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MEMORANDUM OF THE PRESIDENT

OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT,

THE INTERNATIONAL DEVELOPMENT ASSOCIATION

AND THE

INTERNATIONAL FINANCE CORPORATION

TO THE

EXECUTIVE DIRECTORS

ON A

JOINT COUNTRY ASSISTANCE STRATEGY

OF THE

WORLD BANK GROUP

FOR

THE KYRGYZ REPUBLIC

APRIL 14, 1998

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(Exchange Rate Effective February 1998)

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Som 1 = US\$0.056
US\$ 1 = Som 17.7

GOVERNMENT'S FISCAL YEAR

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ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
BOP	Balance of Payments
CAS	Country Assistance Strategy
CSAC	Consolidation Structural Adjustment Credit
EBRD	European Bank for Reconstruction and Development
EDI	Economic Development Institute
ESAF	Enhanced Structural Adjustment Facility
ESW	Economic and Sector Work
EU	European Union
FIAS	Foreign Investment Advisory Service
FSU	Former Soviet Union
GDP	Gross Domestic Product
GNP	Gross National Product
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IDF	Institutional Development Fund
IFC	International Finance Corporation
IMF	International Monetary Fund
MIGA	Multilateral Investment Guarantee Agency
PESAC	Private Enterprise Structural Adjustment Credit
PSRMAC	Public Sector Resource Management Adjustment Credit
TA	Technical Assistance
UNDP	United Nations Development Program
USAID	United States Agency for International Development

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**KYRGYZ REPUBLIC
COUNTRY ASSISTANCE STRATEGY**

TABLE OF CONTENTS

SUMMARY	i
I. ECONOMIC, SOCIAL AND POLITICAL CONTEXT.....	1
II. MACROECONOMIC PERFORMANCE, PROSPECTS AND RISKS.....	4
A. Recent Economic Performance.....	4
B. Growth Prospects, External Environment And Risks.....	6
III. KYRGYZSTAN'S DEVELOPMENT CHALLENGES AND AGENDA.....	7
A. Private Sector Development.....	8
B. Poverty Alleviation, Human Resource Development and Social Protection	11
C. Institutional Capacity and State Governance.....	12
D. Bank's Assessment of Government's Agenda and Areas of Difference.....	12
IV. BANK GROUP COUNTRY ASSISTANCE STRATEGY	13
A. Lessons of Experience from the Previous CAS	13
B. Objectives of this CAS	14
C. Bank Group Assistance Program	15
D. Lending Levels, Triggers and Creditworthiness	19
E. Risks to the Bank Group	21
V. CONCLUDING REMARKS	22

Text Tables:

1	Macroeconomic Performance Indicators, 1993-1997.....	5
2	Donor Collaboration: Selected Key Areas of Involvement	18

Text Boxes:

1	Public Opinion Survey: Views from Kyrgyzstan.....	2
2	Poverty in the Kyrgyz Republic.....	3
3	Triggers to Stay in High Case	20

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Annexes:

- A1: High Case CAS Program Summary FY99-01
- A2: Kyrgyz Republic at a Glance
- B1: CAS Program Matrix
- B2: Selected Indicators of Bank Portfolio Performance and Management
- B3: Bank Group Program Summary, FY1999-2001 (page 1 of 3)
IDA Base-Case Lending Program (page 2 of 3)
IFC and MIGA Program, FY95-98 (page 3 of 3)
- B4: Summary of Nonlending Services
- B5: Social Indicators
- B6: Key Economic Indicators
- B7: Key Exposure Indicators
- B8: Status of Bank Group Operations in Kyrgyz Republic and
Country Portfolio Overview and Issues
IBRD Loans and IDA Credits in the Operations Portfolio (page 1 of 2)
Statement of IFC's Committed and Disbursed Portfolio (page 2 of 2)
- B9: CAS Summary of Development Priorities
- C1: Instruments to Meet CAS Program Objective
- C2: Actual and Proposed IDA Commitments and Disbursements (FY93-01)

**Attachment: Private Sector Assessment
prepared by the International Finance Corporation (IFC)**

Map IBRD26822R1

Kyrgyz Republic

Country Assistance Strategy

SUMMARY

i. This is a joint CAS that integrates the assistance strategies of IBRD/IDA and IFC. It has been discussed with the Kyrgyz Government, members of Parliament, locally based donors and representatives of non-governmental organizations. The previous CAS was discussed by the Board in June 1995.

ii. Kyrgyzstan achieved two years of solid economic growth in 1996-97, following five years of economic decline, and has made great strides in its transition to a market economy. The Government successfully completed a three-year ESAF arrangement with the IMF in 1997 and has stabilized the main macroeconomic balances. The economy is generally open and price mechanisms function freely. The Government has also implemented almost all of the policy measures identified in the 1995 CAS through four adjustment operations (privatization and enterprise reform, agricultural privatization, financial sector reform, and public sector resource management).

iii. Despite this impressive track record of macro stabilization and policy reform, poverty has increased since the time of the last CAS. Absolute poverty increased from 40 percent of the population in 1993 to over 50 percent of the population in 1996 (the latest year for which data is available). Strong growth in 1997 may have ameliorated the increase in poverty during the previous years, but the overall poverty situation is serious and many elements of the population feel worse off than before the transition began. The Government has openly addressed this problem by declaring 1998 as "the year of fighting poverty" and has launched a National Poverty Alleviation Program that aims to increase employment, improve access to basic social services, improve the targeting of social assistance, and assure the timely payment of pensions.

iv. Long-term growth prospects remain modest, despite the strong growth in 1996-97. Agricultural growth is constrained by land scarcity and low productivity. The large majority of state enterprises have been privatized, but the private sector has not yet really taken off. Investment levels are low, foreign investors are scarce, and the economy faces a number of external constraints. On balance, long-term growth prospects are assessed at about 4 percent per annum (about 3 percent in per capita terms), although growth could be faster during the next few years as the economy continues to bounce back from the severe decline in GDP suffered during 1991-95. A concerted program to liberalize the business climate further would contribute to higher growth rates.

v. The Government's over-arching objective is to establish long-term sustainable growth. Without growth, there will be no meaningful reduction in poverty. Nor will the Government have the means to improve basic human services or institutional capacity. The Government sees the private sector as the main vehicle for achieving growth. The two broad thrusts of the Kyrgyz development strategy are thus private sector development and poverty reduction.

vi. For private sector growth, priority is given to agriculture and the re-vitalization of agro-industry, which is appropriate in view of the large part of the population that depends on agriculture for its livelihood. Emphasis is also placed on improving the regulatory environment for business, in order to foster growth and boost job creation. For poverty reduction, the Government envisages a complementary strategy of increasing agricultural productivity to raise the incomes of the majority of the population that

lives in the rural areas, together with improving the targeting of social assistance, attaining the fiscal sustainability of the pension system to assure timely pension payments, and restructuring health and education services to increase efficiency and make better use of resources within the existing budget constraints. The Bank and the Government generally agree on the development agenda, although there are differences of view concerning the pace for achieving fiscal sustainability of the state pension system and for introducing cost recovery and economic pricing for commercial-type public services (heat, electricity, telecoms, water, irrigation and public transport).

vii. The strategic objectives of the CAS are to attain sustained growth, particularly in rural areas, to reduce poverty, to improve governance and to strengthen public finances. The CAS proposes a high case lending program of \$185 million IDA for FY99-01, which would be a continuation of the previous high case lending mode. The program includes two adjustment credits (one to achieve financial sustainability of the state pension system, and a second to improve the environment for private sector investment). IFC, FIAS and EDI would be active participants in formulating the policies for this second stage of structural reform. Seven investment projects focus on increasing agricultural productivity and incomes across a broad swath of the rural population where poverty is concentrated, and on social investments. A land registration project would support the completion of land reform program. The CAS program also includes focussed economic and sector work to underpin the lending program and help strengthen public finances in preparation for the day when the Kyrgyz Republic will no longer require budgetary support and would be better able to borrow on non-concessional terms. Over the next three years, the Bank Group will also continue support for aid coordination and institution building.

viii. The Kyrgyz Republic is not a high risk country for the Bank Group, in view of its continued strong policy performance and the fact that the economy appears to be growing. Nevertheless, there are some risks stemming from a possible reversal in policy direction (which is not considered likely), institutional weakness in the implementation of Bank operations (which will be addressed through intensive supervision and training), and a stagnation in growth (which would serve as a negative demonstration effect for the rest of Central Asia and impede reform in those countries). A pro-active program of financial, technical and intellectual support for continued reform in Kyrgyzstan is the main safeguard against such developments. Risks outside the control of the Bank and the Kyrgyz include external factors such as lower commodity prices and political change in neighboring countries.

Proposed Agenda for Board Discussion

- ix. In discussing the proposed country assistance strategy, the Board may wish to consider:
- whether the structural policies the CAS proposes to address (sustainability of the pension system, improvement of the regulatory framework for business, and strengthening of public finances) are the appropriate areas of focus?
 - whether the choice of Bank Group instruments (lending, advisory and non-lending services) is appropriate to Kyrgyzstan's circumstances?
 - whether the program's focus on stimulating broad-based growth and complementary poverty reduction initiatives is the appropriate strategy to follow?

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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT,
THE INTERNATIONAL DEVELOPMENT ASSOCIATION AND
THE INTERNATIONAL FINANCE CORPORATION
TO THE EXECUTIVE DIRECTORS
ON A COUNTRY ASSISTANCE STRATEGY FOR THE KYRGYZ REPUBLIC**

1. This is the second CAS for the Kyrgyz Republic.¹ It has been prepared jointly by IBRD/IDA and the IFC, in consultation with the Government of the Kyrgyz Republic members of Parliament, locally based donors and representatives of non-governmental organizations. It fully integrates the programs of the World Bank Group. A private sector assessment prepared by IFC (Attachment) supplements the information provided in the text.

2. This CAS comes at a time when the World Bank Group's relationship with the Government is evolving from a provider of post-independence emergency assistance to a steady development partner. Kyrgyzstan achieved two years of solid economic growth in 1996-97, following five years of economic decline, and has made great strides in its transition to a market economy. Yet, unlike several neighboring countries in Central Asia, Kyrgyzstan does not have large natural resources to finance the continuing transition process and finds itself at a considerably lower level of income than three years ago. Poverty has increased, and growth prospects remain modest. Despite efforts to facilitate a favorable investment climate, the private sector has not yet really taken off. Investment levels are low, and foreign investors are scarce. The Government is still establishing the institutional capacity to deal with the rapid changes in legislation that have been enacted to create a market economy and with the demands of implementing a growing public investment program. Public finances are fragile and require further strengthening and restructuring. This CAS discusses these challenges and sets out a strategy for how the Bank Group will work with the Government to address these issues over the next three years.

I. Economic, Social and Political Context

3. **Stabilization and Structural Reform.** The current social and political situation needs to be viewed against the backdrop of five years of economic upheaval and rapid structural change. Following the breakup of the Soviet Union, Kyrgyzstan fell into a vicious spiral of declining production and macroeconomic destabilization with several consecutive years of negative GDP growth in the 15-20 percent per annum range and triple digit inflation. The Government undertook initial programs with the IMF and the Bank in 1993 which included significant trade and price liberalization and the introduction of a market exchange rate. Since then, it has established an impressive track record of stabilization and structural reform. It successfully completed a three-year ESAF program in 1997, and has stabilized the economy within the context of an open international environment. As a result of this program:

- inflation declined to 15 percent in 1997;
- the fiscal deficit no longer requires inflationary borrowing from the central bank; and
- GDP bottomed out in 1995 and grew at about 7 percent per annum in both 1996 and 1997.

4. In terms of structural reform, the Government implemented all of the policy measures identified in the 1995 CAS, except public utility pricing and establishment of an unified land registration system.

¹ The first CAS (Report No. 14548-KG) was discussed by the Board in June 1995.

Through four Bank adjustment operations (privatization and enterprise reform, agricultural privatization, financial sector reform, and public sector resource management), the Government, *inter alia*, :

- privatized about three-quarters (more than 1000) of the medium and large scale enterprises;
- demonopolized and privatized the main agricultural processing complexes, including the bread and grain trade;
- disbanded almost all state farms, distributed land shares for over one-half of the agricultural land, and created legal rights for long-term private leasehold of land;
- restructured the financial sector, including liquidation of insolvent state banks and creation of a sound banking environment;
- established regulatory agencies for utility regulation in electricity and telecommunications;
- introduced government-wide procurement practices consistent with international standards;
- overhauled government budget processes and established a stable framework for inter-governmental finance; and
- transformed a system of myriad consumer subsidies into a targeted social safety net aimed to protect vulnerable elements of the population.

5. **Social Attitudes and Poverty.** The views of the Kyrgyz population on their social, economic and political situation in mid-transition (December 1996) are summarized in Box 1. Despite two years of growth in 1996-97, the social fabric remains severely stretched as a result of a cumulative 51 percent decline in GDP during the preceding five years. Whole industries closed down with resulting unemployment and dislocation of workers. Except for a small segment of the population that is engaged in the emerging private sector, the rest of the population is living considerably less well than during Soviet times. Real wages and consumption levels are about 40 percent below their former levels. GNP per capita (World Bank Atlas methodology) fell to \$570 in 1996, considerably below its level at the time of the last CAS (\$830 for 1993). As in other countries of the FSU, the older generation is less able to adapt to the changing economic times and longs for a return to the higher living standards of the previous regime. In short, the structural changes associated with the Government's notable policy achievements have nevertheless taken a large toll on the population (see Box 2: Poverty in the Kyrgyz Republic).

Box 1: Public Opinion Survey: Views from Kyrgyzstan

An independent national public opinion survey conducted in November/December 1996 showed a populace dissatisfied with the pace and results of reform, ambivalent about the type of economy appropriate to country circumstances, but hopeful for the future. A large majority favored letting citizens own land and allowing them to buy and sell it, provided it is regulated properly, but opposed permitting acquisition by foreign companies. A large majority welcome foreign investment, with young adults also receptive to privatization. Despite concerns about deterioration of the quality of life, there was optimism about the country's future prospects. Most felt relations among ethnic groups were good; however, there were significant differences between groups as to the country's policy direction and future prospects. While public sentiment strongly favored the election process, dissatisfaction with its functioning was indicated. The survey showed distrust of all branches of government and a sense that the justice system was failing the populace. Concerns about the court system and incipient corruption were cited, as were worries about the protection of civil rights. Nevertheless, order and discipline were believed necessary, and there were some consensus on the need to limit political and civil rights to maintain order. Respondents were interested in NGOs active in environment and charitable works; however, half noted that such organizations are not necessary, and a majority indicated that none exists in their communities.

Source: International Foundation for Election Systems

Box 2: Poverty in the Kyrgyz Republic

The Kyrgyz Republic faces a serious and growing poverty problem. In 1993, slightly more than 40 percent of the population were classified as poor. By 1996, at least half of the population had consumption levels below the poverty line. For a smaller part of the population, these shortfalls in consumption are very serious -- malnutrition rates among children (0-6) increased 25 percent over the period. Sixty-five percent of the population live in rural areas, where poverty continues to be significantly worse. Rural areas are largely demonetized and, in the more remote regions, are reverting to subsistence agriculture.

Employment: Much transitional poverty has arisen from the broad changes in the labor market during the past four years (participation rates have fallen from 70 percent in 1993 to 52 percent in 1996). A large part of the decline has come from the fall in female participation rates (65 percent in 1993 to less than 45 percent in 1996), although male participation has also fallen, and men and the young are the most likely to be unemployed. Such drastic drops may primarily reflect involuntary movements out of the labor force (discouraged workers). For those in the labor force, unemployment has increased substantially, from 6.2 percent to 11.0 percent.

Access to social services: The quality of health and education services has fallen substantially following reductions in public expenditure by about 50 percent in real terms since 1993. Modest fees for these services are now being introduced which should improve cost recovery and service quality. The high child malnutrition rates may indicate an absence of proper health care as much as a poor diet. While health care costs, as a share of household budgets, do not appear to be excessive, for each episode of illness these costs may be high.

Social assistance: Social assistance is targeted increasingly to the poor, but the mechanisms for identifying the poor in rural areas need improvement. Resources for social assistance are spread very thinly--about \$4 per month to about one million people (1/4 of population). In total, these resources amount to only about 1.5 percent of GDP, but nevertheless put a considerable strain on the budget. In order to minimize the burden on the budget, in 1998, social assistance was delinked from the minimum wage and replaced with a poverty line based on an annual assessment of the state's fiscal resources, the number of those in poverty, and forecasts of changes in consumer prices.

Pensions and social insurance: The current pension system is generous and some 20 percent of beneficiaries receive early retirement pensions, raising the cost of the system and depressing benefit levels. Further, social insurance taxes (39 percent of payroll covering pensions, unemployment and health insurance) discourage compliance and formal job creation. However, pensions play an important role in preventing poverty. Poverty rates among pensioners are no higher than that of the total population, although data suggests that rural pensioners have been harder hit by arrears and untimely delivery than others.

Gender: There are no significant gender issues in the Kyrgyz Republic. The country has a highly literate and educated female population. Women are not more likely than men to live in poverty. Indeed, people living in female headed households face a significantly decreased probability of being in the lowest poverty quintiles. In large part this is due to an informal social safety net: female headed households receive twice as much in the way of food and three times the cash remittances from relatives and friends. Although there has been a decline in female labor participation rates, especially among the poorest quintiles, data in other parts of the region indicate that some of the decline may be voluntary; however, this will be tracked in subsequent surveys.

The Kyrgyz Multipurpose Poverty Survey was conducted in 1993. Three subsequent surveys, Spring 1996, Fall 1996 and Fall 1997 were completed. A poverty profile from the Spring 1996 survey has been prepared and preliminary results from the Fall 1996 survey are available. Data from the 1997 survey are being evaluated.

6. **Political Economy.** During the past five years, the Government has been preoccupied with macro stabilization and basic structural reform, which has been appropriate. Its commitment to economic reform has not wavered despite the political cost of staying the course. Lately, it has recognized the growing problem of poverty and has taken the bold step of publicly discussing its increased incidence. President Akaev has declared 1998 as the "year of fighting poverty" and has launched a wide-ranging National Poverty Alleviation Program, "Araket." This program seeks to provide employment generation, improved access to social services, more market-oriented labor legislation and pension reform. As a signal of the importance that the President attaches to the Araket program, he elevated the chief architect of the program to the position of Prime Minister in a March 1998 Cabinet reshuffle.

7. The new Government has been given the mandate to work with the Parliament on maintaining and improving the pace and direction of the reform process. The Parliament, which has passed an impressive body of market-oriented legislation, has on occasion undone key provisions through subsequent amendments. Some back stepping has been occurred on tax policy, utility regulation, privatization of large enterprises, and delays in land legislation, however, the overall policy direction remains solid.

8. Aside from dealing with increased poverty and the cohesiveness of policy direction, the major political challenge is to prevent vested interests from establishing or strengthening monopoly control over commercial and trading activities. Many privatized enterprises inherited the monopoly trading position of the former state system and are beginning to exert anti-competitive pressures in the absence of effective anti-monopoly regulation. A second important challenge is to ensure that the privatization of the remaining large state enterprises and utilities continue to be conducted in a transparent manner.

II. Macroeconomic Performance, Prospects and Risks

A. Recent Economic Performance

9. The economy has stabilized over the past two years and begun to regain some of the production lost during the 1991-95 period. As mentioned, GDP grew by about 7 percent per annum in 1996 and 1997. This was a notable achievement in view of the extent to which the economy had been pulled apart by the collapse of trade with the former Soviet Union, the introduction of market pricing throughout the economy (except public utilities), and the dislocations associated with the privatization and/or liquidation of most commercial enterprises and banks.

10. **Growth Factors.** It is not clear, however, whether these initial two years of growth are a signal of a permanent, sustained trend, or whether they represent mainly a "bounce-back" from overly depressed levels of production. This is because growth in 1996-97 can be attributed to several unique factors that are unlikely to recur. First and foremost was the coming-on-stream of the Kumtor gold mine. Investment in Kumtor was equal to about 10 percent of GDP in 1995 and 1996, which gave a big boost to the construction industry--domestic investment levels fell off sharply in 1997, however, reflecting the end of the investment phase of the project. Gold production started in 1997 (at the rate of about 550,000 oz. per annum), which alone added about 4 percent to GDP. Some further increase in gold production may occur in 1998, but production will level off thereafter. Second, the weather during the past two years was very favorable for agriculture, which grew at 10-13 percent each year. Also, the distribution of land shares and liberalized market prices undoubtedly contributed to the production increase, but the introduction of these policies was again a one-time event. Henceforth, agricultural production will be more directly related to increases in productivity, which may be more difficult to achieve. Third, industrial production benefited from the re-

entry into production of about 20 large firms whose production had been halted under the enterprise rehabilitation program. Finally, the public investment program, which is largely funded by external official donors, grew in size to about 3-4 percent of GDP. While the main benefits of the PIP will undoubtedly occur when the projects come on-stream, the initial boost to investment and growth from public investment expenditure has largely occurred.

11. **Fiscal developments** were also favorable during 1996-97, although considerable further strengthening is required before the Government achieves fiscal sustainability. The most notable achievement has been a reduction in expenditure levels from 39 percent of GDP in 1993 to 26 percent of GDP in 1997.² This reduction was achieved mainly through a reduction in consumer subsidies, transfers and net lending to state enterprises. It nevertheless also significantly reduced the level and quality of health and education expenditures, as well as maintenance of public infrastructure (which includes the very extensive irrigation network and associated series of dams).

