

MACROECONOMIC STRUCTURAL AND SECTORAL CONSTRAINTS IN THE KYRGYZ REPUBLIC

GLENN P. JENKINS

Department of Economics, Queen's University, Kingston, Canada.
and Eastern Mediterranean University, North Cyprus.

IGNATIUS PEPRAH

Independent Economic Consultant.

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Abstract

The strategy for economic growth and development in the Kyrgyz Republic stated in the Comprehensive Development Framework (CDF) is to make the private sector the engine of growth. The CDF report also discusses mining, tourism and other export generating activities as well as domestic economy-oriented activities. However, in this paper we propose that the country should put more emphasizes on export promotion by adopting an Export-Oriented Private Sector-led Growth Strategy explicitly in the CDF document for many reasons which are mentioned.

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by

Glenn P. Jenkins
and
Ignatius Peprah

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1. INTRODUCTION

We decided to prepare this paper as a supporting document for the Comprehensive Development Framework (CDF) Report for a number of reasons. First, even though Section 4.3 on Sustainable Economic Growth and Development in the CDF Report is well written, the section is long on economic recommendations and short on presentations on analysis, problems and constraints that led to the recommendations. While there may be good reasons for this, we also believe that one better appreciates the importance of the recommendations if the problems and constraints, which led to them, are presented.

Some of these problems and constraints are presented in the National Strategy on Poverty Reduction Paper, which is considered as a detailed view of the first three years of the CDF. This may be a good reason not to dwell on those problems and constraints again in the CDF paper. Nonetheless, at least summary statements of the problems and constraints together with adequate references to the sections of the NSPR paper where they appear should be made in the CDF paper in order to link the two papers tightly and to ensure consistency.

Some of the problems and constraints as well as opportunities and programs presented in this Paper are not from the NSPR Paper but from other papers written by the Government, the World Bank, the IMF and other organizations and individuals. However, for the CDF report to be as comprehensive as possible, we believe a review of their salient points should have been included in the CDF paper in an appendix. (An appendix would have been suggested so as not to destroy the flow of the CDF report). Since this was not done, we have included some of them in this paper for easy reference.

The second reason for writing this paper is that the macro-economic, structural and sectoral recommendations in the CDF Report are general. More specific recommendations are needed to facilitate their implementation. This paper provides more specific recommendations and therefore would be helpful in the implementation of the CDF Strategy.

Third, in a few cases, we do not agree with recommendations made in the CDF Report. We take advantage of the opportunity presented by this paper and the paper we have written on Taxation to air our views with the hope that these would lead to changes in the CDF paper during the next review.

2. DEVELOPMENT STRATEGY

The strategy for economic growth and development in the Kyrgyz Republic stated in the CDF is to make the private sector the engine of growth. The CDF report also discusses mining, tourism and other export generating activities as well as domestic economy-

oriented activities. However, we propose that the country should put more accent on export promotion by adopting an **Export-Oriented Private Sector-led Growth Strategy** explicitly in the CDF document for the following reasons:

a) Kyrgyz Republic has the export potential to justify this strategy.

1. The country has a rich natural resource base, the exploitation of which will generate much export. In the past, gold exports have accounted for anywhere from 16 – 40 percent of GDP. Mining and exploration activities by Kumtor and other companies show that the potential for increased gold and other minerals production is good. (See section 6). It is perhaps the easiest sector to attract foreign investment in the country as the country has something unique to offer. Our paper entitled “ A Strategy for the Encouragement of Foreign Investment in the Kyrgyz Republic” discusses how to go about this. In brief, what the country needs are a good investment code, and model concession, joint venture and contract of work agreements. It is also recommended that the country reviews its mining laws and code and make them consistent with modern international practice in these areas.
2. Second, Kyrgyz Republic has enormous hydro-electric potential. The country is presently exporting electricity to Uzbekistan and Kazakhstan and could attract foreign investment for further development of this export potential, particularly for export to China (See section 6)
3. Third, oil exploration activities show that the potential exists for the Republic to become an oil producing and exporting country, though much more work needs to be done in this area (See section 6).
4. Fourth, Kyrgyz Republic also has the potential for the development of glaciers water for export (See section 6).
5. Fifth, the potential for the country in the area of tourism (which is a form of export) is very good (See section 7).
6. Finally, the potential for agricultural exports could be high if obstacles to faster agricultural growth, including lack of entry into agribusiness (agri-trade, agri-business and agri-processing) and undeveloped links to export markets could be overcome (See section 5).

b) The domestic economy is too small for the country to rely on it for its development. Low incomes level and the subsistence nature of agriculture have resulted in a very weak domestic demand, which cannot form the basis for the needed increase in production.

