energy resources, primarily solar, and limited wind potential.

The investment costs to develop the most economically attractive large-scale hydro sites in the Kyrgyz Republic are considerable. At the same time, the energy sector already represents a heavy fiscal burden: debt amounted to about 18 percent of GDP at the end of 2018. The capacity of the sector to carry the existing debt is inadequate due to underpricing and contracting such amounts of new debt under current circumstances represents a challenge.

An essential pre-condition for an energy-powered growth strategy is the correction of the country’s massive pricing distortions in the retail electricity sector. Tariff rates in the Kyrgyz Republic, which fall well-short of cost recovery, are among the lowest in the world. Since 2015, there has been no adjustment in tariffs, the annual tariff proposals prepared by the sector regulator have been rejected, and the tariff policy which was adopted for 2014-17 was not implemented. A reform of the institutional structure of the sector was announced in 2018, notably the option to re-establish the Ministry of Energy to restore policy leadership. No concrete proposals or plans have been announced since then.

Subsidies to the energy sector amount to a substantial 3 percent of GDP and disproportionately benefit the rich. Quasi-fiscal deficits – foregone revenues and government mandated or encouraged expenditures that are not compensated by the government – further increase contingent liabilities and fiscal risks. At the same time, the financial conditions of existing companies need improvement, including through private sector-based solutions, and the operational and maintenance gaps must be addressed. The formation of a common electricity market in the EEU offers incentives and financing for institutional strengthening, improvements in the market operations and regulatory frameworks, and the creation of modern infrastructure.

Although politically and socially sensitive, it is possible to increase tariffs while protecting the poor and the vulnerable. As the case of Armenia shows, when the public understands that higher tariffs can lead to improved service delivery and trusts that the government will manage the sector with the public interest in mind, raising tariffs is feasible. For the Kyrgyz Republic, increasing electricity and heating tariffs through 2023—as proposed by the country’s energy regulator—is expected to result in real income losses of 2 percent of total household expenditures

---

14 Tajikistan’s Rogun hydropower plant has a planned capacity of 3,600 MW.
15 Uzbekistan recently auctioned 100 MW at a price of $0.0269, with another 400MW on course for auction and a total of 1,000 MW slated for addition.
for poor households. People most affected by tariff increases will be those that are already energy-
poor (spending more than 10 percent of their income on energy), those living in Bishkek, and those
who depend on electricity for heating. Vulnerable people can be protected from the impact of tariff
increases through a targeted lifeline tariff, mechanisms to smooth energy payments and prevent
bunching in winter months, and targeted social protection systems. These measures were proposed
as part of the 2009 reform package, which was not implemented.

We suggest the government consider the following main policy actions; more details can be
found in Chapter 4 of the report.

- Strengthen the sector’s financial viability by: (i) implementing the government plan to
  increase tariffs to cost recovery levels; (ii) stemming technical and non-technical losses
  by new investment and policy changes; and (iii) putting in place mechanisms to smooth
  highly-volatile hydropower revenues.
- Bring the quasi-fiscal deficits on budget and replace them with explicit subsidies.
- Implement measures to protect the poor and vulnerable from the price adjustments.
- Strengthen the institutional and regulatory capacity of the sector by clarifying the roles
  and responsibilities in the sector.
- Improve the regulatory framework for small-scale hydropower development. Foster
  transparency and communication through governance reforms. Increase the accountability
  of sector companies, for example, using consistent monitoring of key performance
  indicators and their publication, and credible initiatives to strengthen the oversight
  function of the company boards, should be pursued.