12. With the reduction in expenditures, the fiscal deficit has come under control, although it is still high in absolute terms at about 9 percent of GDP. The large majority of the deficit has been financed from external sources, mostly on concessional terms and, in this respect, is not creating an onerous debt service burden. External financing has been mostly for general budget support purposes, but is gradually switching to finance the growing public investment program. To the extent domestic borrowing has been necessary, the Government has made a concerted effort to rely as much as possible on the emerging Treasury bill market and, starting with the 1998 budget, will no longer borrow directly from the National Bank of Kyrgyzstan. This phasing-out of borrowing from the NBK has directly helped reduce inflation and interest rates, which have declined from the high double-digit range three years ago to 15 percent and 26 percent, respectively, by the end of 1997.

Table 1: Macroeconomic Performance Indicators - 1993-1997					
	1993	1994	1995	1996	1997
GDP Growth (% p.a.)	-15.5	-20.1	-5.4	7.1	6.5
Investment (% of GDP)	11.7	9.0	18.3	25.2	14.4
Inflation - CPI - end of period	767.0	95.7	31.9	35.0	14.7
Fiscal Balance (% of GDP)	-14.4	-11.6	-17.3	-9.5	-9.4
Total Revenue & Grants, of which	24.6	20.8	16.7	15.9	17.0
Tax revenues	14.5	13.6	15.0	12.7	13.1
Grants	8.6	2.5	0.3	0.9	0.7
Expenditures, of which	39.1	32.4	34.0	25.5	26.4
Subsidies and Transfers ^{1/}	16.9	7.4	7.5	5.9	5.2
Health & Education	6.8	9.1	10.2	8.4	8.0
Public Investment	..	4.9	4.8	3.8	3.9
Net Lending	8.9	4.7	3.4	0.4	0.5
Current Account Balance (% of GDP)	-6.9	-11.3	-16.2	-23.3	-8.1

Source: National Statistical Committee and World Bank and IMF staff estimates

^{1/} Includes net deficit of the social fund.

² Public finance figures exclude the self-financed expenditures of the Social Funds (pensions, unemployment and disability compensation), about 5 percent of GDP. They include, however, transfers from the budget to the Social Funds, about 2 percent of GDP. Total Social Fund expenditure is, hence, about 7 percent of GDP.

13. **Public Sector Resource Management.** A third major achievement in the area of public finances has been an overhaul of the Government's budgeting procedures and inter-governmental fiscal relations. Under the on-going Public Sector Resource Management Adjustment Credit (PSRMAC), a Budget Commission was created to set initial budget ceilings for drawing up the budget and to monitor and adjust expenditure during the course of the fiscal year. Expenditure is carefully controlled under a system of expenditure warrants, the public investment program is being integrated with recurrent expenditures into a consolidated budget, more informative and transparent accounts are sent to Parliament (and disclosed to the public), and internal audit systems are being strengthened. A clear system of revenue and expenditure sharing has also been set up between the central and local governments, including an equalization grant to help the poorest region meet wage payments for health and education. Under this system, transfers to local governments for health and education expenditures have become much more dependable, which has largely eliminated wage arrears for these services and reduced the need for ad hoc negotiation between levels of government.

14. **Balance of Payments.** The external sector has also registered significant improvement. Following two years of very high current account deficits in 1995-96 (which reflected the high import levels associated with the Kumtor gold mine investments), the current account balance was reduced to 8 percent of GDP in 1997, a level that is consistent with the external financing flows received by the Government budget. Exports have been rising at about 20 percent per annum (in US dollar terms) during the past three years, reflecting a rejuvenation of trade with neighboring countries as well as the start-up of Kumtor gold exports in 1997. Reserve levels are currently a comfortable three months of import requirements.

B. Growth Prospects, External Environment and Risks

15. Despite the Government's considerable policy achievements, many reforms are still on-going, and the private sector faces considerable constraints that prevent it from fully responding to the new market environment.

- The economy is primarily agricultural (45 percent of GDP). Agricultural growth is constrained by land scarcity and low productivity caused by scarce working capital, a disintegrated input and marketing system, out-of-date technology, poor research and extension services, and a deteriorating irrigation system which services 80 percent of the arable land. Efforts are underway to ease these constraints, but the returns in the form of increased productivity will be long-term in nature.
- Most small and medium enterprises have been privatized, but they are either unable or reluctant to restructure their operations and do not generate enough internal cash flow to increase production. As a result, capacity utilization remains low, especially in agro-industries. Also they face a number of regulatory impediments that reduce the incentives for investment.
- Financial intermediation remains very low (broad money is only 14 percent of GDP), and banks have only recently begun to extend long-term loans.
- Domestic savings and investment levels are low (2 and 14 percent of GDP, respectively). Raising these levels will also be slow, in view of a high propensity to consume, the low level of financial intermediation and the structural problems of the fiscal deficit (see below).

16. **External Environment and Risks.** Kyrgyzstan also faces a number of exogenous constraints that will be difficult to change.

- It is geographically isolated from international markets and faces high informal barriers to trade in neighboring countries where high “tolls” are extracted for passage of goods along major transport routes.
- Despite Kyrgyzstan’s membership in customs unions with neighboring countries, its small size make it a price taker in negotiations for exporting electricity and water and for importing energy.
- The heyday of donor premiums to support “the transition” is coming to an end, and assistance levels are likely to remain constant in real terms, at best.

17. In addition, the economy is vulnerable to a number of external risks, including setbacks in Russia (which is an important market for Kyrgyz agricultural exports), increases in the cost of oil and gas imports, and further declines in the gold price. Indeed, the recent decline in gold prices (to under \$300 per oz.), if sustained, will reduce export earnings by up to \$30 million (or 1.5 percent of GDP) per annum compared with the projections at the time the Kumtor project was initiated. Such shocks reduce the external resources available to the economy and slow down growth.

18. **Outlook for Growth.** For these reasons, the outlook for growth is positive but restrained. The positive forces unleashed by the structural reforms to date have to be balanced against the constraints still facing the economy. Taking these constraints into account, long-term growth prospects are assessed at 4 percent per annum (about 3 percent in per capita terms), although growth could be higher during the next few years as the economy continues to bounce back from the severe decline in GDP suffered during 1991-95.

19. Long-term growth could nevertheless be faster than 4 percent per annum with a concentrated effort to reduce the regulatory impediments to business and to improve the incentives for investment. In particular, the privatization of the remaining large state enterprises (electricity, telecoms, gas, cement, etc.) needs to be done in an open and transparent manner, in order to attract strategic investors who would bring the managerial expertise and financial resources needed to increase profitability, and, in the case of electricity, increase exports. More generally, the Government needs to eliminate the monopoly privileges of enterprises that were previously state-owned but are now private and, second, ensure that regulatory bodies carry out their functions free of political interference.

20. Growth will also be affected by the speed with which the Government raises public savings and eliminates the structural deficit in its fiscal position. This deficit is caused by poor tax administration which results in a low overall tax ratio (13 percent of GDP, excluding social insurance taxes for pensions, etc.), an overly generous pension policy (which contributes 1-2 percent of GDP to the deficit), and a reluctance to charge full economic costs for commercial public services (electricity, heat, telephone, water, irrigation, transportation, etc.). Concerted action is needed in all of these areas over the next three years. Also, public debt service, while not high at present (about 10 percent of government revenues in 1997), will need to be managed carefully to avoid rising rapidly if borrowing occurs on non-concessional terms. Public borrowing should therefore be mainly on concessional terms for both BOP and fiscal reasons.

III. Kyrgyzstan’s Development Challenges and Agenda

21. The Government’s over-arching objective is to establish long-term sustainable growth. Without growth, there will be no meaningful reduction in poverty. Nor will the Government have the means to improve basic human services or institutional capacity. The Government sees the private sector as the

main vehicle for achieving growth. The two broad thrusts of the Government's development strategy are thus private sector development and poverty reduction.

22. For private sector growth, priority is given to agriculture and the re-vitalization of agro-industry, which is appropriate in view of the large part of the population that depends on agriculture for its livelihood. Emphasis is also placed on improving the regulatory environment for business, in order to foster growth and boost job creation. For poverty reduction, the Government envisages a complementary strategy of increasing agricultural productivity to raise the incomes of the majority of the population that lives in rural areas, together with improving the targeting of social assistance, attaining the fiscal sustainability of the pension system to assure pension payments, and restructuring health and education services to increase efficiency and make better use of resources within the existing budget constraints.

A. Private Sector Development

23. **Agriculture and Rural Development.** Attaining long-term sustainable growth in agriculture is the greatest challenge facing the country. Strong agricultural growth would raise the incomes of a broad swath of the population who live in rural areas where poverty is concentrated and would reduce poverty for many, although not all, of those currently below the poverty line. Growth in agriculture will come from both livestock and irrigated crops, but, at least in the medium term, the growth rate is more likely to be on the order of 4-5 percent per annum, rather than the 10-13 percent of the past two years. Although Government intervention has largely disappeared (prices have been liberalized, state farms disbanded, land shares distributed, and small private farms have started to appear), the future structure of the sector is still emerging and many issues remain. Major issues include how to improve the efficiency of and stimulate a recovery in livestock, which has collapsed to a mere remnant of its former size due to increased feed prices and loss of markets. Pastures (common property that accounts for 45% of the total land area) need to be better managed, although pastures are recovering due to lower grazing pressures. Despite cessation of state orders, the Government has led a campaign to increase wheat production in a drive for self-sufficiency, which the country has now attained. However, wheat self-sufficiency has been achieved at a high economic cost, since Kyrgyzstan does not have a comparative advantage in this crop, and the Government needs to allow markets determine which crops should be grown. Lack of market information about prices and stocks (for both inputs and outputs) and limited domestic demand for agricultural commodities has contributed to this problem. Agricultural support services need to be established to replace the previous reliance on state farm managers and technical experts and to educate the new private farmers in farm management techniques and appropriate agricultural practices in a market economy. The major policy issue facing agricultural resource management is how to deal with a scarcity of land and to develop appropriate water use policies. In the past, this mix of scarce land and abundant water has led to extensive development of the irrigation system, which has been over-developed in some areas, but which has fallen into disrepair due to many years of underfunded maintenance. Rationalization of the system is required and cost recovery for water use will need to be introduced in a manner consistent with the growth of rural incomes.

24. The strategy for dealing with the above challenges was discussed and agreed with the Government during a Second International Agricultural Conference in Bishkek in December 1997. It envisages a combination of specific investments to provide public goods in agriculture, policy reform and institutional development. A large part of the Government's **investment program** will be allocated to rehabilitation of the irrigation system, initially at the main canal level and subsequently at the on-farm level through the establishment of water user associations which will assume responsibility for operations and maintenance of irrigation system within their areas. Appropriate water pricing policies will also be developed as part of this strategy. Public investment will also focus on adaptive research

and on rural advisory services, livestock and pasture management, rural infrastructure and market information systems to increase the efficiency of input and commodity markets. **Policy reform** will continue to support farm restructuring and the issuance of land share certificates to private farmers. Establishment of a nationwide land registration system will be essential for creating land markets (in both rural and urban areas) and for enabling farmers to increase their access to credit through collateralization of land use rights. In this regard, enactment of the draft Land Code and Land Registration Acts, which have been under debate in Parliament for the past two years, is a necessary prerequisite. **Institution building** needs to focus on human resource development in the public sector institutions dealing with agriculture, improving the quality of data relevant to the sector, promoting exports of agricultural commodities, and creating/strengthening institutions to support private agriculture, particularly agricultural inputs.

25. **Environment and Natural Resource Management.** The unsustainable use of natural resources presents a key environmental problem in the Kyrgyz Republic. The combined impact of extensive overgrazing, over-exploitation of fragile forest resources, inappropriate farming practices, poorly maintained irrigation systems and inefficient water resource management have led to severe land degradation and surface water pollution. As a result of weak forestry management, plantations for fuel-wood and building materials has virtually ceased and the country's watershed has been affected adversely. The Government strategy focuses on improving the legal and regulatory framework, including the introduction of project level environmental assessments; enhancing institutional capacity to enforce environmental standards; addressing past environmental liabilities and developing national biodiversity and water management strategies, within the framework of the Aral Sea Basin Program.

26. **Privatization.** An active private sector is rapidly developing as the Kyrgyz Republic moves to complete privatization of remaining state-owned enterprises. All medium and large enterprises have been at least partially privatized through a coupon auction program, and a majority of enterprises have been fully privatized through subsequent cash auctions. About 300 enterprises remain to be fully privatized over the next three years, including nine large infrastructure companies (energy, telecommunications, printing, aviation, etc.) and several dozen medium-size firms which are earmarked for privatization on a case by case basis to strategic investors. Many of the now-privatized enterprises require substantial restructuring, but their managements have been reluctant to do so out of fear of losing their jobs. Their managements also need considerable training to run companies effectively and develop markets for their products.

27. **Corporate Governance.** Enterprise restructuring has been hampered by a lack of good corporate governance to ensure that the interests of all shareholders are being addressed. The Government, with ADB support, is beginning to institute standard governance rules and procedures applicable to both public and private enterprises. Measures include the institution of company charters, appropriate supervisory and management structures, monitoring and reporting requirements, expediting the liquidation and restructuring of non-viable enterprises; and strengthening the legal framework for insolvency and ensuring its enforcement. Complementary efforts are ongoing to facilitate the adoption of international auditing standards. Much remains to be done however to develop local audit and accounting capacity.

28. **Regulatory Environment.** A multitude of new laws affecting the private sector has been adopted, but court decisions often remain unenforced, due to an ineffective and poorly trained judiciary. Companies face a myriad of regulations about which they are frequently uninformed, and private firms, including nascent industrial groups, operate in an atmosphere of weak enforcement of anti-competitiveness rules. Many taxation, accounting and disclosure issues have now been addressed, but

the tax regime remains burdensome, the accounting system has yet to be brought in line with international standards and disclosure rules are insufficient for outside investors. Finally, firms face difficulties in accessing essential economic and business information and consulting services. A more detailed assessment of the constraints facing the private sector, prepared by IFC, is attached to this CAS.

29. **Legal Reform.** Over the past four years the Government, with donor assistance, has initiated a systematic program to revamp its legislation and modernize the judiciary. These initiatives have been aimed at improving the efficiency, transparency and effectiveness of the law-making process, particularly with respect to economic legislation. Core economic legislation has been enacted, including, *inter alia*, a tax code, civil code, national procurement law, and laws on foreign investment, pledge, banking and bankruptcy. Advanced work on insurance, securities markets, investment funds, leasing, land and mining laws has been undertaken. Despite this impressive start, inconsistencies within the legislation remain and the capacity for interpretation, application and enforcement needs considerable strengthening. Support for legal drafting and judicial training is being provided by USAID, IDA and other donors, and ADB is supporting training for Arbitrage Court personnel.

30. **Foreign Investment.** The Government strongly desires to see an increase in foreign direct investment and has, with IDA/FIAS support, enacted a sound investment law which provides equal rights for local and foreign investors. But it has yet to establish an effective foreign investment promotion agency despite considerable advice from the Bank Group. Aside from a few major investments (e.g., in gold mining), Kyrgyzstan has had only limited success in attracting foreign investors. An essential element for attracting foreign investment to the energy and telecommunications sectors will be for the newly-created regulatory agencies to allow full cost recovery in utility pricing, which the Government has so far resisted. As a result of low cash flow, however, the electricity sector has neglected maintenance and underinvested for many years and now faces an increasingly critical situation of being unable to supply continuous service. Without reliable electricity, little foreign investment is likely to come to the country. The Government has also created multiple "free economic zones" which have served more as vehicles for avoiding taxes in a legal manner than for export promotion. Such abuses need to be eliminated and the law in this area overhauled.

31. **Financial Sector.** Following independence, the Kyrgyz financial sector was debilitated and the majority of the commercial banking system was technically insolvent. The Government has pursued a two-pronged strategy concentrating first on a fundamental restructuring of the banking system. With IDA support, the banking system has become increasingly robust with credit availability growing and interest rates declining. A small core of well managed commercial banks has emerged to serve the emerging private sector. The system currently comprises about 15 private banks (some with foreign ownership, including one with IFC participation); a Settlement and Savings Corporation and a rural finance institution, the Kyrgyz Agricultural Finance Corporation, which was created with IDA participation to provide medium-term finance to agriculture and agro-businesses. A system of rural credit unions is also being established with ADB support.

32. The priorities for the future development of the financial sector center on non-bank financial institutions. The Kyrgyz Stock Exchange was established two years ago and has accepted listings for about 40 firms, about 10 of which are actively traded. The main problem facing the KSE is the lack of adequate securities to trade, in particular, shares of the major state utilities (energy and telecoms), for which only 4-5 percent of their shares have been privatized through the coupon auction. Further privatization of these enterprises through the KSE would help develop the securities markets. Development of voluntary private pension funds is a second near-term priority and would complement

upcoming efforts to reform the state pension system (paras. 35 and 48). Other financial institutions needed for a market economy include insurance and leasing companies.

33. **Transport and Infrastructure.** Continued investment in transport and telecommunications is required to overcome Kyrgyzstan's geographic disadvantages. Inadequate infrastructure, particularly in the rural areas, is a bottleneck to generating employment and economic growth. While constrained budgets have precluded adequate investment, maintenance and rehabilitation, the transport and rural infrastructure sectors also suffer from inadequate policy framework, weak institutions, poor planning and inadequate cost recovery. Consequently, service quality is uneven, rural coverage is low and existing resources are not efficiently used. The challenge for the Government will be to work within the severely constrained fiscal envelope. The Government's transport sector strategy envisages investment to redress the severely debilitated transport and road services in key cities and complementary policy reform. In the rural areas, the strategy is aimed at improving the quality and availability of key infrastructure services (roads, bridges, markets, electricity, telecommunications services etc.) to the under-served rural population.

B. Poverty Alleviation, Human Resource Development and Social Protection

34. **Social Protection.** At independence, the Kyrgyz Republic faced serious challenges, including insufficiently developed systems to monitor standards of living and provide social benefits to those most in need, lack of mechanisms for assisting the unemployed, a mismatch of training with the changing needs of the economy, and difficulties in funding the system of social protection. The decline in incomes, the removal of subsidies and the shifts in relative prices that have accompanied structural changes in the economy have imposed costs on some households, particularly the poor and those at the margin. Since 1993, the depth and incidence of poverty has increased (see Poverty Box), and poverty alleviation has become a top development priority. The Government, with IDA support (Social Safety Net Project, FY94), is improving the development, implementation, monitoring, and evaluation of its social assistance policy in order to ensure that its scarce social assistance resources are targeted effectively to the most vulnerable groups.

35. **Pensions.** The Kyrgyz pension system is overly generous in scope, with early retirement privileges and benefits that are high in relation to the average wage. Government subsidies to the Social Fund have become a major contributor to the overall fiscal deficit, and high payroll tax levels (39 percent, mostly for pensions but also including taxes for unemployment, disability and medical insurance) depress employment and wages while encouraging evasion. As a classic Pay As You Go system, current revenues are used to pay for current benefits and there is no contribution to national savings. The Government plans to work intensively to strengthen the fiscal sustainability, accountability, and effectiveness of the state pension system. At the same time, it anticipates development of a voluntary private pension tier that is well designed, regulated and supervised.

36. **Improving Health Outcomes and Resource Allocation.** The Kyrgyz health care financing and delivery system is a vestige of the centrally planned national health service system of the FSU. System inefficiencies, logistical problems and shortages resulting from the breakup of the Union, combined with the rapid devolution of responsibility without adequate resources and a decline in the overall budget, has led to a severe deterioration of services and outbreaks of some contagious diseases. The Government's sector strategy focuses on reversing these trends while introducing long-term efforts to develop a sustainable system capable of delivering cost effective and efficient health care. The strategy encompasses an integrated reform effort (Health Sector Reform Project, FY96) to promote primary health care and modern treatment protocols for diseases, delivery system restructuring, pharmaceutical

system management and the introduction of incentive-based medical provider payment systems, including a new mandatory medical insurance fund.

C. Institutional Capacity and State Governance

37. **Civil Service Reform.** Since independence the Government has faced the challenge of reorienting its functions to meet the needs of a market economy. It has begun to address the incentive structure of the public sector, look at alternative means of providing public services and strengthen the accountability of public sector officials and agencies. Over the past 18 months, a number of ministries have been merged, functions streamlined and a downsizing of the civil service by about 12 percent has been effected. Nevertheless, the functioning of the system remains weak and continues to be an obstacle to effective implementation of development policy. These institutional weaknesses have become more apparent as the atmosphere of crisis management has subsided into more routine administration of the public sector. Top technical levels within the civil service are leaving for the private sector, thus weakening the capacity for policy dialogue and policy coordination. Further, Government agencies lack the skills and experience to develop, implement, monitor and evaluate sectoral policies. The Government considers the development of a professional civil service cadre among its priorities and has sought technical and financial support for this effort from the UNDP and EU-TACIS.

38. **Procurement Reform.** Responding to the need for clear and transparent procurement system, the Parliament enacted a national procurement law in 1997. The law provides for a comprehensive public procurement system, consistent with international practices, World Bank guidelines and WTO agreements. A National Procurement Agency has been established to regulate and exercise oversight on public procurement. The system is being implemented and a number of efforts toward institutional strengthening are underway with IDA support through two IDF grants. The system, which serves as a vehicle to combat fraud and corruption, has successfully begun to introduce discipline in public expenditure and bolsters accountability by officials responsible for the administration of public procurement in the country. A national workshop to introduce the procurement policies and procedures was held in Bishkek in February 1998.