3. FISCAL ADJUSTMENTS

To achieve the required fiscal adjustment under the CDF program, Kyrgyz Republic will undertake improvements in the tax system, accelerate transformations of public infrastructure and utilities companies, complete programs in pension reform and undertake reforms in the education and health sectors as well as of the public service.

a) Taxation

As in other CIS countries, Kyrgyz Republic's fiscal revenues fell drastically with the breakup of the Former Soviet Union. The country is now building a modern tax system that should generate adequate tax revenue. At 17.0 percent of GDP in 1999 and 16.1 percent (preliminary estimate) in the Year 2000, the revenue effort in the Republic is inadequate. Increasing the tax effort will be necessary if the Government is to achieve the required fiscal adjustment under the CDF program. Tax reforms in the 1990s have resulted in a Tax Code that forms the basis for a value added tax, excises and profit tax and a personal income tax. The country also has a form of presumptive tax through a 'patent' system (monthly fee for traders, small craftsmen, and entrepreneurs) as well as land tax that is levied in lieu of all other taxes on agriculture.

These reforms notwithstanding, many problems remain in the tax system. The tax base is small as tax revenues come mainly from a few enterprises such as the infrastructure and utilities companies. The private sector should be adequately brought into the tax net in order to deal with a vicious circle of low tax revenues, high tax rates, more evasion and less revenue. In addition, some taxes or taxpayers are covered by legislation other than the tax code, creating un-necessary exemptions and additional taxes. This should be dealt with. Proper tax policies for attracting Foreign Direct Investment should be introduced. Numerous fees and local taxes should be carefully evaluated and the number reduced to lessen costs of compliance and administration. The VAT should be improved and rebates for exports should be given in compliance with the Tax Code. Customs administration should be strengthened to deal with problems created by smuggling and contraband goods. These proposals are included in a Government Tax Policy Concept Paper and a World Bank report on fiscal sustainability in Kyrgyz Republic.¹

We have written a paper entitled "A Strategy for the Enhancement of the Tax System in the Kyrgyz Republic" which presents several recommendations for reforming the tax system. In particular, we draw attention to the damage to the labor market caused by the individual income tax and contributions to the Social Fund working together. They contribute to the large underground economy and reduce the total tax revenue, and in particular the income and value added taxes. They also have the potential of causing serious and prolonged retardation of economic growth, as occurred in Uruguay after the Second World War. The paper argues that the recommendation in the CDF paper to shift the payment of social fund from employers to employees may make the case worse.

¹ See World Bank, "Fiscal Sustainability in the Kyrgyz Republic", June 2000.

The paper also highlights the damage to exports being caused by the poor functioning or non-functioning of the duty draw back aspect of the value added tax and the importance of getting it working properly if the target growth rates are to be achieved in the Republic.

b) Transformation of Public Infrastructure and Utilities Companies

Government past borrowings either directly or guaranteed for public infrastructure and utilities companies have been substantial. So has been the debt service burden on the Government. In addition, direct and indirect subsidies to households that do not qualify as poor are placing a strain on the budget. Explicit budget support to infrastructure and utilities companies was 5 percent of GDP in 1998. This reveals only part of the burden they impose on the Government. The utilities have losses that are financed by banks as non-performing loans, or suppliers as non-payment or delayed payment. The companies also live off existing capital by failing to maintain and replace them. All these losses are eventually borne by the Government in one way or another.

Kyrgyzenergo, Kyrgyzgas and Kyrgyz Airlines, for example, have been recording losses in recent years, are illiquid and unable to pay suppliers or have been having difficulty servicing their short term debt to the budget or commercial banks. The poor performance of these and other public utility companies are due to low tariff rates that do not cover costs, and extensive system exemptions and 'privileges' given to people as well as poor incentives to improve efficiency. The resulting implicit price subsidies on electricity, heating and gas, for example, were estimated at 9 percent of GDP in 1998.

These and other problems should be addressed to enable the companies to maintain and expand their services by completing a public infrastructure and utilities reform program that has been started by the Government. To be able to attract foreign and the domestic private sector and improve efficiency and service, the competition and regulatory framework of the sector should be reformed. A new tariff regime that would generate adequate profits and protect the genuinely poor should be instituted, legal barriers to entry should be removed and some companies should be restructured to ensure effective competition. Divestment would remove the budget deficit burden the firms create and put the responsibility of expensive modernization programs on the private sector.