D. Bank's Assessment of Government's Agenda and Areas of Difference

39. The Bank and the Government are in close agreement on most of the policies needed for further transition of the economy. Nevertheless, there are differences in some areas over the pace, scope and starting points for further reform. For example, to date, the Government and the Parliament have chosen to focus on administrative improvements to the current pension system rather than on more fundamental reforms. The Bank and the Government have recently agreed on making the achievement of financial sustainability of the state pension system the centerpiece of the up-coming Social Sector Adjustment Credit (SOSAC). Measures for expenditure containment that will be necessary to achieve this goal are under discussion.

40. The Government and the Bank also have different views regarding the pace of introduction of cost recovery for public services. In this regard, the Government and the Parliament have emphasized the low level of wages and the burden that increased charges would place on the population. The Bank, on the other hand, is pressing for appropriate cost recovery policies to meet operation, maintenance and investment needs of the rapidly deteriorating infrastructure network (electricity, irrigation, water supply, public transportation). These issues are being addressed in the context of sector investment operations and sector analytical work.

41. In the industrial sector, the Government's vision includes restoration of some of the former industries which have not proved viable in recent years. It also sees Kyrgyzstan as a center of high-technology, a mecca for tourism, and a regional banking center. While there may be some long-term potential in these latter areas, results are likely to be limited in the immediate future. Investment in these sectors should come from the private sector, rather than from the government budget. The Government's role should be limited to providing an open, transparent and properly regulated playing field for private sector development. The Bank, IFC, and FIAS will continue to work with the Government on improving the enabling environment for private sector investment.

42. Finally, the Government's new Poverty Alleviation program, *Araket*, takes a broad approach to poverty alleviation, encompassing labor legislation, pension reform, employment generation, access to social services and infrastructure, and better targeted social assistance benefits. At the same time, the program outlines a plethora of programs, of varying quality, that could greatly increase Government expenditure without significantly improving the impact on poverty. The Bank will work intensively with the Government, other donors and NGOs in the refinement and implementation of policies and key program activities.

IV. Bank Group Country Assistance Strategy

A. Lessons of Experience from the Previous CAS

43. The Bank has been a key donor and provider of policy advice on structural issues. This role has been reinforced by the Government's successful implementation of the high case lending program proposed in the FY96-98 CAS. The program encompassed extensive support for policy reform with selective investments in key sectors. A shift away from adjustment lending toward investment lending was envisaged by the end of the program period. Three risks were identified: policy slippage, adverse changes in the external environment and limited implementation capacity. Policy performance has been strong with only a few shortfalls (delay in following through with establishment of a land registration system and in attaining agreed levels of cost recovery for utility pricing). Despite the recent weakness in gold prices, the external environment remained relatively favorable over the past three years. However, the extent and depth of the transition has proven more difficult than expected, and the Government's financial position has not strengthened enough to phase out adjustment lending.

44. Implementation experience with investment projects is still at an early stage, but has generally been good (see Review of Portfolio Performance--Annexes B2 and B8). Nevertheless, institutional capacity has been a constraint. A number of measures have been put in place, but the problem has proven more complex and time intensive than originally envisaged, hence, considerable resources will be deployed to portfolio enhancement (para 50) over the CAS period. Some of the activities under ongoing projects and IDF grants are showing early promise and we are beginning to devolve some responsibility for grant supervision to the Resident Mission on a pilot basis. Concerted efforts among all donors will be required to reach common understandings on capacity building and to promote better utilization of technical assistance.

45. Among the initiatives which have begun to work well are the institutionalization of joint Government-Bank bimonthly portfolio reviews and regular CPPRs, for which the Government has taken an increasingly prominent role in planning, execution and follow-up. The Resident Mission has expanded during the CAS period and its impact, particularly with respect to the promotion of Government ownership, has enhanced project implementation. Greater integration of IFC and EDI

programs with Bank operations is also beginning to be achieved through the assignment of their local officers in the Resident Mission. Bank-EDI collaboration with Parliament has proven successful in terms of producing sound legislation for procurement reform, budget reform and a new law governing foreign investment.

B. Objectives of this CAS

46. Over the next three years, the Bank will continue to work with the Government in defining and implementing the second generation of structural reforms needed to continue the transition to a market economy and to establish sustained growth, which we see as the best vehicle for reducing poverty on a broad scale. In playing this role, we, together with EDI, intend to work closely with the Parliament to enhance its understanding of the rationale for further reform, in particular, the areas of pension reform and public utility pricing.

47. The strategic objectives of the CAS reflect the Government's development priorities. They are:

- (i) **to attain sustained growth** by clearing away the remaining policy and regulatory impediments to private sector activity through a consolidation of structural reforms. The growth objective would be supported by a focused set of projects to increase agricultural productivity (irrigation, agricultural support services, livestock & pasture management) which have the potential to raise the incomes of a broad swath of the rural population where poverty is concentrated.
- (ii) **to reduce poverty** through a growth-enhancing strategy complemented by (i) specific investments to improve basic social services (health, rural water supply and sanitation, and public transportation); (ii) improvements to the system of social protection (assured payment of pensions, better targeting of social assistance, and a stronger capacity to monitor and assess poverty and to translate this analysis into effective sector policies); and (iii) a rural infrastructure project that would provide a direct, if temporary, boost to employment in rural areas.
- (iii) **to improve governance** through continued support for government-wide procurement, audit and budget reforms; further deregulation and enhancement of the competitive environment for business; and tax simplification. These efforts are complemented by bilateral donor support for judicial reform and ADB support for corporate governance. The program would also **strengthen institutional capacity** through establishment of a land registration system and through continued support for the regulatory agencies governing public utilities, privatization, foreign investment promotion, national statistics, and the Environmental Action Office.
- (iv) **to strengthen public finances**, in order to reduce the dependency on external budget support operations. Public finances would be strengthened through reforms that would eliminate the deficit of the existing Pay As You Go pension system, extend the land tax to urban areas, improve the standards for external debt management, and extend the principles of cost recovery and economic pricing to all commercially-oriented public services that are supported by Bank investment projects (power, telecoms, irrigation, public transport, and water supply).

C. Bank Group Assistance Program

48. **IDA Lending.** The structural reforms envisaged in the CAS program would be supported by two adjustment operations:

- **a social sector adjustment credit (SOSAC)** whose primary objective would be to achieve financial viability of the existing Pay As You Go pension system and, thus, assure the timely payment of public pensions. This would be achieved through rationalization of eligibility criteria for pension benefits, enhanced linkage of benefit levels with contribution history, and, to the extent possible within the overall financial constraints, some reduction of the extremely high social insurance contribution rates (39 percent) that are a major impediment to compliance. Measures to improve Social Fund accounting and management would also be supported under this credit, as would development of the legislative and institutional framework for supervision of private pension funds as part of a voluntary private pillar. Finally, SOSAC would support improved targeting of social assistance and a restructuring of unemployment benefits.
- **a consolidation structural adjustment credit (CSAC)** -- a comprehensive structural adjustment operation that would provide the finishing touches to the reforms initiated under the previous five adjustment credits and introduce additional reforms needed to improve the environment for private sector investment and growth. The likely agenda could include the final stages of utility privatization, simplified business regulation, improvements in anti-monopoly and anti-competitive business policy, measures to ensure enforcement of new laws (judicial reform), tax simplification and possible reduction in general business tax rates to increase compliance and lessen the incentives for negotiation with the tax authorities, improved legal framework for private agricultural marketing and input distribution, further development of non-bank financial institutions, and further strengthening of the audit and budget reforms initiated under the PSRMAC.

49. Investment lending would focus on agriculture, in particular, the rehabilitation of the irrigation system which is a priority for the Government. An **irrigation rehabilitation project** (FY98) for the main canals would be followed by an **on-farm irrigation project** (FY00) that would support formation of water user associations for maintaining local irrigation systems and introduction of an appropriate water pricing policy. Consistent with the strategy to promote growth in rural areas, a **livestock and pasture management project** and a **rural infrastructure project** are also included in the program. A **land registration project** would help create functioning land markets in both rural and urban areas and strengthen local government finances by providing the basis to levy and collect land tax. Investment lending would also emphasize social concerns through investments in **public transportation, rural water supply**, and a **second health project** that would continue the improvements in clinical effectiveness promote restructuring of the health system to improve its long-term financial viability, and promote public health strategies for dealing with communicable and non-communicable diseases.

50. Significant resources will be devoted to assist the Government in implementing the proposed program, as well as the existing portfolio which includes some challenging and complex projects. In addition to intensive supervision efforts, other portfolio enhancement instruments include: bi-monthly joint Government-Bank project reviews; continuous implementation of the ongoing Joint Implementation Action Plan (first developed at the 1996 CPPR); and specialized capacity building initiatives (e.g., procurement reform --para 38). Annex B8 provides more information on portfolio management.

Non-lending Services

51. **Economic and sector work** (ESW) will be geared to defining the reform agenda for the CSAC. The on-going post-privatization study will identify remaining impediments to private sector development following the privatization process as well as needed improvements in the regulatory environment for business. Other proposed studies which will support the CSAC's focus on strengthening the climate for private sector investment include an agricultural input marketing strategy to defining strategies for the developing private input dealers and an update on financial sector reform that would focus on non-bank financial institutions. **Economic work** will emphasize the strengthening of public finances (also to be covered under CSAC) through (i) a land tax study to assess the revenue potential of extending the existing land tax from rural to urban areas, and (ii) a fiscal sustainability study that would assess the scope for reducing tax rates within the context of a stable long-term outlook for public finances. As part of our ESW strategy, we will rely on our collaboration with the IMF in preparing the annual Policy Framework Paper for the ESAF programs to stay up-to-date on macro developments and will not produce separate economic reports on the general economy. **Sector work** would support specific investment operations, such as the second health and livestock projects, as well as a forestry and watershed management note / action program.

52. **Technical assistance and capacity building** will be critical elements of the Bank Group strategy. It will be provided through a variety of instruments including project supervision, IDF grants and EDI programs. The Government's capacity to attract private investment is being strengthened through an on-going IDF grant which, *inter alia*, supports the establishment of a one-stop shop for foreign investors. These efforts will be coordinated with and supported by IFC, FIAS and MIGA. A future IDF grant will help develop a national information infrastructure strategy for private investment in the telecommunications sector. Capacity building will also be supported by EDI's program of training government officials and Parliamentarians who are directly engaged in issues concerning the preparation or implementation of Bank operations, e.g., pension reform under SOSAC, and public utility pricing and management training. EDI involvement proved particularly useful in introducing the inter-governmental finance and budget reforms supported under PSRMAC.

IFC Program

53. IFC's involvement in Kyrgyzstan has so far been concentrated in areas where conditions exist for an immediate impact on recovery and growth, i.e., the Kumtor Gold Mine and an investment in a modern joint-venture commercial bank. It has also assisted in attracting foreign investors by hosting an Investor's Conference. Further the Corporation has worked with several enterprises that were undergoing restructuring under the PESAC program to attract strategic investors but to date no investments have materialized. IFC is continuing to try to identify projects in the manufacturing and agribusiness sectors but to date, none have met its standard criteria for financing. In the present environment (see Attachment, Private Sector Assessment), potential projects are of very small size, there is a lack of credible foreign investors, and considerable effort and field presence is required to help small entrepreneurs transform a business concept into a business plan and to follow international business practices. For the coming years, IFC's strategy will focus on:

- **Institution-building in the area of capital markets.** At present, IFC is evaluating a possible investment in the country's first housing finance fund. The development of this project faces a number of constraints related to the legal and regulatory environment for housing and mortgages, such as a lack of a comprehensive title registration system, an absence of a mortgage law, and other necessary laws and regulations. Some of these

constraints are being addressed through technical assistance (USAID) and the proposed Land Registration Project. IFC will also contribute to the IDA's study on non-bank financial institutions and to the financial market policies to be incorporated into the CSAC.

- **Support to SMEs.** IFC will continue to seek ways to assist the SMEs through local financial intermediaries. To address the scarcity of skills and expertise in modern managerial, accounting and marketing practices, IFC, is also exploring opportunities to establish a local consulting firm to provide consulting services and training programs for local entrepreneurs in accounting, marketing and project finance. IFC's capacity to provide support to SMEs would be expanded if the Kyrgyz Republic were included in the Extending IFC's Reach Program.
- **Developing the mining sector,** which has significant potential for export earnings. At present, IFC is working with foreign mining companies to develop the Taldybulak and the Jeruy gold fields and is assisting them with the preparation of environmental studies. Future progress will depend on the outcome of feasibility studies under preparation. Recent movements in gold prices, however, are likely to delay some projects.
- **Development of private sector infrastructure projects.** Privatization of the industry and opening it to private investors would create opportunities for IFC in power, telecommunications and other sub-sectors.
- **Agribusiness and post-privatization restructuring.** IFC will continue to explore ways to attract foreign investors in agribusiness and to assist with post-privatization restructuring.

54. **MIGA** has insured two projects so far in the Kyrgyz Republic, one in the mining sector (Kumtor gold mine) and one in the manufacturing sector (Coca-Cola). Currently, MIGA has one definitive application for a project in the service industry (\$11 million) and five preliminary applications for projects in sectors such as crude oil, forestry and mining, representing investments of approximately \$620 million. MIGA, together with IFC and the Bank will provide capacity building training in foreign investment techniques. Kyrgyzstan is also a pilot country for MIGA's Privatization Link which connects potential investors and those engaged in privatization via the internet. MIGA/OECD are also organizing a conference on Mining Investment and Business Opportunities in June 1998.

Partnerships, Selectivity and Coordination

55. The proposed program takes into account the comparative advantages and additionality offered by the Bank Group, other donor programs and IDA resource constraints. In certain areas, the Bank will either not be involved or our involvement will be of a limited nature. These include **education**, for which the ADB has taken the lead in supporting the development and financing (together with OPEC) of an Education and Training Master Plan and sector investment program, and **roads**, for which ADB and OECF have been key financiers. In other infrastructure areas, particularly **energy and telecommunications**, the ADB and EBRD play significant roles. The Bank will continue to work in partnership with them through supervision of ongoing investment projects and through IFC's involvement with private sector interests. Our future role will be largely confined to policy advice on implementation of the recently created regulatory bodies for those sectors and on the implementation of their privatization plans. Future Bank efforts in the **financial sector** will be limited to analytical work on non-bank financial institutions and preparation of the CSAC, supported and complemented by IFC.

Bilateral donors, notably the Swiss and Finns have taken a strong lead on **forestry and watershed management**. The Bank's proposed forestry sector note will complement these efforts. Bank involvement under the GEF and Aral Sea frameworks will also underpin these efforts. On **legal and institutional reform**, the USAID, EU-TACIS, UNDP and other donors have provided substantial technical assistance for a broad array of reforms dealing with the legal framework, reform of the judiciary, privatization, financial sector reform, etc. Future Bank Group efforts (including IFC and FIAS) will be concentrated on legislative reforms associated with Bank-financed operations and analysis of sector-specific legal issues in programmed ESW. Limited support for judicial training is supported under the ongoing FINSAC TA operation. Table 2 provides an overview of donor program areas of involvement.

Table 2: Donor Collaboration: Selected Key Areas of Involvement

	World Bank Group		IMF	ADB	EBRD	EU	UN System	IFAD	DK NO FI CA NDF	GER	JP	CH	NL	UK KHF	USAID	OPEC
	WB	IFC/EDI														
Macro Framework	✓		✓													
Financial Sector	✓	IFC EDI	✓		✓	✓				✓					✓	
Legal Reform						✓	✓						✓		✓	
PSD/Investment Climate	✓	IFC	✓		✓					✓	✓	✓			✓	
Fiscal Reform	✓		✓												✓	
Governance				✓			✓		CA						✓	
Agriculture/Rural Dev./Land Reform	✓	EDI IFC		✓		✓	✓	✓	FI	✓	✓	✓	✓	✓	✓	
Environment/Forestry	✓	EDI					✓		FI	✓			✓	✓		
Land Reform	✓			✓		✓	✓	✓							✓	
Mining		IFC							CA							
Transport	✓			✓							✓					
Oil/Gas/Power	✓	IFC		✓		✓			DK,NO, NDF			✓			✓	
Urban/Water	✓	EDI		✓			✓					✓				
Telecoms	✓	IFC			✓											
Health	✓	EDI					✓		DK	✓		✓	✓		✓	
Education				✓			✓		DK		✓		✓			✓
Social Protection	✓	EDI		✓		✓	✓						✓	✓		
Labor Mkt./Trng				✓			✓			✓				✓		
Modernization of State	✓	EDI				✓	✓									
Capacity Building	✓		✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓

CA - Canada
DK - Denmark

FI - Finland
NO - Norway

NDF - Nordic Development Fund

GER - Germany

JP - Japan

CH - Switzerland

NL - Netherlands

UK-KHF - UK Know-How Fund

56. The first stage of post-independence assistance to the Kyrgyz Republic was largely managed from donor capitals. Over the last 18 months, a gradual shift has occurred with a larger in-country international presence and a more formalized system of information dissemination and cooperation emerging. To date, there has been general agreement among donors on policy direction and priorities. However, at the operational level, lack of adequate dialogue has, on occasion, led to duplication of efforts and conflicting advice. There is a need for the Government to assume more forceful ownership, direction and coordination of programs. The recent mandate given to the Agency for Foreign

Investment to manage external aid coordination is a welcome signal. However considerable caution will need to be exercised in order to prevent the Agency's multiple functions from diluting attention to this priority area. On the donors part, greater sharing of information at the project/activity level is needed and at the strategic level, advance consultations on respective country strategies is desirable. To assist with this task, the Bank will continue aid coordination efforts in the form of organizing Consultative Group meetings every 18-24 months, as well as a third international agricultural conference in Bishkek to assess progress against the strategy agreed during the recent second conference (para. 24).

57. The phasing of the IDA program of lending and non-lending services that will be used to achieve the CAS objectives is shown in Annex A1. The contribution of these instruments to achieving the CAS objectives is shown in Annex C1.

D. Lending Levels, Triggers and Creditworthiness

58. **IDA Lending Levels.** Kyrgyzstan has been in a high case lending scenario since it began borrowing from IDA in FY93. During FY96-98, the Government prepared and is implementing the full high case lending program envisaged in the 1995 CAS (10 projects, including three adjustment operations, totaling \$223 million IDA).

59. The current CAS proposes a continued high case lending program of \$185 million IDA for FY99-01. The proposed level is lower than the previous three-year period, which included a "transition premium" to help deal with the dramatic collapse in the economy, but is consistent with IDA's current availability of resources. Continued high case lending is justified because, in addition to Kyrgyzstan's continued strong track record of economic management and project implementation,

- (i) the impact of the transition has been much greater than was expected three years ago. Absolute poverty has increased significantly, and structural poverty is much deeper and will take much longer to redress.
- (ii) there is a continued need for balance of payments and budgetary support. The outlook for export earnings is less robust, in view of lower gold prices, and public finances remain weak, despite considerable adjustment to date (paras. 12-14).
- (iii) there is a clearly identified program of structural reform (SOSAC and CSAC) to justify continued BOP support.

60. The CAS program would allocate up to 40 percent of total lending (up to \$70 million) for adjustment lending (SOSAC and CSAC). This is about the same proportion as during FY96-98, but due to differences in the patterns of disbursements between adjustment and investment operations, the proposed program would result in a declining share of quick disbursing assistance over the coming three years (from roughly 80 percent in FY96-98 to 40 percent in FY99-01) and a corresponding increase in the share of disbursements from investment projects. The pattern of commitments and disbursements is shown in Annex C2.

61. **Lending Triggers.** The macroeconomic, portfolio and structural conditions for maintaining a high case lending program are set out in Box 3. SOSAC and CSAC would proceed only when the policy reforms for these operations are ready. Specifically, SOSAC will require agreement on a clear set of policy measures to attain financial sustainability of the existing state pension system within a defined time period. CSAC will require agreement on policies to improve the environment for private sector development and growth (para. 48). Significant delay with preparation of SOSAC or CSAC operations would indicate policy slippage. In this case, in addition to not proceeding with the adjustment operations, IDA would limit lending to the range of \$115-140 million for investment projects. This medium case scenario assumes reasonable macro performance (no deterioration in the fiscal balance and moderate inflation), and agreement on key sector policies necessary for our projects, e.g., cost recovery in energy, irrigation and public transport. In view of the Government's strong track record of policy reform, we assess the probability of this intermediate case as low.