c) Privatization

Privatization of state enterprises has gone a long way in the past years but has focused on smaller enterprises; major state enterprises are yet to be privatized. In February 2001, the Government approved the State Property Privatization Concept and Program for 2001 to 2003, which establish privatization priorities, restrictions in its implementation, and procedures for the transfer of state property to individuals and legal entities. The Concept has been submitted to Parliament for approval for it to come into force. The Program covers the completion of privatization of state enterprises in basic strategically important

sectors, such as the following joint stock companies: Kyrgyz Telecom, Kyrgyz Energy, Kyrgyz Gas and the National Airlines Company. It also covers bringing the legislative and legal base in line with international norms and maintenance of state control over separate strategic companies. Seventy five percent of the privatization receipts would be used for debt reduction. The remaining 25 percent would be allocated for restructuring other to-be-privatized enterprises, the development of the irrigation sector and counterpart funding of foreign-financed investment projects.

We support the above privatization program. However, we draw attention to the fact that that some of these companies are among the few companies that generate the bulk of the tax revenue in the country. The challenge therefore is to ensure that the Government would not lose tax revenue from these companies when they are privatized. One way is to initially divest majority shares of these companies to the private sector with the Government keeping minority shares.

d) Public Sector Reform

The public service is over-sized, inefficient and costly. The Government has already initiated a comprehensive reform of the public service with the goal of forming a more professional, flexible and efficient administration that would respond to the present and future needs of the country. The number of ministries and state agencies has already been reduced. Further reform would include: a) eliminating duplication of functions and reducing the size of the bureaucracy, b) training and retraining, c) introducing a new system of personnel assessment, d) reviewing local administrations at the oblast level with the goal of eliminating duplication, and e) introducing a new system of wages to improve professionalism and to attract qualified people. Political realities, however, suggest that the pace of the reform should be gradual. The Government would therefore implement the reform program on progressive basis. The reform program would also be transparent and based on dialogue with civil society.

At the break-up of the former Soviet Union, public servants who lost their jobs were not given any compensation. The situation was not propitious for it. The public sector reform, which will be undertaken by the Government would be different. We recommend that as has been done in many other countries, public servants who will be retrenched should be given adequate compensation packages and support to enter into the micro-enterprise sector. Donor assistance in the form of grants and highly concessional loans would be needed, as has been done in many other countries. It is also important that a special program be set up to give these people entrepreneurship training, counseling and assistance in choosing viable business activities.

e) Education

Unemployment, lower incomes and the worsening living standard as well as state budget constraints have made the issue of accessibility to education at all levels a problem. The

situation of pre-school education needs special attention, as low wages and the worsening of living standard do not allow parents to use the services of pre-school establishments. Presently, the proportion of children in pre-school establishment, which should be 100 percent is only 82 percent. This indicator is continuously decreasing and is leading to closure of kindergartens. It is also negatively affecting the general level of preparation of children for school as well as their development, including their communication skills.

The education system has undergone significant review and changes at all levels. A master plan for education and training has been developed with assistance of donors and international organizations. Legislations on pre-school, primary, secondary, tertiary and adult education have gone through first reading in parliament. A large amount of work is being done on targeting social support to children from vulnerable groups. Public funds are directed to pre-school and educational establishments to address problems with accessibility to education, including accessibility of children from poor families. Problems with children having problems with development are being addressed. The network of social assistance for children from at “risk” groups is being broadened.

With the legislation on education guaranteeing free access for all students up to the secondary school level, financing from the budget will be mainly oriented to primary and secondary education. The outputs of the education system do not meet the needs of the market. As part of measures to address this problem, the Government will continue to modernize technical and vocational training. The National Educational Movement announced by President Akaev is also to address this problem. The most important educational policies to address under the CDF include improving efficiency, developing private education, improvement of basic education, ensuring equal access for children from poor families to basic education and improvement of vocational education as well as distant education.

Reference to the problems in the education sector and the measures being taken by the Government to address them which are well discussed in the NPRS paper should be made in the CDF report.

We support the above measures to address the emerging problems in the education sector. In particular, we support the projected increase in budget resources to be directed to the social sectors (education and health). However, we have concerns about the fact that with a population of less than 5 million, Kyrgyz Republic, has 45 universities. We recommend that the number of public universities in the country should be reduced to a couple and private universities should be encouraged to amalgamate. This would save the economy much resource, make university education more affordable and increase the quality of these high institutions.

The above situation of duplication in the education sector is symptomatic of the situation in many sectors. There is much horizontal (across Government departments and agencies) and vertical (at different levels of government) duplication of functions in the Government. We recommend that the Government undertake a special study of the situation and eliminate these duplications.

f) Health

With the collapse of production and incomes, the creation of unemployment and the reduction of living standards as a result of the break-up of the Former Soviet led to the deterioration of health indicators of the population. The incidence of infectious diseases (tuberculosis, sexually transmitted diseases) and diseases related to iodine deficiency increased. Lack of funds for the population to access health services is the main cause of these problems. At the same time, Government resources for the health sector has been inadequate. The state budget for the health sector was reduced from 3.7 percent of GDP in 1990 to 2.5 percent in 1999. The level of resources presently allocated by the state for the health service covers only 50 percent of the needs of the sector.

To address the problem, the Government is undertaking health sector reforms under the Manas Program. The aim of the program is to improve the health of the population by: a) improving access to health care, regardless of income and ensuring equal access to health care, and b) enhancing the effectiveness and quality of health care. Seventy percent of the population is presently covered by a system of compulsory medical insurance. The Government has approved a State Medicinal Policy whose goal is to provide the population with safe and good drugs. The Government has also approved a National Prevention Programs on AIDS, sexually transmitted diseases and on tuberculosis.

Priority measures under the Government's public health reform program include: a) enhancing the role of the Government's public health sector in improving sanitation and epidemiological services, b) improvement of medical aid, c) re-structuring the system of granting health services, and d) developing a sustainable system of financing. Considering the limited Government resources for the sector, Government policy would encourage attracting foreign direct investment and domestic private sector resources as well as rational and efficient use of PIP resources.

Reference to the problems in the health sector and the measures being taken by the Government to address them which are well discussed in the NPRS paper should be made in the CDF report.

g) Pension System Reform

The sustainability of the Social Fund is precarious as a big gap exists between contributions for pension insurance and payments made by the Fund. Factors that have resulted in this situation include a) reduction of employment, which reduced the ratio of the employed to pensioner from 3 in 1991 to 1.6 in 1999, b) narrowing of the base of insurance contribution as a result of reduction of wage income as a share of total income and the growth of payments by hired workers that are not captured by the system, and c) existence of multiple privileges for certain categories of citizens. Yet the pension system is one of the important instruments for preventing poverty. Some work has already been

done in designing a sustainable system and need to be continued. The reform program will focus on: a) broadening the base of insurance contributions, b) review of the level of benefits, c) assessment of the level of contributions from both employees and employers, d) creation of a single information system and assigning identification codes to all the population, including the newly born, e) improvement the process for arrears collection, f) improvement of asset management and g) terminating payment in kind. The Government would accelerate the development of legislative work for non-state pension funds.

While the above measures are in the right direction, we believe that they are not adequate. We have already drawn attention to the fact that the individual taxation and the contribution to the social fund working together are largely responsible for driving a significant proportion of the economy underground.

To better appreciate the situation, consider the position of a pensioner who after working hard during the period of the Former Soviet Union expected to enjoy a good pension. The trust such a person had in the system was destroyed with the collapse of the Former Soviet Union and the introduction of the type of pension he/she is receiving now. The breach of trust may also go beyond the pensioner and affect his/her family. It may be a little understandable if the son/daughter of this pensioner (who is taking care of him/her) decides to work in the shadow economy rather than work in the formal economy and pay into a new Government pension fund that takes away a high percentage of his/her salary and promises good rewards in say 20 to 30 years time.

The solutions we recommended in our Taxation Paper are: 1) to make the people who have benefited from the transition and the well to do to carry some of the burden of the pension system by making them pay through a turnover tax of not more than 3 percent; 2) to introduce private pension funds; 3) to allow reputable foreign financial institutions provide pension (and other financial) services in the country.

4. EMPLOYMENT AND THE SME SECTOR

With the collapse of the Former Soviet Union and its system of production, open unemployment and under-employment has become a major problem in Kyrgyz Republic, as in other CIS countries. In January 2001, more than 78,000 people in search of employment were registered with urban and district employment service agencies. Of these 58,300 were officially registered as unemployed. More than half of the unemployed were women (31,000). The share of the youth was 40 percent (23,200), while that of rural residents was 49 percent (28,800). With the transition to a market economy, the Governments expect the private sector to shoulder a greater burden of providing employment. The role of the Government would be to create an appropriate environment for the private sector to generate employment and to increase productivity as well as providing protection for the unemployed. The Government has undertaken a number of measures in this direction. In particular, a legislation on Promotion of Employment has been approved by Parliament. Under this legislation, efforts would be made along the

following lines: a) increase of public works, b) professional training and retraining of the unemployed, especially those who lost their jobs as a result of privatization and reorganization of enterprises, c) development of micro-credit, d) assistance to the unemployed in their search for jobs, e) promotion of micro, small and medium enterprises, f) special attention to support for women in their efforts to find employment, and g) development of social partnerships in the promotion of employment by establishment of Tripartite Councils in the regions.