Box 3: Triggers to Stay in High Case	
Macroeconomic Sustainability	<ul style="list-style-type: none"> • Government stabilization program supported by IMF on track
Portfolio Performance	<ul style="list-style-type: none"> • continuation of bi-monthly Joint Bank-Government Portfolio Reviews and implementation of the Joint Implementation Plan • resolution of the problem project status of the two operations currently rated "U" by end-FY99 and maintenance of a portfolio with no more than 17 percent unsatisfactory projects
Structural Reforms and Private Sector Development	<p>Satisfactory progress in the program of structural reform, including in:</p> <ul style="list-style-type: none"> • adoption of a legal framework for establishing a land registration system consistent with the draft Land Registration Act by March 1999. • attainment of fiscal sustainability of the pension system and the development of a regulatory and legal framework for targeting social assistance. • preparation of a national irrigation rehabilitation action plan by end-1999. • privatization of remaining large state enterprises, including telecommunications and energy, through case-by-case method, consistent with the Government Privatization Program 1998-2000

62. **Creditworthiness.** In the last CAS, it was envisaged that \$25 million IBRD per annum would be available starting in FY98 to replace the IDA "transition premium". However, a recent creditworthiness study concluded that public finances are still too fragile and the impact of non-concessional borrowing too strong for Kyrgyzstan to borrow prudently on IBRD terms. Strengthening creditworthiness is therefore important to prepare for the eventuality that the availability of IDA resources may decline further and for the day when borrowing capacity will be determined more by financial indicators than by poverty indicators. Over the next three years, we will look for improvement in the following indicators of creditworthiness and make a further review before proceeding with lending on IBRD terms:

- sustained GDP and export growth within an open trade, exchange rate and monetary regime.
- strengthened government finances as indicated by financial sustainability of the state pension system, enhanced revenue capacity (e.g., an increase in the tax to GDP ratio from 13 percent to 14-15 percent), tightened procedures for contracting and on-lending external debt to state enterprises, and self-imposed restraint on public and publicly-guaranteed non-concessional borrowing (no more than \$25 million per annum during 1998-2000).

- consolidation of structural reforms through measures as outlined above for the CSAC. In particular, the Bank will look for across-the-board implementation of economic pricing for public services (heat, electricity, telecoms, water, irrigation and public transport).
- an increase in foreign direct investment as an indicator of improvement in the business and regulatory climate.

E. Risks to the Bank Group

63. The Kyrgyz Republic is not a high risk country for the Bank Group, in view of its continued strong policy performance and the fact that the economy appears to be growing. **The main risk to the CAS program is a reversal in policy direction** that would delay the reform process and cause resources that were devoted to ESW and project preparation to be wasted. A failure to reach a consensus within the Government on reforming the state pension system is an example of this kind of risk. The failure to maintain an open and transparent business environment, free of anti-competitive business cartels, or the lack of transparency in the remaining privatization program represents a similar policy risk. In these cases, as discussed above, the Bank would not proceed with the SOSAC and CSAC adjustment operations. One implication is that the Bank would have to spend additional administrative budget to re-appraise these operations as and when the Government returned to an active program of policy reform. The likelihood of a reversal in policy direction does not appear high at this time, however, as there is no significant popular support for a return to the past policies of a command economy. The rural population is pressing hard for enactment of the now-delayed land laws and land registration system, and the business community is concerned with protecting its new-found freedom from state direction. The Government will nevertheless have to be conscientious in continuing its reform efforts in order to avoid “policy drift” and the consequent slowdown in Bank operations.

64. **A second risk is institutional weakness in the implementation of Bank operations.** The Bank’s relationships with government ministries are still in the formative stage, and policy coordination, project implementation and procurement issues require more intensive attention than in countries that have been doing business with the Bank for decades. To address this situation, supervision missions will need to intensify capacity building efforts. This raises the cost of supervision, however, despite the efforts of the Bank’s Resident Mission operations officers who greatly facilitate the day-to-day supervision of Bank projects.

65. **An external risk to the Bank is a stagnation of growth or a renewed decline in the economy.** Such a development would serve as a negative demonstration effect for the rest of Central Asia and impede reform in those countries. A pro-active program of financial, technical and intellectual support for continued reform in Kyrgyzstan is the main safeguard against such a development.

V. Concluding Remarks

66. The Kyrgyz Government has shown commitment and determination in its efforts to realize its vision of a modern, dynamic market-oriented economy based on greater political, economic and social participation. Growth, particularly in the rural areas, will be the key to the successful completion of its transition and equitable development. The first difficult steps have been taken and, after several years of severe economic hardship, are finally beginning to show results. The challenges inherent in the next phase of the transition are likely to prove more complex, and the international community and the World Bank Group will need to work in concert to assist the Government in meeting them. The proposed high case IDA lending strategy is appropriate to country needs and justified by policy and portfolio implementation performance. The program also pays due attention to assisting the Government in strengthening country creditworthiness to prepare for lending on IBRD terms toward the end of the CAS period.

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President

By:

Caio K. Koch-Weser

Jannik Lindbaek

Attachments
Washington D.C.

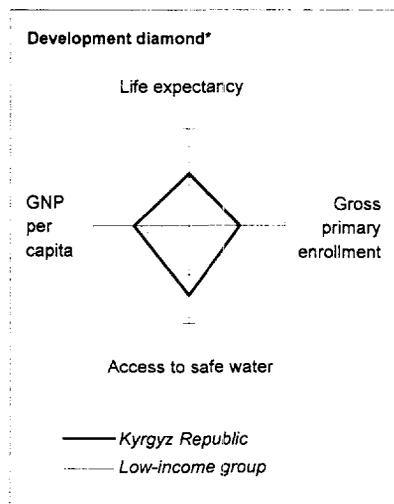
KYRGYZ REPUBLIC: High Case CAS Program Summary FY99-01
(with indicative credit amounts in millions of US\$)

		FY99-01		\$ 185.0	
Current Year (FY 98)		FY 99		FY 00	FY 01
Lending:		Lending:		Lending:	Lending:
Agr. Support Serv.	14.9	SOSAC	35.0 *	Rural Water & Sani.	Health II
Irrigation Rehab	35.0	Land Registration	10.0	On Farm Irrigation	Rural Infrastructure
Power Supplemental	15.0	Public Transp & Maint.	20.0	Consolidation SAC	Livestock & pasture Mgmt.
	64.9		65.0		50.0
Nonlending:		Nonlending:		Nonlending:	Nonlending:
ESW		ESW		ESW	ESW
Agricultural Policy Review		Land Tax Study		Health Restr. & Nutrition* (with focus on finance)	Agr. Sector Policy Update
Post Privatization & PSD		Fiscal Sust. & Growth		Non-bank Fin Sector Update	Creditworthiness Review
Water Sector Note		Forestry Sector Note		Livestock Subsector Note	PPF*
Urban Transport Sector Note		Agr. Input Mktg. Strategy		Poverty Update* (with labor market focus)	TA/Capacity Bldg.
Poverty Update		PPF*		PPF*	Agr. Exp. Promo. Policy (IDF)
PPF					
TA/Capacity Bldg.		TA/Capacity Bldg		TA/Capacity Bldg.	Aid Coordination
Country Procurement		External Debt Mgmt. TA		Poverty Monitoring, Targeting and Labor Mkts (IDF)	Third International Agr. Conference
Assessment & Workshop		Strengthening the National Environmental Action Office (IDF)		National Information Infrastructure Policy (IDF)	
Agro Restart TA for Agroprocessing		Improving Agr Statistics (Natstatkom) (IDF)			
Strengthening the State Property Fund (IDF)					
Strengthening National Procurement (IDF)					
Strengthening National Statistics Agency (IDF)		Other		Aid Coordination	
		Biodiversity Project (GEF)		Consultative Group Meeting	
Aid Coordination					
Second Intl. Agri. Conference					
Consultative Group Meeting					
* amount to be determined commensurate with policy content.					

Kyrgyz Republic at a glance

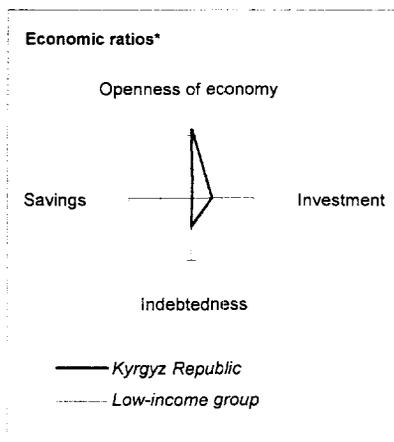
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POVERTY and SOCIAL	Europe & Central Asia		
	Kyrgyz Republic	Central Asia	Low-income
Population mid-1996 (<i>millions</i>)	4.6	479	3,229
GNP per capita 1996 (<i>US\$</i>) ^a	570	2,180	500
GNP 1996 (<i>billions US\$</i>)	1.8	1,043	1,601
Average annual growth, 1990-96			
Population (%)	0.6	0.3	1.7
Labor force (%)	1.2	0.5	1.7
Most recent estimate (latest year available since 1989)			
Poverty: headcount index (% of population)	45	..	..
Urban population (% of total population)	39	65	29
Life expectancy at birth (years)	68	68	63
Infant mortality (<i>per 1,000 live births</i>)	30	26	69
Child malnutrition (% of children under 5)	..	..	..
Access to safe water (% of population)	75	..	53
Illiteracy (% of population age 15+)	3	..	34
Gross primary enrollment (% of school-age population)	111	97	105
Male	110	97	112
Female	111	97	98



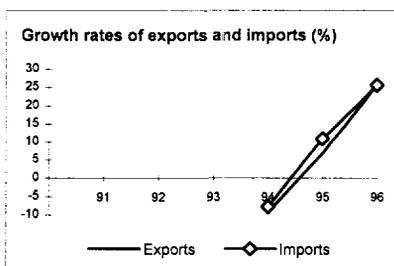
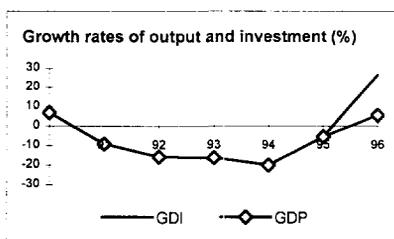
KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1975	1985	1995	1996	
GDP (<i>billions US\$</i>)	1.5	1.8	
Gross domestic investment/GDP	..	30.5	20.4	22.4	
Exports of goods and services/GDP	29.5	30.7	
Gross domestic savings/GDP	..	13.8	5.4	-0.6	
Gross national savings/GDP	..	13.8	1.6	-3.9	
Current account balance/GDP	-16.2	-23.3	
Interest payments/GDP	1.9	1.8	
Total debt/GDP	50.8	59.6	
Total debt service/exports	27.4	19.2	
Present value of debt/GDP	
Present value of debt/exports	
(average annual growth)					
GDP	-5.4	6.5	4.6
GNP per capita	-6.3	6.8	5.2
Exports of goods and services	6.8	25.8	8.8



STRUCTURE of the ECONOMY

	1975	1985	1995	1996
(% of GDP)				
Agriculture	..	30.7	40.7	46.3
Industry	18.1	17.0
Manufacturing	12.0	11.1
Services	33.9	29.8
Private consumption	..	64.1	80.8	83.9
General government consumption	..	22.1	19.9	17.2
Imports of goods and services	42.4	56.6
(average annual growth)				
Agriculture	-1.9	15.1
Industry	-10.6	2.7
Manufacturing
Services	-6.6	-3.1
Private consumption	-1.2	15.3
General government consumption	-5.4	-8.5
Gross domestic investment	12.0	36.2
Imports of goods and services	10.9	25.6
Gross national product	-10.2	8.3



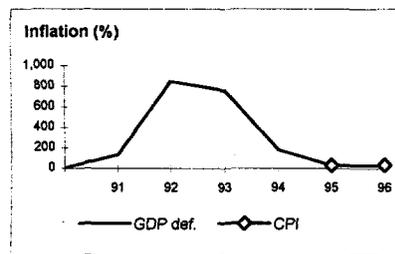
Note: Figures in *italics* are for years other than those specified. a. Calculated by using Atlas synthetic conversion factor.

* The diamonds show four key indicators in the country (in **bold**) compared with its income-group average. If data are missing, the diamond will be incomplete.

Kyrgyz Republic

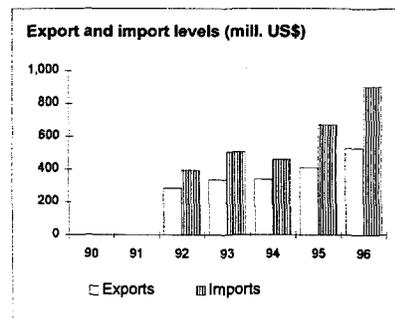
PRICES and GOVERNMENT FINANCE

	1975	1985	1995	1996
Domestic prices				
<i>(% change)</i>				
Consumer prices	31.9	35.0
Implicit GDP deflator	-2.3	-10.3	42.0	35.3
Government finance				
<i>(% of GDP)</i>				
Current revenue	16.4	14.7
Current budget balance	-9.4	-6.5
Overall surplus/deficit	-17.3	-9.5



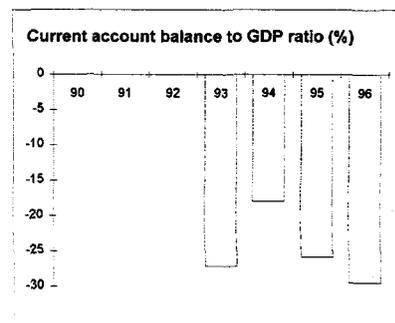
TRADE

	1975	1985	1995	1996
<i>(millions US\$)</i>				
Total exports (fob)	409	531
Electric power	41	74
Gold	0	0
Manufactures	247	298
Total imports (cif)	672	901
Food	87	98
Fuel and energy	174	251
Capital goods	144	182
Export price index (1995=100)	100	96
Import price index (1995=100)	100	102
Terms of trade (1995=100)	100	95



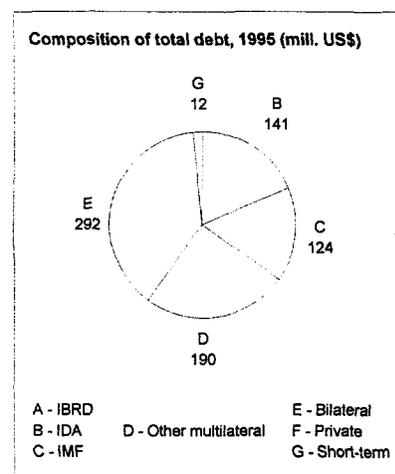
BALANCE of PAYMENTS

	1975	1985	1995	1996
<i>(millions US\$)</i>				
Exports of goods and services	448	562
Imports of goods and services	632	926
Resource balance	-184	-364
Net income	-137	-148
Net current transfers	79	89
Current account balance, before official capital transfers	-242	-423
Financing items (net)	294	462
Changes in net reserves	-51	-39
Memo:				
Reserves including gold (mill. US\$)	115	132
Conversion rate (local/US\$)	10.8	12.9



EXTERNAL DEBT and RESOURCE FLOWS

	1975	1985	1995	1996
<i>(millions US\$)</i>				
Total debt outstanding and disbursed	759	1,081
IBRD	0	0
IDA	140	199
Total debt service	125	109
IBRD	0	0
IDA	1	1
Composition of net resource flows				
Official grants	99	112
Official creditors	65	62
Private creditors	135	182
Foreign direct investment	96	46
Portfolio equity	0	0
World Bank program				
Commitments	60	60
Disbursements	81	59
Principal repayments	0	0
Net flows	81	59
Interest payments	1	1
Net transfers	81	57



KYRGYZ REPUBLIC -- CAS Program Matrix
(most likely scenario)

<i>Key Issues Diagnosis</i>	<i>FY96-98 Main achievements</i>	<i>Strategy / Actions</i>	<i>Measures</i>	<i>World Bank Group Instruments</i>	<i>Other Donors</i>
<p>1. Consolidate macroeconomic stability and creditworthiness: The economy has achieved a moderate level of <u>stabilization</u>. Output recovered. Fiscal consolidation has taken place mainly through expenditure-reduction measures, but deficit is too high to ensure long-lasting stability. Last year of three-year ESAF successfully concluded in December 1997; a new ESAF is expected to begin in early 1998.</p>					
<p>1-A. Sustainability of Budgetary Outcomes and Policies</p>					
		<p>Fiscal deficit limited to the level that can be financed by T-bills sale and foreign assistance at concessional terms:</p>	<ul style="list-style-type: none"> Conclude 1998-2000 ESAF program and observe its targets 		<p>IMF ESAF</p>
<p><i>(i) Revenue</i></p> <ul style="list-style-type: none"> Revenue levels remain depressed despite improvements in policy and administration 	<p>New tax code adopted in 6/96 which modernized the VAT, income, and profit, excise taxes and tax administration</p> <p>Threshold for minimum <u>income taxes</u> reduced, and enterprise-specific exemptions discontinued</p> <p><u>Land tax</u> modified as the main method of taxing agriculture</p> <p><u>Excise tax</u> extended to all oil products, and equalized at higher rate the excise for all domestic and imported goods</p>	<ul style="list-style-type: none"> Further broaden revenue base, improve collection rates and lower tax rates over the medium-term 	<p>Tax Base and rates</p> <ul style="list-style-type: none"> Increase compliance likelihood by reducing overall payroll contributions, introducing parallel expenditure-containment or revenue enhancing measures Identify remaining tax exemptions to excise, VAT, income and payroll taxes and phase them out over CAS period Evaluate potential for land tax revenues in both rural and urban areas and introduce tax in urban areas <p>Administration</p> <ul style="list-style-type: none"> Tighten border controls and an automated customs valuation system Rely increasingly on targeted in-depth audits to detect tax evasion 	<p>Lending: Consolidation SAC (FY00)</p> <p>Non Lending: IMF/WB Policy Framework Paper (FY98-00)</p> <p>Fiscal Assessment (FY99)</p> <p>Land Tax Study (FY99)</p>	<p>IMF ESAF USAID GTZ support to MoF</p>

Key Issues Diagnosis	FY96-98 Main achievements	Strategy / Actions	Measures	World Bank Group Instruments	Other Donors
(ii) Expenditure Management and Control	<ul style="list-style-type: none"> Continued effort needed to match resources and responsibilities 	Increase effectiveness of expenditure by:	<ul style="list-style-type: none"> Revenue sharing and grant schemes <ul style="list-style-type: none"> Retain uniform tax sharing rates across all oblasts Develop mechanisms for establishing the size and funding of equalization pool and fix the formula grant by resolution for 3 years Retain the structure of categorical grants for education and health 	Lending: Public Sector Reform and Management Credit (PSRMAC) (FY97)	IMF ESAF EU /TACIS UNDP
<ul style="list-style-type: none"> Framework for prioritizing and controlling expenditures introduced but needs institutionalization 	Law on Principles of the Budget prepared to improve budget planning and execution and a Budget commission (BC) created to provide budget policy direction	<ul style="list-style-type: none"> Consolidating legislation, institutions and practices of the prioritization and control framework 	<ul style="list-style-type: none"> Planning, Execution and Control <ul style="list-style-type: none"> Adopt Law on Principles of the Budget Implement an expenditure control / warrant system for all spending units to avoid arrears build up Institutionalize early preparation of annual budgets, which include all public investments and an updated MTFF 	Non Lending: Country Procurement Assessment Report and Workshop (IDF)	
	1998 budget included all externally financed investments and a medium-term financial forecasts (MTFF)		<ul style="list-style-type: none"> Move to program-focused methods for estimating requirements in health and education and for monitoring impact of spending programs 	Fiscal Assessment (FY99)	
	MoF set expenditure ceilings for ministries, abandoning the practice of budget plan based on norms that neither resembles priority programs, nor enforces a budget		<ul style="list-style-type: none"> Clarify the responsibilities for external auditing between the Accounts chamber and the State Financial Inspectorate 		
	Capacity for internal financial audits increased at MoF				
(iii) External Financing of Deficit	<ul style="list-style-type: none"> The institutional framework for external debt contracting and management is needed to contain its rapid growth (already at 80% of GDP) 	Borrowing policy broadly consistent, but IMF limits for nonconcessional debt limits surpassed in 1997, which could drive debt service ratios beyond sustainable thresholds	<ul style="list-style-type: none"> Improve the process for contracting debt and issuing budget guarantees 	<ul style="list-style-type: none"> Create a statutory committee to approve all new external debt (MOF, NBK and government apparatus) Limit non-concessional borrowing for government and government guaranteed debt 	Non Lending: External Debt Management TA (FY99)
				Fiscal Assessment (FY99)	
				Creditworthiness Review (FY01)	IMF ESAF (FY01)

<i>Key Issues Diagnosis</i>	<i>FY96-98 Main achievements</i>	<i>Strategy / Actions</i>	<i>Measures</i>	<i>World Bank Group Instruments</i>	<i>Other Donors</i>
1-B. Fiscally Sustainable Approach to Social Assistance					
(i) Health Care					
<ul style="list-style-type: none"> Financing methods need to go in concert with type of service provided (which should be mainly primary health care) 	<p>Incentive based payment mechanism for medical care providers developed and tested in Issyk-Kul, to finance <u>primary Family Group Practices (FGP)</u></p> <p>Introduction of more cost effective treatment protocols and ambulatory care</p> <p>Reform of pharmaceutical procurement/management underway</p>	<ul style="list-style-type: none"> Further strengthen primary health-care (PHC) delivery and financing and refocus health system to PIIC 	<ul style="list-style-type: none"> Expand the pilot on provider payment and FGP from Issyk-Kul to Bishkek and Chui Draft and approve needed regulations and laws to enable provider payment and FGP to advance Harmonize Mandatory Health insurance law with FGP system Rationalize health facilities and beds further 	<p>Lending: Health Reform (FY96) Health II (FY01)</p> <p>Non Lending: Health and Nutrition Note (FY00)</p>	<p>WHO USAID UNICEF UK Know How Fund GTZ and KFW UNDP</p>
(ii) Pensions					
<ul style="list-style-type: none"> Annual deficit of social insurance is high due to low compliance rates, low average retirement age, and subsidization in rural areas 	<p>Law on Pensions enacted in September 1997 gradually introducing personal accounts. Pension deficits are high and constitute a large percentage of the overall fiscal deficit.</p>	<ul style="list-style-type: none"> Introduce fiscal sustainability in the state pension scheme; support institutional strengthening of the SF; develop options for future fundamental reform 	<ul style="list-style-type: none"> Increase compliance rates through better administration Review retirement policy Develop policy for farmers pensions to either reduce implicit subsidy or increase its transparency Decrease payroll taxes with parallel cost containment measures Improve SF accountability and transparency through implementation of accounting procedures consistent with IAS. 	<p>Lending: SOSAC (FY99) PIIRD for PR</p> <p>Non-Lending: Non-bank Financial Sector Update (FY00)</p>	<p>ADB EU TACIS</p>
<ul style="list-style-type: none"> Private pension funds exist but unregulated, and their medium term role vis a vis the State pillar is not clear 	<p>Two private pension funds are operating, but their activity is marginal and unregulated</p>	<ul style="list-style-type: none"> Develop legislative and institutional framework for supervision of private pension funds 	<ul style="list-style-type: none"> Clarify regulatory authority of existing funds, regulate their portfolio management and compliance with reserves Design and implement a medium-term strategy 		
(iii) Welfare Expenditures					
<ul style="list-style-type: none"> As the economy recovers, resources need to focus on poverty alleviation and the low end of the income ladder 	<p>Unified benefit established on the principles of income testing and self-selection to protect most vulnerable</p>	<ul style="list-style-type: none"> Continue to improve targeting of social assistance 	<ul style="list-style-type: none"> Approve a new law on social assistance satisfactory to IDA Strengthen capacity to analyze poverty information that translates into policy formulation 	<p>Lending: Social Safety Net (FY95) Fiscal Assessment (FY99)</p> <p>Non Lending: Poverty Updates (FY98) (FY00) Poverty Monitoring (IDF)</p>	<p>ADB EUTACIS</p>