The development of the micro, small and medium enterprise sector holds potential for significant generation of employment, reduction of poverty and promotion of economic growth quickly. It would also promote entrepreneurship and the market economy. However, to develop the sector, major problems and constraints would need to be addressed. A recently conducted poll revealed that the weak, inadequate and costly financial system, problems with transportation, taxation of the SME sector, corruption and state regulation (in this order) are the main barriers for business to develop in the country. The problems of transportation are accentuated by the landlocked position of the country and inability of small exporters to use the advantages of the low cost of railway transportation, as there are no agents for freight forwarding, who unify small batches of cargo for rail transportation. The Government is taking several measures to simplify procedures for opening business, which is bulky and tiresome. It will take some time to see if these measures would be effective. The Government is seeking to work in two directions for the SME sector: a) creation of maximum favorable environment and b) promotion of entrepreneurial education.

We recommend that the Government ask the International Financial Corporation of the World Bank to establish an office for a CIS Facility for promoting SMEs in Bishkek. Such IFC-managed facilities mobilize donor resources for: a) conducting project feasibility studies on behalf of entrepreneurs using international and local consultants, 2) looking for foreign and domestic financing for such projects, 3) providing short-term consulting, business service support and training to existing SMEs with the goal of improving their efficiency. Such facilities have been in operation by IFC in Africa, the South Pacific and the Mekong. A similar facility operated in the Caribbean. IFC is now in the process of expanding such facilities in other parts of the developing world. The approach is for the IFC staff for the facility to be located at a regional office in one of the countries in a region. The staff would then travel to countries in the region to provide assistance. However, there can be an advantage for the country chosen for the regional office. It is for this reason that it is recommended that Kyrgyz Republic lobbies for a regional office of a CIS facility to be located in Bishkek.

5. AGRICULTURE AND AGRIBUSINESS

The key to Kyrgyz Republic's economic development lies in the development of the agricultural and SME sectors. The country is relatively well endowed with agricultural land and water resources. Arable land per capita is high as a result of extensive irrigation and long hours of sunlight and clear skies. In addition, human skills are available as a

result of scientific training and technical experience although marketing and financial management skills are lacking. The past decade has seen substantial structural reforms that create a positive environment for utilizing this potential. These include the establishment of private farms that have taken over from many old over-large state farms and cooperatives, the ending of most of direct government involvement in price setting and procurement of agricultural commodities, removal of some direct legal restrictions on participation in agricultural output and input markets, development of land rental arrangements for both private and state land and stabilization of key macroeconomic indicators, including inflation and exchange rate. The potential yield from agriculture therefore could be high.

However, obstacles to faster agricultural growth can be found in the lack of entry into agribusiness (agri-trade, agri-services and agri-processing). Agribusiness, which accounted for 20 percent of GDP in 1992, fell to only 10 percent in 1999. The lack of entry into agribusiness has affected farm productivity and profitability in two ways. First, demand for agricultural products is weak since efficient market mechanisms do not exist to connect farmers with domestic and foreign consumers as well as industrial users of agricultural products. During recent years, export of agricultural products constituted only 5 percent of total agricultural production. Second, farmers have poor market access to basic farm inputs and to new international technologies that are embodied in seeds, fertilizers, tools and other inputs.

Further obstacles to agriculture and agribusiness include government policies that continue to block and discourage entrepreneurs from entering or expanding their businesses. These include deficiencies in the tax system, excessive regulation, the regulated seed industry, government procurement of agricultural inputs and commodities, institutional set-ups (e.g. with regard to MAWR and recovery of old agricultural loans), low farm profitability which prevent farmers from making improvements to their land and irrigation systems, using better seeds, fertilizers. These underscore the absolute necessity to improve inputs and output markets to increase profitability. Other factors include reforms on land, water management and credit markets that have been completed and inadequate measures for dealing with agricultural and agribusiness risks (e.g. market monitoring, export market information and research programs and support of trade associations).

The result of these and increased agricultural unemployment in the face of inability to increase agricultural production above 1990 levels is that poverty in rural areas has been increasing steadily. About 59 percent of the rural population could not afford a minimum consumption basket in 1996. This rose to 71 percent in 1998.

Looking at agriculture and agribusiness together, opportunities for growth depend on linking farmers more efficiently to domestic and more importantly, export markets. The current situation – with more than half of all food products going directly from farmers to consumers without passing through any formal trade or processing as well as high income elasticity of demand for food– suggests that market development can bring

substantial gains in efficiency, allowing simultaneous improvements in production, GDP and consumer welfare.

While domestic demand is important, only more effective links to export markets can bring fresh sources of demand to support a faster, more sustainable agriculture and agribusiness growth. CIS export markets offer potential. They are relatively large and have established route for trade. However, non-CIS markets offer the fastest growth potential and links to new technology as well as better business practices and earnings in hard currencies. Domestic and external demand would be more rapid with the development of SMEs.

The goal in the development of the agrarian sector, along side with the provision of the country with basic foodstuffs will be to ensure sustainable growth of products for export. The strategy should be to address the foregoing problems, barriers and constraints. In addition, financial institutions that would serve the credit needs of the agrarian sector should be developed, strengthened and expanded (see under Financial Sector Reform). Other measures include establishment of feasible seed-growing farms, improvement of pasture use and rehabilitation of irrigation systems. The Government's role should be to create the necessary favorable condition and encourage the private sector to undertake these activities.

6. INDUSTRIAL SECTOR

Kyrgyz Republic has significant potential for further development of the mining sector, in particular, with regard to the attraction of direct foreign investment for gold production. Despite significant reserves, only the Kumtor gold deposit and the Kuru-Tegerek deposit in the Chatkal region have attracted foreign investment. Nonetheless, other companies are likely to invest in the sector in the near future. Continuation of the depressed market for gold and other minerals is a factor. In addition, investment in the sector is hampered by unsatisfactory regulatory framework which requires investors to undertake lengthy negotiations on a case by case basis, with uncertain outcome. The Government should seek to develop a fair and transparent framework for the mining sector (See above under Macro-economic Strategy). The Government should also put in place measures to deal with ecological/environmental aspects of mining.

Kyrgyz Republic also has potential for development of hydropower from its enormous resources. Only about 10-15percent of this potential is utilized. The country's hydro-power system was not built for its population. It was part of a system built for the civilian-military-industrial complex of the former Soviet Union. The country has 9 hydro-electric plants of which 3 are working well. The rest need considerable rehabilitation. The Toktogul Hydro-Electric Power Plant alone can provide electricity for Kyrgyzstan's entire population. This plant generates nearly 1.5 billion kwh per year but it can double its output when working at full capacity. In the short-term therefore, Kyrgyzstan has some major challenges to address in the electricity sector. Nonetheless, Kyrgyzstan turn this challenge into an advantage by using this asset to export electricity. The country currently exports electricity to Uzbekistan and Kazakhstan. Additional export markets for

hydropower will need to be developed. China is one such potential market. However, a regulatory and legal framework that would assure investors fair treatment and a fair return on investment will need to be established in order to attract investment capital. In addition, there must be the political will to privatize the sector and to increase tariffs substantially in order to allow full cost recovery with those most disadvantaged provided with assistance through social protection programs. It is possible that Kyrgyzstan can export electricity to China by following a strategy used by Bhutan in getting a hydro-electric dam built for sale of electricity to India.

Kyrgyz Republic currently produces oil in very small quantities. However, the country has the potential for oil production and export in large quantities. Kadima Petroleum, a Canadian oil company has recently discovered the largest oil field in Tien-Shan mountain rocks of south Kyrgyzstan. In addition, the probability of finding other large oil and gas reserves is said to be very high.

Kyrgyzstan also has a large potential to export glacial water to Europe and other regions. Kyrgyz Republic's glaciers area covers about 6,500 square kilometers and the reserves of glacial water is believed to be large. Globally, water is increasingly becoming a scarce commodity and countries like Kyrgyzstan that are blessed with this natural renewable resource should be able to generate much revenue from its export. A German company last year signed a contract for the production and export of the clean and sweet glacial water of the Tien Shan glaciers of Kyrgyzstan.

Exports of tobacco and its products and well as cotton and products resulting from cotton processing such as textile earn Kyrgyzstan not an insignificant amount of revenue and has the potential for further development. Last year the country earned US\$ 47 million and US\$ 23 million, respectively, from these two commodities. The potential exists for increasing these exports.

7. TOURISM

The rich natural, recreational and ecological assets of the Kyrgyz Republic offer much potential for the development of tourism, specialized forms of tourism such as health tourism, winter tourism, hunting tourism and eco-tourism. At least 200 private tour companies presently operate in the country. The number of foreign tourists visiting the country is growing at a rate of about 14 percent per year. To promote tourism, the Year 2001 was declared as Tourism Year in the country. Tourism should be promoted through: a) development of information and advertising campaign in major tourism markets, b) creation of favorable administrative and legal environment for tourists, c) privatization of resort facilities and promotion of private sector activities, d) development of tourism infrastructure, e) attraction of FDI into the sector, f) creation of favorable conditions for cooperation by banks, transport operators and hotels in the sector, etc.