<i>Key Issues Diagnosis</i>	<i>FY96-98 Main achievements</i>	<i>Strategy / Actions</i>	<i>Measures</i>	<i>World Bank Group Instruments</i>	<i>Other Donors</i>
2. Sustained Growth Through Private Sector Development: Albeit from a very low base, agricultural and industrial output began to grow due to privatization, agrarian reform, sound finance and foreign assistance. However, it is not clear how far these sectors have gone in achieving a fundamental restructuring.					
2-A. Privatization and PSD					
(i) Enterprise					
<ul style="list-style-type: none"> Majority of new enterprises choose to remain informal Second phase privatization (case by case) to follow the successfully completed privatization through coupons 	<p>Tax rates remain high (social security is 39% of wages, VAT is 20%, profit tax 35%)</p> <p>Coupons privatization completed for all medium and large enterprises; most ERRA enterprises liquidated or sold; bread complex and agro-processing conglomerate demonopolized</p>	<ul style="list-style-type: none"> Decrease tax pressure for all enterprises Implement second phase privatization program, including utilities 	<ul style="list-style-type: none"> Assess overall tax pressure on nascent private sector and formulate revenue-neutral reduction plans Complete individual privatization plans for utilities and large enterprises aimed at attracting strategic investors Terminate ERRA program 	<p>Non Lending: State Property Fund (IDF grant); Post-privatization & PSD (FY98); Fiscal Assessment (FY99)</p> <p>IFC: Financing for post-privatization restructuring and PSD through investment funds and direct financing; SME development Assistance</p>	GTZ
(ii) Governance					
<ul style="list-style-type: none"> Weak management and low level of motivation of some of managers of privatized enterprises still prevails <p>Decisive reorganization based on private capital or liquidation</p>	<p>Government introduced "resolution on principles of corporate management"; corporate law adopted</p> <p>Credits from the budget eliminated, except in agriculture (to be phased out completely in the year 2000)</p>	<ul style="list-style-type: none"> Facilitate creation of a viable, well functioning private sector Continue enforcing hard budget constraints 	<ul style="list-style-type: none"> Implement accounting, reporting and disclosure standards, and a statutory mechanisms for their enforcement Review flow of vital business information to and within firms Enterprise to seek financing on commercial terms without direct or indirect government guarantees 	<p>Non-Lending: Post-privatization & PSD</p> <p>IFC: Training Program on Accounting</p> <p>Establishment of consulting firm</p>	<p>ADB Corporate Governance Reform</p> <p>Canada</p>
2-B. Transparent Investment Climate					
<ul style="list-style-type: none"> Modernization of industry through price-based introduction of new technology and attraction of FDI 	<p>Law on FDI enacted in 8/97 with: (i) equal treatment to foreign, joint and local firms and (ii) no restrictions on profit and investment income repatriation, except for payments of tax obligations</p> <p>Full capital and current account convertibility facilitates repatriation of investment income</p>	<ul style="list-style-type: none"> Foster favorable conditions for attracting foreign capital, technologies and managerial experience 	<ul style="list-style-type: none"> Establish FDI promotional agency Develop clear objectives regarding Free Trade Zone Areas Facilitate operation of international Investment Funds Simplify registration procedures and reduce the number of permissions required to establish joint ventures Apply for full WTO membership 	<p>Lending: Consolidation SAC (FY00)</p> <p>Non Lending: State Property Fund (IDF grant)</p> <p>IFC/EDI: EDI seminar on FDI FIAS (FDI and Free Trade Zone Areas) IFC Reach Program for SME</p>	<p>EBRD IMF ESAF</p>

<i>Key Issues Diagnosis</i>	<i>FY96-98 Main achievements</i>	<i>Strategy / Actions</i>	<i>Measures</i>	<i>World Bank Group Instruments</i>	<i>Other Donors</i>
2-C. Financial Sector Deepening and Diversification					
(i) Banking Sector Reforms					
<ul style="list-style-type: none"> Collateral legislation in place, but enforcement capacity needs strengthening 	<p>The new laws on Banks, Pledge, and Bankruptcy prepared and enacted</p> <p>A Central Registry for Pledges with four regional offices has been established</p>	<ul style="list-style-type: none"> Create an efficient registry system Strengthen the Judiciary 	<ul style="list-style-type: none"> Complete the establishment of the Central Registry for Pledges in two additional oblasts Design and implement training for judges and improve the legal information systems 	<p>Lending: FINSAC TA (FY97) Consolidation SAC (FY00) Post-Privatization & PSD (FY98)</p>	<p>USAID GTZ IMF ESAF</p>
<ul style="list-style-type: none"> Share of the State in financial market reduced, but competition among participants needs to increase 	<p>Agroprom and Elbank in process of liquidation; Promstroj and AK banks recapitalized with private funds</p> <p>Debt Resolution Agency (DEBRA) restructured a large number of loans, conducted auctions of collateral, won numerous arbitration cases, and paid off part of the creditors</p>	<ul style="list-style-type: none"> Finalize liquidation process, foster competition 	<ul style="list-style-type: none"> Complete liquidation of Agroprom and Elbank, achieve full solvency for Promstroj and AK Complete the debt recovery process and close the Debt Resolution Agency Facilitate foreign investment in the sector Strengthen the already established bases for prudent banking 		
(ii) Non-Bank Financial Institutions (NBFIs)					
<ul style="list-style-type: none"> Sound contractual savings institutions and specialized finance companies not yet developed 	<p>Government has prepared new draft laws for Investment Funds, Insurance Companies, Private Pension Funds and on Leasing; a set of new prudential regulations for Investment Funds have also been prepared</p>	<ul style="list-style-type: none"> Refine and enact these new laws; Clarify and strengthen the regulatory authority(s) over NBFIs 	<ul style="list-style-type: none"> Enact appropriate legislation, clarify regulatory authority for each type of contractual saving institution and specialized finance companies 	<p>Lending: FINSAC TA</p> <p>Non-Lending: Non-bank Financial Sector Update (FY00) Post privatization & PSD (FY98)</p>	<p>GTZ (support to Insurance Industry) USAID (Securities market)</p>
(iii) Capital Markets					
<ul style="list-style-type: none"> Stock market to serve as vehicle for raising new capital for redistribution of privatized assets 	<p>Kyrgyz Stock exchange (KSE) established but only about 26 companies are listed out of about 1300 privatized companies; central depository to be established</p> <p>Revision to law on securities & stock market prepared</p>	<ul style="list-style-type: none"> Create a framework for the orderly development of the capital market and support expansion of securities market 	<ul style="list-style-type: none"> Increase participation of privatized companies in KSE and bring attractive enterprises for sale Use KSE to market bonds Improve enforcement capacity of the State Agency for Securities to protect right of investors Adopt Law on securities & stock market 	<p>Post-privatization & PSD (FY98)</p> <p>IFC: housing finance fund, central depository</p>	<p>USAID TA to local securities market</p>

Key Issues Diagnosis	FY96-98 Main achievements	Strategy / Actions	Measures	World Bank Group Instruments	Other Donors
2-D. Eliminating Labor Market Rigidities					
<ul style="list-style-type: none"> Appropriate incentives to increase work effort and allocative efficiency needed 	<p>Labor markets were made more flexible through restructuring / liquidation of enterprises</p> <p>Discussion on new eligibility for unemployment insurance began</p>	<ul style="list-style-type: none"> Review role of the State in the labor market Reform unemployment insurance 	<ul style="list-style-type: none"> Review labor practices and laws to assess their consistency with labor mobility and with the strengthening of the market Review and improve mechanisms of job search Develop and implement effective criteria for selecting and monitoring and evaluating proactive employment programs In the short-term, tighten eligibility to avoid participation for multiple periods and adjust benefit level to avoid arrears buildup 	<p>Lending: Social Safety Net (FY95) SOSAC (FY99) PHRD for PR</p> <p>Non-Lending: Poverty updates (FY98) FY(00) Poverty Monitoring (IDF grant)</p>	<p>Swiss GTZ</p>
2-E. Promoting Efficient and Profitable Private Agriculture					
<i>(i) Land Privatization and Farm Restructuring</i>					
<ul style="list-style-type: none"> Land market needs further development and farm restructuring needs to be accelerated 	<p>25% of total arable land is placed in a Land Redistribution Fund (LRF) and 50% of the remaining 75% of arable land distributed</p> <p>Right for land use established in the form of 99-year lease</p> <p>Draft Land Registration Law prepared in agreement with market principles</p> <p>Pilot land registration program implemented in two regions</p> <p>38000 private farms (individual and group) have been established</p>	<ul style="list-style-type: none"> Accelerate the development of land markets by: <ul style="list-style-type: none"> ⇒ Ensuring that the right to use land is legally safeguarded and transformed into a property right that can be used as collateral ⇒ Developing land registration system further ⇒ Distributing the remaining land and issuing "regular" land share certificates 	<ul style="list-style-type: none"> Clarify procedures for registering rights and transactions in land shares and prepare standard forms of contract for sale and lease of land shares Design an overall framework for auctioning LRF to ensure efficiency, equity and transparency Educate public in the meaning of the individual rights granted by the land reform program Issue 'regular' land share certificates to those who do not yet have them Facilitate private ownership of land Issue law on land registration Prepare procedural regulations on land and real estate supporting the implementation of land registration system Prepare, in accordance with market principles, and issue Land Code and land mortgage law 	<p>Lending: Agricultural Support Services Project -- ASSP (FY98) Land Registration Project (FY99)</p> <p>Non Lending: Agricultural Policy Reviews (FY98) (FY01) Int'l. Agricultural Conferences (FY98)(FY01) Land Tax Study (FY99)</p> <p>IFC: Possible investments in agro-processing</p>	<p>IFAD USAID</p>

<i>Key Issues Diagnosis</i>	<i>FY96-98 Main achievements</i>	<i>Strategy / Actions</i>	<i>Measures</i>	<i>World Bank Group Instruments</i>	<i>Other Donors</i>
<i>(ii) marketing and agricultural support services</i>					
<ul style="list-style-type: none"> Lack of competitive markets for inputs and outputs 	<p>Most agro-processing enterprises are privatized; markets not yet competitive</p> <p>Inter-oblast trade restrictions made illegal</p> <p>Private farms' share of marketable surplus increased dramatically, while the corresponding share of large enterprises declined</p>	<ul style="list-style-type: none"> Further facilitate increased competition in the markets for inputs and outputs 	<ul style="list-style-type: none"> Simplify the process to establish new enterprises (permits and licenses) Ensure that no inter-oblast trade barriers remain Privatize farm machinery and fertilizer enterprises Privatize seed production farms and implement Seed Law and law on Plant Breeder Protection Rights Promote the establishment of private input dealers Promote the establishment of private leasing companies and service stations for agricultural machinery 	<p>Lending: Sheep Development Project (FY96) ASSP (FY98) Rural Infrastructure (FY01)</p> <p>Non-Lending: Agriculture Inputs Marketing (FY99) Int'l Agricultural Conferences (FY98) (FY01) Agriculture Policy Reviews (FY98) (FY01)</p> <p>IFC: Possible investments in agro-processing</p>	<p>ADB</p> <p>Swiss IFAD</p>
<ul style="list-style-type: none"> Lack of appropriate support services for private farmers 	<p>Existing system of state procurement of agricultural produce and distribution of agricultural inputs is being dismantled</p>	<ul style="list-style-type: none"> Initiate the establishment of appropriate agricultural support services 	<ul style="list-style-type: none"> Establish rural development advisory service for private farmers Strengthen training programs in management and farm technology for emerging private farmers 		
<i>(iii) livestock development</i>					
<ul style="list-style-type: none"> Efficiency and profitability of the livestock sector remains low 	<p>Export taxes on wool removed in 1994, but full access to international markets have not been secured due to lack of quality produce and marketing</p>	<ul style="list-style-type: none"> Facilitate the establishment of appropriate private production and marketing systems 	<ul style="list-style-type: none"> Facilitate creation of sheep breeders associations to provide a framework for efficient production and marketing Help provide access to international markets for livestock product Facilitate management and control of livestock industry by private sector Expand provision of advisory services and training for private farmers Introduce best practices for pasture management 	<p>Lending: Sheep Development Project (FY96)</p> <p>Livestock and Pasture Project (FY01)</p> <p>Non-Lending: Livestock Note (FY00)</p>	<p>SDC</p>
<i>(iv) irrigation and rural infrastructure</i>					
<ul style="list-style-type: none"> Irrigation system and rural infrastructure have deteriorated and are inefficient 	<p>Guidelines on water user associations (WUA) drafted, ad-hoc creation of WUA, cost recovery introduced (with rayons keeping the revenue) but government still finances most of the operations and maintenance (O&M) costs</p>	<ul style="list-style-type: none"> Revitalize irrigation and rural infrastructure with user participation 	<ul style="list-style-type: none"> Develop a strategy and action plan for the rehabilitation, development and cost recovery from irrigation Increase collection rates Facilitate WUA development Promote recovery of all O&M costs or alternatively transfer irrigation O&M to 	<p>Lending: Irrigation Rehabilitation (FY98) On-Farm Irrigation (FY00) Rural Infrastructure (FY01)</p> <p>Non Lending: Agricultural Policy</p>	<p>ADB FAO</p>

<i>Key Issues Diagnosis</i>	<i>FY96-98 Main achievements</i>	<i>Strategy / Actions</i>	<i>Measures</i>	<i>World Bank Group Instruments</i>	<i>Other Donors</i>
			<p>WUA</p> <ul style="list-style-type: none"> Promote participatory irrigation, mainly through transfer of irrigation O&M to users 	<p>Reviews (FY98) (FY01)</p> <p>Int'l Agricultural Conferences (FY98) (FY01)</p> <p>Aral Sea Basin Program GEF Project (FY98)</p>	
<p>(v) Rural Finance</p> <ul style="list-style-type: none"> Lack of rural finance is a serious constraint to accelerate rural growth and reduce rural poverty 	<p>Agroprombank has been liquidated and replaced with a market-based agricultural credit system with minimum budgetary support</p>	<ul style="list-style-type: none"> Establish K AFC to operate commercially Establish community-based financial intermediaries Recover and resolve old agricultural debt 	<ul style="list-style-type: none"> Phase out budgetary subsidies on agricultural credit program after 1999 Promote commercially sustainable lending operations of K AFC Provide sustainable access to financial services to the rural poor Develop financially viable rural financial institutions Charge positive interest rates (in real terms) for rural credit 	<p>Lending:</p> <p>Rural Finance (FY96)</p> <p>Non lending:</p> <p>Agricultural Policy Reviews (FY98)</p> <p>Agriculture Inputs (FY01)</p> <p>Marketing (FY99)</p> <p>IFC:</p> <p>Leasing</p>	<p>ADB</p> <p>UNDP</p> <p>NGOs</p>
2-F. Alleviate infrastructure bottlenecks					
<p>(i) Transport</p> <ul style="list-style-type: none"> Urban population depends on public transportation that is increasingly unable to meet demand Insufficient cost recovery and weak institutional and regulatory framework prevent sound sector development 	<p>Share of private operators has been growing rapidly</p> <p>Privatization of State-owned operators has been initiated</p> <p>Single trip fare had increased substantially</p> <p>Initial assessment of required policy improvements is being conducted</p>	<ul style="list-style-type: none"> Set up institutional and regulatory framework for the competitive supply of services independently of ownership Improve fare policies mostly by reducing exemptions and privileges Start renewing and rehabilitating assets 	<ul style="list-style-type: none"> Issue decrees to stipulate sound urban transport policy and implementation measures Establish urban transport management agencies in main cities Increase cost recovery 	<p>Lending</p> <p>Public Transport & Maintenance (FY99)</p> <p>Rural Infrastructure (FY01)</p> <p>Non Lending:</p> <p>Transport Note (FY98)</p>	
<p>(ii) energy</p> <ul style="list-style-type: none"> Cost recovery not yet achieved; this and other elements impair attraction of foreign investment 	<p>Energy Law enacted 12/96, Electricity Law enacted 3/97</p> <p>State Energy Agency established to regulate tariffs and license new entrants</p> <p>Strategy for sector privatization</p>	<ul style="list-style-type: none"> Rationalize energy use/production and explore new sources Establish a regulatory/policy framework for restructuring the sector to attract 	<ul style="list-style-type: none"> Increase tariff by adopting a new rate structure which reflects economic costs Set up a fund to help low-income households cope with new tariffs; terminate all special tariff discounts Adopt privatization strategy 	<p>Lending:</p> <p>Power and District Heating (FY96)</p> <p>Power Supplement (FY98)</p> <p>Consolidation SAC (FY99)</p> <p>IFC:</p> <p>financing for hydropower projects</p>	<p>ADB</p> <p>EBRD</p> <p>Danish</p> <p>Swiss</p> <p>Norway</p> <p>NDF</p>

<i>Key Issues Diagnosis</i>	<i>FY96-98 Main achievements</i>	<i>Strategy / Actions</i>	<i>Measures</i>	<i>World Bank Group Instruments</i>	<i>Other Donors</i>
	developed and submitted to parliament Kyrgyzenergo reestablished as a joint-stock company	private investors	<ul style="list-style-type: none"> • Improve billing and collection performance of Kyrgyzenergo 		
<i>(iii) telecommunications</i>	<p>Worst bottlenecks of network addressed</p> <p>Institutional capacity (management & financial analysis) of Kyrgyz Telecom (KT) strengthened; KT corporatized and autonomous</p> <p>Sector regulatory and policy frameworks have been developed and a separate regulatory agency created</p> <p>Private sector participation, with licenses issued to 3 paging companies, two e-mail providers and 2 cellular operators</p>	<ul style="list-style-type: none"> • Promptly implement the regulatory and policy framework for further sector restructuring, aimed at ensuring orderly development as well as at attracting private investors 	<ul style="list-style-type: none"> • Enact Telecom law • Establish tariff regulatory capacity • KT to rebalance tariffs and maintain debt service ratio 1.5 • KT to stop all subsidies to postal service (directly or indirectly) • KT to establish economic and financial viability of its investments prior to their undertaking • Implement increase of international tariffs with <u>all CIS</u> countries 	<p>Lending: Telecom (FY94) Consolidated SAC (FY00)</p> <p>Non-Lending: National Information Policy (IDF) Telecom Guarantee</p>	EBRD
<i>(iv) rural infrastructure</i>	<ul style="list-style-type: none"> • Inadequate infrastructure is a major bottleneck for rural development <p>Road network reasonable, but in disrepair and not properly maintained; lack of wholesale market facilities; obsolete communication systems</p>	Prepare rural infrastructure strategy with appropriate municipal role in infrastructure provision	<ul style="list-style-type: none"> • Develop national plan for rural roads • Facilitate creation of wholesale markets • Support modernization of communications systems in rural areas 	<p>Lending: Rural Infrastructure (FY01)</p>	
2-G. Environmental management					
<ul style="list-style-type: none"> • Little progress in preventing unsustainable use of natural resources 	Government completed a National Environment Action Plan, finding: <ul style="list-style-type: none"> - Water resources management is inefficient - Forests regeneration is minimal, with state owned forestry farms without funds for controlling illegal cutting and grazing 	<ul style="list-style-type: none"> • Reverse deterioration of water infra-structure that is allowing significant water losses 	<ul style="list-style-type: none"> • Develop a plan to: (i) to cover O & M ; and (ii) improve management skills at local levels • Clarify competence for regulation of water resource management • Develop a strategy for forestry management • Conserve and protect biodiversity 	<p>Lending: Rural Water Project (FY00)</p> <p>Non Lending: Water Supply Note (FY99) NEAP IDF GEF Central Asian Biodiversity Project</p>	Switzerland Finland USAID UNDP UK