8. FINANCIAL SECTOR REFORM

The banking system in Kyrgyz Republic is fragile, under-capitalized and provide limited short-term lending for businesses. Equity financing, venture capital, leasing operations and other long term capital are practically non-existent. Donor credit lines attempt to fill in the gaps in access to long-term capital. However, in many cases there is mismatch between the loans demanded and supplied. Under the CDF, the banking and financial sector will be reformed to create a competitive environment, increase confidence in the sector and create a favorable operational environment. Financial sector reform will be one of the critical elements in both the achievement and maintenance of macroeconomic stability and private sector-led economic growth.

To establish and maintain a sound banking system, the NBKR will be strengthened and its independence and capacity to perform supervision of the banking system improved. A deposit insurance scheme that would improve confidence in the banking sector should be developed as soon as possible. The judicial agencies would be exposed to technical aspects of banking activities in order to facilitate the work of bank supervision inspectors in the application of sanctions with respect to banks, which violate prudential norms. The legal framework of the banking system would be reviewed with respect to laws and regulations governing collateral and rights of creditors to enforce collateral.

Some policies have recently been undertaken to improve the financial sector. The Government would continue improve the legal and regulatory environment through effective implementation and enforcement of these policies. Government would support the development of a more diversified and deeper financial sector to meet the needs of the emerging private sector and to allow the development of new financial instruments that facilitate the conduct of monetary policy by NBKR.

We recommend that the Government encourage some strong international banks and financial institutions to enter the country. Such institutions will be instrumental in developing a sound pension system, in improving the quality of financial institutions in the country and in making the banking sector competitive. At the same time, the number of banks is too large for a country of this size. The Central Bank should take measures, which would encourage mergers of existing banks.

Financial diversification and deepening would also lead to the creation, strengthening and expansion of leasing companies, export financing, non-government pension funds and insurance companies. The enabling legislations for these institutions would be enacted, following which their operations would be supervised rigorously by the newly-invigorated non-bank department of the ministry of finance.

Financial diversification and deepening will further lead to the creation, strengthening and expansion of micro-finance institutions as well as agricultural and rural credit institutions necessary for fighting poverty given that poverty in this sector is more than 70 percent. The Kyrgyz Agricultural Financial Corporation would be transformed into a Rural Development Bank.

More than 10 NGOs presently provide micro-credit in the Republic, with branches in all the oblasts. They operate within the framework of credit unions with high repayment rates. Many of these micro-credit organizations provide a similar set of services: training, consultation and credit. The sector, however, is in its infancy and needs support. In this connection, a Micro-Credit System Development Concept for the Republic is being drafted. A special Government agency, which will not provide credit but coordinate activities of micro-credit organizations would be created. The activities of micro-credit organizations will be expanded and strengthened.

Corruption of the judiciary is a major factor in the weakness of the banking and financial institutions sector. It makes it impossible for financial institutions to deal with clients who default on loans as corrupt judges rule in favor of borrowers and make it impossible to seize collaterals pledged for loans. To deal with this problem, we recommend that cases involving seizure of collateral be dealt with quickly and without obstacle through a Special Agency set up for this purpose as is done in Turkey and not through the courts.

9. INFRASTRUCTURE

Economic infrastructure in Kyrgyz Republic, including surface transport (roads), airlines and other air transport infrastructure, telecommunications infrastructure, railway infrastructure, and water and sewage infrastructure requires investment to meet the country's growth requirement. Priority areas include the completion of the Bishkek – Osh road and privatization of Kyrgyz Airlines. It is important that infrastructure projects meet economic and financial criteria of viability as well as other criteria set for projects to be included in the country's PIP. Economic infrastructure generally is expensive yet it is a major component for promoting growth. Therefore, the Government's strategy should be to seek the participation of foreign and the local private sector in developing, operating, maintaining and owning these infrastructure, and where feasible to leave their development completely to the private sector. Due to imperfect legislative work, the level of attraction of foreign direct investment in the sector remains low. The situation needs to be corrected. About 28 percent of the rural population does not have access to safe and reliable water supply and about 70 percent of existing systems need rehabilitation. Rural areas do not have access to sewerage and even in urban areas the network covers only about 60 percent of the population. The Government should provide support to local communities, which would participate in partial repayment of capital expenses and take over a major part of obligations for maintenance of these facilities, using the services of NGOs.

10. ENERGY SECTOR

Activities and reforms needed in the energy sector are many and require financial resources much beyond what the Government can provide. Electric power production and distribution is a priority area. It has the potential for increasing the country's export. (See above). Availability of reliable energy supply at competitive prices would also help

induce the inflow of FDI in other sectors of the economy. Investment is needed in the mining of energy materials such as coal, crude oil and natural gas, and in exploration for new deposits. Joint stock companies Kyrgyzenergo and Kyrgyzgas need to be divested (See above under privatization). Local energy losses need to be rationalized and services to users should be improved. Gas distribution should be privatized, transmission lines need to be transferred to the private sector for management, and a tariff regime and tariffs on energy that would attract the private sector need to be instituted. Here again, the Government's strategy should be to seek the participation of both FDI and the local private sector. It is important that energy sector projects meet economic and financial criteria of viability as well as other criteria set for projects to be included in the country's PIP.

11. GENDER

The CDF report states that "the status of women has always been and remains relatively high among the people of Kyrgyz Republic, where women have in most cases had good access to education and skilled work opportunities". The report goes on to state that "compared with neighboring countries, women (in Kyrgyzstan) are well represented in the supreme bodies of state power. The report further stated that "however, continued efforts need to be made by the authorities in order to that women's equal social status is maintained. This is being strongly supported by a growing women's movement a feature of which are the NGOs engaged in the protection of women's rights".

The Government of Kyrgyz Republic has put in place the constitutional and legal frameworks for promoting the status of women and has legislated and ratified the necessary international agreements. A national "Ayalzat" program has the objective of uplifting the livelihood of women. However, the reality of the situation on the ground is that overall, gender disparities have increased significantly in Kyrgyzstan since the country embarked on transition to a market economy. Women have disproportionately borne the burden of transition. While growing poverty, unemployment and the weakening social support and services have been experienced by both genders, women are affected more than men. The situation may be better compared to some other countries in the region, but this should not lead to complacency.

The painful process of democratization in the newly independent state and the establishment of a market economy have on the one hand created new opportunities for women but on the other hand harmed their position or allowed new opportunities to bypass them. For example, on the one hand, women are at par with men in the area of small and medium business. On the other hand, men gained ownership of most of the enterprises and land that were divested. We recommend that this situation be corrected by, promoting women entrepreneurs and assisting them with loans, especially loans provided through donor programs.

Women occupy one-third of the official posts in the country. They suffer from unemployment. About 12 percent of women with diplomas are said to be unemployed

and the average salary of women is 520 soms compared with 728 soms for men.² We recommend that the Government set up a policy for the achievement of gender pay equity during the CDF period. Special programs be also set up to assist unemployed women find jobs.

Women representation in political leadership in Kyrgyz Republic has declined sharply in the post-Soviet period. Women have been removed from the decision-making echelons of power in society and the state.³ For example, currently, only six of the 105 deputies (parliamentarians) are women. Similarly, only nine of the 102 Republican Directors (Governors) are women. The low representation of women in political leadership is attributed to: societal attitudes which undervalue women's leadership, discrimination within political parties and other organizations, women's lack of familiarity with the political machinery and women's triple role in society (reproductive, productive and community work).⁴ Other factors include a low level of gender awareness and lack of media support. The situation also reveals the instability of women's positions in administrative levels during the Soviet era, which was based on the allocation of quotas, rather than a factually achieved equality of rights. We recommend continued efforts in increasing the representation of women in political and other leadership.

12. CORRUPTION

According to the International corruption index, Kyrgyz Republic is one of the most corrupt countries in the world. This was confirmed during our discussions with business people, bankers and the civil society. We heard numerous stories of how pervasive corruption has become in all layers and sectors of the society. Corruption will be one of the biggest threats to the private sector-led economic growth and development strategy adopted in the CDF.

Business people complain of the high cost of doing business and the uncertainty that corruption bring about. Corruption is becoming a major deterrent to doing business in the country. Some foreign companies and businessmen are even threatening to leave the country because of corruption. The CDF report mentions the Government's determination to deal with the problem. However, no concrete measures were cited to deal with it. To break the back of corruption, we recommend that an anti-corruption vigilante with branches in cities, towns and villages throughout the country and with a hotline be set up so that people can report cases of corruption and attempts at corruption. Cases reported would then be dealt with by a people's court and not through the formal court system. We recommend that the Government set a target for a reduction of the country's corruption index over the CDF period of 10 years. Top politicians and Government officials may also be required to declare their assets when they are appointed.

² The Bishkek Observer, April 29th, 2001

³ Anara Tabyshalieva, "Women of Kyrgyzstan: Access to Political Power", Bishkek, 1999.

⁴ UNDP, "Promoting Women in Leadership Project", Annual Report, March 1999 – May 2000.

We also recommend that as part of the public sector reform, salaries be increased so as to discourage public sector corruption. The country will be better off with a lean well paid public service than a fat underpaid and corrupt one.