<i>Key Issues Diagnosis</i>	<i>FY96-98 Main achievements</i>	<i>Strategy / Actions</i>	<i>Measures</i>	<i>World Bank Group Instruments</i>	<i>Other Donors</i>
<ul style="list-style-type: none"> Public health problems related to environmental causes 	<p>About 50% of waste-water treatment facilities are ineffective and 90% of all municipal waste disposal sites do not meet sanitary conditions</p> <p>Key aquifers have been contaminated with heavy metals, radioactive materials, oil or sanitary wastes in adjacent areas to mining and industrial zones</p> <p>There are a number of abandoned and active toxic waste dumps, some of which are in the middle of settlements</p>	<ul style="list-style-type: none"> Decrease risk of contamination of underground aquifers and infiltration into surface water channel 	<ul style="list-style-type: none"> Develop a strategy that could be supported by IFI's or donors Define sanitary protection zones and train local authorities in water and sanitation measures Encourage implementation of pollution prevention incentives Develop monitoring, preventing and enforcement capacity 		WHO
<p>3. Poverty Reduction: Living standards significantly declined during the transition and as many as 50 percent of households may not be able to afford minimum consumption levels. While a number of households experience "cyclical" poverty (mainly the unemployed), other households experience "structural" poverty (including the elderly and those living in depressed rural and agrarian areas).</p>					
<p><i>(i) Structural poverty</i></p> <ul style="list-style-type: none"> Structural reform to provide conducive environment for private sector initiatives and private sector investment will be the driving force of job creation in the years to come. However, a significant part of the population not able to benefit will continue to need assistance 	<p>Monitoring of poverty facilitated by comprehensive household surveys undertaken during the last three years</p>	<ul style="list-style-type: none"> Increase effectiveness of social safety net 	<ul style="list-style-type: none"> Improve targeting of social assistance to the poorest (with lowest quintile receiving 60% of benefits) Improve reliability of essential social services delivery, especially for poor and children, including health and social safety net (unified benefit, pensions) Focus safety net on the most remote rural areas where poverty is more acute 	<p>Lending: SOSAC (FY99)</p> <p>Health Sector Reform Health II (FY01) Rural Infrastructure (FY01) Rural Water (FY00)</p> <p>Non Lending: Poverty Assessment Notes (FY98) (FY00) Poverty Monitoring (IDF)</p>	UNDP ADB
<p><i>(ii) cyclical poverty</i></p> <ul style="list-style-type: none"> Unemployment is the main cause of cyclical poverty 	<p>Initial analysis of data conducted, which suggest that cyclical poverty is greater in the rural areas, and is related to unemployment</p>	<ul style="list-style-type: none"> Promote decentralized (NGO & community) job generation activities in the rural areas 	<ul style="list-style-type: none"> Clarify the roles and responsibilities of the public and private sector, including NGOs, in the design and delivery of social services Encourage microcredits, public works and other outreach programs 	(See above)	

<i>Key Issues Diagnosis</i>	<i>FY96-98 Main achievements</i>	<i>Strategy / Actions</i>	<i>Measures</i>	<i>World Bank Group Instruments</i>	<i>Other Donors</i>
4. Legal and Regulatory Framework: The Kyrgyz Republic has made an impressive headway in drafting and enacting core economic legislation for the appropriate functioning of a market economy. Time is now required to develop a transparent and predictable legal and regulatory framework system and to strengthen institutional capacity, and implementation/enforcement..					
<ul style="list-style-type: none"> Legal system needs strengthening for application of legislation 	<p>A number of new legislation enacted, such as the Tax Code, part 1 of the Civil Code, the national Procurement Law, Law on Foreign Investment, Law on Pledge, Law on Banking, Law on Bankruptcy, Energy Law, etc.</p> <p>Other pieces of legislation advanced, such as laws on insurance, securities markets, investment funds, leasing, mining and land, etc.</p>	<ul style="list-style-type: none"> Build a judiciary system capable to implement legislation in a transparent and predictable manner, including all new procedures on bankruptcy, insolvency, mortgage and collateral, civil code, tax code, and the like Develop legal system, including ways to enforce and disseminate laws, harmonize implementation across the country increase transparency of processes and predictability of the system's timing and methods 	<ul style="list-style-type: none"> Improve the ability of the judiciary to apply legislation by streamlining court procedures Train judges and other legal experts in the applications of specific laws Dedicate adequate resources to the judiciary Develop and strengthen legal information system Avoid unnecessary involvement of notaries (e.g., in creation of enforcement of security rights) through revision of Civil Code Develop comprehensive judicial reform program 	<p>Lending: FINSAC TA Consolidation SAC (FY00)</p> <p>Non -Lending: Post-Privatization & PSD (FY99) Non-bank Financial Sector Update (FY99)</p> <p>FINSAC TA (FY96) Consolidation SAC (FY00)</p>	<p>USAID Netherlands Canada UNDP</p> <p>USAID</p>
<ul style="list-style-type: none"> Public needs to be made aware of rights and obligations under the new legislative framework 					

**Kyrgyz Republic - Selected Indicators of
Bank Portfolio Performance and Management**

Indicator	1995	1996	1997	1998
<i>Portfolio Assessment</i>				
Number of Projects under implementation ^a	6	11	11	10
Average implementation period (years) ^b	.88	1.05	1.63	2.05
Percent of problem projects ^{a, c}				
by number	0.00	9.09	9.09	10.00
by amount	0.00	5.42	5.63	7.26
Percent of projects at risk ^{a, d}				
by number	0.00	11.11	10.00	22.22
by amount	0.00	8.15	7.26	16.47
Disbursement ratio (%) ^c	6.75	10.98	16.04	13.90
<i>Portfolio Management</i>				
CPPR during the year (yes/no)	No	Yes	Yes	Yes
Supervision resources (total US\$ thousands)	693.47	689.47	958.60	648.22
Average Supervision (US\$/project)	115.58	62.68	87.15	64.82

Memorandum item	Since FY80	Last five FYs
Projects evaluated by OED		
by number	2	2
by amount (US\$ millions)	120.0	120.0
Percent rated U or HU		
by number	0	0
by amount	0	0

- a. As shown in the Annual Report on Portfolio Performance (except for current FY)
- b. Average age of projects in the Bank's country portfolio.
- c. Percent of projects rated U or HU on development objectives (DO) and/or implementation progress (IP).
- d. As defined under the Portfolio Improvement Program.
- e. Ratio of disbursements during the year to the undisbursed balance of the Bank's portfolio at the beginning of the year: investment projects only.

Kyrgyz Republic - Bank Group Program Summary, FY 1999-2001

Proposed IBRD/IDA High-Case Lending Program, FY 1999-2001^a

<i>FY</i>	<i>Project</i>	<i>US\$(M)</i>	<i>Strategic rewards^b (H/M/L)</i>	<i>Implementation^b risks (H/M/L)</i>
1999	LAND REGISTRATION	8.0	H	M
	SOSAC	36.0	H	H
	PUBLIC TRANSPORT & MAINTENANCE	21.0	M	M
	Subtotal	65.0		
2000	RURAL/WATER & SANITATION	15.0	M	M
	ON-FARM IRRIGATION	20.0	M	M
	CONSOLIDATED SAC	35.0	H	M
	Subtotal	70.0		
2001	HEALTH II	15.0	M	M
	RURAL INFRASTRUCTURE	20.0	M	M
	LIVESTOCK & PASTURE MANAGEMENT	15.0	M	M
	Subtotal	50.0		
	Total, FY 1999-2001	185.0		

a. This table presents the proposed program for the next three fiscal years.

b. For each project, indicate whether the strategic rewards and implementation risks are expected to be high (H), moderate (M), or low (L).

Kyrgyz Republic - IDA Base-Case Lending Program

Category	Past		Current		Planned ^a		
	1995	1996	1997	1998	1999	2000	2001
Commitments (US\$m)	77.0	98.5	60.0	64.9	65.0	70.0	50.0
Sector (%) ^b							
Agriculture	58.4	11.8	0.0	76.3	16.0	29.0	30.0
Electric Power & Energy.	0.0	20.3	0.0	23.7	0.0	0.0	0.0
Environment	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Finance	19.5	49.1	26.7	0.0	0.0	0.0	0.0
Population, Health & Nutrition	0.0	18.8	0.0	0.0	0.0	0.0	30.0
Public Sector Mgmt.	0.0	0.0	73.3	0.0	0.0	50.0	0.0
Social Protection, etc.	22.1	0.0	0.0	0.0	54.0	0.0	0.0
Transportation	0.0	0.0	0.0	0.0	30.0	0.0	0.0
Water Supply & Sanitation	0.0	0.0	0.0	0.0	0.0	21.0	0.0
Infrastructure	0.0	0.0	0.0	0.0	0.0	0.0	40.0
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Lending instrument (%)							
Adjustment loans ^c	58.4	45.7	73.3	0.0	54.0	50.0	0.0
Specific investment loans and others	41.6	54.3	26.7	100.0	46.0	50.0	100.0
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Disbursements (US\$m)	49.1	84.2	62.8	73.0	55.0	74.0	53.0
Adjustment loans ^c	47.8	78.3	47.4	45.0	18.0	36.0	18.0
Specific investment loans and others	1.3	5.9	15.4	28.0	37.0	39.0	35.0
Repayments (US\$m)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest (US\$m)	.4	.8	1.3	1.8	2.5	2.9	3.4

^a Ranges that reflect the base-case (i.e., most likely) Scenario. for IDA countries, planned commitments are not presented by FY but as a three-year-total range; the figures are shown in brackets. A footnote indicates if the pattern of IDA lending has unusual characteristics (e.g., a high degree of frontloading, backloading, or lumpiness). For blend countries, planned IBRD and IDA commitments are presented for each year as a combined total.

^b For future lending, rounded to the nearest 0 or 5%. To convey the thrust of country strategy more clearly, staff may aggregate sectors.

^c Structural adjustment loans, sector adjustment loans, and debt service reduction loans.

Note:

Disbursement data is updated at the end of the first week of the month.

Kyrgyz Republic - IFC and MIGA Program, FY95-98

Category	Past			
	1995	1996	1997	1998
IFC approvals (US\$m) ^a	40.00	2.30	.15	0.00
Sector (%)				
	0.00	0.00	0.00	0.00
Financial Services	0.00	100.00	100.00	0.00
Mining & Metals	100.00	0.00	0.00	0.00
TOTAL	100.00	100.00	100.00	100.00
Investment instrument (%)				
Loans	75.00	87.00	0.00	0.00
Equity	0.00	13.00	100.00	0.00
Quasi-Equity ^b	25.00	0.00	0.00	0.00
Other	0.00	0.00	0.00	0.00
TOTAL	100.00	100.00	100.00	100.00
MIGA guarantees (US\$m)	0.00	59.25	63.75	63.75
MIGA commitments (US\$m)	0.00	0.00	0.00	0.00

^aExcludes AEF projects.

^bIncludes quasi-equity types of both loan and equity instruments.

Kyrgyz Republic—Summary of Nonlending Services

<i>Product</i>	<i>Completion FY</i>	<i>Audience^a</i>	<i>Objective^b</i>
Recent completions			
Social Protection	FY93	G,B,D	KG,PS
External Trade Policy	FY94	G,B,D	KG,PS
Mining Sector	FY94	G,B,D,PD	KG,PS,PD
Energy Sector	FY95	G,B,D,PD	KG,PS,PD
NEAP	FY95	G,B,D,PD	KG,PS,PD
Poverty Assessment Strategy	FY95	G,B,D,PD	KG,PS,PD
Agr. Sector Review	FY95	G,B,D,PD	KG,PS,PD
Tourism	FY97	G,B,D	KG,PD
Renewable Energy	FY98	G,B,D,PD	KG,PS,PD
Underway			
Agr. Policy Review	FY98	G,D,B,PD	KG,PD,PS
Post Privatization	FY98	G,D,B	KG,PD,PS
Poverty Update	FY98	G,D,B	KG,PD,PS
Water Sector Note	FY98	G,D,B	KG,PD,PS
Urban Transport Note	FY98	G,D,B	KG,PD,PS
Planned			
Land Tax	FY99	G,B,D	KG,PS
Fiscal Sustainability	FY99	G,B,D	KG,PS
Forestry Sector Review	FY99	G,B,D,PD	KG,PS
Agr. Input Dev. Strategy	FY99	G,B,D,PD	KG,PS
PPF	FY98-01	G,B,D	KG
Health & Nutrition Note	FY00	G,B,D,PD	KG,PS
Non-ban Fin Sector Update	FY00	G,B,D,PD	KG,PS
Livestock Sector Review	FY00	G,B,D,PD	KG,PS
Poverty Update	FY00	G,B,D,PD	KG,PS
Agr. Sector Update	FY01	G,B,D,PD	KG,PS
Creditworthiness Review	FY01	G,B	PS
Informal			
WTO Accession	FY96**	G	PS
External Debt Management	FY96**	G	PS
Comments on PIP	FY96/97/98 [Ⓛ]	G,B,D	KG,PS,PD
IDF			
Strengthening National Procurement (2)	FY96/98	G,B,D,PD	KG,PS,PD
Strengthening State Property Fund	FY98	G,B	KG,PS
Strengthening Natl. Statistics Agency	FY98	G,B	KG,PS,PD
Strengthening Natl. Env. Action Agency	FY99	G,B,D,PD	KG,PS,PD
Strengthening Poverty Monitoring (IDF)	FY00	G,B,D	KG,PS
National Information Policy (IDF)	FY00	G,B,D	KG,PS
EDI			
Social Policy Ref in Tran Econ (SPRITE)	FY98	G,PD	KG,PD,PS
Understanding the Transition in Central Asia	FY98	G,PD	KG,PD,PS
Public Finance Reform Prog for Central Asia	FY98	G,B	KG,PD,PS
Training Matrils on Env. Sust. Agric. for CA	FY98	G	KG
ECA Irrigation	FY98	G,PD	PD,PS
EDMFC Accounting Training Program	FY98	PD	KG
Financial System Ref. - CA/Mongolia	FY98	G	PD
Pension Reform & Financial Sec. Dev.	FY98	G	PD
Securities Mkt Dev. (SMD)-ECA/Mongolia	FY98	G	PD

a. Government, donor, Bank, public dissemination.

b. Knowledge generation, public debate, problem-solving.
** completed

Ⓛ FY96/97 completed, FY98 is underway

Kyrgyz Republic Social Indicators

	Latest single year			Same region/income group	
	1970-75	1980-85	1990-95	Europe & Central Asia	Low- income
POPULATION					
Total population, mid-year (millions)	3.3	4.0	4.5	487.6	3,179.9
Growth rate (% annual average)	2.2	2.0	0.9	0.2	1.6
Urban population (% of population)	37.9	38.2	38.6	65.3	28.6
Total fertility rate (births per woman)	4.9	4.2	3.3	2.0	3.2
POVERTY					
<i>(% of population)</i>					
National headcount index	45.4	..	..
Urban headcount index	32.0	..	..
Rural headcount index	52.2	..	..
INCOME					
GNP per capita (US\$)	700	2,220	430
Consumer price index (1990=100)
Food price index (1990=100)
INCOME/CONSUMPTION DISTRIBUTION					
<i>(% of income or consumption)</i>					
Lowest quintile	6.7	..	..
Highest quintile	42.3	..	..
SOCIAL INDICATORS					
Public expenditure					
<i>(% of GDP)</i>					
Health	3.5	..	..
Education
Social security and welfare
Net primary school enrollment rate					
<i>(% of age group)</i>					
Total
Male
Female
Access to safe water					
<i>(% of population)</i>					
Total	75.0	..	53.0
Urban
Rural
Immunization rate					
<i>(% under 12 months)</i>					
Measles	89	83	77
DPT	83	90	80
Child malnutrition (% under 5 years)	42
Life expectancy at birth					
<i>(years)</i>					
Total	..	65	68	68	63
Male	..	62	63	64	62
Female	..	70	72	73	64
Mortality					
Infant (per thousand live births)	..	42	30	26	69
Under 5 (per thousand live births)	42	35	104
Adult (15-59)					
Male (per 1,000 population)	276	289	244
Female (per 1,000 population)	120	116	211
Maternal (per 100,000 live births)	80	..	..

Kyrgyz Republic - Key Economic Indicators

Indicator	Estimate					Projected						
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
National accounts												
	(% of GDP at current market prices)											
Gross domestic product (market prices)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Indirect taxes	6.2	7.3	6.9	6.1	6.6	6.7	6.8	7.0	7.1	7.2	7.3	7.1
Agriculture (at factor cost)	38.4	40.7	46.3	45.2	45.2	45.2	45.2	44.0	44.0	44.0	43.0	43.0
Industry (at factor cost)	23.9	18.1	17.0	20.8	20.8	21.0	21.0	21.0	21.0	22.0	22.0	22.0
Services(at factor cost)	31.6	33.9	29.8	27.9	27.5	27.2	27.0	28.0	27.9	26.8	27.7	27.9
Total Consumption	97.3	94.6	100.6	93.3	92.7	90.5	88.6	88.0	88.0	88.0	88.0	88.0
Gross domestic fixed investment	12.1	20.4	22.4	13.7	11.2	13.4	14.8	15.7	15.7	15.2	15.0	15.1
Government investment	..	..	..	4.2	5.8	5.8	5.5	5.4	5.4	5.4	5.4	5.4
Private investment and increase in stocks	..	..	..	10.2	5.8	8.0	9.7	10.6	10.7	10.1	9.9	9.9
Exports (GNFS) ^a	33.8	29.5	30.7	41.3	38.5	38.6	40.1	40.3	40.0	40.8	40.7	40.7
Imports (GNFS)	40.1	42.4	56.6	48.9	42.7	42.9	43.9	44.4	44.1	44.3	44.0	44.0
Gross domestic savings	2.7	5.4	-0.6	6.7	7.3	9.5	11.4	12.0	12.0	12.0	12.0	12.0
Gross national savings	1.1	1.6	-3.9	2.1	4.1	7.0	9.2	10.2	10.5	10.4	10.1	9.8
<i>Memorandum items</i>												
GDP (US\$ million at current prices)	1103	1495	1814	1683	1881	2011	2161	2326	2508	2702	2909	3122
GNP per capita (US\$, Atlas method) ^b	790	670	570	..	..	..	..	..	..	..	..	..
Real annual growth rates												
	(% calculated from 1995 prices)											
GDP at market prices	-20.1	-5.4	7.1	6.5	6.0	4.5	4.5	4.5	4.5	4.3	4.3	4.2
Gross Domestic Income	-20.2	-12.9	8.5	5.4	9.5	6.2	6.9	4.7	4.4	4.4	4.7	5.4
Real annual per capita growth rates												
	(% calculated from 1995 prices)											
GDP at market prices	-19.4	-5.9	5.7	5.1	5.0	3.5	3.5	3.5	3.5	3.3	3.3	3.2
Total consumption	-25.3	-10.0	18.3	-13.6	20.0	3.6	4.2	3.5	3.6	3.0	3.7	4.7
Private consumption	-26.4	-7.3	18.0	-18.5	28.5	4.8	4.9	3.4	3.2	2.9	3.8	4.7
Balance of Payments (US\$million)												
Exports (GNFS) ^a	369	448	562	695	724	777	867	937	1004	1102	1184	1270
Merchandise FOB	340	409	531	633	688	737	806	870	944	1012	1089	1165
Imports (GNFS) ^a	476	632	926	754	804	863	950	1032	1106	1197	1280	1375
Merchandise FOB	459	588	783	641	692	745	803	862	926	986	1055	1140
Resource balance	-107	-184	-364	-59	-81	-86	-82	-95	-102	-95	-97	-105
Net current transfers (including official current transfers)	29	79	89	65	69	70	70	70	70	70	70	70
Current account balance (after official capital grants)	-124	-242	-423	-137	-142	-137	-129	-136	-140	-138	-152	-174
Net private foreign direct investment	45	96	46	60	30	35	40	45	50	50	50	50
Long-term loans (net)	105	200	244	153	124	118	105	141	142	151	143	137
Official	106	65	62	173	149	134	159	159	152	159	147	118
Private	-1	135	182	-20	-25	-16	-54	-18	-10	-8	-4	19
Other capital (net, including errors and omissions) ^c	-5	-3	172	-42	-3	3	7	-28	-28	-43	-20	-33
Change in reserves ^d	-20	-51	-39	-34	-9	-18	-23	-22	-25	-21	-21	19

(continued)

Kyrgyz Republic - Key Economic Indicators
(Continued)

Indicator	Estimate					Projected						
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
<i>Memorandum items</i>												
Resource balance (% of GDP at current prices)	-9.7	-12.3	-20.1	-3.5	-4.3	-4.3	-3.8	-4.1	-4.1	-3.5	-3.3	-3.4
Current account balance (% of GDP)	-11.3	-16.2	-23.3	-8.1	-7.5	-6.8	-6.0	-5.8	-5.6	-5.1	-5.2	-5.6
Real annual growth rates (1995 prices)												
Merchandise exports (FOB)	-5.1	12.1	35.2	28.7	6.1	3.8	5.2	5.6	6.5	5.2	5.6	5.0
Merchandise imports (CIF)	-15.0	32.5	32.1	-9.6	13.8	8.9	9.1	7.4	7.6	7.6	8.3	9.3
Public finance ^e												
	(as % of GDP at current market prices)											
Current revenues and grants, of which	20.4	16.4	14.7	16.6	17.5	17.5	17.7	18.1	18.2	18.4	18.7	18.6
Tax revenues	13.6	15.0	12.7	13.1	13.3	13.5	13.9	14.3	14.5	14.7	14.9	14.9
Grants	2.5	0.3	0.9	0.7	1.4	1.1	0.9	0.8	0.6	0.6	0.6	0.6
Current expenditures	22.9	25.8	21.2	22.0	20.8	19.2	18.4	18.0	17.8	17.7	17.5	17.5
Budgetary savings	-2.5	-9.4	-6.5	-5.5	-3.3	-1.7	-0.7	0.0	0.4	0.7	1.2	1.1
Capital revenues	0.4	0.3	1.3	0.4	0.3	0.1	0.0	0.1	0.1	0.1	0.0	0.0
Capital expenditure	4.9	4.8	3.8	3.9	5.8	5.8	5.5	5.4	5.4	5.4	5.4	5.4
of which externally financed PIP	3.9	3.8	3.2	3.2	4.7	4.6	4.2	4.0	3.8	3.6	3.5	3.5
Net lending	4.7	3.4	0.4	0.5	-0.2	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-11.6	-17.3	-9.5	-9.4	-8.7	-7.1	-6.2	-5.4	-5.0	-4.6	-4.2	-4.3
Foreign financing	9.8	9.1	6.9	8.2	6.8	5.3	4.5	4.2	4.3	4.0	3.5	3.7
Monetary System Credit (net)	1.9	8.2	2.1	1.2	1.4	1.1	1.1	0.7	0.5	0.5	0.5	0.5
NBKR net	1.3	7.8	1.9	0.4	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	0.5	0.4	0.1	0.5	0.7	0.8	0.8	0.5	0.4	0.4	0.3	0.3
Nonbank	0.0	0.0	0.1	0.3	0.3	0.3	0.4	0.2	0.1	0.1	0.2	0.2
Privatization revenue (net)	0.0	0.0	0.5	0.1	0.5	0.7	0.6	0.4	0.2	0.1	0.1	0.1
Monetary indicators												
M2/GDP (% at current market prices)	12.8	16.8	14.3	14.4	14.0	14.7	14.7	15.5	15.5	16.2	16.2	16.2
Growth of M2 (%)	..	76.7	22.9	26.5	16.6	19.5	11.4	15.9	9.9	15.2	9.2	9.0
Private sector credit growth / total credit growth (%)	..	..	-152.0	30.9	52.1	21.8	58.2	63.4	66.6	69.0	72.2	74.1
Price indices (1995 =100)												
Merchandise export price index	93	100	96	89	91	94	98	100	102	104	106	108
Merchandise import price index	91	100	101	97	94	95	96	98	100	103	104	105
Merchandise terms of trade index	103	100	95	91	97	99	102	102	101	101	101	103
Consumer price index (% growth rate)	95.7	31.9	35.0	14.7	11.1	8.9	6.6	5.6	5.2	5.1	4.7	4.6
GDP deflator (% growth rate)	180.9	42.0	35.3	17.5	13.2	8.9	6.6	5.6	5.2	5.1	4.7	4.6

a. "GNFS" denotes "goods and nonfactor services."

b. Based on the Atlas synthetic conversion factor. The pace for introducing market exchange rates is currently being considered.

c. Includes portfolio investments.

d. Includes use of IMF resources.

e. Includes transfers to the Social Fund and the Public Investment Program.

Kyrgyz Republic - Key Exposure Indicators

Indicator	Estimate					Projected						
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total debt outstanding and disbursed (TDO) (US\$m) ^a	436	759	1081	1319	1482	1621	1737	1856	1969	2086	2195	2303
Net disbursements (US\$m) ^b	120	247	264	215	141	139	122	125	119	122	114	112
Total debt service (TDS) (US\$m) ^a	14	125	109	109	131	166	191	189	197	213	216	164
Debt and debt service indicators (%)												
TDO ^b /XGS ^c	118.0	166.7	190.1	187.7	202.3	206.3	198.3	196.1	194.3	187.7	184.1	180.1
TDO/GDP	39.5	50.8	59.6	78.4	78.8	80.6	80.4	79.8	78.5	77.2	75.5	73.8
TDS/XGS	3.9	27.4	19.2	15.6	17.9	21.1	21.8	19.9	19.5	19.2	18.1	12.8
IDA exposure indicators (%)												
IDA DS/public DS	1.7	0.5	1.5	3.2	4.0	3.4	3.2	3.6	3.7	4.2	5.8	7.4
Preferred creditor DS/public DS (%) ^d	45.2	30.8	13.5	37.1	43.5	34.5	34.8	42.7	49.7	52.3	52.1	51.8
IDA DS/XGS	0.1	0.1	0.2	0.2	0.3	0.3	0.3	0.3	0.4	0.4	0.6	0.7
IDA TDO (US\$m) ^e	59	140	199	266	318	368	446	500	540	598	651	682
IFC (US\$m)												
Loans	0	30	2	0	..	..	..	..	..	..	..	..
Equity and quasi-equity ^f	0	10	0.3	0.2	..	..	..	..	..	..	..	..
MIGA												
MIGA guarantees (US\$m)	0	59.3	4.5	0	..	..	..	..	..	..	..	..

a. Includes public and publicly guaranteed debt, private nonguaranteed, use of IMF credits and net short-term capital.

b. Debt at current prices, in present value terms it is much lower.

c. "XGS" denotes exports of goods and services, including workers' remittances.

d. Preferred creditors are defined as IBRD, IDA, the regional multilateral development banks, the IMF, and the Bank for International Settlements.

e. Includes present value of guarantees.

f. Includes equity and quasi-equity types of both loan and equity instruments.

**Status of Bank Group Operations in Kyrgyz Republic
IBRD Loans and IDA Credits in the Operations Portfolio**

Loan or Credit No.	Fiscal Year	Purpose	Original Amount in US\$ Millions				Latest SPN Mission	Latest Supervision Rating a/		Midterm Review	Monitorable Indicator	Audit Compln
			IDA	Cancellations	Undisbursed	Disbursed		DO	IP			
IDA24910	1993	REHABILITATION	60.00	0.00	0.00	62.00						
IDA26390	1994	PRIVATE & ENT. SAC	60.00	0.00	0.00	64.10						
IDA26340	1994	TELECOMMUNICATIONS	18.00	0.00	5.94	12.06	1/97	S	S	3/98	Y	Y
IDA27500	1995	APEAC	45.00	0.00	0.00	41.80						
IDA27170	1995	PRIV. ENTERP. SUPP.	15.00	0.00	12.20	2.80	10/97	U	U	6/97	N	Y
IDA26430	1995	SOCIAL SAFETY NET	17.00	2.00	4.12	10.88	10/97	S	S	10/96	Y	Y
IDA28910	1996	FINANCIAL SEC. TECH.	3.40	0.00	2.13	1.27	10/97	S	S	N	Y	Y
IDA28900	1996	FINANC. SECTOR ADJ.	45.00	0.00	0.00	45.00	10/97					N/A
IDA28680	1996	POWER & DIST. HEAT	20.00	0.00	18.12	1.88	10/97	S	U	9/98	Y	Y
IDA28600	1996	HEALTH	18.50	0.00	10.95	7.55	10/97	S	S	10/98	Y	Y
IDA28590	1996	SHEEP & WOOL IMPROV.	11.60	0.00	9.59	2.01	12/97	S	S	6/00	Y	Y
IDA29590	1997	RURAL FINANCE	16.00	0.00	13.43	2.57	12/97	S	S	6/99	Y	Y
IDAN0160	1997	PUB SEC RES MGT ADJ.	44.00	0.00	21.61	22.39	12/97	S	S	N	N	N/A
			373.50	2.00	98.09	276.31						
		<u>Active Loans</u>		<u>Closed Loans</u>		<u>Total</u>						
Total Disbursed (IBRD and IDA):			61.51	211.90		273.41						
of which has been repaid:			0.00	0.00		0.00						
Total now held by IBRD and IDA:			161.50	210.00		371.50						
Amount sold :			0.00	0.00		0.00						
Of which repaid :			0.00	0.00		0.00						
Total Undisbursed :			98.09	0.00		98.09						

a. Following the FY94 Annual Review of Portfolio performance (ARPP), a letter based system was introduced (HS = highly Satisfactory, S = satisfactory, U = unsatisfactory, HU = highly unsatisfactory): see proposed Improvements in Project and Portfolio Performance Rating Methodology (SecM94-901), August 23, 1994.

Kyrgyz Republic
STATEMENT OF IFC's
Committed and Disbursed Portfolio
As of 31-Jan-98
(In US Dollar Millions)

FY Approval	Company	Committed				Disbursed			
		IFC				IFC			
		Loan	Equity	Quasi	Partic	Loan	Equity	Quasi	Partic
1995	Kumtor Gold	30.00	0.00	10.00	0.00	30.00	0.00	10.00	0.00
1996	Demirbank Kyrgyz	0.00	.30	0.00	0.00	0.00	0.00	0.00	0.00
Total Portfolio:		30.00	.30	10.00	0.00	30.00	0.00	10.00	0.00
Approvals Pending Commitment									
		Loan	Equity	Quasi	Partic				
1997	DEMIR KYRGYZINCR	0.00	.15	0.00	0.00				
1996	DEMIRBANK KYRGYZ	2.00	0.00	0.00	2.00				
Total Pending Commitment:		2.00	.15	0.00	2.00				

Kyrgyz Republic: Country Portfolio Overview And Issues

The Kyrgyz Republic joined the World Bank and the International Development Association (IDA) in September 1992. Since then, 13 IDA credits totaling approximately US\$373 million equivalent have been approved with roughly 74 percent (\$276 million) disbursed.

Five credits have provided balance of payments support for the Government's Economic Reform Program. These include four completed operations: 1993 - the Rehabilitation Credit; 1994 - Privatization and Enterprise Sector Adjustment Credit (PESAC); 1995 - an Agricultural Privatization and Enterprise Adjustment Credit (APEAC); and 1996 - a Financial Sector Adjustment Credit (FINSAC). A Public Sector Resource Management Adjustment Credit (PSRMAC) is currently under implementation. Preparation of a sixth adjustment operation, focusing on pension reform, social assistance and employment is underway. ICRs for the Rehabilitation Credit and PESAC operations have been completed. The APEAC ICR will be circulated in May 1998. The current portfolio also includes four investment projects (telecommunications; health; power and district heat; and sheep development); two credit operations (private enterprise support project and rural finance); and two technical assistance projects (social safety net and financial sector). An irrigation rehabilitation project and an agricultural support project have been negotiated and are being presented for Board consideration together with the CAS.

During the first three years of IDA's involvement in the Kyrgyz Republic project implementation was very strong. This reflected the heavy bias toward adjustment lending within the portfolio (68 percent of total lending to date). Early investment operations were largely based in the country's capital and environs and financed primarily goods and services rather than civil works. At the outset of the program, counterpart staff received intensive training. The majority of these staff remained with the implementation units for some time, thus enhancing overall country execution capacity.

Recently the program has begun to shift toward heavier investment lending and more complex institutional development initiatives. With this transition, there has been a slight decline in implementation performance. Nevertheless overall portfolio performance remains generally sound and Government commitment to maintaining high standards from the presidential level downward, remains very strong. There are a number of reasons for this slight deterioration in implementation performance. These include to varying degrees: (i) lack of clarity with respect to Government responsibility and accountability (after three years of exceptional continuity in policy leadership, in recent months there have been a number of changes in ministerial portfolios and some shifts in organizational structure); (ii) evolving Government policies and procedures for endorsement of the design, preparation and implementation of projects with resultant weak coordination and communication among ministries, agencies and Goskominvest; (iii) high counterpart staff turnover in the project implementation units; (iv) weak domestic audit and accounting capacity; (v) occasional inadequate counterpart funding provisions; and (vi) an implementation lag between a rapidly changing legal environment and provisions for enactment of new and revamped legislation. The management of technical assistance has also been particularly problematic as there has been a somewhat limited recognition of the need for and acceptance of the value of foreign TA.

The Government is aware of the need to tighten up portfolio performance and is taking action to redress the issues. It has initiated a number of steps to streamline Governmental procedures governing the management of foreign assistance and to introduce greater consistency, efficiency and rationalization into the project development and preparation process. As a first step, a Public Investment Program was developed in 1995. Since then, the Government has undertaken annual reviews and updates in order to ensure that its strategic priorities receive financing. IDA has reviewed the PIP on an annual basis;

including the 1998 PIP to be presented at the May 1998 Consultative Group meeting. Second, in late 1997 the Board of the State Committee on Foreign Investments (Goskominvest) received a stronger mandate to review project preparation at critical points (e.g., identification, appraisal etc.) and to endorse or stop further actions. Although these steps toward institutionalization of the process are encouraging, implementation of the new procedures has to date been inconsistent. During the February 1998 Country Portfolio Performance Review agreements were reached to strengthen the process.

The Government takes implementation very seriously and there has been consistent high level attention to portfolio issues. Currently two projects are rated unsatisfactory: the Private Enterprise Support Project (PESP), whose design no longer meets current country conditions and the Power and District Heating Project. A restructuring plan for the PESP designed to promote participation by private sector banks was agreed in February 1998. A proposal for Board no-objection is to be transmitted shortly. The Power and District Heating project will require a supplemental Credit in the range of US\$15 million owing to higher than anticipated bids for rehabilitation works. A mission in the field is discussing measures to improve KNHEC's financial situation.

Procurement under IDA-supported operations has generally proceeded satisfactorily, but some delays have been encountered, particularly in selection of consultants for project related or free-standing TA programs. These delays are mainly attributable to the inexperience of the agencies involved and inadequate institutional capacity. However, during the past five years, the Government has directed its efforts for capacity building in the country and situation has substantially improved as compared to 1993. ICB and other methods of procurement were introduced under the first IDA-supported operation. The Government has realized the benefits of these procurement procedures, i.e., economy, efficiency, transparency and accountability. Therefore, these procurement procedures are now widely accepted in the country. Procurement processing under the IDA-supported operations has not encountered any major problems, warranting misprocurement or any other similar action. Reforms in foreign exchange and taxation regimes, and banking system have proven conducive to the participation of international suppliers and contractors.

A Country Procurement Assessment Report (CPAR) has been completed. The report covers: (i) an analysis of the current procurement environment in the country; (ii) lessons of experience of procurement processing under the Bank supported operations; (iii) compatibility with the Bank guidelines of the newly developed legal and institutional framework to regulate and manage the public procurement in the country; and (iv) an action program to further strengthen the system and institutions responsible for oversight and administration of public procurement. The CPAR was discussed at a National Workshop for Parliamentarians, officials, private sector representative and the press in Bishkek in February 1998.

A first CPPR was held in April 1996 and an Action Plan was developed. Measures agreed under the Action Plan have been implemented as agreed. Following the CPPR, the Resident Mission instituted quarterly meetings with the Directors of the Project Implementation Units, responsible for project execution. Since then, project implementation summaries are being prepared on a regular basis and circulated to key policymakers. A second CPPR was held in February 1998. Currently all projects are in compliance with respect to audits and mid-term reviews have been held for three operations and two are planned for CY1998. All projects have been supervised within the past four months. The Regional Advisor on Auditing and Accounting visited Bishkek in the Spring of 1997 to discuss capacity. Follow up auditing and accounting courses by EDI/IFC are envisaged. Kyrgyz officials participated in the Bank-organized Central Asia Procurement and Project Implementation Workshop in Istanbul in April 1997.

Kyrgyz Republic—CAS Summary of Development Priorities

<i>Network area</i>	<i>Country performance</i>	<i>Major issue</i>	<i>Country priority</i>	<i>Bank priority</i>	<i>Reconciliation of country and Bank priorities</i>
Poverty Reduction & Economic Management					
• Poverty reduction	Fair to Good	Major contraction in standard of living; structural problem deeper than anticipated. Country Still feeling impact of past negative growth.	High	High	
• Economic policy	Good	Three-year solid track record of stabilization and structural reform. Open trade regime and capital account.	High	High	
• Public sector	Fair to Good	Strong reform of public sector budget & intergovt. finances; gradual govt reorganization. More attention needed on governance and accountability.	High	High	
• Gender	Good	Equal participation and recognition. Appropriate attention in policy formulation and project design.	Low	Low	
Human Development Department					
• Education	Good	Financing and curriculum reform; balance among primary, secondary and tertiary.	High	Low	ADB taking lead on education
• Health, nutrition & population	Good	Financing and protocol reform; refocus of system toward primary health care.	High	High	
• Social protection	Fair to Good	Good and improving targeting of benefits but overly generous, fiscally unsustainable pension system; need for institutional strengthening of social fund.	Moderate	High	SOSAC to strengthen existing system. TA to assess longer term options (ADB).
Environmentally & Socially Sustainable Development					
• Rural development	Good	Prices liberalized; state control and state orders dismantled; export taxes eliminated; ownership shares and land use rights for 99 years transferred to state farm/collective workers. However, land scarcity, low productivity, disintegrated marketing & inputs systems, out of date technology, poor research and extension services and debilitated irrigation network remain major constraints.	High	High	
• Environment	Fair	First Natl. Env. Action Plan designed with significant NGO involvement. Vulnerable watersheds & toxic waste sites. Need for greater mainstreaming of concerns.	Moderate	Moderate	NGO/donor community play leading roles. IDF Grant for Strengthening NEAP Agency.
• Social development	Good	Active and diverse NGO presence and press community.	Moderate	Moderate	
Finance, Private Sector & Infrastructure					
• Financial sector	Good	Comprehensive financial sector reform undertaken, leading to emergence of a viable banking system. Deepening of regulatory and supervisory framework for non-bank financial sector in progress.	High	High	

Kyrgyz Republic—CAS Summary of Development Priorities

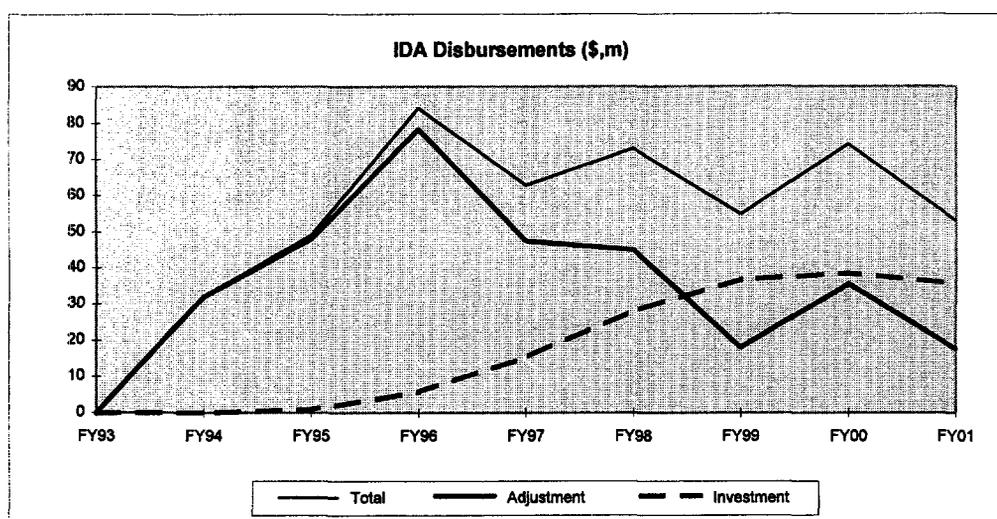
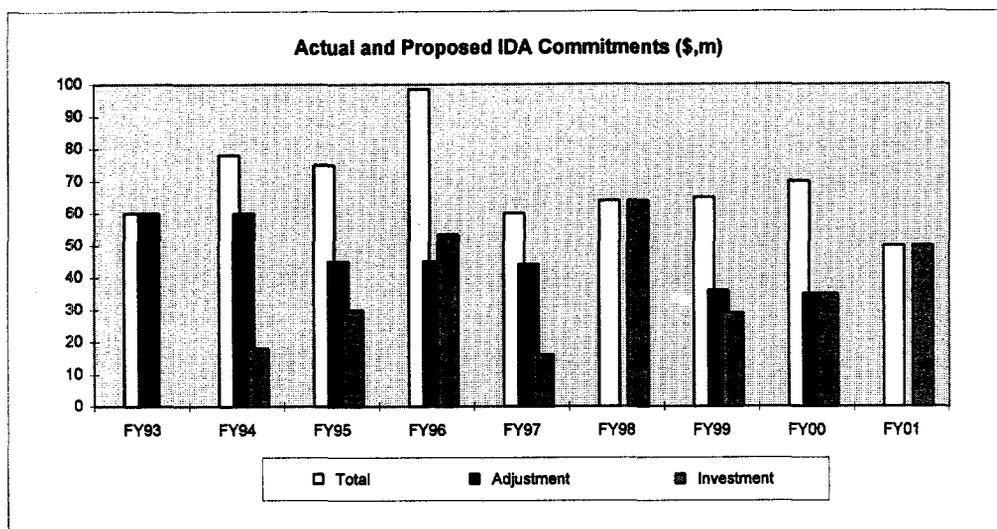
<i>Network area</i>	<i>Country performance</i>	<i>Major issue</i>	<i>Country priority</i>	<i>Bank priority</i>	<i>Reconciliation of country and Bank priorities</i>
• Private sector	Fair to Good	Ambitious privatization program largely completed. Government interference and over-regulation of private sector activities needs to be reduced.	Moderate	High	CSAC; Post-privatization study; Sector operations; Complementary IFC and FIAS activities
• Energy & mining	Fair	Appropriate regulatory framework on paper but implementation of tariff policy weak.	High	High	Policy dialogue and assistance under Power & District Heating Project
• Infrastructure	Fair	Widespread network deterioration. Reluctance to charge full economic costs of public utilities and services.	High	Moderate	Policy dialogue; CSAC Public Transport & Maintenance Project

Instruments to Meet CAS Program Objectives				
	Growth	Poverty Alleviation	Governance & Institutional Strengthening	Strengthening Public Finances
<u>On-going Projects</u>				
Pub. Sec. Resource Mgmt. Adj. Cr.			x	x
Social Safety Net		x	x	
Health		x	x	
Telecoms	x		x	
Power	x		x	
Private Enterprise Support	x			
FINSAC TA	x		x	
Sheep	x	x		
Rural Finance	x	x		
Agricultural Support Services (FY98)	x	x	x	
Irrigation Rehab. (FY98)	x	x		
Power Supplemental (FY98)	x			x
<u>New Projects (FY99-01)</u>				
SOSAC		x	x	x
Land Registration	x	x	x	x
Public Transport & Maint.		x	x	
Rural Water & Sanitation		x		x
On Farm Irrigation	x	x	x	x
Consolidation SAC	x		x	
Health II		x	x	x
Livestock & Pasture Mgmt.	x	x		
Rural Infrastructure	x	x		
<u>ESW (* = on-going)</u>				
Agricultural Policy Review *	x	x		
Post Privatization & PSD *	x		x	
Water Sector Note *		x		x
Urban Transport Sector Note *		x	x	
Poverty Update *		x		
Land Tax Study			x	x
Fiscal Sustainability & Growth				x
Ag. Input Marketing Strategy	x		x	
Forestry Sector Note	x	x		
Health Restructuring Review & Nutrition Note		x	x	
Non-Bank Financial Sector Update	x		x	
Livestock Subsector Note	x	x		
Poverty Update (labor markets)		x		
Agr. Sector Policy Update	x	x		
IBRD Creditworthiness Review				x
<u>TA/Capacity Building (* = on-going)</u>				
Country Procurement Assmt. & Workshop *			x	x
TA for Agroprocessing Restart *	x	x		
Strengthening State Property Fund (IDF) *	x		x	
Strengthening National Procurement (IDF) *			x	x
Strengthening National Statistics (IDF) *			x	
External Debt Management TA			x	x
Strengthening Nat'l Environ. Action (IDF)		x	x	
Matchmaking (RRTF)	x			
Poverty Monitoring (IDF)		x	x	
Improving Agr. Statistics (IDF)			x	
Agr. Exports Promotion Policy				
National Information Infrs. Policy (IDF)				

KYRGYZ REPUBLIC - Actual and Proposed IDA Commitments and Disbursements, FY93-01

Enhanced Lending of US\$185 million for FY99-01

	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01
Commitments									
Total	60	78	75	99	60	64	65	70	50
Adjustment	60	60	45	45	44	0	36	35	0
Investment	0	18	30	54	16	64	29	35	50
Disbursements									
Total	0	32	49	84	63	73	55	74	53
Adjustment	0	32	48	78	47	45	18	36	18
Investment	0	0	1	6	15	28	37	39	35



**KYRGYZ REPUBLIC
COUNTRY ASSISTANCE STRATEGY
PRIVATE SECTOR ASSESSMENT**

I. INTRODUCTION

1. The private sector share in GDP has increased substantially in the Kyrgyz Republic, within the context of a significant decline in output. The increase correlates strongly with progress in privatization, liberalization and stabilization of the economy. According to some estimates, the share of the private sector in GDP has reached 60 percent at the end of 1997.¹ This growth has originated from (i) enterprise privatization; (ii) small-scale investment in new businesses; (iii) foreign direct investment in joint ventures; and (iv) introducing the policies of market economics.
2. Ownership reform accounts for most of the increase in the private sector share in GDP. Most medium and large enterprises have been privatized, including the key agro-industrial enterprises. Also, initial steps are underway to privatize the remaining large enterprises, including the public utilities. State farms have been converted into corporate entities, and land use shares are being issued to the rural population. Spurred by liberalization and investment opportunities, a large number of new private businesses have been established. At the end of 1997, there were about 27,000 small and medium scale enterprises in Kyrgyzstan accounting for about 20 percent of GDP.² With privatization nearing completion, the growth of the private sector share in future will come primarily from post-privatization restructuring (especially in agriculture) and the formation and growth of new firms. Over the period 1989-96, the country has attracted a relatively small amount of foreign direct investment- US\$147 million, concentrated primarily in mining.³
3. Notwithstanding the significant progress in private sector development, future private sector growth faces a number of challenges and constraints. Some are exogenous and relate to the small domestic market, few areas of clear comparative advantage, geographic isolation from international markets and high informal barriers to trade (anecdotal reports of mafia and police extraction of bribes for passage along major transport routes in neighboring countries). Another set of constraints relates to the incomplete and unconsolidated nature of reforms.
4. This annex concentrates on the policy-related impediments to private sector growth in Kyrgyzstan. Section II contains an analysis of existing constraints to private sector development; Section III discusses short-term investment potential and critical issues in key sectors.

II. CONSTRAINTS TO PRIVATE SECTOR DEVELOPMENT

5. ***Privatization and Property Rights.*** Kyrgyzstan has made significant progress with privatization over the past few years. The privatization of small SOEs was completed through competitive voucher and cash auctions. As of June 1997, all medium and large companies have gone through coupon auction and about 800 of the targeted 1300 SOEs have been fully or majority privatized. Despite substantial progress,

¹ EBRD, Transition Report 1997, p.14. The estimates of private sector share in GDP are subject to a great deal of uncertainty due to data limitations and differing definitions of private ownership.

² Akayev, A., On State Economic Policy in 1998, Bishkek, October 1997.

³ EBRD, Transition report 1997, p.126.

public sector enterprises still account for a large share of industrial output- 44 percent in 1996, and continue to claim the largest share of financial resources- 53 percent of total loans and credit to the economy⁴.

6. Ownership reform in the area of agricultural land has also been substantial. The Government has put in place a legal framework to establish privately owned family farms or restructured large farms with 99-year land use right. Land certificates (mostly temporary) have been issued to individual households and a system to register private land titles is being evaluated through a pilot. Despite this progress, land markets have been slow to develop. Limiting factors are the constitutional prohibition of full private land ownership and the inadequate land legislation and administration. Three important pieces of legislation are currently being considered: (i) the Land Code, which guarantees the right to buy, sell and inherit mortgage and transfer land use rights, and prohibits expropriation without compensation; (ii) the Law on Mortgage, which introduces procedures for land to be used as collateral; and (iii) the Land Registration Act, which establishes a unified land registration system.

7. Although the privatization program has proceeded faster in the Kyrgyz Republic than in other Central Asian countries, not much, if any, foreign investment has been attracted through this channel. Although formally not excluded from the privatization process, foreign investors have shown little interest due to several factors, such as, the difficulty in obtaining and interpreting enterprise financial information, as well as interest in investing only if a controlling position could be obtained. While many industrial enterprises, such as in the agro-industrial sector, have been already privatized, a number of attractive enterprises remain in the hands of the Government. Foreign investors' interest could be attracted if the government is prepared to offer the privatization of the remaining large and strategic state-owned enterprises, including those in various infrastructure-related sectors such as telecommunications, power, natural resources (mining), and cement.

8. The present agenda with respect to privatization is to divest the remaining state shares in the partially privatized companies. In addition, the government plans to start the privatization of 9 large monopolies, including utilities, with a view to attracting foreign investment. Finally, the Government will also be considering the disposition of some 4000 social assets divested from SOEs. However, the implementation of this agenda has experienced a number of recent setbacks. The State Property Fund's (SPF) intention to proceed with the privatization of public utilities faces political opposition, which in 1997 has forced the delay of offering stakes in Kyrgyzaltyn (the state gold mining company) and Kyrgyztelecom. A plan to privatize the power industry by 2000 also faces resistance, including from the state energy and fuel company itself.

9. **Corporate Governance.** There is little evidence of the impact of privatization on corporate governance and enterprise restructuring so far. However, severe impediments to restructuring continue to exist both with respect to internal and external factors affecting corporate governance. Regarding internal factors, the voucher process of privatization has led to a system of widely dispersed small shareholders that are unable to monitor the performance of firms or to influence the governance of the enterprises. Many companies are controlled by management and workers who not only lack modern management skills necessary for operations in a market environment, but also refuse to disclose adequate information about the firm's operations to outside investors.

10. Serious weaknesses exist with respect to the external mechanisms for enforcing good corporate governance. The overall legal framework and national accounting regulations are still being developed,

⁴ ADB, Proposed Loan for the Corporate Governance and Enterprise Reform Program, August 1997.

and are not being rigorously enforced. As a result they are not performing their roles as external disciplinary mechanisms in enforcing improved corporate governance. Soft budget constraints as manifested in inter-enterprise arrears, weak competition, and underdeveloped financial markets result in ineffective corporate governance at this stage. Despite the enactment of an Insolvency Law in 1994 and a series of government decrees aimed at imposing financial discipline, there have been only few cases of bankruptcy. Efforts are being made to overcome these problems. Out-of-court settlement procedures for creditors of insolvent enterprises have been introduced to side step the implementation bottlenecks in the legal system. A new bankruptcy law was adopted in October 1997 and a range of insolvency regulations and procedures are currently under preparation. The government has also received ADB's support for a program to improve corporate governance.

11. **Financial Sector.** There were 18 commercial banks and credit institutions with 120 branches at the end of 1997. Restructuring of the banking sector has been successful with the share of doubtful loans decreasing from 72% at the end of 1995 to 18% by the end of 1996. The Basle standards on capital adequacy were adopted in January 1996 and regulations were passed in September 1996 stipulating a stepwise increase in minimum capital requirements. Additional important regulatory changes concern improvements in the registration of pledges and the collateralization of loans, as well as the introduction of international accounting standards. Notwithstanding this progress, the reform program in the banking sector faces many challenges. Failure to establish a repayment culture, weak legal processes for taking possession of collateral as well as a basic distrust of the banking system remain large obstacles to creating an efficient banking system. In addition, lack of critical banking skills, especially skills related to credit risk assessment, continues to have a negative effect on lending practices.

12. Privatized and newly emerging enterprises need working capital and investment credit to grow and restructure, but their demand for financing is still unmet in many instances. The lack of credit, however, is not the binding constraint. Lenders have difficulties finding bankable projects as risks of defaults are substantial, potential borrowers don't have the skills to develop and present strong business plans, loan officers lack training in risk analysis and business plan evaluation, and the high returns on Treasury Bills discourage lending by commercial banks to businesses or individuals. Thus, despite a strong notional demand for funds, the effective demand is still limited. An example of these limitations is the fact that, although there are about twenty credit programs in the country from multilateral, bilateral and government sources, many are not yet lending at full capacity.

13. Though capital markets are underdeveloped, there are a number of non-bank financial institutions. These include 17 investment funds, 47 insurance companies, a stock exchange, a coupon privatization trading center, a state social fund and two pension funds. The government is in the process of amending prudential regulations governing investment funds and introducing new legislation governing insurance companies and pension funds. An independent share registry and tight listing requirements are expected to lead to higher transparency and property rights security. The institutional basis for a secondary market in shares has been established, but trading was still thin at the end of 1997. Some 120,000 physical and legal entities were registered by the end of 1996, but only around 200 issued bonds, bills or shares and only 5-10% of these were actively traded⁵. To develop further the domestic securities market, the government has designed and is implementing a three-year development program, which was adopted in September 1996.

14. **Legal issues.** The Kyrgyz Republic is fairly advanced in establishing the basic legal framework of a market economy. As in other countries in transition, however, the current phase of market

⁵ EBRD, Transition Report 1997, p. 180.

institutions building is characterized by frequent changes in laws and regulations, inconsistencies among legislations⁶, weak administrative capacity to implement the laws⁷, lack of transparency and difficult access to legal information⁸, and considerable bureaucratic discretion in interpreting and applying the rules. Partially as a result of this, there is still limited reliance on the formal legal system. For large foreign investments, special investment agreements have been established which often supersede the general legal codes. In addition, a growing unofficial business sector has emerged over the last couple of years, operating outside the formal legal system. These problems add to the low credibility of the new legal system at present and pose a particularly heavy burden on SMEs.

15. Important aspects of the legal framework are still missing. Current domestic accounting standards outside of the banking sector are still based on the old Soviet system, which distorts the measurement of revenues and profits. Labor legislation is outdated and based on the old Soviet Labor Code.

16. Regarding progress in the areas of pledge, bankruptcy and company laws, Kyrgyzstan is among the leading reformers in the FSU, but problems remain, especially with respect to implementation. The Law on Pledges provides for a single Pledge Registration Office for the registration of non-possessory pledges, which are permitted for any type of tangible or intangible property, both movable and immovable. It is not clear whether a pledgee has the right to enforce a pledge without seeking court assistance. The Company Law provides that joint-stock companies with more than a certain minimum number shares must maintain an independent share registry and that shareholders are entitled to vote by proxy at meetings. The Insolvency Law provides for a reorganization system through which a majority of creditors can reach a binding settlement with the debtor.

17. *Management Expertise and Skills*. Despite a literate population, blessed with a high level of technical skills, the private sector suffers from a lack of management, marketing and financial skills needed in an efficient market economy. Western business concepts are still new to Kyrgyzstan, and few people are versed in Western accounting methods, marketing and other management concepts. Few entities and individuals have the capability to prepare and present internationally acceptable financial reports to encourage external private investment. Many bankers indicate that few entrepreneurs are able to formulate project proposals to an acceptable level of competence and quality. Further, the fact that a local consultancy profession is still only embryonic means that very limited expertise is available to advise on such work. Developing these skills and expertise is one of the main challenges of successful economic transformation in Kyrgyzstan.

III. INVESTMENT POTENTIAL AND SECTORAL ISSUES

18. With substantial progress in liberalizing and stabilizing the economy, the investment potential of the republic is closely linked with prospects for recovery in currently depressed industries and the potential for expansion in sectors that were repressed under the old system. Many segments of the economy are still suffering from a severe transformational recession as a result of (i) the breakup of

⁶ For example, many investors complain about the lack of coordination among the Foreign Investment Law, the new Tax Code, and the Free Economic Zones Law.

⁷ On average, a party can be expected to wait between seven months and a year for a commercial case to be heard on its merits by a court in the most important commercial center and between seven months and one year for a final judgement for payment of a sum of money to be executed.

⁸ Important judgments are not generally published and accessible to practitioners.

payment mechanisms for cross-border transactions; (ii) the loss of traditional markets (iii) the end of large transfers from the central government of the FSU⁹; and (iv) the sharp deterioration in the terms of trade for the country's traditional exports particularly because of higher prices for energy and natural resource imports. The decline in GDP has been associated with major sectoral shifts in the composition of output.

19. The introduction of market forces into the economy has brought about significant structural changes, with some sectors contracting and others expanding. In the industrial sector, which was overbuilt during the Soviet era¹⁰ and characterized by a high degree of specialization and integration with the Union economy, the fall has been across-the-board, but particularly severe in military production, heavy industry and consumer manufactures uncompetitive with imports. The prospects for recovery through investments in restructuring are not very optimistic and the decline in some of the sectors is likely to be permanent. The agricultural sector has also inherited a highly distorted productive structure. Previous activities were overextended in its use of natural resources, inappropriately directed in terms of products and technology, and lacked incentives for the efficient use of inputs. As a result, farm organizations still face difficult restructuring and retrenchment similar to the situation of state-owned industrial enterprises. Although the distorted productive structure precluded a swift supply response to initial reforms, the growth potential of the sector is significant as the republic has strong comparative advantage in certain irrigation-intensive crops and livestock activities. Previously repressed, services have expanded dramatically with growth concentrated in private trade, finance and other business and consumer services. These activities represent an important locus for private wealth accumulation, which is now starting to be used to acquire industrial assets. The immediate export potential of this sector is however limited, although some attractive opportunities might exist in tourism.

20. With a small domestic market, difficult access to international markets and few marketable commodities, Kyrgyzstan's long-term growth prospects are inextricably linked with economic developments in its resource-rich neighbors. The country has few areas with immediate growth potential, the most important being agriculture, mining and energy.

21. ***Agriculture and Agriculture-related Industries.*** Agriculture is the lead sector of the Kyrgyz economy accounting for 48 percent of GDP and 49 percent of total employment in 1997. The share of agriculture and agro-industries was 38 percent in total exports and 23 percent in total imports. Over the last 6-7 years, the agricultural sector has shrunk considerably, but its share in GDP has increased. Especially severe was the decline in livestock production, which remains depressed. The agro-industrial sector is facing serious crisis- the decline in annual production from 1990 to 1996 is over 90 percent for most commodities. The Kyrgyz Republic has turned from being a net importer of primary agricultural products in 1993 to a net exporter in 1996. On the other hand, as far as processed agriculture is concerned, the country changed from being a net exporter in 1993 to a net importer in 1996. The potential to increase efficiency in the sector and growth in the rural economy is large and needs to be exploited with urgency.

22. The country has made significant progress to lay the foundation for private agriculture and is leading the way to agricultural reform in Central Asia. While appropriate decrees or laws have been issued, the progress of actual enforcement and implementation on the ground has been slow, particularly in some of the regions. There is a need to further deepen and broaden reforms related to land privatization

⁹ Estimated at about 12 percent of GDP.

¹⁰ De Melo et al., in "Circumstance and Choice: The Role of Initial Conditions and Policies in Transition Economies", World Bank WPS No 1866, estimate the level of overindustrialization at 6 percent of 1989 GDP.

(land code, land titling, land registration, and land market), farm restructuring, demonopolization and post-privatization support for agro-industry, and agribusiness development in the private sector. Despite liberalization of prices, trade and markets, the slow emergence of competitive input and output markets remains a major barrier to promote efficient, sustainable and profitable agriculture. Privatization has been successful in creating a large number of private entrepreneurs. However, it will take some time to restructure the privatized SOEs and make them efficient. Problems in the agro-industrial sector include poor product quality, poor packaging, declining demand, lack of credit and reduction in raw material supply. Revitalizing agro-industry is critical to modernize the agricultural sector and create rural employment.

23. **Mining.** The principal mineral products produced in the Kyrgyz republic include gold, antimony, mercury, molybdenum and uranium oxide. Significant potential exists in gold production and the country has attracted foreign investment in this sector. Cameco Corp. from Canada is operating the important Kumtor gold deposit. However, depressed gold markets are likely to slow the development of new projects in the sector. Market prospects for some of the other existing products, with the possible exception of antimony, are not very good. Many of the mining and processing facilities are producing at reduced levels or are closed because of the collapse of demand in Russia, production problems, obsolescent technology and /or exhausted deposits. In addition, over-staffing in most of the industries, and the trend towards international prices for electricity and petroleum products will require significant changes in production practices and technology for the metallurgical industries to be internationally competitive.

24. A new mining law has been passed by the parliament in August, 1997. While far from satisfactory in terms of international best practices, it does mark a first step towards a more competitive investment environment. Many mining investors will still seek to negotiate separate investment agreements with the authorities, which can provide for better investment terms. Nonetheless, improvements are needed in the overall investment environment for mining to ensure consistency in treatment of domestic and foreign investors.

25. **Energy.** The Kyrgyz Republic has abundant low-cost hydropower resources, which have been partially developed, small and declining oil and gas production, and a collapsing coal industry (despite significant resources). The largest potential is in hydropower. The currently installed capacity exploits only about 9 percent of hydropower potential. The government is considering several projects in the hydropower sector to increase installed capacity and rehabilitate and expand the distribution and transmission network. If long-term export potential could be secured, these projects might be attractive investment opportunities for international companies. The realization of the country's potential in hydropower generation depends on the progress of reforms in the sector and on the nature of energy trading arrangements with neighboring countries.

26. Reforms in the energy sector have been proceeding slowly, but consistently. Prices of electricity, district heating and household gas have been kept artificially low, although significant increases to prices were effected recently. The government's reluctance to raise these prices to desirable levels is weakening the energy supply industry and distorting the consumption patterns and investment requirements. However, a multi-year tariff policy aimed at promoting energy conservation among wasteful consumers and rapid rehabilitation of the network has been adopted recently. The government has also developed a strategy, to be endorsed by the Parliament, to unbundle and commercialize the power sector in order to attract private sector interest. A regulatory body has also been established.

27. Kyrgyzstan is generally disadvantaged by regional energy trading arrangements. The republic

produces less electricity during peak demand winter months than it could in order to store water needed down stream for summer irrigation, but is not compensated for this loss in production. In addition, electricity is exported at a price close to its cost of supply, while natural gas is imported at a price close to alternative fuels. Energy trade issues have the potential to be quite contentious in the region. A regional program to improve efficiency, promote market pricing, and regional cooperation in energy production and distribution would greatly benefit Kyrgyzstan. In this regard, a positive development is the first multi-year agreement at prime-ministerial level on water sharing among the Central Asian republics of Kazakhstan, Kyrgyzstan and Uzbekistan reached in March 1998. The Agreement includes provision for Kazakhstan and Uzbekistan to share equally in the purchase of summer hydropower from Kyrgyzstan and to make payments either through deliveries of coal and natural gas or through monetary arrangements equivalent to the replacement costs to support Kyrgyzstan's winter fuel needs. The adoption of this agreement is expected to contribute to the stabilization of water and energy supplies in Central Asia and would provide a framework in preparing agreements relating to the integration of energy systems in the region¹¹. The acid test of the new agreement will come during the next winter heating season in Kyrgyzstan.

¹¹ Source: US Department of Commerce's Business Information Service for the Newly Independent States, April 6, 1998.

MAP SECTION

